COMPANY RESEARCH AND ANALYSIS REPORT

DYNAM JAPAN HOLDINGS

06889

Hong Kong Stock Exchange

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Index

Summary

Secured earnings despite a tough business environment; aims to capitalize on stricter regulations to accelerate growth

Dynam Japan Holdings Co., Ltd. (HK06889) is one of Japan's largest operators of pachinko halls with the largest number of halls operated. Its strength and characteristics lie in its low-cost operations based on chain-store theory, which it thoroughly applies to newly opened halls as well as to daily hall operations. In addition, the Company was the first in its industry to be listed on a stock market, which is a result of its management having won recognition for its full enforcement of a customer-first creed, information disclosure, compliance management, and other factors.

1. Secured earnings in FY3/18 1H despite a tough business environment

The Company posted higher earnings on a decline in sales in FY3/18 1H, with operating revenue at ¥77,211mn (-3.3% YoY) and operating profit at ¥8,722mn (+6.3%). While operating revenue missed the previous year's level, due to pressure from stricter gambling regulations, operating profit improved with help from cutbacks in operating expenses enabled by the Company's robust low-cost operations. The Company is delivering steady results from sales efforts that leverage regional characteristics with the aim of increasing hall sales and is seeking to lift overall sales by sharing success cases.

2. Two-pronged growth strategy – hall network expansion and increasing revenue of existing halls

The Company implements a growth strategy that consists of hall network expansion and increasing revenue of existing halls. It focused in recent years on lifting same-site sales in response to the industry's market shrinkage and customer losses. Specifically, it achieved steady results through major hall renovations and adjustments to operating methodology. Although the shrinking market makes it difficult to sustain these benefits over a lengthy period, the Company employs rigorous low-cost operations that enable it to generate stable EBITDA capable of covering dividends and investments in growth.

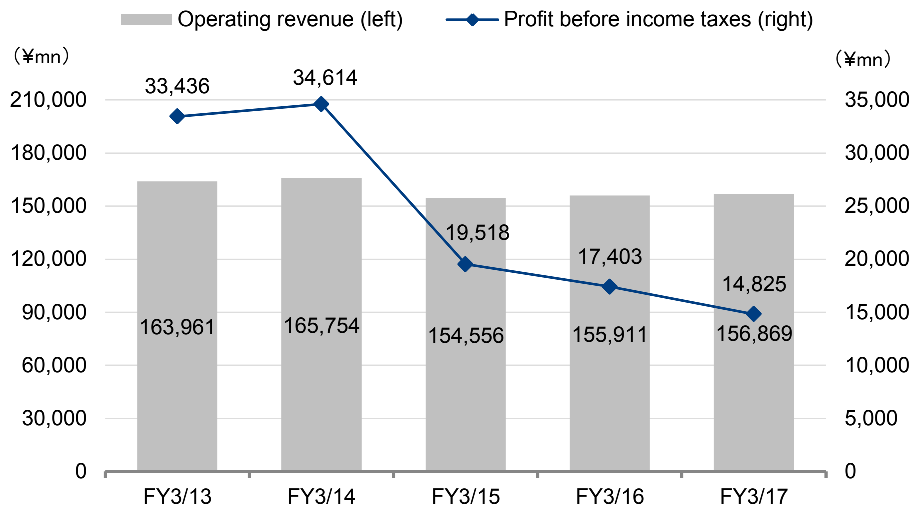
3. Possible acceleration of the growth strategy through expanded hall numbers with stricter regulations as a catalyst

Authorities continue to apply gambling-related regulations in the pachinko industry. New regulations are coming in February 2018 following a stricter rule on the major-win probability ratio adopted in 2016. While the Company is wary of the impact from these regulations, it could also benefit if tougher regulations serve as a trigger for widespread reorganization in the industry via hall closures, bankruptcies, and other changes. Although the Company mainly opened halls according to a standard format based on strict criteria up to now, it intends to aggressively pursue hall network expansion by moving into closed hall locations and engaging in M&A.

Key Points

- Tougher regulations might sustain the long-term trend of market shrinkage
- Two-pronged growth strategy – hall network expansion and increasing revenue of existing halls
- Possibility of sudden acceleration of the growth strategy driven by an increase in the number of halls leveraging low-cost strength and management prowess

Trends in operating results



Source: Prepared by FISCO from the Company's financial results summary materials

Company profile

Steadily expanding business with revolutionary measures based on chain store theory and became the first industry firm to be listed on a stock market

1. History

#Yohei Sato, the father of Yoji Sato, a current Senior Corporate Advisor, founded Sawa Shoji Co., Ltd. in 1967. Yoji Sato, the eldest son who was working at The Daiei, Inc. at the time, took over the business in 1970 when his father passed away, and steadily expanded operations.

The Company was a pioneer in the pachinko hall industry by acting on new initiatives ahead of peers, including hiring new university graduates, suburban halls and low-cost halls, forming a labor union, and beginning low-fee ball rental. Yoji Sato was an important factor in the Company’s adoption of a progressive corporate culture. He joined Daiei due to interest in “chain store theory” that was still a novel concept in Japan. He subsequently managed the Company after the death of his father, who was the founder, and expanded business by consistently applying chain-store theory to pachinko hall operations. Chain store theory is the source of low-cost operations, the Company’s largest strength.

His logical approach rooted in chain store theory took hold as the corporate culture and served as a fundamental force lifting Dynam to the position of being the top industry firm. The Company also moved quickly in embracing the most important concepts for modern management of a customer-first ethos, information disclosure, and compliance, providing a foundation for its listing on the Hong Kong Stock Exchange in August 2012.

Company history

Date	History
July 1967	Founded Sawa Shoji Co., Ltd. (opened the Kameari and Kanamachi halls)
November 1987	Renamed as DYNAM Co., Ltd.
April 1989	First group of new university graduates entered the firm
October 1993	Became a corporate member of the Pegasus Club, an organization that analyzes chainstore operations.
August 1994	Opened the Company' s first low playing cost pachinko hall made of wood in Ebetsu, Hokkaido.
July 1997	Held the Company's first business results briefing with securities analysts.
April 1998	Established the Dynam Union, the first labor union in the pachinko industry
December 2006	Started the first low ball rental fees (pachinko ¥2, slot ¥10) at the Ebetsu hall Established DYNAM HOLDINGS Co., Ltd.
September 2011	DYNAM JAPAN HOLDINGS Co., Ltd. is established, as a result of incorporation-type company split from DYNAM Holdings Co., Ltd.
August 2012	Listed shares on the Hong Kong Stock Exchange
January 2013	Incorporated the Hong Kong entity, Dynam Hong Kong Co., Limited
June 2013	Announced an investment of $35mn in Macau Legend Development Limited
October 2013	Announced an investment of $15mn in IGG Inc.
November 2015	Consolidated Yume Corporation Co., Ltd.

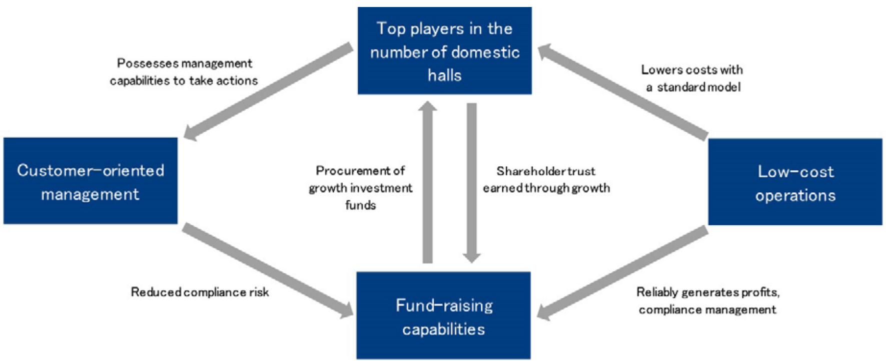
Source: Prepared by FISCO from the Company's website and securities report

Possesses a robust business foundation and achieves differentiation from other firms by leveraging four strengths

2. Dynam Group's features and strengths

We focus on four points as the Company's attributes and strengths – 1) top player in terms of the number of domestic halls, 2) low-cost operations, 3) customer-oriented management, and 4) fundraising capabilities. Importantly these strengths are mutually interactive. We think it is difficult for other firms to realize the same combined strength seen at the Company.

Relationship among the four strengths of the DYNAM Group



Source: Prepared by FISCO from interviews

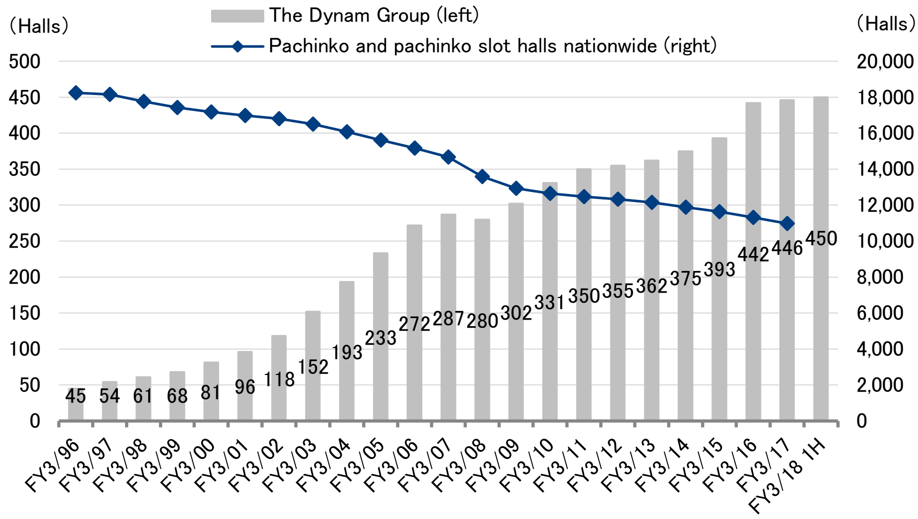
(1) Top group with 450 halls in Japan

The Company has the largest number of halls in the industry with 450 halls as of the end of September 2017 and holds a 4% domestic share.

Economies of scale are a valuable benefit of having a large number of halls (scale merit). They extend to new hall openings, renovations, machine deployment, prize procurement, and logistics and others. Machine deployment is particularly important. The large number of halls naturally means having many pachinko and pachislot machines, thereby enhancing buying (price negotiating) power with equipment manufacturers.

Benefits at Yume Corporation, which entered the Group in November 2015, offer a specific example of scale merit. Yume Corporation reduced costs by a total of about ¥700mn (on an annualized basis) after joining the Group in items such as game machine purchases, logistics, and financing costs. The savings corresponds to 12% of Yume Corporation's previous costs.

Trend in number of group halls



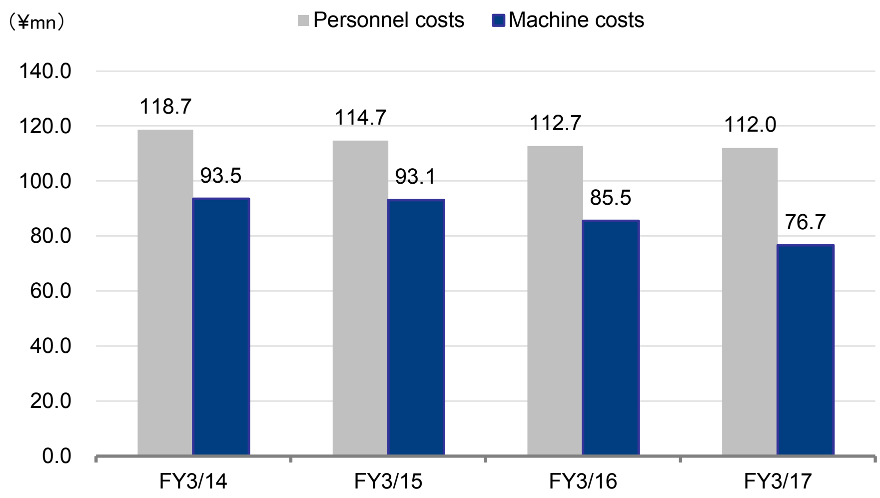
Source: Prepared by FISCO from the Company's results briefing materials

(2) Low-cost operations based on the chain store theory

Low-cost operations are a vital source of the Company's competitiveness. Our understanding is that this aspect enables the Company to realize and benefit from various measures, including the growth strategy.

The chain store theory provides the theoretical backdrop to low-cost operations. Costs of personnel and machines constitute a large portion of the total cost of operating a pachinko hall. Yet it takes more than just direct cost cutbacks. The Company is succeeding with low-cost operations as an overall group by deploying hall designs and hall operating systems (such as ball counters at each machine) that facilitate operations with a small number of employees and by standardizing new halls. The chain store theory plays an important role in a variety of ways and is enabling low-cost operations for the Group.

Trend in personnel costs and machine costs per hall



Source: Prepared by FISCO from the Company's results briefing materials

The Company is the industry leader in Japan, as mentioned earlier, with 450 halls. Aggressive multi-site operations support this position and low-cost operation know-how has been an essential enabler. Hall network expansion has created a virtuous cycle of cost reductions through scale merit that has put the Company in its strong position. We think the customer-oriented management explained below is an outcrop from low-cost operations as well.

The history section explained the background to the Company's utilization of the chain store theory in its management. The Company established the Pachinko Chain Store Association (PCSA), an industry group, with peers who have a similar view, and this entity has been researching application of the chain store theory to pachinko hall management. PCSA activities have not only contributed to strengthening the business foundation of industry peers, but also played a major role in the Company's expanded scope with the addition of Yume Corporation to the Group.

(3) Implementing management from a customer perspective

The Company advocates a customer-first approach as one of its five business policies and has been taking action. This stands out because we think few peers who promote a similar policy are actually seeing actions through.

Among the Company's business policies, we have a favorable view of a) low ball rental fees and b) operations that do not rely on gambling appeal.

a) Low ball rental fee operations

Pachinko is a game that is played with rented balls. The fee for renting balls (halls lend the balls) had been ¥4 per ball. Low ball rental fee operations take a cheaper approach that lowers the fee to ¥1 or ¥2. Customers can rent more balls for the same price, extending their playing time in accordance with the additional balls. The Company has been aggressively opening halls with low ball rental fee formats, which install a high ratio of low-fee ball machines, and increasing installation of low ball rental fee machines at existing halls too. Its low ball rental fee machines currently account for 71.0% of pachinko machines and 56.1% of pachislot machines, substantially exceeding industry averages (as of the end of June 2017).

Data shows that halls offering low ball rental fees have attracted more customers than halls charging higher fees. Yet it takes substantial company wherewithal to adopt this type of strategy as margin declines at halls with low ball rental fees see weaker revenue than halls charging higher fees without much difference in operating costs. A measure to offset this aspect is growth through expansion of hall numbers. The Company has truly followed this path.

b) Operations that do not rely on gambling appeal

As specified, the Company does not position models with strong gambling content as a central strategy. It offers a wide range of pachinko machines from ones with high probability of major wins to ones with low probability. Machines with lower probability give a larger number of balls in a major win and are preferred by pachinko fans. Many pachinko halls hence attract customers by operating halls with an elevated ratio of machines that have low major-win probability (in other words, machines with strong gambling features).

However, authorities introduced regulations to curtail gambling content in FY3/17, lifting the minimum probability threshold from 1/400 to 1/320. The industry removed 1/400 machines by the end of December 2016. New regulations are coming in February 2018 as recent discussion of measures to address addictions gives impetus to restrictions on gambling content. These changes hurt the pachinko hall management style that attracts customers with gambling appeal.

The Company, meanwhile, has a lower ratio of gambling-type machines than the industry and the share of machines with the lowest gambling features at 1/100 probability conversely is 20% higher than the industry average. We expect some impact on the Company from stricter regulations on gambling as well, though the impact should be relatively modest based on its machine composition.

(4) Fundraising capabilities that leverage strength as a listed company

The Company became the first in the pachinko hall industry to list its shares with its IPO on the Hong Kong Stock Exchange in 2012. Only three companies, including the Company, out of the pachinko hall industry's roughly 3,400 firms are listed on stock markets. The industry is projected to face reorganization going forward. An important point for a buyer in this environment is obviously whether it has fundraising capabilities. The Company capitalized on its strength as a listed company to acquire Yume Corporation in November 2015 through a stock swap for all of its shares. We anticipate very strong benefits for the Company as a listed company in non-M&A areas too because of the likely need for a variety of funds in the future for hall investment, new business development and other initiatives.

Medium- to long-term growth strategy

Tougher regulations might sustain the long-term trend of market shrinkage

1. Industry environment

Major themes in the pachinko hall industry, to which the Company belongs, are long-term shrinkage and tougher regulations. These are both headwinds for companies that operate pachinko halls.

Long-term shrinkage is continuing and does not show any sign of reversal. The pachinko hall market (total of rental ball revenue at pachinko halls that corresponds to gross sales) declined 6.9% YoY to ¥21,626bn in 2016. We expect further contraction of the market in 2017 in light of FY3/18 1H results announced by the Company, which is one of the largest hall operators in the industry.

The number of pachinko and pachislot halls nationwide has also been steadily dropping due to ongoing market contraction. The number of halls has been falling at a pace of 200-300 halls per year over the last few years and was down by 324 halls from the previous year to 10,986 halls as of December 2016 (National Police Agency data). This is the lowest level in 20 years.

Considerable attention has been given to applying tougher regulations in recent years. Regulatory action primarily aims to reduce gambling content as a specific measure to battle addictions. Regulation of gambling content heavily affects pachinko hall management because gambling is one of the appeals of pachinko and pachislot games.

A regulatory change in 2016 raised the major-win probability ratio of pachinko machines. Machines with the strongest gambling content prior to then utilized a major-win probability of 1/400. After industry removal of these machines by the end of 2016, today's most potent machines for gambling are those with a 1/320 ratio. Stricter regulation hence changed pachinko from a high-risk, high-return game to a middle-risk, middle-return game.

Authorities plan to roll out new regulations on the output ball ratio and output ball numbers from February 1, 2018. These revisions seek to lower the gambling appeal through restriction of the number of balls obtained from a major win (details are given below).

Core pachinko fans generally exhibit a stronger preference for machines with strong gambling qualities. Diminished gambling appeal thus is likely to result in customer defections. Furthermore, machines with stronger gambling content are more profitable than those with less from a pachinko hall perspective. Regulations on gambling content impacts pachinko hall management through customer defections and less favorable sales mixes.

Rollout of stricter regulations on pachinko might continue because of the IR (Integrated Resort) Promotion Act (Casino Act). The IR Promotion Act itself is program legislation that outlines a basic policy and schedule for promotion of integrated resorts, including casinos, and the government still needs to formulate the IR Implementation Act that stipulates detailed matters. In the discussion process, participants have been calling for measures to address gambling addictions in existing industries, such as horse racing, bicycle racing, and other public-operation competitions and pachinko. This situation is contributing to initiatives to strengthen regulations.

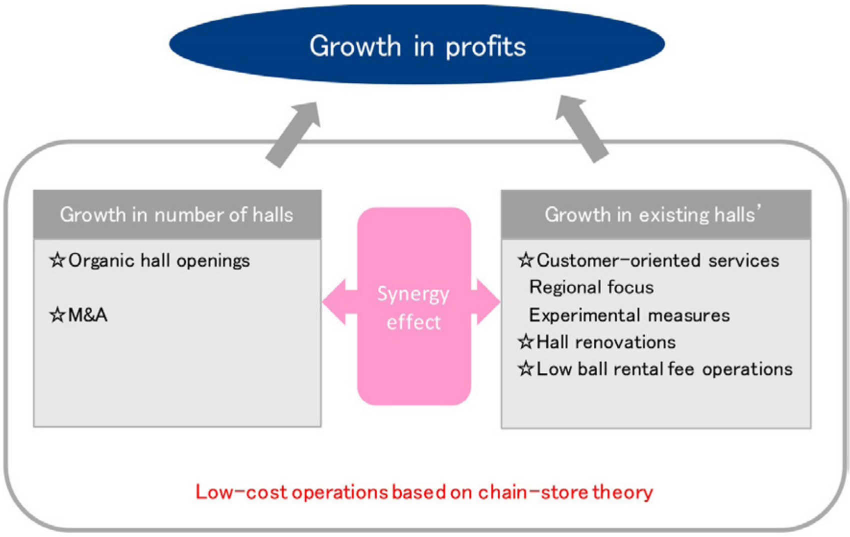
Two-pronged growth strategy – hall network expansion and increasing revenue of existing halls

2. Fundamental approach of the growth strategy

The Company is the top domestic pachinko hall operator in terms of the number of halls. It has presented a long-term goal of running 1,000 halls in Japan and is striving for growth driven by hall network expansion. In recent years, however, the number of sites that meet the Company's opening criteria has dwindled and it is also putting emphasis on growth from raising revenue at existing halls.

The Company adopted a two-pronged approach in the growth strategy that adds a push to increasing revenue of existing halls to its longstanding efforts of driving higher sales through hall network expansion. Both initiatives are similarly important to the growth strategy. We think a key point is flexible use of the growth strategy depending on the business environment in the industry and conditions of rivals (please refer to our past reports for details on the hall opening model for expansion of the hall network and initiatives to increase existing hall revenue).

Image of the two-pronged growth strategy – hall network expansion and increasing revenue of existing halls

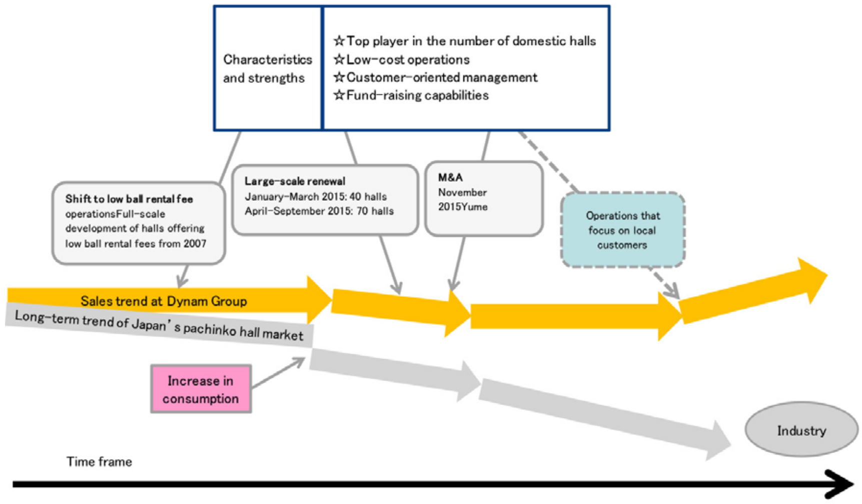


Source: Prepared by FISCO from Company materials

While the Company worked in recent years to bolster the profitability of individual halls, it might be shifting emphasis to growth through expansion of the hall network again in light of a possible acceleration in reorganization of the industry due to increasingly difficult business conditions linked to stricter regulations. While tougher rules negatively affect the Company too, we see stronger resilience to this headwind than other companies as explained above. We believe the Company is capable of converting the headwind from stricter regulations into a catalyst that accelerates its growth by leveraging robust corporate operations and strengths.

Sufficient evidence exists to support this type of scenario. The chain store theory serves as the basis of the Company's management policies and decisions, and the Company possesses know-how for low-cost operations utilizing this theory. Accumulated experience is enabling the Company to generate about ¥30,000mn in annual EBITDA even in the current difficult business environment. We thus think the Company has enough funding to realize its growth strategy.

Conceptual image of the DYNAM Group's various measures and medium- to long-term growth strategy



Source: Prepared by FISCO from Company materials

Possibility of an unprecedented turning point in the industry due to new regulations planned for implementation in February 2018

3. Anticipated changes in the industry environment in 2018

The biggest issue confronting the pachinko and pachislot industry at this point is new regulation planned for implementation in February 2018. Authorities aim to curtail gambling content by regulating 1) the upper limit on the output ball ratio to around two-thirds of the current level and 2) the number of balls received per major win to roughly two-thirds of current volume.

Content of new regulations

	Current regulations	New regulations
Upper limit on output balls	Maximum rounds: 16R Maximum paid output balls: 2,400 balls	Maximum rounds: 10R Maximum paid output balls: 1,500 balls
Playing tests	1 hour: Output ball ratio 3x or less 10 hours: Output ball ratio at no less than 1/2x and up to 2x	1 hour: Output ball ratio at no less than 1/3x and up to 2x 4 hours: Output ball ratio at no less than 2/5x and up to 1.5x 10 hours: Output ball ratio at no less than 1/2x and up to 4/3x
Setting	No setting	Supports settings at 1-6 levels similar to pachislot machines

Source: Prepared by FISCO from Company materials

The industry eliminated 1/400 machines with the lowest probability of major wins (giving them strong gambling qualities) following implementation of a rule to raise the major-win probability ratio in 2016, and this moved 1/320 machines into the category of strongest gambling content. As a result, pachinko and pachislot shifted from being high-risk, high-return gaming with a strong gambling tone to middle-risk, middle-return enjoyment. Planned regulations on output balls are likely to proceed further in this direction.

With the 2016 regulation, halls encountered substantial pressure to replace machines with strong gambling content, including voluntary regulations in the hall industry. The February 2018 regulations, however, allow for continued use of existing machines for as long as three years (through January 31, 2021) if approved. While it is likely to cost about ¥10,000 per machine to acquire approval, hall operators can avoid incurring the capital investment burden accompanying the regulations in a short period of time and take actions to replace machines that meet the new rules at a moderate pace.

Therefore it is difficult to forecast earnings impact from new regulations at this point, though industry trends should continue to be monitored closely going forward.

Possibility of sudden acceleration of the growth strategy driven by increase in the number of halls leveraging low-cost strengths and management prowess

4. The Company's initiatives

The Company intends to address unprecedented changes in the environment accompanying implementation of new regulations in February 2018 with 1) initiatives to lower costs, 2) initiatives to increase operating revenue, and 3) implementation of the growth strategy.

(1) Initiatives to lower costs

The Company has substantially increased the efficiency of its cost structure, compared to industry peers, thanks to deepening and advancing its low-cost operations based on the chain store theory. Nevertheless, we think it must improve cost efficiency even more in order to continue securing profits. Management aims to pursue further initiatives toward reduction of machine costs to address new changes in the business environment. Pachinko halls periodically deploy new machines to maintain freshness and attract customers. Machine costs, which run about ¥400,000 per machine (for pachinko), however, constitute a heavy burden.

The Company plans to extensively deploy private-brand (PB) machines as a way of dealing with this issue. It currently has about 210,000 machines at its halls and will introduce 28,000 PB machines over the next three years. This roughly targets replacement of about 10% of machines with PB machines considering further additions to hall and machine numbers during the period. Deployment of 28,000 machines could offer ¥2.8bn in savings, assuming a price benefit of ¥100,000 per machine for installation of a PB machine, or around 15% of current annual operating profit.

The Company uses a period of three years because PB machine deployment requires a certain amount of time. Nevertheless, this does not leave it fully exposed to changes in the environment from implementation of new rules because existing models can still be utilized for the next three years if they receive approval under the new rules, as explained above. Application of the regulations hence can be postponed. The Company aims to obtain approval for 120,000 machines, or about 60% of its roughly 210,000 existing machines, thereby avoiding the impact of new regulations and curtailing costs required for replacement with new machines while reinforcing PB machines.

The planned PB machines are likely to be at the lower end of gambling content with major-win probability ratios ranging from 1/100-1/200, an indication that the Company remains committed to its stance of operations that do not rely on gambling.

(2) Initiatives to increase operating revenue

The Company's initiatives to increase operating revenue overlap with the target of increasing revenue of existing halls, which is a core component of the growth strategy. Considerable attention has been given to this area in recent years. Our previous report reviewed reinforcement of individual hall management as one example. This effort seeks to attract customers by developing halls that harness unique features of individual sites (locality, customer segment, and others) and sales promotion activities. Some halls are already achieving major successes, and the Company seeks to increase the number of successful halls by sharing best practices (success cases).

The Company also introduced improvement and utilization of customer data analysis technology as a new effort. It possesses customer information for about 4mn people through issuance of member cards and compiles a variety of quantitative data, such as pachinko machine output ball volume and utilization rates. It plans to develop data analysis software to promote effective utilization of this massive amount of data and leverage analysis results to improve the efficiency of customer draw.

(3) Implementation of the growth strategy

The Company's growth strategy employs a two-pronged approach of growth in revenue at existing halls and hall network expansion. We already reviewed efforts to increase revenue of existing halls above. The Company also plans to ramp up hall network expansion.

The Company mainly opened halls using a standard hall model that it has developed up to now. It opened only five halls in FY3/17 and plans to open only six halls in FY3/18. The Company took this approach because almost no properties met its internal criteria for profitability and efficiency. However, it has presented a strategy for future openings entailing moving into vacated halls and using M&A deals, in addition to opening its own halls based on the standard format.

The change in its opening policy reflects the increasingly difficult business environment. The Company expects more hall closures in the industry and a substantial rise in sales of halls that meet its criteria after implementation of the new rules. It decided to alter the opening policy to a more aggressive stance that leverages its robust balance sheet and fundraising capabilities as a listed company and actively takes advantage of opportunities with halls that meet its criteria (rather than just opening self-developed sites).

Furthermore, while there is some overlap with operations tailored to the regional attributes of individual stores from the above-mentioned efforts to increase operating revenue, the Company intends to put further emphasis on operations that focus on people and coexistence with local areas. Activities are taking place at all of the Company's halls, and in-house awards were given to 15 halls with particularly strong results in 1H. We think the approach of focusing on customers and the development of unique incentives to foster them by individual halls, such as improvements in hall comfort and pursuit of operations with lower rental ball fee and gambling levels, is very interesting.

Even more important, however, is that the content of initiatives recognized as successes adhere the Company's past efforts to promote pachinko as daily entertainment. This provides evidence of the correctness of the Company's view and approach. We think the "focusing on people" project should have a sufficient effect as a growth strategy.

Results trends

Posted higher operating profit on lower revenue in FY3/18 1H

1. Summary of FY3/18 1H results

The Company reported a profit increase despite lower revenue, with ¥77,211mn in operating revenue (-3.3% YoY), ¥8,722mn in operating profit (+6.3%), and ¥5,430mn in profit attributable to owners of the parent (+40.7%) in FY3/18 1H. EBITDA rose 2.4% to ¥14,783mn.

Summary of FY3/18 1H results

(¥mn)

	FY3/16	FY3/17	FY3/18		
	1H	1H	1H	YoY	Change
Ball rental fee revenue	417,104	416,246	397,127	-4.6%	-19,119
Cost of prizes	341,261	336,438	319,916	-4.9%	-16,522
Operating revenue	75,843	79,808	77,211	-3.3%	-2,597
Total expenses	68,460	71,600	68,489	-4.3%	-3,111
Operating profit	7,383	8,208	8,722	6.3%	514
Profit before income taxes	7,323	6,635	8,406	26.7%	1,771
Profit attributable to owners of the parent	4,784	3,860	5,430	40.7%	1,570
EBITDA	13,170	14,431	14,783	2.4%	352

Note: Total expenses include vending machine revenue and other revenue and expenses.
Source: Prepared by FISCO from the Company's financial results summary materials

Rental ball revenue, which corresponds to gross sales, dropped 4.6% (¥19,119mn) YoY to ¥397,127mn. Stricter regulations on gambling content meant that FY3/18 started in an environment with 1/320 machines as the most potent gambling models. While the Company has developed halls with a lower ratio of models with strong gambling content than at other operators in line with its existing policy of “not relying on gambling,” it was unable to avoid the impact of difficult conditions in the overall industry, and this led to a decline in rental ball revenue.

Operating revenue is the amount remaining after deducting the cost of prizes from rental ball revenue, and the ratio of operating revenue to rental ball revenue is the gross profit margin. The gross profit margin climbed 0.2ppt YoY to 19.4% in 1H and thereby helped limit the decline in operating revenue to 3.3% (¥2,597mn) YoY.

In costs, the Company leveraged its strength of low-cost operation to boost the efficiency of hall operations. It has also worked to ensure efficient use of sales promotion spending and lower costs for equipment upkeep. These efforts resulted in a 4.3% (¥3,111mn) YoY decline in overall expenses (including vending machine revenue and other revenue and expenses). Operating profit increased 6.3% (¥514mn) YoY to ¥8,722mn as the decline in total costs exceeded the setback in operating revenue.

The Company had 5 hall openings and 1 closure in FY3/18 1H, lifting the total hall count by 4 halls to 450 halls compared to six months earlier at the end of September 2017. The breakdown by operating company is 404 halls at DYNAM Co., Ltd., 38 halls at Yume Corporation, and 8 halls at Cabin Plaza Co., Ltd.

The Company also worked to improve its balance sheet in FY3/18 1H. While it already had a net-cash position, in which cash and deposits exceed outstanding interest-bearing debt, it repaid interest-bearing debt during 1H in light of the current industry environment. Interest-bearing debt declined to ¥14,592mn at the end of FY3/18 1H, or about half of the level at the end of March 2017 of ¥30,049mn. The Company maintained large cash and deposit holdings totaling ¥39,030mn at the end of FY3/18 1H.

We think the Company's strengths stood out in 1H results and this was an "upbeat outcome" in light of the difficult business environment. Operating profit increased thanks to low-cost operations, a key advantage. These 1H results implicitly suggest that the Company should survive as a winner in the anticipated industry reorganization in the future.

Healthy visibility for profit gains (YoY) in FY3/18 with upbeat 1H results and 2H-oriented seasonality

2. Prospects for FY3/18

The Company does not disclose its forecast so we conducted our own simulation using certain assumptions. Our FY3/18 period-start projections were ¥809,599mn in rental ball revenue and ¥157,872mn in operating revenue.

For earnings, while the Company will add five new halls (about 1%) in FY3/18, cutbacks in expenses per hall should be capable of keeping total expenses flat or lower (YoY). Operating profit determined from the above-mentioned operating revenue works to ¥16,902mn (+6.3% YoY) assuming that total cost value is flat. (Refer to our report issued on June 29, 2017 for simulation details.)

Simulation of FY3/18 operating revenue

Factors			Remarks
FY3/17 rental ball revenue for the Company (¥mn)	(A)	817,777	
FY3/18 average rental ball revenue growth estimate for the industry		-4.0%	Average growth rate for pachinko market size (ball rental fee revenue basis) over the 10 years through 2015 with 2005 as the starting point
FY3/18 rental ball revenue growth estimate for the Company	(B)	-1.0%	Estimated growth rate for the Company's ball rental fee revenue in FY3/18 Reduces the negative margin for the active machine utilization rate growth rate (YoY) by 2pp for consistently higher growth than the industry average and 1pp for the new hall effect (four halls at period-start)
FY3/18 rental ball revenue forecast for the Company	(C=A×B)	809,599	
FY3/18 assumed gross profit margin for the Company	(D)	19.5%	Gross profit margin is the percentage of operating revenue in ball rental fee revenue and was 19.2%in FY3/17; expecting a nominal rise in FY3/18 due to the shift to low ball rental fee operations
FY3/18 operating revenue forecast for the Company	(E=C×D)	157,872	

Source: Prepared by FISCO from the Company's financial results summary materials, interviews, and the Japan Productivity Center's "White Paper on Leisure"

As explained earlier, looking at the Company's 1H results, while rental ball revenue was weaker than expected, operating revenue and operating profit improved YoY thanks to stronger-than-anticipated benefits from cost reduction efforts.

Income results are typically larger in 2H than in 1H in the pachinko hall industry because of year-end and New Year's demand. We see a solid chance of the Company securing an increase in operating profit on a full-year basis from this perspective.

The Company plans to open 1 new hall in 2H, giving it a net increase of 5 halls for the full year (based on 6 openings and 1 closure) to 451 halls at the end of March 2018. With this capital investment (new hall openings) outlook, we think robust cash flow should continue in 2H.

Income statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17		FY3/18 1H
				1H	Full year	
Operating revenue	165,754	154,556	155,911	79,808	156,869	77,211
YOY	1.1%	-6.8%	0.9%	5.2%	0.6%	-3.3%
Hall operating expenses	135,940	134,659	138,326	72,474	142,142	69,706
YOY	1.5%	-0.9%	2.7%	5.3%	2.8%	-3.8%
SG&A costs	4,086	5,456	5,798	2,692	5,622	2,445
YOY	31.3%	33.5%	6.3%	-1.7%	-3.0%	-9.2%
Other income	7,139	6,850	8,184	4,676	9,224	4,441
Other expenses	1,132	1,947	1,805	1,110	2,430	779
Total expenses	134,019	135,212	137,745	71,600	140,970	68,489
YOY	3.4%	0.9%	1.9%	4.6%	2.3%	-4.3%
Operating profit	31,735	19,344	18,166	8,208	15,899	8,722
YOY	-7.4%	-39.0%	-6.1%	11.2%	-12.5%	6.3%
Financial income	3,660	2,151	311	173	233	146
Financial expenses	781	1,977	1,074	1,746	1,307	462
Profit before income taxes	34,614	19,518	17,403	6,635	14,825	8,406
YOY	3.5%	-43.6%	-10.8%	-9.4%	-14.8%	26.7%
Tax expenses	13,377	8,259	6,864	2,815	5,520	2,972
Net profit	21,237	11,259	10,539	3,820	9,305	5,434
YOY	1.5%	-47.0%	-6.4%	-20.2%	-11.7%	42.3%
Profit attributable to owners of the parent	21,255	11,303	10,544	3,860	9,360	5,430
YOY	-1.6%	-46.8%	-6.7%	-19.3%	-11.2%	40.7%
EBITDA	42,702	30,622	30,494	14,431	28,469	14,783
YOY	0.9%	-28.3%	-0.4%	9.6%	-6.6%	2.4%
EPS (¥)	28.61	15.22	13.92	5.040	12.23	7.09
Dividend per share (¥)	14.00	14.00	13.00	6.00	12.00	6.00

Source: Prepared by FISCO from the Company's financial results summary materials

Results trends

Balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18 1H
Current assets	50,946	48,723	43,240	63,072	51,556
Cash and deposits	34,836	29,239	28,134	48,499	39,030
Sales receivable	563	486	459	563	472
Non-current assets	135,223	132,213	145,944	142,043	138,370
Tangible fixed assets	94,605	99,961	109,532	106,687	102,976
Intangible assets	1,408	1,029	3,991	3,833	3,670
Total assets	186,169	180,936	189,184	205,115	189,926
Current liabilities	34,910	31,380	30,838	38,496	38,074
Accounts payable	19,049	20,468	17,786	18,282	16,785
Short-term borrowings	1,265	3,160	2,369	7,281	7,086
Non-current liabilities	9,249	14,503	25,727	29,738	14,394
Long-term borrowings	3,059	9,160	18,394	22,768	7,506
Equity attributable to owners of the parent	141,990	135,077	132,645	136,953	137,526
Share capital	15,000	15,000	15,000	15,000	15,000
Capital surplus	10,129	10,129	12,883	12,741	12,741
Retained profits	110,136	111,037	110,253	112,403	113,261
Other constituent of equity	6,725	-1,089	-5,202	-3,191	-3,476
Non-controlling interests	20	-24	-26	-72	-68
Total equity	142,010	135,053	132,619	136,881	137,458
Liabilities & net worth	186,169	180,936	189,184	205,115	189,926

Source: Prepared by FISCO from the Company's financial results summary materials

Cash flow statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18 1H
Net profit before income taxes	34,614	19,518	17,403	14,825	8,406
Depreciation costs	10,234	10,340	11,597	11,895	5,703
Others	-17,463	-16,442	-4,927	-132	-306
Cash flow from operating activities	27,385	13,416	24,073	26,588	13,803
Increase in fixed assets	-9,292	-16,008	-12,613	-9,925	-3,294
Others	-13,098	-1,005	1,960	3,641	378
Cash flow from investing activities	-22,390	-17,013	-10,653	-6,284	-2,916
Cash flow from financing activities	-13,102	-2,898	-15,212	192	-20,397
Effects of exchange rate changes on cash and cash equivalents	1,477	898	687	-131	41
Change in cash and cash equivalents	-6,630	-5,597	-1,105	20,365	-9,469
Cash and cash equivalents at the beginning of FY	41,466	34,836	29,239	28,134	48,499
Cash and cash equivalents at the end of FY	34,836	29,239	28,134	48,499	39,030

Source: Prepared by FISCO from the Company's financial results summary materials

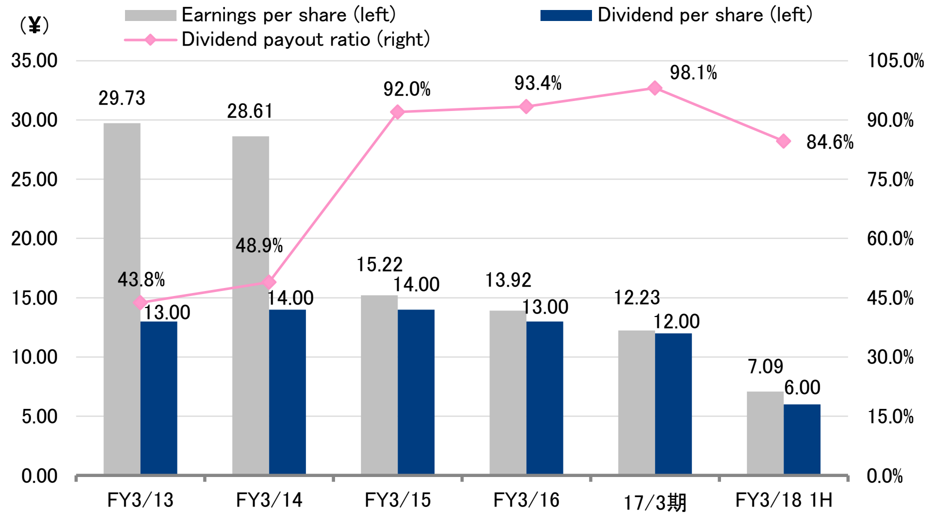
Returns to shareholders

Approved a ¥6 interim dividend; aims to substantially improve the dividend payout ratio from the previous fiscal year to 84.6%

The Company is highly conscious of the significance of returns to shareholders because it recognizes the importance of raising shareholder value in order to achieve sustainable growth. It continues to pay stable dividends based on this view.

The Company decided to pay ¥6 per share for the FY3/18 interim dividend, on par with the previous fiscal year's interim dividend. The interim dividend cost ¥4,596mn, putting the dividend payout ratio at 84.6%, versus the ¥5,430mn in interim profit attributable to owners of the parent. The dividend payout ratio improved considerably from the previous year's 119.0% because of the profit increase (YoY) in 1H.

Trends in earnings per share, dividend per share and dividend payout ratio



Source: Prepared by FISCO from the Company's financial results summary materials

Information security

Strives for rigorous management of personal information (acquired a privacy mark)

The Company issues member cards as part of its efforts to build a fixed customer base. It currently has about 4mn members and possesses massive amounts of personal information on members. It is highly conscious of information security in its activities given these circumstances. As a specific measure, it established operations that comply with JISQ15001:2006, a set of guidelines for appropriate management of personal information defined by JIS (Japan Industrial Standards) and thereby obtained a privacy mark. It also undergoes periodic assessments of overall management operations by the Pachinko Trustee Board (PTB), a third-party evaluation entity for pachinko hall operators, and has continuously received the highest rating (AAA) for items that include information security. We believe the Company has already built sufficient information security operations in light of these results.

Disclaimer