COMPANY RESEARCH AND ANALYSIS REPORT

DYNAM JAPAN HOLDINGS

06889

Hong Kong Stock Exchange

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Summary

Resiliency of low-cost operations amid changes in the business environment

DYNAM JAPAN HOLDINGS Co., Ltd. (HK06889; hereinafter, the Company) owns DYNAM Co., Ltd, which is one of Japan's top operators of pachinko halls with the largest number of halls operated. Its strength and characteristics lie in low-cost operations based on chain store theory. In addition, the Company is a pioneer as the first in its industry to be listed on a stock market, aided by recognition of its high-quality management with implementation of a customer-first creed, information disclosure, compliance management, and other measures.

1. Posted higher profits in FY3/18, despite continuation of a difficult business environment, by leveraging low-cost operation strength

The Company reported higher profits on a decline in sales in FY3/18 with revenue at ¥152,092mn (-3.0% YoY) and operating profit at ¥17,349mn (+9.1%). The pachinko hall industry continues to face a difficult business environment due to decline in customer volume from the impact of diversification of leisure activities, stricter regulations, and other factors. Amid these conditions, the Company promoted measures to boost the number of hall visits by existing customers and recruit new customers. While revenue still dropped for the year, profits rose for the first time in four periods thanks to rigorous implementation of low-cost operations, a key strength.

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

The Company's medium-to long-term growth strategy mainly consists of increasing the number of halls and expansion of same-site sales. While the Company has not changed this fundamental approach, it is also confronting a reality of an increasingly difficult business environment in the pachinko hall industry. Faced with this reality, it pursued cost savings in FY3/18 through reduction of machine costs, mainly by deploying private-brand machines, and curtailment of personnel costs in system development and other areas. In sales efforts, it reinforced low-cost playing (ball rental) sales and promotional activities by individual halls that factor in local considerations with goals of increasing the number of hall visits by existing customers and recruiting new customers. The Company also repaid bank borrowings to improve finances. These measures helped near-term results. We expect realization of higher profits in FY3/19 as well.

3. Leading role in industry reorganization as a winner; likely to restore a revenue and profit growth trend

We think the Company's above-mentioned initiatives are extremely rational and convincing. Even if the pachinko hall industry is unable to restore past vibrancy in the current environment with stricter regulations on gambling content, we believe the Company has the potential to restore a trend of sales and profit increases. We also maintain our view that the likely trigger of this improvement is full-fledged industry reorganization. This timing could arrive within five years at the latest and as soon as two years.

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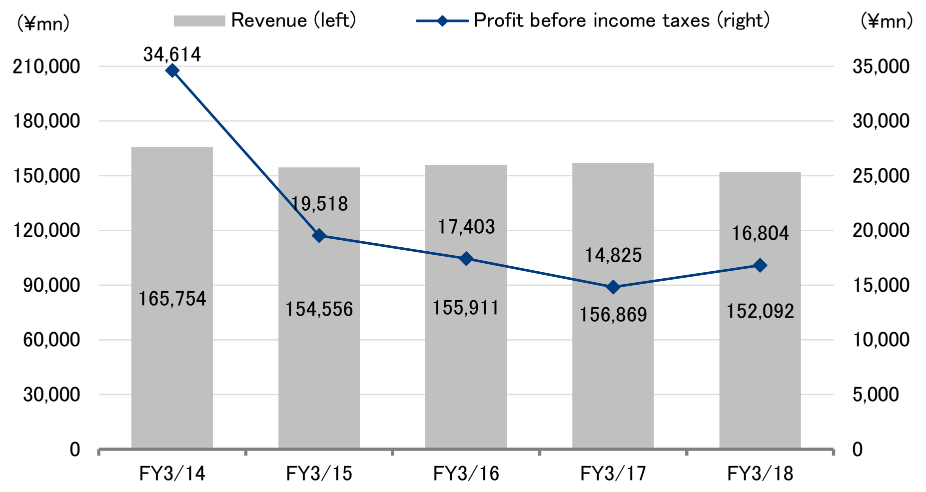
Key Points

- Attained a profit increase for the first time in four fiscal years on reduction of machine costs and other spending with a commitment to low-cost operations
- Unchanging two-pronged growth strategy of expansion of hall volume and increasing sales at existing halls
- Likely to post higher profits again in FY3/19 through continual efforts to lower costs

Trends in operating results



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

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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 spreading low-fee ball rental nationwide. 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 succeeding 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 the Company 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.

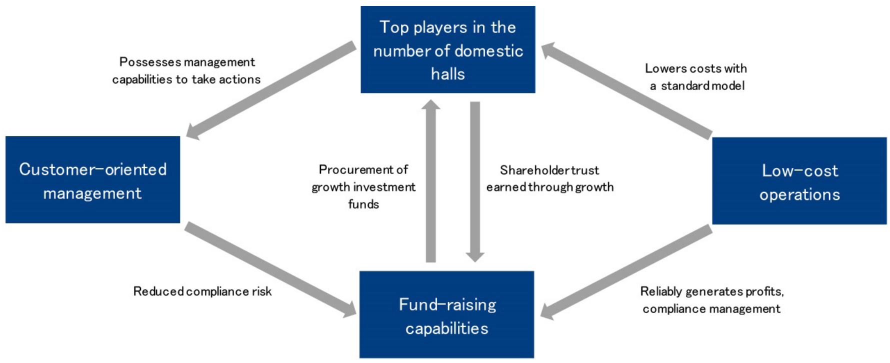
Source: Prepared by FISCO from the Company's website and securities report

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

2. Dynam Japan Holdings 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 Japan Holdings Group



Source: Prepared by FISCO from interviews

(1) Top group with 450 halls in Japan

The Company is the top hall operator in Japan with 450 halls managed within its group (as of end-March 2018), Japanese market share was 4.3% in terms of hall volume and 4.7% based on installed amusement machines.

Economies of scale are a valuable benefit of having a large number of halls (scale merit). They extend to new hall openings, renovations, machine purchasing, prize procurement, and logistics and others. Machine purchasing 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. The Company also develops and deploys private-brand (PB) machines and seeks to attract customers and lower costs by expanding internal distribution of machines. These measures are feasible because of the Company's large network of halls.

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.

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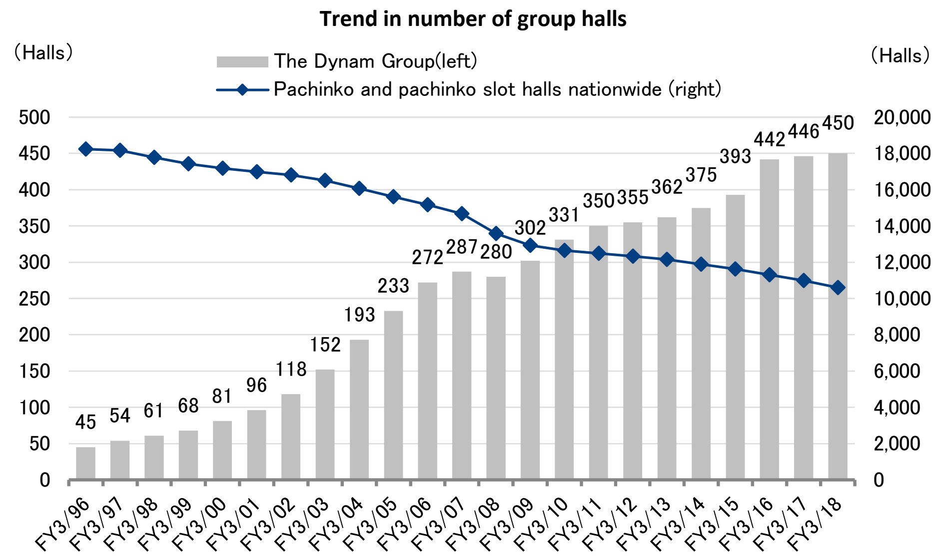

Source: Prepared by FISCO from the Company's results briefing materials

(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.

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 71.1% of pachinko machines 47.2% (for the overall industry) and 56.5% of pachislot machines (23.0% for the overall industry), substantially exceeding industry averages (as of the end of March 2018).

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 December 2016. Regulations on gambling content address the addiction issue and authorities applied new rules in February 2018. These changes are eroding the pachinko hall management style of attracting customers with gambling.

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 20pp higher than the industry average. While the Company cannot avoid an impact from stricter gambling content regulations, we think the negative impact is fairly light due to its existing pursuit of operations that do not rely on gambling content.

(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 3,200 firms are listed on stock markets as of March 31, 2018. 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.

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Results trends

Attained a profit increase for the first time in four fiscal years on reduction of machine costs and other spending with a commitment to low-cost operations

The Company reported higher profits on a decline in sales in FY3/18 with revenue at ¥152,092mn (-3.0% YoY), operating profit at ¥17,349mn (+9.1%), profit before income taxes at ¥16,804mn (+13.3%), and net profit attributable to owners of the Company at ¥10,870mn (+16.1%). Profits rose in all items for the first time in four fiscal years.

Summary of FY3/18 results

(¥mn)

	FY3/17		FY3/18				
	1H	Full year	1H	YoY	Full year	YoY	Change
Ball rental fee revenue	416,246	817,777	397,127	-4.6%	775,060	-5.2%	-42,717
Cost of prizes	336,438	660,908	319,916	-4.9%	622,968	-5.7%	-37,940
Revenue	79,808	156,869	77,211	-3.3%	152,092	-3.0%	-4,777
Total expenses	71,600	140,970	68,489	-4.3%	134,743	-4.4%	-6,227
Operating profit	8,208	15,899	8,722	6.3%	17,349	9.1%	1,450
Profit before income taxes	6,635	14,825	8,406	26.7%	16,804	13.3%	1,979
Net profit attributable to owners of the Company	3,860	9,360	5,430	40.7%	10,870	16.1%	1,510
EBITDA	14,431	28,469	14,783	2.4%	29,524	3.7%	1,055

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

FY3/18 started in an environment with 1/320 machines as the highest gambling content. Even though the Company built a hall network with a lower percentage of machines with high gambling content than peers due to its long-standing approach of running a "business that does not rely on gambling," it still incurred an impact from decline in gambling content with a 5.2% YoY drop in ball rental revenue (gross revenue) to ¥775,060mn. Prize transfer value also fell due to weaker ball rental revenue with a 5.7% decline to ¥622,968mn. Revenue thus slipped by ¥4,777mn YoY to ¥152,092mn.

In costs, meanwhile, the Company reduced amusement machine costs, including machine and parts costs, by about ¥3bn. It promoted streamlining and cost savings in personnel expenses too, including revisions to tasks handled by headquarters and administrative divisions and efforts to shorten working hours through system deployment. The Company's rigorous pursuit of low-cost operations, an important strength, through these measures cut operating costs by ¥6,227mn YoY (total value of changes in hall operating costs, SG&A expenses, other revenue, and other costs) and contributed to a ¥1,450mn YoY rise in operating profit.

The Company only had six openings in FY3/18 (five halls in 1H and one hall in 2H). DYNAM, the Company's core business firm, had all of the openings. Net hall volume rose by four halls because of closures of one hall each by Cabin Plaza Co., Ltd. and Yume Corporation Co., Ltd. This put total store count at end-March 2018 at 450 halls.

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Profiles of Subsidiaries

	DYNAM				Cabin Plaza Total	Yume Corporation Total	Total
	DYNAM	Yuttari Kan	Shinrai no Mori	Total			
FY3/11	168	132	42	342	8	-	350
FY3/12	167	135	44	346	9	-	355
FY3/13	172	147	34	353	9	-	362
FY3/14	171	165	30	366	9	-	375
FY3/15	170	190	24	384	9	-	393
FY3/16	173	197	24	394	9	39	442
FY3/17	171	204	24	399	9	38	446
FY3/18	171	210	24	405	8	37	450

Source: Prepared by FISCO from Company materials

As mentioned above, the Company's operating profit climbed 9.1% YoY to ¥17,349mn, and its EBITDA, which adds back depreciation costs, was up 3.7% to ¥29,524mn (approaching ¥30bn). Even with dividends, capital investments, corporate tax payments, and other cash outlays, the Company has significant surplus funds. It allocated these funds to repaying bank borrowings and sharply reduced interest-bearing debt value by more than ¥20bn from ¥30,049mn a year ago to ¥8,752mn at the end of FY3/18.

Changes in cash and cash equivalents, and interest-bearing debt at the end of the fiscal year

(¥mn)

	FY3/16	FY3/17	FY3/18
EBITDA	30,494	28,469	29,524
New openings (gross value, including M&A deals)	53	5	6
(net increase in hall volume)	49	4	4
Total dividend value (annual)	10,055	9,192	9,192
Cash and cash equivalents at the end of the fiscal year	28,134	48,499	40,533
Interest-bearing debt at the end of the fiscal year	20,763	30,049	8,572
Total assets	189,184	205,115	184,971

Source: Prepared by FISCO from Company materials

We think FY3/18 results were positive due to maximization of strengths and realization of a profit increase despite very difficult business conditions. The Company was an early adopter of the concept of pachinko halls as "time consuming leisure" and consistently carried out progressive initiatives, such as low-cost operations, based on chain store theory. We believe successful attainment of higher profits by leveraging this strength suggests that the Company is likely to play a leading role as a winner in anticipated industry reorganization.

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Medium-term growth strategy and current initiatives

Continuation of a market contraction trend Regulations on gambling content largely finished with February 2018's ball output restrictions

1. Business environment in the pachinko hall industry

(1) Market size and number of halls

The pachinko hall industry currently remains in the midst of a long-term contraction trend. Japan's population of pachinko and pachislot players in 2016 was down 12% (1.3mn people) YoY to 9.4mn people. Reflecting this change, 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 think the market shrunk further in 2017 in light of FY3/18 results announced by the Company, which is the largest hall operator in the industry.

The number of pachinko halls nationwide has also been steadily dropping due to ongoing market contraction. According to National Police Agency data, it has been falling at a pace of 200-300 halls per year over the last few years and was down by 390 halls from the previous year to 10,596 halls (almost falling by 400 halls) as of December 2017.

(2) Regulatory actions targeting pachinko and pachislot businesses

Initiatives by the government to "address gambling and other addictions" serve as the background to regulations targeting pachinko and pachislot businesses. Regulatory action primarily aims to reduce gambling content as a specific measure. 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 introduced regulations on output ball ratio and output ball numbers from February 1 2018. Key points are setting 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.

The February 2018 regulations allow for continued use of existing machines for as long as three years (through January 31, 2021) if approval is obtained. While it costs about ¥10,000 per machine to acquire approval, hall operators can avoid incurring the capital investment burden accompanying the regulations (machine replacements) immediately and take actions to transition to machines that meet the new rules at a moderate pace.

We think the February 2018 regulations finished the discussion of curtailing gambling content in pachinko business for the time being and the pachinko hall industry and pachinko game manufacturers have moved to a stage of gradually complying with the rules.

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Content of ball output 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 2.2x 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

Authorities are implementing stricter regulations on gambling content in the pachislot business too (similar to pachinko). They plan to incrementally lower the permissible percentage of machines with high gambling content from the current 30% threshold to 0% by the end of January 2021.

Zenkoku Yuugi Jigyou Kyoudou Kumiai Rengokai, the industry organization, adopted voluntary regulations in June 2015 to lower the percentage of installed machines not in compliance with new standards (so-called machines with high gambling content) to 30% or less by the end of November 2017. It subsequently proceeded to formulate voluntary regulations to incrementally reduce this ratio to 0% in April 2018.

Installation ratio rules for pachislot machines with high gambling content

Period	Percentage of machines with high gambling content
Present through end-January 2019	Lower from 30% or less to 15% or less
February 2019 to end-January 2020	Lower from 15% or less to 5% or less
February 2020 to end-January 2021	Lower from 5% or less to 0%

Source: Prepared by FISCO from interviews

The two-pronged growth strategy of expansion of hall volume and increasing sales at existing halls is unchanging

2. Growth strategy and initiatives

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.

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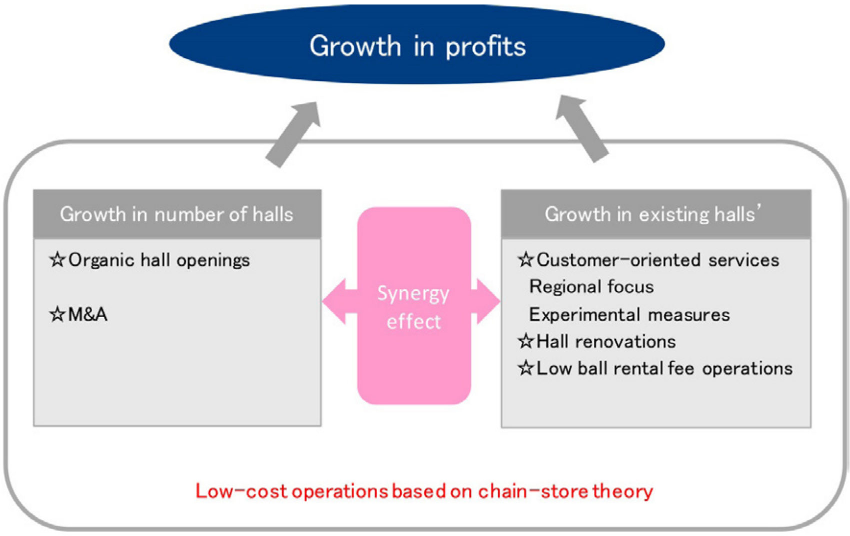
Image of the two-pronged growth strategy – hall network expansion and increasing revenue of existing halls



Source: Prepared by FISCO from Company materials

During FY3/18, in accordance with the growth strategy, the Company mainly promoted 1) initiatives to increase gaming customers, 2) growth via expansion of hall volume, and 3) low-cost operations. While each of these measures are covered in detail below, it is difficult to achieve results with top-line (sales) growth actions, such as expansion of existing hall sales and increase in hall volume, due to changes in the business environment. Given this reality, the Company promptly changed its approach and realized profit growth by rigorously pursuing low-cost operations, beyond the extent of attention on top-line growth. It successfully restored a profit increase, even with a decline in sales, for the first time in four years, as mentioned earlier. We think the Company's strengths of flexible management decisions, scale and resilience from having 450 halls, and low-cost structure played a key role in its FY3/18 response. Thorough analysis of this performance should helping in forming a detailed image of the future blueprint of not only the Company, but also the entire industry.

(1) Efforts to increase gaming customer volume

Increase in gaming customer volume is the most important measure for expansion of existing-hall sales. The Company promoted efforts to increase customer volume (increase the number of visits by regular customers and acquisition of new customers) at headquarters, front-line operation, and companywide layers.

Headquarters centrally manages customer data obtained from all 450 halls. It has a team of data analysis experts to analyze this information (big data) and develop strategies to attract customers and promote sales. The Company intends to promote enhancement of analysis skills and ensure that customer data collection and analysis leads to actual sales promotion and customer recruitment. We will be looking for clarification of sales measures based on the data in FY3/19.

Front-line operations have been engaging in advertising and promotional efforts that address local features, customer attributes, and other realities at individual halls in the past 1-2 years with the aim of increasing customer recruitment. This approach differs totally from previous blanket advertising and promotions at all of the group's halls. Halls conduct customer interaction and initiatives that focus on individual customers and successful examples are shared at events held by headquarters as well as over the Intranet and in internal SNS. Other halls capitalize on this information.

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The companywide effort involves promotion of low cost playing. It offers a daily entertainment with curtailed spending that aims to increase customer volume.

(2) Growth through expansion of hall volume

As measures to expand hall volume, the Company efficiently promotes low cost operations based on chain store theory with standard hall openings and it also occupies vacant halls previously operated by other companies and pursues acquisitions of other companies in recent years due to increases in hall sales and closures by peers.

Despite using this approach in FY3/18, the Company only opened six halls with just one hall at a location closed by another operator. Furthermore, five of the six openings came in 1H and had already been arranged from the previous fiscal year. The opening of only one new hall in 2H implies that new opening activities stalled during 1H.

We attribute this outcome to the reality that very few of the halls closed by other firms met the Company's standards. The same thing is true in acquisitions. While closures and for-sale locations are rising, almost none of them offer robust potential at this point.

We believe the Company has curtailed openings of its standard halls in order to observe the impact of stricter regulations. Although implementation of tougher regulations on pachinko gambling content has largely finished, as noted earlier, hall response will be proceeding at a moderate pace over the next three years. The pachislot market faces similar conditions. We think the Company wanted to limit risks amid ongoing shrinkage of the playing population and market scale.

(3) Promotion of low-cost operations

While the Company had already been continuously pursuing initiatives to efficiently manage machine costs, personnel expenses, and other costs and rigorously implement low-cost operations, it reinforced these efforts in FY3/18.

a) Machine costs

Machine costs account for about one-fourth of hall spending, making them the second largest item after personnel expenses. The Company strives to reduce machine costs from a variety of angles.

Deployment of private-brand (PB) machines and used machines is a way of reducing machine costs. The Company puts efforts into development of PB machines because this leverages its economies of scale with 450 halls. PB machines are generally about 15-20% cheaper than national-brand (NB) machines. However, they must be popular with customers in order to boost operating rates and it is meaningless to deploy them without this capability just because of cheap pricing. The Company addresses this point through use of the big data it possesses for identifying and analyzing customer preferences as the basis for incorporating such features in its machines.

The Company announced the PA Nanashi DXII88GO machine in May 2018. This machine has low gambling content at 1/88.92 and is the Company's first PB machine that complies with the new regulations (output ball rules from February 2018). The Company plans to deploy 1,000 of these machines with steady installations at halls from mid-June 2018.

PB machines (pachinko) were at 5.2% of all of the Company's installed machines at end-FY3/18, an increase of 1.7pp from 3.5% at end-FY3/17. Total installed volume at end-FY3/18 was 7,662 machines.

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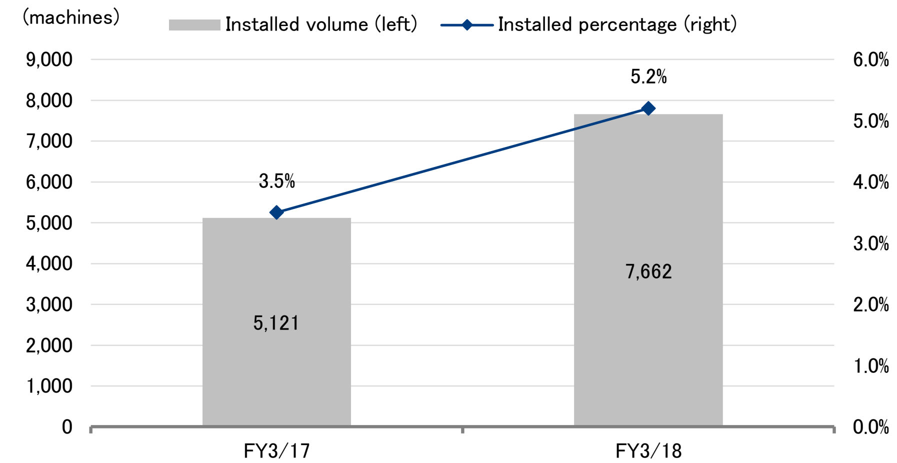
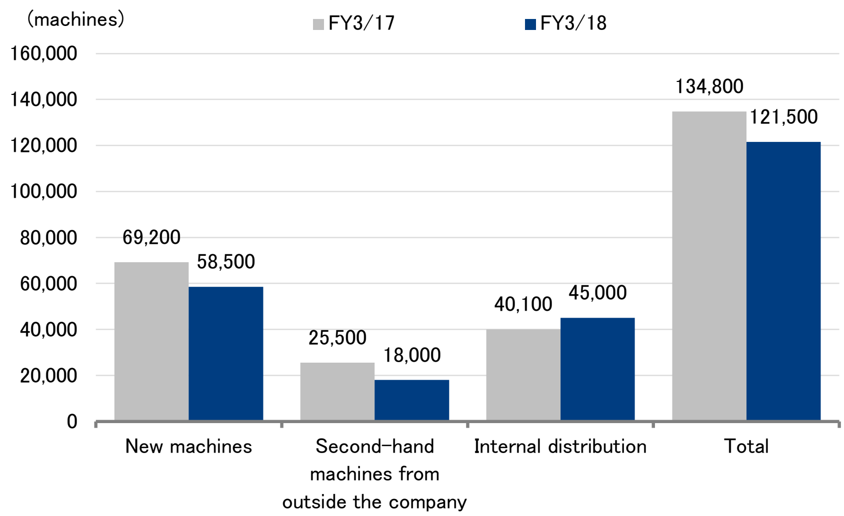
Trends in PB machine installed volume and installed ratio



Source: Prepared by FISCO from Company materials

Another initiate to lower machine costs is secondary use within the company (referred to as "internal distribution") that lengthens the usage period. Pachinko machines normally lose their customer draw effect in 1-2 months after installation (this leads to decline in the machine operating rate). The Company closely monitors customer draw and operating conditions and moves pachinko machines from hall A to hall B when appropriate. This is internal distribution. At hall B, the subject machine has not been previously deployed and thus becomes a "new machine delivery" with potential to attract customers. Subsequent transfer of the machine from hall B to hall C lengthens the operating period and expands the lifetime value per pachinko machine. The Company is capable of handling machines in this manner because of its multi-hall operations. With a network of 450 halls, it can fully take advantage of this effect. Reinforcement of internal distribution also lowers purchases of pachinko machines from outside the company.

Comparison of annual purchase volume



Source: Prepared by FISCO from Company materials

Pachinko hall operators may extend the usage period of existing machines by three years, if approval is obtained, even after implementation of the new regulations from February 2018. The Company already obtained approvals for 130,000 machines, or about 70% of its total installed volume. We think these approvals should enable the Company to adjust to the regulations while minimizing the impact of stricter rules on customer draw capabilities and profitability.

b) Personnel costs

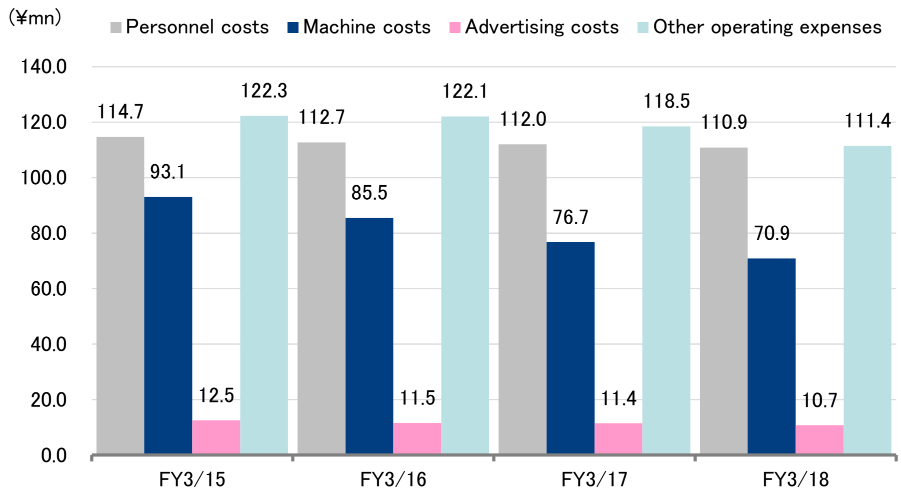
The Company has been taking steps to reduce workload at headquarters (back-office divisions) through revisions to work flow and cutbacks in document handling via systemization. It has also actively moved personnel from headquarters to halls and area management teams and focus on efforts to increase gaming customers by strengthening front-line operations.

The Company has bolstered system development with the aim of shortening task time in hall operations. Specifically, it reduced data entry work for research on rival halls, a key strategy, and promotional item display and removal tasks by installing digital signage.

Estimated savings from these measures are about ¥180mn from allocation of funds secured by improvement in administrative division work to reinforcing sales capabilities and roughly ¥300mn from shortening labor hours via better efficiency enabled by system development.

The Company's efforts to lower various costs, including machine costs and personnel expenses, have been steadily appearing in hall operation costs. Operation costs per hall were about ¥343mn in FY3/15. Continual reforms thereafter reduced personnel expenses, machine costs, advertising costs, and other sales costs, trimming operation costs by 11% to around ¥304mn (about 4% annually) in FY3/18. The ¥10mn in savings per hall works out to ¥4,500mn for the network's 450 halls. We think these activities provided a very large contribution to earnings.

Trends in major expense items per hall



Source: Prepared by FISCO from Company materials

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Likely to post higher profits again in FY3/19 through continual efforts to lower costs

3. Results outlook

We prepared our own simulation for an outlook based on certain conditions because the Company does not disclose guidance.

In terms of revenue, we project a 2.3% YoY decline in ball rental revenue to ¥757,234mn. This estimate assumes a 4.3% decline in industry ball rental revenue (applying the average annual growth rate for the pachinko market over the past 10 years) and then makes an adjustment to a 2.3% drop in light of core subsidiary DYNAM's pachinko machine operating rate that exceeds rivals by 10pp. Gross margin is likely to increase, just as in the previous fiscal year, due to the impact of promoting low ball rental sales, and our estimate is 20.0%. We expect ¥151,447mn in revenue (-0.4% YoY), using these values.

In costs, meanwhile, we think the Company is capable of reducing operation costs per hall by ¥5mn from FY3/18's roughly ¥304mn to ¥299mn. This is just one-third of the YoY savings in FY3/18 (about ¥15mn). Overall hall operation costs (applied to 450 halls) hence could decline by ¥134,550mn. We keep SG&A expenses at the year-ago level of ¥5,000mn and also leave other income (net value) unchanged at ¥7,000mn (surplus income). With these assumptions, total operating costs come to ¥132,550mn (-1.6% YoY). Operating profit therefore works out to ¥18,897mn (+8.9%), a second straight increase.

Simulation of FY3/19 revenue

Factors			Remark
FY3/18 rental ball revenue for the Company (¥mn)	(A)	775,060	
FY3/19 average rental ball revenue growth estimate for the industry		-4.3%	Average growth rate for pachinko market size (ball rental fee revenue basis) over the 10 years through 2016 with 2006 as the starting point
FY3/19 rental ball revenue growth estimate for the Company	(B)	-2.3%	We reduced the decline margin by 2pp in light of the game machine usage rate exceeding rivals by 10pp. We do not factor in a positive impact from FY3/19 new openings because the expected level is just two halls.
FY3/19 rental ball revenue forecast for the Company	(C = A × B)	757,234	
FY3/19 assumed gross profit margin for the Company	(D)	20.0%	Gross profit margin is the percentage of revenue in ball rental fee revenue and rose 0.4pp to 19.6% in FY3/18; expecting a nominal rise in FY3/19 due to the shift to low ball rental fee operations
FY3/19 revenue forecast for the Company	(E = C × D)	151,447	

Source: Prepared by FISCO from interviews

We cannot rule out the possibility of a larger revenue decline than in our outlook. However, the cost reduction value has leeway and actual savings might beat our view. We thus believe that the Company is likely to increase profits in FY3/19.

A key point in our simulation is the lower decline rate in the Company's ball rental revenue than the industry average. We think this is a reasonable assumption in light of management conditions at primary operator DYNAM.

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DYNAM operates 405 halls (as of end-March 2018) and reported ¥139,940mn in FY3/18 revenue, which is 92% of group consolidated revenue. Points discussed for consolidated results in income trends apply to this business as well. The main point is KPI values (key performance indicators). We place particular emphasis on pachinko and slot machine usage rates, and both rates are well above levels at rivals. They are highly reliable, in our view, because the Company's employees collect these data at 1,300 rival halls nationwide.

DYNAM's management situation

	FY3/17	FY3/18	YoY change	Summary
Revenue	143,162	139,940	-3,222	Decline in pachinko machine usage rates , impact from removing machines with high gambling content
Revenue	14,710	15,393	683	Profit increase on cost savings exceeding revenue decline
Ordinary profit	15,573	16,248	675	
Net profit for the year	9,914	10,582	668	
Main KPIs (key performance indicators)				
Halls	399	405	6	450 group halls (six openings, two closures)
Number of halls	44.7%	43.1%	-1.6pt	+10.5pp vs. rival halls
Slot machine usage rate	40.4%	39.6%	-0.8pt	+5.0pp vs. rival halls
Installed volume	183,543	186,898	3,355	Group total: 208,543 machines (4.7% share)
PB machine installed volume	4,980	7,315	2,335	Group total: 7,662 machines (5.2% share)

Source: Prepared by FISCO from Company materials

DYNAM's KPI values highlight once again that the Company's strength lies in the robustness of individual halls (they are generating healthy profits), rather than just having a network of 450 halls. We think it capable of delivering stable profits from FY3/20 as well if this aspect holds up.

Income statement

(¥mn)

	FY3/14 full year	FY3/15 full year	FY3/16 full year	FY3/17 full year	FY3/18	
					1H	full year
Revenue	165,754	154,556	155,911	156,869	77,211	152,092
YOY	1.1%	-6.8%	0.9%	0.6%	-3.3%	-3.0%
Hall operating expenses	135,940	134,659	138,326	142,142	69,706	136,727
YOY	1.5%	-0.9%	2.7%	2.8%	-3.8%	-3.8%
SG&A costs	4,086	5,456	5,798	5,622	2,445	5,049
YOY	31.3%	33.5%	6.3%	-3.0%	-9.2%	-10.2%
Other income	7,139	6,850	8,184	9,224	4,441	9,458
Other expenses	1,132	1,947	1,805	2,430	779	2,425
Total expenses	134,019	135,212	137,745	140,970	68,489	134,743
YOY	3.4%	0.9%	1.9%	2.3%	-4.3%	-4.4%
Operating profit	31,735	19,344	18,166	15,899	8,722	17,349
YOY	-7.4%	-39.0%	-6.1%	-12.5%	6.3%	9.1%
Financial income	3,660	2,151	311	233	146	236
Financial expenses	781	1,977	1,074	1,307	462	781
Profit before income taxes	34,614	19,518	17,403	14,825	8,406	16,804
YOY	3.5%	-43.6%	-10.8%	-14.8%	26.7%	13.3%
Tax expenses	13,377	8,259	6,864	5,520	2,972	5,879
Net profit for the year	21,237	11,259	10,539	9,305	5,434	10,925
YOY	1.5%	-47.0%	-6.4%	-11.7%	42.3%	17.4%
Net profit attributable to owners of the Company	21,255	11,303	10,544	9,360	5,430	10,870
YOY	+1.6%	-46.8%	-6.7%	-11.2%	40.7%	16.1%
EBITDA	42,702	30,637	30,494	28,469	14,783	29,524
YOY	0.9%	-28.3%	-0.4%	-6.6%	2.4%	3.7%
EPS (¥)	28.61	15.22	13.92	12.23	7.09	14.19
Dividend per share (¥)	14.00	14.00	13.00	12.00	6.00	12.00

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

Balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18
Current assets	50,946	48,723	43,240	63,072	53,145
Cash and cash equivalents	34,836	29,239	28,134	48,499	40,533
Trade receivables	563	486	459	563	469
Non-current assets	135,223	132,213	145,944	142,043	131,826
Property, plant and equipment	94,605	99,961	109,532	106,687	98,794
Intangible assets	1,408	1,029	3,991	3,833	3,545
Total assets	186,169	180,936	189,184	205,115	184,971
Current liabilities	34,910	31,380	30,838	38,496	39,643
Trade and other payables	19,049	20,468	17,786	18,282	19,220
Borrowings	1,265	3,160	2,369	7,281	7,351
Non-current liabilities	9,249	14,503	25,727	29,738	7,813
Borrowings	3,059	9,160	18,394	22,768	1,221
Equity attributable to owners of the Company	141,990	135,077	132,645	136,953	137,532
Share capital	15,000	15,000	15,000	15,000	15,000
Capital reserve	10,129	10,129	12,883	12,741	12,741
Retained profits	110,136	111,037	110,253	112,403	114,106
Other component of equity	6,725	-1,089	-5,202	-3,191	-4,315
Non-controlling interests	20	-24	-26	-72	-17
Total equity	142,010	135,053	132,619	136,881	137,515
Liabilities & net worth	186,169	180,936	189,184	205,115	184,971

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

Aiming to enhance long-term enterprise value as "regional infrastructure" in dealing working style reforms, fostering women managers, and other important themes

4. CSR initiatives and enhancement of long-term enterprise value

As a listed company, the Company conducts compliance management in line with the laws and seeks to maximize profits. It also aims to build "regional infrastructure" (being a presence that it vital to local areas) and possesses strong CSR (corporate social responsibility) awareness. Amid discussions of working style reforms, fostering women managers, and other themes, the Company addresses these as important topics in an effort to understand where society is headed and seeks to enhance long-term enterprise value.

We review initiative examples below (initiatives are matched with themes listed in the annual report in parentheses).

(1) Focus on working style reforms (Important theme: Work friendly environment)

The Company has focused on working style reforms for some time. It reinforced the program for shorter working hours for the child-rearing age group in May 2018 by opening it up to employees with nursing care, child care, and illness situations and removing the limit on the number of times it can be used. As other reforms, it arranged an extension of retirement age to improve utilization of seniors, converted non-regular employees to regular employees, and formulated the "healthy management declaration."

(2) Earthquake reconstruction assistance (Important theme: Co-existence with local society)

The Company has been continually engaged in activities for earthquake reconstruction assistance. Its total donations to the three Tohoku prefectures are well above ¥600mn thus far. It is also actively involved in hands-on assistance in the area. One example is the participation of many employees in planting trees to create a row of sakura (cherry) trees along the roughly 170km line where the tsunami reached furthest inland in Rikuzen Takada city (Iwate prefecture) organized by the Sakura Line 311, a non-profit organization (NPO). The Company assists employees in volunteer activities too.

(3) Fostering women managers and interaction assistance
(Important theme: Diversity and human resource development)

The Company has created an internal “Nadeshiko Team” to promote training of women managers. The Nadeshiko Team has repeatedly exchanged views with representatives in charge of promoting utilization of women at industry peers and recently held the Nadeshiko Summit 2018 that also invited representatives from three companies in other industries. The Company intends to continue and bolster initiatives to utilize women.

(4) Continued hiring of new university graduates (Important theme: Diversity and human resource cultivation)

The Company was the first in the pachinko hall industry to establish a framework for hiring new university graduates and continues to hire them without being affected by changes in the business environment. In FY2018, it hired 91 graduates (69 men, 22 women). It intends to continue hiring graduates based on the employment plan.

(5) “Torepachi!” playing events at welfare facilities (Important theme: Co-existence with local society)

The Company has been steadily implementing playing events using the “Torepachi!” pachinko machine developed for welfare facilities since 2016. This event aims to provide enjoyment and rehabilitation training to residents. The Company plans to continue these events and contributions to local society.

(6) Secondhand smoke prevention (Important theme: Provision of a enjoyable and safe playing environment)

The Company recently renovated the Sendai Ichibancho hall (Miyagi prefecture) to completely separate smokers and non-smokers. This is the second hall under the Yukkari Kan brand to deploy this format. It is also the 26th hall in the network with complete separation including the 24 halls from the Shinrai no Mori brand that incorporates smoker separation in the hall concept. Other halls in the Company’s network are structurally ready to immediately support complete separation. We expect the Company to expand halls with this feature in light of societal trends and customer reaction.

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Disclosed an integrated report, enhancing non-financial (ESG) information and provision of tools for dialogue with long-term investors

The Company issued its annual report (Annual Report 2018) on May 29. The Hong Kong Stock Exchange requires companies listed on the exchange to disclose ESG information since last year, and listed companies are ramping up their disclosure of non-financial information. The Company's annual report also added to information disclosure on its views of and initiatives with the environment (E) and society (S) in light of the CSR activities reviewed above. Additionally, the Company's annual report uses a structure that reflects the international integrated report framework defined by the International Integrated Reporting Council (IIRC) and the "guidance on comprehensive disclosure and dialogue to promote collaborative value innovation" presented by METI. Pursuit of improvements in enterprise value from a long-term perspective, including ESG, is gaining recognition as a common theme among long-term investors and companies in an environment that encourages closer dialogue between investors and companies. We have a positive view of the Company's information disclosure in an integrated report as evidence of its openness to dialogue with global long-term investors. The Company also plans to disclose a CSR report (CSR Report 2018) in July. We expect steady enhancement of tools for dialogue with long-term investors to broaden opportunities for appropriate assessment of the Company in the stock market.

Returns to shareholders

Decided to pay a ¥12 annual dividend in FY3/18 Realized a stable dividend in a difficult environment

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 a ¥12 annual dividend (¥6 at the interim period, ¥6 at period-end) in FY3/18. With its ¥10,870mn in net profit attributable to owners of the Company, the ¥9,192mn dividend payment puts the payout ratio at 84.1%. As explained earlier, the Company realized a stable dividend by increasing profits in a difficult business environment with cost savings.

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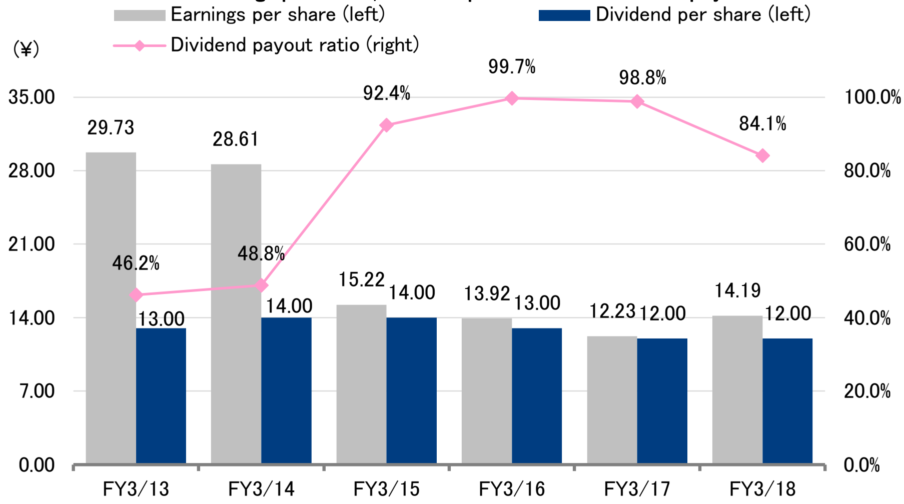
Trends in earnings per share, dividend per share and dividend payout ratio



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.

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