COMPANY RESEARCH AND ANALYSIS REPORT

DYNAM JAPAN HOLDINGS

06889

Hong Kong Stock Exchange

14-Jan.-2021

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Summary

Amid the ongoing headwinds, the Company plans to make securing profits the top priority and bolster its earnings structure in the near term

DYNAM JAPAN HOLDINGS Co., Ltd. (HK06889; hereinafter, the Company) is the 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 the "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 approach, information disclosure, compliance management, and other measures.

1. Significant decline in revenue but posted operating profit in FY3/21 interim consolidated results

In FY3/21 interim consolidated results, revenue declined 37.9% year-on-year (YoY) to ¥45,992mn, while operating profit declined 80.2% YoY to ¥2,781mn. Following the government's declaration of a state of emergency in conjunction with the novel coronavirus pandemic, the Company had no choice but to temporarily close halls from April to May 2020, and the overall pachinko hall industry was forced into a challenging situation. Amid this, the Company worked on thorough cost reductions, including curbing machine purchases. In addition, as a result of posting ¥3,225mn in employment adjustment subsidy, etc. and other factors, the Company achieved its initial goal of posting a positive operating profit. As the entire industry was forced to deal with a challenging business environment, the Company's ability to quickly respond to the changes in the environment and post a profit is worthy of praise. In the aircraft leasing business, which was launched as a new business in FY3/20, the Company continued to lease three aircraft, and posted revenue of ¥737mn (versus ¥82mn in the year-earlier period).

2. Aims to achieve a positive operating profit for the full fiscal year while cutting costs

The Company plans to advance its business with a goal of securing profitability for the full FY3/21. From November 2020 onward, despite the novel coronavirus spreading once again and a murky future outlook, the Company working to bring about a recovery in the number of customers by carrying out thorough infection-prevention measures and promoting its halls as being places where customers can play without worry. In addition, the Company will continue to work to cut personnel expenses and other expenses by revising hall operations. However, machine purchase costs are expected to increase in 2H after machine costs of ¥5,693mn in the FY3/21 interim period. The regulators had initially set a deadline of January 31, 2021 for the removal of machine models under the former regulations, but this deadline appears to have been extended by approximately one year due to the impacts of the novel coronavirus pandemic. The Group still has approximately 130,000 machines under the former regulations, and these machines will gradually be replaced with new regulation machines. The Company plans to minimize expenditures when replacing machines by getting price reductions based on bulk purchases for the entire Company, as well as by introducing field testing (suppressing the purchasing of models that contribute little to earnings).

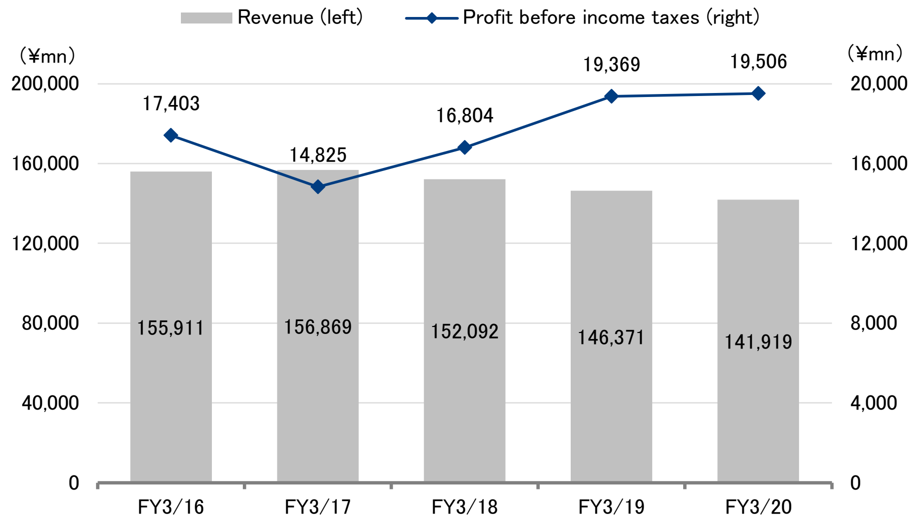
3. Aiming to recover profitability by reforming hall operations and revising the strategy for opening halls

Up until now, the Company has been aiming for growth on two axes: increasing the number of halls, and growing revenue at existing halls. However, the environment will continue to be difficult for some time to come. With this in the background, the Company's policy now will be to place priority on building a revenue foundation that can stably generate profits. Since the start of 2020, the Company has worked on improving hall productivity and lowering the break-even point by promoting the division of labor through concentration on sales promotion operations and hall management operations in the head office on an experimental basis for some halls and by reducing the operational burden on hall staff by, for instance, making hall operations self-serviced. Regarding the hall-opening strategy, the Company has put a freeze on opening new halls for the time being, and will continue examining whether to keep or close unprofitable halls. Based on the fact that the business environment is extremely challenging during the novel coronavirus pandemic, even for an industry leader like the Company, at FISCO we expect there to be further weeding out of weaker, small- and medium-sized halls going forward. The Company's earnings power should strengthen once the novel coronavirus pandemic gets under control, and at FISCO we think there is a good chance that the Company will grow its earnings by increasing its market share even as the overall market contracts.

Key Points

- In FY3/21 interim consolidated results, both revenue and profits declined by double digits due to the impacts of the novel coronavirus pandemic, but a profit was secured as a result of thorough cost reductions
- While it will depend on the situation with the novel coronavirus pandemic, the Company plans to reduce costs and secure a positive operating profit again in FY3/21 2H
- The market continues to contract, but even in this situation, there remains plenty of room to grow through increasing market share

Trends in operation results



Source: Prepared by FISCO from the Company's financial statements announcement

Company profile

Expanded business scope by implementing innovative measures premised on “chain store theory,” first pachinko hall operator to list shares

1. History

The Company was founded as Sawa Shoji Co., Ltd. in 1967 by Yohei Sato, the father of Yoji Sato, a current director and senior corporate advisor. When the founder passed away in 1970, his eldest son, Yoji, who was then aged 24 and working at The Daiei, Inc., took over the business, 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, opening suburban halls and low-cost halls, forming a labor union, and spreading low-fee ball rental nationwide. Yoji Sato’s leadership was an important factor in the Company’s adoption of a progressive corporate culture. He joined Daiei due to interest in the chain store theory that was still a novel concept in Japan. Subsequently, following the death his father, the founder, he succeeded his father for the Company’s management, and within this management, he expanded business by consistently applying the chain store theory to pachinko hall operations. The chain store theory is the source of low-cost operations, the Company’s largest strength.

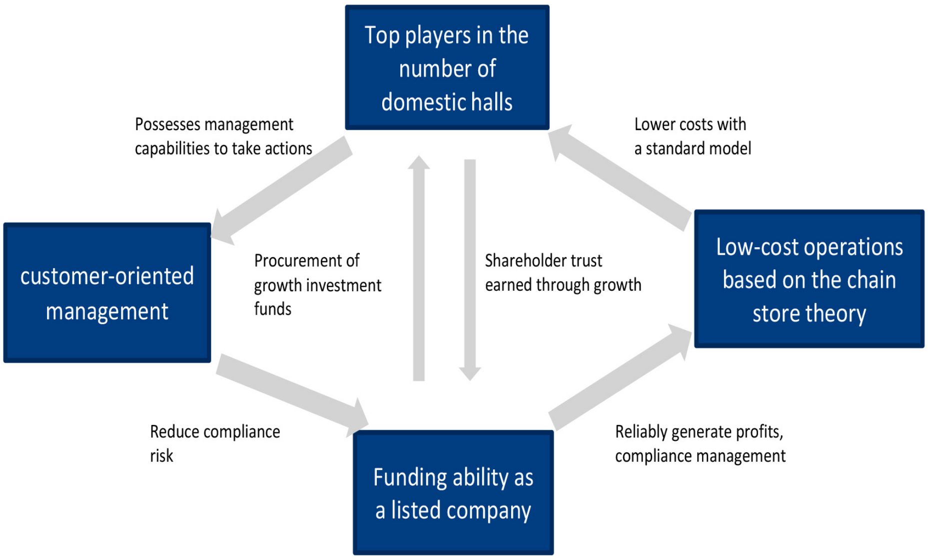
His logical approach rooted in the chain store theory took hold as the corporate culture and served as a fundamental force lifting the Company to the position of being the top company in the industry. The Company also moved quickly in embracing the most important concepts for modern management of a customer-first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

Established a robust management foundation that leverages four strengths, differentiates itself from other companies

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 halls in Japan, 2) low-cost operations, 3) customer-oriented management, and 4) fund-raising capabilities. Importantly these strengths are mutually interactive. We think it is difficult for other companies to realize the same combined strength seen at the Company.

Relationship among the four strengths of the Dynam Japan Holdings Group

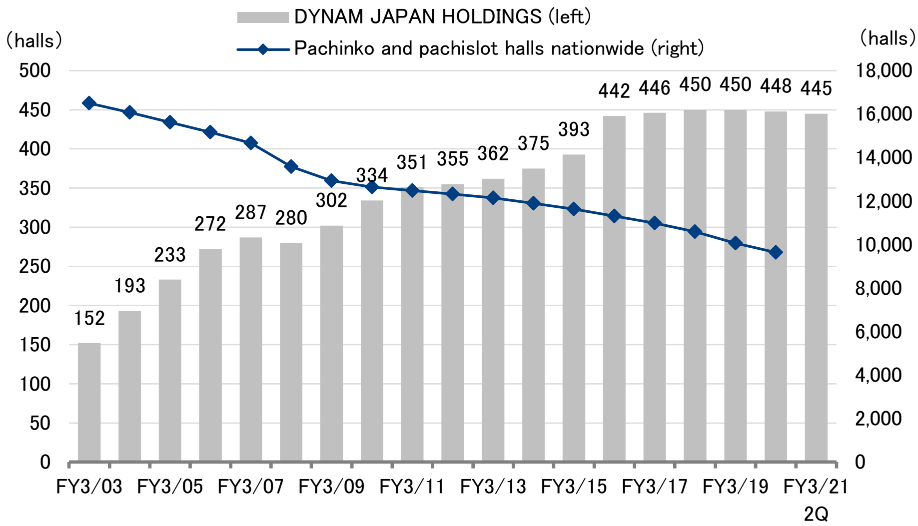


Source: Prepared by FISCO from interviews

(1) The domestic leader with 445 group halls

The Company is the domestic leader with 445 group halls (as of the end of September 2020). While it is not possible to make precise comparisons due to differences in compilation timing, the Company's domestic shares for the number of halls and machine installations are both at around 5%. It exceeded 1% of industry share in 2003, and since then, it has increased the number of halls, including through M&A, and expanded its share in a situation in which hall numbers in the industry as a whole are declining.

Trend in number of group halls



Source: Prepared by FISCO from the Company's website, and the National Police Agency's "Current Situation with Amusement and Entertainment Business and Situation with Policing Amusement and Entertainment-related Crime, etc. in 2019"

The Company's large number of halls provides it with economies of scale that appear in new hall openings, renovations, pachinko and pachislot machine purchases, prize procurement, logistics, and other areas. Benefits in pachinko and pachislot machine purchases and hall operations, which account for a large portion of expenses, are particularly important. The large number of halls obviously means ownership of a high volume of pachinko and pachislot machines and stronger buying power toward amusement equipment manufacturers. The Company also develops and deploys private-brand machines (as of the end of September 2020, 11.3% of installed pachinko machines were private-brand machines) and realizes economies of scale in this respect too. Furthermore, the Company has established logistics centers that cover 20-30 halls in 16 locations nationwide, and the Company is curbing machine costs (costs related to purchasing pachinko and pachislot machines) and reducing shipping costs by having halls flexibly lend machine models to one another. In addition, the Company is managing halls in an agile manner, including adjusting machine model lineups according to customers' needs, and has built a system enabling it to both increase the number of customers and reduce costs.

(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 is tremendous support in enabling the Company to secure the feasibility and effectiveness of various measures, including the growth strategy.

The chain store theory provides the theoretical backdrop as a pillar to low-cost operations. Costs of machines and personnel 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 445 halls. Aggressive hall network expansion supports this position, but the driving force of low-cost operation know-how has been an essential enabler. Hall network expansion has created a virtuous cycle of cost reductions through economies of scale 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 in 2003 with peers who have a similar view. By promoting the activities of PCSA, the Company is contributing to strengthening the management foundations of its industry peers, and this leads to Yume Corporation Co., Ltd. joining the Group in November 2015. In October 2020, PCSA merged with the Japan Association of Pachinko Industry Executives, with the new, post-merger entity named the Mirai Pachinko Industry Federation.

(3) Implementing management from a customer perspective

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

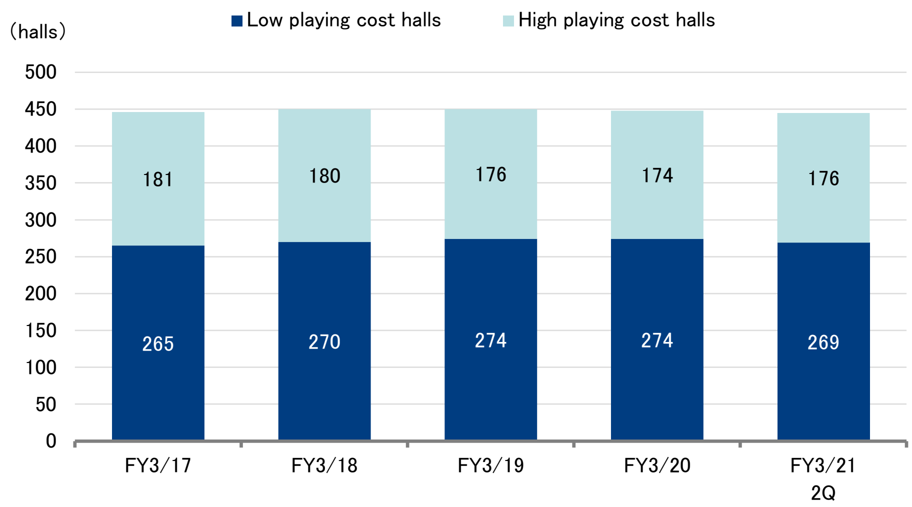
Among the Company's business policies, we have a favorable view of a) low playing cost and b) operations that do not rely on gambling appeal. These are also key words for understanding the Company's business policy and growth strategy.

a) Low playing cost operations

Low playing cost (Pachinko is a game that is played with rented balls) operations refer to a type of operation in which the ball fee has been lowered to ¥1 or ¥2 per ball, which is cheaper than the standard price of ¥4. Customers can rent more balls for the same amount, extending their playing time in accordance with the additional balls. For the Company, whose goal is for everyone to be able to easily enjoy pachinko as part of the infrastructure of a region, it can be said that increasing low playing cost halls is a rational measure. At the end of September 2020, it had 269 low playing cost halls, which is 60.4% of its total halls. In terms of the ratio of machines installed, the ratio of pachinko machines that are low playing cost machines is 72.2% (compared to an industry average of 46.0%) and the ratio of low playing cost pachislot machines is 57.8% (compared to an industry average of 20.0%), so both ratios greatly exceed the industry averages.

Data shows that halls offering low playing cost have attracted more customers than halls charging higher fees. Yet it takes substantial company wherewithal to adopt this type of strategy. A measure to offset this aspect is growth through expansion of hall numbers. The Company has followed this path.

Number of low playing cost halls and high playing cost halls



Source: Prepared by FISCO from the Company's annual report, website and news release

b) Operations that do not rely on gambling appeal

The Company does not position models with strong gambling appeal as a central strategy. Pachinko machines range 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 a high ratio of machines with strong gambling features.

However, based on the strengthening of measures to address gambling addiction and related, the regulatory authorities have been revising the regulations in stages in order to suppress the gambling aspect, and the current situation is that a style of managing pachinko halls by attracting customers through "selling" gambling is coming to an end. The Company, meanwhile, has a lower ratio of gambling-type machines than the industry average and conversely the share of machines with the lowest gambling features at 1/100 probability is 20 percentage points higher than the industry average. While the Company cannot avoid an impact from stricter gambling appeal regulations, we think the negative impact is relatively minor due to its existing pursuit of operations that do not rely on gambling appeal.

(4) Fund-raising 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 2,800 companies are listed on stock markets as of the end of September 2020. The industry is projected to face realignment going forward. An important point for a buyer in this environment is obviously whether it has fund-raising 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. With strong demand for potential capital through not only M&A but investment in halls and new business development, etc., it is likely that the Company's advantage of being a listed company will work tremendously in its favor.

FY3/21 interim results conditions

Double-digit declines in both revenue and profit due to the impacts of the novel coronavirus pandemic, but profit achieved through thorough cost-cutting efforts

1. Summary of FY3/21 interim results

In the FY3/21 consolidated interim results, revenue and profits decreased sharply. Revenue decreased 37.9% YoY to ¥45,992mn, operating profit decreased 80.2% to ¥2,781mn, profit before income taxes decreased 88.8% to ¥1,477mn, and net profit attributable to owners of the Company decreased 92.0% to ¥698mn.

Summary of FY3/21 interim results

(¥mn)

	FY3/20 Interim	FY3/21			Remark
		Interim	YoY	Change	
Revenue	74,052	45,992	-37.9%	-28,060	
Revenue from pachinko business	73,970	45,255	-38.8%	-28,715	High playing cost halls 21,757 (-14,557), low playing cost halls 23,498 (-14,158)
Revenue from aircraft leasing business	82	737	798.8%	655	
Operating expenses	61,220	41,840	76.5%	-14,380	
Pachinko business expenses	61,134	46,396	-24.1%	-14,738	Machine costs -7,481 Personnel costs -2,898
Aircraft leasing business expenses	86	444	416.3%	358	
SG&A expenses	2,339	2,082	-11.0%	-257	
Other income	4,369	6,142	40.6%	1,773	Vending machine fee income -983, employment adjustment subsidy, etc. +3,225
Other operating expenses	820	431	-47.4%	-389	
Operating profit	14,042	2,781	-80.2%	-11,261	
Financial income	286	154	-46.2%	-132	
Financial expenses	1,178	1,458	23.8%	280	
Profit before income taxes	13,150	1,477	-88.8%	-11,673	
Net profit attributable to owners of the Company	8,691	698	-92.0%	-7,993	

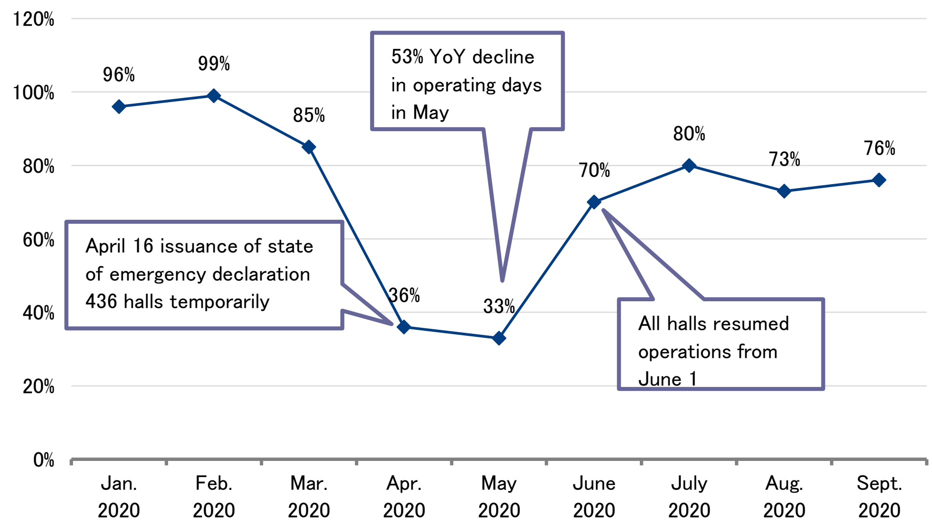
Source: Prepared by FISCO from the Company's financial statements announcement and interim report

Following the Japanese government's declaration of a state of emergency due to the novel coronavirus pandemic, in the pachinko business the Company had no choice but to temporarily close approximately 97% of its halls in the April through May 2020 period. These halls were then reopened from June 2020, but customers have not returned to the level seen before due to caution about the novel coronavirus, resulting in a large drop in revenue in the pachinko business. However, the Company was able to secure a positive operating profit, which was its goal. This was achieved through extensive cost-cutting efforts which included suppressing machine purchase costs, personnel costs, and other variable costs. The Company was also aided by the booking in other income of an employment adjustment subsidy, etc. of ¥3,225mn received from local governments, etc. in conjunction with the temporary closure of halls in response to the demand for refraining from engaging in business operations.

(1) Pachinko business

Following the Japanese government's state of emergency declaration on April 16, local governments asked pachinko halls in their respective areas to suspend operations. In response to these requests, 436 of the 448 pachinko halls in the Group had no choice but to temporarily suspend operations. From the beginning of May, the Group's pachinko halls resumed operations sequentially, with infection control measures in place, in regions where the state of emergency declaration was lifted, with all pachinko halls reopened as of June 1. Revenue in the April – May period plunged to approximately 30-40% of the level of the same month of the previous year due to the impact of hall closures and other factors. While all halls were re-opened from June onward, customers have been hesitant to return due to concerns about infection, and revenue remains at 70-80% of the level of the same month in the previous year.

Pachinko business revenue (YoY)



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

Amid this difficult environment, ball rental fee revenue, which corresponds to gross sales, declined 42.1% YoY to ¥219,663mn. Breaking this down, it fell 40.1% YoY to ¥100,405mn in low playing cost halls, and declined 43.6% YoY to ¥119,258mn in high playing cost halls. Meanwhile, prize issuance value, which represents the cost of goods, declined 42.9% YoY to ¥174,408mn. The difference between ball rental fee revenue and prize issuance value is pachinko business revenue, and this declined 38.8% YoY to ¥45,255mn.

The percentage of total revenue from ball rental fee revenue is the gross margin, and in the FY3/21 interim period, the gross margin increased by 1.1 percentage points (pp) YoY to 20.6%. Breaking it down, the gross margin for low playing cost halls increased 0.9pp YoY to 23.4%, while the gross margin for high playing cost halls increased 1.0pp YoY to 18.2%. Gross margin is the inverse of the payout rate to customers (percentage of prize issuance value to ball rental fee revenue), so if it is too high, it might lead to losing customers. Since past trends show gross margin generally in the 18% range to 19% range, we think the payout rate to customers in the FY3/21 interim period was a bit low.

The Company also thoroughly tightened down on business costs in order to put a stop to the deterioration in earnings. Specifically, the Company reduced machine costs by ¥7,481mn YoY, personnel costs by ¥2,898mn, and other costs including advertising and utilities by ¥4,616mn. Looking at the percentage declines, machine costs declined 58% YoY, personnel costs declined 19% YoY, and the variable cost portion of other costs declined 34%, while the fixed cost portion declined 12%. Total costs in the pachinko business declined 24.1% YoY to ¥46,396mn, exceeding revenue on an amount basis, but the pachinko business was able to secure positive operating profit thanks to the booking of an employment adjustment subsidy, etc. By thoroughly reducing costs, the business was able to recover to a positive operating profit from June 2020 onward, after posting operating losses in April and May 2020. As the entire industry faced a challenging business environment, the Company's ability to quickly respond to the changes in the environment and post a profit is worthy of praise.

As of September 30, 2020, the Group had 445 halls, which is three less than at the end of FY3/20. One hall was newly opened (renovated hall), while four halls were closed.

Looking at the results for DYNAM Co., Ltd., which is the Group's core company, revenue decreased 38.5% YoY to ¥42,456mn, while operating loss was ¥2,401mn (compared to operating profit of ¥10,788mn in the same period of the previous year). While consolidated results are presented based on International Financial Reporting Standards (IFRS), DYNAM Co., Ltd.'s results are presented based on Japanese accounting standards, and approximately ¥2.7bn in employment adjustment subsidy, etc. was booked in non-operating profit. As a result, ordinary profit declined 92.5% YoY to ¥854mn.

DYNAM's interim results (Japanese accounting standards)

(¥mn)

	FY3/20 Interim	FY3/21			Summary
		Interim	YoY	Change	
Revenue	69,082	42,456	-38.5%	-26,626	Temporary hall closures due to impacts of the novel coronavirus pandemic, slow recovery in customers
Machine costs	11,680	5,072	-56.6%	-6,608	Suppression of pachinko and pachislot machine purchases
Personnel costs	22,320	19,365	-13.2%	-2,955	Suppression of part-time workers' wages, reduction of salaries and bonuses
Other costs	24,293	20,420	-15.9%	-3,873	Reduction of hall operating costs
Total expenses	58,293	44,857	-23.1%	-13,436	
Operating profit	10,788	-2,401	-122.3%	-13,189	
Ordinary profit	11,400	854	-92.5%	-10,546	Booked employment adjustment subsidy, etc. of approximately ¥2.7bn
Main KPI (key performance indicators)					
No. of halls	405	404		-1	New hall openings: Ibaraki Inashik Hall Closed halls: Gumma Isesaki Hall and Nishi-nippori Pachinko Hall
Pachinko machine operating rate	42.2%	27.3%		-14.9pt	+3.8pt vs. rival halls
Pachislot machine operating rate	39.2%	27.6%		-11.6pt	+0.3pt vs. rival halls
No. of machines	188,765	189,339		574	Installed machine share 4.5%
Pachinko	133,306	132,971		-335	
Pachislot	55,459	56,368		909	
No. of private-brand machines	11,393	14,969		3,576	Private-brand machine installation rate 11.3% (difference on previous period, +2.8pt)

Source: Prepared by FISCO from the Company's results briefing materials, interim report and materials provided by the Company

Among the KPI (Key Performance Indicators), the operating rate* for pachinko machines declined 14.9pp YoY to 27.3%, while the operating rate fell 11.6pp YoY to 27.6% for pachislot machines, so the operating rate fell significantly for both types of machines due to the impacts of the novel coronavirus pandemic. Still, the operating rates were slightly above the operating rates at competitors' halls. Additionally, with respect to pachinko machines, the ratio of private-brand machines increased 2.8pp YoY to 11.3%, topping the 10% mark for the first time. This shows how the Company raised the ratio of low-cost private-brand machines in the purchase of new machine models, as a part of its effort to reduce costs.

* The number of actual customers / number of machines at the peak time (around 3:00pm)

(2) Aircraft leasing business

In the aircraft leasing business, which was launched in March 2020, the Company has limited its scope of business to narrow body aircraft, which are highly-liquid, and for which demand is expected to be stable. The Company is taking a cautious approach to purchasing new aircraft given the ongoing headwinds, including the major blow suffered by airlines around the world, caused by the novel coronavirus pandemic. Currently, the Company is managing the leases of the three aircraft purchased in FY3/20, conducting credit analyses of airlines, and gathering information for new deals.

Revenue in the FY3/21 interim period was ¥737mn, a ¥655mn YoY increase. The rise was due to the YoY increase in the number of aircraft owned, and during the interim period there were no deferrals of lease fees or other such impacts from the novel coronavirus pandemic.

Meanwhile, aircraft leasing business expenses increased ¥358mn YoY to ¥444mn. The increase in aircraft leasing expenses was due to the increase in the number of aircraft owned and higher personnel costs in conjunction with the bolstering of the organization. Operating profit, including financial expenses and other expenses in order to purchase aircraft, increased ¥45mn YoY to ¥120mn. The fleet value for the three aircraft is ¥15.59bn, and the annualized gross rate of return was 8.8%.

Results for aircraft lease contracts

Leasing party	Contract period	Model	Assets (net worth)	Average age	Average remaining lease period
Vueling Airlines (Spain)	July 2019	Airbus A320	US$147.4mn	1.7 years	5.0 years
IndiGo (India)	October 2019	Airbus A320			
IndiGo (India)	March 2020	Airbus A321			

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

Increasing borrowings in order to secure cash on hand given the uncertain outlook for the business environment

2. Financial condition

At the end of the FY3/21 interim period, total assets increased ¥19,145mn versus the end of the previous fiscal period to ¥296,384mn. The main factor for the change was the roughly ¥10bn increased in cash and deposits resulting from bank borrowings and corporate tax and consumption tax payment deferrals. The tax deferrals were based on special extensions given to companies that were hit hard by the novel coronavirus pandemic. Also, by keeping down machine purchase costs, inventory declined ¥1,197mn and property, plant and equipment fell ¥4,618mn.

Total liabilities were up ¥21,649mn on the end of the previous fiscal period to ¥164,156mn. This was mainly due to the increase in interest-bearing debt, and there was a ¥22,809mn increase in the pachinko business. In addition, trade payable declined ¥314mn, while short-term and long-term lease obligations declined ¥415mn.

Total equity was down ¥2,504mn from the end of the previous fiscal period to ¥132,228mn. While interim profit of ¥689mn was posted, period-end dividend payments were ¥2,298mn, ¥755mn was used on the acquisition and retirement of treasury shares, and other comprehensive income declined ¥140mn.

Mainly due to the increase in interest-bearing debt, the capital ratio declined from 48.6% at the end of FY3/20 to 44.6%. However, net cash, which is the difference between cash and deposits and interest-bearing debt, was ¥32,596mn, a ¥4,014mn increase from the end of the previous period. Therefore, it is deemed that Company has maintained its financial soundness.

Consolidated financial condition

(¥mn)

	End-FY3/20	End-FY3/21 Interim period	Change	Changed items
Total assets	277,239	296,384	19,145	Cash and cash equivalents +26,030, inventory -1,197, property, plant and equipment -4,618, deferred tax assets -452
(Cash and cash equivalents)	41,810	67,840	26,030	
Total liabilities	142,507	164,156	21,649	Interest-bearing debt +22,016, accounts payable -314, lease liabilities -415, provisions -421
(Interest-bearing debt from pachinko business)	2,007	24,816	22,809	
(Interest-bearing debt from aircraft leasing business)	11,221	10,428	-793	
Total equity	134,732	132,228	-2,504	Interim profit +689, dividend payment -2,298, acquisition and retirement of treasury shares -755, other comprehensive income -140
(Capital ratio)	48.6%	44.6%	-4.0pt	
(Net cash)	28,582	32,596	4,014	

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

FY3/21 2H outlook

Although it will depend on the situation with the novel coronavirus pandemic, the Company plans to cut expenses and achieve an operating profit again in FY3/21 2H

1. Pachinko business

As the novel coronavirus has once again been spreading nationwide since November 2020, and people become increasingly cautious regarding infection again, the situation is expected to remain severe in the pachinko hall industry. In fact, since October 2020, it seems that the number of customers has begun to decline in Hokkaido, preceded by the re-expansion of infections, and there are concerns that the number of customers will also decline in Osaka and Tokyo from November. As a measure to attract customers to its halls, the Company is working on thorough measures to prevent novel coronavirus infections and is promoting the safety of its pachinko halls, but unless the number of newly infected people peaks out, it seems that the return of customers will be slow.

Under these circumstances, the Company intends to secure a profit again in FY3/21 2H by working to curb costs. Regarding personnel costs, the Company will continue to reduce hiring-related costs by suspending new hiring of part-time workers as well as by reducing bonuses. According to our estimation, the operating loss of just below ¥5bn in FY3/21 1Q is estimated to have turned into an operating profit of ¥5-6bn in 2Q. If 2H revenue is about the same as in 2Q (roughly 25% lower YoY), we expect the Company to be able to secure an operating profit.

However, with regard to machine costs, the Company needs to gradually replace machines under old regulations with machines under new regulations by the deadline of November 30, 2021 for removing all old regulation machines. Initially, the deadline for removing the old regulation machines was the end of January 2021, but due to the impacts of the coronavirus pandemic, the regulatory authorities pushed back the deadline to the end of November 2021. In response to this, in May 2020, the pachinko hall industry group formulated voluntary rules and announced that members would gradually replace the old regulation machines with new regulation machines, and the Company is going to proceed with the removal of the old regulation machines by replacing them with new regulation machines in line with these rules. As of September 2020, the Group still had about 130,000 old regulation machines, and the pace and method of replacement as we head towards the end of November 2021 will be determined while keeping an eye on the future profit situation. However, at the moment, it seems that the Company is planning to double its machine purchase costs in 2H from the ¥5,073mn in FY3/21 1H.

As a measure to reduce purchase costs, the Company will reduce unit prices through Company-wide bulk purchases. In the past, purchase negotiations were conducted for each block area, but making Company-wide bulk purchases has had the effect of lowering prices, and from 2H onward the Company will continue to work to reduce prices. The Company is also introducing field testing. Field testing is a program in which new machine models are first purchased in small lots experimentally, the operating status is analyzed, and then the purchaser determines whether or not to buy additional machines depending on the outcome of the analysis, thereby quickly improving revenue losses at an early stage. Furthermore, the Company will make full use of internal distribution. By having a hall that purchased a new machine model lend that machine model to another Group hall after a certain amount of time has gone by, it will be possible to reduce the total number of new models purchased.

Plans to proceed cautiously with business talks in the aircraft leasing business

2. Aircraft leasing business

In the aircraft leasing business, the Company plans to cautiously proceed with business talks centered on narrow body models that are no more than five years old, while keeping a close eye on the financial conditions of airlines.

Looking at the medium to long term, global demand for aircraft is forecast to recover at some point, and the aircraft leasing business itself can be expected to provide stable returns. With respect to the number of aircraft it will purchase, the Company's plan for the future is to increase its aircraft holdings to around 20 aircraft, making them a stable source of earnings.

Video slot machines have been greatly impacted by the novel coronavirus pandemic, and the Company is now in a waiting mode

3. Progress in the video slot machine business for casinos

The Company has been working on the planning and development of mass-market video slot machines for the Macau casino market as a new business. Video slot machines are time-consumption-type games, and the development concept is to make straightforward games that incorporate elements of pachinko.

The Company worked on development of this video slot machine jointly with WEIKE GAMING TECHNOLOGY (S) PTE. LTD. (WEIKE), which holds a license for manufacturing and selling casino machines in Macau. So far, the Company has obtained approval for six models from the Macau casino regulatory authorities, and approval for three models in Singapore, while approval for another model has been applied for in Singapore. In addition, in September 2019 the Company concluded a sales agreement with a Macau casino operator and in November 2019 the Company deployed on a test basis one of each of the three models (total of three machines) in Legend Palace Casino. Moreover, the Company deployed 10 machines in a different casino hall from January 2020. It had also planned to deploy machines in another casino, but this was postponed due to the novel coronavirus pandemic.

Installations of casino-use video slot machines and status of development approval

Time	No. of machines	Trial location
From November 2019	3	Legend Palace Casino
From January 2020	10	Word-Class Casino in Ponte 16 Resort Macau

Name of model	Conditions
Pachinko Bonus Series No.1 Machine	Has obtained approval in Macau, and has obtained approval in Singapore in May 2020
Pachinko Bonus Series No.2 Machine	Has obtained approval in Macau, and has obtained approval in Singapore in May 2020
Pachinko Bonus Series No.3 Machine	Has obtained approval in Macau, and has obtained approval in Singapore in September 2020
Pachinko Bonus Series No.4 Machine	Obtained approval in Macau in September 2020, and has applied for approval in Singapore

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

The current sales agreements are on a trial basis, so if the models had been evaluated as being "earning machines" when looking at the operating conditions in the future, it was possible that the number of machines deployed would have increased dramatically. But that was before the impact of the novel coronavirus. Due to restrictions on entry from mainland China, casinos in Macau have seen the number of visitors plunge 80% YoY as of October 2020, and the casinos have been unable to evaluate the models they have been deploying on a trial basis. Therefore, the Company has decided to re-propose to casino operators that they start operations on a trial basis after replacing the software once the number of visitors returns to normal levels.

At FISCO, we think that for the time being, some time will be required before the video slot machines business makes a fully-fledged contribution to earnings. Even when deploying models on a trial basis, they will not subsequently be deployed on a fully fledged basis if they do not obtain the support of the customer. Also, in terms of the business model, the Company only conducts planning and development and it depends on WEIKE for manufacturing and sales licenses. Therefore, even if it succeeds with fully fledged deployments, there are unknown factors to determine the extent to which these deployments will contribute to earnings. The ideal would be to realize revenue sharing agreements with the casino operators, but as there are various regulations, at FISCO we think that some time will also be required for this point. Whatever the case, what is most important is that the Company's new products become "earning machines," and it will be necessary to pay attention to the operating and sales conditions of the models that it will deploy in the future.

Business outlook

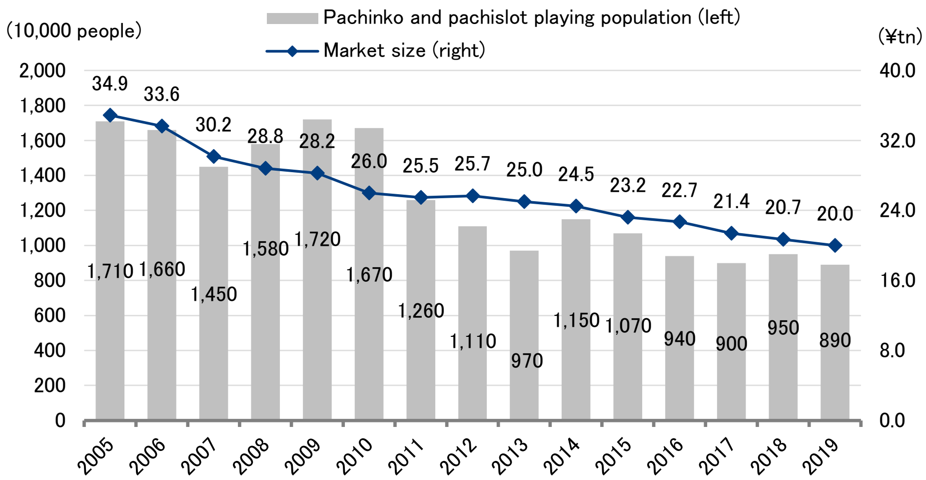
Spurred by the novel coronavirus pandemic, the consolidation of the pachinko hall industry into the major capital players may progress even more

1. Pachinko hall industry conditions and growth strategy

(1) Market trends

The pachinko market continues to experience a long-term contraction trend. According to the "White Paper on Leisure 2020" issued by the Japan Productivity Center, Japan's pachinko and pachislot playing population in 2019 was 8.9 million, a 600,000 person decline from 9.5 million in the previous year, and the pachinko hall market size (total ball rental fee revenue) fell 3.4% YoY to ¥20.0tn, marking the seventh consecutive year of decline.

Trends in the pachinko and pachislot playing population and pachinko hall market size



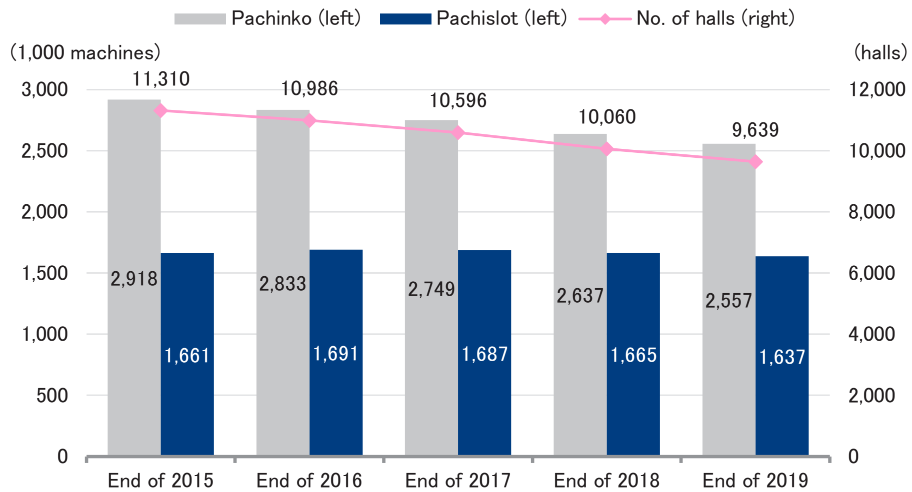
Source: Prepared by FISCO from the Japan Productivity Center's "White Paper on Leisure"

Reflecting these conditions, the number of pachinko and pachislot halls continues to decrease, and at the end of 2019, the number of halls was down 4.2% on the end of the previous year to 9,639 halls (according to the National Police Agency research), falling below the important benchmark of 10,000 halls. Also, in terms of the number of machines installed at the end of 2019, the number of pachinko machines decreased 3.0% on the end of the previous year to 2,557,000 machines, and the number of pachislot machines declined 1.6% to 1,637,000 machines, so both continue to trend downward. At FISCO, we expect there to be further weeding out of weaker, small- and medium-sized halls going forward because of the deterioration of earnings following the voluntary business closures due to the spread of the novel coronavirus, and as even through the deadline has been postponed by one year, due to the concerns about the increased investment burden from transitioning from models under the former regulations to models under the new regulations.

Looking at the numbers of pachinko and pachislot machines installed per hall, the number at the end of 2019 was 435.3 machines, and it has been increasing in the last few years. This seems to indicate the decrease in the number of small- and medium-sized halls. Conversely, the ball rental fee revenue per hall is continuing at around the same level YoY, at slightly more than ¥2bn. It seems a factor for ball rental fee revenue is the increase in low playing cost halls, but for earnings per hall, it can be said that the current situation is that even the large-sized halls are struggling.

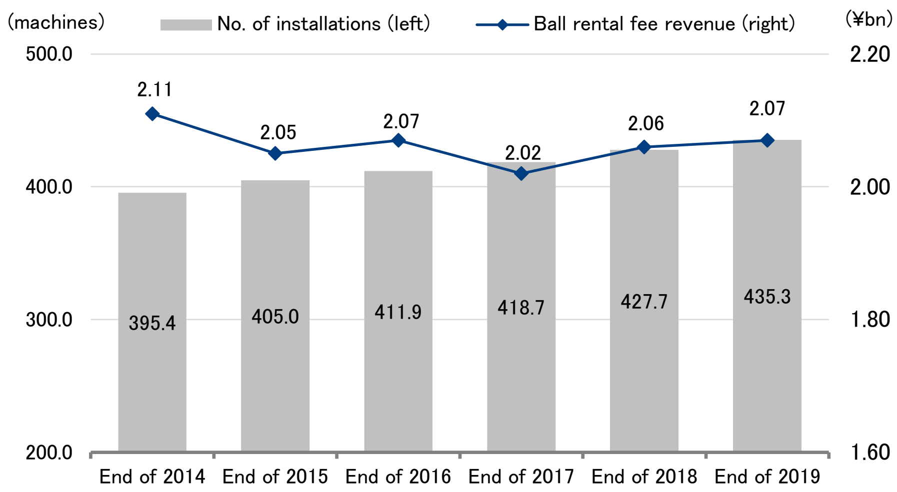
Incidentally, for the Group, the number of pachinko and pachislot machines installed per hall as of September 2020 was 471 machines, and the ball rental fee revenue in FY3/20 was slightly more than ¥1.6bn. The reason why its ball rental fee revenue is low despite the fact that the number of machines installed is above the industry average is considered to be the high percentage of its halls that are low playing cost halls, at over 60%. As previously stated, the Company has positioned pachinko as daily entertainment that anyone can enjoy, and it has worked on implementing low-cost operations that can secure profitability even with low playing cost. Therefore, our understanding at FISCO is that the current strengthening of regulations on models with gambling appeal will have a comparatively small impact on the Company.

No. of halls and no. of installations of pachinko and pachislot machine



Source: Prepared by FISCO from the National Police Agency's "Current Situation with Amusement and Entertainment Business and Situation with Policing Amusement and Entertainment-related Crime, etc. in 2019"

Trends in number of installations and ball rental fee revenue per hall



Source: Prepared by FISCO from the Japan Productivity Center's "White Paper on Leisure" and the National Police Agency's "Current Situation with Amusement and Entertainment Business and Situation with Policing Amusement and Entertainment-related Crime, etc. in 2019"

(2) Growth strategy

The Company's growth strategy in the pachinko business has been to grow by multiplying two axes: increasing the number of halls and growing revenue at existing halls. However, it is difficult to continue such a strategy at the current time as the novel coronavirus pandemic is keeping customers away, so the Company's current policy is to secure the recovery of the profitability of existing halls as a top priority. For this reason, the Company has put a freeze on the opening of new halls for the meantime, and will likely consider closing down existing halls that are struggling with profitability and that the Company feels will take time to recover. Similarly, the strategy of growing revenue at existing halls is on hold until after the novel coronavirus pandemic gets under control, as the necessary recovery in the number of customers, the premise for increasing revenue, has failed to take place.

As measures to recover the profitability of halls, the Company is working on an experimental basis to reduce the working hours of hall employees at some halls through the division of labor. Specifically, in order to establish an environment that enables halls to concentrate on hall services, the operations and functions that are respectively the responsibilities of venues (halls) and the head office are defined, and tasks other than those which can only be done at halls are transferred to the head office. In terms of concrete changes, up until now, staff had been assigned to individual halls to work on sales promotion and hall management operations, but with this new approach the Company is changing to a system in which one staff member is responsible for these operations at around 10 halls. The effects of doing this are expected to be an improvement in productivity (lowering the personnel cost ratio) from reducing the workload at halls and improving customer satisfaction (improving ability to draw in customers) by enhancing services.

In addition, from October 2020 onward the Company has been introducing self-service, with aims including reducing contact chances and lowering transmission risk. By having customers handle tasks that hall staff had been performing up until now during customers' meal breaks and when exchanging rental balls and medals, the chances for contact is reduced and the workload of staff is also lightened. Also, the Company is expanding the test area for introducing self POS (increase the efficiency of gift counter operations). The Company's strategy is to expand these measures to all of the Group's halls, thereby reducing hall operating costs and bolstering profit-earning capacity. The Company also plans to continue working on workstyle reforms, including utilizing personnel in line with their aptitudes (creating workplaces that are rewarding and satisfying to work in) and promoting diversity and inclusion.

Amid the continuing market contraction, there remains plenty of room for growth by increasing share

2. Approach to results from FY3/22 onwards

The novel coronavirus pandemic has reaffirmed the enormity of the impact and risk that an unknown disease can have on economic activity. Looking to the future, until treatments and vaccines are developed, the novel coronavirus risk will follow the Company, making it difficult to forecast future earnings.

Change factors will be the operating rate, machine purchase costs, personnel costs and other hall operating costs. The operating rate bottomed out in the April-May 2020 period, and currently revenue has recovered to around 70-80% of the previous year's level, but until a vaccine and treatments are developed, it is best to understand that the Company's results could be impacted by the situation with infections.

Also, machine costs will change depending on the pace of replacements with models compliant with the new regulations. If the Company keeps down the number of machines purchased in FY3/21, that will result in more machine purchase costs in FY3/22, and this will also depend on the FY3/21 earnings. If it seems that the Company will be able to secure a profit, the Company has the option of increasing the number of machines it purchases in FY3/21, and thereby reducing the cost burden in FY3/22.

Based on the above, there are many variable factors for FY3/22, and it is difficult to forecast results at this point, but in the medium term, even if the pachinko/pachislot industry continues to contract, at FISCO we believe there is ample room for the Company to grow by expanding its market share. This is because, as mentioned before, the Company's market share in the industry is only about 5%, even though it has the most halls of any industry player. In addition, if the Company is able to increase the efficiency of hall operations (it is currently working on this), profits will recover quickly after the coronavirus pandemic has subsided, and there may also be good opportunities to expand market share through M&A.

In addition, the Company's strategic aim of making pachinko a key part of the local infrastructure that all people can easily play as a form of daily entertainment, is in line with the changing times. Going forward, amid the expected industry reorganization and consolidation by major capital players, at FISCO we believe that there is a strong likelihood that the Company will expand its market share as one of the winners in the industry.

Simplified income statement and key indicators

(¥mn)

	FY3/17	FY3/18	FY3/19	FY3/20	FY3/21 interim
Revenue	156,869	152,092	146,371	141,919	45,992
YoY	0.6%	-3.0%	-3.8%	-3.0%	-37.9%
Operating expenses	142,142	136,727	128,024	121,912	46,840
YoY	2.8%	-3.8%	-6.4%	-4.8%	-23.5%
SG&A expenses	5,622	5,049	5,023	5,020	2,082
YoY	-3.0%	-10.2%	-0.5%	-0.1%	-11.0%
Other income	9,224	9,458	8,971	9,010	6,142
Other operating expenses	2,430	2,425	2,953	2,483	431
Total expenses	140,970	134,743	127,029	120,405	43,211
YoY	2.3%	-4.4%	-5.7%	-5.2%	-28.0%
Operating profit	15,899	17,349	19,342	21,514	2,781
YoY	-12.5%	9.1%	11.5%	11.2%	-80.2%
Financial income	233	236	471	461	154
Financial expenses	1,307	781	444	2,469	1,458
Profit before income taxes	14,825	16,804	19,369	19,506	1,477
YoY	-14.8%	13.3%	15.3%	0.7%	-88.8%
Income taxes	5,520	5,879	6,778	6,759	788
Net profit for the year	9,305	10,925	12,591	12,747	689
YoY	-11.7%	17.4%	15.2%	1.2%	-92.1%
Net profit attributable to owners of the Company	9,360	10,870	12,596	12,748	698
YoY	-11.2%	16.1%	15.9%	1.2%	-92.0%
EBITDA	28,469	29,524	31,136	33,151	7,854
YoY	-6.6%	3.7%	5.5%	6.5%	-60.0%
EPS (¥)	12.2	14.2	16.4	16.6	0.91
Dividend per share (¥)	12	12	12	9	3

Source: Prepared by FISCO from the Company's financial statements announcement, results briefing materials and interim report

Statement of consolidated financial position

(¥mn)

	FY3/17	FY3/18	FY3/19	FY3/20	FY3/21 interim
Current assets	63,072	53,145	59,875	55,798	80,257
Cash and cash equivalents	48,499	40,533	47,537	41,810	67,840
Trade receivables	563	469	614	554	396
Non-current assets	142,043	131,826	125,457	221,441	216,127
Property, plant and equipment	106,687	98,794	95,445	105,206	100,588
Licensing assets	-	-	-	79,048	79,027
Intangible assets	3,833	3,545	3,112	3,623	3,476
Total assets	205,115	184,971	185,332	277,239	296,384
Current liabilities	38,496	39,643	36,452	44,028	62,683
Trade payables	18,282	19,220	19,297	14,801	14,487
Short-term borrowings, etc.	7,281	7,351	2,124	3,008	21,932
Lease liabilities	-	-	-	12,185	12,019
Non-current liabilities	29,738	7,813	7,080	98,479	101,473
Long-term borrowings	22,768	1,221	502	10,220	13,312
Lease liabilities	-	-	-	81,611	81,362
Equity attributable to owners of the Company	136,953	137,532	141,821	134,753	132,257
Share capital	15,000	15,000	15,000	15,000	15,000
Capital reserve	12,741	12,741	12,741	12,741	12,023
Retained profits	112,403	114,106	115,204	109,317	107,717
Other component of equity	-3,191	-4,315	-1,124	-2,305	-2,446
Non-controlling interests	-72	-17	-21	-21	-29
Total equity	136,881	137,515	141,800	134,732	132,228
Total liabilities and equity	205,115	184,971	185,332	277,239	296,384

Source: Prepared by FISCO from the Company's financial statements announcement

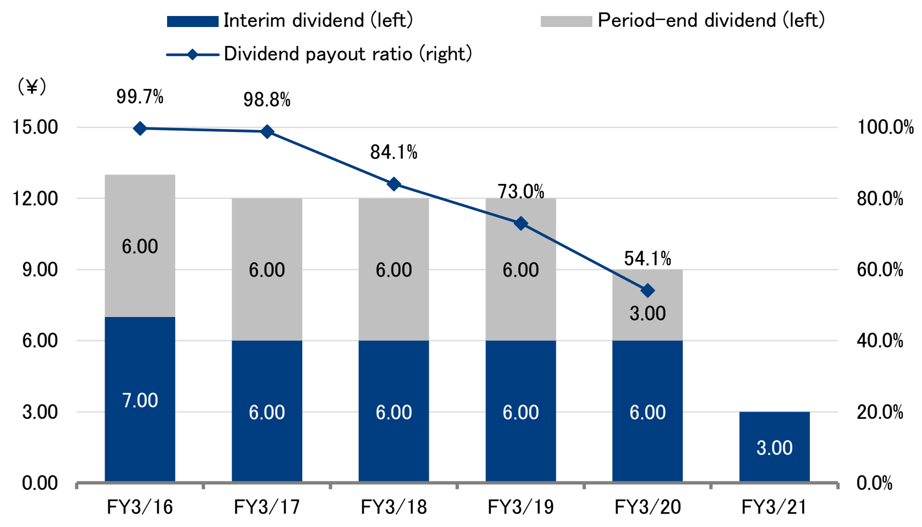
Returns to shareholders

Has decided on a FY3/21 interim dividend of ¥3 per share in light of the current earnings 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. Based on this view, its policy is to pay stable dividends.

Based on this policy, and in light of the current situation with earnings, the Company decided on a FY3/21 interim dividend of ¥3 per share, the same amount as the FY3/20 period-end dividend. Also, in the FY3/21 interim period, the Company carried out a ¥755mn stock buyback.

Trends in dividend per share and dividend payout ratio



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

CSR/ESG initiatives

Carrying out workplace reforms and developing and appointing women managers among other measures with the aim of enhancing long-term corporate value

1. Enhancement of long-term corporate value through CSR

As a listed company, the Company not only conducts compliance management in line with the laws and regulations and seeks to maximize profits, but also possesses strong awareness of CSR (Corporate Social Responsibility) while positioning its aim of building "regional infrastructure" as the axis of management.

Details can be found in its report issued on December 25, 2018. The Company conducts internal discussions and also interacts with external parties (other companies, local society, etc.) and engages in other activities to address social themes, such as work style reforms, training female managers, and efforts to prevent second-hand smoke. It aims to enhance long-term corporate value.

Actively disclosing non-financial (ESG) information and enhancing tools for dialogue with long-term investors

2. ESG activities

The Company made a revision to the CSR section on its website on February 25, 2019, and it became the ESG section. The Hong Kong Stock Exchange requires companies listed on the exchange to disclose ESG information since 2017, and listed companies are ramping up their disclosure of non-financial information. The Company's website also added to information disclosure on its views of and initiatives with the environment (E) and society (S) and governance (G).

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 on its website as evidence of its openness to dialogue with global long-term investors. The Company also disclosed an ESG report (ESG Report 2020) in August 2020. 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.

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