COMPANY RESEARCH AND ANALYSIS REPORT

eREX Co. Ltd.

9517

Tokyo Stock Exchange First Section

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Index

Summary

Healthy progress with the Dash 1000 medium-term plan brings the ¥100bn sales goal within reach

eREX Co. Ltd. <9517> (hereafter, also "the Company") is an independent electricity provider, known as a power producer and supplier, or PPS, operating an electricity retail business. Leveraging its advantages of a competitive base load power supply and a flexible sales strategy, the Company is targeting high growth from the full liberalization of the electricity market from 2016 onward.

1. Raised FY3/17 forecast, announced a stock split and dividend hike

The Company reported Q3 FY3/17 (April to December 2016) results with ¥22,049mn in sales (up 32.8% year on year (YoY)) and ¥2,442mn in operating income (up 141.6%). Both sales and profits moved sharply higher. The Company announced upward revisions of FY3/17 forecast in light of operating income reaching 91.7% of the period-start FY3/17 target through 3Q. It also unveiled a stock split of 3-to-1 shares with March 7 as the effective date and an effective dividend hike.

2. Expanding high-voltage and low-voltage retail electricity customers as planned; making advances in power source procurement too

Upbeat business results can be attributed to healthy growth in retail electricity customer volume in high-voltage (large-volume customers) and low-voltage (small-volume customers) segments. In power source procurement, the Saiki power plant, which the Company had been building for some time, started commercial operation in November 2016 and is continuing trouble-free operation since then. While the Company sells some power generated at the Saiki facility on a wholesale basis on the Japan Electric Power Exchange (JEPX), Saiki output lifted profits by lowering production costs in the imbalance cost calculation.

3. Entered the Okinawa market for sales, finished fundraising for the Buzen project in power sourcing

The Company is making healthy progress in the Dash 1000 medium-term business plan too. The plan focuses on securing proprietary power sources due to biomass power plant and establishing a strong sales network, and steady advances have taken place in both areas. In sales, the Company completed an alliance network and decided to enter the Okinawa market. We think it is looking next at entry into the Shikoku market. In power sources, the Company completed the scheme for project finance in the Buzen project, in which it has taken the initiative. Preparations are also moving for construction of additional power source facilities in Okinawa and one other area.

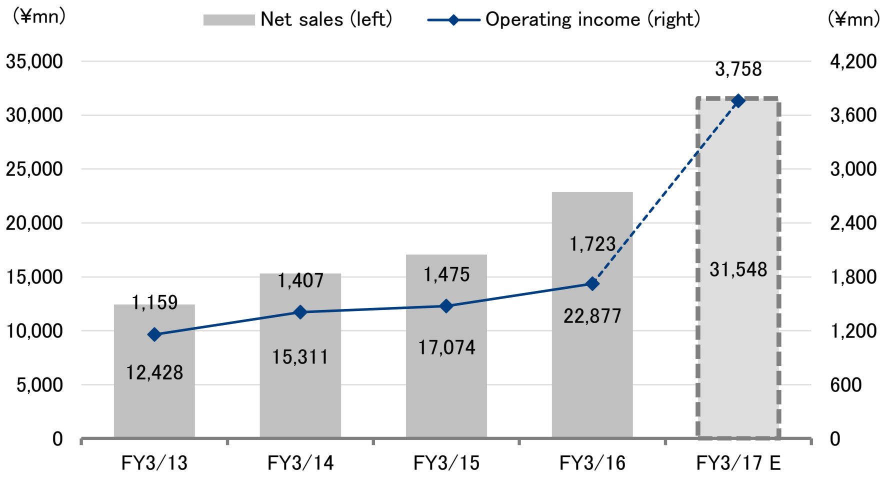
4. Fulfilling the current medium-term business plan brings eREX within reach of the goal of ¥100bn in sales

The Company positions the current Dash 1000 medium-term business plan as a preparatory period for reaching the goal of ¥100bn in sales in 4 to 5year's time and this is basis for the plan's name. We think the FY3/17 upward revision is a sign that the Company's business initiatives are moving in the right direction as a PPS company. We also believe that the Company is within reach of attaining ¥100bn in sales in FY3/20, the year after completion of Dash 1000, if it makes healthy progress in securing power sources and acquiring customers as outlined in Dash 1000.

Key Points

- Building integrated operations from power creation to sales, excels at low-cost, large-scale biomass power generation
- Posted sharply higher sales and profits in Q3, increased FY3/17 forecast
- Launching Ofunato and Buzen projects, arranged funding too

Trends in sales and operating income



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

Company profile

Began electricity retail business in 2001 as a PPS

1. History

The Company was established in 1999 as part of the diversification of Nittan Exco Ltd. Initially named "Nittan Energy Co., Ltd.," the Company changed to its current name the following year. In response to the creation of the PPS system in 2000, the Company submitted notification to the Ministry of Economy, Trade and Industry of its status as a PPS in January 2001, starting an electricity retail business.

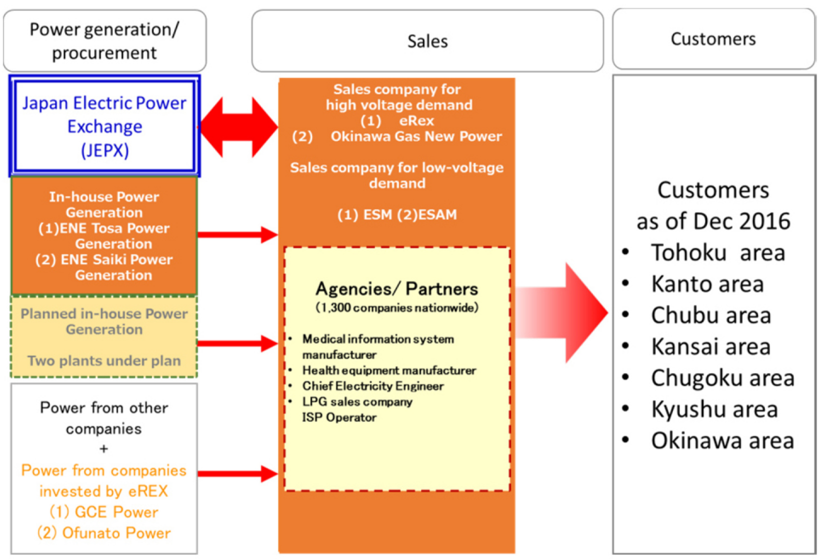
The Company operates as a PPS, conducting wholesale sales of electricity as well as retail sales to users. Previously, Tokyo Electric Power Company, Incorporated <9501> and other major electricity providers (known as "General electric utilities" under the scheme) supplied electricity under regional monopolies. However, during the transition toward the liberalization of the electricity market, the PPS scheme was established in 2000, and the Company started electricity retailing operations as the third operator to register under the scheme from 2001.

Building integrated operations from power creation to sales, excels at low-cost, large-scale biomass power generation

2. Business Model

The Company's business model consists of "producing, procuring, and selling electricity." Electricity is the product in this business with procurement from self-generation and purchases from external sources. The Company sells electricity to customers at the retail level and on a wholesale basis through the exchange. An important point in understanding the electricity business is that electricity cannot be stored. Almost all complexity associated with the electricity business framework compared to ordinary manufacturing and retail business can be traced back to this reality.

Flow of electric power surrounding our group



Source: The Company's "Briefing materials for investment"

The Company procures electricity that it sells through three main routes – self-generation, purchases of electricity from power sources owned by other companies and sources in which it owns a stake, and purchases from JEPX. Procurement strategy seeks a balance of self-generated electricity and electricity from external power sources. Specifically, the Company makes decisions about power-source composition in the context of securing stable supply operations, demand growth forecasts, and realization of a flexible cost structure. It started commercial operation of the Saiki power plant in November 2016 and plans to expand power-generating capacity further (details covered below).

Cost competitiveness of self-operated electricity is central in efforts to secure power sources. The Company generates electricity utilizing a biomass power facility that operates on palm kernel shell (PKS) as the main fuel. The Saiki plant has rated output of 50MW and currently is the largest wood-type biomass plant in Japan. The Company intends to improve cost competitiveness by increasing output levels to 75MW each in the Ofunato and Buzen plants that it will be adding next.

For sales, meanwhile, the Company conducts retail sales directly to customers and also engages in wholesale supply to JEPX. Core points in sales are balance between retail and wholesale operations sales mix in low-voltage segment and high-voltage segment, developing a portfolio of retail customers, selecting sales regions, and building sales operations and a sales network. The Company strives to expand customer volume by using a sales agent system for high-voltage business and an alliance strategy based on sales subsidiaries for low-voltage business.

Results trends

Posted sharply higher sales and profits in Q3, increased FY3/17 forecast

1. Overview of the FY3/17 3Q results

The Company reported Q3 FY3/17 results with ¥22,049mn in net sales (up 32.8% YoY), ¥2,442mn in operating income (up 141.6%), ¥2,328mn in ordinary income (up 144.3%), and ¥1,252mn in profit attributable to owners of parent (up 87.5%). Both sales and profits moved sharply higher.

Overview of the FY3/17 Q3 results

(¥mn)

	FY3/16		FY3/17				
	Q3 (cumulative)	Full year results	Q3 (cumulative)	YoY	Rate of progress	Initial forecast	YoY
Net sales	16,608	22,877	22,049	32.8%	65.9%	33,466	46.3%
Operating income	1,010	1,723	2,442	141.6%	91.7%	2,664	54.6%
Operating income margin	6.1%	7.5%	11.1%	-	-	8.0%	-
Ordinary income	953	1,614	2,328	144.3%	95.0%	2,451	51.9%
Profit attributable to owners of parent	667	1,112	1,252	87.5%	87.8%	1,426	28.2%

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

Looking at progress rates toward period-start forecast, while sales were at less than three-fourths at 65.9%, profit categories were at around 90% with operating income at 91.7%, ordinary income at 95.0%, and quarterly net profit attributable to owners of parent at 87.8%. Given these results, the Company significantly raised its FY3/17 targets for operating income and subsequent profit items (details below).

Sluggish progress in Q3 sales reflected decline in fuel cost adjustment value linked to lower fuel prices and a drop in transaction prices on JEPX for the wholesale business. Earnings advanced considerably, meanwhile, thanks to aggressive buying from JEPX amid a decline in transaction prices on a healthy rise in electricity supply destinations (electricity retail sellers) and reduction of production costs from a system change (revision to the method of calculating electricity surplus or shortfall). Gross profit increased 102.9% YoY to ¥4,790mn due to these factors.

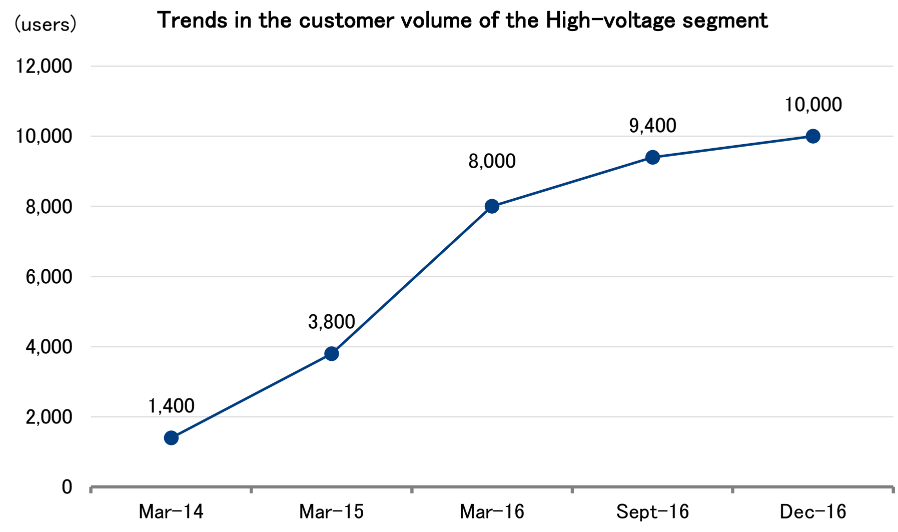
The SG&A expenses ratio was just 10.6%, despite a 73.8% increase in SG&A expenses to ¥2,347mn owing to a rise in employees accompanying business expansion and higher agency fees paid to sales agencies, because the growth rate lagged the pace of gross profit gains. Operating income was up 141.6% to ¥2,442mn, and operating income margin improved substantially from 6.1% a year earlier to 11.1% in Q3 FY3/17.

Acquired 43,000 customers in the low-voltage segment and 10,000 customers in the high-voltage segment

2. Trends in the main KPI

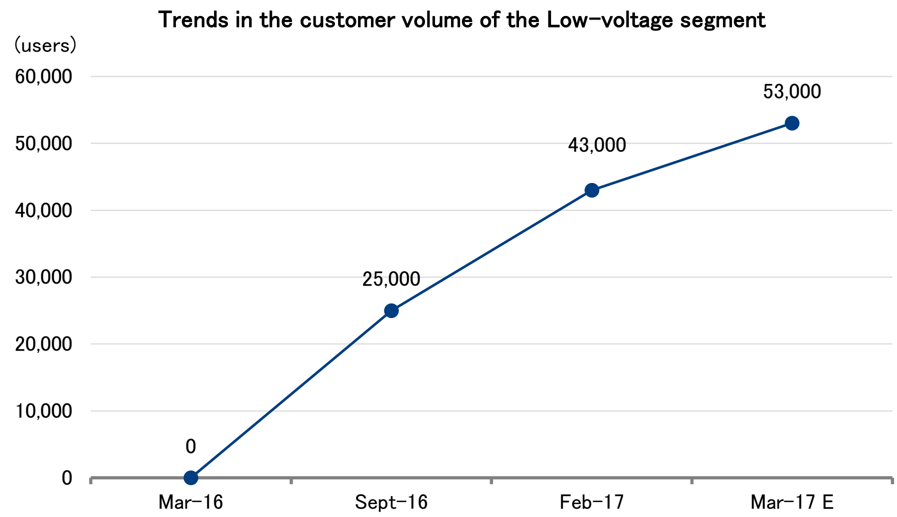
Customer volume in electricity retail business, a key performance indicator (KPI) monitored by us that strongly affects the Company's results, has been steadily growing with increases in the high-voltage segment mainly catering to companies and the low-voltage segment that primarily covers ordinary households and smaller stores.

The Company adopts a sales-agency system for sales in the high-voltage segment, and the number of agencies was at approximately 1,300 at the end of December 2016. The number of Electricity retail sales customers contracted is around 10,000 in the high-voltage segment, increasing at a pace of 200 to 300 customers per month.



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

In the low-voltage segment, the Company is pursuing inroads in the general residential market through alliances with local LP gas sales firms, CATV operators, Tanita Group, and others mainly via eREX Spark Marketing (below, ESM), a joint venture with US-based Spark Energy, and eREX Spark Area Marketing (below, ESAM), which was established by ESM and Hanwa Co., Ltd. <8078>. The Company is targeting 53,000 customers in the low-voltage segment by the end of March 2017 and was at 43,000 customers as of February 2017.



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

Results Outlook

Ample probability of exceeding the upward revision to the FY3/17 results

1. FY3/17 forecast

The Company raised FY3/17 forecast in light of Q3 FY3/17 results. Its new targets are ¥31,548mn in net sales (up 37.9% YoY), ¥3,758mn in operating income (up 118.1%), ¥3,457mn in ordinary income (up 114.2%), and ¥2,000mn in profit attributable to owners of parent (up 79.7%).

Compared to the previous outlook, the Company lowered net sales by ¥1,918mn (5.7%), though raised operating income by ¥1,094mn (41.1%) and also increased ordinary income and profit attributable to owners of parent by 41.0% and 40.3% each.

Outlook of the FY3/17 results

(¥mn)

	FY3/16 Full year results	FY3/17					
		Initial forecast	YoY	Revised forecast	Revised amount to initial forecast	Growth rate to initial forecast	YoY growth rate
Net sales	22,877	33,466	46.3%	31,548	-1,918	-5.7%	37.9%
Operating income	1,723	2,664	54.6%	3,758	1,094	41.1%	118.1%
Operating income margin	7.5%	8.0%	-	11.9%	-	-	-
Ordinary income	1,614	2,451	51.9%	3,457	1,006	41.0%	114.2%
Profit attributable to owners of parent	1,112	1,426	28.2%	2,000	574	40.3%	79.7%

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

The Company expects a shortfall in FY3/17 net sales because of the decline in the price of wholesale electricity sold to JEPX accompanying lower fuel prices. Nevertheless, it envisions increased profits, which are determined as the product of profit margin and sales volume, due to a growing customer base that lifts sales volume and wider margin because of lower wholesale electricity prices on JEPX.

We think utilization of the Saiki power plant, which launched commercial operations in November 2016, is a key focal point in FY3/17. Key aspects are operational condition and recruiting customers for the generated power. Our assessment had been that the risk of operating trouble was small because the Company already possessed operational knowhow from the Tosa power plant that uses the same format. Actual operations remain smooth thus far.

The Company is currently selling some generated electricity to the wholesale market through JEPX because power supply volume from the Tosa and Saiki power plants exceeds demand volume from customers in high-voltage and low-voltage segments. We think this situation was expected from the outset and is currently not a problem. Nevertheless, it is important for the Company to recruit customers to cover electricity generated by the Saiki plant as soon as possible because retail prices are higher than wholesale pricing. The customer base is steadily expanding at a pace of 200 to 400 customers per month in the high-voltage segment. In the low-voltage segment, the Company is aiming for 53,000 customers by the end of March 2017 and some media sources are reporting that volume could reach 120,000 customers by the end of March 2018. We believe it will take until sometime in FY3/19 to accumulate enough customer demand to absorb all of the output from Tosa and Saiki power plants at the retail level.

Upward trends in net sales and profits likely to continue in FY3/18, though still too early to expect upward revisions

2. The approach for FY3/18

Targets presented in Dash 1000 offer a benchmark for FY3/18 results. The Company projects ¥51,280mn in net sales, ¥5,311mn in operating income, ¥5,076mn in ordinary income, and ¥3,336mn in profit attributable to owners of parent for FY3/18.

We expect focus on whether results exceed targets presented in Dash 1000 for FY3/18 too, following sharp upward revisions of the FY3/17 outlook. We think there is a reasonable possibility of beating the targets, but valuation should reflect current numbers from Dash 1000 at this point.

FY3/18 results targets in Dash 1000

(¥mn)

	FY3/17		FY3/18		
	Target	YoY	Dash 1000	YoY change	YoY
Net sales	31,548	37.9%	51,280	19,732	62.5%
Operating income	3,758	118.1%	5,311	1,553	41.3%
Operating income margin	11.9%	-	10.4%	-	-
Ordinary income	3,457	114.2%	5,076	1,619	46.8%
Profit attributable to owners of parent	2,000	79.7%	3,336	1,336	66.8%

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

We begin with a review of anticipated positives and negatives in FY3/18. Higher retail electricity volume (low-voltage and high-voltage segment) in overall power sales than expected is a potential positive, though this requires more acquisitions of large-volume customers and increased customer volume. While a renewed upturn in fuel prices driven by higher crude oil prices might boost sales, in contrast to the FY3/17 trend, this change might have a downward impact on profit margin.

Backlash to lowering of production costs in FY3/17 in the cost calculation of electricity imbalance (excess or shortage) is a potential negative, which needs to be monitored. While this item improved profits in FY3/17, further methodology revisions in FY3/18 could eliminate the positive effect or even cause a negative impact.

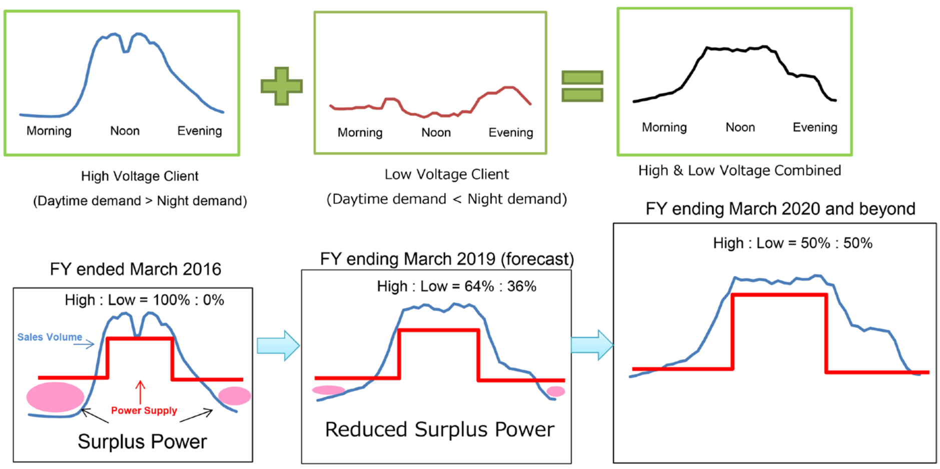
We summarize our view of these factors. We think it is overly optimistic to expect renewed acceleration of customer volume growth in the high-voltage segment with robust profitability. This segment has the most intense competition among PPS firms, and our base scenario is continuation of the existing pace of net increases of 200-300 customers per month. Tokyo, Osaka, and other major urban areas have been experiencing excessive competition in the low-voltage segment too. Competition scope is also widening to regional core cities and cities located on the periphery of major cities (the same trend is occurring in the high-voltage segment). We believe consideration should be given to the possibility of decline in efficiency, compared to sales in major cities, because of the need to expand sales coverage. Some media sources are reporting a goal of 120,000 contracts at the end of FY3/18, as noted earlier. However, this goal, though not completely out of reach, is not easily achieved. We will be paying close attention to the extent to which the Company is capable of leveraging potential from its alliances with 39 LP gas sales firms.

We anticipate a positive impact in FY3/18 from imbalance costs if the current method is maintained, but cannot rule out the possibility of a change in the method. We advise an approach of taking into account earnings impact after confirmation of no change in the calculation methodology in the new fiscal year, rather than waiting for upside from factoring this point in.

We expect crude-oil price change to be a neutral factor absent an extreme upturn or decline. The Company is selling some electricity at low wholesale prices because the Saiki plant's launch raised self-generated power capacity beyond the retail demand portion. We thus fundamentally project a favorable impact on earnings if electricity prices move upward due to higher fuel prices.

The Company continues to focus on improving profitability through its own efforts, separately from above-mentioned external factors. We think the most important initiative is optimizing the sales mix in low-voltage segment and high-voltage segment. This involves boosting electricity demand and flattening the demand cycle by achieving an effective mix of demand from the high-voltage segment with large differences between daytime and nighttime electricity needs and the low-voltage segment with relatively flat demand throughout the day. We expect monetization of surplus power procurement and wider profit margin if this advances. We think the Company requires more than just a simple increase in customer volume and must carefully analyze demand characteristics of individual customers in sales activities. The Company has been steadily making efforts to optimize the sale mix thus far. This is an area that deserves continued monitoring.

Optimization of the sales mix in low-voltage segment and high-voltage segment



Source: The Company's briefing materials

Simplified consolidated income statement

(¥mn)

	FY3/14 full year	FY3/15 full year	FY3/16 full year	FY3/17 Q3 (cumulative)	FY3/17 full year (revised)
Net sales	15,311	17,074	22,877	22,049	31,548
YoY	23.2%	11.5%	34.0%	32.8%	37.9%
Gross profit	2,684	2,676	3,730	4,790	-
YoY	-	-0.3%	39.3%	102.9%	-
Gross profit margin	17.5%	15.7%	16.3%	21.7%	-
SG&A expenses	1,276	1,201	2,006	2,347	-
YoY	-	-5.9%	67.1%	73.8%	-
SG&A margin	8.3%	7.0%	8.8%	10.6%	-
Operating income	1,407	1,475	1,723	2,442	3,758
YoY	21.4%	4.9%	16.8%	141.6%	118.1%
Operating income margin	9.2%	8.6%	7.5%	11.1%	11.9%
Ordinary income	1,390	1,132	1,614	2,328	3,457
YoY	19.4%	-18.6%	42.5%	144.3%	114.2%
Profit attributable to owners of parent	815	922	1,112	1,252	2,000
YoY	19.9%	13.2%	20.6%	87.5%	79.7%
EPS adjusted for stock split (¥)	32.74	29.78	26.78	25.14	40.07
DPS adjusted for stock split (¥)	3.00	6.67	8.33	-	10.00
Net assets per share adjusted for stock split (¥)	138.42	244.06	282.31	270.87	-

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

Simplified consolidated balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17 Q3
Current assets	5,252	9,787	13,406	16,410
Cash and deposits	2,601	5,187	9,525	8,861
Trade receivables	1,652	1,649	1,996	3,246
Inventories	183	189	244	526
Other	814	2,761	1,639	3,775
Non-current assets	4,588	8,170	13,759	24,289
Property, plant and equipment	3,843	6,417	12,730	20,207
Intangible assets	31	36	130	1,614
Investment, etc.	713	1,715	897	2,467
Deferred assets	-	26	36	30
Total assets	9,840	17,984	27,202	40,729
Current liabilities	2,585	2,591	3,096	9,424
Accounts payable - trade	1,304	1,432	1,650	2,828
Short term loans, etc.	488	488	396	3,387
Other	792	670	1,049	3,208
Non-current liabilities	3,799	5,042	9,373	15,163
Long-term debt	2,738	3,939	8,214	10,222
Other	1,060	1,102	1,159	4,941
Shareholders' equity	3,447	9,980	13,784	14,752
Capital stock	625	3,465	4,947	5,118
Capital surplus	-	2,844	4,326	4,504
Retained earnings	2,822	3,670	4,510	5,355
Non-controlling interests	8	369	947	2,569
Total net assets	3,455	10,349	14,732	16,141
Total liabilities and net assets	9,840	17,984	27,202	40,729

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

Simplified consolidated cash flow statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17 Q3
Cash flow from operating activities	845	1,505	818	596
Cash flow from investing activities	-3,280	-6,667	-4,182	-7,168
Cash flow from financing activities	1,848	6,947	7,502	4,306
Change in cash and deposits	-587	1,785	4,138	-2,265
Cash and deposits at the start of period	3,068	2,481	4,267	8,405
Cash and deposits at the end of period	2,481	4,267	8,405	6,140

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

Dash 1000 medium-term business plan and progress

Dash 1000: Preparatory period toward realization of ¥100bn in sales

1. Overview of Dash 1000

The Company newly formulated Dash 1000 to be its medium-term management plan for the three year period of FY3/17 to FY3/19, which is currently being implemented. As indicated by the title, it has positioned the three years of the plan to steadily advance preparations to achieve net sales of ¥1000mn in 4 to 5 years' time.

The results targets in Dash 1000, the new medium-term management plan, are significantly higher than those in the previous medium-term management plan. The targets for the plan's final fiscal year of FY3/19 are net sales of ¥67,339mn, operating income of ¥7,354mn, and an operating income margin of 10.9%. An operating income margin of 10% has been set as the profit target, ROE (return on equity) of 20% as the financial target, and a dividend payout ratio of 20% as the dividend target.

Dash 1000 results targets

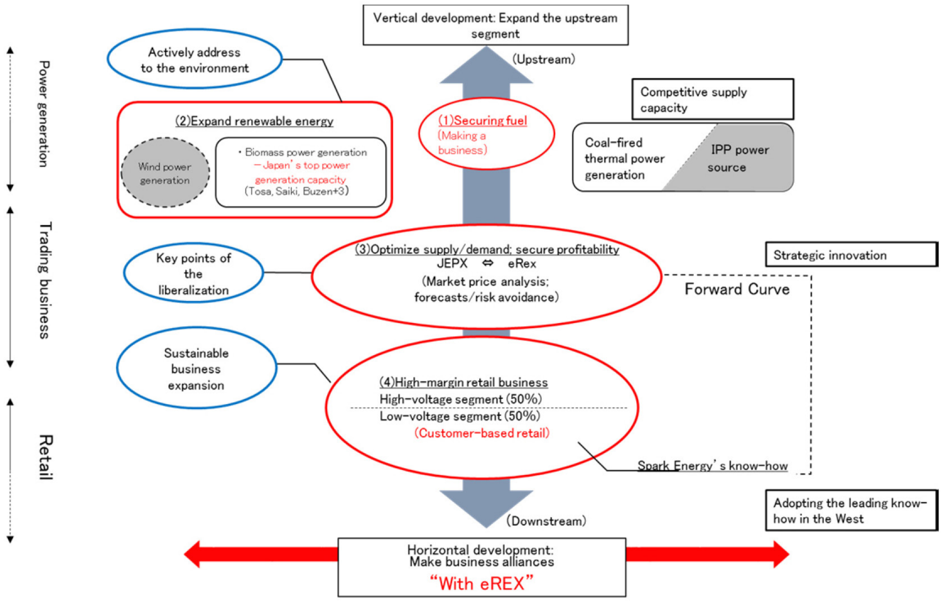
(¥mn)

	FY3/16 Results	FY3/17		FY3/18		FY3/19		FY3/16-FY3/19 CAGR
		Target	YoY	Target	YoY	Target	YoY	
Net sales	22,877	33,466	46.3%	51,280	53.2%	67,339	31.3%	43.3%
Operating income	1,723	2,664	54.6%	5,311	99.4%	7,354	38.5%	62.2%
Operating income margin	7.5%	8.0%	-	10.4%	-	10.9%	-	-
Ordinary income	1,614	2,451	51.9%	5,076	107.1%	7,085	39.6%	63.7%
Profit attributable to owners of parent	1,112	1,426	28.2%	3,336	133.9%	4,754	42.5%	62.3%

Note: YoY values and profit margin values were calculated based on the unit of millions of yen
Source: Prepared by FISCO from the Company's financial results

The Company wants to bolster competitiveness in all value chains. This means securing sufficient competitiveness in power generation, including upstream fuel procurement, midstream trading business, and downstream retail business during the medium-term business plan. We think the plan largely consists of developing self-operated power sources and establishing a sales network. For midstream trading business, we expect advancement and reinforcement in step with JEPX reforms that are currently moving forward and anticipate this timing in the next medium-term business plan period.

Outline of the Dash 1000



Source: The Company's "Briefing materials for investment"

Expanding sales channels utilizing the sales-agent system and alliance partners

2. Sales strategy and progress

(1) Overall situation

The sales strategy is making very smooth progress. The Company adopted a sales-agent system from when it was founded for the high-voltage segment that mainly caters to offices, large stores, and high-volume customers. It works through more than 1,300 agents to recruit customers at this point. As noted earlier, the Company had about 9,400 high-voltage customers in September 2016, compared to around 8,000 customers in March 2016. It maintained the expansion pace in Q3 too, boosting contracted customer volume to 10,000 by the end of December. Content is improving as well with a rising percentage of customers at higher profitability. These trends contributed to the upward revisions of FY3/17 forecast.

The Company develops customers in the low-voltage segment, which mainly covers ordinary households and smaller stores, liberalized in April 2016 through alliances with companies closely involved with these customers in various regions primarily utilizing subsidiaries ESM and ESAM. Alliance partners had roughly 3 million customers (potential customers for the Company) as of end-September, and contract volume has been growing at a faster pace than the initial plan thus far. This business reached about 25,000 customers at end-September 2016 and then climbed to roughly 43,000 customers in early February 2017. The Company is targeting 53,000 customers at the end of March 2017. While recruiting an additional 7,000 contracts in just under two months cannot be easily achieved, we think the target is attainable and a shortfall also would simply mean a delay in timing of a near-term goal. This view factors in the presence of much larger potential scale of customer volume in the low-voltage segment.

Dash 1000 medium-term business plan and progress

Source: The Company's "Briefing materials for investment"

(2) Expansion of sales regions

"Sales strategy" refers to the sales expansion scheme, sales methods, and other content. We already covered the sales-agent system, alliance strategy, and some other points above. The Company achieved notable progress in broadening sales regions in FY3/17 with its entry into electricity retail sales in Okinawa.

The Company decided to enter Okinawa in October 2015 and conducted an investigation toward launching this business. It also decided that the effort required an alliance with a leading local company in order to provide local sales capabilities close to customers. The Company established Okinawa Gas New Power Co. (below, Okinawa Gas NP) as a joint venture with Okinawa Gas Co., Ltd. (investment ratios: eREX 60% and Okinawa Gas 40%). Okinawa Gas is the prefecture's sole city gas operator with city gas supply mainly in Naha. It also supplies LP gas to the southern part of the prefecture.

The registration of Okinawa Gas NP as a PPS was completed in August 2016, and it began supplying power from October 1. The position of Okinawa Gas NP is that it is a PPS, the same as eREX, and it concludes contracts with customers as a power supplier. The structure for the actual acquisition of customers is that Okinawa Gas mainly seeks to acquire them from its own existing customers, with Okinawa Gas NP acting as the sales agency.

Progress was achieved in arranging power sources in Okinawa during Q3 (in this quarter). Electricity cannot be acquired from JEPX for the Okinawa business because Okinawa is not connected by cable to the Japanese mainland. This business hence procures electricity from Okinawa Electric as a back-up source and local solar power operations. It also outlined a plan this time to build self-operated power facilities in Okinawa (refer to the item on securing power sources for details).

We think the Company is likely to enter the Shikoku market as the next step in expansion of regional sales coverage following Okinawa. The Company has Tosa and Saiki power plants that are well-located sites for supplying electricity to Shikoku. Lower priority in terms of people and economic scale appears to have been the main reason for not supplying power to Shikoku up to now. However, competition is heating up among PPS companies in large city areas, as explained earlier, and the main battlefield for PPS contracts is moving to regional cities. We will be looking for an official announcement.

Launching Ofunato and Buzen projects, arranged funding too

3. Progress in securing self-operated power sources

(1) Launch of commercial operations at the Saiki power plant

The Company secures its power supply from three routes; it generates it itself, and it purchases it from IPP (independent power producers) and from JEPX. In order to realize sustainable growth as a PPS, it is essential that it establishes and enhances its own power generation facilities. The Company realized substantial advances in this area as well in FY3/17. It began commercial operation of the Saiki power plant in November 2016. This is the second self-operated plant after the existing Tosa power plant (run by wholly owned subsidiary eREX New Energy Co., Ltd.).

The management company of the Saiki power plant is eREX New Energy Saiki Co., Ltd. and the Company's investment stake is 70% (the remainder is held by the TOSHIBA CORPORATION <6502> Group at 20%, and TonenGeneral Sekiyu K.K. <5012> at 10%). The power plant is located within the grounds of the TAIHEIYO CEMENT CORPORATION's <5233> Saiki plant, and it is a circulating fluidized bed-type plant that uses PKS as the main fuel, the same as the Tosa power plant. Its rated output is 50MW, which is 2.5 times the 20MW output of Tosa power plant. As it is the same type of plant as the Tosa power plant, it is able to utilize the operational technologies and fuel-procurement expertise that have been accumulated at the Tosa power plant, and it seems that it has been able to operate stably and at full capacity as soon as it became operational. The Company collects and sells all of the power that it generates.

(2) Nest power plant construction plans

While commercial operations just started at the Saiki power plant, the Company is moving forward with initiatives to secure the next self-operated power sources. It has two power generation projects that are advancing and both are 75MW-class biomass sites, the Ofunato project (Ofunato, Iwate prefecture) and the Buzen project (Buzen, Fukuoka prefecture).

a) The Ofunato project

On July 29, 2016, the Company officially announced the construction of the Ofunato power plant. The details are that the Company jointly invested with TAIHEIYO CEMENT to establish Ofunato Hatsuden Co., Ltd. (Capital, ¥4bn. Investment ratio; the Company, 35%, TAIHEIYO CEMENT, 65%), and a biomass power plant with a power output of 75MW will be constructed on the grounds of TAIHEIYO CEMENT's Ofunato plant.

The power plant will be a circulating fluidized bed-type, the same as the Tosa and Saiki power plants, and the fuel ratio will also be the same, at 90% biomass and 10% coal. The plan is to use PKS and also empty fruit bunch (EFB) as the biomass fuels. TAIHEIYO CEMENT has succeeded in converting EFB into fuel for power generation through a joint development with Saraya Co., Ltd., and a Thai company. The schedule is for the construction work to start in FY3/17 2H and to finish in the fall of 2019, with the Company to collect and sell to external customers all of the power generated.

b) The Buzen project

On November 10, 2016, the Company announced another biomass power plant in Buzen City. Specifically, it announced that Kyuden Mirai Energy Company, Incorporated, and Kyudenko Corporation <1959> have invested in Buzen New Energy LLC., which the Company established in October 2016, and that these three companies will undertake the project to construct Japan's largest ever biomass power plant. The planned investment ratio is that the Company will invest 65%, Kyuden Mirai Energy 27%, and Kyudenko 8%.

The plant, which will be called the Buzen Biomass Power Plant, will be constructed on the grounds of Kyushu Kouatsu Concrete Industries Co., Ltd. It will be a biomass power plant that uses PKS and wood pellets as the fuel, and it is scheduled to have a power output of 75MW and generate approximately 500,000MWh of power per year. This would make it the largest-scale biomass power plant in Japan. The aim is to start the construction work in March 2017 toward the launch of commercial operations from the October of 2019. All the power generated will be sold to Kyushu Electric Power Co., Inc. <9508>.

The Company hopes to launch the Ofunato and Buzen power plants in 2019 and is planning another two power plants. It clarified that Okinawa is one of the construction candidate sites as progress in Q3. We think this is closely tied to the launch of retail business in Okinawa described in the section on the sales strategy. It also stems from Okinawa's unique circumstances of not having an electrical power cable connection with the Japanese mainland. Meanwhile, we expect considerable focus on how the Company plans to arrange consumption of electricity from the new plant given Okinawa's economic scale. For the other plant, the Company has only disclosed it as "site A" without offering any other details. It plans to employ the same size and generation method as the already announced project. We expect this approach to contribute to reducing operational risk. We will be waiting for a detailed announcement.

(3) Fundraising situation

The biomass power plants being planned by the Company are the largest such facilities in Japan and likely to involve ¥20-30bn in capital investment per site. These outlays clearly present a major burden relative to the Company's scale, and the financing approach is a key point for investors and shareholders.

The Company is moving forward with Ofunato and Buzen projects following completion of the Saiki power plant in 2016, as explained above. It has already arranged financing for these two projects. Below we summarize the schemes.

The Company raised about ¥3bn in a capital increase through public offering in March 2016. It utilized these funds in financing of eREX New Energy Saiki Co., Ltd., which is operating the Saiki power plant, and this subsidiary applied the funds to repaying loans. The Company thus managed to acquire a ¥6bn commitment line from banks, and it utilized the ¥6bn to invest in operating companies for the Ofunato and Buzen projects.

The Company is a minor shareholder in the Ofunato project operator. Its investment completed the fundraising burden for this project. Taiheiyo Cement will be the primary entity involved in raising operational funds for Ofunato Hatsuden Co., Ltd. (established on August 5, 2016). For the Buzen project, meanwhile, the Company has the leading role in financing efforts. It had been planning to utilize project finance and completed financing through finalization of a ¥27.05bn syndicated loan as project finance in January 2017.

We expect renewed interest in financing issues once the Company has fleshed out the next two power plant projects (Okinawa and site A), though interest has moved away from the financing issue at this point.

Shareholder return policy

Announced a 3-to-1 stock split and effective dividend hike

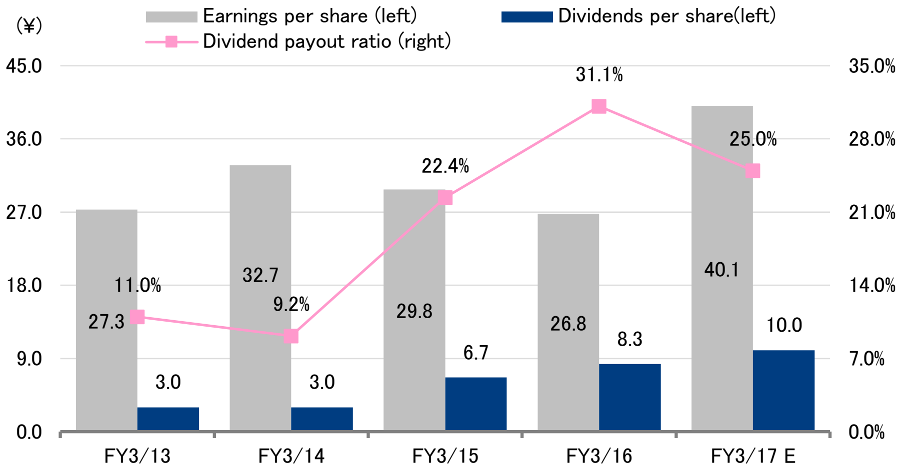
The Company basically returns profits to shareholders in the form of dividends. The level of dividend is based on a targeted dividend payout ratio of 20% under the medium-term business plan.

The Company sharply raised full-year guidance at the Q3 FY3/17 announcement and also unveiled a 3-to-1 stock split and effective dividend hike.

The stock split involves allocation of three shares for an existing share with an effective date of March 6, 2017. This move primarily aims to boost liquidity and expand investor scope by lowering the amount of funds needed per investment unit in light of the share price approaching ¥4,000 (¥3,670 closing price on February 14).

The Company announced a ¥10 period-end dividend for FY3/17 (after adjusting for the stock split). This works out to ¥30 on a pre-split basis for a ¥5 hike over the previous dividend target (¥25 prior to the split). The dividend payout ratio comes to 25.0% based on the ¥40.07 post-split FY3/17 profit per share target, beating the 20% goal presented in the medium-term business plan.

EPS, Dividends and Dividends Payout Ratio



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

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