Estore Corporation
4304 TSE JASDAQ

5-Jan.-17

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FISCO Ltd. Analyst
Hiroyuki Asakawa

Steady Expansion in Marketing Support Services, Signs of Opportunity for Major Advances

Estore Corporation <4304> (hereafter, also “the Company”) is a comprehensive provider of eCommerce (EC) support services. It develops two businesses as its “framework” for EC; the Systems Business for the provision of ASP services, and the Marketing Business, of services to support revenue growth in client companies (EC support).

Estore is substantially increasing sales in marketing support services that seek to expand sales in client businesses thanks to robust demands. Marketing sales (previously Promotions Business sales) climbed 38.6% YoY in 1H FY3/17. The Company is also making smooth progress in securing human resources needed to expand capacity in this business.

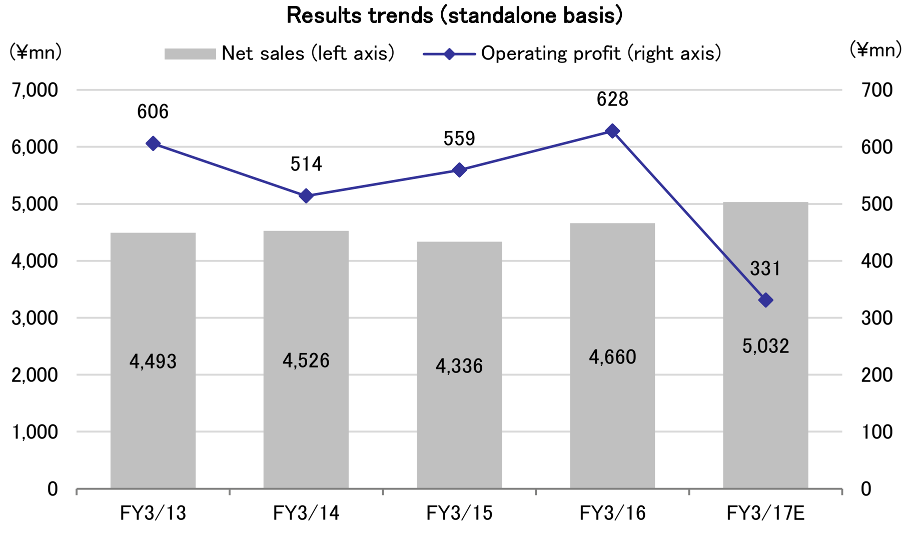
Estore promotes marketing support services to existing customers with subscriptions to its EC comprehensive support ASP service and new external customers. It explains that it has confirmed strong demand for services in both of these groups thus far. We think the main point in 1H results was this confirmation.

Marketing support services utilize a business model that relies on human resources. The Company’s human resources are not keeping pace with demand (resulting in a capacity shortage) at this point. We believe the timing has come for Estore to make a strong push with investments (securing human resources), particularly in light of the confirmation of extensive demand. While this approach temporarily weakens performance (mainly profits), past operating profit results have proven that the Company is likely to achieve a subsequent V-shaped recovery.

We believe 1H FY3/17 results were on track with or exceeded the Company forecast. This was due to a strong growth in marketing sales, as noted above, and steady progress in qualitative improvement of subscribing clients. We expect strong results in FY3/17 too if the current pace continues. We also see a possibility of further expansion of the Company’s investments because the external environment is changing in a favorable direction on a variety of points. While implementing such measures might lead business performance to fall short of the forecast in the immediate term, we think this action should be viewed constructively as a driver of rapid profit growth in the future.

Check Point

- Targeting further improvement in profitability through a shift to a “good products, good stores” strategy
- Profits down sharply on higher sales in 1H FY3/17, though in line with expectations
- Expecting higher sales in FY3/17, but also see a possibility of profits missing the target due to increased investments



Businesses and Structural Reforms Initiatives

Started as a shopping cart service

(1) Review of businesses and past trends

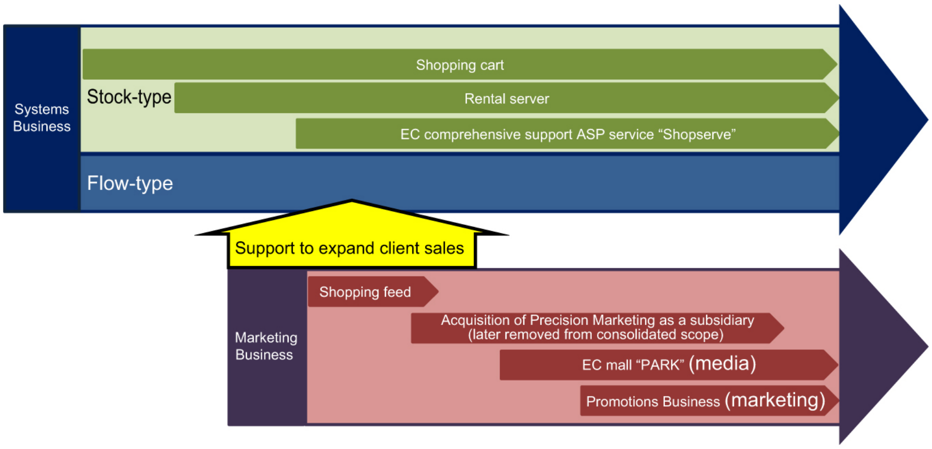
The Company began with provision of IT services to clients engaged in EC. Initially, it started as a shopping cart service, then passed through the provision of rental servers needed to launch a website, and evolved to the provision of the Shopserve EC comprehensive support service in 2006, completing the framework of its current services. Shopserve is an ASP service that integrates a store's website, domain, email, payments, ordering, customer management, and other needs into a single service for EC businesses. Estore refers to this as the Systems Business.

In the Systems Business revenue model, revenue is classified into two main types; the collection of monthly ASP service usage fees from clients, and the collection of a fixed percentage of customer net sales as payment agency commissions (via the store's website on Estore's Shopserve). The Company separates and manages the Systems Business net sales into "stock-type revenue" of monthly usage fees and other revenue that has the same quality as these fees, and "flow-type revenue" which is revenue linked to the customer's net sales.

Estore realized early on that growth in "stock-type revenue" is likely to peak due to fierce competition because of the many other companies supplying ASP services besides itself. It started to support clients to increase their sales through the provision of Shopping Feed, a product search site, in 2006. Based on the above-mentioned conclusion, it acquired Precision Marketing Inc. as a subsidiary and formed the Marketing Business in 2011. This initiative ramped up efforts to expand "flow-type revenue." Under the Marketing Business, the Company launched the PARK EC shopping mall website in 2012 and began Promotions Business that incorporates research and analysis and consulting services in 2014. It quickly rolled out various measures.

The Company's Systems Business and Marketing Business are the two main wheels of its business, and they are connected via the axle of "expanding client sales." Operating profit hit a peak in FY3/13 and has been flat since then. We attribute this trend to management's stance of making investments, despite negative impact on profits growth, in order to refine the business structure and drive future growth. We think the Company is arriving at the final stage of these restructuring reforms in FY3/17.

Business Transitions



Source: Prepared by FISCO

Targeting further improvement in profitability through a shift to a "good products, good stores" strategy

(2) Restructuring of the Systems Business and progress

Revenue in the Systems Business consists of stock and flow portions. Expansion of flow-type revenue overlaps with the Marketing Business, and structural reforms in the Systems Business hence mainly relate to the stock-type revenue.

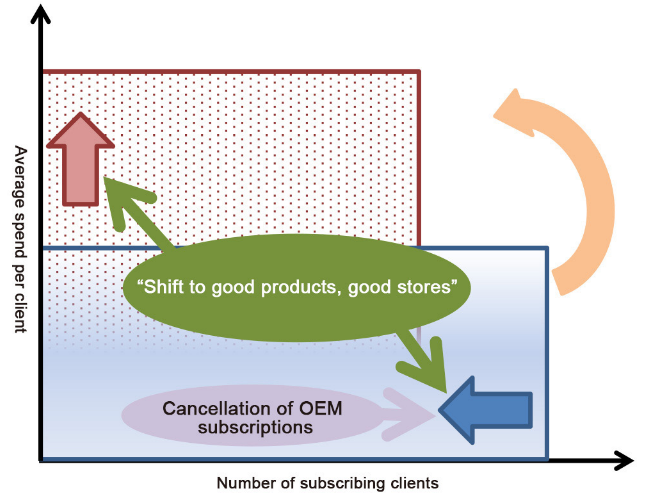
The background to the Company embarking on structural reforms in the stock-type revenue business is that it saw limits to the growth scenario of increasing the number of EC support service clients. Cost of acquiring clients no longer matched the number of acquisitions and average revenue due to the presence of many similar services.

The Company's structural reforms involved multiple steps. The first was to cancel low-margin OEM subscriptions from among clients with subscriptions to the mainstay Shopserve service. These were client subscriptions acquired through business partnerships with external companies in the period soon after the Company's establishment. An imbalance existed between the Company's revenue and costs because of the presence of business partners in-between itself and the clients. Estore actively worked to cancel these OEM subscriptions and eliminated all of them during FY3/14.

The second step, which is still taking place, is raising the average spend per client. This is a positive reform. In acquiring new clients, it has been focusing on stores that handle competitive products, stores with high profit growth potential, and medium-sized companies with prospects of large sales revenue and high monthly average fees under the slogan of shifting to "good products, good stores".

The Company continues to implement the second step, and we expect the shift to "good products, good stores" to carry on as a fundamental policy in the future. The spend per client for ASP service is clearly above ¥10,000 as of 1H FY3/17. We think this confirms steady results from structural reforms because it had been at less than ¥10,000 previously.

Structural reforms of stock-type revenue in the Systems Business



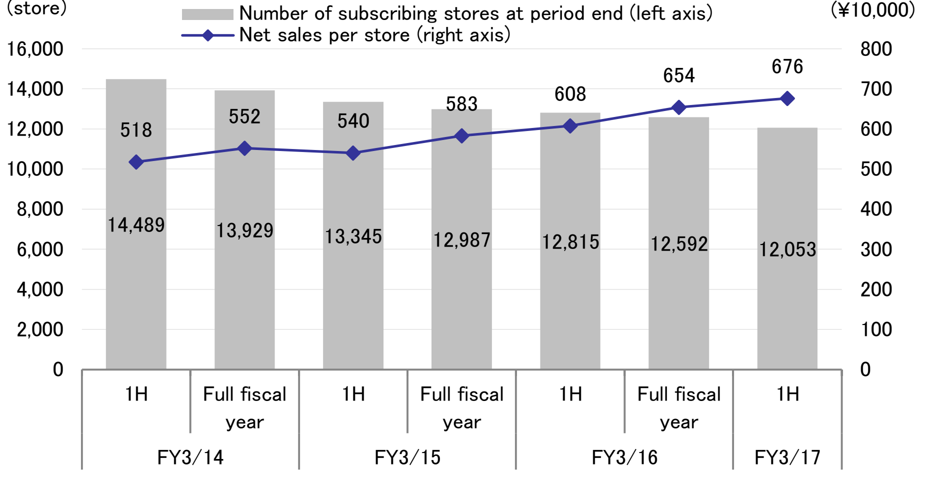
Source: Prepared by FISCO

Subscriptions to Shopserve, the core service in the Systems Business, have been steadily declining every half-year and dropped 16.8% over three years from 14,489 stores at the end of September 2013 to 12,053 stores at the end of September 2016. Conversely, net sales per store have been steadily growing and rose 30.5% from ¥518mn in 1H FY3/14 (converted to an annual value by doubling the actual half-year amount (¥259mn)) to ¥676mn in 1H FY3/17.

The rise in store sales reflects the impact of change in customer mix due to the shift to "good products, good stores" as a structural reform in the Systems Business and benefits from efforts to expand client sales in the Marketing Business. While it is not possible to precisely determine the contributions from these two sources, we think change in customer mix via the shift to "good products, good stores" is the main driver of higher client sales judging from the number of clients utilizing sales expansion support in the Marketing Business.

We believe structural reforms in the Systems Business have achieved very smooth progress thus far, but Estore does not intend to ease reforms and appears to be preparing the next measures. We will be waiting for further initiatives.

Trends in the number of subscribing clients of Shopserve and net sales per store in the Systems Business



Note: 1H store net sales have been doubled to calculate the annual rate

Source: Prepared by FISCO from results briefing materials

Making healthy progress in establishing operations to meet growing demand for the Marketing Business

(3) Marketing Business structural reforms and progress

a) Activities thus far

As explained above, the Company started the Marketing Business to help increase the sales of clients with the aim of expanding flow-type revenue for the Systems Business. It acquired Precision Marketing, an Internet advertising agency, and formed the Marketing Business in 2011. The Marketing Business subsequently launched PARK, an EC marketplace, and entered the EC-related research and analysis and consulting services business. These measures broadened the Market Business to the three sub-segments of the Customer Attraction Business, the Media Business, and the Promotion Business.

Breakdown of the Marketing Business by Sub-Segments

	Marketing Business		
	Customer Attraction Business	Media Business	Promotions Business
Targeted clients	Areas other than eCommerce	eCommerce companies	eCommerce companies
	Medium-sized to large companies	SMEs, private stores, Medium-sized companies	Annual sales of hundreds of millions of yen to several billion yen
Business entity	Precision Marketing	Estore itself	
Business description	Internet advertising agencies (companies' publicity entity)	Management of PARK, a market place website	Research and analysis, consulting, customer attraction, operations management agency services, etc.
Service name		PARK	Management Agency Services, Production Agency Services
Competitors	Internet advertising agencies	Rakuten, Amazon	Softcreate Holdings Corp, etc.

Source: Prepared by FISCO

The Company began the Marketing Business from the standpoint of providing “support to expansion of client sales.” It embraced various efforts to achieve this goal and repeatedly went through a trial-and-error process as seen in the acquisition of Precision Marketing as a subsidiary and the PARK launch and operations.

Precision Marketing is an Internet advertising agency that mainly promotes companies. Estore formed an alliance to obtain knowhow about customer attraction required by marketing services, and it removed Precision Marketing from consolidated scope in January 2016 after accomplishing the mission of gaining knowhow.

PARK is an EC shopping mall and competes with Rakuten <4755>, Amazon, and others. The Company was spending around ¥100mn a year on advertising and publicity for PARK, but these outlays were simply showing up as operating losses due to the presence of massive rivals. Estore decided to scale back its investments in PARK and instead put the funds toward its Promotions Business and other areas from FY3/16.

Given this background, the Promotions Business is what remains as an active operation in the Marketing Business. Promotions Business aims to increase sales for clients through providing services such as research and analysis, consulting, production, and customer attraction and operation agency services. It utilizes EC-related knowledge and knowhow that the Company has accumulated since its founding and directly leverages these strengths. However, the Company has taken some extra time to ramp up the Promotions Business and build operations while confirming various points. We believe it adopted this approach due to uncertainty about whether it could create a business out of charging fees for much of the content in its Promotions Business that is viewed as normally given for “free” in Japan and a desire to assess whether its strategies actually resulted in increased sales. We think the path taken by the Promotions Business suggests that structural reforms in the Marketing Business were essentially part of the growth process for the Promotions Business.

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In FY3/17, Estore converted its business segment structure from the Systems Business and Marketing Business to a single "EC Business" segment. It also renamed the Promotions Business as "Marketing" and presents it as a sales item and refers to the Media Business as "Media" and includes it as a sales item too.

Transformation of the Marketing Business

FY3/13	FY3/14	FY3/15	FY3/16	FY3/17
Start of shift	Verifying the commercialization	Determining the revenue portion	Deciding to concentrate on the Promotions Business	Confirmed confidence in market demand
Partnership with Precision Marketing Starting to benefit from the expertise Developing Single Hand and constructing the Solutions Business (currently, the Promotions Business)	Launching external sales of Single Hand Trialing the content effects of PARK Launching Solutions Business targeting new clients => launch failure Strengthening providing promotions to existing clients	Switching Single Hand sales to internal sales Withdrawal from PARK contents Confirming the market for new client solutions, increasing personnel Clarifying effects of promotions for existing clients => strengthening	Reducing the investment in PARK Removed Precision Marketing Inc. from the scope of consolidation Steadily acquiring clients from new client solutions => Promotions Business sales increase 66% Effects of promotions for existing clients => Promotions Business sales increase 66%	Unified business segments as the EC Business Promotions Business => renamed as "Marketing" Investing in personnel additions as planned Confirmed client demand exceeding capacity

Source: Prepared by FISCO

b) Conditions in Marketing

Marketing (formerly the Promotions Business) targets two types of customer groups. One is existing clients in the Systems Business undertaken by the sales force of this business. It generates revenue from Systems Business existing clients in the form of ASP service monthly fees (stock) and a fixed percentage of net sales (flow) and is cross-selling marketing support services, such as consulting and operations management agency services.

The other is acquiring completely new clients. Its main targets are medium-sized to major companies with net sales in the range of hundreds of million yen to tens of billions of yen, a major size difference with customer in the Systems Business. Many companies in this size category engaging in EC operate their own EC stores (main store websites) and have own branch stores on such as Amazon, Rakuten, Yahoo!, and other sites. Attracting customers through opening a branch store in a shopping mall website is largely determined by the ability of the mall itself to attract customers. In contrast, on their own sites, companies can attract more customers and increase sales through their own efforts, and profitability is theoretically better than branch stores (because companies do not have to pay fees to shopping malls). Estore provides marketing support services aimed at boosting customer draw and sales at main store websites.

Client Initiatives in Marketing (former Promotions Business)

	Existing clients in the Systems Business	New clients
Targeted clients	Private stores, recently established eCommerce companies	eCommerce companies handling specific specialty merchandise
	Annual sales of millions of yen to hundreds of millions of yen	Annual sales of hundreds of millions of yen to several billion yen
Sales entity	The Systems Business sales team	Specialist team
Business content	Cross-selling of marketing support services to clients of Shopserve, the EC management ASP service	Targeting medium-size to major companies, the aim is to attract more customers and increase sales at the EC main store websites through providing services such as research and analysis, website production agency services, management agency services, and other marketing support services
Revenue model	Service provider fee, fixed percentage of net sales	Service provider fee

Source: Prepared by FISCO

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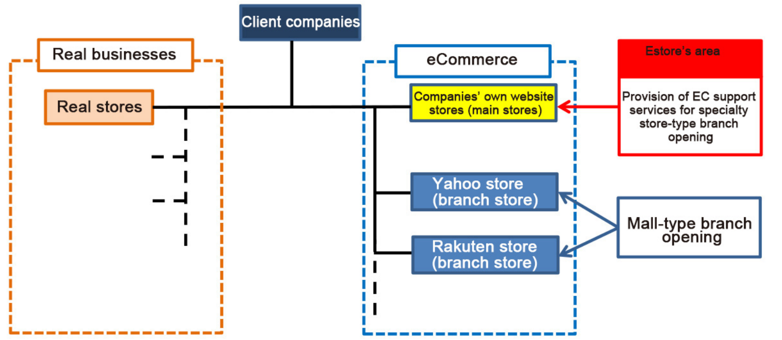
Business area of the Marketing Business



Source: prepared by FISCO

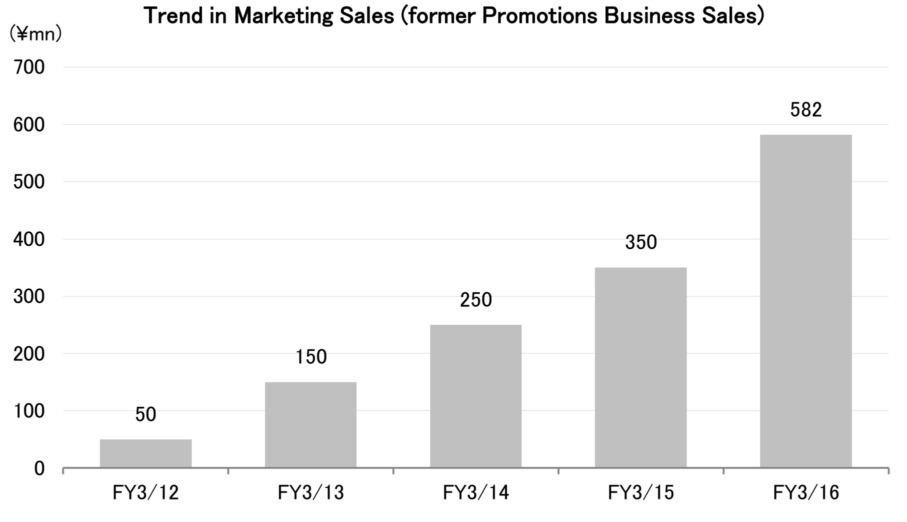
Marketing sales increased 38.6% YoY to ¥351mn in 1H FY3/17. While the sales growth rate was on track with the Company's expectations, customer demand is very strong and orders are arriving at a pace that exceeds capacity. Estore explained that orders have risen in FY3/17 due to success of sales activities implemented thus far.

Clients are steadily increasing in both of the two groups described above. Sales, contract periods, and other details clearly differ based on differences in client size. Contracts with existing customers from the Systems Business have fairly low value in the range of a few hundred thousand yen to a million yen, but volume is high. Contracts with medium-sized to large companies, meanwhile, generally are an order of magnitude greater in value, but volume is less because it takes some time to finalize deals. Estore explains that it has not accumulated enough data to decide a clear policy regarding which client group will be given more attention.

The Company is also making smooth progress in development of operations to handle growing demand. Its marketing support services utilize a labor-intensive business model that depends heavily on human power. Operation reinforcement and capacity additions hence involve securing human resources. The Company's "investments at the expense of profits" also mainly involve personnel costs. Estore added just over 10 employees (on a net basis) in the marketing support services business during 1H as planned. It plans to make a similar addition to personnel in 2H as well and indicates that this effort is proceeding smoothly.

Based on these conditions, Estore expects an even busier 2H and full-fledged expansion of marketing sales, which have lagged the initial plan up to now, in FY3/18.

Trend in Marketing Sales (former Promotions Business Sales)



Source: Prepared by FISCO from the financial results summary

Results Trends

Profits down sharply on higher sales in 1H FY3/17, though in line with expectations

(1) 1H FY3/17 results

Estore reported lower profits on an increase in sales in 1H FY3/17 with ¥2,310mn in net sales (+3.2% YoY), ¥214mn in operating profit (-40.5%), ¥208mn in recurring profit (-42.2%), and ¥142mn in net profit (-37.2%). We cannot asset these results versus forecast because Estore does not disclose 1H targets. Yet we think profits were slightly above the internal plan.

Summary of the 1H FY3/17 results

(¥mn)

	FY3/16	FY3/17				
	Full fiscal year	1H	YoY	Fulfillment rate	Full year forecast	YoY
Net sales	4,660	2,310	3.2%	45.9%	5,032	8.0%
Operating profit	628	214	-40.5%	64.7%	331	-47.3%
Operating profit margin	13.5%	9.3%	-	-	6.6%	-
Recurring profit	628	208	-42.2%	63.1%	331	-47.3%
Net profit	420	142	-37.2%	62.4%	229	-45.6%

Source: Prepared by FISCO from the financial results summary

Estore merged business segments under the EC business from FY3/17. However, it still offered a sales breakdown of flow-type and stock-type revenues from the former Systems Business and two other items under Marketing sales including marketing (former Promotions Business) and media.

Breakdown of Net Sales by Service

(¥mn)

	FY3/15	FY3/16		FY3/17		
	Result	1H result	Full year result	1H results	Change	YoY growth rate
Total net sales	4,336	2,239	4,660	2,310	71	3.2%
Stock	2,112	1,027	2,060	995	-32	-3.1%
Flow	1,737	904	1,915	931	27	3.0%
Marketing	350	253	582	351	98	38.6%
Media	136	54	103	32	-22	-40.7%

Source: Prepared by FISCO from the financial results summary and the financial results briefing materials

Marketing sales increased 38.6% YoY. This is an area where the Company is focusing the most, and robust customer demand and personnel expansion fueled the steep rise in sales.

Flow-type revenue was up 3.0% YoY thanks to a rise in clients' net sales per store as a result of acquiring quality clients.

Stock-type revenue was down 3.1% YoY, despite a steady increase in spend per client (monthly fees paid for ASP services), because of close correlation with number of clients.

Media sales dropped by a sharp 40.7% YoY reflecting the impact of significantly scaling back advertising and promotional costs for PARK, the EC marketplace.

Profits fell sharply YoY for operating profit and following item, though the Company anticipated this outcome. Estore has ramped up investments in personnel recruitment for marketing support services and as well as enhancement of corporate brand value and adoption of bitcoin payments. These accumulated costs resulted in a YoY decline in profits. Yet we think profits exceeded the Company's view because costs were lower than expected in the internal plan.

Expecting higher sales in FY3/17, but also see a possibility of profits missing the target due to increased investments

(2) FY3/17 outlook

Estore forecasts for profit decline on increased sales in FY3/17 with ¥5,032mn in net sales (+8.0% YoY), ¥331mn in operating profit (-47.3%), ¥331mn in recurring profit (-47.3%), and ¥229mn in net profit (-45.6%). The Company has kept the initial forecast unchanged.

Fundamental business conditions and the Company's investment stance in 2H FY3/17 are likely to be the same as in 1H. Sales are larger in 2H because of seasonally higher sales in the year-end and New Year period, and these conditions favor stronger flow-type revenue than in 1H. Further growth in marketing sales in 2H, led by vibrant demand and in-house personnel additions, should contribute too.

Stock-type revenue does not have much of a seasonal pattern and is largely determined by trends in subscription number and fees paid for ASP services. The Company expects subscription number to continue decline in 2H. While the impact of media business on overall income has declined because of significant shrinkage in the absolute value, we anticipate continuation of a downward trend, just in 1H.

It is difficult to assess profits. The Company's profits have been flat to lower in recent years because of a policy of giving priority to investments. The FY3/17 forecast indicates steep YoY profit decline due to maintaining this stance. We think FY3/17 profits could exceed the forecast, if just left to the business trend, considering the high fulfillment rate through 1H (64.7% in operating profit). However, the Company might increase investments in 2H than initially planned because of solid business expansion garnered from vibrant demand for marketing support services in 1H. Profits might even come in below full-year targets in this case.

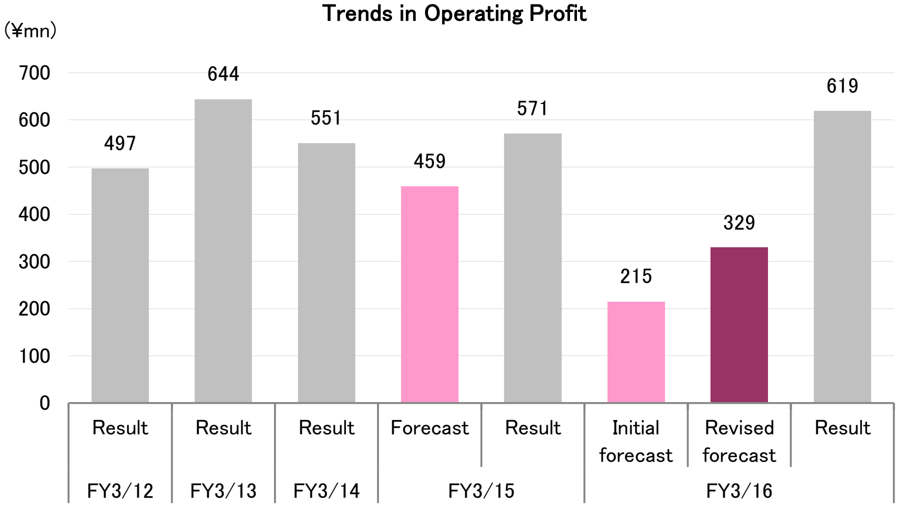
We think it should be noted that profits might vary significantly upward or downward versus forecast depending on executive decisions, the Company has refined the income structure and financial position in FY3/17 and thereby created leaner operations, and profits uplift if the Company lowers investments should be even more pronounced.

(3) Outlook from FY3/18

We think the top point in deciding whether to invest in Estore is the timing of when it returns to a growth trajectory. The latest results confirmed demand exceeding the Company's capacity in market support services, a business seen as a growth engine, as explained above. The Company needs to increase personnel more in order to harness this demand and expand sales. We thus expect the Company's stance in setting the immediate sales goal and the pace at which it plans to strengthen personnel to influence its performance (particularly the profit bottom) and the timing of a subsequent V-shaped recovery.

Our best-case scenario at this point envisions building up capacity to accommodate anticipated demand from FY3/19 during FY3/17-18. This view reflects the dependence of marketing support services on human resources. As noted earlier, the Company has presented a policy for securing human resources based on expectations of future demand growth as an investment (as noted earlier). However, its personnel recruitment has not kept pace with demand up to now in part due to shortages of people with experience and knowledge that the Company requires. We are concerned that profits growth could be modest, even if sales expand, as long as these conditions persist. We think the Company is capable of boosting the profit level and profitability in 1-2 years after making a large investment in human resources at some point. We believe the time has come for Estore to take stronger action in its investments in light of the confirmation of strong customer demand and fluidity of human resources in the industry.

The Company's experiences in FY3/15 and FY3/16 (when it announced forecast) are instructive in assessing the operating profit trend. In both years, Estore expected temporary steep profit decline because of investments in human resources. Yet it made less progress with recruitment than anticipated and operating profit surpassed the plan. We see multiple implications from these outcomes, but focus on two points. One is FY3/17 offers an excellent change to accelerate hiring in light of smooth recruitment activity. We think the fluidity of human resources has increased in the EC-related industry where the Company operates. The other is the current profit structure in which earnings are likely to realize a V-shaped recovery if the Company halt investments in personnel. We believe this point also gives justification to the Company's stance of aggressive investments.



Source: Prepared by FISCO from the financial results summary

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Simplified Income Statement and Main Indicators

(¥mn)

	FY3/14 full year	FY3/15 full year	FY3/16 full year	FY3/17 full year		
				1H	2H (E)	Full year (E)
Net sales	4,526	4,336	4,660	2,310	2,721	5,032
YoY	0.7%	-4.2%	7.5%	3.2%	-	8.0%
Gross profit	1,728	1,649	1,769	781	-	-
Gross profit margin	38.2%	38.0%	38.0%	33.8%	-	-
SG&A expenses	1,214	1,090	1,140	567	-	-
SG&A margin	26.8%	25.1%	24.5%	24.6%	-	-
Operating profit	514	559	628	214	116	331
YoY	-15.3%	8.7%	12.5%	-40.5%	-	-47.3%
Operating profit margin	11.4%	12.9%	13.5%	9.3%	4.2%	6.6%
Recurring profit	516	562	628	208	122	331
YoY	-17.0%	8.9%	11.9%	-42.2%	-	-47.3%
Net profit	314	330	420	142	86	229
Dividend per share (¥)	-	-	-			-

EPS after adjustment for share-split (¥)	47.56	55.27	78.66	27.67	16.70	44.37
BPS after adjustment for share-split (¥)	162.04	197.18	196.74	-	-	-
Dividend after adjustment for share-split (¥)	15.50	17.00	24.00	-	-	-

Source: Prepared by FISCO from the financial results summary

Standalone Balance Sheet

(¥mn)

	FY3/13	FY3/14	FY3/15	FY3/16	1H FY3/17
Current assets	3,395	2,562	2,797	3,058	2,669
Cash and deposits	2,737	1,910	2,155	2,385	2,003
Accounts receivable	517	544	528	553	534
Fixed assets	691	589	511	447	416
Tangible fixed assets	197	159	100	82	68
Intangible fixed assets	268	207	116	108	108
Investments & other	225	223	293	256	240
Total assets	4,087	3,152	3,308	3,505	3,086
Current liabilities	1,991	2,036	2,098	2,471	2,038
Accounts payable	169	178	180	173	156
Short-term borrowings	-	100	100	324	-
Deposits held	1,385	1,392	1,393	1,559	1,513
Fixed liabilities	11	136	40	18	18
Long-term borrowings	-	124	24	-	-
Shareholders' equity	2,078	978	1,162	1,012	1,031
Paid-in capital	523	523	523	523	523
Capital surplus	539	539	539	539	539
Retained profits	2,007	2,203	2,439	2,759	2,778
Treasury stock	-991	-2,287	-2,339	-2,810	-2,810
Total valuation and conversion difference	3	0	6	3	-1
Stock subscription rights	2	0	0	-	-
Total net assets & liabilities	2,084	978	1,170	1,015	1,029
Total net assets & liabilities	4,087	3,152	3,308	3,505	3,086

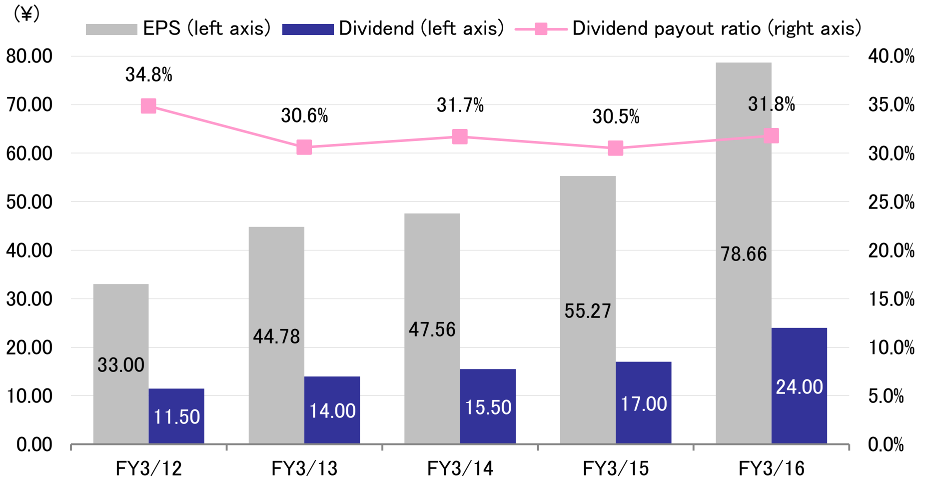
Shareholder Returns

Basic philosophy is to "divide profits between three groups; shareholders, customers, and staff."

The Company basically returns profits to shareholders through dividends. It pays dividends after taking into account a comprehensive range of factors, including business results, financial position, and the need to retain sufficient internal reserves to invest in growth. While it does not formulate an official dividend payout ratio, the foundation of Estore's thinking on the distribution of profits is its basic philosophy of "dividing profits between three groups; shareholders, customers, and staff." In the past also, it has a track record of determining the dividend based on this basic philosophy.

The Company has not announced a dividend forecast for FY3/17. Since it is expected to maintain its basic philosophy described above, of "dividing profits between three groups," it is possible it will sharply decrease the dividend if the results are in accordance with its initial forecasts. However, we do not think this needs to be viewed negatively because it would be the result of investments in future growth. The Company's profit decline is the result of investments toward growth, and these investments are delivering targeted results as noted earlier. Estore is still in a growth stage, and we believe it is sufficiently justified in putting funds into growth investments, rather than dividends.

Trends in EPS, dividend, and dividend payout ratio
(results on a standalone basis)



Source: Prepared by FISCO from the financial results summary

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