Medical System Network

4350 Tokyo Stock Exchange First Section

Company Research and Analysis Report
FISCO Ltd.
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■Increasing earnings through expansion of its pharmaceutical network and mergers and acquisitions in the pharmacy business

Medical System Network (4350) has two main businesses. The one is pharmaceutical network business and the other is pharmacy operation business, which provides an efficient pharmaceutical ordering system for small and medium-sized pharmacies. This system allows pharmacies to outsource operations with pharmaceutical wholesalers such as ordering, price negotiation, and payment. The pharmaceutical network business has been steadily growing, and as of September 30, 2013, the company now offers this system to 1,085 pharmacies. At the same time, the pharmacy business is expanding, in part, through mergers and acquisitions. Thus, the company targets consolidated sales of ¥300bn in 10 years from now in the fiscal year to March 2024, i.e., FY3/24.

In the first half (April-September) of the fiscal year ending March 31, 2014 (FY3/14), the company's consolidated sales increased 16.9% year on year (y-o-y), while operating profit ended on a high note, jumping 66.8% y-o-y. This was mainly due to increased profits at both of its two main businesses. The pharmacy operation business contributed significantly to profitability, with operating profit up 87% y-o-y due to higher prescription prices and an increase in the number of prescriptions filled on pharmacies in operation basis.

The company have left its initial projection for full FY3/14 earnings unchanged. After official drug prices were cut in April 2012, negotiations with pharmaceutical wholesalers for purchase prices are not yet concluded and the impact that Total Medical Service (3163), a wholly owned subsidiary via take over bit (TOB), will have on Medical System Network's performance is still being carefully examined.

Notably, their policy is to reflect this fiscal year's cost of goods sold together with those of FY3/13 following the price negotiations with pharmaceutical wholesalers. Therefore, we must bear in mind that there is a risk of a temporary drop off in earnings depending on the negotiation's outcome. The company hopes to complete negotiations within this year at the latest.

Over the medium- to long-term, we expect earnings growth to remain stable due to the growth of the pharmacy operation business along with the continued addition of more small and medium-sized pharmacies in the pharmaceutical network business. Although there are approximately 50,000 dispensing pharmacies nationwide, there is an accelerating trend toward market consolidation by major companies amid a harsh earnings environment. The company's strength is its pharmaceutical network business, which translates into higher profitability.

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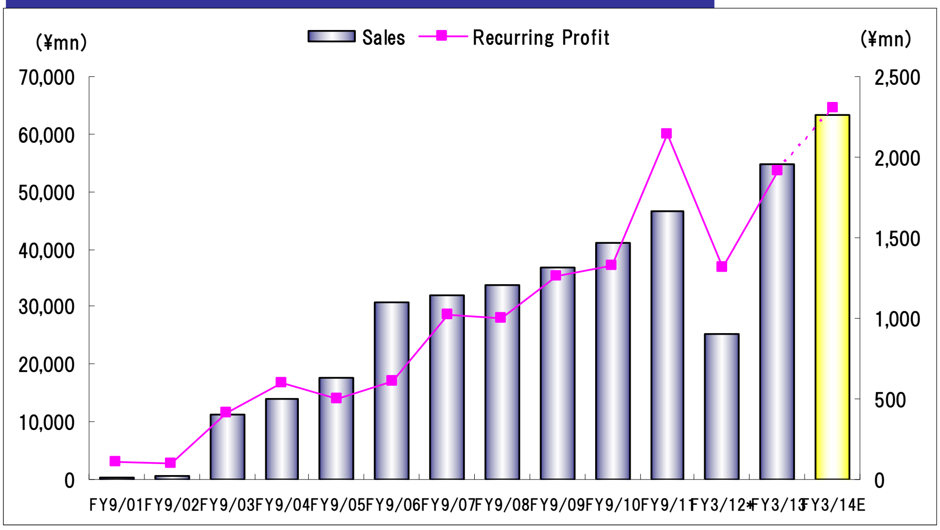
Check Points

- Offers higher productivity and price negotiating power, mainly for small and medium-sized dispensing pharmacies
- Seeking greater growth in "community medical infrastructure development" focused on pharmacies
- Deserves renewed attention as a steadily growing company following the conclusion of price negotiations

Consolidated Sales and Recurring Profit (¥mn)



Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

Company Outline

Over 90% of sales generated by pharmacy operation business and roughly 40% of operating profits generated by pharmaceutical network business

(1) Businesses

The company has two main businesses, pharmaceutical network business and the pharmacy operation business. It also leases property and operates medical facilities related to its two main businesses, and in its other business it supports clinical trials at medical institutions. The network business is conducted by Medical System Network and System Four, while the pharmacy operation business is operated by Pharmaholdings and its subsidiaries, and Hokkaido Pharmaceutical Laboratory.

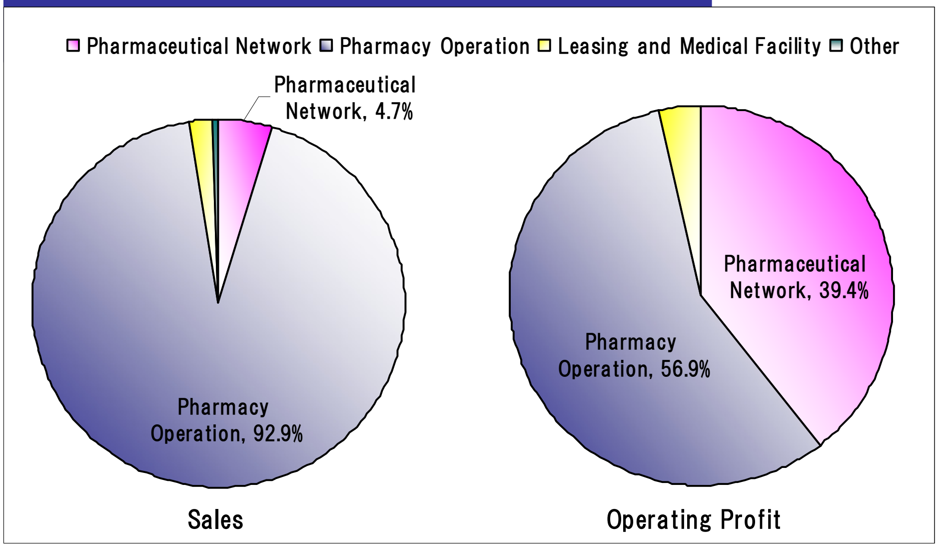
Looking at the company's composition by business, with the pharmacy operation business accounting for the vast majority, over 90% of sales, but the pharmaceutical network business accounting for nearly 40% of operating profit, it is easy to see that these two businesses constitute its main business.

■Company Outline

Group Companies (Business description and investment ratio)

Subsidiary	Ownership ratio (%)	Business
System Four	100.0	Pharmaceutical network business
H&M	51.0	Efficient distribution of pharmaceuticals
		(joint venture with HANSHIN Dispensing Pharmacy Holdings)
Pharmaholdings	90.2	Operate pharmacies (joint venture with Alfresa Holdings)
Compha	100.0	Operate pharmacies in central Hokkaido
Apos	100.0	Operate pharmacies in southern Hokkaido
SKI Pharmacy	100.0	Operate pharmacies in northern and eastern Hokkaido
Sun Medic	100.0	Operate pharmacies in Tohoku, Greater Tokyo and Koshinetsu
Apo Pharmacy	100.0	Operate pharmacies in Greater Tokyo
Tomioka Pharmacy	100.0	Operate pharmacies in Greater Tokyo
UPC	100.0	Operate pharmacies in Greater Tokyo
CR Medical	100.0	Operate pharmacies in Tokai and Hokuriku
Kyoei Pharmacy	100.0	Operate pharmacies in Kinki, Chugoku and Shikoku
Itsuki Pharmacy	100.0	Operate pharmacies in Tokai
Total Medical Service	100.0	Operate pharmacies in Kyushu and Chugoku
Kyushu Pharmacy	100.0	Operate pharmacies in Kyushu
Hokkaido Pharmaceutical Laboratory	100.0	Pharmacy business (train pharmacists)
Nihon Leben	100.0	Leasing of property and operation of medical facilities
SMO Medisys	100.0	Other businesses (supporting clinical trials at medical institutions)

Sales and Operating Profit by Business (FY3/13 Results)



Note: Operating profit before the deduction of unallocated corporate costs and other minor adjustments.

■Company Outline

Offers higher productivity and price negotiating power, mainly for small and medium-sized dispensing pharmacies

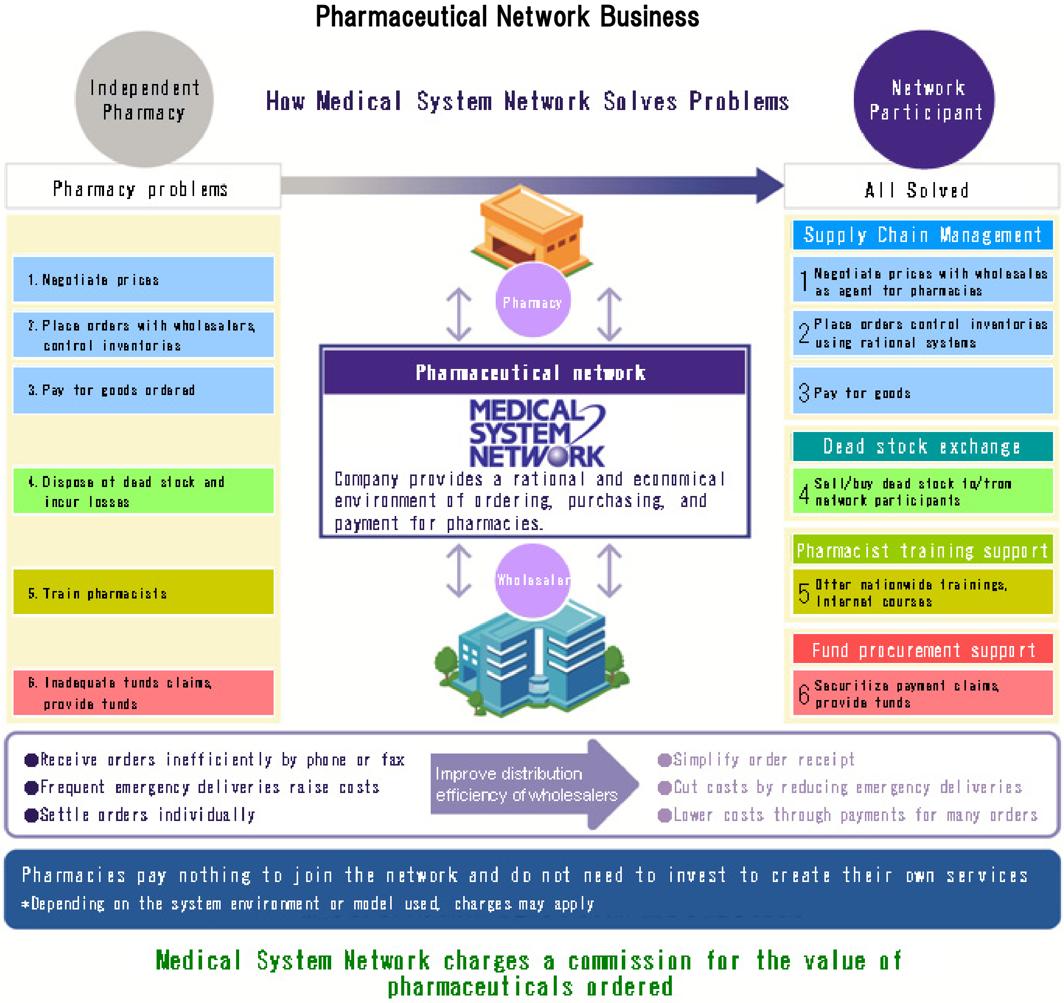
(2) Segment Overview

○ Pharmaceutical Network Business

The pharmacy operation business is a start-up business of the company since establishment. The model for the pharmaceutical network business is as an intermediary between pharmaceutical wholesalers and pharmacies to facilitate efficient distribution. It is now conducted by Medical System Network and its one subsidiary (System Four). For member pharmacies in its network, the company provides supply chain management services, acting as their agent by ordering and making payment and settlement, which member pharmacies had previously done daily with pharmaceutical wholesalers. It also disposes of obsolete inventories through its dead stock exchange service, supports the training of pharmacists and fund procurement.

The supply chain management service facilitates daily order placement, payments and settlement, inventory control, and negotiates prices for the goods ordered. Using the company's order entry system (O/E system), the member pharmacies can raise productivity. Furthermore, they can purchase pharmaceuticals more cheaply than before because Medical System Network can negotiate lower prices for bulk orders than individual pharmacies can negotiate.

Pharmaceutical Network Business



Source: Company

■Company Outline

The dead stock exchange service allows customer pharmacies to both rid themselves of unsold goods and acquire some needed goods cheaply by buying and selling from each other. Using this service, the pharmacies can lower their losses from disposing of unsold inventories.

The pharmacist training support service provides nationwide concentrated training sessions 30-40 times per month to raise the skills of pharmacists. It also provides e-learning lessons. The fund procurement support service securitizes the payment claims of pharmacies and provides funds to the pharmacies a month or more faster than the usual payment process does. Normally, this process takes about two months, but the fund procurement support service pays pharmacies in about a month from the date of dispensing pharmaceuticals.

The pharmaceutical network business also develops, sells and maintains the pharmaceutical order receipt computer system, the company’ s pharmaceutical order entry system, and peripheral equipment for both systems. It also sells equipment, fixtures and fittings used to prepare and dispense pharmaceuticals.

Most of the customers for the pharmaceutical network business of Medical System Network are pharmacy companies with 20 or fewer pharmacies or proprietor pharmacies. At the end of FY9/13, the pharmaceutical network business had 1,085 companies, institutions or pharmacies in its customer network, including 27 hospitals or medical institutions (as detailed in the table below) and it is expanding every year. The company has customers in 43 prefectures and administrative areas of Japan and has spread nearly nationwide, with almost half in Hokkaido where the business was founded, as well as the Greater Tokyo (Kanto) and Koshinetsu areas of Honshu. The Kinki area (Greater Osaka) has the next largest number of customers, followed by the Tokai and Hokuriku areas.

Most of the sales generated by the pharmaceutical network business come from commissions on pharmaceutical orders placed through the company’ s order entry system and from the sale of systems to member pharmacies.

Pharmaceutical Network Business

Classification	FY9/10	FY9/11	FY3/12	FY3/13	1H FY3/14
External customers	393	526	631	764	803
Group pharmacies	204	214	223	269	282
Total	597	740	854	1,033	1,085
Geographical breakdown	**FY9/10**	**FY9/11**	**FY3/12**	**FY3/13**	**1H FY3/14**
Hokkaido	188	180	197	212	216
Tohoku	28	31	63	80	82
Kanto - Koshinetsu	194	202	214	270	285
Tokai - Hokuriku	28	79	96	138	151
Kinki	85	150	150	178	182
Chugoku - Shikoku	48	55	70	77	82
Kyusyu - Okinawa	26	43	64	78	87
Total	597	740	854	1,033	1,085

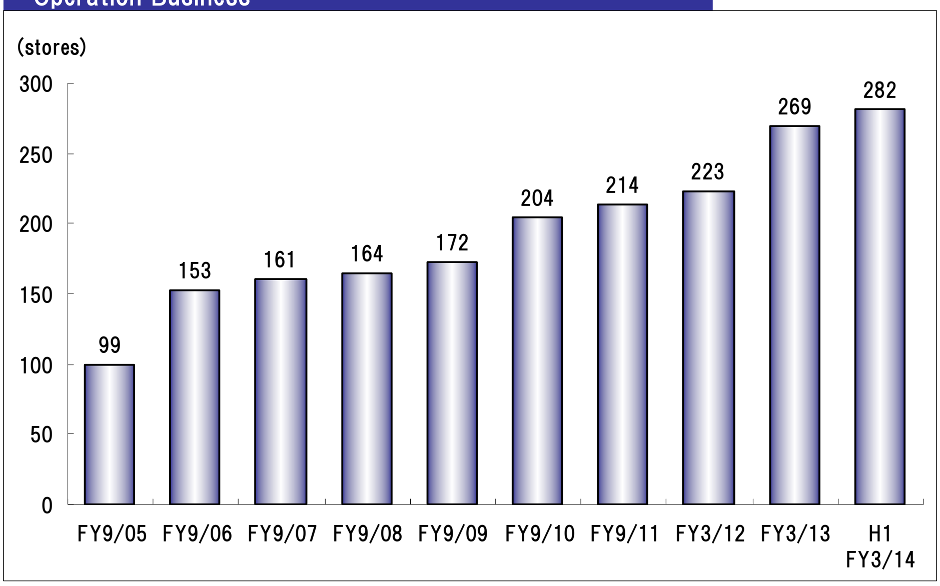
■Company Outline

Accelerating nationwide expansion centered in Hokkaido through M&A

○ Pharmacy Operation Business

The company’s Nanohana pharmacies were operated by 11 subsidiaries of subsidiary Pharmaholdings as of September 30, 2013. These pharmacies are trying to change from a simple chain of pharmaceutical dispensaries into pharmacies that offer a range of services to improve the health of local inhabitants, and as of September 30, 2013 there were 282 pharmacies (excluding one pharmacy that is inactive). By area, Hokkaido had 109 pharmacies, or nearly 40% of the total, and the company is increasing the number of pharmacies partly through M&A. In addition, it operates 12 drugstores and one Care Plan Center (Home Care Support Office). Furthermore, Hokkaido Pharmaceutical Laboratory, another subsidiary of Medical System Network, educates and trains pharmacists and other pharmacy workers, both for group pharmacies and for independent pharmacies.

Number of Pharmacies Operated by the Pharmacy Operation Business



Operating medical and healthcare complex in leasing and medical facility business

○ Leasing and Medical Facility Business

Medical System Network subsidiary Nihon Leben primarily develops land sites on which to build group pharmacies and leases and insures buildings for medical services. It also offers consulting service about medical practice and operates medical malls where many medical specialties are offered on a single floor of a building, medical buildings where many clinics gathers in one building, and homes for the elderly which offer various health services.

○ Other Businesses

Medical System Network subsidiary SMO Medisys signs contracts with medical institutions conducting clinical trials to support these trials.

■Business Trends

Two main businesses going strong, profits up substantially in pharmacy operation business outperforming initial targets

(1) First half of FY3/14 (April to September)

On November 1, Medical System Network announced its results for the first half (April to September) of FY3/14. Consolidated sales increased by 16.9% y-o-y to ¥30,438mn, operating profit climbed 66.8% to ¥1,207mn, recurring profit jumped 79.1% to ¥1,172mn, and net profit rose 68.0% to ¥433mn, a double-digit increase in sales and profits. Moreover, all results exceeded its initial targets.

Pharmaceutical Network Business

	1H FY3/13		1H FY3/14					
	Results	Sales Ratio	Initial Target	Results	Sales Ratio	y-o-y Change	Change from Target
Sales	26,047	100.0%	29,872	30,438	100.0%	16.9%	1.9%
Cost of goods sold	16,891	64.8%	-	19,735	64.8%	16.8%	-
SGA cost	8,432	32.4%	-	9,496	31.2%	12.6%	-
Operating profit	723	2.8%	865	1,207	4.0%	66.8%	39.5%
Recurring profit	654	2.5%	835	1,172	3.9%	79.1%	40.5%
Extraordinary losses	11	-	-	-67	-		-
Net profit	257	1.0%	271	433	1.4%	68.0%	59.8%

The primary factor behind the increases was the strong performance of the main pharmaceutical network business and pharmacy operation business. Above all, in the pharmacy operation business, operating profit grew a substantial 87% y-o-y due to higher prescription prices and an increase in the number of prescriptions filled on a pharmacies in operation basis. This growth helped the company to exceed its initial targets. Although the cost of goods sold ratio was 64.8%, largely unchanged from the corresponding year-earlier period, the SGA cost ratio declined 1.2 percentage points to 31.2% and the operating profit margin rose 4.0%, largely due to higher profits and lower employee stock option plan (ESOP). Trends by market segment are shown in the chart below.

Consolidated Results for First Half (April - September) FY3/14 (¥mn)

Item	Change	Item	Change
Pharmacy Operation Business	+451	Pharmaceutical Network Business	+128
Factors accounting for change in Pharmacy Operation Business		Leasing and Medical Facility Business	-72
Pharmacies in operation	+263	Other Businesses	-1
Pharmacies opened or purchased in previous year	+237	Cost of introducing an employee stock option plan	+45
Pharmacies opened in FY3/14	-62	Company-wide expenses	-71
Pharmacies bought in FY3/14	+16		
Pharmacies closed in FY3/14	+58		
Other business costs	-61	Total	483

■Business Trends

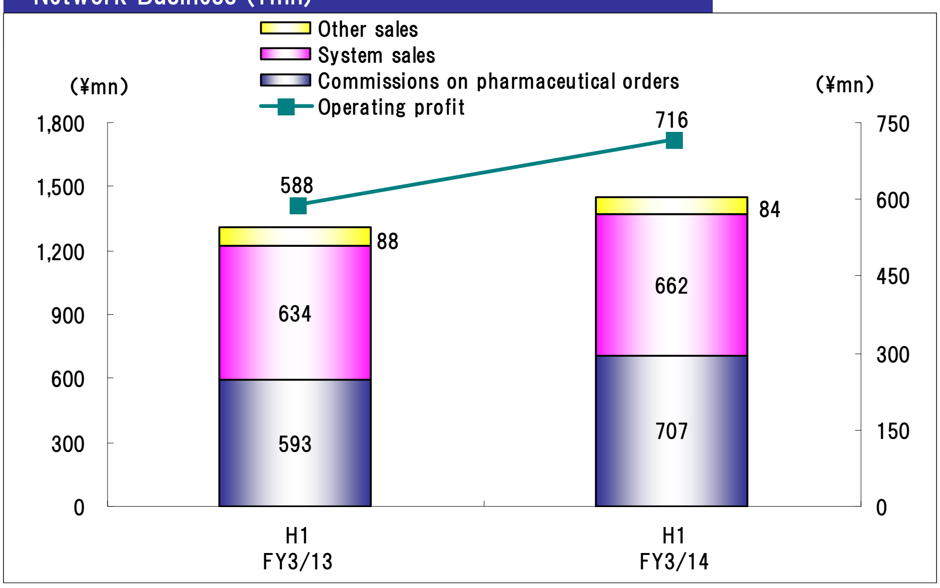
Sales and profits grew by double digits due to increase in member pharmacies and higher commissions

○ Pharmaceutical Network Business

In the first half (April – September) of FY3/14, sales in the pharmaceutical network business increased 10.4% y-o-y to ¥1,453mn, operating profit climbed 21.8% to ¥716mn, and the operating profit margin rose substantially from 44.7% to 49.3%. The main factor behind the increase was a 14.8% surge in the number of member pharmacies to 1,085 pharmacies as of September 30. The rise in the operating profit margin was due to a higher ratio of profitable commissions on pharmaceutical orders.

Looking at the sales breakdown, although commissions on pharmaceutical orders increased 19.2% y-o-y to ¥707mn, system sales were sluggish, rising only 4.2% to ¥661mn. Commissions on pharmaceutical orders were affected by the increase in member pharmacies and the trend in order transaction amount per pharmacy. In the first half, the sales growth from commissions on pharmaceutical orders outpaced the growth rate of member pharmacies, which could be interpreted to mean that the rise in orders per pharmacy had a positive earnings effect. Commissions on pharmaceutical order transaction amounts for all member pharmacies rose 19.5% to ¥53,244mn, and have grown to the point that they are now a major industry player.

Sales and Operating Profit in the Pharmaceutical Network Business (¥mn)



Meanwhile, because sales of hardware and software to member pharmacies are the core of system sales, the growth rate has slowed down. If we look only at the net increase in member pharmacies (March 31 – September 30), it came to no more than 52 in the first half, in contrast to 91 in the same year-earlier period.

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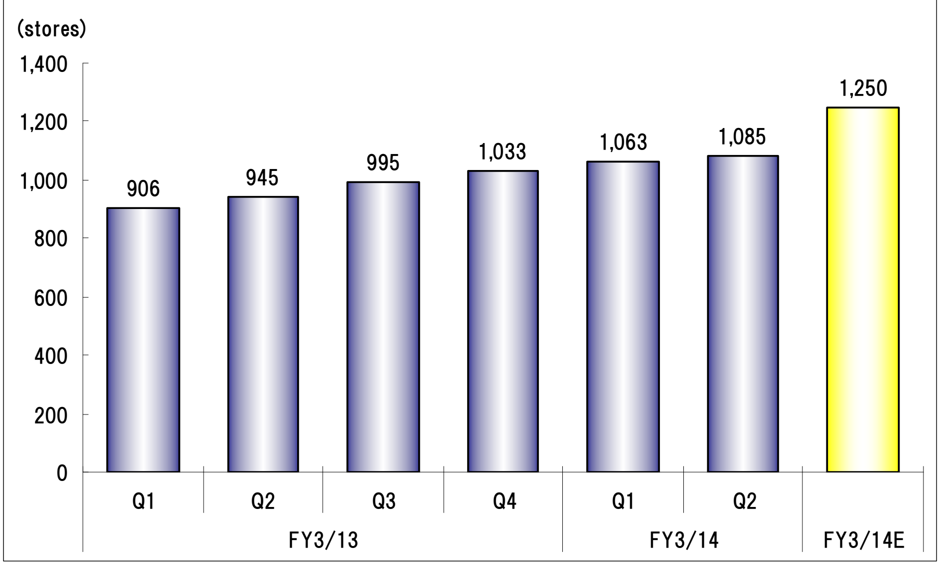
■Business Trends

The full-year target for the number of member pharmacies was 1,250 as of March 31, 2014, but progress is somewhat behind schedule, with 1,085 customers as of September 30, 2013. The main factor for this appears to be the impact of protracted negotiations with pharmaceutical wholesalers about purchase prices after changes to the official drug prices in April 2012. It appears that there are quite a few pharmacies who say they will join the company’s network after finding out what the drug purchase prices will be. As of November 1, 2013, it had 1,109 member pharmacies.

Number of Customers for the Pharmaceutical Network Business



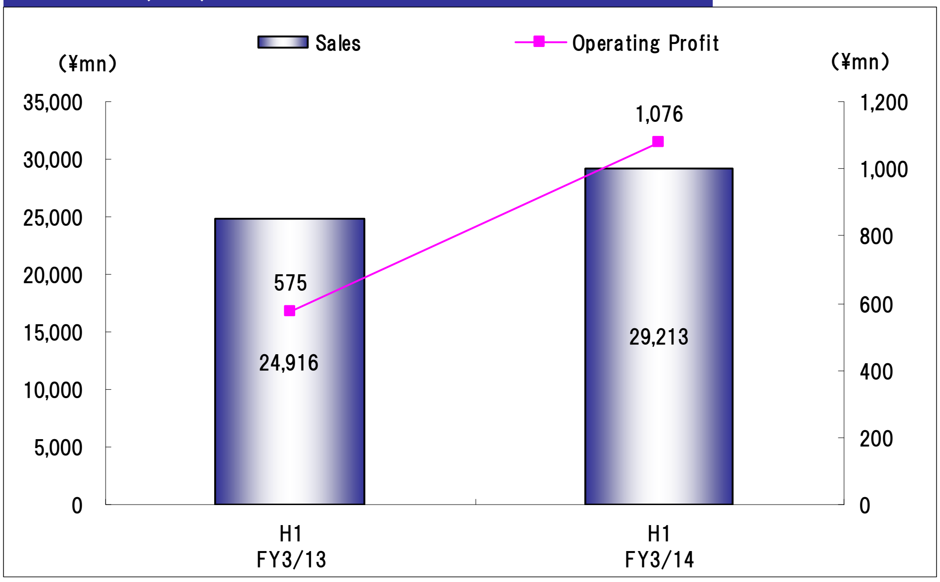
Raised operating profit margin due to increased sales from opening of new pharmacies and streamlining of back office sections

○ Pharmacy Operation Business

In the pharmacy operation business, in the first half (April – September) of FY3/14, sales grew by 17.2% to ¥29,213mn, operating profit jumped 87.0% to ¥1,076mn, and the operating profit margin rose from 2.3% to 3.7%. In addition to higher sales, the streamlining of back-office sections through absorption-type mergers of four group companies helped raise the operating profit margin. As for pharmacy openings and closings in the first half, seven new pharmacies were opened and eight pharmacies were acquired through either merger or acquisition. On the other hand, two pharmacies were closed and the number of pharmacies, as of September 30, 2013, was 282, an increase of 24 compared with the same year-earlier period, and an increase of 13 pharmacies compared with the end of FY3/13.

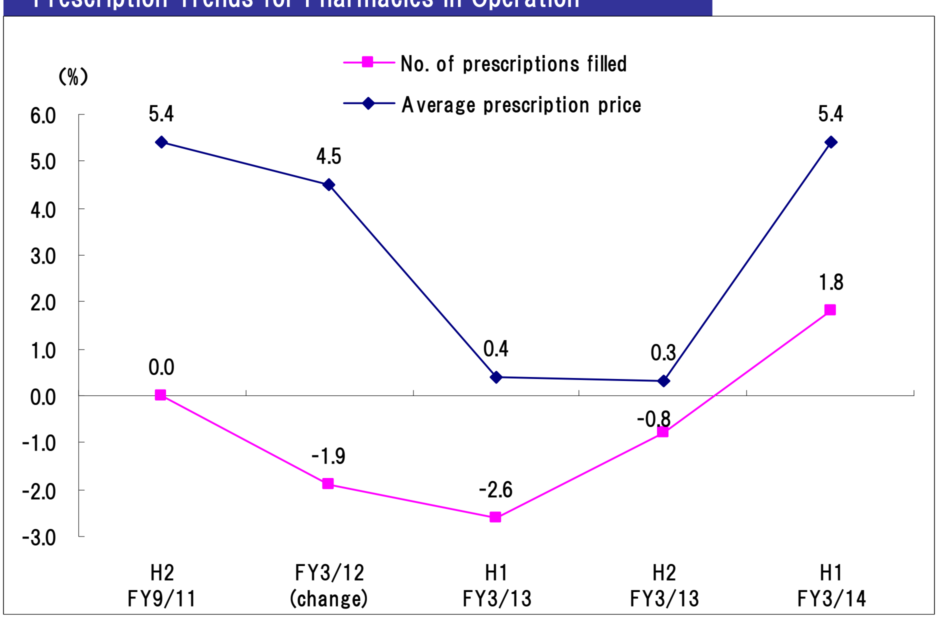
■Business Trends

Sales and Operating Profit in the Pharmacy Operation Business (¥mn)



Against a backdrop of solid sales growth, not only did we see the effects of the increase in the number of pharmacies, pharmaceutical, sales on a pharmacy in operation basis, were greater than expected, increasing 7.3% y-o-y. Factors behind the change in pharmaceutical sales of pharmacies in operation are the 5.4% increase in average prescription price along with the 1.8% increase in the number of prescriptions filled, a major reversal from past decreases. Because of the increase in the number of prescriptions filled and since the prescription price tends to rise in the second year of official drug price changes, the increase in the average prescription price was largely within the boundaries of our assumptions. However, the number of prescriptions filled exceeded the company' s target, changing from negative to positive for the first time in three years on a first-half (April - September) basis. Not only were the previous year' s figures low, we saw the effects of handling an increase in the number of patients visiting pharmacies due to higher customer satisfaction, such as reduced patient waiting time and better amenities in pharmacies.

Prescription Trends for Pharmacies in Operation



Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

■Business Trends

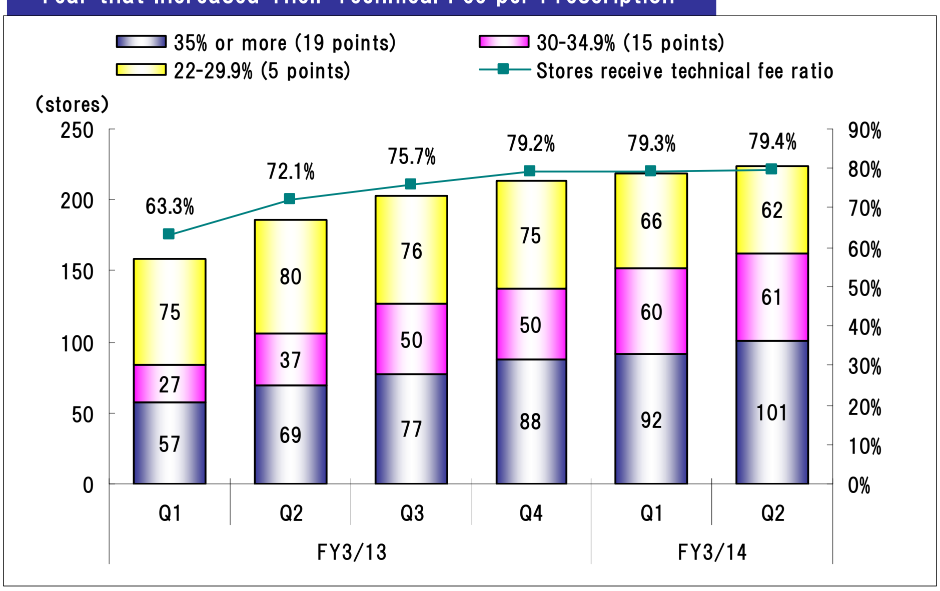
The technical fee (pharmacist fee), which is included in the average prescription price, has also been on a continued upswing, rising 2.6% year on year, and contributes to a higher average price. This reflects an increase in pharmacies with a higher weighting of generic drugs following the development of the company’ s system for dispensing more generic drugs, and an increase in the number of pharmacies with a high technical fee (pharmacies offering a higher proportion of generic drugs) from among these pharmacies. To control the increase in medical costs in Japan, the Ministry of Health, Labor and Welfare is promoting the greater use of generic drugs. To encourage pharmacists to dispense more generic drugs, the ministry allows an increase in the technical fee per prescription when the weighting of generic drug prescriptions exceeds a certain level. As the weighting of generic drug prescriptions rose, an increasing number and proportion of pharmacies raised their technical fees.

Breakdown of Sales Generated by Pharmacies in Operation for More than a Year

	H1 FY3/13	H1 FY3/14	y-o-y
No. of prescriptions filled (thousand)	2,494	2,821	13.1%
Average prescription price (¥)	9,285	9,744	4.9%
Technical fee per prescription (¥)	2,185	2,241	2.6%
Pharmaceutical revenue per prescription (¥)	7,100	7,504	5.7%
Total sales (¥mn)	24,916	29,213	17.2%
Pharmaceutical sales	23,157	27,489	18.7%
OTC pharmaceutical sales and others	1,759	1,724	-2.0%

Note: Pharmaceutical sales is no. of prescriptions filled x avg. prescription price

Number of Pharmacies in Operation for more than a Year that Increased Their Technical Fee per Prescription



■Business Trends

In the leasing and medical facility business, occupancy rates at residences for the elderly offering medical services have been steady and depreciation and amortization expenses have accumulated

○ Leasing and Medical Facility Business

In the first half (April – September) of FY3/14, sales increased by 14.6% y-o-y to ¥622 million, but there was an operating loss of ¥6 million (compared with operating profit of ¥66 million in the corresponding year-earlier period). Revenue from real estate rental leasing increased, but the business invested heavily in Wisteria Kiyota, a residence for the elderly offering medical services that opened in May 2013 as a medical and healthcare complex, thereby incurring depreciation and other costs. As a result, these costs depressed profits. Occupancy at Wisteria Kiyota has been steady with 31 out of the 75 units in total as of September 30, 2013.

○ Other Businesses

In the first half (April – September) of FY3/14, sales in other businesses declined by 7.1% y-o-y to ¥122 million, while operating profit decreased 14.5% to ¥6 million.

Exceeding its initial plan, full-year forecast remains unchanged

(2) Company Forecasts for FY3/14

For FY3/14, Medical System Network forecasts a 15.2% y-o-y rise in sales to ¥63,164mn, an 18.8% upturn in operating profit to ¥2,432mn, a 20.3% increase in recurring profit to ¥2,300mn, and a 9.2% rise in net profit to ¥826mn. The company has left its initial forecast unchanged because it is still carefully examining purchase price negotiations with drug wholesalers following the changes to the official drug prices, as well as the impact that making Total Medical Service (3163) a wholly owned subsidiary via TOB will have on Medical System Network' s performance.

○ Purchase Price Negotiations

Negotiations with drug wholesalers to adjust the purchase prices of drugs have been going on since the previous fiscal year following the changes to the official prices of drugs made in April 2012. However, a gap seems to remain between the prices that each side has proposed and they still have not reached a settlement. Drugstores and small- to mid-sized pharmacies have already reached a settlement, and now only large hospitals and pharmacies are still negotiating. Drawing on past price adjustments during drug price revisions as points of reference, Medical System Network has estimated profits and losses based on tentative purchase prices from the previous fiscal year. But, an increase in purchase price as a result of negotiations would have a negative effect on profits.

The company' s annual purchasing in the pharmacy operation business comes to ¥40 billion, and so price negotiations will have an enormous impact on its profits. Therefore, we should consider this a short-term risk factor when looking at the company' s earnings.

■Business Trends

Medical System Network has overwhelmingly dominant position in Kyushu thanks to TOB

○ TOB of Total Medical Service

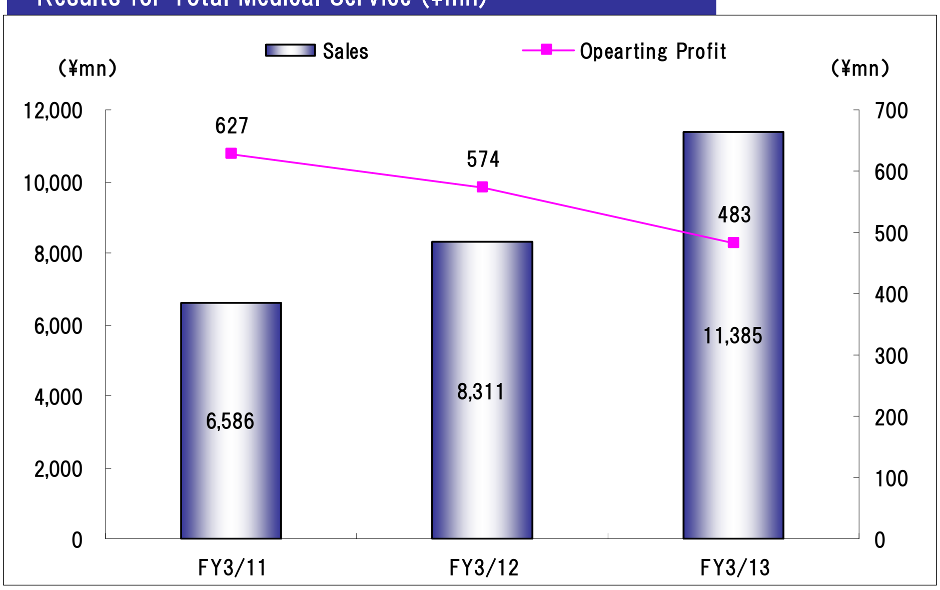
On September 27, Medical System Network announced that through its subsidiary Pharmaholdings, it had launched a takeover bid for Total Medical Service (3163), a company that develops pharmacies, with the goal of making it a wholly owned subsidiary. The takeover period extends to November 19 and the offer price is set at ¥3,200 per share. The acquisition price comes to ¥4,754mn.

Total Medical Service is a company whose main business is pharmacies and medical support. Its pharmacies are primarily in Fukuoka and are mainly operated in close proximity to hospitals and medical clinics (it had 35 pharmacies as of September 30, 2013). On the other hand, its medical support business is run by its subsidiaries, providing food-service operations on a contract basis in hospitals and social welfare facilities, as well as the wholesaling of pharmaceuticals.

The graph below shows earnings during the last three fiscal years. With the December 2011 acquisition of the subsidiary that contracts food services, sales have rapidly increased, but profits have declined. Not only are the profits of the acquired subsidiary still low, it is weighted down by annual goodwill expenses of ¥200mn. Turning our attention to the pharmacy operation business, although its annual sales of ¥7,000mn is low compared to large companies, its industry-leading segment profitability of around 13% is distinctive. The industry average is around 5 to 6%, a more than two-fold difference, even compared to the pharmacy operation business of Medical System Network.

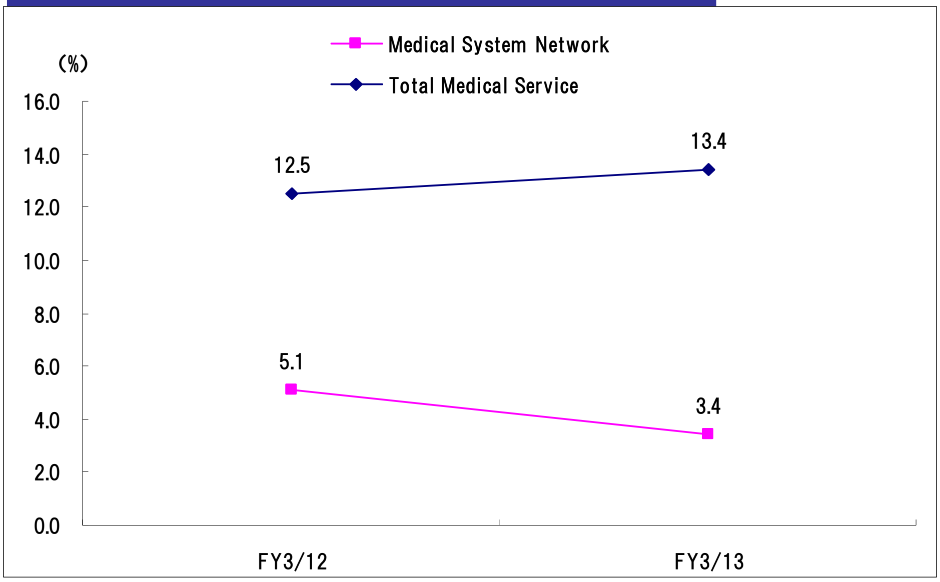
The reason of its high profitability is that it operates pharmacies near large 300-bed hospitals and runs highly efficient mall-type pharmacies. Therefore, making it a subsidiary via takeover bid will help push profitability of its pharmacy operation business up by one percentage point (before deducting goodwill amortization expenses). Moreover, it could further raise its profitability by joining the pharmaceutical network.

Results for Total Medical Service (¥mn)



■Business Trends

Results for Total Medical Service (¥mn)



In the past, the company had only five pharmacies in the Kyushu area, but now it adds 32 pharmacies (the remaining three pharmacies are in Yamaguchi Prefecture) in one fell swoop. Fukuoka Prefecture, where Total Medical Service operates most of its pharmacies, is expected to see an increase in its elderly population and stable market growth is anticipated. For Medical Network System, which is expanding its business nationwide, the acquisition fills in a gap in the Kyushu area where it was weak, and is considered highly advantageous.

While some view the acquisition as too expensive, the company sees it as reasonable when looked at from a cash-flow basis. Moreover, the terms have been set that if its low-profit hospital food service business incurs a loss in the next or following fiscal year, the company can sell off the business to Mr. Ohno, the President and CEO of Total Medical Service, for more than ¥40bn or more in net cash (cash and deposits – interest bearing debt).

Pharmaceutical network business likely to exceed initial targets

○ Forecast for main businesses

The forecast for the main businesses for the third quarter and after is favorable, if we exclude the issue of purchase price negotiations. The pharmaceutical network business is planning to increase its member of pharmacies by 217 pharmacies (compared with March 31, 2013) to 1,250 with the goal of expanding its network into all of Japan' s 47 prefectures (it still has no presence in Ibaraki, Toyama, Kochi and Tokushima prefectures) during FY3/14. As of November 1, 2013 it had 1,109 pharmacies, a somewhat low rate of progress, but it will add 35 pharmacies from Total Medical Service, and if negotiations on purchase prices are settled, the number of member pharmacies in its network should grow. In its initial forecast for full FY3/14, the company expected sales to increase 5.7% y-o-y to ¥2,802mn and operating profit to rise 7.3% to ¥1,311mn. However, looking at the progress it has made of reaching 52% of its sales target and 55% of its operating profit target through the first half, the pharmaceutical network business is likely to exceed its target.

■Business Trends

The full-year forecast for the pharmacy operation business was sales of ¥60,721mn, up 15.5% y-o-y, and operating profit of ¥2,316mn, up 31.1% (assuming a 2% increase in sales of pharmacies in operation). The business achieved 48% of its sales and 46% of its operating profit targets through the first half, and considering seasonal factors, it is on track to exceed its targets. Not only is the forecast for the third quarter and after favorable, Total Medical Service will contribute four-months of earnings. This should add about ¥2,400mn to its sales. Therefore, the pharmacy operation business is expected to exceed its targets, if we exclude the effect of purchase price negotiations.

For FY3/14, the leasing and medical facility business expects sales to rise by 13.7% to ¥1,276mn, a double-digit increase, but anticipates operating profit to decrease by 91.7% to ¥9mn due to an increase in depreciation costs as a result of the full-scale operation of the Wisteria Kiyota, a residence for the elderly with medical services. The company foresees no major changes in FY3/14 for its other businesses and projects a 4.5% rise in business sales to ¥263mn and a 113.8% rise in operating profit to ¥10mn.

Company Forecasts by Segment (¥mn)

	FY9/11	FY3/12	FY3/13	FY3/14	y-o-y
Sales					
Pharmaceutical Network	2,126	1,348	2,650	2,802	5.7
Pharmacy Operation	44,641	24,273	52,581	60,721	15.5
Leasing and Medical Facility	987	509	1,122	1,276	13.7
Other Businesses	225	131	252	263	4.5
Internal sales	-1,473	-852	-1,779	-1,899	-
Total	46,508	25,410	54,827	63,164	15.2
Operating profit					
Pharmaceutical Network	997	596	1,221	1,311	7.3
Pharmacy Operation	2,032	1,233	1,766	2,316	31.1
Leasing and Medical Facility	136	65	111	9	-91.7
Other Businesses	-18	5	4	10	113.8
Internal sales	-884	-542	-1,057	-1,215	-
Total	2,262	1,357	2,046	2,432	
Operating profit margin					
Pharmaceutical Network	46.9	44.2	46.1	46.8	
Pharmacy Operation	4.6	5.1	3.4	3.8	
Leasing and Medical Facility	13.8	12.8	9.9	0.7	
Other Businesses	-	4.1	1.9	3.9	
Total	4.9	5.3	3.7	3.9	

Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

■Growth Strategy

Seeking greater growth in "community medical infrastructure development" focused on pharmacies

For FY3/15, the final year of Medical System Network's current medium-term plan, the company targets sales of ¥75bn, operating profit of ¥4.3bn, recurring profit of ¥4.0bn, and net profit of ¥2.0bn. These targets are based on the assumptions that the pharmaceutical network business will have 1,500 member pharmacies and the pharmacy operation business will have 350 pharmacies by the end of FY3/15.

FISCO

■Growth Strategy

The strategy of the pharmaceutical network business is to maintain stable growth by bringing in more small- to mid-sized pharmacies. Although there are approximately 50,000 pharmacies nationwide, there is an accelerating trend toward market consolidation by major companies amid a harsh earnings environment. With its advantage of owning a pharmaceutical network that helps pharmacies to become more profitable, the company seeks additional growth for its pharmacy operation business by leveraging M&A, while increasing the number of pharmacies in its network. It is targeting sales of ¥300 billion 10 years from now.

The strategy of the pharmacy operation business is to expand its market share in Aichi Prefecture and urban areas including the Tokyo metropolitan area while maintaining its steady foundation in Kyushu. An issue that it must confront in the future is that of increasing the proportion of generic drugs that it offers, which is somewhat lower than the industry average. That is because measures will most likely be adopted to further encourage a shift to generic drugs in order to lower medical costs in Japan. As already stated, the proportion of generic drugs offered at pharmacies will affect the pharmacies' profitability. Therefore, the company's idea is to raise the proportion of generic drugs offered at its pharmacies by continuing to carefully explain and convince customers at all pharmacies.

As an effort to build a new kind of pharmacy, in May 2013, Medical System Network announced that it would cooperate with FamilyMart (8028) in developing pharmacies incorporating a convenience store area. As a first step, the company plans to open its first such pharmacy by FY3/14. The company's pharmacies have an average floor space of about 30 tsubo (99 square meters). About 10-20 tsubo (33-66 square meters) of this floor space could be used to sell convenience store items. The company is now trying to determine what goods and services could be profitably offered in this space. If this business combination proves viable, the company will, as a second step, franchise this new store format that combines the pharmaceutical network with a convenience store to the more than 40,000 small to mid-sized pharmacies in Japan.

In the leasing and medical facility business, the company is developing, through its subsidiary Nihon Leben, residences for the elderly offering medical services. These residences propose a new kind of urban development integrating medical services and nursing care by combining residences for the elderly, a medical services complex, a hospital and a pharmacy. It has already opened Wisteria Kiyota (in the City of Sapporo, Hokkaido), its second facility. The company plans to open three more facilities in Sapporo, and in December 2015, Wisteria Senri-Chuo (tentative name), a large-scale residence for the elderly offering medical services, is scheduled to open in Senri-Chuo in Osaka. With 14 floors above ground, floor B1 through the ninth floor will have a hospital to support community medical care, while floors 10 through 14 will have residences (85 units in total) for the elderly offering medical services. As the scale of the project is large, costing ¥3,173mn for both land and buildings (of which ¥1,289mn has been spent), the plan is to securitize the property and place it off the balance sheets once the project reaches a certain rate of occupancy. The company plans to develop one residence per year in urban areas where the elderly population is growing.

■Financial Condition

Expand business scale through financial leverage

The chart below shows the financial condition of the company at the end of the first half of FY3/2013. Total assets came to ¥34,240mn, a ¥3,451mn y-o-y increase. The breakdown of the increase is as follows. Tangible fixed assets increased ¥2,356mn (due to the opening of new pharmacies and residences for the elderly offering medical services), goodwill was up ¥607mn, and assets increased as a result of business growth. On the other hand, liabilities came to ¥29,018mn, a ¥4,464mn y-o-y increase. Contributing to most of the increase was a ¥4,008mn y-o-y rise in interest-bearing debts. Total equity decreased by ¥1,013mn y-o-y due to the acquisition of treasury stock (an outflow of ¥1,135mn).

Looking at important measures of business performance, all of them including the current ratio, equity ratio, and debt-to-equity ratio are deteriorating due to the increase in interest-bearing debt. Nevertheless, the strategy of expanding business scale using financial leverage at low-interest rates is clear. The funds for the acquisition of Total Medical Service are also expected to be procured from financial institutions, so interest-bearing debt is expected to rise even higher.

Summary Consolidated Balance Sheet (¥mn)

	FY9/11	FY3/12	FY3/13	1H FY3/14
Current assets	7,786	8,901	8,271	8,800
(Cash and deposits)	1,329	2,072	2,091	1,790
Tangible fixed assets	9,162	9,975	11,471	13,828
Intangible fixed assets	4,982	5,040	8,263	8,878
(Goodwill)	4,900	4,968	8,176	8,784
Total assets	24,533	26,602	30,789	34,240
Current liabilities	10,800	12,693	14,375	17,922
Fixed liabilities	8,470	8,229	10,177	11,095
(Interest-bearing debt)	8,663	9,480	12,193	16,202
Total liabilities	19,270	20,923	24,553	29,018
Total equity	5,263	5,679	6,236	5,222
Total liabilities & equity	24,533	26,602	30,789	34,240
(Ratios of financial security)				
Current ratio	72.1%	70.1%	57.5%	49.1%
Equity ratio	20.1%	19.9%	18.8%	14.5%
Debt-to-equity ratio	175.4%	179.0%	210.9%	326.0%
(Ratios of profitability)				
ROA	9.2%	5.1%	6.6%	6.7%
ROE	20.3%	9.8%	13.1%	13.7%
Operating profit margin	4.9%	5.3%	3.7%	4.0%

Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

■Shareholder Returns and Risk Factors

Deserves renewed attention as a steadily growing company after price negotiations are settled

The company's policy is to pay a stable dividend reflecting the company's profits. After securing funds to strengthen its financial condition, expand business, train employees and make other expenditures necessary for growth, a dividend of eight yen per share, the same as the previous fiscal year, shall be paid for a dividend payout ratio of 23.3% in FY3/14.

(Short-term risk factors)
- Purchase price negotiations with drug wholesalers
- Profits in the pharmacy operation business may be adversely affected by more cuts in official drug prices or dispensing fee revision

(Long-term risk factors)
- Intensification of competition as more drugstores incorporate prescription drug pharmacies
- Lifting ban on online sales of mass-market drugs could spread to prescriptions drugs in the future

The probability of long-term risk factors materializing is considered to be extremely low at this point in time. For now, the outcome of purchase price negotiations with drug wholesalers is our focus in terms of the company's stock price, but if we get past this problem, this is a company with stable growth potential over the medium- to long-term.

Stock Price Trend (Daily)

Consolidated Income Statement (¥mn)

	FY9/10	FY9/11	FY3/12	FY3/13	FY3/14E
Sales	41,131	46,508	25,410	54,827	63,164
(y-o-y growth)	11.8	13.1	-	11.9	15.2
Cost of goods sold	27,060	30,291	16,450	35,415	41,010
(Cost of goods sold ratio)	65.8	65.1	64.7	64.6	64.9
SGA cost	12,542	13,954	7,602	17,365	19,722
(SGA cost ratio)	30.5	30.0	29.9	31.7	31.2
Operating profit	1,528	2,262	1,357	2,046	2,432
(y-o-y growth)	6.1	48.0	-	-16.2	18.8
(Operating profit margin)	3.7	4.9	5.3	3.7	3.9
Non-operating income	51	100	81	149	-
Non-operating expenses	250	222	124	284	-
Recurring profit	1,329	2,139	1,314	1,912	2,300
(y-o-y growth)	5.0	61.0	-	-18.3	20.3
(Recurring profit margin)	3.2	4.6	5.2	3.5	3.6
Extraordinary profits	0	110	24	59	-
Extraordinary losses	35	302	40	64	-
Pretax profit	1,294	1,948	1,298	1,907	-
(y-o-y growth)	12.8	50.5	-	-12.5	-
(Pretax profit margin)	3.1	4.2	5.1	3.5	-
Corporate taxes	716	800	702	1,017	-
(Effective tax rate)	55.3	41.1	54.1	53.4	-
Minority interest	105	146	77	133	-
Net profit	473	1,001	518	756	826
(y-o-y growth)	9.7	111.5	-	-24.9	9.2
(Net profit margin)	1.2	2.2	2.0	1.4	1.3
Number of shares outstanding (thousand)	6,492	6,492	12,984	25,968	23,888
EPS (¥)	20.40	38.56	19.97	29.12	34.27
DPS (¥)	4.50	6.25	3.75	8.00	8.00
BPS (¥)	153.54	187.98	201.93	222.86	-
CFS (¥)	53.15	75.96	40.42	80.25	-
Dividend payout ratio	22.1	16.2	18.8	27.5	23.3

Note: Notes: 1) Due to a change of fiscal year, the term to March 2012 contained six months of operations
2) y-o-y rates of change in FY3/13 results are relative to results from April 2011 to March 2012
3) Per-share figures have been adjusted to reflect a two-for-one stock split in April 2012 and another two-for-one stock split in June 2012