Medical System Network
4350 Tokyo Stock Exchange First Section

14-Jan.-16

Important disclosures and disclaimers appear at the end of this document.

FISCO Ltd. Analyst
Yuzuru Sato

Posting record 1H sales and profits

Medical System Network <4350> (hereafter, “the company”) has developed two main businesses: a dispensing pharmacy business, and a pharmaceutical network business that caters to small and medium-sized pharmacies. In the dispensing pharmacy business, it is promoting its Group expansion strategy through proactively employing M&A. The company aims for consolidated sales in the order of ¥300 bn in 10 years.

On October 30, the company announced its consolidated results for 1H FY3/16 (April through September 2015). Sales rose 17.2% YoY to ¥42,105 mn, while operating income jumped 97.2% to ¥1,752 mn. Both figures were record highs on a semiannual basis. Sales soared in the dispensing pharmacy business, while the pharmaceutical network business and the rental & medical facility-related business also contributed to earnings gains.

Management has retained its initial FY3/16 targets of a 13.0% increase in sales to ¥85,353 mn and a 14.9% rise in operating profit to ¥3,036 mn. However, the company is trying to gauge whether earnings gains in the dispensing pharmacy business are sustainable. If there are no major changes in the operating climate, it is highly probable that management will raise its targets when announcing Q3 results.

The company targets sales of ¥105,000 mn and operating profit of ¥4,000 mn by FY3/18, the final year of the 4th Medium-term Management Plan. It is progressing well with plans to increase the number of member pharmacies in its pharmaceutical network business from 1,200 at the end of FY3/18 to 2,200 and the number of dispensing pharmacies from 345 to 500.

The operating climate for small and medium-sized dispensing pharmacies has become more adverse amid restrictions on medical costs. The number of member pharmacies is expected to keep increasing in the company’s pharmaceutical network, which provides services to streamline operations. At the same time, M&A activity among dispensing pharmacies continues in major cities. Under a holistic regional care system that the national government is promoting, dispensing pharmacies are expected to play an even more important role as hubs for medical and preventive care and nursing services. The company will thus strategically differentiate itself competitively by stepping up pharmacist education and training to accommodate these needs.

Check Point

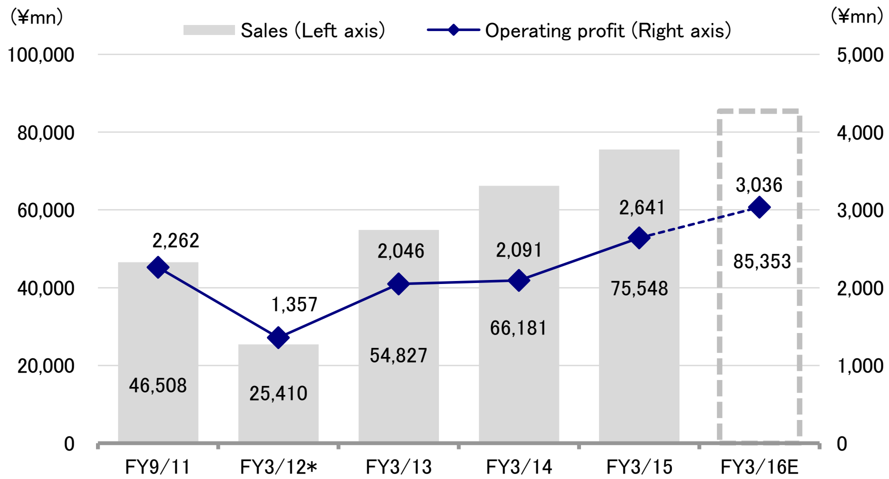
- Regaining ground lost last year by boosting number of network member pharmacies
- Management has conservatively maintained its initial forecasts for the full year and could raise them
- Targeting sales of ¥105,000 mn in FY3/18 as a company that supports community medical care

FISCO

Medical System Network
4350 Tokyo Stock Exchange First Section

14-Jan.-16

Consolidated Results Trends



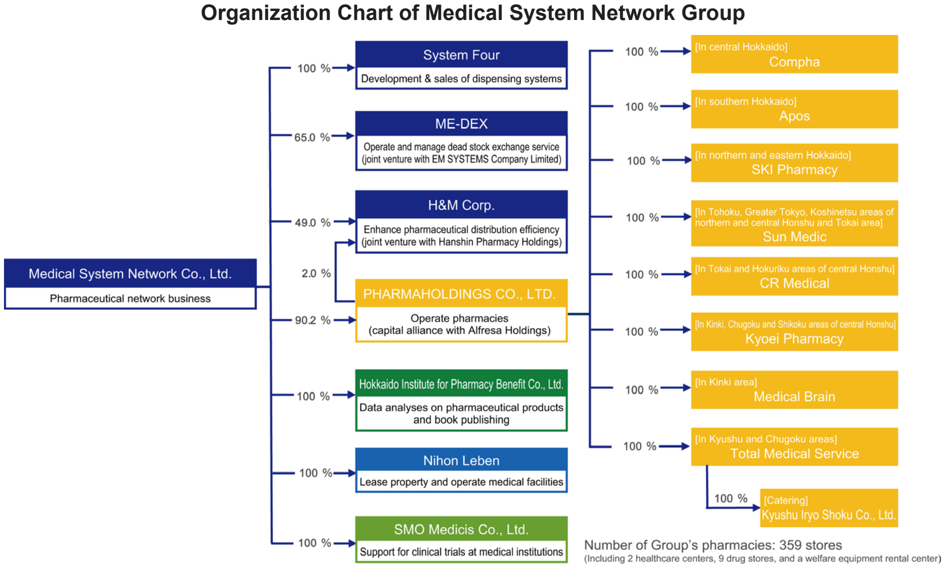
* Due to a change in the accounting year FY3/12 is an irregular 6-month set of accounts.

Company Outline

Its two main businesses are the pharmaceutical network business and the dispensing pharmacy business

The company has two main businesses: the dispensing pharmacy business and the pharmaceutical network business. It is also undertaking peripheral businesses through its respective subsidiaries, including rental and other medical facility-related operations, catering services and clinical facility support services. The pharmaceutical network business is conducted by Medical System Network and subsidiaries System Four and H&M, while the dispensing pharmacy business is conducted by PHARMAHOLDINGS, its subsidiaries and the Hokkaido Institute for Pharmacy Benefit.

Organization Chart of Medical System Network Group



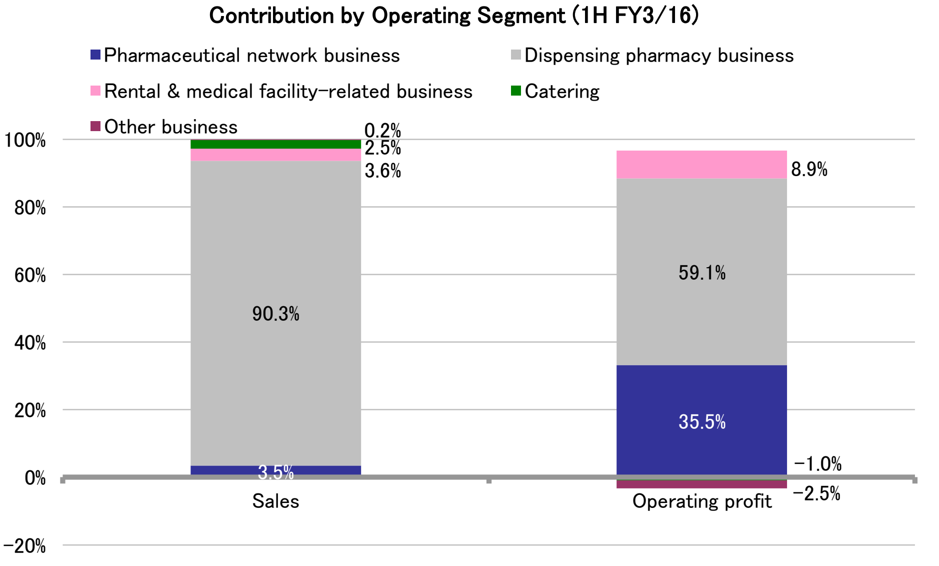
Number of Group's pharmacies: 359 stores
(Including 2 healthcare centers, 9 drug stores, and a welfare equipment rental center)

Looking at the breakdown by segment (1H FY3/16) we see that while the operation of pharmacies represents more than 90% of total consolidated sales, operating profit may be virtually split into the pharmaceutical network and dispensing pharmacy businesses, which are the company's two core businesses. An overview of each segment is as set out below.

FISCO

Medical System Network
4350 Tokyo Stock Exchange First Section

14-Jan.-16

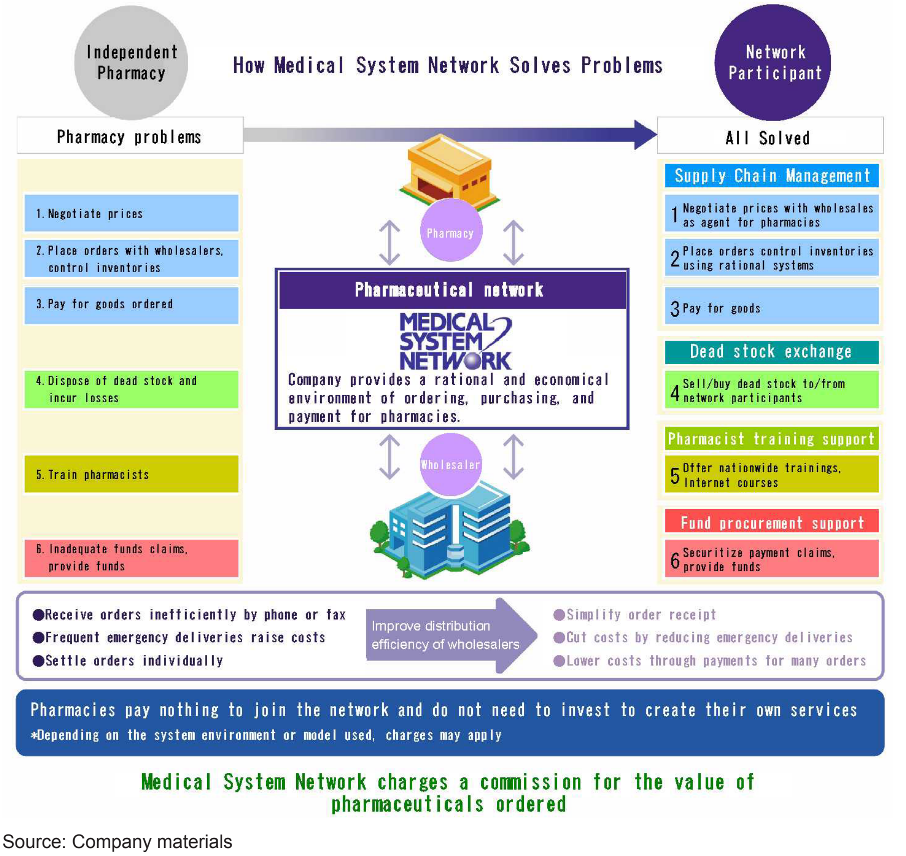


○ **Pharmaceutical Network Business**

The business model for the pharmaceutical network business supports enhanced pharmaceutical distribution efficiency by acting as an intermediary in pharmaceutical sales between dispensing pharmacies, medical institutions and pharmaceutical wholesalers. Customers are mainly small or medium-sized dispensing pharmacies or those operated by sole traders.

The services the company provides in the pharmaceutical network are a supply chain management service where the company negotiates prices with wholesalers as an agent, orders as an agent, as well as acts as an agent for account functions, and a dead stock exchange service (immobile stock liquidation), which allows member pharmacies to exchange dead stock at each of their stores. It also provides pharmacist training support and fund procurement support.

Outline of Pharmaceutical Supply (Network) Business



Source: Company materials

By becoming a member of the network, dispensing pharmacies are able to conduct price negotiations with pharmaceutical wholesalers on more favorable terms than if they did so alone. In addition, they can enjoy a number of other operational benefits, such as reducing pharmaceutical disposal losses and simplifying order-related work. The benefits of becoming a member of the network are particularly large for small to medium-sized dispensing pharmacies.

Also, in its other businesses, the company conducts development, sales and maintenance operations for the receipt computer systems, O/E systems (pharmaceutical ordering system) and peripheral equipment that it installs in dispensing pharmacies, as well as sales of prescription dispensing machines, fixtures and fittings.

As of the end of September 2015, the combined number of member pharmacies in the network, including those in the Group and external members, was 1,280 (including 39 hospitals and clinics) and the number is continuing to increase. The only three prefectures in which the company does not have a presence are Tottori, Tokushima, and Kochi, and it aims to have coverage there as soon as possible. Ordering fees that arise corresponding with order volumes, and system sales represent the majority of overall sales of this segment. But revenue from ordering fees has become a major source of earnings and it is a stock business model in which sales rise stably in line with increases in member pharmacy numbers.

Breakdown of Contracted Network Store Numbers

(Unit: Stores)

By member type	FY3/12	FY3/13	FY3/14	FY3/15	1H FY3/16
General member	631	764	842	855	932
MSN Group	223	269	321	345	348
Total	854	1,033	1,163	1,200	1,280

By area	FY3/12	FY3/13	FY3/14	FY3/15	1H FY3/16
Hokkaido	197	212	216	207	213
Tohoku	63	80	91	93	96
Kanto/Koshinetsu	214	270	298	362	390
Tokai/Hokuriku	96	138	160	182	200
Kinki	150	178	187	131	141
Chugoku/Shikoku	70	77	87	84	82
Kyushu/Okinawa	64	78	124	141	158
Total	854	1,033	1,163	1,200	1,280

Note: From April 2014 figures reflect the withdrawal of one large trading counterparty (230 stores) that had ceased trading.

○ **Dispensing Pharmacy Business**

The dispensing pharmacy business develops dispensing pharmacies in each area mainly under the Nanohana Pharmacy brand, and is expanding its number of Group stores while utilizing M&As. As of the end of September 2015, the number of dispensing pharmacies was 348, making it one of the market leaders. By area, it has the most pharmacies in Hokkaido at 114, followed by Kanto and Koshinetsu at 76, and then Kinki at 51. In addition to pharmacies, the company operates nine drug stores, two healthcare centers, and one welfare equipment rental center.

Further, its subsidiary, the Hokkaido Institute for Pharmacy Benefit, provides training services to pharmacists and operations staff at both internal Group and external dispensing pharmacies.

○ **Rental & Medical Facilities-related Business**

Medical System Network subsidiary Nihon Leben mainly develops sites for building Group pharmacies, as well as renting buildings for medical services, car leasing and insurance services. Further, at the same time as offering consulting services for medical practices, it also operates medical malls that gather multiple treatment disciplines on the same floor, medical buildings that gather clinics in one building, and elderly housing with supportive services.

○ **Catering Business**

Total Medical Service (TMS), which was consolidated as a subsidiary in November 2013, and its subsidiary Sakura Foods, engage in catering outsourcing operations within hospitals and welfare facilities.

○ **Other Business**

Medical System Network subsidiary SMO Medisys (hereafter, SMO) contracts with clinical trial facilities (medical institutions) as a clinical site management organization to provide support services for clinical trials.

Business Trends

Greatly increasing sales and profits in Q2 to post record highs on a semiannual basis

(1) 1H FY3/16 Results

The 1H FY3/16 consolidated results announced on October 30 show consolidated sales up 17.2% YoY to ¥42,105 mn, operating profit up 97.2% YoY to ¥1,752 mn, recurring profit up 105.7% YoY to ¥1,748 mn, and net profit up 233.4% to ¥769 mn. The company posted strong results with record highs on a semiannual basis and it exceeded the initial plan for each item.

Consolidated 1H FY3/15 Results

(¥mn)

	1H FY3/15		1H FY3/16				
	Actual	% Sales	Company plan	Actual	% Sales	YoY	Vs Plan
Sales	35,911	-	41,044	42,105	-	17.2%	2.6%
COGs	22,368	62.3%	-	26,268	62.4%	17.4%	-
SG&A	12,653	35.2%	-	14,083	33.4%	11.3%	-
Operating profit	888	2.5%	1,316	1,752	4.2%	97.2%	33.1%
Recurring profit	850	2.4%	1,247	1,748	4.2%	105.7%	40.2%
Extraordinary profit/loss	-167	-	-	-183	-	-	-
Net profit	230	0.6%	491	769	1.8%	233.4%	56.6%

The dispensing pharmacy business increased revenues per store by promoting the use of generics and reinforcing home care capabilities. Stores acquired in the previous year also contributed to results. The pharmaceutical network business continued to boost revenues and earnings by increasing member numbers. The rental & medical facilities-related business also enhanced earnings, reflecting a ¥242 mn gain on the divestment of real estate for sale. Higher revenues from the dispensing pharmacy business resulted in an increase being higher than initially projected.

Reasons for OP Fluctuations (1H FY3/16, YoY)

(¥mn)

Category	Amount Change	Category	Amount Change
Dispensing pharmacy business	△ 589	Pharmaceutical network business	△ 106
(Breakdown of change in OP)		Rental & medical facility-related business	△ 232
Existing stores	△ 402	Catering business	▲ 18
Stores opened FY3/15	△ 46	Other business	▲ 22
M&A FY3/15	△ 123	Group expenses (adjusted)	▲ 24
Stores opened FY3/16	▲ 70		
M&A FY3/16	▲ 6		
Stores closed	△ 58		
Headquarter costs	△ 36	Total	△ 864

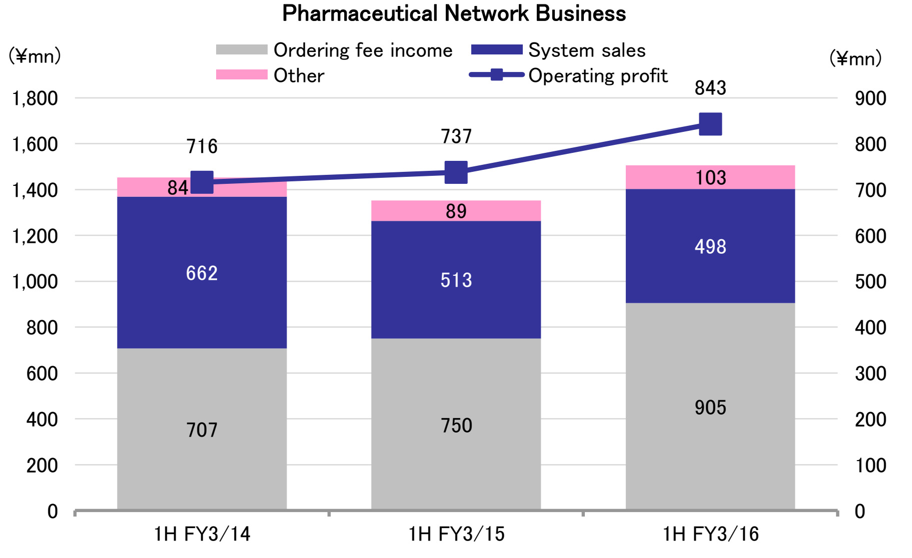
Note: [△] increased profit, [▲] decreased profit

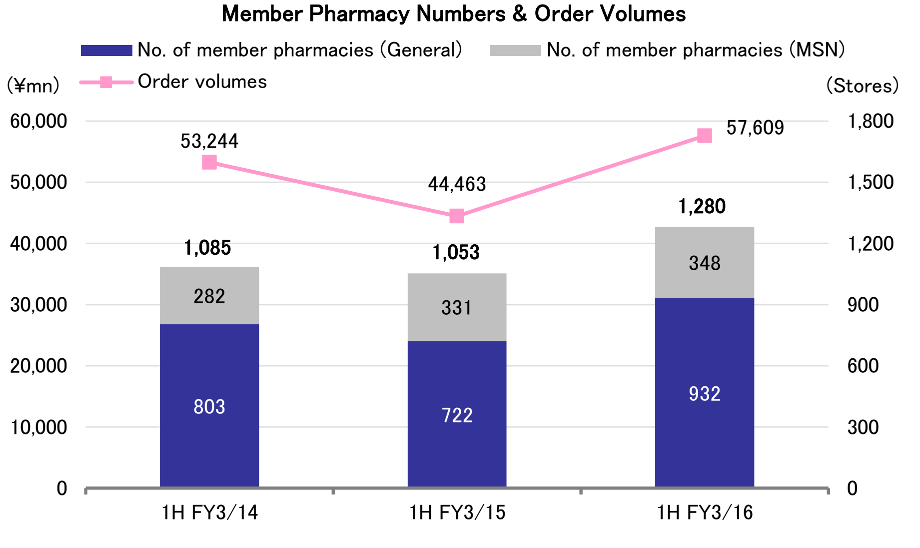
Regaining ground lost last year by boosting number of network member pharmacies

(2) Trends by Operating Segment

○ Pharmaceutical Network Business

Consolidated sales from the pharmaceutical network business increased 11.4% YoY to ¥1,507 mn, and operating profit increased 14.5% YoY to ¥843 mn. Although system sales were down, a gain in revenue from highly profitable ordering fee income boosted pharmaceutical order volume. System profits thus rose 20.7% YoY to ¥905 mn.





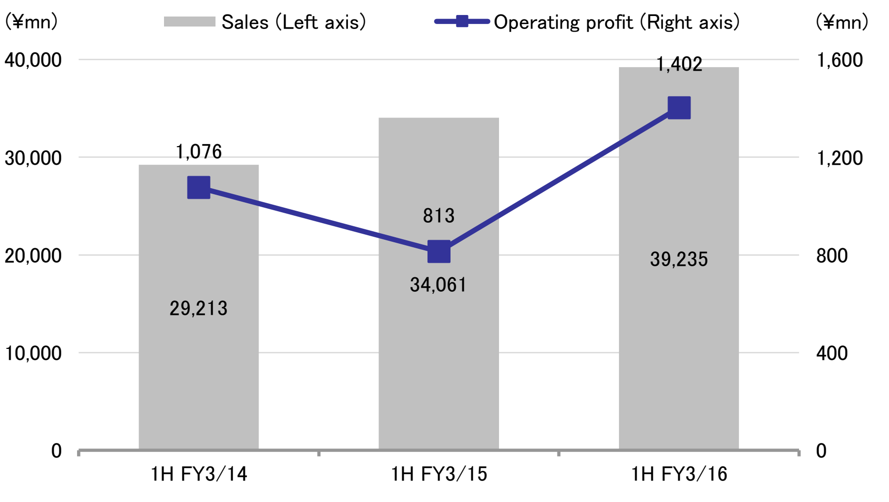
At the end of September 2015, the number of member pharmacies had increased by 227 stores YoY, or 22%, to 1,280. Order volume climbed 29.6% to ¥57,609 mn. The company returned to a volume growth path, having experienced a downturn in August 2014, when a member with 230 stores formally withdrew.

Factors behind an increase in the number of member pharmacies include that the business environment of small and medium-sized dispensing pharmacies is becoming more and more severe each year and therefore the benefits from becoming a member of the company's network are growing stronger. In addition, in January 2015 the company formed a business alliance with Fuyo General Lease Co., Ltd. <8424> and newly launched a pharmaceutical purchase price repayment service, which had a considerable effect on member numbers. The payment period for the pharmaceutical purchase price was determined as two months as a condition to become a member of the company's pharmaceutical network services. But as it is normally three months for many small and medium-sized pharmacies, when these pharmacies become members they incur temporary costs due to this shortening of the payment period. The pharmaceutical purchase price repayment service entails Fuyo General Lease paying in bulk the pharmaceutical purchase prices of members during the first month of membership, with customers thereafter repaying amounts advanced to them in installments. This has lowered the membership hurdle. From February, when the service began, through October 23, membership applications were received from 14 companies covering 81 stores.

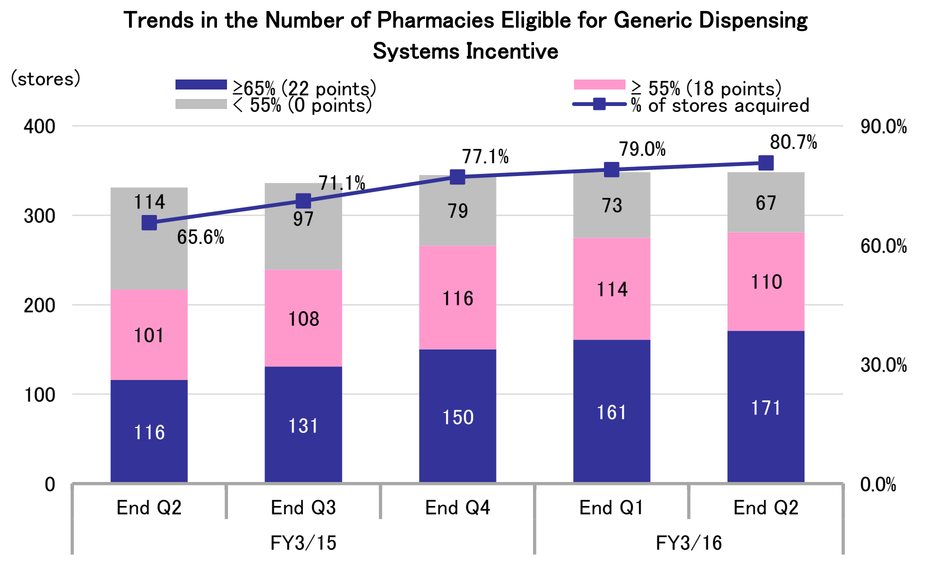
○ Dispensing Pharmacy Business

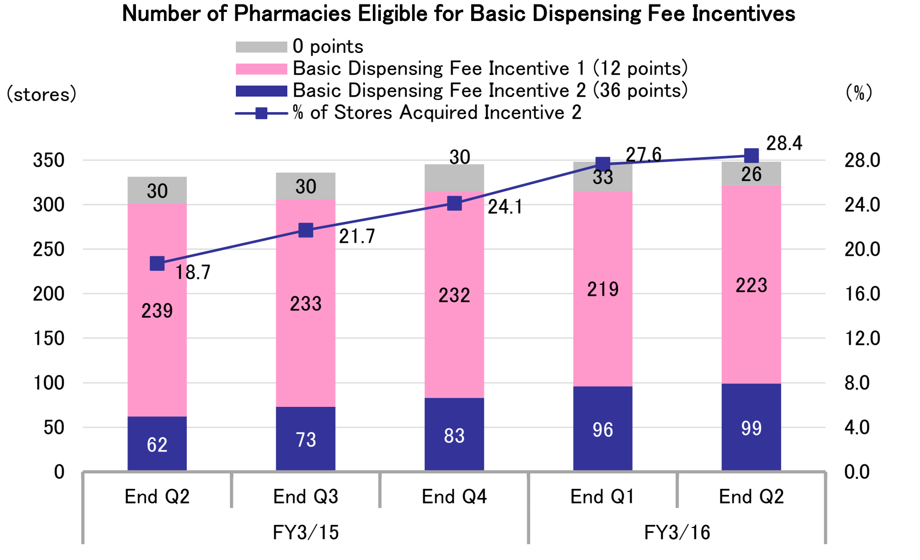
Sales in the dispensing pharmacy business increased 15.2% to ¥39,235 mn and operating profit rose 72.4% to ¥1,402 mn and posted significant increase in sales and profits. At the end of September, the number of dispensing pharmacies was up 17 YoY to 348. The number of prescriptions was up 8.7%. The company endeavored to increase prescription unit prices by encouraging the use of generics and promoting home care. This boosted unit prices at existing stores by 6.1%, driving double-digit revenue gains. Dispensing fees (sales) on an existing store basis rose 7.3% YoY.

Dispensing Pharmacy Business



At the end of September, the number of pharmacies eligible for the generic dispensing systems incentive was 281, or 80.7% of the total. The ratio eligible for dispensing system incentives exceeding 65% rose to 49.1%, from 35.0% at the end of FY3/15. Regarding the number of stores eligible for basic dispensing incentives, the requirements including centralization rates for specified medical institutions and accommodating home care and around the clock dispensing, 28.4% had qualified for Basic Dispensing Fee Incentive 2, from 18.7% at the end of FY3/15, this system offering higher incentive points. This contributed to a rise in prescription unit prices.





A gain in operating profit reflected several factors. Among them were higher prescription unit prices and expanded revenues at existing stores owing to appropriate personnel allocations. They also included revenue contributions from stores acquired in the previous year, the closure of four unprofitable stores, and an increase in the number of prescriptions received as a result of more streamlined operations and a reduction in waiting times. Performances improved significantly at subsidiaries Sun Medic, Kyoei Pharmacy, and CR Medical, which cover operations in Honshu. Many of the stores of CR Medical are relatively small. Their profitability is relatively low, but it could improve through operational streamlining and other enhancements.

Performances of three dispensing pharmacy business companies in Honshu

(¥mn)

		1H FY3/15	1H FY3/16	Chg %
Sun Medic (Kanto, Koshinetsu, Tohoku and Tokai)	Sales	6,689	7,547	12.8%
	Operating profit	225	310	37.8%
	Operating profit margin	3.4%	4.1%	
Kyoei Pharmacy (In Kinki, Chugoku and Shikoku)	Sales	8,724	9,162	5.0%
	Operating profit	57	297	421.1%
	Operating profit margin	0.7%	3.2%	
CR Medical (Tokai and Hokuriku)	Sales	1,893	2,698	42.5%
	Operating profit	-2	75	-
	Operating profit margin	-0.1%	2.8%	

In June 2015, the company announced a business alliance with Yakuju Corporation, which runs about 150 health insurance pharmacies, mainly in metropolitan Tokyo. The alliance encompasses jointly arranging and sharing educational and training programs for pharmacists and other personnel, a system for collaborating during disasters, and joint initiatives to enhance operational efficiencies. Pharmacists are expected to play even greater roles as a holistic regional care system goes into place, so education and training to enhance their skills will become more important. Yakuju been progressive in deploying a curriculum for pharmacists, and the goal is to jointly arrange and share education and training for pharmacists and training of new personnel.

In October 2015, Yakuju began participating in the company's dead stock exchange service as part of efforts to enhance operational efficiency by reducing losses from discarding pharmaceutical products.

○ **Rental & Medical Facility-related Business**

Sales from this business increased 117.5% to ¥1,556 mn. Operating profit was ¥211 mn, compared with an operating loss of ¥21 mn a year earlier. There were several factors in the earnings improvement. One was that the company posted a ¥242 mn gain on the divestment of real estate for sale. Another was that the number of tenancy agreements at Wisteria Kiyota (in Kiyota Ward, Sapporo), which began operating in May 2013, reached 65 out of a total of 75 units at the end of September, up from 60 at the end of FY3/15. This business would have been unprofitable if not for the real estate divestment gain, but this was because of forward investments in two facilities. They are Wisteria Otaru Inaho, which will open in December 2015, and Wisteria Senri Chuo, which is scheduled to open in May 2016.

○ **Catering Business, Other Business**

The catering business that subsidiary TMS runs boosted sales 13.5% YoY to ¥1,098 mn. The operating loss was ¥24 mn, up from ¥6 mn a year earlier. Although revenues rose on new contracts with hospitals and welfare and other facilities, higher forward investments caused slightly higher losses.

Sales of the other business (clinical trial facilities support operations) declined 19.1%, reflecting a decrease in new work, to ¥74 mn, while the operating loss rose from ¥37 mn to ¥59 mn. A capital and business alliance concluded in May this year with industry major Sogo Rinsho Holdings Co., Ltd. <2399>, has yet to bear fruit. That partnership encompasses the two drawing on each other's management resources and knowhow for customer project introductions and other activities to boost business efficiency. Although Sogo Rinsho Holdings has announced that it will integrate with EPS Holdings, Inc. <4282>, in January 2016, the alliance with the company is expected to remain in place.

Management has conservatively maintained its initial forecasts for the full year and could raise them

(3) FY3/16 Results Outlook

The FY3/16 consolidated results outlook is unchanged from the initial plan, with sales up 13.0% to ¥85,353 mn, operating profit up 14.9% to ¥3,036 mn, recurring profit up 14.2% to ¥2,900 mn, and net profit up 16.3% to ¥1,030 mn. Management could raise its projections. That is because by Q2, the company had attained 57.7% of the operating profit it had forecast for the full year. It is also because performance tends to be stronger in 2H and because annual price negotiations with pharmaceutical wholesalers have already ended. The company has decided for a little while longer to keep assessing whether strong earnings are sustainable in the dispensing pharmacy business. If there are no major changes in the market climate, we believe that management could raise its forecasts when announcing Q3 results. Initial results forecasts by business segment are as follows.

Results Forecasts by Segment

(¥mn)

	FY3/13	FY3/14	FY3/15	FY3/16E	Chg %
Sales by segment					
Pharmaceutical network business	2,650	2,843	2,814	3,045	8.2%
Dispensing pharmacy business	52,581	63,006	71,743	80,252	11.9%
Rental & medical facility-related business	1,122	1,317	1,517	2,314	52.5%
Catering business	-	607	1,932	2,233	15.6%
Other business	252	407	182	276	51.7%
Adjustments	-1,779	-1,999	-2,641	-2,769	-
Total	54,827	66,181	75,548	85,353	13.0%
Segment profit					
Pharmaceutical network business	1,221	1,475	1,549	1,690	9.1%
Dispensing pharmacy business	1,766	1,840	2,377	2,591	9.0%
Rental & medical facility-related business	111	-39	25	106	318.7%
Catering business	-	-12	-13	-38	-
Other business	4	10	-76	7	-
Adjustments	-1,057	-1,183	-1,221	-1,321	-
Total	2,046	2,091	2,641	3,036	14.9%

○ Pharmaceutical Network Business

Sales in this business are expected to increase 8.2% to ¥3,045 mn, with operating profit rising 9.1% to ¥1,690 mn. By the end of Q2, the company had attained 49% and 50% of its annual sales and operating profit targets, respectively, so it looks well positioned to reach those objectives. Management forecasts the number of network members to increase by 285 to 1,485 pharmacies. While the attainment pace was somewhat slow through Q2, the market climate is positive as mentioned above, and with the launch of the pharmaceutical purchase price repayment service, expansion in the number of network members is expected to accelerate.

○ Dispensing Pharmacy Business

Sales of this business are forecast to increase 11.9% to ¥80,252 mn, with operating profit rising 9.0% to ¥2,591 mn. By the end of Q2, this business had attained 49% and 54% of its sales and operating targets, respectively. The number of dispensing pharmacies is expected to increase by 55 to 400. Acquisitions will account for 50 of those 55 additions, which should boost sales by around ¥3,500 mn. Because M&A costs have risen recently, however, more acquisitions have been shelved because amounts or other aspects have not been acceptable. Therefore, the company may not be able to achieve the targeted number of dispensing pharmacies. Still, sales growth at existing stores should be able to cover such a reduction. That is because management's initial forecast of 0.7% YoY sales growth for existing stores seems somewhat conservative.

Also, operating income should benefit from reinforced efforts in generics and home care, with growth in prescription unit prices continuing in 2H. Another driver should be the full-scale deployment of the dispensing headquarters' system, which should improve the productivity of clerical work. The company has been rolling out that system since December 2014, and aims to complete deployments at all stores by the end of FY3/16.

The company had 1,189 pharmacists, including temporary staffers, at the end of September 2015, up 87 YoY. It hired 97 new graduates in spring 2015, compared with 47 a year earlier, and plans to hire around 100 in spring 2016.

○ **Rental & Medical Facility-related Business**

Management projects that sales in this business will climb 52.5% to ¥2,314 mn and that operating profit will increase 318.7% to ¥106 mn. This business had reached 67% and 199% of annual sales and operating profit forecasts by the end of Q2, reflecting the posting of a ¥242 mn gain from the divestment of real estate for sale in Q1.

The number of tenancy agreements for Wisteria Kiyota, which provides elderly housing with supportive services, recently reached 71 of the facility's 75 units, already exceeding the breakeven level of 64 units. Wisteria Otaru Inaho, an 81-unit facility in Otaru, Hokkaido, will open in December 2015. The number of tenancy applications as of the end of October was 87, exceeding the number available, so the startup should go well. The 82-unit Wisteria Senri Chuo in Toyonaka, Osaka, is scheduled to open in May 2016. It has yet to accept applications, but it should be fully occupied quickly on the strength of its central location.

Elderly housing facilities with supportive services are basically kept off the balance sheets, and the company's strategy is to push ahead with development to quickly recoup investments. That said, construction costs are rising, so management's policy is to keep tabs on profitability in developing this business.

○ **Catering Business & Other Business**

In the catering business, sales are expected to rise 15.6% to ¥2,233 mn, resulting in an operating loss of ¥38 mn. This business had reached 49% of its annual target by the end of Q2, and there will likely be a small loss in H2.

That said, the acquisition by TMS of all of the shares of Kyushu Iryo Shoku, in October 2015 will boost results. In FY8/15, that new subsidiary posted sales of ¥2,478 mn, operating profit of ¥19 mn, and recurring profit of ¥26 mn. So, while its impact on segment earnings may be small, that subsidiary will almost double segment sales. The company's strategy is to entirely cover Kyushu, expanding scale to boost profitability, so this segment should begin generating earnings from FY3/17.

In the other business, sales are forecast to climb 51.7% to ¥276 mn. Operating profit should be ¥7 mn, from an operating loss of ¥76 mn in FY3/15. By the end of Q2, this segment had attained just 27% of the annual sales target, so it is somewhat unlikely to become profitable during this year. Still, it is expected to go into the black in FY3/17 on the strength of additional projects through the alliance with Sogo Rinsho Holdings.

Medium-term Management Plan

Targeting sales of ¥105,000 mn in FY3/18 as a company that supports community medical care

The company announced its 4th three-year Medium-term Management Plan in May 2015. In a situation where the issues of providing medical care and nursing are becoming increasingly serious because of the aging of society, the company is focusing on “expanding the pharmaceutical network” and “enhancing the functions of community pharmacies,” and its policy is to aim to achieve further growth as a company that supports local community medical care.

The 4th Medium-term Management Plan

Basic Policy
1. Invest resources in the pharmaceutical network, strengthen sales to small and medium-sized pharmacies, and expand member pharmacies by providing new services.
2. Further strengthen existing measures, including for medical safety, customer reception, medication counseling, home care, and reduction of waiting time, and establish the “Nanohana Standard” at an even higher level at every store.
3. Enhance to the greatest possible extent medical care, nursing, and preventative functions that are required within the holistic regional care system in accordance with conditions at existing stores, and develop new stores as next-generation pharmacies to provide customers with a full package.
4. Further strengthen support for doctors’ medical practices to accelerate the construction of medical malls by attracting medical institutions to existing stores.
5. Aim to thoroughly implement cost controls with an eye to future payment system revisions.

The company’s management targets for the plan’s final year of FY3/18 are sales of ¥105,000 mn and recurring profit of ¥3,800 mn. Its core businesses of the pharmaceutical network business and the dispensing pharmacy business will continue to be the driving force behind its growth in earnings.

Medium-term Management Plan Targets

(¥mn)

	FY3/15	FY3/16 E	FY3/18 target
Sales	75,548	85,353	105,000
Pharmaceutical Network Business	2,814	3,045	3,600
Dispensing Pharmacy Business	71,743	80,252	99,500
Operating profit	2,641	3,036	4,000
Pharmaceutical Network Business	1,549	1,690	2,200
Dispensing Pharmacy Business	2,377	2,591	3,000
Recurring profit	2,540	2,900	3,800
Recurring profit ratio	3.4%	3.4%	3.6%
Net profit	885	1,030	1,500
The number of member pharmacies in the pharmaceutical network business	1,200	1,485	2,200
The number of pharmacies	345	400	500

○ Pharmaceutical Network Business

In this business, the company aims to generate ¥3,600 mn in sales and ¥2,200 mn in operating income in FY3/18, boosting the number of member pharmacies in the network to 2,200. Over the past three years, the number of member pharmacies in the network has increased by 346 stores. If factoring out the withdrawal of a 230-store trading partner, the growth would have been 576 stores, and the company plans to accelerate expansion. In the context of measures to keep down medical costs, the business environment of small and medium-sized dispensing pharmacies has become more adverse than to date, which is benefiting the company’s network services business. It is also worth noting that two services created from business alliances announced in 2015 are accelerating the increase in the number of member pharmacies.

The first of these two offerings is the pharmaceutical purchase price repayment service, which has borne fruit since its launch in February 2015. The service has attracted attention in helping shorten trade receivables recovery times for all involved, including dispensing pharmacies seeking to become members and pharmaceutical wholesalers. The number of members is thus expected to rise.

The second service is the "dead stock exchange service (immobile stock liquidation)," for customers of EM SYSTEMS <4820>, with which the company announced a business alliance in April 2015. EM SYSTEMS is a major receipt computer system company that has as its customers around 16,000, or about 30%, of all domestic dispensing pharmacies, and this new dead stock exchange service function is provided as an additional function to its existing system.

Pharmacies' immobile stock is said to be approximately 0.2% of their annual sales. As the market scale is around ¥10 trillion, it is calculated that each year, the entire industry generates an inventory disposal loss of ¥20 br. In the company's network, the immobile stock is at a level of 0.07%, which is one third of the industry average. The dead stock exchange service allows member pharmacies to exchange dead stock at each of their stores, efficiently reducing pharmaceutical disposal losses. Supposing a store with sales of ¥100 mn, which could generate an inventory disposal loss of ¥200,000, uses this service, its disposal loss would shrink to ¥60,000 to ¥70,000, improving its profit margin by 0.1%.

The dead stock exchange service is provided free to pharmacies when they join the company's network, but if an EM SYSTEMS' customer wishes only to use this service, the company is expected to collect a few percent of the inventory turnover as commission. Therefore, although the direct impact on the company's earnings will be negligible, it is entirely possible that the use of this service will result in an increase in members of its pharmaceutical network service.

The launch of this service is scheduled for April 2016.

To prepare the company's network system for the increase in member pharmacies during the medium-term management plan, it plans to increase the system's processing capacity by 300% (invest ¥200 mn in the system over three years).

○ **Dispensing Pharmacy Business**

The segment targets for FY3/18 are ¥99,500 mn in sales, ¥3,000 mn in operating profit, and 500 stores. Management has lowered its operating profit margin forecast from 3.3% to 3.0% because the business climate will probably remain adverse for the dispensing pharmacies industry. In reality, however, there is plenty of room to boost store productivity and otherwise improve the situation, so the company could well maintain or increase profitability. The company plans to push forward with M&As in major cities with eldercare demand potential, including metropolitan Tokyo, Kyoto, Osaka, and Kobe, and in Aichi Prefecture and Fukuoka.

Enhancing community medical care in an aging society has become more important, so dispensing pharmacies should play a growing role in that respect. The company has therefore improved medical safety, customer reception, medication counseling, home medical care, waiting times, and other aspects of service at existing stores. By FY3/ 18, the company aims to have all stores offer home care services and ensure that all pharmacists have home care experience. It aims to continue developing new stores as next-generation pharmacies that offer a full community care package encompassing medical, nursing, and preventative services.

Financial Position

Reducing interest-bearing debt and enhancing financial position

At the end of September 2015, total assets were up ¥632 mn YoY, at ¥46,220 mn. The prime factor in this gain was a ¥1,042 mn increase in fixed assets, which offset declines of ¥739 mn in cash and deposits and ¥357 mn in goodwill. The fixed assets rise largely reflected growth in the construction in progress account for elderly housing with supportive services.

Liabilities were down ¥2,785 mn YoY to ¥36,666 mn. This was due mainly to a ¥3,491 mn decrease in interest-bearing debt. Net assets rose ¥3,417 mn to ¥9,553 mn. Key factors were a ¥670 mn rise in retained earnings and ¥2,815 mn raised from the issuance of new shares for a public offering, a third-party allocation, and disposal of treasury stock.

The company took advantage of the increased capitalization and treasury stock disposal to reduce interest-bearing debt and enhance its financial position. Management plans to keep improving the financial position through efforts in several areas. These will include an ongoing drive to take real estate holdings off the balance sheets and enhancing productivity through the dispensing headquarters' system rollout. Management looks to keep restricting interest-bearing debt to around ¥20 bn while improving the capital adequacy ratio.

Consolidated Balance Sheet

(¥mn)

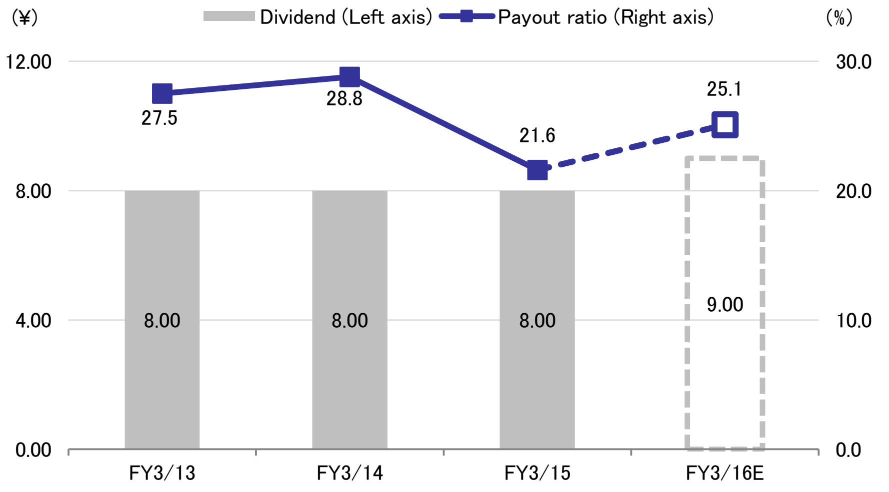
	FY3/14	FY3/15	1H FY3/16 E	Chg
Current assets	10,941	11,023	10,449	-574
(Cash & deposits)	3,106	2,499	1,760	-739
Fixed assets	32,172	34,564	35,771	1,206
(Goodwill)	12,253	13,214	12,857	-357
Total Assets	43,114	45,587	46,220	632
(Interest-bearing debt)	22,011	22,743	19,252	-3,491
Total liabilities	37,761	39,451	36,666	-2,785
Total net assets	5,352	6,135	9,553	3,417
Key operational indicators				
(Safety)				
Equity ratio	11.9%	12.7%	20.1%	
D/E ratio (Interest-bearing debt/Total equity)	433.3%	392.3%	210.0%	
(Profitability)				
Recurring profit to total assets ratio (recurring profit/total assets)	5.5%	5.7%	-	
Shareholders' equity to net profit ratio (net profit/ shareholders' equity)	12.2%	16.2%	-	
Operating profit margin	3.2%	3.5%	4.2%	

Shareholder Returns

Potential for dividend stability and growth in view of payout ratio target exceeding 20%

The company's shareholder return policy is based on rewarding shareholders by way of dividends. Its basic policy is to pay stable dividends that reflect the company's results, after securing sufficient internal reserves to strengthen its financial position and expand operations. Management looks to maintain the payout ratio at above 20%. The company plans a payout ratio in the order of 25.1% for FY3/16, with a dividend of ¥9, which is an increase of ¥1 on the previous year. Dividend growth can be expected if profits continue to increase.

Dividend per Share and Payout Ratio



Disclaimer