Medical System Network
4350 Tokyo Stock Exchange First Section

6-Jan.-17

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FISCO Ltd. Analyst
Yuzuru Sato

Targeting consolidated net sales of ¥300bn in 10 years' time by a Group expansion strategy that employs M&A

Medical System Network <4350> (hereafter, also "the Company") is developing 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 is aiming for consolidated sales in the order of ¥300bn in 10 years' time.

In the FY3/17 1H (April to September 2016) consolidated results announced on November 8, net sales increased 3.1% y-o-y to ¥43,401mn, but operating profit decreased 68.7% to ¥549mn. Due to the impact of the revisions to the dispensing fees and the lowering of drug prices, and also higher personnel costs, earnings in the dispensing pharmacy business fell significantly. They also declined in each of the other businesses, including the rental & medical facilities-related business and the catering business. Conversely, in the pharmaceutical network business, the number of member pharmacies steadily increased to 1,597 by the end of September, an increase of 197 pharmacies compared to the end of the previous fiscal year.

The forecasts for the FY3/17 results are for net sales to increase 2.6% y-o-y to ¥90,000mn and operating profit to decrease 39.2% to ¥2,300mn. The initial targets have been downwardly revised by ¥2,000mn for net sales and by ¥970mn for operating profit. The Company is aiming to recover earnings by progressing measures to respond to the revised dispensing fees. Also, in the other businesses, including the catering business that is continuing to record a loss, it is planning to implement a variety of measures so that the decline in earnings bottoms-out in the current 2H and then improve from the next fiscal year onwards.

Although the harsh market environment will continue for the dispensing pharmacy industry, this conversely provides an excellent opportunity for the Company to increase the number of member pharmacies in its pharmaceutical network business, as becoming a member contributes to their improved management efficiency. For pharmacies, the benefits of becoming a member of the network include improved profitability, such as from lower purchase prices, and going forward the Company's strategy is to create benefits for members through enhancing its services.

There are approximately 50,000 dispensing pharmacies in Japan, and while the market share of the Company's network member pharmacies is about 3%, it is forecast that in 5 years' time this will have increased to around 10%. At FISCO, our forecasts are that in FY3/17, results will temporarily fall due to the worsening of the situations in the dispensing pharmacy business and the other businesses, but that in the medium-to-long term, they will grow with the highly profitable pharmaceutical network business as the driving force.

Check Point

- Due to the increase in the number of member pharmacies in the pharmaceutical network business, the pharmaceutical order volume in FY3/17 1H was a record high for a 1H
- The results momentum is forecast to bottom-out in FY3/17 1H and turn to a recovery trend in 2H
- Is enhancing services and strengthening competitiveness through business partnerships with Japan Post and a systems-development company

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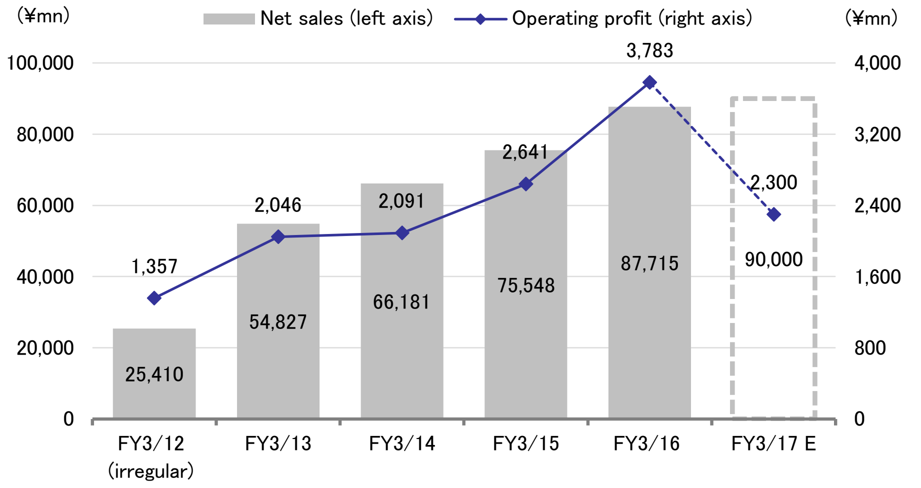
Consolidated Results Trends

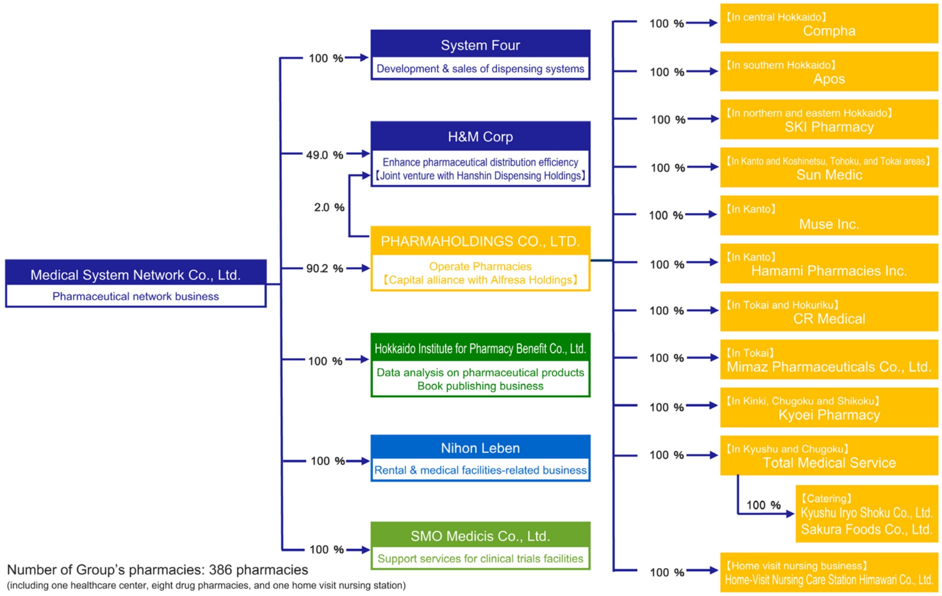


Company Outline

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

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 a rental & medical facilities-related business, catering services, a clinical trial facilities support business, and a home visit nursing business. The pharmaceutical network business is conducted by the Company and its subsidiaries, System Four and H&M, while the dispensing pharmacy business is conducted by Pharmaholdings, its subsidiaries and the Hokkaido Institute for Pharmacy Benefit.

The Group (as of November 1, 2016)



Source: the Company's financial results briefing materials

Looking at the breakdown by business segment, we see that in FY3/17 1H, the dispensing pharmacy business provided the majority of total net sales, of more than 88%, while for operating profit, the pharmaceutical network business provided 66.0%, and dispensing pharmacy business 55.6%, making them the Company's two main businesses. An overview of each segment is as described below.

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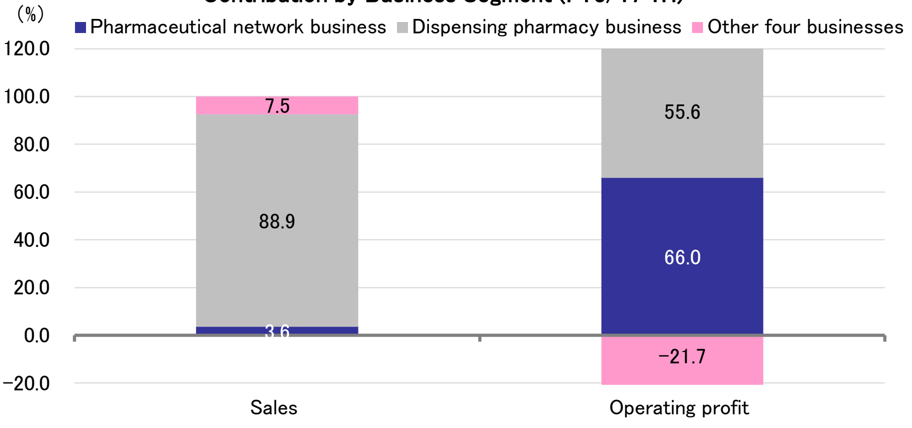
Contribution by Business Segment (FY3/17 1H)



Note: before the offsetting of internal transactions, the other four businesses (the rental & medical facilities-related business, the catering business, the clinical trial facilities support business, and the home visit nursing business)

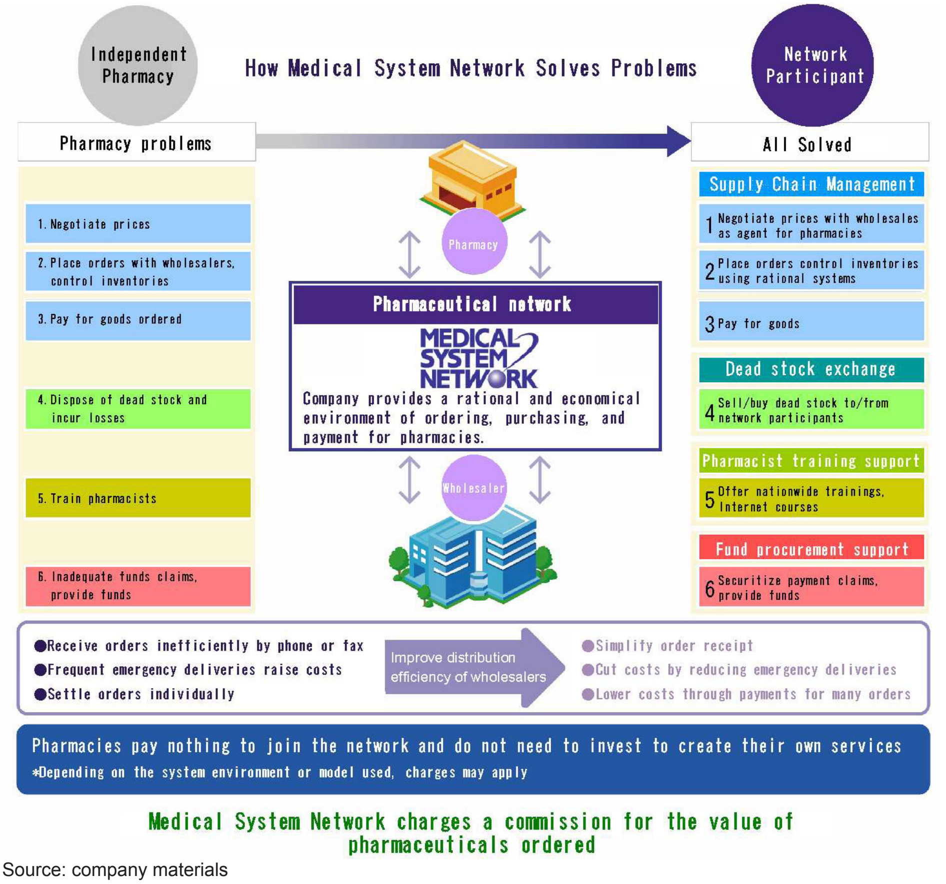
Source: prepared by FISCO from the Company's financial results briefing materials

(1) Pharmaceutical Network Business

The business model for the pharmaceutical network business is that it supports the improvement of pharmaceutical distribution efficiency by acting as an intermediary in pharmaceutical sales between dispensing pharmacies, medical facilities 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 business are a supply chain management service, in which it negotiates prices with wholesalers as an agent, orders as an agent, and acts as an agent for account functions, and furthermore it provides a dead stock exchange service (immobile stock liquidation), which allows member pharmacies to exchange dead stock at each of their pharmacies. The Company also provides support for pharmacist training and for fund raising.

Outline of Pharmaceutical Supply (Network) Business



Source: company materials

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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 ordering-related work. The benefits of becoming a network member 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 equipment, fixtures and fittings.

As of the end of September 2016, the total number of member pharmacies in the network, including those in the Group and external members, was 1,597 (including 33 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 is aiming to have a presence in them as soon as possible. Ordering fees, which arise corresponding to the order volumes, and system sales represent the majority of the sales of this segment, and revenue from ordering fees has become a major source of earnings. Therefore, it can be described as a stock business model in which sales rise stably in line with the increase in the number of member pharmacies.

Breakdown of the number of network member pharmacies

(unit: pharmacies)

By member type	FY3/13	FY3/14	FY3/15	FY3/16	FY3/17 1H
General member	764	842	855	1,047	1,223
MSN Group	269	321	345	353	374
Total	1,033	1,163	1,200	1,400	1,597

By area	FY3/13	FY3/14	FY3/15	FY3/16	FY3/17 1H
Hokkaido	212	216	207	221	225
Tohoku	80	91	93	99	106
Kanto / Koshinetsu	270	298	362	425	502
Tokai / Hokuriku	138	160	182	227	283
Kinki	178	187	131	147	176
Chugoku / Shikoku	77	87	84	86	76
Kyushu / Okinawa	78	124	141	195	229
Total	1,033	1,163	1,200	1,400	1,597

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

(2) Dispensing Pharmacy Business

This business develops dispensing pharmacies in each area mainly under the Nanohana Pharmacy brand, and it is expanding its number of Group pharmacies while actively utilizing M&As. As of the end of September 2016, the Company had 374 dispensing pharmacies, making it one of the market leaders. By area, it has the most pharmacies in Hokkaido at 117, followed by Kanto and Koshinetsu at 84, and then Kinki at 54. In addition to pharmacies, the Company operates eight drug pharmacies and one healthcare center.

Further, its subsidiary, the Hokkaido Institute for Pharmacy Benefit, provides training services to pharmacists and operational staff at both Group and non-Group dispensing pharmacies.

(3) Rental & Medical Facilities-related Business

The Company's subsidiary, Nihon Leben, mainly develops sites for building pharmacies, as well as renting buildings and providing other leasing and insurance services. Further, at the same time as offering consulting services for medical practices, it also provides consulting for medical malls that gather multiple medical disciplines on the same floor, and for medical buildings that gather various medical clinics in the same building, and also management of housing for the elderly with support services.

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(4) Catering Business

Total Medical Service, which was made into a subsidiary in November 2013, its subsidiary Sakura Foods, and Kyushu Iryo Shoku, which was made into a subsidiary in October 2015, carry out catering outsourcing operations within hospitals and welfare facilities

(5) Support services for clinical trials facilities

The Company's subsidiary SMO Medisys contracts with clinical trial facilities (medical facilities) as a clinical site management organization to provide support for clinical trials.

(6) Home visit nursing business

In May 2016, Himawari-kango Station Co., Ltd., which provides home visit nursing services in Nerima Ward, Tokyo, was made into a subsidiary. Home nursing services refers to nurses being dispatched from nursing (kango) stations to visit the homes and other places where the service recipients live to provide them with nursing care, to promote their independence, and to support their medical care. Within the integrated community care system being advocated by the government, nursing stations play a central role in providing high-quality medical and care services while coordinating with a variety of other related professions, including pharmacists, dieticians, doctors, and care managers. The Company has newly incorporated the home visit nursing business into the Group as part of a series of measures to strengthen home medical services in its dispensing pharmacy business, and in the future, it is aiming to coordinate with Group pharmacies to develop this business nationwide. In terms of the business scale of Himawari-kango Station, in FY3/15 it recorded net sales of ¥59mn and operating profit of ¥10mn.

Business Trends

Sales increased and profits decreased in FY3/17 1H, although both were below the initial Company targets

(1) Overview of the FY3/17 1H results

In the FY3/17 1H consolidated results, net sales increased 3.1% y-o-y to ¥43,401mn, operating profit decreased 68.7% to ¥549mn, recurring profit declined 69.0% to ¥542mn, and net profit attributable to owners of parent fell 91.4% to ¥66mn, for an increase in sales but decreases in profits. However, each of these results were below the Company's initial targets.

FY3/17 1H results (consolidated)

(¥mn)

	FY3/16 1H		FY3/17 1H				
	Actual	% Sales	Company target	Actual	% Sales	YoY	vs. plan
Sales	42,105	-	44,500	43,401	-	3.1%	-2.5%
COGs	26,268	62.4%	-	26,943	62.1%	2.6%	-
SG&A	14,083	33.4%	-	15,908	36.7%	13.0%	-
Operating profit	1,752	4.2%	950	549	1.3%	-68.7%	-42.2%
Recurring profit	1,748	4.2%	850	542	1.3%	-69.0%	-36.2%
Extraordinary profit/loss	-183	-	-	5	-	-	-
Profit attributable to owners of parent	769	1.8%	160	66	0.2%	-91.4%	-58.8%

Source: prepared by FISCO from the Company's financial reports summary

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Net sales trended strongly in the pharmaceutical network business, and sales also increased in the dispensing pharmacy business and the catering business from the effects of M&A. However, operating profit declined by double digits y-o-y, with the main factors including a reaction to the recording of a temporary item - a gain on sale of real estate of ¥242mn in the same period in the previous fiscal year, and deteriorated earnings in the dispensing pharmacy business from the impact of the revisions to the dispensing fees and drug prices. Operating profit was also 42.2% down on the initial target. This was mainly because in the dispensing pharmacy business, the total number of prescriptions filled was below target, and also that in the catering business, costs, such as food-purchase costs and personnel costs, increased by more than expected.

Factors behind the change to operating profit (FY3/17 1H, y-o-y)

(¥mn)

Category	Amount Change	Category	Amount Change
Dispensing pharmacy business	-696	Pharmaceutical network business	-4
(breakdown of change in OP)		Rental & medical facilities-related business	-297
Existing pharmacies	-557	Catering business	-78
Pharmacies opened FY3/16	40	Other business	-26
M&A FY3/16	21	Group expenses (adjusted)	-99
Pharmacies opened FY3/17	-119		
M&A FY3/17	21		
Pharmacies closed	3		
Headquarters' expenses	-105	Total	-1,203

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

Factors behind the change to operating profit (FY3/17 1H, vs. initial targets)

(¥mn)

Category	Amount Change	Category	Amount Change
Dispensing pharmacy business	-219	Pharmaceutical network business	-66
(breakdown of change in OP)		Catering business	-83
Existing pharmacies (number of prescriptions declining)	-205	Other business	-33
Existing pharmacies (reduction in dispensing fees)	-41		
Existing pharmacies (growth in the technical fees)	44		
Pharmacies opened • M&A FY3/16	-35		
Pharmacies opened • M&A FY3/17	-57		
Other businesses	75	Total	-400

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

Due to the increase in the number of member pharmacies in the pharmaceutical network business, the pharmaceutical order volume in FY3/17 1H was a record high for a 1H

(2) Trends by Operating Segment

a) Pharmaceutical Network Business

In this business, net sales increased 7.3% y-o-y to ¥1,617m, but operating profit decreased 0.6% to ¥838mn. The number of network member pharmacies steadily increased, rising 317 to 1,597 by the end of September. As a result, the pharmaceutical order volume in 1H climbed 13.9% to reach ¥65,628mn, which was a consecutive record high for a 1H.

Looking at the net sales breakdown, reflecting the growth in the pharmaceutical order volume, ordering fees increased 6.2% y-o-y to ¥961mn, while alongside the rise in the number of member pharmacies, system sales increased 11.0% to ¥553mn. Conversely, profits declined due to the impact of the increases in depreciation costs from the construction of a core system and in personnel costs following the strengthening of the sales system.

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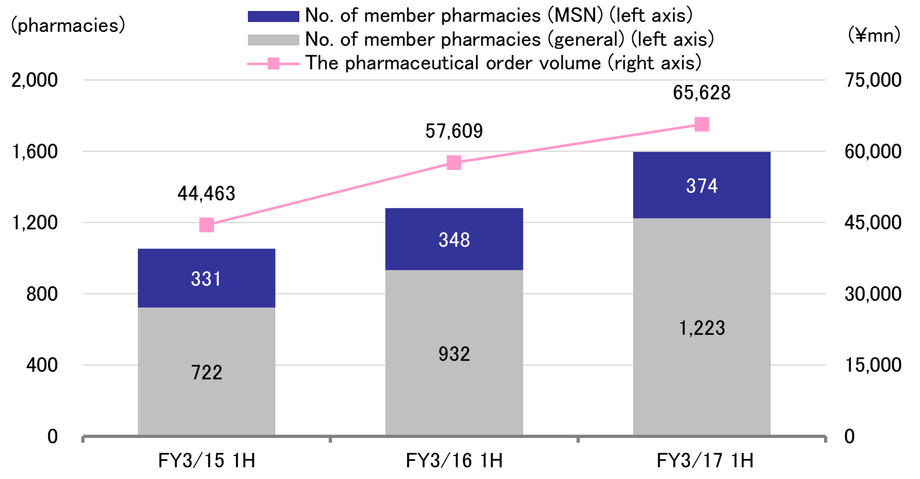
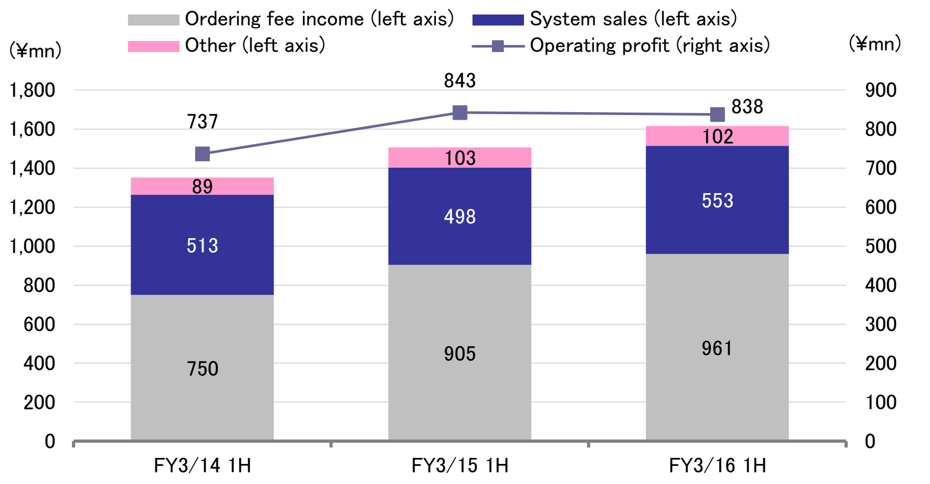
Member Pharmacy Numbers & Order Volumes



Source: prepared by FISCO from Company materials

Pharmaceutical Network Business



Source: prepared by FISCO from Company materials

b) Dispensing Pharmacy Business

In this business, net sales increased 1.6% y-o-y to ¥39,858mn, while operating profit decreased 49.6% to ¥706mn. The total number of pharmacies became 374, which is an increase of 21 pharmacies y-o-y. This was from the increases of 7 new pharmacy openings and the acquisition of 17 pharmacies from M&A and from a business transfer, and the decrease of 3 pharmacies from closures and a business transfer.

The increase in net sales was maintained, if only slightly, from the rise in the number of pharmacies from the new pharmacy openings and M&A. But profits greatly decreased due to the impact of factors including the reduction in prescription unit prices following the April 2016 revisions to dispensing fees and drug prices, and also the increase in personnel costs in order to employ more pharmacists to strengthen pharmacies' "family pharmacy" functions. In addition, while the number of prescriptions rose 0.4% y-o-y on an existing-pharmacies basis, this was still below the initial target of 1.9%, which was also one of the main reasons why profits were below target in this business.

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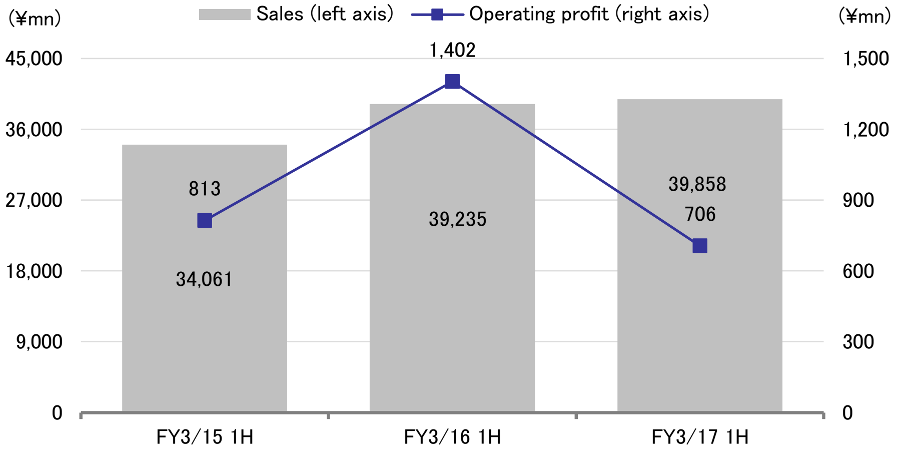
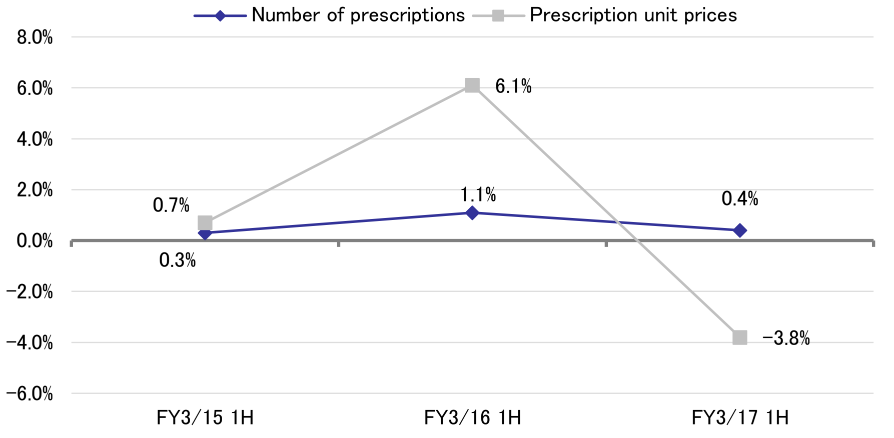
On an existing-pharmacies basis, prescription unit prices declined 3.8% y-o-y. Breaking this down, we see that the dispensing fees and the technical fees fell 4.3% and 1.8% respectively, and that the revisions to the drug prices had a major impact. In the same period in the previous fiscal year, the launch of a new drug for hepatitis C with a high drug price had a major effect and sales rose significantly, by 6.1%. But from this spring, the price of this drug was reduced by 32% and this also impacted the current results. On the other hand, although the technical fees were reduced slightly following the revisions to the dispensing fees, they were still slightly above the forecast. At the end of September, the number of pharmacists, including temporary staff, had increased by 106 to 1,295 people. As a result, the average number of pharmacists per pharmacy rose from 3.4 to 3.5 people.

Dispensing Pharmacy Business



Source: prepared by FISCO from Company materials

Rate of Change of Prescription Numbers and Unit Prices (based on existing pharmacies)



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

c) Rental & Medical Facilities-related Business

In this business, net sales decreased 36.4% y-o-y to ¥989mn, and the operating loss was ¥85mn (compared to an operating profit of ¥211mn in the same period in the previous fiscal year). This was mainly as a reaction to the recording of a temporary item in the same period in the previous fiscal year, of a gain on sale of real estate of ¥242mn. But even when excluding this factor, profits still deteriorated slightly, mainly due to increases in depreciation costs and start-up costs from the launches of Wisteria Otaru Inaho in December 2015 and Wisteria Senri Chuo in May 2016 in housing for the elderly with support services.

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The tenant conditions at the end of September 2016 were that Wisteria Otaru Inaho (Hokkaido) had tenants for 77 of its total of 81 units, meaning it was operating at close to full capacity. Conversely at Wisteria Senri Chuo (Osaka), only 11 of the 82 units had tenants. Normally, the tenant occupancy rate surpasses 90% and the facility becomes profitable by around the third fiscal year, but as the rent for Wisteria Otaru Inaho is inexpensive, at around only ¥50,000 per month, the occupancy rate has exceeded 90% at an earlier stage. The occupancy rates at Wisteria N17 (Hokkaido, opened 2007) and Wisteria Kiyota (Hokkaido, opened 2013) are both 92% and they are already profitable.

d) Catering Business
In this business, net sales increased 110.9% y-o-y to ¥2,315mn from the effects of Kyushu Iryo Shoku being made into a subsidiary in October 2015. But in profits, it recorded an operating loss of ¥102mn (compared to a loss of ¥24mn in the same period in the previous fiscal year), due to increases in food purchasing costs and in labor costs, including to use temporary staffing services because of a shortage of personnel.

e) Other Business
In the other businesses (the clinical trial facilities support business and the home visit nursing business) net sales increased 3.8% y-o-y to ¥77mn, while the operating loss was ¥86mn (compared to a loss of ¥59mn in the same period in the previous fiscal year).

■ Results Outlook

The results momentum is forecast to bottom-out in FY3/17 1H and turn to a recovery trend in 2H

(1) FY3/17 Results Outlook

The outlook for the FY3/17 consolidated results is for net sales to increase 2.6% y-o-y to ¥90,000mn, operating profit to decrease 39.2% to ¥2,300mn, recurring profit to decline 40.4% to ¥2,300m, and profit attributable to owners of parent to fall 62.2% to ¥650mn. Net sales and the profit items have been downwardly revised from the initial targets. The Company reviewed its earnings targets from the fact that results up to Q2 were below their targets and also based on the current conditions. However, in the dispensing pharmacy business in which revenue greatly deteriorated in 1H, the results should recover as the Company is implementing measures to strengthen its response to the revisions to the dispensing fees. In the other four businesses also, it has formulated policies to improve earnings, aiming for them to recover from the next fiscal year after bottoming-out in the current 2H. Therefore in terms of momentum, the results are forecast to bottom-out in the current 1H and turn to a recovery trend after that.

FY3/17 Consolidated Results Outlook

(¥mn)

	FY3/16	FY3/17 (E)			
	Actual	Company target	Revised targets	YoY	Revision rate
Sales	87,715	92,000	90,000	2.6%	-2.2%
Operating profit	3,783	3,270	2,300	-39.2%	-29.7%
(operating profit margin)	4.3%	3.6%	2.6%	-	-
Recurring profit	3,860	3,100	2,300	-40.4%	-25.8%
Net profit attributable to owners of parent	1,720	1,210	650	-62.2%	-46.3%

Source: prepared by FISCO from financial reports summary

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(2) Results Outlook by Segment

Results Outlook by Segment

(¥mn)

Sales	FY3/16	FY3/17			
	Actual	Initial forecast	Revised forecast	Chg %	Revision rate
Pharmaceutical Network Business	3,235	3,421	3,281	1.4%	-4.1%
Dispensing Pharmacy Business	82,002	84,325	82,970	1.2%	-1.6%
Other Business	5,404	7,000	6,830	26.4%	-2.4%
Adjustments	-2,926	-2,748	-3,082	-	-
Total	87,715	92,000	90,000	2.6%	-2.2%

Operating profit	Actual	Initial forecast	Revised forecast	Chg %	Revision rate
Pharmaceutical Network Business	1,776	1,886	1,731	-2.5%	-8.2%
Dispensing Pharmacy Business	3,412	3,033	2,536	-25.7%	-16.4%
Other Business	-70	-214	-515	-	-
Adjustments	-1,335	-1,434	-1,452	-	-
Total	3,783	3,270	2,300	-39.2%	-29.7%

Note: the other businesses (the rental & medical facilities-related business, the catering business, the clinical trial facilities support business, and the home visit nursing business)

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

a) Pharmaceutical network business

In this business, net sales are forecast to increase 1.4% y-o-y to ¥3,281mn and operating profit to fall 2.5% to ¥1,731mn. The number of network members is expected to increase by a record amount, up 350 to 1,750 pharmacies. As of November 1, there were 1,648 network members and it seems fully possible that the result will exceed the target. Despite the impact of the reduction in drug prices, the pharmaceutical order volume is forecast to increase 5.1% to ¥130bn due to the rise in the number of member pharmacies. Profits are set to decline, the main reason being an increase in fixed costs, including depreciation costs due to the construction of a core system.

The background to the high pace of the increase in member numbers is that the dispensing pharmacy management environment is becoming increasingly severe. In order to keep down medical costs that are increasing year by year, every two years the government revises the drug prices and the dispensing fees. In this environment, dispensing pharmacies are required to have the functions of local "family pharmacists," including providing home visits. The resulting increase in costs, such as to employ additional pharmacists, has become a heavy burden on pharmacy management. In this sort of situation, it is considered that the Company's network services, which contribute to improving the efficiency of pharmacy management, are attracting more attention than ever before.

In order to steadily capture these needs, the Company is developing a region-specific sales structure through the introduction of an area system to increase member numbers. It is also aiming to grow member numbers by enhancing its network services to support its members and evolving its services so they are even more attractive to potential members. Its policy to enhance services is to actively pursue partnerships with external companies, and as described below, it has partnered with Japan Post to launch a home delivery service for prescription drugs and healthcare items, and has also entered into a business partnership with Zoo Corporation for sales of "kusudama," a tablet app for pharmacists.

b) Dispensing Pharmacy Business

In this business, the forecast is for net sales to increase 1.2% y-o-y to ¥82,970mn and operating profit to decline 25.7% to ¥2,536mn. The priority measures for this fiscal year will be "Actively opening new pharmacies and conducting M&As" and "Strengthening the responses to the revisions to medical fees and the functions of existing pharmacies."

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In this fiscal year, the Company is aiming for a total of 40 new pharmacies, 10 from new pharmacy openings and 30 to be acquired from M&A. By Q2, the number of pharmacies had increased by 21, so it has already achieved more than half of its target. Going forward, while it will depend on the M&A candidates, it is considered that it will continue to implement M&A by focusing on excellent candidates in terms of responding to the medical fees system. Also, the premise is that the number of prescriptions on an existing-pharmacies basis, which is a premise for net sales, will up 1.0% y-o-y (initial target, up 1.6%). It increased only slightly in 1H, up 0.4%, but further growth is expected in 2H. In addition, the prescription unit prices are forecast to decrease 5.6% (initial target, down 6.1%). The decline in dispensing fees will be a major factor, but it is thought that the efforts to strengthen the response to the revisions to the dispensing fees, including promoting the use of generic pharmaceuticals and enhancing functions as family pharmacies, will keep the extent of the decline to less than initially forecast. Further, in 2H the Company is aiming to achieve its targets by strengthening cost-reduction measures, including reviewing pharmacy costs and headquarters' personnel.

c) The other four businesses

In these businesses (the rental & medical facilities-related business, the catering business, the clinical trial facilities support business, and the home visit nursing business), total net sales are forecast to increase 26.4% y-o-y to ¥6,830mn and for the operating loss to be ¥515mn (compared to an loss of ¥70mn in the previous fiscal year). Net sales are expected to increase from the effects of the M&A in the catering business, but the outlook is for an operating loss in 2H also. However, profits are forecast to improve from the next fiscal year onwards from the effects of the policies to improve profits.

The other businesses' operating profit

(¥mn)

	FY3/16	FY3/17		
	Full fiscal year	1H	2H forecast	Full fiscal year forecast
Rental & medical facilities-related business	129	-85	-97	-183
Catering business	-89	-102	-54	-157
Support services for clinical trials facilities	-109	-74	-38	-113

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

In the rental & medical facilities-related business, the loss in 2H is expected to be around the same as in 1H due to depreciation costs and start-up costs for Wisteria Otaru Inaho and Wisteria Senri Chuo, and the outlook for the full fiscal year is an operating loss of ¥183mn. The Company's targets for 2H at Wisteria Senri Chuo are for 50 tenants (compared to 16 tenancy agreements as of November 4) and an occupancy rate of 60%, and it intends to focus its activities on acquiring new tenants. Alongside the increase in the number of tenants, the extent of the loss is expected to be reduced in the next fiscal year. Also, as a new project, Wisteria Minami 1 Jo (provisional name, a total of 106 units) is set to become the third housing for the elderly with support services in Sapporo, with construction having begun in November 2016 and it scheduled to open in November 2018. In addition to being located next to Sapporo Medical University, the Company plans to establish 6 to 7 medical clinics within this facility, and it may become a core base in the integrated community care system in Sapporo.

The catering business is expected to record an operating loss of ¥54mn in 2H, which will be approximately half of the loss in 1H. The main reason for this will be that Sakura Foods, has increased food unit prices to business partners, and has been profitable on a single month basis since October. Conversely, Kyushu Iryo Shoku is aiming to improve profits going forward by reviewing its food costs and by optimizing the placement of personnel. However, the catering business has continued to record a loss since it was made into a subsidiary in FY3/14, and if on viewing the situation over the next half year the Company determines that it will difficult to recover profits in this business, it is thought that it will look into conducting sweeping measures.

The clinical trial facilities support business is also expected to record an operating loss in 2H of ¥38mn. In terms of the measures to improve profits, the Company is strengthening it sales system with a focus on specific-area diseases for which clinical trial demand is expected (including cancer, diabetes, and rheumatism). Further, it is aiming for this business to become profitable at an early stage while capturing projects from business partners.

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Enhancing services and strengthening competitiveness through business partnerships with Japan Post and a systems-development company

(3) Measures for new services

The Company's strategy in order to strengthen the competitiveness of its dispensing pharmacy business and pharmaceutical network business is to enhance its service content while utilizing partnership with external companies. Projects that it has already announced are a prescription drugs home delivery service and a shopping-support service through a partnership with Japan Post, and support for the introduction and sales to network members of "kusudama," which is a tablet app for pharmacists from a partnership with Zoo Corporation. The potential demand is great in each of these areas, so we will be paying attention to how they develop in the future.

a) A joint business with Japan Post

In May 2016, the Company announced that it would launch a prescription drugs delivery service and a shopping-support service, limited to the areas in which it was currently conducting operations testing. The prescription drugs delivery service is a service to deliver packs of fluid infusions and nutrient drugs to home-care patients who received medication guidance from Nanohana pharmacies in Sapporo and Nagoya. However, for the start of the full service, an issue will be establishing safety standards, such as for temperature management during the delivery, including of the prescription drugs. The Company will be conducting operations testing up to the summer of 2017, and upon establishing safety, it is thought to want to launch the full service from the following fall.

On the other hand, with regards to the shopping-support service, from October 2016 the targeted items have been narrowed down to adult disposable diapers, and operations testing is underway for home-care patients and facilities for the elderly in Otaru and Nagoya. Steady progress has been made for this service, and the full service was scheduled to be launched in Nanohana pharmacies nationwide from February 2017, with construction of the system for this will have been completed in January. In addition, the plan is to progress this business from new joint developments with Japan Post, including expanding the target items to daily necessities and health foods.

The need for home delivery services is expected to rise in the future alongside the forecast increases in the numbers of home-care patients and people requiring nursing care. It would seem the importance of such services will be particularly high in regions with few pharmacies. The Company is a pioneer in the industry in terms of providing home delivery services, and in the future this is expected to improve the competitiveness of its dispensing pharmacy business.

The benefits of introducing home delivery services include reducing the work load on pharmacists in terms of them having to make home visits, and also creating more revenue opportunities from increasing customer numbers and sales of related products, such as daily necessities. In the future also, the dispensing pharmacy industry is likely to continue to be subject to head winds, for example the steps being taken to keep down medical expenses, but the profitability of pharmacies can be expected to improve from developing peripheral products other than pharmaceuticals to be new sources of earnings.

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Medical System Network

4350 Tokyo Stock Exchange First Section

6-Jan.-17

Joint measures with Japan Post

Source: the Company's financial results briefing materials

b) Business partnership with Zoo Corporation

Sales of "kusudama," which a tablet app for pharmacists, were launched in October 2016 through a business partnership with Zoo Corporation, a systems-development company in Nagano Prefecture. The targeted customers are existing member pharmacies and potential member pharmacies in the pharmaceutical network business.

"kusudama" is a work support tool that enables pharmacists to carry out all of the tasks that they routinely perform on a single tablet. Within the pharmacy, they can use it for tasks such as inputting prescriptions, pre-dispensing guidance, prescription audits, selections, dispensing audits, medication guidance, medical history entry, accounts processing, and inventory management. Moreover, outside of the pharmacy, it can provide them with 24 hour support for various home-based tasks. While on the one hand the importance of family pharmacists is increasing, on the other hand there are loud calls for pharmacists to work more efficiently, and the app was developed by Zoo Corporation in response to a request from the Nagano Prefecture Pharmacist Association. As it was developed to reflect the voices of those in workplaces, one of its features is its ease of use.

For prospective new customers, the Company has made it possible to offset the lease fee from the cost reduction effects (such as by lowering the purchase price) from becoming a member of the network. In this way, it is encouraging these customers to become network members.

Following the FY16 revisions to the medical fees, family pharmacist guidance fees were newly established, increasing the importance of family pharmacists. But on the other hand, the family pharmacist is required to carry out complex tasks, such as medication guidance and home-support services, which is prolonging the contact time per patient. As a result, there have been cases where this has been a factor lower the profitability of the pharmacy, including it having to employ additional pharmacists. Therefore, there is a strong need for the introduction of a work support tool that will improve the productivity of pharmacists. Going forward, in addition to introducing it into the Company Group's pharmacies and network member pharmacies, it is expected to play a 'hook' role for the acquisition of new network members.

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Targets for FY3/18 are net sales of ¥105bn and recurring profit ¥3.8bn

(4) The Medium-term Management Plan

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 medical care in local communities.

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 guidance, home care, and the reduction of waiting times, 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 integrated community care system in accordance with conditions at existing pharmacies, and develop new pharmacies 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 pharmacies.
5. Aim to thoroughly implement cost controls with an eye to future revisions to medical fees.

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

In terms of the management numerical targets, the targets for FY3/18, which is the plan's final fiscal year, are net sales of ¥105,000mn and recurring profit of ¥3,800mn. Recurring profit fell temporarily in FY3/17, but despite this, the target has not been changed.

Nationwide, there are around 50,000 dispensing pharmacies, but among these, the share of the major six dispensing pharmacy companies is not even 10%. Going forward, the market environment will become more and more severe due to factors such as the increase in social security expenses, and it is possible that these developments will accelerate the selection and reorganization of medium and medium-to-small size dispensing pharmacies. In this sort of environment, the Company can be said to have significant growth potential, as with 1,648 pharmacies as of November 1, 2016, including network member pharmacies, it is an industry leader for the number of pharmacies and the pharmaceutical order volume. It is targeting 2,200 network member pharmacies by FY3/18, and this figure would seem to be fully achievable based on the current market environment.

The Company's current targets include raising its industry share of the pharmaceutical order volume up to a minimum of 10%, which appears achievable in five years' time. The current scale of the pharmaceuticals market is ¥6 trillion to ¥7 trillion a year, and the Company's order volume in FY3/17 is expected to be ¥130bn. If it can acquire share of 10%, this figure would rise to ¥600bn to ¥700bn, and if looking at ordering fees, we estimate that its FY3/17 forecast of approximately ¥2bn would grow to ¥9bn to ¥10bn.

In FY3/17, results are set to temporarily decline due to the deterioration of the dispensing pharmacy market environment and the worsening of earnings in the other businesses. But looking in the medium-to-long term, at FISCO we forecast that the deterioration of the dispensing pharmacy market environment will actually prove to be a fair wind for the Company and become a driving force behind the growth of the pharmaceutical network business, and that profitability as a whole will also improve alongside this growth in the highly profitable pharmaceuticals network business.

Medium-term Management Plan Targets

(¥mn)

	FY3/15	FY3/16	FY3/17 (E)	FY3/18 target
Sales	75,548	87,715	90,000	105,000
Pharmaceutical network business	2,814	3,235	3,281	3,600
Dispensing pharmacy business	71,743	82,002	82,970	99,500
Operating profit	2,641	3,783	2,300	4,000
Pharmaceutical network business	1,549	1,776	1,731	2,200
Dispensing pharmacy business	2,377	3,412	2,536	3,000
Recurring profit	2,540	3,860	2,300	3,800
Recurring profit margin	3.4%	4.4%	2.6%	3.6%
Net profit attributable to owners of parent	885	1,720	650	1,500
The number of member pharmacies in the pharmaceutical network business	1,200	1,400	1,750	2,200
The number of pharmacies	345	353	385	500

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

Financial Position

Looking at the financial position at the end of September 2016, total assets were up ¥1,477mn compared to the end of the previous fiscal year to ¥50,325mn, mainly due to increases in cash and deposits of ¥474mn, accounts receivable of ¥518mn, and goodwill of ¥301mn.

Total liabilities were up ¥1,554mn to ¥40,136mn, as the increase in interest-bearing debt of ¥2,785mn exceeded the decreases in accounts payable and accrued income taxes of ¥578mn and ¥649mn respectively. Net assets were down ¥76m to ¥10,188mn, as although net profit attributable to the owners of the parent company of ¥66mn was recorded, this was exceeded by the fall in retained earnings of ¥87mn, mainly due to dividend payments of ¥148mn.

Looking at the management indicators, we see that the financial position worsened slightly, as the equity ratio fell from 20.3% in the previous fiscal year to 19.5% due to the increase in interest-bearing debt, and the interest bearing debt ratio rose from 199.7% to 229.6%. But going forward, results are forecast to recover and the Company is not planning any major capital investment at the present time, so its financial position is expected to gradually improve.

Consolidated Balance Sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17 1H	Chg
Current assets	10,941	11,023	10,783	11,910	1,126
(cash & deposits)	3,106	2,499	2,081	2,555	474
Fixed assets	32,172	34,564	38,063	38,414	351
(goodwill)	12,253	13,214	12,916	13,218	301
Investments, etc.	3,797	3,759	4,329	4,406	77
Total assets	43,114	45,587	48,847	50,325	1,477
Current liabilities	24,879	21,625	21,061	18,229	-2,831
Fixed liabilities	12,881	17,826	17,520	21,907	4,386
(interest-bearing debt)	22,011	22,743	19,562	22,347	2,785
Total liabilities	37,761	39,451	38,581	40,136	1,554
Total net assets	5,352	6,135	10,265	10,188	-76
(safety)					
Equity ratio	11.9%	12.7%	20.3%	19.5%	-
Interest bearing debt ratio	433.3%	392.3%	199.7%	229.6%	-

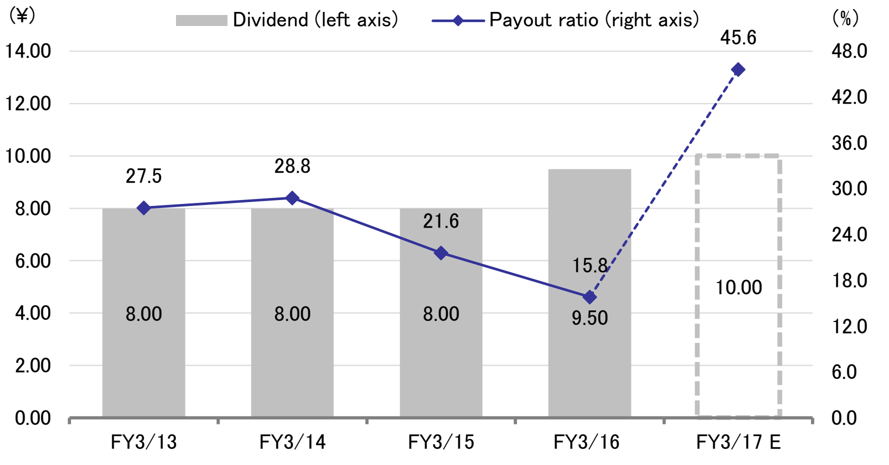
Source: prepared by FISCO from the Company's financial reports summary

Shareholder Returns

In FY3/17, plans to increase dividend by ¥0.5 y-o-y to ¥10.00 for a dividend payout ratio of 45.6%

The Company's policy is to return profits to shareholders by way of dividends. Its basic policy is to pay stable dividends that reflect results after securing sufficient internal reserves to strengthen its financial position and to expand operations, with the standard considered to be maintaining a dividend payout ratio of 20% or above. For FY3/17, the Company plans to increase the dividend by ¥0.5 to ¥10.00 (for a dividend payout ratio of 45.6%). Dividend growth can be expected in the future if profits increase and as a result, the dividend payout ratio falls below this 20% level.

Dividend per Share and Dividend Payout Ratio



Source: prepared by FISCO from the Company's financial reports summary

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