

# **NIHON CHOUZAI Co., Ltd.**

**3341**

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<http://www.fisco.co.jp>

## Index

<b>Summary</b>	<b>01</b>
1. In 1H FY3/18, sales and profits increased both YoY and compared to the forecasts	01
2. The growth strategies in each of the three businesses are clear. Aiming for a 50:50 business portfolio	01
3. Forecasting higher sales and profits for FY3/18.	
The results may even exceed the forecasts considering seasonality	01
<b>Company profile</b>	<b>02</b>
1. History	02
2. Business overview	03
<b>Results trends</b>	<b>04</b>
1. Summary of 1H FY3/18 results	04
2. Trends in the Dispensing Pharmacy business	06
3. Trends in the Pharmaceutical Manufacturing and Sales business	08
4. Trends in the Medical Professional Staffing and Placement business	08
<b>A management strategy toward medium- to long-term growth</b>	<b>09</b>
1. A business portfolio targeting the medium- to long-term	09
2. The Dispensing Pharmacy business growth strategy	10
3. The Pharmaceutical Manufacturing and Sales business growth strategy	13
4. The Medical Professional Staffing and Placement business growth strategy	15
<b>Business outlook</b>	<b>17</b>
1. FY3/18 outlook	17
2. Prospects for FY3/19	18
<b>Shareholder returns</b>	<b>21</b>
<b>Information security</b>	<b>22</b>

## Summary

### Making steady progress on the medium- to long-term growth strategies set clearly for each of its three businesses

NIHON CHOUZAI Co., Ltd. <3341> (hereinafter, also “the Company”) is a leading domestic dispensing pharmacy company that ranks second in sales in the dispensing pharmacy industry. The Nihon Chouzai Group manufactures generic pharmaceuticals, so one of its key characteristics is that it has a manufacturing function. It additionally has a staffing and placement business for medical professionals and an information-provision and consulting business, and it is developing its operations with a structure that covers four business departments.

#### 1. In 1H FY3/18, sales and profits increased both YoY and compared to the forecasts

In 1H FY3/18 results, the Company achieved higher sales and profits both year-on-year (YoY) and compared to the forecasts, with net sales of ¥118,149mn (up 7.9% YoY) and operating profit of ¥4,888mn (up 24.1%). For each profit item from operating profit down, it achieved record highs on a 1H basis. There will be no revisions to the drug prices and dispensing fees in FY3/18, and partly due to this, the Company achieved higher sales and profits. Increases in sales and profits were secured in the Dispensing Pharmacy business and the Medical Professional Staffing and Placement business. However, profits declined YoY in the Pharmaceutical Manufacturing and Sales business, but this was as expected, including due to higher R&D costs and other factors.

#### 2. The growth strategies in each of the three businesses are clear. Aiming for a 50:50 business portfolio

The Company is aiming for a business structure in the medium- to long-term of 50% of operating profit from the Dispensing Pharmacy business, and a total of 50% from the other two businesses. Its strengths include that it has clearly depicted the paths (the strategies) for each of the three businesses in order to achieve this business structure. In the Dispensing Pharmacy business, it is aiming for growth on the twin axes of responding to the policies being promoted by the Japanese government and opening pharmacies. In the Pharmaceutical Manufacturing and Sales business, the axis for the growth strategy is expanding the products manufactured in-house and securing production capacity. In the Medical Professional Staffing and Placement business, in addition to its strength of staffing for pharmacists, the aim is to accelerate growth by strengthening the placement business, which is highly profitable and has significant growth potential.

#### 3. Forecasting higher sales and profits for FY3/18. The results may even exceed the forecasts considering seasonality

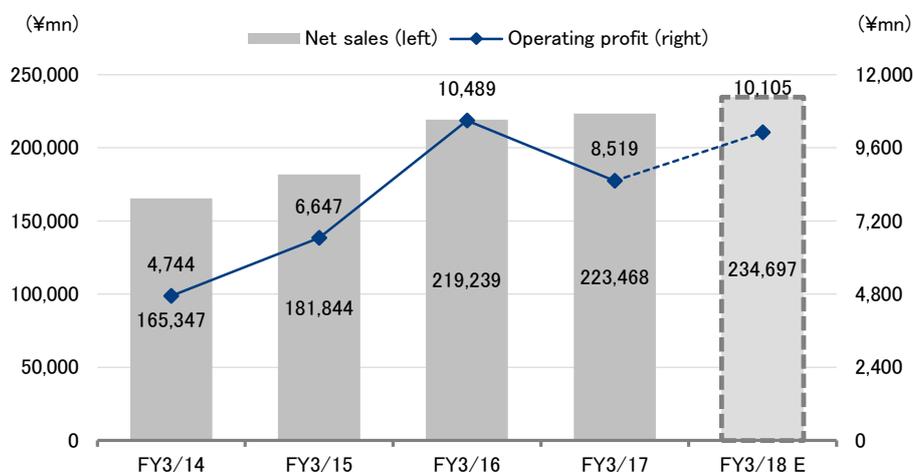
For the FY3/18 full year, the Company is forecasting net sales of ¥234,697mn (up 5.0% YoY) and operating profit of ¥10,105mn (up 18.6%). At FISCO, we think that when considering seasonality, where results are concentrated in 2H, we can fully expect the results to exceed these forecasts. However, FY3/19 may see a levelling-off of results due to the revisions to the drug prices and dispensing fees and with the start of operations at the new plant. But as previously mentioned, the Company has set clear and effective medium- to long-term growth strategies, and we expect growth to fully recover after that.

Summary

Key Points

- The growth strategy in the Dispensing Pharmacy business is on the twin axes of responding to the policies being promoted by the Japanese government and opening pharmacies
- The axis for the growth strategy in the Pharmaceutical Manufacturing and Sales business is to expand products manufactured in-house and to secure production capacity
- Aiming to accelerate growth from the highly-profitable placement business, which has great growth potential, in addition to its strength of staffing of pharmacists in the Medical Professional Staffing and Placement business

Results trends



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

## Company profile

**Developing the Dispensing Pharmacy business and the Pharmaceutical Manufacturing and Sales business toward achieving its corporate philosophy of “Realizing the true separation of the roles of drug prescribing and dispensing services”**

### 1. History

The Company was founded in 1980 in Sapporo City by Mr. Hiroshi Mitsuahara, President and Representative Director. The Company's corporate philosophy is "To realize true separation of the roles of drug prescribing and dispensing services." This is based on the approach of Mr. Mitsuahara, who is a qualified pharmacist, that "the ideal situation is one in which the pharmacists in pharmacies judge whether the prescribed medicine is appropriate for the patient and optimize their medical therapy."

#### Company profile

Since the launch of the Dispensing Pharmacy business, the Company has steadily expanded its pharmacy network and in 1995, it solidified its footholds as a company with a nationwide presence when it transferred its head office to Tokyo. Subsequently, by 2011 it had opened pharmacies in every prefecture in Japan, and by the end of 1H FY3/18, it had a nationwide network of 568 dispensing pharmacies (and also 1 product-sales pharmacy).

In 2000, it established Nihon Chouzai Pharma Staff Co., Ltd. thereby launching a staffing business for doctors, nurses, pharmacists and other medical professionals. This company has steadily expanded its business scope and today, after being integrated with the subsidiary Medical Resources Co., Ltd. that was established separately in 2006, it undertakes the Company's Medical Professional Staffing and Placement business.

In the Company's history, the establishment of Nihon Generic Co., Ltd. in 2005 was a step of similar importance to the founding of the Company itself. Mr. Mitsuhashi considered that generic pharmaceuticals would play a major role in realizing the "separation of dispensing and prescribing," and with the opportunity provided by the enforcement of the revised Pharmaceutical Affairs Act in 2005 (currently, the Pharmaceutical and Medical Devices Act), he decided to embark on the manufacture of generic pharmaceuticals. Nihon Generic struggled for a while after it first began in business, but it increased the number of items it produced and established a production system and in FY3/13, the Pharmaceuticals Manufacturing and Sales business segment recorded an operating profit for the first time. Subsequently, the scope of this business has been further expanded with the acquisition of Choseido Pharmaceutical Co., Ltd. in 2013, and also the Kasukabe plant of Teva Pharma Japan Inc. (currently Teva Takeda Pharma Ltd.) in 2015.

## **A feature of the Dispensing Pharmacy business is pharmacies with high efficiency and advanced adoption of policies being promoted by the Japanese government. The Pharmaceutical Manufacturing and Sales business is demonstrating its presence through active expansion measures**

### **2. Business overview**

The Company is developing four businesses; the Dispensing Pharmacy business, the Pharmaceutical Manufacturing and Sales business, the Medical Professional Staffing and Placement business, and the information-provision and consulting business. In terms of information disclosure, it divides its businesses into three business segments, the Dispensing Pharmacy business, the Pharmaceutical Manufacturing and Sales business, and the Medical Professional Staffing and Placement business. The information-provision and consulting business is included in the Dispensing Pharmacy business segment.

A major feature and strength of Company's Dispensing Pharmacy business is that it ranks first for net sales per pharmacy and there is a considerable distance between the companies ranked second and below for this indicator. Despite placing fifth in the industry for the number of pharmacies, the main reason for placing second in net sales lies in its scale in net sales per pharmacy. The Company places great importance on the net sales per pharmacy indicator. If it is to secure profits as a company while also fulfilling the social responsibility required of pharmacies, naturally the scale per pharmacy must be made bigger, and net sales per pharmacy is the most important KPI (key performance indicator) for this. While the Company has been aiming to expand its network of pharmacies, it does not blindly pursue increasing their numbers, and instead it has expanded its pharmacy network while adhering to strict internal standards, including for net sales per pharmacy. This has led to the measure of expanding the network centered on pharmacy openings by the Company itself. It is not negative toward M&A and its policy is to actively conduct them if there are candidates that meet its own strict standards. The acquisition of Mizuno LLC in FY3/17 can be said to be a good example of this.

#### Company profile

Another feature of the Company in the Dispensing Pharmacy business is that it has made the greatest progresses within the industry in terms of the response to the policies being promoted by the Japanese government (the Ministry of Health, Labour and Welfare). The government is trying to change the forms taken by dispensing pharmacies, including by revising dispensing fees and drug prices, and this can cause significant damage to results if a company falls behind in its response. The Company anticipated the direction the government would take and took steps in advance to acquire the incentive dispensing fees and worked to prevent a decline in profits or to even increase them.

A feature of the Company's Pharmaceutical Manufacturing and Sales business is that in terms of its positioning, it is not limited to vertical integration within the Company as it also has an independent existence as a (whole-sale) company that manufactures and sells generic pharmaceuticals. In the FY3/17 results in the Pharmaceutical Manufacturing and Sales business segment, of the total net sales of ¥36,821mn, ¥24,184mn, or approximately 66%, were external net sales. Demand for generic pharmaceuticals is increasing more and more from the viewpoint of keeping down the growth in medical costs. Since establishing Nihon Generic, in 2005, it has continuously expanded its production capacity by acquiring Choseido Pharmaceutical, and the Kasukabe Plant from Teva Pharma Japan (currently Teva Takeda Pharma) and it sells a total of 627 items (as of the end of September 2017). The phase 1 production facility of the Tsukuba Plant No.2, which is currently under construction, is scheduled to be completed in April 2018.

The Medical Professional Staffing and Placement business is being developed under the "Pharma Staff" brand by the subsidiary Medical Resources Co., Ltd. It places in employment not only pharmacists, but also medical professionals as a whole, including doctors and nurses. But naturally it is particularly strong in the staffing and placement of pharmacists and ranks first in the industry for the number of pharmacist job postings. A high percentage of pharmacists are women, so there are many cases of them temporarily leaving work due to marriage and childbirth. But on the other hand, there is always strong demand for pharmacists from dispensing pharmacies, so the staffing and placement business is a field that is expected to continue to grow in the future.

## Results trends

### No revisions to the drug prices and dispensing fees in FY3/18. Securing steady increases in sales and profits

#### 1. Summary of 1H FY3/18 results

The Company's 1H FY3/18 results were an increase in sales and profits, with net sales of ¥118,149mn (up 7.9% YoY), operating profit of ¥4,888mn (up 24.1%), ordinary profit of ¥4,635mn (up 23.6%), and profit attributable to owners of parent of ¥2,805mn (up 19.9%). Sales and every profit item exceeded their initial forecasts, with net sales and operating profit surpassing 4.0% and 15.0%, respectively.

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## Results trends

## Overview of 1H FY3/18 results

	FY3/17		FY3/18		
	1H		1H		
	Result	Forecast	Result	YoY	Vs. forecast
Net sales	109,478	113,606	118,149	7.9%	4.0%
Operating profit	3,940	4,251	4,888	24.1%	15.0%
Ordinary profit	3,751	4,115	4,635	23.6%	12.6%
Profit attributable to owners of parent	2,339	2,231	2,805	19.9%	25.7%

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

There will be no revisions to the drug prices and dispensing fees in FY3/18, but the growth in net sales was kept down to a single digit, of 7.9%. However, this is due to the effects of a decline in net sales of ¥3.7bn YoY for a drug for hepatitis C with a high unit drug price. In a comparison on excluding this drug for hepatitis C, a double-digit increase in net sales was secured, up 12.1%. The decline in sales for hepatitis C drug is great compared to in the previous fiscal year, but the result is still ¥1.1bn above the forecast and can be evaluated as a strong performance in difficult conditions.

The Company achieved record highs for each profit item from operating profit down on a 1H basis. By segment, profits declined significantly in the Pharmaceutical Manufacturing and Sales business, but this was covered by the major growth in profits in both the Dispensing Pharmacy business and the Medical Professional Staffing and Placement businesses, securing a YoY increase in profits.

On analyzing the factors behind the change in operating profit YoY, the increase factors included the rise in the dispensing technical fee unit price and in the number of prescriptions, which absorbed the decrease in profits in the Pharmaceutical Manufacturing and Sales business, to secure higher operating profit YoY. In addition, on analyzing the factors behind the change in operating profit compared to the initial forecasts, although the technical fee unit price and the number of prescriptions were as planned, the drug fee unit price was higher than expected, and also segment profits exceeded the forecasts in the Medical Professional Staffing and Placement business and the Pharmaceutical Manufacturing and Sales business, and therefore the results were above the initial forecasts.

## Breakdown by business segment for 1H FY3/18

	FY3/17		FY3/18			
	1H		1H			
	Result	Forecast	Result	YoY	Vs. forecast	
Net sales	Dispensing Pharmacy business	92,329	95,128	100,011	8.3%	5.1%
	Pharmaceutical Manufacturing and Sales business	18,722	20,174	19,213	2.6%	-4.8%
	Medical Professional Staffing and Placement business	5,068	5,788	5,993	18.3%	3.5%
	Before adjustment	116,119	121,090	125,217	7.8%	3.4%
	Adjustment	-6,641	-7,484	-7,068	-	-
	Net sales total	109,478	113,606	118,149	7.9%	4.0%
Operating profit	Dispensing Pharmacy business	4,064	4,977	5,617	38.2%	12.9%
	Pharmaceutical Manufacturing and Sales business	1,191	503	638	-46.4%	26.7%
	Medical Professional Staffing and Placement business	808	957	1,012	25.2%	5.7%
	Before adjustment	6,063	6,437	7,268	19.9%	12.9%
	Adjustment	-2,123	-2,186	-2,379	-	-
	Operating profit total	3,940	4,251	4,888	24.1%	15.0%

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

## The number of prescriptions and unit price steadily rose and sales and profits increased both YoY and compared to the forecasts

### 2. Trends in the Dispensing Pharmacy business

In the Dispensing Pharmacy business, net sales are basically determined by the product of the number of prescriptions and the prescription unit price. In 1H FY3/18, the number of prescriptions increased by 6,752, or 6.9%, YoY. It rose only 1.2% on an existing-pharmacies basis, but the contribution from the pharmacies opened in the previous fiscal year that have become fully operational in this fiscal year raised the overall Company growth.

The prescription unit price increased 1.1% YoY to ¥14,628. The prescription unit price includes the dispensing technical fee as well as the drug costs, so it is especially susceptible to drugs with a high unit price. On excluding the effects of hepatitis C drug, which is typical of a drug with a high unit price, the prescription unit price increased 5.8% YoY to ¥14,121. One of the factors behind this was long-term prescriptions (a single prescription for medication for more than 30 days). Long-term prescriptions were expected to decline in the current 1H, so it was anticipated that the unit price would be unchanged YoY. But they did not decline as expected, and this was the major reason why the result exceeded the forecast.

#### YoY growth rates for the KPI in the Dispensing Pharmacy business by pharmacy openings

	1H FY3/18		
	Dispensing net sales	No. of prescriptions	Prescription unit price
Existing pharmacies	2.2%	1.2%	0.9%
Pharmacies opened in FY3/17	326.4%	228.1%	9.9%
All pharmacies	8.1%	6.9%	1.1%

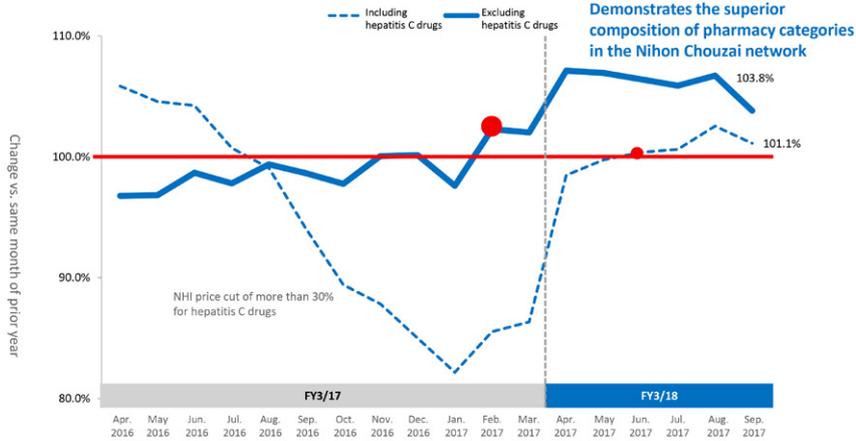
Source: Prepared by FISCO from the Company's financial results briefing materials

The net sales for hepatitis C drug, which can make the results difficult to understand, rapidly increased to ¥20.2bn in FY3/16, but then fell sharply to ¥10.7bn in FY3/17 from the decline in prescription volume and a more than 30% reduction in its drug price. The forecast for FY3/18 full year is net sales of ¥4.2bn (1H ¥2.3bn, 2H ¥1.9bn) due to a further decline in the prescription volume. As previously mentioned, the Q2 result was a ¥3.7bn decrease YoY to ¥3.4bn.

Looking at the (YoY) trend in the drug fee, after excluding hepatitis C drug, in the current Q2 it clearly trended at a level above 100%, with the main factor for this being the superiority of the Company's pharmacy structure. As of the end of 1H FY3/18, it had 568 pharmacies (dispensing pharmacies only), and of these, 72% were hospital-adjacent type pharmacies. In hospital-adjacent type pharmacies, there are many prescriptions of drugs with a comparatively high unit price and new drugs, which is related to the advanced medical treatment provided by university hospitals and other such medical facilities next to which they are located, which leads to a growth in the drug fee.

Results trends

Improvement in Unit Prices of Drugs

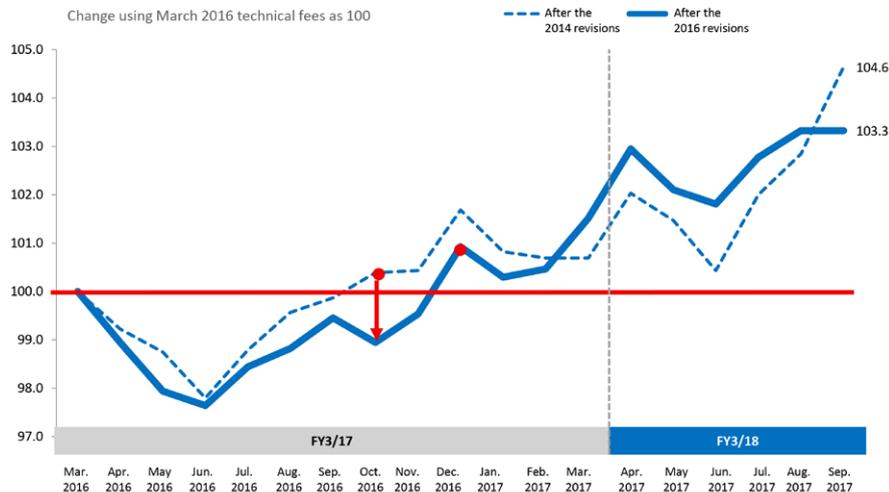


Note: In April 2016, the NHI price for hepatitis C drugs was cut by more than 30%; separate figures are shown above for total performance and performance excluding hepatitis C drugs.

Source: The Company's results briefing materials

Conversely, the technical fee unit price is continuing to steadily rise. Due to the April 2016 revisions to dispensing fees, it temporarily fell significantly YoY, but after returning to above the level of the previous fiscal year in December 2016, it has continued to steadily trend above the unit price in the previous fiscal year.

Progress with Increasing Technical Fees



Note: For reference, the improvement following the previous prescription dispensing fee revision in April 2014 is shown using March 2014 technical fees as 100.

Source: The Company's results briefing materials

The specific details of the Company's measures to improve the dispensing technical fee are as described in the previous report of June 14, 2017. The dispensing technical fee continues to be pushed-up by three improvements, to the basic dispensing fee, the standard dispensing incentive, and the generic pharmaceuticals dispensing system incentive. The usage rate of generic pharmaceuticals, which the Company particularly focuses on, reached 82.5% in the current 1H, exceeding the Japanese government's target of 80% by September 2020.

## **Focusing on sales measures that avoid price competition and prioritize profitability. The decline in operating profit was expected, mainly due to the increase in R&D costs.**

### **3. Trends in the Pharmaceutical Manufacturing and Sales business**

In FY3/18, the Company focused on escaping from the price competition for generic pharmaceuticals as its top priority. The intensification of price competition was the main reason for the deterioration in the results of this segment in FY3/17, so it has been working to improve this situation from the current fiscal period.

In the current 1H, while sales increased from the Company's own dispensing pharmacies, net sales from external sales that avoided price competition remained unchanged YoY. Segment net sales increased 2.6%, but were 4.8% below forecast from the effects of sales measures prioritizing profitability.

Operating profit decreased 46.4% YoY. The main reasons for this decline include the rise in R&D costs to expand the number of products manufactured in-house ahead of the start of phase 1 operations at the Tsukuba Plant No.2 in FY3/19, increased depreciation costs, and fall in gross margin due to price competition.

The result was 26.7% (¥135mn) above forecast. This was because one part of the R&D costs were postponed to the 2H. The postponed costs are expected to be recorded in the 2H, so profits will be pushed-down by this amount.

## **Demand is rising for the placement of highly skilled pharmacists**

### **4. Trends in the Medical Professional Staffing and Placement business**

In the dispensing-pharmacies industry, the level of demand for the staffing and placing of pharmacists continues to be high against the backdrop of the rise in the number of pharmacists required to respond to the Japanese government's system. In this sort of business environment, this segment's net sales increased both YoY and compared to the forecast.

A feature of the current 1H was that recruitment needs changed, from the previous need for staffing agencies to needs for placement agencies. It is considered that in the background to this is the desire to secure highly skilled pharmacists in order to respond to the Japanese government's "Vision of Pharmacies for Patients."

Operating profit and net sales both increased YoY and compared to the forecasts. The main factors included the effects of the higher sales, the reduction in the SG&A ratio from measures to control costs, and the growth in sales from the placement business, which has a high gross margin.

## A management strategy toward medium- to long-term growth

### Aiming for a structure of 50% of operating profit from the Dispensing Pharmacy business and 50% from the other businesses

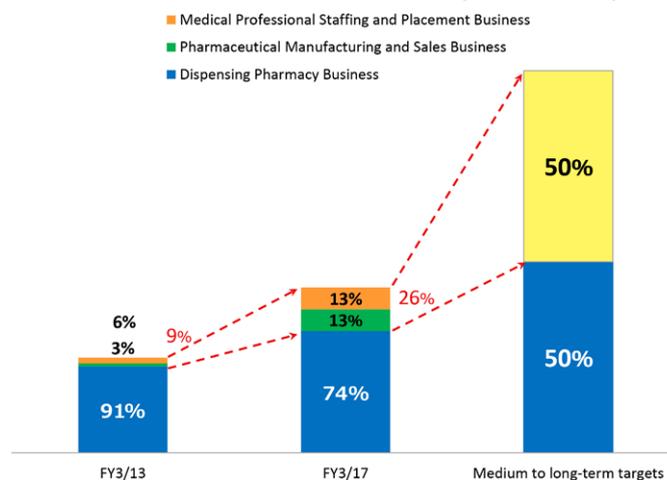
#### 1. A business portfolio targeting the medium- to long-term

The Company is developing three businesses, but currently the core Dispensing Pharmacy business makes up extremely high portion of the result. Based on the FY3/17 results, the Dispensing Pharmacy business provided 74% of operating profit, with the remainder being provided roughly equally by the Pharmaceutical Manufacturing and Sales business and the Medical Professional Staffing and Placement business.

The Company's present aim for its business portfolio is for a structure of 50% of operating profit from the Dispensing Pharmacy business and 50% as the total of the other business segments. As its core business, it will continue to work to expand the Dispensing Pharmacy business as it has done up to the present time, but it also planning to utilize the high profit margins of the other two business and increase the percentages they provide.

Toward this, an important point is that the Company has created clear growth strategies for each of the three businesses. Dispensing pharmacies and the manufacture and sales of pharmaceuticals are incorporated into the national health insurance system, and therefore it cannot avoid the effects of revisions to this system. But despite this constraint, it has established clear growth strategies for each of its businesses, which is leading to results growth, and this can be said to be a feature and the greatest strength of the Company

The business portfolio as seen from percentages of operating profit



Source: The Company's results briefing materials

## The growth strategy is on the twin axes of responding to the policies being promoted by the Japanese government and opening pharmacies

### 2. The Dispensing Pharmacy business growth strategy

#### (1) Overall image

The Dispensing Pharmacy business is incorporated into the national health insurance system, so the risk of it being affected the Japanese government's revisions to this system cannot be avoided. Based on this reality, the Company aims to minimize the effects of this systemic risk by achieving and realizing measures in advance of its industry peers for the policies being promoted by the Japanese government, and thereby growing the business. Currently, its measures to respond to the government's "Vision of Pharmacies for Patients" correspond to this.

In October 2015, the government announced its "Vision of Pharmacies for Patients." Within it, it cited health-support functions, advanced pharmaceutical administrative functions, a 24 hour response system, and home-care services as the functions required of next-generation pharmacies. Also, it called the next generation of pharmacies that are equipped with these functions as "health-support pharmacies" and "family pharmacists and family pharmacies." The Company is currently focusing all its efforts into responding to this vision.

In addition to responding to the system, the other important growth strategy in the Dispensing Pharmacy business is opening pharmacies. Of course increasing the number of pharmacies important, but even more than this, it is considered that opening them based on aspects such as their location (type), scale, and functions, is becoming more and more important.

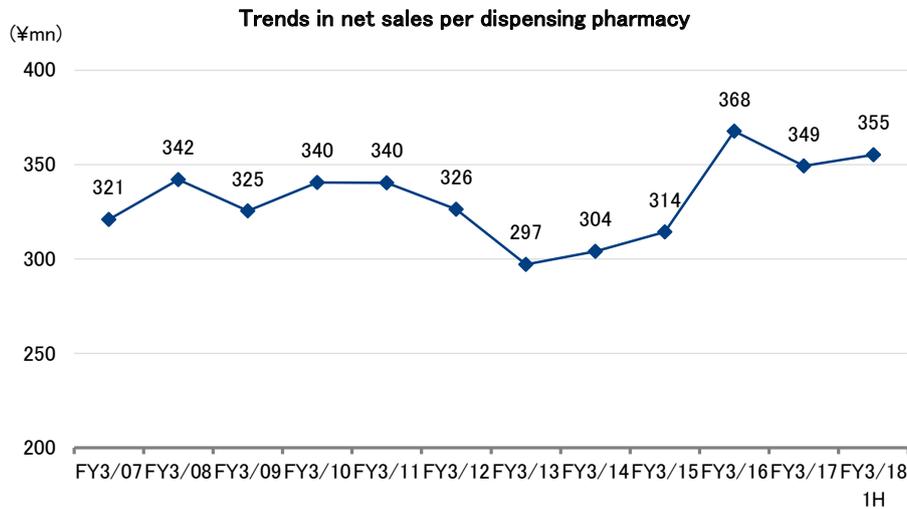
#### (2) Measures to open pharmacies

The Company does not intend to be beaten by other companies in terms of aspiration towards increasing the number of pharmacies in its network, but it does not necessarily give the greatest importance to pharmacy numbers. Its approach toward either growing organically through opening its own pharmacies or through M&A is as described in the Company profile section.

The main focus of the Company's pharmacy-opening strategy is on the type of pharmacy, location, and functions and features that would lead to an increase in net sales per pharmacy.

The KPI for the Company's pharmacy management is net sales per pharmacy (annual sales), which recently was over ¥350mn. With regards to the scale of newly opened pharmacies in the future, based on the current level of net sales from its existing pharmacies, the Company's management strategy is focused on how to accumulate sales starting from this level, which can also be said to be its standard when deciding whether to open a pharmacy.

A management strategy toward medium- to long-term growth

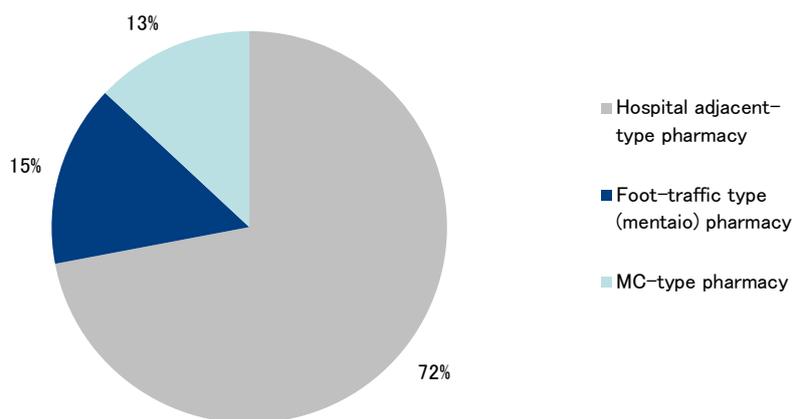


Note: net sales per pharmacy is calculated as Dispensing Pharmacy segment net sales ÷ the average number of dispensing pharmacies during the period. It includes product-sales pharmacies also. To calculate the full-year result, 1H FY3/18 result was doubled.

Source: Prepared by FISCO from Company materials

The pharmacies opened by the Company can be broadly divided into three types according to their location; the hospital-adjacent type (next to large hospitals), the MC-type (abbreviation of medical centers, located in medical malls, etc.), and foot-traffic type (locations with a lot of foot traffic, such as in front of train stations and in shopping districts). At the end of 1H FY3/18, 72% of the Company's pharmacies were the hospital-adjacent type, 13% were the MC-type, and 15% were the foot-traffic type.

**The Company's pharmacies portfolio (1H FY3/18 results)**

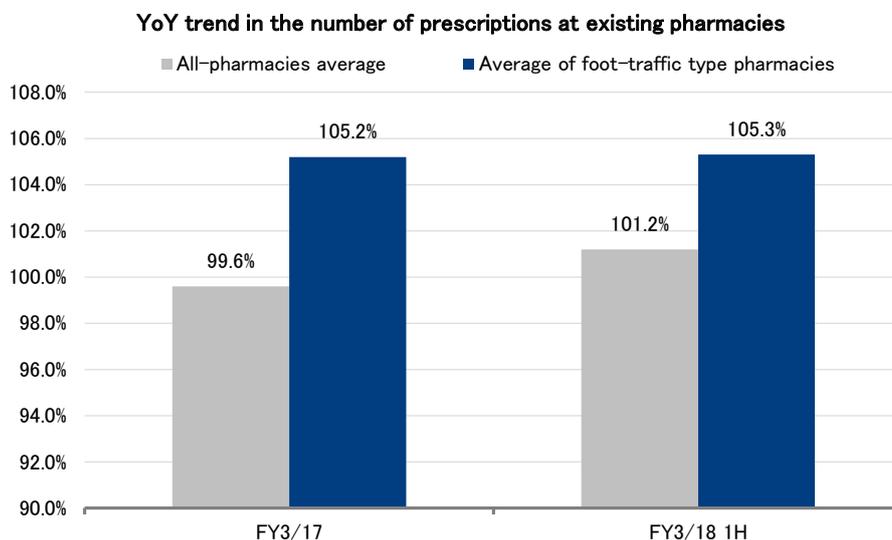


Source: Prepared by FISCO from the Company's results briefing materials

A management strategy toward medium- to long-term growth

Going forward, the policy for the opening of new pharmacies is to accelerate openings of the MC-type, the foot-traffic type, and the hybrid type, which combines the stability of the MC-type with the growth potential of the foot-traffic type. In metropolitan areas with high population density (1 city, 3 prefectures), the total of the MC-type and the foot-traffic type (including the hybrid-type) accounts for more than half of all pharmacies, at 52%. In the future, the Company plans to accelerate the opening of foot-traffic type (including the hybrid-type) toward creating the same structure of pharmacies in Osaka and Nagoya as in the Tokyo metropolitan area.

In the background to this Company policy for pharmacy openings is the high growth potential of the foot-traffic type pharmacies. The growth rate in the number of prescriptions in the foot-traffic type greatly exceeds the Company-wide average. Also, with regards to the number of prescriptions from foot-traffic type pharmacies that have been operating for at least 5 years, its average annual growth rate in the 5 years from FY3/12 to FY3/17 was 8.5% This can be said to show the long-term trend in the growth potential of the foot-traffic type pharmacies.



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

The differences in the type of pharmacies also leads to differences in their functions. The hospital-adjacent pharmacies work to utilize their positions next to university hospitals or regional core hospitals and to have advanced pharmaceutical administrative functions. Conversely, the foot-traffic type, the MC-type, and the hybrid-type incorporate functions such as home services with a focus on health-support functions, and the integrated and continuous management of medication information, and they aim to play a role as health-support pharmacies.

A management strategy toward medium- to long-term growth

### (3) Measures for health-support functions

The Company has a three-step measure for the themes of health-support functions and health-support pharmacies.

The first step was launched in FY3/17 for the preceding 3 pharmacies. The second step, in FY3/18, for the 2 or 3 pharmacies selected under the jurisdiction of each of the Company's support offices and by the end of the period, aiming to have 30 to 40 pharmacies with health-support functions. The third step, which will be from the next period and beyond, is to establish 100 to 150 pharmacies as health-support pharmacies, while looking at the characteristics of each region and other aspects.

As previously mentioned, in terms of the type of pharmacy, the plan is to mainly establish the foot-traffic type, the MC-type, and the hybrid-type pharmacies to be the health-support pharmacies.

### (4) Responses for family pharmacists and pharmacies

There have been no major changes to the Company's responses for family pharmacists and pharmacies that were described in detail in the previous report of June 14, 2017. The main point is that pharmacies that employ a family pharmacist are considered to be family pharmacies, so its measures for this are focused on training family pharmacists. As of November 2017, among all of the Company's pharmacists, 45.9% were family pharmacists. Also, out of all of its pharmacies, 89.6% employed a family pharmacist. At FISCO, our understanding is that the Company is currently leading the race in terms of responding to the requirements for family pharmacists and pharmacies.

### (5) Measures for advanced pharmaceutical administrative functions

There are 163 university hospitals nationwide, and the Company has opened pharmacies adjacent to 71, or approximately 40%, of them. It utilizes their locations and conducts measures for advanced pharmaceutical administrative functions within these hospital-adjacent pharmacies

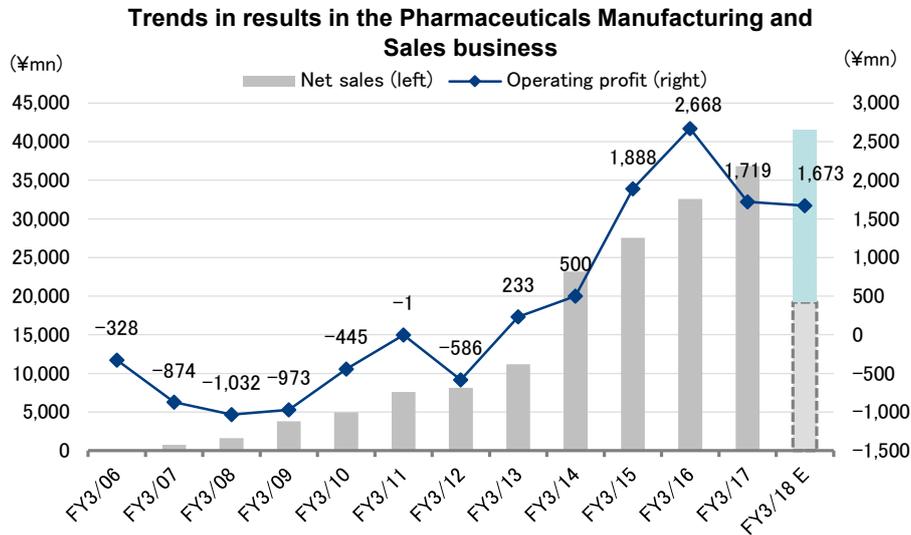
The specific content of the advanced pharmaceutical administrative functions includes a response for the side effects of anticancer drugs in collaboration with specialist agencies. Within the Company, 26 of its pharmacists (as of September 2017) have undergone training to acquire certification as "outpatient cancer treatment certified pharmacists." Also, with regards to training at hospitals, including at university hospitals, national public hospitals, and regional core hospitals, in order to respond to the needs for advanced medical care, as of October 2017, a total of 31 of the Company's pharmacists are receiving training at 10 medical facilities.

## The axis for the growth strategy is to expand pharmaceuticals manufactured in-house and to secure the production capacity for this

### 3. The Pharmaceutical Manufacturing and Sales business growth strategy

Since its establishment in 2005 as Nihon Generic, the results of the Company's Pharmaceutical Manufacturing and Sales business have steadily expanded, including from the acquisitions of Choseido Pharmaceutical in 2013 and the plant of Teva Pharma Japan (currently Takeda Teva Pharma) in 2015.

A management strategy toward medium- to long-term growth



Note: the broken line for FY3/18 is 1H result  
Source: Prepared by FISCO from the Company's financial results

In terms of the breakdown of pharmaceuticals sales by source, on the initial establishment of Nihon Generic, it started from sales of introduced products (products purchased from other companies), but gradually it increased the number of the Company's own approved pharmaceuticals and aimed to become a pharmaceuticals manufacturing company at an early stage. Until its own plant was completed, it outsourced production to other companies, but from October 2010, on the start of operations at the Nihon Generic Tsukuba Factory N Building, it started in-house production of its own approved products. Results are strongly evocative of FY3/13, when this production got on track and became profitable.

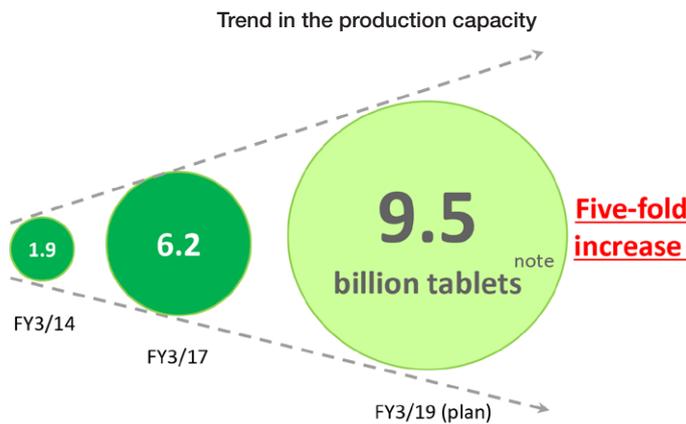
Net sales grew alongside the increase in the number of sales products, and profits also rapidly rose alongside the increase in the number of the Company Group's approved products within these products. As long as a manufacturing company possesses its own plants, it cannot secure sufficient profits unless it increases the number of in-house produced products and maintain high level of operation rates at its plants. On this point, the Company has increased the number of pharmaceuticals it produces in-house by 10 times, from 21 products in FY3/13 to 236 products in 1H FY3/18. Continuing this trend will be one important growth strategy in the future also.

On the other hand, in order to increase the number of its own approved and in-house produced pharmaceuticals, the Company needs to conduct "upfront investment" in the form of R&D costs and capital investment.

Up to the present time, R&D costs have consistently and continuously increased. In FY3/18, R&D costs (forecast amount) will be ¥3,116mn (up ¥727mn YOY) and are expected to have a significant impact on results. The upward trend is set to continue from the next fiscal period onwards also, but at FISCO, we think that in the medium term, it is possible that these costs will be fully absorbed by the expansion in production and sales.

A management strategy toward medium- to long-term growth

In terms of production capacity, construction has been progressed at the Tsukuba Plant No.2, and the plan is to complete the phase 1 facility, which will have an annual production capacity of 3.3 billion tablets, in April 2018. The Company has secured sites and has been constructing buildings at Tsukuba Plant No.2 premised on an annual production capacity of 10 billion tablets. It initially considered installing the machinery all at once up to phase 3, but in the end settled on gradually increasing the capacity. The capital investment amount for the land, building, and phase 1 portion of the machinery is ¥17.2bn, and these funds have already been allocated. Due to the capital investment, depreciation costs are forecast to increase by ¥700mn a year (calculated using the straight-line method).



Note: Expect a capacity increase of 3.3 billion tablets when the first phase of Tsukuba Plant No. 2 starts operating  
Source: The Company's results briefing materials

At FISCO, we have no major concerns about the growth strategy for the Pharmaceutical Manufacturing and Sales business. We think that the direction of the expansion of generic pharmaceuticals will not greatly change in the future, and in this situation, the Company is steadily increasing its own approved pharmaceuticals. It can be said that in response to this trend, management's decision to enhance the production structure was a natural one. The decision to introduce the machinery into Tsukuba Plant No.2 over three phases is thought to have greatly reduced the business risk. The Company has a Dispensing Pharmacy business, and one of its strengths is considered to be that it manufactures in-house one third of the pharmaceuticals that are handled and sold by the Pharmaceutical Manufacturing and Sales business, which is not something other generic pharmaceutical manufacturers are able to do. We shall first keep watch on the launch of operations at the Tsukuba Plant No.2.

## Aiming to accelerate growth from the highly-profitable placement business, which has great growth potential, in addition to its strength of staffing of pharmacists

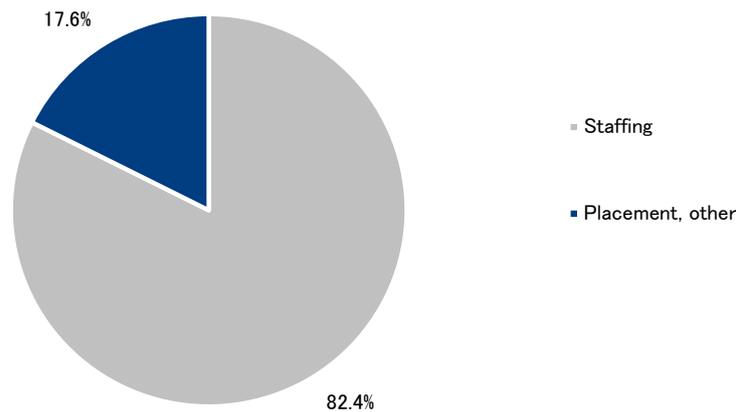
### 4. The Medical Professional Staffing and Placement business growth strategy

The Medical Professional Staffing and Placement business continues to realize stable expansion of business scale and a high profit margin. In the pharmacies industry, demand for pharmacists is increasing, including because a rise in the number of pharmacists per pharmacy will be required in an attempt to respond to the "Vision of Pharmacies for Patients" being promoted by the Japanese government.

A management strategy toward medium- to long-term growth

As the growth strategy for this segment, where continued growth is expected going forward, the Company is maintaining the stability of the staffing business, which has the characteristic of being a stock business, and strengthening the placement business, which is superior in terms of profitability and growth potential,

**Staffing and placement net sales rates (1H FY3/18 results)**



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

At FISCO, we think that strengthening the placement business is persuasive as the Company's growth strategy. The percentage of total net sales provided by the placement business is currently less than 18%, but it is growing at a remarkable rate. Looking at the number of people placed, in FY3/17 it increased 27.5% YoY to 1,447 people, but in the current 1H, it had already reached 903 people, which if converted to an annual rate would be close to 2,000 people. To respond to the "Vision of Pharmacies for Patients," needs are increasing not simply for qualified pharmacists, but also for human resources with advanced pharmaceutical knowledge and excellent communication skills, and it is considered that the trend toward acquiring such human resources through placements is strengthening.

It can be said that the key point that will decide whether or not the Company's growth strategy will succeed is whether it itself can secure pharmacists. On this point, at FISCO we think that the Company, which has high name recognition as a major dispensing pharmacy chain and an enhanced educational system for its recruits to acquire additional qualifications as pharmacists, is highly competitive when compared to its competitors that have entered the market from positions of being general human-resources services businesses.

On the other hand, one more growth strategy for the Company is aiming to expand the occupational categories it handles, such as to doctors and nurses. At FISCO, we think that if it can create synergies with its pharmacies, the Company may succeed with this aim, but that in the short term, because the name recognition and awareness of its competitors is overwhelmingly higher, it might be difficult to progress at the speed that it hopes for. We shall first be paying attention to the growth in the placement business for pharmacists.

## Business outlook

**Considering seasonality, the impression is that the Dispensing Pharmacy business 2H forecasts are conservative, so the focus will be on whether the results exceed them.**

### 1. FY3/18 outlook

For FY3/18, the Company is forecasting net sales of ¥234,697mn (up 5.0% YoY), operating profit of ¥10,105mn (up 18.6%), ordinary profit of ¥9,804mn (up 22.9%), and profit attributable to owners of parent of ¥5,639mn (up 21.6%). These values are unchanged from the initial forecasts.

#### Summary of FY3/18 outlook

	FY3/17			FY3/18				
	1H result	2H result	Full-year result	1H result	2H		Full year	
					Forecast	YoY	Forecast	YoY
Net sales	109,478	113,990	223,468	118,149	116,548	2.2%	234,697	5.0%
Operating profit	3,940	4,579	8,519	4,888	5,217	13.9%	10,105	18.6%
Ordinary profit	3,751	4,225	7,976	4,635	5,169	22.3%	9,804	22.9%
Profit attributable to owners of parent	2,339	2,299	4,638	2,805	2,834	23.3%	5,639	21.6%

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

In the Dispensing Pharmacy business, the forecast for 2H FY3/18 results are for sales and profits to decline compared to 1H results, with net sales of ¥96,670mn and operating profit of ¥5,402mn. At FISCO, we think that the business environment in 2H will basically be the same as in 1H. In this environment, the number of prescriptions is forecast to increase in 2H compared to in 1H due to seasonal factors. The prescription unit price is affected by the drug fee unit price, so an accurate forecast of it is difficult, but the technical fee unit price is expected to rise in 2H compared to 1H due to the continued moderate improvements in the various incentives. On considering these points, we think that the current Company forecasts, for declines in sales and profits compared to 1H results are conservative, and that it is possible that the results in the Dispensing Pharmacy business will exceed the Company forecasts.

In the Pharmaceutical Manufacturing and Sales business, the forecasts for 2H FY3/18 results are for higher sales and profits compared to 1H results, for net sales of ¥22,287mn and operating profit of ¥1,035mn. This would seem to be because the forecasts incorporate the rise in sales of pharmaceuticals in 2H due to seasonal factors. As previously mentioned, in 1H, one part of the R&D costs were postponed and they are expected to be recorded in 2H FY3/18. Therefore, it is possible that operating profit will be below forecast in 2H. But results are expected to be in line with the Company forecasts on a full fiscal year basis.

In the Medical Professional Staffing and Placement business, the forecasts are for the results in the current 2H to be basically unchanged from 1H results, for net sales of ¥6,007mn and operating profit of ¥988mn. There is no clear seasonality in this business, so at FISCO we think that forecasts of unchanged results between 1H and 2H are realistic.

## Business outlook

## Summary of FY3/18 outlook

(¥mn)

	FY3/17			FY3/18			
	1H result	2H result	Full-year result	1H result	2H		
					Forecast	YoY	
Net sales	Dispensing Pharmacy business	92,329	96,998	189,327	100,011	196,681	3.9%
	Pharmaceutical Manufacturing and Sales business	18,722	18,099	36,821	19,213	41,500	12.7%
	Medical Professional Staffing and Placement business	5,068	5,432	10,500	5,993	12,000	14.3%
	Before adjustment	116,119	120,530	236,649	125,217	250,181	5.7%
	Adjustment	-6,641	-6,539	-13,180	-7,068	-15,484	-
	Net sales total	109,478	113,990	223,468	118,149	234,697	5.0%
Operating profit	Dispensing Pharmacy business	4,064	5,496	9,560	5,617	11,019	15.3%
	Pharmaceutical Manufacturing and Sales business	1,191	528	1,719	638	1,673	-2.7%
	Medical Professional Staffing and Placement business	808	902	1,710	1,012	2,000	17.0%
	Before adjustment	6,063	6,926	12,989	7,268	14,692	13.1%
	Adjustment	-2,123	-2,347	-4,470	-2,379	-4,587	-
	Operating profit total	3,940	4,579	8,519	4,888	10,105	18.6%

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

## FY3/19 may see a levelling-off of results from the revisions to the drug prices and dispensing fees and the start of operations at the new plant

### 2. Prospects for FY3/19

FY3/19 is a revision year for drug prices and dispensing fees, which is expected to affect the results of the Dispensing Pharmacy business. In the Pharmaceutical Manufacturing and Sales business also, in addition to the revisions to drug prices, the new plant is scheduled to become operational, so the financial burden from depreciation and other costs will increase. Therefore, the results environment is forecast to be severe, particularly for profits, so it is highly possible that profits will temporarily level-off on a Company-wide basis.

There is no doubt that the effects on results of the revisions to the drug prices and dispensing fees will be negative, as the Japanese government's aim for them is to keep down the growth in medical costs. It is not possible to forecast to what extent they will be negative, as at the present time nobody knows what the content of the revisions will be. If based on past years, the direction of the revisions and their broad content should be announced by around December 2017. It is considered that the Company is waiting for the announcement on their content to consider their impact on its results from the next fiscal period and onwards.

At FISCO, we want to emphasize two points; that the Company is conducting management measures in line with the policies being promoted by the Japanese government (specifically, its promotion of the "Vision of Pharmacies for Patients,") and that the Company is implementing its measures at a speed that is greater than that required by the government. We expect that these measures, as described in the section on growth strategy, will in the medium- to long-term contribute to the Company being on the winning side on the arrival of the fully fledged industry reorganization, and that in the short term, they will contribute to making the negative effects of the revisions on the FY3/19 results relatively small in comparison to their effects on its industry peers.

**NIHON CHOUZAI Co., Ltd.** | 22-Jan.-2018  
 3341 Tokyo Stock Exchange First Section | <http://www.nicho.co.jp/eng/ir/index.html>

Business outlook

In the Pharmaceutical Manufacturing and Sales business, due to the start of operations at the new plant, depreciation costs will increase by around ¥700mn a year, and this will be the first effect on results. There is the question of how much topline growth the Company can achieve by utilizing the new plant, but at FISCO, we think that because it originally had plenty of facilities capacity, the sales growth rate will not greatly differ from the growth rate of the generic pharmaceuticals market as a whole. What we shall be focusing on is, therefore, is how high will be the productivity and production efficiency of the new plant compared to the existing plant after excluding depreciation costs, and to what extent will it be able to reduce costs. We shall also be watching developments from the viewpoints of the new plant's operating rate and the timing of the shift to full production.

**Income statement and the main indicators**

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18	
					1H	Full year E
Net sales	165,347	181,844	219,239	223,468	118,149	234,697
YoY	18.6%	10.0%	20.6%	1.9%	7.9%	5.0%
Gross profit	25,623	31,929	39,068	39,258	21,500	42,261
Gross profit margin	15.5%	17.6%	17.8%	17.6%	18.2%	18.0%
SG&A expenses	20,878	25,281	28,578	30,738	16,611	32,155
Ratio of SG&A expenses to net sales	12.6%	13.9%	13.0%	13.8%	14.1%	13.7%
Operating profit	4,744	6,647	10,489	8,519	4,888	10,105
YoY	46.2%	40.1%	57.8%	-18.8%	24.1%	18.6%
Operating profit margin	2.9%	3.7%	4.8%	3.8%	4.1%	4.3%
Ordinary profit	4,188	6,003	9,878	7,976	4,635	9,804
YoY	46.7%	43.3%	64.6%	-19.3%	23.6%	22.9%
Profit attributable to owners of parent	1,901	2,778	6,329	4,638	2,805	5,639
YoY	928.4%	46.1%	127.8%	-26.7%	19.9%	21.6%
EPS after adjustment for stock split (¥)	131.24	194.48	432.85	290.03	175.42	352.59
Dividend per share after adjustment for stock split (¥)	35.00	35.00	45.00	50.00	25.00	50.00
BPS after adjustment for stock split (¥)	1,090.63	1,257.60	2,030.22	2,278.70	-	-

Note: The Company conducted a two-for-one stock split on October 1, 2015.

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

**NIHON CHOUZAI Co., Ltd.** | **22-Jan.-2018**  
 3341 Tokyo Stock Exchange First Section | <http://www.nicho.co.jp/eng/ir/index.html>

Business outlook

Balance sheet

(¥mn)

	End of FY3/14	End of FY3/15	End of FY3/16	End of FY3/17	End of 1H FY3/18
<b>Current assets</b>	53,373	60,096	84,838	82,327	89,706
Cash and deposits	15,429	13,952	32,385	21,200	26,244
Accounts receivable, etc.	18,665	21,413	26,810	27,643	27,492
Inventories	16,396	21,066	22,016	29,514	32,317
<b>Fixed assets</b>	63,921	70,044	72,770	96,019	97,689
Tangible fixed assets	42,123	48,819	51,997	68,513	70,024
Intangible fixed assets	11,103	10,376	10,122	16,773	17,811
Investments, etc.	10,694	10,848	10,650	10,733	9,852
<b>Total assets</b>	117,295	130,141	157,609	178,347	187,395
<b>Current liabilities</b>	55,666	53,474	68,985	66,305	75,813
Accounts payable, etc.	28,963	33,392	44,653	41,033	46,410
Short-term debt, etc.	18,639	11,169	12,963	13,411	15,633
<b>Fixed liabilities</b>	45,779	59,031	56,151	75,595	72,957
Long-term debt	42,165	53,184	50,621	70,678	68,247
<b>Shareholders' equity</b>	15,845	17,515	32,507	36,345	38,750
Capital	3,953	3,953	3,953	3,953	3,953
Capital surplus	4,754	4,754	10,926	10,926	10,926
Retained earnings	9,310	11,868	17,672	21,511	23,917
Treasury stock	-2,171	-3,059	-44	-46	-46
<b>Total accumulated other comprehensive income</b>	3	119	-34	101	-126
<b>Total net assets</b>	15,849	17,635	32,473	36,447	38,623
<b>Total liabilities and net assets</b>	117,295	130,141	157,609	178,347	187,395

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

Cash flow statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18 1H
<b>Cash flow from operating activities</b>	6,243	5,831	19,327	-940	11,367
<b>Cash flow from investing activities</b>	-14,510	-8,437	-7,823	-28,444	-5,299
<b>Cash flow from financing activities</b>	8,782	1,422	7,031	18,205	-1,024
<b>Change in cash and deposits</b>	514	-1,183	18,535	-11,180	5,044
<b>Cash and deposits at start of fiscal year</b>	14,513	15,027	13,844	32,380	21,200
<b>Cash and deposits at end of fiscal year</b>	15,027	13,844	32,380	21,200	26,244

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

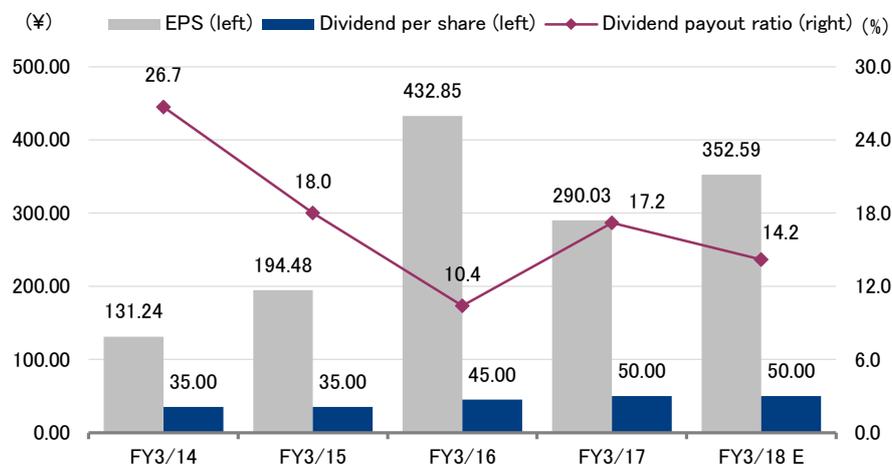
## Shareholder returns

### In a situation in which there are many growth-investment proposals, the dividend forecast for FY3/18 is ¥50, unchanged YoY

The Company's basic approach to shareholder returns is to pay dividends linked to business performance while ensuring it maintains the internal reserves necessary for growth.

For FY3/18, the Company has announced an annual dividend forecast of ¥50, the same as in the previous fiscal year (comprised of an interim dividend of ¥25 and a year-end dividend of ¥25). It paid an interim dividend of ¥25, as forecast. On a full-year basis, the forecast is for earnings per share (EPS) of ¥352.59 (up 21.6% YoY), and based on this, the dividend payout ratio will be 14.2%. The impression is that the dividend payout ratio is at a low level compared to the average of Japanese companies, but the Company is constructing a new pharmaceuticals manufacturing plant, and also in the Dispensing Pharmacy business, there is a strong demand for funds to invest in growth, including for M&A. Looking at the management track record in the past, at FISCO we think that rather than paying dividends at the present time, allocating funds to investment in growth will ultimately maximize returns for shareholders.

Trends in EPS, dividend per share and the dividend payout ratio



Note: The Company implemented a two-for-one stock split on October 1, 2015, and the EPS and the dividend per share in the graph take into account this stock split.

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

## ■ Information security

**In order to handle medical histories and other high-level personal information, it is focusing on the in-house development and management of information systems.**

In its Dispensing Pharmacy business, the Company handles a large amount of extremely important personal information, such as medical histories, and therefore it is highly aware of the importance of information security. In order to mitigate the risk of information leakages, it employs a large number of information-systems managers within the Company and it develops systems in-house. In addition, it does not outsource the administration and management of the customer data it accumulates and conducts this administration and management in-house, and it also has prepared systems to counter information leakages and cyber-attacks.



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