COMPANY RESEARCH AND ANALYSIS REPORT

NIHON CHOUZAI Co., Ltd.

3341

Tokyo Stock Exchange First Section

17-Jan.-2019

FISCO Ltd. Analyst
Hiroyuki Asakawa

FISCO Ltd.
http://www.fisco.co.jp

Index

Summary

Making steady progress in the medium- to long-term growth strategies of each business, despite the harsh environment

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. Although profits decreased greatly in 1H FY3/19, results were in line with the initial forecasts

In the 1H FY3/19 results, net sales were ¥118,694mn (up 0.5% year-on-year (YoY) and operating profit was ¥1,547mn (down 68.4%). The operating profit decrease rate was large because profits declined in all three businesses, but this result was in line with the initial forecast and was not a surprise. As is explained below, even in the harsh business environment, earnings are expected to recover from the 2H onwards, so this result is not considered to be a cause for concern. It would seem fully possible that the Company will achieve its full fiscal year results forecasts.

2. The Dispensing Pharmacy business overcame the severe revisions to achieve higher sales YoY

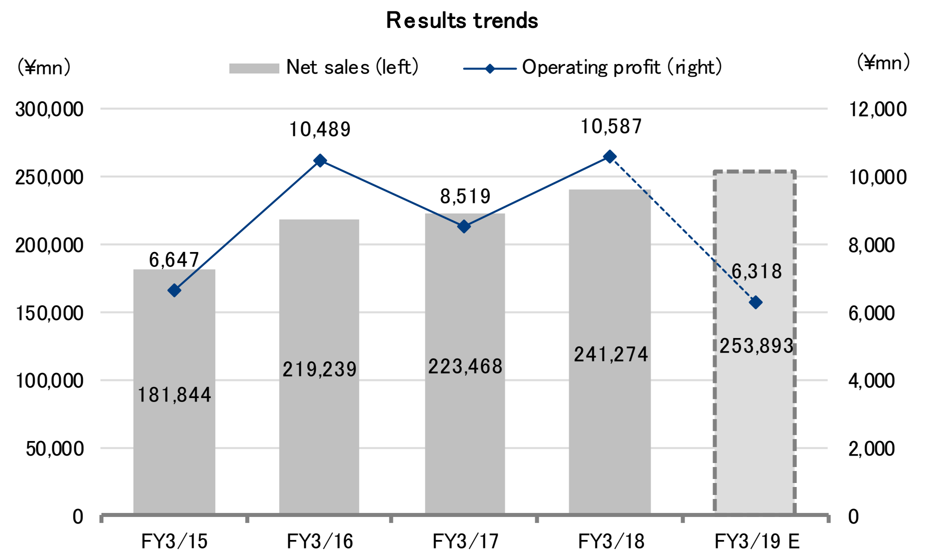
The contents of the 2018 revisions to drug prices and dispensing fees were severe for all the major pharmacy chains, including the Company, and sales of each of these companies declined YoY. But even in this sort of environment, the Company secured higher dispensing net sales. The difference between the Company and other companies can be seen from the differences in their decline rates of the prescription unit price. The reason for the Company’s slight decline in prescription unit price is considered to be the positive effect of the implemented measures; namely, opening pharmacies in line with the Japanese Government’s Vision of Pharmacies for Patients and promoting the use of generics, and opening highly efficient pharmacies, as symbolized by its high net sales per pharmacy. Going forward also, the Company intends to realize its medium- to long-term growth strategy by making steady progress in opening pharmacies that are considered to be ideal and expanding its network of pharmacies according to rules and principles.

3. The Pharmaceutical Manufacturing and Sales business overcame the forecast of a loss and secured profits. The degree of confidence in a V-shaped recovery is rising.

In the Pharmaceutical Manufacturing and Sales business, the Tsukuba Plant No.2 was completed on schedule in April 2018. The Company is aiming to grow earnings in the Pharmaceutical Manufacturing and Sales business in the future by utilizing this state-of-the-art plant to the greatest possible extent. There were concerns about the impact of the sudden increase in depreciation costs and other fixed costs in FY3/19, but even in the 1H results, which will be the harshest period, it secured an operating profit. What is particularly important is that the positive 1H results are rooted in structural factors, including the spread of the sales strategy of focusing on profitability and the measures for low cost operations at plants. This suggests that it is highly likely that the profitable structure will continue in 2H and beyond, and at FISCO, we think that the degree of confidence for achieving a V-shaped recovery in profits in FY3/20 has risen.

Key Points

- The Dispensing Pharmacy business is making steady progress in opening pharmacies that are considered to be ideal and expanding the pharmacy network in accordance with rules and principles
- Aiming to grow earnings in the Pharmaceutical Manufacturing and Sales business by thoroughly implementing measures to utilize the state-of-the-art Tsukuba Plant No.2 to the greatest possible extent
- The pharmacists business is working to shift "from staffing to placements" and to expand its business area into the placements of doctors and registered sales clerk



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

Results trends

Profits decreased significantly, as initially forecast, and the results contain elements that can be positively evaluated

1. Summary of the 1H FY3/19 results

For 1H FY3/19, profits decreased significantly despite a slight sales increase, with net sales of ¥118,694mn (up 0.5% YoY), operating profit of ¥1,547mn (down 68.4%), ordinary profit of ¥1,265mn (down 72.7%), and profit attributable to owners of parent of ¥744mn (down 73.4%).

Compared to the initial forecasts, net sales were 3.6% (¥4,452mn) below the initial forecast, but operating profit was as forecast.

Overview of 1H FY3/19 results

(¥mn)

	1H FY3/18 Results	1H FY3/19			
		Forecast	Results	YoY	Vs. forecast
Net sales	118,149	123,146	118,694	0.5%	-3.6%
Operating profit	4,888	1,549	1,547	-68.4%	-0.1%
Ordinary profit	4,635	1,409	1,265	-72.7%	-10.2%
Profit attributable to owners of parent	2,805	932	744	-73.4%	-20.1%

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

As profits decreased significantly in the 1H FY3/19 results, it would not be appropriate to describe them as "positive results." But even so, at FISCO we think that these results contain content that increases expectations for the future, for the following three reasons: 1) even in the harsh business environment, the Company achieved a YoY increase in sales for the business segments as a whole (in particular, it achieved a YoY increase in sales in the Dispensing Pharmacy business), 2) profits trended basically in line with the forecasts, and 3) the degree of confidence has risen for achieving the scenario of a V-shaped recovery in earnings in the Pharmaceutical Manufacturing and Sales business.

By business segment, in the Dispensing Pharmacy business, which was affected by the revisions to the drug prices and dispensing fees, both net sales and operating profit were below forecast. However, in the Pharmaceutical Manufacturing and Sales business, while net sales were below forecast, in profits, it recorded an operating profit despite the initial forecast of an operating loss, and this completely offset the other business segments' lower results below forecast. In the Medical Professional Staffing and Placement business, net sales trended basically as forecast, but profits were below forecast, mainly due to the occurrence of upfront costs.

Breakdown by business segment for 1H FY3/19

(¥mn)

		1H FY3/18 Results	1H FY3/19			
			Forecast	Results	YoY	Vs. forecast
Net sales	Dispensing Pharmacy business	100,011	103,332	101,054	1.0%	-2.2%
	Pharmaceutical Manufacturing and Sales business	19,213	20,634	19,431	1.1%	-5.8%
	Medical Professional Staffing and Placement business	5,993	6,415	6,351	6.0%	-1.0%
	Before adjustment	125,217	130,381	126,837	1.3%	-2.7%
	Adjustment	-7,068	-7,235	-8,143	-	-
	Net sales total	118,149	123,146	118,694	0.5%	-3.6%
Operating profit	Dispensing Pharmacy business	5,617	3,745	3,197	-43.1%	-14.6%
	Pharmaceutical Manufacturing and Sales business	638	-465	344	-46.1%	-
	Medical Professional Staffing and Placement business	1,012	846	630	-37.7%	-25.5%
	Before adjustment	7,268	4,126	4,172	-42.6%	1.1%
	Adjustment	-2,379	-2,577	-2,625	-	-
	Operating profit total	4,888	1,549	1,547	-68.4%	-0.1%

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

Succeeded in opening highly profitable, highly functional pharmacies and secured a YoY increase in sales by minimizing the decline in the prescription unit price

2. Dispensing Pharmacy business

Dispensing Pharmacy business profit and loss statement

(¥mn)

	1H FY3/18 Results	1H FY3/19 Results	FY3/19			
			1H Plan	1H Results	YoY	Vs. plan
Net sales	92,329	100,011	103,332	101,054	1,043	-2,278
Cost of sales	78,825	84,007	88,628	86,856	2,849	-1,772
Gross profit	13,504	16,003	14,703	14,197	-1,806	-506
Gross profit margin	14.6%	16.0%	14.2%	14.0%	-	-
SG&A expenses	9,439	10,386	10,957	10,999	613	42
Ratio of SG&A expenses to net sales	10.2%	10.4%	10.6%	10.9%	-	-
Operating profit	4,064	5,617	3,745	3,197	-2,419	-548
Operating profit margin	4.4%	5.6%	3.6%	3.2%	-	-
Number of dispensing pharmacy at the end of the period	545	569	595	596	27	1
Net sales per dispensing pharmacy	171	176	173	171	-5	-2

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

In the Dispensing Pharmacy business in 1H FY3/19, sales increased slightly but profits decreased greatly, with net sales of ¥101,054mn (up 1.0% YoY) and operating profit of ¥3,197mn (down 43.1%). Compared to the initial forecasts, both net sales and operating profit were below forecast.

During the 1H FY3/19 period, the Company newly opened 19 pharmacies (of which, 4 pharmacies were from an M&A) and closed 8 pharmacies. As a result, the number of pharmacies at the end of the period was 596 pharmacies (includes 3 product-sales pharmacies). Compared to1 year ago, this is an increase of 27 pharmacies and exceeds the target for pharmacy openings by 1 pharmacy. Net sales per pharmacy were ¥171mn (¥342mn when converted to an annual amount), and although this a decline of ¥5mn on the result of ¥176mn in the same period in the previous fiscal year, there has been no change to the fact that, the same as in the past, this amount is overwhelmingly higher than that of the Company's industry peers.

In the Dispensing Pharmacy business, net sales are calculated by multiplying the product of the prescription unit price and the number of prescriptions. In 1H FY3/19, the prescription unit price was ¥14,358, down 1.8% YoY, but the number of prescriptions increased 2.6%. Looking at the breakdown by pharmacy-opening period, for the core, existing pharmacies, the number of prescriptions was negative, down 1.0%. However, the Company kept down the extent of the decline in the prescription unit price to just 0.6%, which can be evaluated as an excellent effort when considering the severity of the revisions. It seems that the reason for the decline in the number of prescriptions was from the major decrease due to the impact of the natural disasters, particularly the earthquake and typhoons in September. As a result of these events, existing pharmacies' dispensing net sales declined 1.6%. But an increase in dispensing net sales was secured on an all-pharmacies basis, up 0.7%, from the contributions of the pharmacies opened in the previous year (the net sales of the Dispensing Pharmacy business segment, which includes product sales, rose 1.0%).

In the comparison with the initial forecasts, as was previously stated at FISCO we estimate that the prescription unit price was a positive result, higher than the value the Company had expected. On the other hand, for the number of prescriptions, on back calculating from the Company's initial net sales forecast of a 3.3% increase YoY, we estimate that it expected an increase rate of 5% to 6% on an all-pharmacies basis. Therefore, it would seem that in 1H FY3/19, the number of prescriptions was below forecast. As previously mentioned, it is thought that this was due to the major impact of the weather and the natural disasters.

Even though profits decreased significantly YoY in 1H FY3/19, at FISCO our opinion is that the results fully show the Company's strength when compared to its industry peers. As previously stated, the Company was one of the very few companies that were able to secure a YoY increase in sales. On an all-pharmacies basis, the number of prescriptions increased YoY for all companies, and in the background to this is their active opening of new pharmacies. But on the other hand, there were differences between the companies in terms of the extent of the decline of the prescription unit price, and it was this difference that determined which companies' sales increased or decreased YoY. The reason why the extent of the decline in the Company's the prescription unit price was small is explained in detail below. But at FISCO, we think that as a result of its measures – of opening pharmacies in line with the Japanese Government's Vision of Pharmacies for Patients and promoting the use of generics, and opening highly efficient pharmacies, as symbolized by the high net sales per pharmacy – the Company was able to minimize the impact of the revisions to the drug prices and dispensing fees and to secure higher sales YoY. In this sense, we think that the fact the Company secured an increase in sales in 1H FY3/19, even though it was only a 1.0% increase, is extremely significant.

Results for the number of prescriptions and the prescription unit price

	1H FY3/19	
	Actual number	YoY
No. of prescriptions (thousands)	6,927	2.6%
Prescription unit price (¥)	14,358	-1.8%

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

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

	1H FY3/19		
	Dispensing net sales	No. of prescriptions	Prescription unit price
Existing pharmacies	-1.6%	-1.0%	-0.6%
Pharmacies opened in FY3/17	202.8%	316.9%	-27.4%
All pharmacies	0.7%	2.6%	-1.8%

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

In the YoY comparison for profits, as described above, on the one hand the growth in net sales was only an increase of 1.0% (¥1,043mn), but on the other hand, cost of sales rose ¥2,849mn, as purchase price negotiations became tougher based on the Revised Distribution Guidelines*. As a result, gross profit declined ¥1,806mn. SG&A expenses increased ¥613mn, mainly for personnel expenses due to the continued expansion of human resources from a long-term perspective. As a result of these factors, operating profit declined ¥2,419mn (43.1%).

* The official name is Guidelines for Distributors for the Improvement of Medicinal Pharmaceuticals Distribution. Up to the present time, various measures to improve distribution have been carried out based on the official prices prescribed by the drug price standards, toward the goal of achieving the transparent formation of actual market prices. However, a characteristic of the Revised Distribution Guidelines is that it clearly indicate that the government will lead the measures to promote improved distribution (previously, measures were promoted by the distributors). In the background to this is its intention to establish an environment in which it can survey and revise drug prices every year (currently, they are revised once every two years).

Compared to the initial forecasts, net sales were ¥2,278mn (2.2%) below forecast. Alongside this, cost of sales also declined ¥1,772mn, but it was not enough to cover for all of the part below forecast, and gross profit was ¥506mn below the initial forecast. At FISCO, we think the reason why it could not cover for it all (in other words, an unexpected factor), was the significant rise in the cost of pharmaceuticals due to the Revised Distribution Guidelines. SG&A expenses were basically in line with the forecast (an increase of ¥42mn on the forecast), but in the end, operating profit was ¥548mn below the initial forecast.

Supported by the Revised Distribution Guidelines, achieved profitability in 1H FY3/19 despite concerns that it would record a loss, due to the plants' thorough implementation of low-cost operations

3. Pharmaceutical Manufacturing and Sales business

Pharmaceutical Manufacturing and Sales business profit and loss statement

(¥mn)

	1H FY3/18 Results	1H FY3/19 Results	FY3/19			
			1H Plan	1H Results	YoY	Vs. plan
Net sales	18,722	19,213	20,634	19,431	218	-1,203
Cost of sales	15,307	15,965	18,380	16,444	479	-1,936
Gross profit	3,414	3,248	2,253	2,986	-261	733
Gross profit margin	18.2%	16.9%	10.9%	15.4%	-	-
SG&A expenses	2,223	2,609	2,718	2,642	32	-76
Ratio of SG&A expenses to net sales	11.9%	13.6%	13.2%	13.6%	-	-
Operating profit	1,191	638	-465	344	-293	809
Operating profit margin	6.4%	3.3%	-2.3%	1.8%	-	-

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

In the Pharmaceutical Manufacturing and Sales business in 1H FY3/19, net sales were ¥19,431mn (up 1.1% YoY) and operating profit was ¥344mn (down 46.1%). Compared to the initial forecasts, net sales were 5.8% (¥1,203mn) below forecast, but operating profit was ¥809mn above the initial forecast of an operating loss of ¥465mn.

Net sales in this segment are comprised of two types of sales; internal sales to the Company's own dispensing pharmacy chain, and external sales. Within them, internal net sales rose YoY due to the increase in sales on a volume basis in the Dispensing Pharmacy business, and also the effects of the new pharmacy openings. Conversely, external net sales declined 7.6% YoY as a result of the continuation of the sales strategy the Company has been advancing since the past, of focusing on profitability.

Details of net sales in the Pharmaceutical Manufacturing and Sales business

(¥mn)

	1H FY3/18 Results	1H FY3/19	
		Results	YoY
External net sales	12,370	11,428	-7.6%
Internal net sales	6,842	8,003	17.0%
Net sales total	19,213	19,431	1.1%

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

In profits, although net sales increased ¥218mn compared to the same period in the previous fiscal year, cost of sales rose ¥479mn, so gross profit declined ¥261mn. SG&A expenses increased ¥32mn, and therefore operating profit declined ¥293mn. The main reason for the increase in cost of sales was the rise in costs, including depreciation costs, following the start of operations of the Tsukuba Plant No.2.

However, compared to the initial forecasts, while net sales were ¥1,203mn below forecast, cost of sales decreased ¥1,936mn. Therefore, compared to the initial forecast, gross profit was ¥733mn above forecast. SG&A expenses were also ¥76mn below the initial forecast, and as a result, operating profit was ¥809mn above the initial forecast, and profits were secured despite the forecast of a loss.

The biggest reason why gross profit grew compared to the forecast was the sales strategy that the Company is advancing, of focusing on profitability. Specifically, it conducts sales at appropriate prices in transactions with wholesalers, which is a point that the Company has focused on since the past. In 1H FY3/19, this was supported by the previously mentioned Revised Distribution Guidelines and this strategy spread greatly. Moreover, the thorough reduction of expenses at plant work sites, such as in the production process and for equipment maintenance, also contributed significantly. The Company has a comparatively short history as a pharmaceutical manufacturer, but in the 8 years since the start of operations at the Tsukuba Plant in October 2010, it has accumulated expertise in managing production and expenses as a generics manufacturer, and it would seem that it has acquired cost-control capabilities. Due to this factor, the gross profit margin was 15.4% compared to the initial forecast of 10.9%, improving to a level close to that in the previous fiscal year, which in turn led to profits greatly exceeding the forecast.

At FISCO, we think that 1H FY3/19 was one turning point in the pharmaceuticals manufacturing business. One reason for this is the Revised Distribution Guidelines. The Guidelines clearly state that the “government will take the lead,” and it seems that the ability of the Guidelines to spread across the industry is greater than the similar guidelines published in the past. In light of the current business practices and transaction conditions, manufacturers are expected to benefit from the Guidelines, at least initially. The fact that the Company’s results exceeded the forecasts can be said to be a manifestation of this. Major dispensing pharmacy companies have been implementing a variety of measures in response to the Revised Pharmaceutical Affairs Law of 2005, but only the Company selected vertical development, of manufacturing and selling pharmaceuticals. At FISCO we think the significance of the Company having the Pharmaceutical Manufacturing and Sales business has further increased due to the current Revised Distribution Guidelines. One more reason is that FY3/19, which is the first fiscal year of operations for the Tsukuba Plant No.2., will be the most severe year for profits, but even so the outlook is that it will get through this year with an operating profit. The Company had projected operating profit to smoothly recover from loss to profits in FY3/19 (a loss in the 1H, a recovery to profits in the 2H), but having secured an operating profit in 1H, at FISCO, we think the degree of confidence in it realizing a V-shaped recovery in FY3/20 has risen greatly.

Net sales steadily increased, due to the abundant demand. Operating profit declined because of the rise in staffing cost prices and the upfront investment in the doctor placements business

4. Medical Professional Staffing and Placement business

Medical Professional Staffing and Placement business profit and loss statement

(¥mn)

	1H FY3/18 Results	1H FY3/19 Results	FY3/19			
			1H Plan	1H Results	YoY	Vs. plan
Net sales	5,068	5,993	6,415	6,351	358	-64
Cost of sales	3,053	3,634	3,823	3,969	335	146
Gross profit	2,014	2,359	2,592	2,382	22	-210
Gross profit margin	39.7%	39.4%	40.4%	37.5%	-	-
SG&A expenses	1,205	1,346	1,745	1,751	404	6
Ratio of SG&A expenses to net sales	23.8%	22.5%	27.2%	27.6%	-	-
Operating profit	808	1,012	846	630	-381	-216
Operating profit margin	16.0%	16.9%	13.2%	9.9%	-	-

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

In the Medical Professional Staffing and Placement business in 1H FY3/19, net sales were ¥6,351mn (up 6.0% YoY), while operating profit was ¥630mn (down 37.7%), so although sales increased, profits decreased significantly. Compared to the forecasts, net sales were basically in line with the forecast, at 1.0% (¥64mn) below forecast, but operating profit was ¥216mn below the initial forecast of ¥846mn.

In an environment in which there is a chronic shortage of pharmacists in the industry as a whole, net sales steadily expanded, mainly in the staffing business. In addition, sales steadily grew in the new business, of the doctor placements business, including from the effects of the establishment of bases and the increase in personnel.

In profits, the gross profit margin declined from 39.4% in the same period in the previous fiscal year to 37.5%. As a result, even though net sales increased ¥358mn YoY, gross profit rose only ¥22mn. SG&A expenses grew substantially, by ¥404mn, and therefore operating profit declined ¥381mn. The decline in the gross profit margin was due to the rise in staffing costs. The shortage of pharmacists also affects the Company's staffing business, and pharmacist staffing costs are rising. Also, the higher SG&A expenses were because of the establishment of bases and the increase in personnel in the doctor placement business

Compared to the initial forecasts, net sales were slightly below forecast and in addition, costs of sales increased more than forecast, and therefore operating profit did not achieve its initial forecast. The factor behind the rise in cost of sales was the increase in pharmacist staffing costs mentioned above.

Medium- to long- term growth strategy and its progress

The Company announced its Long-term Vision toward 2030 in April 2018. In terms of its content, it describes how the Company will overcome the changes in the social structure within Japan (including the progress toward an ultra-aging society) and the increasing demands to reduce medical costs, and also the environmental changes, such as the advanced functions being required of pharmacies and the weeding-out of dispensing pharmacies. It states that, starting with the Dispensing Pharmacy business, it will dramatically expand each business toward achieving a corporate scale of ¥1tn in net sales by 2030. (Please refer to the report dated July 9, 2018, for details on Long-term Vision toward 2030)

There were no shortcuts on the road to it arriving at its current position, and it was the result of the Company's accumulation of steadfast efforts to steadily make thick its business core, of its three business segments. As previously stated, the 1H FY3/19 results values show an increase in sales and a substantial decrease in profits. But from this content, we can confirm that steady progress is being made in the measures for medium- to long-term growth for each business segment. The progress being made in the growth strategies of each business segment are described below.

Making steady progress in opening pharmacies considered to be ideal and expanding the pharmacy network according to rules and principles

1. Progress made in the Dispensing Pharmacy business growth strategy

(1) Overall image of the growth strategy

The Dispensing Pharmacy business is a business within the framework of the government's health insurance system, so a major assumption is that it will respond to this system. As mentioned repeatedly up to this point, the government is advancing various policies for dispensing pharmacies in accordance with its Vision of Pharmacies for Patients that it announced in October 2015. These polices are being progressed incrementally toward realizing the vision of pharmacies it is aiming for. Moreover, in the 2018 revisions, the government also made more clear what it expects from pharmacies, and at the same time, it further raised the hurdles in terms of the organizational and management strength that it requires from dispensing pharmacy business operators (for the details of the 2018 revisions, please refer to the report dated July 9, 2018).

But even in this sort of business environment, there has been absolutely no change to the Company's growth strategy; namely, expanding share through surviving and winning the competition. It can be said that surviving and winning the competition and expanding share are universal themes that all of the major dispensing pharmacy chains are aiming for. So what is important is whether they have specific methodologies for them and how they will realize the share expansion through surviving and winning the competition.

In the final analysis, these methodologies can be arranged into two questions; 1) in what ways are companies opening pharmacies? and 2) how are they expanding their pharmacy network? The guidelines for opening pharmacies were presented in the Vision of Pharmacies for Patients, and the Company is aiming to go ahead of its industry peers and realize the opening of pharmacies in line with this vision. The methodologies for expanding the pharmacy network can be broadly divided into two; opening pharmacies by the company itself (organic) or by M&A, and they are frequently discussed from the viewpoint of which is effective. However, the Company places the focus on thoroughly opening pharmacies in line with the broad principle of the type of pharmacies it will open, and the Company considers the method as only the outcome of this process.

(2) The approach to opening pharmacies and the progress made

As mentioned above, the greatest base for the Company's pharmacy strategy is opening pharmacies in accordance with the Vision of Pharmacies for Patients. Within its Vision of Pharmacies for Patients, the government requires pharmacies three broad functions; 1) health-support functions, 2) advanced pharmaceutical management functions, and 3) family pharmacist and pharmacy functions. 1) means being able to contribute to the prevention of diseases and health support, and specifically, the roles expected of pharmacies include a health consultation reception desk and consultation recommendations, and medical-facility placements. The government's expectations for 2) are providing support, such as for responding to the side effects of anti-cancer drugs and the choice of HIV drug, while cooperating with specialist organizations. For 3), it expects, medicine-administration information to be ascertained in an integrated and continuous manner, a 24-hour response and at-home medical care services, and coordination with medical and other facilities.

In order to respond to the Vision of Pharmacies for Patients and to realize its own aim of providing high quality medical services, the Company is broadly developing two types of pharmacies; hospital-adjacent pharmacies and hybrid-type pharmacies. Hospital-adjacent pharmacies are the type it develops in locations adjacent to university hospitals and to major hospitals that are the core medical facility in their region. On the other hand, hybrid-type pharmacies can be said to combine the Company's former types, of foot-traffic type pharmacies (pharmacies located in places where many people walk by and that handle a wide range of prescriptions from multiple, unspecified medical facilities) and MC (medical mall) type pharmacies (pharmacies located in medical malls that mainly handle prescriptions from specified medical facilities).

The difference between the hospital-adjacent type and the hybrid type is in relation to their locations, but they are also different in terms of their additional functions. The hospital-adjacent type is expected to have advanced pharmaceutical management functions that it coordinates with university hospitals or other medical facilities. On the other hand, the hybrid type is expected to have health-support functions that contribute to the improvement and promotion of health on a daily basis by utilizing their location, of being close to the sites where people live their lives. Also, as the basic functions shared by both types, they are equipped with family pharmacist and dispensing pharmacy functions, and at-home medical care functions.

A high percentage of the Company's pharmacies are hospital-adjacent pharmacies, at 71% (as of the end of September 2018, based on the total number of pharmacies), and it has developed its pharmacy network with this point as a feature and strength. But in recent years, it has been focusing on opening hybrid-type pharmacies. As of the end of September 2018, the percentage of hybrid-type pharmacies in metropolitan Tokyo and its three adjacent prefectures was more than half, at 54%. The percentage of the hybrid type on an all-pharmacies basis is still low, at 29%. But in the future, it will accelerate the opening of these pharmacies, mainly in urban areas, such as metropolitan Tokyo, Osaka, and Nagoya, and it is aiming for them to constitute half of all pharmacies in the medium term.

The pharmacy-opening strategy based on the functional differentiation of the Company's pharmacies

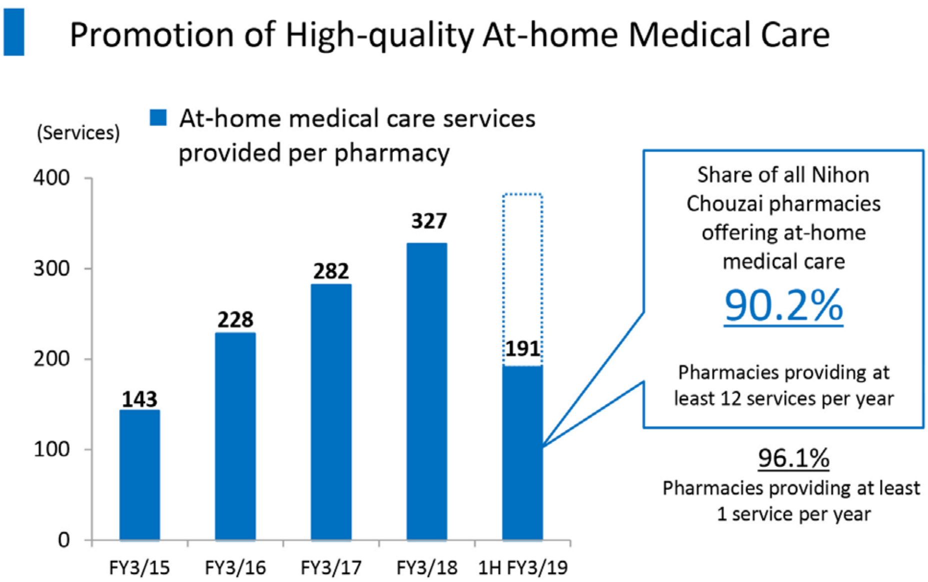
			Hybrid-type pharmacies	Hospital adjacent-type pharmacy
Function	Basic function		Family pharmacist/pharmacy function and at-home medical care function	
	Additional function		Health-support function	Advanced pharmaceutical management function
Store opening format			Organic growth	Organic growth, M&A
% of pharmacies	All pharmacies	As of the end of September 2018	29%	71%
		Target	50%	50%
	Metropolitan Tokyo and three adjacent prefectures (as of the end of September 2018)		54%	46%

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

The measures to develop these types of functionally differentiated pharmacies are closely related to net sales per pharmacy, which the Company prioritizes as a KPI (Key Performance Indicator) for its pharmacy management. For example, it is close to impossible to be able to realize at-home medical care functions with one pharmacist per pharmacy. Also, as there is a limit of 40 prescriptions for the number of prescriptions per day per pharmacist, whether at the hospital-adjacent type or at the hybrid type, naturally this tends towards pharmacies of a certain scale in which there are multiple pharmacists. When pharmacies are efficiently managed in this way (in other words, when there is this number of prescriptions), net sales also naturally increase. Opening pharmacies that are considered to be ideal and net sales per pharmacy have something like a chicken-and-egg relationship. But on looking at the Company's philosophy for opening pharmacies and its actual behavior, at FISCO we think that the relationship is that the opening of the pharmacies comes first, and that the high-level net sales per pharmacy are as a result of this.

Alongside the progress made in developing functionally differentiated pharmacies, the Company is also making steady progress in providing high quality medical services. In terms of its specific provision of health-support functions, it is progressing the establishment of Health Check-up Stations (the Company's registered trade mark), which, for example, provide health consultations and nutrition guidance by a registered nutritionist. The number of pharmacies with Health Check-up Station is steadily growing, from 3 pharmacies at the end of March 2017 to 52 pharmacies at the end of October 2018, a year and a half later. Also, the percentage of pharmacies with a family pharmacist has risen to as high as 81.9% (as of October 16, 2018). In addition, the number of at-home medical care services provided per pharmacy is also steadily rising and had reached 191 in 1H FY3/19 (382 when converted to an annual basis).

Trend in the number of at-home medical care services provided per pharmacy



Source: The Company's results briefing materials

The Company's new measures include the following: 1) the acquisition of business registration certification as pharmacies providing remote medicine-administration guidance at four pharmacies in Fukuoka City, 2) the start of a pharmacist staffing service for Pharmacists on Temporary Leave for Child Birth or Child Care, and 3) the launch of a business for creation of regional formularies. It has positioned 1) as upfront investment (the accumulation of expertise) for the use of ICT and pharmacy/medical institution alliances for health care . The aim of 2) is that it will lead to the deepening of coordination with hospitals and the strengthening of advanced pharmaceutical management functions. For 3), it is aiming for regional contribution in operations to support the creation of regional formularies* to slow the growth of health care expenses.

* The use of formularies are indicated in the Guidelines for the Most Effective and Economic Use of Pharmaceuticals for Patients, and it is the standardized management method for the proper use of pharmaceuticals that has been established in Europe and the United States.

(3) Pharmacy openings

Based on the previously described pharmacy-opening strategy, in 1H FY3/19, the Company newly opened 19 pharmacies. Breaking this down, 15 pharmacies were through organic openings and 4 pharmacies were through an M&A. Also, the breakdown of the 19 pharmacies by type and business form were 8 hospital-adjacent types (including within hospital premises), 10 hybrid types, and 1 product-sales pharmacy (located within a hospital premises). One of the Company's guidelines is to open 50 new pharmacies per year, so in light of this, it can be said to have made steady progress in opening pharmacies in 1H FY3/19.

Pharmacy transfer conditions in 1H FY3/19

	1H FY3/19				
	End of FY3/18	Opened		Closed	End of 1H FY3/19
Dispensing pharmacy	583	Organic growth	14	8	593
		M&A	4		
Stall pharmacy	2	1		0	3
Total	585	19		8	596

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

The Company has not changed its previous stance on M&A. Specifically, it decides on the advantages and disadvantages of an M&A while carefully examining whether the proposal meets its "Nihon Chouzai standards,"as typified by the net sales per pharmacy standard, and it does not conduct an M&A simply as a means of increasing the number of pharmacies. The Company has tended to be evaluated as being negative toward M&A. But at FISCO, we think that this evaluation is simply based on the number of pharmacies it has acquired through M&A, and that it cannot necessarily said to be accurate as an evaluation of the Company's approach.

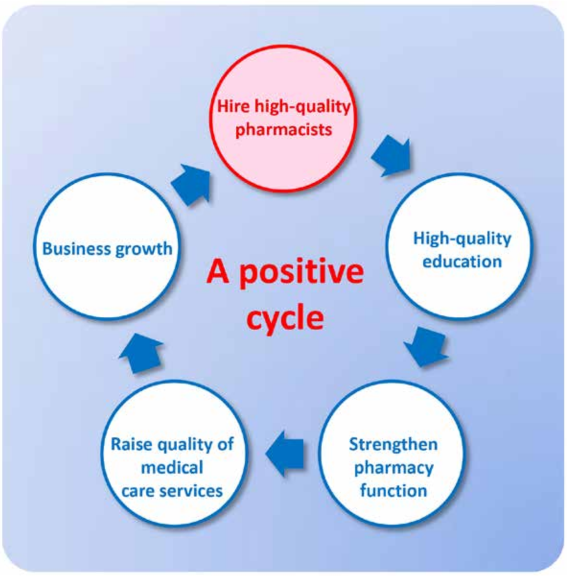
In terms of its awareness of the M&A environment, although recently the number of proposals has increased, the Company has judged that the enterprise value of these individual proposals is significantly lower than in the past. So called regeneration projects are increasing, and it seems this trend will strengthen in the future. In terms of the demand-supply balance, there was excess demand up to the previous fiscal period, but it seems that from 1H FY3/19, there has been excess supply. Based on an awareness of this situation, the Company's policy remains the same as up to the present time, of focusing on excellent proposals and proposals for which regeneration is possible.

(4) Situation for the acquisition of human resources

The acquisition of human resources is the most important point for the Company to realize its growth strategy. Even if it opens pharmacies considered to be ideal and expands its network of pharmacies, it cannot start operations in them unless the human resources are in place. On this point, the Company has stated that it is continuing to make steady progress just as it did in the previous fiscal year, with a new record high (detailed figures not disclosed) for new recruits scheduled to join in the spring of 2019.

As the background to these steady recruitment activities, the Company cites the existence of a positive cycle that are successively connected beginning with recruitment, and then education, the opening of functionally upgraded pharmacies, and the expansion of business scope before returning once again to the recruitment of high-quality pharmacists. The Company itself does not actively talk about this, but at FISCO, we think that the point that should not be overlooked is the existence of elements following on from the expansion of business scope, of measures to improve employee benefits and to reform ways of working.

A Positive Cycle for the acquisition of human resources and the provision of high-quality medical services

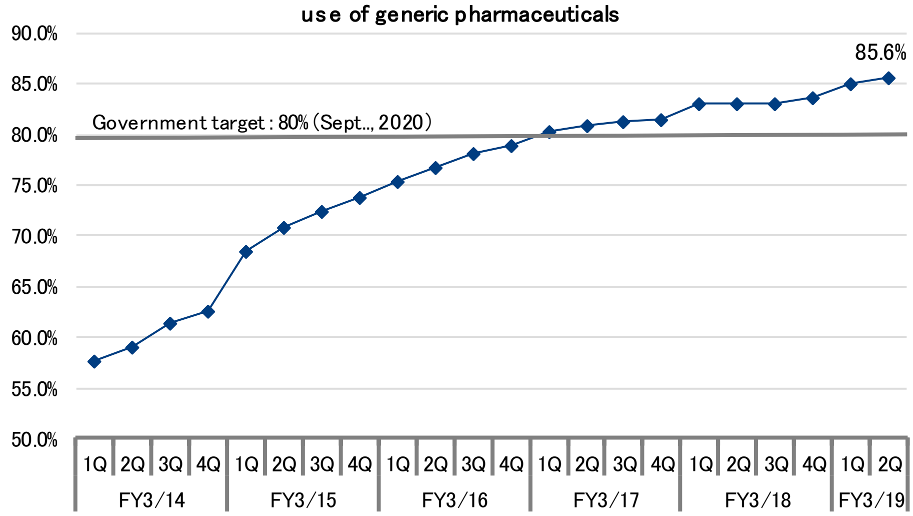


Source: The Company's results briefing materials

(5) Status of responses to the 2018 revisions

Within the dispensing pharmacy technical fees that were reduced in the 2018 revisions, the generic pharmaceuticals dispensing system incentive is steadily recovering. In the 2018 revisions, the standard for the usage rate of generic pharmaceuticals, which is used to determine the incentive classifications, was raised. In response to this, even though the Company had already achieved the government's target of 80%, it aimed to further increase its percentage and in 1H FY3/19, it raised it to as high as 85.6%.

Trend in the percentage of the Company's use of generic pharmaceuticals



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

Since the past, the Company's generic pharmaceuticals usage rate has been high, so the impact on it of the 2018 revisions was relatively minor. But during the period it further increased its usage rate, and as a result, in September it acquired 21.6 points as the Company-wide average for the generic pharmaceuticals dispensing system incentive, which exceeded the 20.7 points from immediately before the revisions (March 2018).

The effects of the revisions to the generic pharmaceuticals dispensing system incentive and the subsequent conditions

Before the revisions (March 2018)		
Classification	Points	% of pharmacies
Incentive 1	18	10%
Incentive 2	22	86%
No incentive	0	4%
Average	20.7	100%
Number of pharmacies	583	

After the revisions (April 2018)		
Classification	Points	% of pharmacies
Incentive 1	18	23%
Incentive 2	22	27%
Incentive 3	26	38%
No incentive	0	12%
Average	20.0	100%
Number of pharmacies	583	

As of September 2018		
Classification	Points	% of pharmacies
Incentive 1	18	15%
Incentive 2	22	27%
Incentive 3	26	50%
No incentive	0	8%
Average	21.6	100%
Number of pharmacies	593	

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

Previously, the basic dispensing fees had three classifications, of basic fees 1 to 3. But in the 2018 revisions, this was changed to 4 classifications (5 classifications if considering the newly established special basic dispensing fee), and the downward pressure on the classifications was strengthened through lowering the concentration rate standard. As a result, the average points for the Company's basic dispensing fee, which is estimated from the percentage of pharmacies, had been 38.1 points immediately before the revisions (March 2018), but it fell to 27.5 points immediately after the revisions (April 2018). As the basic dispensing fee is reviewed once every year, it is hard to image that it will fluctuate greatly during the period (unless, for example, there is a large M&A), and the Company's average number of points for the basic dispensing fee had not changed as of September 2018. Through measures such as accelerating the opening of hybrid-type pharmacies, we expect the percentage of its pharmacies that are basic dispensing fee 1 pharmacies, which receive the highest number of points, to rise by April 2019.

The effects of the revisions to the basic dispensing fee and the subsequent conditions

Before the revisions (March 2018)			After the revisions (April 2018)			As of September 2018		
Classification	Points	% of pharmacies	Classification	Points	% of pharmacies	Classification	Points	% of pharmacies
Basic dispensing fee 1	41	85%	Basic dispensing fee 1	41	48%	Basic dispensing fee 1	41	48%
Basic dispensing fee 2	25	4%	Basic dispensing fee 2	25	1%	Basic dispensing fee 2	25	1%
Basic dispensing fee 3	20	11%	Basic dispensing fee 3-b	15	50%	Basic dispensing fee 3-b	15	50%
			Special basic dispensing fee	10	1%	Special basic dispensing fee	10	1%
Average	38.1	100%	Average	27.5	100%	Average	27.5	100%
Number of pharmacies	583		Number of pharmacies	583		Number of pharmacies	593	

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

Premium for regional support system was newly established together with the abolition of premium for standard dispensing system. Before the revisions, 58% of pharmacies acquired the premium for standard dispensing system (32 points), while the average number of points for all pharmacies was 18.6 points. Following the system being changed to premium for regional support system, the percentage of pharmacies acquiring the incentive (35 points) fell to 34%, while the average number of points for all pharmacies declined to 11.9 points. In order for pharmacies other than basic dispensing fee 1 pharmacies to acquire these incentives, they must clear all of the results requirements comprised of eight items, which is an extremely high hurdle. However, as basic dispensing fee 1 pharmacies will have already satisfied the requirements, such as providing at-home medical care services and family pharmacist notifications (which are the same requirements as for the former premium for standard dispensing system), for the time being, raising the percentage of pharmacies acquiring incentives, with the aim of having 48% of pharmacies as basic dispensing fee 1 pharmacies, is considered to be a realistic effort. As the premium for regional support system is also calculated once a year, the current situation is one of waiting for the new calculations in April 2019.

The effects of the abolition of premium for standard dispensing system and the new establishment of premium for regional support system, and the subsequent conditions

Before the revisions (March 2018)			After the revisions (April 2018)			As of September 2018		
Classification	Points	% of pharmacies	Classification	Points	% of pharmacies	Classification	Points	% of pharmacies
Have incentive	32	58%	Have incentive	35	34%	Have incentive	35	34%
No incentive	0	42%	No incentive	0	66%	No incentive	0	66%
Average	18.6	100%	Average	11.9	100%	Average	11.9	100%
Number of pharmacies	583		Number of pharmacies	583		Number of pharmacies	593	

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

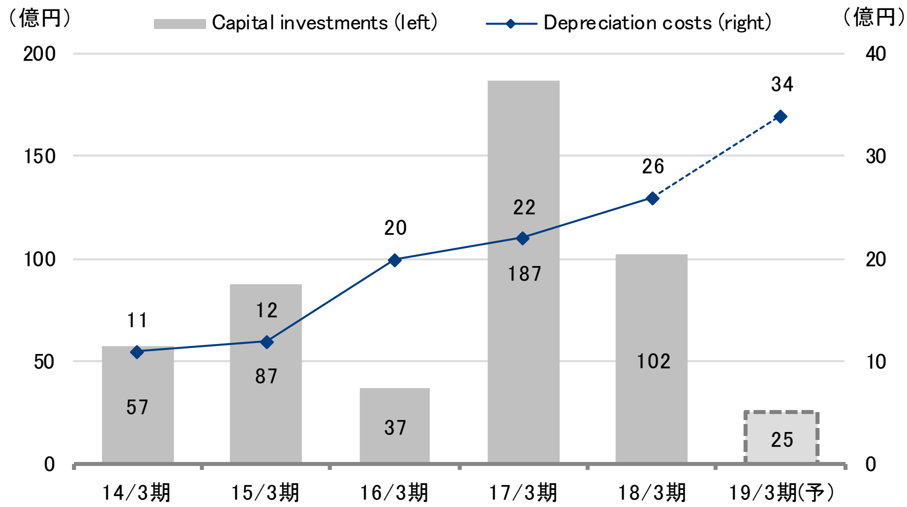
Aiming to increase earnings in the Pharmaceutical Manufacturing and Sales business through thorough measures to utilize the state-of-the-art Tsukuba Plant No.2 to the greatest possible extent

2. The Pharmaceutical Manufacturing and Sales business growth strategy and its progress

Within its Long-term Vision toward 2030, the Company set the target for the Pharmaceutical Manufacturing and Sales business of acquiring 15% market share. At FISCO, our understanding of the significance of this value of 15% is that, based on the view that generic pharmaceuticals manufacturers will be consolidated into five or six companies in the future, it is a figure that symbolizes the share of a single company that will be among these survivors.

The demand for generic pharmaceuticals is expected to increase in the future. This is symbolized by the fact that the government has formulated its goal of increasing to 80% the usage rate of generic pharmaceuticals by the end of September 2020 (according to the Japan Generic Medicines Association, the volume-based share of generics in the FY17 July-to-September period was 68.8%). In order to capture this growth in demand, the Company worked on constructing the state-of-the-art Tsukuba Plant No.2, and it was completed on schedule in April 2018. The production facilities at Tsukuba Plant No.2 are scheduled to be introduced over multiple stages, and with the recent stage 1 introduction production capacity of 3.3 billion tablets a year has been installed. Capital investment in Tsukuba Plant No.2 peaked-out in FY3/17 and is forecast to trend stably from FY3/19 onwards, with an annual capital investment amount of around ¥2.5bn a year. Conversely, depreciation expenses are also forecast to increase greatly, by around ¥800mn YoY in FY3/19, which is the first fiscal year of the plant's operations (actual amount, ¥3.4bn). But from FY3/20 onwards, they are forecast to trend stably, increasing by ¥100mn to ¥200mn a year, so they are not expected to become a factor causing profits to decrease greatly. With FY3/19 as one turning point, the focus in the future will shift to how installing the latest equipment in Tsukuba Plant No.2 can lead to an increase in earnings.

Trends in capital investments and depreciation costs



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

(1) Measures to grow net sales

The Company's strategy to grow net sales has two pillars; growing internal net sales through pursuing synergies with the Dispensing Pharmacy business, and growing external net sales. It is expected that the expansion in the scope of the Dispensing Pharmacy business (the increase in the number of pharmacies and the rise in the generic pharmaceuticals usage rate) will be reflected directly in internal net sales. As previously mentioned, in 1H FY3/19, internal net sales grew significantly, up 17.0% YoY, which covered for the decrease in external net sales. The decrease in external net sales was as a result of thoroughly implementing the sales policy of focusing on profitability. It seems that the Company will be able to continue to maintain this approach, as it is supported by the fact that it can maintain the plant operations rate through the growth in internal net sales.

On the other hand, for external net sales, in addition to sales to medical facilities, dispensing pharmacies, and drug stores outside of the Group through wholesalers, expectations are rising for the contract manufacturing business and alliance drugs business to serve as the new growth drivers. The contract manufacturing business involves development and manufacturing for other generics manufacturers from outsourcing contracts. Generics manufacturers are generally small compared to the manufacturers of forerunner drugs, and in many cases they lack the financial strength for capital investment. In 1H FY3/19, the Company had acquired five new contract-manufacturing projects and eight drugs. The alliance drugs business involves the manufacturing of alliance drugs ordered by other companies, and up to 1H FY3/19, it had a track recorded of two new alliance projects for two drugs.

(2) Measures to improve production efficiency

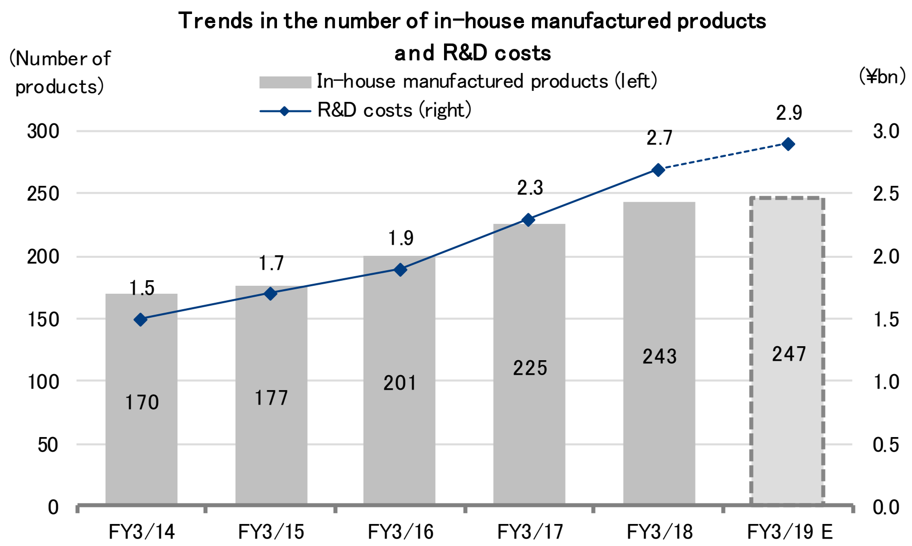
Together with the above-described diversification of the sales strategy, the Company is also implementing various measures on the production side. The key point is its pursuit of improvements in the plant operations rate and production efficiency. Tsukuba Plant No.2 is leveraging its strength of being a state-of-the-art, large-scale plant, and it has features suitable for mass production. On the other hand, a strength of the Tsukuba Plant is that it can deal with small lot production runs. The Company intends to improve production efficiency by transferring production from Tsukuba Plant to Tsukuba Plant No.2, mainly for items with large production volumes, and to reallocate the resulting surplus production capacity at the Tsukuba Plant to contract manufacturing and alliance-drugs manufacturing.

Alongside the completion of Tsukuba Plant No.2, the Company is also improving efficiency by consolidating facilities. In August 2018, it announced that it was to sell its Kasukabe Plant to Nipro Pharma Corporation (the plant is scheduled to be transferred on March 1, 2019). The Kasukabe Plant has a production capacity of 900 million tablets a year, but the Company will transfer this production portion to its existing plants, including Tsukuba Plant No.2. Therefore, the operations rate and production efficiency can be expected to improve.

(3) Measures to improve profitability

The measures to improving profitability first entails thoroughly conducting sales with a focus on profitability. The Company sells to external medical facilities and dispensing pharmacies via wholesalers. But in some cases, it is exposed to price competition with other manufacturers and is unable to secure sufficient profitability, and so in response to this, the Company has been working on sales with a focus on profits. But the announcement of the Revised Distribution Guidelines by the Ministry of Health, Labour and Welfare in January 2018 has proved to be a major benefit for the Pharmaceutical Manufacturing and Sales business. As previously stated, the Revised Distribution Guidelines state that the measures will be led by the government, with one of the aims of this being to establish an environment in which drug prices can be revised every year. Therefore, at FISCO we estimate that their effects will continue for a comparatively long period.

In the medium- to long-term, expectations are rising that profitability will improve due to the increase in in-house manufactured products. It is self-evident that, compared to alliance products and contract-manufactured products for other companies, in-house manufactured products are highly profitable. The aim is to increase the number of in-house manufactured products by actively investing in R&D, and its policy is to establish a spiral of “R&D ⇒increased in-house manufactured products ⇒ improved profitability ⇒ strengthened R&D ⇒”. It also has more than 200 “in-house approved, contract-manufacturing products of other companies.” Through acquiring sufficient production capacity, it plans to simultaneously shift their manufacture to in-house in the future.



Note: For FY3/19, R&D costs is the annual forecast value, while the number of in-house manufactured products is the number at the end of 1H.
Source: Prepared by FISCO from the Company’s results briefing materials

The pharmacists business is working to shift "from staffing to placements" and aiming for growth by expanding its business area into the placements of doctors and registered sales clerk

3. The Medical Professional Staffing and Placement business growth strategy and its progress

Up to the present time, the Company has had two growth strategies for the Medical Professional Staffing and Placement business – growing the pharmacist staffing and placements business, and expanding the occupations handled – but it has now come to further specify and clarify the content of these strategies. Specifically, in the pharmacists business, it is shifting from staffing to placements, and for the expansion of occupations handled, it is strengthening the placements of doctors and registered sales clerk.

The core pharmacist business is comprised of two operations, the staffing and the placement of pharmacists. In terms of their percentages of net sales, staffing provides 82.7% and placements 17.3%. But in their percentages of gross profit, staffing provides 55.9% and placements 44.7%, from which we understand that the profitability of placements is overwhelmingly higher (the figures are the 1H FY3/19 results). Also, the reason why segment profit was below forecast in 1H was that, as previously stated, staffing costs were higher than forecast.

Based on this situation, from around 2016 the Company focused its efforts into the placements of pharmacists, and the number of pharmacists placed steadily increased due to the strengthening of the sales force. The number of contracts increased sharply in 1H FY3/19 from the progress made in strengthening practical field skills through training the sales force. The Company's policy is to expand the pharmacist business, while aiming for the best mix, by leveraging the respective features of both businesses, of staffing being a stock-type model (high stability) and placements being a flow-type model (highly profitable and high growth potential).

For the expansion of the occupations handled, the Company intends to focus on doctors and registered sales clerk. It seems that it has decided to focus on these two occupations from the aspects of the mobility and marketability of human resources. It started the doctor placements business in 2017 and in 1H FY3/19, it worked on opening additional sales bases and increasing the sales force. As upfront investment, these efforts placed downward pressure on segment profit in 1H FY3/19. But once the establishment of the bases is completed, the plan going forward is to shift to strengthening advertising and publicity. As for the registered sales clerk placements business, the Company have made a fully-fledged start in 2018.

Business Outlook

Maintaining the initial forecasts of higher sales but lower profits. While it is possible that profits will exceed the forecast in the Pharmaceutical Manufacturing and Sales business, there are concerns about the continued downward pressure on profits in the Medical Professional Staffing and Placement business.

● FY3/19 results outlook

For FY3/18, the Company is forecasting net sales of ¥253,893mn (up 5.2% YoY), operating profit of ¥6,318mn (down 40.3%), ordinary profit of ¥6,078mn (down 40.1%), and profit attributable to owners of parent of ¥3,756mn (down 38.5%). These values have been left unchanged from the initial forecasts.

Summary of FY3/19 outlook

(¥mn)

	FY3/18			FY3/19				
	1H results	2H results	Full-year results	1H results	2H		YoY	
					Full year	Forecast	Forecast	YoY
Net sales	118,149	123,125	241,274	118,694	135,199	9.8%	253,893	5.2%
Operating profit	4,888	5,699	10,587	1,547	4,771	-16.3%	6,318	-40.3%
Ordinary profit	4,635	5,503	10,138	1,265	4,813	-12.5%	6,078	-40.1%
Profit attributable to owners of parent	2,805	3,299	6,104	744	3,012	-8.7%	3,756	-38.5%

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

As stated above, in FY3/19, the revisions to drug prices and dispensing fees in the Dispensing Pharmacy business, the rapid increase in fixed costs on the start of operations of the new large-scale plant in the Pharmaceutical Manufacturing and Sales business, and the upfront investment in the new businesses in the Medical Professional Staffing and Placement business, are overlapping factors causing profits to decline, although the V-shaped results are as expected. In particular, even though there were concerns that conditions in the 1H would become harsher, the part that profits were below forecast in the Dispensing Pharmacy business was absorbed by the part that profits were above forecast in the Pharmaceutical Manufacturing and Sales business, so the Company achieved profits in line with its initial forecasts. Therefore, at the current point in time, at FISCO we think the degree of confidence in earnings growth from the 2H onwards has risen.

The summaries by business segment are as follows.

In the Dispensing Pharmacy business, the forecasts are for sales to increase and profits to decrease, with net sales of ¥213,133mn (up 3.9% YoY) and operating profit of ¥9,436mn (down 24.0%). In the 1H, the number of prescriptions was less than initially expected due to the impact of the weather and natural disasters, and both sales and profits were below forecast. In the 2H, the number of prescriptions increased rapidly in October, which covered for the part they declined in September, and the fall in the prescription unit price was small compared to the expected decline. Therefore, the forecasts on a full-fiscal year basis are for a recovery in the 2H and for results to be line with the initial forecasts.

In the Pharmaceutical Manufacturing and Sales business, the forecasts are for net sales of ¥42,123mn (up 10.7% YoY) and operating profit of ¥51mn (down 95.7%). In the 2H, internal net sales, which have a solid sales foundation, are expected to increase compared to in the 1H. In the Dispensing Pharmacy business, the number of patients tends to increase in the 2H compared to the 1H due to seasonal factors, and in addition, steady demand is expected including from the effects of the newly opened pharmacies. Also, since the drug price listing of new sales items is scheduled for December, external net sales are likely to increase accordingly, and as a result, net sales are expected to increase in the 2H compared to in the 1H. In profits, as mentioned above, due to the characteristics of the factors that improved profitability in the 1H, of them being continuous and reproducible, we can expect their effects to continue in the 2H as well. In terms of plant productivity, production volume will grow from the expansion of manufacturing of contract-manufacturing items alongside the increase in surplus production capacity, and also due to seasonal factors, so we can expect further improvements compared to in the 1H. As a result of these factors, we think that profits can also be expected to increase in the 2H compared to in the 1H. Despite the fact that profits were significantly higher than forecast in the 1H, the Company has left unchanged the full fiscal year forecasts. Therefore, even if it recorded an operating loss of close to ¥300mn in the 2H, it would still be able to achieve the full fiscal year forecasts. So the situation is that the hurdle to achieve the forecasts has been lowered considerably. However, as explained above, we think that profits in the 2H will increase compared to in the 1H, and that as a result, it is highly likely that the full fiscal year segment operating profit will exceed the forecast.

In the Medical Professional Staffing and Placement business, the forecasts are for higher sales and profits, with net sales of ¥13,500mn (up 12.8% YoY) and operating profit of ¥1,950mn (up 5.9%). In the 1H, net sales trended basically in line with the forecast, but profits were below forecast due to the rise in staffing costs and costs associated with upfront investment. In the 2H, in September the number of contracts in the pharmacist placements business increased significantly (profits are recognized in the 2H), and the Company is maintaining the results forecasts on a full fiscal year basis. At FISCO, we think that it is necessary to consider the situation with caution for various reasons, including that the pharmacist demand-supply balance continues to be tight, and that in the doctor placements business, although upfront investment, such as for establishing bases and strengthening personnel, settled down in the 1H, the outlook going forward is that advertising and publicity costs will be incurred in order to improve name recognition.

Outlook by business segment

(¥mn)

		FY3/18			FY3/19					
		1H results	2H results	Full-year results	1H results	2H			Full year	
						Forecast	YoY	Vs. 1H	Forecast	Vs. FY3/18
Net sales	Dispensing Pharmacy business	100,011	105,181	205,192	101,054	112,079	6.6%	10.9%	213,133	3.9%
	Pharmaceutical Manufacturing and Sales business	19,213	18,853	38,066	19,431	22,692	20.4%	16.8%	42,123	10.7%
	Medical Professional Staffing and Placement business	5,993	5,977	11,970	6,351	7,149	19.6%	12.6%	13,500	12.8%
	Before adjustment	125,217	130,013	255,230	126,837	141,919	9.2%	11.9%	268,756	5.3%
	Adjustment	-7,068	-6,887	-13,955	-8,143	-6,720	-	-	-14,863	-
	Net sales total	118,149	123,125	241,274	118,694	135,199	9.8%	13.9%	253,893	5.2%
Operating profit	Dispensing Pharmacy business	5,617	6,794	12,411	3,197	6,239	-8.2%	95.2%	9,436	-24.0%
	Pharmaceutical Manufacturing and Sales business	638	556	1,194	344	-293	-	-	51	-95.7%
	Medical Professional Staffing and Placement business	1,012	830	1,842	630	1,320	59.0%	109.5%	1,950	5.9%
	Before adjustment	7,268	8,180	15,448	4,172	7,265	-11.2%	74.1%	11,437	-26.0%
	Adjustment	-2,379	-2,482	-4,861	-2,625	-2,494	-	-	-5,119	-
	Operating profit total	4,888	5,699	10,587	1,547	4,771	-16.3%	208.4%	6,318	-40.3%

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

Income statement and the main indicators

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19	
					1H	Full year (forecast)
Net sales	181,844	219,239	223,468	241,274	118,694	253,893
YoY	10.0%	20.6%	1.9%	8.0%	0.5%	5.2%
Gross profit	31,929	39,068	39,258	43,837	19,427	41,500
Gross profit margin	17.6%	17.8%	17.6%	18.2%	16.4%	16.3%
SG&A expenses	25,281	28,578	30,738	33,250	17,880	35,182
Ratio of SG&A expenses to net sales	13.9%	13.0%	13.8%	13.8%	15.1%	13.9%
Operating profit	6,647	10,489	8,519	10,587	1,547	6,318
YoY	40.1%	57.8%	-18.8%	24.3%	-68.4%	-40.3%
Operating profit margin	3.7%	4.8%	3.8%	4.4%	1.3%	2.5%
Ordinary profit	6,003	9,878	7,976	10,138	1,265	6,078
YoY	43.3%	64.6%	-19.3%	27.1%	-72.7%	-40.1%
Profit attributable to owners of parent	2,778	6,329	4,638	6,104	744	3,756
YoY	46.1%	127.8%	-26.7%	31.6%	-73.4%	-38.5%
EPS after adjustment for stock split (¥)	194.48	432.85	290.03	381.69	46.77	234.84
Dividend per share after adjustment for stock split (¥)	35.00	45.00	50.00	50.00	25.00	50.00
BPS after adjustment for stock split (¥)	1,257.60	2,030.22	2,278.70	2,595.00	-	-

Note: The Company conducted a two-for-one stock split on October 1, 2015
Source: Prepared by FISCO from the Company's financial results

Balance sheet

(¥mn)

	End of FY3/15	End of FY3/16	End of FY3/17	End of FY3/18	End of 1H FY3/19
Current assets	60,096	84,838	82,327	81,613	79,717
Cash and deposits	13,952	32,385	21,200	28,464	23,315
Accounts receivable, etc.	21,413	26,810	27,643	21,230	19,116
Inventories	21,066	22,016	29,514	28,224	34,268
Fixed assets	70,044	72,770	96,019	104,956	103,572
Tangible fixed assets	48,819	51,997	68,513	75,662	73,538
Intangible fixed assets	10,376	10,122	16,773	17,952	18,155
Investments, etc.	10,848	10,650	10,733	11,341	11,879
Total assets	130,141	157,609	178,347	186,569	183,289
Current liabilities	53,474	68,985	66,305	70,310	73,798
Accounts payable, etc.	33,392	44,653	41,033	39,973	44,803
Short-term debt, etc.	11,169	12,963	13,411	15,309	17,476
Fixed liabilities	59,031	56,151	75,595	74,752	68,710
Long-term debt, etc.	53,184	50,621	70,678	68,372	62,775
Shareholders' equity	17,515	32,507	36,345	41,648	40,889
Capital	3,953	3,953	3,953	3,953	3,953
Capital surplus	4,754	10,926	10,926	10,926	10,926
Retained earnings	11,868	17,672	21,511	26,816	27,161
Treasury stock	-3,059	-44	-46	-47	-1,152
Total accumulated other comprehensive income	119	-34	101	-144	-108
Total net assets	17,635	32,473	36,447	41,506	40,781
Total liabilities and net assets	130,141	157,609	178,347	186,569	183,289

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

Cash flow statement

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	1H FY3/19
Cash flow from operating activities	5,831	19,327	-940	23,141	3,936
Cash flow from investing activities	-8,437	-7,823	-28,444	-13,843	-3,535
Cash flow from financing activities	1,422	7,031	18,205	-2,034	-5,550
Change in cash and deposits	-1,183	18,535	-11,180	7,264	-5,149
Cash and deposits at start of fiscal year	15,027	13,844	32,380	21,200	28,464
Cash and deposits at end of fiscal year	13,844	32,380	21,200	28,464	23,315

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

Shareholder returns

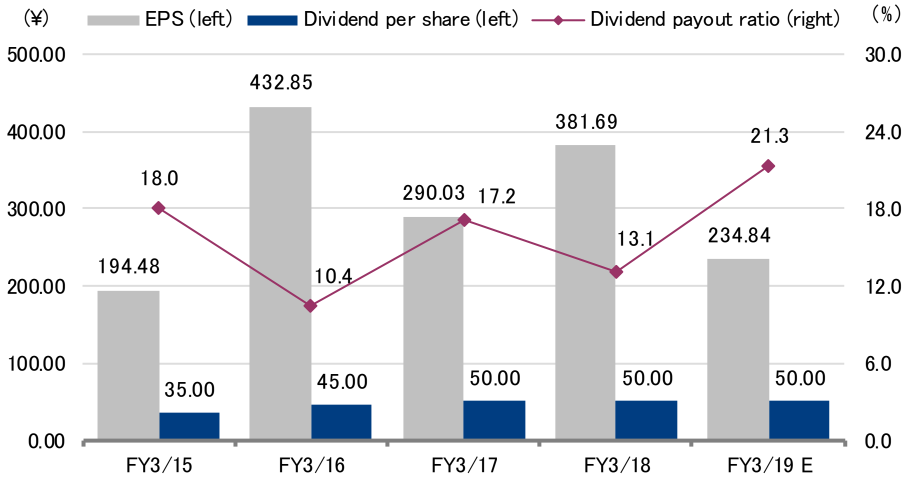
Plans to pay a dividend of ¥50 in FY3/18, the same as in the previous fiscal year.

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 FY3/19, the Company initially announced a dividend forecast of ¥50 (interim dividend of ¥25 and period-end dividend of ¥25), which is the same as FY3/18. As of the end of 1H FY3/19, it had not changed this initial forecast. As the forecast earnings per share is ¥234.84, the dividend payout ratio will be 21.3%.

In FY3/19, in addition to bottoming out towards a V-shaped recovery for profits in the Dispensing Pharmacy business with the 2018 revisions to drug prices and dispensing fees, the Pharmaceutical Manufacturing and Sales business will also be at the bottom of a future V-shaped recovery for profits due to the start of operations at the new large-scale plant. In such ways, it will be a harsh fiscal year. But at FISCO, we think that the Company decided to maintain the dividend forecast because, even in an environment of declining profits, it is highly confident that earnings will recover from FY3/20 onwards.

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

Disclaimer

FISCO Ltd. (the terms "FISCO", "we", mean FISCO Ltd.) has legal agreements with the Tokyo Stock Exchange, the Osaka Exchange,and Nikkei Inc. as to the usage of stock price and index information. The trademark and value of the "JASDAQ INDEX" are the intellectual properties of the Tokyo Stock Exchange, and therefore all rights to them belong to the Tokyo Stock Exchange.

This report is based on information that we believe to be reliable, but we do not confirm or guarantee its accuracy, timeliness,or completeness, or the value of the securities issued by companies cited in this report. Regardless of purpose,investors should decide how to use this report and take full responsibility for such use. We shall not be liable for any result of its use. We provide this report solely for the purpose of information, not to induce investment or any other action.

This report was prepared at the request of its subject company using information provided by the company in interviews, but the entire content of the report, including suppositions and conclusions, is the result of our analysis. The content of this report is based on information that was current at the time the report was produced, but this information and the content of this report are subject to change without prior notice.

The final selection of investments and determination of appropriate prices for investment transactions are decisions for the recipients of this report.

FISCO Ltd.