COMPANY RESEARCH AND ANALYSIS REPORT

Qol Co., Ltd.

3034

Tokyo Stock Exchange First Section

30-Mar.-2018

FISCO Ltd. Analyst
Hiroyuki Asakawa

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

Index

Summary — 01

1. Major dispensing pharmacy chain with a No.2 position in store volume and No.3 position in sales ··· 01
2. Expanding the store network mainly through M&A and targeting a 5% market share with ¥300bn in sales ··· 01
3. Making smooth progress in results; raised FY3/18 forecast a second time ··· 01

Company profile — 02

1. History ··· 02
2. Overview of the business ··· 04
3. Medium-term business goals ··· 05

Pharmacy business overview and growth strategy — 06

1. Pharmacy market and income structure ··· 06
2. Positioning of the pharmacy business ··· 07
3. Store strategy ··· 09
4. Growth strategies ··· 11

BPO business overview and growth strategy — 13

1. Overview of the BPO business ··· 13
2. Growth strategy in the BPO business ··· 14

Business trends — 16

1. Review of FY3/18 3Q results ··· 16
2. FY3/18 outlook ··· 19
3. FY3/19 outlook ··· 20

Shareholder returns — 22

Information security — 23

Summary

Aims to accelerate growth in dispensing pharmacy business with “one-on-one pharmacies” and new-format alliance pharmacies

1. Major dispensing pharmacy chain with a No.2 position in store volume and No.3 position in sales

Qol Co., Ltd. <3034> is a major dispensing pharmacy chain with a No.2 position in dispensing pharmacy store volume and No.3 position in sales (using data from listed companies). It has actively utilized M&A to expand the store network and realize growth since its establishment in 1992. Qol’s strategy in the pharmacy business adopts a two-pronged approach of deploying “one-on-one pharmacies” as the core business and augmentation with new-format pharmacies developed through alliances with companies from other industries. Qol also runs a BPO (business processing outsourcing; this is a service in which customers continually outsource a portion of their business process to external specialized companies) business to supplement the pharmacy business. BPO business includes CSO (contract sales organization) business, which dispatches MRs to drug companies, and a dispatching and recruitment business for pharmacists, nurses, and other medical professionals.

2. Expanding the store network mainly through M&A and targeting a 5% market share with ¥300bn in sales

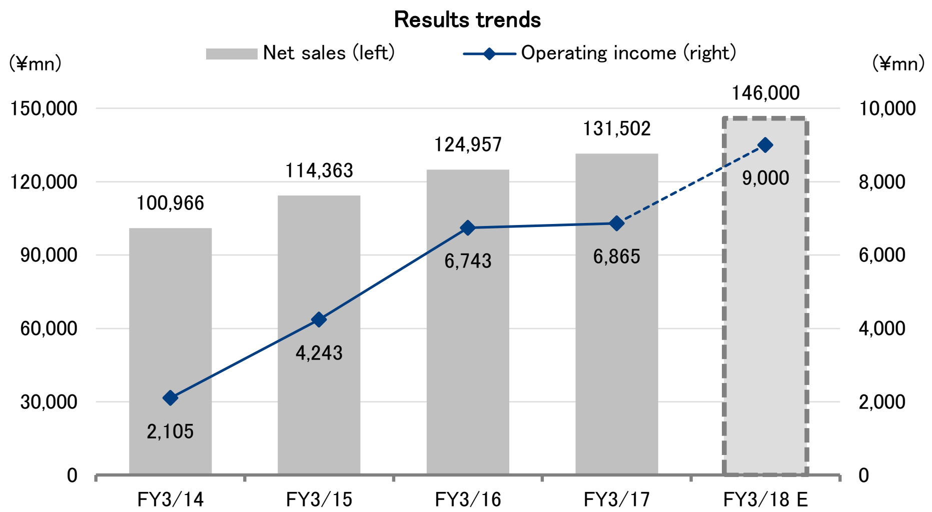
Pharmacy dispensing medical expenditure in national medical care expenditure is the main indicator of market size in the dispensing pharmacy industry in which Qol operates. While the growth rate might slow, we expect the dispensing pharmacy market to continue expanding as Japanese society steadily ages. Qol intends to address this market environment with measures to aggressively expand the store network led by M&A. It promotes the concept of “one-on-one pharmacies” in its store strategy, and we think this helps in efforts to more broadly recruit potential M&A targets. Reorganization in the dispensing pharmacy industry is likely to advance over the medium term. Qol aims to be a winner in this process and is currently targeting a 5% share with ¥300bn in sales.

3. Making smooth progress in results; raised FY3/18 forecast a second time

Qol reported sharply higher sales and profits in 1Q-3Q FY3/18 at ¥108,471mn in net sales (up 12.8% year on year (YoY)) and ¥6,989mn in operating income (up 54.5%). Based on these results, it raised FY3/18 guidance to ¥146,000mn in net sales (up 11.0% YoY) and ¥9,000mn in operating income (up 31.1%). Mainstay pharmacy business is driving upbeat results. Amid relatively stable business conditions since this fiscal year does not face revisions to medical fees and drug prices, Qol achieved income gains on increased sales from M&A deals and improvement in the average prescription price through promotion of primary care pharmacist and pharmacy roles and generic drug usage. We expect Qol to sustain rising sales and profits in FY3/19 too, even though this year faces medical fee revisions, by continuing its strategy of active expansion of store volume.

Key Points

- Holds the No.2 position in store volume and No.3 position in sales in dispensing pharmacy business
- Japan’s dispensing pharmacy market is worth about ¥8trn and likely to continue growing as society steadily ages
- Pursuing growth through expansion of the store network led by M&A; one-on-one pharmacy concept likely to provide a tailwind to realizing M&A progress



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

Company profile

Growth driven by robust M&A since being founded in 1992

1. History

Chairman and CEO Masaru Nakamura established Qol in 1992. Qol has steadily expanded its dispensing pharmacy network since opening the first location in Nihombashi Kabutocho in April 1993. It also moved into related and peripheral areas, including SMO (site management organization) business with the founding of PhaseOn Co., Ltd. in 2003 and dispatching and recruitment business with the establishment of Qol Medis Co., Ltd. in 2008.

Qol has actively utilized M&A as an effective tool to expand business scope. Besides acquiring smaller pharmacy chains in order to expand the pharmacy network, it also steadily acquired companies in related and peripheral businesses as subsidiaries, including Daiichi Medical Co., Ltd., Ebel Co., Ltd., APO PLUS STATION Co., Ltd., and Alpharm Co., Ltd.

While expanding business scope through M&A, Qol also strengthened its management framework and governance. With subsidiaries, it pursued conversion to wholly owned subsidiaries and absorption into main operations and core subsidiaries. Qol organized subsidiary businesses under the two main business segments (pharmacy and BPO contracting) and promoted efficiency in these operations. Furthermore, it presented a plan to transition to a holding-company structure in September 2017 with goals of bolstering the group management strategy promotion function, accelerating decisions, improving corporate governance, and maximizing group synergies. Qol had initially planned to make the transition to the holding company on April 1, 2018, but changed the schedule to adoption of the holding-company format on October 1, 2018 in order to give priority to its response to revisions of medical fees and drug prices that take place at the same timing.

Qol listed its shares on the Osaka Securities Exchange's Hercules market in April 2006. It switched to the Tokyo Stock Exchange's First Section in December 2012, and this is where the shares currently trade.

History

Month and year Date	Major event
October 1992	Qol Co., Ltd. was established to dispense and sell pharmaceutical products
May 2003	Established PhaseOn Co., Ltd. and started testing (SMO) business
April 2006	Listed shares on the Osaka Securities Exchange "Hercules" market (now Tokyo Stock Exchange JASDAQ)
January 2007	Acquired all shares of Daiichi Medical Co., Ltd. (now Medical Qol Co., Ltd.) as a subsidiary and started medical and drug information materials production business
October 2007	Absorbed Ebel Co., Ltd. and converted it to a subsidiary. This change moved Mediceo Paltac Holdings Co., Ltd. (now MEDIPAL HOLDINGS CORPORATION <7459>) and Mitsubishi Corporation <8058> to "other related companies"
December 2008	Established Qol Medis Co., Ltd. to begin the worker dispatch and recruitment business
February 2009	Established Qol Assist Co., Ltd. and started internal administrative services
December 2011	Listed shares on the Tokyo Stock Exchange Second Section (TSE-2)
March 2012	Delisted from Osaka Securities Exchange JASAQ (now Tokyo Stock Exchange JASDAQ)
October 2012	Acquired all shares in APO PLUS STATION Co., Ltd. (now a consolidated subsidiary) to make it a subsidiary
December 2012	Changed the stock listing to the Tokyo Stock Exchange First Section (TSE-1)
April 2013	Established intermediate holding company Qol SD Holdings Co., Ltd. through a company split
April 2013	Absorbed the pharmacy business from APO PLUS STATION (as a spin off)
April 2013	Renamed Qol Medis Co., Ltd. as Qol Academy Co., Ltd.
April 2013	Acquired all shares in Alpharma Co., Ltd. (now a consolidated subsidiary) to make it a subsidiary
August 2013	Acquired 44.44% of shares in consolidated subsidiary Lake Medical Co., Ltd. to make it a wholly-owned subsidiary
August 2014	Absorbed Qol Academy Co., Ltd. and PhaseOn Co., Ltd.
October 2014	Acquired 47.85% of shares in consolidated subsidiary Saint Follow Company Co., Ltd. to make it a wholly-owned subsidiary
October 2016	Acquired all shares of KYOEIDO Co., Ltd. (now a consolidated subsidiary), making it a subsidiary
October 2016	Absorbed intermediate holding company Qol Holdings Co., Ltd.
September 2017	Announced a plan to transition to a holding company organization as of April 1, 2018 (later changed the transition date to October 1, 2018)

Source: Prepared by FISCO from the securities report

Operates two businesses – pharmacy business that manages dispensing pharmacies and BPO business that handles outsourcing of medical-related processes

2. Overview of the business

Qol currently has two business segments – pharmacy business and BPO business. Core companies for these segments are parent Qol for pharmacy business and wholly-owned subsidiary APO PLUS STATION for BPO business (see below for detailed explanations).

The pharmacy business segment operates dispensing pharmacies and hospital shops. However, it is essentially a pharmacy business with dispensing pharmacies at about 97% of store count and most likely a similar percentage of sales.

This segment has a large number of consolidated subsidiaries (17 companies) due to steady acquisitions of smaller pharmacy chains. It retains these businesses as separate entities to respect the autonomy of acquired company management given emphasis on local ties in pharmacy operations and the presence of administrative approvals and permits. We do not see efficiency problems from having numerous subsidiaries because Qol has completed integration of inventory control and other management systems between itself and these subsidiaries.

In the BPO business, Qol has been reorganizing and combining subsidiaries that it created on its own and acquired companies. This business currently has three sub-segments (details provided below) and almost all areas other than publishing business handled by Medical Qol Co., Ltd. come under APO PLUS STATION.

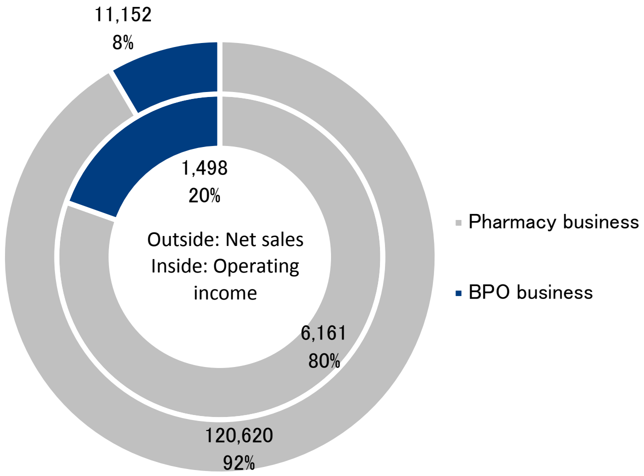
Overview of business segments and main companies

Company	Segments	Business content
Qol (plus 17 consolidated subsidiaries)	Pharmacy business	Dispensing pharmacy operations, hospital shop operations
APO PLUS STATION (plus two consolidated subsidiaries)	BPO business	CSO business, CRO business, medical professional dispatch and recruitment business, and others

Source: Prepared by FISCO from the securities report

Segment income breakdown in FY3/17 was pharmacy at 92% and BPO at 8% of net sales and pharmacy at 80% and BPO at 20% of operating income. BPO business is well above pharmacy business in operating margin as seen in its larger share of operating income than net sales. This difference stems from the BPO segment's involvement in personnel dispatching and recruitment business.

Net sales and operating income breakdown by business segments



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

Aiming for ¥300bn in net sales over the longer term led by pharmacy business

3. Medium-term business goals

Qol has not prepared an official medium-term business plan, though calls for ¥300bn in net sales as a longer-term growth goal (albeit without giving a specific date). To realize the goal, it intends to expand the two existing businesses (pharmacy and BPO) and ramp up a new business as a third area.

We expect pharmacy business to serve as the primary growth driver for the time being. Japan's medical expenses will be increasing as society ages and this means expansion of target markets for Qol, as explained in more detail below. Additionally, we see potential from restructuring in the pharmacy industry, which has an estimated 58,000 locations nationwide, driven by Qol and other major pharmacy chains. A 5% share in the pharmacy market is a threshold level targeted by top pharmacy chains, and this appears to be the basis for Qol's goal of ¥300bn. Conversely, Qol should reach ¥300bn in sales if it obtains a 5% share. We think the main point in assessing Qol's growth strategy is the extent to which it is capable of acquiring a 5% share in the pharmacy business.

Pharmacy business overview and growth strategy

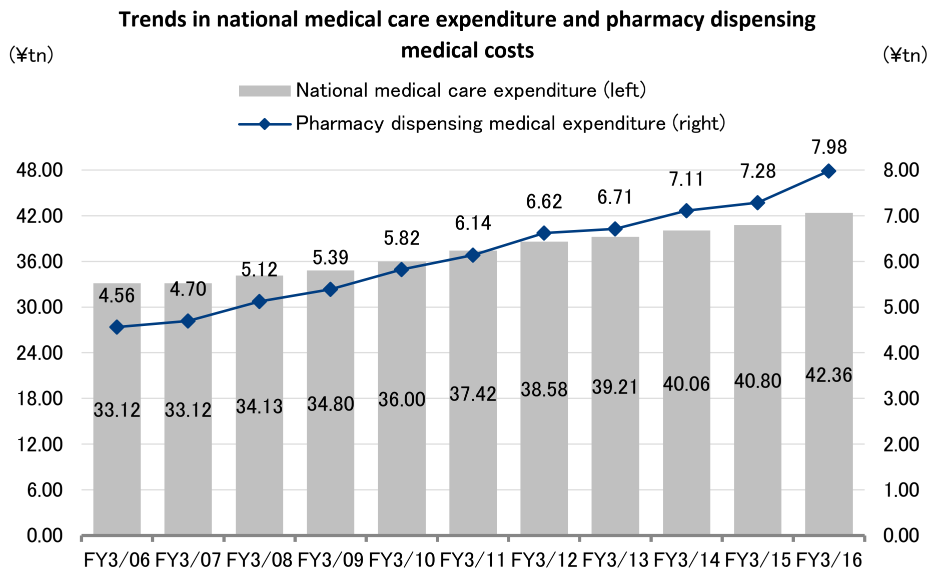
Roughly ¥8trn market as part of the national healthcare system

1. Pharmacy market and income structure

Dispensing pharmacies are part of Japan's national healthcare system along with hospitals (doctors), and sometimes referred to as insurance pharmacies. Only businesses with a permit based on the Pharmaceutical and Medical Device Act can use the "pharmacy" name in Japan, as a general rule. These sites always have a pharmacist at the location and provide a medical service of preparing drugs according to prescriptions issued by doctors in the dispensing office. While businesses not meeting these criteria (pharmacist and dispensing office) cannot use the term "pharmacy" in the store name, even convenience stores, drugstores, and other retail stores can refer to themselves as a pharmacy if criteria are satisfied.

Market size for dispensing pharmacies correlates to "pharmacy dispensing medical expenditure" (total value of technical fees such as dispensing basic fee and drug fees for drugs dispensed through insurance pharmacies based on prescriptions) within national medical care expenditure because this industry is built into the national healthcare system. (In fact, the market also includes sales of non-prescription drugs and other related services). As a trend, this value has been steadily climbing due to the impact from aging of Japanese society. Japan's pharmacy dispensing medical expenditure rose 9.6% YoY to ¥7,983.1bn in FY3/16.

Pharmacy dispensing medical expenditure grew at a 5.8% average annual rate in the 10 years starting from FY3/06 through FY3/16. This pace is substantially higher than the 2.5% growth rate for total national medical care expenditure in the same period. While the growth rate is likely to be slower in future years (compared to the past) because rising national medical care expenditure is not a positive aspect from the standpoint of the national economy, we think the expansion should continue in light of the steadily aging society.



Source: Prepared by FISCO from Ministry of Health, Labour and Welfare statistics

Dispensing pharmacy sales are basically decided by multiplying the number of prescriptions received by the average prescription price. The average price has three main elements – dispensing technical fee, pharmacy management fee, and drug fee. Drug procurement cost is a large percentage of the drug fee, and drug fee income fluctuates considerably due to the impact of high-priced drugs. Dispensing technical fees and pharmacy management fees are key items in pharmacy profits. The national government (Ministry of Health, Labour and Welfare), meanwhile, regularly revises "medical fees," including dispensing technical fees and pharmacy management fees, with aims of curtailing growth in medical expenditure and offering incentives to achieve national medical policies. Given these points, we think changes in gross profit from drug fees and pharmacy fees (dispensing technical fees and pharmacy management fees) are more important in assessing the average prescription price than nominal prescription price movements.

Number of prescriptions received is comparable to customer traffic at a normal retailer. Dispensing pharmacy businesses focus on measures to increase the number of prescriptions received, which means expansion of customer volume, because of the difficulty of anticipating rapid growth in the prescription price (or more precisely, prescription gross profit). Since customer growth at individual stores also faces limitations, adding to store volume is a primary thrust of business strategy from a company perspective.

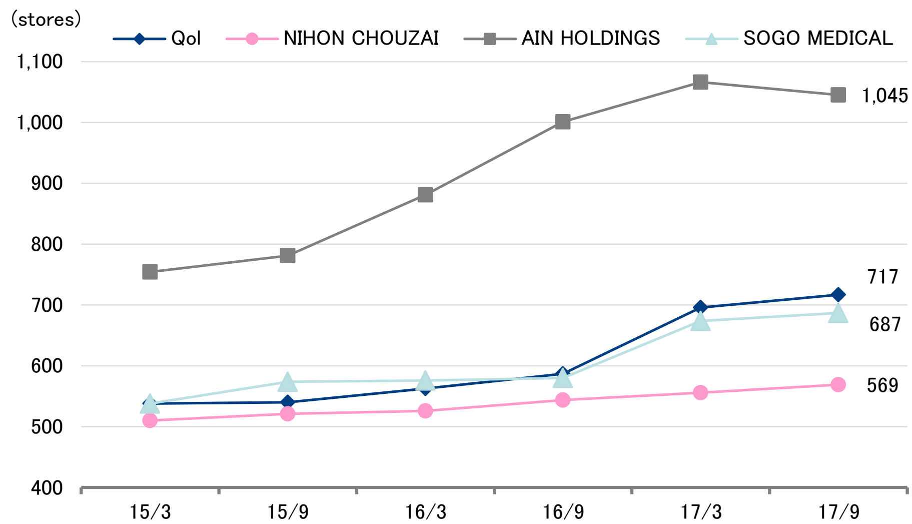
Holds a No.2 position in pharmacy volume and a No.3 spot in net sales among listed pharmacy chains

2. Positioning of the pharmacy business

As mentioned earlier, dispensing pharmacies generate more than 90% of sales in the pharmacy business segment. This means that the segment is essentially equivalent to the dispensing pharmacy business. Similarly segment growth strategy is comparable to dispensing pharmacy strategy.

Looking at the dispensing pharmacy industry landscape at the end of FY3/18 2Q, Qol's 692 stores put it in second place after AIN HOLDINGS INC. <9627> among pharmacy chains. However, third-place SOGO MEDICAL CO., LTD. <4775> is very close at 687 stores and unlisted dispensing pharmacy chain KRAFT Inc. has about 700 stores and is slightly ahead of Qol. Drugstore operator WELCIA HOLDINGS CO., LTD. <3141> also has 1,070 drugstores with pharmacies. These levels highlight very intense competition among major companies in the pharmacy chain industry, and progress in M&A deals or other activities could readily change the ranking order by store counts.

Trends in dispensing pharmacy store counts at major pharmacy chains



Note; End-Apr and end-Oct for AIN Holdings because of its April fiscal year
Source: Prepared by FISCO from financial results and briefing materials of each company

In net sales, Qol ranks third after AIN Holdings and NIHON CHOUZAI CO., LTD. <3341> among listed companies. Difference in average sales per pharmacy is the reason for Nihon Chouzai's higher sales than at Qol, despite having fewer stores. Qol promotes the "one-on-one pharmacy" concept in its store strategy, resulting in relatively lower number of hospital-adjacent type stores (large pharmacies located in front of major hospitals). The situation is explained in detail below. Nihon Chouzai, on the other hand, implements a strategy that emphasizes sales scale per location. It has pharmacies located next to more than 40% of university hospitals nationwide and focuses on this model. The distinction shows up as differences in average prescription price and number of prescriptions received, thereby affecting sales per store.

Dispensing pharmacy business comparison with peers

Company name	Code	Pharmacy business				Other businesses					FY2017 1H Dispensing sales per store (¥mn)	Comments
		Store count (sites)		Net sales (¥mn)		Drug production	Dispatch and recruitment	Drug Store	Drug wholesale	Consulting		
			Timing		Fiscal year							
Qol	3034	717	End-Sep 2017	66,126	FY3/18 1H		●				178	Store count includes joint-venture sites with Lawson, BicCamera, and JR West
Nihon Chouzai	3341	569	End-Sep 2017	100,011	FY3/18 1H	●	●				356	Store count shows dispensing pharmacies; does not include merchandise stores
AIN Holdings	9627	1,045	End-Oct 2017	117,991	FY4/18 1H			●	●		219	Store count shows dispensing pharmacies (based on the outlook)
Sogo Medical	4775	687	End-Sep 2017	53,389	FY3/18 1H					●	157	
Welcia Holdings	3141	1,070	End-Aug 2017	55,289	FY2/18 1H			●			106	Store count shows "stores with dispensing"
Cocokara Fine	3098	260	End-Sep 2017	26,400	FY3/18 1H			●			207	Store count shows "stores with dispensing"

Note: Dispensing sales per store calculated by dividing dispensing business sales by the average number of dispensing stores using period-start and period-end values; 1H doubled to obtain an annualized value
Source: Prepared by FISCO from financial results and briefing materials of each company

Promotes the “one-on-one pharmacy” concept as a core model and pursues a store strategy of broadening to new-format pharmacies in alliances

3. Store strategy

Qol’s pharmacy business strategy has two main themes. The first is the “one-on-one pharmacy” concept, and the other is promotion of new-format pharmacies through business alliances with major convenience store operator Lawson Inc. (2651), West Japan Railway Company (JR West; 9021), and others.

“One-on-one pharmacy” is a concept that defines the fundamental stance in store operations for ordinary Qol pharmacies. It is also the “core business” in Qol’s business model. This concept advocates pharmacy development that fosters a one-on-one relationship between the prescribing medical institution and the Qol pharmacy. One-on-one pharmacies keep spending unrelated to medical service to a minimum and invest these savings to improve patient service. More specifically, these pharmacies adjust physical designs and functions in accordance with the departments of target medical institutions (mainly self-run clinics and smaller hospitals) and local qualities. Funds are obtained from the low cost structure of stores, including better efficiency in drug inventories, a benefit of one-on-one pharmacies. Qol gives primary emphasis to development of pharmacies that provide excellent usage value for patients and are selected by patients under the one-on-one pharmacy concept in its store strategy. The one-on-one pharmacy concept is also an important component of the growth strategy described later.

The catalyst for Qol’s pursuit of new-format pharmacies through alliances was a reform in the Revised Pharmaceuticals Affair Law from June 2009 that lets convenience stores, drugstores, supermarkets, and other industry stores sell OTC drugs as registered businesses. Qol responded to subsequent efforts by companies from other industries to start dispensing pharmacy businesses by arranging business alliances with the two above-mentioned companies. It also entered into business alliances with BICCAMERA INC. <3048> and other partners from different industries.

In the alliance with Lawson, Qol operates the Lawson stores as a franchisee and deploys a pharmacy function (this is the main model, but there is one Lawson store operated by a different company). Many of these stores have locations in urban areas and are positioned as “town pharmacies.”

In the alliance with JR West, Qol opens “Station Qol” stores in JR West stations as retail sites “in train stations.” In the alliance with BicCamera, Qol pharmacies operate inside BicCamera stores. Many BicCamera stores are located near large terminal stations, and Qol positions these as retail sites “near train stations.” Qol also collaborates with Odakyu Electric Railway Co., Ltd. <9007> and LIFE CORPORATION <8194> and aims to expand new-format pharmacies.

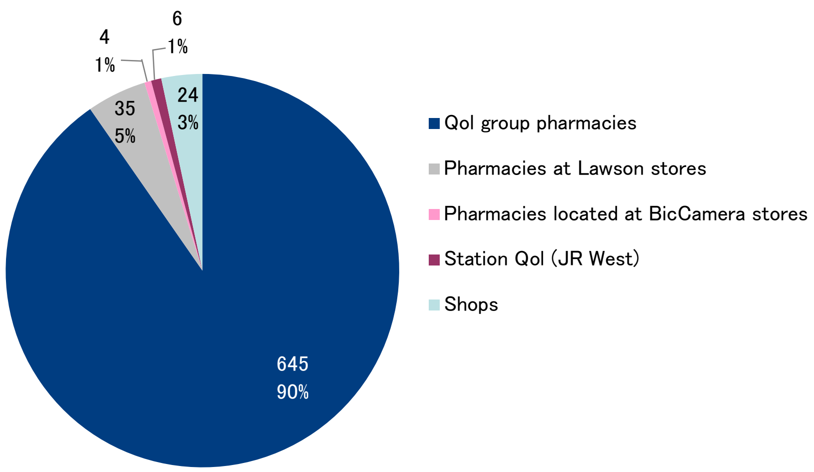
Qol views stores opened through the alliances as a “new format” because they cater to different target customer segments than the “one-on-one pharmacies” described earlier. “One-on-one pharmacies” have somewhat restricted customer scope that enables Qol to improve efficiencies in drug inventory management and other areas. New-format pharmacies, however, target undefined customers in locations with heavy people flow. While these sites require larger inventory investments and other outlays than the “one-on-one pharmacies,” they are likely to attract more customers (and thus receive more prescriptions). We think Qol views “one-on-one pharmacies” as its core model and aims to accelerate growth with the new format.

Qol had a total of 714 locations nationwide at the end of December 2017 with 712 direct-operation stores, including dispensing pharmacies and hospital shops, and two franchise stores, with a breakdown of 690 pharmacies and 24 shops. Dispensing pharmacies mainly utilize the “Qol Pharmacy” brand, but some acquired pharmacies are still using previous names.

Qol’s pharmacy business by location and format consists of 645 standalone Qol group stores run by Qol and group companies, 35 Lawson-based stores, four BicCamera-based stores, six JR West-based stores, and 24 hospital shops (end-December 2017 values; Odakyu Electric Railway and Life Corporation alliance stores are placed under Qol group stores).

We expect Qol to expand the pharmacy business primarily by adding more standalone Qol pharmacy sites, including at group companies. (Refer to the growth strategy section for more details.) Lawson-based stores are unlikely to grow rapidly with the current business model because Qol must factor in operation of a convenience store business, not just the dispensing pharmacy. We also see limits in the number of potential stations that can accommodate “in-station stores” for the “Station Qol” business with JR West. Similarly Qol cannot open more stores than the number of BicCamera locations in the alliance with BicCamera. While new-format pharmacy business still offers significant growth potential, we envision a faster expansion pace for Qol pharmacies adhering to the “one-on-one pharmacy” concept.

Breakdown of group stores (as of the end of December 2017)

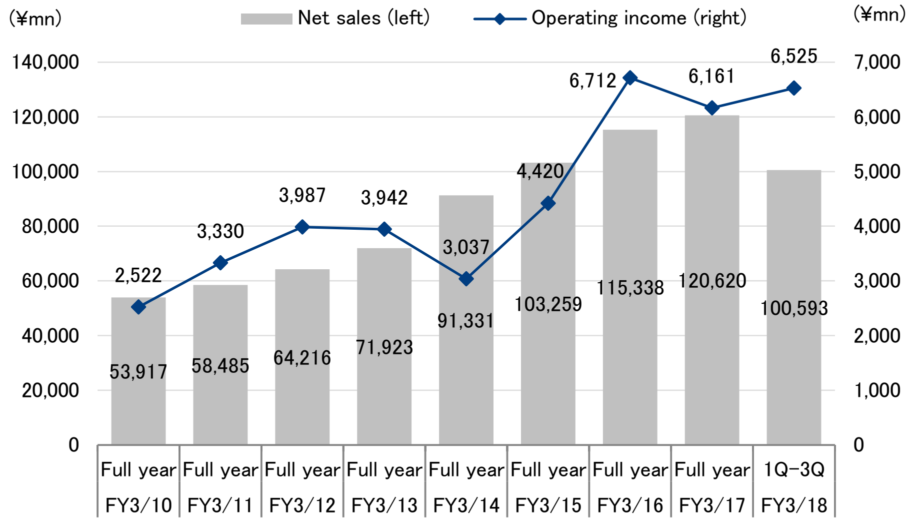


Source: Prepared by FISCO from the Company’s results supplementary materials

Pursuing growth through expansion of the store network led by M&A One-on-one pharmacy concept likely to provide a tailwind to realizing M&A deals

4. Growth strategies

Trends in pharmacy segment results

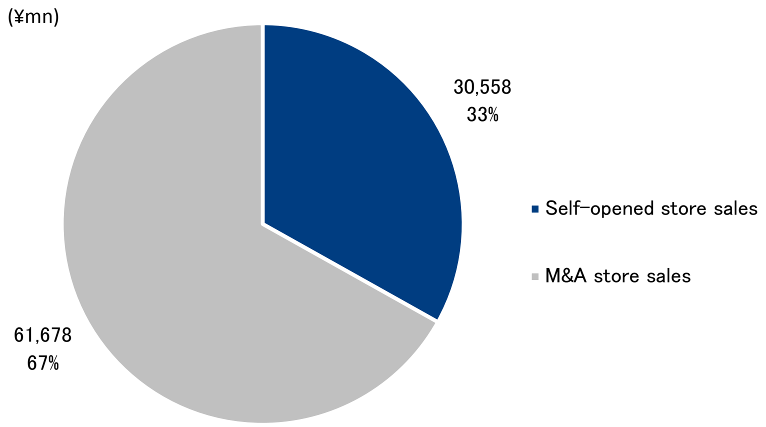


Note: Compilation method changed versus previously from FY3/15; though not much impact
Source: Prepared by FISCO from the Company's financial results

We think Qol's growth strategy in the dispensing pharmacy business mainly relies on increasing store volume with aggressive utilization of M&A as the key driver, just as previously.

Qol's disclosure of dispensing pharmacy business sales (total of drug fee sales and dispensing technical fee sales) still separates sales from stores acquired through M&A deals in past years as M&A store sales. In 1Q-3Q FY3/18 results, M&A store sales totaled ¥61,678mn, or 67% of the ¥92,237mn in overall dispensing pharmacy business sales. The M&A category covers a similar percentage of store volume at an estimated roughly 70%. These values clarify the extent to which Qol has realized growth by utilizing M&A.

Dispensing sales composition ratios by self-opened stores and M&A stores (1Q-3Q FY3/18 results)



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

We think Qol's growth strategy is credible and has a relatively strong prospect of succeeding because it continues to place emphasis on M&A, which has been how the company grew in past years. The "one-on-one pharmacy" concept has been an important factor.

There are roughly 58,000 pharmacies operating in Japan, and the majority is self-run pharmacies and small-scale chains. We expect steady advances in reorganization of the dispensing pharmacy industry led by major pharmacy chains. Qol's growth strategy driven by M&A is part of this overall trend. Nevertheless, other major pharmacy chains also focus on M&A-driven growth as the core element of their growth strategies and these conditions are likely to increase the intensity of competition among major chains for acquisition opportunities.

The "one-on-one pharmacy" concept is a key feature of Qol's business as noted earlier. This concept does not necessarily put top priority on sales per store. Instead it gives more emphasis to improved efficiency in logistics and drug inventory management by building dominance in local areas. We think Qol's stance could enable it to find enough value to consider M&A deals that other major chains pass over. Our favorable view of Qol's growth strategy takes into account the potential of having relatively abundant M&A opportunities.

Qol retains pharmacy chains that it acquires in their existing format without absorption into parent operations. This governance approach is appealing to M&A counterparts too. We believe it might lead to successes in Qol's M&A deals.

BPO business overview and growth strategy

Along with mainstay CSO and dispatching and recruitment businesses, also operates CRO and publishing businesses

1. Overview of the BPO business

BPO stands for Business Process Outsourcing (continuous outsourcing of some business processes to external specialist companies). The BPO business segment handles business consignments from other companies. Its three main areas are CSO business (including general-purpose dispatching and recruitment business), CRO business, and publishing business.

CSO is an abbreviation of Contract Sales Organization. The CSO business receives consignments from drug companies to handle sales and marketing activities and provide a full range of services related to drug sales based on contracts. Specifically, APO PLUS STATION hires medical representatives (MR) and dispatches them to drug companies that have contracts. These dispatched contract MRs conduct sales of drugs for the drug companies they cover to medical institutions and medical personnel.

The industry as a whole has roughly 4,000 contract MRs, and Qol (APO PLUS STATION runs this business) employs 540 CMRs (as of the end of FY3/18 2Q). As positioning in the industry, Qol's CSO business ranks first in contracted company volume with contracts for 44 of the 103 companies using CSO services (according to a survey by the Japan CSO Association) and is the third largest group in sales.

CSO rivals with larger sales are foreign-capital operators Quintiles Transnational Japan K.K. (it plans to change its name to IQVIA Services Japan K.K. in April 2018) and inVentiv Health Japan G.K. We think the industry structure stems from size discrepancies and basic employment stance differences between foreign-capital and domestic companies in the drug industry.

CRO business

CRO is an abbreviation of Contract Research Organization. The CRO business provides total solutions from testing and clinical research plans to publications in ethical drug, OTC drug, food, and healthcare fields. The most typical format is total support for clinical tests at medical institutions during drug development based on a consignment from the drug company.

Publishing business

Subsidiary Medical Qol handles publishing-related business, such as drug sales promotions and outsourced production of pamphlets used by medical personnel and patients, books, magazines, and other materials. The group possesses extensive knowledge of and distribution channel with medical institutions and patients through the pharmacy business and CSO and CRO businesses, and publishing business leverages these resources.

CSO business

CSO business is the largest by far of the three sub-segments in the BPO business described above. Besides these areas, BPO business also handles general-purpose dispatching and recruitment business that mainly involves pharmacists, nurses, registered pharmaceutical sellers (who have qualifications to sell second class and third class OTC drugs), and other medical professionals. We estimate that sales from CSO business (MR dispatching) and general-purpose dispatching and recruitment business amount to about 90% of the BPO segment. This means that CSO business environment and medical professional labor supply-demand conditions are key points in assessing the BPO business.

Targets growth by winning MR outsourcing business at drug companies and broadening CSO business scope

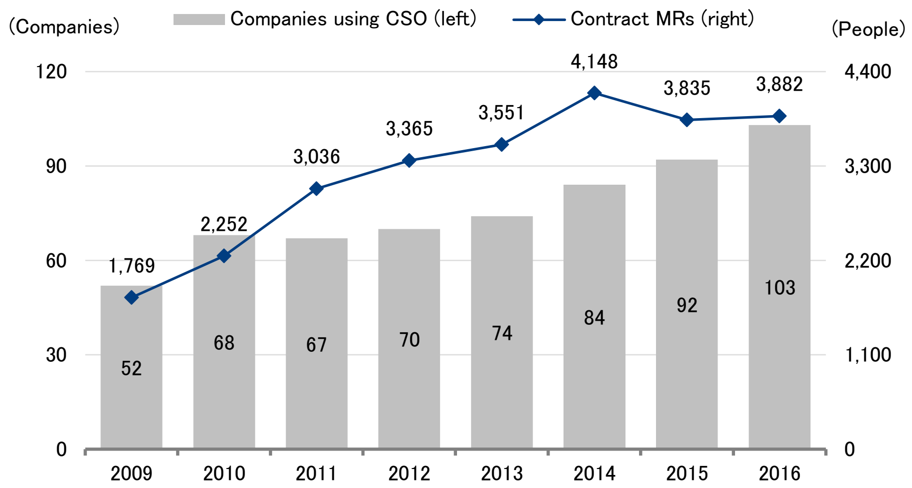
2. Growth strategy in the BPO business

CSO business (includes dispatching and recruitment business mainly for medical professionals) is currently the main source of BPO segment income and should continue as a major growth engine over the medium term.

CSO business is likely to deliver stable growth as drug companies steadily shift MRs from full-time employees to outsourcing (in other words, switch to CSO services). This can be seen in stable expansion of the number of companies utilizing CSO services. Contract MR volume has also been rising due to a trend of drug company full-time MRs converting to contract MRs. While contract MR volume remained flat at just under 4,000 people in the past two years, this just reflects a lull in the conversions.

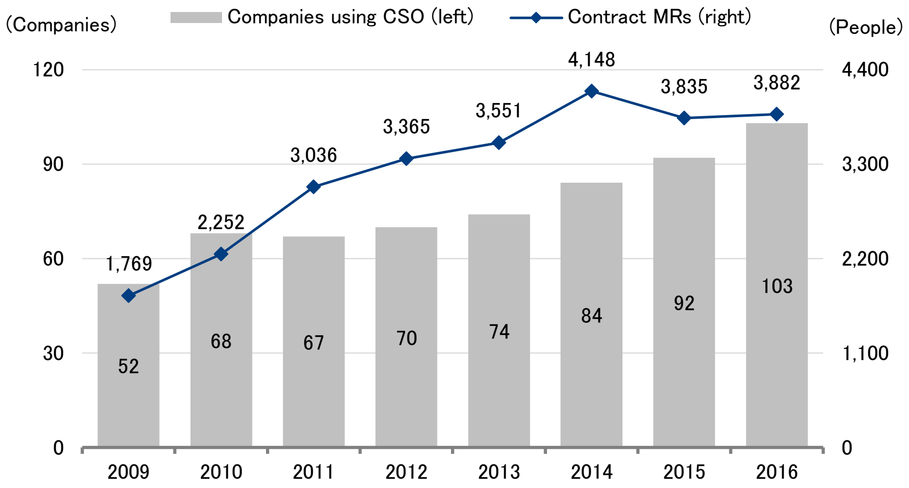
Results trends in the BPO segment

Trends in the number of companies using CSO and contract MR volume



Note: Compilation method changed versus previously from FY3/15; though not much impact
Source: Prepared by FISCO from the Company's financial results

Trends in the number of companies using CSO and contract MR volume



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

APO PLUS STATION has been increasing its contract MR headcount in line with expansion of this market. Contract MRs climbed from 442 people at the end of FY3/14 to 540 people at the end of FY3/18 2Q. Management aims to reach about 600 people by the end of FY3/18 and then continue to increase volume thereafter from FY3/19.

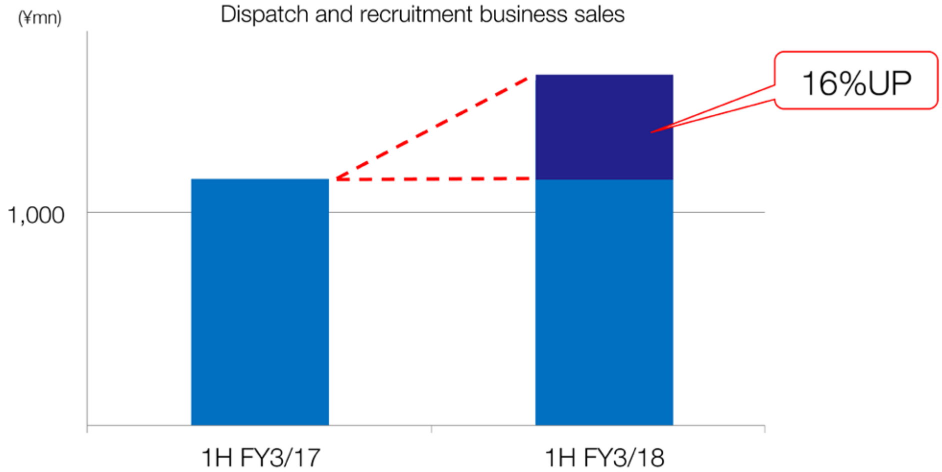
Meanwhile, CSO business exhibits higher income volatility than general dispatching businesses. Demand often increases on a project basis when drug companies release new drugs and pursue sales to medical institutions nationwide. Contract MRs return to their dispatching company after the project finishes. The issue is the number of people. Projects can involve more than 100 people. Resulting movement of contract MRs on a scale of 100 people back and forth between the dispatching company to customers in a relatively short period leads to significant volatility in income.

We think APO PLUS STATION addresses this issue by limiting dispatch volume per projects to no more than 20-30 people. Our estimate takes into account the 44 contracted companies (FY3/18 2Q level) versus roughly 500 contract MRs at APO PLUS STATION. Management uses diversification of dispatch sites to diversify and reduce business risk.

We have a positive view of Qol's direction of bolstering CSO business from the perspective of the trend of growing CSO utilization in the drug industry, its own positioning in the CSO industry, and affinity with the pharmacy business. We also see growing opportunities to increase contract MRs and broaden business scope in light of foreign-capital companies being the top two rivals in the industry sales ranking and movement by contract MRs at these companies.

General-purpose dispatching business, mainly for medical professionals, is also a potential growth engine for the BPO segment. Medical professional dispatching and recruitment needs have been steadily rising amid expanded openings by major dispensing pharmacy chains, robust deployment of sites with a pharmacy by leading drugstores, and nursing labor shortage. While Qol only discloses a summary of medical professional dispatching business, we estimate that dispatching sales were up 16% YoY to about ¥1.5bn in FY3/18 1H. This business appears to have accelerated to a 20% YoY growth pace in 1Q-3Q and is likely to become a ¥3bn annual business in FY3/18. We think Qol is capable of sustaining double-digit growth from FY3/19 as well by leveraging its strong brand as a major pharmacy chain to recruit personnel.

Trends in medical professional dispatching business sales (FY3/18 1H)



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

Business trends

Posted sharply higher sales and profits in FY3/18 1Q-3Q results led by healthy expansion of pharmacy business

1. Review of FY3/18 3Q results

Qol reported FY3/18 1Q-3Q results with sharply higher sales and profits at ¥108,471mn in net sales (up 12.8% YoY), ¥6,989mn in operating income (up 54.5%), ¥7,191mn in ordinary income (up 51.5%), and ¥4,160mn in profit attributable to owners of parent (up 45.4%).

Overview of FY3/18 1Q-3Q results

(¥mn)

	FY3/17		FY3/18			
	1Q-3Q	Full year	1Q-3Q	YoY	Progress rate	Full year (previous outlook)
Net sales	96,200	131,502	108,471	12.8%	74.3%	146,000
Operating income	4,522	6,865	6,989	54.5%	82.2%	8,500
Ordinary income	4,748	7,065	7,191	51.5%	84.6%	8,500
Profit attributable to owners of parent	2,861	4,353	4,160	45.4%	90.4%	4,600

Note: YoY = year on year; Progress rate = extent of progress toward full-year targets
Source: Prepared by FISCO from the Company's financial results

It reached high fulfillment rates for previous FY3/18 forecast through 3Q of 74.3% in net sales, 82.2% in operating income, and 84.6% in ordinary income. We think Qol is making very healthy progress thus far. Qol raised FY3/18 targets (as explained below) in light of the progress through 3Q.

Segment trends are reviewed below.

Breakdown by business segments

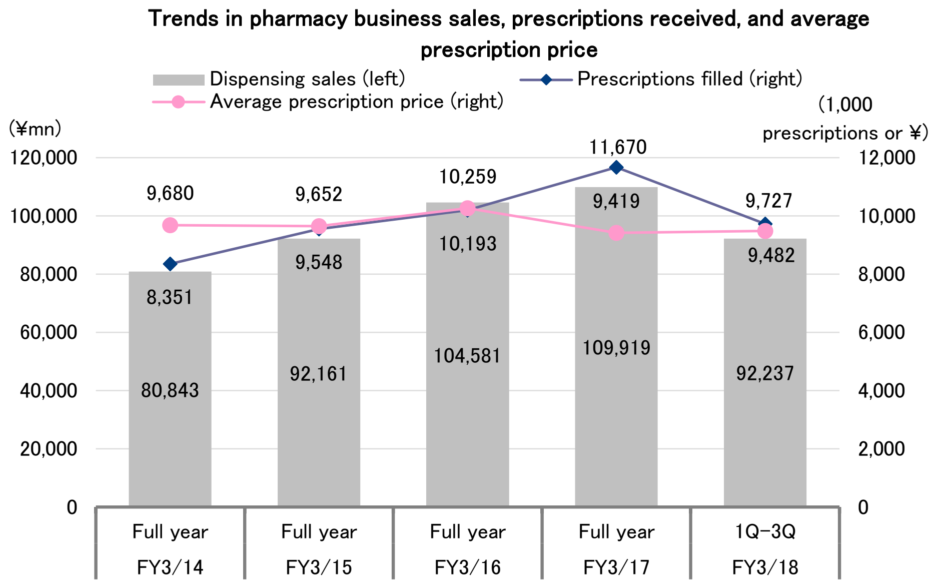
(¥mn)

		FY3/17		FY3/18		
		1Q-3Q	Full year	1H	1Q-3Q	YOY
Net sales	Pharmacy business	87,991	120,620	66,126	100,593	14.3%
	BPO business	8,208	11,152	5,271	7,878	-4.0%
	Prior to adjustment	96,200	131,772	71,397	108,471	12.8%
	Adjusted value	-	-270	-	-	-
	Net sales total	96,200	131,502	71,397	108,471	12.8%
Operating income	Pharmacy business	3,969	6,161	3,903	6,525	64.4%
	BPO business	1,154	1,498	755	1,097	-5.0%
	Prior to adjustment	5,123	7,660	4,658	7,622	48.8%
	Adjusted value	-601	-794	-407	-633	-
	Operating income total	4,522	6,865	4,251	6,989	54.5%
Operating margin	Pharmacy business	4.5%	5.1%	5.9%	6.5%	-
	BPO business	14.1%	13.4%	14.3%	13.9%	-
	Company total	4.7%	5.2%	6.00%	6.4%	-

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

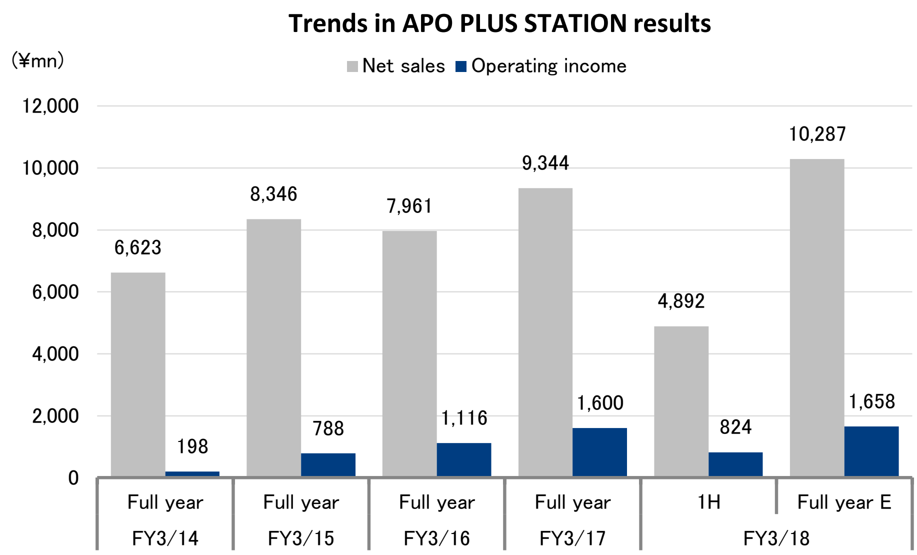
Pharmacy business achieved robust gains to ¥100,593mn in net sales (up 14.3% YoY) and ¥6,525mn in operating income (up 64.4%). M&A deals, including the acquisition of KYOEIDO Co., Ltd. as a subsidiary in October 2016, added ¥10,119mn in sales (YoY). Existing store sales were also higher by 4.5% YoY (¥1,254mn) thanks to expansion of pharmacy fee income via promotion of primary care pharmacy and pharmacist roles and use of generic drugs.

Profit margin improved in earnings because of better control of drug orders placement in the dispensing pharmacy business, enhanced inventory management for the overall group, and efforts to lower COGS by promoting use of generic drugs. While Qol does not disclose profitability just for dispensing pharmacy business, operating margin in the pharmacy business segment climbed by 2.0ppt from 4.5% a year ago to 6.5%.



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

BPO business booked ¥7,878mn in net sales (down 4.0% YoY) and ¥1,097mn in operating income (down 5.0%). Contract MR orders proceeded as planned and Qol retained its top industry position in contracted customers (drug firms) in the mainstay CSO business. Furthermore, general-purpose dispatching and recruitment business, which mainly handles medical professionals, steadily increased the number of dispatched pharmacists and other professionals and realized 20% sales growth. These core businesses also supported high profit margin, just as in the previous year. Nevertheless, segment sales and profits declined due to the lingering impact of reorganization of the CRO business in 1H.



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

Raised FY3/18 forecast again
Profitability improving on progress in pharmacy business initiatives

2. FY3/18 outlook

Qol raised FY3/18 forecast at the 3Q results announcement. This was the second upward revision of the year (the first took place at the 1Q announcement). New FY3/18 targets are ¥146,000mn in net sales (up 11.0% YoY), ¥9,000mn in operating income (up 31.1%), ¥9,200mn in ordinary income (up 30.2%), and ¥4,900mn in profit attributable to owners of parent (up 12.5%).

Overview of the FY3/18 outlook

(¥mn)

	FY3/17		FY3/18					
	4Q Actual	Full year	4Q E	YOY	Full year (previous forecasts)	Full year (new forecasts)	YOY	Difference with the previous forecasts
Net sales	35,302	131,502	37,529	6.3%	146,000	146,000	11.0%	0.0%
Operating income	2,343	6,865	2,011	-14.2%	8,500	9,000	31.1%	5.9%
Ordinary income	2,317	7,065	2,009	-13.3%	8,500	9,200	30.2%	8.2%
Profit attributable to owners of parent	1,492	4,353	740	-50.4%	4,600	4,900	12.5%	6.5%

Note: YoY = year on year; Progress rate = extent of progress toward full-year targets
Source: Prepared by FISCO from the Company's financial results

Management lifted full-year forecast on progress in various measures to improve the pharmacy business and resulting income (particularly profit) gains in this segment. Qol has been successful with incremental increases in pharmacy fees through promotion of primary care pharmacist and pharmacy roles and use of generic drugs. It also bolstered suitable inventory management and drug procurement cost control via deployment of a new inventory system at all stores. These measures had a large impact on earnings and fueled higher profits through 3Q than previously anticipated, leading to the upward revision.

With updated forecast, Qol needs ¥37,529mn in net sales (up 6.3% YoY) and ¥2,011mn in operating income (down 14.1%) in 4Q, making it possible to fulfill full-year targets even with a profit decline. Dispensing pharmacy business normally receives a pick-up in demand in 4Q because of colds, influenza, and other illnesses during this period. Additionally, the fiscal year does not face revisions to medical fees and drug prices and the average prescription price increased YoY through 3Q. We think Qol's revised forecast is still cautious versus actual business given these points.

However, we do not expect FY3/18 results to sharply exceed the new targets. One reason for this view is the transition to a holding company planned for October 2018. Qol will incur costs to re-obtain permits and approvals due to the change in the business operator to a new company. We see a possibility of Qol booking these costs related to the transition to a holding company ahead of time in FY3/18. There are also a number of cost items budgeted in FY3/18 that appear to have slipped into 4Q, providing another reason for caution. A third factor is the update to medical fees and drug prices in April 2018. Medical fee and drug price revisions generally have a negative impact on results. We believe management might try to avoid extremely strong income in FY3/18 in order to maintain the trend of sales and profit growth even with the revision impact. This serves as an incentive to bring costs forward too.

In conclusion, we expect FY3/18 results to surpass forecast, but not by enough to warrant a third round of upward revisions or deliver a positive surprise to the market.

Likely to sustain the sales and profit growth trend with M&A and other growth measures more than offsetting the impact from medical fee and drug price revisions

3. FY3/19 outlook

Qol has obviously not disclosed the FY3/19 outlook yet. The key point is the impact of medical fee and drug price revisions taking effect in April 2018. While the government already presented the framework and direction of revisions, it has not announced point values for specific medical fees (dispensing fees) or revision details yet and this prevents Qol from giving estimates of the impact on its income.

Based on revisions outlined thus far, we believe negative impact on one-on-one pharmacies, which make up the core of Qol's business, should be relatively less by comparison to the large pharmacies with locations next to hospitals. Nevertheless, Qol is a major pharmacy chain and we expect some downside in income from the revisions as a top-level industry firm.

Despite this environment, we think Qol should be capable of maintaining a trend of sales and profit increases (YoY) in FY3/19. Pharmacy business is likely to sustain sales and profit advances, even with the revision impact, due to success in the growth strategy for dispensing pharmacy business led by robust promotion of M&A deals described above. We expect the transition to a holding company format to have a positive effect on M&A initiatives by accelerating decisions. BPO business might restore segment sales and profit growth on sustained growth in core CSO and dispatching and recruitment businesses and rebound in CRO business after the business reorganization. We believe Qol is capable of maintaining the trend of higher sales and profits on a companywide basis thanks to steady income expansion in these two segments.

Income statement and main indicators

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	1Q-3Q	Full year E
Net sales	100,966	114,363	124,957	131,502	108,471	146,000
Growth rate (YoY)	31.5%	13.3%	9.3%	5.2%	12.8%	11.0%
Gross profit	10,897	13,989	15,793	16,876	14,714	-
Gross margin	10.8%	12.2%	12.6%	12.8%	13.6%	-
SG&A expenses	8,791	9,745	9,050	10,010	7,724	-
SG&A expenses ratio	8.7%	8.5%	7.2%	7.6%	7.1%	-
Operating income	2,105	4,243	6,743	6,865	6,989	9,000
Growth rate (YoY)	-25.1%	101.6%	-	1.8%	54.5%	31.1%
Operating margin	2.1%	3.7%	5.4%	5.2%	6.4%	6.2%
Ordinary income	2,208	4,262	6,688	7,065	7,191	9,200
Growth rate (YoY)	-22.0%	93.0%	-	5.6%	51.5%	30.2%
Profit attributable to owners of parent	777	2,155	3,709	4,353	4,160	4,900
Growth rate (YoY)	-42.4%	177.3%	-	17.4%	45.4%	12.5%
Split-adjusted EPS	25.11	63.33	107.78	128.35	121.22	142.77
Split-adjusted dividend	18	20	24	24	-	28
Split-adjusted BPS	521.60	557.42	602.36	652.42	-	-

Note: Growth rates (YoY) not presented for profit items in FY3/16 because of changes in accounting policy
Source: Prepared by FISCO from the Company's financial results

Balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18 3Q
Current assets	24,117	26,534	37,824	36,578	45,064
Cash and deposits	5,162	8,236	16,523	14,174	20,434
Notes and accounts receivable-trade	10,940	12,079	15,242	15,785	16,409
Inventory assets	6,159	4,306	4,254	4,660	6,584
Other	1,856	1,913	1,805	1,959	1,637
Noncurrent assets	29,767	33,023	31,996	44,668	44,863
Property, plant and equipment	8,309	8,276	8,969	10,373	10,548
Intangible assets	17,311	20,380	18,474	29,483	28,824
Investments and other assets	4,147	4,366	4,551	4,812	5,491
Deferred assets	18	15	27	43	31
Total assets	53,904	59,573	69,847	81,290	89,959
Current liabilities	25,450	26,312	29,334	31,183	35,489
Accounts payable-trade	14,704	15,212	18,096	17,626	21,762
Short-term loans payable, etc.	5,733	5,394	4,696	6,373	6,558
Other	5,013	5,706	6,542	7,184	7,169
Noncurrent liabilities	11,078	14,108	19,481	28,473	19,380
Long-term loans payable, etc.	9,984	12,793	18,498	27,234	18,378
Other	1,094	1,315	983	1,239	1,002
Shareholders' equity	16,987	19,059	20,394	21,149	34,837
Capital stock	2,828	2,828	2,828	2,828	5,786
Capital surplus	9,085	10,880	9,354	9,366	13,489
Retained earnings	5,371	6,938	9,680	13,137	16,419
Treasury stock	-298	-1,588	-1,469	-4,182	-858
Total accumulated other comprehensive income	46	92	368	167	252
Non-controlling interests	339	-	259	315	-
Total net assets	17,374	19,152	21,022	21,632	35,089
Total liabilities and net assets	53,904	59,573	69,847	81,290	89,959

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

Cash flow statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	1H FY3/18
Cash flow from operating activities	2,350	7,841	7,539	5,813	6,148
Cash flow from investing activities	-8,383	-5,066	-3,348	-15,392	-2,686
Cash flow from financing activities	5,722	278	4,085	7,435	2,644
Effect of exchange rate changes on cash and cash equivalents	0	1	0	1	1
Net increase (decrease) in cash and cash equivalents	-310	3,053	8,275	-2,143	6,106
Cash and cash equivalents at the beginning of the period	5,268	4,957	8,011	16,287	14,144
Cash and cash equivalents at the end of the period	4,957	8,011	16,287	14,144	20,251

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

Shareholder returns

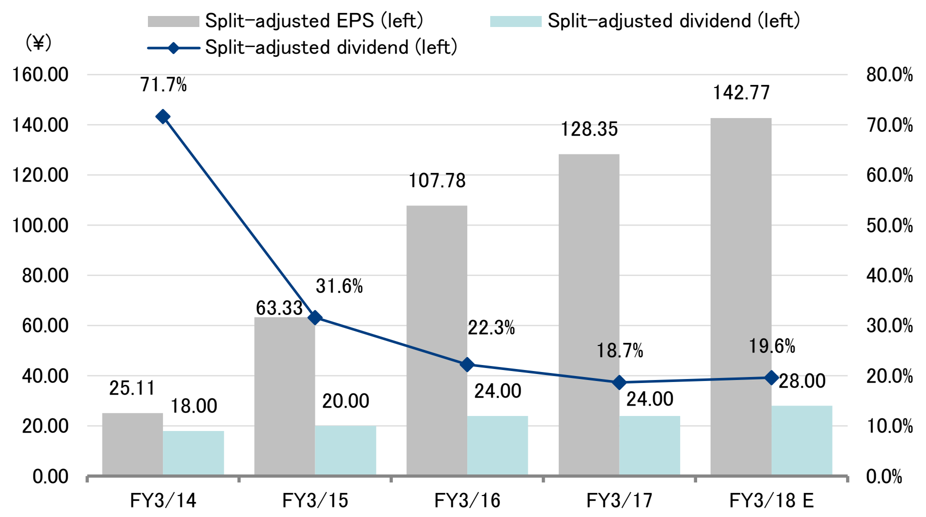
Increased the FY3/18 dividend target again, plans to pay ¥28

Qol primarily relies on dividends as shareholder compensation. Its basic policy advocates steady return of profits to shareholders while also retaining profits in order to pursue future business initiatives and reinforce corporate operations. It does not set an official payout ratio or other standards on dividend value.

Qol increased the FY3/18 dividend target a second time in this fiscal year at the 3Q announcement to ¥28 (comprising the ¥14 interim dividend and a ¥12 ordinary dividend and ¥2 commemorative dividend at the period end). It started year at ¥24 (¥12 interim and ¥12 period-end) and raised the target to ¥26 (¥14 interim and ¥12 period-end) at the 1Q announcement. Qol's dividend payout ratio works out to 19.6% based on current FY3/18 EPS and dividend targets.

Both dividend target revisions occurred at the same time as profit outlook changes, reflecting emphasis on shareholders in Qol's management stance. However, this does not mean that the dividend is always linked to profit changes because Qol stresses stability in profit return and has multiple growth investment plans. We think the decision to make two dividend hikes this fiscal year, despite these considerations, demonstrates confidence in sustainable profit growth.

Dividends per share and dividend payout ratio



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

Information security

Manages drug records and other personal data in a cloud service with strong security, focuses on employee education too

Qol has robust capabilities in information security because it handles highly confidential information, such as customer drug and illness records, in the dispensing pharmacy business. It took steps to acquire a privacy mark as an indicator of personal information protection and already received it. It also promotes employee education and awareness, mainly in the information system division, and conducts security checks periodically and often. Qol switched from an on-premise site to a more secure cloud format in personal information management. This approach reduces business risk and improves security.

Disclaimer