STARTIA, INC.
3393 Tokyo Stock Exchange First Section

8-Jul.-15

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Preparing to reaccelerate growth and greatly increase earnings, focusing on new products

Startia <3393> serves small and medium-sized companies with fewer than 300 employees. Large system integrators and network equipment dealers bypass such companies, which typically cannot maintain full-time IT personnel. Startia provides one-stop IT-related services for these companies, constructing, operating, and maintaining hardware through systems for them. Startia's key advantage is its robust marketing approach, which entails getting geographically close to clients to devise ways to facilitate cross-selling and offer merchandise that locks clients in.

Management targets ¥3,400mn in aggregate recurring profit under its New Three-Year Medium-Term Ordinary Income Plan, which ends in FY3/18. The target for FY3/15, the first year, was ¥866 mn, the same as the level for the previous fiscal year. Management has accelerated the target growth pace for the second and third years to ¥1,134 mn and ¥1,400 mn, respectively.

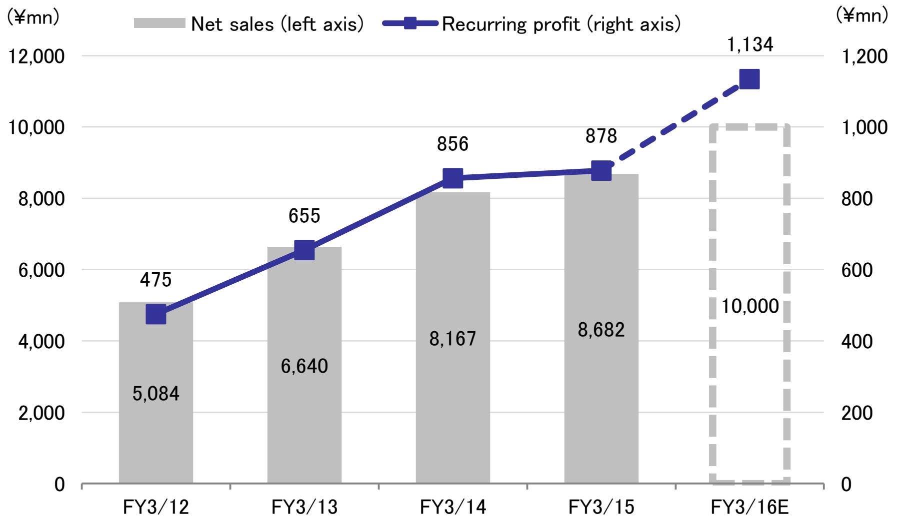
Recurring profit in FY3/15 was ¥878 mn, which was ¥12 mn higher than targeted. Management undertook various strategic steps during the year to pave the way for earnings expansion over the medium term. The company deployed a rapid succession of initiatives to position itself for growth. Efforts included moves to reinforce the security of hosting services, acquiring businesses, undertaking business and capital tieups, and strengthening overseas operations. Forward investment measures should have settled in place in FY3/16, by which time the company will likely leverage its more robust sales structure to again drive forward to secure top-line growth.

Startia is intensively developing new products and services for next-generation growth. Releases in FY3/16 include AppGoose and Startia Hikari. The AppGoose service makes it simple for small and mid-sized stores to engage in online-to-offline marketing, which has become a focus of attention. Startia Hikari is the brand for services launched through participation in NTT's Hikari Collaboration service. We believe that both AppGoose and Startia Hikari will start contributing fully to Startia's earnings from FY3/17. The initial year launches will command considerable attention, as these services have high growth potential.

Check Point

- Startia has released two new products this fiscal year that could become growth engines
- The company has significantly higher revenues and earnings in each segment in the near absence of factors constraining profitability
- Management is prioritizing individual shareholders and pursuing shareholder returns

Trend in corporate performance



Description of businesses

Providing an integrated IT environment to small and medium-sized companies

Hideyuki Hongo, the President, Representative Director and Chief Executive Officer, established Startia in 1996. It started out by selling business phones, expanding by offering Web hosting (rental servers) and other services with the spread of the Internet. Startia's business model focuses on serving small and medium-sized companies with fewer than 300 employees, which are often ignored by the competition, helping these entities overcome weak IT capabilities by providing an integrated IT environment. Startia currently provides one-stop solutions in the three business areas below.

Description of three business areas

	Web solutions related business	Network solutions business	Business solutions related business
Proportion of sales	23.5%	28.0%	48.5%
Proportion of profit	45.2%	25.5%	29.3%
Description of business and main products	Providing Web solutions e-book creating software "ActiBook" Providing AR service "COCOAR" Producing, maintenance, and operation of the web sites Planning and development of Web applications Providing log analysis and search engine optimization and management services Released AppGoose	Providing the network environment NW equipment and NW construction Providing cloud services: Including Digit@Link Secure SAMBA, Digit@Link Cloud, and hosting services Providing Global Gateway, a high-speed, high-security line linking China and Japan Supplying NetResQ, an internal IT network service for small enterprises	Providing optimal communication line, equipment Sale of business phones and multi-functional printers Distribution of "Otoku Line" as an agent Distribution of mobile phones for corporate clients as an agent Launched Startia Hikari as part of Hikari Collaboration setup

Note: Based on actual financial results of FY3/15

(1) Web solutions related business

The wholly owned Startia Lab, Inc., oversees the Web solutions business. This segment focuses on developing and selling ActiBook e-book production software and selling the COCOAR augmented reality service. Both are apparently very high-margin offerings, enabling this segment to account for almost half of Startia's operating income.

This business provides website production, operations, and maintenance services. It also supplies log analysis and search engine optimization and management services.

Startia released AppGoose in FY3/16. We will detail that product later in this report, but in essence, AppGoose makes it simple for small and medium-sized enterprises and stores to produce online-to-offline applications and marketing campaigns.

(2) Network solutions related business

The network solutions business engages in internal IT network construction. It provides integrated hardware and software assistance. On the hardware side, it sells routers, firewalls, and other network equipment and provides network construction and other equipment. On the software side, this business also proposes optimal Internet service provider support that reflects client needs and scales and other factors.

Startia assists clients after network completion, supplying rental servers and the Secure SAMBA and Digit@Link Cloud services. Its offerings also include the Global Gateway dedicated line linking Japan and China and NetResQ, a maintenance service for the networks of small enterprises.

(3) Business solutions business

The business solutions segment focuses on selling and maintaining wireline telephones and corporate mobile phones, copiers, and the Otoku Line service. The business model for many products in this segment is a stock-based revenue structure. Therefore, although margins are low this segment can stably amass earnings.

In May this year, the company launched Startia Hikari, the brand for a retail business for fiber-optic lines. Startia is a provider under the Hikari Collaboration service of NTT <9432>. This new service could put the business solutions segment back on track for growth. We will discuss details later in this report.

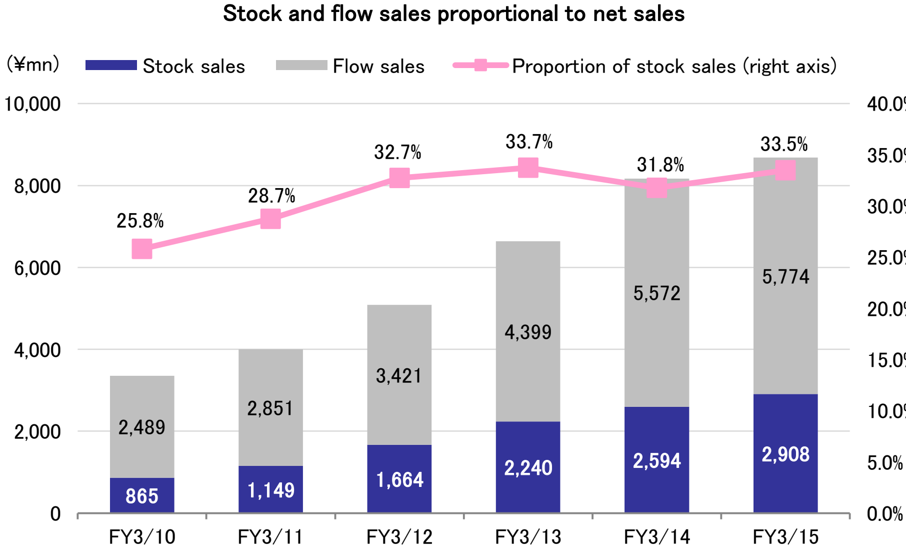
Profit structure and strengths

Emphasizing flow sales growth over stock sales proportion gains

(1) Profit structure

Startia derives its profits from one-time sales (flow) and monthly revenues (stock). Clients can choose from flow or stock options (one example being ActiBook e-book software). In other cases, a dual flow and stock structure applies. An example of this is multi-functional printers (MFPs), for which a one-time sale is recorded to purchase a unit, with monthly revenues accruing from MFP counter fees (charging for paper, toner, and other consumables). Flow sales currently account for 66.5% of net sales, with stock sales representing 33.5%.

■Profit structure and strengths



The higher the stock sales proportion, the more stable the results. Startia, however, maintains a dual flow and stock sales structure for much of its merchandise and services. In addition, the company could provide ActiBook on a stock sales basis, selling on installment, or on a flow basis, which would clearly be more effective in boosting results in a single fiscal year. We believe that Startia should be seen as focusing more on flow sales growth and less on stock sales proportion gains.

Successfully deploying highly efficient marketing strategy

(2) Key factors in strong marketing capabilities

Startia's strong marketing capabilities are central to its growth. The company has successfully devised its own approach to reinforce marketing and turn it into a strength.

The first factor is Startia's business focus. Most of its clients are small and medium-sized enterprises with fewer than 300 employees. There are around 5.43 million such companies around Japan. Many do not have in-house IT engineers. Yet, systems integrators and network equipment dealers generally ignore them because they are so small. Startia's business purpose is to step into this IT void and eliminate the digital divide for these enterprises. This means that Startia's salespeople have to be physically near client enterprises. The company therefore set about expanding sales to clients its people can reach in around an hour and a half. Startia accordingly markets in areas with high population concentrations, notably metropolitan Tokyo, and the Kansai, Tokai, and Kyushu areas. The focus is on being close to clients rather than having a presence in Japan's four major metropolitan areas.

The second factor is that Startia has multiple offerings that it can exploit in cross-selling. For example, it can package business phones with MFPs or provide a package that combines hosting services with network equipment and construction. From the client perspective, the company has a lineup of complementary offerings. Startia's slim billing service is a one-stop billing system covering multiple services from the company. The benefit for clients is that they can contact a single inquiry desk. This is not only more convenient for clients but also helps reduce their administrative and accounting workloads. This is a great motivator for companies to order packages of Startia's IT services. In short, Startia adds one-stop solutions for IT infrastructure and slim billing to achieve cross-selling.

As discussed earlier, Startia has combined its focus on close proximity to clients with proposing a product and service lineup that enhances client convenience as part of a highly efficient marketing strategy that has successfully increased multiple purchasing per client while expanding client numbers.

Medium-term income plan and new services

Accelerating to regenerate profit growth from this fiscal year

(1) Overview of medium-term income plan

Startia announced its New Three-Year Medium-Term Ordinary Income Plan on August 20, 2014. The first noteworthy aspect of this initiative is that the company is targeting ¥3,400 mn in aggregate recurring profit over the three years through FY3/17. This would be 71.2% higher than the ¥1,986 mn generated in the preceding plan. The next key point of the plan is that management looks to maintain the initial year recurring profit at the FY3/14 level and accelerate growth in the second and third years.

New medium-term 3 year income plan

(¥mn)

	FY3/14		FY3/15		FY3/16		FY3/17	
	Actual	Plan	Actual	Growth rate	Plan	Growth rate	Plan	Growth rate
Recurring profit	856	866	878	2.6%	1,134	29.2%	1,400	23.5%

This is apparently the first time for Startia to formulate a medium-term income plan that takes such an approach. We think that the company did so because it has already reached a certain earnings level stemming from ongoing expansion since its establishment and wants to prepare for the next stage of growth. Management itself has characterized the flat recurring profit projection for FY3/15 as "a forward investment." The greatest of several such investments will be on improving security for the network solutions business. From the outset, the company factored in such efforts as hiring and training large numbers of new graduates and beefing up its global strategies.

Exceeding recurring profit projection and increasing technological division engineers as proportion of employee number

(2) Progress assessment: FY3/15 results

In FY3/15, the first year of the current medium-term income plan, Startia posted ¥8,682 mn in net sales (YoY +6.3%), ¥747 mn in operating income (YoY +10.0%), ¥878 mn in recurring profit (YoY +2.6%), and ¥592 mn in net profit (YoY +37.2%). Although net sales and operating income were ¥566 mn and ¥93 mn, respectively, lower than management's forecasts, recurring profit, a key performance indicator under the medium-term income plan, was ¥12mn higher than projected.

Segment sales, operating income, and margins

(¥mn)

Segment	Item	FY3/12 Annual actual	FY3/13 Annual actual	FY3/14 Annual actual	FY3/15 Annual actual	FY3/15 Growth rate
Web solutions related business	Net sales	1,074	1,482	1,943	2,041	5.0%
	Segment profit	220	165	323	359	11.1%
	Net margin on profit	20.5%	11.1%	16.6%	17.6%	–
Network solutions related business	Net sales	1,425	1,843	2,160	2,432	12.6%
	Segment profit	179	363	301	202	-32.9%
	Net margin on profit	12.6%	19.7%	13.9%	8.3%	–
Business solutions business	Net sales	2,585	3,314	4,063	4,208	3.6%
	Segment profit	91	170	254	232	-8.7%
	Net margin on profit	3.5%	5.1%	6.3%	5.5%	–

The main factors in sales and operating income shortfalls below projections were that all businesses, particularly Web solutions, performed more sluggishly than expected in the third quarter. The Web solutions shortfall stemmed from insufficient marketing capabilities despite endeavoring to shift the sales focus from ActiBook to COCOAR, with new graduates spearheading that effort, and COCOAR sales decelerating. In the fourth quarter, the company was unable to offset third quarter shortfalls despite regaining momentum. Recurring profit was ¥12 mn higher than forecast, as equity in earnings of affiliates increased ¥46 mn, while there was a ¥47 mn foreign exchange gain.

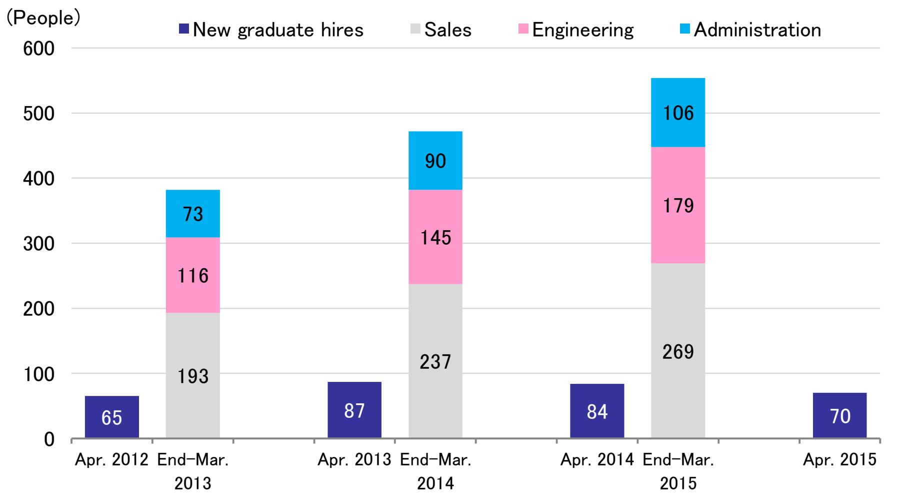
The table below presents key initiatives during FY3/15. Startia invested in security as planned, upgrading to new servers and installing new security software. The company recruited 84 new graduates, representing around 20% of its employees, with around 60 of those new hires still with the company as of the end of FY3/15. The year was noteworthy for business and capital alliances to secure new people and boost personnel capacity. Startia set up a branch in Taiwan during the year. The company had previously marketed its offerings there exclusively through local entity Horma Digital Technology (in which it acquired a 39.76% stake in June 2013). With the new Taiwanese branch, Startia retained that setup while stepping up operational oversight, apparently with considerable success.

Key initiatives in FY3/15

	Contents	Remarks
Through FY	Improving security of the hosting service	¥170 mn increase in investment compared to ordinary years
Apr. 1, 2014	Recruiting 84 new graduates	Large number of hiring following 87 hired in the previous year Among 541 employees on a consolidated basis, about 15% are new graduate and about 30% are fresh employees with a career of less than two years
May 1, 2014	Established Takizawa R&D center	Seeking joint development with Iwate Prefectural College
Jun. 2, 2014	Opened Kobe branch	Enabled targeting about 220,000 companies in Hygo Prefecture.
Aug. 22, 2014	Business and capital tie-up with A.T. WORKS Inc.	Initial 10% capital contribution. Aiming at joint development of products and services, technical support of the hosting service, and personnel exchange
Aug. 28, 2014	Operating tie-up with Japan PC Service Co., Ltd.	Personnel exchange for the purpose of mutual client introductions and business synergy improvement
Sep. 30, 2014	Business and capital tie-up with Kakehashi Promotion Co., Ltd.	Countermeasure to the chronic lack of an excellent "sharp" talented person
Nov. 4, 2014	Established 100% owned subsidiary, Crosscheck Inc.	Taking a major role to improve quality of one stop billing service, "Slim billing," which is a significant service in marketing strategy.
Nov. 28, 2014	Concludes business and capital alliance with Revolver	Cultivating service sales channels and reinforce website production services
Dec. 19, 2014	Acquisition of a part of NextIT Inc.'s business	Took on businesses and 21 engineers to reinforce technological capabilities, established Shinagawa Technical Center
Jan. 5, 2015	Established Taiwan branch	Sold Startia Lab's offerings
Mar. 31, 2015	Acquisition of operations from Issei Business Machines Corporation	Took over equipment sales and counter businesses and established Adachi Technical Center

As well as hiring new graduates in FY3/15, Startia took on engineers from the businesses of Next IT Inc. and Issei Business Machines. The group thus had 554 employees at year-end. It is worth noting that the number of technical operations people is rising as a proportion of all employees.

Employee numbers on consolidated basis



Launching two new products this term that could drive growth

(3) Key new products

Startia made forward investments in FY3/15 to drive growth. The company aims to return to an expansionary trajectory from FY3/16. In that year, it plans to release two new products that could become growth engines, building on the successes of such offerings as ActiBook, COCOAR, and Secure SAMBA.

(a) AppGoose

Online-to-offline marketing is attracting considerable attention in the retailing sector. Typical examples online include distributing discount coupons or providing bricks and mortar store location or event information to encourage visits to those stores.

To execute online-to-off-line marketing, stores have to develop their own apps, which consumers must download from the App Store or Google Play. Stores then distribute coupons and event and other information through the apps. This is one hurdle to stores developing their own apps.

Startia's AppGoose service offers two key advantages. The first is that stores that do not have their own apps can use Startia's GOOSEE app to distribute coupons and event and other information. Second, it enables stores that want to engage in online-to-offline marketing with their own apps to create them simply (distributing coupons and information through the apps). Startia's business model is to charge stores an initial fee and then a monthly usage charge.

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(b) Startia Hikari

NTT <9432> made it possible for service providers to wholesale FLET's Hikari fiber-optic broadband connections, which it previously marketed itself. Those providers can add Hikari to their own services and sell them to consumers at fees that those companies set independently. This setup is called the Hikari Collaboration Service. Providers are called Hikari Collaboration businesses. Startia is one such business, marketing its service package under the Startia Hikari brand.

Consumers using FLET's Hikari can switch to services from Startia Hikari or other Hikari Collaboration businesses, without needing to change their phone numbers or commission construction work for the changes and only requiring a change in contract form. The usage environment remains the same for consumers after the change, as the contracts allow them to continue using services that are available only from NTT.

■ Operational results and financial analysis

Significantly higher revenues and earnings in each segment in near absence of factors constraining profitability

(1) Outlook for FY3/16

Management's forecasts for FY3/16 are for ¥10,000 mn in sales (YoY +15.2%), ¥1,134 mn in operating income (YoY +51.8%), ¥1,134 mn in recurring profit (YoY +29.2%), and ¥567 mn in net profit (YoY -4.2%).

Although the company looks for significantly higher revenues and earnings in each segment, it is important to assess this information carefully because of transfers between some product segments.

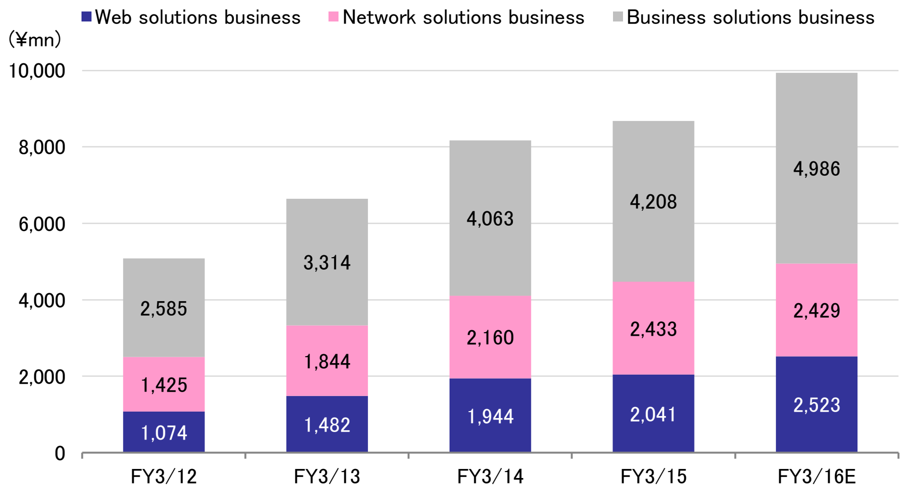
Management forecasts sales of ¥2,523 mn (YoY +23.6%) in the Web solutions business. We believe that most of that growth would come from COCOAR. Development costs are low for this offering, partly because it is a derivative of ActiBook, and the very high profitability of this product makes it attractive. The AppGoose service will probably not contribute fully to earnings until FY3/17 onward, as sales will not kick in during this inaugural year until customers learn of the convenience, utility, and usage advantages. That said, online-to-offline marketing is attracting a lot of attention because it is easy to understand its impact, so AppGoose could have more scope for growth than expected.

The sales projection for the network solutions business is ¥2,429 mn (YoY -0.1%). One factor in that decline would be that Startia has transferred the NetResQ service from the network solutions business-to-business solutions, lowering network solutions sales by around ¥350 mn. Management looks to compensate for the NetResQ transfer by increasing sales of Secure SAMBA as a Saas-based online storage service and sales of network equipment.

The sales projection for the business solutions segment is ¥4,986 mn (YoY +18.5%). The company looks to significantly increase MFP sales after adding new models once it sells out predecessor ones. The accumulated unit sales growth of MFPs should greatly increase counter fee-based revenues and drive segment sales growth. Management estimates sales of ¥80 mn to ¥90 mn for the new Startia Hikari service, and it will be worth monitoring sales trends in this area as salespeople will probably find the service easier to promote than the copper-based Otoku Line service.

On the earnings front, most of the elements that constrained profitability in FY3/15 should be absent in FY3/16. Expenditure to reinforce server security peaked during FY3/15, and this factor should add around ¥30 mn to the bottom line this fiscal year. Startia hired 70 new graduates in spring this year. Management has drawn on the experience of FY3/15 to modify its strategies for cultivating and training new hires and handling merchandise, changing its approach so people gain confidence quicker. This effort seems to be steadily bearing fruit. We think that the company will be well placed to absorb the impacts of higher personal expenses and spending on 20th anniversary celebrations on selling, general and administrative expenses if it reaches its sales goals.

Segment sales



※Note: The aggregate for all segments in FY3/16 does not reach ¥10,000 mn.

Income statement and key performance indicators

(¥mn)

	FY3/11	FY3/12	FY3/13	FY3/14	FY3/15	FY3/16E
Net sales	4,000	5,084	6,640	8,167	8,682	10,000
YOY	–	27.1%	30.6%	23.0%	6.3%	15.2%
Profit on sales	2,257	2,779	3,487	4,245	4,356	–
YOY	–	23.1%	25.5%	21.7%	2.6%	–
Ratio of gross profits to sales	56.4%	54.7%	52.5%	52.0%	50.2%	–
SG&A	1,984	2,319	2,831	3,415	3,609	–
YOY	–	16.9%	22.0%	20.6%	5.7%	–
Ratio of SG&A to sales	49.6%	45.6%	42.6%	41.8%	41.6%	–
Operating income	273	459	656	829	747	1,134
YOY	–	68.0%	42.9%	26.5%	–10.0%	51.8%
Recurring profit	278	475	655	856	878	1,134
YOY	–	71.1%	37.7%	30.6%	2.6%	29.1%
Net income	129	278	391	432	592	567
YOY	–	115.2%	40.4%	10.5%	37.2%	–4.3%
EPS (¥)	29.41	56.24	78.62	85.50	116.18	111.24
Dividend (¥)	5.00	5.62	7.86	15.00	20.00	17.00
BPS (¥)	484.44	534.86	605.71	689.67	779.80	–

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Balance sheet

(¥mn)

	FY3/11	FY3/12	FY3/13	FY3/14	FY3/15
Current assets	2,808	3,092	3,396	4,051	4,057
Cash and deposits	2,010	2,055	2,068	2,247	2,335
Notes and accounts receivable-trade	631	837	1,033	1,438	1,319
Other	166	199	294	365	402
Noncurrent assets	615	676	878	1,115	1,604
Tangible noncurrent assets	97	108	100	105	150
Intangible noncurrent assets	240	258	327	502	811
Investment and other assets	277	309	450	507	642
Deferred assets	14	9	4	-	-
Total assets	3,439	3,777	4,279	5,167	5,662
Current liabilities	898	1,126	1,242	1,661	1,684
Accounts payable-trade	291	354	453	618	565
Short term borrowings	151	141	-	-	-
Others	454	631	789	1,043	1,119
Noncurrent liabilities	141	0	0	12	-
Long term borrowings	141	-	-	-	-
Others	-	0	0	12	-
Shareholder's equity	2,404	2,658	3,044	3,450	3,960
Capital stock	777	777	789	795	824
Capital surplus	918	919	930	937	965
Retained earnings	707	961	1,324	1,717	2,208
Treasury stock	0	0	-0	-0	-38
AOCI (Accumulated Other Comprehensive Income)	-4	-7	-9	42	15
Minority shareholders' interest	0	0	0	0	0
Subscription rights to shares	0	0	0	1	2
Total net assets	2,399	2,650	3,035	3,493	3,977
Total liability and net assets	3,439	3,777	4,279	5,167	5,662

Statement of cash flows

(¥mn)

	FY3/11	FY3/12	FY3/13	FY3/14	FY3/15
Net cash provided by operating activities	410	461	566	638	755
Net cash provided by investment activities	-214	-240	-591	-286	-582
Net cash provided by financing activities	597	-186	-146	-24	-82
Effect of exchange rate change on cash and cash equivalents	-0	-0	-0	-0	48
Net increase (decrease) in cash and cash equivalents	793	35	-171	326	139
Cash and cash equivalents at beginning of period	1,211	2,005	2,040	1,868	2,195
Cash and cash equivalents at end of period	2,005	2,040	1,868	2,195	2,335

ROE trending above average for Japanese companies and international standards

(2) Financial status analysis

In FY3/15, Startia's ROE reached 15.9%. This was not only higher than the average for Japanese companies but also exceeded the 15% average internationally. That said, it is important that this ROE reflected a nonrecurring factor, notably the sale of investment securities that boosted net income by ¥52 mn that year. Still, Startia's ROA was a solid 16.2%, so we can say that its ROE was of a very high quality.

Our ROE forecast for FY3/16 is 13.5%, calculated from total assets and shareholders equity estimates based on management's assumptions. A decline in the ratio of gross profits to sales would have a great impact. Management forecasts great differences in recurring profit and net income because of the company's normal tax rate. We believe that there is ample potential for net income to be higher than management envisages, in which case ROE could be more than 13.5%.

Shareholder's return

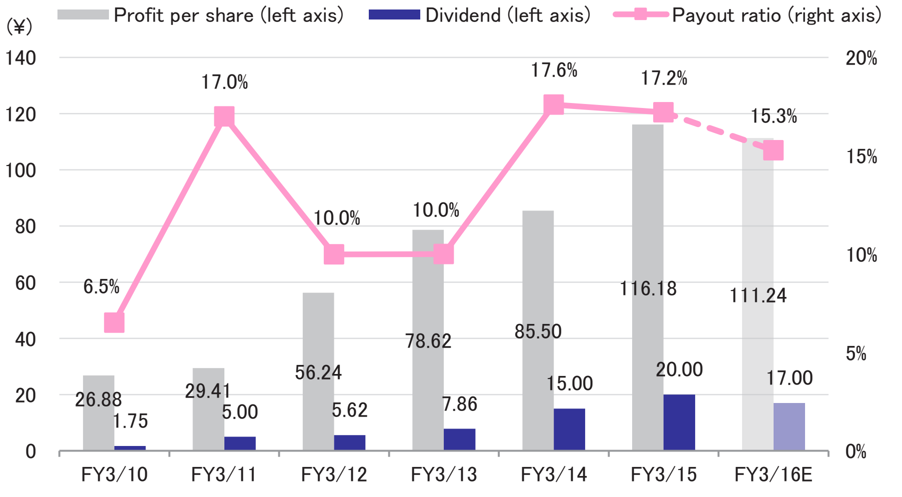
Company emphasizing individual shareholders and pursuing shareholder returns

Startia is emphasizing individual shareholders and pursuing shareholder returns. Dividends are fundamental to that approach, and management has determined dividends that strike a balance with the internal reserves set aside for growth investments.

Management was previously committed to a payout ratio of 10%. In FY3/14, the company paid a dividend of ¥15 per share to commemorate listing on the first section of the Tokyo Stock Exchange, thereby raising the payout ratio to 17.6%. From FY3/15, the company listed the target payout ratio to 15%. A dividend of ¥20 per share in FY3/15 to mark the company's 20th anniversary increased the payout ratio to 17.2%.

In FY3/16, management plans to pay dividends of ¥17 per share. That would represent a payout ratio of 15.3% on the projected net income per share of ¥111.24 yen. If earnings expand even further, we could anticipate commensurately higher dividends, with management possibly raising its payout ratio targets over the medium and long terms.

Trend of profit per share, dividend, and payout ratio



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