COMPANY RESEARCH AND ANALYSIS REPORT

SUN-WA TECHNOS CORPORATION

8137

Tokyo Stock Exchange First Section

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Summary

Likely to deliver higher sales and profits again in FY3/19 on continuation of robust demand
Has established operations to support longer-term sustainable growth by strengthening the financial base

Sun-Wa Technos Corporation <8137> (hereinafter, "the Company") is an independent trading company that specializes in technology products. The Company has steadily expanded its businesses by leveraging coverage of three major areas (electrical machinery, electronics, and general machinery) and two-way trade in which it sells equipment and materials for manufacturers' production lines and then procures the products made by these manufacturers. In recent years, it has been focusing on engineering business and global SCM solutions.

1. Increased income further in 2H and posted sharply higher sales and profits in FY3/18

The Company reported sharply higher sales and profits in FY3/18 at ¥146,759mn in net sales (+25.9% year on year (YoY)) and ¥4,135mn in operating income (+37.2%). While the Company raised forecasts three times during the period, it still overshot the final view. Robust conditions in the various demand industries, which fueled upbeat results in 1H, continued in 2H, and income expanded further during 2H. Key positive trends were capital investments by local smartphone manufacturers in China, reinforcement of semiconductor production capacity in Japan and overseas, and capital investments by the automotive industry in preparation for EV and ADAS (advanced driving assistance system).

2. Expects healthy business conditions to continue, targeting higher sales and profits in FY3/19 too

The Company forecasts for higher sales and profits in FY3/19 at ¥157,500mn in net sales (+7.3% YoY) and ¥4,450mn in operating income (+7.6%). Despite the prospect of sluggish growth in sales volume in the smartphone industry, manufacturers are continuing to invest in automation that targets cost savings at production sites and this activity benefits the Company. Strong demand for automation investments exists in automotive-related industries and other areas too. Continuation of investments to increase output capacity in the semiconductor industry, without impact from final-product memory price trends, provides a tailwind to the Company as well. In flat panel displays (FPDs), we expect steady increase in OLED production lines. Vibrant activity is continuing in the Company's major demand industries. We think these trends are likely to last for a while.

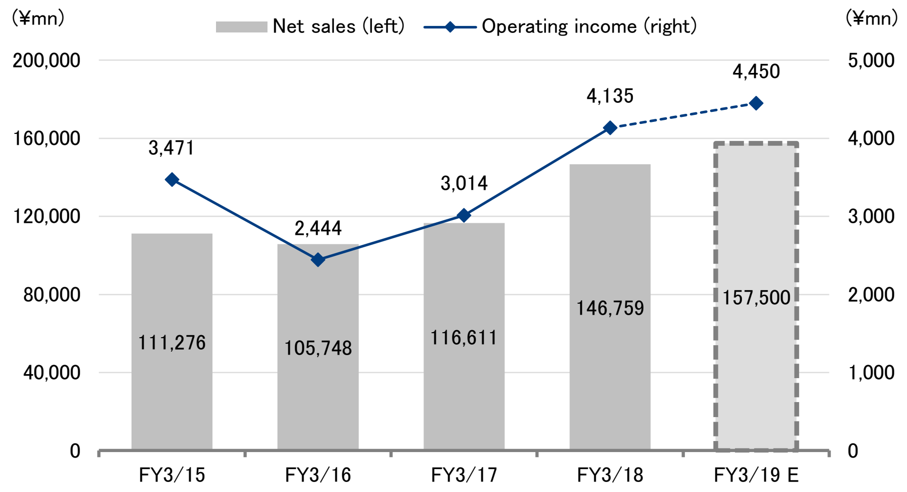
3. Making healthy progress in the current medium-term management plan Challenge 1500; focus on the outcome in FY3/19

The Company is implementing Challenge 1500, its ninth three-year medium-term management plan, with FY3/19 as the final year. It transitions to the next medium-term plan in FY3/20 and has started the process of formulating the new plan. While we expect the current upbeat business environment to continue over the medium term in the next plan's period, the outcome in FY3/19, which sets the starting line for the new plan, is extremely important to presenting a vibrant growth scenario that capitalizes on these conditions. In past medium-term plans, the Company missed goals in the final fiscal year due to overlap with bottoms in the demand cycle. Challenge 1500 targets ¥4.5bn in ordinary income. We see a reasonable possibility of attaining this goal as things currently stand and will be closely monitoring progress.

Key Points

- Rapid growth in sales of automotive parts and materials in the electronics division
- Aiming for steady attainment of Challenge 1500 goals in engineering and global SCM solutions businesses
- Plans to continue initiatives in engineering business aimed at creation of added value and expansion of profitability

Results trends



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

Company profile

Unique independent trading company handing three different types of products - electrical machinery, electronics, and general machinery

1. Background

The Company traces its roots to a self-run business created by the late Tokuro Yamada in July 1946 that leveraged his experience selling electrical machinery in China since before the war. It was incorporated in November 1949 as YAMADA KOGYO CORPORATION and concluded a distributor contract with YASKAWA Electric Manufacturing Co., Ltd. (currently, YASKAWA Electric Corporation <6506>), marking the full-fledged start of the Company's history. While the Company is a major sales distributor of YASKAWA Electric, it went beyond this relationship to conclude sales distributor contracts with other leading electric equipment and machinery manufacturers as an independent trader of technology products, expanding products that it handled and the customer base, and broadening business scope. The Company established a position as a unique trading company that specializes in technology products, handling three different types of products (electric machinery, electronics, and general machinery) that it continues to hold today.

In overseas activities, the Company rapidly broadened its network of local entities from the 1990s in response to offshore moves by customer firms spurred by yen appreciation, trade friction, and other factors. Following the launch of entity in Singapore in 1995, it proceeded to build an overseas subsidiary network in major Asian countries, Europe, and North America. It recently established local entities in Indonesia, Vietnam, Mexico and the Philippines as countries with strong growth potential.

The Company listed its shares on the OTC market in May 1982, moved to the Second Section of the Tokyo Stock Exchange in April 2003, and advanced to the First Section in March 2005.

History

	Domestic business development	Overseas business development
November 1949	Established YAMADA KOGYO CORPORATION	
December 1952	Sales agent contract with Osaka Transformer Co., Ltd. (now DAIHEN Corporation)	
November 1960	Sales agent contract with NIPPON GEAR Co., Ltd.	
October 1966	Agent contract with Origin Electric Co., Ltd.	
March 1969	Distributor contract with Toyo Carrier Engineering Co., Ltd (now Toshiba Carrier Corporation)	
July 1970	Exclusive contract with Tateisi Electric Manufacturing Co. (now, OMRON Corporation)	
November 1970	Established Yamada Kucho Co., Ltd. (now SUN-WA-TRINITY CORPORATION)	
September 1971	Sales agent contract with NIKKISO CO., LTD.'s equipment sales division	
June 1974	Started sales of YE DATA INC. products	
November 1977	Established Yamada Kogyo Kenkyusho	
May 1978	Agent contract with Sumitomo 3M Limited	
July 1978	Special agent contract with STANLEY ELECTRIC CO., LTD.	
November 1979	Special agent contract with Nemic-Lambda Co., Ltd. (now TDK-Lambda Corporation)	
May 1981	Sales agent contract with SANKI ENGINEERING CO., LTD.	
May 1982	Listed shares on the OTC market	
June 1990	Established Yamada Butsuryu Co., Ltd. (now SUN-WAN LOGISTICS CO., LTD.)	
April 1993	Changed to the current company name	
May 1995		Established SUN-WA TECHNOS (SINGAPORE) PTE. LTD.
December 1997		Established SUN-WA TECHNOS (HONG KONG) CO., LTD.
April 1998		Established Sun-Wa Technic Europe Co., Ltd. (now SUN-WA TECHNOS EUROPE GmbH; Dusseldorf)
July 1998		Established SUN-WA TECHNOS AMERICA, INC. (Chicago)
November 1998		Established SUN-WA TECHNOS TAIWAN CO., LTD. (joint venture)
April 2000		Established SUN-WA TECHNOS (MALAYSIA) SDN. BHD.
January 2001		Dissolved SUN-WA TECHNOS TAIWAN CO., LTD. (joint venture) and established SUN-WA TECHNOS TAIWAN CO., LTD. (subsidiary)
December 2001		Established SHANGHAI SUN-WA TECHNOS CO., LTD.
September 2002		Opened the Shenzhen Representative Office
April 2003	Listed on the TSE Second Section	
March 2005	Listed on the TSE First Section	
October 2006		Established SUN-WA TECHNOS ASIA (THAILAND) CO., LTD.
January 2009		Established SUN-WA TECHNOS (SHENZHEN) CO., LTD.
August 2013		Opened the Hanoi Representative Office of SUN-WA TECHNOS (HONG KONG) in Vietnam
October 2013		Opened the Hong Kong Logistics Center
March 2014		Opened Taichung Representative Office of SUN-WA TECHNOS TAIWAN
October 2014		Established PT. SUN-WA TECHNOS INDONESIA
September 2015		Established SUN-WA TECHNOS MEXICO S.A. DE C.V. and SUN-WA TECHNOS (PHILIPPINES), INC.
December 2015	Moved the head office to 3-chome Kyobashi, Chuo Ward	
January 2016	Merged the electronics division into the headquarters	Opened the Los Angeles Branch of SUN-WA TECHNOS (AMERICA), INC.
May 2016		Established SUN-WA TECHNOS (VIETNAM) CO.,LTD.
April 2017	Opened the Nagoya Office (upgraded from a branch) and Yokohama Branch (upgraded from a sales site)	

Source: Prepared by FISCO from Company materials

Production-line capital investments are a growth driver
Broadly and deeply covers three major areas, aims to acquire capital investment demand in a broad range of industries

2. Business overview

The Company is an independent trading company that specializes in technology products and stands out in its coverage of three product fields - electric machinery, electronics, and general machinery. Product information and understanding tends to be broad and superficial when a single company handles three separate fields because of the differences in users, demand drivers and timing. However, the Company derives its strength from pursuit of "broad and deep" interactions. This approach stems from having numerous employees with engineering backgrounds as a technology-oriented trading firm. Another factor is that the Company has accumulated knowledge and experience in each of the three fields through processes carried out over a lengthy period, as it began in general machinery and electrical machinery fields as a sales agent for YASKAWA Electric and DAIHEN <6622> and then added electronic components as "two-way transactions."

The electrical machinery division handles AC servo motors, programmable controllers, linear motors and other motors, inverters, and vacuum chamber robots. The general machinery division covers semiconductor production equipment, industrial robots, clean room robots for conveying liquid crystal displays (LCDs), and medical equipment. The electronics division handles connectors, semiconductors, sensors, LEDs, LCDs, and CPU boards.

List of products handled by Sun-Wa Technos by business division

Electrical machinery	AC servo motors, programmable controllers, linear motors and various other motors, inverters, power conditioners, clean room robots and vacuum chamber robots for semiconductor manufacturing equipment, power substations and other products, and electrical engineering work
General machinery	Semiconductor manufacturing equipment, industrial robots, clean room robots for conveying liquid crystal displays, conveyors, wind- and hydro-power equipment, air conditioners and kitchen equipment, various inspection devices, medical equipment, and other products
Electronics	Power supplies, connectors, semiconductors, sensors, miniature fans, LEDs, LCDs, personal computers for industrial use, circuit boards for central processing units, memory modules, and other products

Source: Prepared by FISCO from Company materials

We explain the relationship among the three divisions using LCDs as an example. LCD manufacturing plants are outfitted with various production systems. The general machinery division delivers a production system (such as a glass transport robot) to the customer company. The electrical machinery division, meanwhile, sells motors, control equipment, and other parts to the manufacturer of the glass transport robot. Additionally, the electronics division sells LCD panels manufactured by the LCD plant to TV and monitor assembly manufacturers and other customers.

The Company has developed a business model that covers the entire commercial flow from upstream (production equipment parts and materials) to downstream (end products) for a single product, such as LCD panels, due to its promotion of businesses that extend across three fields. Another feature of its business is "two-way transactions." The Company refers to transactions that involve acquisition of products (such as LCD panels in the above-mentioned example) for trading purposes from customers to which it delivered manufacturing equipment as "two-way transactions."

General machinery and electrical machinery division both rely on capital investments by corporate customers as a demand driver. Electronics division, meanwhile, might sound as if it mainly handles general-use electronic parts (such as light electric products and LCD panels used in mobile terminals) as products. Nevertheless, theses items are actually just a very small portion of the Company's electronics division, and it primarily supplies materials and parts to the factory automation and industrial machinery industry (products covered by the electrical machinery division) and automotive industry. We hence think capital investments are effectively the main demand driver in this business too. These three businesses are similar as capital investment fields. We believe separation as segments is useful because timing of demand occurrence differs in the capital investment cycle and production and inventory cycle.

Customers and demand drivers for each business division

	Products handled	Source of demand	Drivers of demand, macroeconomic indicators
Electrical machinery	Electrical components for customers' products	Plants of customer companies	Capital investment by manufacturers, machinery orders, and other measures of industrial expansion
General machinery	Production lines of customer companies		
Electronics	Components produced by customer companies	Manufacture of final products	Consumer spending, industrial production index, etc.

Source: Prepared by FISCO from Company materials

Results trends

Posted sharply higher sales and profits on overall healthy momentum in demand industries

1. Review of FY3/18 results

The Company reported sharply higher sales and profits in FY3/18 at ¥146,759mn in net sales (+25.9% YoY), ¥4,135mn in operating income (+37.2%), ¥4,349mn in ordinary income (+35.3%), and ¥3,085mn in net income attributable to owners of the parent (+94.8%).

While the Company raised forecasts at each of its quarterly announcement (from 1Q to 3Q), its results ultimately overshot the final view in sales and the various profit items. We attribute this outcome to vibrant capital investment activity (capacity reinforcement, labor-saving, automation, and other investments) beyond expectations in a broad range of demand industries, rather than the Company taking an overly cautious stance in the period-start outlook.

Results trends

FY3/18 results

(¥mn)

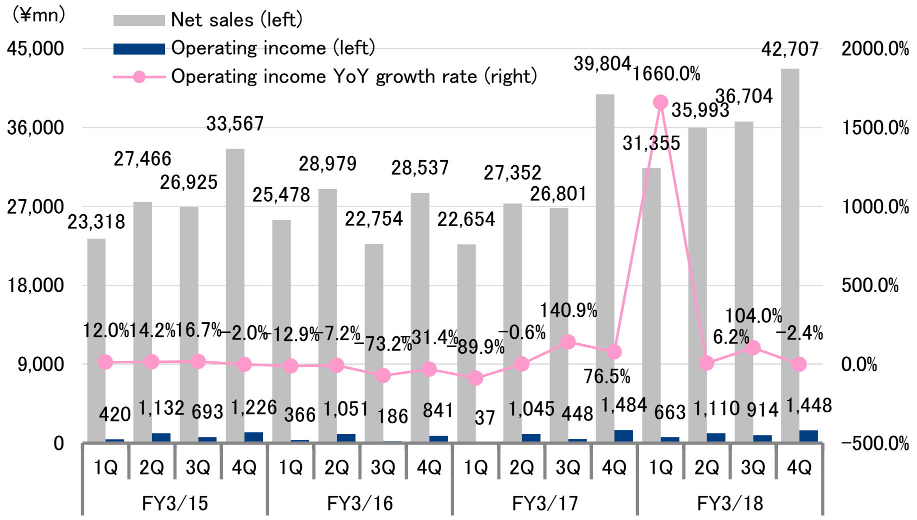
	FY3/17	FY3/18						
	Results	Initial forecasts	1Q announcement forecasts	2Q announcement forecasts	Final guidance	Results	Growth rate (YoY)	Growth rates versus final guidance
Net sales	116,611	126,000	130,000	139,000	144,500	146,759	25.9%	1.6%
Operating income	3,014	3,200	3,350	3,500	3,800	4,135	37.2%	8.8%
Operating income margin	2.6%	2.5%	2.6%	2.5%	2.6%	2.8%	-	-
Ordinary income	3,215	3,450	3,650	3,800	4,200	4,349	35.3%	3.5%
Net income attributable to owners of the parent	1,584	2,150	2,300	2,650	2,900	3,085	94.8%	6.4%

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

The Company's results rapidly recovered from 2H FY3/17, and sales reached an all-time quarterly high at close to ¥40bn in 4Q. This trend continued in FY3/18 and both 1H sales and net income recorded all-time highs on a 1H basis. Robust momentum carried into 2H as well, facilitating the results noted above.

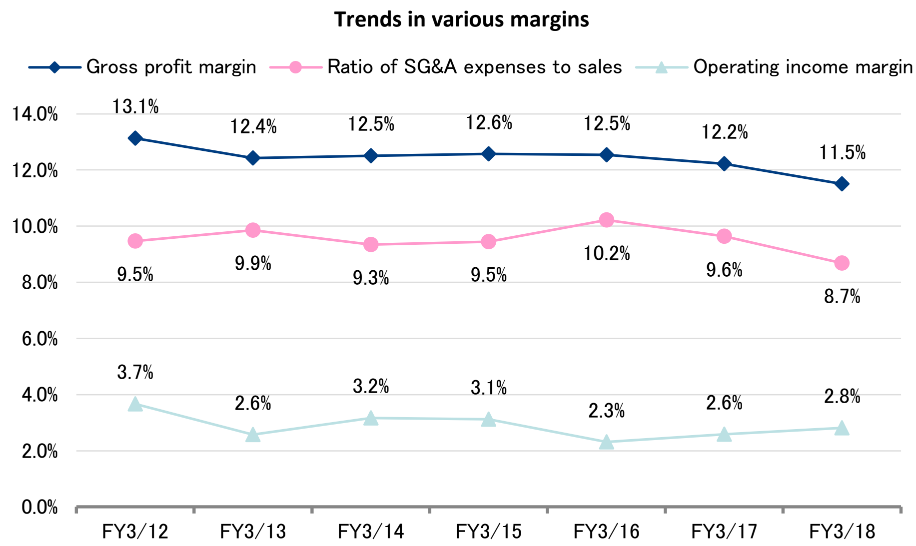
The direct and primary reason is vibrancy in the industrial electronics and mechatronics industry, which is closely tied to the Company's core business. This industry has a broad range of demand drivers, including smartphones, automobiles, semiconductors, and industrial machinery. Within these areas, while demand in the smartphone industry has slowed to some extent because of weaker growth in sales volume, upbeat trends have continued in automotive, semiconductor, and industrial machinery industries. As explained earlier, this wide-ranging expansion of demand steadily contributed to growth in the Company's results because of its involvement in three different areas – electrical machinery, electronics, and general machinery.

Quarterly results trends



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

While FY3/18 results seemed nearly perfect, decline in gross margin is an issue. Gross profit margin dropped from 12.2% in FY3/17 to 11.5% in FY3/18, mainly due to growth in sales to the automotive industry. While the Company increased sales of electronic parts and electronic devices to the automotive industry in FY3/18, profitability tends to be lower than in transactions with other demand industries. Large transaction scale means that this business adds to profits as an absolute amount. Its impact on profitability, however, is negative. We expect transactions with the automotive industry to continue growing at a healthy pace. Nevertheless, it is important to realize how the effect can be viewed differently depending on the perspective.



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

Sales are rapidly growing for on-board products in the electronics division

2. Divisional and regional trends

Net sales trend by division

(¥mn)

	FY3/18						
	1Q	2Q	1H	3Q	4Q	2H	Full-year
Electrical machinery	6,056	6,333	12,390	6,858	7,918	14,776	27,166
YoY	57.0%	20.5%	35.9%	49.9%	12.4%	27.1%	31.0%
Electronics	23,680	26,658	50,339	28,591	31,506	60,097	110,436
YoY	38.2%	36.2%	37.1%	40.5%	9.5%	22.4%	28.7%
General machinery	1,617	3,001	4,619	1,254	3,283	4,537	9,156
YoY	-3.0%	19.2%	10.4%	-33.1%	-17.8%	-22.7%	-8.9%
Total net sales	31,355	35,993	67,348	36,704	42,707	79,411	146,759
YoY	38.4%	31.6%	34.7%	37.0%	7.3%	19.2%	25.9%

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

Below we summarize results trends by business segments.

Electrical machinery division reported ¥27,166mn in sales (+31.0% YoY). Key increases were electrical product sales to semiconductor production equipment (SPE) and industrial machinery manufacturers and electrical product sales to OLED production equipment.

Electronics division posted ¥110,436mn in sales (+28.7% YoY). Major gains were electronic devices and parts sales to the industrial machinery industry and electronic parts sales to the automotive industry.

General machinery division recorded ¥9,156mn in sales (-8.9% YoY). While sales of production equipment grew to the FPD industry, they slipped to the industrial machinery industry. The latter setback, however, was a backlash to a special large-scale deal from the previous fiscal year, and demand remained healthy on an ordinary basis.

Results trends by geographical market

(¥mn)

		FY3/18						
		1Q	2Q	1H	3Q	4Q	2H	Full-year
Japan	Net sales	24,098	28,287	52,385	29,014	33,603	62,617	115,002
	YoY	34.4%	22.3%	27.6%	32.1%	15.1%	22.4%	24.7%
	Operating income	154	781	935	484	914	1,398	2,333
	YoY	-	-6.7%	24.5%	86.2%	-20.8%	-1.1%	7.8%
	Operating income margin	0.6%	2.8%	1.8%	1.7%	2.7%	2.2%	2.0%
Asia	Net sales	8,110	9,624	17,734	10,005	11,752	21,757	39,491
	YoY	40.5%	58.6%	49.7%	50.5%	3.0%	20.5%	32.1%
	Operating income	338	336	674	424	391	815	1,489
	YoY	139.7%	101.0%	118.3%	109.9%	27.8%	60.4%	82.4%
	Operating income margin	4.2%	3.5%	3.8%	4.2%	3.3%	3.7%	3.8%
US and Europe	Net sales	2,306	1,452	3,758	2,290	2,817	5,107	8,865
	YoY	120.9%	71.2%	98.6%	95.6%	-13.6%	15.3%	40.2%
	Operating income	185	-22	162	18	130	148	310
	YoY	-	-	868.1%	-	-	-	-
	Operating income margin	8.0%	-1.5%	4.3%	0.8%	4.6%	2.9%	3.5%

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

We also look at results trends by sales region. Japan delivered higher sales and profits at ¥115,002mn in sales (+24.7% YoY) and ¥2,333mn in operating income (+7.8%). Sales rose in electronic parts for the automotive industry and electrical machinery and electronic parts and devices for the industrial machinery industry. General machinery also increased sales to the FPD industry. While sales of production facilities used in industrial machinery industry weakened, this outcome was backlash from a major deal in the previous fiscal year as mentioned above.

Asia posted sharply higher sales and profits at ¥39,491mn in sales (+32.1% YoY) and ¥1,489mn in operating income (+82.4%). Sales climbed for electronic parts and electrical machinery products used in industrial machinery industry. Regionally, we think the Company expanded business in China.

Europe and US booked ¥8,865mn in sales (+40.2% YoY) and ¥310mn in operating income (roughly 22-fold gain). Sales of electrical machinery products used in OLED production facilities increased in business with the FPD industry. Additionally, sales of electronic parts to industrial machinery and amusement industries strengthened. We believe one-time demand contributed to some of the income gain.

Divisional and regional trends

	Japan			Asia			US and Europe		
	Electrical machinery	Electronics	General machinery	Electrical machinery	Electronics	General machinery	Electrical machinery	Electronics	General machinery
Automotive industry		○							
Semiconductor industry	○								
Industrial machinery industry	○	○	×	○	○		○		
FPD industry	○		○				○		
Smartphone industry									
Amusement industry								○	

Source: Prepared by FISCO from Company's financial results and interviews

Overview and progress of the medium-term management plan

Aiming for steady attainment of Challenge 1500 goals in engineering and global SCM solutions businesses

1. Overview of the medium-term management plan

The Company formulates three-year medium-term management plans and strives for longer-term growth through steady implementation of the plan. Longer-term growth strategies hence are essentially equivalent to the medium-term management plan.

The Company is currently implementing Challenge 1500, its ninth three-year plan that covers FY3/17-19. The plan aims to deepen and advance results from the previous JUMP 1200 medium-term plan that ended in FY3/16. The "Challenge 1500" name embodies management's aim to establish a solid foundation for realizing ¥150bn in net sales in FY3/20, the Company's 70th anniversary.

The Company is pursuing three business strategies aimed at achievement of medium-term plan goals – “systems, equipment, and parts/components sales business,” “engineering business,” and “global SCM solutions business.” “Systems, equipment, and parts/components sales business” overlaps with the three existing divisions. The engineering business and global SCM solutions business deserve attention as strategies that are vital to realizing unique growth in the medium-term plan. Details are given below. We understand the engineering business as a catalyst to expand income by organically linking and achieving synergies in the Company’s three existing divisions. The global SCM solutions business has a role of cutting across the three existing divisions, similar to the engineering business, and offers an opportunity with its potential to develop into a standalone business division in the future.

Four basic policies and three business strategies in Challenge 1500

Basic policies in Challenge 1500
Contribute to customers’ product manufacturing with our core businesses of electrical machinery, electronics, and general machinery
Provide unique high value-added solutions
Provide the latest technology information as a technology trading company
Strengthen group capabilities by enhancing the global network

Three business strategies
Systems, equipment and parts/components sales business
Engineering business
Global SCM solutions business

Source: Prepared by FISCO from Company materials

Healthy progress through the second year of the medium-term management plan, striving to reach final-year goals in FY3/19

2. Medium-term management plan targets and progress

Next, we compare management (results) goals in Challenge 1500 with results up to now. The Company beat forecasts in FY3/17, the first fiscal year of the plan, thanks to rapid recovery and expansion in the second half of the period. It significantly exceeded targets, even after three upward revisions, in FY3/18, the second year. Sales were already above the final fiscal-year goal of ¥137,000mn, and ordinary income came close to the final goal as well.

In FY3/19, the final year of the plan period, the Company forecasts for ¥157,500mn in sales and ¥4,500mn in ordinary income. The sales target is well above the initial plan goal in light of FY3/18 results and the subsequent business environment. Ordinary income, meanwhile, is unchanged from the medium-term plan goal at ¥4,500mn. We see two reasons for this stance. One is the impact of a change in the forex rate assumption from ¥117/$ in the plan to the recent ¥110 rate. The other is retention of the existing goal to demonstrate management’s resolve to attain it in light of the having missed final-year goals in previous medium-term plans.

Challenge 1500 management targets

(¥mn)

	FY3/17		FY3/18		FY3/19	
	Management targets	Results	Management targets	Results	Management targets	Results forecasts
Net sales	117,000	116,611	126,000	146,759	137,000	157,500
Operating income	2,800	3,014	3,500	4,135	4,300	4,450
Operating income margin	2.4%	2.6%	2.8%	2.8%	3.1%	2.8%
Ordinary income	3,000	3,215	3,700	4,349	4,500	4,500
Ordinary income margin	2.6%	2.8%	2.9%	3.0%	3.3%	2.9%
Forex assumption (JPY/USD)	117	116.5	117	113	117	110

Source: Prepared by FISCO from Company materials

While details are reviewed below, we think the Company is likely to achieve its FY3/19 forecasts. The main focus is actually the extent to which it exceeds ¥4,500mn because FY3/19 results and sentiment during the year lay the groundwork for the next medium-term management plan. The Company started formulation of the next medium-term management plan (three-year plan beginning in FY3/20) in FY3/19, and we expect progress during FY3/19 and final results to heavily influence whether the next plan has a strong impact.

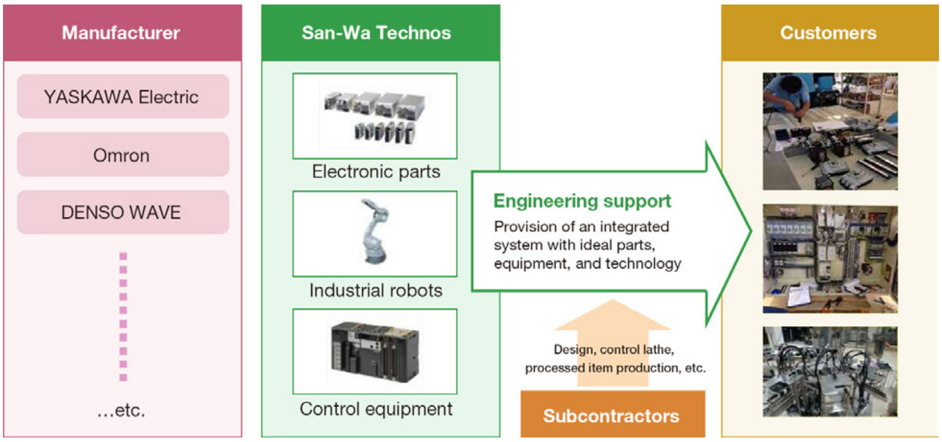
Plans to continue initiatives in engineering business aimed at creation of added value and expansion of profitability

3. Progress of the engineering business

(1) Business overview

The engineering business at the Company is a sales approach for "proposing products from the three divisions of electrical machinery, electronics, and general machinery as system solutions, rather than standalone items." We can use the example of a food supermarket to help explain the positioning of the engineering business. Up to now, the Company had been selling ingredients, such as meat, fish, and vegetables, to customers. The engineering business, meanwhile, involves preparing these individual ingredients for delivery to customers. The extent of processing can vary from selling a prepared item to a meal box. The Company does not book sales as the engineering business and related income is allocated to the electrical machinery, electronics, and general machinery divisions.

Engineering business



Source: Company website

Deployment of robots (industrial robots), a strong area, offers a typical case of the engineering business. Robots began with development and deployment in the automotive industry and subsequently spread to the entire industrial community. Although robot deployment is entering a full-fledged adoption stage outside of the automotive industry, these new users often are unable to sufficiently harness robots after installations. In the engineering business, the Company seeks to expand income by helping customers to smoothly deploy robots and realize their benefits with internal engineers to formulate system concepts and external system integrators to build systems.

Improvement in profitability is a benefit anticipated from expansion of the engineering business. Using the previous example, effort spent on processing box meals and prepared foods creates added value and leads to expansion of profitability. It can also elicit maintenance demand and might generate repeat orders. We think this type of related demand and spillover effect is a major contribution of engineering business.

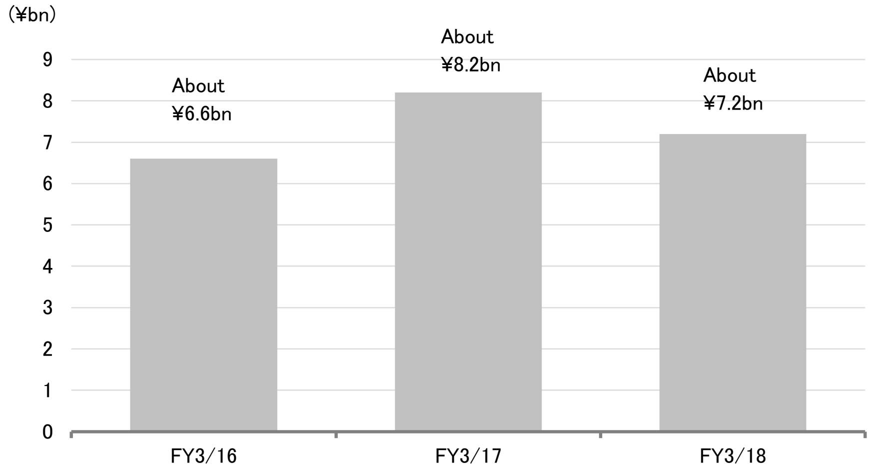
(2) Update on progress

The Company has been making necessary investments to accelerate the engineering business. Using the example cited above, it has been expanding capabilities, including external hires of human resources to handle the role of processing ingredients into prepared items and meals. It restructured in April 2015, establishing the factory automation sales headquarters (now, the FA system sales department), the industrial solutions headquarters (industrial solutions department), and engineering department and accelerating proposals and sales that cut through the three product types.

The Company has also sought to further strengthen the organization in FY3/18. It merged the mechatronics sales and machinery systems sales departments to create the FA system sales department in April 2017. This reorganization aims to enhance comprehensive capabilities by combining electrical and general machinery. Furthermore, in October 2017, it reorganized the engineering department into the sections of robot promotion, IoT promotion, monitoring and control promotion, automated recognition promotion, electrical equipment technology, and technology services.

It is difficult to develop a methodology for quantitatively identifying progress in engineering business because of various definitions and large changes in values depending on the definition. The Company previously expressed it as "system integration (SI) procurement results," but switched the definition this time to "transaction value in a sale that combines two or more products." If SI procurement results equated to processing fees for box meals, the new definition might become the price of a box meal itself. This value dropped YoY to ¥7,217mn in FY3/18, mainly due to backlash from non-recurrence of the major deal included in the previous fiscal year.

Trend in engineering business sales



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

The Company has not provided forecasts on the sales outlook for engineering business in FY3/19. Engineering business is effectively a sales method in the Company's case, as explained earlier, and whether something comes under it is determined in hindsight. We think this aspect interferes with budgeting. Given this point, we see a possibility of substantial growth in engineering business sales in FY3/19 due to the Company's outlook for rapid growth in general machinery division with an 81.3% YoY increase to ¥16,600mn (details reviewed below). General machinery products primarily consist of production facilities used in manufacturing and are fundamentally built to order (business deals hence have a high degree of certainty). Furthermore, production facilities involve more than just moving goods from one location to another and require system integration, including software. This business is an excellent match with the Company's engineering business.

The Company does not disclose details regarding profits in the engineering business. Nevertheless, we think expansion of engineering transactions is likely to generate higher profit margin than just selling individual products on their own. Standalone business is similar to just selling meat and vegetables as ingredients. Sales as engineering business, meanwhile, are comparable to selling a curry meal that uses meat and vegetables. Processing charges for making the curry (or the curry roux portion) adds to profit and results in higher earnings and profit margin. We believe this is why the Company focuses on engineering business and it is an important perspective in our investment opinion.

Within reach of ¥10bn in net sales thanks to the tailwind of increased customer outsourcing needs

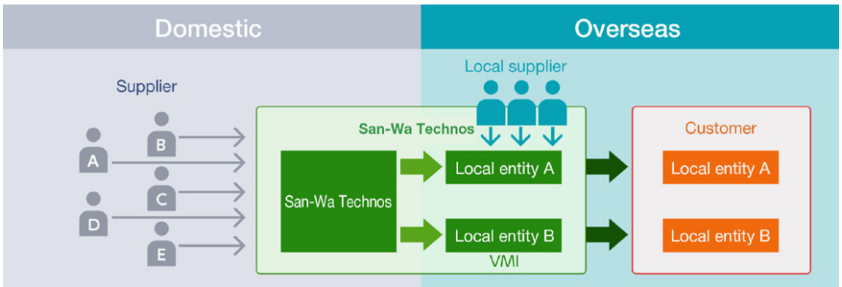
4. Progress on the global SCM solutions business

(1) Business overview

The Company prepared for global SCM solutions during JUMP 1200, the previous medium-term management plan, and officially started this business in the current medium-term plan period. Going back further, however, the Company had already been offering procurement agent, logistics agent, and delivery management services for some time. The global SCM solutions business is an advanced version of these past services that leverages the Company's overseas network (13 overseas local entities and 25 global sites) to create a profitable business.

We think the global SCM solutions business can be implemented in a variety of ways. One example is described here. The Company delivers other items required by the customer at the same time, regardless of whether they are the Company's catalog products or not, in addition to the ordered product when delivering products based on an order from the customer. It intends to operate this service as a profitable business, obtaining margin on each of the products.

Conceptual image of global SCM solutions business



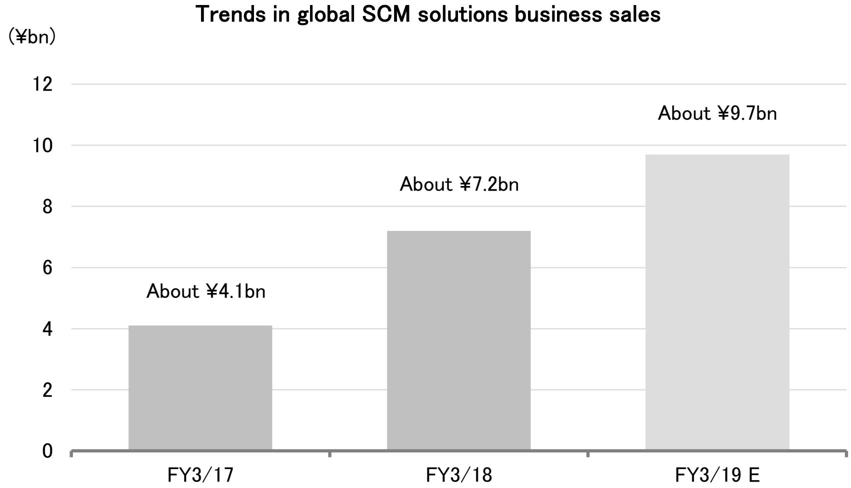
Source: Company website

Motivation for and significance of promoting global SCM solutions business rest in the Company's accumulation of related knowhow over a lengthy history, in contrast to large manufacturers with shortages of personnel in global logistics, inventory management, materials procurement, and others, despite (or because of) their size. Major companies have sought to reduce this area in past business structure reforms and restructuring processes. At the same time, larger companies place greater emphasis on efficient production operations and frequently transfer businesses across country borders. We believe very substantial latent demand exists for the Company's global SCM solutions business as a result.

(2) Update on progress

Global SCM solutions business has been steadily growing, similar to the engineering business. It booked about ¥4.1bn in FY3/17 sales and reached roughly ¥7.2bn in FY3/18. The Company projected ¥6.7bn in the period-start plan, but the actual result was even higher. FY3/19 forecasts call for about ¥9.7bn. Management is aiming for ¥10bn in sales in global SCM solutions business as a near-term goal, and this is coming within visibility.

Trends in global SCM solutions business sales



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

We believe expansion of the global SCM solutions business is clearly positive for the Company. A major reason is because it reliably generates profit due to accumulated knowhow over many years amid rising demand for these services. Nevertheless, profit margin appears to be lower than in the Company's other businesses and rapid growth in related sales is likely to reduce overall profitability. We think improving profitability is an important issue for the Company and will be focusing on balance in expansion of business scale and securing margin as a key point.

Business outlook

Possibility of beating profit targets if the sales outlook is attained

The Company forecasts for ¥157,500mn in sales (+7.3% YoY), ¥4,450mn in operating income (+7.6%), ¥4,500mn in ordinary income (+3.5%), and ¥3,150mn in net income attributable to owners of the parent (+2.1%) in FY3/19.

Overview of FY3/19 forecasts

(¥mn)

	FY3/18			FY3/19					
				1H		2H		Full-year	
	1H results	2H results	Full-year results	Forecasts	Growth rate (YoY)	Forecasts	Growth rate (YoY)	Forecasts	Growth rate (YoY)
Net sales	67,348	79,411	146,759	78,500	16.6%	79,000	-0.5%	157,500	7.3%
Operating income	1,773	2,362	4,135	2,250	26.9%	2,200	-6.9%	4,450	7.6%
Operating income margin	2.6%	3.0%	2.8%	2.9%	-	2.8%	-	2.8%	-
Ordinary income	1,951	2,398	4,349	2,300	17.9%	2,200	-8.3%	4,500	3.5%
Net income attributable to owners of the parent	1,359	1,726	3,085	1,600	17.7%	1,550	-10.2%	3,150	2.1%

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

We believe the Company is capable of reaching its target of ¥157,500mn in sales considering trends in the various demand industries. In profits too, we expect fulfillment of targets if the sales outlook is attained. The Company projects 2.8% in FY3/19 operating margin, unchanged from the previous year. This stance seems somewhat conservative. Nevertheless, we think it makes sense to take a cautious view, similar to the Company, at least the start of the fiscal year, because of the prospect of continuation in gross-margin decline on change in product mix in FY3/17.

1. Outlooks for demand industries

(1) Industrial machinery

The Company broadly sells servomotors and control devices from electrical machinery and electronic parts, devices, and materials from electronics. The main application is factory automation equipment. We expect continued growth in shipments to the industrial machinery industry in light of robust capital investment demand in China, Asian countries, and other regions.

(2) Smartphones

Demand slowed in FY3/18 because of the impact of weaker growth in sales volume and other factors. However, volume does not appear to have dropped enough to undercut capital investments by smartphone manufacturers. While investments to increase output are unlikely, we expect continuation of automation and labor saving outlays with the aim of lowering production costs through enhanced manufacturing efficiency in FY3/19 as well.

(3) Automotive

The Company handles two major commercial flows. One is selling electronic parts and devices under the electronics division. This business expanded in FY3/18 as explained earlier, and we expect further expansion at the same pace in FY3/19 on advances in automotive electronics, such as ADAS and EV. The other is selling control devices, servomotors, and other products from the electrical machinery division to manufacturing lines. This business has also been receiving robust demand from automation and labor saving projects. We think it is likely to sustain strong results in FY3/19 too (this includes cases of indirect delivery to the automotive industry through the industrial machinery industry).

(4) Semiconductors

The Company mainly sells products in Japan, Taiwan, and South Korea. Sales in this business are predominantly electrical machinery and electronic parts and devices to SPE manufacturers, rather than chip manufacturers. We advise against excessive concern about reported declines in 3D NAND flash memory and other semiconductor chip prices because these are essentially commodities with high price volatility. The semiconductor industry is likely to remain a strong source of demand due to structural changes, such as growing use of IoT and advances by China's semiconductor industry.

(5) FPD

While LCD panel business seems to have peaked out, we think demand from OLED panel production equipment will be growing. Japanese companies currently hold a lead in OLED production equipment too, and we think the Company should benefit as long as this structure lasts.

Net sales outlook by division

(¥mn)

	FY3/11	FY3/12	FY3/13	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19 E
Electrical machinery	23,628	24,495	22,222	24,759	22,660	19,069	20,736	27,166	29,900
YoY	156.2%	3.7%	-9.3%	11.4%	-8.5%	-15.8%	8.7%	31.0%	10.1%
Electronics	54,790	56,905	58,628	69,643	80,473	77,593	85,819	110,436	111,000
YoY	36.2%	3.9%	3.0%	18.8%	15.6%	-3.6%	10.6%	28.7%	0.5%
General machinery	6,864	8,306	7,412	6,975	8,141	9,084	10,055	9,156	16,600
YoY	15.6%	21.0%	-10.8%	-5.9%	16.7%	11.6%	10.7%	-8.9%	81.3%
Total net sales	85,283	89,706	88,264	101,378	111,276	105,748	116,611	146,759	157,500
YoY	54.0%	5.2%	-1.6%	14.9%	9.8%	-5.0%	10.3%	25.9%	7.3%

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

The Company presents the following outlook for its business segments in light of prospects and business environments in demand industries described above.

2. Business segments outlooks

(1) Electrical machinery

The Company projects a 10.1% YoY increase to ¥29,900mn. We think the FY3/19 outlook is weaker than momentum in the previous fiscal year due to factoring in exhaustion of smartphone-related equipment demand to some extent in 2H FY3/18, including the impact of slower smartphone sales volume. Nevertheless, the Company should be capable of realizing its target of double-digit sales growth because of robust SPE demand and demand for automated and labor saving investments across industries.

(2) Electronics

The Company expects a 0.5% YoY gain to ¥110,000mn. Electronics division exhibits a similar demand trend to the electrical machinery division because its main items are used in electrical machinery products. We think the outlook for flat sales, in contrast to double-digit sales growth projected for electrical machinery, takes into account the possibility of excess inventories at customers. Accelerated orders placement beyond real demand occurred amid extremely tight market conditions for parts and materials in FY3/18, and adjustment might take place to address this portion. While such concern could also be unnecessary, we do not see any basis to reject it outright at the start of the fiscal year. Separately, accelerated orders risk does not exist in the automotive industry with its rigorous just-in-time management. The 0.5% growth target hence seems moderately cautious considering healthy momentum in the automotive industry.

(3) General machinery

The Company expects an 81.3% YoY increase to ¥16,600mn. This outlook takes into account sales of production equipment to major semiconductor and food manufacturers. Segment sales are likely to climb sharply as planned, assuming no delivery delays, because these are built-to-order systems (rather than forecast production). If anything, our concern is the possibility of a steep YoY decline in FY3/20 sales due to backlash from non-recurrence of these large deals. Nevertheless, the Company expresses confidence in sustaining or expanding the general machinery division's broadened scope in light of change in deal size from ¥100-200mn as the standard level in past years to deals exceeding ¥1bn, with some frequency, in recent years, including support from promotion of engineering business. While prospects are not completely certain because capital investment trends at customers directly affect segment deals, we think this division has arrived at a turning point in terms of customer scale, business deal scale, broadening of covered areas, and increased difficulty and will be closely monitoring developments.

The Company's primary concern in FY3/19 is increase in logistics costs and resulting pressure on earnings. This appears to be one of the major sources of anticipated flat operating margin (YoY) in FY3/19. However, we are not that worried about this point because of room for improvement. The Company placed more emphasis on top-line (sales) growth than cost savings up to now. This was the driving force in lifting sales above the medium-term management plan goal in FY3/18. We believe the Company is capable of absorbing anticipated cost increases in FY3/19 given its clarification of a policy this time to focus on cost reductions.

Summary income statement

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19	
					1H	Full-year E
Net sales	111,276	105,748	116,611	146,759	78,500	157,500
YoY	9.8%	-5.0%	10.3%	25.9%	16.6%	7.3%
Gross profit	13,988	13,256	14,255	16,883	-	-
Gross profit margin	12.6%	12.5%	12.2%	11.5%	-	-
SG&A expenses	10,516	10,812	11,240	12,747	-	-
YoY	11.1%	2.8%	4.0%	13.4%	-	-
Ratio of SG&A expenses to sales	9.5%	10.2%	9.6%	8.7%	-	-
Operating income	3,471	2,444	3,014	4,135	2,250	4,450
YoY	8.1%	-29.6%	23.3%	37.2%	26.9%	7.6%
Operating income margin	3.1%	2.3%	2.6%	2.8%	2.9%	2.8%
Ordinary income	3,761	2,645	3,215	4,349	2,300	4,500
YoY	9.4%	-29.7%	21.6%	35.3%	17.9%	3.5%
Net income attributable to owners of the parent	2,466	1,690	1,584	3,085	1,600	3,150
YoY	13.8%	-31.5%	-6.3%	94.8%	17.7%	2.1%
EPS (¥)	171.83	117.76	113.64	222.65	99.73	196.35
Dividend (¥)	26.00	28.00	28.00	30.00	17.00	34.00

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

Summary balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18
Current assets	45,329	49,239	46,857	55,507	66,231
Cash and deposits	6,937	7,584	6,359	6,759	8,596
Notes and accounts receivable	33,075	34,419	33,006	34,141	39,756
Non-current assets	8,369	9,509	8,581	9,309	11,381
Tangible fixed assets	4,038	3,879	3,788	3,056	3,005
Intangible fixed assets	76	243	240	222	168
Investments and other assets	4,254	5,386	4,553	6,030	8,207
Total assets	53,698	58,748	55,439	64,816	77,613
Current liabilities	30,735	32,370	28,691	36,596	43,077
Notes and accounts payable - trade	25,917	27,496	24,732	31,182	34,298
Short-term loans payable, etc.	2,528	2,782	2,317	2,489	5,722
Non-current liabilities	4,309	4,426	4,484	4,581	6,542
Long-term loans payable	2,205	2,100	2,400	2,300	3,500
Shareholders' equity	16,807	18,929	20,217	21,034	23,731
Capital stock	2,553	2,553	2,553	2,553	2,553
Capital surplus	1,958	1,958	1,958	1,958	1,958
Retained earnings	12,350	14,472	15,761	16,950	19,647
Treasury shares	-53	-54	-54	-427	-428
Net assets	18,654	21,951	22,263	23,637	27,993
Total liabilities and net assets	53,698	58,748	55,439	64,816	77,613

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

Cash flow statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18
Cash flow from operating activities	-1,374	1,353	-60	1,679	-2,221
Cash flow from investing activities	-127	-444	-384	-235	29
Cash flow from financing activities	769	-470	-654	-818	3,962
Cash and cash equivalent conversion difference	236	209	-125	-224	66
Cash and cash equivalent change	-496	647	-1,225	400	1,837
Cash and cash equivalent period-start balance	6,949	6,453	7,100	5,875	6,275
Cash and cash equivalent period-end balance	6,453	7,100	5,875	6,275	8,112

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

Shareholder return policy

Announced a ¥4 dividend hike in FY3/19 to ¥34

The Company's basic policy is to provide returns to shareholders in the form of dividends. Management prioritizes providing stable, continuous dividends, as demonstrated in its track record to date. While the Company does not sharply raise dividends in response to temporary rapid profit expansion, it has steadily increased them in keeping with earnings growth.

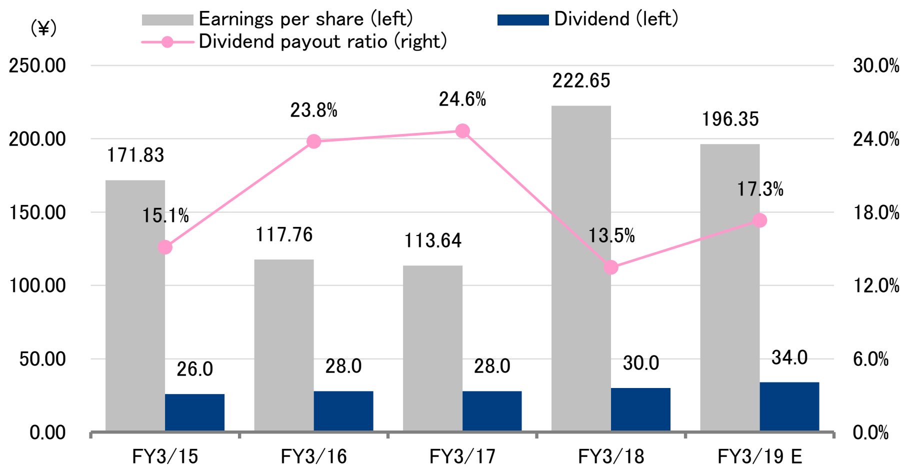
The Company decided to pay a ¥30 dividend (¥14 at interim, ¥16 at period-end) in FY3/18, an increase of ¥2 YoY.

Dividend payout ratio based on ¥222.65 EPS worked out to 13.5%. In FY3/19, it announces for a ¥34 dividend (with an interim dividend of ¥17 and a period-end dividend of ¥17), an increase of ¥4. Payout ratio using the ¥196.35 EPS target comes to 17.3%. The Company expects higher sales and profits in FY3/19, as explained earlier. We think it decided to raise the dividend in light of the healthy profit expansion trend.

While some observers might find the payout ratio to be low since it is less than 20% in FY3/18 and FY3/19, the Company's payout ratio historically has fundamentally been in the 10% range. Declines in FY3/16 and FY3/17 net profits were responsible for lifting the payout ratio above 20% in those years.

Prioritization of dividend stability has been apparent in the Company's past dividends and shareholder returns. Nevertheless, management is very aware of shareholder returns and is likely to consider various measures in the future. The Company has mentioned its 70th-year anniversary in November 2019 as a near-term event.

Earnings per share, dividend and payout ratio



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

Information security

Utilizes a wide range of measures to manage customer information

As a listed company, the Company is keenly aware of the need for information security to combat cyber-terrorism and other threats. It adopts a wide range of measures that leverage strong IT-related knowledge as a technology-centric trading company. We think losses and leaks of private information and credit card numbers are the primary risks in information security in the minds of investors. From this perspective, the Company's risk exposure related to information security is relatively low because it does not operate B-to-C business.

FISCO

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