COMPANY RESEARCH AND ANALYSIS REPORT

System Integrator

3826

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Index

Summary

Steadily expanding profits with support from increase in IT investments aimed at better productivity

System Integrator <3826> is an independent software developer that develops software and services for improvement of corporate productivity with a slogan of "We consistently create software that creates time rather than consumes time." It operates the Object Browser Business, including the database development support tool SI Object Browser and integrated project management tool SI Object Browser PM (below, OBPM), the ERP Business, and the EC and Omni Channel Business and has recently focused on development of a new service that utilizes AI. Furthermore, it actively promotes work- style reforms, child-rearing assistance, and other measures and has a low employee departure rate in the IT industry at less than 5%. System Integrator has a reputation of being highly respected by employees.

1. FY2/19 results

In FY2/19 results, the Company booked ¥4,066mn in net sales (+7.9% YoY) and ¥557mn in ordinary profit (+12.3%), setting all-time highs in a second straight year. While AI-related development costs increased as a new business area, the Company's three main businesses (particularly Object Browser Business) delivered profit increases that exceeded the business plan. While the Company incurred a ¥145mn settlement charge related to an arbitration agreement with a customer for an unprofitable project from FY2/15 as an extraordinary loss, its tax burden dropped sharply on deduction of the orders loss allowance and other amounts from taxable income and net profit hence climbed by a robust 67.4% YoY to ¥578mn.

2. FY2/20 forecast

In FY2/20 guidance, the Company targets ¥4,600mn in net sales (+13.1% YoY) and ¥603mn in ordinary profit (+8.1%), continuing sales and profit increases. It expects the Object Browser Business and ERP Business to drive growth amid ongoing healthy appetites for investments to improve productivity, mainly in the IT industry. It also projects growth in other business sales from ¥11mn in FY2/19 to ¥30mn, thanks to expansion of the number of companies deploying its TOPSIC programming skill evaluation service launched in January 2018. Deployments are growing, mainly at IT companies, as a skill-checking tool for higher engineers, in-house education and training, and outsourcing firm selection. With high gross margin, this business might develop into a fourth major income source for the Company in future years.

3. Medium-term business plan and AI service rollout

The Company announcement revisions to numerical goals in the medium-term business plan along with the disclosure of financial results. It adjusted goals for FY2/21, the final fiscal year, to ¥5,200mn in net sales and ¥753mn in ordinary profit (vs. ¥5,300mn and ¥684mn previously), raising the profit outlook based on reinforcement of a direction of achieving steady growth with emphasis on profits. The Company hopes to attain the goals through promotion of five fundamental policies – share expansion in existing businesses, establishment of overseas bases, success of the AI business (AISI∀), improvement in employee skills, and a position as the top domestic streamlining company. While it does not factor sales from AI business into the plan, this should be closely monitored as a growth area along with TOPSIC. The Company has already received inquires from 30-40 companies for AISI∀-AD (Anomaly Detection), an anomaly detection system via image recognition based on deep learning that was released in October 2018, and is currently at the effect verification stage with a few of these companies. Due to limited human resources, it plans to utilize partner firms as part of coordinating smooth deployment assistance and thereby capturing significant demand opportunities.

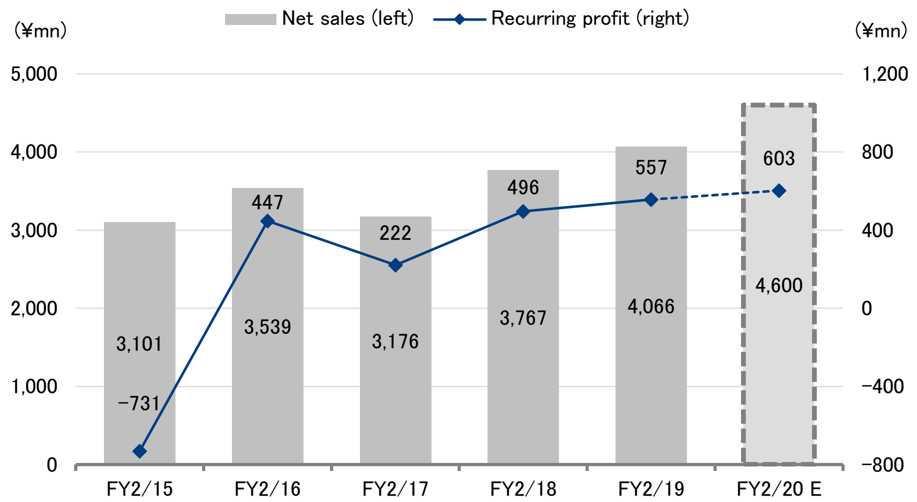
4. Shareholder return policy

As a means of shareholder return, the Company has set a standard dividend payout ratio of at least 30%, thereby linking its dividend payments to its profits. The Company expects a ¥4.0 YoY decline in the dividend to ¥12.0 (31.7% dividend payout ratio) in FY2/20 because of a setback in net profit on normalization of tax burden. In addition, the Company presents a gift of koshihikari rice grown in Niigata Prefecture to shareholders who hold the Company's shares for more than six months.

Key Points

- Realized all-time high results in a second straight year in FY2/19
- Possibility of TOPSIC becoming a fourth income source in the future
- Reinforcing emphasis on profitability and raised the FY2/21 ordinary profit goal

Results trends



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

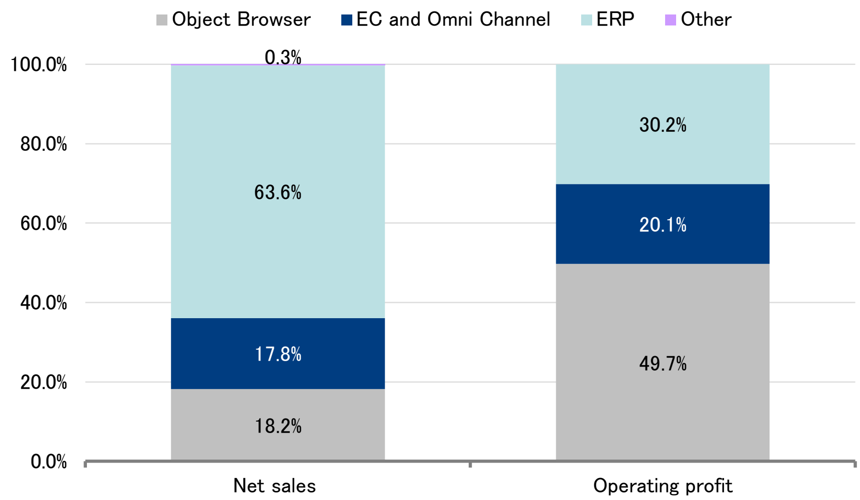
Business overview

Independent software developer, its database development assistance tool SI Object Browser is a de-facto standard

Founded in 1995, System Integrator is an independent software development company. In addition to the development and sales of packaged software, the Company also provides maintenance service and cloud services (SaaS). The Company is mainly looking to develop new products that can be offered as a cloud service. Mainstay existing products include database development support tool SI Object Browser and integrated project management tool OBPM, and package software such as SI Web Shopping for constructing EC websites and GRANDIT Web-ERP package. Business segments are Object Browser Business, EC and Omni Channel Business, ERP Business, and Other Business for reporting the results of new businesses.

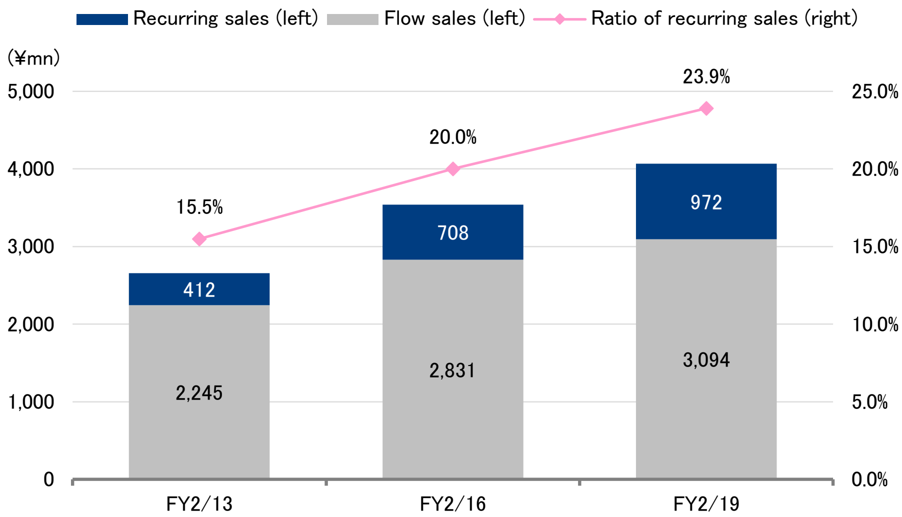
Looking at FY2/19 sales composition, ERP business provided a majority of overall sales at 63.6% and Object Browser Business and EC and Omni Channel Business split the remaining portion. In operating profit (excluding other business), meanwhile, Object Browser Business held the largest share at 49.7% followed by ERP Business at 30.2% and EC and Omni Channel Business at 20.1%. The Object Browser business is highly profitable with segment margin at 45.8%. It achieves this impressive level because of a stable large market share with an absence of rivals. Furthermore, the percentage of monthly fee income, maintenance and support income, and other recurring sales currently stands at 23.9% of overall business. It has been rising over the past few years and reflects progress in strengthening the income base. Below we review content of the Company's various businesses.

Composition of businesses (FY2/19)



Note: Operating profit breakdown (shares) excluding Other Business (new businesses)
Source: Prepared by FISCO from the Company's financial results

Trends in recurring sales and percentage of overall sales

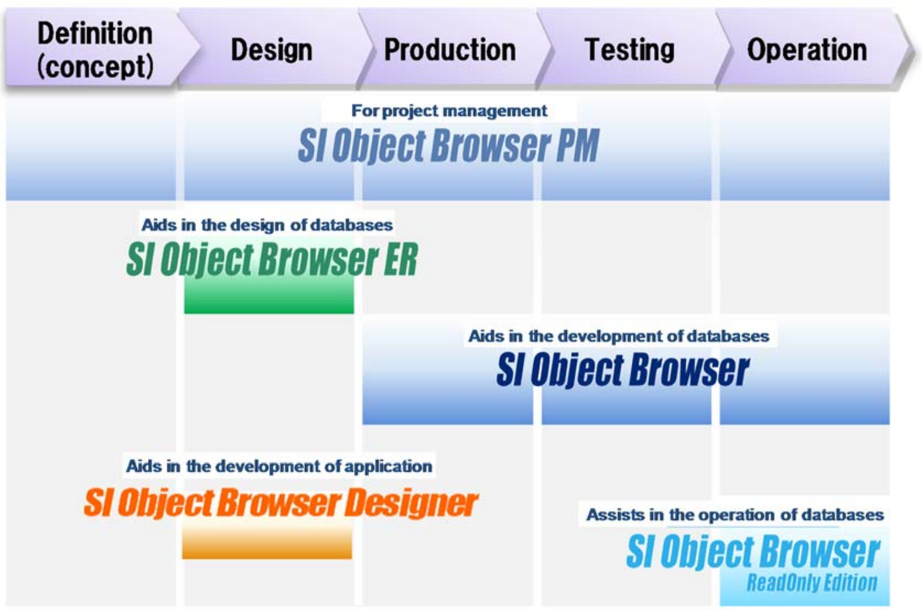


Source: Prepared by FISCO from the Company's results briefing materials

1. The Object Browser Business

Object Browser Business handles development and sales of software products, including the database development support tool SI Object Browser and database design support tool SI Object Browser ER (below, SI Object Browser series) as well as integrated project management tool OBPM and application design support tool SI Object Browser Designer (below, OBDZ) released in June 2013. OBPM and OBDZ are available for either package sales or cloud services.

The software development process and SI products



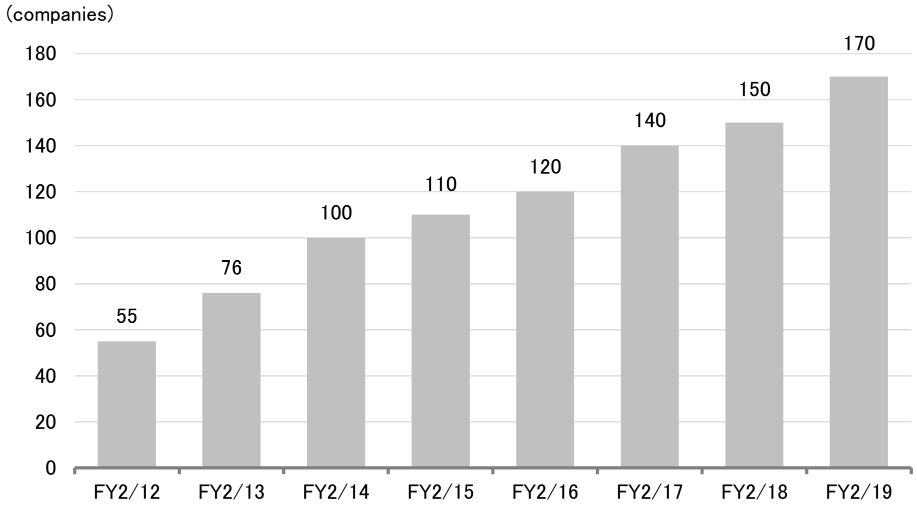
Source: The Company's website

In sales composition, the SI Object Browser series is just over 40% and OPBM is just under 60% and the OBPM share has been rising annually. The SI Object Browser series has deployments at 17,000 companies since its release in 1997 and is a de-facto standard in Japan. Maintenance and support and other recurring income currently stands at just under 30% of sales. This is a highly profitable product with gross margin at about 90% because of the prospect of stable annual sales and almost no sales costs.

OBPM, meanwhile, conducts integrated management of progress in development projects (managing the schedule, costs, human resource , quality, and profitability). This tool prevents occurrence of unprofitable projects ahead of time and supports higher productivity by the development division. It is the only product in Japan that complies with PMBOK*. The Company has deployed OBPM at just over 170 companies as of February 2019 since the release in 2008 and continues to realize double-digit annual growth. Many customers are mid-sized IT companies because large firms use their own products and SMEs largely manage products in Excel and other commercial software products. Nevertheless, even large companies have started looking at deployment of OBPM and inquiries from manufacturing and engineering industries are rising too because of improved awareness and robust quality. To meet these needs, the Company started sales as a cloud service of a light version with limited functionality aimed at divisions of large companies and an engineering version for the manufacturing industry from FY2/17. OBPM has been sustaining stable growth thanks to an almost complete absence of rival commercial products and just over 50% sales in monthly fees and other recurring income. Gross margin is strong at about 65%. Operating margin is modestly lower than for the SI Object Browser series because of advertising costs and deployment support expenses.

* PMBOK (Project Management Body of Knowledge): A set of standard terminology and guidelines (i.e., a body of knowledge) for project management. “A Guide to the Project Management Body of Knowledge” was first published in 1987 by the non-profit Project Management Institute (PMI). PMBOK has evolved over time and is now accepted as the industry standard around the world.

Cumulative number of companies using the OBPM



Source: Prepare by FISCO from the Company’s website

OBDZ is a support tool that enhances productivity and quality of the design process through systemization of basic design and detailed design, which are upstream processes in software development, and promoting of streamlining and standardization. It could be called CAD for the software development field (the Company already obtained a patent). Maintenance and change management for specification revisions and other adjustments were difficult and led to development delays because engineers previously created design specifications separately in Excel and Word. This product handles integrated management of such design specifications in a database and facilitates standardization and streamlining. As applications, it is well suited to development of large-scale waterfall-type* systems, such as mission-critical systems. The Company has achieved deployments at 38 companies since the release in 2013, even though it is still making refinements to functionality.

* Waterfall-type system refers to the development methodology of developing systems by moving through a series of processes – basic plan, external design, internal design, program design, programming, and tests. Since this assumes not returning to previous processes, it is similar to a "waterfall" in which water does not return from downstream to upstream.

2. The EC and Omni Channel Business

The EC and Omni Channel Business mainly develops and sells the Company's mainstay product of SI Web Shopping, which is Japan's first EC sites construction package. A feature of SI Web Shopping is its strength in large-scale EC sites. More specifically, if possesses scalability, being able to process large-volume transactions for sales amounts of several tens of billions of yen; high-level security functions; mobile-compliance functions, including for its use with smartphones; and is also compliant with multiple languages, such as English and Chinese. The Company has built EC sites at more than 1,100 companies since the release in 1996 (active sites are just under 10%). It possesses robust development knowhow and advanced technology capabilities as strengths.

Looking at positions in the EC site-building package industry, while the Company, SOFTCREATE HOLDINGS CORP.<3371> subsidiary ecbeing Corp., and Commerce21 Corporation dominate products supplied to large operators, competition with system integrators (SIers) has been increasing recently. As a recent trend, projects have been growing in size due to addition of collaborative functions with other business systems to EC site-building packages and this is raising the order price per project from a few ten million yen previously to over ¥100mn in an increasing number of cases. The ratio of recurring sales was 14.9% in FY2/19, a relatively low level for the Company, and period profitability fluctuates depending on the state of development projects.

3. The ERP Business

The ERP Business develops and sells (installs) the GRANDIT full Web-based ERP packaged software. This software is sold by a consortium of 13 IT companies. Since this consortium was established in 2004, the Company has been involved in planning and developing a new software product and has contributed to the market diffusion of this product. The GRANDIT Web-ERP packaged software is targeted to medium-sized companies with a few ten billion yen in annual sales and has been sold to more than 1,000 companies by the consortium. A distinctive feature of the GRANDIT software is that it is an ERP that is completely based on the Web. Therefore, customers can easily upgrade their software without maintenance. The software can also be used on smart devices. As the software is independent of hardware, it can be used anywhere in the environment where the Web operates. Because the GRANDIT software is jointly developed by the consortium of 13 companies, it offers a highly competitive performance. It also steadily progresses, including addition of RPA to the line-up in GRANDIT 3.0, the latest version released in 2018.

The Company boasts top performance among many companies as well as those in the consortium, and received the Prime Partner of the Year award in the GRANDIT AWARDs for two consecutive years in 2016 and 2017 (it has received this award a total of five times). As add-on modules that supplement GRANDIT's core features, the Company has developed the "production management add-on module" and "continuous transaction management add-on module" for the manufacturing industry and "project management template (IT template)" that collaborates with OBPM for the software industry.

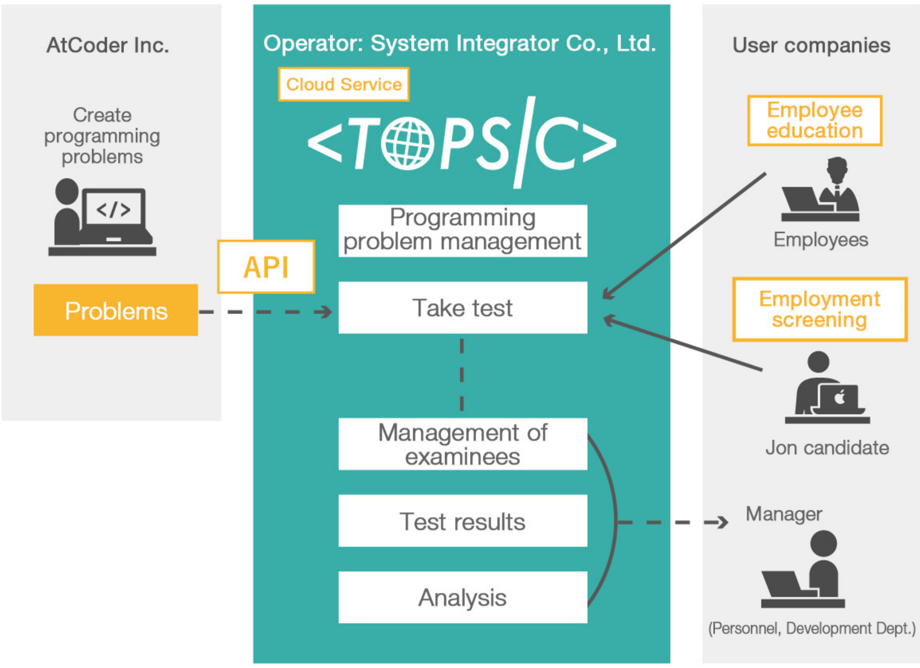
It is estimated that the domestic ERP market grew 2.9% YoY to ¥112.9bn in 2018. Companies are rebuilding mission-critical systems, particularly large companies, and this market is likely to continue stable single-digit growth from 2019 too. ERP vendors can be categorized by customer size. SAP and Oracle hold strong positions in the large company segment. While the Company previously supplied products mainly to mid-sized companies and competed with Fujitsu Limited's <6702> GLOVIA and OBIC Co., Ltd.'s <4684> OBIC7, its project orders have been growing in size recently due to a trend of diversification of customer needs. It had many projects in the ¥100mn range in the past, but projects worth ¥500mn have been increasing lately because of function additions and other needs. Gross margin varies depending on product composition, specifications, and other aspects and hence is not uniform. The average, however, is in the 20% range, and operating margin is roughly 8%. The ratio of recurring sales was 21.4% in FY2/19.

4. Others

The Other Business segment includes new businesses. TOPSIC, the programming skill evaluation service launched in January 2018, is a service that is already contributing to sales. This service clarifies the skill level of the test taker by issuing problems and evaluating the ability of the algorithm, a common skill that does not rely on the programming language, in an online format with a combination of six difficulty stages. Applications include screening in the process of hiring engineers, use as an educational and training tool for employees, and use as a skill check for selection of outsourcing companies. Furthermore, since it supports multiple languages, TOPSIC can be applied to hiring foreigners and selection of offshore companies. The Company provides this service to about 50 companies (including schools) as of end-February 2019 and business is steadily growing.

The fee plan is available on usage basis and on a fixed-fee basis of an annual contract. For the fixed-fee program with an ordinary company (standard plan), the annual basic fee is ¥300,000 and the annual usage charge is added based on the number of users (the lowest usage charge is ¥240,000 for 30 or fewer people). Givery, Inc.'s "track" offering is a rival programming skill evaluation service. Main differences with the Company's service are a broader range that covers from the upstream design area to the programming area and more expensive pricing with a basic service fee that starts at ¥100,000 a month.

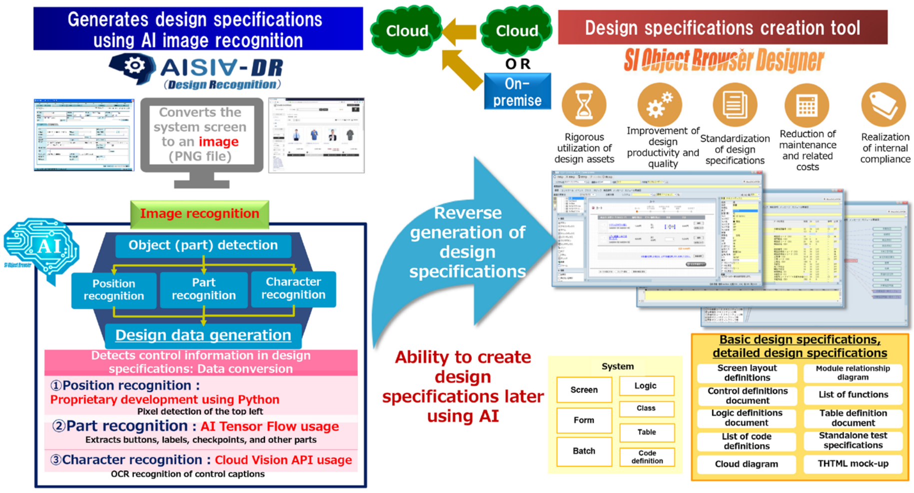
TOPSIC service



Source: The Company's website

As new services that utilize AI technology, while they are not contributing to sales yet, the Company released AISI∀-DR (Design Recognition) in March 2018 and AISI∀-AD in October 2018. AISI∀-DR is a service for reverse creation of design specifications from a system screen using deep learning technology (already received a patent). It supports a one-stop process from a system screen to creating design specifications for collaborative use with OBDZ. The service format is on-premise provision or monthly fee provision via a cloud service.

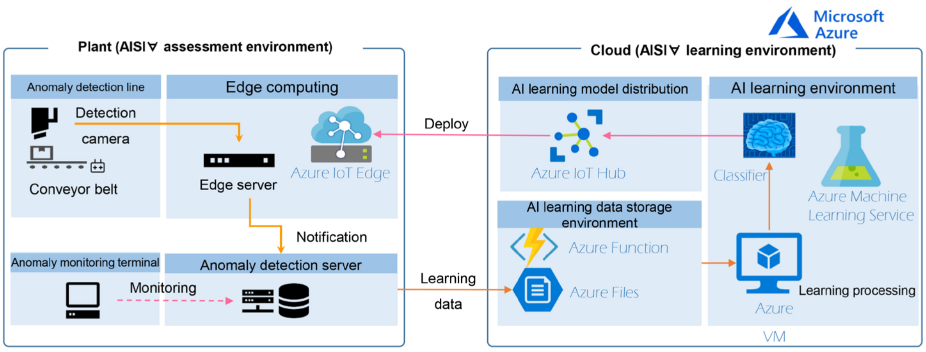
Image of AISI∀-Design Recognition in use



Source: The Company's website

AISI∀-AD is an anomaly detection system based on image recognition using deep learning technology and has demand potential for visual inspection processes utilized on manufacturing lines. It automates visual inspections previously conducted by people with AI technology. Deep learning uses Microsoft's (MSFT) Azure cloud that is equipped with an ideal environment for learning and has a framework for AI assessment via edge computers that are capable of rapid real-time assessment for anomaly detection. It is necessary to adjust specifications for individual projects because of differences in the inspected items, precision, and other details for each customer.

Image of AISI∀-Anomaly Detection in use



Source: The Company's results briefing materials

Trends

Achieved all-time high results in a second straight year in FY2/19

1. Summary of the FY2/19 results

The Company reported all-time high results in a second straight year in FY2/19 at ¥4,066mn in net sales (+7.9% YoY), ¥544mn in operating profit (+9.9%), ¥557mn in ordinary profit (+12.3%), and ¥578mn in net profit (+67.4%). Sales and profits rose in the three major businesses with support from a healthy business environment, such as sustained expansion of IT investments aimed at raising productivity. Moreover, net sales and profits also exceeded the business plan. The main driver was stronger recruitment of new customers than expected in the Object Browser Business with high profitability.

FY2/19 results

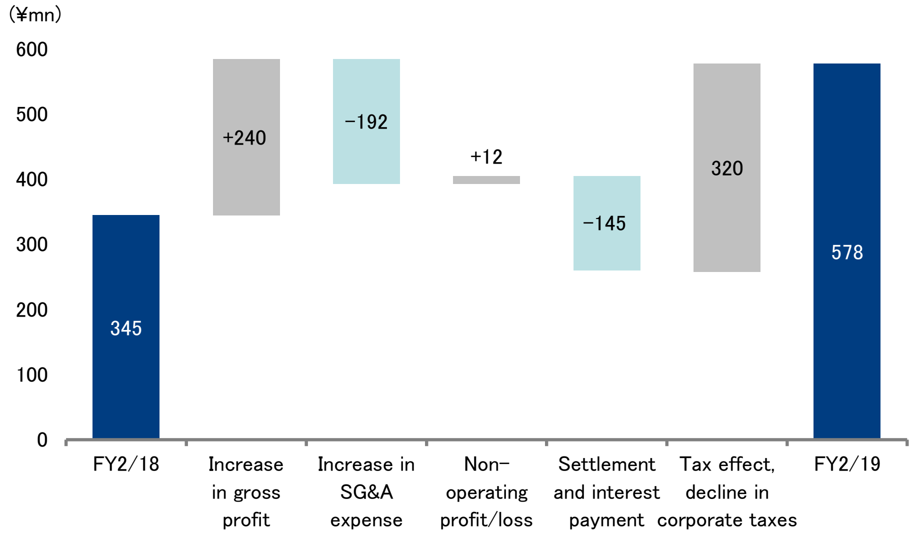
(¥mn)

	FY2/18		FY2/19				
	Result	% of sales	Business Plan	Result	% of sales	YoY	Vs. forecast
Net sales	3,767	-	4,000	4,066	-	7.9%	1.7%
Gross profit	1,275	33.9%	-	1,516	37.3%	18.9%	-
SG&A expenses	780	20.7%	-	972	23.9%	24.6%	-
Operating profit	494	13.1%	500	544	13.4%	9.9%	8.8%
Recurring profit	496	13.2%	503	557	13.7%	12.3%	10.9%
Extraordinary income/loss	3	-	-	(145)	-	-	-
Net profit	345	9.2%	515	578	14.2%	67.4%	12.4%

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

In income variance factors, gross profit climbed by ¥240mn YoY mainly because of the sales increase effect in Object Browser Business and improved profitability in EC and Omni Channel Business. SG&A expenses, meanwhile, increased by ¥192mn YoY primarily due to investments aimed at business expansion. Main increases were ¥60mn in personnel expenses, ¥23mn in R&D expenses, and ¥109mn in advertising, hiring, and educational expenses. Non-operating income added ¥12mn in profit thanks to a rise in lecture fees and other related income and booking consumption tax difference, while extraordinary loss recorded a ¥145mn settlement charge. The Company paid this settlement charge, which addressed an unprofitable system integration project that occurred in FY2/15, in accordance with the result of an arbitration regarding damages compensation with the customer. With finalization of the arbitration, the Company recognized ¥976mn booked in the order losses allowance and the ¥145mn settlement charge as taxable income deductions. This tax effect lowered corporate tax burden by ¥320mn YoY (profit addition), and net profit rose by ¥233mn.

FY2/19 net profit(loss) variance factors



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

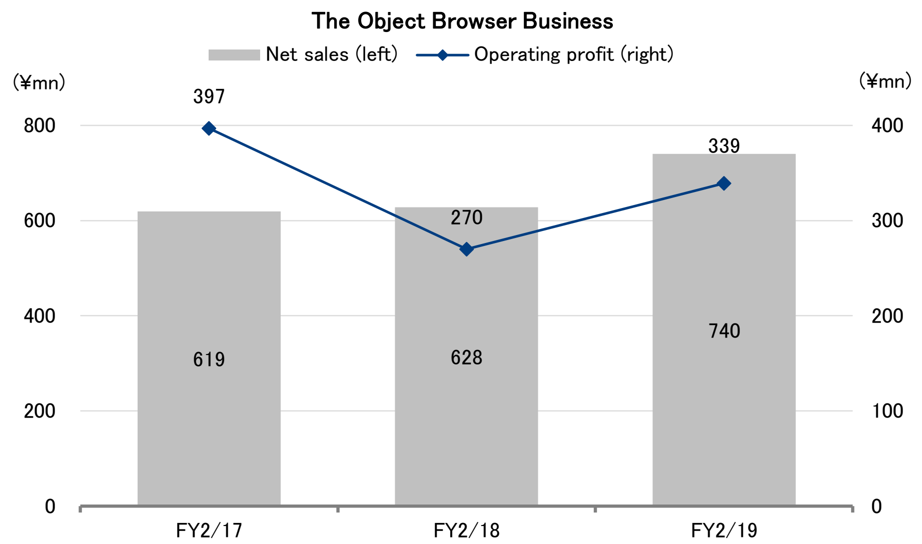
Higher sales and profits in the three main businesses, healthy TOPSIC ramp-up too

2. Earnings by business segment

(1) The Object Browser Business

Object Browser Business posted healthy results with ¥740mn in sales (+17.8% YoY) and ¥339mn in operating profit (+25.6%). Sales set an all-time high in a consecutive year, and operating profit effectively climbed to a new high too (the all-time high from FY2/17 includes a boost of just under ¥100mn due to use of a standard prior to allocation of companywide costs).

Looking at product trends, the SI Object Browser series, which had stalled in the previous 1-2 years, returned to sales growth on progress with installations at new customers. Additionally, in OBPM business, the number of deployments increased at a steady pace from just over 150 companies at end-FY2/18 to just over 170 companies and sales maintained upbeat double-digit growth. Sales rose considerably in 4Q because of a pick-up in inquiries about OBPM with its extensive features amid the growing importance of project management in the IT industry. For the application design tool OBDZ, meanwhile, the Company did not conduct active promotions during the year because of focus on development of a Web version for improved performance and deployment sites only grew slightly from the end of the previous fiscal year to 38 companies.

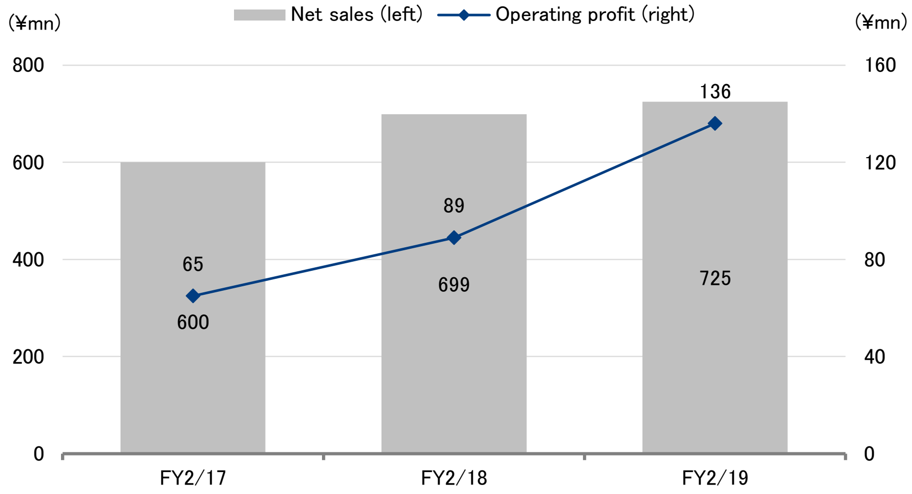


Note: FY2/17 operating profit was on a basis prior to allocation of companywide shared costs
Source: Prepared by FISCO from the Company's financial results

(2) The EC and Omni Channel Business

EC and Omni Channel Business reported ¥725mn in sales (+3.7% YoY) and ¥136mn in operating profit (+52.6%). While sales dropped in three straight years through FY2/17 due to tougher competition, needs are growing for EC sites with larger scale and diverse functionality, including high-volume transaction processing related to expansion of the EC market, enhanced security measures, and collaboration with other business systems, and the Company's inquiries expanded, mainly for large projects, in light of its development knowhow accumulated in over 20 years and robust technology capabilities. Operating margin climbed significantly from the previous fiscal year's 12.8% to 18.7% on orders for development projects with attractive margin and improved productivity.

The EC and Omni Channel Business

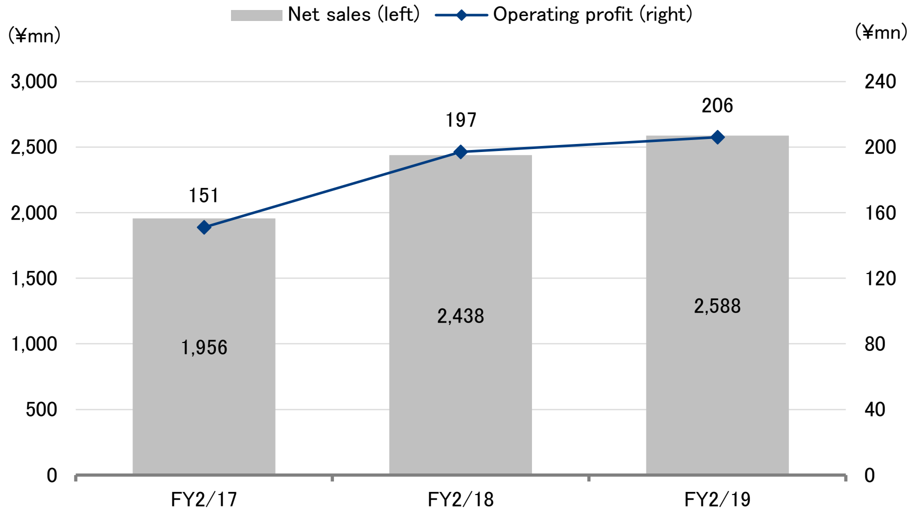


Note: FY2/17 operating profit was on a basis prior to allocation of companywide shared costs
Source: Prepared by FISCO from the Company's financial results

(3) The ERP Business

ERP Business sustained sales and profit growth at ¥2,588mn in sales (+6.1% YoY) and ¥206mn in operating profit (+4.1%). With a tailwind from rising corporate IT investments, the Company expanded orders for GRANDIT-related self-developed products "individual production management add-on module," "repeat production management add-on module," and "continuous transaction management add-on module" from manufacturing and engineering businesses and "IT template" products used together with OBPM from IT-related companies.

The ERP Business



Note: FY2/17 operating profit was on a basis prior to allocation of companywide shared costs
Source: Prepared by FISCO from the Company's financial results

(4) Other business

The Other Business (new businesses) booked ¥11mn in sales (vs. ¥1mn in FY2/18) and had a ¥138mn operating loss (vs. a ¥62mn loss). Sales climbed on expansion of TOPSIC business, which began service in January 2018, to about 50 customers, mainly IT companies. This segment's operating loss widened due to higher investment costs, including development expenses for the AISI∀ series of AI-related services and TOPSIC promotional costs.

The Company held PG Battle (free participation), a programming contest for companies and schools, in November 2018 as an initiative to improve TOPSIC recognition. The contest used a team format with three members per team. Teams wrote four programs within 90 minutes using TOPSIC and competed for a combined score, including response time. This was a lively event with participation by 260 teams and 780 people, including companies and schools. The Company hence plans to hold a second contest on a larger scale in 2019 with targets of 1,000 teams and 3,000 people. It began a sponsor program too that facilitates expansion of prize money and covers some promotion costs.

Substantial rise in the capital ratio on finalized arbitration and increased profits

3. Financial position and management indicators

Gross assets declined by ¥422mn YoY to ¥2,766mn at the end of FY2/19. We review main changes. In current assets, cash and deposits increased by ¥401mn, while work in process dropped by ¥1,054mn. Decline in work in process value accompanied the finalization of an arbitration process for a large-scale unprofitable project that occurred in FY2/15, and the corresponding liabilities item was reduction of the orders losses allowance by ¥976mn. In fixed assets, software (including the work-in-process account) rose by ¥103mn.

Total liabilities value was down by ¥884mn YoY to ¥734mn, mainly because of the ¥976mn decline in the provision for loss on order received. Additionally, net asset value climbed by ¥461mn to ¥2,031mn on booking ¥578mn in net profit, ¥105mn in dividend payments, and other items.

In management indicators, the capital ratio moved sharply higher from 49.2% at the end of FY2/18 to 73.4% thanks to decline in the provision for loss on order received and expanded profit. The Company restored this ratio to roughly the same level as in the fiscal year prior to occurrence of the above-mentioned large-scale unprofitable project (72.6% at end-FY2/14). Furthermore, cash and deposits surpassed the previous peak at end-FY2/14 (¥1,130mn) at ¥1,319mn. We think the financial base is sound, including continuation of debt-free operations. In profitability, operating margin moved upward in a second straight year to 13.4%. The Company's improved profit margin, despite investments to cultivate new businesses, and increased spending on human resources, is good news. ROE was strong too at 32.2%.

Balance sheet

(¥mn)

	FY2/16	FY2/17	FY2/18	FY2/19	Change
Current assets	2,520	2,761	2,789	2,250	-538
(Cash and deposits)	788	725	917	1,319	401
(Work in process)	954	1,211	1,104	49	-1,054
Non-current assets	426	448	399	515	115
Total assets	2,946	3,210	3,189	2,766	-422
Total liabilities	1,717	1,958	1,619	734	-884
(provision for loss on order received)	976	1,256	982	6	-976
(Interest-bearing debt)	20	-	-	-	-
Net assets	1,229	1,251	1,570	2,031	461
(Retained earnings)	464	479	781	1,255	473
Financial indicators					
(Stability)					
Current ratio	146.8%	141.0%	174.4%	306.3%	131.9pt
Equity ratio	41.7%	39.0%	49.2%	73.4%	24.2pt
(Profitability)					
ROE (return on equity)	35.1%	11.1%	24.5%	32.2%	7.7pt
Operating profit margin	12.6%	6.9%	13.1%	13.4%	0.3pt

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

Outlook

Guides for continuation of sales and profit growth in FY2/20, though with skewing to 2H

1. FY2/20 forecast

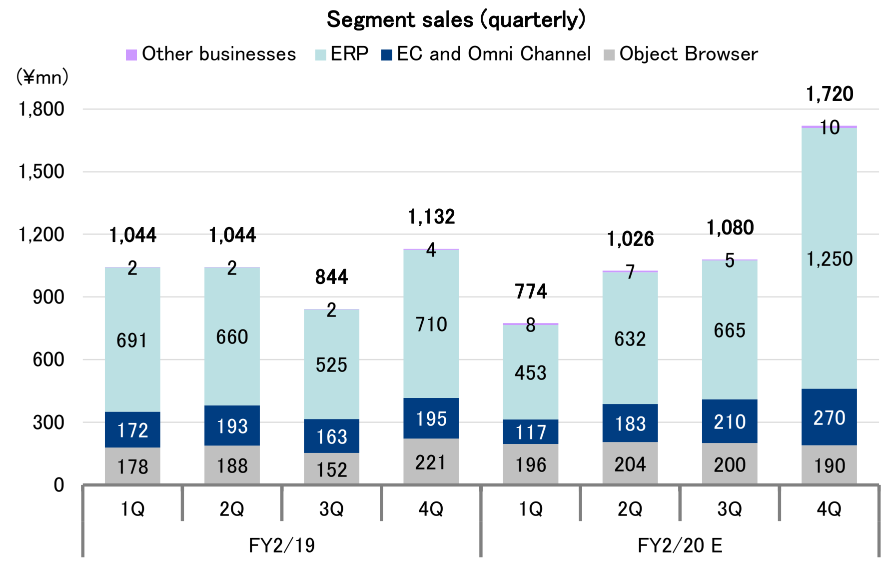
The Company's FY2/20 guidance envisions ¥4,600mn in net sales (+13.1%), ¥600mn in operating profit (+10.3%), and ¥603mn in ordinary profit (+8.1%), sustaining higher sales and profits. In net profit, however, it expects a decline to ¥422mn (-27.1%) due to normalization of tax burden. We think the plan targets are attainable because of a continuing healthy market environment for the Company's businesses amid vibrant appetite for IT investments aimed at higher productivity. While 1H targets forecast lower sales and profits with declines of 13.8% in sales and 49.2% in operating profits, this reflects skewing of final inspections of major projects in EC and Omni Channel Business and ERP Business developments to 2H. At the quarterly level, the Company expects restoration of higher sales and profits (YoY) from 3Q. The plan factors in slightly lower development costs for new products and services (YoY) and with flat hiring, education, and advertising costs around the same level (YoY).

Forecast for FY2/20

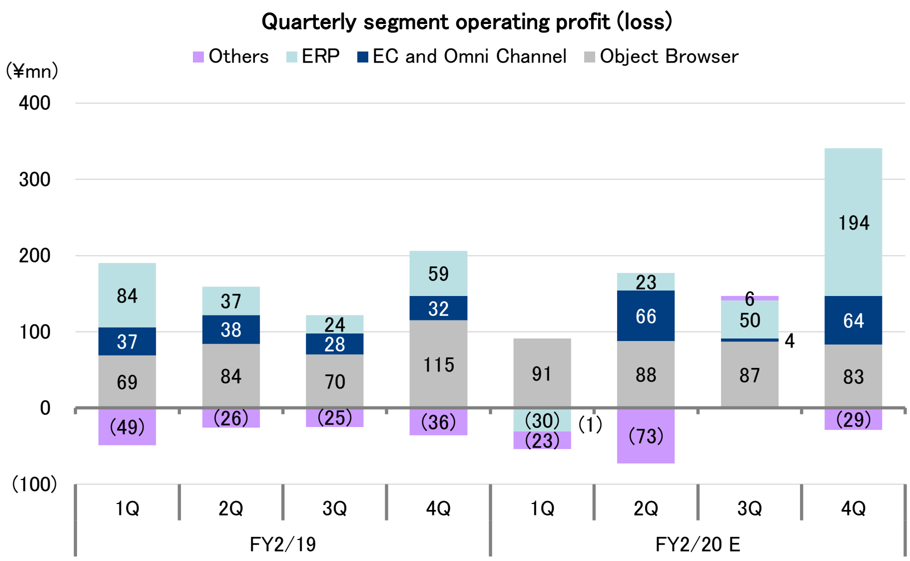
(¥mn)

	FY2/19		FY2/20			
	Full-year result	YoY	1H forecast	YoY	Full-year forecast	YoY
Net sales	4,066	7.9%	1,800	-13.8%	4,600	13.1%
Operating profit	544	9.9%	140	-49.2%	600	10.3%
Recurring profit	557	12.3%	141	-49.2%	603	8.1%
Net profit	578	67.4%	98	-74.7%	422	-27.1%
Earnings per share (¥)	52.26		8.85		38.10	

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



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



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

Possibility of cultivating TOPSIC into a fourth income source in the future

2. Outlook by business segment

(1) The Object Browser Business

In Object Browser Business, the Company projects ¥790mn in sales (+6.6% YoY) and ¥349mn in operating profit (+2.9%). Expansion of OBPM deployments should continue to drive growth. Modest decline in profit margin reflects higher promotion costs for web-version OBDZ* slated for release in 1Q FY2/20. Furthermore, the newest version supports collaboration with AISI∀-DR, which handles automated generation from image recognition using an AI function, and this is likely to provide growth as a tool that realizes improvement in design process productivity.

* While the Company sold products for client/server (C/S) systems up to now, it aims to expand sales through release of a Web version that facilitates faster operation.

The Company opened a new sales office in Nagoya (it currently has one person stationed at this site) in March 2019 with the aim of recruiting new customers and strengthening support operations in the Chubu area, mainly for OBPM. It has 12 existing OBPM customers in the Chubu area and hopes to increase customer volume and sales by making sales proposals to not only IT companies, but also manufacturing companies.

(2) The EC and Omni Channel

In EC and Omni Channel Business, the Company expects lower profit on a rise in sales with ¥780mn in sales (+7.5% YoY) and ¥133mn in operating profit (-2.8%). While sales should continue to expand mainly for large-scale EC site development projects, the outlook for slightly lower profit reflects anticipated backlash from the previous fiscal year's high-margin projects. The Company released SI Web Shopping V12.6, a new version updated for the consumption tax hike and lighter tax rate system, in March 2019.

(3) The ERP Business

In ERP Business, the Company forecasts double-digit sales and profit gains with ¥3,000mn in sales (+15.9% YoY) and ¥237mn in operating profit (+15.0%). It factors in continuation of robust demand, mainly from the manufacturing industry, and anticipates concentrated sales in 4Q. The Company began provision of GRANDIT as a subscription model in March 2019. This service utilizes Internet Initiative Japan Inc.'s cloud service as the basic model (though customers can select AWS and Azure as options). The existing on-premise format primarily targeted mid-sized and large companies and required initial installation costs of ¥100mn or more and a period of over a year from development to operation. Since the subscription model lowers initial costs to a few ten million yen and shortens mission-critical system deployments to less than a year, the Company hopes to broaden its customer scope. It also will give users a tool to handle customization previously conducted by the vendor with the release of an add-on development tool* in September 2019.

* This tool enables easy additions of functionality by users without changing source code, mainly for output-related functions, that previously involved considerable customization.

The Company's sales goal for the subscription model is ¥500mn in the three years from FY2/20. It also aims to generate about 30% of ERP Business sales from the subscription model in five years as part of the policy to steadily raise the ratio of recurring business (this ratio was 21.4% in FY2/19).

The Company has also started RPA deployment proposals (such as labor savings for data input tasks) to GRANDIT customers. As the RPA tool, it proposes WorkFusion's (US) RPA Express (it concluded a contract as the first sales agent in Japan in December 2018), which has proven effective in an in-house deployment. While this business is not contributing much to sales yet due to use of a freemium model*, it should provide a certain amount of sales fee income as customers switch to paid plans.

* This business model provides basic services and products for free and has a scheme for paid supply of more advanced functions and special capabilities.

(4) Other Business

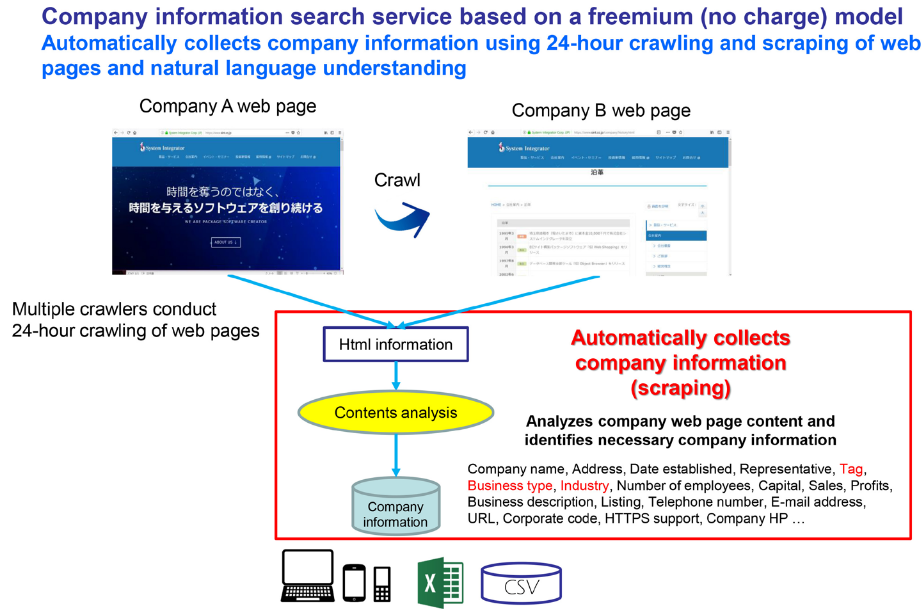
In Other Business, the Company projects ¥30mn in sales (+151.6% YoY) and a ¥119mn operating loss (vs. a ¥138mn loss in the previous year). The main sales driver is anticipated expansion of the number of companies with TOPSIC deployments from 50 at the end of FY2/19 to 100 companies. This growth covers a rise in providing primarily to IT companies, but also wider use at schools following the introduction of an academic plan (at a charge that is one-tenth of the standard plan) for schools from April 2019. TOPSIC deployments might increase from FY2/20 due to reinforcement of programming education at schools too. Some examples of school customers are Rikkyo Ikebukuro Junior & Senior High School, Hosei University, and Tama University.

Sales are likely to expand at a doubling pace for the time being because providing to IT companies should advance further. Gross margin is high, and advertising effect from PG Battle contents should lighten the promotional cost burden. There is also not much need for sales people due to the online sales format (currently one person handles the service). Operating margin should be roughly on par with the Object Browser Business level from FY2/21. We think this could be a fourth major income source in the future.

The FY2/20 sales outlook does not factor in AISI∀ series (AI service) business. Nevertheless, the AISI∀-AD anomaly detection system released in October 2018 made a strong impression manufacturers nationwide struggling with manpower shortages. The Company created the AI solutions division (with four people) in December 2018 as a dedicated unit for promotion and expansion of this business and is responding to opportunities. While it is currently at a stage of accumulating data for verify the effect with multiple companies, this business requires more time until it starts operating at customer sites due to the need for a tuning process that addresses differences, such as the precision level, at each customer. The Company intends to follow a strategy of efficiently expanding service through utilization of external partner companies (SIers, etc.) for deployment assistance. Multiple similar services that apply AI technology are also available. Yet we think the market is still at a stage prior to full-fledged adoption and offers substantial entry room.

As a new service in the AISI∀ series, the Company plans to release AISI∀-CL (Company Lyst), a company information search service, in June 2019. This service uses AI natural language understanding technology to read corporate outlines and product and service pages of roughly 4.8mn companies with web pages on the Internet obtained through 24-hour crawling and scraping (data extraction) and automatically apply tags for business type, industry, and other qualities. The Company expects to make inroads mainly with corporate marketing divisions, sales divisions, and procurement divisions due to the ability to collect fresher information less expensively than traditional company information provision services (such as Teikoku Databank, Ltd. and Tokyo Shoko Research, Ltd.). It plans to offer the service in a cloud format using a freemium model. While industry assessment accuracy is an issue, we expect interest in the service as a way of improving work efficiency.

AISI∀-CL (Company Lyst)



Source: The Company's results briefing materials

We also anticipate stronger sales of AISI∀-DR, the reverse generation service for design specifications data using image recognition, from collaboration with OBDZ.

Net sales by business

(¥mn)

	FY2/16	FY2/17	FY2/18	FY2/19	FY2/20	Growth rate
The Object Browser Business	580	619	628	740	790	6.6%
The EC and Omni Channel Business	672	600	699	725	780	7.5%
The ERP Business	2,286	1,956	2,438	2,588	3,000	15.9%
Others	-	-	1	11	30	151.6%
Total	3,539	3,176	3,767	4,066	4,600	13.1%

Operating profit (loss) by business

(¥mn)

	FY2/16	FY2/17	FY2/18	FY2/19	FY2/20 E	Growth rate
The Object Browser Business	392	397	270	339	349	2.9%
The EC and Omni Channel Business	-30	65	89	136	133	(2.8%)
The ERP Business	401	151	197	206	237	15.0%
Others	-	-	(62)	(138)	(119)	-
Adjustments	(318)	(395)	-	-	-	-
Total	444	219	494	544	600	10.3%

Note: FY2/17 operating profit was on a basis prior to allocation of companywide shared costs
Source: Prepared by FISCO from the Company's financial results and briefing materials

Strengthened emphasis on profitability and raised the FY2/21 ordinary profit goal

3. The medium-term business plan

The Company updated income goals in the Break 2018 medium-term business plan (announced in April 2018) that lasts through FY2/21 in light of FY2/19 results and the current healthy business environment. For FY2/21, the final fiscal year, it slightly reduced the sales goal from ¥5,300mn (initial level) to ¥5,200mn, but lifted the ordinary profit goal from ¥684mn to ¥753mn.

The sales adjustment mainly came from revising the plan for reinforcement of the profit emphasis direction and sustaining healthy growth. In ordinary profit, meanwhile, the Company raised its goal because the three main businesses beat initial FY2/19 profit targets and upbeat momentum is likely to continue from FY2/20 thanks to the healthy orders environment. Additionally, it lifted the FY2/21 ordinary margin goal by 1.6pt to 14.5%, reflecting the resolve to further enhance profitability.

Content of revisions to results goals

(¥mn)

	FY2/19			FY2/20			FY2/21		
	Goal	Result	Revision percentage	Goal	Revised value	Revision percentage	Goal	Revised value	Revision percentage
Net sales	4,000	4,066	1.7%	4,800	4,600	-4.2%	5,300	5,200	-1.9%
YoY	6.2%	7.9%		20.0%	13.1%		10.4%	13.0%	
Recurring profit	503	557	10.9%	578	603	4.3%	684	753	10.1%
YoY	1.3%	12.3%		14.9%	8.1%		18.3%	24.9%	
Recurring profit margin	12.6%	13.7%	-	12.0%	13.1%	-	12.9%	14.5%	-

Source: Prepared by FISCO from the Company's materials

Fundamental policy unchanged, putting priority on the following five areas

(1) Increase market share of existing businesses

In the three main businesses, the Company aims to achieve further growth in Object Browser Business with the SI Object Browser series as a stable income source, increased OBPM share in the IT industry and demand development in manufacturing and other industries, and improved sales from OBDZ and AISI∀-DR collaboration. It also hopes to deliver stable growth in EC and Omni Channel Business with SI Web Shopping as the core system and promotion of an EC eco-system strategy through collaboration with EC-related services and double-digit growth in ERP Business by enhancing add-on module functions, making new added-value proposals that utilize RPA tools and other features, and expanding the customer segment with the start of a subscription model.

(2) Establish bases overseas

The Company is actively hiring overseas human resource to bolster development capabilities in the ERP Business and other areas. It has been hiring university graduates (at a pace of two a year) since 2017 through an alliance with University of Da Nang in Vietnam and is also making mid-career hires of Vietnamese people domestically. The Company plans to train these employees and build partnerships with local companies in Vietnam. It hopes to create a development base in Vietnam during FY2/20.

(3) Establish AI business

The Company started AI research and development of AI services in 2017 and aims to ramp up the three services mentioned earlier. While the medium-term business plan does not factor in sales from these new services, we expect cultivation of these services as a new income source in the future and will be monitoring progress.

(4) Raise skill level of employees

The Company advocates a corporate philosophy that "all employees should be leading engineers" and has actively invested in employee education over the past two years based on this policy. It uses the new TOPSIC service to improve employee programming skills and plans to continue educational investments in employees.

(5) A leading Japanese "streamlined company"

The Company aims to be a top-level "streamlined company" in Japan by raising work efficiency with RPA and harnessing information from various system tools. It also intends to acquire new customers for these products and services by utilizing OBPM, GRANDIT, RPA tools, and other products internally and providing knowhow on streamlining based on its own experience as a model to customers.

4. Initiatives for the work environment

The Company is highly respected for active efforts to improve the employee work environment. Specifically, it introduced a home work program for employees who need to provide child-rearing and care assistance in 2007 and has realized a positive work environment that exceeds industry averages with its 100% job return ratio for employees who take child-rearing breaks, 78.3% paid holiday usage ratio, and 7.4-hour average monthly overtime. In recognition of these initiatives, the Company obtained gold certification as a "firm that implements diverse work style reforms" (Saitama Prefecture) in 2012, was included in the "100 telework pioneers" (Ministry of Internal Affairs & Communications) in 2017, and acquired certification as a "child-rearing support firm (Platinum Kurumin)" (Ministry of Health, Labour and Welfare) in February 2019.

Amid severe manpower shortages in the IT industry, the Company fares relatively well in hiring talented personnel thanks to favorable reaction by students and others to these initiatives and enjoys a high retention rate in the IT industry, including a departure rate of less than 5%, because of strong employee satisfaction. In hiring, the Company increased new university graduate hires from seven people in spring 2018 to 12 people in spring 2019. Employee volume at end-FY2/19 rose by 16 people, including mid-career hires, YoY to 174 people, roughly in line with the plan. The Company intends to hire 30 people in FY2/20, including new university graduates and mid-career hires.

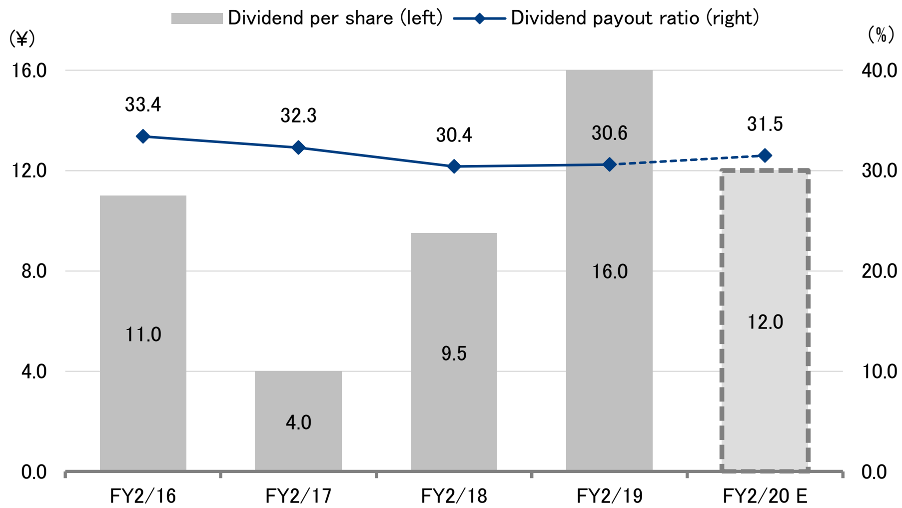
Shareholder return policy

Standard dividend payout ratio is 30% based on performance and a gift of Koshihikari rice through shareholder rewards program

The Company actively promotes shareholder return too with the aim of improving enterprise value. The dividend policy adopts an earnings-based format with a 30% dividend payout ratio. While the Company expects a ¥4.0 YoY decline in the dividend to ¥12.0 (31.5% dividend payout ratio) in FY2/20 because of a temporary setback in net profit on normalization of tax burden, we anticipate upward adjustment of the dividend if the payout ratio is less than 30%.

The Company has also introduced a shareholder rewards program with the objective of cultivating stable shareholders who hold their shares for the medium-to long-term. The program is for shareholders who hold at least 200 shares and who are listed under the same shareholder number in the shareholder ledger at the end of August and end of February in each year. The Company rewards newly harvested Koshihikari rice grown in Niigata, using reduced levels of fertilizers and agrochemicals. Shareholders holding from 200 to 999 shares receive a 1kg bag, those holding 1,000 to 3,999 receive a 2kg bag, those holding 4,000 to 15,999 receive a 5kg bag, and those holding 16,000 shares or more receive a 10kg bag, with the gift being delivered each fall after the harvest.

Dividend per share and dividend payout ratio



Note: Implemented a 1:2 share split on December 1, 2018
Source: Prepared by FISCO from the Company's financial results

Information security policy

As information security measures, the Company assigns an officer to oversee information security, appoints information security managers in each organizational unit, and has formed an information security committee. These actions support safe management of information throughout the company. Additionally, the Company conducts education and training on information security for directors and employees and formulates and complies with internal operational rules to maintain information safeness.

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