COMPANY RESEARCH AND ANALYSIS REPORT

Syuppin Co., Ltd.

3179

Tokyo Stock Exchange First Section

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Summary

Steadily growing income through effective operation of the sales expansion platform, aims to further accelerate growth with AIMD and ladies' watches business

Syuppin Co., Ltd. <3179> (hereafter, also "the Company") is an e-commerce (EC) enterprise specializing in "valuable items," such as cameras and luxury watches. Making the most of the different customer needs and product characteristics of used and new goods, it has succeeded in creating a virtuous cycle in which both used and new goods reinforce each other to increase sales of both types of goods. In the process, the Company has been rapidly expanding the scale of its business.

1. Posted higher sales and profits in all segments in 1H FY3/20, profits up sharply

The Company reported higher sales and sharply stronger profits in 1H FY3/20 with ¥17,852mn in net sales (+9.1% YoY) and ¥1,124mn in operating income (+64.9%). All segments had higher sales and profits (YoY) and bicycles business reached profitability. Main drivers of the steep increase in profits were healthy activity in procurement and sales that supported suitable earnings in used good business, which provides high gross margin, and manifestation of the EC (e-commerce) model benefit of slower increase in SG&A expenses than sales growth.

2. Finalized and effectively operating the sales expansion platform

Meanwhile, the Company is making healthy progress in top-line (sales) growth initiatives as well. One-to-one marketing, which it completed through FY3/18, is currently in the second year of full-fledged operation and the Company believes that it is "effectively using" this framework. With completion of a platform that utilizes CGM* marketing, mainly for cameras (out of the four categories), the Company is smoothly running a sales expansion platform comprised of this capability and one-to-one marketing. A key point is whether it is capable of realizing the camera success story for watches and other goods. While the Company needs to revise these activities to address other categories because of large differences by product types, it has confidence in the ability to establish a reliable sales expansion platform similar to cameras.

* Consumer Generated Media refers to media with contents involving general users, including bulletin boards and word-of-mouth sites.

3. Possible upside in FY3/20 results, focus on ladies' watches business and AIMD in 2H

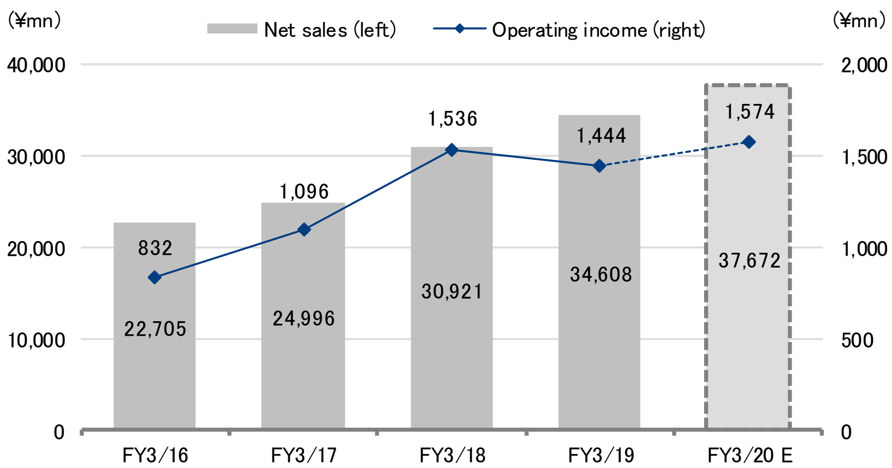
The Company retained its initial forecast for FY3/20, mainly to monitor the impact of backlash decline after rush demand prior to the consumption tax hike on the year-end sales season. Nevertheless, we think there is a good chance of the Company revising its full-year outlook in light of robust earnings progress rates in 1H FY3/20. The ladies' watches business, which the Company is launching as a spinout from watches business, deserves attention in 2H. This initiative targets the women's segment as an important portion of the estimated ¥820bn watches market in Japan. Luxury watches for women serve as accessories, similar to jewelry, and the Company is considering the jewelry market as a future opportunity too. Another important point is deployment of AIMD*, an automated assistance system for making decisions on procurement and selling prices of used goods. Gross margin improvement from better pricing in the business handling used goods clearly showed up in 1H FY3/20. We think full utilization of AIMD should have a large effect in boosting profitability even more.

* Merchandising system that utilizes AI

Key Points

- Moving substantially closer to completion of a platform that expands sales
- Plans to start operating AIMD in 4Q FY3/20
- Pursuing broader scope in watches business with ladies business and overseas business

Results trends



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

Results trends

Posted higher sales and profits in all segments in 1H FY3/20, profits up sharply
Very upbeat results with earnings progress at over 70%

1. Overview of 1H FY3/20 results

(1) Results summary

The Company posted higher sales and a steep rise in profits in 1H FY3/20, with ¥17,852mn in net sales (+9.1% YoY), ¥1,124mn in operating income (+64.9%), ¥1,118mn (+64.7%) in ordinary income, and ¥758mn (+64.0%) in net income.

Compared to the initial forecast, while net sales slightly missed, operating income and other profit items significantly exceeded targets and surpassed 70% as progress rates toward full-year levels.

1H FY3/20 results summary

(¥mn)

	1H FY3/19 results	FY3/20					
		1H forecast	1H result	YoY	Vs. forecast	Progress rate	Full-year forecast
Net sales	16,362	18,277	17,852	9.1%	-2.3%	47.4%	37,672
Gross profit	2,674	-	3,176	18.8%	-	51.5%	6,170
Gross margin	16.3%	-	17.8%	-	-	-	16.4%
SG&A expenses	1,992	-	2,051	3.0%	-	44.6%	4,596
SG&A ratio	12.2%	-	11.5%	-	-	-	12.2%
Operating income	682	741	1,124	64.9%	51.8%	71.5%	1,574
Operating margin	4.2%	4.1%	6.3%	-	-	-	4.2%
Ordinary income	679	736	1,118	64.7%	52.0%	71.5%	1,564
Net income	462	481	758	64.0%	57.7%	74.1%	1,023

Note: Progress rates show the percentage of 1H results versus FY3/20 targets
Source: Prepared by FISCO from the Company's financial results

Sales rose 9.1% YoY with gains in all business segments (as explained in detail below). While cameras and watches were slightly weak for new goods, both categories posted healthy sales in used goods. The shortfall in sales (vs. guidance) stemmed from misreading the extent of rush demand prior to the consumption tax hike. Management expected sales to strengthen in Aug-Sep, but August stayed at the same level as a typical year and September only received rush demand in the latter half, resulting in lower sales than planned.

In profits, gross profit climbed 18.8% (¥501mn) YoY, thanks to higher sales and improved margin from 16.3% a year ago to 17.8% in 1H FY3/20. Drivers of the improvement in gross margin were upbeat purchases of used goods and a larger percentage of used goods in sales. SG&A expenses increased 3.0% (¥59mn) to ¥2,051mn. The 3.0% increase was substantially less than sales growth, trimming the SG&A expenses ratio from by 0.7ppt from 12.2% a year ago to 11.5%. While details are provided below, this outcome clarifies the dynamic of slower growth in SG&A expenses than sales expansion because of light fixed costs in the EC-focused retailer model utilized by the Company. Operating income hence expanded sharply with a 64.9% (¥442mn) gain.

The Company had upbeat 1H FY3/20 results with broad quantitative improvements, including higher sales and profits in all segments (it achieved profitability in bicycles business), a healthy gain in gross margin, and decline in the SG&A expenses ratio to the all-time low level.

Looking more closely at content, ramp-up of one-to-one marketing promoted by the Company was an advance in 1H FY3/20. In July, the Company formed a cross media project aimed at bolstering the CGM marketing strategy, which the Company had been pursuing in the cameras business and this provided an important step, too. Management wants to solidify a virtuous cycle that leads to sales expansion, and 1H FY3/20 results confirmed steady progress in this direction. We think this is the biggest takeaway from 1H FY3/20. Since the Company largely completed a sales expansion platform in cameras business, attention is shifting to a stage of further lift in overall income on broader application of camera success to other goods.

(2) SG&A expenses ratio

As explained above, SG&A expenses increased 3.0% (¥59mn) to ¥2,051mn in 1H FY3/20. While upturns in personnel expenses and outsourcing expenses stood out, other items were flat or lower (YoY). Personnel expenses moved upward as a natural trend accompanying income growth due to increase in bonuses linked to earnings and staff additions. We believe outsourcing expenses grew because of development and other costs for the new AIMD system being pursued by the Company.

Decline in payment fees, meanwhile, deserves notice as a reduction item. This covers the costs related to selling goods at branch sites on EC malls operated by Z Holdings <4689> and Rakuten <4755>. Payment fees fluctuate in accordance with sales value on the EC mall. The Company is currently focusing on expansion of sales through its own site (main store) because it expects a higher conversion rate (and hence stronger sales) due to provision of much richer information content than on the EC mall branches with recent enhancements of product images and videos. One-to-one marketing also aims to steer customers to the Company's own site. Clear decline in payment fees amid healthy growth in sales showed progress with sales on the Company's site in 1H FY3/20.

However, the Company does not intend to eliminate sales through EC malls. Use of EC malls attracts customers too, and it would counterproductive to remove exposure received on major EC malls from the perspective of sustaining and raising awareness and branding. Even though the Company still sees room to lower payment fees in sales composition, it also acknowledges that the level has already moved into a permissible range.

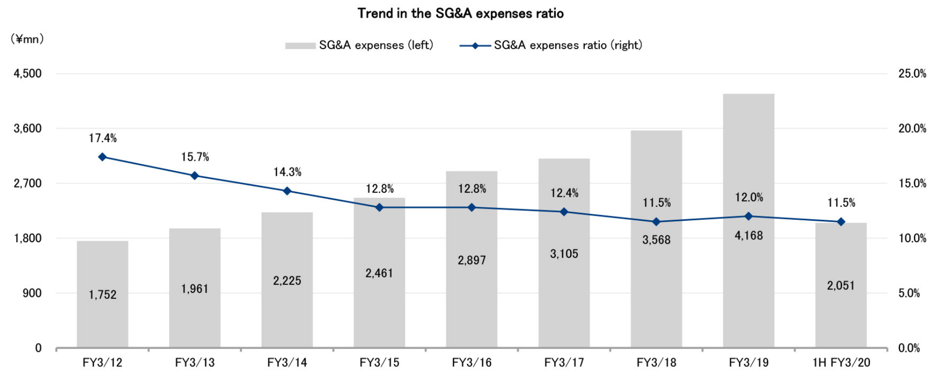
Breakdown of SG&A expenses

(¥mn)

	FY3/19		FY3/20		
	1H	Ratio to net sales	1H	Ratio to net sales	YoY
Personnel expenses	550	3.4%	600	3.4%	50
Advertising expenses	26	0.2%	23	0.1%	-2
Sales promotion expenses	360	2.2%	368	2.1%	8
Outsourcing expenses	97	0.6%	133	0.8%	36
Commissions paid	410	2.5%	394	2.2%	-16
Depreciation and amortization	106	0.6%	105	0.6%	-0.5
Land rent	131	0.8%	131	0.7%	-
Other	309	1.9%	293	1.6%	-16
Total SG&A expenses	1,992	12.2%	2,051	11.5%	59

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

The SG&A expenses ratio dropped to 11.5%. This is a very healthy level. EC businesses do not incur much fixed-cost burden and have an income structure in which the SG&A expenses ratio rapidly declines as sales expand. While expenses do not actually trend downward in a linear manner due to system development investments and above-mentioned payment fees, they have been heading lower over the long term.



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

Healthy income growth in all businesses, achieved operating profitability in the bicycles business

2. Trends by business segment

Sales and operating income by business segment

(¥mn)

		FY3/19	FY3/20		
		1H	1H	YoY	EC ratio
Camera	EC	8,276	8,468	2.3%	71.9%
	Stores	2,838	3,307	16.5%	
	Total net sales	11,114	11,776	6.0%	
	Segment operating income	855	1,261	47.4%	
	Operating margin	7.7%	10.7%	-	
Watches	EC	1,645	1,822	10.7%	32.9%
	Stores	3,140	3,715	18.3%	
	Total net sales	4,785	5,537	15.7%	
	Segment operating income	250	332	32.8%	
	Operating margin	5.2%	6.0%	-	
Stationery	EC	165	183	11.1%	73.2%
	Stores	70	66	-5.3%	
	Total net sales	236	250	6.2%	
	Segment operating income	1	13	-	
	Operating margin	0.5%	5.3%	-	
Bicycles	EC	177	242	37.0%	84.0%
	Stores	48	45	-6.6%	
	Total net sales	225	288	27.6%	
	Segment operating income	-5	5	-	
	Operating margin	-2.4%	2.1%	-	
Company-wide	EC	10,264	10,717	4.4%	60.0%
	Stores	6,098	7,135	17.0%	
	Total net sales	16,362	17,852	9.1%	
	Segment operating income	682	1,124	64.7%	
	Operating margin	4.2%	6.3%	-	

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

(1) Cameras business

Cameras business posted higher sales and a steep rise in profits in 1H FY3/20 at ¥11,776mn in net sales (+6.0% YoY) and ¥1,261mn in operating income (+47.4%). In new goods, two leading firms Nikon <7731> and Canon <7751> have been releasing full-size mirrorless cameras since fall 2018, but sales remain weaker than anticipated because of shortages in the lens line-up and other factors. Although both firms possess large loyal fan bases, replacement buying activity has not picked up and the situation is causing opportunity losses at the Company. Given these conditions, the Company focused on buying used goods and raising sales by boosting sales turnover. It managed to expand segment sales by offsetting sluggishness in new goods with higher sales of used goods.

Viewed by sales channel, EC sales rose 2.3% YoY and store sales climbed 16.5%. Weak EC sales reflected decline (YoY) in sales on EC mall branches during the transition from EC malls to the Company's own site and backlash from bolstering sales campaigns to increase revenue in the previous fiscal year. These results were in line with the Company's intentions and are not reason for concern.

Steep increase in operating income came from improvement in gross margin on used goods. In the previous fiscal year, the Company strengthened campaign sales in used goods for the purpose of countering weaker sales of new goods and also lifted buying prices in order to obtain sufficient volume. These moves pressures margin in sales and unit costs. In 1H FY3/20, however, the Company achieved healthy progress in buying and improved margin versus a year ago.

(2) Watches business

Watches business reported double-digit increases in sales and profits in 1H FY3/20 with sales at ¥5,537mn (+15.7% YoY) and operating income at ¥332mn (+32.8%). EC sales were upbeat, including support from last-minute demand in September. However, watches business has a higher ratio of store sales than cameras because many purchases are a single item and numerous customers focus heavily on the product condition. Store sales expanded at a rapid 18.3% YoY pace amid continued solid demand from domestic customers.

In profits, higher margin driven by increase in the used product ratio facilitated a steep profit gain. The Company is promoting two new initiatives in watches business – expansion of cross-border EC and launch of a ladies business in 2H FY3/20. We think investments related to these activities might be putting pressure on operating income to some extent and hence that actual profitability is even stronger.

(3) Stationery business

Stationery business reported ¥250mn in sales (+6.2% YoY) and ¥13mn in operating income (vs. a ¥1mn profit in the previous fiscal year) in 1H FY3/20. The Company implemented measures to improve efficiency in stationery business, including store renewal, in the previous fiscal year. It also started "receive-first, send-later service" in this business too with the aim bolstering used product procurement. Segment sales and profits increased in 1H FY3/20 on success with these measures.

(4) Bicycles business

Bicycles business booked sharply higher sales and achieved profitability in 1H FY3/20 with ¥288mn in net sales (+27.6% YoY) and ¥500mn in operating income (vs. a ¥500mn loss). The Company enhanced the smartphone app and information on road bikes and realized steady progress as a portal site for enjoyment by a wide range of customer segments from beginners to professional users. It also worked to boost customer appeal and awareness by implementing aggressive sales measures for popular goods and new goods on major EC malls. Success in these areas supported the results described above.

Accelerated monthly increase in Web members to the 4,000-member range
Moved to an all-time high active member rate on a quarterly basis

3. KPI trends

While the Company proposed a variety of new approaches for the purpose of expanding income since its founding, it has promoted one-to-one marketing in recent years. This involves "personalization" of marketing activities that are usually conducted uniformly for the general public by providing necessary information tailored to the needs of individuals and has the potential to realize robust sales efficiency if it functions well. However, it takes some time to cultivate frameworks and the Company spent two years to incrementally build a system. It completed the "personal recommendation" mechanism in FY3/18 and thereby finished the overall one-to-one marketing process (refer to our report issued on January 17, 2019 for details on the Company's sales expansion platform, including one-to-one marketing).

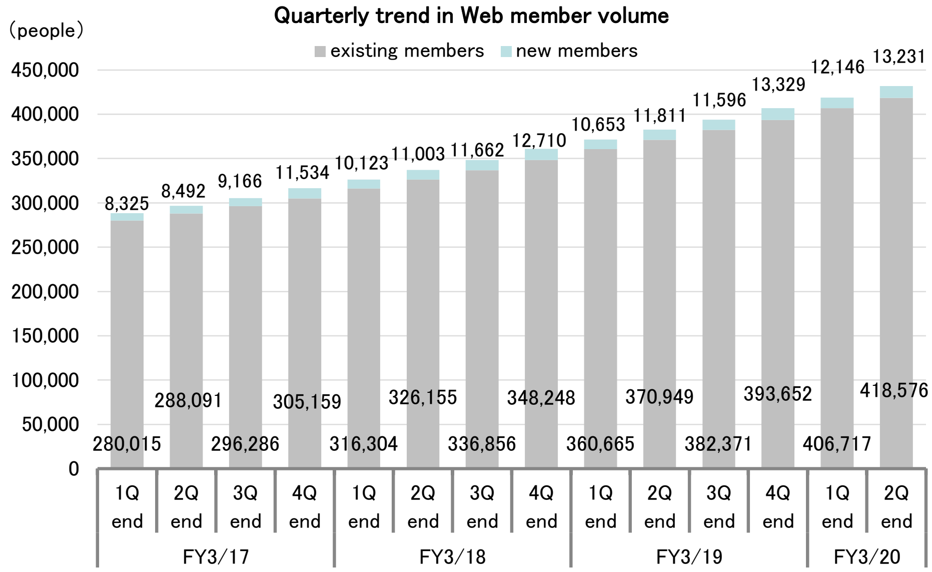
Key performance indicators (KPI) to monitor the Company's situation have gradually changed too. We previously focused on the used good ratio and sales channel EC or store) trends. With the more advanced income model and marketing measures, however, we think these values do not have any significance beyond being "results." We emphasize the following indicators as KPI for effective analysis of current conditions or a source of foresight.

In FY3/19, as the first year after completion of the one-to-one marketing process, the Company encountered shortfalls and points for improvement and reflection in actual operation. Management leveraged this experience in FY3/20 and substantially bolstered confidence in its ability to utilize one-to-one marketing tools.

(1) Web member volume

The Company manages customers who make transactions as "web members." We see two important points in the web member volume trend. The first is the trend in new members (in other words, new customer volume). We think this reflects results from sales efforts, such as sale events and other sales promotion measures and development of the EC system format. The other is total (cumulative) member volume. This constitutes an asset accumulated by the Company. Members are grouped into active members who continuously and repeatedly engage in transactions and inactive members who have not conducted a transaction for over a certain amount of time. Total member volume has considerable significance in determining the percentage of total members who are active as a theory.

The Company reported 431,807 web members at the end of 1H FY3/20, a gain of 24,826 members in a half year (vs. 406,981 members at end-FY3/19). This works out to 4,137 members per month, exceeding paces in FY3/19 (3,835 members per month) and FY3/18 (3,688 members). We attribute the faster pace to full use of one-to-one marketing tools and success in branding and awareness enhancement initiatives.

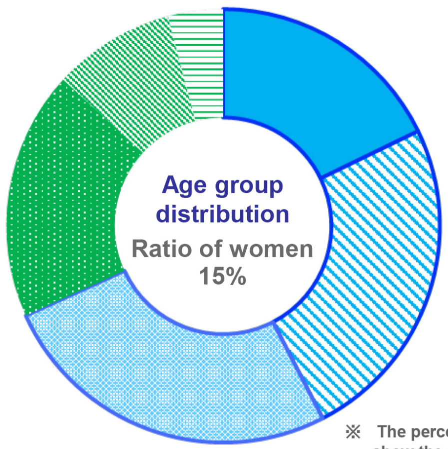


Source: Prepared by FISCO from the Company's results briefing materials

We expect the Company to sustain the recent pace of member additions mainly because of influx of younger members and increase in female members. From an age standpoint, the 50s and 60s segment with leeway to allocate funds to hobbies held a strong presence, but the 20s segment has risen in recent years and is close to 20%. Furthermore, women constitute 26.7% (one-quarter) of the 20s customer segment. The increased percentage of female customers in younger age groups deserves attention too. While it must be noted that these data cover all goods together, we think camera business customer ratios are high considering sales composition.

In the camera market, demand had previously shifted from digital cameras (fixed-lens models (compact cameras)) to smartphones. Camera features have steadily advanced in smartphones, giving this segment a larger share in the camera market. However, people are taking pictures more regularly with cameras and this activity raised awareness of cameras and photography too. These conditions have also boosted demand for photographs with better image quality. Demand is currently returning from smartphones to cameras (though as a shift to advanced cameras with interchangeable lenses) and thereby influencing the Company's membership age breakdown and volume of female customers. We expect such changes to continue for the time being because of the structural nature.

Member attributes in the Company's web membership



※ The percentages in brackets show the ratios of women

Under 20	17.8%	(26.7%)
30s	24.5%	(18.7%)
40s	25.7%	(12.5%)
50s	18.6%	(8.7%)
60s	9.2%	(5.1%)
Over 70	4.2%	(4.4%)

Source: The Company's results briefing materials

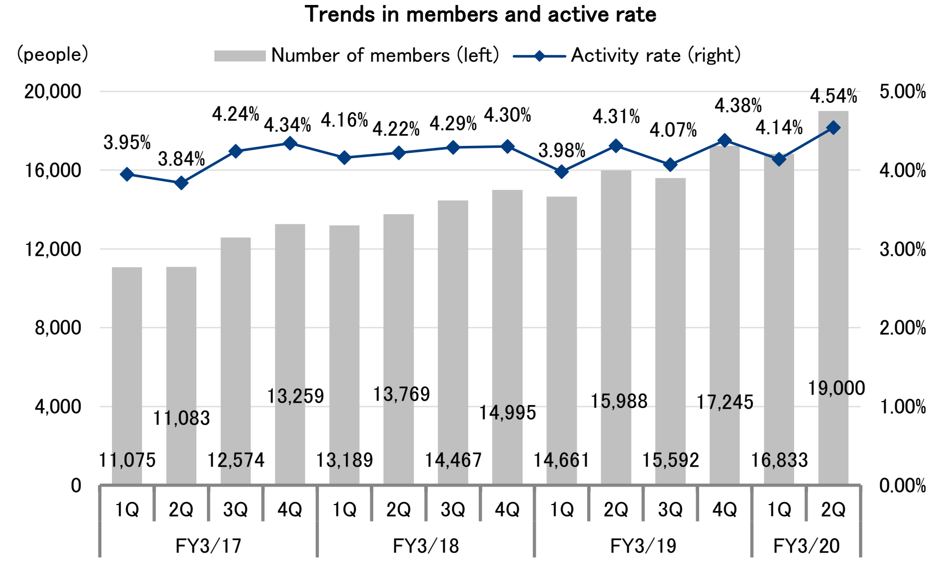
(2) Member numbers and activity rate

Purchase member volume is the number of members who make a purchase on the Company's sites per quarter excluding new members. In other words, this is the number of existing members who made a purchase. The active rate is the percentage of purchase member volume per quarter to member volume at the start of each quarter.

The Company has strong expectations for stimulation of existing members as total member volume expands. This is because of high efficiency. Even though new members are currently joining at a pace in the range of 4,000 people per month, the increase pace is about 10% a year with total member volume at over 400,000 people (the sales increase rate therefore is also about 10%). Meanwhile, if active members from the existing membership expand purchases by one time in a year, we estimate a sales boost of 30%. This is why it is meaningful to track purchase member volume and the active rate.

The activity rate reached an all-time high on a quarterly basis at 4.54% in 2Q FY3/20. This progress could be seen as the one-to-one marketing effect in light of steady increases in recommended list registrations and product arrival notification mail registrations. However, we think it is necessary to carefully monitor what happens to this value from 3Q because rush demand ahead of the consumption tax hike might have provided a lift too.

Results trends

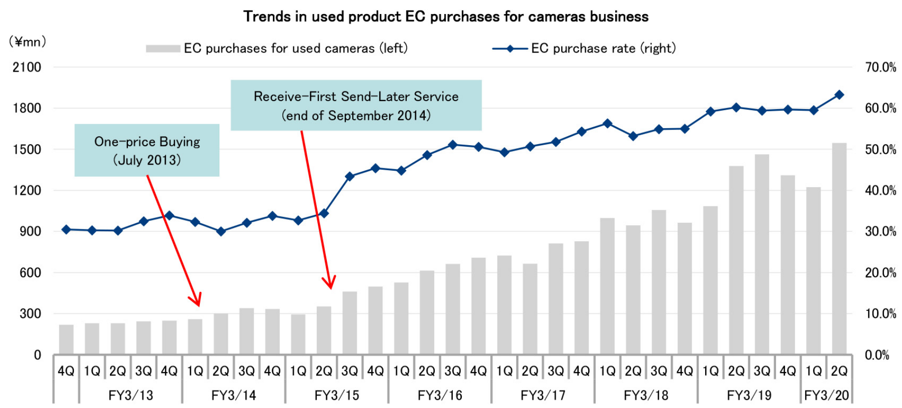


Source: Prepared by FISCO from the Company's results briefing materials

(3) Used camera purchases value

We believe used camera purchase value is extremely important in assessing trends in camera business, which is the Company's core business. A key point in the business model is the role of used goods as a catalyst for sales of new goods and expansion of new and used good sales. This pattern applies well to cameras as a pure industrial product.

Camera purchase value steadily expanded in 1H FY3/20 with increases of 12.7% YoY in 1Q (Apr-Jun) and 12.3% in 2Q (Jul-Sep). Procurement of used goods is very important to the Company's success, and various measures, such as one-price buying and receive-first, send-later service and trade-ins, have been supporting healthy purchases. The Company has been managing to procure goods at suitable prices, in contrast to the previous fiscal year, and thereby raised gross margin, as explained above.



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

Medium- to long-term strategy

Growth strategy focuses on building frameworks to expand income Moved substantially closer to completion of a sales expansion platform, the near-term goal

1. Overview of overall medium- to long-term strategies

We think the Company's medium- to long-term growth strategy should be assessed in the content of its business model characteristics and thus review key points and strengths of the business model below.

The Company is a retailer that specializes in e-commerce (EC) and only handles items that are valuable. It sells new and used goods for these categories.

Assessment of the Company is likely to differ depending on how treatment of used goods within the overall business is understood and positioned. While some observers focus on the used-good portion and see the Company as a reuse business, we believe this approach runs the risk of misunderstanding its strength and value. We view the used good business as a catalyst to accelerate sales of new goods because of the lack of constraints on new good sales (in contrast to used goods that are typically a single item).

The Company, meanwhile, positions used good business as an important income source and growth engine, similar to new good business. Used goods surpass new goods in profitability (gross margin). They also play a valuable role in realizing stable growth by filling lulls in the model cycle of new goods. Used good business goes beyond just being a catalyst and has the potential to function as an income pillar alongside new goods. The Company is actually accomplishing this.

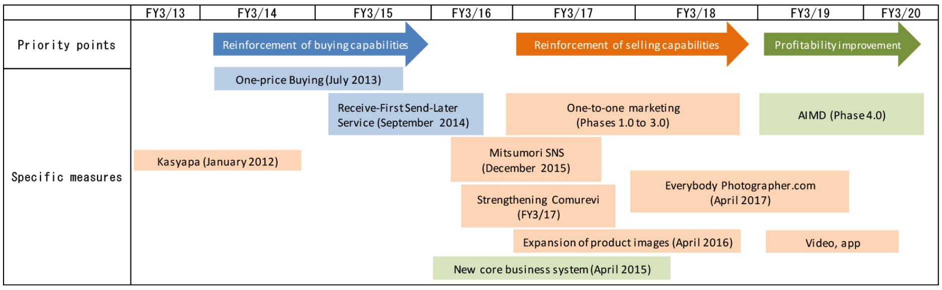
Characteristics and income models differ in new product and used product businesses. We think the Company's business model is innovative and robust in its organic linkage of two businesses with totally different profiles (this refers to the catalyst relationship described above) and pursuit of overall maximization of income growth.

While it might seem that other companies could readily copy the model when it is explained in this way, this is not the case. The Company itself has built today's business by implementing a variety of measures since it was founded. "Measures" in this context are not campaigns and other temporary sales promotion actions and instead refer to building frameworks for income growth. As explained above, the Company has designed measures to expand income in an intertwined manner with close reactions between "valuable" new and used goods in an EC business model. This is the essence of its medium- to long-term growth strategy.

The Company aims to complete the "platform to expand sales" as the near-term goal of its current medium- to long-term growth strategy. "Platform" refers to a framework for increasing sales and generally covers formats used to attract and retain customers. Specific initiatives are one-to-one marketing and CGM marketing.

For one-to-one marketing, the Company has put worked to build this process as a key initiative to strengthen sales capabilities over the past few years. It finalized the "personal recommendations" format, which corresponded to phase 3.0, by FY3/18 and thereby largely completed the framework. Since FY3/19, it has been ramping up utilization of one-to-one marketing and pursued application of AIMD as a new project. While the goal in these efforts is improving profitability, measures to bolster used product purchases contribute directly to higher sales and hence could be viewed as top-line growth initiatives too.

Trends in initiatives for growth at the Company



Source: Prepared by FISCO

The Company promotes CGM marketing for cameras, the main product category. Images, comments, and other contents from consumers are steadily growing in volume and becoming more robust. A specific example of advancement in this type of activity is the increase in submissions to EVERYBODY×PHOTOGRAPHER.com, a fun venue after buying camera equipment, from 35,953 photos a year ago to 64,875 photos at end-September 2019. However, the Company is not at all satisfied with this pace and hopes to accelerate submissions to the site and expand total photo volume by holding periodic photo contests and other events. Enhancement of images and comments from consumers should help in building the "cycle" targeted by management and thereby contribute to a faster income expansion pace.

AIMD in the final stage of development, operation likely to begin in 4Q FY3/20

2. AIMD rollout and progress

AIMD is an automated assistance system for decisions on used camera procurement and selling prices that utilizes AI. The Company currently determines procurement and selling prices manually. While it handles roughly 20,000 items, it is only possible to make timely price decisions in a few cases (estimated at about 400-500 items) and this results in many lost opportunities. AIMD assists the manual process, increasing items that receive suitable and timely price decisions and reducing opportunity losses.

We see multiple benefits. One is having fewer mispricing (pricing failure) cases that improves overall average gross margin in used product transactions. Another is securing sales and lifting top-line growth by appealing to customers with transactions at reasonable pricing and selecting the best-suited items for sale campaigns and promotions. The third is improved inventory management through selection of priority sales inventory. We think these effects should grow as accumulated AIMD knowhow and data raise system accuracy.

The AIMD rollout is likely to occur in 4Q (Jan-Mar 2020). Software development was at the final stage as of November 2019. We expect full-fledged usage in FY3/21 due to the prospect of test operation for the time being after deployment.

The Company does not intend to move decisions on purchase and sale prices for used cameras entirely to AIMD even after it starting full-fledged usage. AIMD is an automated assistance system with a supplementary role, and buyers remain in charge of decisions just as now. The Company wants to gradually raise the percentage of automated assistance utilization as accuracy improves. We think this operational approach is very effective in lowering business risk.

Looking at specific values, we anticipate an increase in timely price decisions to about 2,000 items after the AIMD rollout. While this is about one-tenth of total items (roughly 20,000), it constitutes a five-fold increase from the current level. In terms of actual transactions (the top 10% items account for substantial portions of volume and value), we expect significant decline in opportunity losses and a hefty boost in overall average gross margin on transactions for used goods.

Pursuing broader scope in watches business with ladies business and overseas business

3. Growth strategy in watches business and progress

Watches business is the Company's second largest business after cameras business. As explained above, the Company is nearly finished in building a platform to expand sales with one-to-one marketing, launch of a project to strengthen CGM marketing, and AIMD slated for operation relatively soon. We think whether or not this framework for cameras business can be applied to watches business and other businesses has emerged as a key point in assessing the Company's medium- to long-term growth potential.

The Company has clearly stated that it believes it is possible to build a framework similar to what it has done for cameras with watches and expand income scale. However, it also acknowledges the need to develop a framework tailored to differences in product features for cameras and watches. Cameras are industrial products with value determined by the number of pixels, consecutive shooting speed, and other performance indicators. While watches are also industrial products, output volume is relatively low and craftsmanship becomes more important for higher-end models and value assessment depends more on rarity and model story than time precision and functionality. Watches are closer to jewelry and sell at much higher prices than cameras.

In light of these product characteristics, the Company's efforts to expand scale in watches business focus on ramp-up of ladies business and overseas business. Management is putting emphasis on corporate branding too as a shared aspect that supports these areas.

(1) Overview of the ladies business and progress

The Company intends to begin a full-fledged ladies business that mainly handles watches for women as a spinout of watches business. It decided to promote this business independent of the GMT brand used by watches business and with a separate name, BRILLER, in light of expansion in both female customer volume and female staff.

While the business mainly handles watches, the Company also plans to broaden coverage to jewelry and precious stones in the ladies business because of the role of luxury watches for women as jewelry too.

The Company started this business in 2H FY3/20 with a launch in December timed to the year-end and New Year sales season. In the income plan, it does not give a specific goal for FY3/20, the initial fiscal year, but has disclosed roughly ¥2bn as the second-year FY3/21 target (refer to the section on the medium-term management plan for details).

We think the Company's entry into the ladies business offers significant potential. Japan has a massive watches market that is worth an estimated ¥820bn. While it consists of a wide range of segments, including men and women, drive method types, and price ranges, the Company's business focused on luxury mechanical watches for men up to now. The GMT name and site design and arrangement in this business targeted male customers. Even this GMT site managed to sell a certain amount of ladies watches, and ladies watches provided about 6% of segment sales in FY3/19 (¥0.6bn (ladies' watches) out of ¥9.8bn in segment sales).

Ladies business obviously offers very large growth room considering the population make-up. We think this is the biggest reason for the decision to pursue ladies watches. Rollout of a brand and site dedicated to ladies watches is an important point in entering this business. Ladies watches are even closer to jewelry, and price assessment standards differ substantially from men's products. Popular and top-selling brands differ greatly with the men's business too. Handling these businesses on the same site hence would be cumbersome. Since branding is a top priority, we think an independent site is clearly more effective. Given these aspects, the Company formed a team that mainly consists of women, including vendors, to implement tasks for the ladies business project. We are highly confident in the Company's success potential given this logical mindset and well-managed implementation.

(2) Overseas business

The Company's overseas business refers to cross-border EC business activity. Positioning of overseas business emphasizes overall branding (brand establishment and increased awareness), rather than income growth. Cross-border EC started with cameras in August 2017. The Company opened a shop on eBay, a major North American EC mall and initially targeted four countries. This business steadily expanded and currently sells to 20 countries. It booked about ¥480mn in FY3/19 sales.

In watches business, meanwhile, the Company launched cross-border EC activity in May 2019 on Chrono24, one of the world's largest marketplaces for luxury watches. Chrono24 lists over 400,000 watches and has 7mn users in 110 countries.

The Company started in the US and Hong Kong and has been gradually broadening scope. It currently sells products in the UK, Austria, Thailand, Malaysia, and the UAE too.

We think overseas business mainly targets branding at this point, similar to cameras, though expect a growing presence as an income-earning business in light of healthy sales conditions. Since a market for luxury watches handled by GMT exists globally, we anticipate rapid gains once the GMT brand makes inroads. We also think having an overseas market provides an advantage in price strategy in the domestic market and should help increase profitability in watches business too.

The Company aims to reach ¥47,542mn in net sales, ¥2,322mn in operating profit in FY3/22

4. Medium-term results targets

While the Company does not prepare fixed-style three-year business plans, it annually discloses medium-term targets for the next three years. The plan presented in May 2019 sets goals of ¥47,542mn in net sales, ¥2,322mn in operating income, and ¥2,312mn in ordinary income in FY3/22, the final year.

Medium-term results targets covering FY3/20-22

(¥mn)

	FY3/19 Results	2019 rolling medium-term plan (FY3/20-22)						
		FY3/20		FY3/21		FY3/22		CAGR*
		Plan	YoY	Plan	YoY	Plan	YoY	
Net sales	34,608	37,673	8.9%	42,359	12.4%	47,542	12.2%	11.2%
Camera business	23,776	25,391	6.8%	28,382	11.7%	32,067	12.9%	10.5%
Watches business	9,860	11,206	13.7%	12,808	14.2%	14,159	10.5%	12.8%
Stationery business	491	530	7.8%	575	8.5%	645	12.2%	9.5%
Bicycles business	480	545	13.3%	594	9.0%	671	13.0%	11.8%
Gross profit	5,612	6,170	9.9%	7,022	13.8%	8,095	15.3%	13.0%
Gross margin	16.2%	16.4%	-	16.6%	-	17.0%	-	-
SG&A expenses	4,168	4,596	10.2%	5,162	12.3%	5,774	11.9%	11.5%
SG&A ratio	12.0%	12.2%	-	12.2%	-	12.1%	-	-
Operating income	1,444	1,574	9.0%	1,860	18.2%	2,322	24.8%	17.2%
Operating margin	4.2%	4.2%	-	4.4%	-	4.9%	-	-
Ordinary income	1,433	1,564	9.2%	1,851	18.3%	2,312	24.9%	17.3%
Net income	982	1,023	4.1%	1,211	18.3%	1,512	24.9%	15.5%
Global strategy division	-	601	-	780	29.7%	1,014	30.0%	-
Ladies business	-	-	-	1,953	-	2,343	20.0%	-

*Note: Average annual growth rate shows the average growth rates for the three years through FY3/22 with the starting point in FY3/19
Source: Prepared by FISCO form the Company's materials

Following 1H FY3/20, management did not make significant revisions to medium-term results targets and segment focus points. All segments performed well and earnings surpassed 70% of full-year targets in 1H FY3/20, as explained earlier. If management revises FY3/20 guidance upward in light of this progress, it might broadly adjust medium-term targets at the announcement in May 2020.

In camera business, the Company targets 10.5% sales CAGR over the three years through FY3/22 with FY3/19 as the standard level. Its cautious view of FY3/20 as a transition phase to full-size mirrorless cameras at the two major firms curtails three-year CAGR. It should be noted that the Company factors in robust sales growth of nearly 30% a year in overseas cross-border EC business.

In watch business, it forecast 12.8% sales CAGR, but this seems conservative in light of the recent growth rate. Planned rapid growth in ladies business in FY3/21. We expect slightly higher overall growth in combined men's and ladies business because of upbeat growth in watches business over the past few years and the start of overseas initiatives.

In stationery and bicycle businesses, it forecasts sales CAGRs of 9.5% and 11.8% respectively with new customer acquisitions and revitalization of existing customer business. We think this plan is attainable because of steady improvements in recognition and awareness.

Outlook

We see a good chance of revisions to the full-year outlook if the Company had upbeat activity in the year-end sales season

For FY3/20, the Company forecasts an increase in both sales and profits, with net sales at ¥37,672mn (+8.9% YoY), operating income at ¥1,574mn (+9.0%), ordinary income at ¥1,564mn (+9.2%), and net income at ¥1,023mn (+4.1%). The Company has not changed these values from initial forecasts.

Outlook for FY3/20

(¥mn)

	FY3/19			FY3/20				
	1H result	2H result	Full-year result	1H result	2H forecast	YoY	Full-year forecast	YoY
Net sales	16,362	18,246	34,608	17,852	19,819	8.6%	37,672	8.9%
Operating income	682	761	1,444	1,124	449	-41.0%	1,574	9.0%
Operating margin	4.2%	4.2%	4.2%	6.3%	2.3%	-	4.2%	-
Ordinary income	679	754	1,433	1,118	445	-40.9%	1,564	9.2%
Net income	462	520	982	758	264	-49.2%	1,023	4.1%

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

The Company reported healthy results in 1H FY3/20 with earnings progress (percentage of 1H results to initial full-year forecasts) at over 70%. Since it maintained existing guidance despite this outcome, operating income required in 2H to meet the target was down sharply to just ¥449mn (-41.0% YoY).

The Company attributed its decision to maintain the FY3/20 outlook to uncertainty about the year-end sales season, the largest demand period, because of concern that backlash from rush demand prior to the consumption tax hike in October 2019 might adversely affect business in that key timeframe.

We think the Company's cautious stance should be accepted frankly and backlash from rush demand cannot be taken lightly given past experience. We expect clarification of how business fared in the year-end sales season by the announcement of 3Q FY3/20 results slated in February 2020, and it should not be too late to wait for this confirmation. The Company might revise FY3/20 targets if it advanced smoothly through the year-end season.

The following two points also deserve attention in 2H besides results values.

The first is operation of the new merchandising system (AIMD) that utilizes AI. Development work on the vendor side (outsourcing partner in charge of software development) was nearly done in November 2019, and we expect the Company to begin operation of the system in 4Q. We expect test operation initially and full-fledged use from FY3/21.

The second is the launch of the ladies' watches business. The Company opened a dedicated site in December in time for the year-end sales season in 2019. While actual contributions to results are likely to surface in FY3/21 and beyond, we think opening the site in December was very significant in raising awareness and name recognition.

Income statements

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	1H FY3/20	FY3/20 E
Net sales	22,705	24,996	30,921	34,608	17,852	37,672
YoY	18.5%	10.1%	23.7%	11.9%	9.1%	8.9%
Cameras business	16,572	18,131	21,937	23,776	11,776	25,391
Watches business	5,301	6,013	7,974	9,860	5,537	11,206
Stationery business	470	511	573	491	250	530
Bicycles business	360	339	436	480	288	545
Gross profit	3,729	4,202	5,105	5,612	3,176	6,170
Gross margin	16.4%	16.8%	16.5%	16.2%	17.8%	16.4%
SG&A expenses	2,897	3,105	3,568	4,168	2,051	4,596
SG&A ratio	12.8%	12.4%	11.5%	12.0%	11.5%	12.2%
Operating income	832	1,096	1,536	1,444	1,124	1,574
YoY	-6.1%	31.8%	40.1%	-6.0%	64.9%	9.0%
Operating margin	3.7%	4.4%	5.0%	4.2%	6.3%	4.2%
Ordinary income	821	1,078	1,521	1,433	1,118	1,564
YoY	-5.6%	31.3%	41.1%	-5.8%	64.7%	9.2%
Net income	560	741	1,077	982	758	1,023
YoY	-0.6%	32.3%	45.4%	-8.8%	64.0%	4.1%
After adjustment						
EPS (¥)	23.41	30.96	45	41.11	32.12	43.34
DPS (¥)	4.00	6.00	10.00	14.00	0.00	14.00
BPS (¥)	114.74	141.69	180.68	206.90	-	-

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

Balance sheets

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	1H FY3/20
Current assets	4,905	5,727	7,692	8,656	8,790
Cash and deposits	506	644	1,268	1,403	1,257
Accounts receivable - trade	1,327	1,612	1,851	1,916	2,170
Merchandise	2,757	3,209	4,194	4,781	5,066
Non-current assets	1,001	949	1,088	1,214	1,119
Property, plant and equipment	137	123	136	156	145
Intangible assets	530	468	443	377	316
Investments and other assets	333	356	508	680	657
Total assets	5,907	6,676	8,780	9,871	9,909
Current liabilities	2,585	2,954	3,353	3,943	3,457
Accounts payable - trade	940	823	1,045	1,206	1,081
Short-term loans payable, etc.	1,215	1,428	1,474	1,831	1,493
Non-current liabilities	568	322	1,095	1,018	1,183
Long-term loans payable	568	322	1,095	1,018	1,183
Shareholders' equity	2,746	3,392	4,325	4,903	5,263
Capital stock	508	508	508	513	518
Capital surplus	408	408	408	413	418
Retained earnings	1,829	2,474	3,408	4,151	4,578
Treasury shares	-	-	-0	-175	-252
Subscription rights to shares	6	6	5	5	5
Total net assets	2,753	3,399	4,331	4,909	5,268
Total liabilities and net assets	5,907	6,676	8,780	9,871	9,909

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

Cash flow statements

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	1H FY3/20
Cash flows from operating activities	90	388	134	689	477
Cash flows from investing activities	-333	-122	-184	-419	-42
Cash flows from financing activities	257	-128	675	-135	-581
Change to cash and deposits	14	137	624	134	-145
Balance of cash and deposits at start of period	492	506	644	1,268	1,403
Balance of cash and deposits at end of period	506	644	1,268	1,403	1,257

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

Shareholder returns

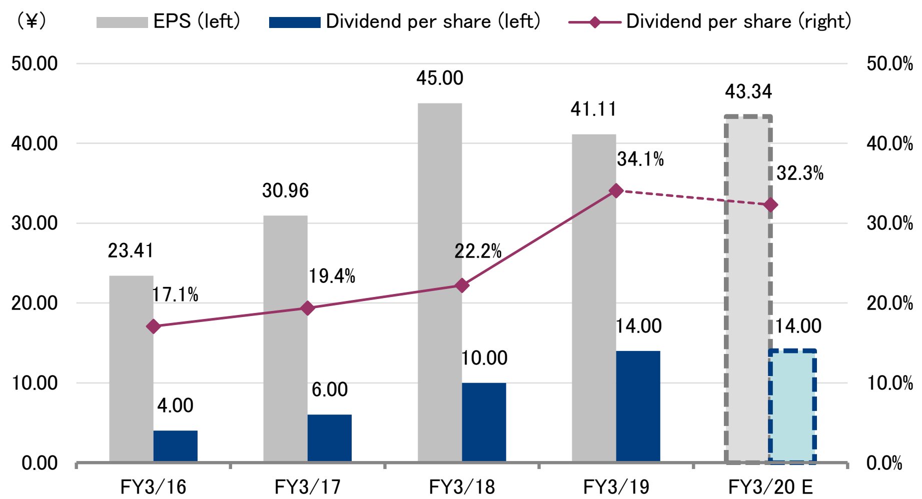
The Company announced a dividend forecast of ¥14 for FY3/20 on par with the previous fiscal year

The Company sees shareholder return as an important management issue and has a basic policy of return with dividends. It previously adhered to a stable and continuous dividend policy, but switched to setting a dividend payout target and paying a dividend in line with the target from FY3/17. It currently targets "25-35% dividend payout."

The Company disclosed a ¥14 dividend target (year-end dividend only) for FY3/20, a flat level YoY, at period-start timing and retained this target after 1H results. It works out to 32.3% dividend payout based on the ¥43.34 FY3/20 EPS target.

As explained above, the Company might raise FY3/20 guidance depending on recent progress and this could alter anticipated dividend payout. Considering the Company's broad target range for dividend payout, however, we think it is safest to use the current dividend target as the basic scenario.

Trends in EPS, the dividend, and the dividend payout ratio



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

Disclaimer

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