

Daikoku Denki Co., Ltd.

6430

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<http://www.fisco.co.jp>

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Summary

Earnings trending weak as industry approaches major turning point, but good prospects for growth over medium to long term

Daikoku Denki Co., Ltd. <6430> (hereafter, “the Company”) has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese slot machines) parlors and halls, and the other that develops, produces and sells display and control units for pachinko and pachislot machines. The Company holds the leading market share, approximately 35%, of the Japanese market for hall computers reflecting an information management method that is the de facto standard for the industry. Furthermore, the industry’s leading membership-based information provision service Daikoku Denki Strategic Information System (DK-SIS) to support the operations of pachinko hall associations forms a network of approximately 3,700 pachinko and pachislot halls. The Company has also made full-fledged entry into development, manufacture and sales of in-house developed pachislot machines.

Japan’s pachinko market has been shrinking for several years. In response, the Company seeks to reform its businesses over the medium to long term. Reforms include developing a next-generation hall computer, shifting to a business model more reliant on services that provide recurring revenue and developing and commercializing in-house developed pachislot machines. In particular, the next-generation hall computer (including peripheral equipment), in which the Company has invested aggressively, will operate on a cloud server and be capable of advanced analysis of large quantities of data. It will be far superior to any competing computer and should allow the Company to increase its market share of the Japanese market for these machines. Recently, however, with revisions to regulations (including controlled ball payouts and measures against gambling addiction) having brought the industry to a major turning point, uncertainty about the future promises to keep sales and earnings under pressure in the near term.

In 1H FY3/18, the Company posted lower sales and earnings, with net sales falling 10.9% YoY to ¥17,996mn and operating income down 38.1% to ¥375mn. Net sales were below the Company’s initial forecast but earnings finished well above. The operating environment remained difficult, leading to lower sales in both the Information System Segment and the Control System Segment. In the Information System Segment, a decline in new pachinko hall openings and lack of enthusiasm for new investments among existing hall operators left sales well short of the Company’s initial forecast. In the Control System Segment, delays in bringing a new model display unit to market led to a decline in overall unit sales volume. On the earnings front, the drop in sales combined with a rise in the production cost ratio left earnings well below levels seen a year ago, though still higher than the Company had initially forecast thanks to declines in R&D expenses, sales commissions and advertising expenses, as well as from reversal of allowance for doubtful accounts.

Summary

The Company has maintained its initial forecast for FY3/18, projecting lower sales but higher earnings, with sales projected to fall 4.2% YoY to ¥39,000mn while operating income rises 24.0% to ¥1,300mn. The Company expects higher sales from the Information System Segment upon the introduction of new models, but still expects lower net sales overall as a result of the sharp decline in sales from the Control System Segment. In contrast, on the earnings front, the Company expects to secure higher operating income from reductions in R&D expenses and improved profits in the Control System Segment. At FISCO, we are skeptical as to the Company's ability to meet its sales target for the full year, especially given the likely impact of the revised regulations* and the ongoing uncertainty about the industry's future. The Company's earnings target is another story though, as progress reported for 1H and reasonable assumptions made for 2H suggest that its full-year earnings target is achievable. Still, with the earnings forecast weighted so heavily towards 2H, there is a risk that lower-than-expected sales in 2H will leave full-year earnings below plan as well.

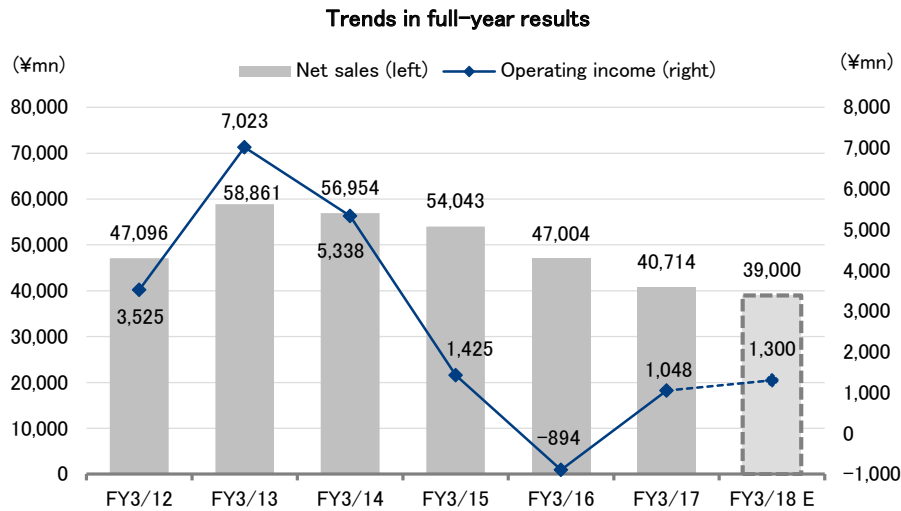
* Regulations on the Partial Revision of Regulations Regarding the Enforcement of the Act on Control and Improvement of Amusement Business, etc. and Regulations Regarding the Certification of Game Machines and Examination of Model officially promulgated on September 4, 2017 with an enforcement date set for February 1, 2018.

The Company is currently promoting the Next 50 Chapter One medium-term management plan that lasts through FY3/20. In FY3/18, the second year of the plan, the organization was altered, including replacement of the president and a new management team, to help address sharp changes in the business environment and to strengthen its income structure. Nevertheless, the Company did not change its overall direction. It intends to enhance growth potential and profitability through expansion of market share with next-generation products and new value creation by leveraging data analysis and planning and development capabilities. We expect the Company to gauge the timing of the rollout of the next-generation hall computer in consideration of measures against gambling addiction, a new issue in the industry, and market environment trends. Peripheral equipment, which should be steadily released ahead of the rollout, is likely to fuel income during this period by tapping into replacement demand at existing customers while flexibly responding to market changes. We hence think the Company deserves attention for transitioning to an income structure that is unaffected by the market environment, including expansion of management support services that have become a stable income source. With the industry undergoing a major transition, there is a good chance Daikoku Denki will find opportunities to expand business. While uncertainty should continue in the near term, we see opportunities for growth in the Company's business over the longer term by leveraging its dominant position and we will also be focusing on the Company's initiatives to stimulate the overall industry.

Key Points

- Posted lower sales and income in 1H FY3/18 reflecting the impact of the external operating environment
- With the industry facing a major turning point, uncertainty about the future will keep its performance under pressure in the near term
- Despite the industry undergoing a major transition, there is a good chance Daikoku Denki will find opportunities to expand business
- Focusing on Daikoku Denki's growth in market share through introduction of next-generation products as well as its management support services and value creation utilizing advanced data analysis capabilities

Summary



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

Description of businesses

Holds the No. 1 market share in hall computers and peripheral equipment for the pachinko industry with support from provision of the industry's main information control method

While emphasizing development, production and sales of computer systems for pachinko halls, the Company also manufactures and sells display and control units for pachinko machines and develops, manufactures and sells in-house developed pachislot machines.

As a pioneer in the development of hall computers, which assist in the management of pachinko halls, and holder of the top market share* in the Japanese market, the Company won hall's trust and satisfied pachinko players by proposing a management method which puts emphasis on data management, introducing innovative peripheral equipment for its hall computers and providing the industry's leading membership-based information provision service.

* The Company holds an approximately 35% share of the Japanese market for hall computers.

The Company's two main businesses are the Information System Segment and the Control System Segment, but the Information System Segment provided approximately 67.0% of its total sales in FY3/17 and was the main source of stable profit.

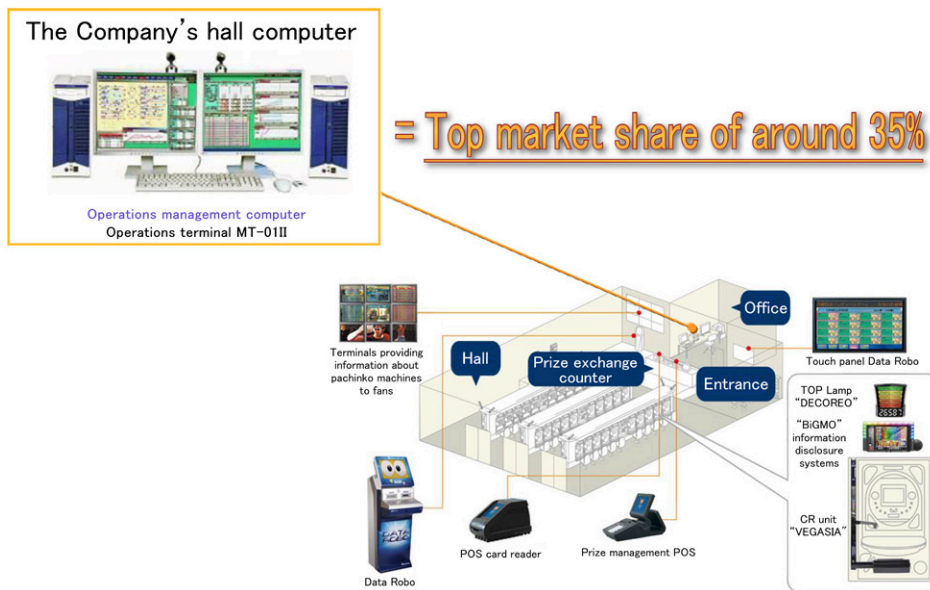
Description of businesses

1. Information System Segment

The Information System Segment offers a complete line of information equipment and services to support sales and operational management at pachinko halls. Hall computers are the core of the system used at pachinko halls, and these computers are supported by peripheral equipment, such as prize management systems and information display systems. The segment also offers various services such as hall management support services through information equipment and the membership-based information provision service DK-SIS, which is the leading service in Japan that provides strategic information about associated halls.

Hall computers are the core systems for supporting pachinko hall operations. These computers display the operating conditions and sales of each machine in a hall. As mentioned above, these computers are supported by peripheral equipment, such as prize management and information display systems. They also serve as the foundation of the membership-based information provision service. Peripheral equipment and support services are often sold with hall computers as a package deal. The Company has been aiming to transition to a recurring revenue business model and strengthen its aftersales commission fee-based services such as management support services and the membership-based information provision service.

Hall computers and main peripheral equipment



Source: The Company's results briefing materials

Description of businesses

2. Control System Segment

The Control System Segment produces and sells displays and control units, as well as sells components used for pachinko and pachislot machines. Applying the knowledge obtained from analyzing data from pachinko machines as a hall computer manufacturer of many years, the segment functions beyond the scope of a machine manufacturer and proposes specs based on the trends of popular models and acquires copyrights for popular characters.

Since FY3/14, the Company's consolidated subsidiary Daxel Co., Ltd. has been producing and selling pachislot machines developed by Daikoku Denki under the Daxel brand name. The first model released under the Daxel brand name, Magical Sweet Prism Nana Ace, created value by offering a unique gaming experience for pachislot players. As these models quickly became some of the most-played pachislot machines, Daxel has established a high-quality brand image with its focus on tie-ups with many animations. In FY3/18, Daxel has released two more models, Sora-no-Otoshimono Forte and Yuki Yuna is a Hero.

New products

	<p>The number of issues of original comics exceeded four million, KADOKAWA's major hit anime with two seasons of TV anime aired and two films were released.</p> <p>The biggest feature is a premium freeze called "Miracle of 1/8192," and specializes in premium freeze.</p> <p>It is an easy to visually understand game, even for those who are usually not good at sharpshooting at the pattern on the reel, as a character reel is used as the main spindle.</p>		<p>Work being much talked about now, and whose second-season TV anime will be aired in October 2017.</p> <p>ART, which adds the difference between the number of loaded tokens and the number of put-out tokens, is adopted for the first time in an anime-collaborated pachislot machine series. While the ART "Hero RUSH" is on, an additional specialized zone becomes "fully bloomed" and gains put-out balls.</p> <p>When "Hero RUSH" ends, a continuation lottery through a scenario is offered, and/or stocked freezes are discharged, etc. The feeling of expectation can be exciting until the end.</p> <p>A large-volume 124 Gbit ROM is mounted, and the images are also more powerful.</p>
© 2014 KADOKAWA / © 2014 KADOKAWA / © 2014 KADOKAWA	© AXEL / © 2014 PROJECT 2M	© AXEL / © 2014 PROJECT 2M	© AXEL / © 2014 PROJECT 2M

Source: The Company's results briefing materials

Company strengths

Track record of creating new opportunities for the industry and provides added value for hall management in various aspects

1. Growth model based on market expansion through innovation

Since its establishment, the Company has consistently planned and developed new categories of goods and services, thereby developing the pachinko market and achieving growth. It has not just developed machines with superior functions but emphasized the importance of data management and the need for information disclosure. Thus, it has been able to present ideas with added value to the various aspects of management of pachinko halls.

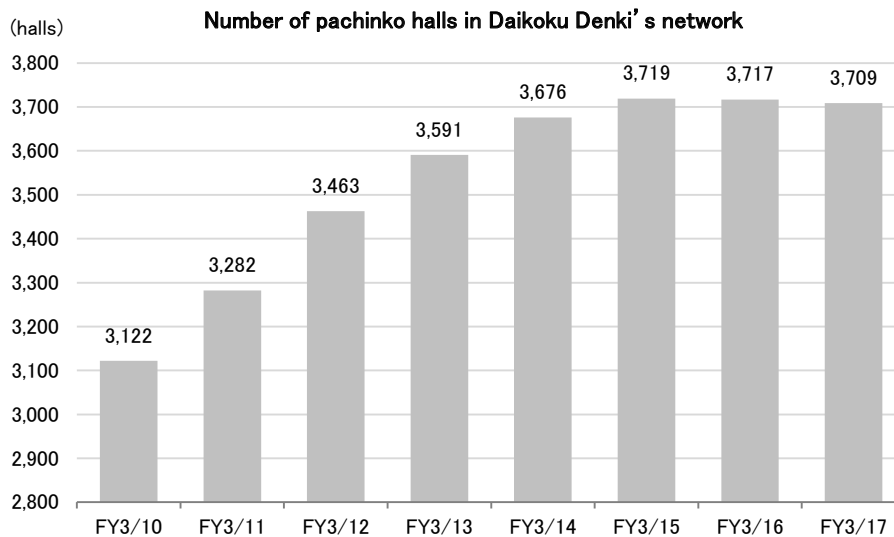
Company strengths

Launched in 1974, the Company’s first hall computer enabled the managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic information, but with the introduction of hall computers, data-based hall management became the de facto standard. In subsequent years, the Company developed other kinds of information equipment with revolutionary functions. One such piece of equipment was the Data Robo terminal, which provides information about different models of pachinko and pachislot machines to the players of these machines. This equipment has increased the satisfaction of pachinko players and the efficiency of pachinko hall management, as well as the profitability of pachinko halls.

A newer business being pursued by the Company is development, production, and sales of in-house developed pachislot machines that differ from previous pachinko and pachislot machines, which tended to be chosen based on their gambling appeal. The Company is committed to creating machines with thorough quality by adopting original characters produced by popular illustrators and focusing on character animation and voices. This has won accolades from fans of anime, and the Company has again established a new market for amusement equipment.

2. Strong network of pachinko halls

Another advantage the Company has is its membership-based information provision service, DK-SIS. This service creates a network connecting the Company and member pachinko halls, and gathers, processes and analyzes the daily operational information of pachinko halls recorded by hall computers and gives feedback to hall managers to improve their operations. It enables the managers to conduct effective hall operation based on nationwide pachinko machine information, operational data broken down by machine model and other valuable external information. At the same time, this strong network made up of members also supports the Company’s business foundation. The Company’s DK-SIS allows it to serve as a think tank in the pachinko industry and elevates its brand name. At the end of March 2017, the number of pachinko and pachislot halls in the Company’s network was 3,709, operating approximately 1.45mn machines, or 32.0% of all the machines installed in Japan, and gathering data on ¥9.5tn worth of annual sales.

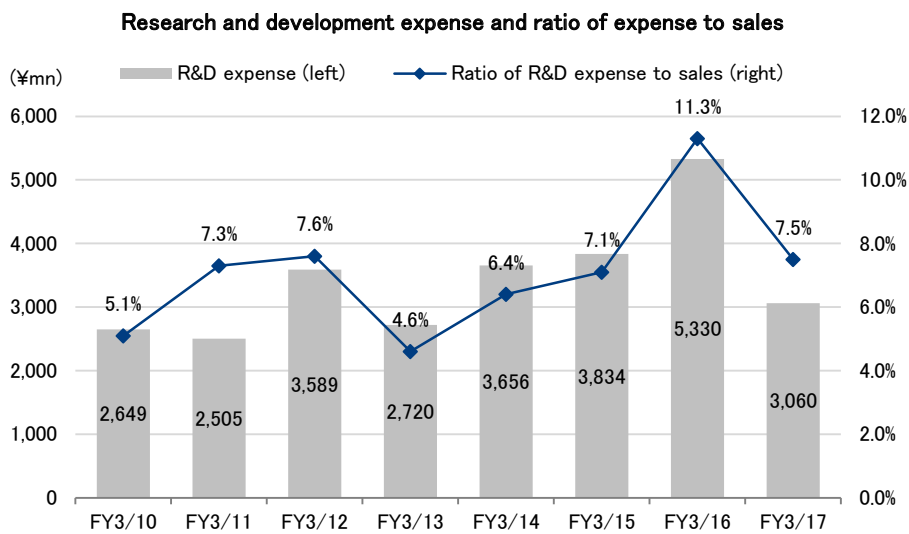


Source: Prepared by FISCO from the Company's results briefing materials

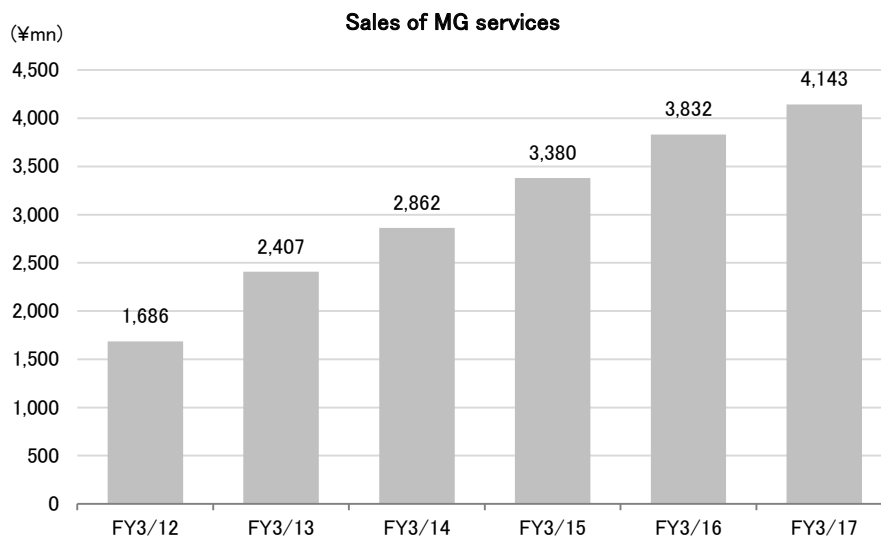
Company strengths

3. Stable profit base that supports investment for the future

The Company’s main source of competitiveness is its proactive upfront investment eyeing future growth, including its R&D expenditure. Over the past few years, the Company has developed unique pachislot machines, a next-generation hall computer (including peripheral equipment), and other products to drive its sales and profit growth hereafter. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, the management support services which have been nurtured by the Company to promote a recurring revenue business model have grown to provide enough profit to maintain funding investment in R&D at a high level, limiting investment risk. The Company’s ability to balance large profits from its existing businesses with heavy investment in businesses of the future allows it to produce value on a continuing basis.



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



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

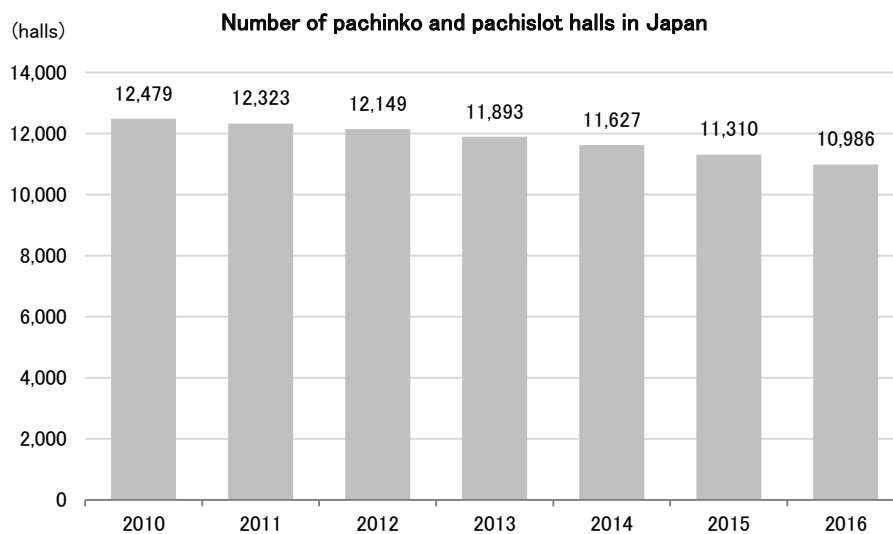
Industry environment

The industry is approaching a major turning point with revisions to regulations and other factors. While the outlook remains uncertain in the near term, we see opportunities for growth over the medium term

Japan's pachinko industry has been shrinking for years, reflecting a decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The self-regulatory action taken by the industry in 2015 (tightening restrictions on both pachinko and pachislot machines with strong gambling elements) left the whole industry in a slump in 2016 as it started to grapple with the problem of collecting and removing all pachinko machines that may perform differently from certified standards. In 2017, the industry was hit yet again, this time by the revised regulations*. With the pessimistic view towards the industry and uncertainty about the future, the industry remains in a state of flux.

* Among the latest revisions are restrictions on the maximum number of balls that can be paid out and clearly defined standards for "controlled machines." And while older models that do not meet the new standards will remain in pachinko halls alongside new models for at least a while longer, transitional measures are but one of many issues that the regulatory authorities have yet to address. Pachinko hall operators are worried that their earnings will continue to decline and they will be faced with difficult decisions about the timing of equipment replacement and other matters. It can be said that these lingering uncertainties have diminished their investment appetite.

According to surveys by the National Police Agency, the number of pachinko and pachislot halls in Japan declined at an average annual rate of 2.3% from 2011 to 2016. In 2016, the number of halls was 10,986 (down 324 YoY). It is estimated that the Company served about 3,900 of these halls based on the fact that it held approximately 35% of the Japanese market for hall computers in FY3/17 according to Company estimates. Most of the Company's customers are large high-end pachinko halls that are the top performers in their respective local markets, averaging 519.1 machines per hall, or about 30% more than the average number of machines per hall. Therefore, the business of these halls is relatively insensitive to economic cycles, and the halls can invest in new businesses.

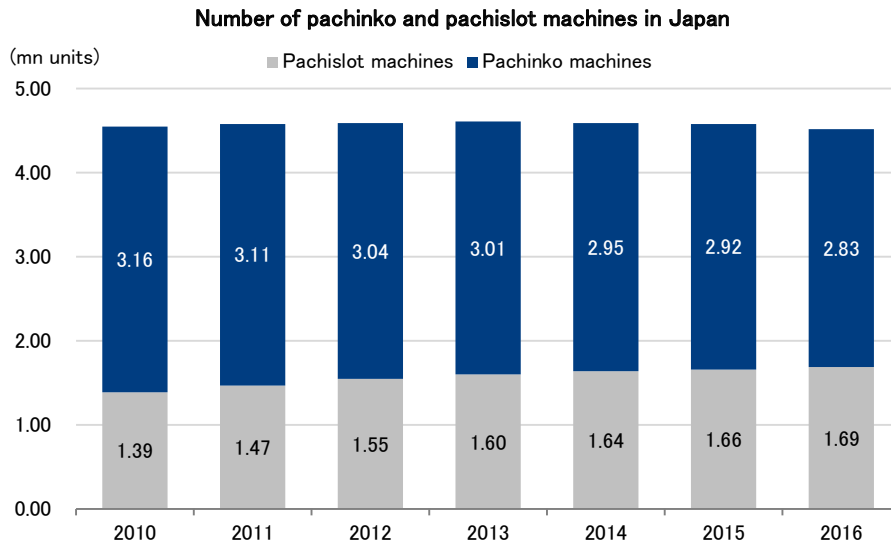


Source: Prepared by FISCO from the Present State of the Public Moral Environment and Crimes Related to Public Morals for each year and other information from the Consumer and Environmental Protection Division, Community Safety Bureau, National Police Agency

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Industry environment

However, the National Police Agency reports that while the number of pachislot machines has increased, the number of pachinko machines has declined, so the combined number of pachinko and pachislot machines has remained fairly constant. Since the number of pachinko and pachislot halls decreased over the same period, the average size of halls has increased. This trend toward larger pachinko and pachislot halls that command merits of scale benefits the Company as it can propose effective investment with its advanced functions and services with added value.

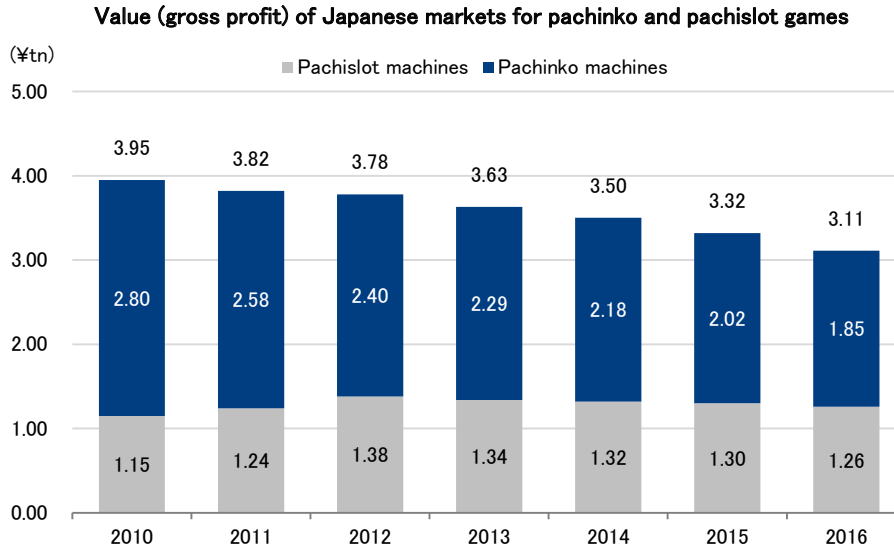


Source: Prepared by FISCO from the Present State of the Public Moral Environment and Crimes Related to Public Morals for each year and other information from the Consumer and Environmental Protection Division, Community Safety Bureau, National Police Agency

According to the Company, Japan's combined market size for pachinko and pachislot games, as measured by the gross profit earned by all halls nationwide, has fallen each year, similar to the decline in the number of halls. This value has also declined on a per-machine basis. Thus, even though pachinko and pachislot halls are increasing in average size, they continue to operate in a challenging business. Additionally, Japan passed the Integrated Resort Facilities Promotion Act* on December 15, 2016. Given this change, the government is promoting measures to deal with gambling and related addictions, a new challenge for the industry. Past curtailment of machines with strong gambling features led to temporary customer losses and sustained difficult market conditions for roughly a year. Recent developments are also having a major impact on the industry. However, we think the current situation offers a transition to hall management that does not rely on gambling, including a cleansing of the industry. The Company expects the market to recover in the medium term if the industry can be rejuvenated from a turnaround centered on halls with high resilience. This view takes into account the bottoming out and subsequent recovery that occurred 2-3 years after the previous earnings downturn.

* It is officially named the Act on Promoting Development of Areas for Specified Integrated Resort Facilities. The act stipulates that the government must prepare necessary legal measures to allow for the establishment of integrated facilities with casinos, meeting halls, hotels, and other features by private-sector businesses with permits at "specified integrated resort zones" within a year from it taking effect. Since its passage, the government has been promoting measures to broadly address gambling and related addictions for pachinko and publicly operated races.

Industry environment



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

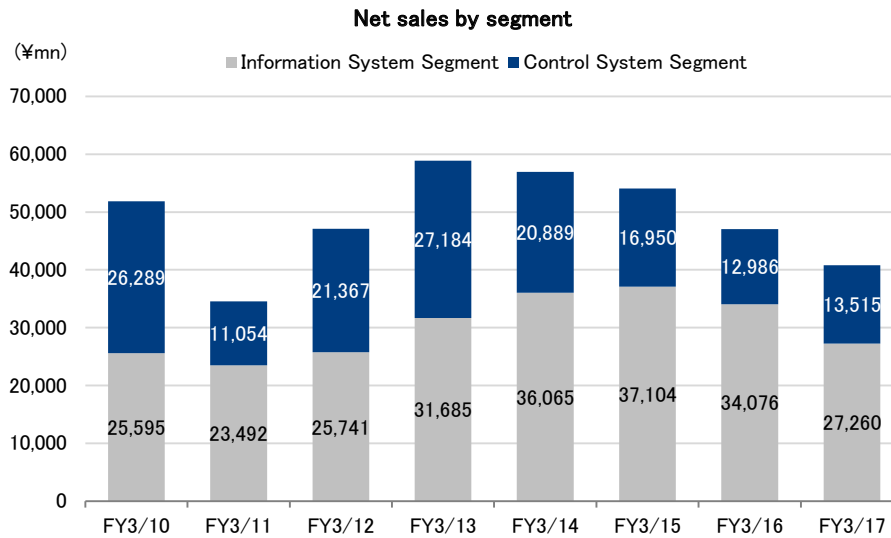
Financial results trends

Aggressively investing in R&D to develop next-generation products and drive future growth amid contraction of the industry

1. Performance over the past fiscal years

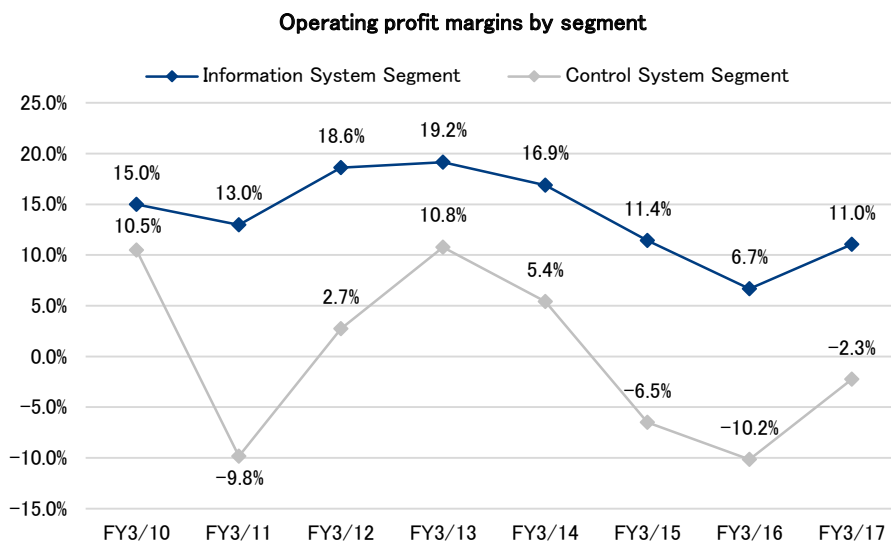
In FY3/11, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake. Its net sales rebounded in FY3/12-FY3/13, even though the pachinko industry continued to contract. This recovery was led by the Information System Segment, which holds high market shares for its products. Sales in this segment reached consecutive record highs in FY3/13-FY3/15, supporting the Company's overall performance. In FY3/16, sales in the Information System Segment contracted YoY, reflecting the impact of industry restrictions on risky machines and collecting and removing of such machines.

Financial results trends



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

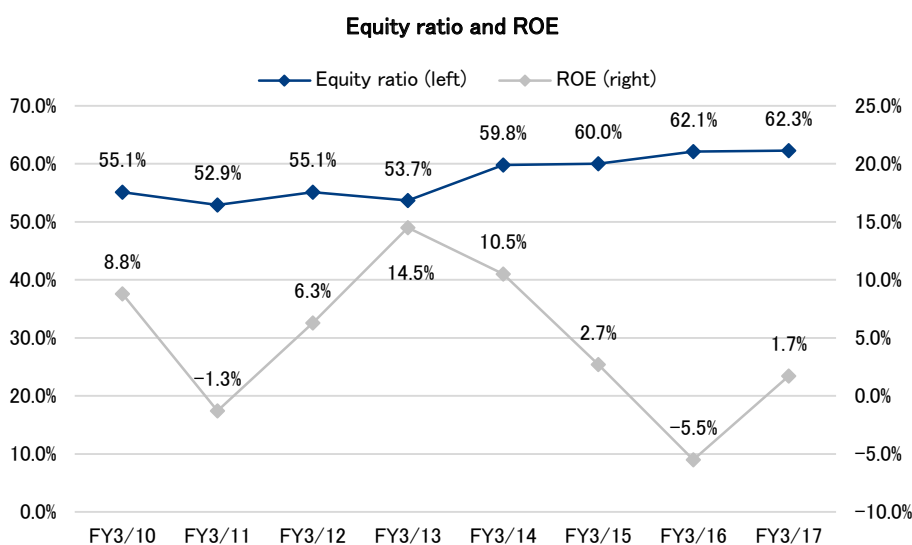
The Information System Segment provides profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in the development of the next-generation products since FY3/14, profit margins have declined, but considering the size of the investment, margins are still high.



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

Financial results trends

The Company's equity ratio, a measure of financial stability, has risen, reflecting large retained earnings, reaching 62.3% in FY3/17. The current ratio, which indicates the ability to make payments in the short term, was 181.1% in FY3/17, mainly due to large holdings of cash and deposits. The ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. In FY3/15, the Company suffered a loss due to the bankruptcy of a manufacturer customer. In FY3/16, because of the industry restrictions on risky machines, the Company launched fewer new pachislot machine models than planned, and its sales volume of these machines were far below the planned level. As a result, the Company suffered a loss due to the devaluation of parts and materials for its pachislot machines.



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

With the industry facing a major turning point, uncertainty about future is depressing near-term performance

2. Overview of 1H FY3/18 results

In 1H FY3/18, the Company saw declines in both sales and earnings, posting net sales of ¥17,996mn (-10.9% YoY), operating income of ¥375mn (-38.1%), ordinary income of ¥493mn (-30.1%), and net income attributable to owners of the parent of ¥296mn (-10.1%). Sales came in below the Company's initial forecast but earnings finished well above.

The market environment remained difficult as uncertainty continued to prevail, leaving sales short of year-ago levels at both the Information System Segment and the Control System Segment. In the Information System Segment, a decline in new pachinko hall openings coupled with a loss of appetite for new investments among existing hall operators left sales well short of the Company's initial forecast. In the Control System Segment, sales finished slightly ahead of plan despite fewer in-house developed pachislot machines and delays in rolling out a new display unit model.

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Financial results trends

On the earnings front, the drop in sales combined with a rise in the production cost ratio left earnings well below year-ago levels. These were partially offset by sharp cuts in SG&A expenses, but the operating margin still came in at 2.1% versus 3.0% at this time last year. Meanwhile, earnings finished above the Company's initial forecast thanks to declines in R&D expenses, sales commissions, advertising expenses and provision of allowance for doubtful accounts.*

* Reversal of allowance for doubtful accounts as the bankrupt claims were finally settled in July 2017 for a client company that declared bankruptcy in April 2015.

With respect to the Company's financial position, net assets at the end of 1H FY3/18 were ¥28,887mn, down 0.9% from the end of FY3/17, a modest decline owing to the dividend payment. In contrast, total assets of ¥43,500mn were down 7.1%, reflecting a decline in cash and deposits (following dividend and other payments), a decline in inventories (from sales of pachislot machines), and further depreciation of fixed assets. As a result, the Company's equity ratio rose to 66.4% versus 62.3% at the end of FY3/17.

Overview of 1H FY3/18 results

	1H FY3/17 results		1H FY3/18 results		YoY change		FY3/18 initial forecast		vs. forecast	
	Ratio to sales		Ratio to sales		YoY rate of change		Ratio to sales		Progress rate	
Net sales	20,187		17,996		-2,191	-10.9%	19,000		-1,004	94.7%
Information System Segment	13,126	65.0%	11,757	65.3%	-1,369	-10.4%	13,000	68.4%	-1,243	90.4%
Control System Segment	7,093	35.1%	6,262	34.8%	-831	-11.7%	6,000	31.6%	262	104.4%
Adjustment	-31	-	-23	-	8	-	0	-	-23	-
Gross profit	7,532	37.3%	6,097	33.9%	-1,435	-19.1%	6,800	35.8%	-703	89.7%
SG&A expenses	6,926	34.3%	5,722	31.8%	-1,204	-17.4%	6,700	35.3%	-978	85.4%
Operating income	605	3.0%	375	2.1%	-230	-38.1%	100	0.5%	275	375.0%
Information System Segment	1,414	10.8%	872	7.4%	-542	-38.3%	1,000	7.7%	-128	87.2%
Control System Segment	95	1.3%	374	6.0%	279	293.7%	0	0.0%	374	-
Adjustment	-903	-	-871	-	32	-	-900	-	-	-
Ordinary income	706	3.5%	493	2.7%	-213	-30.2%	100	0.5%	393	493.0%
Net income attributable to owners of the parent	329	1.6%	296	1.6%	-33	-10.0%	50	0.3%	246	592.0%
Depreciation							900			
R&D expense	1,711		1,240		-471	-27.5%	1,650		-410	
Information System Segment	1,093		965		-128	-11.7%	1,000		-35	
Control System Segment	618		275		-343	-55.5%	650		-375	
Breakdown of segment sales										
Information System Segment										
Equipment	7,911		6,555		-1,356					
Service	5,215		5,202		-13					
Control System Segment										
Units and components	3,825		3,955		130					
Pachislot machines and other equipment	3,268		2,307		-961					
		End-March 2017 results		End-September 2017 results	YoY change					
						YoY rate of change				
Total assets		46,828		43,500	-3,328	-7.1%				
Total equity		29,151		28,887	-264	-0.9%				
Equity ratio		62.3%		66.4%	4.1%	-				

Source: Prepared by FISCO from Company materials

Financial results trends

The results by segment were as follows.

(1) Information System Segment

The Information System Segment reported lower sales and lower earnings, with sales falling 10.4% YoY to ¥11,757mn and segment income dropping 38.3% to ¥872mn. The Company attributed the below-plan results to the reluctance of pachinko hall operators to make new investments in the face of continued uncertainty about the future. A decline in new pachinko hall openings*¹ weighed heavily on demand for the Company's CR unit VEGASIA series and prize management systems, leaving unit sales of these product lines down versus the same period last year. On the plus side, the Company reported an increase in customers*² adopting player's information display units drawn by the solid reputation.

*¹ Daikoku Denki estimates that new pachinko parlor openings were down as much as 20% YoY.
 *² Includes new transactions with operators of major pachinko hall chains.

On the earnings front, despite a drop-off in R&D spending following a surge last year together with cuts in advertising and promotion spending, lower earnings resulting from the drop in sales could not be fully covered, and the segment income margin dropped to 7.4% from 10.8% in 1H FY3/17.

Even as equipment sales as a whole ran into increasingly stiff headwinds, sales from services were basically flat, and should be given credit for underpinning sales and earnings as a whole. (In particular, we would note that sales from management support services, an area where the Company is working hard to expand, rose 4.6% YoY to ¥2,138mn.) The Company also managed to achieve certain progress for future growth including the release of its new CR unit, the VEGASIA III*¹, followed by the launch of Fan-SIS*², a new data publishing service that tracks pachinko and pachislot player trends nationwide and permits even more detailed analysis of data, as well as other add-on services.

*¹ The most distinguishing feature of VEGASIA III is its built-in facial recognition camera that allows pachinko hall managers to get a good handle on player trends. While contributions to its business performance will not start kicking in until 2H, this next-generation CR unit is already attracting a lot of attention.
 *² Fan-SIS is a new data analytical service that offers more detailed analysis based on the data collected via VEGASIA III. By collecting data from pachinko halls nationwide, the Company will be able to do more accurate and reliable analysis of player trends. At the individual pachinko hall level, hall operators will be able to see how their establishment stacks up against national trends, find the strengths and weakness of their operations, and see where there is room to improve. In particular, this helps individual pachinko halls find the optimum equipment lineup suited for their own player segment and is expected to improve their profitability.

(2) Control System Segment

The Control System Segment also saw lower sales, with sales declining 11.7% YoY to ¥6,262mn. However, segment income was up sharply, rising to ¥374mn versus ¥95mn in 1H FY3/17. Both sales and earnings finished above plan.

Although sales volume was down versus a year earlier owing to delays in the rollout of a new model display unit, which was pushed out into 2H, sales were higher than expected thanks to strong sales of pachinko machine components. Sales of in-house developed pachislot machines* were also down from last year but finished slightly ahead of plan.

* Unit sales did not reach 8,800 sold in 1H FY3/17 however, the Control System Segment sold 5,500 and surpassed the planned 5,400 from releasing two new models, Sora-no-Otoshimono Forte and Yuki Yuna Is a Hero.

On the earnings front, segment income finished well above the Company's initial forecast, having benefited from a drop in commissions paid on sales of in-house developed pachislot machines, sharp cuts in R&D spending (which were reduced even more than expected), and the reversal of allowance for doubtful accounts.

Financial results trends

Sales volume in 1H FY3/18

	1H FY3/17 results	1H FY3/18 results	YoY change	1H FY3/18 forecast
Sales volume (Information System Segment)				
Hall computers	30 units	33 units	3 units	40 units
Call lamps				
BiGMO PREMIUM	12,674 units	12,295 units	-379 units	16,000 units
REVOLA	19,583 units	18,079 units	-1,504 units	19,000 units
IL-X series	10,757 units	11,490 units	733 units	11,000 units
VEGASIA CR unit	30,327 units	24,438 units	-5,889 units	32,000 units
Facial recognition system	3 halls	15 halls	12	20 halls
Sales volume (Control System Segment)				
Display unit models	4 models	4 models	0 models	5 models
Units sold	32,054 units	23,318 units	-8,736 units	35,000 units
Pachislot machine models	1 models	2 models	1 models	2 models
Units sold	8,800 units	5,500 units	-3,300 units	5,400 units

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

Looking at 1H results, as detailed above, we think it is fair to say that even though the harsh operating environment left overall sales short of expectations, the Company's focus on earnings have paid off, as it made good progress towards improving profitability even excluding the impact of special, one-time factors (reversal of allowance for doubtful accounts). Combined with the release of new ground-breaking products and services, and the start of transactions with major chain operators, we believe this bodes well for the direction of the Company in the future.

■ Outlook

Earnings likely to rise sharply on lower sales in FY3/18 amid a difficult market environment

For FY3/18, the Company has left the initial forecast unchanged. The Company projects vibrant earnings growth on weaker sales with net sales at ¥39,000mn (-4.2% YoY), operating income at ¥1,300mn (+24.0%), ordinary income at ¥1,300mn (-5.4%), and net income attributable to owners of the parent at ¥800mn (+59.1%).

The Company expects net sales to decline due to the significant shrinkage of the Control System Segment despite higher sales from the Information System Segment with the launches of new products and services*. For earnings, meanwhile, it projects a gain in operating income primarily because of decline in R&D expenses, improved income in the Control System Segment.

* Such as the previously mentioned new CR unit VEGASIA III and Fan-SIS.

For our part, we are skeptical as to the Company's ability to meet its net sales target for the full year, especially given the likely impact of the latest revisions to regulations and the heightened uncertainty surrounding the outlook for the industry. The Company's earnings target is another story though, as progress reported for 1H and reasonable assumptions made for 2H suggest that its full-year earnings target is achievable. Still, with the earnings forecast weighted so heavily towards 2H, there is a risk that lower-than-expected sales in 2H will leave full-year earnings below plan as well.

Outlook

Company forecasts for FY3/18

(¥mn)

	FY3/17 results		FY3/18 forecast		YoY change	
	Ratio to sales		Ratio to sales		YoY rate of change	
Net sales	40,714		39,000		-1,714	-4.2%
Information System Segment	27,260	67.0%	28,500	73.1%	1,240	4.5%
Control System Segment	13,515	33.2%	10,500	26.9%	-3,015	-22.3%
Gross profit	13,953	34.3%	13,400	34.4%	-553	-4.0%
SG&A expenses	12,904	31.7%	12,100	31.0%	-804	-6.2%
Operating income	1,048	2.6%	1,300	3.3%	252	24.0%
Information System Segment	3,011	11.0%	2,500	8.8%	-511	-17.0%
Control System Segment	-306	-2.3%	700	6.7%	1,006	-
Adjustment	-1,656	-	-1,900	-	-	-
Ordinary income	1,374	3.4%	1,300	3.3%	-74	-5.4%
Net income attributable to owners of the parent	502	1.2%	800	2.1%	298	59.1%
Depreciation	1,661		1,850		189	11.4%
R&D expense	3,060		2,200		-860	-28.1%
Information System Segment	2,240		1,900		-340	-15.2%
Control System Segment	820		300		-520	-63.4%

Source: Prepared by FISCO from Company materials

Future strategic direction

Seeking to boost market share with next-generation products and solidify an earnings structure unaffected by the market environment

The Company is currently promoting the Next 50 Chapter One medium-term management plan that lasts through FY3/20. In FY3/18, the second year of the plan, the organization was altered, including replacement of the president and a new management team, to help address sharp changes in the business environment and to strengthen its income structure. Nevertheless, the Company did not change its overall direction. The plan focuses on bolstering the business foundation to help responding to market change (acquiring players with stronger interest in game features) and reforming pachinko hall management (strategic decision-making based on data analysis) with an outlook of moderate recovery in the market environment over the medium term despite the ongoing uncertainty in the near term. In particular, the Company intends to enhance growth potential and profitability through expansion of market share with the next-generation hall computers (including peripheral equipment) that it has been aggressively developing and new value creation by leveraging data analysis and planning and development capabilities.

Future strategic direction

Medium-term management plan

	FY3/17 results		FY3/18 forecast		FY3/20 targets	
	Ratio to sales		Ratio to sales		Ratio to sales	
Sales	40,714		39,000		57,000	
Information System Segment	27,260	67.0%	28,500	73.1%	38,000	66.7%
Control System Segment	13,515	33.2%	10,500	26.9%	19,000	33.3%
Operating income	1,048	2.6%	1,300	3.3%	4,000	7.0%
Information System Segment	3,011	11.0%	2,500	8.8%	5,000	13.2%
Control System Segment	-306	-2.3%	700	6.7%	1,000	5.3%
Adjustment	-1,656	-	-1,900	-	-2,000	-
ROE	1.7%		-		7.0%	or over
Sales of management support services	4,143		4,350		4,900	

Source: Prepared by FISCO from Company materials

The strategic direction of individual segment is outlined below.

1. Information System Segment

The pachinko market's appetite for new investments is likely to remain depressed for at least a while longer. However, equipment demand is gradually stirring due to replacement of game machines in response to recent regulation revisions, Daikoku Denki intends to develop new products and services that will help it bring in new players, increase its market share, while maintaining the flexibility needed to respond to changing market conditions. More specifically, the Company has set forth three key measures, as detailed below.

(1) As before, the Company plans to work at growing its market share and transforming its earnings structure by increasing sales of CR units, data displays, and other equipment. Coupling this with an expansion of management support services, the Company also aims to shift to a business model that is more reliant on services that produce recurring revenue. The expansion of management support services in particular, because they help pachinko hall operators increase their competitiveness and reduce labor costs, is expected to help the Company secure its customer base while at the same time stabilizing its own sales and earnings.

(2) The Company plans to make timely introductions of new products and services that have the flexibility needed to meet the changing needs of the market following revisions to regulations. The Company will also be looking to take advantage of the business opportunities created by the changes in the industry by developing new products and services that will help attract new players (winning back former players as well as attracting new players). One example here would be the expansion of various services to provide information to players.

(3) After reviewing product development plans to comply with the standards set forth under the revised regulations, the Company plans to continue actively investing in R&D to create a new generation of products. Along with the changes in the market environment, the Company will make additional technical adjustments and alter its product development process to comply with the new rules and regulations. The Company also plans to step up its efforts to provide products and services that will help pachinko halls improve their operating efficiency and reduce labor costs. In terms of the timing of new product and service introductions too, the Company will keep a close watch on market trends and respond flexibly.

Future strategic direction

2. Control System Segment

In addition to a growing demand in reduced development costs for pachinko and pachislot machines, product planning is becoming increasingly important at the manufacturing level as the need grows for new ideas that will help clients cope with the changes in the market environment. In response, Daikoku Denki intends to closely coordinate the efforts of its Control System and Information System segments in order to further differentiate itself from competitors, assure rapid response to changes in the market environment, and raise operating efficiency. Towards this end, the company has laid out three specific measures it intends to implement, as outlined below.

- (1) Contribute to the healthy operations of pachinko halls by emphasize the entertainment aspect, and focus on the activation of the game environment through creation of games that comply with new rules.
- (2) Promptly respond to the requests of game machine manufacturers to shorten customer's product development period and contribute to cost reduction and quality improvement, while at the same time leading to lower in-house costs.
- (3) Utilize Information System Segment's DK-SIS data and Fan-SIS data to help implement project proposals that will create new "game value" and help expand business territory of the Control System Segment.

Even though the pachinko industry is approaching a major turning point and this is weighing heavily on near-term performance, over the medium to longer term, we believe the years Daikoku Denki has spent actively developing next-generation hall computers and related peripheral equipment will give it a major advantage over competitors. In particular, we see the Company's management support services and value proposal through its unique services and data analysis, putting it in a strong position to meet the changing needs of the industry. Even assuming the pachinko market continues to contract for a while longer, we believe it will be possible for Daikoku Denki to sustain growth with the help of a full-scale rollout of a high value-added lineup of next-generation products that will capture the replacement demand of existing pachinko hall operators. Additionally, polarization is likely to proceed further in the pachinko hall industry with survival mainly by firms with extensive capital resources. These conditions are likely to work favorably for the Company in its efforts to increase market control with the next-generation hall computers and raise market share.

With regard to sales, which are easily swayed by changes in the external operating environment, we must remain cautious in the near term. That said, we will be keeping a close eye out for improvements in profitability stemming from the development of new products and services designed to help clients cope with changes in the market environment and the expansion of management support services. Although the impact of the latest revisions to regulations is likely to leave the pachinko industry in a state of flux for at least a while longer as many sit on the sidelines to watch and wait, we believe that pachinko hall operators who have been holding off on making any new investments thus far may soon re-enter the market to buy new equipment, especially those with adequate financial resources. As this could put demand on the road to recovery from next fiscal year, investors will want to keep an especially close eye on developments on this front. Over the medium to long term, we see Daikoku Denki's growth taking full advantage of its dominant position within the industry, as well as additional measures aimed at revitalizing the industry as a whole.

■ Shareholder returns

Likely to lower the dividend in FY3/18 but stay at a high level, still has room to raise the dividend as earnings grow

In FY3/18, the Company plans to lower the dividend by ¥10 to ¥40 per share for the full year (¥10 interim and ¥30 year-end), taking into account uncertainty about the future market environment. However, the dividend payout ratio is a strong 73.9% (using forecast) and this indicates that the Company continues to implement a robust dividend policy.

Given the Company's policy of supplementing its minimum dividends with dividends dependent on earnings, FISCO foresees the likelihood of increases in annual dividends as the Company's profits grow over the medium term.

To make its shares more attractive to investors and to encourage shareholders to keep their holdings over the medium-to-long term, the Company has adopted a system of awarding gifts to shareholders. According to this system, all shareholders registered at the end of September will be awarded points that vary depending on the number of shares held (the minimum holding is 100 shares) and the length of time they have been held. These points can be exchanged for food, beverage, electronic goods, travel and experiential events and donations to social contribution activities.



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