

Daikoku Denki Co., Ltd.

6430

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

■ Index

■ Summary	01
■ Description of businesses	03
1. Information System Segment	04
2. Control System Segment	04
■ Company strengths	05
1. Growth model based on market expansion through innovation	05
2. Strong network of pachinko halls	05
3. Stable profit base that supports investment for the future	06
■ Industry environment	08
■ Financial results trends	11
1. Performance over the past fiscal years	11
2. Overview of FY3/18 results	13
■ Outlook	16
■ Future strategic direction	17
1. Information System Segment	18
2. Control System Segment	18
■ Shareholder returns	19

■ Summary

Posted higher profits on a decline in sales amid a transition phase in the industry, achieving successes in forward-looking initiatives

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.

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.

The Company reported higher profits on a decline in sales in FY3/18 with net sales down 16.3% year on year (YoY) to ¥34,093mn and operating income gaining 13.8% to ¥1,192mn. Sales dropped in both the Information System Segment and Control System Segment on ongoing difficulty in market conditions with cautious customer stances toward capital investments because of uncertainty about the impact of “new regulations” (*). Information System Segment sales were substantially lower than forecasts due to impacts from declines in new pachinko hall openings and major renovations. Furthermore, Control System Segment sales undershot forecasts on delays in development schedules and equipment release timing ahead of new rules in an environment of sluggish new sales volume for the amusement equipment market as a whole. Profit rose, despite weakness caused by the decline in sales, thanks to revisions in the “next-generation system” development plan that reduced development costs. Growth in MG service business provided support. The Company is making steady progress in shifting to an income structure that is not affected by market conditions (recurring-income model). We think releases of novel products and services should also contribute to future business expansion.

* 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 (details are given below).

Summary

The Company forecasts stronger sales and profits in FY3/19 with gains of 2.7% YoY in net sales to ¥35,000mn and 9.0% in operating income to ¥1,300mn. While Control System Segment sales are likely to weaken again, the overall outlook calls for a boost from the Information System Segment with pick-up in sales of new products and services driving growth in the second half of the fiscal year. In earnings, the Company expects improvement in operating margin on the higher sales effect and better efficiency in the development process (Control System Segment). We think the Company is capable of attaining its targets, even with continuation of difficult market conditions, on likely strengthening of replacement demand in peripheral equipment with customer draw amid market deployment of amusement equipment that meets new regulations. However, it is important to recognize that the outlook is skewed toward 2H (factoring in a 16.7% YoY decline in 1H sales).

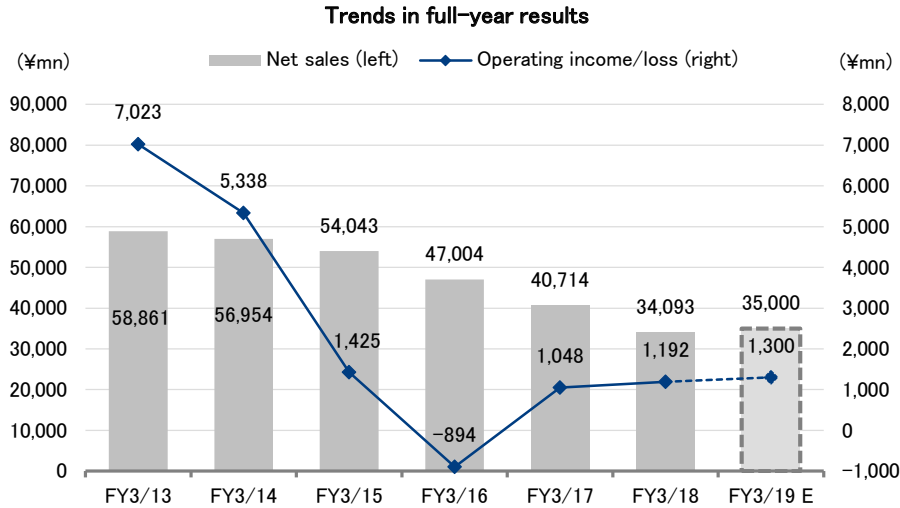
The Company is currently promoting the “Next 50 Chapter One” medium-term management plan with FY3/20 as the final year. It hopes to improve growth potential and profitability by expanding market share with next-generation products, and creating new value through utilization of data analysis and planning and development capabilities. While it is likely to be difficult to attain quantitative goals due to various external factors, we think the Company is steadily advancing in a strategic direction that factors in change in the industry structure.

We also expect calibration in timing of market release of the next-generation hall computer to responses to “addiction measures” as a new industry issue and market environment trends. Peripheral equipment steadily released prior to then, meanwhile, should contribute to income by tapping into replacement demand with flexible response to market changes. Major transition in the industry offers a business expansion opportunity to the Company as well. For the time being, we expect growth at the Company itself that leverages an overwhelmingly attractive position from a longer-term perspective, despite lingering uncertainty in the market environment, and initiatives to stimulate the industry.

Key Points

- Posted higher earnings on a decline in sales in FY3/18 (MG service growth supported profits)
- 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 halls' 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's hall computer is utilized at roughly 3,700 stores (giving it a share of about 35%) and in around 1,900,000 installed amusement machines (about 42%).

The Company's two main businesses are the Information System Segment and the Control System Segment, but the Information System Segment provided approximately 72.7% of its total sales in FY3/18 and was the main source of stable profit

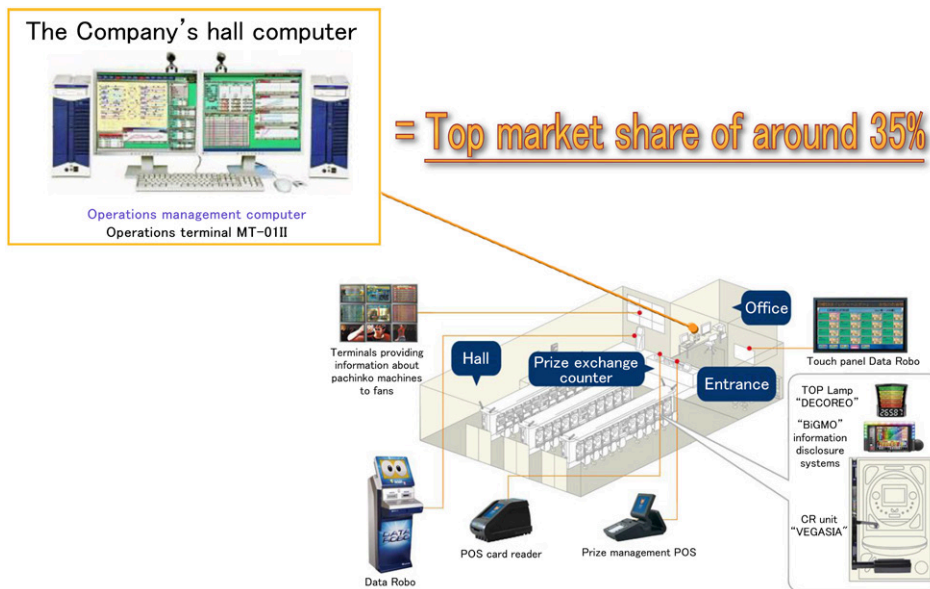
Description of businesses

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

2. Control System Segment

The Control System Segment produces and sells displays and control units, as well as 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. It steadily releases hit products with unique value that place emphasis on gaming features, including Magical Suite Prism Nana, Sasamisan@Gambaranai Slot, and Pachislot Hyakkaryoran Samurai Girls. These successes have solidified the Company's brand image of high-quality animation. In FY3/18, Daxel has released two more models, Sora-no-Otoshimono Forte and Yuki Yuna is a Hero.

We encourage readers to review our complete legal statement on "Disclaimer" page.

■ 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.

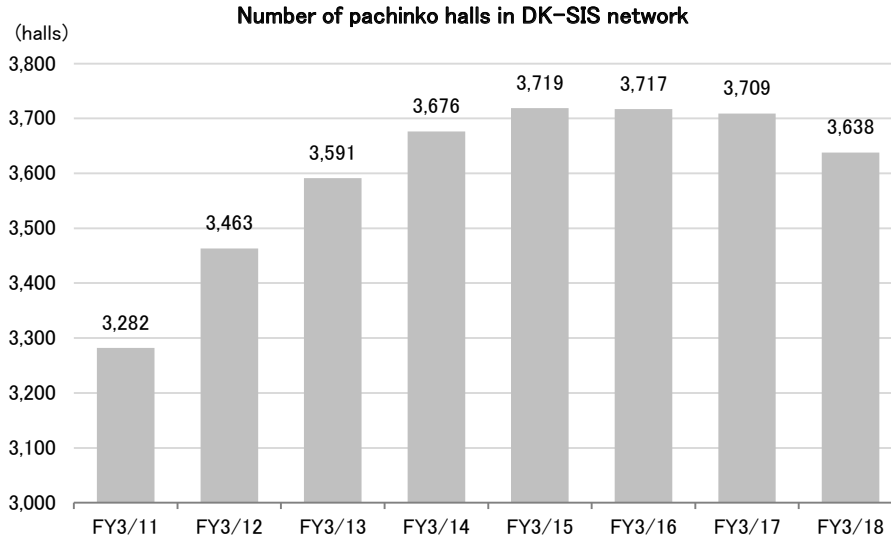
Launched in 1974, the Company's first hall computer enabled the managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic information, but with the introduction of hall computers, data-based hall management became the 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. Additionally, it occupies an industry think-tank role and helps improve the Company's brand as a leading company, and its strategic proposal and sales contacts with amusement equipment manufacturers. Membership totaled 3,638 stores at the end of March 2018 with 1.46mn managed machines (32.8% share) and ¥9.2trn in data scale (annual sales). While member volume has peaked amid a recent decline in overall pachinko halls, DK-SIS enjoys a large share in managed machines, mainly at large sites.

Company strengths



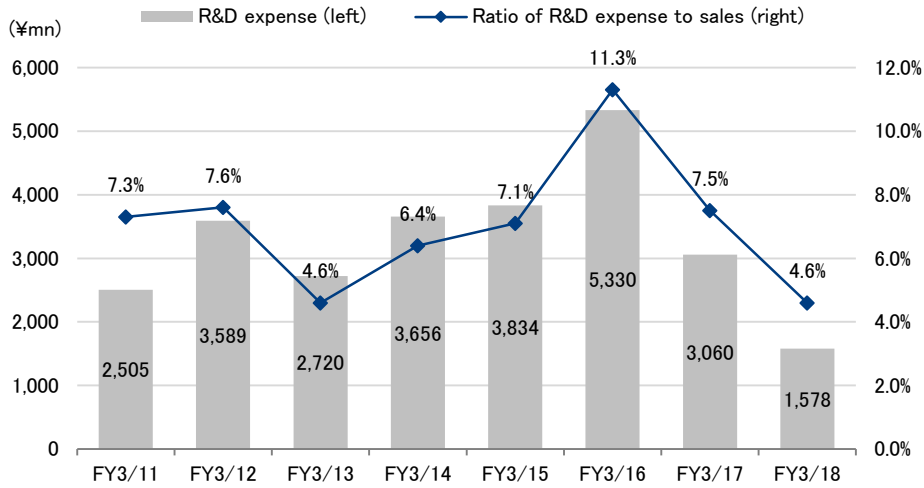
Source: Prepared by FISCO from the Company's results briefing materials

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 (and 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. The Company revised its "next-generation system" development plan in FY3/18 and R&D expenses are declining.

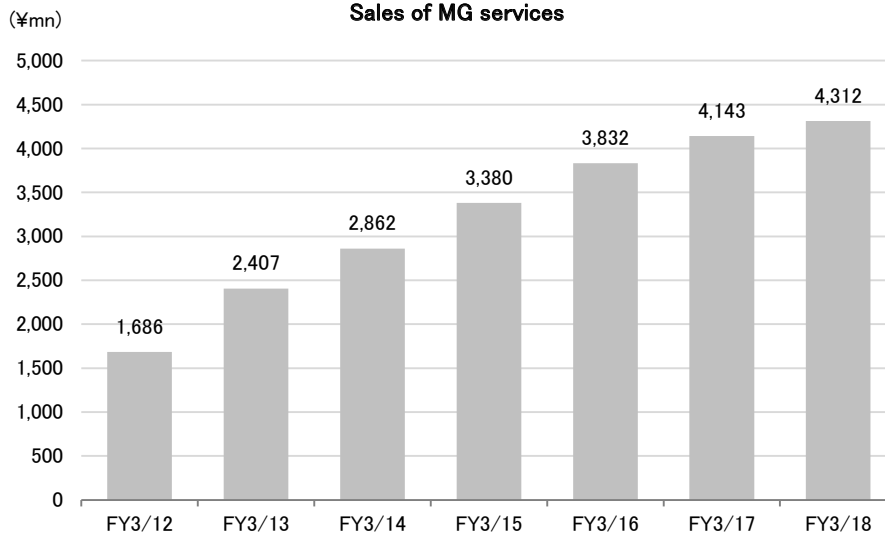
Company strengths

Research and development expense and ratio of expense to sales



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

Sales of MG services



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

■ Industry environment

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

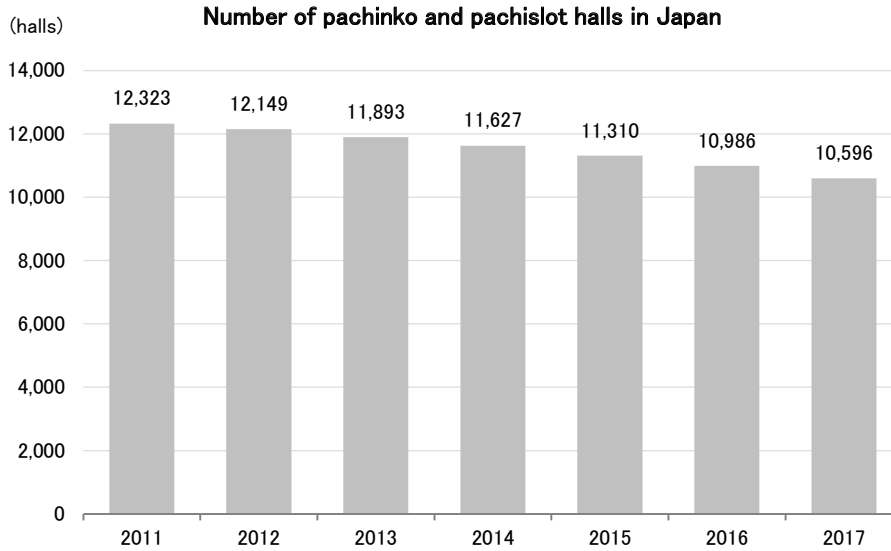
Japan's pachinko industry has been shrinking for years, reflecting a decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The self-regulatory action taken by the industry in 2015 (tightening 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 new regulations*. With the pessimistic view towards the industry and uncertainty about the future, the industry remains in a state of flux.

* Among the new regulations are restrictions on the maximum number of balls that can be paid out and clearly defined standards for "controlled machines." Older models that do not meet the new standards will remain in pachinko halls alongside new models for at least a while longer. 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 2.4% from 2011 to 2017. In 2017, the number of halls was 10,596 (down 390 YoY). It is estimated that the Company served about 3,700 of these halls based on the fact that it held approximately 35% of the Japanese market for hall computers. The Company's customer halls are often the top locations in the area and exceed the market average in size (*). Average amusement machine volume per store is 512 machines, surpassing the average at other companies (369 machines) by about 40%. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. We expect an excellent opportunity for the Company to expand business once investment appetites recover mainly at large halls (after uncertainty fades and market activity picks up).

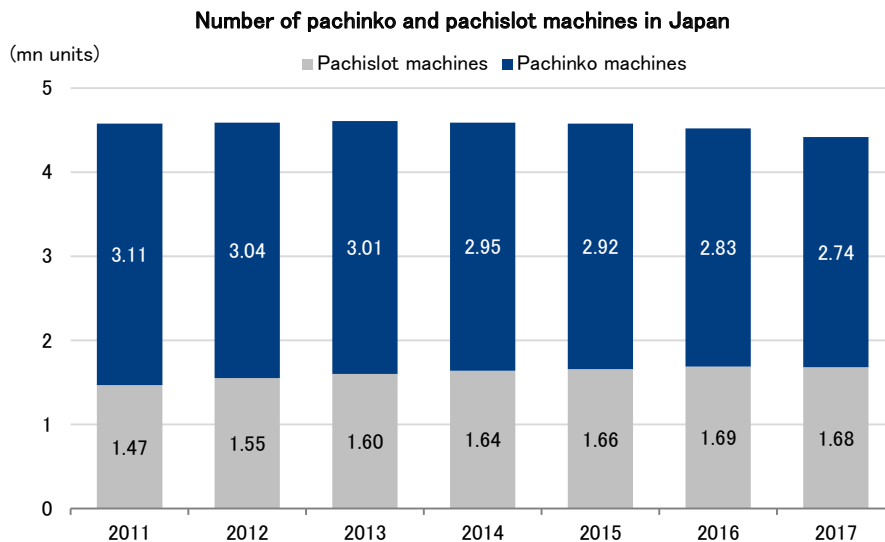
* The Company holds a roughly 53% share in mid-sized to larger sites (501 to 1,000 machines) and around 70% in large sites (1,001 or more machines). Its market presence is higher at large sites.

Industry environment



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

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. As discussed above, larger pachinko and pachislot halls that command economies of scale are the Company's main segment and this trend should benefit the Company with its ability to realize robust investment return through advanced functionality and added value.

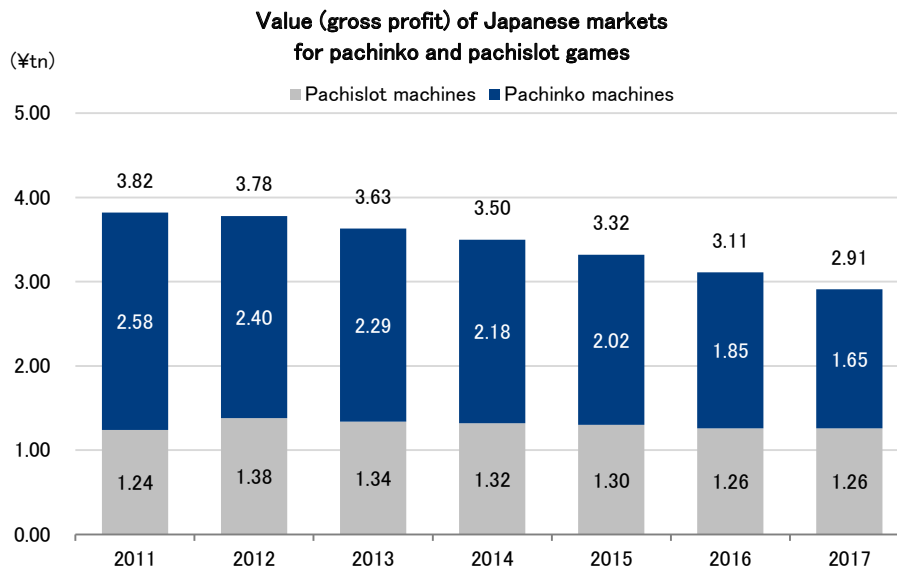


Source: Prepared by FISCO from the Present State of the Public Moral Environment and Crimes Related to Public Morals for each year and other information from the Consumer and Environmental Protection Division, Community Safety Bureau, National Police Agency

Industry environment

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, and will lead to a cleansing of the industry. The Company projects recovery toward a ¥4trn market over the longer term because there have been bottoms and recoveries 2-3 years after past profit slowdowns. This outlook takes into account possible fading of the deflation economy ahead of the Tokyo Olympics too.

* 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.



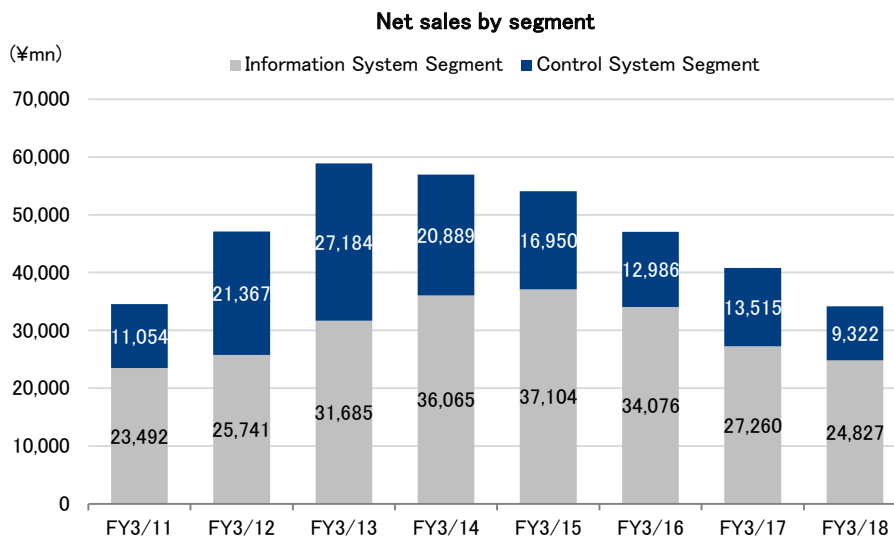
Source: Prepared by FISCO from the Company’s results briefing materials

Financial results trends

Proactively allocating R&D expenses toward future growth since FY3/14 with the arrival of a major industry turning point

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. However, sales have been contracting since FY3/16 due to various negative external factors, such as voluntary industry regulations, retrievals and removals of risky machines, and uncertainty related to new regulations.

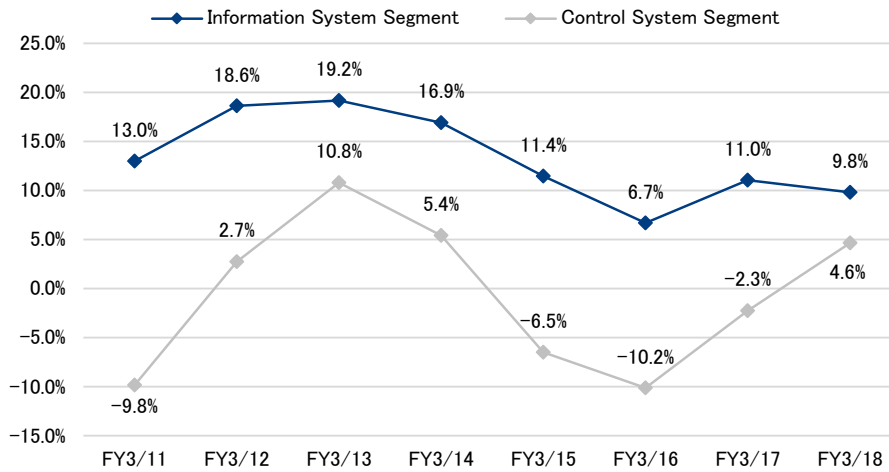


Source: Prepared by FISCO from the Company's results briefing materials

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 next-generation products since FY3/14, profit margins have declined, but considering the size of the investment, margins are still high. In particular, steady progress in conversion to a recurring-income business model, such as growth in MG service business, has been supporting income.

Financial results trends

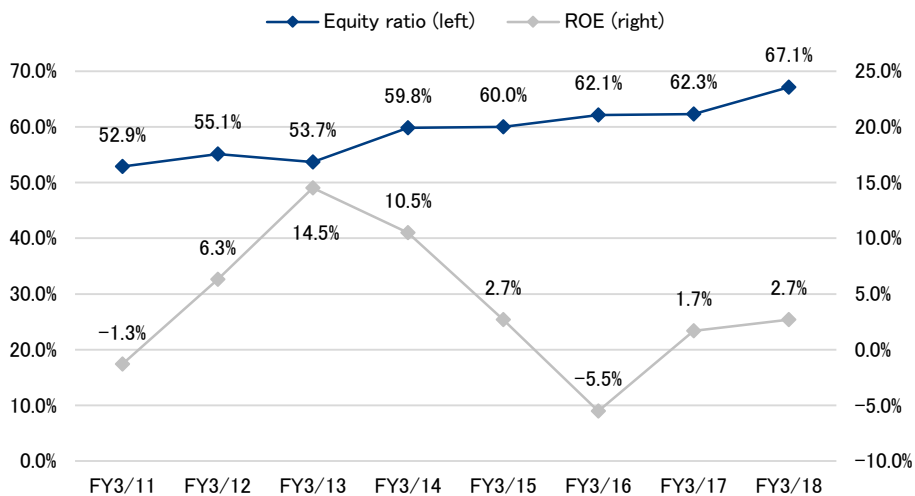
Operating profit margins by segment



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

The Company's equity ratio, a measure of financial stability, has risen, reflecting large retained earnings, reaching 67.1% in FY3/18. The current ratio, which indicates the ability to make payments in the short term, was 203.8% in FY3/18, 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 was 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. However, conditions have been gradually recovering recently.

Equity ratio and ROE



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

Posted higher earnings on a decline in sales in FY3/18 Growth in service sales is providing support to income

2. Overview of FY3/18 results

The Company reported higher profits on a decline in sales in FY3/18 with net sales at ¥34,093mn (-16.3% YoY), operating income at ¥1,192mn (+13.8%), ordinary income at ¥1,390mn (+1.2%), and net income attributable to owners of parent at ¥785mn (+56.2%). Both sales and profits missed period-start targets.

Sales dropped in the Information System Segment and Control System Segment due to continuation of a difficult market environment of cautious stances toward capital investments because of uncertainty about the impact of new regulations. Information System Segment sales were substantially lower than forecasts due to impacts from declines in new pachinko hall openings and major renovations. Furthermore, Control System Segment sales undershot forecasts on delays in development schedules and equipment release timing at amusement equipment firms ahead of new regulations.

Profit rose, despite weakness caused by the decline in sales, thanks to a large improvement in operating margin to 3.5% (vs. 2.6% in FY3/17) on revisions in the “next-generation system” development plan that reduced development costs. Main sources of decline in the SG&A expenses ratio were a lull in R&D spending and the reversal of allowance for doubtful accounts (*).

* As the bankruptcy claims were finally settled in July 2017 for a client company that declared bankruptcy in April 2015.

In finances, while total assets dropped 7.0% YoY to ¥43,564mn on decline in notes and accounts receivable -trade (with lower revenue), decline in inventories (self-developed pachislot amusement machines), and depreciation under non-current assets, shareholders' equity was roughly flat at ¥29,369mn and the shareholders' equity ratio improved to 67.1% (vs. 62.3% at end-FY3/17).

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Financial results trends

Overview of FY3/18 results

	FY3/17		FY3/18		YoY change		FY3/18		vs. forecast	
	Results	Ratio to sales	Results	Ratio to sales	YoY change	YoY rate of change	Initial forecast	Ratio to sales	Achievement rate	
Net sales	40,714		34,093		-6,620	-16.3%	39,000		-4,906	87.4%
Information System Segment	27,260	66.9%	24,827	72.8%	-2,433	-8.9%	28,500	73.1%	-3,672	87.1%
Control System Segment	13,515	33.1%	9,322	27.3%	-4,192	-31.0%	10,500	26.9%	-1,177	88.8%
Adjustment	-61	-	-56	-	4	-	0	-	-56	-
Gross profit	13,953	34.3%	11,837	34.7%	-2,115	-15.2%	13,400	34.4%	-1,562	88.3%
SG&A expenses	12,904	31.7%	10,644	31.2%	-2,260	-17.5%	12,100	31.0%	-1,455	88.0%
Operating income	1,048	2.6%	1,192	3.5%	144	13.8%	1,300	3.3%	-107	91.7%
Information System Segment	3,011	11.0%	2,435	9.8%	-575	-19.1%	2,500	8.8%	-64	97.4%
Control System Segment	-306	-2.3%	433	4.7%	739	-241.6%	700	6.7%	-266	61.9%
Adjustment	-1,656	-	-1,676	-	-19	-	-1,900	-	-	-
Ordinary income	1,374	3.4%	1,390	4.1%	16	1.2%	1,300	3.3%	90	107.0%
Net income attributable to owners of the parent	502	1.2%	785	2.3%	283	56.2%	800	2.1%	-15	98.1%
Depreciation	1,661		2,085		424		1,850		-235	112.7%
R&D expense	3,060		1,578		-1,482	-48.4%	2,200		-622	
Information System Segment	2,240		1,470		-770	-34.4%	1,900		-430	
Control System Segment	820		108		-712	-86.8%	300		-192	
Breakdown of segment sales										
Information System Segment										
Equipment	16,698		14,413		-2,285					
Service	10,562		10,414		-148					
Control System Segment										
Units and components	8,413		6,261		-2,152					
Pachislot machines and other equipment	5,102		3,062		-2,040					

	End-March 2017 results	End-March 2018 results	YoY change	
			YoY change	YoY rate of change
Total assets	46,828	43,564	-3,264	-7.0%
Total equity	29,151	29,251	99	0.3%
Equity ratio	62.3%	67.1%	4.8pt	-

Source: Prepared by FISCO from the Company's materials

Financial results trends

The results by segment were as follows.

(1) Information System Segment

Both sales and profits slipped with sales off 8.9% YoY to ¥24,827mn and profit down 19.1% to ¥2,435mn, substantially missing forecasts. Sales volume for the BiGMO PREMIUM and IL-X series that disclose information to enthusiasts was higher than in the previous fiscal year, even with ongoing cautious investment stances at pachinko halls amid uncertainty about industry prospects, thanks to increase in new customers (*1) and acquisition of demand with the effect of new products (*2). Nevertheless, fewer new openings and large-scale renovations weighed heavily on sales volume in CR units (mainly the new VEGASIA III) released in June 2017) and hall computer and prize management systems, undermining segment results.

*1 Includes new transactions with operators of major pachinko hall chains.

*2 Replacement proposals with BiGMO PREMIUM II and IL-X released in December 2017.

In earnings, operating margin dropped to 9.8% (vs. 11.0% in FY3/18), despite decline in R&D expenses (through revisions to the development plan) and cutbacks in sales promotion costs, and advertising and promotional expenses, because these benefits were not enough to fully offset profit shortfall from lower sales.

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 in which the Company is working hard to expand, rose 4.1% YoY to ¥4,312mn.) The Company also achieved solid results in forward-looking activities, such as the new CR-unit VEGASIA III (*1) with innovative functions, and Fan-SIS (disclosure service covering nationwide fan trends) (*2) that supports more detailed customer analysis. While it needs some time to expand sales, the Company appears to have secured firm footing for income contributions from FY3/19.

*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 its contributions to 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

Earnings climbed sharply (restoring a profit) on lower sales with a 31.0% YoY decline in net sales to ¥9,322mn and ¥433mn in profit (vs. a ¥306mn loss a year earlier). (These results missed forecasts.)

Display unit and control unit sales volumes dropped significantly because of delays in development schedules and releases from changes in machine type factoring new regulations at amusement equipment firms, along with sluggish new sales volume in the amusement equipment market. Proprietary pachislot amusement machines slightly exceeded the plan at about 5,500 units, but this was considerably less than the previous year's deployment (about 12,300 machines).

Earnings, on the other hand, improved because of lower sales commission fees for proprietary pachislot amusement machines, substantial decline in R&D expenses (less than expected) on postponement of the development schedule, and reversal of allowance for doubtful accounts.

Financial results trends

Sales volume in FY3/18

	FY3/17 results	FY3/18 results	YoY change
Sales volume (Information System Segment)			
Hall computers	76 units	64 units	-12 units
Call lamps			
BiGMO PREMIUM	27,154 units	34,275 units	7,121 units
REVOLA	48,156 units	32,771 units	-15,385 units
IL-X series	22,638 units	32,265 units	9,627 units
VEGASIA CR unit	65,862 units	53,600 units	-12,262 units
Facial recognition system	12 halls	34 halls	22 units
Sales volume (Control System Segment)			
Display unit models	7 models	6 models	-1 models
Units sold	69,937 units	51,106 units	-18,831 units
Pachislot machine models	2 models	2 models	0 models
Units sold	12,300 units	5,500 units	-6,800 units

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

We have a favorable view of FY3/18 results in light of these trends, despite the setback from shortfall in sales readily affected by external conditions, given income support from growth in MG service income (this trend signals steady conversion to a profitable income structure). While full-fledged sales growth is likely to take some time, we think the Company clarified the general direction of its business with releases of revolutionary products and services and the start of transactions with major chain stores.

■ Outlook

Expecting higher sales and profits on reinforced sales of new products as the market recovers from difficult conditions

For FY3/19, the Company forecasts increase in sales and profits, with net sales at ¥35,000mn (+2.7% YoY), operating income at ¥1,300mn (+9.0%), ordinary income at ¥1,400mn (+0.7%), and net income attributable to owners of the parent at ¥800mn (+1.9%).

While Control System Segment sales are likely to weaken again, the overall outlook calls for a boost from the Information System Segment with pick-up in sales on reinforced activities in new products and services* in the second half of the fiscal year. In earnings, the Company expects improvement in operating margin to 3.7% (vs. FY3/18's 3.5%), even with increase in SG&A expenses led by advertising and promotion cost and consignment costs, on the higher sales effect and better efficiency in the development process (Control System Segment).

* Feature enhancements that place emphasis on "understandability and easy viewing" in BiGMO PREMIUM II, REVOLA, IL-X3, and other machines that disclose information, and Fan-SIS (data disclosure service on nationwide fan trends) proposals and reinforced sales of the VEGASIA III CR unit required in deployment of this service

Outlook

We think the Company is capable of attaining its targets, even with continuation of difficult market conditions, on likely strengthening of replacement demand in peripheral equipment with customer draw amid market deployment of amusement equipment that meets new regulations and expansion of transactions with major chains and others added as customers in FY3/18. However, it is important to recognize that the outlook is skewed toward 2H (factoring in a 16.7% YoY decline in 1H sales).

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 respond 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 achieve new value creation by leveraging data analysis and planning and development capabilities.

While it is likely to be difficult to attain quantitative goals due to various external factors, we think the Company's steady advances in the strategic direction described below are positive.

Medium-term management plan

	FY3/18 results		FY3/19 forecast		FY3/20 targets	
		Ratio to sales		Ratio to sales		Ratio to sales
Sales	34,093		35,000		57,000	
Information System Segment	24,827	72.7%	26,000	74.3%	38,000	66.7%
Control System Segment	9,322	27.3%	9,000	25.7%	19,000	33.3%
Operating income	1,192	3.5%	1,300	3.7%	4,000	7.0%
Information System Segment	2,435	9.8%	2,400	9.2%	5,000	13.2%
Control System Segment	433	4.7%	800	8.9%	1,000	5.3%
Adjustment	-1,676	-	-1,900	-	-2,000	-
ROE	2.7%		-		7.0%	or over
Sales of management support services	4,312		4,430		4,900	

Source: Prepared by FISCO from the Company's materials

Future strategic direction

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 the new regulations, and Daikoku Denki intends to develop new products and services that will help it bring in new players, and 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 the new 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 systems. 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.

2. Control System Segment

In addition to a growing demand for 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 emphasizing the entertainment aspect, and focus on revitalizing the game environment through creation of games that comply with new rules.
- (2) Promptly respond to the requests of game machine manufacturers to shorten customers' 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.

Future strategic direction

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 new 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 2H, 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. We will be closely monitoring direct contacts beyond just pachinko halls and amusement equipment firms to pachinko and pachislot fans, amusement fans, and new fan segments (such as providing information to members via a smartphone app and efforts to draw people to halls).

Shareholder returns

Plans to pay a ¥40 annual dividend in FY3/19 (same as in FY3/18); likely to have room to raise the dividend over the medium term accompanying profit growth

In FY3/18, the Company decided 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. The Company plans to pay a ¥40 annual dividend in FY3/19 (¥10 interim, ¥30 year -end), the same as in the previous fiscal year.

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. Shareholders (owning 100 or more shares) as of September 30 each year receive points that can be exchanged with products (such as food, beverages, electronic equipment, travel or experiences, or donations to social contribution activities) in accordance with the number of shares owned and length of ownership. The Company's IR official explains that this program has been highly praised by individual shareholders.



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