

Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange First Section and Nagoya Stock Exchange First Section

24-Sept.-2020

FISCO Ltd. Analyst

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FISCO Ltd.

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

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Summary

In FY3/20, sales increased while profits declined, but profit was higher than the initial forecast. As the difficult environment continues, the AI hall computer “X (Kai)” is contributing to earnings

1. Business overview

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 3,504 pachinko halls and supports the Company’s business foundation.

Japan’s pachinko market has been shrinking over the years. In response, the Company has been working to reform its businesses over the medium to long term. Reforms include developing a next-generation hall computer and shifting to a business model more reliant on services that provide recurring revenue. However, with the series of revisions to regulations (including controlled ball payouts, measures against gambling addiction, and replacements with machines under new regulations) having brought the industry to a major turning point, earnings right now remain difficult due to the impact of future uncertainty, along with the impact of the coronavirus pandemic. Meanwhile in June 2019, the Company released the AI hall computer “X (Kai),” the first of its kind in the industry, as the Company started in earnest on its efforts targeting future business expansion. Toward a new era with machines under new regulations, the Company is aiming to increase its market share and boost profitability while helping hall operators improve efficiency and save labor.

2. FY3/20 results

In FY3/20, the Company’s sales increased while profits declined, with net sales up 5.6% year on year to ¥32,922mn and operating income dropping 6.3% YoY to ¥1,431mn. Profit was higher than the initial forecast. Net sales in the Information System Segment grew at a pace that exceeded the forecast. In particular, the newly-launched AI hall computer “X (Kai)” contributed to the increase in net sales. Meanwhile, in the Control System Segment, sales of display and control units declined significantly through 2H, due to factors including the revisions of sales plans by game machine manufacturers in conjunction with the overall decline in sales of new machines in the market. In terms of profits, operating income declined due to an increase in depreciation expenses and sales promotion expenses, but profit exceeded the forecast due to growth in the highly profitable MG Service.

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Summary

3. FY3/21 forecast

The Company's forecast for FY3/21 is for a decrease in sales and profits, with net sales of ¥28,000mn (-15.0% YoY) and operating income of ¥400mn (-72.1%). However, it is necessary to keep in mind that this earnings forecast involves more earnings being booked in 2H. Net sales are expected to decline significantly in 1H due to the impacts of the coronavirus pandemic (closure of pachinko halls and shorter hours of operations, etc.), and the associated cooling of investment appetite. However, the Company expects the market environment to normalize gradually through 2H, and expects net sales to recover. In particular, the Company seems to think that the replacement of machines with machine types that comply with new pachinko industry standards (play time) and M&A by major pachinko hall companies will contribute to the revitalization of the market. In terms of profits, the Company is expecting to post significant losses in 1H, but is forecasting a profit for the full fiscal year. Still, full-year profits are expected to decline significantly year on year.

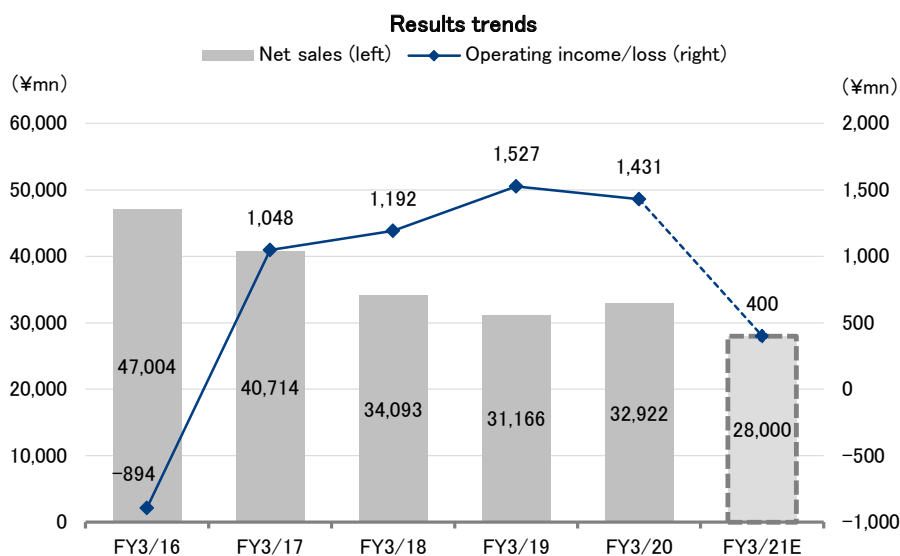
4. Future strategic direction

In the Company's view, regulatory revisions and other changes in conditions surrounding the pachinko industry will, in the medium to long term, represent a good opportunity for the industry to evolve into one that enjoys even wider public support. The Company's policies are focused particularly on expanding market share with its industry-first AI hall computer "X (Kai)" and other next-generation products, as well as on creating new value through its data analytics and planning and development capabilities, which will contribute to industry growth while also leading to improved growth and profitability for the Company itself. In the medium to long-term view, at FISCO we are also keeping a close watch on the Company's efforts to revitalize the industry as a whole, and its M&A action both in and outside the industry.

Key Points

- In FY3/20, net sales increased while profit declined, but profit was higher than expected
- Amid the continued challenging market environment, the new AI hall computer "X (Kai)" contributed to earnings. The MG Service, which the Company is focusing efforts on, also grew steadily
- For FY3/21, the Company is forecasting a decline in both net sales and profits due to the impacts of the coronavirus pandemic and other factors. The forecast is for 1H earnings to decline significantly, but start to recover in 2H
- Toward a new era under machines with new regulations, the Company aims to increase its market share and improve profitability by helping pachinko halls improve their operating efficiency and save labor, as well as by providing new value leveraging data.

Summary



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

Description of businesses

Focuses on hall computers and peripheral equipment for pachinko halls. Aims to further expand its top market share in the industry by promoting the industry's first AI hall computer

While emphasizing on development, production and sales of computer systems for pachinko halls, the Company also develops, manufactures and sells display and control units for pachinko and 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 3,434 halls (giving it a share of about 35.6%) and around 1,867,000 amusement machines are installed (about 44.5% share).

The Company's two main businesses are the Information System Segment and the Control System Segment, but the Information System Segment provided 80.0% of its net sales in FY3/20 and has been the main source of stable profit in the past few years.

Description of businesses

1. Information System Segment

The Information System Segment offers a complete line of information equipment and services necessary to support operational management at pachinko halls. It sells hall computers, which are the core of the system used at pachinko halls, and peripheral equipment, such as prize management systems and information disclosure systems. The segment also offers 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. These computers are supported by peripheral equipment, such as prize management system and information disclosure system. They also serve as the foundation of the membership-based information provision service. Introducing a hall computer provides the advantage that peripheral equipment and support services can be sold as a package deal. The Company has been aiming to transition to a business model that provides recurring revenue by collecting membership fees such as its aftersales management support services and information provision service in addition to information equipment sales.

In June 2019, the Company released the industry's first AI hall computer "X (Kai)" for the first time in 12 years after the release of a hall computer "CII." Based on the concept of a "hall computer that teaches," the main feature of this AI hall computer is that it will guide pachinko hall operators to the optimal solutions by utilizing the Company's big data and having AI automatically analyze the data. By helping pachinko hall operators improve their operating efficiency and save labor, the Company aims to expand its market share and increase its profitability.

Hall computers and main peripheral equipment



Source: Prepared by FISCO from 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 components used for pachinko and pachislot machines for amusement machines manufacturers. Applying the knowledge obtained from analyzing data from pachinko machines as a hall computer manufacturer for many years, the segment serves as a development partner for the content as well, moving beyond the scope of a machine manufacturer by proposing specs based on the trends of popular models and acquiring copyrights for popular characters. In particular, from FY3/21 (2H), the Company plans to leverage the hardware and software technologies it has cultivated to advance bundled contract development of pachislot machines and expand the business domains it sells products in, thereby ramping up the pachislot business in earnest.

■ 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 necessity for information disclosure. Thus, it has been able to provide added value from various aspects to management of pachinko halls.

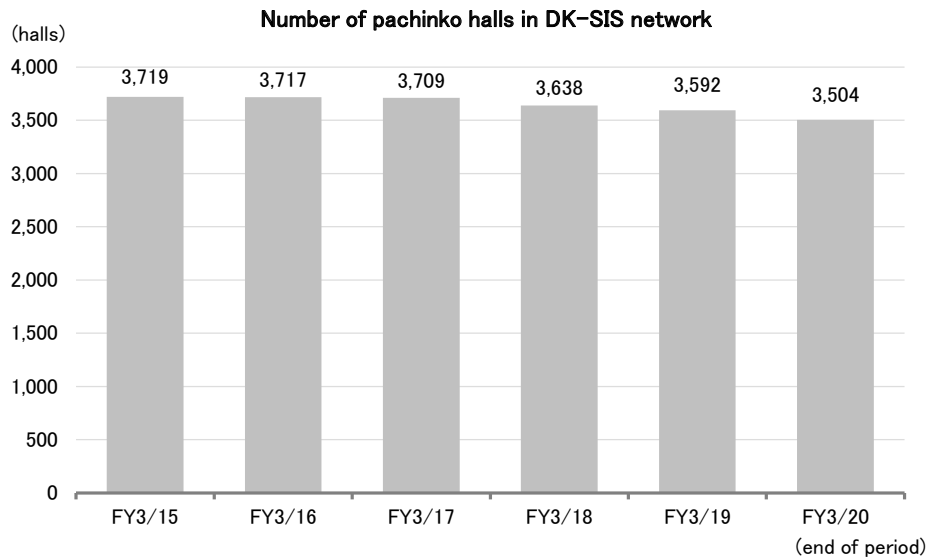
Launched in 1974, the Company's first hall computer enabled the managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic data, but with the introduction of hall computers, data-based hall management became the de facto standard. In subsequent years, the Company has been introducing information equipment with revolutionary functions which is the first of its kind in the pachinko industry consecutively. 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, and hereby improved the profitability of pachinko halls.

In June 2019, the Company released the industry's first AI hall computer "X (Kai)." This AI hall computer will greatly help pachinko hall operations, for which shortage of manpower is an issue, by improving operating efficiency and reducing necessary labor by having AI automatically analyze big data that the Company possesses.

Company strengths

2. Strong network of pachinko halls

Another advantage the Company has is its membership-based information provision service, DK-SIS. This service creates an information network connecting the Company and member pachinko halls, and processes and analyzes the daily operational information of pachinko halls recorded by hall computers and gives feedback to hall managers to help their operations. It enables the managers to conduct effective hall operation utilizing valuable external information, including nationwide pachinko machine information and operational data broken down by machine model. 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 contribute to improve the Company's brand as a leading company, and utilized to its strategic proposal and sales activities to amusement machines manufacturers. Membership totaled 3,504 halls at the end of March 2020 with 1.47mn managed machines (35.1% share in managed machines). 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.



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 expense. 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 (hereafter, "MG services") which have been promoted by the Company as a recurring revenue business model have grown and enabled funding of R&D at a high level while maintaining stable segment operating income, and investment risk has been limited. The Company's ability to balance large profits from its existing businesses with heavy investment in businesses for the future growth allows it to produce value on a continuing basis. From FY3/18 onwards, R&D expenses have continuously been on the decline because of a lull in major investment in the next-generation hall computer, etc. Going forward, the Company intends to proactively invest its R&D expenses in fields including data analysis features related to AI hall computer "X (Kai)," which has already been introduced in the market.

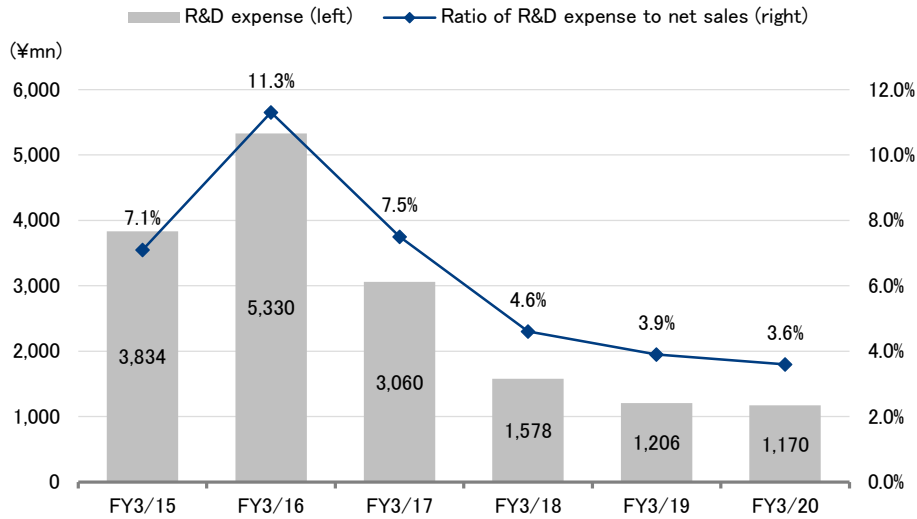
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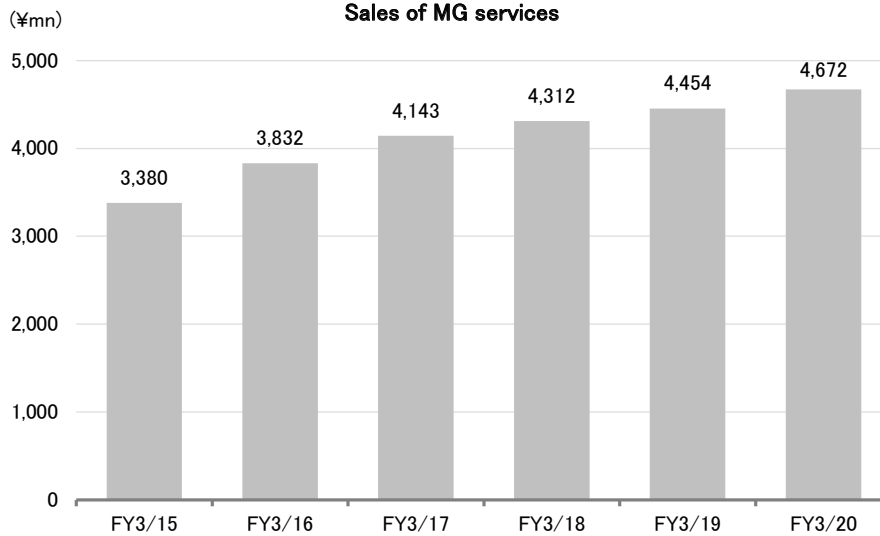
Company strengths

Research and development expense and ratio of expense to net sales



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

Sales of MG services



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

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Industry environment

Uncertainty remains for the time being due to the replacement of machines under new regulations and the coronavirus pandemic, but in the medium term it is a good opportunity for transformation

Japan's pachinko industry has been experiencing a challenging environment over the past few years, reflecting the 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. Since the Regulations Regarding the Certification of Game Machines and Examination of Model (enforced on February 1, 2018, hereafter, "new regulations")* were officially announced on September 4, 2017, the industry has remained in a state of flux due to a pessimistic view and uncertainty toward the industry. As for pachislot machines in particular, the certification of mainstay models with strong gambling elements which had been the breadwinners for the management of pachinko halls had expired at the end of December 2019 (deadlines for removing), and this will have a considerable impact on pachinko halls' business. This, combined with the impacts of the coronavirus pandemic (pachinko hall closures and shortened operating hours) since the start of 2020, has made the future outlook increasingly uncertain.

* Among the new regulations are restrictions on the maximum number of balls that can be paid out and clearly defined standards for "controlled machines." However, although more than two years have passed since the enforcement of the new regulations, there are still a large number of machines that continue to operate while relying on previous regulations. Pachinko hall operators are worried that their earnings will decline and they will be faced with difficult decisions about the timing of equipment replacement and other matters. This has likely prolonged their diminished investment appetite (cautious stance).

On the other hand, the deadline for completely removing machines under the previous regulations was extended for one year (until the end of January 2021) due to the coronavirus pandemic, and the replacement with the machines under new regulations*¹ is expected to progress gradually in stages. Amusement machines with new game features (play time, etc.)² will be released based on the revisions to the Criteria for Interpretation of Technological Standards enacted in January 2020, and the associated establishment of internal regulations in the Japan Pachinko Machine Industry Association. With this, there are hopes that the market will be revitalized by the demand for replacements of amusement machines. In addition, as the machines under the previous regulations are being removed and the machines under new regulations are introduced to the market in the future, it is believed that investment (to draw in customers) as pachinko halls compete to win customers will be sparked, and it is also expected that the efforts to save labor will be activated to resolve the labor shortage in the operation of pachinko halls and that there will also be investments made to address the move to eliminate smoking in pachinko halls as a part of the Health Promotion Law that went fully into effect in April 2020.

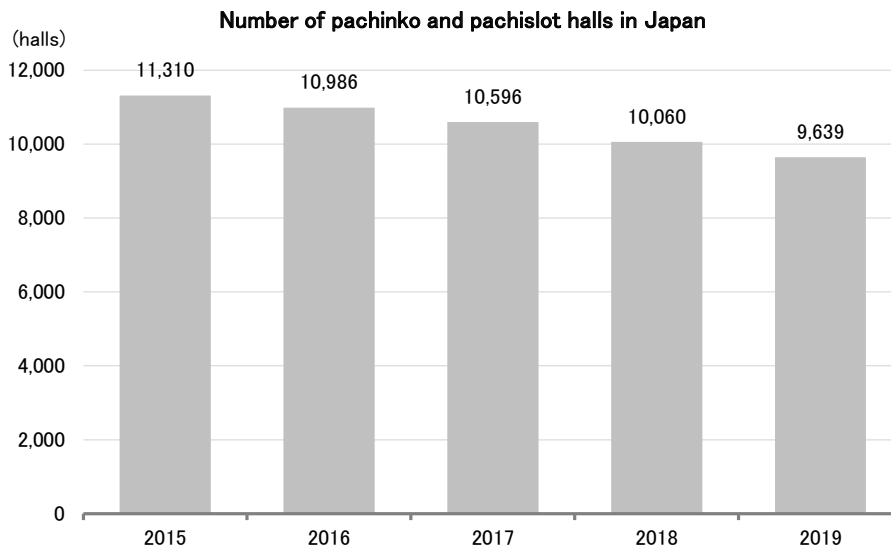
*¹ According to Company estimates, the rate of deployment of machines under new regulations as of the end of July 2020 was about 48% for pachinko and about 34% for pachislot. Deployment for pachislot, where earnings from type-6 machines are weak, is particularly slow.

*² "Play time" is a system (rescue measure) whereby the machine enters a shortened time mode (a function that efficiently rotates balls without reducing the number of balls up to a certain number of times) if the player did not have a big win during normal play time (low probability time) up to a certain number of rotations. With the recent industry regulations, new functions such as "play time" have been added, and the breadth of game features of amusement machines has expanded significantly.

Industry environment

According to surveys by the National Police Agency, the number of pachinko halls in Japan declined at an average annual rate of 3.0% from 2011 to 2019. In particular, there is a noticeable decline in new hall openings due to the impact of the new regulations and other factors. In end of December 2019, the number of halls was 9,639 (down 421 YoY). It is estimated that the Company served about 3,434 of these halls based on the fact that it held approximately 35.6% of the Japanese market for hall computers. The Company’s customer halls are often high-end, large pachinko halls that are the top performers in their respective local market which exceed the market average in size*. Average amusement machines volume per store is 544 machines, surpassing the average at other companies (375 machines) by about 45%. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. As the Company moves toward a new era with machines under new regulations, we expect an excellent opportunity for the Company to expand business once investment appetites recover mainly at large halls.

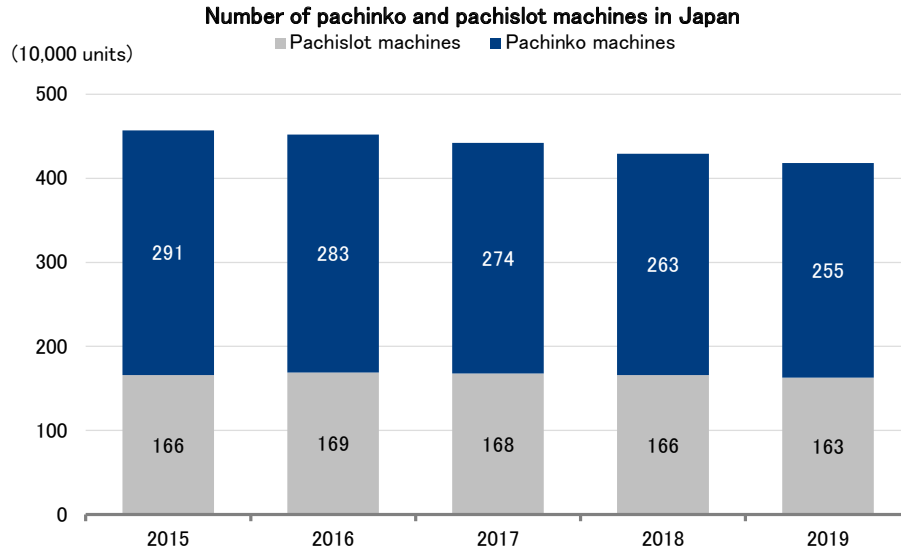
* The Company holds a roughly 55.3% share in mid-sized to larger sites (501 to 1,000 machines) and around 72.3% in large sites (1,001 or more machines). Its market presence is higher at large sites.



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

Meanwhile, although the number of amusement machines is on a downward trend (the decline in pachinko machines is particularly striking), the number of machines per hall is increasing, indicating that halls are becoming larger. As discussed above, larger pachinko 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.

Industry environment



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

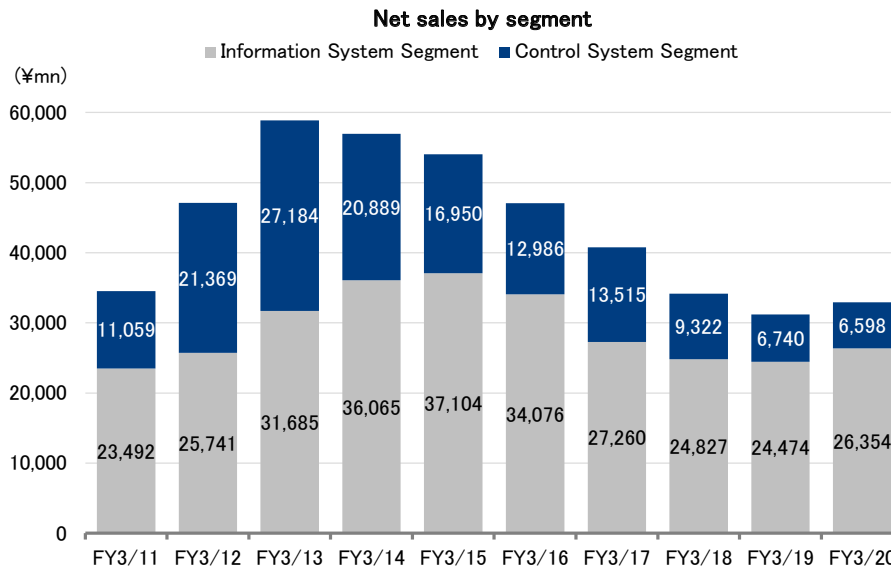
Financial results trends

As the industry enters a period of transition, earnings have been on downward curve, but the Company is establishing a foundation for sustainable growth eyeing the future

1. Performance over the past fiscal years

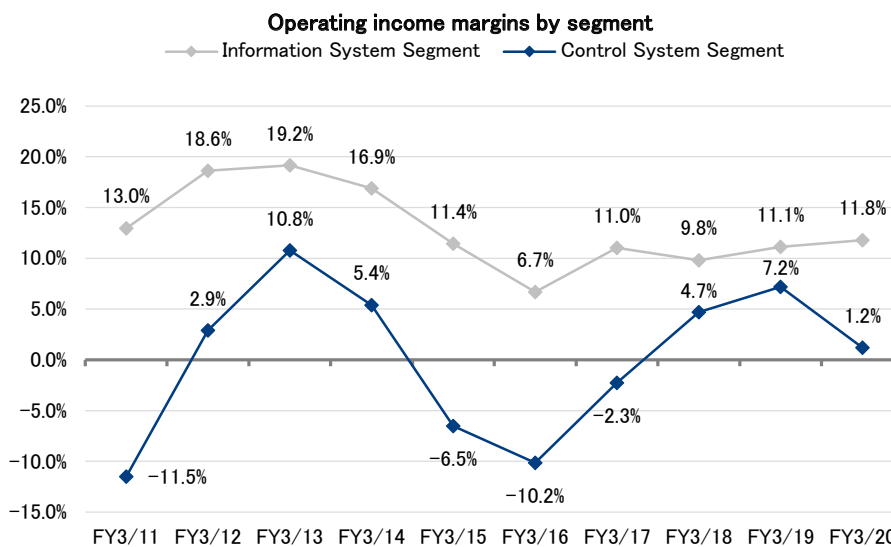
Looking back at past results, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake in FY3/11. Its results rebounded in afterwards, even though the pachinko industry continued to contract. This recovery was mainly led by the Information System Segment, which holds high market shares for its products. Net sales in this segment reached consecutive record highs in FY3/13–FY3/15, supporting the Company's overall performance. However, net sales have been weak since FY3/16 due to the impacts of negative factors in the industry (self-regulatory action, collecting and removing of machines, and uncertainty related to new regulations), as well as the impacts of the coronavirus pandemic since the start of 2020.

Financial results trends



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

The Information System Segment has become the source of profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in R&D for next-generation products from FY3/14 to FY3/17, profit margins have declined, but considering the size of the investment, margins are still high. However, although R&D for next-generation products has run its course for the meantime since FY3/18, profit margins have not completely returned to the previous high levels due to factors including the stagnation in net sales. Meanwhile, steady progress in the conversion to a recurring revenue business model, including growth in the MG Service business, has been supporting income.



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

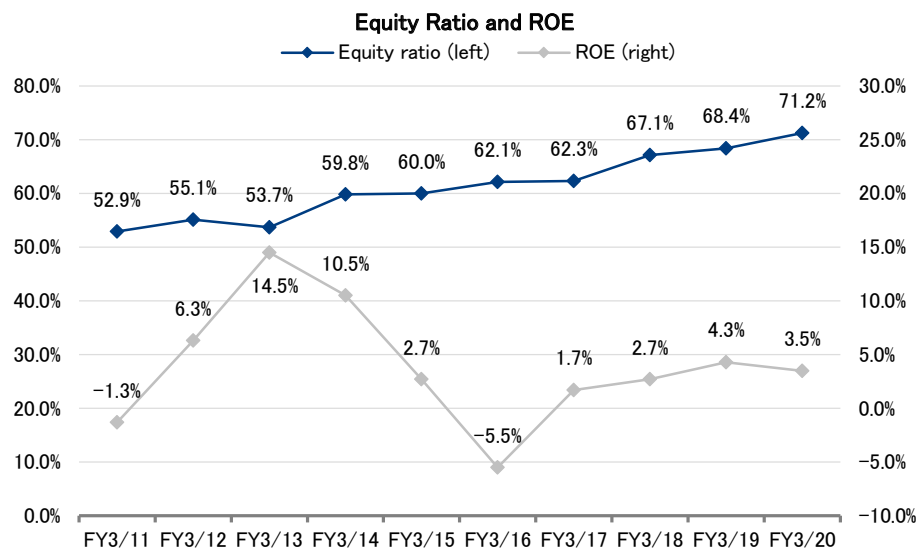
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Financial results trends

In terms of financial indicators, the Company's equity ratio, a measure of financial stability, has been rising, reflecting the accumulation of retained earnings, reaching a high level of 71.2% in FY3/20. The current ratio, which indicates the ability to make payments in the short term, was 235.4% in FY3/20, mainly due to large holdings of cash and deposits, as the Company's robust financial base is a strength not only for business continuity, but also as a source for powering future growth. 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 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

2. Overview of FY3/20 results

In FY3/20, the Company saw an increase in sales but a decline in profits, posting net sales of ¥32,922mn (+5.6% YoY), operating income of ¥1,431mn (-6.3%), ordinary income of ¥1,674mn (-4.2%) and net income attributable to owners of the parent of ¥1,061mn (-16.0%). Net sales fell slightly short of the Company's forecast, but profits were well above its initial guidance.

Net sales in the Information System Segment grew at a pace well above plan. The replacement with the newly launched AI hall computer "X (Kai)" as a system upgrade contributed greatly to the increase in net sales. The information disclosure terminal "REVOLA" and other products also performed well. Meanwhile, net sales in the Control System Segment declined, falling well short of the forecast. In the Control System Segment, sales of display and control units declined significantly through 2H, due to factors including the revisions of sales plans by game machine manufacturers in conjunction with the overall decline in sales of new machines in the market.

In terms of profits, despite the increase in gross profit due to the rise in net sales, operating income declined due to an increase in depreciation expenses and sales promotion expenses (exhibitions, etc.), and the operating margin also declined to 4.3% (compared to 4.9% in FY3/19). However, profit was higher than initial forecast due to the large growth in profits in the Information System Segment due to growth in the MG Service.

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Financial results trends

In terms of financial condition, total assets declined 2.3% from the end of FY3/19 to ¥42,702, while equity increased 1.7% YoY to ¥30,406mn due to the accumulation of retained earnings. As a result, the equity ratio increased to 71.2% (compared to 68.4% at the end of FY3/19).

Overview of FY3/20

	FY3/19		FY3/20		Change		FY3/20		vs. forecast	
	Results	Ratio to sales	Results	Ratio to sales	%	change	Initial forecast	Ratio to sales	Achievement rate	
Net sales	31,166		32,922		1,756	5.6%	34,000		-1,077	96.8%
Information System Segment	24,474	78.5%	26,354	80.0%	1,880	7.7%	26,000	76.5%	354	101.4%
Control System Segment	6,740	21.6%	6,598	20.0%	-142	-2.1%	8,000	23.5%	-1,401	82.5%
Adjustment	-49	-	-31	-	18	-	0	-	-31	-
Gross profit	11,673	37.5%	12,040	36.6%	367	3.1%	12,100	35.6%	-59	99.5%
SG&A expenses	10,145	32.6%	10,608	32.2%	463	4.6%	10,900	32.1%	-291	97.3%
Operating income	1,527	4.9%	1,431	4.3%	-96	-6.3%	1,200	3.5%	231	119.3%
Information System Segment	2,725	11.1%	3,104	11.8%	379	13.9%	2,500	9.6%	604	124.2%
Control System Segment	488	7.2%	78	1.2%	-410	-83.9%	700	8.8%	-621	11.2%
Adjustment	-1,686	-	-1,751	-	-65	-	-2,000	-	248	-
Ordinary income	1,748	5.6%	1,674	5.1%	-73	-4.2%	1,250	3.7%	424	134.0%
Net income attributable to owners of the parent	1,263	4.1%	1,061	3.2%	-202	-16.0%	800	2.4%	261	132.7%
Depreciation	1,742		2,212		469		2,380		-167	92.9%
R&D expense	1,206		1,170		-36		1,210		-40	
Information System Segment	1,124		939		-185		1,050		-111	
Control System Segment	82		230		148		160		70	
Breakdown of net sales										
Information System Segment										
Equipment	13,871		15,456		1,585		15,157		299	
Service	10,603		10,898		295		10,843		55	
Control System Segment										
Units and components	5,427		5,159		-268		6,280		-1,121	
Pachislot machines and other equipment	1,313		1,439		126		1,720		-281	

	End of FY3/19	End of FY3/20	YoY	
				% change
Total assets	43,729	42,702	-1,026	-2.3%
Total equity	29,898	30,406	508	1.7%
Equity ratio	68.4%	71.2%	2.8pt	-

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

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Financial results trends

The results by segment were as follows.

(1) Information System Segment

Both sales and profit increased, with net sales up 7.7% YoY to ¥26,354mn, while segment operating income rose 13.9% to ¥3,104mn, exceeding plans. The newly launched AI hall computer “X (Kai)” (replacements from existing hall computers) greatly contributed to the increase in net sales due to the addition of new functions and the strengthening of proposal activities. Despite the struggles with introductions of new hall computers amid the challenging market conditions, sales of the information terminal “REVOLA”^{*1} were strong, while sales of the CR unit “VEGASIA” series^{*2}, which performed well in 1H, were higher than forecast in 2H despite struggling due to the impact of the decline in new pachinko parlors and the decline in large-scale renovations. Profits increased significantly as a result of the growth of the highly-profitable MG Service^{*3} and high-value-added proposal-based sales, along with other factors, and the segment operating income margin increased to 11.8% (compared to 11.1% in FY3/19).

*1 Its sophisticated and stylish form as well as diverse contents have been well received in the market.

*2 The most distinguishing feature is its built-in facial recognition camera that allows pachinko hall managers to get a good handle on player trends. In particular, customers have highly praised the realization of ideal model composition through data analysis and enhanced security features.

*3 MG Service sales have grown steadily, increasing 4.9% YoY to ¥4,672mn, and have helped prop up overall income. In particular, the Company is focusing on the spread of the trading area analysis service “Market-SIS” which shows the customer status in the surrounding area.

(2) Control System Segment

Net sales and segment profit declined YoY, with net sales falling 2.1% YoY to ¥6,598mn, and segment operating income declining 83.9% YoY to ¥78mn. Both fell short of the Company’s forecasts. Performance was strong in 1H, but certification of mainstay models which had been the breadwinners for pachinko halls expired at the end of December 2019 (deadline for removing them), and this combined with the impacts of the coronavirus pandemic resulted in an unstable market environment in 2H. In particular, sales of components for pachinko machines were strong, but the revisions of sales forecasts by amusement machine manufacturers in conjunction with the decline in overall sales of new machines in the market as well as the increase in the reuse rate, resulted in a major drop in sales of display and control units in 2H. The decline was also caused by the delay in the release of new machine types which had been expected. Profits fell significantly, due to the dip in sales of display units and the increase in R&D expenses, resulting in a segment operating income margin of 1.2% (compared to 7.2% in FY3/19).

Sales volume in FY3/20

	FY3/19	FY3/20	YoY change
Sales volume (Information System Segment)			
Hall computers*	84 units	57 units	-27 units
Call lamps			
BIGMO PREMIUM	32,686 units	33,979 units	1,293 units
REVOLA	32,972 units	39,450 units	6,478 units
IL-X series	18,887 units	9,038 units	-9,849 units
VEGASIA CR unit	52,711 units	51,849 units	-862 units
Sales volume (Control System Segment)			
Display unit models	12 models	10 models	-2 models
Units sold	73,693 units	61,251 units	-12,442 units

*Number of hall computers does not include the number of system upgrades to “X (Kai).”

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

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Financial results trends

3. Summary

For the above reasons, looking back at FY3/20, the Company performed well in 1H amid the challenging market environment, but operating performance slowed down in 2H, as the Company was unable to indicate a clear path towards recovery. However, in the Information System Segment, we can highly evaluate the fact that the AI hall computer “X (Kai),” which will be the Company’s trump card going forward, has gotten off to a good start, as well as the fact that the Company achieved an increase in profit exceeding the forecast as a result of growth in high-value-added new products. In particular, as uncertainty about the future increases, partially due to the impacts of the coronavirus pandemic, the fact that the market highly evaluated the data analytics and security functions, which are the Company’s strengths, is a bright sign for the future.

■ Outlook

Based on the impacts of the coronavirus pandemic, the Company is forecasting a decline in net sales and profit in FY3/21. Expecting a large decline in 1H, but a recovery trend in 2H

1. FY3/21 forecast

In its forecast for FY3/21, the Company is projecting a decline in both sales and profits, with net sales of ¥28,000mn (-15.0% YoY), operating income of ¥400mn (-72.1%), ordinary income of ¥500mn (-70.1%), and net income attributable to owners of the parent of ¥300mn (-71.7%). It must be noted this forecast is weighted towards 2H results*.

* While the Company expects net sales of ¥11,000mn and operating loss of ¥1,300mn in 1H, it is expecting a recovery in 2H, with net sales of ¥17,000mn and operating income of ¥1,700mn.

Net sales are expected to decline significantly in 1H due to the impacts of the coronavirus pandemic (closure of pachinko halls and shortened hours of operations, etc.), and the associated cooling of investment appetite. However, the Company expects the market environment to gradually normalize through 2H, and looks for net sales to recover. In particular, the Company seems to think that the replacements with machine types compliant with new regulations (play time) and M&A by major pachinko hall companies will contribute to the revitalization of the market. Looking by segment, the expectation is that both the Information System Segment and the Control System Segment will see large declines in 1H, while the Information System Segment will see a decline in sales for the entire year, while the Control System Segment will see an increase in net sales.

In terms of profits, the Company expects to post a large loss in 1H. For the full year, the Company expects to post a profit, but is projecting a large YoY decline in profit.

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Outlook

FY3/21 forecast

	FY3/20		FY3/21		YoY change	
	Result	Ratio to sales	Forecast	Ratio to sales		% change
Net sales	32,922		28,000		-4,922	-15.0%
Information System Segment	26,354	80.0%	21,000	75.0%	-5,354	-20.3%
Control System Segment	6,598	20.0%	7,000	25.0%	402	6.1%
Adjustment	-31	-	-	-	-	-
Gross profit	12,040	36.6%	10,500	-	-1,540	-
SG&A expenses	10,608	32.2%	10,100	-	-508	-
Operating income	1,431	4.3%	400	1.4%	-1,031	-72.1%
Information System Segment	3,104	11.8%	1,700	8.1%	-1,404	-45.2%
Control System Segment	78	1.2%	600	8.6%	522	-
Adjustment	-1,751	-	-1,900	-	-	-
Ordinary income	1,674	5.1%	500	1.8%	-1,174	-70.1%
Net income attributable to owners of the parent	1,061	3.2%	300	1.1%	-761	-71.7%
Depreciation	2,212		2,119		-93	
R&D expense	1,170		753		-417	
Information System Segment	939		670		-269	
Control System Segment	230		83		-147	

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

At FISCO, we appreciate the fact that the Company's earnings forecasts are values that have been reasonably estimated at the current point in time based on the negative factors (impact of the coronavirus pandemic) and positive factors (replacement demand for play time machines, etc.), but we recognize that it is necessary to make cautious decisions based on the fact that uncertainty in the market remains high. In particular, we feel that the most important issue is how the Company can curb the current (1H) decline in earnings, and create a recovery scenario towards 2H. We will keep a close watch on the revitalization in the market stemming from the transition to the "play time" machine types, industry consolidation, and other developments.

2. 1Q FY3/21 operating results

In 1Q FY3/21, net sales declined 41.9% YoY to ¥5,311mn, operating loss was ¥331mn (compared to operating income of ¥787mn in 1Q FY3/20), ordinary loss was ¥277mn (compared to ordinary income of ¥829mn in 1Q FY3/20) and net loss attributable to owners of the parent was ¥211mn (versus net income of ¥546mn in 1Q FY3/20).

In the Information System Segment, net sales were ¥4,115mn (-45.6% YoY), and segment income was ¥157mn (-87.3%). In addition to the challenging market environment from the previous fiscal year, the requests to suspend pachinko parlor business dealt the final blow, and with capital investment limited because of delays in the opening of new parlors and the cancellation of renovation plans, sales of mainstay products fell far short of sales in the same quarter of the previous fiscal year. Sales of the MG Service fell due to the period of suspension of the monthly fee-based service for closed pachinko parlors.

In the Control System Segment, net sales declined 23.9% YoY to ¥1,200mn, while segment loss was ¥83mn (compared to segment profit of ¥1mn in 1Q FY3/20). In 1Q, sales of components for pachinko machines were favorable, but the number of amusement machines sold in the market overall decreased greatly under the impact of the pachinko parlor closures, resulting in a YoY decline in sales of display units and control units.

Future strategic direction

In addition to increasing market share with the AI hall computer “X (Kai),” the Company aims to generate new value utilizing its data analytics and planning and development capabilities

In the Company’s view, regulatory revisions and other changes in conditions surrounding the pachinko industry will, in the medium to long term, represent a good opportunity for the industry to evolve into one that enjoys even wider public support. The Company’s policies are focused particularly on expanding market share with its AI hall computer “X (Kai)” and other next-generation products, as well as on creating new value through its data analytics and planning and development capabilities, which will contribute to industry growth while also leading to improved growth and profitability for the Company itself.

1. Information System Segment

While investment appetite in the pachinko market is expected to remain depressed for a little while longer, despite the fact that the deadline for the complete removal of machines under the previous regulations was extended by one year, amusement machines compatible with the new game functions due to “play time” and other factors are expected to be released, and the Company’s strategy is to capture such replacement demand. In particular, the Company will focus on AI hall computer “X (Kai)” proposals, and promote the replacement of existing hall computers, as well as introduce products equipped with various contents that are compatible with new game functions like “play time,” thereby contributing to improved earnings at pachinko halls. Furthermore, by promoting the MG Service (especially the commercial area analysis service “Market-SIS”), the Company will help pachinko hall operators increase competitiveness and save labor, thereby securing its own customers and stabilizing its own operating performance. Additionally, on top of measures amid the coronavirus pandemic*1, the Company plans to release new products that match the changing times, including products that help hall operators save labor*2 and products that address the prohibition of smoking in pachinko halls*3.

*1 The Company has added a function that helps prevent the spread of the novel coronavirus to the call lamp. Fans are notified about machines that have been cleaned and disinfected, and machines that need to be cleaned and disinfected are also notified by a light.

*2 The Company released a wearable device (WW-01) for hall staff to use. This is a smartwatch-type device with a large LCD screen that hall staff can wear to use. It conveys various information such as call notices from fans, abnormalities or unauthorized investigations of game machine data by vibration of the device and on-screen display each time it occurs.

*3 When leaving machines to smoke, fans use the seat-leaving operation on each machine such as the BIGMO PREMIUM, REVOLA and VEGASIA machines. Fans can smoke with peace of mind while looking at their smoking time on the “DISMO” signage installed in the “Smoking Ark” smoking booth. Staff can respond quickly with an incoming voice notification from a game machine where the fan has exceeded the smoking time limit.

2. Control System Segment

In addition to the growing demand for reduced development costs for pachinko and pachislot machines, demand for new proposals to address future changes in the market environment is rising, and as planning capabilities have become increasingly important, the Company 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. In particular, the segment will revise its development system and further improve operating efficiency, as well as use the hardware and software technologies it has cultivated over the years to advance bundled contract development of pachislot machines and expand the business domains it sells products in (start the pachislot business in earnest), as well as utilize the Information System Segment’s DK-SIS data and Fan-SIS data to promote project proposals that generate new gaming value.

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Future strategic direction

3. Strengthening the R&D system

On April 1, 2020, the Company established the R&D Department which will handle basic research on new technologies from a medium- to long-term perspective, and studying new businesses, along with other efforts. Aiming to support technologies that will lead to future business expansion, the department will construct a technology foundation in order to introduce AI technology and other cutting-edge technologies into the Company. The Company will work on promoting open innovation, and on accumulating technologies and building alliances with outside entities. In addition, the Company has incorporated the Business Development Office into the R&D Department, where it will continue to explore and conceive new business opportunities.

Even though the pachinko industry is approaching a major turning point that renders the Company's surrounding profit conditions uncertain from a medium- to long-term perspective, the successful launch of AI hall computer "X (Kai)" aimed at future growth, in addition to its high value-added next-generation products, will give it a major advantage over its competitors. In particular, we see the Company's MG services and value proposal through its unique services and data analysis as 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 the Company 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 AI hall computer "X (Kai)" and raise market share.

We believe that for the time being, it is necessary to cautiously assess net sales growth, which is readily affected by the external environment, but we should also focus on improvement in profitability through development of products and services that respond to changes in market conditions and expansion of the MG service. From a medium- to long-term perspective, we also anticipate results from the Company's efforts to revitalize the industry as a whole, as it faces a new age with the complete transition to machines under new regulations. We will also keep watch on the Company's efforts to engage directly with pachinko and pachislot fans, amusement fans and new fan segments (including provision of member information via a smartphone app and initiatives that bring people to halls) as well as with pachinko halls and amusement machines manufacturers. Further, as the Company completes a round of major investment in next-generation hall computers and begins collecting on that investment, we need to also monitor its M&A moves, including those outside the industry. Because the Company's expertise in utilizing data can be extended in other areas, we believe M&A will be an important strategy, both for securing a new source of profits and for distributing risk.

■ Shareholder returns

Plans to pay a ¥40 annual dividend in FY3/21 (same as in FY3/20); likely to have room to raise the dividend over the future accompanying profit growth

As initially planned, in FY3/20 the Company paid an annual dividend of ¥40 per share (¥10 interim and ¥30 year-end). For FY3/21, the Company plans to pay an annual dividend of ¥40 per share (¥10 interim, ¥30 year-end), the same amount as in FY3/20. Given the Company's policy of supplementing its minimum dividend with dividends dependent on earnings, at FISCO we see the likelihood of future increases in annual dividends as the Company's profits grow.

The Company had a system of awarding gifts to shareholders in order to make its shares more attractive to investors and to encourage shareholders to keep their holdings over the medium to long term, but on August 7, 2020 the Company announced that it was abolishing this shareholder gifts system. This decision was made based on both the expectation that the impacts of the coronavirus pandemic would result in a continued uncertain business environment in the pachinko industry, along with the forecast for a significant decline in profit in FY3/21. The Company has decided to emphasize dividends as a means of returning profits to shareholders.



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