

Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange Prime Market and Nagoya Stock Exchange Premier Market

15-Feb.-2023

FISCO Ltd. Analyst

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FISCO Ltd.

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

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Summary

Sales and profits declined in 1H FY3/23 but topped plan. The AI hall computer X (Kai) saw sharp growth alongside heightened expectations for smart gaming machines. The Company revised up its FY3/23 forecasts, and had major success with strategic M&A

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 machines. The Company holds the leading market share, approximately 37.1%, 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) facilitating the operations of pachinko hall associations forms a network of 3,303 pachinko halls and supports the Company’s business foundation.

With the pachinko market on a trend of steady annual shrinkage, the Company is striving to increase market share at large halls and promoting business reforms, including a shift to a business model with recurring revenue that continues over time, from a medium to long term perspective. Over the past several years, controlled ball payouts, measures against gambling addiction, and the Implementation Rules for the Act on Control and Improvement of Amusement Business, etc. and Rules on Partial Revision of Rules Related to Gaming Machine Certification and Format Inspection (enforced on February 1, 2018; hereafter, “new regulations”) have brought the pachinko hall industry to a major turning point. This has been compounded by impact from the COVID-19 pandemic, and earnings have been lackluster for some time due to uncertainty about the future. However, machines complying with the former regulations at the end of January 2022 are being replaced in stages, the gaming machine market is showing signs of an upswing driven by pachinko machines that meet the new regulations, and closely-watched smart gaming machines* got off to a good start from November 21, 2022. Alongside the market’s recovery, the Company is entering a new phase. On December 20, 2022, the Company made the cloud service system developer GLOBAL WISE Co. a consolidated subsidiary, a major achievement towards using the cloud (realizing new services) at the core of its medium- to long-term strategy.

* This refers to smart pachinko and smart pachislot and enables users to play without directly touching the balls and medals in contrast to the past format. Key points are elimination of facilities related to balls and medals at pachinko halls and enhancement of gaming performance compared to existing gaming machines. Future developments should be closely monitored considering support from gaming machine manufacturer organizations (Nikkoso and Nichidenkyo). Smart pachislot machines were introduced from November 21, 2022, and smart pachinko machines are slated to be rolled out in spring 2023.

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Summary

2. Overview of 1H FY3/23 results

The Company posted 1H FY3/23 results, with net sales of ¥11,289mn (-6.3% YoY) and operating income of ¥749mn (-13.2%). Though net sales and profit declined, both topped plan. In the Information Service Segment, net sales declined because the Company had to adjust sales volumes since the global semiconductor shortage prevented supply from keeping up with demand, but that was to be expected. As the rollout of closely-watched smart gaming machines drew near, the number of system upgrades to the AI hall computer X (Kai), which is optimal for data management, increased sharply such that the segment's net sales topped plan. In the Control System Segment, sales of parts were strong, whereas sales of display units and control units declined accompanying weak momentum for gaming machine sales volumes in the market overall since customers were gauging trends for smart gaming machines. On the profit front, operating income declined because lower sales weighed on earnings, and the recording of a provision of allowance for doubtful accounts in connection with customer game machine manufacturers undergoing civil rehabilitation proceedings squeezed profit. However, the Company attained profit levels well above plan, mainly owing to growth in the number of upgrades to the highly profitable X (Kai) system, and a milder-than-expected increase in the cost of products. In terms of activities too, the next-generation cloud service ClarisLink (cloud-based chain store management system) is growing at a solid clip, and business structure transformation is steadily advancing.

3. FY3/23 forecasts

The Company revised up its initial forecasts for FY3/23. It forecasts net sales of ¥29,000mn (+18.9% YoY) and operating income of ¥1,850mn (+55.3%), envisioning higher sales and profits. It raised its net sales forecast because it expects sales volumes to exceed plan for products such as the card unit VEGASIA required for smart gaming machines, which have gotten off to a good start, and envisions the Information Service Segment's growth as contributing significantly to growth in net sales. Conversely, the Company forecasts lower sales in the Control System Segment due to sales of products such as display units being shifted to the next fiscal year. As for profits, the Company forecasts higher operating income as boosts to earnings, including from higher sales and MIRAIGATE SERVICE's (hereinafter, "MG Services") growth, offset drags, including from proactive investment in areas like the cloud and pachislot, semiconductor shortages, and surging raw material prices.

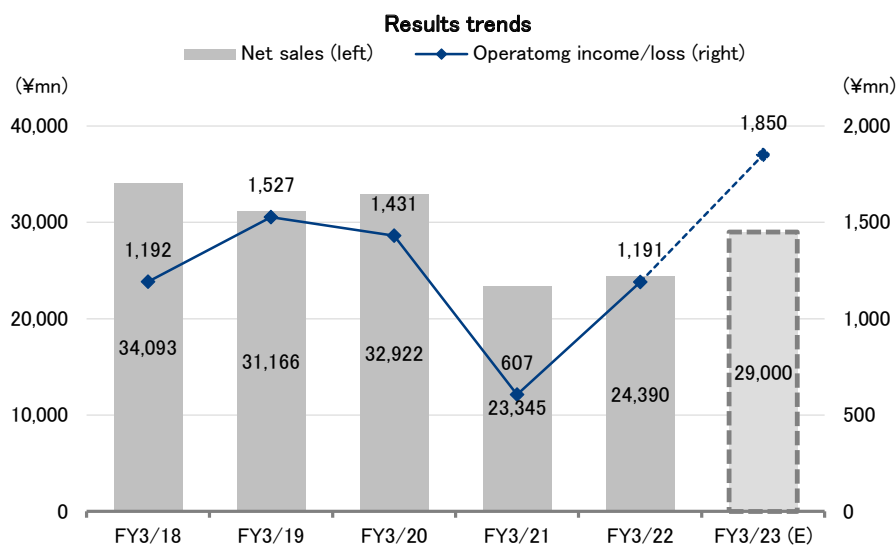
4. Medium-term management plan

The Company started a medium-term management plan (three years) starting from FY3/23 with full transition to machines in anticipation of meeting the new regulations from February 2022 and seeing a path to livelier conditions in the gaming machine market and pachinko hall capital investments as the new era of smart gaming machines emerges. The Company outlined a strategy of capturing demand using smart gaming machines, continued promotion of AI hall computer X (Kai) uptake, and carrying on building the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services). Numerical goals for FY3/25, the final fiscal year, are ¥34,000mn in net sales (11.7% average growth rate over three years) and ¥2,200mn in operating income (6.5% operating income margin). Projected incremental improvement in the operating income margin relies on recurring business led by MG Services becoming the growth driver and substantial contributions from the resulting change in the earnings structure (lifting the bottom line).

Summary

Key Points

- Sales and profits declined in 1H FY3/23 but topped plan
- Number of system upgrades to the AI hall computer X (Kai) grew sharply as expectations for smart gaming machines rose even while feeling the impact of the semiconductor shortage
- Revised up FY3/23 forecasts, expects to secure higher sales and profits accompanying market vitalization in light of smart gaming machines' solid debut
- Started the three-year medium-term management plan. Aims to build the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services) for the arrival of a new era with smart gaming machines



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

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 development, production and sales of computer systems for pachinko halls, the Company also develops, manufactures and sells display and control units for pachinko 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.

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Description of businesses

The Company's share of the hall computer market is 37.1%, and in particular, its market share of large-scale halls with at least 501 machines is 61.4%. (as of FY3/22).

The Company's two main businesses are the Information System Segment and Control System Segment, but the Information System Segment provided around 75% of its net sales and has been the main source of stable profit in the past few years.

1. Information System Segment

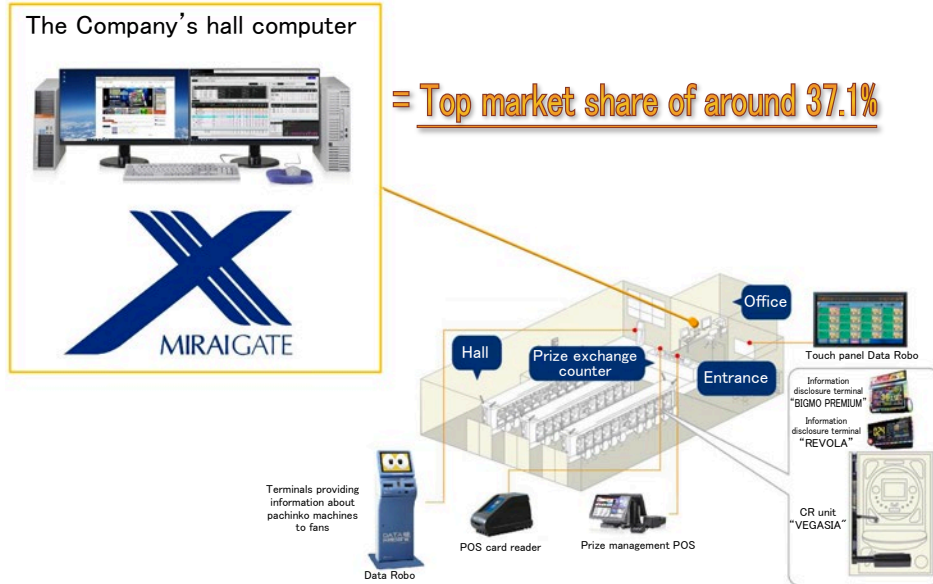
The Company sells hall computers (machine management systems), which serve as core systems at pachinko halls, and peripheral equipment, such as prize and customer management systems, information disclosure systems and card units, and offers MG Services that provide various services on hall computers and over the internet via a server. DK-SIS, a membership information provision service and the industry's foremost strategic information tool, is the pillar of MG Services.

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, are supported by peripheral equipment such as prize management and information disclosure systems and card units, and serve as the foundation of MG Services. Introducing a hall computer provides the advantage that peripheral equipment and support services can be sold as a package deal.

In June 2019, the Company released industry-first AI hall computer X (Kai), its first launch in 12 years since the release of the 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 optimal solutions by utilizing the Company's big data and having AI automatically analyze the data. By using AI's ability to prepare forecasts utilizing big data that cannot be processed by people to instantaneously generate analyses that previously required significant time and assist personnel with limited experience in making assessments expected of highly experienced personnel, the Company wants to enhance efficiency and reduce labor resources in hall management, contribute to further customer attraction and expand its market share and improve profitability.

Description of businesses

Hall computers and main peripheral equipment



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

2. Control System Segment

The Control System Segment develops, produces and sells displays and control units, as well as components used for pachinko and pachislot machines for game machine 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 plans based on the trends of popular models and sales of copyrights for popular characters. In particular, the Company is ramping up pachislot business from FY3/22 by leveraging hardware and software technologies cultivated up to now and broadening its business scope, including through sales of proprietary pachislot systems. Additionally, the Company intends to focus on manufacturing and selling its own brand of pachislot machines as a gaming machine manufacturer*, targeting launches in 2024.

* Consolidated subsidiary Daxel Inc. is taking on that role.

■ Company strengths

Track record of creating new product 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 cultivating 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 to various aspects of pachinko hall management.

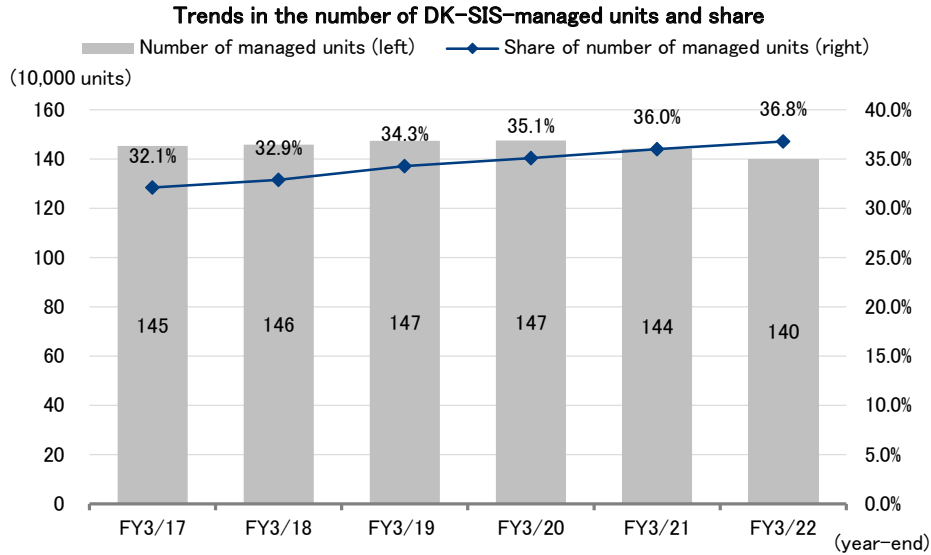
Launched in 1974, the Company's first hall computer enabled managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic data, but with the introduction of hall computers, data-based hall management became the de facto standard. Ever since then, it has been steadily rolling out industry-first information equipment that contains innovative functions, such as the Data Robot information disclosure terminal that provides operational information about gaming machines at pachinko halls to fans. It has contributed to healthier hall results by boosting the efficiency of hall management and supplying added value that raises fan satisfaction.

In June 2019, the Company released the industry's first AI hall computer, X (Kai). This AI hall computer is unique in that it will not only greatly help the performance of pachinko halls, but also improve operating efficiency by having AI automatically analyze big data that the Company possesses, thus reducing labor necessary for hall management already undergoing labor shortages.

2. Strong network of pachinko halls

Another one of the Company's strengths is that it has built a robust network with member pachinko halls through an array of services based on hall computers (MG Services), and evolved it into the industry's only platform. Launched in 1990, DK-SIS is a service offering feedback in the form of information that is useful in hall operations after processing and analyzing the daily operational information of pachinko and pachislot machines received from pachinko halls. Simulations based on nationwide gaming machine sales data support forecast management, and a strong network of members underpins the Company's business foundation. Additionally, the service takes on a role as a sort of think tank in the industry, helping to enhance the Company's brand power as a leading company, and it is apparently being utilized in strategic proposals and sales activities to game machine manufacturers. Membership totaled 3,303 halls at the end of March 2022 with 1.4mn managed machines (36.8% share in managed machines). Recently, the Company has been focusing on promoting widespread use of its Market-SIS market area analysis service, which analyzes customer numbers, utilization rates, market share, and support rates of pachinko hall rivals operating in the commercial sphere. Market-SIS is being well received as a tool that grasps mobility (player) trends and helps halls improve their ability to attract customers. Moreover, the Company launched the cloud-based chain store management system ClarisLink in 2021. The new system is its first using the cloud.

Company strengths

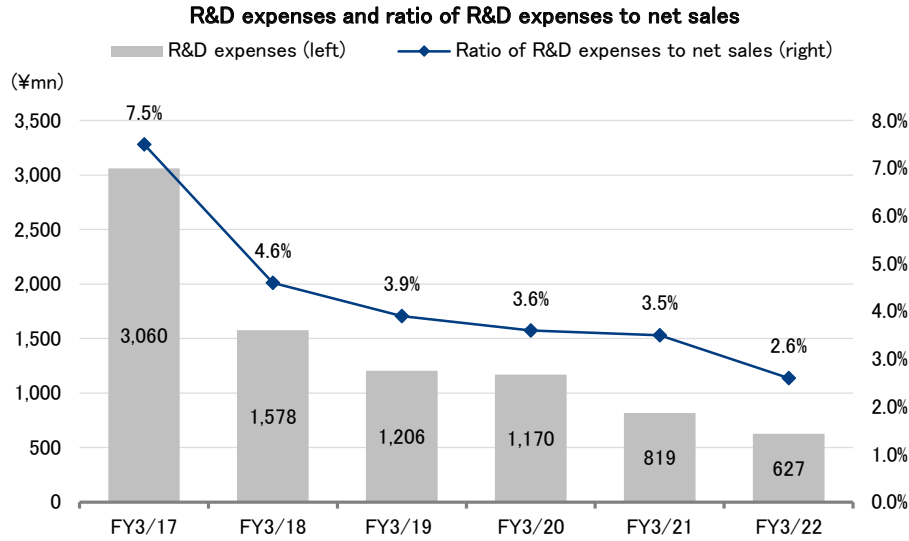


Source: Prepared by FISCO from the Company's materials

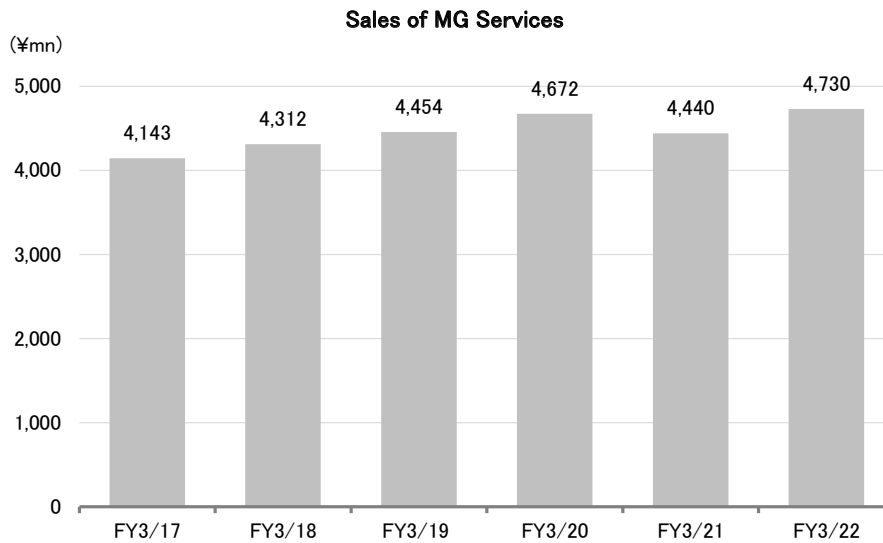
3. Stable profit base that supports investment for the future

The Company's main source of competitiveness is its proactive upfront investment eyeing future growth, including its R&D expenses. Development of a next-generation hall computer (and peripheral equipment) and start of a new MG Services in recent years are evidence of continued aggressive investment in areas expected to become its growth driver. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, MG Services 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 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 future growth allows it to produce value on a continuing basis. While exhaustion of large-scale investments in the next-generation hall computer and other outlays have kept R&D expenses at roughly 3% of net sales since FY3/18, the Company intends to aggressively allocate R&D expenses, mainly for central components of its strategy such as the cloud and smart pachislot, in the medium-term management plan (Details below).

Company strengths



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



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

Financial results trends

Sales and profits declined in 1H FY3/23 but topped plan, the AI hall computer X (Kai) saw sharp growth alongside heightened expectations for smart gaming machines

1. Overview of 1H FY3/23 results

In 1H FY3/23 results, the Company posted decreased sales and profits, with ¥11,289mn in net sales (-6.3% YoY), ¥749mn in operating income (-13.2% YoY), ¥871mn in ordinary income (-5.2% YoY), and ¥570mn in net income attributable to owners of parent (-15.9% YoY), but net sales and each item of profit finished higher than the initial outlook.

Pachinko halls remained downbeat on capital investment in new openings and large-scale remodeling, holding off on them in order to get a feel for trends for smart gaming machines scheduled to be introduced soon (November 2022). However, heightened expectations for smart gaming machines fueled brisker capital investment in preparation for the gradual introduction of these new machines. Against this backdrop, sales declined in the Information System Segment because the Company had to adjust sales volumes since the global semiconductor shortage prevented supply from keeping up with demand, but that was to be expected. However, net sales in the segment topped plan due to sharp growth in number of system upgrades to the AI hall computer X (Kai), which is optimal for data management. Sales were also strong for services such as the MG Service. Turning to the Control System Segment, sales of parts did well, but sales of display units and control units decreased amid lackluster gaming machine sales volumes in the market overall due to customers gauging trends for smart gaming machines. However, net sales in this segment also apparently topped plan, owing mainly to dividends from equity in content.

On the profit front, operating income decreased because lower sales weighed on earnings, and the posting of a provision of allowance for doubtful accounts (about ¥230mn)* squeezed profit. However, the Company attained profit levels well above plan, mainly owing to growth in the number of upgrades to the highly profitable X (Kai) system, and a milder-than-expected increase in the cost of products. Although the operating income margin declined to 6.6% from 7.2% in 1H FY3/22, the level improved significantly if impact from the provision of allowance for doubtful accounts is excluded.

* This is for receivables due from customer game machine manufacturers under civil rehabilitation proceedings. However, doubtful account-related expenses pertaining to this matter have apparently all been accounted for as of 1H FY3/23 and will not arise in the future.

Looking at financial conditions, total assets declined 3.8% from the end of FY3/22 to ¥39,911mn as merchandise and products decreased looking to the introduction of smart gaming machines, whereas cash and deposits and accounts receivable – trade increased, and non-current assets shrank in connection with depreciation. In addition, total equity trended broadly flat, inching up 0.2% to ¥31,194mn, since the accumulation of retained earnings and the payment of dividends were basically balanced. Therefore, the equity ratio improved slightly to 78.2% (75.1% at the end of FY3/22).

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Financial results trends

Overview of 1H FY3/23

	1H FY3/22		1H FY3/23		Change		1H FY3/23		Difference	
	Results	Share	Results	Share	%	%	Initial forecast	Share	Progress rate	
									change	change
Net sales	12,047		11,289		-757	-6.3%	11,000		289	102.6%
Information System Segment	9,187	76.3%	8,505	75.3%	-681	-7.4%	-	-	-	-
Control System Segment	2,866	23.8%	2,788	24.7%	-78	-2.7%	-	-	-	-
Adjustment	-6	-	-4	-	2	-	-	-	-	-
Gross profit	5,103	42.4%	5,233	46.4%	130	2.6%	-	-	-	-
SG&A expenses	4,239	35.2%	4,483	39.7%	243	5.8%	-	-	-	-
Operating income (loss)	863	7.2%	749	6.6%	-113	-13.2%	50	0.5%	699	1499.6%
Information System Segment	1,346	14.7%	1,406	16.5%	59	4.4%	-	-	-	-
Control System Segment	265	9.3%	48	1.7%	-217	-81.8%	-	-	-	-
Adjustment	-749	-	-704	-	44	-	-	-	-	-
Ordinary income (loss)	919	7.6%	871	7.7%	-47	-5.2%	130	1.2%	741	670.4%
Net income (loss) attributable to owners of the parent	678	5.6%	570	5.1%	-108	-15.9%	100	0.9%	470	570.4%
Depreciation	867		795		-72	-8.3%	805		-10	98.8%

	End of FY3/22	End of 1H FY3/23	Change	
				% change
Total assets	41,489	39,911	-1,577	-3.8%
Total equity	31,141	31,194	52	0.2%
Equity ratio	75.1%	78.2%	3.1pt	-

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

The results by segment were as follows.

(1) Information System Segment

The segment reported lower sales but higher profits, with net sales at ¥8,505mn (-7.4% YoY) and segment income at ¥1,406mn (+4.4%). Sales of products for pachinko parlors declined because the Company had to adjust sales volumes since the global semiconductor shortage prevented supply from keeping up with demand. Also, service sales inched down as strong sales of mainstay services such as the MG Service were offset by sluggish consumer business. However, the segment's net sales topped plan since the number of system upgrades to the AI hall computer X (Kai), which is optimal for data management, rose sharply as the scheduled rollout of smart gaming machines (November 2022) drew near. As for earnings, segment income grew and sharply topped plan, driven by growth in the number of upgrades to X (Kai) system, support to earnings from the MG Service, and a milder-than-expected increase in the cost of products. The segment margin also improved to 16.5% (14.7% in 1H FY3/22).

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Financial results trends

(2) Control System Segment

The segment reported lower sales and profits, with net sales at ¥2,788mn (-2.7% YoY) and segment income at ¥48mn (-81.8%). Sales of parts rose YoY. However, sales of display units and control units fell YoY amid a pullback from the replacement demand for new machines complying with the new regulations in the previous fiscal year, and a decline in the market's overall gaming machine sales volumes due to customers looking to get a feel for smart gaming machine trends going forward. As for earnings, segment income declined sharply, owing to the posting of a provision of allowance for doubtful accounts (about ¥230mn) in connection with customer game machine manufacturers undergoing civil rehabilitation proceedings, but was apparently above plan due to dividends from equity in content. The segment margin also decreased significantly to 1.7% (9.3% in 1H FY3/22). However, the margin level was around 10% if impact from the provision of allowance for doubtful accounts is excluded. Therefore, the Company can also be viewed as maintaining the improvements to its earnings structure that it has been working on since FY3/22.

2. Summary of 1H FY3/23

To sum up 1H FY3/23 based on the above, net sales and profits declined due to impact from semiconductor shortages, but that is only because of production adjustments, and it is commendable that results exceeded the Company's plan as the number of system upgrades to X (Kai) grew accompanying a gradual upturn in demand itself (pachinko parlors' investment appetite), driven by expectations for smart gaming machines. In addition, that smart pachislot machines launched on November 21, 2022 are trending in line with expectations so far and being well received is a positive catalyst going forward. In future-oriented activities too, the next-generation cloud service ClarisLink has steadily grown, and the Company achieved great results in M&A (details below) aiming to strengthen cloud initiatives. In particular, ClarisLink apparently grew twice as fast as planned, earning high marks for its data not available elsewhere and response speed, among other things.

■ Main activities

Made a company that develops cloud services and other systems into a subsidiary, a major step towards realizing its medium- to long-term strategy

On December 22, 2022, the Company made the cloud service system developer GLOBAL WISE* into a consolidated subsidiary through a stock acquisition. In November 2021, the Company announced a medium-term management plan (details below) positioning the cloud and smart pachislot as central to its strategy, and setting out to proactively make upfront investments. This M&A can be viewed as a move to reinforce its cloud business. For the Company advancing utilization of the cloud in building platforms for services to support pachinko parlor management, the M&A is very advantageous in terms of being able to gain the human resources, expertise, and so forth of GLOBAL WISE, a company that realizes one-stop provision of services from cloud construction to system development, and system operation and maintenance. For GLOBAL WISE, the M&A is likely to raise its value as a business, including its employees' motivation, by proactively taking part in projects as a member of the Daikoku Denki Group with its excellent financial power, business foundation, and so on.

* The Company acquired 5,677 shares (acquisition price: ¥237mn), 98.3% of GLOBAL WISE's outstanding shares. GLOBAL WISE has about 50 employees. As for GLOBAL WISE's most recent results (FY3/22), net sales were ¥422mn and operating income was ¥8mn, and, in terms of its financial position, net assets were ¥188mn and total assets were ¥960mn, so its impact on the Company's FY3/23 earnings is likely to be minor.

■ Outlook

Raised initial forecasts for FY3/23, expects earnings growth to accelerate as market gains vigor

1. FY3/23 forecast

The Company revised up its outlook for FY3/23 for the second time on December 5, 2022.* The Company forecasts results in FY3/23, the first year in the new medium-term management plan, that will deliver higher sales and profits with ¥29,000mn in net sales (+18.9% YoY), ¥1,850mn in operating income (+55.3%), ¥2,050mn in ordinary income (+50.0%), and ¥1,300mn in net income attributable to owners of the parent (+5.9%). The initial outlook for increased sales and reduced profit was overturned and the forecast is now for significant increases in sales and profits.

* This was the second upward revision, following the first on November 14, 2022.

The Company raised its net sales forecast since 1H results topped plan (the reason for its first upward revision), and because smart gaming machines (pachislot machines this time) launched on November 21, 2022 have gotten off to a good start, and it now expects products such as the card unit VEGASIA required for smart gaming machines to do well in the Information Service Segment. Conversely, the Company forecasts lower sales in the Control System Segment due to sales of products such as display units being shifted to the next fiscal year.

In the Information Service Segment, the Company plans to continue to accelerate investment in cloud development by strengthening its development framework, including through M&A, while working to expand existing products' market share by 1) increasing sales of card units, information disclosure devices, and so forth alongside the deployment of smart gaming machines, 2) growing sales of Market-SIS looking to achieve No. 1 market share, and 3) expanding sales of ClarisLink, its first cloud-based service. In the Control System Segment, the Company looks to transition from "pachinko" to "smart pachislot" as the main business driver, and build a stable development system by insourcing development frameworks for medal-less bodies and software development. In addition, the Company is developing its own brand of smart pachislot machines, targeting launches two years from now.

As for earnings, the Company forecasts higher operating income as boosts to earnings from higher sales and growth for MG Services offset drags from proactive investment in areas like the cloud and pachislot, semiconductor shortages, and surging raw material prices.

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Outlook

FY3/23 forecast (revised)

(¥mn)

	FY3/22		FY3/23				YoY change (revised forecast)	
	Result	Share	Initial forecast	Share	Revised forecast	Share	% change	
Net sales	24,390		26,000		29,000		4,609	18.9%
Information System Segment	18,647	76.4%	19,500	75.0%	23,600	81.4%	4,952	26.6%
Control System Segment	5,759	23.6%	6,500	25.0%	5,400	18.6%	-359	-6.2%
Adjustment	-17	-	-	-	-	-	-	-
Gross profit	10,143	41.6%	14,000	-	-	-	-	-
SG&A expenses	8,952	36.7%	9,550	-	-	-	-	-
Operating income (loss)	1,191	4.9%	850	3.3%	1,850	6.4%	658	55.3%
Information System Segment	2,171	11.6%	1,950	10.0%	3,150	13.3%	978	45.0%
Control System Segment	537	9.3%	450	6.9%	250	4.6%	-287	-53.5%
Adjustment	-1,518	-	-1,550	-	-1,550	-	-31	-
Ordinary income (loss)	1,367	5.6%	950	3.7%	2,050	7.1%	682	49.9%
Net income (loss) attributable to owners of the parent	1,228	5.0%	650	2.5%	1,300	4.5%	71	5.8%

Note: FY3/23 revised forecast are the figures announced on December 5, 2022

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

2. FISCO focus

Net sales of ¥17,711mn and operating income of ¥1,101mn are needed in 2H to meet the revised up targets. Though impact from semiconductor shortages and rising raw material prices continue to warrant caution, we at FISCO also believe that the Company's earnings forecasts are well within reach since smart gaming machines have gotten off to a good start, and the Company's forecasts are modeled on conservative assumptions for impact from semiconductor shortages and rising raw material prices. Potential for additional upside should also be noted if gaming machine manufacturers across the board roll out smart pachislot machines and bottlenecks from semiconductor shortages are resolved earlier than expected going forward. A point to watch is trends heading into FY3/24 when smart gaming machines gain traction in earnest. The Company expects demand to expand accompanying the introduction of (replacements with) smart gaming machines over the next three years. Since the reviews of smart pachislot machines that have been launched as well as the magnitude of expectations for smart pachinko machines slated to be launched in spring 2023 will have a significant impact on sales of products such as the AI hall computer X (Kai) and card units, future trends require monitoring from that perspective.

Medium-term management plan

Started the medium-term management plan for an era of smart gaming machines. Aims to build the industry's only platform on a cloud server

Seeing a path to livelier conditions in the gaming market and pachinko hall capital investments as the switch to the new era of smart gaming machines emerges, the Company launched its medium-term management plan (three years) starting in FY3/23. Based on the corporate philosophy of “continuing to consistently deliver sustainable growth in the future by creating new value through innovations,” the Company intends to redefine business domains as a way of addressing future changes in the market environment. Specifically, it outlined a strategy of capturing demand related to inroads from the introduction of smart gaming machines, continuing promotion of AI hall computer X (Kai) uptake, and carrying on building the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services).

1. Market environment

The gaming machine market and pachinko hall industry are anticipating the arrival of a new era accompanying full transition to machines that meet the new regulations from February 2022 and new rollout of smart gaming machines that started from November 21, 2022. The switch to smart gaming machines might dramatically advance data collection and utilization and significantly affect fan growth and the format of hall management by broadening “game” aspects. In particular, some observers think manifestation of differences in customer draw by individual pachinko halls might accelerate the trend of industry reorganization driven by leading companies. The Company envisions a scenario of significant income expansion from the second year of the medium-term management plan (FY3/24) amid advances in the shift to smart gaming machines as pachinko halls ramp up capital investments (including new site openings) for survival.

2. Priority measures (redefining business domains)

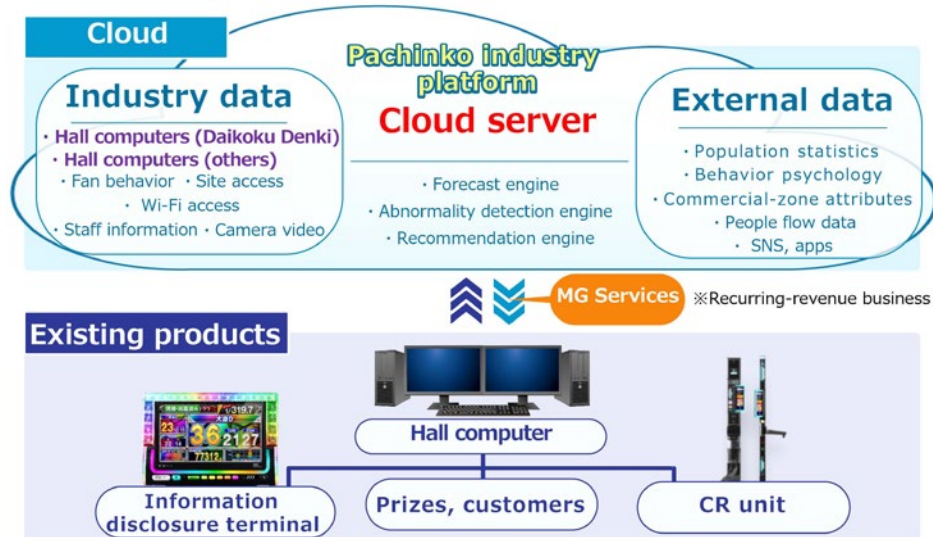
(1) Information System Segment

The centerpiece of the strategy is its aim to build the industry's only platform through reinforcement of new MG Services that apply a cloud server in anticipation of future market changes, and thereby lock in customers (primarily major hall operators) and effectively assist hall management and contribute to industry reforms. This requires continued promotion of AI hall computer X (Kai), provision of products and services that flexibly address machines that meet the new regulations and smart gaming machines, further progression of labor and headcount savings, and improvement in the market shares of all products through timely launch of products that transform the way hall staff work and the strategy for attracting fans. It also involves launching a platform that consolidates and utilizes industry and external data on a cloud server* and raising stable income through reinforcement of new MG Services.

* The platform consolidates industry data (hall computers of Daikoku Denki and others, fan behavior, site access, Wi-Fi access, staff information, and surveillance video) and external data (population statistics, behavior psychology, trading area attributes, people flow data, and SNS and apps) on a cloud server, and effectively utilizes and analyzes it with engines focused on forecasting, abnormality detection, and recommendations, among other functions.

Medium-term management plan

Target image after three years



Source: The Company's results briefing materials

(2) Control System Segment

The Company advocates a policy of transitioning from “pachinko” to “smart pachislot” as the main business driver. It plans to further pursue consignments for comprehensive development of pachislot gaming machines that it started in 2H FY3/21 and aims to complete medal-less body and software development operations and cultivate this business into a core earnings source within three years. It is also working on developing its own brand of pachislot machines as a gaming machine manufacturer, targeting launches two years from now.

3. Investment plan

In the three-year investment plan, the Company intends to cumulatively spend ¥4bn in R&D expenses (¥2.8bn in the previous three years) and ¥6.2bn in capital investments (¥4.1bn in the previous three years), exceeding combined outlays in the previous three years. It also plans to mainly allocate R&D expenses to smart pachislot machines (Control System Segment) and capital investments to server development (Information System Segment).

4. Numerical goals

Numerical goals for FY3/25, the final fiscal year, are ¥34,000mn in net sales (11.7% average growth rate over three years) and ¥2,200mn in operating income (6.5% operating income margin). While the Company conservatively anticipates results in FY3/23, reflecting the difficulty of assessing the timing of full-fledged profit gains (ramp-up of capital investments at pachinko halls) due to semiconductor shortages and the impact of the COVID-19 pandemic, it factors in realization of significant business expansion in the second year (FY3/24), when the introduction of smart gaming machines will become fully fledged. Additionally, projected incremental improvement in the operating income margin, despite aggressive R&D spending and capital investments, relies on enhanced added value in various product areas, recurring business led by MG Services becoming the growth driver and substantial contributions from the resulting change in the earnings structure (lifting the bottom line).

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Medium-term management plan

Medium-term management plan

(¥mn)

	FY3/22		FY3/23 (First year of the medium-term management plan)		FY3/24 (Second year of the medium-term management plan)		FY3/25 (Third year of the medium-term management plan)		Annual average growth rate (Three years)
	Results	Share	Target	Share	Target	Share	Target	Share	
Net sales	24,390		26,000		32,000		34,000		11.7%
Information System Segment	18,647	76.4%	19,500	75.0%	25,000	78.1%	26,500	77.9%	12.4%
Control System Segment	5,759	23.6%	6,500	25.0%	7,000	21.9%	7,500	22.1%	9.3%
Gross profit	10,143	41.6%	10,400	40.0%	11,970	37.4%	13,100	38.5%	8.9%
SG&A expenses	8,952	36.7%	9,550	36.7%	10,270	32.1%	10,900	32.1%	6.8%
Operating income (loss)	1,191	4.9%	850	3.3%	1,700	5.3%	2,200	6.5%	22.7%
Ordinary income (loss)	1,367	5.6%	950	3.7%	1,800	5.6%	2,300	6.8%	18.9%
Net income (loss) attributable to owners of the parent	1,228	5.0%	650	2.5%	1,200	3.8%	1,500	4.4%	6.9%

Note: FY3/23 figures are before revisions (initial targets)

Source: Prepared by FISCO from the Company's financial results and medium-term management plan

5. Focus points in the FISCO analyst

To reinforce MG Services premised on tapping into its strength in data for the arrival of a new era driven by smart gaming machines, FISCO agrees that the Company's strategy to advance from hall computers to business utilizing a cloud server makes sense when considering changes in the industry environment as opportunities to leverage its advantages. Furthermore, FISCO thinks the platform business it targets is likely to reinforce the Company's overwhelming position by fueling a beneficial cycle (networking effect) wherein members are drawn to places with extensive data and data accumulates in places with more members. We also intend to focus on the extent of new value realized through innovation and sustainability initiatives as its exercise of leadership in the industry contributes substantially to its own continuation and the sustainability of the industry and society. Additionally, since the know-how of using the Company's data can be expanded horizontally, it is important to closely monitor developments in M&A and business alliances aimed at entering other industries in order to secure new income sources and diversify risk.

Furthermore, we believe the medium-term management plan (numerical goals) is well within reach with smart gaming machines gaining solid traction so far. There are currently about 3.5mn pachinko and pachislot machines installed in total. The Company expects about 1.32mn (roughly 38%) of them to be replaced with smart gaming machines. Therefore, how quickly smart gaming machines gain traction over the next few years will be key*. Also, new Japanese bills (new banknotes) scheduled to be issued in 2024 are expected to underpin replacement demand. At any rate, pachinko halls need to make considerable capital investments for the introduction of smart gaming machines. Industry realignment could therefore suddenly accelerate, and the evolution of game features is likely to be accompanied by a turn to recovery from the downturn to date in pachinko and pachislot fan numbers, including by capturing new users. Such structural changes can also be regarded as offering excellent opportunities for the Company to expand its market share and strengthen its earnings capabilities. As such, whether the Company is able to play a central role in revitalizing the industry will probably be an important point for accelerating its own growth too.

* The Company's outlook apparently assumes initial introduction of about 85,000 smart pachislot machines by the end of March 2023.

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Industry environment

There are signs of market gaining vigor with the emergence of popular machine models and an eye to future deployment of smart gaming machines, but semiconductor shortages and rising costs are a concern

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. Furthermore, promulgation of "new regulations" on September 4, 2017 fueled pessimistic views of the industry and uncertainty about the future. This disarray persisted for a while, and additional impact by COVID-19 (temporary hall closures and shorter operating hours) since the start of 2020 accelerated the harsh environment.

In 2021, however, the market was enlivened by replacement demand for gaming machines, driven by progress in gradually replacing gaming machines with those meeting the new regulations ahead of the deadline at the end of January 2022, and the emergence of several popular gaming machine models with new amusement features (such as "play time"*) following revisions to the Technology Format Interpretation Standards adopted in January 2020, and in accordance with related Nikkoso internal stipulations. In addition, the phased introduction of smart gaming machines started in November 2022 and the gaming machine market and pachinko hall industry are approaching a new era, with attention focusing on the deployment of smart gaming machines going forward. As for near-term risks, renewed expansion of the COVID-19 pandemic, including due to the emergence of new variants, delivery delays from semiconductor shortages, and other negative impacts are a concern.

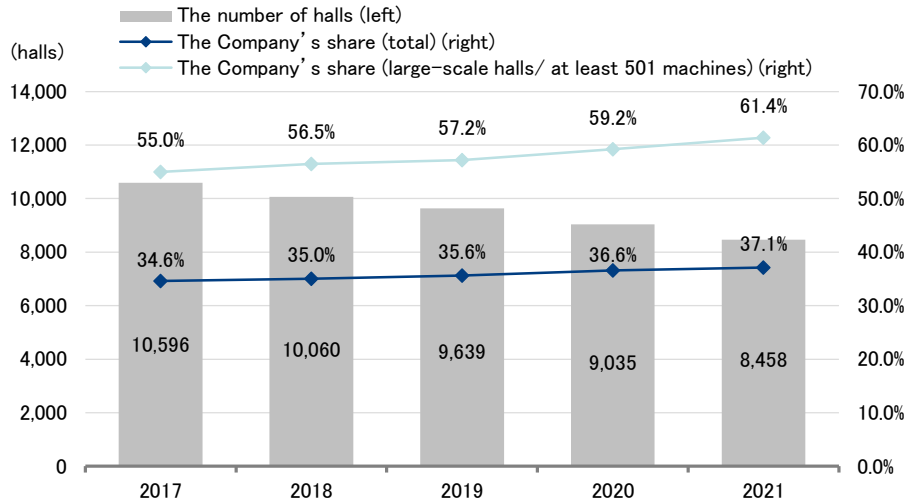
* "Play time" is a system (rescue measure) whereby the machine enters a shortened time mode (a function that efficiently rotates balls without reducing the number of balls up to a certain number of times) if the player does not have a big win in a specified number of rotations during normal play (low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

According to surveys by the National Police Agency, the number of pachinko halls in Japan declined at an average annual rate of 3.9% from 2012 to 2021. In particular, in recent years there has been a noticeable decline in new hall openings due to the impact of the new regulations and other factors. However, at the end of December 2021, the number of halls was 8,458 (-577 YoY), and the Company share of hall computer customers rose to 37.1% continuing the trend to increase year by year. Its customer halls are often high-end, large pachinko halls that are the top performers in their respective local markets and exceed the market average in size*. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. As the Company moves toward a new era with new smart gaming machines, we expect an excellent opportunity for it to expand business once investment appetites recover, mainly at large halls.

* The Company's share of the large-scale halls (at least 501 machines) market is even higher at 61.4%.

Industry environment

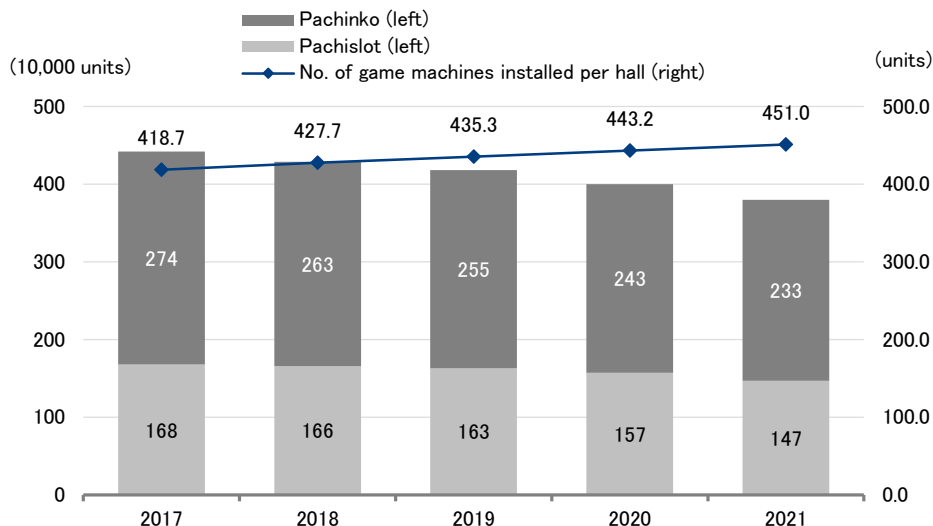
Trends in the number of halls and the Company's share of the hall computer market



Source: Safety Division, Community Security Bureau, National Police Agency
 Prepared by FISCO from the Current Status of Entertainment and Amusement Businesses, etc. and the Status of Measures for Crimes relating to Entertainment and Amusement Businesses, etc. 2021 and the Company's results briefing materials

Meanwhile, although the number of game machines installed and running in the market is on a downward trend (the decline in pachislot 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 a main segment, therefore this trend should benefit the Company with its ability to realize robust investment return through advanced functionality and added value.

Trends in the number of installed units in the gaming machine market

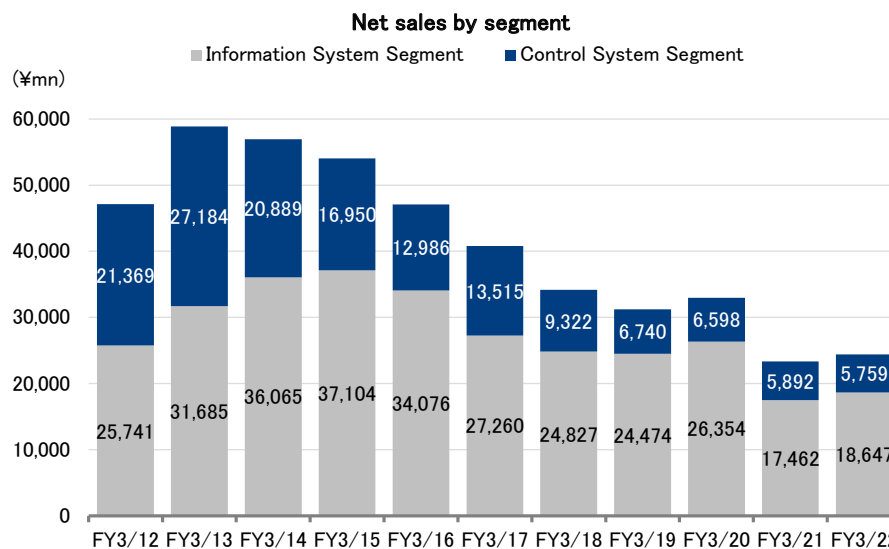


Source: Safety Division, Community Security Bureau, National Police Agency
 Prepared by FISCO from the Current Status of Entertainment and Amusement Businesses, etc. and the Status of Measures for Crimes relating to Entertainment and Amusement Businesses, etc. 2021

■ Performance over the past fiscal years

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

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 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 from FY3/13 to 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 COVID-19 pandemic and other factors since the start of 2020.



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

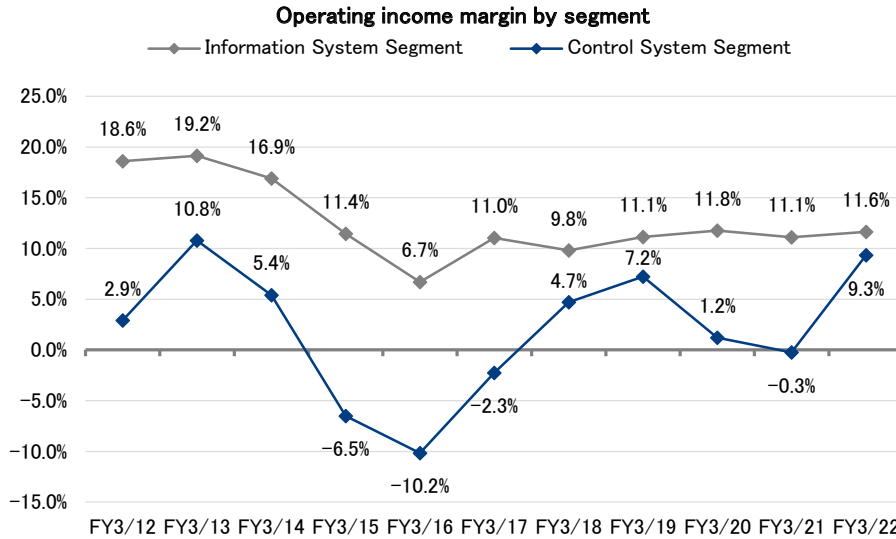
The Information System Segment has become the source of profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in R&D for next-generation products from FY3/14 to FY3/17, profit margins have declined, but considering the size of the investment, they 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 MG Services, has been supporting income.

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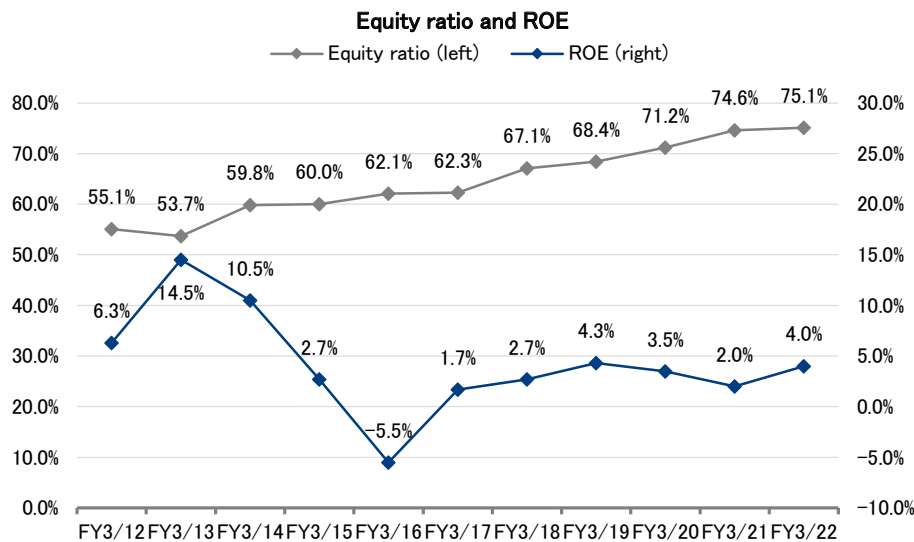
<https://www.daikoku.co.jp/en/ir/>

Performance over the past fiscal years



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

In terms of financial indicators, the Company's equity ratio, a measure of financial stability, has been rising, reflecting an accumulation of retained earnings and reaching a high level of 75.1% in FY3/22. The current ratio, which indicates the ability to make payments in the short term, was 284.1%, mainly due to large holdings of cash and deposits, as the Company's robust financial base is a strength as a source for powering future growth. ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. The Company suffered losses in FY3/15 due to the bankruptcy of a manufacturer customer and in FY3/16 due to the devaluation of parts and materials for its pachislot machines as industry restrictions were placed on risky machines. Going forward, the Company will work on growing profits and improving ROE.



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

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

Initiatives in sustainability

Announced its sustainability policy aiming to realize a sustainable society and aim for Group growth

To pursue the Group’s own growth and realize a sustainable society through business activities based on its corporate philosophy of “continuing to consistently deliver sustainable growth in the future by creating new value through innovations,” the Company again resolved at the Board of Directors matters pertaining to the sustainability policy and identification of materiality (important issues) and disclosed the information (March 2022). The Company is advancing specific initiatives in line with materiality, including raising awareness through games to check gambling addiction, holding parent-child programming experience classes, promoting telecommuting and other workstyle reforms as well as human resource engagement, and installing solar panels. It has also established the Sustainability Committee as part of its building of frameworks to promote sustainability activities in a continuous and organized manner, and is disclosing information regarding climate change based on the Task Force on Climate-related Financial Disclosures (TCFD) recommendations. In December 2022, the Company achieved a “B-” management level rating for its climate control efforts from the CDP, an international non-profit organization headquartered in London, England that evaluates and certifies companies and other entities’ environmental-related strategies, initiatives, and so forth.

Initiatives in sustainability

<p>Corporate philosophy Sustainability Policy</p>	<p>We will continue to achieves sustainable growth consistently from now on through the creation of new value based on innovation</p> <p>The Daikoku Denki Group solves social issues through business activities based on its management philosophy, and will aim for the realization of a sustainable society and the growth of the group together with stakeholders.</p>
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ESG	Materialities	SDGs
E	Contributions to the global environment	
S	Promotion of activities by human resources	
	Provision of solutions based on innovation	
	Handling of addiction	
G	Strengthening of governance and compliance	

Source: The Company's results briefing materials

Shareholder returns

Plans to pay a ¥60 (¥10 interim, ¥50 year-end) annual dividend in FY3/23, revising initial year-end dividend forecast upward

Regarding the dividend, the Company has a fundamental policy of paying a stable dividend and implements a special dividend based on earnings. For FY3/23, it raised its dividend forecast alongside upward revisions to its results forecast on December 5, 2022. It revised up the year-end dividend from ¥30 to ¥50, and plans to pay a ¥60 dividend per share for the full year (¥10 interim, ¥50 year-end). We at FISCO believe there is also a good chance of dividend increases accompanying medium-term profit growth in the future.

Additionally, the Company resumed the shareholder benefit program, which seeks to enhance the investment appeal of its stock and promote medium- to long-term ownership, in FY3/22*. The benefit program gives QUO cards to shareholders with the value calibrated to the number of shares owned and the period of sustained ownership at the end of September each year.

* The Company temporarily eliminated the shareholder benefit program in FY3/21 due to sharply lower profits caused by the impact of the COVID-19 pandemic amid continued uncertainty in the business environment.

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