Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange First Section and Nagoya Stock Exchange First Section

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FISCO Ltd. Analyst

Ikuo Shibata
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Summary

Lower sales due to the impact of new regulations but profits rose sharply in 1H, healthy trend for products (including innovative new services)

Daikoku Denki Co., Ltd. <6430> (hereafter, “the Company”) has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese slot machines) parlors and halls, and the other that develops, produces and sells display and control units for pachinko and pachislot machines. The Company holds the leading market share, approximately 35%, of the Japanese market for hall computers, reflecting an information management method that is the de facto standard for the industry. Furthermore, the industry’s leading membership-based information provision service Daikoku Denki Strategic Information System (DK-SIS) to support the operations of pachinko hall associations forms a network of approximately 3,620 pachinko and pachislot halls (as of September 30, 2018).

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

The Company reported sharply higher profits on a decline in sales in 1H FY3/19 with net sales down 20.9% to ¥14,230mn and operating income increasing 132.6% to ¥872mn compared to 1H FY3/18. Sales dropped in the Information System Segment and Control System Segment on ongoing difficulty in market conditions with cautious customer stances toward capital investments because of uncertainty about the impact of new regulations*. Information System Segment, in particular, faced weak sales trends for major products, besides progress with deployments of information disclosure terminals and hall computers, amid significant declines in new pachinko hall openings and major renovations. Furthermore, Control System Segment sales slipped on the absence of in-house developed pachislot machine sales and lower sales of control units and components for pachinko machines. In profits, operating income surpassed the forecast with a sharp increase thanks to improved gross margin, lower R&D expenses (including some delays), and other factors.

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

The Company maintained its initial forecast for FY3/19 and thus continues to forecast higher sales and profits with increases of 2.7% YoY in net sales to ¥35,000mn and 9.0% in operating income to ¥1,300mn. While Control System Business sales are likely to weaken again, the overall outlook calls for a boost from Information System Business with pick-up in sales of new products and services driving growth in the second half of the fiscal year. In earnings, the Company expects to achieve an increase in operating income through the effect of higher sales and improvements to the gross margin. We think the Company is capable of attaining its targets, despite continuation of difficult market conditions, in light of stronger 1H profits than planned and the recent rise in orders for VEGASIA III, a CR unit that includes innovative new services. Our main focus is progress in laying the groundwork for earnings expansion from FY3/20, such as trends for amusement machines that meet new regulations (market deployment pace, market assessment after deployment, etc.) and the timing of related pachinko hall activity (recovery in investment appetites).

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

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

Key Points

- Reported sharply higher profits despite lower sales in 1H due to the impact of new regulations
- Contributions to higher profits from curbing the discount rate with proposal sales to existing halls and growth in service sales
- Left the initial FY3/19 forecast unchanged (projecting higher sales and profits)
- Favorable orders for VEGASIA III, a CR unit that includes innovative new services
Description of businesses

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

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

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

The Company’s hall computer is utilized at roughly 3,700 halls (giving it a share of about 35%) and in around 1,900,000 installed amusement machines (about 42%).

The Company’s two main businesses are the Information System Segment and the Control System Segment, but the Information System Segment provided 77.7% of its total sales in 1H FY3/19 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 to support sales and operational management at pachinko halls. Hall computers are the core of the system used at pachinko halls, and these computers are supported by peripheral equipment, such as prize management systems and information disclosure systems. The segment also offers various services such as hall management support services (hereafter, “MG services”) through information equipment and the membership-based information provision service DK-SIS, which is the leading service in Japan that provides strategic information about associated halls.

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

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 equipment manufacturers. Applying the knowledge obtained from analyzing data from pachinko machines as a hall computer manufacturer of many years, the segment functions beyond the scope of a machine manufacturer and proposes specs based on the trends of popular models and acquires copyrights for popular characters.
Since FY3/14, the Company’s consolidated subsidiary Daxel Co., Ltd. has been producing and selling pachislot machines developed by Daikoku Denki under the Daxel brand name. It steadily releases hit products with unique value that place emphasis on gaming features, including Magical Suite Prism Nana, Sasamisan@Gambaranai Slot, and Pachislots Hyakkaryoran Samurai Girls. These successes have solidified the Company’s brand image of high-quality animation. In FY3/18, Daxel has released two more models, Sora-no-Otoshimono Forte and Yuki Yuna is a Hero. (However, the Company does not plan to release any machines for FY3/19 in consideration of the industry environment and other factors.)

**Company strengths**

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

1. **Growth model based on market expansion through innovation**

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

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

   A newer business being pursued by the Company since FY3/14 is the development of pachislot machines. The Company has developed machines that differ from previous pachinko and pachislot machines, which tended to be chosen based on their gambling appeal. The Company is committed to creating machines with thorough quality by adopting original characters produced by popular illustrators and focusing on character animation and voices. This has won accolades from fans of anime, and the Company has again established a new market for amusement equipment.
2. Strong network of pachinko halls

Another advantage the Company has is its membership-based information provision service, DK-SIS. This service creates a dedicated network connecting the Company and member pachinko halls, and gathers, processes and analyzes the daily operational information of pachinko halls recorded by hall computers and gives feedback to hall managers to improve their operations. It enables the managers to conduct effective hall operation based on nationwide pachinko machine information, operational data broken down by machine model and other valuable external information. At the same time, this strong network made up of members also supports the Company’s business foundation. Additionally, it occupies an industry think-tank role and helps improve the Company’s brand as a leading company, and its strategic proposal and sales contacts with amusement equipment manufacturers. Membership totaled 3,638 halls at the end of March 2018 with 1.46mn managed machines (32.8% share) and ¥9.2tn in data scale (annual sales). While member volume has peaked amid a recent decline in overall pachinko halls, DK-SIS enjoys a large share in managed machines, mainly at large sites.

3. Stable profit base that supports investment for the future

The Company’s main source of competitiveness is its proactive upfront investment eyeing future growth, including its R&D expenditure. Over the past few years, the Company has developed unique pachislot machines, a next-generation hall computer (and peripheral equipment), and other products to drive its sales and profit growth hereafter. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, the MG services which have been nurtured by the Company to promote a recurring revenue business model have grown to provide enough profit to maintain funding investment in R&D at a high level, limiting investment risk. The Company’s ability to balance large profits from its existing businesses with heavy investment in businesses of the future allows it to produce value on a continuing basis. The Company revised its “next-generation system” development plan for FY3/18 onwards and R&D expenses are declining.
Company strengths

Research and development expense and ratio of expense to sales

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

Sales of MG services

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

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Industry environment

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

Japan's pachinko industry has been shrinking for years, reflecting a decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The self-regulatory action taken by the industry in 2015 (tightening restrictions on both pachinko and pachislot machines with strong gambling elements) left the whole industry in a slump in 2016 as it started to grapple with the problem of collecting and removing all pachinko machines that may perform differently from certified standards. In 2017, the industry was hit yet again, this time by the new regulations*. With the pessimistic view towards the industry and uncertainty about the future, the industry remains in a state of flux. While amusement equipment manufacturers announced pachinko machines with a settings feature (capable of setting the probability of major wins at up to six levels) and type-6 pachislot machines as amusement machines that comply with new regulations, the industry has not begun full-fledged deployment yet due to the limited number of certified models at this stage and undecided market assessment of certified models. Nevertheless, we expect increased investments by halls targeting survival (customer draw) amid market releases of new-standard machines as the industry advances in removal of former-standard machines. Manpower shortages have worsened for hall operations too. This is likely to spur deployment of facilities and equipment that provide labor savings.

* Among the new regulations are restrictions on the maximum number of balls that can be paid out and clearly defined standards for “controlled machines.” Older models that do not meet the new standards will remain in pachinko halls alongside new models for at least a while longer. Pachinko hall operators are worried that their earnings will continue to decline and they will be faced with difficult decisions about the timing of equipment replacement and other matters. It can be said that these lingering uncertainties have diminished their investment appetite.

According to surveys by the National Police Agency, the number of pachinko and pachislot halls in Japan declined at an average annual rate of 2.4% from 2011 to 2017. In particular, there is a noticeable decline in new hall openings due to the impact of the new regulations and other factors. In 2017, the number of halls was 10,596 (down 390 YoY). It is estimated that the Company served about 3,700 of these halls based on the fact that it held approximately 35% of the Japanese market for hall computers. The Company’s customer halls are often the top locations in the area and exceed the market average in size*. Average amusement machine volume per store is 512 machines, surpassing the average at other companies (369 machines) by about 40%. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. We expect an excellent opportunity for the Company to expand business once investment appetites recover mainly at large halls (after uncertainty fades and market activity picks up).

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

Actively invest in R&D aimed at future growth, even amidst weak performance trends while the industry moves towards a transitional phase

1. Performance over the past fiscal years

In FY3/11, the Company’s sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake. Its net sales rebounded in FY3/12-FY3/13, even though the pachinko industry continued to contract. This recovery was led by the Information System Segment, which holds high market shares for its products. Sales in this segment reached consecutive record highs in FY3/13-FY3/15, supporting the Company’s overall performance. However, sales have been contracting since FY3/16 due to various negative external factors, such as voluntary industry regulations, retrievals and removals of risky machines, and uncertainty related to new regulations.

The Information System Segment provides profits, and has maintained high profit margins as the Company’s performance recovered. Reflecting increasing investment in R&D for next-generation products since FY3/14, profit margins have declined, but considering the size of the investment, margins are still high. In particular, steady progress in conversion to a recurring-income business model, such as growth in MG service business, has been supporting income.
The Company's equity ratio, a measure of financial stability, has risen, reflecting large retained earnings, reaching 67.1% in FY3/18. The current ratio, which indicates the ability to make payments in the short term, was 203.8% in FY3/18, mainly due to large holdings of cash and deposits. The ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. In FY3/15, the Company suffered a loss due to the bankruptcy of a manufacturer customer. In FY3/16, because of the industry restrictions on risky machines, the Company launched fewer new pachislot machine models than planned, and its sales volume of these machines was far below the planned level. As a result, the Company suffered a loss due to the devaluation of parts and materials for its pachislot machines. However, conditions have been gradually recovering recently.
Financial results trends

Profits rose sharply, despite sales decline from the impact of new regulations, in 1H; contributions to higher profits from curbing the discount rate and growth in service sales

2. Overview of 1H FY3/19 results

In 1H FY3/19, the Company recorded sharply higher profits on a decline in sales, posting net sales of ¥14,230mn (-20.9% YoY), operating income of ¥872mn (+132.6%), ordinary income of ¥1,005mn (+103.7%), and net income attributable to owners of the parent of ¥637mn (+115.3%). Sales came in below the Company’s initial forecast but earnings finished well above.

Sales dropped in the Information System Segment and Control System Segment on ongoing difficulty in market conditions with continued cautious customer stances toward capital investments because of uncertainty about the impact of new regulations*. Information System Segment, in particular, faced weak sales trends for major products, besides progress with deployments of information disclosure terminals and hall computers, amid significant declines in new pachinko hall openings and major renovations. Furthermore, Control System Segment sales slipped considerably on the absence of in-house developed pachislot machine sales and lower sales of control units and components for pachinko machines, albeit in line with expectations (modest upside).

* While amusement game manufacturers have announced pachinko machines with a settings feature (capable of setting the probability of major wins at up to six levels) and type-6 pachislot machines as amusement machines that comply with new regulations, the industry has not begun full-fledged deployment yet due to the limited number of certified models at this stage (because of time needed to obtain certification) and undecided market assessment of certified models. Halls continue to delay new openings and replacement investments because of this situation.

In profits, gross margin climbed by 6.3pt with support from curtailment of the discount rate. Additionally, SG&A expenses fell significantly on lower R&D expenses (including some delays), cutbacks in sales commissions, and other revisions. As a result, operating income surpassed the forecast with a sharp increase. The Company’s operating margin improved to 6.1% (compared to 2.0% in 1H FY3/18). We attribute this success to curtailment of the discount rate on fewer transactions with new halls and progress in high value-added proposal sales to existing halls.

In financial conditions, total assets declined 4.2% from the end of FY3/18 to ¥41,735mn reflecting declines in cash and deposits and notes and accounts receivable - trade. However, equity ratio increased to 70.5% (compared to 67.1% at the end of FY3/18) because total equity was roughly unchanged at ¥29,428mn (+0.6%).

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Financial results trends

Overview of 1H FY3/19 results

<table>
<thead>
<tr>
<th></th>
<th>1H FY3/18 results</th>
<th>1H FY3/19 results</th>
<th>YoY change</th>
<th>1H FY3/19 results vs. forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Results</td>
<td>Ratio to sales</td>
<td>Results</td>
<td>Ratio to sales</td>
</tr>
<tr>
<td>Net sales</td>
<td>17,996</td>
<td>14,230</td>
<td>-3,766</td>
<td>-20.9%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Information System Segment</td>
<td>11,757</td>
<td>11,077</td>
<td>-679</td>
<td>-5.8%</td>
</tr>
<tr>
<td></td>
<td>6,626</td>
<td>3,173</td>
<td>-3,453</td>
<td>-43.3%</td>
</tr>
<tr>
<td></td>
<td>-23</td>
<td>-20</td>
<td>3</td>
<td>-20</td>
</tr>
<tr>
<td>Gross profit</td>
<td>6,097</td>
<td>5,722</td>
<td>-374</td>
<td>-6.2%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5,900</td>
</tr>
<tr>
<td>SG&amp;A expenses</td>
<td>5,722</td>
<td>4,803</td>
<td>-919</td>
<td>-15.2%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5,450</td>
</tr>
<tr>
<td>Operating income</td>
<td>375</td>
<td>872</td>
<td>497</td>
<td>132.6%</td>
</tr>
<tr>
<td></td>
<td>872</td>
<td>1,399</td>
<td>527</td>
<td>60.5%</td>
</tr>
<tr>
<td></td>
<td>374</td>
<td>335</td>
<td>-38</td>
<td>-10.4%</td>
</tr>
<tr>
<td></td>
<td>-671</td>
<td>-862</td>
<td>8</td>
<td>-8</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>493</td>
<td>1,005</td>
<td>512</td>
<td>103.7%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>500</td>
</tr>
<tr>
<td>Net income attributable to owners of the parent</td>
<td>296</td>
<td>637</td>
<td>341</td>
<td>115.3%</td>
</tr>
<tr>
<td>Depreciation</td>
<td>1,004</td>
<td>842</td>
<td>-162</td>
<td>-162</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>840</td>
</tr>
<tr>
<td>R&amp;D expense</td>
<td>1,240</td>
<td>511</td>
<td>-729</td>
<td>-729</td>
</tr>
<tr>
<td></td>
<td>965</td>
<td>430</td>
<td>-535</td>
<td>-535</td>
</tr>
<tr>
<td></td>
<td>275</td>
<td>80</td>
<td>-195</td>
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</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>260</td>
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</tbody>
</table>

Breakdown of segment sales

<table>
<thead>
<tr>
<th></th>
<th>Information System Segment</th>
<th>Control System Segment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Equipment</td>
<td>Service</td>
</tr>
<tr>
<td></td>
<td>6,555</td>
<td>5,202</td>
</tr>
<tr>
<td></td>
<td>5,836</td>
<td>5,241</td>
</tr>
<tr>
<td></td>
<td>-718</td>
<td>-39</td>
</tr>
<tr>
<td></td>
<td>Information System Segment</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Units and components</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3,955</td>
<td>2,558</td>
</tr>
<tr>
<td></td>
<td>2,558</td>
<td>-1,397</td>
</tr>
<tr>
<td></td>
<td>Pachislot machines and other equipment</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,307</td>
<td>615</td>
</tr>
<tr>
<td></td>
<td>1,692</td>
<td>-</td>
</tr>
</tbody>
</table>

The results by segment were as follows.

(1) Information System Segment

Profit rose sharply on lower sales with sales falling 5.8% YoY to ¥11,077mn and segment income increasing 60.5% to ¥1,399mn. Sales were below the initial forecast and profits were higher than expected. Sales slumped for major products, besides higher sales of BIGMO PREMIUM II information disclosure terminals and hall computers making inroads at major companies*, amid significant declines in new pachinko hall openings and major renovations. Yet demand for individual-machine calculating systems, an optional feature of CR units, is trending upward due to growing manpower shortages at pachinko halls. Replacements are advancing mainly for pachislot machines.

<table>
<thead>
<tr>
<th></th>
<th>End-FY3/18 results</th>
<th>End-1H FY3/19 results</th>
<th>YoY change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total assets</td>
<td>43,564</td>
<td>-1,829</td>
</tr>
<tr>
<td></td>
<td>Total equity</td>
<td>29,251</td>
<td>176</td>
</tr>
<tr>
<td></td>
<td>Equity ratio</td>
<td>67.1%</td>
<td>70.5%</td>
</tr>
</tbody>
</table>

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

* This includes transactions with a major chain operator that started in FY3/18.

Profit rose sharply and surpassed the forecast on successful high value-added proposal sales to existing halls that strengthened gross margin and lower R&D expenses, as explained above.

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Furthermore, despite weakness in overall equipment sales, service sales steadily improved to ¥5,241mn (including ¥2,206mn in sales for the MG service, to which the Company is particularly focusing its efforts) and are contributing to profit stability.

(2) Control System Segment

Both sales and profits declined with sales falling 49.3% YoY to ¥3,173mn and segment income declining 10.4% to ¥335mn, though both surpassed the forecast. Sales of display units for pachinko amusement equipment were healthy. However, sales for control units and components weakened due to revisions to sales plans of amusement equipment manufacturers with the impact of new regulations, a rise in the reuse rate*, and other factors. Another major setback was the absence of sales of in-house developed pachislot machines (compared to market deployment of about 5,500 units in 1H FY3/18).

| * Reflecting reuse of secondhand amusement equipment |

While profit fell because of the effect of weaker sales, it still outpaced the plan on decline in R&D expenses (though this includes postponements) and other factors.

Sales volume in 1H FY3/19

<table>
<thead>
<tr>
<th>Sales volume (Information System Segment)</th>
<th>1H FY3/18 results</th>
<th>1H FY3/19 results</th>
<th>YoY change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hall computers</td>
<td>33 units</td>
<td>36 units</td>
<td>3 units</td>
</tr>
<tr>
<td>Call lamps</td>
<td>12,295 units</td>
<td>13,977 units</td>
<td>1,682 units</td>
</tr>
<tr>
<td>BigGMO PREMIUM</td>
<td>18,079 units</td>
<td>10,183 units</td>
<td>-7,896 units</td>
</tr>
<tr>
<td>REVOLA</td>
<td>11,490 units</td>
<td>11,017 units</td>
<td>-473 units</td>
</tr>
<tr>
<td>IL-X series</td>
<td>24,438 units</td>
<td>19,681 units</td>
<td>-4,757 units</td>
</tr>
<tr>
<td>VEGASIA CR unit</td>
<td>15 Store unit</td>
<td>11 Store unit</td>
<td>-4 units</td>
</tr>
</tbody>
</table>

Sales volume (Control System Segment)

<table>
<thead>
<tr>
<th>Display unit models</th>
<th>4 models</th>
<th>6 models</th>
<th>2 models</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units sold</td>
<td>23,318 units</td>
<td>45,953 units</td>
<td>22,635 units</td>
</tr>
<tr>
<td>Pachislot machine models</td>
<td>2 models</td>
<td>0 models</td>
<td>-2 models</td>
</tr>
<tr>
<td>Units sold</td>
<td>5,500 units</td>
<td>0 units</td>
<td>-5,500 units</td>
</tr>
</tbody>
</table>

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

Looking back at 1H results in light of these trends, sales dropped amid an ongoing tough market environment with steep declines in new hall openings and major renovations, but we have a favorable view of a larger profit gain than planned on improved gross margin with proposal sales to existing halls and the contribution of MG service growth to stabilizing income. We also think favorable trends in orders of VEGASIA III, a CR unit that includes innovative new services, offers a positive catalyst going forward.

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

Maintained FY3/19 forecast for sales and profit gains, VEGASIA III (including new services) likely to drive 2H results

1. Company forecasts for FY3/19

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

While Control System Segment sales are likely to weaken again, the overall outlook calls for a boost from the Information System Segment with pick-up in sales on reinforced activities in new products and services* in the second half of the fiscal year. In earnings, the Company expects to achieve an increase in operating income through the effect of higher sales and improvements to the gross margin, despite an increase in SG&A expenses due to advertising and promotion costs.

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

We believe the Company is capable of attaining its targets, despite likely continuation of difficult market conditions, because 1H results (profit) outpaced the plan and orders of VEGASIA III, a CR unit that includes innovative new services, are still rising. Our primary focus is the extent of progress with milestones for earnings expansion from FY3/20, including trends in amusement equipment that complies with new regulations (release pace and post-release market assessment) and related timing of pick-up in pachinko hall activity (recovery of investment appetite).

2. FY3/20 outlook

While difficult market conditions might continue in FY3/20 too, we expect clarification of at least a path to earnings expansion during FY3/20 because of gradual activation of replacement demand for related equipment aimed at attracting customers as amusement machines that comply with the new regulations enter the market, positive results in high value-added proposal sales mainly targeting large chains with capital resources, and the need for even pachinko halls that had been delaying investments to address changes in the market environment (such as regulatory responses, recruiting new fan segments, manpower savings, and enhanced security) by investing in order to survive. We think the Company is examining actions (sales measures) for when pachinko halls start investing again and it is important to closely monitor these trends going forward.
Future strategic direction

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

The Company is currently promoting the Next 50 Chapter One medium-term management plan that lasts through FY3/20. Despite uncertainty in the current market environment, the Company is taking steps to bolster the business foundation to address market changes (acquisition of fans with more emphasis on gaming) and contribute to pachinko hall management reforms (making strategic decisions based on data analysis) assuming moderate recovery over the medium term. It aims to lift market share with next-generation hall computers (including peripheral equipment) that it has actively developed up to now and enhance growth potential and profitability through creation of new value that leverages data analysis and planning and development capabilities.

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

* The Company presented FY3/20 goals of ¥57.0bn in net sales, ¥4.0bn in operating income, and at least 7.0% ROE.

1. Information System Segment

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

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

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

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

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

1. Contribute to the healthy operations of pachinko halls by emphasizing the entertainment aspect, and focus on revitalizing the game environment through creation of games that comply with new rules.

2. Promptly respond to the requests of game machine manufacturers to shorten customers’ product development period and contribute to cost reduction and quality improvement, while at the same time leading to lower in-house costs.

3. Utilize Information System Segment’s DK-SIS data and Fan-SIS data to help implement project proposals that will create new “game value” and help expand business territory of the Control System Segment.

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

We believe it is necessary to cautiously assess sales growth, which is readily affected by the external environment, for the time being, but are focusing on improvement in profitability through development of products and services that respond to changes in the market environment and expansion of MG service. From a longer-term perspective, we also anticipate growth for the Company that leverages its dominant position and initiatives seeking to bolster the overall industry. We intend to monitor Company’s activities that directly engage 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), and not only with pachinko halls and amusement equipment manufacturers.
Shareholder returns

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

In FY3/18, the Company lowered the dividend by ¥10 to ¥40 per share for the full year (¥10 interim and ¥30 year-end), taking into account uncertainty about the future market environment. The Company plans to pay a ¥40 annual dividend in FY3/19 (¥10 interim, ¥30 year-end), the same as in the previous fiscal year.

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

To make its shares more attractive to investors and to encourage shareholders to keep their holdings over the medium-to-long term, the Company has adopted a system of awarding gifts to shareholders. Shareholders (owning 100 or more shares) as of September 30 each year receive points that can be exchanged with products (such as food, beverages, electronic equipment, travel or experiences, or donations to social contribution activities) in accordance with the number of shares owned and length of ownership. The Company’s IR official explains that this program has been highly praised by individual shareholders.
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