COMPANY RESEARCH AND ANALYSIS REPORT

Qol Co., Ltd.

3034

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Summary

Aims to accelerate growth in dispensing pharmacy business with “one-on-one pharmacies” and new-format alliance pharmacies

Qol Co., Ltd. <3034> is a major dispensing pharmacy chain positioned at No.2 in dispensing pharmacy store quantity and No.3 in sales (using data from listed companies). Qol’s strategy in the pharmacy business adopts a two-pronged approach of “one-on-one pharmacies” and new-format pharmacies developed through alliances with companies from other industries. Qol also runs CSO (contract sales organization) business, CRO (contract research organization) in BPO (business processing outsourcing), and dispatching services.

1. Reported higher sales and profits on healthy expansion of pharmacy business in FY3/18, reached all-time high earnings

The Company reported sharply higher sales and profits in FY3/18 at ¥145,516mn in net sales (+10.7% YoY) and ¥9,091mn in operating income (+32.4%). In pharmacy business, stores added in a major acquisition during FY3/17 contributed for the full year in FY3/18, giving a roughly ¥9,527mn boost to sales. Same-store sales improved too with a 6.3% YoY increase on gains in the average prescription price and filled prescription volume. In BPO business, while some businesses, such as CRO business, were sluggish, mainstay CSO business and dispatching services were healthy. These trends supported all-time highs in sales and profits on an overall basis, as noted above.

2. Seeking sustainable growth with provision of pharmacies sought by patients and scale expansion as main drivers

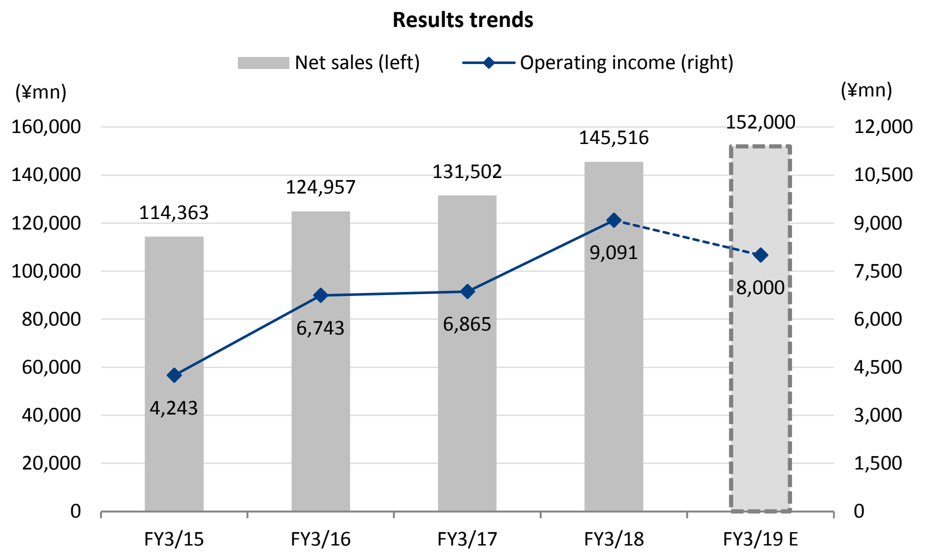
The Company’s pharmacy business growth strategy emphasizes increasing scale, building pharmacies sought by patients, and cultivating human resources. Aggressive acquisitions are the primary tool in expanding scale. We think the Company is capable of establishing a relatively advantageous position by leveraging its concept of one-on-one pharmacies. In provision of pharmacies sought by patients, it focuses on initiatives that utilize strengths, such as pharmacies that provide health support. In cultivating human resources, it aims to improve skills and raise motivation with a unique credentials certification system.

3. Expects lower profits in FY3/19 because of the impact of pharmacy fee revisions, but recovery should be relatively fast

Pharmacy fee revisions in 2018 had some impact on the Company as well. Due to the changes, the Company forecasts profit decline on higher sales in FY3/19. Nevertheless, the 2018 changes are not significant enough to require adjustment of the longer-term growth strategy. We think profit setback from fee revisions should settle down within a year and envision restoration of sales and profit increases in FY3/20. More importantly, we are looking at whether the Company fully carries out growth strategy initiatives mentioned above. If these efforts succeed, we believe it is possible to convert the 2018 revisions (as well as future revisions) into a catalyst accelerating growth, though not necessarily a full-fledged tailwind.

Key Points

- Holds the No.2 position in store volume; pursuing a two-pronged approach of one-on-one pharmacies and new-format pharmacies (through alliances with companies from other industries)
- Seeks growth by increasing scale, building pharmacies sought by patients, and cultivating human resources
- Not much profit decline due to fee revisions and likely to restore profit increases in FY3/20; possibility of a favorable contribution to growth over the longer term



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

Company profile

No. 2 in the industry in terms of store numbers Pursuing a two-pronged approach of one-on-one pharmacies and new-format pharmacies (through alliances with companies from other industries)

1. History

Chairman and CEO Masaru Nakamura established Qol in 1992. Qol has steadily expanded its dispensing pharmacy network since opening the first location in Nihombashi Kabutocho in April 1993. It also moved into related and peripheral areas, including SMO (site management organization) business in 2003, as well as worker dispatching services in 2008.

Qol currently has two business segments – pharmacy business and BPO business. Core companies for these segments are parent Qol for pharmacy business and wholly-owned subsidiary APO PLUS STATION for BPO business (see below for detailed explanations).

Business segment income composition in FY3/18 was pharmacy business at 93% and BPO business at 7% in net sales and 87% and 13% respectively in operating income.

2. Pharmacy business

(1) Business scale and positioning in the industry

The pharmacy business segment operates dispensing pharmacies and convenience stores/hospital shops. However, it is essentially a pharmacy business with dispensing pharmacies at about 97% of store count and most likely a similar percentage of sales.

The Company is ranked second in store volume and third in sales in Japan's pharmacy industry. It had 718 stores in total (including 24 shops) at the end of FY3/18, putting it second after listed pharmacy chain AIN HOLDINGS INC. <9627>. In sales, it ranks third in the industry among listed companies after AIN HOLDINGS and NIHON CHOUZAI CO., LTD. <3341>. NIHON CHOUZAI beats the Company is sales as the industry leader in sales per store. The gap in sales per store is rooted in store strategy differences. We think it is important for pharmacy operators to have clear strategies and concepts in their store approaches and implement them accordingly. Sales per store do not exclusively determine the effectiveness of stores.

(2) Pharmacy strategy

Qol's pharmacy business strategy has two main themes. The first is the "one-on-one pharmacy" concept, and the other is promotion of new-format pharmacies through business alliances with major convenience store operator Lawson, Inc. (2651), West Japan Railway Company (JR West; 9021), and others.

"One-on-one pharmacy" is a concept that defines the fundamental stance in store operations for ordinary Qol pharmacies. It is also the "core business" in Qol's business model. This concept advocates pharmacy development that fosters a one-on-one relationship between the prescribing medical institution and the Qol pharmacy. One-on-one pharmacies keep spending unrelated to medical service to a minimum and invest these savings to improve patient service. More specifically, these pharmacies adjust physical designs and functions in accordance with the departments of target medical institutions (mainly self-run clinics and smaller hospitals) and local qualities. Funds are obtained from the low cost structure of stores, including better efficiency in drug inventories, a benefit of one-on-one pharmacies. Qol gives primary emphasis to development of pharmacies that provide excellent usage value for patients and are selected by patients under the one-on-one pharmacy concept in its store strategy. The one-on-one pharmacy concept is also an important component of the growth strategy described later.

The catalyst for Qol's pursuit of new-format pharmacies through alliances was a reform in the Revised Pharmaceuticals Affair Law from June 2009 that lets convenience stores, drugstores, supermarkets, and other industry stores sell OTC drugs as registered businesses. Qol responded to subsequent efforts by companies from other industries to start dispensing pharmacy businesses by arranging business alliances with the two above-mentioned companies. It also entered into business alliances with BICCAMERA INC. <3048> and other partners from different industries.

Qol views stores opened through the alliances as a "new format" because they cater to different target customer segments than the "one-on-one pharmacies" described earlier. "One-on-one pharmacies" have somewhat restricted customer scope that enables Qol to improve efficiencies in drug inventory management and other areas. New-format pharmacies, meanwhile, target undefined customers in locations with heavy people flow. While these sites require larger inventory investments and other outlays than the "one-on-one pharmacies," they are likely to attract more customers (and thus receive more prescriptions). We think Qol views "one-on-one pharmacies" as its core model and aims to accelerate growth with the new format.

Promoting four businesses with primary focus on CSO and medical personnel dispatching services

3. Overview of the BPO business

BPO stands for Business Process Outsourcing (continuous outsourcing of some business processes to external specialist companies). The BPO business segment handles business consignments from other companies. Its four main areas are CSO business, dispatching services, CRO business, and publishing business.

(1) CSO business

CSO is the largest business in the BPO segment by far and a core area. We estimate that the CSO business and general dispatching services mainly for medical personnel (described below) amount to about 90% of BPO segment sales. This means the business environment in the CSO industry and labor market conditions for medical personnel are key points in assessing BPO business prospects.

CSO stands for "Contract Sales Organization." The CSO business receives consignments from drug companies to handle sales and marketing activities and provide a full range of services related to drug sales based on contracts. It could be called a type of dispatching business.

Specifically, APO PLUS STATION hires medical representatives (MR) and dispatches them to drug companies that have contracts. These dispatched contract MRs (CMRs) conduct sales of drugs for the drug companies they cover to medical institutions and medical personnel.

The industry as a whole has roughly 4,000 CMRs, and Qol (APO PLUS STATION runs this business) employs 520 CMRs (as of the end of FY3/18). As positioning in the industry, Qol's CSO business ranks first in contracted company volume with contracts among the 116 companies using CSO services (in 2017 according to a survey by the Japan CSO Association) and is the third largest group in terms of sales.

CSO rivals with larger sales are the foreign-capital groups IQVIA Services Japan K.K. (changed its name from Quintiles Transnational Japan K.K. in April 2018) and inVentiv Health Japan G.K. We think the industry structure stems from size discrepancies and basic employment stance differences between foreign-capital and domestic companies in the drug industry.

(2) Dispatching services

While dispatching services handle a wide range of medical professionals, we think it involves a large number of pharmacists. We estimate that the Company ranks in the industry's top ten in dispatching pharmacists.

The Company's dispatching services continue to grow rapidly amid constant shortages of manpower in the medical industry, and dispatching services in the BPO business are positioned for further growth. The Company aims to sustain high growth by pursuing synergies with pharmacy business.

(3) CRO business

CRO is an abbreviation of Contract Research Organization. The CRO business provides total solutions from testing and clinical research plans to publications in ethical drug, OTC drug, food, and healthcare fields. The most typical format is total support for clinical tests at medical institutions during drug development based on a consignment from the drug company.

(4) Publishing business
Subsidiary Medical Qol handles publishing-related business, such as drug sales promotions and outsourced production of pamphlets used by medical personnel and patients, books, magazines, and other materials. The group possesses extensive knowledge of and distribution channel with medical institutions and patients through the pharmacy business and CSO and CRO businesses, and publishing business leverages these resources.

Business trends

Reported higher sales and profits in FY3/18 Profits reached all-time highs on strong increases in pharmacy business

1. Review of FY3/18 results

Qol reported FY3/18 results with sharply higher sales and profits at ¥145,516mn in net sales (up 10.7% YoY), ¥9,091mn in operating income (up 32.4%), ¥9,333mn in ordinary income (up 32.1%), and ¥4,986mn in profit attributable to owners of parent (up 14.5%).

Overview of FY3/18 results

(¥mn)

	FY3/17			FY3/18					
	1H	2H	Full year	1H	2H	Full year E	Full year	YoY	vs. forecast
Net sales	60,572	70,930	131,502	71,397	74,119	146,000	145,516	10.7%	-0.3%
Operating income	2,366	4,499	6,865	4,251	4,840	9,000	9,091	32.4%	1.0%
Ordinary income	2,558	4,507	7,065	4,290	5,043	9,200	9,333	32.1%	1.4%
Profit attributable to owners of parent	1,534	2,819	4,353	2,415	2,571	4,900	4,986	14.5%	1.8%

Note: FY3/18 guidance shows updated values from January 2018
Source: Prepared by FISCO from the Company's financial results

The Company raised guidance twice during the period. It ultimately beat the most recent outlook in earnings and sets all-time highs in sales and profits. Net sales climbed in an 11th straight year, and operating income rose in a fourth straight year.

Mainstay pharmacy business delivered higher sales and a steep rise in profits, offsetting sales and profits declines in the BPO business and lifting overall results. We review details below, though primary drivers of stronger pharmacy results were a large contribution from store additions (including M&As), a core growth initiative, and increases in volume (prescription volume) and average price (average prescription price and pharmacy technical fee) at existing stores.

While BPO business incurred lower sales and profits, core CSO business maintained stable activity and dispatching business, a growth area, steadily increased income.

Sales climbed sharply full-year contribution from stores added through M&A from the previous fiscal year; existing store sales expanded smoothly as well

2. Detailed trends in pharmacy business

Pharmacy business recorded sharply higher results with net sales at ¥135,109mn (+12.0% YoY) and operating income at ¥8,652mn (+40.4%).

The ¥14,489mn YoY rise in sales consisted of a large addition of ¥9,527mn from a full-year contribution by the acquisition of KYOEIDO Co., Ltd. as a subsidiary in October 2016, ¥2,349mn in sales growth at existing stores, and ¥2,185mn in sales from new stores in FY3/18 (including acquisitions).

Earnings benefited from higher profits driven by increased sales as well as higher pharmacy technical fees due to promoting use of generic drugs. The Company also strengthened profits by improving precision and optimizing control of costs for drug inventory management and procurement thanks to its deployment of a new inventory system at all stores. As a result, pharmacy operating income expanded ¥2,490mn YoY and operating margin rose by 1.3ppt from 5.1% in FY3/17 to 6.4% in FY3/18.

Total store volume increased by 22 sites from 696 stores at the end of FY3/17 to 718 stores, due to 35 openings and 13 closures. The breakdown of the 35 new stores 17 Qol stores as organic openings, 14 Qol stores through acquisitions, three Lawson stores, and one shop. The 13 closures, meanwhile, were seven Qol stores, two Lawson stores, one station Qol (West Japan Railway), and three shops.

Filled prescription volume expanded at a healthy pace with an increase of 12.1% YoY to 13,084,000 prescriptions on an overall basis. However, recent acquisitions (last two fiscal years) and store openings played a large role. We think the 5.1% YoY rise in same-store prescriptions is a more accurate depiction of the growth trend.

KPI growth rates by pharmacy opening and by fiscal year in the dispensing pharmacy business

	FY3/18					
	Dispensing sales		Prescriptions filled		Average prescription price	
	Growth rate	Net sales (¥mn)	Growth rate	Prescriptions (thousands)	Growth rate	Price (¥)
Existing pharmacies	6.3%	39,823	5.1%	3,802	1.1%	10,473
Pharmacies opened in FY3/17	61.0%	1,159	48.6%	124	8.4%	9,342
Acquisitions, etc.	15.7%	82,999	14.9%	9,157	0.7%	9,063
All pharmacies	12.8%	123,982	12.1%	13,084	0.6%	9,476

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

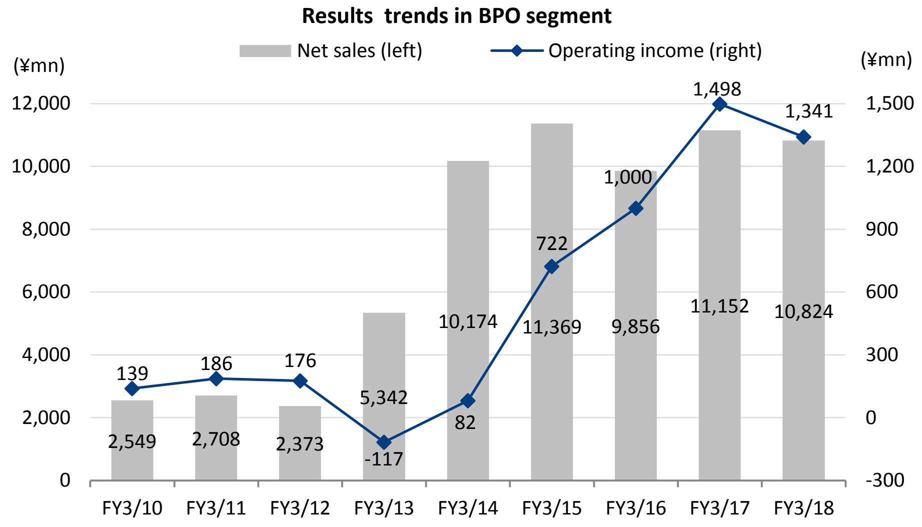
The average prescription price was up 0.6% YoY on an overall basis and 1.1% on a same-store basis. This value should be carefully analyzed because it includes the pharmacy fee and impact of its change.

Change in the pharmacy technical fee is even more important in terms of the impact on pharmacy business profits. Technical fees are initially lowered once every two years, and then efforts are made to restore income through acquisition of add-on points. Points calculated for the basic dispensing fee, standards for dispensing system premium, and generic drug dispensing system premium apply to all prescriptions handled by the subject store and thereby have a very large impact on results.

Healthy trend in CSO and dispatching services; sales and profits dropped on weakness in CRO and publishing businesses

3. Detailed trends in BPO business

The BPO business reported lower sales and profits at ¥10,824mn in net sales (-2.9% YoY) and ¥1,341mn in operating income (-10.5%).



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

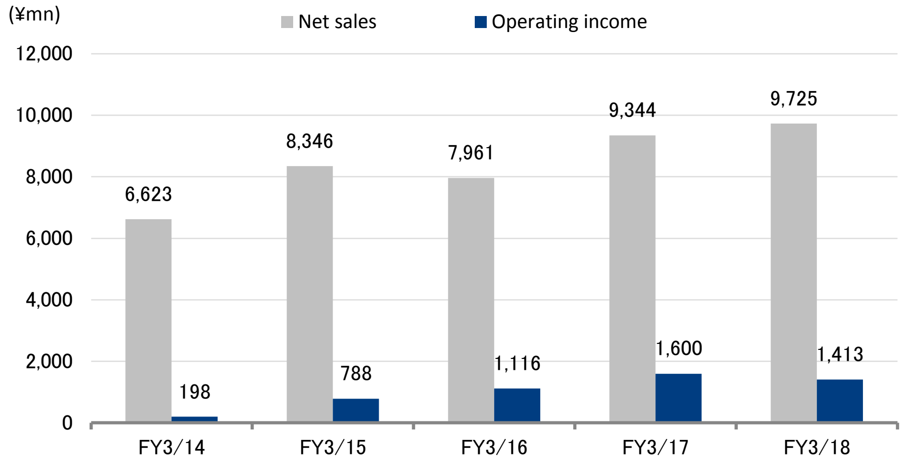
CSO business, the core BPO area, maintained the number of contracted companies and achieved stable activity amid flat market conditions. The Company's CMRs, however, slipped from 540 people at end-1H FY3/17 to 520 people at end-FY3/17. While the Company aims to increase CMRs as a major direction, we think it curtailed the expansion pace in light of market conditions.

Dispatching business, which handles medical personnel, sustained strong growth again in FY3/18. The Company dispatches and recruits mainly pharmacists and nurses, but also registered pharmaceutical sellers, nutritionists, and occupational health nurses. It dispatched more pharmacists than planned in FY3/18 with support from chronic manpower shortages for medical personnel.

CRO business was sluggish in FY3/18. The Company reorganized its CRO operations in 1H, and we think the revisions continued to have an impact in 2H. Project orders volume hence slowed, and this led to the decline in sales.

Given these circumstances, APO PLUS STATION, the core company in the BPO business, posted lower profits on an increase in sales at ¥9,725mn in sales (+4.1% YoY) and ¥1,413mn in operating income (-11.7%). We think sales dropped in BPO business as a whole because of sales decline in publishing business implemented by a different subsidiary.

Trends in APO PLUS STATION results



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

The content and the effects of the 2018 revisions to dispensing fees

Not much profit decline due to fee revisions and likely to restore profit increases in FY3/20; possibility of a favorable contribution to growth over the longer term

1. Overview of the 2018 revisions to dispensing fees and effects on Qol

The drug prices and dispensing fees were revised in April 2018 for the first time in two years. The revisions' impact on results is expected to be extremely severe, and the Company is forecasting that in FY3/19, operating profit in the dispensing pharmacy business will decline 11.9% YoY.

However, the 2018 revisions are not extensive enough to force major change in the Company's growth strategy. We think profit-decline impact should finish in a year (FY3/19) and expect restoration of profit increases in FY3/20.

We believe the biggest points from the 2018 revisions were additional clarification of the direction targeted by the national government (Ministry of Health, Labour and Welfare) and likely accelerated reorganization in the pharmacy industry due to the tough content. In core one-on-one pharmacy operations, the Company aims to deliver "pharmacies sought by patients" and realize the "vision of pharmacies for patients" promoted by the national government. We expect it to continue these initiatives and reverse some of the profit setback from the 2018 revisions in this process. Anticipated increase in acquisition opportunities through pick-up in industry reorganization, meanwhile, could reinforce benefits of the one-on-one pharmacy concept and help the Company steadily convert the reorganization trend into its own growth.

Below we review the following three items from the 2018 revisions – basic dispensing fee, generic drug dispensing system premium, and elimination of the standard for dispensing system premium and introduction of the community-support-system for dispensing system premium. These three items affect all prescriptions handled by stores. Furthermore, while criteria used to calculate the community-support-system for dispensing system premium contain all of the items requested by the national government to pharmacies, we think responses to these items are likely to differ substantially depending on store and growth strategies at each company. We also expect an important role in stock selection for investments.

The review of the evaluations of hospital-adjacent pharmacies is continuing, and the basic dispensing fee is being greatly reduced

2. Content of the revisions to the basic dispensing fee

The government has set different basic dispensing fees according to the type of pharmacy. The government's awareness with regards to the types of pharmacy are as follows: 1) there are many hospital-adjacent pharmacies, including large-scale ones, but there are few pharmacies that are accepting prescriptions from various medical facilities; and 2) major dispensing pharmacy chains (major insurance pharmacies with a chain of more than 20 pharmacies) are increasing and profitability is tending to rise from the deployment of multiple pharmacies. Based on this awareness, the government has reached the conclusion that it cannot be said that the current situation realizes the "family pharmacies" that it is aiming for. Therefore, it is introducing measures to specifically reduce the basic dispensing fee with the aim of optimizing hospital-adjacent pharmacies' dispensing fees.

Before the revision, the basic dispensing fee was divided into three levels, of 1 (41 points) to 3 (20 points) depending on the concentration rate and the number of prescriptions. The difference between the basic dispensing fees 1 to 3 is 21 points. But this basic dispensing fee applies to all of the prescriptions handled by the relevant pharmacies. For instance, in terms of a pharmacy that handles 200 prescriptions per day, it would create a difference in revenue (which is more or less equivalent to profit) of 200 prescriptions x 26 points x 22 days (assuming 2 days of holidays per week) x 12 months x ¥10 / points = ¥11,088,000.

In the 2018 revisions, the standard for the concentration rate was lowered, so it has become easier for pharmacies that had calculated as the basic dispensing fee 1 up to that time to calculate as 2. In addition, the basic dispensing fee 3 was divided into a further 2 levels, and the group with more than 400,000 prescriptions per month was reduced to 15 points, as "3-b."Also, a special basic dispensing fee (10 points) was newly created, targeting pharmacies located within hospital premises.

Immediately before the revisions in March 2018, 70.1% of the Company's pharmacies calculated as basic dispensing fee 1. On applying the 2018 revisions, this percentage drops greatly, to 40.1%. In contrast, the percentage taking the basic dispensing fee 3–b increases to 57.4%, and in addition, the percentage calculating the newly established special basic dispensing fee for pharmacies located within hospital premises becomes 1.6%. The weighted-average points, which is based on the number of dispensing pharmacies at the end of March 2018 of 689 pharmacies, falls from 34.9 points before the revision to 25.4 points after the revision.

The pharmacy basic fee revision has a significant impact on the Company; the related special measure on this fee targets adjustment in assessing pharmacies located next to hospitals, as explained above. However, due to the use of a concentration ratio, the change affects the Company's one-on-one pharmacies as well. One-on-one pharmacies tend to exhibit higher concentration ratios, similar to pharmacies next to hospitals (even though the absolute number of prescriptions differs substantially), given their concept of one-on-one relationships with a certain medical institution.

The content and the effects of the 2018 revisions to dispensing fees

Effects of revisions to the basic dispensing fee

Before revision		
Classification	Points	% of pharmacies
Basic dispensing fee 1	41	70.1%
Basic dispensing fee 2	25	3.3%
Basic dispensing fee 3	20	26.6%
Average	34.9	100.0%
No. of pharmacies	689	

After revision		
Classification	Points	% of pharmacies
Basic dispensing fee 1	41	40.1%
Basic dispensing fee 2	25	0.9%
Basic dispensing fee 3-b	15	57.4%
Special basic dispensing fee	10	1.6%
Average	25.4	100.0%
No. of pharmacies	690	

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

Possesses significant room to improve the generic drug usage percentage; possibility of converting the revisions to a sales and profit increase factor

3. Generic drugs dispensing system premium

Depending on the generic drugs dispensing conditions, each pharmacy can receive the incentive. The incentive points differ depending on the percentage of generic drugs dispensed (on a volume basis), and previously pharmacies with a percentage of 75% or more were calculated as incentive 2 and were able to receive 22 points. However, following the 2018 revisions, this standard was raised to 80% or more. The figure of 80% is the level that the government (the Ministry of Health, Labour and Welfare) has set as the overall target up to 2020. Also, pharmacies with 85% or above are to be newly calculated as incentive 3 (26 points), but conversely, the level to acquire incentive 1 (18 points) has been raised to 75%. This is a so-called carrot and stick strategy, and it shows the strengths of the government's intention to achieve the target.

The revisions to the generic drugs dispensing system premium

	2016 revisions		
	Classification	Standard	Points
Generic drugs dispensing system premium	1	65-75%	18
	2	75% or above	22

	2018 revisions		
	Classification	Standard	Points
Generic drugs dispensing system premium	1	75-80%	18
	2	80-85%	22
	3	85% or above	26

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

The Company's generic drug usage ratio is 71.5% (74.8% on a standalone basis), still trailing the national government's goal of 80%. Its ratio of stores with addition 2 (22 points) prior to the revision was 54.1%. At the standard following the revision, it drops to 22.8%. Tougher standards for acquisition of addition 1 (18 points), meanwhile, raised the percentage of stores with no additions from 17.4% to 42.2%. These changes resulted in decline in the weighted average points from 17.0 points prior to the revision to 12.2 points after the revision.

Nevertheless, we think the Company has substantial room to increase this level because its generic drug usage ratio is generally low, as noted above. We expect the core business model of one-on-one pharmacies, which involve close collaboration with certain medial entities, to pay off in this respect. Recovery in the generic drug pharmacy operation addition should progress relatively fast by strengthening communication with doctors and promoting generic drug prescriptions.

Impact of the revision to the generic drugs dispensing system premium

Before revision		
Classification	Points	% of pharmacies
Premium 1	18	28.4%
Premium 2	22	54.1%
No Premium	0	17.4%
Average	17.0	100.0%
No. of pharmacies	689	

After revision		
Classification	Points	% of pharmacies
Premium 1	18	24.5%
Premium 2	22	22.8%
Premium 3	26	10.6%
No Premium	0	42.2%
Average	12.2	100.0%
No. of pharmacies	690	

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

Policy focuses on “provision of pharmacies sought by patients” rather than seeking point acquisition

4. Abolition of the standards for dispensing system premium and the establishment of the new community-support-system for dispensing system premium

Up until recently, the standards for dispensing system premium (32 points) was calculated for pharmacies that received the classification of one for basic dispensing fee by them meeting certain requirements. But this system was abolished in the 2018 revisions and the new community-support- system for dispensing system premium (35 points) was established.

For the standard for facilities, the government set 11 items as the calculation requirements, and within them, the biggest point is the requirement of having “A considerable track record showing that there is a system in place that contributes to community medical care (hereafter, abbreviated to “track record requirement”). The specific content of the track record requirement is that it is necessary to satisfy all eight items per full-time pharmacist in one year.

This requirement is not applied to pharmacies classified as basic dispensing fee 1, and it is only necessary for them to clear the same requirement as that of the previous standards for dispensing system premium. As previously explained, the government’s policy clarifies that the basic dispensing fee 1 will not be calculated for hospital-adjacent pharmacies, and it seems that the basic dispensing fee 1 will be mainly applied to pharmacies managed by individuals and to foot traffic-type pharmacies in urban areas. The major dispensing chains that have a high percentage of hospital-adjacent pharmacies must supplement the part of the basic dispensing fee that has been reduced with the community-support-system for dispensing system premium. So it seems that the government’s intention is to bring pharmacies closer to the image it has for them through the efforts to obtain this premium.

The Company received the standards for dispensing system premium at 39.9% of its stores in FY3/18 prior to the revision. However, application of criteria for the new local assistance operation addition lowers the ratio of stores receiving related points to 22.8% (this reduces weighted average points from 12.8 points before the revision to 8.0 points after the revision). The main setback is a large decline in the percentage of stores at basic dispensing fee 1 under the revised standard, as explained above. Some time is needed because stores other than those at basic dispensing fee 1 must satisfy eight one-year result conditions in order to obtain the community-support-system for dispensing system premium (one-year results are fundamentally assessed for the year prior to April of each year; this will be calculated in July for 2018 as the first fiscal year of the new program).

While the community-support-system for dispensing system premium sets a tough hurdle, the Company has a clear strategy for dealing with it. The first step is filling the gap between the pharmacy basic fee 1 store ratio of 40.1% and the local assistance operation addition store ratio of 22.8%. Stores receiving pharmacy basic fee 1 do not apply the one-year results items and can obtain the points on easier terms. This is where the Company intends to focus initially.

The Company will not overstretch to obtain the community-support-system for dispensing system premium at stores without basic dispensing fee 1 qualifications because the eight items assessed in one-year results include some that are difficult to attain with the one-on-one pharmacy concept. Rather than engaging in forced activities, it intends to address the community-support-system for dispensing system premium with a natural approach in the belief that seeking to provide pharmacies selected by patients and serving patient needs should ultimately lead to improved store profitability.

Medium- to long-term growth strategy

Pursuing growth with three main points at the core: scale expansion, provision of pharmacies sought by patients, and cultivating personnel

1. Growth strategy for the pharmacy business

The Company implements a consistent growth strategy in its dispensing pharmacy business (pharmacy business) that targets scale expansion and provision of pharmacies sought by patients. As a real-world issue, it is also vital to secure pharmacists to work at stores and improve quality. Efforts to expand dispensing pharmacy business therefore focuses on three main points: 1) expanding scale, 2) building pharmacies sought by patients, and 3) cultivating personnel.

(1) Building pharmacies sought by patients

This mission strives to enhance customer draw (thereby raising the number of prescriptions filled). Store sales are determined as product of multiplying the average prescription price by the number of prescriptions. The average prescription price is affected by drug cost, and the pharmacy technical fee, a key component, is impacted by periodic fee revisions. Prescription volume, on the other hand, can be increased through Company efforts.

The national government specified the ideal image of pharmacies in its “vision of pharmacies for patients.” In its “building pharmacies sought by patients,” the Company adhered to the pharmacy image presented by the government. Specifically, it realizes pharmacies with family pharmacist and pharmacy, advanced pharmaceutical management, and health support functions. A key point is bolstering certain functions in accordance with the location and customer segment, rather than providing all these capabilities in a single pharmacy. The one-on-one pharmacy, which was described above, is the core format in the store strategy. The Company implements measures for “being sought by patients” based on one-on-one pharmacy attributes.

In one-on-one pharmacies, the Company is putting efforts into promotion of pharmacies with health support. It reached 43 stores with such support as of March 2018. It is also engaging in education of personnel and had 753 pharmacists who completed a training course on pharmacies with health support. The Company held a roughly 5% share in this category since the total number of qualified pharmacies with health support functionality nationwide at end-March was 817 stores. While a “5% share” is an important value in the longer-term growth strategy, we think it is very significant to have quickly reached the 5% share in the category of pharmacies with health support.

The one-on-one pharmacy has a direct relationship with a certain medical institution. From this perspective, the Company's emphasis on pharmacies with health support is extremely sensible. We actually think the one-on-one pharmacy is the best-suited way of utilizing pharmacy health support to attract customers because it rooted in the local community and has a fixed customer base. Street pharmacies are unlikely to attract people walking past the store who do not have a prescription to visit even if they set up a sign as a pharmacy with health support. If people use the pharmacy on a regular basis, meanwhile, they might be more inclined to enter the store following some other activity with the aim of measuring blood pressure or ask about a health matter. We expect increase in customer draw and income if pharmacies are capable of fostering an approachable atmosphere through enhancement of pharmacist communication skills and broadening of product line-ups. We also believe this might help lower the concentration ratio.

Along with its initiatives in pharmacies that provide health support, the Company is working to foster a comfortable usage environment at stores. It has deployed free WiFi and multi-payment devices at all Qol pharmacies. It is also promoting use of Qol cards and a prescription transmission app to achieve continuous management that employs ICT. A future initiative is the planned deployment of digital signage at Qol pharmacies.

(2) Expanding scale

Dispensing pharmacy business sales reflect sales per store multiplied by the number of stores. Expansion of scale (store volume) hence is an extremely important aspect of the growth strategy.

The Company has a two-pronged approach to store deployment, as explained above, with Qol pharmacies that mainly utilize the one-on-one model and new-format pharmacies through collaboration with other industries. Qol pharmacy additions come through organic openings (new stores opened by the Company) and acquisitions (purchase stores from another company). The Company aggressively utilizes acquisitions in its growth.

We think the Company's aggressive use of acquisitions in its store expansion strategy make sense and is more likely to be successful. A major reason for this view is the one-on-one pharmacy concept that it employs. All leading pharmacy chains look to acquisition-driven growth as a core component in their growth strategies. These conditions could fuel tougher competition among major chains in acquisition deals. The Company's one-on-one pharmacy concept should pay off when this happens.

The one-on-one pharmacy concept does not necessarily put top priority on sales per store. Instead the Company stresses enhancement of efficiency by building a concentrated dominant presence in areas that helps in logistics, drug inventory management, and other ways. The success scenario we envision is the Company's stance giving it leeway to consider acquisitions that other major chains might reject.

Meanwhile, the Company plans to continually expand new-format stores. These stores are primarily aimed at achieving high customer draw. It is useful to work with companies in other industries for new-format pharmacy rollout because they can effectively deploy street-type pharmacies.

An issue is the significantly greater number of medical entities providing prescriptions and resulting increase in the number of drugs in inventory. This makes it difficult to enjoy the benefits of highly efficient and low-cost store operation enabled by one-on-one pharmacies.

The Company has accumulated knowhow and experience in this area and should offer improvements. Specifically, it operates a division at the logistics center assigned to handling transfers among stores and efficiently manages the inventories of new-format stores. We think it is important to establish conditions that facilitate transfers among stores, such as a store strategy for local dominance, in order to fully take advantage of this mechanism. The Company is implementing related actions. We will be looking for faster openings of new-format pharmacies and improved profitability.

(3) Personnel education

The Company focuses on personnel training, particularly for pharmacists. It arranged the QOL Certified Pharmacist Program, a proprietary credential with the aim of training pharmacists capable of providing quality medical care and boosting pharmacist skills and motivation. More than 3,000 people have become QOL Certified Pharmacists thus far.

Besides this, the Company hopes to enhance pharmacist communication capabilities and change attitudes from passive to proactive.

Growing needs for communication capabilities from pharmacists already began in the response to family pharmacists. With its model of one-on-one pharmacy features and pharmacy health support, the Company expects improved pharmacist communications to contribute to stronger income.

Another perspective is clarification of a shift in the approach to assessing pharmacist activities in the 2018 revisions from “working with things” to “working with people.” To fulfill their role in the local comprehensive care system, pharmacies needs to collaboration with medical entities, authorities, and others in their work. We believe the one-on-one pharmacy concept has an advantageous position in this respect. Pharmacists might also take initiative in achieving closer collaboration and broader scope in some cases. Proactive attitude is essential in order to accommodate this.

Expansion of CSO business with a higher CMR ratio and dispatching services with stable gains as growth engines

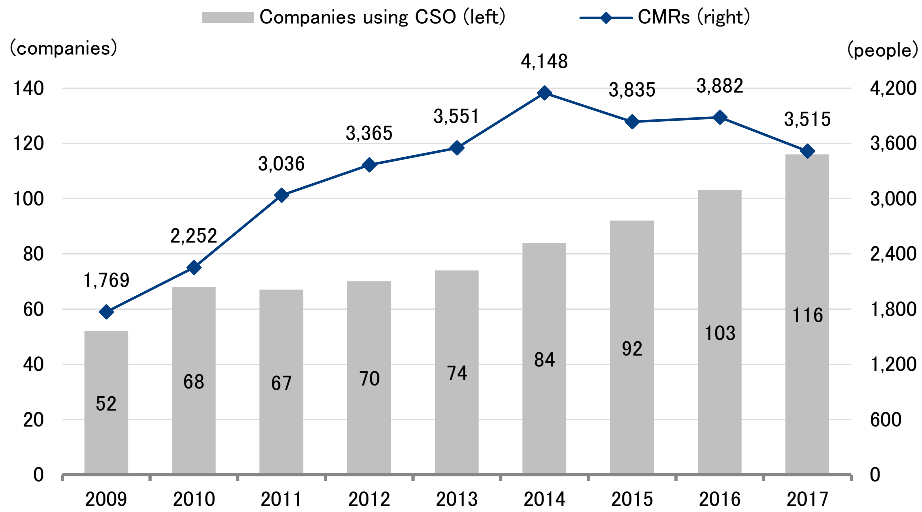
2. Growth strategy in the BPO business

BPO business is involved in CSO, dispatching services, CRO, and publishing. The Company aims to expand coverage in these businesses by collaborating with Qol pharmacies. CSO and dispatch services are main income sources at this point. We think these areas should continue as growth engines over the medium term too.

(1) CSO initiatives

The main source of income in CSO business is outsourcing demand for MRs, who are currently full-time employees, at drug companies. Even in Japan, drug companies are increasingly switching MR from full-time employees to outsourcing each year and the number of companies using CSO service is steadily rising. The number of CMRs climbed as well in line with this trend.

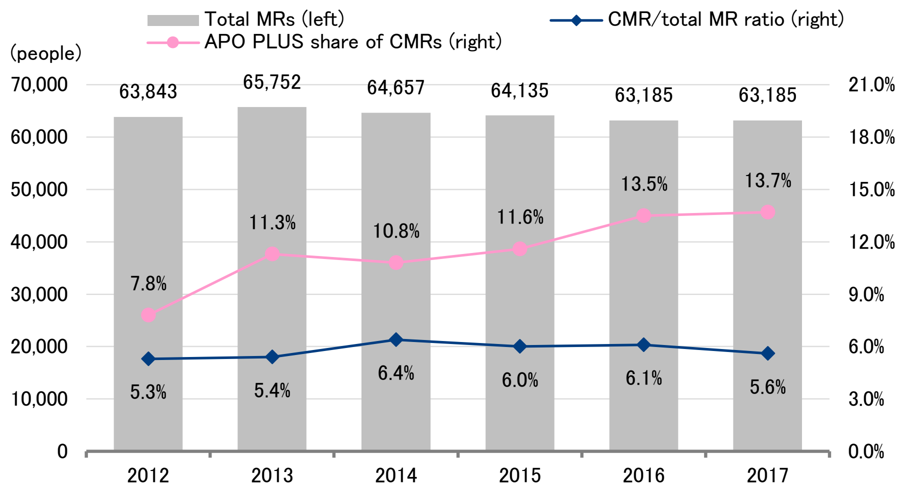
Trends in the number of companies using CSO and CMRs



Source: Prepared by FISCO from materials from Japan CSO Association and the Company

The CMR ratio (percentage of CMRs in all MRs) has been increasing too. The Company expects Japan to move toward the 10-20% level seen in the US and European countries.

Total MRs, CMR ratio, and APO PLUS STATION's CMR share trends



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

CSO business exhibits stronger income volatility (fluctuation) than seen in general dispatching businesses. Demand often increases on a project basis when drug companies release new drugs and pursue sales to medical institutions nationwide. Contract MRs return to their dispatching company after the project finishes. The issue is the number of people. Projects can involve more than 100 people. Resulting movement of contract MRs on a scale of 100 people back and forth between the dispatching company to customers in a relatively short period leads to significant volatility in income. The top two companies in Japan's CSO industry in the sales ranking are foreign-capital entities. We think they with demand shifts by allowing CMR movement.

In response, the Company plans to steadily expand the number of contracted companies and secure CMRs as preparation for a future era of a 15% CMR ratio. We believe the Company (APO PLUS STATION) limits the number of CMRs per dispatch location to smaller teams of a few tens of people in light of CMRs affiliated with it and the number of contract companies. In other words, it is distributing and lowering business risk through distribution of dispatching customers. This cautious stance reassures CMRs and customer companies. We expect benefits in recruiting people and acquiring contracts.

A key point is improvement in CMR quality. The Company aims to train and reinforce general MRs and professional MRs, including use of Qol training and educational programs. It wants to accelerate growth in CSO business by combining trust and reassurance as a CSO business and the presence of quality CMRs.

(2) Dispatching services

Dispatching services delivered a third straight year of higher sales and profits through FY3/18 and is realizing stable growth potential and profitability. The Company expects further growth and has prepared a plan to double sales compared to FY3/16 in FY3/21.

The Company's dispatching services stand out in having a rich variety of professions in the field of medical personnel. It mainly covers pharmacists, but also dispatches and recruits nurses, occupational health nurses, pharmacy administrative staff, nutritionists, and registered sales people. The Company recently formed a Health & Beauty (H&B) division and is dispatching and recruiting personnel who can propose health support products backed by evidence and sold at special medical entity shops.

We think the Company, one of the major pharmacy chains, is capable of advantageously recruiting personnel thanks to its broad recognition, and continuing the double-digit growth sustained up to now from FY3/19.

Outlook

Projecting lower profits on a sales increase in FY3/19 due to pharmacy fee revisions; aiming for recovery from FY3/20 via steady implementation of a growth strategy led by store acquisitions

● **FY3/19 outlook**

For FY3/19, the Company projects a 4.5% YoY rise in net sales to ¥152,000mn, a 12.0% decrease in operating income to ¥8,000mn, a 14.3% fall in ordinary income to ¥8,000mn, and a 9.7% drop in profit attributable to owners of parent to ¥4,500mn.

Overview of FY3/19 outlook

(¥mn)

	FY3/18	FY3/19	
	Full year	Full year E	YoY
Net sales	145,516	152,000	4.5%
Gross profit	19,648	20,995	6.9%
SG&A expenses	10,557	12,995	23.1%
Operating income	9,091	8,000	-12.0%
Ordinary income	9,333	8,000	-14.3%
Profit attributable to owners of parent	4,986	4,500	-9.7%

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

The Company forecasts ¥140,600mn in net sales (+4.1% YoY) and ¥7,600mn in operating income (-11.9%) in FY3/19. It expects to deliver higher sales, despite the setback of weaker pharmacy technical fee income related to the 2018 revisions, thanks to the addition of new store sales based on a plan to increase store volume by 100 stores (including acquisitions) in FY3/19. The breakdown includes 20 Qol pharmacy openings, 10 new-format stores, and 70 stores acquired from others.

The main cause of profit decline is the impact from pharmacy fee revisions. New openings should offset the sales impact. In earnings, meanwhile, losses often occur at new stores in the first fiscal year due to an inability to cover initial costs. Profitability at acquired stores also tends to be lower in the first fiscal year because of downward pressure on profitability from various costs. We think the outlook factors in lingering impact from price revisions that and thus a profit decline.

We estimate the impact of the 2018 revisions for three main items (pharmacy basic fee, generic drug pharmacy operation addition, and elimination of the standard pharmacy addition and introduction of the local assistance operation addition) as a 19.1-point drop in average points at all of the Company's stores. We see a sales setback of ¥2,623mn, assuming a 5% rise in the number of prescriptions from the FY3/18 result (13,084,000) and the point gap before and after revisions lasting one year (therefore, (19.1 points x 13,084,000 x 1.05) x ¥10 = ¥2,623mn), and a direct earnings impact from this amount.

If the Company added 100 stores, meanwhile, we estimate extra sales at ¥17,900mn (on a full-year contribution basis) using the Company's average sales per store (¥179mn in FY3/18). In fact, the Company will be opening the stores during the fiscal year and the results impact could vary considerably depending on the timing. If the additions come at mid-year, the boost in FY3/19 sales works out to ¥8,950mn, which is half of the above-mentioned level. This leaves ¥6,327mn after subtracting the estimated sales decline effect from above-mentioned revisions, which is generally in line with the target of a 4.1% sales increase (¥5,491mn).

The Company actually plans to acquire point additions by promoting use of generic drugs and taking other actions and hence revive average point volume. Conversely, sales at new stores (including acquired ones) are often lower than the Company's average and deal timing of acquisitions is often in the latter half of the fiscal year. Even with these detailed adjustments, however, we believe the Company is sufficiently capable of attaining a sales increase of about ¥5.5bn YoY if it adds to store volume as planned.

In BPO business, the Company guides for ¥12,000mn in net sales (+11.7%) and ¥1,700mn in operating income (+33.5%). Orders and sales slipped in FY3/18, despite healthy CSO and dispatching service activity, because of reorganization in the CRO business. Publishing-related business was also sluggish. The FY3/19 plan expects higher sales and profits driven by recovery in CRO business and solid growth in CSO and dispatch businesses.

Outlook by business segments

(¥mn)

		FY3/18	FY3/19		
		Full year	Full year E	YOY	amount of increase or decrease
Net sales	Pharmacy business	135,109	140,600	4.1%	5,491
	BPO business	10,824	12,000	11.7%	1,176
	Prior to adjustment	145,934	152,600	4.6%	6,666
	Adjusted value	-417	-600	-	-183
	Net sales total	145,516	152,000	4.5%	6,483
Operating income	Pharmacy business	8,652	7,600	-11.9%	-1,052
	BPO business	1,341	1,700	33.5%	359
	Prior to adjustment	9,994	9,300	-6.9%	-694
	Adjusted value	-902	-1,300	-	-398
	Operating income total	9,091	8,000	-12.0%	-1,091
Operating margin	Pharmacy business	6.4%	5.4%	-	-
	BPO business	12.4%	14.8%	-	-
	Company total	6.2%	5.3%	-	-

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

Income statement and main indicators

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19	
					1Q-2Q	Full year E
Net sales	114,363	124,957	131,502	145,516	68,500	152,000
Growth rate (YoY)	13.3%	9.3%	5.2%	10.7%	-4.1%	4.5%
Gross profit	13,989	15,793	16,876	19,648	-	-
Gross margin	12.2%	12.6%	12.8%	13.5%	-	-
SG&A expenses	9,745	9,050	10,010	10,557	-	-
SG&A expenses ratio	8.5%	7.2%	7.6%	7.3%	-	-
Operating income	4,243	6,743	6,865	9,091	3,200	8,000
Growth rate (YoY)	101.6%	-	1.8%	32.4%	-24.7%	-12.0%
Operating margin	3.7%	5.4%	5.2%	6.2%	4.7%	5.3%
Ordinary income	4,262	6,688	7,065	9,333	3,200	8,000
Growth rate (YoY)	93.0%	-	5.6%	32.1%	-25.4%	-14.3%
Profit attributable to owners of parent	2,155	3,709	4,353	4,986	1,800	4,500
Growth rate (YoY)	177.3%	-	17.4%	14.5%	-25.5%	-9.7%
Split-adjusted EPS	63.33	107.78	128.35	141.19	50.97	127.43
Split-adjusted dividend	20.00	24.00	24.00	28.00	14.00	28.00
Split-adjusted BPS	557.42	602.36	652.42	936.74	-	-

Note: Growth rates (YoY) not presented for profit items in FY3/16 because of changes in accounting policy
Source: Prepared by FISCO from the Company's financial results

Balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18
Current assets	24,117	26,534	37,824	36,578	43,313
Cash and deposits	5,162	8,236	16,523	14,174	19,820
Notes and accounts receivable-trade	10,940	12,079	15,242	15,785	16,640
Inventory assets	6,159	4,306	4,254	4,661	4,720
Noncurrent assets	29,767	33,023	31,996	44,668	43,971
Property, plant and equipment	8,309	8,276	8,969	10,373	10,544
Intangible assets	17,311	20,380	18,474	29,483	27,938
Investments and other assets	4,147	4,366	4,551	4,812	5,489
Deferred assets	18	15	27	43	29
Total assets	53,904	59,573	69,847	81,290	87,315
Current liabilities	25,450	26,312	29,334	31,183	33,991
Accounts payable-trade	14,704	15,212	18,096	17,626	18,265
Short-term loans payable, etc.	5,733	5,394	4,696	6,373	6,199
Noncurrent liabilities	11,078	14,108	19,481	28,473	17,387
Long-term loans payable, etc.	9,984	12,793	18,498	27,234	16,361
Shareholders' equity	16,987	19,059	20,394	21,149	35,694
Capital stock	2,828	2,828	2,828	2,828	5,786
Capital surplus	9,085	10,880	9,354	9,366	13,489
Retained earnings	5,371	6,938	9,680	13,137	17,245
Treasury stock	-298	-1,588	-1,469	-4,182	-827
Total accumulated other comprehensive income	46	92	368	167	241
Non-controlling interests	339	-	259	315	-
Total net assets	17,374	19,152	21,022	21,632	35,935
Total liabilities and net assets	53,904	59,573	69,847	81,290	87,315

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

Cash flow statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18
Cash flow from operating activities	2,350	7,841	7,539	5,813	11,116
Cash flow from investing activities	-8,383	-5,066	-3,348	-15,392	-3,775
Cash flow from financing activities	5,722	278	4,085	7,435	-1,685
Effect of exchange rate changes on cash and cash equivalents	0	1	0	1	0
Net increase (decrease) in cash and cash equivalents	-310	3,053	8,275	-2,143	5,656
Cash and cash equivalents at the beginning of the period	5,268	4,957	8,011	16,287	14,144
Cash and cash equivalents at the end of the period	4,957	8,011	16,287	14,144	19,800

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

Shareholder returns

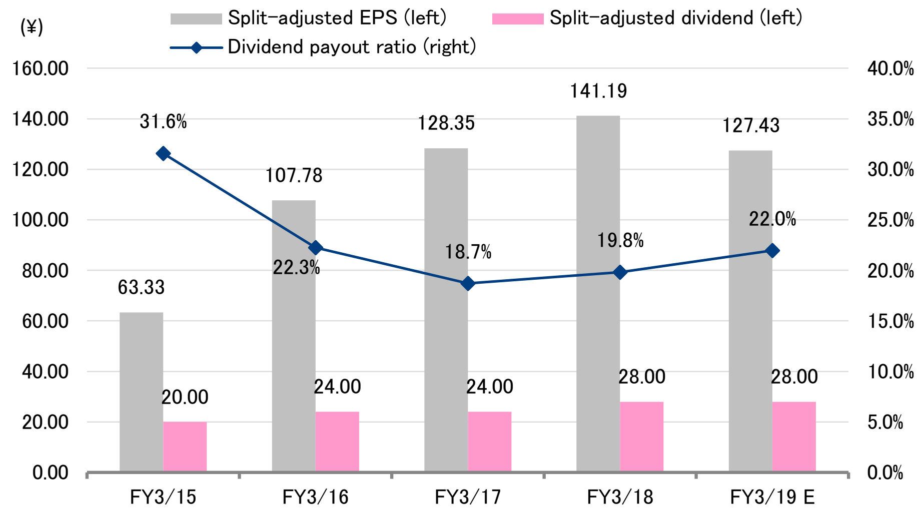
Raised the FY3/18 annual dividend by ¥4 to ¥28
Plans to keep the dividend unchanged, despite lower profit, in FY3/19

Qol primarily relies on dividends as shareholder compensation. Its basic policy advocates steady return of profits to shareholders while also retaining profits in order to pursue future business initiatives and reinforce corporate operations. It does not set an official payout ratio or other standards on dividend value.

The Company decided to raise the dividend by ¥4 to ¥28 (¥14 at end-1H, ¥12 (normal) and ¥2 (commemorative) at period end), as expected. While the period-start dividend target was ¥24 (¥12 at end-1H, ¥12 at period-end), the Company raised the dividend along with upward revisions of the results outlook during the fiscal year and ultimately lifted it by ¥4 YoY. This puts the dividend payout ratio at 19.8%.

The Company disclosed a ¥28 dividend target (¥14 at end-1H, ¥14 at period-end), which is flat YoY, in FY3/19. As mentioned earlier, while it projects lower profit in FY3/19 from the impact of pharmacy fee revisions, we think it kept the dividend unchanged in line with a policy of continuously implementing stable dividends. Dividend payout based on anticipated net income per share comes to 22.0%. The stance of retaining the dividend also contains a message of confidence in restoring profit increase in FY3/20, in our view.

Dividends per share and dividend payout ratio



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

Information security

Manages drug records and other personal data in a cloud service with strong security, focuses on employee education too

Qol has robust capabilities in information security because it handles highly confidential information, such as customer drug and illness records, in the dispensing pharmacy business. It took steps to acquire a privacy mark as an indicator of personal information protection and already received it. It also promotes employee education and awareness and conducts security checks periodically and often. Qol switched from an on-premise site to a more secure cloud format in personal information management. This approach reduces business risk and improves security.

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