COMPANY RESEARCH AND ANALYSIS REPORT

NIHON CHOUZAI Co., Ltd.

3341

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Summary

Making steady progress in its responses for the next-generation pharmacies. Also putting preparations in place prior to a fully-fledged industry reorganization

NIHON CHOUZAI Co., Ltd. <3341> (hereinafter, also "the Company") is a leading domestic dispensing pharmacy company that ranks second in sales in the dispensing pharmacy industry. The Nihon Chouzai Group manufactures generic pharmaceuticals, so one of its key characteristics is that it has a manufacturing function. It additionally has a staffing business for medical practitioners and an information-provision and consulting business, and it is developing its operations with a structure that covers four business departments.

1. Slight increase in sales but decrease in profits in FY3/17. The operating income margin rose compared to the revision year

In the FY3/17 results, net sales were ¥223,468mn (up 1.9% YoY) and operating income was ¥8,519mn (down 18.8%). With regards to the revisions to the drug prices and dispensing fees, in the Dispensing Pharmacy business, the technical fee unit price was recovered, but a significant reduction in the price of a drug for hepatitis C and the sluggish growth in the number of prescriptions had negative effects. In the Pharmaceutical Manufacturing and Sales business, profits declined from the impact of price reductions of long-term listed items by manufacturers of forerunner pharmaceuticals and the intensification of price competition between manufacturers of generic pharmaceuticals. However, compared to the previous revision year (FY3/15), it can be confirmed that on a Company-wide basis, the operating income margin exceeded that in FY3/15 and that the base of profitability has been raised to a higher level.

2. Approximately 90% of its pharmacies meet the facilities standard for the application of family pharmacist guidance fees, which is the highest in the industry. Annually, it receives around 250,000 consent forms

The Company's growth strategy in the Dispensing Pharmacy business is to open pharmacies to be the family pharmacies and health-support pharmacies that are being promoted by the Japanese government as next-generation pharmacies. It is currently making steady progress toward this, including that approximately 90% of its pharmacies meet the facilities standard for the application of family pharmacist guidance fees, and that it received around 250,000 consent forms from patients in FY3/17. Many aspects of the Company's various types of responses for pharmacy openings overlap with its measures to raise the dispensing technical fee unit price, so we can expect it to actively conduct measures in this area in the future also.

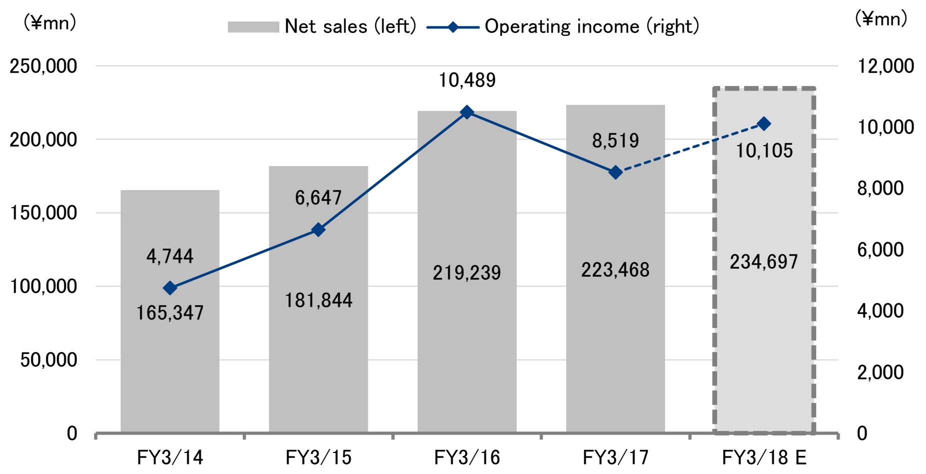
3. Is adopting a cautious stance toward FY3/18, although is forecasting higher sales and profits

For FY3/18, the Company is forecasting higher sales and profits, of net sales of ¥234,697mn (up 5.0% YoY) and operating income of ¥10,105mn (up 18.6%). Looking at the breakdown by business segment, in the Dispensing Pharmacy business, the net sales growth rate will be low, but in this non-revision year, the technical fee unit price that has major impact on profits will trend stably, so an increase in profits is still expected. In the Pharmaceutical Manufacturing and Sales business, the forecast is for a double-digit increase in net sales based on the continued expansion of the market, but profits are expected to trend basically unchanged YoY due to higher costs from upfront investment (including for capital investment and recruitment). In the Medical Professional Staffing and Placement business, it is considered that profits will increase alongside the double-digit rise in net sales.

Key Points

- Growth strategy is to open "family pharmacies" and "health-support pharmacies" as next-generation pharmacies
- Acquired 21 pharmacies through M&A in FY3/17, while closely examining quality. Expects to accelerate M&A in the future
- Adopting a cautious stance toward FY3/18 in preparation for the following year, which is a revision year, but is still forecasting higher sales and profits

Trends in the consolidated results



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

Company profile

Is developing a chain of 556 pharmacies nationwide. Has also entered-into pharmaceutical manufacturing aiming "To realize the true separation of the roles of drug prescribing and dispeusing services".

1. History

The Company was founded in 1980 in Sapporo City by Mr. Hiroshi Mitsuhara, President and Representative Director. The Company's corporate philosophy is "To realize true separation of the roles of drug prescribing and dispensing services" This is based on the approach of President Mitsuhara, who is a qualified pharmacist, that "the ideal situation is one in which the pharmacists in pharmacies judge whether the prescribed medicine is appropriate for the patient and optimize their medical therapy."

Since the launch of the Dispensing Pharmacy business, the Company has steadily expanded its pharmacy network and in 1995, it solidified its footholds as a company with a nationwide presence when it transferred its head office to Tokyo. Subsequently, by 2011 it had opened pharmacies in every prefecture in Japan, and by the end of FY3/17, it had a nationwide network of 556 dispensing pharmacies (and also 1 product-sales pharmacy).

In 2000, it established Nihon Chouzai Pharma Staff Co., Ltd. thereby launching a staffing business for doctors, nurses, pharmacists and other medical practitioners. This company has steadily expanded its business scope and today, after being integrated with the subsidiary Medical Resources Co., Ltd. that was established separately in 2006, it undertakes the Company's Medical Practitioners Staffing business.

In the Company's history, the establishment of Nihon Generic Co., Ltd. in 2005 was a step of similar importance to the founding of the Company itself. President Mitsuhara considered that generic pharmaceuticals would play a major role in realizing the "separation of dispensing and prescribing," and with the opportunity provided by the enforcement of the revised Pharmaceutical Affairs Act in 2005 (currently, the Pharmaceutical and Medical Devices Act), he decided to embark on the manufacture of generic pharmaceuticals. Nihon Generic struggled for a while after it first began in business, but it increased the number of items it produced and established a production system and in FY3/13, the Pharmaceuticals Manufacturing and Sales business segment recorded an operating income for the first time. Subsequently, the scope of this business has been further expanded with the acquisition of Choseido Pharmaceutical in 2013, and also the Kasukabe plant of Teva Pharma Japan Inc. in 2015.

History

March 1980	Established Nihon Chouzai Co., Ltd. in Sapporo to manage dispensing pharmacies
April 1980	Opened the first pharmacy
August 1987	Opened a Tokyo branch
January 1994	Opened the Tohoku branch. Established the subsidiary Miyagi Nihon Chouzai Co., Ltd.
April 1995	Relocated the headquarters to Tokyo. Opened a Sapporo branch and a Kyushu branch
March 2000	Changed the corporate name of Miyagi Nihon Chouzai and established Nihon Chouzai Pharma Staff Co., Ltd.
October 2000	Opened an Osaka branch
September 2004	Listed on the Tokyo Stock Exchange Second Section
January 2005	Established Nihon Generic Co., Ltd. as a subsidiary
September 2006	Listing upgraded to the TSE First Section
October 2006	Established Medical Resources Co., Ltd. as a subsidiary
July 2008	Merged Nihon Chouzai Pharma Staff and Medical Resources (with Medical Resources as the surviving company)
October 2010	Launched the manufacture of generic pharmaceuticals at Nihon Generic's Tsukuba plant
March 2011	Achieved the opening of a pharmacy in every prefecture in the country
January 2012	Established Japan Medical Research Institute Co., Ltd. as a subsidiary
April 2013	Made a subsidiary of Choseido Pharmaceutical Co., Ltd.
February 2015	Nihon Generic acquired the Kasukabe plant of Teva Pharma Japan Inc.*

*Currently Teva Takeda Pharma Ltd.
Source: Prepared by FISCO from the Company's website and securities report

A feature of the Dispensing Pharmacy business is the opening of highly efficient and highly functional pharmacies. It is also demonstrating its presence in the manufacture and sale of generic pharmaceuticals.

2. Business overview

The Company is developing four businesses; the Dispensing Pharmacy business, the Pharmaceutical Manufacturing and Sales business, the Medical Professional Staffing and Placement business, and the information-provision and consulting business. In terms of information disclosure, it divides its businesses into three business segments, the Dispensing Pharmacy business, the Pharmaceutical Manufacturing and Sales business, and the Medical Professional Staffing and Placement business. The information-provision and consulting business is included in the Dispensing Pharmacy business segment.

The Company's Dispensing Pharmacy business ranks fifth among the major dispensing pharmacies chains for the number of pharmacies, but second for net sales. As a result, it ranks first for net sales per pharmacy and there is a considerable distance between it and the companies ranked second and below for this indicator, which is one feature and strength of the Company. This seems to be due to the fact that its pharmacy strategy is not to haphazardly expand its pharmacy network through M&A, but instead to prioritize the opening of its own highly efficient pharmacies. It is not negative toward M&A and its policy is to actively conduct them if there are candidates that meet its own strict standards. The acquisition of Mizuno LLC in FY3/17 can be said to be a good example of this. Another feature of the Company in the Dispensing Pharmacy business is that it has made the greatest progresses within the industry in terms of the response to the policies being promoted by the Japanese government (the Ministry of Health, Labour and Welfare). The government is trying to change the forms taken by dispensing pharmacies, including by revising dispensing fees and drug prices, and this can cause significant damage to results if a company falls behind in its response. The Company anticipated the direction the government would take and took steps in advance to acquire the incentive dispensing fees and worked to prevent a decline in profits or to even increase them. As is described below, FY3/17 was the year when this strength of the Company became clearly apparent.

A feature of the Company's Pharmaceutical Manufacturing and Sales business is that in terms of its positioning, it is not limited to vertical integration within the Company as it also has an independent existence as a (wholesale) company that manufactures and sells generic pharmaceuticals. In the FY3/17 results in the Pharmaceutical Manufacturing and Sales business segment, of the total net sales of ¥36,821mn, ¥24,184mn, or approximately 66%, were external net sales. As described in the Company history, since establishing Nihon Generic Co., Ltd., in 2005, it has expanded its production capacity by acquiring Choseido Pharmaceutical Co., Ltd., and the Kasukabe Plant from Teva Pharma Japan Inc.* and it sells a total of 611 items (as of the end of March 2017). It is currently working on the construction of the Tsukuba Plant No.2 that will have a maximum annual production capacity of 10 billion tablets.

* Currently, Teva Takeda Pharma Ltd.

The Medical Professional Staffing and Placement business is being developed under the "Pharma Staff" brand by the subsidiary Medical Resources Co., Ltd. It places in employment not only pharmacists, but also medical practitioners as a whole, including doctors and nurses. But naturally it is particularly strong in the staffing and placement of pharmacists and ranks first in the industry for the number of pharmacist job postings. A high percentage of pharmacists are women, so there are many cases of them temporarily leaving work due to marriage and childbirth. But on the other hand, there is always strong demand for pharmacists from dispensing pharmacies, so the staffing and placement business is a field that is expected to continue to grow in the future.

Results trends

The results exceeded the revised forecasts, with an increase in sales but decrease in profits YoY. The operating margin improved compared to the revision year.

1. Summary of the FY3/17 results

The Company's FY3/17 results were an increase in sales but a decrease in profits, with net sales of ¥223,468mn (up 1.9% YoY), operating income of ¥8,519mn (down 18.8%), recurring income of ¥7,976mn (down 19.3%), and net income attributable to the owners of the parent company of ¥4,638mn (down 26.7%). It downwardly revised its results forecasts when it announced the Q3 results, but all the sales and profit items exceeded these revised forecasts.

Overview of the FY3/17 results

(¥mn)

	FY3/16	FY3/17						
	Result	Initial forecast	YoY	Revised forecast	YoY	Result	YoY	Vs. revised forecast
Net sales	219,239	240,013	9.5%	222,888	1.7%	223,468	1.9%	0.3%
Operating income	10,489	11,165	6.4%	7,985	-23.9%	8,519	-18.8%	6.7%
Recurring income	9,878	10,778	9.1%	7,907	-20.0%	7,976	-19.3%	0.9%
Net income attributable to the owners of the parent company	6,329	6,642	4.9%	4,347	-31.3%	4,638	-26.7%	6.7%

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

The overview of the FY3/17 results can be easily understood by looking at the breakdown by business segment. Compared to the initial forecasts, net sales were down 4.2% (¥8,209mn) in the Dispensing Pharmacy business and down 20.4% (¥9,450mn) in the Pharmaceutical Manufacturing and Sales business. It can be said that the decline in net sales compared to the initial forecasts in these two businesses was the reason why the Company downwardly revised the forecasts during the fiscal period. The factors behind this are explained in detail below, but it was basically due to the impact of the revisions to the drug prices and dispensing fees in the Dispensing Pharmacy business, and also the impact of the intensified price competition in the Pharmaceutical Manufacturing and Sales business.

In addition to their sluggish net sales, segment operating income also declined YoY in the Dispensing Pharmacy business and the Pharmaceutical Manufacturing and Sales business. In the Dispensing Pharmacy business, it declined 10.7% (¥1,147mn), and in the Pharmaceutical Manufacturing and Sales business, it fell 35.5% (¥948mn). As a result, on a Company-wide basis operating income fell 18.8%, despite the increase in operating income in the Medical Professional Staffing and Placement business.

Breakdown by business segment

(¥mn)

		FY3/16		FY3/17				
				Initial forecast		Result		
			YoY		YoY		YoY	Vs. initial forecast
Net sales	Dispensing Pharmacy business	190,874	20.8%	197,536	3.5%	189,327	-0.8%	-4.2%
	Pharmaceutical Manufacturing and Sales business	32,598	18.3%	46,271	41.9%	36,821	13.0%	-20.4%
	Medical Professional Staffing and Placement business	8,934	36.3%	10,500	17.5%	10,500	17.5%	0.0%
	Before adjustment	232,406	21.0%	254,308	9.4%	236,649	1.8%	-6.9%
	Adjustment amount	-13,166	-	-14,295	-	-13,180	-	-
	Net sales total	219,239	20.6%	240,013	9.5%	223,468	1.9%	-6.9%
Operating income	Dispensing Pharmacy business	10,707	39.1%	-	-	9,560	-10.7%	-
	Pharmaceutical Manufacturing and Sales business	2,668	41.3%	-	-	1,719	-35.5%	-
	Medical Professional Staffing and Placement business	1,599	26.3%	-	-	1,710	7.0%	-
	Before adjustment	14,974	38.0%	-	-	12,989	-13.3%	-
	Adjustment amount	-4,484	-	-	-	-4,470	-	-
	Operating income total	10,489	57.8%	11,165	6.4%	8,519	-18.8%	-23.7%
Operating income margin	Dispensing Pharmacy business	5.6%	-	-	-	5.0%	-	-
	Pharmaceutical Manufacturing and Sales business	8.2%	-	-	-	4.7%	-	-
	Medical Professional Staffing and Placement business	17.9%	-	-	-	16.3%	-	-
	Company-wide total	4.8%	-	-	-	3.8%	-	-

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

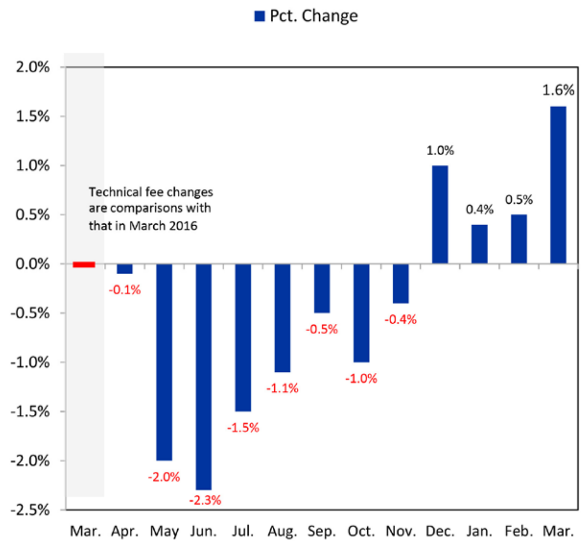
To summarize the FY3/17 results, while sales increased but profits decreased YoY, at FISCO we evaluate that the Company still realized a number of achievements. One achievement was that even though the year started with the revenue base at a lower level, particularly in the Dispensing Pharmacy business, due to the April 2016 revisions to the drug prices and dispensing fees, the operating income margin still rose by 0.1% compared to the previous revision year (FY3/15). This suggests that the profitability base has been further raised-up. Also, the negative effects of the revisions to the dispensing fees were practically completely eliminated by the effects of the revisions to the acquisition of incentives. As is explained below, this signifies the steady progress the Company is making in its growth strategy.

The impact of the reduction in the dispensing technical fee unit price was completely absorbed.

2. Trends in the Dispensing Pharmacy business

Due to the revisions to the dispensing fees in April 2016, the dispensing technical fee unit price in April 2016 started at a negative level compared to immediately before that time, at the end of March 2016. However, as a result of the Company's efforts to improve the basic dispensing fee and to acquire the standard dispensing incentives and the generic pharmaceuticals dispensing system incentives, it was able to gradually reduce the extent of the negative change in the dispensing technical fee unit price compared to March 2016, and by December, it had recovered to a positive change.

Trends in the dispensing technical fee unit price (change compared to March 2016)



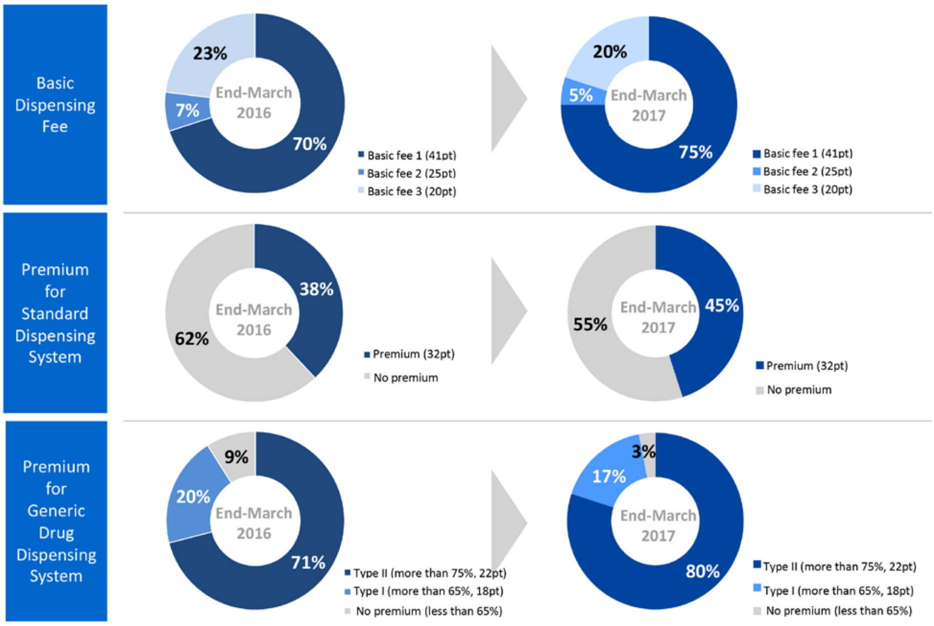
Source: From the Company's results briefing materials

With regards to the basic dispensing fee, prior to the revisions, 89% of the Company's pharmacies acquired the standard fee level 1 (41 points), which fell significantly to 70%, after the revisions, but then recovered by the end of March 2017 to 75%. It would seem that the main factor behind this was that, among the basic dispensing fee level 2 and level 3 pharmacies, there is a rule that enables the application of the basic dispensing fee level 1 when the application of the family pharmacist guidance fees exceeds certain conditions, and some pharmacies achieved this.

The percentage of pharmacies acquiring the standard dispensing incentives (32 points) improved from 38% at the end of March 2016 to 45%. A precondition of acquiring the standard dispensing incentives is to be a pharmacy for which the basic dispensing fee level 1 is applied, and the status of the measures for this are as previously described. In addition, the Company worked to further establish and enhance its system, including to improve pharmacy opening hours, the number of items in stock, 24-hour service system and home-care services, and in this way it increased the percentage of pharmacies acquiring incentives.

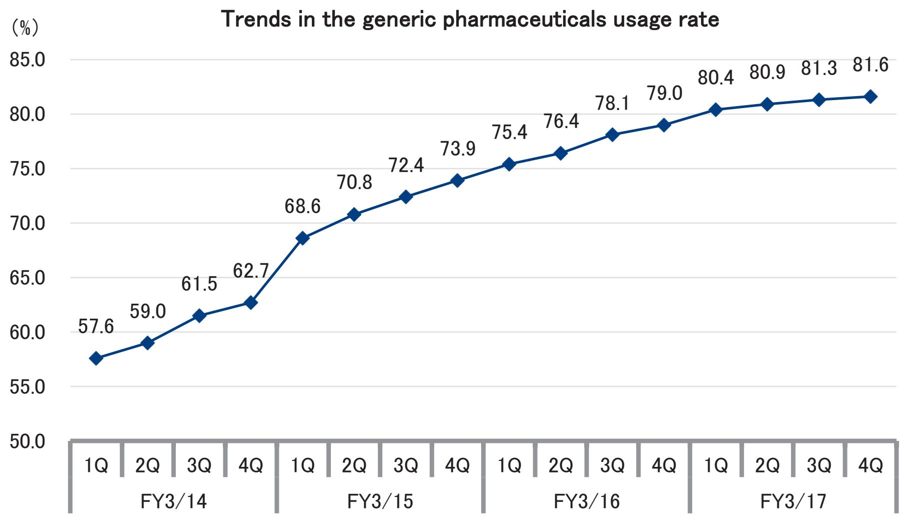
With regards to the generic pharmaceuticals dispensing system incentives, the Company had already achieved the government's target of a generic pharmaceuticals usage rate of 80%, but it has continued to work to further raise this percentage. As a result, the percentage of pharmacies with a generic pharmaceuticals usage rate of 75% or above and that had acquired incentives level 2 (22 points) had risen from 71% at the end of March 2016 to 80% at the end of March 2017.

Improvements to the dispensing technical fee conditions



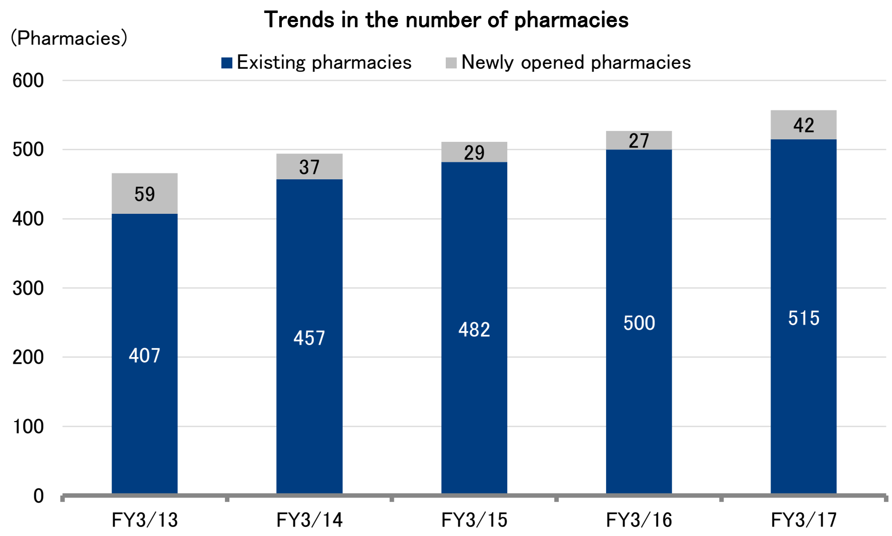
Source: From the Company's results briefing materials

Trends in the generic pharmaceuticals usage rate



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

The Company has been actively conducting M&A to acquire pharmacies, including Mizuno pharmacies that were Japan's first ever dispensing pharmacies. Combined with the opening of its own pharmacies, it added a total of 42 pharmacies to its chain. Conversely, it closed 12 pharmacies, so during the period there was a net increase of 30 pharmacies, for a total of 556 dispensing pharmacies at the end of the fiscal period (it also has 1 product-sales pharmacy). By type, 73% were hospital adjacent-type pharmacies, 15% were foot-traffic type (*mentaio*) pharmacies, and 12% were MC-type pharmacies (in medical centers and medical malls).



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

As previously mentioned, the Company has been able to basically recover all of the impact from the revisions to the dispensing fees by raising its technical fee unit price and from the effects of the higher sales following the increase in the number of pharmacies. However, due to the impact of a major decrease in the price of a drug for hepatitis C and that the number of prescriptions was lower than expected, segment net sales declined 0.8% YoY to ¥189,327mn. As a result, it was unable to absorb the increases in various costs, including pharmacy costs and personnel costs, and segment operating income declined 10.7% to ¥9,560mn.

Is accelerating the expansion of in-house manufactured pharmaceuticals ahead of the start of operations at the new large factory

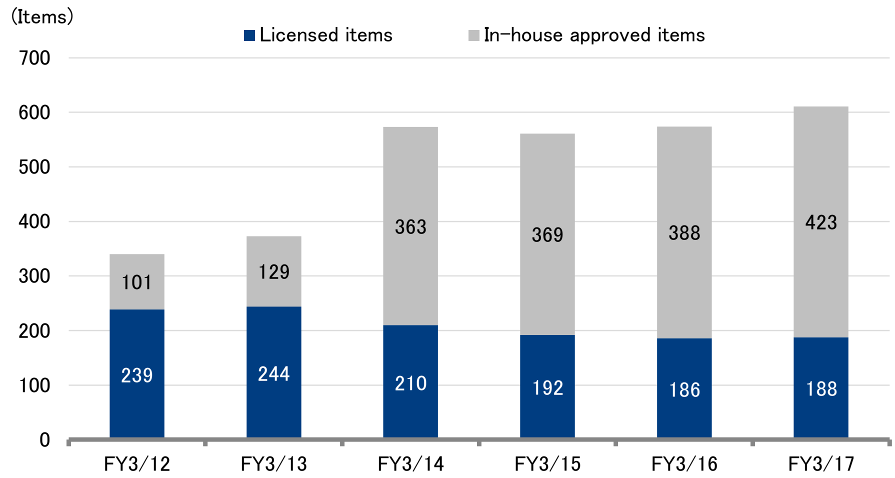
3. Trends in the Pharmaceutical Manufacturing and Sales business

In the Pharmaceutical Manufacturing and Sales business, sales prices fell due to the effects of the April 2016 revisions to drug prices. They also fell further because of the intensification of price competition described below, so there occurred some major factors negatively affecting prices. However, demand continued to increase, including because the revisions to the medical fees are promoting the use of generic pharmaceuticals in medical institutions. As a result, segment net sales increased 13.0% YoY to ¥36,821mn, although this was down 20.4% compared to the initial forecast.

Profits were adversely affected by the intensification of price competition and declined 35.5% YoY to ¥1,719mn. The main factors behind this intensification of price competition included that the manufacturers of forerunner pharmaceuticals reduced the prices of long-term listed items and the price competition between manufacturers of generic pharmaceuticals.

The Company steadily increased the number of pharmaceutical sales items, which had reached 611 items by the end of FY3/17. Of these, 423 items are approved by Nihon Chouzai Group. In addition, it is making steady progress in the construction of the Tsukuba Plant No.2, which will have an annual production capacity of 10 billion tablets. When this new factory is fully operational, the Company's maximum annual production capacity will immediately increase from 6.2 billion tablets in FY3/17 to 16.2 billion tablets. In order to raise the operations rate at the new factory, it will be essential to further increase the number of sales items, and in particular to increase the number approved and manufactured in-house. Toward this, in the future it is expected that its demand for capital will shift from capital investment to research and development.

Trend in the number of generic pharmaceutical sales items



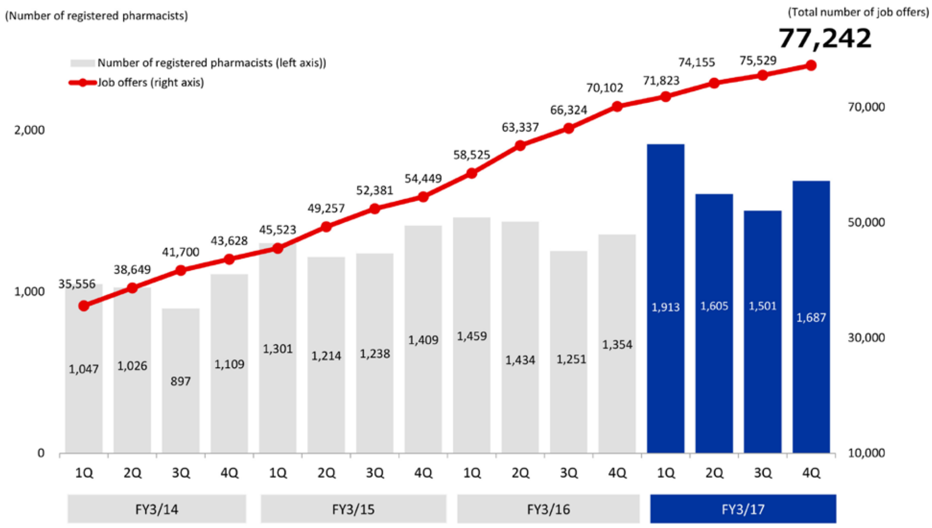
Source: Prepared by FISCO from the Company's results briefing materials

Both the numbers of pharmacist entrants and total job openings are steadily increasing. Reducing recruiting costs is an issue.

4. Trends in the Medical Professional Staffing and Placement business

The direction taken in the April 2016 revisions to the dispensing fees was of expanding and strengthening the roles that should be played by pharmacists and pharmacies, which has increased demand for pharmacist staffing and placements. Benefiting from this development, both the numbers of pharmacist entrants and total job openings are steadily increasing in the Company's Medical Professional Staffing and Placement business, and its net sales rose 17.5% YoY to ¥10,500mn, and segment operating income climbed 7.0% to ¥1,710mn, securing higher sales and profits.

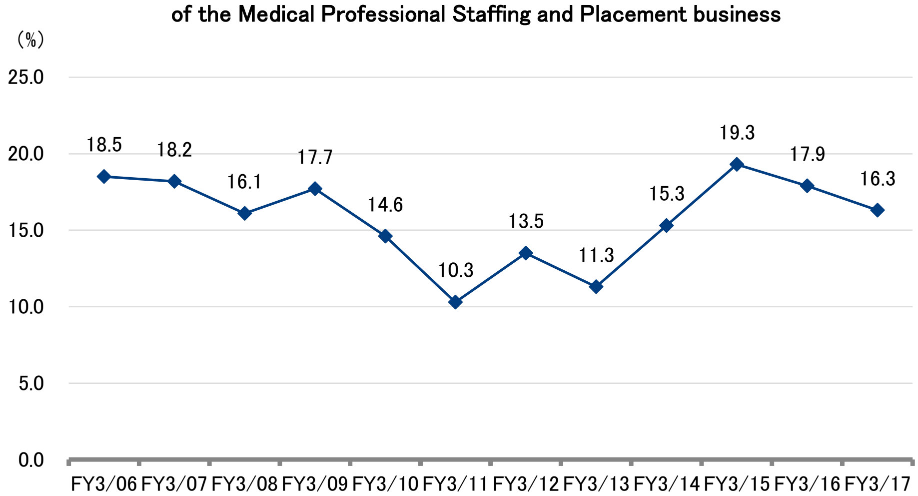
Trends in the number of registered pharmacists and job offers



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

The business content of the Medical Professional Staffing and Placement business continues to expand, and the growth in net sales is expected to be maintained in the future. However, it would seem necessary to be aware of the point that the operating margin has fallen in each of the last two fiscal years. The background to this is the soaring costs of Web advertisements to secure pharmacists. Looking at the trend in the segment operating margin, the result in FY3/17, of 16.3%, is certainly not at a low level. However, because the percentage of fixed costs is not high in this business model, a higher profit margin can be expected by appropriately controlling the costs to increase sales. We will pay attention to the kinds of policies and ideas the Company comes up with to reduce its recruitment costs.

Trends in the operating income margin
of the Medical Professional Staffing and Placement business



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

Medium- to long-term growth strategy

Growth strategy is to open "family pharmacies" and "health-support pharmacies" as next-generation pharmacies

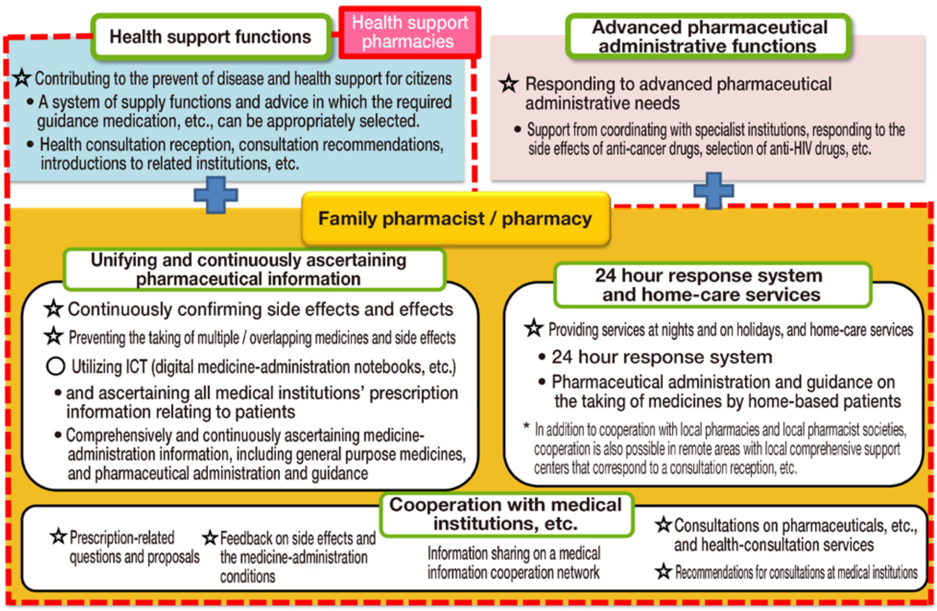
1. The Dispensing Pharmacy business growth strategy: the overall image

In the Dispensing Pharmacy business, net sales are directly determined by the product of the number of pharmacies and net sales per pharmacy. Of these two items, net sales per pharmacy moves comparatively easily in a downward direction by the revisions to dispensing fees, but it is hard to raise it. Therefore, in many cases the growth strategy for a Dispensing Pharmacy business can be said to be synonymous with an M&A strategy that aims to increase the number of pharmacies.

But in its growth strategy, the Company positions the opening of dispensing pharmacies as the first departure point and based on this (and in some cases concurrently with it), it basic stance is to then increase the number of pharmacies, including through M&A.

In October 2015, the government announced its "Vision of Pharmacies for Patients." Within it, it cited health-support functions, advanced pharmaceutical administrative functions, a 24 hour response system, and home-care services as the functions required of next-generation pharmacies. Also, it called the next generation of pharmacies that are equipped with these functions as "health-support pharmacies" and "family pharmacists and family pharmacies." Through its pharmacy openings, the Company is aiming to promote and expand its network of family pharmacies and health-support pharmacies.

Schematic model of the "Vision of Pharmacies for Patients"



Source: A Vision of Pharmacies for Patients

This is not something that is being exclusively addressed by the Company and can be expected of all pharmacy companies. It goes without saying that because there are places where it can and cannot be implemented, it is considered to be a powerful catalyst for industry reorganization. Naturally M&A occur in an industry reorganization, and the Company's basic stance is to first enhance its system so that when the wave of M&A occurs, it can ride it as the acquiring side. The Company tends to be evaluated as being passive toward M&A, but at FISCO we think that it is certainly not passive and this is merely a consequence of its order of priorities, of "Opening pharmacies (or "securing the competitiveness of pharmacies") "M&A."

Approximately 90% of its pharmacies meet the facilities standard for the application of family pharmacist guidance fees, which is the highest in the industry. Annually, it receives around 250,000 consent forms.

2. The Dispensing Pharmacy business growth strategy: status of measures for next-generation pharmacies

For family pharmacies, there is no such thing as a "notification of being designated a family pharmacy." In other words, there is no clear definition of the requirements to be cleared in order to be considered a family pharmacy. However, as the functions a family pharmacist should have overlap with the functions that a family pharmacy should have, it would seem that employing a family pharmacist is a precondition for being considered to be a family pharmacy.

Requirements for family pharmacists

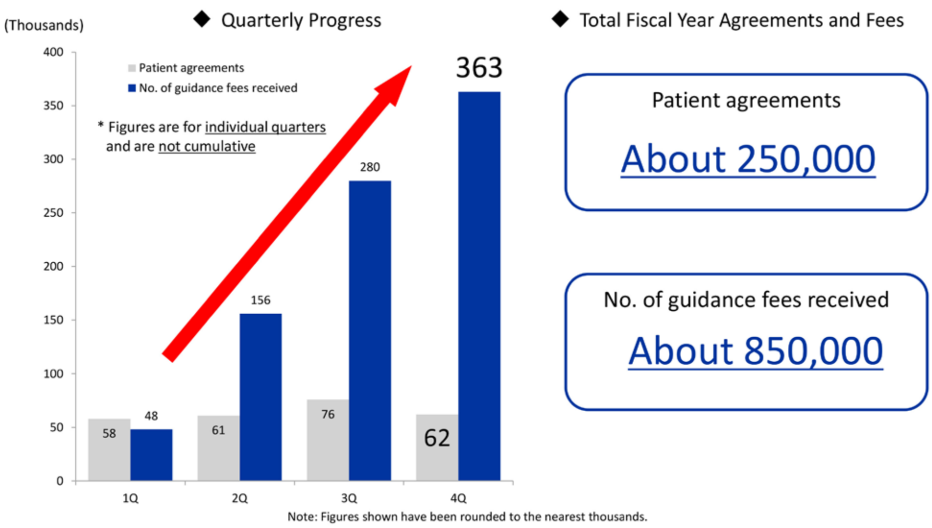
1	Have at least 3 years of experience of working at a pharmacy
2	Work for 32 or more hours per week at the same pharmacy
3	Have been employed by the relevant pharmacy for 6 months or more
4	Participate in community activities involving health care
5	Have acquired the training certification
	(Must satisfy all of 1 to 5 above)

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

The requirements to be a family pharmacist are strictly defined, and after they have been met, the family pharmacist obtains the "family pharmacist guidance fees" (70 points) and "family pharmacist comprehensive management fees" (270 points), including from the consent forms from patients (a consent form naming pharmacist ○○ as the family pharmacist), which can lead to profits for a dispensing pharmacy business. In other words, important indicators for the state of progress in converting to family pharmacies are the percentage of pharmacies that meet the facilities standard for the application of family pharmacist guidance fees, the status of the acquisition of consent forms from patients, and the number of applications of family pharmacist guidance fees.

In FY3/17, approximately 90% of the Company's pharmacies had met the facilities standard for the application of family pharmacist guidance fees (for which the employment of a family pharmacist is a requirement), which positions it as a leader among the major pharmacies chains, whether listed or unlisted. In addition, in FY3/17 it received around 250,000 consent forms from patients and approximately 850,000 applications of family pharmacist guidance fees.

Status of the Company's measures for family pharmacies and family pharmacists



Source: From the Company's results briefing materials

For health-support pharmacies, the Company is aiming to establish health check stations within 150 pharmacies in the next 3 years, and to provide pharmacies with health support functions and to convert them to being health-support pharmacies. It manages three types of pharmacy; the large, hospital adjacent-type, foot-traffic type (*mentaio*), and the MC-type (in medical centers and medical malls). Of these, it plans to actively develop health check stations to be receptacles for customers mainly in the foot-traffic type and the MC-type pharmacies.

Many of the hospital adjacent-type pharmacies are located adjacent to regional core hospitals and to large-scale hospitals, like university hospitals. These are the main places that patients obtain a prescription and the idea is to have pharmacies with "advanced pharmaceutical administrative functions" as one of the functions required of pharmacies by the government. The Company has opened pharmacies adjacent to 69, or around 40%, of the university hospitals around the country. Going forward, at these pharmacies it plans to work to further improve the skill levels of its pharmacists, including by having them acquire cancer specialist pharmacist certification from the Japanese Society of Pharmaceutical Health Care and Sciences.

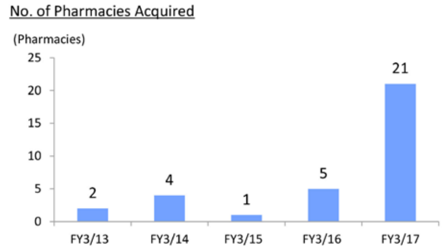
Acquired 21 pharmacies through M&A in FY3/17, while closely examining quality. Expects to accelerate M&A in the future.

3. The Dispensing Pharmacy business growth strategy: status of measures for M&A

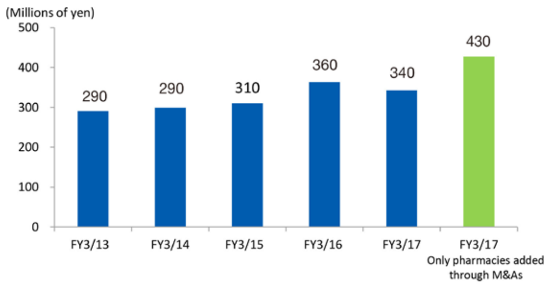
As described above, at FISCO our understanding is that the Company is not passive about M&A but that it only conducts them while faithfully adhering to its order of priorities. The Company's annual net sales per pharmacy are approximately ¥345mn, which is an industry-leading level among the major listed dispensing pharmacies chains. Its stance is to actively conduct M&A if there are candidates that meet its own strict standards.

In FY3/17, the net sales per pharmacy of the pharmacies acquired through M&A was ¥430mn, which exceeds the Company average of ¥340mn. However, this figure of ¥430mn has an exaggerated aspect in that it includes the Mizuno pharmacies that have exceptionally high sales. But it can also be said to indicate the point that the Company prioritizes quality for its M&A.

The Company's M&A strategy
Prioritizing quality and the scale of net sales per pharmacy



Mizuno Pharmacy,
located in front of the University of Tokyo Hospital



Note: Prescription Drug Sales per Pharmacy = Prescription Drug Sales / Average No. of Pharmacies during the Period

Source: From the Company's results briefing materials

In FY3/17, the Company acquired a total of 21 pharmacies through M&A. Although this is a high number not seen in recent years, at FISCO we do not think that it will be an unusually high number in the future. The reason for this is closely related to the above-described promotion of next-generation pharmacies. Currently, there are considered to be around 58,000 dispensing pharmacies nationwide, but it seems that more than half of these are "one-pharmacist pharmacies." It is obvious that a single pharmacist cannot physically carry out all of the functions that will be required of next-generation pharmacies, like family pharmacies. Based on this fact, discussions on "whether consolidation is necessary to a certain extent" have already taken place within the government. This is extremely significant and it can be understood as indicating that the government will promote M&A by the major dispensing pharmacy chains.

It is considered that if progress is made in industry reorganization and M&A, it will result in greater market shares for the major dispensing pharmacy companies. Although it goes without saying that this will be from the effects of the increase in the number of pharmacies, it is also thought that the rise in net sales per pharmacy (from the more advanced functions and larger scales of pharmacies) will be a factor behind their higher shares. It is difficult to make precise predictions about the future at the current point in time, but it seems fully feasible to expect the Company will double its number of pharmacies (to a chain of 1,000 pharmacies) and also its net sales per pharmacy will increase by 1.5 times compared to the Company-wide average. It seems that in the short term, there will be a period in which various negative factors, such as the yearly revisions to drug prices, will have to be endured, but at FISCO we think that after that, there will be a period of growth and expansion through the industry reorganization. We consider that the Company, which up to the present time has been steadily advancing measures for next-generation pharmacies, is presently at the start of a period of conducting M&A in earnest and that it will accelerate M&A from now on.

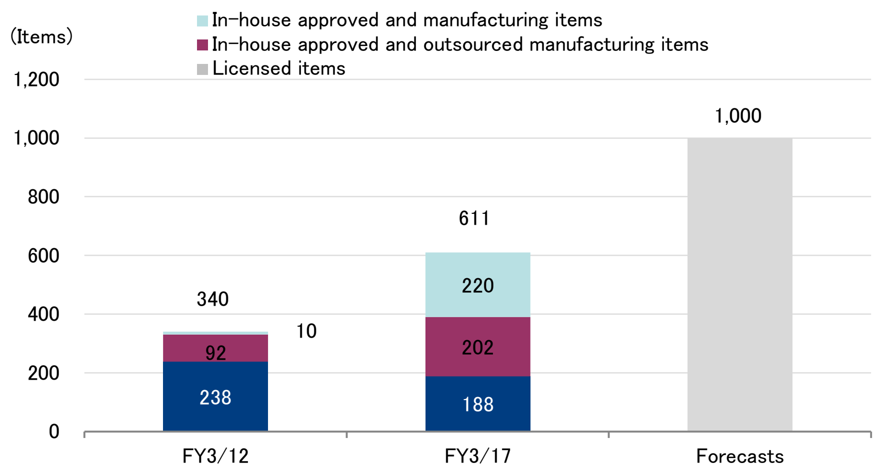
The focus of the growth strategy is securing operations at the Tsukuba Plant No.2. The key will be increasing in-house manufacturing.

4. The Pharmaceutical Manufacturing and Sales business growth strategy

In the Pharmaceutical Manufacturing and Sales business, the Company is currently focusing on constructing the Tsukuba Plant No.2. If the progress continues to be smooth, it is expected to be completed and become operational in April 2018. The maximum production capacity of the Tsukuba Plant No.2 will be 10 billion tablets a year, which means that its annual production of 6.2 billion tables from the existing facilities will immediately and substantially increase. Securing the operations at the new plant will also secure the net sales to cover the fixed costs, including the depreciation expenses. This in itself is the growth strategy for the Pharmaceutical Manufacturing and Sales business.

On this point, the first policy to be cited is expanding the number of generic pharmaceuticals manufactured in-house. At the end of FY3/17, the Company sold 611 items, of which approximately 36% were items that were approved and manufactured in-house. For the future, it is aiming to increase the total number of items sold to 1,000 items, and within this number, increasing the percentage of items approved and manufactured in-house will lead to an improvement in the operations rate at the new factory. Also, in order to secure a high operations rate for its facilities, the Company might consider accepting outsourced manufacturing from other companies.

Trend in the number of generic pharmaceutical sales items



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

In addition to securing the operations rate for production, an important point in the Pharmaceutical Manufacturing and Sales business will also be securing sales channels. It is meaningless to produce items if you cannot then sell them. On this point, at FISCO we think that the fact the Company has the Dispensing Pharmacy business is a major advantage.

In the FY3/17 results, 34.3% of the sales in the Pharmaceutical Manufacturing and Sales business were internal sales. As production volume and the number of items will increase in the future, it can be said that the fact that the Company has already secured a sales destination for approximately one third of its sales is a major strength. As previously stated, the trend of an increase in the number of pharmacies in the Dispensing Pharmacy business, such as through M&A, is expected to continue in the future, and even if the percentage of internal sales does not change, the absolute values of the sales volume and sales amount can be expected to increase. If looking at this from the opposite direction, a positive factor is that there seems room to increase the percentage of Nihon Generic items among the generic pharmaceuticals sold in the Dispensing Pharmacy business.

In the short term, there are concerns that profits in this business will fall greatly in FY3/19. This is because the depreciation expenses that will accompany the start of operations at the Tsukuba Plant No.2 will overlap with the impact of the revisions to drug prices in April 2018. Naturally the Company has already considered this point and has been preparing for it ahead of time since FY3/17. Specifically, it has been hiring personnel to conduct the operations at the Tsukuba Plant No.2 ahead of schedule and is training them at the existing Tsukuba Plant toward improving their proficiency in operations. The Company is incurring upfront costs as a result of this, which is putting downward pressure on profits at the current time, but conversely it means a major increase in personnel costs is not expected in April 2018. Also, within the Pharmaceutical Manufacturing and Sales business as a whole, it is also investing in expanding production capacity and in the types of pharmaceuticals that can be produced at the Tsukuba Plant S Building and the Kasukabe Plant, and it is preparing a system to make possible optimized production after the Tsukuba Plant No.2 becomes operational.

Business outlook

Is adopting a cautious stance toward FY3/18 in preparation for the following year, which is a revision year, but is still forecasting higher sales and profits

For FY3/18, the Company is forecasting net sales of ¥234,697mn (up 5.0% YoY), operating income of ¥10,105mn (up 18.6%), recurring income of ¥9,804mn (up 22.9%), and net income attributable to the owners of the parent company of ¥5,639mn (up 21.6%).

Summary of the FY3/18 outlook

(¥mn)

	FY3/17		FY3/18			
	1H	Full year	1H		Full year	
	Result	Result	Forecast	YoY	Forecast	YoY
Net sales	109,478	223,468	113,606	3.8%	234,697	5.0%
Operating income	3,940	8,519	4,251	7.9%	10,105	18.6%
Recurring income	3,751	7,976	4,115	9.7%	9,804	22.9%
Net income attributable to the owners of the parent company	2,339	4,638	2,231	-4.6%	5,639	21.6%

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

In the Dispensing Pharmacy business, the forecast is for net sales to increase 3.9% YoY to ¥196,681mn. As there will be no impact from revisions to dispensing fees in FY3/18, the base of the technical fee unit price will not be lowered. Therefore, we can expect the trend of higher sales and profits to return alongside the increases in the number of pharmacies and prescriptions. The net sales forecast of an increase of 3.9% appears somewhat conservative in light of the rise in the number of pharmacies (supposing a net increase of 30 pharmacies, the same as in the previous fiscal year, the average number of pharmacies during the period will rise 5.5%). However, in this fiscal period also, there is expected to be a major decline in sales from a drug for hepatitis C, whose sales had already declined in the previous fiscal year, due to the decrease in the number of patients. Also, despite the trend toward fewer "long-term prescriptions," of prescribing medication for more than 30 days on a single prescription, the unit price per prescription will fall, which will have a major impact on net sales. On taking these factors into consideration, it can be said that a target of a 3.9% increase in sales is not low at all.

In the Pharmaceutical Manufacturing and Sales business, the forecast is for net sales to increase 12.7% YoY to ¥41,500mn. The fact that the Company's sales-increase rate is below the forecast growth rate for the generic pharmaceuticals industry as a whole, of 15%, can be understood as indicating its cautious stance. At FISCO, we think that the background to this cautious stance is the Company's concerns that the developments seen in the previous fiscal year, of a reduction in prices of long-term listed items by manufacturers of forerunner pharmaceuticals and the intensification of price competition between manufacturers of generic pharmaceuticals, will continue in this fiscal period also. The Company itself does not intend to engage in price competition, but it is important that it secures a certain level of market share in advance of the start of operations at the new plant in April 2018. Therefore, it cannot be denied that, depending on the situation, it may be forced into price reductions, and it seems to have taken this into consideration for its sales forecast.

In the Medical Professional Staffing and Placement business, net sales are forecast to increase 14.3% YoY to ¥12,000mn. The labor shortage in the industry as a whole will continue, so it is estimated that the total number of job openings and the number of pharmacist entrants will also continue to trend upwards. There would seem to be little cause for concern about whether or not the Company can achieve its sales forecast for this fiscal year.

Net sales outlook by business segment

	FY3/17		FY3/18	
	Result	YoY	Initial forecast	YoY
Dispensing Pharmacy business	189,327	-0.8%	196,681	3.9%
Pharmaceutical Manufacturing and Sales business	36,821	13.0%	41,500	12.7%
Medical Professional Staffing and Placement business	10,500	17.5%	12,000	14.3%
Before adjustment	236,649	1.8%	250,181	5.7%
Adjustment	-13,180	-	-15,484	-
Net sales total	223,468	1.9%	234,697	5.0%

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

In terms of profits, operating income is expected to increase ¥10,105mn YoY to ¥1,586mn (up 18.6%). The Company does not disclose operating income forecasts by segment, but we can calculate that if the operating income margin in the Dispensing Pharmacy business improves from 5.0% in FY3/17 to above around 5.5%, this forecast can be achieved even if the operating income amounts in the other two business segments remain basically unchanged.

In actuality, the growth rate of net sales in the Dispensing Pharmacy business will fall due to the previously mentioned reasons, but dispensing technical fees, which directly impact profits, are unlikely to decline because it is a non-revision year. So it is thought that profits will increase proportional to the increase in the number of prescriptions alongside the rise in the number of pharmacies. As a result, the operating income margin will improve compared to FY3/17. In the Pharmaceutical Manufacturing and Sales business, a double-digit increase in net sales, up 12.7%, is forecast. But as previously described in the section on trends by segment, the Company is conducting upfront investment, including for capital investment and recruitment, and as a result it is certain that deprecation expenses and personnel costs will increase compared to the previous fiscal year. Therefore, we think that profits will not increase in the same way as net sales. But we think that it is highly likely that profits will rise in the Medical Professional Staffing and Placement business, because the Company has reflected on FY3/17 and will keep down recruitment costs, including for Web advertisements. A decline in profits in this business would be from a case in which the operating income margin worsens by more than 2% YoY, which we think is unlikely.

Income statement and the main indicators

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18	
					1H E	Full year E
Net sales	165,347	181,844	219,239	223,468	113,606	234,697
YoY	18.6%	10.0%	20.6%	1.9%	3.8%	5.0%
Gross profit	25,623	31,929	39,068	39,258	-	-
Gross profit margin	15.5%	17.6%	17.8%	17.6%	-	-
SG&A expenses	20,878	25,281	28,578	30,738	-	-
Ratio of SG&A expenses to net sales	12.6%	13.9%	13.0%	13.8%	-	-
Operating income	4,744	6,647	10,489	8,519	4,251	10,105
YoY	46.2%	40.1%	57.8%	-18.8%	7.9%	18.6%
Operating income margin	2.9%	3.7%	4.8%	3.8%	3.7%	4.3%
Recurring income	4,188	6,003	9,878	7,976	4,115	9,804
YoY	46.7%	43.3%	64.5%	-19.3%	9.7%	22.9%
Net income attributable to the owners of the parent company	1,901	2,778	6,329	4,638	2,231	5,639
YoY	928.4%	46.1%	127.8%	-26.7%	-4.6%	21.6%
EPS (¥)	262.48	388.96	432.85	290.03	139.53	352.59
Dividend per share (¥)	70.00	70.00	65.00	50.00	25.00	50.00
BPS (¥)	2,181.26	2,515.19	2,030.22	2,278.70	-	-
EPS after adjustment for stock-split (¥)	131.24	194.48	432.85	290.03	139.53	352.59
Dividend per share after adjustment for stock-split (¥)	35.00	35.00	45.00	50.00	25.00	50.00
BPS after adjustment for stock-split (¥)	1,090.63	1,257.59	2,030.22	2,278.70	-	-

Note: the Company conducted a 1:2 stock split on October 1, 2015
Source: Prepared by FISCO from the Company's financial results

Balance sheet

(¥mn)

	End of FY3/13	End of FY3/14	End of FY3/15	End of FY3/16	End of FY3/17
Current assets	43,037	53,373	60,096	84,838	82,327
Cash and deposits	14,583	15,429	13,952	32,385	21,200
Accounts receivable, etc.	13,645	18,665	21,413	26,810	27,643
Inventories	12,405	16,396	21,066	22,016	29,514
Fixed assets	52,102	63,921	70,044	72,770	96,019
Tangible fixed assets	32,459	42,123	48,819	51,997	68,513
Intangible fixed assets	9,423	11,103	10,376	10,122	16,773
Investments, etc.	10,219	10,694	10,848	10,650	10,733
Total assets	95,140	117,295	130,141	157,609	178,347
Current liabilities	44,702	55,666	53,474	68,985	66,305
Accounts payable	24,542	28,963	33,392	44,653	41,033
Short-term debt, etc.	14,065	18,639	11,169	12,963	13,411
Fixed liabilities	35,735	45,779	59,031	56,151	75,595
Long-term debt	33,845	42,165	53,184	50,621	70,678
Shareholders' equity	14,353	15,845	17,515	32,507	36,345
Capital	3,953	3,953	3,953	3,953	3,953
Capital surplus	4,754	4,754	4,754	10,926	10,926
Retained earnings	7,915	9,310	11,868	17,672	21,511
Treasury stock	-2,269	-2,171	-3,059	-44	-46
Total accumulated other comprehensive income	349	3	119	-34	101
Total net assets	14,702	15,849	17,635	32,473	36,447
Total liabilities and net assets	95,140	117,295	130,141	157,609	178,347

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

Cash flow statement

(¥mn)

	FY3/13	FY3/14	FY3/15	FY3/16	FY3/17
Cash flow from operating activities	2,885	6,243	5,831	19,327	-940
Cash flow from investing activities	-6,422	-14,510	-8,437	-7,823	-28,444
Cash flow from financing activities	5,496	8,782	1,422	7,031	18,205
Change in cash and deposits	1,958	514	-1,183	18,535	-11,180
Cash and deposits at start of fiscal year	12,544	14,513	15,027	13,844	32,380
Cash and deposits at end of fiscal year	14,513	15,027	13,844	32,380	21,200

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

Shareholder returns

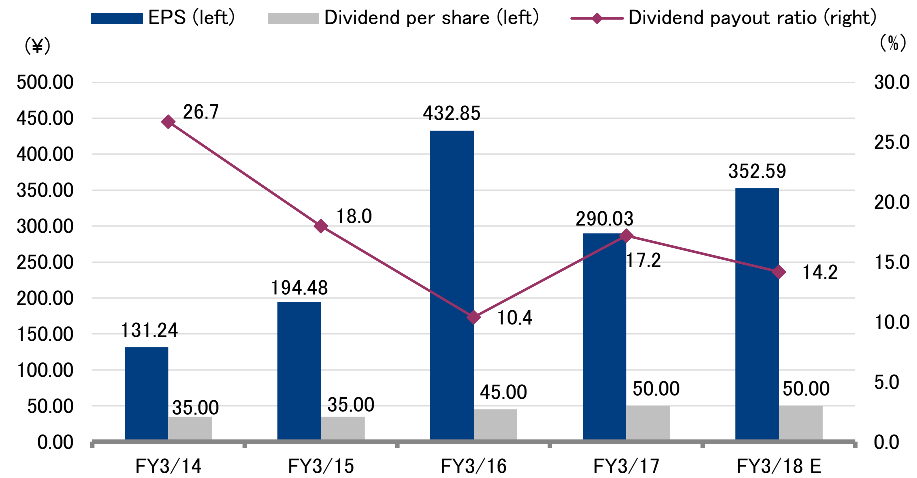
Policy is to return profits to shareholders linked to business performance. Paid a dividend of ¥50 in FY3/17, an actual increase of ¥5.

The Company's basic approach to shareholder returns is to pay dividends linked to business performance while ensuring it maintains the internal reserves necessary for growth.

In FY3/17, the Company paid an annual dividend of ¥50, comprised of an interim dividend of ¥25 and a year-end dividend of ¥25, which was just as forecast. After adjusting for the stock split, the annual dividend in FY3/16 was ¥45, meaning the FY3/17 dividend actually increased by ¥5 YoY. The dividend payout ratio rose to 17.2% from 10.4% in FY3/16.

For FY3/18, the Company has announced an annual dividend forecast of ¥50, the same as in the previous fiscal year (comprised of an interim dividend of ¥25 and a year-end dividend of ¥25). The forecast EPS is ¥352.59 (up 21.6%), and based on this, the dividend payout ratio will be 14.2%. The Company is advancing the construction of the new pharmaceutical manufacturing plant and also has considerable requirements for funds in the Dispensing Pharmacy business, including for M&A. So on the one hand we do not think an easy increase in dividends can be expected, but on the other hand the Company is aware of the importance of returning profits to shareholders. Therefore, first of all we shall be keeping a close watch on how business performance trends.

Trends in EPS, dividend per share and the dividend payout ratio



Note: the Company implemented a two-for-one stock split on October 1, 2015, and the EPS and the dividend per share in the graph take into account this stock split.
Source: Prepared by FISCO from the Company's financial results

FISCO

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