Walden Research Japan

URL: www.walden.co.jp
Analyst : Yoshiyuki Muroya
E-mail: yoshiyuki_muroya@walden.co.jp
Phone : +81 3 3553 3769

Company Visit Memo

Interviews with Company (24 August 2010)

Small Cap Company Visits

We, Walden Research Japan, have continued visiting listed companies in Japan, those of small cap as the core constituents. Having interviewed with IR persons, managing directors and top management, we investigated business models, recent trading and prospects with them. Main points based on the contents of the interviews, as of the date specified below, have been summarized as Company Visit Memo here in this text, concerning the companies listed below:

Date of Interviews	Listed Markets	Name (Ticker)
27 July (Tuesday)	JASDAQ	Index Holdings (4835)
2 August (Monday)	JASDAQ	AFC-HD AMS Life Science (2927)
2 August (Monday)	TSE1	Nihon Trim (6788)
6 August (Friday)	JASDAQ	EPCO (2311)
9 August (Monday)	Heracles	Yumeshin Holdings (2362)

Index Holdings (4835)

index

Share Price (Japanese) Company Information (English) IR Information (English)

A Future Chance for Resumption of Dividend Payment

In Q3 FY08/2010 (9-month period), sales came in at ¥29.7bn (down 50.9% YoY), operating profit ¥2.5bn (up 1.6%), recurring profit ¥1.5bn (versus losses in the previous year) and net profit ¥0.7bn (ditto). The current levels of the turnover with the Company equates to some 30% when compared with the peak levels in FY08/2007. This is a result of the Company's full-scale reorganization to pull out of all the loss-making operations. Through this process, the Company maintained making money at the operating levels, but it reported massive losses at the non-operating and extraordinary levels, associated with the reorganization, having ended up with collective net losses of ¥60.4bn through FY08/2007 to FY08/2009. Earned surplus stood at negative ¥68.1bn as of the end of FY08/2009, while shareholders' equity ¥4.5bn supported by paid-in capital etc. of ¥72.6bn. With a condition that the Company will not report any major losses as in the previous years, the Company should see some sequential improvements in its state of finance, and thus imply sequentially improved future chance for resumption of dividend payment. While dividends were suspended in both FY08/2008 and FY08/2009, the Company has not announced any prospects for the resumption to date. The other thing is that the Company started a capital tie-up with Incubator Bank of Japan, Limited in March 2009, while it was announced on 16 July 2010 that the tie-up was to be terminated. Even now, the Company has some loans outstanding associated with the bank, but "The issue would not affect earnings of the Company", according to the Company.

Mobile & Entertainment Company

The Company calls itself "Mobile & Entertainment Company", and its business domains remained rather diversified even in the results in Q3 FY08/2010. Nevertheless, the overall picture is that the Company has two earnings pillar, i.e., Mobile Contents (accounting for 60% of operating profit) and Game Software (35%) while the rest of the Company comprises other businesses, all roughly breaking-even. In Mobile Contents, taken care of by Index Corporation, it is a key feature that the business includes so-called "B to B to C" operations where consigned development of mobile contents as well as solution providing are carried out for clients comprising TV stations and Pachinko / pinball-style slot machine makers, while peers specialize in B to C businesses. Game Software, of Atlas Co., Ltd. i.e., a 100% subsidiary after stock swap in May 2010, has a potential to further enhance its earnings into FY08/2011, driven by increasing sales associated with the launches of titles for social game platforms.

AFC-HD AMS Life Science (2927)

Share Price (Japanese) Company Information (English) IR Information (English)

Steady Increases of Functional Foods Manufacturing on an OEM Basis

Sales were ¥10.9bn (up 15.9% YoY), operating profit ¥0.7bn (up 27.3%) in Q3 FY08/2010 (9 months) results, announced on 9 July, having shown favorable earnings growth with the Company. Still, the Company has achieved only 63.4% of prospective operating profit in FY08/2010, and thus it remains questionable whether the Company may meet its Company forecasts or not. The key driving force with the Company's earnings is the manufacturing of functional foods on an OEM basis, and this business is faring well, literally driving the earnings with the Company. In terms of Q2 results (6 months), the manufacturing of functional foods on an OEM basis saw sales of ¥2.4bn (up 43.3%), due mainly to new demand from new clients, and this trend is still continuing. Meanwhile, the Company suffers from delayed developments in its advertising agency business, reporting operating losses, albeit small, making Company forecasts a touch too optimistic. In Q3 results (9 months), the segment of Health Care, including the manufacturing of functional foods on an OEM basis, accounted for the bulk of earnings, while also including retailing of functional foods through own shops and via mail order as well.

For Future Capacity Increases

In the market for functional foods, it is almost always the case that brand makers do not manufacture products but procure from suppliers or OEM makers like the Company. Out of the suppliers, the Company is, presumably, ranked No.10 in terms of production value, and is the only listed company. The market for functional foods in Japan is currently estimated at some ¥1.1 trillion pa, and equates to some 85% of the historical peak levels. The market as a whole is not so stable or rather volatile, tended to be influenced by boom & burst of some appealing but fugitive products. The current state is estimated to be closer to the bottom end. Meanwhile, the Company intends to be and is mainly exposed to basic products whose demand is to pick up stably in a long-term, while mainly involved with brand makers who are mainly exposed to mail order, i.e., the sales channel, most accepted by consumers now. Thus, sales with the Company would not completely depend upon the overall trends in the market for functional foods. In fact, it appears that the Company is likely to see ongoing increases in demand even in a long-term view, give the aforementioned two positive factors. As a result of recent pickup in demand, the Company has started to see almost the highest levels of capacity utilization rates in some production lines, while Company has been getting ready for capacity increases by setting up a new factory (to start its operation in August 2011) that could enhance the whole capacity by 2.5x when compared with the current levels. Meanwhile, the Company is starting to enhance sales of Chinese medicine goods through a tie-up with a generic medicine maker, although the business had been sluggish until recently. To add to this, there should be no reappearance of set-up costs, concerning own retailing shop business as well as concerning advertising agency business. As a whole, the Company is likely to see further increases in earnings in FY08/2011.

Nihon Trim (6788)

Share Price (Japanese) Company Information (English) IR Information (English)

Leading the Market for Electrolyzed Reduced Water

In Q1 FY03/2010 results, sales came in at ¥2.3bn (up 4.6% YoY), operating profit ¥0.4bn (up 26.0%), and they were roughly in line with Company forecasts. On a full-year basis, sales are expected to be ¥9.1bn (up 10.2%) and operating profit ¥1.4bn (up 18.9%). The Company has a dominant exposure to its home-use system for electrolyzed reduced water, over 90% in terms of sales and even more in terms of earnings. The system comprises hardware (accounting for some 75% of sales) and filter cartridge (25%). Meanwhile, the Company is not only involved with the developments and the manufacturing of the system but also with sales directly to consumers. Some 80% of hardware sales are associated with so-called “Shokuiki Hanbai” and its equivalents, in which the Company holds small gathering directly for consumers so that they should notice detailed advantages of the Company’s system. In this main sales channel, “TRIM ION NEO”, the Company’s new system, made a substantial contribution to overall hardware volume, having resulted in 1.8x increases when compared with the levels in the previous year and this was the key positive factor for Q1 earnings growth. “TRIM ION NEO” has retail price of ¥172,000 per unit and filter cartridge to be placed every 12 months ¥9,975. These levels are meaningfully lower than their old equivalents, and a concept, advocated by the Company, that “the system is of home appliance”, does appear to have started to penetrate into consumers. The Company is the leading maker of the home-use system, accounting for almost half of the domestic market, while the second Panasonic Electric Work (6991).

Market Expansion Potential and New Fields

It is estimated that the penetration of home-use system for electrolyzed reduced water is some 3 million on a volume basis or some 6% in Japan. In a long-term view, this could be some 10 million and 20%. Meanwhile, it is also estimated that the penetration of home-use water purifiers is some 35% at present. The market for the system is expected to expand by gradually replacing water purifiers. Electrolyzed reduced water or “TRIM Water”, generated by the system, relates to tap water after being purified by built-in water purifier and also after the electrolyzed and reduced processes. When compared with mineral water, it is advantageous that the water contains much hydrogen, generated by the electrolyzed and reduced processes for the water. The advantages relate to its effect to reduce oxidation action by oxygen and thus improving the state of users’ stomachs and intestines. Such advantages are now available at increasingly reasonable prices, and this is expected to drive the changeover from stand-alone water purifiers to the system. Longer-term, the Company is looking to setting up new businesses in the field of medical & gene, based on its technology associated with the electrolyzed and reduced processes, eventually making them into new earnings pillars.

Exceeding Assumptions

Q2 FY01/2011 results are set to be released on 9 September, and the release is likely to confirm that earnings are running ahead of the assumptions of full-year earnings forecasts by the Company. At the Q1 stage, sales were exceeded by 6.3% and operating profit by 20.2%. More importantly, it is suggested that the trends of earnings have not changed much so far. On a full-year basis, sales are expected to be ¥2,420m (up 6.9% YoY), operating profit ¥604m (up 1.3%) and operating profit margins 25.0%. In Q1 results, sales came in at ¥571m (up 18.4%), operating profit ¥143m (up 59.4%) and operating profit margins 25.0%. The "EPCO System" is steadily accepted by clients, and thus this is driving sales and earnings with the Company. The Company's target is to achieve operating profit growth rate of 30% pa and operating profit margins of 30%. In FY01/2009, the Company achieved the target on an operating profit growth rate front, by reporting operating profit ¥596m (up 35.3%) and operating profit margins 26.3%.

Designing & Consulting for Water Supply & Drainage Equipment

When assuming the domestic housing starts 0.8m pa, it should comprise 0.3m of condominium etc. and 0.5m of low-rise houses, represented by detached houses. The Company is in charge of consignment operations on behalf of major house makers for designing "EPCO System", i.e., water supply & drainage equipment for low-rise houses. Given the number of projects some 60,000 pa, it is estimated that the Company has some 11% share in the market for low-rise houses. As far as condominium etc. are concerned, general contractors have been in charge of execution management, having resulted in efficient setup of equipment across the board. To the contrary, as far as water supply & drainage equipment for low-rise houses is concerned, it has been the case that local equipment installers were in charge so inefficiently one by one and independently. As for water supply & drainage equipment of low-rise houses as a whole, including those of major house makers, have been all outsourced to local equipment installers, all of low-rise houses used to suffer from inefficiency in terms of water supply & drainage equipment in the history. "EPCO System" of the Company removes such inefficiency, having brought some cost cutting benefits to major house makers, has it started to steadily increased its order intake since the inception in 1992. According to the Company, it should be the case that it sees market share up to 30% in the foreseeable future. On top of this, the Company is to be involved with designing & consulting associated with low-rise houses as a whole through capital tie-up with Panasonic Electric Work (6991). Towards the end of FY01/2010, the Company was getting ready for future order intake associated with designing & consulting for solar power systems by means of increasing the number of engineers, while sales associated with solar power systems are expected to account for some 6% of total in FY01/2011 and even more in the foreseeable future. Longer-term, the Company has a plan to develop overseas markets like China, together with its "EPCO System". Thus, the Company has plural driving forces for future earnings, comprising market share increase potential with its existing business, applications of the existing business model to surrounding areas and overseas developments.

Temporary Staff Service for General Contractors and Construction-Related Operations

In terms of 9-month results in Q3 FY09/2010, announced on 30 July, sales were ¥3,632m (equating to 76.0% of prospective full-year sales) and recurring profit ¥451m (79.1%). Meanwhile, the Company's long-term target calls for sales of ¥11,570m (versus ¥4,780m in FY09/2010) and recurring profit of ¥1,740m (¥570m) in FY09/2013. Currently, temporary staff service for general contractors and construction-related operations is the key earnings pillar with the Company. The core of this business is that of construction management engineers (white collar) for general contractors, on a regularly employed basis. In the market for this business, the largest five operators account for collective 50% of the market, while the Company is ranked No. 5 with a 5% market share. A typical feature of the Company on a cost front is that it has a high exposure to low-wage youngsters, given that the employees in their 20's account for more than 60% of total. Meanwhile, the Company has high exposure to relatively highly-rated construction projects in metropolitan areas on an order intake front, pursuing profit margins combined with its low-wage burdens. A problem is that the industry trend for general contractors as a whole is now sluggish and will remain so in the foreseeable future. In order to cope with this, the Company is well expanding into electric engineering, equipment construction etc. or all those construction-related operations with its temporary staff service.

"Total Nursery School Service" & "Medical Field"

According to the Company's long-term plan, the existing temporary staff service is expected to steadily increase its sales and recurring profit during the periods, while new businesses are expected to sequentially and substantially increase their contributions to the overall earnings. The Company set up its new subsidiary Gakidaisho Inc., in October 2009, in which "Total Nursery School Service" is expected to be offered. The collective number of authorized nursery school run by this subsidiary is planned to reach 25 by the end of September 2013. In addition, the Company is to enter highly-valued-added services associated with "Medical Field" on a full-fledged basis in FY09/2011, and is expected to bring more benefits to own earnings than "Total Nursery School Service". The Company believes "Medical Field" has a high growth potential while it is exposed to high social needs, and thus the Company is likely to focus it resources mainly upon this in the future. To date, details of the projects are not available, but will be disclosed in the foreseeable future.

Disclaimer

Based on "IR Information" of the Company, Walden Research Japan worked on an analysis of the Company from a neutral and professional standing point, and the results are described here in this analyst report. "IR Information" of the Company comprises a) contents of our interview, b) contents of presentations for institutional investors, c) contents of timely disclosed information and d) contents of the homepage.

Company name: Walden Research Japan Incorporated

Headquarters : #1110 4-12-4 Hatchobori, Chuo, Tokyo 104-0032

URL: www.walden.co.jp

E-mail: info@walden.co.jp

Phone : +81 3 3553 3769