COMPANY RESEARCH AND ANALYSIS REPORT

create restaurants holdings inc.

3387

Tokyo Stock Exchange First Section

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FISCO Ltd. Analyst

Ikuo Shibata

FISCO Ltd.

http://www.fisco.co.jp

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Summary

Steep rise in operating income on slightly higher sales in FY2/18 Some success in strengthening existing outlets and developing new formats

create restaurants holdings inc. <3387> (hereafter, also "the Company") focuses mainly on the operation of restaurants and food courts inside shopping centers, while also developing izakaya (traditional Japanese eating and drinking establishments) and restaurant formats acquired through M&A. One characteristic is that the Company carefully selects locations that attract large numbers of customers, and employs a distinctive multi-brand, multi-location strategy, which involves developing a variety of restaurant formats attuned to specific locations (regional characteristics, customer attributes, competition status, etc.). This strategy has supported the Company's main business. Currently, the Company has 864 restaurants*1 in approximately 200 brands (as of the end of February 2018). Moreover, the Company is achieving higher growth by engaging in "Group Federation Management,*2 which involves incorporating brands with high growth potential into the Company's own growth profile through aggressive M&A, such as the seafood izakaya chain ISOMARU SUISAN*3, which has been gaining popularity with its 24-hour operation in favorable station-front locations. In this way, the Company appears to have entered a new growth phase.

*1 Including all business consignment outlets and franchise outlets (same below)
*2 Developed by SFP Holdings Co., Ltd. <3198> that was acquired in April 2013
*3 Through the group management promoted by the Company, growth is advanced by achieving a balance between "cohesion" from the holding company and "autonomy" at each Group operating entity.

The Company reported a steep rise in operating income on slightly higher sales in FY2/18 with net sales at ¥116,567mn (+2.7% YoY) and operating income at ¥6,413mn (+9.5%). Sales improved on contributions from the beginning of the fiscal year for outlets opened in the previous fiscal year (116 outlets) and newly opened outlets (68 outlets). Brand conversions (37 outlets), which the Company aggressively implemented, also aided income growth. Same-store sales were healthy at a 2.9% YoY decline (exceeding forecast by 0.1ppt) thanks to success in renovations and other enhancement measures. Nevertheless, the sales growth rate was modest due to intentional reduction of new openings and accelerated closures of poor-performing outlets. Operating income climbed more than expected because of successful control of personnel and other expenses, lower opening expenses accompanying reduction of new openings, and benefits from cross-functional team initiatives.

The Company presented FY2/19 guidance based on IFRS (international financial reporting standards) accounting in light of the planned transition to IFRS from 4Q FY2/19. Its FY2/19 targets are ¥125,000mn in revenue and ¥7,600mn in operating profit. While it is not possible to make simple comparison with the previous fiscal year (J-GAAP), we think the forecast envisions continuation of income growth at a healthy pace. The Company expects support for stronger sales from full-year contributions by outlets opened in FY2/18 and additions by newly opened outlets in FY2/19 (68 outlets in the plan) and assumes a 1.9% YoY decline in same-store sales. Downward revision of the sales target versus the previous medium-term plan goal reflects reduction of new openings factored into the outlook. We think the Company aims to drive income growth by reinforcing existing outlets, just as in FY2/18, with allocation of investment leeway from fewer openings to brand conversions.

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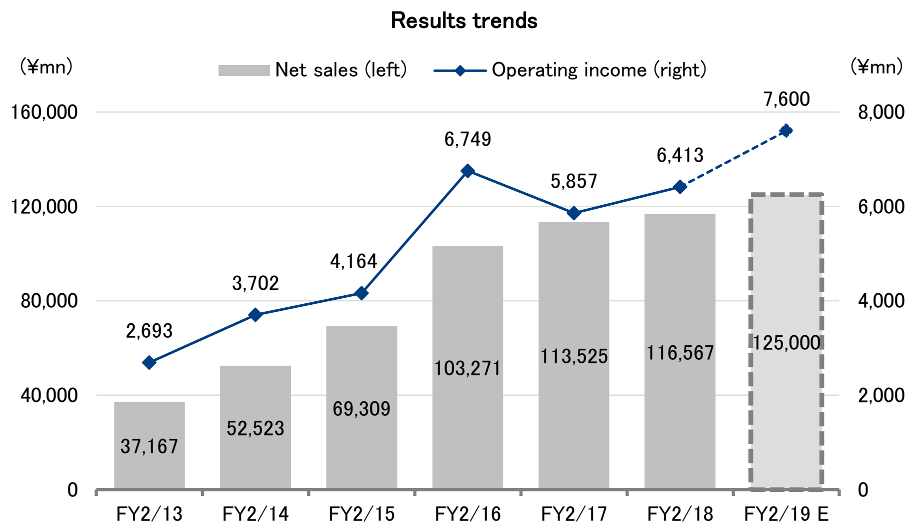
The Company announced a new three-year medium-term management plan (IFRS basis) that takes into account the transition to IFRS and partial revisions to the openings plan. Its final-year (FY2/21) goals, excluding M&A, are ¥145,000mn in revenue and ¥9,300mn in operating profit. The fundamental growth scenario is unchanged, despite modestly slower organic growth due to reduction of new openings targets. In other words, the medium-term plan seeks sustainable growth by combining (1) organic openings, (2) M&A, and (3) further overseas initiatives within a framework of "Group Federation Management" that leverages aggressive M&A activity to incorporate brands with growth potential to fuel growth.

We think the Company should be capable of attaining medium-term plan goals because it still has considerable room to open izakaya that drive growth, the M&A environment is healthy, and overseas business should benefit from accumulated know-how and popularity of Japanese foods. Key points to watch are outcomes from existing outlet reinforcement (including brand conversions), launch of new brands, advance in overseas expansion, M&A activity, and creation of group synergies.

Key Points

- Steep rise in operating income and ordinary income on slightly higher sales in FY2/18
- Achieved profit growth exceeding forecast through reinforcement of existing outlets, and cost controls despite reduction of new openings
- Plans to change the accounting policy to IFRS in 4Q FY2/19
- FY2/19 strategy continues to involve modest reduction of new openings and focus on brand conversions (sustaining healthy growth)
- Announced a new medium-term management plan (IFRS basis), but does not significantly alter the direction of pursuing sustainable growth via Group Federation Management



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

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Company profile

Implements “Group Federation Management” that pursues a variety of brands utilizing aggressive M&A

1. Business description

The Company mainly have operated restaurants and food courts at shopping centers and has moved into izakaya and other type restaurants acquired through M&A. As a holding company, it brings together 15 consolidated subsidiaries (including 4 overseas companies) and 3 unconsolidated subsidiaries (as of end of FY2/18).

The Company carefully selects locations that attract large numbers of customers, and employs a distinctive multi-brand, multi-location strategy, which involves developing a variety of restaurant brands attuned to specific locations (regional characteristics, customer attributes, and competition status, etc.). This strategy has supported the Company’s main business. Further, recently, the Company is achieving a high growth rate by promoting “Group Federation Management,” which involves incorporating various brands with high growth potential into the Company through aggressive M&A activities. As of the end of February 2018, the Company has 864* restaurants in approximately 200 brands.

* Includes directly operated outlets, business consignments, and franchise outlets (same below)

The Company’s businesses are divided into four categories: (1) the CR Category, involving the operation of restaurants and food courts with multiple brands mainly at commercial facilities, (2) the SFP Category, involving the operation of izakaya brands, (3) the Specialty Brands Category, involving the operation of various restaurant brands, and (4) the Overseas Category, which involves operation of Japanese restaurants in Singapore, Hong Kong, Taiwan, and so forth. The mainstay CR Category makes up 37.5% of the Company’s sales, while the SFP Category makes up 31.6%, the Specialty Brands Category 28.5%, and the Overseas Category 2.4% (as of the end of FY2/18).

Overview of business categories (as of the end of February 2018)

CR Category	Comprising outlets operated by create restaurants (CR) and create dining (CD) Operates restaurants and food courts with multiple brands mainly at commercial facilities 417 outlets as of the end of February 2018 Main brands include Harvest, Shabu Sai, Rio Grande Grill, and Roast Beef Hoshi Steadily ramping up the new BEEF RUSH (all-you-can-eat steak) brand
SFP Category	Comprising restaurants operated by SFP Holdings, which the Company entered into a capital tie-up, in April 2013 Operating izakaya in urban downtown districts 225 outlets as of the end of February 2018 Main brands include seafood izakaya ISOMARU SUISAN and fried chicken wing specialty restaurants Toriyoshi and Toriyoshi Shoten Steadily ramping up the Toragoro (Ichigoro; gyoza izakaya) brand
Specialty Brand Categories	Comprised of KR Food Service (KR), LE MONDE DES GOURMET (LG), eatwalk (EW), YUNARI (YNR), and Gourmet Brands Company (GBC) Focusing on Kagonoya mainly for roadside locations and developing their respective specialty brands for urban commercial facilities 191 outlets as of the end of February 2018 Main brands include Kagonoya Japanese restaurants, TANTO TANTO Italian restaurants, primarily vegetable-based AWkitchen Italian restaurants, Tsukemen TETSU, and JEAN FRANCOIS bakery and café
Overseas Category	Comprised of restaurants operated by the Company’s Singaporean, Hong Kong, and Taiwanese subsidiaries 31 outlets as of the end of February 2018 Main brands include Shabu Sai and MACCHA HOUSE Opened the first NAOKI TAKAHASHI Japanese food brand in North America (New York) in July 2017

Source: Prepared by FISCO from Company materials and interviews

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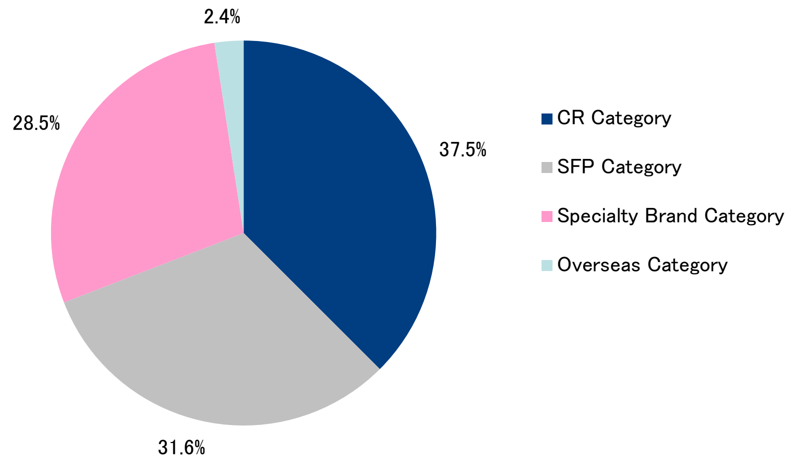
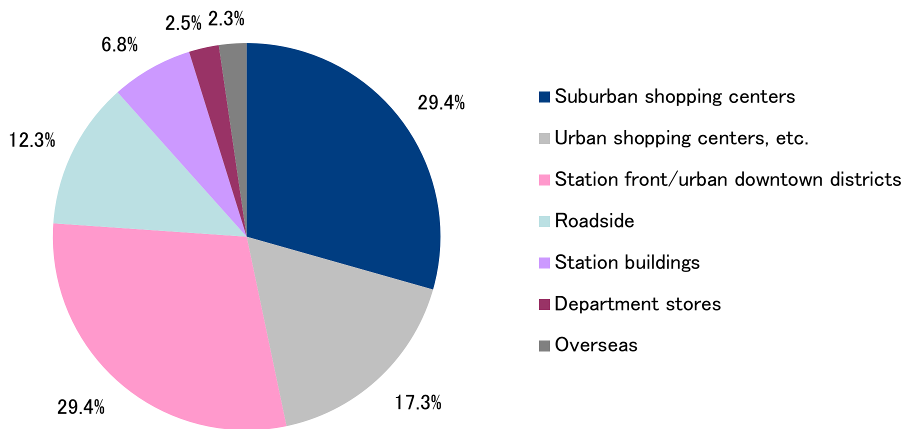
Net sales by category (FY2/18 results)



Source: Prepared by FISCO from Company materials

Further, the breakdown of restaurant numbers by location shows 29.4% for suburban SC, 17.3% for urban SC, 29.4% for station front and urban downtown districts, 12.3% for roadside, 6.8% in station buildings, 2.5% for department stores, and 2.3% overseas; having achieved a good, balanced distribution from the previous concentration in commercial facilities (as of the end of FY2/18).

Composition of restaurant numbers by location
(as of the end of February 2018)



Source: Prepared by FISCO from Company materials

2. History

The Company was established in 1997 as the Yokosuka Brewing Company K.K. (the company name was changed to create restaurants inc. in 1999) by Tokuju, K.K., the family business of the Company's current chairman, Hitoshi Gotoh. However, its actual foundation was in 1999, when it took over the operation of five western-style restaurants from Tokuju and started the restaurant business in earnest. In 2000, then employee of Mitsubishi Corporation <8058> and current representative director, president and CEO Haruhiko Okamoto engaged with the Company through an in-house venture scheme, with the Company also receiving a capital investment from Mitsubishi (the capital relationship with Mitsubishi was terminated in 2012). Thereafter, backed by Mitsubishi's reputation and other resources, the Company accelerated its growth by increasing its number of restaurants, mainly opening them in commercial facilities and similar locations. In 2005, the Company listed on Mothers market of the Tokyo Stock Exchange, changing to the First Section in 2013.

The Company has also been aggressive in M&A, acquiring the Japanese cuisine chain KISSHO in 2007 and shifting to a holding company structure in 2010 to establish a platform for "Group Federation Management." Subsequently, the Company has acquired LE MONDE DES GOURMET in 2012, SFP Dining* and eatwalk in 2013, YUNARI and Shanghai Bishoku Chushin Co., Ltd. (company name changed from R21 Cuisine) in 2014, KR Food Service and RC Japan (now Create Dining inc.) in 2015, successively bring them into the Group. SFP Dining* was listed on the TSE Second Section in December 2014 (a subsidiary listing).

In overseas deployment, the Company started in 2008 by establishing a joint venture with a local company in Shanghai, and among other initiatives went on to establish wholly owned subsidiaries in mainland China in 2010, Singapore in 2011, Hong Kong in 2012, and Taiwan in 2014. While the Company's overseas expansion is still considered to be in the experimental stage, it is preparing the groundwork for a full-fledged expansion in the future. In February 2016 it established a subsidiary in New York also aimed at a US rollout, and in July 2017, it opened NAOKI TAKAHASHI in New York. The Company completed the exit of all restaurants from China (Shanghai) at the end of August 2017.

* SFP Dining Co., Ltd. changed its name to SFP Holdings Co., Ltd. in June 2017

Corporate characteristics

Possesses a strong brand portfolio with industry development capabilities and robust M&A results

1. Multi-brand, multi-location strategy

The characteristics of the Company's main business are 1) opening restaurants in commercial facilities that attract large numbers of customers (shopping centers, station buildings, etc.) and 2) operating diverse brands attuned to their local environments (regional characteristics and customer attributes, status of competition, etc.). The diversity of these brands, including Japanese, Western, and Chinese cuisine, as well as ethnic food and cafes, enables the Company to open multiple restaurants within a single commercial facility and respond to various needs of the facility owner (developer, etc.). This has worked to the Company's advantage in opening restaurants inside commercial facilities, which typically have a higher barrier to entry. Naturally, there is also a cost factor involved in creating multiple brands attuned to their local environments; however, the capacity to develop brands that use the customer drawing power of favorable locations to maximum advantage is the Company's true worth. The source of its value creation is accumulation of know-how in brand development and operations.

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On the other hand, the seafood izakaya ISOMARU SUISAN, developed by SFP which was acquired in 2013, has as a special characteristic in its 24-hour operation in station-front locations populated with convenience stores and drugstores. In challenging fierce competition with street-level locations, the chain deliberately selected high-cost station-front sites due to its insistence on locations that attract large numbers of customers. This may be cited as one reason why the chain has a strong affinity with the strategy employed by the Company thus far. Therefore, it can be seen as an extension of the scope of the multi-location strategy to include the street-level domain, and it could pave the way for future full-scale development of diverse brands among street-level locations in urban downtown districts, in addition to the existing commercial facilities. Further, the Kagonoya Japanese restaurant chain by KR Food Service has been developed focusing on roadside locations, and via aggressive M&A including other specialty brands, the Company will strive to further expand location diversity and brand specialization.

2. Growth model based on "Group Federation Management"

In addition to organic (internal) growth, the Company's growth model is one where growth arises by supporting growth through engagement with high growth potential brands via M&A, creating various synergies and providing a platform (support from a funding and management perspective etc.). In the past, the Company expanded its operational base through operating restaurants in commercial facilities and food courts. However, given that it was a growth model that was readily influenced by the commercial facility's circumstances, along with the shift to a holding company structure, the Company sought to transition to a strategy that aims for autonomous growth via "Group Federation Management." Understandably, it is recognized the Company succeeded because it had been established from an internal Mitsubishi Corporation venture. Additionally, it was a management style familiar in terms of management resources (with staff etc. that were skilled in business management) and corporate cultural perspective. Furthermore, it was recognized as a partner with which a relationship could be readily formed, and done so with relatively little resistance from capital tie-up partners.

Financial results

Sustaining high growth potential and profitability through aggressive additions including M&A

1. "Group Federation Management" progress and results trends

Looking back at results, expansion in restaurant numbers, via new openings and M&A, has been the driver of growth. In particular, the turning point was from FY2/13 with a shift to a new growth strategy through "Group Federation Management." By realizing high growth potential through bringing a range of formats with growth potential into the Group, while supporting further additions, the Company sought to enhance location diversity and specialty branding. Looking at the composition of restaurants by location, at the end of February 2012, commercial facilities (the total of suburban SC and urban SC) represented 78.4% of overall numbers. However, at the end of February 2018 while representation by commercial facilities had shrunk to 46.7%, a balanced portfolio had been established with station-front locations and those in urban downtown districts (29.4%) and roadside locations (12.3%) having been newly added.

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Openings and closings (including M&A) and total at the end of period

	New openings	Closures	Acquired via M&A	Total at the end of the period
FY2/12	14	-33	0	356
FY2/13	45	-29	7	381
FY2/14	61	-36	108	514
FY2/15	102	-42	26	616
FY2/16	108	-38	109	795
FY2/17	116	-54	0	857
FY2/18	68	-63	2	864

Note: From FY2/15, total at the end of the period includes restaurants where outsourced operations are provided, FC locations, non-consolidated locations and overseas J/V locations.
Source: Prepared by FISCO from Company materials

M&A track record

Date acquired	Company name	Main brand(s)	Acquisition price (¥mn)
March 2012	LE MONDE DES GOURMET	TANTO TANTO	Undisclosed
April 2013	SFP Dining	ISOMARU SUISAN, Toriyoshi Shoten, etc.	6,573
April 2013	eatwalk	AWkitchen, Yasaiyamei, etc.	858
April 2014	YUNARI	Tsukemen TETSU, etc.	1,506
November 2014	Shanghai Bishoku Chushin	Nanxiang Mantou Dian	180
June 2015	KR Food Service	Kagonoya, etc.	14,979
August 2015	RC Japan	Rain Forest Café, etc.	65

Source: Prepared by FISCO from Company materials

From a financial perspective, the equity ratio, which represents the stability of the financial foundation, achieved a level exceeding 35% by FY2/12. Mitsubishi Corporation's shares were acquired by way of TOB, and as a result of around 80% of those shares being retired, the equity ratio declined to 19.7% at end-FY2/13. In FY2/14, equity was strengthened through the sale of treasury shares and the equity ratio improved to 32.4% temporarily at the end of FY2/15 due to a new share issuance in line with the listing (subsidiary listing) of SFP Dining. However, it declined again to 24.1% at the end of FY2/16 due to the acquisition of KR Food Service. Net interest-bearing debt also rose significantly to surpass the ¥18bn level.

The cash flow status up to FY2/13 shows cash flow from investment activities trended stably within cash flow from operating activities, however, from FY2/14, cash flow from investment activities has expanded significantly due to aggressive new openings and M&A.

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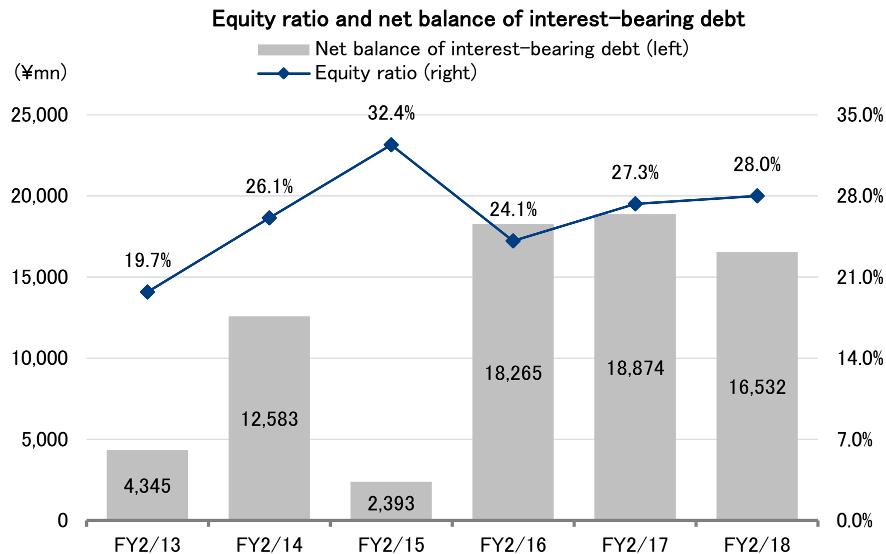
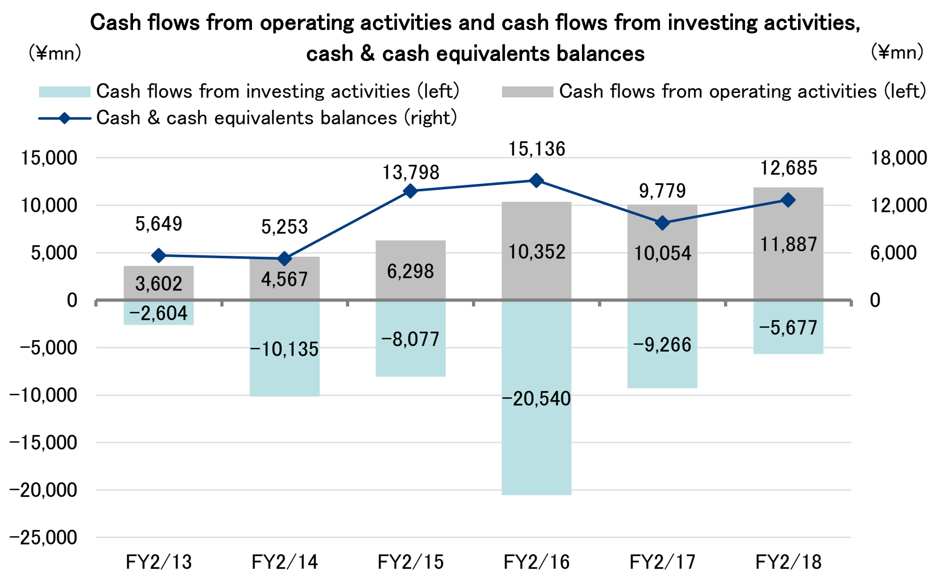


Source: Prepared by FISCO from the Company's financial results



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

For the Company, which aims to continue to engage in M&A aggressively, strengthening the financial foundation is an issue. However, having secured a net D/E ratio of 0.82*1 and net interest-bearing debt to cash flow ratio of 1.39*2, it is thought that for the time being there are no concerns regarding financing capabilities judging from its past track record and ample operating cash flows.

*1 Net D/E ratio is calculated as net interest-bearing debt / equity. Generally, a multiple of less than 1x is rated as having no stability concerns.
*2 Net interest-bearing debt to cash flow ratio is calculated as net interest-bearing debt / cash flows from operating activities. It is an indicator determining how many years of cash flows from operating activities are required to repay interest-bearing debt, with it generally regarded as of concern if the rate exceeds 10x.

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Steep rise in operating income on slightly higher sales in FY2/18

2. FY2/18 results overview

The Company realized significant profit increases on slightly higher sales in FY2/18 with net sales at ¥116,567mn (up 2.7% YoY), operating income at ¥6,413mn (up 9.5% YoY), ordinary income at ¥6,894mn (up 8.6% YoY) and profit attributable to owners of parent of ¥2,501mn (down 24.0% YoY). While sales slightly missed the initial outlook, operating (and ordinary) income were higher.

Sales and profits expanded in all categories except for overseas. Sales improved on contributions from the beginning of the fiscal year for restaurants opened in the previous fiscal year (116 outlets) and newly opened restaurants (68 outlets). Brand conversions (37 outlets), which the Company aggressively implemented, also aided income growth. Same-store sales were healthy at a 2.9% YoY decline (exceeding forecast by 0.1ppt) thanks to success in renovations (47 outlets) and other enhancement measures. The sales growth rate modestly undershot due to intentional reduction of new openings (eight fewer than planned) and unexpected closures (accelerated closures of poor-performing restaurants). There was a notable impact from revisions to the openings policy in the Specialty Brands Category. The Company had 864 restaurants at the end of February 2018 (net increase of seven outlets YoY) based on 68 new openings, two M&A additions, and 63 closures.

Operating income and ordinary income climbed more than expected because of successful control of personnel and other expenses, lower opening expenses accompanying reduction of new openings to 68 outlets (decline of 48 outlets YoY), and benefits from cross-functional team initiatives (restricting headquarter costs). Net income, meanwhile, missed forecast and fell YoY due to booking extraordinary losses from accelerated renovations, brand conversions, and closures as measures for dealing with poor-performing outlets and backlash from temporarily lower income taxes in the previous fiscal year. Nevertheless, we believe the extraordinary losses largely involved strategic business decisions (aimed at improving financial health and raising future income), including adjustments prior to planned transition to IFRS from 4Q FY2/19.

Overview of FY2/18 results

(¥mn)

	FY2/17		FY2/18		Change		FY2/18		Achieve-ment rate
	Results	% of total	Results	% of total		Change rate	Plan	% of total	
Net sales	113,525		116,567		3,042	2.7%	118,000		98.8%
CR Category	42,862	37.8%	43,735	37.5%	873	2.0%	43,295	36.7%	101.0%
SFP Category	35,957	31.7%	36,841	31.6%	884	2.5%	37,000	31.4%	99.6%
Specialty Brand Category	31,530	27.8%	33,177	28.5%	1,647	5.2%	34,686	29.4%	95.7%
Overseas Category	3,167	2.8%	2,834	2.4%	-333	-10.5%	2,976	2.5%	95.2%
Cost of sales	32,823	28.9%	33,533	28.8%	709	2.2%	-	-	-
SG&A expenses	74,844	65.9%	76,620	65.7%	1,776	2.4%	-	-	-
Operating income	5,857	5.2%	6,413	5.5%	556	9.5%	6,300	5.3%	101.8%
Ordinary income	6,348	5.6%	6,894	5.9%	545	8.6%	6,800	5.8%	101.4%
CR Category	3,710	8.7%	4,050	9.3%	340	9.2%	3,757	8.7%	107.8%
SFP Category	3,560	9.9%	3,828	10.4%	268	7.5%	3,700	10.0%	103.5%
Specialty Brand Category	1,316	4.2%	1,674	5.0%	358	27.2%	1,884	5.4%	88.9%
Overseas Category	280	8.8%	-0	-	-280	-	34	1.1%	-
Profit attributable to owners of parent	3,293	2.9%	2,501	2.1%	-791	-24.0%	3,300	2.8%	75.8%

Source: Prepared by FISCO from Company materials

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Category results are set out as below.

(1) CR Category

The CR category posted higher sales and profits that exceeded forecast at ¥43,735mn in net sales (+2.0% YoY) and ¥4,050mn in category income (+9.2%). Sales benefited from full-year contributions by restaurants opened in the previous year (51 outlets) and new openings (31 outlets). The Company aggressively opened popular Roast Beef Hoshi outlets at suburban shopping centers, and its Japanese café format performed well too. We think brand conversions (18 outlets), mainly to BEEF RUSH (all-you-can-eat steak), also helped boost income. Same-store sales exhibited resilience at a 1.9% YoY decline (beating forecast by 1.8ppt) thanks to healthy business at higher-priced outlets, such as shabu-shabu. Profits advanced on upbeat sales, successful control of personnel and other costs (despite higher meat prices and other factors), and lower outlet opening costs due to limiting new openings to 31 outlets (decline of 20 outlets YoY).

(2) SFP Category

The SFP category booked higher sales and profits with ¥36,841mn in net sales (+2.5% YoY) and ¥3,828mn in category income (+7.5%). Compared to forecast, sales slightly undershot due to weather impacts (prolonged rain, cold waves, and snowfall), but profit was substantially higher. Sales improved on full-year contributions by restaurants opened in the previous year (42 outlets) and new openings (20 outlets)*1. Sales growth was relatively modest versus previous strong levels because of temporary reduction of new openings. We think policy intent is clear in the limitation of mainstay ISOMARU SUISAN openings (directly operated outlets) to two amid efforts to bolster existing outlets. Conversely, the SFP Category posted strong growth in Toriyoshi Shoten business with openings of 10 outlets (including one conversion) and achieved healthy ramp-up of its new Toragoro (Ichigoro) brand (gyoza izakaya)*2 by launching nine outlets (including four conversions). Additionally, same-store sales were vibrant at a 2.7% YoY decline (beating forecast by 0.1ppt) thanks to success with measures aimed at improving business in existing outlets (such as renovations and tablet deployments). This segment realized profit growth above forecast with support from not only higher sales and cost controls, but also lower opening expenses related to reduction of new openings (excluding franchises) to 18 (decline of 22 YoY) and reduction of hiring costs*3. Category margin rose to 10.4% (vs. 9.9% in the previous period), moving above the 10% threshold.

*1 Two of the 20 new outlets are franchise operations (ISOMARU SUISAN uses a franchise model in the Kyushu area).
*2 This is a gyoza izakaya that opened the first outlet in Shinjuku (Otakibashi Street) as Gyoza Seizo Hanbaiten Toragoro in March 2017. It changed the name to Ichigoro, which reflects the aim of being the top restaurant in each local area, from the second outlet.
*3 The Company improved efficiency in part-time worker hiring with a switch to performance-based compensation media and through use of an employee introduction program (hiring-related costs dropped by ¥292mn YoY).

(3) Specialty Brand Category

The Specialty Brand Category reported higher sales and profits with net sales at ¥33,177mn (+5.2% YoY) and category income at ¥1,674mn (+27.2%), though both results missed forecast. Sales climbed on full-year contributions by restaurants opened in the previous year (19 outlets) and new openings (13 outlets). However, new openings were well below forecast (undershooting by 12 outlets) due to launches in prime locations such as Komazawa Park (eatwalk) and GINZA SIX (Gourmet Brands Company), as well as stringent restriction of openings at suburban roadside locations (KR Food Service) to those with high investment efficiency. Same-store sales were sluggish with a 4.2% YoY decline (1.9ppt below forecast) due to weakness at Kagonoya (KR Food Services). While profit missed forecast due to the slump in same-store sales, the category delivered a gain thanks to improved management of personnel costs that had been an issue (KR Food Service).

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(4) Overseas Category

The Overseas Category reported ¥2,834mn in net sales (-10.5% YoY) and roughly zero profit (vs. a ¥280mn profit in the previous year). Decline in the number of restaurants at the end of February 2018 to 31 (down by four YoY), which occurred due to four openings and eight closures, weighed on income. While the Singapore business posted healthy sales and profits, the category faced pressure on Hong Kong business from China's weaker economic activity as well as setbacks from contract-expiration closures of outlets with strong income and typhoon impact. Nevertheless, results are currently recovering on reinforcement of cost controls and the Company is aiming for a profit in FY2/19. Another positive development is the opening of the first NAOKI TAKAHASHI Japanese restaurant in North America (New York) and smooth ramp-up of this business.

Initiatives

Some success in reinforcement of existing outlets and development of new brands

1. Review of issues and responses

The Company reviewed issues after missing forecast in FY2/17 and took actions to address these areas in FY2/18. As explained below, it achieved some success in reinforcement of existing outlets, development of new brands, and cost controls.

(1) Reinforcement of existing outlets

While the Company has been reducing openings, as noted above, it conducted investments to reinforce existing outlets, including renovations and conversions, and also improved convenience with tablet deployment (SFP) and expanded activities with point members (KR). Furthermore, it converted 18 outlets from struggling buffets (CR) at regional suburban shopping centers to BEEF RUSH and other brands and renovated 28 ISOMARU SUISAN (SFP) outlets. These measures drove income growth without relying on new openings.

(2) Rollout of new core concept brands with high investment efficiency

The Company has developed and rolled out BEEF RUSH (CR), Toragoro (Ichigoro) (SFP), and Kamikochi Azusa Coffee (Specialty Brand) as new brands. These brands have steadily ramped up with openings of nine Toragoro (Ichigoro) outlets and two Kamikochi Azusa Coffee outlets. We expect new growth drivers that accelerate overall growth.

(3) Advances in Group Federation Management (initiatives to resolve Group horizontal issues)

The Company is promoting cost controls and improved investment efficiency through initiatives by Groupwide cross-functional teams. These efforts have lowered headquarters costs and reduced hiring-related costs. In FY2/19, activities include enhanced hiring, internalized maintenance*1, joint procurement*2, and sales promotion revisions. We think the Company has advanced to a new stage of Group Federation Management.

*1 Launched a maintenance team for repairs within the Group (March 2018)
*2 Joint Group purchases of pork, coffee, and other items (it plans to extend purchases to rice and seafood too)

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(4) Efforts to raise productivity

Initiatives include extensive utilization of machinery and IT*, improvements in shabu-shabu pans (significantly shortening cleaning time), and deployment of video manuals (reducing time spent on training). The Company views productivity improvement as an important strategic theme in the industry faced with growth bottlenecks from promotion of working style reforms and personnel recruitment.

* Deployment of tablets for placement of orders using a touch panel as well as bakery scans and automated change machines

2. Other topics

(1) First North American restaurant opening

The Company established a local subsidiary in New York in March 2016 and prepared for an opening. It launched the first NAOKI TAKAHASHI Japanese restaurant in the Chelsea district* of New York City in July 2017, successfully entering the North American market. The location appears to be performing well with help from recent strong interest in Japanese food. The Company intends to leverage this success to actively develop business led by the Japanese restaurant brand. Through an alliance with Sarashina Horii Co. Ltd., which operates the longstanding SARASHINA HORII soba restaurant, the Company is currently working on a project to open HORII NY (tentative name) in the US.

* This is an area with many IT-related companies and located near Google's <GOOG>) headquarters.

(2) Food hall in Tokyo Midtown Hibiya

A major result in the current fiscal year was securing overall operation of Tokyo Midtown Hibiya*1's food hall*2. This multi-faceted facility had a grand opening on March 29, 2018. Three Group companies opened a variety of brands (eight restaurants) in the food hall. We think favorable review of the Company's track record and knowhow in food hall operations supported its selection. This deal also represents a major step forward in consignment operation of food halls at urban-type multi-faceted facilities, which have emerged as a major trend.

*1 Multi-faceted facility with about 60 shops and restaurants, offices, movie theaters, and elevated garden and plaza space.
*2 This is a new trend from New York attracting interest. While conventional shopping mall food courts have a casual and uniform image, the approach differs with its relatively high-end and individual booth features. A growing number of urban multi-faceted commercial facilities are adopting this style.

(3) Applying for the SFP tender offer

In March 2018, the Company applied 3,200,000 shares to the tender offer by listed subsidiary SFP, which purchased 3,198,800 shares (at ¥2,030 per share). (SFP already retired all of the shares after the purchase.) This transaction was a step by SFP toward a move to the TSE First Section in the future, and the Company agreed with this action. While the sale modestly lowered the Company's stake from about 67% to around 64%, it does not affect the relationship between the two companies.

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(4) Conclusion of two M&A deals

The Company finalized two M&A deals that it has been strategically pursuing. Route 9g Inc. (and its wholly owned subsidiary), which it acquired on January 31, 2018, operates the well-known Singaporean restaurant Hainan Jeefan Shokudo (outlets in Azabujuban and Ebisu). The Company purchased roughly 51% of the shares through a private placement capital expansion. It aims to improve business value by supporting future rollout while maintaining and boosting the founder's passion.

On March 1, 2018, the Company acquired all shares of Create Bayside Inc., which was established as a spinoff from IKSPIARI Co., LTD.* that received IKSPIARI's directly operated restaurant business. Create Bayside operates restaurants (nine outlets) and the food court (eight booths) at the IKSPIARI multifunctional commercial facility. This was an M&A deal that targeted spinoff of non-core business. The Company's aims are acquisition of outlets at a prime commercial facility (IKSPIARI) and improved management efficiency and synergies via consolidation of its own outlets at IKSPIARI and the acquired outlets.

* IKSPIARI is a subsidiary of Oriental Land Co., Ltd. <4661>. It manages the IKSPIARI multifunctional commercial facility located at Tokyo Disney Resort in Urayasu City, Chiba Prefecture, develops and manages product sales stores and restaurants, and manages movie theaters.

Outlook

Plans transition to IFRS in FY2/19 4Q
New openings and conversions are likely to drive income growth

● FY2/19 outlook

The Company presented FY2/19 guidance based on IFRS (international financial reporting standards) accounting in light of the planned transition to IFRS* from 4Q FY2/19. Its FY2/19 targets are ¥125,000mn in revenue and ¥7,600mn in operating profit. While it is not possible to make simple comparison with the previous fiscal year (J-GAAP), we think the forecast envisions continuation of income growth at a healthy pace.

* Its goals in the IFRS transition are establishing a foundation for promoting domestic and overseas M&A, improvement of international comparability in capital markets, and optimization of management activities through use of uniform accounting standards in the group.

The Company expects support for stronger sales from full-year contributions by restaurants opened in FY2/18 (68 outlets), additions by newly opened restaurants in FY2/19 (68 outlets), large-scale conversions (30 outlets), and boosts from the two above-mentioned M&A deals (totaling an estimated ¥2.5bn). It also assumes a 1.9% YoY decline in same-store sales. Downward revision of the sales target versus the previous medium-term plan goal (¥130bn in FY2/19 sales), meanwhile, reflects reduction of new openings factored into the outlook (particularly lowering SFP Category openings from 40 to 20). We think the Company intends to drive income growth by reinforcing existing outlets, just as in FY2/18, with allocation of investment leeway from fewer openings to brand conversions. The openings breakdown is 23 in the CR Category, 20 in the SFP Category, 18 in the Specialty Brand Category, and seven in the Overseas Category.

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The Company expects higher operating margin, despite increase in personnel costs, with cost controls by cross-functional teams (particularly lowering materials costs through promotion of joint purchasing) and improvements in investment efficiency. The IFRS transition removes amortization of goodwill (about ¥900mn a year) booked up to now, but also dictates recognition of impairment losses in operating income. The Company appears to have a conservative budget for impairment losses (estimated at about ¥800mn). This means that IFRS transition could slightly add to operating income on a net basis. We still expect real improvement in operating margin even after deduction of this portion.

Comparison of FY2/19 forecast (IFRS) and FY2/18 (J-GAAP)

(¥mn)

	FY2/18 (J-GAAP)	
	Results	% of total
Net sales	116,567	
Operating income	6,413	5.5%
Ordinary income	6,894	5.9%
Profit	3,557	3.1%
Profit attributable to owners of parent	2,501	2.1%

(¥mn)

	FY2/19 (IFRS)	
	Forecast	% of total
Revenue	125,000	
Operating profit	7,600	6.1%
Profit before tax	7,400	5.9%
Profit	5,100	4.1%
Profit attributable to owners of parent	4,000	3.2%

Source: Prepared by FISCO from Company materials

We think the openings plan utilized as the basis for forecast is attainable in light of results up to now and the above-mentioned bulk consignment of food hall operations at Tokyo Midtown Hibiya. Same-store sales and cost factor outlooks seem reasonable too. We thus conclude that the Company should be capable of attaining its projections. Key points as parameters in assessing growth potential, in our view, are new brand trends and the extent to which conversions, a central initiative in FY2/19, contribute to earnings. It is also necessary to monitor new M&A deals as a possible source of earnings upside.

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Growth strategy

Disclosed a new medium-term plan based on IFRS Basic growth scenario is unchanged

1. Medium-term management plan

The Company is promoting a rolling three-year business plan. It announced a new three-year medium-term management plan (IFRS basis) that takes into account the transition to IFRS and revisions to the openings plan. Its final-year (FY2/21) goals, excluding M&A deals, are ¥145,000mn in revenue, ¥9,300mn in operating profit, ¥9,100mn in profit before tax, ¥6,100mn in profit, and ¥5,000mn in profit attributable to owners of parent. The fundamental growth scenario is unchanged, despite modestly slower organic growth due to reduction of new openings targets. In other words, the medium-term plan seeks sustainable growth by combining (1) organic openings, (2) M&A, and (3) further overseas initiatives within a framework of Group Federation Management that leverages aggressive M&A activity to incorporate brands with growth potential to fuel growth.

Medium-term management plan based on IFRS (not including M&A)

(¥mn)

	FY2/19	FY2/20	FY2/21
Revenue	125,000	135,000	145,000
(Growth rate)	-	8.0%	7.4%
Operating profit	7,600	8,300	9,300
(Profit margin)	6.1%	6.1%	6.4%
Profit before tax	7,400	8,100	9,100
(Profit margin)	5.9%	6.0%	6.3%
Profit	5,100	5,400	6,100
(Profit margin)	4.1%	4.0%	4.2%
Profit attributable to owners of parent	4,000	4,500	5,000
(Profit margin)	3.2%	3.3%	3.4%

Source: Prepared by FISCO from Company materials

Key points from growth strategies are reviewed below.

(1) Organic openings

The Company aims to open about 70-90 outlets a year via reinforcement of existing brands and expansion of new brands. In the CR Category, it intends to strengthen existing brands along with new upbeat brands, such as BEEF RUSH (steak and buffet) and MACCHA HOUSE (Japanese café). In the SFP Category, while it is reducing new openings in suburban areas readily affected by economic activity trends, it plans to continue promoting the two main brands ISOMARU SUISAN and Toriyoshi Shoten with substantial openings leeway, including the Kansai area (via a dominant player strategy), and full-fledged rollout of Ichigoro (gyoza izakaya), a new brand with potential to become a third major brand. In particular, it has outlined a strategy of deploying multiple contents in prime locations that targets growth in multiple brands leveraging location advantages. In the Specialty Brand Category, it intends to mainly promote Azusa Coffee (Japanese café) with excellent investment efficiency and Mr. FARMER (vegetables café) doing well in the health food boom.

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(2) M&A

Leveraging its extensive M&A track record, the Company aims to continue realizing good M&A deals in Japan and overseas. It has been receiving many proposals recently and plans to actively pursue early implementation of new M&A.

(3) Further overseas expansion

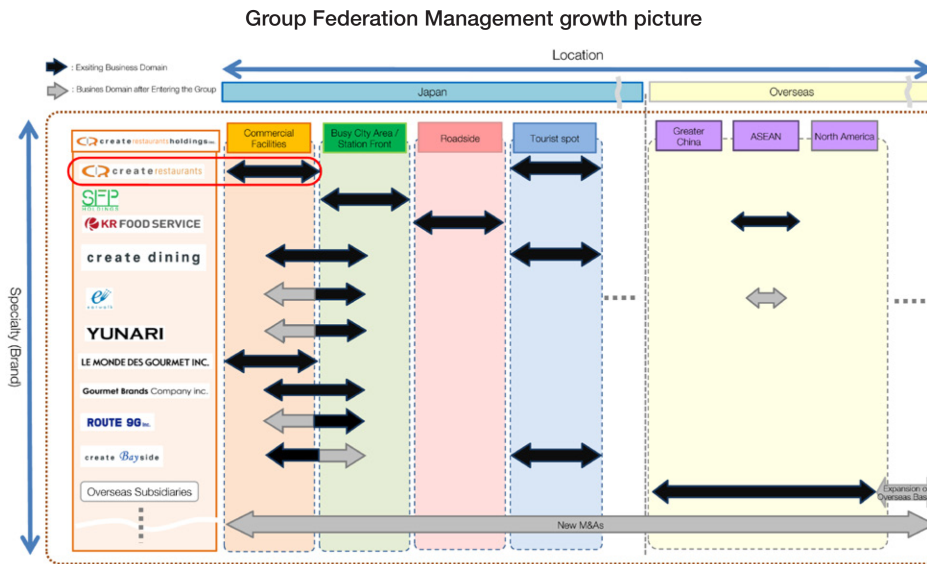
In overseas business, the Company intends to accelerate openings in North America and new parts of the ASEAN region in light of knowhow obtained in its Singapore and Hong Kong operations. It is also considering joint venture and franchise approaches with low investment risk and rapid deployment paces.

2. Longer-term growth image

The Company is aiming for continuous growth by building a strong portfolio through further development of Group Federation Management. Given that in M&A to date, it has sought to attain location diversity, including commercial facility locations, bustling area and station front locations (SFP) and roadside locations (KR), newly emerged tourist destinations, and overseas locations (Greater China region, ASEAN, and North America etc.), and expanded the variety of brands (Specialty Brand), the result has produced new growth opportunities by seeking further combinations of location diversity and brand specialization.

As a near-term goal, it is targeting prompt achievement of ¥200bn in sales, including M&A. The Company has formed cross-functional teams by themes and intends to pursue Group-wide issue resolution in order to advance Group Federation Management (noted above). Initial aims are significant cost savings in purchasing, restaurant design, and hiring. We think synergy creation activities are truly ramping up.

Group Federation Management growth picture



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

We think the Company is capable of attaining medium-term management plan goals owing to existence of sufficient leeway to open izakaya that are growth drivers, a healthy M&A environment, and potential in overseas businesses from accumulated know-how and popularity of Japanese cuisine. While new openings have slowed from the previous pace in FY2/18 and FY2/19, we have a positive view of the rational decision to address changes in the business environment and quickly strengthen existing outlets and develop new brands in order to accelerate future growth. Group Federation Management, which has pursued scale expansion through aggressive M&A up to now, meanwhile, has entered a new phase with creation of specific synergies. Key points are results from strengthening existing outlets, new brand ramp-up, advances in overseas business, M&A efforts, and creation of group synergies. We think M&A might increasingly focus on overseas deals (particularly, North America) due to maturation of the domestic economy and are closely watching overseas initiatives utilizing M&A from a longer-term perspective.

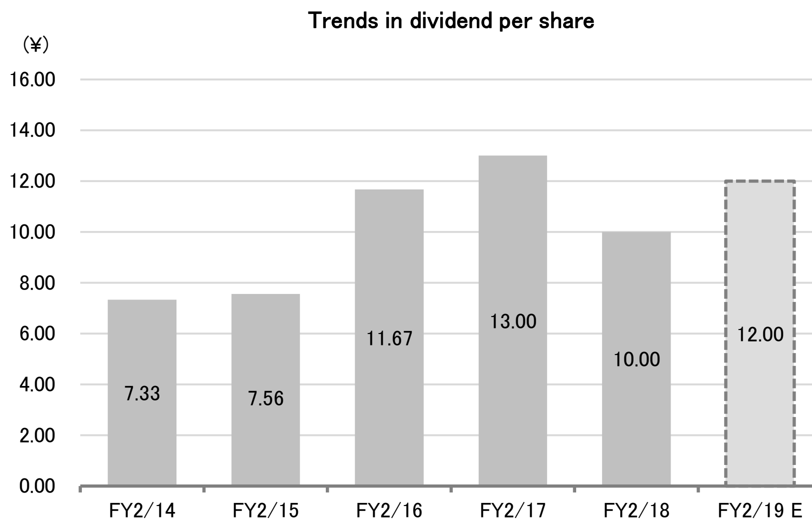
Shareholder returns

Plans to increase dividend by ¥2 YoY in FY2/19
The Company possesses large room for dividend hikes driven by profit growth

The Company plans to pay a ¥10 dividend (¥5 interim, ¥5 period-end) in FY2/18, in line with the period-start outlook. In FY2/19, it is targeting a ¥12 dividend (¥6 interim, ¥6 period-end), an increase of ¥2 versus the previous year.

The Company saw a temporary dividend decline in FY2/18, but we see substantial room for dividend hikes accompanying profit growth from FY2/19.

Trends in dividend per share



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

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Further, the Company has introduced shareholders' benefits program. Twice a year, in February and August, it distributes meal vouchers to the value of ¥3,000 (¥6,000 annually) to shareholders with 100-499 shares, ¥6,000 (¥12,000 annually) to shareholders with 500-1,499 shares, ¥15,000 (¥30,000 annually) to shareholders with 1,500-4,499 shares, and ¥30,000 (¥60,000 annually) to shareholders with 4,500 or more shares.

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