

Alpha-Win Company Research Report

CUBE SYSTEM Inc. (2335 TSE First Section)

Issued: 2/1/2019

• Summary

Research Dept., Alpha-Win Capital Inc.

<http://www.awincap.com/>

◆ Independent, mid-tier system integrator with 46 years of history in the industry and stable growth over the long term

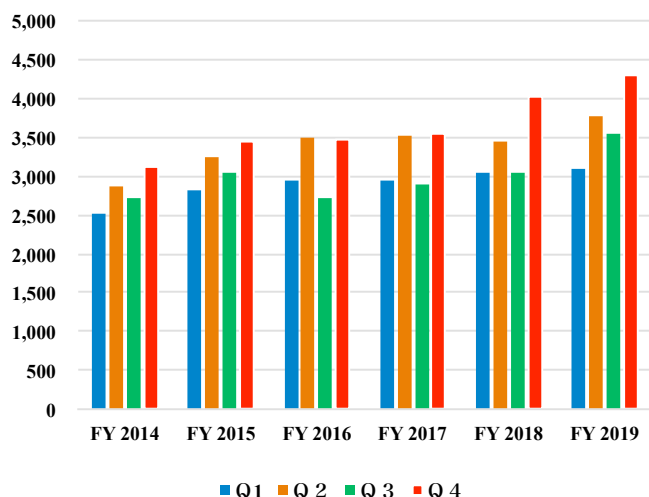
- CUBE SYSTEM Inc. (hereinafter “the Company”) is an independent, mid-tier system integrator listed on the First Section of the TSE. Its main customers include Nomura Research Institute and Fujitsu Group. It provides services and develops systems mainly for the finance, distribution, and telecommunications industries. Its strengths are its excellent customer base, high experience, excellent customer trust, and technological skill and know-how that it has accumulated over the years. Founded in 1972, it has 46 years of history in the industry.
- With the exception of one fiscal year, the Company has been continuously increasing sales YOY for the past 17 years (note that all fiscal years or FY in this document are March-ending; e.g. FY 2019 ends in March 2019). During this period, its sales growth rate (simple average increase in sales) was +6.5% per year and its recurring profit growth rate (simple average) was +5.9% per year; the Company has been steadily expanding its business and keeping its business in the black over the long term. Recurring margin has been stable at around 7% and the increase in sales has been contributing directly to increases in profit, dividend, and market capitalization.

◆ This FY’s Q3 financial results (cumulative): sales rose by 9.0% YOY and operating profit increased significantly by 36.6% YOY. Excellent fundamentals maintained.

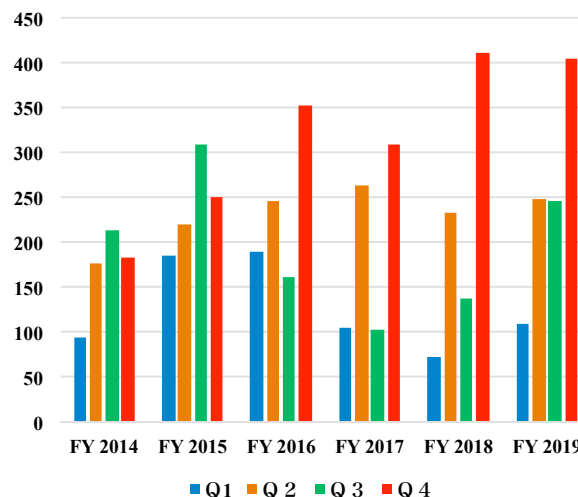
- For the third quarter of FY 2019 (cumulative from Apr. through Dec. 2018; hereinafter “Q3”), the Company’s financial results were excellent: Y10,404 million (+9.0% YOY) for sales, Y605 million (+36.6% YOY) for operating profit, Y632 million (+40.4% YOY) for recurring profit, and Y383 million (+48.4% YOY) for net profit attributable to owners of the parent (hereinafter “net profit”) (Figures 1 and 2). Progress with both sales and profit was mostly in line with the Company’s target (internal targets; not disclosed). In Q3 (Oct. through Dec.), sales grew by 16.3% YOY and operating profit increased significantly by 79.6% YOY (due to the drop in retirement-benefit-related expenses recorded last FY, improved human resource utilization rate, etc.).
- The Company’s business environment and fundamentals have not changed since the disclosure of its Q2 financial results and business conditions remain great.
- With regards to Q3 financial results by industry type, for the finance industry, sales declined by 10.4% YOY and gross profit decreased by 23.7% YOY due to the shrinkage of system development businesses with banks and life insurance companies. However, this decline was offset by the contribution to both sales and profit by the “other industries” category, along with the telecommunications industry. The “other industries” were able to make this large contribution due to the expansion of the Cloud consulting business as well as the expansion of system development businesses with manufacturers such as construction machinery and food manufacturers thanks to continued sales efforts. For telecommunications too, infrastructure development business for telecom carriers had continued to expand.
- In Q3, the “other industries” made the largest contribution to both sales and gross profit, beating the finance industry, with its large sales and profit increase (Figure 3; in the order of % composition for sales and % composition for gross profit; 34.9% and 32.6% for “other”; 27.4% and 25.1% for finance).
- Also, the amount of orders received up through Q3 was Y10,522 million, 8.5% greater (+Y823 million) compared to last year’s Y9,699 million. The Professional Service segment that includes the consulting business was the biggest growth driver, since the amount of orders for this segment had increased by 55.3% (+Y749 million).
- Meanwhile, with regards to profit, quarterly gross margin improved during this FY from Q1:16.1%→Q2:16.9%→Q3:17.4%. Also, since SG&A expenses were held down and stayed about the same on a quarterly basis, operating margin also rose from 3.6%→6.5%→6.9% (Figure 4). This improvement of both profit margins may have been caused by the gradually increasing effects of various measures that the Company has been pushing forward, such as the improvement in productivity, optimization of personnel placements, and cost control. With no large factors such as non-operating income/expense or extraordinary gain/loss, net profit increased significantly by 48.4%.

- Q3-end balance sheet does not indicate a large change. Liquidity is high with cash and deposits of Y3.2 billion and financial condition is sound with an equity ratio of 68.5%.

【Figure 1】 Quarterly Change in Sales (unit: Y mil)

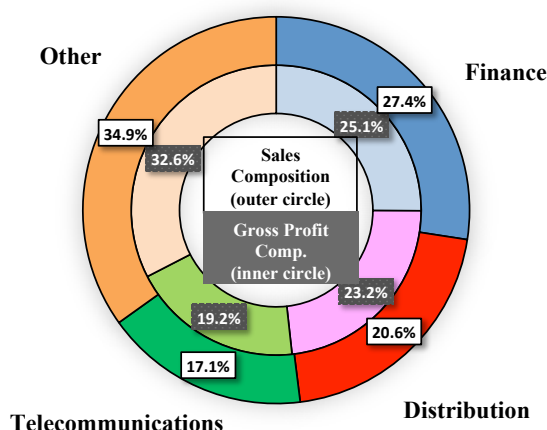


【Figure 2】 Quarterly Change in Operating Profit (unit: Y mil)

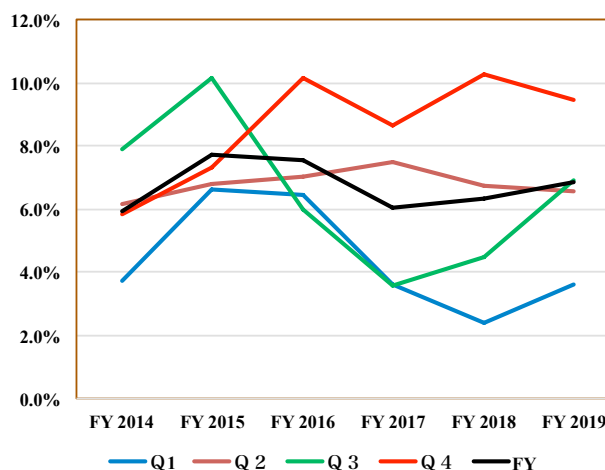


(Ref) All figures were prepared by Alpha-Win Research Dept. based on the financial results summary and financial results presentation supplementary material. (Note) Forecast for FY 2019 Q4 was calculated back from the Company's full-year plan.

【Figure 3】 Sales Breakdown by Industry for FY 2019 Q3 Cumulative (unit: %)



【Figure 4】 Quarterly Change in Operating Margin (unit: %)



◆ **Progress rate in terms of full-year financial forecast was also mostly great, raising likelihood of achieving target.**

- As with last FY, sales and profit increases are also expected to for this FY. The Company plans to achieve new record-high sales and profit for this FY's results. The Company has not changed the full-year forecast for sales or profit for this FY from the initial forecast made at the beginning of the FY. Progress in Q4 is expected to be in line with the Company's plan.
- Q3's progress rate in terms of the Company's full-year financial results forecast for this FY was 70.8% for sales and 59.9% for operating profit. In comparison, progress rate in terms of full-year financial results for the same period during last FY was 70.4% for sales and 51.7% for operating profit. Similarly, the simple average for the last five fiscal years' Q3 progress rates (including last FY) is 72.0% for sales and 64.4% for operating profit; this

FY's progress rates are below average. However, in recent years, the percent contribution of fourth quarter results (Q4: Jan – Mar) to full-year financial results has been gradually increasing, and the YOY growth rates for sales and operating profit in Q3 (cumulative) are greater than the Company's estimates of +8.4% and +18.1% YOY, respectively, for the full fiscal year; therefore, the Company seems to be making steady progress.

- Alpha-Win Research Department believes that the Company's full-year sales and profit targets should mostly be achievable for the following reasons and has not made any revision to this FY's financial results forecast at this point.
 1. With orders for new projects and the expansion of the consulting business, Q3's cumulative sales and profit are both growing as expected and the fundamentals are excellent.
 2. The Company is making progress with productivity improvement and cost control mostly in line with its plan; going forward, further improvements are expected.
 3. The Company is making steady acquisition of orders for new projects and product delivery.
- Since the expansion of the enhancement business, acquisition of new customers, development of new or overseas businesses, and productivity improvement through various measures are expected, Alpha-Win Research Dept. believes that over the medium to long term the Company's sales and profit will continue to steadily grow at about 10% per year.

◆ **Stock price and characteristics: stock value does not seem cheap, but it is a domestically-oriented, defensive stock. Stock price rose in response to Q3 results and share buyback.**

- Since last year's October, the Company's stock has been underperforming the TOPIX amidst a large-cap-oriented market environment. However, upon disclosure of information on Q3 results and share buyback (upper limit of 400 thousand shares; upper limit of Y300 million for the value of acquired stock; equivalent to 2.8% of all outstanding shares excluding treasury shares), the stock price was positively affected and rose significantly. 400 thousand shares, the upper limit, is about twelve days' worth of the average daily trading volume during 10/1/2018 to 1/30/2019 (approx. 33 thousand shares). This share buyback, realizing the "improvement of asset efficiency and expansion of shareholder benefit" declared in the medium-term plan, is a good indication that the Company is true to its word.
- Compared to the average of the First Section of the TSE (based on the closing price on 2/1/2019: P/E=13.4, P/B=1.17, and dividend yield [simple average] = 2.02%) and the Company's competitors (HIMACS and Toho System Science; Figure 5), the Company's stock does not seem cheap, which may be reflective of the Company's stable growth.
- The Company's stock is a domestically-oriented, defensive, and stable growth stock with a low volatility in price with respect to index values. In the past ten years or so, stock price has increased by about four times and has been significantly outperforming the TOPIX. Regarding stock price, we should continue to keep a close eye on this FY and next FY's financial results as well as the development of new technologies or new business domains and shareholder return (dividend hike and enhancement of shareholder benefit program).

【Figure 5】 Comparison of Valuation Indicators with Competitors

Company Name	CUBE SYSTEM (CS: consolidated)	HIMACS (HM: consolidated)	Toho System Science (TS: non-consolidated)
Code	2335	4299	4333
Stock Price (at 2/1 closing)	736	1,785	911
Market Cap (Y mil)	11,246	11,079	12,632
P/E (price-to-earnings ratio)	16.1	12.8	16.1
P/B (price-to-book ratio)	1.9	1.2	1.7
Dividend Yield (%)	2.2	2.8	2.2
EV/EBITDA	9.2	6.2	6.1
P/S (price-to-sales ratio)	0.8	0.8	1.0

Market cap=(shares outstanding) x (market share price [at 2/1/2019 closing])

EV/EBITDA=(market cap + interest bearing debt - cash & deposits) / (O.P. + depreciation + intangible fixed asset amortization), based on FY 2018

P/S=market cap / sales [the companies' estimate for FY 2019], P/S reflects actual value at end of Q3 of FY 2019.

P/E and the EPS and forecasted dividend used in dividend yield calculation are all from the companies' plans for FY 2019.

(Ref) Prepared by Alpha-Win Research Dept. based on each company's financial results summary

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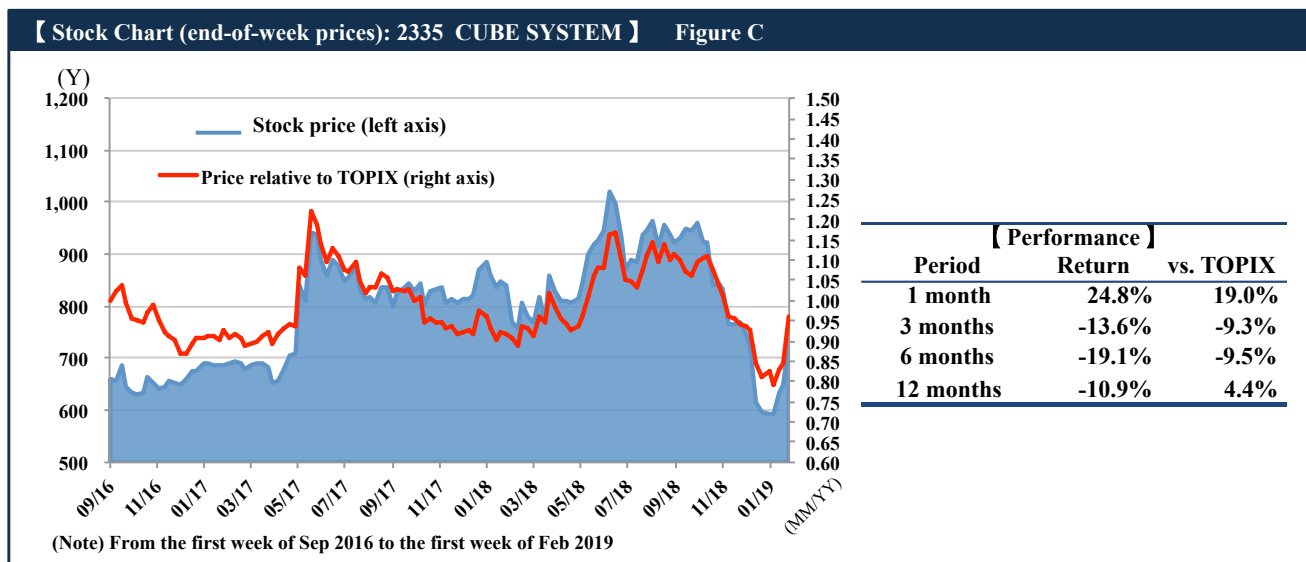
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【 2335 CUBE SYSTEM Sector: Information & Communication 】 Figure A											
FY	Sales	YOY	O.P.	YOY	R.P.	YOY	N.P.	YOY	EPS	BPS	Dividend
	(Y mil)	(%)	(Y mil)	(%)	(Y mil)	(%)	(Y mil)	(%)	(Y)	(Y)	(Y)
2016	12,622	0.8	949	-1.5	960	-2.1	628	5.8	43.22	322.76	14.0
2017	12,899	2.2	781	-17.7	811	-15.5	551	-12.3	39.15	346.47	14.0
2018	13,559	5.1	855	9.5	892	10.0	567	2.9	40.59	372.23	16.0
2019	CE 14,700	8.4	1,010	18.1	1,010	13.1	640	12.9	45.80		16.0
2019	E 14,600	7.7	1,000	17.0	1,000	12.1	635	12.0	47.03	388.74	16.0
2020	E 15,800	8.2	1,150	15.0	1,150	15.0	730	15.0	54.06	425.80	17.0
2021	E 17,300	9.5	1,340	16.5	1,340	16.5	851	16.6	63.02	470.83	18.0
2018	Q3 9,540	2.1	442	-6.5	450	-7.9	258	-20.3	18.48	372.23	-
2019	Q3 10,404	9.0	605	36.6	632	40.4	383	48.4	27.74	388.72	-

(Note) CE = Company forecast, E = Alpha-Win Res. Dept.'s forecast. EPS estimated by Alpha-Win Res. Dept. reflects the planned additional share buyback of 400 thou. shares.

【 Stock Price and Valuation Indicators: 2335 CUBE SYSTEM 】 Figure B							
Item	As of 2/1/2019	Item	P/E	P/B	Dividend Yield	Dividend Payout Ratio	
Stock Price (Y)	736	Last FY (actual)	18.1	2.0	2.2%	39.4%	
Shares Outstanding (thou.)	15,280	This FY (est.)	15.7	1.9	2.2%	34.0%	
Market Capitalization (Y mil)	11,246	Next FY (est.)	13.6	1.7	2.3%	31.4%	
Dilutive Shares (thou.)	0	Equity Ratio at Last FY-End	68.1%	Last FY's ROE	11.4%		

(Note) Forecasts were made by Alpha-Win Res. Dept.



(Note) The graph reflects stock price and index values up to the closing price of Feb 1, 2019. However, performance was calculated based on the closing price at the end of Jan 2019.

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