Alpha-Win Company Research Report

CUBE SYSTEM INC.

(2335 TSE First Section)

Issued: 7/1/2020

● Summary

Alpha-Win Capital Inc. Research Department
http://www.awincap.com/

Business Description

・CUBE SYSTEM INC. (hereinafter, the "Company") is an independent, mid-tier system integrator (SI) 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. Founded in 1972, it has 48 years of history.

Current Financial Performance

・With the exception of one fiscal year, the Company has been continuously increasing sales YoY for the past 22 years (including the period when its results were nonconsolidated). During this period, its annual sales growth rate (simple average of the rate of increase in sales) was +7.0% and its annual recurring profit growth rate (simple average) was +8.3%; the Company has been steadily expanding its business and keeping its business in the black over many years. Thanks to its committed efforts in business development and management reform, the recurring margin has been stable at around 7% (7.2% on average) and the increase in sales has been contributing directly to increases in profit, dividend, and market capitalization.

・Last fiscal year (FY 2020; note that the Company's fiscal year is March-ending), sales and operating profit were about 5% and 12% lower than the Company's initial forecast, respectively, but sales grew by 2.7% to Y14.7 billion and operating profit grew by 4.1% to Y960 million. Record-high sales were achieved for the seventh consecutive year and both the operating profit and recurring profit came close to their record highs. However, due to the posting of an extraordinary loss, net profit decreased by 11.9%. Dividend was raised by Y2 so that Y18 was paid per share.

・This fiscal year (FY 2021), the Company plans to achieve sales of Y16 billion (+8.8%), operating profit of 1.12 billion (+16.8%), and net profit of Y700 million (+33.3%). It is planning to achieve record highs for sales and each of its profits. It plans to keep dividend at Y18. The impact of COVID-19 on the business environment is uncertain, but it plans to increase sales through strengthened sales efforts toward its main accounts (clients) and IT-investment-related areas and through the development of new DX businesses. In addition to sales growth, by working on improving profitability and productivity, the Company plans to achieve a significant profit growth.

・Given the risk of COVID-19 and the Company's assumptions, Alpha-Win Research Department made a somewhat more cautious forecast than the Company. However, we believe that sales and profits may potentially reach their record highs.

Competitiveness

・Its strengths are its excellent customer base, extensive experience, strong trust from its customers, and the skill and know-how that it has built up over the years. Along with the expansion of business content and domain, the Company has been improving its capacity to meet project needs and gaining more competitive advantage as well.

Business Strategy

・In the medium- to long-term management vision V2020, for its final year or this fiscal year, the Company had planned to achieve sales of Y18.5 billion, operating profit of Y1,776 million (margin of 9.6%), and ROE of 13%. Currently, though, the values described above have been announced as forecast values. While working on expanding business and improving its earning power mainly through its Enhancement business, it has also been putting efforts into new areas of growth such as DX, cloud, agile development, blockchain, AI, and IoT, thus preparing itself for future business development. Going forward, the key points will most likely be the improvement of project management skills, continued improvement of profit margins, monetization of businesses in new business domains, acquisition of new customers, acquisition and training of employees, M&As and alliance strategies, globalization, and incorporation of new technologies.

・In June 2020, Mr. Nakanishi was newly appointed as Representative Director, President, and CDO (former Executive Managing Officer; used to work at Nomura Research Institute). In the next medium-term management plan (V2026), which will start next fiscal year, the Company plans to actively work on developing its proposal-

based businesses in addition to its contract-based businesses, as well as strengthening the SI business based on the Enhancement business and enhancing the digitalization business. Going forward, the announcement of specific measures and the new president's skills and achievements will be the points of interest.

Forecast on Medium-Term Financial Results

・The Company's business is affected by the financial performance and system investment trends of its domestic corporate customers. However, Alpha-Win Research Department believes that the Company will be able to continue to steadily increase both sales and profit by about 6-10% per year over the medium to long term due to continuous expansion of IT investment by its corporate users, the expected growth of the Enhancement business (the Company's strong point), acquisition of new customers, new business development, and productivity improvement.

Shareholder Return

・The Company has been proactively returning profit to shareholders through share buybacks, stock splits, and gradual dividend hikes. When benefits from the shareholder benefit program are added to the dividend, the actual dividend yield comes out to be about 2.5% at maximum. The forecasted dividend payout ratio is about 35%, which is about average for its industry, but its DOE (recent actual value) is high at 4.5%. With great financial performance and ample cash, shareholder return measures such as share buybacks, dividend hikes, and enhancement of the shareholder benefit program can be continued to be anticipated.

Stock Characteristics and Stock Price

・The Company's stock is a domestic-demand-related, defensive, stable growth stock, most likely seen as a medium- to long-term investment target. Its financial forecast for this fiscal year is relatively good compared to other companies in the industry. Valuation is somewhat cheap regarding P/E and P/S. Over the past 11 years or so, its stock price has increased by about four times and has been largely outperforming the TOPIX. Regarding stock price, we should watch the progress with this fiscal year's financial performance, financial performance in the next fiscal year and onward, development of new technologies and areas such as those related to DX and AI, alliances with other companies, M&As, and increased shareholder return.

【 2335 CUBE SYSTEM Sector: Information & Communication 】 Figure A

FY		Sales (million yen)	YOY (%)	O.P. (million yen)	YOY (%)	R.P. (million yen)	YOY (%)	N.P. (million yen)	YOY (%)	EPS (Y)	BPS (Y)	Dividend (Y)
2018		13,559	5.1	855	9.5	892	10.0	567	2.9	40.59	372.23	16.0
2019		14,325	5.6	921	7.8	959	7.5	596	5.1	43.25	393.29	16.0
2020		14,708	2.7	959	4.1	976	1.7	525	-11.9	38.69	411.96	18.0
2021	CE	16,000	8.8	1,120	16.8	1,120	14.7	700	33.3	51.56	-	18.0
2021	E	15,300	4.0	1,050	9.5	1,050	7.6	655	24.8	48.21	442.12	18.0
2022	E	16,300	6.5	1,130	7.6	1,130	7.6	705	7.6	51.89	476.01	20.0
2023	E	17,200	5.5	1,200	6.2	1,200	6.2	750	6.4	55.20	511.20	20.0

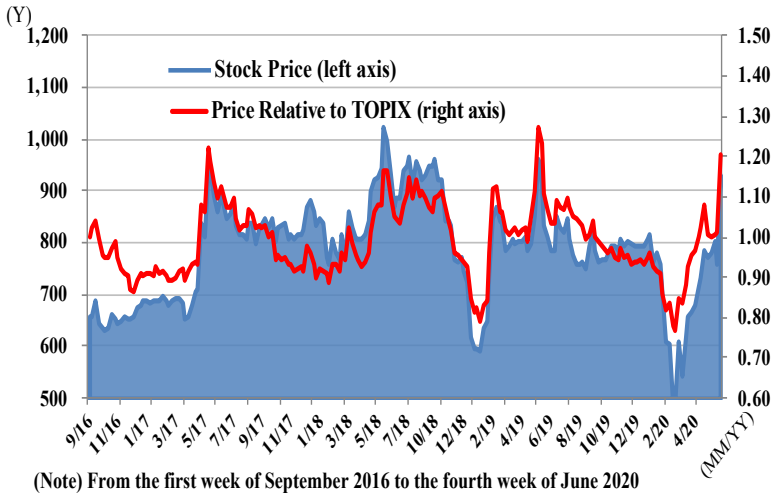
(Note) CE = the Company's estimate/forecast. E = Alpha-Win Research Dept.'s estimate/forecast. The Company's fiscal year is March-ending.

【 Stock Price and Valuation Indicators: 2335 CUBE SYSTEM 】 Figure B

Item	6/26/2020	Item	P/E	P/B	Dividend Yield	Dividend Payout Ratio
Stock Price (Y)	932	Last FY (actual)	24.1	2.3	1.9%	46.5%
Shares Outstanding (thou.)	15,280	This FY (est.)	19.3	2.1	1.9%	37.3%
Market Capitalizatoin (million yen)	14,241	Next FY (est.)	18.0	2.0	2.1%	38.5%
Dilutive Shares (thou.)	0	Equity Ratio at Last FY-End		69.6%	Last FY's ROE	9.6%

(Note) Estimates/forecasts were made by Alpha-Win Research Dept.

【Stock Chart (end-of-week prices): 2335 CUBE SYSTEM】 Figure C



(Note) From the first week of September 2016 to the fourth week of June 2020

【Performance】

Period	Return	vs. TOPIX
1 month	20.7%	19.7%
3 months	57.4%	40.0%
6 months	17.1%	27.8%
12 months	18.7%	16.8%

(Note) Reflects stock price and index values up through the closing price on 6/26/2020. Return for the 1-month period is the comparison of closing price at the end of May and on June 26. The same applies to the other periods. Prepared by Alpha-Win Research Dept.

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Contents

Note: 1) Upon translating to English, when the page numbers differed from the original Japanese version, they were adjusted to those of the English version of the report. 2) The Company's fiscal year is March-ending; i.e. FY 2021 ends in March 2021.

1. Company Overview

◆ Independent, Mid-Tier System Integrator

- **An independent system integrator with 48 years of history in the industry. Specialized and mid-tier. Stable customer base with several blue-chip companies among its customers.**

CUBE SYSTEM INC. (hereinafter, the "Company") is an independent system integrator[1] (a.k.a. SI). It is listed on the First Section of the TSE and is a mid-tier player in the system integration industry. Often as a subcontractor for major SIs, the Company mainly develops the systems of large companies in the finance, telecommunications, and distribution industries, as well as of the government. Its customer base is firm, having expanded its business with its main customers over many years. The Company has technological expertise and has earned strong trust from its customers, with the four corporate groups Nomura Research Institute, Fujitsu, Aeon, and Mizuho as its main customers and receiving outsourced jobs from the Tokyo Stock Exchange as well.

(1) System integrator: a company that conducts system integration. Abbreviated as "SI" or "SIer." A general term for companies that plan, design, develop, operate, and provide other solutions for the IT operation systems of customers including companies and the government.

Founded in 1972 at the outset of the software industry, the Company has 48 years of history. Mr. Sakiyama, who became Chairman and Representative Director (was President and Representative Director since 1989) upon the appointment of a new president, is one of the founding members. Mr. Nakanishi was promoted to Representative Director, President, and CDO (Chief Digital Officer) in June 2020 after experiencing Executive Managing Officer. He graduated from Kyoto University at the age of 61. After working as vice manager of Nomura Research Institute's Chubu Branch, he joined the Company in 2017. He also has experience working for a consulting company, and as one of the Company's officers, he is also the top salesperson for DX projects.

- **The Company's group is made of the Company and three subsidiaries.**

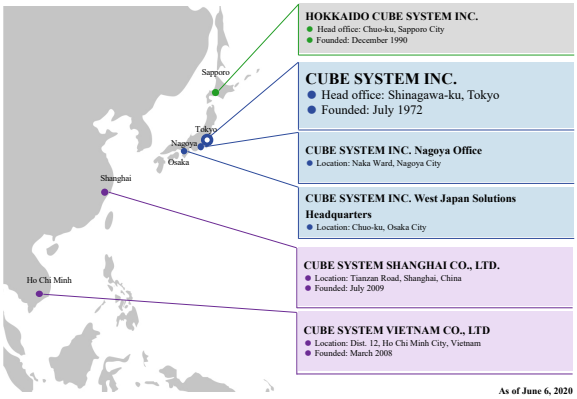
The Company's group consists of four companies: the Company and three consolidated subsidiaries. The consolidated subsidiaries are as follows (Figure 1).

1. HOKKAIDO CUBE SYSTEM INC.
(Located in Sapporo, Hokkaido; founded with 90.9% of the shares owned; for system development and sales reinforcement in the Tohoku and Hokkaido regions)
2. CUBE SYSTEM VIETNAM CO., LTD.
(Ho Chi Minh City, Socialist Republic of Vietnam; founded by the Company as a 100% owned subsidiary)
3. CUBE SYSTEM SHANGHAI CO., LTD.
(Shanghai, China; the Company established a joint company and then acquired all shares in 2017)

(2) Offshore development: providing services that meet customer needs, from system development to maintenance, at a low cost using overseas/offshore sites

The Company established its overseas subsidiaries mainly for the purpose of conducting offshore development[2].

[Figure 1] Locations of CUBE SYSTEM Group's Subsidiaries and Offices

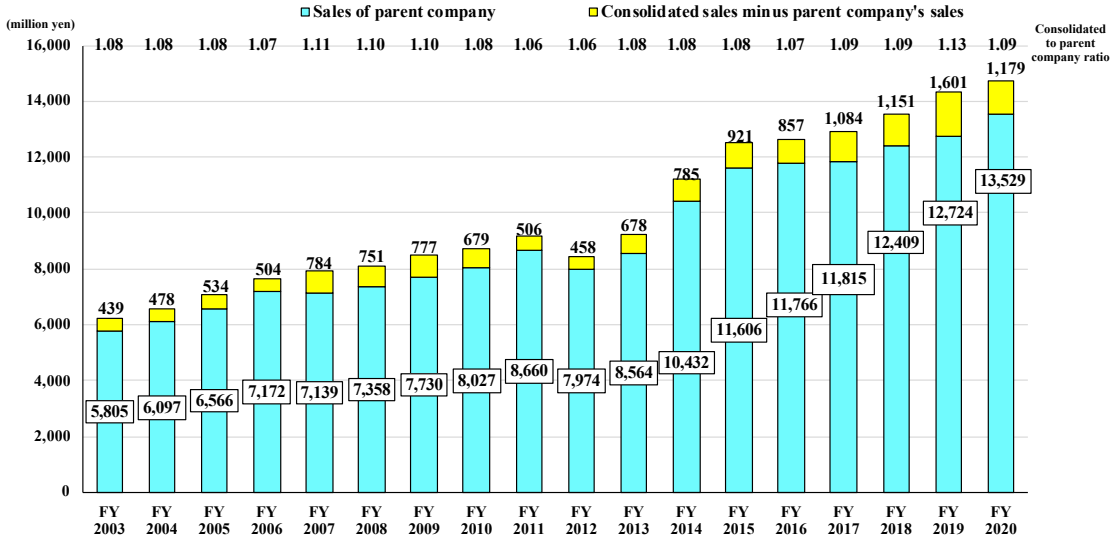


(Ref) The Company's materials and data

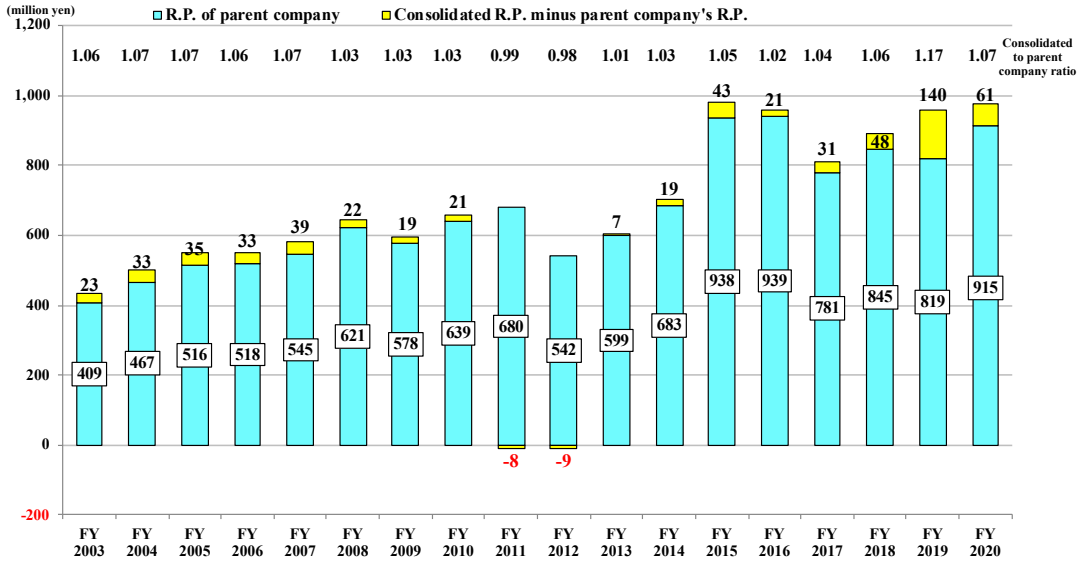
- **For consolidated financial results, sales and profit have been rising. Consolidated subsidiaries have been staying in the black. Consolidated-to-parent-company ratios have been a little over 1 for both sales and profit.**

The consolidated-to-parent-company sales ratio has stayed around 1.1 for the past 18 years, indicating that a large weight is placed on the parent company's results (Figure 2). Although the individual subsidiary's profit and loss are not disclosed, the consolidated-to-parent-company recurring profit ratio has been around 0.98-1.17 during the same period. Moreover, the total profit or loss of the three subsidiaries, calculated by subtracting the parent company's recurring profit from the consolidated recurring profit, has been a surplus with the exception of the two periods FY 2011 and FY 2012 (Figure 3). During the three fiscal years from FY 2017 to FY 2019, sales and profit of the subsidiaries (= consolidated minus parent company) grew. Most recently in FY 2020, due to the completion of the subsidiaries' major system development projects, their sales and profit declined.

[Figure 2] Ratio of Consolidated to Parent Company Sales (ratios shown on upper portion of graph)



[Figure 3] Ratio of Consolidated to Parent Company Recurring Profit (ratios shown on upper portion of graph)



(Ref) Both Figures 2 and 3 were prepared by Alpha-Win Research Dept. based on the securities report.

(Note) The estimates/forecasts are, unless otherwise noted, generally from the Company's plan/forecast. Since we generally round off decimal places, certain values may slightly differ from the Company's official disclosed values, etc. These apply to the rest of this document.

◆ Origin of its name

The company name CUBE comes from the first letters of "CU=Customer (customer first as the motto)," "B=Brain (exert high-level intellect and knowledge)," and "E=Emotional mind (solutions that move the heart). Also, CUBE also has the meaning of a geometrical cube – it reflects the aspiration to grow as a company with a cube-like multi-dimensionality (the six faces are innovation, humanity, vitality, internationality, technology, and youthfulness).

◆ Essentially debt-less, firm management. Rich in cash.

The Company's finance is strong with essentially no debt. Its free cash flow (FCF) has also been stably positive, and cash and deposits have been gradually accumulating (Figure 4). The Company has approximately Y3.6 billion in cash and deposits in addition to more than Y800 million in high-liquidity stocks and bonds, totaling about Y4.4 billion in highly liquid assets. In comparison, its debt is Y240 million (total assets of Y8 billion, market capitalization of Y9 billion, and sales of Y14.7 billion). Its financial ratios are also high and stable, with an equity ratio of 70% and current ratio of 333% (all are values as of the end of March 2020).

[Figure 4] Transition in Cash Flow (CF) **(Note: FCF stands for free cash flow. Unit = million yen)**

Unit: million yen	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
Operating CF ①	283	622	101	451	317	503	534	936	388	773	747
Investing CF ②	-1	309	54	-321	-172	-307	25	94	28	46	25
Financing CF	-144	-173	-125	-151	-188	-439	-241	-610	-392	-531	-339
FCF (①+②)	282	931	155	130	145	196	559	1,030	416	819	772
Cash and Cash Equivalents	1,619	2,376	2,405	2,383	2,339	2,099	2,408	2,822	2,846	3,131	3,557

(Ref) Prepared by Alpha-Win Research Dept. based on the financial results summary
(Note) "Cash and cash equivalents" are not equivalent to "cash and deposits" in the B/S but are from the "Statements of Consolidated Cash Flows" in the financial results summary.

◆ The business philosophy / goal is to "create a world-class company."

◆ The basic management policies are "Customer First," "Focus," and "All-Employee Sales."

(3) All-employee sales system: a system where there is no dedicated department for sales but instead each project is managed as a whole from receiving an order to delivering the product and confirming payment. The system engineer, who is in charge of responding to customers, will materialize the systemization needs of customers through dialogues and carry out projects with responsibility and authority under a sales goal.

◆ Shares management targets/results with all employees

◆ Business Philosophy and Basic Management Policy

The Company's business philosophy is as follows:

・A company flourishes with the people's support. We must continue to exist to promise the well-being of people including our employees. Root of continuity and development is profit, and profit is brought by customers. Under this philosophy, we will "create a world-class company."

The following are the Company's three basic management policies:

・Customer First: All decisions are based on our customers' values and it is our standard to think from our customers' perspectives.

・Focus: The four main elements of a company are people, assets, money, and time. In order to maximally utilize these elements, we will focus our business resources on the most important matters that have been decided based on our customer-first policy.

・All-Employee Sales: In order to provide user-oriented services, each employee will work toward the development of the Company's business as independent business persons. (⇒ has established a unique all-employee sales system[3])

Moreover, targets such as sales, profits, and progress for the entire company as well as for each department are disclosed to all employees. Thus, information is being shared in an open management system.

2. Business Description and Business Model

◆ Three Lines of System Service

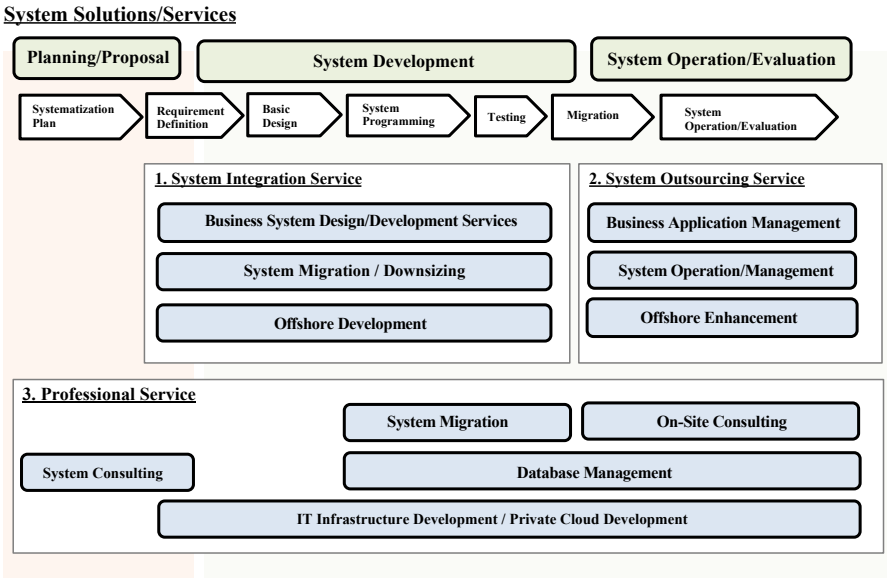
- **Business is classified into three categories. The System Integration Service, which is mainly system development, accounts for 70% of the total sales. Profit margins of the three categories are about the same.**

As its business, the CUBE SYSTEM Group provides system solutions[4]. Specifically, the Company provides a series of services from developing systems through planning/proposal, design, and manufacture (by programming) to testing, operating, and evaluating systems for other companies or the government. Since this is the Company's single business, the business is further classified by the informatization cycle of the customer into the following three categories (services lines).

1. System Integration Service (SIS)
2. System Outsourcing Service (SOS)
3. Professional Service (ProS)

(4) System solution: solving issues related to systems through hardware, software, and services

[Figure 5] Overview Diagram of the Processes in Each Service



(Ref) Prepared by Alpha-Win Research Dept. based on the securities report

(5) Requirement definition: defining the scope and target of systemization

(6) Basic design: also called external design, a part of the upstream process where the basics of the functions necessary for a system from the user's perspective are designed (screen, method of operation, security, etc.). The workflow is as follows: basic design → internal design → detailed design → manufacture (also called programming or implementation).

1. System Integration Service (SIS)

・The Company's main business. Develops business operation systems that meet the needs of end users such as companies and the government (hereinafter collectively referred to as "corporate users"). Includes requirement definition[5], basic design[6], programming, and testing (Figure 5).

- **Projects are diversified.**

・While the time it takes from receiving an order to delivering the product can range from a few months at the shortest to about three years, most projects are completed in the order of a few months. Most orders are received and delivered during the same fiscal year. The price can also range from several million yen to several hundred million yen, but projects priced less than Y50 million are by far the most common.

・In general, engineers are stationed at the corporate user's site and conduct system development for each project in teams. However, to cut down on cost and secure the necessary number of engineers, a part of the development is outsourced to domestic and overseas subsidiaries or other companies in the same business under the supervision of the Company's project manager.

・Since the system development business is, in general, based on contract agreements, the SI (the Company), who is the contractor, bears responsibility

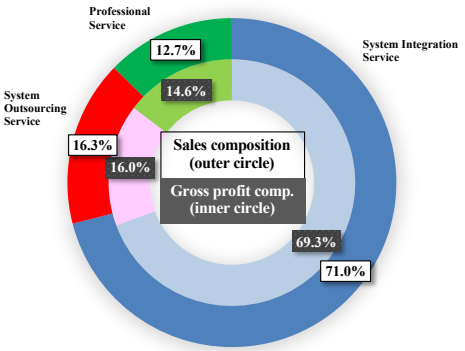
- **System Integration Services are based on contracts. Project management of the risks and the profit/loss is important.**

(7) Standard development framework F@CE: The Company's unique general framework for standardizing and streamlining application development. A tool for carrying out projects efficiently by preventing operation errors or omissions.

(8) Enhancement Service: Providing not just system maintenance, management, and development services but also improving system performance and quality to increase the value of the system. Or proposing ideas for new businesses. Improves customer satisfaction through these means. For the Company, this service means continued business with the customer.

(9) Business related to Oracle Cloud: Cloud-related services and proposals based on Oracle's database. The Company plans to continue to strengthen this business by increasing the number of certified employees. Current annual sales are several hundred million yen.

[Figure 6] Breakdown of Sales (outer circle) and Gross Profit (inner circle) by Service Category in FY 2020



(Ref) Prepared by Alpha-Win Research Dept. based on the financial results summary

for the products (systems). Therefore, management of the risks and the profit/loss of projects and products is important.

・Projects are often obtained through proposals or by bidding. Estimates are generally calculated based on [number of staff] x [number of months]. After receiving an order, in developing a system, the Company employs knowledge, know-how, and fundamental technologies pertaining to various industries, companies, and businesses that it has accumulated over the years, as well as its standard development framework F@CE[7], to reduce the risk and improve quality, profitability, and efficiency.

・Since unexpected changes in specifications, additional work exceeding the initial estimate, etc., negatively affect profitability and may make a project unprofitable, the Company is especially keen on improving its project management skills. The Company has also been actively providing the Enhancement Service[8], where the Company works closely with corporate users to make various proposals that will lead to new businesses (compact system development).

2. System Outsourcing Service (SOS)

・Services related to the operation and evaluation of systems. It provides two solution services: System Operation & Management (development, management, and evaluation of components of a system such as hardware, basic software, database, network environment, etc.) and Business Application Management (maintenance, management, and improvement of business applications and evaluation of management processes). The Company also has a seamlessly linked service structure where new challenges found and proposed during system maintenance and operation (SOS) can lead to a new Enhancement Service project (SIS).

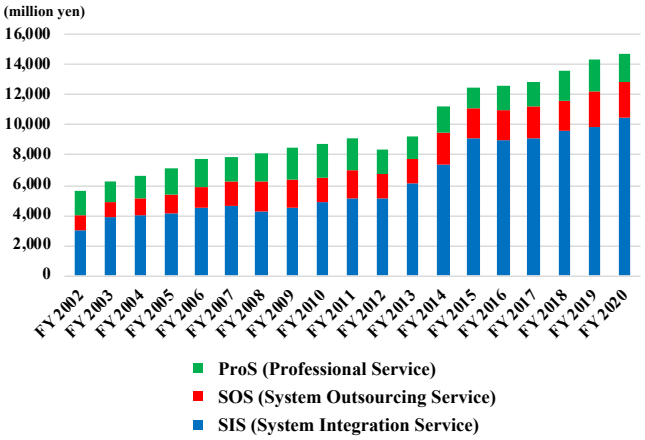
3. Professional Service (ProS)

・Services that utilize the Company's technologies to solve everything related to the informatization cycle from planning, designing, and developing infrastructure to operating/monitoring systems, such as consulting, database improvement for greater efficiency, system monitoring, management support, and IT strategies. High performance is realized through development tools and the skills of certified experts. The Company is especially strong in database technologies, for which it has expert engineers (business related to Oracle Cloud[9]).

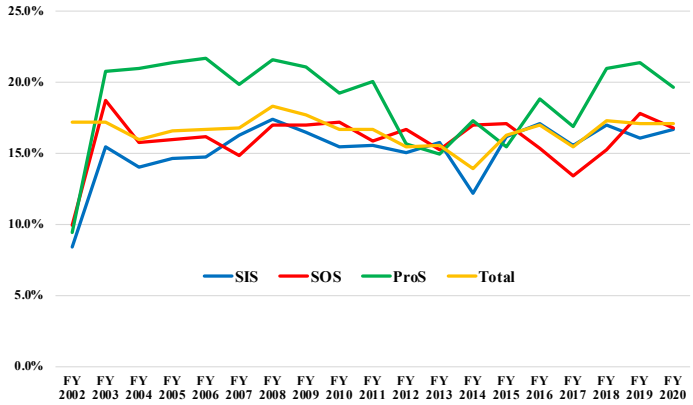
Breakdown of sales and gross profit by each of the three categories and their transition over the years are shown in Figures 6-8. The sales breakdown shows that SIS accounts for about 70% of the total, and SOS and ProS almost equally share the remaining 30% (outer circle of Figure 6). Over the past 18 years, total sales grew by 2.6x. Specifically, sales of SIS grew by 3.3x, SOS grew by 2.3x, and ProS grew by 1.4x; SIS has been the main driver of business growth (Figure 7).

Breakdown of gross profit is shown in Figure 6 (inner circle). The breakdown is not very different from that of sales. Also, as indicated by the transition in gross margin shown in Figure 8 on page 10, although some years were marked by a 5% deviation at maximum, each category has generally stayed within the range of 15% to 17%. However, the gross margin of ProS, which has high added-value, has been increasing and is 4-5 points higher than the other two categories. The overall gross margin, though, depends on the gross margin of SIS since SIS accounts for an extremely large percentage of the total sales.

[Figure 7] Sales by Service Category



[Figure 8] Transition in the Gross Margin of Each Service Category



(Ref) Figures 7 and 8 were prepared by Alpha-Win Research Dept. based on the financial results briefing materials.

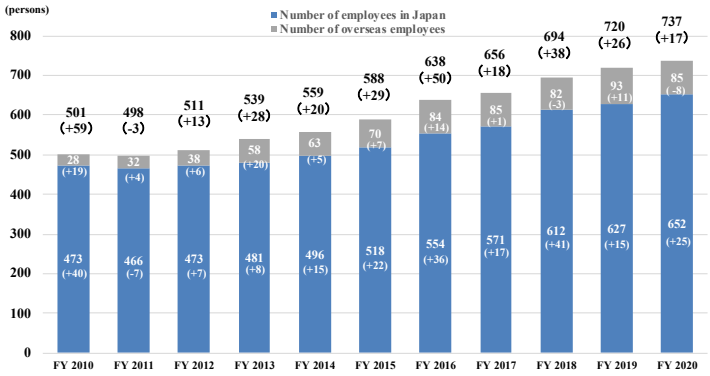
◆ Labor-Intensive Business Model Where Human Resources Are the Key

- **Labor-intensive business. Acquisition and training of talented employees are the key to growth.**

Since most of the Company's business is based on made-to-order, contract development of systems, its business is strongly characterized as a labor-based, single-product production model. Therefore, the acquisition and training of talented personnel are key factors since human resources are the source of competitive advantage and growth potential. Especially since systems are becoming more advanced and complex, talented employees for roles such as project managers for overall project management and system engineers are crucial in order to manage system quality, cost, deadlines, and profit/loss. Currently, the Company has about 260 project managers, but due to the recent years' labor shortage, it has not been able to secure enough managers for its business expansion. This shortage has been a bottleneck to further growth. The Company' challenge will be to increase new recruitment as well as improving the retention rate of its employees.

The change in the number of employees for the entire CUBE SYSTEM Group is shown in Figure 9. Every year, the Company has been adding a few dozen new employees in preparation for business expansion. In recent years, most of the new employees have been assigned to system engineer roles (in new areas such as DX).

[Figure 9] Change in the Number of Employees in the Group



(Ref) Prepared by Alpha-Win Research Dept. based on the financial results briefing materials

With regards to cost structure, labor cost and subcontracting cost paid to business partners (basically, mostly personnel expense) account for over 90% of the cost of sales (stand-alone percentage for FY 2020; percentage of each cost over sales is 25% and 51%, respectively). Therefore, the Company's skill in controlling these two costs may affect profitability, making project management crucial.

(10) Agile development: an approach to project development. Unlike the conventional waterfall development, it divides a system into short phases and conducts repeated implementation (programming) and testing to cut down on development time. "Agile" means dexterous and quick.

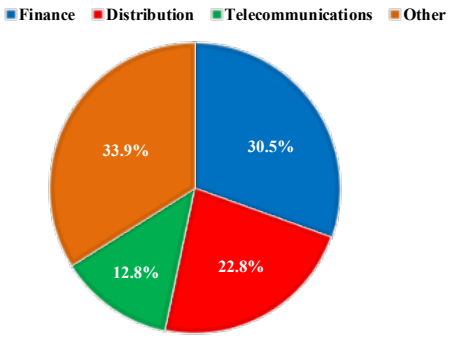
Generally, the system integration business is one where rapid expansion by unique products and services is difficult. Additionally, although the sharing and utilization of know-how is possible to some extent, currently there is a limit to improving productivity due to the reliance on manpower. The difficulty with profit margin improvement is a characteristic of the industry rather than just the Company. Faced by this challenge, the Company plans to continue to improve its profit margins by carrying out various measures that do not rely heavily on manpower such as the adoption of agile development[10], use of a standard platform, company-wide strengthening of project management, utilization of overseas subsidiaries (offshore development), and reviewing of contracts (negotiating and proposing to change from payment based on the number of staff and months to payment in return for services).

- **Sales breakdown by industry shows that other > finance > distribution > telecommunications. The "other" industries beat finance as the largest.**
- **Acquisition of new customers and diversification of industry are in progress.**

◆ Sales Composition Well-Balanced by Industry

Sales breakdown by industry is shown below (Figure 10). Sales for the finance industry, which must process a massive amount of data and must to be secure and reliable, had been the largest by industry type. However, while the sales for the finance industry declined, sales for the "other" industries (industries excluding the three industries of finance, distribution, and telecommunications) grew significantly, switching places with finance in its contribution to total sales starting in FY 2019 (Figure 11 on page 12). Following these two industries, the distribution industry and then the telecommunications industry is the next largest with regards to the percentage of total sales. HIMACS (TSE First Section: 4299) and Toho System Science (TSE First Section: 4333), competitors whose business is especially similar to the Company, specialize in business for the finance industry, with sales for the finance industry being over 70% or 80% of the total, respectively. On the contrary, the Company is becoming more diversified through the expansion of business with non-finance industries.

[Figure 10] Sales Breakdown by Industry in FY 2020



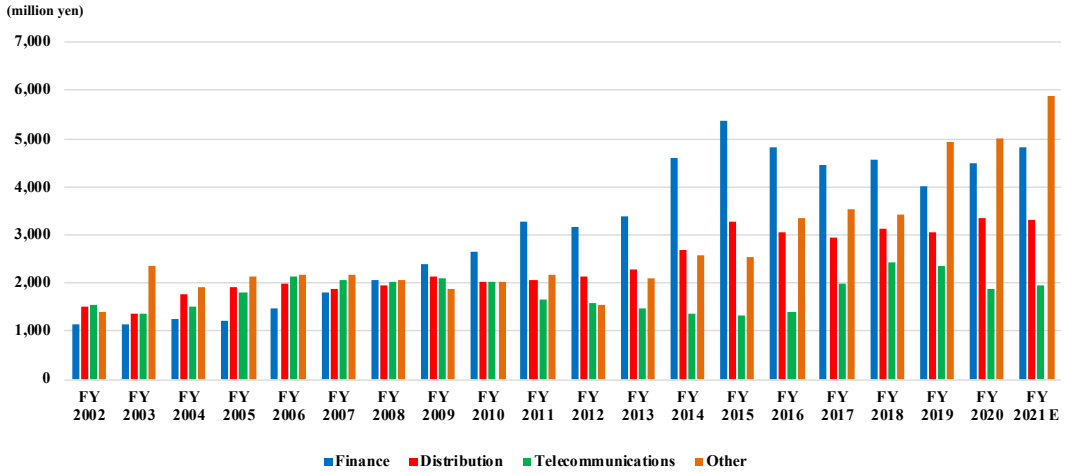
(Ref) Prepared by Alpha-Win Research Dept. based on information including the financial results summary

Concerning business for the finance industry, systems demand from mostly megabanks had been the financial growth driver for many years, but in the last few years, this demand has been beginning to level off due to weak earnings and the completion of consolidations and alliances in the finance industry. Instead, there has been brisk demand from areas related to credit cards, cashless payment, and insurance, which is beginning to help business for this industry bottom out. Meanwhile, sales for telecommunications have been generally increasing over the long term, although with some fluctuations, under the influence of the system investment cycle of telecom carriers, etc.

In the past few years, the "other" industries have become the most significant growth driver since business with manufacturers, the government, energy-related industries such as electricity, and the cloud-consulting-related industry grew largely with the acquisition of new customers and new contracts. As a result, the Company appears to have become more balanced and diversified with regards to industry type, leading to greater business stability.

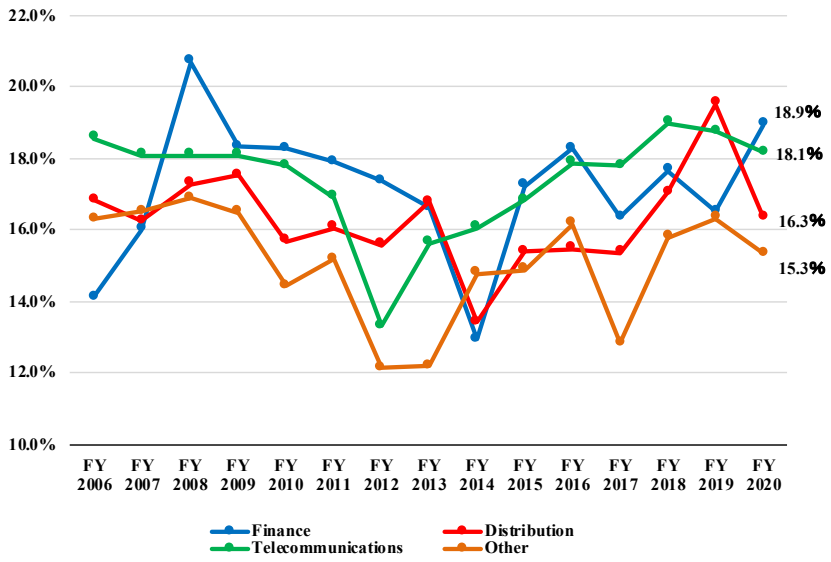
The breakdown of gross margin by industry changes somewhat every year. Gross margin was somewhat high for the finance and telecommunications industries in the most recent fiscal year, but there is no significant trend or change in margin (Figure 12). We believe that this is because the differences in the profitability of each individual project, rather than the differences in the characteristics of each industry, are reflected in the gross margin.

[Figure 11] Transition in Sales of Each Industry



(Ref) Figures 11 and 12 were prepared by Alpha-Win Research Dept. based on the securities report and financial results briefing materials

[Figure 12] Transition in Gross Margin by Industry



◆ Stable Customer Base and Business with High Continuity

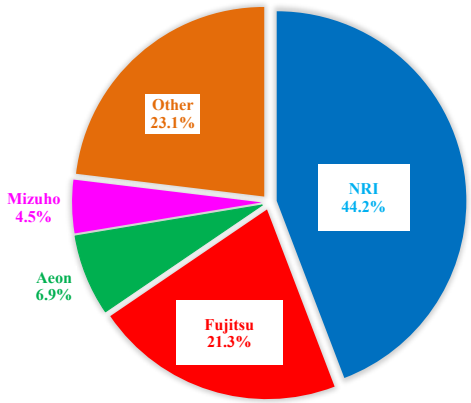
- **Stable business where repeated contracts with the existing customers comprise a majority of the business**

Since the Company's customers and end users are Japan's leading corporate groups and its business deals with mission-critical operations, the Company must be reliable, stable, user-friendly, secure, and have continuity. Moreover, for system development and operations, the Company must accumulate business knowledge and know-how. Consequently, the Company has a high contract continuity with its existing customers. The prime ratio (percentage

of direct contracts made with end users in system development) is 20 to 30% and many projects are outsourced from major SIs.

- **Sales breakdown by customer shows that Nomura Research Institute is the largest, followed by Fujitsu, Aeon, and Mizuho. These four groups account for a little less than 80% of the total.**

[Figure 13] Sales Breakdown by Customer Group in FY 2020



(Ref) Prepared by Alpha-Win Research Dept. based on the securities report.

As shown by the sales breakdown by customer group in FY 2020 (Figure 13), Nomura Research Institute (hereinafter, "Nomura Res. Inst." or "NRI") is the largest customer, followed by Fujitsu, Aeon, and Mizuho. These four corporate groups account for a little less than 80% of the total. Thanks to the success of the "account" strategy (a strategy where marketing activities are conducted in a concentrated manner by a person in charge) toward the four main client groups, an upward trend has been seen for the total sales of the four groups, increasing by 2.8% YoY to Y10,351 million (+Y281 million) in FY 2019 and by 9.3% YoY to Y11,316 million (+Y965 million) in FY 2020 .

Over the past ten years, the sales growth rate for clients other than the four main groups had been high, and the percentage of the sales of the four groups over the total had been gradually decreasing. However, in FY 2020, the proportion of the four groups increased (Figure 14 on page 14).

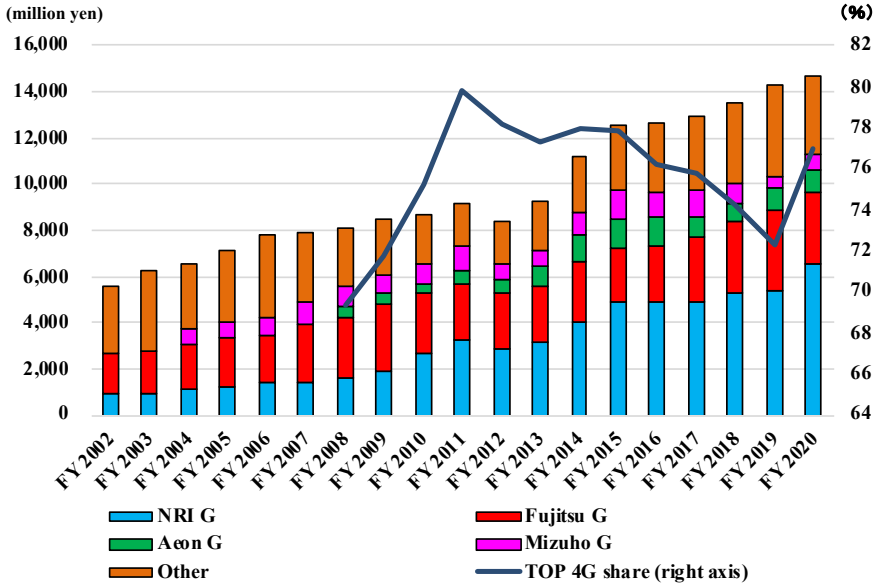
Looking at long-term changes, we can see that the sales for Nomura Res. Inst. Group had increased by approx. Y5.6 billion from approx. Y900 million in FY 2002 to approx. Y6.5 billion in FY 2020 thanks to the expansion of business field from the initial focus on the distribution industry to other industries such as finance. During this period, the Company's overall sales grew by approx. Y9.1 billion from approx. Y5.6 billion to approx. Y14.7 billion, with the NRI Group contributing to a majority of this growth (62%). Similarly, Fujitsu Group contributed Y1.4 billion to sales, which is 15% of the total increase in sales, thanks to its expansion of telecommunications, electrical power infrastructure, and government-related businesses. Having raised sales over the long term for each of the major corporate groups, the Company has excellent trust from its customers and great contract continuity.

In fact, the Company is one of the few companies that are partnered with Nomura Res. Inst. (NRI) as an e-e Partner[11]. In this partnership, the Company is in a close relationship with NRI, partnered not only in business but also making mutual investments and exchanging human resources. Looking at the transaction with each company, we can see that NRI is also the largest by transaction size, at approx. Y5.3 billion or 36.2% (percent of total sales in FY 2020). The second largest is the transaction with Fujitsu at Y2.6 billion or 17.8% (percent of total sales in FY 2020).

(11) e-e Partner: an especially close partner among all partners of NRI. Of the "e Partners" (approx. 150 companies) with highly specialized business know-how and IT skills and high-level IT security, e-e Partners cooperate with NRI not only in the operation of specific projects but also in the cooperative promotion of innovative activities in the Enhancement business; in the strategic reinforcement of HR, quality, and IT security; and in the creation of a mutually prosperous business model that takes advantage of each other's expertise. NRI has only announced three companies (the Company, HIMACS, and Toho System) as its e-e Partners.

In addition, in February 2019, the Company was awarded the Best Partner Award by AEON IBS, with whom the Company has been in a business relationship for 30 years. As seen from this, the Company's customer satisfaction level is high.

[Figure 14] Transition in Sales by Customer Group (G) and Share of the Top 4 Groups
(Note: information on sales of Mizuho G before FY 2003 and of Aeon G before FY 2007 is not disclosed)



(Ref) Prepared by Alpha-Win Research Dept. based on the securities report and financial results briefing materials

- **Focused on DX projects**
- **Upfront investment in growth areas of focus such as cloud, blockchain, agile development, AI, and IoT**

(12) DX (Digital Transformation): The transformation brought about by the penetration of IT (information technology) everywhere in the society. Not only the businesses, but the industrial structure and social infrastructure are said to also become affected. For companies, the use of digital technologies can bring reform to its business model, operation, processes, organization, and culture.

(13) Cloud solution service: a type of service where applications are used as a "service" via web browsers, etc.

(14) Blockchain: distributed network where information is synchronized, recorded, and accumulated among many computers

(15) AI: artificial intelligence

(16) IoT: Internet of things. A system that connects all devices around us by the Internet.

◆ Future Areas of Growth and Foundation for Next-Generation Technologies

Alongside its own R&D activities, the Company has been forming alliances with companies with advanced, new technologies and has become awarded or certified by various major companies as their partners (Figure 15 on page 15). It has been conducting investments and preparing for the development of businesses that utilize next-generation technologies. Since DX[12]-related IT investment of corporate users are expected to rapidly increase, the Company plans to put company-wide efforts into this area as its area of growth, actively make proposals, and respond to needs. The total R&D cost in FY 2020 was Y32 million, which may appear small since it is only approx. 0.2% of sales. However, the R&D cost is also actually separately recorded as "personnel expense for developers" under "periodic profit and loss."

The Company is especially focused on technology investment in cloud solution services[13] including Oracle-related services; participation in proof experiments of the Blockchain[14] Collaborative Consortium; capital and business alliances with companies with expertise in AI technology[15], IoT technology[16], and blockchain; alliance in agile development; development of corporate currency platform using blockchain technology; and creation of new solutions. These are aimed at acquiring and sharing expertise and information on advanced technologies, developing human resources, making joint development and proposals, and creating new businesses.

Furthermore, it created the Technology Strategy Office within the company in 2016. In the Office, there are both dedicated members and members who also work for the marketing department. The role of the Office is to catch up to leading-edge technologies and conduct R&D and business development based on the newest core technologies. Furthermore, it has been working on strategically collecting information on new technologies and developing relationships with new, promising companies through an investment partnership (outstanding balance on the B/S at the end of March 2020: Y183 million) and investment in private companies (similarly, Y34 million). Although it will probably take at least several years for those technologies and new businesses to begin to make a substantial contribution to the financial results, their progress is an important point to watch.

[Figure 15] Summary of Recent Alliances, Awards, and Key Points

Date	Annoucement	Details
April 2019	Created Sustainability Promotion Committee	Created the Sustainability Promotion Committee to accelerate progress with solving societal issues such as SDGs.
April 2019	Certified as Cybozu, Inc.'s official partner	The Company was certified as Cybozu's official partner. Reason for certification: in order to meet the customer needs for cloud-based business solutions, which are rapidly becoming popular, the Company provides solution services to its customers that merge a new business scheme based on Cybozu's cloud service *kintone* (cloud service for creating business apps) with the Company's Enhancement Service (its strong point) and offshore service based on overseas sites of the Company's group.
May 2019	Established Nagoya Office	Established the Nagoya Office in Nagoya Citiy, Aichi Prefecture, to further enhance solution services and expand business in the Chubu region. Will strengthen sales activities mainly toward the automobile, electricity, and machine sectors.
August 2019	Awarded by Oracle Japan	In the *Oracle Excellence Awards 2019* that Oracle Corporation Japan gives to its partners that have achieved especially remarkable results, the Company was awarded *Oracle Excellence Award Specialized Partner of the Year: Consulting - Japan* . It was recognized for its expansion of Oracle businesses (Oracle Database, Oracle Cloud, etc.) over 20 years.
November 2019	Demonstration experiment of face-recognition-based entrance control service with Tripleize Co., Ltd.	Conducted a demonstration testing of the face-recognition-based entrance control service Future Pass (trademark registration pending) with Tripleize and achieved some positive results.
December 2019	Certified as AWS Partner Network Select Consulting Partner	Certified by Amazon Web Services ("AWS") as AWS Partner Network (APN) Select Consulting Partner (SI). APN is a global partner program of AWS. SI is a certification given to companies with sales and technology systems for AWS.

(Ref) Prepared by Alpha-Win Research Dept. based on the news release on the Company's website

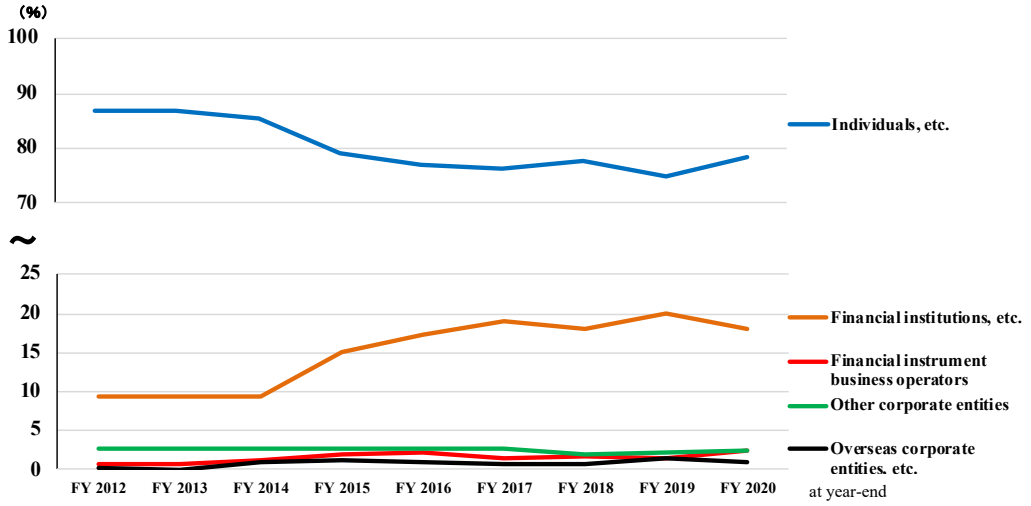
3. Shareholder Composition

◆ Change in Composition by Type of Shareholder

- **"Individuals, etc." own slightly less than 80% of all shares.**

With regards to shareholder composition by type of shareholder as of the end of March 2020 (Figure 16), "individuals, etc." is by far the largest, owning approx. 78% of the total. Second to this is "financial institutions, etc.," owning 18%. Together, these two types of shareholders own 95%, which is most of the outstanding shares. "Foreign corporate entities, etc." is small, owning 1.1%. Over the years, shares of "individuals, etc." have somewhat decreased and shares of "financial institutions, etc." have increased.

[Figure 16] Change in Shareholder Composition by Type of Shareholder (unit: %)



(Ref) Prepared by Alpha-Win Research Dept. based on the securities report

◆ Major Shareholder Composition

The Company's major shareholder composition has been stable and has not greatly changed. The major shareholders as of the end of March 2020 are shown in Figure 17 on page 17. The following is supplemental information.

- **The employee stock ownership plan and current and former directors are the most prominent among the major shareholders.**

・Since the amount of shares owned by the Employee Stock Ownership Plan decreased, in March 2019, its ranking among major shareholders became switched with chairman Sakiyama (previously president), who became the largest shareholder instead. Possessing a little less than 12% of all shares as of the end of March 2020, he owns slightly more than the Employee Stock Ownership Plan at second place.

・The new president Mr. Nakanishi owns 24.2 thousand shares (0.17% of all shares).

- **Increase in investments under the name of trust banks. Incorporated in several investment funds.**

・The Master Trust Bank of Japan (trust account) rose to third place among the major shareholders. The name of its final investors and its purpose are unknown (note that Mitsubishi UFJ Trust and Banking Corporation owns more than 40% of the shares of this trust bank). The final investors and purpose of the tenth largest shareholder Japan Trustee Services Bank (trust account 5) are also unknown (note that Sumitomo Mitsui Trust Holdings, Mizuho Financial Group, etc., own shares of this trust bank). The Company's stock is incorporated in funds such as the Open-End Low-Price Equity Fund managed by Nikko Asset Management (parent company: Sumitomo Mitsui

Trust Bank), several funds managed by Mitsubishi UFJ Kokusai Asset Management (part of Mitsubishi UFJ Group), and the Japan Equity Index Fund managed by Nomura Asset Management. Considering the hierarchy of capital, a part of these funds is likely invested under the name of each trust bank.

- **The largest individual shareholders are those affiliated with the Company.**

・The fourth largest shareholder Mr. Onuki is one of the Company's previous presidents. The fifth largest Mr. Uchida is the Company's current director.
・The sixth largest shareholder The Master Trust Bank of Japan is the BIP trust account for the Company's director remuneration (stock-remuneration-type director incentive plan).
・The eighth largest shareholder Mr. Sato is the Company's former executive managing director.
・The ninth largest shareholder MUFJ Bank is a correspondent financial institution.

- **With share buyback, treasury shares rose to about 11% of all shares.**

・Of the top ten shareholders, the Employee Stock Ownership Plan, the directors/employees (including former members), and the treasury shares add up to about 40% of the total. The Company has been actively buying back its shares, and its treasury shares including the BIP trust account were 15,276 thousand shares as of the end of FY 2020, which is about 11% of the total number of shares (treasury shares plus all outstanding shares). This essentially places the Company at third place in the shareholder ranking.

[Figure 17] Current Major Shareholders

Shareholder Name (unit: thou. shares)	FY 2015 year-end	FY 2016 year-end	FY 2017 year-end	FY 2018 year-end	FY 2019 year-end	FY 2020 year-end	% of Total Shares	Ranking
Osamu Sakiyama (indiv.): CUBE SYSTEM's president	1,775	1,675	1,655	1,646	1,638	1,632	11.70	1
CUBE SYSTEM Employee Stock Ownership Plan	1,641	1,672	1,663	1,668	1,565	1,602	11.49	2
The Master Trust Bank of Japan, Ltd. (trust account)	-	-	-	321	394	485	3.48	3
Akemi Onuki (indiv.): CS's former president	401	401	401	401	401	401	2.88	4
Toshio Uchida (indiv.): current director	475	415	403	393	376	369	2.65	5
The Master Trust Bank of Japan (director renumeration BIP trust: 75,824 account)	-	270	270	262	369	358	2.56	6
Masatsugu Sakurai (indiv.): general individual investor	316	316	316	316	316	316	2.27	7
Toshikuni Sato (indiv.): CS's former exec. managing director	380	340	300	300	304	304	2.18	8
MUFJ Bank, Ltd.	258	258	-	-	258	258	1.85	9
Japan Trustee Services Bank, Ltd. (trust account 5)	-	-	348	324	-	219	1.57	10
Nomura Research Institute, Ltd.	-	-	-	-	-			
Mizuho Bank, Ltd.	276	276	276	276	276			
CUBE SYSTEM INC.	682	458	1,035	1,236	1,356			
Resona Bank, Limited	241	-	-	-	-			
(CUBE SYSTEM's Actual Treasury Shares)	682	728	1,306	1,498	1,725	1,692		
(Percentage of Treasury Shares)	4.5%	4.8%	8.5%	9.8%	11.3%	11.1%		

Note: "-" indicates that there were no data available on the major shareholder in the securities report, and does not necessarily mean zero.
: (CUBE SYSTEM's Actual Treasury Shares) includes the BIP trust account for director renumeration.

(Ref) Prepared by Alpha-Win Research Dept. based on the securities report

- **Uses a portion of treasury shares as an incentive for directors**

Three times in the past, the Company had issued a portion of its treasury shares to its directors as an incentive. In FY 2016, the Company terminated its previous director retirement benefit plan and instead started the stock-remuneration type (BIP trust) director incentive plan where the Company's treasury shares are issued and granted according to his or her position and achievement rate with respect to the medium-term management goals. The plan is renewed every three fiscal years, or the span of a medium-term management plan, and vesting occurs upon a director's retirement.

Also, in September 2018 and September 2019, it issued a portion of the treasury shares to its directors and executive officers as limited-transfer,

stock-based remuneration as part of the new system created in the transition to a new step in the medium-term management plan. Prior to this, direct ownership of shares by members of the current management team was limited. Therefore, the introduction and continuation of this new stock remuneration system should be effective in raising the incentives of directors with regards to management and financial results and aligning their directions with the shareholders' profit.

- **Bought back shares worth approx. Y300 million**

In addition, in February 2019, the Company bought back approximately 348 thousand shares (equivalent to 2.8% of outstanding shares excluding treasury shares) for a total of approximately Y300 million (average acquisition price: Y863). The purpose of this buyback was to improve capital efficiency and margins and to maintain the ROE at 10% or greater. The total return ratio was 91.3% in FY 2019 and 46.5% in FY 2020, including the share buyback and dividend.

The Company has not decided on how to make use of the remaining treasury shares, but some possibilities include using them for stock remuneration as another director incentive, stock cancellation, or a stock-swap in a tie-up or an M&A.

4. ESG

◆ Environment

- **Works on continual improvement of environmental performance (energy and resource conservation)**

Although the Company's business does not harm the environment, under the policy to "practice environment-friendly management through continual improvement in environmental performance (energy/resource conservation)," the Company engages in environment-friendly activities (obtained ISO14001 certification). Specifically, the Company works on reducing electricity and paper usage, reducing waste, implementing "cool biz" and "warm biz," promoting green purchasing, and planting trees in Vietnam.

◆ Society

As a key industry necessary for the infrastructure supporting economy and society, the CUBE SYSTEM Group believes its mission is to contribute to the further development of the IT society and the strengthening of its customers' competitiveness. It aims to create a more prosperous and convenient society through the power of IT systems.

- **Actively engaged in activities that support the education of next-generation talents**

It has been supporting the education of next-generation talents in Japan and overseas. In Vietnam, it started a scholarship for students enrolled in engineering universities. It is also engaged in cleaning and beautification activities.

◆ Governance

As a company with auditors, the Company has set up the Nomination and Compensation Advisory Committee and the Integrated Risk Committee (which directly controls the Compliance Committee, the Internal Control Committee, the Security Committee, the Working Style Reform Committee, and other committees). The Company has also adopted the executive officer system in order to reinforce corporate governance. To deliberate on important matters related to the general management of the Company, a management meeting is held every week. The deliberated matters are communicated to each department by the managing officers. The Company has also set up an internal hotline system for compliance-related matters. It has not adopted any anti-takeover measures.

- **Of the 10 directors and auditors, 6 are from outside the Company.**

The management team is made up of seven directors (of which three are outside directors) and three auditors (all are outside auditors from Mitsubishi Corporation and have overseas working experience). Two of the directors are dedicated members, including the new chairman. Three are from Nomura Research Institute, including the new president (additionally, one is an outside director). Of the remaining two outside directors, one is a lawyer and one is a doctor (female doctor; newly appointed). Since all directors as well as executive officers used to be men, this is the first time that the Company has a female director.

(17) SDGs (Sustainable Development Goals): International goals for the period from 2016 to 2030 described in "The 2030 Agenda for Sustainable Development" that was adopted at the UN Summit in September 2015. Consists of 17 goals and 169 targets and pledges to "leave no one (on earth) behind."

Also, under the health management policy, the Company is working on improving and maintaining the mental and physical health of its employees and creating a comfortable working environment (won a silver award as a Health Management Outstanding Organization in May 2018). Since the workstyle reform will be the next important challenge, the Company has recruited an occupational health physician as director so that she can help create specific measures with her expertise in nursing care and mental health. In April 2019, it newly created the Sustainability Promotion Committee and has been working on social issues such as the SDGs[17].

5. History of Growth

◆ Company History

- **Founded under the anticipation that the importance and potential of computer systems will grow. Specialized in the system integration business.**

In 1972, the Company was founded as Customer Engineers Corporation by its founding members, which included the current chairman, for the purpose of software development and system operation/management (changed its name to the current one in 1990). As computers became popular in the Japanese society, IT investments increased and the system development market grew. The Company became specialized in the system integration business and built its trust and track record. One after another, it increased the number of contracts with leading Japanese companies – its current main customer groups. As those companies increased their IT investment and outsourcing of system development/operation, the Company expanded its business domain as well as business in general at a steady pace.

- **Its main customers are leading blue-chip companies of Japan.**

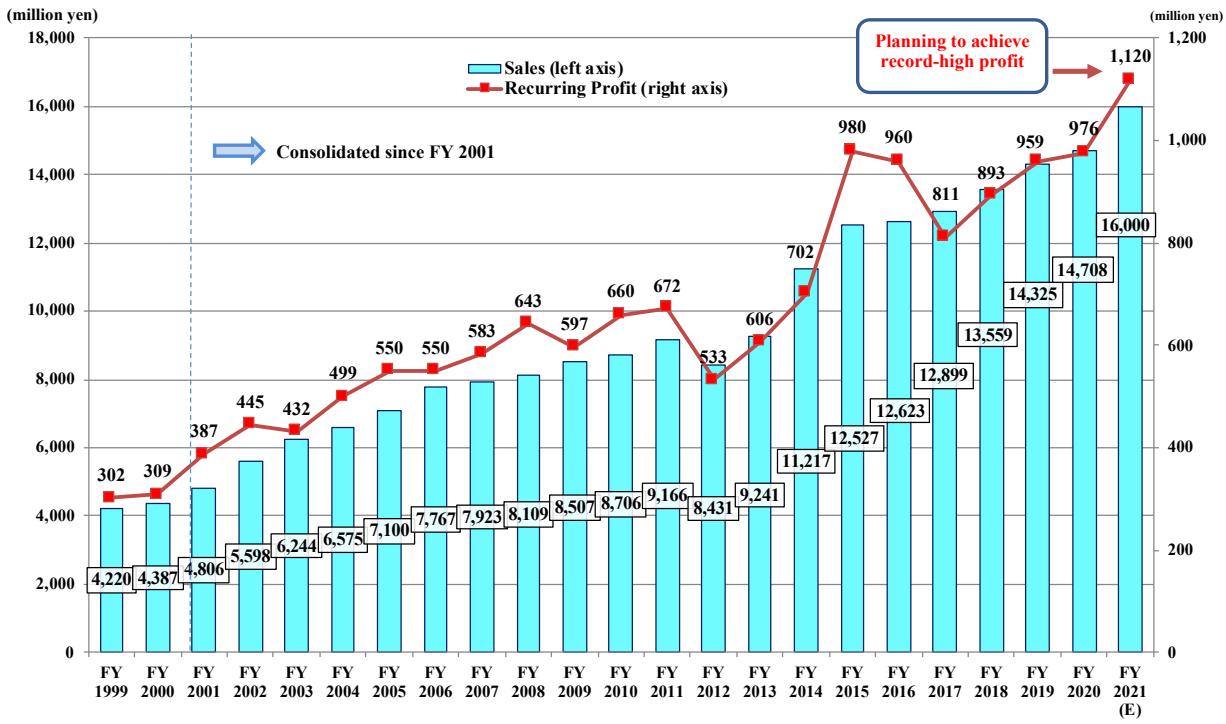
Regarding stock, the initial offering was made in the JASDAQ market in 2002. In 2006, the Company became listed on the Second Section of the TSE, and then became listed on the First Section on March 2014.

- **Changed its listing from TSE Second Section to the First Section in March 2014**

◆ Past Transition in Financial Results

From foundation until now, the Company has been improving its financial performance as a specialist (SI) in the development and operation of systems outsourced from other companies and the government. Long-term transition in financial performance is shown in Figure 18. The following are details on the financial results in chronological order.

[Figure 18] Long-Term Transition in Financial Results



(Ref) Prepared by Alpha-Win Research Dept. based on the securities report and financial results summary. E = the Company's estimate/forecast.

- **Has been growing steadily and continuing to increase sales over many years. Profit margins have stayed about the same.**
- **Sales decreased only for 1 fiscal year during the past 18 years.**
- **Rate of change in financial results has been low and stable.**

・On a consolidated basis, with the exception of only a single fiscal year (FY 2012), the Company has being achieving an year-on-year increase in sales every fiscal year for the past 18 fiscal years (at least 22 years including the period when accounting was nonconsolidated). This stable growth trend is noteworthy.

・During this period, the annual sales growth rate (simple average of the annual rate of increase in sales) was +6.4% and similarly the recurring profit growth rate was +6.0%, showing how the Company has been steadily improving its financial performance over the long term (during the period that its accounting was nonconslidated, the rates were +7.0% and +8.3%, respectively).

・Although recurring profit decreased in five out of the 18 fiscal years, the largest annual drop stayed within the range of approx. -20%, and the Company has been able to always stay in the black with regards to net profit for the year.

・Analyzed statistically, the Company's standard deviation for the rate of change in financial result and its variation coefficient (= standard deviation / average; shows relative dispersion; also called relative standard deviation) are small, indicating that the volatility of the Company's fundamentals is low (see Figure 19 for a comparison with similar-sized competitors for the most recent 16 fiscal years).

・Furthermore, because the Company's operating margin has been stable at around 7% (Figure 20 on page 22), an increase in sales has been directly correlated with increases in profit, dividend, and market capitalization.

[Figure 19] Performance Volatility Analysis for the Most Recent 16 Years (% YoY change for sales and R.P.)

Note: non-consolidated for Toho System only; actual values for FY 2005 - FY 2020

Target of Analysis	% Change in Sales (YoY %)			% Change in Recurring Profit (YoY %)		
FY 2005 - FY 2020	Cube	HIMACS	Toho System	Cube	HIMACS	Toho System
Market: TSE 1st Sec.	2335	4299	4333	2335	4299	4333
n=16 fiscal years	CS	HM	TS P	CS	HM	TS P
Standard deviation	6.05	7.79	17.79	13.31	31.65	324.01
Average	5.33	3.11	8.26	5.14	5.82	93.30
Coefficient of variation	1.13	2.50	2.15	2.59	5.43	3.47

(Ref) Prepared by Alpha-Win Research Dept. based on the securities report and financial results summary

- **Increased transaction with the major 4 groups has helped the Company grow significantly.**

External environmental factors, such as active IT investments by Japanese companies and the government, have not been insignificant to the Company's growth to date. However, much of the Company's success is thought to have been brought by its efforts to improve its expertise, earn trust from its customers, build a strong customer base, and consistently produce positive results. Although it is an independent company, it has strengthened its relationship with the four major groups NRI, Fujitsu, Aeon, and Mizuho and succeeded in developing long-term business relationships; this success was its major growth driver.

- **Even right after the Lehman shock, sales increased for 3 consecutive fiscal years.**

The financial performance for the most recent 12 years or so is as follows.

・In FY 2009 when the Lehman shock occurred, the economy was sluggish and customers became more cautious about IT investments. However, the Company was able to continue to increase its sales owing to the continued business with the existing customers mainly for systems in the finance and distribution industries, as well as due to the entry of companies into the banking business leading to projects for operation expansion.

・The economic recession continued into FY 2010 and FY 2011. System development plans continued to be postponed, cancelled, or scaled down, companies continued to hold off on IT investments, and competition over

- **In FY 2012, due to the Great East Japan Earthquake, sales decreased for the first time since becoming listed. Operating profit decreased by 20%.**

price and between companies became intense. However, thanks to the business with the existing customers and the expansion of business with life insurance companies, banks, and manufacturers, the Company continued to increase its sales. With increased sales, fluctuation in the operating profit for the three fiscal years following the Lehman shock stayed within a small range.

・The Great East Japan Earthquake, though, had a large negative impact on the Company in FY 2012. Amidst the difficult situation, sales decreased by approx. 8%. Sales of all industries excluding telecommunications declined, with an especially large decline for the business toward manufacturers and the government. This was the single instance in which sales decreased in the history of the Company from FY 2002 to the previous fiscal year. Its operating profit decreased by -20.9%, the largest drop during the same period, but a net profit was maintained.

- **Business environment improved thanks to Abenomics and digitalization investments. The Company began to increase sales again.**

・Then, IT investments by companies and the government recovered from their previous inclination to hold off or postpone thanks to factors such as the economic recovery brought by Abenomics since December 2012, recovery of company performance and employment, redevelopment of IT infrastructure due to M&As, smartphone-related telecommunications infrastructure, business related to the liberalization of electrical power retail, and increased investment in the field of social securities. Due to this recovery, as well as the full-scale investment in digitalization in recent years, the Company's sales growth trend became a more definite one.

- **Record highs achieved for both operating profit and recurring profit in FY 2015**

・Regarding profit, in FY 2015, since sales increased due to the development of businesses with existing customers and the acquisition of new customers, and productivity improved due to the reinforcement of project management, etc., a record-high operating profit and recurring profit of Y964 million and Y980 million were recorded, respectively (net profit for the year also hit a record high in the following year or FY 2016, at Y629 million).

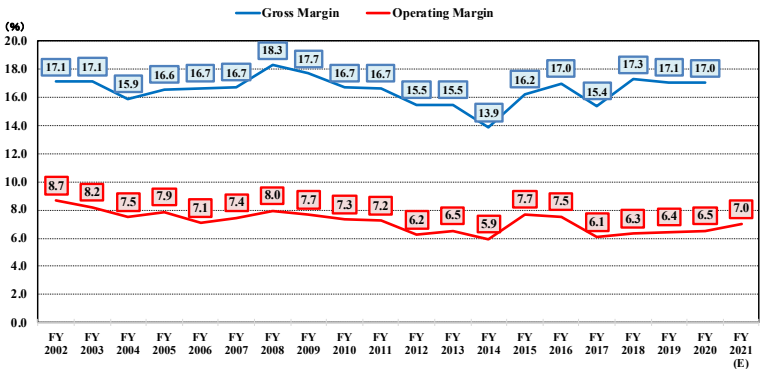
- **Sales have been hitting record highs for 7 fiscal years in a row, but profit has been fluctuating within a boxed range due to increased cost.**

・Since then, the Company has been consecutively posting new record-high sales every fiscal year. However, due to increased cost and intensified price competition, the Company's gross margin and operating margin have been gradually decreasing over the long term (Figure 20).

・The operating margin decreased especially due to the increased cost of sales (subcontracting cost and labor cost), upfront investment cost, and SG&A expenses (especially personnel expense; as a reference, the SG&A expenses ratio changed from 7.9% in FY 2014 → 8.5% in FY 2015 → 9.5% in FY 2016 → 9.3% in FY 2017 → 11.0% in FY 2018 → 10.6% in FY 2019 → 10.5% in FY 2020), but it began to improve in FY 2018. In the previous fiscal year (FY 2020), although neither profit quite reached their all-time highs, they have recovered to a close level.

・However, even with an improving economic environment, the Company has not yet been able to improve its profit margins beyond a boxed range.

[Figure 20] Long-Term Transition in the Company's Gross Margin and Operating Margin



(Ref) Prepared by Alpha-Win Research Dept. based on the financial results summary. E = the Company's estimate/forecast.

6. Business Environment

◆ History of the System Integration Business

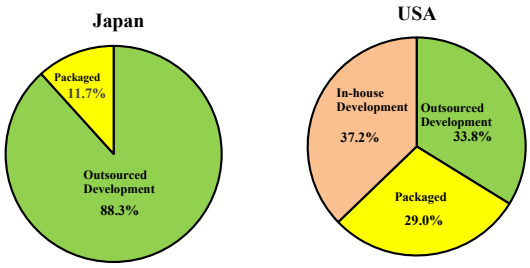
The system integration business is said to have begun in the 1960s when the US military industry outsourced its system development. In the US, there used to be a strong tendency for companies (users) to use packaged software or, when they needed to develop their own systems, conduct everything from system development to operation in-house. Meanwhile, the system integration business began in Japan when Nippon Telegraph and Telephone Public Corporation DATA Communications Bureau (now known as NTT DATA) was founded in 1967 and conducted system development for the Regional Bank Association of Japan and large-scale system development projects for the government.

- **As the outsourcing of system development became popular, SIs grew by taking those outsourced system development jobs.**
- **Made-to-order system development contract is popular in Japan.**

Previously, the IT system department of each company was in charge of system integration. However, as systems became more advanced and were required to be more efficient and rational, their in-house operation and management became difficult. Consequently, more companies started to outsource all or a part of the planning, development, management, and operation of systems. As a result, system integration outsourcing became popular and, as the contractor, system integrators (SIs) expanded their business.

In Japan, the proportion of outsourced system development is much higher than packaged software compared to the US (Figure 21).

[Figure 21] Ratio of Software Type in Japan and the USA



(Note) Monetary amount of software developed in-house is not disclosed in Japan's statistics (System of National Accounts). Therefore, data from software providers are used, but these data do not include in-house developed software. When the total of the US's packaged software and outsourced development software is set to 100% in order to compare data between the two countries, US's proportion of packaged software comes out to be 46.2%, which is about four times that of Japan.

(Ref) Ministry of Internal Affairs and Communications: "WHITE PAPER Information and Communications for 2019" (Japan: Ministry of Internal Affairs and Communications and Ministry of Economy, Trade, and Industry) (USA: US Department of Commerce)

◆ Structure of the System Integration Industry

- **The industry is in a mild oligopoly. Entry barrier is relatively high.**

Japan's system integration industry has no monopolistic player but is instead often described as being in a mild oligopoly (the top five players by sales account for about 40% of the total shares). This situation is most likely due to the fact that since this business deals with made-to-order system development, unlike the manufacturing and sales of products (general-purpose, mass-produced goods), one cannot meet the requirements for a monopoly such as technology protection and differentiation by means of patents and expansion of shares through mass production. Additionally, because of the language barrier and the uniqueness of business, entry of foreign companies into the Japanese market has been limited. On the flip side, aside from offshore development, full-scale entry of Japanese companies into foreign markets is also difficult. While the competition is intense, there should not be large changes in the shares since the demands for system reliability and continuity make the entry barrier relatively high.

- **The system integration industry has a vertically layered structure.**

This industry has a vertically layered structure where its players often share work, cooperate in work, and take contractor- or subcontractor-like roles among themselves. The players are mostly being able to exist alongside one another by taking strong positions in niches differentiated by industry, size, and corporate group of users including companies and the government, or by the business function of the system. Due to this structure, profitability as well as risks generally tend to increase as the number of direct contracts with end customers (prime contracts) increases, as one moves further upstream in the development process, and as business is conducted in more new areas.

Japanese companies (corporate users) prefer IT systems that are made-to-order and tend to outsource system development to other companies. Generally, the role of Japanese SI companies is to develop systems based on the requirements set by corporate users. Consequently, ownership of the intellectual property related to the system developed under an outsourcing contract belongs to the corporate user. This means that productivity cannot be easily boosted by selling the system to other customers or reusing it. Moreover, as described above, since the industry has a layered structure and is labor-intensive, profitability and global competitiveness are generally not high.

SI companies may choose to strategically achieve growth by securing human resources and expanding its scale through M&As and capital/business alliances among themselves as well as consolidations and mergers following the carve-out of the systems division of clients. Indeed, M&As are increasing.

- **SIs can be categorized into three types: independent (the Company belongs here), manufacturer, and user.**

System integrators (SIs) can mainly be categorized into the following three types.

1. Independent: Founded as a system integrator. A fully independent company. If it is a mid-tier player or smaller, it often works on contract development projects, etc., as a subcontractor for other SIs in addition to its own business with end customers. The Company belongs to this type. Whether or not it can develop a firm relationship with growing blue-chip customers is the key to success (company examples: TIS, Fujisoft, Otsuka Corporation, NSD, etc.).

2. Manufacturer: Manufacturer in the business of producing and selling hardware such as computers, or a company that was previously such manufacturer's systems division or software development division but had been separated. Or a company belonging to a manufacturer's corporate group (e.g. Fujitsu, NEC, Hitachi, IBM Japan, their IT-specialized subsidiaries, etc.).

3. User: Founded as a system integrator by major corporate players in industries such as finance, telecommunications, and trading. Or the IT systems subsidiary of such major company that was previously that major company's IT systems division before it become independent. Sells mostly to capitally tied companies within the corporate group (e.g. Nomura Res. Inst., NTT DATA, NS Solutions, SCSK, etc.).

(Reference) Other: category for those that do not fit into the above.
・Trading company: Started out as an equipment distributer, etc. Sells mostly to companies within the corporate group (e.g. Itochu Techno-Solutions, etc.).
・Telecommunications company: (e.g. NTT Communications, etc.)
・Accounting auditor or consulting company: (e.g. Accenture, etc.)

- **Although slowly, the system integration market is growing. Meanwhile, elimination and enlargement of companies are in progress.**

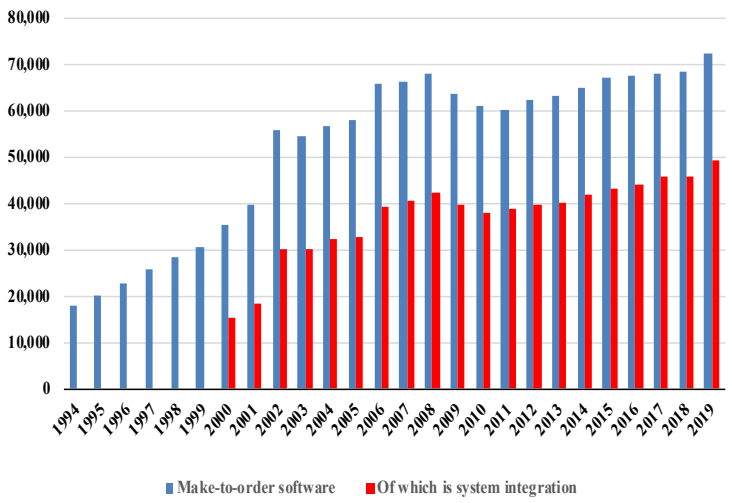
(18) Survey of Selected Service Industries: Nation-wide survey of companies on the current activity and business management status of industries in the service industry sector with high needs for statistics from both govt. and economic perspectives. Includes the IT services industry, which is further divided into software dev. (includes SI), assigned system management, etc.

◆ Trends in Japan's System Integration Market

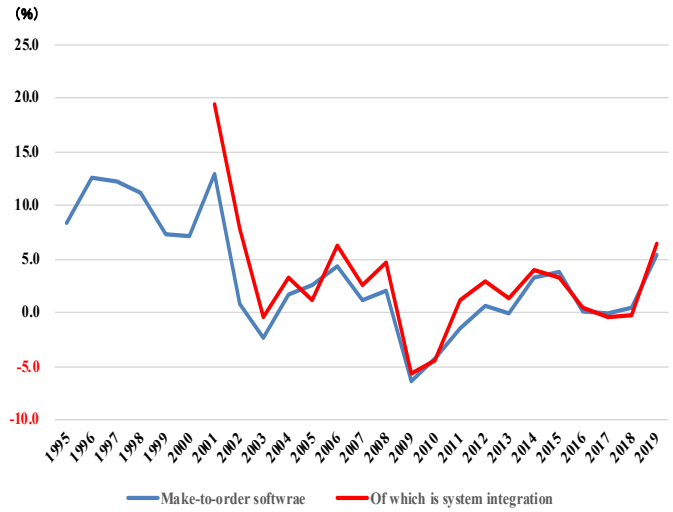
Looking at "Sales by category of business, number of establishments, and number of permanent employees for the information services industry," the survey result of the "Survey of Selected Service Industries"[18] by the Ministry of Economy, Trade, and Industry, we find that the sales of make-to-order software, as well as the sales of system integration which make up more than half of make-to-order software sales, have been increasing with the exception of the few years after the Lehman shock (Figures 22 and 23).

According to the same data, from 2010 to 2019, sales of system integration had increased by about 3.1% per year on a simple average. The current market size is about Y5 trillion. The number of establishments (mostly synonymous with the number of companies) in the IT services business has been gradually decreasing every year since 2003 (simple average of approx. -1.2% per year). In contrast, the number of permanent employees has been increasing with the exception of 2010 to 2012 (from 144 thousand in 1998 → 338 thousand in 2019), indicating that the elimination and expansion of companies are the industrial trend (the number of employees per establishment: 107.2 in 1998 → 138.7 in 2019).

[Figure 22] Changes in the System Integration Market
(annual sales: unit = 100 million yen)



[Figure 23] Rate of Change in the SI Market
(rate of change in sales: %)



(Ref) Prepared and reworked by Alpha-Win Research Dept. based on data from the April 2020 Survey of Selected Service Industry by the Ministry of Economy, Trade and Industry. Part of the original data used for market size (sales) in Figure 22 does not have continuity due to changes in the target size. However, the rate of change in Figure 23 has been adjusted so that there is continuity.

Since large-scale projects in system development (such as business combinations by megabanks) have already reached their peak and are beginning to decline, cost control is becoming a prominent issue and competition is starting to intensify. Over the short term, market environment is starting to become difficult due to the COVID-19 impact. However, structurally inherent lack of manpower, demands for improvement in operation efficiency, and IT investments by companies and the government will likely continue to steadily increase. In various industries and fields, companies have been strategically developing new areas and technologies to raise their competitive advantage. As systems become more advanced and the demand for DX increases, we predict that the market size will grow at about 2-3% per year.

- **Middle-ranking in the industry by sales, at 80th to 90th place from the top. Its share of sales in the entire system integration market is estimated to be about 0.3%.**
- **Its benchmark companies are HIMACS and Toho System. Both are Nomura Research Institute's e-e Partners and their market positions are very similar.**
- **No significant difference for each of the profit margins between the three companies. The Company's O.P. margin has stayed about the same, but its ROE has greatly improved.**

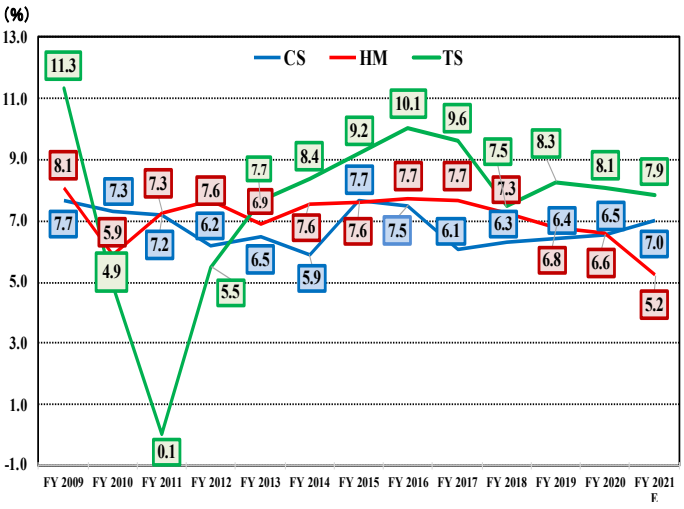
◆ CUBE SYSTEM's Market Position and Comparison with Competitors

In the system integration industry, there are about 220 companies defined by general terms as a SI whose sales can be confirmed through disclosed securities reports, etc. Among them, the Company is estimated to be ranked at around 80th to 90th place from the top by sales volume. Additionally, the Company's share in the Japanese market is estimated to be approx. 0.3%.

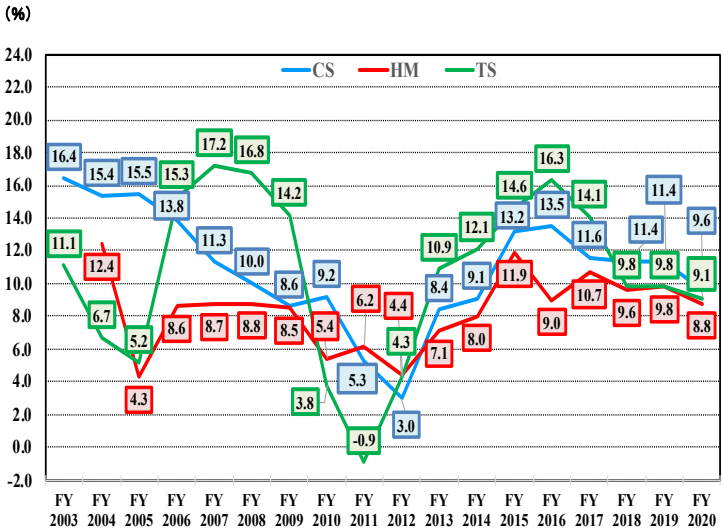
Some of the Company's competitors are HIMACS (TSE First Section: 4299) and Toho System (TSE First Section: 4333), which are similar in size and which the Company uses as its benchmark. They are both e-e Partners of Nomura Research Institute and are similar to the Company in market position and size. Meanwhile, several of the largest SI players such as Nomura Research Institute and Fujitsu are the Company's partners and allies rather than direct competitors.

Comparison of the long-term transition in the operating margin of the three major listed companies including the Company (hereinafter, the Company is abbreviated as CS in the graphs; similarly, HM for HIMACS and TS for Toho System) is shown in Figure 24. Compared to the other two companies, the Company's operating margin is relatively stable and is in no way inferior. A similar comparison of the ratio of net profit for the year to shareholders' equity (ROE) (Figure 25) shows that the Company's ROE has been the highest of the three companies during the past three years. Its ROE has recovered greatly from one point in time, and since FY 2015, it has been around 11-13% for five fiscal years in a row. Last fiscal year, due to a temporary factor (extraordinary loss, etc.), the ROE was 9.6%, which is below the target of greater than 10%. However, this fiscal year, the Company is aiming for 13%.

[Figure 24] Comparison of O.P. Margin for Three Mid-Tier Listed Companies (the Company, HM, and TS)



[Figure 25] Change in ROE for the Three Companies



(Ref) Figures 24 and 25 were prepared by Alpha-Win Research Dept. based on the financial results summary and securities report

[Figure 26] Company Overview and Management Indicator Comparison for Three Mid-Tier Listed Companies (the Company, HM, and TS)

Company Name	CUBE SYSTEM (CS)	HIMACS (HM)	Toho System Science (TS)
Code	2335	4299	4333
Characteristics	Independent. Mainly sys. dev. for finance, distribution, telecom, and other industries (makers & gov. excluding the above 3 industries). Sales for finance are a little less than 30% of total sales. Sharp growth of "other industries" category.	Independent. 70% of sales comes from the finance industry. Sales for insurance companies are espcially high - greater than 40%.	Began as Toho Mutual Life Insurance Co.'s affiliate but is now indep. Specialized in software dev. for finance (insurance, securities, etc.) - greater than 80% of total sales. Also develops software for the telecom industry.
Founded	July 1972	May 1976	June 1971
Listed Date (JASDAQ→TSE 2nd→TSE 1st)	10/2002→11/2006→03/2014	03/2001→03/2004→03/2015	06/2001→03/2007→03/2014
Sales Categories/Breakdown (FY 2020)	▪System Integration 71.0% ▪System Outsourcing 16.3% ▪Professional 12.7%	▪System Solution 47.6% ▪System Maintenance 52.4%	▪Software Development 97.1% ▪IT System Service, etc. 2.9%
Director Composition	▪Directors (7; 3 outside & 1 woman = 14.3%) ▪Auditors (4; all outside) ▪Executive officers (12; no woman)	▪Directors (7; 3 outside) ▪Auditors (4; 2 outside) ▪Executive officers (11; 1 woman = 9.1%)	▪Directors (5; 2 outside) ▪Auditors (4; 2 outside) ▪Executive officers (9; 1 woman = 11.1%)
ajor Clients/Customers (FY 2020) (million yen; % of sal	1. NRI 6,506 (44.2%) 2. Fujitsu 3,135 (21.3%)	1. NRI 6,295 (41.0%) -	1. NRI 3,361 (28.8%) 2. SCSK 1,336 (11.4%)
Sites (including consolidated subsidiaries)	▪Head office: Shinagawa-ku, Tokyo ▪West Japan Solutions Headquarters: Osaka & Nagoya ▪3 subsidiaries	▪Head office: Yokohama, Kanagawa ▪Minatomirai Office: Yokohama ▪1 subsidiary	▪Head office: Bunkyo-ku, Tokyo
Management Goals (indicators)	▪ROE: ≥10% continuously ▪Consolidated O.P. margin: ≥10.0% ▪Consolidated sales per domestic employee: ≥Y30 mil ▪O.P. (same as above): ≥Y2.5 mil	Medium term management plan, final FY: In FY 2023, ▪Sales Y17.75 bil ▪O.P. margin ≥6% ▪ROE ≥8%	Medium-term management plan, final FY: In FY 2023, ▪Sales Y20 bil ▪O.P. Y2 bil ▪O.P. margin ≥10% ▪ROE ≥15%
Management Policy/Strategy (summary)	▪As a key industry necessary for infrastructure supporting economy and society, contribute to further dev. of the IT society and enhancement of the customers' competitiveness ▪Become "a company selected as its customers' best partner" and create "a corporate culture where employees and the company grow together and share happiness and wealth" ▪Business dev. in Japan and overseas ▪Invest in new businesses and tech ▪Strengthen business foundation to promote growth	▪Contribute to the dev. of the IT society by enhancing the customers' competitiveness as their best partner ▪Expand existing contract development biz (core biz) ▪Actively work on receiving orders for DX projects responding to technology innovations and business model transformation ▪Continue investment in structural reinforcement ▪Increase development staff ▪Conduct M&As and create capital/business alliances to solve issues with current plan	▪A company that works together with customers to create and realize values needed by the customers ▪Traditional IT business (maintain & expand SI business) ▪Digital IT business (a challenge) ▪Create-IT business (dev. a service-providing business) ▪Provide new service with "Using Service Infrastructure" (general communication service infrastructure for various purposes) ▪Strengthen business foundation (HR, work satisfaction, internal control)
Sales (million yen) CE for FY 2021	*16,000*	*14,500*	*11,700*
Sales Growth Rate, YoY (%) CE for FY 2021	*8.8*	*-5.5*	*0.1*
Operating Profit (million yen) CE	*1,120*	*758*	*920*
O.P. Growth Rate, YoY (%) CE	*16.8*	*-25.1*	*0.5*
EPS (CE) for FY 2021, YoY (%)	*33.3*	*-26.3*	*0.1*
DOE (%) Actual	4.5	3.1	4.4
Past 10 Years' Sales Growth Rate (FY 2020 result div. by FY 2010 result: %)	68.9	99.4	60.0
O.P. Growth Rate (same condition as above)	50.6	124.4	157.8
Equity Ratio (%) Actual	69.6	78.4	68.7
# of Domestic/Overseas Employees, Actual	737	843	576
Est. Sales Per Employee (million yen / person)	*21.7*	*17.2*	*20.3*
Est. O.P. Per Employee (million yen / person)	*1.5*	*0.9*	*1.6*
ROE (%) Actual for FY 2020 A=B×C×D	9.6	8.8	9.1
N.P. Margin (N.P. for the year / sales : %) B	3.6	4.5	5.4
Total Asset Turnover Ratio (sales / ave. total asset) C	1.8	1.5	1.1
Financial Leverage (ave. total asset / ave. owner's equity) D	1.5	1.3	1.5
ROA (R.P. / total asset : %) E=F×G	12.3	9.9	8.9
R.P. Margin (%) Actual F	6.6	6.6	7.9
Total Asset Turnover Ratio (sales / ave. total asset) G	1.8	1.5	1.1

Italics show each company's estimates/forecasts (CE) for FY 2021. Other values are actual results for FY 2020.

(Ref) Prepared by Alpha-Win Research Dept. based on each company's securities report, financial results briefing, briefing materials, website, interviews, etc.

7. Last Fiscal Year's Results and This Fiscal Year's Forecast by the Company

◆ Full-Year Financial Results for FY 2020 (last fiscal year)

- **Last FY's results were slightly below the initial company forecast and our forecast, but sales grew for the 8th consecutive year and O.P. grew for the 2nd consecutive year.**

Summary

For the consolidated results for FY 2020 (last fiscal year), sales were Y14,708 million (+2.7% YoY), operating profit was Y959 million (+4.1% YoY), recurring profit was Y976 million (+1.7% YoY), and net profit attributable to owners of the parent was Y525 million (-11.9% YoY; hereinafter, "net profit"). Last fiscal year, sales and profits were both below the forecast made at the beginning of the fiscal year as well as the targets for the second year of the medium-term management plan *V2020 3rd STEP* (FY 2019-2021), but the results were generally solid with increased sales and operating profit. However, due to an extraordinary loss, net profit decreased for the first time in three fiscal years.

- **Hitting record-high sales consecutively. Profits also came close to record highs.**

Sales have been increasing for eight years in a row since FY 2013 and a record high was achieved. In addition, for profit, although the growth rate had slowed down, a consecutive growth was achieved, and operating profit and recurring profit came close to their record highs. Compared to the Company's rather ambitious initial plan, sales were 5.1% lower, operating profit was 12.0% lower, and net profit was 23.2% lower (Figure 27).

- **However, results were below the company forecast and our forecast. With a slowdown in the orders received, there was only a small sales growth, and with the posting of an extraordinary loss, net profit decreased.**

In our previous report (February 3, 2020), we had forecasted sales of Y15,200 million for last fiscal year, which was a somewhat cautious forecast compared to the Company's forecast (Y15,500 million). However, the actual results fell below our forecast, and similar results were seen for each of the profits too. The main factors that caused this downward revision in operating profit are (1) sales only increasing by a small amount due to a slowdown in the orders received and (2) less-than-expected improvement in operating margin. We had expected the operating margin to improve by 0.6 points from 6.4% in FY 2019 to 7.0% in FY 2020 (the Company's estimate was also 7.0%). However, due to the rise in various costs and an unexpected occurrence of unprofitable projects, it improved only by 0.1 point to 6.5%. In addition, an extraordinary loss of approx. Y93 million was posted due to the loss on revaluation of securities concerning a strategic stock investment in a private company. This caused a double-digit downward revision of net profit and an overall decline in net profit.

- **Both the amount of orders received and the order backlog have stayed about the same.**

Orders Received and Order Backlog

The amount of orders received during the fiscal year also did not grow as well as it had been hoped, decreasing from the fiscal year before the previous → last fiscal year by Y8 million (0.1%) from Y14,750 million → Y14,741 million. The order backlog (at the end of each fiscal year) also stayed mostly about the same, having increased by Y33 million (0.8%) from Y3,996 million → Y4,029 million in the same order as above.

[Figure 27] Comparison of Initial Forecast and Actual Result for FY 2020 (last FY)

(Ref) Prepared by Alpha-Win Research Dept. based on the financial results summary

Unit:: million yen	Company Plan at Beginning of FY (Initial)	Alpha-Win's Previous Forecast	Result	Diff. from Company Plan	% of Initial Company Plan Achieved
Sales	15,500	15,200	14,708	-792	94.9%
Gross Profit		2,610	2,503		
Gross Margin		17.2%	17.0%		
SG&A Expenses		1,540	1,544		
SG&A Expenses Ratio		10.1%	10.5%		
Operating Profit	1,090	1,070	959	-131	88.0%
O.P. Margin	7.0%	7.0%	6.5%	-0.5pt	
Recurring Profit	1,090	1,080	976	-114	89.6%
Net Profit	684	680	525	-159	76.8%

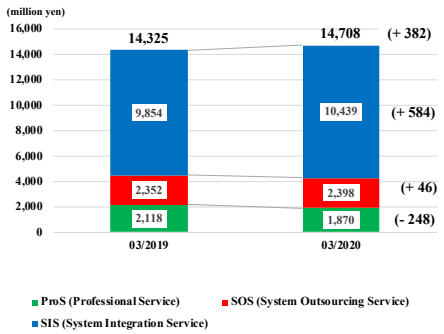
- **SIS and SOS's sales grew, offsetting decreased sales in ProS. The overall gross margin stayed about the same.**

Sales and Profit by Service Category

The Company's overall increase in sales compared to FY 2019 was Y383 million. By service category, the two categories of SIS (+Y585 million) and SOS (+Y46 million) grew, and ProS (-Y248 million) decreased (Figure 28). For gross profit, only SI's increased by Y157 million (Figure 29).

In terms of gross margin by service category, the SIS's gross margin improved by 0.6 point from 16.0%→16.6%. On the other hand, SOS's deteriorated from 17.7%→16.7% and ProS's worsened from 21.4%→19.6%. Since SIS's sales account for about 70% of total sales, the overall gross margin fell only slightly from 17.1%→17.0%. However, thanks to the sales growth, gross profit increased by Y55 million (2.2%) from Y2,448 million → Y2,503 million.

[Figure 28] Contribution of Each Service Category to Sales in FY 2020 (last fiscal year)



[Figure 29] Contribution of Each Service Category to Gross Profit in FY 2020 (last fiscal year)

		FY 2019	FY 2020	Diff.	% Diff.
Gross Profit (unit: million yen)	Total	2,448	2,503	55	2.2%
	SIS	1,577	1,734	157	10.0%
	SOS	417	401	-16	-3.8%
	ProS	453	366	-87	-19.2%
Gross Margin (unit: %)	Total	17.1%	17.0%	-0.1%	
	SIS	16.0%	16.6%	0.6%	
	SOS	17.7%	16.7%	-1.0%	
	ProS	21.4%	19.6%	-1.8%	

(Ref) Figures 28 and 29 were prepared by Alpha-Win Research Dept. based on the financial results supplemental reference materials

- **By industry, business toward the finance industry recovered and contributed to sales and profit growth.**

Sales and Profit by Industry

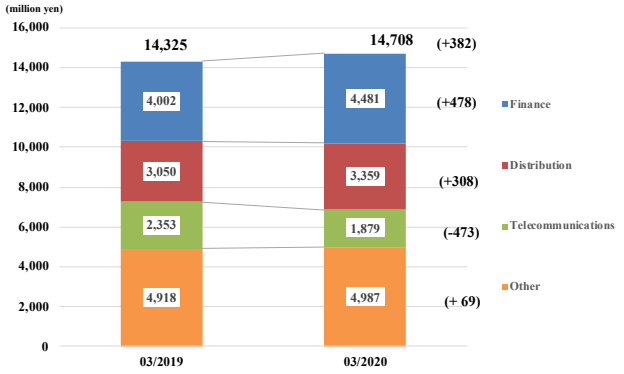
・Similarly, by industry, of the total sales growth of Y383 million (compared to FY 2019), finance increased by Y478 million (+12.0%), distribution increased by Y308 million (+10.1%), and the "other" industries increased by Y69 million (+1.4%), offsetting the decline in telecommunications by Y473 million (-20.1%). In the finance industry, the Company's business grew from system development projects for credit card companies, internet insurance companies, and banks related to the development of cashless payment and new services. In the distribution industry, projects increased from the need to respond to the reduced consumption tax rate system. In the "other" industries category, although the completion of projects with construction machinery manufacturers and the government caused some decline, this was offset by the increase in system development projects with paper processing companies and education business companies. On the other hand, due to the completion of projects with telecom carriers, sales of telecommunications significantly decreased (Figure 30 on page 30).

・Gross profit increased in finance and telecommunications by Y187 million and Y6 million, respectively, offsetting the decrease of Y100 million in telecommunications and Y39 million in the "other" industries category.

・Comparing actual sales for each industry with the initial forecast, of the net downward revision in sales by Y792 million, finance exceeded its target by Y164 million, distribution was Y629 million below its target, and telecommunications was Y297 million lower. This is because the Company had made it its priority to deal with the unprofitable projects and could not receive orders for some DX projects as it had hoped (Figure 31 on page 30).

・Regarding gross margin by industry, aside from finance whose gross margin increased by 2.4% YoY, the remaining three industries' margins decreased. Last fiscal year (FY 2020), finance had a large positive effect on both sales and gross profit (Figure 12 on page 12).

[Figure 30] Contribution of Each Industry to Sales in FY 2020 (last fiscal year)



[Figure 31] Difference in Sales of Each Industry in FY 2020 (last fiscal year)

	FY 2020			
	Result	Initial Forecast	Diff: million yen	Diff: %
Finance	4,481	4,317	164	3.8%
Distribution	3,359	3,988	-629	-15.8%
Telecommunications	1,879	2,176	-297	-13.6%
Other	4,987	5,017	-30	-0.6%
Total	14,706	15,498	-792	-5.1%

(Ref) Figures 30 and 31 were prepared by Alpha-Win Research Dept. based on the financial results briefing materials

- **Sales growth absorbed the increase in labor cost and decline in profitability of some of the projects, resulting in an operating profit growth.**

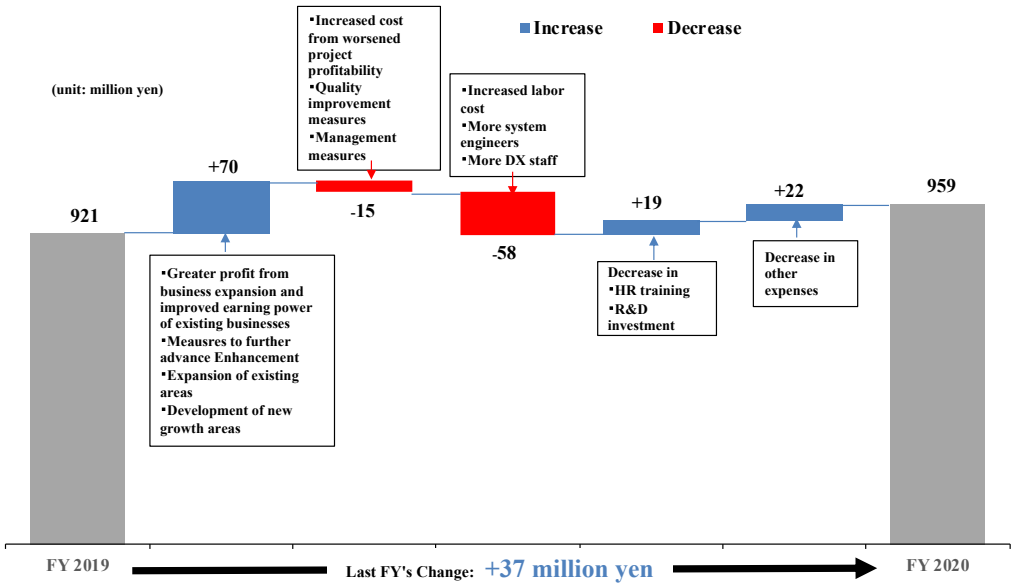
- **SG&A expenses ratio slightly improved with cost control.**

Analysis of Factors Contributing to Increase/Decrease in Operating Profit

Figure 32 shows an analysis of the factors that caused an increase or decrease in the overall operating profit. A large growth of Y70 million was caused by the expansion of the Enhancement business mainly for finance and the improvement of earning power, and with the decrease in R&D expenses and other expenses, these accumulated to a total profit growth of Y111 million. On the other hand, labor costs increased due to the heavy cost burden of increasing SEs and DX-related staff, causing a Y58 million decrease in profit. Also, although the decline in profitability due to unprofitable projects was partially alleviated during the fiscal year, it still caused a Y15 million decrease in profit. In sum, operating profit increased by Y37 million.

Since SG&A expenses increased only by 1.1% YoY, which is less than half of the sales growth rate of 2.7%, the SG&A expenses ratio improved by about 0.2 point from 10.7% in the fiscal year before the previous to 10.5% in the previous fiscal year. As a result, the decline in gross margin by about 0.1 point was offset and the operating margin rose slightly from 6.4% to 6.5%. Combined with the increase in sales, operating profit increased by 4.1%.

[Figure 32] Reasons for Increased Profit in FY 2020 (last fiscal year) (unit: million yen)



(Ref) Prepared by Alpha-Win Research Dept. based on the financial results summary

- **This FY, planning for consecutive sales/profit growth and record-high sales/profit. Fifth challenge at achieving Y1 billion each in operating and recurring profit.**

[Figure 33] Forecast for FY 2021 (this FY)

Unit: million yen	Full-Year Forecast (FY 2021)	% YoY Change
Sales	16,000	8.8%
Gross Profit	Not disclosed	
Gross Margin		
SG&A Expenses		
SG&A Exp. Ratio		
Operating Profit	1,120	16.8%
O.P. Margin	7.0%	Improved 0.5pt
Recurring Profit	1,120	14.7%
Net Profit	700	33.3%

(Ref) Prepared by Alpha-Win Research Dept.

◆ CUBE SYSTEM's Financial Forecast for FY 2021 (this fiscal year)

Summary

For this fiscal year, the Company is expecting sales of Y16,000 million (+8.8% YoY), operating profit of Y1,120 million (+16.8% YoY), recurring profit of Y1,120 million yen (+14.7% YoY), and net profit of Y700 million (+33.3% YoY). It plans to achieve a consecutive record high for sales and record highs for each of the profits (operating, recurring, and net) (Figure 33). For operating and recurring profit, it aims to achieve Y1 billion for each for the first time (this would be the Company's fifth challenge of this goal).

Impact of COVID-19

Regarding the impact of COVID-19 on the financial results, the Company commented as follows in the financial results summary: "Regarding the impact of COVID-19 on our group, we expect there to be postponement of new development projects by our corporate customers and an impact on our sales activities such as fewer negotiation opportunities. However, we are seeing a trend toward actively incorporating ITC in order to keep the society moving and overcome this situation. We made calculations (of forecast figures) based on the assumption that the COVID-19 crisis will settle down and economic and social activities will gradually recover. Depending on the situation with the COVID-19 crisis, our financial forecast may be changed." The Company did not disclose the financial forecast for the first half of FY 2021 because the impact of COVID-19 is difficult to predict. However, it will most likely announce the H1 forecast at the same time as the announcement of Q1 results.

Assumptions behind Sales Growth

Overall, the Company plans to make use of its strengths to increase sales through the following measures.

1. Expand existing business areas (Enhancement business) through strengthened sales efforts toward the major accounts (clients)
2. Strengthened sales efforts toward its clients' strategic IT investment projects (develop new markets, channels, and areas → incorporate new technologies, Chubu region, energy business, industrial sectors, etc.)
3. Development of new DX businesses and creation of new services

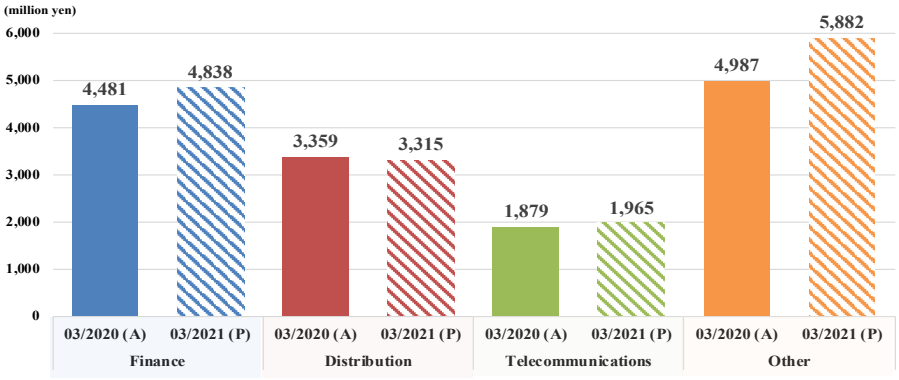
- **By industry, sales for "other" industries and finance are expected to make a large contribution. Telecommunications will bottom out.**

・By industry, the Company expects to see a slight sales decrease for the distribution industry by Y44 million YoY (-1.3% YoY) due to the completion of consumption-tax-related projects. On the other hand, in the "other" industries category, it anticipates a large sales growth of Y894 million YoY (+17.9%) since strategic investment is expected mainly among manufacturers, which will bring opportunities for acquiring and expanding DX/AI-related projects and help develop proposal-based businesses. This growth is equivalent to 70% of the total expected sales growth of Y1,239 million (Figure 34 on page 32).

・Sales for the finance industry are expected to increase by Y356 million (+8.0%, which is 30% of the total sales growth), growing consecutively, due to increased market share in the cashless payment and Internet banking businesses and from acquiring and enlarging projects related to credit card and direct life insurance. In the telecommunications industry, projects for telecom carriers have been completed, and a slight increase in sales (Y85 million; +4.5%) is expected due to increased demand and new services.

- **Planning to further improve margins**

[Figure 34] Predicted Contributions to Sales in FY 2021 (this fiscal year) by Industry (the Company's plan)



(Ref) Prepared by Alpha-Win Research Dept. based on the financial results briefing material. A = actual value. P = planned value.

- **Planning to improve operating margin by 0.5% through improvement of gross margin and SG&A expenses ratio**

Assumptions behind Profit Growth

Both gross profit margin and SG&A expenses ratio are expected to improve during this fiscal year. Operating margin is projected to rise by 0.5 point YoY to 7.0%. Due to these factors and the growth in sales, the Company anticipates a double-digit growth in profit (as reference: operating margin was 6.1% in FY 2017 → 6.3% in FY 2018 → 6.4% in FY 2019 → 6.5% in FY 2020). Operating profit forecast by service category or industry has not been disclosed. The Company expects the following factors to contribute to an increase in profit.

- **Will improve productivity and shift to high added-value businesses to raise its earning power**

1. Improved earning power from enhanced efficiency and added-value of the Enhancement service for its existing businesses
2. Company-wide functions, per-project quality management, and preventive measures against unprofitable projects
3. Providing high added-value services (DX projects and proposal-based business)
4. Sales growth, strengthened cost control, improved productivity, and the shift from contracts based on the number of staff and months to service-providing business model (expanding consulting business, switching contracts to service-based payment, etc.)
5. Improved earning power through sped-up development and adoption of a development model that involves cooperation with overseas partners.

- **No extraordinary loss expected this FY**

This fiscal year, no nonoperating profit/loss (net sum of zero) or extraordinary profit/loss is expected in particular (estimated corporate tax rate: 37.5%).

8. Growth Strategy

◆ Medium- to Long-Term Management Vision *VISION 2020*

- **Declared to expand its service lineup in the current medium-term management plan. This FY is the final year of V2020.**

The Company has established *VISION 2020*, a medium- to long-term management vision for 2012 to 2020. Its target span is divided into three strategy steps. The Company is currently in the final year of the 3rd STEP (the three years from FY 2019 to FY 2021).

The goal of the 3rd STEP is to "maximize customer value by contributing to the growth of the customers' businesses through the expansion of service-providing and SI businesses, creation of a new service lineup, and development of the service business" and the Company has been developing its business in line with this goal (Figure 35).

- **In the organizational reform, specialized departments were established for the areas of focus.**

In order to accelerate business development toward the achievement of its goals and strengthen its business foundation, in February 2020 the Company executed organizational changes. It established the DX Promotion Office and the Overseas Business Management Office under direct supervision of the President. It also established the Cloud Computing Solution Division and the Center for Future Human Resources Development (improvement of HR value) and created a General Administration Office (profitability management) under each division. Through these changes, the Company has created a system for allocating its resources to the areas of growth.

[Figure 35] Summary of the Medium- to Long-Term Management Vision *VISION 2020*: Contents of the 3rd STEP

(Ref) Prepared by Alpha-Win Research Dept. based on the financial results briefing material

◆ Management Indicator Targets and Areas of Focus

- **4 management indicator targets**

The following are the CUBE SYSTEM Group's long-term management indicator targets. Currently, they have not been achieved but are beginning to improve. The Company plans to improve its productivity and profitability by streamlining its operation and reinforcing training/education.

- ROE: greater than or equal to 10% (FY 2018 → FY 2019 → FY 2020: 11.4% → 11.4% → 9.6%. The same order for below.)
- Consolidated operating margin: greater than or equal to 10% (6.3% → 6.4% → 6.5%)
- Consolidated sales per employee in Japan (excludes employees of overseas subsidiaries): greater than or equal to Y25 million (Y22.2 million → Y22.8 million → Y22.6 million; progress rate of 88.8% → 91.2% → 90.4%)
- Consolidated operating profit for the same condition as above: Y2.5 million

- **Announced a new forecast for this FY, the final year of the current medium-term plan, apart from the one set forth in the plan**

- **Targets have not been achieved, but developing business toward future growth.**

(Y1.40 million → Y1.47 million → Y1.47 million; progress rate of 55.9% → 58.8% → 58.8%)

The Company had disclosed a medium-term financial forecast up through FY 2021, but in taking into account last fiscal year's results and the current situation, it announced a new forecast for this fiscal year (Figure 36).

Progress with V2020 is shown in Figure 37. Targets have generally not been achieved yet, but there has been a certain level of achievement as the Company has been growing sales and profit (operating profit) through the execution of measures toward future growth in line with its plan.

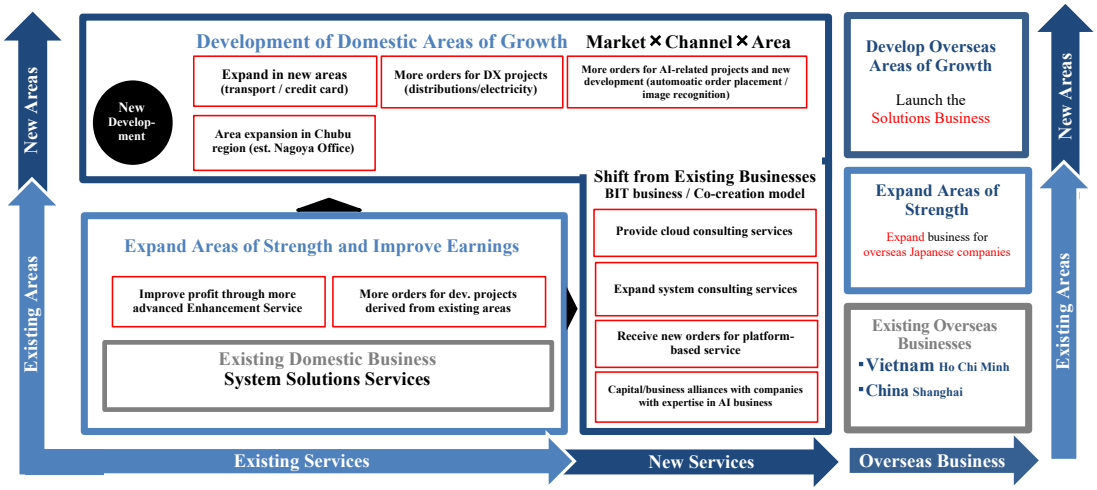
[Figure 36] The Company's Medium-Term Plan, Actual Results, and Forecast

	FY 2019			FY 2020			FY 2021		
Unit: million yen, %	Medium-Term Plan	Initial Company Plan	Difference	Medium-Term Plan	Initial Company Plan	Difference	Medium-Term Plan	Initial Company Plan	Difference
Sales	14,700	14,700	14,325	16,300	15,500	14,708	18,500	16,000	-2,500
Growth Rate	8.4%	8.4%	5.6%	10.9%	8.2%	2.7%	13.5%	8.8%	-4.7%
Operating Profit	1,010	1,010	921	1,323	1,090	959	1,776	1,120	-656
O.P. Margin	6.9%	6.9%	6.4%	8.1%	7.0%	6.5%	9.6%	7.0%	-2.6%
ROE	12.1%	-	11.4%	13.0%	-	9.6%	13.0%	-	

(Ref) Prepared by Alpha-Win Research Dept. based financial results briefing material

[Figure 37] Progress with the Medium-Term Plan

Topics for 2019



(Ref) Prepared by Alpha-Win Research Dept. based financial results briefing material

◆ Medium- to Long-Term Management Vision *VISION 2026*

- **The new president announced the next medium-term plan V2026. Plans to actively develop the proposal-based business based in additional to its conventional businesses.**

The new president Nakanishi annouced the general direction of *VISION 2026*, a new vision succeeding *VISION 2020* for the six years from FY 2022 to FY 2027 (Figure 38 on page 35). With the impact of COVID-19, themes and workstyles are expected to change as the society makes a transition to the new normal. To proactively and flexibly respond to these changes, the Company has set the following two points as its guidelines.

・The employees themselves will have a vision and a business-oriented mindset, thinking and acting for themselves.
・Achieve business growth through the proposal-based business (a business

model where solutions developed based on the Company's technologies and expertise in its customers' industries are proposed to its customers/industries and the corresponding services are provided) and the contract-based business (a business model where the Company conducts contract development of information systems as requested by its customers).

For the achievement of the above, the Company has declared to work on the sophisticatation of its core technologies (software engineering) and contribute to society through software engineering. Each employee will aim to contribute to society through business and improve corporate value.

- **Four priority measures: develop the DX business, improve quality and HR value, and improve governance.**

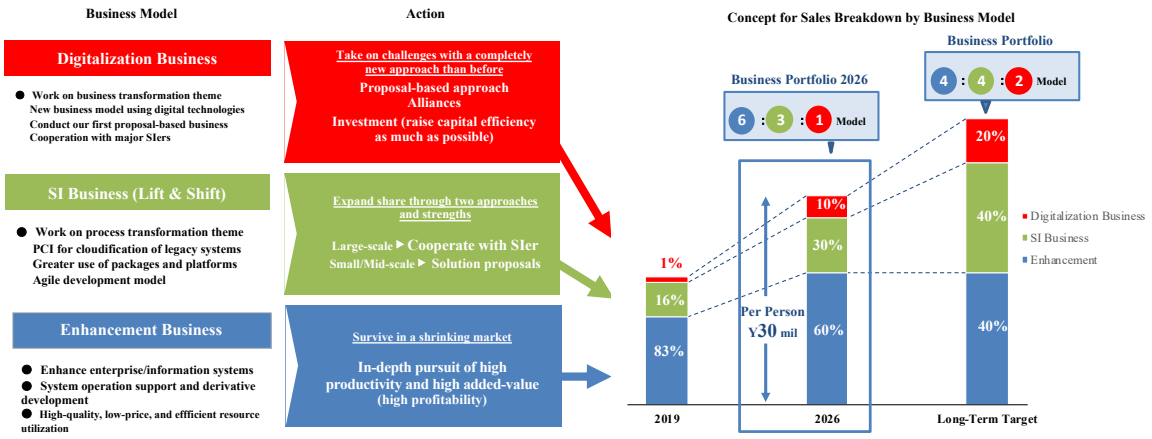
The general direction of business is to aim at actively making proposals and creating new businesses by shifting from the conventional contract-based business to the proposal & contract based business; to create a stable and sustainable business foundation; and to especially make investments in the SI and digitalization businesses with the Enhancement business as their basis. To achieve these goals, four priority measure have been set:

1. Develop the DX business (develop the proposal-based business, IP technology and platform businesses, and system consulting business)
2. Work on improving quality (thorough review of each process through system development meetings and strengthened monitoring)
3. Raise HR value (established the Future Human Resources Development Center aimed at raising HR value)
4. Improve governance system (faster decision-making with renewed management meetings; strengthened reporting system for management risks such as those related to business strategy and HR strategy; create new sytem development meetings and HR development meetings; conduct sustainability management; and improve corporate governance to prepare itself for a structural transformation of the market)

- **Will focus on the SI business and digitalization business based on the Enhancement business over the medium to long term**

Categories composing the business model was changed from V2020 and the business model is now divided into the three categories of Enhancement, SI, and Digitalization. The Company intends to expand the SI (especially cloudification projects) and Digitalization businesses based on Enhancement and thus attain growth. As shown in Figure 38, the ratios of the sales of each category in the order of Enhancement to SI to Digitalization are planned to be improved from the current (FY 2020) 83%, 16%, and 1% to 60%, 30%, and 10% in FY 2027 through investment and various measures and to 40%, 40%, and 20% over the long term (from now to about 12 years into the future).

[Figure 38] Direction of the Next Medium-Term Plan (V2026)



(Ref) Prepared by Alpha-Win Research Dept. based financial results briefing material

◆ Alpha-Win Research Dept.'s Financial Forecast for FY 2021 (this fiscal year)

- **Alpha-Win Research Dept. reviewed the previous forecast and made revisions to the financial forecast for this FY onward.**

Summary of Revision to the Financial Forecast

We reviewed our financial forecast for the current and the next fiscal year and newly added a forecast for FY 2023 (Figure 39). We had previously predicted sales to be Y16,500 mllion for the current fiscal year, but revised this to Y15,300 million in our new forecast (the Company's forecast for the current fiscal year: Y16,000 million).

Consequently, we also revised our previous forecast for profit and somewhat cautiously predicted that operating profit will be Y1,050 million (the Company's forecast for the current fiscal year is Y1,120 million; our previous forecast is Y1,200 million). In this revision, we made cautious predictions that take into account the risks of COVID-19 such as stopped negotiations with corporate users, stalled sales activities, financial downturn of corporate users, weaker busines environment (see "Currnet Business Environment" on the next page), and short-term uncertatinties in IT investment trends.

Also, for the SI industry in general, business must basically be conducted on-site, so the Company's productivity is expected to decline in remote work. In addition, since various costs such as personnel costs and logistics costs have been remaining high, we revised the effect of improved gross margin and the SG&A expenses ratio based on a somewhat more cautious analysis. However, our estimate for operating margin is nearly the same as the 7.0% forecasted by the Company (previously, we had predicted 7.3%).

[Figure 39] Alpha-Win's Forecast on Financial Results for This Fiscal Year and Over the Medium Term

Unit: million yen, %	FY 2020 A	FY 2021 CE	FY 2021 New E	FY 2022 New E	FY 2023 New E	*FY 2021 Old E*	*FY 2022 Old E*
Sales	14,708	16,000	15,300	16,300	17,200	*16,500*	*17,800*
Gross Profit	2,503		2,600	2,780	2,950	*2,825*	*3,060*
Gross Margin	17.0%		17.0%	*17.1%*	*17.2%*	*17.1%*	*17.2%*
SG&A Expenses	1,544		1,550	1,650	1,750	*1,625*	*1,740*
(% over sales)	10.5%		10.1%	10.1%	10.2%	*9.8%*	*9.8%*
Operating Profit	959	1,120	1,050	1,130	1,200	*1,200*	*1,320*
(% over sales)	6.5%	7.0%	6.9%	6.9%	7.0%	*7.3%*	*7.4%*
Recurring Profit	976	1,120	1,050	1,130	1,200	*1,200*	*1,320*
(% over sales)	6.6%	7.0%	6.9%	6.9%	7.0%	*7.3%*	*7.4%*
Net Profit	525	700	655	705	750	*750*	*825*
(% over sales)	3.6%	4.4%	4.3%	4.3%	4.4%	*4.5%*	*4.6%*
Sales (% YOY growth)	2.7%	8.8%	4.0%	6.5%	5.5%	*12.2%*	*7.9%*
Gross Margin (% YOY diff.)	-0.1%		*0.0%*	*0.1%*	*0.1%*	*0.1%*	*0.1%*
SG&A Expense (% YoY growth)	1.1%		0.4%	6.5%	6.1%	*5.2%*	*7.1%*
Operating Profit (% YoY growth)	4.1%	16.8%	9.5%	7.6%	6.2%	*25.1%*	*10.0%*
Recurring Profit (% YoY growth)	1.7%	14.7%	7.6%	7.6%	6.2%	*22.9%*	*10.0%*
Net Profit (% YoY growth)	-11.9%	33.3%	24.7%	7.6%	6.4%	*42.8%*	*10.0%*

(Ref) Prepared by Alpha-Win Research Dept. based on the securities report
(Note) CE = the Company's estimate/forecast; E = Alpha-Win Res. Dept.'s estimate/forecast; A = Actual.

Q1 Situation

Normally, it takes at least three months from conducting sales activities for system development projects to actually receiving orders. COVID-19 has likely caused sales activities from March to June to become stalled, although this is not limited to the Company alone. However, in Q1 (April-June), since the effect of self-restraint and travel restrictions will help suppress costs in some ways, and since the proportion of Q1 in the full-year results is small, the impact on financial results should be limited.

- **Macroeconomic environment is somewhat uncertain due to COVID-19. Should watch the trend in the orders received.**

- **Predicting that sales growth, profit growth, and record high sales/profit are possible this FY**

- **In the past, a generally small deviation between the initial forecast and actual result on average over the long term, but a tendency to announce somewhat ambitious forecasts**

Full-Year Forecast

The order backlog at the end of March 2020 was Y4,029 million, which was a 0.8% YoY increase. In general, this fiscal year's results have been predicted based on the orders received and sales posted during the fiscal year. Even if we assume that the effects of COVID-19 will settle down in the next few months, it is expected that there will be a greater weight placed on the second half, also causing personnel-related restrictions. In any case, regarding the full-year results for the current fiscal year, we must analyze the quarterly number of orders received and order backlog, as well as the Q4 results which account for a high proportion of the total, more carefully than usual.

If COVID-19, which is presumably the largest risk factor, does not become prolonged, we believe that there is unlikely to be a significant downward deviation in actual results from the Company's initial forecast. Economic activities are gradually returning to normal, so even if there is some time lag, we believe that the Company may be able to increase its sales and profits and achieve record-high sales and profits if recovery in Q2 and later goes well.

Track Record of Financial Forecast and Results

Figure 40 shows an analysis of the discrepancy between the Company's initial forecast and actual results over the long term in the past. During this period, on a simple average, actual sales were 1.5% lower than the initial forecast, and the actual operating profit and recurring profit were 6% and 4.5% lower, respectively. However, neither profits have ever been more than 30% lower than the forecast in any fiscal year. The Company has generally tended to announce targets that are ambitious but within a realistically achievable range.

[Figure 40] Comparison of (the Company's) Initial Forecast for Consolidated Financial Results with the Actual Results in Chronological Order

Consolidated	Sales		Operating Profit		Recurring Profit		Net Profit Attributable to Owners of the Parent (N.P.)		Sales	O.P.	R.P.	N.P.	Sales	O.P.	R.P.	N.P.
Unit: million yen	*Initial Forecast*	Actual	*Initial Forecast*	Actual	*Initial Forecast*	Actual	*Initial Forecast*	Actual	% Diff. from Initial Forecast				% YoY Change for Actual Result			
FY 2001	-	4,806	-	-	-	387	-	-	-	-	-	-	-	-	-	-
FY 2002	-	5,598	-	485	-	445	-	246	-	-	-	-	16.5%	-	15.0%	-
FY 2003	-	6,244	-	510	-	432	-	235	-	-	-	-	11.5%	5.2%	-2.9%	-4.4%
FY 2004	*6,900*	6,575	-	491	*522*	500	*284*	280	-4.7%	-	-4.3%	-1.5%	5.3%	-3.7%	15.7%	18.9%
FY 2005	*7,000*	7,100	-	558	*532*	551	*287*	315	1.4%	-	3.5%	9.7%	8.0%	13.6%	10.2%	12.5%
FY 2006	*7,800*	7,767	-	549	*600*	551	*340*	312	-0.4%	-	-8.2%	-8.3%	9.4%	-1.6%	0.0%	-1.0%
FY 2007	*8,300*	7,923	-	590	*570*	584	*330*	324	-4.5%	-	2.4%	-1.8%	2.0%	7.4%	5.9%	3.9%
FY 2008	*8,300*	8,109	*605*	645	*610*	643	*336*	342	-2.3%	6.6%	5.4%	1.9%	2.3%	9.4%	10.2%	5.7%
FY 2009	*8,500*	8,507	*680*	652	*685*	597	*350*	308	0.1%	-4.1%	-12.8%	-12.1%	4.9%	1.1%	-7.1%	-10.1%
FY 2010	*8,800*	8,706	*660*	637	*670*	660	*350*	349	-1.1%	-3.5%	-1.5%	-0.3%	2.3%	-2.3%	10.6%	13.4%
FY 2011	*9,200*	9,166	*675*	662	*680*	672	*263*	208	-0.4%	-1.9%	-1.2%	-20.9%	5.3%	4.0%	1.8%	-40.4%
FY 2012	*9,300*	8,431	*665*	524	*675*	533	*350*	118	-9.3%	-21.2%	-21.0%	-66.4%	-8.0%	-20.9%	-20.7%	-43.4%
FY 2013	*9,000*	9,242	*620*	601	*630*	606	*350*	338	2.7%	-3.1%	-3.8%	-3.5%	9.6%	14.8%	13.7%	186.7%
FY 2014	*10,000*	11,217	*700*	665	*700*	702	*380*	387	12.2%	-5.0%	0.3%	1.7%	21.4%	10.6%	15.8%	14.5%
FY 2015	*12,000*	12,527	*840*	964	*840*	981	*480*	594	4.4%	14.8%	16.7%	23.8%	11.7%	45.0%	39.7%	53.7%
FY 2016	*13,000*	12,623	*1,000*	949	*1,020*	960	*600*	629	-2.9%	-5.1%	-5.9%	4.8%	0.8%	-1.6%	-2.1%	5.9%
FY 2017	*14,000*	12,899	*920*	781	*940*	811	*450*	551	-7.9%	-15.1%	-13.7%	22.4%	2.2%	-17.7%	-15.5%	-12.4%
FY 2018	*14,300*	13,559	*1,060*	855	*1,080*	893	*650*	567	-5.2%	-19.3%	-17.3%	-12.8%	5.1%	9.5%	10.1%	2.9%
FY 2019	*14,700*	14,325	*1,010*	922	*1,010*	960	*640*	597	-2.5%	-8.8%	-5.0%	-6.8%	5.7%	7.8%	7.5%	5.2%
FY 2020	*15,500*	14,708	*1,090*	959	*1,090*	976	*684*	525	-5.1%	-12.0%	-10.5%	-23.2%	2.7%	4.1%	1.7%	-12.0%
FY 2021 E	*16,000*		*1,120*		*1,120*		*700*									
Simple average of diff. (unit: %), calc. for longest period with data on both sales and profits→									-1.5%	-6.0%	-4.5%	-5.5%	6.2%	4.7%	5.8%	11.1%
Green highlight: record-high value			Number of times revised up:down from initial forecast →						5:12	2:11	5:12	6:11	↑ Simple average for each FY			

(Ref) Prepared by Alpha-Win Research Dept. based on the financial results summary

Current Business Environment (various data from the BOJ Tankan, Ministry of Economy, Trade, and Industry, and industry groups)

According to the BOJ Tankan Survey in March 2020, the amount of software investment in FY 2020 (planned) for small- to medium-sized companies in all industries is expected to decrease by 1.8% YoY (of which manufacturing will decrease by 5.0% and non-manufacturing will decrease by 0.4%). In

◆ **Currently worsening market environment**

addition, business sentiment of small- to medium-sized companies decreased from +1 in the December 2019 survey ("recent") to -7 in March 2020, and "outlook" also decreased from -4 to -23; the market environment has been worsening over the short term.

In addition, according to the Survey of Selected Service Industries (finalized in April 2020) by the Ministry of Economy, Trade, and Industry, although the system integration sales of make-to-order software had turned positive in September 2018 based on a year-on-year comparison (%), it became negative in March 2020 to -0.9 for the first time in 19 months and then hit another negative consecutively in April, at -1.2.

Similarly, according to the JISA-DI Survey by the Japan Information Technology Services Industry Association (FY 2020 ending in March 2020), the expected DI (sales outlook) for the sales of make-to-order software suddenly changed from positive to negative, from +45.3 in Jan-Mar 2020 to -46.2 in April-June 2020, the largest drop ever. Even by major customer group, the DI was negative for all industries including manufacturing, government, finance, and insurance. Although the employment situation index dropped from 77.6 to 59.6, there is a strong sense of employee shortage. In particular, there is a shortage of IT engineers both in number and quality, and system development staff continues to be difficult to secure.

All of these current data indicate that COVID-19 seems to be creating a difficult situation with regards to the current financial performance and short-term outlook.

◆ Alpha-Win Research Dept.'s Financial Forecast for the Medium Term

We revised our previous medium-term forecast and made a forecast for the three fiscal years through FY 2023 (Figure 39 shown previously on page 36).

◆ **Revised our medium-term financial forecast based on changes in the macroeconomic environment and risk factors**

Taking into consideration the following risk factors, we made a somewhat cautious forecast for the medium term too.

・Regarding the macroeconomic environment, the impact of the US-China trade war and COVID-19 will likely remain to some extent over the medium to long term. Other points of concern are the uncertainties in the global and domestic economy, the economic downturn after the Tokyo Olympics in July to August of 2021, and worsening of the financial performance of companies.

・At this point, it is hard to predict what will happen to the Company's main final users' industry trends and IT investment trends, the cost increase rate, recruitment, etc..

However, we have not changed our forecast that sales and profits will continue to increase by about 6-10% per year over the medium to long term for the following reasons.

◆ **Expecting annual sales and profit growth rate of 6-10% over the medium term**

<u>Factors and Assumptions in Predicting Increased Sales</u>

・Development of the Enhancement business and businesses for its major customers based on the technological expertise and trust that the Company has built up over the years

・Strengthening and development of the capacity to receive orders for large-scale projects

・Acquisition of new customers (acquire customers in the "other" industries such as manufacturers)

・Development of new businesses and new business areas – specifically, DX-related, energy-related, consulting, and new solutions (cloud, blockchain, etc.) businesses
・Overseas development (mainly toward overseas Japanese companies)
・However, sales increase from large-scale M&As, etc., is not expected

Factors and Assumptions in Predicting Increased Profit

・The gross margin is expected to gradually improve due to various measures (transition to service-based contracts, improved productivity, reviewing subcontracting cost, etc.), although at a slower pace than initially expected.
・Rise in profit from the new businesses is not expected to largely contribute to results for the time being.
・Next fiscal year onward, a somewhat high estimate was set for the rate of increase in SG&A expenses – about 6% per year, which is about the same as the sales growth rate. This takes into account the reinforcement of business foundation for future growth (expansion of HR, organization, and sites), the rise in costs (personnel expense, subcontracting cost, etc.), and continued upfront investment in new technology and business research.
・Consequently, the operating margin is estimated to improve by about 0.1 point per year starting this fiscal year.
・No expectation for extraordinary profit or loss

9. Analyst's View

◆ SWOT Analysis

The Company's SWOT analysis result is shown in Figure 41.

[Figure 41] SWOT Analysis

Strength	・Long history in the industry and extensive experience ・Stable and excellent customer base ・Technological expertise / unique know-how / staff with expertise / organization (business type / project management) ・Entry barrier essentially high; business with high continuity ・Firm financial standing ・Consulting-based sales through direct sales activity; Enhancement ・Low-cost development system using overseas subsidiaries
Weakness	・Relies heavily on certain customers ・Needs to secure and acquire more talented personnel ・Industry structure where profit margin is hard to improve ・Takes a long time for next-generation, growth-strategy products and services to gain momentum ・Project management (risk of occurrence of unprofitable projects) ・Specialized in domestic demands; overseas development difficult
Opportunity	・Increased demand for IT systems due to HR deficit and the need to streamline operation ・New products, new services, and technology innovations leading to increased strategic demand for systems ・Shfiting to upstream processes, niche areas, large-scale dev. projects, direct-contract projects; reinforce Enhancement business ・Business expansion following the global entry of customers ・Strengthening alliances
Threat	・Lost business chance due to COVID-19 prolongation ・Reduced IT investment, less demand for updates, and intensified price competition during recession ・Emergence of alternatives (popularization of AI or packaged business software), delayed product development, and product defects ・Risk of loss due to project management ・Information management and leakage risks ・Increased personnel expense and subcontracting cost

(Ref) Prepared by Alpha-Win Research Dept.

- **Many years' worth of trust, track record, and technological expertise are its strengths. Growth potential is large since Japanese companies are expected to increase IT investments.**
- **Acquisition of talented employees is the bottleneck to further growth.**
- **Challenges: improving margins, strengthening project management, and acquiring new major corporate groups as its customers**

Describing the strengths listed in Figure 41 in more detail, the Company has a high business continuity and stability because of its excellent customer base owing to its long years of business during which it has earned trust and built technological expertise. Moreover, the Company's strength lies in the fact that it is in a position close to the end users, such that it can propose related or derivative systems to customers and obtain new development and service projects (Enhancement). Since its users or Japanese companies are expected to continuously and strategically increase IT investment to improve business efficiency and profitability, the Company's growth potential is large.

On the other hand, looking at its weaknesses in more detail, for the Company's industry in general, the profit margins tend to not change over the long term, and profit tends to not increase without an increase in sales. New business domain development and new customer acquisition are necessary to increase sales, but human resources and especially project managers are in shortage, becoming a bottleneck to further growth. Due to the nature of the system integration business, since there are only limited ways to improve productivity or largely reduce cost, fundamental improvements in the profit margins will probably take a long time.

The Company as well as the entire SI industry has been strengthening preventive measures and project management over many years, but some projects such as development in new areas still sometimes become unprofitable and cause a temporary decline in profit. Although this could be interpreted as an investment-like cost, it should be noted as a risk factor.

◆ Shareholder Return and Shareholder Benefit Program

- **Proactive stance with regards to shareholder return**

The Company's policy is to raise shareholder asset value by improving its financial results in order to conduct stable dividend payments and increase market capitalization. So far, it has been taking a proactive stance with regards to improving shareholder return, having conducted incremental dividend hikes, share buyback, stock splits, enhancement of shareholder benefit program, etc.

- **Actual annual (maximum) yield including the shareholder benefit program is about 2.5%.**
- **Has been gradually increasing dividend, raising it every few years**

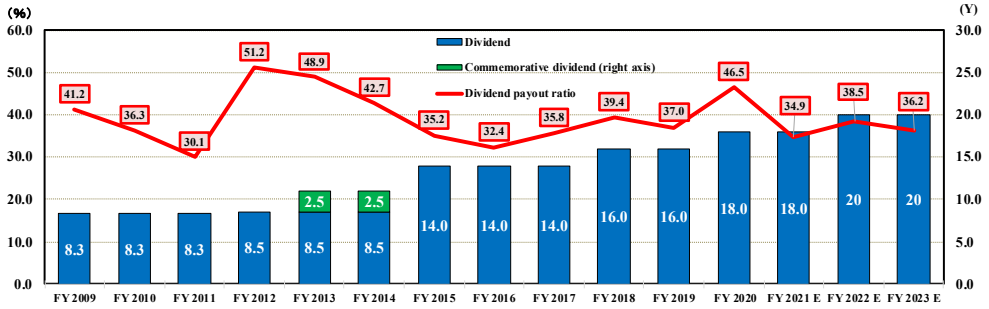
The Company's consolidated dividend payout ratio was 39.4% in FY 2018, 37.0% in FY 2019, 46.5% in FY 2020, and predicted to be 34.9% in FY 2021 (the Company's forecast), mostly meeting the Company's target of 35%. The Company raised its dividend from Y14 to Y16 in FY 2018 and kept it the same in FY 2019. In FY 2020, it raised dividend by Y2 to a total of Y18 and has announced that it will keep this dividend in FY 2021 (Figure 42). Since profit growth is expected over the medium term, we believe that incremental rises in the dividend at an interval of a few years are possible next fiscal year and onward.

Dividend yield is 1.9% when calculated based on a stock price of Y932 (closing price as of the end of June 26, 2020). The Company conducts IR activities toward individual investors, one of its major types of shareholders. It has a shareholder benefit program where JCB Gift Cards are given to shareholders based on the number of shares they own (Figure 42 on page 43). When this benefit program is taken into account, the actual dividend yield increases to approx. 2.5% at maximum (for the optimum number of shares owned). The Company plans to continue to maintain its stable dividend payment and raise the EPS to enhance shareholder return. Under the same conditions, the actual annual yields of its competitors are approx. 2.6% for HIMACS (no shareholder benefit program) and approx. 2.8% for Toho System (shareholder benefit program taken into account). Dividend on equity ratio (= total dividend / shareholder's equity) in FY 2020 was 4.5% for the Company, 3.1% for HIMACS, and 4.4% for Toho Systems. The Company's is the highest.

- **Has also been actively conducting stock splits and share buybacks**

Since becoming listed on the market, the Company has performed a total of six stock-splits, including a 1-to-2 split in April 2010, a 1-to-1.5 split in April 2011, and a 1-to-2 split in October 2014. It has also conducted six share buybacks, including the approx. 350,000 shares (Y300 million) bought back in February of last year. As a result, the Company acquired a total of approx. Y650 million's worth of shares (acquisition price at the time of acquisition). Since the Company has a great financial standing and is rich in cash, depending on the level of the stock price, additional share buybacks are possible.

[Figure 42] Change in Dividend and Dividend Payout Ratio



(Ref) Prepared by Alpha-Win Research Dept. Estimate/forecast (E) also made by Alpha-Win.

[Figure 43] Shareholder Benefit Program and Actual Net Yield (shareholder benefit vesting date: end of Sept)

Number of Shares Owned (greater than or equal to)	(less than)	Shareholder Benefit (JCB Gift Card: Y)	Dividend: Y	Actual Net Yield: %
200	400	1,000	18	2.5
400	1,000	2,000	18	2.5
1,000		3,000	18	2.3

Actual net yield* = (dividend + benefit value) / (stock price)
*Calculated for the min. (optimum) number of stock owned in each range
Stock price assumed to be: Y932 (closing price on June 26, 2020)

(Ref) Prepared by Alpha-Win Research Dept. based on the Company's website

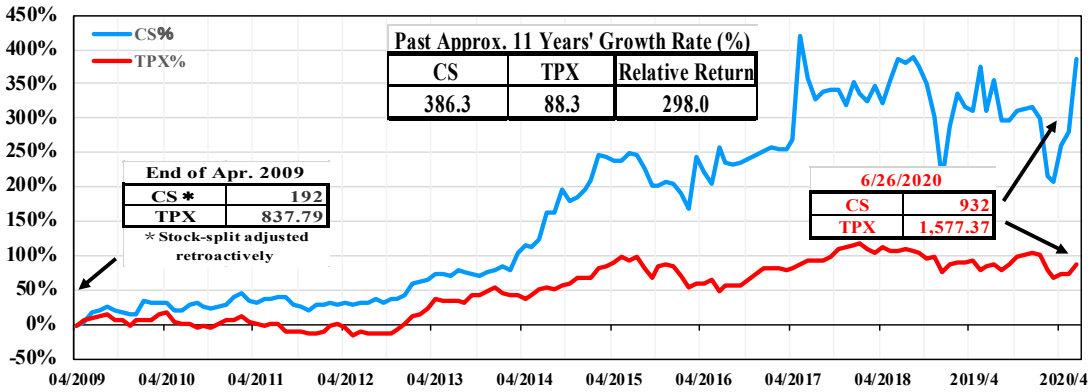
- **A defensive, domestic-demand-related growth stock. Stock price increased by approx. 4x over the past 11 years or so, largely outperforming the TOPIX.**
- **Predicted to remain an attractive investment target over the medium to long term**

◆ Stock Characteristics/Price and Factors that May Affect Stock Price

Over the past approximately 11 years, the Company's stock price rose by about four times, largely outperforming the TOPIX by 298% (calculated with stock splits taken into account; closing price as of the end of June 26, 2020; Figure 44). This growth seems to reflect the Company's strong fundamentals and firm growth in financial results over the long term.

As strategic IT investment by Japanese companies will generally increase, the Company is expected to continue to increase profit at a relatively stable pace. Also, the Company is characterized as being defensive. For these reasons, the Company will likely be recognized as a candidate for medium- to long-term investment.

[Figure 44] Long-Term Return on the Company's Stock (CS) and TOPIX (change in the past 11 years' monthly stock price)



Note: CS stock price and TOPIX at the end of April 2009 set at 0% as the start point

(Ref) Prepared by Alpha-Win Research Dept.

The Company has been outperforming the TOPIX this fiscal year as well. It has most likely gained attention as a domestic-demand-related growth stock with firm financial results amidst the increasing stock market volatility due to the anticipated deterioration in companies' financial performance from COVID-19 and the trade war. When the lowest value for this year, which is Y483 (closing price) on March 13 during the sharp drop in the market after COVID-19, is set as the point of comparison, the Company's stock has been outperforming the TOPIX by 68% even during the market rebound phase up through June 26. This rise seems to have been brought by how the Company

- **Outperforming the TOPIX since the beginning of the year**
- **Valuation is about average or slightly low for its industry.**
- **Looking at the valuation, we can see that its stock price is relatively cheap. Going forward, points of interest are this FY and next FY's financial performance, development of new businesses, and enhancement of shareholder return.**

was positively evaluated for announcing sales growth, profit growth, record-high profit, and same dividend as last year's after the dividend hike, while a majority of the TSE First Section companies have kept their financial forecast and dividend forecast for FY 2021 undetermined.

A meaningful comparison of valuation with the average of the TSE First Section stocks cannot be currently made, since many companies have not determined their financial forecast as described above. Therefore, we compared the major valuation indicators of the Company with its competitors that are listed on the First Section. Compared to its similar competitors (HIMACS and Toho System), the Company's valuation used to be somewhat expensive. However, although the Company's stock price has significantly increased, its current stock price is somewhat cheap in terms of P/E and P/S (Figure 45). In addition, the Company's liquidity is relatively high (reference: average approximate trading value per day).

[Figure 45] Comparison of Valuation Indicators and Liquidity of Three Same-Business Companies

Company Name	CUBE SYSTEM (CS: consolidated)	HIMACS (HM: consolidated)	Toho System Science (TS: non-consolidated)
Code	2335	4299	4333
Stock Price (at 6/26 closing)	932	2,049	980
Market Cap (Y mil)	14,241	12,717	13,589
P/E (price-to-earnings ratio)	18.1	19.5	18.8
P/B (price-to-book ratio)	2.3	1.2	1.7
Dividend Yield (%)	1.9	2.4	2.6
EV/EBITDA	10.6	6.6	6.5
P/S (price-to-sales ratio)	0.9	0.9	1.2
Ave. Daily Traded Amount in Past 6 Months (million yen)	31	8	6

Market cap= (shares outstanding) x (market share price [at 6/26/2020 closing])
The companies' planned EPS and dividend values for FY 2021 were used in all P/E and dividend yield calculations.
Actual BPS values of FY 2020 were used in P/B calculations.
EV/EBITDA=(market cap + interest bearing debt - cash&deposits)/(O.P. + depreciation + intangible fixed asset amortization)
P/S=market cap / sales [the companies' forecasts for FY 2021]

(Ref) Figures 45 and 46 were prepared by Alpha-Win Research Dept. based on the securities report and stock data.

Relative to a universe of the leading 22 SI companies listed on the First Section of the TSE (including the Company and the two companies mentioned above; the total market cap of the 22 companies is Y10.6 trillion), the Company's stock valuation seems slightly cheap for the SI sector (Figures 46 on page 44). In the future, we believe that if the Company's operating margin improves and its sales increase, then its valuation (P/E, etc.) may rise in addition to the rise in EPS and the market capitalization may also increase.

Going forward, we should keep note of the following factors or events that may affect stock price.

・Quarterly profit/loss trends and achievement rate of full-year targets during this fiscal year or FY 2021, and financial forecast for the next fiscal

year (FY 2022) onward (targets of the next medium-term plan: specific business development strategies and announcement of specific numbers)
・Progress with the growth strategy including the expansion of business domain, M&As, and alliances
・Fully committed start of new-technology businesses such as blockchain, cloud, AI, IoT, and agile development that are currently in the R&D or investment phase. The contribution of these businesses to sales and profit.
・Share buyback, dividend hike, stock split, and enhancement of shareholder benefit program

[Figure 46] Comparison of Major Stocks in the SI Sector
(Note: includes companies that have not announced a forecast for this fiscal year)

Code	Company Name	Market Cap.	Stock Price	Sales	O.P.	O.P. Margin	Actual ROE (%)	Est. P/E	Actual P/B	Est. Dividend Yield	Est. Dividend	Est. EPS	Actual BPS	P/S
9613	NTT DATA	1,699,830	1,212	ND	ND	-	8.1	-	1.8	1.5%	18.00	ND	670.01	-
4307	Nomura Research Institute	1,920,000	3,000	540,000	83,000	15.4%	20.5	30.3	6.7	1.1%	34.00	98.96	446.69	3.6
4684	OBIC	1,938,216	19,460	84,000	45,300	53.9%	15.4	49.2	7.3	0.8%	160.00	395.73	2,680.06	23.1
4768	Otsuka Corporation	1,103,912	5,810	864,000	63,700	7.4%	17.8	25.3	4.5	2.0%	115.00	229.59	1,299.08	1.3
4739	Itochu Techno-Solutions	985,200	4,105	500,000	44,600	8.9%	12.6	31.6	4.1	1.5%	63.00	129.85	1,002.76	2.0
9719	SCSK	551,122	5,290	380,000	41,000	10.8%	15.6	19.0	2.6	2.5%	130.00	278.70	2,000.16	1.5
3626	TIS	607,062	2,305	440,000	44,000	10.0%	12.5	19.5	0.8	1.5%	35.00	117.95	2,890.27	1.4
8056	Nihon Unisys	379,436	3,460	320,000	26,000	8.1%	15.5	20.4	2.9	2.0%	70.00	169.38	1,200.33	1.2
2327	NS Solutions	280,894	2,966	ND	ND	-	12.8	-	1.8	2.2%	65.00	ND	1,633.31	-
9749	Fujisoft	145,584	4,320	238,000	13,600	5.7%	7.2	16.9	1.2	1.2%	51.00	255.64	3,570.35	0.6
1973	NEC Networks & System Int.	322,086	2,157	ND	ND	-	8.8	-	2.9	-	ND	ND	741.12	-
4812	ISID	164,260	5,040	105,000	10,500	10.0%	11.8	23.8	3.0	1.7%	86.00	212.11	1,702.64	1.6
9759	NSD	172,684	1,870	ND	ND	-	13.8	-	3.4	-	ND	ND	557.46	-
9682	DTS	114,963	2,279	95,000	10,700	11.3%	13.8	14.1	1.9	2.4%	55.00	161.49	1,190.71	1.2
9692	CEC	66,552	1,770	53,000	6,100	11.5%	12.2	14.7	2.0	2.3%	40.00	120.26	891.74	1.3
4674	CRESCO	36,000	1,500	40,000	3,400	8.5%	15.0	12.9	1.9	2.4%	36.00	116.72	770.72	0.9
9739	NIPPON SYSTEMWARE	33,287	2,234	ND	ND	-	13.2	-	1.6	-	ND	ND	1,434.46	-
9600	I-NET	24,851	1,530	ND	ND	-	11.3	-	1.6	-	ND	ND	956.89	-
4725	CAC Holdings	26,581	1,294	52,000	2,000	3.8%	5.6	15.3	0.9	4.6%	60.00	84.76	1,512.07	0.5
2335	Cube System	14,241	932	16,000	1,120	7.0%	9.6	18.1	2.3	1.9%	18.00	51.56	411.96	0.9
4333	Toho System	13,589	980	11,700	920	7.9%	9.1	18.8	1.7	2.6%	25.00	52.16	584.44	1.2
4299	HIMACS	12,717	2,049	14,500	758	5.2%	8.8	19.5	1.2	2.4%	50.00	105.07	1,659.93	0.9
Simple Average		482,412				11.6%	12.3	21.8	2.6	2.0%				2.7
Simple Average (excl. OBIC)		394,311				8.8%	12.2	18.8	2.4	2.1%				1.3

Note: Units for market cap., sales, and O.P.: million yen
Units for stock price, dividend, est. EPS, and actual BPS: Y Units for P/E, P/B, and P/S: none
Sales and O.P. are generally the companies' most recent forecast values
Stock prices are closing prices on June 26, 2020
Only valid data included in the averages

(Ref) Prepared by Alpha-Win Research Dept. based on the securities report and stock data. ND = not determined.