

Alpha-Win Company Research Report

CUBE SYSTEM INC. (2335 TSE First Section)

Issued: 8/14/2019

Research Dept., Alpha-Win Capital Inc.

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

Summary

◆ Independent, mid-tier system integrator with long-term, stable growth

- 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. 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. Founded in 1972, it has 47 years of history.
- With the exception of one fiscal year, the Company has been continuously increasing sales YoY for the past 18 years. During this period, its annual sales growth rate (simple average of the rate of increase in sales) was +6.4% and its annual recurring profit growth rate (simple average) was +6.0%; the Company has been steadily expanding its business and keeping its business in the black over many years. The recurring margin has been stable at around 7% and the increase in sales has been contributing directly to increases in profit, dividend, and market capitalization.

◆ This Q1’s results: sales inc. by 9.6% YoY and O.P. dec. by 8.8% YoY – sales rose with strong growth in orders received but profit temporarily fell due to unprofitable projects

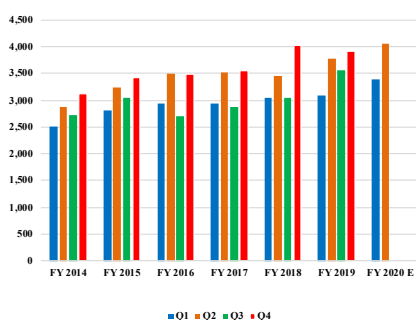
- Results for the first quarter of FY 2020 (April to June 2019; hereinafter “Q1”) (note that all fiscal years in this report are March-ending; e.g. FY 2020 ends in March 2020) were as follows: sales were Y3,379 million (+9.6% YoY), operating profit was Y100 million (-8.8% YoY), recurring profit was Y107 million (-19.0% YoY), and quarterly profit attributable to owners of the parent (hereinafter “net profit”) was Y50 million (-34.2% YoY) (Figures 1-3). Sales were strong, but the profits fell because some projects became unprofitable. Consequently, the gross margin and operating margin both fell by about 0.6 point from 16.1% in Q1 of the previous year to 15.5% in Q1 of this year and from 3.6% to 3.0% (in the same order), respectively (Figure 4). Sales seem to have slightly exceeded the Company’s internal targets (undisclosed), but the profits had probably been below the targets.

[Figure 1] Financial Results for Q1

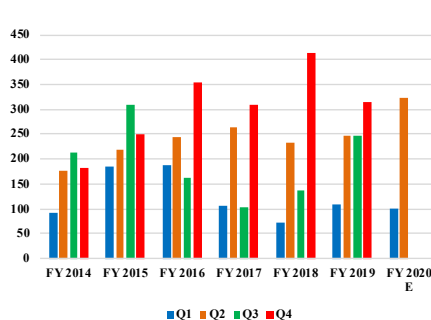
		Q1 Results		FY 2019 Q1	FY 2020 Q1	% Change	Difference	Share of Diff.	Share of Total	FY 2020 Company Target	% Change
		Unit: Y million		Apr-Jun 2018	Apr-Jun 2019	YoY: %	YoY: Y mil / %	%	%	Apr 2019 - Mar 2020	YoY: %
By Service Category	Total	Cons. Sales	Name of Service/Industry	3,082	3,379	9.6	297	100.0	100.0	15,500	8.2
	Sales	System Integration: SIS	2,164	2,411	11.4	247	83.2	71.4			
		System Outsourcing: SOS	856	520	-6.5	-36	-12.1	15.4			
		Professional: ProS	361	447	23.9	86	29.0	13.2			
	Gross Profit	System Integration: SIS	344	354	2.9	10	37.0	67.6			
		System Outsourcing: SOS	93	95	2.9	2	7.4	18.1			
		Professional: ProS	58	73	23.9	15	55.6	13.9			
	Gross Margin (%)	System Integration: SIS	15.9	14.7	-1.2						
		System Outsourcing: SOS	16.7	18.4	1.7						
		Professional: ProS	16.1	16.5	0.4						
By Industry	Sales	Finance	856	993	16.0	137	46.1	29.4	4,317	7.8	
		Distribution	695	771	10.9	76	25.6	22.8	3,988	30.7	
		Telecommunications	472	488	2.8	13	4.4	14.4	2,176	7.5	
		Manufacturing (other)	297	296	-33.5	-99	-33.3	-11.7			
		Government (other)	220	245	11.2	25	8.4	7.3	5,019	2.0	
		Other (other)	539	486	-9.9	-53	-17.8	-14.4			
	Gross Profit	Finance	131	181	37.7	50	175.4	34.5			
		Distribution	128	122	-4.9	-6	-21.1	23.3			
		Telecommunications	70	74	5.3	4	14.0	14.1			
		Manufacturing (other)	48	45	-5.5	-3	-10.5	8.6			
		Government (other)	36	34	-5.6	-2	-7.0	6.5			
		Other (other)	79	66	-17.2	-13	-45.6	12.6			
	Gross Margin (%)	Finance	15.4	18.2	2.8						
		Distribution	18.5	15.9	-2.6						
		Telecommunications	14.9	15.2	0.3						
		Manufacturing (other)	16.4	11.6	-4.8						
Government (other)		16.6	14.1	-2.5							
Other (other)		14.8	13.6	-1.2							
Total	Gross Profit	496	524	5.7	29						
	Gross Margin (%)	16.1	15.3	-0.6							
By Financial Metric	SG&A Exp.	386	424	9.9	38						
	SG&A Exp. Ratio (%)	12.5	12.3	-0.2							
	O.P.	109	100	-8.3	-9			1,090	18.3		
	O.P. Margin (%)	3.6	3.3	-0.6				7.0			
	R.P.	133	107	-19.0	-26			1,090	13.6		
	R.P. Margin (%)	4.3	3.3	-1.1				7.0			
	N.P.	76	30	-34.2	-46			684	14.6		
	N.P. Margin (%)	2.5	1.3	-1.0				4.3			

(Note) All figures were prepared by Alpha-Win Res. Dept. based on the financial results summary and financial results supplemental reference materials. Due to various processing during calculations, there may be slight differences in the numbers.

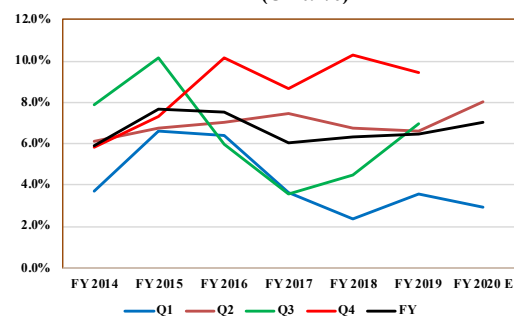
[Figure 2] Quarterly Change in Sales (Unit: Y million)



[Figure 3] Quarterly Change in O.P. (Unit: Y million)



[Figure 4] Quarterly Change in O.P. Margin (Unit: %)

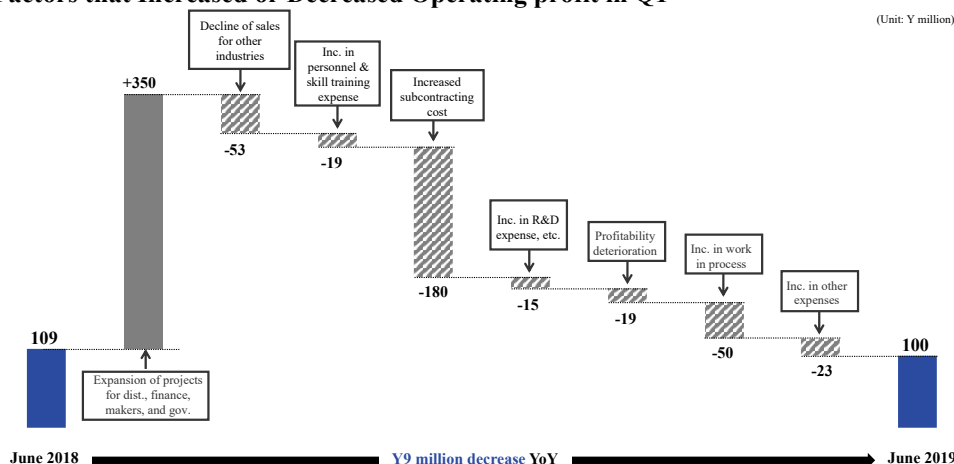


(Note) In Figures 2-4, FY 2020 Q1 is based on the actual results and Q2 and full-year values are based on the Company's estimates/forecasts (E).

- Overall, sales increased by Y297 million YoY. By service category (three categories), Q1 sales for the System Integration Service (SIS) increased by Y247 million YoY with a 11.4% sales growth, accounting for 83% of the total increase in sales. This rise was brought by the increase in the projects for the distribution industry dealing with the consumption tax and new business areas, the projects for the finance industry concerning systems for internet banking and credit, and the projects for manufacturers including construction machinery and paper processing. However, since the profitability of some projects deteriorated, the gross margin decreased from 15.9% in the previous Q1 to 14.6% in the current Q1, so that the gross profit only increased slightly by Y10 million (+ 2.9%). On the other hand, sales of the System Outsourcing Service (SOS) decreased by Y36 million (-6.5% YoY) due to the completion of projects for telecom carriers but its gross profit remained about the same since the gross margin had improved. Thanks to the expansion of consulting projects, etc., sales of the Professional Service (ProS) increased by Y86 million (+ 23.9% YoY) and its profit increased by Y13 million (+ 27.1% YoY).
- By industry (four industries), as described above, sales increased for all industries (Figure 1). Sales and profits of the finance industry especially increased as the development of new business fields began to clearly improve the business with this industry. For the distribution industry, sales increased by 10.9% but profit declined by 4.9% (gross profit), and for the other industries, too, sales increased by 6.7% but profit declined by 11.2% (gross profit). This result was caused by the decline in gross margin due to the occurrence of unprofitable projects and the changeover period of the profitable projects.

- Figure 5 shows the factors that increased or decreased operating profit in the current Q1. The increase in sales accompanying the expansion of projects for distribution, finance, and other industries (manufacturing/government) greatly contributed to the increase in profit, offsetting the decline in sales for the telecommunications industry, the rise in subcontracting cost (rise in work hours and unit price for certain projects), and the rise in various expenses such as personnel and R&D expenses. For non-operating profit/loss, the premium refund for cancelled insurance that had been recorded during last Q1 is no longer present in the current Q1, causing a decrease in the non-operating profit by Y16 million from Y23 million to Y7 million. No extraordinary gain or loss has been recorded.

[Figure 5] Factors that Increased or Decreased Operating profit in Q1



(Note) Financial results supplemental reference materials

Short Report

- Due to the nature of the Company's business model, the sales growth largely depends on the number of employees. The number of domestic employees has increased from 707 in June 2017 (at month-end) → 745 in June 2018 (+38; +5.4%) → 766 in June 2019 (+21; +2.8%). Although the number of employees is still somewhat short of the potential demand for systems, the Company is reinforcing recruitment as well as putting efforts into improving the productivity of each person such as sales and operating profit per person.
- The balance sheet at the end of Q1 has not changed significantly. The Company has ample liquidity at hand, with cash and deposits of Y3.1 billion. Its financial standing is also firm, with an equity ratio of 68.1%.

◆ No change to the initial full-year forecast that sales will rise by +8.2% and profit will grow at a double-digit rate and the plan to increase dividend by Y2

- The Company has not changed its initial forecast on H1 and full-year sales, profits, and dividend announced at the beginning of the fiscal year. Like the previous fiscal year, it plans to increase sales and profits during this fiscal year and hit a record high in sales for consecutive fiscal years, as well as achieving a record-high in profit. The Company will also aim again to raise operating profit and recurring profit so that they exceed Y1 billion for the first time (this challenge had been tried but could not be achieved during last fiscal year).
- Q1's progress in terms of the full-year company forecast was 21.8% for sales and 9.2% for operating profit. In comparison, last fiscal year's Q1 progress rate against the full-year results was 21.5% for sales and 11.9% for operating profit. The simple average of Q1 progress rates over the past six years, including the previous fiscal year, is 22.5% for sales and 14.6% for operating profit; this Q1's progress rate is below the average progress rate of recent years. However, the Company has been experiencing seasonal variability on a quarterly basis such that, in recent years, the fourth quarter (Q4: January to March) has been contributing the most to the full-year results (27.9% of sales and 35.4% of operating profit on average for the same six years), the second quarter (Q2: July to September) has been the next largest in contribution (26.4% and 27.2%, in the same order), the third quarter (Q3: October to December) has been the third largest (23.3% and 22.9% in the same order), and Q1 has been the smallest in contribution. This means that there is a potential for recovery in the future. Also, when the Q1 results are subtracted from the Company's disclosed H1 forecast, we can see that the Company is planning to increase sales and profit in Q2 such that Q2 sales reach Y4,058 million (+7.6% YoY) and operating profit reaches Y324 million (+30.6% YoY) and improve the operating margin from 6.6% in the previous year's Q2 → 8.0% during this Q2.
- As Alpha-Win Research Department, we have made analysis that the Company's sales and profits may both hit their record highs, although they may be somewhat below the Company's full-year targets. In addition, we have noted that the Company has been strengthening sales toward its main accounts (clients), expanding existing businesses, and developing business in new domains and areas. The number of orders received during this Q1 and the order backlog at the end of Q1 have both grown at a steady pace of about 20% YoY. Therefore, at this stage, we have not revised the full-year forecast. However, the occurrence of unprofitable projects from the end of last fiscal year to Q1 despite the reinforcement of project management in recent years, as well as the consequent struggle in improving the profit margins, has been a surprise. In Q2 and onward, we must closely examine the impact of this trouble on the profit and loss, its duration, the Company's measures against its reoccurrence, and the effectiveness of those measures. We may consequently make some revisions to the profit forecasts for this fiscal year and onward.
- Over the medium to long term, the users are expected to continue to increase their IT investments to develop new business models, strengthen their competitive advantage, deal with the labor shortage, streamline and speed up operation, and promote DX. Consequently, the Company's growth potential is large. We expect that the Company's profit and sales will grow stably at a rate of 8-10% per year by expanding its Enhancement business, acquiring new customers, developing new and overseas businesses, and improving its productivity through various measures.

◆ Stock price and characteristics: market-average valuation, outperforming TOPIX over many years as a domestic-demand-related, stable growth stock

- Compared to the average of the First Section of the TSE (based on the closing price on 8/2/2019: P/E of 13.3, P/B of 1.1, and simple-average dividend yield of 2.1%) and its competitors (HIMACS and Toho System Science; Figure 6), its valuation is about average. Going forward, if the Company could achieve a relatively stable, double-digit profit growth, then its stock price could potentially rise.

- The Company's stock is a domestic-demand-related, defensive, stable growth stock that is little affected by fluctuations in foreign exchange and international trade wars. Its stock price's volatility is relatively small.
- In the past ten years or so, the Company's stock price has increased by about four times and has been largely outperforming the TOPIX. Regarding stock price, the quarterly financial performance in Q2 and onward is the key factor to watch over the short term. Over the medium term, we should watch the Company's change in margins and profit growth rate in the next fiscal year and onward, development of and achievements in new technologies and businesses domains, and shareholder return (dividend hike, shareholder benefit program enhancement, share buyback, stock split, etc.), as well as the financial performance and IT investment trends of the Company's end users (Japanese companies).

[Figure 6] Comparison of Valuation Indicators with Competitors

Company Name	CUBE SYSTEM (CS: consolidated)	HIMACS (HM: consolidated)	Toho System Science (TS: non-consolidated)
Code	2335	4299	4333
Stock Price (at 8/2 closing)	808	1,825	973
Market Cap (Y mil)	12,346	11,327	13,492
P/E (price-to-earnings ratio)	16.3	16.5	15.3
P/B (price-to-book ratio)	2.1	1.2	1.7
Dividend Yield (%)	2.2	2.7	2.6
EV/EBITDA	9.5	5.7	5.7
P/S (price-to-sales ratio)	0.8	0.8	1.0

Market cap= (shares outstanding) x (market share price [at 8/2/2019 closing])

The companies' planned EPS and dividend values for FY 2020 were used in all P/E and dividend yield calculations.

Actual BPS values of FY 2019 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 2020]

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

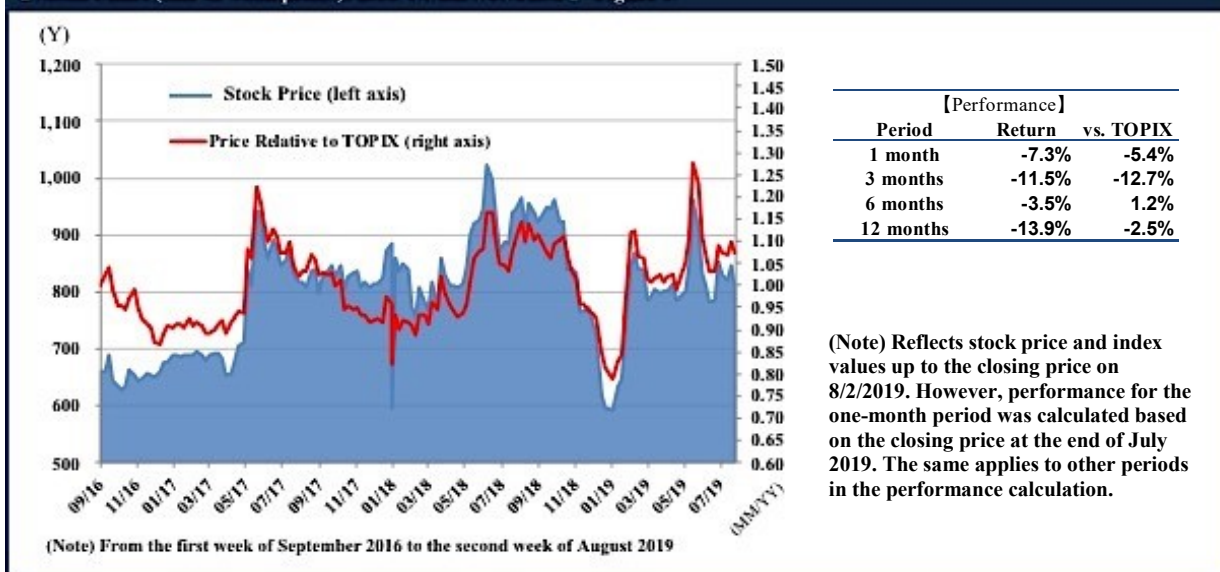
[2335 CUBE SYSTEM Sector: Information & Communication] Figure A												
FY		Sales (Y mil)	YOY (%)	O.P. (Y mil)	YOY (%)	R.P. (Y mil)	YOY (%)	N.P. (Y mil)	YOY (%)	EPS (Y)	BPS (Y)	Dividend (Y)
2017		12,899	2.2	781	-17.7	811	-15.5	551	-12.3	39.15	346.47	14.0
2018		13,559	5.1	855	9.5	892	10.0	567	2.9	40.59	372.23	16.0
2019		14,325	5.6	921	7.8	959	7.5	596	5.1	43.25	393.29	16.0
2020	CE	15,500	8.2	1,090	18.3	1,090	13.6	684	14.6	49.58	-	18.0
2020	E	15,400	7.5	1,080	17.3	1,080	12.6	680	14.1	50.17	427.45	18.0
2021	E	16,500	7.1	1,200	11.1	1,200	11.1	750	10.3	55.33	464.78	18.0
2022	E	17,800	7.9	1,320	10.0	1,320	10.0	825	10.0	60.86	507.65	20.0
2018	Q1	3,082	1.4	109	52.4	132	80.5	76	131.3	5.45	393.29	0.0
2019	Q1	3,379	9.6	100	-8.8	107	-19.0	50	-34.2	3.70	379.63	0.0
2019	Q2-CE	4,058	7.6	324	30.1	317	29.9	200	34.2	14.42		
2019	H1-CE	7,437	8.5	424	18.3	424	12.5	250	10.9	18.12		8.0

(Note) CE = the Company's estimate/forecast. E = Alpha-Win Research Dept.'s estimate/forecast. Q1 is from April to June, Q2 is from July to September, and H1 (first half) is from April to September.

[Stock Price and Valuation Indicators: 2335 CUBE SYSTEM] Figure B						
Item	as of 8/2/2019	Item	P/E	P/B	Dividend Yield	Dividend Payout Ratio
Stock Price (Y)	808	Last FY (actual)	18.7	2.1	2.0%	37.0%
Shares Outstanding (thou.)	15,280	This FY (est.)	16.1	1.9	2.2%	35.9%
Market Capitalization (Y mil)	12,346	Next FY (est.)	14.6	1.7	2.2%	32.5%
Dilutive Shares (thou.)	0	Equity Ratio at This Q1-End	68.1%	Last FY's ROE		11.4%

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

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



Disclaimers

This Alpha-Win Company Research Report (hereinafter “this Report”) has been prepared by Alpha-Win-Capital Inc. (hereinafter “Alpha-Win”) on the request of the company presented in this Report.

This Report is not to be construed as a recommendation or solicitation of investment. Alpha-Win shall not be liable for any consequences including direct or indirect loss, lost profit, or damage resulting from the use of or reliance on this Report. Investors who read this report must make their own decisions on all investment matters and take full responsibility regarding their investment.

This Report has been prepared with a focus on objectivity and neutrality based on the analysis of generally accessible public information and supplemental information including interview(s) by the analyst. Alpha-Win, the writer, and/or other persons involved in the publication of this Report may already hold, or buy and sell in the future, the stock of the company presented in this Report.

Contents of this Report are based on information current as of the issue date and are subject to change without notice. We do not warrant or represent that the information in this Report is accurate, reliable, complete, appropriate, or fit for any purpose and do not accept any responsibility or liability.

Copyright of this Report belongs to Alpha-Win and no part of the publication may be copied, photocopied, cited, or translated without our consent.

For inquiries regarding this Report, please send us an e-mail to info@awincap.com. However, Alpha-Win and the writer of this Report do not have any obligation to reply to inquiries.

PSV20190814-10