

Alpha-Win Company Research Report

CUBE SYSTEM INC. (2335 TSE First Section)

Issued: 11/18/2019

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 (NRI) 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 fiscal year’s Q2 results: sales grew by 3.2% and O.P. rose by 9.4% YoY; record-high H1 sales; recovering from the profit decline in Q1.

- Results for the second quarter of FY 2020 (Apr. to Sept. 2019; hereinafter, the “first half” or “H1”) (note that all fiscal years in this report are March-ending; e.g. FY 2020 ends in March 2020) were as follows: sales were Y7,071 million (+3.2% YoY), operating profit was Y392 million (+9.4% YoY), recurring profit was Y397 million (+5.6% YoY), and profit for the period attributable to owners of the parent (hereinafter, “net profit”) was Y241 million (+7.3% YoY) (Figures 1-3). Sales were strong, hitting a record high. Concerning profit, some of the projects’ profitability worsened, leading to an increase in cost (by Y42 million YoY). Still, an overall increase in profit was achieved owing to the rise in sales and the improvement of margins. While an all-time high could not be attained for profit during this H1, the profit was still at a high level compared to past results. However, sales, operating profit, and net profit were Y366 million (4.9%), Y32 million (7.5%), and Y8 million (3.2%) lower than the Company’s initial targets, respectively.

[Figure 1] Financial Results for This H1 (the period ending Sept. 2019)

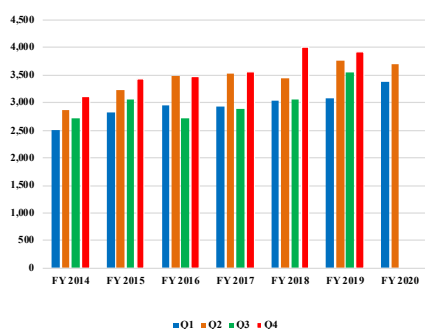
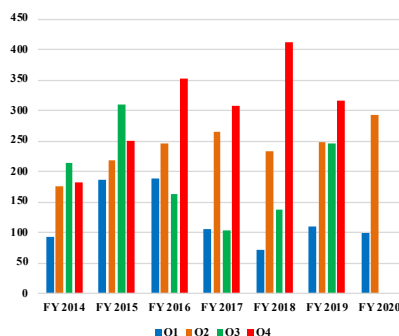
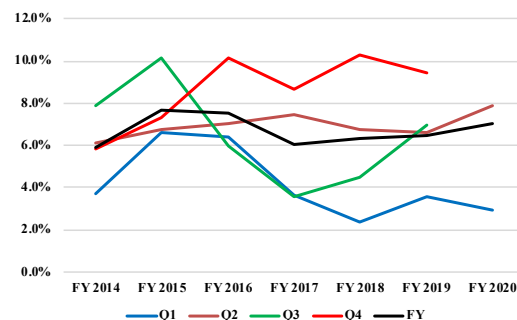
Results		Q1 FY 2019	Q1 FY 2020	Q2 FY 2019	Q2 FY 2020	H1 FY 2019	H1 FY 2020	H1: % Change	Difference	Share of Diff.	Share of Total	FY 2020 Full-Year Company Target	% Change	
Unit: Y million		Apr-Jun 2018	Apr-Jun 2019	Jul-Sep 2018	Jul-Sep 2019	Apr-Sep 2018	Apr-Sep 2019	YoY: %	YoY: Y mill / %	%	%	Apr 2019 - Mar 2020	YoY: %	
Total	Cons. Sales	3,082	3,379	3,771	3,692	6,853	7,071	3.2	218	100.0	100.0	15,500	8.2	
	Sales	System Integration: SIS	2,164	2,411	2,587	2,532	4,751	4,943	4.0	192	87.9	69.9		
		System Outsourcing: SOS	556	520	564	691	1,120	1,211	8.1	91	41.6	17.1		
		Professional ProS	362	447	620	469	982	916	-6.6	-66	-29.7	13.0		
	Gross Profit	System Integration: SIS	344	354	403	470	747	824	10.3	77	100.0	68.2		
		System Outsourcing: SOS	93	95	96	130	189	225	19.2	36	46.8	18.6		
		Professional ProS	58	73	136	84	194	157	-18.9	-37	-38.1	13.0		
	Gross Margin (%)	System Integration: SIS	15.9	14.7	15.6	18.6	15.7	16.7	1.0	1.0				
		System Outsourcing: SOS	16.7	18.4	17.0	18.8	16.9	18.7	1.8	1.8				
		Professional ProS	16.1	16.5	21.9	17.9	19.8	17.2	-2.6	-2.6				
By Service Category	Sales	Finance	856	993	1,092	1,125	1,948	2,118	8.7	170	77.8	30.0	4,317	7.8
		Distribution	695	771	738	916	1,433	1,687	17.7	254	116.3	23.9	3,988	30.7
		Telecommunications	472	485	700	432	1,172	917	-21.8	-255	-116.7	13.0	2,176	7.5
	Gross Profit	Manufacturing (other)	297	396	482	417	779	813	4.4	34	15.6	11.5		
		Government (other)	220	245	237	209	457	454	-0.6	-3	-1.4	6.4		
		Other (other)	539	486	522	593	1,067	1,079	1.7	12	1.4	15.3	5,019	2.0
	Gross Margin (%)	Finance	131	181	159	228	290	409	41.1	119	155.4	33.9		
		Distribution	128	122	133	165	261	287	9.9	26	33.9	23.8		
		Telecommunications	70	74	136	66	206	140	-31.9	-66	-86.2	11.6		
	Gross Margin (%)	Manufacturing (other)	48	45	77	62	125	107	-13.9	-18	-23.5	8.9		
Government (other)		36	34	38	34	74	68	-8.5	-6	-7.8	5.6			
Other (other)		79	66	93	127	172	193	12.2	21	27.4	16.0			
Total	Gross Profit	496	524	636	684	1,131	1,208	6.8	77					
	Gross Margin (%)	16.1	15.5	16.9	18.5	16.5	17.1	0.6	0.6					
	SG&A Exp.	386	424	387	392	773	816	5.5	43					
SG&A Exp. Ratio (%)	SG&A Exp. Ratio (%)	12.5	12.5	10.3	10.6	11.3	11.5	0.3	0.3			1,090	18.3	
	O.P.	109	100	249	292	350	392	9.4	34					
	O.P. Margin (%)	3.6	3.0	6.6	7.9	5.1	5.5	0.3	0.3					
R.P.	R.P.	133	107	245	291	375	398	5.6	23			1,090	13.6	
	R.P. Margin (%)	4.3	3.2	6.5	7.9	5.5	5.6	0.1	0.1					
	N.P.	76	50	149	192	225	242	7.3	16			684	14.6	
N.P. Margin (%)	N.P. Margin (%)	2.5	1.5	4.0	5.2	3.3	3.4	0.1	0.1					

(Note) Prepared by Alpha-Win Res. Dept. based on the financial results summary and its supplemental reference materials. Due to various steps of processing during calculations, there may be slight differences in the numbers (applies to the rest of this document).

Short Report

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[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: %)

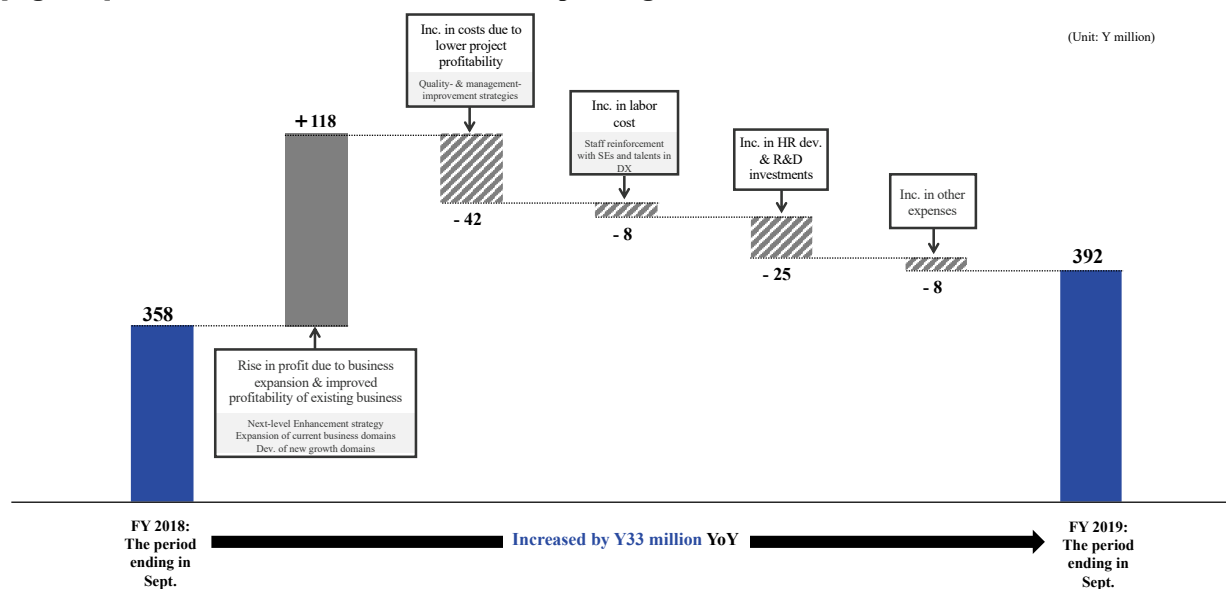
(Note) In Figures 2-4, Q1 and Q2 of FY 2020 are actual results and full-year FY 2020 values are based on the Company's estimates/forecasts.

- Overall, in H1, sales increased by Y218 million YoY and gross profit increased by Y76 million YoY.
- By service category (three categories), the sales of the System Integration Service (SIS) increased by Y192 million YoY (+4.0% YoY), accounting for 88% of the total increase in sales. This increase was brought forth by the expansion of system development projects for consumer co-ops in the distribution industry, credit card companies in the finance industry, paper-processing manufacturers, and education companies. The gross margin of the SIS increased from 15.7% in the previous H1 to 16.7% in the current H1, raising the gross profit by Y76 million (+10.3% YoY), which helped boost the total profit. Additionally, sales of the System Outsourcing Service (SOS) increased by Y91 million (+8.1% YoY) thanks to the expansion of projects for supermarkets. This category's gross margin also improved, resulting in a Y36 million increase in gross profit (+19.2% YoY). On the other hand, sales of the Professional Service (ProS) decreased by Y64 million (-6.6% YoY) and its profit decreased by Y36 million (-18.9% YoY) due to the completion of system development projects for telecom carriers.
- By industry (four industries), sales increased for three industry types, excluding the telecommunications industry whose sales and profit declined for the reason described above (Figure 1). The finance industry was the growth driver for the Company's overall sales and profit (gross profit; the same applies below), as performance of business with this industry began to clearly improve due to the increase in system development projects for insurance companies as well as credit card companies. Additionally, business with the distribution industry also contributed to the results with the expansion of projects concerning the consumption tax revision and new projects in growth fields (digitalization projects, etc.). Meanwhile, the gross margin of the "other industries" category decreased due to the unprofitable projects and the changeover period of the profitable projects, but the category's sales and profit have stayed about the same.
- By customer group, excluding the Fujitsu Group (hereinafter, abbreviated as "G") whose sales toward telecom carriers dropped, sales for the other three Gs (NRI, Aeon, and Mizuho) increased. Sales for the main four Gs were Y5,332 million, having increased by Y226 million YoY (+4.4%), exceeding the overall sales growth in amount as well as rate.
- The gross margin increased from 16.5% in H1 of the previous year to 17.1% for this H1, and the operating margin also improved from 5.2% to 5.5% in the same order (Figure 4). The factors that increased or decreased this H1's operating profit (a Y34 million net increase) are shown in Figure 5. Profit increased thanks to the rise in sales of the Enhancement business and the expanded businesses including those in new business domains, as well as the improvement of profit margins from cost reduction and efficiency improvement. Regarding the unprofitable projects, related expenses have already been booked and, at this point, no additional costs are expected to be incurred in H2 and onward. As for the non-operating profit and loss, a loss of Y12 million was posted due to a fallback from the one-time profit from the premium refund for cancelled insurance, etc., in the previous H1. There was no extraordinary gain or loss, and net profit had increased.
- Due to the nature of the Company's business model, sales growth largely depends on the number of employees. The number of domestic employees has been increasing from 617 in Sept. 2017 (at month-end) → 655 in Sept. 2018 (+38; +6.2%) → 664 in Sept. 2019 (+9; +1.4%). Although the number of employees is still somewhat short

of the system development demand, the Company has been gradually improving the productivity of each person, such as the sales and operating profit per person.

- There have been no large changes to the balance sheet as of the end of H1. The Company is essentially debt-less and has ample liquidity at hand, with cash and deposits of Y3.2 billion. Its financial standing is also firm, with an equity ratio of 67.4%.

[Figure 5] Factors that Increased or Decreased Operating Profit in H1



(Note) Financial results supplemental reference materials

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

- The Company has not changed its initial forecast on the 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 profit during this fiscal year and hit a record high in sales for consecutive fiscal years, as well as achieving record highs in profits. 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 attempted but could not be achieved during last fiscal year).

- Progress during this H1 in terms of the full-year company forecast was 45.6% for sales and 36.0% for operating profit. In comparison, the simple average of the H1 progress rates over the past ten years, including the previous fiscal year, is 49.0% for sales and 44.8% for operating profit; this H1's progress rate is below the average of recent years. Also, when the H1 results are subtracted from the Company's full-year forecast, we can see that in H2 the Company plans for sales of Y8,429 million (+12.8% YoY) and an operating profit of Y698 million (+24.0% YoY) – a double-digit growth in sales and profit – as well as an improvement in operating margin (from 7.5% in the previous year's H2 → 8.3% for this H2). However, the Company has been experiencing a quarterly variability such that the fourth quarter (Q4: Jan. to Mar.) has been contributing the most to the full-year results. Therefore, although the achievement of H2 targets may seem somewhat difficult at this point, there is a chance that the Company may catch up to its plan as it approaches the end of the fiscal year. Compared to its competitors – HIMACS experienced a 7.6% rise in sales but a 28.7% decline in profit (due to unprofitable projects) and Toho System Science recorded a 4.6% decline in sales and a 11.2% drop in profit (operating profit for both companies) in H1 (ending Sept. 2019) – the Company's performance is strong, maintaining growth in sales and profit.

- We, at Alpha-Win Research Department, revised our full-year financial forecast in considering the H1 sales and profit that were affected by the unprofitable projects (Alpha-Win Research Department's initial→current forecast: for sales, Y15.4 billion → Y15.2 billion; for operating profit, Y1,080 million → Y1,070 million; no change to recurring profit and other items that follow). However, we are still keeping our previous 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." Also, 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, resulting in a steady rise in the number of orders received during this H1 and the order backlog at the end of the same period by 2.8% and 8.5% YoY, respectively. Therefore, we have not made large changes to the full-year forecast at this point. While it was a surprise that some projects turned out to be unprofitable, since the Company has been reinforcing project management in recent years, the effect of those projects has mostly diminished as of the end of H1 (the impact on quarterly loss/profit in the order of last year's Q4 → this year's Q1 → Q2 in million yen: -52 → -15 → -27). Going forward, since the Company plans to strengthen customer communication, accumulate and utilize know-how, and conduct thorough quality control, we believe that the projects are unlikely to become a major concern. In H2 and onward, their effect on the loss/profit and the effectiveness of the reoccurrence prevention measures should be watched.

- 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, significantly outperforming the 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 11/15/2019: P/E of 15.74, P/B of 1.24, and simple-average dividend yield of 1.90%) and its competitors (HIMACS and Toho System Science; Figure 6), the Company's valuation is about average. Going forward, if the Company could continue to demonstrate a 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 has little to do with international relations or fluctuations in forex. The stock is characterized as having a stock price that is relatively low in volatility. Therefore, in situations where the entire stock market suddenly rises in price, the Company's stock may get a late start.
- In the past ten years or so, the stock price has increased by about four times and has been largely outperforming the TOPIX. Regarding the stock price, short-term points of interest are the quarterly financial performance and the trend in the orders received. Over the medium term, we should watch the change in profit margins and profit growth rates in the next fiscal year (the final year of the current medium-term plan), contents of the next medium-term business plan, 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 11/15 closing)	785	1,972	919
Market Cap (Y mil)	11,995	12,239	12,743
P/E (price-to-earnings ratio)	15.8	17.9	14.4
P/B (price-to-book ratio)	2.0	1.2	1.6
Dividend Yield (%)	2.3	2.5	2.7
EV/EBITDA	9.1	6.7	5.2
P/S (price-to-sales ratio)	0.8	0.8	0.9

Market cap= (shares outstanding) x (market share price [at 11/15/2019 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 H1 (ending Sept. 2019) were used in P/B calculations.

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

*Values for interest-bearing debt and cash & deposits are actual values from H1.

P/S=market cap / sales [the companies' forecasts for FY 2020]

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

FY		Sales (Y mill)	YOY (%)	O.P. (Y mill)	YOY (%)	R.P. (Y mill)	YOY (%)	N.P. (Y mill)	YOY (%)	EPS (Y)	BPS (Y)	Dividend (Y)
3/2017		12,899	2.2	781	-17.7	811	-15.5	551	-12.3	39.15	346.47	14.0
3/2018		13,559	5.1	855	9.5	892	10.0	567	2.9	40.59	372.23	16.0
3/2019		14,325	5.6	921	7.8	959	7.5	596	5.1	43.25	393.29	16.0
3/2020	CE	15,500	8.2	1,090	18.3	1,090	13.6	684	14.6	49.58	-	18.0
3/2020	E	15,200	6.1	1,070	16.2	1,080	12.6	680	14.1	50.04	426.38	18.0
3/2021	E	16,500	8.6	1,200	12.1	1,200	11.1	750	10.3	55.20	463.58	18.0
3/2022	E	17,800	7.9	1,320	10.0	1,320	10.0	825	10.0	60.72	506.29	20.0
6/2018	Q1	3,082	1.4	109	52.4	132	80.5	76	131.3	5.45	357.23	0.0
6/2019	Q1	3,379	9.6	100	-8.8	107	-19.0	50	-34.2	3.70	379.63	0.0
9/2018	Q2	3,770	9.4	248	6.4	243	4.8	149	1.0	10.88	381.80	0.0
9/2019	Q2	3,691	-2.1	291	17.3	290	19.3	191	28.2	14.13	397.59	8.0
9/2018	H1 (actual)	6,852	5.6	358	17.3	376	23.0	225	24.8	16.33	381.80	0.0
9/2019	H1 (actual)	7,071	3.2	392	9.4	397	5.6	241	7.3	17.83	397.59	8.0
9/2019	H1 (initial CE)	7,437	8.5	424	18.3	424	12.5	250	10.9	18.12	-	8.0
3/2019	H2 (actual)	7,473	5.7	563	2.4	583	-0.5	371	-4.1	26.92	-	16.0
3/2020	H2 (CE)	8,429	12.8	698	24.0	693	18.9	443	19.4	31.75	-	10.0

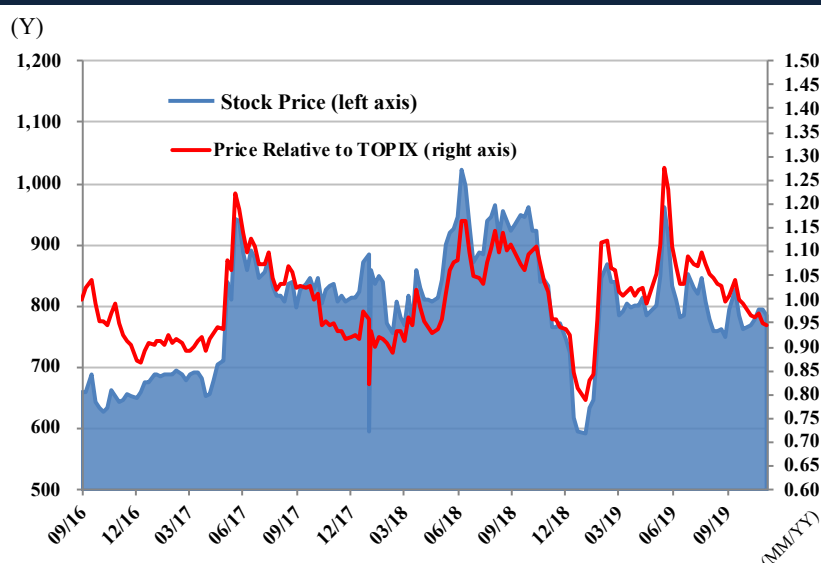
(Note) CE = the Company's estimate/forecast. E = Alpha-Win Research Dept.'s estimate/forecast. Q1 is from April to June, Q2 is from July to September, H1 (first half) is from April to September, and H2 (second half) is from October to March.

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

Item	as of 11/15/2019	Item	P/E	P/B	Dividend Yield	Dividend Payout Ratio
Stock Price (Y)	785	Last FY (actual)	18.2	2.0	2.0%	37.0%
Shares Outstanding (thou.)	15,280	This FY (est.)	15.7	1.8	2.3%	36.0%
Market Capitalization (Y mil)	11,995	Next FY (est.)	14.2	1.7	2.3%	32.6%
Dilutive Shares (thou.)	0	Equity Ratio at This Q2-End	67.4%	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



【Performance】		
Period	Return	vs. TOPIX
1 month	-0.6%	-2.4%
3 months	3.2%	-8.1%
6 months	-14.0%	-23.4%
12 months	1.8%	0.1%

(Note) Reflects stock price and index values up to the closing price on 11/15/2019. However, performance for the most recent one-month period was calculated based on the closing price at the end of Oct. 2019.

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