3676 Digital Hearts Holdings

Sponsored Research
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Sessa Investment Research

Announces Outlook for Sales and Profit Growth in Full-Year FY3/21. Springs into Action to Turn Enerprise Business Profitable Over Full Year and Stage Recovery in Entertainment Business in 2H.

1. 1Q FY3/21 Results

1) Net sales grew 2.1%, as the Enterprise Business expanded sales despite the Entertainmaint Business being affected by COVID-19.

At Digital Hearts Holdings (DHH), in 1Q FY3/21, net sales grew 2.1% YoY, operating profit fell 16.4% YoY, and net profit attributable to owners of parent declined 11.8% YoY.

In the Entertainment Business, net sales fell 11.5% YoY, mainly due to some delays in game title development at client's end and a decline in demand from overseas clients as a result of COVID-19. (See table on next page).

On the other hand, in the Enterprise Business, which DHH is focusing on in the "Second Founding" period, net sales continued to expand significantly, by 59.6% YoY, driven by sales contributions from LogiGear Corporation acquired in August 2019 (LogiGear's Jan-Mar sales booked in DHH's 1Q net sales; estimated at approx. ¥300 million).

DHH's operating profit declined 16.4% YoY, as the negatives in the Entertainment Business (deterioration in gross profit margin on lower sales, decline in gross profit) outweighed the positives in the Enterprise Business (improved gross profit margin on higher sales, increased gross profit, reduction in SG&A expenses).

2) Trends by segment

a) Entertainment Business

In the debugging division, sales for game consoles declined 13.7% YoY, due to the drop-out of the large project booked last year along with the impact of COVID-19. Demand for mobile solutions also temporarily contracted, owing to changes in the market environment and the impact of COVID-19. The utilization ratio of Labs (test centers) fell, resulting in a lower gross profit margin in the Entertainment Business. In response, DHH launched remote debugging and strengthened cost controls, including the consolidation of Labs.

JPY mn	Net Sales	*YoY (%)*	Oper. Profit	*YoY (%)*	Ord. Profit	*YoY (%)*	Profit ATOP	*YoY (%)*	EPS ¥
FY3/17	15,444	*2.9*	1,906	*-2.9*	1,997	*2.0*	795	*120.2*	35.58
FY3/18	17,353	*12.4*	1,735	*-9.0*	1,782	*-10.8*	1,200	*50.9*	55.14
FY3/19	19,254	*11.0*	1,605	*-7.5*	1,651	*-7.4*	1,575	*31.3*	72.13
FY3/20	21,138	*9.8*	1,394	*-13.2*	1,372	*-16.9*	792	*-49.7*	36.21
FY3/21 CE	23,080	*9.2*	1,600	*14.8*	1,600	*16.6*	1,100	*38.9*	51.09
1Q FY3/20	4,988	*12.1*	189	*-37.2*	189	*-37.0*	112	*-38.2*	5.14
1Q FY3/21	5,093	*2.1*	158	*-16.4*	194	*2.5*	99	*-11.8*	4.61

Note: CE = company estimate
Source: Sessa Partners from company materials

FOLLOW-UP

DIGITAL HEARTS HLDGS.

Focus Points

Pioneer specialist firm in software testing. In the "Second Founding" period, focusing on Enterprise Business, which has been expanding sales by 50% per year most recently. Enterprise Business now accounts for 30% of total sales, and profitability is in sight.

Key Indicators	
Share price (Aug. 19)	1,012
YH (Feb. 10, 2020)	1,118
YL (Mar. 23, 2020)	552
10YH (Sep. 29, 2016)	2,200
10YL (Mar. 23, 2020)	552
Shrs. out. (mn, shrs.)	23.890
Mkt cap (¥bn)	24.177
EV (¥bn)	22.984
Shr eqty ratio (Mar. 31)	46.4%
FY3/21 P/E (CE)	19.81x
FY3/20 P/B (act)	4.48x
FY3/20 ROE (act)	16.4%
FY3/21 DY (CE)	1.38%

Share Price Chart 52 Weeks

Source: SPEEDA

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Quarterly Consolidated Earnings Trend by Segment

	FY3/19				FY3/20				FY3/21
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q
Net Sales	**4,451**	**4,882**	**5,059**	**4,861**	**4,988**	**5,234**	**5,455**	**5,457**	**5,093**
YoY	*10.2%*	*15.6%*	*7.7%*	*10.6%*	*12.1%*	*7.2%*	*7.8%*	*12.3%*	*2.1%*
Entertainment Business	**3,798**	**4,074**	**4,199**	**3,876**	**4,032**	**4,093**	**4,320**	**3,664**	**3,569**
YoY	*1.9%*	*5.1%*	*-1.5%*	*4.9%*	*6.2%*	*0.5%*	*2.9%*	*-5.5%*	*-11.5%*
% of SLS	85.3%	83.4%	83.0%	79.7%	80.8%	78.2%	79.2%	67.1%	70.1%
Debugging	3,110	3,282	3,493	3,217	3,444	3,480	3,730	3,167	3,023
YoY	*-4.6%*	*-1.6%*	*-3.1%*	*7.8%*	*10.7%*	*6.0%*	*6.8%*	*-1.6%*	*-12.2%*
% of SLS	69.9%	67.2%	69.0%	66.2%	69.0%	66.5%	68.4%	58.0%	59.4%
Game console	979	1,002	1,157	1,017	1,186	1,056	1,340	1,125	1,023
YoY	*-10.9%*	*4.8%*	*-0.9%*	*7.1%*	*21.1%*	*5.4%*	*15.8%*	*10.6%*	*-13.7%*
% of SLS	22.0%	20.5%	22.9%	20.9%	23.8%	20.2%	24.6%	20.6%	20.1%
Mobile solution	1,993	2,135	2,098	1,944	2,013	2,171	2,141	1,848	1,819
YoY	*16.1%*	*20.2%*	*7.4%*	*-0.4%*	*1.0%*	*1.7%*	*2.0%*	*-4.9%*	*-9.6%*
% of SLS	44.8%	43.7%	41.5%	40.0%	40.4%	41.5%	39.2%	33.9%	35.7%
Amusement	138	144	237	255	245	252	247	193	179
YoY	*-68.9%*	*-76.1%*	*-51.0%*	*218.8%*	*77.5%*	*75.0%*	*4.2%*	*-24.3%*	*-26.9%*
% of SLS	3.1%	2.9%	4.7%	5.2%	4.9%	4.8%	4.5%	3.5%	3.5%
Creative	511	561	422	395	350	307	282	285	311
YoY	*50.3%*	*42.0%*	*-15.1%*	*-22.5%*	*-31.5%*	*-45.3%*	*-33.2%*	*-27.8%*	*-11.2%*
% of SLS	11.5%	11.5%	8.3%	8.1%	7.0%	5.9%	5.2%	5.2%	6.1%
Media and others	176	231	284	264	238	306	308	212	234
YoY	*39.7%*	*59.3%*	*74.2%*	*30.0%*	*35.2%*	*32.5%*	*8.5%*	*-19.7%*	*-1.5%*
% of SLS	4.0%	4.7%	5.6%	5.4%	4.8%	5.8%	5.6%	3.9%	4.6%
Enterprise Business	**652**	**806**	**859**	**983**	**954**	**1,139**	**1,133**	**1,793**	**1,523**
YoY	***109.8%***	***77.1%***	***100.2%***	***41.6%***	***46.3%***	***41.3%***	***31.9%***	***82.4%***	***59.6%***
% of SLS	14.7%	16.5%	17.0%	20.2%	19.1%	21.8%	20.8%	32.9%	29.9%
System testing	260	286	366	483	431	570	488	924	788
YoY	*57.4%*	*58.9%*	*23.2%*	*9.5%*	*65.8%*	*99.3%*	*33.3%*	*91.3%*	*83.1%*
% of SLS	5.8%	5.9%	7.2%	9.9%	8.6%	10.9%	8.9%	16.9%	15.5%
IT service / security	393	520	493	500	524	569	645	869	735
YoY	*168.9%*	*89.1%*	*273.5%*	*97.6%*	*33.4%*	*9.4%*	*30.8%*	*73.8%*	*40.4%*
% of SLS	8.8%	10.7%	9.7%	10.3%	10.5%	10.9%	11.8%	15.9%	14.4%
Operating profit	**302**	**475**	**464**	**364**	**190**	**329**	**548**	**328**	**158**
YoY	*-44.0%*	*2.5%*	*-15.2%*	*96.9%*	*-37.2%*	*-30.9%*	*18.0%*	*-9.8%*	*-16.7%*
Operating profit margin	6.8%	9.7%	9.2%	7.5%	3.8%	6.3%	10.0%	6.0%	3.1%
Entertainment Business	**677**	**834**	**840**	**735**	**727**	**760**	**892**	**585**	**517**
YoY	*-16.6%*	*0.2%*	*-4.4%*	*65.9%*	*7.4%*	*-8.9%*	*6.2%*	*-20.4%*	*-28.9%*
% of Seg.SLS	17.8%	20.5%	20.0%	19.0%	18.0%	18.6%	20.6%	16.0%	14.5%
Enterprise Business	**(58)**	**(61)**	**(76)**	**(30)**	**(184)**	**2**	**14**	**100**	**(21)**
YoY	*--*	*--*	*--*	*--*	*--*	*--*	*--*	*--*	*--*
% of Seg.SLS	-8.9%	-7.6%	-8.8%	-3.1%	-19.3%	0.2%	1.2%	5.6%	-1.4%

Note: Numbers in figures may not be perfectly consistent due to rounding.
Source: Sessa Partners from company materials

b) Enterprise Business

IT investments continued to expand even amidst COVID-19's spread, fueling growth in existing services. In addition, LogiGear's sales contributed. As a result, net sales grew 59.6% YoY in the Enterprise Business. Despite booking a segment loss in 1Q FY3/21, the Enterprise Business has achieved positive EBITDA for four straight quarters.

2. Impact of COVID-19 and Countermeasures

1) Impact on earnings

In the Entertainment Business, which is DHH's mainstay business, net sales fell by over 10% YoY. However, this was due to development delays at clients, and it does not mean that the virus caused hindrances in the firm's operation structure. As such, earnings should pick up going into 2H, once development at clients start to recover.
Meanwhile, in the Enterprise Business, COVID-19 appears to have had a modest impact on sales activities for new client acquisition.

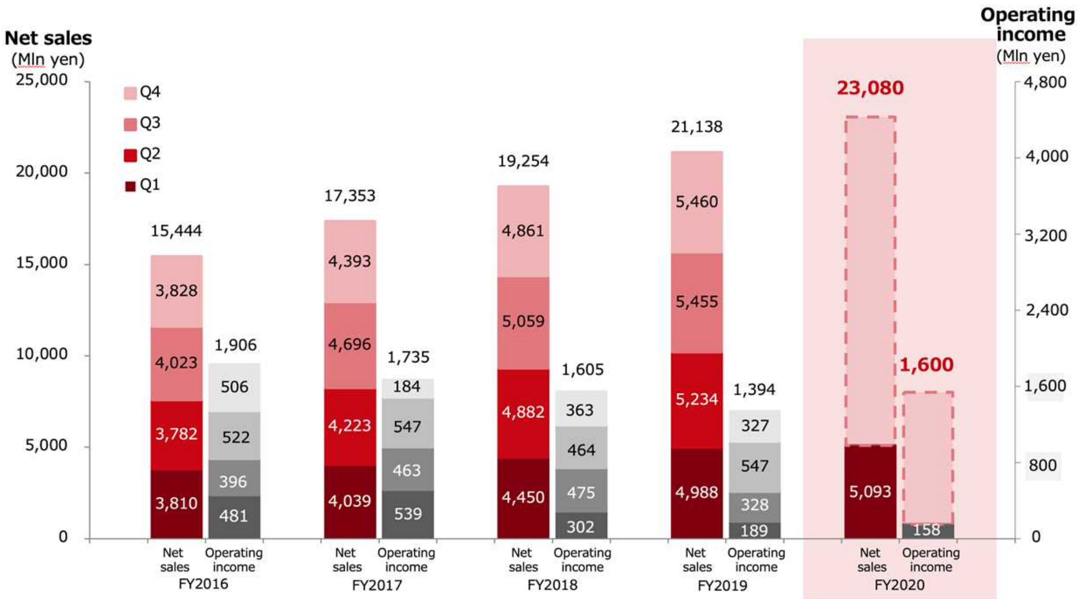
2) Response at development sites

In the Entertainment Business, debugging services are conducted in Labs, which are susceptible to the "Three Cs" (closed spaces, crowded places, close-contact settings), due to many testers gathering. However, the company took various measures to curb the spread of the virus and shifted to a structure that mitigates the risk of the Three Cs. As a result, there have been no infections so far among the firm's employees.
As explained earlier, DHH launched remote debugging. Currently, there are around 160 testers conducting remote debugging. Going forward, the firm is considering to increase the ratio of debugging work done remotely to 10–20% while obtaining client approval.

3. Full-year FY03/21 guidance: Expects OP growth for first time in five years

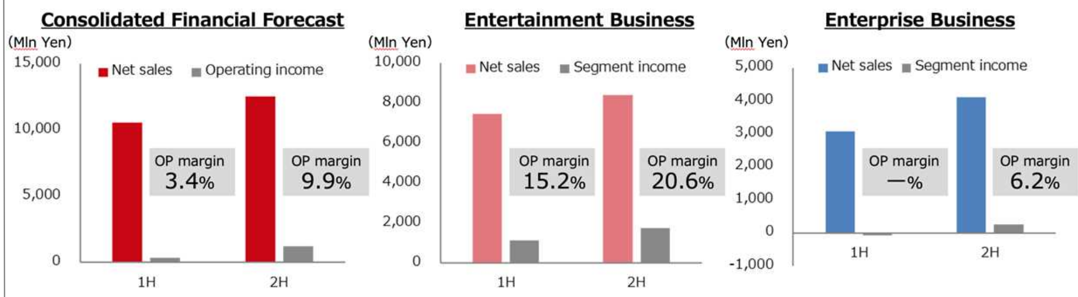
DHH left full-year forecasts undecided at the time of announcing FY03/20 results. However, this time, it disclosed the following forecasts based on 1Q results and recent trends: net sales of ¥23,080 million (+9.2% YoY), operating profit of ¥1,600 million (+14.8% YoY), ordinary profit of ¥1,600 million (+16.6% YoY), and net profit attributable to owners of parent of ¥1,100 million (+38.9% YoY).

Consolidated quarterly results and full-year sales/OP forecasts



Source: Company materials (earnings presentation for 1Q FY3/21)

FY03/21 guidance: 1H and 2H



Source: Company materials (earnings presentation for 1Q FY3/21)

The 1H and 2H outlook break down as follows.

1H outlook: net sales up, operating profit down.

—DHH expects nets sales to increase YoY, supported by the ongoing robust growth in the Enterprise Business, but operating profit to decrease YoY due to a drop in net sales in the Entertainment Business.

2H outlook: net sales up, operating profit up.

—Assuming the tumult around COVID-19 will quiet down, DHH expects net sales in the Entertainment Business to expand YoY as debugging enters the busy period, and the segment profit margin to recover. In the Enterprise Business, it expects to achieve ongoing growth and full-year profitability. In 2H overall, it forecasts a rise in both sales and profit.

In the past, DHH made bullish earnings forecasts, while results frequently came in short of the targets. However, we believe the firm is highly likely to achieve the forecasts for FY3/21 in consideration of the following points.

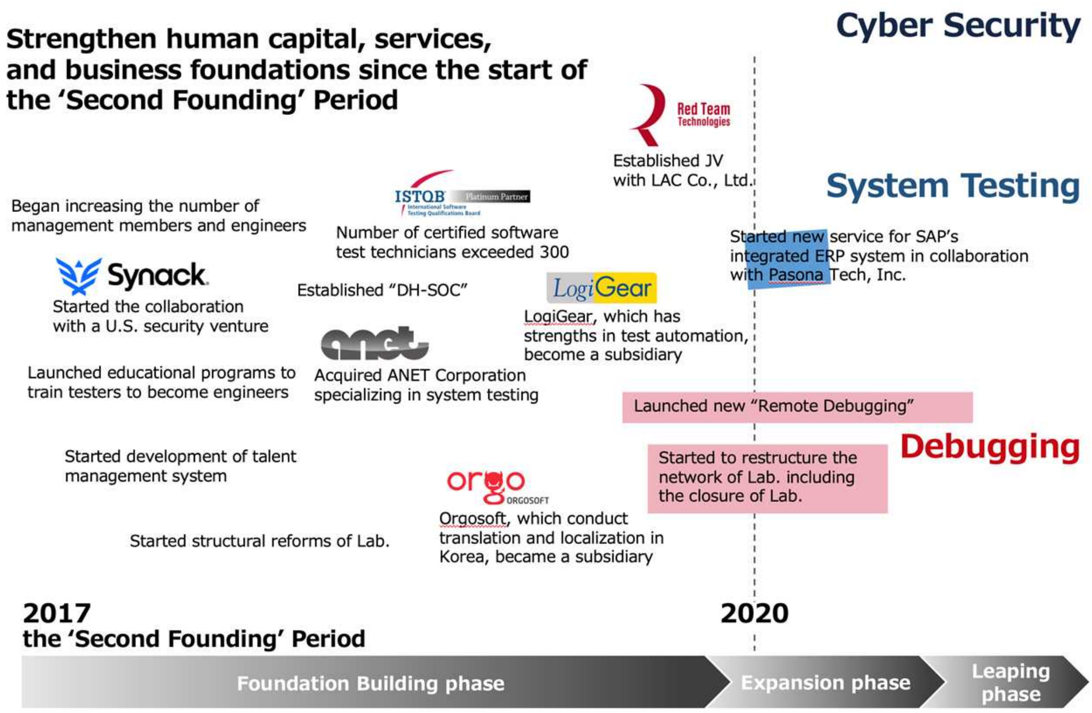
1) The Enterprise Business is expected to see continued robust growth and contribute to a profit trajectory in terms of earnings, spurred in part by digital transformation (DX).
2) Debugging in the Entertainment Business does not have issues in the supply structure and will enter the busy period heading into year-end. Hence, sales should move upwards once demand for debugging recovers at clients.

(However, the impact of COVID-19 warrants continued caution.)

4. Progress in the "Second Founding" period and share price performance

DHH made a full-scale entry into the Enterprise Business, calling the current stage of the business a "Second Founding" period, and has subsequently executed various measures and investments (see figure on the next page). However, the firm's share price has underperformed the market, as profits have continued to decline due to a run-up in strategic investments. The sales weighting of the Enterprise Business exceeded 20% in FY3/20, and the segment turned EBITDA positive on a quarterly basis starting from 2Q FY3/20. In FY3/21, full-year profitability in terms of segment profit is in the cards.

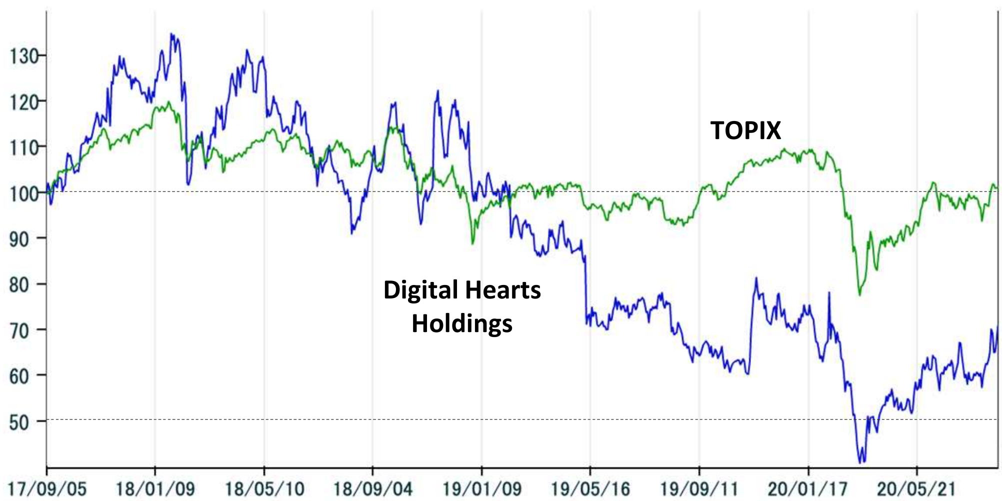
Progress in the "Second Founding" period



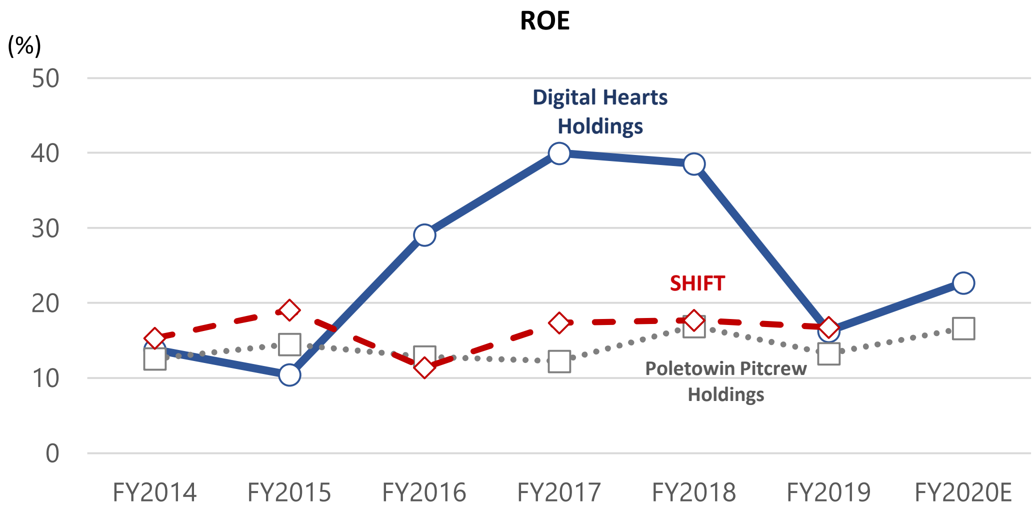
Source: Company materials (earnings presentation for 1Q FY3/21)

Meanwhile, securing personnel will be critical in expanding the top line, given that the software industry is labor-intensive. The supply-demand of highly skilled IT personnel remains tight. For the Enterprise Business to continue to deliver strong growth, further tactics such as M&A may be required.

Relative performance (vs. TOPIX)



Source: Sessa Partners from SPEEDA data



Note: FY2020E figures are based on company estimates in FY3/21 for Digital Hearts Holdings and in FY1/21 for Poletowin Pitcrew Holdings. For SHIFT, FY2019 is a forecast ROE based on company estimates.
Source: Sessa Partners from SPEEDA and each company's financial data

The Enterprise Business is gradually shaping up to be the firm's second earnings driver, as initially envisioned by the management team. DHH targets an ROE of 22.3% in FY3/21, underpinned by its full-year forecast for sales and profit growth. Going forward, whether progress is made in the reassessment of the share price bears attention.

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