

4847 INTELLIGENT WAVE INC.

Sponsored Research
February 12, 2021

 Sessa Investment Research

1H results topped guidance despite COVID-19

Posted record for 2Q sales and 2Q OPM achieved 9.2%

SUMMARY

- The company announced 1H results at 15:30 after the close on 2/3, and held a virtual results briefing on 2/5, hosted by newly appointed CEO Kunimitsu Sato and GM of the Business Planning Dept. Yoshihiro Fujisawa. 1H FY6/21 results are summarized in the table below. Following the roughly 5% decline in 1Q sales and profits, 1H actual results topped guidance, with both sales and OP beating initial guidance by 5%+. 2Q results were impressive, with net sales of ¥2,949mn (+15.7% YoY), posting a record for the 2Q exceeding the last 5 years. OP of ¥271mn (+19.7%) achieved OPM of 9.2%, confirming that efforts aimed at structural improvement of profitability are steadily beginning to appear in results.
- 1Q results had been affected by delay in a system development project, which was caught up in the 2Q. While sales declined for its top customer and parent company DNP, that was as expected and is factored into initial guidance. More importantly, this was offset by a FEP system upgrade project including profitable replacement hardware sales for a credit card issuer. Focus initiative cloud service sales rose +20% YoY as a new customer came on line.
- Over the last 3 months, relative to the +13.1% rally in TOPIX, IWI's share price actually declined -0.7%, continuing underperformance from the previous 3 months after strong 4Q results in August and ahead of weak 1Q results announced in early November. IWI's P/E is now trading at a 19.8% discount to its historical average. Based on the company's visibility and expectations for gains in sales and profits to continue in 3Q results to be announced in May, we believe a good case can be made for a short-term rebound trade going into 3Q results. The long-term driver of the share price is structural improvement of profitability, as cloud services business gains critical mass and turns profitable, and the company successfully addresses and eliminates losses in security business.

IWI 1H FY6/21 Financial Results Summary

JPY mn, %	1Q 6/21	2Q 6/21	1H 6/21	1H 6/21	CHG AMT	CHG PCT
	act	act	act	CE	vs 1H CE	vs 1H CE
Net sales	2,299	2,949	5,248	5,000	248	5.0
Operating profit	134	271	406	380	26	6.7
Ordinary profit	129	293	421	400	21	5.3
Net profit	84	202	286	280	6	2.0
YoY	1Q 6/21	2Q 6/21	1H 6/21a	1H 6/21e		
Net sales	(4.9)	15.7	5.7	0.7	—	—
Operating profit	(4.8)	19.2	10.0	3.0	—	—
Ordinary profit	(8.8)	33.5	17.0	11.1	—	—
Net profit	(8.3)	38.4	20.5	18.1	—	—

Source: compiled by Sessa Partners from TANSBIN financial statements.

2Q Follow-up



Focus Points:

Systems integrator boasting an overwhelming share with credit card companies in FEP systems development for nonstop secure datacenter connection packages.

Key Indicators

Share price (2/9)	711	
YH (20/8/6)	918	
YL (20/3/23)	398	
10YH (18/10/24)	1,180	
10YL (12/11/9)	163.8	
Shrs out. (mn shrs)	26.340	
Mkt cap (¥ bn)	18.73	
EV (¥ bn)	14.99	
Shr equity ratio	67.8%	
21.6	P/E (CE)	22.8x
21.6	EV/EBITDA (CE)	8.0x
20.6	H1 P/B (act)	2.64x
20.6	ROE (act)	11.4%
21.6	DY (CE)	1.41%

1Y price chart (weekly)



Source: SPEEDA price database

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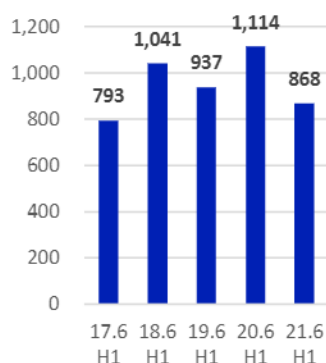
IWI Sales by Product/Service Category

JPY mn, %	Flow/ stock	21.6 Q1 act	CHG AMT	21.6 Q2 act	CHG AMT	21.6 H1 act	CHG AMT	21.6 H2 CE	CHG AMT	FY6/21 CE	CHG AMT
Net sales		2,298	(119)	2,949	399	5,247	280	5,753	(200)	11,000	80
• System software development	flow	1,113	(138)	1,324	1	2,437	(137)	2,925	(292)	5,362	(429)
• Software maintenance	stock	315	14	332	27	647	41	637	(3)	1,284	38
• In-house package software	flow	144	47	65	(17)	209	30	188	123	397	153
• Cloud service	stock	224	46	246	34	470	80	470	32	940	112
• Hardware	flow	208	(145)	664	337	872	192	622	(224)	1,494	(32)
• Third party package software	flow	110	49	130	96	240	145	183	58	423	203
• Security products	flow	181	8	188	(79)	369	(71)	731	108	1,100	37
YoY		21.6 Q1		21.6 Q2		21.6 H1		21.6 H2		FY6/21	
Net sales		(4.9)	—	15.6	—	5.6	—	(3.4)	—	0.7	—
• System software development	flow	(11.0)	—	0.1	—	(5.3)	—	(9.1)	—	(7.4)	—
• Software maintenance	stock	4.7	—	8.9	—	6.8	—	(0.5)	—	3.0	—
• In-house package software	flow	48.5	—	(20.7)	—	16.8	—	189.2	—	62.7	—
• Cloud service	stock	25.8	—	16.0	—	20.5	—	7.3	—	13.5	—
• Hardware	flow	(41.1)	—	103.1	—	28.2	—	(26.5)	—	(2.1)	—
• Third party package software	flow	80.3	—	282.4	—	152.6	—	46.4	—	92.3	—
• Security products	flow	4.6	—	(29.6)	—	(16.1)	—	17.3	—	3.5	—

One thing worth flagging is that 2Q orders declined -15% YoY. However, the company noted that strong 1Q orders included roughly ¥700mn for hardware and ¥200mn for cloud service. Despite the challenging macro environment due to COVID-19, weakness in one major client is being made up by others. Ultimately, backlogs remain at a high level, and high-margin system development backlogs managed to continue rising in the 2Q, so the company has visibility on sales and profit growth continuing in the 3Q.

DNP

DNP 1H Sales (JPY mn)



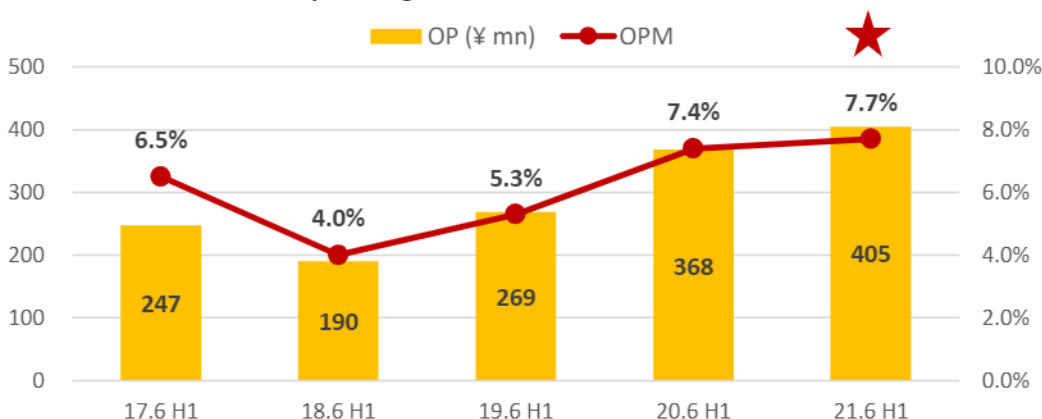
Source: company IR materials

IWI 1H Sales by Top 3 Customers

JPY mn	20.6 H1	21.6 H1	CHG	Main projects
1) DNP	1,114	868	(246)	TSP system (smartphone payment), system operations (24/365), payment platform
2) Credit card issuer	236	662	426	Development and hardware sales for FEP replacement
3) System dev. co.	124	551	427	FEP system for telecom co. credit card business, fraud detection

Source: compiled by Sessa Partners from company IR materials

IWI 5-Year Trend of 1H Operating Profit and OPM

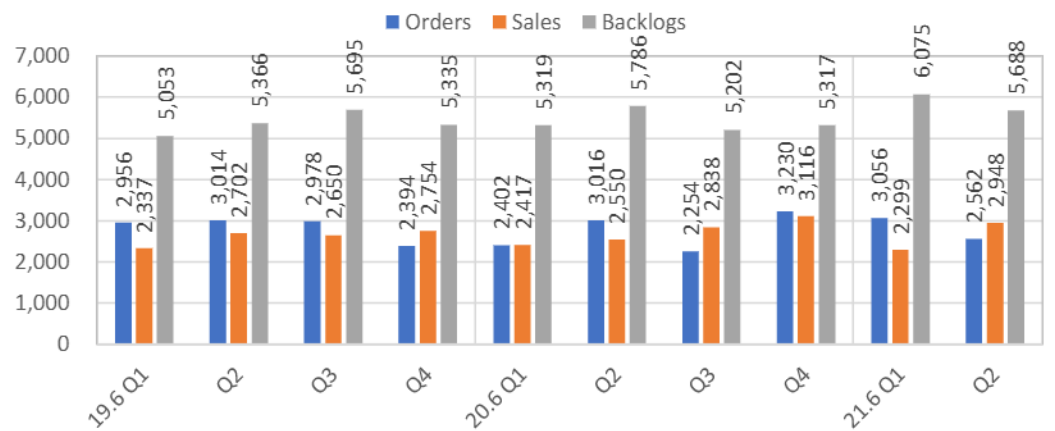


IWI Quarterly Trend of Orders, Sales and Backlogs

JPY mn, %	Orders	YoY	Sales	YoY	Backlogs	QoQ
19.6 Q1	2,956	6.7	2,337	0.6	5,053	14.0
Q2	3,014	28.5	2,702	14.0	5,366	6.2
Q3	2,978	21.6	2,650	(15.5)	5,695	6.1
Q4	2,394	(8.1)	2,754	(0.8)	5,335	(6.3)
20.6 Q1	2,402	(18.7)	2,417	3.4	5,319	(0.3)
Q2	3,016	0.1	2,550	(5.6)	5,786	8.8
Q3	2,254	(24.3)	2,838	7.1	5,202	(10.1)
Q4	3,230	34.9	3,116	13.1	5,317	2.2
21.6 Q1	3,056	27.2	2,299	(4.9)	6,075	14.3
Q2	2,562	(15.1)	2,948	15.6	5,688	(6.4)

Source: compiled by Sessa Partners from company IR materials

2Q posted record net sales for the 2Q exceeding the last 5 years helped by the systems development project delayed from the 1Q along with strong replacement hardware sales

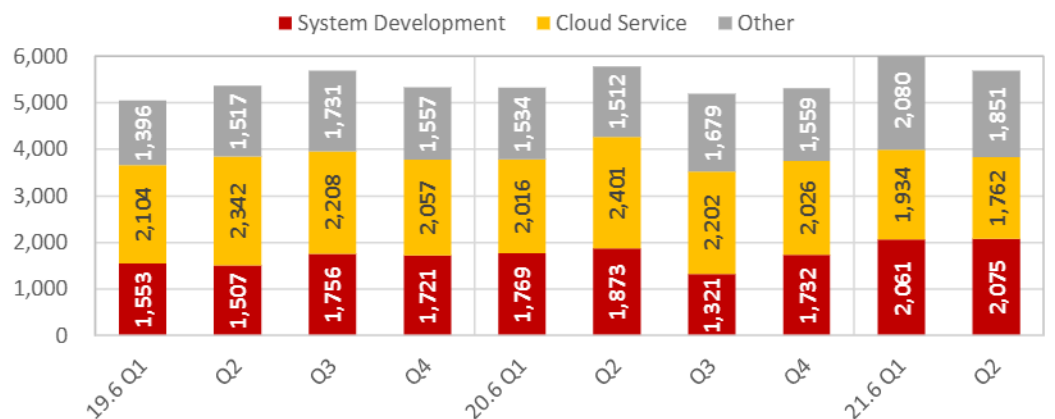


IWI Quarterly Trend of Backlogs by Category

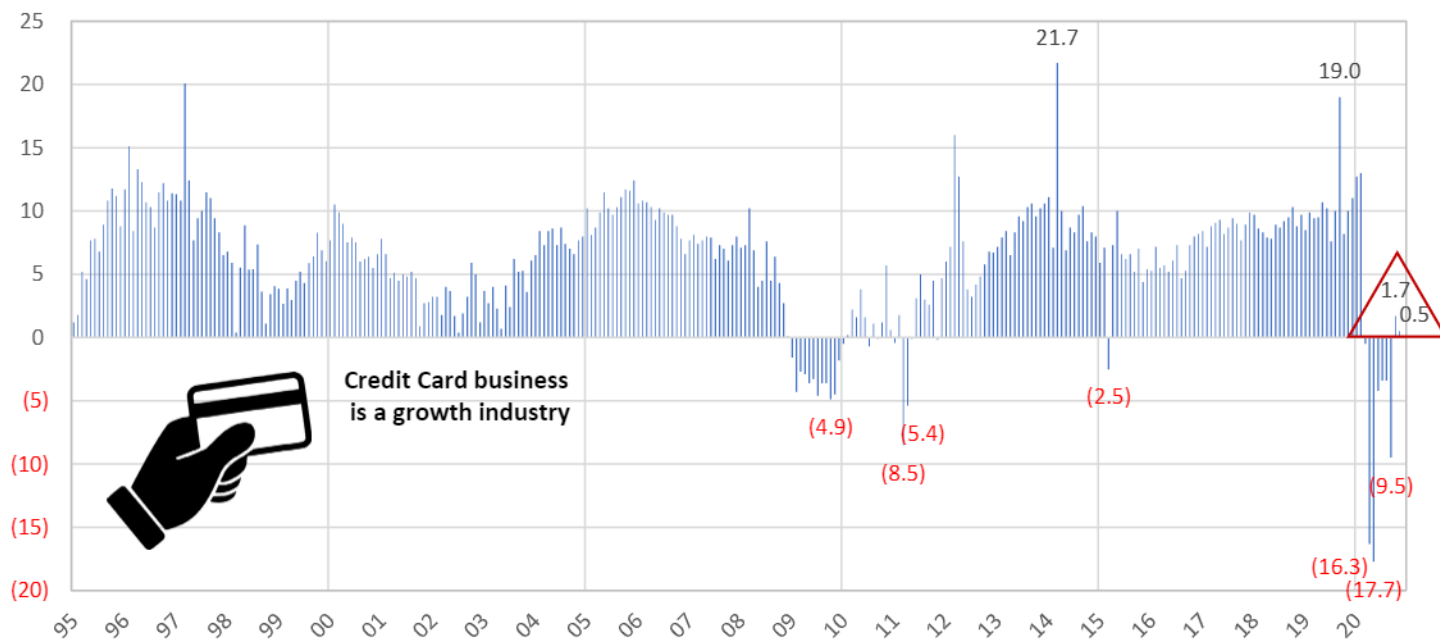
JPY mn, %	System Devpt.	QoQ	Cloud Service	QoQ	Other	QoQ
19.6 Q1	1,553	0.3	2,104	30.3	1,396	9.8
Q2	1,507	(3.0)	2,342	11.3	1,517	8.7
Q3	1,756	16.5	2,208	(5.7)	1,731	14.1
Q4	1,721	(2.0)	2,057	(6.8)	1,557	(10.1)
20.6 Q1	1,769	2.8	2,016	(2.0)	1,534	(1.5)
Q2	1,873	5.9	2,401	19.1	1,512	(1.4)
Q3	1,321	(29.5)	2,202	(8.3)	1,679	11.0
Q4	1,732	31.1	2,026	(8.0)	1,559	(7.1)
21.6 Q1	2,061	19.0	1,934	(4.5)	2,080	33.4
Q2	2,075	0.7	1,762	(8.9)	1,851	(11.0)

Source: compiled by Sessa Partners from company IR materials

The trend for high-margin system development backlogs is still rising sequentially



METI Current Survey of Selected Service Industries: YoY Monthly Trend of Total Credit Card Transactions



Source: Ministry of Economy, Trade and Industry monthly data from Jan-1995 — Nov-2020. Note: average monthly growth over the period is +6.2% YoY.

Growth Outlook:
The primary driver of FEP orders is credit card capex

- Transaction value +8-10% CAGR
- Credit card capex +5-7% CAGR
- IWI FEP orders +3-5% CAGR

Source: IR handout material
Note: growth ests added by Sessa Partners



FEP (front-end processing):
Credit card on-premise infrastructure for authorization center connection packages

IWI's parent company is Dai Nippon Printing (50.6% stake), which is also the largest customer, accounting for annual sales of roughly ¥2bn out of ¥10-11bn total sales. **One concern for IWI by investors is the difficult earnings environment for DNP, which has a high gearing to general economic activity, and current earnings are struggling.**

IWI belongs in the sector of systems integrators (SI) focused on financial systems. IWI's specialty is in developing FEP (front-end processor) systems for credit card companies, specifically on-premise infrastructure in the form of authorization center connection packages (system software development + hardware). Sessa Partners estimates IWI has a 70-80% overwhelming share in this market. Credit card companies have been enjoying robust structural growth not only from the ongoing shift to e-commerce, but also from government policy promoting raising the ratio of cashless payments.

The graphic on the left highlights the point that the primary driver of FEP orders is credit card company capex. The graph above shows the YoY monthly trend of total credit card transactions. For the last 25 years and 11 months of 2020, growth averaged +6-7% over the entire period, +8-10% over the last 5 years. Until this year, there were only 3 cases of declines: the financial crisis in 2009, March and April 2011 after the earthquake and tsunami, and Mar-2015 in reactionary decline to frontloading demand ahead of the consumption tax hike in Apr-2014. In stark contrast, April and May this year under stay-at-home orders posted high double-digit declines, and they continued -3% to -4% declines from June through August. The -9.5% for Sep-2020 was a reactionary decline to frontloading demand ahead of the consumption tax hike in Oct-2019. While the shift to teleworking and spending more time at home gave a boost to e-commerce, use of restaurants and bars dropped sharply, and occupancy at hotels cratered in the wake of travel restrictions. **Another concern for IWI is that credit card companies may seek to push out ongoing capex projects given the tough environment, although no signs of that have appeared yet, according to IWI.**

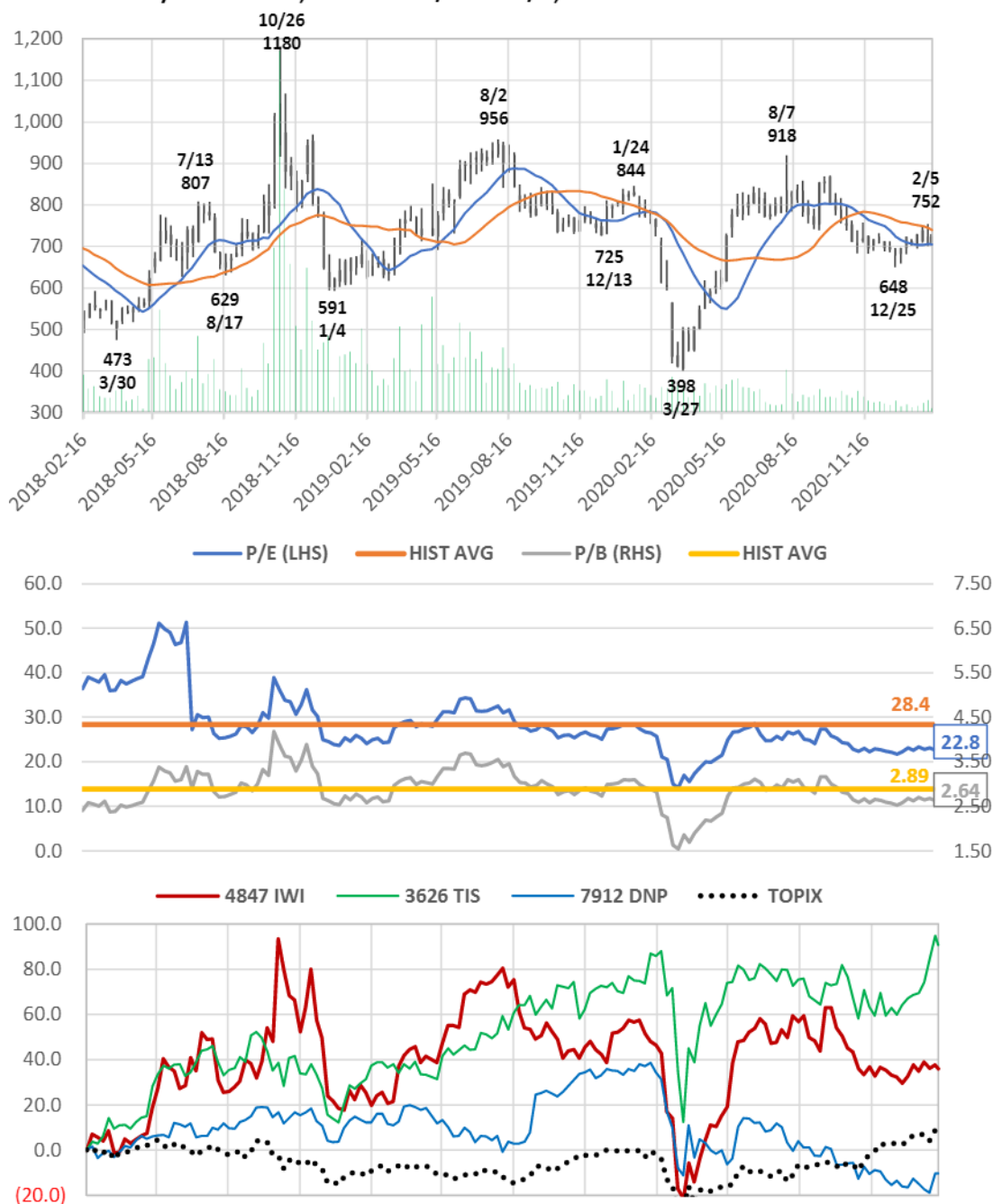


SESSA Smart Charts

Share price trend, valuations and relative performance

- Over the last 3 months, relative to the +13.1% rally by TOPIX and +16.8% gain by competitor 3626 TIS, 4847 IWI actually declined -0.7%, even underperforming parent 7912 DNP (+0.3%), which has stopped falling. IWI also underperformed in the previous 3 months following strong 4Q results in August, and leading up to 1Q declines in both sales and profits announced in November.
- IWI's valuations are now trading on discounts, with a P/E of 22.8x trading 19.8% below its 3-year avg., and a 1H P/B of 2.64x trading 8.5% below its 3-year avg.
- Based on the company's visibility and expectations for gains in sales and profits to continue in 3Q results to be announced in May, we believe a good case can be made for a short-term rebound trade going into 3Q results.**

3-Year Weekly Share Price, Historical P/E and P/B, and Relative Performance



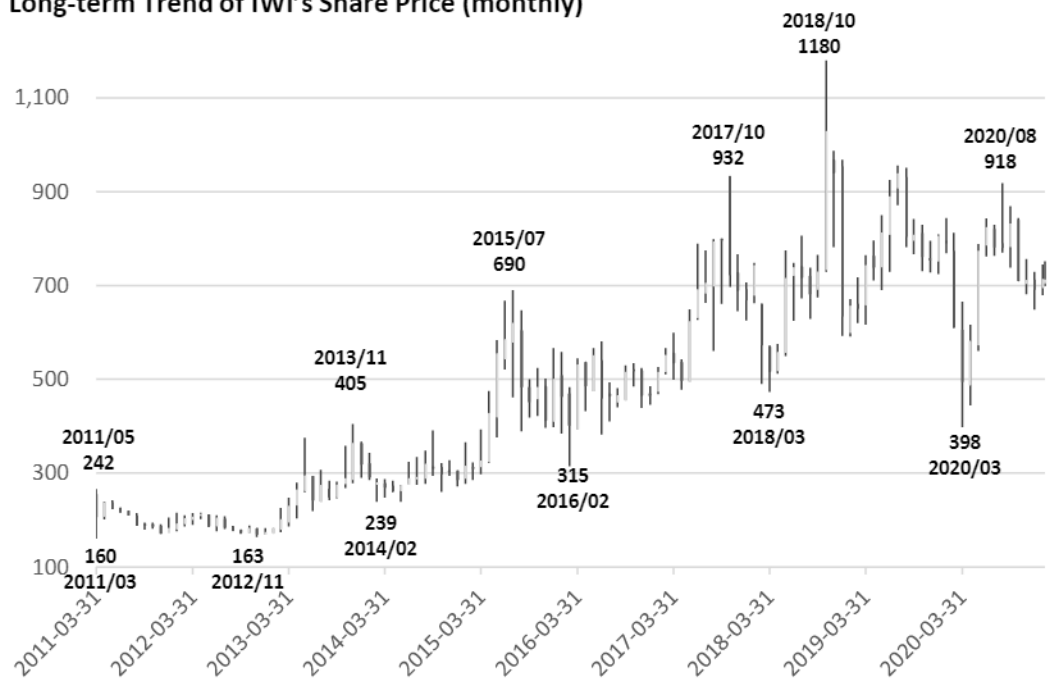


Analyst's view

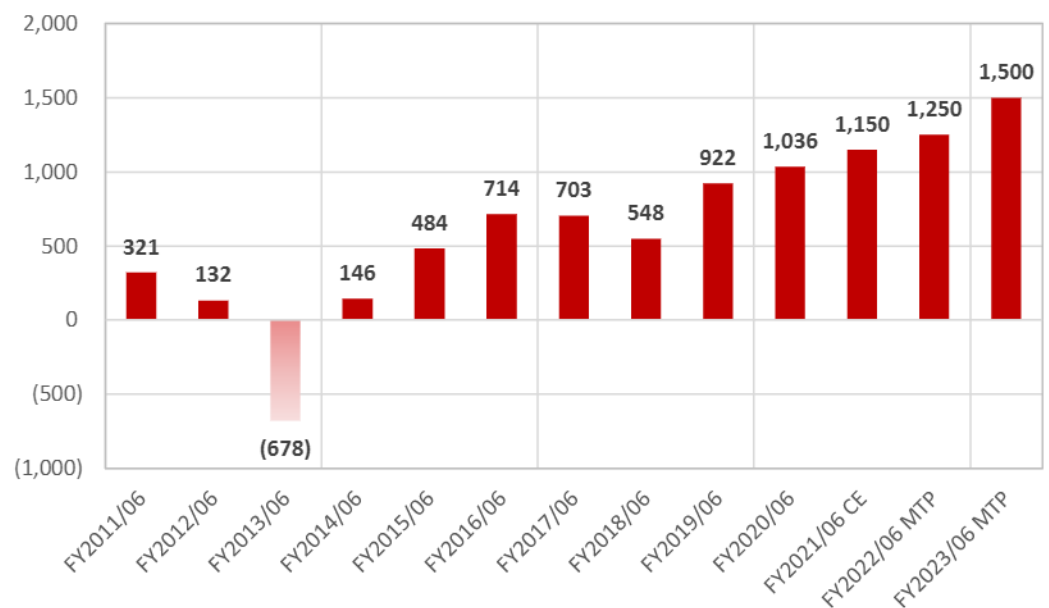
Structural profitability improvement is the key share price driver

- 1) One of the unavoidable characteristics of system integrator business is a certain amount of order volatility due to macroeconomic impacts on client capex. A focus initiative is switching to a recurring (stock) revenue model for cloud services. As startup costs disappear and revenue gains critical mass, it is set to turn profitable.
- 2) Eliminating losses associated with security business will be another key driver. Low margins have been partly a function of heavy upfront costs in educating clients. Management is exploring potential tie-up partners, as well as managed services.

Long-term Trend of IWI's Share Price (monthly)



Long-term Trend of IWI Operating Profit (JPY mn)



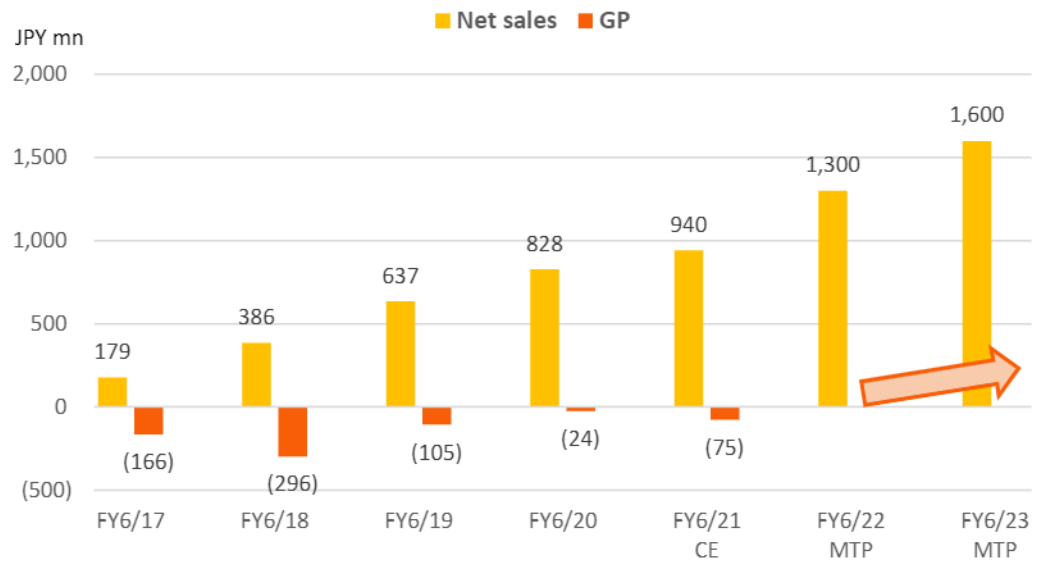
Source: compiled by Sessa Partners from SPEEDA earnings database.
 Note: MTP forecasts from company IR materials

Cloud Services

According to the Japanese Bankers Association (JBA), as of December 2019, there are 64 regional banks, and 39 type-2 regional banks, for a total of 103. IWI identified a major business opportunity here, targeting regional banks considering to become credit card issuers. IWI's IOASIS cloud service to support acquiring merchants is the only one of its kind available.

Given the smaller scale relative to the megabanks, the initial investment burden for installing their own FEP switching system is a potential barrier. By porting IWI's proprietary Net+1 and AcePlus into cloud service solutions, the benefit to the regional bank client is an affordable scheme to lease the service, fixing the running costs including maintenance. **In return, IWI gets a recurring revenue stream that is scalable.**

Focus initiative: shifting to a recurring (stock) revenue model based on cloud services



Source: compiled by Sessa Partners from IR results briefing materials



Cloud Service	Functionality
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IOASIS: Merchant acquiring

IFINDS: Fraud detection

IGATES: Switching, gateway

IPRETS: Point rebate system

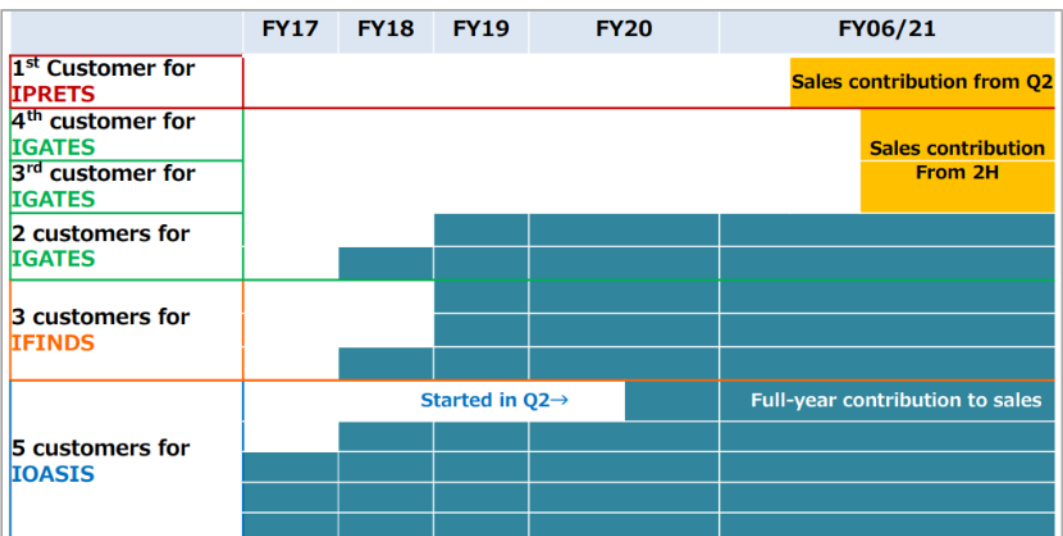
FY6/21: Upfront investment results in higher costs, expecting 3 new clients

	FY06/17 actual	FY06/18 actual	FY06/19 actual	FY06/20 actual	FY06/21 forecast
Net sales	179	386	637	828	940
Gross profit (loss)	(166)	(296)	(105)	(24)	(75)

Services and customers	IPRETS	IGATES	IFINDS	IOASIS
	0	0	0	3
	0	1	1	4
	0	2	3	4
	0	2	3	5
	1	4	3	5



Regional Banks (approx. 100)



IPRETS (Point system): Started in October

Source: IR results briefing materials

INTELLIGENT WAVE INC. Earnings Seasonality Analysis

J-GAAP	JPY mn, %	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1H	2H	FY	1H	2H	FY
		Earnings				Progress ratio				Earnings			Progress ratio		
FY6/16	Net sales	1,331	1,665	1,891	2,320	18.5%	23.1%	26.2%	32.2%	2,996	4,211	7,207	41.6%	58.4%	100.0%
Consol	Oper. profit	34	169	227	284	4.8%	23.7%	31.8%	39.8%	203	511	714	28.4%	71.6%	100.0%
	Ord. profit	41	175	230	285	5.6%	23.9%	31.5%	39.0%	216	515	731	29.5%	70.5%	100.0%
	Profit ATOP	34	112	141	192	7.1%	23.4%	29.4%	40.1%	146	333	479	30.5%	69.5%	100.0%
FY6/17	Net sales	1,654	2,139	2,264	2,413	19.5%	25.3%	26.7%	28.5%	3,793	4,677	8,470	44.8%	55.2%	100.0%
Non-Con	Oper. profit	38	210	275	180	5.4%	29.9%	39.1%	25.6%	248	455	703	35.3%	64.7%	100.0%
	Ord. profit	37	238	289	202	4.8%	31.1%	37.7%	26.4%	275	491	766	35.9%	64.1%	100.0%
	Net profit	20	172	214	141	3.7%	31.4%	39.1%	25.8%	192	355	547	35.1%	64.9%	100.0%
FY6/18	Net sales	2,322	2,371	3,136	2,775	21.9%	22.4%	29.6%	26.2%	4,693	5,911	10,604	44.3%	55.7%	100.0%
Non-Con	Oper. profit	129	61	177	181	23.5%	11.1%	32.3%	33.0%	190	358	548	34.7%	65.3%	100.0%
	Ord. profit	128	69	176	201	22.3%	12.0%	30.7%	35.0%	197	377	574	34.3%	65.7%	100.0%
	Net profit	83	46	109	139	22.0%	12.2%	28.9%	36.9%	129	248	377	34.2%	65.8%	100.0%
FY6/19	Net sales	2,337	2,702	2,650	2,754	22.4%	25.9%	25.4%	26.4%	5,039	5,404	10,443	48.3%	51.7%	100.0%
Non-Con	Oper. profit	71	198	407	246	7.7%	21.5%	44.1%	26.7%	269	653	922	29.2%	70.8%	100.0%
	Ord. profit	79	203	406	266	8.3%	21.3%	42.6%	27.9%	282	672	954	29.6%	70.4%	100.0%
	Net profit	48	157	262	217	7.0%	23.0%	38.3%	31.7%	205	479	684	30.0%	70.0%	100.0%
FY6/20	Net sales	2,417	2,550	2,838	3,116	22.1%	23.3%	26.0%	28.5%	4,967	5,954	10,921	45.5%	54.5%	100.0%
Non-Con	Oper. profit	141	228	217	450	13.6%	22.0%	20.9%	43.4%	369	667	1,036	35.6%	64.4%	100.0%
	Ord. profit	141	219	241	474	13.1%	20.4%	22.4%	44.1%	360	715	1,075	33.5%	66.5%	100.0%
	Net profit	91	146	161	364	11.9%	19.2%	21.1%	47.8%	237	525	762	31.1%	68.9%	100.0%
5Y AVG	Net sales	2,012	2,285	2,556	2,676	21.1%	24.0%	26.8%	28.1%	4,298	5,231	9,529	45.1%	54.9%	100.0%
	Oper. profit	83	173	261	268	10.5%	22.1%	33.2%	34.2%	256	529	785	32.6%	67.4%	100.0%
	Ord. profit	85	181	268	286	10.4%	22.0%	32.7%	34.8%	266	554	820	32.4%	67.6%	100.0%
	Net profit	55	127	177	211	9.7%	22.2%	31.1%	37.0%	182	388	570	31.9%	68.1%	100.0%
											CE	CE		CE	CE
FY6/21	Net sales	2,299	2,949	—	—	20.9%	26.8%	—	—	5,248	5,752	11,000	47.7%	52.3%	100.0%
Non-Con	Oper. profit	134	272	—	—	11.7%	23.7%	—	—	406	744	1,150	35.3%	64.7%	100.0%
	Ord. profit	129	292	—	—	10.8%	24.5%	—	—	421	769	1,190	35.4%	64.6%	100.0%
	Net profit	84	202	—	—	10.2%	24.6%	—	—	286	534	820	34.9%	65.1%	100.0%

5-Year Basic Earnings Analysis to Gauge Current Performance

- ◆ **Seasonality (progress ratios above)**
 - While 1Q was in line with the 5Y AVG, 2Q was nicely ahead for sales and profits
 - The strong 1H reflects solid 4Q and 1Q orders
- ◆ **YoY Trend (top of following page)**
 - 1Q sales and profits declined in part due to delays in a development project
 - Strong growth in the 2Q raises potential to achieve bullish 2H guidance
- ◆ **Margins (bottom of following page)**
 - Record sales for the 2Q were driven by strong hardware replacement
 - Profitable hardware margins boosted 2Q OPM to 9.2%

1H 6/21 conclusion and takeaways:

- According to the company, it has good visibility on the 3Q, and expects gains in both sales and profits to continue (3Q results TBA in May).
- However, we believe it is too early to have expectations for a 2H overshoot, given implied 2H guidance has a high hurdle targeting OPM of 12.9%, and we need to monitor the outlook for 4Q sales (still low visibility).

Non-consolidated Balance Sheets

	Previous term end (as of June 30, 2020)	Thousands of yen Current term end (as of December 31, 2020)
Assets		
Current assets		
Cash and deposits	3,641,864	3,741,171
Notes and accounts receivable	1,720,318	1,586,894
Inventories	413,482	522,183
Other	605,574	606,216
Total current assets	6,381,239	6,456,466
Non-current assets		
Property, plant and equipment	537,972	508,757
Intangible assets		
Software	1,262,416	1,218,995
Other	202,895	100,260
Total intangible assets	1,465,312	1,319,255
Investments and other assets		
Investment securities	1,359,193	1,457,124
Other	808,293	689,133
Total investments and other assets	2,167,487	2,146,257
Total non-current assets	4,170,771	3,974,270
Total assets	10,552,011	10,430,736
Liabilities		
Current liabilities		
Notes and accounts payable	627,020	623,767
Income taxes payable	61,971	114,692
Advances received	1,381,890	1,138,462
Provision for bonuses	295,182	265,388
Provision for bonuses for directors	42,682	17,173
Other	541,881	566,058
Total current liabilities	2,950,627	2,725,543
Non-current liabilities		
Provision for retirement benefits	490,430	518,348
Provision for retirement benefits for directors	30,052	20,250
Asset retirement obligations	87,421	87,454
Other	10,010	5,720
Total non-current liabilities	617,914	631,773
Total liabilities	3,568,542	3,357,317
Net assets		
Shareholders' equity		
Capital stock	843,750	843,750
Capital surplus	573,099	573,099
Retained earnings	5,043,372	5,066,017
Treasury stock	(26,712)	(26,712)
Total shareholders' equity	6,433,508	6,456,153
Valuation and translation adjustments		
Valuation difference on avail-for-sale securities	549,960	617,265
Total valuation and translation adjustments	549,960	617,265
Total net assets	6,983,469	7,073,419
Total liabilities and net assets	10,552,011	10,430,736

Non-consolidated Statements of Income

	Thousands of yen	
	Previous term (from July 1, 2019 to December 31, 2019)	Current term (from July 1, 2020 to December 31, 2020)
Net sales	4,967,041	5,247,940
Cost of sales	3,633,129	3,858,124
Gross profit	1,333,911	1,389,816
Selling, general and administrative expenses	965,130	984,228
Operating profit	368,781	405,587
Non-operating income		
Interest income	305	344
Dividend income	20,735	20,887
Other	2,366	3,805
Total non-operating income	23,408	25,036
Non-operating expenses		
Interest expenses	55	21
Commitment fees	2,113	2,758
Compensation expenses	29,618	5,000
Other	348	1,744
Total non-operating expenses	32,135	9,524
Ordinary profit	360,053	421,100
Extraordinary income	—	—
Extraordinary losses	—	—
Profit before income taxes	360,053	421,100
Income taxes - current	65,785	92,125
Income taxes - deferred	57,161	43,345
Total income taxes	122,947	135,471
Profit	237,106	285,628

Non-consolidated Statements of Cash Flows

	Previous term (from July 1, 2019 to December 31, 2019)	Thousands of yen Current term (from July 1, 2020 to December 31, 2020)
Cash flows from operating activities		
Profit before income taxes	360,053	421,100
Depreciation	291,632	357,515
Share-based remuneration expenses	24,282	38,787
Increase (decrease) in provision for bonuses	(46,380)	(29,794)
Increase (decrease) in provision for bonuses for directors (and other officers)	(25,005)	(25,508)
Increase (decrease) in provision for retirement benefits	22,868	27,918
Increase (decrease) in provision for retirement benefits for directors (and other officers)	3,057	(9,802)
Interest and dividend income	(21,041)	(21,231)
Interest expenses	55	21
Compensation expenses	29,618	5,000
Commitment fees	2,113	2,758
Decrease (increase) in notes and accounts receivable	(85,257)	(110,002)
Decrease (increase) in inventories	(206,849)	(108,700)
Increase (decrease) in notes and accounts payable	100,471	(11,150)
Other	(100,209)	60,782
Sub-total	349,408	597,692
Interest and dividend income received	21,099	21,226
Interest expenses paid	(47)	(19)
Commitment fees paid	(2,215)	(2,443)
Income taxes paid	(329,871)	(41,726)
Net cash provided by (used in) operating activities	38,373	574,730
Cash flows from investing activities		
Purchase of property, plant and equipment	(119,233)	(29,044)
Purchase of intangible assets	(295,949)	(164,866)
Purchase of investment securities	(1,043)	(1,218)
Other	10,450	(384)
Net cash provided by (used in) investing activities	(405,776)	(195,513)
Cash flows from financing activities		
Repayments of lease obligations	(17,781)	(16,704)
Purchase of treasury stock	(136,100)	—
Cash dividends paid	(235,921)	(262,209)
Net cash provided by (used in) financing activities	(389,803)	(278,914)
Effect of exchange rate change on cash and cash equivalents	414	(994)
Net increase (decrease) in cash and cash equivalents	(756,791)	99,307
Cash and cash equivalents at beginning of period	3,254,913	3,641,864
Cash and cash equivalents at end of period	2,498,122	3,741,171

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