Alpha-Win Company Research Report

CUBE SYSTEM INC.
(2335 TSE First Section)

Issued: 8/3/2020

Alpha-Win Capital Inc. Research Department
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 listed on the First Section of the TSE. Its main customers include Nomura Research Institute (NRI) and Fujitsu Group. It develops systems and provides services 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 expertise that it has built up over the years. Founded in 1972, it has 48 years of history.

・With the exception of one fiscal year, the Company has been continuously increasing sales YoY for the past 22 years. 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%; it 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. Under the new president, the Company will also expand its business in the area of digitalization starting this fiscal year.

◆ This FY's Q1 Results: sales slightly fell by 0.2% YoY, but operating profit grew significantly by 141.3% YoY since no unprofitable project was posted and cost reduction was effective. Small COVID-19 impact but a decline in the amount of orders received.

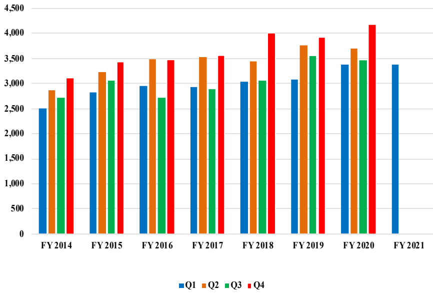
・In the first quarter of FY 2021 (April-June 2020; hereinafter "Q1"; note that the Company's fiscal year is March-ending, so FY 2021 ends in March 2021), sales were Y3,373 million (-0.2% YoY), operating profit was Y242 million (+141.3% YoY), recurring profit was Y248 million (+130.8% YoY), and quarterly profit attributable to owners of the parent (hereinafter "net profit") was Y165 million (+229.3% YoY) (Figures 1-3). Although sales had stayed about the same, the profits increased significantly since no unprofitable projects were posted like in Q1 of the previous fiscal year and cost control had been strengthened, for instance, by reducing business trip expenses in response to the COVID-19 crisis. Operating, recurring, and net profit all reached their Q1 record highs (previous record high: Q1 FY 2016). Gross margin increased from 15.5% in the previous Q1 to 19.1% this Q1. Operating margin increased by approximately 4.4 points from 3.0% to 7.4% in the same order (Figure 4). The achieved sales seem to have been in line with the Company's plan (not disclosed), while the profits were greater than expected.

[Figure 1] Transition in Q1 Financial Performance

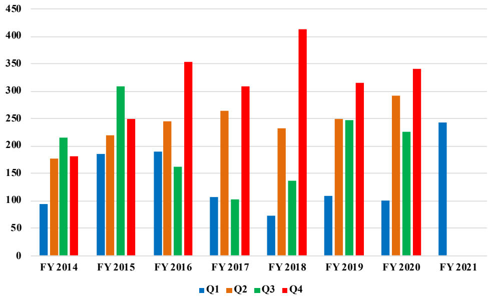
(Note) All figures were prepared by Alpha-Win Research Dept. based on the financial results summary and financial results supplemental briefing materials. Due to the calculation process, values for the same item may slightly differ.

	Q1 Results	Unit: million yen	Q1 FY 2020 Apr-June 2019	Q1 FY 2021 Apr-June 2020	% Change YoY: %	Change in Amount / Diff. YoY: million yen / %	% of Total Change %	% of Total %	Company Plan for FY 2021 Apr 2020 - Mar 2021	% Change YoY: %
Total	Consolidated Sales	Name of Service/Industry	3,379	3,373	-0.2	-6	100.0	100.0	16,000	8.8
By Service Category	Sales	System Integration: SIS	2,411	2,311	-4.1	-100		68.4		
		System Outsourcing: SOS	520	506	-2.8	-14		15.0		
		Professional: ProS	447	555	24.1	108		16.4		
	Gross Profit	System Integration: SIS	354	437	23.2	83	70.3	83.4		
		System Outsourcing: SOS	95	82	-13.6	-13	-11.0	15.6		
		Professional: ProS	73	123	66.9	50	42.4	23.5		
	Gross Margin (%)	System Integration: SIS	14.7	18.9		4.2				
		System Outsourcing: SOS	18.4	16.3		-2.1				
		Professional: ProS	16.5	22.2		5.7				
By Industry	Sales	Finance	993	989	-0.4	-4		29.3	4,838	8
		Distribution	771	675	-12.5	-96		20.0	3,315	-1.3
		Telecommuications	485	592	21.9	107		17.6	1,965	4.5
		Manufacturing (other)	396	329	-16.9	-67		9.8		
		Government (other)	245	182	-25.6	-63		5.4	5,882	17.9
		Other (other)	486	603	24.2	117		17.9		
	Gross Profit	Finance	181	191	5.7	10	8.4	29.8		
		Distribution	122	123	0.8	1	0.8	19.2		
		Telecommuications	74	141	91.4	67	56.4	22.0		
		Manufacturing (other)	45	56	22.7	11	9.3	8.7		
		Government (other)	34	24	-28.0	-10	-8.4	3.7		
		Other (other)	66	105	58.7	39	32.8	16.4		
	Gross Margin (%)	Finance	18.2	19.3		1.1				
		Distribution	15.9	18.3		2.4				
		Telecommuications	15.2	23.9		8.7				
		Manufacturing (other)	11.6	17.1		5.5				
		Government (other)	14.1	13.6		-0.5				
		Other (other)	13.6	17.4		3.8				
Total	Total Gross Profit		524	643	22.7	119	-	-		
		Gross Margin (%)	15.5	19.1		3.6	-	-		
	SG&A Expenses		424	401	-5.4	-23	-	-		
		SG&A Expenses Ratio (%)	12.5	11.9		-0.7	-	-		
	Operating Profit		100	242	-8.8	142	-	-	1,090	18.3
		O.P. Margin (%)	3.0	7.2		4.2	-	-	7.0	
	Recurring Profit		107	248	-19.0	141	-	-	1,090	13.6
		R.P. Margin (%)	3.2	7.4		4.2	-	-	7.0	
	Net Profit		50	166	-34.2	116	-	-	684	14.6
		N.P. Margin (%)	1.5	4.9		3.4	-	-	4.3	

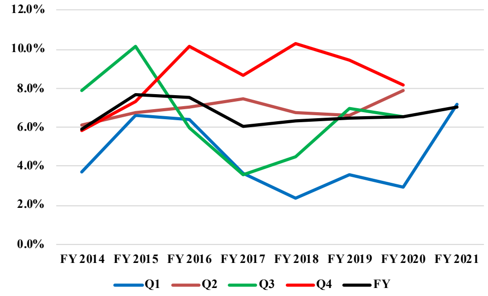
[Figure 2] Quarterly Change in Sales
(unit: million yen)



[Figure 3] Quarterly Change in O.P.
(unit: million yen)



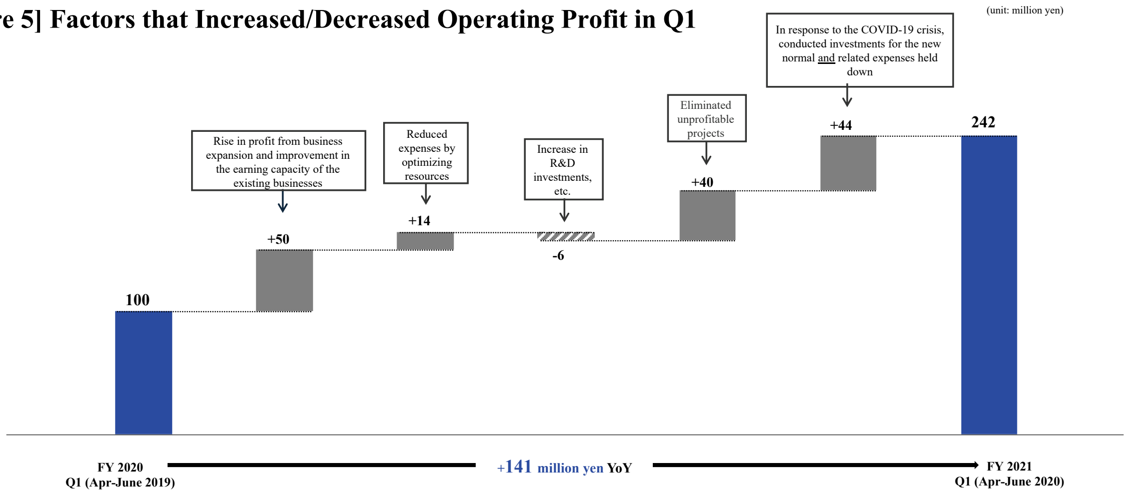
[Figure 4] Quarterly Change in O.P. Margin
(unit: %)



(Note) In Figures 2-4, values for Q1 FY 2021 are actual results and full-year (FY) values for FY 2021 are based on the Company's forecast.

- Overall, sales declined by Y9 million YoY and gross profit increased by Y118 million YoY.
- Q1 results by service category (three categories) are as follows.
- Sales of its core business, or the System Integration Service (SIS), decreased by Y99 million (-4.1% YoY). System development projects for delivery service companies in the transportation industry and for education business companies had grown. However, since system development projects for construction machinery manufacturers in the manufacturing industry became finished and projects for the distribution industry and system development projects for online banking services in the finance industry became reduced, overall sales of this category decreased. This Q1, though, there were no unprofitable projects posted like in Q1 of the previous fiscal year, so the gross profit increased by Y82 million (+23.2% YoY) to Y437 million.
- As projects outsourced from the distribution industry became reduced, sales of the System Outsourcing Service (SOS) decreased by Y14 million (-2.8% YoY) to Y506 million and its gross profit declined by Y13 million (-13.6% YoY) to Y82 million.
- Thanks to the expansion of system development projects for telecom carriers and group banks of major distribution companies, as well as the solid progress of the consulting business, sales of the Professional Service (ProS) increased by Y107 million (+24.1% YoY) to Y555 million and its gross profit increased by Y49 million (+66.9% YoY) to Y123 million.
- Sales by industry (four sectors) are mostly as described above; sales only increased for the telecommunications and transportation industries (Figure 1). Sales for the finance industry and other industries declined only slightly, but sales for the distribution industry declined at a double-digit rate due to the completion of projects related to changes in the consumption tax. However, profit grew for all industries mainly due to cost reduction and profit improvement measures.
- Figure 5 shows the factors that helped increase or decrease operating profit this Q1. While sales had stayed about the same, profit grew especially due to improvements in the profitability of the existing businesses, elimination of unprofitable projects, and cost control. Non-operating profit/loss was about the same as last fiscal year's Q1, and there was no extraordinary profit/loss. As a result, net profit increased threefold.

[Figure 5] Factors that Increased/Decreased Operating Profit in Q1



(Note) Financial results supplemental briefing materials; partially edited and modified.

▪ In the Company's business model, sales growth is generally directly correlated with the number of employees. The total number of employees in Japan and overseas has been increasing from 707 in June 2017 (end of month) → 745 in June 2018 (+38; +5.4%) → 766 in June 2019 (+21; +2.8%) → 799 in June 2020 (+33; +4.3%). The future impact of COVID-19 remains uncertain, but since system development demand from potential customers continues to be strong (non-face-to-face, DX businesses such as those related to remote work, EC, and AI), the Company is somewhat short of staff. It is working on strengthening recruitment through web interviews and other means, as well as improving per-person productivity such as sales and operating profit per person.

▪ There has been no significant changes in the balance sheet as of the end of Q1. It has ample liquidity on hand, with Y3.7 billion in cash and deposits (equivalent to 2.8 months of average monthly sales; essentially debt-less). Its financial standing is also firm, with an equity ratio of 70.8%.

◆ No change to the full-year forecast made at the beginning of the FY: sales +8.8% and double-digit profit growth. Also, no change to the plan to pay Y18 in dividend.

・The Company has not made changes to its full-year forecast announced at the beginning of the fiscal year that sales will be Y16,000 million (+8.8% YoY), operating profit will be Y1,120 million (+16.8% YoY), net profit will be Y700 million (+33.3% YoY), and dividend will be Y18 per share. Like the previous fiscal year, it expects to achieve sales and profit growth again this fiscal year. In fact, it plans to achieve record-high sales for another consecutive year as well as record-high profits. It will also aim again to achieve Y1 billion each in operating and recurring profit for the first time (it had aimed to achieve this goal last fiscal year too but was unsuccessful).

・Q1's progress rate in terms of the Company's full-year forecast was 21.1% for sales (last Q1: 23.0%) and 21.6% for operating profit (last Q1: 10.4%). The simple average of the progress rate in Q1 over the past seven years including the previous fiscal year is 22.6% for sales and 13.9% for operating profit, so this fiscal year's Q1 progress rate for operating profit is higher than the recent years' average. It should be noted that seasonal fluctuations are seen on a quarterly basis, and in recent years, the fourth quarter (Q4: January-March) has contributed the most to the full-year financial results (the quarter's average percent of sales over the total for those seven years is 28.0%; 35.4% for operating profit). The second quarter (Q2: July-September) has been the second largest in contribution (26.2% and 27.6%, in the same order), followed by the third quarter (Q3: October-December) (23.3% and 23.0%). Q1 contribution has always been the smallest. When we subtract this Q1's results from the Company's full-year forecast, we can see that in the remaining nine months (Q2-Q4), the Company expects sales of Y12,627 million (+11.5% YoY), an operating profit of Y878 million (+2.2% YoY), and operating margin to worsen from 7.6% in the same period of the previous fiscal year to 7.0%.

・Alpha Win Research Department took into account the impact of COVID-19 and made a slightly more cautious full-year forecast than the Company. The Company has been strengthening sales activities toward its main clients, expanding its existing businesses, and developing new domains and areas. However, due to the COVID-19 crisis, sales activities have been stalled especially for new negotiations and some of its corporate customers have been starting to reduce their IT investments due to worsened financial performance. Consequently, in Q1, the amount of orders received and the order backlog decreased by about 8.3% and 6.1% YoY, respectively. Therefore, since July, the Company has been working on strengthening its sales activities while taking into account the COVID-19 impact (decentralized/non-contact business operation through the use of digital technology, combined with face-to-face sales) and focusing on approaching customers who are actively conducting strategic IT investments.

・However, if the impact of COVID-19 is prolonged, the profit forecast for this fiscal year and onward may need to be revised. It will be important to carefully assess the change in the amount of orders received and in the profit margins in Q2 and onward. The Company has been strengthening its project management, so the effect of preventive measures against unprofitable projects will also be key.

・Alpha-Win Research Department has not changed the evaluation of the Company for the medium- to long-term period. We believe that the Company's users will eventually increase their IT investment as they adapt to the changes in the world with and after COVID-19 by developing new business models, strengthening their competitive advantage, fixing HR shortages, streamlining and speeding up operations, and conducting DX. Therefore, the Company has a large growth potential. If the economic environment settles down, we believe that the Company will be able to stably increase its sales and profit at 8-10% per year through the expansion of the Enhancement business, new customer development, development of new or overseas businesses, and improvement of productivity through various measures.

◆ The Company's Response to COVID-19

・The Company has launched four task forces headed by the president in order to optimize working styles for the post COVID-19 world and the new normal. The purpose is to create a new way of working where each employee can work from their most suitable location in terms of the characteristics of their jobs as well as their abilities. Currently, through the remote work system, more than 50% of its employees work from home.

・The four task forces are as follows (excerpt from the financial results supplemental briefing materials).

1. Office Environment: improve working environment and tools
2. Internal Operation Processes: thorough review and digitalization of operation processes
3. Project Execution Environment: create a selling style that is new but still reflects CUBE SYSTEM's strengths and uniqueness
4. Management of Corporate Rules: improve regulations and guidelines

◆ Stock price and characteristics: domestic-demand-related, stable growth stock that has been significantly outperforming the TOPIX over the long term. Average valuation.

・Over the past ten years or so, thanks to its solid financial performance, the Company's stock price has increased by about four times and has been significantly outperforming the TOPIX. It has also been outperforming the TOPIX and its competitors (HIMACS and Toho System Science; Figure 6) over the past 12 months, but its valuation is about average and does not seem expensive compared to its competitors. Currently, many companies listed on the First Section of the TSE have not disclosed their forecast for this fiscal year, so they cannot be feasibly used as a representation of the entire market in the valuation comparison.

・Upon the announcement of Q1 results, major companies that had previously not disclosed their full-year forecasts have been starting to announce this fiscal year's forecasts, such as large profit declines, massive net losses, and reduced or zero dividend. In contrast, the Company continues to expect a sales growth and a double-digit profit growth this fiscal year as well and has become highly evaluated as a domestic-demand-related, defensive, and stable growth stock. These may be some of the reasons why its stock price has been solid.

・Over the short term, the stock price will likely be affected by how the COVID-19 crisis will settle down and by the quarterly trend in the amount of orders received and in the overall financial performance starting in Q2. Over the medium term, it may also be affected by the following factors: changes in its operating margin and operating profit growth rate starting next fiscal year; progress with new technologies and areas such as DX and their contribution to financial performance; shareholder return (dividend hike, share buyback, and stock split); and the financial performance and IT investment trends of Japanese companies – its end users. Going forward, if the Company can show a steady profit growth close to a double-digit rate, its stock price may possibly rise further.

[Figure 6] Comparison of Valuation with Its Competitors

Company Name	CUBE SYSTEM (CS: consolidated)	HIMACS (HM: consolidated)	Toho System Science (TS: non-consolidated)
Code	2335	4299	4333
Stock Price (at 7/31 closing)	943	1,928	945
Market Cap (million yen)	14,409	11,966	13,103
P/E (price-to-earnings ratio)	18.3	18.4	18.1
P/B (price-to-book ratio)	2.3	1.2	1.6
Dividend Yield (%)	1.9	2.6	2.6
EV/EBITDA	10.6	6.0	5.5
P/S (price-to-sales ratio)	0.9	0.8	1.1

Market cap= (shares outstanding) x (market share price [at 7/31/2020 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 Q1 FY 2021 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 Q1 FY 2021.
P/S=market cap / sales [the companies' forecasts for FY 2021]

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

【 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
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
2020	Q1	3,373	-0.2	242	141.3	248	130.8	165	229.3	12.17	418.69	0.0

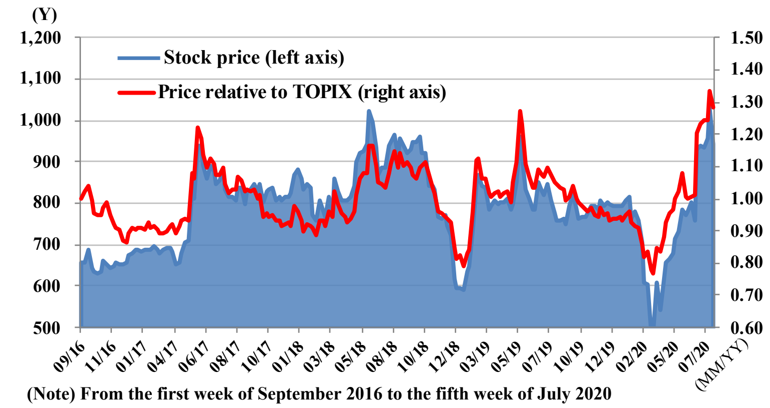
(Note) CE: the Company's forecast. E: Alpha-Win Research Dept.'s forecast. Q1 is from April to June.

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

Item	7/31/2020	Item	P/E	P/B	Dividend Yield	Dividend Payout Ratio
Stock Price (Y)	943	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 Capitalization (million yen)	14,409	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 had been 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 fifth week of July 2020

【Performance】

Period	Return	vs. TOPIX
1 month	-11.4%	-7.7%
3 months	36.3%	33.4%
6 months	23.3%	38.8%
12 months	8.1%	13.1%

(Note) Reflects stock price and index values up through the closing price on 7/31/2020.

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