

## 7618 PC DEPOT Corporation

### – Uniqueness realized by service sales of PC Clinics –

November 21, 2012

JASDAQ

#### Points

- Specializing in PC (personal computer), the Corporation seeks its unique business model with focuses on lifetime values of merchandise and services. It has shifted to a profit structure supported mainly by its service sales, which has gained good results, but there remains tough price competition of goods sales around PCs.
- The Corporation has seen substantially lower profit in the first half, and because it became difficult to achieve the recovery as initially anticipated for the current FY2013.3, earnings forecasts were amended downward. Although up-front expenditure associated with opening new stores extensively had been taken into consideration from the early stage, declining PC prices had much influence. However, such situation would turn favorably in the second half thanks to release of Windows 8 (by Microsoft), diffusion of LTE (a standard of high-speed telecommunication), and reduced burden of investment in opening new stores.
- As for the profit structure, sales of hardware such as PCs represent 68% of the total sales but constituent ratio thereof drops to 27% in terms of marginal gain (similar to gross profit). On the contrary, profit derived from service sales represents 73%. That is, service sales including technical services and premium services have rapidly represented a growing share. “Premium service” means the one that provides convenient contents services and maintenance services to users who purchased a PC or a smartphone, upon payment of certain amount of monthly fees.
- In order to provide such services, the Corporation thought it more efficient to operate directly managed stores than FC (franchise chain) stores, and has promoted direct management of PC Clinics since FY2010. It has accelerated opening new PC Clinics in cooperation with K’s Denki. Although it has so far focused on opening new stores including its flagship stores of PC DEPOT, now it intends to strengthen the foundation in the current second half and onward, opening less stores than ever.
- The Corporation has turned its profit structure steadily to the one in which profit can be assured by service sales stably. Even though smartphones and tablet devices are going to establish new markets, PCs still remain as the platform. So the Corporation would be able to stimulate demands for various services. However, as noted above, declining goods prices have much influence and therefore further efforts would be required for increased profitability. When it could put an end to such decline in profit of goods sales, profit contributed by service sales would be much prominent. Such a situation should be anticipated.

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## Table of contents

1. Characteristics: Growth as stores specializing in PCs
2. Strength: Profit structure turned to be contributed by service sales.
3. Mid-term business plan: Demands for various services would be further stimulated.
4. Near-term operating results: Declining PC prices cause effects of service sales being diminished.
5. Evaluation: Recovery of profitability is not enough. Next movement should be anticipated.

## Company rating: C

Stock price (Nov. 21, 2012): 16840 yen

Market capitalization: 3800 million yen (225,020 shares)

PBR: 0.38

ROE: 3.7%

PER: 10.5

Dividend yield: 4.2%

Fiscal year end	Net sales	Operating income	Ordinary income	Net income	(million yen)	
					EPS (yen)	Dividend (yen)
2006.3	45695	1210	1493	981	4501	500
2007.3	42345	839	1112	511	2302	500
2008.3	42439	1229	1340	816	3674	600
2009.3	42899	1259	1429	684	3108	700
2010.3	44740	1226	1306	677	3108	700
2011.3	46912	1368	1509	737	3418	700
2012.3	49693	553	717	280	1275	700
2013.3 (forecast)	51000	600	700	350	1600	700
2014.3 (forecast)	53000	800	900	450	2056	700

\* Forecasts are based on the financial results as of September, 2012.

Total assets: 22486 million yen

Net assets: 9574 million yen

Equity ratio: 42.1%

BPS: 43762 yen

NOTE: ROE, PER and dividend yield are based on the forecast for the FY 2013.3.

Analysis by: Yukio Suzuki

(Chief Analyst, Belle Investment Research of Japan)

**Definition of Company rating:** Qualitative evaluation with viewpoints on 1) management abilities of the manager; 2) abilities to grow/sustain the business; 3) possibilities of downward amendment to earnings forecasts. It is expressed by four-level rating as A: Good; B: some degree of efforts is required; C: considerable improvement is required; and D: being in a quite crucial stage.

## 1. Characteristics: Growth as stores specializing in PCs

### **Business started with PC (personal computer)**

In the past, president Nojima of PC DEPOT worked at Nojima Co., a mass home electronics retailer (code No. 7419, JASDAQ). First son of the founder of Nojima Co. is the current president of Nojima Co., and president Nojima of PC DEPOT is second son. He was in charge of supervising stores and merchandise at Nojima Co., but at the time when PC became gradually popular, he decided to do business on his own and got independent. While he is still the second major shareholder (9.5%) of Nojima Co., there is no business relationship between PC DEPOT and Nojima Co.

President Nojima was 35 years old when he started his business which is now in its 18th year. At early stage after its incorporation, PCs were on the way to be gradually popular. Many people wanted their own, but PCs were still beyond their reach. In those days, only a limited number of people went all the way to Akihabara to buy PCs. In contrast, president Nojima went into retailing PCs, just like retailers in general deal with some new merchandise. The Corporation successfully raised its performance, and in 1999, five years since its establishment, got listed on JASDAQ.

As the internet era emerged in 2000, the Corporation entered into its new phase. When having got listed, it operated about a dozen stores with net sales of 15000 million yen, ordinary income of 800 million yen, and no debt.

At present, PC-related products are commonly sold at mass home electronics retailers. Also, there is a wide variety of mass retailers specializing in PC. Considering broadly in the sectors of mass home electronics / PC retailers, the Corporation stands at 9th place among the major 11 listed companies, but it competes in a little bit different field and does not compete directly with the biggest companies in the industry such as Yamada Denki (1st place as measured by sales volume), Edion (2nd) and K's Denki (3rd). It should be noted that the Corporation seeks to emphasize its uniqueness.

### **Cooperation with K's Denki**

In developing PC DEPOT stores (comprehensive stores specializing in PC), the Corporation made K's Denki stores (operated by K's Holdings Co. (code No. 8282)) its franchisees (FC stores). That is, K's Denki participated in the FC stores of PC DEPOT for the second place. It was beneficial for both of them in that a mass home electronics retailer starts dealing with PCs.

The Corporation does business in cooperation with K's Denki because, president Nojima says, management concepts of the two companies are quite similar and he feels much empathy with Mr. Kato, Chairman and CEO of K's Holdings Co. The Corporation focuses on easy-to-understand management, such as sales in self-service style except for service items, sales with cash discount not dependent on point system, on the basis of chain-store operation.

Meanwhile, Mr Max Co. (comprehensive discount stores) and Kitamura Co. (specializing in cameras) also participated in the FC stores of PC DEPOT. Kitamura adopted a form similar to joint operation, and Mr Max adopted so-called "in-shop" style, namely operation inside PC DEPOT stores. Afterwards, however, major mass home electronics retailers became advantageous and it became hard for discount stores to deal with PCs. FC stores run by Mr Max were taken up by the Corporation as its subsidiaries (current PC DEPOT Stores) by 2010.

### Converting FC stores to directly-managed stores

Aside from FC stores of PC DEPOT, other FC stores providing technical services were established as “in-shops” inside some mass home electronics retailers. These were named “PC DEPOT PC Clinic.” PC Clinics were successfully operated in many of K’s Denki stores, and then expanded. PC DEPOT stores deal with goods, services and clinic functions. Among them, just clinic functions were extracted to be provided in PC Clinics. These PC Clinics were developed as FC stores.

At present, as PC DEPOT, there are 50 directly-managed stores, 11 stores other than Kanto region run by the subsidiary PC DEPOT Stores Co., and 5 FC stores, for a total of 66 stores. In addition, as PC Clinics, there are 49 directly-managed stores, 1 store run by PC DEPOT Stores, and 7 FC stores, for a total of 57 stores. So, the Corporation now operates 123 stores. PC Clinics had been operated mainly as FC stores until two years ago, and subsequently these have been converted, at a stretch, to directly-managed. The Corporation and K’s Denki agreed that direct-management would be more effective for enhancing service functions, and the former took up FC stores from the latter. Currently, the Corporation operates PC Clinics inside K’s Denki stores, as directly-managed stores.

In addition, the Corporation started to deal with TV sets in June, 2010. Even in a wave of digitalization, the Corporation considered the possibilities of connecting TV sets to the internet, and also in the context of eco-point scheme, decided to sell TV sets at PC DEPOT stores.

### Situation of store development

		number of stores (at the end of October, 2012)	
PC DEPOT	directly-managed	50	PCs and related products for home users; technical support services Kanto region (Kanagawa, Tokyo, Chiba, Saitama, Shizuoka, Gunma, Tochigi and Ibaraki)
	subsidiaries	11	PC DEPOT Stores (former PC DEPOT Kyushu) (Kyushu, Chubu, Shikoku and Tohoku regions)
	FC	5	Koushinetsu, Shikoku, Chugoku and Kinki regions
	subtotal	66	
PC DEPOT PC Clinic	directly-managed	49	Operations inside the premises of other mass home electronics retailers
	subsidiaries	1	PC technical services / support counter
	FC	7	
	subtotal	57	
<b>Total</b>		<b>123</b>	

NOTE: FC (franchise chain) stores pay royalties.

### Web business is continued

EJWORKS Co., a subsidiary, engages in IT solution business such as internet service provider and creating Web contents. Internet services started to be familiar around 2000. Now such situation is almost peaking and internet service providers are to be selected. The Corporation intends to acquire small-to-midsize providers and continue its own customer services. For customers, continuity would remain since there is no need to change their email address.

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## 2. Strength:

### Profit structure turned to be contributed by service sales.

#### Specialized technical services

The Corporation leads the industry in repairing PCs and providing maintenance services. Moreover, service sales have increased by more than 20% each year, demonstrating its high-rate growth. Although it is at 7th or 8th place in terms of number of PCs sold, service sales are the source of its characteristics.

The Corporation has shown its unique presence in competing with mass home electronics retailers over the past decade. It survived well in localized competitions as specializing in PC, whereas it could not hold against major companies in terms of total volume (sales quantity). Under such circumstances, the Corporation did not try too hard to expand its business by opening new stores. In 2002, it decided, however, to be an IT solution company beneficial for customers, by making efforts to improve its services, rather than by quantitative expansion of sales of hardware, namely PCs. This was the second turning point for the Corporation since its foundation.

#### Comparison of constituent ratio of sales and of marginal gain

(%)

		constituent ratio of sales			constituent ratio of marginal gain		
		2010.3	2011.3	2012.3	2010.3	2011.3	2012.3
Merchandise	PCs and peripherals	58.9	57.5	55.1	17.7	16.0	11.9
	software and accessories	15.0	13.9	12.6	20.5	18.5	14.9
	used items	4.3	4.4	4.6	5.9	5.9	5.0
	(subtotal)	<u>78.2</u>	<u>75.8</u>	<u>72.3</u>	<u>44.1</u>	<u>40.4</u>	<u>31.8</u>
	Royalties from FC stores	1.3	1.1	0.8	*	*	*
	Income from technical service and commissions	<u>15.4</u>	<u>18.6</u>	<u>23.3</u>	<u>55.9</u>	<u>59.6</u>	<u>68.2</u>
	Internet-related business	5.1	4.5	3.7	*	*	*
<b>Total</b>		<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

NOTE: Marginal gain is similar to but a little different from gross profit, because service-related personnel expenses are included in SG&A expenses. Data in this table is based on the allocation of such marginal gain.

Cells denoted by "\*" are not considered.

Royalties are paid by FC stores.

Providing solutions in combination with various services is the key. The Corporation provides telecommunication services on behalf of EMOBILE, as an MVNO (Mobile Virtual Network Operator). Moreover, upon subscribing to the Corporation's premium services, members can get supported in every necessary aspect such as maintenance, call-center service, anti-virus support, and full-installation works when replacing PCs. The Corporation exerts its strength by originally developing and carrying out these menus. No other PC shop is capable of speedy technical services, especially data recovery, like PC DEPOT. It is too hard for other companies to follow.

The Corporation set its policy towards growing as a store specializing in services, and has

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strengthened such movement over the internet era. “OZZIO” is a brand name of its private brand (PB) products. Emphasis was also put on PB. Even though accessories and supplies are highly profitable among goods sales, its direction has been towards services.

In fact, looking to the marginal gains in FY2011, those derived from service sales were higher than those derived from goods sales. In a stage where companies with greater sales volume cannot be beaten just by goods sales, the Corporation has set its position in a good state.

### **Earnings by premium service**

The Corporation’s business model is quite unique, even in overseas. It consists of goods sales, service sales, and MVNO. Members should enter into premium service contract for a term of three years. However, support cost is to be incurred first by the Corporation and to be collected from customers subsequently.

A customer would like to use the PC immediately after buying it and returning home. President Nojima was also such a user. After buying, if it takes, for example, 3 hours to make various settings such as recovery disc, anti-virus measures, initial settings and password, and then comes to a dead end, the user should ask someone for help. The premium service is a solution to help such users by means of network.

Suppose a customer brings his/her old PC and member card to a PC DEPOT store, and buys a new PC. Then the store’s service staff makes every necessary installation works. The customer takes the new PC to home, and can use it immediately in the same way as before, via the wireless router (PC DEPOT original), with no particular operation required. This is exactly convenient. A system patent had been applied for this router, and was registered in March, 2012. This service is provided upon paying the monthly fee of 2,450 yen, together with other services. Furthermore, this service is planned to support cloud computing.

The business model that takes service sales into account has been fully in progress and steadily expanded since November, 2005. Conventionally, various technical services such as adding memories have been provided for a price. Today, members who bought their PCs can borrow wireless routers upon paying certain monthly fees (no additional charge up to 3~6 routers depending on the course), through which they can connect to the internet with no particular operation required.

An MVNO does not have its own mobile communication network, but provides its original brand services by borrowing other major carriers’ network. The Corporation provides services to customers as a telecommunications carrier, rather than taking incentives from other carriers. This makes it possible to provide services that customers may want in just one package, and is quite convenient as premium service. This type of service (EM premium service supporting multiple devices) is provided upon paying monthly fee of 4,750 yen.

For the Corporation, PC Clinics tend to provide only one-time technical services. In order to capture customers to provide them with continuous services for a long time, keeping them as premium service users should be better. Then direct management should make it easier. That is why the Corporation turned its policy to manage PC Clinics directly. Sales amount of technical services include premium service, technical services, communication fees of MVNO and others.

### 3. Mid-term business plan:

#### **Demands for various services would be further stimulated.**

##### **Will PCs cease to exist?**

In today's digital era, Google, Windows (Microsoft) and Apple are the Big 3. With these Big 3 on center, president Nojima sets his basic policy as helping users' resolve their "troubles."

The Corporation has registered its patent for the original router. This can be used to make earnings with service sales. Currently, goods sales do not make much profit, which is supplemented by service sales. Even though service sales do not occur without selling goods, profit derived from service sales has not yet been prominent enough due to decline in goods prices. If such a situation could be overcome, some interesting scenario would be anticipated.

As it is entering into smartphone era, there is a question about whether PCs will become unnecessary. Of course not. For sure, if smartphones are equipped with keyboards and displays, PCs might be unnecessary. The point is, where data should be saved. Google recommends using cloud system, based on an idea that all the data may be saved in that system. However, PCs are necessary for those who want to back-up their data locally. Without PC, personal cloud system cannot be realized adequately.

While conventional PCs will evolve, tablet devices and smartphones will be sophisticated. Each of them will be used separately according to its most suitable usage. Instead, there would be no border between TV sets and PCs, and TV sets would serve as displays for PCs. If connected to TV sets, to monitors, or to printers, there is no difference from PCs. In some aspects, they might be deemed as PCs with telephone functions.

##### **Even if forms of PCs change, services would remain.**

A movement has emerged where leading player of personal communication is shifted from PC to smartphone. Cloud system as an infrastructure evolves, and air cloud system using wireless communication becomes fully in operation. PCs having been at the center of the internet gives the place over to net devices used anywhere in appliances, cars and homes. Software is required to control such functions, and services to make full use of the software are also required. The Corporation makes pursuit of these services, and aims at adopting a strategy to expand its business to cover internet devices, not limiting its services to those around PCs. It can be said that PC DEPOT is going to grow out of a PC shop to a company that provides services for personal communication.

Mass home electronics retailers are going to put sales of photovoltaic installations in full progress, and some are going to deal with electric cars. An era may possibly come where competitions with car dealers and with house sellers would arise.

The Corporation has so far, in cooperation with K's Denki, put PC Clinics in full progress. Not only selling hardware, it seeks to provide services for make full use of hardware stably. Emphasis is also put on keeping up service users.

In terms of making full use of network, telecommunications carriers are advantageous, but mass home

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electronics retailers do not always have enough capabilities. The Corporation's business model pursues services dependent on goods sales. It sells PCs and its originally-designed routers, and then recovers the cost as service sales. To provide sufficient services, some degree of goods sales is required first. No other mass home electronics retailer provides services comparable to PC DEPOT. The Corporation operates PC Clinics in cooperation with K's Denki, capitalizing each other's strength.

### Main menu of the principal premium services

	Nandemo (Anything) support 3 & All wireless for all devices	Gacchiri (Steady) support 6 & All wireless for Windows
Initial setting/support	up to 3 all devices	up to 6 all devices
Wireless internet connection	complete & delivery at store front	complete & delivery at store front
Home wireless connection	setting at store front, free of charge	setting at store front, free of charge
Measures against virus infection / data leakage / entering dangerous sites	up to 3 Windows PC, Mac or smartphone	up to 6 Windows PC, Mac or smartphone
ozzio email account registration/setting	1 address	1 address
Explanation on basic operations at store front	up to 3 Windows PC, Mac or smartphone	up to 6 Windows PC, Mac or smartphone
OS upgrade & backup	up to 3 all devices	up to 6 all devices
Inspection at store front / periodic backup	up to 3 all devices	up to 6 all devices
Trouble restoration service	up to 3 all devices	up to 6 all devices
Data reconfiguration upon replacement	up to 3 all devices	up to 6 all devices
Memories in smart video	up to 5 (free of charge) VHS, 8 mm, or miniDV extra: 500 yen per piece, up to 100 pieces	up to 10 (free of charge) VHS, 8 mm, or miniDV extra: 500 yen per piece, up to 100 pieces
Tethering set-up	as many devices as needed	as many devices as needed
Monthly fee	2450 yen (816 yen per device)	2950 yen (491 yen per device)

### Service members are increasing, to get helped to resolve their troubles

To maintain relationship with customers for a long time, the Corporation makes its motto that it helps customers resolve their various troubles. For example, when a customer calls to the call center, the line is connected to the staff at the nearest store, thereby enabling conversation among three persons. This system is useful for clarifying what kind of trouble the customer is facing, what is the issue, and how the staff should respond. Sometimes a service staff visits a customer, and sometimes a customer brings his/her PC to a store. The customer comes all the way to the store because he/she wants to get the PC fixed right away. At the store, the service staff responds to the call for help and is able to fix the PC right away. That means



quick response. Although it requires some cost, such attitude for preparedness is one of the good points of PC DEPOT.

The Corporation put emphasis on increasing premium members. Detailed data is accumulated and followed for each area, so that as many customers as possible could be premium members when, for example, buying PC, visiting for repair, or replacing PC.

It can be expected that premium members would increase at a considerably high rate. However, that would not make money in a short time. Initial investment is required for the router, and it takes about a year to recover by means of monthly fees for premium service. From the second year, after recovering the initial cost, a certain amount of profit is generated.

In the mid-term, the Corporation aims at growth by 15 to 20% annually on the basis of ordinary income. To achieve that goal, it intends to promote opening new stores. Many PC users feel some kind of inconvenience. The strategy is that such users should be provided with the premium service and be premium members.

Increasing number of members are provided with the premium service. Monthly service fees are in the range from 1,000 yen up to 5,000 yen. A call center has been established in order to improve services for members and to respond quickly. The Corporation has not disclosed the number of members. Based on the current level, the number can be expected to increase by 50,000 to 100,000 annually. A wide range of services is available and it is estimated that there are more than 300,000 members, rapidly increasing by more than 20% annually.

### Store development history of PC DEPOT

(number of stores at the end of each FY)

		1994	1999	2004	2005	2006	2007	2008	2009	2010	2011
PC DEPOT	directly-managed	1	10	28	32	33	34	40	43	44	48
	subsidiaries	0	0	0	0	0	0	0	4	4	12
	FC	0	8	32	24	21	24	21	17	17	5
PC DEPOT	directly-managed	0	0	0	0	0	0	0	0	30	46
PC Clinic	subsidiaries	0	0	0	0	0	0	0	0	0	1
	FC	0	0	0	5	14	14	21	24	6	7
Total		1	18	60	61	68	72	82	88	101	119

### Expanding directly-managed stores

For several years until FY2010, newly opened PC DEPOT stores were limited to just 1 or 2 per year. Opening new stores in Tokyo metropolitan area had been planned, but rental rates were high and it was hard to find suitable location. The Corporation did not try too hard, resulting in slowly opening new stores. However, looking ahead, there are some rooms in Kanto region for expanding more stores: up to 60 PC DEPOT stores and 120 PC Clinics. President Nojima wants to achieve these goals.

Numbers of newly-opened stores of PC DEPOT were, on the basis of net increase, 3 in FY2009, 1 in FY2010, and 12 in FY2011 (practically 4, because the other 8 stores were converted from FC to

directly-managed). Basic policy is that 4 or 5 directly-managed PC DEPOT stores would be newly opened in Tokyo metropolitan area.

All the 4 new directly-managed PC DEPOT stores in FY2011 are newly constructed, whereas from FY2012, properties with existing furnishings may be utilized. New construction puts some extra monetary burden. Concretely, some 300 to 400 million yen investment is required for a premise of around 2,000 m<sup>2</sup>.

On the other hand, the Corporation intends to open some 5 to 10 PC Clinics as in-shops operated inside K's Denki stores. Human resource development is underway to support opening new stores. Staff at PC DEPOT stores love PCs. Moreover, many women work there. Women having expertise in hardware, software and their usage are thought to be smart, even from other women's perspectives. Staff is well trained here, and they are able to support opening new PC Clinics.

The Corporation does not impose any quota on individual sales/service staff. Everything is supported by a team. A team consists of 3 to 5 personnel and, for example, there are 5 teams. Management concept is that experiences are shared, thereby raising levels each other. Attitudes and responses of regular employees are the key. Part-time employees having worked for a long time may be promoted to regular employees proactively.

Another point is use of cyber operation. It is originally a kind of risk management scheme for internal monitoring, by which persons in charge at the front and the head office can be connected via voice communication and they can communicate anytime, anything. Service support can also be carried out from the head office. Alternatively, if a person in charge at the front faces some difficulty, another person in the store immediately comes for help. Such a quick responsiveness leads to improved service capabilities. From the customers' viewpoint, they feel kindness, politeness and quickness at PC DEPOT stores.

### **Good service is the source of competitiveness. Advantage is also exerted in opening new stores.**

60% of visitors to PC Clinics are those who bought products at other stores. That means they want different contact points, not low-price. PC Clinics widely cover products which customers currently own. This brings about significant efficiency to the Corporation.

In considering marginal gains derived from goods sales and from service sales at the stage of operating income, clear-cut separation cannot be done in terms of specific profit level and constitution. The reason is that the Corporation does not operate its business by distinguishing goods sales and service sales. Even though staff members at stores have their own roles, they provide both goods and services. Their duties are not evaluated by distinguishing these sales. One routine is that a customer buys a product and subscribes to a service, thus becoming a regular customer of PC DEPOT, and naturally comes again to buy some other product.

While other mass home electronics retailers have also moving further to provide similar services, the Corporation provides well-organized services accompanied by 1) services at store front; 2) remote services (by the call center); and 3) services provided by staff visiting by car. No other company has exactly the same business model.

As for movement of merchandise, following the termination of analog terrestrial broadcasting in July,

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2011, support for digital terrestrial broadcasting came to an end, resulting in substantial decline in sales of TV sets. Mass home electronics retailers put emphasis on merchandise of higher unit price such as PCs and air-conditioners, causing more severe price competition. Besides, demands for smartphones and tablet devices have greatly increased. The Corporation deals with smartphones and tablet devices actively, but at the same time, puts emphasis on PCs, its principal merchandise, aiming at grabbing demands for services.

In a competition to grab such demands for services, the Corporation has an advantage leveraged by its achievements over the years and human resource. That is, the Corporation has set its core policy for making difference, to provide services taking time and efforts to customers who might need more efforts to make full use of their purchases, not such volatile customers as other companies deemed their main target for just selling goods.

#### Enhanced services

target devices	contents of principal services
Windows machine	initial setting migrating stored data of music, photo and address book support on telephone & lecture at store front
iPhone	data synchronization of music, photo and others with PC saving telephone bill with iPhone iPhone connected to big-screen TV
docomo smartphone	tethering set-up (smartphone connected by LAN) Wi-Fi connection backup of address book and photo data
iPad	iTunes setting iCloud setting AppleTV set

#### Expanding new stores and pursuit of management efficiency

PC DEPOT stores are operated in residential areas, with relatively small sized premises around 500 to 1,000 m<sup>2</sup>. Regardless of whether it is large-sized or small-sized, operations at the head office can be carried out at the same level. This is true for advertisement analysis. Although merchandise items are different in quantity and in quality, new format is not attempted but variations of stores are enhanced. As located in residential areas, many of the customers come by bicycles or by walk. The higher performance of PC, tablet devices and smartphones becomes, the more clinic services will be required, and there will be more rooms for new stores. Besides, a directly-managed store running only PC Clinic has been in operation in Okinawa, which is to be monitored a little longer for more possibilities.

The Corporation has, for three years, put emphasis on building up directly-managed stores. Due to decline in real estate prices, broader options are available than a tenant and it can take the advantage to create a store more freely. On the other hand, operating as a tenant allows better asset turnover ratio, and in addition, higher ROE can be maintained. Having its own store causes lower asset turnover ratio, so the Corporation intends to keep balance to determine whether a store should be operated as a tenant or be built on its own.

In addition, if sales of technical services increase, since sales volume is smaller than goods sales, turnover ratio drops as well. On the other hand, since profit rate of service sales is higher, ROE can be raised by higher profit rate. The Corporation basically aims at ROE of 12 to 16%, assuming profit-to-turnover ratio of 3 to 4%, total asset turnover of 2.0, and leverage of 2 (equity ratio of 50%).

Assuming 400 million yen investment in a PC DEPOT store (about 1,650 m<sup>2</sup>), annual sales of 1,000 million yen, and taking current assets into account, value of total assets is 600 million yen. And if aiming at profit-to-turnover ratio of 4%, then ROE is  $4.0 \times 1.7 \times 2 = 13.4\%$ . In this case, the store will have a surplus from the third year, starting to contribute to profit.

Expanding new stores involves increased loans. Costs can be reduced by means of using properties with exiting furnishings and operation as a tenant like PC Clinics. The Corporation has ceased to use lease for five years. The reason is that lease assets should be on balance sheet at some future time, and that interest on lease causes higher cost.

#### Number of stores operating for less than one year

(FY)	2010 3Q	2010 4Q	2011 1Q	2011 2Q	2011 3Q	2011 4Q	2012 1Q	2012 2Q	Total (2011 3Q ~ 2012 2Q)
PC DEPOT directly-managed	1	0	2	1	1	0	2	1	4
subsidaries	–	–	–	–	1	4	2	0	7
(subtotal)					2	4	4	1	11
PC Clinic (directly-managed)	11	17	4	4	6	3	1	2	12
Total	12	17	6	5	8	7	5	3	23

Investment amount for opening new stores is about 2,000 million yen per year, including rental deposits, guarantee deposits and others. Taking depreciation (700 million yen) and retained profit (200 to 400 million yen) into account, financing such as loans is necessary. The Corporation intends to make the ratio of owned stores and tenants 50:50, so that it can afford to open new stores funded by its internally-raised capital.

Apart from this, demand for finance varies depending on the degree of monetary burden imposed by M&A of internet service providers. In fact, for the period from 2008 to 2009, such M&A required much external funds.

The Corporation pays attention also to inventory turnover rate. To raise it means merchandise lineup is narrowed down to marketable ones. Since the Corporation specializes in PCs, what is important is abundant lineup, especially that of PC parts. PC parts are highly profitable. Unit prices of PC main bodies and color

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TV sets tends to significantly decline, but those of parts do not. At one time the Corporation set its inventory turnover rate as 10 times, but currently about 7 times is deemed an indication.

Pace of opening new stores has been in up trend. Assuming ROE of 10% as an indication, it is necessary to achieve ordinary income of 200 million yen. PC main bodies do not make much gross profit, whereas peripherals and parts do. Moreover, the Corporation has turned its business model further to get earnings by service sales rather than by goods sales. By getting more subscriptions to premium service, higher quality of service and more stable income can be realized.

### Capital investment and cash flow

	(million yen)			
	2010.3	2011.3	2012.3	2013.3 (forecast)
Capital investment	1650	1500	1920	1100
Depreciation	510	600	720	750
Goodwill amortization	340	330	300	250
Internal reserve	530	580	120	200
Total	1380	1510	1140	1200

#### 4. Near-term operating results:

##### Declining PC prices cause effects of service sales being diminished.

**Previous FY2012.3 was affected by increased cost for new stores and decline in unit prices.**

FY2012.3 has seen substantially lower profit: net sales 49,693 million yen (up 5.9% YoY); operating income 555 million yen (down 59.5% YoY); ordinary income 717 million yen (down 52.5% YoY); and net income 280 million yen (down 62.0% YoY). This is mainly because net sales were up 5.9% YoY, whereas SG&A expenses were up 15.7% YoY.

Among SG&A expenses, especially personnel expenses increased. Opening a lot of new stores since one year ago was expected to have positive effects gradually, but to the contrary, negative effects were greater due to such as more severe PC-related sales competition and undersupply of peripherals affected by the huge flood in Thailand. Above all, 4Q has seen deficit balance. The Corporation took over 6 FC stores run by OA System Plaza, which also caused short-term monetary burden.

Consolidated number of employees was 487 in FY2010.3, 533 in FY2011.3 (+46 YoY), and 656 in FY2012.3 (+123 YoY).

## Balance sheets comparison

(million yen)

	2010.3	2011.3	2012.3	2012.9
Current assets	10511	11678	14185	13394
Cash and deposits	1754	2505	2083	2858
Accounts receivable-trade	2251	2533	3619	3583
Inventories	5316	5500	7285	5861
Fixed assets	7443	8051	9052	9091
Tangible fixed assets	2844	3736	4941	5203
Goodwill	1025	690	406	280
Guarantee deposits	1479	1440	1466	1425
Lease deposits	1329	1234	1272	1276
<b>Total assets</b>	<b>17954</b>	<b>19729</b>	<b>23238</b>	<b>22486</b>
Current liabilities	6473	6449	9225	8332
Accounts payable-trade	2764	2421	3506	2536
Short-term loans payable	800	700	2100	1850
Long-term loan payable (within one year)	690	1004	1518	1776
Fixed liabilities	2743	3747	4449	4578
Long-term loans payable	1936	2759	3809	3935
<b>Net assets</b>	<b>8738</b>	<b>9533</b>	<b>9563</b>	<b>9574</b>
Interest-bearing liabilities	3426	4463	7428	7562
Interest-bearing liabilities ratio	19.1%	22.6%	32.0%	33.6%

On the balance sheet of 2012.3, assets increased by about 3,500 million yen, and increase in accounts receivable by 1,100 million yen includes 700 million yen for installment of premium service, and increase in inventories by 1,800 million yen includes 700 million yen corresponding to covering FC stores. Increase in tangible fixed assets by 1,200 million yen is due to opening new stores. Capital investment increased from 1,500 million yen to 1,920 million yen. Out of the 123 stores operated by the Corporation, 96 stores are located in Kanto region. As can be seen, dominance in that area is in progress.

Such increase in assets has involved increase in loans. Interest-bearing liabilities increased by 2,965 million yen, from 4,463 million yen in FY2011.3 to 7,428 million yen in FY2012.3. At the end of March, 2013, it is planned to decrease inventories to 7,000 million yen, which would be optimized in the move of increase in net sales.

Service sales achieved quite goods results, up 32.5% YoY. While sales in existing stores were down 3.5%, gross profit rate was slightly raised from 29.1% to 29.7%. During these progress, increase in expenses took the lead, resulting in substantially lower profit. Although cost for opening new stores had been taken into consideration from the early stage, gross profit derived from goods sales was amended downward, due to more severe price competition. In terms of service sales, initial cost takes the lead over the early stage since subscription and it should be recovered for a period of 2 or 3 years. So even if service sales increase, profit as a whole cannot be covered so soon because it is accompanied by increase in number of sales persons and in personnel expenses.

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Sales of PCs and peripherals experienced very tough situation. Merchandise lineup is completely different between major mass home electronics retailers and the Corporation. The Corporation concentrates on PC-related merchandise. It deals with TV sets, but the share is extremely small. Major mass retailers have inventory guarantee scheme for home electronics such as TV sets, whereas the Corporation adopts complete buy-out scheme, and therefore if sales price fall below the purchase price, the Corporation have to incur the difference.

Another adverse effect was that the huge flood in Thailand caused supply of HDD (hard disc drive) to be significantly difficult. Because of undersupply and higher price of HDD, users who use these peripherals became hesitant to buy them. Accordingly, sales of other peripherals also slowed down.

As can be seen on the balance sheet, inventories increased. It is due to, in addition to opening new stores, taking over more than half stores of OA System Plaza. Following termination of FC contracts, 8 stores were transferred to the Corporation. Two of them were integrated and the remaining six were taken over. Despite initial burden, direct management would be more beneficial for efficient operation and more profit from service sales. Thus, it should be effective sooner or later.

### **Downward amendment in the current FY2013.3**

Earnings forecasts for the current FY2013.3 were amended downward, in accordance with the announcement by the Corporation: net sales from 55,000 million yen to 51,000 million yen; operating income from 680 million yen to 600 million yen; and ordinary income from 800 million yen to 700 million yen. At the ordinary income stage, slightly lower profit is expected as compared to the previous year.

This is because goods sales around PC-related merchandise are lower than as planned. Sales in existing stores were amended downward: 95% YoY to 92% YoY. Although service sales have been kept at high level, decline in goods sales have balanced out.

The current first half (2Q cumulative) has seen higher revenues but lower earnings. Net sales increased by about 1,000 million yen, but specifically, service sales were up 1,500 million yen and goods sales were down 500 million yen. Number of PCs sold was up 14.2%, whereas sales amount was up only 9.7%, thus decline in unit price still remains.

Service sales were in good state: up 28.3% YoY and total gross profit was up 8.5% YoY. Profit-to-turnover ratio was also raised to 31.7%. Ratio of service to sales was raised from 23.0% in previous first half to 28.2%. However, sales in existing stores in the first half was 91.4% YoY, lower than 95.0% as planned. Due to increase in expenses associated with opening new stores and increased human resource in the service department, ordinary income of the entire Corporation was down 47.0% YoY.

### **Towards strengthened foundation**

In the current period, the Corporation has put emphasis on vitalizing existing stores. In the next period, too, the Corporation will set responding to demands for services as its main axis, and may slow down opening new stores.

Numbers of newly opened stores in the first half were 5 for PC DEPOT and 3 for PC Clinic. In the

first half, 5 stores were newly opened and 3 were closed. Concretely, 2 stores in Morioka were integrated to 1 store, and the other 1 store was merely relocated, thus 3 stores were closed but this is not a problem.

For the second half, there will be new stores if any good location or any premise with exiting furnishings could be found suitable for PC DEPOT, but the Corporation intends to wait and see for a while. As for PC Clinic, the Corporation intends to open if any premise is available at some K's Denki store. However, there might be no PC Clinic newly opened in any K's Denki store if there is no potential for business. There is no store construction plan for the second half, so monetary burden will be smaller.

Number of stores increased from 88 to 123, in two and a half years from the end of March, 2010, and at this point the Corporation intends to strengthen the whole scheme. Besides, opening new stores as a whole is planned with its center on Kanto region, and efficiency provided by dominance in this area is envisioned.

### Comparison of earnings forecasts and of profit ratios

		(million yen, %)				
		2010.3	2011.3	2012.3	2013.3 (forecast)	2014.3 (forecast)
Net sales		44740	46912	49693	51000	53000
Gross profit		11558	13640	14756	16170	17060
	ratio to sales	25.8	29.1	29.7	31.7	32.2
SG&A expenses		10331	12271	14202	15570	16260
	ratio to sales	23.1	26.2	28.5	30.5	30.7
Operating income		1226	1368	553	600	800
	ratio to sales	2.7	2.9	1.1	1.2	1.5
Ordinary income		1306	1509	717	700	900
	ratio to sales	2.9	3.2	1.4	1.4	1.7

### Cap on investment

During this first half, 5 stores were opened: Kannana Okudo store (April), Takamatsu-Higashi By-Pass store (April), Morioka Flagship store (June), Tookaichiba store (June), and Iizuka-akimatsu store (September). Among these, Takamatsu, Morioka and Iizuka-akimatsu are operated by the subsidiary, PC DEPOT Stores Co. PC DEPOT Stores is the former PC DEPOT Kyushu, whose name was changed in April.

In terms of recently opened PC DEPOT stores, Maebashi (2011 summer) and Tsukuba (2011 winter) have been doing well. On the other hand, Tama-Newtown is having a hard time. Material difference is that decline in unit prices of goods sales could be covered by service sales.

Increase in capital investment in the current period was planned as 1,800 million yen, out of which about 550 million yen was spent on opening 5 stores in the first half, and for the second half there would be little opening and increase in capital would be put on systems, thus the increase in capital investment for the whole FY would be at most 1,100 million yen which can be considered as within the range of internal fund.

For the current period onward, there will be less newly opened stores and the Corporation intends to

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respond to rush of new products. Call center will be doubled in the context of growing number of inquiries from customers.

To open a PC DEPOT store, 350 million yen for building and 100 to 150 million yen for merchandise inventory are required. Assuming investment of 450 million yen, sales amount can be expected as 1,000 million yen. It can be estimated that it would take one and a half to two years to generate surplus, and operating profit on sales of 5 to 7%.

To open a PC Clinic, required investment is only 1 to 1.5 million yen. Assuming annual sales of 40 to 50 million yen, it can be estimated that it would take two years to generate profit. In addition to technical service fees, stable income comes from monthly charges. This PC Clinic is a business model in which operating profit on sales of around 20% can be anticipated.

Smartphones sell well also at PC DEPOT stores. And the Corporation has greatly enhanced services for smartphones. However, it can be thought difficult that smartphones would be the pillar of profit. It may be better to consider profit is generated in conjunction with PC sales.

In terms of PC Clinic, not only the conventional in-shops, operations as independent stores are also under consideration for the future. Customers evaluate PC DEPOT stores, for example, as providing excellent services related to goods sales and as fulfilling service contents of PC Clinic.

### Newly opened stores (results and forecasts)

		(number of stores)			
		2011.3	2012.3	2013.3 (forecast)	2014.3 (forecast)
PC DEPOT	directly-managed	1	4	2~3	2~3
	subsidiaries	0	6	3	0
	FC	0	-12	0	0
PC DEPOT	directly-managed	30	16	3~5	3~5
PC Clinic	subsidiaries	0	1	0	0
	FC	-18	1	0	0

NOTE: forecast by the analyst

### Situation turned a little favorably. Windows 8 is a promising factor.

Severe competition with mass home electronics retailers would remain for the time being. Price competitions of PCs cause decline in gross profit, but sales volume can be increased. On the other hand, the Corporation has kept its service sales growing steadily, and therefore, even though facing tough situation of goods sales, it is in a position to be able to secure profit of the entire business.

Regarding development of in-shops of PC Clinics operated inside K's Denki stores, time span from opening new store to generating surplus is slightly prolonged, affected by price competitions of PCs. Nevertheless, there is no problem with generating surplus since service sales should assure constant earnings. It can be estimated that it would take a little less than two years from opening new store, to

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generate surplus.

Service members of PC DEPOT are steadily increasing. Indeed, service sales of the Corporation have increased by more than 20%, so increase in the number of members can be deemed equal or greater.

Data cards for LTE which use high-speed telecommunication have been promoted in full swing. Core users would reach for them to use them as internet connection line for PC. Then demands for them would be much bigger. Connection becomes faster, so everyone would want to use LTE. Options are to buy a data card or rather, to replace PC. As the Corporation deals with EMOBILE preferentially, this is a great chance. If LTE has any additional effect, average unit price of service sales may possibly be somewhat raised in FY2012. In fact, LTE data cards produced by EMOBILE are made available by the Corporation, with monthly fee of 3,880 yen (including tax).

PC software of Windows 8 was released in October as scheduled, but release of tablet devices and smartphones which operate on Windows 8 in Japan was postponed to next year. For PCs, Windows 7 is still the mainstream and Windows 8 accounts for only 20%. Upgrading to Windows 8 needs quite a bit effort. For premium service members of PC DEPOT, installation work is assisted free of charge.

### Constituent ratio of marginal gain

	(%)					
	2011.3		2012.3		2013.3 (2Q)	
hardware	16.0		11.9		10.1	
software and accessories	18.5		14.9		12.5	
used items	5.9		5.0		4.7	
merchandise total	40.4	[75.8]	31.8	[72.3]	27.3	[67.6]
services	59.6	[18.6]	68.2	[23.3]	72.7	[28.2]

NOTE: Numbers in parentheses are constituent ratio of sales amount.

There are other constituents of sales: internet-related business and royalties from FC stores. Marginal gain is simply a gross profit. Expenses such as subcontracting costs, business consignment expenses and personnel expenses are not reflected as initial costs. These are treated as SG&A expenses.

### Premium service is accelerated.

Looking at marginal gain (gross profit), share of service has been raised to 72.7%. In the first half, net sales of service are 6,800 million yen and constituent ratio is approaching 30%. Service menu has been further enhanced, so high growth of service sales can be deemed to continue for the time being.

Customers need services strongly, and every store is busy expanding service counter. On weekend two to three times as many guests come than weekdays, many of them want services. Services specific to the Corporation such as repair, how to use, functional upgrading are highly appreciated. On weekend, waiting time becomes longer and therefore more staff members are required.

The Corporation has currently 680 regular employees and about 1,000 part-time employees (conversion by 8 hours). At present demands for services are so big that about 200 more staff members are

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required.

Spaces for selling TV sets at stores have been substantially reduced. Instead, support counter is expanded and responds to such demand for services increased due to rush of new products, making efficient use of space.

Members have been continuously increasing. A customer buys some merchandise related to PC, smartphone or tablet device, and he/she is eligible to subscribe to premium service. Nowadays several persons in a family have digital devices, so growing number of members subscribe to service for more than one devices. Depending on the number of devices, various courses of monthly fees are available such as 1,500 yen, 2,000 yen and 2,500 yen, and this is certainly convenient as wide variety of services can be provided. As number of devices increases, monthly fee also increases. So does added-value for the Corporation.

Marginal gain (simple gross profit) of service sales has been steadily increasing. Marginal gain as described herein means that gross profit in general refers to the amount of sales minus sales cost, whereas personnel expenses and depreciation are not allocated to the sales cost, and expenses that occur at stores are all treated as SG&A expenses.

Based on this marginal gain, in terms of 2Q cumulative (April to September) of FY2013.3, marginal gain derived from goods sales is 27.3% (10.1% for hardware, 12.5% for software and accessories, 4.7% for used items), and that from service sales is 72.7%, thus share of service has been further raised.

### **Response to internet shopping**

There is a concern that internet shopping might be a threat to over-the-counter sales. In fact, some people take a look at some commodities at stores and actually buy them via internet. Prices are lower on the internet. That's why.

In such cases, there is no problem if the user is able to make full use of the hardware. Elsewhere, there are strong needs for convenient services in cases where the user does not understand how to use the hardware fully or faces some failure. That is where the Corporation has a chance to show off. Simply selling such as iPhone, iPad, Nexus or Kindle does not make much profit. But if the customer subscribes to premium service, relationship with him/her can be maintained for a long time and service sales will contribute to earnings. In that sense, the Corporation keeps dealing with new products proactively.

### **Pursuit of lifetime value**

“Lifetime value” is a concept that a time span during which a customer uses a product is considered as the product's duration (lifetime), and value for the customer during the lifetime is raised as a whole, according to which earnings would be made. Then, how should the Corporation make profit? Competitions of goods sales are more and more severe. Unit prices go down. On the other hand, service sales have grown

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steadily. In a contract for a period of three years, the Corporation can make profit in the second and third years. Quality of service should be improved so that members would like to buy new products at the same store. Of course, stock of members is bigger at existing stores than new stores. New stores have to compete in goods sales and thereafter, increase their members. So, if prices go down in competitions of goods sales, making profit at new stores would be slower than expected.

By increasing members, service sales can be raised and several years later, surplus profit thereof would be generated. So far, members are rapidly increasing, but there may be a situation where such effect is surpassed by lowered profitability in goods sales.

President Nojima has set his basic policy as not to be beaten in selling. He tries to ensure that in a flyer, price for an identical product is lower than any other competitors. The Corporation specializes in PCs and seeks to make difference in services with PC Clinics at the center. Suppose a customer buys a PC and subscribes to premium service for a period of three years. Then the total earnings and profitability can be determined based on the cumulative total over the three years. On the other hand, without selling a product, contract for service sales cannot be made. Thus, on the basis of not to be beaten in selling, quantity should be considered, which would lead to service sales. That means, if decrease in gross profit of goods sales falls below the projection, the Corporation may possibly face lower profit.

Thus, the Corporation's business model is unique, but in a sense that stable operating income should be achieved in the current environment, it is necessary to see, a little longer, how it works. For the time being, there is far less possibility for the Corporation to restore its ordinary income on sales of 5%. To restore its ROE of 8% or more, ordinary income of 1,500 million yen is required, but such a situation would not come even for the next FY.

President Nojima makes his motto that the Corporation should be aggressive in price competitions, not to be defensive. He goes aggressive also in the current period, unit prices will go down instead of increase in quantity, resulting in difficulties in improving profitability. Nevertheless, service subscription members are increasing, and certain level of lifetime values may be ensured taking the periods of the members' subscription terms into account. The game is towards expanding this stock-type business. The Corporation does management, reading its service sales. Since service sales have accumulated associated with increased members, there is no need to worry about large scale collapse of business performance.

Since summer of last year, service subscription term for members has been extended from two years to three years. It would be still difficult to push up business performance by service sales during the current FY2013.3. From the next period and onward, it would be indeed effective.

### **Response to consumption tax**

How should the Corporation respond to consumption tax? Every mass home electronics retailer

displays prices including tax. Consumption tax is not displayed separately, so customers do not understand explicitly how much it is. It is already included in the price as displayed. In this regard, price display including tax continues with respect to goods sales. On the other hand, with respect to services, prices will be shown excluding tax, from this November.

Essentially, consumption tax is to be paid separately by consumers. With respect to services, the Corporation decided to respond and prepare earlier.

## 5. Evaluation:

### **Recovery of profitability is not enough. Next movement should be anticipated.**

#### **Pay attention to the lifetime value including service sales**

Reorganization of mass home electronics retailers has effect also on the Corporation. Those having got advantage in purchase prices thanks to the reorganization would make attempts to discount, which should spread to the whole market.

The Corporation's business model intends, through selling PC hardware, to ensure stably profit from service sales. Even if a PC DEPOT store is located near a large mass home electronics retailer, customers can be segregated, president Nojima says. Some customers may prefer PC DEPOT because they can receive fine-tuned services for PCs. The strategy is that such users should be captured in a long-time relationship as premium service members.

PC Clinic is a kind of store which aims at providing PC-related services, and taking advantage of years of cooperation with K's Denki, directly-managed PC Clinic stores are planned to be newly opened inside other mass home electronics retailers. Opening new stores is accelerated, and then it takes two to three years to have those stores make profit. During this period, decline in prices of goods sales such as PCs acts negatively on improvement of total lifetime value, including service sales. The key is to survive such situation and to have profit structure reform linked with improvement of profit rate. To ensure ROE of 8% or more sustainably, considerable efforts are still required. Therefore, Company rating for the Corporation is C. (for explanation on Company rating, refer to the cover page)

As a measure, gross profit rate of goods sales should be raised by 2 to 3%. Then expansion of burden of sales activities on goods sales would be slower, and profit derived from increase in services would come to the surface. Increase in operating income of 700 to 1,000 million yen per year may be anticipated. In addition, if unit price of services per person could be increased by 500 yen per month, increase in operating income of 1,500 to 2,000 million yen per year may be anticipated in the mid-term. If these two improvements could successfully go on, operating income of the entire Corporation can be estimated as 2,800 to 3,600 million yen per year. Consequently, the Corporation would be able to establish its unique status as a service company of personal communication, both in name and reality. There are sufficiently

such possibilities, but for now, hurdle is high.

Based on the stock price on November 21, PBR is 0.38, ROE is 3.7%, PER is 10.5, and dividend yield is 4.2%. How should we envision the era next to this PC era? Will the Corporation be able to counteract against mass home electronics retailers? In this regard, the Corporation is capable of demonstrating a certain level of presence. In that sense, if a scheme where services for personal communication makes profit and a positioning where the Corporation and other mass home electronics retailers co-exist differently could lead to profit, value of the Corporation should be reconsidered. For the time being the Corporation should aim at ordinary income of 2,000 million yen. If this is achieved, ROE will be raised to 10%, and it can be anticipated that PBR would approach close to 1.0.