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Medical System Network

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Executive summary

Business overview

Medical System Network operates the Nanohana Pharmacy chain. It also provides a wide range of pharmacy management support services (from pharmaceuticals procurement to pharmacist training) to dispensing pharmacies and medical institutions including directly operated pharmacies and non-group affiliates that register to become members of the company's network. The core of these services is the one-stop supply chain management service that comprises the determination of appropriate transaction prices with drug wholesalers, drug ordering, and settlement of bills. Medical System Network receives commissions from its network members based on the amount of drug orders they place. As of end-FY03/22, there were 7,401 network members (+1,285 from end-FY03/21) comprising 425 directly operated pharmacies and 6,976 affiliates. The company has reorganized its business segments in FY03/20, moving the former Pharmaceuticals Network and Dispensing Pharmacy businesses, as well as the Manufacture and Market Pharmaceuticals business previously included in the Other business, under the Community Pharmacy Network segment. The Leasing and Facility-related business and the Meal Catering business are unchanged. The Other business segment mainly comprises home-visit nursing care following the transfer of the Manufacture and Market Pharmaceuticals business.

The Nanohana Pharmacy chain falls under the Community Pharmacy business, a subdivision of the Community Pharmacy Network segment. The dispensing pharmacies operated by the company are generally located near large medical institutions or in medical malls or complexes that integrate multiple clinics and hospitals. According to the Ministry of Health, Labour and Welfare, there were 60,951 dispensing pharmacies in Japan at end-March 2020. Pharmacies directly operated by Medical System Network accounted for 0.7% of this market. The majority of the pharmacies that make up the domestic market are mid-tier regional chains with roots in local communities and small, family-owned pharmacies. Given this environment, growth strategies of major pharmacy chain operators such as Medical System Network emphasize not only new pharmacy openings but expansion through acquisition of smaller operations. The company has had success in having dispensing pharmacies (typical shops that make up the majority) join its pharmaceuticals network, and since FY03/21, its network members have collectively accounted for over 10% of the domestic market.

The company currently operates in four segments: Community Pharmacy Network (accounting for 94.5% of total sales in FY03/22), Leasing and Facility-related (3.1%), Meal Catering (2.2%), and Other (0.3%). The Community Pharmacy Network segment is a new segment following a segment change in FY03/20 that initially combined the former Pharmaceuticals Network and Dispensing Pharmacy segments with Manufacture and Market Pharmaceuticals business (previously part of Other segment); the Digital Shift business was added to the new segment from FY03/21. At present, the Community Pharmacy Network segment comprises the Pharmaceuticals Network, Community Pharmacy, Manufacture and Market Pharmaceuticals, and Digital Shift businesses. The company discloses operating status of each business under the segment, but does not provide a sales and profit breakdown by business.

Trends and outlook

FY03/22 results: For FY03/22, the company reported sales of JPY106.7bn (+2.3% YoY), EBITDA of JPY6.7bn (+4.4% YoY), operating profit of JPY3.9bn (+12.3% YoY), recurring profit of JPY4.3bn (+24.0% YoY), and net income attributable to owners of the parent of JPY2.4bn (+8.9% YoY). Sales increased 2.3% YoY in part because measurable recovery in prescription count offset a decline in prescription unit price at the Community Pharmacy business. A steady increase in new network affiliates at the Pharmaceutical Network business also contributed to sales growth. Operating profit grew 12.3% YoY, thanks in part to the increase in new network affiliates in the Pharmaceuticals Network business. Net income attributable to owners of the parent increased 8.9% YoY thanks in part to gains on the sale of investment securities and a decrease in the company's income tax burden stemming from its July 2021 absorption of consolidated subsidiary Home-Visit Nursing Care Station Himawari Co., Ltd.

The company's FY03/22 earnings forecast calls for sales of JPY110.0bn (+3.1% YoY), EBITDA of JPY6.2bn (-7.6% YoY), operating profit of JPY3.5bn (-9.1% YoY), recurring profit of JPY3.7bn (-14.2% YoY), and net income attributable to owners of the parent of JPY1.8bn (-26.9% YoY). In the dispensing pharmacy industry, earnings traditionally have been at the mercy of revisions to NHI drug prices and dispensing fees. Although the NHI drug price and dispensing fee revisions implemented in April 2022 resulted in a 1.35% reduction in drug prices, they also delivered a 0.08% increase in dispensing fees due to higher points awarded for the interpersonal work of pharmacists. The company views these circumstances as an opportunity for expansion and in the Pharmaceuticals Network business it will strive to acquire new network affiliates, provide comprehensive management support to pharmacies, and further improve the efficiency of pharmaceutical distribution. In

the Community Pharmacy business, it will endeavor to strengthen interpersonal operations by fostering a medical mindset and facilitating high-quality pharmacotherapy, while also targeting prescription acquisition primarily through its official "Tsunagaru Pharmacy" LINE account. In the Leasing and Facility-related segment, it will aim to achieve occupancy rates of 90% at Wisteria SenriChuo and Wisteria Minami-Ichijo (both serviced residences for the elderly) as soon as possible.

When reporting FY03/22 results, Medical System Network also released its sixth medium-term plan spanning FY03/23 through FY03/26. While under the fifth medium-term plan the company sought to expand both market share and the scale of operations, under the new plan it aims to transition to a new stage in which the company's networks form a foundation platform that functions as a new pharmacy infrastructure with group pharmacies at the core but also including affiliates. Medical System Network plans to utilize this platform to pursue growth in various businesses.

Strengths and weaknesses

Strengths: a management support network service available to small and mid-tier pharmacies; certified pharmacist training support system that appeals to pharmacies struggling with the pharmacist shortage; and regional dispensing pharmacy strategy in line with administrative guidance. Weaknesses: potential conflict of interest between M&A-driven pharmacy chain expansion and support services for small pharmacies; low profit margins for dispensing pharmacies without drugstore function; and relatively small assets being a disadvantage in acquisitions. (See the Strengths and weaknesses section for details.)

Key financial data

Income statement (JPYmn)	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18	FY03/19	FY03/20	FY03/21	FY03/22	FY03/23
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Est.
Sales	54,827	66,182	75,548	87,715	88,865	93,977	98,232	105,241	104,257	106,685	110,000
YoY	-	20.7%	14.2%	16.1%	1.3%	5.8%	4.5%	7.1%	-0.9%	2.3%	3.1%
Gross profit	19,412	22,737	28,476	32,801	34,164	36,607	37,271	40,214	42,412	44,429	
YoY	-	17.1%	25.2%	15.2%	4.2%	7.2%	1.8%	7.9%	5.5%	4.8%	
Gross profit margin	35.4%	34.4%	37.7%	37.4%	38.4%	39.0%	37.9%	38.2%	40.7%	41.6%	
Operating profit	2,047	2,091	2,641	3,783	2,113	3,163	1,428	1,615	3,429	3,852	3,500
YoY	-	2.2%	26.3%	43.2%	-44.1%	49.7%	-54.9%	13.1%	112.3%	12.3%	-9.1%
Operating profit margin	3.7%	3.2%	3.5%	4.3%	2.4%	3.4%	1.5%	1.5%	3.3%	3.6%	3.2%
Recurring profit	1,912	2,020	2,540	3,860	2,109	3,250	1,501	1,560	3,479	4,313	3,700
YoY	-	5.6%	25.8%	52.0%	-45.4%	54.1%	-53.8%	3.9%	123.0%	24.0%	-14.2%
Recurring profit margin	3.5%	3.1%	3.4%	4.4%	2.4%	3.5%	1.5%	1.5%	3.3%	4.0%	3.4%
Net income	756	668	885	1,720	571	1,022	462	-895	2,198	2,394	1,750
YoY	-	-11.6%	32.4%	94.4%	-66.8%	79.0%	-54.8%	-	-	8.9%	-26.9%
Net margin	1.4%	1.0%	1.2%	2.0%	0.6%	1.1%	0.5%	-	2.1%	2.2%	1.6%
Per-share data											
Shares issued (year-end; '000 shares)	25,970	25,970	25,970	29,890	29,890	30,523	30,643	30,643	30,643	30,643	-
EPS	29.1	27.7	37.1	60.1	19.3	34.5	15.3	-29.5	72.5	79.4	58.0
EPS (fully diluted)	-	-	-	-	-	34.3	15.0	-	-	-	-
Dividend per share	8.0	8.0	8.0	9.5	10.0	10.0	10.0	10.0	10.0	12.0	12.0
Book value per share	222.9	214.7	243.3	334.9	345.3	351.4	354.8	310.4	370.2	439.7	-
Balance sheet (JPYmn)											
Cash and cash equivalents	2,092	3,106	2,499	2,081	2,252	10,201	11,703	11,722	10,118	8,201	
Total current assets	8,271	10,941	11,023	10,783	11,098	18,736	21,055	20,578	19,313	18,701	
Tangible fixed assets	11,472	15,976	17,249	20,253	21,246	24,129	25,721	25,126	24,634	24,624	
Investments and other assets	2,783	3,798	3,759	4,329	4,559	4,847	5,922	6,143	6,926	6,848	
Intangible assets	8,263	12,399	13,554	13,481	13,833	15,045	16,235	14,615	13,572	12,767	
Total assets	30,789	43,114	45,587	48,847	50,737	62,759	68,935	66,464	64,448	62,941	
Accounts payable	5,616	7,798	8,598	9,525	9,144	9,416	10,198	10,021	9,258	9,680	
Short-term debt	5,119	12,922	9,214	6,910	3,863	7,463	9,158	8,905	10,210	5,935	
Total current liabilities	14,375	24,880	21,626	21,061	16,920	21,769	23,844	23,296	25,418	20,435	
Long-term debt	8,758	10,948	15,391	14,859	20,186	26,329	29,739	28,653	22,348	23,631	
Total fixed liabilities	10,178	12,882	17,826	17,520	23,172	30,404	34,329	33,749	27,841	29,219	
Total liabilities	24,553	37,762	39,452	38,581	40,092	52,174	58,173	57,045	53,260	49,654	
Total net assets	6,236	5,352	6,136	10,265	10,644	10,584	10,761	9,418	11,187	13,286	
Total interest-bearing debt	13,877	23,870	24,605	21,769	24,049	33,792	38,897	37,558	32,558	29,566	
Cash flow statement (JPYmn)											
Cash flows from operating activities	3,790	3,706	3,838	6,409	3,084	6,699	2,840	4,232	5,205	4,010	
Cash flows from investing activities	-5,425	-7,559	-3,958	-5,040	-3,909	-6,848	-5,921	-2,383	-1,485	-2,511	
Cash flows from financing activities	1,654	4,864	-483	-1,792	998	8,050	4,338	-1,687	-5,312	-3,415	
Financial ratios											
ROA (RP-based)	6.7%	5.5%	5.7%	8.2%	4.2%	5.7%	2.3%	2.3%	5.3%	6.8%	
ROE	13.7%	12.2%	16.2%	21.9%	5.7%	9.8%	4.3%	-8.9%	21.3%	19.6%	
Equity ratio	18.8%	11.9%	12.7%	20.3%	20.1%	16.9%	15.6%	14.2%	17.3%	21.1%	

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

Trends and outlook

Quarterly trends and results

Cumulative (JPYmn)	FY03/21				FY03/22				FY03/23	FY03/23			
	Q1	Q1-Q2	Q1-Q3	Q1-Q4	Q1	Q1-Q2	Q1-Q3	Q1-Q4	Q1	% of Est.	1H Est.	% of Est.	FY Est.
Sales	25,162	51,045	78,167	104,257	25,914	52,169	79,868	106,685	26,299	49.2%	53,460	23.9%	110,000
YoY	-1.7%	-2.2%	-1.0%	-0.9%	3.0%	2.2%	2.2%	2.3%	1.5%		2.5%		3.1%
Gross profit	9,704	20,502	31,665	42,412	10,738	21,861	33,443	44,429	11,062				
YoY	-1.4%	3.4%	4.8%	5.5%	10.7%	6.6%	5.6%	4.8%	3.0%				
Gross profit margin	38.6%	40.2%	40.5%	40.7%	41.4%	41.9%	41.9%	41.6%	42.1%				
SG&A expenses	9,765	19,147	28,892	38,982	10,071	19,999	30,379	40,576	10,713				
YoY	2.7%	0.7%	-0.4%	1.0%	3.1%	4.4%	5.1%	4.1%	6.4%				
SG&A ratio	38.8%	37.5%	37.0%	37.4%	38.9%	38.3%	38.0%	38.0%	40.7%				
Operating profit	-61	1,355	2,773	3,429	667	1,862	3,063	3,852	348	31.1%	1,120	9.9%	3,500
YoY	-	70.2%	125.8%	112.3%	-	37.4%	10.5%	12.3%	-47.8%		-39.8%		-9.1%
Operating profit margin	-	2.7%	3.5%	3.3%	2.6%	3.6%	3.8%	3.6%	1.3%		2.1%		3.2%
Recurring profit	-62	1,397	2,770	3,479	935	2,235	3,485	4,313	392	31.1%	1,260	10.6%	3,700
YoY	-	78.2%	129.3%	123.0%	-	60.0%	25.8%	24.0%	-58.1%		-43.6%		-14.2%
Recurring profit margin	-	2.7%	3.5%	3.3%	3.6%	4.3%	4.4%	4.0%	1.5%		2.4%		3.4%
Net income	-201	578	2,013	2,198	583	1,431	2,144	2,394	91	15.4%	590	5.2%	1,750
YoY	-	165.1%	517.5%	-	-	147.6%	6.5%	8.9%	-84.4%		-58.8%		-26.9%
Net margin	-	1.1%	2.6%	2.1%	2.2%	2.7%	2.7%	2.2%	0.3%		1.1%		1.6%
Quarterly (JPYmn)	FY03/21				FY03/22				FY03/23				
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1				
Sales	25,162	25,883	27,122	26,090	25,914	26,255	27,699	26,817	26,299				
YoY	-1.7%	-2.8%	1.5%	-0.8%	3.0%	1.4%	2.1%	2.8%	1.5%				
Gross profit	9,704	10,798	11,163	10,747	10,738	11,123	11,582	10,986	11,062				
YoY	-1.4%	8.2%	7.3%	7.6%	10.7%	3.0%	3.8%	2.2%	3.0%				
Gross profit margin	38.6%	41.7%	41.2%	41.2%	41.4%	42.4%	41.8%	41.0%	42.1%				
SG&A expenses	9,765	9,382	9,745	10,090	10,071	9,928	10,380	10,197	10,713				
YoY	2.7%	-1.4%	-2.3%	5.1%	3.1%	5.8%	6.5%	1.1%	6.4%				
SG&A ratio	38.8%	36.2%	35.9%	38.7%	38.9%	37.8%	37.5%	38.0%	40.7%				
Operating profit	-61	1,416	1,418	656	667	1,195	1,201	789	348				
YoY	-	206.5%	228.2%	69.5%	-	-15.6%	-15.3%	20.3%	-47.8%				
Operating profit margin	-	5.5%	5.2%	2.5%	2.6%	4.6%	4.3%	2.9%	1.3%				
Recurring profit	-62	1,459	1,373	709	935	1,300	1,250	828	392				
YoY	-	216.5%	223.8%	101.4%	-	-10.9%	-9.0%	16.8%	-58.1%				
Recurring profit margin	-	5.6%	5.1%	2.7%	3.6%	5.0%	4.5%	3.1%	1.5%				
Net income	-201	779	1,435	185	583	848	713	250	91				
YoY	-	543.8%	1,228.7%	-	-	8.9%	-50.3%	35.1%	-84.4%				
Net margin	-	3.0%	5.3%	0.7%	2.2%	3.2%	2.6%	0.9%	0.3%				

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

Quarterly results

By segment (cumulative) (JPYmn)	FY03/21				FY03/22				FY03/23
	Q1	Q1-Q2	Q1-Q3	Q1-Q4	Q1	Q1-Q2	Q1-Q3	Q1-Q4	Q1
Sales	25,162	51,045	78,167	104,257	25,914	52,169	79,868	106,685	26,299
YoY	-1.7%	-2.2%	-1.0%	-0.9%	3.0%	2.2%	2.2%	2.3%	1.5%
Community Pharmacy Network	23,922	48,539	74,368	99,214	24,657	49,663	75,986	101,457	25,045
YoY	-1.2%	-1.5%	-0.4%	-0.4%	3.1%	2.3%	2.2%	2.3%	1.6%
% of total	94.5%	94.5%	94.6%	94.6%	94.6%	94.6%	94.5%	94.5%	94.5%
Leasing and Facility-related	723	1,438	2,194	2,940	739	1,536	2,461	3,326	794
YoY	-4.9%	-21.4%	-17.5%	-14.2%	2.2%	6.8%	12.2%	13.1%	7.4%
% of total	2.9%	2.8%	2.8%	2.8%	2.8%	2.9%	3.1%	3.1%	3.0%
Meal Catering	612	1,248	1,874	2,474	586	1,166	1,752	2,322	573
YoY	-16.2%	-13.0%	-11.9%	-11.5%	-4.2%	-6.6%	-6.5%	-6.1%	-2.2%
% of total	2.4%	2.4%	2.4%	2.4%	2.2%	2.2%	2.2%	2.2%	2.2%
Other	51	110	171	229	74	152	232	305	77
YoY	34.2%	39.2%	40.2%	38.8%	45.1%	38.2%	35.7%	33.2%	4.1%
% of total	0.2%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%
Segment sales adjustments	-154	-292	-442	-601	-143	-350	-563	-727	-190
Operating profit	-61	1,355	2,773	3,429	667	1,862	3,063	3,852	348
YoY	-	70.2%	125.8%	112.3%	-	37.4%	10.5%	12.3%	-47.8%
Community Pharmacy Network	434	2,369	4,329	5,703	1,202	2,885	4,663	6,117	1,014
YoY	-47.4%	36.5%	56.6%	52.4%	177.0%	21.8%	7.7%	7.3%	-15.6%
Operating profit margin	1.8%	4.9%	5.8%	5.7%	4.9%	5.8%	6.1%	6.0%	4.0%
Leasing and Facility-related	6	16	34	32	-2	32	53	39	-43
YoY	-	-76.5%	-49.3%	-28.9%	-	100.0%	55.9%	21.9%	-
Operating profit margin	0.8%	1.1%	1.5%	1.1%	-	2.1%	2.2%	1.2%	-
Meal Catering	-19	-13	-2	-21	-1	1	7	1	-11
YoY	-	-	-	-	-	-	-	-	-
Operating profit margin	-	-	-	-	-	0.1%	0.4%	0.0%	-
Other	-11	-13	-17	-31	-7	-12	-10	-12	-2
YoY	-	-	-	-	-	-	-	-	-
Operating profit margin	-	-	-	-	-	-	-	-	-
Segment profit adjustments	-472	-1,003	-1,569	-2,253	-523	-1,043	-1,650	-2,293	-608
	FY03/21				FY03/22				FY03/23
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Sales	25,162	25,883	27,122	26,090	25,914	26,255	27,699	26,817	26,299
YoY	-1.7%	-2.8%	1.5%	-0.8%	3.0%	1.4%	2.1%	2.8%	1.5%
Community Pharmacy Network	23,922	24,617	25,829	24,846	24,657	25,006	26,323	25,471	25,045
YoY	-1.2%	-1.8%	1.9%	-0.5%	3.1%	1.6%	1.9%	2.5%	1.6%
% of total	94.5%	94.6%	94.7%	94.7%	93.5%	94.5%	94.3%	94.4%	96.8%
Leasing and Facility-related	723	715	756	746	739	797	925	865	794
YoY	-4.9%	-33.1%	-8.9%	-2.6%	2.2%	11.5%	22.4%	16.0%	7.4%

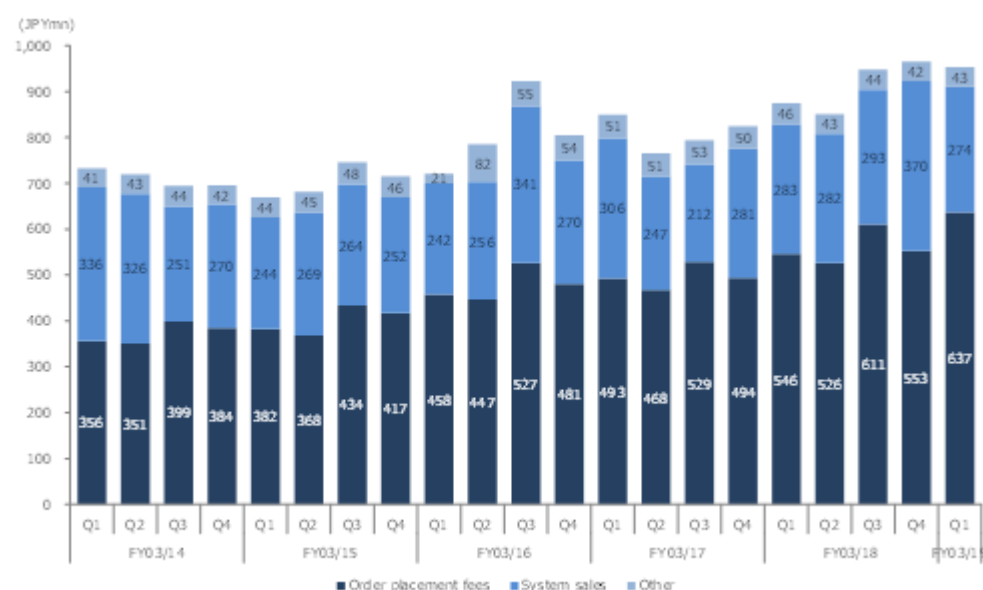
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% of total	2.9%	2.7%	2.8%	2.8%	2.8%	3.0%	3.3%	3.2%	3.1%		
Meal Catering			612	636	626	600	586	580	586	570	573
YoY			-16.2%	-9.7%	-9.8%	-10.3%	-4.2%	-8.8%	-6.4%	-5.0%	-2.2%
% of total			2.4%	2.4%	2.3%	2.3%	2.2%	2.2%	2.1%	2.1%	2.2%
Other			51	59	61	58	74	78	80	73	77
YoY			34.2%	43.9%	41.9%	34.9%	45.1%	32.2%	31.1%	25.9%	4.1%
% of total			0.2%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%
Segment sales adjustments			-154	-138	-150	-159	-463	-207	-213	-164	413
Operating profit			-61	1,416	1,418	656	667	1,195	1,201	789	348
YoY			-	206.5%	228.2%	69.5%	-	-15.6%	-15.3%	20.3%	-47.8%
Community Pharmacy Network			434	1,935	1,960	1,374	1,202	1,683	1,778	1,454	1,014
YoY			-47.4%	112.4%	90.7%	40.3%	177.0%	-13.0%	-9.3%	5.8%	-15.6%
Operating profit margin			1.8%	7.9%	7.6%	5.5%	4.9%	6.7%	6.8%	5.7%	4.0%
Leasing and Facility-related			6	10	18	-2	-2	34	21	-14	-43
YoY			-	-86.8%	-	-	-	240.0%	16.7%	-	-
Operating profit margin			0.8%	1.4%	2.4%	-	-	4.3%	2.3%	-	-
Meal Catering			-19	6	11	-19	-1	2	6	-6	-11
YoY			-	-	-	-	-	-66.7%	-45.5%	-	-
Operating profit margin			-	0.9%	1.8%	-	-	0.3%	1.0%	-	-
Other			-11	-2	-4	-14	-7	-5	2	-2	-2
YoY			-	-	-	-	-	-	-	-	-
Operating profit margin			-	-	-	-	-	-	2.5%	-	-
Segment profit adjustments			-472	-531	-566	-684	-523	-520	-607	-643	-608

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

(Reference) Former Pharmaceuticals Network segment sales

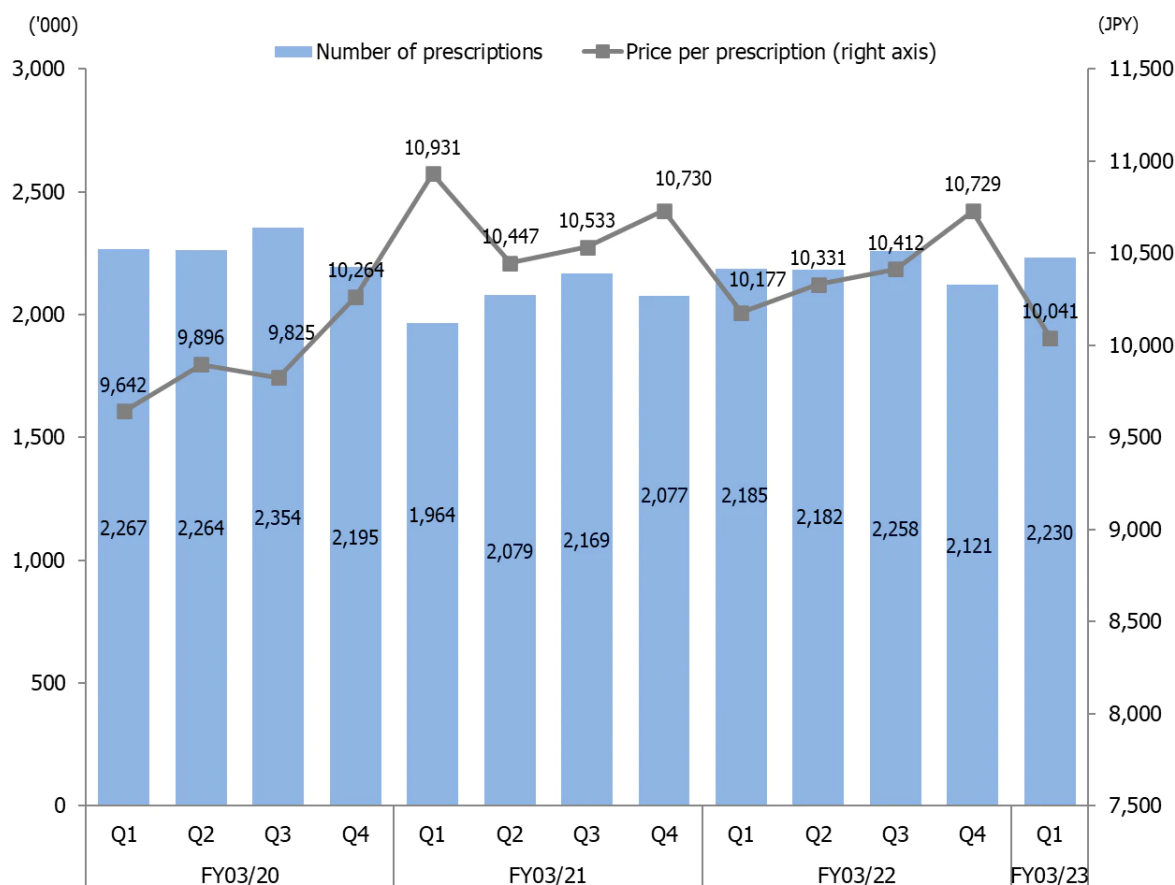


Source: Shared Research based on company data

Notes: Undisclosed from Q2 FY03/19

The former Pharmaceuticals Network segment was integrated into the new Community Pharmacy Network segment from FY03/20

Quarterly trends in prescription volume and price per prescription (drug price + technical fees; Community Pharmacy business [former Dispensing Pharmacy business]; all stores)



Source: Shared Research based on company data

Note: NHI drug price and dispensing fee revisions were put into effect on April 1, 2014, April 1, 2016, and April 1, 2018.

Number of network members by region

Area	Directly operated pharmacies	Affiliates	Total
Hokkaido	123	199	322
Tohoku	24	512	536
Kanto and Koshinetsu	98	2,340	2,438
Tokai and Hokuriku	44	1,312	1,356
Kinki	53	1,147	1,200
Chugoku and Shikoku	21	790	811
Kyushu and Okinawa	63	1,086	1,149
Total	426	7,386	7,812

Source: Shared Research based on company data (as of December 31, 2022)

Q1 FY03/23 results (out August 5, 2022)

Overview

Q1 FY03/23 (April–June 2022) earnings results

- Sales: JPY26.3bn (+1.5% YoY)
- Operating profit: JPY348mn (-47.8% YoY)
- Recurring profit: JPY392mn (-58.1% YoY)
- Net income attributable to owners of the parent: JPY91mn (-84.4% YoY)

Operating results and business conditions

Sales rose 1.5% YoY. In the mainstay Community Pharmacy Network segment, sales were 1.6% higher YoY. Contributing factors included an increase in network members at the Pharmaceutical Network business. In the Community Pharmacy

business, the prescription unit price fell due to the impact of the NHI drug price and dispensing fee revisions, but the opening of new stores and acquisition of stores, as well as increased dispensing fees (all-store basis), contributed to earnings.

Operating profit fell 47.8% YoY. This was due in part to a decline in profit at the Community Pharmacy business (part of the Community Pharmacy Network segment) as a result of NHI drug price and dispensing fee revisions and increased labor expenses accompanying efforts to strengthen interpersonal services at directly managed pharmacies. Higher company-wide expenses for the development of operational systems (related to personnel, inventory management, security enhancement, etc.) also weighed on profit. The company had projected that generating profit in Q1 would be challenging because the quarter came immediately after NHI drug price and dispensing fee revisions and it accordingly anticipated smaller profit margins. However, operating profit exceeded its initial projection due to steady growth in network affiliates and an increase in prescription count.

In Q1, sales reached 49.2% of the company's 1H forecast (23.9% of full-year forecast), while operating profit came to 31.1% (9.9%), recurring profit 31.1% (10.6%), and net income 15.4% (5.2%). NHI drug price and dispensing fee revisions in April 2022 had an impact on progress rates, particularly in terms of profit.

Segment results

Community Pharmacy Network

- Segment sales: JPY25.0bn (+1.6% YoY; including intra-group sales and transfers between segments, same applies below)
- Segment profit: JPY1.0bn (+15.6% YoY)
- This is a new segment that integrates the former Pharmaceuticals Network business, the Dispensing Pharmacy business, and the manufacture and market pharmaceuticals business (mainly Feldsenf Pharma) previously included in Other. A digital shift business that utilizes instant messaging app LINE was added to the segment from FY03/21.

Community Pharmacy

The prescription unit price fell by 1.3% YoY due to NHI drug price and dispensing fee revisions, but the stores newly opened and acquired since Q2 FY03/22 contributed to earnings. As a result, the prescription count rose to 2.2mn (+2.1% YoY) and dispensing fees reached JPY22.4mn (+0.7% YoY) on a company-wide basis. The company faced challenges in terms of profit in Q1 because it was required to sell drugs procured before the NHI price revisions implemented in April 2022 at post-revision selling prices. During Q1 FY03/23, the company opened three community pharmacies, including two inside medical malls. As of June 30, 2022, the company had 426 community pharmacies, one care plan center, and eight cosmetics/drug stores.

Pharmaceuticals Network

The company observed a growing need for improvement in operational efficiency at pharmacies as pharmacists concentrated more intensely on interpersonal operations due primarily to impact stemming from dispensing fee revisions. Accordingly, the company reported a net increase of 411 network affiliates (525 new additions and 114 departures) in Q1. As of June 30, 2022, pharmaceutical network members totaled 7,812 (an increase of 411 from March 31, 2022), comprising 426 directly operated pharmacies and 7,386 affiliates. Shared Research assumes that the increase in network affiliates contributed to segment profit growth.

Manufacture and Market Pharmaceuticals

Sales of Feldsenf Pharma Co., Ltd., the core subsidiary in this business, amounted to JPY630mn (+61.5% YoY). In the Manufacture and Market Pharmaceuticals business, the company group aims to provide a stable supply of good-quality, low-priced generic drugs. The company offered 82 products (41 ingredients) as of June 30, 2022, and supplied these to 1,732 general network affiliates (an increase of 34 from March 31, 2022).

Digital Shift

The company established subsidiary PharmaShift Co., Ltd. on October 1, 2020, to create a "new pharmaceutical platform" for the digital age. In March 2021 the subsidiary launched the "Tsunagaru Pharmacy" service utilizing its official LINE account. As of end-June 2022, the number of pharmacies using the service was 1,549 (an increase of 638 from March 31, 2022) while 2,194 had placed orders for the service use (an increase of 551 from March 31, 2022). The company believes that early growth of the Tsunagaru Pharmacy service will lead to an increase in prescription count. Accordingly, despite the temporary advance outlays it will incur in association, the company has begun offering a free trial of this service to its network affiliates.

Leasing and Facility-related

- Segment sales: JPY794mn (+7.4% YoY)
- Segment loss: JPY43mn (versus a loss of JPY2mn in Q1 FY03/22)

Operating conditions of serviced elderly housing facilities

Segment sales rose 7.4% YoY, as property leasing revenue was generally strong and orders for construction projects increased. On the profit front, the operating loss widened due to increased advertising expenses accompanying aggressive sales promotion activities for the Wisteria serviced residences for the elderly and support services for physicians opening their own practices. As of end-June 2022, the company reported stable occupancy rates at three of its five properties (the overall occupancy rate at the five serviced residences for the elderly stood at 81.8%), while for the remaining two, at Wisteria Senri-Chuo it reported an occupancy rate of 76.8% (with 63 out of 82 units occupied), and at Wisteria Minami Ichijo it reported an occupancy rate of 69.0% (with 80 out of 116 units occupied).

Meal Catering

- Segment sales: JPY573mn (-2.2% YoY)
- Segment loss: JPY11mn (versus a loss of JPY1mn in Q1 FY03/22)

In Q1 FY03/22, sales decreased and losses worsened, as the number of meals supplied declined due to the company withdrawing from loss-making facilities.

Other (mostly home-visit nursing care)

- Segment sales: JPY77mn (+4.1% YoY)
- Segment loss: JPY2mn (versus a loss of JPY7mn in Q1 FY03/22)

Company forecast for FY03/22

Recent performance and FY03/22 company forecast

(JPYmn)	FY03/21			FY03/22			FY03/23		
	1H Act.	2H Act.	FY Act.	1H Act.	2H Act.	FY Act.	1H Est.	2H Est.	FY Est.
Sales	51,045	53,212	104,257	52,169	54,516	106,685	53,460	56,540	110,000
YoY	-2.2%	0.4%	-0.9%	2.2%	2.5%	2.3%	2.5%	3.7%	3.1%
Cost of sales	30,542	31,303	61,845	30,307	31,949	62,256			
Gross profit	20,502	21,910	42,412	21,861	22,568	44,429			
Gross profit margin	40.2%	41.2%	40.7%	41.9%	41.4%	41.6%			
SG&A expenses	19,147	19,835	38,982	19,999	20,577	40,576			
SG&A ratio	37.5%	37.3%	37.4%	38.3%	37.7%	38.0%			
Operating profit	1,355	2,074	3,429	1,862	1,990	3,852	1,120	2,380	3,500
YoY	70.2%	153.2%	112.3%	37.4%	-4.1%	12.3%	-39.8%	19.6%	-9.1%
Operating profit margin	2.7%	3.9%	3.3%	3.6%	3.7%	3.6%	2.1%	4.2%	3.2%
Recurring profit	1,397	2,082	3,479	2,235	2,078	4,313	1,260	2,440	3,700
YoY	78.2%	168.3%	123.0%	60.0%	-0.2%	24.0%	-43.6%	17.4%	-14.2%
Recurring profit margin	2.7%	3.9%	3.3%	4.3%	3.8%	4.0%	2.4%	4.3%	3.4%
Net income	578	1,620	2,198	1,431	963	2,394	590	1,160	1,750
YoY	165.1%	-	-	147.6%	-40.6%	8.9%	-58.8%	20.5%	-26.9%
Net margin	1.1%	3.0%	2.1%	2.7%	1.8%	2.2%	1.1%	2.1%	1.6%

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

When reporting Q1 FY03/23 results on August 5, 2022, the company made no changes to its full-year earnings forecasts (including segment forecasts). The earnings forecast, as announced at the start of the fiscal year, is as follows.

- Sales: JPY110.0bn (+3.1% YoY)
- EBITDA: JPY6.2bn (-7.6% YoY)
- Operating profit: JPY3.5bn (-9.1% YoY)
- Recurring profit: JPY3.7bn (-14.2% YoY)
- Net income attributable to owners of the parent: JPY1.8bn (-26.9% YoY)
- EPS: JPY57.99 (versus JPY79.35 in the previous year)

Forecast by key segment

Community Pharmacy Network business: sales of JPY104.7bn (+3.2% YoY), segment profit of JPY6.0bn (-1.5% YoY)

Other three businesses (Leasing and Facility-related, Meal Catering, and home-visit nursing care): sales of JPY6.2bn (+3.7%

YoY), segment profit of JPY61mn (+114.1% YoY)
Adjustments: JPY874mn for sales, JPY2.6bn for segment profit

Forecast on new pharmacy openings and network member count

In FY03/23, the company looks to expand the total number of network members to 8,900 (+1,499 YoY). Also included in its forecast is the opening of 15 directly operated pharmacies, primarily in medical malls. Given the status of NHI drug price revisions and earnings trends of wholesalers, the company assumes that the pressure of pharmaceuticals price hikes will further intensify for small and medium-sized dispensing pharmacies. In terms of the network member count, while the company observed a temporary outflux of departing member affiliates who left to join rival networks, it believes the situation has improved in tandem with heightening recognition of its competitiveness in the industry. As such, the company views its estimated net increase in network members as the minimum target for FY03/23.

Background to earnings forecasts

In the dispensing pharmacy industry, earnings traditionally have been heavily impacted by revisions to NHI drug prices and dispensing fees. The NHI drug price and dispensing fee revisions implemented in April 2022 resulted in a 1.35% reduction in drug prices, and delivered a 0.08% increase in dispensing fees due to higher points awarded for the interpersonal work of pharmacists. In addition to the hardship brought about by reduction of drug prices, the generic drugs industry has seen a number of quality issues in recent years. Under these circumstances, the company believes the needs for improved operational efficiency and more stable management will remain strong in the pharmacy industry.

The company views these circumstances as an opportunity for expansion and in the Pharmaceuticals Network business it will strive to acquire new network affiliates, provide comprehensive management support to pharmacies, and further improve the efficiency of pharmaceutical distribution. In the Community Pharmacy business, it maintains a cautious view on the recovery of prescription volume. That being said, it will endeavor to strengthen interpersonal operations by fostering a medical mindset and facilitating high-quality pharmacotherapy, while also targeting prescription acquisition primarily through its official "Tsunagaru Pharmacy" LINE account. As of end-FY03/23, a total of 4,400 pharmacies (+2,757 YoY) have placed orders to take up the Tsunagaru Pharmacy service, and 3,400 pharmacies (+2,489 YoY) have already adopted the service. On the expense front, the company expects to incur upfront costs associated with strengthening store development and increasing new store openings with a view to expanding the pharmacy network.

In the Leasing and Facility-related business, which is the largest of the other three businesses, the company will aim to achieve occupancy rates of 90% at Wisteria SenriChuo and Wisteria Minami-Ichijo (both serviced residences for the elderly) as soon as possible.

Medium-term plan (out May 6, 2022)

Sixth medium-term plan

When reporting FY03/22 results, Medical System Network also released its sixth medium-term plan kicking off in FY03/23. While under the fifth medium-term plan the company sought to expand both market share and the scale of operations, under the new plan it aims to transition to a new stage in which the company's networks form a foundation platform that functions as a new pharmacy infrastructure with group pharmacies at the core but also including affiliates. Medical System Network plans to utilize this platform to pursue growth in various businesses. Quantitative targets for the final year of the plan calls for sales of JPY140.0bn (CAGR of 7.0% over the span of the sixth medium-term plan), operating profit of JPY6.5bn (14.0%), 12,000 network members in the Pharmaceuticals Network business, and 550 community pharmacies (directly operated pharmacies).

Review of the fifth medium-term plan

Medical System Network announced its fifth medium-term plan (FY03/19–FY03/22) at the time of its earnings announcement for FY03/18. Starting from the fifth medium-term plan, the company changed the plan's term from three years to four years, which would be in line with the cycle of medical treatment fee revisions.

Core strategies

The core strategies of the fifth medium-term plan were as follows. The first four were in response to the NHI drug price and dispensing fee revisions implemented in April 2018. The third strategy was linked to the company's full-scale entry into the generic drug business (manufacture and sales), and the company expected earnings contribution from its consolidated

subsidiary Feldsenf Pharma, which has a central role in managing the business. Regarding the fifth strategy, given that the construction of a new serviced elderly housing facility was near completion as of end FY03/18, the company aimed to focus on boosting occupancy rates for these units. Also, having made continued investments into these new facilities, the company saw the period covered by the fifth medium-term plan as a time to focus on stepping up its financial base.

- ▶ Drive collective efforts of all network members to expand the pharmaceuticals network and provide management support to small and mid-tier pharmacies that help sustain community-based medical care; also improve drug distribution efficiency through collective efforts.
- ▶ Position directly operated pharmacies as medical institutions and raise their caliber; promote their family pharmacy functions, allowing them to take initiative in resolving issues surrounding community medical care.
- ▶ Assist government-driven efforts to increase generic drug utilization and help develop efficient drug distribution systems by expanding manufacture and sales of quality generic drugs.
- ▶ Strengthen collaboration among group businesses and take a unified approach in providing community care functions (medical care, long-term care, and disease prevention) that are considered essential to the community-based integrated care system.
- ▶ Improve cash flows, take further steps to achieve efficient management structure, and fortify financial base.

We understand that in the mid- to long-term, Feldsenf Pharma, a generic drugs subsidiary (manufacture and sales) established by the company, will take on a significant role in Medical System Network's generic drug business cited in the third strategy. In the final year of the fifth medium-term plan, the company planned on sourcing around 50% of its consolidated operating profit from the Supply Chain Management (SCM) business, which is the combination of the generic drugs business centering on Feldsenf Pharma, and the Pharmaceuticals Network business.

Although the business environment surrounding Medical System Network changed during the fifth medium-term plan because of the spread of COVID-19, the company did not change its basic policy outlined above, even from FY03/20 when the effects of the pandemic were felt strongly. It did, however, revise the sales and profit targets for the plan's final year (FY03/22) to reflect the pandemic's impact.

Final year of the fifth medium-term plan

The company was unable to fulfill the quantitative targets of its fifth medium-term plan due to the spread of COVID-19. Consolidated sales in FY03/22 (plan's final year) stood at JPY106.7bn versus the JPY120.0bn target, consolidated operating profit was JPY3.9bn versus the JPY5.0bn target, and consolidated EBITDA came to JPY6.7bn versus the JPY7.5bn target. The equity ratio was 21.1% versus the target of at least 30%.

Meanwhile, network members in the Pharmaceuticals Network business continued a steady increase, surpassing the 6,000 mark in FY03/21, well above the plan's target of 5,000. By number of pharmacies, the company captured over 10% of the domestic dispensing pharmacy market. The network member count continued to expand in the final year of FY03/22, reaching a total of 7,401. In addition to business growth in the Pharmaceuticals Network business, profitability improvements at directly managed pharmacies in the Community Pharmacy business contributed to earnings, and the recurring profit margin in the final year reached 4.0%, largely in line with the 4.1% target.

Positioning of the sixth medium-term plan and basic policy

Up until the fifth medium-term plan, the company mainly sought to expand market share and scale of operations under its pharmaceuticals network. As a result of focusing on scale expansion, sales grew 1.9x over the past decade from JPY54.8bn in FY03/13 to JPY106.7bn in FY03/22, with recurring profit increasing 2.3x from JPY1.9bn to JPY4.3bn over the same period. Medical System Network primarily operates in two areas: pharmaceuticals network (the Pharmaceuticals Network business under the current Community Pharmacy Network segment) and dispensing pharmacies (Community Pharmacy business). Now that its pharmaceuticals network has expanded to account for 10% of the domestic dispensing pharmacy market by number of pharmacies, the company thinks these two businesses have strengthened their correlation, and are evolving into a "platform" for community pharmacies. It maintains that the sixth medium-term plan positions this platform as a foundation based on which the company will seek to expand into new growth areas and further bolster overall scale. In this way, the company plans to transition into a new growth stage and build a new growth model.

The company says the platform, comprising network members with directly operated pharmacies at its core, will function as an infrastructure for community pharmacies. Put differently, the platform can be described as a base formed by the Community Pharmacy business (directly operated pharmacies) overlaid with the Pharmaceuticals Network business, which involves all network members. One of the growth strategies under the sixth medium-term plan seeks to establish multiple layers of new growth businesses over this platform to achieve multifaceted operations. While improving the pharmacy infrastructure, the company will step up efforts to provide quality healthcare, goods, and services, and streamline pharmaceuticals distribution to ensure sustainability of local healthcare and the distribution market.

Another growth strategy under the sixth medium-term plan calls for continued expansion of the platform's base. The company's directly operated pharmacies managed under the Nanohaha Pharmacy brand underwent eliminations, new openings, and acquisitions, and reached a total of 425 locations as of end-FY03/22. Over the four years of the sixth medium-term plan, Medical System Network plans to increase this number to 550 through acquisitions and new openings. At the same time, it will continue to expand network membership, roughly doubling the current member count to 12,000 (including directly operated pharmacies) over the same period. If the company manages to achieve this number, it would capture about 20% of the domestic dispensing pharmacy market (by number of pharmacies). Because boosting network membership leads to an increase in pharmaceuticals transactions, Shared Research understands that an upscaled network will grant the company an even greater presence in pharmaceuticals distribution.

Numerical targets for the sixth medium-term plan

(JPYmn)	Fifth medium-term plan results		Sixth medium-term plan targets	
		FY03/22		FY03/26
Consolidated revenue		106,685		140,000
Consolidated operating profit		3,852		6,500
Operating profit margin		3.6%		4.6%
Consolidated EBITDA		6,708		10,000
No. of network members		7,401		12,000
No. of community pharmacies		425		550
Equity ratio		21.1%		30.0%

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

Note: Segment figures include internal transactions.

Business strategies and measures by business category

Medical System Network places its community pharmacies—in other words, the directly operated pharmacy business—at the core of the aforementioned platform. In the first two years of the sixth medium-term plan, the company will seek to establish how individual dispensing pharmacies should play a role in the community-based integrated care systems. The plan is to elevate their functions from a simple “monzen” pharmacy (conveniently located near hospitals) to a family pharmacy, and to a community pharmacy, enhancing the quality of their services by shifting the focal point from objects to people. For example, enhanced services cover centralized and continuous management of medication information, home healthcare support, 24-hour support, and collaboration with various internal and external specialists in the areas of medical care, long-term care, food, and daily care.

The objective for the latter two years of the medium-term plan is to equip the company's pharmacies with the means to function as the central body or a hub supporting local healthcare and community at large. The company will seek to achieve optimization for the area rather than within the boundaries of its own operations. For instance, it will work to share knowledge, human resources, and pharmaceuticals across the community, maximize and jointly use local resources, and expand the network of hub pharmacies. The company's goal is to have the platform provide values and functions needed in the community while also maintaining profitability as a business.

Community Pharmacy

The sixth medium-term plan's principal theme for this business is “be ‘the town's beacon of light’ supporting local communities and bolster area coverage.” Priority measures comprise improving quality and efficiency of store operations to prepare for enhanced interpersonal work (the initiative includes pharmacist training), providing medical care that supports community-based integrated care systems, and strengthening store development capabilities. The company is laying the groundwork to open 25 new pharmacies per year, and says that costs will temporarily precede earnings when it begins spending upfront on these store openings.

Pharmaceuticals Network

The plan's principal theme for this business is "target of 12,000 network members × (distribution improvement + service expansion)." Priority measures include boosting network member count to 12,000 by FY03/26 (the final year of plan), capturing 20% industry share, improving distribution and establishing supply chain management, and contributing to community-based medical care by building an area network.

Manufacture and Market Pharmaceuticals

The plan's principal theme for this business is "stable supply of safe and secure pharmaceuticals to the company's network." Group company Feldsenf Pharma is the main driver of this business. Priority measures include creating a system to ensure quality and safety, building a system to ensure stable supply, and expanding the product lineup and sales channels. The company targets sales of JPY10.0bn in this business in the plan's final year.

Digital Shift

The plan's principal theme for this business is "establishment of pharmacy business infrastructure and expansion to multiple business lines." Priority measures include expanding market share (raising the number of pharmacies using the LINE app-based Tsunagaru Pharmacy service to 20,000 by the plan's final year), upgrading services with highly value-added functions (such as the ability to network with medical institutions and long-term care facilities), and launching new businesses.

Nursing care, long-term care, and nutrition

The plan's principal theme for this business is "deepen cooperation between medical and long-term care." Separate priority measures have been set for nursing care, long-term care, and nutrition. In nursing care, the plan calls for expansion of collaborative opportunities with dispensing pharmacies and development of service locations. In long-term care, the company will roll out home-visit services at its Wisteria series serviced elderly housing facilities. In nutrition, it will pursue expansion in scale and earnings.

Earnings structure to achieve targets; financial outlook

Historically speaking, the company's earnings growth was propelled by expansion of the Pharmaceuticals Network business and profitability improvement in the Community Pharmacy business. However, with the sixth medium-term plan, Medical System Network made a major turn toward proactively opening more pharmacies to further develop the platform structure. Since this means that the company will be making front-loaded spending in the Community Pharmacy business, it expects profit from this business to decline over the span of the medium-term plan. Accordingly it has positioned the three pharmacy support businesses (Pharmaceuticals Network, Manufacture and Market Pharmaceuticals, and Digital Shift) to take on the role of absorbing the earnings drop in the Community Pharmacy business.

In the final year of the plan (FY03/26), the company targets sales of JPY140.0bn, an increase by roughly JPY35.0bn from FY03/22, which it plans to generate in the Community Pharmacy business (+JPY20.0bn) and the pharmacy support businesses (+JPY15.0bn). Meanwhile, the target for operating profit in the final year is JPY6.5bn, up roughly JPY2.7bn from FY03/22. Since the company anticipates operating profit in the Community Pharmacy business to fall due to the burden of upfront opening costs, the three pharmacy support businesses are expected to underpin profit growth, lifting the operating profit margin by 1.0pp as well, by the final year.

In terms of cumulative cash flows over the four years of the medium-term plan, the company expects JPY20.0bn in net cash inflow from operating activities and JPY18.0bn in net cash outflow from investing activities (business development and acquisitions focusing on investment efficiency). The free cash flow of JPY2.0bn will be used mainly to reduce debt (JPY2.0bn in net cash outflow from financing activities). By reducing interest-bearing debts that account for about 60% of total liabilities in FY03/22, the company will seek to achieve equity ratio of 30% by the final year of plan.

Business

Business model

Medical System Network provides dispensing pharmacy support services to its own pharmacies and to affiliates. Based on the FY03/19 results reported under the former segment classifications, approximately 90% of the company's sales came from the operation of dispensing pharmacies (Community Pharmacy business*). The dispensing pharmacy support service (Pharmaceuticals Network business**), while highly profitable, accounts for a smaller portion of overall sales than operation of dispensing pharmacies. As such, the company can be considered a pharmacy chain that also extends its services to non-directly operated pharmacies.

*The former Dispensing Pharmacy segment; currently the Community Pharmacy business under the Community Pharmacy Network segment

**The former Pharmaceuticals Network segment; currently the Pharmaceuticals Network business under the Community Pharmacy Network segment

The dispensing pharmacy support service developed by Medical System Network is provided not only to directly-operated pharmacies but also to non-group dispensing pharmacies (affiliates). The Dispensing Pharmacy business generated about 30% of operating profit (unadjusted for internal transactions) in FY03/19 while the Pharmaceuticals Network business accounted for about 70%, suggesting high OPM for the latter considering the segment's small share of sales.

Dispensing pharmacies in Japan are regulated by the nation's universal healthcare insurance system governed by the Ministry of Health, Labour and Welfare (MHLW). The system requires the separation of prescription and dispensary practices, where patients receive prescriptions from physicians at medical institutions and have them filled at dispensing pharmacies by a pharmacist. Under the universal healthcare insurance system, the cost of medication is split between patients and their insurance plans. When a pharmacy dispenses drugs, it collects the patient co-payment (30% of total cost for most company employees) in cash and obtains dispensing fee receivables for the insurance plan portion (70%), for which a reimbursement claim is later submitted. The prices for drugs and medical services are set and periodically revised by MHLW, which is the governing authority.

Overview of business segments

Medical System Network comprised five business segments until FY03/19. The mainstay segments were Pharmaceuticals Network and Dispensing Pharmacy. These two segments were consolidated into the Community Pharmacy Network segment along with the Manufacture and Market Pharmaceuticals business (previously included in the Other business and operated by Feldsenf Pharma). PharmaShift Co., Ltd, was established on October 1, 2020 to operate the Family Pharmacy Support Service. The Community Pharmacy Network segment as of FY03/22 comprises the Pharmaceuticals Network, Community Pharmacy, Manufacture and Market Pharmaceuticals, and Digital Shift businesses. The company does not disclose a sales and profit breakdown by business.

As peripheral business in healthcare and care-related businesses, the company maintains its three segments; Leasing and Facility-related, Meal Catering, and Other businesses. The main business in the Other business segment is home-visit nursing care. Each business segment continues to be operated by respective core subsidiaries.

Affiliated companies (as of May 31, 2021)

Segment	Company	Location	Ratio of voting rights
Community Pharmacy Network	Hokkaido Institute for Pharmacy Benefit Co., Ltd.	Sapporo, Hokkaido	100.0%
	Nanohana Hokkaido Co., Ltd.	Sapporo, Hokkaido	100.0%
	Clinics Co., Ltd.	Sapporo, Hokkaido	100.0%
	Nanohana Tohoku Co., Ltd.	Hachinohe, Aomori	100.0%
	Nanohana East Japan Co., Ltd.	Minato-ku, Tokyo	100.0%
	Metro Pharmacy Co., Ltd.	Minato-ku, Tokyo	100.0%
	Nanohana Central Co., Ltd.	Nagoya, Aichi	100.0%
	Nanohana West Japan Co., Ltd.	Toyonaka, Osaka	100.0%
	Total Medical Service Co., Ltd.	Kasuya, Fukuoka	100.0%
	Nagatomi Pharmacy Co., Ltd.	Oita, Oita	100.0%
Digital Shift	Feldsenf Pharma Co., Ltd.	Sapporo, Hokkaido	80.0%
Leasing and Facility-related	PharmaShift Co., Ltd.	Minato-ku, Tokyo	51.0%
Meal Catering	Paltecno Co., Ltd.	Sapporo, Hokkaido	100.0%
Other	Sakura Foods Co., Ltd.	Kasuya, Fukuoka	100.0%
	Agrimas Corp. *	Ota-ku, Tokyo	77.7%
	Home-Visit Nursing Care Station Himawari Co., Ltd. ***	Nerima-ku, Tokyo	100.0%

Source: Shared Research based on data from the company website.

Notes: * Not consolidated

** Company names for Apotec Co., Ltd. and Kyoei Pharmacy Co., Ltd. were changed to Nanohana Tohoku Co., Ltd. and Nanohana West Japan Co., Ltd. as of April 1, 2019.

*** Home-visit Nursing Care Station Himawari was consolidated through absorption-type merger on July 1, 2021 (announced in May 2021) and ceased to exist at end-March 2022.

Community Pharmacy Network

The Community Pharmacy Network business is a new segment created in FY03/20 from consolidating the Pharmaceuticals Network, Dispensing Pharmacy, and a part of the Other (Manufacture and Market Pharmaceuticals business) segments. The new Family Pharmacy Support Service business was also added from FY03/21.

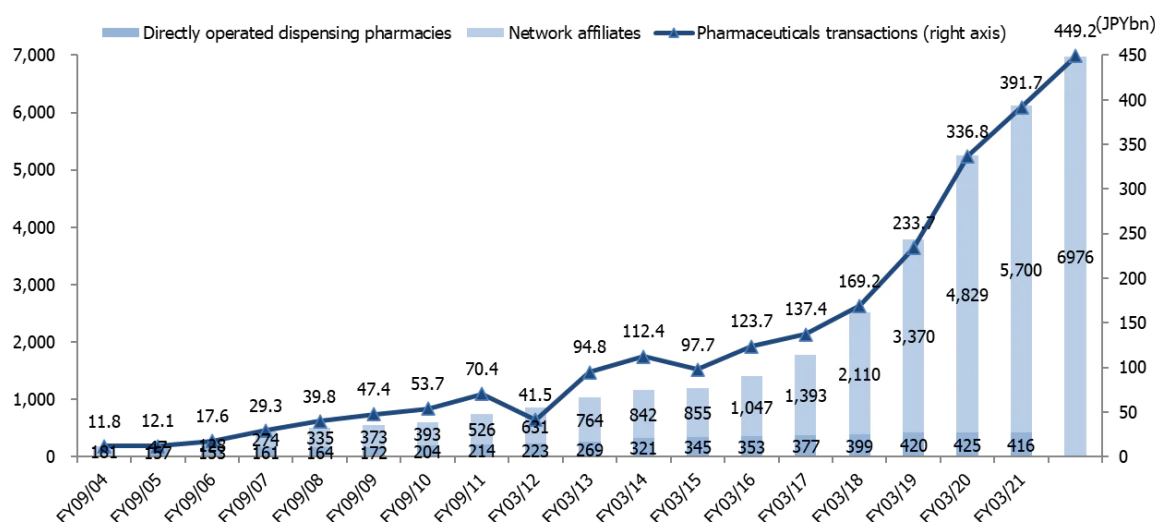
The company cited following two reasons for the reorganization:

- To accommodate expansion of the company's business scope to the entire supply chain accompanied by the rise in pharmaceuticals network members and full-scale development of the Manufacture and Market Pharmaceuticals business
- To transition to a structure that can provide value to the entire supply chain while taking into account possible conflicts of interest between business segments due to the aforementioned changes

Pharmaceuticals Network business (former Pharmaceuticals Network segment)

The core Pharmaceuticals Network business offers comprehensive support for operating pharmacies, ranging from the sourcing of drugs to pharmacist training and financing. It can be broken down into four major functions: Pharmaceuticals supply chain management, slow moving inventory clearance, pharmacist training, and financing.

Network members and pharmaceuticals transactions



Note: Figures for FY09/04 are totals of directly operated dispensing pharmacies and affiliates only.

Source: Shared Research based on company data

Four functions

(1) Pharmaceuticals supply chain management

Medical System Network determines appropriate transaction prices with drug wholesalers on behalf of its network members. Typically, dispensing pharmacies have to negotiate prices separately with each wholesaler. In contrast, after receiving authorization from its member affiliates, the company determines unit prices per product with wholesalers around the country on their behalf. The wholesalers benefit from the company's services in a number of ways. They can receive payment from all network members two months after closing instead of the standard three months, which reduces interest expenses. The company's collection service helps them minimize the cost of recovering outstanding payments for pharmaceutical products. The online ordering system improves and optimizes inventory control for pharmacies, reducing order frequency and emergency deliveries, thus lowering wholesaler costs. These cost-saving advantages give the company the power to negotiate better prices with wholesalers. Price negotiation is crucial to dispensing pharmacies since the difference between the actual drug sourcing cost and official price of prescription drugs represents their profit stream, but it is also a source of heavy operational burden.

In negotiating terms with wholesalers, Medical System Network adopts the law of one price. Instead of using order volume as bargaining power (making lower price a condition for large orders), it negotiates with all wholesalers based on a common price per each pharmaceutical product. Further, the company does not get involved in the transactions and relationships between the pharmacies and their regular suppliers* (wholesalers). Members can choose which wholesaler to buy from on the basis of service and other conditions, not price. This system lowers the hurdle for dispensing pharmacies thinking of joining the network, but wants to keep existing trading accounts with their regular suppliers, and appeals to wholesalers as well, because they can maintain relationships with existing customers. It is thus a win-win for both retailers and wholesalers. The company also benefits, because it can attract new network members by allowing them to maintain their existing accounts.

Medical System Network is also focusing on handling generics, whose use is being strongly promoted by MHLW. The company gathers and analyzes detailed information such as interview forms** mainly about drugs added to the NHI list that it receives from pharmaceutical companies. The company then negotiates with wholesalers about stable supply of the product, price, and other conditions, and provides information on the product to network members if it concludes that it can be dispensed safely by the pharmacists. The company also provides a substantial support system to its affiliates to increase their handling of generics, including an inventory management system with the same features as the generic drug recommendation system used by its directly operated pharmacies.

Since FY03/21, the company's network members—directly operated dispensing pharmacies (the Nanohana Pharmacy chain under the Community Pharmacy business) and affiliates (non-group pharmacies) in its pharmaceuticals network, combined—have accounted for over 10% of the domestic dispensing pharmacy market. Shared Research understands that the company's

presence in terms of strength in drug price negotiations is growing. In FY03/22, the volume of pharmaceuticals orders handled by Medical System Network expanded 2.5x over the four years from FY03/18.

*Regular supplier/trading account: A relationship between retailer and wholesaler whereby the retailer has a trading account with the wholesaler. For a retailer, a regular supplier is a wholesaler with which it has a history of doing business.

**Interview form: Pharmaceutical Interview Form (IF), whose purpose is to supplement information that is not fully covered in package inserts of prescription drugs. These forms are supplied by pharmaceutical companies and provide all-round product information. Japan Society of Hospital Pharmacists (JSHP) sets IF drafting guidelines and instructs pharmaceutical companies to distribute the forms. Historically produced by pharmacists interviewing companies, the current format was established in 1988.

(2) Slow moving inventory clearance service (dead stock exchange)

This system allows for the exchange of dead stock pharmaceuticals among network members. A pharmaceutical product can no longer be dispensed once it expires, so the disposal of dead stock becomes a cost burden on dispensing pharmacies. The primary objective of the system is to reduce inventory disposal losses substantially by registering members' dead stock in the system and matching the stock with other members that can use it. Charges for matched dead stock can be settled together with order placement commissions to Medical System Network, so member pharmacies do not need to make payments to each other.

The MHLW has identified wasted pharmaceuticals as a cost burden that needs to be addressed in healthcare reforms. Note that Medical System Network has acquired a patent for this system.

(3) Pharmacist training support

An attractive training system can improve staff loyalty and draw talented recruits to dispensing pharmacies. The company holds nationwide training courses for pharmacists including those working at network pharmacies in collaboration with training organization Iyaku Sogo Kenkyukai (ISK). These workshops are run by dispensing pharmacies and online courses are also available. The workshops cover topics such as simulated patient training, POS* training, case studies, and customer relations training. Certification by Japan Pharmacists Education Center (JPEC; a public interest incorporated foundation) requires attendance at, and gaining credits for workshops run by JPEC and registered organizations that provide group and practical training sessions such as Japan Society of Hospital Pharmacists (JSHP) and Japan Pharmaceutical Association (and their regional chapters).

ISK is one of the few private-sector organizations registered as a provider of various certification programs for pharmacists. Medical System Network and ISK help pharmacies run training sessions and apply for accreditation, which enables them to become members of the ISK organization and run JPEC accredited training courses. ISK issues attendance stickers to pharmacists who attend these courses. This is an incentive for network pharmacies, because it helps them recruit pharmacists.

*POS: Problem Oriented System. A predetermined logical and scientific resolution approach used in team medical care, wherein patient information and healthcare professionals' records are shared to clearly ascertain patient medical problems from each professional's point of view.

(4) Financing support

In Japan, the cost of prescription drugs is borne by patients and the public health insurance programs (such as social insurance for company employees and the National Health Insurance [NHI] for non-employees). Dispensing pharmacies receive the patient co-payment over the counter when dispensing drugs and the portion covered by insurance becomes dispensing fee receivables until it gets monetized two months later when pharmacies receive payment from the insurance programs. Under the company's financing support service (optional), these receivables are purchased and securitized, and directly operated pharmacies are provided cash funding more than a month earlier than the payment from insurance programs. This service offers dispensing pharmacies stable low-cost financing, as unlike financing from a bank, no collateral is required. There are also no restrictions on how the funds can be utilized. Social insurance and NHI claims can be securitized separately. Dispensing fee receivables are converted into small-lot securities through financial institutions and sold to investors for capital recovery.

Community Pharmacy business (former Dispensing Pharmacy segment)

Scale

The Community Pharmacy business (operation of dispensing pharmacies) is a core business that accounts for about 90% of the company's sales and about half of its operating profit. The group's dispensing pharmacies had been operating under the umbrella of a holding company Pharmaholdings Co., Ltd., which was the company's subsidiary until October 2017, when it was absorbed by the company. At present, the group's dispensing pharmacies are operated through seven regional consolidated subsidiaries. Another subsidiary, Hokkaido Institute for Pharmacy Benefit Co., Ltd., publishes specialized books for pharmacists and other healthcare professionals and analyzes pharmaceuticals-related data.

The Community Pharmacy business operates the group's directly operated pharmacies. The company provides support services through its pharmaceuticals network to both its directly-operated pharmacies and non-directly operated pharmacies (affiliates). Directly operated pharmacies and affiliates make up the company's pharmaceuticals network, but the affiliates are not included in the scope of the Community Pharmacy business. The numbers of both affiliates and directly operated pharmacies continue to rise. The total value of drug orders (which dictates the company's commission revenue) tends to rise in line with the increase in network members, although there are periods when the value declined due to periodical drug price revisions.

Affiliates and directly operated pharmacies are found in most areas nationwide, although the home base of Hokkaido has the highest concentration of the latter followed by the Kanto and Koshinetsu area. The highest concentration of affiliates is in the Kanto and Koshinetsu area followed by the Tokai and Hokuriku area (for recent regional patterns see the figures Distribution of network members and Number of pharmacies by region in the Trends and Outlook section). As of end-March 2022, the number of directly operated pharmacies and non-directly operated pharmacy members of the Pharmaceuticals Network (affiliates) stood at 7,401, accounting for over 10% (by number of pharmacies) of all dispensing pharmacies in Japan (60,951 pharmacies as of end-March 2020 based on MHLW survey) and ranking first in the domestic market. In FY03/22, the total value of drug orders was JPY449.2bn (+14.7% YoY), representing the largest scale in Japan.

Directly operated pharmacies

Functions provided by the company's directly operated dispensing pharmacies do not dramatically differ from those of other dispensing pharmacies, although one distinguishing characteristic is that they tend to be located in residential areas where homes and medical institutions coexist (categorized by the company as the medical mall format including medical plazas). As such, they are well suited to take on the "family pharmacy" function advocated by MHLW. The company aims to strengthen the family pharmacy functions of its pharmacies by offering consultation services concerning nutrition, health, and self-care.

The company regularly provides guidance to directly operated pharmacies. It sets a bar for their financial performance, and when the pharmacies fail to meet those targets, the company investigates the cause and seeks possible solutions. It also advises pharmacy managers, on matters including potential closures. With such guidance, the company continues to promote revitalization of pharmacies, and in FY03/19 it closed 15 outlets while opening eight new stores and acquiring three through M&A.

Market position of directly operated Nanohana Pharmacy

The number of Nanohana brand pharmacies totaled 425 at end-March 2022. The following table compares sales and pharmacy numbers for other major pharmacy chains as of their fiscal year-ends. Unlisted companies and companies mainly operating dispensaries within drugstores are excluded. The figure for Medical System Network represents sales of the Community Pharmacy Network segment including the network business. The company has far fewer own-brand outlets than the top-ranking pharmacy chains, but in terms of all network members including affiliates in the company's pharmaceuticals network, the total exceeds the counts of major chains. Medical System Network also ranks among the top five by sales.

Number of dispensing pharmacies

	FY end	Sales (JPYmn)	No. of pharmacies
1 Ain Holdings	April	297,305	1,065
2 Kraft	-	193,700	1,002
3 Qol	March	166,199	834
4 Toho Holdings	March	96,124	778
5 Sogo Medical Holdings	March	-	745
6 Nihon Chouzai	March	299,392	697
7 Suzuken	March	96,439	593
8 Medical System Network	March	101,457	425
9 Aisei Pharmacy	March	67,300	396
10 Pharmanise Holdings	May	52,324	298

Source: Shared Research based on data from each company's websites and materials

Note: Sales figures are aggregate of dispensing pharmacy segment, Aisei Pharmacy Co., Ltd. and Kraft Inc. (Sakura Pharmacy) are unlisted, Sogo Medical Holdings was delisted in April 2020, and companies that are primarily drugstore chains were excluded.

Note: Based on earnings announcement data disclosed as of May 2022.

Initiatives in line with the distribution improvement guidelines

The company has taken steps in line with the MHLW objective of reducing medical expenses through streamlining distribution to establish a more efficient supply chain that bolsters online ordering, reduces product returns, and lowers delivery frequency. Particularly noteworthy is its local network initiatives. The company has incorporated these initiatives into its sixth medium-term plan.

A local network aims to foster collaboration among local affiliates of the company's pharmaceuticals network within a community with the following four objectives:

- Information sharing by affiliates of available pharmaceuticals and inventories
- Enhanced distribution for the entire region
- Cooperation on at-home medical care, facility sharing, holding study sessions and exchange meetings
- Product sharing, interaction and collaboration among employees, and knowledge sharing

Efforts to streamline Nanohana Pharmacy operations

Several measures have been taken to streamline operations of the directly operated pharmacy chain, Nanohana Pharmacy, as shown below. Going forward, the company plans to nationally roll out pharmacies that have achieved these types of operational efficiency.

- Reduce time required to input medication history and register drugs to be reviewed: Tablet computers are provided to each pharmacist thus making work more flexible and enabling utilization of free time between dispensing work. Average time required for this task was reduced from 60 minutes to 30 minutes a day.
- Reduce time spent on ordering drugs: Full adoption of in-house developed automated drug ordering system reduced the time spent on ordering drugs from a daily average of 30 minutes to less than 10 minutes.
- Reduce patient waiting time: Improvement of waiting time measurement system helped identify causes of long waiting time. A successful case showed that waiting time was cut by about five minutes three months after the identified problem was solved.
- Optimization of staffing: Setting standard working hours for pharmacists and staff (appropriate number of staff) for each pharmacy and installing management tools enabled the company to gauge appropriate staffing for any given week or any given day of the week.

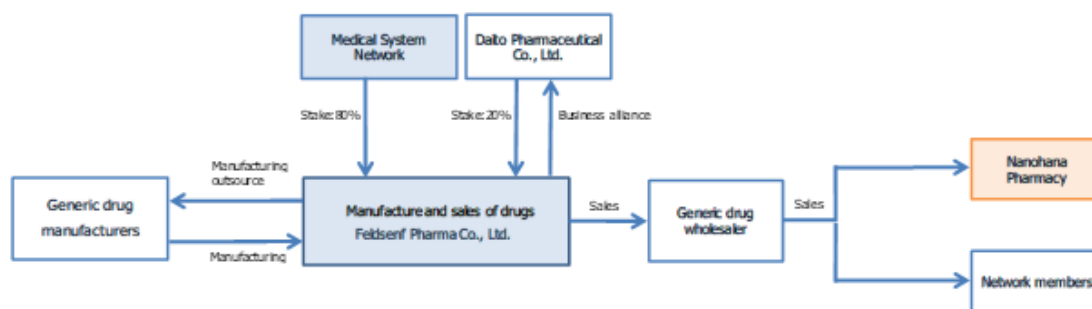
Manufacture and Market Pharmaceuticals business (formerly in the Other business)

Business overview

The Manufacture and Market Pharmaceuticals business was transferred from the Other business to the Community Pharmaceutical Network business in FY03/20. It is operated by consolidated subsidiary Feldsenf Pharma Co., Ltd., which was established in September 2016 to manufacture and market ethical drugs. It does not have manufacturing capabilities or facilities but aims to develop an efficient pharmaceutical distribution system from manufacturing through the filling of prescriptions at the pharmacy by building a collaborative relationship with pharmaceutical manufacturers with capability to provide a stable supply of high-quality, lower-priced generic drugs. In 2018, it formed a business alliance with Daito Pharmaceutical Co., Ltd. (TSE Prime: 4577), which manufactures and supplies ethical drugs to Feldsenf Pharma.

Feldsenf Pharma started marketing generic drugs from 2018. It mainly supplies directly-operated pharmacies and network affiliates of Medical System Network; in FY03/22, it supplied drugs to 1,698 affiliates. Feldsenf Pharma also has eyes set on expanding its lineup of in-house brand generic drugs in the future to become a supplier to dispensing pharmacies and medical institutions nationwide.

Feldsenf Pharma's generic drugs supply chain



Source: Shared Research based on company data

Business scale, profit trends

In FY03/19, Feldsenf Pharma started out with 17 active pharmaceutical ingredients (API) across 34 items, and expanded to 41 API across 82 products at FY03/22. Management aims to further expand the product lineup of in-house drugs and sales tie-up products. In FY03/21, the company supplied its products to directly-operated pharmacies and affiliates. In FY03/22, it reported sales exceeding JPY1.8bn and was profitable at the operating level.

Digital Shift business (established in FY03/21)

Family Pharmacy Support Service

The company established a Joint venture, PharmaShift Inc. in September 2020 with OPT, Inc. (unlisted; trade name changed to Re:teigi, Inc. following organizational change), a core subsidiary of Digital Holdings (TSE Prime: 2389). Medical System Network holds a 51% equity stake while RePharmacy, Inc. (wholly-owned subsidiary of Re:teigi, Inc.) holds the remaining 49%.

PharmaShift's main business is Family Pharmacy Support Service. Medical System Network created the Digital Shift business as a new business with establishment of PharmaShift. In the joint venture, PharmaShift is mainly in charge of customer development while RePharmacy focuses on system development.

Family Pharmacy Support Service engages in and pursues the following three points:

- Facilitates smooth communication between patients and pharmacies by leveraging official LINE accounts and aggregating patients' medical information
- Contributes to strengthening functionality and enhancing efficiency of family pharmacies while also supporting non-dispensing businesses such as health and nutrition counseling
- Building an information infrastructure that can be linked with various other businesses such as physicians by aggregating information obtained from having strengthened functionality of family pharmacies

Utilization of official LINE accounts

The plan is to integrate various functions based on the LINE communication app to facilitate communication between patients and pharmacies using the official LINE account. Specifically, Medical System Network looks to incorporate functions such as prescription transmittal, electronic medication records, surveys of pharmacy visits, and follow-ups during medication. In collaboration with OPT, it aims to develop products using the LINE official account based on a common platform for dispensing pharmacies so that it can provide the products not only to directly-operated and network member pharmacies, but to all pharmacies nationwide.

The Family Pharmacy Support Service utilizing the official LINE account launched from March 15, 2021. In FY03/22, the number of registered friends (users) exceeded 310,000; meanwhile, 1,643 pharmacies placed orders and 911 already adopted the service. For dispensing pharmacies, the service offers functions such as centralized management of medication (which could lead to additional medical fee points), medication follow-ups, and online medication guidance, all available on the LINE app. According to the company, the number of prescriptions sent to pharmacies that have adopted the service more than doubled that of those that have not. Safe management of personal information is a high priority, so proactive measures being taken include no need to fill out personal information on the LINE Talk screen, making service available on external website apps, and utilizing highly secure domestic servers. The company is encouraging its network members to adopt the service, and plans to establish the system as a standard service of its network at an early stage.

LINE is a messaging application developed and operated by LINE Corporation (unlisted). The LINE messaging application has achieved substantial market penetration in Asian countries such as Japan, Thailand, and Taiwan.

Leasing and Facility-related

Planning and development of medical buildings and medical plazas

In addition to private practice clinics, the company engages in the planning and development of facilities that house multiple medical clinics (medical buildings and medical plazas). The real estate business is mainly operated by subsidiary Nihon Leben, which was a subsidiary, but was absorbed in October 2017.

This business supports development of clinics that goes beyond just real estate brokerage. The focus is on providing a broad range of support to physicians looking to start a practice, beginning with the stage of formulating a basic business plan for the clinic, and spanning the creation of a management philosophy and strategy, investigating the medical area, selecting real estate property, overseeing design and construction, financing, and processing the business start-up application.

The company develops medical malls* where multiple medical institutions are located in one area, which benefit both patients and physicians. Grouping various medical institutions in the same premises provides patients with opportunities to receive one-stop treatment from multiple specialists. It is also more efficient for physicians, as they can lower costs by sharing facilities and benefit from synergies in patient traffic and advertising.

*Medical mall: Where several specialized clinics and dispensing pharmacies are located in the same building or area. It is called a medical building when they are in the same building and a medical plaza when they are located in the same area.

Medical malls have different formats. For the building format where tenants are only clinics and dispensing pharmacies, the building is often constructed based on the assumption that clinics will move in, so the floor space and specifications are designed accordingly. Another type is a medical area located within a shopping mall or a commercial facility attached to a train station; since station users and local residents frequent these commercial facilities, they can see their physicians after shopping or on their way home. A third format is a congregation of multiple detached clinics in the same area, often established along suburban main roads where land is easy to acquire.

An example of a medical building developed by the company is the Leben Building in Sapporo, Hokkaido. Standing near a general hospital in Sapporo, in an area where multiple specialty clinics are also located, the building houses four clinics, including surgery and internal medicine, and a Nanohana Pharmacy. An example of a medical plaza is the Shizunai Aoyagi district, located in Hidaka, Hokkaido, with five clinics, including internal medicine and otolaryngology, and two Nanohana Pharmacies. The company notes the latter is a medical mall with roots in the local community, and has been attracting attention as a model case for supporting regional medical care in cities experiencing depopulation and aging.

Planning and development of long-term care facilities

The company plans and develops serviced elderly housing facilities that collaborate with medical institutions, long-term care centers, and dispensing pharmacies to ensure an environment where residents can live safely with peace of mind. Wisteria N17, located in Sapporo, Hokkaido, is the company's first serviced elderly housing facility. Standard services include daily safety checks and 24-hour on-call emergency service while fee-based services such as meal catering and long-term care

services are also available. Wisteria N17 is also networked with local medical institutions such as the general hospital, specialty clinics, dental clinics, and dispensing pharmacies. The company's fourth facility, Wisteria Senri-Chuo (Toyonaka, Osaka Prefecture), was launched in 2016, and the fifth facility, Wisteria Minami Ichijo (Sapporo, Hokkaido), was opened in November 2018.

According to the company, investment for expansion of serviced elderly housing facilities came to an end in FY03/19, and it is now taking measures to boost occupancy rates at the Wisteria series facilities, especially for the Wisteria Senri-Chuo and Wisteria Minami Ichijo. The company plans to focus on building a community where medical care and long-term care are offered as one, with local dispensing pharmacies, hospitals, and long-term care and childcare facilities surrounding the serviced elderly housing facilities.

Meal Catering

The company provides meals to hospitals and welfare facilities. The meal catering service is provided by Total Medical Service, Kyushu Iryo Shoku Co., Ltd. (merged with Total Medical Service in April 2018), and Sakura Foods Co., Ltd. (wholly owned subsidiary of Total Medical Service) in the Kyushu and Chugoku areas (Fukuoka, Saga, Nagasaki, Oita, Kumamoto, Miyazaki, Kagoshima, and Yamaguchi prefectures).

Other

The major business in this segment is home-visit nursing care carried out by subsidiary Home-Visit Nursing Station Himawari Co., Ltd., which is slated for an absorption-type merger from July 1, 2021. In addition, the Manufacture and Market Pharmaceuticals business, conducted by subsidiary Feldsenf Pharma Co., Ltd., was consolidated into the newly established Community Pharmacy Network segment from FY03/20.

The home-visit nursing care business dispatches specialized nurses to patients' homes to check on their conditions, and provides appropriate nursing care and advice. It collaborates with physicians, healthcare and long-term care professionals, and pharmacists at the company's Nanohana Pharmacy.

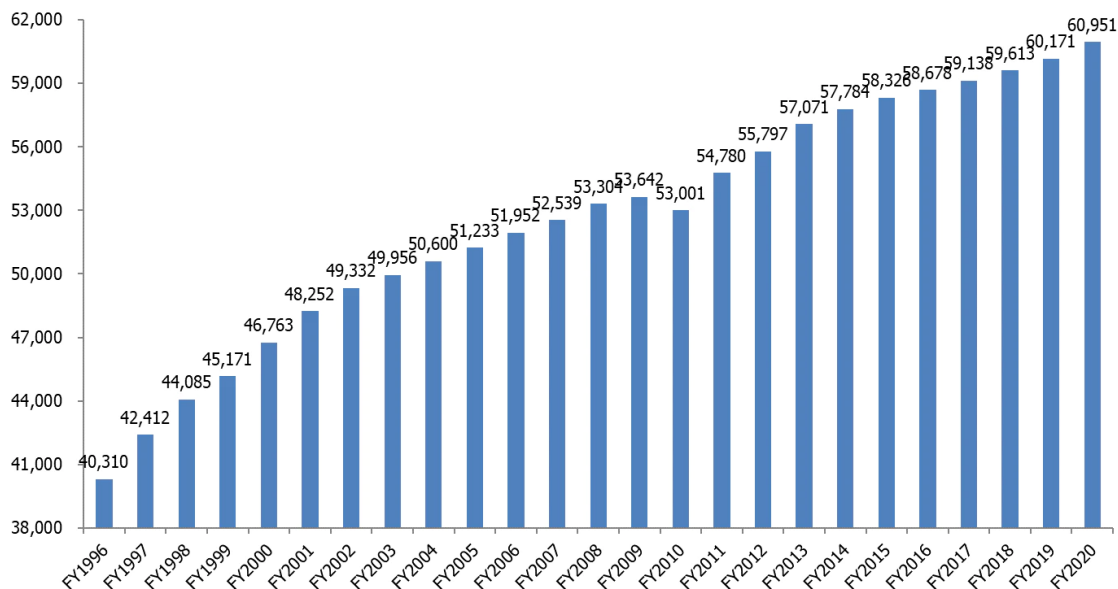
Market and value chain

Continued growth in the dispensing pharmacy market

Dispensing pharmacies fill prescriptions issued by medical institutions. This is based on the separation of prescribing and dispensing functions, in an effort to raise the quality of medical care by letting physicians focus on examining patients and determining appropriate treatment while allowing pharmacists to specialize in dispensing drugs, managing medication history, and providing guidance on usage. According to the Japan Pharmaceutical Association (JPA), the separation accelerated sharply from 1997 when the Ministry of Health and Welfare (the predecessor of MHLW) instructed 37 national hospitals to adopt complete separation (more than 70% of prescriptions must be filled outside the hospital). The out-of-hospital dispensing ratio exceeded 50% nationwide for the first time in 2003. According to JPA estimates, the average ratio rose to 70% in FY2016 and reached 76.1% in February 2022.

The number of dispensing pharmacies steadily increased as separation of prescribing/dispensing advanced and pharmacies that previously marketed OTC drugs became dispensing pharmacies. There was also a pronounced increase in independent pharmacies operating near large hospitals—so-called “monzen” (Japanese meaning “in front of the gate”) pharmacies. Another factor driving growth has been the expansion of drugstores into the dispensary business. Prescription volumes issued by medical institutions have also been rising.

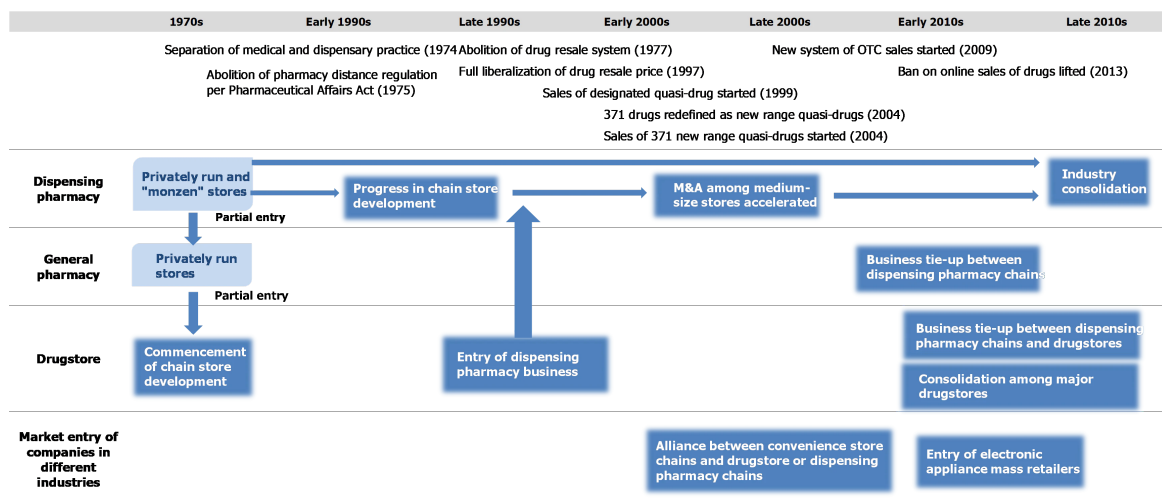
Number of dispensing pharmacies



Source: Shared Research based on MHLW's Report on Public Health Administration and Services

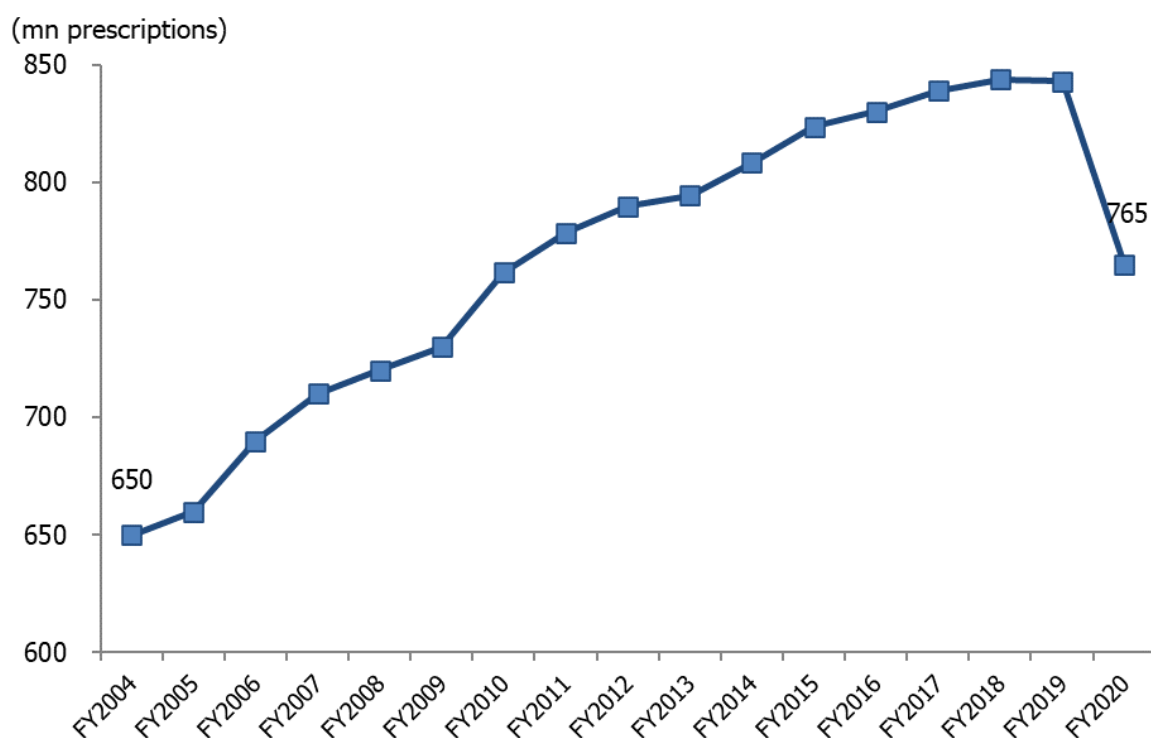
Note: 2010 does not include some of Miyagi or Fukushima Prefectures' data.

Developments surrounding dispensing pharmacies



Source: Shared Research based on MHLW's Report on Public Health Administration and Services

Prescription volume

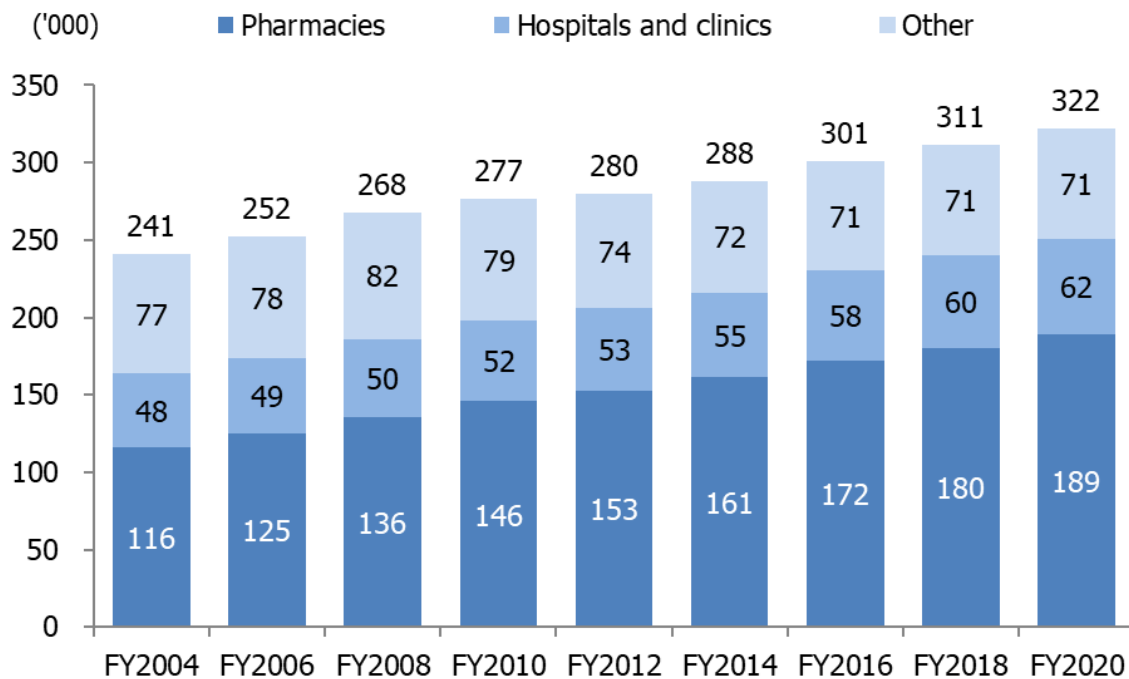


Source: Shared Research based on MHLW's Trends in Prescription Medicine Costs

Note: Shared Research understands that the volume in FY2020 reflects an increase in long-term prescriptions due to the COVID-19 pandemic.

Relative to the increase in the elderly population, the number of dispensing pharmacists has not kept pace with the increase in pharmacies, and securing sufficient staffing is a pressing issue, particularly for small and mid-tier pharmacies.

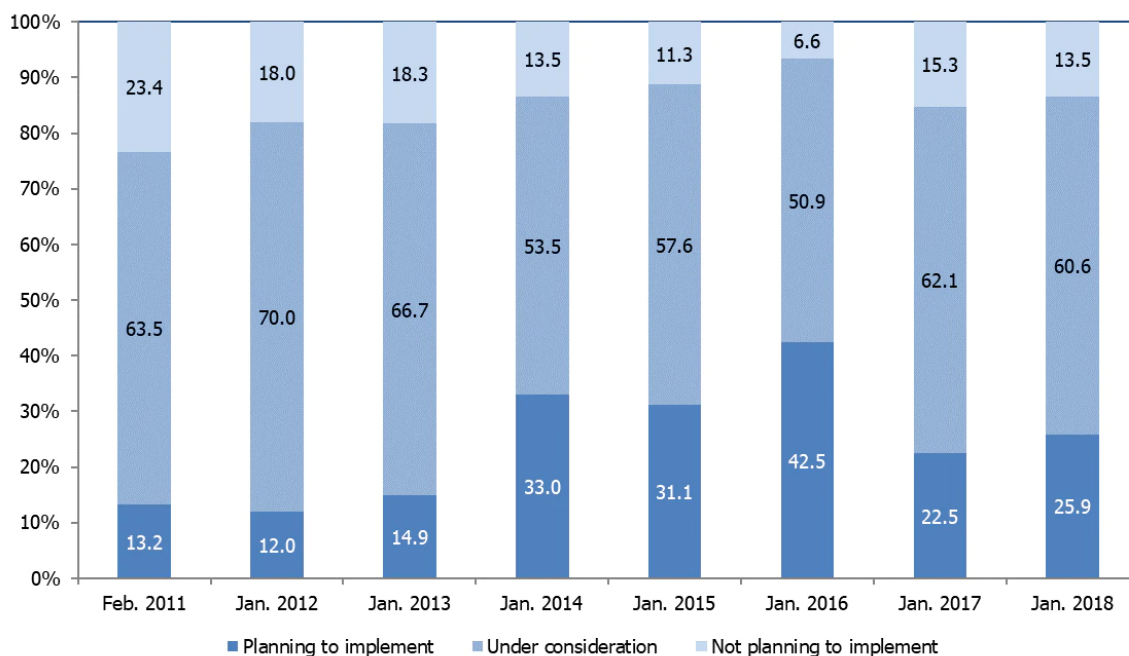
Pharmacist numbers



Source: Shared Research based on MHLW's Report on Survey of Physicians, Dentists and Pharmacists

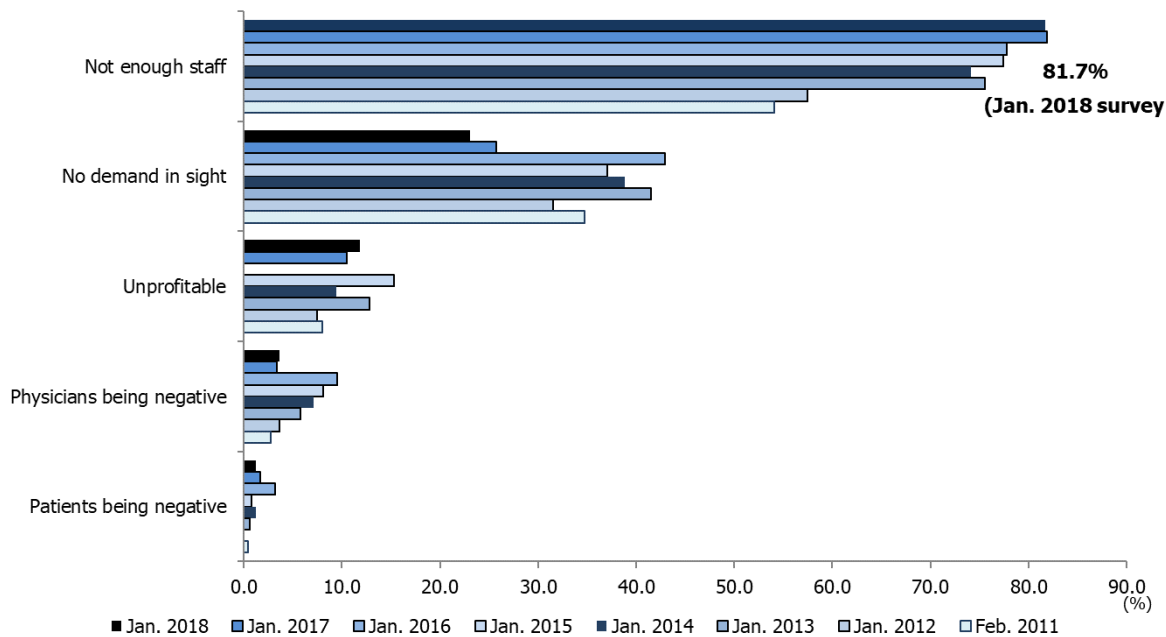
A 2018 Nippon Pharmacy Association (NPhA) survey of member pharmacies showed that the percentage of pharmacies planning to embark on home-based medication management and guidance services, one of the new roles being promoted by MHLW, is not expanding. Most respondents cited labor shortages as the main reason. MHLW is also advocating for 24-hour availability as a means to improve patient convenience, but this service will also likely increase labor costs for dispensing pharmacies.

Survey results on home-based medication management service



Source: Shared Research based on data from Nippon Pharmacy Association Committee for Expansion of Pharmacist Functionality, Report on 2017 Survey of Member Pharmacists (February 2018)

Reasons cited for not providing home-based medication management service

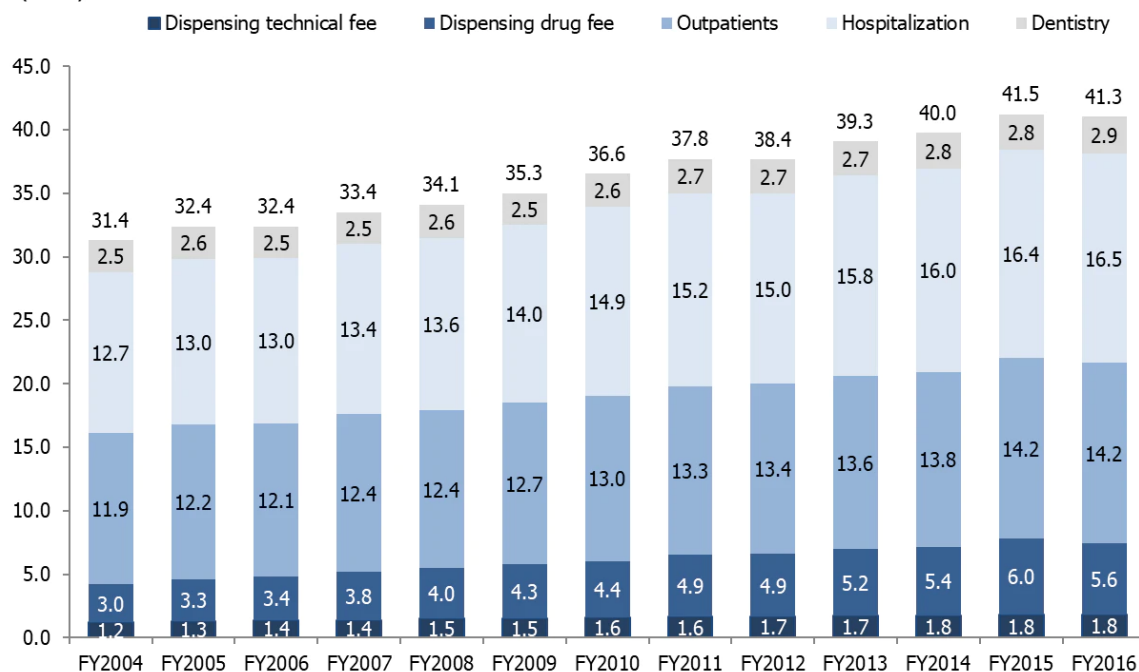


Source: Shared Research based on data from Nippon Pharmacy Association Committee for Expansion of Pharmacist Functionality, Report on 2017 Survey of Member Pharmacists (February 2018)

The motivation behind MHLW's push to expand these roles for pharmacies is a response to steadily rising medical costs in Japan, and, as the Japanese population ages, reducing unnecessary drug use will be essential to maintaining sound healthcare spending. For the same reason, MHLW is also encouraging pharmacies to take on a more patient-centered approach rather than to focus primarily on pharmaceuticals.

(Reference) Drug expenditures

(JPYtn)



Source: Medical costs and dispensing drug expenditures compiled by Shared Research based on MHLW's Statistics of Medical Care Activities in Public Health Insurance

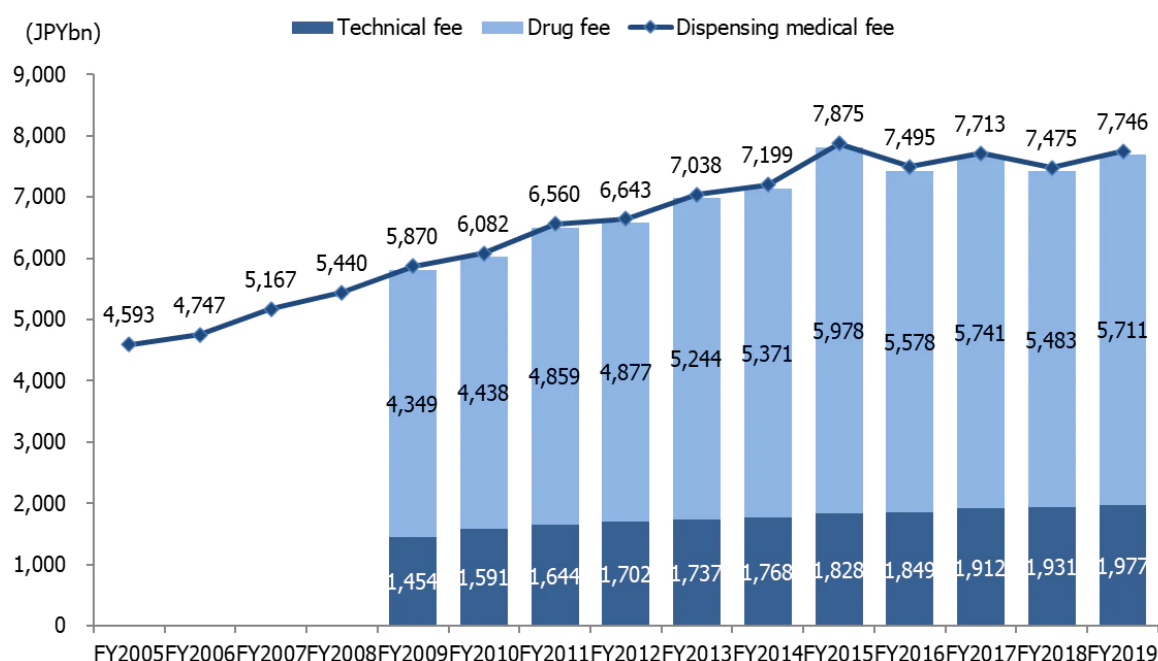
MHLW wants dispensing pharmacies to expand their role from just filling prescriptions to providing comprehensive care to patients as a family pharmacy. This push has made the shortage of pharmacists an even more pressing issue.

Role of dispensing pharmacies in community-based integrated care system: transforming to family, regional pharmacies

Environment facing smaller pharmacies: dispensing fee revisions

The dispensing fee revision implemented in April 2014 reduced the basic dispensing fee for pharmacies that receive more than 90% of their prescriptions from specific medical institutions. The government enacted the changes after reassessing medical care finances amid chronic fiscal deficits, a health insurance program on the verge of collapse, and continually expanding long-term care expenditures. Further reductions in dispensing fees are likely. In addition, faced with concerns of rising medical costs, the government opted to expand the functions of pharmacies rather than increase physician numbers. Thus, it has promoted home medical care services such as prescription delivery and offered preferential treatment to dispensing pharmacies that can provide a 24-hour on-call service. These trends put smaller pharmacies (such as those near large hospitals) at a disadvantage. At a time of flat dispensing fee expenditures, in order to survive, it is crucial for community pharmacies to strengthen their family pharmacy functions and strengthen services that directly earn revenues such as technical fees.

Dispensary charges



Source: Shared Research based on MHLW's Trends in Prescription Medicine Costs

MHLW initiates "Guidelines for the Improvement of Commercial Transaction Practices of Ethical Drugs"

The "Guidelines for the Improvement of Commercial Transaction Practices of Ethical Drugs" (so-called distribution improvement guidelines) were adopted starting April 2018. Issued by MHLW, the guidelines targeting industry members reflect the ministry's initiative to shift the role of spearheading improvement in prescription drug distribution from the distributors to the government. Items of note on the relationship between drug wholesalers and medical institutions/dispensing pharmacies include the avoidance of excessive discounts. According to these guidelines, offering prices involving excessive discounts that do not reflect the actual value of pharmaceuticals, such as using a benchmark without considering transaction terms, is incompatible with the current NHI drug price system (where individual drug price reflects the value). The guidelines urge wholesalers and medical institutions/dispensing pharmacies also to consider distribution costs and stable provision/sourcing of pharmaceuticals, and to take a comprehensive perspective on each price negotiation, seeing it as an extension of the price negotiations between drug manufacturers and wholesalers.

Key points from the "distribution improvement guidelines"

- ▶ Items of note between manufacturers and wholesalers:

- Elimination of negative primary margins, presentation of appropriate prices

► Items of note between wholesalers and medical institutions/dispensing pharmacies:

- Rapid settlement of transaction prices and promotion of individual drug unit price transactions
- In principle, all drugs should have individual drug unit prices (no bundling contracts)
- At a minimum, the percentage of individual drug unit price contracts must exceed previous year levels
- Adjustment of excessive price discounts that do not reflect pharmaceuticals value and distribution costs

► Ensured efficiency and safety of distribution

- Avoidance of costly practices such as frequent and emergency deliveries that can impede stable supply

MHLW will establish a consultation office to support guideline compliance and plans to proactively disclose cases as they come up. In addition to confirming compliance, it will also check to see if the guidelines' intent and substance are reflected in medical fees.

FY2022 medical fee revision

The FY2022 medical fee revision called for a 0.43% increase in medical fee (0.23% increase in core medical fee) and 1.35% reduction in NHI drug prices (official price of medicines).

Net medical fee revision -0.94% = medical fee +0.43% + drug reimbursement price -1.35% + medical materials price -0.02%

The increase in the core medical fee includes +0.26% for medical fees, +0.29% for dental fees, and +0.08% for dispensing fees. In contrast, the reduction in the NHI drug prices includes -1.35% for pharmaceuticals prices and -0.02% for medical material prices. The result of the revisions is a shift from a merchandise-based approach to a patient-centered one, evidenced by the expansion of guidance fees for pharmacists who interact with patients, and the recognition of pharmacies that contribute to community-based medical care such as through provision of medication information to hospitals.

Medical fee revision (%)

Year of revision	2002	2004	2006	2008	2010	2012	2014	2016	2018	2020	2022
Core medical fees (actual)	-1.30	±0.00	-1.36	+0.38	+1.55	+1.379	+0.10	+0.49	+0.55	+0.55	+0.43
Dispensing fee	-1.30	+0.00	-0.60	+0.17	+0.52	+0.46	+0.04	+0.17	+0.19	+0.16	+0.08
Drug prices (actual)	-1.40	-1.05	-1.80	-1.20	-1.36	-1.375	-1.36	-1.33	-1.74	-1.01	-1.35
NHI basis	-6.30	-4.20	-6.70	-5.20	-5.75	-6.00	-5.64	-5.57	-7.48	-4.38	-1.44
Consumption tax addition	-	-	-	-	-	-	+1.36	-	-	-	-
Total (nominal)	-2.70	-1.05	-3.16	-0.82	+0.19	+0.004	+0.10	-0.84	-1.19	-0.46	-0.94

Source: Shared Research based on company data

The key point regarding dispensing fees raised around the time of the FY2018 revision is a reassessment of the role of dispensing pharmacies with an emphasis on patient-centered service. Specifically, it promotes evaluation of family pharmacies and pharmacists, patient-centric businesses and at-home medical care; and promotes the use of generic drugs. It also encourages the proper assessment of large pharmacies operating near medical institutions. On generic drug utilization, MHLW is continuing efforts to improve utilization rates, and the FY2020 medical fee revision includes components that will further stimulate generic drug use.

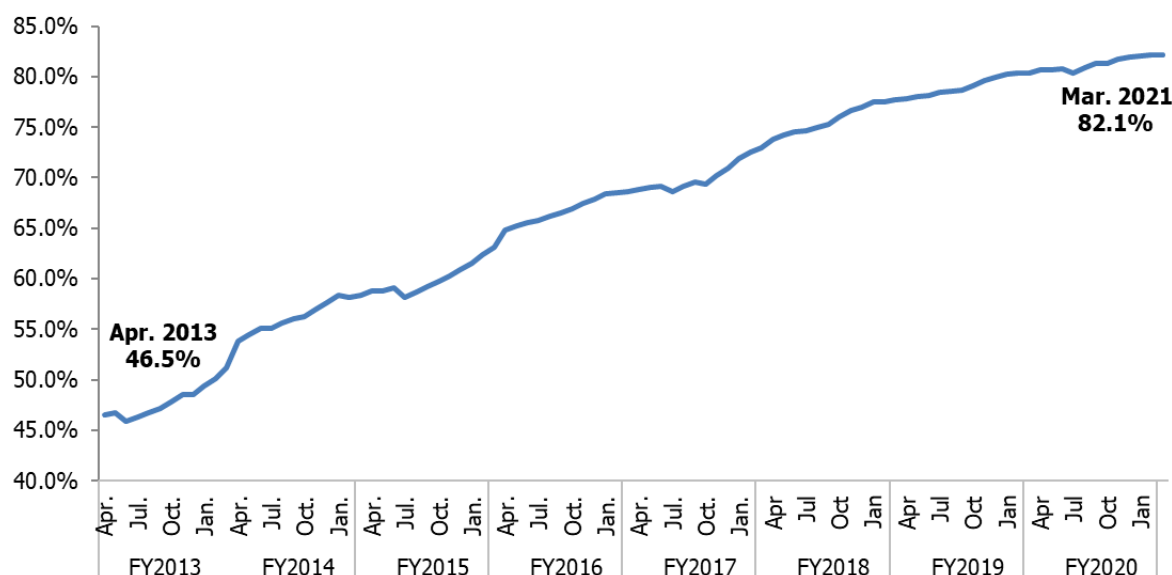
Mid-year revision of NHI drug price

NHI drug price revisions, previously held once every other year, were shifted to an annual basis effective from 2021 with the first mid-year revision conducted in April 2021. The reasoning behind the shift was that the stance of the Japanese government and MHLW intending to reduce healthcare expenditures by reflecting the drop in market values more quickly onto the official reimbursement pricing.

As of May 2021, about 14,228 drugs were listed as ethical drugs used in healthcare services provided by health insurance for reimbursement under the NHI scheme and 12,180 of them were subject to this mid-year price revision. The first mid-year revision was applied to drugs for which the pricing differential between official reimbursement price and actual market price was 0.625x of the average 8.0% divergence (divergence of 5.0% or higher). A breakdown of the 12,180 drugs for which reimbursement prices were revised shows 1,350 were new drugs (59% of new drugs), 1,490 were long-listed drugs (88% of long-listed drugs), 8,200 were generic drugs (83% of generic drugs), and 1,140 were products in the other categories

commercialized before 1967 (31% of other drugs). Most of generic and long-listed drugs were subject to this price revisions. Shared Research anticipates the impact of the NHI price revision will be far-reaching, not limited to generic and brand drug manufacturers but extended to pharmaceutical distribution-related companies and dispensing pharmacies.

Generic drug ratio



Source: Shared Research based on MHLW's Recent Trends of Dispensing Medical Costs (electronically processed)

Industry peers (dispensing pharmacy chains)

As industry peers we selected listed companies that operate dispensing pharmacies as their mainstay business. Comparing the operating profit margin of the business segments that operated dispensing pharmacies, Ain Holdings (TSE Prime: 9627) had the highest OPM in 2021. Profit margins declined across the board in FY2017 owing to the diminished impact of major drugs for hepatitis C. The whole industry was affected by the NHI medical fee revision in FY2019, with almost all companies recording lower profit margin than in the previous fiscal year. The uptrend in the profit margin of Medical System Network's dispensing pharmacy business since FY2019 mainly reflects a change in segmentation.

Comparison of profit margins of industry peers' pharmacy operation segments

Ticker	Company	FY end	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
2796	Pharmarise Holdings	May	2.6%	2.0%	3.5%	2.3%	3.4%	3.4%	-
3034	Qol Holdings	March	5.8%	5.1%	6.4%	4.7%	4.7%	6.5%	7.7%
3341	Nihon Chouzai	March	5.6%	5.0%	6.0%	4.2%	4.2%	4.3%	4.3%
4350	Medical System Network	March	4.2%	2.8%	3.5%	3.6%	3.8%	5.7%	6.0%
-	Sogo Medical Holdings	March	5.0%	6.3%	6.5%	5.0%	-	-	-
7649	Sugi Holdings	February	5.6%	5.3%	5.4%	5.3%	5.5%	5.6%	5.1%
9627	Ain Holdings	April	9.1%	8.6%	9.5%	7.5%	7.9%	8.0%	-

Source: Shared Research based on each company's data and websites (as of end-May 2021)

Notes: * Values for Medical System Network are profit margins of the Community Pharmacy Network business from 2019.

** Sogo Medical Holdings: FY2016 earnings are total profit margins as segment information is regional, transitioned to a holding company (9277) in October 2018 and delisted on April 17, 2020.

*** Sugi Holdings: Total company profit margins since there is only one segment.

Main industry peers

Ticker	Company	Latest FY results			Business description
		Sales (JPYmn)	Operating profit margin (%)	ROE (%)	
2796	Pharmarise Holdings	52,324	2.4%	7.3%	Middle-tier pharmacy chain. Leverages partnerships with regional drug wholesalers to acquire local dispensing chains. Has a reputation for community care support. Established joint ventures with Higuchi and FamilyMart to develop pharmacies.
3034	Qol	166,199	5.9%	12.9%	Major pharmacy chain. Started as monzen pharmacy. Opened stores with Lawson and Bic Camera. Also developing MR and pharmacist dispatch business.
3341	Nihon Chouzai	299,392	2.2%	7.2%	Second-ranked dispensing pharmacy chain. Nationwide expansion centered on monzen pharmacies in Kanto-Koshinetsu area. Established generic drug manufacturing subsidiary, also developing in-house drugs. Referral & placement of medical staff such as pharmacists.
4350	Medical System Network	98,232	1.5%	4.3%	Dispensing pharmacy holding company that also operates a pharmaceutical information intermediary network business. Started in Hokkaido, but expanding nationwide through M&A.
7649	Sugi Holdings	625,477	5.1%	9.4%	Developed drugstore/dispensing pharmacy, Sugi Pharmacy, in its stronghold Tokai area. The holding company also has discount stores.
9627	Ain Holdings	297,305	3.7%	5.9%	Top-ranked dispensing pharmacy chain. Originated in Hokkaido, expanded into metropolitan areas, with nationwide coverage of mainly monzen pharmacies. Concluded capital and business tie-up with Seven & i Holdings.

Source: Shared Research based on company data

Medical System Network ranks among the top ten dispensing pharmacy chains by sales. They all have negative cash flow from investment activities, which we attribute to their strategies of achieving growth by absorbing smaller local dispensing pharmacies (these smaller pharmacies account for 90% of the market). In contrast, Medical System Network has two growth options: integrate pharmacies into the Nanohana Pharmacy group through capital investment, or allow the smaller pharmacy to continue operating independently and bring them into the company group as affiliates (i.e., network users).

Financials of industry peers

(JPYmn)	Medical System Network (4350)			Pharmarise Holdings (2796)			Qol Holdings (3034)		
	FY03/20	FY03/21	FY03/22	FY05/19	FY05/20	FY05/21	FY03/20	FY03/21	FY03/22
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	105,241	104,257	106,685	51,728	51,030	52,324	165,411	161,832	166,199
Gross profit	40,214	42,412	44,429	7,342	7,437	8,067	21,094	21,102	23,163
SG&A expenses	38,599	38,982	40,576	6,702	6,403	6,821	13,361	13,737	13,308
Operating profit	1,615	3,429	3,852	640	1,034	1,246	7,733	7,364	9,855
Recurring profit	1,560	3,479	4,313	590	1,023	1,288	8,024	7,403	10,094
Net income	-895	2,198	2,394	23	577	426	4,067	3,365	5,489
ROE	-8.9%	21.3%	21.3%	0.4%	10.5%	7.3%	10.3%	8.2%	12.9%
ROA (RP-based)	2.3%	5.4%	6.9%	2.4%	4.1%	5.2%	8.1%	7.3%	10.3%
Operating profit margin	1.5%	3.3%	3.6%	1.2%	2.0%	2.4%	4.7%	4.6%	5.9%
Total assets	66,464	64,448	62,941	24,217	25,206	24,724	102,872	100,571	95,984
Net assets	9,418	11,187	13,286	5,619	5,946	6,331	41,001	41,834	43,881
Equity ratio	100.0%	100.0%	102.4%	21.9%	22.6%	24.3%	39.4%	40.9%	45.7%
Operating CF	4,232	5,205	4,010	895	1,572	1,945	4,468	12,912	10,112
Investing CF	-2,383	-1,485	-2,511	-501	-734	-1,076	-8,670	-3,065	-3,087
Financing CF	-1,687	-5,312	-3,415	354	-766	-728	-225	-6,114	-10,006
Cash and deposits	11,722	10,118	8,201	4,393	4,464	4,604	15,766	19,498	16,516
Interest-bearing debt	37,558	32,558	29,566	11,138	10,375	10,251	32,650	29,721	23,282
Net debt	25,836	22,440	21,365	6,745	5,911	5,647	16,884	10,223	6,766
	Nihon Chouzai (3341)			Sugi Holdings (7649)			Ain Holdings (9627)		
	FY03/20	FY03/21	FY03/22	FY02/20	FY02/21	FY02/22	FY04/19	FY04/20	FY04/21
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	222,147	278,951	299,392	541,964	602,850	625,477	275,596	292,615	297,305
Gross profit	46,372	49,374	52,422	162,182	181,631	191,490	45,363	46,861	46,155
SG&A expenses	38,779	41,267	45,833	132,420	147,590	159,353	29,295	30,793	35,222
Operating profit	7,593	8,106	6,589	29,762	34,041	32,137	16,067	16,068	10,932
Recurring profit	7,405	8,409	6,767	31,473	35,333	33,082	16,637	16,822	12,649
Net income	6,697	3,538	3,705	20,782	21,120	19,389	9,029	9,179	6,697
ROE	15.2%	7.3%	7.2%	11.9%	11.0%	9.4%	9.0%	8.5%	5.9%
ROA (RP-based)	4.1%	4.5%	3.7%	10.9%	10.7%	9.7%	8.9%	8.8%	6.4%
Operating profit margin	2.8%	2.9%	2.2%	5.5%	5.6%	5.1%	5.8%	5.5%	3.7%
Total assets	185,551	186,262	178,753	313,757	345,933	334,758	189,021	193,451	203,662
Net assets	47,072	49,868	52,876	182,750	200,629	213,890	103,922	111,003	115,837
Equity ratio	25.4%	26.8%	29.6%	58.2%	58.0%	63.9%	54.9%	57.3%	56.8%
Operating CF	13,192	11,213	19,411	45,353	34,027	7,174	14,788	17,747	14,928
Investing CF	-2,731	-7,767	-9,313	-18,422	-29,254	-23,892	-19,985	-11,474	-9,493
Financing CF	-7,955	-2,806	-17,448	-4,895	-5,274	-5,295	-10,681	-7,837	3,643
Cash and deposits	32,254	32,893	25,543	56,347	55,845	33,831	47,495	45,931	55,009
Interest-bearing debt	63,624	44,365	42,806	0	0	0	11,957	6,074	12,004
Net debt	31,370	11,472	17,263	-56,347	-55,845	-33,831	-35,538	-39,857	-43,005

Source: Shared Research based on each company's data

Note: * Sogo Medical (4775) became Sogo Medical HD (9277) in October 2018 and delisted on April 17, 2020.

Strengths and weaknesses

Strengths

- ▶ Management support network service available to small and mid-tier pharmacies:

Small pharmacies and mid-tier regional chains (90% of the market) fall behind major nationwide chains in buying power versus drug wholesalers and means to optimize pharmaceuticals inventory. However, by joining the company's network and becoming an affiliate, they can tap into majors-class strength and infrastructure without giving up their autonomy to a major pharmacy chain. The process does not involve a business transfer, so the hurdle for joining the network is relatively low. The company has a network system boasting the largest pharmaceuticals order volume in Japan, and negotiates procurement terms with suppliers on behalf of its members. It is also the only company that offers a dead stock clearance service, which matches members' inventory surpluses with deficiencies to reduce costly write-offs. This service cuts operating costs of network members by 1.3% (company estimate) on average even after factoring for the network usage fee. From the company's standpoint, an increase in network members translates to revenue growth from rising commissions and greater buying power in the pharmaceuticals market.

▶ Certified pharmacist training support system that appeals to pharmacies struggling with pharmacist shortage:

The company's Pharmaceuticals Network business collaborates with a training organization to support pharmacists (both network member pharmacists and others) enrolled in a certification program authorized by the Japan Pharmacists Education Center (JPEC). Aimed at raising the skill level of pharmacists, the JPEC program certifies those pharmacists who have completed their credit requirements through participation in various training courses (40 credits within four years and 30 credits every three years thereafter). The certification is one of the criteria of a "family pharmacist," whose pharmacy becomes eligible to charge an additional family pharmacist guidance fee. The company mainly utilizes its directly operated pharmacies and affiliates to help the training organization Iyaku Sogo Kenkyukai (ISK) run its accredited training courses nationwide. The service strengthens pharmacists' loyalty to their employers and improve recruitment outcomes. ISK is one of the few private-sector organizations registered with JPEC as a training organization and is authorized to issue the proof of attendance stickers that JPEC issues at its training courses.

▶ Regional dispensing pharmacy strategy in line with administrative guidance:

A distinguishing feature of the company's dispensing pharmacies is their high concentration in medical malls. This is in line with MHLW's vision for the role of pharmacies in the face of an aging society, and the company's outlet-location strategy benefits from the revised insurance point system. MHLW has revised dispensing fees to encourage a shift away from the pharmacy model linked to specific hospitals (pharmacies operating adjacent to large hospitals) and toward the family pharmacy and regional medical care models that accept prescriptions from a wide range of medical institutions. The company's strategy of opening pharmacies in medical complexes is in line with MHLW guidance and works to its favor in terms of dispensing fee eligibility.

Weaknesses

▶ Potential conflict of interest between M&A-driven pharmacy chain expansion and support services for small pharmacies:

The Pharmaceuticals Network business provides non-directly operated pharmacies (i.e., affiliates) access to the company's proprietary system, thus allowing them to maintain management independence, but this has the potential negative effect of impeding growth of the Dispensing Pharmacy business. While the company's peers are expanding through acquisition of smaller pharmacies, the availability of membership to the Pharmaceuticals Network system is a possible lifeline to smaller pharmacies that could encourage them to delay M&A action.

▶ Low profit margins for dispensing pharmacies without drugstore function:

The Dispensing Pharmacy business OPM of about 3.0% (based on disclosed data through FY03/19) is 2–5pp below that of other major chains. This is mainly because most of the company's dispensing operations are limited to prescription drugs and are not accompanied by drugstore functions handling items such as OTC drugs, long-term care products, and toiletries. Many of the other major chains have adopted the strategy to boost pharmacy profit margins by integrating drugstore operations with added floor space for food products and cosmetics. The company is looking to expand its product offerings to include various long-term care products like adult diapers as part of a family pharmacy service, but it will take time to transition to this business format.

▶ Relatively small assets a disadvantage in acquisitions:

The company is at a disadvantage versus the major players in terms of asset scale when it comes to acquisitions targeting pharmacy chain expansion. Looking at the M&A-based increases in outlet numbers over the past three years, industry leader

Ain Holdings acquired more than 100 pharmacies while Medical System Network was flat YoY in FY03/21. From the perspective of regional expansion, about 30% of the company's pharmacies are located in Hokkaido while less than 10% are located in Tokyo and Osaka, despite their high population density. In total assets, an important indicator of the buyer's financial strength in an M&A deal, comparable companies range in the JPY100.0bn mark and over, while Medical System Network significantly falls behind at around JPY64.0bn. In order to advance acquisitions and increase pharmacy outlets in regions other than its home ground Hokkaido, the company will need to be able to demonstrate its financial strength to the sell-side companies' management as well as M&A intermediaries.

Historical performance and financial statements

Income statement

Income statement (JPYmn)	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18	FY03/19	FY03/20	FY03/21	FY03/22
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	54,827	66,182	75,548	87,715	88,865	93,977	98,232	105,241	104,257	106,685
YoY	-	20.7%	14.2%	16.1%	1.3%	5.8%	4.5%	7.1%	-0.9%	2.3%
Cost of sales	35,415	43,445	47,072	54,913	54,700	57,369	60,961	65,027	61,845	62,256
Gross profit	19,412	22,737	28,476	32,801	34,164	36,607	37,271	40,214	42,412	44,429
YoY	-	17.1%	25.2%	15.2%	4.2%	7.2%	1.8%	7.9%	5.5%	4.8%
Gross profit margin	35.4%	34.4%	37.7%	37.4%	38.4%	39.0%	37.9%	38.2%	40.7%	41.6%
SG&A expenses	17,365	20,646	25,835	29,018	32,050	33,444	35,842	38,599	38,982	40,576
SG&A ratio	31.7%	31.2%	34.2%	33.1%	36.1%	35.6%	36.5%	36.7%	37.4%	38.0%
Operating profit	2,047	2,091	2,641	3,783	2,113	3,163	1,428	1,615	3,429	3,852
YoY	-	2.2%	26.3%	43.2%	-44.1%	49.7%	-54.9%	13.1%	112.3%	12.3%
Operating profit margin	3.7%	3.2%	3.5%	4.3%	2.4%	3.4%	1.5%	1.5%	3.3%	3.6%
Non-operating income	150	250	457	275	378	405	288	361	758	
Non-operating expenses	284	321	349	380	279	291	333	343	312	296
Recurring profit	1,912	2,020	2,540	3,860	2,109	3,250	1,501	1,560	3,479	4,313
YoY	-	5.6%	25.8%	52.0%	-45.4%	54.1%	-53.8%	3.9%	123.0%	24.0%
Recurring profit margin	3.5%	3.1%	3.4%	4.4%	2.4%	3.5%	1.5%	1.5%	3.3%	4.0%
Extraordinary gains	59	155	169	88	57	19	49	48	914	146
Extraordinary losses	65	404	415	470	260	976	128	1,586	426	447
Income taxes	1,018	1,073	1,315	1,599	1,262	1,271	962	918	1,769	1,624
Implied tax rate	53.4%	60.6%	57.3%	46.0%	66.2%	55.4%	67.7%	4,172.7%	44.6%	40.5%
Net income attributable to non-controlling interests	133	29	92	158	72	0	-2	0	0	0
Net income	756	668	885	1,720	571	1,022	462	-895	2,198	2,394
YoY	-	-11.6%	32.4%	94.4%	-66.8%	79.0%	-54.8%	-293.7%	-345.6%	8.9%
Net margin	1.4%	1.0%	1.2%	2.0%	0.6%	1.1%	0.5%	-0.9%	2.1%	2.2%

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

The third medium-term plan (FY03/13–FY03/15) began the following year. We believe the company has also applied plan targets to its business strategy from FY03/16 and beyond (the fourth medium-term plan), i.e., to increase the number of network member pharmacies and grow its own dispensing pharmacies. The five key initiatives of the fifth medium-term plan, which started in FY03/19, are as follows. We note that OPM has remained in the 1% range in FY03/19 and FY03/20 amid a severe business environment such as NHI medical fee revisions and price negotiations with wholesalers but recovered to the 3% level in FY03/21 owing to growth of the Pharmaceuticals Network business and improved profitability of the Dispensing Pharmacy business (currently, Community Pharmacy business). In FY03/22, the operating profit margin rose to 3.6% thanks to a boost in the number of network members and further profitability improvement in the Community Pharmacy business (name changed from Dispensing Pharmacy business).

SG&A expenses

SG&A expenses (JPYmn)	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18	FY03/19	FY03/20	FY03/21
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Salaries and allowances	6,364	7,489	9,266	10,406	12,088	12,481	13,467	14,195	14,435
Provision for employee bonuses	685	724	939	1,062	1,133	1,418	1,333	1,393	1,486
Retirement benefit expenses	172	195	264	329	361	466	457	596	566
Provision for directors' bonuses	64	68	76	55	47	35	33	41	42
Provision for directors' stock benefits	-	-	-	33	52	38	33	35	29
Taxes and dues	1,913	2,350	3,870	4,479	4,374	4,420	4,692	5,691	5,818
Depreciation	658	802	945	1,029	1,052	1,491	1,624	1,811	1,859
Amortization of goodwill	487	669	849	917	1,009	1,056	1,147	1,217	1,136
Other	5,509	6,612	7,537	8,486	9,630	9,559	15,827	16,648	16,606
Total	17,365	20,646	25,835	29,018	32,050	33,444	35,842	38,599	38,982

Source: Shared Research based on company data

Extraordinary losses in excess of JPY400mn were booked in each of the three years between FY03/14–FY03/16; these were mainly impairment losses at pharmacies that failed to reach projected earnings. The company monitors the profitability of each pharmacy based on specific criteria and provides guidance when they are not met. If improvements are not made within a specified period of time, the company closes the pharmacy and sells off the business rights. In FY03/20, the company booked an impairment charge on fixed assets of existing stores and shares in acquired companies to reflect the impact of the spread of COVID-19.

Balance sheet

Balance sheet	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18	FY03/19	FY03/20	FY03/21	FY03/22
(JPYmn)	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Assets										
Cash and deposits	2,092	3,106	2,499	2,081	2,252	10,201	11,703	11,722	10,118	8,201
Notes and accounts receivable	1,514	2,802	2,484	2,614	2,223	2,332	2,420	2,313	2,646	2,891
Inventories	2,219	2,732	3,846	3,431	4,053	3,520	4,297	4,452	4,408	4,780
Other	614	664	709	927	958	868	1,528	940	994	1,435
Allowance for doubtful accounts	-6	-6	-7	-7	-10	-11	-12	-12	-12	-3
Total current assets	8,271	10,941	11,023	10,783	11,098	18,736	21,055	20,578	19,313	18,701
Total tangible fixed assets	11,472	15,976	17,249	20,253	21,246	24,129	25,721	25,126	24,634	24,624
Total intangible assets	8,263	12,399	13,554	13,481	13,833	15,045	16,235	14,615	13,572	12,767
Investment securities	54	179	157	524	583	812	726	483	397	155
Long-term loans receivable										
Other	2,771	3,645	3,631	3,838	4,008	4,066	5,217	5,686	6,549	6,712
Allowance for doubtful accounts	-42	-26	-29	-33	-32	-31	-21	-26	-20	-19
Investment and other assets	2,783	3,798	3,759	4,329	4,559	4,847	5,922	6,143	6,926	6,848
Total fixed assets	22,518	32,173	34,564	38,063	39,639	44,023	47,879	45,885	45,134	44,239
Total assets	30,789	43,114	45,587	48,847	50,737	62,759	68,935	66,464	64,448	62,941
Liabilities										
Notes and accounts payable	5,616	7,798	8,598	9,525	9,144	9,416	10,198	10,021	9,258	9,680
Short-term debt	5,119	12,922	9,214	6,910	3,863	7,463	9,158	8,905	10,210	5,935
Income taxes payable	459	578	599	1,065	413	1,135	695	454	1,556	617
Other	3,181	3,582	3,215	3,561	3,500	3,755	3,793	3,916	4,394	4,203
Total current liabilities	14,375	24,880	21,626	21,061	16,920	21,769	23,844	23,296	25,418	20,435
Long-term debt	8,758	10,948	15,391	14,859	20,186	26,329	29,739	28,653	22,348	23,631
Deferred tax liabilities	1	1	1	1	1					
Other	1,419	1,933	2,434	2,660	2,985	4,075	4,590	5,096	5,493	5,588
Total fixed liabilities	10,178	12,882	17,826	17,520	23,172	30,404	34,329	33,749	27,841	29,219
Total liabilities	24,553	37,762	39,452	38,581	40,092	52,174	58,173	57,045	53,260	49,654
Net assets										
Capital stock	1,091	1,091	1,091	1,932	1,932	2,097	2,128	2,128	2,128	2,128
Capital surplus	901	901	901	1,742	1,742	1,160	1,185	1,183	1,182	1,182
Retained earnings	3,836	4,300	4,980	6,467	6,735	7,459	7,616	6,414	8,305	10,393
Treasury stock	-45	-1,181	-1,147	-328	-302	-275	-233	-206	-344	-326
Valuation differences on securities	3	2	11	15	49	143	83	-37	-24	-7
Foreign currency translation adjustments										
Other	-40	-31	-28	-17	23	52,316	58,239	56,945	53,154	49,547
Non-controlling interests	493	273	338	469	514	2	0	0	23	17
Total net assets	6,236	5,352	6,136	10,265	10,644	10,584	10,761	9,418	11,187	13,286
Total liabilities and net assets	30,789	43,114	45,588	48,846	50,736	62,759	68,935	66,464	64,448	62,941
Working capital	-1,883	-2,265	-2,268	-3,480	-2,868	-3,564	-3,481	-3,256	-2,204	-2,009
Total interest-bearing debt	13,877	23,870	24,605	21,769	24,049	33,792	38,897	37,558	32,558	29,566
Net debt	11,785	20,763	22,120	19,708	21,814	23,591	27,194	25,836	22,440	21,365

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

Assets: Assets expanded from 2012–13 on business growth

The company's business transformed in 2012–13, due in part to the formulation of its third medium-term plan. The company's consolidated subsidiary Pharmaholdings Co., Ltd., which operates dispensing pharmacies, entered a business alliance in December 2012 with Hanshin Dispensing Pharmacy Co., Ltd. (later became a subsidiary of Hanshin Dispensing Holding Co., Ltd. [merged into I&H Co., Ltd. in November 2019]). In July 2013, the two companies established a joint venture, H&M Co., Ltd. The main purpose of the joint venture was joint sourcing and distribution of pharmaceuticals, purchase of medical devices, and clearance of dead stock. H&M's chief goal is not to win pricing concessions from drug wholesalers as a result of buying power due to large-volume procurement, but to collaborate with drug wholesalers to set economically rational prices. This is the core objective of the company's Pharmaceuticals Network business.

Assets have continued to increase under the fourth medium-term plan and beyond. The company has sought to increase the number of dispensing pharmacies by M&A, but has carefully monitored the performance of pharmacies and booked impairment charges or disposed of those whose earnings have not improved. Under the fifth medium-term plan, assets have shrunk reflecting the impact of the COVID-19 pandemic since FY03/20. In FY03/22, the company continued to reduce assets through absorption of Home-visit Nursing Care Station Himawari Co., Ltd. among other means.

Liabilities: External financing

Liabilities rose during this period as the number of directly operated pharmacies increased in line with a rising network member count. The increase in current assets, which is working capital, was especially pronounced in FY03/14, when in addition to the increase in current assets, tangible fixed assets increased JPY4.5bn (+JPY2.5bn for buildings, +JPY1.9bn for land) and intangible fixed assets increased JPY4.1bn (JPY4.1bn increase in goodwill). Assets also increased in FY03/15 (buildings and structures +JPY237mn, land +JPY640mn, goodwill +JPY961mn). Growing demand for funds was met primarily through external financing. Short-term borrowings increased by about JPY7.0bn to JPY102.7bn in FY03/14, while long-term borrowings increased by about JPY4.5bn to JPY14.2bn in FY03/15 and has continued to gradually rise. Short- and long-term

borrowings have been over JPY30.0bn since FY03/18. Profits increased in FY03/21 and FY03/22 while interest-bearing debt declined YoY in both years.

Net assets: Capital stock increase in FY03/16

The company increased capital and retired treasury stock in FY03/16, lifting the equity ratio in line with one of the third medium-term plan targets of achieving a ratio of 20% or higher. At the same time, management shored up the balance sheet through reducing short-term borrowing by JPY6.2bn YoY. Improving its financial position remains a key initiative of its fifth medium-term plan, and of its sixth medium-term plan unveiled together with the announcement of FY03/22 results.

Cash flow statement

Cash flow statement (JPYmn)	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18	FY03/19	FY03/20	FY03/21	FY03/22
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Cash flows from operating activities (1)	3,790	3,706	3,838	6,409	3,084	6,699	2,840	4,232	5,205	4,010
Pre-tax profit	1,907	1,770	2,294	3,479	1,906	2,293	1,422	22	3,967	4,012
Depreciation	841	1,077	1,209	1,362	1,594	1,491	1,624	1,811	1,859	1,727
Amortization of goodwill	487	669	849	917	1,009	1,056	1,147	1,217	1,136	1,128
Change in trade receivables	1,739	382	935	191	812	496	500	285	-239	-214
Change in inventories	-74	-173	-689	455	-472	759	-620	-140	72	-406
Change in trade payables	-558	365	-295	683	-765	-569	69	-328	-864	400
Cash flows from investing activities (2)	-5,425	-7,559	-3,958	-5,040	-3,909	-6,848	-5,921	-2,383	-1,485	-2,511
Purchase of tangible fixed assets	-1,625	-4,180	-2,360	-3,674	-2,170	-4,050	-3,094	-1,351	-1,375	-1,934
Purchase of intangible assets	-13	-44	-93	-273	-192	-190	-82	-107	-154	-194
Purchase, sale, and redemption of investment securities	1	129		-267	-19	-39	-16	102	18	379
Change in loans (short- and long-term; net)	-245	-56	-106	-106	-38	-95	-3	-102	-233	7
Free cash flow (1+2)	-1,635	-3,853	-120	1,369	-825	-149	-3,081	1,849	3,720	1,499
Cash flows from financing activities	1,654	4,864	-483	-1,792	998	8,050	4,338	-1,687	-5,312	-3,415
Change in short-term borrowings	685	7,255	-4,334	-2,314	-3,241	2,598	1,471	-505	0	-2,901
Change in long-term borrowings	1,846	-250	4,816	-896	5,292	7,292	3,701	-376	-4,634	33
Acquisition of treasury stock	-129	-1,155		1,005	0					
Dividends paid	-276	-221	-190	-229	-297	-297	-304	-305	-304	-304

Source: Shared Research based on company data

Note: Figures may differ from company materials due to differences in rounding methods.

Cash flows from operating activities

Cash flow from operating activities since FY03/12, when the accounting period was changed, has trended around JPY3.7bn–3.8bn, approximately half of which is derived from pre-tax profit, except for FY03/16–FY03/17 when profits fluctuated sharply. FY03/16–FY03/17 earnings were impacted by a number of temporary factors and a changing business environment owing to NHI drug price and dispensing fee revisions. The company notes temporary factors that boosted FY03/16 profits such as JPY242mn in gains from the sale of real estate, JPY100mn in subsidies for opening a serviced elderly housing facility, and a JPY90mn tax benefit from acquisition of subsidiary shares. The decline in FY03/17 profits was exacerbated by factors such as drug price and dispensing fee revisions, a winding down of major hepatitis C drug sales, and the absence of temporary factors that boosted FY03/16 profits. Operating cash flow in FY03/19 declined by half YoY owing to the April 2018 NHI price revision, but increased YoY in FY03/20 and FY03/21 as earnings recovered. In FY03/22, operating cash flow fell YoY again due to an increase in inventories and income taxes paid accompanying earnings recovery.

Depreciation and goodwill have been steadily increasing (except during the abbreviated accounting period) on business expansion owed to an upswing in the number of directly operated pharmacies, and this has had a positive impact on cash flow. Accounts receivable and accounts payable tend to fluctuate from year-end to year-end, showing no set pattern as the timing of receivable collections and the debt repayment period varies. Further, fiscal years with negative cash flow for inventory assets are common. We think this is due to the nature of Medical System Network's business of handling prescription drugs, which calls for the maintenance of sufficient inventories to avert shortage versus prescriptions.

Cash flows from investing activities

Cash flow from investing activities has been consistently negative for the 10 years through FY03/17 owing to a business expansion strategy that leverages alliances and M&A. The cash flow deficit from investing activities has been especially pronounced since the third medium-term plan was initiated in FY03/13. Prior to that, it was typically in the JPY1.0bn–3.0bn range, but then expanded to the JPY4.0bn–7.0bn range. In FY03/14, the company posted its largest cash flow deficit in 10 years, but this was mostly due to acquisition of tangible fixed assets: JPY4.2bn for serviced elderly housing facilities and land/buildings for new pharmacies and JPY4.2bn for shares acquired through M&A and from business transfers. Even in other fiscal years, the acquisition of land and buildings had a major impact on cash flow from investing activities—JPY3.7bn in

FY03/16 and JPY3.1bn in JPY03/19, accounting for the bulk of the deficit in both years. The company commented that Wisteria Minami Ichijo would be the last elderly housing planning and development project for a while.

The company has aimed to make its network system an industry standard by expanding the number of affiliates and to improve profitability of the directly operated pharmacy business. Accordingly, in the third to fifth medium-term plans, it focused on profitability improvements in these mainstay businesses. Since the company's businesses call for front-loaded spending by nature, free cash flow has been negative up to FY03/19, with the exception of FY03/16 when free cash flow turned positive due to temporary factors that sharply lifted profits. From FY03/20 onward, free cash flow turned positive owing to selective engagement in M&A and earnings recovery.

Cash flows from financing activities

Financing will be indispensable as the company looks to continue expanding its business. In addition to using internal funds, the company raises funds through short- and long-term borrowing. We list the relatively large-scale financings of the past 10 years below. Most were short- and long-term borrowings, of which a large majority was for business expansion, such as purchase of real estate for new pharmacies and M&A.

In FY03/14, there was a JPY1.2bn cash flow deficit due to a share buyback accompanying the restructuring of an affiliated company. In FY03/16, cash flow saw a JPY2.8bn surplus as the company increased capital and sold treasury shares to improve its financial standing. Total borrowing also increased JPY5.2bn in FY03/19, but JPY3.9bn was invested in M&A, including the acquisition of Nagatomi Pharmacy. There were few M&A deals in FY03/20 and FY03/21 because the company prioritized improving profitability of existing stores. Under better financial standing, the company reduced its interest-bearing debts, particularly short-term borrowings, in FY03/22.

Historical performance

Full-year FY03/22 results (out May 6, 2022)

Overview

Full-year FY03/22 (April 2021–March 2022) earnings results

- Sales: JPY106.7bn (+2.3% YoY)
- Operating profit: JPY3.9bn (+12.3% YoY)
- Recurring profit: JPY4.3bn (+24.0% YoY)
- Net income attributable to owners of the parent: JPY2.4bn (+8.9% YoY)

Operating results and business conditions

Sales rose 2.3% YoY as the Pharmaceuticals Network business recorded a steady increase in new network members, and the Community Pharmacy business saw some recovery in the number of prescriptions filled despite a drop in the average prescription price. On the profit front, earnings improvement from centralized procurement of generic drugs in the Community Pharmacy business and growth in the number of network members in the Pharmaceuticals Network business contributed to results. With these factors more than offsetting the increase in personnel and other SG&A expenses, operating profit rose 12.3% YoY. Net income attributable to owners of the parent increased 8.9% thanks in part to gains on the sale of investment securities and a decrease in the company's income tax burden stemming from its July 2021 absorption of consolidated subsidiary Home-Visit Nursing Care Station Himawari Co., Ltd.

Segment results

Community Pharmacy Network

- Segment sales: JPY101.5bn (+2.3% YoY; including intra-group sales and transfers between segments, same applies below)
- Segment profit: JPY6.1bn (+7.3% YoY)
- This is a new segment that integrates the former Pharmaceuticals Network business, the Dispensing Pharmacy business, and the Manufacture and Market Pharmaceuticals business (mainly Feldsenf Pharma) previously included in Other. A Digital Shift business that utilizes instant messaging app LINE was added to the segment from FY03/21.

According to the company, all operations in this segment finished in the black in FY03/22, with the exception of the Digital Shift business, which logged a small loss due to front-loaded spending on the sales force and systems development.

Pharmaceuticals Network

The number of new network members continued to increase, driven by the need for improved operating stability for dispensing pharmacies amid harsh business conditions in the industry, including annual NHI drug price revisions starting in April 2021. As of end-March 2022, network members numbered 7,401 (+1,285 versus end-FY03/21), consisting of 425 directly operated pharmacies and 6,976 affiliates.

Community Pharmacy

The number of prescriptions filled during the period recovered to some extent, despite a drop in the average prescription price. As of end-March 2022, the group had 42 community pharmacies, one care plan center, and eight cosmetics/drug stores.

Manufacture and Market Pharmaceuticals

This business aims to provide a stable supply of good-quality, low-priced generic drugs. The company launched 14 products (seven ingredients) during the fiscal year under review, and had 82 products (41 ingredients) available as of end-March, 2022.

Digital Shift

Subsidiary PharmaShift Co., Ltd. was established on October 1, 2020, to create a “new pharmaceutical platform” for the digital age. In March 2021 the subsidiary launched the “Tsunagaru Pharmacy” service utilizing its official LINE account. As of end-March 2022, the official LINE account had more than 310,000 registered users, with 911 stores having introduced the service.

Leasing and Facility-related

- Segment sales: JPY3.3bn (+13.1% YoY)
- Segment profit: JPY39mn (+21.9% YoY)

Operating conditions of serviced elderly housing facilities

Property leasing revenue was generally strong and orders for construction projects increased. However, occupancy rates at the company's serviced elderly housing facilities remained sluggish. As of end-March 2022, the company reported stable occupancy rates at three of its five properties, while for the remaining two, at Wisteria Senri-Chuo it reported an occupancy rate of 78.1% (with 64 out of 82 units occupied), and at Wisteria Minami Ichijo it reported an occupancy rate of 69.8% (with 81 out of 116 units occupied).

Meal Catering

- Segment sales: JPY2.3bn (-6.1% YoY)
- Segment profit: JPY1mn (versus a loss of JPY21mn in the previous year)

Segment turns profitable

Despite a drop in the number of meals supplied due to the pandemic, the segment turned profitable in Q2 as the company revised its operations and changed its suppliers. The segment remained in the black in Q3.

Other (mostly home-visit nursing care)

- Segment sales: JPY305mn (+33.2% YoY)
- Segment loss: JPY12mn (versus a loss of JPY31mn in the previous year)

Q3 FY03/22 earnings results (out February 4, 2022)

Overview

Q3 FY03/22 (April–December 2021) earnings results

- Sales: JPY79.9bn (+2.2% YoY)
- Operating profit: JPY3.1bn (+10.5% YoY)
- Recurring profit: JPY3.5bn (+25.8% YoY)
- Net income attributable to owners of the parent: JPY2.1bn (+6.5% YoY)

Operating results and business conditions

Performance was steady in the core Community Pharmacy Network segment, with sales growing 2.2% YoY over cumulative Q3. The trend in the main business areas was as follows. In the Pharmaceuticals Network business, the number of new network members increased steadily. In the Dispensing Pharmacy business, the average prescription price dropped, but the number of prescriptions filled recovered to some extent.

Gross profit increased 5.6% YoY to JPY33.4bn, and GPM improved 1.4pp to 41.9% due to profit growing in the Pharmaceuticals Network business on an increase in the number of network members. According to the company, increased profitability of dispensing operations (due to a rise in the ratio of technical fees in the breakdown of prescription unit price) in the Dispensing Pharmacy business contributed to GPM improving, in addition to growth in sales and profit in the Pharmaceuticals Network business. SG&A expenses also increased 5.1% or JPY1.5bn YoY to JPY30.4bn due to expenses rising with the opening of new dispensing pharmacies, but the impact was offset by higher gross profit. As a result, operating profit grew 10.5% YoY and OPM rose 0.3pp to 3.8%. Meanwhile, net income attributable to owners of the parent increased 6.5% YoY as a result of gains on the sale of investment securities and tax benefits from the absorption-type merger with consolidated subsidiary Home-Visit Nursing Care Station Himawari Co., Ltd. in July 2021.

Breakdown of Q3 FY03/22 (April–December 2021) results by segment

Community Pharmacy Network

- Segment sales: JPY76.0bn (+2.2% YoY; including intra-group sales and transfers between segments, same applies below)
- Segment profit: JPY4.7bn (+7.7% YoY)
- This is a new segment that integrates the former Pharmaceuticals Network business, the Dispensing Pharmacy business, and the Manufacture and Market Pharmaceuticals business (mainly Feldsenf Pharma) previously included in Other. A Digital Shift business that utilizes instant messaging app LINE was added to the segment from FY03/21.

Pharmaceuticals Network

The number of new network members continued to increase, driven by the need for improved operating stability for dispensing pharmacies amid harsh business conditions in the industry, including annual NHI drug price revisions starting in April 2021. As of end-December 2021, network members numbered 7,003 (+887 versus end-FY03/21), consisting of 424 directly operated pharmacies and 6,579 affiliates. This was 74.9% of the company's target of 1,184 network members by end-March 2022.

Dispensing Pharmacy

The average prescription price dropped due to the drug charge per prescription decreasing, but the number of prescriptions filled during the period recovered to some extent. As a result, dispensing fees increased 3.4% YoY across all stores and 2.0% YoY at existing stores. As of end-December 2021, the group had 424 dispensing pharmacies, one care plan center, and eight cosmetics/drug stores.

Manufacture and Market Pharmaceuticals

This business aims to provide a stable supply of good-quality, low-priced generic drugs. As of end-December 2021, the company was selling 41 different ingredients and 80 products. The company plans to increase the number of clients it sells to, starting with stores it operates directly, before expanding sales to network members.

Digital Shift

Subsidiary PharmaShift Co., Ltd. was established on October 1, 2020, to create a “new pharmaceutical platform” for the digital age. In March 2021, the subsidiary launched the “Tsunagaru (connected) Pharmacy” service utilizing its official LINE account. The introduction of this service is designed to support the “family pharmacy” functions of dispensing pharmacies. At end-December 2021, the official LINE account had more than 250,000 registered users, with 745 stores having introduced the service. These numbers continue to grow, with the number of registered users having reached 271,000 and stores 788 at end-January 2022.

Leasing and Facility-related

- Segment sales: JPY2.5bn (+12.2% YoY)
- Segment profit: JPY53mn (+55.9% YoY)

Operating conditions of serviced elderly housing facilities

Property leasing revenue was generally strong and orders for construction projects increased. However, occupancy rates at the company’s serviced elderly housing facilities remained sluggish. As of end-December 2021, the company reported stable occupancy rates at three of its five properties, while for the remaining two, at Wisteria Senri-Chuo it reported an occupancy rate of 78.1% (with 64 out of 82 units occupied), and at Wisteria Minami Ichijo it reported an occupancy rate of 69.8% (with 81 out of 116 units occupied).

Meal Catering

- Segment sales: JPY1.8bn (-6.5% YoY)
- Segment profit: JPY7mn (versus a loss of JPY2mn in the previous year)

Segment turns profitable

Despite a drop in the number of meals supplied due to the pandemic, the segment turned profitable in Q2 as the company revised its operations and changed its suppliers. The segment remained in the black in Q3.

Other (mostly home-visit nursing care)

- Segment sales: JPY232mn (+35.7% YoY)
- Segment loss: JPY10mn (versus a loss of JPY17mn in the same period last year)

1H FY03/22 earnings results (out November 5, 2021)

Overview

1H FY03/22 (April–September 2021) earnings results

- Sales: JPY52.2bn (+2.2% YoY)
- Operating profit: JPY1.9bn (+37.4% YoY)
- Recurring profit: JPY2.2bn (+60.0% YoY)
- Net income attributable to owners of the parent: JPY1.4bn (+147.6% YoY)

Operating results and business conditions

Sales were up 2.2% YoY, driven by a 2.3% sales increase in the mainstay Community Pharmacy Network segment. Of the four businesses that make up the Community Pharmacy Network segment, Pharmaceuticals Network and Dispensing Pharmacy businesses contributed to segment sales and profit growth. Sales were up both in the Pharmaceuticals Network and Dispensing Pharmacy businesses, owed to steady growth in new network members in the former, and to a certain degree of recovery in the number of prescriptions filled in the latter. Operating profit rose 37.4% YoY, also driven by growth in the

Pharmaceuticals Network and Dispensing Pharmacy businesses. Net income attributable to owners of the parent increased 147.2% as a result of profit from the sale of investment securities and tax effect of the absorption-type merger with Home-Visit Nursing Care Station Himawari Co., Ltd.

Breakdown of 1H FY03/22 (April–September 2021) results by segment

Community Pharmacy Network

- Segment sales: JPY49.7bn (+2.3% YoY; including intra-group sales and transfers between segments, same applies below)
- Segment profit: JPY2.9bn (+21.8% YoY)
- This is a new segment that integrates the former Pharmaceuticals Network business, the Dispensing Pharmacy business, and the Manufacture and Market Pharmaceuticals business (mainly Feldsenf Pharma) previously included in Other. A Digital Shift business that provides services utilizing the company subsidiary's (PharmaShift) official LINE (instant messaging app) account was added to the segment from FY03/21.

Pharmaceuticals Network

In 1H FY03/22, of the JPY1.1bn YoY increase in overall sales, growth in the Pharmaceuticals Network business accounted for JPY156mn. In Japan, dispensing pharmacies sought to improve operating stability amid harsh business environments in the industry, including the start of annual NHI drug price revisions in April 2021. As a result, there was increased demand among pharmacy operators to join the company's pharmaceuticals network in the hopes of streamlining operations involved in negotiations with wholesalers and ordering. The number of new network members continued to increase steadily, with network members totaling 6,700 (+584 versus end-FY03/21) at end-September 2021, consisting of 419 directly operated pharmacies and 6,281 affiliates. On the profit front, of the JPY507mn increase in company-wide operating profit in 1H, JPY156mn was from the Pharmaceuticals Network business.

Dispensing Pharmacy

In 1H, of the JPY1,124mn increase in overall company sales, growth in the Dispensing Pharmacy business contributed JPY1,059mn. Price per prescription dropped due in part to the NHI drug price revisions, but the number of prescriptions filled recovered to some extent. As a result, in Q2 FY03/22 all-store dispensing fees for the directly managed Nanohana Pharmacy chain grew 3.7% YoY. As of end-September 2021, the group had 419 dispensing pharmacies (up three versus end-FY03/21), one care plan center, and eight cosmetics/drug stores. On the profit front, the Dispensing Pharmacy business contributed JPY331mn to company-wide operating profit growth of JPY507mn.

Manufacture and Market Pharmaceuticals

This business aims to provide a stable supply of good-quality, low-priced generic drugs. As of end-September 2021, the company was selling 39 different ingredients and 77 products. The company said Feldsenf Pharma, the main subsidiary operating the business, has continued operating in the black.

Digital Shift

Subsidiary PharmaShift Co., Ltd. was established on October 1, 2020 to create a "new pharmaceutical platform" for the digital age. In March 2021 the subsidiary launched the "Tsunagaru (connected) Pharmacy" service utilizing its official LINE account. Main services include electronic medication records, prescription transmittal, follow-up medication management, online medication guidance, and payment services. The company receives a monthly service usage fee of JPY10,000 from dispensing pharmacies that have introduced the service. As of end-September 2021, the official LINE account had more than 170,000 friends (users), with 552 stores having introduced the service.

Leasing and Facility-related

- Segment sales: JPY1.5bn (+6.8% YoY)
- Segment profit: JPY32mn (+100.0% YoY)

Operating conditions of serviced elderly housing facilities

In 1H FY03/22, property leasing revenue was generally strong and orders for construction projects increased. However, the spread of COVID-19 limited sales activities for the company's serviced elderly housing facilities, leading to sluggish growth in occupancy. As of end-September 2021, the company reported stable occupancy rates at three of its five properties, while for the remaining two, at Wisteria Senri-Chuo it reported an occupancy rate of 78.1% (with 64 out of 82 units occupied), and at Wisteria Minami Ichijo it reported an occupancy rate of 70.7% (with 82 out of 116 units occupied).

Meal Catering

- Segment sales: JPY1.2bn (-6.6% YoY)
- Segment profit: JPY1mn (versus loss of JPY13mn in 1H FY03/21)

Despite a drop in the number of meals supplied due to the pandemic, the segment turned profitable in 1H FY03/22 as the company revised its operations, including changing its suppliers.

Other (mostly home-visit nursing care)

- Segment sales: JPY152mn (+38.2% YoY)
- Segment loss: JPY12mn (versus loss of JPY13mn in 1H FY03/21)

Q1 FY03/22 earnings results (out August 6, 2021)

Overview

Q1 FY03/22 (April–June 2021) earnings results

- Sales: JPY25.9bn (+3.0% YoY)
- Operating profit: JPY667mn (loss of JPY61mn in Q1 FY03/21)
- Recurring profit: JPY935mn (loss of JPY62mn in Q1 FY03/21)
- Net income attributable to owners of the parent: JPY583mn (loss of JPY201mn in Q1 FY03/21)

Operating results and business conditions

The Pharmaceuticals Network business recorded a steady increase in new network members in general, and the Dispensing Pharmacy business saw some recovery in the number of prescriptions filled despite a drop in the average prescription price. The increase in Pharmaceuticals Network business network members contributed to profit growth.

Breakdown of Q1 FY03/22 (April–June 2021) results by segment

Community Pharmacy Network

- Segment sales: JPY24.7bn (+3.1% YoY; including intra-group sales and transfers between segments, same applies below)
- Segment profit: JPY1.2bn (+177.0% YoY)
- This is a new segment that integrates the former Pharmaceuticals Network business, the Dispensing Pharmacy business, and the Manufacture and Market Pharmaceuticals business (mainly Feldsenf Pharma) previously included in Other. A Digital Shift business that utilizes instant messaging app LINE was added to the segment from FY03/21.

Pharmaceuticals Network

The number of new network members continued to increase, driven by the need for improved operating stability amid harsh business environments in the dispensing pharmacy industry. As of end-June 2021, network members numbered 6,367 (+251 versus end-FY03/21), consisting of 417 directly operated pharmacies and 5,950 affiliates. By end-June 2021, the company's market share exceeded 10%.

Dispensing Pharmacy

The number of prescriptions filled during the period recovered to some extent, despite a drop in the average prescription price. As of end-June 2021, the group had 417 dispensing pharmacies, one care plan center, and eight cosmetics/drug stores.

Manufacture and market pharmaceuticals

This business aims to provide a stable supply of good-quality, low-priced generic drugs. As of end-June 2021, the company was selling 37 different ingredients and 74 products.

Digital Shift

Subsidiary PharmaShift Co., Ltd. was established on October 1, 2020, to create a “new pharmaceutical platform” for the digital age. In March 2021 the subsidiary launched the “Tsunagaru (connected) Pharmacy” service utilizing its official LINE account. As of end-June 2021, the official LINE account had more than 87,000 friends (users), with 350 stores having introduced the service.

Leasing and Facility-related

- Segment sales: JPY739mn (+2.2% YoY)
- Segment loss: JPY2mn (profit of JPY6mn in Q1 FY03/21)

Reasons for segment loss

In Q1 FY03/22, the spread of COVID-19 limited sales activities for the company's serviced elderly housing facilities, leading to sluggish growth in occupancy. The company also incurred increased expenses for implementing counter-infection measures. As of end-June 2021, the company reported stable occupancy rates at three of its five properties, while for the remaining two, at Wisteria Senri-Chuo it reported an occupancy rate of 78.1% (with 64 out of 82 units occupied), and at Wisteria Minami Ichijo it reported an occupancy rate of 67.2% (with 78 out of 116 units occupied).

Meal Catering

- Segment sales: JPY586mn (-4.2% YoY)
- Segment loss: JPY1mn (versus loss of JPY19mn in Q1 FY03/21)

Loss improved

Losses narrowed due to a decline in the number of meals supplied due to the pandemic, withdrawal from unprofitable facilities, and changes in suppliers.

Other (mostly home-visit nursing care)

- Segment sales: JPY74mn (+45.1% YoY)
- Segment loss: JPY7mn (versus loss of JPY11mn in Q1 FY03/21)

News and topics

Revision to its full-year earnings forecast and year-end dividend forecast

2022-02-07

On February 4, 2022, Medical System Network Co., Ltd. announced revisions to its full-year earnings forecast and year-end dividend forecast.

Revisions to earnings forecast

2021-10-28

Medical System Network Co., Ltd. announced revisions to its earnings forecast.

Revisions to 1H FY03/22 consolidated earnings forecast (announced on October 28, 2021)

Sales: JPY52.2bn (previous forecast: JPY51.9bn)

Operating profit: JPY1.9bn (JPY1.4bn)

Recurring profit: JPY2.2bn (JPY1.8bn)

Net income attributable to owners of the parent: JPY1.4bn (JPY750mn)

EPS: JPY47.41 (JPY24.87)

Reasons for revision

The company now forecasts 1H FY02/22 consolidated sales of JPY52.2bn (up 0.6% from its previous forecast), largely because the price per prescription and number of prescriptions filled were higher than expected at the Dispensing Pharmacy business. It also forecasts operating profit of JPY1.9bn (up 32.9%), due to higher sales, reduction in travel and other such expenses, and the deferral of some expenses expected in 1H to 2H; recurring profit of JPY2.2bn (up 27.4%); and net income of JPY1.4bn (up 90.7%), owing to a gain on the sale of investment securities held and the tax effect of the absorption-style merger of consolidated subsidiary Home-Visit Nursing Care Station Himawari Co., Ltd., in July 2021. The company made no change to the full-year consolidated earnings forecast announced on May 7, 2021.

Other information

History

Data	Description
Sep 1999	Established Medical System Network (capital stock :JPY 10mn) in Chuo-Ward, Sapporo, to streamline hospital operation and pharmaceuticals distribution
Mar 2002	Registered shares on Osaka Stock Exchange NASDAQ Japan market (now JASDAQ)
Dec	Acquired 100% of Pharmaholdings and Nihon Leben shares, making them wholly owned subsidiaries
Feb 2005	Established joint venture MM net with Mitsui & Co. (capital JPY 200mn, Medical System Network held 51% equity stake, but dissolved alliance and absorbed MM net in 2013)
Oct	Pharmaholdings acquired 100% of Sunmedic Co., Ltd. (now Nanohana East Japan Co., Ltd.) shares, making it a wholly owned subsidiary
	Pharmaholdings acquired 100% of Hankyu Kyoei Pharmacy (now Kyoei Pharmacy) shares, making it a wholly owned subsidiary
Jan 2007	Acquired 100% of CR Medical (now Nanohana central Co., Ltd.), making it a wholly owned subsidiary
Mar	Acquired 100% of Hokkaido Hiclips (now SMO-MDS) shares, making it a wholly owned subsidiary
Sep 2008	Listed shares on the Second Section of the Tokyo Stock Exchange
Jun 2010	Listed shares on the First Section of the Tokyo Stock Exchange
Nov 2012	Formed Business alliance with Hansin Dispensing Pharmacy (Switched to alliance with parent Hansin Pharmacy Holdings when the holding company was established in December 2012)
May 2013	Formed business alliance with FamilyMart
Jul	Pharmaholdings and Hansin Dispensing Holdings established joint venture, H&M Co.
Nov	Pharmaholdings acquired 98.96% of Total Medical Service shares through public tender offer, making it a subsidiary
Jan 2015	Concluded comprehensive strategic alliance with Fuyo General Lease Co., Ltd.
Mar	Formed business alliance with Sogo Clinical Holdings (now EP-Sogo)
Apr	Formed business alliance with EM Systems
May	Concluded capital tie-up with Sogo clinical Holdings (now EP-Sogo)
Jun	Formed Business alliance with Yakujin Corporation
May 2016	Pharmaholdings acquired 100% of Home-Visit Nursing Care Station Himawari Co. shares and entered home-visit nursing care business
Oct	Formed business alliance with Zoo Corporation
Jan 2017	Formed business alliance with Career Brain
May	Formed business alliance with Okura Information System
Jun	Sold shares of SMO-MDS (no longer a subsidiary)
Oct	Absorbed subsidiaries System Four, Pharmaholdings, and Nihon Leben
Jan 2018	Acquired all shares in Apotec and made it a wholly owned subsidiary
	Formed business alliance with Polaris Co., Ltd.
Feb	Feldsenf Pharma Co., Ltd. formed Business alliance with Daito Pharmaceutical Co., Ltd.
Jun	Feldsenf Pharma Co., Ltd. started sales of generic drugs
Jan 2019	Acquired all shares in Nagatomi Pharmacy Corporation and made it a wholly owned subsidiary
Apr	Acquired A-System Co., Ltd. in a absorption-type merger
Feb 2020	Dissolved H&M Co., Ltd, terminating business tie-up with I&H Co., Ltd.
Oct	Established PharmaShift Co., Ltd., a joint venture with Opt, Inc. (now Re:teigi, Inc.)

Source: Shared Research based on company data (as of March 2021)

Corporate governance and top management

Corporate governance

The company recognizes the importance of legal compliance and corporate ethics, and aims to continuously enhance corporate value through rapid decision-making and improved management soundness. While looking to aggressively expand its business in line with growth of the overall medical market, Medical System Network is aware of the importance of ensuring a fair management system and accordingly maintains a flexible meeting of the board of directors, has developed a system to monitor business execution, and has enhanced internal controls. The company further recognizes that management of subsidiaries is especially crucial to internal control, and thus aims to enhance corporate governance by ensuring thorough compliance, building a risk management system, and establishing a system for reporting financial and other important matters.

Compliance

Management has established the Medical System Network Group Charter of Corporate Behavior, a Code of Conduct for corporate ethics and compliance, and the basic regulations to clarify the company's basic stance on corporate ethics and compliance. The company appoints an officer in charge of compliance as stipulated in its group compliance basic regulations, under whose supervision a compliance department has been established to develop a compliance system for the group.

Risk management

The company has established an organization and management system based on Medical System Network Group Risk Management Basic Rules that enables efficient execution of duties through the clarification of directors' authorities and responsibilities. Discussions of important matters by each group company's board of directors are held after preliminary consultations with the company. In addition, appropriate management control of subsidiaries is conducted in accordance with management regulations for affiliated companies. Reports of business results, financial status, and important matters are received at regularly scheduled Board of Directors and other important meetings. A system is in place for the prompt reporting of serious risk factors such as compliance violations.

Internal and corporate audits

The Internal Audit Office is in charge of internal auditing and its manager is responsible for drafting the basic internal audit plan prior to the start of the fiscal year, obtaining approval by the President and Representative Director, and formulating an implementation agenda based on the basic internal audit plan. In terms of auditing by corporate auditors, corporate auditors attend regular and extraordinary meetings of the board of directors to observe the performance of duties by company officers such as directors and Internal Audit Office managers as part of a system to audit performance of directors and the status of internal controls. Auditing efficiency is further enhanced through mutual cooperation and information-sharing with the accounting auditor and the Internal Audit Office.

Form of organization and capital structure	
Form of organization	Company with Audit & Supervisory Board
Controlling shareholder	None
Directors and Audit & Supervisory Board members	
Number of directors under Articles of Incorporation	15
Number of directors	12
Directors' term of office under Articles of Incorporation	2 years
Chairperson of the Board of Directors	President
Number of outside directors	3
Number of independent outside directors	3
Number of members of Audit & Supervisory Board per Articles of Incorporation	4
Number of members of Audit & Supervisory Board	4
Number of outside members of Audit & Supervisory Board	3
Number of independent outside members of Audit & Supervisory Board	3
Other	
Participation in electronic voting platform	In place
Providing convocation notice in English	In place
Implementation of measures regarding director incentives	Performance-linked remuneration, Other
Disclosure of directors' compensation	None
Policy to determine amount and calculation method of remuneration	In place
Corporate takeover defenses	None

Source: Shared Research based on company materials

Top management

President and director (Representative Director) Inao Tajiri

Mar 1974	Joined Ichino Yamagata Pharmaceutical Co., Ltd.
Jan 1981	Joined Medical Yamagata Pharmaceutical Co., Ltd.
Nov 1989	Representative director of Medical Yamagata Pharmaceutical Co., Ltd.
Jun 1991	Director of Akiyama Aiseikan Co., Ltd. (now Suzuken Co., Ltd)
Sep 1999	Established Medical System Network and became representative director and president (current)
Apr 2000	President (current) of Social Welfare Corporation Nomad-Fukushikai
Dec 2004	Representative director of Nihon Leben Co., Ltd.
Feb 2005	Representative director of MM Net Co., Ltd.
Apr 2013	President and representative director of SMO-MDS Co., Ltd.
Jul 2013	Vice president and representative director of H&M Co., Ltd.
Jun 2015	President and representative director of H&M Co., Ltd.
Jan 2016	President of Social Welfare Corporation Hokushikai
Sep 2016	President and representative director of Feldsenf Pharma Co., Ltd.
Jun 2020	President and representative director (current) of Feldsenf Pharma Co., Ltd.

Source: Shared Research based on company data (as of March 2021)

Dividend policy

The company's basic policy on dividends is to maintain stable disbursements to shareholders in line with earnings while retaining sufficient internal reserves to reinforce its financial position, expand business operations, and develop human resources. Since FY03/13, dividends have been paid twice a year—an interim dividend and a fiscal year-end dividend. The dividend decision-making bodies are the general shareholders meeting for year-end dividends and the board of directors for

interim dividends. The articles of incorporation stipulate the board of directors has the authority to decide on interim dividends through a resolution.

Major shareholders

Top shareholders	Shares held	Shareholding ratio
The Master Trust Bank of Japan, Ltd.(Trust account)	2,999,400	9.80%
S&S G.K.	2,769,100	9.05%
QUINTET PRIVATE BANK (EUROPE) S.A. 107704	2,523,400	8.25%
Yasuyuki Okinaka	2,506,000	8.19%
Jiro Akino	2,220,400	7.26%
Custody Bank of Japan, Ltd. (Trust account)	1,008,400	3.29%
EPS Holdings Co., Ltd.	950,000	3.10%
Inao Tajiri	730,200	2.38%
Medical System Network Employees Stockholding Association	690,300	2.25%
NOMURA PB NOMINEES LIMITED OMNIBUS-MARGIN(CASHPB)	687,400	2.24%
SUM	17,084,600	55.81%

Source: Shared Research based on company data (as of March 31, 2022)

Employees

Segment	No. of employees	No. of temporary employees	Total
Community Pharmacy Network	3,031	497	3,528
Pharmacists	1,459	279	1,738
Leasing and Facility-related	130	16	146
Meal Catering	185	256	441
Other	37	13	50
Corporate (administration)	131	9	140
Total	3,514	791	4,017

Source: Shared Research based on company data (as of March 31, 2022)

Note: The sum of temporary employees does not equal to the total due to differences in rounding methods (based on eight– hour work days).

Profile

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(011) 612-1069

Established

1999-09-16

Website

<https://www.msnw.co.jp/>

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Corporate management Department

IR Phone

-

Head Office

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Listed On

Tokyo Stock Exchange, Prime Market

Exchange Listing

2002-03-18

Fiscal Year-End

Mar

IR Web

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IR Email

-

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We offer corporate clients comprehensive report coverage, a service that allows them to better inform investors and other stakeholders by presenting a continuously updated third-party view of business fundamentals, independent of investment biases. Shared Research can be found on the web at <https://sharedresearch.jp>.

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