

Provide cloud service by SaaS / ASP

Scala, Inc.

(4845.TSE 1st)

Recommendation rating (Apr 1)

Overweight → Neutral

Stock Price	Unit of Investment	Market Cap	52-Week High	52-Week Low	PER(E)
412yen (20/4/1)	100Shares	7.21Bil yen (20/4/1)	830yen (20/1/21)	355yen (20/3/15)	— (20/4/1)

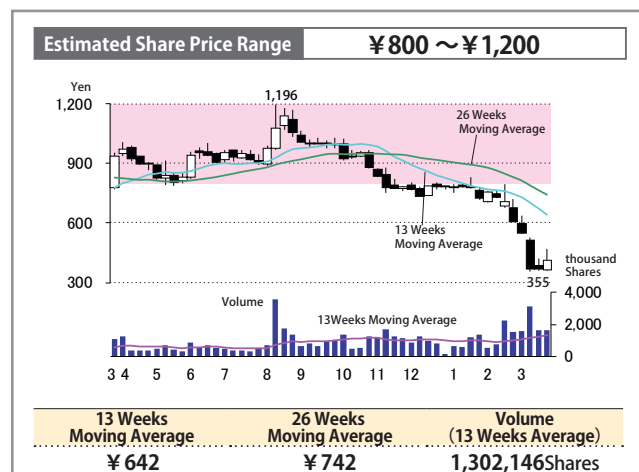
High expectations of newly launched engagement fund to drive mid and long-term growth

■ 1H FY2020 prioritized strategic investment plans

Scala, Inc. reported its consolidated business results (non-GAAP base) for the first six months (July ~ December 2019, 1H) of fiscal year ending June 2020 (FY2020). In the period, sales revenue came to Yen 8,606 million (up 2.4% from the same period last year) but operating income was down 27% y-o-y to Yen 828 million. The company achieved sales growth thanks primarily to stable revenue from a long-lasting royal client base (referred to as 'stock-based revenue') while upfront investment costs including personnel expenses borne by major business segments dragged down its operating profit. With regard to segmental results, **the core SaaS/ASP business (a provider of wide-ranging applications via the Internet and telephone lines) enjoyed solid orders for development and product projects from non-life insurance clients, which attributed to sales revenue growth.** The business also continued to progress in product-line changeover toward the mainstay 'i-series' products it proposes to clients in collaboration with Leo Connect Co., Ltd. ('LC'), a customer support company. In the Softbrain (security code:4779) ('SB') segment, the SFA business (a provider of 'e-Sales Manager' and other sales support systems) and the Field Marketing business (offering, among all, various on-site sales promotion support for retail and service industries) contributed to higher stock-based revenue, however increased development and staff costs weighed on its profit, resulting in posting higher sales and lower profit compared with a year ago. **The Customer Support business disposed of unprofitable projects among its inbound call center operations. It promoted operational effectiveness with the help of consultation for the implementation of SaaS/AS services and other measures, resulting in lower sales and higher profit.** Other businesses overall posted a decrease in both sales and profit, as they suffered up-front investment costs.

■ Promising high-value added services and cross selling opportunities

Scala did not disclose consolidated business results forecasts for full FY2020 ending June 2020, on the grounds that its performance was expected to be significantly influenced by the progress in new businesses. Up-front investment costs were a squeeze on profit for 1H FY2020, but 2H is likely to see higher demand reflecting a seasonal pattern that most clients draw up an annual IT budget toward fiscal year-end in March, as well as an increase in profitable projects. **The company's e-design system 'One-click to get an estimate for automobile insurance premium' developed for non-life insurers won the 'Good Design Award 2019'**; it was the first online automobile insurance design to receive the prize. Its function that helps users get an estimate of insurance premium by clicking just once rather than the conventional around 30 times, has been received very well. The technology employed in the system has been incorporated into Scala's modularization know-how that drives shorter development time. This is expected to help the company enhance the value of SaaS/ASP development projects offered in 2H. Other promising developments include the switching to or cross-selling of services that provide 'IVR



(automatic responses to voice calls), 'C7' (cloud-based backbone system) and other technologies. These services are cooperatively offered by Scala's three businesses comprising the Connect Agency business (CA), a provider of outbound services using a cloud-based PBX (private branch telephone exchange), the LC business that offers various services to control the quality of inbound call center operations and the existing SaaS/ASP business. Both CA and LC are former Hikari Tsushin, Inc. (code 9435) group enterprises. Scala is now able to approach a few thousand of their nationwide agents and customers (mostly SMEs) to promote its services.

Scala has formulated its medium-term management plan ('the mid-term plan'). The plan sets out sales revenue and operating income targets for two separate periods; one is to achieve sales revenue of Yen 100 billion (operating income of Yen 10 billion) by FY2025 ending June 2025 and the other Yen 500 billion (Yen 50 billion in operating income) by FY 2030 ending June 2030 (for details of the mid-term plan, see 'Business Environment and Outlook' noted later). During 4Q (April-June 2020), Scala is set to launch 'Engagement Fund' (an investment fund that pursues long-term capital gains by investing in enterprises striving to enhance their corporate value with the help of AI). The company expects to post fund management fees from this new business as sales revenue in FY2021 ending June 2021.

Over recent months, the coronavirus pandemic has sent the stock market into unprecedented panic. In light of this, we, Morningstar, have revised our previous estimated share price range of Yen 1,600 ~ Yen 1,700. Our new estimated lower end price is Yen 800, which is set at a level approximately 50% higher than the 52-week high/low range, while the upper end is Yen 1,200, set around the highest price of the 52-week high/low range. We have changed our valuation of the company's shares from 'Overweight' to 'Neutral'.

Financial Results (as of April 1, 2020)

		Revenue (Yen Mil)	YoY (%)	Operating Profit (Yen Mil)	YoY (%)	Income Before Income Taxes (Yen Mil)	YoY (%)	Net Profit (Yen Mil)	YoY (%)	EPS (Yen)
2018-6	Past Results	12,829	20.3	1,546	11.3	1,535	11.1	707	28.0	41.9
2019-6	Past Results	17,112	33.4	2,153	39.2	2,137	39.1	946	33.8	55.9
2020-6	Company est.	-	-	-	-	-	-	-	-	-
	MS est.	18,560	8.5	2,280	5.9	2,265	6.0	1,020	7.8	58.3
2021-6	MS est.	27,000	45.5	3,100	36.0	3,050	34.7	1,370	34.3	78.3

* Scala, Inc. has prepared its financial statements under IFRS (International Financial Reporting Standards) from the fiscal year ended June 2016, but figures in the table (adjusted items that arose after the adoption of IFRS were excluded) are restated in line with non-GAAP.

We note that the share price may rise to test the upper end of the range, providing the current panic market is restored to normal in a short period of time and the bullish sentiment revived in the Japanese stock market, prompting investors to favorably reevaluate the company share.

(Takahiro Arimura)

(Note) *The 'GOOD DESIGN AWARD2019 was hosted and presented by the Japan Institute of Design Promotion.

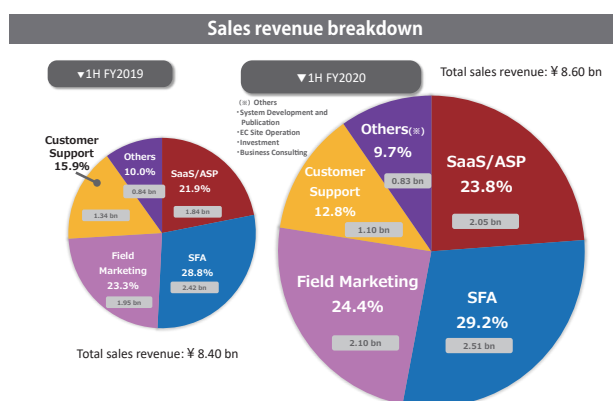
Company Overview

An operator of services with core SaaS/ASP business models. In July 2016, Scala, Inc. incorporated a major marketing support system provider Softbrain Co., Ltd., as its consolidated subsidiary. In August 2017, Scala acquired 'plube Co., Ltd. (present Scala PLAYce, Inc.), an operator of EC sites for trading matching game cards. In March and November 2018, Scala bought 66% and 51% stakes in Leoconnect, Inc. and Connect Agency Inc. respectively, subsequently both incorporated as its consolidated subsidiaries. The two companies were formerly owned by the Hikari Tsushin Group (the former 100% owned and the latter sub-subsidiary). Scala also established Scala Next, Inc., with the aim of planning and developing new SaaS/ASP businesses and services. Then in December 2018, it founded an offshore development base, Scala Next Mandalay in Myanmar. Myanmar demonstrates relatively low wage and price levels. Scala Next Mandalay is expected to recruit and nurture local IT engineers to win more projects and drive profitability for the SaaS/ASP service. In August 2019, in line with its mid-term plan, Scala announced that it had consolidated J-Phoenix Research Inc. which primarily engaged in supporting and consultation for the implementation of AI/IoT technology. At the same time, It established Scala Partners, Inc. to provide financial assistance and facilitate business development in AI and other fields. In March 2020, with the aim of pushing through the objective set out in the mid-term plan to deal with central and local governments, the company incorporated Grid Group Holdings Co., Ltd., a facilitator of regional revitalization and regeneration programs among other services, as its wholly owned subsidiary.

Business Environment and Outlook

According to the '2019 WHITE PAPER: Information and Communications' released by the Japanese Ministry of Internal Affairs and Communications, the penetration of AI (artificial intelligence) and IoT (Internet of Things) has shown marked growth, with the number of IoT devices in use worldwide estimated to increase from roughly 30.7 billion units in 2018 to 44.8 billion units by 2021. On the back of mounting needs for further efficiency and labor saving across the board, the speed of adoption of AI technology is likely to accelerate.

Meanwhile, Scala has formulated the 'Medium-term Management Plan: COMMIT5000'. The plan highlights the company's three 'capabilities' that have been acquired through the operation of SaaS/ASP services (comprising the capability to identify real issues; the capability to discover the hidden value of resources; and the capability to maximize value by proposing and executing an optimal combination of issues and resources). To date, the company has developed and merchandised projects or programs building on the three capabilities in order to propose them largely to listed companies in Japan. The new mid-term plan, however, has implemented a new policy to further accelerate earnings growth. To this end, the plan sets out new goals to expand its markets to government-affiliated enterprises, local authorities and overseas companies, as well as enhancing the collaboration with partner companies to drive the entry into the peripheral business domain with the SaaS/ASP model.



Source: Created by Morningstar Japan, based on the company's information

Classification	Outline	Product name
Site Assistance Service	Search engine for the site	i-search
	Link-loss detection system	i-linkcheck
	Site print service	i-print
	Related link display service	i-linkplus
CMS Service	FAQ system	i-ask
	Product site management system	i-catalog
	Progress management and approval system	i-flow
	Web chatbot system	i-assist
CRM	Web chat system	i-livechat
	Digital gift service	i-gift
Telephone System Service	24-hour a day and everyday automated voice response	SaaS-IVR
News Distribution Service	Keep in touch with important business information	Corporation News
	Latest patent management system	PatentManager6
Data Management	Contract management system	GripManager
Site Operations Business	Search portal site	Fresheye
IoT, Big Data	Processing and management of Big Data	Safe Driving Checks
	Sales support system	e-Sales Manager
Field Marketing Business	Market research and on-site field activity	Field Operations, Field Research, etc.
EC	Mail order selling/buying of trading cards and related items	Online Card Shop
Customer Support Business	Customer support consultation	Contact Center

Source: Created by Morningstar Japan, based on the company's information

Although these three capabilities will be replaced with three business segments over the medium term, support for companies addressing the AI/IoT fields seems to be an important initial task for the first year of the mid-term plan. We believe that structuring and managing engagement funds as well as the development of AI-related systems will contribute to Scala's revenue growth.

Risk Factors

Scala commits to a service level agreement (SLA) with clients of SaaS/AS services. SLA defines a certain-level of assurances for server operations, care for service failures, notices of scheduled maintenance among others. This indicates that the company may face a large amount of indemnity, should its service, for whatever reason, fails to comply with the levels of assurance defined by SLA. In addition, an outage or breakdown of service arising from hardware/software deflection or disorder, human error or network line disturbance and service disruption or breakdown caused by the telecom carrier, cyberattack or system failure caused by natural disasters or other factors are likely to affect its earnings and financial standing.

Shareholder Return (As of Apr 1)

Dividends

		Dividend Per Share		
		First half	Second half	Annual
2018-6	Past Results	¥10	¥10	¥20
2019-6	Past Results	¥12	¥12	¥24
2020-6	Company est.	¥14	¥14	¥28

Shareholder Special Benefits

None

Competitor Comparison (If the number is better than rivals, it's highlighted by red character) (As of Apr 1)

	Scala, Inc. (4845•TSE 1st)	PiPEDO HD, Inc. (3919•TSE 1st)	Cybozu, Inc. (4776•TSE 1st)	
Basic Point	Stock Price	¥412	¥1,100	¥1,845
	Unit of Investment	100Shares	100Shares	100Shares
	Minimum Investment Amount	¥41,200	¥110,000	¥184,500
	Fiscal Year End	June	February	December
Share Price Indicator	PER (E)	—	12.1	132.3
	PBR	1.0	3.5	21.2
	Dividend Yield (E)	6.8%	1.1%	—
Growth	Revenue Growth Rate (E)	—	14.4%	12.9%
	Operating Profit Growth Rate (E)	—	251.5%	▲23.6%
	EPS Growth Rate (E)	—	389.5%	▲36.8%
	Operating Margin (E)	—	22.3%	8.7%
Profitability	ROE	14.1%	5.9%	27.4%
	ROA (Ordinary income/Total assets)	12.2%	7.1%	22.3%
	Equity ratio	37.5%	41.1%	45.0%
Financial Health	Debt-Equity Ratio	85.3%	90.8%	0.0%
	Current Ratio	203.9%	151.6%	97.8%

We selected PiPEDO HD, Inc. (code: 3919) and Cybozu, Inc. (code: 4776) as industry peers. Scala competes with the two companies on some operations of the Site Assistant and CRM Service businesses in the SaaS/ASP domain.

■ Growth Potential

Scala didn't disclose consolidated business results forecasts for the full fiscal 2020, as its performance is expected to be significantly influenced by the progress in new businesses. However, we note that revenue from the SB segment that operates with particular emphasis on the stock-based business represents more than 50% of total consolidated sale revenue and its revenue has scaled up over the past few years. Also, not only does the SaaS/ASP business continue its upbeat performance, but the steady growth of the Customer Support, Cloud PBX Service and EC Site Operations businesses is likely to remain.

As for industry peer comparisons, PiPEDO is entering into a period of reaping returns from its aggressive investment in earnings growth made until the previous fiscal year ended February 2019. Although PiPEDO's revenue for fiscal 2020 ended February 2020 is likely to have fallen short of its initial projection, it is still larger than that of Scala.

■ Profitability

Scala did not disclose its forecast for operating income margin for FY2020. It should be noted, however, that the low-margin Customer Support business has significantly progressed in its service-line changeover toward SaaS/ASP services, therefore the business appears to be improving its break-even points. Operating margin for 1H FY2020 came to an unimpressive 9.6%, as up-front investment costs weighed down on profit. However, given 2H is likely to see a jump in demand thanks to the seasonal pattern in which most clients tend to draw up their annual IT budgets in the run-up to fiscal year-end in March, as well as an increase in profitable projects, the company is expected to maintain a double-digit operating margin on a full-year basis.

Its ROE is at a relative low position in the peer comparison but still at a high double-digit level.

■ Financial Stability

Scala has a low equity ratio and its debt equity ratio is at a relative mid position. Management pursues effective use of interest-bearing debts as it regards M&A (corporate mergers and acquisitions) as its important business issue. On the other hand, the company owns a large proportion of current assets, with its liquidity ratio being higher than that of any other peer. We believe that Scala's balance sheet is well controlled strategically, with no particular concerns about its financial standing.

Morningstar Japan K.K.

Research & Analysis Department
Analyst Takahiro Arimura

+81-3-6229-0078
tarimura@morningstar.co.jp

How to Read Morningstar Equity Research Report

Our Uniqueness

(1) Emphasize Its Position as an Independent Evaluation Organization

Morningstar emphasizes its position as an independent evaluation organization and is committed to providing objective comparison and assessment in the Morningstar Equity Research Report. For all stocks covered by us, we determine investment decisions, estimated share price range and earnings forecasts based on expertise of an individual analyst as well as the stock assessment committee consisting of several analysts.

(2) Universe of Covered Stocks

The stock assessment committee selects covered stocks based on the following criteria.

[Stock Selection Criteria]

- Domestic emerging companies that are rarely covered by analysts
- Stocks that are popular among retail investors (refer to data from online security brokers)
- Size of market capitalization (over about 5 billion yen)
- Exclude stocks which are liquidated or trade control, or stocks with going concern and excessive debt

(3) Investment Decisions Classified into Three Groups

We determine investment decisions for covered stocks after consultation with the stock assessment committee based on research, interview and analysis by each Morningstar analyst.

Each stock is classified into either of three groups according to the following criteria.

Overweight

: Forecasted to go beyond the current stock price level by 15% or more in the next 6 months.

Neutral

: Forecasted to fall into the range of -15% ~+15% of the current stock price level in the next 6 months.

Underweight

: Forecasted to go below the current stock price level by 15% or more in the next 6 months.

We flexibly respond to any changes of observations regarding earnings forecasts, financial situations and stock price trends, and change investment decisions accordingly. "Under Review" status may be applied if any new information comes out and extra time is needed to determine investment decisions. Also we don't change investment decisions during trading hours. "Suspension" status may be applied when an analyst leaves our company.

(4) Estimated Share Price Range in the Medium Term

It shows the price range for a stock price in the next 6 months. We determine upper and lower range of stock price based on fair value estimates from share price indicator, technical factors such as chart points, most recent high and low prices, trend line and moving average, trading volume in each price range and such.

Analysis Points

■ Analyst Comment

Each analyst reports and evaluates the most recent earnings trend and business environment. It shows the most important information for stock investment such as evidence for investment decisions, perspectives on earnings forecasts and business prospects. Also to make sure it is easy to comprehend, we write in 2-4 paragraphs and use bold to emphasize important texts.

■ Revenue and Earnings Trend

It reports earnings in past two fiscal years, company forecasts and our forecasts for the current and next fiscal year. We predict earnings based on research as well as past quarterly earnings trend and analysis by segments.

■ Company Overview

It explains in detail what businesses the company is engaged in and how revenue sources are defined. Also on the basis of our research, it discusses what businesses the company will focus on in years to come and how it carries out mid-term business plan.

■ Business Environment and Outlook

It discusses current circumstances and growth potential of the industry to which the company belongs. A comprehensive report on the industry from different perspectives is provided through research interviews to competitors. Specific figures of the industry data are also introduced.

■ Risk factors

It shows the company's risk factors and describes various aspects of risks such as business, earnings and financials. Typical stock market risks are also taken into consideration.