

An packaged service provider supporting business management, DX initiatives, etc.

Recommendation rating (Apr 21)

Scala, Inc.

(4845.TSE Prime)

Overweight

Stock Price	Unit of Investment	Market Cap	52-Week High	52-Week Low	PER(E)
743yen (4/21)	100Shares	13.14Bil yen (4/21)	774yen (22/4/6)	628yen (22/1/20)	— (4/21)

Steady increase in co-creation-type programs, promising to evolve into large projects

■ 1H saw sales growth in IT/AI/IoT/DX, HR & Education and EC Businesses

Scala, Inc. reported its consolidated business results (non-GAAP base) for the first six months of fiscal year ending June 2022 (July ~ December 2021, hereinafter '1H'). In the period, sales revenue came to ¥4,268 million (down 0.4% from the same period last year) and operating income fell 24.5% y-o-y to ¥63 million. The company achieved sales growth in the **IT/AI/IoT/DX, HR & Education, EC and Investment & Incubation Businesses**, but it suffered a moderate profit decrease overall, thanks in large part to the effects of a large Customer Service account cancellation. It also blamed the profit decline on fewer call center projects at the Customer Support Business and the cost of up-front investment in the Investment & Incubation Business.

■ A number of system development projects and other programs are expected to boost earnings for 2H

Scala is likely to post better business results in 2H (January ~ June 2022) than 1H. Major factors for this include **the expected recognition at the IT/AI/IoT/DX Business of a number of orders for system development projects from large insurers, electronic manufacturers, and pharmaceutical companies, along with additional orders for the real-estate trust DX platform development. Also, the Customer Support Business is likely to record part of the sales revenue from labor-saving and high profit call center projects. These projects are expected to offset the declined sales revenue from unprofitable call center projects recorded in 1H.**

In addition, **the company has seen steady progress in the 'co-creation' type programs. These programs have potential to develop into large projects from the fiscal year ending June 2023. Scala has decided to cooperate on 'U-Medical Support', a co-creation program initiated by desamis Co., Ltd. (a provider of support for the implementation of IoT/AI technologies in the husbandry business) and Mitsui Sumitomo Insurance Company, Limited. U-Medical Support is the first support service program for farm animal diagnoses in animal husbandry. Although it is in the development stage, the implementation and further development of its service is expected to contribute to company earnings.** Meanwhile, in January 2021, Scala launched a matching platform entitled 'Reversed Public Offering Proposal' (or 'Gyaku Propo'). Gyaku Propo is a service that calls on local municipalities to suggest approaches or ideas for public-private co-creation schemes designed to address social issues identified by private sector organizations; whilst private sector organizations are to plan and finance actual programs to address those issues. Since its launch, the service has increasingly embarked on programs. Scala receives not only commissions for driving Gyaku Propo deals but also service fees for the development of a DX support platform that fleshes out the local municipality's idea, as well as loyal clientele-based income derived from each of the relevant municipality programs. In addition, Scala is highly likely to make an additional investment in its capital and business tie-up partner xID, Inc. a provider of digital ID solutions using identification number cards. With the help of a digital solution 'xID application', the

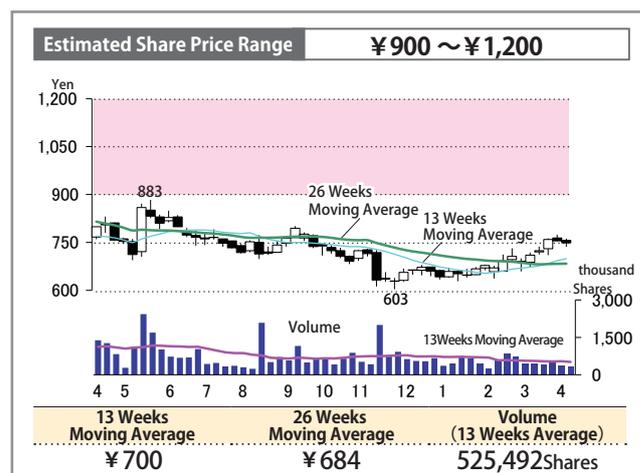
Financial Results (as of Apr 21, 2022)

	Revenue (Yen Mil)	YoY (%)	Operating Profit (Yen Mil)	YoY (%)	Income Before Income Taxes (Yen Mil)	YoY (%)	Net Profit (Yen Mil)	YoY (%)	EPS (Yen)
2020-6 Past Results	7,624	—	337	—	313	—	218	—	12.6
2021-6 Past Results	8,734	14.6	282	▲16.2	251	▲19.9	121	▲44.3	6.9
2022-6 Company est.	—	—	—	—	—	—	—	—	—
MS est.	14,750	68.9	300	6.4	280	11.6	185	52.9	10.5
2023-6 MS est.	29,500	2.0times	2,150	7.2times	2,100	7.5times	1,570	8.5times	88.8

※ The company prepares its financial information under the IFRS (International Financial Reporting Standards), but the above figures have been reconciled to non-GAAP measures (actual figures) by excluding adjustments and other items made on adoption of the IFRS.

※ Sales revenue, operating income and income before taxes for FY2020 and FY2021 are from continuing operations, while net income for these years represents actual figures excluding those from non-continuing operations.

※ Year-on-year changes for FY2020 have not been disclosed.



company is set to co-create and enhance convenient services.

With the aim of incorporating them as consolidated subsidiaries, Scala's board has passed a resolution to acquire the total shares in Nihon Pet Small-amount Short-term insurance company and EGG CO., LTD. The former is a provider of low-premium and short-term pet insurance plans and the latter a developer of hometown taxation programs for local authorities (NB. the former company is slated to become a consolidated subsidiary upon approval from authorities). In consideration of accounting reclassification in conformity to the IFRS accounting standards, it has withdrawn consolidated financial results forecast for FY2022 ending June 2022. In August 2019, Scala formulated its 'Medium-term Management Plan COMMIT5000' (detailed in 'Business Environment and Outlook' noted later). The above two M&As (corporate mergers and acquisitions) can be regarded as a driver to expand business domains into the insurance/financial sectors and further penetrate the local government DX field. However, Morningstar predicts that the two M&As' contributions to the consolidated business results for FY2022 will be limited and the cost of strategic investment in the Investment & Incubation may accrete further. Consequently, we have downwardly revised our Scala earnings forecasts previously reported on September 22 2021. However, up-front investment, posted this fiscal year, is highly likely to come to fruition in and after the subsequent fiscal years. In light of this, our business results forecasts for FY2023 remain unchanged.

Following the withdrawal of company forecasts, we have revised our estimated share price range to ¥900 ~ ¥1,200 (previously ¥1,500 ~ ¥2,000). The downward revision in the share price range also reflects the slumping average share price

performance of the telecommunication sector since the issue of our previous report. The new share price range represents the yield on forecast dividend for FY2022 (¥36.00) at 4 ~ 3 percent. Judging by the sector's average dividend yield hovering at between 2.0 ~ 2.5 percent, even the upper limit of the estimated share price range appears to be undervalued. The company projects to pay increased full-year dividends for 13 years in succession, which is another positive factor. Our valuation of the company shares remains unchanged with an 'Overweight' rating.

(written by Takahiro Arimura)

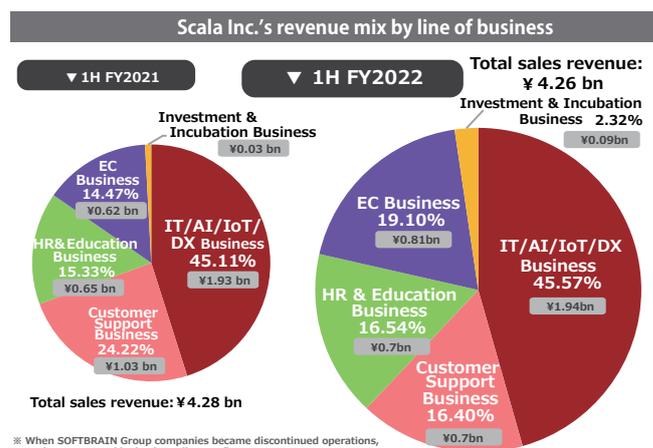
Company Overview

Scala, Inc. embarked on an enterprise with the SaaS/ASP business. In July 2016, the company incorporated a marketing support system provider SOFTBRAIN Co., Ltd., as its consolidated subsidiary. In March and November 2018, Scala incorporated both Leoconnect, Inc., then a subsidiary of Hikari Tsushin, Inc. (security code 9435), and Connect Agency Inc., a sub-subsidiary of Hikari Tsushin, as its consolidated subsidiaries. In August 2019, in line with its midterm plan, Scala announced that it had consolidated J-Phoenix Research Inc. which engaged primarily in support and consultation for the implementation of AI/IoT technology. At the same time, it established Scala Partners, Inc., an enterprise that provides financial assistance and develops companies within AI and other fields. In April 2020, the company incorporated Grid Group Holdings Co., Ltd., a facilitator of regional revitalization and regeneration programs among other services, as its wholly owned subsidiary. In September 2021, the company incorporated readytowork Corp. as its wholly owned subsidiary. The subsidiary supports domestic clients in Nepal in their new business developments and DX changeovers, primarily concerning web systems. The Nepal subsidiary is Scala's second offshore technology development base, following the first Scala Next Inc. Mandalay branch (Myanmar) established in December 2018. Combined with the base in Japan, the company now deploys three technology bases with a view to shortening DX development time and accumulating expertise. In November 2021, the company started up a subsidiary SOCIALX, Inc. to operate 'Gyaku Propo' programs.

Business Environment and Outlook

According to the '2021 WHITE PAPER: Information and Communications' released by the Japanese Ministry of Internal Affairs and Communications, the penetration of AI and IoT has shown marked progress, with the number of IoT devices in use worldwide estimated to increase from roughly 25.3 billion units in 2020 to 34.1 billion units by the end of 2023. On the back of mounting needs for further efficiency and labor saving across the board, the speed of adoption of AI technology appears to accelerate going forward.

Scala, Inc. has formulated its 'Medium-term Management Plan COMMIT5000'. The plan outlines the company's three 'capabilities' that have been acquired through the operation of SaaS/ASP services (1. The capability of discovering real issues; 2. The capability of revealing the hidden value of resources; and 3. The capability of proposing and executing an optimal combination of issues and resources to maximize value). With the purpose of effectively proposing these capabilities, the company has newly established the following segments that will assume the objective: 1. An added value-based management support business; 2. An IT/AI/IoT-related business; 3. A social issue solution-oriented business. In line with the Medium-term Management Plan, Scala is set to organically coordinate the three capabilities with the three business segments to maximize customer value. With the fulfillment of this vision, the plan has set dual-period earnings projections. One is to achieve ¥100 billion in sales revenue (operating income of ¥10 billion) by FY2025 and the other ¥500 billion in sales revenue (operating income of ¥50 billion) by FY2030. The company plans to develop and commercialize the three capabilities for public companies and others in Japan. It is also set to expand its markets targeting government-affiliated enterprises, local authorities and overseas companies.



※ When SOFTBRAIN Group companies became discontinued operations, Scala recomposed its business lines to five segments.

(Source) Created by Morningstar Japan, based on the company's information.

Business segment overview		
Reportable segment	Group company	Description of business
IT/AI/IoT/DX	Scala Communications, Inc.	Provision of SaaS/ASP services
	Scala Service, Inc.	Development of SaaS/ASP services and offshore development
	Scala Next Inc.	Cloud-based PBX service
	readytowork Corp.	Planning, development and sale of cloud activity management tools
	Connect Agency, Inc.	Support for administrative bodies and local municipalities in their DX and SDGs programs
Customer Support	Retool, Inc.	Consulting of customer support (call center operation, etc.)
	Social Studio Inc.	Provides support for personnel employment (new graduates and mid-career recruitment) and other services
HR & Education	Leoconnect, Inc.	Provides support for child education, community development etc.
	Athlete Planning, Inc.	Operates physical education, sports lessons and others
	FourHands, Inc.	Operates physical education, sports lessons and others
EC	Sports Stories, Inc.	Operation of EC sites to trade matching game cards
	Scala PLAYee, Inc.	Group headquarters, holding company and investment business
Investment & Incubation	Scala, Inc.	Innovation, incubation and investment
	Scala Partners, Inc.	Preparation of analyst and integration reports; fund management support
	J-Phoenix Research Inc.	Investment fund management
	SCL Capital LLC	Investment fund
	SCSV-1 Investment Limited Liability Partnership	Investment fund
	SOCIALX, Inc.	Planning and operating a public-private co-creation platform 'Gyaku Propo'

(Source) Created by Morningstar Japan, based on the company's data.

Risk Factors

Scala commits to a service level agreement (SLA) with clients for SaaS/AS services. SLA defines a certain level of assurances for server operations, care for service failures, notice concerning scheduled maintenance, among others. This indicates that the company may face a large amount of indemnity should its service fail, for whatever reason, to comply with the levels of assurance defined by SLA. Separately, in November 2018 the company established Scala Next, Inc., with the aim of planning and developing SaaS/ASP businesses and services. The subsidiary develops part of the cost-reduction projects in its Mandalay branch in Myanmar. In March 2021, the Myanmar national army launched a coup d'etat and six districts in Yangon (the country's largest city) were placed under martial law. Although the Mandalay branch of Scala Next, Inc. has incurred no actual damage, it is necessary to keep a close watch on the heightening geopolitical risk in the country.

Shareholder Return (As of Apr 21)

Dividends

		Dividend Per Share		
		First half	Second half	Annual
2020-6	Past Results	¥14	¥14	¥28
2021-6	Past Results	¥16	¥18	¥34
2022-6	Company est.	¥18	¥18	¥36

※ Dividends for FY2021 included a ¥2.00 special dividend to commemorate its 30th anniversary.

Shareholder Special Benefits

None

Competitor Comparison (If the number is better than rivals, it's highlighted by red character) (As of Apr 21)

	Scala, Inc. (4845•TSE Prime)	PiPEDO HD, Inc. (3919•TSE Standard)	Cybozu, Inc. (4776•TSE Prime)	
Basic Point	Stock Price	¥743	¥2,305	¥1,290
	Unit of Investment	100Shares	100Shares	100Shares
	Minimum Investment Amount	¥74,300	¥230,500	¥129,000
	Fiscal Year End	June	February	December
Share Price Indicator	PER (E)	—	20.0times	—
	PBR	1.3times	4.0times	9.3times
	Dividend Yield (E)	4.8%	1.1%	1.0%
Growth	Revenue Growth Rate (E)	—	11.9%	17.5%
	Operating Profit Growth Rate (E)	—	5.1%	▲76.1%
	EPS Growth Rate (E)	—	▲25.5%	—
Profitability	Operating Margin (E)	—	20.5%	1.6%
	ROE	34.9%	29.3%	8.6%
	ROA (Ordinary income/Total assets)	0.8%	19.1%	11.2%
Financial Health	Equity ratio	50.0%	55.6%	45.4%
	Debt-Equity Ratio	84.4%	39.1%	34.5%
	Current Ratio	264.5%	221.3%	111.1%

Note: We selected PiPEDO HD, Inc. (security code: 3919) and Cybozu, Inc. (security code: 4776) as industry peers. Scala competes with these on some operations of the site assistant service in the SaaS/ASP business field.

■ Growth Potential

Scala has withdrawn its initial forecast of the business results for FY2022 ending June 2022. This is due to the necessary reclassification in conformity to the IFRS accounting standards concerning the accounts of the newly incorporated consolidated subsidiaries, Nihon Pet Small-amount Short-term insurance company and EGG CO., LTD. Meanwhile, the ongoing Medium Term Management Plan, formulated in August 2019, sets a target for net sales of ¥ 100 billion and operating income of ¥ 10 billion. If the company envisages the maintenance of steady linear growth, it must deliver an annual sales growth rate of 65-70 percent. The growth rate for FY2022 is likely to underrun the linear line due to the strain of up-front investment. That said, the company is implementing its business policy, under which it promotes the diversification of its business portfolio, investment in new businesses and rigorous pursuit of M&A deals, evolving around the core IT/AI/IoT/DX Business which descended from the founding business. Consequently, for the accomplishment of the Midterm Plan, M&A and other strategies are required to provide noncontinuous contributions to its earnings in the latter half of the period of the Midterm Management Plan. We are expecting to see this fiscal year as a phase in which

the company implements a series of new programs and measures. These comprise co-creation-type programs and M&A deals among others, which are promising to come to fruition in and after the subsequent fiscal years.

■ Profitability

Due to the non-disclosure of the FY2022 Scala forecasts, the company's forecast for operating profit margin was also undecided. While the IT/AI/IoT/DX Business, which is mainly a stock business and consistently secures more than 10% of segment profit, is expected to support the company's overall profitability, investment in new businesses and development of new business schemes, mainly in the Investment & Incubation Business, is expected to accelerate. On the other hand, its ROE is expected to improve significantly to 34.9% (a 30.4-point increase from last year). This is probably due to a sharp rise in net profit thanks to the recognition of a profit from a non-continuing operation in FY2021.

■ Financial Stability

Scala's equity ratio at the end of FY2021 showed a marked recovery to 50.0% (a 20.3-point increase from last year). In the year, its cash position soared after it posted an income from a non-continuing operation. Its debt equity ratio is relatively high, but the company management regards M&A as an important business issue, therefore, the effective use of interest-bearing debt can be viewed as its strategic intent. On the other hand, the company owns a large proportion of current assets, with its liquidity ratio being at the highest position in the competition. We believe that Scala's balance sheet is well controlled overall, 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.