

A provider of SaaS/ASP-based cloud service

Scala, Inc.

(4845.TSE 1st)

Recommendation rating (Oct 12)

Neutral → Overweight

Stock Price	Unit of Investment	Market Cap	52-Week High	52-Week Low	PER(E)
1,016yen (10/12)	100Shares	17.79Bil yen (10/12)	1,135yen (20/10/2)	355yen (20/3/15)	6.1 (10/12)

Scala deploys AI Engagement Fund to win DX and management support projects

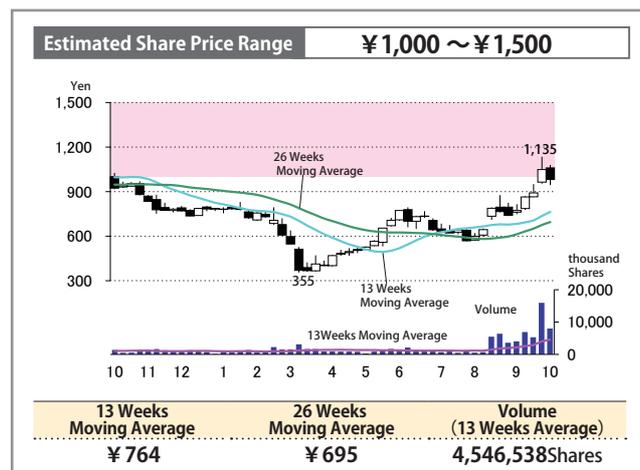
■ Growth and development investment costs weighed down FY2020 earnings

Scala, Inc. reported its consolidated business results (non-GAAP base) for the full fiscal year 2020, ended June 2020 (FY2020). In the period, sales revenue came to Yen 17,025 million (down 0.5% year-on-year) and operating income was Yen 1,045 million (down 51.5% y-o-y). **The moderate fall in sales was in large part attributable to the disposal of low-margin projects in the Customer Support business. The company suffered a sharp profit decline, as its mainstay SaaS/ASP business (the provider of wide-ranging applications via the Internet and phone lines) increased operational development/ growth investment and faced higher manpower costs.** In addition, restraints in client activity amidst the new coronavirus pandemic put pressure on profit margins for the SFA and Field Marketing businesses within the segment of Softbrain Co., Ltd. (security code: 4779; hereinafter 'SB').

■ Investment in profitable projects using proceeds from sale of SB shares

In August 2019, Scala formulated its 'Medium-term Management Plan COMMIT5000' (details in 'Business Environment and Outlook' noted later); FY2020 was the period to lay the groundwork for the plan's success. The SaaS/ASP business has built up the modularization technology enabling a shorter time for the development of projects. Going forward, the company is set to deploy this technology **with the aim of acquiring in-house capability to develop new digital transformation ('DX') projects.** In December 2018, Scala founded an offshore development base in Myanmar. **Since, the company has dedicated itself to the development of local IT engineers. As the location can offer high-level technological performance with relatively low personnel costs, it helps the company facilitate its low-cost operations.** Further into 2020, Scala invested in MyanCare Co., a local remote medical care service provider; it also set up a joint venture with a major local IT enterprise, Ace Data Systems. The JV is to grapple with solving social issues in the education, healthcare and agriculture areas by means of AI/IT/IoT/technologies. Scala now plans to place Myanmar not only as its technology development base but also a foothold to offer social issue solutions, in line with the goal set by its Medium-term Management Plan.

One of its two main business objectives is the acquisition of projects in the AI/IT/IoT and DX areas, the other is supporting added value-oriented management. Scala identifies and signs up a contract with listed companies positively promoting digital transformation and promising to be revalued in the future. The company invests in those companies through its AI Engagement Fund (an investment limited partnership designated as 'Scala Co-creating Shared Value' (SCSV) No.1). The typical contract term is around five years, during which Scala receives various orders from these investees for their DX system development projects, while providing them with its business support packages designed to assist them create added



value. Early staged DX projects are funded by SCSV fund's capital but in subsequent stages they are charged with monthly usage fees, therefore Scala can expect to record a stable monthly fee revenue. Separately, as SCSV enhances its corporate value, Scala is expected to generate gains on its disposal.

Meanwhile, the social issue solution-oriented business is expected to post sales from FY2022 ending June 2022. The business is to be partially managed by its recently consolidated-as-subsiary, Grit Group Holdings ('GGH'). However, it is currently serving as a source of manpower for the (Scala) Group. Employment support-based subsidiaries under the GGH umbrella have business relations with the University of Tokyo and 476 other Japanese universities. Graduates from this university network have been employed by SaaS/ASP and other operating subsidiaries of the Scala group.

A notable development concerning selection and focus of management resources is **the disposal of total shares in Softbrain Co., Ltd. while and investing the proceeds into highly profitable projects. Scala has finalized the list of investees to allocate the full amount of capital from SCSV No.1, launched in FY2019. In light of this, the company is now highly likely to launch SCSV No.2 by the end of FY2021, promising upside potential for its forecast earnings.**

Recently, the company's share price renewed its year-to-date high on October 2, following the news of its business alliance with Public dots & Company with its proven record of successful local government DX projects, among others. Morningstar predicts that Scala will raise the possibility of achieving the goals set by the Medium-term Management Plan through a robust earnings model in which SCSV will extend its DX market, driven primarily by the SaaS/ASP business. Our estimated low end of the price range equals a support level at which the dividend yield stands at around 3%. The

Financial Results (as of Oct 12, 2020)

		Revenue (Yen Mil)	YoY (%)	Operating Profit (Yen Mil)	YoY (%)	Income Before Income Taxes (Yen Mil)	YoY (%)	Net Profit (Yen Mil)	YoY (%)	EPS (Yen)
2019-6	Past Results	17,112	33.4	2,153	39.2	2,137	39.1	946	33.8	55.9
2020-6	Past Results	17,025	▲0.5	1,045	▲51.5	1,018	▲52.3	431	▲54.4	24.8
2021-6	Company est.	10,000	▲41.3	3,100	3.0倍	3,100	3.0倍	2,900	6.7倍	165.6
	MS est.	11,500	▲32.5	3,250	3.1倍	3,250	3.2倍	3,050	7.1倍	174.2
2022-6	MS est.	30,000	2.6倍	4,100	26.2	4,100	26.2	3,850	26.2	220.7

* 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.

high end price is set at the resistance level of ¥1,324, a 10-year high posted on July 13, 2018; but should the share price break through this level, the next higher turning point of ¥1,500 will be in sight. We have changed our valuation of the company's shares from 'Neutral' to 'Overweight'.

(Takahiro Arimura)

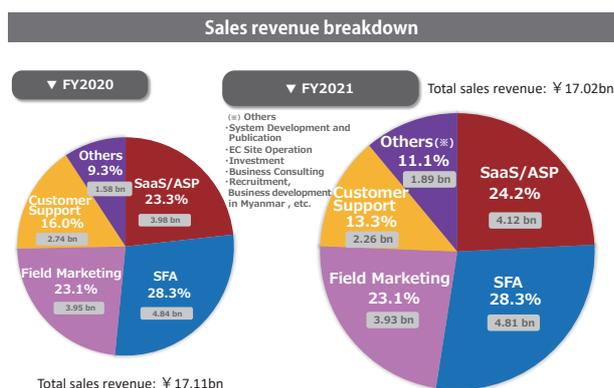
Company Overview

Scala, Inc. is an operator of services with core SaaS/ASP business models. In July 2016, the company incorporated a major marketing support system provider Softbrain Co., Ltd., (SB) as its consolidated subsidiary. In August 2017, it acquired 'plube Co., Ltd. (present Scala PLAYce, Inc.), an operator of EC sites to trade matching game cards. In March and November 2018, Scala incorporated respectively Leoconnect, Inc., then a subsidiary of Hikari Tsushin, Inc., and Connect Agency Inc., a sub-subsidiary of Hikari Tsushin, as its consolidated subsidiaries. The company also established Scala Next, Inc., with the aim of planning and developing new SaaS/ASP businesses and services. 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. an enterprise that provides financial assistance and develops companies in the 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. Further in August 2020, Scala and Branding Technology Inc. (security code: 7067) established a joint venture, Social Studio Co., Ltd., to support administrative bodies and local municipalities in their promotion of DX programs. Meanwhile, this August, Scala adopted a resolution to sell its entire stakes in SB, through a share transfer method scheduled for March 2021.

Business Environment and Outlook

According to the '2020 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 25.4 billion units in 2019 to 34.8 billion units by the end of 2022. 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.

Meanwhile, 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 an eye to effectively implementing the three 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 rearrange the existing and new businesses into the three segments, with a view to generating an organic alliance between them and three capabilities to maximize customer value. With the fulfillment of this vision, the plan has set dual-period earnings projections. One is to



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-less 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
CRM	Web chatbot system	i-assist
	Web chat system	i-livechat
Telephone System Service	Digital gift service	i-gift
	24-hour a day and everyday automated voice response	SaaS-IVR
News Distribution Service	Keep in touch with important business information	Corporation News
Data Management	Latest patent management system	PatentManager6
Site Operations Business	Contract management system	GripManager
	Search portal site	Fresheye
IoT, Big Data	Processing and management of Big Data	Safe Driving Checks
SFA Business	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

achieve Yen 100 billion in sales revenue (operating income of Yen 10 billion) by FY2025 and the other Yen 500 billion in sales revenue (operating income of Yen 50 billion) by FY2030. To date, the company has developed and commercialized projects or programs building on its three capabilities, aimed mainly at listed companies in Japan. However, it now plans to expand its markets to target government-affiliated enterprises, local authorities and overseas companies.

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, notice concerning scheduled maintenance, among others. This indicates that the company may face a large amount of indemnity should its service fails, for whatever reason, 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, system failure caused by natural disasters or other factors are likely to affect its earnings and financial standing.

Shareholder Return (As of Oct 12)

Dividends

		Dividend Per Share		
		First half	Second half	Annual
2019-6	Past Results	¥12	¥12	¥24
2020-6	Past Results	¥14	¥14	¥28
2021-6	Company est.	¥16	¥16	¥32

Shareholder Special Benefits

None

Competitor Comparison (If the number is better than rivals, it's highlighted by red character) (As of Oct 12)

	Scala, Inc. (4845•TSE 1st)	PiPEDO HD, Inc. (3919•TSE 1st)	Cybozu, Inc. (4776•TSE 1st)	
Basic Point	Stock Price	¥1,016	¥1,765	¥3,370
	Unit of Investment	100Shares	100Shares	100Shares
	Minimum Investment Amount	¥ 101,600	¥ 176,500	¥ 337,000
	Fiscal Year End	June	February	December
Share Price Indicator	PER (E)	6.1	20.2	241.6
	PBR	2.4	3.7	38.7
	Dividend Yield (E)	3.1%	—	0.3%
Growth	Revenue Growth Rate (E)	▲41.3%	▲6.6%	15.4%
	Operating Profit Growth Rate (E)	196.7%	▲28.1%	13.7%
	EPS Growth Rate (E)	797.2%	▲2.1%	▲35.9%
Profitability	Operating Margin (E)	31.0%	17.2%	12.7%
	ROE	4.5%	21.9%	27.4%
	ROA (Ordinary income/Total assets)	4.2%	21.6%	22.3%
	Equity ratio	29.7%	54.4%	45.0%
Financial Health	Debt-Equity Ratio	155.8%	36.8%	0.0%
	Current Ratio	145.5%	197.6%	97.8%

We selected PiPEDO HD, Inc. (security code: 3919) and Cybozu, Inc. (security code: 4776) as industry peers. Scala competes with these on some operations as the Site Assistant and CRM Services in the SaaS/ASP business field.

※ The latest earnings outlook figures shown above represent the low end of their company guidance ranges.

■ Growth Potential

The consolidated earnings outlook for FY2021 ending June 2021 shows a steep decline in sales revenue due to the exclusion of SB from the scope of consolidation. However, the recognition of a gain from the sale of SB shares is expected to boost operating income as well as the other income items presented under it. As a result, Scala's operating income margin and EPS growth rate are relatively larger than those of its peers. The company has replaced its contact center's human operator jobs with an AI-based telephone interactive voice response service at its business segments with primary focus on the mainstay SaaS/ASP business. As the company promotes this type of change in service provision (from labor-intensive to DX-conversional operations), its profitability is likely to improve going forward.

Of the industry peers, Cybozu, Inc., has relatively higher sales growth. Cybozu has revised its full-year sales outlook after, among other factors, its cloud service marked strong performance in 1Q of fiscal year ending March 2021. On the contrary, PiPEDO HD, Inc. announced a negative growth outlook on both sales and operating income for FY2021 ending February 2021. As at the announcement of earnings for 1Q of FY2021, it discounted uncertainties associated with the COVID-19 pandemic into its full-year earnings outlook.

Each of the above earnings figures for comparison represents the low end of its company guideline range.

■ Profitability

Scala forecasts that its operating income margin for FY2021 will be 31% (the low end of its forecast range). The recognition of a gain from sales of SB shares is expected to boost the margin. Meanwhile, its proactive investment in growth and development programs implemented in FY2020 lowered levels of operating income as well as the other income items presented under it, thereby its ROE and ROA are relatively lower than those of its peers.

■ Financial Stability

At the end of FY2020, Scala's equity ratio was relatively lower than those of its peers. Its debt equity ratio was greater than 100%, meaning its debt, including borrowings, was in excess of its equity capital. Nevertheless, the company management regards M&A (corporate mergers and acquisitions) 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 in the mid-position in the competition table. We believe that Scala's balance sheet is well controlled overall, with no particular concern about its financial standing.

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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.