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Highlights of Food Service Companies' Financial Results for Fiscal Year 2021

The following are Japan Credit Rating Agency, Ltd. (JCR)'s perception of the current status and highlights for rating concerning the financial results for the fiscal 2021 (FY2021) and earnings forecasts for FY2022 of Japan's five food service companies: FOOD & LIFE COMPANIES LTD. ("F&LC") with a fiscal year ending September; SKYLARK HOLDINGS CO., LTD. ("SKYLARK HD") and ROYAL HOLDINGS Co., Ltd. ("ROYAL HD") with a fiscal year ending December; and ZENSHO HOLDINGS CO., LTD. ("ZENSHO HD") and KISOJI CO., LTD. ("KISOJI") with a fiscal year ending March (IFRS is applied to F&LC and SKYLARK HD).

1. Industry Trend.

The COVID-19 has been prolonged, and the food service companies are still in a severe business environment. According to the Japan Food Service Association's "Food Service Industry Market Trends," their net sales have continued to be below the pre-pandemic level over the last two years. Store closures and withdrawals have also been increasing, and the number of stores has been on a downward trend (Chart 1). Although there are moves that customer traffic to restaurants is recovering when infectious conditions stabilize, the outlook remains uncertain, and it is anticipated that regulations, such as store operating restrictions and behavioral constraints, may become stricter again. There are also concerns that because of the prolonged situation, HMR and home meals will take hold as a new behavior pattern, reducing eat-out opportunities. While continuing sales measures such as take-out and delivery services to curb the downturn in demand, it is important to stimulate demand for store visits through business format changes and menu strategies.

In addition to the spread of infections in many parts of the world, the external environment is becoming increasingly unstable, as shown by Russia's invasion of Ukraine and the depreciation of the yen, among others. Raw material prices and logistics costs are rising, putting pressure on each company's earnings. In the COVID-19 pandemic, the companies have thoroughly reduced costs, but further flexible responses, such as reviewing menus (menu mixing) and sales prices, are required.

2. Financial Results

The total net sales of the five food service companies in FY2021 were 1,284.6 billion yen (up 6.7% from the previous year), and the total operating income was 39.4 billion yen (operating loss of 22.4 billion yen in the previous fiscal year) (Chart 2). By company, F&LC saw higher sales and income, ZENSHO HD saw higher sales but lower income, and KISOJI saw higher sales and smaller losses. Other two companies reported a sales decline, but SKYLARK HD returned to profitability and ROYAL HD reduced losses. Despite a prolonged negative impact from the request to shorten operating hours, F&LC and ZENSHO HD maintain strong resilience against the COVID-19 pandemic with their strengths in providing everyday meals and high adaptability to HMR. The two companies also succeeded in their store-opening strategy which captures trends and demand. Meanwhile, ZENSHO HD's profits seem to have been squeezed by the high prices of beef, its principal raw material, due to increased demand in China and disrupted distribution network. The other three companies continue struggling because of their store format characteristics which are centered on dinning at restaurant. However, they improved their earnings structure by thoroughly controlling costs, such as cutting personnel costs and improving logistics efficiency. The main reason for an increase in net sales at KISOJI is that, from the current fiscal year, the Company's results reflect those of DAISYOGUN CO., LTD., which became a wholly owned subsidiary in FY2020. On the other hand, the current income level of each company is in part largely supported by the national government subsidy for reduced operating hours. Since F&LC and SKYLARK HD are adopting IFRS, they booked a subsidiary revenue of 10.7 billion yen and 42.6 billion yen at the operating income level, respectively (250 million yen and 70 million yen in the previous fiscal year). The other three companies also booked subsidy revenue as non-operating revenue or extraordinary income. As a result, at the ordinary income level and below, ROYAL HD reduced losses, ZENSHO HD increased income, and KISOJI returned to profitability.

On the financial front, the combined equity ratio of the five food service companies as of the end of FY2021 was 32.0% (26.8% in the previous fiscal year; the same applies hereinafter) and the DER was

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1.6x (2.0x). Shareholders' equity increased to 428.6 billion yen (329.4 billion yen), while interest-bearing debt slightly declined to 670.7 billion yen (673.4 billion yen). By company, SKYLARK HD, ROYAL HD and KISOJI, three companies that saw a decline in shareholders' equity in FY2020 due to severe damage from the COVID-19 pandemic, implemented measures to increase their capital in FY2021. Their financial structure improved, with sufficient cash on hand and a move to repay a portion of additionally financed interest-bearing debt. On the other hand, although noticeably increasing its interest-bearing debt for business expansion, F&LC is steadily expanding its equity capital by taking advantage of its strong earning capacity, and is maintaining a certain financial structure.

3. Highlights for Rating

For FY2022, the five food service companies plan to increase net sales and operating income to 1,532.5 billion yen (up 19.3% year on year) and 55.7 billion yen (up 41.1% year on year), respectively. By company, three companies, ROYAL HD, ZENSHO HD and KISOJI, forecast higher sales and income (ROYAL HD and KISOJI are planning to return to profitability), and F&LC and SKYLARK HD plan higher sales and lower income. Overall, the companies expect the mitigation of the impact of pandemic as a positive factor, while incorporating a considerable amount of cost increases due to yen depreciation, soaring raw material prices, etc. in their plan. The key point in rating are as follows:

First, JCR will continue to closely monitor trends in existing store sales. The current status of infections has been subdued and customer traffic to restaurants is also trending toward recovery, but there are concerns that the situation will deteriorate again in the future. In particular, for family restaurants and dinner restaurants, the number of diners swings widely depending on the status of infections. Therefore, raising sales through take-out and delivery services is important. Further, under action constraints, the burden of losses is mitigated by income from subsidy revenue, but if the impact of pandemic wanes, each company needs to record income by itself. Currently, the range of choice for HMR and home meals is enlarged, and consumption sentiment can be expected to deteriorate due to inflation. The companies intend to expand the number of products with a reasonable price, as well as make customers reaffirm the attractiveness of restaurants through provision of high-value-added products and services. JCR believes that whether a company is excel in such menu and sales strategies will be easily show in results.

As the yen depreciation coincides with rising food, utilities and logistics costs, pressure to raise costs on the food service companies is intensifying. JCR will confirm whether the companies can secure profitability by implementing appropriate cost countermeasures in a timely manner. Since the pandemic, each company has pushed ahead with cost structure improvement through fixed cost cutting and drastic restructuring, in order to cope with the sharp decline in sales. However, a full-fledged recovery in the net sales level has been in delay, and additional measures are essential to absorb the current increase in costs. In addition to improving cost to sales ratios by reviewing menus and changing product standards, moves to pass on cost increases to menu prices have been increasing. Although price revisions are expected to improve profits, there are concerns that this may lead to a decrease in the number of customers. While assessing the success or failure of price revisions, JCR will be paying attention to whether the companies can generate profits even amid the increasing pressure to raise costs.

JCR will continue to follow up on the status of store development. At the time of the beginning of the pandemic, each company's store-opening strategy was subject to its earning capacity and financial strength. Many of the companies restrained new store openings, but currently there are new moves to reopen stores on the assumption that the recovery from the pandemic will proceed going forward. On the other hand, there are cases in which earnings are smoothly returning to their previous growth trajectory by maintaining the aggressive pace of store opening. Following the mitigation of the pandemic's impact, aggressive overseas business development can be expected. JCR will confirm whether the companies can strengthen their business bases while securing financial strength.

On the financial front, JCR is paying close attention to the companies' equity capital position. Certain provisions have been made for the shareholders' equity and on-hand liquidity impaired by the pandemic through capital reinforcement measures implemented in FY2021. It can be said that the recording of subsidy revenue also contributed to a certain degree of financial improvement. However, there is a risk that the companies' financial structure will deteriorate again if they are slow to themselves out of the red. JCR will closely monitor future trends in the government subsidy policy as well as the cash flow status and their financial impacts.

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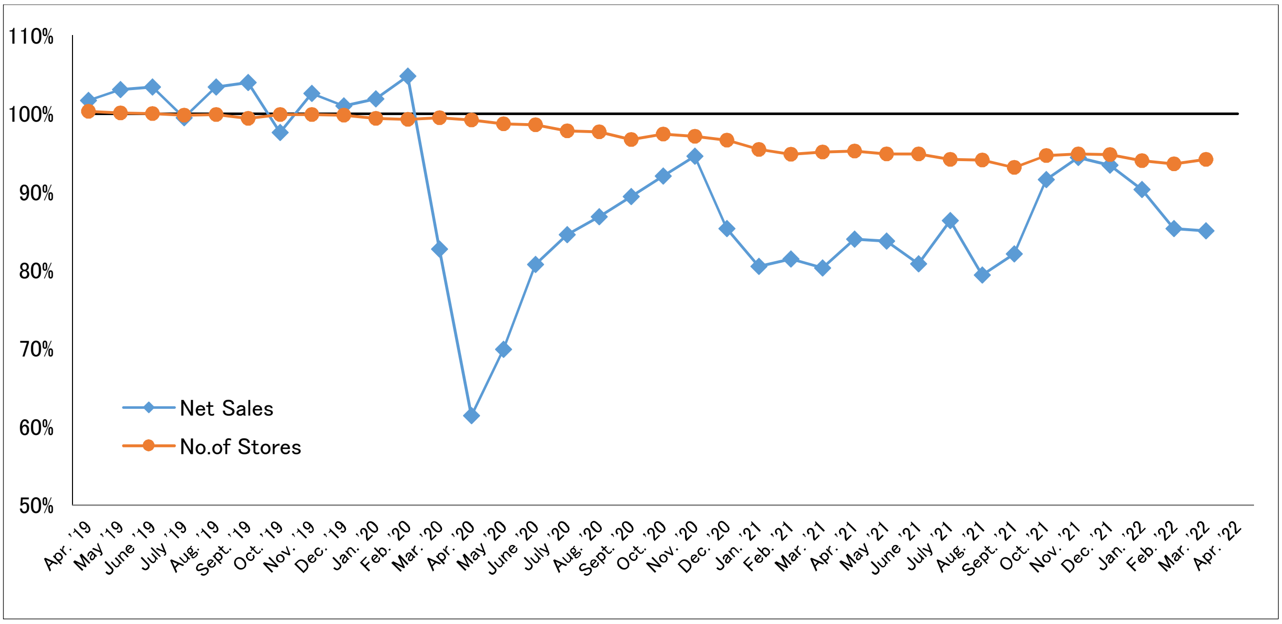
(Chart 1) Year-on-Year Changes in Net Sales



Source: Prepared by JCR based on Japan Food Service Association "Food Service Industry Market Trends"

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(Chart 2) Business Performance of Food Service Companies (JPY100 mn, %, times)

		FY2019	FY2020	FY2021	FY2022
ZENSHO HD (7550)	Net Sales	6,304	5,950	6,585	7,455
	Operating Income	209	121	92	250
	Shareholders' Equity	1,166	1,203	1,383	
	Interest-bearing Debt	1,715	1,933	1,950	
	Shareholders' Equity Ratio	31.9	30.4	32.4	
	Interest-bearing Debt/EBITDA	3.8	5.0	4.9	
	D/E Ratio	1.5	1.6	1.4	
SKYLARK HD (3197)	Net Sales	3,754	2,884	2,646	3,360
	Operating Income	206	-230	182	100
	Shareholders' Equity	1,328	1,138	1,662	
	Interest-bearing Debt	2,585	2,658	2,317	
	Shareholders' Equity Ratio	29.3	25.8	36.3	
	Interest-bearing Debt/EBITDA	3.4	7.4	8.6	
	D/E Ratio	1.9	2.3	1.4	
F&LC (3563)	Net Sales	1,991	2,050	2,408	2,950
	Operating Income	145	121	229	160
	Shareholders' Equity	474	509	636	
	Interest-bearing Debt	421	1,363	1,721	
	Shareholders' Equity Ratio	34.7	21.5	21.5	
	Interest-bearing Debt/EBITDA	2.1	4.8	5.2	
	D/E Ratio	0.9	2.7	2.7	
ROYAL HD (8179)	Net Sales	1,406	843	840	1,040
	Operating Income	46	-193	-74	28
	Shareholders' Equity	508	209	340	
	Interest-bearing Debt	315	622	590	
	Shareholders' Equity Ratio	49.6	19.7	31.0	
	Interest-bearing Debt/EBITDA	2.8	-4.8	-28.2	
	D/E Ratio	0.6	3.0	1.7	
KISOJI (8160)	Net Sales	439	311	368	520
	Operating Income	14	-42	-35	19
	Shareholders' Equity	292	235	266	
	Interest-bearing Debt	19	154	127	
	Shareholders' Equity Ratio	76.5	50.6	55.5	
	Interest-bearing Debt/EBITDA	0.7	-5.0	-6.5	
	D/E Ratio	0.1	0.7	0.5	
Total of 5 Companies	Net Sales	13,894	12,038	12,846	15,325
	Operating Income	621	-224	394	557
	Shareholders' Equity	3,768	3,294	4,286	
	Interest-bearing Debt	5,057	6,734	6,707	
	Shareholders' Equity Ratio	34.4	26.8	32.0	
	Interest-bearing Debt/EBITDA	3.3	7.7	7.0	
	D/E Ratio	1.3	2.0	1.6	

Source: Prepared by JCR based on financial materials of above companies

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Notes:

Japanese GAAP: ZENSHO HD, ROYAL HD and KISOJI (applied consolidated accounting from FY2020.)

EBITDA (Japanese GAAP) = operating income + interest and dividend income + depreciation expenses + goodwill amortization

Interest-bearing Debt (Japanese GAAP) = short-term borrowing + long-term borrowing + corporate bonds + lease obligations

IFRS: F&LC and SKYLARK HD

EBITDA (IFRS) = (gross income G & A expenses) + interest and dividend income + depreciation expenses

Interest-bearing debt (IFRS) = short-term borrowing + long-term borrowing + corporate bonds + other financial liabilities

ZENSHO HD's financial indicators are after consideration of equity content of subordinated loan

<Reference>

Issuer: FOOD & LIFE COMPANIES LTD.

Long-term Issuer Rating: A-   Outlook: Stable

Issuer: ROYAL HOLDINGS Co., Ltd.

Long-term Issuer Rating: BBB-   Outlook: Stable

Issuer: ZENSHO HOLDINGS CO., LTD.

Long-term Issuer Rating: BBB+   Outlook: Stable

Issuer: KISOJI CO., LTD.

Long-term Issuer Rating: BBB-   Outlook: Stable

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