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Highlights of Food Service Companies' Financial Results for Fiscal Year 2022

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 2022 (FY2022) and earnings forecasts for FY2023 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.

According to the Japan Food Service Association's "Food Service Industry Market Trends," the net sales of food service companies in the past year showed a steady recovery from the COVID-19 pandemic (Chart 1). In the summer of 2022, the infection status reached an unprecedented level with the number of infected persons per day hitting a record high many times. However, the impact on the customer traffic was limited, partly because there were no specific behavioral regulations. Since March 2023, the use of masks, which had been mandatory in principle, has been relaxed, and currently in May, the status of COVID-19 in the infection law was shifted to Class 5, the same level as seasonal influenza, and the pre-pandemic daily life is gradually returning. Until now, food service companies have focused on closing of unprofitable stores and strengthening of existing stores in order to achieve an early recovery in sales. As a result, the number of stores is still declining slightly, but the reorganization of stores has almost ended. As the number of companies that resume store opening is increasing along with an improvement in the business environment, JCR sees that the market size will start recovering going forward.

FY2022 was also a year of unprecedented rises in costs such as raw material and energy prices, triggered by the Russian invasion of Ukraine. Each company worked thoroughly to reduce costs in order to curb the impact, but as it could not be absorbed only by the internal company efforts, upward price revisions were implemented by all companies, including beef bowl chain and revolving sushi chain companies, which has been showing cautious stance toward price hikes until now. However, because prices of all necessities have been rising one after another, consumers' awareness to defend their daily lives seems to be on the rise. Each company needs to be skillful in its pricing strategy. Moreover, it is indispensable to stimulate the motivation for visiting stores, such as improving the value of the store experience through its menus and services, and offering extraordinariness and leisure features unique to restaurants.

2. Financial Results

In FY2022, the five food service companies' total net sales amounted to 1,514.9 billion yen (up 17.9% year on year) and operating income stood at 27.9 billion yen (down 29.3% year on year) (Chart 2). By company, ROYAL HD, ZENSHO HD and KISOJI saw higher sales and income, but F&LC and SKYLARK HD saw higher sales and lower income. As the two companies are adopting IFRS, the decline in income due to the absence of revenue from COVID-19-related subsidies was significant, which had the effect of reducing income of the total of the five companies. Meanwhile, F&LC reported a series of inappropriate events following the so-called "bait-and-switch ad" issue in June 2022, causing customers to leave, and in addition, a price hike implemented in October 2022 seems to have been a negative factor on the recovery of visiting customers. Store sales are still on the way of returning to profitability. Attention will be paid to whether F&LC will be able to regain the trust of customers and restore the ability to attract customers and the earning capacity. On the other hand, the ROYAL HD has returned to profitability, and KISOJI narrowed deficits. Recovery from the pandemic can be confirmed despite the impact of high costs, although the pace varies depending on the type of business and individual case.

Financially, the five food service companies' combined equity ratio was 32.2% (32.0% in FY2021, after taking into account the subordinated loan-to-equity ratio of the ZENSHO HD; the same hereafter), and the D/E ratio was 1.6x (1.6x in FY2021). Shareholders' equity increased to 450.1 billion yen (428.6 billion yen in FY2021), and interest-bearing debt increased to 704.5 billion yen (670.7 billion yen in

FY2021). Looking at individual companies, SKYLARK HD and ROYAL HD, which conducted fund procurement to respond to the pandemic, continue to repay interest-bearing debt as cash flow is returning, while ZENSHO HD and F&LC, which continue with growth investment as they had in the past, saw an increase in interest-bearing debt. As noted previously, F&LC's cash flow generation capacity has somewhat weakened recently, and JCR will pay attention to its investment policy for the time being and its impact on its financial position.

3. Highlights for Rating

For FY2023, the five food service companies plan to achieve total net sales of 1,757.5 billion yen (up 16.0% year on year) and a total operating income of 63.1 billion yen (up 126.2% year on year), for increases in both sales and income. Looking at individual companies, all five companies are planning to increase sales and income (SKYLARK HD and KISOJI plant to return to profitability). Upward pressure on cost, such as the yen's depreciation and rising raw materials prices, is expected to continue for the time being, but the establishment of the living-with-COVID-19 policy, and the recovery of inbound tourists are expected to be positive factors in terms of demand. For rating, points to focus on are as follows:

The first factor is trends in existing store sales. Consumption activity has been recovering to the pre-COVID-19 condition, while prices related to living expenses, such as food and electricity charges, have continued to rise in FY2023, and consumers' real wages have declined. At present, there is no major downturn in the customer traffic at restaurants, but there is a possibility that consumption sentiment will deteriorate if prices rises continue for a prolonged period going forward. In order to stimulate demand for store visits, it is important to set out characteristics unique to restaurants by developing specialized menus and providing store spaces and services that can enjoy extraordinariness. In addition, after 2023, inappropriate acts by customers have been discovered one after another at restaurants. Although the impact on attracting customers is expected to be limited, there is a need to take thorough measures to ensure food safety/security and work to prevent recurrence.

The second factor is responses to rising food materials and energy costs. All companies revised menu prices in FY2022, but consumers' price sensitivity to relatively affordable store formats, such as fast food and family restaurant, is high, and the room for further price revisions will likely be limited. It is necessary to adopt a price strategy that is acceptable to consumers, such as raising prices in conjunction with quality improvement and developing wide price ranges through menu mix. It is also indispensable to make ongoing efforts to reduce costs, such as reviewing unprofitable menus and saving labor in store operations.

JCR paying attention to each company's store opening policy as well. In the pandemic, the companies restrained store openings in order to prioritize securing its financial strength and enhancing existing stores. They have identified the essential earning capacity of their business formats and stores, and have been reorganizing businesses. Currently, as the consolidation of stores has almost completed and the business environment has turned around, an increasing number of companies are returning to the pace of store openings before the pandemic. There are also moves to aggressively expand overseas in order to expand the business base in the future. However, domestically, it is necessary to scrutinize the extent to which conventional behavioral patterns recover and the extent to which the market size returns, as well as location strategies and room for store openings. Overseas, the hurdle for expanding the store network is considerably high due to differences in eating habits. As it may take time to recover investments, the key point is whether the companies can simultaneously maintain its financial base and strengthen its business base.

On the financial front, JCR sees that a financial levels at the previous fiscal year will be maintained. With the capital buildup measures implemented in FY2021 and the subsequent recovery in cash flow generation capacity, the financial indicators that had deteriorated due to the pandemic, such as the capital adequacy ratio and D/E ratio, will likely to improve to a certain extent. On the other hand, some companies continue to expand interest-bearing debt, mainly because of growth investments such as new store openings. JCR will check the investment policy and financial status to see if the investment will proceed while considering the balance with cash flow.

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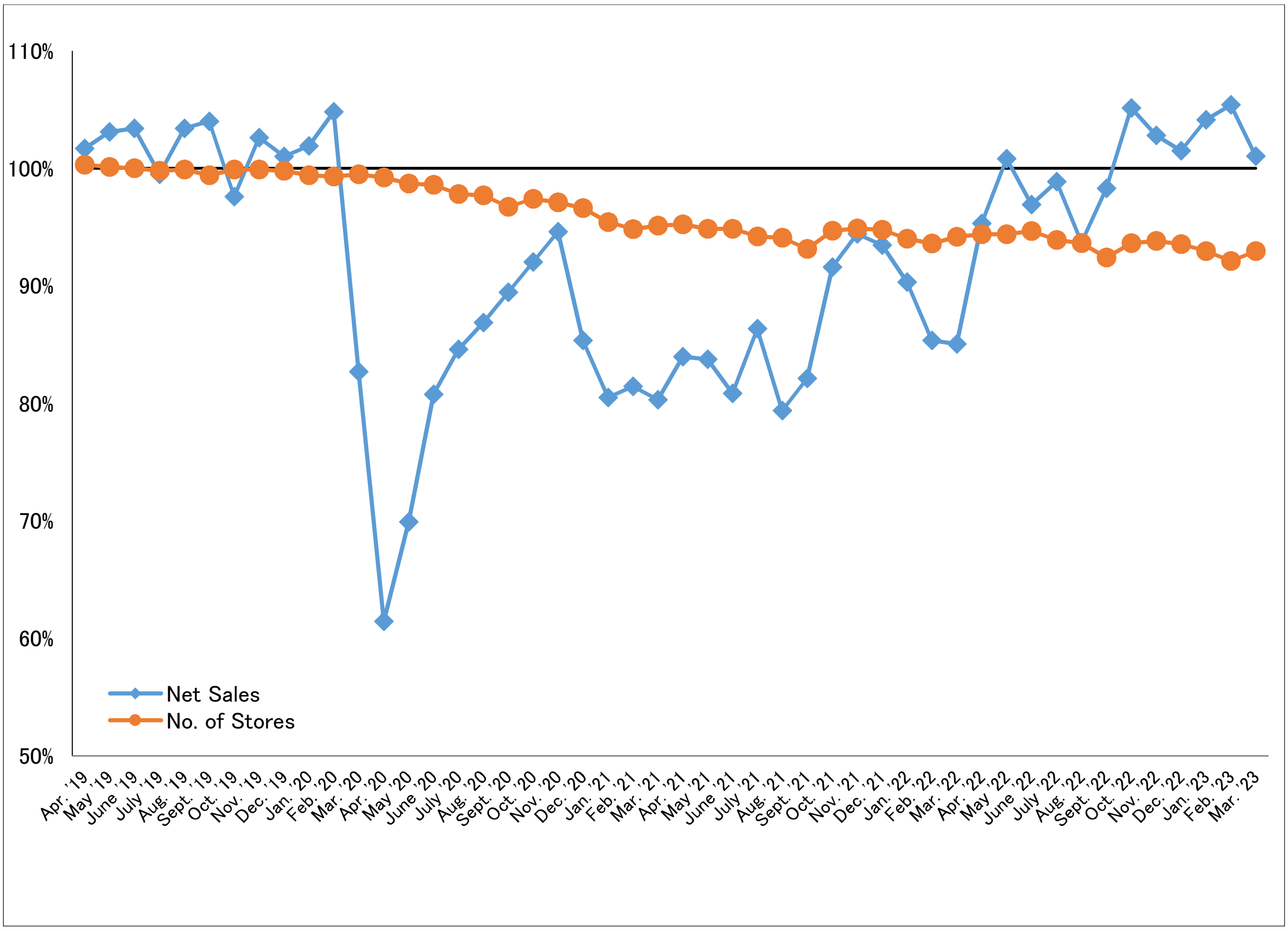
(Chart 1) Changes in Net Sales and Number of Stores (vs. same month of fiscal year ended March 2019)



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

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

		FY2020	FY2021	FY2022	FY2023
ZENSHO HD (7550)	Net Sales	5,950	6,585	7,800	8,985
	Operating Income	121	92	217	401
	Shareholders' Equity	1,203	1,383	1,556	
	Interest-bearing Debt	1,933	1,950	2,128	
	Shareholders' Equity Ratio	30.4	32.4	33.1	
	Interest-bearing Debt/EBITDA	5.0	4.9	3.9	
	D/E Ratio	1.6	1.4	1.4	
SKYLARK HD (3197)	Revenue	2,884	2,646	3,037	3,550
	IFRS Operating Income	-230	182	-56	60
	Equity Attributable to Owners of Parent	1,138	1,662	1,577	
	Interest-bearing Debt	2,658	2,317	2,098	
	Ratio of Equity Attributable to Owners of Parent	25.8	36.3	37.1	
	Interest-bearing Debt/EBITDA	7.4	8.6	5.4	
	D/E Ratio	2.3	1.4	1.3	
F&LC (3563)	Revenue	2,050	2,408	2,813	3,200
	IFRS Operating Income	121	229	101	110
	Equity Attributable to Owners of Parent	509	636	651	
	Interest-bearing Debt	1,363	1,721	2,142	
	Ratio of Equity Attributable to Owners of Parent	21.5	21.5	19.6	
	Interest-bearing Debt/EBITDA	4.8	5.2	6.0	
	D/E Ratio	2.7	2.7	3.3	
ROYAL HD (8179)	Net Sales	843	840	1,040	1,310
	Operating Income	-193	-74	22	44
	Shareholders' Equity	209	340	443	
	Interest-bearing Debt	622	590	554	
	Shareholders' Equity Ratio	19.7	31.0	35.8	
	Interest-bearing Debt/EBITDA	-4.8	-28.2	7.8	
	D/E Ratio	3.0	1.7	1.3	
KISOJI (8160)	Net Sales	311	368	459	530
	Operating Income	-42	-35	-6	16
	Shareholders' Equity	235	266	273	
	Interest-bearing Debt	154	127	121	
	Shareholders' Equity Ratio	50.6	55.5	56.5	
	Interest-bearing Debt/EBITDA	-5.0	-6.5	10.9	
	D/E Ratio	0.7	0.5	0.4	
Total of The Five Companies	Net Sales	12,038	12,846	15,149	17,575
	Operating Income	-224	394	279	631
	Shareholders' Equity	3,294	4,286	4,501	
	Interest-bearing Debt	6,734	6,707	7,045	
	Shareholders' Equity Ratio	26.8	32.0	32.2	
	Interest-bearing Debt/EBITDA	7.7	7.0	5.1	
	D/E Ratio	2.0	1.6	1.6	

Notes:

1. ZENSHO HD and KISOJI end their fiscal year in March, F&LC in September, and SKYLARK HD and ROYAL HD in December.
2. ZENSHO HD, ROYAL HD and KISOJI adopt Japanese GAAP. F&LC (from FY2020) and SKYLARK HD adopt IFRS.
3. KISOJI announces consolidated accounts from FY2020.
4. EBITDA (Japanese GAAP) = operating income + interest and dividend income + depreciation expenses + goodwill amortization

   EBITDA (IFRS) = (gross income - G&A expenses) + interest and dividend income + depreciation expenses
5. Interest-bearing Debt (Japanese GAAP) = short-term borrowing + long-term borrowing + corporate bonds + lease obligations

   Interest-bearing debt (IFRS) = short-term borrowing + long-term borrowing + corporate bonds + other financial liabilities
6. For the total of the five companies, in the case of IFRS: Net Sales = Revenue, Operating Income = IFRS Operating Income, Shareholders' Equity = Equity Attributable to Owners of Parent, and Shareholders' Equity Ratio = Ratio of Equity Attributable to Owners of Parent.
7. ZENSHO HD's financial indicators are after consideration of equity content of subordinated loan

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

<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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