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Highlights of Food Service Companies' Financial Results for Fiscal Year 2018

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 year 2018 (FY2018*) and earnings forecasts for FY2019 of Japan's 5 food service companies:

* : the fiscal year ended December 2018:
    SKYLARK HOLDINGS CO., LTD. ("SKYLARK HD") **
    ROYAL HOLDINGS Co., Ltd. ("ROYAL HD")
* : the fiscal year ended March 2019:
    ZENSHO HOLDINGS CO., LTD. ("ZENSHO HD"),
    COLOWIDE CO., LTD. ("COLOWIDE"), **
    KISOJI CO., LTD. ("KISOJI")

**: IFRS applied

1. Industry Trend

According to Japan Food Service Association's "Food Service Industry Market Trends," net sales of food service companies have been increasing year-on-year for 32 months in a row since September 2016 till April 2019 (Chart 1). Amid constraints on new store openings due to rising store opening costs and labor shortages, JCR guesses that the store strategy are increasingly more focused on enhancement of existing stores and the effects of revitalization measures are emerging. The demand environment after the consumption tax hike in October 2019 is uncertain, but many business formats are becoming increasingly popular in daily life as an option to reduce the burden of housework, so it is hard to anticipate a significant decline.

On the other hand, the cost burden is increasing. Foodstuff costs remain high. Although the entry into force of the Japan-Europe Economic Partnership Agreement (EPA) and the Trans-Pacific Economic Partnership Agreement (TPP) are positive factors, such costs have recently been affected by the weaker yen and the appreciation of the market prices. In addition, personnel costs are under strong upward pressure due to increases in minimum wages and severe labor shortages. As a result, food service companies generally have to raise products prices. However, consumers remain price sensitive, and there is a risk that food service companies will not be able to absorb the cost burden if the risk of customers departing materializes. There is a growing need for efforts to raise labor productivity by reviewing businesses and investment in labor saving, in addition to the skills of menu policies to deal with ongoing cost increases.

2. Financial Results

While total net sales of 5 food service companies increased year-on-year 2.6% to 1,401.2 billion yen, total operating income of the 5 companies decreased 6.9% year-on-year to 54.1 billion yen for FY2018 (Chart 2). Although each company's performance depended on its business format, overall sales were robust due to new store openings, growth in existing stores, and M & A. On the other hand, in addition to rising costs centered on personnel expenses, impairment losses and shareholder benefit expenses weighed on operating income. By company, both ZENSHO HD and KISOJI increased net sales and income, both SKYLARK HD and ROYAL HD increased net sales but declined income, and COLOWIDE declined net sales and income.

The aggregate equity ratio and D/E ratio of the 5 food service companies at end-FY2018 resulted almost unchanged from 31.6% and 1.4x a year earlier to 32.5% and 1.3x, respectively. Investments exceeded operating cash flow, and interest-bearing debt increased to 454.9 billion yen from 439.7 billion yen a year earlier. Their total equity capital increased to 347.1 billion yen from 309.3 billion yen a year earlier thanks to the increased retained earnings as well as the financing of subordinated loan by a company. Despite the second consecutive decline in income after peaking in FY2016, it can be said that these results are thanks to the facts that the companies has maintained their solid performance and ability to generate cash flow, and have made investments that took financial discipline into consideration. By company, ZENSHO HD improved its financial structure, and the three companies, namely, the SKYLARK HD, the COLOWIDE and KISOJI, remained at the same level as the previous fiscal year. ROYAL HD slightly deteriorated its financial structure.

3. Highlights for Rating

The total net sales of the 5 companies are expected to increase 5.6% year-on-year to 1,479.4 billion yen and their total operating income is expected to increase 15.0% year-on-year to 62.2 billion yen for FY2019. By company, while SKYLARK HD expects increase in net sales and decline in income, other four companies expect increase in net sales as well as income. As a whole, while each company expects costs to rise, it intends to cover these costs by rigorously controlling costs and improving productivity, as well as by opening new stores and increasing sales of existing stores. Therefore, JCR will pay attention to the following points for the time being.

First, JCR will pay attention to the same-store sales. The current consumption environment is firm, but after the consumption tax hike in October 2019, there is a possibility that consumers will temporarily become more saving oriented. In addition, many food service companies and ready-to-eat businesses are competing for demand, and the business environment remains challenging. Under these circumstances, it is important to improve the quality of services by enhancing menus, methods of provision, and payment methods in line with the diversification of consumers' preferences.

In addition, there are some companies that their same-store cost increases more than the growth of same-store sales. While focusing on the success or failure of passing cost increases to products, JCR will watch initiatives for continued cost reductions. Specifically, the key points are reducing food loss, improvement the cost of sales ratio through a menu mix, curbing personnel expenses through labor-saving investments and shortening operating hours when profitability cannot be expected, and improving logistics efficiency through a review of the distribution network.

It is also essential to expand the scale by opening new stores. It negatively affects earnings in the short term, but leads to differences in future earnings growth. While the pace of new store openings is constrained under the circumstances, JCR will pay attention to whether the companies can steadily open new stores by strengthening their development capabilities, such as by developing franchises and diversifying store formats.

In anticipation of the future impact of Japan's aging and falling population issue, each company is expanding overseas business, and attention should be paid to developments. Some companies have begun to get on track by expanding the number of overseas stores, but there are many cases where companies in general incur losses till they establish a certain store network due to burdens for the infrastructure development and management cost. Impairment losses may be recorded, and profitability and financial strength of domestic businesses to be able to tolerate losses are required.

JCR sees that the financial structure in FY2019 will be in general at the same level in the FY2018. Given that the impairment risk has been reduced due to the favarable performance of existing stores and that capital investment can be absorbed by period cash flow, accumulation of shareholders' equity and reduction of interest-bearing debt can be expected. However, if sales policies fail or compliance problems arise, the risk of impairment may materialize due to the rapid deterioration of existing stores, leading to the impairment of shareholders' equity. In addition, M & A may occur for companies with strong growth orientation, which may put a strain on the financial base.Some financial indicators of some companies change due to changes in IFRS lease accounting standards, and it is necessary to confirm whether there are any changes in the economic conditions.

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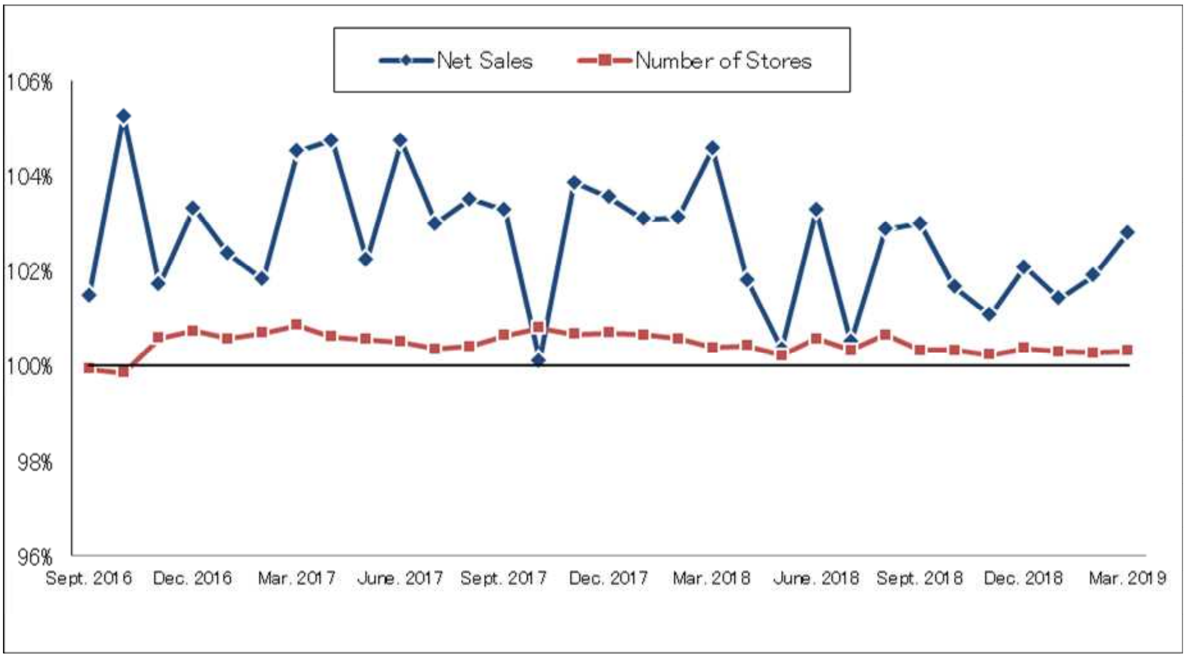
(Chart 1) Year-on-Year Changes in Net Sales and Number of Stores



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)

		FY2016	FY2017	FY2018	FY2019F
ZENSHO HD (7550)	Net Sales	5,440	5,791	6,077	6,614
	Operating Income	188	176	188	238
	Shareholders' Equity	679	675	1,022	
	Interest-bearing Debt	1,481	1,503	1,662	
	Shareholders' EquityRatio	23.5	22.9	27.0	
	Interest-bearing Debt/EBITDA	3.8	3.9	4.1	
	D/E Ratio	2.2	2.2	1.6	
SKYLARK HD (3197)	Net Sales	3,545	3,594	3,664	3,700
	Operating Income	312	281	229	220
	Shareholders' Equity	1,142	1,273	1,305	
	Interest-bearing Debt	1,417	1,376	1,419	
	Shareholders' EquityRatio	35.9	40.0	39.5	
	Interest-bearing Debt/EBITDA	3.0	3.2	3.7	
	D/E Ratio	1.2	1.1	1.1	
COLOWIDE (7616)	Net Sales	2,344	2,459	2,444	2,580
	Operating Income	41	42	41	74
	Shareholders' Equity	342	346	348	
	Interest-bearing Debt	1,334	1,249	1,159	
	Shareholders' EquityRatio	14.7	15.1	15.7	
	Interest-bearing Debt/EBITDA	7.4	6.9	5.7	
	D/E Ratio	3.9	3.6	3.3	
ROYAL HD (8179)	Net Sales	1,330	1,356	1,377	1,430
	Operating Income	52	60	57	63
	Shareholders' Equity	474	510	499	
	Interest-bearing Debt	262	253	290	
	Shareholders' EquityRatio	50.3	52.5	50.1	
	Interest-bearing Debt/EBITDA	2.4	2.2	2.5	
	D/E Ratio	0.6	0.5	0.6	
KISOJI (8160)	Net Sales	443	444	451	470
	Operating Income	11	22	26	27
	Shareholders' Equity	289	289	298	
	Interest-bearing Debt	13	13	18	
	Shareholders' EquityRatio	76.5	75.2	75.6	
	Interest-bearing Debt/EBITDA	0.6	0.4	0.5	
	D/E Ratio	0.0	0.0	0.1	
Total	Net Sales	13,104	13,645	14,012	14,794
	Operating Income	604	581	541	622
	Shareholders' Equity	2,926	3,093	3,471	
	Interest-bearing Debt	4,509	4,397	4,549	
	Shareholders' EquityRatio	30.1	31.6	32.5	
	Interest-bearing Debt/EBITDA	3.8	3.8	4.0	
	D/E Ratio	1.5	1.4	1.3	

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

Notes: Japanese GAAP: ZENSHO HD, ROYAL HD and KISOJI (unconsolidated)
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: SKYLARK and COLOWIDE
EBITDA (IFRS) = (gross profit – SG & A expenses) + interest and dividend income + depreciation expenses

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

In the financial indicators of ZENSHO HD, equity content of the subordinated loan is taken into consideration

<Reference>

Issuer: ZENSHO HOLDINGS CO., LTD.

Long-term Issuer Rating: BBB Outlook: Stable

Issuer: ROYAL HOLDINGS Co., Ltd.

Long-term Issuer Rating: BBB+ Outlook: Stable

Issuer: KISOJI CO., LTD.

Long-term Issuer Rating: BBB- Outlook: Positive

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