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Highlights of Major Dispensing Pharmacies Companies' Financial Results for Fiscal Year Ended March 2017

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 ended March 2017 (FY2016) and earnings forecasts for FY2017 of 6 dispensing pharmacies companies: Qol Co., Ltd., NIHON CHOUZAI Co., Ltd., MEDICAL SYSTEM NETWORK Co., Ltd., SOGO MEDICAL CO., LTD. and TOKAI Corp. with fiscal year end in March and AIN HOLDINGS INC. with fiscal year end in April.

1. Industry Trend

Japan's dispensing fee had been constantly increasing till FY2015, but the fee has been below the last year's in FY2016 for periods from April to December (Chart 1). This is because unit price per prescription has significantly declined, despite the increasing number of prescriptions along with progress of separation of medical and dispensary practice. Rate of revisions of NHI drug prices in April 2016 was minus 7.8%, which was larger than those of past years, and prescription of therapeutic agent for hepatitis C with high drug price, which was launched in 2015, has peaked out, increasingly placing downward pressure on medicine fee. As there will be no revisions of NHI drug prices in FY2017, it is highly likely that medicine fee will turn to an increase and dispensing fee will expand.

The dispensing fee revisions in FY2016 were tough ones for pharmacies including stricter calculation requirements for premiums for generic drug and standard dispensing and reduction of basic dispensing fees for chain pharmacies as a special case. Unit technical fee immediately after the revision fell into negative year-on-year growth, but the fee subsequently recovered to a level of last fiscal year on a full fiscal year average basis, thanks to the progressed efforts for the fee raise. In April 2017, it was found that a part of Qol's stores had been requesting wrongful insurance claims to avoid reduction of basic dispensing fees as a special case. It is feared that bad reputation for pharmacy industry will intensify and that criticism toward the industry and the way of separation of medical and dispensary practice will also intensify.

M&As are currently more actively seen than before. Major companies successively conducted relatively large M&As, which amounted from several billions of yen to 10 billion and several billions of yen, and also is engaging in small-sized M&As. It is considered that worsened earnings environment after the strict NHI drug price and dispensing fee revisions, shortage of pharmacists and absence of successors, and so on lie behind this trend concerning the sellers. Market shares by major companies are only a several percentage point, but JCR assumes that oligopoly will accelerate going forward.

2. Financial Results

While total net sales of the 6 companies increased 2.9% year-on-year to 918.7 billion yen, total operating income decreased 7.1% year-on-year to 45.7 billion yen for FY2016. Their operating income margin was 4.98%, down 0.53% year-on-year. Five companies excluding TOKAI increased net sales, but only 2 companies, Qol and SOGO MEDICAL, ensured an increase of operating income. For pharmacy related segment performance also, FY2016 earnings results were bleak: only Qol and AIN HOLDINGS increased revenue and all 6 companies decreased their profits. Although the increased number of customers visiting stores shortly after the opening is considered to have helped increase the earnings, larger reduction of drug price as compared with past years and decreased therapeutic agent for hepatitis C worked as negative factors. Total operating income of the 6 companies ended with a shortfall of 4.4 billion yen to the planned amount of 50.1 billion yen at the beginning of FY2016. It seems that impact of drug price revision, etc. had more impact than assumed by them. For businesses other than pharmacy, AIN HOLDINGS' loss from the product sales business expanded due primarily to an active scrap-and-build process for stores. Qol, SOGO MEDICAL and TOKAI ensured an increase of both revenue and profit for businesses other than pharmacy, which covered deceleration of their pharmacy business to a certain extent.

For the financial structure, equity ratio and D/E ratio of the 6 companies combined as of the end of FY2016 decreased to 34.08% and increased to 0.91x, down 0.58% and up 0.13x from a year earlier, respectively. Their interest-bearing debt increased by 42.8 billion yen to 197.1 billion yen. While all companies increased equity capital, interest-bearing debt for 5 companies excluding TOKAI out of the 6 companies increased, which worsened financial structure. There were active investments in FY2016 as shown by the number of opened stores by Qol, SOGO MEDICAL and AIN HOLDINGS including M&As exceeding 100 and NIHON CHOUZAI's enhancement of production capacity of its manufacturing & marketing of pharmaceuticals business.

3. Highlights for Rating

Total net sales and operating income of the 6 companies for FY2017 are forecast at 984.7 billion yen and 51.4 billion yen, up 7.2% and 12.5% year-on-year, respectively. All 6 companies plan to increase their net sales and 5 companies of the 6 companies except TOKAI expect operating income to increase. TOKAI expects its operating income to slightly decrease due partly to the increasing labor cost for installation of stores, which strengthen in-home dispensing.

For net sales, upward trend will likely continue for FY2017 thanks to finish of a decline of unit medicine fee, increased number of customers visiting recently opened stores, and contributions throughout the fiscal year from stores that were acquired through M&As in the previous fiscal year. As estimations by the companies include those from indeterminate opening and M&As, however, net sales can fluctuate with progresses of these plans. For the income, it is assumed that efforts for a raise of technical fee revenue will help increase the income as well as finish of a decline of unit medicine fee and an increase of revenue from recently opened stores. JCR will pay attention to progress of store opening and dealings with an increase of point additions for generic drug and standard dispensing as key points. Since it is important to steadily strengthen functions of personal pharmacies/ and pharmacists towards dispensing fee revisions in and after FY2018 such as in-home and 24 hours a day treatments, JCR will pay attention to the initiatives for these treatments.

It is expected that major dispending pharmacies companies will continue aiming to expand their businesses through opening their own stores and M&As, which will then require them to keep on making a high level of investment. AIN HOLDINGS plans to open 100 stores, while carefully watching impact from opening of pharmacies within premises of medical institutions (pharmacies to be opened within premises of university hospitals and other medical institutions after deregulation in 2016). Other companies may also increase their investment spending including such spending for businesses other than pharmacy. Given these anticipations, it is considered that an improvement of financial structure is in general difficult for major pharmacies companies.

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(Chart 1) Year-on-Year Growth of Domestic Dispensing Fee, Number of Prescriptions and Dispensing Fee per Prescription and Drug Price Revision Rate

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016 Apr. – Dec. (YoY)
Dispensing Fee	3.6%	7.9%	1.3%	5.9%	2.3%	9.4%	-3.3%
No. of Prescriptions	4.3%	2.2%	1.5%	0.6%	1.8%	1.9%	1.5%
Dispensing Fee per Prescription	-0.6%	5.5%	-0.3%	5.4%	0.5%	7.3%	-4.7%
Technical Fee	*4.7%*	*1.1%*	*2.0%*	*1.4%*	*0.0%*	*1.4%*	*0.0%*
Medicine Fee	*-2.4%*	*7.2%*	*-1.1%*	*6.8%*	*0.6%*	*9.2%*	*-6.3%*
Drug Price Revision Rate	-5.75%	-	-6.00%	-	-2.65%	-	-7.8%

Source: Prepared by JCR based on Ministry of Health, Labour and Welfare "Trend in Recent Dispensing Fee (for Computerized Process)"

(Chart 2) Business Performance of Dispensing Pharmacies

(Y mn)

	FY	Net Sales	Operating Income	Net Income Attributable to Owners of the Parent	Total Assets	Equity Capital	Interest-bearing Debt
QoI (3034)	FY2015	124,957	6,743	3,709	69,847	20,763	23,194
	FY2016	131,502	6,865	4,353	81,290	21,317	33,607
	FY2017F	145,000	7,500	4,400			
NIHON CHOUZAI (3341)	FY2015	219,239	10,489	6,329	157,609	32,473	66,361
	FY2016	223,468	8,519	4,638	178,347	36,447	86,090
	FY2017F	234,697	10,105	5,639			
MEDICAL SYSTEM NETWORK (4350)	FY2015	87,715	3,783	1,720	48,847	9,914	21,769
	FY2016	88,865	2,113	571	50,737	10,222	24,049
	FY2017F	95,000	3,100	1,000			
SOGO MEDICAL (4775)	FY2015	120,776	6,087	2,318	74,621	29,442	16,779
	FY2016	122,216	6,248	3,779	86,760	32,605	23,529
	FY2017F	135,566	7,001	4,029			
AIN HOLDINGS (9627)	FY2015	234,843	14,619	7,917	139,888	53,258	21,742
	FY2016	248,110	14,563	7,949	156,323	60,105	26,808
	FY2017F	267,500	16,600	8,900			
TOKAI (9729)	FY2015	105,517	7,513	5,226	80,252	52,048	4,480
	FY2016	104,572	7,443	5,306	84,514	56,698	3,104
	FY2017F	106,937	7,163	4,991			
Total	FY2015	893,047	49,234	27,219	571,064	197,898	154,325
	FY2016	918,733	45,751	26,596	637,971	217,394	197,187
	FY2017F	984,700	51,469	28,959			

Note: Interest-bearing debt is a total of short-term borrowings, current portion of bonds, current portion of long-term borrowings, lease obligations (current liabilities), bonds, long-term borrowings, lease obligations (non-current liabilities), and long-term accounts payable - installment purchase (non-current liabilities).

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

<Reference>

Issuer: SOGO MEDICAL CO., LTD.

Long-term Issuer Rating: BBB Outlook: Stable

Issuer: AIN HOLDINGS INC.

Long-term Issuer Rating: A- Outlook: Stable

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