BRIDGE REPORT

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Kunihiro Tanaka, President	SAKURA Internet Co., Inc.(3778)

Company Information

Exchange	First Section, Tokyo Stock Exchange
Industry	Information, Telecommunication
President	Kunihiro Tanaka
HQ Address	Grand Front Osaka Tower A 35F 4-20 Ofukachou, Kita-ku, Osaka City, Japan
Year-end	March
Homepage	https://www.sakura.ad.jp/

Stock Information

Share Price	Number of shares issued (excluding treasury shares)	Total market cap	ROE(Act.)	Trading Unit
¥632	37,620,256 shares	¥23,776 billion	4.5%	100 shares
DPS(Est.)	Dividend yield (Est.)	EPS(Est.)	PER(Est.)	BPS(Act.)	PBR(Act.)
¥2.50	0.4%	¥17.28	36.6 x	¥209.03	3.0 x

* Stock price as of the close on October 26, 2018.

*Outstanding shares as of most recent quarter end, shares issued excluding treasury stock. ROE, BPS are actual results at the end of the previous term.

Consolidated Earnings

Fiscal Year	Net Sales	Operating Income	Ordinary Income	Net Income	EPS (¥)	DPS (¥)
March 2015(Act.)	10,576	964	857	516	59.52	10.00
March 2016(Act.)	12,086	978	822	443	15.95	2.50
March 2017(Act.)	13,961	1,018	804	548	15.74	2.50
March 2018(Act.)	17,033	745	574	349	9.29	2.50
March 2019(Est.)	20,400	1,200	1,000	650	17.28	2.50

*Unit: ¥mn

* Estimates are those of the company. As of March 2016, the definition of net profit has been changed to net profit attributed to parent company shareholders. (Same applies to the whole report.)

* Since Fiscal year March 2016 represents consolidated data. A four for one stock split was conducted in September 2015.

This Bridge Report presents Sakura Internet's earning results for the first half of fiscal year March 2019, along with estimates for fiscal year March 2019.

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Key points

● **For the first half of the fiscal year March 2019, sales grew 11.0% year on year, but operating income declined 6.6% year on year. Sales rose, thanks to the 19.3% increase in sales of VPS and cloud services, BitStar Inc., which became a subsidiary in September last year, and the transactions for governmental satellite data. Operating income declined, due to the augmentation of depreciation and lease fees for the operation of the third building of Ishikari Data Center and the investment in servers and networks, the increase of engineers and sales staff, and so on, but within the scope of assumption.**

● **There is no revision to the full-year forecast, and it is estimated that sales and operating income will increase 19.8% and 60.9%, respectively, year on year. The progress rate to the full-year forecast is 44.2% for sales, and 23.6% for operating income. As for sales, the company will strive to bolster existing services by enriching functions, and plans to rent servers to other companies. In addition, the transactions for governmental satellite data will contribute to full-year results, and the business negotiations for multiple large-scale transactions are ongoing for the conclusion of contracts at the beginning of the following year or later. As for profit, depreciation, lease fees, and repair cost are estimated to fall below the estimates due to the cost for IoT modules and the timing of investment in service equipment.**

● **Since the start of business, SAKURA Internet has focused on the provision of Internet infrastructure that is excellent in cost performance, and currently engages in the strengthening of the added value domain related to Internet infrastructure, including MSD and data platforms for IoT and AI. As part of these activities, the company increased engineers and sales staff. Especially, the recruitment of engineers is aimed at improving services. The increase of engineers will not be reflected in sales immediately like the dispatch of engineers, so it will be an upfront investment for a while.**

1. Company Overview

Sakura Internet operates data centers located in Tokyo (Nishi Shinjuku, Higashi Shinjuku and Daikanyama, all using rented floor space), Osaka (Dojima, using rented floor space) and Hokkaido (Ishikari, owned land and buildings) to provide internet based hosting services for server environments (Computer resources), and server installation space for housing services, electrical and network circuits and other services.   While many hosting service companies tend to outsource their infrastructure (Data center facilities), Sakura Internet owns its own infrastructure, allowing them to pursue higher profitability (A source of price competitiveness) and utilization of this infrastructure for their housing services allows for reduced risk of fixed costs through the ability to increase utilization rates (Infrastructure possession risk).

【Business Description】

Sakura Internet's business is divided into housing, hosting, other services including domain and SSL acquisition (Certification for unique domain acquisition outsourcing), with each these services accounting for 15%, 68% (Exclusive servers, rental servers and VPS Cloud accounting for 23%, 18% and 27% respectively) and 17% respectively.

Housing Service Business

Within their data center, Sakura Internet provides space for customers to freely install their own telecommunication equipment, together with rental of necessary circuits and power supplies for Internet connections.   The renting of installation space for "rental rack" units (Also offering circuits, power supply and other equipment) is the core service of this business.   However, the Company also began providing a "rental space" (Large-scale housing) services with the start of operations of their Ishikari Data Center, where real estate is

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owned by the Company.

Hosting Service Business

The hosting service is divided into the physical hosting of dedicated server services, rental server services, virtual hosting of virtual private server (VPS) and cloud service.
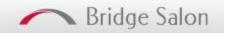
Dedicated Server Service

This service offers the exclusive use of Sakura Internet's own physical servers ('Sakura's Dedicated Server'). This service allows users to use physical servers like the cloud, and is overwhelmingly superior to the normal cloud using the virtualization technology in performance and security. Although there are the burdens of server maintenance, which requires expertise, etc., it is possible to configure a server independently and there is no restriction on software installation. This indicates a high degree of freedom compared with rental server services. There is no limitation on the number of servers, users can configure multiple servers, and it is possible to start using a sever in a minimum of 10 minutes after application. Sales of dedicated servers have decreased along with the spread of virtual servers for cloud and VPS services. However, functional merits of stable performance, ability to use high-performance database storage, cost advantage of being able to limit cost increases with expansion in scale compared to cloud service, and renewed interest in utilization of high-speed processing required in the artificial intelligence (AI) realm made possible by the implementation of new services have contributed to increases in customers using cloud (virtual servers) and dedicated servers (physical servers).

Rental Server Service

This service provides the use of Sakura Internet's own physical servers and abundant functions, which are maintenance free. They offer services for the use of one physical servers ('Sakura's Managed Server'), as well as the shared use of one physical server with a number of customers ('Sakura's Rental Server'). While there are set conditions on the server set-up and the installation of software, Sakura Internet is able to considerably decrease the burden of work required of users as the specialized knowledge needed for maintenance of the servers is handed by Sakura Internet.

Virtual Private Server, Cloud Service

A service that leverages virtualization technologies that allows customers to establish multiple virtual servers on a physical server, allowing them to be used individually like dedicated servers. Sakura Internet offers a basic virtual server service with a single contract ("Sakura's VPS"), as well as a contract that allows for the application and set-up of numerous servers that can be charged by the day or by the hour ("Sakura's Cloud"). They offer greater flexibility and excel in cost performance compared to physical servers. (Dedicated server services or rental server services.)

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2. First Half of Fiscal Year March 2019 Earnings

(1) Consolidated Earnings

	1H FY3/18	Share	1H FY3/19	Share	Change from the previous term
Sales	8,120	100.0%	9,014	100.0%	+11.0%
Gross profit	2,299	28.3%	2,545	28.2%	+10.7%
SG&A	1,995	24.6%	2,261	25.1%	+13.3%
Operating profit	303	3.7%	283	3.1%	-6.6%
Ordinary profit	219	2.7%	208	2.3%	-4.9%
Net profit	105	1.3%	108	1.2%	+3.1%

*Unit: ¥mn

*Figures include reference figures calculated by Investment Bridge Co., Ltd. Actual results may differ (same applies to all tables in this report).

Profit declined due to upfront investment, including the augmentation of depreciation and lease fees, but within the scope of assumption.

Sales were 9,014 million yen, up 11.0% year on year. While the sales of VPS and cloud services increased 19.3% year on year, the sales of other services grew 20.5% year on year, due to the contribution of BitStar Inc., which became a subsidiary in September last year and excels at MSP services for small and medium-sized corporations, from the beginning of the term and the posting of sales from transactions for governmental satellite data.

Operating income was 283 million yen, down 6.6% year on year. Rents decreased due to the integration of data centers, but the depreciation and lease fees augmented due to the operation of the third building of Ishikari Data Center and the investment in servers and network equipment, and equipment for sales, etc. increased. Consequently, cost of sales rose 11.1% year on year to 6,469 million yen. SG&A expenses augmented 13.3% year on year, due to the increase of engineers for developing in-company systems and sales staff of subsidiaries.

Net income rose 3.1% year on year, due to the decline in extraordinary loss and tax effect accounting in addition to the improvement in non-operating income/loss because of the posting of an income from subsidies of 21 million yen, etc. The damage by the Hokkaido Eastern Iburi earthquake was minor, and a disaster-caused loss of 7 million yen was posted as an extraordinary loss.

The company invested about 1.7 billion yen for renewing servers and network equipment, the third building of Ishikari Data Center (2 rooms to be constructed), etc.

In the first half, the company invested about 1.7 billion yen, which is composed of 400 million yen for the third building of Ishikari DC, 100 million yen for the first and second buildings, and 1 billion yen for servers and network equipment. In the full year, it plans to invest about 8.4 billion yen, which is composed of 2 billion yen for the third building of Ishikari DC, 300 million yen for the first and second buildings, 4.8 billion yen for servers and network equipment, and 800 million yen for other data centers.

Active recruitment was continued. The company increased the number of employees, especially engineers and sales staff of subsidiaries, by 55.

The number of employees as of the end of the first half was 618 (563 as of the end of the previous term). The company recruited 55 people, including 30 engineers, 4 managers, 10 employees of BitStar Inc., and 7 employees of Prunus.

Service Segment Sales

	1H FY3/18	Share	1H FY3/19	Share	Change from the previous term
Housing	1,215	15.0%	1,341	14.9%	+10.4%
Dedicated Servers	1,908	23.5%	1,926	21.4%	+0.9%
Rental Servers	1,556	19.2%	1,626	18.0%	+4.5%
VPS, Cloud	2,176	26.8%	2,597	28.8%	+19.3%
Others	1,263	15.6%	1,522	16.9%	+20.5%
Total	8,120	100.0%	9,014	100.0%	+11.0%

*Unit: ¥mn

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3. Fiscal Year March 2019 Earnings Estimates

(1)Consolidated Earnings

	FY 3/18 Act	Share	FY 3/19 Est.	Share	YoY
Sales	17,033	100.0%	20,400	100.0%	+19.8%
Operating profit	745	4.4%	1,200	5.9%	+60.9%
Ordinary profit	574	3.4%	1,000	4.9%	+74.1%
Net profit	349	2.0%	650	3.2%	+86.0%

*Unit: ¥mn

There is no revision to the full-year forecast, and it is estimated that sales and operating income will rise 19.8% and 60.9%, respectively, year on year.

The progress rate to the full-year forecast is 44.2% for sales, 23.6% for operating income, 20.9% for ordinary income, and 16.7% for net income. The progress rates of profits seem to be low, but they are within the scope of assumption.

As for sales, the sales of IoT services, whose market is still immature, are estimated to fall below the estimate, but the sales from transactions of governmental satellite data will be posted, and the negotiations for 3 large-scale transactions with R&D institutions, etc. are ongoing for the conclusion of contracts at the beginning of the following year or later. As for rental servers, the transfer from Yahoo is scheduled. The company will shore up VPS and cloud services, rental servers, and dedicated servers (existing) by launching new services and enriching functions.

As for profit, the costs for large-scale transactions, sale of equipment, etc. are projected to exceed the estimates, but depreciation, lease fees, and repair cost are estimated to fall below the estimates due to the cost for IoT modules and the timing of investment in service equipment.

(2) Growth strategy

To become a platformer that supports the digital transformation (DX) age

After the ages of "the first platform," which is based on main frames, and "the second platform," which is based on servers, clients, and the Internet, we are entering the age of "the third platform," which is based on cloud computing, social services, big data, and mobility. IDC Japan defined digital transformation (DX) as creating new value and establishing competitive advantage of enterprises by utilizing the third-platform technology. The examples of new values created include Fintec (IT × finance), automatic driving (IT × automobiles), remote diagnosis (IT × medicine), and smart agriculture (IT × agriculture). It is expected that the efforts to create new value by utilizing the third-platform technology will be enhanced.

In the DX age, data resources will become more important. Data resources become information when gathered and analyzed, and information is utilized for making decisions and taking actions. Therefore, data will become the yardstick for measuring the advantage in a market. SAKURA Internet aims to become a platformer that will support the DX age by offering a cloud platform, an IoT platform, a data platform, and IT solutions, which are required for collecting and analyzing data resources. In August 2018, the company reorganized IzumoBASE, Inc. into a subsidiary for the purpose of acquiring engineers for storage to accelerate the development of services, and included its performance in consolidated results from September. IzumoBASE, Inc. is a venture firm from the University of Tokyo, and possesses storage software engineers who have plenty of knowledge and advanced skills. Through this M&A, the corporate group plans to develop storage services by itself and accelerate the development of services.

To make the working environment more comfortable

One of growth strategies is to make efforts to make the working environment more comfortable and make employees' jobs more meaningful. The company set the 4 objectives: (1) to increase salaries, (2) to increase on-site workers, (3) to improve the office environment, and (4) to shorten working hours, and has been striving to attain them. To achieve these objectives, the company adopted a system for working at home, a system for shifting working hours, and an in-house system called "Saburiko," which enables employees to leave their office 30 minutes earlier than the specified time if they have completed their tasks, and implemented measures for allowing

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shorter working hours for child care or nursing care and paying 5,000 yen per day for consecutive leaves of 2 or more days. In January 2017, the company announced that it would encourage employees to do external activities, including sideline business, as their parallel career. Furthermore, the company changed payment dates so that employees could receive salaries earlier than before, expecting the effect of reducing paperwork, and relocated the Osaka headquarters for solving the problem of shortage of space due to the increase of employees and motivating employees.

Thanks to these efforts, turnover rate is currently 1-2%, which is extremely low among IT enterprises. President Tanaka mentioned with confidence, "There is a possibility that some enterprises will face difficulty in expanding their business due to the constraints of manpower, but our company is free from the bottleneck in human resources, and has data centers, indicating plentiful resources. Namely, we now have the ground for growth in the AI and IoT fields."

4. Conclusion

Since the start of business, SAKURA Internet has focused on the provision of Internet infrastructure that is excellent in cost performance, and currently engages in the strengthening of the added value domain related to Internet infrastructure, including MSD and data platforms for IoT and AI, with the aim of becoming a platformer supporting the DX age. As part of these activities, the company increased engineers and sales staff. It is forecasted that it will be more difficult to secure engineers several years from now. The recruitment of engineers is aimed at improving services. The increase of engineers will not be reflected in sales immediately like the dispatch of engineers, so it will be an upfront investment for a while. In the first half, depreciation augmented about 300 million yen year on year and personnel cost increased about 150 million yen year on year, and then operating income dropped 20 million yen year on year. President Tanaka thinks, "It is important to increase the sales rather than curtailing investment." The company is recruiting workers while curbing costs by increasing the referral-based recruitment, etc., and striving to make the working environment comfortable and make employees' jobs meaningful. Thanks to them, turnover rate decreased to 1-2%, indicating the improvement in efficiency of personnel investment.

In addition, the company will enhance group management. In the first half, the performance of SAKURA Internet was healthy due to the increase of VPS and cloud services and transactions with public offices, but subsidiaries incurred an operating loss of about 80 million yen, due to the cancellation of large-scale transactions, etc. (In the same period of the previous year, they earned a profit of about 35 million yen). The company has put importance on autonomy, but plans to bolster its business with support, including the dispatch of personnel.

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