



President Kunihiro Tanaka

Sakura Internet Inc. (3778)



Company Information

Market	TSE 1st Section
Industry	Information, Telecommunication
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Year-end	March
Website	http://www.sakura.ad.jp/

Stock Information

Share Price	Number of shares issued (excluding treasury shares)		Total market cap	ROE Act.	Trading Unit
¥538	36,480,056 shares		¥19,626 million	1.2%	100 shares
DPS Est.	Dividend yield Est.	EPS Est.	PER Est.	BPS Act.	PBR Act.
¥2.50	0.5%	¥5.48	98.2 x	¥199.06	2.7 x

*The share price is the closing price on April 26, 2019.

Earnings Trend

Fiscal Year	Sales	Operating Income	Ordinary Income	Net profit attributed to parent company shareholders	EPS	DPS
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 Act.	19,501	567	395	91	2.44	2.50
March 2020 Est.	22,900	720	480	200	5.48	2.50

*Estimates are provided by the company. Units: ¥mn, ¥.

This Bridge Report presents Sakura Internet's earning results for the fiscal year March 2019, along with estimates for fiscal year March 2020.

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Key Points

- The sales for the fiscal year March 2019 rose 14.5% year on year, and operating income fell 24.0% year on year. While VPS and Cloud grew 15.0% year on year, subsidiaries and projects involving government satellite data contributed. However, gross profit margin decreased due to a rise in project costs for government satellite data, depreciation expenses, and lease fees, and an increase of engineers. Upfront investment such as investment into data centers, hiring in-house system development engineers, and increasing sales staff was a burden.
- The sales for the fiscal year March 2020 are forecast to increase 17.4% year on year, with operating income rising 26.9%. The large-scale transactions seized in FY 3/19 will contribute to sales for the full fiscal year, and sales of VPS and Cloud will remain on a rising trend. Although depreciation and lease expenses will increase due to additional equipment replacements made in order to strengthen competitiveness, and personnel expenses will augment because of hiring done in the previous term, these will be offset by the growth in sales.
- Sakura Internet intends to strengthen management for investments while increasing sales. As the company's business has a large amount of fixed costs, the company operated business while raising sales as a top priority. However, it seems that there was also an excessive amount of investment taking place in the name of upfront investment, therefore the company strengthened management for investments in the second half of FY 3/19. As a result, sales were in line with the revised forecast, and operating income significantly exceeded the revised forecast. Sakura Internet will also work to improve customer satisfaction and raise the standard for main services by curbing cancellations.

1. Company Overview

Sakura Internet operates data centers located in Tokyo (Nishi Shinjuku, Higashi Shinjuku and Daikanyama, 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. Sakura Internet owns its own infrastructure, allowing them to pursue higher profitability and utilization of this infrastructure for their housing services allows for reduced risk of fixed costs through the ability to increase utilization rates.

Business Description

Sakura Internet's business is divided into housing, hosting (Dedicated servers, rental servers, VPS, and cloud), domain and SSL acquisition (Certification for unique domain acquisition outsourcing), and others including subsidiary business. The composition ratio of sales of fiscal year March 2019 is 13.6%, 64.5% (of which exclusive servers, rental servers and VPS Cloud accounting for 20.5%, 16.8% and 27.2% respectively), and 21.9%.

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 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’). Physical servers can be utilized just like the cloud, but the performance and security are far superior to those of the normal cloud with the use of virtualization technologies. While burdens associated with the specialized knowledge required for server maintenance and other tasks arise, the ability to establish the customers’ own servers, unlimited restrictions on software installation, and other features allow for great flexibility compared to rental server services.

After applying to this service, the servers will be available in 10 minutes at the fastest, and you can use some of them at once since the number of them is unlimited. 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 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.)

2. Fiscal Year ended March 2019 Earnings Results

Unit: million yen	FY 3/ 18	Ratio to sales	FY 3/ 19	Ratio to sales	YoY	3Q Revised forecasts	Difference from the forecast
Sales	17,033	100.0%	19,501	100.0%	+14.5%	19,400	+0.5%
Gross profit	4,818	28.3%	5,345	27.4%	+10.9%	5,192	+2.9%
SG&A	4,072	23.9%	4,778	24.5%	+17.3%	4,782	-0.1%
Operating Income	745	4.4%	567	2.9%	-24.0%	410	+38.3%
Ordinary Income	574	3.4%	395	2.0%	-31.1%	220	+79.9%
Net profit attributed to parent company shareholders	349	2.1%	91	0.5%	-73.8%	60	+52.7%

Sales rose 14.5% and operating income fell 24.0% year on year

Sales were 19,501 million yen, up 14.5% year on year. The sales of VPS and Cloud continued to increase, rising 15.0% year on year. Other sales grew 44.9% year on year due to sales having been posted for government satellite data projects, and also due to the contribution of Bitstar Inc., which became a consolidated subsidiary in the second quarter of the previous term. Sales of dedicated servers, rental servers, and housings (which were boosted by equipment sales) also increased.

Operating income was 567 million yen, down 24.0% year on year. Despite the decrease in rent expenses after consolidating data centers, the cost of sales rose 1,941 million yen to 14,155 million yen due to cost increases for government satellite data projects (885 million yen), depreciation and leasing expenses accompanying the operation of Ishikari Data Center Building No. 3, increased floor space, and investments in server and network equipment (533 million yen), and a rise in personnel costs due to employing more engineers (264 million yen). SG&A expenses also increased by 705 million yen due to a 321 million yen rise in personnel expenses resulting from the employment of additional systems development engineers within the company and more sales staff at subsidiaries, and a 62 million yen increase in amortization of goodwill. The number of employees at the end of the term was 652, an increase of 89 employees over the end of the previous term. Out of the 89 employees, 60 were employed at Sakura Internet, and were mainly engineers and sales staff. The remaining 29 were employed at various subsidiaries.

Sakura Internet recorded 311 million yen as extraordinary income, mainly due to government subsidies. An extraordinary loss of 383 million yen was also recorded, including a 265 million yen loss on the reduction of fixed assets and a 103 million yen loss on valuation of investment securities. As a result, extraordinary income/loss declined. Profit attributable to owners of the parent company decreased by 73.8% to 91 million yen due to tax effect accounting.

Reasons for differences from the revised forecast

Depreciation, leasing fees, personnel expenses, and advertising expenses fell short of estimates due to the timing of investment into service equipment replacements and determining the time period for these policies.

3. Fiscal Year ending March 2020 Earnings Forecasts

Unit: million yen	FY 3/19 Act.	Ratio to sales	FY 3/20 Est.	Ratio to sales	YoY
Sales	19,501	100.0%	22,900	100.0%	+17.4%
Gross profit	5,345	27.4%	5,965	26.1%	+11.6%
SG&A	4,778	24.5%	5,245	22.9%	+9.8%
Operating Income	567	2.9%	720	3.1%	+26.9%
Ordinary Income	395	2.0%	480	2.1%	+21.3%
Net profit attributed to parent company shareholders	91	0.5%	200	0.9%	+118.2%

Sales and operating income estimated to rise 17.4% and 26.9% year on year, respectively.

Sales are projected to increase 17.4% year on year to 22.9 billion yen. Despite a slight downward trend in housing sales, the sales of dedicated servers are estimated to grow 33.6% year on year, driven by Koukaryoku (high firepower) computing (which is expected to grow from approximately 900 million yen to 2 billion yen). Other sales are estimated to grow 35.8% year on year, as sales of government satellite data projects (about 1 billion yen) are projected to continue, and subsidiary companies will contribute. In addition, VPS and Cloud sales are projected to augment 10.3%, thanks to continuous service improvements and strengthening business ties with partners, and rental server sales are expected to increase 7.2% year on year as a result of the company strengthening their approach to customers (taking measures to improve customer satisfaction) by continuing service improvement and calculating a “customer health score” which quantifies a customer’s likelihood of continuing to use the service or not.

Operating income is forecast to be 720 million yen, up 26.9% year on year. The cost of sales is projected to augment 2,778 million yen, consisting mainly of depreciation and leasing expenses (up 1,107 million yen), material costs for machinery parts (up 1,020 million yen), and engineer labor costs (up 449 million yen). SG&A expenses are forecast to rise 467 million yen mainly due to a 250 million yen increase in personnel expenses. However, these expenses will be offset by an estimated 3,398 million yen growth in sales.

The company will allocate 6.3 billion yen to capital investment, including 1.5 billion yen towards data centers and 4.6 billion yen towards server and network equipment. The company group plans to hire 60 new employees (20 at Sakura Internet, 9 at Gehim, 24 at Bitstar, and 7 at Prunus).

The year-end dividend is to be 2.5 yen/share. The estimated payout ratio is 45.6%.

4. Growth strategy

[The Vision of Sakura Internet and the Company Group]

The “first platform” was centered around mainframes, and the “second platform” on servers, clients and the internet. We are now entering the age of the “third platform,” which involves the cloud, social networking, big data, and mobility. At IDC Japan, this process where companies create new value and establish a competitive advantage by using the “third platform” technology is defined as digital transformation (DX). FinTech (IT + finance), automatic driving (IT + cars), remote medical care (IT + medical care), and smart agriculture (IT + agriculture) are all examples of new value creation. In the future, it is expected that efforts to create new value will be made using the “third platform” technology.

In the DX era, data resources will become more important. Data resources are collected and analyzed to provide information, and information is used for decision making and action. As such, the ability to handle data becomes a measure of market dominance. Sakura Internet aims to become a platform that supports the DX era by providing the cloud platforms, IoT platforms, data platforms, and IT solutions necessary for collecting and analyzing data resources.

Efforts in FY 3/20

The basic policy will continue, with an emphasis on “business activities in growing fields” and “focused investment into growing fields.”

The market for data centers is expected to continue growing as cloud usage will increase. According to IDC Japan’s “2017-2022 Sales Forecast for the Domestic Data Center Service Market by Type of Business Operator,” the data center market is expected to grow 23.1% annually between 2017 and 2022, rising from 244 billion yen in 2017 to nearly 690 billion yen in 2022.

Business activities in growing fields

Sakura Internet will utilize alliances as they strive to improve functionality and ease of use in order to support the continued use of hosting and cloud services. As for efforts in individual fields, they will continue to focus on supporting and promoting usage by customers in the IoT field, and acquire public and technical venture projects together with group companies in the AI field. In the data distribution field, the industrial use of satellite data and awareness of the data distribution market will be jointly promoted by the government and private organizations. The satellite data platform “Tellus” began operation in February, and the number of account registrations had risen to over 7,000 in just one month after its launch.

Focused investment into growing fields

Sakura Internet will work to improve customer satisfaction and strengthen start-up support. In order to improve customer satisfaction, they will fully utilize the Group's resources to deliver new value to customers. Specific measures include strengthening customer support based on analysis of data on customers’ behavior, and fulfilling customers’ wishes using the company’s know-how and technology. The company intends to review the structure of sales and development which are not tied to services. They will strengthen employee training, improve the ability to handle large-scale projects at the Ishikari Data Center, and acquire projects that take advantage of immediate stress. They will also enhance start-up support by promoting collaboration within the Group and with allied companies, and through restructuring.

5. Conclusions

Sales in FY 3/19 were 900 million yen lower than the initial estimate of 20.4 billion yen. Operating income was also slightly more than 600 million yen lower than the initial estimate of 1.2 billion yen. Sales did not reach initial estimates because initial payments for Koukaryoku (high firepower) computing projects were not recorded as sales due to misunderstandings, while at the same time efforts were made towards active recruitment, which was carried out as planned, focusing on engineers, sales promotion staff, and standardized goods.

A focus on improving customer satisfaction

The projects that were not recorded as sales due to misunderstandings are expected to contribute to earnings in FY 3/20. Sakura Internet once again plans to strengthen their sales, focusing on rental servers, VPS, and cloud. Specifically, in addition to increasing sales, they will focus on improving customer satisfaction and preventing contract cancellations. As part of this, they altered their sales structure last November. Many cancellations tend to occur within one year of signing the contract, and although there is also a free 3-month trial period that is offered by the company, there are cases where the trial period ends but does not result in a contract. Through surveys, the company has learned that the reason for early cancellation or leaving after the trial period is that the services could not be fully utilized. Based on this feedback, Sakura Internet revised their support system with customer satisfaction in mind. The introduction of the “customer health score” is part of this, and the company will work to ensure customer success (supporting the customer so that they will succeed).

Sakura Internet provides one-stop service from offering computing resources to system design, operation and maintenance

Nowadays, the use of the cloud by governments and government agencies is common, and this provides a unique business opportunity for the company, who has data centers in Japan that operate at a high speed and low cost and is the highest level in Asia. In fact, the company has accumulated the operational results, for instance, Koukaryoku (high firepower) computing (which is optimal for AI and deep learning) has been adopted by the National Research and Development Agency for developing data systems and for applications such as analysis and processing of research papers and research data files. However, in providing this service, the company also received requests for “one-stop service from system design to operation and maintenance” in addition to the large-scale, high-speed computing resources. To meet this demand, they established the wholly-owned subsidiary Prunus Solutions Inc. in April 2018 with the aim of integrating business in the high-performance computing field. In August of the same year, the company also converted IzumoBASE Co., Ltd. into a subsidiary. IzumoBASE is proficient in storage virtualization technology.

In order to be ready for business opportunities, it is essential not only to establish subsidiaries, but to also increase the number of engineers in the company Group, including those at Sakura Internet. For this reason, the company has been actively recruiting engineers. It also becomes necessary to increase sales staff when considering the customer support mentioned above. Although recruiting is difficult these days, fortunately it seems to be going smoothly thanks to the quickly-implemented working style reforms.

Strengthening of management for investments

Sakura Internet intends to strengthen management of costs and figures while increasing sales. The company's business is heavy on fixed costs, but has a high marginal profit rate. For this reason, raising sales has been the company's top priority, but it seems that there was also an excessive amount of investment taking place in the name of upfront investment. Reflecting on this fact, in the second half of FY 3/19, Sakura Internet strengthened investment management by appropriately timing investment into service equipment replacements and determining a time period for these policies. As a result, with regard to the full-year forecast for FY 3/19, depreciation, leasing, personnel, and advertising expenses were below estimates, sales were in line with the revised forecast, and operating income significantly exceeded the revised forecast.

Reference: Regarding Corporate Governance

◎Organization type, and the composition of directors and auditors

Organization type	Company with an audit and supervisory board
Directors	6 directors, including 3 outside ones
Auditors	4 directors, including 3 outside ones

◎Corporate Governance Report (Updated on December 27, 2018)

Basic Policy

Our company has strived with the basic policy about corporate governance: promote the maintenance of business management organizations and enhance efficient and systematic management and internal controls of each department while expanding the company size. There is a greater social responsibility in internet industry than in other industries as communication facilities are released to a large number of invisible customers and its market is the internet users around the world. We consider that the establishment of corporate governance at our company means the management base which enables to fulfill such social responsibilities.

<Reasons for Non-compliance with the Principles of the Corporate Governance Code (Excerpts)>

Principle 5-2: [Formulation and disclosure of management strategies and plans]

When formulating our business strategies and business plans, we have set our goal based on the premise of achieving the Group's goal; that is, a continuous sales growth rate of 10% or more, a gross profit margin of 30% or more, and an ordinary income-to-sales ratio of 10% or more. With regard to disclosing management plans that accurately describe the cost of capital, we will carefully consider how to best communicate information by maintaining an open dialogue with shareholders through financial results briefings and individual meetings.

<Disclosure Based on the Principles of the Corporate Governance Code (Excerpts)>

Principle 4-9: [Criteria regarding the independence of independent outside directors and their qualifications]

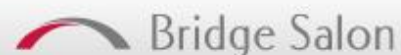
When selecting outside directors, the Company has determined that those who fall under the following criteria are considered to be not independent.

- (1) A person whose main business partner is the Company or a person who executes the business thereof
- (2) Our main business partner or a person who executes the business thereof
- (3) A person who obtained payment of more than 10 million yen from the Company (excluding remuneration for executives) as a legal, accounting, or tax expert or consultant in any of the last three years (In the case that payment is made to a group such as a corporation or association (hereinafter referred to as "group"), any person who belongs to such a group that has obtained more than 2% of consolidated sales from the Company in any of the past three fiscal years)
- (4) A spouse or second-degree relative of the following person, or a relative that is living with the following person:
 - a. A person who meet any condition stated in (1) to (3)
 - b. A director or executive of the Company's subsidiary (limited to notable person)
 - c. A person for whom b. above was true in the last 3 years; or a person who has become a director or executive of the Company in the last 3 years (limited to notable person)
- (5) A major shareholder of the Company or a party performing on their behalf
- (6) In any of the last three years, a person who received a donation of more than 10 million yen from the Company, or a director or other executive of a group who received said donation (limited to notable persons)
- (7) A person who belongs to a group in which one of the members concurrently serves as outside director at another company

Principle 5-1 [Policy regarding constructive dialogue with shareholders]

The Company has established an organization for managing IR, and holds financial results briefings for shareholders and investors at least twice a year. We also create opportunities for dialogue by obliging individual interviews with persons such as the Director and Chief Financial Officer upon request. We have also created a system for sharing the opinions received during these interviews with management on an as-needed basis. As discussions unfold, we consider the topic of the discussion and strictly control insider information.

BRIDGE REPORT



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