



Digital Arts / 2326

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How to read a Shared Research report: This report begins with the trends and outlook section, which discusses the company's most recent earnings. First-time readers should start at the business section later in the report.

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Executive summary

Software company focusing on web security

- Digital Arts develops and markets internet, email, and file security software, focusing on web security to block access to harmful sites. At its establishment in 1995, it developed internet-related application software in a variety of genres, but in September 2004 sold most of its other businesses to focus on filtering software. Since then, the company has concentrated on developing and marketing security-related software.
- Main products are i-FILTER® (filtering software, roughly 75% of sales) and m-FILTER® (email security, almost 20% of sales). The company's core product, i-FILTER®, has roughly 53% of the domestic web filtering software market in the enterprise and public sectors (in 2016, according to a study by ITR). Digital Arts attributes this to its database of harmful websites, the most extensive one within the Japanese-language environment, finely tuned over time. Further, m-FILTER® has roughly 51% of the email filtering and archiving software market (in 2016, according to a study by MIC Research Institute Ltd.). In 2012, the company launched FinalCode®, file encryption software independent of the language environment (having approximately 78% of the market (2016 according to a study by ITR), which it also plans to sell overseas.
- Most of its customers are in the enterprise (59% in FY03/18) and public (34%) sectors. Sales are primarily via over 20 agents, with the top three distributors accounting for 70–80% of sales.

Trends and outlook

- From FY03/06 through FY03/18, consolidated sales and operating profit grew on average at around 11% and 13% per year, respectively. While the company does not release a long-term plan, it wants to grow sales to JPY10bn (2.9x the FY03/15 figure) as soon as possible, driven both by i-FILTER®, m-FILTER® and the new product, FinalCode®. In the first two products the company anticipates annual sales growth of around 15%, thanks to increasing demand for security.
- The company released i-FILTER® Ver.10 and m-FILTER® Ver.5 on September 19, 2017. With these products, customers can strengthen their security against data leaks and malware attacks from both the internet and email, and also reduce the costs of educating employees about security and creating multi-level security systems. The company was able to fulfil its aim to expand its business area by providing security against targeted outside attacks (Outside Security) in addition to its core competency of preventing internal information leaks (Inside Security). The company said that this reflected its decision to make upgrades to i-FILTER® Ver.10 and m-FILTER® Ver.5 for customers of i-FILTER® Ver.9 and m-FILTER® Ver.4 free of charge until the end of September 2022. The company aimed to get a positive customer response to its free upgrades and use it in cross-selling and new customer acquisition from 2H onward.
- For FY03/18, Digital Arts reported sales of JPY5.1bn (+1.2% YoY), operating profit of JPY1.9bn (+4.3% YoY), recurring profit of JPY1.9bn (+5.4% YoY), and net income attributable to parent company shareholders of JPY1.3bn (+13.9% YoY). Sales growth in the enterprise sector covered the absence of extraordinary demand from local governments and major government contracts won in FY03/17. As a result, sales rose YoY. Operating profit rose YoY due mainly to higher sales and the effects of controls on personnel costs as organizational structure and human resources strategy were reviewed targeting medium- and long-term growth, and resources were allocated more optimally.
- For FY03/19, Digital Arts forecasts sales of JPY5.8bn (+13.3% YoY), operating profit of JPY2.6bn (+36.6% YoY), recurring profit of JPY2.6bn (+36.2% YoY), and net income attributable to parent company shareholders of JPY2.0bn (+56.0% YoY). The company plans to increase the annual dividend per share to JPY36 (from JPY28 in FY03/17).

Strengths and weaknesses

Shared Research considers Digital Arts' strengths to be swift support capabilities, an extensive database of harmful websites tailored to the Japanese-language environment, and stable recurring sales underpinned by high renewal rates. Weaknesses: lack of scale which limits the ability to respond to an increasingly complex cybercrime environment, a business model dependent on the domestic market, and having core products in a maturing market.

Key financial data

Income statement (JPY mn)	FY03/06	FY03/07	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18	FY03/19
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Est.
Total sales	1,389	1,387	1,701	1,853	2,191	2,308	2,708	2,907	3,027	3,403	4,001	5,059	5,117	5,800
YoY	-	-0.1%	22.6%	8.9%	18.2%	5.4%	17.3%	7.3%	4.1%	12.4%	17.6%	26.4%	1.2%	13.3%
Gross profit	1,070	1,071	1,343	1,465	1,753	1,845	2,059	2,174	2,149	2,428	3,075	4,052	4,042	
YoY	-	0.1%	25.4%	9.1%	19.7%	5.2%	11.6%	5.6%	-1.1%	13.0%	26.6%	31.8%	-0.2%	-
GPM	77.0%	77.2%	79.0%	79.1%	80.0%	79.9%	76.0%	74.8%	71.0%	71.4%	76.9%	80.1%	79.0%	
Operating profit	430	346	623	629	711	686	587	737	653	865	1,007	1,824	1,903	2,600
YoY	-	-19.5%	80.0%	1.1%	12.9%	-3.5%	-14.4%	25.5%	-11.4%	32.5%	16.4%	81.2%	4.3%	36.6%
OPM	30.9%	24.9%	36.6%	34.0%	32.5%	29.7%	21.7%	25.3%	21.6%	25.4%	25.2%	36.1%	37.2%	44.8%
Recurring profit	418	343	623	633	714	687	566	726	660	910	994	1,811	1,909	2,600
YoY	-	-18.0%	81.6%	1.6%	12.8%	-3.8%	-17.6%	28.3%	-9.1%	37.9%	9.2%	82.2%	5.4%	36.2%
RPM	30.1%	24.7%	36.6%	34.2%	32.6%	29.8%	20.9%	25.0%	21.8%	26.8%	24.9%	35.8%	37.3%	44.8%
Net income	208	175	350	351	371	390	310	444	400	531	546	1,125	1,282	2,000
YoY	-	-15.6%	99.7%	0.3%	5.6%	5.2%	-20.4%	43.2%	-10.1%	33.0%	2.8%	106.1%	13.9%	56.0%
Net margin	14.9%	12.6%	20.6%	18.9%	16.9%	16.9%	11.5%	15.3%	13.2%	15.6%	13.6%	22.2%	25.1%	34.5%
Per share data (JPY, adjusted for splits)														
Shares issued (year end; '000)	13,658.40	13,769.70	13,846.10	13,858.20	13,861.00	13,987.20	13,992.60	14,133.00	14,133.00	14,133.00	14,133.00	14,133.00	14,133.00	
EPS	15	12.76	25.33	25.32	26.75	28.51	22.68	32.17	28.81	38.27	39.26	80.92	92.46	143.91
EPS (fully diluted)	15	12.50	24.87	24.94	26.40	28.26	22.56	32.15	28.74	38.19	39.14	80.68	92.13	
Dividend per share	0.00	-	-	2.72	4.00	4.50	6.00	8.00	8.00	14.00	15.00	24.00	28.00	36.00
Book value per share	103.28	116.96	142.80	168.19	191.34	208.13	226.32	249.48	272.98	303.40	329.03	375.07	446.43	
Balance sheet (JPYmn)														
Cash and cash equivalents	738	650	1,215	1,342	1,529	1,737	1,905	2,070	2,156	2,674	2,943	3,899	4,426	
Total current assets	1,343	1,312	1,828	2,104	2,724	2,883	2,832	3,104	3,498	4,078	4,263	5,375	5,766	
Tangible fixed assets	53	63	53	61	60	85	150	127	127	145	127	125	157	
Investments and other assets	72	73	70	189	97	111	506	548	360	590	748	724	720	
Intangible fixed assets	430	451	428	404	373	471	613	784	888	936	996	1,156	1,286	
Total assets	1,898	1,898	2,379	2,758	3,254	3,551	4,101	4,563	4,873	5,749	6,134	7,381	7,929	
Short-term debt	85	107	25	0	0	0	0	0	0	0	0	0	0	
Total current liabilities	406	284	402	413	562	599	858	962	954	1,409	1,448	2,066	1,636	
Long-term debt	82	-	0	0	0	0	0	0	0	0	0	0	0	
Total fixed liabilities	82	4	0	0	0	15	30	32	42	43	44	45	45	
Total liabilities	488	288	402	413	562	614	889	995	997	1,451	1,492	2,111	1,681	
Net assets	1,411	1,611	1,977	2,345	2,692	2,936	3,213	3,568	3,876	4,298	4,642	5,270	6,248	
Total interest-bearing debt	167	107	25	0	0	0	0	0	0	0	0	0	0	
Cash flow statement (JPYmn)														
Cash flows from operating activities	424	171	828	685	601	751	848	821	817	1,355	1,027	2,012	1,663	
Cash flows from investing activities	-305	-327	-394	-535	-456	-56	-899	-558	-646	-848	-441	-672	-775	
Cash flows from financing activities	84	-33	-69	-23	-58	-185	-80	-97	-85	-120	-188	-503	-293	
Financial ratios														
ROA (RP-based)	25.4%	18.1%	29.1%	24.6%	23.8%	20.2%	14.8%	16.8%	14.0%	17.1%	16.7%	26.8%	24.9%	
ROE	17.1%	11.6%	19.5%	16.3%	14.9%	14.2%	10.4%	13.6%	11.0%	13.3%	12.4%	23.0%	22.5%	
Equity ratio	74.3%	84.8%	83.1%	84.5%	81.2%	80.1%	75.5%	75.6%	77.8%	73.3%	74.7%	70.2%	78.2%	

Source: Shared Research based on company data

Note: Figures may differ from company data due to differences in rounding methods.

Note: No YoY comparisons are shown for FY03/06, as this was the company's first year of reporting consolidated results.

Note: In FY03/08, the company changed its method of recording sales. Before the change, full contract amounts were recorded as sales when contracts were signed.

Under the new method, the company records the portion of sales corresponding to maintenance and support as advances received, transferring the advances to sales by month over the contract period, beginning the month after the contract is concluded. The company still records the software portion of sales as before, as a lump sum at contract signing. This change reduced sales levels by 3.1% in FY03/08. The downward effect in FY03/09 was 8.0%.

Recent updates

Highlights

On **January 31, 2019**, Digital Arts Inc. announced earnings results for Q3 FY03/19 (see the results section for details).

On **November 21, 2018**, Shared Research updated the report following interviews with the company.

On **October 30, 2018**, the company announced earnings results for 1H FY03/19 and revisions to FY03/19 forecasts.

For previous releases and developments, please refer to the News and topics section.

Trends and outlook

Quarterly trends and results

Quarterly earnings (JPYmn)	FY03/17				FY03/18				FY03/19				Q4	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Sales	917	1,503	1,098	1,541	1,158	1,310	1,083	1,566	1,218	1,546	1,403			
YoY	14.1%	32.8%	35.2%	22.9%	26.3%	-12.9%	-1.4%	1.6%	5.2%	18.0%	29.5%			
Gross profit	676	1,247	854	1,275	926	1,075	777	1,264	928	1,310	1,120			
YoY	14.2%	37.9%	44.7%	29.0%	36.9%	-13.8%	-9.0%	-0.8%	0.2%	21.8%	44.2%			
GPM	73.7%	82.9%	77.7%	82.8%	79.9%	82.1%	71.7%	80.8%	76.2%	84.7%	79.8%			
SG&A expenses	577	556	498	596	569	509	534	526	632	569	482			
YoY	13.0%	13.8%	3.4%	1.6%	-1.3%	-8.4%	7.1%	-11.7%	11.1%	11.8%	-9.7%			
SG&A ratio	62.9%	37.0%	45.4%	38.7%	49.1%	38.9%	49.3%	33.6%	51.9%	36.8%	34.4%			
Operating profit	99	691	355	679	357	566	243	738	295	741	638			
YoY	21.7%	66.2%	229.8%	68.9%	258.9%	-18.1%	-31.7%	8.7%	-17.1%	30.9%	163.0%			
OPM	10.8%	45.9%	32.3%	44.1%	30.8%	43.2%	22.4%	47.1%	24.3%	47.9%	45.5%			
Recurring profit	79	688	367	677	360	572	245	732	295	745	634			
YoY	-8.1%	66.5%	230.7%	76.3%	356.3%	-16.9%	-33.2%	8.1%	-18.2%	30.3%	158.6%			
RPM	8.6%	45.8%	33.4%	43.9%	31.1%	43.7%	22.6%	46.7%	24.2%	48.2%	45.2%			
Net income	14	441	239	431	258	361	159	504	175	817	426			
YoY	-76.4%	71.6%	426.1%	131.9%	1797.9%	-18.2%	-33.5%	16.9%	-32.1%	126.5%	168.0%			
Net margin	1.5%	29.3%	21.8%	28.0%	22.3%	27.5%	14.7%	32.2%	14.4%	52.8%	30.4%			
Cumulative	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	% of FY	FY Est.
Sales	917	2,420	3,518	5,059	1,158	2,468	3,551	5,117	1,218	2,764	4,167		71.8%	5,800
YoY	14.1%	25.0%	28.1%	26.4%	26.3%	2.0%	0.9%	1.2%	5.2%	12.0%	17.3%			13.3%
Gross profit	676	1,923	2,776	4,052	926	2,001	2,777	4,042	928	2,237	3,358		71.4%	4,700
YoY	14.2%	28.5%	33.1%	31.8%	36.9%	4.0%	0.0%	-0.2%	0.2%	11.8%	20.9%			16.3%
GPM	73.7%	79.5%	78.9%	80.1%	79.9%	81.1%	78.2%	79.0%	76.2%	80.9%	80.6%			81.0%
SG&A expenses	577	1,133	1,631	2,227	569	1,078	1,612	2,139	632	1,201	1,683		80.2%	2,100
YoY	13.0%	13.4%	10.1%	7.7%	-1.3%	-4.8%	-1.2%	-4.0%	11.1%	11.4%	-1.8%			-1.8%
SG&A ratio	62.9%	46.8%	46.4%	44.0%	49.1%	43.7%	45.4%	41.8%	51.9%	43.5%	40.4%			36.2%
Operating profit	99	790	1,145	1,824	357	922	1,165	1,903	295	1,036	1,674		64.4%	2,600
YoY	21.7%	58.9%	89.3%	81.2%	258.9%	16.8%	1.7%	4.3%	-17.1%	12.4%	43.7%			36.6%
OPM	10.8%	32.6%	32.5%	36.1%	30.8%	37.4%	32.8%	37.2%	24.3%	37.5%	40.2%			44.8%
Recurring profit	79	767	1,134	1,811	360	932	1,178	1,909	295	1,040	1,674		64.4%	2,600
YoY	-8.1%	53.6%	85.8%	82.2%	356.3%	21.5%	3.8%	5.4%	-18.2%	11.5%	42.2%			36.2%
RPM	8.6%	31.7%	32.2%	35.8%	31.1%	37.8%	33.2%	37.3%	24.2%	37.6%	40.2%			44.8%
Net income	14	455	694	1,125	258	619	778	1,282	175	992	1,419		70.9%	2,000
YoY	-76.4%	44.5%	92.7%	106.1%	1,797.9%	36.1%	12.1%	13.9%	-32.1%	60.4%	82.4%			56.0%
Net margin	1.5%	18.8%	19.7%	22.2%	22.3%	25.1%	21.9%	25.1%	14.4%	35.9%	34.0%			34.5%

Source: Shared Research based on company data

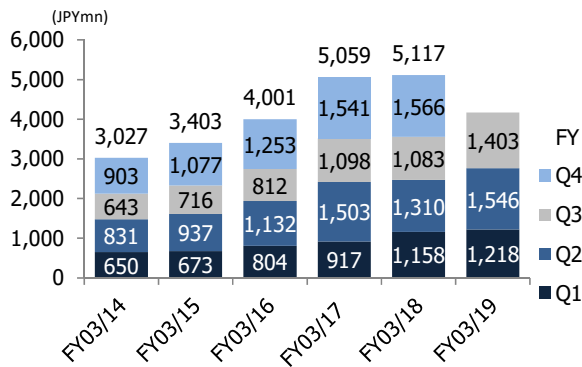
Note: Figures may differ from company data due to differences in rounding methods.

Earnings seasonality: Sales tend to be concentrated in Q4. This seasonality reflects the tendency of private-sector companies and public organizations to place orders for IT products in the run-up to their March fiscal year-ends.

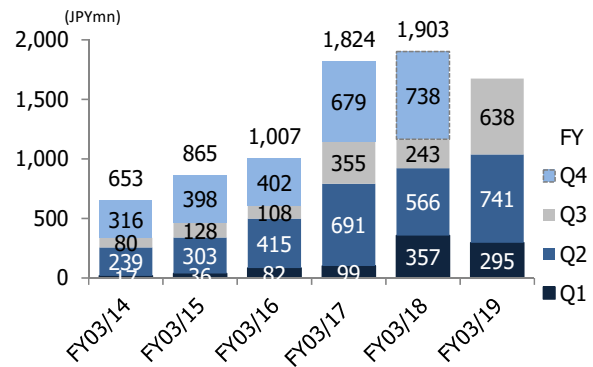
Q3 FY03/19 results

- ▷ For cumulative Q3 FY03/19, Digital Arts reported consolidated sales of JPY4.2bn (+17.3% YoY), operating profit of JPY1.7bn (+43.7% YoY), recurring profit of JPY1.7bn (+42.2% YoY), and net income attributable to parent company shareholders of JPY1.4bn (+82.4% YoY).
- ▷ Factors in the 17.3% YoY increase in sales: Sales increased 5.1% in the enterprise sector, 32.7% in the public sector, and 38.7% in the consumer sector. The company heightened its profile as a comprehensive security solutions company in the public sector and sales to the consumer sector were also strong.
- ▷ Factors in the 43.7% YoY increase in operating profit: While the company incurred restructuring expenses accompanying a review of the group's overseas strategy in 1H, profitability improved as it selectively focused its management resources during group restructuring. The operating profit margin also increased 7.4pp YoY to 40.2% as a result of gross profit margin rising 2.4pp to 80.6% and the SG&A expense ratio declining 5.0pp to 40.4%.
- ▷ Against full-FY03/19 forecasts, Q3 sales reached 71.8% (69.4% of full-FY03/18 results were reached in Q3 FY03/18), operating profit 64.4% (61.2%), recurring profit 64.4% (61.7%), and net income 70.9% (60.7%).

Consolidated sales by quarter



Consolidated operating profit by quarter



Source: Shared Research based on company data

Enterprise sector

Sales in the enterprise sector rose 5.1%YoY to JPY2.1bn. Sales of core m-FILTER® products were strong as the company steadily secured orders, primarily from ongoing projects since FY03/18. Concerning FinalCode®, the company won its largest project in Q3 on a pick-up in business, after a period of temporary weakness, as a result of adding a Browser View function for which demand was strong. Further, the company created new project opportunities with its high-end i-FILTER® Ver.10 and m-FILTER® Ver.5 products, launched in FY03/19, as product awareness increased following aggressive sales promotions. However, as the projects are relatively large in size, project acquisition tends to be concentrated towards the end of the fiscal year. As a result, enterprise sector sales only rose 5.1% YoY.

Public sector

Sales in the public sector grew 32.7% YoY to JPY1.7bn. The company had previously established a strong profile and market share as a provider of security measures against internal information leaks. Leveraging its strong track record and reputation for reliability, the company successfully sold i-FILTER® Ver.10 and m-FILTER® Ver.5, its sophisticated security solutions that prevent not only internal data leakage, but also targeted attacks. Before doing so in the enterprise sector, the company was able to heighten its profile as a comprehensive security solutions company in the public sector.

Consumer sector

Sales in the consumer sector rose 38.7% YoY to JPY377mn. In the consumer sector, Digital Arts worked together with mobile operators, MVNO operators, and other partner companies to expand sales of i-FILTER® Multi-Device, which can be used on multiple operating systems (Windows, iOS, and Android™) with a single serial ID number. It also introduced content filters in response to increasing smartphone use amongst children. In addition, direct sales of multi-year package products and i-FILTER® Multi-Device, which can be used on multiple devices, held up well. Due to the above, sales increased considerably in the consumer sector.

For historical performance, see the Historical performance and financial statements sections.

Full-year company plan

(JPYmn)	FY03/17			FY03/18			FY03/19		
	1H Act.	2H Act.	FY Act.	1H Act.	2H Act.	FY Act.	1H Act.	2H Est.	FY Est.
Sales	2,420	2,639	5,059	2,468	2,649	5,117	2,800	3,000	5,800
YoY	25.0%	27.8%	26.4%	2.0%	0.4%	1.2%	13.4%	13.3%	13.3%
Cost of sales	497	510	1,007	468	608	1,075	527	573	1,100
Gross profit	1,923	2,129	4,052	2,001	2,041	4,042	2,237	2,463	4,700
YoY	28.5%	34.9%	31.8%	4.0%	-4.1%	-0.2%	11.8%	20.7%	16.3%
GPM	79.5%	80.7%	80.1%	81.1%	77.0%	79.0%	79.9%	82.1%	81.0%
SG&A expenses	1,133	1,095	2,227	1,078	1,060	2,139	1,201	1,063	2,100
SG&A ratio	46.8%	41.5%	44.0%	43.7%	40.0%	41.8%	42.9%	35.4%	36.2%
Operating profit	790	1,034	1,824	922	981	1,903	1,200	1,400	2,600
YoY	58.9%	102.9%	81.2%	16.8%	-5.2%	4.3%	30.1%	42.8%	36.6%
OPM	32.6%	39.2%	36.1%	37.4%	37.0%	37.2%	42.9%	46.7%	44.8%
Recurring profit	767	1,044	1,811	932	977	1,909	1,200	1,400	2,600
YoY	53.6%	111.0%	82.2%	21.5%	-6.4%	5.4%	28.7%	43.3%	36.2%
RPM	31.7%	39.6%	35.8%	37.8%	36.9%	37.3%	42.9%	46.7%	44.8%
Net income	455	670	1,125	619	663	1,282	777	1,223	2,000
YoY	44.5%	189.8%	106.1%	36.1%	-1.1%	13.9%	25.6%	84.4%	56.0%

Source: Shared Research based on company data

Note: Figures may differ from company data due to differences in rounding methods.

Full-year forecast for FY03/19

The company revised up its full-year FY03/19 forecasts* at the time of 1H earnings announcement on October 30, 2018.

*Revised FY03/19 full-year forecasts

Sales:	JPY5.8bn (previous forecast: JPY5.8bn)
Operating profit:	JPY2.6bn (JPY2.5bn)
Recurring profit:	JPY2.6bn (JPY2.5bn)
Net income:	JPY2.0bn (JPY1.6bn)

Reason for revision

Digital Arts identified readily achievable cost-saving benefits of JPY100mn from a review of its medium-term product strategy and sales strategy and the results of group restructuring, which it incorporated into its budgets.

The company had limited its activities to FinalCode in the overseas markets, but going forward it plans to roll out the Digital Arts brand globally as a comprehensive security measure provider, in a similar manner to the domestic Japanese market. As part of these plans, it will liquidate its North American subsidiary FinalCode, Inc. and continue business in that market through Digital Arts America, Inc. In the Asia-Pacific, the company will conduct business as Digital Arts Asia Pacific Pte. Ltd. (changing its name from FinalCode Asia Pacific Pte. Ltd.). In Europe, it will conduct business as Digital Arts Europe Ltd. (changing its name from FinalCode Europe Limited).

Digital Arts expects consolidated SG&A expenses to decline as it selectively focuses its management resources accompanying group restructuring. It has thus incorporated JPY100mn in highly achievable cost-saving benefits into its budgets and revised its profit forecasts. Although the market environment is improving, the company said it has kept conservative sales and dividend forecasts.

Summary

For FY03/19, Digital Arts forecasts sales of JPY5.8bn (+13.3% YoY), operating profit of JPY2.6bn (+36.6% YoY), recurring profit of JPY2.6bn (+36.2% YoY), and net income attributable to parent company shareholders of JPY2.0bn (+56.0% YoY). The company plans to increase the annual dividend per share to JPY36 (from JPY28 in FY03/17). The company also expects organic growth (increased sales from renewals and new customer acquisition) to continue. It also expects more consulting projects at subsidiary Digital Arts Consulting and higher profitability of overseas business will contribute to higher profit.

Initiatives

In the enterprise and public sectors, the company plans to make efforts to offer high-precision security environments, enhancing products and adding functionality, while continuing to expanding sales of i-FILTER® Ver. 10 and m-FILTER® Ver. 5. Using a function of i-FILTER® Ver. 10, from January 25, 2018, the company has been providing the D Alert: Cyber Risk Information Provision Service (D Alert), which provides infection information and homepage tampering information. The information is

provided free of charge, not only to users of Digital Arts software who may be affected by a malware infection but also to users of other software.

Further, against the backdrop of the cloud's rapid expansion for web-services and e-mail environments, the company commenced its i-FILTER® Ver.10 and m-FILTER® Ver.5 cloud services on May 9, 2018. They will allow users to browse the web securely and open emails without hesitation, even in a cloud environment. As well as moving large-scale enterprise web-services and email environments onto the cloud, the company is targeting small-scale enterprises which are too small in scale for on-premises servers and who would like to use the services easily through the cloud.

The company also plans to introduce functions to FinalCode® for which there is high demand among existing users and prospective customers*, and expand the number of users and sales.

*These extended functions will allow messages to be sent to those without a viewer by providing a browser view, which recipients can read on the web, without downloading client software. To this point, when a FinalCode® user sent a message to a non-user, the recipient had to install a viewer to see the message. Many companies restrict software downloads, which was a factor obstructing the spread of FinalCode®.

Additionally, because it is anticipated that demand for the company's products will increase in response to government-driven plans to equip public elementary, junior high, and high schools with Wi-Fi, the company wants to make steady progress in winning new projects in this area. In the consumer sector, the company will continue to collaborate with MVNO operators to expand sales of i-FILTER® for smartphones, and promote further collaboration.

Digital Arts aims to become a comprehensive security solutions company. It aims to first develop higher-quality products in the domestic market by integrating new concepts into its existing product lineup. The company had previously established a strong name recognition and market share in the field of security measures against internal information leaks. The Digital Arts group and distributors are working as one to conduct sales promotion activities. The result is that sales are accelerating as customers appreciate the new worldview and solutions that the company offers and it has a rising profile as a comprehensive security solutions provider in the domestic market.

The company had limited its activities to FinalCode in the overseas markets, but going forward it plans to roll out the Digital Arts brand globally as a comprehensive security measure provider, in a similar manner to the domestic Japanese market. As part of these plans, it will liquidate its North American subsidiary FinalCode, Inc. and continue business in that market through Digital Arts America, Inc. In the Asia-Pacific, the company will conduct business as Digital Arts Asia Pacific Pte. Ltd. (changing its name from FinalCode Asia Pacific Pte. Ltd.), and in Europe, as Digital Arts Europe Ltd. (changing its name from FinalCode Europe Limited).

Strategy

Sales target of JPY10bn through accelerating growth of existing products, expanding key product sales

The security industry faces increasingly advanced and complex risks. These stem from cyberattacks targeting specific companies and national institutions, and information leaks by people inside organizations. Recent incidents include the 2014 case of an employee at Benesse Corporation taking a large volume of customer data outside the office, and the incident in 2015, when an employee of Japan Pension Service opened a virus-laced email that caused a large volume of pension information to be leaked. Companies and organizations are seeing that it is insufficient to focus solely on attacks from outside the organization, as they are also susceptible to information leaks from within. The increased interest in internal information security solutions (the focus of Digital Arts since its founding) is driving demand for the company's core products, i-FILTER® and m-FILTER®, as well as FinalCode®.

Digital Arts does not release a medium-term plan. However, it says that the growing demand for security solutions has made it raise its projections for annual sales growth in the domestic market from 10% to around 15%. To address increasingly complex security needs, the company is working on tie-ups with other companies. Through such partnerships and boosted sales of FinalCode®, the company targets sales of JPY10.0bn (2.9x the FY03/15 level).

Digital Arts plans on full-scale global expansion from FY03/16. It anticipates major growth in the global market for data loss prevention (DLP) services. In preparation for global expansion, Digital Arts has acquired patents related to FinalCode® in key markets including the US. In FY03/15, it set up a US subsidiary FinalCode, Inc., whose sales team has connections and experience in the security industry. Using this base, the company plans to enter the North American market in FY03/16. It is also investing in its system to quickly expand global sales. Digital Arts expects existing businesses to keep growing steadily, and intends to use global operations as a springboard for growth.

With the release of the new versions of i-FILTER® Ver.10 and m-FILTER® Ver.5 in September 2017, the company is expanding its business area by providing security against targeted outside attacks (Outside Security) in addition to its existing competency of preventing internal information leaks (Inside Security) (refer to Business for details). i-FILTER® Ver.10 and m-FILTER® Ver.5 version upgrades are being provided for free until the end of September 2022 to i-FILTER® Ver.9 and m-FILTER® Ver.4 users. The company obtains customer evaluations through the free version upgrades, and uses these for cross-selling and new customer acquisition.

In contrast to the JPY10.0bn market for Web filtering which i-FILTER® has been targeting, the market for countermeasures to targeted outside attacks is JPB130.0bn, which means the scale of the company's target markets will expand.

Digital Arts has obtained patents in 27 countries for the data collection technologies used in its mainstay web filtering software. Its medium-term goal is to expand its product lineup and make its products globally accessible. The company aims to become a globally-recognized, Japanese security software provider.

Key alliances

Date	Product	Details
June 6, 2017	i-FILTER®	Collaborated with Allied Telsis, Inc. solution Secure Enterprise SDN, realizing a one-stop solution, from threat detection to diffusion prevention and message blocking
April 25, 2017	i-FILTER®	Worked with OPTiM Corporation's MDM (Mobile Device Management) to provide East Japan Railway Company (JR East) highly secure tablets
November 7, 2016	i-FILTER®	Strengthened alliance with IBM Japan to conduct correlative analysis on targeted attack logs
December 8, 2016	All products	Announced efforts to sell cyberattack insurance as part of an alliance with Tokio Marine & Nichido Fire Insurance Co., Ltd. and JLT Risk Services Japan Limited
June 2, 2016	m-FILTER®	Entered agreement with YASKAWA INFORMATION SYSTEMS Corporation to develop an appliance server with email security function for local governments

May 9, 2016	m-FILTER®	Announced that it will begin offering an option to add the secure file/data transfer appliance File Zen® from SOLITON SYSTEMS K.K.
April 6, 2016	i-FILTER®	Adopted a new style for the filtering database from an alliance option with FireEye Inc. (began June 2016)
March 8, 2016	FinalCode®	Began providing linkage options on the Box cloud service, being rolled out globally
January 29, 2016	FinalCode®	Formed link with JP1, integrated system operations management software from Hitachi, Ltd., for secure transmission of large CAD and video files
January 21, 2016	FinalCode®	Entered tie-up with Mitsubishi Space Software Co., Ltd., and Toshiba Information Systems Corp. (Japan) to provide solutions that automatically locate and encrypt files containing important and confidential information
January 13, 2016	i-FILTER®, m-FILTER®	Commenced product tie-up with Japan Info Net Service, a provider of integrated ID management solutions, to enhance the efficiency of corporate ID management
December 10, 2015	i-FILTER® Browser & Cloud	Formed tie-up with Gluegent, Inc., and Cybertrust Japan Co., Ltd., to augment convenience and offer security measures in the cloud for the enterprise sector
May 12, 2015	m-FILTER®	Entered tie-up with UBIC, Inc., to provide solutions using artificial intelligence to prevent data leaks
October 29, 2014	i-FILTER®	Began providing a linkage option with the NX/CM series of web security products of FireEye, Inc., whose strengths are in products and services for countering cyber threats
May 13, 2014	m-FILTER®	Began collaborating with NRI Secure Technologies, Ltd. (NRI Secure), to develop a service for sending large files over email easily and securely

Source: Shared Research based on company data

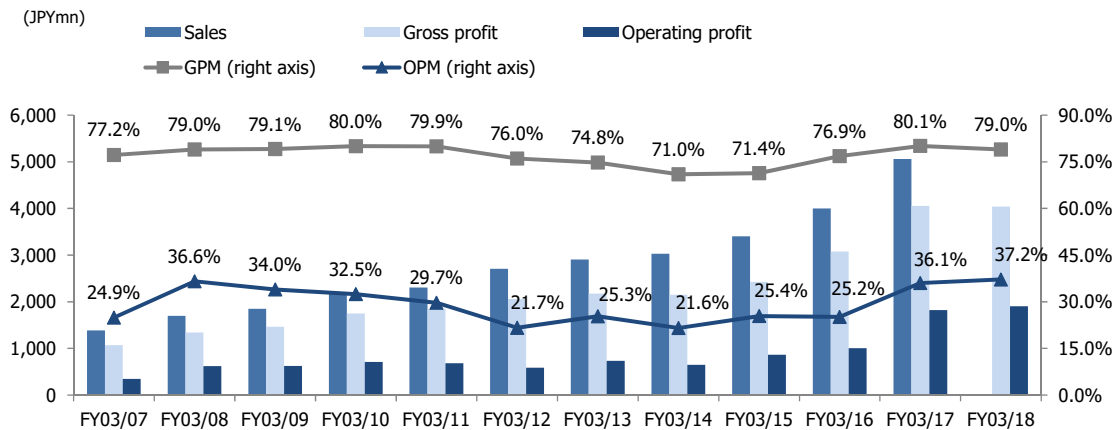
Business

Description

Software developer and marketer focusing on web filtering

Digital Arts, established in 1995, develops and markets internet and email security software, with a focus on web filtering to block access to harmful sites. Its core product, i-FILTER[®], has over 40% of the web filtering software market in the enterprise and public sectors. At the time of its establishment in 1995, the company developed web application software in a range of genres. In September 2004, however, it sold its other businesses to focus on filtering software. Since then, the company has concentrated on developing security software.

Consolidated performance



Source: Shared Research based on company data

Targeting outside security

In FY03/18, the company aimed to expand its business area by providing security against targeted outside attacks (“Outside Security”) in addition to its existing strength of preventing internal information leaks (“Inside Security”). i-FILTER[®] is a web security product, whereas m-FILTER[®] is an email security product with several different functions, from preventing erroneous email transmissions to neutralizing contamination threats. In September 2017, the company released new versions of these two products, with improved functionality to protect client devices against targeted attacks. If customers implement both of the updated versions, m-FILTER[®] Ver.5 and i-FILTER[®] Ver.10, they can strengthen their security against data leaks and malware* attacks from both the internet and email, and also reduce the costs of educating employees about security and creating multi-level security systems. i-FILTER[®] Ver.10 and m-FILTER[®] Ver.5 version upgrades are being provided for free until the end of September 2022 to i-FILTER[®] Ver.9 and m-FILTER[®] Ver.4 users. The company plans to leverage the customer evaluations from the free version upgrades for its cross-selling and new customer acquisition efforts (see below for more detail).

*Malware: a category of malicious software or codes intentionally created to cause damage

Business model

Recurring sales and stable earnings: renewal rate around 90%

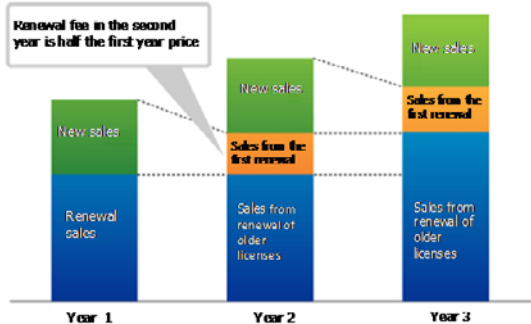
Digital Arts develops web security software such as i-FILTER[®], which it sells to companies, schools, and government agencies through distributors. Most of its contracts are for 250-500 licenses* (number of individuals or computers allowed to use the software). Typical fees for a 500-license contract are roughly JPY3,000 per license per year (in the case of a standard license for i-FILTER[®] Ver.9 standard version).

The company’s business model allows for recurring sales and stable earnings, with renewal rates of around 90%. Web filtering products account for around 75% of its sales, and its pricing strategy helps maintain high renewal rates. To encourage customers

to continue using its software after the first year, Digital Arts offers software renewals at half of the first-year price. According to company research, over five years its products are up to 45% cheaper than similar domestic products (comparison with standard-priced corporate products). A survey of web filtering products by Veriserve Corporation ranks Digital Arts' products as number one in terms of accuracy. The product's quality and the price discounts allow Digital Arts to enjoy a renewal rate of around 90%, resulting in recurring sales and stable earnings.

The method of booking earnings varies between i-FILTER®, m-FILTER®, and FinalCode® as well as between one year contracts and multiple year contracts. For i-FILTER® and m-FILTER®, the software portion of the sales is booked in full (at each contract start for one year contracts). The maintenance support portion (for example, database updating for i-FILTER®) is divided by the number months in the contract and booked as sales each month starting the month after the contract is signed. For FinalCode®, the license fee is booked on a monthly basis.

i-FILTER® sales growth model



Source: Shared Research based on company data

Renewal rate of key products

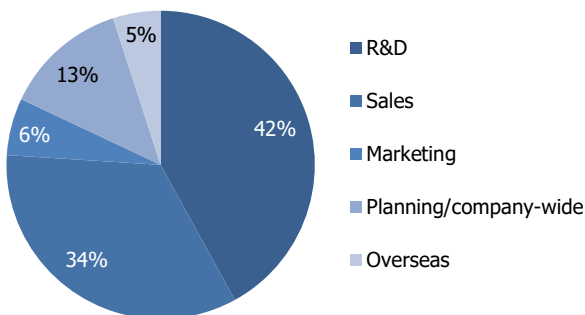
Product	FY03/16 renewal rate
Avg. for all products	94.30%
i-FILTER®	94.10%
m-FILTER®	94.50%
i-FILTER® Browser & Cloud	92.90%

Source: Shared Research based on company data

Almost half of the company's employees work in the development department, which focuses on product development and upgrades. While large overseas security software developers handle products in various genres, Digital Arts specializes in certain product categories. Although small and not as well-known, it leverages its flat and flexible organization to quickly develop products that reflect customers' needs. In-house development allows it to respond to problems and provide support more quickly than large software vendors.

In 2012, Digital Arts launched FinalCode® (file encryption and tracking software), which is independent of the language environment. It plans to sell this product overseas.

Employees, by department (end FY03/15)



Source: Shared Research based on company data

The breakdown of sales by product and customer segment is shown in the following charts. For details, see the following section on product and customer breakdown.

Sales by product

The company has four main products: i-FILTER[®] (web security software), m-FILTER[®] (email security software), D-SPA[®] (proxy server with the company’s filtering function), and FinalCode[®] (file encryption and tracking software). The biggest contributor to sales and profits is i-FILTER[®], followed by m-FILTER[®]. FinalCode[®] makes a small contribution to sales, but the company sees this as a product that will drive future growth.

i-FILTER[®] (web security software)

i-FILTER[®] (web security software) is the company’s core product, accounting for approximately 75% of consolidated sales. Although high, this percentage is declining as Digital Arts expands its product lineup. The enterprise sector is now the biggest market for this product, although it was first sold to schools and other public-sector entities seeking to prevent browsing on harmful websites. The company remarks that although public-sector demand is on the rise, fluctuations in the national budget are affecting sales in the short term. In comparison, sales to the enterprise sector are growing, as customers look to counter malware and other cyberattacks, and prevent browsing on harmful websites.

Product characteristics

i-FILTER[®] is software that prevents data leakage by blocking both unauthorized external access and internal fraudulent activity. The company specializes in filtering software in Japan, and in addition to gathering website data, it also handles the entire process from product planning, development, sales, and support. This enables it to provide support for software upgrades and its web filtering database more quickly than larger software developers overseas.

Leading share of the domestic web filtering market for enterprise and public-sector

The company’s rapid support and highly accurate filtering database are enabling it to steadily expand its customer base. It notes that more than 7,300 companies and government organizations, and more than 31,000 schools and educational facilities across Japan had installed i-FILTER[®] as of March 31, 2017.

According to “ITR Market View: 2017 Market for Cybersecurity Measures,” published by ITR Corporation in November 2017, in 2016 i-FILTER[®] accounted for a leading 53.1% share of the URL filtering (web filtering) market by sales. According to “Education Market 2017” (March 2017), a study by Fuji Chimera Research Institute, Inc., Digital Arts had the top share of sales in the educational sector (40.7% share).

Vendor share of URL filtering market

Company	Market share of i-FILTER [®] (based on sales in FY2016)
Digital Arts	53.1%
Company A	26.6%
Company B	10.0%
Others	10.3%
Total	100.0%

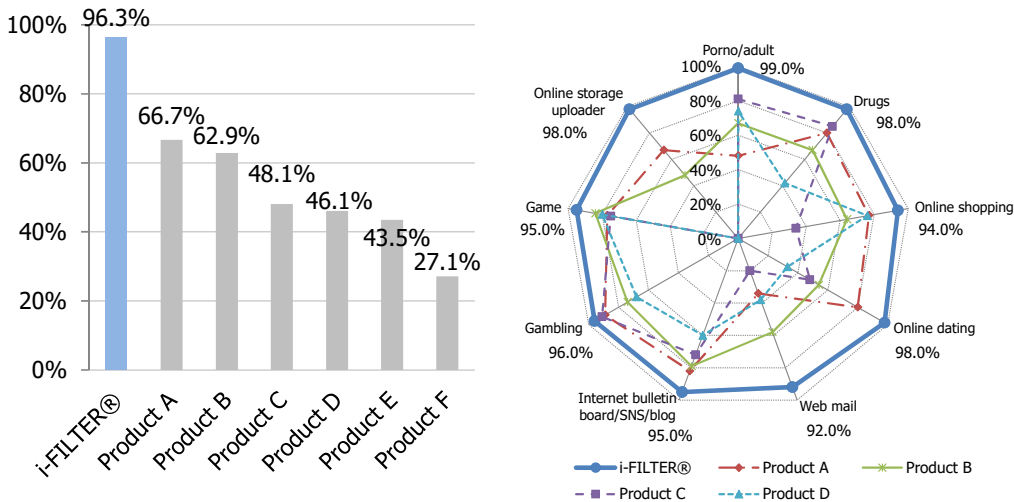
Source: Shared Research based on “ITR Market View: 2017 Market for Cybersecurity Measures,” ITR Corporation

Top web filtering database for accuracy

The company’s high domestic market share stems from its database on harmful websites, which is one of the largest in the Japanese-language environment. The prototype for i-FILTER[®] was Japan’s first web filtering software to prevent browsing of harmful websites, developed in August 1998. It launched a version for schools in July 2000, followed by a version for the enterprise sector in January 2001. As this was in the early days of the Internet in Japan, when foreign software dominated both in scale and recognition, Digital Arts struggled to sell its filtering software. The company leveraged its small scale to swiftly respond to issues and provide support—helping it build up its customer base. Filtering harmful websites requires an extensive database of those sites, and the company was one of the earliest Japanese companies to build such a database. It did so while developing its web filtering product in 1998.

Digital Arts' i-FILTER® database tops the list of web filtering products in a comparative study of product quality and accuracy (Veriserve Corporation, which provides third-party verification of IT products). In this study, i-FILTER® achieved a blocking rate of over 90% across all 10 categories, including “adult/porn,” “online message boards,” and “games,” with an average blocking rate of 96.3%. The second-ranked product had an average blocking rate of 66.7%.

Blocking rate of harmful websites by product (based on 2013 Veriserve Corporation research)



Source: Shared Research based on company data
 Note: The survey targeted 10 categories of websites to block: porn/adult, narcotics, online shopping, online dating, online mail, online message boards/SNS blogs, gambling sites, gaming sites, online storage/uploading sites, and information threats.

At Digital Arts, a specialized team uses proprietary technology to manually collect data. The team works to increase database effectiveness not only by adding new URLs to its database but also by removing defunct URLs. The company says that the effort it has put into building this database has made it the leading web filtering database in Japan. This plus its high degree of effectiveness, serve as a strong barrier to entry by competitors.

m-FILTER® (email security software)

m-FILTER® accounts for nearly 20% of sales, and is the second-largest contributor to sales after i-FILTER®. Companies and public institutions use this product to counter email-based data leaks and the growing amount of spam email. m-FILTER® was launched in February 2007. Although a latecomer to the email security software market, Digital Arts uses its support capabilities and sales channels developed through i-FILTER® to grow sales of m-FILTER®.

Top share of the email filtering and archiving market by shipment volume

Out of the companies in the email filtering and archiving market in FY2016 (worth JPY6.5bn on a sales basis), m-FILTER® had the leading share of the market by new shipments for the fourth year in a row, at 51.1% (survey released in August 2017 by MIC Research Institute Ltd.). Share of the market by shipments rose from 44.8% in FY2015 (market share of Digital Arts and other companies rose while Company A, Company B, and Company C fell).

Vendor share of the email filtering and archiving market

Company	Market share of m-FILTER® (based on unit shipment in FY2016)
Digital Arts	51.1%
Company A	13.9%
Company B	8.4%
Company C	7.3%
Others	19.3%
Total	100.0%

Source: Shared Research based on “Current Status and Future Outlook for the Information Security Solutions Market 2017, Edition on Solutions for Preventing Internal Leaks” by MIC Research Institute Ltd.
 Note: In FY2016, the email filtering and archiving market had a sales value of JPY6.5bn.

The main functions of m-FILTER® are email security (prevent information leaks due to mistaken email transmission), email archiving and management (promote internal governance), and spam email filtering. These functions can be combined depending on customer needs.

m-FILTER® MailFilter: Prevents mistakenly sent email and data leaks via email

To prevent data leaks, companies set rules for sending and receiving email, but preventing all leaks, both intentional and accidental, can be difficult. m-FILTER® helps employees automatically comply with company policies, preventing intentional or accidental data loss.

m-FILTER® Archive: Stores and manages all email (email archiving)

Stores all incoming and outgoing emails. High-speed searches and tamper detection promote secure use of information.

m-FILTER® Anti-Spam: Prevents spam with the industry’s highest detection rate

This product uses a global spam detection engine to identify and eliminate spam email. The detection engine is provided by Cloudmark, Inc., and features one of the highest detection rates in the world.

FinalCode® (file encryption and tracking software)

This file encryption and tracking software was launched in July 2012. While Digital Arts’ other products leverage the Japanese-language environment and the company’s swift support in Japan, FinalCode® does not depend on a specific language environment. It also differs from the other products as it offers a heightened security function for important files. Digital Arts plans to use this product to bolster its sales overseas.

FinalCode®	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
Sales YoY by market					
Enterprise	-	394.3%	257.0%	97.7%	12.1%
Public	-	-	13.5x	47.8%	59.2%
Consumer	-	-	-	-	-

Source: Shared Research based on company data

According to the market report “ITR Market View: Data Leakage Prevention Markets 2017,” published in December 2017 by ITR Corporation, in the Information Rights Management (IRM)*¹ market, when market share is broken down by offering type, the company’s FinalCode® obtained 78.4% of the SaaS-based*² IRM market in 2016.

*¹ Refers to a system through which a business can encrypt files with confidential information that it stores and manages, allow individual users to decrypt and view such files, grant precise operational authority such as printing, and monitor usage conditions

*² Software as a Service (SaaS): Refers to software (predominantly application software) provided as a service allowing use of necessary functions as required, or the mode of delivery of such software. Generally necessary functions are used through the internet

Vendor share of the SaaS-based IRM market

Company	Market share of FinalCode® (based on sales in FY2016)
Digital Arts	78.4%
Company A	5.7%
Others	15.9%
Total	100.0%

Source: Shared Research based on “ITR Market View: 2017 Market for Cybersecurity Measures,” ITR Corporation

Product characteristics

FinalCode® is file security software that allows remote tracking and operation of files after they have been sent. It is the world’s first file security software that allows files to be deleted after being sent.

Managing important electronic files is a challenge when dealing with external entities. FinalCode® is a proprietary product that helps secure important files.

Typically, managing important electronic files involves password protection, and if passwords are leaked, it is impossible to know who has opened a file, or to retrieve files. FinalCode® provides full tracking of the use of files sent outside of a company, and allows those files to be deleted if necessary.

The company's other products have a solid foothold in the Japanese-language environment. In comparison, FinalCode® is independent of the language environment, and is being positioned as a key product for overseas markets.

FinalCode® has three main functions: protection, tracking, and deletion after sending.

FinalCode®'s three functions

Protection	Files can only be viewed by designated people. Permissions can be changed as necessary. (Main features: no password, specification of file duration and number of times it may be accessed, automatic deletion if tampering is detected, and specification of who can view files)
Tracking	Files may be tracked via an access log even after they have been sent. (Main features: checking who accessed the file and what operations were done, detection of unauthorized viewing)
Later deletion	Files can be deleted even after they have been sent. (Main functions: Remote file deletion, remote changing of permissions)

Source: Shared Research based on company data

D-SPA® (Proxy appliance server with filtering function)

Launched in November 2010, D-SPA® is a proxy appliance server equipped with a filtering function. PCs connect to the internet via D-SPA®, which has caching* and web filtering functions, increasing security and enabling fast network communication speeds and smooth internet connections. According to a user survey by the company, customer satisfaction with the product was 98.0%.

*Caching function: The content of accessed sites are stored in a file to display information faster the next time sites are accessed.

D-SPA®	FY03/14	FY03/15	FY03/16
Sales YoY			
Enterprise	180.5%	15.5%	39.6%
Public	9.9%	41.0%	42.8%
Consumer	-	-	-

Source: Shared Research based on company data

Third-party evaluation and market share by product

The products developed by Digital Arts have garnered high third-party ratings. The following table lists major third-party ratings announced since 2016, as well as product share information.

Third-party ratings of Digital Arts (announced in 2016-2017)

Announcement	Product	Description
November 30, 2017	i-FILTER®	i-FILTER® won the top vendor position with a 53.1% share (sales value) in the URL filtering market in FY2016, according to an ITR survey
August 22, 2017	m-FILTER®	For the fourth consecutive year, m-FILTER® came first in a survey of new installations by MIC Research Institute. No.1 with a 51.1% share in shipment volume in FY2016
May 16, 2017	i-FILTER®	According to Fuji Chimera Research Institute survey of culture/education market, i-FILTER® had the highest web filtering tool market share in 2016 at 40.7%
October 4, 2016	m-FILTER®	For the third consecutive year, m-FILTER® came first in a survey of new installations by MIC Research Institute. No.1 in the number of companies installing its product in the email archiving/filtering market with 44.8% market share
August 23, 2016	FinalCode®	FinalCode® became the leader in the SaaS market in 2015 with a 76.7% market share, according to a survey by ITR
-	i-FILTER®	According to a survey by ITR, i-FILTER® had the leading vendor share (49.8%) of the URL filtering market in 2015

Source: Shared Research based on company news releases

Introduction date of principal services

Date	Description
Aug.1998	Develops first internet filtering software in Japan and starts collecting information on harmful websites
Jul.2000	Launches i-FILTER School Edition filtering software for schools
Sep.2000	Launches i-FILTER filtering software aimed at consumer market
Jan.2001	Launches i-FILTER Business Edition for corporate market
Jul.2001	Launches m-FILTER email filtering software for schools
Feb.2007	Launches m-FILTER® email filtering software for schools
Nov.2010	Launches secure proxy appliance D-SPA®
Jul.2012	Starts offering FinalCode®

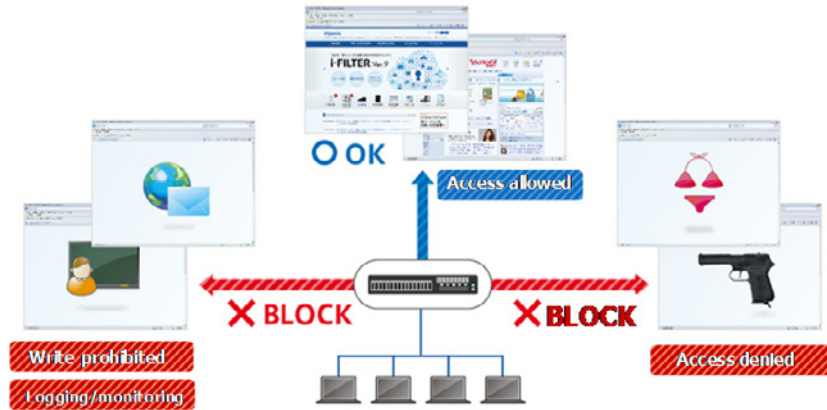
Source: Shared Research based on company data

Product details

i-FILTER® (web security software)

i-FILTER® uses URL filtering to filter inappropriate websites, such as those featuring adult content, drugs, and crime, to block access in the workplace or in school settings. By blocking access to SNS and dangerous websites, the product prevents intentional and accidental information leaks.

Web filtering (URL filtering) structure



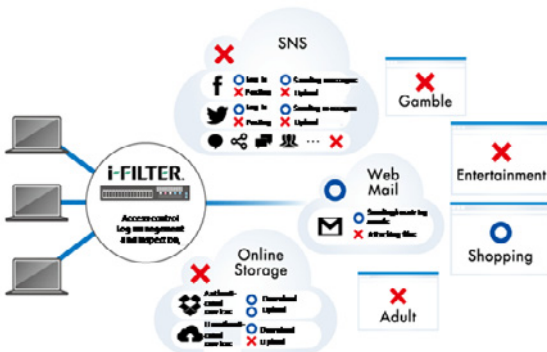
Source: Company data

i-FILTER® has three main functions: preventing data leaks, preventing cyber threats, and strengthening internal controls.

Main function	Description
Prevent data leaks	Prevents data leaks stemming from electronic bulletin boards, email, Twitter, Facebook, and malware or phishing websites. Web filtering is used to keep logs of employees' web access and make this access visible. Information system administrators can track employees' browsing activities and go back over past posts. This helps prevent information leaks due to careless communications and intentional actions.
Prevent cyberattacks	Cyberattacks can arise from malware infection through careless web access by employees, as well as targeted email attacks. Employees may not even be aware that their PCs have been taken over. The number of such attacks has increased, where infections have spread from malicious outside servers and extracted important information from an organization. Preventing such threats calls for "exit measures" that block web access to malicious external servers. Digital Arts says that i-FILTER® is being used to prevent cyberattacks by incorporating a specialized database of malicious websites.
Strengthen internal controls	Similar to preventing data leaks, making employees' web access visible helps prevent them from carelessly posting information on SNS or using online storage to intentionally send sensitive information outside of the company. This strengthens internal controls.

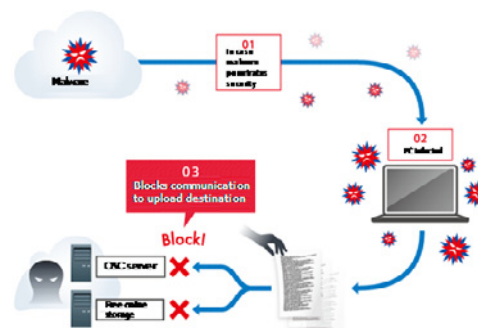
Source: Shared Research based on company data

Preventing data leaks



Source: Shared Research based on company data

Preventing cyberattacks



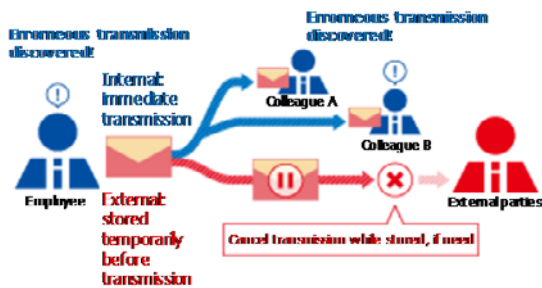
m-FILTER® (email security software)

m-FILTER® offers three functions: preventing erroneous email transmission, email archiving, and spam blocking.

Main function	Description
m-FILTER® MailFilter: prevents erroneous email transmission	Gateway-style software prevents erroneous email transmission. Based on set transmission rules, it promotes strict compliance with operating policies. It also prevents deliberate and accidental information leaks from erroneous email transmission using staggered transmission times (delayed sending) depending on whether the recipient's address is internal or external, and password protection for sent files.
m-FILTER® Archive: email archive	This product supports internal controls and strengthens compliance by providing secure storage and management of the entire text of emails through email archiving. Tampering detection enables preservation of the entire text of emails, securely maintaining their value as evidence. Also, it is possible to quickly search entire emails and attachments by specifying detailed search criteria and by batch downloads of multiple emails that are relevant to a search. The user can manage and search stored emails without depending on a system administrator.
m-FILTER® Anti-Spam: antispam function	This product blocks spam email with the highest detection rates in the industry. It uses a spam detection engine from Cloudmark, Inc., which boasts the highest detection rates in the industry. It also incorporates an individually managed spam email function, leaving the final judgment to the user, lightening the burden on administrators and enabling more accurate spam detection.

Source: Shared Research based on company data

Preventing erroneous email transmission



Source: Shared Research based on company data

FinalCode® (file encryption and tracking software)

FinalCode® is file encryption and tracking solution that allows remote tracking and operation of sent files. Released in 2010, this is the world's first file security software that enables files to be deleted after sending. Digital Arts began selling this product in July 2012. Different from its filtering software, FinalCode® is independent of the language environment, and Digital Arts plans to use the product as a springboard for global development. Digital Arts is concentrating on increasing sales and sales partners in overseas markets, as well as in Japan.

FinalCode® uses encryption key technology, which offers the functions outlined in the previous table, but without the need for passwords.

FinalCode® details

Before sending file (sender)	The sender sets recipient permissions. These include setting the email addresses of people permitted to view the file, the number of times the file can be viewed, settings in the event of illegal operations (such as remote deletion), retrieving the original file, overwriting, copy/paste and capture, and printing permissions.
When sending file (recipient)	The file is automatically encrypted when sent to the recipient. Simultaneously, an encryption key to open the file is automatically generated. This key contains information about the preset permissions and is stored on the FinalCode® server.
After receiving file (recipient)	When attempting to open the file, the recipient's email address and information about the machine being used is sent to the FinalCode® server. If the FinalCode® server authorizes the recipient, an encryption key is sent, and the file can be opened. The file access log and operational history are recorded on the FinalCode® server. The file remains encrypted and is never available as plain text on the PC (or hard drive). The recipient must access the FinalCode® server to receive an encryption key each time the file is opened.
After sending file (sender)	If necessary, after a file is sent, the recipient's permissions and the file itself can be deleted. When the recipient wants to perform an operation on the file they must access the FinalCode® server, where the new information is reflected.
Of all these operations, only setting and changing permissions need to be performed manually by the sender. Other operations are performed automatically.	

Source: Shared Research based on company data

The SaaS (cloud) version of FinalCode® does not require server configuration. For this edition the user simply downloads specialized FinalCode® Client software and installs it on a PC.

i-FILTER® Ver.10 and m-FILTER® Ver.5: countermeasures for targeted outside attack

In September 2017, the company released updated versions of these two products, with improved functionality to protect client devices against targeted attacks. If customers implement both new updated versions, m-FILTER® Ver.5 and i-FILTER® Ver.10, they can strengthen their security against data leaks and malware* attacks from both the internet and email, and also reduce the costs of educating employees about security and creating multi-level security systems.

98% of targeted attacks strike through email

A targeted attack* is a kind of cyberattack that aims to steal certain information from within an organization. 98% of these attacks begin by sending an email containing a computer virus to a member of the organization (source: Information-technology Promotion Agency, “The Threat of Targeted Attacks and Measures to Combat Them”). The remaining 2% stem from the internet (contamination through visiting websites) and USB memory sticks. In order to combat targeted attacks, the number of steps for opening emails has increased. As a result, for many companies and institutions, using the internet can often lead to a decrease in work efficiency.

*Currently, not only major companies and financial institutions but also individuals and small businesses have become the target of such attacks. Information leaks from targeted attacks are the most concerning security threat. In the Information-technology Promotion Agency’s “10 Major Security Threats 2016,” information leaks from targeted attacks was ranked the number one largest threat for organizations (ranked second in overall largest threat for both organizations and individuals).

Digital Arts’ protection against targeted attacks: email

In the new m-FILTER® Ver.5, emails with suspicious attachments are quarantined and any internet traffic that may lead to a suspicious website is suspended. As a result, users can enjoy a security environment where they may use the internet or email freely, without worrying about potential threats. This product can determine* whether the email sender, attached file, or internet link has been disguised. For example, if the email contains a macro-enabled Office file, the email will be quarantined. This allows each member of the organization to be able to receive the neutralized email of their client. i-FILTER® Ver.10 can check URLs within an email and convert them to text if the links are determined to be potentially harmful. If accessing the URL is absolutely necessary, users can do so with a quarantined PC.

According to company information based on the operational status (October–December 2016) of the Cyber Information Initiative (J-CSIP), 58% of attacks from targeted emails came from attached files while 16% came from URLs. Of the attached files, 36% were executable files (programs that run automatically when the user clicks on them), 27% of them were RLO executable files (Right-to-Left Override, a fraudulent file which uses special characters in Unicode, the industry encoding standard for text), and the remaining 37% were Office document files.

Digital Art’s protection against targeted attacks: web

According to the company, roughly 80% of information leaks occur through the internet. The new i-FILTER® Ver.10 limits access to malicious websites and file downloads that may cause malware infections. The company planned to review the previous data gathering method of its website filter database and increase the coverage of searchable website filter to nearly 100% six months from the update’s release (current coverage level was around 60%). This product classifies all searchable websites in a cloud database. If a user accesses a website which is not managed by i-FILTER® (not classified), i-FILTER® will either warn or block access* to the site, preventing potential targeted attacks. Only PCs identified by i-FILTER® Ver. 10’s cloud database (whitelisted devices) can access this database.

*The main route of leaking information is through command and control servers (servers that issue commands to a group of computers called a botnet, in which each device serves as a bot¹ infected with malware). These servers use the Darknet² or Deep Web³ to hide. Because sites on the Darknet or Deep Web are not searchable on search engines, they are not registered in the i-FILTER® database and are blocked or trigger a warning.

¹Bot: Application software that executes tasks automatically on the internet.

²Darknet: An IP address that does not have a host name allotted for the IP address.

³Deep Web: A website that is unsearchable on search engines

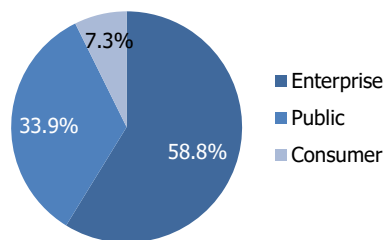
Implementation and operation costs for customers

The company calculates that if a customer implements m-FILTER® Ver.5 and i-FILTER® Ver.10 as a set, companies of around 3,000 employees could cut roughly 55% of costs and companies of around 20,000 employees could cut roughly 45% of costs compared to using a multi-level security system with other companies' products to prevent data leaks and malware infections. This is because companies can cut installation and operation costs as well as personnel and educational costs, and expenses related to using the services of a SOC (Security Operation Center).

Customers by sector

Digital Arts has customers in the enterprise, public, and consumer sectors. Its main customers are corporate clients, government offices, and schools. In FY03/18, the enterprise sector accounted for 59% of sales, the public sector, 34%, and the consumer sector, 7%.

Sales by sector: FY03/18



Source: Shared Research based on company data

Enterprise sector

Sales breakdown (JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
Enterprise	781	923	1,014	1,205	1,429	1,436	1,637	1,900	2,240	2,574	3,009
YoY	36.3%	18.2%	9.8%	18.9%	18.6%	0.5%	14.0%	16.0%	17.9%	14.9%	16.9%
% of total sales	45.9%	49.8%	46.3%	52.2%	52.8%	49.4%	54.1%	55.8%	56.0%	50.9%	58.8%
YoY by product											
i-FILTER®							7.8%	9.4%	13.8%	9.2%	13.6%
m-FILTER®							15.4%	36.2%	15.0%	8.3%	9.3%
FinalCode®							-	394.3%	257.0%	97.7%	12.1%

Source: Shared Research based on company data

In FY03/18, the enterprise sector contributed most to consolidated sales, at 51%. The public sector used to account for a largest share of sales, due to efforts to prevent viewing of harmful websites in educational settings. In recent years, however, sales to the enterprise sector have grown amid increasing security concerns. The company sells all four of its products (i-FILTER®, m-FILTER®, FinalCode®, and D-SPA®) in this sector. Sales have expanded YoY each year for the last 10 years (with annual growth at a rate of 14.4%).

Public sector

Sales breakdown (JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
Public	691	672	887	843	998	1,152	1,029	1,140	1,418	2,125	1,732
YoY	9.6%	-2.7%	31.9%	-5.0%	18.4%	15.5%	-10.7%	10.8%	24.4%	49.9%	-18.5%
% of total sales	40.6%	36.3%	40.5%	36.5%	36.9%	39.6%	34.0%	33.5%	35.4%	42.0%	33.9%
YoY by product											
i-FILTER®							-12.7%	6.0%	22.9%	33.6%	-15.6%
m-FILTER®							-0.7%	46.8%	5.8%	189.6%	-38.3%
FinalCode®							-	-	13.5x	47.8%	59.2%

Source: Shared Research based on company data

Although the company separates sales to the public and enterprise sectors, the products and pricing are the same in both sectors. The company also sells all four of its products (i-FILTER®, m-FILTER®, FinalCode®, and D-SPA®) to the public sector. Sales are increasing in the public sector due to growing security needs, but tend to be affected in the short term by fluctuating government spending. In FY03/17, sales rose because many local governments invested in security in response to the Ministry of Internal Affairs and Communication's guidelines to strengthen local government information security. In FY03/18 sales to the public sector as a proportion of total sales declined 8.1pp due to the falling away of extraordinary demand from local governments and major government contracts.

Consumer sector

Sales breakdown (JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
Consumer	229	258	291	260	281	318	361	363	342	360	376
YoY	24.7%	12.4%	12.8%	-10.4%	7.9%	13.3%	13.5%	0.5%	-5.6%	5.0%	4.4%
% of total sales	13.5%	13.9%	13.3%	11.3%	10.4%	10.9%	11.9%	10.7%	8.6%	7.1%	7.3%
YoY by product											
i-FILTER® for PC							-4.2%	4.5%	-28.1%	5.5%	8.4%
i-FILTER® for game/TV							7.4%	64.6%	29.3%	-13.0%	-3.9%
i-FILTER® for mobile devices							108.2%	-28.0%	41.6%	15.8%	2.7%

Source: Shared Research based on company data

Most of the company's sales in the consumer sector are from i-FILTER® (web filtering software). Specifications for the consumer sector differ from the enterprise and public sectors. i-FILTER® can be used for computers, smartphones, game consoles, or on multiple devices (including computers and smartphones). In FY03/16, sales fell due to lower PC version sales, with the overall decline in number of PCs sold. However, in FY03/17 sales recovered, growing due to solid results for the i-FILTER® for smartphones as the company worked with mobile phone vendors and MVNO providers. The company also improved OEM sales and increased shipments of multi-year packaged products, leading to a recovery of the PC version i-FILTER®. Similar trends continued in FY03/18.

Sales channel

The company mostly sells its products in the enterprise and public sectors through distributors. It says it has distributor agreements in place with some 20–30 distributors, and the top three account for 70–80% of its total sales. It sells its products to the consumer sector via computer manufacturers and telecoms companies.

Product pricing and sales mix

Product pricing

The company offers various versions of its products. The following tables indicate basic fees. One contract is typically for 250–500 licenses.

i-FILTER Ver.10 (standard license)

	Number of license	Price per license New (JPY)	Price per license Renewal (JPY)
1	10 ~	9,800	4,900
:	:	:	:
5	200 ~ 299	6,600	3,300
6	300 ~ 499	5,800	2,900
7	500 ~ 749	5,000	2,500
:	:	:	:
15	10,000 ~	Quoted separately	

m-FILTER Ver.5 (standard license)

	Number of license	Price per license New (JPY)	Price per license Renewal (JPY)
1	10 ~	9,800	4,900
:	:	:	:
5	200 ~ 299	6,600	3,300
6	300 ~ 499	5,800	2,900
7	500 ~ 749	5,000	2,500
:	:	:	:
15	10,000 ~	Quoted separately	

Note: The above price (unit: JPY) is for a one-year license. The standard license is aimed at organizations such as businesses, central government agencies, local governments and the like. There are, additionally, academic licenses for educational institutions. i-FILTER® Ver.10 and m-FILTER® Ver.5 version upgrades are being provided for free until the end of September 2022 to i-FILTER® Ver.9 and m-FILTER® Ver.4 users, respectively.

i-FILTER® Ver.9 standard edition (standard license)

	Number of license	Standard price (JPY)	Price per license (JPY)
1	10 ~	89,000	8,900
:	:	:	:
5	250 ~	1,274,000	5,096
6	500 ~	1,460,000	2,920
:	:	:	:
21	10,000 ~	10,530,000	1,053
:	10,001 ~	Quoted separately	

m-FILTER® Ver.4 MailFilter (standard license)

	Number of license	Standard price (JPY)	Price per license (JPY)
1	30 ~	404,000	13,467
:	:	:	:
5	250 ~	1,200,000	4,800
6	500 ~	1,409,000	2,818
:	:	:	:
21	10,000 ~	6,604,000	660
:	10,001 ~	Quoted separately	

i-FILTER®

	For one (JPY)	For three (JPY)
i-FILTER®		
One month	360	-
One year	4,320	-
i-FILTER® for game systems*		
One month	324	-
i-FILTER® for multi devices		
One year	4,320	9,400
Two year	6,400	14,800
Three year	9,400	19,800

FinalCode® Ver.5 (at time of annual contract)

	Business Edition	Enterprise Edition
Type	Cloud	Cloud, On-premises
Monthly fee for one license (JPY)	2,000	3,600
Minimum no. of licenses	10	50
Unit of license	1	1

D-SPA®

	Number of license	Price per license (JPY)
1	10 ~	2,000
2	301 ~	1,900
3	501 ~	1,800
4	1,001 ~	1,700
5	3,001 ~	1,600
6	5,001 ~	Quoted separately

Source: Shared Research based on company data

Sales mix

Around 75% of the company's sales stem from i-FILTER® (software sales and maintenance fees). When a contract is signed, Digital Arts books around 90% as software sales, and the remaining 10% as maintenance fees apportioned over the life of the agreement. For m-FILTER®, the second pillar of sales, it sells software and maintenance services separately. If maintenance is required after the first year, annual maintenance fees are equivalent to 15% of the software price.

Principal group companies (as of March 31, 2018)

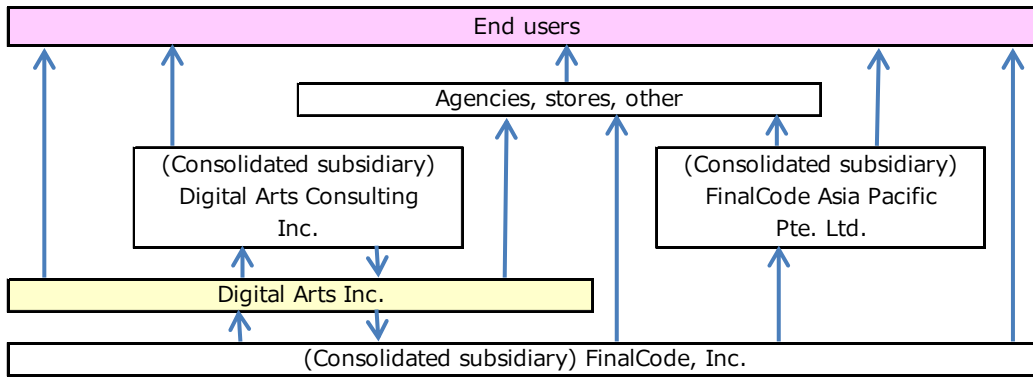
The Digital Arts group comprises the parent company and four consolidated subsidiaries. The group designs, develops, and sells web and email security software, and file encryption and tracking solutions.

Overview of principal group companies

Company	Major businesses	Share of voting rights	Relationship with Digital Arts
Digital Arts	Design, development, and sale of internet security software and appliances	—	—
FinalCode, Inc. (California, US)	Design, development, and sale of FinalCode® (file encryption and tracking solution)	100.0%	Concurrent officers. Consigned operations. Product procurement.
FinalCode Asia Pacific Pte. Ltd. (Singapore)	Sales of FinalCode® (file encryption and tracking software)	100.0%	Concurrent officers. Consigned operations.
Final Code Europe Limited	Sales of FinalCode® (file encryption, tracking software)	100.0%	Concurrent officers. Consigned operations.
Digital Arts Consulting Inc.	Information security consulting	84.6%	Concurrent officers. Consigned operations.

Source: Shared Research based on the company's securities report

Business functions



↑ Products and services

Source: Shared Research based on company data

Group company responsibilities by customer and product

Customer sector	Main products	Company responsible
Enterprise sector	<ul style="list-style-type: none"> i-FILTER® (web security software) m-FILTER® (email security software) D-SPA® (Digital Arts Secure Proxy Appliance) (proxy appliance) FinalCode® (file encryption and tracking solution) 	Digital Arts IQS' Co., Ltd. FinalCode, Inc.
Public sector	<ul style="list-style-type: none"> Communication Server System (Integrated security-focused internet server system for schools) i-FILTER® (web security software) m-FILTER® (email security software) D-SPA® (Digital Arts Secure Proxy Appliance) (web security appliance) FinalCode® (file encryption and tracking solution) 	Digital Arts IQS' Co., Ltd. FinalCode, Inc.
Consumer sector	<ul style="list-style-type: none"> i-FILTER® (web security software) 	Digital Arts

Source: Shared Research based on the company's securities report

The table below compares parent and non-consolidated performance, but there is little difference between the two. Digital Arts plans to expand its overseas sales by leveraging FinalCode®, and it thinks the profit contribution of overseas subsidiaries to earnings will widen the gap between consolidated and non-consolidated performance.

Income statement (JPYmm)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Consolidated											
Sales	1,701	1,853	2,191	2,308	2,708	2,907	3,027	3,403	4,001	5,059	5,117
Gross profit	1,343	1,465	1,753	1,845	2,059	2,174	2,149	2,428	3,075	4,052	4,042
Operating profit	623	629	711	686	587	737	653	865	1,007	1,824	1,903
Recurring profit	623	633	714	687	566	726	660	910	994	1,811	1,909
Net income	350	351	371	390	310	444	400	531	546	1,125	1,282
Parent											
Sales	1,650	1,805	2,105	2,239	2,652	2,845	2,961	3,396	4,019	5,104	5,047
Gross profit	1,303	1,428	1,678	1,783	2,009	2,124	2,116	2,479	3,124	4,028	3,986
Operating profit	652	660	697	652	561	709	632	914	1,335	2,068	2,088
Recurring profit	659	664	701	654	491	699	639	926	1,329	2,056	2,098
Net income	385	389	384	367	265	428	389	574	841	1,339	861
Consolidated/Parent ratio											
Sales	103.1%	102.7%	104.1%	103.1%	102.1%	102.2%	102.3%	100.2%	99.5%	99.1%	101.4%
Gross profit	103.1%	102.6%	104.5%	103.5%	102.5%	102.3%	101.6%	97.9%	98.4%	100.6%	101.4%
Operating profit	95.5%	95.4%	102.0%	105.2%	104.7%	103.9%	103.3%	94.7%	75.4%	88.2%	91.2%
Recurring profit	94.5%	95.3%	101.9%	105.0%	115.2%	103.9%	103.3%	98.3%	74.8%	88.1%	91.0%
Net income	90.8%	90.2%	96.5%	106.4%	116.9%	103.9%	102.8%	92.6%	65.0%	84.0%	149.0%

Source: Shared Research based on company data

The company's US subsidiary, FinalCode, Inc., pays the parent development fees for FinalCode®, which are accounted for as sales at the parent-level accounts. In consolidated accounts, these development fees are eliminated internally and instead added to sales of US subsidiary FinalCode, Inc. The US subsidiary started to substantially boost sales of FinalCode®, but sales in FY03/16 were less than the commissions paid to Digital Arts (parent). As a result, there was an inversion such that in FY03/16 consolidated sales were lower than those of Digital Arts (parent). This trend continued in FY03/17. According to Digital Arts, as sales of FinalCode® in the US expand, this inversion of sales was likely to disappear in the near term, and it was in fact resolved in FY03/18.

Analysis of profitability

Profit margins (JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	1,701	1,853	2,191	2,308	2,708	2,907	3,027	3,403	4,001	5,059	5,117
Cost of sales	358	388	438	463	649	733	878	975	926	1,007	1,075
Cost ratio	21.0%	20.9%	20.0%	20.1%	24.0%	25.2%	29.0%	28.6%	23.1%	19.9%	21.0%
Gross profit	1,343	1,465	1,753	1,845	2,059	2,174	2,149	2,428	3,075	4,052	4,042
GPM	79.0%	79.1%	80.0%	79.9%	76.0%	74.8%	71.0%	71.4%	76.9%	80.1%	79.0%
SG&A expenses	720	836	1,042	1,159	1,472	1,437	1,496	1,563	2,068	2,227	2,139
SG&A ratio	42.4%	45.1%	47.6%	50.2%	54.4%	49.4%	49.4%	45.9%	51.7%	44.0%	41.8%
Operating profit	623	629	711	686	587	737	653	865	1,007	1,824	1,903
OPM	36.6%	34.0%	32.5%	29.7%	21.7%	25.3%	21.6%	25.4%	25.2%	36.1%	37.2%
EBITDA	798	827	948	927	898	1,112	1,142	1,454	1,511	2,347	2,476
EBITDA margin	46.9%	44.7%	43.3%	40.2%	33.2%	38.2%	37.7%	42.7%	37.8%	46.4%	48.4%
Net margin	20.6%	18.9%	16.9%	16.9%	11.5%	15.3%	13.2%	15.6%	13.6%	22.2%	25.1%
Financial ratios											
ROA (RP-based)	29.1%	24.6%	23.8%	20.2%	14.8%	16.8%	14.0%	17.1%	16.7%	26.8%	24.9%
ROE	19.5%	16.3%	14.9%	14.2%	10.4%	13.6%	11.0%	13.3%	12.4%	23.0%	22.5%
Total asset turnover	0.80	0.72	0.73	0.68	0.71	0.67	0.64	0.64	0.67	0.75	0.67
Working capital (JPY'000)	555	509	728	663	722	814	815	930	1,076	1,279	1,104
Current ratio	454.7%	509.4%	484.7%	481.3%	330.1%	322.7%	366.7%	289.4%	294.4%	260.2%	352.5%
Quick ratio	449.8%	504.8%	480.2%	475.5%	326.2%	317.0%	360.6%	282.2%	290.0%	255.7%	343.0%
OCF / Current liabilities	2.41	1.68	1.23	1.29	1.16	0.90	0.85	1.15	0.72	1.15	0.90
Net debt / Equity	-60.2%	-57.2%	-56.8%	-59.2%	-59.3%	-58.0%	-55.6%	-62.2%	-63.4%	-74.0%	-70.9%
OCF / Total liabilities	2.1	1.7	1.1	1.2	1.0	0.8	0.8	0.9	0.7	1.0	1.0
Cash cycle (days)	121.5	106.3	106.0	110.9	92.5	97.0	99.1	93.2	90.3	81.6	79.7
Changes in working capital	-19	-46	219	-65	59	92	1	115	146	203	-175
Breakdown of costs											
(JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Cost of sales	358	388	438	463	649	733	878	975	926	1,007	1,075
Labor costs	-	-	-	253	322	357	378	384	373	443	453
Depreciation	-	-	-	122	158	197	278	357	288	293	322
Transfer to other accounts	-	-	-	87	167	177	220	232	263	270	298
SG&A expenses	720	836	1,042	1,159	1,472	1,437	1,496	1,563	2,068	2,227	2,139
Personnel expenses	-	-	-	595	674	670	780	805	1,115	1,183	1,050
Advertising expenses	-	-	-	98	263	263	178	158	271	309	287
Other	-	-	-	465	533	502	537	599	680	733	800
Cash conversion cycle											
	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Accounts receivable turnover	3.0	3.5	3.6	3.3	3.9	3.8	3.7	3.9	4.0	4.3	4.2
Accounts receivable days	121.0	104.4	102.3	109.7	93.6	96.2	97.8	93.8	91.9	85.8	86.4
Inventory turnover	102.3	86.2	87.6	132.3	185.4	122.2	117.1	245.9	1381.2	2140.6	1758.7
Days in inventory	3.6	4.2	4.2	2.8	2.0	3.0	3.1	1.5	0.3	0.2	0.2
Accounts payable turnover	119.3	155.2	876.0	231.5	118.0	162.9	195.1	181.8	193.7	84.2	53.5
Accounts payable days	3.1	2.4	0.4	1.6	3.1	2.2	1.9	2.0	1.9	4.3	6.8
Cash conversion cycle (days)	121.5	106.3	106.0	110.9	92.5	97.0	99.1	93.2	90.3	81.6	79.7

Source: Shared Research based on company data

The company's major cost of sales is personnel and depreciation expenses. Production costs have grown as the product lineup has expanded. The cost ratio rose from FY03/12 to FY03/14 (from 20.1% in FY03/11 to 29.0% in FY03/14), in part due to the July 2012 sales launch of FinalCode®. The company considers this a key product that will underpin global expansion. Although this product's contribution to sales is small, it required upfront expenditures, including increased personnel to handle new product development and sales, as well as costs related to overseas development. Since FY03/14, the cost ratio has been falling, but in FY03/18 depreciation increased so the cost ratio rose slightly YoY (1.1pp). On the other hand, SG&A expenses decreased YoY due to controls on personnel costs as the company reviewed organizational structure and human resources strategy targeting medium-term growth, and resources were allocated more optimally. As a result of these factors, OPM rose 1.1pp YoY to 37.2%, the highest level in the last 10 years.

Comparison with competitors

(JPYmn)	Digital Arts						Trend Micro					
	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18	5-yr avg.	FY12/13	FY12/14	FY12/15	FY12/16	FY12/17	5-yr avg.
Consolidated												
Sales	3,027	3,403	4,001	5,059	5,117	4,121	108,314	115,205	124,317	131,936	148,811	125,717
Gross profit	2,149	2,428	3,075	4,052	4,042	3,149	88,935	94,775	103,045	108,895	120,672	103,264
Operating profit	653	865	1,007	1,824	1,903	1,250	29,450	30,652	30,976	34,360	36,441	32,376
Recurring profit	660	910	994	1,811	1,909	1,257	32,456	35,992	34,071	35,138	37,035	34,938
Net income	400	531	546	1,125	1,282	777	19,595	22,303	21,435	24,651	25,691	22,735
ROE	11.0%	13.3%	12.4%	23.0%	22.5%	16.4%	15.7%	15.3%	13.9%	15.3%	15.1%	15.1%
ROA (RP-based)	14.0%	17.1%	16.7%	26.8%	24.9%	19.9%	13.5%	13.3%	11.9%	11.7%	11.6%	12.4%
OPM	21.6%	25.4%	25.2%	36.1%	37.2%	29.1%	27.2%	26.6%	24.9%	26.0%	24.5%	25.9%
Total assets	4,873	5,749	6,134	7,381	7,929	6,413	261,493	279,938	290,520	308,537	331,157	294,329
Net assets	3,876	4,298	4,642	5,270	6,248	4,867	142,539	153,094	159,693	166,471	177,077	159,775
Equity ratio	77.8%	73.3%	74.7%	70.2%	78.2%	74.8%	53.6%	53.8%	54.4%	53.4%	53.0%	53.6%
CF from operating activities	817	1,355	1,027	2,012	1,663	1,375	30,567	31,942	30,490	33,510	46,915	34,685
CF from investing activities	-646	-848	-441	-672	-775	-676	-16,150	-32,922	-4,926	12,925	-33,817	-14,978
CF from financing activities	-85	-120	-188	-503	-293	-238	-210	-16,887	-9,321	-15,050	-16,908	-11,675
Cash and deposits	2,156	2,674	2,943	4,426	4,426	3,325	79,632	63,109	73,838	84,509	85,897	77,397
Interest-bearing debt	0	0	0	0	0	0	0	0	0	0	0	0
Net debt	-2,156	-2,674	-2,943	-4,426	-4,426	-3,325	-79,632	-63,109	-73,838	-84,509	-85,897	-77,397

Source: Shared Research based on company data

Digital Arts leads the domestic web filtering industry, with a market share of nearly 50%. Still, it only focuses on the web filtering market, while competitors also handle other areas, so it is smaller than rivals. The second-largest company in the web filtering business, Trend Micro, offers a broad range of products, and since FY03/11, its average annual sales have been 31x the sales of Digital Arts. Still, the company does not lag behind Trend Micro in terms of profit margin and rate of return (indeed, it is ahead of Trend Micro), because it has focused development on products where it is competitive (its renewal rate on web security software for the enterprise and public sectors was above 90%). We believe efficient operations with a small number of staff have also contributed to its competitive profit margins.

Strengths and weaknesses

Strengths

- ▶ **Swift support capabilities leading to high market share:** Digital Arts' core product, i-FILTER[®], has a leading share of the web filtering software market in the enterprise and public sectors (53%, according to a study by ITR). Shared Research thinks that the company's swift support capability and flexible development structure underpin its high market share. Sales of i-FILTER[®] struggled initially, as Digital Arts was small and relatively unknown compared to major overseas software developers who entered the market earlier. The company focused on offering speedy support to distinguish itself from the majors. It leverages its small scale and flat organization to swiftly offer products that respond to customers' needs, and has steadily built up its customer base.
- ▶ **Database of harmful websites strong in the Japanese-language environment:** Shared Research thinks that the company's database of harmful websites is a source of its competitiveness. The company has put a lot of man-power and time into fine-tuning the database in a Japanese-language environment since August 1998, when it developed the first Japanese web filtering software. The company's software blocks over 90% of harmful websites, putting it well ahead of the number two player, which has a blocking rate of under 70% (based on July 2013 Verisign survey).
- ▶ **Business model of recurring sales, underpinned by high contract renewal rates:** For the company's core web filtering software product, contract renewal rates are over 90%, resulting in stable, recurring sales. Customers renew given the complexity and initial setup costs when replacing systems. The company's pricing strategy also helps maintain high renewal rates. For core software i-FILTER[®], after the first year, Digital Arts offers software renewals at half the first-year price. According to company research, over a five-year period its products were up to 45% cheaper than similar domestic products (comparison with standard-priced products for the enterprise sector). By being a specialist in filtering software, Digital Arts is working to distinguish itself from the major developers, which offer a wider suite of security products.

Weaknesses

- ▶ **Lack of scale, which limits the ability to respond to an increasingly complex cybercrime environment:** Digital Arts leads the domestic market in filtering software, but we believe it lags its larger rivals in its services for handling increasingly advanced and complex cybercrime. Cybercrime is growing more complex each year, spawning the need to develop and provide integrated services. As such, the security software market, Digital Arts' specialty, is growing and showing promise, and competitors are responding by accelerating their own development in the field. Digital Arts recognizes this vulnerability and is addressing it by partnering with competitors who are experienced in various fields.
- ▶ **Business model depending on the domestic market:** Digital Arts has specialized in web filtering in the domestic market, so brand awareness of the company outside this area is low. Further, its strength in the domestic filtering software market—a Japanese-language database and a swift support structure—are not transferrable overseas. Digital Arts plans to use FinalCode[®] as a springboard to enter global markets. We believe the company is likely to face sales hurdles similar to the ones it encountered when i-FILTER[®] was launched: a lack of name recognition. As such, we believe Digital Arts will need to adopt fresh approaches in expanding overseas.
- ▶ **Mature market for the company's core products:** The market for the company's core product in web filtering is worth more than JPY8bn (2015 estimate by Fuji Chimera Research Institute). Fuji Chimera forecasts the market to continue growing at an annual rate of 5%, but Digital Arts already holds over 50% of the market, suggesting limited scope for future growth. As a result, the company is focusing on growing sales of its FinalCode file encryption and tracking solution in order to expand into the wider security market.

Market and value chain

Security solutions market

The security solutions market has moved into the limelight following a series of serious cyberattacks from 2011 that resulted in leaks of important and confidential information at major corporations, and the falsification of government websites. As a result, the security market is likely to continue expanding.

According to the preliminary results of a study on the domestic information security market released in March 2018 by the Japan Network Security Association (JNSA), the information security market in Japan (combining information security services and information security tools) is expected to reach JPY1tn for the first time in history in FY2018. From FY2008 to FY2010 the information security market was temporarily stagnant (with the global recession following the 2008 global financial crisis, the Great East Japan Earthquake, the 2011 Thailand Floods, and the European debt crisis). Since 2011, however, awareness of cyber security issues has spread rapidly through society, backed by a recovery in the economic environment, increased cyber security threats, and heightened social awareness for such threats.

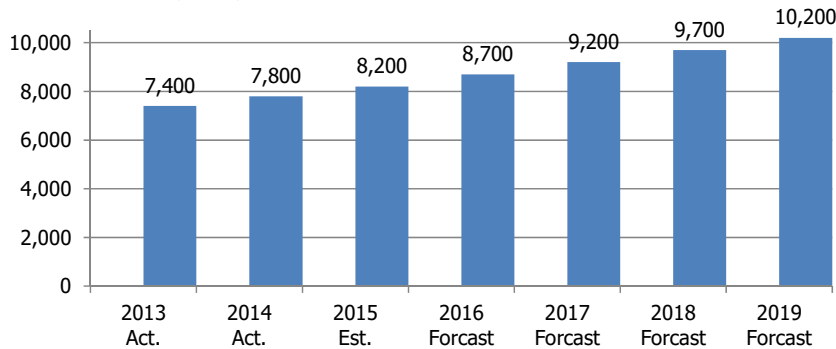
Information security market in Japan (estimated) (JPY mn)	FY2013 Act. (estimated)		FY2014 Act. (estimated)			FY2015 Act. (estimated)			FY2016 Act. (estimated)			FY2017 Act. (estimated)			FY2018 Forecasts		
	Value	% of total	Value	% of total	YoY	Value	% of total	YoY	Value	% of total	YoY	Value	% of total	YoY	Value	% of total	YoY
Information security market total	776,988	-	842,842	-	8.5%	896,507	-	6.4%	948,175	-	5.8%	996,496	-	5.1%	1,045,450	-	4.9%
Information security services	362,849	46.7% *	393,901	46.7% *	8.6%	425,967	47.5% *	8.1%	452,311	47.7% *	6.2%	465,881	46.8% *	3.0%	489,175	46.8% *	5.0%
		100.0%		100.0%	-		100.0%	-		101.7%	-		100.0%	-		100.0%	-
Information security consulting	72,731	20.0%	71,452	18.1%	-1.8%	80,611	18.9%	12.8%	78,700	17.7%	-2.4%	81,061	17.4%	3.0%	85,114	17.4%	5.0%
Secure system architecture	144,875	39.9%	156,356	39.7%	7.9%	132,280	31.1%	-15.4%	127,339	28.6%	-3.7%	131,159	28.2%	3.0%	137,717	28.2%	5.0%
Security management services	109,379	30.1%	125,248	31.8%	14.5%	174,247	40.9%	39.1%	197,025	44.3%	13.1%	202,936	43.6%	3.0%	213,083	43.6%	5.0%
Information security education	26,979	7.4%	30,365	7.7%	12.6%	27,052	6.4%	-10.9%	31,024	7.0%	14.7%	31,955	6.9%	3.0%	33,553	6.9%	5.0%
Information security insurance	8,885	2.4%	10,479	2.7%	17.9%	11,777	2.8%	12.4%	18,223	4.1%	54.7%	18,770	4.0%	3.0%	19,708	4.0%	5.0%
Information security tools	414,139	53.3% *	448,941	53.3% *	8.4%	470,540	52.5% *	4.8%	495,864	52.3% *	5.4%	530,616	53.2% *	7.0%	556,275	53.2% *	4.8%
		-		-	-		-	-		-	-		-	-		-	-

Source: Shared Research based on the JNSA "FY2016 Information Security Market Survey" (initial report)
 *: Indicates percentages of the overall market. Figures without asterisks indicate percentages by sector.

Web filtering market

The company's key web filtering market has also continued to grow as investment in security has expanded. In November 2015, Fuji Chimera Research Institute, Inc., published its "Network Security Business 2015 Comprehensive Research Report." According to this report, in 2015 the web filtering market grew 5.1% YoY, to JPY8.2bn. The report projects continued growth, with the market reaching a value of JPY10.2bn in 2019, 1.24x the 2015 level (annual growth of 5.6%).

Web filtering market (JPYmn)



Source: Shared Research based on "Network Security Business 2015 Comprehensive Research Report," Fuji Chimera Research Institute

Competitors and sales partners

Competitors

Digital Arts enjoys a leading market share (over 50%) of the enterprise and public sectors for its core web security software, i-FILTER®. It has the top uptake track record in the industry for its email security software, m-FILTER®. Its competitors for i-FILTER® include Trend Micro Inc. (TSE1: 4707), Alps System Integration Co., Ltd. (unlisted), Forcepoint Japan (previously Websense Japan), and Canon IT Solutions Inc. (unlisted). On the other hand, m-FILTER® is supplied by companies including Canon IT Solutions.

Principal sales partners

The company sells products via distributors, and does not sell directly to end users.

Sales and % of consolidated sales by principal sales partner

(JPYmn)	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17
Softbank Commerce & Service Corp.	683	671	701	863	1,098
% of consolidated sales	23.5%	22.2%	20.6%	21.6%	21.7%
Daiwabo Information System Co., Ltd.	308	411	526	622	857
% of consolidated sales	10.6%	13.6%	15.5%	15.5%	16.9%
SIOS Technology, Inc.	na	284	na	382	na
% of consolidated sales	na	9.4%	na	9.5%	na
Marubeni Information Systems Co., Ltd.	295	na	327	na	na
% of consolidated sales	10.1%	na	9.6%	na	na
PFU Limited	na	na	na	na	549
% of consolidated sales	na	na	na	na	10.8%

Source: Shared Research based on company data
Note: top three sales partners for each fiscal year

Historical performance and financial statements

Historical performance

1H FY03/19 results

Results summary: YoY Growth of 12.0% in sales and 12.4% in operating profit

For 1H FY03/19, Digital Arts reported consolidated sales of JPY2.8bn (+12.0% YoY), operating profit of JPY1.0bn (+12.4% YoY), recurring profit of JPY1.0bn (+11.5% YoY), and net income attributable to parent company shareholders of JPY992mn (+60.4% YoY). The company posted record 1H sales against the backdrop of its growing profile*¹ as a comprehensive security measure provider in the public market, burgeoning domestic demand for new implementations, and expansion in consulting. Digital Arts also promoted organizational expansion, primarily at its US subsidiary, and conducted Group restructuring*² through revision of its medium- to long-term product and sales strategies. Growth in sales absorbed expenses associated with these initiatives, allowing the company to post double-digit gains in operating profit.

*¹ Digital Arts made progress opening up sales channels in 2016, when local governments were expanding security measures in coordination with initiatives spearheaded by the Japanese Ministry of Internal Affairs and Communications. These channels allow the company to make more advanced and comprehensive security proposals. Utilizing distributors as a driving force, the company conducted sales promotions for i-FILTER® Ver.10 and m-Filter® Ver.5. These efforts resulted in higher recognition for both products. Thanks to these initiatives, the company made advances in securing contracts and heightened its profile as a comprehensive security solutions provider. According to an October 30, 2018 press release from Digital Arts, m-FILTER® achieved the top share of sales by vendor (19.6%) in the Japanese messaging security (on-premises) software market. This ranking was established by International Data Corporation Japan (IDC Japan) through market research regarding Japanese products designed to prevent external threats that was published in IDC Japan's *Japan IT Security Products Market Shares, 2017*, issued in September 2018. The company's share rose 3.9pp from 15.7% in 2016.

*² The company had been expanding human resources, including appointing a new CEO, at its North American subsidiary, FinalCode, Inc., but liquidated this company by the end of Q2 due to a change in strategy (this is explained in more detail below, in the "Revised FY03/19 full-year forecasts" box). Moving forward, the company, as a comprehensive security solutions provider, will endeavor to expand the Digital Arts brand throughout the world, in the same way it did in the Japanese market.

1H sales reached 98.7% of 1H forecasts, operating profit reached 86.4%, recurring profit reached 86.7%, and net income attributable to parent company shareholders reached 127.7%. Sales were mostly in line with forecasts, operating profit and recurring profit were below, and net income was above. Operating profit finished at 86.4% of the forecasted figure (JPY164mn short). This result was mainly due to slight shortfalls in sales (of which JPY36mn had an effect on operating profit), as well as front-loaded investment consisting of advertising and sales promotion expenses*² and an increase in SG&A expenses associated with the liquidation of North American subsidiary FinalCode, Inc.

*² The company ran advertisements in trade journals and held seminars to expand its brand image from its previous profile of a company specializing in web filtering to a new portrait of a comprehensive security solutions provider.

Upward revision to company's FY03/19 forecasts

Digital Arts revised up its FY03/19 profit forecasts*³. The company identified readily achievable cost-saving benefits of JPY100mn from a review of its medium-term product strategies and sales strategies and the results of group restructuring, which it incorporated into its budgets.

*³ Revised FY03/19 full-year forecasts

Sales:	JPY5.8bn (previous forecast: JPY5.8bn)
Operating profit:	JPY2.6bn (JPY2.5bn)
Recurring profit:	JPY2.6bn (JPY2.5bn)
Net income:	JPY2.0bn (JPY1.6bn)

Reason for revision

Digital Arts identified readily achievable cost-saving benefits of JPY100mn from a review of its medium-term product strategy and sales strategy and the results of group restructuring, which it incorporated into its budgets.

The Group is aiming to become a comprehensive security solutions provider and, as a first step, has been integrating new ways of thinking (such as whitelist filtering, which differs from conventional blacklist filtering in that it only allows access to PCs recognized by a cloud-based database) into its

existing product lineup to develop high-quality products for the Japanese market. The company had previously secured a strong profile and market share in the field of security aimed at preventing internal information leaks, but the group has since heightened its presence as a comprehensive security solutions provider in Japan through sales promotion activities conducted in collaboration with distributors.

The company had limited its activities to FinalCode® in the overseas markets, but going forward it plans to roll out the Digital Arts brand globally as a comprehensive security measure provider, in a similar manner to the domestic Japanese market. As part of these plans, it will liquidate its North American subsidiary FinalCode, Inc. and continue business in that market through Digital Arts America, Inc. In the Asia-Pacific, the company will conduct business as Digital Arts Asia Pacific Pte. Ltd. (changing its name from FinalCode Asia Pacific Pte. Ltd.). In Europe, it will conduct business as Digital Arts Europe Ltd. (changing its name from FinalCode Europe Limited).

Digital Arts expects consolidated SG&A expenses to decline as it selectively focuses its management resources accompanying group restructuring. It has thus incorporated JPY100mn in highly achievable cost-saving benefits into its budgets and revised its profit forecasts. Although the market environment is improving, the company said it has kept conservative sales and dividend forecasts.

Progress rate of 1H results versus the company's revised FY03/19 forecast

1H sales reached 47.7% of revised full-year forecasts (1H FY03/18 sales reached 48.2% of full-year FY03/18 results), operating profit reached 39.9% (48.5%), recurring profit reached 40.0% (48.8%), and net income attributable to parent company shareholders reached 49.6% (48.3%). In 1H FY03/19, the company conducted strategic sales promotion activities against a backdrop of burgeoning demand for new implementations in the domestic market, and strengthened its organization and sales force primarily in the US subsidiaries after recruiting highly experienced personnel. It incurred restructuring expenses accompanying a review of the group's overseas strategy, leading to temporary increases in advertising expenses, sales promotion expenses, personnel expenses, and commissions paid. Still, the company said that it expected cost reductions in 2H thanks to selectively concentrating its management resources accompanying these initiatives.

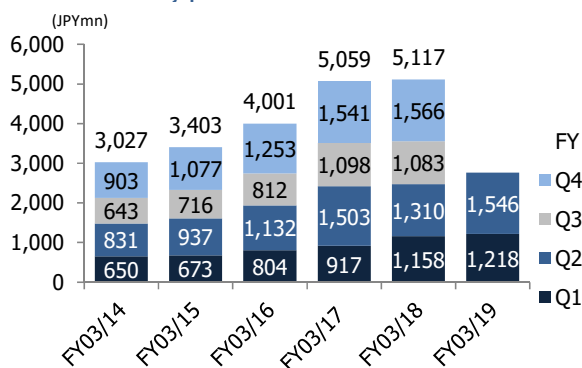
In order to provide solutions to allow its customers to enjoy a secure internet environment regardless of their size, the company has continued to aim to expand sales of i-FILTER® Ver. 10, and m-FILTER® Ver. 5 for the enterprise/public sectors. As web services and message platforms quickly shift to the cloud, the company started cloud services of i-FILTER® and m-FILTER® in May 2018. It aims to ensure an environment in which its customers can browse the web in comfort and open their emails without hesitation, even in a cloud environment.

Regarding Final Code, the company also added a Browser View function, whose demand was high among existing users and customers who are considering implementation. This function allows outside users who receive an encryption file to view it without installing client software. The company will continue to strengthen the functions of FinalCode and strive to expand sales.

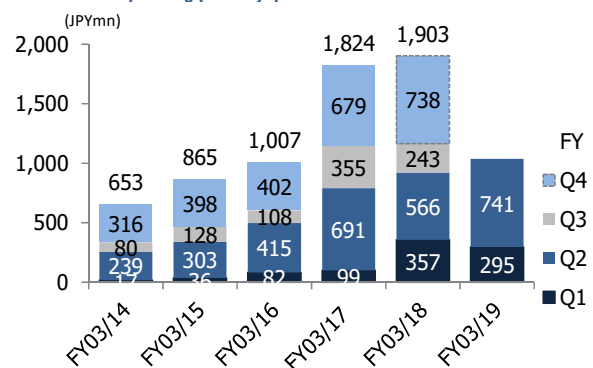
In the consumer market, the company continued to work together with MVNO operators to expand sales and cooperation on the mobile device version of i-FILTER® for smartphones.

In the overseas business, under the leadership of a new CEO, the company promoted activities to hire experienced personnel, strengthen its organizational structure, and tap into collaborative partners and channel partners. However, as mentioned previously, the group conducted restructuring through medium- to long-term product development and sales strategy revisions.

Consolidated sales by quarter



Consolidated operating profit by quarter



Source: Shared Research based on company data

Enterprise sector

Sales in the enterprise sector rose 3.9%YoY to JPY1.4bn. Although there is a notable bias to 2H as orders become larger, sales of core products i-FILTER[®], m-FILTER[®], and FinalCode[®] (down 2.1% YoY, up 4.3% YoY, and up 34.2% YoY, respectively) were strong as the company steadily secured orders, primarily ongoing projects from FY03/18. Concerning FinalCode[®], the large-scale order received at the end of FY03/18 contributed to sales growth. Sales at subsidiary Digital Arts Consulting, established in FY03/17, increased significantly with a heightened awareness of the need to implement additional data security measures and respond to a shortage of security personnel, adding to enterprise sector sales.

Public sector

Sales in the public sector grew 20.2% YoY to JPY1.1bn. The company had previously established a strong profile and market share as a provider of security measures against internal information leaks. In FY03/17 the Ministry of Internal Affairs and Communications instructed local governments to strengthen their information security arrangements. From that time, the company developed sales channels that enabled it to offer more sophisticated and comprehensive security solutions. Marketing driven by its distributors spurred sales of its mainstay products i-FILTER and m-FILTER. Awareness of these products' features spread, and the company won more projects and heightened its profile as a comprehensive security solutions company in the public sector. Sales of i-FILTER[®] and m-FILTER[®] rose 9.4% YoY and 95.2% YoY, respectively. FinalCode[®] sales fell 38.5% YoY, but this was due to large-scale projects that were recorded during same time in the previous year and demand remained healthy.

Consumer sector

Sales in the consumer sector rose 31.7% YoY to JPY236mn. In the consumer sector, Digital Arts worked together with mobile operators, MVNO operators, and other partner companies to expand sales of i-FILTER[®] Multi-Device, which can be used on multiple operating systems (Windows, iOS, and Android™) with a single serial ID number. The ongoing decline in domestic sales of consumer-use PCs for notwithstanding, company sales of consumer-use products have held up well thanks to sales of multi-year packaged products, sales to internet cafes, and growing direct sales of i-FILTER[®] Multi-Device. As for household versions of i-FILTER[®], sales for the PC version were up 17.9% YoY, 4.1% YoY for the video game/television version, and 61.8% YoY for the mobile device version.

Q1 FY03/19 results

Secured YoY sales growth despite lower profits due to domestic sales promotion activities and upfront spending on overseas subsidiaries

Overview of results

For Q1 FY03/19, Digital Arts reported consolidated sales of JPY1.2bn (+5.2% YoY), operating profit of JPY295mn (-17.1% YoY), recurring profit of JPY295mn (-18.2% YoY), and net income attributable to parent company shareholders of JPY175mn (-32.1% YoY).

Sales growth of i-FILTER[®] and m-FILTER[®] in the enterprise sector covered the absence of extraordinary demand from local governments which was acquired in Q1 FY03/18. As a result, sales rose 5.2% YoY. Excluding the impact of extraordinary demand from local governments seen in Q1 FY03/18, sales increased by roughly 10% YoY, achieving double-digit growth in terms of organic growth. In addition to large organizations which were previously at the center of demand, the company enjoyed increased demand from small- and medium-sized enterprises that were relatively behind in adopting security measures. In addition, as risks security managers have to control are becoming more diversified and sophisticated following the spread of IoT and AI as well as promotion of work style reforms, demand for security services is on the rise.

However, on the profits front, gross profit was only up 0.2% YoY to JPY928mn due to an increase in CoGS-to-sales ratio (+3.7pp YoY to 23.8%) against the backdrop of increases in depreciation costs accompanied by the launch of new products and in personnel expenses stemming from hiring of more staff at domestic consulting subsidiary Digital Arts Consulting. Due to temporary increases in advertising expenses, sales promotion expenses, and personnel expenses as the company executed strategic sales promotion activities to capture the expanding demand in domestic new implementations and strengthened the

organizational and sales structure by securing experienced personnel, primarily in the US subsidiary, SG&A expenses rose 11.1% YoY to JPY632mn. SG&A-to-sales ratio was up 2.8pp YoY to 51.9%. As a result, operating profit fell 17.1% YoY (OPM fell 6.5pp YoY to 24.3%). Although profit is usually weak in Q1 due to upfront spending in a typical fiscal year, spending in Q1 FY3/19 was higher than usual, pushing down profit. Further, as mentioned above, profit was higher in Q1 FY03/18 owing to the impact of extraordinary demand from local governments. Lower profit YoY seen in Q1 FY03/19 was in line with company forecasts.

Progress

Q1 sales reached 43.5% of 1H forecasts (Q1 FY03/18 sales reached 46.9% of 1H FY03/18 results), operating profit reached 24.6% (38.7%), recurring profit reached 24.6% (38.6%), and net income attributable to parent company shareholders reached 22.6% (41.7%).

Q1 sales reached 21.0% of full-year forecasts (Q1 FY03/18 sales reached 22.6% of full-year FY03/18 results), operating profit reached 11.8% (18.7%), recurring profit reached 11.8% (18.9%), and net income attributable to parent company shareholders reached 10.8% (20.1%).

Progress in Q1 FY03/19 was sluggish compared with that in Q1 FY03/18 due to the absence of extraordinary demand from local governments.

Initiatives in Q1

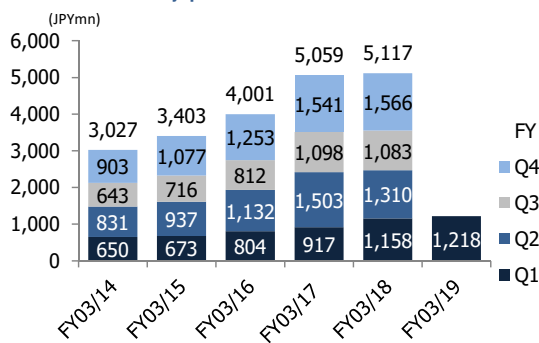
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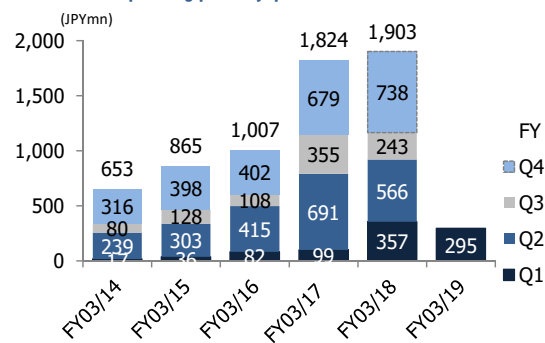
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In the overseas business, under the leadership of a new CEO, the company promoted activities to hire experienced personnel, strengthen its organizational structure, and tap into collaborative partners and channel partners.

Consolidated sales by quarter



Consolidated operating profit by quarter



Source: Shared Research based on company data

Enterprise sector

Sales in the enterprise sector rose 7.5% YoY to JPY688mn. Sales of core products i-FILTER® (-3.1% YoY), m-FILTER® (+10.4% YoY), and FinalCode® (+100.9% YoY) were strong as the company steadily secured orders, primarily ongoing projects from FY03/18.

Concerning FinalCode®, the large-scale order received at the end of FY03/18 contributed to sales growth. Sales at subsidiary Digital Arts Consulting, established in FY03/17, increased significantly with a heightened awareness of the need to implement additional data security measures and respond to a shortage of security personnel, adding to enterprise sector sales.

Upgrades to i-FILTER® Ver.10 and m-FILTER® Ver.5 at no charge for customers using previous versions progressed steadily. At the same time, demand from new customers also expanded. Under such circumstances, the 3.1% fall in i-FILTER® sales was attributed to the longer-than-usual approval process for new implementations (delay in the timing of order) as the price per project rose due to a roughly 70% price increase from the previous version. Relatively weaker sales of D-SPA® (integrated appliance products comprising both hardware and software such as i-FILTER®) also had an impact on the drop in i-FILTER® sales (D-SPA® also has a high CoGS ratio as it includes servers, but has a minor impact on profit).

Public sector

Sales in the public sector fell 3.8% YoY to JPY489mn. Strong sales of the mainstay i-FILTER® (+0.6% YoY) and m-FILTER® (+10.4% YoY) products were able to absorb the backlash from extraordinary demand in FY03/18 due to the security strengthening initiatives led by the Ministry of Internal Affairs and Communications. Sales of FinalCode® fell 65.3% YoY due to the absence of large-scale projects seen in Q1 FY03/18. As extraordinary demand for security strengthening measures wound down, a temporary slump in demand was seen from Q2 FY03/18. However, demand for new implementations in the public sector recovered in Q1 FY03/19. The business environment for the company has allowed for substantial growth since Q2 FY03/18.

Consumer sector

Sales in the consumer sector rose 30.0% YoY to JPY121mn. In the consumer sector, Digital Arts worked together with mobile operators, MVNO operators, and other partner companies to expand sales of i-FILTER® Multi-Device, which can be used on multiple operating systems (Windows, iOS, and Android™) with a single serial ID number. The ongoing decline in domestic sales of consumer-use PCs for notwithstanding, company sales of consumer-use products have held up well thanks to sales of multi-year packaged products, sales to internet cafes, and growing direct sales of i-FILTER® Multi-Device.

Full-year FY03/18 results

Results summary: Sales to the enterprise sector continue to be strong; profits rise as human resources strategy is reviewed, and resources are allocated more optimally

For FY03/18, Digital Arts reported consolidated sales of JPY5.1bn (+1.2% YoY), operating profit of JPY1.9bn (+4.3%), recurring profit of JPY1.9bn (+5.4%), and net income attributable to parent company shareholders of JPY1.3bn (+13.9%). The company compensated for the absence of extraordinary demand from local governments and major government contracts which were acquired in FY03/17 by securing sales growth of 1.2% YoY in the enterprise sector. As a result, sales rose 4.3% YoY. Operating profit rose YoY due mainly to higher sales and the effects of controls on personnel costs as organizational structure and human resources strategy were reviewed targeting medium- and long-term growth, and resources were allocated more optimally.

Results highlights

- ▶ The company was able to grow sales and profits YoY with growth in the enterprise sector, compensating for the absence of the major government contracts and extraordinary demand from local governments seen in FY03/17. However, results fell slightly below forecasts.
- ▶ Version upgrades to i-FILTER® Ver.10 and m-FILTER® Ver.5 progressed steadily (at end FY03/18 the company had sold 2mn licenses to 1,500 companies, the fastest rate of diffusion in company history). The company further expanded its business area by providing security against targeted outside attacks (Outside Security) in addition to its core competency of preventing internal information leaks (Inside Security)
- ▶ Amid increased awareness of the need to strengthen information security, subsidiary Digital Arts Consulting made solid progress in booking orders for consulting projects

Results versus company forecasts

Sales reached 91.4% of full-year forecasts for FY03/18, operating profit reached 95.1%, recurring profit reached 95.5%, and net income attributable to parent company shareholders reached 103.4%. Sales and operating profit fell slightly below company forecasts due to the renewal of certain contracts sliding into FY03/19.

Sales

The company's sales in FY03/18 were the highest on record, at JPY5.1bn (+1.2% YoY), as the company compensated for the absence of FY03/17's major government contracts and extraordinary demand from local governments with growth in the enterprise sector and recorded its highest sales yet. Sales rose in the enterprise (+16.9%) and consumer (+4.4%) sectors, compensating for a decline in the public sector (-18.5%).

Operating profit

Operating profit was JPY1.9bn (+4.3% YoY), a new company record. Although the CoGS ratio rose 1.1pp YoY due to higher depreciation, the SG&A expense ratio declined 2.2pp due to costs controls as the company reviewed its organizational structure and human resources strategy, aiming for medium-term growth, and allocated resources more optimally. As a result, operating profit margin rose 1.1% to 37.2% (the highest level in the last 10 years).

License and user numbers for i-FILTER® Ver.10 and m-FILTER® Ver.5 increased steadily

In addition to its mainstay business preventing data leakage from companies or organizations, a focus since its inception, the company has promoted planning and development of solutions against outside threats, most notably targeted attacks, while utilizing its strength in domestic production and in-house development. As a result, the company released i-FILTER® Ver. 10 and m-FILTER® Ver. 5 in September 2017. By implementing these products, customers can strengthen their security against data leaks and malware infection stemming from the internet or email. They can also reduce expenses for multi-level security systems and employee training. The free version upgrades for existing users and acquisition of new users progressed smoothly. As of the end of FY03/18, there were 1,500 companies with a total of 2mn licenses for i-FILTER® Ver. 10 and m-FILTER® Ver. 5, the fastest license expansion for the company to date. According to the company, approximately 10% of those companies are new customers (approximately 90% upgraded for free from older versions). It said half a year since the release, use is proceeding without trouble and the rate of new customer acquisition heightening in April 2018.

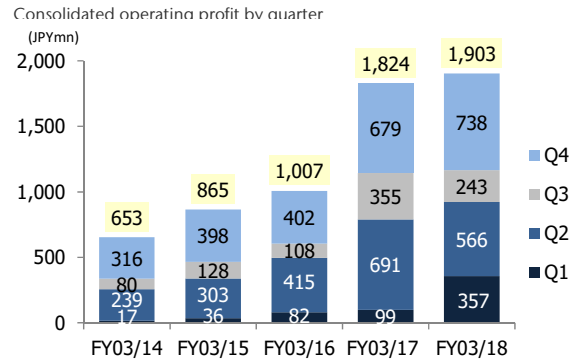
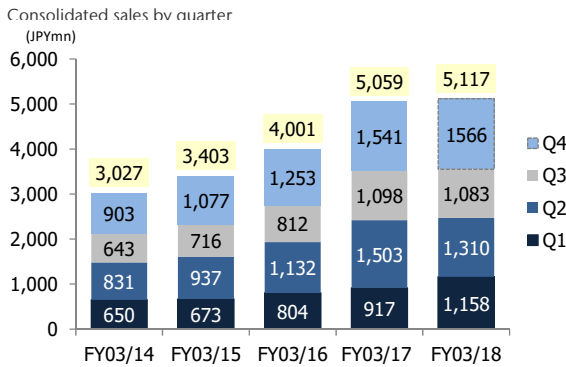
The company has heard positive reviews of its new products from both new and existing users. With these products, the company has taken the first step toward transitioning from a security solutions company that focused solely on preventing data leakage from companies and organizations to a comprehensive security solutions company that also prevents targeted attacks from the outside.

Subsidiary and overseas business trends

Subsidiary Digital Arts Consulting made steady progress in booking orders for consulting projects, due to the heightened awareness of the need to strengthen information security countermeasures, contributing to overall company sales and operating profit.

In the overseas business, the company has received contracts from both companies and government-related entities as concern about file security heightens around the globe. In order to secure such contracts, the company is engaged in proactive sales activities, primarily in the US subsidiary FinalCode, Inc.

FinalCode®, established in April 2014, has achieved some success in raising awareness and receiving positive product evaluation, but failure to achieve initial targets resulted in a significant reorganization at the local level as managers with a wealth of global experience were brought in with the objective of expanding business under a new organization and business plan. Accordingly, the company decided to liquidate investments up to the previous financial year, and recorded a JPY93.1bn loss on valuation of shares of subsidiaries. This loss will be offset in consolidated accounts, so there is no effect.



Source: Shared Research based on company data

Enterprise sector

Sales in the enterprise sector rose 16.9% YoY to JPY3.0bn. Sales of core products i-FILTER®, m-FILTER®, and FinalCode® were strong. i-FILTER® drew new orders among large-scale companies seeking countermeasures to targeted attacks and precise countermeasures against internal information leaks. m-FILTER® secured steady growth, acquiring orders with the objective of preventing internal information leaks. Concerning FinalCode®, orders in the form of test installation projects and small-scale trials have wound down, and although orders for additional licenses and full installation mainly concentrated around the end of FY03/18, the company managed to secure sustainable growth. Sales at subsidiary Digital Arts Consulting, established in FY03/17, increased significantly with a heightened awareness of the need to implement additional data security measures, adding to enterprise sector sales.

Public sector

Sales in the public sector fell 18.5% YoY to JPY1.7bn. Local governments have become increasingly aware of the importance of data security and increasingly adopted Digital Arts' i-FILTER®, m-FILTER®, and Final Code® security software as a means to further enhance their data security. However, the movement seen in cumulative Q3 FY03/17 when cities, wards, towns, and villages actively improved their security (using the model for improving local government's data systems), and prefectures consolidated their internet connections and strengthening surveillance (using cloud solutions for local government data security) wound down. Major government contracts, such as the ones acquired in FY03/17, were also absent. As a result, sales fell YoY.

Consumer sector

Sales in the consumer sector rose 4.4% YoY to JPY376mn. In the consumer sector, Digital Arts worked together with mobile operators, MVNO operators, and other partner companies to expand sales of i-FILTER® Multi-Device, which can be used on three operating systems (Windows, iOS, and Android™) with a single serial ID number. The ongoing decline in domestic sales of consumer-use PCs for notwithstanding, company sales of consumer-use products have held up well thanks to sales of multi-year packaged products, sales to internet cafes, and growing direct sales of i-FILTER® Multi-Device.

FY03/17 results

Earnings overview: record highs sales and significant profit growth amid ongoing favorable environment

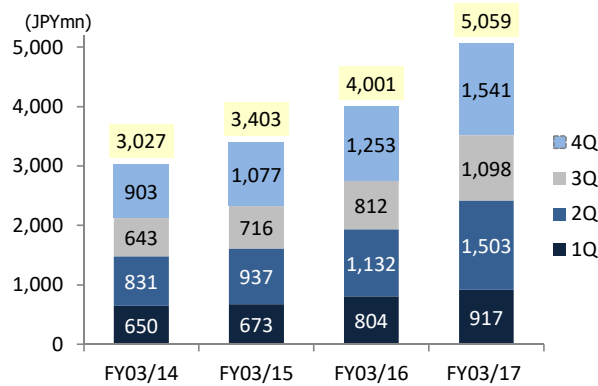
In FY03/17, consolidated sales were at a record high of JPY5.1bn (+26.4% YoY). Sales in Q4 alone kept up the favorable pace of Q3, increasing 22.9% YoY.

Sales from the enterprise sector, public sector, and consumer sector were up. In the public sector, sales of core products i-FILTER® and m-FILTER® swelled in light of demand in response to the Ministry of Internal Affairs and Communication's guidelines. According to the company, in order to strengthen local government information security as detailed in these guidelines, many local governments invested in security, resulting in roughly JPY400mn in special demand.

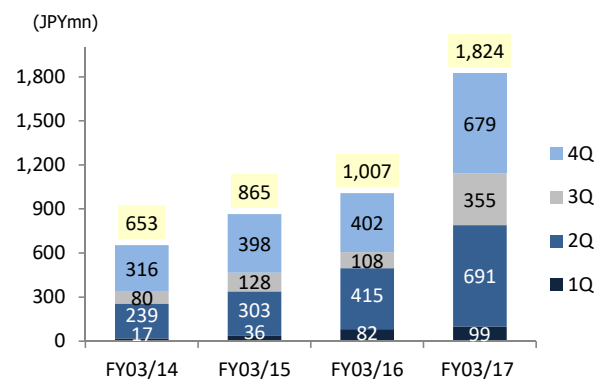
Although domestic personnel and other expenses increased, higher sales had a positive influence on profits. Operating profit was JPY1.8bn (+81.2% YoY), and OPM rose to 36.1% (25.2% in FY03/16). Recurring profit was JPY1.8bn (+82.2% YoY), and net income attributable to parent company shareholders was JPY1.1bn (+106.1% YoY).

As a result, progress against full-year forecasts as revised on March 23, 2017, was sales at 101.2%, operating profit at 107.3%, recurring profit at 106.5%, and net income attributable to parent company shareholders at 107.1%.

Consolidated sales by quarter



Consolidated operating profit by quarter



Source: Shared Research based on company data

Enterprise sector

Sales in the enterprise sector were JPY2.6bn (+14.9% YoY).

Sales of core products i-FILTER® and m-FILTER® were favorable (+9.2% and +8.3% YoY, respectively) and sales of FinalCode® grew significantly (+97.7%). Corporate managers are more aware of the importance of improving information security as targeted attacks on specific companies are causing increasingly more damage. In such an environment, the company saw continued implementation of its i-FILTER® and m-FILTER® products, which can deal with a variety of complex security risks. In an environment where leaks of large volumes of customer data occur often, FinalCode Ver. 5, released in FY03/16, provided company-wide advanced file security, meeting the needs of corporations that handle large volumes of customer data and increasing sales of FinalCode®. Moreover, order receipts at Digital Arts Consulting Inc. also remained favorable due to the growing awareness of the importance of strengthening information security, contributing to the growth of sales.

Public sector

Sales in the public sector were JPY2.1bn (+49.9% YoY).

Sales in the public sector flourished for the company's core products, i-FILTER® and m-FILTER® (+33.6% and +189.6% YoY, respectively).

The Ministry of Internal Affairs and Communications released guidelines for strengthening local government data security. In response, cities, wards, towns, and villages actively improved their security (using the model for improving local government's data systems), and prefectures consolidated their internet connections and strengthening surveillance (using cloud solutions for local government data security).

Amid such an environment, sales grew since the company captured the demand for centralizing web access using i-FILTER® and providing email security with m-FILTER® that resulted from customers' needs to respond to the guidelines. Sales of FinalCode® grew 47.8% YoY thanks to robust implementation of the version of FinalCode® limited to local governments, which provides the simple functions that public organizations are looking for.

Consumer sector

Sales in the consumer sector were JPY360mn (+5.0% YoY).

In the consumer sector, Digital Arts was entering tie-ups with mobile operators and MVNO operators in an effort to expand sales and increase collaboration for the mobile device version of i-FILTER® for smartphones.

Sales were firm for the PC version of the company's products due to OEM-driven sales, robust shipments of multi-year packaged products, and other positive factors, despite a decline in the number of domestic consumer PC shipments. Sales also expanded thanks to robust direct sales of i-FILTER® Multi-Device, which can be used on three operating systems (Windows, iOS, and Android™) with a single serial ID number.

FY03/16 results

Demand shifting from external threats to preventing internal information leaks (the company's strength)

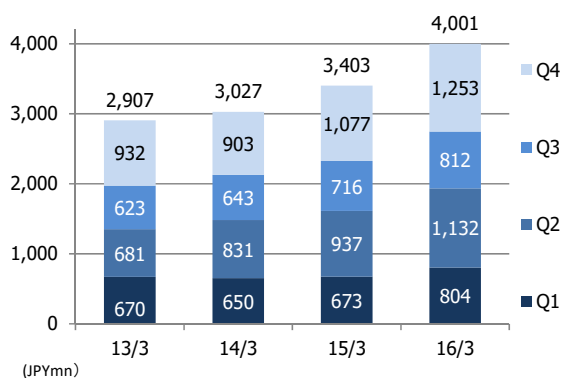
According to the company, the security industry faces increasingly sophisticated and complex risks. These stem from attacks targeting specific companies and national institutions, and leaks of personal information by people inside of these organizations. Companies and organizations are realizing that security that solely addresses external threats is inadequate, and are shifting focus to internal information leaks. In other words, demand is leaning toward internal information security solutions—a strength of Digital Arts since its founding. Accordingly, demand is rising for its mainstay products, i-FILTER® and m-FILTER®, as well as the key product in its overseas strategy, FinalCode®.

Earnings overview: OP up 16.4% YoY, rising sales absorb upfront expenditures for overseas expansion

Consolidated sales for FY03/16 were JPY4.0bn (+17.6% YoY), to a record high. Sales growth was strong due to a 17.6% YoY increase in sales of the company's mainstay i-FILTER® (+8.0% in FY03/15) and brisk sales of FinalCode® in the Japanese market. Profits were up despite expenses increasing in line with the full-fledged launch of the company's US subsidiary, FinalCode, Inc., investments to set up overseas offices, and costs for 20th anniversary events. Operating profit came to JPY1.0bn (+16.4% YoY), recurring profit JPY994mn (+9.2%), and net income attributable to parent company shareholders to JPY546mn (+2.8%).

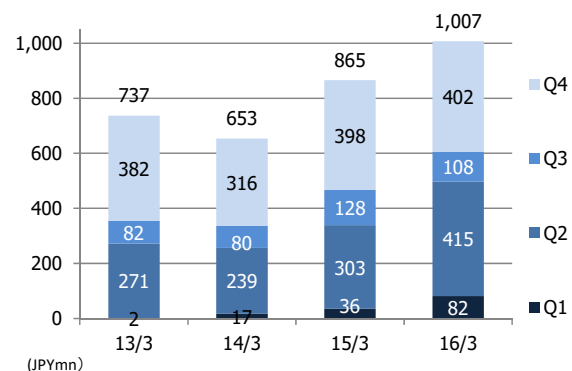
As a result, progress versus latest company forecasts were: sales, 101.3% (105.3% versus initial forecast); operating profit, 100.7% (110.7%); recurring profit, 99.1% (109.3%); and net income, 94.6% (99.6%). Results were solid overall, but recurring profit fell slightly short of the new forecast due to forex losses of JPY20mn (gains of JPY41mn in FY03/15).

Consolidated sales, by quarter



Source: Shared Research based on company data

Consolidated operating profit, by quarter



Accelerated growth to enterprise, public sectors on brisk core product and expanded FinalCode® sales

Sales growth accelerated to both the enterprise sector (+17.9% YoY versus +16.0% in FY03/15) and public sector (+24.4% versus +10.8%), due to increased interest in dealing with targeted attacks and preventing the leak of confidential company information. Sales to the consumer sector were down 5.6% YoY, although still relatively stable compared to the large decline in the number of domestic computer shipments.

According to Digital Arts, its customers are recognizing the effectiveness of its core product, i-FILTER® (web security software) in addressing targeted attacks, in addition to its filtering function. The company also says that by linking with other companies' products, it can increasingly meet the needs of major organizations, which is pushing up sales. Burgeoning use of smartphones and tablets in business and educational settings are boosting sales of i-FILTER® Browser & Cloud, i-FILTER® for mobile devices. Sales of this product were particularly robust to financial institutions, leading educational institutions, and school boards, who want to ensure the secure operation of smart devices. m-FILTER® (email security software) is contributing to robust sales growth due to an additional function to counter erroneous email transmission. The product also links with other companies' products, leading to greater scalability.

FinalCode® (file encryption and tracking solution) saw orders up to roughly 4x the previous year levels on a favorable reception for the Ver. 5's shared folder monitoring and automatic encryption features. There is a sharp rise in demand for file security to prevent information leaks due to targeted attacks and deliberate leaks by personnel within organizations. Sales are particularly favorable for the cloud edition of this software, which is easy to install. The company also noted that a number of large-scale contracts that had been under consideration have progressed to the order phase.

Overseas, the company concentrated on branding activities, mainly at its US subsidiary FinalCode, Inc. It also worked to build sales and support structures in Asia-Pacific and Europe to meet demand from corporations with a global presence. FinalCode, Inc. secured its first overseas order, and in FY03/16, the company had secured 14 orders overseas (local companies, five contracts; Japanese companies, nine contracts). Also, there were major marketing effects, such as winning a global security vendor award.

Enterprise sector: Sales of mainstay products growing steadily

Sales to the enterprise sector were JPY2.2bn (+17.9% YoY).

Sales were favorable for the company's main products in the enterprise sector: i-FILTER®, m-FILTER®, and FinalCode®. Given the growing risk of information leaks and improving corporate earnings, large companies in particular were investing in security measures. Digital Arts won new orders from large companies to prevent information leaks, by linking other companies' products and its i-FILTER® and m-FILTER®. It also made progress in introducing i-FILTER® Browser & Cloud (for mobile devices), particularly at financial institutions, which require highly secure browsers. Sales of this product have soared. Sales of FinalCode® also rose steadily due to companies rushing to bolster security in the wake of a spate of incidents where critical information was leaked, and due to the ease of installing the cloud version. Existing FinalCode® customers highly rate the product's effectiveness and usability, leading to increases in the number of licenses (number of users). The company has begun to see a flow of orders from existing customers who had been contemplating larger contracts.

Public sector: substantial increase in large i-FILTER® contracts and expanding sales of FinalCode®

Sales in the public sector were JPY1.4bn (+24.4% YoY).

Sales in the public sector were firm for the company's core product, i-FILTER®, and sales of FinalCode® grew. Similarly, in the enterprise sector, linking the company's i-FILTER® with other companies' products enabled Digital Arts to win large new orders with major organizations looking to strengthen their security. Meanwhile, i-FILTER® Browser & Cloud (for mobile devices) is being introduced at leading educational institutions and school boards, which are promoting tablet-based ICT (information and communications technology) education to foster ICT literacy from an early age. Further, sales grew sharply amid uptake by local government authorities nationwide, given the critical need to protect against attacks targeting specific organizations and information leaks from insiders.

Consumer sector: Market environment sluggish, but performance solid

Sales in the consumer sector were JPY342mn (-5.6% YoY).

In the consumer sector, Digital Arts was entering tie-ups with mobile operators and their business partners in an effort to expand sales and increase collaboration for i-FILTER® for smartphones.

The company's sales in the consumer sector were weighed down by a fall in domestic shipments of PCs, and the conclusion of some alliances with internet service providers. Still, sales were firm thanks to robust sales of i-FILTER® Multi-Device, which can be used on three operating systems (Windows, iOS, and Android™) with a single serial number. Sales were also up due to robust performance of New Nintendo 3DS™, a mobile gaming device launched last fiscal year by Nintendo Co., Ltd. (TSE1: 7974), which has Digital Arts' filtering technology pre-installed.

Income statement

Income statement (JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Total sales	1,701	1,853	2,191	2,308	2,708	2,907	3,027	3,403	4,001	5,059	5,117
YoY	22.6%	8.9%	18.2%	5.4%	17.3%	7.3%	4.1%	12.4%	17.6%	26.4%	1.2%
Cost of sales	358	388	438	463	649	733	878	975	926	1,007	1,075
Gross profit	1,343	1,465	1,753	1,845	2,059	2,174	2,149	2,428	3,075	4,052	4,042
YoY	25.4%	9.1%	19.7%	5.2%	11.6%	5.6%	-1.1%	13.0%	26.6%	31.8%	-0.2%
GPM	79.0%	79.1%	80.0%	79.9%	76.0%	74.8%	71.0%	71.4%	76.9%	80.1%	79.0%
SG&A expenses	720	836	1,042	1,159	1,472	1,437	1,496	1,563	2,068	2,227	2,139
SG&A-to-sales ratio	42.3%	45.1%	47.6%	50.2%	54.4%	49.4%	49.4%	45.9%	51.7%	44.0%	41.8%
Operating profit	623	629	711	686	587	737	653	865	1,007	1,824	1,903
YoY	80.0%	1.1%	12.9%	-3.5%	-14.4%	25.5%	-11.4%	32.5%	16.4%	81.2%	4.3%
OPM	36.6%	34.0%	32.5%	29.7%	21.7%	25.3%	21.6%	25.4%	25.2%	36.1%	37.2%
Non-operating income	-3	4	4	2	1	2	7	45	8	3	7
Non-operating expenses	3	1	0	1	23	13	1	0	20	16	0
Recurring profit	623	633	714	687	566	726	660	910	994	1,811	1,909
YoY	81.6%	1.6%	12.8%	-3.8%	-17.6%	28.3%	-9.1%	37.9%	9.2%	82.2%	5.4%
RPM	36.6%	34.2%	32.6%	29.8%	20.9%	25.0%	21.8%	26.8%	24.9%	35.8%	37.3%
Extraordinary gains (losses)	-1	-1	0	-6	-3	6	8	-2	4	-8	-3
Pre-tax profit	622	632	714	682	565	732	667	908	999	1,803	1,906
Income taxes	273	281	343	292	255	288	268	377	453	678	623
Implied tax rate	43.9%	44.5%	48.0%	42.8%	45.1%	39.3%	40.2%	41.5%	45.3%	37.6%	32.7%
Minority interests	0	0	0	0	0	0	0	0	0	0	2
Net income	350	351	371	390	310	444	400	531	546	1,125	1,282
YoY	99.7%	0.3%	5.6%	5.2%	-20.4%	43.2%	-10.1%	33.0%	2.8%	106.1%	13.9%
Net margin	20.6%	18.9%	16.9%	16.9%	11.5%	15.3%	13.2%	15.6%	13.6%	22.2%	25.1%

Source: Shared Research based on company data

Note: Figures may differ from company data due to differences in rounding methods

Note: No YoY comparisons are shown for FY03/06, as this was the company's first year of reporting consolidated results.

Against the backdrop of growing security needs, Digital Arts is seeing a steady increase in earnings. Average annual sales growth has been 11% from FY03/06 (when the company started announcing consolidated results) to FY03/18. Operating profit fell during the same period due to lean public sector investment and because the company opted for large-scale investment in new services and expanded overseas development. Still, average annual profit growth over the past 12 years has been around 13%.

SG&A breakdown (consolidated) (JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
Advertising	59	82	105	98	264	264	179	158	272	310	288
Salaries and allowances	178	223	303	364	409	437	489	491	697	728	657
Provision for bonuses	18	26	36	41	49	36	63	44	66	90	53
Commission fee	58	56	58	72	77	74	88	72	77	96	111
Goodwill amortization	52	52	52								
Total R&D expenses	10	11	14	21	18	8	8	5	3	9	15
Loss on retirement of fixed assets	1	0	0	0	1	1	0	0	2	2	10

Net service cost (parent) (JPYmn)	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
Raw material costs	11	9	7	14	40	22	35	34	87	139	167
Labor costs	282	314	360	393	496	600	558	532	517	697	674
Other costs	252	278	335	402	548	614	713	786	702	745	738
Total costs	545	601	702	809	1,084	1,237	1,306	1,352	1,306	1,581	1,579
Transfer to other accounts	197	200	274	350	440	510	462	440	411	504	519
Net service cost	348	380	428	459	644	727	843	912	894	1,076	1,061
Labor costs											
Salaries and allowances	163	175	210	244	314	384	360	357	322	419	436
Legal welfare expenses	25	28	33	41	57	69	66	66	62	82	84
Bonuses	21	20	23	26	36	42	39	44	47	58	59
Provision for bonuses	14	20	23	30	39	39	45	42	42	73	43
Miscellaneous salaries					43	62	45	16	37	56	47
Expenses											
Subcontract expenses	13	15	30	83	98	60	36	69	102	131	113
Depreciation	162	185	219	216	273	338	434	506	377	368	382
Rents	40	41	47	42	59	61	66	74	78	92	99
Transfer to other accounts											
SG&A expenses	21	24	44	62	78	69	70	76	56	58	40
Fixed assets	173	196	230	289	362	441	392	364	355	447	479
Fee cost	3										
Total	197	220	274	350	440	510	462	440	411	504	519

Source: Shared Research based on the company's securities report

Accounting treatment for R&D expenses and software

According to the Japanese "Accounting Standard for Research and Development Costs," software for market sale is accounted for as follows.

When producing software for sale, the costs of R&D associated with production activities up to the time a "product master for initial commercialization" is complete must be expensed as incurred. (As no product is generally associated with such expenditures, they are recorded as general expenses). Production costs after a product is completed (costs for revising or enhancing the functions of a product master) are in principle capitalized. Software that is incomplete at fiscal year-end is recorded as software in progress, while completed software is recorded under the software line item, both of which are intangible fixed assets.

Intangible fixed assets, such as software, can be depreciated according to their expected sales volume or expected profit on sales. However, annual depreciation may not be less than the average proportional amounts corresponding to their remaining useful life (typically within three years). In other words, annual depreciation amounts must be based either on expected sales volume (expected profit on sales) or remaining useful life, whichever yields the higher amount. As sales progress over time, if the undepreciated amount exceeds expected profit on sales for the next fiscal year, the amount of excess is written off in a lump sum as expense or loss.

Balance sheet

Balance sheet (JPYmn)	FY03/08 Cons.	FY03/09 Cons.	FY03/10 Cons.	FY03/11 Cons.	FY03/12 Cons.	FY03/13 Cons.	FY03/14 Cons.	FY03/15 Cons.	FY03/16 Cons.	FY03/17 Cons.	FY03/18 Cons.
Assets											
Cash and deposits	1,215	1,342	1,529	1,737	1,905	2,070	2,156	2,674	2,943	3,899	4,426
Accounts receivable	556	504	724	664	725	808	815	933	1,082	1,296	1,125
Marketable securities		200	401	401	101	101	401	301	101	-	-
Inventories	3	6	4	3	4	8	7	1	0	1	1
Deferred tax assets	34	33	41	43	64	63	61	67	74	88	58
Other current assets	20	19	25	35	33	54	58	102	63	91	155
Total current assets	1,828	2,104	2,724	2,883	2,832	3,104	3,498	4,078	4,263	5,375	5,766
Buildings and structures	28	36	38	58	101	94	118	124	124	127	130
Accumulated depreciation	9	13	17	27	24	32	51	67	80	88	97
Buildings and structure (net)	19	23	21	31	77	62	67	57	44	39	34
Tools, furniture and fixtures	95	111	121	167	207	216	241	275	294	305	361
Accumulated depreciation	61	73	89	117	136	157	181	201	222	226	251
Tools, furniture and fixtures (net)	34	38	32	50	71	59	60	74	73	79	110
Construction in progress	-	-	-	-	-	-	-	14	-	-	-
Others	-	-	7	4	2	6	-	-	11	7	13
Total tangible fixed assets	53	61	60	85	150	127	127	145	127	125	157
Software	260	301	321	387	556	718	755	811	821	894	971
Others	65	51	52	84	57	66	133	125	174	262	315
Total intangible fixed assets	428	404	373	471	613	784	888	936	996	1,156	1,286
Investment securities	-	101	-	-	303	302	-	300	404	404	403
Deferred tax assets	1	2	8	14	17	19	65	63	48	31	15
Stocks of subsidiaries and affiliates	-	-	-	-	49	57	63	58	57	33	33
Others	69	86	89	97	137	170	170	169	239	257	268
Investments and other assets	70	189	97	111	506	548	360	590	748	724	720
Total fixed assets	551	654	530	668	1,269	1,459	1,376	1,671	1,871	2,006	2,162
Total assets	2,379	2,758	3,254	3,551	4,101	4,563	4,873	5,749	6,134	7,381	7,929
Liabilities											
Accounts payable	4	1	-	4	7	2	7	4	6	18	22
Short-term debt	25	-	-	-	-	-	-	-	-	-	-
Advances received	-	-	191	252	390	443	476	675	721	1,017	917
Income taxes payable	216	142	209	144	129	155	182	267	284	475	305
Provision for bonuses	32	46	59	71	87	77	99	97	110	166	112
Other current liabilities	125	224	103	128	245	285	190	366	327	390	279
Total current liabilities	402	413	562	599	858	962	954	1,409	1,448	2,066	1,636
Long-term debt	-	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	15	30	32	42	43	44	45	45
Total fixed liabilities	-	-	-	15	30	32	42	43	44	45	45
Total interest-bearing debt	25	-	-	-	-	-	-	-	-	-	-
Total liabilities	402	413	562	614	889	995	997	1,451	1,492	2,111	1,681
Net assets											
Capital stock	682	683	683	697	698	714	714	714	714	714	714
Capital surplus	668	670	670	684	685	700	732	736	766	778	826
Retained earnings	627	978	1,311	1,646	1,895	2,215	2,490	2,897	3,220	4,099	4,992
Treasury stock	-	-	-22	-181	-181	-181	-147	-143	-118	-411	-328
Total shareholders' equity	1,977	2,331	2,642	2,847	3,097	3,449	3,789	4,203	4,583	5,180	6,203
Valuation difference on securities	-	-	-	-	-	-	-	-	-	-	-
Subscription rights to shares	-	14	50	90	116	120	87	84	58	81	34
Foreign currency translation adjustments	-	-	-	-	-	-	-	11	1	4	-5
Minority interests	-	-	-	-	-	-	-	-	-	5	15
Total net assets	1,977	2,345	2,692	2,936	3,213	3,568	3,876	4,298	4,642	5,270	6,248
Working capital	555	509	728	663	722	814	815	930	1,076	1,279	1,104
Total interest-bearing debt	25	-	-	-	-	-	-	-	-	-	-
Net debt	-1,190	-1,342	-1,529	-1,737	-1,905	-2,070	-2,156	-2,674	-2,943	-3,899	-4,426

Source: Shared Research based on company data

Note: Figures may differ from company data due to differences in rounding methods.

Due to its positive profit performance, Digital Arts has maintained a net cash position. The company has not held interest-bearing debt since FY03/09. In FY03/08, it changed its method of recording sales, from booking the full amount under sales when the contract was signed, to recording the portion of sales corresponding to maintenance and support as advances received, and transferring the advances to sales by month over the contract period (beginning the month after the contract is signed). The company still records the software portion of sales as before, as a lump sum at contract signing. This change in accounting had a 3.1% negative impact on sales in FY03/08, and 8.0% in FY03/09. The company began reporting advances received in FY03/10.

Cash flow statement

Cash flow statement (JPYmm)	FY03/07	FY03/08	FY03/09	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Cash flows from operating activities (1)	171	828	685	601	751	848	821	817	1,355	1,027	2,012	1,663
Cash flows from investing activities (2)	-327	-394	-535	-456	-56	-899	-558	-646	-848	-441	-672	-775
Free cash flow (1+2)	-156	434	150	145	695	-51	263	171	507	586	1,340	888
Cash flows from financing activities	-33	-69	-23	-58	-185	-80	-97	-85	-120	-188	-503	-293
Depreciation and amortization (A)	147	175	198	237	241	311	375	489	589	504	523	574
Capital expenditures (B)	227	194	234	255	356	489	524	583	548	574	664	776
Working capital changes (C)	25	-19	-46	219	-65	59	92	1	115	146	203	-175
Simple FCF (NI + A - B - C)	70	350	361	134	340	73	203	305	457	329	781	1,255

Source: Shared Research based on company data

Note: Figures may differ from company data due to differences in rounding methods.

Other information

History

Digital Arts was established in June 1995 to develop internet-related application software. At that time, the company handled products in a wide range of genres. In September 2004, Digital Arts sold off most of its businesses to focus on filtering software. Since then, it has concentrated on the development of security software.

June 1995	Digital Arts Inc. established to develop and market internet-related application software
August 1998	Developed the first web filtering software in Japan and started collecting information about harmful websites
May 2000	Launched NET iScope internet monitoring service
September 2002	Listed on the NASDAQ Japan Osaka Securities Exchange (now JASDAQ standard)
September 2004	Began sales of NET iScope internet monitoring service, focusing on corporate filtering software
February 2005	Obtained patents in 22 countries and regions for "internet access controls including filtering" (Also obtained patent in China in July 2009, increasing the number of countries and regions in which patents acquired to 27, including Japan, the US, South Korea, Hong Kong and India)
March 2005	Acquired all shares in IQS' Co., Ltd., making it a subsidiary
April 2011	Established US subsidiary Digital Arts America, Inc., and UK subsidiary Digital Arts Europe Ltd. (current FinalCode Europe Limited)
February 2012	Listed on the Second Section of the Tokyo Stock Exchange
June 2012	Founded US subsidiary Digital Arts Investment, Inc.
March 2013	Listed on the First Section of the Tokyo Stock Exchange
May 2013	Founded Polkast Japan, entered into business alliance with US company Polkast LLC (alliance ended in January 2015)
June 2013	Entered into strategic business alliance with NRI Secure Technologies, Ltd., and accepted a business transfer
April 2014	Founded US subsidiary FinalCode, Inc.
November 2015	Founded Singapore subsidiary Digital Arts Asia Pacific Pte. Ltd. (current FinalCode Asia Pacific Pte. Ltd.)
February 2016	Changed trade names of UK subsidiary to FinalCode Europe Limited and Singapore subsidiary to FinalCode Asia Pacific Pte. Ltd.
April 2016	Established Digital Arts Consulting Inc.

Source: Shared Research based on company website

News and topics

March 2017

On **March 31, 2017**, the company announced that it will establish a subsidiary in Vietnam.

The company announced that it will set up a subsidiary in Vietnam for the purpose of developing products for overseas markets, such as customized development for overseas clients and product localization into multiple languages. The new company will have paid-in capital of VND6bn (around JPY30mn) wholly invested by Digital Arts, and its date of establishment is slated for July 1, 2017. The impact of this transaction on the company's consolidated earnings results will be minimal.

On **March 23, 2017**, the company announced a revision to its consolidated FY03/17 earnings and dividend forecasts.

Revisions to the FY03/17 forecast (previous forecasts in parentheses)

Sales:	JPY5.0bn (JPY4.6bn)
Operating profit:	JPY1.7bn (JPY1.4bn)
Recurring profit:	JPY1.7bn (JPY1.4bn)
Net income attributable to owners of the parent:	JPY1.1bn (JPY870mn)
EPS:	JPY75.42 (JPY62.49)

Reasons for the revisions to earnings forecasts

Sales, operating profit, recurring profit, and net income attributable to shareholders of the parent are expected to outperform initial forecasts due to brisk sales of the company's mainstay i-Filter and m-FILTER series to the domestic public sector. This is because prefectures, cities, wards, towns, and villages enhanced their internet security in response to guidelines from the Ministry of Internal Affairs and Communication for strengthening local government data security. The company also won large orders for i-Filter for the public sector.

Revisions for the revision to year-end dividend forecasts

The previous FY03/17 year-end dividend forecast was JPY10 per share, but the company revised up this forecast by JPY4 to JPY14, in light of its earnings outlook and financial position. As a result, the annual FY03/17 dividend is expected to be JPY24 per share (JPY15 in FY03/16).

Major shareholders

Top shareholders (as of March 31, 2018)	Shareholding ratio
Toshio Dogu	17.91%
Japan Trustee Services Bank, Ltd. (Trust account)	10.59%
DAM Corporation	4.90%
The Master Trust Bank of Japan, Ltd. (Trust account)	3.36%
Japan Trustee Services Bank, Ltd. (Trust account 9)	3.24%
JP Morgan Chase Bank 380055 (Standing proxy: Mizuho Bank, Ltd. Settlement Department)	2.98%
State Street London Care of State Street Bank and Trust, Boston SSBTC A/C UK London Branch Clients-United Kingdom (Standing proxy: The Hongkong and Shanghai Banking Corporation Limited Tokyo Branch Custody Department)	2.88%
Threadneedle Investment Funds ICVC-Japan Fund (Citibank N.A. Tokyo Branch)	2.83%
Morgan Stanley MUFG Securities Co., Ltd.	2.64%
BBH (Lux) For Fidelity Funds Pacific Fund (Standing proxy: The Bank of Tokyo-Mitsubishi UFJ, Ltd.)	2.00%
Total	53.33%

Source: Shared Research based on company data

Corporate governance and top management

Corporate governance status

Capital structure	
Controlling shareholders	None
Parent company ticker	N/A
Organization and directors	
Organizational form	Company with Audit & Supervisory Board
Number of directors under Articles of Incorporation	10
Directors' terms under Articles of Incorporation	1 year
Number of independent outside directors	2
Voluntary committee equivalent to Nomination Committee or Compensation Committee	None
Number of Audit & Supervisory Board members under Articles of Incorporation	3
Full-time member of Audit & Supervisory Board	1
Independent outside directors and members of Audit & Supervisory Board	2
Other	
Disclosure of directors' compensation	Total amount disclosed
Policy on determining amount of compensation and calculation methodology	In place
Corporate takeover defenses	None

Source: Shared Research based on company data

Top management

Toshio Dogu, CEO of Digital Arts, joined Forval Corporation (TSE1: 8275; current name) in 1988 and was involved in sales. In November of that same year, he entered MacroSystem, gaining experience in programming, before moving to TDK Core Co., Ltd. (current Creative Core Co., Ltd.) in October 1992, gaining experience in education and entertainment planning. In October 1997, he assumed the current position of CEO of Digital Arts.

Employees

As of March 31, 2018, the company had 207 employees on a consolidated basis.

	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Number of employees	116 (22)	141 (16)	163 (7)	174 (25)	178 (23)	179 (20)	186 (25)	194 (30)	207 (33)

Source: Shared Research based on company data

Note: Figures in parentheses indicate the average number of temporary employees (external).

Average age, years of service, and salary of employees (194 employees) at the parent in FY03/18:

- ▷ Average age: 36.4 years (36.7 years in FY03/17)
- ▷ Average years of service: 5.6 (5.5 years in FY03/17)
- ▷ Average salary: JPY6.5mn (JPY6.9mn in FY03/17)

Shareholder return

The company sees shareholder returns as a priority, and targets a payout ratio of approximately 30% of consolidated net income.

	FY03/10	FY03/11	FY03/12	FY03/13	FY03/14	FY03/15	FY03/16	FY03/17	FY03/18
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Dividend per share (JPY)	400.00	450.00	600.00	800.00	8.00	14.00	15.00	24.00	28.00
Dividend per share adjusted for stock splits (JPY)	4.00	4.50	6.00	8.00	8.00	14.00	15.00	24.00	28.00
Consolidated payout ratio	14.2%	15.8%	26.4%	24.9%	27.8%	36.6%	38.2%	29.7%	30.3%

Source: Shared Research based on company data

Types of web filtering

Web filtering generally uses three methods: whitelist, blacklist, and category.

Method	Main characteristics
Whitelist filtering	This method uses a list of registered websites that can be accessed (a whitelist), and access to all other websites is denied. The advantage is that access to harmful websites is completely blocked. The disadvantage is that the scope of internet use is restricted.
Blacklist filtering	This method uses a list of websites to be blocked (a blacklist), and access to the websites on the list is denied. The advantage is relatively limited restrictions on the scope of Internet use. The disadvantage is that corporate system administrators have to continually recording an increasing number of harmful websites.
Category filtering	Websites are classified into categories, such as "adult," "offensive," and "online dating." Corporate information system administrators use filtering software to simply block access to categories not necessary to operations. In general, a software company produces a database that categorizes websites and offers filtering services. The advantage is that corporate information system administrators do not have to monitor and register websites on an ongoing basis. Disadvantages are that poor database accuracy could result in blocked access to harmless websites and failure to block harmful ones.

Source: Shared Research based on company data

Glossary

- ▶ **SaaS (Software as a Service):** Refers to software (or mode of delivery) in which necessary functions are provided in the required quantities as services via telecommunications networks for instance.
- ▶ **Web filtering software:** Software where user settings determine which websites can be browsed and which cannot.
- ▶ **Caching function:** To accelerate data access, data is temporarily stored on a medium with faster response. Web browsers and server caching functions allow the content of pages that have been viewed once to be stored, thereby displaying site information faster the next time they are accessed.
- ▶ **Cyberattack:** Computer systems and the internet are used to obtain unauthorized access to targeted computers or networks and fraudulently obtain, destroy, or falsify data, sometimes causing targeted systems to malfunction. In typical cases, attackers might falsify website content, flood a system with traffic to hamper site functionality (DoS attacks/DDoS attacks), or send large numbers of emails containing computer viruses.
- ▶ **Targeted attack:** A type of cyberattack targeting the information of a specific organization.
- ▶ **File encryption and tracking solution:** A password-free encryption service that allows electronic files to be tracked and controlled remotely.
- ▶ **Filtering function:** A mechanism allowing data to be selected and excluded based on certain conditions. This function can be used to identify and block harmful emails or websites, thereby augmenting security.
- ▶ **Proxy server:** A server that provides website access in lieu of the user's own computer, heightening PC security and convenience. Proxy servers may be equipped with caching and filtering functions.
- ▶ **Educational market:** Market encompassing culture and education.
- ▶ **Malware:** A catch-all term for software and malicious code created to perform fraudulent or harmful activities.
- ▶ **Email filtering software:** Software with functionality that controls the sending and receiving of emails based on user settings.

Profile

Company	Head office
Digital Arts Inc.	14F Otemachi First Square West Tower 1-5-1Otemachi, Chiyoda-ku, Tokyo
Phone	Listed on
+81-3-5220-1160	Tokyo Stock Exchange 1st Section
Established	Exchange listing
June 21, 1995	September 19, 2002
website	Fiscal year-end
http://www.daj.jp/en/	March
IR Contact	IR web
+81-3-5220-6045	http://www.daj.jp/en/ir/

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cocokara fine Inc.	Lasertec Corporation	Take and Give Needs Co., Ltd.
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CRE, Inc.	MATSUI SECURITIES CO., LTD.	TEAR Corporation
CREEK & RIVER Co., Ltd.	Medical System Network Co., Ltd.	Tenpo Innovation Inc.
Daiseki Co., Ltd.	MEDINET Co., Ltd.	3-D Matrix, Ltd.
DIC Corporation	Mercuria Investment Co., Ltd.	TKC Corporation
Digital Arts Inc.	Milbon Co., Ltd.	TOKAI Holdings Corporation
Digital Garage Inc.	MIRAIT Holdings Corporation	Tri-Stage Inc.
DIGITAL HEARTS HOLDINGS Co., Ltd	Monex Goup Inc.	VISION INC.
Dream Incubator Inc.	NAGASE & CO., LTD	VISIONARY HOLDINGS CO., LTD.
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FaithNetwork Co., Ltd.	Nisshinbo Holdings Inc.	ZAPPALLAS, INC.
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