

Digital Hearts Holdings (TYO: 3676)

Strong performance in all business segments.
A 30% uplift in full-year OP guidance, to look at 40% growth YoY

◇ Summary of Financial Results for Q3 FY2022/3

The company's Enterprise business grew enormously with the tailwind of accelerating DX, while the Entertainment business ran ahead of the forecasts. In addition to the M&A effect, organic growth was +17%. These resulted in a 30% YoY increase in nine-month consolidated sales, and operating profit rose 80% YoY. Consequently, the management raised its full-year operating profit forecast by about 30%. Since hitting a high on 13 December 2021, the share price has adjusted by around 40%, affected by the global growth stock sell-off. Considering the growth outlook in the future, we would see the current PER of 18.9x as undervalued.

◇ Results for Q3 FY2022/3: Record level of sales and profits achieved

The company's Q3 results for FY2022/3 show strong performance in both Enterprise and Entertainment businesses. Sales of Enterprise business, which is the company's focus, grew by 66%, driven by the acceleration of DX. In the Entertainment business, sales rose 15% YoY thanks to the M&A contribution and the strong performance of the domestic debugging business. Overall, sales grew by 30% (to 21,246 million yen), or a 17% underlying growth excluding the M&A contribution.

An improvement in gross profit margin (+1.2% YoY) and robust top-line sales led to higher gross profit over the nine-month period. SG&A expenses were under reasonable control. The segment income of Enterprise business shot up 11 times YoY. The entertainment business, a cash cow, saw its profit rise 34% YoY to 2,884 million yen. All in all, the company booked OP of 2,123 million yen marking a 79.5% YoY growth. This already exceeds the historic-high annual profit registered in FY2016/3. The operating margin increased by 2.7% to 10.0%.

◇ Full year forecast for 2022/3: Operating profit forecast revised up by approx 30%

Following the Q3 results, the company raised its full-year forecast (see table below). The new sales forecast of 29.0 billion yen consists of 11.2 billion yen from Enterprise business (+60.1% YoY) and 17.8 billion yen from Entertainment business (+13.5% YoY). The market environment is favourable in Enterprise segment thanks to the accelerating DX. The company is working to win new orders through aggressive sales activities, hiring and training engineers, and strengthening cross-selling in areas such as test automation and security. The company won many domestic debugging projects for console games at a pace ahead of the plan in the Entertainment business. As per the global business, synergies from the acquisition of the DIGITAL HEARTS CROSS Group is already contributing to business results. To summarise, the main reasons for the upward revision are sales growth, high-profit projects, improving profitability by efficient project management and progress in cost control.

Over the past nine months, the company has achieved 73.3% of its revised full-year sales forecast and 78.6% vis-a-vis the operating profit guidance.

* In the text, unless otherwise stated, changes refer to year-on-year comparisons (cumulative basis).

JPY, mn, %	Net sales	YoY %	Oper. profit	YoY %	Ord. profit	YoY %	Profit ATOP	YoY %	EPS (¥)	DPS (¥)
2018/3	17,353	12.4	1,735	-9.0	1,782	-10.8	1,200	50.9	55.14	11.50
2019/3	19,254	11.0	1,605	-7.5	1,651	-7.4	1,575	31.3	72.13	13.00
2020/3	21,138	9.8	1,394	-13.2	1,372	-16.9	792	-49.7	36.31	14.00
2021/3	22,669	7.2	1,908	36.9	1,975	43.9	974	23.0	45.15	14.00
2022/3 (old CE)	28,420	25.4	2,100	10.0	2,100	6.3	1,400	43.7	64.77	15.00
2022/3 (new CE)	29,000	27.9	2,700	41.5	2,800	41.7	1,800	84.7	83.24	15.00
2021/3 Q3	16,313	4.1	1,183	11.0	1,245	18.0	794	21.7	36.82	—
2022/3 Q3	21,246	30.2	2,123	79.5	2,192	76.0	1,363	71.6	63.05	—

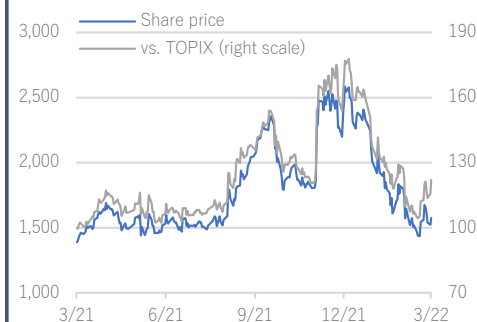
Q3 results update

Information Technology

As of Mar. 8, 2022

Share price (3/8)	1,576 Yen
52weeks high/low	¥2,700/1,354
Avg Vol (3 month)	185.0 thou shrs
Market Cap	¥37.6 bn
Enterprise Value	¥33.0 bn
PER (22/3 CE)	18.9 X
PBR (21/3 act)	4.99 X
Dividend Yield (22/3 CE)	0.95 %
ROE (TTM)	24.56 %
Operating margin (TTM)	10.32 %
Beta (5Y Monthly)	1.13
Shares Outstanding	23.890 mn shrs
Listed market	TSE 1 st section

Share price performance



% of	1mo.	3mo.	12mo.
Share prices	-9.6	-36.2	13.5
Relative share price	-0.6	-27.4	22.1

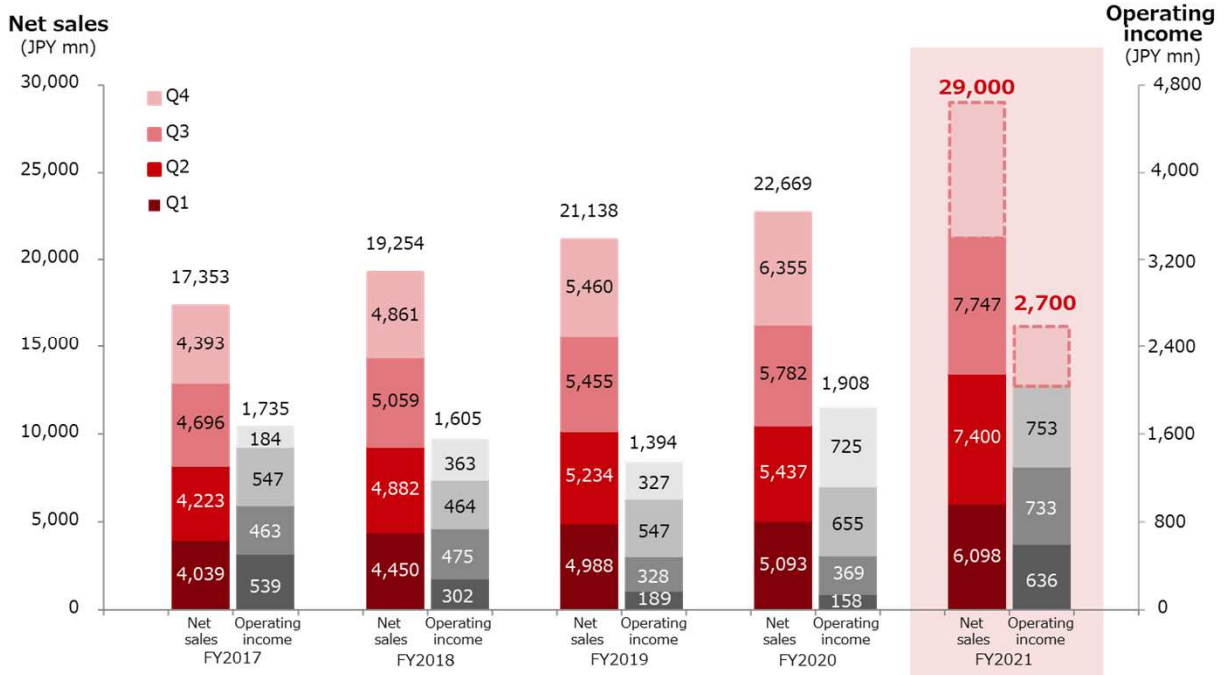
Points of interest

Expanding from game debugging to enterprise software testing. Enterprise business is growing rapidly driven by DX. The new management aims to achieve sales of 50 billion yen in the medium term.

This report (financial update) has been prepared at the request of Digital Hearts Holdings. For details, please refer to the Disclaimer on the last page.



Full year consolidated sales / operating profit trend



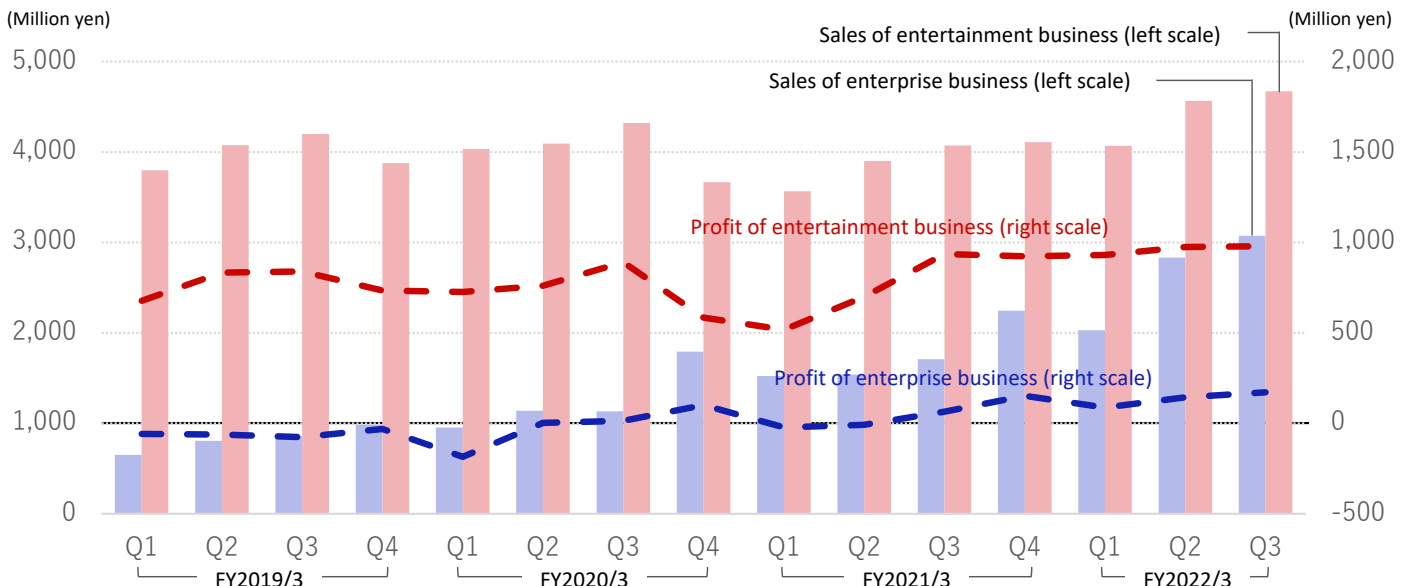
Source: The company handout for the 3rd quarter results for FY2022/3 (published on February 8, 2022)

◇ Trends by segment: (see also table on page 6)

1) Enterprise business: Revenue up by 60% (7,937million yen), profit margin recorded 5.1%. The acceleration of DX and the recent M&A activity (see figure on next page) boosted sales. The company established profitability of this segment, with the segment income shooting up 11 times YoY to 403 million yen. The profit margin was 5.1%, overriding the amortization of goodwill on M&A.

System testing: Sales: 3,395 million yen (+35.7%). In addition to aggressive marketing, the reinforcement of cross-selling was successful. From Q2, MK Partners and TPP SOFT, which LogiGear acquired, contributed to the results. In addition, existing businesses achieved double-digit sales growth. Despite the consistent investment to grow this key segment, the company maintains a high gross profit margin of 34.4%. It aims to differentiate itself from the competition by leveraging game debugging resources and test automation services.

Sales/Profit by Segment

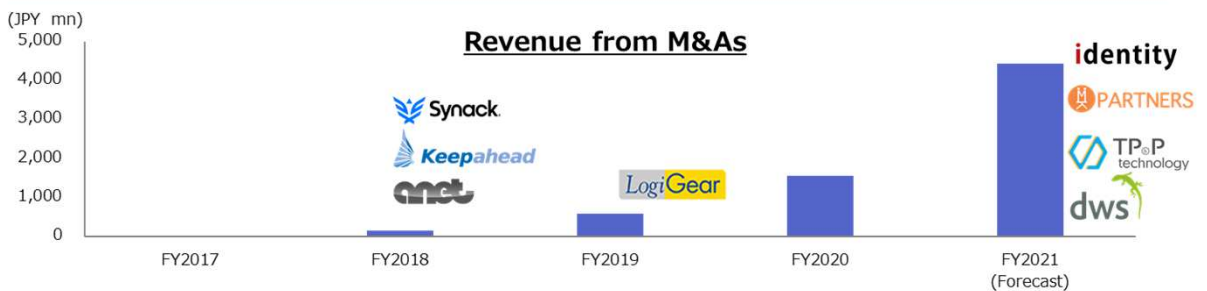


Source: Omega Investment, based on company data



Mergers and acquisitions in Enterprise business

ANET Corporation	Software testing company in Japan focusing on medical industry
Keepahead Co.Ltd.	Telecommunications software development company in Japan
Synack, Inc.	U.S. company providing penetration tests by global ethical hackers
LOGIGEAR CORPORATION	U.S. Silicon Valley software testing company with its unique test automation tools and offshore bases in Vietnam
TPP SOFT, JSC	Software development company in Vietnam with customers in Europe and the U.S.
MK Partners, Inc.	U.S. company providing Salesforce consulting service
identity Inc.	IT engineer platform service provider in Japan with large number of registered freelance engineers
DEVELOPING WORLD SYSTEMS LIMITED	U.K. company with unique service including test automation tools for Oracle software



Source: The company handout for the 3rd quarter results for FY2022/3 (published on February 8, 2022)

IT Service / Security: Sales doubled (to 4.5 billion yen) on the back of accelerating DX and the expansion of remote working. "identity Inc.", acquired in June 2021, also contributed. The company has strengthened its human resources. Even excluding the effect of the acquisition, the company has achieved double-digit sales growth in all services, i.e., contract development and SES, maintenance and operation, and security.

2) Entertainment business: A 15% increase in sales (13,308 million yen) and a 34% rise in segment profit.

Domestic debugging for console games was solid. Sales of Global and others increased by nearly 40% thanks to the corporate acquisitions. Profits rose 34% to 2,884 million yen on strong sales and better gross profit margins for Domestic debugging. The company's cash cow continues to generate high levels of profit. The segment profit margin remained high at 21.7%.

Domestic debugging: Sales increased by 7.4% (9,111 million yen). The development of new titles for major console games in Japan has been active and strong. Since Q3 FY2021/3, this business has recovered from the impact of COVID-19 and secured a gross profit margin of over 30%.

Global and Other: Sales increased by 37.3% (4,196 million yen). The company won cross-border and global projects on the back of a positive market environment. The company delivered double-digit sales growth in Global, Creative, and Media and others. From Q2, the DIGITAL HEARTS CROSS Group (DHX, formerly Metaps Entertainment Limited, acquired in March 2021) made a significant contribution to the business performance.

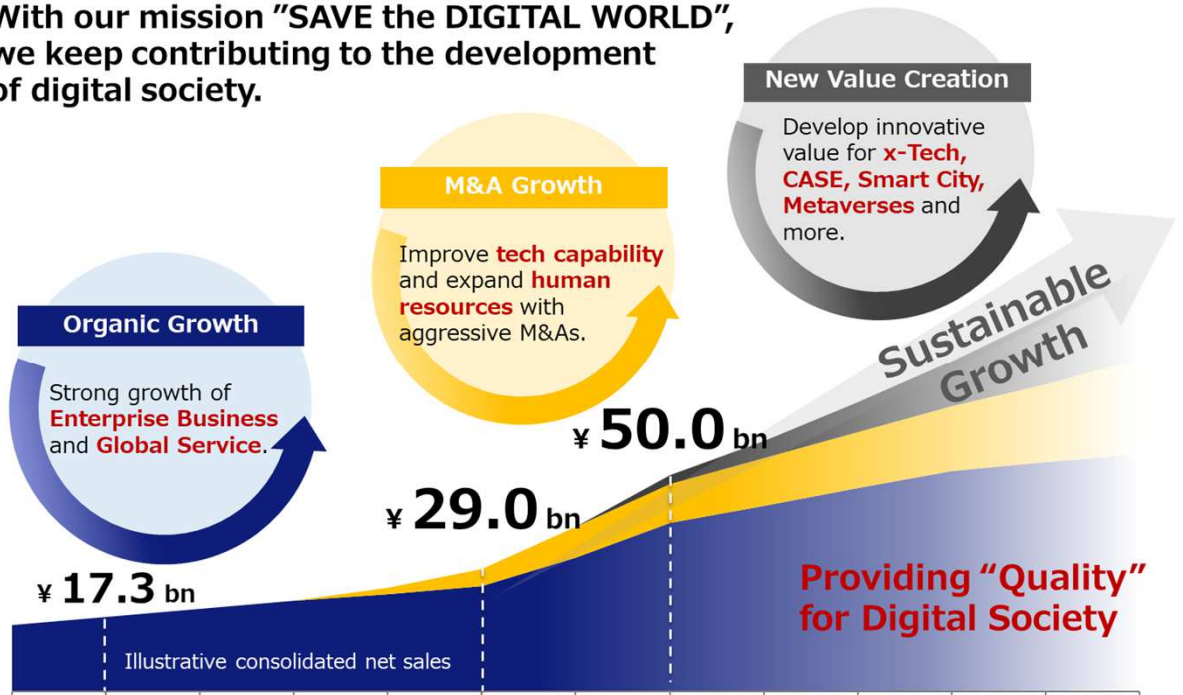
◇ Growth strategy update, etc.

The company runs a growth strategy to achieve sales of 50 billion yen in FY2024/3. On top of organic growth, it plans to raise 5-10 billion yen by M&A. Based on the sales forecast for the current year, this translates into a top-line CAGR of 30% over the next two years. In FY2022/3 alone, the company expects to achieve a ca 30% rise in sales by M&A contributions and steady growth in existing businesses. We think the same degree of growth is achievable beyond this year. The company's core Entertainment business is generating good cash from Domestic debugging, which should provide funds for further M&A. In addition, the company's services, which M&A has already expanded, are generating enough revenue to cover the amortization of goodwill. Hopefully, the company should achieve sales of 50 billion yen.



Growth story

With our mission "SAVE the DIGITAL WORLD", we keep contributing to the development of digital society.



Source: The company handout for the 3rd quarter results for FY2022/3 (published on February 8, 2022)

With FY2024/3 numbers now in sight, the company has revealed guidance on how it envisages growth from FY2024/3 onwards (see above): the transition to the second business phase in FY2018/3 marked a significant shift from a single focus on game debugging. The company expects Enterprise business to account for about half the consolidated sales in FY2024/3. From FY2024/3 onwards, it aims to provide innovative value through new business areas like metaverse. As previously announced, in April 2022, the company will spin out its Enterprise business from a single business unit into an independent corporation called AGEST Inc. AGEST will launch various projects and take on the challenge to create innovative value as described above.

◇ Share price: Affected by growth stock adjustment, but undervalued given growth outlook

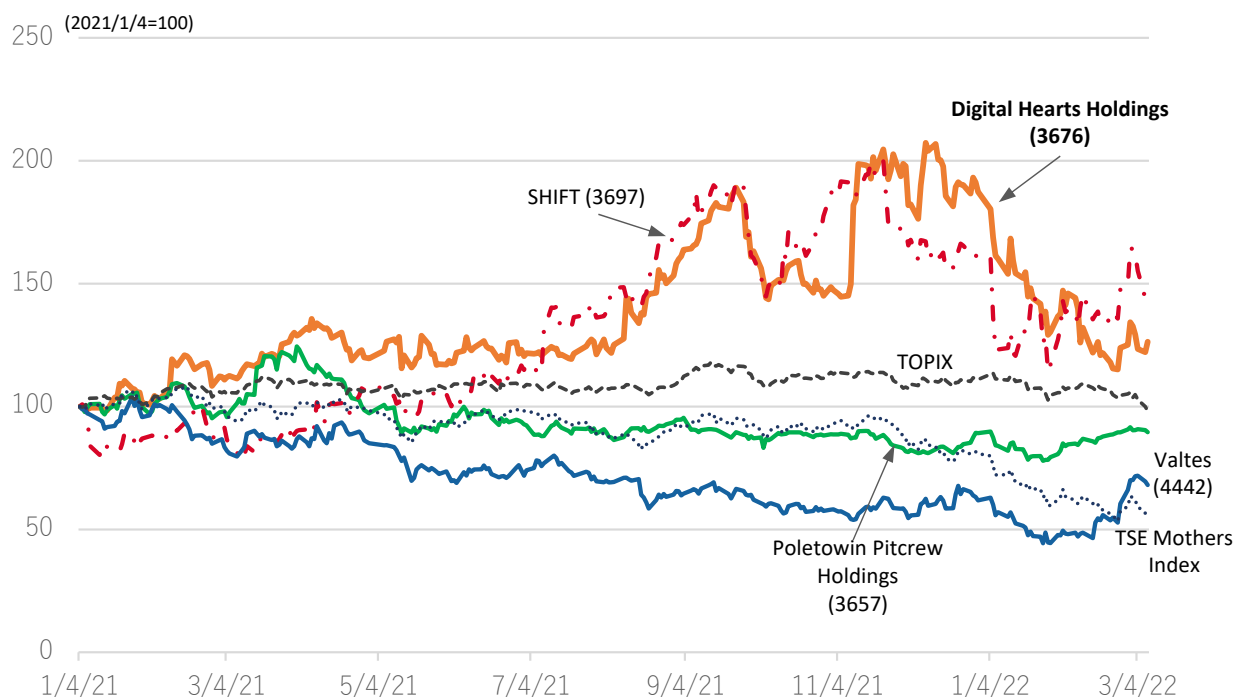
The share price hit a record high at 2,700 yen on 13 December 2021 after the announcement of the 2Q results but has fallen amidst the global repricing of growth stocks. The economic environment may affect the shares and the equity market moves during CY2022. Still, the company's fundamentals are tracking a steady growth trajectory, as shown by the Q3 results. The latest share price adjustment should be closely monitored.

Digital Hearts Holdings (3676) Share Price Trend (3Year-to-date)



The following chart compares the share price performance of four software testing companies. Both the company and SHIFT (TSE: 3696) were on an upward trajectory since the beginning of CY2021 but have adjusted sharply since last autumn. SHIFT's sales composition is over 90% enterprise, and the company's shares are awarded with high PER thanks to the rapid business expansion by M&A. The company's revenue proportion of enterprise business is now around 40%, and M&A activities have been steady. From a valuation perspective, it may be better to view the company as an enterprise-focused high-tech company.

Share price performance (four software testing companies, TOPIX, TSE Mothers Index)



Software Testing four Companies Comparison

Code	3676	3657	3697	4442
Company name	Digital Hearts Holdings	Poletowin Pitcrew Holdings	SHIFT	Valtes
Financial year	March, 2021	January, 2021	August, 2021	March, 2021
Share price (3/8)	1,576	1,041	21,480	1,498
Market cap. (million yen)	37,652	39,720	381,895	10,711
PER (x)	18.9	18.3	89.8	33.9
PBR (x)	4.99	2.31	17.46	6.67
Percentage fall from recent peak	-41.6	-29.1	-27.4	-35.8
Peak year/month/day	2021/12/13	2021/4/2	2021/11/18	2021/1/25
Financial indicators (%)				
ROE	17.1	13.5	12.6	16.5
ROA	6.8	10.4	8.2	9.7
ROIC	13.1	17.6	8.6	14.2
DPS (company estimate, yen)	15.00	14.00	0.00	0.00
Financial data (TTM)				
Net sales (million yen)	27,602	31,860	50,853	6,250
Three-year growth rate (%)	14.4	10.8	58.4	17.4%*
Operating profit (million yen)	2,857	3,218	5,400	376
Three-year growth rate (%)	23.7	9.5	65.1	26.5%*
Operating profit margin (%)	10.4	10.7	10.6	6.0

* Two years growth rate for VALTES

Source: Company materials

Financial data I

	2020/3				2021/3				2022/3		
	1Q	2Q	Q3	4Q	1Q	2Q	Q3	4Q	1Q	2Q	Q3
[Sales by segment]											
Net sales	4,988	5,234	5,455	5,460	5,093	5,437	5,782	6,355	6,098	7,400	7,747
YoY	12.1	7.2	7.8	15.0	2.1	3.9	6.0	16.4	19.7	36.1	34.0
Enterprise business	954	1,140	1,133	1,794	1,523	1,540	1,710	2,246	2,029	2,833	3,074
YoY	46.3	41.5	32.0	82.5	59.6	35.1	50.9	25.2	33.2	83.9	79.7
Composition of sales	19.1	21.8	20.8	32.9	29.9	28.3	29.6	35.3	33.3	38.3	39.7
System testing	430	570	488	924	788	777	937	1,078	1,018	1,144	1,233
YoY	65.8	99.5	33.5	91.4	83.1	36.2	92.0	16.7	29.2	47.2	31.5
Composition of sales	8.6	10.9	8.9	16.9	15.5	14.3	16.2	17.0	16.7	15.5	15.9
IT services / Security	523	569	645	869	735	763	772	1,167	1,011	1,688	1,841
YoY	33.4	9.5	30.9	73.9	40.4	34.1	19.8	34.3	37.5	121.2	138.2
Composition of sales	10.5	10.9	11.8	15.9	14.4	14.0	13.4	18.4	16.6	22.8	23.8
Entertainment business	4,033	4,093	4,321	3,666	3,566	3,900	4,072	4,109	4,069	4,566	4,672
YoY	6.2	0.5	2.9	-5.4	-11.6	-4.7	-5.8	12.1	14.0	17.1	14.7
Composition of sales	80.9	78.2	79.2	67.1	70.0	71.7	70.4	64.7	66.7	61.7	60.3
New sub-segments											
Domestic debugging					2,681	2,846	2,953		2,931	3,030	3,149
YoY					-	-	-		9.3	6.4	6.7
Composition of sales					52.7	52.4	51.1		48.1	41.0	40.7
Global and other					887	1,049	1,118		1,137	1,536	1,522
YoY					-	-	-		28.2	46.3	36.1
Composition of sales					17.4	19.3	19.3		18.7	20.8	19.7
Old sub-segments											
Debugging	3,444	3,480	3,730	3,167	3,023	3,235	3,375	3,424	-	-	-
YoY	10.8	6.0	6.8	-1.5	-12.2	-7.0	-9.5	8.1	-	-	-
Composition of sales	69.1	66.5	68.4	58.0	59.4	59.5	58.4	53.9	-	-	-
Game Consoles	1,186	1,056	1,341	1,126	1,023	1,147	1,258	1,402	-	-	-
YoY	21.1	5.4	15.9	10.7	-13.7	8.6	-6.2	24.5	-	-	-
Composition of sales	23.8	20.2	24.6	20.6	20.1	21.1	21.8	22.1	-	-	-
Mobile solutions	2,013	2,171	2,141	1,848	1,819	1,959	2,005	1,870	-	-	-
YoY	1.0	1.7	2.0	-4.9	-9.6	-9.8	-6.4	1.2	-	-	-
Composition of sales	40.4	41.5	39.2	33.8	35.7	36.0	34.7	29.4	-	-	-
Amusement	245	253	248	193	179	130	111	153	-	-	-
YoY	77.5	75.7	4.6	-24.3	-26.9	-48.6	-55.2	-20.7	-	-	-
Composition of sales	4.9	4.8	4.5	3.5	3.5	2.4	1.9	2.4	-	-	-
Creative	350	307	282	285	311	367	372	398	-	-	-
YoY	-31.4	-45.2	-33.1	-27.6	-11.2	19.6	32.0	39.2	-	-	-
Composition of sales	7.0	5.9	5.2	5.2	6.1	6.8	6.4	6.3	-	-	-
Media and others	238	306	308	212	234	294	324	286	-	-	-
YoY	35.5	32.6	8.7	-19.4	-1.5	-3.9	5.0	34.5	-	-	-
Composition of sales	4.8	5.9	5.7	3.9	4.6	5.4	5.6	4.5	-	-	-
Operating profit	189	328	547	327	158	369	655	725	636	733	753
YoY	-37.2	-30.9	18.0	-9.9	-16.4	12.4	19.7	121.3	301.3	98.5	14.9
Operating profit margin	3.8	6.3	10.0	6.0	3.1	6.8	11.3	11.4	10.4	9.9	9.7
Enterprise business	-184	2	14	100	-21	-7	64	152	87	144	171
YoY	-	-	-	-	-	-	363.5	52.4	-	-	163.8
Segment profit margin	-19.4	0.3	1.2	5.6	-1.4	-0.5	3.8	6.8	4.3	5.1	5.6
Entertainment business	727	760	891	585	517	700	936	923	930	975	978
YoY	7.3	-8.8	6.1	-20.3	-28.9	-8.0	5.0	57.9	79.9	39.3	4.5
Segment profit margin	18.0	18.6	20.6	16.0	14.5	18.0	23.0	22.5	22.9	21.4	20.9

Source: Omega Investment, based on company data

Financial data II

	2020/3				2021/3				2022/3		
	1Q	2Q	Q3	4Q	1Q	2Q	Q3	4Q	1Q	2Q	Q3
[Statements of income]											
Net sales	4,988	5,234	5,455	5,460	5,093	5,437	5,782	6,355	6,098	7,400	7,747
Cost of sales	3,772	3,830	3,949	3,953	3,819	4,002	4,001	4,700	4,271	5,290	5,579
Gross profit	1,216	1,403	1,506	1,507	1,273	1,437	1,781	1,655	1,827	2,109	2,167
SG&A expenses	1,026	1,074	958	959	1,115	1,067	1,126	1,150	1,191	1,375	1,414
Operating profit	189	328	547	327	158	369	655	725	636	733	753
Non-operating income	3	2	1	1	38	10	24	5	38	31	12
Non-operating expenses	3	7	7	7	2	3	4	10	4	4	5
Ordinary profit	189	323	542	542	194	376	675	720	670	760	759
Extraordinary income		0	0	0		19	32		13	66	1
Extraordinary expenses		0	0	75	82	13	16	415	2	42	32
Net profit before income taxes	189	323	542	240	113	381	691	318	681	785	730
Total income taxes	77	159	162	99	38	122	224	145	189	281	233
Net profit attributable to owners of the parent	112	165	375	139	99	256	438	180	487	429	445
[Balance Sheets]											
Current assets	6,717	7,574	7,710	7,453	6,648	7,291	8,017	9,744	9,604	9,848	10,658
Cash and deposits	3,650	3,849	3,882	3,739	3,027	3,482	4,085	5,076	4,911	5,435	5,746
Notes and accounts receivable	2,677	3,017	3,013	2,985	2,889	3,099	3,201	4,097			
Notes, accounts receivable and contract assets									4,161	3,872	4,372
Non-current assets	2,481	3,252	3,227	3,184	3,205	3,167	3,160	4,593	6,321	6,178	6,342
Tangible fixed assets	545	646	627	579	560	549	565	598	602	623	621
Intangible fixed assets	793	1,404	1,390	1,379	1,445	1,424	1,433	2,670	4,389	4,244	4,225
Goodwill	491	1,066	1,033	1,027	1,032	991	950	2,467	4,175	4,042	3,945
Investments and other assets	1,142	1,202	1,209	1,225	1,199	1,193	1,161	1,324	1,330	1,309	1,495
Total assets	9,199	10,827	10,938	10,637	9,854	10,459	11,177	14,338	15,925	16,026	17,001
Current liabilities	3,621	4,679	4,863	5,135	4,450	4,655	5,061	7,904	8,954	8,775	9,354
Short-term borrowings	1,704	2,504	2,506	2,546	2,546	2,551	2,552	4,728	5,534	5,406	5,406
Non-current liabilities	622	624	629	63	62	132	135	119	294	55	58
Long-term debt	48	46	48	-	-	66	65	63	236	-	-
Total liabilities	4,243	5,304	5,493	5,198	4,513	4,788	5,196	8,024	9,249	8,830	9,413
Total net assets	4,955	5,523	5,445	5,438	5,340	5,670	5,980	6,314	6,677	7,196	7,588
Shareholders' equity	4,734	5,039	4,919	4,898	4,841	5,172	5,460	5,642	5,983	6,436	6,719
Capital	300	300	300	300	300	300	300	300	300	300	300
Legal capital reserve	366	357	357	355	355	331	331	331	331	338	338
Retained earnings	6,378	6,543	6,765	6,904	6,848	7,105	7,393	7,575	7,916	8,342	8,626
Treasury shares	-2,311	-2,162	-2,503	-2,662	-2,662	-2,565	-2,565	-2,565	-2,565	-2,545	-2,546
Stock acquisition right	13	13	13	13	13	13	13	13	-	-	-
Total liabilities and net assets	9,199	10,827	10,938	10,637	9,854	10,459	11,177	14,338	15,925	16,026	17,001
[Statements of cash flows]											
Cash flow from operating activities		-5		1,086		101		1,416		1,703	
Net profit before tax and other adjustments		513		1,296		494		1,504		1,466	
Cash flow from investing activities		-963		1,018		-261		-1,813		-1,682	
Cash flow from financing activities		637		-515		-90		1,730		316	
Free cash flow		958		68		362		3,229		3,385	
Cash and cash equivalents at end of period		-347		-458		-252		1,341		359	
Cash and cash equivalents at beginning of period		4,162		4,162		3,704		3,704		5,041	
Cash and cash equivalents at end of period		3,814		3,704		3,447		5,041		5,400	

Source: Omega Investment, based on company data



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