

Digital Hearts Holdings (TYO: 3676)

Record-high 1H profit - Enterprise business continues high growth while Entertainment business posts double-digit earnings growth

◆ Summary of financial results: both businesses registered a significant increase in sales, posting record 1H profits

Enterprise Business, a key business, continued to grow strongly, with sales up 60% yoy. Entertainment Business also achieved double-digit revenue growth on solid sales for console games. Despite continued growth investment in Enterprise Business, the company delivered record profits in 1H, partly because of increased sales in Entertainment Business. The company continues to invest in AGEST, which is responsible for the enterprise business, to develop the business infrastructure and continues to focus on this business as a critical segment for high growth in the medium term.

◆ Stock price trends: undervalued compared to peers

The company's share price has rebounded over the past year, bottoming out at 1,405 yen on 24 February. The profit model has worked as designed, with profits generated by the highly profitable Entertainment Business underpinning earnings while continuing growth investment in Enterprise Business. With good business performance and future growth expectations combined, the company's shares look undervalued in terms of PER and PBR compared to its peers.

◆ Financial results for Q2 FY2023/3: record high sales and operating profit in 1H

Digital Hearts Holdings' Q2 results for FY2023/3 show double-digit revenue growth in both Enterprise Business and Entertainment Business. While continuing growth investment in Enterprise Business, the company achieved a record 1H operating profit due to profit generation in Entertainment Business, which is a cash cow. Sales and operating profit reached record 1H highs of 17,562 million yen (+30.1% YoY) and 1,382 million yen (+0.9% YoY), respectively, despite amortisation of goodwill on M&A and growth investment in Enterprise Business. EBITDA increased to 1,920 million yen, rising 17.7%.

By segment, Enterprise Business saw a 56.6% increase in sales, with existing businesses continuing double-digit revenue growth while M&As carried out in the previous year contributing to the growth as well. Segment profit halved (+17.8% on an EBITDA basis) due to the strengthening of the already-announced business platform and aggressive investment in growth. On the other hand, sales for console games in Entertainment Business remained extremely strong. The segment's profit grew 15.0% yoy, registering profit margins of 21.9%.

◆ Full-year progress in FY2023/3: on track with plans, targeting record sales and operating profit

As of Q2, progress against the full-year forecast was 49% of sales, 42% of operating profit and 45% of EBITDA. In 2H, those companies that have been added to the group through M&A will make a full earnings contribution, and the company will likely achieve these targets.

Q2 results update

Information Technology

As of Dec. 12, 2022

Share price (12/9) 1,876 Yen

52weeks high/low	¥2,700/1,405
Avg Vol (3 month)	93.4 thou shrs
Market Cap	¥44.8 bn
Enterprise Value	¥41.7 bn
PER (23/3 CE)	18.1 X
PBR (22/3 act)	4.77 X
Dividend Yield (22/3 CE)	1.11 %
ROE (TTM)	24.69 %
Operating margin (TTM)	5.45 %
Beta (5Y Monthly)	0.90
Shares Outstanding	23.890 mn shrs
Listed market	TSE Prime section

Share price performance



% of	1mo.	3mo.	12mo.
Share prices	-4.9%	8.6%	-26.3%
Relative share price	-5.5%	8.4%	-25.7%

Points of interest

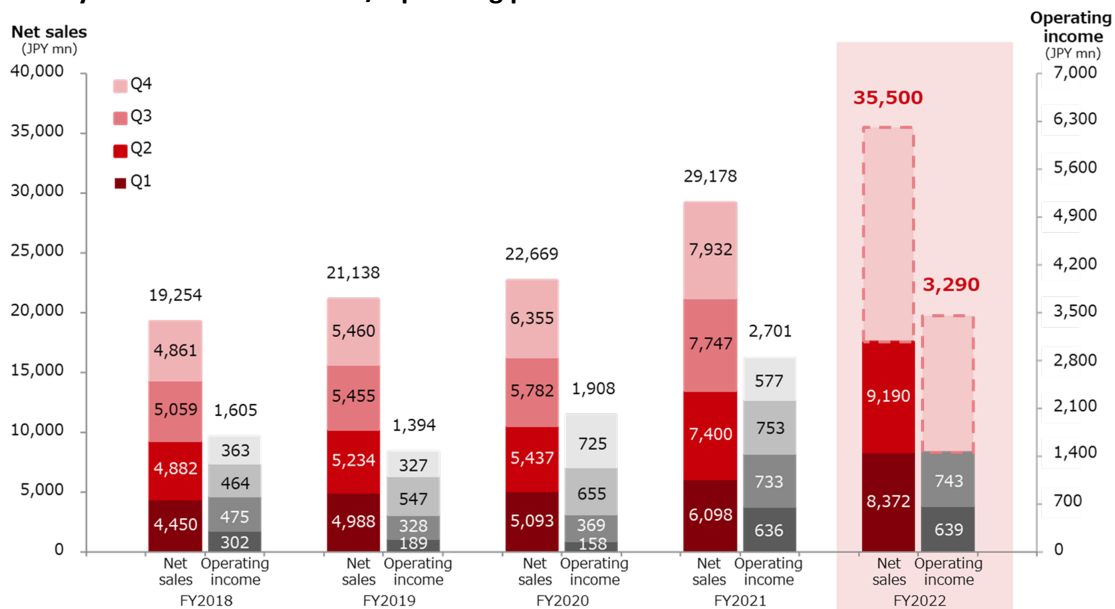
Expanding from game debugging to enterprise software testing. Enterprise Business is growing rapidly, driven by DX. Focus on global expansion in entertainment. The new management aims to generate sales of 50 billion yen in FY2024/3.

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.

JPY, mn, %	Net sales	YoY %	Oper. profit	YoY %	Ord. profit	YoY %	Profit ATOP	YoY %	EPS (¥)	DPS (¥)
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	29,178	28.7	2,701	41.5	2,778	40.7	1,780	82.7	82.35	15.00
2023/3 (CE)	35,500	21.7	3,290	21.8	3,290	18.4	2,250	26.4	104.04	21.00
2022/3 Q2	13,498	28.2	1,370	159.7	1,431	151.0	917	157.9	42.45	7.50
2023/3 Q2	17,562	30.1	1,382	0.9	1,527	6.7	950	3.5	43.89	10.50



Full year consolidated sales / operating profit trend



Source: The company handout for the 2nd quarter results for FY2023/3 (published on November 10, 2022)

◇ Segmental trends: (see also graph on p. 3 and table on p. 6)

1) Enterprise Business: 56.6% increase in revenue (7,614 million yen), 17.8% increase in EBITDA

The company actively pursued proposal-based sales activities to win new projects, driven by the development of DX and the growing need for test outsourcing. As a result, existing businesses continued to achieve double-digit revenue growth. In addition, the recent mergers and acquisitions have also contributed to a nearly 60% increase in sales. In line with the rise in sales, the gross profit margin also improved, reaching almost 28% in Q2 alone. On the other hand, segment profit halved due to higher SG&A expenses associated with growth investments, such as building a solid future business foundation. On an EBITDA basis, the company posted a 17.8% increase, to 443 million yen.

QA solution: sales of 4,583 million yen (+54.5%). Improved profitability through cross-selling, including security testing and test automation, based on the company's strength in manual software testing. Focused on increasing the number of new customers and the scale of transactions per customer company, CEGB, acquired through M&A, has been contributing to the company's results since Q1, but even excluding the impact of CEGB and other new consolidated subsidiaries, sales grew 29.1%. The gross profit margin also rose as the utilisation rate of engineers increased and stood at 35.3% in Q2 alone. In Q2, the number of customers placing orders and the average order value per customer increased steadily by 23 companies and 2 million yen, respectively, to 650 companies and 12 million yen, compared with Q1. (Calculated based on LTM results, excluding subsidiaries that consolidated for less than 12 months).

IT services and others: sales of 3,030 million yen (+59.9%). identity Inc. (SES: temporary engineer staffing), which became a subsidiary in June 2021, contributed. The number of registered engineers at identity Inc. grew to 23,000, driving the top-line expansion. Security monitoring services are also growing steadily against the expansion of remote working.

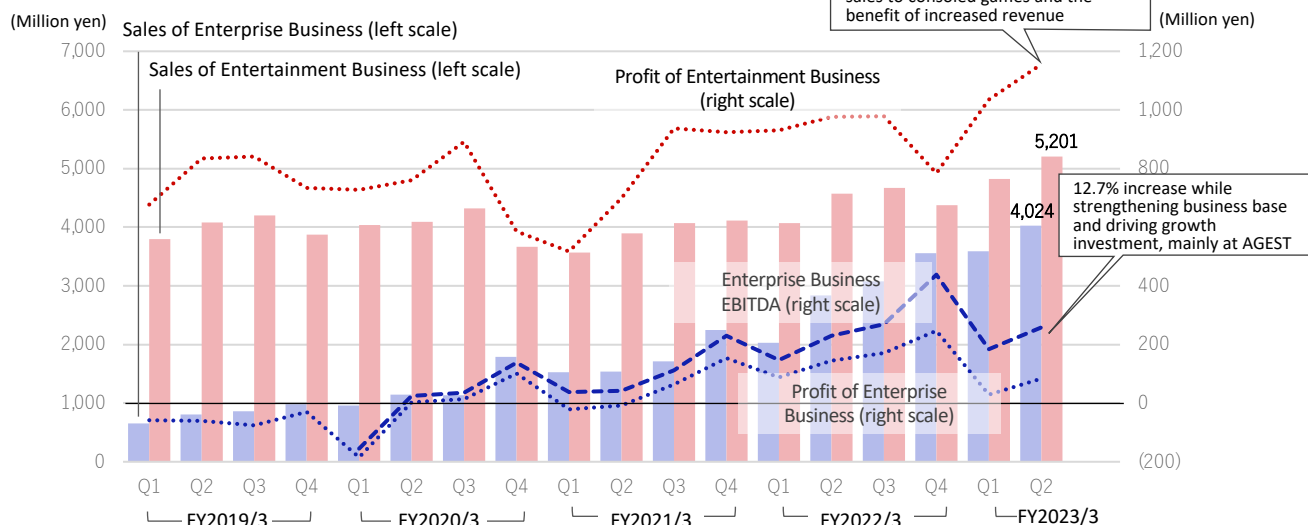
2) Entertainment Business: 16.0% increase in revenue (10,020 million yen), 15.0% increase in segment profit

The domestic console games market is robust, and the overseas marketing for content is accelerating, capturing demand well. Domestic debugging and Global and others saw sales increase by more than 15%. Segment profit increased by 15.0% due to an increase in Domestic debugging sales and an improvement in gross profit margin, generating a record-high 1H segment profit. The profit margin remained high at 21.9%.

Domestic debugging: sales 6,896 million yen (+15.7%). The development of new titles in the console game market has become active. Sales to console games increased significantly, up 1.5 times yoy. New titles are becoming larger, and the scale of debugging projects is rising. New large-scale projects are being steadily acquired, and the company's market share in this field appears to be increasing. On the profit side, gross profit margins have remained high at more than 32% due to ongoing efforts to improve operational efficiency and the benefits of increased revenues.

Global and others: sales 3,124 million yen (+16.8%). The company secured a steady stream of cross-border/global projects in a buoyant market environment. All Global, Creative, Media and others services achieved double-digit revenue growth. From now on, in addition to pursuing synergies among the DIGITAL

Sales/Profit by Segment (Quarterly basis)



Source: Omega Investment, based on company data

HEARTS CROSS Group and overseas subsidiaries, the company plans to expand its business and create new value in the Asian domain by strengthening initiatives with alliance partners, including GameWith, with which it has newly formed a capital and business alliance.

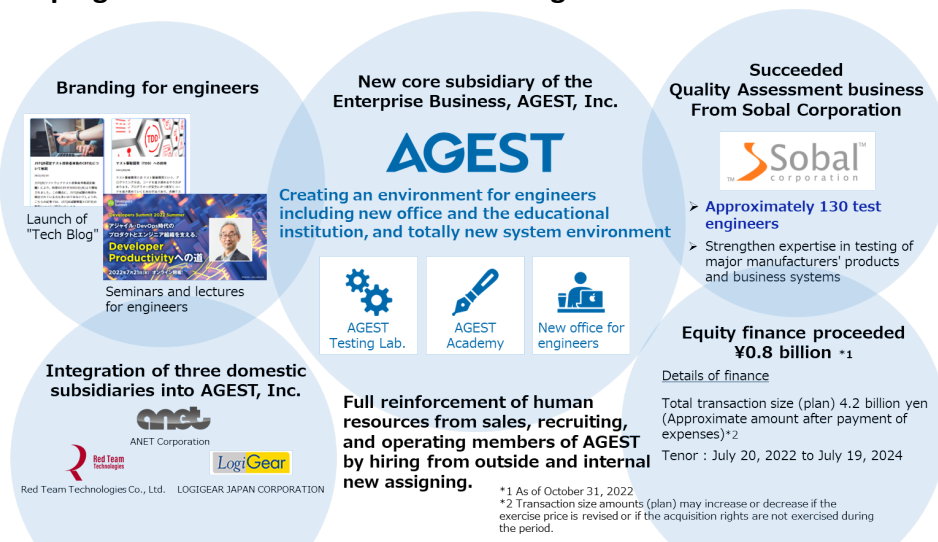
◇ FY2023/3 forecasts: on target. Aiming for record-high sales and operating profit.

Q2 progress ratios were sales 49.5%, operating profit 42.0%, EBITDA 45.3% and profit ATOP (attributable to owners of the parent) 42.2% versus the company's full-year forecasts. Sales are expected to progress on target, as growth is expected centring around Enterprise Business from Q3 onwards, and because the benefits of M&A and other factors will kick in. As per profit, the company may well meet its full-year targets as it will likely benefit from revenue growth and curb some of the growth investments in 2H, which were extensive in 1H.

◇ Growth strategy: pursue advanced quality technology and actively use M&A to rapidly expand Enterprise Business

As mentioned repeatedly, the company's focus for future growth is Enterprise Business. To ensure the growth of this business, the company launched AGESt in April 2022. The company made it the core Enterprise Business and concentrates the management resources. Apart from "Digital Hearts", which has a strong brand in

Developing a business foundation for future growth



Source: The company handout for the 2nd quarter results for FY2023/3 (published on November 10, 2022)



the debugging field, the company has invested in strengthening its business foundation and growth in the enterprise field by strengthening its branding as an “AGEST” (Advanced Quality Technology Company), reinforcing its human resources and improving its office environment. (see the previous page bottom graphic).

The company invested 0.32 billion yen more in AGEST in 1H (breakdown: +0.2 billion yen in personnel costs, +0.05 billion yen in office costs, +0.04 billion yen in branding enhancement and 0.04 billion yen in system-related expenses). Although this will decrease slightly in 2H, the company plans to invest +0.56 billion yen for the full-year over last year (excluding one-off costs). It aims to increase QA solution customers to 830 by the end of FY2023/3 and by more than 20% beyond this year. The company thinks it can recover the upfront investment made this year if the number of customers grows to this degree. By expanding sales while strengthening recruitment, the company aims to deliver an operating margin in the 7% range in Enterprise Business in 2H and over 10% in the medium term.

◇ Share price: scope for further upside judging from peer comparison

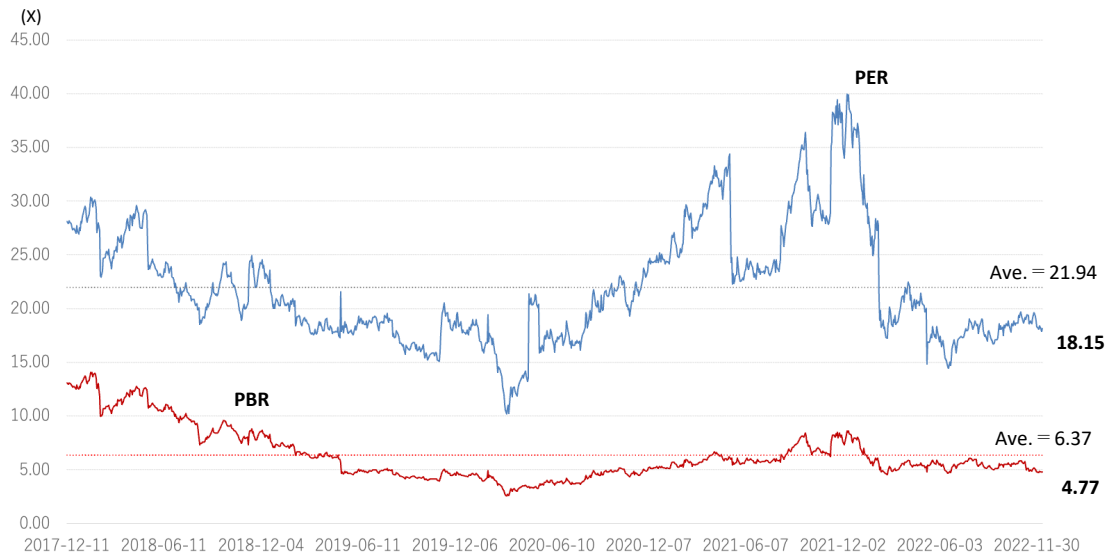
The company’s share price has continued to rise over the past year, bottoming out at 1,405 yen on 24 February. The profit model is working as designed, with profits generated by the highly profitable Entertainment Business underpinning earnings while continuing to invest in growth in Enterprise Business.

On the other hand, the valuations of the shares have remained below the historical averages (following page graphic). The multiples of the peers are Pole to Win Holdings (3657, debugging only) PER: 19.13, PBR: 2.03, SHIFT (3697, enterprise 90%), PER: 77.04, PBR: 18.76 and VALTES (4442, all enterprise business) PER: 39.72, PBR: 11.86. The company's Enterprise Business accounts for more than 40% of sales and should contribute to profits in the future. Growth expectations and the company's valuation relative to its peers point to further upside in the share price.

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



Historical PER/PBR (five years)



Note: PER is based on company forecasts; PBR is based on actual results; company forecasts for the period 19 May 2020 - 10 August 2020 were not announced due to the pandemic disease, so the guidance announced on 11 August 2020 were applied retrospectively. PBR is based on LTM and therefore may differ from the figures in the table in P1.

Financial data I

	2020/3				2021/3				2022/3				2023/3	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
[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	7,932	8,372	9,190
YoY	12.1%	7.2%	7.8%	15.0%	2.1%	3.9%	6.0%	16.4%	19.7%	36.1%	34.0%	24.8%	37.3%	24.2%
Enterprise business	954	1,140	1,133	1,794	1,523	1,540	1,710	2,246	2,029	2,833	3,074	3,553	3,589	4,024
YoY	46.3%	41.5%	32.0%	82.5%	59.6%	35.1%	50.9%	25.2%	33.2%	83.9%	79.7%	58.2%	76.8%	42.0%
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%	44.8%	42.9%	43.8%
New sub-segments														
QA solutions									1,395	1,572	1,772	2,121	2,102	2,481
YoY									—	—	—	—	50.7%	57.8%
Composition of sales									22.9%	21.2%	22.9%	26.7%	25.1%	27.0%
IT services and others									634	1,260	1,301	1,432	1,486	1,543
YoY									—	—	—	—	134.3%	22.4%
Composition of sales									10.4%	17.0%	16.8%	18.1%	17.7%	16.8%
Old sub-segments														
System testing	430	570	488	924	788	777	937	1,078	1,018	1,144	1,233	1,558	—	—
YoY	65.8%	99.5%	33.5%	91.4%	83.1%	36.2%	92.0%	16.7%	29.2%	47.2%	31.5%	44.5%	—	—
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%	19.6%	—	—
IT services / Security	523	569	645	869	735	763	772	1,167	1,011	1,688	1,841	1,995	—	—
YoY	33.4%	9.5%	30.9%	73.9%	40.4%	34.1%	19.8%	34.3%	37.5%	121.2%	138.2%	70.9%	—	—
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%	25.2%	—	—
Entertainment business	4,033	4,093	4,321	3,666	3,566	3,900	4,072	4,109	4,069	4,566	4,672	4,378	4,818	5,201
YoY	6.2%	0.5%	2.9%	-5.4%	-11.6%	-4.7%	-5.8%	12.1%	14.0%	17.1%	14.7%	6.6%	18.4%	13.9%
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%	55.2%	57.6%	56.6%
New sub-segments														
Domestic debugging					2,681	2,846	2,953	3,054	2,931	3,030	3,149	3,011	3,334	3,562
YoY					—	—	—	—	9.3%	6.4%	6.7%	-1.4%	13.7%	17.5%
Composition of sales					52.7%	52.4%	51.1%	48.1%	48.1%	41.0%	40.7%	38.0%	39.8%	38.8%
Global and others					887	1,049	1,118	1,054	1,137	1,536	1,522	1,366	1,484	1,640
YoY					—	—	—	—	28.2%	46.3%	36.1%	29.6%	30.4%	6.8%
Composition of sales					17.4%	19.3%	19.3%	16.6%	18.7%	20.8%	19.7%	17.2%	17.7%	17.8%
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	577	639	742
YoY	-37.2%	-30.9%	18.0%	-9.9%	-16.4%	12.4%	19.7%	121.3%	301.3%	98.5%	14.9%	-20.4%	0.5%	1.3%
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%	7.3%	7.6%	8.1%
Enterprise business	-184	2	14	100	-21	-7	64	152	87	144	171	246	29	84
YoY	—	—	—	—	—	—	363.5%	52.4%	—	—	163.8%	61.9%	-66.2%	-41.5%
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%	6.9%	0.8%	2.1%
Entertainment business	727	760	891	585	517	700	936	923	930	975	978	783	1,036	1,155
YoY	7.3%	-8.8%	6.1%	-20.3%	-28.9%	-8.0%	5.0%	57.9%	79.9%	39.3%	4.5%	-15.2%	11.4%	18.5%
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%	17.9%	21.5%	22.2%

Note) The sum of this table's segment sales and operating profit may not match the consolidated results, as there are some sales and operating profit adjustments.

Source: Omega Investment, based on company data

Financial data II

	2020/3				2021/3				2022/3				2023/3	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
[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	7,932	8,372	9,190
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	5,645	5,899	6,478
Gross profit	1,216	1,403	1,506	1,507	1,273	1,437	1,781	1,655	1,827	2,109	2,167	2,287	2,472	2,713
SG&A expenses	1,026	1,074	958	959	1,115	1,067	1,126	1,150	1,191	1,375	1,414	1,709	1,832	1,970
Operating profit	189	328	547	327	158	369	655	725	636	733	753	577	639	742
Non-operating income	3	2	1	1	38	10	24	5	38	31	12	30	5	1
Non-operating expenses	3	7	7	7	2	3	4	10	4	4	5	21	7	5
Ordinary profit	189	323	542	542	194	376	675	720	670	760	759	587	637	889
Extraordinary income		0	0	0		19	32		13	66	1	1	–	–
Extraordinary expenses		0	0	75	82	13	16	415	2	42	32	35	–	–
Net profit before income taxes	189	323	542	240	113	381	691	318	681	785	730	552	637	882
Total income taxes	77	159	162	99	38	122	224	145	189	281	233	38	201	306
Net profit attributable to owners of the parent	112	165	375	139	99	256	438	180	487	429	445	417	416	533
[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	10,392	10,874	12,182
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	5,208	5,573	6,850
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	4,411	4,614	4,672
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	7,172	8,158	8,505
Tangible fixed assets	545	646	627	579	560	549	565	598	602	623	621	693	1,067	1,077
Intangible fixed assets	793	1,404	1,390	1,379	1,445	1,424	1,433	2,670	4,389	4,244	4,225	5,094	5,206	5,750
Goodwill	491	1,066	1,033	1,027	1,032	991	950	2,467	4,175	4,042	3,945	4,763	4,812	5,301
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	1,384	1,883	1,678
Total assets	9,199	10,827	10,938	10,637	9,854	10,459	11,177	14,338	15,925	16,026	17,001	17,565	19,033	20,688
Current liabilities	3,621	4,679	4,863	5,135	4,450	4,655	5,061	7,904	8,954	8,775	9,354	9,679	10,759	11,330
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	5,421	6,806	–
Non-current liabilities	622	624	629	63	62	132	135	119	294	55	58	309	162	154
Long-term debt	48	46	48	–	–	66	65	63	236	–	–	169	–	–
Total liabilities	4,243	5,304	5,493	5,198	4,513	4,788	5,196	8,024	9,249	8,830	9,413	9,989	10,921	11,485
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	7,576	8,111	9,202
Shareholders' equity	4,734	5,039	4,919	4,898	4,841	5,172	5,460	5,642	5,983	6,436	6,719	6,776	7,030	7,779
Capital	300	300	300	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	–	–	60
Retained earnings	6,378	6,543	6,765	6,904	6,848	7,105	7,393	7,575	7,916	8,342	8,626	9,021	9,275	9,809
Treasury shares	-2,311	-2,162	-2,503	-2,662	-2,662	-2,565	-2,565	-2,565	-2,565	-2,545	-2,546	-2,545	-2,545	-2,391
Stock acquisition right	13	13	13	13	13	13	13	13	–	–	–	–	–	10
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	17,565	19,033	20,688
[Statements of cash flows]														
Cash flow from operating activities		-5		1,086		101		1,416		1,703		3,077		1,430
Net profit before tax and other adjustments		513		1,296		494		1,504		1,466		2,749		1,520
Cash flow from investing activities		-963		1,018		-261		-1,813		-1,682		-2,537		-1,496
Cash flow from financing activities		637		-515		-90		1,730		316		-546		1,488
Free cash flow		958		68		362		3,229		3,385		5,614		2,926
Cash and cash equivalents at end of period		-347		-458		-252		1,341		359		132		1,676
Cash and cash equivalents at beginning of period		4,162		4,162		3,704		3,704		5,041		5,041		5,173
Cash and cash equivalents at end of period		3,814		3,704		3,447		5,041		5,400		5,173		6,850

Source: Omega Investment, based on company data.



General disclaimer and copyright

This report was created and displayed based on interviews with the company concerned and financial statements, but we do not guarantee the accuracy, completeness, or credibility of the content and data. This report is for informational purposes only and is not intended to solicit or recommend investment. Omega Investment is not responsible for the consequences of using this report.

This report is informed by the target company through interviews with the target company, but the hypotheses, conclusions and all other content contained in this report are based on research by Omega Investment.

Intellectual ownership, including copyrights of the text and data, belongs to Omega Investment. Distribution, transfer, reproduction, transfer or other use constitutes copyright infringement of this report and is strictly prohibited.