

An operator of 'TOMAS' private classes for students preparing for higher education

Recommendation rating (Aug 9)

Riso Kyoiku Co., Ltd. (4714-TSE)**Overweight**

Stock Price	Unit of Investment	Market Cap	52-Week High	52-Week Low	PER (E)
451yen (8/9)	100Shares	234.8Bil yen (8/9)	473yen (16/7/20)	274yen (16/2/12)	18.7 (8/9)

Vigorously deploys a customer retention strategy, aggressive shareholder returns is also promising

100% shareholder return ratio for FY 2016

On July 11, Riso Kyoiku Co., Ltd. announced its results for 1Q of the fiscal year ending February 2017 (fiscal 2016). The company posted an operating loss of 206 million yen (compared with a loss of 270 million yen in 1Q of fiscal 2015) on revenue of 4,061 million yen, up 6.9% on the same period last year. We are not surprised by the operating loss for 1Q, as the company operates a private cramming school business with seasonally fluctuating earnings. **The company has been on a steady growth path, as it posted revenue growth across all business segments. The 1Q operating loss was lower than that seen in the same period of last year and exceeded its projections.**

Riso suffered a net loss in fiscal 2013, in the face of inappropriate accounting, but it resolved the issue thanks to remedial measures, including internal control shakeups. The company swung back to profitability in fiscal 2014. It achieved further earnings growth in the following fiscal 2015, indicating that it had moved into a stage of full-scale growth.

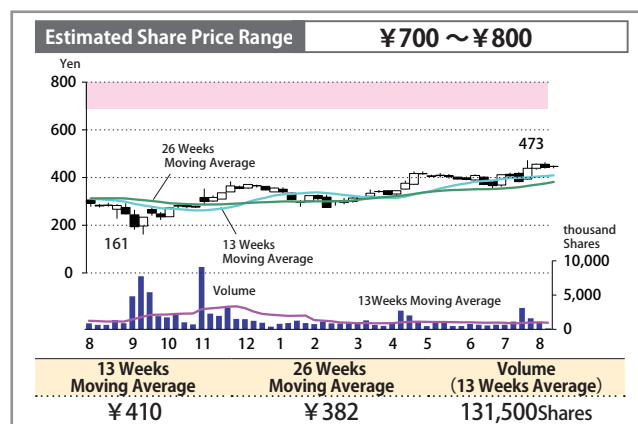
As the company leases all of its cram school premises, no large-scale capital expenditure is required, which allows it to implement an aggressive shareholder return policy. **Riso has already promised to increase dividends for fiscal 2016. It plans to raise the interim dividend for the year from the previous 8.0 yen to 12.0 yen per share, with the aim of delivering a 100% shareholder return ratio for the year. In addition to its consideration of quarterly dividend payments, there is a growing expectation for another rise in the dividend for the second half of fiscal 2016, if the Company sustains its strong earnings performance.** August 19, Riso announced that would pay dividend 12.0 yen (6.0 yen at 3Q, 6.0 yen at 4Q) for the second half of the year

Growth is driven by new businesses; but the share price is further undervalued

In April 2016, Riso announced its medium-term management plan that ends in the fiscal year ending February 2019 (fiscal 2018). Under the plan, it predicts to post revenue of 23,800 million yen (up 7.2% year-on-year) and ordinary income of 2,800 million yen (up 16.7%) in fiscal 2018. The successful achievement of projections set in the medium-term management plan relies in large part on the performance of its cram school business, the mainstay operation, that provides tutorial lessons at its branded "TOMAS" schools. Currently, TOMAS operates a total of 67 schoolrooms in Tokyo and another three prefectures; the number of schoolrooms is far lower than that operated by its competitors. This shows that there is great potential for Riso to open further cramming classes in the Tokyo metropolitan area. The company has embarked on a 'satellite cram school strategy', in which it will open schoolrooms relatively smaller than conventional sized ones, in a convenient location such as near a train station. Through this strategy, it plans to double the number of schoolrooms to approximately 120. **In the context of the falling birthrate, the cost of education per head has demonstrated an upward trend in Japan.**

Revenue and Earnings Trend (As of August 9)

		Revenue (Yen Mil)	YoY (%)	Operating Profit (Yen Mil)	YoY (%)	Ordinary Profit (Yen Mil)	YoY (%)	Net Profit (Yen Mil)	YoY (%)	EPS (Yen)
2015-2	Past Results	18,776	-5.1	1,006	▲298.0	978	▲284.5	2,379	▲188.7	47.8
2016-2	Past Results	19,643	4.6	1,890	87.9	1,857	89.9	1,428	▲40.0	27.7
2017-2	Company est.	20,800	5.9	2,100	11.1	2,050	10.4	1,250	▲12.5	24.1
	MS est.	20,800	5.9	2,100	11.1	2,050	10.4	1,250	▲12.5	24.0
2018-2	MS est.	22,500	8.2	2,500	19.0	2,550	24.4	1,555	24.4	29.9



There is growing demand for tutorial lessons on a complete one teacher to one student basis, through which a higher-quality education service is delivered.

During the period in which the medium-term plan is in place, the company is set to solidify the foundation for growth on the back of new businesses. The Shinga's Club comprises classes that provide early learning programs to nurture pre-school children aged one to three. There is mounting public concern about long lists of pre-school children who are waiting to be admitted to publicly certified nursery schools. Hence, the Shinga's Club is expected to be a solution to the problem. The Club engages with a total of six schools, principally in the Tokyo Metropolitan area, but it plans to rapidly establish more schools. The Shinga's Club also operates schools that offer care programs for children from the first to the third grades. There are 11 schools providing these programs but the operator plans to boost the number going forward. The School TOMAS business, another promising segment to grow, operates tuition-style (i.e. one-on-one) classrooms branded 'TOMAS' within ordinary school buildings. The business offers one-on-one tutorial programs to students after ordinary school lessons. Considering the benefits, these programs are likely to attract more students. Recently, as a new initiative, the School TOMAS business has embarked on the online English conversation business. Prior to this new initiative, topnotch schools, known for their rigorous admission criteria, were unwilling to locate School TOMAS classes within them; however, according to the company, the new business specializing in online English conversation lessons has made a breakthrough in these topnotch schools. Morningstar believes that Riso will bolster up these new businesses over the next three years, thereafter they will begin to show progressive profit growth.

Based on our five-year revenue forecast and using the DCF (discounted cash flow) method, we estimated Riso's share price to be in the range of 700 ~ 800 yen. The computation of the estimated share price range took into consideration the assumed permanent growth rate for free cash flows using the estimated annual average growth

rate of GDP (gross domestic product) at 0.5% for the next five years and the estimated going concern value, calculated by multiplying the estimated EBITDA after five years by the industry average EV/EBITDA of roughly 10 times. Our assumed WACC (weighted average cost of capital) was 5.7%. Riso shares closed on 8 August at 447 yen, which was 67.8% below the midpoint of our estimated share price range of 750 yen. Since the share price has ample potential to rise further, we begin our valuation of the company shares with an 'Overweight' rating.
(Hiroyuki Miyamoto)

Company Overview

Riso Kyoiku Co., Ltd. is an operator of 'TOMAS', private tutorial-based cram schools primarily in the Tokyo Metropolitan area, for children preparing for higher education. Traditionally, tutorial lessons were largely seen as an opportunity to receive supplementary education. However, Riso, for the first time in the industry, targeted children aspiring to 'higher-level education'. Because of this, its schools have demonstrated high-level advancement rates. While tutorial lessons at cram schools operated by other companies often take the form of 'one tutor to a few students', Riso's lessons are strictly on a one tutor to one student basis. For this reason, its programs require relatively high monthly tuition fees. In return, its students can receive higher-quality education programs from proficient tutors who have completed the company's intensive training courses and choose lessons that meet their specific requirements from 'various curricula', among other distinctive services.

As of the end of June 2016, Riso were operating 67 TOMAS schools. They had fewer classrooms compared with competitors, but this suggests that there is plenty of room for the company to open new classrooms. In addition to TOMAS, other major businesses include Meimonkai (14 branches with 27 schools), tutoring centers that specialize in dispatching professional tutors and the Shingakai (24 classrooms) which the company acquired (M&A) in 2013.

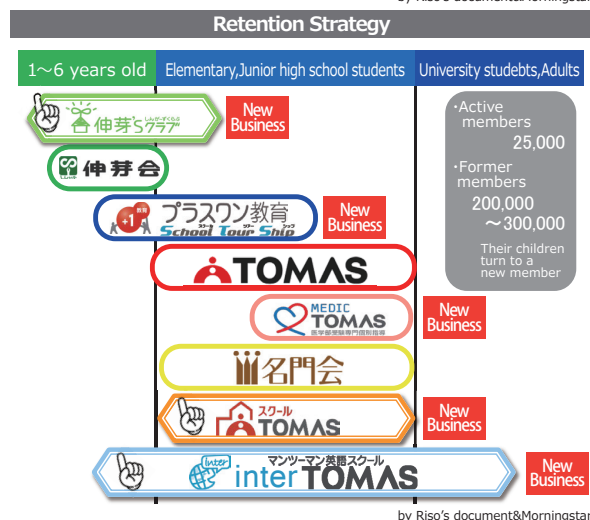
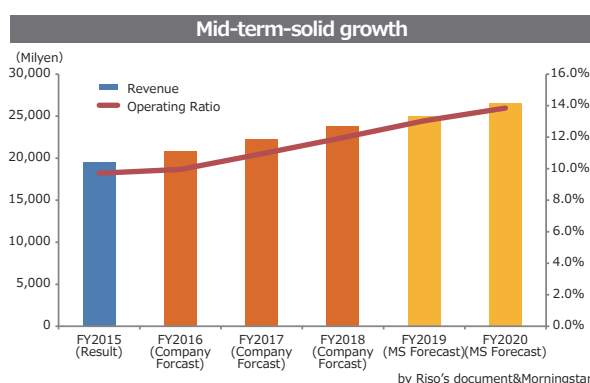
Under its medium-term management plan, Riso focuses its management resources on the expansion of newly established businesses, including the Shinga's Club, the nursery aiming to develop the ability of pre-school children (aged one+), School TOMAS, an operator of TOMAS classes within school buildings and Inter TOMAS that provides one-on-one English lessons not only for children but college students but business people as well. The company also promotes a 'strategy to retain customers' by extending its target demographic from one-year-old toddlers to adults.

In December 2013, Riso established a third-party review panel to address the issue concerning its inadequate accounting procedures. This issue led the company to face the danger of the delisting of its shares from the stock exchange, before it successfully dealt with and resolved the issue by implementing drastic reformation of its internal controls. Subsequently the company is now set to move into a stage of growth.

Business Environment and Outlook

According to the Vital Population Statistics issued by Japan's Ministry of Health, Labour and Welfare, in 2015 there were 1,008,000 newborn babies, 15% fewer than those registered in 2000. Meanwhile, the Family Income and Expenditure Survey of the country's Ministry of Internal Affairs and Communications showed that complementary education expenses as a percentage of total education expenses in 2015 stood at 23.4%, a modest increase on the 22.6% logged in 2000, indicating that education expenses per head were on an upward trend.

Riso's tutoring programs completely comprise lessons on a one tutor to one student basis. The company takes the view that the cram school



business belongs to the service sector not the education, therefore it makes thoroughgoing efforts to constantly improve its service quality. Although it charges relatively higher service prices, its one-on-one lessons provide significantly higher-quality service compared with group teaching and one-tutor for multi-student programs. There is a growing trend among cram school users to seek higher-level education services as such those offered by the company. Riso's tutors receive comparatively higher salaries than others. This has helped the company to recruit highly competent tutors. It also implements rigorous training programs for employees and tutors. Employees in the classroom are assigned to full-time tutoring jobs, which allows them to concentrate on their lessons.

Risk Factors

Fewer children amidst an increasingly aging society with a lower birthrate, leading to a shrinking market and tougher competition may increase pressure on competitors' results; but these factors are likely to have limited impact on Riso's performance as the company primarily targets wealthy individuals. In addition, Mr. Mitsugu Iwasa, the founder, director and corporate advisor to Riso, has led the company's management for a long period of time, significantly contributing to the company's 28 consecutive fiscal years of revenue growth. Therefore, the possibility that Mr. Iwasa became unable to engage in company management for any reason would pose a threat to its smooth operation.

Shareholder Return (As of August 9)

Dividends

		Dividend Per Share		
		First half	Second half	Annual
2015-2	Past Results	¥0	¥0	¥0
2016-2	Past Results	¥0	¥10	¥10
2017-2	Company est.	¥12	※ ¥12	¥24

※Changed dividend as of August 19

Shareholder Special Benefits

None

Competitor Comparison (If the number is better than rivals, it's highlighted by red character) (As of August 9)

	Riso Kyoiku Co., Ltd. (4714•TSE 1st)	MEIKO NETWORK JAPAN CO.,LTD. (4668•TSE 1st)	Tokyo Individualized Educational Institute, INC. (4745•TSE 1st)	
Stock Price	¥ 451	¥ 1,050	¥ 594	
Basic Point	Unit of Investment	100Shares	100Shares	1000Shares
	Minimum Investment Amount	¥ 45,100	¥ 105,000	¥ 594,000
	Fiscal Year End	February	August	February
Share Price Indicator	PER (E)	18.7	32.4	36.5
	PBR	3.0	2.0	3.9
	Dividend Yield (E)	5.3% ※	3.6%	4.4%
Growth	Revenue Growth Rate (E)	5.9%	1.2%	5.3%
	Operating Profit Growth Rate (E)	11.1%	▲37.4%	17.3%
	EPS Growth Rate (E)	▲13.1%	▲62.3%	20.4%
Profitability	Operating Margin (E)	10.1%	11.7%	14.4%
	ROE	20.7%	17.1%	17.5%
	ROA (Ordinary income/Total assets)	15.1%	21.6%	21.9%
Financial Health	Equity ratio	62.3%	78.0%	78.5%
	Debt-Equity Ratio	0.0%	0.7%	0.0%
	Current Ratio	210.2%	292.8%	365.6%

Our chosen industry peers are MEIKO NEYWORK JAPAN (4668), an operator of "MEIKOGIJYUKU". We also pick up Tokyo Individualized Education Institute (4745), known as a group company of Benesse.

※ August 19, Riso announced that would pay dividend 12.0 yen (6.0 yen at 3Q, 6.0 yen at 4Q) for the second half of the year

■ Growth

Riso provides high-quality education services that demonstrate strong resistance to lower birthrates, therefore the Company is expected to achieve steady growth in the face of difficult business conditions.

In its medium-term management plan, the company expects to post revenue of 23,800 million yen and ordinary income of 2,800 million yen in fiscal 2018, the final year of the plan. The Company has a policy not to implement far-fetching new school opening plan, thereby aiming to achieve a steady high-single-digit rate of revenue growth over the next three years. Contrary to the moderate revenue growth, the company is likely to maintain a high-level and double-digit rate of profit growth, as it rolls out an expansion in profitable new business operations. From fiscal 2019, when contributions to its earnings from new businesses are set to gain momentum, the company may accelerate its growth pace.

■ Profitability

In the past, Riso was acclaimed for delivering high ROEs (returns on equity). With the resolution of the irregular accounting issue, it now expects to resume a policy of placing emphasis on ROEs. The ROE for fiscal 2015 stood at 20.7%, which already outnumbered that of its competitors. Going forward, Riso's ROE is likely to increase, supported by solid contributions from the School Thomas and other highly profitable new businesses.

The company indicated its adoption of a policy to attach importance to returning profits to shareholders and employees, therefore profit growth is highly likely to lead to a dividend increase among other returns.

■ Financial Health

Riso's equity ratio at the end of fiscal 2015 was 62.3%, up from 50.1% at the end of the previous fiscal year. With no interest-bearing debts, the company essentially manages its operations without relying on borrowings. It uses all schoolrooms on lease and the nature of the industry in which it is involved does not require major capital expenditure. The School TOMAS business builds a classroom at its own expense if it is unable to locate to one within a school building, however this seems to be very exceptional. In light of these factors, together with its liquidity ratio exceeding 200%, there is little concern about the company's financial standing.

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How to Read Morningstar Equity Research Report

Our Uniqueness

(1) Emphasize Its Position as an Independent Evaluation Organization

Morningstar emphasizes its position as an independent evaluation organization and is committed to providing objective comparison and assessment in the Morningstar Equity Research Report. For all stocks covered by us, we determine investment decisions, estimated share price range and earnings forecasts based on expertise of an individual analyst as well as the stock assessment committee consisting of several analysts.

(2) Universe of Covered Stocks

The stock assessment committee selects covered stocks based on the following criteria.

[Stock Selection Criteria]

- Domestic emerging companies that are rarely covered by analysts
- Stocks that are popular among retail investors (refer to data from online security brokers)
- Size of market capitalization (over about 5 billion yen)
- Exclude stocks which are liquidated or trade control, or stocks with going concern and excessive debt

(3) Investment Decisions Classified into Three Groups

We determine investment decisions for covered stocks after consultation with the stock assessment committee based on research, interview and analysis by each Morningstar analyst.

Each stock is classified into either of three groups according to the following criteria.

Overweight : Forecasted to go beyond the current stock price level by 15% or more in the next 6 months.

Neutral : Forecasted to fall into the range of -15% ~+15% of the current stock price level in the next 6 months.

Underweight : Forecasted to go below the current stock price level by 15% or more in the next 6 months.

We flexibly respond to any changes of observations regarding earnings forecasts, financial situations and stock price trends, and change investment decisions accordingly. "Under Review" status may be applied if any new information comes out and extra time is needed to determine investment decisions. Also we don't change investment decisions during trading hours. "Suspension" status may be applied when an analyst leaves our company.

(4) Estimated Share Price Range in the Medium Term

It shows the price range for a stock price in the next 6 months. We determine upper and lower range of stock price based on fair value estimates from share price indicator, technical factors such as chart points, most recent high and low prices, trend line and moving average, trading volume in each price range and such.

Analysis Points

■ Analyst Comment

Each analyst reports and evaluates the most recent earnings trend and business environment. It shows the most important information for stock investment such as evidence for investment decisions, perspectives on earnings forecasts and business prospects. Also to make sure it is easy to comprehend, we write in 2-4 paragraphs and use bold to emphasize important texts.

■ Revenue and Earnings Trend

It reports earnings in past two fiscal years, company forecasts and our forecasts for the current and next fiscal year. We predict earnings based on research as well as past quarterly earnings trend and analysis by segments.

■ Company Overview

It explains in detail what businesses the company is engaged in and how revenue sources are defined. Also on the basis of our research, it discusses what businesses the company will focus on in years to come and how it carries out mid-term business plan.

■ Business Environment and Outlook

It discusses current circumstances and growth potential of the industry to which the company belongs. A comprehensive report on the industry from different perspectives is provided through research interviews to competitors. Specific figures of the industry data are also introduced.

■ Risk factors

It shows the company's risk factors and describes various aspects of risks such as business, earnings and financials. Typical stock market risks are also taken into consideration.