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JASDAQ

OUTSOURCING Inc.

A Summary of Follow-Up Interview on Q1 FY12/11 Business Results

The following is a summary of Trias Corporation's interview with Haruhiko Doi, Chairman and President of OUTSOURCING Inc. (hereinafter OSI or the Company) on its Q1 FY12/11 business results announced on April 27, 2011.

Changes in Production Outsourcing Industry's Operating Environment

The global financial crisis triggered by the Lehman Bros. collapse ushered in drastic changes in the operating environment of the production outsourcing service industry, OSI's core business. The industry's origins go back to the 1960s and, over the next two decades, unlisted companies such as NIKKEN SOGYO CO., LTD., NISSO COPRORATION, TAKAGI KOGYO CO., LTD. and Advantage Resourcing Japan Inc., the former Crystal Group, spearheaded the market. The market began to grow when a few Japanese manufacturers, buoyed by "made in Japan" quality and amid an effort to expand business both at home and abroad, started to aggressively outsource parts of their production process in order to secure the required workforce.

In the ensuing years, the production outsourcing industry expanded more in times of economic downturns than in upturns, from Black Monday in 1989 to the burst dot-com bubble in the 1990s. This trend took shape as Japanese makers sought to strengthen cost competitiveness by outsourcing production in survive in an era of fierce global competition. As a result, outsourcing services, which were initially employed by only a handful of companies, came to be adopted by a majority of manufacturers. The production outsourcing industry continued to grow at a time when the macroeconomic environment was adverse and client-makers were underperforming. In the peak year of this trend, the Crystal Group, for example, generated annual sales of 600 billion yen and NIKKEN and NISSO earned some 200-300 billion yen each. While the industry's dramatic growth was led in part to structural changes in Japan's manufacturing sector, another factor lay with its convenience-based business model, which allowed for quick capital recovery and absence of any frontloaded investment.

In the 2000s, the shift by manufacturers to production outsourcing services accelerated even further. While prolonged deflation acted to hamstring domestic demand, consumption grew swiftly in the emerging economies and East Asian makers, particularly those in China, rose to prominence to meet local demand. Given that high labor costs in Japan made domestically manufactured products too expensive to meet demand in the emerging economies, Japanese makers moved their factories to China and other foreign countries—and, in the process, rapidly diluting the value-added branding strength of being “made in Japan.” In addition, regulatory restrictions on manufacturing temporary placement services, which had been widely adopted merely as a means to secure manpower, were reinforced.

The contraction of the Japanese manufacturing market should have triggered a major shakeout within the production outsourcing industry. Many of the newer outsourcing providers, whose core business revolved around outsourced volume production services, listed on stock exchanges and sought to differentiate their business from the older, established rivals by emphasizing their compliance capabilities as more stringent regulations were being adopted. However, while makers were willing to switch from older to newer outsourcing providers, they were discouraged from doing so because it would entail a large number of worker contract terminations, which could prove a public relations anathema in an era of government protection of temp worker job security. As a result, the expected shakeout in the outsourced production industry did not materialize.

It took the post-Lehman global financial and economic crises to force changes to the extant structure. In the ensuing contraction of the consumer market, Japanese manufacturers were forced to lay off temp staff and other contract workers en masse. And when production began to recover, makers shunned service providers that could not meet their compliance needs. As a result, the newer providers—which were much smaller players than the established providers—had reached parity in terms of business scale. (See Table 1)

●【Table 1】Major Production Outsourcing Firms with Volume Production Service

Establish-ment	Securities Code	Company Name	Latest Term End	Net Sales (¥ million)	Operating Income (¥ million)	Operating Margin
Apr.81	Unlisted	NIKKEN SOGYO CO., LTD.	n.a.	n.a.	n.a.	n.a.
Feb.93	2429	WORLD INTEC CO., LTD.	FY12/10	32,109	344	1.1%
Feb.71	Unlisted	NISSO CORPORATION	FY3/10	30,385	n.a.	n.a.
Jan.97	2427	OUTSOURCING INC.	FY12/10	28,386	1,173	4.1%
Sep.85	2162	Nippon Manufacturing Service Corp.	FY3/11	20,675	602	2.9%
Apr.07	2146	UT Holdings Co., Ltd.	FY3/11	20,227	1,442	7.1%
1963	Unlisted	TAKAGI KOGYO CO., LTD.	Fiscal 2010	15,500	n.a.	n.a.

Note: All tables prepared by Trias Corp. by the data disclosed by OUTSOURCING Inc. and other firms.

Impact of March 11 Disaster and FY12/11 Earnings Forecast

When OSI announced its Q1 FY12/11 earnings results, it also revised its 1H and full-year projections downward. From the post-Lehman industry shakeout up until the March 11 disaster, the Company had been winning orders at a rate that would have outpaced the target level set at the beginning of the fiscal year. OSI was preparing to capture a larger share of the market by increasing the number of worksite employees, from 700 per month last year to 2,000 per month, through a system that covers everything from the recruiting and interviewing of potential candidates to the post-hiring labor administration services. At the time of the March 11 disaster, nearly 1,000 worksite employers were about to be placed, in fact.

●【Table 2】Revised Earnings Forecast for FY12/11

(¥ million)	FY12/11 Apr. 27 Fcst.						FY12/11 Feb. 10 Fcst.		
					Y/Y Chg.				
	1H	2H	FY	Ratio	Amount	Ratio	1H	2H	FY
Net Sales	14,960	19,620	34,580	100.0%	6,194	21.8%	16,850	23,150	40,000
Operating Income	110	1,020	1,130	3.3%	-43	-3.7%	600	1,200	1,800
Ordinary Income	180	1,070	1,250	3.6%	-151	-10.8%	650	1,250	1,900
Net Income	-45	700	655	1.9%	-105	-13.8%	350	790	1,140

However, some 40% of these workers became idle as a result of the disaster, which severed the supply chains of the automotive, electrical and electronics, construction materials and other industries. Although there were only three client-makers that were directly affected by the March 11 disaster and another inland temblor a few days later, production halts attributed to the crippled supply chain led the Company's worker utility ratio in March to plummet to 25% compared to the rate posted in the same month in other years. As a result, OSI was saddled by high personnel costs incurred by its idle workers, a corps it had been strategically increasing, and its operating, ordinary and net incomes in Q1 (Jan-Mar 2011) fell far short of the initial forecast. In specific terms, contracts for some 500 of the Company's workers were cancelled—200 in the transport equipment sector, 100 in electrical and electronics, 25 in pharmaceuticals and chemicals, and 75 in other fields. In March alone, such opportunity losses amounted to an estimated 1 billion yen or more. Moreover, the number of workers contracted under the Administrative Operations Outsourcing Services in Q1 remained stagnant at 531 versus the forecast's 950. The shortfall was primarily attributed to production halts by client-makers in the electrical and electronics, as well as the construction materials industries.

●【Table 3】Consolidated Financial Results for Q1 FY12/11

(¥ million)	FY12/10 Actual		FY12/11 Actual			Feb.10 Fcst.
	Q1 (Jan-Mar)	Ratio	Q1 (Jan-Mar)	Ratio	Y/Y Chg.	
Net Sales	**6,282**	**100.0%**	**7,501**	**100.0%**	**19.4%**	**7,886**
Gross Profit	1,282	20.4%	1,457	19.4%	13.7%	n.a.
SG&A Expenses	1,154	18.4%	1,366	18.2%	18.4%	n.a.
Operating Income	**128**	**2.0%**	**90**	**1.2%**	**-29.7%**	**239**
Ordinary Income	**207**	**3.3%**	**132**	**1.8%**	**-36.2%**	**n.a.**
Net Income	**111**	**1.8%**	**-24**	**-0.3%**	**-121.6%**	**n.a.**

●【Table 4】 Net Sales by Segment for Q1 FY12/11

(¥ million)	FY12/10 Actual Q1 (Jan-Mar)	FY12/11 Actual Q1 (Jan-Mar)	Y/Y Chg. Amount	Y/Y Chg. Ratio	Feb.10 Fcst.
Production Outsourcing Business	**6,020**	**7,251**	**1,231**	**20.4%**	**7,357**
Electrical and Electronics	1,754	2,159	405	23.1%	n.a.
Foods	510	440	-70	-13.7%	n.a.
Transport Equipment	1,564	2,511	947	60.5%	n.a.
Chemicals and Medicals	1,017	1,016	-1	-0.1%	n.a.
Metals	72	84	12	16.7%	n.a.
Other	1,100	1,040	-60	-5.5%	n.a.
Administrative Operations Outsourcing Business	**80**	**213**	**133**	**299.8%**	**313**
Other Business (Incl. Nursing-Care)	**181**	**36**	**-145**	**-80.1%**	**32**
Total	**6,282**	**7,501**	**1,219**	**19.4%**	**7,886**

As stated above, the Company's operating environment underwent a dramatic change in an extremely short period of time. While cost controls and other internal adjustments take precedence under such circumstances, OSI opted to retain its workers in the belief that the resumption of production halts would be faster than most anticipated. Many initially believed that production would restart from around November, but led by the automotive sector, some makers began resuming manufacturing operations from as early as June. Orders from general users for hybrid vehicles—which proved their superior power-charging and –storing capabilities in the March 11 disaster—have been growing, for example. In order to minimize the opportunity loss, the automotive industry as a whole worked to resolve the supply-chain issues besetting its affiliated suppliers and related firms. The industry-wide initiatives also included support to electronics components makers as well.

It should be noted that client-makers are opting for contracts with listed outsourcing service providers to restart production operations and that OSI's competitive superiority has clearly emerged, particularly in the automotive industry—so much so that it has hardly had to compete head-to-head with rivals in winning contracts. In addition, the construction materials industry has also been restoring its supply chain and is moving quickly to meet demand generated by the reconstruction effort.

OSI Group's Future Initiatives

Initiatives in Japan

OSI expects special demand in the production outsourcing market generated from the rebuilding effort to continue for the next two years or so. During this time, the Company will be aiming to expand domestic market share through a recruitment regime capable of hiring 2,000 contract workers a month. On the regulatory front, meanwhile, OSI believes that a bill to prohibit manufacturing temporary placement contracts may be shelved this year, in fact. Over the past few years, production outsourced contracts were seen as a service that would replace manufacturing temporary placement contracts, but that view may no longer be valid.

In a contingency like the one created by the March 11 disaster and subsequent need to rapidly restart and ramp up production, it is difficult to rely on production outsourced contracts as they require considerable lead times to implement. Another shift that appears to be developing is client-makers' criteria in choosing service providers, from one emphasizing technical expertise in such services as production outsourced contracts, to one valuing labor management expertise, including how a provider can respond to labor suits and other issues.

OSI has responded to such changes by focusing on temporary placement contracting and that, in turn, has significantly altered its sales composition ratio by business model. At present, sales from temporary placement accounts for over 60% of total sales, with full-range administrative services—which includes recruitment agency and labor management operations—comprising over 30%, and production outsourcing contracts making up the rest with a mere several percentage points. Even as the Company takes steps to ensure that its business models remain viable, it is placing the highest priority on delivering productivity improvements for client-makers so that it can respond to changes in the market and client needs, and, in the process, achieve its target of placing 20,000 worksite employees.

After the one-time demand from reconstruction runs its course, OSI will be pushing harder into the temporary replacement of engineers in such specialized, non-manufacturing fields as broadcasting and the IT industry. Meanwhile, in the manufacturing sector, the Company will be reinforcing its competitiveness in segments in which the value-added strengths of "made in Japan" products can be sustained. OSI will also be placing even greater strategic emphasis on solutions to develop other areas as well, including the hybrid vehicle field as mentioned above.

Initiatives for Overseas Operations

Given the rapidly saturating domestic market, the Company is committed to developing overseas markets in the medium- to long-term. It has positioned the Southeast Asian nations of Thailand, Malaysia and Indonesia as its primary jump-off points for its overseas development strategy that will eventually include Vietnam, Cambodia and Laos. The region boasts a population of some 600 million people and major movement has begun in terms of people, ideas and industrialization. Considering the fact that the majority the population is expected to engage in manufacturing activities in the years ahead, the situation there is similar to Japan's 35 years ago, when the domestic production outsourcing market began to blossom rapidly. The Company will be pushing into this fledgling market at the earliest possible opportunity to reap the benefits of local market growth. Starting from this year, OSI plans to assign key members of its domestic operations to its foreign subsidiaries so they can develop a robust business foundation over the next five years.

References

Key Financial Data and Business Results (Consolidated)

Key Stock Indicators		
No. of Shares Issued	Dec. 10	15,547,000
No. of Treasury Stock	Dec. 10	1,139,500
Market Value (¥million)	Jun.24, 11	7,463
BPS (¥)	Dec. 10	230.9
ROE (%)	Dec. 10	22.9
ROA (%)	Dec. 10	7.1
PER (times)	FY12/11 fcst.	10.6
PCFR (times)	Dec. 10	7.3
PBR (times)	Dec. 10	2.1
Share Price (¥)	Jun.24, 11	480
Unit Share (shares)	Dec. 10	1
Average Daily Volume (shares)	Jun.24, 11	62,552

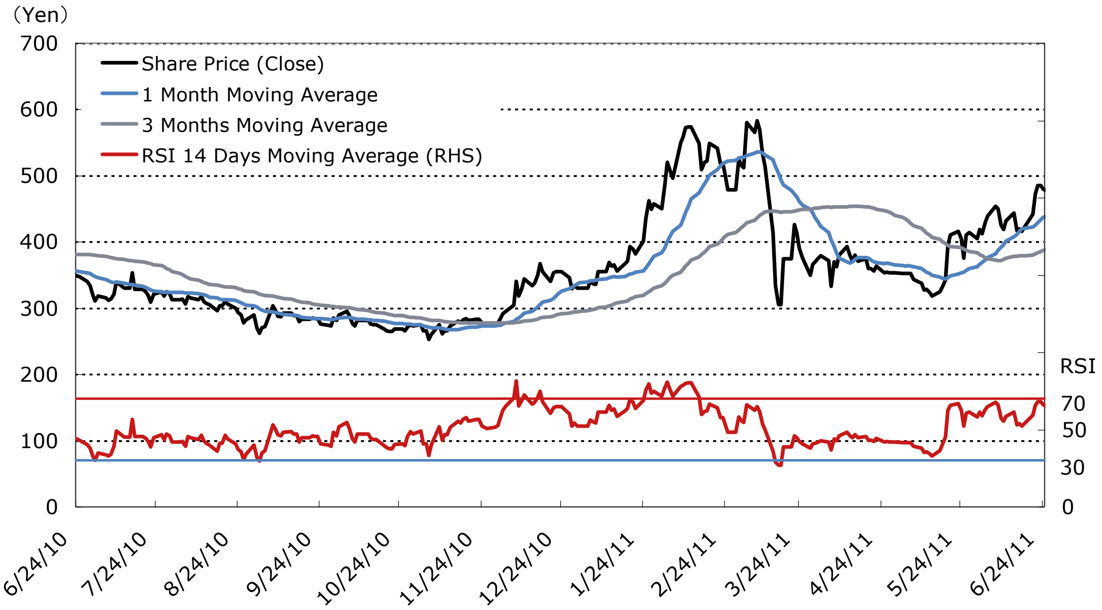
Key Financial Data		
Total Assets (¥million)	Dec. 10	10,707
Shareholders' Equity (¥million)	Dec. 10	3,326
Interest-Bearing Debt (¥million)	Dec. 10	2,670
Equity Ratio (%)	Dec. 10	31.1
Ratio of Interest-Bearing Debt (%)	Dec. 10	80.3
Free Cash Flows (¥million)	Dec. 10	1,201

ROE=Current Net Income÷Shareholders' Equity
ROA=Current Net Income÷Total Assets
PCFR=Maket Value÷(Current Net Income+Depreciation)
Ave. Daily Vol.=Ave. Daily Vol. for the last 12 months
Interest-Bearing Debts Ratio=I.B.D.÷Shareholders' Equity
Free Cash Flows=Operating CF+Investment CF

Consolidated (¥million)	Net Sales	Operating Income	Ordinary Income	Net Income	EPS (¥)	DPS (¥)
FY12/07	24,321	1,013	1,004	583	4,917.28	492.00
FY12/08	24,148	1,113	1,134	641	5,412.29	644.00
FY12/09	17,964	-150	22	-215	-1,511.00	644.00
FY12/10	28,386	1,173	1,401	760	52.46	7.21
FY12/11 1H fcst.	14,960	110	180	-45	-3.11	--
FY12/11 fcst.	34,580	1,130	1,250	655	45.40	8.00

Note: FY12/11 forecasts announced on April 27, 2011

Stock Price Charts and RSI



Source: Prepared by Trias Corp. with Bloomberg data.
Note: RSI, Relative Strength Index, is the index representing the ratio of overbought or oversold share prices.
In general, over 70 in RSI shows overbought share price range, while below 30 shows oversold share price range.
RSI=averaged share price appreciation for N days÷(averaged share price appreciation for N days +averaged share price decline for N days) x100