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TSE2

OUTSOURCING Inc.

Q2 FY12/12 Business Results Meeting and Follow-up Interview

OUTSOURCING Inc., hereinafter the Company or OS Group, held its Q2 FY12/12 financial results meeting, and Trias Corporation conducted an interview with Chairman and CEO Haruhiko Doi. The following is a summary of the interview.

Summary of Q2 FY12/12 Consolidated Financial Results

Consolidated 1H results can be seen in Table 1, with solid double-digit gains in both net sales and operating income. Operating income only rose 20.1% YOY versus a 37.2% increase in net sales due to one-off expenses of approximately ¥300mn for listing expense on the TSE 2nd Section in Q1 and moving expense for re-locating the head office from Shizuoka to Tokyo in Q1 and Q2. Stripping out these one-time expenses, both net sales and operating income marked new record highs for the 1H. The Company invested strategically last term in increasing worksite employees, and benefitted during the 1H especially from ongoing high output of autos as car makers restored global inventory levels, with a further boost from revival of domestic eco-car tax subsidies. Net income was depressed due to front-loading of group re-organization from the 2H, resulting in a decrease of tax credits of ¥100mn in the 1H.

●【Table 1】Q2 FY12/12 Summary of Consolidated Earnings Results

(¥ million)	FY12/11 1H	FY12/12 1H	YOY CHG	FY12/12 Q1	YOY CHG	FY12/12 Q2	YOY CHG
Net Sales	14,874	20,408	37.2%	10,179	35.7%	10,228	38.7%
Gross Profit	3,029	4,037	33.3%	1,932	32.6%	2,104	33.8%
SG&A Expenses	2,821	3,787	34.2%	1,880	37.6%	1,906	31.1%
Operating Income	208	249	20.1%	52	-42.0%	197	67.8%
Ordinary Income	280	309	10.0%	70	-46.8%	238	60.4%
Net Income	10	(23)	in red	(9)	in red	(14)	in red
[Sales Margins/Ratio]							
Net Sales	100.0%	100.0%		100.0%		100.0%	
Gross Profit	20.4%	19.8%		19.0%		20.6%	
SG&A Expenses	19.0%	18.6%		18.5%		18.6%	
Operating Income	1.4%	1.2%		0.5%		1.9%	
Ordinary Income	1.9%	1.5%		0.7%		2.3%	
Net Income	0.1%	-0.1%		-0.1%		-0.1%	

Source: Company materials, compiled by Trias Corporation

1H FY12/12 net sales increased ¥5.5bn compared with the 1H of last term. In the Production Outsourcing Business, in addition to high growth in the Transportation Equipment (autos) segment which increased ¥1.6bn (+35.3% YOY), new contracts for building materials and housing fixtures in the Metal Products segment increased ¥1.7bn (+929.7% YOY) as reconstruction demand began to pick up. Also, new business in the IT & Telecommunications segment added ¥1.0bn from mobile device applications development etc. These three segments offset the decline of ¥0.7bn (-16.2% YOY) in Electrical & Electronics segment, including semiconductors (please refer to table 2 below).

●【Table 2】1H FY12/12 Sales Breakdown by Industry

(¥ million)	FY12/11 1H	FY12/12 1H	YOY CHG Value	YOY CHG Ratio
TOTAL NET SALES	14,874	20,408	5,533	37.2%
Production Outsourcing	14,385	19,768	5,383	37.4%
Foods	930	868	(61)	-6.6%
Electrical & Electronics	4,416	3,703	(713)	-16.2%
Transport Equipment	4,617	6,245	1,628	35.3%
Pharm. & Chemicals	2,161	2,093	(68)	-3.2%
Metal products	186	1,919	1,733	929.7%
IT & Telecommunications	0	1,005	1,005	new
Others	2,072	3,932	1,860	89.7%
TO TOTAL NET SALES	100.0%	100.0%		
Production Outsourcing	96.7%	96.9%		
Foods	6.3%	4.3%		
Electrical & Electronics	29.7%	18.1%		
Transport Equipment	31.0%	30.6%		
Pharm. & Chemicals	14.5%	10.3%		
Metal products	1.3%	9.4%		
IT & Telecommunications	0.0%	1.9%		
Others	13.9%	19.3%		

Source: Company materials, compiled by Trias Corporation
Note: ‘Others’ 1H FY12/12 figures reflect an increase in overseas sales.

While Q1 net sales came in-line with the initial budget, Q2 net sales came in slightly below budget, coming in just under ¥0.8bn below initial company estimates. According to the Company, this was in part due to a slower-than-expected pickup in reconstruction demand for building materials and housing fixtures. While there is huge latent demand for reconstruction, delays in finding alternative building sites safe from potential tsunami damage as well as delays in distribution of compensation payments for damage from the nuclear accident resulted in the slower start. However, both operating income and ordinary income came in slightly ahead of initial company estimates with solid cost control by the Company of recruitment expense, so full-term estimates remain unchanged.

The Company began to book overseas sales from last term, and is reporting overseas sales as a separate operating segment from FY12/12. Demand for overseas production outsourcing from Japanese manufacturing transplants in ASEAN emerging countries has risen rapidly in the last few years, and the OS Group has been aggressively investing in establishing its local presence, and is now operating in 9 countries. In the future the company sees large potential upside from additionally tapping demand from local manufacturers, and has already begun to have some success there. 1H overseas sales added ¥2.0bn to the increase in net sales, and accounted for 9.8% of total net sales.

●【Table 3】1H FY12/12 Summary of Operating Segment Results by Quarter

(¥ million)		FY12/11 Q1	FY12/11 Q2	FY12/11 Q3	FY12/11 Q4	FY12/12 Q1	FY12/12 Q2
Production Outsourcing Business	Number of contract workers	6,780	6,893	7,667	8,271	7,879	7,826
	Net sales	7,248	7,127	7,571	8,815	8,834	8,940
	Operating income	51	62	(106)	344	55	188
Administrative Operations Outsourcing Business	Number of outsourced administrative workers	4,409	4,682	4,636	6,273	8,500	5,070
	Net sales	97	104	103	140	189	112
	Operating income	52	51	79	59	62	40
Recruitment Agency Services Outsourcing	Workers hired through ORJ	618	513	1,079	928	512	694
	Net sales	116	102	231	219	115	144
	Operating income	30	29	16	75	18	48
Overseas Outsoursing Business	Net sales	4	6	20	356	998	996
	Operating income	(4)	(10)	(16)	(24)	(36)	(38)
Other Business	Net sales	36	33	33	34	43	35
	Operating income	0	(2)	0	2	2	2
Internal Transfer	Net sales	(121)	(104)	(246)	(196)	(150)	(136)
Eliminations	Operating income	(39)	(13)	(38)	(35)	(50)	(43)
Total	Net sales	7,501	7,372	7,958	9,564	10,179	10,228
	Operating income	90	117	(65)	421	52	197

Source: Company materials

Note: Administrative Operations and Recruitment Agency Services Outsourcing segments net sales figures do not include worker salaries as are included in Production Outsourcing.

2H and Full-Term FY12/12 Consolidated Financial Outlook

Consolidated 2H and full-term company estimates can be seen in Table 4. At first glance 44.3% YOY growth in 2H sales and 301.3% growth in 2H operating income may appear optimistic, especially considering the largest industry sector in production outsourcing, Transport Equipment (autos), is entering a production adjustment in the 2H. However, according to Chairman Doi, barring a Lehman-type credit event where credit contraction causes demand to completely shut down, he is comfortable with the company's 2H forecasts. This is because the Company's sales growth assumptions are largely from new areas of demand, as well as regulatory factors not correlated with underlying production trends.

Regarding the company assumption for 2H operating income margin of 5.6%, note that this is basically in-line with average 2H seasonality over the last 5 years: OPM 2H07 5.0%, 2H08 4.9%, 2H09 2.2%, 2H10 5.9%, 2H11 2.0%. Profitability was depressed in the 2H of last term due to distortions in the labor market causing recruitment cost to rise sharply during a period the Company was investing heavily. Initial company estimates for 2H net income assumed the ¥100mn increased tax charge for group re-organization (decrease in tax credits); since this was pulled forward into the 1H, it will be added back to 2H net income.

●【Table 4】2H and Full-Term FY12/12 Consolidated Financial Forecasts

(¥ million)	FY12/11 2H Act	FY12/12 2H CE*	YOY CHG	FY12/11 Act	FY12/12 CE*	YOY CHG
Net Sales	17,523	25,290	44.3%	32,397	46,470	43.4%
Gross Profit	3,709	-		6,738	-	
SG&A Expenses	3,354	-		6,175	-	
Operating Income	355	1,425	301.3%	563	1,660	194.7%
Ordinary Income	421	1,470	248.5%	702	1,750	149.0%
Net Income	184	810	340.2%	194	875	349.6%
EPS(¥)				13.5	60.6	
DPS(¥)				8.0	8.0	
BPS(¥)				238.4	-	
[Sales Margins/Ratio]						
Net Sales	100.0	100.0		100.0	100.0	
Gross Profit	21.2	-		20.8	-	
SG&A Expenses	19.1	-		19.1	-	
Operating Income	2.0	5.6		1.7	3.6	
Ordinary Income	2.4	5.8		2.2	3.8	
Net Income	1.1	3.2		0.6	1.9	

Source: Company materials, compiled by Trias Corporation
Note: Act = Actual Results, CE = Initial Company Estimates

2H sales forecasts by industry are shown in Table 5. The Company is forecasting 2H FY12/12 net sales to increase by ¥7.8bn compared with the 2H of last term. By industry sector, building materials and housing fixtures in metal products are expected to post a ¥2.6bn increase as reconstruction demand enters full swing. New business in the IT & Telecommunications segment is substantially higher in the 2H as it includes actual placement of system engineers (SE), to increase ¥1.8bn. Net sales of the Overseas Companies Group are estimated to newly contribute an increase of ¥2.6bn, accounting for over 10.2% of total 2H net sales. These 3 segments together account for roughly ¥7.0bn of the estimated increase in 2H sales (roughly 90% of the total).

● 【Table 5】2H FY12/12 Sales Forecast Breakdown by Industry

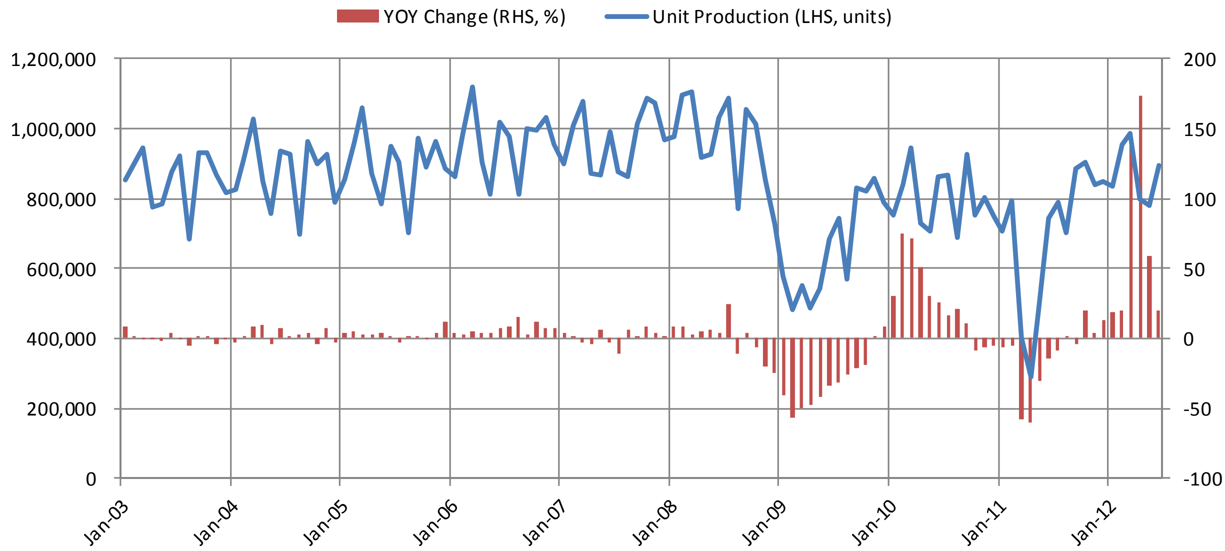
(¥ million)	FY12/11 2H Act.	FY12/12 2H CE*	CHG YoY	YoY
TOTAL NET SALES	17,523	25,290	7,766	44.3%
Production Outsourcing	16,761	25,010	8,248	49.2%
Electrical & Electronics	4,251	4,138	(113)	-2.7%
Transport Equipment	5,987	7,228	1,240	20.7%
Pharm. & Chemicals	2,013	2,266	253	12.6%
Metal products	650	2,599	1,948	299.7%
IT & Telecommunications	0	1,840	1,840	new
Others, including Foods and Overseas Business	3,860	6,939	3,079	79.8%
TOTAL NET SALES	100.0	100.0%		
Production Outsourcing	95.7	98.9%		
Electrical & Electronics	24.3	16.4%		
Transport Equipment	34.2	28.6%		
Pharm. & Chemicals	11.5	9.0%		
Metal products	3.7	12.3%		
IT & Telecommunications	0.0	7.3%		
Others, including Foods and Overseas Business	22.0%	27.4%		

Source: Company materials, compiled by Trias Corporation.

Note: Act = Actual Results, CE* = Initial Company Estimates as of Feb.10, 2011

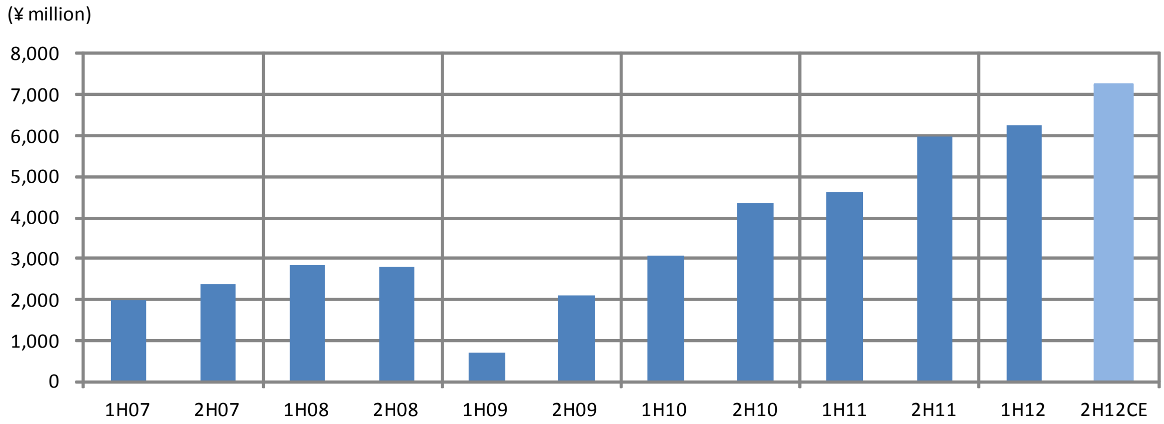
That leaves Transport Equipment (autos), which is entering production adjustment following the expiration of eco-car tax subsidies, and Electricals & Electronics, including Semiconductors, which continues to struggle. According to the Company, it is hearing from major automaker clients that monthly domestic production is expected to bottom in the Oct-Dec Q4 at 600,000 units, down sharply from the recent 800,000+ levels. The trend of Japan vehicle monthly unit production is shown below in Graph 1. The trend of production outsourcing revenue for Transport Equipment (autos) is shown in Graph 2. To be sure, 1H09 sales plunged post-Lehman, however, there was no impact from massive supply chain disruptions in 2011. Production Outsourcing for autos therefore is not necessarily correlated strictly to monthly unit production. Rather, Production Outsourcing for autos is benefitting from a structural shift, with 1H12 sales up more than 3 times 1H07.

【Graph 1】Japan Vehicle Monthly Unit Production



Source: Japan Automobile Manufacturers Association (JAMA)

【Graph 2】OS Group Transport Equipment (Autos) Production Outsourcing Revenue



Source: Company materials, compiled by Trias Corporation
Note: CE = Company estimate as of Feb.10, 2012

However, the Company's forecast for 2H Transport Equipment sales growth of 20.7% YOY is based on demand not correlated with production trends. Specifically, the Company is targeting new orders in response to client manufacturers confronted with large numbers of seasonal workers hired in the uncertain period post-Lehman, running into legal limits prohibiting renewal of temporary contracts for more than 3 years. First and foremost the Company sees its role as a solutions provider. For seasonal workers near term expiration at 2 years and 11 months, the OS Group is strengthening proposals for rotational use of these workers between client firms (third parties), and is targeting 2H sales of 820 workers.

Table 6 below summarizes the Company's strategy for capturing business related to the "Year 2012" issue (the 820 workers are included in these totals), to which Transport Equipment (autos) has the highest exposure. Makers have the option of either converting to outsourced contracting, or shifting to direct employment of seasonal workers. Group subsidiary ORJ is responsible for handling Administrative Operations Outsourcing and Recruitment Agency Services.

While Electrical & Electronics continues to struggle, the Company highlights another area of new demand not correlated with production trends: rising demand for outsourcing as part of re-organization plans. The Company gave the concrete example of Micron Technology's plan to shift workers at Elpida Memory's Hiroshima Plant to a temporary staffing agency, introducing a system to allow workers to continue working at the plant. It remains to be seen whether Company 2H forecasts for Transport Equipment and Electrical & Electronics are too bullish, but at the very least they are based in part on demand not correlated with production.

●【Table 6】Demand not correlated with production trends: 2H New Orders Targets

	FY12/12 Plan	
	Q3	Q4
Outsourced Contracting		
No. of prospects (companies)	20	40
No. of contract workers	1,400	2,250
Temporary Placement		
No. of prospects (companies)	5	12
No. of contract workers	200	320
Recruitment Agency / Administrative Operations Outsourcing		
No. of prospects (companies)	3	6
No. of workers under the service	770	1,340

Source: Company materials

2H FY12/12 operating segment forecasts are shown in Table 7 below. Noteworthy is operating income for the Overseas Companies Group turning into the black as high growth in net sales covers initial startup costs, and the growing contribution of operating income from the Administrative Operations Outsourcing Business, boosted by regulatory factors mentioned earlier. The Company noted new 2H orders for 1,700 additional workers in Thailand and 300 additional workers in Vietnam.

【Table 7】2H FY12/12 Operating Segment Forecasts by Quarter

(¥ million)		FY12/12 Q1 Act*	Q2 Act*	Q3 CE*	Q4 CE*
Production Outsourcing Business	Number of contract workers at term end**	12,892	13,010	16,894	18,845
	■Domestic Companies Group	7,963	7,894	10,171	10,951
	■Overseas Companies Group	4,929	5,116	6,723	7,894
	Net income	9,832	9,936	11,775	13,235
	■Domestic Companies Group	8,834	8,940	10,545	11,880
	■Overseas Companies Group	998	996	1,230	1,355
	Operating income	19	150	407	913
	■Domestic Companies Group	55	188	367	823
	■Overseas Companies Group	(36)	(38)	40	90
Administrative Operations Outsourcing Business	Workers hired through ORJ	512	694	973	1,065
	Net income	304	257	325	345
	Operating income	80	88	101	108
Other Business	Net income	42	35	40	50
	Operating income	2	2	2	4
Internal transfer	Net income	(150)	(136)	(230)	(250)
Eliminations	Operating income	(50)	(43)	(55)	(55)
Total	Net income	10,179	10,228	11,910	13,380
	Operating income	52	197	455	970

Source: Company materials

Note: Administrative Operations Outsourcing net sales figures do not include worker salaries as are included in Production Outsourcing.

*Note: Act = Actual Results, CE = Initial Company Estimates as of Feb.10, 2012

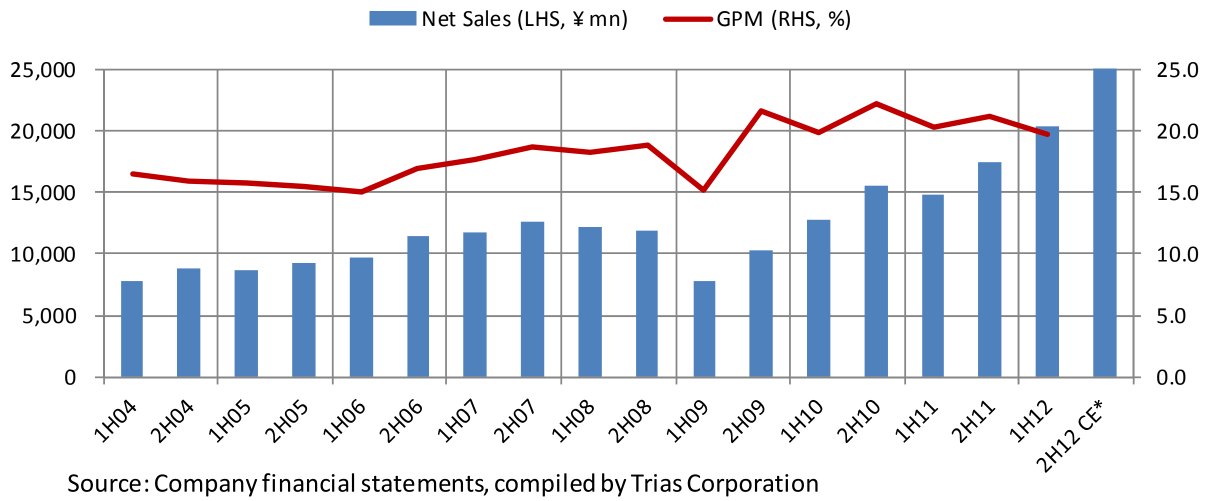
**Note: includes workforce, actual and forecast, of Indonesia-based PT. SELNAJAYA PRIMA, an equity-method

Operating Income Margin Analysis: Impact of Recruitment Expense on SG&A

Since the Company listed on JASDAQ in December 2004, the Company's earnings have achieved rapid expansion despite high volatility in the macroeconomic environment and a surging yen. It may actually be that high macro uncertainty that has spurred brisk structural demand for the Company's services.

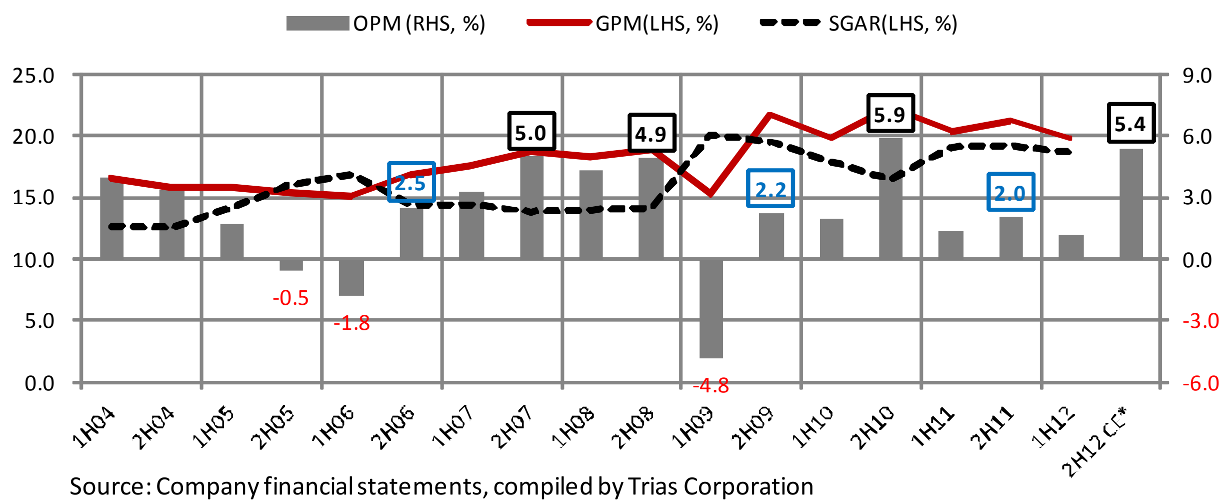
Graph 3 below shows consolidated net sales have grown steadily over the period, with the exception of 1H09 post-Lehman. Net sales in the 1H of FY12/12 reached ¥20.4bn, posting CAGR of 12.9% over the 8-year period from the 1H of FY12/04. Gross profit achieved CAGR of 15.5% over the same period as the GPM rose from 16% to over 20%, likely in part due to a higher level of net sales. Graph 4 below shows that SG&A expenses actually exceeded gross profit on two occasions, causing operating income to drop into the red. Excluding the sudden drop in global demand post-Lehman 1H09, recruitment expense as a percentage of SG&A rose sharply in 2H05 and 2H11.

● 【Graph 3】Trend of Consolidated Net Sales and Gross Profit Margin (GPM)



Source: Company financial statements, compiled by Trias Corporation
Note: CE* = Initial company 2H estimate as of Feb.10, 2012

● 【Graph 4】Trend of SG&A Expenses Ratio (SGAR) and Operating Income Margin (OPM)

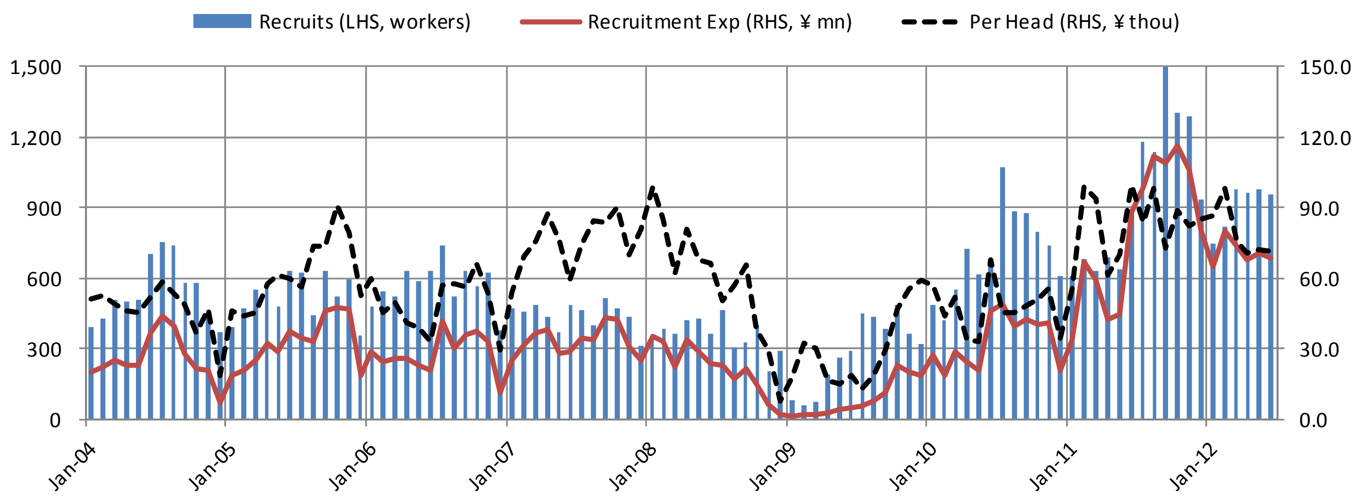


Source: Company financial statements, compiled by Trias Corporation
Note: CE* = Initial company 2H estimate as of Feb.10, 2012

An important observation from Graph 4 is that since 2H06, 2H operating income has always been seasonally higher than 1H. According to the Company, this is largely due to increased use of production outsourcing to handle production for the high demand year-end sales season. More importantly, excluding post-Lehman, 2H operating income margin has averaged 5% in 4 out of 6 terms.

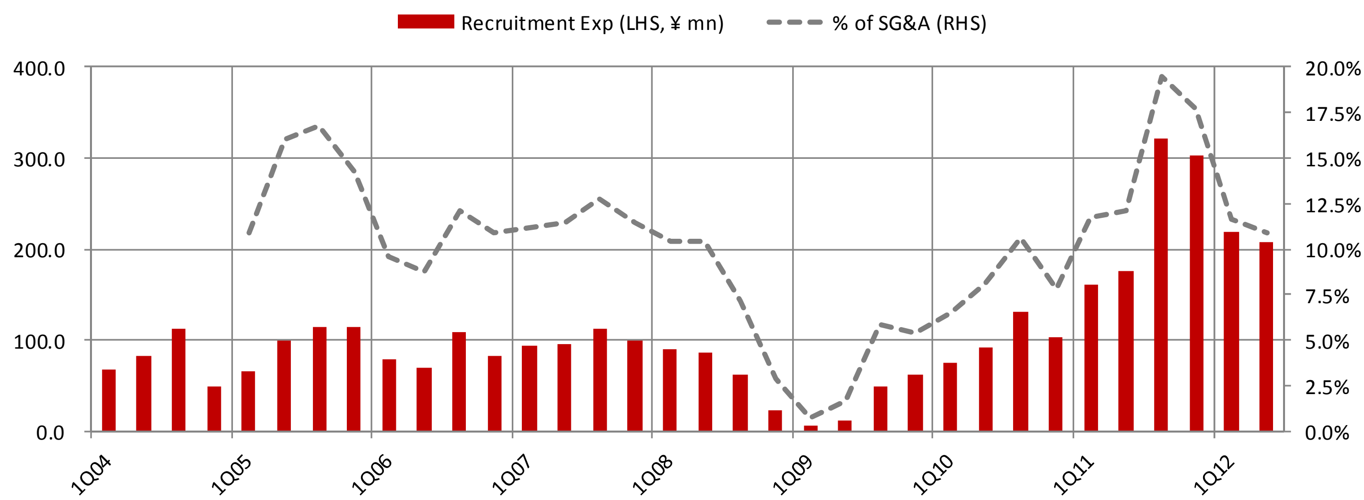
The two exceptions correspond with sharp rises in recruitment expense as a percentage of SG&A expenses mentioned on the previous page. Graph 5 shows the trend of monthly recruiting activity. Tight conditions in the labor market can cause the average cost per recruit to increase sharply. Graph 6 shows this happened in the 2H05, and again in 2H11. Stripping out roughly ¥150mn additional recruitment expense in each of the 3Q and 4Q last term would have yielded a 2H FY12/11 OPM of over 4.0%. The takeaway for the 2H of FY12/12 is that the labor market has clearly calmed down from massive production disruptions last year, and risk of recruitment expense spiking up appears low, according to the Company.

●【Graph 5】Trend of Monthly Recruits, Total Recruitment Expense, and Average Cost per Recruit



Source: Company financial statements compiled by Trias Corporation

●【Graph 6】Trend of Quarterly Recruitment Expense, Ratio of Quarterly SG&A Expenses



Source: Company financial statements compiled by Trias Corporation

Reference

Key Financial Data and Business Results (Consolidated)

No. of Shares Issued	Jun-12	15,569,800
No. of Treasury Stock	Jun-12	1,139,500
Market Value (¥mn)	24-Aug-12	5,247
BPS (¥)	Dec-11	238.4
ROE (%)	Dec-11	10.2
ROA (%)	Dec-11	2.9
PER (times)	FY12/12 fcst	5.6
PCFR (times)	Jun-12	6.8
PBR (times)	Jun-12	1.4
Share Price (¥)	24-Aug-12	337
Unit Share (shares)	24-Aug-12	100
Average Daily Volume (shs)	24-Aug-12	14,736

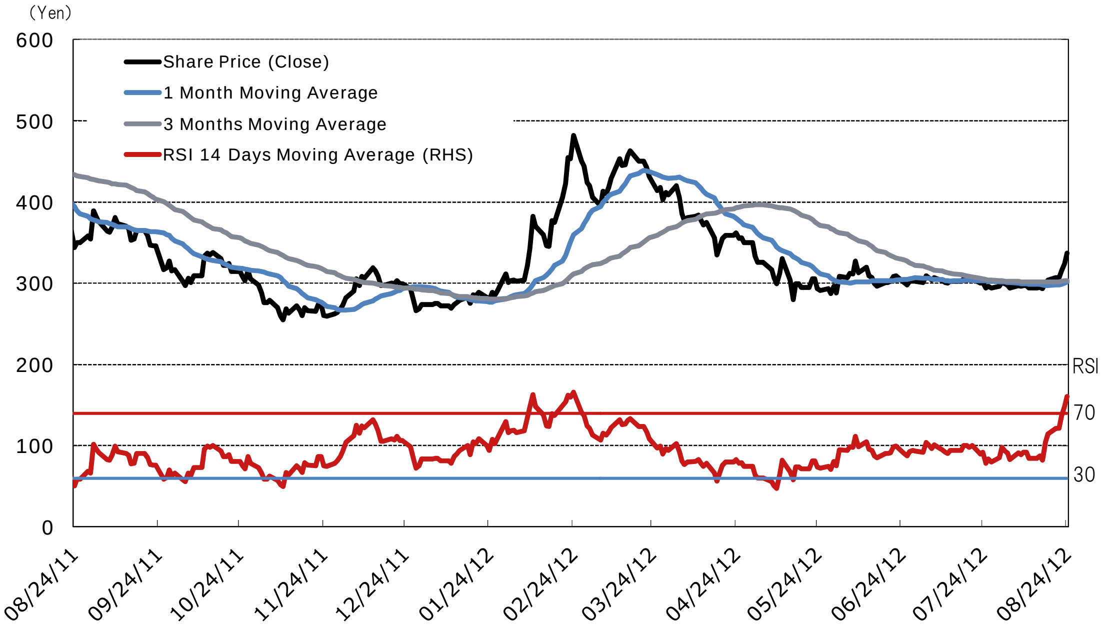
Total Assets (¥mn)	Jun-12	14,962
Shareholders' Equity (¥mn)	Jun-12	3,040
Interest-Bearing Debt (¥mn)	Jun-12	7,215
Equity Ratio (%)	Jun-12	28.9
Ratio of Interest-Bearing Debt (%)	Jun-12	237.3
Free Cash Flows (¥mn)	Jun-12	27

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 (¥)
FY12/08	24,148	1,113	1,134	641	5,412.28	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	32,397	563	702	194	13.48	8.00
1H FY12/12	20,408	249	309	(23)	(1.63)	0.00
FY12/12 fcst	46,470	1,660	1,750	875	60.63	8.00

Note: FY12/12 forecast announced on February 10, 2012

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