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PALTEK CORPORATION

Summary of Q3 FY12/16 Financial Results and Follow-Up Interview

The PALTEK Corporation (hereinafter "PALTEK" or the "Company") announced its Q3 cumulative (January-September) FY12/16 consolidated financial results. The following is a summary of the results, and individual follow-up interview by Trias Corporation.

Summary of Q3 Cumulative FY12/16 Financial Results

PALTEK's consolidated financial results for the Q3 cumulative FY12/16 were hit hard by negative impacts from revaluation losses in its receivables due to the stronger yen. Without the impacts of forex fluctuations, however, its performance would have been in fact improving as its semiconductor profitability had bottomed out after suffering from continued declines.

As [Table 1] shows, the Q3 cumulative consolidated performance proved sharp declines in profits despite a very strong growth in net sales. While net sales jumped by 20.8% YoY, operating income plunged by 99.3% YoY and profit attributable to owners of parent turned to a loss of ¥15 million from a profit of ¥507 million for the same period of the last fiscal year. As for net sales, Semiconductor Business grew sharply thanks to newly acquired commercial rights and increases in memory sales, and Design Service Business also fared well. Meanwhile, profits were hit severely by a negative impact from the stronger yen of about ¥1,200 million YoY.

●[Table 1] Q3 Cumulative (January-September) FY12/16 Consolidated Financial Results

	FY12/15		FY12/16		YoY Changes	
(¥ million, %)	Q3 YTD	Composition Ratio	Q3 YTD	Composition Ratio	Amount	Ratio
Net sales	20,642	100.0%	24,944	100.0%	4,301	20.8%
Gross profit	3,081	14.9%	2,318	9.3%	(763)	-24.8%
SG&A expenses	2,114	10.2%	2,311	9.3%	197	9.3%
Operating income	967	4.7%	6	0.0%	(961)	-99.3%
Ordinary income	819	4.0%	35	0.1%	(783)	-95.6%
Profit attributable to owners of parent	507	2.5%	(15)	-0.1%	(523)	-

Source: Compiled by Trias Corporation from the Company IR materials

By segment, as are shown in [Table 2] on page 2, Semiconductor Business jumped by 20.9% YoY while Design Service Business soared by 23.2%, both registering growth in excess of the 20% mark.

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●[Table 2] Q3 Cumulative (January-September) FY12/16 Net Sales by Segment

(¥ million, %)	FY12/15 Q3 YTD	FY12/15 Composition Ratio	FY12/16 Q3 YTD	FY12/16 Composition Ratio	YoY Changes Amount	YoY Changes Ratio
Semiconductor	19,507	94.5%	23,587	94.6%	4,079	20.9%
Design Service	1,016	4.9%	1,252	5.0%	235	23.2%
Others	119	0.6%	104	0.4%	(14)	-12.3%
Total	20,642	100.0%	24,944	100.0%	4,301	20.8%

Source: Compiled by Trias Corporation from the Company IR materials

In Semiconductor Business, in addition to acquisitions of new clients triggered by the last year's cancellation of FPGA agency contracts of TOKYO ELECTRON DEVICE LIMITED (TSE1: 2760, hereinafter "TED"), memory sales grew sharply. Design Service Business enjoyed strong demand for original design manufacturing (ODM) from aviation/aerospace and medical device industries as well as various contract design works.

The consolidated gross profit margin (GPM) declined sharply by 5.6% points to 9.3% from 14.9% for the same period of the last fiscal year. As shown in [Table 3], forex impacts from overseas procurements of semiconductors turned from positive ¥385 million for a year ago period to negative ¥808 million, causing a significantly adverse YoY net effect of ¥1,198 million. Excluding these, GPM would stand at 12.5% in real term, eroding by only 0.6% from the same period of the last fiscal year.

This decline was partly caused by 0.2% point decline in Semiconductor Business. Profit margins were low in FPGA sales accompanying the acquisition of TED commercial rights, as PALTEK was not involved in the design-in (products adopted through preproduction prototypes) as well as design-win (products adopted through mass production) processes. In addition, the memory business with a new client acquired at the beginning of the fiscal year, which is worth roughly ¥3.5 billion of the net sales in the Q3 cumulative, bears thin GPM of less than 5% as it is a mere commission sales. These 2 factors explain most of the GPM decline. Excluding both forex impacts and the commission sales, normalized GPM could have improved to 12.6% from 11.0% for the same period of the last fiscal year, which would be attributed to Company's efforts to improve profits.

●[Table 3] Impacts to Gross Profit from Forex Rate Changes

(¥ million, %)	FY12/15 Q3 YTD	FY12/15 Margin to Net Sales	FY1216 Q3 YTD	FY1216 Margin to Net Sales	YoY Changes Amount
Gross profit	3,081	14.9%	2,318	9.3%	(763)
(Impacts from forex)	385	1.9%	(808)	-3.2%	(1,193)
Adjusted gross profit	2,697	13.1%	3,126	12.5%	429

Source: Compiled by Trias Corporation from the Company IR materials

SG&A expenses increased by ¥197 million YoY, mostly due to an increase in personnel expenses of ¥138 million. Major factors include additions of development and marketing personnel in accordance

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with the acquisition of FPGA commercial rights, as well as overall annual wage hikes.

Operating income dropped from ¥967 million for the Q3 cumulative FY12/15 to a mere ¥6 million. Again, forex impacts being subtracted from each, they could be ¥582 million and ¥814 million, respectively, implying a sharp real-term growth. This is attributable to better profitability for overall existing semiconductors. Also contributing should be the growth in high-margin Design Service Business. After this adjustment, operating margin would have risen from 2.8% to 3.3% YoY.

Non-operating balance improved by ¥177 million mainly due to a turnaround of forex accounts from a loss of ¥110 million in the same period of the last fiscal year to a profit of ¥105 million, a positive net contribution of more than ¥200 million. As a result, ordinary income outweighed operating income but in fact decreased to ¥35 million from ¥819 million YoY. At the bottom line, a change in the tax rate urged a use of deferred tax assets, resulting in a net loss of ¥15 million.

As can be seen in [Table 4] on page 4 for balance sheet, total assets decreased by ¥1,234 million, or 7.7% from the FY12/15-end. On the accounts receivable-trade and inventories, accounts receivable-trade declined by ¥1,520 million. At the FY12/15-end, the receivables bloated as sales of goods succeeded from TED increased sharply toward the end of the fiscal year and these were subsequently collected this fiscal year. A part of the collected cash led to an increase in the cash and deposit account. The balance of inventories (goods in [Table 4]) decreased by ¥487 million. This should be chiefly caused by sale of TED products also.

Accounts receivable-other contained in other current assets dropped by about ¥200 million. The balance, mainly consisting of receivables associated with discounts of procurement of overseas products, also declined as collection of receivables proceeded.

As for liabilities, notable is a decrease in short-term loans from ¥4,130 at the end of the FY12/15-end to ¥3,320 million at the Q3-end FY12/16, a decline of ¥810 million. Part of this repayment was allowed by increased cash at hand as a result of more collection of receivables. With this as a main cause, the equity ratio rose from 56.6% at the FY12/15-end to 60.2% at the Q3-end FY12/16.

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●[Table 4] Summary of Q3-End FY12/16 Consolidated Balance Sheet

(¥ million, %)	FY12/15 FY-End	FY12/16 Q3-End	YoY Changes Amount	Major Factors
Cash and deposits	1,199	2,305	1,106	Increased due to the decrease in accounts receivable-trade and inventories
Notes and accounts receivable - trade	7,367	5,847	(1,520)	Collection of accounts receivable progressed along with decrease in net sales
Goods	3,918	3,430	(487)	
Other current asstes	2,988	2,691	(296)	
Non-current assets	504	468	(36)	
Total assets	15,977	14,743	(1,234)	
Notes and accounts payable - trade	1,047	1,113	66	
Short-term loands payable	4,130	3,320	(810)	Repayed since collection of accounts receivable progressed
Other current liabilities	1,468	1,158	(309)	
Non-current liabilities	283	270	(13)	
Net assets	9,048	8,881	(167)	
Total assets and liabilities	15,977	14,743	(1,234)	

Source: Compiled by Trias Corporation from the Company IR materials

FY12/16 Consolidated Financial Forecasts

Company's full-year forecasts remained intact. When it announced Q1 and 1H results (May 9 and August 3, respectively), profit forecasts had been revised down. Both cited the stronger yen as the reasons. In contrast, net sales had been revised upward by ¥2.0 billion and ¥1.0 billion at each time, on the back of Company's own prospects for higher memory sales.

As can be seen from [Table 5] on page 5, the Company is guiding for net sales of ¥33,000 million and operating income of ¥330 million for the FY12/16 full-year consolidated financial forecasts. Despite a net sales growth of 14.4% YoY, operating income is forecast to plunge from the last fiscal year's ¥1,361 million, hit significantly by forex losses in accounts receivable due to the stronger yen. Nontheless, the Company dares to reinforce staffs for future growth as has been planned and foresees a ¥339 million increase in SG&A expenses, the amount largely unchanged from its plan at the beginning of the fiscal year.

Forecasts by operating segment are shown in [Table 6] on page 5, where the Comapny is looking for Semiconductor Business to elevate by 14.1% in net sales and for Design Service Business to jump by 32.9%.

Growth in semiconductor sales, forecast to slow down from up 24.5% YoY of the last fiscal to up 14.1% YoY this fiscal year, in fact includes the following special impacts. During the last fiscal year, sales from products succeeded from TED newly contributed and there also were one-time ramp-up purchase of inventories at clients triggered by planned termination of shipments for certain semiconductors. During this fiscal year, on the other hand, aforementioned commission sales of memory should bolster memory sales significantly.

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In addition to the ramp-up sales of ¥600 million during the last fiscal year, the FPGA business succeeded from TED, about ¥4.0 billion in total, amounted to ¥3.0 billion in net sales. For this fiscal year, succeeded clients from TED fully contribute to net sales of ¥4.0 billion while the commission sales of memory business should newly add ¥3.5 billion. Subtracting these from nominal net sales of the Semiconductor Business, adjusted figures would be ¥22.0 billion, ¥23.5 billion and ¥23.5 billion in this order for 3 years from FY12/14, which translates YoY growth rate of 8% of the last fiscal year and 0% this fiscal year.

In the overall Semiconductor Business, in addition to the sharp increase brought by the commission sales of memory business, "Second Pillar" products (from Micron, NXP, Microchip, Linear Technology), which are among Company's focus, are solidly growing also in other segments than memories and analogs. Design Service Business, on the other hand, is expected to achieve a strong growth of 32.9% YoY thanks to robust ODM businesses in the 1H.

●[Table 5] FY12/16 Financial Forecasts

	FY12/15 Actual		FY12/16 Forecasts		YoY Changes	
(¥ million, %)	Full-Year	Composition Ratio	Full-Year	Composition Ratio	Amount	Ratio
Net sales	28,841	100.0%	33,000	100.0%	4,158	14.4%
Gross profit	4,261	14.8%	3,570	10.8%	(691)	-16.2%
SG&A expenses	2,900	10.1%	3,240	9.8%	339	11.7%
Operating income	1,361	4.7%	330	1.0%	(1,031)	-75.8%
Ordinary income	1,144	4.0%	300	0.9%	(844)	-73.8%
Profit attributable to owners of parent	674	2.3%	175	0.5%	(499)	-74.1%

Source: Compiled by Trias Corporation from the Company IR materials

●[Table 6] FY12/16 Net Sales Forecasts by Segment

	FY12/15 Actual		FY12/16 Forecasts		YoY Changes	
(¥ million, %)	Full-Year	Composition Ratio	Full-Year	Composition Ratio	Amount	Ratio
Semiconductor	27,255	94.5%	31,100	94.2%	3,844	14.1%
Design Service	1,354	4.7%	1,800	5.5%	445	32.9%
Others	231	0.8%	100	0.3%	(131)	-56.9%
Total	28,841	100.0%	33,000	100.0%	4,158	14.4%

Source: Compiled by Trias Corporation from the Company IR materials

Gross profit should be decreasing by 16.2% YoY from ¥4,261 million of the last fiscal year to ¥3,570 million, and hence GPM from 14.8% to 10.8%. Forex impacts are estimated at negative ¥785 million this fiscal year, which compares to positive ¥431 million the last fiscal year.

After these forex amounts being subtracted, real-term gross profit would be increasing from ¥3,830 million to ¥4,355 million, or up 13.7% YoY, leading to would-be GPMs of 13.3% and 13.2%, respectively. This implies a sharp increase in the thin-margin commission sales of memory business would offset better profitability expected to be delivered by strengths in other semiconductor businesses and Design Service Business.

SG&A expenses are to increase rapidly by ¥339 million from ¥2,900 million of the last fiscal year to

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¥3,240 million (doesn't add due to rounding). The hiring during the last fiscal year fully weighs on and ongoing reinforcement of development staffs in this fiscal year also causes the hike. The Company, despite sharp declines in profits, is eager for future investments in order to leverage new clients.

As a result, operating income drops from ¥1,361 million of the last fiscal year to ¥330 million this fiscal year. Again, excluding forex impacts, these numbers would be ¥930 million and ¥1,115 million respectively, or up about 20.0% YoY, leading the adjusted operating margin to widen from 3.2% to 3.4%.

Forex-adjusted operating income for the Q4 alone (October-December) is expected to jump to ¥324 million, from ¥6 million and ¥89 million for the Q3 cumulative total and Q3 alone, respectively. There are 2 factors behind the boost. One is that negative forex impacts will be limited as inventories purchased at weaker yen rates had been mostly sold out by September, and the other is that net sales for high-margin Design Service Business in this Q4 alone are to increase sharply to ¥548 million compared to the quarterly average of ¥400 million or slightly more for Q1-3.

Here, note that the assumed average yen rate for September to the rest of this fiscal year is ¥104.82/USD and, this means, if the actual rate is weaker, profits should be better than the forecasts while, if stronger, profits could fall short. When the rate moves by ¥1/USD, gross profit would vary by ¥15 million per month, the Company explains.

As for non-operating balance, net loss should narrow from ¥216 million of the last fiscal year to ¥30 million this fiscal due mainly to a turnaround of the forex account and as a result ordinary income is expected to decrease from ¥1,144 million to ¥300 million.

TOPIC 1: Adjusted Real Profit Margins Turning Up on Improvement of Semiconductor Business

PALTEK profits deteriorated sharply in FY12/16, however, stripping out the negative forex impacts, etc., a different picture can be seen.

[Graph 1] on page 7 shows the quarterly trend of the consolidated gross profit margin (GPM) and operating income margin (reported and adjusted basis). In each case, the thin lines are reported figures, and the bold lines were calculated by stripping out the impacts of forex fluctuations in cost of sales. Reported GPM (thin red line) peaked at 20.2% in the Q4 FY12/14, and has basically declined in a straight line to 9.1% in the 3Q FY12/16, however, forex-adjusted GPM (bold red line) bottomed in the Q1 FY12/16, rising since then, and the Q3 FY12/16 recovered to the level in the Q3 FY12/14.

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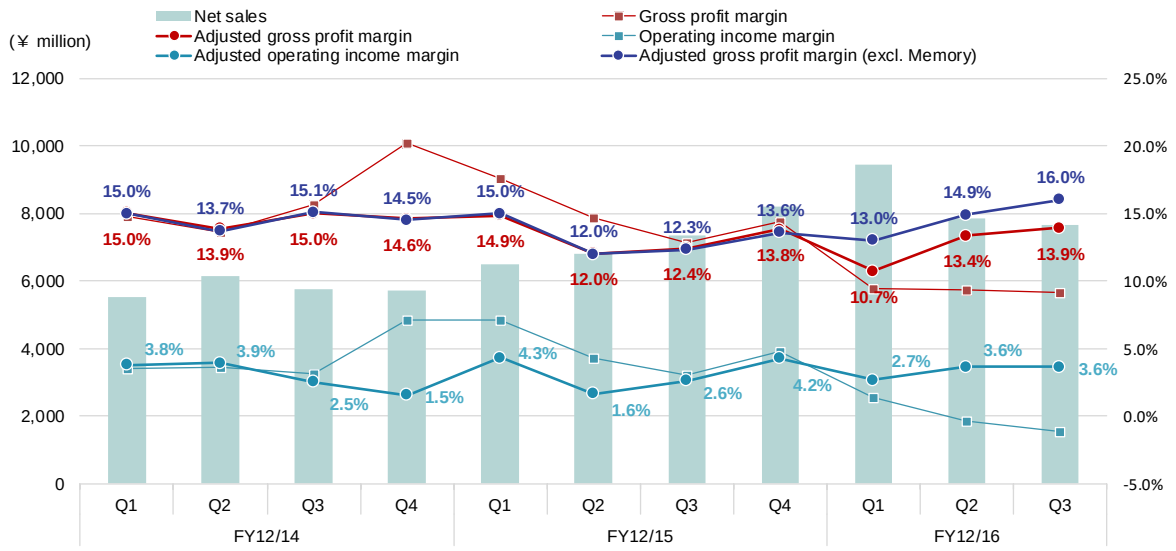
●[Graph 1] Gross Profit/Operating Income Margins after Forex Changes Adjustment



Source: Compiled by Trias Corporation from the Company IR materials

The point to emphasize here is that the recovery in profit margins was achieved within the backdrop of the aforementioned sharp increase in the commission sales of memory. This business was in response to requests from memory vendors, and sold to overseas makers. GPM is less than 5%, only 1/3 the level of other PALTEK products in the mid-teens, however, since selling does not require any special efforts, it is not bad business according to the Company.

Forex-adjusted GPM dropped sharply in the Q1 in this fiscal year to 10.7% due to this memory sales business accounting for as much as nearly 20% of consolidated net sales of ¥9,431 million. In order to strip out this effect, the bold blue line in [Graph 1] shows forex-adjusted GPM with memory sales and gross profit excluded from consolidated figures.

Looking at this, the worst point for adjusted GPM (bold blue line) was the Q2 FY12/15, in a rising trend since then, reaching 16.0% in this Q3 fiscal year, exceeding the level in the FY12/14. This has recovered sharply particularly in the FY12/16: Q1 13.0%, Q2 14.9%, and Q3 16.0%, and this is mainly due to GPM rising for yen-denominated transaction items from the yen's advance, as well as GPM improving for low-margin items. We want to follow this indicator going forward as a measure for checking the profitability of the Company.

As is the case in the Q4 of this fiscal year, the negative impact will shrink if the amount of currency fluctuation decreases. As long as the yen does not appreciate to a large extent going forward, it would not be surprising at all for reported operating income in the next fiscal year to be on par with forex-adjusted operating income of ¥1,115 million for this fiscal year.

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In addition, the fact that orders for new projects from clients taken over from TED have started to be a positive news for profits in particular. PALTEK's own design-in and design-win FPGA sales increasing is expected to boost profit margins, and in conjunction, sales of other semiconductor products can be expected to grow.

TOPIC 2: Launching Encoders Compatible with the Latest 2K and 4K Imaging Technology

Realization of mass production shipments of encoder devices using the PALTEK Group's specialty in the latest H.265/HEVC image compression technology is drawing near. Developed by the Company's subsidiary Explorer Inc. (hereinafter "Explorer"), which boasts a high resolution codec and high level of technical expertise, the Company is commencing order-taking as the Company's own product from January, and commencing shipments from April. Since its performance meets market needs, demand can likely be expected from the fields of broadcasting equipment, surveillance cameras, remote medical care, etc.

An encoder is a device that compresses without degrading the image, and as image quality progresses to higher resolutions from the current High Vision (HV) to 2K (2x that of HV) and 4K (4x that of HV), the challenge is how to efficiently compress images and send them with tiny delay. The answer to this is the two encoder devices being launched by the Company, compatible with 2K and 4K resolutions. These products were displayed at the 2016 International Broadcast Equipment Exhibition (Inter BEE 2016) held from November 16 to18.

One factor for differentiation with competitor products is GearBox Evaluation Board for transfer rate conversion for an SDI interface, supporting conversion of non-compressed 4K video transfer to 12G-SDI (*1) , installed on the products displayed at Inter BEE.

(*1) A video transmission method used in broadcasting equipment such as cameras and switchers. The technology can transmit both high quality digital video and digital audio on a single coaxial cable.

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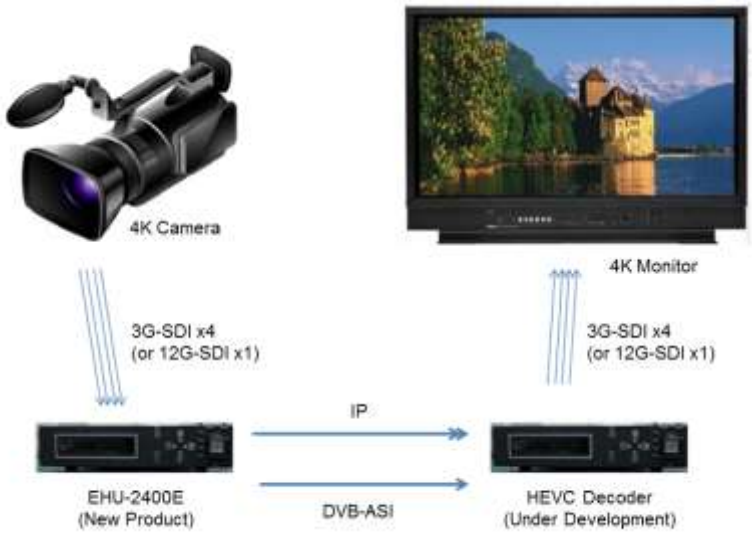
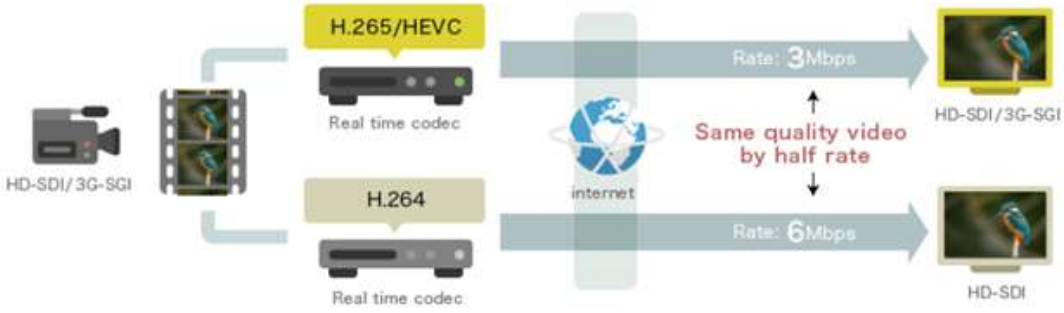
●[Figure 1] H.265/HEVC4K Encoder



●[Figure 2] H.265/HEVC2K（FulHD） Encoder



Source: Both [Figure 1] and [Figure 2] were from the press release on November 7, 2016 by Explorer Inc.

●[Figure 3] GearBox Evaluation Board

Source: Compiled by Trias Corporation from information on product catalog by Explorer Inc.

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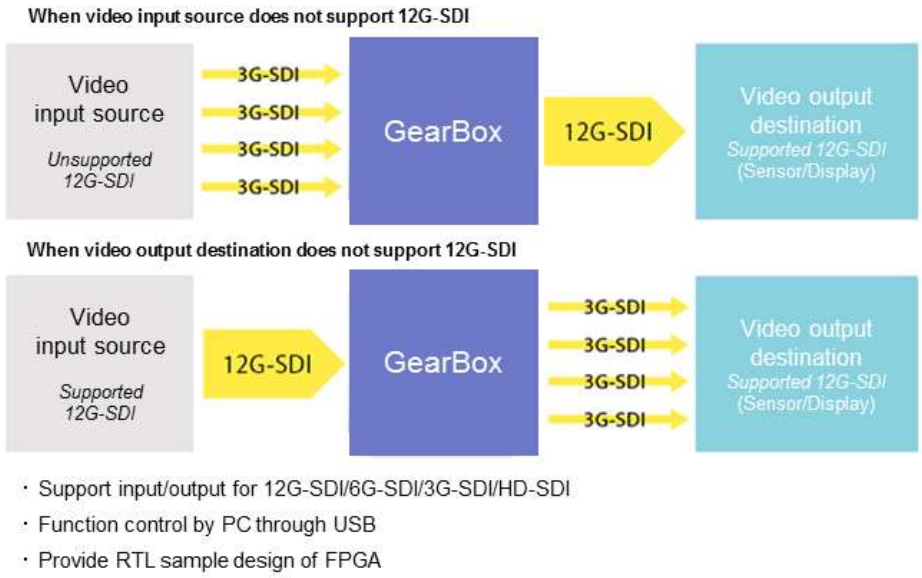
[Figure 4] outlines the conversion functions of GearBox Board, and by converting four 3G-SDI (3Gbps) video images to one 12G-SDI (12Gbps) video image, and vice versa, transmission of 4K and 8K video is achieved.

●[Figure 4] GearBox Board Interface Examples



Source: Compiled by Trias Corporation from information on the Company's website

GearBox Board was jointly developed with MACOM Technology Solutions Holdings, Inc. (hereinafter "MACOM", US), which was a pioneer in offering the industry's first chipset product group compatible with 12G-SDI for achieving a transmission rate of 12Gbps. Until MACOM's 12G-SDI compatibility began, 4K video images were handled using 4 channels of 3G-SDI, which employs non-compressed transmission of full HD video images, which then required four coaxial cables to connect 4K compatible cameras to a switcher, and also required four connectors for each device. The background for this was the technical difficulty in achieving 12G-SDI compatibility.

In order to overcome this situation, MACOM acquired semiconductor solution maker Mindspeed Technologies, Inc. (hereinafter "Mindspeed") in 2013. By inheriting the interface IC business for broadcasting equipment from the former Mindspeed, the company commercialized the industry's first 12G-SDI compatible cable equalizers, cable drivers, etc., and started mass production from September 2014.

GearBox Board is equipped with the latest MACOM chipset for the input/output terminal section, and changing and maintaining settings can be easily handled with a dedicated graphical user interface (GUI) software. Also, flexible conversion was realized by making Xilinx, Inc. FPGA the core conversion

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hardware.

As an “Innovation Commercialization Venture Support Project” sponsored by the Independent Administrative Corporation New Energy and Industrial Technology Development Organization (NEDO), from 2014 Explorer proceeded to develop “Hybrid Delivery Device through ultra-low delay 8K compatible HEVC-ECF,” focusing efforts on developing a codec device. 2K/4K codec devices that were shown at the exhibition this time incorporate 12G-SDI technology equipped in GearBox Board, and seems likely to be able to leverage significant price advantage relative to competitor products.

In Japan, the timing of rolling out 4K service for general terrestrial broadcasting has not been officially decided yet (*2), however, broadcast equipment manufacturers are already including 4K compatible broadcast equipment in their offerings, and demand is first expected to emerge from the broadcasting field. Other promising applications include: mobile telecommunications infrastructure, remote medical care, surveillance cameras, etc.

(*2) “4K TVs” currently sold on the market are actually ‘pseudo 4K,’ which show an HV image on the receiving end (TV), which is processed to make it look high resolution.

In the field of mobile telecommunications, in addition to the rapid increase in interaction with videos due to diffusion of smart phones, demand for high resolution is rising. As a result, for telecom carriers that are struggling with the explosive increase in data traffic, encoders that compress transmission data volume are a promising way to avoid overload of circuits.

In the field of medicine, by leveraging the use of high resolution images for remote medical care which is being promoted by the government, there is potential to exert great influence through color reproduction of the affected part, stereoscopic view, etc. This has the potential to make possible discovery of lesions previously undetectable, accurate diagnoses and surgical instructions in real time, etc.

In other areas, there is likely also demand for 2K/4K encoders for surveillance and observation cameras that require precise images, teleconferences for designers and architects, etc.

According to the Company, it has already received inquiries from a number of firms regarding encoders. Next July the Company plans to begin shipments of decoders which restore compressed image data to its original resolution. While there are similar types of competitor products, the Company explains that its advantage is being able to respond flexibly to needs of individual clients.

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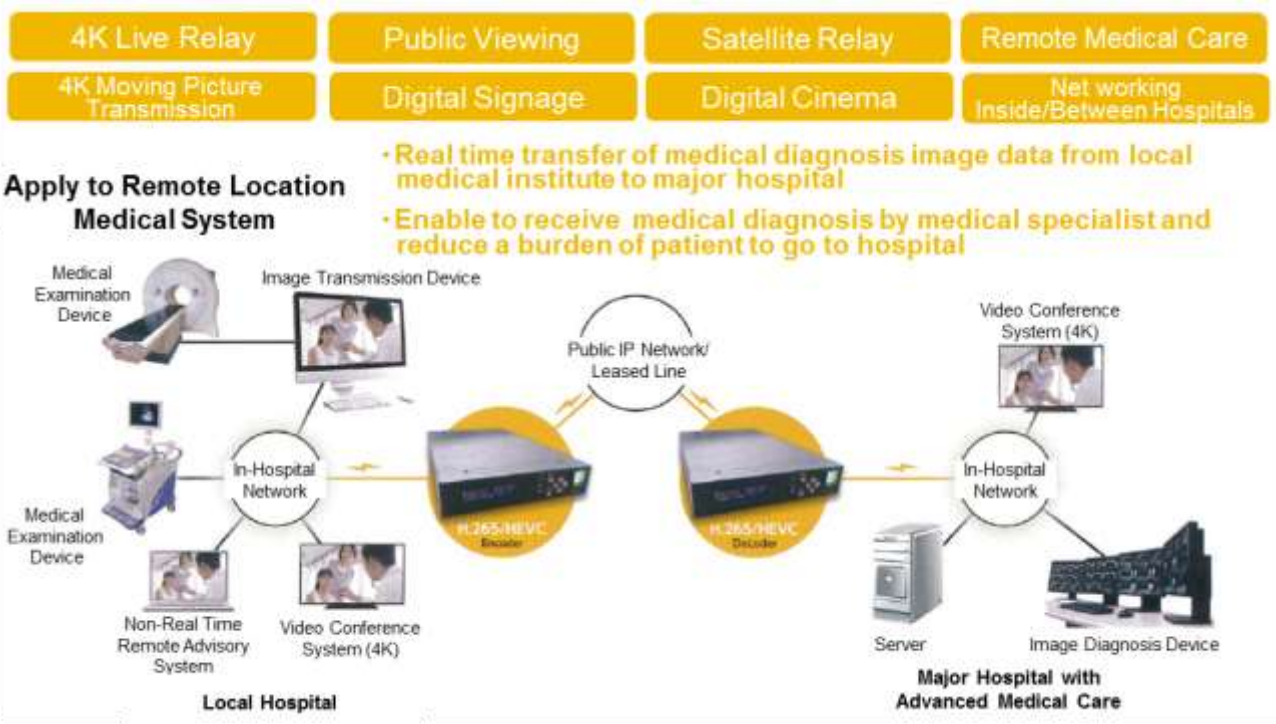
●[Figure 5] HEVC/H.265 Encoder Application Examples



Source: Comiled by Trias Corporation from information on product catalog by Explorer Inc.

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Reference

●Consolidated Financial Results

No. of Shares Issued	Jun-16	11,849,899
No. of Treasury Shares	Jun-16	895,577
Market Value (¥million)	12-Dec-16	7,785
BPS (¥)	Dec-15	825.98
ROE (%)	Dec-15	7.6%
ROA (%)	Dec-15	4.2%
PER (times) FY12/16 fcst.	12-Dec-16	41.1
PCFR (times) 1H FY12/16 actual	12-Dec-16	97.3
PBR (times) FY12/15 actual	12-Dec-16	0.8
Share Price (¥)	12-Dec-16	657
Unit Share (shs)	12-Dec-16	100
Average Daily Volume (shs)	12-Dec-16	29,417

Total Assets (¥million)	Jun-16	15,269
Shareholders' Equity (¥million)	Jun-16	8,934
Interest-Bearing Debt (¥million)	Jun-16	4,040
Equity Ratio (%)	Jun-16	58.5
Ratio of Interest-Bearing Debt (%)	Jun-16	45.2
Free Cash Flows (¥million)	Jun-16	1,289

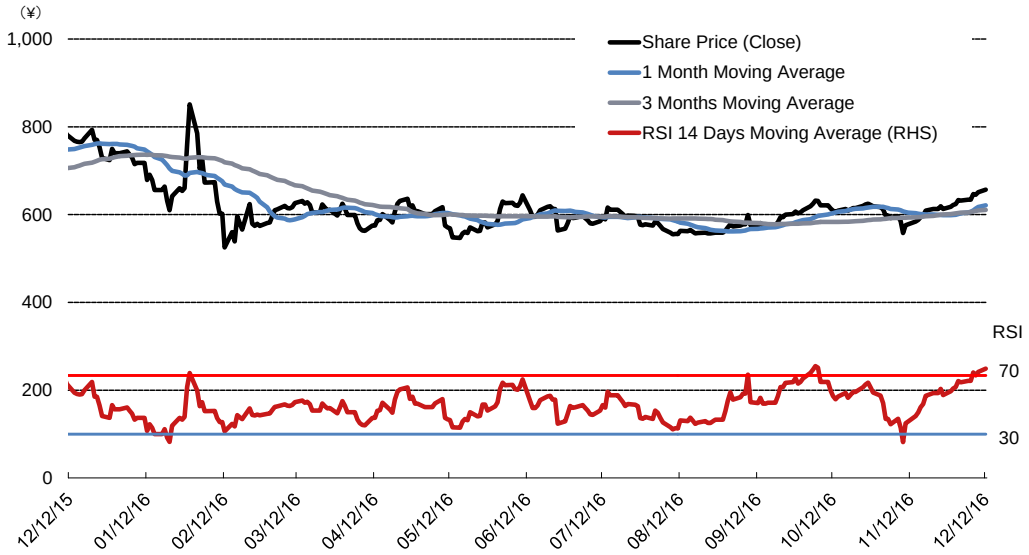
ROE=Current Net Income÷Averaged Shareholders' Equity
ROA=Current Net Income÷Total Assets
PCFR=Maket Value÷(Current Net Income+Depreciation)
Ave. Daily Volume=ADV for the period from 12-Dec-15 to 12-Dec-16
Interest-Bearing Debts Ratio = I.B.D.÷Shareholders' Equity
Free Cash Flows=Operating CF+Investment CF

●Consolidated Key Financial Data

Consolidated (¥million)	Net Sales	Operating Income	Ordinary Income	Net Income	EPS(¥)	DPS(¥)
FY12/12	13,231	(317)	(185)	(106)	(9.33)	5.00
FY12/13	17,611	772	782	443	38.86	8.00
FY12/14	23,155	1,008	1,052	563	49.31	8.00
FY12/15	28,841	1,361	1,144	674	61.16	15.00
1H FY12/16	17,286	96	116	51	4.72	0.00
FY12/16 Forecasts	33,000	330	300	175	15.98	13.00

Note: FY12/16 forecasts announced on August 3, 2016

●Share Price and RSI Charts (December 12, 2015 – December 12, 2016)



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) x 100

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