

EM Systems 4820

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by

gvinvesting

			2015	2016
Price:	1,750.00	EPS	166	190
Shares Out. (in M):	9	P/E	10.5	9.2
Market Cap (in \$M):	126	P/FCF	9.3	8.2
Net Debt (in \$M):	2	EBIT	19	22
TEV (\$):	128	TEV/EBIT	6.2	4.8

Description

EM Systems is a software provider for the Japanese healthcare industry with a market leading cloud-based pharmacy software business. The market cap today is roughly covered by an additional asset on the balance sheet, the Company's fully leased prime office building in Osaka, offering investors an opportunity to own a growing high quality business for less than 1x EBIT. We estimate that upside to conservative fair value today is between 44% and 80%, with additional upside to come from earnings growth going forward.

Pharmacy Software – Receipty Next

EM Systems originated as a joint venture partner with Epson to distribute Epson's medical administration system in 1980. When Epson decided to shift their business focus to printers, EMS developed its own software to manage the administrative process for pharmacies of settlement and claiming proceeds from health insurers for prescriptions and launched the first version of "Receipty" in 1991. The current version of the software, "Receipty Next," in addition to computing complicated medical expenses and preparing invoices necessary for insurance disbursement, also provides patient history data to pharmacies, which would otherwise have to be filled out manually.

Receipty Next is used by 13,000 pharmacies out of a target market of roughly 56,000 (similar to the number of convenience stores in Japan). The number of dispensing pharmacies is still increasing 1-2% annually due to Japanese government regulations mandating the separation of dispensing pharmacies from clinics, the rate of which is now 67%, up from 17% in 1992 and 49% in 2002. 95% of dispensing pharmacies have a receipt system installed, and EM Systems boasts leading market share over Panasonic Healthcare (80% owned by KKR, 10,000 pharmacies) and

Mitsubishi Electronics (7,000 pharmacies), as well as a dozen other smaller players. Some of these competitors are independent businesses, and some are noncore businesses within larger corporations.

Recepty Next's key differentiation from competing services is that it is the only ASP (Application Service Provider) model available in the market. This model differs from the competing package software models in the following ways:

ASP Model	Package Software Model
Pharmacies connected to EMS data center via VPN	Pharmacies are standalone
Updates automatically distributed through central server	Updates manually distributed, less efficient support operations
Centralized prescription data can be shared and analyzed by pharmacies with multiple outlets	Pharmacies cannot share data across multiple outlets
JPY 1.5 million upfront for hardware and software installation, JPY 8,000 monthly base fee plus transactional fee per prescription; JPY 15,000 monthly fee for premium service which includes patient history service; no binding terms for hardware replacement	JPY 3 million upfront for 5-year license, including hardware, software, maintenance and updates; renewal required at end of contract

EM Systems began the migration from package software to ASP using its in-house salesforce in 2008, which resulted in short-term pain on the Income Statement but has now put the Company comfortably ahead of competitors in terms of pricing, functionality, ease of use and operational efficiency. Competitors, none of which have their own salesforce, have been unable to follow suit, as the distributors they sell through are unwilling or unable to budge from the current model, as they are primarily incentivized based on upfront licensing fees generated. Whereas competitors still rely on the lumpy renewal of long-term contracts to stay in business, EM Systems is generating roughly JPY 3 billion of annual recurring and transactional fees at 90% gross margins, which will continue to grow as the client base expands, existing customers are upgraded to the premium service with patient history data, and the total number of prescriptions issued rises along with Japan's growing senior population.

Now that the migration of their existing clients to ASP is complete, the Company is focusing its resources on growing the customer base. The Company is best positioned to lead the consolidation of the industry by winning market share and integrating subscale competitors with its superior ASP offering and in-house salesforce. In October 2014, the Company took its first step toward this goal by acquiring Cosmo Systems, which will add 2,600 package software clients to EM Systems' customer base.

The Company paid JPY 145 million for Cosmo, which generated a JPY 50 million annual operating loss over the past two years. In the last quarter, the Company completed development of transfer software that will allow Cosmo clients to easily migrate to EM Systems software, and as of this quarter the salesforce has started to convert Cosmo clients to the ASP model. The Company expects to fully migrate the customer base to ASP within 5 years; however, as Cosmo had not previously updated their software for 7 years, it's likely that there is pent up demand to upgrade and the migration could be faster than expected. A full migration of Cosmo's customer base to ASP would result in an additional JPY 600 million of annual recurring revenues, and EM Systems should benefit from substantial operating leverage by adding the new clients to their existing system.

It is difficult to break out the profitability of just the core pharmacy software business, as the numbers are consolidated with an investment stage medical records business which has yet to break even. TTM EBIT net of rental operating income is about JPY 1,150m, down from JPY 1,673m in FY2014 due to increased investments in sales and development ahead of corresponding revenue increases from Cosmo Systems and the medical records business, which we will discuss in further detail below. However, we expect Q4 to be stronger now that migration of Cosmo has begun and the Company has thus far maintained their core EBIT targets for FY2015.03, FY2016.03 and FY2017.03 at JPY 1,673m, JPY 1,740m, and JPY 2,040m respectively.

The two listed comparables we have identified, Pharmagest in France and Compugroup Medical in Germany, trade at 11x and 28x EV/EBIT, respectively. A conservative fair valuation of 8x EBIT for the core business would imply a valuation between JPY 9,200m and JPY 13,384m, and given the Company's competitive position and growth prospects, we would lean toward the latter valuation.

Osaka Office Building

The Company houses its headquarters and data center in “Shin-Osaka Brick Building,” a 15-story earthquake-proof building located near the main train station which was developed and is still owned by the Company, through the following course of events:

Paid JPY 3,675m for the land in 2005 using debt

Raised JPY 2,325m at roughly 23x trailing P/E in early 2006 to pay off debt (still using package software model)

Completed building in 2008 after investing a total of JPY 13,000m, taking on roughly JPY 8,000m of bank financing

Paying down debt with cash flow, gross debt down to JPY 4,050m from JPY 7,723m and net debt down to JPY 1,217m from JPY 6,765m in 2009.

EM Systems currently occupies 2 floors for headquarters and a data center for their core business. The remaining floors are 95% occupied. A wholly owned subsidiary, Lasante, was created to manage leasing for the rest of the building as well as three businesses owned by EM Systems which were created to operate in the building: a childcare center, a sports gym and a meeting room rental business. The businesses are profitable and pay market rent, but the Company does not have any plans to expand these businesses beyond their own building.

In FY 2014.03, the building generated JPY 1,051m of rental revenue and roughly JPY 800m of EBITDA less maintenance capex. The floors not occupied by the main business are held at cost less depreciation on the balance sheet, currently JPY 8,358m. However, this implies a 9.6% cap rate, much too high in the context of the current Osaka property market environment.

The current average implied cap rate of JREITs, meaning the price that stock market investors are paying in relation to net debt and net operating income, is less than 4%, while the spread between this implied cap rate and the average cap rate that the JREITs are paying for real estate assets is about 1%. Both the implied cap rate and spread are lower than average for commercial properties.

Source: http://www.smtri.jp/en/JREIT_Market/index.html

Of course, JREITs are heavily weighted toward Tokyo property, so Osaka cap rates are likely higher. The closest data point we have specifically for prime Osaka office buildings is a recorded average 5.4% cap rate in Osaka's Midosuji district as of October 2014. Note that even Nagoya and Fukuoka prime office cap rates have also fallen below 6%:

Source: <http://www.midreit.jp/english/ir/statistics-market.html>

Given Shin-Osaka Brick Building's good location and pristine condition, we think a market cap rate of 5.5% to 6% is appropriate, implying a market valuation for the property between JPY 12,816m and JPY 13,981m (not including two self-occupied floors).

Medical Records - MRN

In 2009, EM Systems launched a medical administrative system for small clinics called "MRN" (Medical Recepty Next). MRN combines two core functions, a receipt system and an electronic medical record system. Similar to Recepty Next, MRN uses an ASP model with a lower initial fee and recurring billing revenues.

As patient data is centrally stored in EM System's data center, clinics using MRN are able to access receipt information from pharmacies using Recepty Next, and pharmacies using Recepty Next have access to medical information recorded by clinics using MRN.

Unlike the pharmacy receipt software market, which is roughly 95% penetrated, small medical clinics in Japan are still largely paper-based, with only 27% penetration of electronic medical record software. However, this is changing quickly, as 70-80% of new clinics are implementing an electronic medical records system, and newly opened clinics in urban areas utilize electronic patient records at a rate of more than 90%. The total market size of electronic patient records is forecasted to grow from JPY 13.5 billion in 2013 to JPY 23.8 billion in 2018, in part driven by a central government initiative to improve connectivity and to share medical information between hospitals, universities, and clinics in order to gradually shift some of the burden away from heavily

trafficked hospitals to smaller clinics.

Source: <https://www.seedplanning.co.jp/press/2014/2014082001.html>

In September 2013, the Company acquired Unicon, another electronic medical record software provider, for JPY 22 million plus the assumption of Unicon's JPY 500 million of debt. At the time of acquisition, Unicon was generating JPY 1 billion of revenue and JPY 50 million of EBIT. The Company is working toward total integration of management and sales efforts of this subsidiary with MRN.

As of March 2014, MRN had 460 contracted clinics. The market is still very fragmented, and EM Systems is one of the smallest players:

Panasonic Healthcare (Medicom HR III) – 24%

- BML (Qualis, Medical Station Clinic) -10% ☒
- Fujitsu (Hope EGMAIN RX) – 9% ☒
- Dynamics (Dynamics) – 8% ☒
- Hitachi Medical Computer (Hi-SEED, Hi-SEED AS) - 8% ☒
- Yuyama (Brain Box V III) – 7% ☒
- Toshiba Medical Systems (TOSMEC Aventy) - 6% ☒
- Labotech (Super Clinic) – 3% ☒
- Shimazu (SimCLINIC T3) – 3% ☒
- CMS (Doctor's Desktop) - 3% ☒
- EM Systems (Medical Recepty MRN) – 3% ☒
- Others – 13%

Source: <http://clinic.m3.com/showSpecialSlot.htm?slotId=5767&moduleId=backnumber&linkId=title>

However, EM System's MRN is currently the market leading ASP offering. Cloud-based electronic medical records systems are currently only a sliver of the total market, but they are expected to contribute the bulk of the market's growth going forward due to relatively low implementation

costs. The cloud-based market for medical clinics is expected to reach JPY 32 billion by 2024. If EM Systems can continue to maintain its lead in the cloud-based market, MRN could potentially become equally as large as their pharmacy receipt business.

Source: <https://www.seedplanning.co.jp/press/2014/2014121001.html>

EM Systems charges an initial fee of JPY 1 million per computer for MRN, which includes a set of hardware with a 5-year warranty. The monthly subscription fee is JPY 25,000 per clinic, plus an additional JPY 5,000 for each additional computer. Similar to the pharmacy receipt business, the salesforce is incentivized based on initial revenues generated, and once the Company reaches scale it will benefit from significant operating leverage from incremental recurring monthly fees as the customer base grows.

In order to step up its sales efforts last year, the Company hired 30 additional salespeople, which contributed to pressure on overall operating margins in 2014. However, the Company is now moving away from direct sales to doctors and recently signed distribution agreements with several drug distributors, which should improve sales and profitability in 2015. As part of the sales strategy, the Company is emphasizing the merits of shared receipt and medical record data when approaching clinics that issue prescriptions handled by Recepty Next's dispensing pharmacy users.

We have not assigned any value to the electronic medical records business, but we think that it has the potential to serve as a core pillar of the Company's overall EBIT growth going forward.

Medical Information Network

EM System's entry into the electronic medical records market is a logical step in the Company's broader long-term strategy of building a centralized database of patient information that can be shared across various medical institutions, including dispensing pharmacies, clinics, hospitals and at-home care facilities. The scheme is supported by the Japanese government, which is looking to counter increasing national medical care expenditures as the population ages. There are two main components of EM System's medical information network scheme, PHR (Personal Health Record) and EHR (Electronic Health Record).

PHR is a service that enables patients to collect and manage their own health information, such as dispensing information, health diagnosis results, and regular inputs such as blood pressure, heart rate, and diet. Patients are able to provide history of their own health information to a medical practitioner to receive the most appropriate medical service.

EHR is a system for hospitals and clinics to make medical information available to be shared with other institutions. The system aims to make medical treatment more accurate and efficient by mutually sharing dispensed medication information and other medical information. Combined with PHR, the goal is to streamline the process for a patient to see a medical practitioner and receive optimal treatment.

Given its unique position as the leading receipt software provider and sole cloud-based model, EM Systems has a significant lead over other competitors in collecting and consolidating patient information, and it is perhaps the only player with the ability to share this information across different institutions. At the moment, a major change in the competitive environment seems unlikely, as package software players either lack the focus or ability to migrate to a cloud-based model. In the long run, EM Systems could become the de facto medical information platform in Japan and the natural consolidator in not only the pharmacy and clinic administration software markets but hospital and nursing care provider markets as well.

Management Alignment

The CEO/Founder owns 37% of the total shares outstanding. There are several other large institutional investors, such as First Eagle at 5%, and we understand that management maintains a healthy dialogue with long-term shareholders. Beyond this, we have several more key pieces of evidence that lead us to conclude that management is focused on creating long-term shareholder value.

The Company issued equity in 2006 at fairly high valuation, which ensured that the balance sheet could support the construction of the new data center and headquarters building in conjunction with the migration to ASP. The Company repurchased shares in 2010 and 2011 at more than a 50% discount to the previous equity issuance, which it has used to fund an employee share

ownership program. These two transactions suggest that management understands the value of their shares and knows how to use the market to create shareholder value, an important distinction to make when investing in Japan.

The Company is focusing on acquiring complementary businesses that benefit from scale in its core dispensing pharmacy software business and strengthen its medical information network ecosystem; it also has divested non-core assets to strengthen that focus. In July 2010, the Company divested a non-core dispensing pharmacy business, “Shokan-do,” with JPY 3.5 billion annual revenue; it sold 90% of the business to Mitsui Co. and recognized a JPY 1.1 billion special profit.

Unlike many companies in Japan that allow cash levels to rise well beyond their organizational needs, EM Systems has actually maintained a manageable level of net debt for most of its history as a listed company in order to make a relatively low risk property investment that filled an important strategic need and generated an attractive return. Now that the Company is generating steady cash flow from recurring billing revenue and net debt as of December 2014 was only JPY 1.2 billion (with an additional JPY 1,088m of cash coming in due to recent Medipal transaction discussed below), it stands to reason that the Company will either step up its M&A efforts, return more capital to shareholders, or both. The Company tripled its dividend per share from 2010 to 2014, but there is still room for the payout ratio to grow from only 16% of net income in FY2014.03.

Medipal Investment

On February 20th, EM Systems announced that it would issue 659,000 new shares to Medipal, one of the four largest pharmaceutical distributors in Japan, at 1,652 yen per share. Although disclosure is limited, our initial investigation points to this being an offensive move that will open new avenues for growth in recurring cash flow.

Two years ago, Medipal created an all-in-one operations management software service for pharmacies called PRESUS, which includes inventory management linked to Medipal’s robust drug distribution infrastructure, a POS system, administrative functions, and most importantly for our purposes, medical fee receipt and electronic medical records history coordination systems.

Source: http://www.medipal.co.jp/english/ir/pdf/e20140520_c.pdf

Medipal, which prior to this deal owned a 2.8% stake in the Company, will integrate EM Systems' Recepty Next and MRN systems into PRESUS, and EM Systems will leverage its existing client base and sales force to sell PRESUS. Medipal will also leverage its distribution relationships, which extend to nearly every pharmacy in Japan, to sell the system. While the details are not yet clear, the Company expects that sales of Recepty Next services bundled with PRESUS will have better economics than they do standalone.

PRESUS is currently only implemented in two small pharmacy chains, but Medipal is targeting an installed base of 10,000 clients in 10 years. As we understand the situation, although the CEO knows that the Company's shares are undervalued, Medipal wanted equity to participate in the expected upside of the tie-up, and the long-term value to be created from the deal is expected to outweigh the 8% dilution.

Current Business Valuation (JPY millions)

	Low	High
Core Business (8x EBIT)	9,200	13,384
Investment Property	12,816	13,981
Net Debt	(129)	(129)
Total	21,887	27,236
Current Market Cap	15,150	15,150
Upside from Current Price	44%	80%

Based on the current level of business today, upside to fair value is 50-88%. If the Company can meet its core EBIT target of JPY 2,040m for FY2017.03, upside to fair value at 8x EV/EBIT in two years is about 120%.

If management can successfully execute on their growth plans by integrating sub-scale acquisitions to expand market share in the pharmacy receipt software market and by promoting the cross-institutional information sharing capabilities of its ASP model to grab market share in the underpenetrated electronic medical records software market for small clinics, our measure of fair value could prove to be too conservative. As the market recognizes the dominance of the Company's competitive position in pharmacy receipt software and the competitive advantage the Company is building in the electronic medical records market through centralized data collection and sharing, its estimation of fair value may start to include the likelihood of significant earnings growth thanks to various structural tailwinds and operating leverage.

A decision to divest the non-core investment property would result in an instant revaluation of the stock, although due to the corporate tax cut measures recently announced by Abe's administration, we would not expect such a transaction to occur until the tax rate has been fully lowered two years from now. We think that given the Company's past history of divesting a non-core business and the opportunity in front of them to add value through acquisitions, it is realistic to assume that the Company would consider a sale into a resurgent property market as a strategic option.

I do not hold a position with the issuer such as employment, directorship, or consultancy.
I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

- Strengthening of market-leading core pharmacy ASP business through tie-ups and sub-scale acquisitions
- Growing market recognition of business quality and growing recurring cash flows, operating leverage
- Realization of noncore real estate asset value
- Increased capital returns to shareholders

Messages

Subject English financials?
Entry 03/01/2015 06:19 PM
Member chris815

Thank you for posting this interesting idea. I wasn't able to find English financial statemetns for EM Systems - do you know if they post financial statemetns in English?

Subject Re: English financials?
Entry 03/01/2015 08:58 PM
Member gvinvesting

No English financials yet, but here is their latest investor presentation in English:

<https://www.dropbox.com/s/rehhokah0pyvxtu/EM%20Systems%20Presentation%20Dec%202014.pdf?dl=0>

Subject Positive Profit Warning
Entry 10/13/2015 11:52 PM
Member gvinvesting

<http://www.emsystems.co.jp/image/info/ir/irnews/2015/20150924.pdf>

The company raised their operating profit forecast for the quarter ending September 30, 2015 by 24.5%. They are now expecting yoy net income growth for the quarter of 89%. They will likely need to raise their forecast for the full year after announcing results for this quarter.

Subject New Mid-Term Plan
Entry 05/08/2018 10:20 PM
Member peter140

What do you make of management's new mid-term plan? Thanks in advance for any thoughts.