



Mr. Masato Isobe
2-1-4 Awaza Nishi-ku,
Osaka, 550-8550
Japan

13th November, 2017,

For the attention of: The Board of Directors of Sumitomo Densetsu Co., Ltd.

Dear Mr. Masato Isobe,

We are writing to you as long-term shareholders of Sumitomo Densetsu regarding the Company's corporate governance and shareholder return policies. Our goal is simply to maximize value for all long-term shareholders, and it is our sincere hope that management is able to use the contents of this letter to shape company policy toward that end.

Consistent Profitability and Improving Margins

Sumitomo Densetsu has been well managed, as evidenced by the Company's long-term track record of consistent profitability. In particular, there have been improvements in both gross margin and EBIT margin since FY2011. This has resulted in a 100% increase in EBIT, despite a revenue increase of 25% over that period.

JPY M	2011	2012	2013	2014	2015	2016	2017
REVENUE	109,360	132,105	153,333	161,364	144,322	146,899	137,227
GROSS PROFIT	11,122	13,808	17,192	17,929	16,002	17,183	16,535
GROSS MARGIN	10.2%	10.5%	11.2%	11.1%	11.1%	11.7%	12.0%
EBIT	4,102	6,771	9,301	10,082	8,047	8,716	8,250
EBIT MARGIN	3.8%	5.1%	6.1%	6.2%	5.6%	5.9%	6.0%



T. +852 3758 2608 info@ascendercapital.com www.ascendercapital.com
Suite 3001, W50, 50 Wong Chuk Hang Road, Hong Kong

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Room for Improvement in Corporate Governance

The Company's record high profitability in recent years has strengthened the balance sheet significantly, with a net cash position increasing from JPY5.6 billion in 2011 to JPY12.8 billion as of 30th September, 2017.

We also note that the Company has deposited JPY18.9 billion of cash in its parent company, Sumitomo Electric Industries, accounted as notes receivables on the balance sheet. As such, the actual net cash position should be JPY31.7 billion. We have to say that depositing your cash in your parent company does not follow good corporate governance practice.

Room for Improvement in Capital Allocation

In addition to cash, the Company also owns investment securities worth JPY17 billion. Altogether, this amounts to JPY48.7 billion, which is 43% of total assets and 76% of total equity as of 30th September, 2017. In theory, without all these non-core assets, the underlying ROE would be 42.8%, significantly above the current level of 8.9%. As Sumitomo Denetsu operates an asset-light engineering business, your core ROE should be closer to 42% than 9%.

JPY M	CURRENT	WITHOUT NON-CORE ASSETS
NET INCOME	5,500	5,500
NON-CORE ASSETS	48,700	0
EQUITY	61,536	12,836
ROE	8.9%	42.8%

In FY2017, the Company generated JPY5.5 billion of net income which will cause the Company's excess cash reserves to increase in the coming years well beyond the needs of the current business operations.

The company's cash balances are earning very low rates of interest, and as the company's cash balances grow larger, shareholders will further suffer from declining returns on equity:

JPY M	2018E	2019E	2020E	2021E
NET INCOME	5,500	5,500	5,500	5,500
NET CASH	35,825	39,950	44,075	48,200
EQUITY	60,918	65,043	69,168	73,293
ROE	9.0%	8.5%	8.0%	7.5%

There are two main ways for Sumitomo Denetsu to improve returns on shareholders' equity going forward: 1) Pay a special dividend and 2) Increase regular dividends.



Special Dividend

Since the Company is in the asset-light engineering business, there is no practical need to hold as much cash as it currently does. The fact that the Company deposited JPY18 billion in Sumitomo Electric Industries highlights both the low returns available in the capital markets and the minimal investment opportunities for the Company. As a result, we believe it is a better capital allocation policy to return at least the portion of cash deposited in the parent company to shareholders. Return on equity would improve instantly should the JPY18 billion be returned to shareholders. At the same time, the balance sheet of Sumitomo Denetsu would remain strong.

JPY M	BEFORE SPECIAL DIVIDEND	AFTER SPECIAL DIVIDEND	CHANGE
EQUITY	61,536	43,536	-29.0%
NET INCOME	5,500	5,500	
ROE	9.0%	12.6%	+40.0%

Dividend Policy

An additional option available to the Company to address their growing excess cash reserves is to raise the dividend payout ratio. Prior to FY2017, the Company had maintained a dividend payout ratio below 20%.

	2011	2012	2013	2014	2015	2016	2017
EPS	56.5	94.9	133.8	144.7	125.3	142.9	155.2
DPS	11	10	13	21	27	30	44
PAYOUT %	19.5%	10.5%	9.7%	14.5%	21.5%	21.0%	28.4%

We applaud management's decision to increase payout ratio to above 28%. However, we believe more can be done. As an asset-light engineering business with a net cash balance sheet, the Company could afford to pay out the entirety of its net income to shareholders. Should the Company pay out 100% of earnings, the dividend yield to shareholders would increase to above 6%. This ought to make shares of Sumitomo Denetsu a very attractive investment in the current low yield environment in Japan.



Conclusion

In conclusion, we firmly believe that all shareholders of Sumitomo Densetsu would greatly benefit from an improved capital allocation policy, namely a special dividend and a higher dividend payout ratio. Our recommendations would also improve corporate governance markedly. Importantly, due to the Company's strong market position and stable cash flows, Sumitomo Densetsu will remain safe with a net cash balance of more than JPY12 billion. Increased capital returns will boost shareholder return on equity and dividend income, and we expect that more efficient capital allocation will be rewarded by the market with higher valuations.

Kind Regards,

Edouard Mercier
edouard@ascendercapital.com and

Andrin Bachmann
andrin@ascendercapital.com