

# Alpha-Win Company Research Report

## CUBE SYSTEM INC. (2335 TSE First Section)

Issued: 11/6/2020

Alpha-Win Capital Inc. Research Department

<http://www.awincap.com/>

### ● Summary

#### ◆ Independent, mid-tier system integrator with long-term, stable growth

- CUBE SYSTEM INC. (hereinafter, the “Company”) is an independent, mid-tier system integrator listed on the First Section of the TSE. Its main customers include Nomura Research Institute (“NRI”) and Fujitsu Group. It develops systems and provides services mainly for the finance, distribution, and telecommunications industries. Its strengths are its excellent customer base, extensive experience, strong trust from its customers, and the skill and expertise that it has built up over the years. Founded in 1972, it has about 48 years of history.
- With the exception of one fiscal year, the Company has been continuously increasing sales YoY for the past 22 years. During this period, the annual sales growth rate (simple average of the rate of increase in sales) was +7.0% and its annual recurring profit growth rate (simple average) was +8.3%; it has been steadily expanding its business and keeping its business in the black over many years. The recurring margin has stably been at around 7% and the increase in sales has been contributing directly to increases in profit, dividend, and market capitalization. Starting this fiscal year, the Company will further focus on the digital business under the new president.

#### ◆ Consolidated financial results for the first half of FY 2021: sales slightly grew by 0.2% YoY and operating profit grew significantly by 41.0% YoY. Record-high H1 profit achieved thanks to improved gross margin and reduced SG&A expenses.

- Consolidated financial results for the first half of FY 2021 (April to September 2020; hereinafter, “H1”; note that the Company’s fiscal year is March-ending, so FY 2021 ends in March 2021) were as follows: sales of Y7,083 million (+0.2% YoY), operating profit of Y552 million (+41.0% YoY), recurring profit of Y603 million (+51.7% YoY), and net profit attributable to owners of the parent (hereinafter, “net profit”) of Y400 million (+65.5% YoY) (Figures 1-4). As in the first quarter (April to June 2020; hereinafter, “Q1”), sales were about the same on a YoY comparison. However, unlike the previous H1, there were no unprofitable projects during this H1, and the Company was also able to hold down costs and improve operational efficiency during the COVID-19 crisis. As a result, a significant profit growth was achieved. In fact, H1 record highs were achieved for all three profit items – operating, recurring, and net. The gross margin rose from 17.1% in the previous H1 to 18.7% in this H1 (as a general rule, numbers have been rounded to the first decimal place; the same applies to below), and the SG&A expenses ratio fell from 11.5% to 10.9%, resulting in a rise in operating margin by approx. 2.3 percentage points from 5.5% to 7.8% (Figures 1 and 4). Compared to the Company's plan (not disclosed), sales seem to have been smaller than expected, while the profits had probably exceeded the plan. Although the COVID-19 crisis had caused sales activity to become stagnant and affected the amount of orders received as well as sales, the impact was limited and in fact nearly negligible as far as profit is concerned.

- Overall, sales for the first half increased slightly by Y12 million YoY and gross profit increased significantly by Y118 million YoY (+9.8%) thanks to the improvement in the profit margin. First-half results by service category (three categories) are described below.

- Sales of its core business, or the System Integration Service (SIS), increased by Y45 million (+0.9% YoY). The increase in system development projects for delivery service companies in the transportation industry and for education business companies had compensated for the completion of system development projects for construction machinery manufacturers in the manufacturing industry as well as the decrease in co-op-related projects for the distribution industry. No unprofitable projects were included in this H1’s results. Mostly owing to the improvement in gross margin (16.7% last H1 ⇒ 18.4% this H1), gross profit increased by Y94 million (+11.4% YoY) to Y918 million.

- Due to the decrease in projects outsourced from the distribution industry, sales of the System Outsourcing Service (SOS) decreased by Y119 million (-9.9% YoY) to Y1,091 million. Its gross margin also declined, causing its gross profit to decrease by Y43 million (-19.1% YoY) to Y182 million.

- Thanks to the increase in system development projects for group banks of major distribution companies, as well

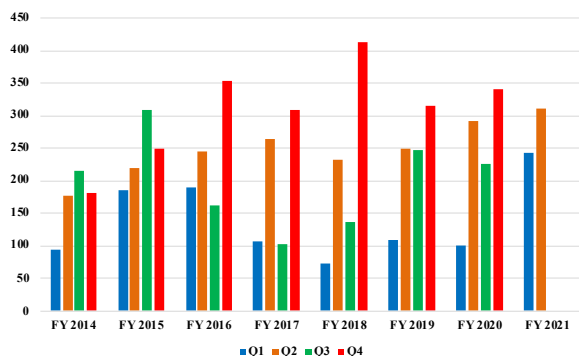
as the steady progress of the consulting projects, sales of the Professional Service (ProS) increased by Y86 million (+9.4% YoY) to Y1,002 million and its gross profit increased by Y67 million (+42.6% YoY) to Y225 million.

- Sales by industry (four sectors) were mostly as already described above. Sales and profit growth of the business with the telecommunications and transportation industries contributed significantly to the overall results (+348 million yen in sales and +148 million yen in profit, YoY; Figure 1), compensating for the sales and profit decline of the business with the finance industry (system development projects were scaled down) and the distribution industry (the completion of projects related to the consumption tax revision had a large impact).
- By major customer group, a significant sales growth was only seen for NRI (sales of Y3,457 million; +412 million yen or +13.5% YoY), for which there was an increase in new system development projects. Sales of NRI accounted for 48.8% of the total sales in H1.

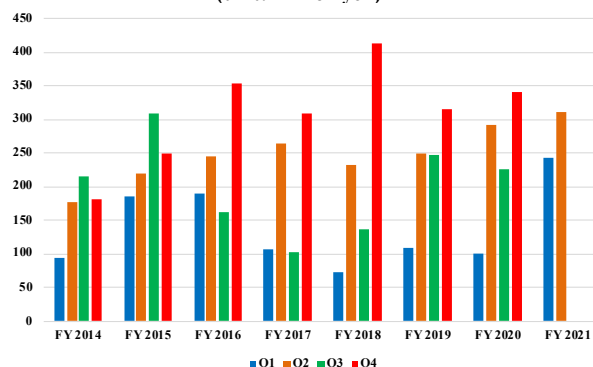
[Figure 1] Change in Financial Results in Q1, Q2, and H1 (first half; cumulative through Q2)

		Q1 Results				Q2 Results				H1 Results					
		Unit: million yen	Q1 FY 2020	Q1 FY 2021	Change in Amount / Diff. YoY: million yen / %	Q2 FY 2020	Q2 FY 2021	Change in Amount / Diff. YoY: million yen / %	H1 FY 2020	H1 FY 2021	Change in Amount / Diff. YoY: million yen / %	% of Total Change	% of Total		
By Service Category	<b>Total Consolidated Sales</b>	3,379	3,379	3,493	114	3,493	3,710	217	7,071	7,083	12	0.2	100.0		
	Sales	2,411	2,311	2,532	121	2,532	2,677	145	4,943	4,988	45	0.9	375.0		
	Gross Profit	520	506	691	185	691	585	-106	1,211	1,091	-120	-9.9	-1000.0		
	Gross Margin (%)	21.5	21.6	20.1	-1.5	20.1	17.0	-3.1	35.3	35.2	-0.1	-0.3	-14.1		
	By Industry	Sales	447	555	108	63	469	447	-22	241	916	675	-266	-109.5	
		Gross Profit	354	437	83	23.4	470	481	11	23.2	824	918	94	11.4	
		Gross Margin (%)	14.7	18.9	4.2	28.5	2.0	-0.5	-2.5	16.7	18.4	1.7	10.2	69.3	
		By Industry	Sales	95	82	-13	-13.7	130	100	-30	-23.6	225	182	-43	-19.1
			Gross Profit	73	123	50	68.5	84	102	18	66.9	157	225	68	42.6
			Gross Margin (%)	14.7	18.9	4.2	28.5	2.0	-0.5	-2.5	16.7	18.4	1.7	10.2	69.3
By Industry			Sales	16.5	22.2	5.7	34.5	9.7	9.2	-0.5	-5.2	17.2	22.4	5.2	30.2
			Gross Profit	993	989	-4	-0.4	1,125	1,073	-52	-4.6	2,118	2,062	-56	-2.6
			Gross Margin (%)	771	675	-96	-12.5	916	729	-187	-20.5	1,687	1,404	-283	-16.8
			By Industry	Sales	485	592	107	22.1	432	673	241	21.9	917	1,265	348
	Gross Profit			396	329	-67	-16.9	417	367	-50	-16.9	813	696	-117	-14.4
	Gross Margin (%)			245	182	-63	-25.7	209	204	-5	-25.6	454	386	-68	-14.9
	By Industry			Sales	486	603	117	24.1	593	664	71	24.2	1,079	1,267	188
		Gross Profit		181	191	10	5.5	228	199	-29	-12.7	409	390	-19	-4.7
		Gross Margin (%)		122	123	1	0.8	165	128	-37	-22.4	287	251	-36	-12.6
		By Industry		Sales	74	141	67	90.5	66	147	81	91.4	140	288	148
Gross Profit				45	50	5	11.1	62	67	5	8.1	107	123	16	14.4
Gross Margin (%)				34	24	-10	-29.4	34	35	1	2.9	68	59	-9	-13.0
By Industry				Sales	66	105	39	59.1	127	107	-20	-15.7	193	212	19
			Gross Profit	18.2	19.3	1.1	6.0	18.2	19.3	1.1	6.0	19.3	18.9	-0.4	-2.1
			Gross Margin (%)	15.8	18.2	2.4	15.2	15.9	18.3	2.4	15.1	17.9	0.8	4.4	
			By Industry	Sales	15.3	23.8	8.5	55.5	15.2	23.9	8.7	57.2	15.4	22.8	7.4
	Gross Profit			11.4	17.0	5.6	49.1	11.6	17.1	5.5	47.5	13.3	17.7	4.4	32.4
	Gross Margin (%)			13.9	13.2	-0.7	-5.0	14.1	13.6	-0.5	-3.5	15.0	15.3	0.3	2.0
	By Industry			Sales	13.6	17.4	3.8	27.9	13.6	17.4	3.8	27.9	17.9	16.8	-1.1
		Gross Profit		524	643	119	22.7	683	682	-1	-0.1	1,207	1,325	118	9.8
		Gross Margin (%)		15.3	19.1	3.8	24.8	18.5	18.4	-0.1	-0.6	17.1	18.7	1.6	9.3
		By Industry		SG&A Expenses	424	401	-23	-5.4	391	372	-19	-4.9	815	773	-42
Operating Profit				100	242	142	142.0	292	310	18	6.2	582	552	-30	-5.2
O.P. Margin (%)				3.0	7.2	4.2	140.0	7.9	8.4	0.4	4.4	5.5	7.8	2.3	41.8
By Industry				Recurring Profit	107	248	141	132.1	290	355	65	22.4	587	603	16
			R.P. Margin (%)	3.2	7.4	4.2	132.1	7.9	9.6	1.7	21.4	5.6	8.5	2.9	51.8
			Net Profit	50	166	116	231.7	191	234	43	22.6	241	400	159	65.9
			N.P. Margin (%)	1.5	4.9	3.4	22.8	5.2	6.3	1.1	21.1	3.4	5.7	2.3	67.6

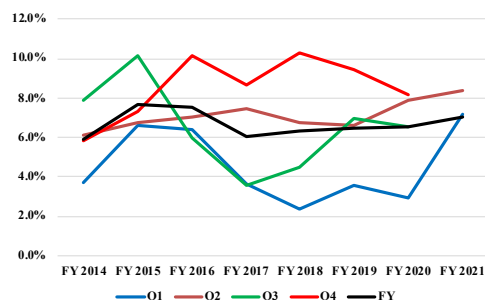
[Figure 2] Quarterly Change in Sales (unit: million yen)



[Figure 3] Quarterly Change in Operating Profit (unit: million yen)



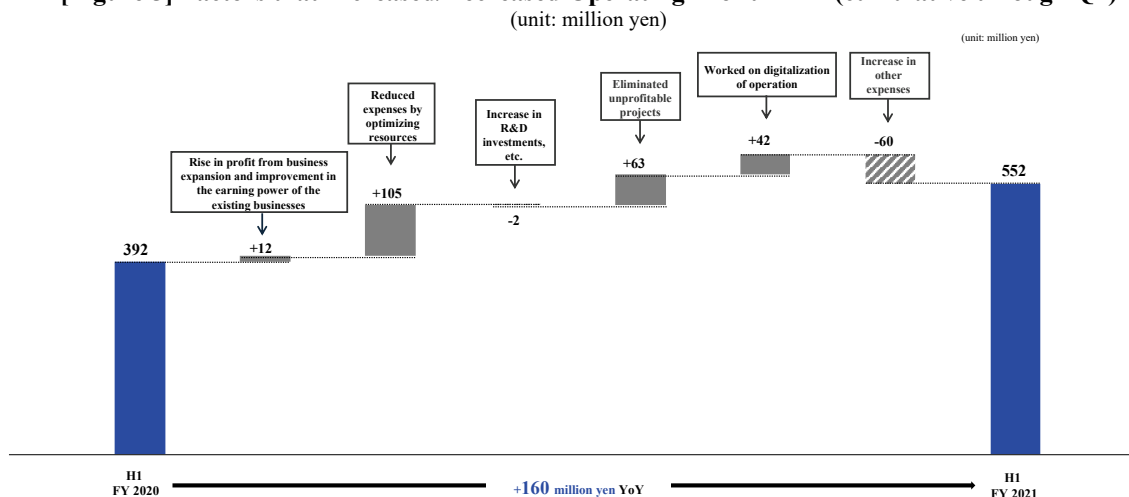
[Figure 4] Quarterly Change in O.P. Margin (unit: %)



(Note) Figures 1-4 were prepared by Alpha-Win Research Dept. based on the financial results summary and financial results supplemental briefing materials. Due to processing of data during calculations, values for the same item may slightly differ in this report, including the figures and tables. FY 2021 values for Q1, Q2, and H1 are actual results and the values for the full year (FY) are the Company's forecasts.

- Figure 5 describes the factors that increased or decreased operating profit during this H1. Although sales had stayed about the same and the personnel expenses rose (by approx. +40 million yen YoY; included in “other expenses”), profit grew mainly due to the optimization of human resources (contributed to profit by +105 million yen YoY), streamlining of operation through digitalization (+42 million yen YoY), and elimination of unprofitable projects (+63 million yen YoY). Under non-operating profit/loss, although not mentioned in the initial forecast, Y44 million was recorded as gains on investments in partnership (last H1: Y5 million). As a result, the growth rates for recurring profit and net profit were both greater than the operating profit growth rate.

**[Figure 5] Factors that Increased/Decreased Operating Profit in H1 (cumulative through Q2)**



(Note) Financial results supplemental briefing materials; partially edited and modified.

- In the second quarter (July to September 2020; hereinafter, “Q2”), sales were Y3,710 million (+0.5% YoY), operating profit was Y310 million (+6.2% YoY), recurring profit was Y355 million (+22.4% YoY), and net profit was Y235 million (+23.0% YoY) (Figures 1-3). As with Q1, profit also increased on a YoY comparison in Q2. Due to seasonal variations, this Q2’s sales and operating profit were about 10% and 28% greater than in Q1, respectively, but the order backlog decreased slightly from Y3,983 million ⇒ Y3,909 million.
- In the Company’s current business model, sales growth is generally directly correlated with the number of employees. The total number of employees in Japan and overseas has been increasing from 749 in Sept. 2018 (at end of month) ⇒ 760 in Sept. 2019 (+11; +1.5%) ⇒ 791 in Sept. 2020 (+31; +4.1%). In recent years, sales per employee in Japan have stayed about the same but operating profit per employee in Japan has improved significantly (in the same order as above, H1 operating profit per person has grown from 547 ⇒ 590 ⇒ 782 thousand yen per person). As the Company has said, while the future impact of COVID-19 remains uncertain, since system development demand is still strong (non-face-to-face, DX businesses such as those related to remote work, EC, and AI), it is somewhat short of staff. The Company has not been able to make as much progress with mid-career recruitment as expected, but it plans to increase recruitment through web interviews and other means and improve productivity and efficiency by, for instance, optimizing human resources allocation.
- There has been no significant changes in the balance sheet as of the end of H1. The Company has ample liquidity on hand, with Y4 billion in cash and deposits (equivalent to 3.4 months of average monthly sales in H1; essentially debt-less). Its financial standing is also firm, with an equity ratio of 69.6%.

### ◆ No change to the initial full-year forecast made at the beginning of the FY. Greater likelihood of achieving record-high profits.

- The Company has not made changes to its full-year forecast announced at the beginning of the fiscal year that sales will be Y16,000 million (+8.8% YoY), operating profit will be Y1,120 million (+16.8% YoY), net profit will be Y700 million (+33.3% YoY), and annual dividend will be Y18 per share (interim dividend has been decided to be Y8). It has also not changed its forecast for this full fiscal year’s sales by industry since the beginning of the fiscal year. Like the previous fiscal year, the Company expects to achieve sales and profit growth this fiscal year.

In fact, it plans to achieve record-high sales for another consecutive year as well as record-high profits (past record highs: operating profit of Y964 million in FY 2015 and net profit of Y628 million in FY 2016). It will also aim again to achieve Y1 billion each in operating and recurring profit for the first time (it had tried to achieve this goal last fiscal year too but was unsuccessful).

- In H1, progress against the Company's full-year forecast was 44.3% for sales (last H1: 48.1%) and 49.3% for operating profit (last H1: 40.9%). The sales growth rate in H1 was lower than the Company's plan for the full year, but the profit growth rate was significantly greater. When the H1 results are subtracted from the Company's disclosed full-year forecast, the expected results for the second half (October 2020 to March 2021; "H2") come out to be Y8,917 million for sales (+16.8% YoY), Y568 million for operating profit (+0.2% YoY), and Y300 million for net profit (+5.6% YoY). Operating margin is expected to be 6.4% in H2, worsening in profitability from the previous H2's 7.4% and this H1's 7.8%.
- Taking into account the risks pertaining to COVID-19, Alpha-Win Research Department had made a slightly more cautious full-year forecast than the Company. Indeed, due to the COVID-19 crisis, the Company's sales activity has been stagnated especially for new negotiations and some of its corporate customers have also been scaling down their IT investments due to worsened financial performance. As a result, in H1, the amount of orders received and the order backlog decreased by 3.7% and 6.0% YoY, respectively. Sales also only increased by 0.2% YoY. However, because some of its customers with strong financial performance have been starting to actively conduct strategic IT investments, the Company has been able to maintain its sales. Also, its measures to improve and streamline operation have been more effective than expected, leading to a surprising improvement in the profit margins. Considering this current situation, we decided to keep our original full-year sales forecast for this fiscal year, which is slightly below the Company's forecast. With regards to profit, the Company's assumptions for the profit margins in H2 seem to reflect a cautious consideration of the various risk factors as well as the costs related to upfront investment in areas of growth. Therefore, we raised our profit forecast for the full fiscal year to about the same level as the Company's forecast.
- We also reviewed our forecast for the Company's financial results over the medium term (next fiscal year onward). We revised sales downward and profit upward. However, since these forecasts were made based on the assumption that the economic environment will gradually normalize, the medium-term profit forecasts may need to be revised again depending on the COVID-19 situation.
- As the Japanese government continues to promote and accelerate digitalization, the Company's users (companies, organizations, etc.) have been further increasing their IT investment in order to adapt to the changes in the world with and after COVID-19, as they develop new business models, strengthen their competitive advantage, work on solving HR shortages, streamline and speed up operations, and make progress with DX. Therefore, the Company has a large growth potential over the medium to long term. In fact, we believe that the Company will be able to continue to stably increase its sales and profit at about 8% per year (under normal conditions) through the expansion of the Enhancement business, new customer development, development of new or overseas businesses, and improvement of productivity through various measures.

#### ◆The Company's recent activities (COVID-19 response, updated management policy, etc.)

- The Company's four task forces headed by the president have been working on optimizing working styles for the post-COVID-19 world and the new normal (please refer to the Q1 report published in August 2020 for details). The goal is to create a new way of working where each employee can work from their most suitable location in terms of the characteristics of their jobs as well as their abilities. Currently, through the remote work system, more than 50% of its employees work from home.
- The Company has been continuing to focus on strengthening its sales activity while taking into account the COVID-19 situation (decentralized/non-contact business operation through the use of digital technology, combined with face-to-face sales), prioritizing and strengthening approach toward customers who are actively conducting strategic IT investments, maintaining and expanding the Enhancement business with its major customers, and acquiring new and promising projects (projects related to AI-based image recognition technology and blockchain, digitalization systems for the government, etc.).

- The new president has mentioned in the “Shareholder Letter” (message from the president to shareholders that will be published semi-annually starting this H1) that the Company will “continue to transform itself and take on new challenges with the DX theme to meet the society’s needs” and at the same time work on further ensuring sustainable management. In the management vision *V2026*, the Company has set out its plan to strengthen its proposal-based business (proposal of solutions to customers/industries based on the Company’s technology and expertise in its customer’s industries, followed by the providing of the corresponding services) and contract-based business (contract development of information systems according to customer request) and achieve business growth mainly through the SI and digitalization businesses.

#### ◆ Stock price and characteristics: domestic-demand-related, stable growth stock that has been significantly outperforming the TOPIX over the long term.

- Over the past eleven and a half years or so, the Company’s stock price has increased by about six times and has been outperforming the TOPIX by about 510% thanks to its solid financial performance. It has also been significantly outperforming the TOPIX and its competitors (HIMACS and Toho System Science; Figure 6) over the past six months. Its valuation is relatively somewhat high (estimated current average for TSE First Section: forecasted P/E of 25.3 and weighted dividend yield of 2.1% for this fiscal year and actual P/B of 1.2 in the previous fiscal year).
- Due to the COVID-19 crisis, financial performances of companies seem to have split into two ends of the spectrum, with some companies revising their forecasts upward while others – even major, listed companies – have been posting large profit drops and enormous net losses and decreasing or terminating their dividend payment. Meanwhile, the Company has become increasingly more likely to achieve record-high profit and double-digit profit growth this fiscal year. The Company’s stock price seems to reflect a valuation premium resulting from the market’s high evaluation of the Company as a domestic-demand-related, defensive, and stable growth stock with solid financial performance.
- Over the short term, its stock price will likely be affected by whether and when the COVID-19 crisis will settle down, how far business activities will recover, and the quarterly trends in the amount of orders received and in the overall financial performance (level of sales and profit margins and whether there will be unprofitable projects) in Q3 onward. Over the medium term, stock price may also be affected by the following factors: development of new customers, development of new technologies and areas such as DX and their contribution to financial performance; overall sales growth rate; changes in operating margin and operating profit growth rate; shareholder return (dividend hike, share buyback, and stock split); and the financial performance and IT investment trends of Japanese companies (the Company’s current and potential end users). Going forward, if the Company maintains a stable, double-digit annual growth rate for its profit (EPS), we believe that it will be able to keep its current level of valuation and have a stock return that matches the growth in EPS.

[Figure 6] Comparison of Valuation with Competitors

Company Name	CUBE SYSTEM (CS: consolidated)	HIMACS (HM: consolidated)	Toho System Science (TS: non-consolidated)
Code	2335	4299	4333
Stock Price (at 11/4 closing)	1,350	1,197	937
Market Cap (million yen)	20,628	14,858	12,992
P/E (price-to-earnings ratio)	26.2	15.8	18.0
P/B (price-to-book ratio)	3.1	1.4	1.6
Dividend Yield (%)	1.3	2.1	2.7
EV/EBITDA	16.4	8.6	5.5
P/S (price-to-sales ratio)	1.3	1.0	1.1
Company Forecast for FY 2021 Sales (million yen)	16,000	15,100	11,700
YoY Sales Growth Rate (%)	8.8	-1.6	0.1
Company Forecast for FY 2021 Operating Profit (million yen)	1,120	1,100	920
YoY O.P. Growth Rate (%)	16.8	8.7	0.5
Company Forecast for FY 2021 O.P. Margin (%)	7.0	7.3	7.9

Market cap= (shares outstanding) x (market share price [at 11/4/2020 closing])

The companies' planned EPS and dividend values for FY 2021 were used in all P/E and dividend yield calculations.

Actual BPS values of H1 FY 2021 were used in P/B calculations.

EV/EBITDA=(market cap + interest bearing debt - cash&deposits)/(O.P. + depreciation + intangible fixed asset amortization)

\*Values for interest-bearing debt and cash & deposits are actual values as of the end of H1 FY 2021.

P/S=market cap / sales [the companies' forecasts for FY 2021]

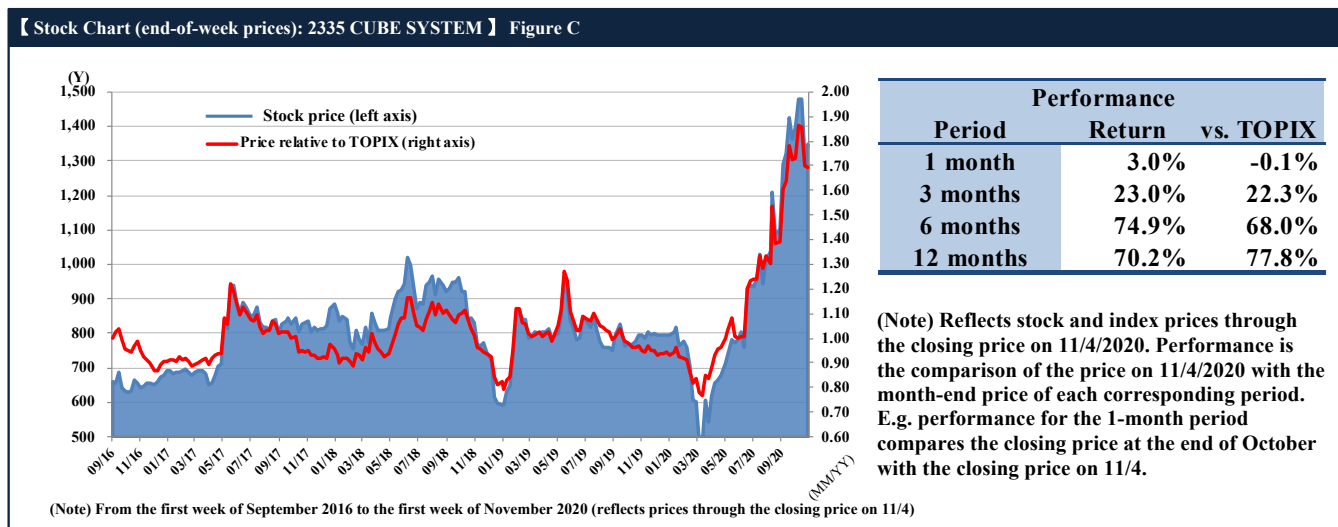
(Note) Prepared by Alpha-Win Research Dept. based on each company’s financial results summary

【 2335 CUBE SYSTEM Sector: Information & Communication 】 Figure A												
FY		Sales (million yen)	YOY (%)	O.P. (million yen)	YOY (%)	R.P. (million yen)	YOY (%)	N.P. (million yen)	YOY (%)	EPS (Y)	BPS (Y)	Dividend (Y)
2018		13,559	5.1	855	9.5	892	10.0	567	2.9	40.59	372.23	16.0
2019		14,325	5.6	921	7.8	959	7.5	596	5.1	43.25	393.29	16.0
2020		14,708	2.7	959	4.1	976	1.7	525	-11.9	38.69	411.96	18.0
2021	CE	16,000	8.8	1,120	16.8	1,120	14.7	700	33.3	51.56	-	18.0
2021	Old E	15,300	4.0	1,050	9.5	1,050	7.6	655	24.8	48.20	-	18.0
2021	New E	15,300	4.0	1,120	16.8	1,120	14.7	700	33.3	51.56	454.10	18.0
2022	New E	16,000	4.6	1,180	5.4	1,180	5.4	735	5.0	54.08	490.24	20.0
2023	New E	17,000	6.3	1,280	8.5	1,280	8.5	800	8.8	58.87	529.10	20.0
2019	Q1	3,379	9.6	100	-8.8	107	-19.0	50	-34.2	3.70	379.63	0.0
2020	Q1	3,373	-0.2	242	141.3	248	130.8	165	229.3	12.17	418.69	0.0
2019	Q2	3,692	-2.1	292	17.3	290	18.9	191	28.2	14.13	411.96	8.0
2020	Q2	3,710	0.5	310	6.2	355	22.4	235	23.0	17.30	440.07	8.0
2019	H1	7,071	3.2	392	9.4	397	5.6	241	7.3	17.83	411.96	8.0
2020	H1	7,083	0.2	552	41.0	603	51.7	400	65.5	29.47	440.07	8.0
2020	H2	7,637	2.2	567	0.7	579	-0.7	284	-23.5	20.86	411.96	10.0
2021	H2 - CE	8,917	16.8	568	0.2	517	-10.7	300	5.6	22.09	411.96	10.0

(Note) CE: the Company's forecast. E: Alpha-Win Research Dept.'s forecast. Q1: Apr-June. Q2: July-Sept. H1: Apr-Sept. H2: Oct-Mar.

【 Stock Price and Valuation Indicators: 2335 CUBE SYSTEM 】 Figure B						
Item	11/4/2020	Item	P/E	P/B	Dividend Yield	Dividend Payout Ratio
Stock Price (Y)	1,350	Last FY (actual)	34.9	3.3	1.3%	46.5%
Shares Outstanding (thou.)	15,280	This FY (est.)	26.2	3.0	1.3%	34.9%
Market Capitalization (million yen)	20,628	Next FY (est.)	25.0	2.8	1.5%	37.0%
Dilutive Shares (thou.)	0	Equity Ratio at End of This H1	69.6%	Last FY's ROE		9.6%

(Note) Estimates were made by Alpha-Win Research Dept.



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Disclaimers

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