

kaonavi, inc. (4435 JP – TSE MOTHERS)

Sponsored Research

Transforming Japan Inc.'s HR Management

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NIPPON INVESTMENT BESPOKE RESEARCH UK LTD

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Contents

Summary – Transforming Japan Inc.’s HR Management.....	2
Business Model – from HR Database to Talent Management.....	3
Competitive Advantages and Risks.....	5
Medium-term Growth Perspective.....	6
Expansion of the Existing Business.....	6
Expansion of New Business Areas.....	7
Financials	9
FY19 IH.....	9
Full-Year Guidance	10
Corporate Governance Summary.....	11
Financial Summary.....	12
General disclaimer and copyright.....	13

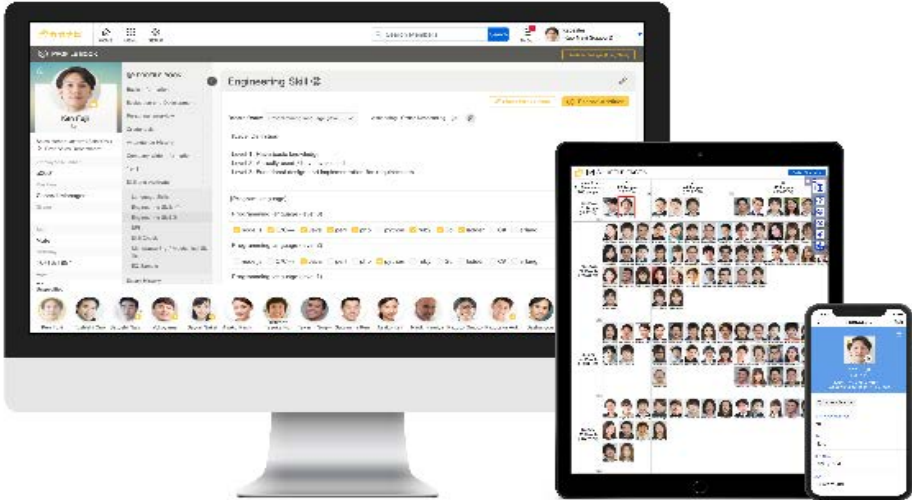
Summary – Transforming Japan Inc.’s HR Management

kaonavi, inc. (Kaonavi) is a cloud-based SaaS (software as a service) provider specialised in the human resource [HR] management. The Kaonavi system helps the user companies’ management make decisions associated with HR by utilising employee data stored in a cloud-based database.

The name Kaonavi – the company name and the service brand name – comes from the uniqueness of its system where portrait pictures of employees are displayed. “Kao” in Japanese means face. By clicking on a picture of an employee, a manager can readily extract data of that employee from the database. This feature of the Kaonavi system was created based on a suggestion from one of its first customers that it was important for management to know names of his/her employees and to know them by face. It turned out to be a simple but innovative feature that has been well accepted by Kaonavi users as they are able to manage their employees’ data / information – such as skill sets, professional qualification certificates, performance track records – all of which is stored in one place, with just one click on their portrait.

What is KAONAVI ?

A cloud-based human resource management system



Features :

1 Specialized In HR Management

2 A Cloud-based HR Database

3 Intuitive and Simple Usability

Source: kaonavi, inc. Presentation Material, Oct. 19

The firm was founded by Hiroki Yanagihashi in 2008, under the name of Japan Operation Lab. Having started his career as an IT engineer in Accenture, he then moved to iStyle (3660 JP), where he managed the Human Resources Department. During his tenure at iStyle, he realised that talent management is a key aspect of running the human resources of a company. Using his background as an IT engineer, it was a natural course of action to build an IT-based talent management system under the SaaS business model.

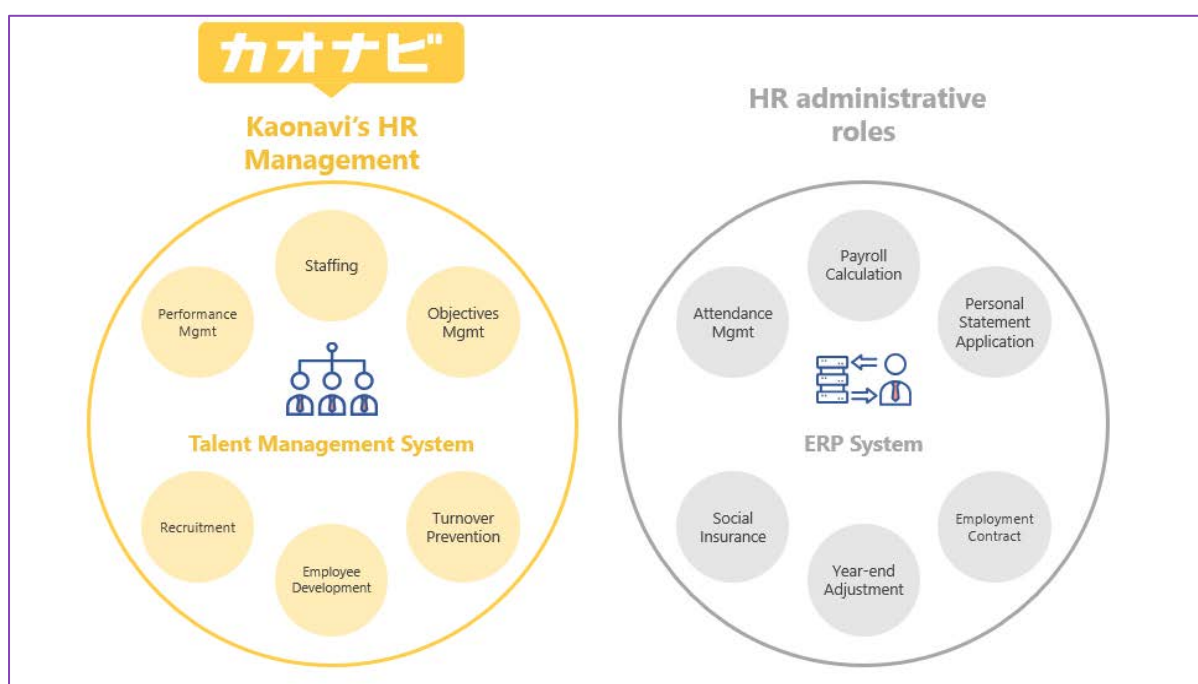
However, it was not always smooth sailing for Kaonavi. Soon after the inception of the firm, the Lehman Crisis hit, and the business was negatively influenced by the ensuing weak business sentiment. Many of the IT ventures that started up at around the same time as Kaonavi were mainly

game-app creators – firms whose earnings were often highly volatile. Mr Yanagihashi's decision to utilise a SaaS business model, with the aim for a more stable revenue flow, made the firm stand out.

In many Japanese companies, HR departments tend to simply manage personnel-related tasks geared to administration rather than the actual management of the firm's human resources. Even though Japan is known for its "job for life" employment policy and, therefore, having a high staff retention rate, optimal allocation of human resources was not necessarily the priority of a HR department.

The Work Style Reform promoted by the Abe administration, as well as significant shortage in the working population due to demographic changes, has now forced Japanese companies to revise their HR management in a completely new way.

The current situations faced by the labour market casts a spotlight on talent management which has not been covered by existing HR functions. Kaonavi expands its service specialised in the new area of HR management.



Source: kaonavi, inc.'s FY19 1Q Earnings Presentation, modified by Nippon-IBR

Business Model – from HR Database to Talent Management

Kaonavi provides several functions (described as below) that manage all the HR information under one database.

Kaonavi is used mainly for 3 purposes:

- 1) **Data Management:** consolidating all the HR-related data and information into one database,
- 2) **Performance Management:** this service makes the performance evaluation of employees more efficient, and
- 3) **Talent Management:** here Kaonavi aims to better allocate existing staff and their skill sets to enhance corporate growth strategy.

Kaonavi Features

Functions	Functional Details
HR Database	Easy access to all HR related data at one place, interface with portrait pictures of employees. Able to freely customise data items based on customer specific requirements.
Pickup List	Form any group of employees in order to manage members for projects, succession plan, newly hired etc.
Organization Chart	Organisational chart with portrait pictures. Able to simulate reorganizing structures, employee placement etc.
Review Workflow	Support performance reviews in any form such as MBO, OKR and 360-degree appraisal. Flexibly manage escalation flows and progress state.
Employee Survey	Manage the process of surveys, gather voices /aspirations of employees such as new business ideas through questionnaires.
Matrix Chart	With portrait represented by an icon, management/managers can sort employees by freely setting criteria/conditions. Able to simulate employee development, evaluation, promotions, placement etc.
Employee Data Graph	Visualize company's current state (employees from various angles such as gender ratio, qualification possession, assessment distribution etc.) and trends of headcount in form of charts
API Integration	Offer APIs that can link between core system and other services

Source: kaonavi, inc.

For each of those 3 purposes, Kaonavi has matching subscription pricing plan. Prices are charged on the per unit of employees registered on Kaonavi database (e.g. for a company with less than 1,000 registered employees, one unit is 100 and for a company with more than 1,000 registered employees, one unit is 1,000) and paid monthly by the user companies:

1) Database Plan from ¥39,800~

It is a cloud-based service that compiles the existing HR data, information which is typically stored on copious amounts of paper / files, into a database. Moreover, even though a lot of HR-related data / information may already exist, it is often not very well organised.

2) Performance Plan from ¥59,700~

This is a service that manages the employee performance evaluation process on the Kaonavi platform. Many companies have not yet introduced an IT system that enables an efficient performance evaluation (e.g. many companies still manage the evaluation process on Excel). Evaluation results can then be stored in the system.

3) Strategy Plan from ¥79,600~

This plan includes the above two plans and the talent management services.

The talent management market is still in an emerging period; therefore, it has a low penetration rate. Kaonavi deliberately set the subscription price at an affordable level in an aim to speedily capture the market share. As a result, active user numbers have been rapidly increasing (e.g. 1,535 companies in FY19 2Q, +9.0% QoQ / +42.8% YoY), however, sales from the top 10 customers comprises less than 10% of the firm's revenue.

Kaonavi's Fee Structure

Fee Structure

Fee structure depends on the number of registered employees and available functions

	DATABASE PLAN	PERFORMANCE PLAN	STRATEGY PLAN
	Consolidate all personnel data JPY 39,800~/Month	Efficient review operation JPY 59,700~/Month	More advanced HR strategy JPY 79,600~/Month
HR Database	✓	✓	✓
Pickup List	✓	✓	✓
Organization Chart	✓	✓	✓
Review Workflow		✓	✓
Employee Survey		✓	✓
Matrix Chart			✓
Employee Data Graph			✓

※ 1 : The above amount is based on the number of registered employees, 100 or less

1

Source: kaonavi, inc.'s Presentation Material, Nov. 19

The Kaonavi's business model is based on the assumption that its customers will continue to subscribe for the service, therefore, customer engagement that successfully leads to customer satisfaction is important. In addition to operational support through the customer service help desk and online support, the firm allocates each customer a dedicated representative to help set up the service and suggest the optimal use of the platform.

Not only does the firm offer platform-use support but it also provides offline seminars and networking opportunities. As a result, nearly 95% of existing customers are willing to continue subscription based on the firm's survey.

To date, the firm's competitors include Plus Alpha Consulting (unlisted), Cydas (unlisted) and Ashita-no-Team (unlisted) – companies that provide talent management system, (or employee's performance review tool only in case of Ashita-no-Team). For a more advanced strategic HR support service, the firm is likely to compete with some of the major recruitment service agents such as Persol Holdings (2181 JP), en-japan (4849 JP) and BizReach (unlisted) – companies that apparently have plans to expand their services to talent management.

Competitive Advantages and Risks

While the Kaonavi's business model does not particularly offer a high barrier to entry, the management reckons that there are several competitive advantages that benefit the firm summarised as below;

I. Customer awareness and brand recognition:

Thanks to be a front runner and having the top market share, Kaonavi has greater customer awareness and brand recognition among existing and prospective customers.

2. Technological expertise:

The firm's backbone is in IT, which gives Kaonavi an advantage in expertise such as capability in building database that gives greater flexibility to its customers. Freely customisable feature enables both user companies and Kaonavi to reduce engineer man-hours as well as lead-time to implement the system. In-house technological expertise is something that the recruitment service agencies are unlikely to have.

3. Customer engagement to enhance customer success:

Kaonavi is currently used by 1,535 companies (as at FY19 1H), which creates a solid network. The firm has built expertise and knowledge of how the HR data is used in those customer companies. Talent management systems are powerful HR tools if used effectively, but many customers are often not capable to fully utilise them without support and suggestions. There are offline networking events and seminars that are organised for users to participate in and exchange usage ideas, in addition to regular online support services. Ultimately, such efforts that improve customer success can lead to better customer retention rate.

On the other hand, general risks to the firm's business model that should be clarified are as follows:

1. New entrants and more intense competition as the industry expands:

The talent management market has been growing with strong demand. Therefore, as new entrants arrive, there is the potential risk of more intense competition. However, the diffusion rate of talent management IT systems is only 12.6%, according to *IDC Japan*. The market for talent management systems presents a significant growth potential as the whole pie gets bigger, hence new entrants and competition are expected to actively cultivate the untapped customer base before the market becomes too crowded.

2. Stricter regulations on data security and privacy concerns:

While the firm has placed sufficient safeguards on the HR data exchanged on its platform, any incident of data leakage can kill the business. Mishandling such information can damage the reputation of the firm and its business.

Medium-term Growth Perspective

Kaonavi sets numerical targets to FY23 (year ending March 2024), guiding for sales of ¥10,000mil (5yr CAGR ca. 42.7%) with an OP margin of 30% – a vast improvement from the ¥73.4mil operating loss recorded. In addition to recurring revenue that earns more than 75% of total sales, the firm aims to expand the top line with a focus on:

Expansion of the Existing Business

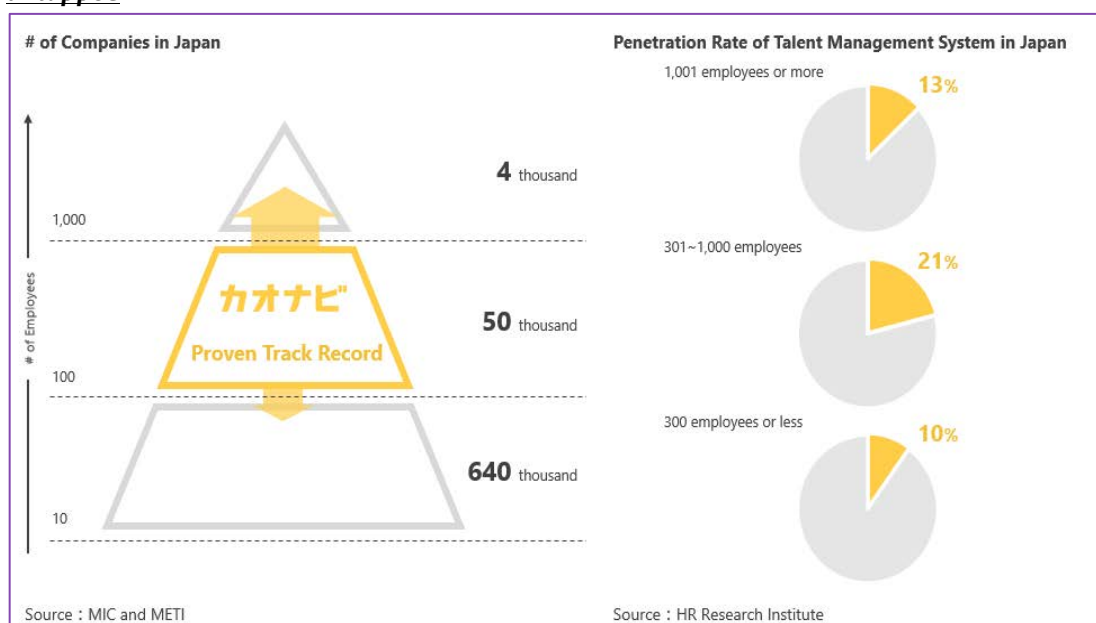
a. Expand the customer base:

There are circa 700,000 companies in Japan that have ten or more employees. Kaonavi has a proven track record in capturing customers among those with between 100 and 1,000 employees, of which there are ca. 50,000 companies in this universe. It can also expand its customer reach to include the 4,000 companies with more than 1,000 employees which recently started to catch up with the trend to better manage their employees.

Currently, at the top-end of the market – i.e. the 4,000 firm with 1,001 or more employees – the diffusion rate of talent management systems is only 13%. In the smaller-sized companies'

universe with 300 employees or less employees – the diffusion rate is 10%. Uniquely, the penetration of such systems is highest in the middle-tier group of companies with 301~1,000 employees, having reached a diffusion rate of 21%. This is also the market to which Kaonavi has the most exposure. In such an underdeveloped market, Kaonavi has already established circa 30% market share on the sales value basis (ca. 33% on the registered user basis). The firm also plans to expand the customer base by increasing its geographical coverage outside of Tokyo to other major commercial cities such as Nagoya and Osaka. To capture traction among the top-end companies, the firm spends marketing costs as an upfront investment. FY19 1H marketing cost was ¥344mil compared to ¥238mil spent during the entire FY18.

Expanding the Customer Base – the vast majority of the talent management systems market still untapped



Source: kaonavi, inc.'s FY19 1Q Earnings Presentation

b. Increase ARPU:

ARPU from the existing customers can be raised through 1) increase in the user base among companies with larger numbers of employees and 2) existing users upgrading plans.

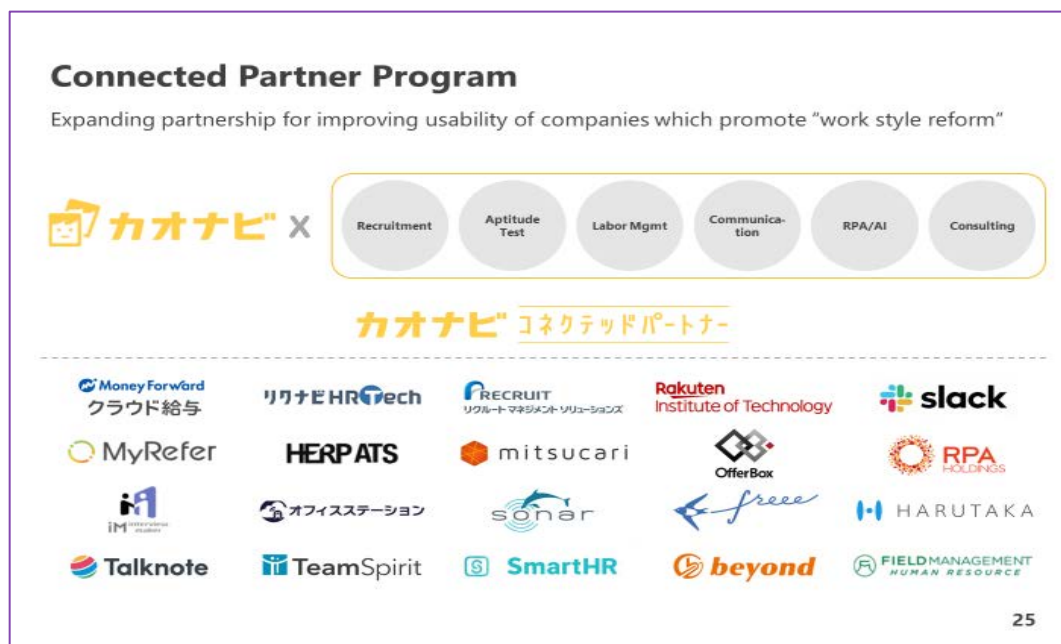
Furthermore, the firm aims to increase ARPU through additional new features. The most recent example is the “Pulse Survey”, launched in Oct 2019, which is a short survey conducted to improve real-time visibility of employees’ conditions. It is used to detect early signs of staff turnover and other organisational issues. The system visualizes the behavioural tendencies of each staff and help managers capture issues before staff makes decision to resign from the work.

Expansion of New Business Areas

As mentioned above, Kaonavi has a proven track record in capturing customers in mid-tier-sized companies with 100~1,000 employees. The firm also aims to expand the customer base in the top-tier companies with more than 1,000 employees. In those universes, there are 54,000 companies. The medium-term sales target of ¥10,000mil assumes that the firm gains

4,000~5,000 customers. With the number of customers, Kaonavi's HR master database will become substantial in scale and scope. The firm is also considering further collaboration with external HR service providers by linking through API (Application Programming Interface).

There are currently 20 partners forming the "Connected Partner Programme", most of which are HR service providers. Master data of employee information is stored on Kaonavi, which can be utilised in various HR services. With the master data as a hub of services, Kaonavi can be linked to various other HR services, offering customers seamless and comprehensive access to those services.



Source: kaonavi, inc.'s Presentation Material, Oct. 19

By incorporating these efforts, growth will then depend on how the firm can expand monetising opportunities through the master data.

Furthermore, the historical data piled through existing services can add value to Kaonavi's services. One example is a development project that Kaonavi co-works with Rakuten Institute of Technology. This project aims to develop an AI algorithm for an employee turnover prediction by utilising various HR data. Historical data is more reliable in predicting employees' behavioural patterns than a fixed point observation, hence can become a powerful asset in decreasing staff turnover and high performer analysis, for example.

1-B Increase ARPU

Launched development project of “AI algorithm for employee turnover prediction” with Rakuten

HR Data Innovation Project
Recruiting participants between February 8th and March 29th in 2019

- Develop AI algorithm for predicting employees condition and turnover risks
- Analyze the questionnaire and personnel data (attendance, personality, facial image, stress, retirement status, etc.) collected by kaonavi and the participating companies through deep learning technologies by Rakuten Institute of Technology

About Rakuten Institute of Technology
Established in 2006 as the dedicated R&D organization for the Rakuten Group.

Source: kaonavi, inc.'s Presentation Material, Oct. 19

Financials

FY19 1H

Kaonavi reported FY19 1H earnings on 14 November with GP ¥922.7mil (2.0x YoY) on sales ¥1,211.3mil (+61.5% YoY). In 2Q alone, GP was ¥483mil (+94.6% YoY / +10.0% QoQ) on sales of ¥635mil (+60.5% YoY / +10.2% YoY). Stock revenue (recurring revenue from increasing ARPU) ratio improved from 78.1% from 1Q's 76.8%, with ARPU rose from ¥108,000/month in 1Q to ¥112,000/month in 2Q (+17.9% YoY / +3.7% QoQ).

Active users also steadily increased from 1,408 companies in 1Q to 1,535 companies in 2Q. Of 127 companies added as new users, the firm sees the most increase in the middle-tier companies with 200~900 registered employees – 86 companies. There are 26 companies newly subscribed in the lower-tier companies with less than 100 registered employees and 15 in the top-tier companies with more than 1,000 registered employees.

By having more exposure to larger corporates, the fee per customer tends to rise along with larger number of employees registered. Consequently, it is more efficient for Kaonavi to be able to generate fees from one large company.

Breakdown of Active Users

(unit: Companies)	FY18	FY19	
	4Q	1Q	2Q
Companies with more than 1,000 registered employees	204	227	242
% of total	15.8	16.1	15.8
Companies with 200~900 registered employees	772	858	944
% of Total	59.7	60.9	61.5
Companies with 100 registered employees	317	323	349
% of Total	24.5	22.9	22.7
Total active users	1,293	1,408	1,535

Source: Nippon-IBR based on kaonavi, inc.'s presentation materials

The GPM in 2Q alone was 76.1%, thanks to lower than expected COGS. Cost of engineers, estimated from sum of labour cost and subcontract cost in COGS, was ¥119mil, remained low at 18.7% of total sales. The management intends to hire engineers needed for its future growth during this fiscal year and continues to increase key personnel in the organisation, therefore, estimates that the 2H GPM would become lower to 70.0% level.

COGS Breakdown

(¥mil)	FY17	FY18	FY19 1Q	FY19 2Q
Labour Cost (Cost of Engineers)	121	202	50	52
Subcontracting Cost	178	248	54	67
Total Cost of Engineers	298	450	104	119
Total cost of engineers / sales (%)	31.3	26.6	18.0	18.7
Total COGS	405	583	137	152
Total Sales	952	1,690	576	635
Gross Profit	548	1,108	439	483
GPM (%)	57.5	65.6	76.3	76.1

Source: Nippon-IBR based on kaonavi, inc.'s YUHO and FY19 1Q & 2Q presentation materials

The firm saw the operating loss -¥10mil in 2Q alone, compared to ¥6mil (due to the larger-than-expected drop in COGS rather than the start of uptrend in OP) in profit in 1Q and -¥50mil in FY18 2Q. Reason for the operating loss is the marketing cost, which the firm considers as a strategic investment to promote Kaonavi to wider range of audiences, especially to companies with more than 1,000 employees. In 2Q only, the firm spent ¥203mil marketing-related expenses. Without such expenses, the firm must have earned ca. ¥193mil profit (30.3% OPM) in 2Q. In 1H, the firm spent the total of ¥343mil in marketing-related expenses. Suppose such expenses were not spent, 1H OP would have been ca. ¥339mil (OPM 28.0%). The management plans to continue investing on marketing, including TV advertisement and other upfront cost, to garner the future growth.

Full-Year Guidance

With its 2Q results release, Kaonavi revised up its full-year guidance for sales from ¥2,540mil to ¥2,600mil. The initial forecast was based on +50% YoY growth in sales and a 70%+ GPM – levels the firm achieved in 1H. However, Kaonavi is guiding for an operating loss of ¥250mil~350mil for FY19 due to its continued investments for marketing to capture potential customers. Furthermore, the firm plans to increase employee numbers – mainly engineers, sales & marketing staff – by 17.1% YoY to 130 people (as of 2Q, it had 116 employees, a net increase of 4 employees from the beginning of the year).

There are 3 benchmarks that measures success of mass advertisement:

1. The conversion count – measuring the traffic of people who became interested in Kaonavi as a result of marketing activities – rose to 1.36 in 2Q vs 1.00 in FY18 1Q. Those potential customers have been identified because they've searched on their own, visited Kaonavi's website and have sent enquiries via the website.
2. The number of active leads: This figure is up 85.6% since the beginning of this fiscal year. Given success of the marketing in 1H, the firm plans to further invest in marketing in 2H, particularly for TV adverts – the firm started launching tv ads this year and they have proved successful.

3. LTV / CAC – the ratio of LTV (Lifetime Value) to CAC (Customer Acquisition Cost): This measures the marketing and sales efficiencies in terms of customer acquisition. The higher the ratio, the more efficiently marketing activities are working. LTV / CAC was 8.2x and 6.7x in 1Q and 2Q, respectively. It is said that in SaaS business, this ratio should be higher than 3.0x, which implies Kaonavi has room for further marketing expenditure. Kaonavi intends to look to the KPI as a discipline to make decision for future investment amount.

Corporate Governance Summary

Kaonavi has 8 Board members including the founder CEO Mr. Yanagihashi who owns 33.8% of the shares and is the top shareholder. The firm's Board has 5 external, independent members including one external director and 4 external auditors. Although Recruit Holding's (6098 JP) Recruit Strategic Investment Fund (RSI Fund) owns 22.7% of Kaonavi, there is no director associated with RSI on the Board – it is considered as a capital alliance with Recruit along with service alliances such as SPI3 and Talent Finder– and conversely, Kaonavi does not have any cross-holdings in Recruit shares but is an equity-method company of Recruit.

Financial Summary

kaonavi, inc. (4435 JP)

(¥mil)	FY17	1Q	2Q	3Q	FY18	FY19CE
Sales	952	354	750	1,188	1,690	2,600
Operating Profit	-244	-35	-85	-98	-73	-250~-350
Recurring Profit	-249	-35	-85	-101	-92	-251~-351
Net Profit	-282	-35	-85	-102	-96	-255~-355
EPS (JPY)	-	-	-	-22.30	-20.64	-47.06~-65.53
Adjusted EPS (JPY)	-	-	-	-	-	-
Cash flow from operation (CFO)	-75	-	-80	-	174	-
Cash flow from investment (CFI)	-141	-	-26	-	-44	-
Cash flow from finance (CFF)	553	-	-32	-	1,069	-
Cash and cash equivalent	586	-	447	-	1,786	-
Free cash flow (FCF)	-216	-	-106	-	130	-
CFO per share (JPY)	-3,009.15	-	-	-	37.37	-
FCF per share (JPY)	-8,666.35	-	-	-	27.92	-
Total asset	882	796	792	838	2,145	-
Liabilities	588	538	584	645	798	-
Net asset	293	258	208	192	1,347	-
Capital	440	440	440	441	1,015	-
Shareholders' equity	293	258	208	192	1,347	-
BPS (JPY)	-	-	-	-	248.68	-
OPM (%)	-25.63	-9.89	-11.33	-8.25	-4.32	-
ROE (%)	-120.26	-50.82	-67.86	-56.08	-11.71	-
ROA (%)	-38.64	-16.69	-20.55	-15.35	-4.96	-
Shareholders Equity Ratio (%)	33.22	32.41	26.26	22.91	62.80	-
D/E ratio (%)	200.68	208.53	280.77	335.94	59.24	-
Total asset turnover (X)	1.51	1.69	1.79	1.84	1.12	-
Interest coverage (x)	-	-	-85.00	-98.00	-36.50	-
Current ratio	158.80	148.54	127.75	118.43	273.88	-
Interest-bearing debt	198	182	166	142	130	-
EBIT	-249	-35	-84	-100	-90	-
EBIT Margin (%)	-26.16	-9.89	-11.20	-8.42	-5.33	-
EBITDA	-241	-29	-74	-91	-77	-
EBITDA margin (%)	-25.32	-8.19	-9.87	-7.66	-4.56	-
Dividend (JPY)	0.00	-	-	-	0.00	0.00
Dividend pay-out ratio (%)	-	-	-	-	-	-
DOE (%)	-	-	-	-	-	-
Shares outstanding (shares)	45,680	45,680	45,680	4,788,000	5,418,500	5,418,500
Treasury (shares)	-	-	-	-	-	-

Source: Nikkei Value Search

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