KAONAVI, INC. (4435 JP)

FY20 1H EARNINGS TO BE LED BY CONTINUOUS RISE IN RECURRING REVENUE. NO CHANGE IN FY23 TARGET.

FY19 EARNINGS

In FY19 (March yr-end), kaonavi, inc. (4435 JP) reported an operating loss of ¥278mil (vs FY18 operating loss of ¥73mil) on sales of ¥2,625mil (+55.3% YoY). Both figures were in line with the firm's guidance, however, the gross profit [GP] overshot the company's forecast by 4.9%.

The quarterly sales trend continues to improve thanks to the steady growth in recurring revenue. In FY19 4Q alone, sales hit ¥731mil (+45.9% YoY / +25.6% QoQ), of which recurring revenue was ¥611mil (+57.9% YoY / +10.5% QoQ).

The full year FY19 GPM surpassed the firm's 72~73% target, rising to 75.1%. This improvement reflects the higher than expected GPM (76%) recorded in 1H while the firm was still in the middle of increasing numbers of engineers. However, the GPM started falling from 3Q due to reinforcing development capability by employing engineers (both direct employment and outsourcing costs are items in COGS). Hence, the fall in GPM in 2H is as expected and not at all viewed as a negative.

Losses at the operating level were due to advertisement and marketing costs. This expenditure was specifically for gaining new kaonavi users. During the year, kaonavi spent ca. ¥905mil on the aforementioned costs. If such cost were not incurred, the firm would have generated an OP of ca. ¥627mil in FY19, which would take the OPM to 23.9%. For the time being, however, the firm will continue to prioritise top-line growth by gaining new customers.

Earnings Summary

(¥mil)	FY18	FY19			
	Results	Results	Guidance	YoY (%)	vs. CE (%)
Sales	1,690	2,625	2,600	55.3	1.0
GP	1,108	1,972	1,880	78	4.9
GPM (%)	65.6	75.1	72.3	+9.6pp	+2.8pp
OP	-73	-278	-250~-350		
OPM (%)	n/a	n/a	n/a		
RP	-92	-280	-251~-351		
NP	-96	-357	-327~-427		

Source: kaonavi, inc. FY19 earnings presentation material

EXECUTIVE SUMMARY

- kaonavi, inc. (4435 JP) reported an operating loss of ¥278mil (vs FY18's operating loss of ¥73mil) on sales of ¥2,625mil (+55.3% YoY) in FY19 (Mar yr-end). Both figures were in line with the firm's guidance.
- GPM for the year was 75.1%, surpassing the targeted 72~73%. This is because of higher than expected GPM in 1H while the firm was still seeking to hire more engineers. By 4Q, it managed to hire its desired quota of engineers.
- Over the year, total marketing cost hit ¥905mil, putting the firm in the red at the operating level. Such an investment proved successful as the LTV / CAC ratio has substantially improved. Without the marketing investment, the firm would have reported an operating profit of ca. ¥627mil and an OPM of 23.9%.
- All 3 major KPIs, namely, 1) numbers of active users, 2) ARPU and 3) recurring revenue ratio demonstrate that the firm's growth strategy was successful. Of particular note is the rise in active users with larger numbers of registered employees contributing to growth in both ARPU and recurring revenue.
- The recurring revenue ratio improved to 83.5% in FY19 4Q vs 76.8% in 1Q. This ratio is an important indicator for future growth as it demonstrates stability in earnings. On top of that, kaonavi managed to see high growth rate in recurring revenue, which was 57.9% YoY in 4Q.
- Only FY20 1H guidance was announced amid restricted marketing activities under the current contra-COVID-19 policies.
- There was no change in the long-term target of GPM 80% and OPM 30% on sales of ¥10,000mil (4-year CAGR 40%) in FY23.

COGS Breakdown

(¥mil)	FY17	FY18	FY19					
	FY	FY	1Q	2Q	3Q	4Q	FY	YoY (%)
Labour Cost (Cost of Engineers)	121	202	50	52	51	60	213	5.3
Subcontracting Cost	178	248	54	67	81	94	296	19.5
Total Cost of Engineers	298	450	104	119	132	154	509	13.1
Total cost of engineers / sales (%)	31.3	26.6	18.0	18.7	19.4	21.1	19.4	
Total COGS	405	582	137	152	169	195	652	12.1
Total Sales	952	1,690	576	635	682	731	2,625	55.3
Gross Profit	548	1,108	439	483	514	536	1,972	78.0
GPM (%)	57.5	65.6	76.3	76.1	75.3	73.3	75.1	

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

OP and marketing cost

(¥mil)	FY19				
	1Q	2Q	3Q	4Q	FY
Total Sales	576	635	682	731	2,625
Total COGS	137	152	169	195	652
Gross Profit	439	483	514	536	1,972
GPM (%)	76.3	76.1	75.3	73.3	75.1
SG&A	433	493	587	737	2,250
OP	6	-10	-73	-200	-278
Marketing cost	140	203	266	296	905
OP if no marketing cost	146	193	192	96	627
OPM if no marketing cost (%)	25.3	30.4	28.2	13.1	23.9

Source: Nippon-IBR based on kaonavi, inc. FY19 earnings presentation materials

FY19 ACHIEVEMENTS

kaonavi reported the key performance indicator (KPI) with earnings results. The table below shows the KPI data.

Key Performance Indicators (KPIs) Historical Trend (quarterly, non-cumulative)

(March year-end)	FY18				FY19					
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	YoY (%)	QoQ (%)
Number of active users	961	1,075	1,194	1,293	1,408	1,535	1,642	1,789	38.4	9.0
More than 1,000 registered employees	-	178	188	204	227	242	273	295	44.6	8.1
200~900 registered employees	-	617	699	772	858	944	1,009	1,125	45.7	11.5
100+ registered employees	-	280	307	317	323	349	360	369	16.4	2.5
ARPU (¥000)	94	95	98	102	108	112	117	121	18.6	3.4
Total sales (¥mil)	355	396	439	501	576	635	582	731	45.9	25.6
Recurring revenue (¥mil)	264	297	336	387	443	496	553	611	57.9	10.5
Recurring revenue ratio (% of total sales)	74.3	75.1	76.7	77.1	76.8	78.1	81.0	83.5	+6.4pp	+2.5pp

Source: kaonavi, inc. FY19 earnings presentation material

Performance Within Each KPI:

1) **Number of Active Users:** The number of active users reached 1,798 companies as in March 2020. In 4Q, number of active users grew by 38.4% YoY / 9.0% QoQ. The QoQ growth hit a record level in 4Q. Especially, active user number showed strong growth in companies with 200~900 employees and those with more than 1,000 employees. Some 62.9% of the active users were from companies with 200~900 employees (+45.7% YoY / +11.5% QoQ) and 16.5% with employees with more than 1,000 employees (+44.6% YoY / +8.1% QoQ). Growth in users among larger companies led to rise in ARPU and recurring revenue ratio which will be discussed below.

Breakdown of active users

(unit: Companies)	FY18	FY19				
	4Q	1Q	2Q	3Q	4Q	YoY (%)
Companies with more than 1,000 registered employees	204	227	242	273	295	44.6
% of total active users	15.8	16.1	15.8	16.6	16.5	
Companies with 200 to 900 registered employees	772	858	944	1,009	1,125	45.7
% of total active users	59.7	60.9	61.5	61.4	62.9	
Companies with 100 registered employees	317	323	349	360	369	16.4
% of total active users	24.5	22.9	22.7	21.9	20.6	
Total active user companies	1,293	1,408	1,535	1,642	1,789	38.4

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

2) **ARPU:** FY19 4Q ARPU improved to ¥121,000 (18.6% YoY / +3.4% QoQ). For the full year, ARPU improved from ¥108,000 (1Q) to the current level thanks to an increase in active users with larger number of employees.

3) **Recurring Revenue Ratio:** The recurring revenue ratio rose from 76.8% in 1Q to 83.5% in 4Q. kaonavi provides unique key performance indicators (KPIs) specific to the recurring revenue trend. They are as follows:

   a. *Recurring Revenue Growth Ratio* [*RRGR*]: In FY19 4Q, the RRGR was +57.9% YoY / +10.5% QoQ. By having higher exposure to the larger active users, recurring revenue is expected to steadily grow.

   b. *LTV*[1] / *CAC*[2] (lifetime value of customers divided by customer acquisition costs): This ratio is an important metrics for the SaaS business model and compares the value of customers over their life time to the acquisition costs (not only sales and marketing costs but also associated personnel costs, system usage fees, rent etc). The general assumption of success in the SaaS business model is to achieve an LTV / CAC ratio of at least 3x. The firm has been carefully investing in customer acquisition to ensure the ratio does not fall below 3x. In 4Q, the ratio hit 7.5x, thanks to increase in active users (measured by ARPU) and the low churn rate (one of the LTV variables) of existing customers. Furthermore, the return on investment on customer acquisition became apparent in 4Q, earlier than estimated FY20.

   Investment on customer acquisition through sales and marketing efforts also led to improvement in website conversions (a number of cases when a visitor to kaonavi's website completes desired actions such as downloading materials and filling in a web form). The conversion number is a leading indicator of future new customers and the subsequent increase in sales. Over the past year, the accumulated customer leads rose nearly 3x.

[1] LTV (Lifetime value of customers) = (ARPU / Last 3-month average of MRR churn rate) x Gross profit margin

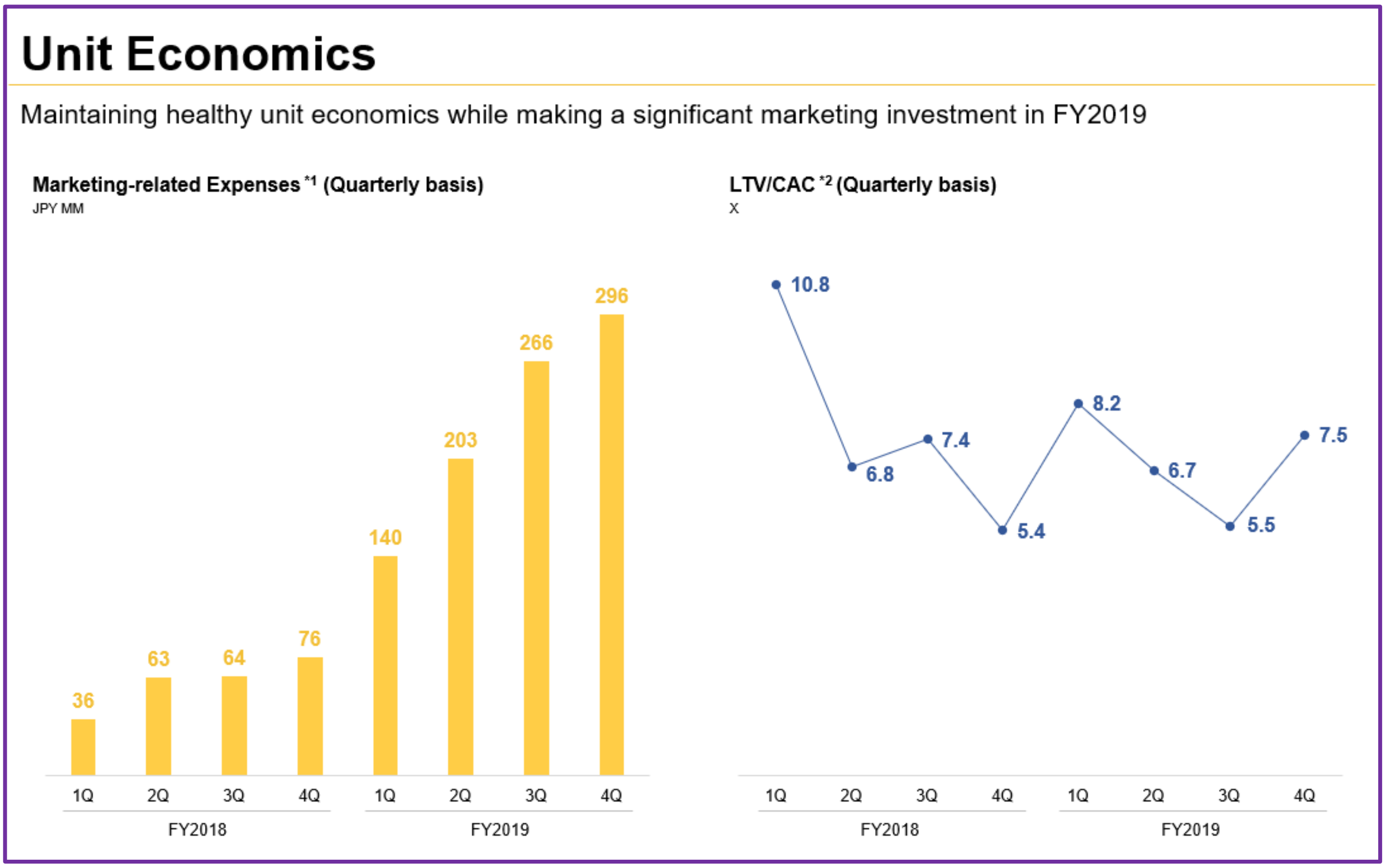
[2] CAC (customer acquisition cost) = Sales & Marketing cost (personnel costs for sales & marketing, customer success and PR, marketing-related expenses, rents, system usage fee, etc.) / # of new customers acquired

Website conversion dipped in 4Q because of impact from COVID-19, although such a dip did not give a big impact on FY19 earnings.

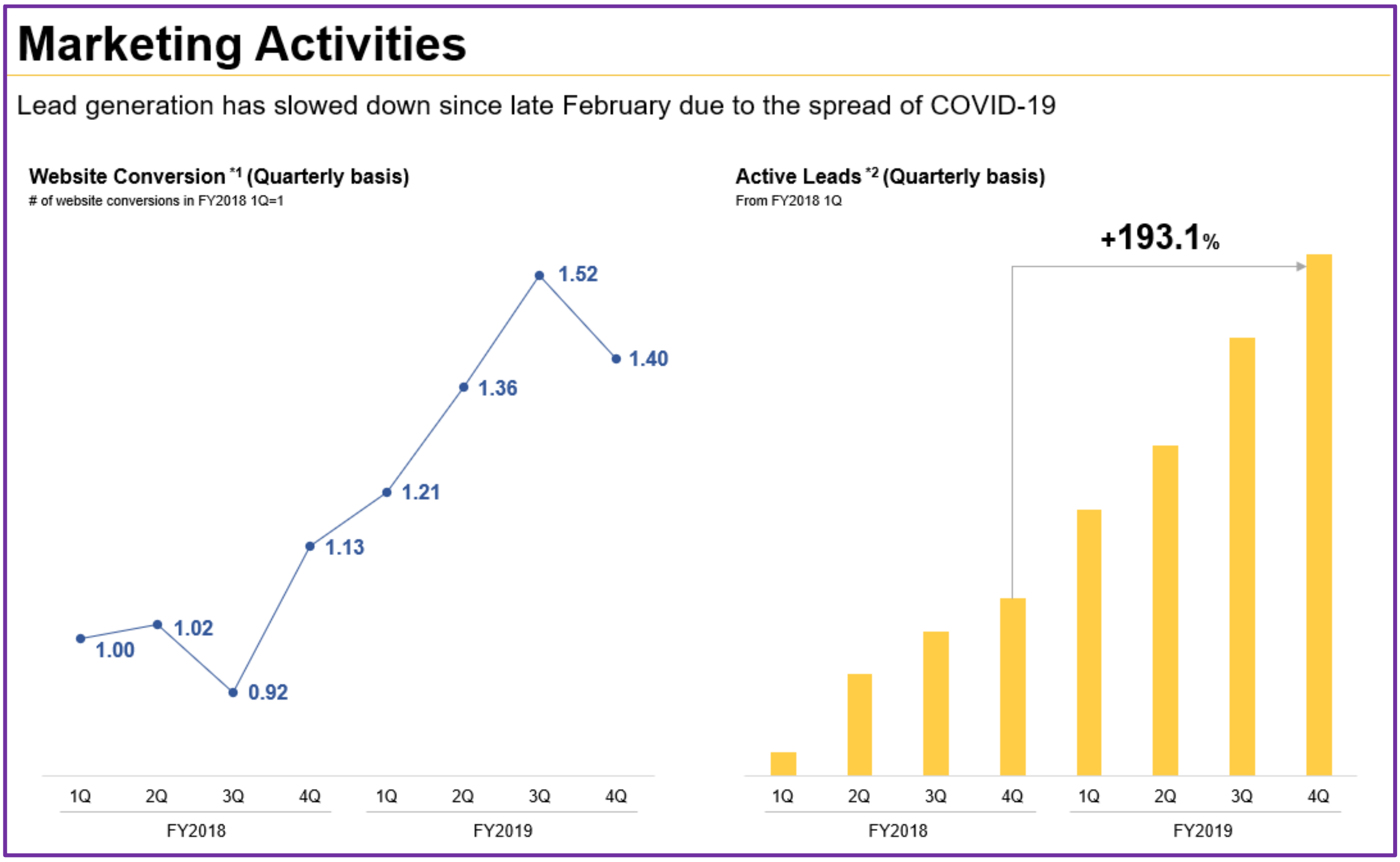
c. *MRR (monthly recurring revenue) Churn Rate:* kaonavi disclosed the MRR churn rate for the first time when it reported FY19 results. In March 2020, the rate dropped to 0.56% from 0.68% in Dec 2019. Again, the decline in the churn rate is associated with the increase in active users with larger numbers of employees as there is a tendency that larger companies are less likely to cancel their subscriptions.

   In general, for B2B SaaS businesses, the ideal annualised MRR churn rate is deemed to be less than 10%. kaonavi's annualised MRR churn rate is proved to be much lower (6.72%) than the 10% ideal.

   Although an apple-to-apple comparison is not possible, comparing the MRR churn rate of the peer of SaaS companies can be useful. Companies such as Sansan (4443 JP) and Chatwork (4448 JP) have MRR churn rates of 0.55% (FY5/20 3Q) and 0.4% (FY12/20 1Q), respectively. Among the HR Tech SaaS company, Atrae (6194 JP) offers Wevox, an employee engagement tool, whose MRR churn rate was 1.0% in FY20 (Sep yr-end) 1H.



Source: kaonavi, inc. FY19 earnings presentation material



Source: kaonavi, inc. FY19 earnings presentation material

FY2020 OUTLOOK AND BEYOND

kaonavi is guiding for a range of FY201H GP of ¥995mil~¥1,160mil (+7.8%~25.7% YoY) on sales of ¥1,420~¥1,600mil (+17.2%~32.1% YoY). It is yet to announce the full-year guidance due to low visibility beyond 1H amid restrictions placed on the effective marketing activities to reach potential customers.

Sales up to 2Q are visible thanks to the high proportion of recurring revenue. The firm assumes 1H recurring revenue growth of between 40.6%~49.2% YoY, based on monthly recurring revenue (MRR) MoM growth estimates. kaonavi estimates the MRR can improve in the range of 0.9~2.2% MoM in 1Q and 1.0~2.7% MoM in 2Q. The most worrying downside risk could be a slowdown in gaining new customers because face-to-face meetings with potential customers have been put on hold due to Covid-19. As a result, the growth of new MRR will likely slow. On the other hand, upselling by existing customers and the low MRR churn rate are likely to continue. kaonavi's active users include those in the leisure and restaurant sector – industries which are the most affected under the current environment. Therefore, the firm assumes lower MRR monthly growth rates under the influence of COVID-19. If there were no such a negative impact, MRR monthly growth would be 3.8% MoM in 1Q and 3.2% MoM in 2Q, respectively.

kaonavi is guiding for a range of -¥80mil~¥120mil at the operating level in FY20 1H. Despite successful marketing investment during FY19, however, it has been put on hold so far this year. This is because unlike last year, when TV commercial marketing proved successful in gaining awareness of potential customers, the same level of return is unlikely to be achieved. After the voluntary closure of cities and businesses in Japan, TV productions have also been suspended. Each TV station, as a result, has been broadcasting old programmes. Although the nationwide state of emergency restriction is now lifted, the resumption of suspended production for broadcasting programmes is assumed to take some time to recuperate production schedules. Those circumstances could potentially reduce the attractiveness of TV as a media for sponsor companies and reduce the value of sponsorship. kaonavi has been researching on the optimal media and cost of investment to reach target population so that it will likely realise the successful investment.

New product functions, such as Pulse Survey launched in Oct 2019 and Dashboard, are enjoying greater usage, especially for large companies. Pulse Survey, for example, was introduced as a tool to detect signs of employee turnover with the addition of scoring data that includes a satisfaction score, a relationship score and a well-being score. This will likely provide useful information for firms in times of remote work. However, it is still premature to see a notable impact to earnings from those functions.

Although FY20 presents uncertainties that could affect kaonavi's growth scenario, its medium to long-term growth target remains unchanged. The aim is to achieve a GMP of 80% and an OPM of 30% on sales of ¥10,000mil (4-year CAGR of ca. 40%) in FY23. To achieve the GPM target of 80%, the firm will improve its cost efficiency so as to earn more revenue without increasing engineering costs.

SHAREHOLDER STRUCTURE

Over the past year, the shareholder structure saw an increase in holdings by institutional investors. Currently, 32.3% of the firm's shares is owned by institutional investors, an increase of 14.9pp YoY. Foreign ownership has risen from 6.9% in FY18 to 14.2% as of the FY19 end. Domestic institution's holdings also increased from 10.5% to 18.1%.

Should the firm aim to move up to the TSE 1st Section from the current TSE MOTHERS, obstacles are likely to be the lack of liquidity of its shares and the number of shareholders.

SHAREHOLDER PROPOSALS AT THE COMING AGM

On 22 May 2020, kaonavi made a press release about the Board resolution on two AGM proposals. Those are:

1. Revision of the remuneration plan for directors.
   The annual cap on total director remuneration is proposed to be revised from the current ¥100mil/annum to ¥300mil.

2. Adoption of the Restricted Stock Award Plan.
   The restricted stock remuneration is proposed so that the firm's directors shall be incentivised to enhance the corporate value and share the value with other shareholders. Awards will be provided in the form of common shares. The total amount of remuneration paid to the eligible directors will be capped at ¥50mil/annum, though is separate from the aforementioned annual remuneration, and a max. 20,000 shares in total.

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