

Financial Results

for the First-half FY2023

Headwaters Co., Ltd.

August 18, 2023

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01 — The History of Headwaters

- Past
- Present
- Future



Name	Headwaters Co., Ltd.
Established	November 2005
CEO	Yosuke Shinoda
Head office	Shinjuku-I-Land 4F 5-1, 6-chome, Nishishinjuku, Shinjuku-ku, Tokyo
Capital	367,773 thousand yen
Number of employees	148 including contract employees

* As of June 30, 2023

ISMS (ISO/IEC 27001:2005/JIS Q 27001:2006) certified



**Becoming
the center of industry,
headwaters.**

Engineering × Business = ∞

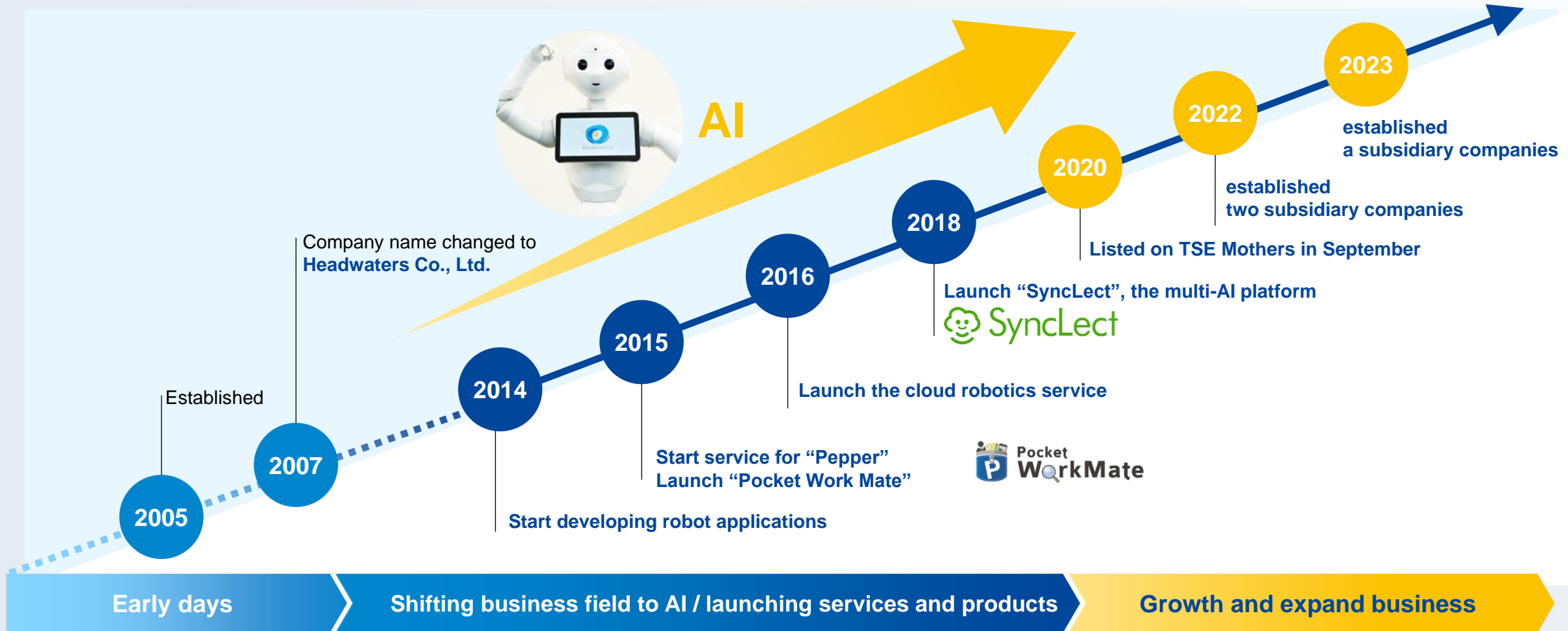
**Implement new technology
to the society**



私たちは持続可能な開発目標 (SDGs) を支援しています。

▶ Our Commitments since 2005

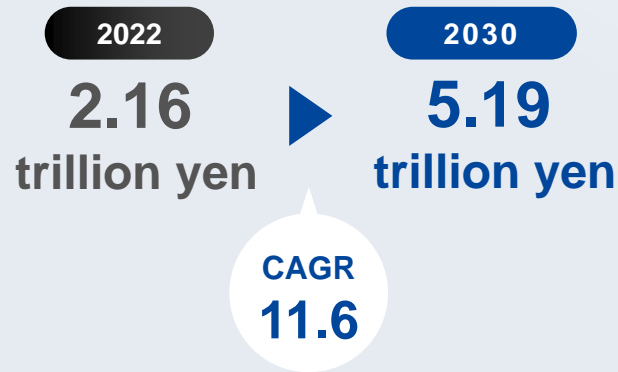
We are a front-runner with abundant data accumulated since the early days of AI, analytical methods, and development capabilities.



▶ The Market Environment

The demand for DX and AI utilization has increased significantly due to the decreasing workforce resulting from the aging population. Especially, the expansion of municipality DX is expected. As the market growing, the shortage of human resources related to AI/DX will be concerned.

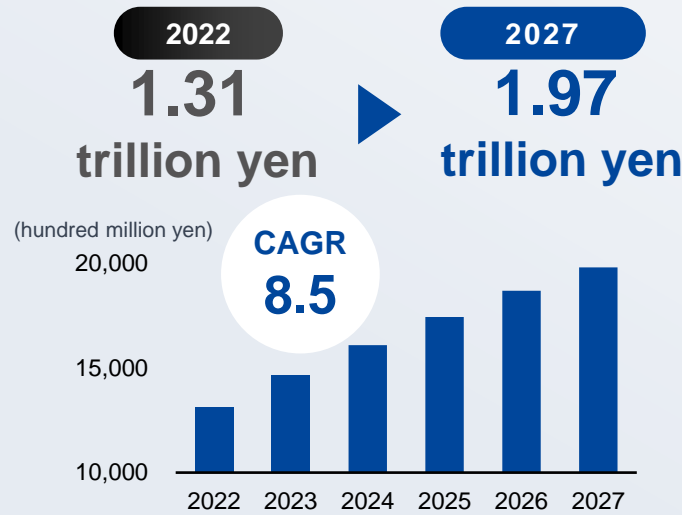
The DX Market in Japan



Industry-specific DX Market

	CAGR
Manufacturing DX Market	11.2
Retail DX Market	16.8
Transportation/Logistics DX Market	13.5
Real Estate DX Market	12.4
Municipality DX Market	19.0

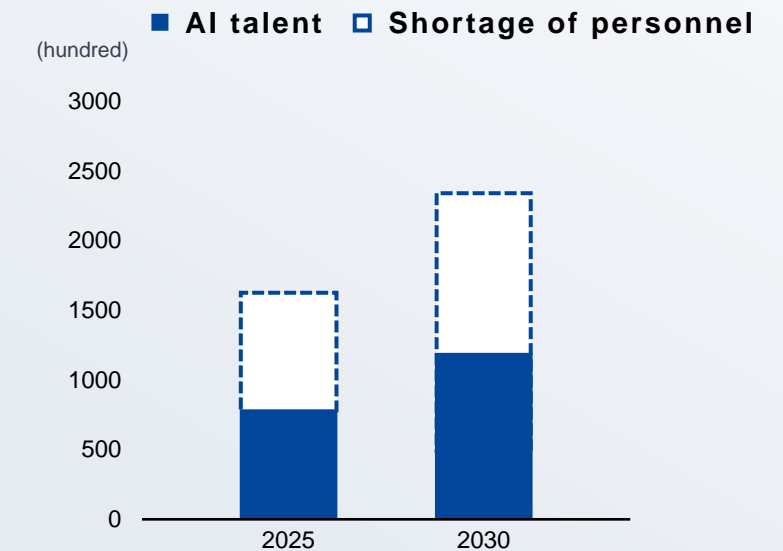
The AI market in Japan



AI Business Market

	CAGR
Service Market	8.2
Application Market	8.4
Platform Market	9.0

Shortage of AI Talent

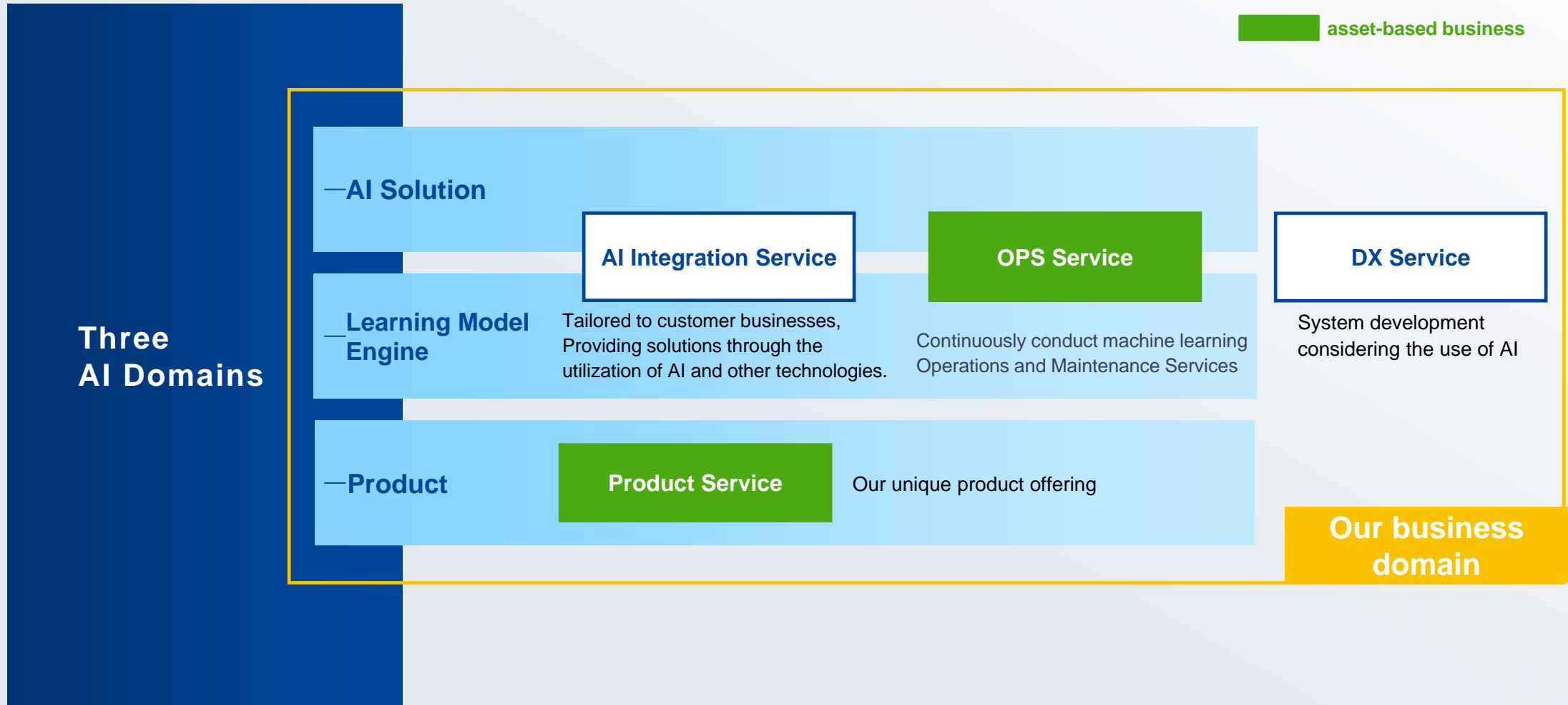


Source: Based on the "2022 Artificial Intelligence Business Comprehensive Survey" and "Future Outlook of the 2022 Digital Transformation Market" by Fuji Chimera Research Institute Co., Ltd., as well as the survey on IT personnel supply and demand by Mizuho Information & Research Institute, Inc. conducted and compiled by our company.

▶ Our Business

Offering services by synergistically combining three AI domains

cash flow business
 asset-based business

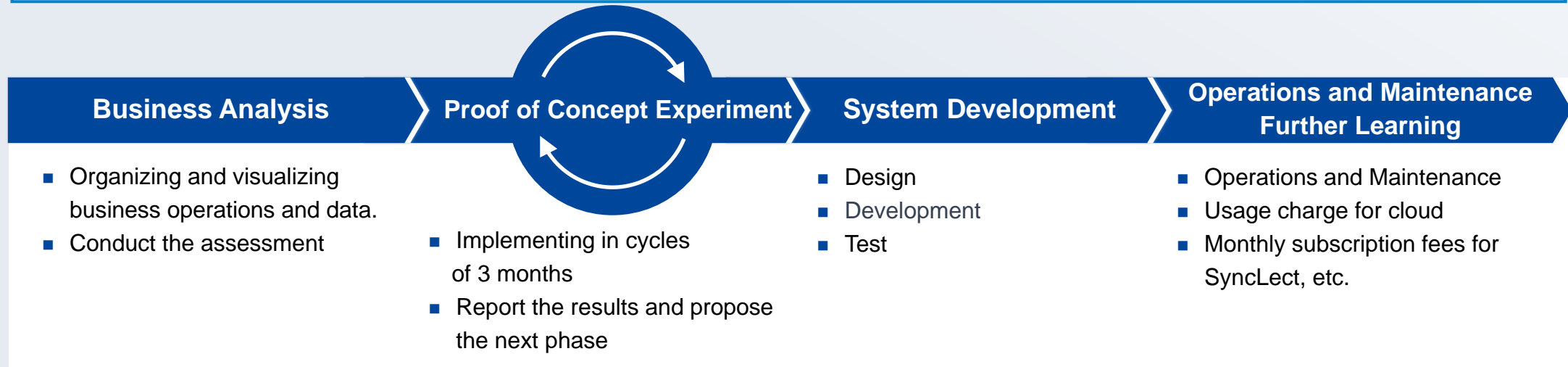


▶ AI Integration Services

After engaging in extensive communication with our customers, we deliver a highly practical system with 'end-to-end' functionality.

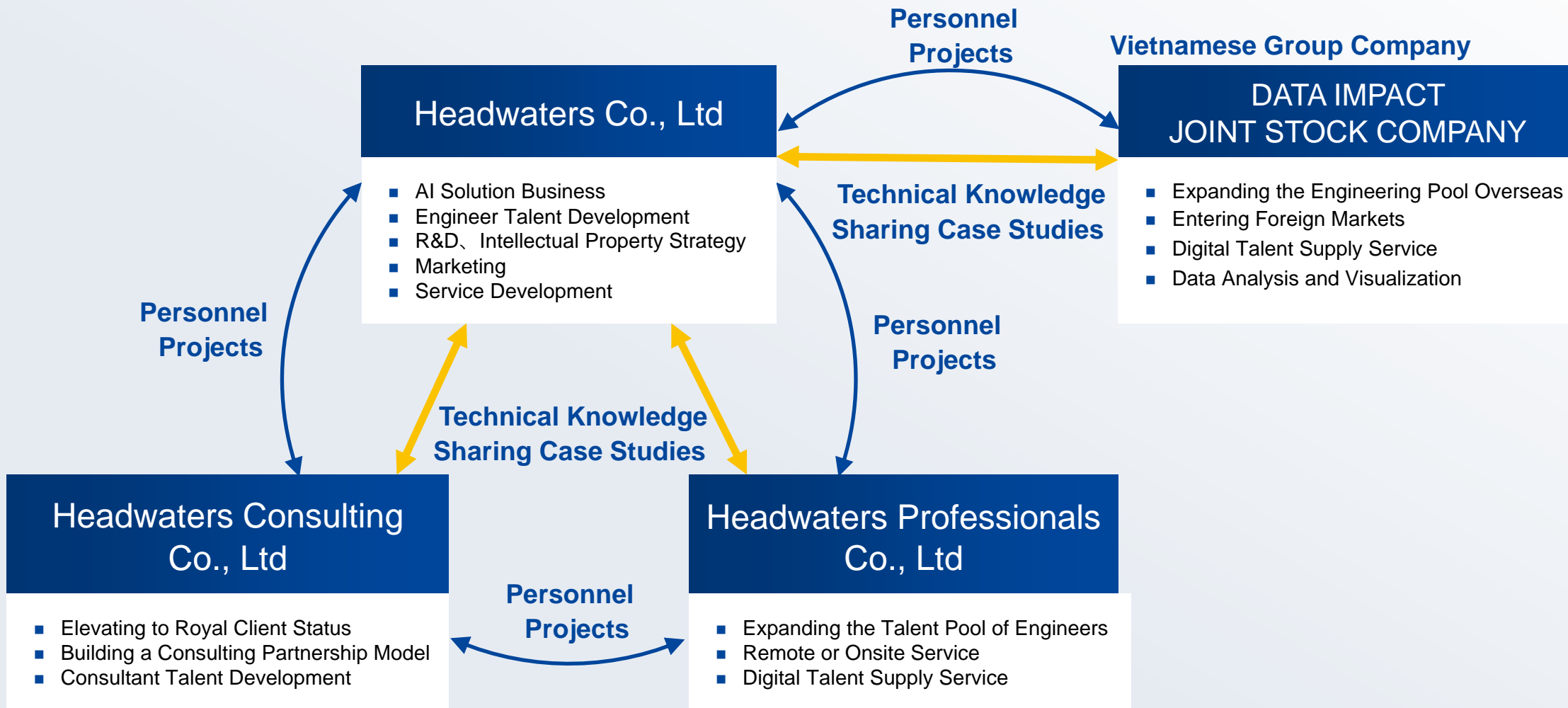
The key points

- To prevent any misunderstandings with the customer, we repeat the processes of business analysis and conducting proof-of-concept experiments.
- To prevent contract disputes, it is advisable to enter into a quasi-delegation contract rather than a subcontracting agreement.
- In a PoC, we identify challenges through trial operations and strive for implementation suitable for production use.



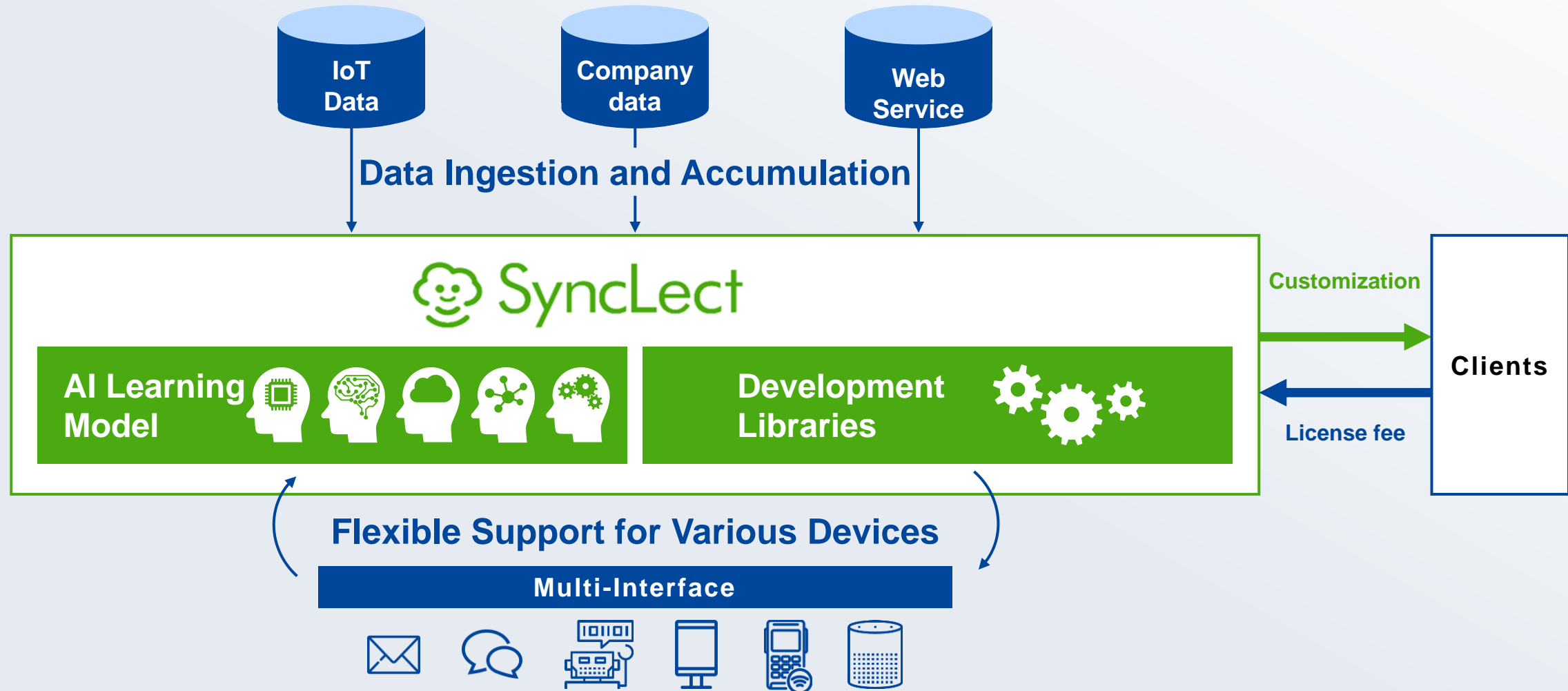


The Role of Group Companies



▶ Utilizing “SyncLect” Components

"AI + IoT + Big Data Development & Operation Platform" that enables parts to be reused. It enables to deliver system as a customer asset by utilizing our knowledge component.





Our Achievements toward “Super City Initiative”



J-Tech challenges SDGs

Healthcare & Community

- Online medical care cloud app
- Rehabilitation AI
- Regional disaster prediction solution
- UI for digital divide

Logistics AI /DX

- Ride allocation planning AI
- Routing analysis
- Space analytics

Mobility

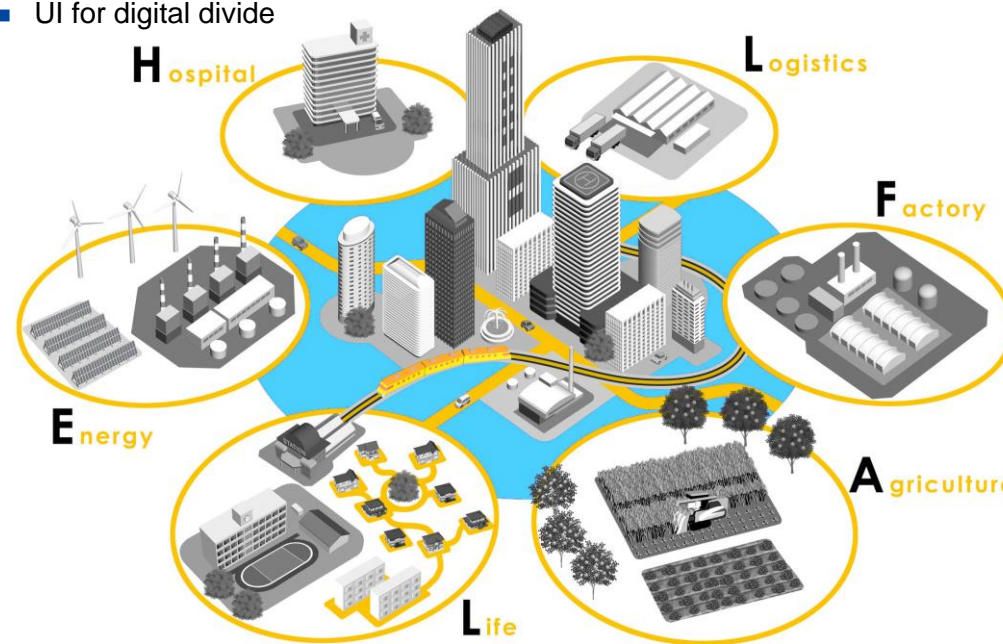
- Image analysis for mobility
- Smart glasses
- 5G solutions

Smart Store

- Facial recognition payment platform
- Smart speaker payment
- Dynamic pricing
- In-store purchase behavior analysis

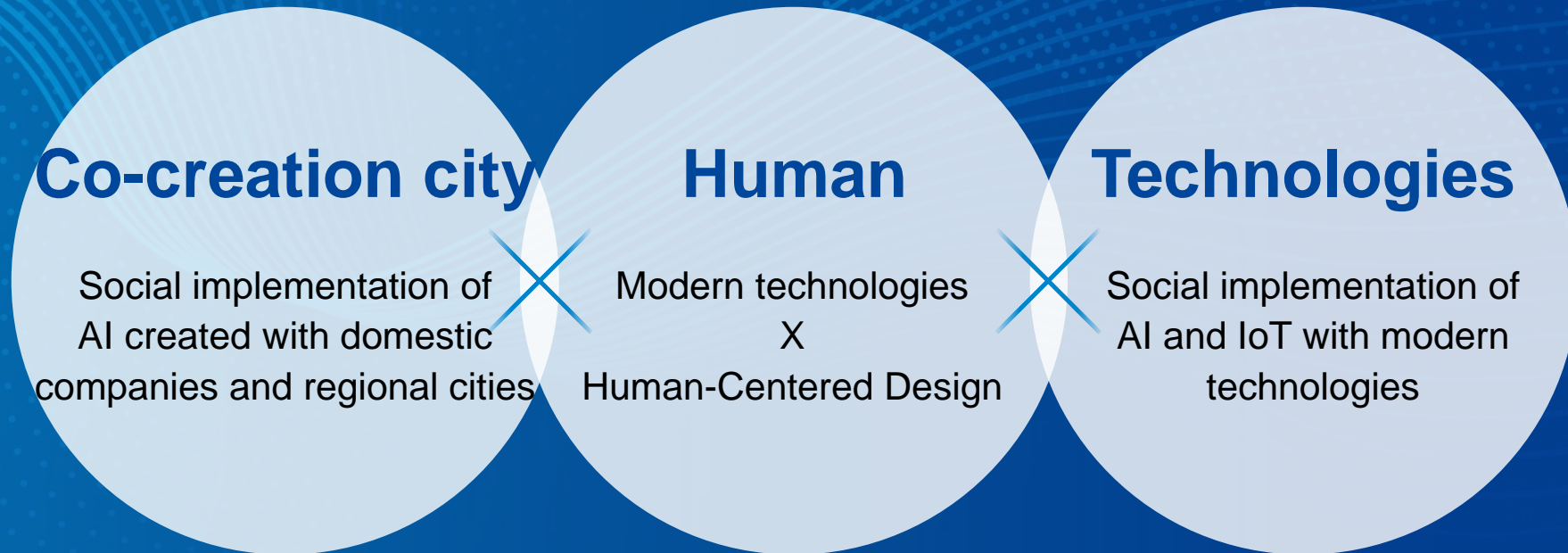
Smart Building

- Detection of lost items in restroom
- Congestion visualization service
- Digital twin



Social implementation of AI technologies

Achieving Society 5.0



02 — Highlight of FY2023 H1

- **Accomplishment**
- **Improvement**



FY2023 2Q Consolidated Financial Results

(thsnd yen)

(thsnd yen)

	FY2022 2Q Cumulative		FY2023 2Q Cumulative			
		Composition Ratio (%)		Composition Ratio (%)	YoY Comparison (%)	Annual Budget Attainment Rate (%)
Net sales	645,895	100.0	1,158,212	100.0	179.3	54.9
AI	167,631	25.9	462,805	40.0	276.1	56.4
DX	360,762	55.8	523,936	45.2	145.2	55.0
Product	44,803	6.9	53,171	4.6	118.7	44.6
OPS	72,698	11.2	118,300	10.2	162.7	54.6
Operating profit	1,529	0.2	46,724	4.0	3,054.3	38.8
Ordinary profit (Loss)	△7,410	—	47,857	4.1	—	38.3
Net profit (Loss)	△8,774	—	30,069	2.5	—	34.7
Profit attributable to owners of parent (Loss)	△8,774	—	30,166	2.6	—	34.8
Net income per share	△4.69 yen		16.11 yen			

Net Sales

1,158,212 thsnd yen

- YoY Comparison

179.3%

- Annual Budget Achievement Rate

54.9%

All-time High

<Accomplishments>

- There was a significant increase in year-end budget consumption projects from enterprise companies in the 1Q.
- The implementation of the alliance strategy obtained large accounts, which changed the layer of clients led to the increase of unit price.
- Driving multiple large-scale projects and the Net Sales increased compared to the same period last year (YoY) in all service category.
- The two group companies established in FY2022 have been growing steadily.
- Sales is progressing with a 20% increase over our sales plan.

< Things that did not go as planned >

- Opportunity loss in operations due to unprofitable projects in the 2Q.

Operating Profit

46,724

thsnd yen

- YoY Comparison **3,054.3%**

- Annual Budget Achievement Rate **38.8%**

<Accomplishments>

- The gross profit amount has reached a new record high for two consecutive quarters (2H FY 2022, 1H FY 2023).
 - ➔ Gross Profit: 395 million yen, 146.9% YoY
- Costs were incurred for recruitment and training, leading to an increase in SG&A expenses. However, progress is on track as planned.
 - ➔ SG&A Expenses: 348 million yen, 130.3% YoY
- The acquisition of large accounts has resulted in an increase in the average sales per company.
 - ➔ Average sales per company: 6.54 million yen, 183.4% YoY

<Things that did not go as planned>

- Operating loss of 14.55 million yen in the 2Q
- The increase in COGS
 - ➔ COGS: 762 million yen, YoY Comparison 202.5%
 - ➔ The allocation of personnel resources during the new project launch phase.

Ordinary Profit

47,857 thsnd yen

- Annual Budget Achievement Rate 38.3%

<Accomplishments>

- Non-operating income: Income of approximately 1.1 million yen generated from subsidies

Others

<Improvement>

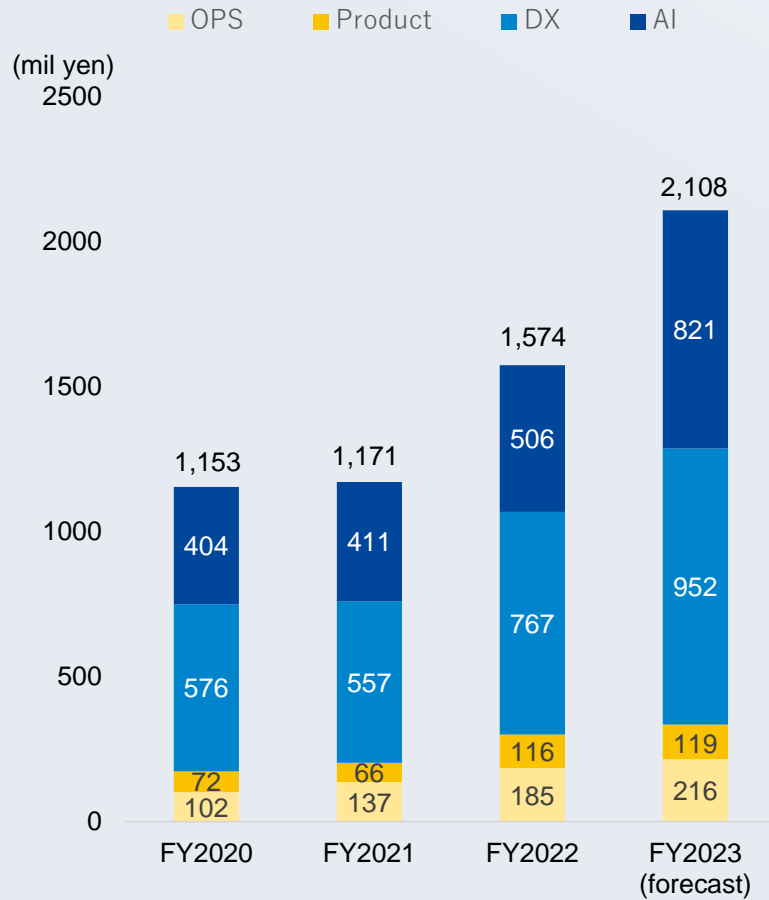
- The hiring process is progressing smoothly, and the number of employees has reached an all-time high.
 - ➔ The number of employees (as of the end of June 2023): 148 employees
 - ➔ Net increase of 35 employees across the entire group of companies.
- Collaboration is underway due to the establishment of overseas subsidiary.
 - ➔ Received a medal in the Kaggle competition!



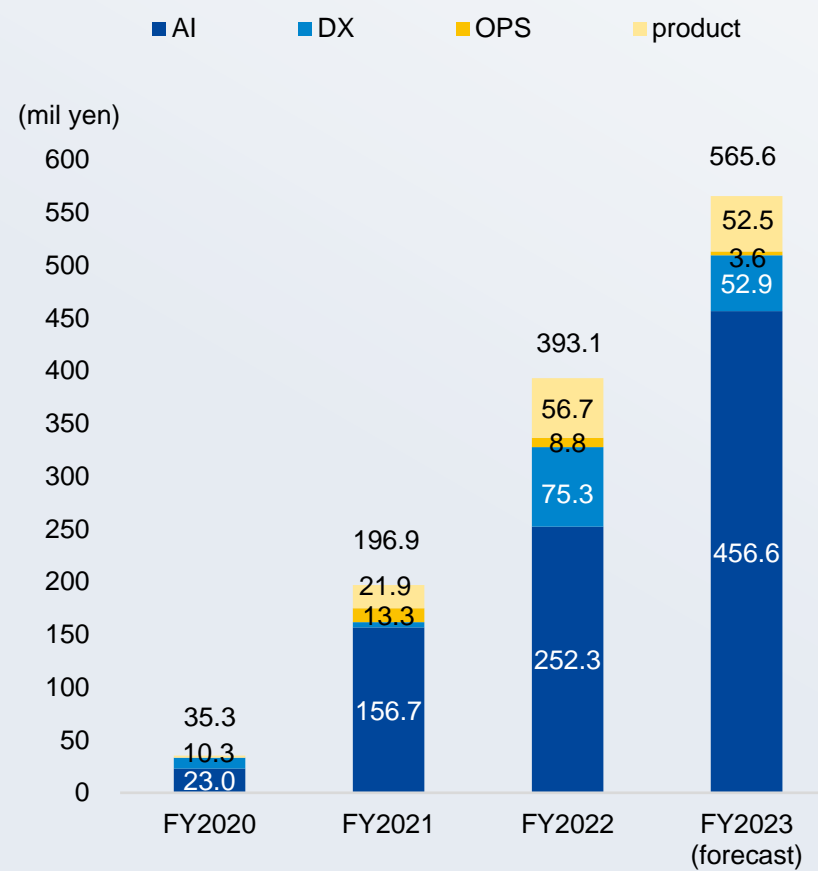


KPI-1

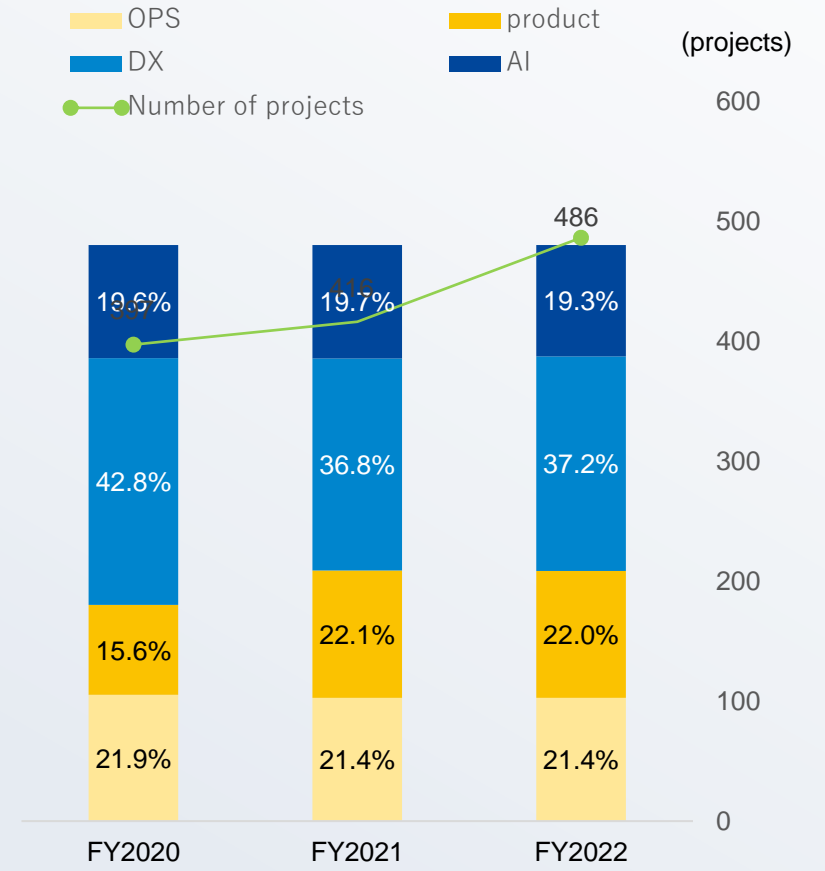
Net Sales by Service



Alliance Strategy-Related Revenue

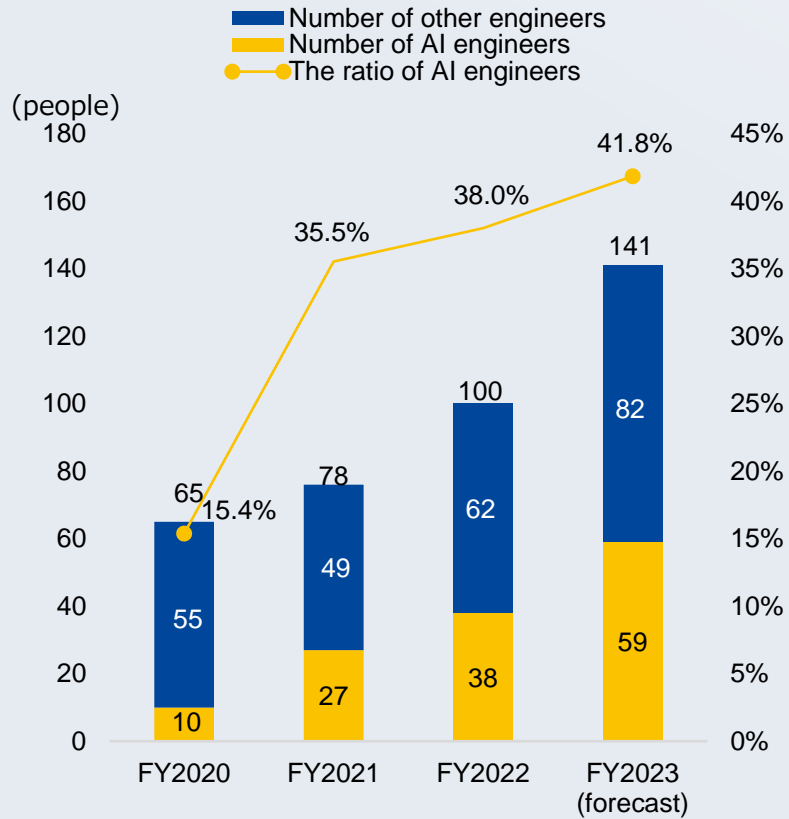


The number of implemented projects and the ratio of projects by service

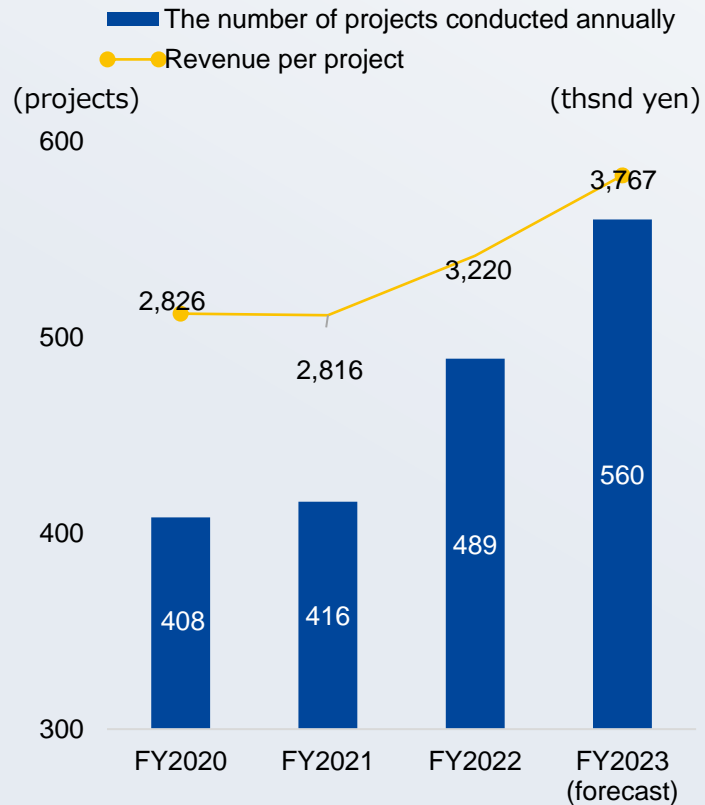


*The figures have been consolidated, including group companies, since FY2022 4Q

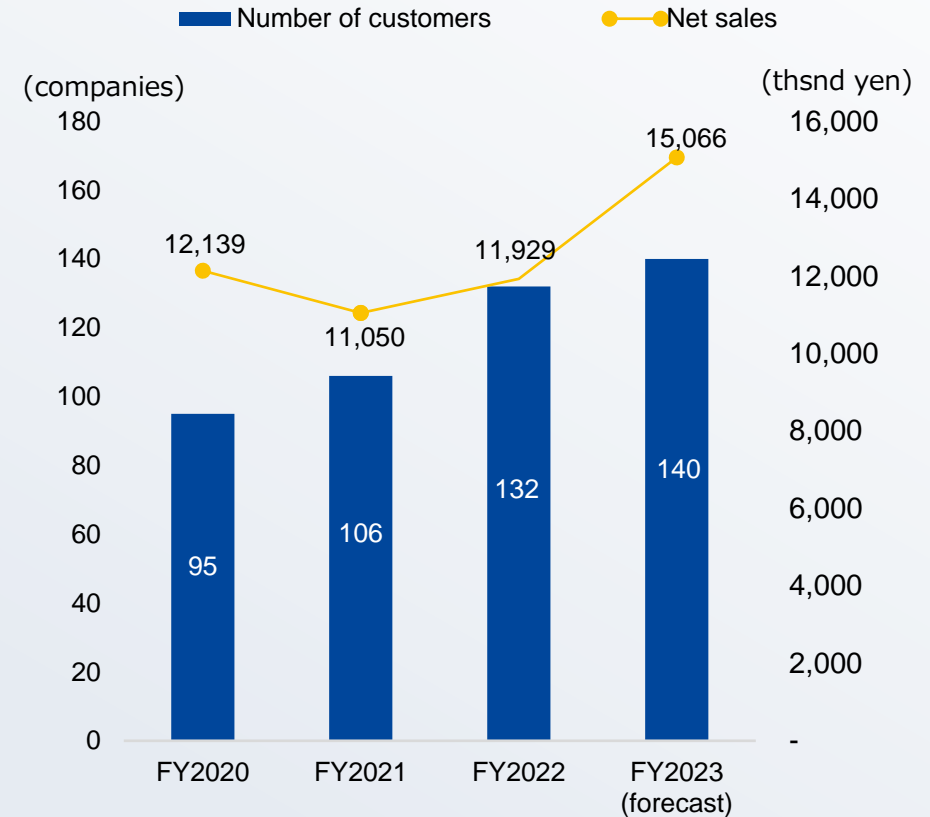
The evolution of the number of AI engineers



Revenue per project



Annual revenue per company



*The figures have been consolidated, including group companies, since FY2022 4Q

▶ The Progress of the Growth Strategy

Short term

Address DX Needs

- Address both projects and talent education for DX needs
- Increasing collaborative projects

Utilization of External Resources

- Rapid expansion in our revenue through alliance strategy
- Strengthened collaborations with major companies, such as Microsoft

(Reference: KPI-1)

- Net sales by service category
- The number of implemented projects and the ratio of projects by service

(Reference: KPI-1,2)

- Alliance Strategy-Related Revenue
- Annual revenue per company

Medium to Long-Term

Increasing Revenue in Asset-based Business

- Improving the ratio towards establishing a solid revenue foundation.
- FY2023 1H: Asset-based business is 170 million yen

New Revenue Streams

- R&D for new technologies
- Development of our in-house service
- Driving our intellectual property strategy

(Reference: KPI-1)

- Net sales by service category

Microsoft Intelligent Cloud

- Microsoft Solution Partner certification
- Azure OpenAI RA Partner
- Microsoft Enterprise Accelerator GovTech

We will promptly catch up with the cutting-edge technologies offered by various companies and implement them for our clients.

Technologies / Knowledge



**Certified Solution Provider
for Global Technology Companies**

Social implementation
of new technologies

Technologies / Knowledge

SONY Sensing Technology

- Edge AI Sensing Platform "AITRIOS"
- Intelligent Vision Sensor "IMX500"
- Sony's wireless communication standard "ELTRES IoT Partner"

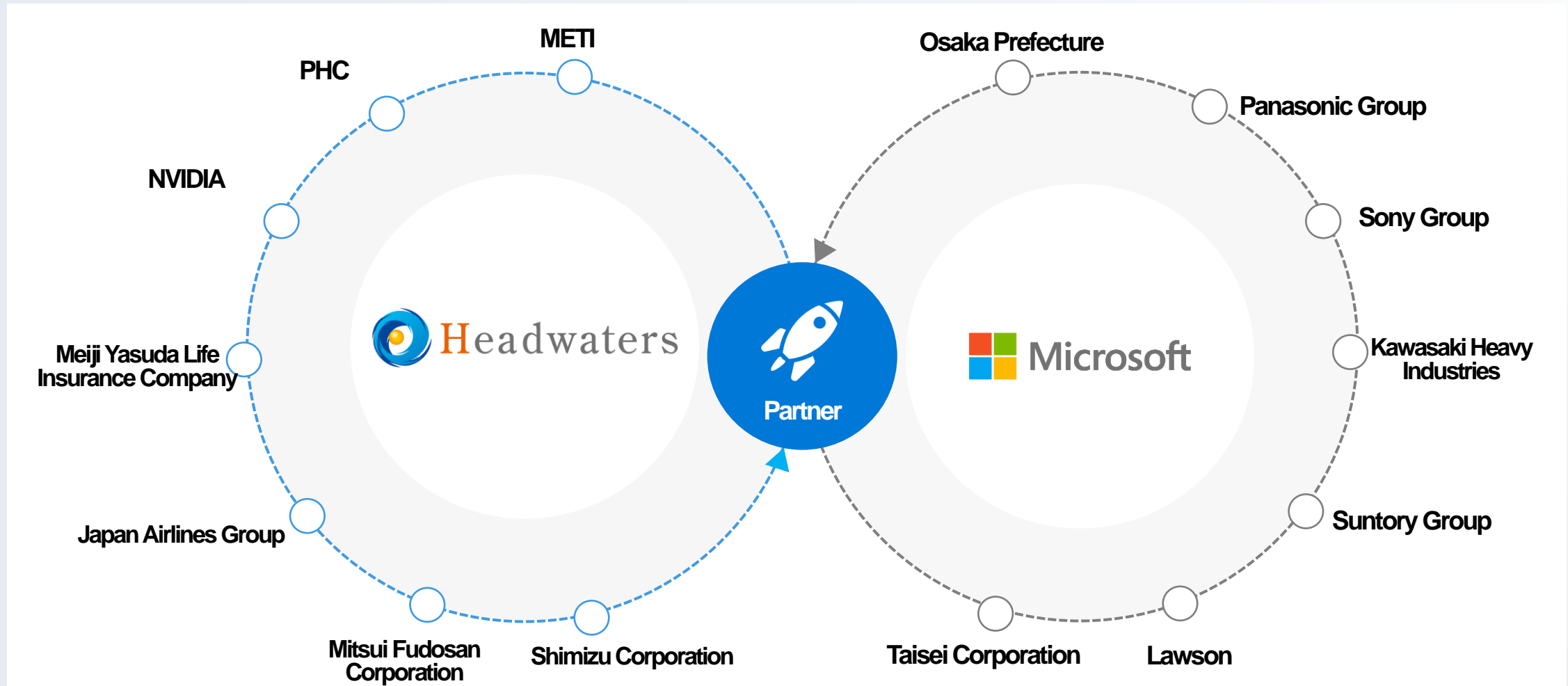
Technology · Knowledge

NVIDIA Supercomputer

- NVIDIA Metropolis Partner Program certification
- NVIDIA Omniverse Partner Council certification
- NVIDIA DX Acceleration Program

▶ Alliance Strategy : Collaboration with Microsoft

Accelerating business by leveraging Microsoft's customer base and technology along with our own customer base and technical expertise and building an ecosystem through "Joint Sales x Joint Marketing x Joint Solutions".



Part of Our Clients by Industry

(* Note: Asterisk denotes a new client acquired within the past year.)

Manufacturing

- Sony Corporation
- YKK Corporation *
- Mitsubishi Materials Corporation *
- ROHM Co., Ltd. *
- Toyota Tsusho Corporation *
- Asahi Kasei Corp. *
- Lion Corporation *
- Kawasaki Heavy Industries, Ltd.

Wholesale / Logistics

- Tokyo Seika Co., Ltd.
- ALPS LOGISTICS CO., LTD.*

Travel

- Japan Airlines Co., Ltd.
- Keio Corporation*

Retail / Food

- Sapporo Holdings Limited
- J-OIL MILLS , INC.
- Suntory Spirits Ltd. *
- TO EN, LTD. *
- Nisshin Flour Milling Inc. *

Construction / Real Estate

- TAISEI CORPORATION *
- SHIMIZU CORPORATION
- Mitsui Fudosan Co., Ltd.

IT Industry

- SoftBank Corp.
- NTT DATA Japan Corporation *
- Sony Network Communications Inc. *

Finance / Insurance

- Meiji Yasuda Life Insurance Company
- Seven Bank, Ltd. *

Retail

- Village Vanguard Co., LTD.
- Lawson, Inc.
- Pan Pacific International Holdings Corporation
- BICCAMERA INC. *
- SEVEN-ELEVEN JAPAN CO.,LTD. *
- NITORI Co., Ltd. *

Government / Public Sector

- Ministry of Economy, Trade and Industry
- Osaka Prefecture
- Kobe University*

Part of our Alliance Partners

- Sony Corporation
- Intel Corporation
- SECURE, INC.
- Microsoft Japan Co., Ltd.
- Scenera, Inc.
- Sony Network Communications Inc.
- NVIDIA Corporation
- MACNICA HOLDINGS, INC.
- CHANGE Holdings, Inc.

03 — Challenges and Strategies

▶ Future Initiatives

Increase of Sales

- Acquisition of large accounts
 - ▶ By strengthening our consulting team, we leverage the advantage of being our one-stop solution
 - ▶ Strengthening alliances

Improvement of Profit Margin

- Strengthening the stock-based business, including the licensing mode
- Increasing profit margins through the utilization of SyncLect

Stabilization of Revenue

- Expanding recurring business through team development under a lab-type contract
- Improvement of sales ratio in the stock-based business

Talent Acquisition

- Continuous talent recruitment, including three affiliated companies within the group
 - ▶ Enhancement of internal systems
 - ▶ Talent acquisition through M&A

Enhancement of Employee Benefits

- Engineers with a wide range of technical skills
 - ▶ Reviewing the salary system for each group company
 - ▶ Enhancement of welfare benefits

Challenges for companies in utilizing ChatGPT

When specialized for corporate use

- Security concerns
- Lack of familiarity with the latest information
- Lack of standardized or organized prompt management
- Character limits when using ChatGPT API
- Inability to reference internal company knowledge (documents in Excel, Word, PDF, etc.)
- Request for training on company-specific public information via URL
- Less GPT training accuracy in Japanese compared to English

Proprietary Generative AI Solution Service

SyncLect Generative AI

About SyncLect Generative AI

- Convenient feature set for further leveraging GPT.
- Quick and cost-effective implementation after resolving challenges.
- Azure OpenAI Service GPT-4 and ChatGPT API accessible to non-technical users



▶ Generative AI (Example-1)

Support for Integrating ChatGPT into Project Management Tools

Support Description:

Utilizing Azure OpenAI Service leads to **more efficient project management operations.**

Tasks:

Selection, integration, and optimization of relevant data
validation of prompt engineering methods.

Duration:

3 months

Team Size

3 people

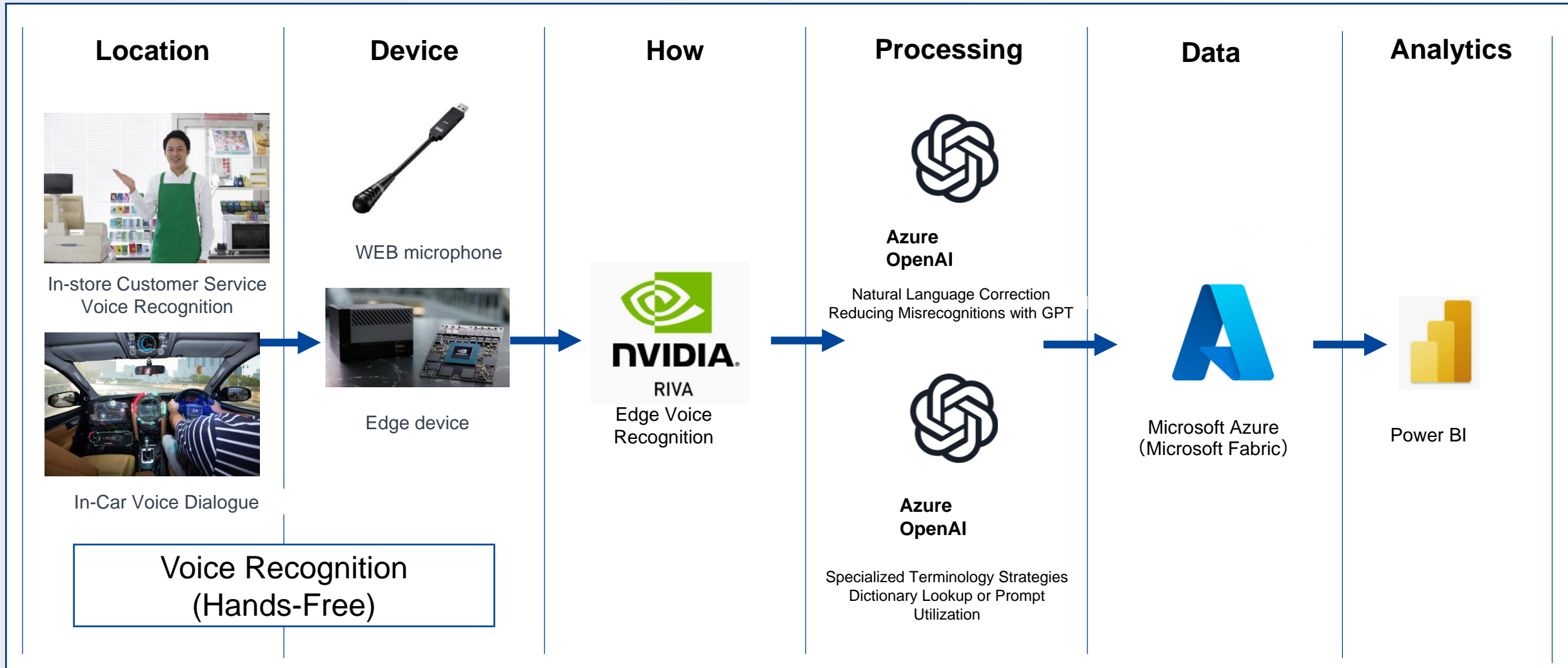
Outcome:

Implementation of a secure ChatBot that can provide responses exclusively for project management issues and guidance on tool utilization.



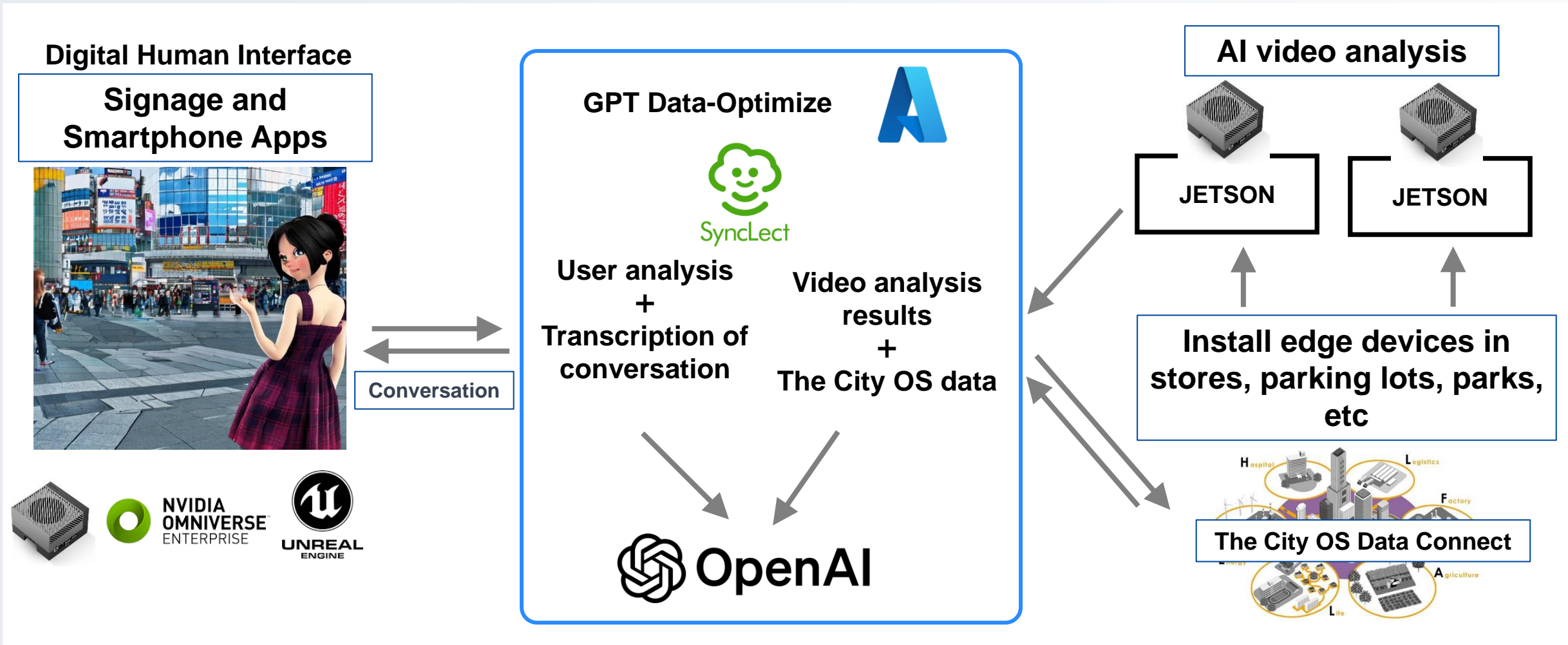
▶ Generative AI (Example-2)

Speech Recognition with NVIDIA Edge x Azure OpenAI Service



▶ Generative AI (Example-3)

Smart City: Accessing real-time data integrated with the City OS by interacting with animations and engaging in conversations displayed on signage and smartphone apps.



▶ The Achievement in Generative AI

Inquiries and orders for generative AI development have been steadily increasing.

Inquiry

Inquiry **41** inquiries


order **9** orders

* Results for the past 3 months
* Major enterprise companies are counted.

Our solution

- Prompt Engineering Lab Service
- SyncLect GenerativeAI Service
- Azure OpenAI Service PowerApps bot
- Azure OpenAI Service WebUI bot

Alliance Case Studies



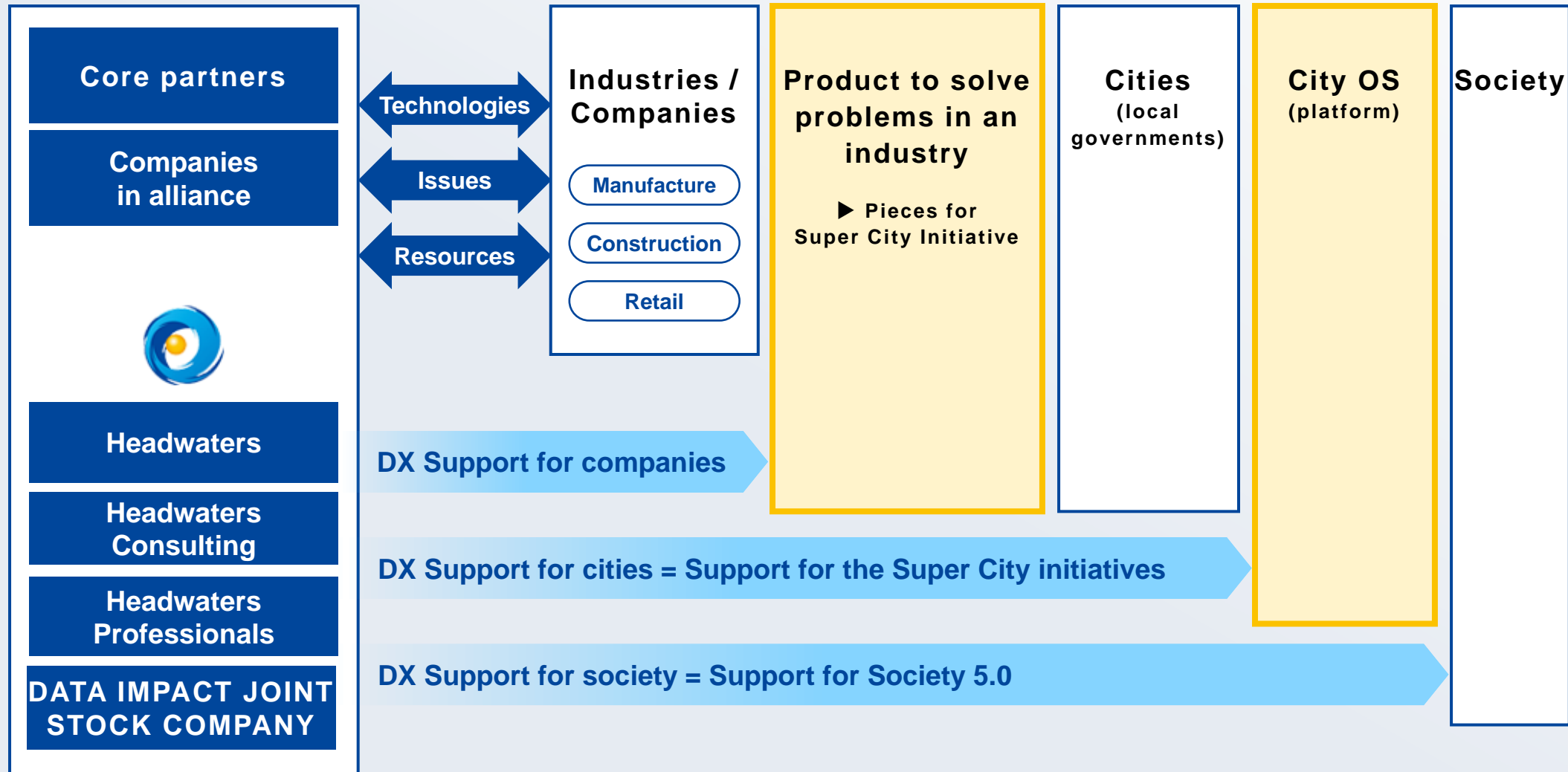
Azure OpenAI Service
Reference Architecture

**Microsoft's Azure OpenAI Service
Alignment with Reference Architecture Partners**



The technical capabilities of Headwaters
×
The natural language processing expertise of Rinna

Developing a foundation to enable close communication with industries and companies for Society 5.0



▶ **Strategic Scenario for Society5.0**

Scenario for developing a successful model for our AI and DX-related businesses

**DX for
In-house**

**DX for Companies /
Industries**

**DX for Cities
(Super City Initiative)**

**DX for Society
(Society 5.0)**

AI / IoT /
Big data

AI / IoT /
Big data

AI / IoT /
Big data

**Our capability to achieve DX as social deployment of
cutting-edge technologies in each phase**

Consultation / UX



Modern technology centered on AI

— Appendix



Consolidated Balance Sheets

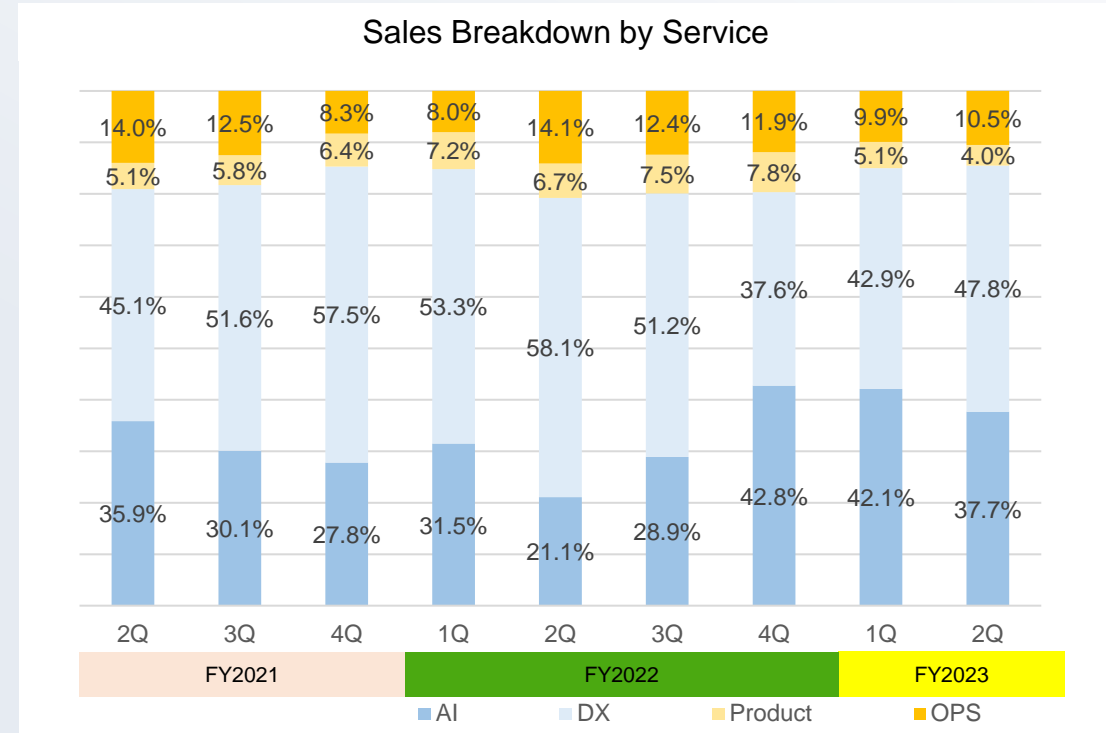
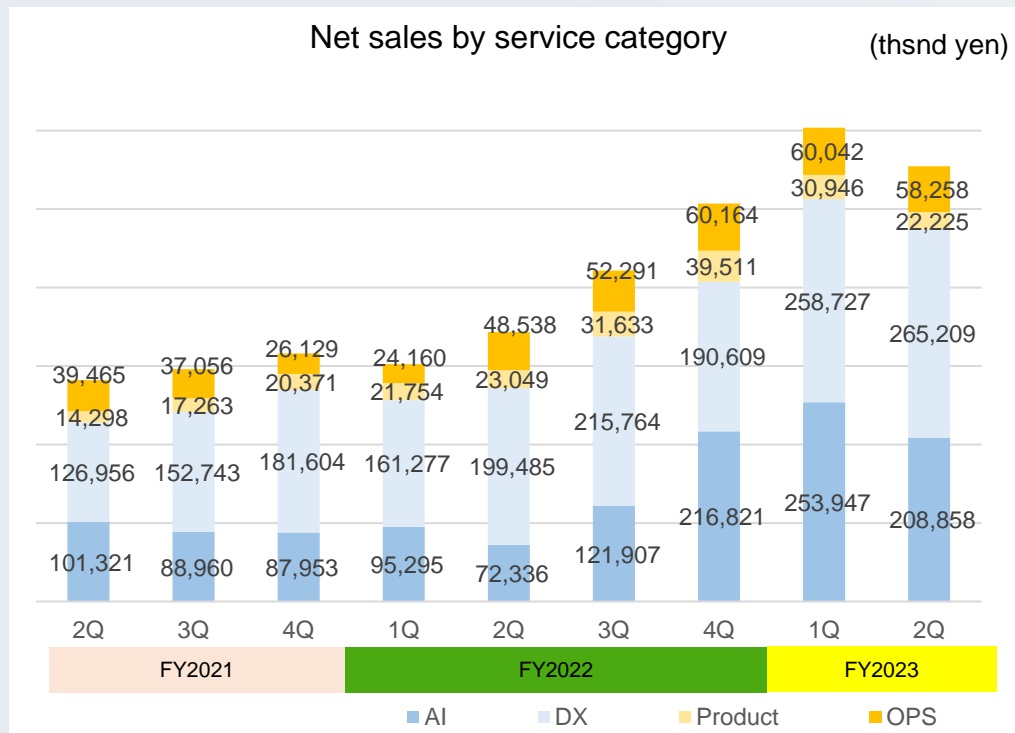
(Thousand yen)

	30 Jun 2022		31 Dec 2022		30 Jun 2023	
	Results	Composition Rate (%)	Results	Composition Rate (%)	Results	Composition Rate (%)
Current assets	918,375	92.9	1,103,103	94.3	1,215,155	94.6
(Cash and deposits)	748,571	75.7	818,610	70.0	846,087	65.8
(Account receivable-trade)	152,808	15.5	265,526	22.7	327,191	25.5
(Other)	16,993	1.7	18,965	1.6	41,875	3.3
Non-Current assets	70,255	7.1	66,138	5.7	69,812	5.4
(Property, plant and equipment)	26,946	2.7	26,347	2.3	31,399	2.4
(Intangible asset)	6,904	0.7	16,881	1.4	15,541	1.2
(Other)	36,373	3.7	22,909	2.0	22,871	1.8
Total assets	988,600	100.0	1,169,242	100.0	1,284,968	100.0
Total liabilities	197,076	19.9	293,799	25.1	369,380	28.7
(Current liabilities)	197,076	19.9	293,799	25.1	369,380	28.7
Total net assets	791,524	80.1	875,442	74.9	915,587	71.3
Total liabilities and net assets	988,600	100.0	1,169,242	100.0	1,284,968	100.0

▶ The Transition of Sales

The net sales achieved the second-highest and the DX business segment reached the record high in sales.

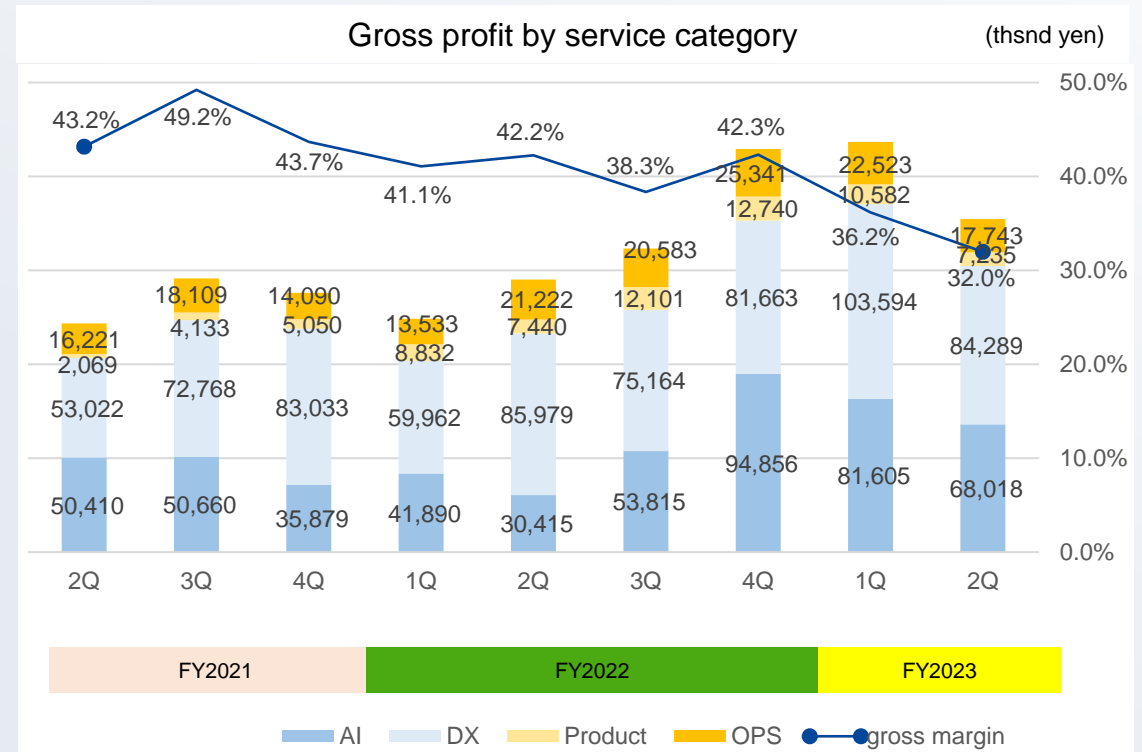
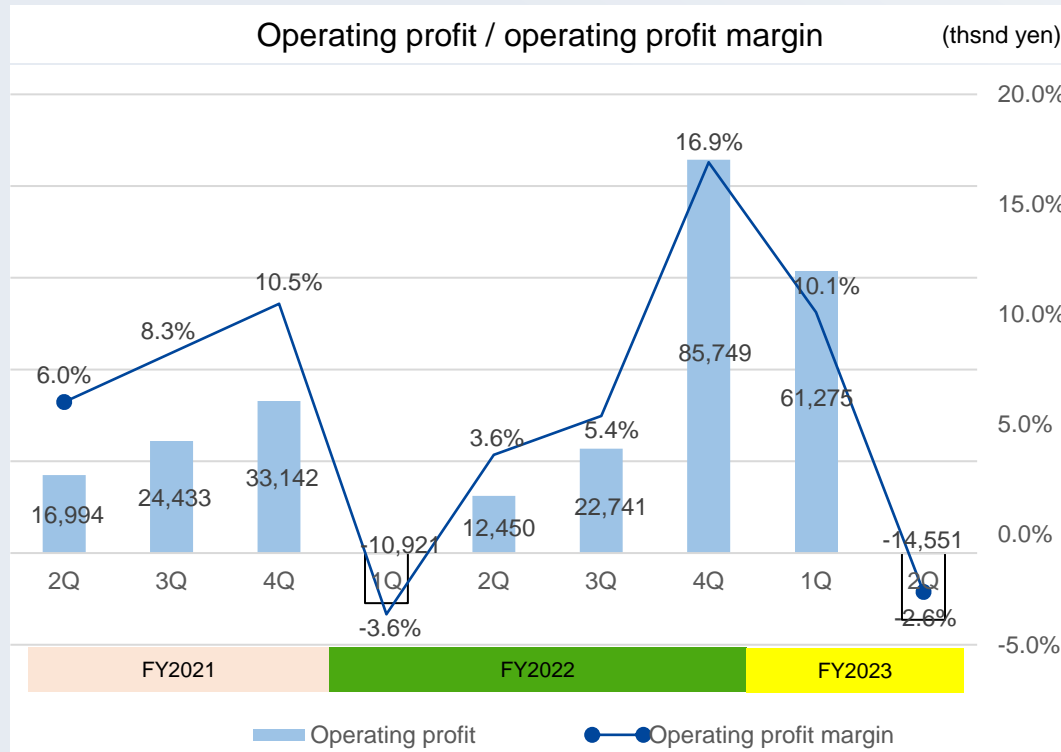
Some unprofitable projects led to the opportunity loss in business.



The Transition of Operating Profit / Gross Profit by Service

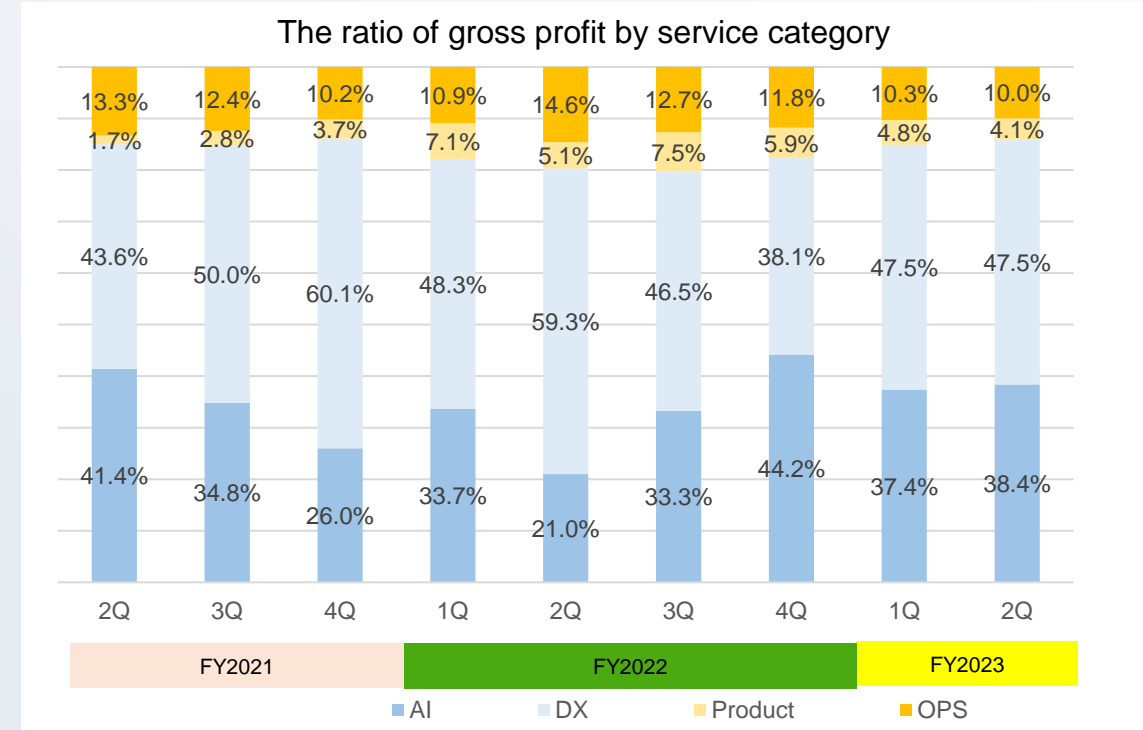
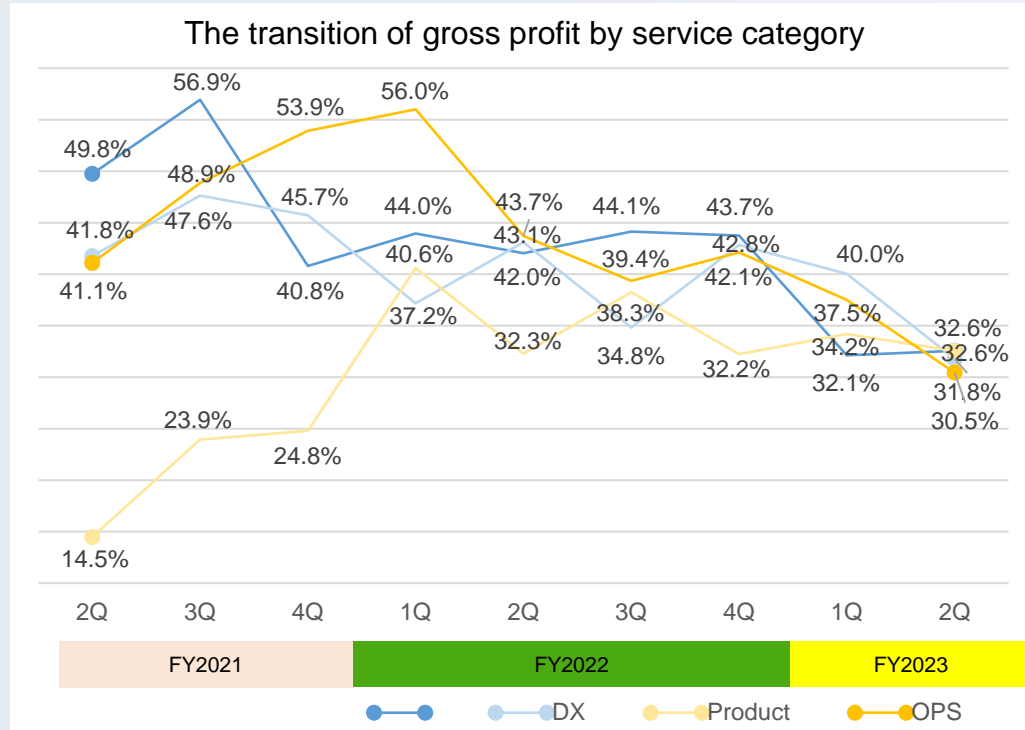
In addition to some unprofitable projects, an increase in OJT projects due to steady recruitment and a rise in the partner ratio led to a decline in profit margins.

Gross profit achieved 122.2% compared to the same quarter of the previous year.



▶ The Transition of Gross Profit

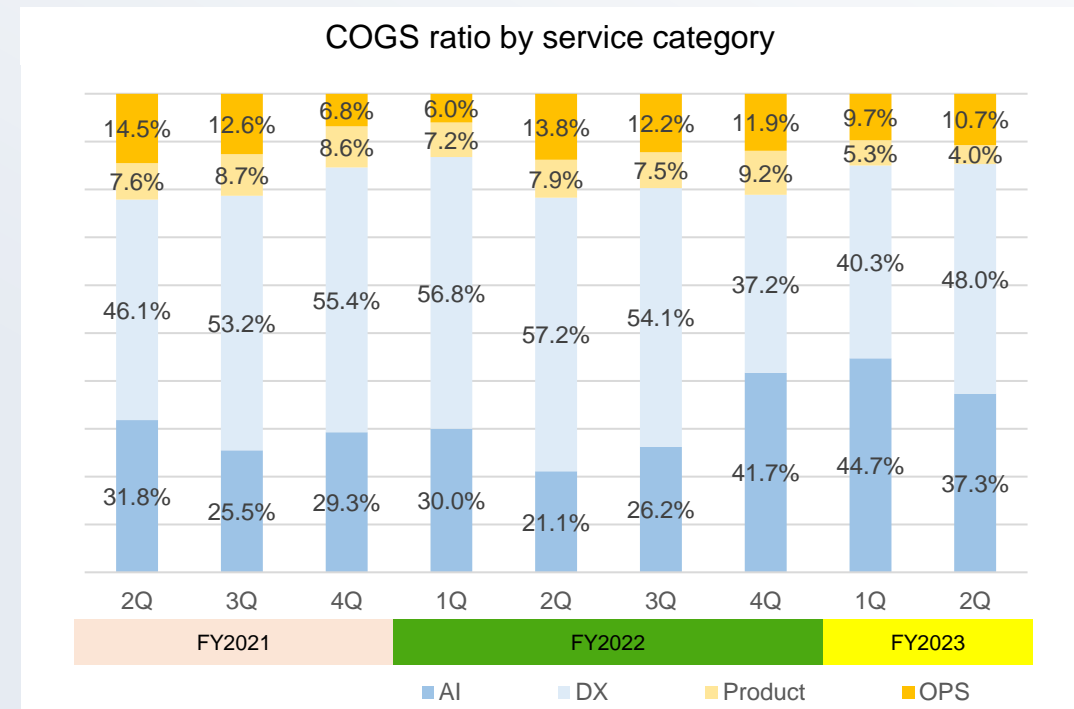
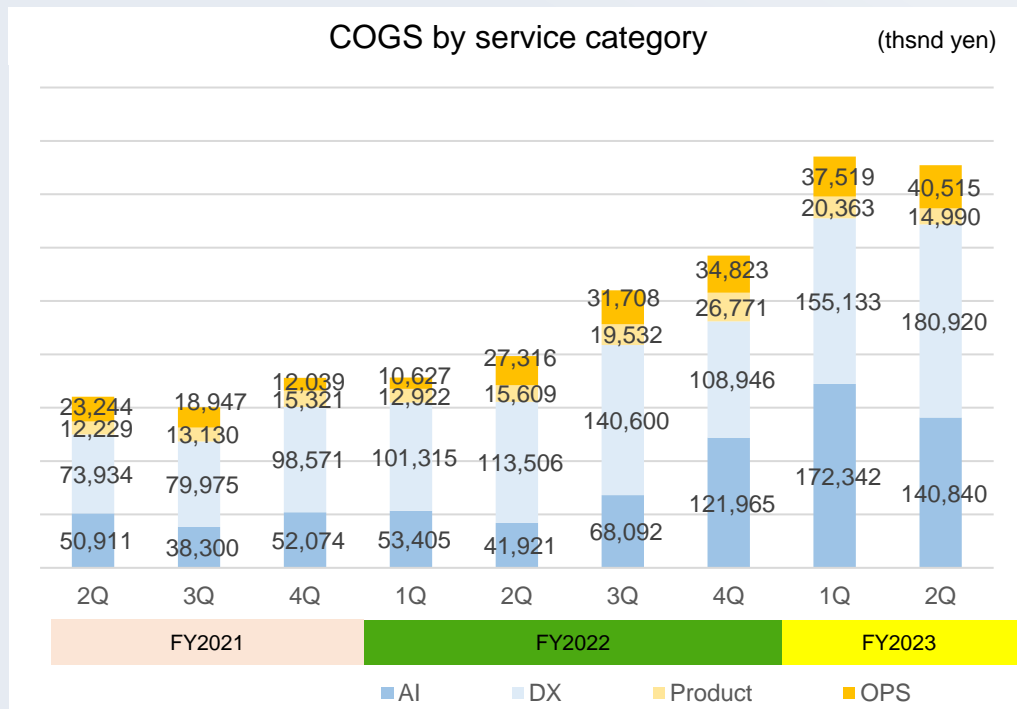
Along with the increase in sales, the partner ratio has increased in each service category. The soaring unit price of partner engineers had an impact on the decline in gross profit.



▶ The Transition in Cost of Goods Sold

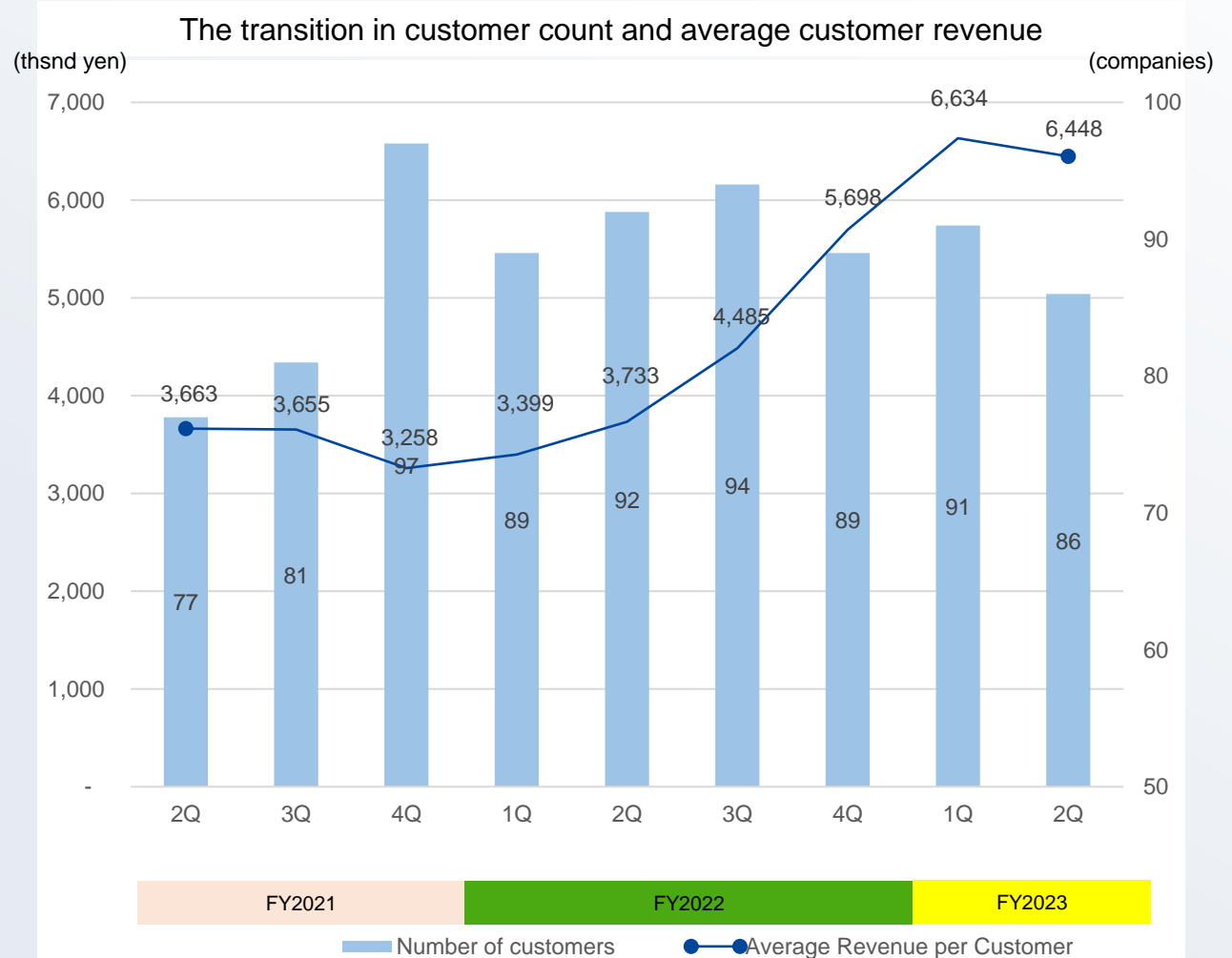
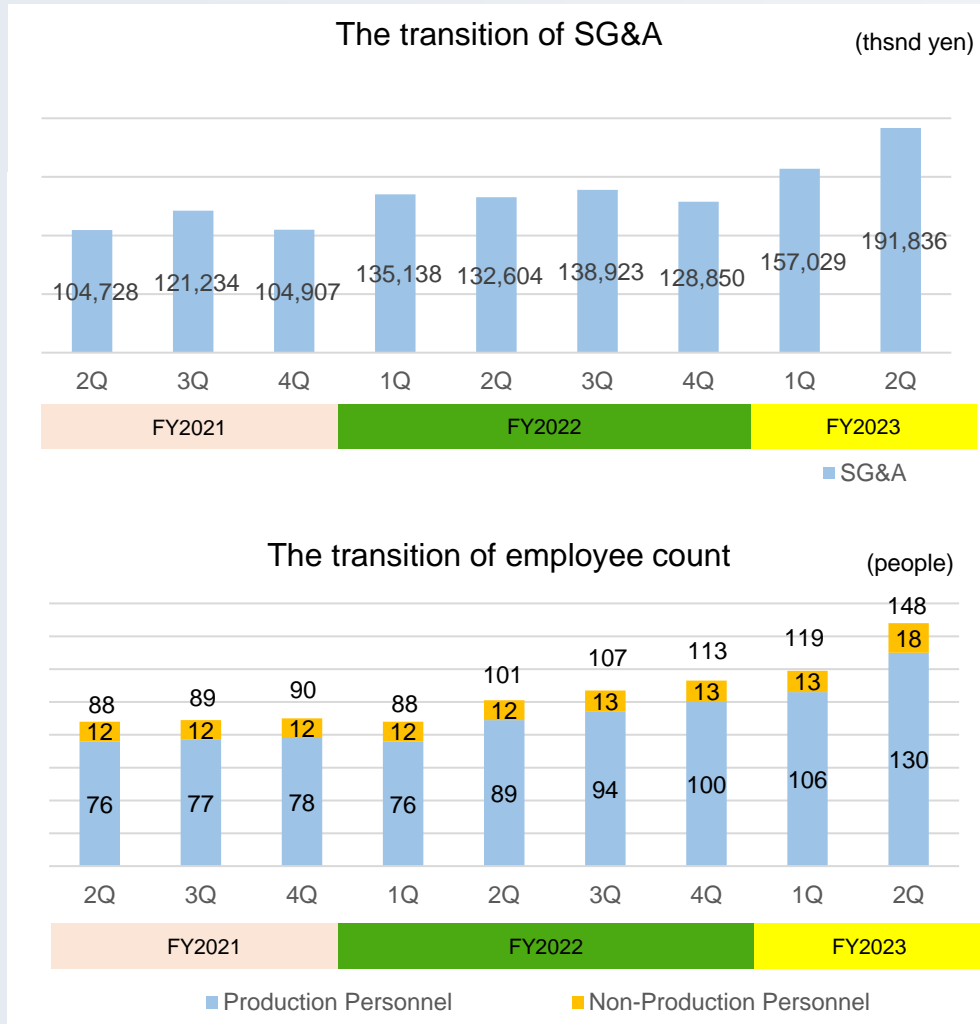
The cost of goods sold is increasing at a rate higher than the increase in sales, 190.2% compared to the same quarter of the previous year, QoQ 97.9%.

The price surge for partner engineers is affecting the increase in cost of goods sold.



The Transition of SG&A, Employees, Clients and Unit Price

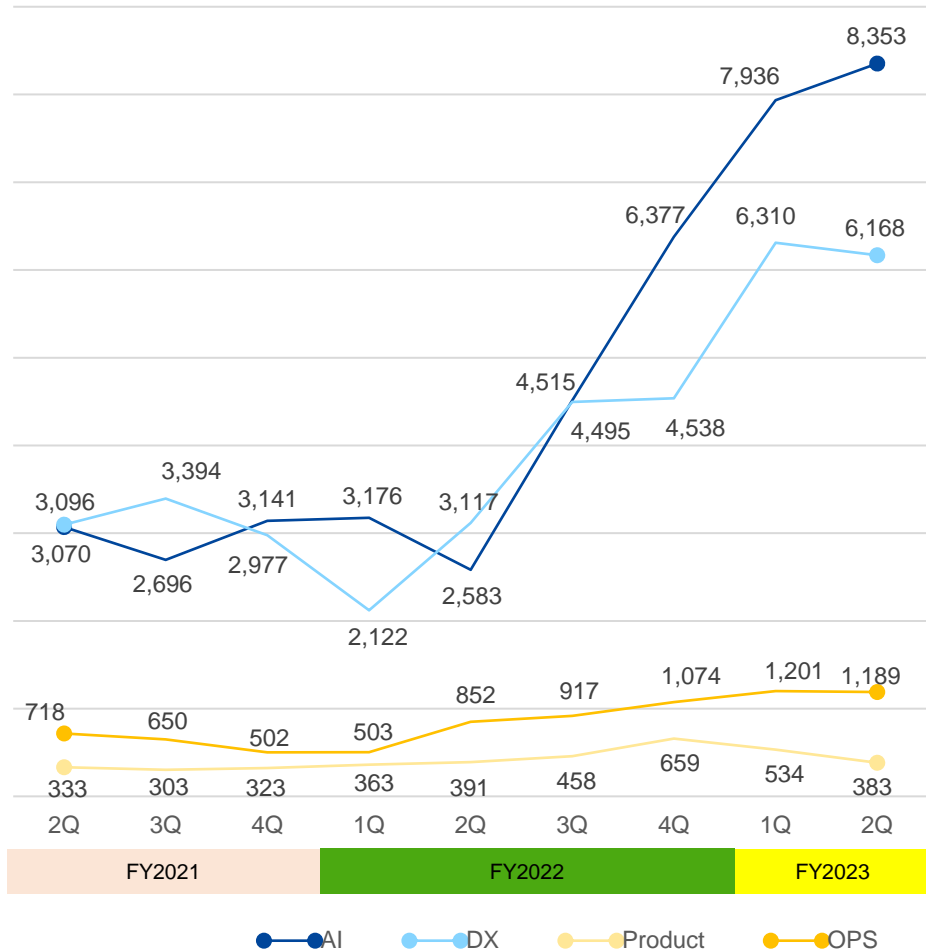
The promotion of large accounts has helped maintain a high level of customer average transaction value.
Customer Average Transaction Value: 170.7% compared to the same quarter of the previous year, QoQ 96.1%.



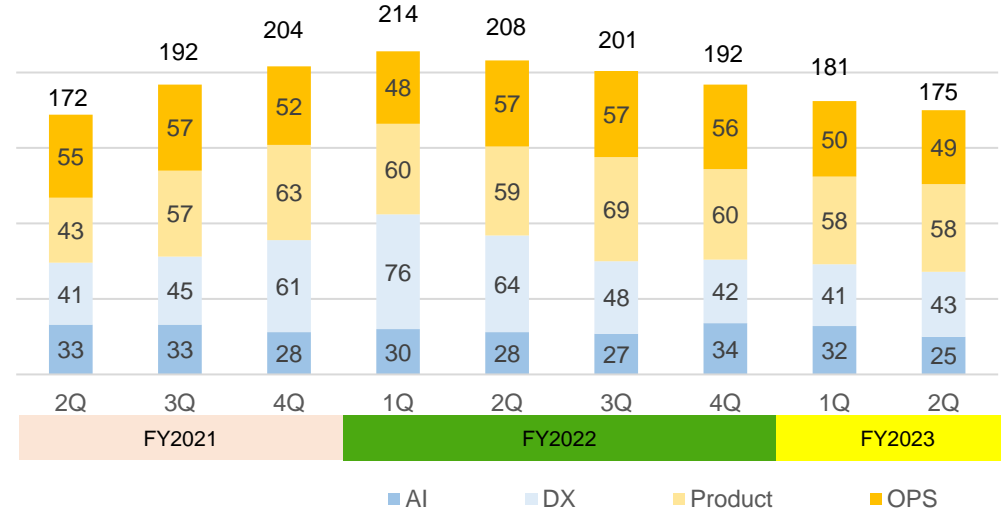


The unit sales price per project in the AI category has further increased due to changes in client demographics. The decrease in the number of projects is due to changes in the client base and larger scale of projects, and the progress is in accordance with the plan.

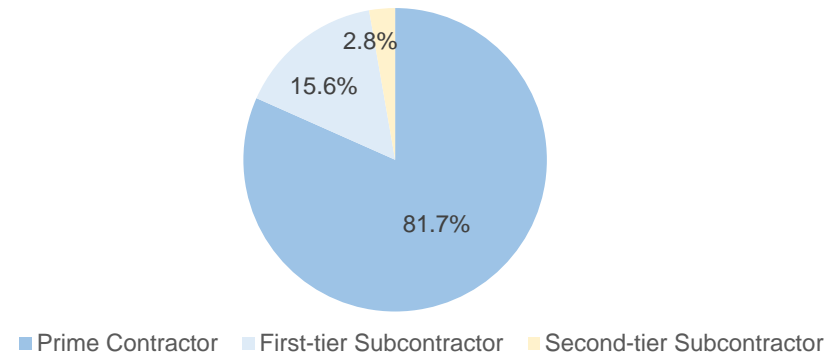
The sales price per project by service category (thsnd yen)



The number of projects by service category



The ratio of the contractual chain



▶ Initiatives for SDGs

Addressing climate change issues and promoting diversity

Expressed support for the TCFD recommendations.



Participation in the TCFD Consortium



Participation in the Ministry of Economy, Trade and Industry's 'GX League'



Participation in the 'OSAKA Zero Carbon Foundation'



Obtaining the 'Kurumin' certification



- Promotion of Parental Leave Uptake
- Improvement of the Short-Time Work System
- Build a Diverse Work Environment

Developed the app 'Tabenate' contributing to food loss reduction





Forward-Looking Statements

Materials and information provided in this announcement include so-called “forward-looking statements”.

They are estimated at the present and are based on the assumption that involves forecasts and risks, and substantially they include uncertainties which could cause different results from these statements.

These risks and uncertainties include general industry and market conditions, and general domestic and international economic conditions, such as interest rates and currency exchange fluctuations.

In the future, even if there is new information or future events etc., we shall not be obligated to update and revise the “forward-looking statements” included in this announcement.

Headwaters Co., Ltd.

Contact : Investor Relations Dept.

ir@headwaters.co.jp

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