Financial Supplementary Materials
for the Third Quarter FY2023

Headwaters Co., Ltd.

November 14, 2023 **Securities code:4011**

FY2023 3Q Consolidated Financial Results Overview

(thsnd yen)

(thsnd yen)

	FY2022 3Q (Cumulative)		FY2023 3Q (Cumulative)			
		Composition Ratio (%)		Composition Ratio (%)	YoY Comparison (%)	Annual Budget Attainment Rate (%)
Net sales	1,067,490	100.0	1,786,500	100.0	167.3	84.6
AI	289,538	27.1	719,209	40.3	248.3	87.5
DX	576,526	54.0	832,431	46.6	144.3	87.3
Product	76,436	7.2	79,037	4.4	103.4	66.3
OPS	124,989	11.7	155,821	8.7	124.6	71.9
Operating profit	24,270	2.3	84,399	4.7	347.7	70.1
Ordinary profit/loss	19,822	1.9	85,581	4.7	431.7	68.4
Net profit/loss	11,873	1.1	53,691	3.0	452.1	61.9
Profit/loss attributable to owners of parent	11,873	1.1	53,801	3.0	453.1	62.1
Net income per share	6.34yen		28.71yen			

《Net Sales》
- The sales revenue reached a record high at 628 million yen, having an upward revision of the full-year performance outlook to 2.32 billion yen. (YoY growth of 167.3%, QoQ growth of 113.2%, and 149.0% growth compared to the same quarter of the previous year)
  ➡The acceptance inspections of large projects related to both AI and DX, which had been ongoing since the previous fiscal year, contributed significantly to sales.
  ➡We have been successfully expanding our order intake, not only in Edge AI projects but also in Generative AI projects. This has made a significant contribution to acquiring new clients and expanding our business.

《Operating Profit》
- Although gross profit margin improved to 40.5% by higher revenue and gross profit, the operating profit margin remained at 5.9% due to an overspending in sales and administrative expenses beyond the planned budget.
  ➡Net sales: With the push-up of unit selling prices, the unit price reached a record high of 6.68 million yen.
  ➡Gross Profit: With the increase in net sales and improvements in cost of sales, the gross profit reached a record high of 254 million yen.
  ➡SG&A: To expand sales, we expanded middle office functions such as production support and partner procurement. Additionally, although hiring was controlled from the second quarter, successful recruitment activities with the recruitment plan achievement rate of 126%, resulted in the recording of recruitment expenses and the surge in SG&A expenses.

《Ordinary Profit》
- Non-operating income: As in the second quarter, income of approximately 1.18 million yen was generated through grants and subsidies.

《Others》
- Recruitment: In the 3Q, the entire group companies hired 21 employees, resulting in a net increase of 19 employees after accounting for 2 retirements.
  ➡Number of Employees as of September 2023: 167, including 3 contract employees.
  ➡Annual Recruitment Plan for FY2023: Exceeded the target by achieving a net increase of 54 employees compared to the planned net increase of 43.

Headwaters

In the 3Q, the revenue reached a record high of 628 million yen. The DX category marked its third consecutive quarter of achieving a record high, while the AI category reached its highest point in two quarters. While the large-scale projects that have been ongoing since last year are closing, revenue was supported by projects related to generated AI and edge AI.

Net sales by service category (thsnd yen)

Sales Breakdown by Service
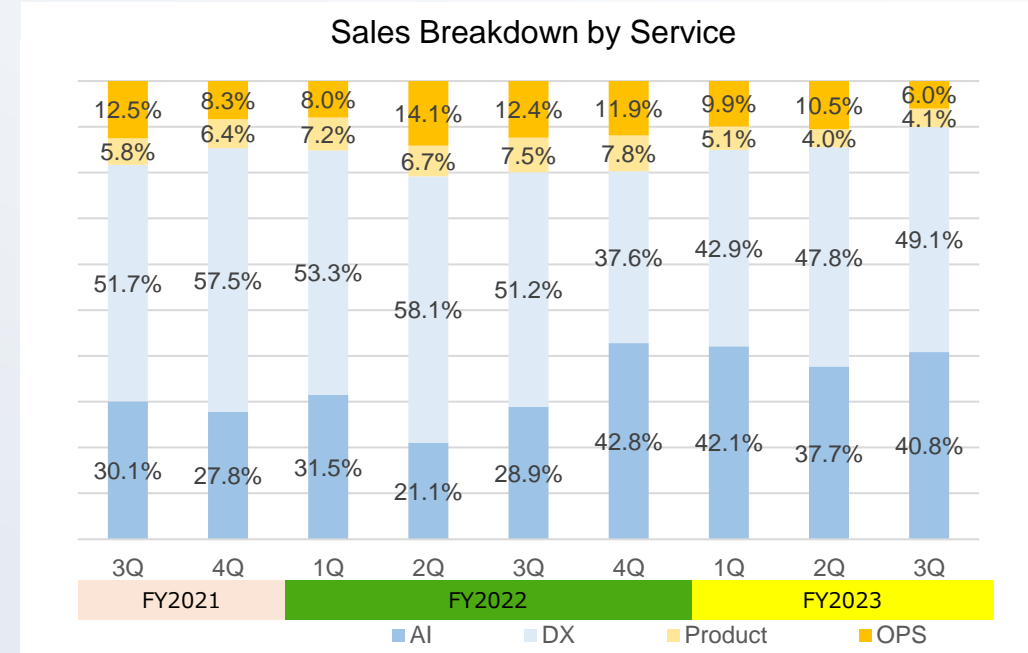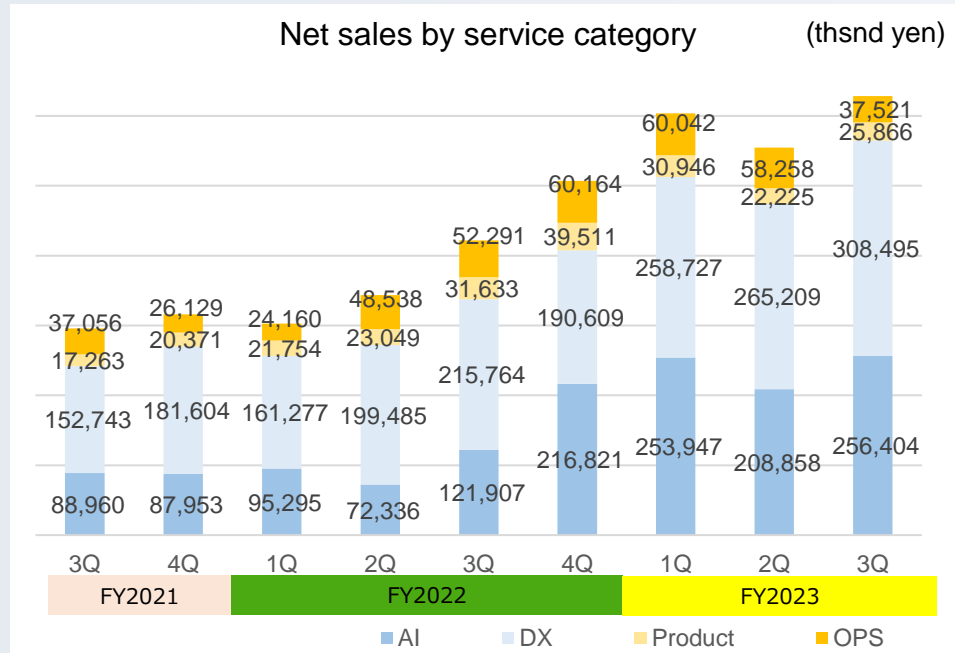
Recurring Revenue Business (Service Category: OPS, Product): 75.5% YoY growth rate, 78.8% QoQ growth rate compared to the previous quarter.
- OPS: YoY growth rate: 71.8% / QoQ growth rate: 64.4%
  The decrease in revenue was attributed to project consolidation, mainly web system maintenance.
- Product: YoY growth rate: 81.8% / QoQ growth rate: 116.4%
  We have started recording licenses for projects related to generative AI, in addition to the services to support in-house operation of PowerPlatform.

Pay-Per-Service Business (Service Category: AI, DX): 167.3% YoY growth rate, 119.2% QoQ growth rate.
- AI: YoY growth rate: 210.3% / QoQ growth rate: 122.8%
  While the large-scale projects that have continued since the previous year are closing, new medium and large-scale projects are starting.
- DX: YoY growth rate: 143.0% / QoQ growth rate: 116.3%
  While cloud projects on Azure and consulting projects are in progress, some large-scale projects successfully underwent acceptance in the 3Q.

The Transition of Gross Profit Margin

Improving the gross profit margin primarily through large-scale projects in pay-per-service business, which constitutes 90% of the revenue, had led to an overall gross profit margin increase to 40.5%
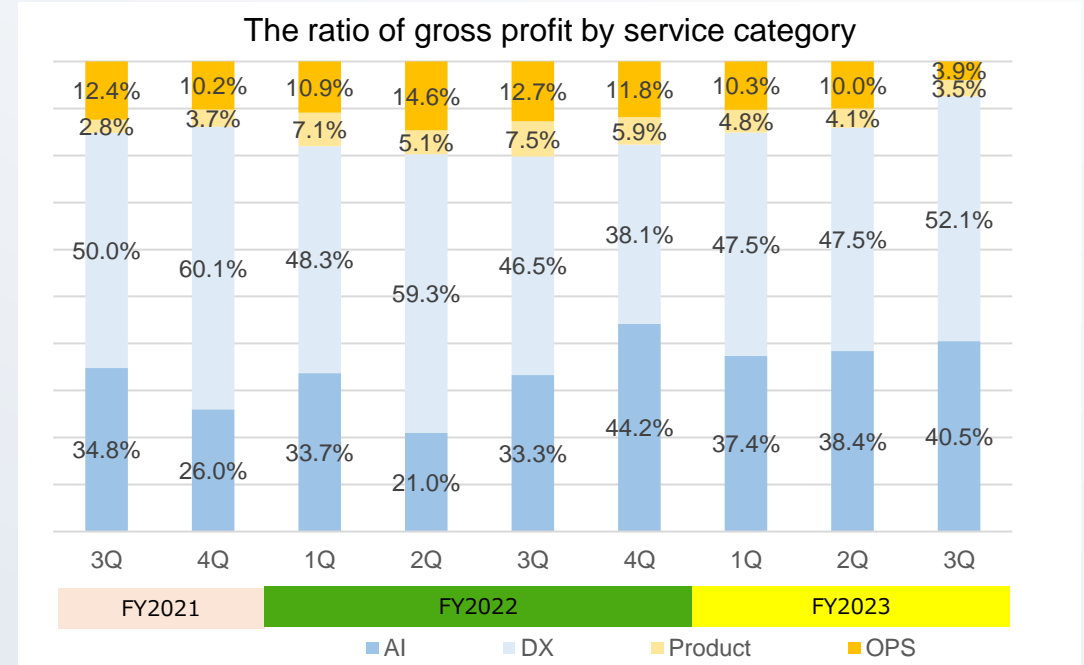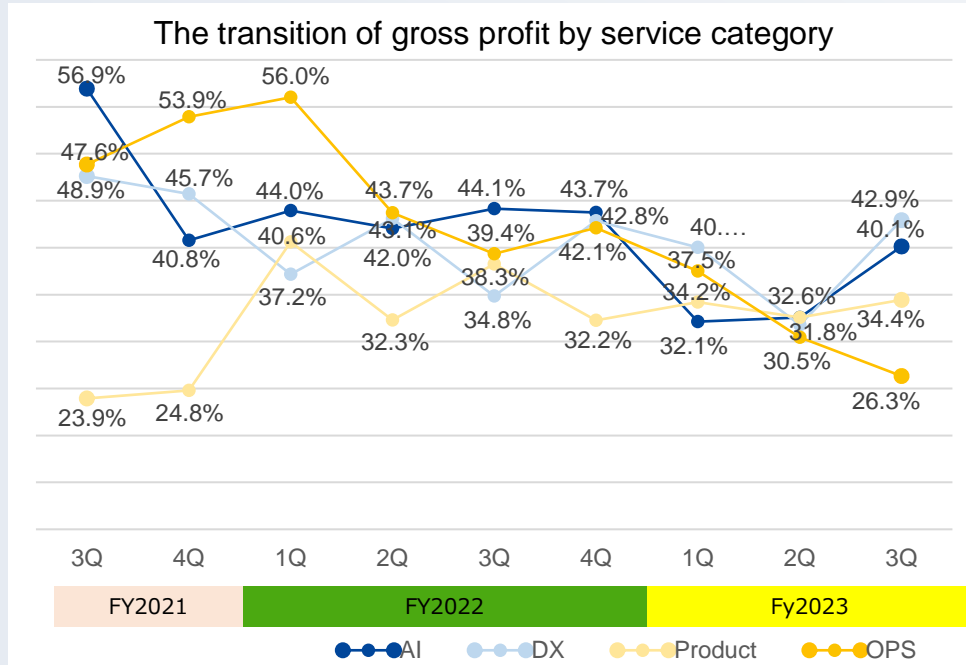
Recurring Revenue Business (Service Category: OPS, Product)

OPS: The impact was due to takeover costs incurred while streamlining the ongoing maintenance projects for web systems.
(previous quarter 30.5% ➡ 26.3%: -4.2 points)

Product: The increasing adoption of the licensing model for projects related to generated AI contributed to the improvement in the gross profit margin.
(previous quarter 32.6% ➡ 34.4%: +1.8 points)

**Pay-Per-Service Business (Service Category: AI, DX)**

AI: The decrease in external partner ratio along with large-scale projects getting close to the end contributed to an increase in the gross profit margin.
(previous quarter 32.6% ➡ 40.1%: +7.5 points).

DX: Some large-scale projects, based on percentage of completion method, were accepted for inspection, which significantly contributed to both revenue and gross profit, leading to a substantial increase in the gross profit margin.
(previous quarter 31.8% ➡ 42.9%: +11.1 points)

The Transition of Operating Profit / Gross Profit by Service

Both the operating profit margin and gross profit margin faced a decline due to an increase in external partner ratio alongside revenue expansion and the soaring unit price of engineers. However, the gross profit amount reached 254 million yen, a record high, as a result of (1)replacement of outsourcing partners, (2)revision of sales unit price, and (3)reallocation of employees, which have been undertaken since the second quarter.
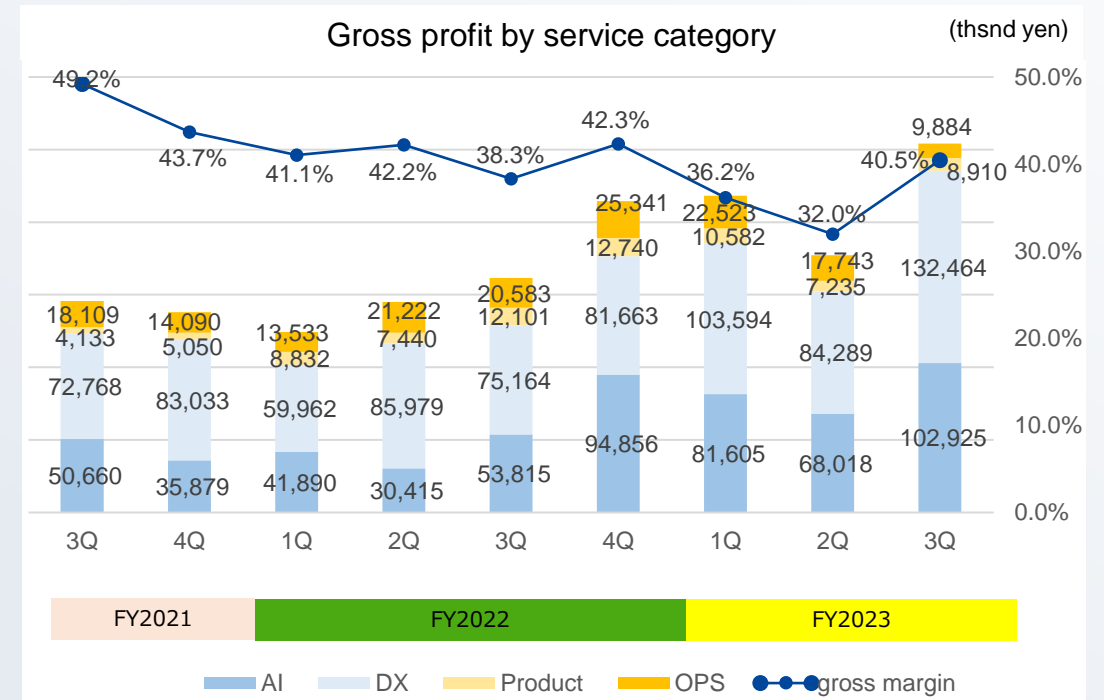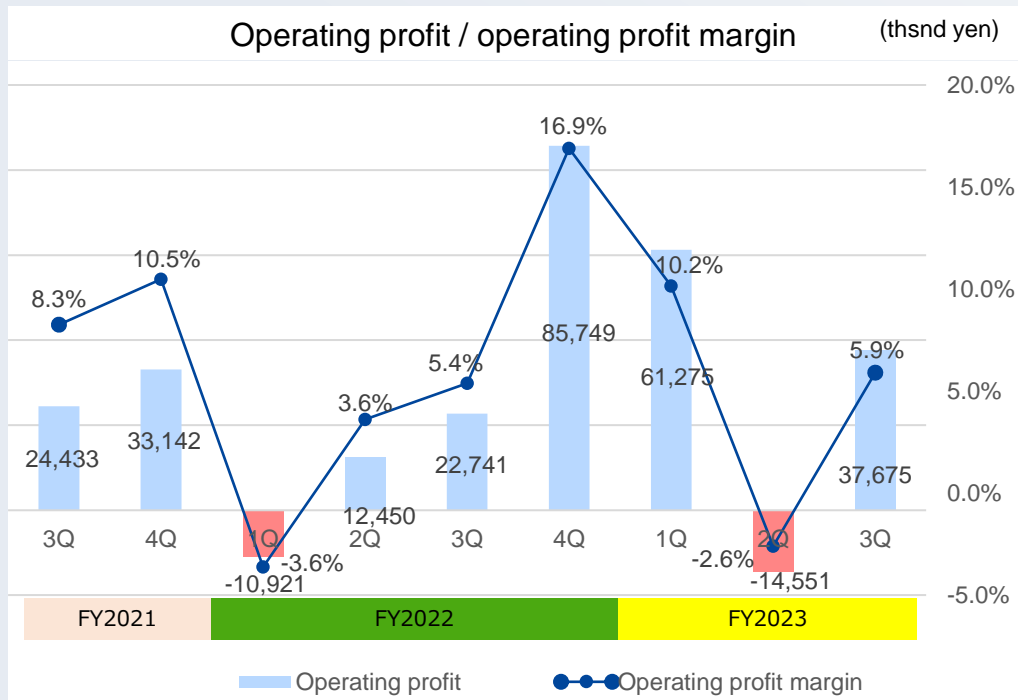
· Although there was an increase in selling, general, and administrative expenses (refer to page 7), the reinforcement of mechanisms and efficiency through initiatives such as external partner promotion and strengthening of production support departments contributed to the improvement of the operating profit margin.

Recurring Revenue Business (Service Category:OPS, Product)
Gross Profit: YoY growth rate: 57.5% / QoQ growth rate: 75.2%

Pay-Per-Service Business (Service Category: AI, DX)
Gross Profit: YoY growth rate: 182.5% / QoQ growth rate: 154.5%

The Transition in Cost of Sales

Due to cost reduction measures in sales expenses, sales have reached a record high, while successfully containing the growth of production costs. (YoY growth rate: 143.9%, QoQ growth rate: 99.2%)
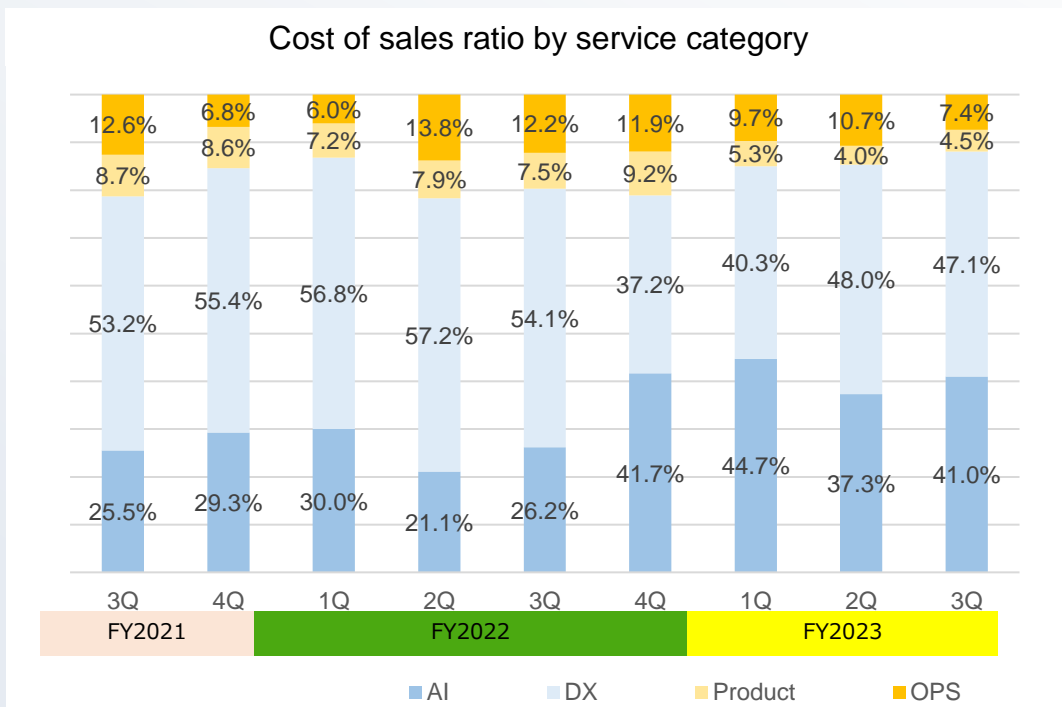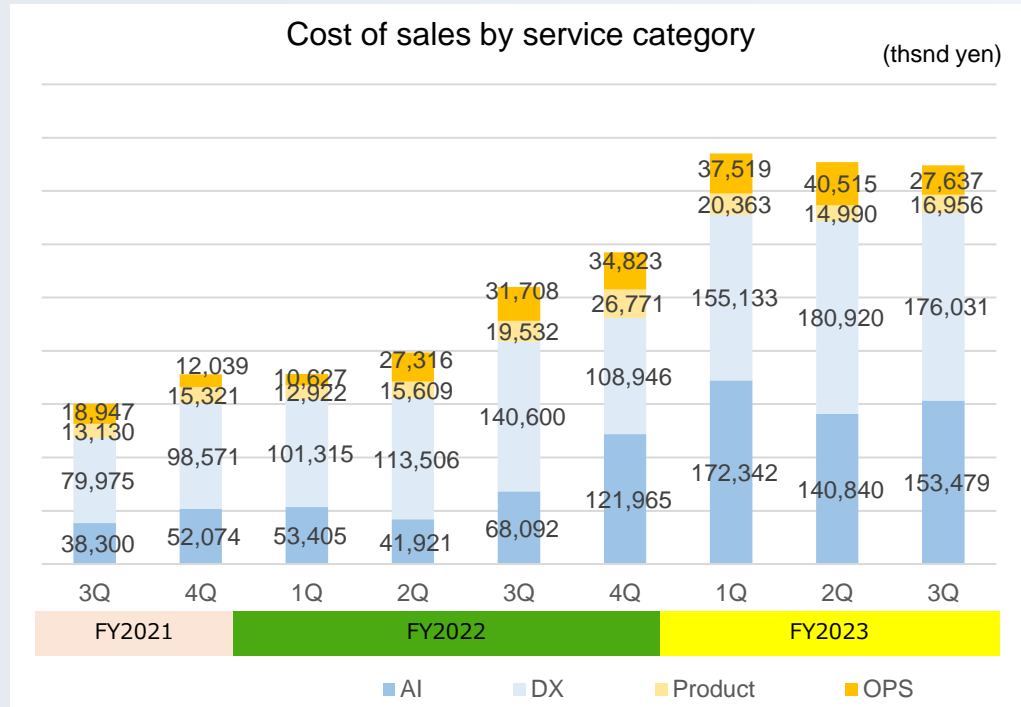
Recurring Revenue Business (Service Category: OPS, Product): 87.0% YoY decrease, 80.3% QoQ decrease in cost of sales.
Due to project consolidation, primarily focusing on existing web maintenance projects in OPS, recurring revenue business saw a decrease in both revenue and cost of sales in line with the decrease in sales.

Pay-Per-Service Business (Service Category: AI, DX): 157.9% YoY increase, 102.4% QoQ increase in cast of sales.
Pay-per-service business has seen an increase in the use of external partners since the current fiscal year, and from the second quarter onward, improvements have been made to reduce cost of sales. The growth of cost of sales was successfully held down in relation to the growth of sales.

Selling, general and administrative expenses increased due to the strengthening of the external partner promotion and production department support, in addition to personnel and recruiting costs associated with the expansio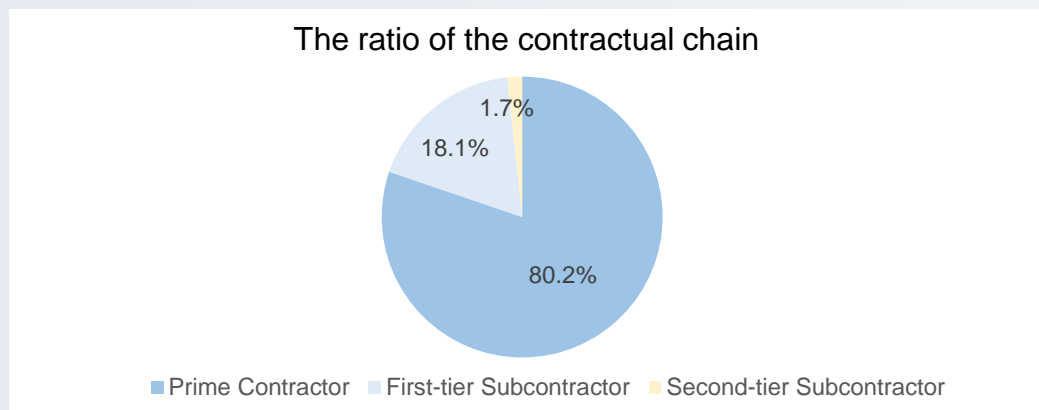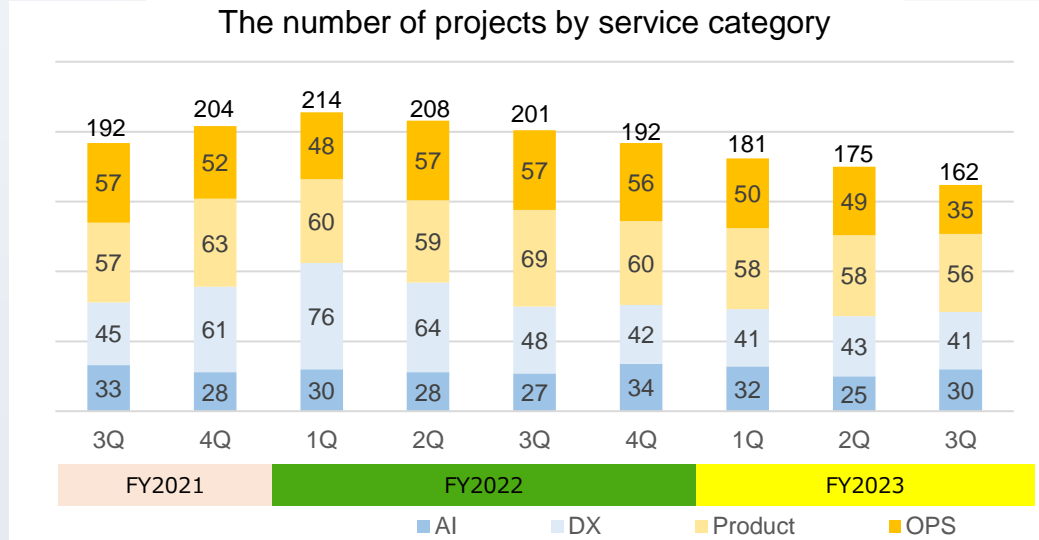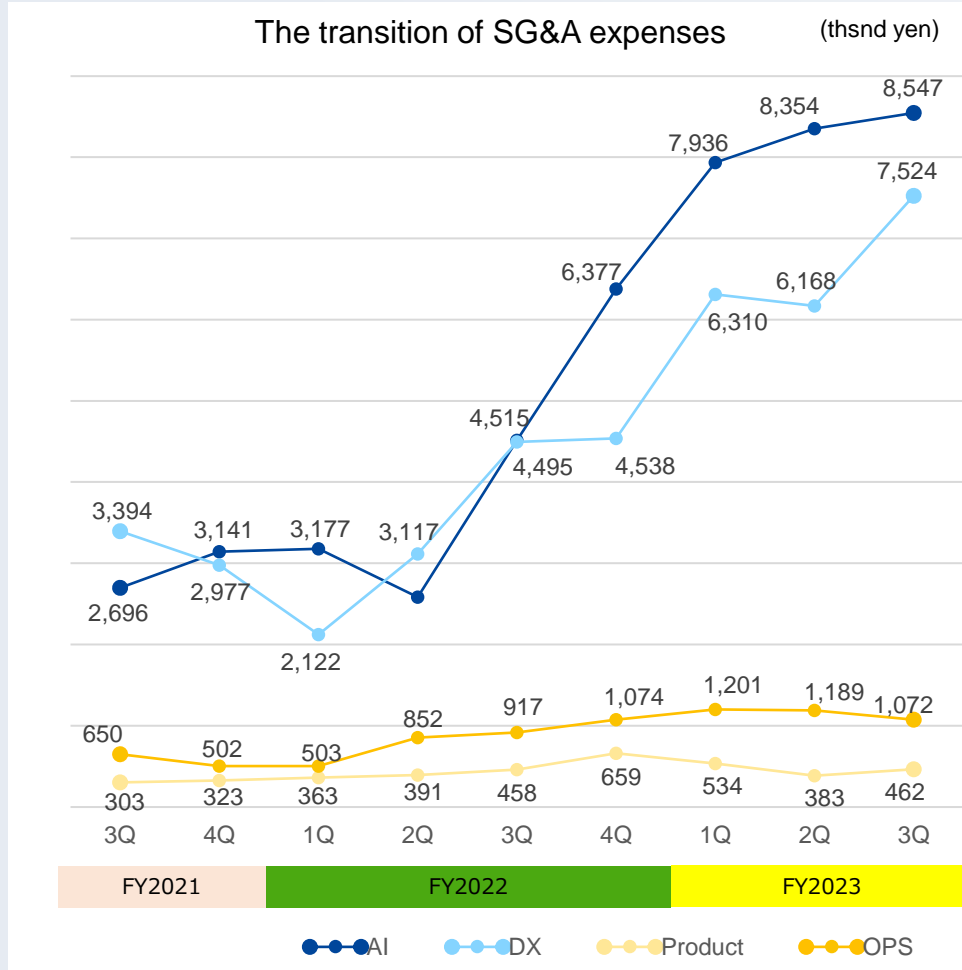n of the number of employees. The acquisition of new clients through projects related to generated AI resulted in an increase in the client base, and the average revenue per client **reached a new record high**.

The transition of SG&A expenses (thsnd yen)

	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q
SG&A	121,234	104,907	135,138	132,604	138,923	128,850	157,029	191,836	216,510

FY2021 | FY2022 | FY2023

■ SG&A

The transition of employees （people)

	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q
Total	89	90	88	10	107	113	119	148	167
Non-Production Personnel	12	12	12	12	13	13	13	18	18
Production Personnel	77	78	76	89	94	100	106	130	149

FY2021 | FY2022 | FY2023

■ Production Personnel   ■ Non-Production Personnel

The transition in clients and sales per client

(thsnd yen) / (companies)

	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q
Average Sales per Client	3,655	3,258	3,399	3,733	4,485	5,698	6,634	6,448	6,684
Number of Clients	81	97	89	92	94	89	91	86	94

FY2021 | FY2022 | Fy2023

■ Number of Clients   ●—● Average Sales per Client

The unit sales price per project for both AI and DX-related projects rose further due to the impact of the shift of the client base to enterprise-level through the alliance strategy. In terms of the number of projects executed, optimization of project manager assignments is being carried out through the strategic withdrawal from multiple small-scale OPS projects.

The transition of SG&A expenses (thsnd yen)

The number of projects by service category

The ratio of the contractual chain

■ Prime Contractor ■ First-tier Subcontractor ■ Second-tier Subcontractor

IR News ： https://www.headwaters.co.jp/ir/news/

■ Services
- Enterprise GPT Service Lineup with *Azure OpenAI Service x Voice*
- Commencement of Prompt Engineering Lab Service: Building Knowledge Sharing and Accompanying Support for LLM Technology for Enterprises Utilizing *Azure OpenAI Service*
- Launch of the Service *SyncLect Generative AI*: A Platform Utilizing Generated AI for Unique Data Training of *Azure OpenAI Service*

■ Collaborations
- Enhancing Collaboration with Village Vanguard Co., Ltd., Commencing The Demonstration Experiment of Digital Signages Utilizing Sony's *AITRIOS* and Microsoft's *Microsoft Azure*
- Commencing Collaboration with Management Solutions Co., Ltd. Offering Comprehensive Support for *Azure OpenAI Service* Utilization and Organizational Integration through *the Generative AI Project Lab*

■ Others
- We have joined *the Shibuya Smart City Promotion Organization*
- We have been certified as a partner for *the OpenAI Service Reference Architecture*

Notes on forward-looking statements

➢ This document contains outlooks, plans for the future, and business objectives related to our company. Descriptions regarding these forward-looking statement are based on assumptions made at the current moment about future events and trends, and there is no guarantee that these assumptions are accurate. Various factors may cause actual performance to significantly differ from what is described in this document.

➢ The figures in this document represent consolidated figures for the entire group, including DATA IMPACT JOINT STOCK COMPANY, established in June.

➢ In this document, numerical comparisons are presented in the following three categories.

　・**Quarter-over-Quarter**: A comparison between the figures of the previous four quarters and the figures of the corresponding quarter

　　➡ Compare the figures between 2Q of FY12/2023 and 3Q of FY12/2023

　・**Year-over-Year**: A comparison between the cumulative figures of the corresponding quarter for the previous fiscal year and the current fiscal year

　　➡ Compare the figures between the cumulative numbers for 3Q of FY12/2022 including 1Q and 2Q and 3Q of FY12/2023 including 1Q and 2Q

　・**Year-over-Year for the Quarter**: A comparison between the figures of the corresponding quarter for the previous fiscal year and the current fiscal year

　　➡ Compare the figures between 3Q of FY12/2022 and 3Q of FY12/2023

➢ Unless otherwise specified, the financial data presented in this document is displayed in accordance with generally accepted accounting principles in Japan.

➢ Information regarding companies other than our own is based on generally known information.