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PALTEK CORPORATION

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**Changing Transaction Form with the Largest Supplier;
Painful for FY12/18 Earnings, But Also a Major Opportunity**

PALTEK Corporation (hereinafter “PALTEK” or the “Company”) announced on November 28, 2017 that from January 2018 it will change its transaction form with its largest supplier Xilinx Inc./U.S. (hereinafter “Xilinx”), and held an explanation briefing for institutional investors and analysts on November 30 ([announcement materials](#), [explanation briefing video/materials](#)).

Until now PALTEK has marketed Xilinx FPGAs to clients including technical and development support, however, going forward, it will only conduct sales and logistics operations for major clients. Accordingly, the outlook for FY12/18 is for profits to decline.

At the same time, this change will also be beneficial for PALTEK. Through improving “handling” of FPGA sales operations, that portion of management resources are freed up to be used for strategic businesses of Design Service and Solutions on which the Company is focusing, as well as being able to fully devote resources to growth markets in Semiconductor Business. In fact, President Yabuki commented at the explanation briefing “although this is a critical situation, it is also a major opportunity.”

New Transaction Form and Impact on Earnings

In selling FPGAs, until now PALTEK has provided clients with research, project discovery, project acquisition and technical support (hereinafter collectively referred to as “technical support”). As a result of the change in transaction form, Xilinx will handle technical support for major clients directly, and PALTEK will handle the trading company functions of selling and logistics. However, this change is limited to transactions with major clients only, and the Company will continue to provide sales operations including technical support to all other clients.

As a result of the change, there is not a major impact on FPGA sales volume or sales amount, however, profits from technical support will decline. Specifically, the Company estimates that the gross profit margin for corresponding transactions will decline sharply, calculating that FY12/18 gross profit will decline up to a maximum ¥750 million. Estimated FPGA sales for FY12/17 are ¥11.8 billion, and corresponding sales to major clients account for roughly 70% of the total, however, there is no impact on profits.

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● [Figure 1] Overview of Change in Transaction Form with Xilinx

Sales activities until now (all handled by PALTEK)



Sales activities from January 2018 onward for key major clients



 : Handled by PALTEK  : Handled by Xilinx

Source: Excerpt from PALTEK disclosed materials

Background Leading UP To Change in Transaction Form

FPGA is a logic LSI (Large-scale Integrated Circuit) which is programmable after manufacture and can control functionality of the final product, becoming a major differentiating point, the so-called “heart” of a product. Performance has greatly improved as a result of miniaturization of semiconductors, currently equipped with many functions including processors, interfaces, memory, etc., and along with advances in speed and reducing power consumption, application fields are expanding.

For this reason, the number of cases for highly technologically advanced products requiring direct technical support from the FPGA maker from the design and development phase is rising, mainly in for telecommunications infrastructure, industrial equipment, image processing and automotive applications. According to the Company, the change is in line with this trend.

For PALTEK, earnings decline related to technical support for major clients is painful, however, conversely is also a major opportunity. Until now the Company has devoted a large portion of management resources relative to the size of the Company to FPGA business, and in recent years the Company has increasingly become involved with client product development from earlier stage, becoming a heavy burden as needs have become more sophisticated and complex, and pressure on profitability has become increasingly more severe.

However, as a result of this change, the burden is greatly reduced, freeing up that portion of management resources for strategic business such as Design Service and Solutions, as well as being able to devote resources to growth markets in Semiconductor Business.

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Priority Initiatives Going Forward Based on Reallocation of Management Resources

PALTEK plans to devote extra capacity freed up in personnel resources to strategic new business, as well as growth markets for existing business, and specific initiatives for their utilization include the following:

- Strengthening the sales force for Solutions Business
- Strengthening the sales force for Design Service Business (ODM business)
- Developing and marketing FPGA-based solutions
- Strengthening Semiconductor Business for growth markets

The Company just formulated its new Medium-Term Management Plan in February 2017, and it can likely be said that management resources being freed up in this way is superb timing toward achievement of plan targets. The new Medium-Term Plan targets expanding business fields of Design Service, and newly launching Solutions Business, toward reaching net sales of over ¥40 billion, and operating profit margin over 5% for FY12/20.

Although Solutions Business until now had not been clearly specified as a business segment, the Company announced at the explanation briefing that it would be treated as a separate business segment. The policy direction for each business shown at the explanation briefing is summarized below. Also, Figure 2 on page 4 shows the relationship of segments until now with new business segments.

Semiconductor Business: Focusing on growth markets, generating stable earnings

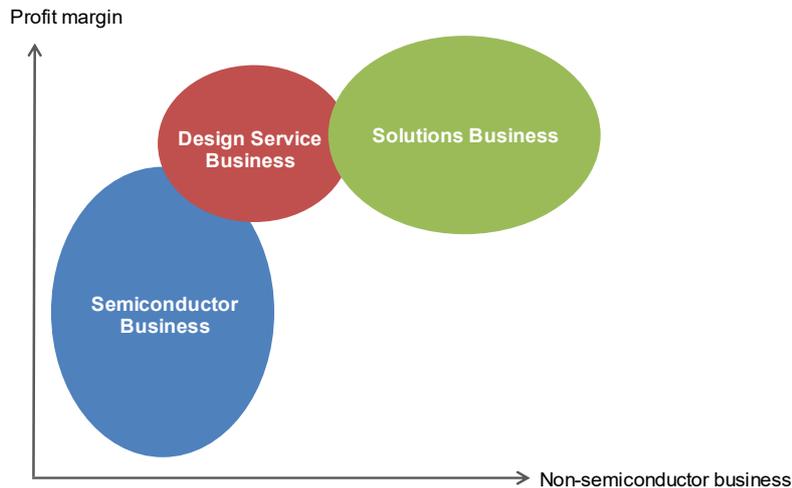
Design Service Business: Leveraging strengths in core technologies, developing high value-added solutions, raising profitability

Solutions Business: Based on accumulated technologies, discover, develop and market solutions at the final product level

In Design Service Business until now, there were many cases where orders had to be abandoned due to limitations of management resources even when there were inquiries, and this issue is expected to disappear going forward. In addition, many new businesses in new focus Solutions Business just started up this year, in a situation with introduction of personnel resources to be conducted from now on. A significant portion of this can likely also be covered by reallocation of personnel resources from FPGA Business. Considering the tight supply/demand in Japan's labor market and difficulty in securing personnel, as President Yabuki has said, "Xilinx has provided us with a great opportunity."

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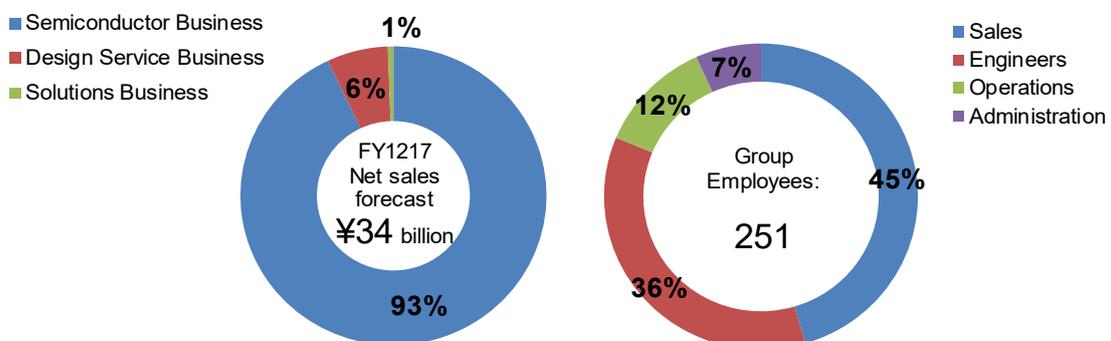
● [Figure 2] New Business Segments and Business Portfolio Overview



Source: Compiled by Trias Corporation from interviews with PALTEK

Graph 1 shows the sales breakdown of each business based on net sales forecasts for FY12/17, and breakdown of group employee allocation. Based on our interviews with the Company, among PALTEK's 251 consolidated employees, engineers including field engineers account for roughly 40%. In addition, among the roughly 50% of sales staff, roughly 30% have expertise in FPGA, and through optimal allocation of these staff, business development with a sense of speed which had been difficult in the past becomes possible.

● [Graph 1] Summary of PALTEK Group Sales Breakdown and Personnel Resource Allocation

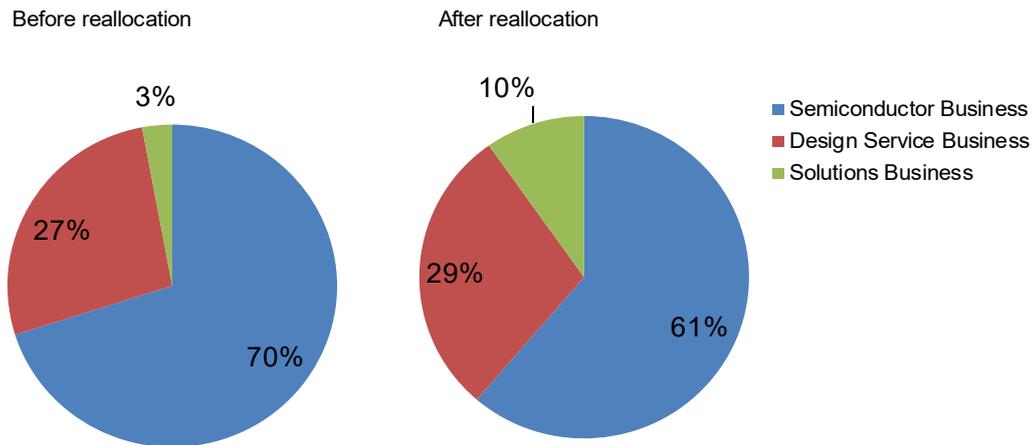


*Net sales forecast for Solutions Business only includes Smart Energy.

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Graph 2 shows the breakdown of personnel allocation by business segment before and after reallocation (excluding administration employees). For reference, the Company noted at the explanation briefing that over 20 persons in charge of major clients can be reallocated to strategic business areas. After personnel reallocation, management resources for strategic business areas, in particular Solutions Business, will be enhanced, which is expected to become a driving force for PALTEK establishing a new business pillar.

● **[Graph 2] Image of Optimized Personnel Allocation**



Source: Both Graphs 1 and 2 were compiled by Trias Corporation from interviews with PALTEK

At the explanation briefing, the Company provided progress updates for 2 new solutions businesses already disclosed, and 1 newly started business.

Tire Pressure Monitoring Systems (TPMS):

Currently 6 companies including logistics and bus operators, etc. are undergoing trials, and apparently the Company is also making aggressive promotion to truck dealers.

Paper Packaging Materials Business:

The Company has already won orders from a mail order company for everyday miscellaneous items, and in addition 1 company is undergoing a trial. 6 companies have decided to undergo trials

*Note: For details regarding these 2 solutions businesses, please refer to the TOPIC section of the [“Summary of 1H FY12/17 Financial Results and Follow-up Interview”](#) memo by Trias Corporation.

In addition to these, the Company introduced as a new solutions business, the “IBUKI PLUS” monitoring system for nursing care and childcare using non-contact vital sensors, shown on page 6. This system which uses non-contact vital sensors can monitor heartbeat, respiration and body movement of an infant without contact to the body, and is expected to help contribute to preventing

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suffocation accidents during sleep and sudden infant death syndrome (SIDS). The Tokyo Metropolitan Government and certain local governments decided to grant subsidies in September 2017, and the Company has already received over 20 inquiries from child daycare center operators, etc.

With the advancement of IoT expected going forward, each of these solutions likely present opportunities for personnel with a wealth of expertise in FPGA for systems design, infrastructure construction, etc.

● **[Figure 3] "IBUKI PLUS" Monitoring System for Nursing Care and Childcare utilizing Non-Contact Vital Sensors**



Source: Excerpt from PALTEK disclosed materials

Roadmap for 2018-2020

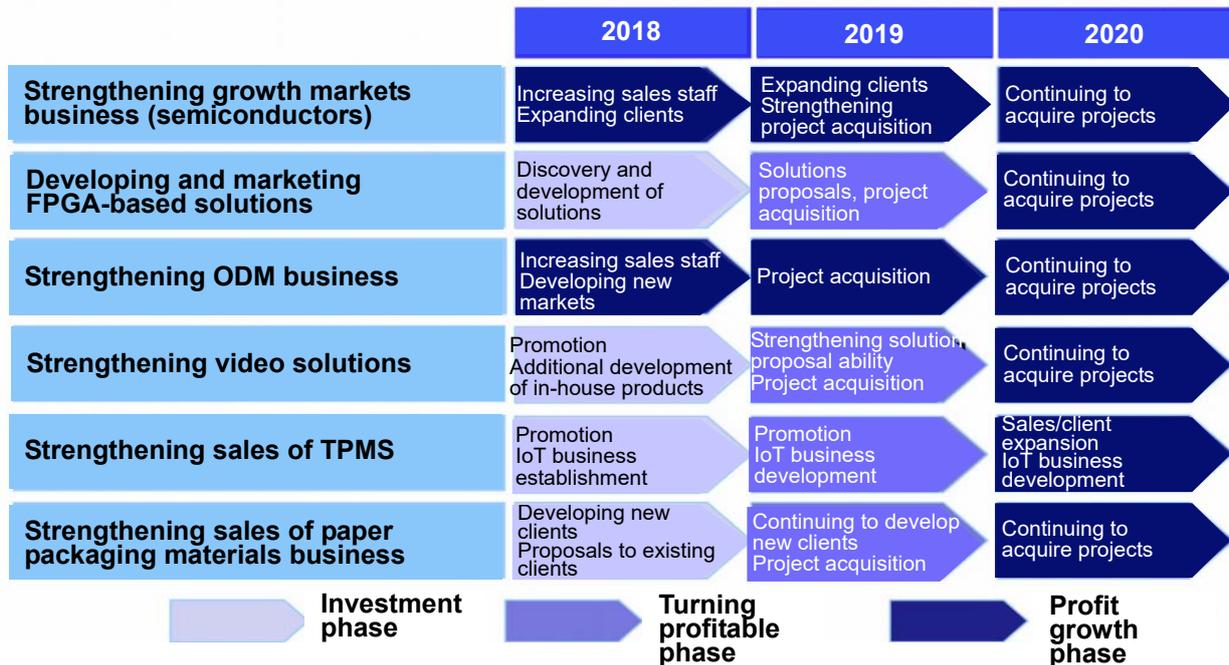
PALTEK presented a roadmap, Figure 4 on page 7, at the explanation briefing as the direction of business development going forward.

For extra capacity to be freed up in personnel resources, Figure 4 shows mainly 4 businesses marked as Investment phase for their introduction. As can be seen in Graph 3 on page 7, profits are expected to decline temporarily in FY12/18 from the decline of gross profit for FPGA Business, and investment burden for Solutions Business. However, Design Service Business and Solutions Business are expected to make a large contribution to increased profits in FY12/19 from enhanced management resources, with these 2 segments expected to account for 60% of operating profit in FY12/20.

While the decline in profits from FPGA Business is painful in the short-term, projects for major clients within FPGA business are broadly with low margins, according to the Company. Through reallocation of management resources, strengthening initiatives for higher margin medium- and small-scale FPGA clients, as well as focusing more on Design Service Business and Solutions Business will be implemented, which will actually achieve higher revenues, and President Yabuki expressed confidence in ample potential to achieve the Medium-Term Plan targets. 

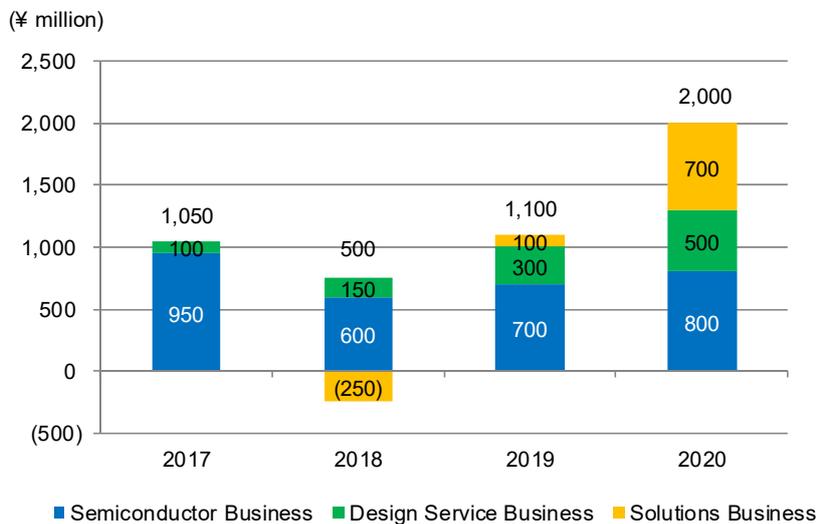
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● [Figure 4] Roadmap Pertaining to Future Business Development



Source: Excerpt from PALTEK disclosed materials

● [Graph 3] Image of Medium-Term Operating Profit Trend



Source: Excerpt from PALTEK disclosed materials

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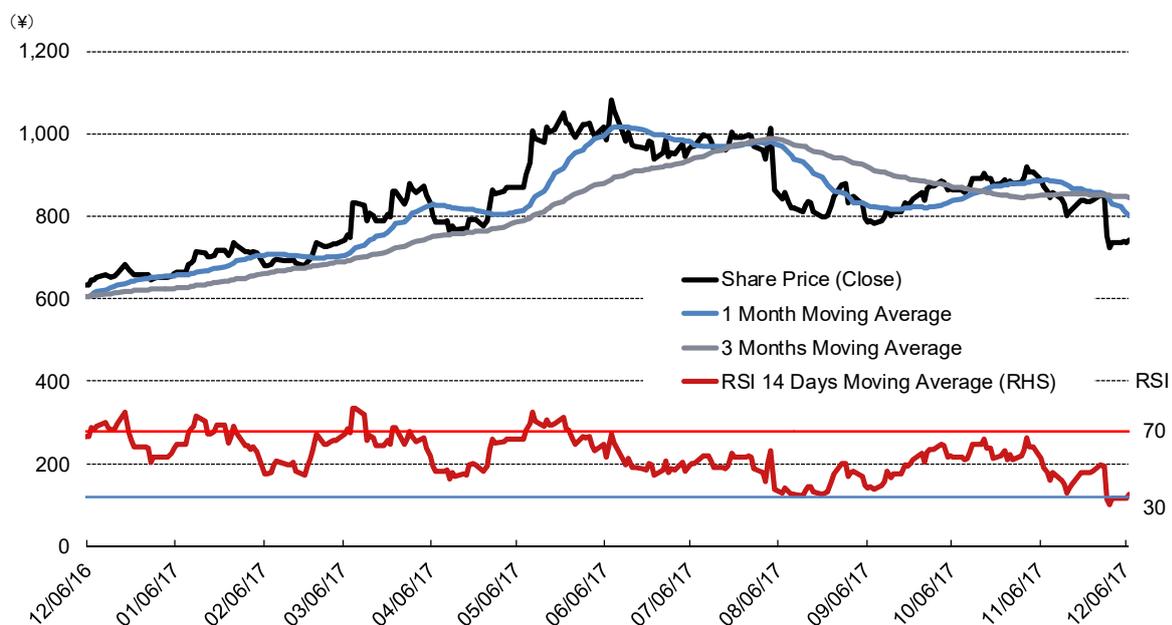
Reference
Consolidated Financial Results

No. of Shares Issued	Jun-17	11,849,899	Total Assets (¥million)	Jun-17	16,295
No. of Treasury Shares	Jun-17	895,717	Shareholders' Equity (¥million)	Jun-17	9,168
Market Value (¥million)	6-Dec-17	8,721	Interest-Bearing Debt (¥million)	Jun-17	4,580
BPS (¥)	Jun-17	33.82	Equity Ratio (%)	Jun-17	56.3
ROE (%)	Dec-16	0.1%	Ratio of Interest-Bearing Debt (%)	Jun-17	50.0
ROA (%)	Dec-16	0.1%	Free Cash Flows (¥million)	Jun-17	(1,536)
PER (times) FY12/17 fcst.	6-Dec-17	11.5	ROE=Current Net Income÷Averaged Shareholders' Equity		
PCFR (times) 1HFY12/17 actual	6-Dec-17	21.8	ROA=Current Net Income÷Total Assets		
PBR (times) 1H FY12/17 actual	6-Dec-17	21.8	PCFR=Market Value÷(Current Net Income+Depreciation)		
Share Price (¥)	6-Dec-17	736	Ave. Daily Volume=ADV for the period from 6-Dec-16 to 6-Dec-17		
Unit Share (shs)	6-Dec-17	100	Interest-Bearing Debts Ratio = I.B.D.÷Shareholders' Equity		
Average Daily Volume (shs)	6-Dec-17	68,280	Free Cash Flows=Operating CF+Investment CF		

Consolidated Key Financial Data

	Consolidated (¥million)	Net Sales	Operating Income	Ordinary Income	Net Income	EPS(¥)	DPS(¥)
FY12/13		17,611	772	782	443	38.86	8.00
FY12/14		23,155	1,008	1,052	563	49.31	8.00
FY12/15		28,841	1,361	1,144	674	61.16	15.00
FY12/16		33,544	515	110	11	1.05	13.00
1H FY12/17		16,074	533	563	370	33.82	0.00
FY12/17 Forecasts		32,500	1,050	1,060	700	63.90	13.00

Note: FY12/17 forecasts announced on August 3, 2017

Share Price and RSI Charts (December 6, 2016 – December 6, 2017)


Source: Prepared by Trias Corp. with Bloomberg data.

Note: RSI, Relative Strength Index, is the index representing the ratio of overbought or oversold share prices. In general, over 70 in RSI shows overbought share price range, while below 30 shows oversold share price range.

RSI = averaged share price appreciation for N days ÷ (averaged share price appreciation for N days + averaged share price decline for N days) x 100

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