COMPANY RESEARCH AND ANALYSIS REPORT

SAKAI HEAVY INDUSTRIES, LTD.

6358

Tokyo Stock Exchange Prime Market

14-Apr.-2022

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* This is an English translation of a report issued on March 29, 2022.

Summary

A manufacturer specializing in road rollers for road paving and other road construction equipment. Its domestic market share is the highest in the industry at over 70%, and it aims to grow by expanding its overseas market share

Sakai Heavy Industries, Ltd. <6358> (herein after also referred to as "the Company") is a manufacturer specializing in road rollers for road paving and other road construction equipment. It has a long history in this field, and boasts the industry's highest market share in Japan at over 70%. In recent years, the Company has been focusing on developing overseas markets, especially in North America and Southeast Asia.

1. Outline of results for FY3/22 3Q

In the consolidated results for FY3/22 3Q*, net sales increased 28.7% year on year (YoY) to ¥19,793mn, operating profit increased 189.0% YoY to ¥1,165mn, ordinary profit increased 286.2% to ¥1,206mn, and profit attributable to owners of parent was ¥836mn (versus a ¥285mn loss in the year-earlier period). Both net sales and operating profit increased significantly YoY due to the fact that both were heavily impacted by the COVID-19 pandemic in the same period of the previous fiscal year, and both were higher than the Company's forecasts due to a full-fledged recovery in demand in markets in Japan and overseas. In addition, by region, the Company performed strongly both in Japan and overseas, with a more favorable performance than expected overseas in particular.

* Since the start of FY3/22, the Company has been applying the Accounting Standard for Revenue Recognition (ASBJ Statement No. 29, March 31, 2020) and other relevant standards, but there was no impact on FY3/22 3Q. Figures for the same period of the previous fiscal year do not reflect the application of the standard.

2. Outlook for FY3/22

For FY3/22 consolidated results, the Company is forecasting net sales of ¥26,000mn (+20.2% YoY), operating profit of ¥1,200mn (+71.1%), and ordinary profit of ¥1,250mn (+89.6%), and profit attributable to owners of parent of ¥850mn (versus ¥4mn in FY3/21). While the impact of the COVID-19 pandemic is still uncertain, solid performance is forecast both in Japan and overseas. On the other hand, the Company expects cost increases due to the high prices of supplies and materials, such as steel materials, and the high price of container freight. Most of this increase is scheduled to be recorded in the cost of sales for the fourth quarter, and the forecast is therefore a cautious one. Nevertheless, the outlooks seems a little conservative, with operating profit is expected to reach ¥35mn or above in the fourth quarter (accounting period), and we think there is a possibility that the profit forecast may be revised further upward.

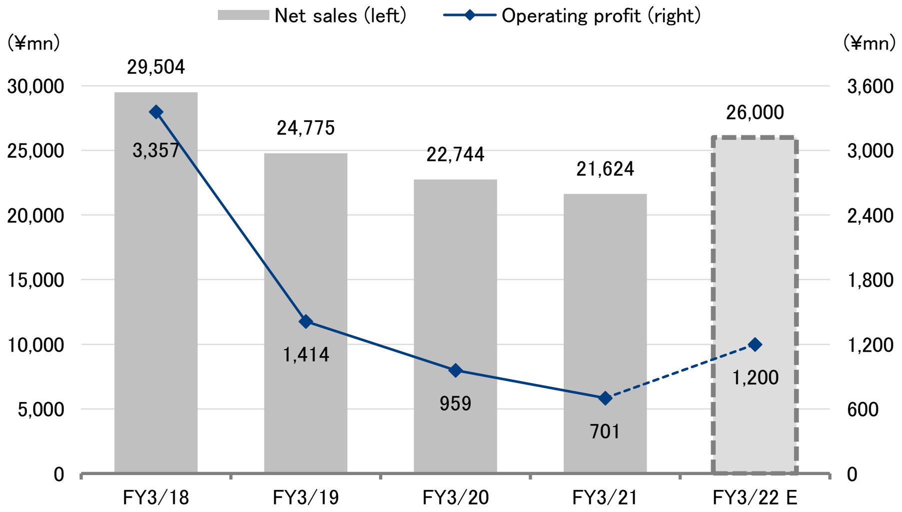
3. Medium- to long-term growth strategy

In June 2021, the Company released its "Medium-Term Management Policy" which runs through FY3/26. The ultimate goal is to increase corporate value and shareholder value, and in order to achieve this the Company will promote a "business growth strategy" and an "efficient capital strategy." In terms of numerical targets, the Company is aiming for net sales of ¥30bn, operating profit of ¥3.1bn, ROE (Return on Equity) of 8% in FY3/26, and will aim to maintain a stable dividend payout ratio of 50% (DOE (Dividend on Equity) of 4%). In line with this policy, the Company has announced a dividend payout ratio of 100% (annual dividend of ¥120) for FY3/22, and with the upward revision of the earnings forecast, the Company announced that it would change the dividend standard from dividend payout ratio to DOE, along with an increase in the annual dividend to ¥150.0. If the earnings increase even further, we think further dividend increases are also possible. In this way, it is commendable that the Company has released a clear capital policy targeting an improvement in ROE, and is carrying out shareholder returns in line with this policy.

Key Points

- Japan's leading manufacturer of road rollers with a long history. Domestic market share is over 70%, and the Company aims to grow by expanding its overseas market share
- Despite upward revision of earnings forecast for FY3/22, the forecast seems conservative, and there may be potential for further upward revision
- As medium-term numerical targets, the Company is aiming for net sales of ¥30bn, operating profit of ¥3.1bn, and ROE of 8% in FY3/26

Result trends



Source: Prepared by FISCO from the Company's financial results

Company profile

The top manufacturer of road rollers with a long history

The Company is a specialized manufacturer of road rollers for paving roads and other road construction equipment, and is the top manufacturer in Japan, with a market share of above 70%. In 1970, the Company established a joint venture in Indonesia, as part of its effort to expand overseas business at an early stage. As of March 31, 2021, the Company has four domestic subsidiaries and five overseas subsidiaries (U.S., China, three in Indonesia). The Company listed its shares on the Second Section of the Tokyo Stock Exchange in 1964, and its shares were reclassified to the First Section of the Tokyo Stock Exchange in 1981.

Business overview

The top manufacturer of road rollers with a domestic market share of over 70%. Will seek growth by offering high value-added and expanding overseas market share

1. Business description

The Company's main business is the manufacture and sale of road rollers used in road paving and other applications, and road roller-related net sales account for approximately 95% of all net sales. The term "road roller" actually covers quite a wide range of machines in terms of capabilities and size, among other features. The Company has roughly 20 platforms alone for road rollers, and when different variations are added the total number of products is in the 70-80 range. There is also a wide range in sizes, from one ton to 20 tons (for large civil engineering projects). The core price range is from ¥5mn (medium-size rollers) to ¥10mn (large rollers).

In terms of net sales by region in FY3/22 3Q*, net sales in Japan were ¥11,083mn (56.0% of total net sales), net sales in North America were ¥3,220mn (16.3%), net sales in Asia were ¥4,871mn (24.6%), net sales in the ME and Russia/CIS were ¥18mn (0.1%) and net sales to Other regions totaled ¥598mn (3.0%).

* Net sales by region is the amount of products actually sold to customers, and differs from the reportable segment "Net Sales by Location" in the financial results.

2. Characteristics and strengths

As mentioned above, the Company is a specialized manufacturer of road rollers and other road construction equipment, and the Company has the following special characteristics and strengths.

(1) Long history as a specialized manufacturer

The Company's greatest strength is its long history as a specialized manufacturer of road rollers and other road construction equipment. In other words, by deploying a global niche strategy through selection and concentration the Company has increased its level of expertise and accumulated its own unique technologies.

(2) Technological capabilities

When it comes to hardening and paving roads, the necessary pressure, torque, and other variables (compaction technology) differ depending on the specific land, land quality, soil, and other conditions. Therefore, roadwork companies often require different types of road rollers to match individual worksites (ground, etc.). Because the Company has been a specialized manufacturer of road roller and other road construction equipment for many years, it boasts a high level of technological capabilities with respect to compaction technology, and it is not easy for its competitors to catch up to it.

(3) Credibility

Credibility backed by experience engineering and track record is also a strength of the Company. The technology to ensure underground compaction quality is a black box, and is not something that is easy for late-arriving manufacturers and non-specialized manufacturers to copy. For example, asphalt mixture brought in at high temperatures must be worked on within a limited time, and if the work is of poor quality, it must be redone which involves a large price. Also, work quality issues for roads and embankments are slow to emerge, and the compaction quality at the time that work is completed tends to be a black box. For this type of experience engineering, the Company's brand which customers have used for many years and the long-term insight due to variety of worksite experiences are strengths, and these are points that have earned the trust of many customers.

3. Market share and competitors

According to data from the Japan Construction Equipment Manufacturers Association, in FY2020 domestic construction equipment shipment value was ¥2.2tn, and road roller and other road construction equipment (the Company's main products) account for 2.8% of this amount. The Company has a share of over 70% in this road equipment market, making it the top manufacturer in Japan. Competitors include companies such as Hitachi Construction Machinery Co., Ltd. <6305>, but none of these companies are specialized manufacturers. Some overseas manufacturers have entered the market in Japan, but none have much of a presence. In Japan, the Company's earnings rise and fall along with the ups and downs of the market.

In the global market, although there are no accurate statistics, the Company's market share (on a units produced basis) is estimated to be in the 6-7% range. However, this is on a global basis, and if we limit the scope to the main markets that the Company operates in (Japan, ASEAN, North America), the Company's market share is around 20%. The Company's main competitors in the global market include Caterpillar <CAT>, FAYAT SAS, Deere & Company <DE>, and Volvo Personvagnar AB, but none of these companies are manufacturers that specialize in road rollers.

Results trends

FY3/22 3Q saw full-fledged recovery of demand in Japan and overseas, with operating profit increasing 189.0% YoY. Overseas business performed particularly favorably

1. Outline of results for FY3/22 3Q

In the consolidated results for FY3/22 3Q, net sales increased 28.7% YoY to ¥19,793mn, operating profit increased 189.0% YoY to ¥1,165mn, ordinary profit increased 286.2% to ¥1,206mn, and profit attributable to owners of parent was ¥836mn (versus a ¥285mn loss in the year-earlier period).

Both net sales and operating profit increased significantly YoY due to the fact that both were heavily impacted by the COVID-19 pandemic in the same period of the previous fiscal year, and both were also higher than the Company's forecasts. Furthermore, as the economic recovery in the "with COVID" period continues, as a result of full-scale recovery in demand in Japan and overseas, business performance was favorable, particularly overseas. Although the gross margin declined to 24.9% (25.2% in the previous fiscal year), mainly due to increases in the price of raw materials (steel, etc.), gross profit was up 27.2% YoY to ¥4,918mn due to the increase of sales. Meanwhile, SG&A expenses increased 8.4% YoY due to the increase in business travel and networking/entertainment expenses resulting from more sales activity than in the year-earlier period as well as an increase in personnel expenses. However, the SG&A expense ratio declined to 19.0% (from 22.5% in the year-earlier period) due to the increase in sales. As a result, operating profit increased significantly.

Analyzing the change factors for operating profit, the increase in sales had a positive ¥1,111mn impact, the increase in the cost of goods sold ratio had an impact of minus ¥59mn, and the increase in SG&A expenses had an in impact of minus ¥289mn (personnel expenses had a positive ¥95mn impact, shipping expenses had a positive ¥59mn impact, technology and research expenses had a positive ¥43mn impact, and other expenses had a positive ¥92mn impact).

Overview of FY3/22 3Q consolidated results

(¥mn)

	FY3/21 3Q		FY3/22 3Q		Change	
	Results	% of net sales	Results	% of net sales	Amount	%
Net sales	15,374	100.0%	19,793	100.0%	4,419	28.7%
Gross profit	3,866	25.2%	4,918	24.9%	1,052	27.2%
Selling, general and administrative expenses	3,463	22.5%	3,753	19.0%	289	8.4%
Operating profit	403	2.6%	1,165	5.9%	762	189.0%
Ordinary profit	312	2.0%	1,206	6.1%	894	286.2%
Profit attributable to owners of parent	-285	-1.9%	836	4.2%	1,121	-

Source: Prepared by FISCO from the Company's financial results

2. Trends by region

In looking at FY3/22 3Q sales by region, on the whole, sales are on a recovery trend from the impacts of the COVID-19 pandemic. In Japan, while performance is still impacted by COVID-19, net sales were ¥11,083mn (up 16.0% YoY), which was generally on par with the forecast, as a result of strong performance in road and civil engineering projects, as well as other public investment-related projects.

Overseas, net sales significantly increased by 49.6% YoY to ¥8,709mn, due to the recovery in demand for construction machinery in key markets. Net sales in North America were ¥3,220mn (up 62.9%), due to the recovery in demand for construction machinery, amid brisk construction investment, as well as an increase in market share. In Asia, net sales were ¥4,871mn (up 37.7%) as demand recovered in the buoyant markets of Indochina, such as Vietnam and Thailand, as well as in the stagnant market of Indonesia. In other regions, net sales increased 100.6% to ¥598mn, based on the relative strong performance in Australia, New Zealand and Latin America.

Net sales by region

(¥mn)

	FY3/21 3Q		FY3/22 3Q		Change	
	Results	% of total	Results	% of total	Amount	%
Japan	9,553	62.1%	11,083	56.0%	1,530	16.0%
Overseas	5,820	37.9%	8,709	44.0%	2,888	49.6%
North America	1,976	12.9%	3,220	16.3%	1,243	62.9%
Asia	3,538	23.0%	4,871	24.6%	1,332	37.7%
ME and Russia/CIS	6	0.0%	18	0.1%	12	184.5%
Other regions	298	1.9%	598	3.0%	300	100.6%
Total	15,374	100.0%	19,793	100.0%	4,419	28.7%

Source: Prepared by FISCO from the Company's results briefing materials

Stable financial condition, ample cash and deposits of ¥8,469mn

3. Financial condition

In terms of the Company’s financial condition as of December 31, 2021, current assets were ¥25,691mn (up ¥2,763mn from the end of the previous fiscal year). The main factors included a ¥1,486mn increase in cash and deposits, a ¥717mn increase in notes and accounts receivable – trade, and a ¥275mn increase in inventory assets. Non-current assets were ¥12,152mn (down ¥21mn). The main factors included a ¥92mn increase in property, plant and equipment, a ¥33mn decrease in intangible fixed assets, and a ¥79mn decrease in investments and other assets. As a result, total assets were ¥37,843mn (up ¥2,742mn YoY). As of December 31, 2021, cash and deposits stood at a high level of ¥8,469mn.

Meanwhile, total liabilities were ¥15,503mn (up ¥2,440mn from the end of the previous fiscal year). The main factors among current liabilities included a ¥2,445mn increase in payables (notes and accounts payable – trade and electronically recorded obligations – operating), an ¥19mn increase in short-term borrowings, and a ¥70mn decline in non-current liabilities. Total net assets stood at ¥22,340mn (up ¥301mn), with the main factors including a ¥368mn increase in retained earnings due to the booking of profit attributable to owners of parent, a ¥369mn increase in foreign currency translation adjustment, and a ¥173mn decrease in valuation difference on available-for-sale securities. As a result, the equity ratio as of December 31, 2021, was 58.9% (versus 62.7% at the end of the previous fiscal year).

Furthermore, the Company has been focusing on slimming down its balance sheet, and as a result of this effort, net working capital (trade receivables + inventories – trade payables) at the end of FY3/22 3Q declined 19.2% (down ¥2,114mn) YoY to ¥8,868mn. Mainly due to increasing the efficiency of inventory management, inventories declined ¥878mn to ¥7,326mn. As a result, the net sales/inventory turnover ratio improved 1.1 times to a 3.6 times per year.

Net working capital

(¥mn)

	FY3/21 3Q Results	FY3/22 3Q Results	Change	
			Amount	%
Consolidated net sales (annualized consolidated net sales)	20,429	26,044	5,615	27.5%
Trade receivables	7,510	8,676	1,166	15.5%
Inventories	8,204	7,326	-878	-10.7%
Trade payables	-4,732	-7,134	-2,402	50.8%
Net working capital	10,982	8,868	-2,114	-19.2%

Note: Annualized consolidated net sales = cumulative FY3/22 3Q net sales + FY3/21 2H net sales
Source: Prepared by FISCO from the Company's results briefing materials

Outlook

Since the earnings forecast for FY3/22 seems conservative, despite upward revision, there may be potential for further upward revision

● Outlook for FY3/22

Based on its recent favorable performance amid further progress in the global recovery of demand for construction machinery, in February 2022, the Company revised its consolidated results forecast upward. The Company is forecasting net sales of ¥26,000mn (+20.2% YoY), operating profit of ¥1,200mn (+71.1%), and ordinary profit of ¥1,250mn (+89.6%), and profit attributable to owners of parent of ¥850mn (versus ¥4mn in FY3/21).

While the impact of the COVID-19 pandemic is still uncertain, in Japan the Company forecasts solid demand to continue against a backdrop of disaster prevention and mitigation and the plan for national resilience. Overseas, global construction machinery demand is continuing to recover, mainly due to large-scale infrastructure upgrade plans in the United States and the economic measures of ASEAN and emerging countries, among other factors. On the other hand, the Company expects cost increases due to the high prices of supplies and materials, such as steel materials, and the high price of container freight, with most of this increase is expected to be recorded in the cost of sales for the fourth quarter. Therefore, the upwardly revised full-year forecast is a cautious one. Nevertheless, the outlooks seems a little conservative, with operating profit is expected to reach ¥35mn or above in the fourth quarter (accounting period), and we think there is a possibility that the profit forecast may be revised further upward.

Consolidated outlook for FY3/22

(¥mn)

	FY3/21		FY3/22		Change	
	Results	% of net sales	Revised forecast	% of net sales	Amount	%
Net sales	21,624	100.0%	26,000	100.0%	4,375	20.2%
Operating profit	701	3.2%	1,200	4.6%	498	71.1%
Ordinary profit	659	3.0%	1,250	4.8%	590	89.6%
Profit attributable to owners of parent	4	0.0%	850	3.3%	845	-

Note: FY3/22 revised forecasts are the values announced in February 2022
Source: Prepared by FISCO from the Company's financial results

Medium- to long-term growth strategy

As its medium-term growth strategy, the Company will seek to grow its overseas market share, expand overseas business domains, and create added value by developing next-generation businesses. FY3/26 targets include net sales of ¥30bn and operating profit of ¥3.1bn

In June 2021, the Company released its "Medium-Term Management Policy" which runs through FY3/26. The ultimate goal is to increase corporate value and shareholder value, and in order to achieve this the Company will promote a "business growth strategy" and an "efficient capital strategy." In terms of numerical targets, the Company is aiming for net sales of ¥30bn, operating profit of ¥3.1bn, ROE of 8% in FY3/26, and will aim to maintain a stable dividend payout ratio of 50% (DOE of 4%). As of the end of FY3/22 3Q, the Company had kept these numerical targets unchanged.

1. Business strategy

(1) Domestic market: Create added value through stabilization and developing next-generation businesses
The domestic market for road rollers is already in its mature phase and the Company's market share is large. Therefore, the Company will aim to grow by adding new value to existing products (high-performance, etc.), in other words, by developing next-generation businesses.

(2) Overseas markets: Increase market share and expand business domains
In overseas markets, there are many regions (countries) where demand is increasing, and there is significant room for growth given the Company's low market shares. Therefore, the Company will seek growth through the two strategies of more fully cultivating existing markets and expanding its business domains.

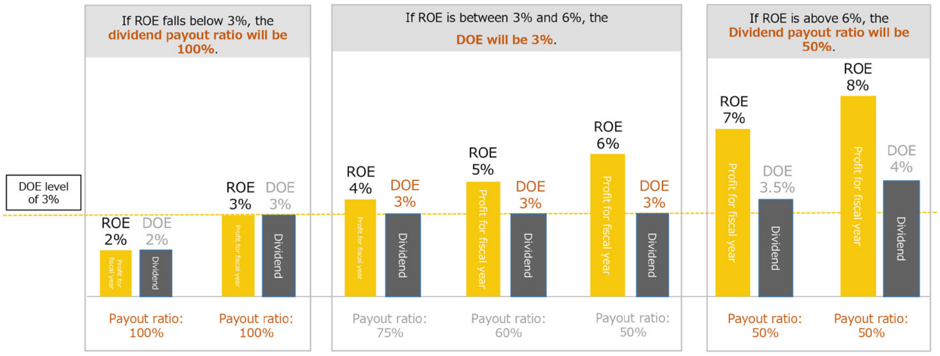
(3) Numerical targets
As medium- and long-term numerical targets, the Company aims for net sales of ¥26.5bn, operating profit of ¥2.0bn, and ROE of 5.5% in FY3/24, and net sales of ¥30.0bn, operating profit of ¥3.1bn, and ROE of 8% in FY3/26.

2. Capital Strategy

As its basic policy for capital strategy, the Company will return profits to shareholders at a level that supports the Company's objective of ROE of 8%, and will increase shareholder value (improve capital efficiency). As a final target for FY3/26, the Company will strive to achieve ROE of 8% and a 50% dividend payout ratio. This would be DOE of 4%.

Generally, two things need to be improved in order to increase ROE. One is of course increasing profit attributable to owners of parent, while the other is suppressing shareholders' equity (not increasing shareholders' equity more than necessary, or decreasing it). In order to increase operating profit, the Company plans to promote the business strategies discussed above, but at the same time, in order to keep from increasing shareholders' equity more than needed, the Company plans to execute a dividend policy in which, if ROE falls below 3%, the dividend payout ratio will be 100%, if ROE is between 3% and 6%, the DOE will be 3%, and if ROE is above 6%, the dividend payout ratio will be 50%.

Basic capital policy approach



Source: Medium-Term Management Policy

In terms of share buybacks, through FY3/26 the Company will consider flexible share buybacks with an upper limit of ¥0.5bn to ¥2.0bn. With respect to investment securities, the Company will review investment securities from the perspective of business strategy. Also, concerning growth investment, the Company will consider utilizing leverage with an emphasis on return on capital (ROIC).

3. ESG initiatives

Through its core business, the Company is working proactively on social issues such as SDGs, ESG, and decarbonization. The main initiatives related to ESG are as follows.

(1) E (Environmental) initiatives: Efforts towards being carbon neutral

The Company's manufacturing plants in Japan emit approximately 2,000 tons of CO_2 per year (this includes about 1,000 tons of CO_2 emissions from fossil fuels, and around 1,000 tons of emissions from electricity use), but the Company aims to cut its emissions by 50%. Specifically, the Company has decided on a policy of reducing its indirect CO_2 emissions from the use of electricity by switching to renewable energy.

(2) S (Society) initiatives: Management policy of contributing to social projects through road construction

The Company has a management policy of contributing to the social project of global land development through road construction, and is advancing worker safety, activities to contribute to society, and human capital development. In terms of worker safety, the Company aims to improve safety at construction worksites by widely using rollers equipped with an emergency brake system. In terms of activities to contribute to society, the Company is developing technologies that contribute to land development in terms of road construction. With respect to human capital development, the Company is promoting diversity.

(3) G (Governance) initiatives: Compliance with the revised Corporate Governance Code

In compliance with the recently revised Corporate Governance Code, the Company has determined that the skills to be possessed by our Board of Directors, comprising Directors and Executive Officers, are in the areas of corporate management, road construction equipment, global perspective, capital markets, and manufacturing, marketing, and administration. The Company is working to disclose these skills as a skills matrix for its Board of Directors. The Company has determined to establish, under the Board of Directors, a Nomination and Remuneration Committee, the majority of whose members are Outside Directors. This is to enhance independence of functions, objectivity, and accountability of the Board of Directors when nominating and compensating Directors. Going forward, the Company plans to ensure diversity and address climate change risks in accordance with the Task Force on Climate-related Financial Disclosures.

Shareholder return policy

Following the upward revision of the earnings forecast for FY3/22, the Company changed the standard for dividends to DOE, and plans to pay an annual dividend of ¥150.0. The Company aims to conduct share buybacks with an upper limit of ¥0.5-2.0 billion up to FY3/26

The Company works to secure a stable management base over the long term, and also places importance on the continuation of stable dividends, and makes it a basic policy to distribute results that are supported by business performance and a sound financial structure. Based on this basic policy, the Company decides dividends and conducts share buybacks. As discussed above, the Company's medium-term shareholder return policy is as follows. If ROE falls below 3%, the dividend payout ratio will be 100%, if ROE is between 3% and 6%, the DOE will be 3%, and if ROE is above 6%, the dividend payout ratio will be 50%. With respect to share buybacks, the Company is considering flexible share buybacks with an upper limit of ¥0.5bn to ¥2.0bn by FY3/26.

Based on the above dividend policy, for FY3/22, the Company initially announced the dividend payout ratio of 100% (annual dividend of ¥120.0). However, as mentioned, following the upward revision of the full-year earnings forecast due to recent favorable performance, ROE at the end of FY3/22 is expected to exceed 3%, and the Company announced that dividend standard has been changed from a dividend payout ratio of 100% to DOE of 3%, for an annual dividend of ¥150.0 (interim dividend ¥60.0, year-end dividend ¥90.0). Furthermore, if business performance increases further, we believe there is a possibility of a further dividend increase.

Furthermore, regarding share buybacks, based on the medium-term management policy, the Company bought back 130,000 shares (¥340mn) by July 15, 2021.

The Company's stance of announcing a clear plan to improve ROE and carrying out shareholder return plans in line with that plan is commendable.

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