COMPANY RESEARCH AND ANALYSIS REPORT

SAKAI HEAVY INDUSTRIES, LTD.

6358

Tokyo Stock Exchange First Section

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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 1H

In the consolidated results for FY3/22 1H*, net sales increased 27.8% year on year (YoY) to ¥12,987mn, operating profit increased 279.2% YoY to ¥725mn, ordinary profit increased 332.8% to ¥732mn, and profit attributable to owners of parent was ¥509mn (versus a ¥373mn 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 it seems that both were higher than the Company’s forecasts. In addition, results in Japan as well as overseas recovered to strong levels.

* Since the start of FY3/22, the Company has been applying the Accounting Standard for Revenue Recognition (ASBJ Statement No. 29, March 31, 2020), but there was no impact on FY3/22 1H.

2. Outlook for FY3/22

For FY3/22 consolidated results, the Company is forecasting net sales of ¥25,000mn (+15.6% YoY), operating profit of ¥900mn (+28.3%), and ordinary profit of ¥800mn (+21.4%), and profit attributable to owners of parent of ¥520mn (versus ¥4mn in FY3/21). While the impacts of the COVID-19 pandemic remain uncertain, in Japan, the Company expects demand related to civil engineering and roads to remain firm due to disaster prevention and mitigation efforts as well as the national resilience plan, among other factors. In the U.S., massive infrastructure upgrades under the American Jobs Act are being discussed, and a recovery is expected. In Asia, demand is recovering due to economic measures in China and ASEAN nations, and in even in Indonesia, where the situation had been weak, conditions have been recovering. Amid the global recovery in demand for construction equipment, the Company upwardly revised its initial net sales forecast for FY3/22 from ¥23,500mn, due to the expectations for strong sales in 2H as well as the fact that FY3/22 1H results exceeded the initial forecasts. Meanwhile, based on the fact that the Company expects costs to increase in 2H as a result of soaring parts and materials prices such as steel materials and container freight rates, the Company left its initial forecasts for profits unchanged. However, if the increase in costs are lower than expected, there is a chance that the Company might upwardly revise its profit forecasts.

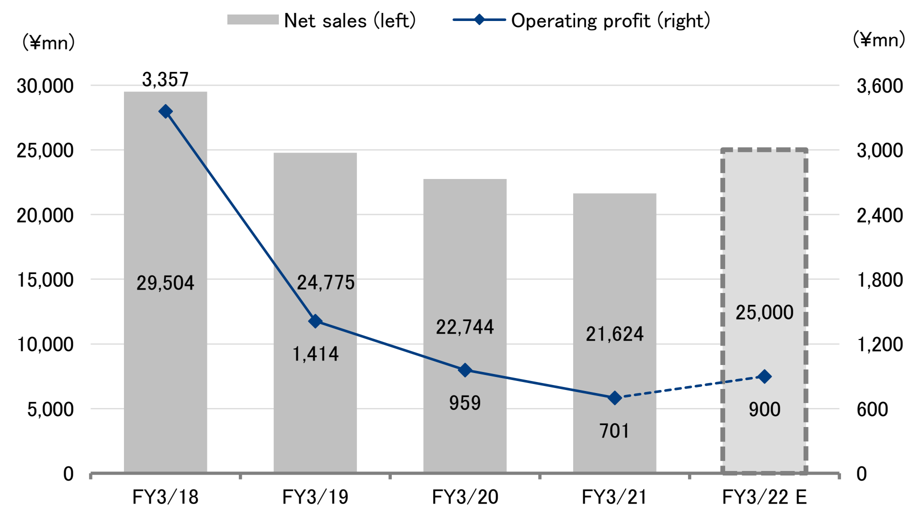
3. Medium- to long-term growth strategy

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% for FY3/22 (annual dividend = ¥120), but at FISCO we think that there is a possibility that the Company will increase the dividend if it seems that results will exceed the forecasts. 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
- Upwardly revised net sales forecast for FY3/22 due to expectation for strong sales in 2H. Kept profit forecasts unchanged due to expectations for rising costs in 2H, but there is also a possibility for upward revisions
- 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

Results 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 1H*, net sales in Japan were ¥6,968mn (53.7% of total net sales), net sales in North America were ¥2,297mn (17.7%), net sales in Asia were ¥3,298mn (25.4%), net sales in the ME and Russia/CIS were ¥4mn (0.0%) and net sales to Other regions totaled ¥418mn (3.2%).

* 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

Both sales and profits increased significantly in FY3/22 1H, and even exceeded the Company's forecasts. Both the domestic and overseas businesses are recovering from the impacts of the COVID-19 pandemic and are performing well

1. Outline of results for FY3/22 1H

In the consolidated results for FY3/22 1H, net sales increased 27.8% YoY to ¥12,987mn, operating profit increased 279.2% YoY to ¥725mn, ordinary profit increased 332.8% to ¥732mn, and profit attributable to owners of parent was ¥509mn (versus a ¥373mn 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. By region, results recovered both in Japan and overseas, and the recovery overseas was especially large. The gross margin was 24.8%, which was almost the same as in the year-earlier period (24.9%), and gross profit increased 27.3% YoY to ¥3,220mn due to the effect of the increase in net sales. Meanwhile, SG&A expenses increased 6.7% 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 19.2% (from 23.0% 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 ¥702mn impact, the increase in the cost of goods sold ratio had an impact of minus ¥11mn, and the increase in SG&A expenses had an in impact of minus ¥157mn (personnel expenses had a positive ¥56mn impact, shipping expenses had a positive ¥37mn impact, technology and research expenses had a positive ¥20mn impact, and other expenses had a positive ¥43mn impact).

Overview of FY3/22 1H consolidated results

(¥mn)

	FY3/21 2Q		FY3/22 2Q		Change	
	Results	% of net sales	Results	% of net sales	Amount	%
Net sales	10,163	100.0%	12,987	100.0%	2,824	27.8%
Gross profit	2,529	24.9%	3,220	24.8%	691	27.3%
Selling, general and administrative expenses	2,338	23.0%	2,495	19.2%	157	6.7%
Operating profit	191	1.9%	725	5.6%	534	279.2%
Ordinary profit	169	1.7%	732	5.6%	563	332.8%
Profit attributable to owners of parent	-373	-3.7%	509	3.9%	882	-

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

2. Trends by region

In looking at FY3/22 1H sales by region, on the whole, sales are on a recovery trend from the impacts of the COVID-19 pandemic. In Japan, despite continued impacts from COVID-19, net sales were ¥6,968mn (up 13.7% 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 increased 49.2% YoY to ¥6,019mn, due to the recovery in demand for construction machinery in key markets. Net sales in North America were ¥2,297mn (up 61.5%), due to the recovery in demand for construction machinery, which had been slowing down, amid firm construction investment, as well as an increase in market share. Net sales in Asia were ¥3,298mn (up 38.1%), as demand recovered in Thailand, Vietnam, South Korea, China and elsewhere due to the rejuvenation of the economy, while there was a recovery trend in Indonesia after a bottoming out. In other regions, net sales increased 90.4% to ¥418mn, based on the relative strong performance in Australia, New Zealand and Latin America.

Net sales by region

(¥mn)

	FY3/21 2Q		FY3/22 2Q		Change	
	Results	% of total	Results	% of total	Amount	%
Japan	6,127	60.3%	6,968	53.7%	840	13.7%
Overseas	4,035	39.7%	6,019	46.3%	1,983	49.2%
North America	1,423	14.0%	2,297	17.7%	874	61.5%
Asia	2,388	23.5%	3,298	25.4%	909	38.1%
ME and Russia/CIS	3	0.0%	4	0.0%	1	26.1%
Other regions	219	2.2%	418	3.2%	198	90.4%
Total	10,163	100.0%	12,987	100.0%	2,824	27.8%

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

Stable financial condition, ample cash and deposits of ¥8,765mn

3. Financial condition

In terms of the Company's financial condition as of September 30, 2021, current assets were ¥24,259mn (up ¥1,332mn from the end of the previous fiscal year). The main factors included a ¥1,781mn increase in cash and deposits, a ¥252mn decrease in notes and accounts receivable – trade, and a ¥317mn decrease in inventory assets. Non-current assets were ¥12,194mn (up ¥21mn). The main factors included a ¥112mn increase in property, plant and equipment, and a ¥107mn decrease in investments and other assets. As a result, total assets were ¥36,454mn (up ¥1,353mn YoY). As of September 30, 2021, cash and deposits stood at a high level of ¥8,765mn.

Meanwhile, total liabilities were ¥14,220mn (up ¥1,157mn from the end of the previous fiscal year). The main factors among current liabilities included a ¥1,173mn increase in payables (notes and accounts payable – trade and electronically recorded obligations – operating), an ¥80mn decrease in short-term borrowings, and a ¥43mn decline in non-current liabilities. Total net assets stood at ¥22,234mn (up ¥196mn), with the main factors including a ¥293mn increase in retained earnings due to the booking of profit attributable to owners of parent, a ¥301mn increase in foreign currency translation adjustment, and a ¥134mn decrease in valuation difference on available-for-sale securities. As a result, the equity ratio as of September 30, 2021, was 60.9% (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 1H declined 22.2% (down ¥2,445mn) YoY to ¥8,576mn. Mainly due to increasing the efficiency of inventory management, inventories declined ¥1,492mn to ¥6,732mn. 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 2Q Results	FY3/22 2Q Results	Change	
			Amount	%
Consolidated net sales (annualized consolidated net sales)	20,809	24,448	3,639	17.5%
Trade receivables	6,379	7,706	1,327	20.8%
Inventories	8,224	6,732	-1,492	-18.1%
Trade payables	-3,582	-5,862	-2,280	63.7%
Net working capital	11,021	8,576	-2,445	-22.2%

Note: Annualized consolidated net sales = FY3/22 1H net sales + FY3/21 2H net sales
Source: Prepared by FISCO from the Company's results briefing materials

4. Status of Cash flows

In FY3/22 1H, net cash provided by operating activities totaled ¥2,673mn. The main sources of cash provided were ¥741mn in profit before income taxes, ¥326mn in depreciation, a ¥322mn decrease in trade receivables, a ¥437mn decrease in inventories, and a ¥1,119mn increase in trade payables. Net cash used in investing activities was ¥124mn, mainly due to ¥119mn used for the purchase of property, plant and equipment. Net cash used in financing activities was ¥848mn, mainly due to a ¥221mn decrease (net) in short- and long-term borrowings, ¥341mn used to purchase treasury shares, and ¥215mn in dividends paid. As a result, cash and cash equivalents increased by ¥1,781mn, and the balance of cash and cash equivalents at the end of FY3/22 1H was ¥8,628mn.

Outlook

Upwardly revised FY3/22 net sales forecast to a 15.6% YoY increase, but left the forecast of a 28.3% increase in operating profit unchanged based on expectations for rising costs

● Outlook for FY3/22

For FY3/22 consolidated results, the Company is forecasting net sales of ¥25,000mn (+15.6% YoY), operating profit of ¥900mn (+28.3%), ordinary profit of ¥800mn (+21.4%) and profit attributable to owners of parent of ¥520mn (versus ¥4mn in FY3/21).

While the impacts of the COVID-19 pandemic remain uncertain, in Japan the Company expects demand related to civil engineering and roads to remain firm due to factors including disaster prevention and mitigation efforts and the government's national resilience plan. In the U.S., deliberations on plans for massive infrastructure upgrades under the American Jobs Act are ongoing, and a recovery is expected. In Asia, demand is recovering due to economic measures in China and ASEAN nations, and in Indonesia, where demand had been weak, a recovery trend is taking place. Amid the global recovery in demand for construction equipment, the Company upwardly revised its initial net sales forecast for FY3/22 by 6.4% from the initial forecast of ¥23,500mn, due to the expectations for strong sales in 2H as well as the fact that FY3/22 1H results exceeded the initial forecasts. Meanwhile, based on the fact that the Company expects costs to increase by approximately ¥500mn in 2H as a result of soaring parts and materials prices (such as steel materials) and container freight rates, the Company left its initial forecasts for profits unchanged. However, if the increase in costs is less than expected, there is a possibility that the Company could upwardly revise its profit forecasts.

Consolidated outlook for FY3/22

(¥mn)

	FY3/21		FY3/22		Change	
	Results	% of net sales	Forecast	% of net sales	Amount	%
Net sales	21,624	100.0%	25,000	100.0%	3,375	15.6%
Operating profit	701	3.2%	900	3.6%	198	28.3%
Ordinary profit	659	3.0%	800	3.2%	140	21.4%
Profit attributable to owners of parent	4	0.0%	520	2.1%	515	-

Note: FY3/22 forecasts are values announced in November 2021
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 1H, 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.

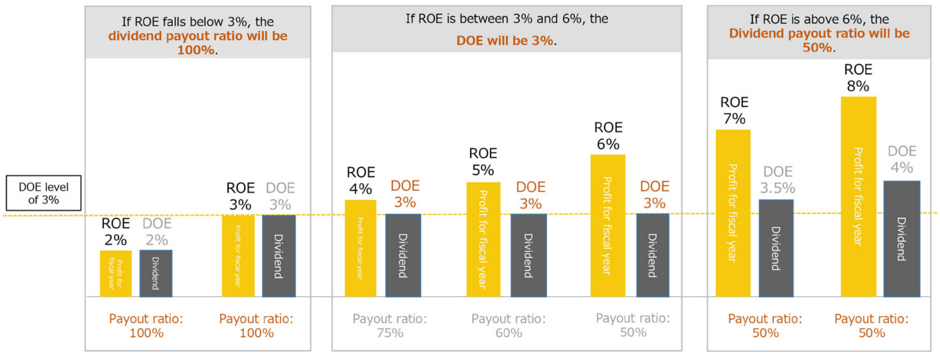
(3) Numerical targets
As medium- and long-term numerical targets, the Company aims for net sales of ¥26.5bn, operating profit of ¥2.0bn, and ROE of 5.5% in FY3/24, and net sales of ¥30.0bn, operating profit of ¥3.1bn, and ROE of 8% in FY3/26.

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). 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

The Company plans to pay an annual dividend of ¥120.0 (up ¥40.0 YoY) in FY3/22. Completed share buybacks of 130,000 shares in July 2021

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.

The Company paid an annual dividend of ¥100.0 in FY3/20, and an annual dividend of ¥80.0 in FY3/21. For FY3/22, the Company has announced a dividend payout ratio of 100% (annual dividend = ¥120.0), but at FISCO we think that there is a possibility that the Company will increase the dividend if it appears that results will exceed the forecasts. Concerning share buybacks, the Company has announced that it will buy back up to a maximum of 130,000 shares (¥500mn) by December 2021, and as of July 15, the Company has purchased 130,000 shares (¥340mn).

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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