COMPANY RESEARCH AND ANALYSIS REPORT

SAKAI HEAVY INDUSTRIES, LTD.

6358

Tokyo Stock Exchange Prime Market

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Summary

Full swing demand recovery in both domestic and overseas markets, and operating profit increased greatly in FY3/23 1Q, exceeding forecasts

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 70.0%. In recent years, the Company has been focusing on developing overseas markets, especially in North America and Southeast Asia.

1. Outline of results for FY3/23 1Q

In the consolidated results for FY3/23 1Q, net sales increased 12.7% year on year (YoY) to ¥6,865mn, operating profit increased 121.7% YoY to ¥448mn, ordinary profit rose 140.8% to ¥516mn, and profit attributable to owners of parent increased 160.9% to ¥402mn. In Japan, net sales were strong against a backdrop of measures to accelerate the national resilience plan, but profit struggled to grow due to cost increases, including rising raw materials costs and soaring energy prices. Meanwhile, overseas, performance was strong in both the U.S. and Asia (particularly in Indonesia and Vietnam), and both net sales and profits increased. The Company did not disclose its 1Q forecasts, but it appears that the results exceeded the Company's numerical targets.

2. Outlook for FY3/23

For FY3/23 consolidated results, the Company left its initial forecasts unchanged with net sales of ¥29,300mn (up 10.2% YoY), operating profit of ¥1,500mn (up 8.4%) ordinary profit of ¥1,450mn (up 3.0%), and profit attributable to owners of parent of ¥950mn (down 33.4%). The decline of profit attributable to owners of parent is mainly due to the absence of temporary deferred tax assets recorded (¥381mn) that occurred in the previous fiscal year. The outlook for net sales and profit by region has not been disclosed, but the Company's policy is to pursue sales increases in all regions. In spite of the fact that construction equipment is on track toward stable recovery as infrastructure investments increase globally, there are many uncertain factors including further increases in supply and material prices and the heightening of pressure to reorganize supply chains, in addition to the impact of the situation in Russia and Ukraine. For those reasons, the operating profit margin is projected to decline by 0.1pp YoY.

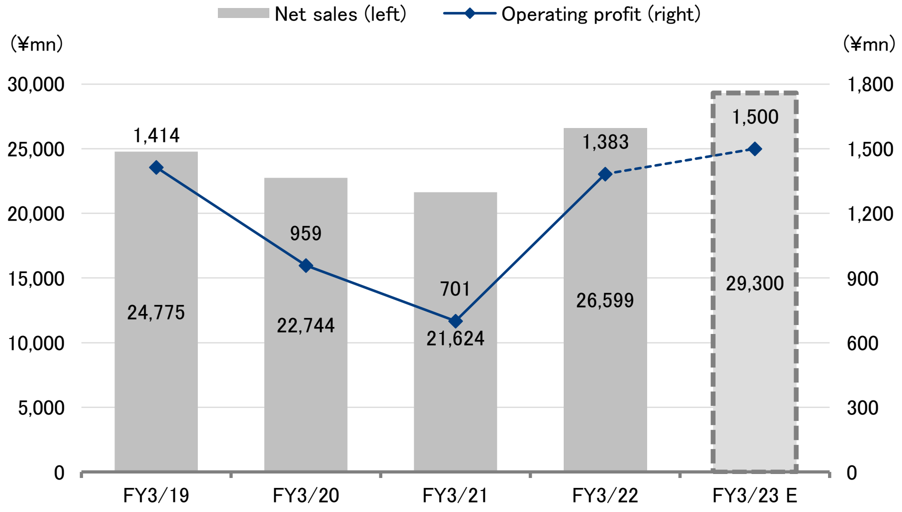
3. Medium- to long-term growth strategy

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, in FY3/26, the Company is aiming for net sales of ¥30.0bn, operating profit of ¥3.1bn, ROE (return on equity) of 8%, and will aim to maintain a stable dividend payout ratio of 50% (a DOE (dividend on equity ratio) of 4%). Net sales developed at a pace exceeding the plan in its first year of FY3/22, but the policy currently remains the same, and the Company has kept these numerical targets unchanged. With regard to dividends, a ¥165.0 annual dividend was paid in FY3/22 (a dividend payout ratio of 49.0%) and a ¥165.0 annual dividend (a dividend payout ratio of 73.6%) is also planned in FY3/23. 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
- The Company left its initial forecasts for FY3/23 unchanged, and is forecasting an 8.4% increase from the previous fiscal year in operating profit, exceeding 1Q forecasts
- As medium-term numerical targets, the Company is aiming for net sales of ¥30.0bn, 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 develops as a specialized manufacturer of road rollers for paving roads and other road construction equipment, and currently, the Company is the top manufacturer in Japan, and boasts a market share of over 70%. In 1970, the Company established a joint venture in Indonesia, as part of the Company's effort to expand business overseas at an early stage. As of March 31, 2022, 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. In conjunction with the Tokyo Stock Exchange's market recategorization in April 2022, it moved to the Prime Market.

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. Also, the Company's corporate philosophy is to "Contribute to the social project of global land development through the road construction equipment business."

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), but the Company also has road cutters and other machines that cost tens of millions in yen. Production is carried out on an expected production basis, and the Company does not manufacture machines based on individual orders. The useful lives of the Company's products are in the 20-30 years range, but very few customers use a machine until the end of its useful life. In most cases, they replace it after statutory depreciation (7-10 years) with a new one. Most of the depreciated equipment are resold as used machines to overseas customers (especially in developing countries).

In terms of net sales by region in FY3/22, net sales in Japan were ¥14,292mn (53.7% of total net sales), net sales in North America were ¥5,039mn (18.9%), net sales in Asia were ¥6,492mn (24.4%), and net sales to Other regions totaled ¥775mn (3.0%). Moreover, in terms of net sales by region in FY3/23 1Q, net sales in Japan were ¥2,811mn (41.0%), net sales in North America were ¥1,729mn (25.2%), net sales in Asia were ¥2,184mn (31.8%), and net sales to Other regions totaled ¥140mn (2.0%).

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 rollers 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 FY2021 domestic construction equipment shipment value was ¥2.9tn, and road roller and other road construction equipment (the Company's main products) account for 2.6% 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 5-6% 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

Full swing demand recovery in both domestic and overseas markets, and operating profit increased greatly in FY3/23 1Q, profits increased 121.7% YoY. Especially, overseas businesses are performing strongly

1. Outline of results for FY3/23 1Q

In the consolidated results for FY3/23 1Q, net sales increased 12.7% YoY to ¥6,865mn, operating profit increased 121.7% to ¥448mn, ordinary profit increased 140.8% to ¥516mn, and profit attributable to owners of parent increased 160.9% to ¥402mn.

In Japan, sales continued to be strong against a backdrop of measures to accelerate the national resilience plan, and net sales were solid, but profit struggled to grow due to preceding cost increases, including rising raw materials costs and soaring energy prices. Growth in profits was sluggish as there was a delay in passing on these costs to sales prices compared to the cost increases. Meanwhile, overseas, the Company's operating performance was strong. In particular, in the U.S. and Indonesia, there was progress in the recovery of demand, and both sales and profits increased, while results were also favorable in the Vietnam market. The Company did not disclose its 1Q forecasts, but it appears that the results exceeded its forecasts.

The gross margin improved to 25.6% (23.7% in the year-earlier period), mainly due to sales price revisions and improved logistics efficiency. On top of this, there was the impact of higher sales, and gross profit increased 21.5% YoY to ¥1,754mn. On the other hand, however, SG&A expenses increased by 5.2% due to the increase in travel and transportation expenses accompanying the resumption of business activities following restrictions on movement, as well as higher personnel costs and other factors, but the SG&A expenses ratio declined from 20.4% in the year-earlier period to 19.0% 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 ¥183mn impact, the increase in the cost of goods sold ratio had an impact of plus ¥126mn, and the increase in SG&A expenses had an in impact of minus ¥64mn (Breaking down the increase, personnel expenses had a positive ¥19mn impact, technology and research expenses had a positive ¥18mn impact, travel and transportation expenses had a ¥12mn impact, and other expenses had a positive ¥15mn impact).

Overview of FY3/23 1Q consolidated results

(¥mn)

	FY3/22 1Q		FY3/23 1Q		Change	
	Results	% of net sales	Results	% of net sales	Amount	%
Net sales	6,089	100.0%	6,865	100.0%	775	12.7%
Gross profit	1,443	23.7%	1,754	25.6%	310	21.5%
Selling, general and administrative expense	1,241	20.4%	1,305	19.0%	64	5.2%
Operating profit	202	3.3%	448	6.5%	246	121.7%
Ordinary profit	214	3.5%	516	7.5%	302	140.8%
Profit attributable to owners of parent	154	2.5%	402	5.9%	248	160.9%

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

2. Trends by region

With respect to FY3/23 1Q net sales by region, the overall results were solid. In Japan, sales related to public investments such as road and civil engineering projects were strong against a backdrop of measures to accelerate the national resilience plan. Net sales were ¥2,811mn (up 1.7% YoY), but appear to have slightly undercut the Company's forecast. This was due to the stagnation in some shipments stemming from delays in procuring parts caused by global logistics turmoil and other factors, not due to weak demand. Looking at it differently, there is a strong possibility that net sales would have increased further if the Company had been able to procure parts as planned.

Overseas, net sales increased significantly, amounting to ¥4,053mn (up 22.0% YoY) because of progress in the recovery of demand for construction equipment in the main markets. Of this amount, in North America net sales increased to ¥1,729mn (up 25.6%) as a result of the strong recovery in demand against the backdrop of robust investment in construction, as well as an increase in market share based on progress in cultivation of distributors. In Asia, net sales were ¥2,184mn (up 22.6%), due to recoveries in demand in Vietnam, which had been a strong market, in addition Indonesia, which had been sluggish. In other regions, net sales totaled ¥140mn (down 15.2%), which had a minor impact on overall earnings.

Net sales by region

(¥mn)

	FY3/22 1Q		FY3/23 1Q		Change	
	Results	% of total	Results	% of total	Amount	%
Japan	2,765	45.4%	2,811	41.0%	45	1.7%
Overseas	3,323	54.6%	4,053	59.0%	729	22.0%
North America	1,376	22.6%	1,729	25.2%	352	25.6%
Asia	1,782	29.3%	2,184	31.8%	402	22.6%
Other regions	165	2.7%	140	2.0%	-25	-15.2%
Total	6,089	100.0%	6,865	100.0%	775	12.7%

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

Stable financial condition, ample cash and deposits of ¥9,391mn

3. Financial condition

In terms of the Company's financial condition as of the end of FY3/23 1Q, current assets were ¥25,566mn (up ¥491mn from the end of the previous fiscal year). The main factors included a ¥1,397mn increase in cash and deposits, a ¥831mn decrease in notes and accounts receivable - trade (including electronically recorded monetary claims - operating), and a ¥250mn increase in inventories. Non-current assets were ¥12,869mn (up ¥86mn). The main factors include a ¥156mn increase in property, plant and equipment, a ¥45mn decrease in intangible assets, and a ¥24mn decrease in investments and other assets. As a result, total assets were ¥38,436mn (up ¥577mn). Furthermore, cash and deposits remained at a high level of ¥9,391mn as of the end of FY3/23 1Q.

Meanwhile, total liabilities were ¥14,867mn (up ¥170mn from the end of the previous fiscal year). The main factors among current liabilities included a ¥75mn decrease in payables (notes and accounts payable – trade and electronically recorded obligations – operating), a ¥162mn increase in short-term borrowings, and a ¥6mn decline in non-current liabilities. Total net assets stood at ¥23,568mn (up ¥407mn), with the main factors including a ¥39mn decrease in retained earnings due to the payment of dividends, a ¥485mn increase in foreign currency translation adjustment and a ¥39mn decrease in valuation difference on available-for-sale securities. As a result, the equity ratio as of the end of FY3/23 1Q was 61.2% (61.1% at the end of the previous fiscal year).

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 FY3/23 1Q increased 2.3% (up ¥212mn) YoY to ¥9,273mn. This was mainly due to the increase in inventories (up ¥691mn) and trade receivables (up ¥294mn), but the strong sales (net sales) resulted in the inventory turnover ratio improving 0.25 times YoY to 3.67 times per year.

Net working capital

(¥mn)

	FY3/22 1Q Results	FY3/23 1Q Results	Change	
			Amount	%
Consolidated net sales (annualized consolidated net sales)	23,148	27,375	4,227	18.3%
Trade receivables	7,412	7,706	294	4.0%
Inventories	6,767	7,458	691	10.2%
Trade payables	-5,118	-5,891	-773	15.1%
Net working capital	9,061	9,273	212	2.3%

Note: Consolidated net sales (annualized) = Net sales in 1Q of the fiscal year under review + cumulative net sales in 2Q-4Q of previous fiscal year
Source: Prepared by FISCO from the Company's financial results

Outlook

Left the initial FY3/23 forecast unchanged, forecasts a 10.2% sales increase and 8.4% operating profit increase YoY

● Outlook for FY3/23

For FY3/23 consolidated results, the Company is forecasting net sales of ¥29,300mn (up 10.2% YoY), operating profit of ¥1,500mn (up 8.4%) ordinary profit of ¥1,450mn (up 3.0%), and profit attributable to owners of parent of ¥950mn (down 33.4%). 1Q results were relatively strong, but the outlook remains unclear, so the Company left its initial forecasts unchanged.

The decline of profit attributable to owners of parent is mainly due to the absence of deferred tax assets temporarily recorded (¥381mn) in the previous fiscal year. The outlook for net sales and profit by region has not been disclosed, but the Company's strategy is to pursue sales increases in all regions. In spite of the fact that global demand for construction equipment is on a firm recovery track amid the global expansion in infrastructure investment, there are many uncertain factors, including further increases materials prices and the heightening of pressure to reorganize supply chains, in addition to the outlook for the situation in Russia and Ukraine. For these reasons, the operating profit margin is forecast to decline by 0.1pp YoY.

As discussed above, the Company's results in 1Q exceeded its forecasts overall due to strong performance in overseas markets, despite the delays in parts procurement and in passing on higher costs to sales prices in Japan. There is a strong possibility that results would have been even higher if there had not been delays in procuring parts and in passing on higher costs to sales prices. As a result, at FISCO we think there is a high likelihood that the Company will upwardly revise its full fiscal year forecasts at some point. Meanwhile, the Company has stated that in the future, it will make revisions as needed when it discloses quarterly financial results, so attention must be given to future developments.

Consolidated outlook for FY3/23

(¥mn)

	FY3/22		FY3/23		Change	
	Results	% of net sales	Forecast	% of net sales	Amount	%
Net sales	26,599	100.0%	29,300	100.0%	2,700	10.2%
Operating profit	1,383	5.2%	1,500	5.1%	116	8.4%
Ordinary profit	1,407	5.3%	1,450	4.9%	42	3.0%
Profit attributable to owners of parent	1,427	5.4%	950	3.2%	-477	-33.4%

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 ¥30.0bn 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 ¥30.0bn, 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%). Net sales developed at a pace exceeding the plan in its first year of FY3/22, but the policy currently remains the same, and 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

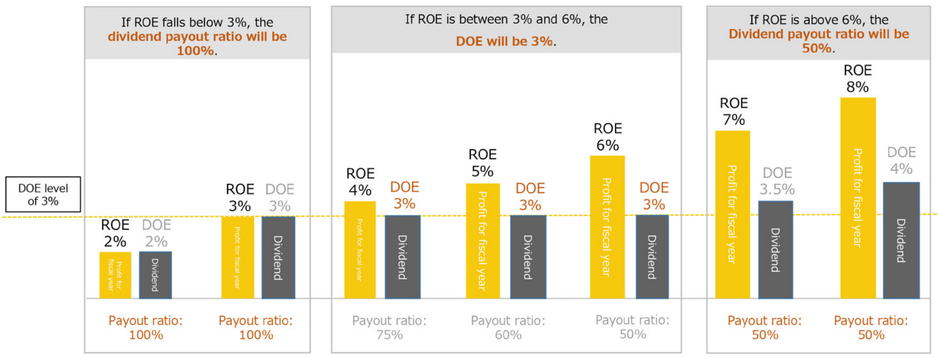
As medium- to long-term numerical targets, the Company aims for net sales of ¥26.5bn, operating profit of ¥2.0bn, and ROE of 5.5% in FY3/24, and net sales of ¥30.0bn, operating profit of ¥3.1bn, and ROE of 8% in FY3/26.

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

In June 2022, the Company disclosed its response to Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), which comprises climate change-related information in line with the recommendations of TCFD. For FY2019, the Company's Scope 1 and Scope 2 CO_2 emissions in Japan totaled 3,300 tons. In its disclosure, the Company established a target of achieving a 50% reduction in emissions by FY2030 and achieving carbon neutrality by FY2050.

(2) Society (S) 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 equipment business, 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 and development of highly specialized human resources.

(3) Governance (G) initiatives: Building a management structure to strengthen corporate governance

Based on the revisions to the Corporate Governance Code, the Company determined that the skills that the Board of Directors (comprising Directors and Executive Officers) should possess are: Corporate Management; Road Construction Equipment, Global, Capital Markets, Manufacturing, Marketing, and Administration, and publicly disclosed this as the skill matrix for our Board of Directors. Also, the Company has established a Nomination and Compensation Committee comprising a majority of Outside Directors under the Board of Directors in order to enhance the independence, objectivity, and accountability of the functions of the Board of Directors with respect to the nomination and compensation of Directors. At the General Meeting of Shareholders held in June 2022, the Company appointed its first-ever woman outside director as part of its effort to ensure diversity.

Shareholder return policy

Plans to pay the same annual dividend of ¥165.0 in FY3/23. To FY3/26 aims to conduct share buybacks with an upper limit of ¥0.5-2.0 bn up

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, although the Company announced a dividend payout ratio of 100% (annual dividend of ¥120.0) at the beginning of FY3/23, due to the strong operating results the Company changed the dividend criteria from a dividend payout ratio of 100% to a DOE of 3%, thereby paying an annual dividend of ¥165.0 (interim dividend of ¥60.0 and fiscal year-end dividend of ¥105.0). For FY3/23, the Company is again planning to pay an annual dividend of ¥165.0 (interim dividend of ¥80.0 and fiscal year-end dividend of ¥85.0). If the Company's operating results improve even further, we at FISCO think there is a possibility that the Company will raise the dividend even higher. With respect to share buybacks, based on its medium-term management plan, the Company acquired 130,000 shares (¥340mn) during FY3/22.

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

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Disclaimer

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