

Can management's commitment return Sumitomo's stock to previous heights?



Valuation Master Class

CASE  STUDY
VALUATION MASTER CLASS
by
A. Stoltz INVESTMENT
RESEARCH



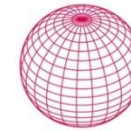
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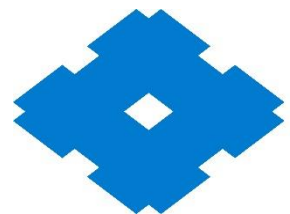


Ask
Ajarn
Andrew

Can management's commitment return Sumitomo's stock to previous heights?



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Sumitomo
Heavy Industries, Ltd.

*Japanese heavy equipment manufacturer and
part of the 400-year-old Sumitomo
conglomerate*

Our estimate:

JPY3,647
(Upside 24%)

BUY



3 things to know about this company

- ★ Gearing up in M&A activity to drive top-line growth
- ★ Growing CAPEX lays foundation for organic growth
- ★ Management focus on ROIC should enhance returns

Key statistics

Analyst consensus (7)

JPY3,500
(Upside 19%)

BUY

PB ratio

0.8x

Dividend yield

2.1%

Revenue breakdown 2021



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Sales

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Risks

Logistics &
Construction 36%



Industrial Machinery
24%



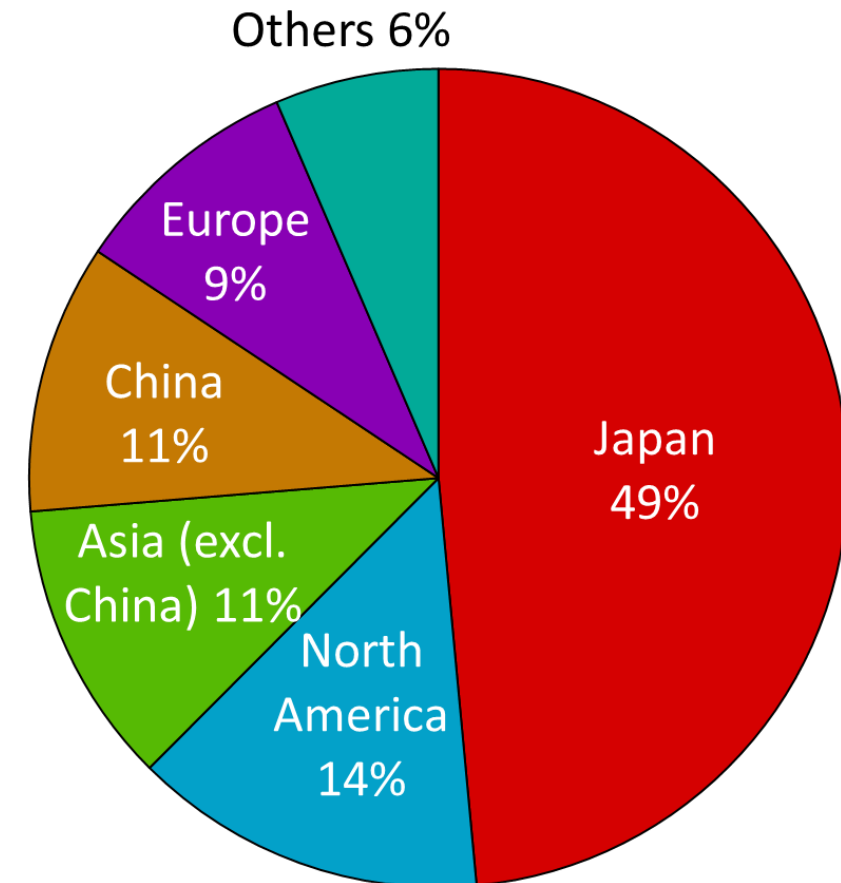
Energy & Lifelines
24%



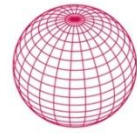
Mechatronics
16%



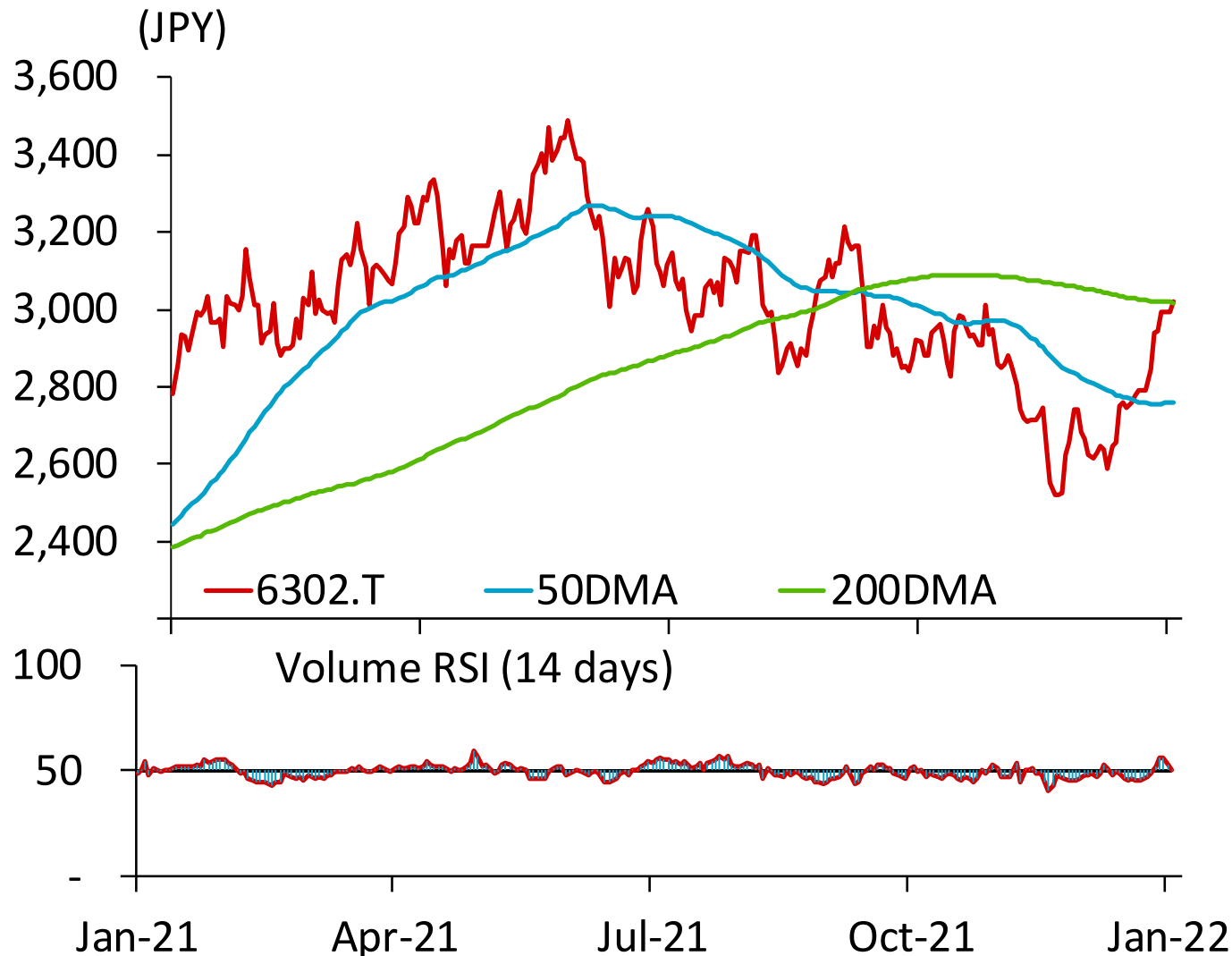
Breakdown by region



Price still bearish; volume unclear

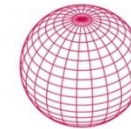


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- ★ Overall, the stock price has performed poorly over the past 6 months, down 26%
- ★ Since 3Q21, the 200 DMA stayed above the 50 DMA, which indicates a bearish signal
 - However, since early 2022, the share price has seen a strong rebound effect which should push the 50 DMA upward
- ★ Throughout the whole period, the RSI Volume fluctuated around the 50%, providing no clear signal

1 Gearing up in M&A activity to drive top-line growth



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Risks

Most recent acquisitions

2017  **Sumitomo**
SHI FW JPY23bn



JPY4bn

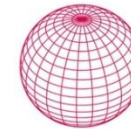
2018  **LAFERT** JPY22bn

2019  **Invertek**
Drives.com JPY15bn

Note: Transaction prices have been converted with Jan-22 exchange rate

- ★ Sumitomo's management has a strong commitment to continuous growth
 - M&A has been a useful tool to expand the business
- ★ For the next 3 years, the company allocated JPY40bn for acquisition purposes
 - This equals roughly 20% of the total budget available for CAPEX, R&D and M&A
 - I expect the company to pursue 2-3 acquisitions of similar size of recent transactions

2 Growing CAPEX lays foundation for organic growth



Sales

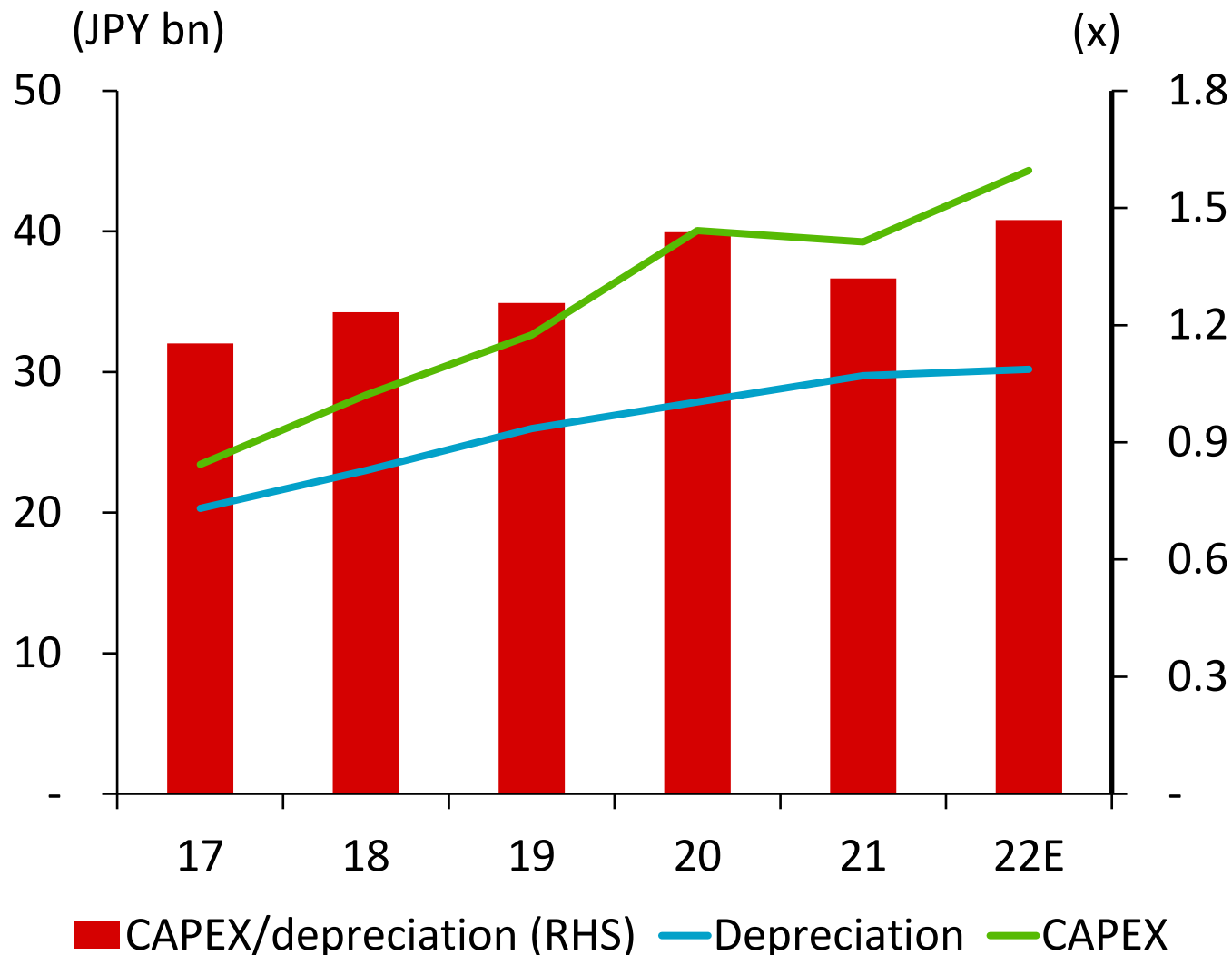
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- ★ With an average CAPEX-to-depreciation ratio of 1.3x, the company is still in an expansion stage
- ★ Capital investments and R&D expenses are likely to further increase, adding capacity to realize revenue growth
 - The R&D budget for the next 3 years accumulates to JPY70bn, a 40% increase to the past 3 years

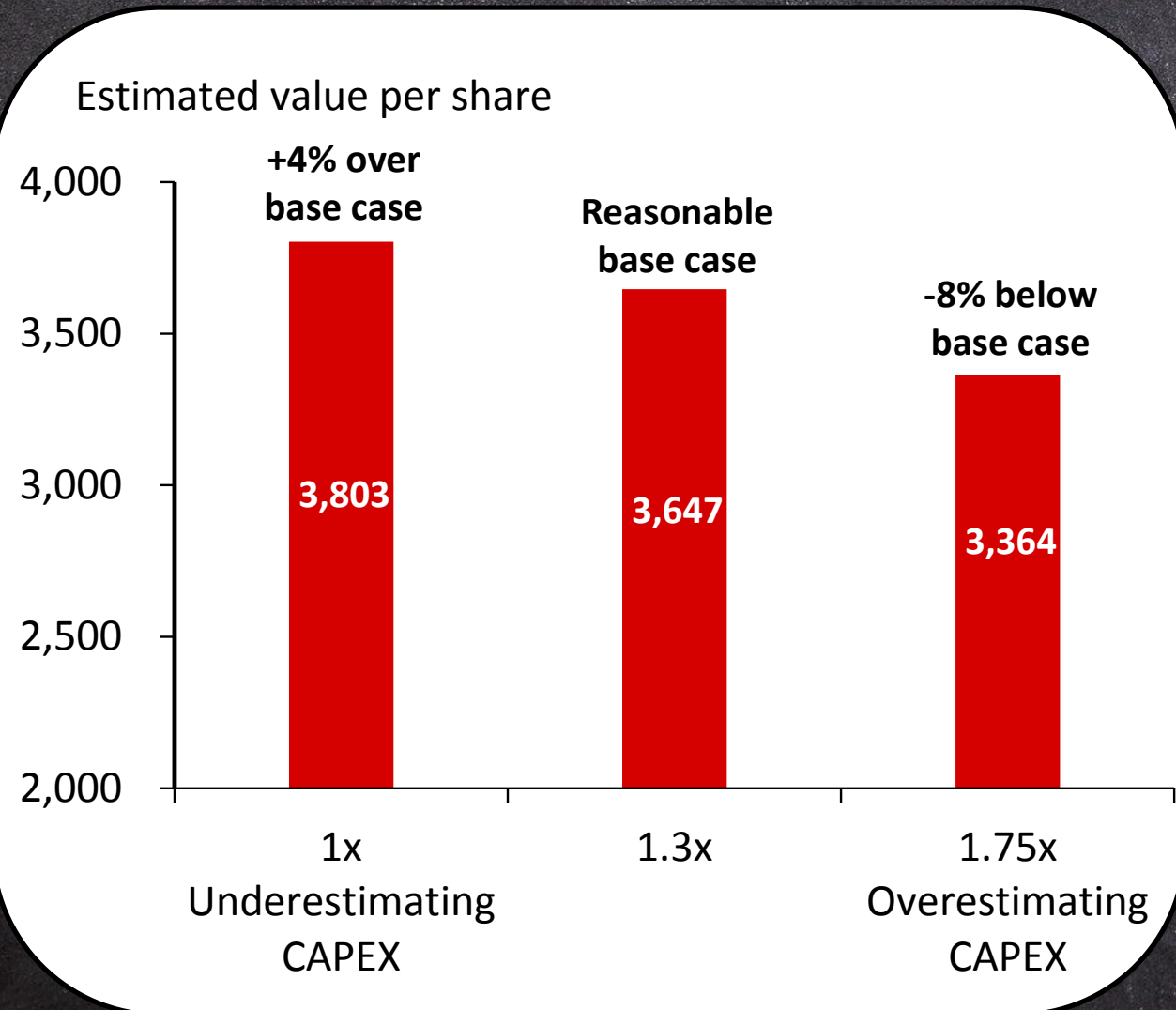
What can the CAPEX-to-depreciation ratio tell us?

- **Growth firms**
 - Capex should be more than the annual P&L depreciation charge, maybe around 150% of it
- **Very high growth firms**
 - Capex could much more than 150% of depreciation
- **Low or no growth firm**
 - Capex about equal to annual depreciation charge
 - It mainly covers maintenance

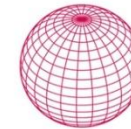


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Choose CAPEX assumption carefully as it has a huge impact on your estimate. Let's look at Sumitomo



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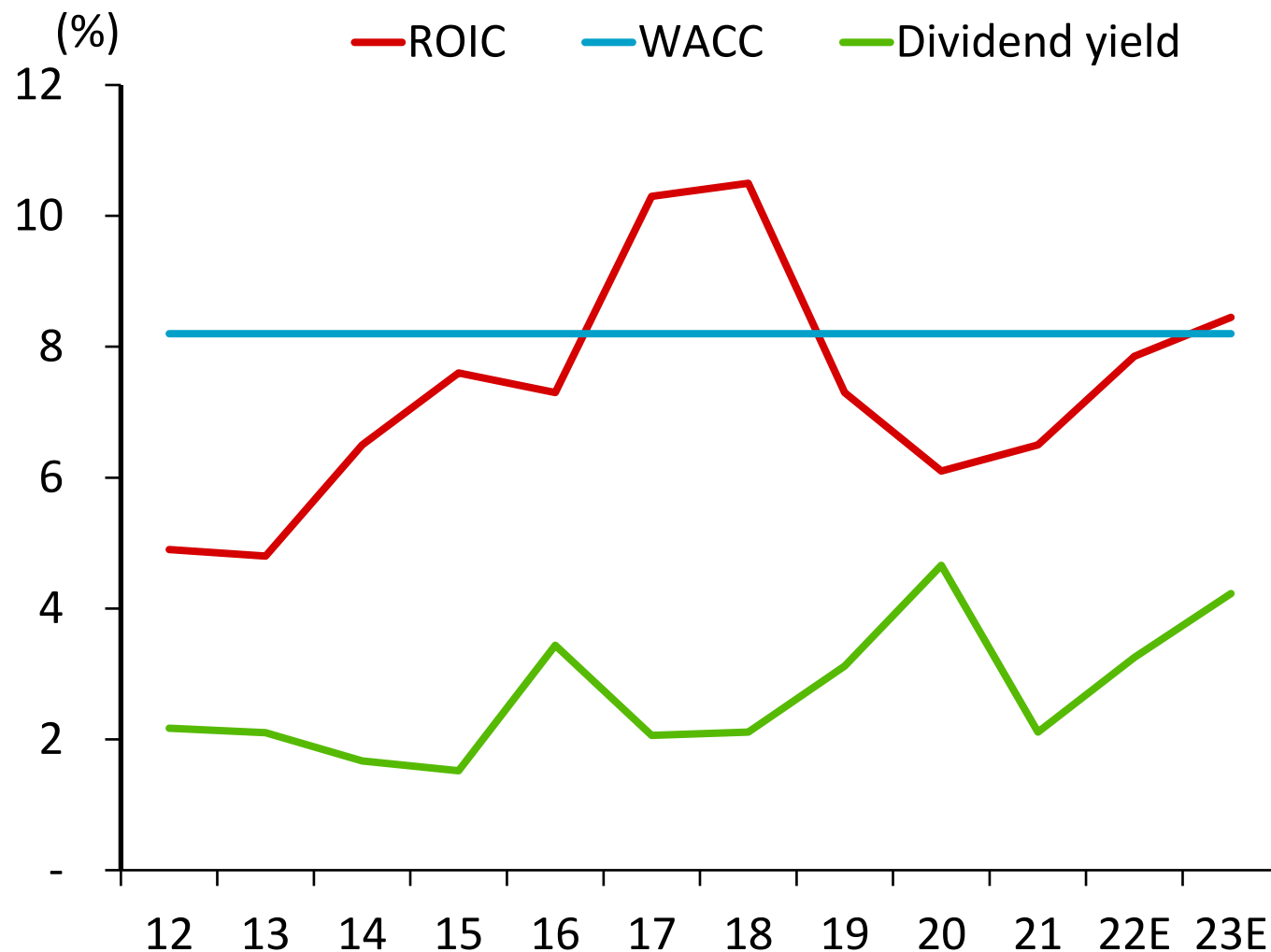
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Risks



- ★ Recovery of ROIC is one of the management's top priority
 - It aims to get back to 8.5% ROIC in 23E, which is realistic based on my forecast
- ★ The company focus on a constant payout ratio of 30% for dividends
 - Enhanced profit prospects could lead to a juicy dividend yield of 3.3% in 22E and 4.2% in 23E



What Is Going to Happen with Inflation?

What Is Going to Happen with Inflation?

By Valuation Master Class Student

Many forces at work impact inflation. There are current trends that cause both inflationary and deflationary measures. Whether we'll see inflation or deflation in the future depends on which of these forces dominate.

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HOW TO VALUE A STARTUP

ANDREW STOTZ



How to Value a Startup

By Andrew Stotz

This story started when Dan, a podcast listener, replied to my recent weekly email with this question, "How do you value a startup, especially if there is no revenue?"

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How to Fight Back When Your Dreams Are Crushed

By Andrew Stotz

The trouble you face is not your fault, and I'm gonna show you how you can fight back. I challenge you to recommit to your dreams today!

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What Does It Mean to Be Financially World Class?

What Does It Mean to Be Financially World Class?

Liabilities To Assets Ratio

What Is Liabilities To Assets Ratio?

Growth Year Over Year

What Is Growth Year Over Year?

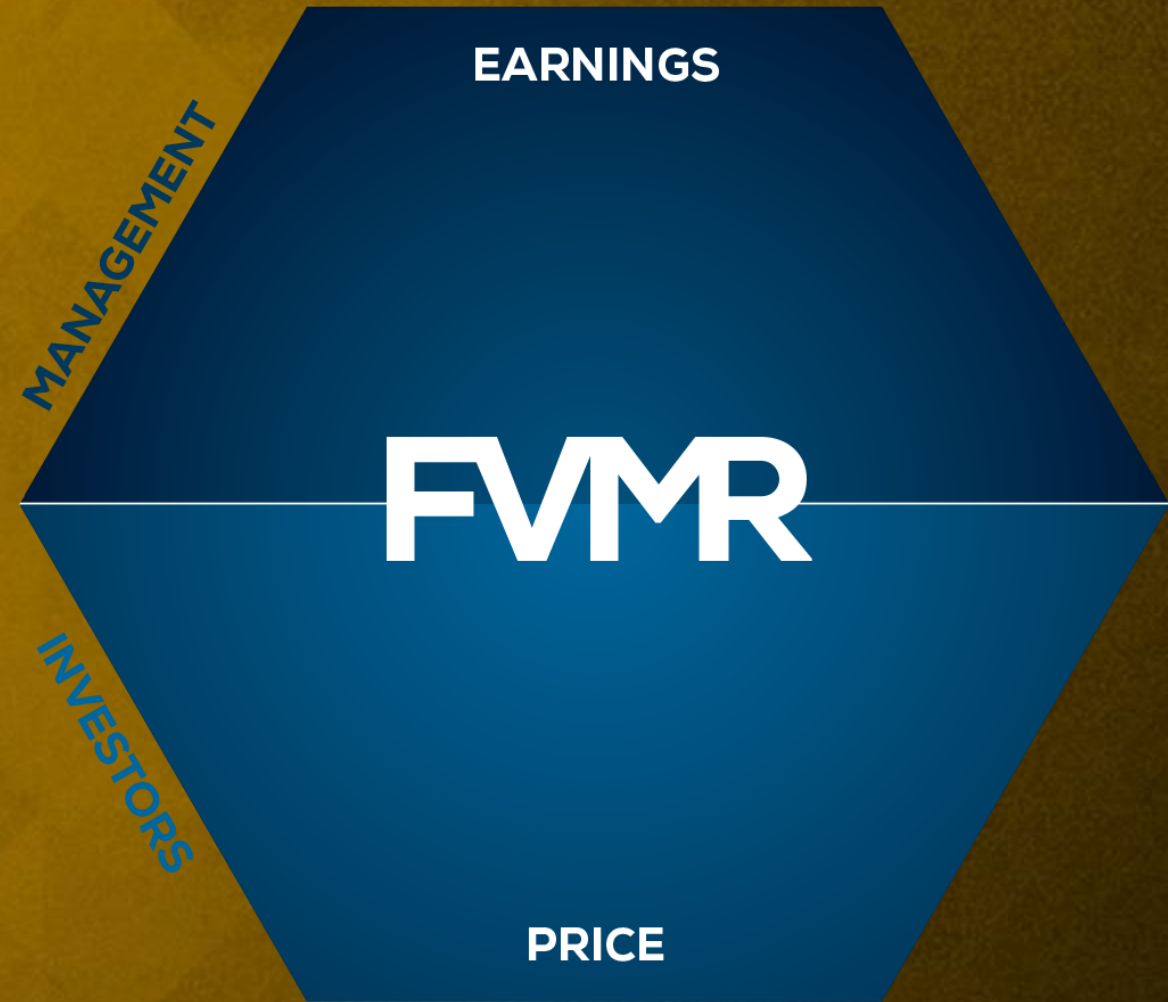
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**It's usually up within 24h.*



FVMR Scorecard

- ★ Measures a stock's attractiveness relative to all other companies
- ★ Attractiveness is based on four elements
 - Fundamentals, Valuation, Momentum, and Risk
- ★ Scale from 1 (Best) to 10 (Worst)



Ranked below average in Japan



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Risks

Worst Neutral Best

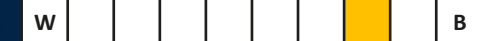
Rank relative to all other companies*



Fundamentals



Valuation



(%)	Mar-18	Mar-19	Mar-20	Mar-21	PTM**
Operating profit margin	8.9	8.5	6.7	6.0	6.3
Recurring net margin	5.8	5.7	3.9	3.6	4.2
Asset turnover	93.5	97.7	88.7	83.8	88.4
Return on assets	5.4	5.6	3.5	3.1	3.7
Recurring return on equity	11.1	11.6	7.4	6.5	7.7

(x)	Mar-18	Mar-19	Mar-20	Mar-21	PTM**
Price-to-sales	0.6	0.5	0.3	0.4	0.4
Price-to-earnings	10.8	8.6	7.0	12.2	8.5
Price-to-book	1.1	1.0	0.5	0.8	0.6
PE-to-EPS growth (PEG)	0.3	0.7	nm	nm	0.3
EV/EBIT	7.0	6.0	5.2	8.4	5.8

Momentum



Risk



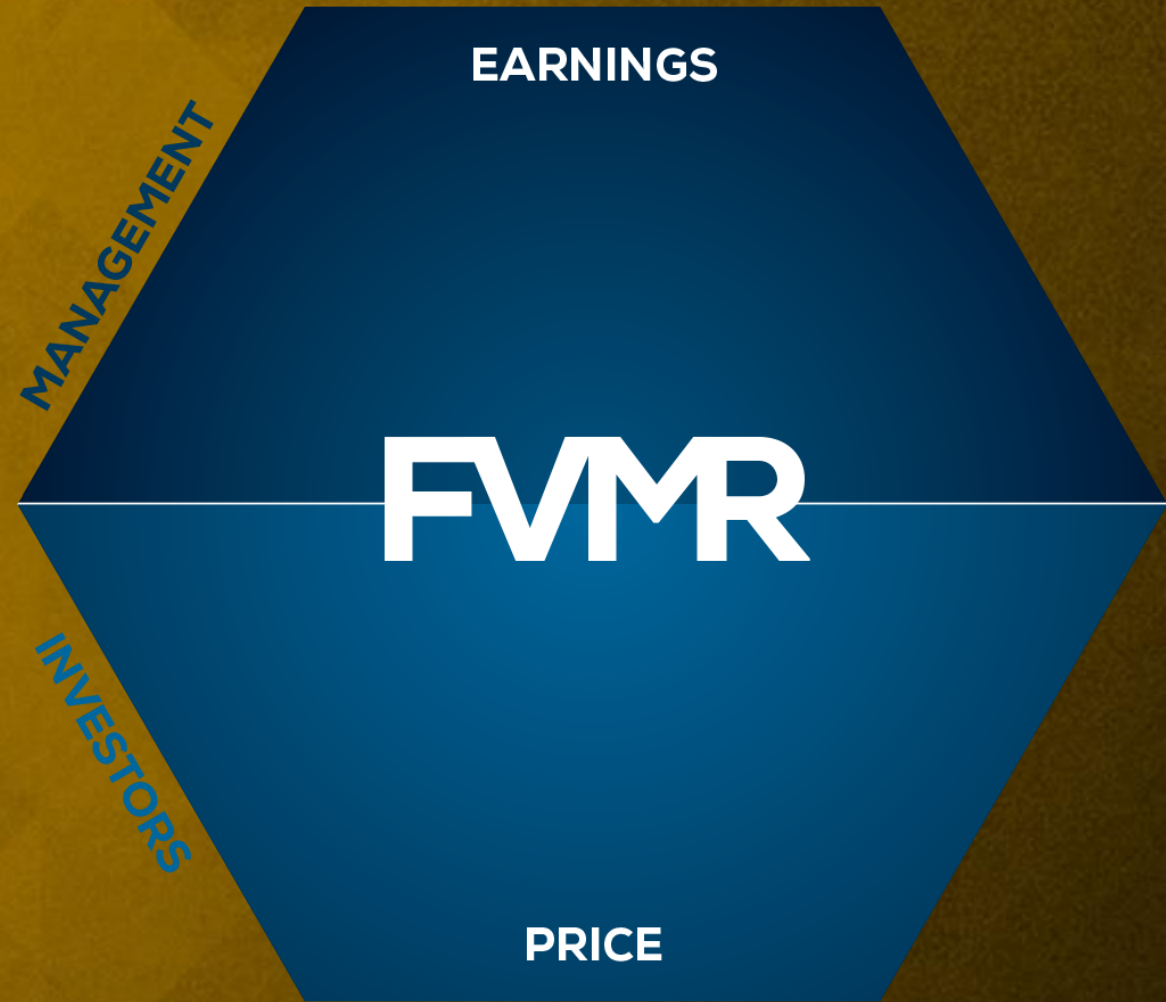
(%)	Mar-18	Mar-19	Mar-20	Mar-21	PTM**
Revenue growth	17.3	14.2	(4.3)	(1.8)	8.6
Recurring EPS growth	31.8	11.9	(33.8)	(9.1)	33.9
Operating profit margin chg. (bps)	167	(41)	(182)	(66)	12
	6mth	3mth	1mth	3wk	1wk
Price change	(24.8)	(13.8)	(12.8)	(8.9)	(0.9)

(x)	Mar-18	Mar-19	Mar-20	Mar-21	PTM**
Current ratio	1.6	1.5	1.6	1.8	1.8
Net debt-to-equity (%)	0.3	4.5	13.5	10.4	2.0
Times-interest-earned	68.8	70.8	48.6	53.5	70.1
	5yr	3yr	1yr	6mth	3mth
Beta	1.4	1.4	1.1	1.1	1.2

Note: Benchmarking against 2,350 non-financial companies in Japan.

Recently, I created a short
online course explaining my
FVMR investing approach

I usually sell it
for \$97 but for
a limited time
I am offering
it for FREE



Most analysts still on hold, but see upside



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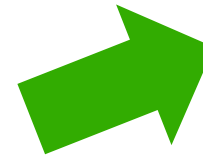
Risks

Analyst consensus valuation

Recommendation	Oct-21	Nov-21	Dec-21	Current
Strong buy	1	1	1	1
Buy	2	2	2	2
Hold	4	4	4	4
Sell	-	-	-	-
Strong sell	-	-	-	-
Average score	2.4	2.4	2.4	2.4

Price target	Oct-21	Nov-21	Dec-21	Current
Median	3,500	3,500	3,500	3,500
Mean	3,770	3,767	3,638	3,737

7
analysts



Upside: 19%

Analyst consensus 3-year forecast

(%)	18	19	20	21E	22E	23E
Revenue growth	2.5	(4.3)	(1.8)	9.3	4.1	0.1
Gross margin	23.3	22.5	21.8	21.9	22.0	22.3
EBIT margin	8.3	6.6	6.0	na	na	na
Net margin	5.1	3.8	3.2	3.9	4.1	4.6

- ★ 3 analysts issued a BUY recommendation while 4 stay on HOLD for now
- ★ Consensus expects two strong years in terms of revenue but no growth in 23E
 - I think that the company's strong commitment to growth could lead to a positive surprise in 23E



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Risks

(YE Mar, Yen m)	2020A	2021A	2022E	2023E
Revenue	864,490	849,065	925,481	968,053
Cost of goods & services	(670,177)	(663,580)	(724,652)	(754,113)
Gross profit	194,313	185,485	200,829	213,940
SG&A	(137,507)	(134,142)	(143,450)	(150,048)
Other operating (exp)/inc	-	(1)	-	-
EBIT	56,806	51,342	57,380	63,891
Interest expense (net)	(167)	(55)	76	122
Other non-operating inc/(exp)	(2,190)	(1,168)	(584)	(572)
Earnings before taxes (EBT)	54,449	50,119	56,872	63,441
Income tax	(17,823)	(15,133)	(18,768)	(20,936)
Earnings after taxes (EAT)	36,626	34,986	38,104	42,505
Equity income/Minority interest	(2,012)	(1,877)	(1,905)	(2,125)
Earnings from cont. operations	34,614	33,109	36,199	40,380
Forex/Exceptionals before tax	(1,807)	(6,344)	(0)	-
Net profit	32,807	26,765	36,199	40,380

- ★ Sumitomo has a strong ability to drive growth organically and through M&A
 - Also, its product portfolio is well-equipped to ride the demand rebound



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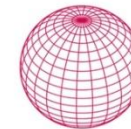
Value

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Risks

(YE Mar, Yen m)	2020A	2021A	2022E	2023E
Cash & short-term investments	87,067	99,518	83,293	87,125
Accounts receivable	268,065	279,670	269,932	282,349
Inventories	200,978	200,156	211,357	219,950
Other current assets	36,674	34,276	37,019	38,722
Total current assets	592,784	613,620	601,601	628,145
Long-term investments	9,957	10,024	10,424	10,824
Net fixed assets	268,066	275,804	289,953	299,047
Intangible assets	45,280	47,432	47,432	47,432
Goodwill	28,831	29,364	29,364	29,364
Other long-term assets	51,193	54,440	54,984	55,534
Total assets	996,111	1,030,684	1,033,759	1,070,347

- ★ Sumitomo has high working cap requirements, more than 40% of its total assets



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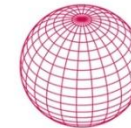
WCB

Risks

(YE Mar, Yen m)	2020A	2021A	2022E	2023E
Overdrafts & short-term loans	71,245	38,052	14,312	9,917
Accounts payable	158,489	160,260	161,034	167,581
Other current liabilities	135,923	142,850	148,077	154,888
Total current liabilities	365,657	341,162	323,422	332,387
Long-term debt	65,472	98,489	89,641	85,159
Other long-term liabilities	87,334	86,105	87,827	89,584
Total liabilities	518,463	525,756	500,890	507,129
Minority interest	13,191	14,230	16,135	18,260
Paid-up capital - Common shares	56,942	56,943	56,943	56,943
Paid-up capital - Preferred shares	-	-	-	-
Retained earnings	367,229	390,336	416,399	444,665
Revaluation/Forex/Others	40,286	43,419	43,391	43,349
Total equity	464,457	490,698	516,733	544,957
Total liab & shareholders' equity	996,111	1,030,684	1,033,759	1,070,347

★ LT-debt has tripled between 2019 and 2021

- I expect the company to slowly repay it given its strong cash generation ability



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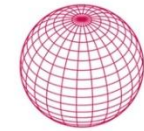
Value

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Risks

(YE Mar)	2020A	2021A	2022E	2023E
General growth (YoY, %)				
Revenue	(4.3)	(1.8)	9.0	4.6
Assets	4.4	3.5	0.3	3.5
Gross profit	(7.5)	(4.5)	8.3	6.5
Operating profit	(24.5)	(9.6)	11.8	11.3
Attributable profit	(28.1)	(18.4)	35.2	11.6
EPS	(28.1)	(18.4)	35.3	11.6
Recurring EPS	(33.8)	(9.1)	17.1	11.6
Du Pont analysis (%)				
Net profit margin	3.8	3.2	3.9	4.2
Revenue per Yen100 of assets	88.7	83.8	89.7	92.0
Assets/equity (x)	2.1	2.1	2.0	2.0
Return on equity	7.1	5.6	7.2	7.6
Others (%)				
Effective tax rate	33.9	34.6	33.0	33.0
Dividend payout ratio	32.7	25.8	28.0	30.0

- ★ Revenue has been resilient throughout the pandemic
 - The company only recorded a drop of 4% in 2020 and 2% in 2021



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Risks

(YE Mar)	2020A	2021A	2022E	2023E
Internal liquidity (x)				
Current ratio	1.6	1.8	1.9	1.9
Quick, or acid test ratio	1.1	1.2	1.2	1.2
Working cap. mgmt (Days)				
Inventory conversion period	105	109	102	103
Receivables collection period	116	116	107	103
Days from raw mat to coll	220	225	209	206
Payables deferral period	93	86	80	78
Cash conversion cycle	127	138	129	127
Profitability ratios (%)				
Gross profit margin	22.5	21.8	21.7	22.1
EBIT margin	6.6	6.0	6.2	6.6
EBIT return on avg assets	5.8	5.1	5.6	6.1
Return on average assets	3.4	2.6	3.5	3.8
Financial risk (x)				
Liabilities-to-assets (%)	52.0	51.0	48.5	47.4
Debt-to-equity	0.3	0.3	0.2	0.2
Net debt-to-equity	0.1	0.1	0.0	0.0
Times-interest-earned	71.5	85.0	95.3	135.3
Effective interest rate (%)	1.1	0.7	0.8	0.7

★ The company has low leverage and could turn net cash in the future



Good / Moderate / Weak

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Ratios

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Risks

Earnings

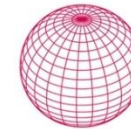
Driver	Potential	Our thoughts
Price	Moderate	Certain specialized equipment can charge premium
Quantity	Moderate	Capital investments and M&A activity to drive growth
COGS	Weak	Input prices can fluctuate a lot, difficult to control
Opex	Weak	SG&A expected to rise in line with expansion

EPS could realize high single-digit growth

Price

Driver	Potential	Our thoughts
PE	Good	Cheap on 22E (10.2x) vs. Japan; slightly higher EPS growth
PB	Good	Cheap on 22E (0.7x) vs. Japan; slightly weaker ROE

Re-rating to country average provides significant upside



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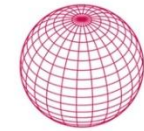
Value

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Risks

(YE Mar, Yen m)	2020A	2021A	2022E	2023E
EBIT	56,806	51,342	57,380	63,891
Est tax rate (%)	34	35	33	33
NOPAT	37,573	33,593	38,444	42,807
Add: Depre & amort	27,865	29,746	30,190	32,298
Less: CAPEX	(40,057)	(39,255)	(44,339)	(41,391)
Chg in A/R	19,684	(11,605)	9,738	(12,417)
Chg in inventory	(11,933)	822	(11,201)	(8,593)
Chg in oth curr assets	(3,489)	2,398	(2,743)	(1,703)
Chg in A/P	(29,580)	1,771	774	6,547
Chg in oth curr liabs	(3,881)	6,927	5,227	6,812
Less: Chg in working cap	(29,199)	313	1,795	(9,354)
Less: Chg in invest cap				
Free cash flow to firm	(3,818)	24,397	26,090	24,360

- ★ Cash flow should return positive from 22E onward



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Forecast assumptions			
3-year average	Consensus		My assumptions
Revenue growth (CAGR)	4.4		5.2
Gross margin	22.1		22.0
EBIT margin	na		6.7
Net margin	4.2		4.2

My valuation method	
Market: Japan	
Market risk-free rate	0.5
Market equity risk premium	8.0
Market return	8.5
Company beta (x)	1.3
COE	10.5
WACC	8.2
Terminal growth rate	2.0

Valuation Method:
FCFF

Valuation Method:
FCFF

- ★ I am a bit more optimistic about the growth outlook
 - Both, M&A and organic expansion should pay off in terms of revenue
- ★ Sumitomo’s margin has been pretty stable over time
 - Therefore, there is no reason to deviate significantly in the assumptions



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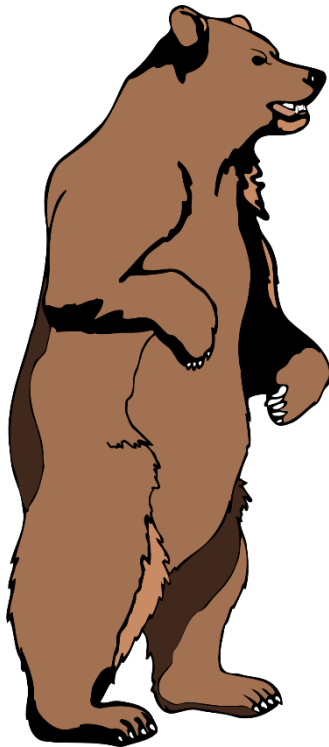
Value

Risks

Bear

JPY3,507

(Upside 19%)



Base

JPY3,647

(Upside 24%)



Bull

JPY3,800

(Upside 29%)



World Class Benchmarking Scorecard

- ★ We identify a company's competitive position relative to global peers
- ★ We use a composite rank of profitability and growth, called "Profitable Growth"
- ★ Scale from 1 (Best) to 10 (Worst)





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Risks

Profitability
slightly declined
during pandemic

Profitable Growth

'18	'19	'20	'21	PTM
4	4	6	6	6

Growth has fallen
behind pre-
pandemic rank

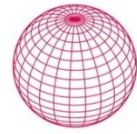
Profitability

'18	'19	'20	'21	PTM
4	4	6	5	6

Growth

'18	'19	'20	'21	PTM
4	5	8	6	6

Benchmarked against 1,480 large Industrials companies worldwide.



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Risks

- ★ Acquisitions could drag margins when integration takes time
- ★ Potential overinvestment in capital-intensive industry could be harmful
- ★ Environmental pressure to develop sustainable machineries requires high R&D

CONCLUSION

- Past has shown management's commitment to growth and enhancing ROIC
- Valuation appears cheap, could be a good opportunity to buy
- Attractive dividend yield adds additional return



**Can management's
commitment return
Sumitomo's stock
to previous
heights?**

