

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Bullet Points August 18, 2020

Onoken -- 7414 JP -- 1551

all data in JPY

Sales and earnings					Target price & valuation data		
	2021	2022e	2023e	2024e			
Sales (mlns.)	202825	233249	247244	262078	My 12-mo. target	1,941	(based on 7.75x 2024 EPS)
Sales growth	-12%	15%	6%	6%	Upside to target	25%	Div yield 5.9%
							<i>Adj EV 16,482</i>
EPS	214	368	283	250	Mkt cap (mlns.)	32,819	EV (mlns) 50,554
Cash flow	317	474	393	363	P/sales (2022e)	0.14	EV/sales (2022e) 0.22
FCF	45	332	242	202	P/E (2022e)	4.2	EV/EBITDA (2022e) 3.7
					P/E (2023e)	5.5	EV/EBITDA (2023e) 4.5
Cons. EPS					P/E (2024e)	6.2	EV/EBITDA (2024e) 5.0
<i>cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.</i>					Daily vol (\$000s) \$600		
<i>Fiscal year ends March 31</i>					Price/book 0.44		

Japanese steel distributor Onoken posted huge Q1 earnings (96y/share up from 24y in last year's Q1) and sharply increased its FY guidance (to 306y from 195y) and dividend (to 92y from 65y). A well-run steel distributor can really be a cash cow during decent economic times. New estimates are:

Changes to Onoken estimates

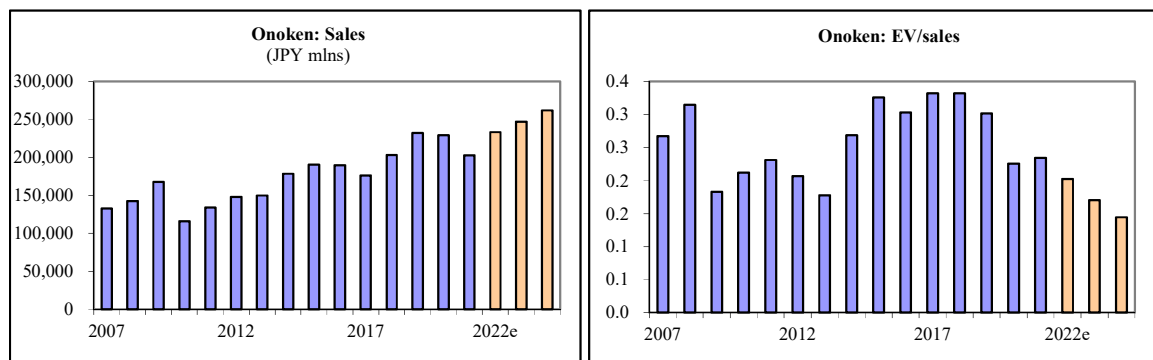
	was	is
2021 act	177	214
2022e	180	368
2023e	218	283
2024e	--	250

Source: Churchill Research estimates

I am valuing this at 7.75x expected fiscal 2024 earnings for a 1,941 yen/share target (was 1,796 or 7.5x 2023). The model assumes margins fall back to historical norms.

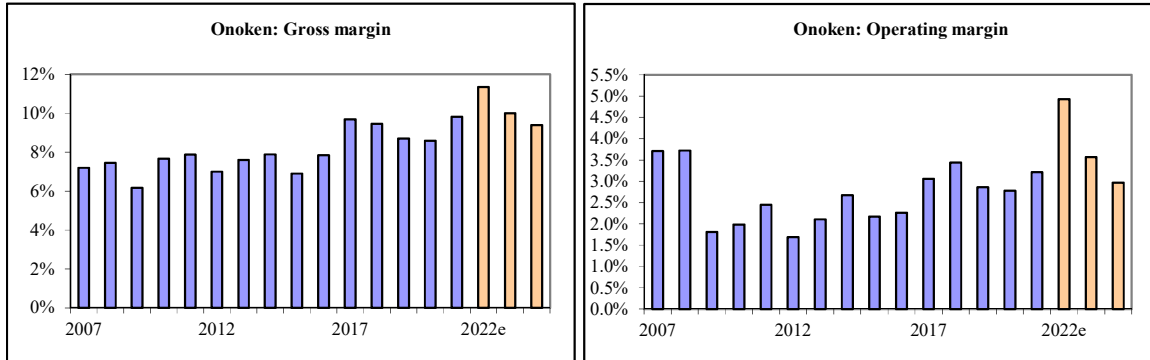
In theory, over the next 2.5 years Onoken will have earnings equal to 60% of the current market cap. So that factors into my P/E multiple. The question is always something like, "How do I get PAID if management just puts all those earnings on the balance sheet and sits on them forever?" In this case the firm has raised the dividend (now 5.9% yield) and probably they can do acquisitions, as this is a fragmented market.

1) Sales rose 9% in Q1 YoY and I am modeling for 15% FY sales growth (as selling prices adjust upwards) followed by 6% in 2023 and 2024. Logically these may be conservative estimates.

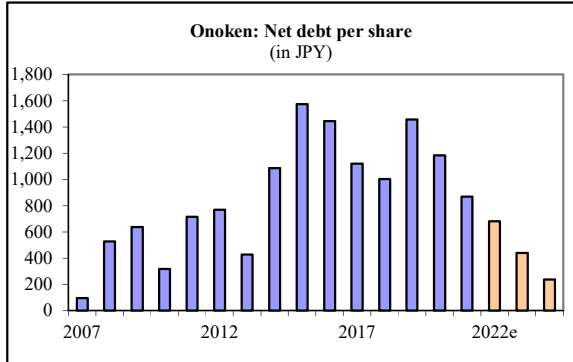


2) EV/sales (above right) is a bit on the low side relative to recent norms, despite the firm being extremely profitable at present.

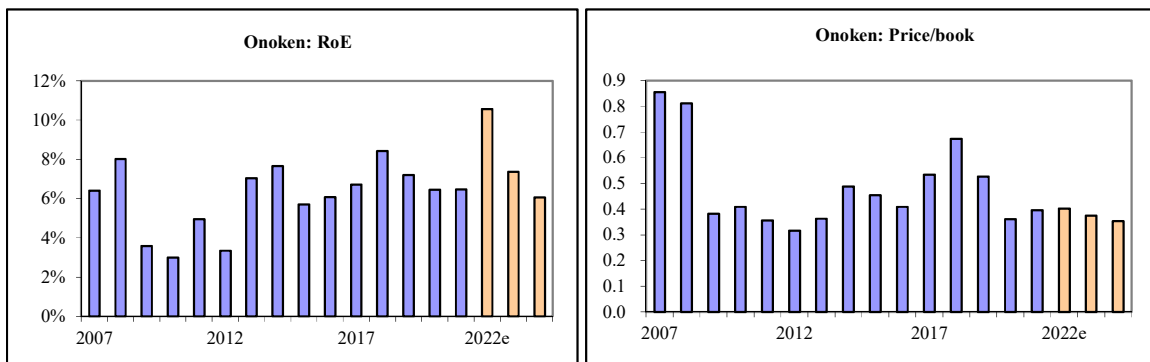
3) Gross margin is very elevated this year – but realistically it can't stay at this level for a long time because that's just not how the steel distribution business works. It's a low mark-up business by definition. Q1 gross margin was 13.0% (up from 8.4% in last year's Q1) and I have that falling to 9.4% by fiscal 2024. FIFO gains may continue for a bit but then reverse.



4) The firm is on track to bring net debt down to 600 JPY/share by March 2022 – from 1,400 yen/share in March 2019. This is part of why management felt comfortable raising the dividend. One has to assume they do more acquisitions, as Onoken is the biggest player in Japanese steel distribution but has just a 3% share. They have a history of buying up small competitors.



5) ROE is an interesting series because it has been chronically low, usually around 6%. This year it is on pace for 10% but I have that falling back to 6%. Perhaps there is more they could do to increase efficiency of capital? Price/book is 0.44x, reflecting Onoken's low historical profitability.



Onoken: income statement highlights					
	2020	2021	2022e	2023e	2023e
Revenues (JPY mln)	229,290	202,825	233,249	247,244	262,078
COGS	209,601	182,920	206,752	222,519	237,443
SG&A	13,329	13,393	15,000	15,900	16,854
Operating income	6,360	6,512	11,497	8,824	7,781
Interest expense	52	18	14	14	14
Non-op losses (gains)	(117)	(196)	(216)	(216)	(216)
Taxes	2,009	2,208	3,836	2,954	2,610
Net income	4,416	4,536	7,788	5,997	5,298
Shares out	22.3	21.2	21.2	21.2	21.2
EPS	198	214	368	283	250
Depreciation	1,877	2,182	2,247	2,315	2,384
Capex	(4,299)	(5,759)	(3,000)	(3,200)	(3,400)
Free cash flow	1,994	959	7,035	5,112	4,283
Free cash flow/share	89	45	332	242	202

Sources: Bloomberg, Churchill Research estimates

Turning to Alconix ...

Alconix (3036 JP) -- 1615

all data in JPY

Sales and earnings					Target price & valuation data			
	2021	2022e	2023e	2024e				
Sales (mlns.)	214987	142000	153360	165629	My 12-mo. target	2,065	(based on 8x 2023 EPS)	
Sales growth	-7%	-34%	8%	8%	Upside to target	28%	Div yield	2.6%
							Adj EV	36,173
EPS	114	294	258	234	Mkt cap (mlns.)	40,790	EV (mlns)	73,523
Cash flow	265	453	423	406	P/sales (2022e)	0.29	EV/sales (2022e)	0.52
FCF	142	341	302	276	P/E (2022e)	5.5	EV/EBITDA (2022e)	5.1
					P/E (2023e)	6.3	EV/EBITDA (2023e)	5.5
Cons. EPS					P/E (2024e)	6.9	EV/EBITDA (2024e)	5.8
cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.					Daily vol (\$000s)		\$1,025	
					Price/book		0.89	

Japanese metals processor Alconix posted great Q1 earnings of 97 yen/sh, up from 22 yen in last year's Q1. Operating income nearly tripled. Management raised FY guidance to 240 yen/sh (was 175) but even that is probably too conservative. New estimates are:

Changes to Alconix estimates

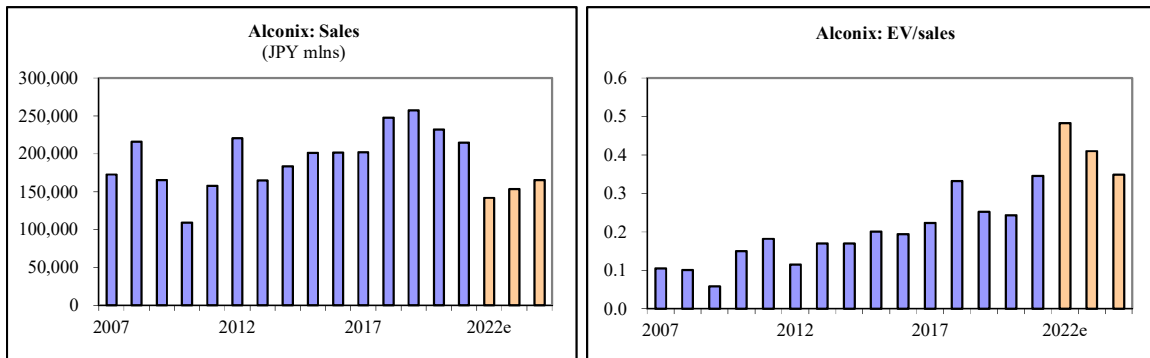
	was	is
2021 act	193	114
2022e	221	294
2023e	247	258
2024e	--	234

Source: Churchill Research estimates

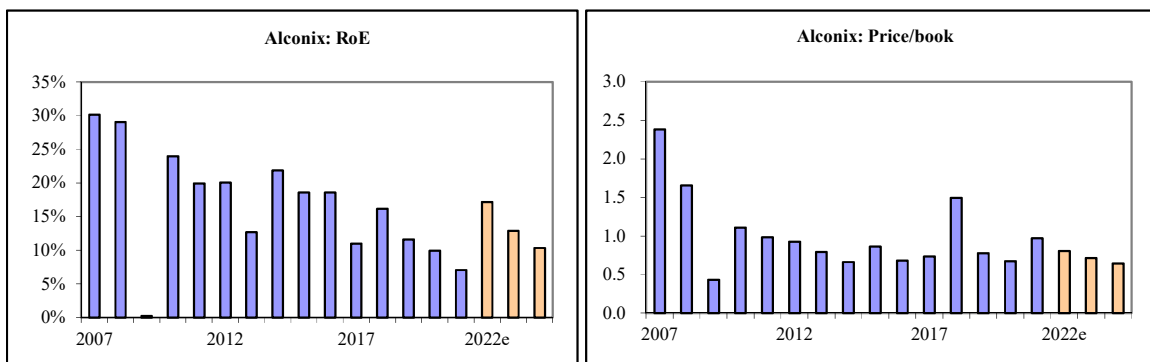
Alconix buys in scrap metals and processes them into auto parts and electronic components. As such, the prime drivers of profit are industrial metal prices, rare earth prices and growth in semiconductor and auto sales.

The new price target of 2,065 yen/sh (was 1,979) is based on an 8x multiple to expected fiscal 2024 earnings (was 8x 2023). Here again the model assumes margins fall back to historical norms.

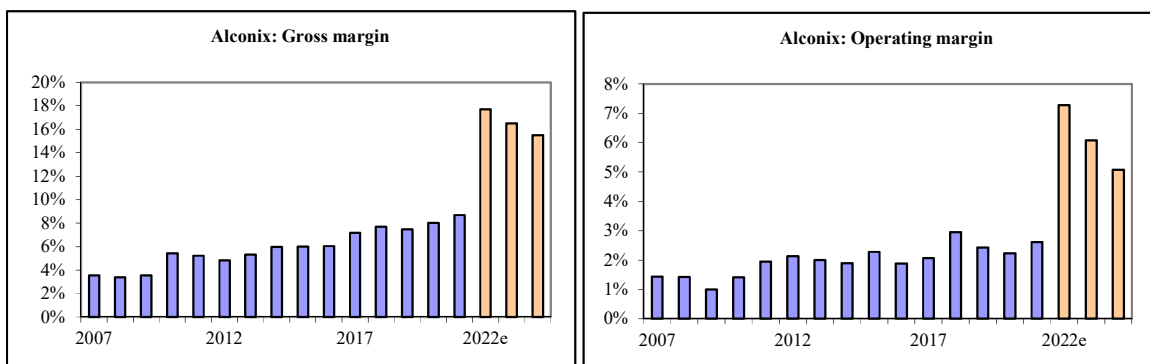
1) The accounting method for calculating sales was changed at year-end, so the “official” sales figure is much lower now. In reality, though, there was no change in the business. I model for 8% sales growth in 2023 and 2024. That said, it depends on metals prices. It’s possible some or all of that growth could be pulled in to the current fiscal year.



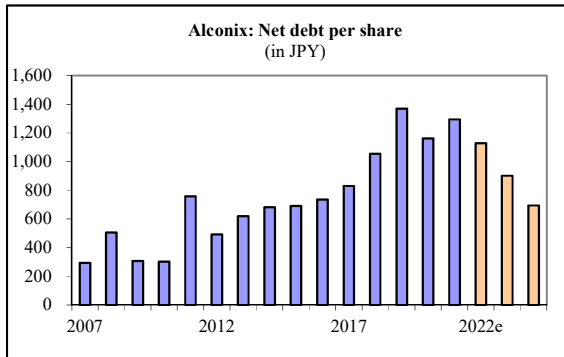
2) ROE is perhaps the most useful figure to focus on given the accounting changes. What’s interesting about the ROE chart is that the 2022 forecast (17.2%) would be basically right in the middle of the firm’s 2007-2018 historical range. So in that sense, perhaps my 2023-24 EPS earnings estimates could be conservative. Strong ROEs help explain why historically Alconix has been valued at a higher price/book than Onoken. (Though P/Es for both have tended to be around 7-8x.)



3) The gross margin chart is interesting (despite the misleading stair step in 2022) in that it steadily rose from 2007 to 2021 as the firm moved up the value-added chain (creating higher-value added products). I have margins declining in 2023-24.



4) Net debt was rising into 2019 as the firm made a series of acquisitions to move up the value chain. In theory it can begin to fall as those are absorbed.



Alconix: income statement highlights					
	2020	2021	2022e	2023e	2024e
Revenues (JPY mln)	232,242	214,987	142,000	153,360	165,629
COGS	213,620	196,415	116,866	128,056	139,956
SG&A	13,446	12,951	14,800	15,984	17,263
Operating income	5,176	5,621	10,334	9,320	8,410
Interest expense	736	492	492	492	492
Non-op losses (gains)	(1,524)	(486)	(1,600)	(1,200)	(1,200)
Taxes	2,223	2,090	3,961	3,475	3,156
Net income	3,768	2,860	7,356	6,453	5,862
Shares out	25.3	25.2	25.0	25.0	25.0
EPS	149	114	294	258	234
Depreciation	3,673	3,820	3,973	4,132	4,297
Capex	(3,131)	(3,100)	(2,800)	(3,024)	(3,266)
Free cash flow	4,310	3,580	8,529	7,561	6,893
Free cash flow/share	171	142	341	302	276

Sources: Bloomberg, Churchill Research estimates

The Classical Insights portfolio holds Onoken and Alconix.

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