COMPANY RESEARCH AND ANALYSIS REPORT

MonotaRO Co., Ltd.

3064

Tokyo Stock Exchange First Section

23-Mar.-2018

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Summary

Net sales increased for a 16th consecutive period and profit for an 8th consecutive period. The Company is aiming to achieve net sales of ¥100.0 billion and net income of ¥10.0 billion in FY12/18.

MonotaRO Co., Ltd. <3064> (hereafter, also "the Company") is headquartered in Amagasaki, Hyogo Prefecture. The Company conducts online direct marketing of maintenance, repair, and operating (MRO) products* for production plants and construction work and automobile upkeep through the Internet.

* Maintenance, repair and operating (MRO) products refer to products used in the manufacturing process such as abrasives, drills, and work gloves, which are for internal use by companies and not for resale. The nature of such materials is highly individual for each industry.

A key characteristic of the Company's business model is that it sells MRO products at a single price. This policy has won the Company strong support from small to mid-size customers, who are usually forced to accept unfair prices from sellers in a conventional market. In this way the Company has established a solid position as a unique online direct marketing operator in a niche market. As of December 31, 2017, the number of registered accounts has reached 2.74 million, the Company stocks 302,000 inventory SKUs itself and has a product lineup of over 13 million items.

1. FY12/17 non-consolidated results

The Company sustained high growth above 20% in non-consolidated net sales and earnings throughout FY12/17 with ¥84,656mn in net sales (up 26.2% YoY), ¥12,168mn in operating income (up 24.4%), ¥12,177mn in ordinary income (up 24.3%), and ¥8,699mn in net income (up 31.2%). Net sales performed steadily with both new customer additions and higher sales from existing customers. The Company expanded its new customer acquisitions by reinforcing listing ads, improving landing pages (including enhanced search features) and with successful TV commercials. Existing customer sales grew, mainly thanks to successful measures aimed at boosting usage frequency implemented since March 2017 and a favorable economic environment. The growth in sales also reflects increases in the numbers of large corporate customers and their usage. The gross margin dropped 0.4 pp YoY in real terms, reflecting the boosted usage frequency, an increase in the delivery cost rate as delivery services from the Kasama Distribution Center (Kasama DC) increased and delivery service providers raised their prices. The SG&A expense ratio declined by 0.2 pp in real terms. Kasama DC opening expenses increased the ratio of logistics-related costs, but the result also reflected a lower ratio of non-logistics-related SG&A expenses due to the increase in net sales. Overall, although the real cost effect of opening Kasama DC was slightly delayed, sales promotion measures proved effective in expanding sales so that ultimately the Company achieved a major increase in profit.

2. Consolidated outlook for FY12/18

The Company is forecasting continued high growth in sales and earnings for FY12/18 consolidated results, with ¥109,469mn in net sales, up 23.9% YoY, ¥14,249mn in operating income, up 20.4%, ¥14,191mn in ordinary income, up 19.7%, and ¥10,044mn in net income attributable to owners of the parent, up 18.7%. If it can achieve these targets, the Company will realize 17 consecutive periods of net sales growth and 9 of profit growth, with net sales reaching the ¥100bn level and net income attributable to owners of the parent ¥10bn level. In net sales, the Company will continue working to expand new customer acquisitions and increase the usage frequency and average spend of existing customers. It will also work to acquire new customers and increase the usage frequency among large corporate customers. The gross margin is expected to decline 0.8 pp YoY, mainly due to a decline in product profit margins and an increase in the ratio of delivery costs. On the other hand, the ratio of SG&A expenses is projected to drop by 0.5 pp, reflecting a shift of shipping operations to the Kasama DC, which has advanced automation, and an increase in sales. Other strategies worth noting for their potential benefit to earnings are shorter lead times, the establishment of a marketing system development based on data science, and strengthening of the overseas business.

3. Establishment of data science development bases in Osaka and Tokyo. Establishment of a subsidiary for expanding into The Chinese market

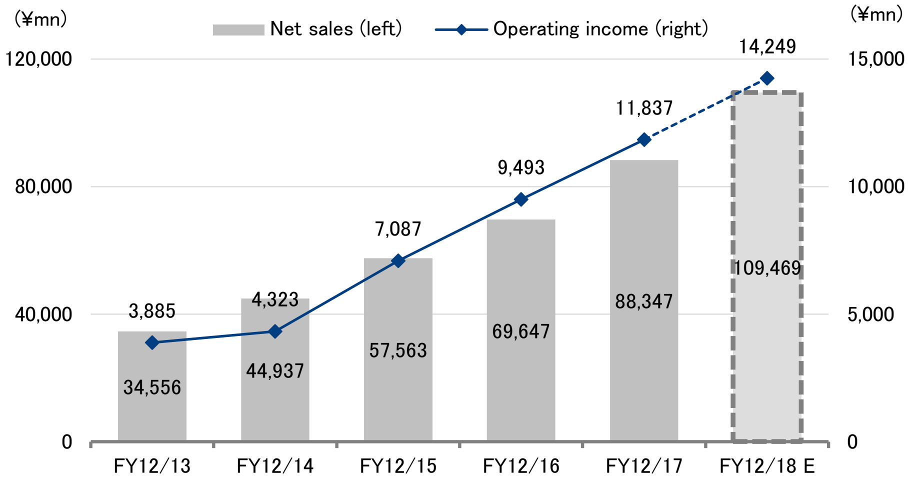
The Company has announced plans to establish development bases in Tokyo and Osaka for improving high level marketing and developing systems based on data science. The centers are schedule to open around spring of 2018. The Company has been quick to adopt machine learning for use in attracting customers on the Internet and continuous purchasing, and it will now move this initiative up a level. The Company plans to increase the staff at the bases to around 30 people over the next two to three years.

The Company established a subsidiary in Shanghai in February 2018 to expand into the Chinese market. The subsidiary is to develop online direct marketing of MRO products as in South Korea and Indonesia and further expand the Group's business activities and bases. The Chinese MRO market is the largest in Asia at roughly twice the size of Japan's. Most retailers are small-scale with limited product lines, presenting challenges in terms of efficient materials procurement for SMEs seeking to procure small volumes on an ad hoc basis. The Company initially plans to service the Yangtze delta area through its base in Shanghai. It has a 75% equity stake in the new subsidiary, with Sumitomo Corporation <8053> holding 25%. Net sales in the first year are projected at ¥60mn, with an operating loss of ¥170mn.

Key Points

- In FY12/17, achieved growth in sales for a 16th consecutive period and growth in profit for an 8th. Sales increase absorbed the startup cost of Kasama DC and increase in delivery cost
- For FY12/18 targeting net sales of ¥100.0bn and net income attributable to owners of the parent of ¥10.0bn
- Establishment of bases in Osaka and Tokyo for improving marketing and developing systems based on data science. Establishment of a subsidiary for expanding into the Chinese market

Trends in net sales and operating income



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

Results trends

In FY12/17, achieved growth in sales for a 16th consecutive period and growth in profit for an 8th. Sales increase absorbed the startup cost of Kasama DC and increase in delivery cost

● **Review of FY12/17 results (non-consolidated)**

The Company sustained robust growth in non-consolidated net sales and earnings of more than 20% in FY12/17 with ¥84,656mn in net sales (up 26.2% YoY), ¥12,168mn in operating income (up 24.4%), ¥12,177mn in ordinary income (up 24.3%), and ¥8,699mn in net income (up 31.2%).

Net sales benefited from healthy trends in new customer acquisitions and existing customer sales growth. New customer acquisitions expanded with help from reinforcement of listing ads, improved landing pages (including enhanced search features), and success in TV commercials. Average new account acquisitions accelerated from 35,905 accounts per month in FY12/16 to 44,199 accounts per month in FY12/17. Existing customer sales grew, mainly thanks to successful measures aimed at boosting usage frequency implemented since March 2017 and a favorable economic environment. Sales growth also reflected growth in the number of large corporate customers to 429 (up 120 YoY) and an increase in their usage.

The gross margin dropped 0.9 pp YoY. Breaking this down, 0.5 pp of the decline represents a change in recognition of credit card payment fees from SG&A expense to cost of sales. The remaining 0.4 pp of the decline reflects the impact of an increase in the ratio of delivery costs due to measures to increase usage frequency, an increase in delivery services from Kasama DC, and an increase in prices by delivery service providers, although an improved profit margin on private brand and imported products covered an increase in the national brand and domestic products sales ratio associated with the increase in sales.

SG&A expenses ratio improved (declined) by 0.7 pp. The change comprised a 0.5 pp decline from the change in the recognition of credit card payment fees and a 0.2 pp decline resulting from a decline in the ratio of non-logistics-related SGA expenses due to the increase in sales, despite an increase in logistics-related costs associated with expenses for opening Kasama DC.

The Company started full-scale operations at Kasama DC, a new logistics site with industry-leading scale. Operation has proceeded as planned so far, and the site has achieved a smooth start-up. The logistics expense ratio was slightly behind the revised 2H FY12/17 target of 5.9% at 6.0%, but is expected to come down to around 5.6% in 2H FY12/18 as the ratio of shipments from Kasama DC increases.

As a result, operating income rose 24.4% YoY and the ratio to net sales was 14.4%. Furthermore, as the Kasama DC facility was eligible for the tax system to promote capital investment in raising productivity, reducing the tax rate, net income increased 31.2% YoY. Looking at the year overall, although the real cost effect of opening Kasama DC was slightly delayed, sales promotion measures proved effective in expanding sales so that ultimately the Company achieved a major increase in profit.

Non-consolidated income summary for FY12/17

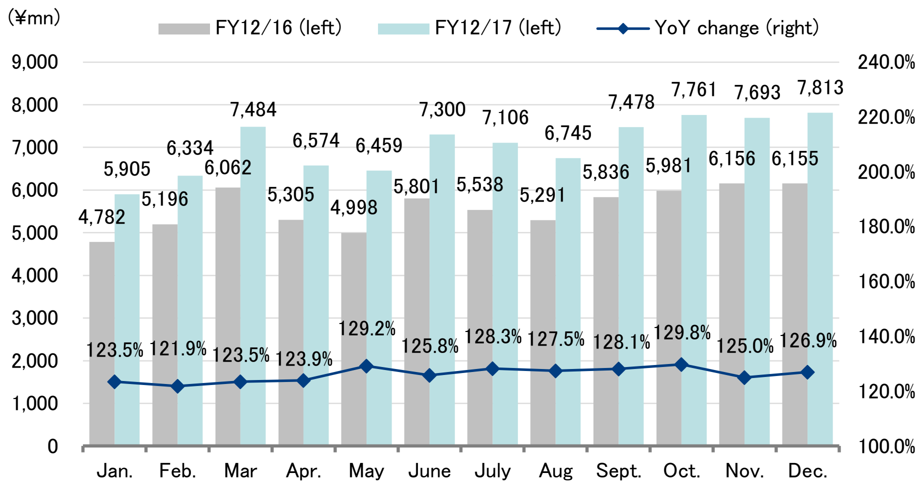
(¥mn)

	FY12/16		FY12/17			Change factors
	Results	vs. net sales	Results	vs. net sales	YoY	
Net sales	67,105	100.0%	84,656	100.0%	26.2%	· Increase in listing ads, improved landing page, and success in TV commercials drove expansion in new customers (increased by 530,000 accounts) · Measures to increase usage frequency and a favorable economic environment led to increase existing customer sales · Sales to large corporate customers increased
Gross profit	21,406	31.9%	26,204	31.0%	22.4%	· Gross margin dropped 0.9 pp YoY · Change in recognition of credit card payment fees from SG&A expenses to cost of sales accounted for 0.5 pp of the decline · Gross margin declined due to an increase in the ratio of delivery costs, although an improved profit margin on private brand and imported products covered an increase in the national brand and domestic products sales ratio associated with the increase in sales
SG&A expenses	11,624	17.3%	14,035	16.6%	20.7%	· SG&A expense ratio declined 0.7 pp YoY · Change in recognition of credit card payment fees from SG&A expenses to cost of sales accounted for 0.5 pp of the decline · Despite an increase in logistics-related costs associated with opening-related expenses for Kasama DC, SG&A expense ratio declined due to the increase in net sales
Operating income	9,782	14.6%	12,168	14.4%	24.4%	· 0.2 pp YoY decrease
Ordinary income	9,800	14.6%	12,177	14.4%	24.3%	· 0.2 pp YoY decrease
Net income	6,631	9.9%	8,699	10.3%	31.2%	· 0.4 pp YoY increase

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

Looking at monthly results, the Company has sustained at least 25% YoY sales growth since May, even with seasonal fluctuations and promotion-related variations. The buoyant sales appear to be due in part to promotion offering free delivery for the same month when customers place a single order worth ¥7,000 or more (excluding tax).

Monthly sales



Source: Prepared by FISCO from the Company's IR news

Business outlook

For FY12/18 targeting net sales of ¥100.0bn and net income attributable to owners of parent of ¥10.0bn

● FY12/18 consolidated outlook

The Company forecasts for FY12/18 consolidated results are ¥109,469mn in net sales (up 23.9% YoY), ¥14,249mn in operating income (up 20.4%), ¥14,191mn in ordinary income (up 19.7%), and ¥10,044mn in net income attributable to owners of the parent (up 18.7%) and thus expects to sustain robust sales and earnings growth. If it can achieve these targets, the Company will realize 17 consecutive periods of sales growth and 9 of earnings growth, with sales reaching the ¥100bn level and net income attributable to owners of parent the ¥10bn level.

In net sales, the Company will continue working to expand new customer acquisitions and increase the usage frequency and average spend of existing customers. It will also work to acquire new customers and increase the usage frequency among large corporate customers. The gross margin is expected to decline 0.8 pp YOY. This reflects a decline in product profit margins due to an increase in costs and other factors associated with an increase in the sales ratio of national brands and domestic products and rising cost for energy, such as oil. Other factors include an increase in the ratio of delivery costs as delivery services increase and delivery service providers raise their prices. Meanwhile, the SG&A expense ratio is expected to drop by 0.5 pp YoY, reflecting a decline in the ratio of personnel expenses and outsourcing expenses due to a shift of shipping operations to Kasama DC, which has advanced automation, and scale benefits accompanying increased sales. As a result, operating income is expected to increase 20.4% YoY, with the ratio to net sales at 13.0% (down 0.4 pp).

There are three additional points to note for 2018. The distribution network improvement and supply chain strengthening undertaken in 2017 can be expected to improve service and increase existing customer sales by shortening lead times. Furthermore, with the announcement of new development bases in Osaka and Tokyo for improving high level marketing based on data science and developing systems, short-term results should be expected. As an additional bonus, overseas business is set to expand, with South Korean operations projected to achieve profitability over the full year.

Consolidated targets

(¥mn)

	FY12/17		FY12/18			1H FY12/18	
	Results	vs. net sales	Forecast	vs. net sales	YoY	Forecast	YoY
Net sales	88,347	100.0%	109,469	100.0%	23.9%	51,311	22.8%
Gross profit	26,929	30.5%	32,604	29.8%	21.1%	15,284	18.2%
SG&A expenses	15,091	17.1%	18,355	16.8%	21.6%	8,808	19.6%
Operating income	11,837	13.4%	14,249	13.0%	20.4%	6,476	16.3%
Ordinary income	11,858	13.4%	14,191	13.0%	19.7%	6,441	14.8%
Net income attributable to owners of the parent	8,464	9.6%	10,044	9.2%	18.7%	4,522	14.0%

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

Topics

Establishment of data science development bases in Osaka and Tokyo. Establishment of a subsidiary for expanding into the Chinese market

1. Establishment of data science development bases in Osaka and Tokyo

The Company has announced plans to establish development bases in Tokyo and Osaka for improving high level marketing based on data science and developing systems. The centers are schedule to open around spring of 2018. The Company has been quick to adopt machine learning for use in attracting customers on the Internet and continuous purchasing, and it will now move this initiative up a level. The Company plans to increase the staff at the bases to around 30 people over the next two to three years.

2. Establishment of a subsidiary for expanding into the Chinese market

The Company established a subsidiary in Shanghai in February 2018 to expand into the Chinese market. The objective of developing the China business is to expand online direct marketing of MRO products to business operators in China, the largest market in Asia and second largest in the world after the U.S., and further expand the Group's business activities and bases. The Chinese MRO market is roughly twice the size of Japan's. Most retailers are small-scale with limited product lines, presenting challenges in terms of efficient materials procurement for SMEs seeking to procure small volumes on an ad hoc basis. The subsidiary initially plans to service the Yangtze delta area, including Shanghai. It is capitalized at about ¥340mn. It is to be established by the Company with a 100% equity stake but is intended to conduct a private placement of new shares with Sumitomo Corporation to receive a 25% stake. Net sales in the first year are projected at ¥60mn, with an operating loss of ¥170mn.

Incidentally, the Company expanded into South Korea in 2012 and Indonesia in 2016. In South Korea, the Company achieved profits for certain months (July, November) and is expected to achieve full-year profitability in 2018.

Overview of Chinese subsidiary

Company name	(Undetermined)
Location	Shanghai, People's Republic of China (Planned)
Date of establishment	February 2018 (Planned)
Start of operations	July 2018 (Planned)
Fiscal year-end	December
Name of representative	Dongcan Yu
Business activities	Planning, procurement, and sales of industrial MRO products
Paid-in capital	CNY 20mn (Approx. ¥240mn)
Ownership ratio	MonotaRO (the Company) 75% Sumitomo Corporation 25% (The Company will establish the subsidiary with a 100% equity stake, then the subsidiary is to conduct a private placement of new shares to be subscribed by Sumitomo Corporation)

Source: Prepared by FISCO from Company materials

3. Pursuing higher productivity though new working styles

The Company is working to bolster productivity while reforming working styles. Examples of this can be seen in 1) the introduction of robot conveyors at Kasama DC and 2) time measurement for employees, including white-collar employees. To support efficient picking of a wide range of products at Kasama DC, which was completed in April 2017, the Company has installed 154 automated guided vehicle robots. This format significantly shortens walking time, which previously accounted for a large portion of picking operations, by having robots bring shelves to workers. Time measurement is a highly original initiative unique to the Company. The system applies to approximately 300 of the Company's employees, including part-time staff, and records operation times each day for approximately 2,000 types of operation categories. Simply reviewing the time allocation enables priority orders for operations to be identified, along with inefficient operations. The system is also used for creating manuals and working time models and is likely to help increase productivity over the medium term.

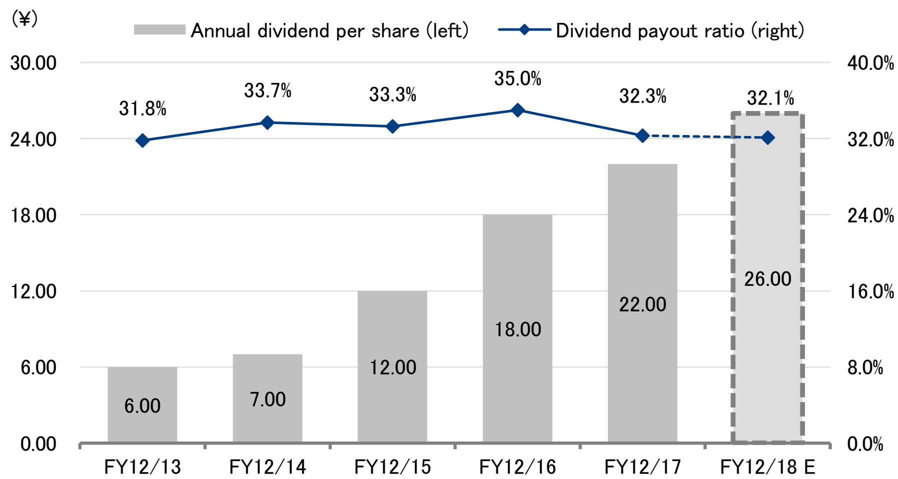
Shareholder return policy

Dividend increase to ¥26 per share for FY12/18 (dividend payout ratio 32.1%)

The Company's policy on dividends is to pay a stable dividend in accordance with its operating results. The Company sharply raised the FY12/17 dividend to ¥22 (up ¥4 YoY) at ¥11 in 1H and ¥11 in 2H. For FY12/18 the Company is projecting another dividend increase to ¥26 per share, comprising a 1H dividend of ¥13 and a 2H dividend of ¥13 in line with an increased profit target for the year. The dividend payout ratio has been maintained at the 30% level over the past five years and is projected to maintain the same level for FY12/18 at 32.1%. The Company offers shareholder benefits in the form of private brand product gifts for each shareholder holding 100 or more shares for at least six months at the end of the fiscal year (December 31) (worth ¥3,000 for six months or longer, ¥5,000 for three years or longer, and ¥7,000 for five years or longer*).

* Amounts do not include tax

Dividends and dividend payout ratio



Note: The Company conducted 2-for-1 stock splits in FY12/13 and FY12/15, which have been reflected retroactively.
Source: Prepared by FISCO from the Company's financial results

Disclaimer