COMPANY RESEARCH AND ANALYSIS REPORT

MonotaRO Co., Ltd.

3064

Tokyo Stock Exchange First Section

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Index

Summary

Healthy progress toward FY12/18 targets of ¥100bn in sales and ¥10bn in net income attributable to owners of the parent
Started business in the Chinese market
Decided to invest about ¥3bn to expand facilities at the cutting-edge Kasama DC

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.. The Company handles more than 15 million items for a customer base of 3,031,000 accounts (as of June 30, 2018) and sells about 500,000 items with same-day shipment (including roughly 348,000 items for which the Company has its own inventories).

1. 2Q FY2/18 non-consolidated results

The Company sustained robust growth in non-consolidated sales and earnings through 2Q FY12/18 with ¥48,707mn in sales (up 24.1% YoY), ¥6,956mn in operating income (up 20.2%), ¥6,919mn in ordinary income (up 18.8%), and ¥4,765mn in net income (up 15.1%). Both sales and profits sustained robust growth momentum. Sales rose substantially YoY and beat the plan target by 1.5% due to healthy trends in new customer acquisitions and rising sales at existing customers. The Company boosted new customer acquisitions on successes with various measures, such as reinforcement of listing advertisements, search engine optimization (SEO), airing a new-version TV commercial, and broadening product scope (from 13 million items to more than 15 million items). Sales to existing customers grew at a healthy pace on a stronger effect from measures to enhance usage frequency since March 2017 and healthy economic conditions. Furthermore, business with large corporations grew considerably. Gross margin fell due to a decline in product margin as a result of higher sales ratios for national brands and domestic products accompanying the rise in new customer sales as well as on a higher delivery cost ratio linked to delivery fee hikes and implementation of usage frequency enhancement measures. The SG&A expenses ratio, meanwhile, declined on a drop in the distribution-related cost ratio. Given these trends, operating income increased 20.2% YoY and exceeded the plan target by 3.7% and operating margin dropped by 0.4 pp.

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2. Consolidated outlook for FY12/18

The Company's FY12/18 consolidated targets 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%). This outlook expects continuation of strong growth in sales and profits and retains period-start values. 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 sales, the Company hopes to continue expansion of the customer base, increase in sales to existing customers, and promotion of business with large corporations. It reached 47.2% of the full-year sales target through 2Q (vs. 47.3% a year earlier), on par with the previous year. It will continue to take steps to raise sales to existing customers because this segment generates over 90% of sales. Modest decline in gross margin owing to higher national brands and domestic product sales ratios is within expectations. In SG&A expenses, meanwhile, the Company is shifting shipments to the highly automated Kasama DC and plans to reduce personnel expense and outsourcing cost ratios even more. The 47.1% progress toward the FY12/18 operating income target (vs. 47.0% a year ago) is roughly in line with the previous year. The Company's business model possesses the advantage of steady build-up in customer volume and increase in purchase value from customers with a longer purchasing record. These dynamics lead to higher sales and profits in 2H, than in 1H. We hence do not expect much deviation from forecasts in full-year results absent major disruptions in the external environment in 2H. It is worth noting that July sales increased by a healthy 29.8% even with torrential rain and landslide disasters and heat wave conditions in Japan.

3. Overseas business growth and progress in distribution-related initiatives

The Company's growth potential does not rely exclusively on the mainstay domestic direct marketing business (monotaro.com). While there is no question that monotaro.com is the core component at over 80% of consolidated sales (2Q FY12/18) and with 20.6% average annual growth in the past three years, other businesses besides the main area, where the Company has invested resources in recent years, offer attractive opportunities and grew even faster with business with large corporations averaging 57.0% over the past three years and overseas business at 29.9%. In overseas business, the Company established the Global Business Department in June 2018 that brings oversight of US and European royalty businesses and consolidated subsidiaries in South Korea, Indonesia, and China under the manager in charge of overseas operations. It brought forward the launch of the ZORO SHANGHAI business in China, which was originally planned for July 2018, to June. China's MRO market is reportedly at least twice the size of Japan's market, and the Company is taking actions to realize future growth.

The Company plans to invest to expand capacity at the Kasama DC even more in order to support broadening of business scope beyond expectations. Specifically, it will increase auto-guided vehicle robots from 150 units now to 250 units and add conveyors and shipping equipment with an investment budget if about ¥3bn. New equipment is scheduled to begin operating in April 2019. We have a favorable view of the Company's firm commitment to improving distribution, a key strength.

Key Points

- Realized 1H FY12/18 targets in sales and profits on upbeat trends in new customer acquisitions, orders from existing customers, and business with large corporations
- Healthy progress toward FY12/18 targets of ¥100bn in sales and ¥10bn in net income attributable to owners of the parent
- Establish an overseas business division and started business in the Chinese market; lowered the distribution-related cost ratio to 5.8% and decided to invest about ¥3bn to expand facilities at the cutting-edge Kasama DC

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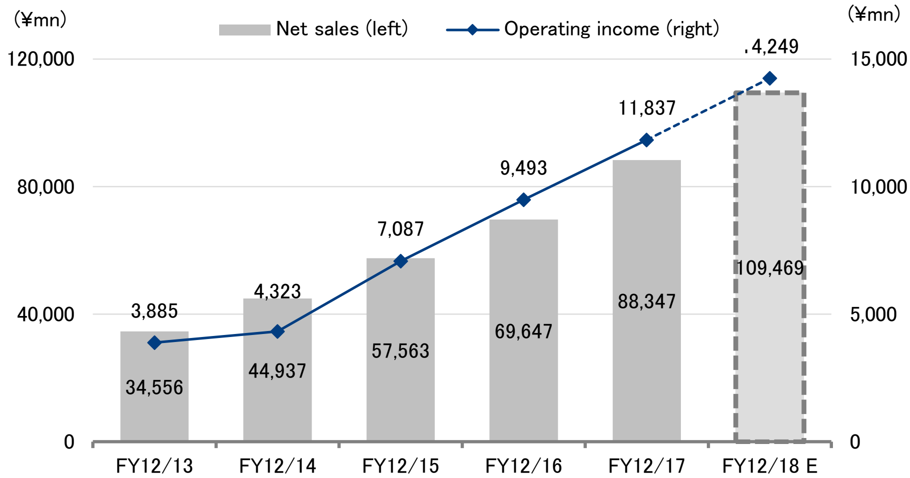
Trends in net sales and operating income



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

Results trends

Realized 1H FY12/18 targets in sales and profits on upbeat trends in new customer acquisitions, orders from existing customers, and business with large corporations

● Review of 2Q FY12/18 results (non-consolidated)

The Company sustained robust growth in non-consolidated sales and earnings through 2Q FY12/18 with ¥48,707mn in sales (up 24.1% YoY), ¥6,956mn in operating income (up 20.2%), ¥6,919mn in ordinary income (up 18.8%), and ¥4,765mn in net income (up 15.1%).

Sales rose substantially YoY and beat the plan target by 1.5% due to healthy trends in new customer acquisitions and rising sales at existing customers. The Company boosted new customer acquisitions on successes with various measures, such as reinforcement of listing advertisements, search engine optimization (SEO), airing a new-version TV commercial, and broadening product scope (from 13 million items to more than 15 million items). It recruited 294,000 new accounts in 2Q, giving it a total of 3,031,000 accounts (moving above 3 million accounts. Sales to existing customers grew at a healthy pace on a stronger effect from measures to enhance usage frequency implemented since March 2017* and healthy economic conditions. Furthermore, the Company increased the number of partners in business with large corporations to 513 companies (adding 146 companies versus June 30, 2017) and usage has risen too. These advances lifted the sales ratio from this business to 12.2%.

* Free delivery for the month on additional orders regardless of the amount after making a single order worth ¥7,000 (tax exclusive) or more (only applies to Web-based orders).

Gross margin dropped 1.4 pp YoY, with a decline of 0.7 pp in product margin due to increase in national brands and domestic product sales ratios linked to higher new customer sales and a setback of 0.7 pp from a higher delivery cost ratio because of price hike in delivery fees and implementation of usage frequency enhancement measures.

The SG&A expenses ratio was down 0.9 pp YoY. While depreciation costs climbed after the start of operations at the Kasama DC in April 2017, costs related to the launch booked in FY12/17 declined in FY12/18 and this led to a drop in the ratio of distribution-related costs.

As a result of these factors, operating income increased 20.2% YoY and beat the plan target by 3.7%, while operating margin declined by 0.4 pp. Net income only expanded 15.1% YoY owing to resumption of a normal tax rate after a tax incentive (coverage of Kasama DC investments under the tax program promoting capital investments in productivity improvements) from the previous year ended.

Non-consolidated income summary for 2Q FY12/18

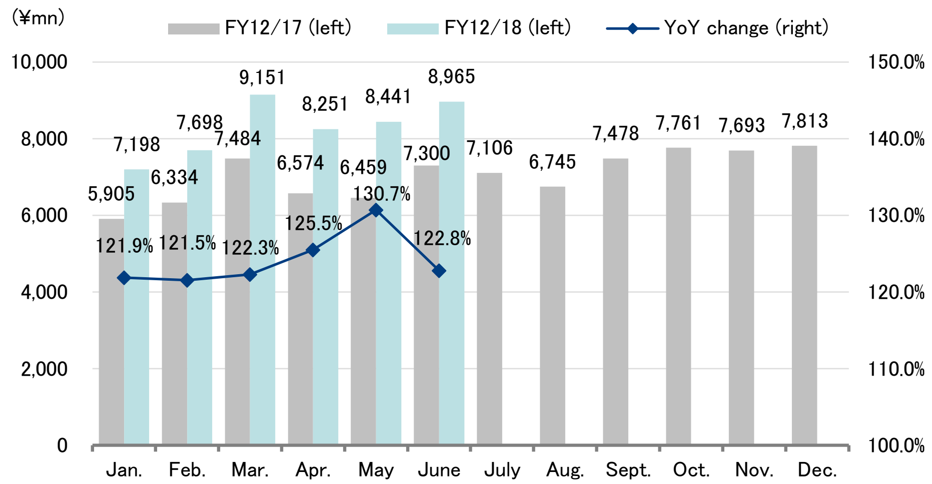
(¥mn)

	2Q FY12/17		2Q FY12/18			Change factors
	Results	vs. net sales	Results	vs. net sales	YoY	
Net sales	40,058	100.0%	49,707	100.0%	24.1%	• Expansion of new customers (adding 294,000 accounts) with support from strengthened listing advertisements, improved SEO, new TV commercials, and increase in the number of handled items • Measures to increase usage frequency and a favorable economic environment led to increase existing customer sales • Increase in business with large corporations and stronger sales (up 52% YoY)
Gross profit	12,609	31.5%	14,964	30.1%	18.7%	• Gross margin dropped 1.4 pp YoY • 0.7 pp decline in product margin due to increase in national brands and domestic product sales ratios • 0.7 setback from a higher delivery cost ratio because of price hike in delivery fees and implementation of usage frequency enhancement measures
SG&A expenses	6,823	17.0%	8,007	16.1%	17.3%	• SG&A expense ratio declined 0.9 pp YoY • Decline in the distribution-related cost ratio accompanying the Kasama DC launch • Decline in the SG&A expenses ratio due to higher sales
Operating income	5,785	14.4%	6,956	14.0%	20.2%	0.4 pp YoY decrease
Ordinary income	5,824	14.5%	6,919	13.9%	18.8%	0.6 pp YoY decrease
Net income	4,140	10.3%	4,765	9.6%	15.1%	0.7 pp YoY decline owing to a tax rate change

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

Looking at monthly results in 2018, the Company sustained 20% or stronger sales growth in all months, even with severe weather changes such as heavy snow in January and February and torrential rains and heat wave conditions in July.

Monthly sales



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

Business outlook

Healthy progress toward FY12/18 targets of ¥100bn in sales and ¥10bn in net income attributable to owners of the parent

● FY12/18 consolidated outlook

The Company retains initial forecasts for FY12/18 consolidated results at ¥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 sales, the Company hopes to continue expansion of the customer base, increase in sales to existing customers, and promotion of business with large corporations. It reached 47.2% of the full-year sales target through 2Q (vs. 47.3% a year earlier), on par with the previous year. It will continue to take steps to raise sales to existing customers because this segment generates over 90% of sales. Specifically, this included usage frequency enhancement measures with a growing effect, expansion in the number of handled items, increase in inventory items (to 400,000 items in FY12/18), and further shortening of lead times by widening distribution and bolstering the distribution network.

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New customers generally begin with purchases of national brand products and increase buying volume in private-brand products over time in repeat activity. Additionally, the Company significantly expanded the number of handled items to 15 million items (vs. 13 million items at the end of FY12/17), mainly for automotive parts (primarily in Japan). Modest decline in gross margin owing to higher national brands and domestic product sales ratios thus is within expectations. In SG&A expenses, meanwhile, the Company is shifting shipments to the highly automated Kasama DC and plans to reduce personnel expense and outsourcing cost ratios even more. While 2-3 months behind schedule, the Kasama DC shipment ratio is currently approaching about 50%. Progress toward FY12/18 targets of 47.1% in operating income (vs. 47.0% a year ago), 47.1% in ordinary income (vs. 47.3%), and 45.9% in net income attributable to owners of the parent (vs. 46.9%) caught up to roughly the same levels as the previous year. The Company's business model possesses the advantage of steady build-up in customer volume and increase in purchase value from customers with a longer purchasing record. These dynamics lead to higher sales and profits in 2H, than in 1H. We hence do not expect much deviation from forecasts in full-year results absent major disruptions in the external environment in 2H. It is worth noting that July sales increased by a healthy 12.0% even with torrential rain and landslide disasters and heat wave conditions in Japan.

Consolidated targets

(¥mn)

	FY12/17		FY12/18			2Q FY12/18		
	Results	vs. net sales	Forecast	vs. net sales	YoY	Forecast	Results	2Q progress rates
Net sales	88,347	100.0%	109,469	100.0%	23.9%	51,311	51,694	47.2%
Gross profit	26,929	30.5%	32,604	29.8%	21.1%	15,284	15,386	47.2%
SG&A expenses	15,091	17.1%	18,355	16.8%	21.6%	8,808	8,676	47.3%
Operating income	11,837	13.4%	14,249	13.0%	20.4%	6,476	6,710	47.1%
Ordinary income	11,858	13.4%	14,191	13.0%	19.7%	6,441	6,684	47.1%
Net income attributable to owners of the parent	8,464	9.6%	10,044	9.2%	18.7%	4,522	4,605	45.9%

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

Topics

Establish an overseas business division and started business in the Chinese market; lowered the distribution-related cost ratio to 5.8% and decided to invest about ¥3bn to expand facilities at the cutting-edge Kasama DC

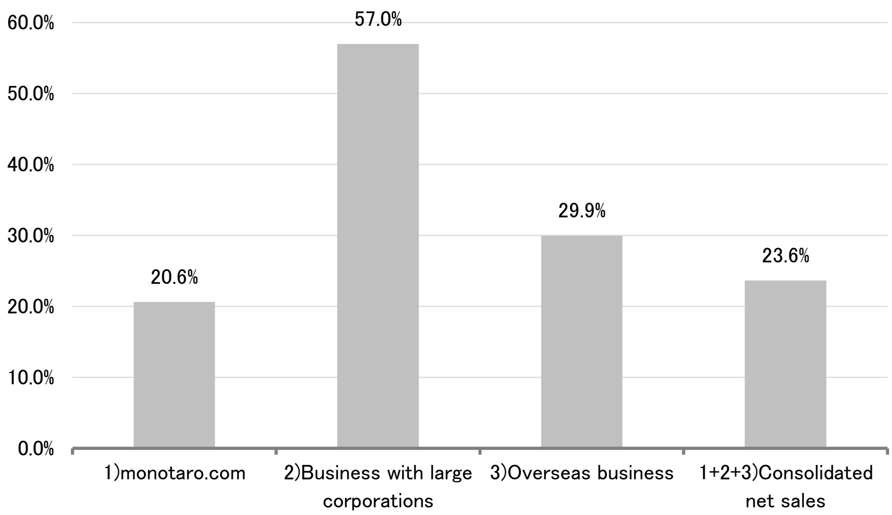
1. Establish an overseas business division and started business in the Chinese market

The Company's growth potential does not rely exclusively on the mainstay Domestic Direct Marketing Business (monotaro.com). While there is no question that monotaro.com is the core component at over 80% of consolidated sales (2Q FY12/18) and with 20.6% average annual growth in the past three years, other businesses besides the main area, where the Company has invested resources in recent years, offer attractive opportunities and grew even faster with business with large corporations averaging 57.0% over the past three years and overseas business at 29.9%.

In business with large corporations, the Company promotes transactions by arranging system collaboration with the purchasing systems of major corporate customers. Product coverage incorporates items handled by monotaro.com and products selected independently by the subject company on the same system. The Company projects ¥12.9bn in FY12/18 sales (up 47% YoY) from this business, which corresponds to 11.8% of total consolidated sales.

In overseas business, the Company established the Global Business Department in June 2018 that brings oversight of US and European royalty businesses and consolidated subsidiaries in South Korea, Indonesia, and China under the manager in charge of overseas operations. It positions US and European royalty businesses as cash cows. While the NAVIMRO business in South Korea booked a slight operating loss in 2Q cumulative FY12/18, this unit has grown enough to target an operating profit for the full year. The Company brought forward the launch of the ZORO SHANGHAI business in China, which was originally planned for July 2018, to June. China's MRO market is reportedly at least twice the size of Japan's market, and the Company is taking actions to realize future growth.

Average growth rates in the past three years



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

2. Lowered the distribution-related cost ratio to 5.8% and decided to invest about ¥3bn to expand facilities at the cutting-edge Kasama DC

The Company lowered its distribution-related cost ratio to 5.8% in 1H FY12/18. Full-fledged launch of the Kasama DC in April 2017 resulted in one-time costs as a transition period, and the distribution-related cost ratio was over 6% in 1H and 2H FY12/17. Inventory volume increased to 210,000 items at the Kasama DC, out of the 348,000 inventory items nationwide, in 1H and is still rising at pace of 10,000 items per month. The Company expects shipment ratios for the Kasama DC and Amagasaki DC at about half each. Increase in the ratio at Kasama DC with cutting-edge facilities that utilize auto-guided vehicle robots is likely to reduce the distribution-related cost ratio.

The Company plans to invest to expand capacity at the Kasama DC even more in order to support broadening of business scope beyond expectations. Specifically, it will increase auto-guided vehicle robots from 150 units now to 250 units and add conveyors and shipping equipment with an investment budget if about ¥3bn. New equipment is scheduled to begin operating in April 2019. We have a favorable view of the Company's firm commitment to improving distribution, a key strength.

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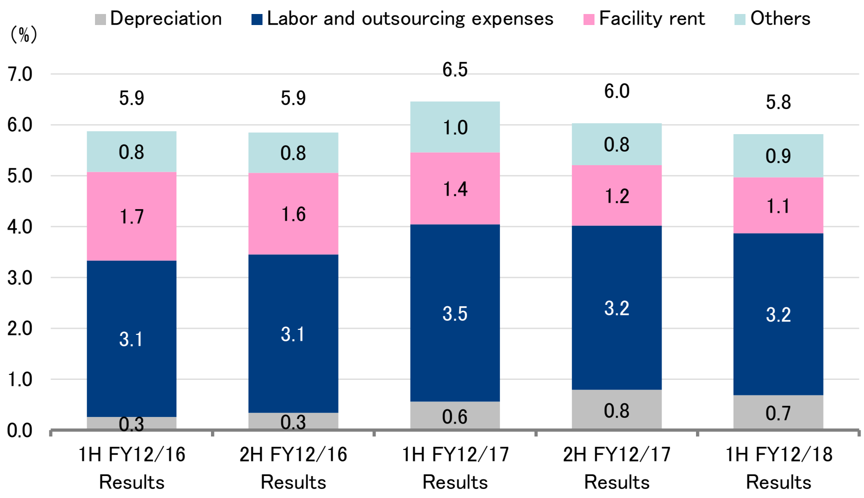
Distribution-related cost ratio



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

Shareholder return policy

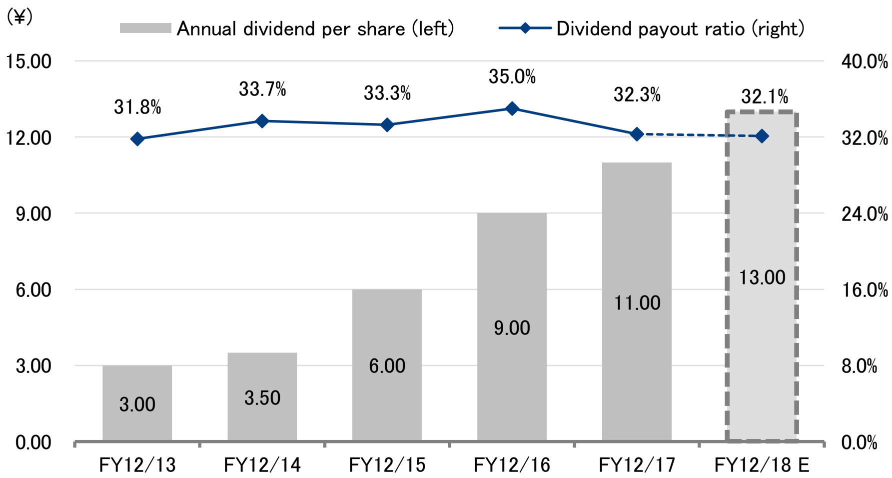
Targets a ¥13 dividend in FY12/18 (up ¥2 YoY; adjusted for the share split), 32.1% dividend payout ratio

The Company adheres to a policy of paying a stable dividend in line with earnings. It substantially raised the dividend from ¥3 in FY12/13 to ¥11 in FY12/17 and has maintained a payout ratio of over 30%. In FY12/18, it paid ¥6.5 in 1H (actual) and expects to pay ¥6.5 at year-end in light of upbeat earnings. This puts the full-year dividend at ¥13 (up ¥2 YoY) and a 32.1% payout ratio. The Company passed a resolution at its Board of Directors' meeting on July 27, 2018 to conduct a 2-for-1 stock split that takes effect on October 1, 2018. We retroactively adjusted dividend values for the share split.

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. It also decided at its Board of Directors' meeting on July 27, 2018 to conduct a 2-for-1 stock split that takes effect on October 1, 2018. We retroactively adjusted dividend values for the share split.
Source: Prepared by FISCO from the Company's financial results

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