

## HAGIHARA INDUSTRIES (7856 JP)

FY20 GUIDANCE REVISED DOWN DUE TO THE MARKET INVENTORY AND REVALUATION LOSS OF RAW MATERIALS

### FY20 (OCT-20) 2Q RESULTS

Hagihara Industries (7856 JP) reported FY20 2Q results with OP of ¥1,421 mil (+9.2% YoY) on sales of ¥14,150mil (-4.3% YoY). Sales fell short of the company's guidance made at the beginning of the year (¥15,300mil) by ¥1,150mil but OP surpassed the guidance (¥1,395mil), thanks to improved profitability of the Plastic-processed Products (PLS) segment.

Of the ¥638mil YoY fall in sales, ¥249mil (-2.1% YoY) was from PLS. Flexible container bags sales were weak amid the slowdown in the global economy which led to slower movement of goods. Products used for the agricultural purposes (e.g. grain cover) also saw a weak sales trend due to bad weather conditions overseas. On the positive side, the segment saw a steady rise in sales of blue sheets as local governments stocked up for disaster prevention purposes. One of Hagihara Industries' strategic products BarChip sales also increased thanks to a rise in new applications in addition to use in a concrete floor material. Customers also looked to secure inventory amid concern over supply disruptions, especially after the large-scale social restriction implemented in Indonesia. Furthermore, a rapid fall in material prices linked to naphtha supported profitability. Therefore, the PLS segment OPM rose from 7.9% in FY19 1H to 9.8% in FY20 1H.

Another ¥389mil (-13.2% YoY) fall in sales came from the Engineering Products segment. Demand for paper slitters remained strong thanks to an increase in demand from receipt paper processing companies as the shift towards cashless transactions takes hold. Replacement demand for depleted paper slitters also rose. However, the physical delivery and installation of products have been delayed due to restrictions under COVID-19, resulting in the order backlog rising 6.9% HoH to ¥3,831 mil.

The impact of COVID-19 became apparent from the end of March. In April, Hagihara Industries experienced a rapid surge in demand as customers started stockpiling inventory amid concerns over supply disruption. The utilisation rate was running at full capacity until June. However, due to the likelihood of excess supply, the firm reduced the operation of its factories by 4-5 days from July.

Hagihara Industries announced a downward revision to its full-year guidance together with its 2Q results. The new guidance assumes the ongoing pandemic situation remains under control while the global economy gradually restarts activities. The firm is concerned about the high level of the market inventory potentially weakening demand for its products and revaluation losses from raw material inventory due to the rapid change in naphtha price which affects the value of the firm's two major raw materials – polyethylene and polypropylene.

### EXECUTIVE SUMMARY

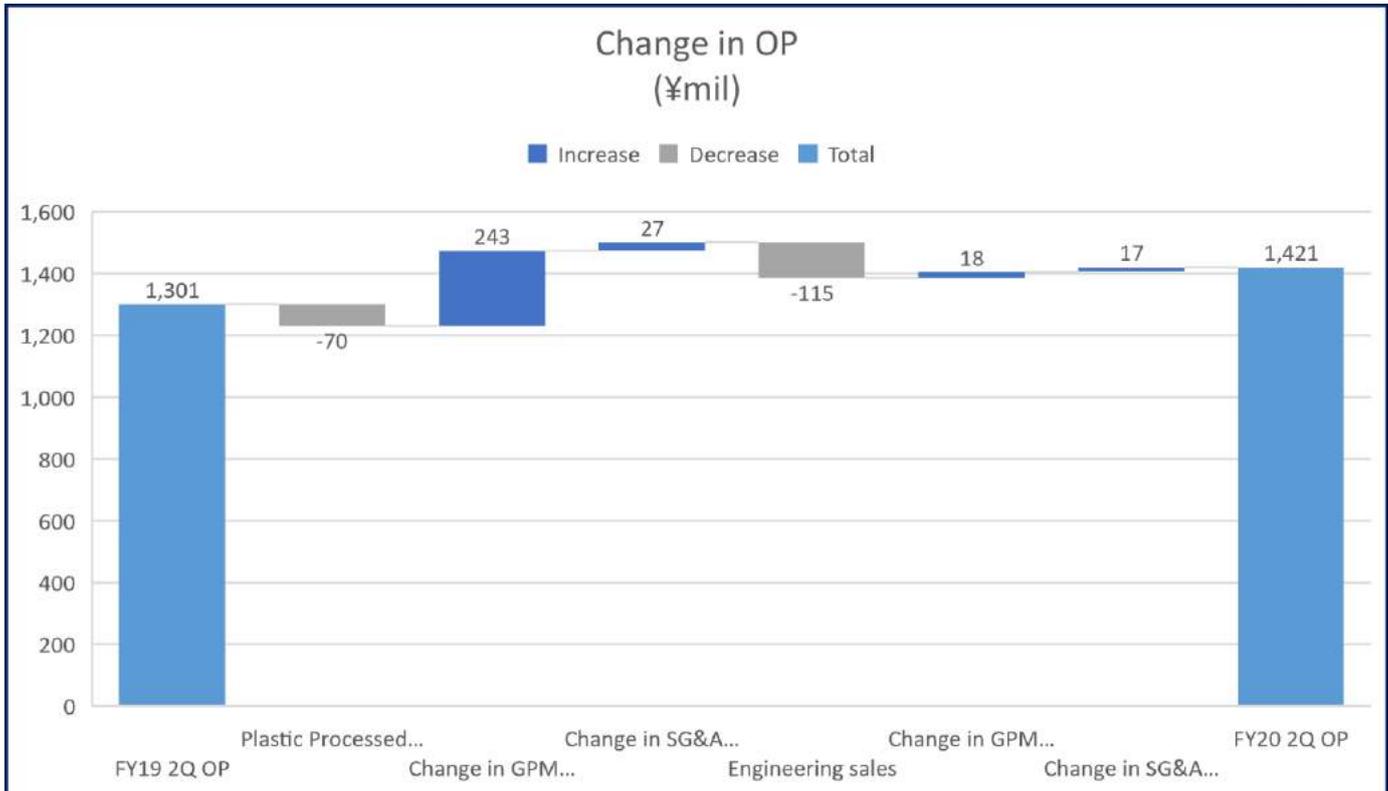
- Hagihara Industries (7856 JP) reported FY20 2Q OP of ¥1,421 mil (+9.2% YoY) on sales of ¥14,150mil (-4.3% YoY). Sales fell short of the guidance, but OP was ahead.
- Full-year guidance was revised down (sales by 8.7% and OP by 9.3%) due to concerns over market inventory. Also, there is a possibility that the firm needs to write off revaluation losses of raw materials (a BS item) due to the rapid fall in the naphtha price – the new forecast is based on ¥20,000/kl vs. ¥42,100/kl previously.
- The COVID impact is apparent in that market inventory remains high for the Plastic-processed Products (PLS) segment. In the engineering segment, delivery, installation, and the final inspection could not be carried out due to restrictions on physically visiting customers.
- FY20 1H PLS segment OP hit ¥1,132mil (+21.5% YoY) on sales of ¥11,589mil (-2.1% YoY), with OPM up 1.9ppt to 9.8%.
- Engineering segment 1H OP declined 21.7% YoY to ¥289mil on sales of ¥2,560mil (-13.2% YoY).
- Strategic products, whose GPM is more than 30%, and in-house developed by Hagihara Industries earned sales of ¥6,080mil, flat YoY. A concrete enforcement material BarChip saw sales rose 5.3% YoY to ¥1,786mil. Adhesive tape cloth saw sales improve 6.2% YoY to ¥998mil thanks to a surge in packaging demand. The yarn for artificial grass has seen a rapid drop in demand because of market inventory levels. Film slitter sales fell 5.6% YoY to ¥1,727mil due to a peaking out in demand for LiB separator film in China.

Earnings Guidance (Cumulative)		FY20CE									
		IH	YoY (%)	2HCE (prev)	2HCE (new)	Chg in CE (%)	HoH (%)	FYCE (prev)	FYCE (New)	Chg in CE (%)	YoY (%)
Consolidated	Sales	14,150	-4.3	15,700	14,149	-9.9	0.0	31,000	28,300	-8.7	-4.5
	OP	1,421	9.2	1,305	1,028	-21.2	-27.7	2,700	2,450	-9.3	-10.1
	OPM (%)	10.0	+1.2pp	8.3	7.3	-1.0pp	-2.7pp	8.7	8.7	0.0pp	-0.5pp
	RP	1,656	31.1	1,305	1,073	-17.8	-35.2	3,000	2,730	-9.0	-4.2
	RPM (%)	11.7	+3.2pp	8.3	7.6	-0.7pp	-4.1pp	9.7	9.7	0.0pp	+0.1pp
	NP for parent's shareholders	1,139	31.3	900	700	-22.2	-38.5	2,090	1,840	-12.0	-8.7
Parent	Sales	10,730	-5.3	11,990	10,850	-9.5	1.1	23,350	21,580	-7.6	-5.3
	OP	1,227	13.7	1,145	833	-27.2	-32.1	2,285	2,060	-9.8	-12.2
	OPM (%)	11.4	+1.9pp	9.6	7.7	-1.9pp	-3.7pp	9.8	9.5	-0.3pp	-0.8pp
	RP	1,472	30.6	1,145	958	-16.3	-34.9	2,585	2,430	-6.0	-8.9
	RPM (%)	13.7	+3.8pp	9.6	8.8	-0.8pp	-4.9pp	11.1	11.3	+0.2pp	-0.4pp
	NP	1,073	33.5	770	647	-16.0	-39.7	1,795	1,720	-4.2	-13.2

Source: Hagihara Industries' results materials



Source: Hagihara Industries FY20 2Q earnings presentation



Source: Hagihara Industries FY20 2Q earnings presentation

## SEGMENT

### *Plastic-processed Products (PLS) segment*

The Plastic Processed Products (PLS) segment earned FY20 1H OP of ¥1,132mil (+21.5% YoY) on sales of ¥11,589mil (-2.1% YoY). The surge in the segment OP was due to an improved gross profit margin (GPM) thanks to a drop in raw material prices, which rose from 27.2% in FY19 2Q to 29.2% in FY20 2Q. In CY20 1Q, the domestic naphtha price was ¥44,800/kl (+8.7% QoQ). A ¥1,000/kl change in the naphtha price gives ca. ¥60mil impact to OP on the annualised basis. At the same time, raw material inventory on BS will be revalued by ¥8mil. In CY20 Q2, however, due to COVID-19, the naphtha price fell sharply – to below ¥20,000/kl. Demand for petrochemical products in Asia remains weak, hence the recovery in naphtha price appears slow. Segment OP went up by ¥200mil, of which ¥161mil was due to the improved GPM of sheet products used in the construction sector.

For Hagihara Industries, a drop in raw material price is positive in the short-term. However, the raw material value is reviewed on a monthly moving average basis and every revaluation of the BS inventory asset will be reflected in the COGS part of PL. As naphtha prices fell, the inventory revaluation loss hits the GPM, albeit with a time lag. There is also a negative impact on its P&L from inventory revaluation. Such a revaluation loss will likely appear in COGS from 3Q. This is one of the major reasons the firm revised down its full-year guidance. The new guidance is based on a naphtha price of ¥20,000/kl, revised down from ¥42,100/kl. The firm assumes revaluation losses of ¥100mil for the next two quarters.

Within the PLS segment, the core Industrial Materials sub-segment – which includes one of the firm's strategic products, BarChip – saw a 1.0% YoY rise in sales to ¥5,148mil in FY20 1H. Construction is globally categorised as essential work under the COVID restrictions, therefore, there has been demand for construction materials such as BarChip. FY20 1H BarChip sales rose 5.4% YoY to ¥1,786mil. On the other hand, flexible container bags are also included in the Industrial Materials sub-segment, but sales of this product remained weak due to slower movement of goods globally.

The Sheet and Construction Materials sub-segment saw sales fall 4.2% YoY to ¥2,917mil. Whilst demand from the construction sector remained solid, demand associated with agriculture, such as grain cover in the US, dragged down sales. The Living Materials sub-segment reported sales of ¥2,970mil (-5.4% YoY). This sub-segment includes two of Hagihara Industries' strategic products: 1) yarn for artificial grass and 2) adhesive tape cloth. Adhesive tape cloths continued to grow in 1H, with sales reaching ¥998mil (+6.2% YoY) thanks to a rise in packaging demand. However, orders for yarn for artificial grass, which was in the spotlight when used in a stadium that hosted the 2019 Rugby World Cup, have completely stopped due to the increase in market inventory. Sales of the yarn is included in the Other High Functionality Products sub-segment, which saw sales dip 3.7% YoY to ¥1,568mil.

### Engineering Products

The Engineering segment earned OP of ¥289mil (-21.7% YoY) on sales of ¥2,560mil (-13.2% YoY). Film slitter sales for lithium-ion battery separators in China had run its course. FY20 1H film slitter sales fell 5.7% YoY to ¥1,727mil. The segment was affected by COVID restrictions on delivery and physical installation, as well as the final inspection of the machinery not being able to be completed. Delivery of some engineering products, in total of ¥147mil, was pushed back to later this year. As of Apr 2020, the order backlog was ¥3,831mil (+6.9% HoH), equivalent of ca. 9-month of sales.

Segment Sales and OP									
(¥mil / Oct year-end)	FY17	FY18	FY19			FY20CE			
	A	A	1H	A	YoY (%)	1H	YoY (%)	CE	YoY (%)
Plastic processed Products Segment	17,746	20,854	11,838	23,674	13.5	11,589	-2.1	22,800	-3.7
Sheet and construction materials	5,594	6,180	3,044	6,281	1.6	2,917	-4.2	5,304	-15.6
Industrial materials	7,951	9,398	5,095	10,038	6.8	5,148	1.0	10,594	5.5
Living materials	3,401	4,288	3,139	6,164	43.8	2,970	-5.4	6,130	-0.6
Other plastics	798	986	559	1,189	20.6	552	-1.1	771	-35.2
Segment OP	2,139	1,917	932	1,934	0.9	1,132	21.5	1,820	-5.9
Segment OPM (%)	12.1	9.2	7.9	8.2	-1.0pp	9.8	+1.9pp	8.0	-0.2pp
Engineering Products Segment	5,492	5,602	2,949	5,973	6.6	2,560	-13.2	5,500	-7.4
Segment OP	581	768	369	788	2.6	289	-21.7	630	-20.2
Segment OPM (%)	10.6	13.7	12.5	13.2	-0.3pp	11.3	-1.9pp	11.5	-1.7pp
Total Sales	23,238	26,457	14,788	29,647	12.1	14,150	-4.3	28,300	-4.5
Total OP	2,721	2,685	1,301	2,723	1.4	1,421	9.2	2,450	-10.0
OPM (%)	11.7	10.1	8.8	9.2	-1.0ppt	10.0	+0.8pp	8.7	-0.5pp

Source: Nippon-IBR based on Hagihara Industries' FY20 2Q earnings results materials

Sales trend of strategic products			
(¥mil / Oct year-end)	FY19	FY20	YoY (%)
	1H	1H	
BarChip	1,695	1,786	5.4
Adhesive tape cloth	939	998	6.3
Other high functional products (incl. artificial grass yarn)	1,628	1,568	-3.7
Film slitter	1,831	1,727	-5.7

Source: Hagihara Industries' FY20 2Q earnings presentation

## FY20 2H OUTLOOK

Hagihara Industries revised down the full-year guidance with the 2Q results due to concerns over excess inventory and possible revaluation losses on raw material inventory on the BS due to rapid fall in naphtha price. It is now guiding for consolidated OP of ¥2,450mil (-10.1% YoY) on sales of ¥28,300mil (-4.5% YoY), revised down by 9.3% and 8.7%, respectively.

Reasons for the downward revision is as follows:

### 1. Rapid fall in naphtha price:

Hagihara Industries has raw material inventory of ca. ¥1,024mil on the BS as in 1H. For 2H, the firm changed its naphtha price assumption from ¥42,100/kl to ca. ¥20,000/kl, which leads to ca. 3.7pp drop in the 2H segment OPM to 6.1%. The revaluation loss estimated based on the aforementioned naphtha price assumption is ca. ¥100mil. Not all the raw material inventory is applicable to the revaluation.

### 2. COVID-19 impact to earnings

The negative effect of the pandemic has been more apparent in shipment and marketing activities. The firm is concerned about pre-empted demand in the PLS segment as market inventory has already been hefty. Hagihara Industries estimates a hit of ¥1,140mil from the drop in PLS segment sales volume in 2H amid the drop in demand as economic activity slowed due to COVID-19. Examples of products that will likely see a drop in sales volume are laminated cloth in the construction sector, flexible container bags in the automobile industry and carpet base layers due to cancellation of events.

The firm also expects around a ¥400mil negative impact in sales from a drop in the selling price as follows:

- ¥150mil will likely come from the change in price in the artificial grass yarn products given the lower naphtha price.
- Also due to the change in naphtha price, a ¥50mil hit to industrial materials yarn sales is expected
- ¥200mil from non-naphtha related factors such as FOREX revaluation loss

Some 50% of the segment sales is based on the naphtha slide pricing (i.e. the selling price change along with change in the naphtha price without changing the spread), therefore, not all profit is affected by change in the naphtha price.

FY20 annual dividend estimate is ¥36.00/share, up ¥2/share YoY. Estimated pay-out ratio is 28.3% vs. the firm's pay-out target of 20%.

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For further enquiry, please contact:

Yumi Yamamoto-Tyrrell

Nippon Investment Bespoke Research UK Ltd

First Floor,

35 Little Russell Street

London WC1A 2HH

TEL: +44 (0)20 7993 2583

Email: [y.yamamoto@nippon-ibr.com](mailto:y.yamamoto@nippon-ibr.com)



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