

Keyence (6861)

Operational excellence but status quo on corporate governance

- Estimate Change
- Target Price Change

- **Raising estimates and target price** — Following the solid start to the year, with Q1 sales up 13% YoY and OP rising 19%, we revise our estimates for this term and next. Assuming the shares are worth 20x our FY3/15E EPS, the PER average for the past eight years (up from 18x to reflect steady overseas growth) and adding back the after-tax value of its cash and investments, we lift our target price to ¥35,000 from ¥31,500 and keep a Neutral rating. While Keyence is gaining traction in overseas markets in our view the same cannot be said for its governance.
- **Overseas growth leading the way** — According to Keyence, Asian sales in Q1 increased 30% YoY. The company says China makes up c50% of its Asian revenues and demand from local makers is upbeat. In the Americas, we estimate USD sales jumped 31% in Q1 (+58% in yen terms). It was a similar story in Europe where we estimate local-currency sales rose 8% but rose 30% in yen. In our view, Keyence is now seeing a return on the investments made in overseas markets over the past decade. At end-June, the company had 107 sales offices, and over the past 12 months new locations have been added in Mexico, Thailand, Italy, and Germany.
- **Domestic sales underwhelmed in Q1** — According to Keyence, domestic sales fell 3% YoY and we estimate this is a decline of 7% QoQ. While there is some seasonality in the company's domestic business, we are disappointed that domestic sales have now fallen in YoY terms for two straight quarters. The company states that Q2 sales should show a sequential improvement, but it strikes us that the benefits of Abenomics have yet to be felt.
- **Corporate governance issues** — Looking at votes cast at the most recent AGM in June, we note that 32.3% of shareholders with voting rights opposed the company's proposal for distribution of retained earnings, we believe an implicit criticism of the annual dividend of only ¥60/share. The re-election of founder and Chairman Takemitsu Takizaki as a director was opposed by 23.5% of those with voting rights, and President Akinori Yamamoto was opposed by 19.7%. Keyence continues to have no outside directors. We would like to think the company is considering appointing one or more outside directors, but without access to senior management we assume for now the status quo will be maintained.

Neutral	2
Price (02 Sep 13)	¥32,650
Target price	¥35,000
from ¥31,500	
Expected share price return	7.2%
Expected dividend yield	0.2%
Expected total return	7.4%
Market Cap	¥1,980,022M
	US\$19,933M

Price Performance (RIC: 6861.T, BB: 6861 JP)



Consol.	Sales		OP			RP		NP		EPS	PE
	¥M	YOY (%)	¥M	YOY (%)	OPM(%)	¥M	YOY (%)	¥M	YOY (%)	¥	X
3/12A	199,334	7.9	91,145	5.2	45.7	94,241	4.7	58,160	5.1	1,054	31.0
3/13A	217,829	9.3	99,223	8.9	45.6	108,392	15.0	67,575	16.2	1,225	26.7
3/14E	251,350	15.4	115,118	16.0	45.8	119,961	10.7	75,575	11.8	1,305	25.0
3/14RE	254,350	16.8	118,909	19.8	46.8	126,651	16.8	80,345	18.9	1,388	23.5
3/15E	270,300	7.5	124,879	8.5	46.2	130,050	8.4	81,956	8.4	1,351	24.2
3/15RE	273,300	7.5	128,314	7.9	47.0	136,304	7.6	87,810	9.3	1,448	22.5
3/16E	290,500	7.5	135,083	8.2	46.5	140,603	8.1	88,627	8.1	1,461	22.3
3/16RE	291,900	6.8	137,777	7.4	47.2	145,128	6.5	93,530	6.5	1,542	21.2

A: Actuals, E: Citi Research Ests, CE: Co. Ests, RE: Citi Research Revised Ests, CRE: Co. Revised Ests, NA: Not Available, NM: Not Meaningful

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6861.T: Fiscal year end 31-Mar						Price: ¥32,650; TP: ¥35,000; Market Cap: ¥1,980,022m; Recomm: Neutral					
Profit & Loss (¥m)	2012	2013	2014E	2015E	2016E	Valuation ratios	2012	2013	2014E	2015E	2016E
Sales revenue	199,334	217,829	254,350	273,300	291,900	PE (x)	31.0	26.7	23.5	22.5	21.2
Cost of sales	-47,542	-53,306	-60,408	-65,045	-68,597	PB (x)	2.8	2.5	2.5	2.3	2.0
Gross profit	151,792	164,523	193,942	208,255	223,304	EV/EBITDA (x)	15.3	13.6	10.8	9.5	8.2
Gross Margin (%)	76.1	75.5	76.3	76.2	76.5	FCF yield (%)	2.6	3.4	3.9	4.2	4.5
EBITDA (Adj)	94,070	102,213	121,925	131,347	140,802	Dividend yield (%)	0.2	0.2	0.2	0.2	0.2
EBITDA Margin (Adj) (%)	47.2	46.9	47.9	48.1	48.2	Payout ratio (%)	6	5	4	4	4
Depreciation	-2,925	-2,990	-3,017	-3,032	-3,025	ROE (%)	9.4	9.9	10.6	10.5	10.1
Amortisation	0	0	0	0	0	Cashflow (¥m)					
EBIT (Adj)	91,145	99,223	118,909	128,314	137,777	EBITDA	94,070	102,213	121,925	131,347	140,802
EBIT Margin (Adj) (%)	45.7	45.6	46.8	47.0	47.2	Working capital	-7,446	-784	-8,388	-6,661	-6,538
Net interest	1,323	1,103	1,242	1,389	1,551	Other	-36,604	-37,554	-36,563	-38,504	-42,247
Non-op/Except	1,773	8,066	6,500	6,600	5,800	Operating cashflow					
Recurring profit	94,241	108,392	126,651	136,304	145,128	Capex	-3,544	-2,788	-3,000	-3,000	-3,000
Tax	-36,081	-40,817	-46,306	-48,493	-51,598	Net acq/disposals	0	0	0	0	0
Extraord./Min.Int./Pref.div.	0	0	0	0	0	Other	-42,163	-55,921	-55,000	-58,000	-60,000
Reported net profit	58,160	67,575	80,345	87,810	93,530	Investing cashflow					
Net Margin (%)	29.2	31.0	31.6	32.1	32.0	Dividends paid	-3,309	-2,563	-3,639	-3,639	-3,639
Core NPAT	58,160	67,575	80,345	87,810	93,530	Financing cashflow					
Per share data	2012	2013	2014E	2015E	2016E	Net change in cash	-2,423	996	15,335	21,543	25,378
Reported EPS (¥)	1,054	1,225	1,388	1,448	1,542	Free cashflow to s/holders					
Core EPS (¥)	1,054	1,225	1,388	1,448	1,542		46,476	61,087	73,974	83,182	89,017
EPS* (¥)	959	1,114	1,325	1,448	1,542						
DPS (¥)	60	60	60	60	60						
CFPS (¥)	907	1,158	1,329	1,421	1,517						
FCFPS (¥)	843	1,107	1,278	1,372	1,468						
BVPS (¥)	11,755	13,021	13,108	14,496	15,978						
Wtd avg ord shares (m)	55.2	55.2	57.9	60.6	60.6						
Wtd avg diluted shares (m)	55.2	55.2	57.9	60.6	60.6						
Growth rates	2012	2013	2014E	2015E	2016E						
Sales revenue (%)	7.9	9.3	16.8	7.5	6.8						
EBIT (Adj) (%)	5.2	8.9	19.8	7.9	7.4						
Core NPAT (%)	5.1	16.2	18.9	9.3	6.5						
Core EPS (%)	5.1	16.2	13.3	4.4	6.5						
Balance Sheet (¥m)	2012	2013	2014E	2015E	2016E						
Cash & cash equiv.	377,349	422,738	496,542	577,361	663,973						
Accounts receivables	65,912	68,517	74,809	80,382	85,853						
Inventory	14,040	16,126	18,830	20,233	21,610						
Net fixed & other tangibles	36,045	39,117	38,100	37,068	36,043						
Goodwill & intangibles	658	1,252	1,400	1,400	1,400						
Financial & other assets	190,666	206,234	206,306	206,463	206,617						
Total assets	684,670	753,984	835,987	922,907	1,015,496						
Accounts payable	3,962	3,624	4,232	4,547	4,856						
Short-term debt	0	0	0	0	0						
Long-term debt	0	0	0	0	0						
Provisions & other liab	32,274	32,103	36,793	39,226	41,614						
Total liabilities	36,236	35,727	41,024	43,773	46,471						
Shareholders' equity	648,433	718,256	794,962	879,134	969,025						
Minority interests	0	0	0	0	0						
Total equity	648,433	718,256	794,962	879,134	969,025						
Net debt	-377,349	-422,738	-496,542	-577,361	-663,973						
Net debt to equity (%)	-58.2	-58.9	-62.5	-65.7	-68.5						

Note: Consolidated data. * EPS: NP/Est Shares OS.

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Keyence

Investment strategy

We rate Keyence Neutral with a ¥31,500 target price. Keyence is a leading domestic supplier of sensors, measuring equipment, PLCs, and other components crucial to the trend of factory automation. It also makes a range of digital microscopes and 3D printers. Approx 60% of sales are generated in Japan but we believe most of the long-term growth opportunities are overseas. The largest overseas market is Asia, which we estimate in FY3/13 made up 18% of total sales. The main Asian markets are China, South Korea, and Taiwan and the company is well placed to benefit from the long-term trend of factory automation in China. We estimate that China makes up approx 1/3 of total Asian sales. In FY3/13 the Americas and Europe made up 17% and 10% of total sales respectively. Offsetting the upside from the scope for overseas growth in general and Asia in particular is the low importance attached to shareholder returns both in the form of dividends and share buybacks (despite a three-year cycle of 11-for-10 stock splits). In addition, in an era where investors are pushing for more and improved transparency, the management's minimalist approach to disclosure is frustrating. Keyence publishes no data on sales by product, there are no analyst meetings, and there is no access to top management. As such, investors are left having to take a lot on trust.

Valuation

Over the past eight years (FY3/06 – FY3/13), the average PER has been 20x, with an EV/EBITDA of 7x and a PBR of 2.0x. The shares usually trade at a premium to both the Japanese machinery sector and the global industrials sector which in our view reflects the fabless, consulting-engineering characteristics of the company, the high operating margins, the robust state of the balance sheet (with the combined value of its cash and investments comprising 85% of total assets) and the solid track record of growing top-line sales (a 9% CAGR between FY3/03 – FY3/13). In setting our target price we include the after-tax value of its cash and short-term investments which at the end of March 2013 stood at approx ¥7,000/share, and apply a target multiple of 18x our FY3/15 EPS estimate. This compares with the global average for the industrial sector of 15x CY13 and 13x CY14.

Given its high operating margins and fabless business model, it is no surprise that operating cash flow is usually impressive. However, even though the company does not have high capex requirements, its reported FCF is depressed by the long-held strategy of reinvesting its operating cash flow into financial instruments (mainly low-risk government and corporate bonds) or simply keeping cash on deposit. For this reason cash conversion is relatively low. For example, between FY3/05 – FY3/13, compared to total cumulative net profits of ¥478bn, reported FCF was negative to the tune of ¥16bn. Ignoring the company's financial investment strategy, and just subtracting capex from OP gives a total different impression with an adjusted FCF total of ¥442bn, over the same period.

We believe that Keyence attaches a relatively low importance to shareholder returns. Annual dividends have been pegged at ¥60/share since FY3/07, although the company has done an 11 for 10 stock split every three years since 1994.

Risks

Upside risks to our target price include a re-acceleration in global economic growth, an improvement in disclosure and/or greater access to top management. In the same way, any change by the company to embrace shareholder returns either in the form of higher dividends or share buybacks would be a big plus.

On the downside, the main risks to our target price are an ongoing derating of industrial shares globally, and further weakness in electronic related demand which makes up approx 30% of total domestic revenues.

Appendix A-1

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Keyence (6861)

Ratings and Target Price History Fundamental Research

Analyst: Graeme McDonald
Covered since October 25 2010



Date	Rating	Target Price	Closing Price
1 25-Oct-10	*1L	*22,273	18,255
2 30-May-11	1L	*21,636	19,100
3 22-Aug-11	*2L	*18,636	17,773
4 7-Oct-11	Stock rating system changed		

* Indicates change

Date	Rating	Target Price	Closing Price
5 7-Oct-11	*2	18,636	18,636
6 13-Dec-11	*3	*16,545	17,818
7 15-Mar-12	3	*19,000	19,720
8 30-May-12	3	*17,000	17,900

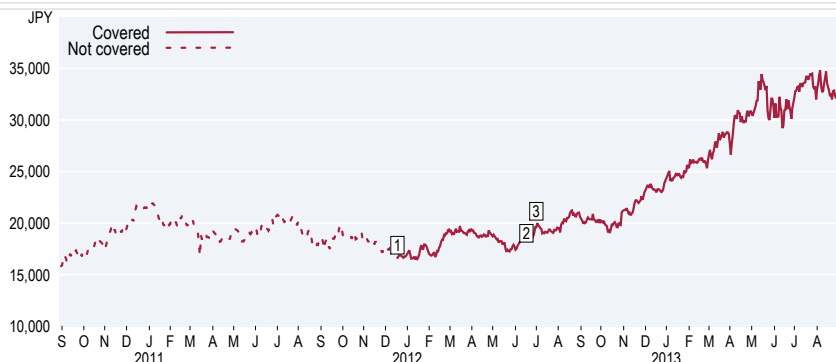
Date	Rating	Target Price	Closing Price
9 9-Aug-12	3	*19,500	20,430
10 15-Oct-12	*2	19,500	19,380
11 17-Jan-13	2	*26,500	24,730
12 3-Jun-13	2	*31,500	30,200

Rating/target price changes above reflect Eastern Standard Time

Keyence (6861)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Graeme McDonald
Covered since October 25 2010



Date	Rating	Target Price	Closing Price
1 19-Dec-11	*ADD LP	-	16,609

* Indicates change

Date	Rating	Target Price	Closing Price
2 18-Jun-12	*REM LP	-	18,570

Date	Rating	Target Price	Closing Price
3 30-Jun-12	*N	-	19,620

Rating/target price changes above reflect Eastern Standard Time

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Graeme McDonald

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