

30 October 2013 | 10 pages

Machinery
Japan

Fanuc (6954)

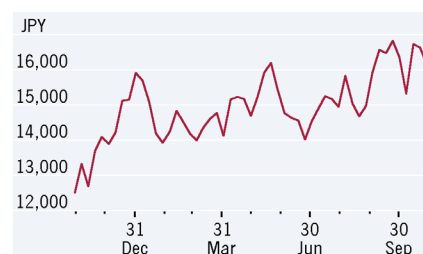
Times are usually tough when the cycle is against you

- **Revising earnings** — Despite a better-than-expected Q2 operating performance, weaker than forecast orders lead us to trim our OP estimate for this term though it is ahead of the first-time company guidance. Our view remains that domestic machine tool demand is recovering, industrial robot demand globally will remain buoyant and any recovery in Robodrill demand will be slow to materialize. We believe Fanuc's earnings troughed in April-June, and with operating margins back at 37% in Q2 helped by firm cost control, backed by a cash-rich balance sheet, we remain buyers. Fanuc has never been immune from the cycle and against a brighter global backdrop any share price correction as an opportunity to accumulate shares.
- **FA outlook** — In Q2 domestic machine tool orders rebounded 25% QoQ and 19% YoY. This data provides the starting point for believing FA division sales in Q3 will be around ¥55bn (+1% QoQ and +27% YoY). In contrast, exports of Japanese machine tools to China remain depressed partly due to the contraction of demand for equipment used in smartphone manufacturing. The weakness of machine tool demand in China is one reason why FA sales have lagged the recent overall trend of machine tool orders. However against a backdrop of a better global economy (Citi economists forecast global GDP growth of 3.2% in CY14 up from 2.5% in CY13), we are confident this division will rebound. The one caveat we have is that recent announcements by MHI and JTEKT to install Siemens CNCs on machine tools for export may slowly undermine Fanuc's hitherto dominant share.
- **Robots & robo-machines** — Following a 25% YoY increase in H1 robot division sales, we think Q3 sales could reach ¥35bn (+28% YoY and -6% QoQ). The peak in Apple capex in Q4 CY12 coincided with the quarterly high on Robo-machine sales at Fanuc. Divisional revenues have dropped by 2/3 since then, but we were encouraged by the 16% QoQ increase in Q2 and we model a 13% QoQ rise to ¥20bn in Q3.
- **Target price** — We raise our target price to ¥18,000 from ¥17,000, applying a PER of 20x to our higher FY3/15E EPS raised due to the impressive progression in gross and operating margins seen in Q2 and adding back cash as of September 2013 of ¥3,950 vs ¥3,750 at end-June.

- Estimate Change
- Target Price Change

Buy	1
Price (30 Oct 13)	¥15,780
Target price	¥18,000
	from ¥17,000
Expected share price return	14.1%
Expected dividend yield	1.0%
Expected total return	15.1%
Market Cap	¥3,088,242M
	US\$31,453M

Price Performance (RIC: 6954.T, BB: 6954 JP)



Consol.	Sales		OP			RP		NP		EPS	PE
	¥M	YOY (%)	¥M	YOY (%)	OPM (%)	¥M	YOY (%)	¥M	YOY (%)	¥	X
3/12A	538,492	20.7	221,834	16.9	41.2	228,579	17.0	138,820	15.5	709	22.3
3/13A	498,395	-7.4	184,821	-16.7	37.1	191,242	-16.3	120,484	-13.2	615	25.6
3/14E	463,000	-7.1	157,420	-14.8	34.0	165,338	-13.5	108,095	-10.3	552	28.6
3/14RE	446,000	-10.5	155,965	-15.6	35.0	164,003	-14.2	105,802	-12.2	540	29.2
3/15E	529,000	14.3	186,737	18.6	35.3	196,454	18.8	128,395	18.8	656	24.1
3/15RE	520,000	16.6	192,400	23.4	37.0	202,276	23.3	132,529	25.3	677	23.3
3/16E	586,000	10.8	213,890	14.5	36.5	225,025	14.5	147,041	14.5	751	21.0
3/16RE	585,000	12.5	222,300	15.5	38.0	234,018	15.7	153,412	15.8	784	20.1

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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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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6954.T: Fiscal year end 31-Mar						Price: ¥15,780; TP: ¥18,000; Market Cap: ¥3,088,242m; Recomm: Buy					
Profit & Loss (¥m)	2012	2013	2014E	2015E	2016E	Valuation ratios	2012	2013	2014E	2015E	2016E
Sales revenue	538,492	498,395	446,000	520,000	585,000	PE (x)	22.3	25.6	29.2	23.3	20.1
Cost of sales	-262,120	-258,670	-233,035	-265,200	-295,425	PB (x)	3.1	2.8	2.7	2.5	2.3
Gross profit	276,372	239,725	212,965	254,800	289,575	EV/EBITDA (x)	10.3	11.7	12.8	10.2	8.6
Gross Margin (%)	51.3	48.1	47.8	49.0	49.5	FCF yield (%)	3.2	3.7	2.9	5.1	5.7
EBITDA (Adj)	237,300	202,688	178,151	215,305	245,652	Dividend yield (%)	1.3	1.2	1.0	1.3	1.5
EBITDA Margin (Adj) (%)	44.1	40.7	39.9	41.4	42.0	Payout ratio (%)	30	30	30	30	30
Depreciation	-15,466	-17,867	-22,186	-22,905	-23,352	ROE (%)	14.8	11.6	9.4	11.0	11.7
Amortisation	0	0	0	0	0	Cashflow (¥m)					
EBIT (Adj)	221,834	184,821	155,965	192,400	222,300	EBITDA	237,300	202,688	178,151	215,305	245,652
EBIT Margin (Adj) (%)	41.2	37.1	35.0	37.0	38.0	Working capital	-26,302	29,931	-15,714	20,825	18,963
Net interest	2,563	2,767	3,038	3,376	3,718	Other	-66,775	-73,771	-48,663	-58,371	-67,388
Non-op/Except	4,182	3,654	5,000	6,500	8,000	Operating cashflow	144,223	158,848	113,773	177,759	197,227
Recurring profit	228,579	191,242	164,003	202,276	234,018	Capex	-43,959	-44,445	-25,000	-20,000	-20,000
Tax	-89,136	-70,253	-57,601	-69,047	-79,806	Net acq/disposals	0	0	0	0	0
Extraord./Min.Int./Pref.div.	-623	-505	-600	-700	-800	Other	1,862	481	-2,000	-2,000	-2,000
Reported net profit	138,820	120,484	105,802	132,529	153,412	Investing cashflow	-42,097	-43,964	-27,000	-22,000	-22,000
Net Margin (%)	25.8	24.2	23.7	25.5	26.2	Dividends paid	-41,551	-41,550	-31,741	-39,759	-46,024
Core NPAT	138,820	120,484	105,802	132,529	153,412	Financing cashflow	-42,052	-42,049	-32,241	-40,259	-46,524
Per share data						Net change in cash	56,143	68,905	54,533	115,500	128,704
Reported EPS (¥)	709	615	540	677	784	Free cashflow to s/holders	100,264	114,403	88,773	157,759	177,227
Core EPS (¥)	709	615	540	677	784						
EPS* (¥)	709	615	540	677	784						
DPS (¥)	213	185	162	203	235						
CFPS (¥)	737	811	581	908	1,008						
FCFPS (¥)	512	584	454	806	905						
BVPS (¥)	5,013	5,565	5,943	6,417	6,965						
Wtd avg ord shares (m)	196	196	196	196	196						
Wtd avg diluted shares (m)	196	196	196	196	196						
Growth rates											
Sales revenue (%)	20.7	-7.4	-10.5	16.6	12.5						
EBIT (Adj) (%)	16.9	-16.7	-15.6	23.4	15.5						
Core NPAT (%)	15.5	-13.2	-12.2	25.3	15.8						
Core EPS (%)	15.5	-13.2	-12.2	25.3	15.8						
Balance Sheet (¥m)											
Cash & cash equiv.	637,076	727,753	810,490	895,999	997,260						
Accounts receivables	98,717	81,318	74,333	89,655	104,464						
Inventory	86,599	72,184	63,714	74,286	83,571						
Net fixed & other tangibles	248,521	273,568	274,635	270,730	266,378						
Goodwill & intangibles	0	0	0	0	0						
Financial & other assets	59,712	64,290	62,703	63,617	64,419						
Total assets	1,130,625	1,219,113	1,285,877	1,394,287	1,516,093						
Accounts payable	30,196	22,040	22,300	27,368	32,500						
Short-term debt	0	0	0	0	0						
Long-term debt	0	0	0	0	0						
Provisions & other liab	115,107	102,944	95,386	105,958	115,243						
Total liabilities	145,303	124,984	117,686	133,326	147,743						
Shareholders' equity	981,323	1,089,260	1,163,321	1,256,092	1,363,480						
Minority interests	3,999	4,869	4,869	4,869	4,869						
Total equity	985,322	1,094,129	1,168,190	1,260,961	1,368,349						
Net debt	-637,076	-727,753	-810,490	-895,999	-997,260						
Net debt to equity (%)	-64.7	-66.5	-69.4	-71.1	-72.9						

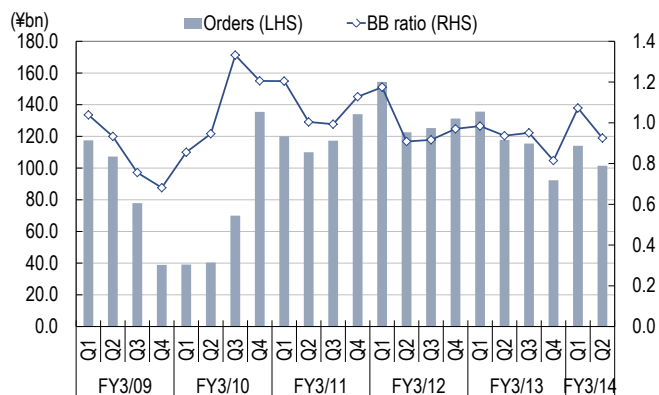
Note: Consolidated data. * EPS: NP/Est Shares OS.

Figure 1. Fanuc: Sales by segment, OP, and operating margin (%)

(¥bn)	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14e	Mar-15e	Mar-16e
FA	242.9	269.1	223.7	131.5	247.7	267.6	200.1	225.0	260.0	285.0
Robots	103.3	115.7	106.8	73.6	78.0	114.8	119.1	143.0	155.0	170.0
Robomachines	73.4	83.6	57.7	48.3	120.5	156.1	179.1	78.0	105.0	130.0
- Robodrills	-	-	-	29.3	83.2	101.5	127.0	35.0	60.0	75.0
- Roboshot	-	-	-	15.0	30.1	46.8	45.1	35.0	35.0	45.0
- Robocut	-	-	-	4.0	7.2	7.8	7.0	8.0	10.0	10.0
Total sales	419.6	468.4	388.2	253.4	446.2	538.5	498.4	446.0	520.0	585.0
OP	162.9	189.6	134.4	55.0	189.8	221.8	184.8	155.9	192.4	222.3
Operating margin (%)	39%	40%	35%	22%	43%	41%	37%	35%	37%	38%

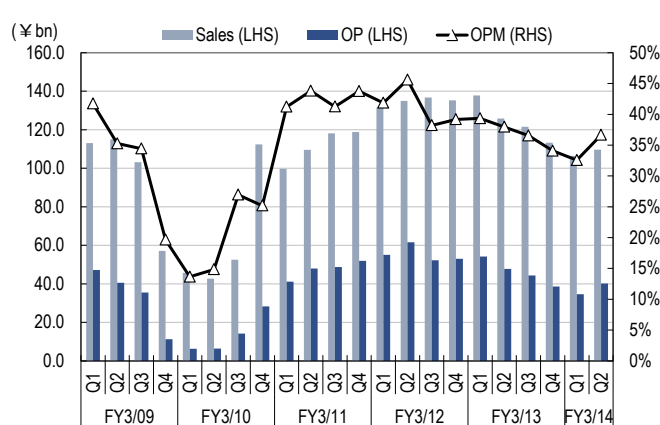
Source: Company data, Citi Research.

Figure 2. Quarterly orders and BB ratio



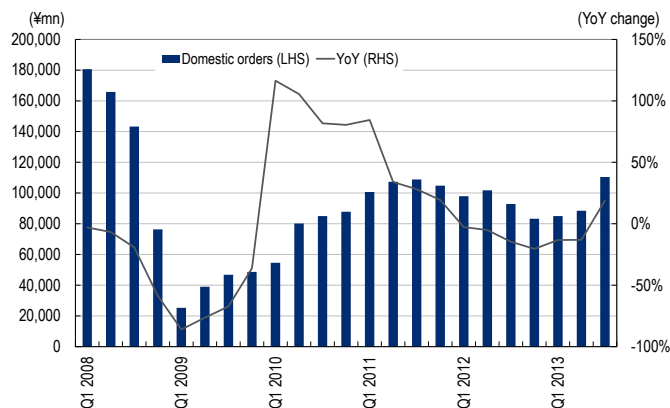
Source: Company data, Citi Research.

Figure 3. Quarterly trend of sales, OP and OPM



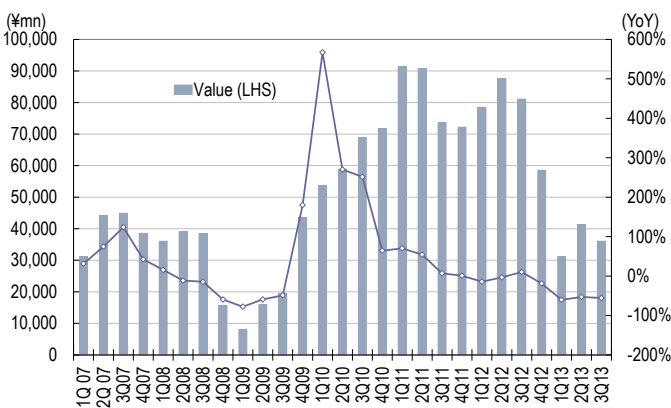
Source: Company data, Citi Research.

Figure 4. Domestic machine tool orders



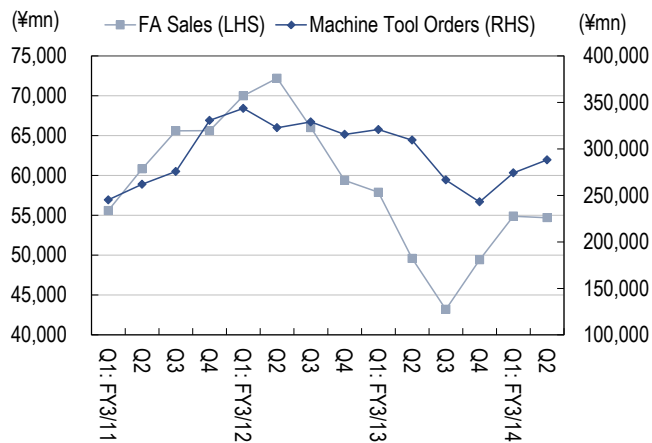
Source: JMTBA, Citi Research.

Figure 5. Japanese machine tool exports to China



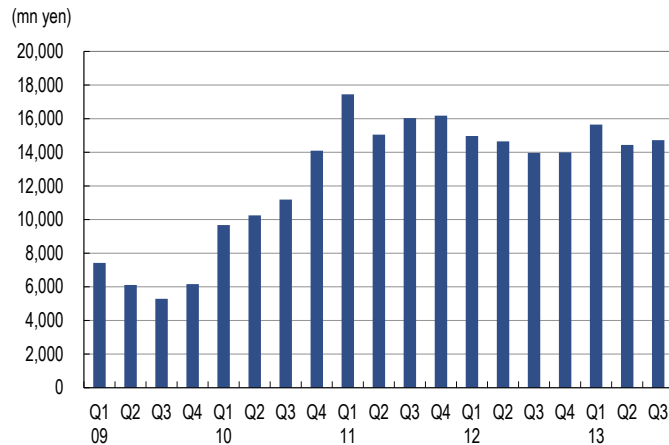
Source: JMTBA, Citi Research.

Figure 6. Fanuc FA division sales and Japanese m/tool orders (total)



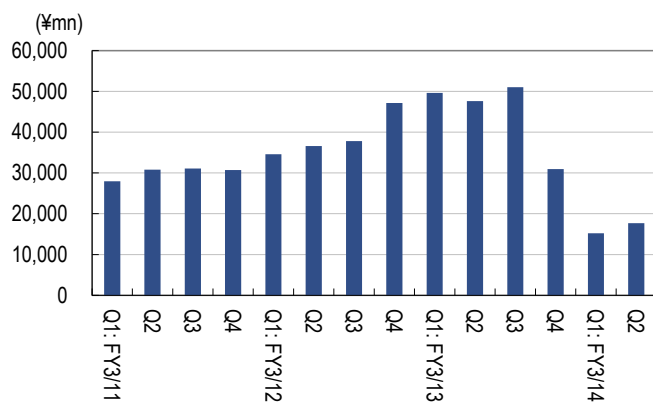
Source: Company data, JMTBA, Citi Research.

Figure 7. Japanese robot shipments to North America



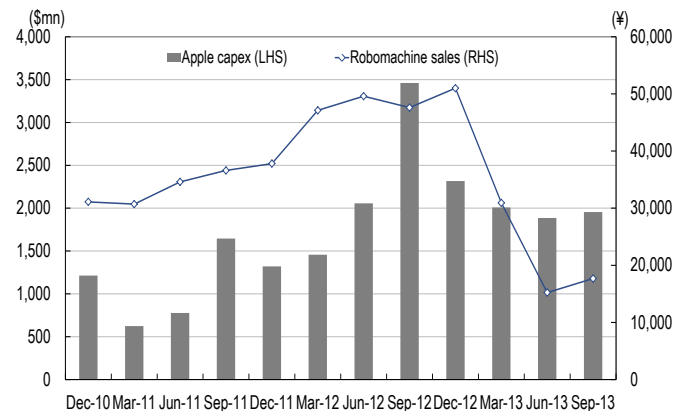
Source: JARA, Citi Research.

Figure 8. Fanuc's robo-machine sales



Source: Company data, Citi Research.

Figure 9. Apple capex and Fanuc's robo-machine sales



Source: Company data, Citi Research.

Fanuc

Investment strategy

We rate the shares of Fanuc Buy, with a target price of ¥18,000. FY3/12 OP marked a new all-time high, led by strong top-line sales growth in Asia. However, FY3/13 earnings were hit by a combination of 1) slower global demand for machine tools, which impacted the performance of its high-margin FA division; and 2) a downturn in Apple's capex which hit shipments of its small-scale machining centers ("Robodrills"). In FY3/13 Hon Hai Precision one of the leading EMS companies in China made up 17% of total revenues, up from 10% in FY3/12. The downturn in Apple related demand was unfortunate as in December 2012 Fanuc opened a new plant which doubled monthly capacity of Robodrills to 5,000 units. For reference, monthly robot capacity is said to be around 5,000 units, while CNC production capacity is reported to be 30,000 units / month.

With c50% of direct sales generated from Asia (ex-Japan), Fanuc remains one of the most geared names to long-term growth in the region, and the growth story in Asia has both cyclical and structural elements to it. In addition its balance sheet remains solid with net cash of ¥773.5bn at the end of Sep 2013. Over the past ten years Fanuc has delivered impressive CAGR sales growth of close to 10%, and barriers to entry in the mainstay FA division are high. From a long-term perspective, we continue to view Fanuc as one of Japan's World Champions and see it as setting the benchmark for Japanese manufacturing (except in areas like investor relations).

Valuation

We set our target price for Fanuc referencing the following: 1) The average global PER for the industrial sector in CY2014 is 14.2x, falling to 12.8x in CY15, and as one of the world's top industrial franchises with outstanding operating margins and positive CF generation, we feel some kind of premium is deserved. Fanuc has a 50% plus share of the worldwide market for machine tool-use CNCs/servo motors and a 20% share in industrial robots. 2) Between FY3/06-3/13, the median PER was 19x, the EV/EBITDA was 8.6x and EV/sales was 3.6x. 3) Fanuc has one of the highest operating margins among global industrials. Even in a tough quarter margins were still 37% in Q2 FY3/14. 4) Between FY3/06-FY3/13 its RoE averaged 12% (with 11.6% generated in FY3/13).

Using FY3/15 as our base year, and applying a PER of 20x, and then adding back the cash per share of c¥3,950 as of Sep 2013, we arrive at a rounded up target price of ¥18,000. Fanuc has often been criticized for its inefficient balance sheet, essentially holding too much cash. Management has bought back shares in the past, but there has been no corporate action on this front since August 2009. At present, Fanuc holds 43.7mn shares (or 18% of total shares outstanding) as treasury stock. There are no signs that management is considering canceling them or using some to carry out a share-swap type acquisition.

Risks

Factors that could cause the shares to fail to reach our target price include 1) signs of a further slowdown in Chinese economic activity; 2) a contraction in machine tool demand globally; 3) a downturn in global auto capex; 4) an increase in the value of the yen compared to the US dollar and/or the euro; and 5) a move by domestic customers to shift CNC suppliers from Fanuc. If these or other factors manifest

themselves to a greater extent than we have anticipated, the share price may differ from our target price. Longer-term risks would include the emergence of a credible Chinese competitor in CNCs. Also, a rapid increase in the penetration rate of electric vehicles could also be construed as a negative for the whole machine tool industry, a key customer base for Fanuc.

Appendix A-1

Analyst Certification

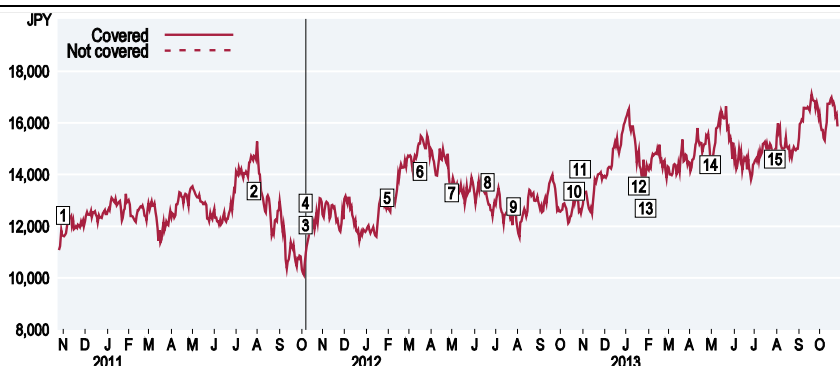
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IMPORTANT DISCLOSURES

Fanuc (6954)

Ratings and Target Price History Fundamental Research

Analyst: Graeme McDonald



Date	Rating	Target Price	Closing Price
1 29-Oct-10	1M	*15,000	11,650
2 27-Jul-11	1M	*17,000	14,730
3 7-Oct-11	Stock rating system changed		
4 7-Oct-11	*1	17,000	10,980
5 31-Jan-12	1	*14,500	12,810

* Indicates change

Date	Rating	Target Price	Closing Price
6 16-Mar-12	1	*17,500	15,200
7 1-May-12	1	*16,800	13,550
8 20-Jun-12	1	*15,300	12,960
9 26-Jul-12	1	*15,100	12,680
10 19-Oct-12	1	*15,000	13,290

Date	Rating	Target Price	Closing Price
11 29-Oct-12	1	*14,500	12,630
12 18-Jan-13	*2	14,500	14,930
13 29-Jan-13	2	*14,200	13,930
14 30-Apr-13	2	*14,800	14,700
15 30-Jul-13	*1	*17,000	14,950

Rating/target price changes above reflect Eastern Standard Time

Fanuc (6954)

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

Analyst: Graeme McDonald



Date	Rating	Target Price	Closing Price
1 27-Jan-11	*ADD MP	-	13,250

* Indicates change

Date	Rating	Target Price	Closing Price
2 11-Oct-12	*REM MP	-	12,120

Rating/target price changes above reflect Eastern Standard Time

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Citi Research Equity Ratings Distribution

Data current as of 30 Sep 2013

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Research Global Fundamental Coverage	48%	40%	12%	6%	87%	6%
% of companies in each rating category that are investment banking clients	55%	50%	43%	64%	51%	48%

Guide to Citi Research Fundamental Research Investment Ratings:

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Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.

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Relative three-month ratings: Citi Research may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

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