

Lacto Japan | 3139 |

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On **July 12, 2018**, Lacto Japan announced earnings results for 1H FY11/18.

1H FY11/18 earnings results

Summary

For 1H FY11/18, Lacto Japan reported consolidated net sales of JPY59.2bn (+27.3% YoY), operating profit of JPY1.5bn (+17.2%), ordinary income of JPY1.1bn (-36.1%; reasons explained below), and net income attributable to parent company shareholders of JPY736mn (-38.7%). Results were in line with the revised company forecasts announced on July 9, 2018.

*** Reference: Revised forecasts for 1H FY11/18 (out July 9, 2018):**

Sales: JPY59.2bn (initial forecast JPY53.0bn)

Ordinary income: JPY1.1bn (JPY1.2bn)

Net income attributable to parent company shareholders: JPY735mn (JPY830mn)

Net income per share: JPY150.23 (JPY169.65)

Sales: Sales forecasts were revised upwards by approximately JPY6.1bn. Underlying this increase were: (1) the continuation of steady demand for imported dairy ingredients against a background of decline in domestic production of raw milk; (2) the progress in sales of products for which successful bids were made when the government repeatedly called for additional bids for imports, due to the shortage of skim milk powder during the last fiscal year; and (3) a strong trend for customers to accelerate the acquisition of ingredients due the declining price for dairy ingredients and strengthening yen from the end of 2017 to the beginning of 2018.

Ordinary Income: Ordinary income forecasts were revised downwards slightly. Underlying this revision were: the fact that foreign exchange losses resulting from forex hedging, as the yen continued to appreciate in Q2 were recorded as non-operating losses in advance; the fact that the company conducted sale from on hand inventory at high cost in response to vigorous demand for cheese; and increased sales of products with a relatively low profit margin.

The company's perspective on trends in 2H FY11/18

The company expects strong sales to continue in 2H FY11/18. The sense of a shortage of skim milk powder will disappear, and demand will settle as a result of the government's additional imports of skim milk powder. However, the company expects sales of milkfat ingredients to increase as supply, which had been tight, increases. Additionally, the company expects increased sales of prepared milk powder mixtures, used predominantly for chocolate and ice cream. The company also expects the vigorous demand for cheese to continue. Further, the company forecasts continued sales growth in the Asia Business as demand for dairy products expands in the Asian market leading to new transactions.

The company expects ordinary income to improve in 2H due to higher profit margins in the Cheese business accompanying market uptrends, as well as sales growth for high-margin milkfat ingredients, for which an excess supply capacity has emerged. As a result, the company has not changed the forecasts for full-year FY11/18 announced on January 12, 2018.

Sales

Sales were up in both monetary and volume terms (setting a new record high for 1H) across all segments except Meat Products, where changes in the procurement policies at a major customer weighed heavily on sales. Consolidated net sales of JPY59.2bn were up 27.3% YoY, setting a new record high for 1H sales. Underlying these results are solid increases in demand and new client acquisition in the Dairy ingredients and Cheese segment, and expansion in the Asia Business following growth in the Asian market.

Profits

Operating profit

Operating profit increased 17.2% YoY. The cost of goods sold was up 28.4% YoY to JPY56.0bn, and gross profit on sales up 9.7% to JPY3.1bn. Controls were effective for SG&A expenses, which finished up 3.7% at JPY1.7bn.

* In order to avoid taking on exchange rate risk in the course of regular business transactions, as a rule the company enters into forward exchange contracts to cover the cost of the purchases made in foreign currencies at the time the contract is signed. Meanwhile, regarding the accounting treatment of the purchase transaction, procurement (purchase) is recorded at the time of shipment, which creates a lag from the point in time the purchase contract is signed. If the yen strengthens during that timeframe, the exchange rate will be lower than the forward rate at purchase and the actual cost of the goods will be lower than the cost based on forward exchange rate secured at the time the contract was concluded. Lacto Japan calculates its gross profit using the cost of goods sold based on the forward exchange rate at the time the goods were purchased, and records a forex hedging loss (or gain) under non-operating income/expenses as a forex-related loss (or gain).

Ordinary income

Despite a favorable environment, forex impact pushed down 1H ordinary income by JPY639mn YoY to JPY1.1bn. The sharp drop reflects the reversal of the underlying trend in yen forex rate, which added JPY447mn to ordinary income in 1H previous year but worked to reduce ordinary income in 1H FY11/18 by JPY245mn. If not for this JPY639mn YoY hit to ordinary income stemming from forex rate changes, ordinary income would have finished up with a JPY54mn increase YoY.

Breakdown by business category

Dairy ingredients and Cheese (Sales: JPY43.8bn, +46.4% YoY)

In volume terms, sales of 104,168 tons were up 37.9% YoY. In addition to ongoing sales of skim milk powder to the Agriculture Livestock Industries Corporation (ALIC) after winning additional bids last fiscal year, Lacto Japan saw steady increases in sales of dairy ingredients to long-time customers as well as to a number of new customers that it has picked up in recent years (including the beverage and feed industries). Sales rose steadily in the Cheese business with heightened demand following a decline in the global pricing of cheese from the end of 2017 to the beginning of 2018, which had been steady until then. New 1H record highs were set for both sales and sales volume.

Meat products (Sales: JPY6.6bn, -21.1% YoY)

Sales volumes have been declining since Q3 FY11/17 owing to changes in procurement policies at a major customer. Sales to other customers have been growing steadily as the company has worked to diversify procurement and sales routes, but this was not enough to offset the aforementioned drop, leaving sales volume down 22.0% YoY, at 11,366 tons.

Asia Business and other (Sales: JPY8.7bn, +6.9% YoY)

Dairy ingredients sales: JPY7.3bn (+6.1%)

In volume terms, sales of 26,431 tons were up 14.4% YoY. The gains were underpinned by rising sales to large, existing customers, as the company responded to their demand for high-quality products and competitive pricing. The company

also bolstered sales to new customers, resulting in a new record high for 1H sales. Repeat customers grew as well, since many years of marketing efforts bore fruit and more customers saw Lacto Japan as a reliable business partner in terms of quality, delivery time, and the provision of information. In the Philippines in particular sales improved steadily due to growing demand for dairy products, and share increases at some customers.

Cheese manufacturing and sales: JPY997mn (+12.1% YoY)

In volume terms, sales of 1,289 tons were up 9.8%. While sales of certain products in the low price range were down due to intensifying competition in China, overall sales and sales volume both increased YoY as the company steadily won new business through proposal-based products (developed in collaboration with customers), a strength of the company.

Financial position

As of end-1H FY11/18, the company's balance sheet showed total assets of JPY49.9bn, up JPY4.0bn from end-FY11/17.

Current assets of JPY47.3bn were up JPY3.8bn, with increases in notes and accounts receivable, inventories of merchandise and finished goods inventories, and inventories of raw materials and supplies.

Fixed assets of JPY2.6bn were up JPY191mn. The rise reflected an increase in "other assets" stemming from a deposit made in connection with the company's move to a new headquarters building, in addition to the acquisition of tangible fixed assets.

Current liabilities of JPY25.2bn were up JPY4.3bn, with accounts payable coming down but short-term debt going up.

Fixed liabilities of JPY11.5bn were down JPY682mn, reflecting a decline in long-term debt and corporate bonds.

Net assets of JPY13.1bn were up JPY306mn from end- FY11/17, primarily due to an increase in retained earnings.

Quarterly (cumulative) earnings

Cumulative (JPYmn)	FY11/16				FY11/17				FY11/18			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	22,316	43,233	65,700	88,679	21,778	46,479	72,847	101,335	29,462	59,165		
YoY	na	-10.3%	-10.2%	-9.5%	-2.4%	7.5%	10.9%	14.3%	35.3%	27.3%		
Dairy Ingredients and Cheese	na	29,827	45,451	60,543	13,573	29,922	49,198	70,019	21,972	43,812		
YoY	na	-10.8%	-11.8%	-12.3%	na	0.3%	8.2%	15.7%	61.9%	46.4%		
% of sales	na	69.0%	69.2%	68.3%	62.3%	64.4%	67.5%	69.1%	74.6%	74.1%		
Meat Products	na	7,655	11,696	16,338	4,301	8,388	11,908	15,253	3,337	6,616		
YoY	na	5.2%	5.7%	5.8%	na	9.6%	1.8%	-6.6%	-22.4%	-21.1%		
% of sales	na	17.7%	17.8%	18.4%	19.7%	18.0%	16.3%	15.1%	11.3%	11.2%		
Asia Business and other	na	5,750	8,551	11,797	3,903	8,168	11,739	16,061	4,151	8,735		
YoY	na	-23.1%	-18.9%	-12.6%	na	42.1%	37.3%	36.1%	6.4%	6.9%		
% of sales	na	13.3%	13.0%	13.3%	17.9%	17.6%	16.1%	15.8%	14.1%	14.8%		
Dairy ingredients	na	4,544	6,745	9,379	3,253	6,880	9,775	13,348	3,436	7,302		
YoY	na	na	-23.0%	na	na	51.4%	44.9%	42.3%	5.6%	6.1%		
% of sales	na	10.5%	10.3%	10.6%	14.9%	14.8%	13.4%	13.2%	11.7%	12.3%		
Cheese	na	786	1,116	1,525	453	890	1,372	1,919	499	997		
YoY	na	na	-11.5%	na	na	13.1%	22.9%	25.8%	10.0%	12.1%		
% of sales	na	1.8%	1.7%	1.7%	2.1%	1.9%	1.9%	1.9%	1.7%	1.7%		
Other	na	420	689	893	197	398	592	794	216	436		
YoY	na	na	na	na	na	-5.2%	-14.1%	-11.1%	na	9.5%		
% of sales	na	1.0%	1.0%	1.0%	0.9%	0.9%	0.8%	0.8%	0.7%	0.7%		
< Sales volume (tons)>												
Dairy Ingredients and Cheese	na	67,973	107,544	148,091	35,772	75,567	123,296	172,885	53,509	104,168		
YoY	na	3.4%	2.1%	4.6%	na	11.2%	14.6%	16.7%	49.6%	37.9%		
Meat Products	na	12,937	20,006	28,029	7,492	14,577	20,607	26,349	5,789	11,366		
YoY	na	11.8%	13.2%	12.1%	na	12.7%	3.0%	-6.0%	-22.7%	-22.0%		
Asia Business: dairy ingredients	na	16,993	27,015	37,472	10,847	23,105	33,173	45,014	11,977	26,431		
YoY	na	-5.0%	4.0%	9.5%	na	36.0%	22.8%	20.1%	10.4%	14.4%		
Asia Business: cheese	na	944	1,388	1,912	615	1,175	1,806	2,509	643	1,289		
YoY	na	-1.4%	-4.0%	-2.4%	na	24.5%	30.1%	31.2%	4.6%	9.8%		
< Unit price (JPY/kg) >												
Dairy Ingredients and Cheese	na	439	423	409	379	396	399	405	411	421		
YoY	na	-13.7%	na	-16.2%	na	-9.8%	-5.6%	-0.9%	8.2%	6.2%		
Meat Products	na	592	585	583	574	575	578	579	576	582		
YoY	na	-6.0%	na	-5.6%	na	-2.8%	-1.2%	-0.7%	0.4%	1.2%		
Asia Business: dairy ingredients	na	267	250	250	300	298	295	297	287	276		
YoY	na	na	na	na	na	11.4%	18.0%	18.5%	-4.3%	-7.2%		
Asia Business: cheese	na	833	804	798	737	757	760	765	776	773		
YoY	na	na	na	na	na	-9.0%	-5.5%	-4.1%	5.4%	2.1%		
CoGS	20,948	40,427	61,123	82,333	20,238	43,619	68,792	95,948	27,942	56,028		
YoY	na	-13.9%	-13.6%	-12.7%	-3.4%	7.9%	12.5%	16.5%	38.1%	28.4%		
CoGS ratio	93.9%	93.5%	93.0%	92.8%	92.9%	93.8%	94.4%	94.7%	94.8%	94.7%		
Gross profit	1,368	2,806	4,576	6,346	1,540	2,860	4,055	5,387	1,519	3,137		
YoY	na	123.9%	94.0%	73.9%	12.6%	1.9%	-11.4%	-15.1%	-1.3%	9.7%		
GPM	6.1%	6.5%	7.0%	7.2%	7.1%	6.2%	5.6%	5.3%	5.2%	5.3%		
SG&A expenses	736	1,480	2,222	2,996	763	1,598	2,406	3,463	752	1,657		
YoY	na	4.2%	3.5%	2.3%	3.6%	8.0%	8.3%	15.6%	-1.3%	3.7%		
SG&A ratio	3.3%	3.4%	3.4%	3.4%	3.5%	3.4%	3.3%	3.4%	2.6%	2.8%		
Operating profit	632	1,326	2,354	3,349	777	1,262	1,649	1,924	767	1,480		
YoY	na	nm	1014.6%	365.1%	23.0%	-4.8%	-30.0%	-42.6%	-1.4%	17.2%		
OPM	2.8%	3.1%	3.6%	3.8%	3.6%	2.7%	2.3%	1.9%	2.6%	2.5%		
Gains (losses) on foreign exchange	-227	-631	-1,261	-1,537	611	705	925	1,159	38	-219		
YoY	nm	nm	nm	nm	nm	nm	nm	nm	-93.8%	nm		
% of sales	-1.0%	-1.5%	-1.9%	-1.7%	2.8%	1.5%	1.3%	1.1%	0.1%	-0.4%		
OP + Gains (losses) on forex	405	695	1,093	1,812	1,388	1,967	2,574	3,082	805	1,261		
YoY	na	-14.2%	-22.0%	2.2%	243.0%	183.2%	135.4%	70.1%	-42.1%	-35.9%		
% of sales	1.8%	1.6%	1.7%	2.0%	6.4%	4.2%	3.5%	3.0%	2.7%	2.1%		
Ordinary income	268	448	779	1,434	1,272	1,773	2,321	2,523	746	1,133		
YoY	na	-28.7%	-26.9%	6.8%	374.7%	296.2%	198.0%	75.9%	-41.4%	-36.1%		
Profit margin	1.2%	1.0%	1.2%	1.6%	5.8%	3.8%	3.2%	2.5%	2.5%	1.9%		
Net income	158	270	496	946	857	1,200	1,573	1,755	493	736		
YoY	na	-28.5%	-23.5%	13.8%	442.2%	344.1%	217.4%	85.5%	-42.5%	-38.7%		
Net margin	0.7%	0.6%	0.8%	1.1%	3.9%	2.6%	2.2%	1.7%	1.7%	1.2%		
Foreign exchange												
USD/JPY		114.54		109.33	114.62	113.21		112.43	110.61	109.18		
EUR/JPY		126.97		121.18	121.58	121.26		125.71	134.17	132.52		

Source: Shared Research based on company data

Note: Figures rounded to the nearest million yen (amounts less than JPY1mn are rounded down in materials released by the company).

Quarterly earnings

Quarterly (JPYmn)	FY11/16				FY11/17				FY11/18			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	22,316	20,918	22,466	22,979	21,778	24,701	26,368	28,488	29,462	29,703		
YoY	na	na	-9.9%	-7.6%	-2.4%	18.1%	17.4%	24.0%	35.3%	20.3%		
CoGS	20,948	19,480	20,696	21,210	20,238	23,381	25,173	27,156	27,942	28,085		
YoY	na	na	-13.1%	-10.0%	-3.4%	20.0%	21.6%	28.0%	38.1%	20.1%		
CoGS ratio	93.9%	93.1%	92.1%	92.3%	92.9%	94.7%	95.5%	95.3%	94.8%	94.6%		
Gross profit	1,368	1,438	1,770	1,769	1,540	1,320	1,195	1,332	1,519	1,618		
YoY	na	na	60.2%	37.2%	12.6%	-8.2%	-32.5%	-24.7%	-1.3%	22.6%		
GPM	6.1%	6.9%	7.9%	7.7%	7.1%	5.3%	4.5%	4.7%	5.2%	5.4%		
SG&A expenses	736	744	742	774	763	835	808	1,057	752	905		
YoY	na	na	2.1%	-0.8%	3.6%	12.3%	8.9%	36.6%	-1.3%	8.4%		
SG&A ratio	3.3%	3.6%	3.3%	3.4%	3.5%	3.4%	3.1%	3.7%	2.6%	3.0%		
Operating profit	632	694	1,028	995	777	485	387	275	767	713		
YoY	na	na	171.7%	95.5%	23.0%	-30.2%	-62.4%	-72.4%	-1.4%	47.1%		
OPM	2.8%	3.3%	4.6%	4.3%	3.6%	2.0%	1.5%	1.0%	2.6%	2.4%		
Gains (losses) on foreign exchange	-227	-404	-630	-276	611	94	220	234	38	-257		
YoY	nm	nm	nm	nm	nm	nm	nm	nm	-93.8%	nm		
% of sales	-1.0%	-1.9%	-2.8%	-1.2%	2.8%	0.4%	0.8%	0.8%	0.1%	-0.9%		
OP + Gains (losses) on forex	405	290	399	719	1,388	579	607	508	805	456		
YoY	na	na	-32.6%	93.2%	243.0%	99.7%	52.1%	-29.3%	-42.1%	-21.2%		
% of sales	1.8%	1.4%	1.8%	3.1%	6.4%	2.3%	2.3%	1.8%	2.7%	1.5%		
Ordinary income	268	180	331	656	1,272	501	548	202	746	388		
YoY	na	na	-24.3%	135.8%	374.7%	178.9%	65.4%	-69.2%	-41.4%	-22.6%		
Profit margin	1.2%	0.9%	1.5%	2.9%	5.8%	2.0%	2.1%	0.7%	2.5%	1.3%		
Net income	158	112	225	451	857	343	373	182	493	243		
YoY	na	na	-16.5%	145.7%	442.2%	206.0%	65.4%	-59.6%	-42.5%	-29.2%		
Net margin	0.7%	0.5%	1.0%	2.0%	3.9%	1.4%	1.4%	0.6%	1.7%	0.8%		

Source: Shared Research based on company data

Note: Figures rounded to the nearest million yen (amounts less than JPY1mn are rounded down in materials released by the company).

Company forecasts for FY11/18

For the reasons given above, the company made no changes to its initial forecast for FY11/18, announced on January 12, 2018.

The company's forecasts for FY11/18 are as follows:

Sales: JPY110.3bn (+8.9% YoY)

Ordinary income: JPY2.6bn (+3.1% YoY)

Net income*: JPY1.8bn (+2.6% YoY)

EPS: JPY367.91

*Net income attributable to parent company shareholders

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