

## Watts (2735, JP)

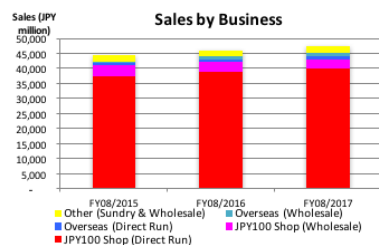
Exchange: TSE 1  
Sector: Retail  
Market Cap: JPY15.3 billion  
P/B: 1.5x (8/17 act)

Recommendation: HOLD  
Share Price: JPY1,095 (4/20/2018)  
Target Price: JPY1,011  
P/E: 16.0x (8/18 CE)  
Div. Yield: 1.4% (8/18 CE)

### Highlight - *Deteriorated profit margin weighs on cash flow growth* -



METRICAL downgraded Watts (2735, JP) from OUTPERFORM to HOLD again for 12-month horizon. In the previous report on October 18<sup>th</sup> 2017, due to plunge in the share price from JPY1,590 to JPY1,152, the rating was upgraded. However, bad weather pulled store sale for 1H FY8/2018 lower to -1.1% YoY in its existing store sale. For the same period, higher SGA/sales put downward pressure on its profit margin. Due to the increase in rent and labor cost, the profitability is less likely to recover soon, without further increase in store sale. Sale is expected to be in line with its guidance for FY8/2018, but the profit will miss the company projection. For FY8/2019, the store sale will rebound from soggy sale for the previous year, but the recovery of sale is unlikely to offset the increase of SGA. In terms of valuation, EV/EBITDA multiples does not look so much expensive than peers but relatively higher than its historical level. DCF valuation is dragged by its slower growth of future cash flows.



### Business Description

Watts was founded 1995 in Osaka and has grown to the 4<sup>th</sup> largest JPY100 shop in Japan, acquiring JPY100 shop operators such as Saitama based O-Three in 2007 and Okayama based Daisen in 2013 and an import sundry wholesaler Amano in 2010. Watts has expanded its JPY100 shop business to overseas market such as Thailand, China, Malaysia, Vietnam, Peru and Mexico. but most of revenue comes from domestic business as shown the bar Chart on left. Watts has set its basic business strategies such as low cast operation, low cost store development and great value of daily life goods in differentiation from other 3 competitors. In short, Watts runs low cost operation at small outlets of 230 square meters on average and providing great value daily items to customers, whereas competitors operate larger stores of 330-1,000 square meters. Daiso (privately owned) makes JPY420 billion sale from 3,150 stores, Seria (2783, JP) sells JPY145 billion at 1,369 stores, Cando (2698, JP) also earns JPY69 billion revenue from 982 stores for FY2015. Watts sells JPY47 billion at 1,083 outlets at store brand name as 'Silk', 'meets' and newly launched "Watts' and "Watts With.'

	Daiso (Private)	Seria (2782, JP)	Cando (2698, JP)	Watts (2735, JP)
Sales (JPY million)	420,000	145,328	68,900	47,494
# of Stores	3,150	1,369	982	1,083
Sales/Store (JPY million)	133	106	70	44
Sale Space (sq meter)	330-1,000	330-1,000	330-1,000	230

## Industry Overview and Competitive Positioning

### Industry Overview

#### *History of JPY100 shops*

##### 1990s

JPY100 shops rapidly grew in mid-1990s as Japan's economy deteriorated after bubble economy collapsed. Consumers that strengthened budget mind highly supported the emerging retailers in depression. Meantime, China's production increasingly improved and stronger JPY rates helped the retailers' cost of goods sold lower.

##### 2000s

JPY100 shop was no longer niche business. Sales of Daiso increased from JPY48 billion for FY1997 to JPY281 billion for FY2003 but slowed to grow to single digit pace from FY2004. Tailwind of deflation economy and consumer's budget mind continued but customers come to buy goods more selectively, while other retailers such as super market, discount stores and DIY retailers developed private brand selling at low price. Low price goods were not selling at only JPY100 shops. JPY100 operators started to find differentiation strategy. Some JPY100 operators sold goods not only at JPY100 but multi prices. It was 2004 Seria introduced real time POS for the first time in this sector. Daiso, Cando and Watts followed far later after 2012.

##### 2010s

JPY100 shops are expanding to shopping malls. Developers consider JPY100 shops as featured store that collect many consumers. In fact, food court and JPY100 shops are the most popular sites. Developers are very likely to lease shopping space to a shop that is anticipated to gather more consumers. GMS and Super Market chain are losing costumers and many of them make revenue from property leasing revenue like a developer. They also expect JPY100 shops to call customers into their stores. In this market trend, Seria has expanded stylish stores to bring young customers. Competitors are following the store development.

#### *Change in Environment*

##### Customer Value

Any goods were sold out easily at JPY100 shop in 1990s if just put price tag of JPY100. But low price commodities are not special after tons of private brand goods arrive at stores in mid-2000s. Customer value seems to be changing and diversified. Just cheap goods remain unsold at store. Conversely, 'premium' private brand at convenience stores are highly supported in these days. Customers are more likely to visit not only to buy daily items and expendables but to expect to find something new or something different goods even at JPY100 shop rather than. In fact, sale in months holding event such as Halloween, Christmas, Valentine Day is increasing year by year. Customers are expecting to buy special goods for their extraordinary event.

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## External Environment

Currency rates are one of the factors that have greatly influenced the profitability of JPY100 shop operators, as the retailers import many of goods from China. USD/JPY hit the bottom at 75 in 2011 and moved higher due to massive quantitative easing by Bank of Japan. When USD/JPY gets stronger, JPY100 shop chains try to make goods smaller or change to lower cost material (i.e. from glass to plastic). No one can expect the direction of currencies but company management should not run a company on optimistic view of further appreciation of JPY rates.

## **Competitive Positioning**

### ***Basic Business Strategy***

#### Low cost store development

Watts expanded to 1,049 stores, most of which are smaller size stores of 230 sq meter on average. Its low cost store development system enables the company to run a small size site selling JPY3.6 million per month on average. A smaller site tends to lower rent, as competitors need larger site for larger sale. Low opening cost benefits to low closing cost, too. Lighter opening/closing cost enables quick decision of scrup and build and this helps flexible store expansion for growing to more than 1,000 outlets.

#### Basic Business Strategy



#### Low cost operation

Its store operation aims at a completely low cost operation. By eliminating waste work, store staff can focus on more customer service than other work. Watts standardized store works enable part-time employees to operate a store for themselves. A supervisor manages normally 6-7 stores in a area.

#### Great value daily goods

Above 2 lower cost operations boost product development. Watts has been promoting private brand goods named 'Watts Select' since 2010. 'Watts Select' appeals customers its great value, showing its more volume or made of higher quality than a similar product. Watts aims at increasing loyal customers, offering great value goods. Watts has expanded business on its basic business strategy, but revised the strategy to meet cahange in market environment.

### ***Revised Business Strategy***

#### Low cost store development

Watts has focused on developing small size stores, which would benefit to differentiate from competitors. However, not only shopping mall but also

super market is more likely to rent a tenant who calls more customers and different category of customers into its store, as super market cannot stop losing customers. While competitors are developing stylish outlets recently, competitive store design becomes a factor of renewing leasing and new rent contract. Due to this environment, Watts decided to develop more fashionable stores as 'Watts' store in August 2015. Performance of 'Watts' stores is so far so good, increasing approximately 20% sales for a year. Renovation of a new brand store is higher but positive sale and store design would be positive effect on leasing contract with landlord as company expected.

### Low cost operation

Its 'Silk' and 'meets' stores have been well operated by part-time employees without POS. As its hot-seller items were normally regular items, even part-time staff could easily predict how many they should order. This saved IT system expenses. However, as customer need is diversified, in-store inventory was getting higher. POS data and automated order system help store staff to reduce workload at stores in large cities where it is not easy to hire part-time workers due to labor shortage. Installing POS will add a few hundred million Yen for the investment.

### Great value daily goods

Watts has mainly targeted at a homemaker who lives in neighborhood and frequently buys daily items and expendables. To increase loyal customers, the company has promoted great value goods as 'Watts Select' from 2010 but the number of the private brand items decreased to 100 items in 2016 from its peak of 220 items in 2014 in line with depreciation of JPY rates. 'Watts Select' is like a bargain good for highly appealing customers but has to decrease the number of items if profit margin comes under pressure on weaker JPY rates. OP margin of the company decreased to 2.6% in FY03/2016 from 5% in FY08/2012. In order to enhance profit margin, Watts is gradually to move to data-based merchandizing helped by POS data, which collects customer need.

### ***Competitive Positioning***

In each business strategy, competitive positioning is analyzed further below.

#### Low cost store development (key: Sales growth)

Higher 'Watts' brand store development cost pulled SGA/Sales up to 35.7% in 1Q FY08/2016 from 34.4% in 1Q FY08/2015. After rebuilding development cost of a new store that is classified in cost/benefit, SGA/Sales came to stabilize to 34.8% and 35.0% in 3Q and 4Q FY08/2016. But it remained slightly higher at 35.8% in 1Q and 34.3% in 2Q FY08/2017, compared with 35.7% in 1Q and 34.1% in 2Q FY08/2016. Store design necessarily became a part of important factor for maintaining competitiveness for both of store sale and sale space leasing with landlord. In renovation plan of 'Silk' and 'meets' stores that is located in super market, "Watts With' brand has been launched, which maintains current floor and wall design at lower renovation cost but looks very nicely. Such investment seems to be inevitable, as there are 6,000 JPY100 stores in this country and necessarily 3 or 4 stores competes each other in a area. 'Watts' stores widens customer base from 40s and 50s to 30s

women due to new store design. Reviewing FY08/2017 result, OP margin inched down to 2.6% from 2.5% a year ago after improved to 3.4% and 3.0% for 2Q and 3Q but dropped to 1.7% for 4Q due to opening cost of Søstrene Grene. The Table below shows comparison of 3 companies in SGA/Sales and COGS/Sales. On COGS/sales, the ratio mostly depends on sales volume, as the larger sale of the company is the lower COGS/Sales is. On SGA/Sales, Watts is doing well, maintaining low-cost store operation compared with larger sale of Cando, but Seria benefits from large sale volume. All 3 companies run 1,000 outlets and will have to spend renovation expense in future for keeping competitiveness., although Watts has accelerated renovation to Watts' or 'Watts with' from 'meets' and "SILK" store to 257 outlets of 1,087 stores as of August 2017. As a result, SGA/Sales of Watts is less likely to decrease significantly due to such renovation cost, unless the sales increase more rapidly, while the company forecasts 3% annual growth for the domestic JPY100 shop business. In addition, when I visited stores of all 4 companies, display furniture of 'Watts' store was the tallest. These days, a number of large retailers set lower furniture, as Shimamura (8227, JP) replaced shorter display and performs well. Female customers can not reach items that are displayed at the top of it and feel lock up.

	Cando (2698, JP)	Watts (2735, JP)	Seria (2782, JP)
Sales	68,900	47,494	145,328
COGS/Sales	61.5%	62.1%	57.1%
SGA/Sales	35.3%	35.3%	32.5%
# of Stores	982	1,083	1,369

(Note) COGS/Sales and SGA/Sales of Watts are FY08/2017.

(Note) COGS/Sales and SGA/Sales of Can Do are F3Q Y11/2017.

(Note) COGS/Sales and SGA/Sales of Seria are FY03/2017.

### Low cost operation (key: Inventory control)

Finally, Watts installed POS in total 409 stores (38% of current total stores) for FY08/2017. The rest of 60% stores that are consigned to super market will not use Watts POS system. Although the company uses POS data of a similar store, location or same area instead, it takes some time to construct precise analysis on the operation. Another Table below shows inventory turnover of 3 companies for the latest full year period. Apparently, the number of Watts is the highest in Inventory/COGS of 3 companies. Reduction of inventory is the best way of low cost operation. Watts needs further improvement on this point, including inventory control of 60% of stores that are in-super market with consignment sale contract and need indirect data analysis.

	Cando (2698, JP)	Watts (2735, JP)	Seria (2782, JP)
Inventory	5,551	6,534	13,562
COGS	31,773	29,499	82,940
Inventory/COGS	2.10	2.66	1.96
total # of items	20,000	20,000	20,000

Great value daily goods (key: Combination of daily items and women items)  
 Due to POS installation, GPM of Watts improved to 37.9% for FY8/2017 from 37.5% for FY8/2016, as 'Watts' stores sell more value-added goods increasing sundry goods replacing foods from shelves. Seria has superior more than 10-years' experience in using POS data analysis. It would not easy to catch up with the IT aid merchandiser, although the software system and device are much improved than those in 10 years ago. Cando employed POS in 2012 that updated data overnight, and switched in 2015, whereas Watts newly adopted real-time POS in 2015. It takes some time to gather data and construct accurate analysis. Watts's customer base remains senior ages (mainly 40s-50s even slightly widened to 30s women) that buy daily items. If weaker JPY rates continue, the number of items and profitability of "Watts Select' will come under pressure. Seria enriches craftwork items and interior goods and Cando is selling beauty or cosmetic goods for young women by using Instagram. For instance, Cando lost 0.3% sale from male customers but increased sale from female customers by 5.4% YoY and overall sales and OP margin raised 4.3% YoY and 1.4pt for FY11/2016, as items for female customers are generally higher gross profit margin. If Watts aims at raising profit margin, the company should reinforce items for younger women. Watts is likely to reinforce women items.

## Business Outlook

### Monthly Store Sale

The existing store sale slid -1.1% YoY for the 6-month period from September to February FY08/2018 mainly due to bad weather (see Table below). The sale for 3Q and 4Q of FY8/2018, while new stores will help the sale pull higher, existing store sale is expected to remain flat (+0.4% YoY).

Existing Store Sales Growth (% YoY)

Month	FY2012/8	FY2013/8	FY2014/8	FY2015/8	FY2016/8	FY2017/8	FY2018/8	FY2019/8	FY2020/8	FY2021/8
9	4.3	0.0	1.3	-1.0	0.2	1.3	0.6	-0.5	0.6	-0.5
10	4.2	-1.1	0.1	-1.2	2.8	1.8	-3.5	3.6	-3.5	3.6
11	1.9	0.4	3.1	-2.5	-1.8	3.2	0.7	-0.6	0.7	-0.6
12	3.0	-0.7	1.7	-1.7	1.3	1.9	-0.2	0.3	-0.2	0.3
1	0.5	-1.3	1.2	-3.5	1.6	3.2	-1.8	1.9	-1.8	1.9
2	2.5	-3.7	-0.7	0.8	3.4	-0.5	-2.5	2.6	-2.5	2.6
3	-4.9	-0.1	12.3	-12.5	1.3	1.5	0.1	0.0	0.1	0.0
4	-1.5	-2.0	-2.7	2.0	2.3	1.8	-0.2	0.3	-0.2	0.3
5	-0.8	0.1	-0.4	1.4	0.9	0.8	0.8	-0.7	0.8	-0.7
6	-2.0	1.7	-2.3	-1.6	1.5	1.0	0.6	-0.5	0.6	-0.5
7	-0.5	-0.8	-2.0	0.2	3.8	-0.1	1.7	-1.6	1.7	-1.6
8	0.1	1.1	0.3	0.5	-0.2	1.8	-0.2	0.3	-0.2	0.3

1Q	3.5	-3.8	1.5	-1.6	0.4	2.1	-0.7	0.8	-0.7	0.8
2Q	2.0	-1.9	0.7	-1.5	2.1	1.5	-1.5	1.6	-1.5	1.6
3Q	-2.4	2.4	3.1	-3.0	1.5	1.4	0.2	-0.1	0.2	-0.1
4Q	-0.8	2.9	-1.3	-0.3	1.7	0.9	0.7	-0.6	0.7	-0.6
YR	0.2	3.8	-0.1	-1.6	2.8	1.5	-0.3	0.4	-0.3	0.4

(Source) Watts, METRICAL

CE 2.0 0.0 1.0

## Company Outlook for Full Year FY8/2018

The company posted full year outlook. Sale will be up 4.4% YoY to JPY49,600 million and OP, RP and NP are expected to gain 19.9% YoY to JPY1,450 million, 19.5% YoY to JPY1,520 million and 10.2% YoY to JPY925 million respectively.

## METRICAL forecast for FY8/2018

The sale is expected to be in line at JPY49,599 million, but profits are expected to miss the company projection led by the increase in SGA expenses. OP, RP and NP are expected to decrease 12.5% YoY to JPY1,058 million, 16.1% YoY to JPY1,067 million and 13.2% YoY to JPY678 million respectively (see Table on appendix).

## Mid-Term Outlook

Mid-term outlook is projected based on modest existing store sale of +0.4% YoY for FY8/2019, -0.3% YoY for FY8/2020 and +0.4% YoY for FY8/2021. Assuming flat store sale is unlikely to improve SGA/Sale, the earnings are expected to increase at modest pace for the mid-term (see Table of Sales by Segment and Income Statement in Appendix).

## Valuation

EV/EBITDA at 10x for FY8/2018 (E) and 9x for FY8/2019 (E), FY8/2020 (E) and FY8/2021 (E) looks lower than Seria and other retailers in the industry, but more than 9x of EV/EBITDA remains historically higher level, compared with 6x to 8x from FY8/2013 to FY8/2016. This is because investors bought the shares in favor of relatively lower multiples, whereas the cash flows have improved at slower than expectations. Deteriorated profitability at this time, METRICAL revised down mid-term free cash flows for the mid-term and the DCF valuation indicates fair or slightly higher valuation of the closing share price on April 20<sup>th</sup> 2018.

## EV/EBITDA

The table below shows historical EV/EBITDA of the company. 9x of the multiple does not look expensive in general for peers and industry average, but that looks higher than historical average of the company.

	Aug-13	Aug-14	Aug-15	Aug-16	Mar-17	Aug-18(E)	Aug-19(E)	Aug-20(E)	Aug-21(E)
Avg. Mkt. Cap	JPY 14,606	JPY 12,105	JPY 12,701	JPY 12,884	JPY 14,835	JPY 14,835	JPY 14,835	JPY 14,835	JPY 14,835
EV	JPY 10,315	JPY 6,815	JPY 8,947	JPY 9,374	JPY 10,655	JPY 10,717	JPY 10,596	JPY 10,415	JPY 10,216
EV/EBITDA	6.32	5.94	8.26	8.15	9.47	10.47	9.94	9.63	9.26

## WACC - Watts (2735 JP)

Debt	1,390
Equity Market Value	15,285
Risk free Rate	0.6%
Equity Risk Premium	5.0%
Beta	-0.01
Cost of Debt	1.4%
Cost of Equity	4.6%
WACC	4.3%

## DCF

DCF valuation uses expected free cash flows from FY8/2018 (E) to FY3/2021 (E). The sales are expected on the scenario that existing store sale assumes growing at -0.3% YoY, +0.4% YoY, -0.3% YoY and -0.3% YoY for FY8/2018 (E), FY8/2019 (E), FY8/2020 (E) and FY8/2021 (E) respectively, and the number of domestic JPY100 stores increases +30 each year. The DCF value is estimated based on the PV of expected FCFs for the next 4 years and the terminal value divided by WACC of 4.3% (see tables on left). In estimating Cost of Equity, 4.1% (=1/21.7, P/E for FY3/2018 (E)) is used as Beta of the

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<u>DCF - Seria (2782 JP)</u>	<u>JPY million</u>
PV of SUM of FCF	1,128
PV of Terminal Value	9,307
Enterprise Value	10,434
Non Business Assets	4,651
Debt	1,390
Equity Value	13,696
Equity Value/Share	1,011

share price is slightly negative. On this assumption, the valuation of DCF is estimated to be JPY1,011 a share (Please see DCF table on Appendix).

## Investment Risks

4 middle-high risks are listed that are likely to hurt its earnings.

### Competition in industry (Very Likely, Middle-High Risk)

Watts has developed niche market, expanding small size stores. Competition is getting intense, as rivals are more likely to develop smaller size stores than before. Seria announces it plans to double its market share going forward. Also, Cando closed its diversified business in the previous year and focuses on its core business. If the competitors really accelerate small size stores, it would be significant risk for the company.

### Weaker JPY currency (Likely, Middle Risk)

As mentioned earlier, depreciation of JPY rates will hurt gross profit margin of 'Watts Select' items, although Watts tries to reduce negative impact on its earnings as much as possible. However, "Watts Select' is its major products and highly supported by frequent customers. Therefore, weaker JPY rates are very likely to put the earnings downward pressure for the company. Recently, the number of items of 'Watts Select' is decreasing and tries to change to data based merchandising by using POS data.

### Increase in rent (Likely, Middle Risk)

Store location is one of key factors for retailers. The OP was negatively affected by the increase in rent for 2Q FY8/2018. The rent of competitive shopping sites is very likely to remain high or even flat, as many retailers want to rent.

### Increase in labor cost (Likely, Middle Risk)

Continuing tight labor market in this industry raises labor cost and put downward pressure for the profit margin. This is very likely to continue for the mid-term. Unless positive sale grows more rapidly than such costs, SGA/sales will weigh on the future cash flows and the share price

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## Appendix

### Sales by Segment Analysis

Sales by Segment (6 month period)		JPY100 Shop										Overseas					Other					Total JPY (million)
		Sales JPY (million)	change (YoY)	Existing Store Sale (YoY)	# of DR Outlets	Yearly Sale/Outlet	Sales JPY (million)	change (YoY)	# of FC Outlets	Yearly Sale/Outlet	Sales JPY (million)	change (YoY)	# of Outlets	Yearly Sale/Outlet	Wholesale Sales JPY (million)	Sales JPY (million)	change (YoY)	Existing Store Sale (YoY)	# of Outlets	Yearly Sale/Outlet		
FY2013/8	2Q	17,034		-1.1%	780	44	1979		55	72	0		8		0	1,486			24	62	20,499	
	4Q	17,958		0.0%	810	44	2036		53	77	0		8		0	1,231			25	49	21,225	
FY2014/8	2Q	18,227	7.0%	1.2%	857	43	2026	2.4%	53	77	38	NA	9	9	187	1,064	-28.4%		21	52	21,542	
	4Q	18,791	4.6%	0.7%	899	42	2015	-1.0%	52	78	74	NA	15	10	208	1,068	-13.2%		23	47	22,156	
FY2015/8	2Q	18,569	1.9%	-1.6%	926	40	1939	-4.3%	51	77	149	292.1%	22	14	270	1,082	1.7%		29	37	22,009	
	4Q	18,881	0.5%	-1.8%	951	40	1882	-6.6%	50	75	228	208.1%	29	16	411	1,050	-1.7%		27	39	22,452	
FY2016/8	2Q	19,073	2.7%	1.2%	969	39	1764	-9.0%	49	72	320	114.8%	43	15	645	1,090	0.7%		24	46	22,892	
	4Q	19,001	0.6%	1.6%	980	39	1748	-7.1%	48	73	387	69.7%	55	14	529	987	-6.0%		23	44	22,652	
FY2017/8	2Q	19,670	3.1%	1.8%	993	40	1655	-6.2%	46	73	459	43.4%	63	15	623	1,076	-1.3%	-3.8%	24	45	23,483	
	4Q	20,154	6.1%	1.1%	1,025	39	1583	-9.4%	43	74	466	20.4%	66	14	748	1,057	7.1%	-2.6%	27	39	24,008	
FY2018/8	2Q	20,221	2.8%	1.8%	1,074	38	1410	-14.8%	38	74	526	14.6%	64	16	771	956	-11.2%	-0.6%	27	36	23,884	
	3Q	10,155	1.2%	0.2%	1,076	38	632	-19.9%	34	74	263	15.5%	64	16	771	968	-0.6%	-0.6%	27	36	12,789	
	4Q	10,238	0.9%	0.7%	1,080	38	635	-10.1%	34	74	275	2.3%	67	16	807	968	-0.6%	-0.6%	27	36	12,924	
FY2019/8	1Q	10,301	2.5%	0.8%	1,085	38	636	-9.4%	34	74	284	8.6%	69	16	870	974	#REF!	0.0%	27	36	13,065	
	2Q	10,424	2.5%	1.6%	1,090	38	641	-9.4%	34	74	288	8.6%	70	16	909	1,010	#REF!	0.0%	28	36	13,272	
	3Q	10,301	1.4%	-0.1%	1,095	38	630	-0.3%	34	74	300	14.1%	73	16	962	1,010	4.3%	0.0%	28	36	13,203	
	4Q	10,303	0.6%	-0.6%	1,100	38	627	-1.2%	34	74	308	11.9%	75	16	1,031	1,046	8.1%	0.0%	29	36	13,315	
FY2020/8	1Q	10,476	1.7%	-0.7%	1,120	38	626	-1.6%	34	74	321	13.0%	78	16	1,101	1,046	7.4%	0.0%	29	36	13,570	
	2Q	10,447	0.2%	-1.5%	1,125	38	621	-3.1%	34	74	329	14.3%	80	16	1,175	1,046	3.6%	0.0%	29	36	13,618	
	3Q	10,664	3.5%	0.2%	1,130	38	632	0.3%	34	74	337	12.3%	82	16	1,235	1,046	3.6%	0.0%	29	36	13,914	
	4Q	10,756	4.4%	0.7%	1,135	38	635	1.3%	34	74	345	12.0%	84	16	1,297	1,082	3.4%	0.0%	30	36	14,115	
FY2021/8	1Q	10,784	2.9%	0.0%	1,145	38	631	0.7%	34	74	353	10.3%	86	16	1,360	1,082	3.4%	0.0%	30	36	14,210	
	2Q	10,989	5.2%	1.6%	1,150	38	641	3.1%	34	74	362	10.0%	88	16	1,425	1,154	10.3%	0.0%	32	36	14,571	
	3Q	10,867	1.9%	-0.1%	1,155	38	630	-0.3%	34	74	370	9.8%	90	16	1,491	1,190	13.8%	0.0%	33	36	14,548	
	4Q	10,868	1.0%	-0.6%	1,160	38	627	-1.2%	34	74	378	9.5%	92	16	1,559	1,227	13.3%	0.0%	34	36	14,659	

(Source) Watts, METRICAL

### Financial Ratios Analysis

Financial Ratios:	Aug-12	Aug-13	Aug-14	Aug-15	Aug-16	Mar-17	Aug-18(E)	Aug-19(E)	Aug-20(E)	Aug-21(E)
ROE	15.21%	14.55%	11.77%	8.05%	7.78%	8.77%	6.86%	7.02%	7.15%	7.33%
Gross Margin	38.25%	38.30%	38.06%	38.98%	37.53%	37.89%	38.46%	38.46%	38.46%	38.46%
EBITDA Margin	5.73%	5.54%	4.68%	3.46%	3.42%	3.30%	2.86%	2.82%	2.79%	2.76%
EBIT Margin	5.04%	4.97%	4.09%	2.83%	2.61%	2.55%	2.13%	2.15%	2.14%	2.15%
Return on Assets	6.46%	6.18%	5.00%	3.92%	3.84%	4.18%	3.31%	3.30%	3.34%	3.40%
Return on Fixed Asset:	158.20%	150.94%	109.85%	72.31%	60.91%	65.50%	52.89%	54.72%	57.04%	60.05%
Revenue / Assets	223.70%	229.56%	229.62%	248.74%	249.82%	236.50%	242.62%	249.08%	252.40%	256.20%
Depreciation / Capex	51.29%	102.16%	38.40%	39.52%	54.34%	81.74%	45.78%	63.36%	61.72%	61.72%
Depn / Sales	0.68%	0.57%	0.59%	0.63%	0.81%	0.75%	0.72%	0.68%	0.65%	0.62%
Capex / Sales	1.33%	0.56%	1.52%	1.60%	1.50%	0.92%	1.58%	1.07%	1.05%	1.00%
Depn / Net FA	37.37%	31.85%	29.55%	29.03%	32.30%	27.95%	27.95%	27.94%	27.94%	27.94%
Asset / Equity	2.35	2.36	2.25	1.99	2.00	2.03	2.07	2.10	2.11	2.13
Equity / Asset	42.48%	42.34%	44.37%	50.15%	50.12%	49.16%	48.31%	47.59%	47.33%	47.01%
Total Debt / EBITDA	0.85	0.86	0.70	0.91	0.96	0.99	1.09	1.04	1.00	0.97

### Cash Flow Statement Analysis

Cash Flow Analysis	Aug-12	Aug-13	Aug-14	Aug-15	Aug-16	Mar-17	Aug-18(E)	Aug-19(E)	Aug-20(E)	Aug-21(E)
Net Income	1,177	1,123	948	700	709	839	678	701	731	769
Depreciation*	278	237	255	281	376	358	358	358	358	358
Amortization*	89	37	0	0	0	0	0	0	0	0
Other non-cash charge	290	-12	226	-154	-252	193	0	0	0	0
Changes in WC	93	1,384	379	-1,448	-105	-233	-106	-164	-119	-139
Operating Cash Flow	1,927	2,769	1,808	-621	728	1,157	930	895	970	988
Per share	JPY 305.48	JPY 218.40	JPY 133.45	(JPY 45.84)	JPY 53.74	JPY 85.40	JPY 68.62	JPY 66.09	JPY 71.60	JPY 72.93
Capex	-542	-232	-664	-711	-692	-438	-782	-565	-580	-580
Free Cash Flow	1,385	2,537	1,144	-1,332	36	719	148	330	390	408
Per share	JPY 219.56	JPY 200.10	JPY 84.44	(JPY 98.32)	JPY 2.66	JPY 53.07	JPY 10.90	JPY 24.39	JPY 28.79	JPY 30.12
Beginning Cash	3,039	4,086	6,280	6,714	5,149	5,030	5,727	5,665	5,786	5,967
Net cash used	1,047	2,194	434	-1,565	-119	697	-62	121	181	199
Ending cash	4,086	6,280	6,714	5,149	5,030	5,727	5,665	5,786	5,967	6,166

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## Income Statement Analysis

	Sales	Sales chg	COGS	COGS/S	GP	SGA	SGA/S	OP	OPM	RP	EBT	Tax	Minority	NP	EPS	Existing Store
FY2015/8	10,931	1.9%	-6,782	-62.0%	4,149	-3,764	-34.4%	383	3.5%	401	396	-89	0	307		-1.6%
2Q	11,080	2.4%	-6,868	-62.0%	4,212	-3,797	-34.3%	416	3.8%	399	372	-186	0	186		-1.5%
3Q	11,293	1.2%	-7,121	-63.1%	4,172	-3,840	-34.0%	333	2.9%	332	308	-147	0	161		-3.0%
4Q	11,158	2.7%	-6,963	-62.4%	4,195	-4,069	-36.5%	125	1.1%	131	98	-51	0	47		-0.3%
Full Year	44,462	2.0%	-27,734	-62.4%	16,728	-15,470	-34.8%	1,257	2.8%	1,263	1,263	1,193	-	701	51.73	-1.6%
FY2016/8	11,329	3.6%	-7,133	-63.0%	4,196	-4,046	-35.7%	149	1.3%	158	169	-57	0	112		0.4%
2Q	11,566	4.4%	-7,182	-62.1%	4,384	-3,947	-34.1%	437	3.8%	427	385	-150	0	235		0.0%
3Q	11,622	2.9%	-7,271	-62.6%	4,351	-4,048	-34.8%	303	2.6%	282	277	-107	3	173		0.0%
4Q	11,659	4.5%	-7,258	-62.3%	4,401	-4,085	-35.0%	316	2.7%	326	330	-137	6	199		0.0%
Full Year	46,176	3.9%	-28,844	-62.5%	17,332	-16,126	-34.9%	1,205	2.6%	1,193	1,190	-121	9	719	53.07	2.8%
FY2017/8	11,609	2.5%	-7,221	-62.2%	4,388	-4,153	-35.8%	235	2.0%	258	220	-121	33	132		2.1%
2Q	11,875	2.7%	-7,395	-62.3%	4,480	-4,071	-34.3%	409	3.4%	437	429	-87	14	356		0.0%
3Q	12,142	4.5%	-7,584	-62.5%	4,558	-4,189	-34.5%	369	3.0%	367	361	-145	25	241		0.0%
4Q	11,868	1.8%	-7,299	-61.5%	4,569	-4,372	-36.8%	196	1.7%	210	207	-125	28	110		0.9%
Full Year	47,494	2.9%	-29,499	-62.1%	17,995	-16,785	-35.3%	1,209	2.5%	1,272	1,217	-478	100	839	61.96	1.5%
Full Year (CE)	48,000	4.0%						1,370		1,350				910	67.17	0.0%
FY2018/8	11,844	-0.3%	-7,307	-61.7%	4,537	-4,289	-36.2%	247	2.1%	265	265	-113	19	171		-0.7%
2Q	12,042	-0.8%	-7,372	-61.2%	4,670	-4,324	-35.9%	346	2.9%	337	326	-136	18	208		0.0%
3Q (E)	12,789	2.9%	-7,943	-62.1%	4,846	-4,612	-36.1%	234	1.8%	234	234	-84	0	150		0.2%
4Q (E)	12,924	3.2%	-7,903	-61.2%	5,021	-4,790	-37.1%	231	1.8%	231	231	-83	0	148		0.7%
Full Year	49,599	4.4%	-30,525	-61.5%	19,074	-18,015	-36.3%	1,058	2.1%	1,067	1,056	-416	37	678	50.01	-0.3%
Full Year (CE)	49,600	4.4%						1,450		1,520				925		
FY2019/8	13,065	3.3%	-8,060	-61.7%	5,005	-4,731	-36.2%	274	2.1%	273	233	-84	0	149		0.8%
2Q	13,272	3.8%	-8,125	-61.2%	5,147	-4,766	-35.9%	381	2.9%	381	381	-137	0	244		1.6%
3Q	13,203	2.6%	-8,200	-62.1%	5,003	-4,761	-36.1%	242	1.8%	242	242	-87	0	155		-0.1%
4Q	13,315	2.3%	-8,143	-61.2%	5,173	-4,935	-37.1%	238	1.8%	238	238	-85	0	152		-0.6%
Full Year	52,856	6.6%	-32,528	-61.5%	20,328	-19,193	-36.3%	1,135	2.1%	1,134	1,093	-392	0	701	51.75	0.4%
Full Year (CE)	51,500	3.8%						1,600		1,700				1,050		
FY2020/8	13,570	2.2%	-8,372	-61.7%	5,198	-4,914	-36.2%	284	2.1%	284	242	-87	0	155		-0.7%
2Q	13,618	1.7%	-8,337	-61.2%	5,281	-4,890	-35.9%	391	2.9%	391	391	-140	0	251		-1.5%
3Q	13,914	2.9%	-8,642	-62.1%	5,273	-5,017	-36.1%	255	1.8%	255	255	-91	0	163		0.2%
4Q	14,115	3.2%	-8,632	-61.2%	5,483	-5,231	-37.1%	252	1.8%	252	252	-90	0	162		0.7%
Full Year	55,218	4.5%	-33,982	-61.5%	21,235	-20,053	-36.3%	1,183	2.1%	1,181	1,140	-409	0	731	53.94	-0.3%
Full Year (CE)	53,500	3.9%						1,800		1,900				1,150		
FY2021/8	14,210	3.3%	-8,767	-61.7%	5,443	-5,146	-36.2%	298	2.1%	297	253	-91	0	163		0.8%
2Q	14,571	3.8%	-8,920	-61.2%	5,651	-5,232	-35.9%	419	2.9%	418	418	-150	0	268		1.6%
3Q	14,548	2.6%	-9,035	-62.1%	5,513	-5,246	-36.1%	267	1.8%	266	266	-96	0	171		-0.1%
4Q	14,659	2.3%	-8,964	-61.2%	5,695	-5,433	-37.1%	262	1.8%	262	262	-94	0	168		-0.6%
Full Year	57,987	5.0%	-35,686	-61.5%	22,301	-21,056	-36.3%	1,245	2.1%	1,243	1,200	-430	0	769	56.79	0.4%
Full Year (CE)																

(Source) Watts, METRICAL

## Discount Cash Flow Valuation

### SOTP NAV - Watts (2735 JP)

(In Y million)	Aug-12	Aug-13	Aug-14	Aug-15	Aug-16	Mar-17	Aug-18(E)	Aug-19(E)	Aug-20(E)	Aug-21(E)	SUM of Future FCF
<b>Retail</b>											
Sales	40,758	41,725	43,573	44,462	46,176	47,494	49,599	52,856	55,218	57,987	215,660
EBIT	2,056	2,074	1,784	1,257	1,205	1,209	1,058	1,135	1,183	1,245	4,621
Dep	278	237	255	281	376	358	358	358	358	358	1,432
Wkg Capital	-542	-232	-664	-711	-692	-438	-782	-565	-580	-580	-2,507
OCF	1,927	2,769	1,808	-621	728	1,157	930	895	970	988	3,783
Capex	-542	-232	-664	-711	-692	-438	-782	-565	-580	-580	-2,507
FCF	1,385	2,537	1,144	-1,332	36	719	148	330	390	408	1,276

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## Balance Sheet Analysis

	2012/8	2013/8	2014/8	2015/8	2016/8	2017/8	2018/8(E)	2019/8(E)	2020/8(E)	2021/8(E)
Consolidated Balance Sheets										
Assets										
Current Assets										
Cash and Cash Equivalents	4,086	6,280	6,714	5,149	5,030	5,727	5,665	5,786	5,967	6,166
Short-Term Investments	-	-	-	-	-	-	-	-	-	-
Notes and Accounts	1,812	2,320	2,318	2,052	2,163	2,201	2,299	2,449	2,559	2,687
Allowance for Doubtful	(21)	(24)	(24)	(22)	(20)	(22)	(23)	(24)	(26)	(27)
Inventories	4,642	4,975	5,233	5,642	6,126	6,534	6,824	7,272	7,597	7,978
Deferred Income Taxes	272	261	238	237	233	303	316	337	352	370
Other Current Assets	456	469	383	409	376	533	557	593	620	651
<b>Total Current Assets</b>	<b>11,247</b>	<b>14,281</b>	<b>14,862</b>	<b>13,467</b>	<b>13,908</b>	<b>15,276</b>	<b>15,638</b>	<b>16,413</b>	<b>17,069</b>	<b>17,824</b>
Property, Plant and										
Land	80	257	257	257	257	257	257	257	257	257
Buildings	773	879	944	1,092	1,208	1,454	1,454	1,454	1,454	1,454
Machinery and Equipment	2,208	2,366	2,587	2,761	2,975	3,098	3,098	3,098	3,098	3,097
Construction in Progress	-	-	-	-	-	(0)	(0)	(0)	(0)	(0)
<b>Total</b>	<b>3,061</b>	<b>3,502</b>	<b>3,788</b>	<b>4,110</b>	<b>4,440</b>	<b>4,809</b>	<b>4,809</b>	<b>4,809</b>	<b>4,809</b>	<b>4,809</b>
Accumulated Depreciation	(2,284)	(2,501)	(2,668)	(2,885)	(3,019)	(3,271)	(3,271)	(3,271)	(3,271)	(3,270)
<b>Net Property, Plant and</b>	<b>777</b>	<b>1,001</b>	<b>1,120</b>	<b>1,225</b>	<b>1,421</b>	<b>1,538</b>	<b>1,538</b>	<b>1,538</b>	<b>1,538</b>	<b>1,538</b>
Software & Other intangible	28	28	33	54	61	78	78	78	78	78
Goodwill	44	-	-	-	-	-	-	1	2	3
	72	28	33	54	61	78	78	79	80	81
Other Assets										
Investments in and Advances	-	-	-	-	-	-	-	-	-	-
Investment Securities	84	216	245	384	314	453	453	453	453	453
Software & Others	(30)	(27)	(29)	(30)	(3)	(1)	(1)	(1)	(1)	(1)
Deferred Income Taxes	93	88	98	124	122	119	119	119	119	119
Other	2,560	2,589	2,647	2,651	2,661	2,619	2,619	2,619	2,619	2,619
<b>Total Other Assets</b>	<b>2,707</b>	<b>2,866</b>	<b>2,961</b>	<b>3,129</b>	<b>3,094</b>	<b>3,190</b>	<b>3,190</b>	<b>3,190</b>	<b>3,190</b>	<b>3,190</b>
<b>Total</b>	<b>14,803</b>	<b>18,176</b>	<b>18,976</b>	<b>17,875</b>	<b>18,484</b>	<b>20,082</b>	<b>20,444</b>	<b>21,220</b>	<b>21,877</b>	<b>22,634</b>
Liabilities and Stockholders'										
Current Liabilities										
Bank Loans	140	140	100	100	100	100	100	100	100	100
Notes and Accounts Payable,	4,433	6,578	7,170	5,842	6,129	6,325	6,605	7,039	7,354	7,722
	-	-	-	-	0	0	0	0	0	0
Accrued Expenses	-	-	-	-	-	-	-	-	-	-
Income Taxes	782	346	448	285	261	601	628	669	699	734
Other Current Liabilities	816	1,302	1,248	1,133	1,026	1,150	1,201	1,280	1,337	1,404
Current Portion of Long-Term	1,267	957	679	565	626	648	648	648	648	648
<b>Total Current Liabilities</b>	<b>7,438</b>	<b>9,323</b>	<b>9,645</b>	<b>7,925</b>	<b>8,142</b>	<b>8,824</b>	<b>9,182</b>	<b>9,736</b>	<b>10,137</b>	<b>10,608</b>
Long-Term Debt	1,102	644	403	468	534	771	771	771	771	771
Deferred Income Taxes	-	-	-	-	-	-	-	-	-	-
Termination and Retirement	201	248	242	262	260	28	28	28	28	28
Other Long-Term Liabilities	247	266	267	255	284	587	587	587	587	587
	2,509	1,741	1,182	1,133	1,260	1,519	1,519	1,519	1,519	1,519
<b>Total Liabilities</b>	<b>8,988</b>	<b>10,481</b>	<b>10,557</b>	<b>8,910</b>	<b>9,220</b>	<b>10,210</b>	<b>10,568</b>	<b>11,122</b>	<b>11,523</b>	<b>11,994</b>
Stockholders' Equity										
Common Stock	440	440	440	440	440	440	440	440	440	440
Additional Paid-in Capital	876	1,583	1,583	1,583	1,583	1,637	1,637	1,637	1,637	1,637
Legal Reserve	4,783	5,716	6,434	6,905	7,393	8,029	8,497	8,989	9,510	10,056
Retained Earnings	-	1	1	1	1	-	-	-	-	-
Treasury Stock	(268)	(84)	(84)	(84)	(84)	(137)	(137)	(137)	(137)	(137)
<b>Total Stockholders' Equity</b>	<b>5,831</b>	<b>7,656</b>	<b>8,374</b>	<b>8,845</b>	<b>9,333</b>	<b>9,969</b>	<b>10,437</b>	<b>10,929</b>	<b>11,450</b>	<b>11,996</b>
Comprehensive Income	(15)	39	46	121	(67)	4	(561)	(830)	(1,097)	(1,357)
Minority Interests in										
	-	-	-	-	-	-	-	-	-	-
<b>Total Stockholders' Equity</b>	<b>5,816</b>	<b>7,695</b>	<b>8,420</b>	<b>8,966</b>	<b>9,266</b>	<b>9,973</b>	<b>9,876</b>	<b>10,099</b>	<b>10,354</b>	<b>10,639</b>
<b>Total</b>	<b>14,804</b>	<b>18,176</b>	<b>18,977</b>	<b>17,876</b>	<b>18,486</b>	<b>20,082</b>	<b>20,444</b>	<b>21,220</b>	<b>21,877</b>	<b>22,634</b>