Strategy

Who Are the Inflation Beneficiaries?

9 November 2020

Key Takeaway

With COVID-19 uncertainties remaining, economic support and stimulus measures are still needed in many parts of the world, and a consequent rise in inflation-bias is possible at any time. At the same time, this inflation could coincide with accelerated consolidation, which changes the competitive landscape by giving pricing power to the dominant players. This report collects Jefferies Japan's research analysts' views on these topics.

Given the recent surge in COVID-19 infections in the EU and the US (and possibly in Japan), concerns are increasing. At the same time, governments are working on additional packages to support their economies. Together with easing monetary policy, sizable government fiscal support could create inflation-bias in the market, or could lead to actual inflation in Japan.

At the same time, consolidation is accelerating. The driving forces include: 1) calls for stronger corporate governance, leading to growth in acquisitions of, or divestiture and reshuffling of, subsidiaries; 2) COVID-19 acting as a trigger for industry consolidation. Often, these are industries where consolidation was needed to begin with, but COVID-19 has brought to the fore the necessity of consolidation, in order to survive and recover. In addition to the potential synergies created by consolidation, some players may gain pricing power, and these companies could thus stand to benefit from rising inflation.

Jefferies Japan analysts have been publishing reports on these themes, and this report collects our analysts' most recent views.

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^Prior trading day closing price unless otherwise noted.

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Chemicals/Electronic Components

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The companies that have consolidated or are consolidating in the sectors covered

In gas, recently, Nippon Sanso HD (4091 JP). Within the paint industry, consolidation is progressing gradually and steadily.

How is consolidation impacting the pricing power of each player in the sector(s)?

In gas, players' pricing power is rising in the US and EU. In industrial gas, the four majors have 80% market share in the US and EU. The industrial gas industry has been consolidating. Linde acquired BOC in 2006, Air Liquide acquired Airgas in 2016, and Linde merged with Praxair in 2019. As a result, four companies (Linde, Air Liquide, Air Products, and Nippon Sanso) dominate the US and European markets. Industrial gas companies' pricing power has been rising for decades, and US gas suppliers have been successfully passing on raw material and logistics cost hikes. Decorative suppliers in India have strong pricing power, with Asian Paints as the price leader, while decorative paint suppliers in China do not, as it is still a fragmented market. Auto OEM paint suppliers have decent pricing power, with five suppliers (PPG, Axalta, BASF, Nippon Paint, and Kansai Paint) dominating the market.

Inflation beneficiaries

In an inflationary business environment, companies with 1) high financial leverage, 2) decent pricing power, 3) good enough execution capabilities (cost control), and 4) high breakeven points tend to outperform. Most Japanese diversified petrochemical companies (e.g., Mitsubishi Chemical and Mitsui Chemicals) meet criteria 1) and 4), but they do not have pricing power, and thus it would be tough for them to enjoy continuous margin expansion, unless there is really high inflation (such as a \$90–100/barrel oil price). We assume more-moderate inflation (a \$50–70 oil price). We believe Nippon Sanso meets criteria 1)–3) above. SUMCO, Kansai Paint, Taiyo Yuden, and Murata also meet the above criteria to a lesser degree.

Financial leverage?

Niippon Sanso's net debt/EBITDA is 5x. Kansai Paint has almost zero.

In which sub-sector do you expect consolidation?

Paint: Yes

Gas: No

Sap: Yes

Wafer: No

Petro: No

Rubber: Yes (but marginal)

MLCC: No

Relevant report links

Nippon Sanso Top Pick in Inflationary Environment (23 October)

Nippon Sanso: Inflation + Debt = Equity Leverage (23 October)

Consumer Electronics/Gaming/Telecoms

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Overall, we do not see material price inflation across the sectors we cover (telecoms, games, music/video subscription, electronic goods).

The companies that have consolidated or are consolidating in the sectors covered

1. Telecoms: Facing price cuts
2. Games: Prices are being raised from $60 to $70 after 14 years. This is just a delayed catch-up and barely covers the increase in development costs.
3. Music/video subscription: The space remains pretty competitive—recently, Disney has offered monthly price plans of $6–7, when Netflix was close to $13–14.
4. Electronic products: Apple offers much higher-spec (i.e., higher-value) products for the same prices. In essence, there is structural deflation in this space.

How is consolidation impacting the pricing power of each player in the sector(s)?

At best, the pace of price decline is becoming less steep.

Inflation beneficiaries

None

Cosmetics and HPC

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How is consolidation impacting the pricing power of each player in the sector(s)?

Consolidation in the cosmetics and HPC sectors, if any, does not impact the pricing power of any particular player.

Financial Services

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The companies that have consolidated or are consolidating in the sectors covered

MUFJ Lease (8593 JP) and Hitachi Capital (8586 JP), within the MUFG Group (8306 JP). Shinsei Bank (8303 JP) announced that it would acquire 100% of the shares of its subsidiary, Aplus (8589 JP).

How is consolidation impacting the pricing power of each player in the sector(s)?

Consolidation within the leasing industry is not necessarily leading to a rise in pricing power since the market is still fragmented, but negotiating power in procuring leasing assets tends to be reinforced, which tends to lead to better profit margins and lower residual value risks.

Similarly, while banking sector consolidation will not lead to a rise in pricing power in the services they provide, the providers of systems and infrastructure to the regional banks for digitalization should benefit from regional bank consolidation.

On the other hand, consolidation of the domestic P+C insurance market is already done, but profitability is still relatively secured or improving, because of the oligopolistic nature of the market and also due to regulations.

Inflation beneficiaries

A steeper yield curve will benefit life insurers more than the other interest-rate-sensitive sectors given current monetary policy (yield curve control will tend to cap the rise in up to 10 year yields, the zone that is more beneficial to spread banking businesses).

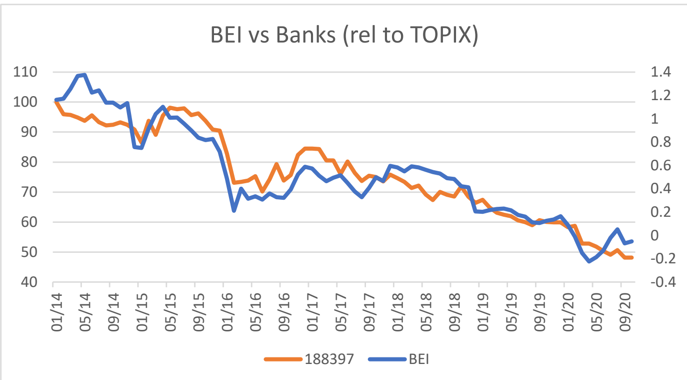
At the same time, wholesale banking will benefit. Retail and wealth management business is already benefiting from the “stay home” environment (rises in trading volumes and new account openings). However, as inflation expectations rise, corporates will start accelerating investments, and investment (wholesale) banking business should benefit in such an environment

Inflation and share price

Also, financial stock performance is more correlated with inflation expectations than the actual CPI. Banks and life insurers are the most highly-correlated and non-banks the least correlated.

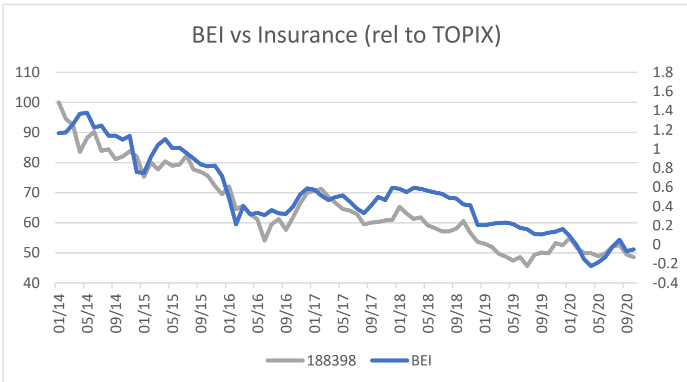
Exhibits 1–4 show financial sub-sectors’ performances relative to TOPIX versus the 10-year breakeven inflation rate

Exhibit 1 - BEI vs Banks (Relative to TOPIX)



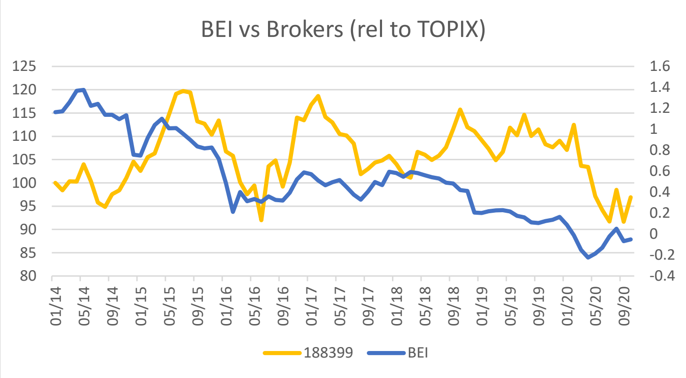
Source: Jefferies, Bloomberg, FactSet

Exhibit 2 - BEI vs Insurance (Relative to TOPIX)



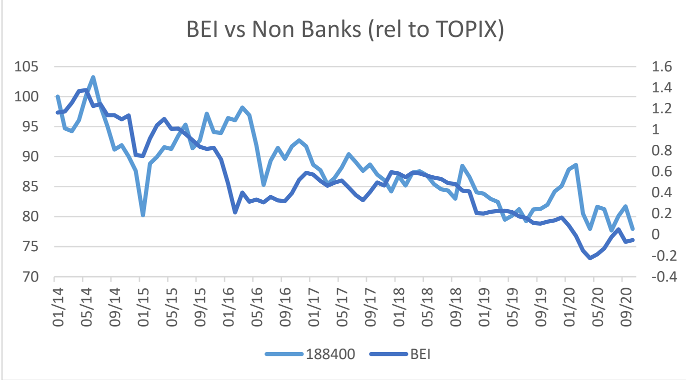
Source: Jefferies, Bloomberg, FactSet

Exhibit 3 - BEI vs Brokers (relative to TOPIX)



Source: Jefferies, FactSet, Bloomberg

Exhibit 4 - BEI vs Non-Banks (Relative to TOPIX)



Source: Jefferies, Bloomberg, FactSet

In which sub-sector do you expect consolidation?

Major banks : No

Regional banks: Yes

Investment banks: No

Retail brokers: Yes

Leasing: Yes (continuing)

Consumer finance: Yes

P+C insurance: No

Life insurance: Yes

Healthcare/Med-Tech

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How is consolidation impacting the pricing power of each player in the sector(s)?

Drug companies currently have pricing power that was not necessarily via consolidation in the US, and have historically been able to raise prices of on-patent drugs at a rate that exceeds inflation. However, this has invited political risk. One of the few things that both US parties agree on is the desirability of bringing down drug prices.

Inflation beneficiaries

We do not think any companies in the pharmaceutical, medical device, or biotech sectors are particularly likely to benefit from inflation. On the contrary, political risks in Japan and the US have led to ongoing pressure to lower drug prices.

As a result, we do not think investors will necessarily trust pharma companies to be a good hedge against inflation.

Financial leverage?

Most large-cap companies have little debt, so we think their financial risk is also minimal.

In which sub-sector do you expect consolidation?

Within pharma, there are two possible consolidation stories:

1. Parent/child consolidation: Kirin may buy Kyowa Kirin and Sumitomo Chemical may buy Sumitomo Dainippon. This would not automatically give either company new pricing power, however.
2. Generics: The two strongest local players, Sawai and Towa, may not actually buy any of their local competitors, and are very unlikely to merge. But these two companies may be able to continue to increase their market share as weak foreign and local players continue to get weaker.

IT Services/Internet

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The companies that have consolidated or are consolidating in the sectors covered

IT services: SCSK bought and fully consolidated MINORI this year.

Internet: ZHD consolidated ZOZO, and next March will be fully consolidating LINE.

How is consolidation impacting the pricing power of each player in the sector(s)?

Internet: The merger of LINE and ZHD will form, at ¥3trn, Japan's biggest media platform. But will they have stronger pricing power as a result?

Inflation beneficiaries

IT services: There are many "must do" topics in this space that need to be addressed, such as DX, cashless, telework, etc. We do not think inflation (or deflation) will change IT spending much. Many of the investments happening now are to lower future IT spending costs.

Internet: There is currently a big shift towards on-line activity on the back of the coronavirus experience. We do not think Inflation will change that trend.

Financial leverage?

Internet: Reasonably leveraged, but not overly so.

IT service companies: Basically most of the companies are cash-rich, low-leverage companies.

In which sub-sector do you expect consolidation?

IT service companies in general will likely see more consolidation as bigger companies are going after the engineering resources. Niche software solutions, consulting, datacenters, and service-oriented are targets for take-outs. DX-related, Cloud.

Internet: Digital content, logistics, financial-related services, cashless, DX-related, internet ad agencies, on-line doctors, on-line medical services, a variety of marketplace solutions.

Machinery/Capital Goods

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The companies that have consolidated or are consolidating in the sectors covered

Within the Japanese capital goods sector, companies that have been actively engaging in acquisitions include LIXIL Group (5938 JP), Nabtesco (6268 JP), Komatsu (6301 JP), Sumitomo Heavy Industries (6302 JP), Daikin Industries (6367 JP), Daifuku (6383 JP), Hoshizaki (6465 JP), and Hitachi (6501 JP). Mitsubishi Heavy Industries (7011 JP) conducts frequent internal consolidation as part of its restructuring activities. Japanese capital goods companies under our coverage have mostly secured top global share. Acquisitions usually help these companies expand their product line-up to penetrate new customer groups.

How is consolidation impacting the pricing power of each player in the sector(s)?

Companies' pricing power is not necessarily reinforced via consolidation, but we would highlight the following companies with strong pricing power in our universe. Daifuku's top presence in the global material handling industry has secured it the ability to offer value-added logistics solutions. Daikin executes a premium pricing policy in the global air-conditioning industry, especially in commercial air-conditioning. Komatsu faces intense price competition in China, but its pricing power remains high in other regions. Companies with high revenue exposure to the public and utilities sectors, such as Hitachi, would likely benefit from accelerating economic growth, with increased overall government and corporate spending.

Inflation beneficiaries

Fiscal stimulus in Europe, Japan, and the US will likely lead to an inflationary environment. Under such a scenario, we highlight Daifuku, Daikin Industries, and Komatsu as the main beneficiaries among Japanese capital goods companies under our coverage. Our rationale rests on 1) these companies' pricing power in B-B (business-to-business) applications and leading market share, 2) a favorable pricing environment led by inflation, 3) accelerated pace of improving financial standing from better cash flow generation, and 4) ease of financing for acquisitions and organic growth.

Financial leverage?

Most Japanese capital goods sector companies under our coverage have secured net cash positions. Mitsubishi Heavy Industries (7011 JP), Kawasaki Heavy Industries (7012 JP), and IHI (7013 JP) are the most leveraged within our coverage.

In which sub-sector do you expect consolidation?

Factory automation: No

Construction/agricultural machinery: No

Air conditioning: Yes

Building equipment: No

Heavy industries: Yes

Relevant report links

Who Will Benefit from an Inflationary Environment? (26 October)

Real Estate/J-REIT

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The companies that have consolidated or are consolidating in the sectors covered

Office development by the nine largest Japanese developers has led them to increase market share of Tokyo office from 21.2% in 2014 to 24% in 2020. There has been very little M&A, although the takeover of Unizo in 2019/2020 and MBO of NTT Urban by parent NTT in 2018 stand out as examples. In particular, the final ¥6,000 take-out price of Unizo was 300% higher than the ¥2,000 market price before a bidding battle began.

In JREITs, there have been 19 mergers since 2010, including one successful hostile takeover in 2019. There have also been 23 IPOs of new JREITs since 2010, and they are rapidly increasing in variety. Logistics JREITs have been popular, and we cover three of them. We also cover two renewables infrastructure funds, similar to REITs.

How is consolidation impacting the pricing power of each player in the sector(s)?

Given the commodity nature of real estate generally, this remains a challenge, but superior functionality, amenities, location, etc. of new development creates pricing power.

Consolidation of REITs is generally motivated more by cost benefits rather than pricing, but the larger the REIT, the larger the leasing network, and the easier it becomes to re-lease properties.

Inflation beneficiaries

Exhibits 9–14 show Japanese OTC inflation-linked swap yields (FYISJY55 on Bloomberg)—a proxy for inflation expectations—against Mitsubishi Estate, Mitsui Fudosan, and the property market (TPREAL) share prices. These charts are frequently used to infer that, essentially, Japanese real estate stocks are "an inflation trade" and nothing much else. This oversimplifies fundamentals, but a strong relationship (93% correlation in 2013, 83% eight-year period) is compelling. A recent increase in inflation expectations to 0.102% (up 30bps in three months) has not been followed by an increase in developer share prices, which may be an opportunity (Exhibits 9–12).

In 2014, Abenomics led to the BOJ 2% targeted inflation rate (from the FYISJY55 charts we see expectations reached 1.5%). We can then see from exhibits 5 and 6 that real estate stock valuations (PBR) went up 2.5–3x. Any increasing risk of inflation makes these stocks attractive now, given distressed valuations near post-Lehman lows.

Exhibit 15 reveals that JGB yields and JREIT yields have directionally trended down together over time with lower interest rates, but suggests that during periods of crisis the risk component of cap rates overrides the price-of-money component.

Exhibit 17 explains the mechanisms of inflation in the property market. As suggested by Exhibit 16, both risk appetite and price-of-money factor into aggregate cap rates (discount rates).

Financial leverage?

Banks typically lend on a basis of close to 70% of project value, and over time IBD as a percentage of leasing assets, including inventory, tends to run around that level. Exhibit 7 shows Mitsui Fudosan (8801 JP) as an example. Mitsui's consolidated total leverage (IBD/total assets) is around 50%, with net debt/equity around 140%.

Most JREITs have leverage around 50%. NBF (8951 JP) is one of the longest-listed JREITs and maintains around 42% leverage (Exhibit 8).

In which sub-sector do you expect consolidation?

The Unizo takeover event led many to speculate that further M&A was possible in Japanese real estate given that many are trading below intrinsic value (Exhibits 5 and 6). As yet, this has not occurred but it remains a possibility.

We would expect consolidation of small and mid-sized JREITs. Many have proliferated during a bull market but are now trading at deep NAV discounts and are unable to grow.

Relevant report links

Japan Property Expert Survey: COVID-19 Impact (17 September)

Japanese Developers Stock Picking Guide (19 June)

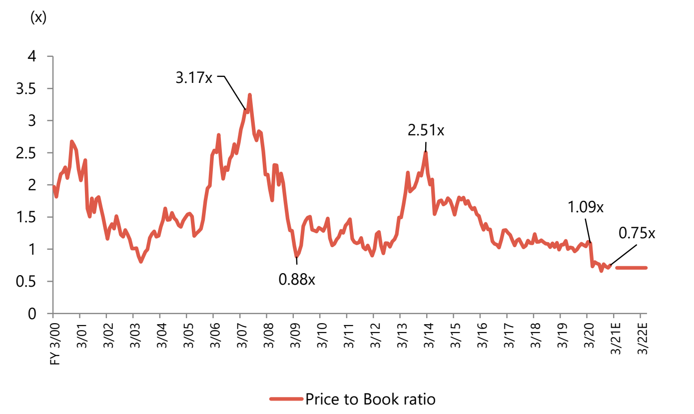
Mitsubishi Estate - Becoming Significantly Undervalued (27 October)

Mitsui Fudosan - Also Significantly Undervalued (27 October)

Logistics J-REITS: Safety in Numbers (27 April)

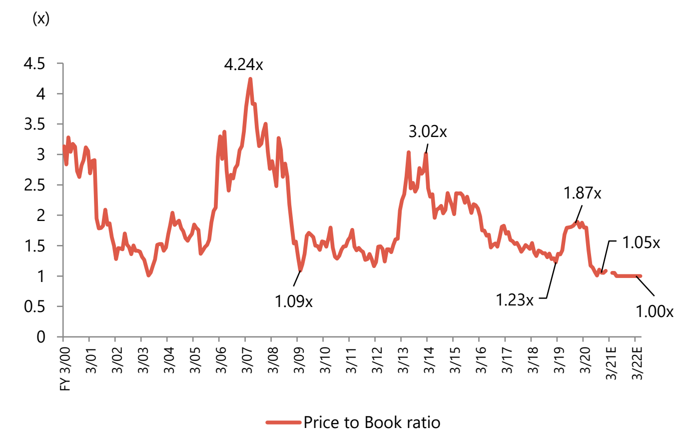
Sunshine Is the Best Medicine: Initiate on Canadian Solar at Buy (30 September)

Exhibit 5 - Mitsui Fudosan (8801 JP) PBR



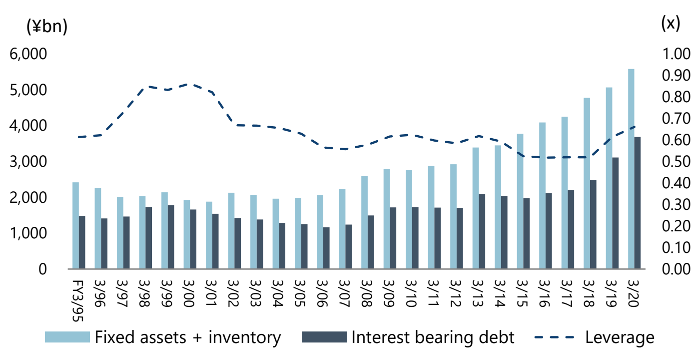
Source: Jefferies, Company data, Bloomberg

Exhibit 6 - Mitsubishi Estate (8802 JP) PBR



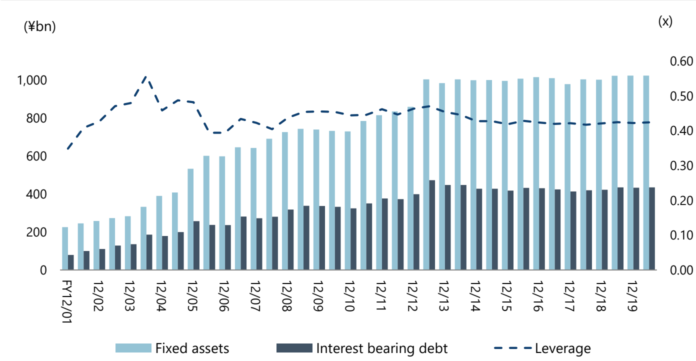
Source: Jefferies, Company data, Bloomberg

Exhibit 7 - Mitsui Fudosan (8801 JP) Leverage Employed



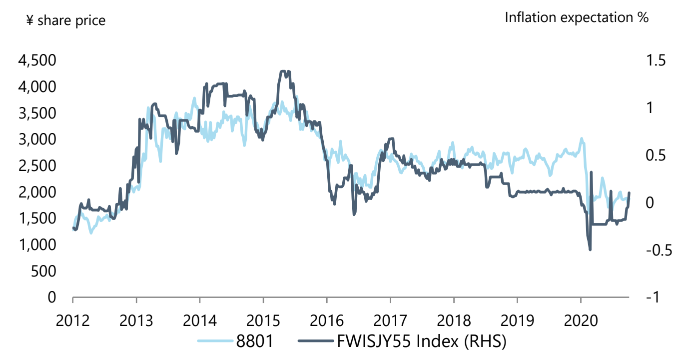
Source: Jefferies, Company data

Exhibit 8 - NBF (8951 JP) Leverage Employed



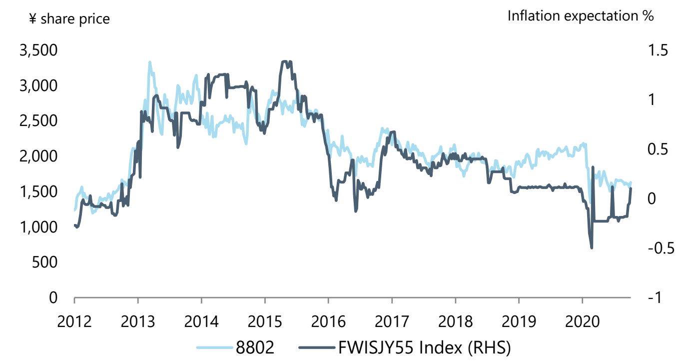
Source: Jefferies, Company data

Exhibit 9 - Mitsui Fudosan and Inflation Expectation



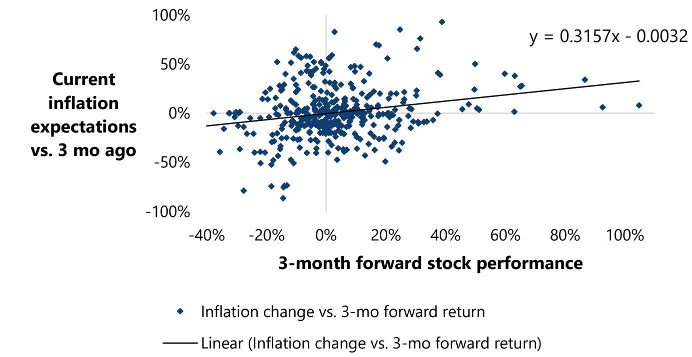
Source: Jefferies, Bloomberg

Exhibit 10 - Mitsubishi Estate and Inflation Expectation



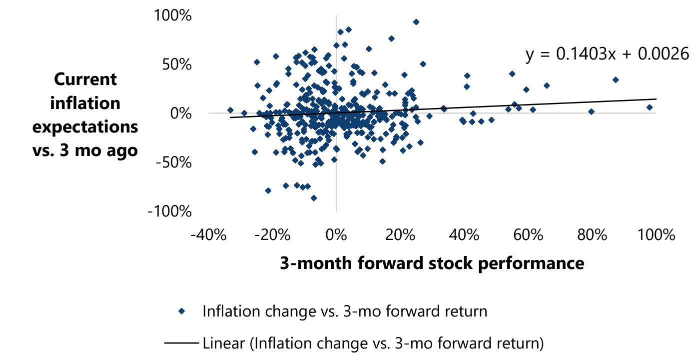
Source: Jefferies, Bloomberg

Exhibit 11 - Mitsui Fudosan Return vs. inflation Expectation



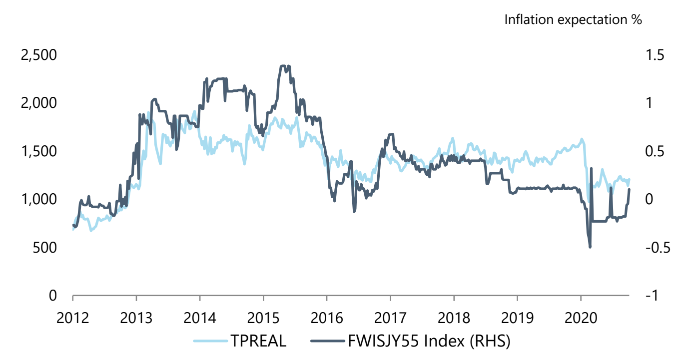
Source: Jefferies, Bloomberg

Exhibit 12 - Mitsubishi Estate Return vs. iInflation Expectation



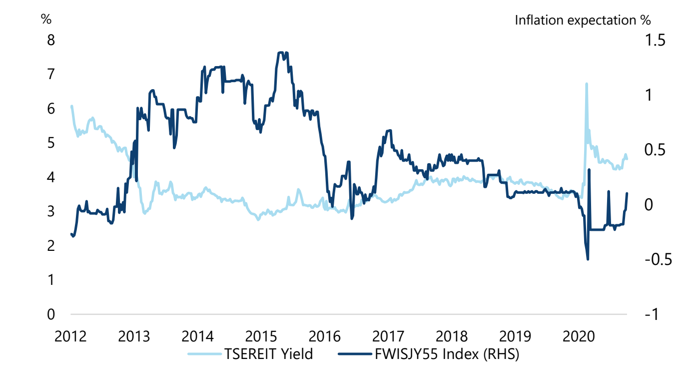
Source: Jefferies, Bloomberg

Exhibit 13 - TPREAL and Inflation Expectation



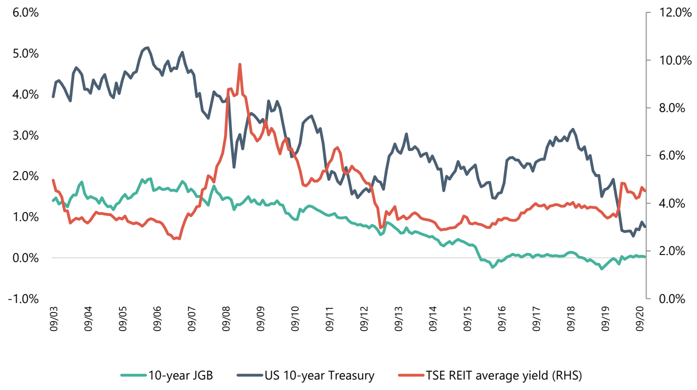
Source: Jefferies, Bloomberg

Exhibit 14 - TSEREIT Yield and Inflation Expectation



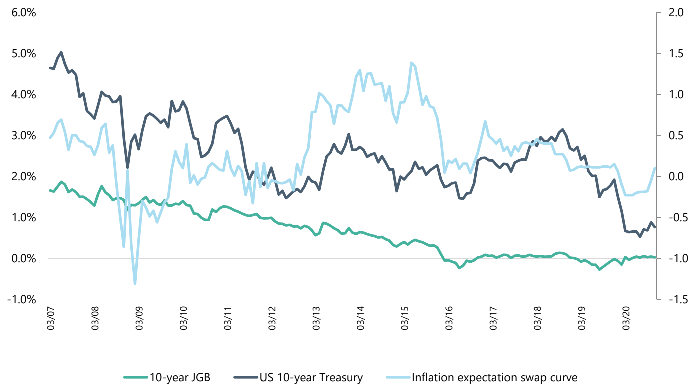
Source: Jefferies, Bloomberg

Exhibit 15 - 10-Year JGB and TSE REIT Average Yield



Source: Jefferies, Bloomberg

Exhibit 16 - 10-Year JGB and Inflation Expectation



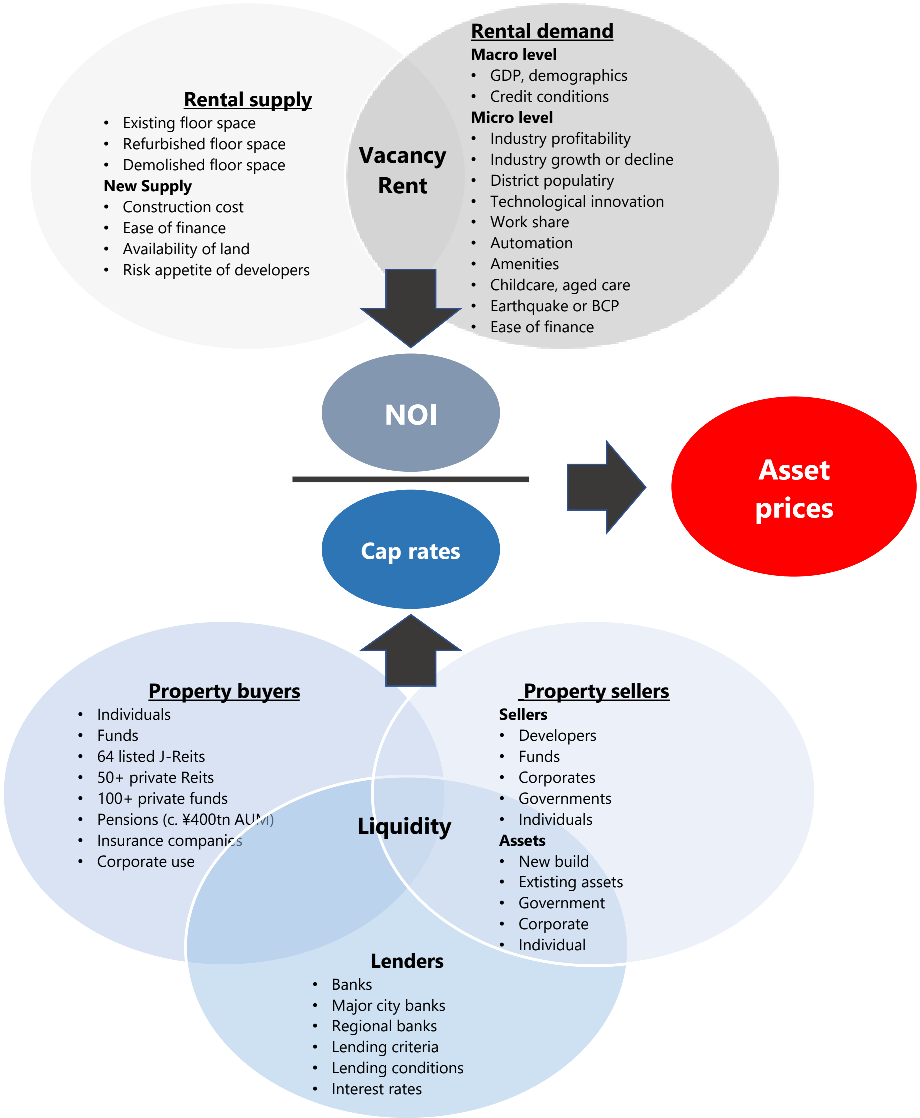
Source: Jefferies, Bloomberg

Inflation impacts both the numerator and the denominator of the asset value equation.

The numerator (NOI) rises in an inflationary environment. Generally speaking, corporate earnings rise, which leads to increased property demand. NOI rises as a result.

The denominator (cap rates), while on the one hand are a function of interest rates (price of money) and liquidity (supply of money), are on the other hand a function of risk appetite, which generally increases in an inflationary environment.

Exhibit 17 - Asset Value = NOI/Cap Rate



Source: Jefferies

Retail

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Japanese retailing is usually the place that inflation goes to die. In most segments of the industry, there are hundreds of competitors offering roughly the same merchandise to highly informed consumers who are notoriously disloyal.

While we would argue that no company in our coverage has reliable pricing power, some would have more ability to deal with an inflationary environment than others. In general, most of the competitive advantages that some retailers enjoy would be the same regardless of the direction of general prices. However, there are at least three emerging fault-lines of competitive pressures that we see changing.

Exhibit 18 - Pricing Power Factors

Tkr	Company	Core Segment	Estimated Share	No. of Competitors	Private Label (% of Sales)	Pricing
2651	Lawson	Food	4.0	270+	40	Centralized
2685	Adastria	Apparel	3.0	900+	50	Centralized
2782	Seria	Household Good:	30.0	4.0	30	Centralized
3034	QOL	Pharmacy	2.0	50000+	0	Centralized
3088	Matsumoto Kiyoshi	Drug Store	7.0	400+	13	Centralized
3141	Welcia	Drug Store	11.0	400+	5	Centralized
3349	Cosmos	Drug Store	10.0	400+	0	**Decentralized**
3382	7&i	Food	6.0	270+	45	Centralized
3391	Tsuruha	Drug Store	11.0	400+	8	Centralized
7453	Ryohin Keikaku	Home Furnisings	4.0	900+	100	**Decentralized**
7532	Pan Pacific	Discounter	2.0	270+	12	**Decentralized**
7606	United Arrows	Apparel	1.0	900+	50	Centralized
8227	Shimamura	Apparel	4.0	900+	30	**Decentralized**
9627	Ain	Pharmacy	3.5	50000+	0	Centralized
9843	Nitori	Furniture	13.0	2,210.0	n.a.	Centralized
9983	Fast	Apparel	11.0	900+	100	Centralized

Source: Company data

Store Level Pricing

The newest line of competitive advantage that could change dramatically in the next several years is the ability to price goods at the local or store level. Most Japanese retailers are not set up to set prices at the store level. Companies that can do this, like Cosmos (3349 JP, Underperform) and Pan Pacific (7532 JP, Hold), are able to target local competitors for elimination by lowering prices locally without damaging their nationwide margins. This is not an easily-replicated skill. These companies not only have more-sophisticated software to set and track prices at the store level, but also have trained and incentivized hundreds of employees in how to gather raw market information and use it to set prices.

At least two other companies, Shimamura (8227 JP, Buy), and Ryohin Keikaku (7453 JP, Buy), are installing the necessary software and preparing to develop this capability. In both cases, management sees an opportunity to increase margins by cutting prices more carefully, if, when, and especially where necessary, without damaging margins in stores where the cuts are not needed. This strategy is designed to deal more effectively with deflationary pressures, but in our view, it should help in an inflationary environment equally well. The ability to hold prices down in locations that are more competitive, while raising prices selectively in less-competitive locations, should give these companies an advantage in an environment of rising prices as well.

Private Label

Historically, the primary differentiating factor in Japanese retailing was always real estate. With a declining population and the growth of e-commerce, superior location selection is no longer a viable path to leadership. Differentiation based on merchandise should become more important, but this skill-set is still in its infancy in Japan. Only two companies, Fast Retailing (9983 JP, Hold) and Ryohin Keikaku, rely on differentiated merchandise for 100% of their sales. Nitori (9843 JP, Hold) does not disclose the share of private label merchandise in its assortment, but its bid for Shimachu (8184 JP) includes a claim that private brands account for 90% of its revenue.

For most Japanese retailers, private label items are only a substitute for some other widely available commodity, and pricing power is more often lost because the retailer is now responsible for the inventory and must price the item to the level where it sells out.

Matsumoto Kiyoshi (3088 JP, Hold) is the most important exception to this rule, in our view. The company's merchandising developers are deeply involved in the development of new products that are not available elsewhere for the purpose of differentiating their brand. Matsumoto's share of the nationwide drugstore market is only about 8%. Its focus on cosmetics gives it a slightly higher edge of the cosmetics market, at probably 11%, and following a merger with Cocokarafine, we expect the share of the cosmetics market to rise to 19%. This expansion of market share should afford Matsumoto Kiyoshi an opportunity to further strengthen its private label assortment, but any pricing power the company achieves will be limited to its line of private label goods. Most of its merchandise will still be subject to intense pricing pressure.

Mergers and Acquisitions

Japanese retailers are no strangers to acquisitions. Of the 16 companies in our coverage, only two can claim to have relied on organic growth for 100% of their expansion, and eight consider M&A to be an essential component of their current strategy. Typically, however, an acquisition of a small company by a large one does not confer significant pricing power on the surviving entity, as the Japan Fair Trade Commission does not allow mergers that eliminate consumer choice in any local market. Only when merged entities subsequently develop a differentiated merchandising strategy can any pricing power be derived.

Mergers are typically more useful in helping to reduce the cost of advertising, distribution and procurement. Even if the merged entities cannot easily raise prices, they are often able to lower their costs. Most of the time, though, we cannot predict the timing or targets of such acquisitions, so counting on M&A for investment ideas is usually a difficult way to make money, in our view.

Steel/Trading Houses/Energy

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The companies that have consolidated or are consolidating in the sectors covered

Refiners—Oligopoly provides strong pricing power. Three refiners in Japan corner the refined oil products market. Recently ENEOS (5020 JP, Buy) merged with TonenGeneral in 2017, and Idemitsu Kosan (5019 JP, Buy) merged with Showa Shell 2019. The only independent refinery is Cosmo Energy (5021 JP, Hold). These three have tremendous pricing power in Japan. For example, despite plummeting Singapore margins, refinery spreads in Japan have been stable at around ¥10–11/liter. Thus, the domestic business is a cash cow. On top of this, due to ESG pressure, refiners are more conscious of shareholder returns and have pledged to pay out, on average, half of their earnings to shareholders. We think that this sector provides strong underlying fundamentals.

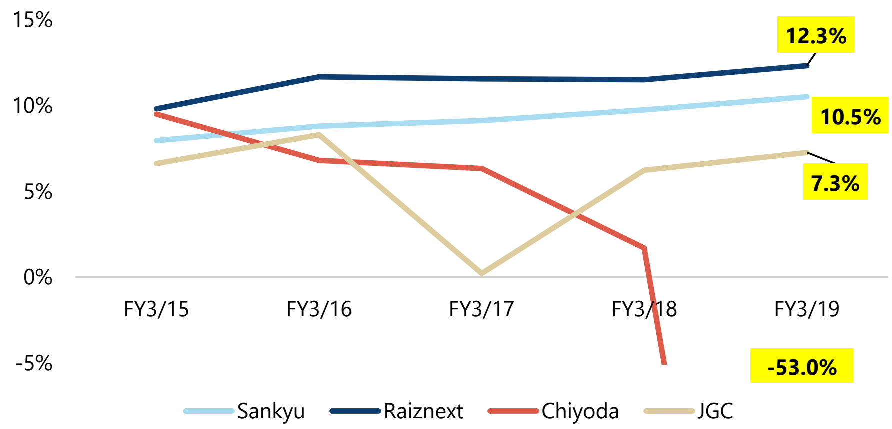
How is consolidation impacting the pricing power of each player in the sector(s)?

Graphite electrodes have been consolidating in the last decade—Graftech (EAF) went bankrupt/was sold to a PE fund; SGL was sold to Tokai Carbon (5301 JP, Buy)/Showa Denko (4004 JP, Buy), and there was a hard close of 20% of capacity. Graphite electrodes are essential for producing steel in electric arc furnaces (EAFs). Recycling scrap steel is also experiencing a secular growth trend. Mini-mills are responsible for about 70% of steel production in the US, and about 45% in Europe. On the other hand, Asian steelmakers are still producing the bulk of their products via blast furnaces—melting iron ore with coking coal. However, a focus on the environment should boost the EAF ratio in the future, and demand for high-quality graphite electrodes should increase. Growing demand is meeting tight supply (limited capacity, and expanding production facilities is unlikely due to strict environmental controls). Thus, we expect price inflation for graphite electrodes as soon as H2 CY21. This would benefit major players, such as Tokai Carbon or Showa Denko.

Plant maintenance is a niche industry, as most plant owners have their own maintenance subsidiaries. Sankyu (9065 JP, Buy) and Raiznext (6379 JP, Buy) are the only independent and listed companies that provide maintenance service to large-scale plants. Excluding plant owners' subsidiaries, third-party maintenance (3PM) is a duopoly dominated by two companies. Continued increasing orders for Sankyu and Raiznext imply that plant owners do not have alternative maintenance service providers. Both Sankyu and Raiznext have been improving their profitability over the past few years, supported by increasing demand and a favorable competitive environment. Compared with EPC companies such as Chiyoda (6366 JP, Hold) or JGC (1963 JP), which usually target a GPM of 7–8%, plant maintenance companies already achieved GPM of more than 10%. Raiznext merged with JX Engineering, a 100% subsidiary of ENEOS, in July 2019, and we think there is a possibility that ENEOS may fully acquire Raiznext to procure enough resources for maintenance. Further consolidation would tighten industry supply/demand and benefit Sankyu, in our view.

Please see important disclosure information on pages 20 - 25 of this report.

Exhibit 19 - Plant Maintenance Companies' GPM



Source: Company data, Jefferies

In which sub-sector do you expect consolidation?

Steelmakers: Yes

Trading companies: No

Oil refiners: No

Non-ferrous metal: No

Plant engineering: Yes

Graphite electrode: No

Titanium: Yes

Road construction: Yes

Tech Precision / Semi Equipment

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The companies that have consolidated or are consolidating in the sectors covered

Fujifilm is acquiring Hitachi's medical business. Fujifilm's Japan domestic market share in medical devices is now around 15%, and will go up to 20%.

Financial leverage?

Ricoh and Toshiba Tech's leverage are relatively high—their debt-to-equity ratios are above 200%.

In which sub-sector do you expect consolidation?

Printing :Yes

The printing market is maturing, and this trend is being accelerated by COVID-19. Tier-2 companies' earnings environments will be severe, and drastic change in profit structure will be needed.

SPE :Yes

The combined market share of the top-three companies in SPE is 70–80%. In the next stage, integration between different forms of equipment and expanding product portfolios will continue.

Analytical instruments: Yes

There are many small or mid-sized analytical instrument makers in Japan. These companies have specific products and technologies, but if they consolidate or are acquired by larger companies, there should be synergies.

Medical devices: Yes

Japanese medical companies are relatively small compared with the global competition. Integration and increasing corporate business domains will continue.

Relevant report links

Office Equipment: Major Changes Coming—Initiate on Brother & Toshiba Tec (29 June)

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(Article 3(1)e and Article 7 of MAR)

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