

May 1, 2015

Dear clients and colleagues,

Japanese corporate behavior is changing. Abenomics has set up a roadmap to corporate reform, putting corporations at the front and center of its structural transformation. As a result, we have seen several powerful changes ranging from the Japan Stewardship Code and the Corporate Governance Code, to reforms to the public pension investment policy and the introduction of the JPX Nikkei 400 (a new ROE-driven equity index).

Better corporate governance and higher ROE should rekindle interests in Japanese equities. The average ROE of listed companies in Japan was 8.6% in FY2013/3. However, most companies have ROEs of around 4%. Institutional investors typically expect a ROE of at least 8% on Japanese stocks.

This week we feature Pola Orbis, a Japanese company that has been increasing its ROE since 2012. We initiated a position in August 2014, and its outperformance has been clearly supported by better corporate behavior.

Pola Orbis (4927 JP - ¥6,560)

www.po-holdings.co.jp/en/

Business Overview

Founded in 1929, Pola Orbis is the fourth largest cosmetics maker in Japan. The company is known for its skincare products for anti-aging and skin whitening. It has nine brands within its portfolio; this includes its flagship brands POLA and ORBIS, and its overseas brands, Jurlique and H2O PLUS.

Unlike peers who usually sell products in stores, Pola Orbis uses various distribution channels. As an example, POLA products are commonly sold directly to customers through home visits from its 150,000 POLA Ladies. ORBIS is distributed online and through catalogs, while other brands are sold in stores.

Pola Orbis has a 6% market share in the Japanese skincare market. Asia accounts for 12% of total sales, and is growing at a double digit pace.

ESG

Pola Orbis has a comprehensive ESG report that identifies important issues, addresses each topic, and provides a progress report each year. Back in 2000, it had already obtained the ISO-14001 certification for environmental management systems, demonstrating a commitment to preventing global warming and realizing a sustainable society. The corporate culture encourages a healthy work-life balance, female career advancement, and involvement in the local community.

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The management team is very stable. The CEO is the grandson of the founder. The founding family owns 60% of the company. Two out of seven of the directors are independent. Also, the dividend payout ratio is high at 50%.

Market Data

Market Cap \$3.1Bn, Net Cash \$413Mn, Dividend Yield 2.3%, P/E (2016/12) 28.1x, Ev/Sales 1.5x, Ev/Ebitda 10.6x, Gross Margin 80.2%, Operating Margin 8.9%, Profit Margin 5.2%, ROE 5.9%

Target Market

The Japanese skincare market is approximately \$28Bn in size, growing at 1.5-2% per year. This is mainly due to the increasing presence of value-added products. Within skincare, anti-aging and whitening account for 50% of sales and are growing more rapidly. This segment is what Pola Orbis is focused on.

The Skincare market in China is expected to maintain a CAGR of 9%, according to Euromonitor International.

Competition

Kao, Shiseido, Kose, Fancl, DHC

Competitive Advantages

- Strong brands
- Innovation: Pola Orbis boasts the highest number of top-of-the-line cosmetic-related patents in Japan
- #1 in the Home-visit sales market, with a nationwide network and long-lasting relationships with customers

Growth Strategy

- Product: Develop new products with higher added-value
- Distribution: More store openings in Japan; expand in Asia, especially China
- Consolidation: Acquire new brands

Risks

- Weak consumer sentiment in Japan
- Intensifying competition and rising labor costs in China

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We met Pola Oribis in Tokyo last March. The CEO considered improving capital efficiency and profit distribution as priorities. A ROE target of at least 8% in FY2016 was reiterated, which is compared to 4.3% in FY2013. This week, Pola Orbis announced better-than-expected first quarter results, and maintained full-year guidance of double-digit growth in operating profits. We are confident that it is able to expand its margin further through cost reductions, better product mix, and new brands turning profitable.

Have a nice weekend.

The Global Alpha Team

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