

Showa Paxxs Corp. (3954:JP)

Positive EBITDA business (8x P/E); growing BV at 8%+ CAGR but trading at <39% of BV

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Price Target: ¥3475

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Executive Summary:

Showa Paxxs is a Japanese net-net that trades at 38.5% of book value. Using the net-current asset value framework of Graham and Dodd, we valued Showa Paxxs on a liquidation basis at ¥15,464m. This value derives primarily from their large cash position and equity portfolio. Including PP&E discounted by 50% the liquidation value would be ¥18,047m. Alongside the significant margin of safety, there are catalysts for value realization in the short term driven primarily by corporate governance reforms which have increased pressure to return capital to shareholders.

Company Overview:

Showa Paxxs is the domestic leader in kraft paper bags for synthetic resin products, chemical products, rice, and barley. Established in 1935 under the name of Showa Seitai Kogyo, it leverages advanced technical expertise and high value-added products to differentiate from others and is gradually increasing its market share in kraft paper bags as a result of the acquisitions of regional companies in the same business. Showa also has strengths in sales to the petrochemical industry for the use in export packing materials. Produces kraft paper bags at its subsidiary in Thailand, which is positioned as an export base to China and Asia, in addition to Thailand's domestic market. Packaging bags centering on kraft paper bags account for a majority of the total sales and profits. The company also engages in the manufacture of film products for agricultural and industrial use.

Product Description:

Heavy-Duty Packing Bag:

- Domestic leader in kraft paper bags for synthetic resin products, chemical products, rice, and barley
- Produces kraft paper bags at its subsidiary in Thailand, which is positioned as an export base to China and Asia, in addition to Thailand enjoying growing demand
- Different bags produced include sewn bottom bag, bag in bag, easy open bag, pinch bottom bag, pasted bottom bag, valve bag and bag + box (bax)
- Financial performance highlighted in Figure 2

Film Products:

- They offer both industrial and agricultural use films
- Industrial-Use Films: Estite, Eslap and Pallet Cover
- Agricultural-Use Films: Kiriyoke Bernal, Super Bernal, High Clear Fruit, and Agricultural Sakubi
- Financial performance highlighted in Figure 3

Containers:

- Widely used in a range of fields from transporting powders and liquids
- Type of container required varies by the contents being transported and thus Showa Paxxs offers them in various types
- Financial performance highlighted in Figure 4

Packaging Machine Equipment:

- Simple packing and automatic packing machines

Key Ratios and Statistics (€M):

Price Target	¥3475
Upside	92%
Share Price (10/3)	¥1810
Market Cap (mm)	¥8036
Enterprise Value	¥1390
52-Week Low	¥1484
52-Week High	¥1924

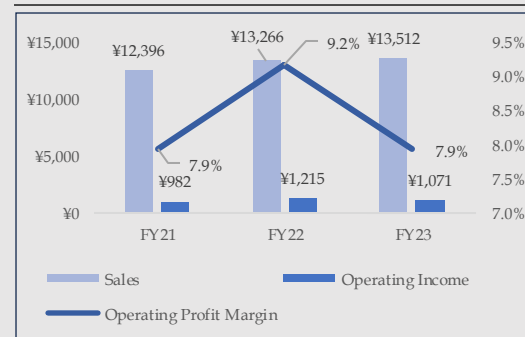
Historical Financials

(¥M)	2021A	2022A	2023A	2024E
Revenue	19,938	21,599	22,277	21,163
Gross Profit	3,650	3,983	3,738	3,492
EBIT	1,170	1,404	1,116	847

Figure 1. Shareholding Structure

Investor Name	% Outstanding
Sun A. Kaken Co Ltd	19.01%
Shinsei Pulp & Paper Co., Ltd.	18.81%
MUFG Bank, Ltd.	3.03%
Tokushu Tokai Paper Co Ltd	2.92%
Morofuji (Shuhei)	1.84%
Mizuho Bank, Ltd.	1.80%
Showa Paxxs Corp. Employees	1.62%

Figure 2. Heavy-duty Packing Bags Overview



Situation Overview

Historically Japanese management of public companies have not aligned their interests with shareholders. Often, they have viewed them as an opposing force to their interests. Unlike in the US, management in Japan has been very slow to unlock value for shareholders. This is primarily driven by complex shareholding structures and a lack of activist investing. The revolution in corporate governance took place in the US close to 3 decades ago but is still yet to take place in Japan. This has led many Japanese companies to trade at significant discounts to tangible book value with unlevered asset-rich balance sheets.

Additionally, unlike in the US where the board tends to be quasi-independent from management, Japanese boards tend to be made up solely of management. This means that it tends to be harder to use the board's fiduciary responsibility as a lever to enact change.

Investment Thesis

Discount to Book Value Shrinking

Showa currently trades at approximately 1810 yen/share. With 4,441,000 shares outstanding. This translates into a market cap of Yen 8.15 billion (approx. USD 55 million). For FY2023 they reported net income of Yen 947 million and book value of Yen 21,255 million. This equates to a trailing P/E ratio of 8.6x and a Price/Book Value of 0.38. The company has a net cash balance of Yen 930 million.

To further demonstrate how cheap the business is we can look at it on an EV/EBIT basis. Showa for FY2023 reported EBIT of Yen 1,116 million against an Enterprise Value of Yen 507 million. This results in an EV/EBIT multiple of 0.45.

a) Core Business is Value Accretive

The company has historically traded below a Price/Book Value of 1, as shown in Figure 5, which is indicative of the fact that the market effectively expects them to deliver a rate of return less than the cost of capital, destroying value for shareholders in the long run. However, this has not been the case. In 2014, the company only had net cash of Yen 108 million yen compared to Yen 930 million today. Book value increased from Yen 6,664 million in FY2010 to Yen 21,255 million in FY2023, which represents a 7% CAGR. This is not the typical growth profile of a company that is trading at 35% of book value. If we were to go ahead and also include the Yen 1,060 million of dividends that have been paid out since FY2010 then the CAGR for book value + dividends would be 8%+. The low capex demands and above-average return on equity profile mean that this business is likely to get cheaper over time as IAG holds it in its books.

To further validate this thesis, we calculated an adjusted ROE metric where all non-core assets have been removed from SE. This results in an adjusted ROE of 15.6% as opposed to an unadjusted ROE of 5.6%. Showa Paxx's ROE is artificially lowered because of their asset-heavy balance sheet, which obfuscates the true quality of the business. This can be seen in Figure 6.

We also built a ROIC build, which inherently excludes all non-operating assets. This can be seen in Figure 7. Showa Paxx's 5-year average ROIC is 11.7% and conveys a similar story as our adjusted ROE calculation. This gives us further confidence in the core business and is also reflective of management who while may not have been the most efficient capital allocators in the past have certainly not destroyed value in the last 20 years.

Figure 3. Film Products Overview

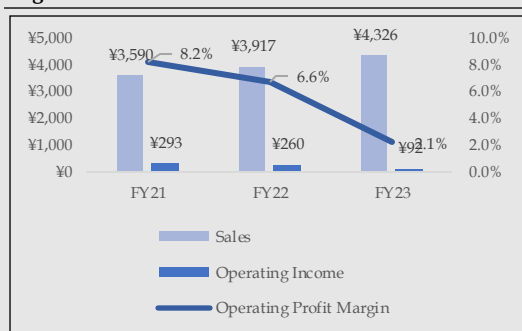


Figure 4. Containers Overview

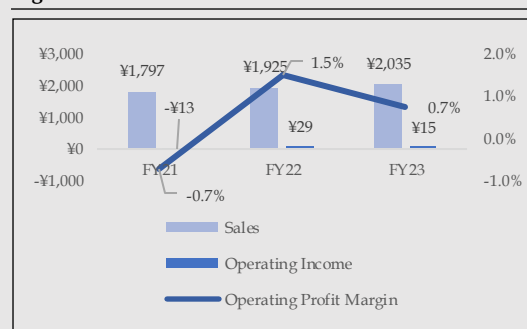


Figure 5. Discount to Tangible Book Value

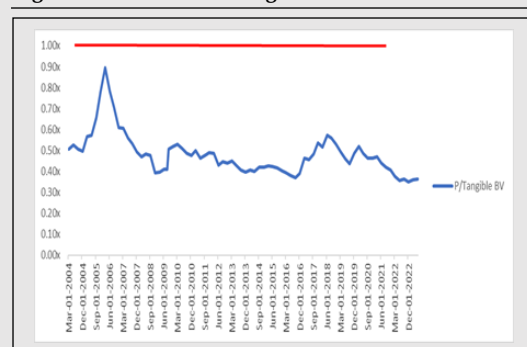


Figure 6. Adjusted ROE Build

For the Fiscal Period							5yr Avg
Ending	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22	31-Mar-23	
Currency (in millions)	JPY	JPY	JPY	JPY	JPY	JPY	JPY
Net Income	873	1,000	894	741	942	797	875
SE	15,770	16,142	16,899	19,058	20,075	21,255	18,686
Non Operating Assets (-)							
Cash & Cash Equivalents	6,114	7,023	7,235	7,575	8,047	8,152	7,606
Short Term Investments	0	0	0	0	0	0	0
Long Term Investments	5,877	5,089	4,687	6,763	6,839	6,837	6,043
Adjusted SE	3,779	4,030	4,977	4,720	5,189	6,266	5,036
Normal ROE	5.53%	6.19%	5.29%	3.89%	4.69%	3.75%	4.76%
Adjusted ROE	23.10%	24.81%	17.95%	15.70%	18.14%	12.72%	17.87%

Figure 7. ROIC Build

IC Calculation	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22	31-Mar-23
Operating Current Assets	9,774	9,102	8,630	9,409	9,878
(-) Non-interest bearing current liabilities	6,640	5,481	5,168	5,952	5,589
Net Working Capital	3,134	3,621	3,462	3,457	4,289
(+) Net PPE	4,268	4,299	4,747	4,894	5,165
(+) Acquired Intangibles	19	26	52	146	261
(+) Goodwill	0	0	0	0	0
(+) Other	0	0	0	0	0
Invested Capital	7,421	7,946	8,261	8,497	9,715

NOPAT Calculation	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22	31-Mar-23
EBIT	1,523	1,361	1,170	1,403	1,116
Effective Tax Rate	26.82%	27.02%	27.41%	26.32%	25.06%
NOPAT	1,114	993	849	1,034	836

ROIC Calculation	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22	31-Mar-23
ROIC Calculation	15.02%	12.50%	10.28%	12.17%	8.61%

5yr Avg
11.71%

Thesis Points Continued:

b) Regulatory Changes in Japan

Unlike in the US, the corporate governance revolution has yet to take place in Japan. This is primarily driven by complex shareholding structures and a lack of activist investing in Japanese companies. This revolution took place in the US close to 3 decades ago, with companies no longer trading at significant discounts to tangible book value with unlevered asset-rich balance sheets.

The Tokyo Exchange Group recently finalized its market restructuring rules. There have been rumors about changes coming to these rules since January of last year, but they have finally been confirmed and finalized in early June of 2023. Prior to the reform, the Tokyo Stock Exchange had four market divisions: 1st Section, 2nd Section, Mothers, and JASDAQ (Standard and Growth). The reason for this was that when TSE and Osaka Securities Exchange integrated their equity markets in 2013, TSE maintained the existing market divisions of each one to avoid an impact on listed companies and investors. This created a multitude of issues. The first and minor one is that the concept of each market division is ambiguous, which reduces convenience for many investors. There is overlap between the intended uses of the 2nd section, Mothers, and JASDAQ markets, and the concept of the 1st Section is unclear. Furthermore, the prior market divisions were not providing sufficient incentives for listed companies to sustainably increase corporate value. For example, since delisting criteria were significantly less strict than the initial listing criteria, the delisting criteria did not incentivize listed companies to continue to satisfy after listing the level of quality required at the time of initial listing.

Thus, the TSE has introduced a broad range of new measures to revamp the Japanese stock market. The official exchange documentation is detailed in Figures 9 and 10. Among the latest measures was one that directed listed companies to “comply or explain” if they are trading below a price-to-book ratio of one. The TSE warned that such companies could face the prospect of delisting as soon as 2026. There is a strong case to be made that this will press Japanese companies’ notoriously resistant management (which has historically not cooperated with shareholders) for greater capital efficiency and profitability. There has been a historic case of companies and managers not proactively listening to shareholder proposals. Furthermore, rules will also require companies to publish public disclosures in English, alongside the currently provided statements in Japanese.

The impact of these reforms has been felt abruptly. After we went through the last 18 years of Showa Paxx’s earnings management has not once mentioned the word ‘shareholders’. However, this changed in Q1 of FY2024 with management stating “The group is committed to management based on the belief that it is necessary to strike a balance between customer satisfaction, securing profits, and returns to shareholders, while simultaneously fulfilling these three objectives”. They also stated “returning profits to shareholders is one of its most important management policies”.

We also had the opportunity to talk to an expert on Japan who also runs an IR business in Japan. He similarly echoed our view of immense pressure on management. He also cited the reforms in the Company Act which has increased corporate governance pressure, which in combination with the likely introduction of a tax on retained earnings leads to strong catalysts for value realization.

Figure 8. JPX Market Segment Reforms

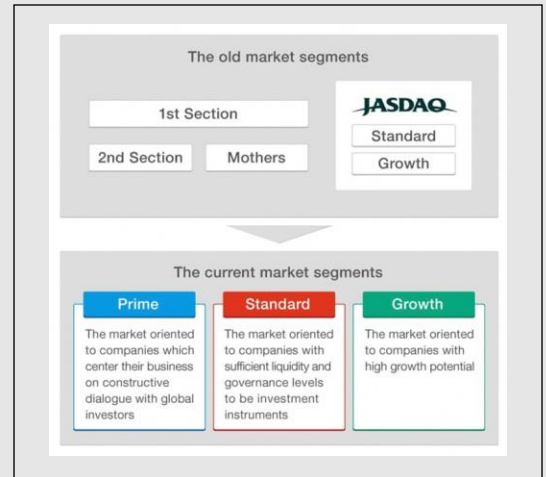


Figure 9. JPX Market Reform Requests

Details of Request

Companies Subject to Request

- All companies listed on the Prime and Standard Markets.

Requested Action

- In order to implement management that is conscious of cost of capital and stock price, please implement the following series of actions on an ongoing basis.
 - Analysis of Current Situation**
 - Gain a proper understanding of the company's cost of capital and profitability
 - Analyze and evaluate the current situation around these and the market valuation at board of directors meetings
 - Planning & Disclosure**
 - Have board of directors discuss and develop policies, targets, planning periods, and specific initiatives for improvement
 - Disclose clear information on these, along with assessment of the current situation, to investors
 - Implementation of Initiatives**
 - Push forward with management that is conscious of cost of capital and stock price, based on the disclosed plans
 - Engage in proactive dialogue with investors based on this disclosure

Note: Key points to consider when implementing each action are summarized from page 3.

Start Date

- Since analysis and discussion of the current situation must be carried out sufficiently before planning and disclosure can begin, TSE is not specifying a timeframe for the start date of disclosure, but requests as prompt a response as possible.

Note: If it takes some time to analyze and discuss the current situation, disclosure could be expanded in stages, for example by first indicating the level of progress of plan development and preparation for disclosure and the expected timing of disclosure, and then disclosing specific details once the plan is developed.

Figure 10. JPX Cost of Capital Reforms

Key Points to Consider for "Analysis of Current Situation"

Examples of Possible Indicators

Cost of Capital	Balance Sheet Profitability	Market Valuation
<ul style="list-style-type: none"> Weighted Average Cost of Capital (WACC) Cost of Equity (rate of return expected by investors) etc. 	<ul style="list-style-type: none"> Return on Invested Capital (ROIC) Return on Equity (ROE) etc. 	<ul style="list-style-type: none"> Stock Price and Market Cap. Price-to-Book Ratio (PBR) Price Earnings Ratio (PER) etc.

Note 1: Although there is no specific standard for which indicator to use, please consider which one to use in light of investors' needs and other factors.

Note 2: The purpose of calculating the cost of capital is to analyze the current situation, not necessarily to calculate it in a precise manner.

Questions to Answer and Points to Note

Questions to Answer in Analysis and Assessment	Points to Note
<ul style="list-style-type: none"> Whether the company has achieved profitability that exceeds its cost of capital, and if not, the reasons why 	<ul style="list-style-type: none"> In analyzing and assessing profitability, companies could use ROIC in comparison with WACC, and ROE with cost of equity In addition to company-wide analysis and assessment, companies could calculate ROIC or other indicators for each business segment and analyze/assess profitability for each one
<ul style="list-style-type: none"> Even if the company has achieved the above, if the market valuation is not high enough (e.g., PBR less than 1), the reasons why 	<ul style="list-style-type: none"> If profitability exceeds cost of capital but the PBR is not high enough (e.g., below 1), it suggests that investors are not seeing enough growth potential. Companies could also analyze/assess PBR, PER, or similar indicators in terms of changes over time and comparison with other companies in the same industry.

Thesis Points Continued:

c) Pressure from Activist Investors

In 2022, activist investors sent a record total of 293 shareholder proposals to a record number of 77 Japanese publicly listed companies with demands on changing the capital structure, management pay, and overall transparency in disclosures. Highlights from 2022's proxy season include the following:

- 816 directors failed to attain majority support (104 more than in 2021)
- Support levels for say-on-pay proposals dropped to 85% on average, the lowest level in five years
- Greater number of retail shareholders, but their voting participation remains relatively low compared to that of institutional shareholders

Surprisingly, a large portion of such proposals were approved. And even those proposals that were not approved put companies' management on notice that the change is required, and pressure will likely persist. Historically, Japanese companies have been known for their large cross-holdings, especially between companies that cooperate with each other. This has led to unnecessary capital tie-ups that would sit on companies' balance sheets for years.

Investor activism does not necessarily originate from foreign institutions. Japan's Government Pension Fund, which is one of the largest owners of Japanese equities is also pushing for significant. In their mandate, if a particular company is not able to achieve at least 8% ROE in the medium term, the fund will pressure the company for a management change.

Typically, cross-shareholdings are seen as a significant disadvantage by activist investors or to unlock value more generally. Showa owns approx. 11.5% of Sun A. Kaken and conversely Sun A. Kaken owns approx. 20% of Showa. Sun A. Kaken has been running its own share-buyback program given pressure from Shinsei Pulp & Trading which is also a common shareholder of both companies. Shinei Pulp & Trading is putting similar pressure on Showa Paxxs. The added cross-shareholding and similar industry serve as indicators that Showa Paxxs is likely to follow suit. This was also further confirmed in our discussion with the expert on Japan as he said that typically companies tend to set dividends and capital return targets based on proxy peer groups historically.

Investment Summary:

In no way are we trying to argue that management is outstanding, excellent at capital allocation, or that this is a high-quality business.

We believe that at current prices, we are offered an incommensurate reward to risk profile by Showa Paxxs. The margin of safety is immense, and the downside risk is significantly minimized due to the fact that the operating business accounts for such a small proportion of the value hidden within Showa Paxxs.

Furthermore, our belief is that the timeline for value realization will be expedited given both extrinsic and intrinsic factors related to corporate governance reforms and activist involvement.

Valuation:

Revenue Build Base Case								
For the Fiscal Period Ending	31-Mar-23	31-Mar-24	31-Mar-25	31-Mar-26	31-Mar-27	31-Mar-28	31-Mar-29	31-Mar-30
Currency (in millions)	JPY	JPY	JPY	JPY	JPY	JPY	JPY	JPY
Revenues								
Heavy Packaging Bag	13,830	13,139	12,482	11,857	11,265	10,701	10,166	9,658
% YoY growth	4.25%	-5%	-5%	-5%	-5%	-5%	-5%	-5%
Film products	3,842	3,650	3,467	3,294	3,129	2,973	2,824	2,683
% YoY growth	-1.94%	-5%	-5%	-5%	-5%	-5%	-5%	-5%
Other	2,492	2,367	2,249	2,137	2,030	1,928	1,832	1,740
% YoY growth	11.61%	-5%	-5%	-5%	-5%	-5%	-5%	-5%
Real Estate Rental	250	237	225	214	203	193	183	174
% YoY growth	-2.63%	-5%	-5%	-5%	-5%	-5%	-5%	-5%
Container	1,863	1,770	1,682	1,598	1,518	1,442	1,370	1,301
% YoY growth	-3.21%	-5%	-5%	-5%	-5%	-5%	-5%	-5%
Corporate	0	0	0	0	0	0	0	0
% YoY growth		0%	0%	0%	0%	0%	0%	0%
Total Revenues	22,277	21,163	20,105	19,100	18,145	17,238	16,376	15,557
% YoY growth	3.14%	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%
(less) COGS	18,539	17,671	16,788	15,948	15,151	14,393	13,674	12,990
% rev	83.22%	84%	84%	84%	84%	84%	84%	84%
Gross Profit	3,738	3,492	3,317	3,151	2,994	2,844	2,702	2,567
% Gross Margin	16.78%	16.50%	16.50%	16.50%	16.50%	16.50%	16.50%	16.50%
(less) SG&A	2,622	2,645	2,513	2,387	2,268	2,155	2,047	1,945
% rev	11.77%	13%	13%	13%	13%	13%	13%	13%
EBIT	1,116	847	804	764	726	690	655	622
% Blended EBIT Margin	5.01%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%

3954 DCF Base Case							
As of 7/19/2023							
Year	2024e	2025e	2026e	2027e	2028e	2029e	2030e
Period	1	2	3	4	5	6	7
EBIT	847	804	764	726	690	655	622
Corporate Tax Rate	30.62%	30.62%	30.62%	30.62%	30.62%	30.62%	30.62%
EBIAT	587	558	530	504	478	454	432
D&A	500	500	500	500	500	500	500
Change in Net Working Capital	(666)	(208)	(202)	(189)	(157)	(164)	(138)
Capex	(500)	(500)	(500)	(500)	(500)	(500)	(500)
Unlevered Free Cash Flows	(79)	350	328	315	321	291	294
Discount Rate	11.00%	11.00%	11.00%	11.00%	11.00%	11.00%	11.00%
PV of FCF	(71)	284	240	207	191	155	142
Sum of I (stage 1)	851						

3954 Value Base Case	
Perp. Rate	0.00%
Implied EV/FCF	7.28x
Discount Rate Used	11.00%
Free Cash Flow in 1+t	293.92
Terminal Value	2,671.98
PV of Terminal Value	1,286.98
Enterprise Value	2,138.45
less Debt	(1,874.00)
plus Cash and Cash Equivalent	14,989.00
Equity Value	15,253.45
Diluted Shares Outstanding	4,400,000
Equity Value per Share	¥ 3,466.69
Upside	92%

Current Share Price	¥	1,810.00
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FX Analysis:

Showa Paxxs' financial statements are all in terms of Japanese Yen. For the year ended March 31st, 2023, revenue denominated in US dollars accounted for 0% of total revenue. All revenue earned was in Japanese Yen.

USD/JPY is currently trading at 149.91, which is the highest level in 11 months. The Japanese Yen is likely to continue to depreciate against the dollar in the short to medium term due to higher inflation and rates taking time to catch up. If the BOJ does lift off through the ending of the YCC program, we could see upside potential in the Yen through fixed-income buying. Chances of this are low as Ueda recently clarified that a recent comment regarding a quiet exit from monetary easing was misinterpreted. Elevated Treasury yields have also been providing strong support to the dollar.