

Lacto Japan

Independent trading company handling dairy ingredients, cheese: seeks growth via rise in Japan's import ratio and in Asian consumption

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Business

One of Japan's leading independent trading company focused on dairy products; expanding into meat products, Asia market

Leading company with a share of approximately 38% in dairy ingredients, cheese imports: Lacto Japan is the nation's biggest independent specialist trading company of dairy ingredients and cheese (38% import share in FY11/18). It imports dairy ingredients and cheese from milk-producing nations globally, for wholesale mostly to leading domestic food makers. The company handles around 40 general-purpose ingredients and over 500 customized (primary processed) products. With no corporate affiliations, it has about 140 suppliers and a diverse range of customers. In 13 years, its dairy ingredient and cheese handling volume has grown 2.7x, from 76,868 tons in FY11/06 to 204,105 tons in FY11/19. The company's sales and profit come mainly from the fees (commissions) on these imports. Adjusted for forex gains and losses, its operating profit margin is about 3%. The company has 285 employees (as of November 30, 2019). Lacto Japan was founded by long-standing employees of Toshoku (dairy product division), in response to pleas from the latter's suppliers and clients following its collapse.

New business domains: Aside from its dairy ingredients and cheese business (73.0% of sales in FY11/19), Lacto Japan has imported meat products since FY11/05 (10.5%). It also has an Asian business centered in Singapore, engaged in dairy ingredient importing and the manufacture and sale of cheese (16.5%).

Performance trends

FY11/20: company forecasts ordinary income rise of 9.2% YoY (+5.1% in FY11/19)

FY11/19 earnings: FY11/19 sales of JPY116.8bn (+1.2% YoY) and ordinary income of JPY2.8bn (+5.1%) were both new record-highs. Although sales volume increased 5.0% YoY, sales came in 6.7% below the company's initial forecast, reflecting yen appreciation in 1H and a fall in the average unit price as new free trade agreements came into effect. Ordinary income broadly matched guidance, due to higher sales volume, product mix improvement, and sales efforts.

FY11/20 forecast: For FY11/20, the company is forecasting sales of JPY130.0bn (+11.3% YoY) and ordinary income of JPY3.0bn (+9.2%). The forecast reflects the company's expectation that domestic companies will continue to shift toward using more imported dairy products in response to the ongoing decline in domestic milk production. In FY11/20, the company forecasts that overall sales volume will increase 9.6% YoY, including dairy ingredients/cheese (+4.7%), meat products (+38.9%), dairy ingredient sales in Asia (+16.0%), and cheese manufacturing in Asia (+4.3%). In short, the company expects sales volume to increase at all businesses. ◦

Strengths and weaknesses

Strengths

Wealth of information, ability to offer solutions, respond to client needs: Lacto Japan is a leading specialist trading company with a share of some 38% in dairy ingredients and cheese imports. Over the years (including the Toshoku era), it has amassed a wealth of specialist expertise and know-how.

Independence: Being free of capital alliances or complex trading relationships is the key difference vs. rival general trading companies; diversity of suppliers (about 140) and customers.

Presence in Asia and manufacturing function:

Lacto Japan has been in Singapore for nearly 20 years. It set up plants and added manufacturer to its trading company identity before general trading companies invested in manufacturing dairy products in Asia.

Weaknesses

Heavy reliance on domestic market

(constraint on growth): Although the import ratio has increased, dairy product consumption in Japan remains flat.

Limits on potential for adding value: Lacto Japan's stable supply of ingredients is a source of added value, as are the above information resources and ability to offer solutions and respond to customer needs. Still, in comparison with suppliers and customers, potential for adding value is limited.

Profit growth drivers

To Date: Importing dairy ingredients and cheese into Japan (and sales)

Medium term: Above plus cheese manufacturing and dairy ingredient sales in Asia

Indices	
Market capitalization	JPY38.0 bn
Stock price (2020/1/29)	JPY3,865
Issued shares	9,835,200 shares
Foreign stockholding ratio	8.60 %
BPS (FY11/19)	JPY1,618.31
PBR (FY11/19)	2.39 x
PER (FY11/20 Est.)	18.1 x
Dividend (FY11/20 Est.)	JPY30.00
Dividend yield (FY11/20 Est.)	0.78 %
ROE (FY11/20 Est.)	13.2 %
Net debt / Equity ratio (FY11/19)	81.7 %

*Number of issued shares includes treasury stock

Medium-term strategy

Achieve sustained growth by expanding customer base, developing new products, and increasing scale of operations in Asia

Medium-term plan: Under its NEXT-LJ2022 medium-term business plan, the company is targeting FY11/22 sales of JPY141.0bn (+120.7% vs FY11/19) ordinary income of JPY3.5bn (+127.4%), and net income of JPY2.5bn (+127.4%). The target figures assume increased sales via ongoing growth in sales volume, from 289,300 tons in FY11/19 to 343,575 tons in FY11/22, and rising contributions to earnings from overseas businesses. In developing new dairy ingredients, Lacto Japan will give due consideration to the minutiae of free trade agreements involving milk-producing regions around the world. It will also look to cultivate new supply lines not just in traditional dairy powerhouse nations but also in emerging areas such as Eastern Europe. At the same time, the company will continue with efforts to expand its customer base, as well as developing and starting to sell new products in such areas as functional dairy ingredients, processed foods, healthcare ingredients, and milk proteins. With a view to expanding its business in the fast-growing Asian market, Lacto Japan furthermore seeks to increase handling volume in dairy ingredients, invest in additional manufacturing capacity for cheese, and enlarge sales channels in emerging ASEAN markets, modelled on the approach used in the Philippines.

		Sales (JPYmn)	YoY	Operating profit (JPYmn)	YoY	Ordinary income (JPYmn)	YoY	Net income (JPYmn)	YoY	EPS (JPY)	BPS (JPY)	ROA (OI-based)	ROE
FY11/14	Cons.	96,550	27.1%	1,532	118.8%	1,653	-1.0%	988	-1.9%	127.79	1,165.58	4.5%	12.2%
FY11/15	Cons.	98,001	1.5%	720	-53.0%	1,343	-18.8%	831	-15.9%	98.94	1,062.54	3.3%	8.5%
FY11/16	Cons.	88,679	-9.5%	3,349	365.1%	1,434	6.8%	946	13.8%	96.79	1,167.72	3.7%	8.7%
FY11/17	Cons.	101,335	14.3%	1,924	-42.6%	2,523	75.9%	1,755	85.5%	179.48	1,302.98	6.0%	14.5%
FY11/18	Cons.	115,441	13.9%	3,009	56.4%	2,613	3.6%	1,784	1.7%	182.31	1,462.35	5.5%	13.2%
FY11/19	Cons.	116,794	1.2%	3,144	4.5%	2,747	5.1%	1,963	10.0%	200.11	1,618.31	5.7%	13.0%
FY11/20	Est. Cons.	130,000	11.3%	-	-	3,000	9.2%	2,100	7.0%	213.62	-	-	-

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

Business

One of Japan's leading trading company of dairy products (roughly 38% import share); expanding into meat products, Asia market

Company overview

Among Japan's leading independent food trading company focused on dairy products

Lacto Japan is the nation's biggest independent specialist trading company of dairy ingredients and cheese (38% share of imports in FY11/18). The company imports dairy ingredients—which includes customized (primary processed) products and products that are extracted from concentrated raw milk, including whole milk powder, skim milk powder, whey (liquid separated out from milk solids during the manufacture of yogurt and cheese), and sweetened condensed milk—and cheese from milk-producing nations around the world. It then wholesales these imported dairy ingredients to leading domestic food makers, the Agriculture Livestock Industries Corporation (ALIC), and other entities. In all, Lacto Japan handles around 40 general-purpose ingredients and over 500 customized (primary processed) products. With no corporate affiliations, the company has 250 suppliers. Fees (commissions) for wholesaling (importing) serve as the main source of sales and profit. In real terms (adjusted for exchange gains and losses), the operating profit margin is about 3%. As of November 30, 2019, the company had 285 employees.

Background to establishment

Lacto Japan was founded by a team previously engaged in importing for dairy product division of Toshoku*, in response to strong pleas from Toshoku suppliers and clients after that company filed for bankruptcy, reportedly because of a subsidiary's excessive investments. Previous Chairman Shigeru Yasumi, who served as President from that time

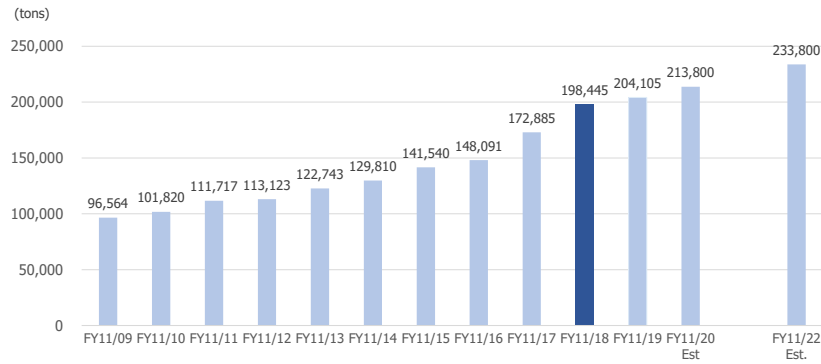
Among Japan's leading independent trading companies of dairy products

- ▶ Leading company with 38% share
- ▶ Imports dairy ingredients and cheese from milk-producing nations around the world (140 suppliers)
- ▶ Handles around 40 general-purpose ingredients and over 500 customized (primary processed) products
- ▶ Customers include leading domestic dairy product, confectionery, oil & fats, beverage, and animal feed makers
- ▶ Employees number 285 (as of November 30, 2019)

until February 2017, has worked with dairy products for his entire career of 47 years since joining Toshoku. Current President Motohisa Miura similarly was one of Lacto Japan’s founding members; over his many years at Toshoku and Lacto Japan, he has acquired a wealth of experience in selling dairy ingredients and cheese. Lacto Japan celebrated the 20th anniversary of its founding in May 2018.

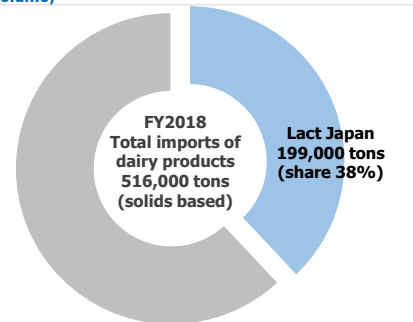
*Toshoku: a leading specialist food trading company, which filed for bankruptcy in 1997. Formerly a part of Mitsui and Co., it was founded in 1946 in line with the dissolution of conglomerates in postwar Japan.

Lacto Japan import volume (ingredients and cheese; solid content based)



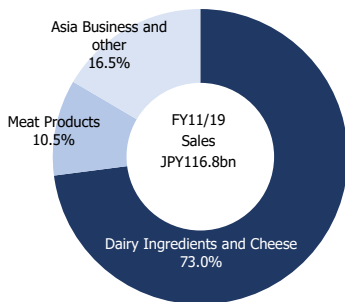
Source: Shared Research based on company data

Lacto Japan share of dairy products imports to Japan (by volume)



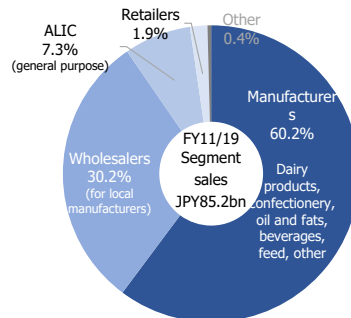
Source: Shared Research based on company data with reference to MAFF Food Balance Sheet
Note: Share calculated on solid content-based total imports (conversion factor: 0.1).

Sales by segment



Source: Shared Research based on company data

Sales by customer type (ingredients and cheese)



Source: Shared Research based on company data

Lacto Japan's defining characteristics

- Independent specialist trading company:** Aside from the relevant business units of large general trading companies such as Mitsubishi Corporation, Mitsui & Co., and Itochu Corporation, other dairy product trading companies tend to be small or mid-sized. Lacto Japan is distinguished by its full lineup of dairy ingredients and its lack of capital ties to other companies. According to management, Lacto Japan requires approximately 60 personnel to run its Dairy ingredients and Cheese divisions (as of November 30, 2019). Even the large general trading companies devote just five to ten people to this area. Other trading companies specializing in dairy ingredients usually are small in scale and focus on particular product categories.
- Long-standing relationships with suppliers and customers:** Lacto Japan plays the role of business partner both for dairy ingredient makers (its suppliers) and for domestic dairy product, confectionery, oil & fats, beverage, and animal feed makers (its customers). The company conveys information from overseas to customers, whose specific demands it relays to suppliers who then undertake primary processing, with Lacto Japan subsequently delivering the processed products to customers.

Expansion into new business domains

Aside from its dairy ingredients and cheese business, Lacto Japan also has run a business

- Expansion into new business domains
- ▶ Dairy ingredients and cheese (73.0% of sales in FY11/19)
 - ▶ Meat products (10.5%)
 - ▶ Asia business and other (16.5%)

importing meat products since FY11/05. In addition, it has an Asian regional headquarter in Singapore-based subsidiary Lacto Asia Pte. Ltd., with subsidiaries, second-tier subsidiaries, and affiliates in Malaysia, Thailand, Indonesia, the Philippines, and China. These companies are engaged in dairy ingredient wholesaling and in the manufacturing and sale of cheese (primary processing is conducted at company plants in Singapore, Thailand, and Indonesia).

Products handled and their respective sales weightings (in FY11/19)

- ▶ Dairy ingredients and cheese (73.0%): handles around 40 general-purpose ingredients and over 500 customized (primary processed) products

Dairy ingredients: Dairy ingredients are the raw materials for milk products (collective term for products made by processing raw milk). Raw milk can be converted into solids, powders, and so forth, and with the exception of cheese, these products can be reconstituted as milk and other types of dairy product.

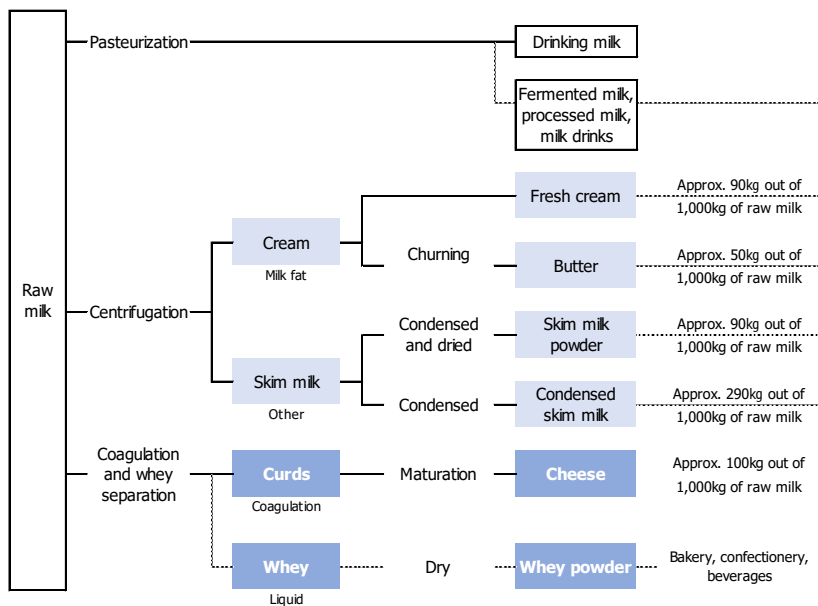
Whole milk powder: Whole milk powder is made by drying raw milk to remove water. In comparison with skim milk powder, whole milk powder has higher fat content. It therefore is not suited to long-term storage, as fat oxidation can cause the taste to deteriorate quickly. Whole milk powder primarily is used as an ingredient in cafe au lait and other canned coffee blends (coffee drinks), and in milk tea-type tea drinks.

Skim milk powder: Skim milk powder is made by removing water from skim milk (raw milk that has had the milk fat removed). It also is widely used in the food industry, as in comparison with whole milk powder it has a longer shelf life.

Curd: Curd is a dairy product obtained by coagulating raw milk through the addition of acids or enzymes such as chymosin. When the curd is molded and then heated, the result is natural cheese.

Whey: Whey is the liquid remaining when raw milk is treated to remove milk fat, casein, and so forth.

Casein: Casein is a family of phosphoproteins found in raw milk and cheese (roughly 80% of all protein in cows' milk is casein, and 20% is whey).



Source: Shared Research based on Ministry of Agriculture, Forestry and Fisheries data

- ▶ Meat products (10.5%): chilled and frozen pork, dry-cured ham, salami, bacon, etc.
- ▶ Asia business and other (16.5%): dairy ingredients and cheese, own-brand cheese (processed cheese* brand Foodtech, natural cheese** brand Choosy)

* Natural cheese: Natural cheese is raw milk that has been coagulated to form a solid, before undergoing fermentation.

** Processed cheese: To make processed cheese, one or more varieties of natural cheese are shredded and heated, and then reshaped after addition of an emulsifier and other ingredients.

Suppliers

- Dairy ingredients and cheese: Suppliers include dairy ingredient makers from milk-producing nations around the world (not only the three main producers, Australia, New Zealand, and the US, but also countries including the Netherlands, Germany, France, Denmark, and Italy; over 140 suppliers across 20 countries). Over the past 13 years, Lacto Japan's dairy ingredients and cheese import volume has risen 2.7x, from 76,868 tons in FY11/06 to 204,105 tons in FY11/19.
- Meat products: In pork products, the chief supplier is US-based Seaboard Foods. Lacto Japan also imports from companies that repackage dry-cured ham and salami into different shapes and sizes, primarily Italy's Fratelli Galloni S.P.A. (Parma prosciutto) and Villani S.P.A. (Milano salami), and Spain's Esteban Espuna S.A. (Serrano ham).

Global network

- Overseas bases charged mainly with procurement: US, Australia, Netherlands, Italy
- Overseas bases responsible principally for manufacturing and sales: Singapore, Malaysia, Indonesia, Thailand, Philippines, and China

Customers

- Dairy ingredients and cheese: Customers include domestic dairy product, confectionery, oil & fats, beverage, and animal feed makers, among them Meiji, Morinaga Milk Industry, Yotsuba Milk Products, Megmilk Snow Brand, Ezaki Glico, and Lotte, as well as the Agriculture Livestock Industries Corporation (ALIC; see later section on "state trading system").
 - Meat products: Customers are domestic food manufacturers, particularly ham and sausage makers.
- * For dairy product, confectionery, oil & fats, beverage, and animal feed makers, trading companies like Lacto Japan fulfil functions including ensuring a stable supply of ingredients (decentralization of procurement routes) and improving production efficiency (outsourcing the processing of raw materials).

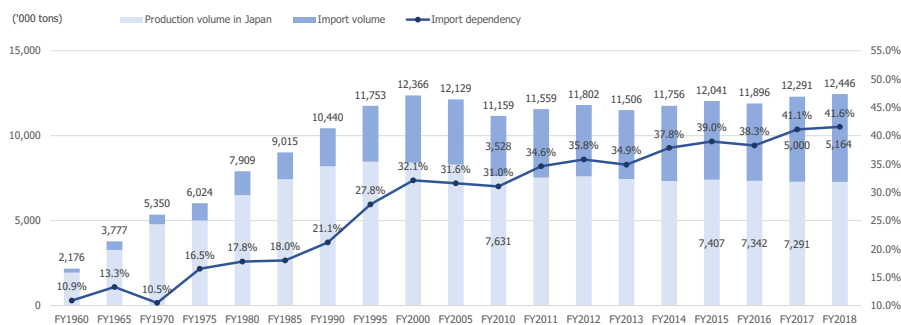
Market environment

Business climate favorable at present

As a company importing dairy ingredients from milk-producing nations around the world, we think Lacto Japan currently enjoys a beneficial external (market) environment. That is to say, Japan's dairy product consumption (milk equivalent basis) has remained stable since FY2000, at about 12 million tons per year. With domestic production (milk equivalent basis) contracting from 7.6 million tons in FY2010 to 7.3 million tons in FY2018, for a CAGR of -0.6%,* Japan has become increasingly reliant on imports (import weighting of 41.6% in FY2018, up from 31.0% in FY2010) in order to meet consistently high demand. Japan's dairy product import volume (milk equivalent basis) has risen from 3.5 million tons in FY2010 to 5.2 million tons in FY2018, for a CAGR of 4.9%.

* The number of dairy farming households in Japan peaked at 418,000 in 1963, and by 2019 had dropped to only 15,000, largely due to aging dairy farmers exiting the industry without successors. Similarly, the total number of dairy cows in Japan declined from 2,111,000 in 1985 to 1,323,000 in 2017, before logging a modest increase to 1,328,000 in 2018 and 1,332,000 in 2019. (Source: *Statistics on Livestock*, Ministry of Agriculture, Forestry and Fisheries.)

Japan's dairy product consumption ('000 tons, milk equivalent basis)



Source: Shared Research based on Ministry of Agriculture, Forestry and Fisheries' Food Balance Sheet
 Note: For the sake of convenience, consumption is defined as the total of domestic production and import volume. In reality, domestic consumption is this sum less export volume, also taking into account changes in inventory. However, the difference is negligible.

Countries of origin for Japan's dairy product imports

According to the Ministry of Finance's Trade Statistics of Japan, in 2019 the nation's dairy product import volume (solid content basis) fell 3.7% YoY to 405,813 tons (0.09 of milk equivalent), while the value of dairy product imports decreased 4.6% to JPY171,442mn (see table below). While butter imports were up 41.9% YoY, there were declines of 14.3% for powdered milk and 11.6% for whey. The three main countries of origin for dairy imports are Australia (source of the largest volume of cheese), New Zealand (source of the largest volume of milk powder), and the US (source of the largest volume of whey). Japan also imports dairy products from European nations including the Netherlands, Germany, Denmark, France, and Italy. According to the company, the above list also covers the main countries of origin for Lacto Japan's imports.

Volumes and prices of Japan's dairy product imports (2019)

(tons)	Imports	By category					
		Milk and cream	Powdered milk	Fermented dairy products	Whey	Butter	Cheese and curd
Total	405,813	124	46,448	45	57,426	22,505	279,264
Value (JPYmn)	171,442	35	12,292	33	12,693	13,262	133,127
Unit price (JPY/kg)	422	287	265	729	221	589	477
Three main countries	240,335	2	28,101	25	25,347	13,737	173,123
Australia	88,010	-	7,826	3	3,552	387	76,242
New Zealand	94,011	2	14,979	1	3,705	12,228	63,096
US	58,314	0	5,296	21	18,090	1,122	33,784
Share of the three	1	0	1	1	0	1	1
Europe	148,141	104	17,615	19	20,862	8,241	101,300
Netherlands	18,585	-	1,848	1	2,949	3,733	30,619
Germany	11,707	91	728	16	5,476	1,805	17,561
Denmark	39,149	-	-	-	468	47	16,121
France	16,636	3	4,247	0	1,953	1,733	10,649
Italy	25,677	-	71	0	1,089	2	10,544
South America	6,754	17	17	-	1,766	430	4,525
Argentina	5,977	-	-	-	1,023	430	4,525
Brazil	34	17	17	-	0	0	0
Asia, other	10,583	-	716	1	9,452	97	317

Source: Shared Research based on Ministry of Finance's Trade Statistics of Japan (figures rounded to the nearest millions of yen)

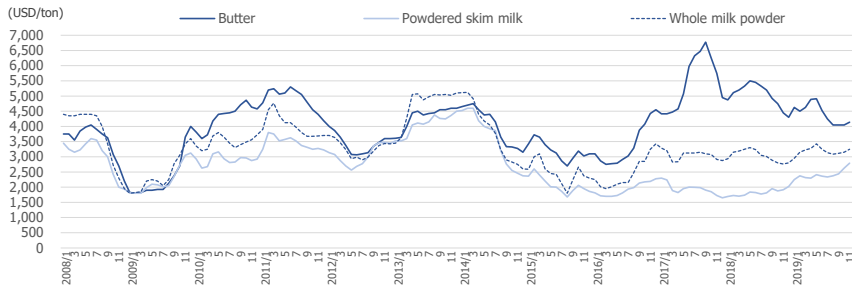
Note: HS code column shows sums for items covered under ITC HS Codes 0401 to 0406

International market

At this time, international market prices for dairy products are mostly holding steady after a period of increase that occurred in mid-2016. Market conditions were bearish during through the first half of 2016, but prices began trending upward in the middle of 2016 as an adjustment to global supply and demand came to an end. Prices fell again during the latter half of 2017, and prices were generally stable at low levels throughout 2018 and 2019, making for a favorable environment from the perspective of buyers. In 2018, contributing factors included steady growth in production in the world's major milk-producing nations and high inventories levels of skim milk powder (roughly 300,000 tons) in the EU. Butter prices rose sharply between 2016 and the middle of 2017 in

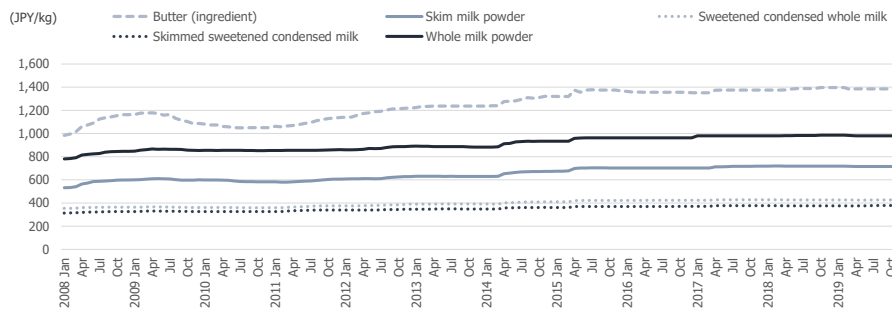
response to growing worldwide demand for natural foods, but then fell after that, remaining on a downtrend with the exception of short upswings in 2018 and 2019 that extended into early summer. In contrast, skim milk powder prices have been on the mend since the latter half of 2018 (gaining momentum in 2019), thanks to a steady decline of inventory levels in the EU.

International dairy product prices (USD/ton)



Source: Shared Research based on Japan Dairy Association (J-Milk) data (referencing original data from ALIC)
 Note: Prices are simple averages of highs and lows (FOB, Western European ports)

Domestic selling prices of designated dairy products for big users (JPY/kg)

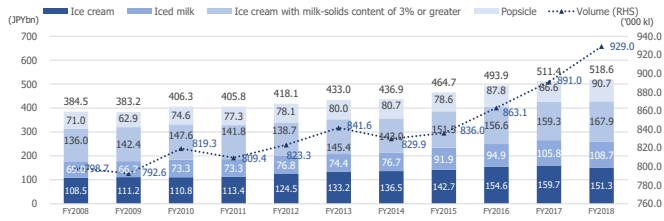


Source: Ministry of Agriculture, Forestry and Fisheries' data on Price Survey on Major Foods

Demand for main users' products

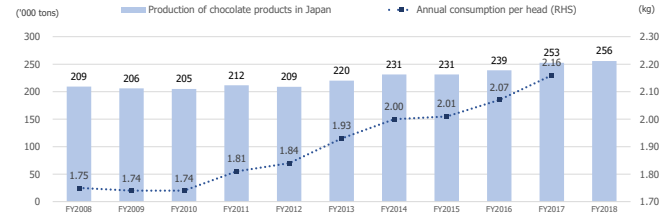
Domestic demand for dairy ingredients continues to rise thanks to steady growth in sales of major products made by dairy product and confectionery manufacturers. Domestic consumption of cheese continues to grow, rising from 204,535 tons in 1995 to 352,930 tons in 2018 for average annual growth of 2.4%. Imported cheese accounted for roughly 80% of that, rising from 159,345 tons in 1995 to 289,212 tons in 2018 for average annual growth of 2.6%.

Sales of ice cream and popsicles (JPYbn)



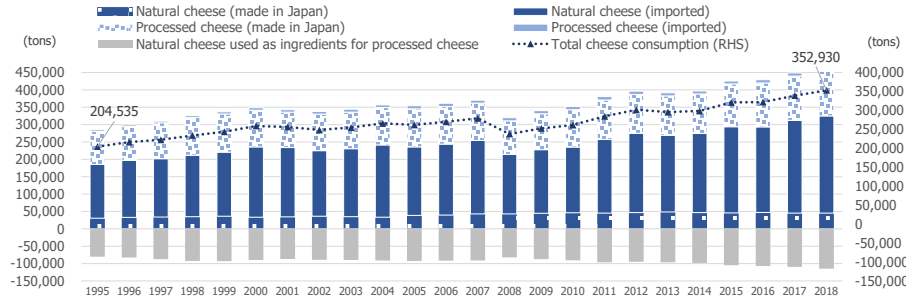
Source: Shared Research based on Japan Ice Cream Association

Domestic production of chocolate products ('000 tons)



Source: Shared Research based on Chocolate & Cocoa Association of Japan

Cheese consumption in Japan (Unit: tons)



Source: Shared Research, based on statistics from the Japan Dairy Association (J-Milk), as compiled in the Survey of Cow Milk and Dairy Product Production conducted by the Livestock Industry Department of the Agricultural Production Bureau of the Ministry of Agriculture, Forestry and Fisheries

State trading system and tariff rate quota for dairy products

State trading system

In Japan, designated dairy products,* such as skim milk powder, butter, and whey, are subject to a state trading system and tariff rate quota, with the Agriculture and Livestock Industries Corporation (ALIC) controlling imports. The difference between the import price and the wholesale price is retained by ALIC to fund subsidies for domestic dairy farmers. Butter and skim milk powder can be easily reconstituted to manufacture virtually all milk and dairy products. The government took the big-picture view that unregulated imports of butter and skim milk powder could adversely affect domestic supply-demand for all dairy products, including drinking milk, and accordingly opted for a state trading system. In conducting its state trading activities, ALIC uses two systems of tendering: general tender** and SBS (simultaneous buy and sell) tender.***

*In the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), Japan committed to import purchases for designated dairy products of up to 137,000 tons annually (in milk equivalent calculation).

** The state (ALIC) buys products in an import tender, then temporarily holds these products as stockpile before offering them to users via sell tender.

***Under this system, shortlisted import agents (sellers) and domestic users (buyers) can pair up and make a joint bid. The state (ALIC) chooses the bids that have the biggest difference between the purchase price (from the import agent) and the sales price (to internal markets), retaining the difference between the prices as a mark-up (e.g., JPY949/kg for butter as of April 1, 2018). The state (ALIC) enters into a contract of sale with the seller and the buyer, simultaneously buying from the former and selling to the latter.

While there is some variation between fiscal years, Lacto Japan more often participates in SBS tenders (in roughly 60% of cases). In FY11/19, wholesaling to ALIC accounted for 7.3% of total sales in the dairy ingredients and cheese business.

Tariff rate quota system

Under the tariff rate quota system, no tariff or a reduced tariff (the primary tariff rate) is applied to imports of below a certain quantity, to ensure that imported products are available to users at lower prices. Imports above that quota limit are subject to a higher

tariff (the secondary tariff rate),* in order to protect domestic producers.

The in-quota tariff rate (primary tariff rate) is 25% for skim milk powder, 35% for butter, 25% for whey (35% for whey containing added sugar), and 25% for unsweetened condensed milk. The out-of-quota tariff (secondary tariff rate) is 21.3% + JPY396/kg for skim milk powder, 29.8% + JPY985/kg for butter, 29.8% + JPY425/kg (or JPY687/kg) for whey, and 21.3% + JPY254/kg (or 25.5% + JPY509/kg) for unsweetened condensed milk. Tariffs of zero within the quota apply for whey and skim milk powder for use in animal feed. There are no quotas for imported cheese, where the tariff rate is 29.8% for natural cheese (in some cases 26.3% or 22.4%), and 40% for processed cheese.

Impact of new trade agreements

As new trade agreements (including TPP-11 and Japan-EU EPA) go into effect with countries other than the US, Japan's import tariffs on cheese, whey, and other dairy products will come down year by year (dairy product categories under the Japan-U.S. trade agreement are the same as those for the TPP, and there is no ceiling on U.S. imports). In the case of hard cheeses like cheddar and gouda that account for much of Lacto Japan's cheese sales, the import tariff will come down from the current rate of 29.8% by 1.9pp each year until it reaches zero in 16 years. Under the Japan-EU EPA, Japan's import tariff on fresh cheese will come down by a fixed rate every year and will reach zero in 11 years; likewise, under both TPP-11 and the Japan-EU EPA, Japan's tariff on whey will also be reduced by a fixed rate every year and will reach zero after 11 years. Imports of goods such as skim milk powder and whey will remain under the bidding system run by ALIC (Agriculture and Livestock Industries Corporation), but new import ceilings will be established for countries participating in these trade agreements, and import tariffs will be gradually reduced to zero in 16 years. Between the new import ceilings and the steady reduction in import tariffs, Lacto Japan believes that the resulting decline in prices, coupled with promotions conducted by retailer distributors, will generate additional domestic demand for dairy products.

Japan-foreign price gap for dairy products

Whereas in the main milk producing nations a kilogram of butter retails for approximately USD8, in Japan the price is about USD19. In large part, this is because the producer's price for a kilogram of raw milk is around USD35–40 in the main milk producing nations, but in Japan it is a much higher USD91 or so (Source: Japan Dairy Industry Association, "Japan Dairy Yearbook 2019 Edition").

Impact of exchange rates

To understand how forex affects revenue and profit at Lacto Japan, it is necessary first to gain an understanding of accounting standards for foreign currency transactions and accounting standards for financial instruments (hedge accounting rules). We use the following hypothetical transaction to illustrate the effects of forex.

Hypothetical transaction: On October 31, 20XX, Lacto Japan inks a USD10,400 sales contract (sales: $\text{USD}10,400 \times \text{USD}/\text{JPY}98 = \text{JPY}1,019,200$) with Japanese dairy company A. At the same time, it enters into a USD10,000 forward exchange contract (settlement date: February 28, 20X1) with a bank to hedge the forex risk associated with the USD-denominated import transaction (scheduled for December 31, 20XX), for which the settlement of accounts payable is slated for February 28, 20X1. Lacto Japan applies separate accounting treatment* for the foreign currency-denominated transaction. The forward exchange contract satisfies the accounting standards for financial instruments (hedge accounting). The effective tax rate is 40%.

*Separate accounting treatment of the foreign currency-denominated transaction that is being hedged, and the forward exchange contract used as a hedging device. Hedge accounting is an exceptional accounting treatment to recognize the gains or losses on a hedging instrument in the same period as the gains or losses on the hedged exposure.

[Forward exchange contract]

Buy USD10,000 (contract date October 31, 20XX; settlement date February 28, 20X1)

[Forex assumptions] (yen depreciation)

JPY per USD		Spot rate (SR)	Forward rate (FR)
As of transaction contract = at foreign exchange forward contract	(Oct. 31, 20xx)	98	95
As of settlement	(Nov. 30, 20xx)	99	96
As of shipping = at booking of purchase	(Dec. 31, 20xx)	100	97
As of payment for the purchase	(Feb. 28, 20x1)	104	-

Note: Difference between SR and FR set at JPY3/USD for the sake of convenience (not on the basis of detailed calculations)

[Transaction in foreign currency (deferred hedging): rundown of accounting process]

Transaction in foreign currency (deferred hedging): accounting process			
Forward exchange contract date (Oct. 31, 20xx)	No journal entry		
Settlement (Nov. 30, 20xx)	< Market-value evaluation of forward exchange contract >		
	Debit: Forward exchange contract	10,000 (*1)	Credit: Deferred tax liability
			Deferred hedge gain (loss)
			4,000 (*2)
			6,000
	*1 (FR on settlement date [96] - FR on contract date [95]) x USD10,000		
	*2 USD10,000 x effective tax rate [40%]		
	Trial balance after settlement		
	Forward exchange contract	10,000	Deferred tax liability
			Deferred hedge gain (loss)
			4,000
			6,000
Purchase (Dec. 31, 20xx)	① Debit: Purchase	1,000,000	Credit: Accounts payable
	② Debit: Forward exchange contract	10,000 (*4)	Credit: Deferred tax liability
			Deferred hedge gain (loss)
			4,000
			6,000
	③ Debit: Deferred tax liability	8,000	Credit: Forward exchange contract
	Deferred hedge gain (loss)	12,000	
	*3 SR on purchase date [100] x USD10,000		
	*4 (FR on purchase date [97] - FR on settlement date [96]) x USD10,000		
Payment for the purchase (Feb. 28, 20x1)	① Debit: Accounts payable	1,000,000	Credit: Cash and deposits
	Gain (loss) on forex	40,000	
	② Debit: Cash and deposits	90,000 (*6)	Credit: Gain (loss) on forex
	*5 SR on date of payment for the purchase [104] x USD10,000		
	*6 (SR on forward contract settlement date [104] - FR on contract date [95]) x USD10,000		
Sales (Mar. 15, 20x1)	Debit: Accounts receivable	1,019,200	Credit: Sales
Summary of a series of transaction (Income statement assuming the whole process took place within the same fiscal year)	Sales	1,019,200	
	CoGS	1,000,000	
	Gross profit	19,200	
	Gain (loss) on forex	50,000	
	Profit	69,200	
	* CoGS [950,000] is excluded from sales (based on contract date FR)		
	The profit above equals the actual profit of JPY69,200		
Summary of a series of transaction (Cash out from the purchase)	Settlement of accounts payable	-1,040,000	
	Net settlement on foreign exchange	90,000	
	Balance	-950,000	

Source: Shared Research

Note: journal entry ③ at time of transaction (account item on credit side) is based on Lacto Japan's actual practice.

[Main point]

In the simulation above, the forward exchange contract ensures that actual profit (gross profit adjusted for forex gains/losses) remains fixed at JPY69,200, regardless of exchange rate movements. In short, the actual cost of sales remains fixed at JPY950,000 (based on the forward rate agreed upon for the settlement date).

By thus entering into a forward exchange contract with a financial institution* whenever it signs a sales contract, Lacto Japan determines the actual profit (gross profit adjusted for forex gains/losses) at the time of the sales contract. In other words, foreign exchange movements have no impact on an actual profit basis once the sales contract is signed. That said, yen depreciation is preferable from the standpoint of the sales amount determined at the time the sales contract is signed, and the commission on that amount (while this is disadvantageous from the perspective of price competition with domestically produced ingredients, the reality is that customers are being forced to import because domestic production is insufficient to meet their needs). There is usually a four- to six-month lag between the signing of the sales contract and the booking of sales.

* Lacto Japan's policy is not to bet on currency markets. Even when the yen is expected to strengthen it enters into forward exchange contracts to buy US dollars, etc. (in short, every sales contract is accompanied by a forward exchange contract, without exception).

Competitive landscape

Aside from the relevant business units of large general trading companies, other dairy

product trading companies tend to be small or midsized (see the earlier section on “Lacto Japan’s defining characteristics” for a discussion of how the company differs from its competition).

- ✔ Large general trading companies (relevant business units): Mitsubishi Corporation (TSE1: 8058), Mitsui & Co. (TSE1: 8031), and Itochu Corporation (TSE1: 8001)
- ✔ Specialist food trading company: Shoei Foods (TSE2: 8079)

Comparison with competitors (listed companies)

Ticker	Company	Fiscal year		Sales	Ordinary income, pre-tax profit	% of sales	ROA (OI-based)	ROE	Equity ratio
				(JPYmn)	(JPYmn)				
8058	Mitsubishi Corp.	FY03/19	IFRS	16,103,763	851,813	5.3%	5.2%	10.7%	34.5%
8001	Itochu Corp.	FY03/19	IFRS	11,600,485	695,383	6.0%	5.3%	17.9%	29.1%
8031	Mitsui & Co.	FY03/18	IFRS	6,957,524	584,338	8.4%	5.0%	10.1%	35.7%
3139	Lacto Japan	FY11/19	Cons.	116,794	2,747	2.4%	5.7%	13.0%	33.0%
8079	Shoei Foods	FY10/19	Cons.	105,800	4,087	3.9%	5.4%	6.8%	53.6%
Average				6,976,873	427,674	5.2%	5.3%	11.7%	37.2%

Source: Shared Research based on company data

Earnings

For FY11/20, company forecasts 9.2% increase in ordinary income following 5.1% rise in FY11/19

FY11/19 results

FY11/19 results: Sales up 1.2% YoY, ordinary income up 5.1%

Summary

For FY11/19, Lacto Japan reported sales of JPY116.8bn (+1.2% YoY), operating profit of JPY3.1bn (+4.5%), ordinary income of JPY2.7bn (+5.1%), and net income attributable to parent company shareholders of JPY2.0bn (+10.0%). Sales volume increased 5.0% YoY to 289,300 tons, and sales, ordinary income, and net income attributable to parent company shareholders all reached record highs.

Sales

Sales came in 6.7% lower than the company’s initial forecast.

- ▶ Sales were weighed down as dairy ingredient and cheese sales volume fell short of guidance (rising 2.9% YoY to 204,105 tons versus the company’s initial forecast of a 5.5% increase to 209,320 tons) owing to an increase in skim milk powder inventory as Japan’s yogurt boom faded, and as unit prices fell owing to yen appreciation in 1H and the implementation of free trade agreements. The per-ton average unit price at the dairy ingredients and cheese business was down 2.9% YoY at JPY417,462, as against the company’s initial assumption of a 2.6% increase to JPY440,808.
- ▶ Contributions to the JPY1.4bn YoY increase in sales included higher volume (+JPY5.0bn), lower sales prices (-JPY3.2bn; stemming from foreign exchange (mainly the euro), low prices in global markets, and tariff reductions), and other factors (-JPY414mn; foreign sales conversions to yen, etc.)

Ordinary income

Ordinary income, on the other hand, was basically in line with the company’s forecast, rising 7.2% YoY to JPY2.8bn.

- ▶ In the main, this was due to sales being higher than the company initially projected in the Asia and other business (which Lacto Japan views as its “growth engine”). It also reflected product mix improvement (higher sales volume of butter and processed products) and sales efforts.

- ▶ Contributions to the JPY134mn YoY increase in ordinary profit included higher sales (+JPY78mn); improvement in the product mix and, by extension, the gross profit margin (+JPY210mn); higher SG&A expenses (-JPY154mn; in FY12/19, the company booked a JPY120mn reversal of allowance for doubtful accounts); and other factors (-JPY1mn).
- ▶ Some of Lacto Japan's income is proportional to sales prices and some is proportional to volume. A decade or so ago, most of the company's income fit the first description, but now there is a fairly equal division between the two. In short, the actual value of sales now has less impact on income than was the case 10 years ago. Note that Lacto Japan considers sales volume an important KPI.

Earnings by business

- ▶ **Dairy ingredients and Cheese:** Sales of JPY85.2bn were down 0.1% YoY. As noted earlier, sales volume rose 2.9% YoY to 204,105 tons. Not only were domestic skim milk powder inventories high throughout the year, but also end-user demand for some products (e.g., ice cream and beverages) was weak due to cool and wet weather during the first part of summer. Demand for imported dairy ingredients, though, increased steadily owing to the implementation of new free trade agreements including the TPP 11 and Japan-EU EPA. Sales volume was down 7.0% YoY in Q1 and 3.9% in Q2, but swung upward in 2H, falling by only 0.9% in Q3 and increasing 2.9% in Q4. In Q4 alone, the company segment had sales of JPY20.4bn (+4.0% YoY) and sales volume of 51,152 tons (+15.9%).

According to Lacto Japan, skim milk powder inventories remain high, partly because the yogurt boom has peaked, but there are signs of recovery, such as increasing purchases of skim milk powder by some customers. The company also said that cheese sales, which had weakened in 1H FY11/19, are currently strong. Lacto Japan expects imported butter sales volume to remain robust because of brisk demand caused by softening international butter prices (see above) and differences between butter prices in Japan and other countries.

- ▶ **Meat products:** Sales of JPY12.3bn were down 2.4% YoY. Sales volume slid 0.3% YoY to 21,532 tons. In 1H FY11/19, there was an increase in the volume of imported pork, which has established a firm position in Japan, in addition to which domestic pork production increased after declining in prior years. The result was a surplus of pork in Japan and slower sales of finished pork products. In 2H, though, there were outbreaks of classical swine fever in Japan and African swine fever in China. There were also expectations that US-China trade friction would ease. Prices of pork produced in the US and other countries increased and there were signs of improvement in the excess supply problem in Japan. Measures to further diversify the product lineup also yielded positive results.
- ▶ **Asia business and other:** Sales were JPY19.3bn, up 9.9% YoY, as detailed below:
 - Dairy ingredients sales division: Sales were JPY16.0bn, up 9.9% YoY. Sales volume increased 13.4% YoY to 59,925 tons. Sales prices for skim milk powder, a core product, strengthened, in part because milk production in the Oceania region is decreasing because of climate change. Lacto Japan has responded by using its global supply network (covering the three main milk-producing regions of Europe, the US, and Oceania) to target opportunities created for replacing Oceania exports with dairy ingredients from Europe and North America. Sales were upbeat in the Philippines, and Lacto Japan plans to continue growing sales there via the sales subsidiary (second-tier subsidiary) it established in September 2019 with a view to increasing

sales activities in that country.

Cheese manufacturing division: Sales were JPY2.7bn, up 25.3% YoY and sales volume jumped 40.1% YoY to 3,737 tons, with both sales and sales volume reaching record highs. Factors contributing to higher cheese sales including a favorable operating environment in the form of ongoing growth in cheese demand in Asia, development of products that match customers' requirements regarding functions and price, and increased sales activities. In Thailand, a key market for this business, sales were higher in the food service category and in the food processing company sector (through agents).

Company forecast for FY11/20

Summary

For FY11/20, Lacto Japan is forecasting sales of JPY130.0bn (+11.3% YoY), ordinary income of JPY3.0bn (+9.2%), and net income attributable to parent company shareholders of JPY2.1bn (+7.0%). In FY11/20, the company assumes that overall sales volume will rise 9.6% YoY to 317,100 tons, with volumes up in all areas, including dairy ingredients/cheese (+4.8%; see below for details, same hereafter), meat products (+38.9%), dairy ingredient sales in Asia (+16.0%), and cheese manufacturing in Asia (+4.4%).

Company forecasts for FY11/20: sales up 11.3%, ordinary income up 9.2%

Assumptions

- ▶ Lacto Japan assumes there will be no change over the medium term in the downtrend in raw milk production in Japan (while production is on the rise in Hokkaido, it is decreasing in other regions).
- ▶ New free trade agreements such as the Japan-EU EPA and US-Japan Trade Agreement should enhance Lacto Japan's competitive edge in procurement, by allowing the company to leverage its global supply network.
- ▶ In the dairy ingredients and cheese business, the company will cultivate new business formats and customers, for example by selling imported dairy ingredients to beverage and animal feedstuff makers. It sees a business opportunity in the replacement of domestically produced ingredients with imported ingredients.
- ▶ In Asia, where demand for dairy products remains brisk, Lacto Japan will look to further grow its business through increased sales activities and expanded sales channels.

Forecasts by business

- **Dairy ingredients and Cheese:** Lacto Japan projects a YoY increase in sales of 7.7% to JPY91.8bn, assuming a 4.8% rise in sales volume to 213,800 tons, and a 2.8% increase in the average unit price, to JPY429,139 per ton.
- **Meat products:** Lacto Japan forecasts a YoY increase in sales of 30.3% to JPY16.0bn, assuming a 38.9 increase in sales volume to 29,900 tons, and a 6.2% decrease in the average unit price, to JPY535,117 per ton.
- **Asia business and other:** Lacto Japan projects a YoY increase in sales of 15.2% to JPY22.3bn, assuming a 16.0% increase to 69,500 tons in sales volume for dairy ingredients and a 4.4% increase to 3,900 tons in sales volume for cheese manufacturing.

Operating environment

Dairy ingredients and cheese

The company forecasts that domestic companies will continue shifting to imported dairy products in response to the ongoing decline in domestic milk production. Milk prices in

Japan are already much higher than in other developed countries (*see Note 1 below) but continue to rise (*see Note 2 below), causing prices of imported dairy ingredients to increase as well. When milk prices go up, companies in the dairy industry are able to pass along some of the cost increases by raising the prices of their end-products, but this leads to lower demand domestic for domestic dairy products and creating a self-perpetuating downward spiral. Once the aforementioned new trade agreements go into effect, however, there is a good chance that growth in imports of low-cost dairy products will pick up markedly.

*Note 1: Average 2017 milk prices per 100kg in major milk-producing countries were JPY4,686 in New Zealand, JPY4,467 in the 28 countries that comprise the European Union, and JPY4,392 in the US, compared with JPY10,240 in Japan. (Source: Japan Dairy Association (J-Milk) based on data from the Japanese National Committee of International Dairy Federation)

*Note 2: According to the HOKUREN Federation of Agricultural Cooperatives, which sets the price for the roughly 80% of milk produced in Hokkaido that is used in food processing, in FY2019, the price of milk was to increase by ¥4 per kilogram (not including tax). There would also be an increase in prices for specific types of milk: in the case of milk used for drinking, prices would go up 3.4%; in this case of milk used in yogurt, prices would go up 4.6%; and in this case of milk suitable for other uses, prices would go up 4.2%. This represented the first increase in the price of milk used for drinking in four years. Hokkaido milk producers had also set their sights on raising prices for milk used to produce butter, powdered skim milk, and other dairy products, but encountered strong pushback from dairy product manufacturers and ended up leaving these prices where they were. It was announced on January 29, 2020, that prices for all types of milk would be left unchanged for FY2020.

In November 2019, according to Ministry of Agriculture, Forestry and Fisheries (MAFF) statistics, domestic inventories of skim milk powder (estimated inventory volume at month-end) stood at 65,901 tons, down from the most recent peak of 71,719 tons in July 2019. In December 2019, though, inventories rose again to 69,337 tons, and in general levels remain high in comparison with the period FY2014 through FY2018 (low of 46,542 tons in FY2014, high of 66,757 tons in FY2017). Lacto Japan, though, expects the skim milk powder supply glut in Japan to ease, based on evidence that some customers are increasing purchases of skim milk powder, and on leading dairy companies' plans to roll out new yogurt products in the spring of 2020.

Meat products

In the domestic meat market, pork imports are on the rise thanks to higher quality and increased consumer recognition. Out of an estimated 1,827,400 tons of pork (+0.9% YoY) on the Japanese market in FY2018, imports accounted for 931,400 tons (+0.5% YoY) and domestically produced pork 896,000 tons (+1.3% YoY). (FY2017 was the first year that the volume of pork imports exceeded the volume of domestically produced pork on the Japanese market.)

According to supply and demand statistics from Japan's Ministry of Agriculture, Forestry and Fisheries, annual per capita consumption of pork in Japan rose from 10.6kg in 2000 to 12.9kg in 2018. OECD statistics for meat consumption put per capita pork consumption in Japan at 16.2kg in 2018. Either way, per capita consumption of pork is much higher in the US and the European Union (35.5kg) than it is in Japan, while neighboring China and South Korea consume roughly twice as much pork as Japan, with per capital consumption of 30.4kg and 30.1kg, respectively. As these international comparisons suggest that pork consumption in Japan is likely to continue rising in the years ahead, the company intends to focus on cultivating and securing new sources of supply in pursuit of growth.

- ▶ Lacto Japan procures much of its chilled and frozen pork from the US, and it believes the 2020 start of the US-Japan Trade Agreement (USJTA) will enhance its price

competitiveness. With respect to pork tariffs*1, under the USJTA the ad valorem tariff ((3) in the box below) is to be eliminated progressively (reduced from 4.3% before the USJTA was enacted to 1.9% in the first year and zero in the ninth year), while the specific duty ((1) in the box below) is to be reduced progressively from JPY482/kg before (JPY361/kg for carcass meat) to JPY50/kg (JPY37.5/kg) in the ninth year (as in the TPP). The gate price system*2 and current gate price of JPY524/kg will be maintained, though. Under the gate price system, importers can minimize their tariff bill by combining pork cuts with differing customs duties to ensure that the value per kilogram of the imported pork is in the vicinity of JPY524/kg (the price at which the per-kilogram duty is at its smallest, at JPY23/kg before USJTA implementation, to be reduced to zero in the final year of tariff reductions), and Lacto Japan has the expertise and suppliers/sales routes needed to practice combination imports.

*1 Tariff structure for pork: Pork imports are subject to one of three tariff rates depending on dutiable value, as indicated below. The tariff bill is lowest for pork valued at the gate price of JPY524/kg (at JPY23/kg before USJTA implementation, to be reduced to zero in the final year of tariff reductions).

Before enactment of USJTA

1. When the value per kilogram of the imported pork is below the administratively set minimum price of JPY64.53/kg: specific duty of JPY482/kg applied
2. When the value per kilogram of the imported pork is below the gate price of JPY524/kg but above the minimum price of JPY64.53/kg: tariff applied is equal to gap between JPY524/kg (the standard import price) and the import value per kilogram
3. When the value per kilogram of the imported pork equals or exceeds the gate price: ad valorem duty of 4.3% applied

In final year of tariff reductions

- When the value per kilogram of the imported pork is below the administratively set minimum price of JPY474/kg: specific duty of JPY50/kg applied
- When the value per kilogram of the imported pork is below the gate price of JPY524/kg but above the administratively set minimum price of JPY474/kg: tariff applied is equal to gap between JPY524/kg (the standard import price) and the import value per kilogram
- When the value per kilogram of the imported pork equals or exceeds the gate price of JPY524/kg: no duty is applied

*2 Gate price system for pork imports. A system designed to balance the needs of consumers and domestic pork producers. As outlined above, if the import price is below the gate price, then the importer must pay a differential duty equal to the gap between the standard import price and import value per kilogram, thereby protecting domestic pork producers. If the import price is at the gate price level or above, then only the ad valorem tariff is paid, thereby benefiting consumers.

Asia business

- ▶ Dairy ingredient sales: Lacto Japan believes that the volume of dairy ingredients supplied by the Oceania region is very likely to continue decreasing, with this decline creating more opportunities for the company because of its global supply network. Lacto Japan also intends to apply the approach used successfully in the Philippines to expand its business into emerging markets within the ASEAN region. The company seeks to capture market share from the likes of Fonterra, a leading global supplier of dairy ingredients and solutions, based in New Zealand.
- ▶ Cheese manufacturing and sales: Demand for cheese in Asia is expected to remain strong as the consumption of European and American food increases, creating greater demand for dairy products. Competition is intense among processed cheese producers in Europe and Oceania and the increasing number of Asian companies that are starting to make processed cheese. Lacto Japan plans to become more price competitive by

using its procurement skills to supply safe, low-cost dairy ingredients. Another goal is to continue increasing sales by developing products that target customers' needs.

Expanding cheese production capacity

- ▶ For FY11/20, Lacto Japan targets a 4.4% increase to 3,900 tons in sales volume for cheese manufacturing in Asia, with manufacturing to take place at the Singapore and Thai plants.
- ▶ The Singapore plant currently is operating at full capacity, based on which the company plans to add capacity in 2H FY11/20. The Thai plant is still operating below full capacity.
- ▶ While Lacto Japan is considering building new plants in order to expand cheese production in Asia, no such investment is included in the latest medium-term plan, NEXT-LJ2022.

Topics: Implementation of US-Japan Trade Agreement (USJTA)

- ▶ The US-Japan Trade Agreement (USJTA) came into effect on January 1, 2020. Lacto Japan is the nation's leading importer of dairy ingredients from the US, and for the company's dairy ingredients and cheese business the US remains potentially a key source of supply, as it ranks second only to the EU in terms of raw milk production volume. The US also is the company's foremost supply source for chilled and frozen pork.
- ▶ Provisions for reducing and eliminating tariffs under the USJTA are the same as those under the TPP (positive for Lacto Japan). The USJTA's (positive) impact on Lacto Japan is as outlined above.

Earnings by business category

Earnings by business category												
(JPYmn)	FY11/10	FY11/11	FY11/12	FY11/13	FY11/14	FY11/15	FY11/16	FY11/17	FY11/18	FY11/19	FY11/20 Est.	FY11/22 Est.
	Parent	Parent	Parent	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	46,411	56,089	55,201	75,943	96,550	98,001	88,679	101,335	115,441	116,794	130,000	141,000
	-	20.9%	-1.6%	37.6%	27.1%	1.5%	-9.5%	14.3%	13.9%	1.2%	11.3%	6.5%*
< Sales by category >												
Dairy Ingredients and Cheese	-	-	-	47,899	63,978	69,047	60,543	70,019	85,290	85,206	91,750	99,000
YoY	-	-	-	-	33.6%	7.9%	-12.3%	15.7%	21.8%	-0.1%	7.7%	5.1%*
% of sales	-	-	-	63.1%	66.3%	70.5%	68.3%	69.1%	73.9%	73.0%	70.6%	70.2%
Meat Products	-	-	-	14,971	15,673	15,449	16,338	15,253	12,576	12,280	16,000	17,200
YoY	-	-	-	-	4.7%	-1.4%	5.8%	-6.6%	-17.6%	-2.4%	30.3%	11.9%*
% of sales	-	-	-	19.7%	16.2%	15.8%	18.4%	15.1%	10.9%	10.5%	12.3%	12.2%
Asia Business and other	-	-	-	13,073	16,899	13,503	11,797	16,061	17,574	19,308	22,250	24,800
YoY	-	-	-	-	29.3%	-20.1%	-12.6%	36.1%	9.4%	9.9%	15.2%	8.7%*
% of sales	-	-	-	17.2%	17.5%	13.8%	13.3%	15.8%	15.2%	16.5%	17.1%	17.6%
< Sales by region >												
Japan	-	-	-	62,387	79,693	84,879	77,395	85,418	98,483	-	-	-
YoY	-	-	-	-	27.7%	-	-8.8%	10.4%	15.3%	-	-	-
% of sales	-	-	-	82.1%	82.5%	86.6%	87.3%	84.3%	85.3%	-	-	-
Asia	-	-	-	13,142	16,824	13,083	11,270	15,911	16,945	-	-	-
YoY	-	-	-	-	28.0%	-	-13.9%	41.2%	6.5%	-	-	-
% of sales	-	-	-	17.3%	17.4%	13.4%	12.7%	15.7%	14.7%	-	-	-
Other	-	-	-	414	33	39	14	6	12	-	-	-
YoY	-	-	-	-	-92.1%	-	-63.9%	-54.8%	92.9%	-	-	-
% of sales	-	-	-	0.5%	0.0%	0.0%	0.0%	0.0%	0.0%	-	-	-
Customers (over 10% of total sales)	-	-	-	10,530	10,170	-	10,235	8,823	-	-	-	-
Yonekyu Corporation	-	-	-	10,530	10,170	-	10,235	8,823	-	-	-	-
% of sales	-	-	-	13.9%	10.5%	-	11.5%	8.7%	-	-	-	-
< Sales volume by category >												
Total sales volume (tons)	-	-	-	-	192,263	202,732	215,504	246,757	275,530	289,299	317,100	343,575
YoY	-	-	-	-	-	5.4%	6.3%	14.5%	11.7%	5.0%	9.6%	5.9%*
Dairy Ingredients and Cheese	101,820	111,717	113,123	122,148	129,810	141,540	148,091	172,885	198,445	204,105	213,800	233,800
YoY	5.4%	9.7%	1.3%	8.0%	6.3%	9.0%	4.6%	16.7%	14.8%	2.9%	4.8%	4.6%*
Price per ton (JPY)	-	-	-	392,136	492,861	487,827	408,823	405,003	429,792	417,462	429,139	423,439
YoY	-	-	-	-	25.7%	-	-16.2%	-0.9%	6.1%	-2.9%	2.8%	0.5%*
Meat Products	-	-	-	25,809	25,010	28,029	26,349	21,595	21,532	29,900	32,000	32,000
YoY	-	-	-	-	-	-3.1%	12.1%	-6.0%	-18.0%	-0.3%	38.9%	14.1%*
Price per ton (JPY)	-	-	-	607,257	617,713	582,896	578,883	582,357	570,314	535,117	537,500	537,500
YoY	-	-	-	-	1.7%	-5.6%	-0.7%	0.6%	-2.1%	-6.2%	-2.0%*	-2.0%*
Asia Business: dairy ingredient	-	-	-	34,914	34,223	37,472	45,014	52,822	59,925	69,500	72,600	72,600
YoY	-	-	-	-	-2.0%	9.5%	20.1%	17.3%	13.4%	16.0%	6.6%*	6.6%*
Asia Business: cheese	-	-	-	1,730	1,959	1,912	2,509	2,668	3,737	3,900	4,500	4,500
YoY	-	-	-	-	13.2%	-2.4%	31.2%	6.3%	40.1%	4.4%	6.4%*	6.4%*

Source: Shared Research based on company data

* Note: Represents compound average annual growth rate from FY11/19 through FY11/22 (company forecast)

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

Quarterly (cumulative) earnings

Cumulative (JPYmn)	FY11/18				FY11/19			
	Q1 Cons.	Q2 Cons.	Q3 Cons.	Q4 Cons.	Q1 Cons.	Q2 Cons.	Q3 Cons.	Q4 Cons.
Sales	29,462	59,165	87,943	115,441	27,886	57,712	87,536	116,794
YoY	35.3%	27.3%	20.7%	13.9%	-5.3%	-2.5%	-0.5%	1.2%
Dairy Ingredients and Cheese	21,972	43,812	65,668	85,290	21,109	42,675	64,795	85,206
YoY	61.9%	46.4%	33.5%	21.8%	-3.9%	-2.6%	-1.3%	-0.1%
% of sales	74.6%	74.1%	74.7%	73.9%	75.7%	73.9%	74.0%	73.0%
Meat Products	3,337	6,616	9,607	12,576	2,941	6,104	9,291	12,280
YoY	-22.4%	-21.1%	-19.3%	-17.6%	-11.8%	-7.7%	-3.3%	-2.4%
% of sales	11.3%	11.2%	10.9%	10.9%	10.5%	10.6%	10.6%	10.5%
Asia Business and other	4,151	8,735	12,667	17,574	3,834	8,932	13,449	19,308
YoY	6.4%	6.9%	7.9%	9.4%	-7.6%	2.3%	6.2%	9.9%
% of sales	14.1%	14.8%	14.4%	15.2%	13.7%	15.5%	15.4%	16.5%
Dairy ingredients	3,436	7,302	10,431	14,578	2,992	7,303	11,013	16,026
YoY	5.6%	6.1%	6.7%	9.2%	-12.9%	0.0%	5.6%	9.9%
% of sales	11.7%	12.3%	11.9%	12.6%	10.7%	12.7%	12.6%	13.7%
Cheese	499	997	1,552	2,116	658	1,284	1,963	2,651
YoY	10.0%	12.1%	13.1%	10.3%	31.9%	28.8%	26.5%	25.3%
% of sales	1.7%	1.7%	1.8%	1.8%	2.4%	2.2%	2.2%	2.3%
Other	216	436	684	880	184	345	473	630
YoY	9.6%	9.5%	15.5%	10.8%	-14.8%	-20.9%	-30.8%	-28.4%
% of sales	0.7%	0.7%	0.8%	0.8%	0.7%	0.6%	0.5%	0.5%
< Sales volume (tons) >								
Dairy Ingredients and Cheese	53,509	104,168	154,317	198,445	49,784	100,139	152,953	204,105
YoY	49.6%	37.9%	25.2%	14.8%	-7.0%	-3.9%	-0.9%	2.9%
Meat Products	5,789	11,366	16,505	21,595	4,985	10,511	16,317	21,532
YoY	-22.7%	-22.0%	-19.9%	-18.0%	-13.9%	-7.5%	-1.1%	-0.3%
Asia Business: dairy ingredients	11,977	26,431	38,409	52,822	11,298	27,892	41,746	59,925
YoY	10.4%	14.4%	15.8%	17.3%	-5.7%	5.5%	8.7%	13.4%
Asia Business: cheese	643	1,289	1,950	2,668	874	1,804	2,732	3,737
YoY	4.6%	9.8%	8.0%	6.3%	35.8%	40.0%	40.1%	40.1%
< Unit price (JPY/kg) >								
Dairy Ingredients and Cheese	411	421	426	430	424	426	424	417
YoY	8.2%	6.2%	6.6%	6.1%	3.3%	1.3%	-0.4%	-2.9%
Meat Products	576	582	582	582	590	581	569	570
YoY	0.4%	1.2%	0.7%	0.6%	2.3%	-0.2%	-2.2%	-2.1%
Asia Business: dairy ingredients	287	276	272	276	265	262	264	267
YoY	-4.3%	-7.2%	-7.8%	-6.9%	-7.7%	-5.2%	-2.9%	-3.1%
Asia Business: cheese	776	773	796	793	753	712	719	709
YoY	5.4%	2.1%	4.8%	3.7%	-3.0%	-8.0%	-9.7%	-10.6%
CoGS	27,942	56,028	83,001	108,930	26,319	54,347	82,387	109,994
YoY	38.1%	28.4%	20.7%	13.5%	-5.8%	-3.0%	-0.7%	1.0%
CoGS ratio	94.8%	94.7%	94.4%	94.4%	94.4%	94.2%	94.1%	94.2%
Gross profit	1,519	3,137	4,942	6,511	1,567	3,365	5,149	6,801
YoY	-1.3%	9.7%	21.9%	20.9%	3.1%	7.3%	4.2%	4.4%
GPM	5.2%	5.3%	5.6%	5.6%	5.6%	5.8%	5.9%	5.8%
SG&A expenses	752	1,657	2,568	3,502	831	1,757	2,660	3,656
YoY	-1.3%	3.7%	6.7%	1.1%	10.4%	6.0%	3.6%	4.4%
SG&A ratio	2.6%	2.8%	2.9%	3.0%	3.0%	3.0%	3.0%	3.1%
Operating profit	767	1,480	2,374	3,009	736	1,608	2,490	3,144
YoY	-1.4%	17.2%	44.0%	56.4%	-4.0%	8.7%	4.9%	4.5%
OPM	2.6%	2.5%	2.7%	2.6%	2.6%	2.8%	2.8%	2.7%
Gains (losses) on foreign exchange	38	-219	-256	-135	-116	-185	-186	-114
YoY	-93.8%	-	-	-	-	-	-	-
% of sales	0.1%	-0.4%	-0.3%	-0.1%	-0.4%	-0.3%	-0.2%	-0.1%
OP + Gains (losses) on forex	805	1,261	2,118	2,874	620	1,423	2,303	3,030
YoY	-42.1%	-35.9%	-17.7%	-6.8%	-22.9%	12.8%	8.8%	5.4%
% of sales	2.7%	2.1%	2.4%	2.5%	2.2%	2.5%	2.6%	2.6%
Ordinary income	746	1,133	1,924	2,613	536	1,253	2,087	2,747
YoY	-41.4%	-36.1%	-17.1%	3.6%	-28.2%	10.5%	8.4%	5.1%
Profit margin	2.5%	1.9%	2.2%	2.3%	1.9%	2.2%	2.4%	2.4%
Net income	493	736	1,291	1,784	376	888	1,490	1,963
YoY	-42.5%	-38.7%	-17.9%	1.7%	-23.8%	20.5%	15.4%	10.0%
Net margin	1.7%	1.2%	1.5%	1.5%	1.3%	1.5%	1.7%	1.7%
Foreign exchange								
USD/JPY	110.61	109.18	109.73	110.47	110.62	110.78	109.71	109.33
EUR/JPY	134.17	132.52	131.34	130.91	125.89	125.30	123.73	122.63

Source: Shared Research based on company data

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

Quarterly earnings

Quarterly (JPYmn)	FY11/18				FY11/19			
	Q1 Cons.	Q2 Cons.	Q3 Cons.	Q4 Cons.	Q1 Cons.	Q2 Cons.	Q3 Cons.	Q4 Cons.
Sales	29,462	29,703	28,778	27,498	27,886	29,826	29,824	29,258
YoY	35.3%	20.3%	9.1%	-3.5%	-5.3%	0.4%	3.6%	6.4%
CoGS	27,942	28,085	26,974	25,929	26,319	28,028	28,040	27,607
YoY	38.1%	20.1%	7.2%	-4.5%	-5.8%	-0.2%	4.0%	6.5%
CoGS ratio	94.8%	94.6%	93.7%	94.3%	94.4%	94.0%	94.0%	94.4%
Gross profit	1,519	1,618	1,805	1,569	1,567	1,798	1,784	1,651
YoY	-1.3%	22.6%	51.0%	17.8%	3.1%	11.1%	-1.1%	5.2%
GPM	5.2%	5.4%	6.3%	5.7%	5.6%	6.0%	6.0%	5.6%
SG&A expenses	752	905	910	934	831	926	903	997
YoY	-1.3%	8.4%	12.7%	-11.7%	10.4%	2.3%	-0.9%	6.7%
SG&A ratio	2.6%	3.0%	3.2%	3.4%	3.0%	3.1%	3.0%	3.4%
Operating profit	767	713	894	635	736	872	882	655
YoY	-1.4%	47.1%	131.1%	131.2%	-4.0%	22.3%	-1.4%	3.1%
OPM	2.6%	2.4%	3.1%	2.3%	2.6%	2.9%	3.0%	2.2%
Gains (losses) on foreign exchange	38	-257	-37	121	-116	-69	-1	72
YoY	-93.8%	-	-	-48.3%	-	-	-	-40.3%
% of sales	0.1%	-0.9%	-0.1%	0.4%	-0.4%	-0.2%	0.0%	0.2%
OP + Gains (losses) on forex	805	456	857	756	620	802	881	727
YoY	-42.1%	-21.2%	41.3%	48.7%	-22.9%	75.9%	2.7%	-3.9%
% of sales	2.7%	1.5%	3.0%	2.7%	2.2%	2.7%	3.0%	2.5%
Ordinary income	746	388	791	688	536	717	834	660
YoY	-41.4%	-22.6%	44.5%	240.7%	-28.2%	84.9%	5.5%	-4.1%
Profit margin	2.5%	1.3%	2.7%	2.5%	1.9%	2.4%	2.8%	2.3%
Net income	493	243	555	493	376	512	602	473
YoY	-42.5%	-29.2%	48.9%	170.8%	-23.8%	110.6%	8.6%	-4.0%
Net margin	1.7%	0.8%	1.9%	1.8%	1.3%	1.7%	2.0%	1.6%

Source: Shared Research based on company data

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

Medium-term strategy

Achieve sustained growth by expanding customer base, developing new products, and increasing scale of operations in Asia

Medium-term strategy

Rolling approach

The company said it would revise targets annually, producing a rolling medium-term plan in order to respond flexibly to change in the operating environment. On January 12, 2017, Lacto Japan released a three-year plan, NEXT-LJ2019, covering FY11/17 through FY11/19. In just one year (i.e., in FY11/17), it met the targets set for FY11/19. The company unveiled NEXT-LJ2020 (FY11/18 through FY11/20) on January 12, 2018 and unveiled NEXT-LJ2021 (covering FY11/19 through FY11/21) on January 15, 2019. On February 14, 2020, it released NEXT-LJ2022 (covering FY11/20 through FY11/22).

Summary

Under its NEXT-LJ2022 medium-term business plan, the company is targeting FY11/22 sales of JPY141.0bn (+120.7% vs FY11/19) ordinary income of JPY3.5bn (+127.7%), and net income of JPY2.5bn (+127.4%). The target figures assume increased sales via ongoing growth in sales volume, from 289,300 tons in FY11/19 to 343,575 tons in FY11/22, and rising contributions to earnings from overseas businesses. The plan also calls for Lacto Japan to build next-generation businesses.

Assumptions underlying numerical objectives

- ▶ No change in basic scenario, but a small revision to product prices due to tariffs and other factors
- ▶ Outlook for more growth as well as some expenses to support growth, including increased recruiting and training activities

Business climate

- ▶ Continuation over medium-term in shortage of domestically produced dairy ingredients

Medium-term strategy

- ▶ Targeting sales of JPY141.0bn in FY11/22 (+120.7% vs. FY11/19 result)
- ▶ Ordinary income target of JPY3.5bn (+127.7%)
- ▶ Premised on top-line growth driven by increase in handling volume, and higher profit contribution from overseas business (Asia)
- ▶ Building next-generation businesses
- ▶ Key initiatives: (1) Grow business with existing customers and secure new customers; (2) build next generation businesses; (3) expand business in fast-growing markets in Asia; and (4) build sound foundation for sustained growth

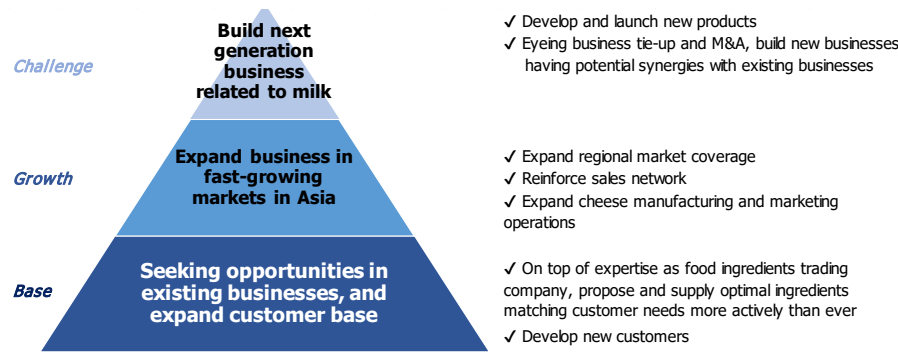
- ▶ Firm sales of imported ingredients due to tariff cuts and Japan/foreign price gap
- ▶ Progress in development of new ingredients (more advanced processing, more and better functions)
- ▶ More structural change in locations of suppliers
- ▶ Increasing need for processed food products due to labor shortages and other reasons
- ▶ Growth of dairy products market in Asia

Overview of current medium-term business plan, NEXT-LJ2022

(JPYmn)	FY11/19 Est.	FY11/21 Est.	FY11/22 Est.
Sales	116,794	130,000	141,000
Ordinary income	2,747	3,000	3,500
Profit margin	2.4%	2.3%	2.5%
Net income	1,963	2,100	2,500
Net margin	1.7%	1.6%	1.8%
Transaction volume (tons)	289,300	317,100	343,575

Source: Shared Research based on company data

Medium-term business plan, NEXT-LJ2022: basic policy and key initiatives



Source: Shared Research based on company data

Basic policy: Grow business with existing customers, and create next-generation businesses

The plan consists of three key initiatives.

- ▶ Grow business with existing customers* and secure new customers
- ▶ Expand business in fast-growing markets in Asia
- ▶ Build next-generation businesses (new businesses expected to realize synergies with existing businesses).

* Three years have now passed since the appointment of Motohisa Miura as president. The slogan of growing business with existing customers stems from the notion of rediscovering engines for companywide growth in order to pursue ongoing evolution rather than merely leveraging favorable operating conditions to ensure near-term growth. To that end, the company believes it is important to waste no time in developing new products and building new businesses. Profits currently are at record-high levels, but Lacto Japan is nonetheless actively engaged in developing new products, cultivating new customers, and building new businesses.

Lacto Japan regards personnel as its most important business resource, in the belief that human-driven merchandise and information flows have a key role to play in cultivating new customers and building next-generation businesses. While the company is keen to support in-house nurturing of individuals who can drive evolution, introduce promising new products and ingredients, and promote development of other human resources, it also is committed to bringing in capable people from outside.

Key initiatives

- ▶ Grow business with existing customers and secure new customers: The aim is to grow business with existing customers by using more advanced processing and adding more and better functions. Lacto Japan plans to abide by the aforementioned free

trade agreements in expanding its operations, while continuing to seek new suppliers, not just in leading dairy countries but also in Eastern Europe and other areas new to the international dairy ingredients market. The company also looks to broaden its customer base.

With advances in dairy technology, Lacto Japan says there are dairy ingredients that are not produced domestically. The only dairy ingredients produced in Japan are cream, butter, skim and whole milk powder, cheese, and whey. On a global basis, though, more than 100 types of dairy ingredient are manufactured. Lacto Japan plans to introduce customers (including dairy product makers and beverage makers) to dairy ingredients that cannot be manufactured in Japan, and then source these items. The key with infant formula, for example, is to ensure that the proteins are as close as possible to those in breast milk. The protein mix is the single greatest difference between breast milk and cow's milk, and Lacto Japan can supply infant formula makers with milk powder mixtures that have had the protein mix suitably adjusted. High tariffs are applied under the current system. As discussed earlier, though, Japan's reliance on imports is increasing year by year, as the volume of domestically produced dairy ingredients is insufficient to support domestic consumption. Domestic manufacturers (Lacto Japan's customers) are very demanding when it comes to dairy ingredients, and moreover they have a strong tendency to be specific in their requirements. Long-standing relationships with suppliers are critical in meeting these customers' needs in a timely manner (a difficult task for new market entrants with no such channels in place). Furthermore, Lacto Japan can offer customers value-added. For example, in order to attract a lower secondary tariff rate, it can import blended preparations containing non-dairy constituents such as sugar and vegetable oil.

- Expand business in fast-growing markets in Asia: In addition to strengthening sales to existing customers (increasing transactions via the Lacto Approach*), the aim is to further build on the approach used in the Philippines (taking business from leading dairy ingredients suppliers with large market shares), and use these proven models to open up new sales routes in emerging markets within the Southeast Asian region.

* Lacto Approach: This is a style of management that has the goal of precisely targeting the needs of customers in Japan that Lacto Japan has served for many years. Accomplishing this involves the use of a global supply network for the provision of information and the reliable supply of quality ingredients. Meeting customers' needs also entails the provision of a variety of knowledge and expertise by a team of professionals.

According to Lacto Japan, the company has more than nine expatriate staff in Asia, which reportedly is more than would be seen at the local food business units of Japan's major general trading companies. Moreover, Lacto Japan's practice of specializing in dairy products affords it a competitive advantage in Asia. In the immediate aftermath of capital expenditure in cheese manufacturing facilities in Asia (a total of JPY2.0bn for the Singapore and Thai plants), the company was burdened by losses. Now, however, those losses have been eradicated, and the company can begin recouping its investments. As was the case in Japan, Lacto Japan believes that demand for dairy products and food containing large amounts of dairy products, (such as ice cream, chocolate, and pizza) will increase in Asia as food cultures become more westernized. The company chose Asia as the site of its overseas business for the opportunity to (1) supply "Japanese-quality" dairy ingredients and cheese to Japanese manufacturers with operations in Asia; and (2) leverage its familiarity with information on local economy, etc. in introducing Japan's unique dairy ingredients and cheese culture to Asia (the company sees limited potential for competing in Western markets, where dairy products are well entrenched). By building a greater brand presence in Asia, Lacto Japan aims to broaden the application of its businesses fostered in Japan.

- Building next-generation businesses: The company has begun to develop and sell new products*, with development areas including functional dairy ingredients, processed food, healthcare ingredients, and milk proteins. Lacto Japan also plans to use alliances and M&A to construct new businesses with potential to realize synergies with existing businesses.

* This includes secondary ingredients other than those for dairy products, and products in peripheral areas, to which Lacto Japan will apply the same approach it uses for existing products.

- Build sound foundation for sustained growth: Lacto Japan seeks to build a larger and more skilled workforce, ensuring that personnel also are equipped to support business expansion into new domains. It plans to devise training activities, strengthen corporate governance, and pursue sustainable management.

Outlook for longer-term use of funds

- ▶ Investments for growth of cheese manufacturing and sales business in Asia: Production line expansion, new factories, and other projects
- ▶ Further increase in financial soundness: Increase equity (raise the equity ratio from the high-30% level to about 40%) to build a sound base for the diversification of business operations (transition from a trading company model to a combination of trading and manufacturing)
- ▶ Use funds to start new businesses

Review of previous medium-term plan, NEXT-LJ2021 (Reference)

- ▶ Seek further opportunities in existing businesses and expand customer base through new business development: In the dairy ingredients and cheese business, the company increased sales to beverage and animal feed companies, and built relationships with Japanese dairy product producers in areas other than major metropolitan areas by strengthening ties with regional wholesale firms. Lacto Japan began using suppliers in emerging dairy product countries such as India and countries in Eastern Europe, and started using pork suppliers in Europe in addition to existing suppliers in the US and Canada. The company also began handling more primary processed food ingredients and products and supplying an even broader range of meat.
- ▶ Expand business in fast-growing markets in Asia: In the dairy ingredients and cheese business, the company used competitive pricing, information and innovative ideas to increase sales to companies in Asia, pursuing further business growth by enlarging sales channels and handling a larger number of items. In cheese manufacturing, higher factory operating rates in Singapore and Thailand led to business expansion and higher profitability.

Strengths and weaknesses

Strengths

- **Wealth of information, ability to offer solutions, respond to customer needs:**
As a trading company specializing in dairy ingredients and cheese, Lacto Japan is a leading company with a share of some 38% in imports of these products. The company was founded in May 1998 by long-standing employees of Toshoku (dairy product division), in response to pleas from the latter's suppliers and clients following Toshoku's collapse. Since then, Lacto Japan has amassed a wealth of specialist expertise and know-how, with around 60 employees involved in the dairy ingredients and cheese fields (even more than the five to ten employed at competing business units of general trading companies). The company is able to provide customers with specialist knowledge of overseas markets, including information on dairy ingredients not manufactured in Japan, international markets, forex, trade, and tax systems. At the same time, it boasts a full lineup comprising around 40 general-purpose dairy ingredients as well as over 500 primary processed products tailored to customers' detailed specifications. Lacto Japan has built favorable relationships with leading dairy

companies in key milk producing countries, and now boasts 140 suppliers in 20 countries around the world (including almost all major suppliers in the main milk producing countries). As a consequence, the company is now able to source products worldwide, and therefore is able to ensure Japanese customers of a reliable flow of imports (supplies).

- ✔ **Independence** (not bound by capital alliances or complex trading relationships): Lacto Japan operates independently, with no ties to any particular corporate group. Not only does this permit it to cultivate new suppliers and customers with no constraints from capital relationships or complicated dealings within business groups, but the company is also able to put itself always in the customer's shoes in order to devise optimal solutions, and can act nimbly, starting with swift decision-making. Although there are other trading companies specializing in food, they tend to be small in scale, and none have a sufficiently broad lineup of dairy ingredients and cheese products to compete with Lacto Japan.
- ✔ **Presence in Asia and addition of manufacturing capability:** Since establishing a subsidiary in Singapore in 1999, Lacto Japan has accumulated nearly 20 years of experience in Asia, importing and selling "Japanese-quality" dairy ingredients (surpassing international standards on aspects such as bacteria count) to Japanese manufacturers operating in the region. Back in 2005—before Mitsui & Co, Itochu, and Mitsubishi Corp respectively invested in dairy product manufacturing in Asia in August 2007, August 2009, and June 2012—Lacto Japan started up its own processed cheese plant in Singapore, thus adding manufacturer to its trading company persona. In 2015, the company built another plant in Thailand.

Weaknesses

- ✔ **Heavy reliance on domestic market (constraint on growth):** Some 70% of Lacto Japan's sales come from importing dairy ingredients and cheese for sale to Japanese customers (as of FY11/19). The company has benefited from the fact that dairy product imports grew at a CAGR of 4.9% over the eight years from FY2010 to FY2018, reflecting a 0.6% yearly decline over the same period in Japan's dairy product output. Since FY2000, however, domestic consumption of dairy products has remained flat at roughly 12 million tons per year on a milk equivalent basis. This has acted as a constraint on growth.
- ✔ **Limits on potential for adding value:** Lacto Japan imports the dairy ingredients required by customers from appropriate suppliers, earning a commission for doing so. The company's ability to stably supply ingredients is a source of added value, as are the aforementioned information resources and ability to offer solutions and respond to customer needs. Potential for adding value is limited, however, in comparison with the scope for suppliers (dairy ingredient makers) and customers (dairy product, confectionery, oils & fat, and beverage makers) to add value through manufacturing and sales. In real terms (adjusted for exchange gains and losses), the company's operating profit margin is only about 3%.

Income statement

Income statement											
(JPYmn)	FY11/10	FY11/11	FY11/12	FY11/13	FY11/14	FY11/15	FY11/16	FY11/17	FY11/18	FY11/19	FY11/20 Est.
	Parent	Parent	Parent	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Sales	46,411	56,089	55,201	75,943	96,550	98,001	88,679	101,335	115,441	116,794	130,000
YoY	-	20.9%	-1.6%	37.6%	27.1%	1.5%	-9.5%	14.3%	13.9%	1.2%	11.3%
CoGS				72,684	92,291	94,352	82,333	95,948	108,930	109,994	
YoY	-	-	-	-	27.0%	2.2%	-12.7%	16.5%	13.5%	1.0%	
CoGS ratio	-	-	-	95.7%	95.6%	96.3%	92.8%	94.7%	94.4%	94.2%	
Gross profit				3,259	4,259	3,648	6,346	5,387	6,511	6,801	
YoY	-	-	-	-	30.7%	-14.3%	73.9%	-15.1%	20.9%	4.4%	
GPM	-	-	-	4.3%	4.4%	3.7%	7.2%	5.3%	5.6%	5.8%	
SG&A expenses				2,559	2,727	2,928	2,996	3,463	3,502	3,656	
YoY	-	-	-	-	6.6%	7.4%	2.3%	15.6%	1.1%	4.4%	
SG&A ratio	-	-	-	3.4%	2.8%	3.0%	3.4%	3.4%	3.0%	3.1%	
Operating profit				700	1,532	720	3,349	1,924	3,009	3,144	-
YoY	-	-	-	-	118.8%	-53.0%	365.1%	-42.6%	56.4%	4.5%	
OPM	-	-	-	0.9%	1.6%	0.7%	3.8%	1.9%	2.6%	2.7%	
Forex gains (losses)				1,189	638	1,053	-1,537	1,159	-135	-114	
YoY	-	-	-	-	-46.3%	65.0%	-	-	-	-	
% of sales	-	-	-	1.6%	0.7%	1.1%	-1.7%	1.1%	-0.1%	-0.1%	
OP + Gains (losses) on forex				1,889	2,170	1,773	1,812	3,082	2,874	3,030	
YoY	-	-	-	-	14.9%	-18.3%	2.2%	70.1%	-6.8%	5.4%	
% of sales	-	-	-	2.5%	2.2%	1.8%	2.0%	3.0%	2.5%	2.6%	
Other non-operating income (expenses)				-219	-516	-430	-378	-560	-261	-284	
YoY	-	-	-	-	-	-	-	-	-	-	
% of sales	-	-	-	-0.3%	-0.5%	-0.4%	-0.4%	-0.6%	-0.2%	-0.2%	
Ordinary income	876	1,497	787	1,670	1,653	1,343	1,434	2,523	2,613	2,747	3,000
YoY	-	70.9%	-47.4%	112.2%	-1.0%	-18.8%	6.8%	75.9%	3.6%	5.1%	9.2%
Profit margin	1.9%	2.7%	1.4%	2.2%	1.7%	1.4%	1.6%	2.5%	2.3%	2.4%	2.3%
Net income attrib. to parent company shareholders	566	845	422	1,007	988	831	946	1,755	1,784	1,963	2,100
YoY	-	49.4%	-50.0%	138.6%	-1.9%	-15.9%	13.8%	85.5%	1.7%	10.0%	7.0%
Net margin	1.2%	1.5%	0.8%	1.3%	1.0%	0.8%	1.1%	1.7%	1.5%	1.7%	1.6%
Depreciation and amortization of goodwill	-	-	-	96	100	179	174	226	212	220	-
EBITDA	-	-	-	796	1,632	900	3,524	2,149	3,221	3,365	-

Source: Shared Research based on company data
 Figures rounded to the nearest million yen

Balance sheet

Balance sheet										
	FY11/10	FY11/11	FY11/12	FY11/13	FY11/14	FY11/15	FY11/16	FY11/17	FY11/18	FY11/19
(JPYmn)	Parent	Parent	Parent	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Cash and deposits	-	-	-	3,305	4,300	5,132	6,724	4,006	4,930	4,475
Notes and accounts receivable	-	-	-	11,908	14,941	12,695	14,278	17,199	15,873	17,852
Inventories	-	-	-	13,180	19,193	18,496	13,101	21,446	25,216	22,946
Merchandise and finished goods	-	-	-	13,053	19,040	18,331	12,910	21,178	24,873	22,618
Raw materials and supplies	-	-	-	126	153	165	191	268	343	328
Deferred tax asset	-	-	-	8	11	124	28	139	101	0
Other	-	-	-	708	1,694	316	1,001	700	318	501
Total current assets	-	-	-	29,109	40,139	36,764	35,133	43,491	46,337	45,775
Tangible fixed assets	-	-	-	344	715	698	663	560	597	569
Buildings and structures	-	-	-	117	142	268	262	205	250	191
Machinery, equipment, and vehicles	-	-	-	133	226	281	287	263	221	229
Lease assets	-	-	-	-	3	135	96	73	42	121
Other	-	-	-	12	12	14	11	11	33	28
Land	-	-	-	28	-	-	-	-	-	-
Construction in progress	-	-	-	53	332	-	7	7	52	0
Intangible assets	-	-	-	150	125	95	56	21	39	30
Investments and other assets	-	-	-	1,407	1,543	1,765	1,711	1,833	1,917	1,762
Investment securities	-	-	-	658	735	900	790	998	889	738
Deferred tax asset	-	-	-	181	149	45	82	102	117	160
Other	-	-	-	568	661	822	839	735	915	863
Allowance for doubtful accounts	-	-	-	-	-1	-1	-1	-1	-3	-
Total fixed assets	-	-	-	1,901	2,382	2,558	2,429	2,414	2,631	2,360
Total assets	19,961	22,662	21,894	31,010	42,522	39,322	37,562	45,905	48,968	48,135
Accounts payable	-	-	-	6,559	10,189	8,620	6,890	11,411	11,174	12,649
Short-term borrowings	-	-	-	7,031	10,476	1,560	209	4,796	8,686	6,100
Current portion of bonds	-	-	-	688	300	355	620	690	660	450
Current portion of long-term debts	-	-	-	2,625	3,308	3,687	3,474	2,893	2,333	6,643
Income taxes payable	-	-	-	587	300	175	298	657	397	410
Deferred tax liability	-	-	-	-	378	-	130	-	-	-
Other	-	-	-	418	602	703	878	460	730	946
Total current liabilities	-	-	-	17,908	25,553	15,099	12,500	20,908	23,979	27,198
Corporate bonds	-	-	-	485	385	860	1,590	1,380	720	270
Long-term borrowings	-	-	-	4,839	6,708	12,202	11,209	9,926	8,493	4,050
Deferred tax liability	-	-	-	48	65	73	61	91	72	18
Net defined benefit liability	-	-	-	264	269	263	297	264	279	311
Provision for directors' retirement benefits	-	-	-	265	313	225	269	-	-	-
Asset retirement obligations	-	-	-	11	37	37	36	36	36	36
Other	-	-	-	60	60	171	181	515	982	287
Total fixed liabilities	-	-	-	5,973	7,837	13,832	13,643	12,212	10,557	4,972
Total liabilities	-	-	-	23,880	33,390	28,931	26,142	33,120	34,561	32,171
Shareholder's equity	4,369	5,170	5,664	6,698	7,673	9,646	10,446	12,050	13,655	15,416
(Treasury stock)	-	-	-	(11)	-	-	-	-0	-0	-53
Accumulated other comprehensive income	-	-	-	401	1,459	744	973	700	666	480
Non-controlling interests	-	-	-	30	-	-	-	-	-	-
Share subscription rights	-	-	-	-	-	-	-	36	111	69
Total net assets	-	-	-	7,130	9,132	10,391	11,419	12,785	14,432	15,964
Net debt	-	-	-	12,362	16,877	13,531	10,378	15,679	15,962	13,038
Working capital	-	-	-	18,528	23,946	22,571	20,489	27,234	29,916	28,150

Source: Shared Research based on company data
Figures rounded to the nearest million yen

Per-share data (JPY)

Per-share data (adjusted for stock splits; JPY)										
	FY11/10	FY11/11	FY11/12	FY11/13	FY11/14	FY11/15	FY11/16	FY11/17	FY11/18	FY11/19
	Parent	Parent	Parent	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Shares issued (year-end)	7,836,400	7,836,400	7,836,400	7,836,400	7,834,800	9,779,000	9,779,000	9,785,000	9,793,000	9,835,200
EPS	74.58	110.38	54.90	130.75	127.79	98.94	96.79	179.48	182.31	200.11
EPS (fully diluted)	-	-	-	-	-	-	-	177.16	178.49	195.98
Dividend per share	8.00	8.00	8.00	15.00	15.00	15.00	16.00	19.00	20.00	22.00
Book value per share	571.61	673.22	736.10	920.94	1,165.58	1,062.54	1,167.72	1,302.98	1,462.35	1,618.31

Source: Shared Research based on company data

Cash flow statement

Cash flow statement										
	FY11/10	FY11/11	FY11/12	FY11/13	FY11/14	FY11/15	FY11/16	FY11/17	FY11/18	FY11/19
(JPYmn)	Parent	Parent	Parent	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
Cash flows from operating activities	-	-	-	-3,229	-4,062	2,535	3,560	-5,048	356	3,365
Cash flows from investing activities	-	-	-	-130	-541	-242	5	-137	-864	849
Cash flows from financing activities	-	-	-	3,802	5,412	-1,476	-1,655	2,385	990	-3,695

Source: Shared Research based on company data
Figures rounded to the nearest million yen

Financial indicators

Financial indicators										
	FY11/10	FY11/11	FY11/12	FY11/13	FY11/14	FY11/15	FY11/16	FY11/17	FY11/18	FY11/19
	Parent	Parent	Parent	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.	Cons.
ROA (OI-based)	4.4%	7.0%	3.5%	6.3%	4.5%	3.3%	3.7%	6.0%	5.5%	5.7%
ROE	14.0%	17.7%	7.8%	15.6%	12.2%	8.5%	8.7%	14.5%	13.2%	13.0%
Inventory turnover	-	-	-	-	4.8	5.0	5.2	5.6	4.7	4.6
Fixed assets turnover	-	-	-	-	135.0	138.7	130.4	165.8	199.6	200.3
Current ratio	-	-	-	162.6%	157.1%	243.5%	281.1%	208.0%	193.2%	168.3%
Net assets ratio	21.9%	22.8%	25.9%	22.9%	21.5%	26.4%	30.4%	27.8%	29.2%	33.0%

Source: Shared Research based on company data
Note: Figures rounded to the nearest million yen

Policy on shareholder returns

Lacto Japan believes in prioritizing profit returns to shareholders, and has a basic policy of maintaining a stable and steady dividend stream. The company expects to pay a dividend of JPY22 per share in FY11/19 and JPY30 per share in FY11/20. At the same time, Lacto Japan aims to secure a sufficient level of internal reserves to invest in realizing growth over the medium to long term, in order to enhance corporate value.

Shareholders

As of November 30, 2019		
Shareholders	Shares	Shareholding ratio
Japan Trustee Services Bank, Ltd. (Trust account)	849,600	8.6%
The Master Trust Bank of Japan, Ltd. (Trust account)	713,900	7.3%
The Nomura Trust and Banking Co., Ltd. (Trust account)	390,600	4.0%
Shigeru Yasumi	311,400	3.2%
Kiichiro Kamakura	243,000	2.5%
Motohisa Miura	240,290	2.4%
State Street Bank and Trust Company	240,200	2.4%
Ryosuke Morozaki	236,600	2.4%
Japan Trustee Services Bank, Ltd. (Trust account 9)	235,300	2.4%
Jun Ishii	231,700	2.4%
Shares issued	9,835,200	100.0%

Source: Shared Research based on company data

Corporate governance

Organization type, capital structure etc.	
Controlling shareholder	None
Parent company code	-
Director	
Number of directors under Articles of Association	7
Directors' terms under Articles of Association	2 years
Number of external (independent) directors	2
Audit & Supervisory Board	
Number of auditors under Articles of Association	No upper limit
Number of external (independent) auditors	2
Other	
Number of independent officers (aggregate of external directors/auditors)	4
Participation in electronic voting platform	None
Other initiatives to enhance voting rights of investors	In place
Providing convocation notice in English	None
Disclosure of directors' compensation	None
Disclosure of executive officers' compensation	-
Policy on determining amount of compensation and calculation methodology	In place
Takeover defenses	None

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