

Papyless 3641

February 24, 2017 - 12:16am EST

by

gvinvesting

			2017	2018
Price:	6,200.00	EPS	295	380
Shares Out. (in M):	5	P/E	21x	16.3x
Market Cap (in \$M):	279	P/FCF	21x	16.3x
Net Debt (in \$M):	-47	EBIT	19	25
TEV (\$):	232	TEV/EBIT	11.2x	8.0x

Description

Japan's robust internet ecosystem is fertile ground for finding mispriced securities. However, in contrast to the standard deep value, net-net approach that attracts many value investors to Japan, attractive opportunities in this sector often come in the form of growth at a reasonable price. We usually try to capture an initial margin of safety by focusing our efforts on growing companies that are priced for little to no growth. Occasionally, we are forced to reconsider our original investment thesis if actual earnings growth surprises us one way or another.

Papyless is one such investment, where we believe that the stock is still attractively priced in the context of accelerated revenue and earnings growth, although it is no longer trading at a low earnings multiple.

We believe that Papyless has carved out an attractive and defensible niche in the rapidly growing Japanese e-book market and will be able to grow revenue and EBIT at a 20-30% annual rate over the next 3-5 years, despite the presence of Amazon Kindle and 50+ local players.

Even after an impressive 170% advance in the share price over the past 6 months, we believe that the shares are still attractively valued in the context of accelerated revenue and earnings growth in the last two quarters. We think that in a worst case scenario the compounding of earnings over the next several years will provide downside protection from today's share price, and in a best case scenario the shares could further rerate to reflect higher earnings growth expectations, which would generate annualized returns of over 30%.

Papyless was founded in 1995 as an e-book distribution platform, first for PC and then mobile phones in 2004. The Company has never been involved in e-commerce sales of physical books or electronic reading devices. Books purchased on the platform are compatible with PCs, Android and iOS smartphones, tablets, and 3rd party reading devices (the only exception being the Kindle Paperwhite).

The Company offers several differentiated services:

- **Ebook Shop Papyless** - General ebook store
- **Inu Mimi Shoten (Dog Ear Bookstore)** - Specializing in practical books, this service allows readers to purchase only a section of a book for a reduced price
- **Renta!** - Rental site mainly for e-comics (manga), where users can rent titles for 48 hours for as low as ¥100. Also operating Chinese and English language sites.
- **upppi** - Free e-book submission and editing platform for independent authors

We believe that the most important driver of revenue and profits is Renta, which was launched by the Company in 2007. The business model is centered on the ability to rent books, mainly manga, for a 48-hour period for as low as \$1. This revenue model is fairly unique as most sites operate around a fully paid (\$4-6 per volume of manga), monthly subscription, or free with advertising model. However, what makes Renta more unique is the site's focus on a demographic that is widely underrepresented in the traditional print manga reader base: adult females.

While a wide range of manga subgenres have emerged in post-war Japan, including many authored by women for women, the size of the market was quite limited due to the simple fact that women were embarrassed to be seen buying certain titles, reading them on the train, or being caught with them at home. More specifically, since the 1980's, the redisu-josei subgenre or "ladies comic" has dealt with themes of young adulthood such as the workplace, friendships or love among women, and the emotions and problems associated with sex.

Since the dawn of the smartphone (of course in Japan this started with very advanced feature phones), an increasing number of women have been able to read comics on their daily commute without drawing the attention of nosy neighbors or to purchase and read them in private.

Papyless recognized early on this opportunity to create a new market, while many other players are competing for the same mainstream market with far less success. More popular titles have suffered disproportionately from online piracy, and platforms such as eBook Initiative Japan which feature blockbuster titles have struggled to break even due to higher royalty rates owed to the major publishers.

Naturally, as understanding the female comic reader is critical to executing their strategy, Papyless' CEO is a woman. We would not be surprised if this was the only player (out of the 50+) in the industry with a female CEO, and it is one of the only companies we have met in Japan with a female CEO.

The following ads will give you a good idea of Renta's brand positioning, even if you don't speak Japanese:

https://www.youtube.com/watch?v=4-dwQecc_D0

<https://www.youtube.com/watch?v=uZ54Zh0VtXc>

Despite the proliferation of pirated manga and the slowly melting ice cube of the traditional print manga market, the overall manga industry actually turned a corner and started growing revenues since 2012, primarily thanks to new female e-comic readers. User growth at Renta, measured by the number of registered users who have bought at least one title, may actually be accelerating: the user base passed 1m in

March 2014, 2m in February 2016, and 3m this month (February 2017). Revenue has grown 33.5% through the first nine months and 40% yoy in the last quarter, compared with 23% growth the year before. At these accelerated growth rates, Papyless appears to be quickly gaining market share.

The Company believes that the market is still poised to grow; in its most recent presentation the Company forecasts that the Japanese e-book market will roughly double by 2020 and that they expect their market size to increase by 10x over the next 20 years, including overseas markets. The Company is continuing to innovate and differentiate its services as market competition heats up; for example, they have created a new format for novel content to make chat dialogue easier to read as well as a moving comic format.

Structure of Japanese e-Book Market - Competition

E-comics make up 70-80% of the entire e-book market in Japan. There are 50+ domestic competitors and 1000+ publishers, which makes for quite a varied landscape of business models.

Amazon Kindle is dominant in the general e-book category, despite entering the market in only 2009 and going up against local competitors. Amazon is about the size of Papyless in the e-comic market, despite only entering in 2010. In October 2016, Amazon released a new Kindle model which appears to be specifically for handling larger manga files.

<https://arstechnica.com/gadgets/2016/10/a-kindle-for-your-manga-amazon-launches-32gb-paperwhite-for-japan/>

Around the same time, Amazon launched an unlimited e-reading service, the first in Japan, making about 25% of their Japanese titles available for ¥980 per month. However, even Amazon has its limitations as to how much cash it is willing to burn, as it quickly pulled some of the more popular manga titles from the service to limit the royalties it would owe to publishers. Currently, the Kindle Unlimited service does not include any content published in the last 6 months, which is exactly what manga readers are looking for, so this does not pose a direct threat to the rest of the e-comic market.

<http://www.japantimes.co.jp/news/2016/10/04/national/japanese-publisher-lodges-protest-amazon-unit-deletes-1000-e-book-titles/#.WKV-pG994uX>

Amazon has clearly noticed the growing female audience, as they are currently offering female comic titles at a 50% discount through the end of February. However, Amazon's more passive and generalist approach may limit the resources they are willing to spend or the extent they are willing to curate content to address any given niche market.

Mecha Comics is the largest e-comics platform by revenue, operating a monthly subscription model. Like Papyless, they are also targeting the female 20-30 year-old demographic (an estimated 90% of their audience), but the service is only available on smartphone. The service is generating about 30% more annual revenue than Papyless as of December 2016.

Mecha has about 1m users paying a minimum monthly subscription of ¥300. This does not allow for unlimited reading, however, as the user is given the equivalent number of points to spend on comics. The points are carried over for as long as the user is subscribed. About 80% of new users terminate the service after one month, but the remaining 20% tend to stick with the service long-term.

Like Papyless, Mecha runs TV advertising in addition to banner advertising to acquire customers. Their results this year suggest just how much their TV advertising might matter. For the first time in corporate history, they ran an ad campaign around a specific hit title, "Transparent Creep," rather than the standard broad campaign. They believe that the net result was that Papyless benefited from increased sales of the title without having to advertise, and Mecha's own revenue growth fell slightly below the overall market at 19%.

As for the rest of their advertising, Mecha has gone the cute route:

<https://www.youtube.com/watch?v=pKSf7UvPY0Y>

eBOOK Initiative Japan is the #4 player in terms of revenue. Based on their best sellers, they appear to have a more mainstream male audience. 13 of their top 20 best sellers are published by Kodansha, the largest manga publisher. As Kodansha would have much greater bargaining power than the smaller publishers, we suspect this is the reason for EIJ's lower gross margins and struggle to break even.

Barriers to Entry:

- **Content** – Japan's publishing market is highly fragmented, particularly for manga. Papyless has continuously grown their distribution agreements since 1995 to cover over 600 publishers, which allows them to offer about 180,000 titles. These agreements are not exclusive, but this appears to be a difficult task for new entrants to replicate; in fact Papyless actually provides some content to Amazon Kindle (since 2012) and Yahoo! Japan, but the proportion of revenue and specific publishers/titles are not disclosed.

However, as the large majority of titles are available on a number of platforms and the titles are so numerous, content curation is what's most important. Renta is differentiated from competitors in that it focuses much of this effort on romance manga for women. This stands out clearly when comparing the site's Best of 2016 list to Amazon's:

http://renta.papy.co.jp/renta/sc/frm/page/topics/c_2016best.htm

<http://amzn.to/2ISaCB7>

Amazon's Best of 2016 list is mainly filled by blockbusters such as "One Piece," which are not even available on Renta's site. In most cases, the popular romance titles have significantly more reviews on Renta than they do on Amazon's site.

- **Switching Costs** - Users have a central library of all titles that they have purchased from a particular platform as long as that platform stays in business. There have been cases in the past where sites have had to shut down and users have lost their entire digital manga collection purchased on that platform, such as JManga in 2013: <http://www.comicsbeat.com/jmanga-shuts-down-taking-all-the-manga-you-bought-with-it/>. Papyless' longevity and profitable history as a listed company, as well as web-based compatibility with most user devices should ease any concerns a potential user may have about having access to their collection. This is important, as print manga series have traditionally made for excellent collectors' items, and digital manga may similarly serve avid collectors' psychological needs.
- **Scale** - While Papyless is ranked 3rd in market share of general ebooks at only about 7%, they are not too far behind #1 Amazon and #2 Infocom in terms of revenue. The next largest competitor, eBook Initiative Japan, is generating 30% less revenue, 50% less gross profit, and is lossmaking. We suspect that the majority of the industry is subscale and lossmaking, fighting to keep market share in hopes that a rapidly growing market eventually leads to profitability, and that ultimately many of the 50+ players may have to rationalize their operations and shut down. We think that Papyless' market share looks much more favorable when the market is segmented by gender and genre (very high share of female romance comics). This also makes Papyless a very important distribution channel for the smaller publishers which get more exposure on their platform and have less bargaining power than the blockbuster publishers.
- **Advertising** - Papyless spends about 32% of revenues on advertising, with a recurring fixed portion for TV advertising (20% of expense) and a variable portion on banner ads (80% of expense). The top three players (Amazon, Papyless, Mecha) will be able to continue to outspend subscale players on marketing, making it very difficult for new entrants to compete.

Valuation Model

Papyless is one of a number of Japanese stocks we have come across that has had to switch back and forth between publishing consolidated and unconsolidated financial statements over the years, making it less likely to show up in screens, especially those based on long-term business quality. We have compiled the key stats here (JPY millions):

	3/2005	3/2006	3/2007	3/2008	3/2009	3/2010	3/2011	3/2012	3/2013	3/2014	3/2015	3/2016	LTM 12/2016
Revenue	573	932	2,057	3,458	3,388	3,753	4,034	4,756	5,578	6,921	8,424	10,443	13,040
Gross Profit	277	464	1,136	1,858	1,832	2,069	2,245	2,721	3,262	4,089	4,923	6,023	7,511
GPM	48.3%	49.8%	55.2%	53.7%	54.1%	55.1%	55.7%	57.2%	58.5%	59.1%	58.4%	57.7%	57.6%
SGA	231	379	786	1,509	1,596	1,705	1,970	2,405	2,819	3,428	4,396	4,889	5,956
EBIT	46	85	350	349	236	364	275	316	443	661	527	1,134	1,555
EBIT Margin	8.0%	9.1%	17.0%	10.1%	7.0%	9.7%	6.8%	6.6%	7.9%	9.6%	6.3%	10.9%	11.9%
Net Income	45	113	223	242	171	234	189	211	313	434	355	750	1,040
Net Cash	244	190	606	733	915	1,308	1,568	1,683	2,288	3,020	3,415	4,413	5,312

	10-yr CAGR (to Mar 2016)	5-yr CAGR (to Mar 2016)	3-yr CAGR (to Mar 2016)	Last 9 months yoy
Revenue	27.3%	21.0%	23.2%	33.50%
Gross Profit	29.2%	21.8%	22.7%	33.30%
SGA	29.1%	19.9%	20.1%	26.20%
EBIT	29.6%	32.8%	36.8%	63.80%
Net Income	20.8%	31.7%	33.8%	71.30%

Revenue and earnings have accelerated significantly this year, and it is difficult to say how long this trend will persist. Based on the current market cap of ¥31.5 billion and assuming a return to 30% annualized earnings growth, the next five years would look like this (JPY mil.):

		1	2	3	4	5
EBIT	1,555	2,022	2,628	3,416	4,441	5,774
Net Income	1,040	1,352	1,758	2,285	2,970	3,861
P/E	30.3	23.3	17.9	13.8	10.6	8.2
Net Cash	5,312	6,664	8,422	10,706	13,677	17,538
EV/EBIT	16.8	12.3	8.8	6.1	4.0	2.4

Assuming a 5-year holding period and various growth and valuation scenarios, we get this range of potential long-term returns:

		5-yr Fwd. Earnings CAGR			
		20%	30%	40%	50%
Exit P/E	20x	10.4%	19.6%	28.8%	38.1%
	30x	19.8%	29.8%	39.7%	49.7%
	40x	26.9%	37.4%	48.0%	58.6%

Over the next twelve months, we think that the odds for a sustained level of high growth are favorable, as the last two quarters were particularly strong, with revenue growing nearly 40% and EBIT up nearly 90%. This leads us to believe that we may see two more relatively strong quarters as the business is now operating at a higher base. In this scenario, earnings growth over the next year would average 50% or higher, which makes the current valuation appear not unreasonable.

I do not hold a position with the issuer such as employment, directorship, or consultancy.

I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

- Accelerated revenue growth and operating leverage

Messages

Subject Back on Track?
Entry 01/04/2019 09:35 AM
Member gvinvesting
http://v4.eir-parts.net/v4Contents/View.aspx?template=ir_material&sid=102751&code=3641

Shortly after this write-up was published, the company ramped up advertising expenses that did not convert into an increase in sales, significantly compressing margins and trashing my short-term thesis. However, the first two quarters of this year have shown marked improvement in both revenue growth and operating margins, as you can see on slide 30 in the link above. In the second quarter, revenue growth accelerated to 16% yoy and 14.6% qoq, while EBIT margin for the half rose to 12.2% and EBIT grew 87% yoy. Over two years, this equates to 16% annualized revenue growth and 26.5% annualized EBIT growth, back in the ballpark of what I was originally expecting.

The reason given for the jump is increased efficiency of advertising. Advertising expense dropped 14% yoy while revenue for H1 rose 11%. If this trend holds, the company should beat their guidance by a wide margin (they have done 1.1B vs. original guidance of 1.3B, now raised to 1.7B). If they can match their H1 performance in H2, which they have typically done in the past, the stock is trading at about 7x EV/EBIT for the year ending March 2019.

A rise in piracy was cited as one potential reason for the poor results last year:

<https://www.japantimes.co.jp/news/2018/04/10/reference/internet-piracy-taking-major-bite-japans-famed-manga-culture/#.XC9vURMzYdU>

A major pirated comics site was shut down mid-2018, which correlates with the improved results:

<https://goodereader.com/blog/manga-and-anime-news/the-closure-of-a-prolific-pirate-manga-website-is-a-boon-to-authors>