BP Castrol K.K. 5015

June 24, 2014 - 3:28am EST
by gvinvesting

			2014	2015
Price:	629.00	EPS	$60.00	$60.00
Shares Out. (in M):	23	P/E	10.4x	10.4x
Market Cap (in $M):	141	P/FCF	10.4x	10.4x
Net Debt (in $M):	-89	EBIT	24	24
TEV ($):	52	TEV/EBIT	1.9x	1.6x

Description

We believe the following idea offers investors a unique combination of a very cheap valuation underpinned by a strong balance sheet, a consistently profitable asset-light and high-margin business, and alignment with a Western corporate controlling shareholder taking steps to unlock shareholder value.

BP Castrol K.K. (5015:JP) is a listed subsidiary of BP plc engaged primarily in the marketing and distribution of BP and Castrol branded motor oil in Japan. This is an asset-light, high-margin, branded consumer goods business with leading share in a mature market. The shares are glaringly cheap, given the following metrics (all numbers in JPY, as of 3/31/14):

Current Market Cap: 14.44B at ¥629/share

Net Cash and Cash Equivalents: 9.1B (including additional ~500m from sale of BP Air)

Net Tangible Assets: 10.47B

TTM Operating Income: 2.43B (17.8% margin)

TTM Net Income: 1.39B

TTM P/E: 10.3x

TTM EV/EBIT: 2.2x

TTM EV/E: 3.8x

TTM Pre-tax ROIC: 130%

The excess cash on the balance sheet covers roughly 65% of the market cap and continues to accumulate, providing significant downside protection for investors at the current share price. We estimate that the upside to fair value today is at least 75%, which is likely to be realized relatively quickly as the Company ramps up cash distributions to shareholders.

Company Overview

BP Castrol K.K. in its current form is the result of a number of corporate actions over the past several decades. In 1978, BP appointed Petrolub, a local company, as the sole agent of BP branded motor oil and lubricants in Japan. Petrolub was listed in 1995, at which point BP held a 33% stake in the company. In 2001, BP merged with Castrol and subsequently created a subsidiary solely focused on the marketing and distribution of Castrol motor oil and lubricants in Japan. In 2005, the Castrol subsidiary was merged with the listed Petrolub to become BP Castrol K.K. After purchasing Petrolub's founder's stake, BP controlled roughly 64% of the listed entity, which is now the sole agent for distribution and marketing of BP and Castrol branded motor oils and lubricants in the Japanese market.

Products (Best viewed in Chrome browser, which will automatically translate):

http://www.bp.com/ja_jp/bp-castrol-japan/business/bp-brand.html

Cost of goods sold primarily consists of licensed manufacturing costs. Over 90% of the marketed products are manufactured by 3rd parties in Japan, and the remainder is imported. Given the strength of its brands, the Company is generally able to pass on rising input costs to maintain gross margins around 50%, although this can fluctuate due to exchange rate movements, input cost fluctuations, timing of selling price increases, and changes in sales mix. Gross margins expanded significantly from 2008 to 2009 due to a price hike followed by a collapse in oil prices, after which selling prices remained stable. Gross margins have drifted lower since 2009 as input costs have risen due to rising crude oil prices and a weakening yen without further selling price hikes.

SG&A expenses include employee salaries and bonuses, commissions to dealers, sales promotions, transportation and warehousing, and royalty fees. The key factor in the decline of SG&A expenses from 2005 to 2008 was a reduction in annual sales promotion expense by roughly 50%; operating expenses have since remained relatively flat. Royalty fees to the parent are fixed based on sales volume; they have ranged between 4.4% and 4.6% of revenues since 2009. The risk that the royalty agreement is amended in a way that would hurt BP Castrol's margins appears to be low; in 2007 the agreement was actually adjusted downward for two years in the midst of soaring oil prices.

The Company estimates its market share at about 4% of the total Japanese automotive lubricant market. While the overall market is mature and has been declining by about 1-2% annually for the past five years, the Company's sales have grown slightly due to the strength of its brand (managed at the parent level) and distribution channels, as well as the introduction of new products such as low viscosity oil for hybrid vehicles.

The Company sells through two channels, direct through dealerships and to consumers, which account for 47% and 53% of revenues respectively. The Company sells through approximately 15% of domestic dealerships (Honda, Toyota, Nissan) and 70% of foreign dealerships (BMW, Mercedes, etc.). The biggest competitors are actually the domestic automotive brands themselves, which all offer their own automotive lubricants. However, BP Castrol is able to maintain steady business with dealers, who benefit from higher profit margins by selling BP and Castrol branded lubricants. Consumer sales are maintained with promotions such as the current World Cup campaign, where the parent is managing the branding at the event and BP Castrol is offering small gifts with their products.

The factors discussed above have resulted in a relatively stable, highly profitable business. The numbers tell a similar story (all numbers in JPY millions):

Year	Revenue	EBIT	Net Income
2009	12,189	2,326	1,268
2010	13,177	2,881	1,631
2011	13,479	2,869	1,600
2012	12,989	2,803	1,574
2013	13,377	2,566	1,460

According to Mr. Koishi, the Company President, who answered questions from investors at the last AGM in May, only ¥1,500m of working capital is required to maintain current business operations as the Company does not own any fixed manufacturing, distribution, or warehousing assets. The business is therefore generating post-tax returns on invested capital of about 100%.

Most listed subsidiaries of Western multinational corporations that we have come across in Asia with these characteristics (stable or growing market share, asset-light, consistently profitable, no prospect of acquisition or significant capital outlay) generally pay out a substantial portion of their net income as dividends and periodically pay special dividends if cash reserves grow too large. In fact, BP's listed subsidiary in India, which is operationally very similar to BP Castrol, does precisely that, maintaining a regular dividend payout ratio over 75% in addition to distributing a special dividend in 2010. However, BP Castrol has been behaving more like a typical Japanese corporation, maintaining a pitifully low payout ratio while cash continues to pile up on the balance sheet for no apparent reason, dragging down return on equity:

Year	Dividend (¥ mil.)	Payout Ratio	Net Cash (¥ mil.)	ROE
2009	367	28.9%	5,114	23.8%
2010	367	22.5%	6,194	25.2%

2011	367	22.9%	7,527	20.7%
2012	367	23.3%	8,392	17.6%
2013	527	36.1%	8,500	14.5%

To make matters worse, most of this cash is held in BP's corporate treasury, denominated in yen and earning a meager 0.3% annual interest. Whether BP Castrol management realized this was poor corporate governance or not, BP (parent) has essentially been receiving dirt cheap financing at the expense of minority shareholders for a decade.

We suspect there are several reasons why this issue was not previously addressed and the shares have remained so cheap for so long. For one, the minority shareholder base mainly consists of Japanese retail investors. Secondly, it is easy for prospective foreign investors to miss: not only is this a sub-$150m market cap company, but a large part of the balance sheet is lost in translation. What we discovered to actually be a cash deposit of ¥8.5 billion is held on the balance sheet as a "Loan Receivable." This would normally be an obvious red flag upon first glance at the financial statements, with all excess cash flow going into this mysterious line item year after year. On top of this, Bloomberg is actually missing all financial data after 2010 in its database, so there is no way for this to come up in an automated screen.

Following our initial investment, we raised the following points to the Board:

- BP Castrol's business model is asset light and highly cash generative, with no conceivable major capex requirements or acquisition targets for the excess cash.
- BP Castrol is holding cash far beyond the needs of the organization, in an arrangement that may be perceived as a conflict of interest and depresses return on shareholders' equity.
- Shareholders would greatly benefit from a cash management policy similar to that of Castrol India, with the aim of maximizing shareholder returns

As a result, upon announcing their 2013 annual results in February, the Company also announced their first final dividend increase since 2009 with the stated intention to increase the dividend progressively over time.

http://www.bp.com/content/dam/bp-castrol-japan/ja_jp/PR20140204_1.pdf

In May, BP Castrol announced the sale and transfer of its previously unmentioned subsidiary engaged in the import and distribution of aviation turbine oils to a Japanese subsidiary of Eastman Chemical Company, in connection with the sale of BP's global Aviation Turbine Oils business at the start of the year. The business was apparently fully integrated into BP Castrol, and as such segmental revenues and earnings were not previously reported. The sales price was ¥806m, equivalent to 6.3x TTM EBIT.

http://www.bp.com/en/global/corporate/press/press-releases/bp-agrees-to-sell-its-specialistglobal-aviation-turbine-oils-bu.html

http://www.bp.com/content/dam/bp-castrol-japan/ja_jp/oshirase20140521_2.pdf

As this additional windfall came shortly after the Company started hinting at returning more cash to shareholders, we think that the next logical step is for the Company to announce a special dividend at least as large as the Air BP divestment along with another increase in the regular interim dividend on July 30th, when they announce their H1 results.

With the downside substantially protected by cash and cash flow and the controlling shareholder apparently taking steps to unlocking value, the only question remains, how high can it go?

Bear Case: For the next five years, the current level of profitability and dividends remain the same, and the stock still trades at 2x EV/EBIT at the end of year 5. Given the Company's stated intention to increase dividends and the subsequent rerating already in progress, we think this scenario is unlikely. **IRR: 8.5% annualized over 5 years.**

Takeover Offer: BP decides it would rather keep the cash where it is and extends a takeover offer to minority shareholders. Seeing as how they just sold a similar business for 6.3x TTM EBIT, they could make a similar offer to minority shareholders by the end of this year. However, the announced decision to increase dividends over the next five years suggests that BP may be committed to keeping BP Castrol public. **IRR: 73% in 6-12 months.**

Optimized Capital Allocation: BP brings its subsidiary's capital allocation more in line with the parent's focus on total shareholder returns by paying a large special dividend of ¥5B (bringing the ROE back above 25%) and increasing the regular payout ratio to 80-90%; after which the stock trades up to a 5% dividend yield. In this scenario, the shares could trade up to ¥1,000 in addition to a special dividend of ¥200. **IRR: ~100% over 1-2 years with substantial upfront return of capital.**

I do not hold a position of employment, directorship, or consultancy with the issuer.
I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

- Shareholder pressure on Western corporate parent to increase cash distributions
- Large special dividend or takeover offer

Messages

Subject Dividend Ex-Date
Entry 06/25/2014 11:20 PM
Member gvinvesting

Often works a bit differently in Japan and Korea than in other markets. Today was the ex-date for BP Castrol's interim dividend, which will not be declared until results are announced on July 30th. Google finance will show the forecasted interim dividend until then, which is not necessarily the final amount. For last year's final dividend, the amount shown was 10.5/share until a final dividend of 17.5/share was declared in February.

If a special dividend is announced along with the interim results, it is possible that only shareholders as of the end of June 25 will receive it.

Subject Shareholder Activism in Japan in the Headlines
Entry 06/27/2014 06:14 AM
Member gvinvesting

http://online.wsj.com/articles/in-japan-dividends-buybacks-take-the-stage-1403711174

http://online.wsj.com/articles/japan-seeks-to-lure-investors-with-improved-corporate-governance-1403848454

Subject Interim Results and Special Dividend Announced
Entry 07/30/2014 04:26 AM
Member gvinvesting

http://www.bp.com/content/dam/bp-castrol-japan/ja_jp/2014_2Qtanshin_20140730.pdf
http://www.bp.com/content/dam/bp-castrol-japan/ja_jp/20140730%20haitou.pdf

All in Japanese, just download the document and use Google Translate for a rough translation. Revenue up 6.1% for the first half of 2014, EBIT down 16.4%. Margins were squeezed by weaker yen and higher crude oil prices.

Shareholders as of June 30th will receive a regular dividend of 13 yen (the Company guided for 10 yen) and a special dividend of 35 yen in connection with the Air BP sale. Together with the 17.5 yen final dividend earlier this year, that's a 4.7% trailing regular dividend yield on today's closing price.

We believe the special dividend and regular dividend increase shows that the Company is receptive to minority shareholder demands and opens the door for more shareholder friendly actions in the future.

There is still nearly 9 billion yen of net cash on the balance sheet and room to roughly double the regular dividend, but it may take a bit more prodding from a chorus of like-minded investors...

Subject RE: Interim Results and Special Dividend Announced
Entry 08/01/2014 03:25 AM
Member nozick85

nice call!

Subject RE: Interim Results and Special Dividend Announced
Entry 08/01/2014 04:14 PM
Member razor99

indeed. great find...

Subject Starbucks Japan Buyout
Entry 09/23/2014 09:09 PM
Member gvinvesting
http://www.streetinsider.com/Corporate+News/Starbucks+Coffee+(SBUX)+to+Acquire+Remaining+Starbucks+Japan+in+~$914M+Deal/9855583.html

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Subject BOJ urges japan inc. to stop hoarding cash
Entry 11/25/2014 11:48 PM
Member gvinvesting
http://www.bloomberg.com/news/2014-11-25/kuroda-warns-hoarding-cash-will-be-costly-as-boj-ends-deflation.html

We continue to hold our position in BP Castrol, while hedging the yen. We think the continued expansionary monetary policy from the BOJ and subsequent slide in the yen is pushing companies to seriously reconsider their cash management strategies, or lack thereof. BP Castrol was one step ahead of the rest in increasing their regular dividend, paying an initial special dividend, and guiding for continued dividend increases.

Subject Stock weakness / oil price
Entry 01/05/2015 04:50 PM
Member razor99
Hi gvinvesting,

I was wondering what your thoughts are on the recent stock weakness. Is it just aggressive profit taking, or is the market concluding that lower oil prices is bad for the company. If the latter, then this seems like an interesting opportunity. My understanding is that the big drop in oil prices, which is large even in yen terms, should be a pretty sizeable tailwind for margins in the upcoming year.

Subject Full Year Earnings Out
Entry 02/04/2015 09:27 PM
Member gvinvesting
Feb. 4 (Bloomberg) -- BP Castrol KK (5015 JP) reported unconsolidated earnings results for the year ended Dec. 31. Figures other than EPS are in millions of yen.

	Revenue	Operating Profit	Current Profit	Net Income	Earnings Per Share
Full-Year Results	13,929	2,459	2,440	1,895	82.57
Year Earlier Period	13,377	2,566	2,562	1,460	63.63
Versus Results	4.1%	-4.2%	-4.8%	29.8%	
Company Forecast	13,276	2,136	2,164	1,750	76.26
Versus Results	4.9%	15.1%	12.8%	8.3%	

Toyo Keizai Est.	13,300	2,100	2,150	1,750	76.20
Versus Results	4.7%	17.1%	13.5%	8.3%	

Next Year Forecast	13,034	2,251	2,259	1,373	59.84
Versus Results	-6.4%	-8.5%	-7.4%	-27.5%	
Half Year Forecast	6,039	959	965	587	25.57
Previous Half-Year	6,505	1,033	1,051	1,103	48.04
Versus Result	-7.2%	-7.2%	-8.2%	-46.8%	

Full Year Dividend	81.00
Previous Full-Year Dividend	23.00
Forecast 2nd Qtr Dividend	26.00
Forecast Full-Year Dividend	54.00

TTM EBIT as of September was JPY2,375m, So Q4 EBIT was actually 84m higher yoy, about 10.8% higher, and this is with Air BP included in last year's results (probably at least 13% growth yoy). Oil in JPY has fallen 40% from the peak at the end of September, but Q4 would not show the full effect of the improvement in margins as inventory turnover is about 3-4 weeks.

Full year EBIT came in 15% ahead of the company's forecast. Given current low oil prices and oversupply issue, and the very positive results on margins this had for the company last time around, I think it's safe to say that forward estimates are probably too low.

The final dividend was well ahead of their forecast for the year, although technically no special dividend was paid. The trailing dividend payout now amounts to 99%! Looking at their EPS and dividend forecast, the projected payout is 90%.

There is still roughly JPY9.5B of cash on the balance sheet, so EV/EBIT is about 6.5x. P/E is about 16x, EV/E is 10-11x, recurring dividend yield is about 6% at 100% payout, which is likely the highest yield in the market still. This is all assuming an effective tax rate at 40%.

With Abe's reelection, it looks like the government is intent on lowering the corporate tax rate to their target of 30% over the next several years. If BP Castrol's EBIT grew by 10% and the effective tax rate dropped to 35% while maintaining a 100% payout ratio, the dividend yield would be 7%. The average yield on a REIT in Japan, for comparison, is 3%.

(As I wrote this, the stock jumped 15%, so some of my valuation work is already stale).

Subject Re: Stock weakness / oil price

Entry 02/04/2015 09:37 PM
Member gvinvesting

Sorry for the long delay - Yes, oil prices have dropped 40% in terms of yen, which should be very positive for margins. You can go back to 2008-2009 to see what happened last time around. Retail prices of motor oil do not actually fluctuate like gasoline prices, so revenue should remain stable and gross margins should improve markedly.

http://www.exchangerates.org.uk/commodities/live-oil-prices/OIL-JPY.html

Subject Author Exit Recommendation
Entry 08/24/2015 02:02 AM
Member gvinvesting

The author has recommended exiting the position