

## Kobayashi Pharmaceutical (TSE: 4967)

125 Year High Quality Business with Wide Moat, High Returns on Capital, Shareholder Aligned Management and Multiple Catalysts



*“You Make a Wish and We Make it Happen”*

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# Investment Philosophy

## Asia is a Fertile Hunting Ground for Disciplined Value Investors with Few Sophisticated Boots on the Ground Creative Significant Opportunity

**“In 1984, very few investors in London looked at securities like in New York. Many companies in London would have no analysts visit them. Invest where others are not looking” – Michael Price**

- **Asia provides a very fertile hunting ground for disciplined value investors given “too far, too hard” bias**
  - Over 11,500 companies over \$50mm market cap, with ~6300 companies or 55% with practically no analyst coverage
  - Asia is over 25% of world market cap but ~5% of hedge fund AUM with few “sophisticated boots on the ground”
  - Too far, too hard mentality create tremendous opportunities for disciplined value investors on the ground in Asia
- **Investment philosophy focused only on “best ideas portfolio” of high quality value and niche growth (small companies with potential to become big companies) that must meet 5Cs criteria for the complete package**
  - Circle of competence: Businesses we understand and can reliably predict
  - Cheap relative to our estimate of intrinsic value: If it’s not a no-brainer, we are not interested
  - Competitive advantage: Wide and enduring moat with history of proven predictability
  - Corporate governance: Honest, capable management focused on “core” with 100% alignment of shareholder interests
  - Catalysts: Presence of one or more catalysts enhances margin of safety
- **Seek companies that create shareholder value through a combination of high returns on tangible invested capital employed and profitable growth with demonstrated superior capital allocation ability**
- **Value investing provides a time arbitrage by taking a longer term view of the best compounding machines in Asia**
- **Flexibility to invest across Asia Pacific countries, market capitalization and sectors with focus *always* being buying good businesses at prices substantially below their intrinsic value**
- **Independent, scuttlebutt primary approach through extensive network across Asia**

**“The number of sizable, highly sophisticated, professional investors in overseas foreign markets is far fewer, making those markets more fertile fields to till.” – Seth Klarman**

# Why is Kobayashi Worth Your Attention?

## Investment Thesis

(US\$ billions, unless otherwise specified)



**Kobayashi is a high quality 125 business run by value creating management and available at bargain prices**

- **High quality business with 125 year history and over 150 “brands”**
  - Simple, predictable products (toilet bowl cleaners, body warmers, cooling sheets, heat pads, oral hygiene)
- **Genuine competitive advantage from high market share, returns on tangible capital and equity and customer captivity**
  - Stability of high market share (over 30% in several categories) in core consumer products “cash cow” business
  - High tangible returns on invested capital -- in excess of 50% and unlevered returns on equity greater than 10%
  - Customer captivity through niche products that don't need to change
- **Disciplined management (six generations of Kobayashi family in 125 years) with value creating track record**
  - Focus on ROIC relative to cost of capital. Adopted EVA (Economic Value Added) and aligned management compensation. This is rare in Japan and drew us closer to the opportunity.
  - History of disciplined share buybacks, no equity dilution, high standards of disclosure and conservative accounting
  - Management has “skin in the game” with Akihiro Kobayashi, current president, owning 10.9% of shares outstanding
- **Bargain valuation for a high quality company (statistics as of Nov 3 2013)**
  - Key Stats: market cap \$2.2bn, EV \$1.8bn, share price ¥5,400, strong balance sheet (cash \$449mm with limited to no debt)
  - 8.2x EBITDA (debt free with minimal levels of capex/working capital)
- **Misunderstood business with multiple ways to win create complete package**
  - Divestments of loss-making wholesale and medical devices in 2008 and 2012 (ugly sales decline is misleading)
  - Catalysts: Overseas business, increased focus on “crown jewel” consumer business after divestments, new product launches, bolt-on M&A, increased analyst coverage (first non-Japanese analyst initiated coverage), special dividend, etc.

Source: Company filings.

Note: US\$1 = JPY98 as of November 1 2013.

# Kobayashi Traces its Humble Roots to 1886 and is a Simple, Predictable High Quality 125 Year Old Business

**Kobayashi has a rich history of 125 years spanning 6 generations of the direct Kobayashi family lineage with an average tenure of 20+ years**

- **Founded in 1886 with a rich 125 year history**
  - Traces roots back to 1886 when Chubei Kobayashi founded the first store in Nagoya, Japan and moved to Osaka in the early 1900s
  - Began as wholesaler of cosmetics, general merchandise and medicine
- **Motto: People, Product and Sales**
  - Motto focused on People, Hit Products and Sales (hito, hitto shohin, and hanbairyoku)
  - Statue was erected in Tokyo in 1928 upon Chubei Kobayashi's passing away at age 78 to recognize impact on Japan
- **Over 150 brands with track record of "hit" products and creating new markets**
  - Hakkiri, a headache medicine in 1939
  - Ammeltz, an external anti-inflammatory in 1967
  - Bluelet, a toilet flush deodorizer in 1969
  - Sawaday, an air freshener in 1975 and Sawaday, car freshener in 1977
  - Netsusama sheet, cooling gel sheet for high temperature in 1994
- **Run by successive generations of the Kobayashi family**
  - Six Presidents with an average tenure of 20+ years



**Chubei Kobayashi**



**Original wholesale store**



**Unveiling ceremony for Kobayashi Chubei's bronze statue (November 3, 1928)**



**Products released in 1894**

**People, Hit Products and Sales (on hito, hitto shohin, and hanbairyoku in Japanese) is the company's motto**

*Source: Company filings.*

# Why does the Opportunity Exist?

**Kobayashi is a misunderstood and under-followed business with the market yet to catch on to the “transformation” over the last few years**

**Kobayashi is a dull and misunderstood business with limited analyst coverage despite having incentivized and value creating management with “skin in the game”**

- **Kobayashi is a perfectly simple business, which sounds dull – or even ridiculous and is not in a “hot” industry**
  - Toilet cleaners, pain relief, cooling gel sheets, etc – products that people have to keep buying
  - “Stable” mature industry with limited change – indeed several products have never changed for over 45 years
  - Mohnish Pabrai’s Dhando Framework of buying simple businesses in an industry with a slow rate of change
- **Limited analyst coverage (but non-Japanese analysts recently initiated coverage and foreign ownership also increasing)**
  - Until most recently, only 1 local Japanese analyst (Mitsubishi UFJ) covering company (analyst has chosen retailer comparable as well that have entirely different business economics)
  - However, first non-Japanese, Barclays initiated coverage and foreign ownership increasing with MFS at 10.5% stake
- **Misunderstood business with market yet to fully catch on to “transformation” over last few years**
  - Given divestments of 2 business segments (medical devices and wholesale) in 2008 and 2012, investors looking primarily for sales growth will see declines over a 5 year period on Bloomberg and CapitalIQ which is misleading
  - Mr. Market has largely ignored the transformation that will lead to greater focus on “crown jewel” cash cow consumer products business and higher margin business
- **“Japanese value trap” initial gut reaction by investors without doing the work**
  - Kobayashi is not your typical Japanese company that solely focuses on needs of employees, suppliers and customers over shareholders. The company has high returns on capital, with management that has a track record of excellent capital allocation focusing on higher margin business, share buybacks, and effective asset utilization.

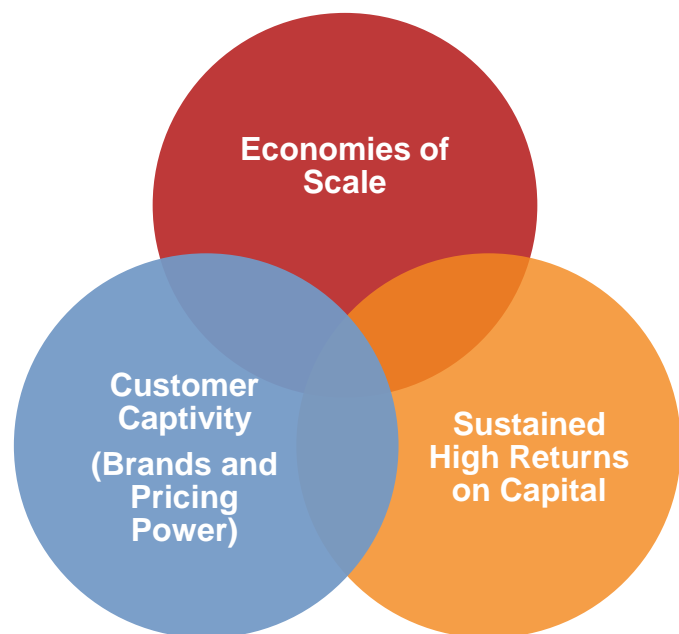
*Source: Company filings.*

*Note: US\$1 = JPY98 as of November 1 2013.*

# Kobayashi is a High Quality Business with Economies of Scale, High Returns of Capital and Customer Captivity

Competitive advantages = Economies of scale + high returns of capital + customer captivity

## Key Characteristics of a High Quality Company



## Kobayashi Fits High Quality Characteristics We Look For

- **Significant local economies of scale**
  - Allows Kobayashi to purchase products in bulk from suppliers of raw materials, leading to margin expansion as fixed costs are spread over more units, with average cost per unit declining
- **Sustained high tangible returns on invested capital**
  - High tangible returns on invested capital in excess of 50% and unlevered returns on tangible equity greater than 10%
  - Prodigious free cash flow generative business (that does not require significant capital to continue to do so)
- **Customer Captivity**
  - Stable high market share (gap relative to other peers) in excess of 30% in several categories
  - Niche products that people have to keep buying









**“Economies of scale when combined with some customer captivity (that rivals cannot match) provide sustainable advantages” – Bruce Greenwald, Columbia Business School Value Investing Professor**

Source: *Competition Demystified: A Radically Simplified Approach to Business Strategy* (Bruce Greenwald), *McKinsey Measuring and Managing Value of Companies*.

# Kobayashi's "Crown Jewel" Consumer Products Business Has Over 150 Household Brands Sold in Over 20 Countries

(US\$ millions, unless otherwise stated)

Kobayashi's "crown jewel" consumer products operations consists of 150 simple household brands delivering high margin and contributing nearly 95% of Kobayashi's FY 2013 operating earnings

Segments	Select Key Products	FY2013 Revenue Contribution	FY2013 EBIT Contribution	FY2013 Margin
<b>Consumer Products</b>	<p>Cooling Sheets</p>  <p>Pain Relief – Analgesic</p>  <p>Air Freshener</p>  <p>Toilet Cleaner</p> 	<p><b>\$1,100mm<sup>1</sup></b> (88.7% of revenue)</p>	<p><b>\$164mm</b> (94.8% of EBIT)</p>	<p><b>14.9%</b></p>
<b>Mail Order</b>	<p>Nutritional Supplement</p>  <p>Skin Care</p> 	<p>\$104mm (8.4% of revenue)</p>	<p>\$2mm (1% of EBIT)</p>	<p>1.6%</p>
<b>Medical Devices<sup>1</sup></b>	<p>Wrist Plating System</p>  <p>Silver Tray</p> 	<p>\$25mm (2.0% of revenue)</p>	<p>\$0.1mm (0.06% of EBIT)</p>	<p>0.4%</p>
<b>Total</b>		<p><b>\$1229mm<sup>2</sup></b></p>	<p><b>\$166mm<sup>2</sup></b></p>	

Source: Company filings. Note: US\$1 = JPY98 as of November 1 2013.

<sup>1</sup> Medical devices division changed from subsidiary to an equity method affiliate in FY2013 as 80% of shares in May 2012 and remaining 20% in May 2013 transferred to Mitsubishi Corporation.

<sup>2</sup> Overseas operations within Kobayashi's consumer products business segment accounted for US\$97mm or 7.8% of FY2013 revenue.

<sup>3</sup> Kobayashi's other non-core businesses account for \$11mm or less than 1% of FY2013 total revenue (advertising, real estate management) and \$6.9mm or less than 4% of FY2013 total EBIT.

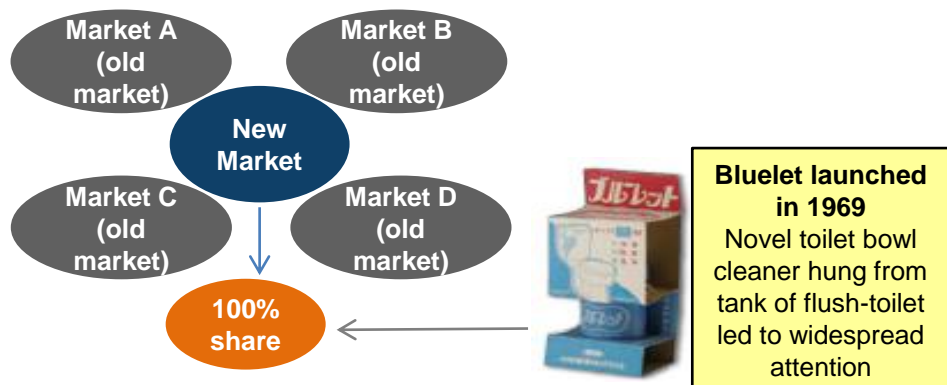
# Kobayashi Demonstrates Competitive Advantages and “Lack of Change” Quality in its Core Business that Mr. Buffett Seeks

“Our approach is profiting from lack of change rather than from change. With Wrigley chewing gum it’s the lack of change that appeals to me. I don’t think its going to be hurt by the Internet. That’s the kind of business I like” – Warren Buffett

## Business Model with Genuine Competitive Advantages

- **High market share and products that have been time tested**
  - Niche consumer product categories with sustained market share of 50%+ over a 5 year period
  - Products like Ammeltz since 1967 with minimal changes
- **Generate new markets with 100% share in new market**
  - Launches 20 – 25 new products annually with accelerated development in just ~13 months
  - Employee proposals generating 20,000+ ideas per year - invented “kick starter or crowd-sourcing model”

## Generating New Markets



Source: Company filings.

## Historical High and Stable Market Share

Product Category	2009	2010	2011	2012	2013	5 Year Average
Eye Wash	62%	59%	59%	62%	62%	61%
Anti-Obesity	36%	36%	37%	35%	38%	36%
Oral Breath Freshener	73%	76%	80%	81%	81%	78%
Cooling Gel Sheets	58%	59%	54%	50%	52%	55%
Sanitary Sheets	36%	38%	38%	38%	37%	37%
Toilet Bowl Cleaners	76%	77%	77%	76%	78%	77%
Air Fresheners	33%	30%	35%	32%	32%	32%

## Market Share and # of Years for Key Products

Function	Product	Picture	Market Share	Launch
Muscular pain	Ammeltz		>50%	1967 (47 years)
Toilet Cleaner	Bluelet		78%	1969 (45 years)
Air Freshener	Sawaday		32%	1975 (39 years)
Menstrual Pads	Sarasarty		37%	1988 (26 years)
Cooling Gel sheet	Netsusama		52%	1994 (19 years)
Eye Cleansing	Eyebon		62%	1995 (18 years)



# Disciplined Management with Track Record of Value Creation: Kobayashi is Not Your Typical Japanese Company

A Japan idea invokes your typical “value trap” perception: Kobayashi is not your typical Japanese company

- **Kobayashi Value Added (KOVA) management Index**
  - Instituted a proprietary management index indicator (EVA adoption from US based Stern Stuart) since 2002 to measure efficiency of capital employed
- **Succession Planning at the Core of Kobayashi - Six Generations of the Kobayashi Family in 125 Years**
  - 6 successive generations of Kobayashi family lead company with average tenure of 20+ years
  - Current president Akihiro Kobayashi has served company for 15+ years as Senior Executive Director and has 10.9% of shares outstanding
- **Shareholder Value Creation Through Divestment of Lower Margin Businesses and Bolt-On M&A**
  - Divested wholesale and medical devices loss-making divisions in 2008 and 2012
  - M&A of complimentary niche businesses (e.g. acquired body warmer producers Heatmax and Grabber in 2006 and 2012)
- **History of Dividend Increases and Timely Share Repurchases**
  - Timely share buyback in May 2008 at very attractive prices
  - Raised dividend for 14 consecutive years with consistent payout ratio
- **Commitment to the Highest Standards of Corporate Governance, Transparency and Disclosure**

Shareholder friendly management has a track record of value creation and high return on equity over last 10 years which is contrary to the typical corporate governance model of a Japanese value trap

# Kobayashi has Consistently High Returns on Tangible Invested Capital and Returns on Equity

## Key Return Driver Metrics

Sustained ROIC in excess of 50%+ over last 10 years highlights management's value creating ability and competitive moat

### Return on Invested Capital – Key Drivers (2003 – 2013)

	FY2003A	FY2004A	FY2005A	FY2006A	FY2007A	FY2008A	FY2009A	FY2010A	FY2011A	FY2012A	FY2013A
ROIC excluding Goodwill & Intangibles	57.9%	59.4%	51.7%	67.3%	62.9%	87.9%	68.0%	82.1%	70.9%	77.4%	63.8%
ROIC including Goodwill & Intangibles	45.4%	48.7%	42.2%	53.4%	41.7%	54.7%	47.5%	58.3%	57.9%	63.9%	53.5%

### Return on Invested Capital - Key Drivers (2003 - 2013)

	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
Gross Margin (%)	32.8%	33.2%	33.3%	32.3%	33.0%	35.5%	54.6%	55.6%	57.1%	58.3%	57.4%
SG&A excl D&A/Revenues (%)	23.7%	24.0%	24.5%	24.0%	24.6%	25.7%	38.7%	39.2%	39.6%	41.2%	41.1%
D&A/Revenues (%)	1.6%	1.6%	1.5%	1.4%	1.3%	1.6%	3.4%	3.3%	3.2%	2.5%	2.4%
<b>1 Operating Margin (%)</b>	<b>7.5%</b>	<b>7.6%</b>	<b>7.3%</b>	<b>6.8%</b>	<b>7.0%</b>	<b>8.1%</b>	<b>12.6%</b>	<b>13.2%</b>	<b>14.2%</b>	<b>14.7%</b>	<b>13.9%</b>

Operating Working Capital/Revenues	-0.2%	1.2%	2.5%	0.9%	2.5%	2.6%	4.5%	4.6%	9.2%	8.6%	10.5%
Net PPE/Revenues	13.2%	11.6%	11.6%	9.2%	8.7%	6.7%	14.0%	11.4%	10.8%	10.4%	11.3%
<b>2 Revenues/Invested Capital (%)</b>	<b>7.7x</b>	<b>7.8x</b>	<b>7.1x</b>	<b>9.8x</b>	<b>9.0x</b>	<b>10.8x</b>	<b>5.4x</b>	<b>6.2x</b>	<b>5.0x</b>	<b>5.3x</b>	<b>4.6x</b>

Premium over Book Capital	27.6%	22.0%	22.7%	26.0%	50.9%	60.6%	43.2%	40.7%	22.6%	21.2%	19.2%
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ROIC excluding Goodwill <b>1</b> x <b>2</b>	57.9%	59.4%	51.7%	67.3%	62.9%	87.9%	68.0%	82.1%	70.9%	77.4%	63.8%
ROIC including Goodwill	45.4%	48.7%	42.2%	53.4%	41.7%	54.7%	47.5%	58.3%	57.9%	63.9%	53.5%

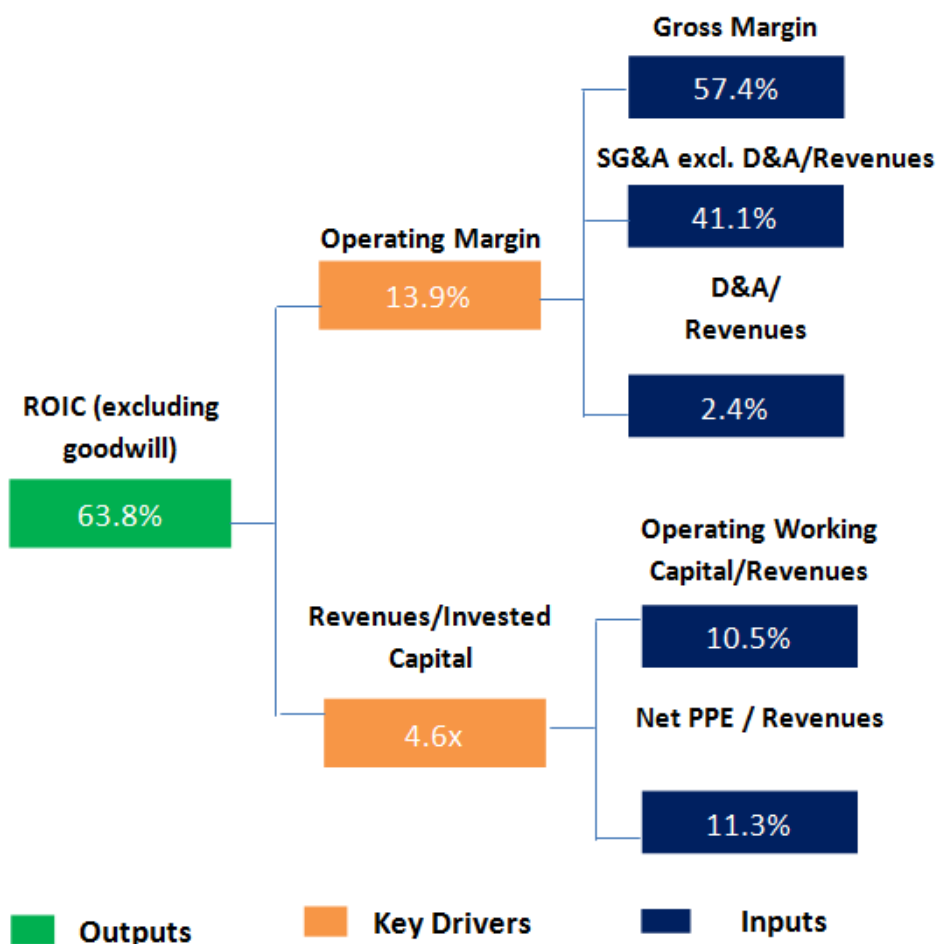
### Return on Equity – Key Dupont Formula Drivers (2003 – 2013)

Net profit margin (%)	3.1%	3.2%	3.1%	3.0%	3.2%	3.7%	7.0%	7.2%	7.1%	8.9%	10.0%
Asset turnover	168%	165%	160%	162%	156%	187%	100%	98%	97%	89%	77%
Total assets/shareholders equity	255%	236%	224%	227%	213%	159%	164%	156%	147%	145%	137%
<b>Return on Equity</b>	<b>13.4%</b>	<b>12.3%</b>	<b>11.2%</b>	<b>11.2%</b>	<b>10.7%</b>	<b>11.0%</b>	<b>11.6%</b>	<b>10.9%</b>	<b>10.2%</b>	<b>11.5%</b>	<b>10.6%</b>

Source: Company filings, *Managing and Measuring the Value of Companies*, 5<sup>th</sup> Edition, McKinsey.

# Kobayashi Value Creation is Driven by High Returns on Invested Capital and Growth

Return on Invested Capital Drivers Tree - FY2013



Key Observations

- Companies create value by investing capital to generate future cash flows at rates of return that exceed their cost of capital.
- Kobayashi has been able to sustain high levels of ROIC due to the long life cycles of its business and products, genuine competitive advantages due to economies of scale, customer captivity and its sustained high market share
- From FY2008 to FY2012, gross margins have expanded from 35.5% to 57.4% given management's decision to divest loss making operations
- Revenue/Invested Capital has dropped due to decline in revenues as a result of spin-off of 2 business units (wholesale and medical devices operations)
- Returns on invested capital on balance have consistently stayed above 50% indicating competitive advantage
- Kobayashi can increase returns on invested capital through pursuing disciplined growth

Source: Company filings, *Managing and Measuring the Value of Companies*, 5<sup>th</sup> Edition, McKinsey.

# Potential Catalyst: Divestment of Lower Margin Business Allows for Greater Focus on “Crown Jewel” Consumer Business

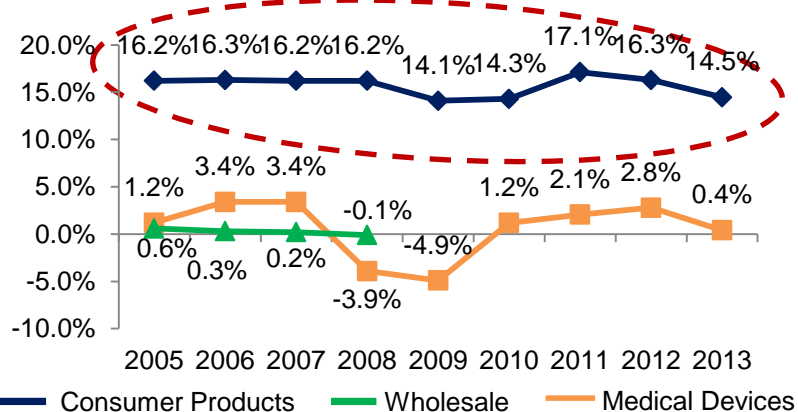
(US\$ millions, unless otherwise stated)

Management’s decision to divest non-core, struggling business divisions is value creating

## Key Improvements

- Management’s active divestment of non-core operations continue to fully yield margin improvements in FY2014
  - Management sold wholesale operations through a share swap with Mediceo Pacatel driving sales down 45.1% in FY2008
  - Sold 80% of specialist medical devices subsidiary in May 2012 to Mitsubishi Corporation (followed by a remaining 20% stake sale in May 2013)

## Operating Margin (%) Comparison (FY2005 – FY2013)



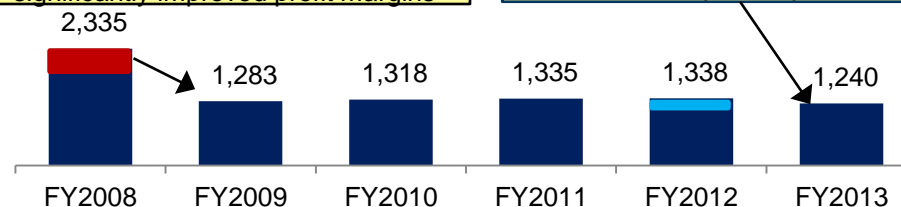
Source: Company filings.

Note: US\$1 = JPY98 as of August 1 2013.

## Sales (FY2008 – FY2013)

In FY2009, wholesale was excluded from consolidation (FY2008: \$1,347mm sales) due to divestiture of operation in Jan 2008. This led to sales decline of 45.1% YoY, but significantly improved profit margins

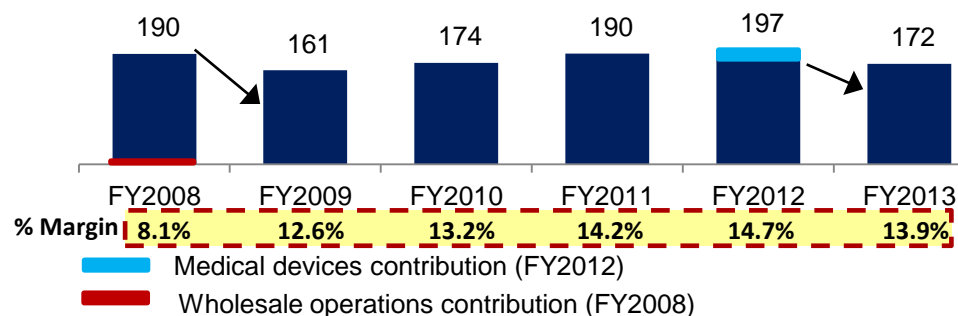
In FY2013, 80% of the medical devices subsidiary (FY2012: US\$77mm sales) was excluded from consolidation due to its sale in May 2012. This led to a sales decline by 7.3% but improved profitability



## Operating Income (FY2008 – 2013)

In FY2009, operating margins improved due to wholesale business (FY2008 EBIT of -\$1mm or -10% margin) being excluded from consolidation

In FY2013, operating margins improved with sale of lower margin medical devices subsidiary (FY2012: \$5mm EBIT; 6.7% margin) compared to higher consumer products business with margin of 16.3%

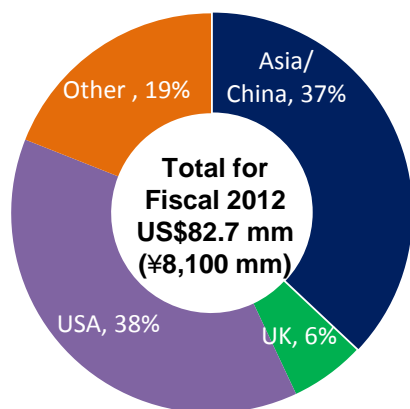


# Potential Catalyst: Replicating Niche Products in Overseas Markets Represents Free Call Option

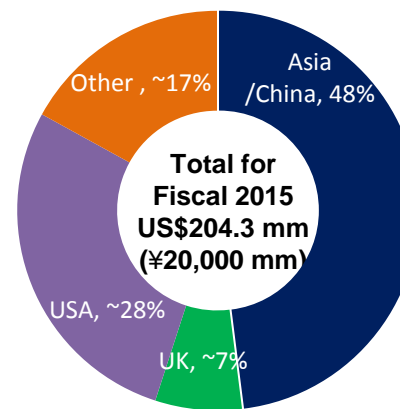
(US\$ millions, unless otherwise stated)

The company's simple, predictable products have significant growth potential that is already beginning to materialize in overseas markets

Sales by Region for Overseas Business FY 2012



Sales by Region for Overseas Business FY2015 (Target)



## Overseas Business is a Tangible Growth Opportunity for Kobayashi without Significant Capital Investment

- Overseas business a major growth driver as company replicates niche products that already have begun to materialize
  - US currently 38% of FY2012 overseas sales however Asia (ex-Japan) has upside potential and expected to account 48% of FY2015 \$204.3mm sales target
  - Recently established local subsidiaries to further roll out overseas strategy in Singapore in 2009, Malaysia and Taiwan in 2011 and Indonesia in 2012
  - Capital allocation towards localization marketing (e.g. Disney themed body warmers in US) for replication of niche products)

Source: Company filings.

Note: US\$1 = JPY98 as of August 1 2013.

# Potential Catalyst: Greater Analyst Coverage and Increasing Foreign Ownership Provides Additional “Ways to Win”

- **First non-Japanese broker, Barclays has initiated coverage that should serve to shine greater attention on this high quality company. Prior to Barclays, the company was actively covered by just one local analyst, Mitsubishi MUFJ**
- **Foreign ownership is increasing (MFS Investment Management has taken a greater than 10% stake in Kobayashi)**

## Commentary

- **Initiating coverage by first non-Japanese broker, Barclays on Kobayashi is a positive**
  - Currently, the company is covered by Mitsibushi MUFG Morgan Stanley, who has mostly published brief 1-2 page reports
  - Barclays has initiated coverage in Kobayashi as of 18 Sept 2013 with an overweight rating
  - Both brokers have buy recommendations on the name
- **Increasing foreign ownership is a positive**
  - Massachusetts Financial Services Asset Management based in Boston has taken a 10.5% in Kobayashi
  - Annual reports and disclosure will encourage investors who do the work given historical annual reports in Kobayashi all in English
  - Other value oriented investors include: First Eagle, Fidelity, Norges Bank, etc

# Potential Catalyst: Kobayashi Management Have Had a History of Disciplined M&A and Capital Allocation

**Bolt-on M&A opportunities will continue to act as a catalyst for Kobayashi**

## Key Improvements

- **Bolt-on M&A opportunities given cash flow generation and cash pile present further upside**
  - \$483mm cash pile (23% of market cap) provides potential for value creation catalyst through M&A
- **Management has track record of conducting free cash flow generative bolt-on acquisitions**
  - Easy Fiber, a dietary fiber supplement manufacturer (1998)
  - Whitehall Japan (Kimko brand), market leading refrigerator deodorizer (2001)
  - Kiribai Chemical, market leader in chemical and body hand warmers (2001)
  - Inochi No Haha A rights, a general-use medication for women's health issues (2005)
  - Lanacane and Feminina trademark rights from Combe in the US (2005)
  - Heatmax, US body warmer manufacturer (2006)
  - Grabber, a US body warmer manufacturer with strong distribution ties with hunting and sporting good specialty stores (2012)

**Kobayashi is committed to expansion of operations with proactive investments in the overseas and mail order business**

# Kobayashi is Demonstrably Undervalued for a High Quality Business with a 125 Year Old Track Record

(US\$ millions, unless otherwise specified)

**At current valuation, Kobayashi is a great business at an attractive price whose business transformation and catalysts are not fully appreciated by the market**

## Valuation

Market capitalization	2200
Short term debt + current portion of capital leases	2.7
Non current capital leases	1.7
Cash & ST Investments	-449
<b>Enterprise value</b>	<b>1,755</b>
<b>Normalized EBITDA<sup>1</sup></b>	<b>213</b>
<b>EV/EBITDA Multiple</b>	<b>8.2x</b>

## Key Observations

- At current levels, Kobayashi trades at a 8.2x EBITDA which translates into a 29% discount to its median 11.5x EBITDA of comparative Asian peers
- Kobayashi also trades at 1.4x sales which represents a 22% discount to the median multiple of 1.8x of comparative peers
- Kobayashi is demonstrably undervalued given the business has sustained ROIC in excess of 50% and its transformation through divestments of non-core divisions is yet to be fully recognized by the market

## Asian Peers

Company	Country	Market Cap	EV	Div. Yield %	2013 Sales	EV/Sales	2013 Net Income	2013 EBITDA	EV/EBITDA	ROIC (5y Avg)	Capex % of CFO (3y Avg)	Type of products
Hindustan Unilever	India	21,964	21,349	1.7	4,472	4.8x	634	696	30.7	NA	12.5%	Skin care, toothpaste, hair nourishment
Taisho	Japan	5,512	4,298	1.6	2,902	1.5x	268	482	8.9	26.9%	23.4%	Hair growth, nutritional, cold remedy
Shiseido	Japan	6,104	7,210	3.2	6,896	1.0x	(149)	647	11.1	19.7%	33.4%	Cosmetics, hair growth, skin care
Marico	India	2,243	2,331	0.5	712	3.3x	66	113	20.6	57.6%	118.7%	Coconut oil, cosmetics, hair nourishment
<b>Kobayashi</b>	<b>Japan</b>	<b>2,200</b>	<b>1,755</b>	<b>1.5</b>	<b>1,237</b>	<b>1.4</b>	<b>124</b>	<b>213</b>	<b>8.2</b>	<b>74.4%</b>	<b>15.4%</b>	<b>Cooling sheets, toilet cleaners</b>
Amorepacific	Korea	4,983	4,732	0.7	2,590	1.8x	220	410	11.5	25.4%	82.3%	Skin care, cosmetics
Haw Par	Singapore	1,243	835	2.5	110	7.6x	94	31	27.0	16.5%	12.2%	Pain relief analgesics
<b>Median</b>				<b>1.6</b>		<b>1.8x</b>			<b>11.5x</b>	<b>26.1%</b>	<b>23.4%</b>	
<b>Peer Discount</b>						<b>-22%</b>			<b>-28.6%</b>			

Source: Company filings, CapitalIQ.

Note: US\$1 = JPY98 as of November 1 2013.

Note: Under SFAS 142 under US GAAP, goodwill is not amortized but tested annually for impairment. Kobayashi's operating income is reduced due to the requirement that goodwill in excess of investment cost over the parent's share of the underlying equity shall be amortized within 20 years.

<sup>1</sup> Normalized EBITDA calculated by operating income of \$173mm plus one-time share transfer expense associated with divestment of medical devices subsidiary of \$5mm plus goodwill amortization of \$5mm plus depreciation expense of \$30mm leading to \$213mm.



# Kobayashi is the Complete Package

**Kobayashi is a high quality company with significant competitive advantages run by superior, incentivized management with a history of value creation and tangible catalysts on the horizon**

- ✓ **High Quality business that is simple, easy to understand and predictable**
- ✓ **Demonstrably undervalued**
- ✓ **Significant competitive moat with history of high returns on capital, profitability and market share**
- ✓ **Disciplined management, intelligent capital allocation with “skin in the game” and focus on returns on capital: a hidden gem in Japan**
- ✓ **Catalysts provide multiple ways to win increasing margin of safety**

## **Appendix: Financial Summary**

# 1 Financial Summary

## Income Statement

(US\$ millions, unless otherwise specified)

### Income Statement Summary

	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
<b>Net Sales<sup>12</sup></b>	<b>2,152</b>	<b>2,160</b>	<b>2,201</b>	<b>2,519</b>	<b>2,623</b>	<b>2,335</b>	<b>1,283</b>	<b>1,318</b>	<b>1,335</b>	<b>1,338</b>	<b>1,240</b>
YoY % Growth	-	0.4%	1.9%	14.4%	4.1%	-11.0%	-45.1%	2.8%	1.3%	0.3%	-7.3%
<b>Cost of Sales</b>	<b>1,446</b>	<b>1,443</b>	<b>1,468</b>	<b>1,707</b>	<b>1,758</b>	<b>1,507</b>	<b>582</b>	<b>585</b>	<b>573</b>	<b>558</b>	<b>528</b>
<b>Gross Profit</b>	<b>707</b>	<b>717</b>	<b>733</b>	<b>812</b>	<b>864</b>	<b>828</b>	<b>701</b>	<b>734</b>	<b>762</b>	<b>781</b>	<b>712</b>
Gross Margin %	32.8%	33.2%	33.3%	32.3%	33.0%	35.5%	54.6%	55.6%	57.1%	58.3%	57.4%
<b>D&amp;A</b>	<b>36</b>	<b>34</b>	<b>33</b>	<b>35</b>	<b>34</b>	<b>38</b>	<b>43</b>	<b>43</b>	<b>42</b>	<b>33</b>	<b>30</b>
D&A % of Revenue	1.6%	1.6%	1.5%	1.4%	1.3%	1.6%	3.4%	3.3%	3.2%	2.5%	2.4%
<b>R&amp;D Costs</b>	<b>18</b>	<b>21</b>	<b>22</b>	<b>24</b>	<b>25</b>	<b>29</b>	<b>34</b>	<b>40</b>	<b>42</b>	<b>45</b>	<b>46</b>
% of Revenue	0.8%	0.9%	1.0%	1.0%	1.0%	1.2%	2.7%	3.1%	3.1%	3.3%	3.7%
<b>Total SG&amp;A</b>	<b>545</b>	<b>553</b>	<b>572</b>	<b>640</b>	<b>680</b>	<b>639</b>	<b>539</b>	<b>560</b>	<b>572</b>	<b>584</b>	<b>540</b>
SG&A as % of Sales	25.3%	25.6%	26.0%	25.4%	25.9%	27.4%	42.1%	42.5%	42.8%	43.6%	43.5%
<b>Operating Income</b>	<b>162</b>	<b>165</b>	<b>160</b>	<b>172</b>	<b>184</b>	<b>190</b>	<b>161</b>	<b>174</b>	<b>190</b>	<b>197</b>	<b>173</b>
Operating Margin %	7.5%	7.6%	7.3%	6.8%	7.0%	8.1%	12.6%	13.2%	14.2%	14.7%	13.9%
<b>Income before Taxes &amp; Minority</b>	<b>131</b>	<b>121</b>	<b>130</b>	<b>143</b>	<b>164</b>	<b>161</b>	<b>166</b>	<b>149</b>	<b>134</b>	<b>202</b>	<b>192</b>
Statutory Tax Rate (%)	42.0%	42.0%	40.6%	40.6%	40.6%	40.6%	40.6%	40.6%	40.6%	40.6%	40.6%
Effective Tax Rate (%)	48.6%	44.1%	46.7%	44.8%	49.0%	46.2%	45.6%	36.4%	29.2%	40.8%	35.4%
Income taxes	64	53	61	64	80	74	76	54	39	83	68
<b>Net Income to Company</b>	<b>67</b>	<b>67</b>	<b>69</b>	<b>79</b>	<b>83</b>	<b>87</b>	<b>90</b>	<b>94</b>	<b>95</b>	<b>120</b>	<b>124</b>
<b>Minority Interest</b>	<b>0</b>	<b>1</b>	<b>(1)</b>	<b>(3)</b>	<b>1</b>	<b>0</b>	<b>0</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Net Income</b>	<b>67</b>	<b>68</b>	<b>69</b>	<b>76</b>	<b>85</b>	<b>87</b>	<b>90</b>	<b>94</b>	<b>95</b>	<b>120</b>	<b>124</b>
Net Margin %	3.1%	3.2%	3.1%	3.0%	3.2%	3.7%	7.0%	7.2%	7.1%	8.9%	10.0%

Source: Company filings.

Note: US\$1 = JPY98 as of August 1 2013.

<sup>1</sup> In FY2009, wholesale was excluded from consolidation (FY2008: \$1,347mm sales) due to divestiture, leading to sales decline of 45.1% (with margins improving significantly).

<sup>2</sup> In FY2013, 80% of medical devices subsidiary (FY2012: \$77mm sales) was excluded from consolidation due to sale, leading to sales decline by 7.3% (but improved margins).

# 1 Financial Summary

## Balance Sheet and Cash Flow Statement

(US\$ millions, unless otherwise specified)

### Balance Sheet and Operation Working Capital/Invested Capital Summary

	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
<b>Total Current Assets</b>	789	817	885	1,009	1,042	674	747	869	907	1,046	963
YoY % Growth	-	3.5%	8.3%	14.1%	3.2%	-35.3%	10.8%	16.5%	4.3%	15.4%	-8.0%
<b>Inventory</b>	143	144	161	169	203	126	131	117	111	123	114
YoY % Growth	-	0.8%	12.0%	4.7%	20.1%	-37.8%	3.8%	-10.7%	-4.8%	10.3%	-6.8%
<b>Accounts Receivables</b>	403	426	450	487	524	268	280	269	305	328	314
YoY % Growth	-	5.7%	5.7%	8.1%	7.6%	-48.9%	4.6%	-3.8%	13.2%	7.5%	-4.0%
<b>Net PP&amp;E</b>	283	251	255	233	227	155	180	151	144	139	140
% of Revenue	13.2%	11.6%	11.6%	9.2%	8.7%	6.7%	14.0%	11.4%	10.8%	10.4%	11.3%
<b>Total Current Liabilities</b>	673	656	663	735	786	387	406	398	352	386	352
YoY % Growth	-	-2.5%	1.1%	10.8%	6.9%	-50.7%	5.0%	-2.0%	-11.5%	9.5%	-8.8%
<b>Current Assets - Current Liabilities</b>	116	161	221	274	256	287	340	471	554	661	611
YoY % Growth	-	38.1%	37.9%	23.8%	-6.7%	12.2%	18.5%	38.5%	17.6%	19.2%	-7.5%
<b>Goodwill and Other Intangibles</b>	77	61	70	67	149	131	102	86	60	54	52
<b>Shareholders Equity</b>	503	556	613	682	788	788	779	863	932	1,040	1,172
YoY % Growth	-	10.5%	10.4%	11.1%	15.6%	-0.1%	-1.1%	10.8%	8.0%	11.5%	12.8%
<b>ST Debt + Current Portion of Leases</b>	61	46	27	14	33	7	11	25	5	4	3
<b>Long Term Debt</b>	19	9	3	3	2	0	2	0	0	0	0
<b>Cash &amp; Short Term Investments</b>	181	180	194	265	223	234	294	435	436	549	483
<b>Operating Working Capital<sup>1</sup></b>	(4)	26	55	23	65	60	57	61	123	115	130
<b>Invested Capital<sup>2</sup></b>	279	277	310	256	293	216	237	212	268	254	270

### Cash Flow Statement Summary

	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
<b>Cash Flows from Operating Activities</b>	123	71	85	134	90	124	131	156	134	176	94
% of Revenue	5.7%	3.3%	3.9%	5.3%	3.4%	5.3%	10.2%	11.9%	10.1%	13.2%	7.6%
<b>Capital Expenditures (Capex)<sup>3</sup></b>	27	25	51	29	23	30	35	36	24	23	32
% of Revenue	1.2%	1.2%	2.3%	1.1%	0.9%	1.3%	2.8%	2.8%	1.8%	1.7%	2.6%
<b>Cash flow from Operating less Capex</b>	96	46	34	106	67	95	96	120	110	153	62
% of Revenue	4.5%	2.1%	1.6%	4.2%	2.6%	4.1%	7.5%	9.1%	8.3%	11.5%	5.0%

Source: Company filings.

Note: US\$1 = JPY98 as of August 1 2013.

<sup>1</sup> Operating working capital defined as (current assets - cash & ST investments) - (current liabilities - short term debt - current portion of capital leases).

<sup>2</sup> Invested Capital defined as non-cash operating working capital plus net property, plant and equipment.

<sup>3</sup> The business has an average capital intensity as % of sales of 2.3% with strong free cash flow growth.