

KOKUYO (7984 JP)

DOMESTIC OFFICE FURNITURE LED THE EARNINGS. NO CHANGE IN MEDIUM-TERM VISION.

QUARTERLY EARNINGS SUMMARY**3Q EARNINGS RESULTS SUMMARY**

Kokuyo reported FY19 (Dec year-end) 9-month cumulative results as follows: OP of ¥14,479mil (-5.2% YoY) on revenue of ¥243,469mil (+3.2% YoY). For 3Q only, the firm generated OP of ¥3,149mil (+67.7% YoY / -6.3% QoQ) on sales of ¥75,817mil (+10.0% YoY / -3.3% QoQ).

Domestic office furniture sales growth contributed the most to the overall performance. Of the ¥7,475mil 9-month cumulative YoY total sales increase, ¥4,548mil came from the Spatial Value Domain (48% of total revenue and 89.4% of total OP in 1~3Q) which includes ¥3,500~3,700mil earned from the Office Furniture business. The more favourable conditions for the Office Furniture segment are due to an increase in office relocation, especially in smaller offices and secondary relocation. Spatial Value Domain sales rose 10.6% YoY in the 3Q alone, despite the fact that it usually has low seasonality, due to buying ahead of the October consumption tax hike. Thus far into the Q4, sales have naturally fallen back.

While the cumulative (Q1~Q3) gross profit (GP) rose 2.3% YoY to ¥87,799mi, the GP margin (GPM) dipped from 36.4% in the same period last year to 36.1% due to higher raw materials costs, eg for paper and steel, and a deterioration in the sales mix; an increase in the low margin wholesale business within the Business Supply Domain dragged profitability down. SG&A also rose 4.0% YoY due to higher logistics costs. As a result, the cumulative OPM dropped by 0.3ppt to 6.6% in 3Q. OPM of Business Supply Domain dropped from 3.5% in 3Q last year to 2.1% in this 3Q. In the Global Stationary Domain, cumulative 3Q OPM was 7.7%, down from 8.8% in the 3Q last year because of higher cost of paper and sales promotion expense.

As of Q3, the firm has achieved 75.6% and 87.8% of its FY targets for sales and OP, slightly ahead of levels it achieved in the same period last year. Kokuyo revised down both 1H and full-year guidance in April, when it released 1Q results. At that time, the firm cut its FY19 sales guidance from ¥326,000mil (+3.4% YoY) to ¥322,000mil (+2.2% YoY) and OP from ¥18,800mil (+2.8% YoY) to ¥16,800mil (-8.2% YoY) but as of Q3, Kokuyo not made any further changes to its guidance.

Kokuyo reckons that it is still on track to achieve its medium-term targets. The company is forecasting OP of ¥21,500mil+ on sales of ¥346,000mil+ in FY21.

EARNINGS TREND IN EACH DOMAIN**SPATIAL VALUE DOMAIN**

Cumulative segment Q3 OP was ¥13,186mil (+8.1% YoY) on sales of ¥116,897mil (+4.0% YoY). In the 3Q only, segment OP was ¥3,046mil (+50.5% YoY / -6.7% QoQ) on sales of ¥35,289mil (+10.6% YoY / -3.8% QoQ). Office furniture sales contributed significantly to growth thanks to the firm's success in capturing office relocation demand from customers looking to move to smaller office spaces.

According to research by *Mori Trust Group*, the supply of office space with floor space greater than 10,000m² will likely dip to 990,000m² in 2019 from 1,410,000m² in 2018. Taking this on board, Kokuyo focused on signing small relocation mandates – an area that has proved to be active this year. In addition, Kokuyo was able to secure the relocation business in a “chain” of moves, where it provided

EXECUTIVE SUMMARY

- Kokuyo reported FY19 (Dec year-end) 9-month cumulative results as follows: OP of ¥14,479mil (-5.2% YoY) on sales of ¥243,469mil (+3.2% YoY).
- Office furniture sales grew more than expected in the 3Q, thanks to forward sales ahead of the consumption tax rise. Kokuyo's focus on small office relocation mandates proved successful.
- The Business Supply Domain still requires improvement in profitability. Cumulative 3Q Kaunet sales rose 3% but this is only due to pre-tax hike orders on heavy items (eg water and copy papers. Logistics cost remain high.
- In the Global Stationary Domain, the 37.45% stake in Pentel Kokuyo received from Mercuria Fund will be raised to make Pentel a consolidated subsidiary.
- The majority of Kokuyo's voting rights is owned by the founder family and companies in cross-holding relationships. This can effectively constitute as a take-over defence. The firm is yet to consider if it is to renew the existing takeover defence measure at the next AGM.
- Kokuyo has ¥180,000mil in retained earnings on the BS, nearly 80% of its current market cap. It has not yet officially committed a target ROE under the ongoing medium-term plan, nor commented on optimising the BS.

new furniture to companies that was moving out as well as for companies that were moving in.

There is always seasonality in IH earnings, especially in the 1Q since many Japanese companies' accounting year-end is in March (Kokuyo's 1Q) – a time when corporates often tend to spend their annual budgets for items such as furniture. Although Kokuyo anticipated a positive impact to 3Q quarterly earnings on the back of the consumption tax rise when it revised full year guidance in April, the demand for domestic office furniture was even stronger than expected. This resulted in an improved sales mix and the firm was able to pass on the higher logistics costs as well. Consequently, the cumulative OP margin (OPM) improved from 10.9% in the same period last year to 11.3%. In 3Q only, the segment OPM improved by 2.3ppt, from 6.3% in 3Q last year to 8.6% in 3Q this year.

The better than expected 3Q, however, has led to concerns in the market that the Q4 guidance is conservative, given the firm expects segment OP to fall to ¥2,314mil (-19.3% YoY / -24.0% QoQ) on revenues of ¥36,703mil (+0.8% YoY / +4.0% QoQ). The main reason management has not changed the full-year forecasts – FY19 OP of ¥15,500mil (+2.9% YoY) on sales of ¥153,600mil (+3.3% YoY) – is because they are looking to better balance the impact of forward buying ahead of the consumption tax rise in October and the natural reactionary fall after that.

With the introduction of the Work Style Reform in Japan, demand for satellite offices – where employees can freely work in their own time, away from the main office – has started to see a pick-up. Over the medium-term, Kokuyo is looking to build business opportunities brought about by the Work Style Reform Initiatives, so it is not just looking to sell furniture, but it aims to provide advice on adding spatial value. Kokuyo has already been receiving enquiries for office furniture for FY20, mainly for large office spaces.

Unlike smaller mandates, large mandates require direct communication between Kokuyo and the relocating companies. In case of small relocation mandates, business tends to come about via office furniture sales reps, especially in the cities outside of Tokyo. During FY19, Kokuyo made efforts to expand its relationships with sales reps especially in the areas other than Tokyo. The firm reckons that by having multiple sales channels, it would be able to better weather the volatility expected in the large office space supply in Tokyo. Having read market conditions correctly this year, the firm will continue to take a flexible approach in how to gain business, depending on the overall market.

In FY21, Kokuyo is guiding for Spatial Value Domain sales of ¥162,000mil+ (CAGR over the 3-year period is 2.9% or over).

BUSINESS SUPPLY DOMAIN

Business Supply Domain comprises largely of two businesses:

- 1) Kaunet, an office supply mail-order business, and
- 2) the wholesale of non-Kokuyo brands to the secondary wholesalers.

Cumulative segment Q3 OP was ¥1,725mil (-33.5% YoY) on sales of ¥88,445mil (+4.2% YoY). In 3Q only, the firm earned ¥455mil (+14.0% YoY / -40.4% QoQ) on sales of ¥28,911 (+12.4% YoY / +0.9% QoQ). Cumulative Q3 sales improved ¥3,300mil YoY (or +1.1% YoY), of which ca. 50% came from the Wholesale business. Wholesale business, which generated ¥20,000mil+ cumulative sales, grew by nearly 20% YoY. In the 3Q alone, there was pre-tax hike demand in the wholesale business. However, given it is a low margin business with an OPM of less than 1%, it is one of the reasons why the segment OP dropped sharply YoY.

Pre-consumption tax demand saw Kaunet earn cumulative ¥50,000mil+ revenue, up ca. 3.0% YoY (approx. +¥1,500mil YoY cumulative but 80~90% of the increase was in 3Q only, presumably due to pre-tax hike demand). Customers rushed to buy heavy office supplies such as printing paper and bottled water. Sales of those heavy items increased by 1.5x YoY.

In total, cumulative 3Q segment OP fell by 33.5% YoY (-¥870mil YoY), of which circa ¥200~300mil was due to Kaunet-related expenses such as sales promotion cost and increase in logistics cost. The remainder resulted from a worsening in the sales mix due to an increase in the wholesale business.

Kokuyo estimates FY19 segment OP of ¥2,200mil (-32.8% YoY) on sales of 117,000mil (+1.1% YoY). For the 4Q, the firm expects OP of ¥475mil (+4.4% YoY / -29.9% QoQ) on sales of ¥28,555 (-7.7% YoY / -1.2% QoQ).

GLOBAL STATIONARY DOMAIN

The Global Stationary Domain generated cumulative 3Q OP of ¥4,829 (-12.8% YoY) on sales ¥62,532 (-0.1% YoY), with Q3 OP of ¥1,237mil (+22.5% YoY / +9.7% QoQ) on sales of ¥28,991 (+12.4% YoY / +0.9% QoQ).

Cumulative domestic sales fell 10% YoY, while overseas sales improved 6.7% YoY. The overseas business OPM is still lower than domestic at around 5%, therefore, the change in sales mix saw a deterioration in OPM from 8.8% in 3Q last year to 7.7% this 3Q on a cumulative basis.

Kokuyo aims to revive the domestic stationary business by launching unique products such as *Gloo* (sales has been 15% above expectation) with a sales promotion campaign to place its products in the prime spaces at retailers. The firm launched *KOKUYO ME*, a series of stylish stationary products that can appeal to working Millennials and Xennials, in October. The concept of *KOKUYO ME* is stationary as an accessory – ie consumers can include the products as part of their fashion. Management reckons that the success of stationary business strategy depends on a combination between targeted products and their successful display on retailers' shelves. This has led to BtoC stationary sales both at stores and online, achieve positive growth in the Q3 alone, even excluding the pre-consumption tax increased demand. Kokuyo is yet to disclose data by different sales channels.

In the overseas business, sales growth in both China and India has been strong. However, products in those countries are not truly global products but rather are more bespoke to local demand, therefore targeting only domestic clientele. Kokuyo plans to launch stationary products on a global basis going forward.

Kokuyo's core stationary products are paper-based products, therefore are not suitable items to be sold globally since they are heavy and costly to ship, and each country has different de-facto standard paper sizes. However, pens do not have such issues. Taking an example of Frixion pens by Pilot (7846 JP), the same, identical pens are sold across the world. Pens are light, therefore can be readily exported. Moreover, they are universal and do not need to be customized to different countries / market needs. For this, the recently announced acquisition of Pentel, an unlisted Japanese penmaker, may play an important role.

Pentel Stake

In May 2019, Kokuyo became the largest investor of a fund managed by Mercuria Investment (7190 JP) – the largest shareholder of Pentel. Mercuria initially acquired 37.45% of Pentel's shares from founding family member Keima Horie, the previous president of Pentel. In Oct 2019, it was announced that Pentel shares held by the fund would be transferred to Kokuyo so that the firm would directly own 37.45% of Pentel, making it an equity-method affiliate.

On 15 November, Kokuyo announced its intention to make Pentel a consolidated subsidiary by taking its stake to over 50%. Kokuyo initially offered ¥3,500/share to acquire the additional (at least 1,097,752) Pentel shares between 15 November and 15 December. The offer price is estimated to be ¥500/share higher than the original investment made by Kokuyo – a positive for existing shareholders such as founding family members, ex-employees and current employees – when it became the largest shareholder of the Mercuria's fund.

On 20 November, Japan Stationary Consortium LLC whose core member is Plus Corporation, an unlisted Japanese stationary maker, announced that it would counterbid Kokuyo's ¥3,500/share offer for Pentel. To guarantee Pentel's independence, the Consortium aims to acquire a maximum of 33.4% of Pentel and would not instigate take-over proceedings if less than a 20% stake is acquired through the process. Pentel's Board announced its support to the Consortium's proposal but Kokuyo has countered by raising its acquisition price to ¥3,750/share. On 29 Nov, Kokuyo further raised the acquisition price to ¥4,200/share. This would boost the estimated minimum cost of acquisition for Kokuyo from the original ¥3,842mil to ¥4,610mil.

On 12 Dec, Kokuyo confirmed acquisition of additional 7.86% (707,470 shares) of Pentel. With the additionally acquired shares, Kokuyo's voting rights ratio in Pentel reached 45.66% and remained as the largest shareholder of Pentel. Kokuyo is yet to announce its medium-term growth strategy in the Global Stationary business.

Comparison: Kokuyo (7984 JP) and Plus (unlisted)

(¥mil)	Kokuyo (7984 JP)	Plus (Unlisted)
Consolidated Sales (FY18)	315,155	177,269
Consolidated OP (FY18)	18,296	958
OPM (%)	5.8	0.5
Cash & Cash Equivalent	76,718	15,875
Retained Earnings	172,090	28,940
Shareholder Equity Ratio (%)	68.0	28.8
Ownership of Pentel (%) (as of 29 November 2019)	37.80	0.00
TOB price per share (¥) (as of 29 Nov 2019)	4,200	3,500
Target ownership	over 50%	20~33.4%

Source: Nippon-IBR based on officially available data on Kokuyo and Plus

Kokuyo is guiding for Global Stationary Domain FY19 OP of ¥6,300mil (-5.2% YoY) on sales of ¥83,400mil (+1.3% YoY), with Q4 OP ¥1,471mil (+33.2% YoY / +18.9% QoQ) on revenues of ¥20,868mil (+5.8% YoY / +9.8% QoQ).

CORPORATE GOVERNANCE

One of the likely shareholder proposals at the next AGM, likely scheduled for March 2020, is the renewal of a takeover defence policy. The firm has not decided if it should be renewed or scrapped.

There are circa ¥50,000mil+ of investment securities on Kokuyo's BS, of which ¥30,000~35,000mil are cross-held shares. In 1H, Kokuyo sold two cross-held holdings, generating gains from extraordinary profit of ¥968mil. Since the beginning of this year, some of its cross-holdings have asked if they could unwind the cross-holding shares. In these cases, Kokuyo is willing to unwind the relationship and the firm is planning to slim down the list, except for the shares of its important business partners.

Practically, those cross-held shares can act as a take-over defence. The founder and family together with the cross-held shares hold the majority of voting rights.

Another BS issue is retained earnings, which is almost as big as ca. ¥180,000mil and nearly 80% of its current market cap. Kokuyo's ROE has been around 6.5~7.0% for the past 3 years. The ROE level improved from 3~4% to the current level 3 years ago, thanks to shift to focusing on profitability and cost efficiency. Yet, the past 2-year average of 7.3% ROE level is lower than that of competitor Okamura's (7994 JP) 8.5%. Kokuyo has a range of long-term revenue and profit targets (8~9% OPM / CAGR of 7.9%~10.5% on sales of ¥450,000~500,000mil / CAGR of 3.4%~4.5% over the next 10 years to FY2030) but has not commented on what the firm plans to do with optimising its BS structure, which is currently richly capitalised with hefty retained earnings. Kokuyo is yet to commit to the official ROE target and how to achieve such a target.

Please also refer to research the introduction report on Kokuyo (7984 JP) issued in the past on www.nippon-ibr.com/research-coverage.

Sales and OP by domains (Cumulative)

(JPY million)		FY18				FY19						FY21 (3yr Target)	
		IQ	IH	3Q	FY	IQ	IH	3Q	YoY (%)	FY	YoY (%)	FY	CAGR (3yrs)
Spatial Value Domain	Sales	43,688	80,429	112,349	148,759	44,938	81,608	116,897	4.0	153,600	3.3	162,000	2.9
	OP	6,803	10,166	12,190	15,056	6,877	10,140	13,186	8.2	15,500	2.9	n/a	
	OPM(%)	15.6	12.6	10.9	10.1	15.3	12.4	11.3	+0.4ppt	10.1	+0.0ppt	11.7	
Business Supply Domain	Sales	30,336	59,113	84,843	115,773	30,890	59,534	88,445	4.2	117,000	1.1	124,000	2.3
	OP	1,017	2,196	2,595	3,273	506	1,270	1,725	-33.5	2,200	-32.8	n/a	
	OPM(%)	3.4	3.7	3.1	2.8	1.6	2.1	2.0	-1.1ppt	2.4	-0.4ppt	2.9	
Global Stationary Domain	Sales	23,031	44,398	62,617	82,336	22,725	43,526	62,532	-0.1	83,400	1.3	94,000	4.2
	OP	2,887	4,530	5,540	6,644	2,464	3,592	4,829	-12.8	6,300	-5.2	n/a	
	OPM(%)	12.5	10.2	8.8	8.1	10.8	8.3	7.7	-1.1ppt	8.4	+0.3ppt	9.6	
Others	Sales	527	1,103	1,645	2,263	623	1,297	1,956	18.9	2,500	10.5	n/a	
	OP	32	47	50	80	32	69	104	108.0	100	25.0	n/a	
	OPM(%)	6.1	4.4	3.0	3.5	5.1	5.3	5.3	+2.3ppt	4.2	+1.2ppt	n/a	
Adjustment	Sales	-9,455	-17,965	-25,461	-33,978	-9,908	-18,314	-26,362	n/a	-34,500	n/a	n/a	
	OP	-1,750	-3,259	-4,818	-6,759	-1,642	-3,453	-5,096	n/a	-7,300	n/a	n/a	
Total as in PL	Sales	88,128	167,081	235,994	315,155	89,269	167,652	243,469	3.2	322,000	2.2	346,000	3.2
	OP	8,991	13,680	15,558	18,296	8,239	11,600	14,749	-5.2	16,800	-8.2	21,500	5.5
	OPM(%)	10.2	8.2	6.6	5.8	9.2	6.9	6.1	-0.5ppt	5.8	-0.8ppt	6.2	

Source: Nippon-IBR based on Kokuyo's earnings presentation materials

Quarterly Sales and OP by Domain

(JPY million)		FY18				FY19							
		IQ	2Q	3Q	4Q	IQ	2Q	3Q	QoQ (%)	YoY (%)	4QCE	QoQ (%)	YoY (%)
Spatial Value Domain	Sales	43,688	36,741	31,920	36,410	44,938	36,670	35,289	-3.8	10.6	36,703	4.0	0.8
	OP	6,803	3,363	2,024	2,866	6,877	3,263	3,046	-6.7	50.5	2,314	-24.0	-19.3
	OPM (%)	15.6	9.2	6.3	7.9	15.3	8.9	8.6	-0.3ppt	+2.3ppt	6.3	-2.3ppt	-2.3ppt
Business Supply Domain	Sales	30,336	28,777	25,730	30,930	30,890	28,644	28,911	0.9	12.4	28,555	-1.2	-7.7
	OP	1,017	1,179	399	678	506	764	455	-40.4	14.0	475	4.4	-29.9
	OPM (%)	3.4	4.1	1.6	2.2	1.6	2.7	1.6	-1.1ppt	+0.0ppt	1.7	+0.1ppt	-0.5ppt
Global Stationary Domain	Sales	23,031	21,367	18,219	19,719	22,725	20,801	19,006	-8.6	4.3	20,868	9.8	5.8
	OP	2,887	1,643	1,010	1,104	2,464	1,128	1,237	9.7	22.5	1,471	18.9	33.2
	OPM (%)	12.5	7.7	5.5	5.6	10.8	5.4	6.5	+1.1ppt	+1.1ppt	7.0	+0.5ppt	+1.4ppt
Others	Sales	527	576	542	618	623	674	659	-2.2	21.6	544	-17.5	-12.0
	OP	32	15	3	30	32	37	35	-5.4	n/a	-4	n/a	n/a
	OPM (%)	6.1	2.6	0.6	4.9	5.1	5.5	5.3	n/a	n/a	n/a	n/a	n/a
Adjustment	Sales	-9,455	-8,510	-7,496	-8,517	-9,908	-8,406	-8,048	n/a	n/a	-8,138	n/a	n/a
	OP	-1,750	-1,509	-1,559	-1,941	-1,642	-1,811	-1,643	n/a	n/a	-2,204	n/a	n/a
Total as in PL	Sales	88,128	78,953	68,913	79,161	89,269	78,383	75,817	-3.3	10.0	78,531	3.6	-0.8
	OP	8,991	4,689	1,878	2,738	8,239	3,361	3,149	-6.3	67.7	2,051	-34.9	-25.1
	OPM (%)	10.2	5.9	2.7	3.5	9.2	4.3	4.2	-0.1ppt	+1.5ppt	2.6	-1.6ppt	-0.9ppt

Source: Nippon-IBR based on Kokuyo's earnings presentation materials

Financial Summary

(¥million)	FY14	FY15	FY16	FY17	FY18	FY19CE
Sales	293,054	304,276	307,625	315,622	315,155	322,000
Operating Profit	7,598	11,102	15,438	17,591	18,296	16,800
Recurring Profit	9,643	11,880	15,690	19,130	19,178	18,400
Net Profit	5,065	6,312	12,182	15,000	14,231	14,400
EPS (JPY)	42.83	53.37	103.01	126.83	120.34	121.76
Adjusted EPS (JPY)	-	-	-	-	-	-
Cash flow from operation (CFO)	15,882	12,054	23,725	17,500	20,880	-
Cash flow from investment (CFI)	-702	-3,186	784	-1,660	-2,427	-
Cash flow from finance (CFF)	-9,106	-5,616	-3,919	-14,636	-4,585	-
Cash and cash equivalent	43,949	46,953	67,328	68,620	82,324	-
Free cash flow (FCF)	15,180	8,868	24,509	15,840	18,453	-
CFO per share (JPY)	134.28	101.92	200.60	147.97	176.55	-
FCF per share (JPY)	128.34	74.98	207.23	133.93	156.03	-
Total asset	273,772	286,313	293,971	305,147	304,788	-
Liabilities	103,419	105,520	105,931	100,653	95,826	-
Net asset	170,352	180,793	188,040	204,493	208,962	-
Capital	15,847	15,847	15,847	15,847	15,847	-
Shareholders' equity	168,274	178,972	186,273	202,602	207,162	-
BPS (JPY)	1,422.75	1,513.23	1,574.99	1,713.11	1,751.69	-
OPM (%)	2.59	3.65	5.02	5.57	5.81	5.22
ROE (%)	3.05	3.64	6.67	7.71	6.95	-
ROA (%)	3.01	4.13	5.50	6.04	6.17	-
Shareholders' equity ratio (%)		62.51	63.36	66.39	67.97	-
D/E ratio (%)	61.46	58.96	56.87	49.68	46.26	-
Total asset turnover (X)	1.08	1.09	1.06	1.05	1.03	-
Interest coverage (x)	12.22	19.09	27.34	36.33	45.32	-
Current ratio (%)	209.07	205.44	202.08	224.76	249.52	-
Interest-bearing debt	25,898	24,299	23,687	13,759	13,893	-
EBIT	10,297	12,474	16,260	19,617	19,584	-
EBIT Margin (%)	3.51	4.10	5.29	6.22	6.21	-
EBITDA	17,435	19,641	22,740	26,100	25,919	-
EBITDA margin (%)	5.95	6.45	7.39	8.27	8.22	-
Dividend (JPY)	15.00	17.50	22.00	29.00	32.00	37.00
Dividend payout ratio (%)	35.00	32.80	21.40	22.90	26.60	30.39
Shares outstanding (shares)	128,742,463	128,742,463	128,742,463	128,742,463	128,742,463	128,742,463
Treasury (shares)	10,468,374	10,470,864	10,473,301	10,476,272	10,478,700	10,478,700

Source: Nikkei Value Search

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