DAIDO STEEL CO., LTD. (5471 JP)

CONTINUED INVENTORY ADJUSTMENT OF STAINLESS STEEL WILL BE THE KEY FOR FY23 EARNINGS ACHIEVEMENT

FY23 Q1 RESULTS

Daido Steel (5471 JP) reported FY23 Q1 (March year-end) results on 28 July 2023 with operating profit [OP] of ¥7,979mil (-21.7% YoY) on sales of ¥141,938mil (+3.1% YoY). Q1 sales were largely in line with expectations. Although Q1 steel product sales volumes declined -5% YoY to 266,000 tonnes, the sales value rose by +3.1% YoY thanks to positive impact from price revisions.

Moreover, the progress rate of Q1 OP to the 1H OP company guidance of ¥19,000mil (-18.2% YoY) was 42%, primarily due to delays in inventory adjustments in the stainless-steel market. Nevertheless, the Q1 results were essentially in line with the firm's assumption for steel products sales volumes will continue to increase throughout the year as auto production will gradually increase at major auto makers. Consequently, management have kept their 1H and full year forecasts.

The -¥6,100mil YoY decline in sales volumes in FY23 Q1 OP was offset by a +¥10,000mil YoY boost from price revisions – including a hike in base prices and an improved slide gap. Compared to FY22 Q1, higher raw materials (steel scrap +¥3,000mil YoY / alloys, such as Nickel -¥2,600mil YoY) and energy costs (-¥4,200mil) squeezed overall OP by -¥3,800mil.

FY23 Q1 EARNINGS BY SEGMENT

The FY23 Q1 performance for Daido Steel's three major segments is discussed below:

1. Specialty Steel Segment

[FY23 Q1 Sales ¥55,333mil (+9.4% YoY) / OP ¥2,732mil (20.2x YoY) / OPM 4.9% (+4.6ppt)]

Specialty Steel FY23 Q1 sales rose a solid +9.4% YoY to ¥55,333mil, thanks to a recovery in auto production as the supply of semiconductors improved. At the OP level, the company reported a substantial 19-fold increase YoY to ¥2,732mil (vs FY22 Q1 ¥135mil) thanks to price adjustments offsetting the rise in costs (energy / alloys).

The +¥2,597mil YoY (+19.2x YoY) surge in FY23 Q1 OP was due to successful price adjustments (+¥5,200mil), which offset the -¥2,900mil hit primarily from (1) higher energy and raw material costs (-¥800mil) and (2) a deterioration in sales mix (-¥1,000mil). The slide gap of steel scrap in FY23 Q1 – the effect of which tends to have a time lag – improved by +¥600mil YoY to -¥100mil, vs FY22 Q1's -¥700mil. On a QoQ basis, however, it worsened by -¥900mil vs FY22 Q4's ¥800mil.

EXECUTIVE SUMMARY

- Daido Steel (5471 JP) reported FY23 Q1 (March year-end) results on 28 July 2023 with OP of ¥7,979mil (-21.7% YoY) on sales of ¥141,938mil (+3.1% YoY).
- The progress rate of Q1 OP to the 1H OP guidance of ¥19,000mil (-18.2% YoY) was 42%, primarily due to delays in inventory adjustments in the stainless steel market. However, this is in line with Daido's expectation.
- Daido Steel maintained its FY23 1H and FY23 full-year guidance which calls for. 1H OP of ¥19,000mil (-18.2% YoY) on sales of ¥290,000mil (+2.9% YoY), and full year OP of ¥47,000mil (flat YoY) on sales of ¥600,000mil (+3.7% YoY).

  Key factors for FY23 earnings include:
  1) specialty steel sales volume recovery along with auto production by Japanese OEM makers, 2) post inventory adjustment recovery in stainless steel. The annual dividend of ¥230.00/share will be maintained, which generates a pay-out ratio of 30.6%.
- The flat FY23 OP forecast is because management did not anticipate the one-off positive factors seen in FY22 – such as: (1) the time lag between procurement costs and final selling prices for products in the Specialty Steel, and High Performance & Magnetic Materials segments, and (2) a gain from FOREX hedging at a group company. While those factors will unlikely occur in FY23, sales volumes should rise as auto production recovers. Further price hikes, including surcharges on energy prices and price hikes in tool steel, are also expected to offset the lack of the aforementioned one-off positive factors.
- FY23 is the last year of the three-year medium-term management plan. The plan's OP target of over ¥40,000mil was achieved in FY22. Growth in Daido Steel's strategic products, such as high-performance stainless steel and open die forging, has led to a marked improvement in sales mix. As a result, ROE reached 10.4% in FY22, surpassing the medium-term target of 8%.

2. High Performance Materials & Magnetic Materials Segment

[FY23 Q1 sales ¥51,252mil (-5.8% YoY) / OP ¥3,331mil (-55.6% YoY) / OPM 6.5 % (-7.3ppt YoY)]

The segment reported FY23 Q1 OP of ¥3,331mil (-55.6% YoY) on sales of ¥51,252mil (-5.8% YoY), resulting in the OPM contracting -7.3ppt YoY to 6.5%. The segment underperformed management's expectation due to inventory adjustment delays, and led the -¥5,200mil YoY decline in sales.

Two main reasons for the decline in Q1 are:

1. Weak shipments of stainless steel on the back of inventory adjustments by customers: Unlike the specialty steel used that is also in the auto industry, e.g., structural steel for shafts, stainless steel is mostly used in highly processed auto parts such as sensors and power trains. Stainless steel used in those auto parts tends to have a longer value chain before delivery to the end-users. Consequently, the impact from inventory adjustment tends to appear with a time lag.
2. A greater-than-expected decline in shipments to the SPE sector: The firm enjoyed peak demand from the SPE sector in FY22, resulting in a 6-fold surge in sales compared to FY19-levels. Daido Steel expected the trend would likely peak out in FY23, along with the trend in silicon cycle, yet, compared to management anticipating that shipments would fall back to 4x the level seen in FY19, FY23 Q1 sales contracted to 3.5x.

3. Parts for Automobile and Industrial Equipment Segment

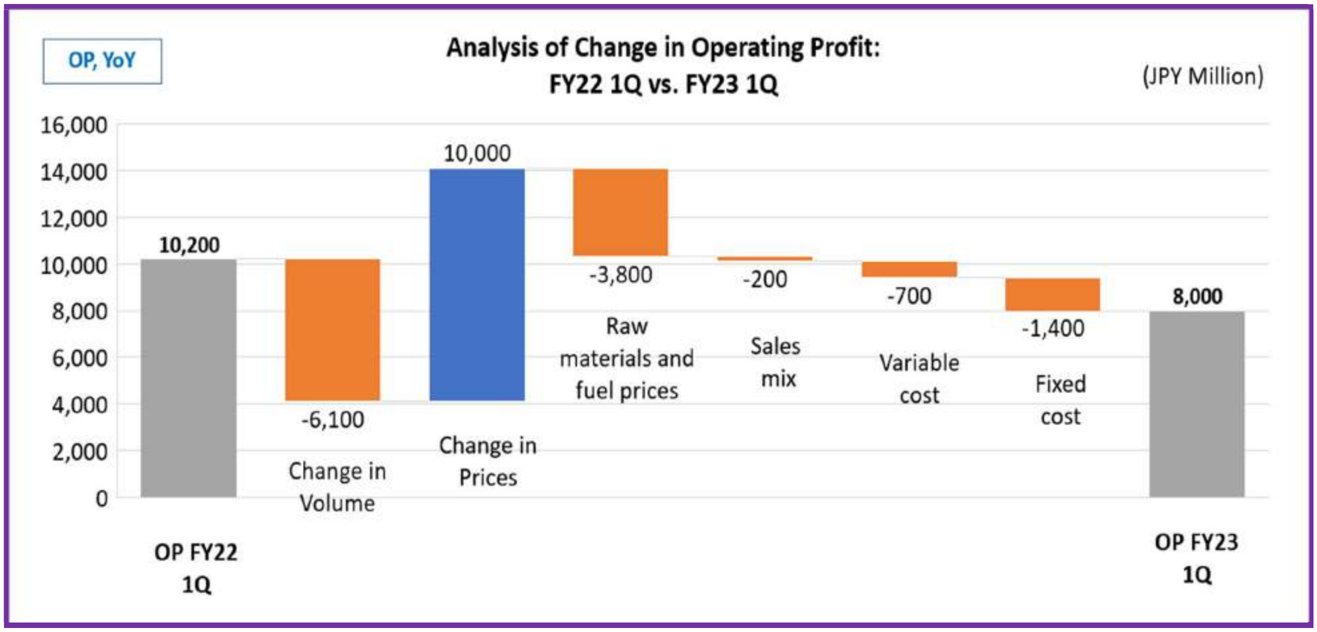
[FY23 Q1 sales ¥24,082mil (+1.1% YoY) / OP ¥529mil (-69.9% YoY) / OPM 2.2% (-5.2ppt)]

Parts for Automobile and Industrial Equipment reported FY23 Q1 OP of ¥529mil (-69.9% YoY) on sales of ¥24,082mil (+1.1% YoY). Given precision forging demand weakened and die forging sales volumes declined, Q1 segment OP fell by -69.9% YoY to ¥529mil. Furthermore, on a QoQ basis, the sales mix of open die forging worsened. This is because the sales proportion of high-alloy products, such as open die forging used in airplane parts and for heavy electric machinery, increased, which temporarily affected throughput in Q1. Management expects that sales mix of open die forging will likely recover as throughput starts to recover, along with shipment of high-alloy products.

Daido Steel (5471JP): Sales, OP and OPM by Segment (Cumulative)

(¥mil)		FY21		FY22				FY23	
		1H	FY	Q1	1H	FY	YoY (%)	1Q	YoY (%)
Specialty Steel	Sales	93,168	197,803	50,591	102,740	214,770	8.6	55,333	9.4
	OP	1,441	3,827	135	4,223	9,771	155.3	2,732	1,915.4
	OPM (%)	1.5	1.9	0.3	4.1	4.5	+2.6ppt	4.9	+4.6ppt
High Performance Materials & Magnetic Materials	Sales	94,756	197,604	54,431	109,566	219,724	11.2	51,252	-5.8
	OP	13,921	26,650	7,507	13,437	24,286	-8.9	3,331	-55.6
	OPM (%)	14.7	13.5	13.8	12.3	11.1	-2.4ppt	6.5	-7.3ppt
Parts for Automobile and Industrial Equipment	Sales	46,521	92,504	23,828	49,485	101,232	9.4	24,082	1.1
	OP	3,127	4,979	1,758	3,362	8,217	65.0	529	-69.9
	OPM (%)	6.7	5.4	7.4	6.8	8.1	+2.7ppt	2.2	-5.2ppt
Engineering	Sales	8,732	18,214	3,778	8,336	18,956	4.1	5,022	32.9
	OP	-709	-1,277	-65	412	1,425	N/A	500	N/A
	OPM (%)	n/a	n/a	n/a	5.0	7.5	N/A	10.0	N/A
Trading & Service	Sales	12,047	23,540	5,051	11,727	23,881	1.4	6,248	23.7
	OP	1,387	2,834	883	1,816	3,293	16.2	881	-0.2
	OPM (%)	11.5	12.0	17.5	15.5	13.8	+1.8ppt	14.1	-3.4ppt
Total	Sales	255,224	529,667	137,682	281,857	578,564	9.2	141,938	3.1
	OP	19,156	36,982	10,190	23,225	46,986	27.1	7,979	-21.7
	OPM (%)	7.5	7.0	7.4	8.2	8.1	+1.1ppt	5.6	-1.8ppt

Source: Nippon-IBR based on FY21, FY22 and FY23 Q1 Earnings Results Materials published by Daido Steel



Source: Nippon-IBR based on FY23 Q1 Earnings Results Materials published by Daido Steel

FY23 OUTLOOK

Daido Steel maintains its guidance for FY23 1H OP of ¥19,000mil (-18.2% YoY) on sales of ¥290,000mil (+2.9% YoY), and full year FY23 OP of ¥47,000mil (+0.0% YoY) on sales of ¥600,000mil (+3.7% YoY). The FY23 annual dividend will remain at ¥230/share, or a pay-out ratio of 30.6%.

Earnings Forecast

	FY21			FY22			FY23 CE		
(¥mil)	1H	2H	FY	1H	2H	FY	1H CE	2H CE	FY CE
Steel Products Sales Volume (tonne)	634,000	619,000	1,253,000	540,000	545,000	1,085,000	544,000	585,000	1,129,000
Sales	255,224	274,443	529,667	281,857	296,707	578,564	290,000	310,000	600,000
OP	19,156	17,826	36,982	23,225	23,761	46,986	19,000	28,000	47,000
OPM (%)	7.5	6.5	7.0	8.2	8.0	8.1	6.6	9.0	7.8
RP	20,556	18,644	39,200	24,092	24,030	48,122	20,000	28,500	48,500
Extraordinary Profit / Loss	-424	1,970	1,546	-407	1,648	1,241	N/A	N/A	N/A
Corporation Tax	-5,643	-5,477	-11,120	-4,225	-6,642	-10,867	-7,000	-9,500	-16,500
NP*	12,840	14,054	26,894	18,294	18,144	36,438	13,000	19,000	32,000

Source: Nippon-IBR based on Daido Steel's earnings results presentation materials

** NP attributed to the parent's shareholders*

Although FY23 OP growth appears flat, the firm reckons one-off positive factors in FY22 – due to 1) the time lag between procurement costs and selling prices in Specialty Steel, and High Performance and Magnetic Materials segments, and 2) FOREX hedging gains at a group company – will unlikely occur in FY23. However, as auto production recovers and price hikes take hold, including surcharges on energy prices and for tool steel, sales volumes are expected to increase enough to offset the lack of the aforementioned one-off factors.

FY23 earnings achievement depends on: 1) specialty steel sales volumes recovery along with auto production by Japanese OEM makers, and a 2) post inventory adjustment recovery in stainless steel.

A recap of the assumptions behind the company's estimates are as follows:

1. Specialty steel sales volumes will likely rise +4.1% YoY /+44,000 tonnes to 1,129,000 tonnes, thanks to the recovery in auto production. On a semi-annual basis, the firm assumes 1H sales volume of 544,000 tonnes (+0.7% YoY / -0.2% HoH) and 2H sales volume of 585,000 tonnes (+7.3% YoY / +7.5% HoH).

   The aforementioned sales volume forecast is based on Daido's own CY23 global auto production estimates of 25.1mil units (+3.3% YoY) – 1H 12.4mil units (+0.0% HoH) and 2H 12.7mil units (+2.4% HoH) – appears more conservative than OEM makers' own estimates which call for approx. 14.0mil units in the 2H.

2. The impact on Daido's earnings from the swings and roundabouts in the surcharges on energy costs have a time lag of approx. 3~6 months from the price settlement with the firm's energy supplier, Chubu Electric Power Co., Inc. (9502 JP). The cost of energy, including electricity, peaked in FY22 Q3, hence was already reflected on selling prices in FY23 Q1. For Q2, management expects the QoQ impact will not be as significant.

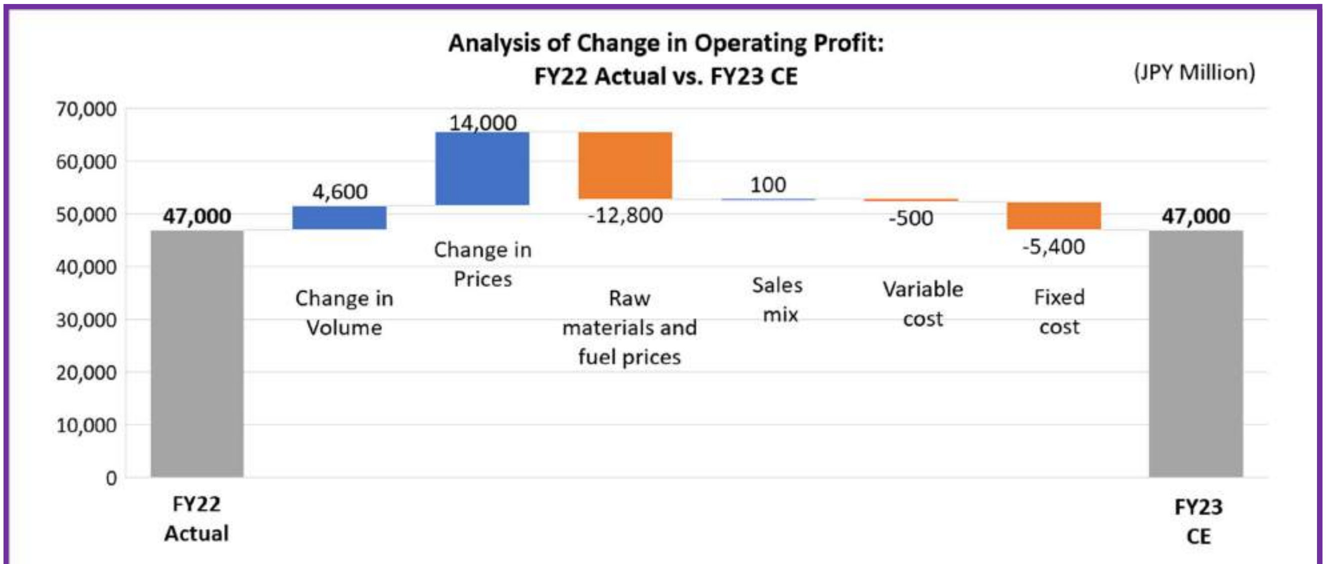
   At the beginning of FY23, Daido expected a negative impact of -¥7,000mil from the rise in energy cost in FY23. The firm also assumed a -¥6,000mil YoY hit from a higher nickel price. These will be offset by increases in selling prices (+¥14,000mil YoY).

3. Moreover, although the current price of crude oil price has risen to over $80/bbl from the March 23 low of $66.7/bbl, it is below Daido's assumption of $85/bbl, which might have a positive impact on FY23 earnings.

Raw Materials Price Trend

			FY20	FY21	FY22		FY23 (CE)
			Result	Result	Assumption	Result	Assumption
Scrap	H2	¥000/t	24.9	47.6	61.5	46.3	50.0
	Factory Bundle		28.9	53.9	66.5	50.7	53.0
Nickle	LME	$/Lb	6.8	9.3	14.0	11.6	12.0
Crude Oil	Dubai Brent	$/bbl.	45.8	76.6	100.0	90.3	85.0
FOREX	TTM	¥/$	107.1	113.4	120.0	135.5	130.0

Source: Daido Steel FY22 Earnings Results Presentation



Source: Nippon-IBR based on FY22 Earnings Results Materials published by Daido Steel

FY23 FORECASTS BY SEGMENT

Daido Steel (5471JP): Sales, OP and OPM by Segment (semi-annually)

(¥mil)		FY22				FY23CE					
		1H	2H	FY	YoY (%)	1H	YoY (%)	2H	YoY (%)	FY	YoY (%)
Specialty Steel	Sales	102,740	112,030	214,770	8.6	112,000	9.0	120,000	7.1	232,000	8.0
	OP	4,223	5,548	9,771	155.3	5,000	18.4	8,500	53.2	13,500	38.2
	OPM (%)	4.1	5.0	4.5	+2.6ppt	4.5	+0.4ppt	7.1	+2.1ppt	5.8	+1.3ppt
High Performance Materials & Magnetic Materials	Sales	109,566	110,158	219,724	11.2	105,000	-4.2	115,000	4.4	220,000	0.1
	OP	13,437	10,849	24,286	-8.9	9,000	-33.0	12,500	15.2	21,500	-11.5
	OPM (%)	12.3	9.8	11.1	-2.4ppt	8.6	-3.7ppt	10.9	+1.1ppt	9.8	-1.3ppt
Parts for Automobile and Industrial Equipment	Sales	49,485	51,747	101,232	9.4	52,000	5.1	54,000	4.4	106,000	4.7
	OP	3,362	4,855	8,217	65.0	3,000	-10.8	5,500	13.3	8,500	3.4
	OPM (%)	6.8	9.4	8.1	+2.7ppt	5.8	-1.0ppt	10.2	+0.8ppt	8.0	-0.1ppt
Engineering	Sales	8,336	10,620	18,956	4.1	9,000	8.0	10,000	-5.8	19,000	0.2
	OP	412	1,013	1,425	n/a	500	21.4	500	-50.6	1,000	-29.8
	OPM (%)	4.9	9.5	7.5	n/a	5.6	+0.7ppt	5.0	-4.5ppt	5.3	-2.2ppt
Trading & Service	Sales	11,727	12,154	23,881	1.4	12,000	2.3	11,000	-9.5	23,000	-3.7
	OP	1,816	1,477	3,293	16.2	1,500	-17.4	1,000	-32.3	2,500	-24.1
	OPM (%)	15.5	12.2	13.8	+1.8ppt	12.5	-3.0ppt	9.1	-3.1ppt	10.9	-2.9ppt
Total	Sales	281,857	296,707	578,564	9.2	290,000	2.9	310,000	4.5	600,000	3.7
	OP	23,225	23,761	46,986	27.1	19,000	-18.2	28,000	17.8	47,000	0.0
	OPM (%)	8.2	8.0	8.1	+1.1ppt	6.6	-1.6ppt	9.0	+1.0ppt	7.8	-0.3ppt

Source: Nippon-IBR based on FY21 & FY22 Earnings Results Materials published by Daido Steel

FY23 earnings for Daido Steel's three major segments are as follows:

1. Specialty Steel

[FY23 sales ¥232,000 mil (+8.0% YoY) / OP ¥13,500mil (+38.2% YoY) / OPM 5.8% (+1.3ppt)]

Daido Steel guides for 1H segment OP of ¥5,000mil (+18.4% YoY) on sales of ¥112,000mil (+9.0% YoY) and 2H segment OP of ¥8,500mil (+53.2% YoY) on sales of ¥120,000mil (+7.1% YoY).

FY23 segment earnings forecast are based on the assumption that:

1. Sales volumes start to increase on a YoY basis towards 2H, as global auto production volumes recover,
2. OPMs will be optimized as much a possible on the back of price adjustments to offset higher energy and raw materials costs, and
3. Tool steel prices in the 2H will be raised by approx. +5~15%. The slide gap will likely fall back from -¥2,500mil YoY to -¥1,100mil (-¥900mil in 1H and -¥200mil in 2H), vs the positive impact of ¥1,400mil in FY22.

2. High Performance Materials & Magnetic Materials

[FY23 sales ¥220,000mil (+0.1% YoY) / OP ¥21,500mil (-11.5% YoY) / OPM 9.8% (-1.3ppt)]

The YoY decline in segment FY23 OP is based on expectations that inventory adjustment of stainless steel will likely continue until 2H as:

1. The weak auto production during FY22 is likely to still be suffering from high inventory levels of stainless steel throughout the entire supply chain, and
2. Demand for stainless steel used for SPEs will likely weaken as the silicon cycle tries to find a bottom.

The firm guides for 1H segment OP of ¥9,000mil (-33.0% YoY) on sales of ¥105,000mil (-4.2% YoY) and 2H OP of ¥12,500mil (+15.2% YoY) on sales of ¥115,000mil (+4.4% YoY).

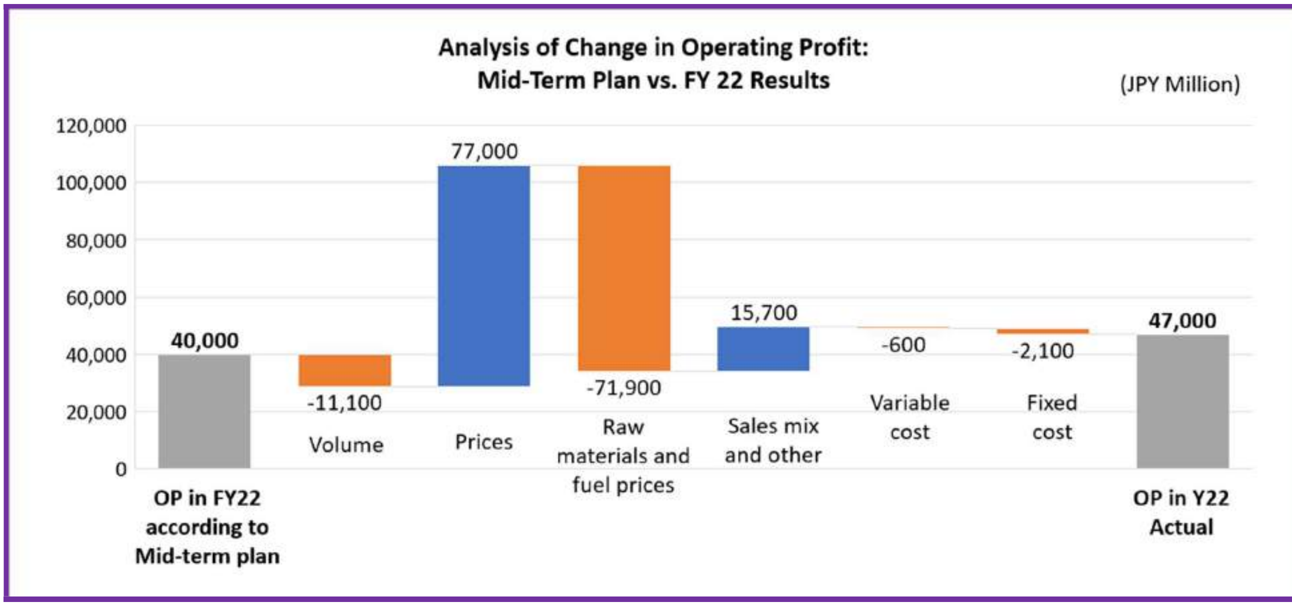
3. Parts for Automobile and Industrial Equipment Segment

[FY23 sales ¥106,000mil (+4.7% YoY) / OP ¥8,500mil (+3.4% YoY) / OPM 8.0% (-0.1ppt)]

The segment will likely enjoy solid growth in open die forging. Daido Steel guides for 1H segment OP of ¥3,000mil (-10.8% YoY) on sales of ¥52,000mil (+5.1% YoY) and 2H OP of ¥5,500mil (+13.3% YoY) on sales of ¥54,000mil (+4.4% YoY). As auto production increases in 2H, sales volumes will likely improve thanks to higher sales of engine valves.

MEDIUM TERM PLAN - RECAP

FY23 is the last year of the three-year medium-term management plan. The plan's OP target of over ¥40,000mil was achieved in FY22. Growth in Daido Steel's strategic products, such as high-performance stainless steel and open die forging, has led to a marked improvement in sales mix. As a result, ROE reached 10.4% in FY22, surpassing the medium-term target of 8%.



Source: Nippon-IBR based on FY22 Earnings Results Materials published by Daido Steel

Medium-term Management Plan (FY21~FY23) Target				
	Target to achieve in FY23	FY22 Results	FY23 Forecast	Progress
OP (¥mil)	40,000	47,000	47,000	Achieved in FY22
ROE (%)	8.0	10.4	8.4	Achieved in FY22
D/E ratio (x)	0.5	0.64	0.65	Likely fall short of the target.
Investment (¥mil)	85,000	-	90,000	Strategically invest on growing businesses
Sales volume (tonne)	1.2mil	1.085mil	1.129mil	Likely fall short due to weak auto production

Source: Nippon-IBR based on Daido Steel's FY22 earnings results presentation

CAPITAL ALLOCATION POLICY

Daido Steel has three major allocations for its capital: strategic investment for growth, including (1) CAPEX, (2) investments related to achieve a carbon neutral status and (3) dividend payments. The firm plans to finance CAPEX via cash flow, bank loans and the proceeds from the unwinding of some of its investment securities. Over the current medium-term plan, Daido plans to spend total of ¥90,000mil investment to achieve carbon neutrality.

In FY23, the firm guides for CAPEX of ¥32,900mil which includes strategic investment including business portfolio restructuring, and cost and productivity improvement, carbon neutral-related investment and IT investment vs. depreciation cost of ¥26,800mil.

1. **CAPEX:** Daido Steel identifies 1) business portfolio restructuring, and 2) improvement in cost and production efficiency as strategic investment focus. For example, in FY23, the firm plans to dedicate approx ¥5,200mil in CAPEX on the second vacuum remelting furnaces (VAR) in the Chita Second Factory to enhance production capacity of high-performance stainless steel and high alloy used for SPEs, which Daido has approx 40% global market share. In FY22, the firm spent CAPEX of approx ¥24,300mil vs. depreciation cost of ¥26,100mil.
2. **Investment to achieve a carbon neutral status:** At the ESG presentation held on 19 December 2022, the firm announced a renewed initiative, *Daido Carbon Neutral Challenge* 2030, which aims to reduce Scope 1 & Scope 2 CO2 emissions by -50% by 2030 compared to emmission volume of approx 1mil tonne in FY13 and to become carbon neutral by 2050 on a parent basis.
3. **Dividend policy:** The company currently does not have any shareholder return measures other than an annual cash dividend payout, at 30% of net profit. FY22 annual dividend was ¥230/share vs forecast of ¥200/share, which was revised due to better-than-expected profit level. FY23 dividend is currently guided for ¥230/share, which will generate 30.6% of FY23 profit forecast.

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