

Honma Golf Limited Company Report

We recommend an **Overweight** in Honma Golf.

Honma Golf, domiciled in Japan and listed in Hong Kong, is the dominant player in premium golf equipment. With industry-leading margins and strong growth prospects, we see an intrinsic value to the shares that far exceeds the current price.

While many of Honma's markets are mature and low growth, Honma has succeeded in launching new products and capturing new customer segments.

As one of the few branded equipment manufacturers in golf, offered at a cheap valuation, we view Honma as a strong candidate for investors seeking exposure to this niche segment of the sporting goods industry.

Recommendation

Overweight

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Honma Golf Limited	
Ticker	6858 HK
Price (Apr 13, 2018)	8.65 HKD
Price Target	11.59 HKD
52-week Range	5.70 – 9.40 HKD
Market Cap	\$670 mn
EV	\$544 mn
Shares out, dil	609.1 mn
P/E	14.1x
Fiscal Year End	March

Please see the disclaimer at back of this report for important information.

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Company Overview

Honma Golf designs, develops, manufactures, and sells a range of golf club equipment in mainly in Asia, North America, Europe. Honma's main sales are from its golf clubs products, which account for >80% historically on average, golf balls, apparels, footwear products, other golf-related accessories under their iconic brands of BERES, TOUR WORLD, Be ZEAL, and G1X, etc. The company is headquartered in Tokyo, Japan, and went IPO in Hong Kong in Oct 2016.

Honma is one of the three largest golf product companies that are public listed. The firm is currently trading at an attractive multiple compared to its peers and the broader sporting goods sector. The firm is currently traded at the P/E ratio of 14.1x, while the golf equipment industry average is 21.8x.

Table 1: Global golf equipment brands v.s. major sportswear brands

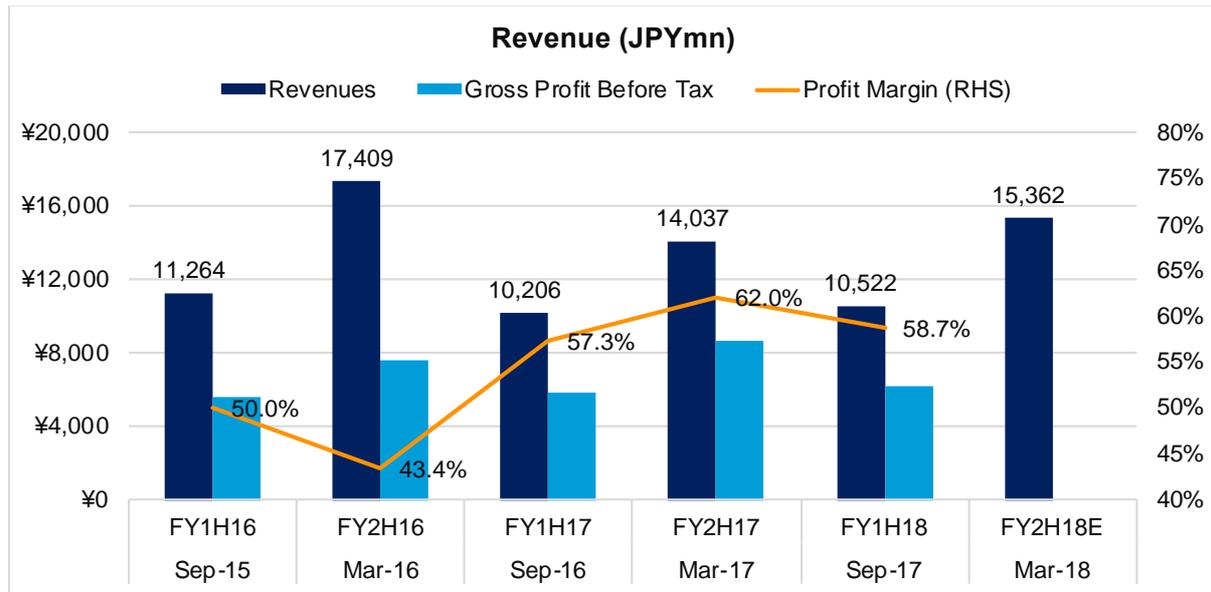
	Market Cap (USD mn)	P/E*	Price (USD)	EPS
Golf Products				
Honma Golf Limited (SEHK:6858)	672.7	14.1x	1.1	0.08
Callaway Golf Company (NYSE:ELY)	1,654.3	41.4x	17.37	0.43
Acushnet Holdings (NYSE:GOLF)	1,802.1	19.6x	24.11	1.24
Graphite Design (JASDAQ:7847)	39.5	6.5x	5.68	0.97
Maruman & Co. (JASDAQ:7834)	30.4	16.2x	1.77	0.16
Endo Manufacturing (JASDAQ:7841)	62.8	32.8x	7.2	0.22
Competitive Sportswear Manufacturers/ Retailers				
Under Armour, Inc. (NYSE:UAA)	6,819.3	NM	16.49	(0.11)
Adidas AG (DB:ADS)	52,928.1	31.8x	259.92	6.68
NIKE, Inc. (NYSE:NKE)	108,390.8	62.1x	67.25	2.56

Source: Capital IQ; Date as of Apr 13, 2018; *P/Diluted EPS Before Extra LTM

Financials Discussion

Revenue

The profit margin of Honma is relatively high to its competitors such as Callaway and Acushnet whose margin is on average <50%. This is mainly due to the firm's strategy of positioning its brands in the prestigious, premium segments.



- **Product Mix**

Honma specialized in golf club products which accounted for >83% of its sales. We see a slightly decreasing trend (decreasing from a stable >84% to 83% in FY2017), but as clubs are Honma's signature premium products, we believe it will continue to mainly invest in club. Additionally, as the firm is expanding to create a golf lifestyle experience to strengthen its premium brand image, we expect the proportion of sales from apparel, accessories and balls to increase gradually in the longer run. Therefore, in our revenue mix projection, the contribution of golf clubs would gradually decline to ~80% in the next 10 years period.

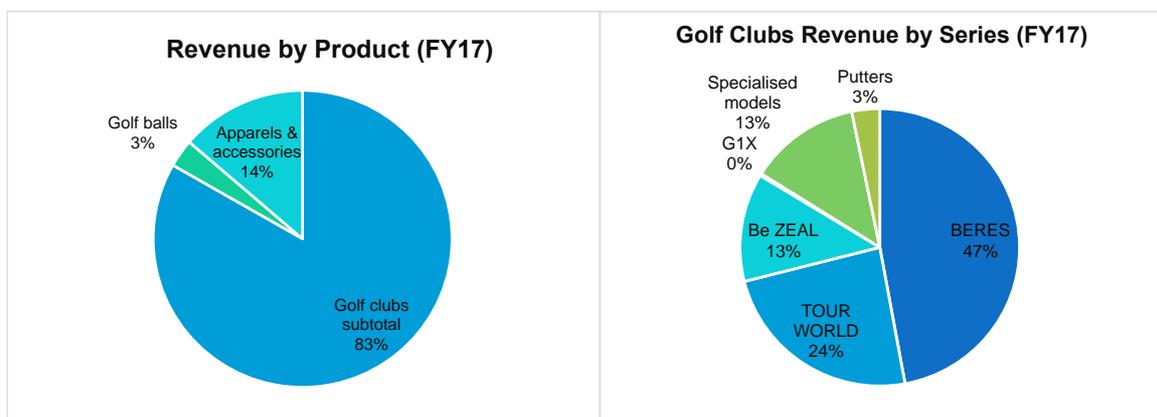


Table 2: Golf Consumer Segmentation and Honma's Positioning

Enthusiasm Affluence	High	Mid	Low
High	Design & Performance	Design <u>BERES</u>	Design & Price
Mid	Performance <u>TOUR WORLD</u>	Performance & Design <u>ZEAL</u>	Performance & Price
Low	Price & Performance <u>G1X</u>	Price & Design <u>G1X</u>	Price

The **BERES** golf clubs, which has traditionally been Honma's key product line promotes the craftsmanship design, target the segment of customers purchasing high-priced golf clubs and caring about the design of the clubs. The BERES sales declined over the past two years as the firm has been focusing on launching new products for other series. For our projection, we expect that with new BERES product expected to be released this year, BERES' negative sales growth during the past two years would be offset. However, since BERES targets at a higher-end, mature customer segment, we do not expect an aggressive growth as Honma's other cheaper series experienced in the past. In the longer term, we project that with the overall global economy recovering, the sales growth for this premium product line would gradually recover to 2.1%, which is the weighted average of the GDP growth of Honma's main developed markets.

The **TOUR WORLD** clubs series allow Honma to target the segment that comprises golf enthusiasts who emphasize more on performance; while the **Be ZEAL** series allow Honma to step in the segment of beginner golfers who aim to improve their performance while being able to afford mid-price golf products (pricing range around the same as Callaway's). These two segments have experienced relatively higher growth rates among major golf markets and we expect Honma to benefit from this trend which mainly occurs in emerging markets. Also, the sporting goods market in China has experienced a CAGR of 9.26% over the past five years, and we expect the markets to continue this high growth trend. Thus, our long term revenue growth projection for TOUR WORLD and Be ZEAL is 4.3% – which is a projected weighted average of the GDP growth of Honma's major markets with more weight and contribution from China and other Asia EMs.

For the **G1X series, balls, apparel, and accessories**, we expect China and other Asia EM regions having more effect on the sales growth. Thus in the long run, we forecast the growth of these products to be 4.3%. For **specialized models** (special series or customized products) and **putters**, since these products more targeting at people with more disposable income, we expect the sales growth to be generally in line with BERES' growth which is ~2.1%.

Table 3: Revenue projection

JPY mn	FY16	FY17	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E
Clubs													
BERES	9,912	9,510	9,144	9,144	9,199	9,309	9,476	9,703	9,993	10,352	10,786	11,303	11,545
TOUR WORLD	4,331	4,830	6,269	7,606	8,582	8,955	9,344	9,750	10,174	10,616	11,077	11,558	12,060
Be ZEAL	1,173	2,548	2,515	2,496	2,492	2,502	2,526	2,564	2,618	2,687	2,773	2,878	3,003
G1X	59	51	67	70	73	76	79	83	86	90	94	98	102
Specialised models	2,878	2,596	2,764	2,931	3,096	3,256	3,410	3,557	3,695	3,822	3,937	4,039	4,125
Putters	500	651	560	490	437	397	367	345	330	321	318	319	326
Golf clubs subtotal	18,853	20,186	21,319	22,737	23,878	24,494	25,202	26,002	26,896	27,888	28,985	30,195	31,162
Golf balls	420	736	1,078	1,125	1,174	1,225	1,278	1,334	1,391	1,452	1,515	1,581	1,650
Apparels & accessories	3,096	3,321	3,487	3,658	3,836	4,020	4,210	4,407	4,610	4,819	5,034	5,256	5,485
Total	22,369	24,242	25,884	27,520	28,888	29,739	30,690	31,742	32,897	34,159	35,534	37,032	38,296
YoY%				6.3%	5.0%	2.9%	3.2%	3.4%	3.6%	3.8%	4.0%	4.2%	3.4%
YoY%													
Clubs													
BERES		-4%	-4%	0.0%	0.6%	1.2%	1.8%	2.4%	3.0%	3.6%	4.2%	4.8%	2.1%
TOUR WORLD		12%	30%	21.3%	12.8%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%
Be ZEAL		117%	-1%	-0.7%	-0.2%	0.4%	1.0%	1.5%	2.1%	2.7%	3.2%	3.8%	4.3%
G1X		-14%	32%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%
Specialised models		-10%	6%	6.0%	5.6%	5.2%	4.7%	4.3%	3.9%	3.4%	3.0%	2.6%	2.1%
Putters		30%	-14%	-12.4%	-10.8%	-9.2%	-7.6%	-6.0%	-4.3%	-2.7%	-1.1%	0.5%	2.1%
Golf clubs subtotal		7%	6%										
Golf balls		75%	47%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%
Apparels & accessories		7%	5%	4.9%	4.9%	4.8%	4.7%	4.7%	4.6%	4.5%	4.5%	4.4%	4.3%

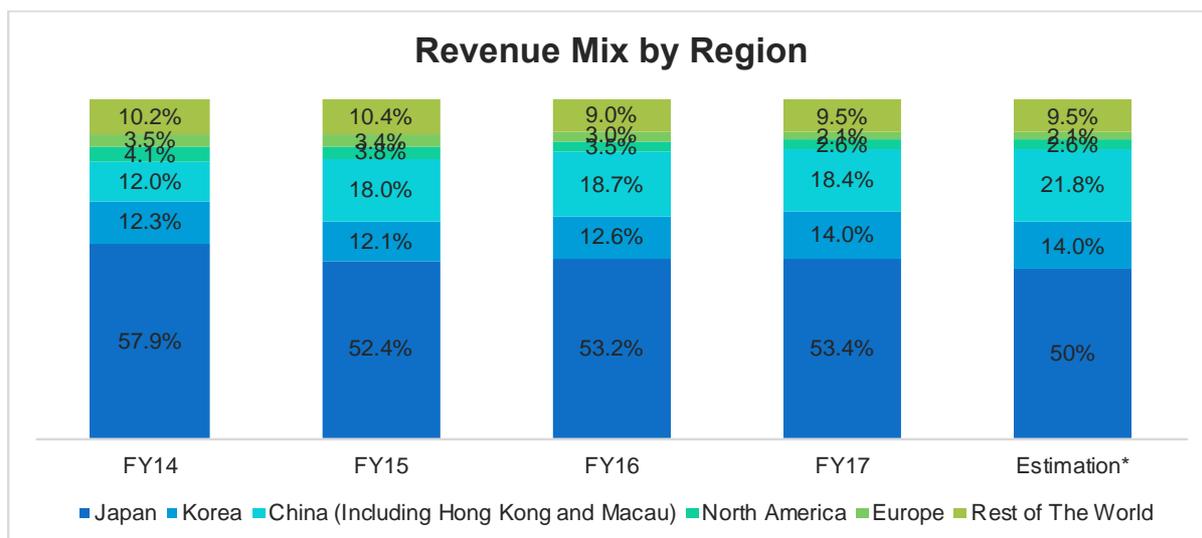
- Revenue by Region**

Honma is highly concentrated in the Asia markets, as it has traditionally been operating mainly in the Japanese market where the brand has been known for its high quality and premium golf clubs.

Sales growth from Japan has been relatively stable and we see a decreasing trend of Japan's contribution to total revenue. In FY14, the revenue from Japan was ~60% and the ratio declined gradually to 53% in FY17. Thus, we expected the ratio to continue declining to ~50% as the Japanese market has been stabilizing given the maturity of the Japanese golf industry and the stable Japanese economic growth. Also, the firm is expecting to invest more in expanding the Chinese and the US markets by opening new stores and distributor partnership.

We hold a positive view on the Greater China markets as the Chinese government introduced the promotion of golf sport to the masses as part of the country's 13th Five Year Plan in 2017. The goal is to add 20 million golfers by 2020. We expected the policies to further fuel the Chinese golf population expansion, thereby benefiting Honma's growth in China. However, 20 million is a very ambitious goal and we believe that golf is a kind of sport that is highly associated with income growth which usually cannot grow very aggressively in the short run. Therefore we're expect a slower but long-run growth of China's contribution to Honma's sales.

In North America and Europe, because the markets have traditionally been dominated mainly by the US brands, such as Callaway, Titleist and TaylorMade, we believe that it will be more challenging for Honma to grow aggressively in these markets. Thus, we forecast the contribution of these regions to stay relatively flat.



*Long-term projection – For the purpose of estimating effective tax rate for our valuation model. For the usage of the estimated figures, please refer to the Taxes section.

NOTE: THE PRECEDING FIGURES WERE STATED IN JAPANESE YEN FOR THE BOTTOM-UP REVENUE PROJECTIONS.

FROM HERE FORWARD, THE MODEL IS PRESENTED IN U.S. DOLLARS FOR EASE OF UNDERSTANDING MAGNITUDE.

COGS and SG&A

Honma currently enjoys margins well in excess of its golf equipment peers. While we believe there is reason for some persistence of this outsized margin given its premium positioning, we see a decline in margins as the company aims for broader footprint, both geographically and in consumer segments. For our model, gross margin and EBIT margin decline linearly for the next five years to reach parity with the industry average, and remain flat thereafter.

	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E
Gross Margin	58.9%	59.0%	60.0%	59.6%	57.6%	55.6%	53.6%	51.5%	49.5%	49.5%	49.5%	49.5%	49.5%	49.5%
EBIT Margin	10.6%	17.1%	18.8%	21.5%	19.2%	16.9%	14.6%	12.2%	9.9%	9.9%	9.9%	9.9%	9.9%	9.9%

Capital Expenditures

CapEx of Honma shows a relatively consistent relationship with depreciation and amortization (D&A), so we forecast a stable relationship going forward. Effectively, D&A flows through as a percentage of beginning PP&E, and CapEx follows as a multiple of D&A.

USD mn

	FY17	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E
PP&E, Net	36	38	40	43	46	49	52	55	59	63	67	71
Depreciation & Amortization	3	3	4	4	4	4	5	5	5	6	6	6
CapEx	6	6	6	7	7	7	8	8	9	10	10	11

Working Capital

Non-cash current assets (accounts receivable, inventory, etc.) are forecasted as a flat percentage of revenue.

Non-debt current liabilities (accounts payable, etc.) are forecasted as a flat percentage of COGS. Short-term debt is held flat at a very low level. Thus as revenue grows, working capital grows proportionally, which acts as a small cash drag on the company. Detailed projection is in the Appendix.

Taxes

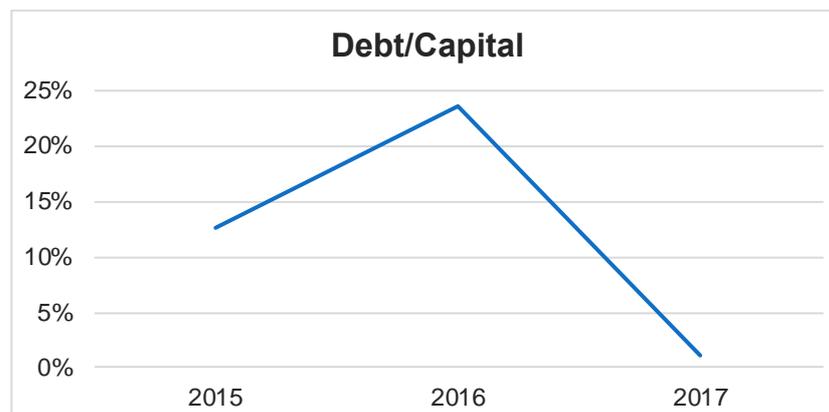
The firm's effective tax rate was 24.0% for the six months ended 30 September 2017 (FY1H18), down from 39.9% for the six months ended 30 September 2016. We assume the effective tax rate to stay at a constant level, and forecast the tax rate to be 25.4% weighed based on our projected revenue mix by region. The weight used were explained in the previous Revenue section.

Key Regions	Weight	Tax Rate
Japan	50.0%	30.9%
Korea	14.0%	25.0%
China (Including Hong Kong and Macau)*	21.8%	17.8%
North America**	2.6%	29.6%
Europe***	2.1%	0.0%
Other****	9.5%	18.5%
		<u>25.4%</u>

*Taking a more simple approach, we calculated the China tax rate by averaging the tax rates of PRC China (25%), Hong Kong (16.5%), and Macau (12%). **29.6% = 21% (Federal tax rate) + 8.64% (State tax). ***The firm is not subject to any income tax in the Cayman Islands and British Virgin Islands. ****As the firm did not report other countries' revenue contribution and their effective tax rates, we took the average of Taiwan's and Thailand's corporate tax rates, which were the only other two countries whose effective tax rates were mentioned in the firm's annual report.

Leverage

Leverage appears volatile in the past few years, but only because the book value of equity was low. Given Japanese culture of financial conservatism, we assume debt will stay low (zero long-term debt and \$3 million of short-term debt).



Valuation

For the valuation, we use the APV method because the Debt/Equity ratio of Honma is not stable.

Variable	Input	Comment
Risk-free rate	2.29%	One-year Treasury note
Market risk premium	4.85%	Damodaran (NYU) risk premium (May 1)
Beta	0.98	Honma has only been public for 18 months; calculated beta using weekly prices since IPO
Return on equity	7.04%	Applying CAPM to the above inputs
Return on debt	3.86%	Used Callaway cost of debt, because no information was available on Honma debt yield
Return on assets	7.03%	See below note
Terminal growth rate	3.0%	From bottom-up analysis presented earlier in the report
PV of unlevered cash flows	771	
PV of tax shield	2	
Enterprise Value	773	
less Debt and Preferred Equity	3	
plus Cash	129	
Estimated value of common equity	899	USD
Converted to HKD	7,058.14	HKD
Shares outstanding	609.1	
Estimated Value per share	11.59	HKD
Current share price	8.40	HKD
Upside (Downside)	38%	

Note:

rE = return on equity	7.04%	From CAPM above
rD = return on debt	3.86%	From Bloomberg
rA = return on assets	7.03%	Applying formula below
D = market value of debt	3	
E = market value of equity	652	As of May 7
$rE = rA(1 + D/E) - rD(D/E)$		
$rA(1 + D/E) = rE + rD(D/E)$		
$rA = [rE + rD(D/E)] / (1 + D/E)$		

Conclusion

We recommend an **Overweight** in Honma Golf Limited.

With conservative assumptions underlying our slowdown in revenue growth, as well as significant margin compression, we see an upside of 38% from the current share price.

Appendix: Detailed financial model

USD mn	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E
Income Statement														
Revenue	169	187	224	253	269	282	290	300	310	321	333	347	362	374
COGS	(70)	(77)	(90)	(102)	(114)	(125)	(135)	(145)	(156)	(162)	(168)	(175)	(183)	(189)
Gross Profit	100	110	135	151	155	157	155	154	153	159	165	172	179	185
SG&A	(82)	(78)	(92)	(96)	(103)	(109)	(113)	(118)	(123)	(127)	(132)	(137)	(143)	(148)
Operating Income	18	32	42	54	52	48	42	37	31	32	33	34	36	37
Net interest expense	(0)	-	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
Pretax income	18	32	42	54	51	47	42	36	30	32	33	34	36	37
Income taxes	3	(2)	1	(7)	(13)	(12)	(11)	(9)	(8)	(8)	(8)	(9)	(9)	(9)
Net Income	21	30	43	48	38	35	31	27	23	24	24	25	27	27
Balance Sheet														
<i>Total Assets</i>														
Cash & Equivalents	19	16	114	129	143	157	171	182	190	196	202	208	214	221
Accounts Receivable	19	32	46	52	55	58	59	61	63	66	68	71	74	76
Inventory	59	66	57	64	68	71	73	75	78	81	84	87	91	94
Other short-term assets	5	14	4	5	5	5	5	6	6	6	6	6	7	7
Total Current Assets	102	128	221	248	271	291	309	324	337	348	360	372	385	398
PP&E, Net	30	35	36	38	40	43	46	49	52	55	59	63	67	71
Other long-term assets	14	15	22	23	25	26	28	30	32	34	36	39	41	44
Total Noncurrent Assets	45	51	57	61	65	69	74	79	84	89	95	101	108	115
Total Assets	147	178	278	309	336	360	383	402	420	437	455	474	493	513
<i>Liabilities & Shareholders' Equity</i>														
Accounts Payable	5	7	23	26	29	32	34	37	40	41	43	45	47	48
Short-term debt	4	15	3	3	3	3	3	3	3	3	3	3	3	3
Other short-term liabilities	89	84	1	1	2	2	2	2	2	2	2	3	3	3
Total Current Liabilities	99	106	27	30	33	36	39	42	45	46	48	50	52	54
Long-term debt	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other long-term liabilities	19	23	20	20	20	20	20	20	20	20	20	20	20	20
Total Noncurrent Liabilities	19	23	20	20	20	20	20	20	20	20	20	20	20	20
Total Liabilities	118	129	47	50	53	56	59	62	65	66	68	70	72	73
Total Equity	29	49	231	259	283	304	324	341	356	371	387	404	421	439
Total Liabilities & Equity	147	178	278	309	336	360	383	402	420	437	455	474	493	513
Cash Flow Statement														
<i>Cash from Operating Activities</i>														
Net income	21	30	43	48	38	35	31	27	23	24	24	25	27	27
Depreciation & Amortization	3	3	3	3	4	4	4	4	5	5	5	6	6	6
Change in working capital	(19)	(22)	(5)	(10)	(4)	(3)	(1)	(2)	(2)	(4)	(4)	(5)	(5)	(4)
Other non-cash items	(6)	1	(6)	-	-	-	-	-	-	-	-	-	-	-
Cash from Operating Activities	(1)	12	34	41	38	36	34	30	26	25	26	27	28	30
<i>Cash from Investing Activities</i>														
CapEx	(3)	(4)	(6)	(6)	(6)	(7)	(7)	(7)	(8)	(8)	(9)	(10)	(10)	(11)
Acquisitions and divestitures	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other investing activities	-	(7)	7	-	-	-	-	-	-	-	-	-	-	-
Cash from Investing Activities	(3)	(11)	1	(6)	(6)	(7)	(7)	(7)	(8)	(8)	(9)	(10)	(10)	(11)
<i>Cash from Financing Activities</i>														
Dividends	(4)	(10)	(19)	(21)	(17)	(15)	(14)	(12)	(10)	(10)	(11)	(11)	(12)	(12)
Debt issuance and payments	7	65	(80)	-	-	-	-	-	-	-	-	-	-	-
Equity issuance and repurchases	-	-	155	-	-	-	-	-	-	-	-	-	-	-
Other financing activities	(5)	(60)	-	-	-	-	-	-	-	-	-	-	-	-
Cash from Financing Activities	(3)	(5)	57	(21)	(17)	(15)	(14)	(12)	(10)	(10)	(11)	(11)	(12)	(12)
Net Changes in Cash	(6)	(4)	101	14	15	14	14	11	8	6	6	6	6	7

KEY INPUTS

Revenue growth	8.0%	10.1%	20.3%	12.7%	6.3%	5.0%	2.9%	3.2%	3.4%	3.6%	3.8%	4.0%	4.2%	3.4%
Gross Margin	58.9%	59.0%	60.0%	59.6%	57.6%	55.6%	53.6%	51.5%	49.5%	49.5%	49.5%	49.5%	49.5%	49.5%
EBIT Margin	10.6%	17.1%	18.8%	21.5%	19.2%	16.9%	14.6%	12.2%	9.9%	9.9%	9.9%	9.9%	9.9%	9.9%
EBIT	18	32	42	54	52	48	42	37	31	32	33	34	36	37
Interest expense, net of taxes	(0)	-	(0)	-	-	-	-	-	-	-	-	-	-	-
NOPAT	18	32	42	54	52	48	42	37	31	32	33	34	36	37
D&A	3	3	3	3	4	4	4	4	5	5	5	6	6	6
CapEx	(3)	(4)	(6)	(6)	(6)	(7)	(7)	(7)	(8)	(8)	(9)	(10)	(10)	(11)
Increase in non-cash working capital	(19)	(22)	(5)	(10)	(4)	(3)	(1)	(2)	(2)	(4)	(4)	(5)	(5)	(4)
Unlevered free cash flow	(1)	9	34	42	49	45	39	34	27	28	29	30	32	33
Year #					1	2	3	4	5	6	7	8	9	10
cash flow discount factor					1.07	1.15	1.23	1.31	1.40	1.50	1.61	1.72	1.84	1.97
cash flow PV					48	42	34	28	22	21	21	20	19	19
Tax rate	-19%	7%	-1%	12%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%
CapEx	(3)	(4)	(6)	(6)	(6)	(7)	(7)	(7)	(8)	(8)	(9)	(10)	(10)	(11)

Important Disclaimer

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