

Polaris Holdings (3010)

A watershed quarter, raising our estimates

Share price: ¥104

Market cap: ¥12.2bn

Q2 FY3/2023 results update

- **Positive OP, raising our estimates** – Polaris reported a 4.6% operating profit margin for Q2 FY3/2023, highlighting their business transformation and recapitalization strategy are bearing fruit. Market conditions are recovering driven by domestic demand, and momentum has remained robust in October 2022. We raise our FY3/2023 earnings estimates, the key change of forecasting ¥0.29bn operating profit (previously ¥0.87bn operating loss).
- **Recapitalization strategy delivering** – exercise of warrants in September 2022 raised ¥2.1bn, boosting shareholders' equity to ¥2.2bn (the highest level seen since FY3/2012). We view limited credit risk, with recapitalization and solid sponsor support.

14 November 2022



Source: Bloomberg

Recovering profitability

- **A positive surprise in profitability** – the stable trend in gross margins highlights the improvement in the hotel contract mix, but generating positive OP in Q2 FY3/2023 was a positive surprise. This was achieved by a combination of improving domestic demand driving revenues, operating a cost-efficient setup, and receiving hotel opening preparation fees from hotel owners with management contracts. We believe seasonality into H2 FY3/2023 will drive earnings to recover more strongly HoH.
- **Domestic demand driving recovery** – data from Japan Tourism Agency demonstrates that domestic customer demand has significantly recovered, with August 2022 overnight guest numbers standing at 46.7 million, nearly at the pre-pandemic level of 53.7 million seen in August 2019. Overseas traveler numbers continue to recover, although at a much slower pace.
- **Valuations** – We have raised our earnings estimates for FY3/2023. The shares are trading on an estimated FY3/2024 free cash flow yield of 17.1% (14.2% on a fully diluted basis).

Price performance

	YTD	1mth	3mth	12mth
Abs (%)	+42.5	-1.9	+3.0	+30.0
Rel (%)	+45.0	-4.8	+4.4	+36.1

Company sector

Real Estate Management/Services
Hotels, Restaurants & Leisure (GICS)

Stock data

Price (¥)	104
Mkt cap (¥bn)	12.2
Mkt cap (\$m)	86.7
52-week range (¥)	58-125
Shares O/S (m)	116.9
Average daily value (\$m)	0.1
Free float (%)	16.6
Foreign shareholding (%)	83.0
Ticker	3010
Exchange	Tokyo Standard
Net Debt/Equity (x)	N/A
FFO leverage (x)	N/A
BBG BUY HOLD SELL	0 0 0

Source: Bloomberg

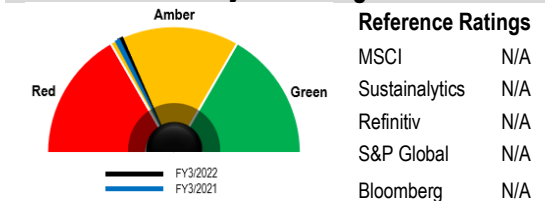
Year-end	3/2021	3/2022	3/2023E	3/2024E	3/2025E
Sales (¥bn)	2.97	3.71	5.88	12.03	12.03
OP (¥bn)	(1.63)	(1.33)	0.29	1.93	2.05
NP (¥bn)	(2.10)	(1.83)	0.17	1.26	1.35
EPS (¥)	(37.83)	(19.98)	1.41	10.76	11.54
DPS (¥)	-	-	-	-	-
Sales growth YoY (%)	-45.5	+24.9	+58.5	+104.6	+0.0
OP growth YoY (%)	N/A	N/A	N/A	+554.6	+6.3
NP growth YoY (%)	N/A	N/A	N/A	+661.8	+7.3
EPS growth YoY (%)	N/A	N/A	N/A	+661.8	+7.3
PER (x)	N/A	N/A	73.6	9.7	9.0
EV/EBITDA (x)	N/A	N/A	33.4	8.8	8.3
EV/Sales (x)	6.6	5.3	3.3	1.6	1.6
PBR (x)	(15.5)	63.1	4.2	2.8	2.0
ROE (%)	N/A	N/A	5.7	29.0	22.6
ROCE (%)	N/A	N/A	2.4	14.5	14.0
FCF yield (%)	(34.5)	(82.1)	7.4	17.1	14.6
Dividend yield (%)	-	-	-	-	-

Note: EPS and FCF yield calculations are undiluted; outstanding dilution is 20.4%

Business Overview

Polaris Holdings is a hotel operator with three key franchises - Best Western Japan, KOKO HOTEL, and Value The Hotel. It is shifting its business model towards low-risk management contracts and as an owner/operator.

Astris-Sustainability ESG rating



Next events

Q3 FY3/2023 results February 2023

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This report has been commissioned and paid for by the company

Q2 FY3/2023 results

Results highlights

Key financials

JPY (millions)	Q1-2 FY3/2022	Q1-2 FY3/2023	Growth YoY (%)	Astris FY3/2023 estimates
Sales	1,754	3,114	+77.6	4,820
Operating profit/(loss)	(728)	31	N/A	(870)
Operating margins	-41.5%	1.0%		-18.0%
Recurring profit/(loss)	(778)	(60)	N/A	(1,050)
Net income attributable to the parent	(792)	(107)	N/A	(1,050)

Source: Company

Positive OP in Q2 FY3/2023

JPY (millions)	Q4 FY3/2022	Q1 FY3/2023	Q2 FY3/2023	Growth QoQ (%)
Sales	912	1,192	1,922	+61.2
Operating profit/(loss)	(317)	(58)	89	N/A
Operating margins	-34.7%	-4.8%	4.6%	
Recurring profit/(loss)	(370)	(107)	47	N/A
Net income attributable to the parent	(482)	(120)	13	N/A

Source: Company

Per business segment (pre-elimination)

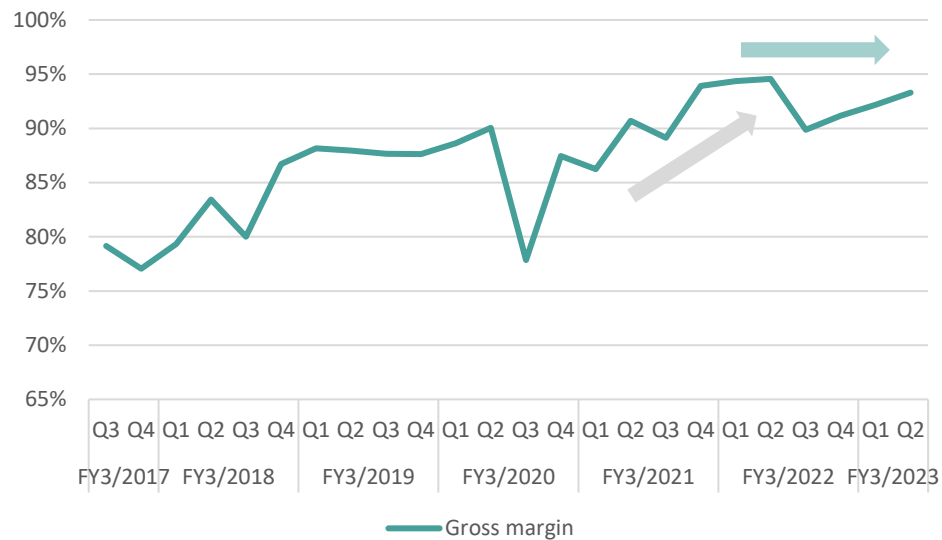
JPY (millions)	Q1-2 FY3/2022	Q1-2 FY3/2023	Growth YoY (%)
Sales			
Hotel operations	1,753	3,096	+76.6
Real estate	73	175	+139.7
Operating profit/(loss)			
Hotel operations	(572)	164	N/A
Real estate	(13)	18	N/A
Operating margins			
Hotel operations	-32.6%	5.3%	
Real estate	-17.8%	10.2%	

Source: Company

Polaris Holdings recorded a positive operating profit for Q2 FY3/2023, highlighting their **business transformation and recapitalization strategy is bearing fruit**. The market environment continues to improve, driven by domestic demand making a robust recovery.

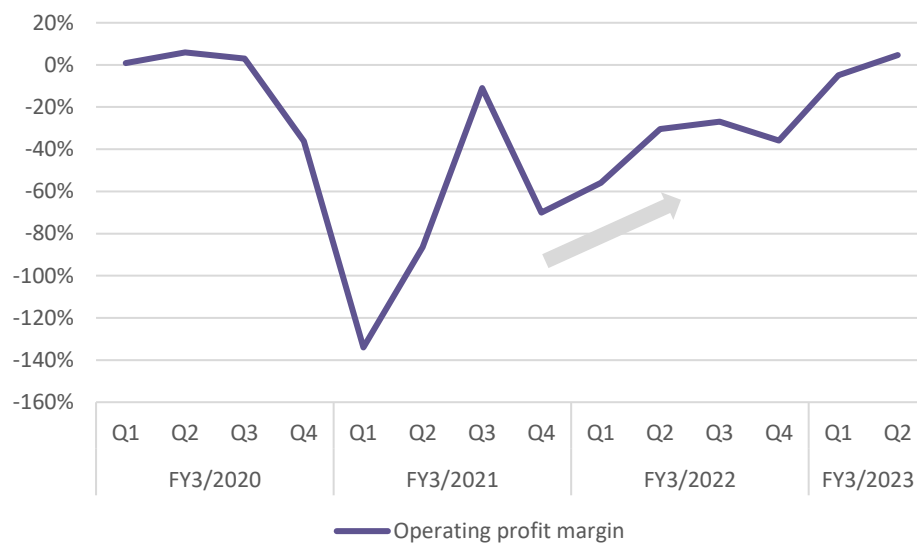
Quarterly gross margin trends appear stable at around 90% plus as the company's profit structure has improved (changing the contract mix away from legacy contracts with costly long-term fixed leases to fee-based management contracts). With increasing sales volume, the trend in operating margins has also become more visible.

Figure 1: Gross margin trend – quarterly basis



Source: Company

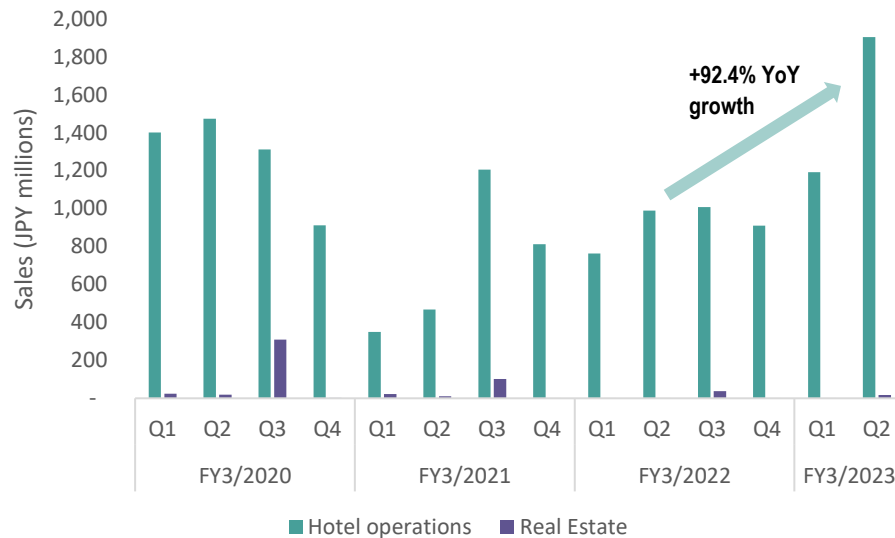
Figure 2: Operating margin trend – quarterly basis



Source: Company

The quarterly sales trend in Hotel Operations shows the highest volume recorded, driven by new hotel assets, increasing utilization rates, and RevPAR as well as upfront fees received for opening preparation fees for new hotel assets.

Figure 3: Quarterly sales trend

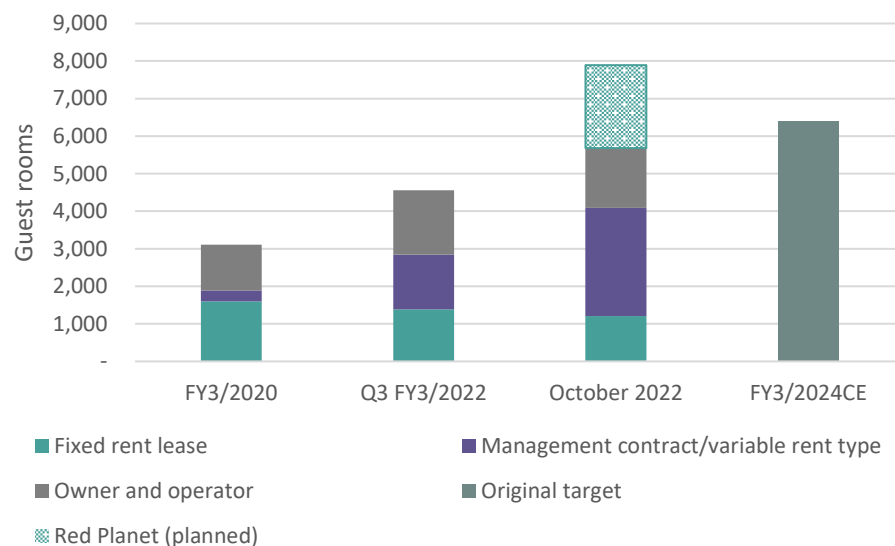


Source: Company

Growth in hotel assets and changing contract mix

The company's original target was to build up a hotel operation platform with 6,396 rooms by FY3/2024. With the pending strategic expansion into the Philippine market with the acquisition of Red Planet, this target will be reached sooner reaching a total of 7,890 rooms.

Figure 4: Guest rooms by contract type – impact of Red Planet acquisition and original FY3/2024 target



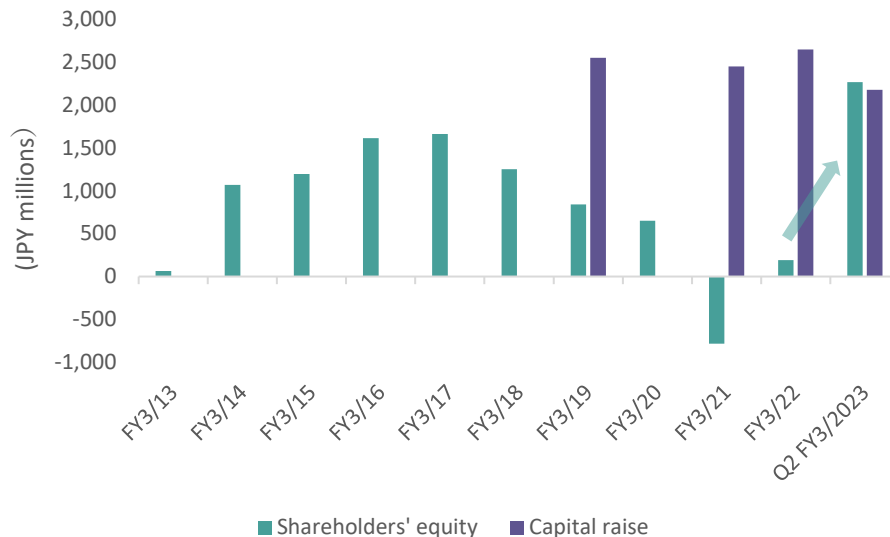
Source: Company

Strengthened capital base

We continue to see stabilization of the company's capital base. Shareholders' equity in Q2 FY3/2023 grew YoY due to the following factors:

- The exercise of warrants resulted in an equity injection of ¥2,179 million.
- Taking into account the quarterly net loss of ¥106 million, the balance increased by ¥2,073 million.

Figure 5: Trend in shareholders' equity (FY3/2013 to Q1 FY3/2023) and capital raises



Source: Company

Note: FY3/2022 capital raise includes ¥950 million subordinated loan from the Japan Finance Corporation (repayable in September 2040); Q2 FY3/2023 capital raise is via the exercise of stock acquisitions rights

We believe management has conducted extensive recapitalization, consequently placing the business in positive stead for the medium to long term. There are also the following measures to ensure the company has a strong capital outlook:

- An agreement with its main bank for a ¥600 million fixed-term loan commitment line was signed in September 2020.
- A 0.5% 20-year term COVID-19 subordinated loan worth ¥0.95 billion was raised from the Japan Finance Corporation in October 2020.

Out of the ¥1.5 billion convertible bonds issued in July 2020, ¥600 million has been converted. Conversion of the remaining ¥900 million balance will boost shareholders' equity.

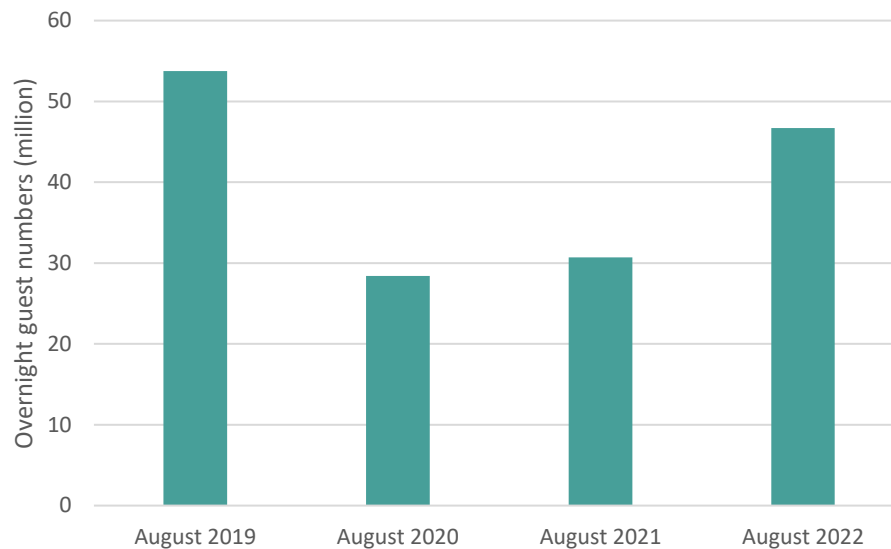
- The exercise of the remaining warrants issued will raise ¥2,380 million.
- With regards to borrowings of ¥150 million that technically breached debt covenants in February 2022, management has ensured that the lender will not exercise any penalties and will seek to refinance.

Star Asia Group LLC is a holding company and the ultimate 73.05% owner of Polaris Holdings. It acts as a sponsor to Polaris, providing significant financial and management resources. We believe as a sponsor Star Asia Group is committed to the business with plans to open new hotels and leverage the strengths of both parties. Management believes there is no significant uncertainty concerning Polaris Holdings as a going concern.

Market environment

Demand is recovering, with data from the Japan Tourism Agency highlighting that domestic overnight guest numbers for August 2022 reached 46.7 million, nearly reaching pre-pandemic levels last seen in August 2019.

Domestic overnight guest numbers



Source: Japan Tourism Agency

Statistics from the Japan National Tourism Organization (JNTO) highlight that overseas traveler arrivals have begun to trend positively from February 2022, and reaccelerated in September 2022.

Although overseas visitor numbers remain over 90% below the level of CY2019, we believe this illustrates a significant upside to a recovery cycle.

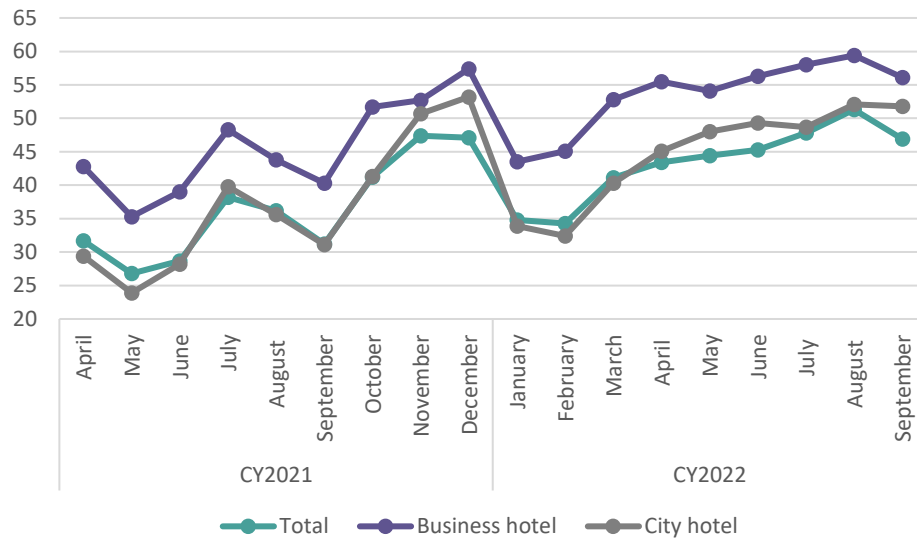
Overseas visitor arrivals

Month	CY2021	CY2022	Growth YoY (%)
January	46,552	17,776	-61.8
February	7,355	16,700	+127.1
March	12,276	66,100	+438.4
April	10,853	139,548	+1,185.9
May	10,035	147,046	+1,364.9
June	9,251	120,430	+1,201.8
July	51,055	144,578	+183.2
August	25,916	169,800	+555.2
September	17,720	206,500	+1,065.3
CY half-year	96,292	507,600	+427.1
September YTD	191,013	1,028,478	+438.4

Source: JNTO

Occupancy rates at hotels have stabilized, and City Hotels remain on a steady uptrend YoY. According to management, **momentum remained positive in October 2022.**

The trend in occupancy rate by facility type



Source: Ministry of Land, Infrastructure, Transport, and Tourism

Summary

Polaris Holdings is a domestic hotel operator with three franchises – Best Western Japan, KOKO HOTEL, and Value The Hotel. It has undergone significant capital raising and is positioned to capitalize on the recovering hotel demand in a post-pandemic environment.

Under the sponsorship of Star Asia Group, Polaris has undergone significant reforms with the key thematic of effectively utilizing resources, taking advantage of the dislocated hotel market, and targeting stable earnings growth.

The core element of this is **to strategically shift the hotel operator model:**

Shifting hotel operator model to higher return formats

- from the domestic legacy model involving long-term fixed rent leases towards low-risk **“Fee-For-Service”** management contracts.
- Another facet is to further scale the **owner/operator model** taking advantage of the dislocated hotel market as well as Star Asia Group’s extensive experience, a capital-intensive method that allows for high current returns and potential sizeable capital gains for Polaris as the hotel owner without paying rent or management fees.

Key recent developments

Investors should be aware of the following **recent developments:**

- Polaris Holdings has expanded operations overseas to the Philippines, acquiring assets from Red Planet Group.
- Polaris Holdings’ ultimate parent company Star Asia Group has made strategic investments in two listed Japanese hotel operators; Greens Co. (6547) and Washington Hotel Corp (4691). We believe Polaris will be involved in efforts to bring structural changes to the domestic limited-service hotel market, by participating in market consolidation.

We estimate that Polaris Holdings will experience major growth in FY3/2024 driven by the following factors:

- The business environment will return to similar levels as seen in CY2019.
- Consequent improving demand and sales mix will drive TRevPAR recovery.
- The lowered fixed cost base will allow for greater operating leverage. We estimate an operating margin of 16%.

The shares are trading on an estimated FY3/2024 free cash flow yield of 17.1% (fully diluted 14.2%).

Company description

Overview

Polaris Holdings is a group company of Star Asia Group LLC (an independent investment group), its core business currently operates 31 hotels totaling 5,706 rooms. It operates three domestic hotel franchises:

- **Best Western Japan** – 11 sites targeting accommodations for leisure and business travelers, the global brand was originally established in the United States in 1946.
- **KOKO HOTEL** – proprietary brand of 7 business hotels located in in-fill, metropolitan locations. 5 out of 7 assets are formerly HOTEL UNIZO owned by real estate fund Lone Star (which acquired Unizo Holdings in April 2020). The business commenced in September 2020 via management contracts from Star Asia Group (which acquired these hotels at deep discounts in the 3rd quarter of 2020 during the COVID pandemic).
- **Value The Hotel** – 5 hotels based in the Tohoku area, designed for medium to long-term stays originally intended for people involved in local regeneration projects after the Tohoku earthquake.
- 2 other hotels are operating under other brands (Kinuura Grand Hotel and Fino Hotel Sapporo Odori).

The company has expanded overseas to the Philippines, increasing its hotels under management to 45 totaling 8,135 rooms.

Business segment details

Polaris has two business segments – Hotel Operations and Real Estate.

Business segment details

Business segment	Key services	Description
Hotel Operations	<ul style="list-style-type: none"> • Management • Operations • Consulting • Franchise 	<ul style="list-style-type: none"> • Owner/operator of hotels • Operating hotels under lease or management contracts • Aiming to improve new openings or existing hotels • Memberships for the 'Best Western Hotel' franchise
Real Estate		

Source: Company

Astris earnings estimates and key assumptions (updated)

Our revised key earnings forecasts are as follows:

Earnings estimates

Year-end	Old FY3/2023E	Revised FY3/2023E	FY3/2024E (key assumptions unchanged)	FY3/2025E (key assumptions unchanged)
TrevPAR (¥)	3,318	*3,792	5,226	5,226
Growth YoY (%)	+35.4	+60.0	+57.5	-
Average No. of rooms	3,979	*4,250	6,396	6,396
Growth YoY (%)	-4.1	+2.4	+50.5	-
Sales (¥bn)	4.82	5.88	12.03	12.03
Growth YoY (%)	+29.8	+58.5	+149.7	-
OP (¥bn)	(0.87)	0.29	1.93	2.05
OPM (%)	-18.0	*5.0	16.0	17.0
EBITDA (¥bn)	(0.61)	0.59	2.26	2.26
FCF (¥bn)	(0.51)	0.90	2.08	1.78
FCF margin (%)	-10.6	15.3	17.3	14.7
FCF conversion (%)	N/A	543.1	165.2	131.5
FCF yield (%)	(4.1)	7.4	17.1	14.6
Diluted FCF yield (%)	(3.4)	6.1	14.2	12.1

Source: Astris Advisory

Note: *denotes key assumption changes

We have upwardly revised our FY3/2023 earning estimates. The core assumptions of these estimates are as follows:

- **TrevPAR increased from ¥3,318 to ¥3,792** – with Japan experiencing prices increasing, we have increased our estimate.
- **The average number of rooms** – with the recovery profile of domestic demand, we have modestly increased the average number of rooms available by 2.4% YoY.
- **Operating margin raised to 5.0% from -18.0%** – the combination of an improved contract mix in the hotel portfolio and rising prices, we believe the company can generate positive operating profit for the FY. One-off income from hotel opening preparation fees will also temporarily boost revenue.

We are not estimating any one-time gains from the sale of tradeable real estate assets.

JGAAP Financials

	FY	FY	FY	FY	FY
(¥bn)	3/21	3/22	3/23E	3/24E	3/25E
Sales	2.97	3.71	5.88	12.03	12.03
COGS	0.29	0.28	0.29	0.48	0.48
Gross profit	2.68	3.43	5.59	11.55	11.55
Gross profit margin (%)	90.3	92.4	95.0	96.0	96.0
Total OP	(1.63)	(1.33)	0.29	1.93	2.05
OP margin (%)	(54.7)	(35.9)	5.0	16.0	17.0
Non-operating income	0.07	0.05	0.06	0.06	0.06
Non-operating expense	(0.13)	(0.34)	(0.19)	(0.18)	(0.18)
Recurring profit	(1.68)	(1.62)	0.17	1.80	1.93
Extraordinary gains	-	-	-	-	-
Extraordinary losses	(0.40)	(0.19)	-	-	-
Pre-tax profit	(2.08)	(1.81)	0.17	1.80	1.93
Tax	0.016	0.02	-	0.54	0.58
Effective tax rate (%)	(0.8)	(4.57)	-	30.0	30.0
Net income	(2.10)	(1.83)	0.17	1.26	1.35
Non-controlling NI	-	-	-	-	-
Parent attributable NI	(2.10)	(1.83)	0.17	1.26	1.35
Sales growth YoY (%)	-45.5	+24.9	+58.5	+104.6	+0.0
OP growth YoY (%)	N/A	N/A	N/A	+554.6	+6.3
NI growth YoY (%)	N/A	N/A	N/A	+661.8	+7.3

Balance sheet	FY	FY	FY	FY	FY
(¥bn)	3/21	3/22	3/23E	3/24E	3/25E
Cash & equivalents	1.84	2.40	5.26	7.06	8.59
Trade debtors	0.33	0.62	0.49	0.49	0.49
Stock	0.06	5.95	5.95	5.95	5.95
Other	0.28	0.39	0.31	0.31	0.31
Current assets	2.51	9.36	12.02	13.82	15.34
Tangible assets	1.21	1.03	0.80	0.55	0.30
Intangible assets	0.02	0.01	0.01	0.01	0.01
Investment & others	1.26	1.64	1.64	1.64	1.64
Fixed assets	2.48	2.67	2.44	2.19	1.94
Total assets	5.00	12.04	14.46	16.01	17.29
Short term borrowing	1.08	1.49	1.49	1.49	1.49
Trade creditors	0.00	-	-	-	-
Other	0.79	0.70	0.75	1.22	1.22
Current liabilities	1.87	2.19	2.23	2.71	2.71
Long term borrowing	3.76	8.39	8.04	7.69	7.34
Other LT liabilities	0.15	1.27	1.27	1.27	1.27
Long term liabilities	3.91	9.66	9.31	8.96	8.61
Shareholder's equity	(0.78)	0.19	2.92	4.35	5.97
Non-controlling interests	-	-	-	-	-
Total net assets	(0.78)	0.19	2.92	4.35	5.97
Total liabilities & net assets	5.00	12.04	14.46	16.01	17.29

Cash flow statement	FY	FY	FY	FY	FY
(¥bn)	3/21	3/22	3/23E	3/24E	3/25E
Net income	(2.10)	(1.83)	0.17	1.26	1.35
Depreciation/amortization	0.16	0.29	0.29	0.31	0.31
Other non-cash items	0.52	(0.13)	0.20	0.03	0.12
Changes in working capital	(0.09)	(6.15)	0.25	0.48	0.00
Cash from Operating Activities	(1.51)	(7.82)	0.90	2.08	1.78
Capex	(0.48)	(0.00)	(0.00)	(0.00)	(0.00)
Acquisition of business	-	-	-	-	-
Other investing cash flow	(0.17)	(0.41)	(0.29)	(0.35)	(0.32)
Cash from Investing Activities	(0.65)	(0.42)	(0.29)	(0.35)	(0.32)
Total cash dividends paid	-	-	-	-	-
Debt issuance/(retirement)	2.06	5.17	(0.35)	(0.35)	(0.35)
Equity financing	0.06	2.65	2.18	-	-
Other	0.83	0.99	0.42	0.42	0.42
Cash from Financing Activities	2.95	8.80	2.25	0.07	0.07
FX impact	-	-	-	-	-
Net cash flow	0.79	0.56	2.86	1.80	1.53
Free cash flow	(1.99)	(7.82)	0.90	2.08	1.78
Free cash flow margin (%)	-67.0	-210.7	15.3	17.3	14.7
Free cash flow conversion (%)	N/A	N/A	543.1	165.2	131.5
Capex/sales (%)	16.2	0.1	0.0	0.0	0.0
Capex/depreciation (%)	299.0	1.0	1.0	0.9	0.9
CFO margin (%)	-50.8	-210.6	15.3	17.3	14.8

Key metrics	FY	FY	FY	FY	FY
	3/21	3/22	3/23E	3/24E	3/25E
Profitability					
Gross margin (%)	90.3	92.4	95.0	96.0	96.0
Operating margin (%)	(54.7)	(35.9)	5.0	16.0	17.0
Net margin (%)	(70.7)	(49.3)	2.8	10.5	11.2
ROA (%)	(42.0)	(15.2)	1.1	7.9	7.8
ROE (%)	N/A	N/A	5.7	29.0	22.6
ROCE (%)	(52.1)	(13.5)	2.4	14.5	14.0
ROIC (%)	(45.1)	(19.7)	2.6	10.4	10.1
Liquidity					
Current ratio (x)	1.3	4.3	5.4	5.1	5.7
Quick ratio (x)	1.3	1.6	2.7	2.9	3.5
Leverage					
Debt/Equity ratio (x)	N/A	51.3	3.3	2.1	1.5
Net Debt/Equity ratio (x)	N/A	38.8	1.5	0.5	0.0
Equity ratio (x)	(0.2)	0.0	0.2	0.3	0.3
Interest cover (x)	(14.9)	(10.1)	1.5	10.5	11.6
Net Debt/EBITDA (x)	(2.0)	(7.2)	7.2	0.9	0.1
Valuation					
EPS reported (¥)	(37.83)	(25.98)	1.41	10.76	11.54
PER (x)	N/A	N/A	73.6	9.7	9.0
DPS (¥)	-	-	-	-	-
Dividend payout ratio (%)	-	-	-	-	-
Dividend yield (%)	-	-	-	-	-
Free cash flow yield (%)	(34.5)	(82.1)	7.4	17.1	14.6
Diluted FCF yield (%)	(28.6)	(68.2)	6.1	14.2	12.1
PBR (x)	(15.5)	63.1	4.2	2.8	2.0
EV/sales (x)	6.6	5.3	3.3	1.6	1.6
EV/EBITDA (x)	N/A	N/A	33.4	8.8	8.3
EV/EBIT (x)	N/A	N/A	66.7	10.2	9.6
EV/FCF (x)	N/A	N/A	21.9	9.4	11.1



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