Kimura Dreamvisor Newsletter Summary 11th December 2006

Next fiscal year big theme is M&A

'Triangular mergers' deregulation increasingly draws interest but practical implementation looks difficult.

Just 3 weeks left before the end of the calendar year, securities houses are competing for market forecasts and investment strategy. As all analysts and strategists base their forecasts on the same data sector picks are bound to be more or less the same whatever the tool: macro economy or earnings forecasts. This is unavoidable. However when too much market anticipations pile up simultaneously market ceiling is quickly reached and this could lead to upside potential reached before year's end. For the same reason next year promising stocks selected by well-known market professionals will not show remarkable performance.

Nearly everyone agrees on one point: next year big theme should be M&A related stocks. The full legislation change will be implemented in May and will allow foreign firms to use share swap, not only cash, to acquire Japanese companies. Triangular merger does not mean that any foreign firm can suddenly exchange its shares against any Japanese company; a 'cushion' is needed with a proper Japanese onshore subsidiary. Then the foreign company Japanese subsidiary can then exchange its shares with another Japanese company (this made to avoid foreign exchange risk).

The scheme has been engineered so that very large companies can take over mid to small companies. Companies willing to speed up their industrial position are widely expected to use the scheme. This is not solely targeted at foreign owned companies, Japanese companies already increased profile for M&A operations since last year, we had numerous cases such as Toshiba, Nippon Sheet Glass or Oji Paper's TOB on Hokuetsu Paper. I cannot give specific examples of M&A related stocks right away but Toyota for example recently increased above 50 % level its controlling equity in listed subsidiaries to fully incorporate them or takes up to 5 % participation in non related companies.

M&A related theme cannot be taken as a whole, there is a wide range of potential operations like pressurizing idle companies top management to increase dividend or merge with another company or have the company return private through an MBO. Usually when an M&A operation pos out then quickly market speculates on industrial reorganization and new potential M&A targets.
Recently Nippon steel registered a new high picked as a core M&A related stock. Today again Maruha and Nichiro announced a merger and stocks rose. This said it is extremely rare for an M&A operation target to be disclosed publicly before it actually happen, in other words it is difficult to pick M&A targets.

Buying cheap stocks expecting to hit the 'jackpot'

Even if it does prove difficult it is worth the challenge. Industries reorganisation needs should keep raising therefore chances to dig out 'treasures' have increased. The best strategy remains buying cheap stocks with a 'gold digger' mentality. In a genuine lottery you are sure to suffer losses, however those losses are worth the risk when buying stocks in anticipation of M&A. PBR and Pe are not the only indicators to search for relative value, for example

Hitachi or MHI have both high Pe but offer huge technical value. Like shown in the Westinghouse purchase by Toshiba, if the buyer does consider the purchase as necessary for strategic purpose standard valuation ratios are not enough to explain high price buying. On the reverse stocks highly valued and strongly capitalised are not appropriate either. No buyers are interested in such stocks. If some buyers show interest in highly valued companies the stock is quasi sure to fall. An extreme example is ex Livedoor, Rakuten is another example A limited free float led those stocks higher but scarcity value decreases quickly when target and buyer's free float add up.

M&A most interesting feature is precisely when it leads to the full reorganization of industries suffering earnings power deterioration, although still having high industry share. Kawasaki Steel, NKK or Nissan motor are typical examples. Although this is already old story just remember market strong opposition to the merger of the three large banks that eventually led to Mizuho financial group creation (In the end market's view proved exaggerated).

Other interesting examples: companies having sufficient know-how and technology in high demand or high market share in specific areas but unprofitable and unable to expand. M&A can totally change the situation. Rather than looking at companies anybody knows, those are interesting because if you don't properly search you just can't find. I believe potential candidates can be found in energy, environment, water and food resources business fields

Stocks cheap in absolute term are obvious candidates. In the past, after it was known that ex-Murakami fund or Dalton Investments had accumulated then the new shareholder's pressure made stocks go up. If management style stays unchanged there is no choice but to increase dividend payout ratio or buy back own stocks. To sum up a lot of companies offer M&A attractive points therefore by spreading your investment you reduce loss risk.