NEWSLETTER 10th December 2006 http://japoninvestissements.free.fr

From value to growth (2) but with economic cycle pause value is back…

The 'revival funds' role is slowly decreasing to the benefit of 'buyout' funds, which is why I focus my value search strategy on selecting appropriate targets. The core idea remains: from 07 both foreign and domestic funds flow should focus on industry reorganisation. Revival funds generated +50 to 70 % average return for subscribers and as deflation is now ending in Japan such high return seems difficult to repeat. Stocks valued below NAV could be found by droves during market historic bottom back in 2003. Take MBO operations for example stocks under net asset value (PBR < 1) are more difficult to spot (but current economic 'pause' adds opportunities). Usually investors use EV (PBR, gross debt and capitalisation) / cash flow indicator EBITDA to analyse relative value of companies. Companies with EV/EBITDA <1 are becoming scarce and competition tough with large players such as KKR or Permira entering Japanese market. We can gather some clues form what happened on European or US markets: for current year specialized funds targeting European special situations has reached 19 trillion Yen 4 times year 2003 level however most operations are short term oriented. According to US financial press back in May Thomas H. Lee partners reached agreement to buy a US ethanol company and in less than 3 weeks an IPO was decided, Thomas H. Lee partners earned only 5 million US $ and 20 million US $ fees from the de*al.*

Clearly such operations are not aimed anymore at increasing target companies value and fees are enormous. Most US/European buyout funds are aiming at quick profit taking through swift listing of target companies .It becomes more difficult to generate returns high enough to satisfy investors. Consequently most private equity, buyout or revival funds are looking at Japan market scale with envy to increase market share. It has been a fantastic year for London city professionals enjoying historic M&A boom. LSE listed Hedge fund specialist Man Group stock price had a good year up 50 % compared to last calendar year closing price. Globally commodities funds registered a sizeable fall in performance (with casualties like Amaranth advisers) but in Japan the super rich stratum expansion makes it a heaven for such funds. Funds managed by Man group reached 60 billion US $ triggering medias critics regarding huge fees scale. However full scale expansion have probably reached a nadir. Man has diversified activities becoming a hedge fund conglomerate making management conscious of its own 'discount'. Recently discussed Japanese parent companies buying out listed subsidiaries or spinning off non strategic assets is an already old phenomenon long experienced by European markets, 'conglomerates discount' meaning the sum of additional unrelated business sectors lowers considerably the value of the whole. Foreign fund managers have been talking of Japanese conglomerates value discount for the past 15 years already but what happened in Europe could give some clues for Japan future. Note that in the Japanese financial business field we are exactly experiencing the reverse phenomenon with brokerage and asset management side full integration advancing. European or US cycles are totally different but Japanese industry is progressively favouring 'value unleashing' for shareholders through 'resolution type M&A' but Japanese finance is moving the opposite direction for the same reasons. It remain to be seen what business model will prove more profitable for shareholders long term.

Now what to buy?

Long term low PBR stocks performance is better than average. Consequently low PBR stocks can be expected to yield above average performance. In abnormal periods like IT bubble for example PBR based strategy profitability decreased but after, up to mid 2005, low PBR stocks rise was above average. This said it is a heavy mistake to use this as a short-term strategy as usually returns are very poor. It is extremely difficult to grasp the exact timing of the stock true recovery timing. Analysts, always looking for innovative screening tools, devised a scheme to squeeze out best candidates from low PBR basic screening: This is called External Finance (EF). Generally speaking when earnings are good management thinks about business scale expansion and how to invest in new business areas using cash at hand, capital can be sourced either from creditors or shareholders. This indicator is no more than translating cash at hand utilisation ratio into a defined indicator. The analysts therefore divide EF into *appropriate* and *abnormal* categories. Technically speaking EF/current assets can be explained through current profit growth rate, what is left (the 'abnormal part') is taken out. Using this indicator it becomes possible to screen profitable low PBR stocks. This is just another investment tool. However what's the point? As I personally consider low PBR stocks investment a long-term investment.

Anyway Stocks with PBR < 1 increased again recently. TSE 1st section listed stocks satisfying this criteria increased to 465 by November end (a one year high) and double January 06 number, retail or regional banks stocks (nor to mention other financials) are numerous in this category due to lingering doubts on domestic consumption recovery trend.

News on the TOB front.

Nikkei compiled statistics for TOB offers: there were already 48 TOB offers for fiscal year 2006 which is above full fiscal 2005 year level. The amount has reached 1 trillion 500 billion Yen 2,5 x previous fiscal year amount. TOB premium nicely expanded to reach US/European levels. I shall continue to give hints toward potential targets across all sectors. I recall that the so called 'triangular' M&A (shares swap) legislation will come in force by may 2005 channelling to Japan new type of money inflow specifically targeted at M&A.

Banks, expectations betrayal ?

Analysts and observers believed that banks stocks would recover quickly but hopes were betrayed due to prolonged stability of Japanese low rates. Rates charged on loans did not go up as expected by analysts, which explain the understanding gap. However I still believe that it has just been postponed. I feel Japanese banks hidden strengths (see my previous newsletter on the subject) will be re-rated by investors before the end of current fiscal year. For example Sumitomo Trust return on loans only rose +0,02 % YOY. Mizuho financial group registered a 0,03 %decline on loan returns YOY. This said most analysts believe that returns on loan have bottomed out for good this time. Large banks substantially increased dividends at interim stage. Banks average payout ratio stands at only 10 % but Mizuho aim at 30 %, MUFJ 20 %. MUFJ and Mistsui Sumitomo financial group forward Pe's stand at 17x, Mizuho 14x, which is slightly under TSE first section, average forward Pe. Most market observers believe BOJ will hike between January- march 07. As previously suggested I believe Mitsui Sumitomo Financial group is a laggard and contrary to other large banking groups MSFG income sources are diversified with non-collateral loans to domestic mid-businesses standing at roughly 1 trillion Yen balance. MSFG chief executive officer said he did not intend to cancel relationship with consumer loan company Promise (back in 2004 MSFG became Promise core shareholder) but that a full revamp of the relationship was unavoidable. MFSG prime target is to raise dividend payout ratio for its shareholders aiming at full fiscal year 7000 Yen (+4000 Yen YOY) although dividend payout ratio is still barely 9,6 %. MSFG immediate concern is shareholding equity ratio, by September end interim stage payout ratio decrease 2,3 points at 10,07 due to the last wave of public funds repayment. There are only two ways to replenish shareholders equity, either through earnings increase or rising additional money through market.

A word on (6752) Matsushita, despite earlier announced positive interim earnings the stock dropped 10 % and this is not only due to the US $ plunge (Yen recovery) but certainly to price war in plasma screens industrial sector which I earlier mentioned. By November end large plasma screens (above 50 inches) domestic market retail share had gone down to 67,1 % from previous year 97,3 % but I believe this has already been discounted in MEI stock price. As I earlier mentioned all market participants eyes are focused on MEI mid term strategy to be announced in January 07.

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