

Hidden value in Japanese financial stocks?

Obvious value in Steel stocks...

### **The hidden strengths of Japanese large bank stocks**

It is interesting to take notice of underlying changes on the Japanese OTC individual stocks options market relative to banking stocks. Main Japanese banking stocks *Put option selling* increased substantially recently. Increased flow of put options selling reflects investor's positive opinion of Japanese banking stocks underlying strength. Said in other words trading in options betting on the stability of Japanese banks stocks seems to be more profitable than the reverse. According to Japanese securities dealers association the OTC options market trading volume registered a 67 % rise between October 2005 and March 2006. Average daily trading volume is 300 billion Yen out of which 100 billion yen for individual stocks options. Traders have been reporting that bank stocks options trading is now representing the largest part of daily volume. Large Japanese banks earnings are good. By March 2006 end the largest six banking group's bad loans percentage had fallen to 1.6 %. The so called 'finance rebuilding plan' target set up by the MOF three years before has been nearly achieved. Banks loan ability has greatly improved as shown by July 06 statistics pointing at a high loan output level not reached for the past 10 years and a half. Japanese Banks are highly expected to benefit from the mild upward trend in rates by expanding margins. Although bank share prices do not reflect this positive outcome over the short term. Nikkei rose 13.3 % from the low touched on the 18<sup>th</sup> of July but banking index rose only 7.6 %. According to market participants this mean most good factors have been already discounted in banks stock prices plus the BOJ status quo on rates led to profit taking on the sector. However there is a hidden angle. Investors have become quite short sighted recently and I believe bank stocks may start to rise again over the medium term considering that dividend hikes and commission's income flow will increase further from March 2008. On the short term large banking stocks do not reflect this hidden strengths but current OTC options market may already give us some signs about it. Next interim earnings announcements could kick start a new surge in banking stocks. This said bank stocks require time for the market to recognize inside value.

Within the leading pack: Mizuho Financial group, Sumitomo Trust Bank, Sumitomo Mitsui Financial group are worth considering. Sumitomo Mitsui Financial group (8316) is currently at discount compared to the bank sector average and therefore lagging due to the comparatively higher bad loans weight but earnings should start to recover from

march 2008 onward and based on analysts estimates forecasts consensus the stock trades at 12 times march 2009 estimated consolidated earnings.

### Japanese steel stocks earnings forecasts as expected but still at discount to the whole market

Have all announced on the 7<sup>th</sup> current fiscal year forecasts (03/07) earnings upward revision which were above consensus and at par roughly with market forecasts although the main risk for Japanese steel companies is their huge cash at hand and this makes their technical know how in high quality specials steels the more attractive for potential outside bidders hence the market interest since Mittal TOB offer. Most Japanese large steel makers stock price are at historic high levels like Nippon Steel trading above 500 Yen first time for the last 15 years. However looking at the expected growth prospects through the Per ratio large Japanese steel makers are trading at 10x times average earnings which is cheap compared to the whole market average Per of 19,5x. This would leave the Japanese steel makers vulnerable to outside bids? (Although I do not believe this). Most steel makers have geared their strategy toward reducing the debt level but are now shifting toward giving cash back to shareholders or investing in equipments. Nippon Steel for example will invest no less than 280 billion Yen (consolidated level) for next fiscal year. Dividend payment will be 60 billion Yen based on last year 9 yen annual dividend. Most of the ordinary cash flow is therefore nearly fully allotted (400 billion Yen in FY 2005). Much more can be done.

	(5401)Nippon Steel	(5411) JFE	(5405)Sumitomo Metal	Kobe Steel
Market expected	4,926	4,950	3,043	1,603
Nikkei expected	4,900	4,700	2,700	1,450
Revised 09/07	<b>5,000 (-8 %)</b>	<b>4,750(-8%)</b>	-	<b>1,600(-10%)</b>
Company initial expected	4,600	4,600	<b>2,600(-7%)</b>	1,450
Previous earnings	5,474	5,173	2,807	1,769

Market expected was Quick consensus, Sumitomo metal had revised up by July end.  
All figures are for consolidated ordinary pretax profit .Unit: 100 Million Yen

Now what to buy?

Considering large caps were bought alongside the Nikkei which rose 13.5 % from its 18<sup>th</sup> of July low and by analyzing TSE capitalization indexes breakdown mid caps rose only +12,8 % and small caps +11 %. Therefore there is ample margin for this category to close the gap. On a supply demand basis the peak margin buying amount was in February 06 and has gone down 30 % since therefore latent selling pressure has eased a lot. The key for further upside potential remain linked to Japanese individual's money input. One suggestion considering 1- small diversion from 25 days moving average 2- buy margin ratio < 2 and 3- PERxPBR < 30 and owned capital ratio in line with value philosophy. (A list of no less than 30 stocks was published by the Nikkei financial daily on the 6<sup>th</sup> of September but I found none of them that exiting and were focused on spare parts, machinery and real estate))

stock	Q1ordinary earnings growth %	Diversion to 25 days moving average %	Margin buy ratio	Stock price
(7224)ShinMaywa	107.55	2.29	0.43	570*

\* 12<sup>th</sup> September closing

In the 30<sup>th</sup> of June newsletter I came across most widely used *value strategies* in the Japanese stock market. Among them PEDY (price earning dividend yield ratio) methodology. I fully assume the PEDY selection published in that newsletter but some time things can go utterly wrong. That is seemingly the case for suggested OSE 2 (9374) Keika Express which has been trading since at 63 Yen (forecasted per of less than 3x!) on unusual huge daily volumes. In Japan this price level is close to bankruptcy level therefore something unforecasted is going on. By judging the Japanese individuals comments exchange on a daily basis regarding the stock I believe it has to do with either 1-the underwriting broker (SMBC friends in that case) 2-some unforeseen huge downside revision to be announced. I'll report in any cases.

M&A update.

I mentioned the HHI methodology in last report and pointed to some sectors. The 6<sup>th</sup> of September (8001)C.Itoh announced that by April 2007 it would merge two (unlisted

Nishiya Trading & Japan access) subsidiaries which will give birth to number two Food trading company after the sector leader Ryoshoku (Capitalized at 1 trillion Yen) . Precisely one of the sectors mentioned in the screening. This does testify of the usefulness of HHI index to spot the hot sectors. Expect even more interesting M&A operations by 2007.