Japanese companies' profitability centennial trend.

To protect against unwelcome bids higher R.O.E is the sole strategy.

Large cap Japanese companies' shares buy back is gathering pace. The Nikkei stated on the 28th of August that for April July 2006 the net shares buy back increased to 1 trillion 680 billion Yen. (The following figures were published as Nikkei's head title)
Unit: 100 million Yen

company	Year 2006	Year 2005
Toyota Motor (7203)	1,625	617
Nippon Steel (5401)	1,000	0
Takeda (4502)	799	0
Millea holdings (8766)	767	90
NTTDocomo (9437)	500	0
Matsushita (6752)	400	500
Toyota Industries Co (6201)	354	0
Kyowa Hakko (4151)	204	0
Denso (6902)	200	2
Maruha group	120	0

The comment is interesting: management consider the share buy back not only to increase ROE and reward shareholders but at the same time a defensive way to guard against unwelcome TOB offer as this is an increasing concern of Japanese management. For example it the first time ever (4502) Takeda Pharmaceutical has launched a share buy back program. The Nikkei states that Takeda net cash was roughly 1 trillion Yen800 billion Yen by 2005 year end.
By the end of July including New Growth Markets shares buy back operations (source is Nomura Securities Economic Research Institute) had nearly doubled (at 1 trillion 680 billion Yen) on a twelve months basis this equal's last year historic high (5 trillion 100 billion Yen).
This in turn is directly related to what I mentioned in previous newsletter related to Parent companies targeting strategic subsidiaries as the ultimate target is use shares buy back program to eventually buy back subs with shares swap program. It also relates to the fact that from next year Japanese companies will be subject to takeover risks (new legislation). All in all this is pretty good for the market supply demand

balance, expect volumes to rise.

Also very interesting is the new set of regulations announced back in May 06 regarding dividends payout source. The previous rule was that latent profits (from shares held in own account at market evaluation) could not be used to pay dividends however now earnings from stocks held could be used to pay out dividends. There are not much Japanese companies holding stocks for investment purpose *however* the profit/loss balance of stocks held as long term cross shareholdings is attracting professional's attention. There are strong requests from investors to use such cross holdings profit to increase dividend payout ratio.

The Toyota group of companies for example: by March 2006 Toyota Industries Corp was showing 1 trillion Yen profit earned from cross holdings of Toyota group companies, an 80 % increase relative to marc 2005! The gross dividend paid out has been fixed at shareholders meeting at 180 billion Yen but should the above mentioned figure be taken in account for dividend payment then the dividend reserves would instantly quadruple.

Question is now who's entitled to receive the benefits of latent earnings on cross shareholdings? Activist fund managers obviously have a good argument.

In fact current legislation on dividends payment makes life easier for companies having quality large financial assets not to bow to shareholders pressure to increase payment therefore the change in legislation allowing the above mentioned would be welcomed.

The Nikkei Financial daily published a list of High estimated profits form cross holdings by March 2006 end (on a non consolidated basis, unit: 100 million Yen)

company	Latent cross holdings profit	% of shareholders equity
Toyota Industries Co	10,455	68,2
Mitsubishi Corp	5,197	36,8
Toyota Motor	5,181	7,7
Nippon Steel	3,642	26,2
Denso	3,179	19,0
Mitsubishi Heavy	2,545	19,5
Sumitomo Corp	2,531	28,2
Ohbayashi Corp	2,019	42,9
Mitsui Corp	1,868	44,2
Fujitsu	1,768	18,8

A word about Japanese individual's current market share

I mentioned as previous newsletter head title that 'individuals hold the key' .Regarding Japanese individuals current equities holding market share I recommend strongly you read **Kiyoshi Kimura 31st of august newsletter** (loaded on site) it does give a very clear picture of Japanese current state of equities holdings and outcome. Although on that very point I believe that the institutionalization of Japanese equities market is somewhat different than the US pattern plus the Japanese individual's equity holdings market share rose to close 30 % in 2005 second half (just before Livedoor shock). Obviously it is now back on its 20 years average however the profit/loss ratio on margin buying which is an important indicator for individual's financial health has been improving since February 2006.

Now what to buy?

Just another good example of mid cap value search coupled with timely TOB offer (or interest from a major Japanese company) was Jasdaq listed (9057) Enshu Truck Company which rose strongly the 29th of august 2006. The background was announced TOB offer by (9303) Sumitomo Warehouse however stock fundamental ratios by 29th august speak for themselves (Per 12,04x, PBR 0,83 x, shareholders equity ratio 44,6%) and are totally in line with the M&A value search strategy I insist on. Chart basis the stock had lost 54 % since January peak. Perfect target and good contrarian timing.

Regarding new growth markets in general analysts seem to be divided over the trendsetter Softbank (9984), in fact since the acquisition of Vodafone Japanese subsidiary there are lingering doubts concerning the fact that after having incorporated Vodafone Japan 1 trillion Yen of assets are still missing…. Based on such doubts the 24th of August Lehman Brothers issued a report suggesting a 900 Yen target price for the stock which invited heavy selling by individuals. 2006 second quarter (July September) earnings will be followed closely as this will incorporate Vodafone Japan.
Meanwhile large caps continue to outperform the small to mid caps, being contrarian by nature I continue to regard current directionless market as an opportunity.