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Long Term investment (4)

Deep historic discount VS Japanese investors conviction entrenchment.

Back in March Pe ratio for Nikkei 225 average falling to a 36-years low was impressive even for veteran value player like myself. Same for Price book ratio falling below 1 at 60 % of TSE 1st section listed firm. Even discounting inevitable downside revisions (currently materializing) Japanese market looks 'historically' discounted. To cheer up professionals Norway's SWF wisely doubled its Japanese holdings. For pension type long-term investors this does make sense (*I detailed some SWF holdings in the ' Now what to buy?' section). Current historic discount is a strong reminder that wealth is always born in pain.? On 14th of May MOF stated that for the whole of fiscal year 2007 foreign investors sold net Y1 trillion 521 billion of Japanese stocks compared to Y8 trillion 946 billion net buying previous year. Considering the absence of counterweight by domestic investors the free fall was self-sustainable. In addition domestic investors kept buying foreign securities at high pace. Situation is improving though. Based on technical long-term analysis and Kiyoshi Kimura' Gann angle from zero analysis there is a high possibility that we have now embarked in a long but slow upward trend.? Large chunks of TSE listed stocks remain one of the worlds most undervalued asset classes. However who will eventually pull the trigger? Don't expect any divine wind as stagflation is looming in the States and Euroland.
Segregation between mid and large caps does not have much sense at that stage. Another interesting indicator to gauge at such levels is the margin loss/profit appraisal ratio which I already mentioned several times on this website, how far do we stand from break-even point? (Break-even point taken as the level to which unrealized loss is cancelled). The margin loss appraisal break-even point has been improving for 7 weeks in a row standing recently at -15.12 % on May 2cd since hitting - 14.59% in December 2007. Also margin buying balance on the three main markets (TSE, OSE, NSE) has never been so low since 12 September 2003 coming at Y1 trillion 722 billion on 8th of May.

Japan proved not to be the last subprime stopgap (or did it?)

This said the 6 large city banks suffered around Y70-80 billion losses due to subprime related damage. For March 2008 aggregated net consolidated earnings came to Y1 trillion 500 billion YoY or 40 % decline registering the second decline in earnings for two years (MUFJ, MitsuiSumitomo, Resona, Sumitomo Trust, Chuo-Mitsui Trust). Problem is few foreign observers believe the figures and Mizuho financial group made them prove right by revising down a third time dividing by half its consolidated net earnings at Y310 billion against Y490 billion original estimate but this was due to heavy losses incurred by subsidiary Mizuho securities bringing the Mizuho financial group total loss to Y565 billion. So who's next? At that stage those damages are limited compared to most foreign banks and Japanese banks appear in relative better shape compared to most foreign competitors. Despite being forced to lower their earnings major Japanese banks are becoming more shareholder friendly as all major bank dividends are surging ahead for the ninth straight year up 50 % to a record Y591billion. Therefore many see Japanese banks as attractive investment. More than this I believe the relative good shape of Japan banks' balance sheet is probably making them eager to look for potential outside targets.

Coming to Japanese onshore investment industry recent developments it appeared crystal clear that industry expansion rate has cooled off as first time in seven years publicly distributed equity investment trusts AUM balance was announced down YoY. The Japanese Investment Trusts association published fiscal year 2007 figures back on 14th April. By end of March AUM was down 2,8 % YoY at Y57 trillion 700 billion. First time since 2000 that publicly distributed onshore investment trust balance had decreased on a yearly basis. Assets under management decreased by Y10 trillion 200 billion for fiscal year 2007. Alternative investment on the contrary embarked on unstoppable growth trend but interested parties should contact IIP partners for this purpose, this information being exclusively for IIP customers.
Nevertheless don't be fooled, long-term trend is still intact, money inflow is still positive at Y 11 trillion 500 billion (down 13 % YoY). Total publicly distributed investment trusts (equity + fixed income) balance declined to Y69 Trillion 700 billion (down 3,8 % YoY).
Speaking about long term investment I must give a warm welcome to the new breed of asset managers recently launched in Japan; Kaitaku asset Management, Luctin asset Management and Naniwa Ofukuro asset Management. Business model is totally different from the larger established players, as these boutique style managers are selling direct to the retail investor's base promoting long only traditional equities holdings. It does mean things are moving forward in relation to individual investors stance toward Western style long-term equity investment. I shall keep a close eye on those exiting developments.

The long, long case (part 8)

Surprise, surprise 16th of March Nikkei relayed by Reuters and others revealed that despite Yen implied volatility (long expected by me) upsurge Japanese individuals appetite to buy foreign currencies denominated assets remained strong. Deep rooted is the belief that Yen cannot keep up strengthening at that pace very long, this underlying conviction looks suspicious to me. Undoubtedly despite short-term pain money kept flowing out in non US dollar denominated securities. This is no surprise as diversification into foreign currency denominated assets is part of the long-term equation. This said I personally feel this deeply entrenched conviction may prove dangerous at some point and surely also reflects lack of sophistication form the retail side. Anyway fact is that despite short-term losses redemptions are damaging purely domestic equities invested investment trusts. No panic at all considering investors consider foreign currency denominated assets a long term need. From July 07 to February 08 retail investors withdrew net 265.4 billion yen ($2.7 billion) from investment trusts focusing solely on domestic assets. On the reverse investment trusts targeting overseas assets registered net fund inflow.
The 15 years long Yen Euro parity bubble has not burst. It is nerve testing but my advice remains unchanged:? whenever Yen bounces above 155 against the Euro just get long and wait! After all Japanese currency in itself has been one of the most rewarding assets since beginning of the calendar year (for a US dollar based investor).

Value trap (2)

The value trap I mentioned in previous newsletters is making further waves in the market as new equity warrants issued to friendly banks by Japanese companies like Sumitomo Metal Industries 'raise eyebrows'. Those private placements, which allow banks to have latent equity, are severely critized as a disguised way to return to friendly cross-shareholding practice by market players. Sumitomo Real estate replied that they could secure funds at a relatively low cost through loans with new equity warrants. Another explanation is that it would allow (by exercising the equity warrant rights) increased shareholding equity should the company face shortage of funds in the future. Adding value to a standard loan through new equity warrant issue is feasible through main bank.
Should the bank exercise the warrants at some point then automatically equity stake in Sumitomo Metal Industries existing shares would increase to maximum 9,8 %, Sumitomo real estate maximum 23,2 % and JFE 5,7 %. This tool is less powerful than other 'poison pill' techniques but psychological impact on would be third party buyer couldn't be denied. TSE president Saito recently stressed that those new equity warrants loans were clearly linked to bank rights misuse or anti-takeover measures.
Those new type of loans have cooled down any would be appetite from foreign investors. JFE has launched Y 300 billion new equity warrants covered bonds and at the same time announced own shares buy back Y 120 billion program. This is a widely used practice in the states to increase ROE but taken with some suspicion in Japan as a potential anti takeover tool. Furthermore there is growing impatience with foreign investors regarding dividend yield increase slow pace, Nikkei's Veritas Fujii columnist pointed this specific aspect in an article titled 'why is dividend yield not working (in Japan)?' somewhat this links with value trap.
I won't comment on TCI vs. J-Power ongoing legal battle as this has been widely publicized in the financial press.

Now what to buy ?

Japanese E-money front; as already suggested this is becoming very serious business. By the end of March 2008 the number of domestic subscribers had passed the 90 million mark and is trending toward 100 million individuals by summer. The number of affiliated retailers is increasing fast and the silent monetary revolution is unstoppable. Nationwide most convenience stores and Taxi are equipped with reader writer terminals. I recall that by the end of February the number of subscribers was 89 million. On average subscribers growth rate can be estimated to 3 million per month. For example E-money settlement is close to reach no less than 5 % of Uny group sales. JR West 'Mobile Suica' (settling transactions via your mobile phone Suica application) subscribers has passed the 1 million mark. This is explosive growth considering the potential size of domestic market, those foreigners putting in doubt the domestic demand led growth should think twice.
M&A front

It came as a surprise but rather positive news as Asahi Beer made public its planned acquisition of up to 4 % of (7522) Watami up to march 2009. Watami was only selling Suntory beers? (5 % stakeholder) but those products will be replaced with the Asahi brand at its 'Izakaya' subsidiary 'Wataminka'. The 'wataminka' chain has 125 outlets and represents 20 % of all Watami outlets. Again as the domestic beer market is shrinking fast beer makers are eager to take direct stake in food restaurant or bar chains like Watami. Asahi becomes third large shareholder after Suntory with stake valued at Y2,7 billion. Incidentally the stock touched a new high for current fiscal year, Nikkei having announced dividend would be boosted twofold by March 2008 (not confirmed).

*Norway SWF Japanese holdings are worth of interest considering large sovereign funds usually only buy traditional large cap blue chips. Norwegian sovereign wealth Fund is also targeting Japanese mid to small caps.

By the end of December 2007 the Norwegian giant had already doubled (I guess had to average down since) its Japanese equities Holdings form 661 to 1.391 always being careful not to trespass the 5% rule disclosure.
Below is a sample of interesting mid to small cap holdings (list non exhaustive, just a sample) with holding percentage relative to capital and market value at the end of December 2007.

(2792) Honeys >4,76 % (Y3.5b)
(6287) Sato> 3,80% (Y2b)
(3003) Shohei >3,64% (Y3.3b)
(8518) Japan Asia inv. > 3,60% (Y2.7b)
(6513) Origin > 3,50% (Y0.7b)
(7453) Ryohin Keikaku > 3,55% (Y6.5b)
(2605) Point > 2,98% (Y4.3b)

Alongside traditional Japanese heavyweight the likes of

(7203) Toyota 0,26% (Y54.3b)
(2914) JT 0,59% (Y38.3b)
(8306) MUFJ 0,34% (Y37.4b)
Etc…

But when it comes to value investment it is worth targeting stocks with EV/EBITDA under 2: (7263) Aichi steel was one of those with EV/EBITDA at 1.48x by March 2008 end. The stock has since jumped + 113 % in less than 2 months!
Cash rich stocks (cash position above total purchase cost) are also interesting targets. There are lots of listed auto spare parts makers in this universe. Do not hesitate to consult us for more information.

Pascal Jeannenot