JIP JAPON INVESTISSEMENTS

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Long Term investment (7)

'Les jeux sont faits, rien ne va plus ! *'.

Changing times: Japanese companies better equipped than US counterparts? Because it's pay back time stupid!

Let's proceed with a snapshot US/Japan equity markets basic comparison: the standard measure of the cost of stocks remains the price-earnings ratio: the current price of stocks divided by some measure of annual earnings. A Pe ratio based on the average corporate earnings over the past 5 or 10 years looks a more accurate indicator. After several gyrations the Standard & Poor 500 stock index is till around 900. That meant the five-year Pe ratio was just below 12. (Estimate). It was last that low late 1985. Over the past 100 years, the average Pe has been about 15.5. Not so cheap.

Compared to this Nikkei Pe ratio closed at 37 years low on 17th October. Nikkei continuously traded since 1949 only so comparative analysis extend maximum over 59 years, Past 40 years or so Nikkei average Per should be around 21x or so (precise figure uneasy to secure) therefore current level is half long term average. Far cheaper than US figures. Japanese market broader index Topix 17th October low was 820 at 1.06 times 2003 low (770). What is unfortunate though is recent close correlation between S&P 500 and Topix; up to 22 October correlation rate is 79.9% close to 2003 record 80.4 %. This is easily explained through the fact that foreign investors made two third of TSE volumes back in September.

Figures have spoken. Still reading? Now let's dig deeper into US/Japan comparative analysis

Time to recall a simple fact: Japanese companies strong balance sheet and debtless status make them more resilient to current global slowdown. As global recession bites in companies able to show solid balance sheet will attract worldwide investors attention as de-leveraging carries on. Corporates over-reliant on debt look risky. As I already wrote on this website countless times listed Japanese companies financial foundations are more solid than US and European counterparts. Nikkei reported recently that Japanese companies fiscal 07 average debts to capital ratio was 0.82 x (the lower the better) against 1.58x 10 years ago, which represent a substantial improvement. Current foundations are the direct result of continuous debt repayment and 6 years uninterrupted earnings growth, by repaying debt Japanese companies expanded core capital. That is one of the big differences between Toyota and GM: financial strength, recurrent losses ate GM's capital. Everyone knows the reasons: US companies constantly favoured profitability (ROE) against Japanese companies favouring financial stability. US companies continuously rewarded shareholders through shares buy-back and dividends, of course this has put a brake on capital expansion. Investment bankers favourite US/Japan comparison using ROE shows US companies average ROE (15%) is 6 points above Japanese companies average. As global credit crisis takes its toll on equity markets companies real value analysis is increasingly becoming difficult. TSE 1st section listed companies average PBR is now below par and 17th of October Nikkei 225 closed at just 1.2 times previous historic bottom (28th April 2003). Besides wider TOPIX already hit 820 level which is 1.06 times previous 03 low (770).

Technically speaking I did not expect Nikkei to get that close to previous historic bottom. For next 2 to 3 months Nikkei 225 should trend up then hit another low in February or March 09 (based on Kiyoshi Kimura's technical view through Gann angles from zero analysis) and then trend strongly upward for the long-term. Should Nikkei break under 7,607 (2003 historic bottom) this would mean long-term bear trend is not over; personally I strongly doubt this scenario. Japanese companies have long been bashed for insufficient profitability (low ROE) and low dividend yields but as recession worsens on global scale stable management and strong capitalization should be re-rated by market participants whoever and wherever they are.

Now let's have a look at American equity markets:

American listed companies are reducing dividend payment, dividend growth rate is now at 6 years low and companies are favouring cash at hand. For the whole calendar year 2008 total dividend payments should increase

+ 4 % which is the lowest growth rate for past 6 years. Manufacturing and financials are either curbing dividend or just passing it away! 'All-for-shareholders' strategy seems to have reached a surprising turnaround point. S&P 500 components aggregated total dividend should equal US$2.5b (Y23 trillion) or +4,04% YoY only! For the past 4 years S&P had maintained 10 % growth so this calendar looks to be the smallest growth rate since 2002 (+2.14% growth). From January 8th to 16th October 27 US companies already announced dividend cut and 15 companies to forego totally dividend payment. Companies either cutting or cancelling dividend rose 6 times. Besides companies raising dividends decreased 14%. Money flows have all but dried up and financing through CP market is increasingly difficult. A good example is GE who regularly increased dividend payments for 32 years in a row but stopped doing so. GE is now just expecting flat dividend at par with current fiscal year (US$0.31).

Is America turning Japanese?

Japanese and US buy sides quick snapshot comparison.

Japanese institutional side: well Japanese financial institutions (including investment banks, trust banks and insurance companies) recently decreased to Y374 Trillion (down Y34 Trillion) for the first time since NRI started to compile data (2002) this said decline is the direct consequence of global markets selloff and second half inward money flow was still positive. However Nomura calculated that should assets under management stay at this level then by the end of current fiscal year AUM would be down 18 % as investment advisers commission earnings decreases. Onshore investment advisory income would then fall back to fiscal year 2006 level. But should markets stabilize (which looks the most likely scenario) then Japan domestic asset management industry has lots of potential to continue growing again. According to NRI Japanese investors financial assets 'pure water' (hardcore money for investment purpose) is Y 1,680 Trillion and within this figure no less than Y140b in commissions potential. There is still wide scope for onshore asset management industry to expand. Between 2002 and 2007 Japanese savings pool institutionalization led to Y 29 Trillion money shift, NRI thinks that for 2008 2012 (5 years period) we should see additional Y 15 to 30 Trillion money shift. Basically I do agree however one important question remains: in what asset class will individual's money shift from now? I already wrote about this subject in a previous newsletter and my conclusions are hairdressing for some.

Any Japanese buy side seasoned professional keeps an eye on Kokusai AM Global sovereign investment trust, investment trust broke Y 7000 face value first time in 8 years direct consequence of Euro retreat as 40 % of the fund fixed income is Euro denominated. Kokusai AM Global Sovereign was launched back in 2001-2002 and reached Y 5Trillion AUM by November 2005. Current subscribers are no less than 1.5 million individuals in Japan. 2cd of October Global sovereign investment trust asset allocation was:

Japan: 12.4 %

US: 27 %

Canada: 7.2 %

Australia: 1.2 %

Euro: 38.6 %

UK: 6.1 %

Northern Europe: 7.5%

According to Kokusai Euro slide accounts for 48 % of forex loss suffered in September. Since autumn 2007 the fund increased Yen based assets but considering this is a global fixed income product with regular payment distribution heavy shift toward Yen based assets is not feasible. Should Yen implied strength be just temporary no problem but should Yen implied volatility keeps going up it will be hard for Kokusai to maintain same distribution level. I feel they better prepare for this scenario.

US buy side: run for cover!

Situation is far worse in US (nor to mention Europe). Since September start no less than US$ 105.5b (Y 10 trillion) flowed out of both mutual funds and hedge funds alike. During the two weeks up to 15th October industry outflows reached US$ 572b (Y8 Trillion 500b). According to Trim tabs October's first week US onshore mutual fund industry outflows reached US$43.3b and US$13.9b during October's second week. By consequence since early September outflows reached total US$ 105.5b (Y10 Trillion). Based on same source money outflows from US Hedge Fund industry reached at least US$43b by mid-September (Y 4 Trillion 400b) a new historic record.

Now what to buy?

Japanese companies continuously increased payout ratio during last 6 years so domestic brokers are focusing sales promotion efforts in this very category. Financial retail industry is trying its best efforts to call back runaway individuals on the basis of logical decision-making. Efforts start to pay off; online brokers recently registered a surge in accounts openings.

By October 17th close Nikkei 225 expected dividend yield was 2.63 % compared to 10 years JGB 1.37 %. Within Nomura 400 index 222 listed companies (42 % of total) yield more than utility stocks average dividend yield. Of course discounting inevitable downward revisions makes it difficult to objectively select companies on this basis, however considering most Japanese manufacturing companies are debtless it is still a useful selection tool. Bellow's a random sample of stocks mentioned in a Nomura report published on 6th of October just for fun:

Stock	Price (10/6)	Dividend yield (%)	Dividend policy
Central Glass	306	3.92	Dividend payout ratio > 30%
Nippon Oil corp.	467	4.28	DOE >2%
JFE Holdings	2,625	4.57	Cons. payout above 25%
Mitsui Mining & Smelting	211	5.69	Cons. payout above 58%
Sumitomo Metal & mining	853	3.52	Cons. payout above 20%(target)
Sanwa Holdings	337	3.86	Cons. payout above 30%
Amada	462	4.76	Cons. Payout above 30%
OSG	692	3.76	Cons payout above 30 %

Moriseiki	1,002	4.99	DOE 3 %
Komatsu	1,242	3.51	Cons payout above 20%
Amano	780	4.36	Cons payout above 35%
Makita	1,816	5.18	Cons payout ratio above 30%
Nissan	584	7.19	
Toyota motor	3,900	3.59	Cons payout ratio above 30%
Nintendo	33,800	4.91	Cons payout ratio above 50 %
Marubeni	406	3.94	Cons payout ratio above 15%
Mitsui corp.	1,114	5.39	Cons payout ratio above 20%
Sumitomo corp.	827	4.96	Cons payout ratio above 20%
Mitsubishi corp.	1.827	4.21	Cons payout ratio above 20%
Nippon Yusen	571	4.55	Cons payout ratio above 25%
Mitsui OSK	751	4.13	Cons payout ratio above 20%
Kawasaki Kisen	516	5.23	Cons payout ratio above 30%
Koei	1.213	4.12	Cons payout ratio targeting 50%
Meitec	2.245	4.25	DOE >5% Cons payout ratio above 50%

Note: screening conditions are 1- Expected dividend yield above 3.5% 2-Dividend payout ratio under 80 % 3-Companies having set up specific targets for dividend policy. Dividend yield based on current fiscal year estimates (as of 6th October 08)

Valuations have reached historic lows in Japan alongside strengthening balance sheets. Fundamentally Japanese market is already in clear oversold territory and probably shaped double bottom pattern on the 17th of October. In its 28th September edition Nikkei published a screening of 100 so called 'low foreign exchange correlation stocks' (within Nikkei 500 and excluding financials). Sorry what's the point? Not very interesting and solely targeted to retail domestic investors. Ranking was based on stock price vs. exchange market correlation (the closer to zero the best). I have long been suggesting Yen implied volatility is back in bull cycle so any investor would be well inspired to search for Japanese companies able to take Advantage rather than neutrality. Form top of the list (0 correlation to 0.1) in decreasing correlation companies worth mentioning are (9022) JR Tokai, (8113) Unicharm, (9021) JR West, (8011) Sanyo shokai, (4544) Miraka Holding, (9020) JR East, (7532) Don quijotte.

J-REIT hidden value or value trap (3)

Worldwide REIT markets are equally down since august but J-REIT market fall has been particularly harsh why? Asian Public Real Estate association and Association For Real Estate Securitization held a Real Estate Forum submit back in September in Tokyo Midtown area. All participants felt a sense of crisis. According to Mizuho Securities world REIT market expanded to Y 100 Trillion by spring 07 but since then has contracted (collapsed?) by Y60 Trillion Yen. Comparing august 07 and September 08 data J-REIT index collapsed 50 % compared to US REIT index 15 % fall. If we compare both residential market prices: by July 07 the S & P Case Shiller residential price index was down 17.5% YoY, same time Japanese national residential prices were down 1.2 % (only). J-REITs index fall has structural causes: one is lack of investor's confidence. In the US mutual funds and direct individuals holding rate is close to 5% compared to a small 3 % for Japan. Leverage foreign money drove J-REIT index rise in 2007 as much as deleveraging led to its collapse in 2008 leaving Japanese domestic institutions with no choice but loss-cut sales. Analysts also point at low freedom degree for the Japanese system compared to more tax efficient US system.

Japanese professional body (ARES) has been urging authorities to revise rules in order to facilitate REITs mergers. Within current system 'negative goodwill' raises profit but makes earnings distribution totally opaque.

Not a few TSE listed medium size property developers are in distress situation trading at close to 100% discount to tangible assets; you can commonly spot real estate developers trading at 0.002 to 0.16 PBR! Namely companies such as Shinko Real Estate, Hoosiers Corporation, Hinode Real Estate, The Japan General Estate Co, Azel Corporation registered 70 to 90 % price collapse and it still does not mean those are cheap. Clearly Japanese real estate sector is braced for heavy consolidation at the mid-size range level.

M&A this little hidden paradise you cannot ignore!

Everything (or nearly everything) has been said regarding Japan's overseas M&A momentum but less said on domestic mergers and acquisitions solid momentum. I shall get into more details on the subject later. In addition for those of you interested I shall briefly outline my views regarding Japanese consumer finance sector.

In French in the text ('The die are cast').

Pascal Jeannenot