Long Term investment (3)

In the eye of the storm.

As financial crisis takes its toll with foreign money withdrawing from Japanese equities the red-hot debate between uncompromising long-term investments versus shareholder's rights activist style investment has resurfaced stronger than ever. Japanese style capitalism defenders versus shareholder's rights activism epitomize this crisis. Kamiyacho is whispering. High ranked MOF civil servants were seen organizing high profile meetings in Tokyo very recently shouting against unwanted foreign activists.
The question looks pointless considering by March 2007 foreign investors (both short and long term) held 28 % of all listed Japanese equities against 4,1 % 20 years ago. Japanese public and private pension funds held roughly 11 % of Japan stock market capitalization. There is no going back to the past. Furthermore activist type shareholders (by opposition to passive shareholders) always favor dynamic and professional management leading to wealth creation, which in the end also reflects companies' ultimate social duty and each Japanese citizen ambition. There is no real conflict of interest.

Japan next sub-prime stopgap? Think twice, the answer is not so simple.

Another hot topic subject has emerged among analysts and strategists: could Japan be the last domino affected by worldwide-securitized products crash? I have a fairly balanced view on this subject. Over simplistic views (read my lips) stating that Japanese institutions sit on a large amount of unrealized losses need to be slightly tuned down. True Japan is still, by far, the largest creditor nation and clearly Japanese investors too recycled part of their surplus in CDOs and other type of collaterized debt instruments so further losses look inevitable. However a solid decade of balance sheet rebuilding by Japanese banks made them quite conservative for investment in securitized products compared to European and US financial institutions. Consequently although I agree unrealized losses will probably emerge as soon as new fiscal year kicks in I don't believe they will be as massive as those already confessed by big US and European global banks. Past ten years balance sheet rebuilding cycle gap was large enough to prevent this happening.
Less exposed does not mean immune and clearly yields hunt drive institutions to invest in funds based on securitized products they may not fully understand. However consider that Basel II related risk-weighted assets ratio requirements forced many Japanese banks to unload or avoid non-compliant products then side effects are clearly limited. For those of you interested Japanese FSA did publish a short report named ' exposure of Japanese deposit-taking institutions to subprime-related products' on its website (ABBs, CDOs, sub-prime loans etc.) so far nothing worrying.

Japan sovereign fund.

At last Nikkei 22cd February revealed that LDP inaugurated the official study group on potential Japanese sovereign wealth fund creation (by making use of its foreign currency reserves, world's largest after China). This is a highly political issue as Japan is a mature OECD member. Finance minister Nukaga is going softly softly on this matter. However I personally feel Japan should go for it to assert its financial might. March 8th Nikkei trumpeted that first time ever Japan foreign currency reserves surpassed US$ 1 Trillion by February end so opportunity knocks and now is the time to make it happen! While Japan sovereign fund launch is on its way (I hope) onshore investment trust universe is moving fast. As I stressed many times global balanced funds were the core engine but for the first time since September 04 this sub-category suffered net outflows in January (Y 62,9 billion) and February (Y29, 2 billion by 20th February). Investors are losing interest meanwhile low risk low return global fixed income funds registered net money inflows. Although new growth markets specialized investment trusts suffered form recent market turmoil money inflow remain positive. There are still wide discrepancies in the Japanese individuals risk assessment and new product launches reflect those discrepancies. In fact Japanese individual investors still clearly favour distribution and over long-term growth, which explain Japanese asset managers regular rush to market new products. This is fully part of 'hunt for yield'

Source: Nomura Research Institute Balance investment trusts: red chart, BRICS investment trusts: dark blue chart, Global fixed income trusts: light blue chart.

The long, long case (part 7)

Individuals margin Forex trading pattern is changing alongside recent upsurge in Yen's implied volatility. Some individuals are now going long in Yen that's new! Amounts are tiny and short term trading focused but this ads fuel to my long-standing Yen implied volatility upsurge scenario. Trading volumes are raising both sides. In previous newsletters I advised to keep a close look on Yen REEF, well Yen's real effective exchange arte jumped 3,3 points on January to 99,5 (March 1973=100) and 100 level in February 2008 (+4,6 points) registering highest level since November 2006. This is solely attributed to risk aversion triggered by worldwide markets volatility but could also signal a much broader turnaround point in money flows. Anyway foreign currency-denominated asset investments *temporary* slowdown gives Japanese currency implied volatility a boost.
Meanwhile just as confirmation January individual money flows toward onshore investment trusts decreased 70 % compared to same month last year, however new money still comes in as net subscriptions were Y100 billion (subscriptions minus redemptions). Despite worldwide volatility January registered net positive subscriptions, therefore recent Yen narrow trading range comes as no surprise. But make no mistake underlying trend has changed for good.

Now what to buy?

Japanese E-money, just go for it. I told you.

By 18th of January Contac less IC cards Suica and East Japan Railways related Pasmo had cleared the 30 million unit mark. This does confirm what I repeatedly mentioned about Japanese E-money market growth. Aeon also announced that the number of retail outlets accepting E-money card 'Waon' would increase form 2,700 to 4000 by 1st of March 08. Most retail outlets are located in Kinki and Chubu but should expand to the whole country by March. Aeon bank cash card is also including Waon capacities. By December 07 E-money sponsor Waon (Aeon Credit) cards jumped to 2 million 200,000 units. Seven & I holdings e-money card Nanaco reached 5 million 300, 000 units. Further Seven & I holdings have reached an agreement with banks and brokerages for points to be swapped for Nanaco credit to be used in convenient stores and supermarkets. First time an E-money sponsor company agrees with financial institutions to do so. Seven & I has reached agreement with 50 financial institutions: among them mega banks MUFJ, Mizuho, regional banks (Chiba bank, Yokohama bank) and credit cooperatives (Shinkin). Japanese E-money flows are getting larger by the minute! As I speak Bank Of Japan has finally decided *to include E-money within its publicly available statistical data*: 5 large E-money sponsors including Edy and Suica are targeted. From April onward BOJ plans to make public monthly settlement value, card numbers and E-money flows based on E-money sponsor companies data (Bit-Wallet and others). Nikkei Research (Nikkei Net subsidiary) recently interviewed a consumer's representative panel age ranging form 20 to 69. The survey reveals that 64,7 % are male users, 35,3 % female users with largest proportion of end-users in late thirties. 30 % of E-money users average settlement is limited to 800-1000Y per card. E-money sponsors relative market share is roughly: Edy 52,4% (including myself!), Suica (46,7%), Nanaco (21,9%), Pasmo (20,6%). Below chart shows several E-money sponsor relative usage (most consumers hold different E-money cards).

http://it.nikkei.co.jp/business/news/index.aspx?n=MMITba000024012008&type=largephoto&ps=2

Above chart represent each e-money sponsor relative usage (click to enlarge the hyperlink). Blue is Edy, Green: Suica, Yellow: Nanaco, Pink: Pasmo etc.

Source: Nikkei.business.IT.plus.net

Property, look out!

I previously stressed that Japanese real estate stocks ultra-low valuations did not automatically equal tremendous 'buy opportunities'. The phenomenon accelerated and property companies Per downside trend further accelerated. 24th January TSE 1st section average Per was 14,8 however 38 % of the 142 listed real estate companies are now trading at less than 5 times current fiscal year earnings! By March 2007 you could not spot a single real estate company trading at less than 5 times earnings so something clumsy is happening there! Simply market is discounting property fundamentals deterioration. I already said several times Japanese real estate market was a multi-edged sword and I was happy to note this opinion is shared by Nikkei .The 'yet to come' Nikkei Veritas financial daily published an article stressing that Real Estate sector index had collapsed 51 % since June 2007 peak with several companies now trading at 2 to 3 times current fiscal year earnings! Most property developers suffered share price collapse, which makes it very difficult indeed to raise capital through public offering. Not so long ago foreign securities houses dominated the juicy CMB's market offering a cheap funding source supply to developers. Now this cheap funding source is over in addition to Japanese banks getting very conservative toward real estate financing. In short funding is getting expensive. 21st of February Pacific Management launched a 2 years SB with 3,43 % coupon, spread reached 2,5% which represent a 0,9 % increase YoY 1 % above Mizuho Corporate bank 10 years notes. Although Pacific Management ranks among top managers by properties portfolio size premium was high. According to Da Vinci adviser's president the market should be prepared for large sell off by April 08. Da Vinci looks ready to grasp opportunities having launched a corporate opportunities fund back in December 2007 for that purpose. Large Real Estate Companies will take advantage of upcoming M&A opportunities, for example late January Mitsubishi Real Estate launched a 15-year note bearing 2,075 % coupon, which is cheap compared to current market premium. The sword is sharpening, be selective.

(7522) Watami looks cheap at Y 1610 trading at 18 times next fiscal year earnings. Watami hit Y 1592 low on 16th January after hitting Y 2115 peak in June 2007. Interim consolidated current earnings increased twofold at Y1 billion 627 million, net profit registered Y 1 billion 516 million above target. Full year consolidated current earnings is scheduled to increase + 26 % at Y 5 billion 160 million and net profit increase 2,3 times at Y 3 billion 630 million. Home care division sales increased 2,6 times at Y 4 billion 799 million. Interim sales increased 2,1 times at Y 51 billion 142 million.

Another sector I felt would be exiting was Japanese media industry in general but on January 31st Japanese financial daily Nikkei Financial Daily hard copy edition sudden termination came as a surprise to me. The 21 years history financial daily is to be replaced by Nikkei 'Veritas' from march 16th. Nikkei 'Veritas' first digital edition article called 'Can Japanese shares break free of the value trap?' attracted my attention as one of my long-standing favorite subjects.

To sum up briefly: By January end foreign brokers like Merrill Lynch were forecasting Japanese 1st section listed companies earnings to decline 10 % by march 2009, Goldman Sachs Securities was forecasting 6,5 % decline and Morgan Stanley anticipated flat earnings (0%). Overall consensus is pointing at first decline in seven years anyway. Most Japanese companies are discounting rate differential between US and Japan to shrink and Yen to strengthen. US recession, Yen strength and global market turmoil's toxic cocktail makes it inevitable for companies to tighten belts. Looking back at Japanese equities falls for the past year TSE first section lost no less than Y 120 trillion but still most market observers were convinced global investors would look again at Japan historic low valuations at some point. However the Japanese so called 'value trap' makes it difficult. Merrill Lynch Chief Strategist even called current calendar year the 'value-trap' year. The danger comes form within as Japanese companies suffer capitalization decline. On 31st of January Sumitomo Metal Industries and Sumitomo Corp announced cross-shareholdings agreement citing 2007 second half earnings decline as the reason. Both companies registered price decline after the announcement. Clearly this was not taken well among foreign investors as such agreement symbolizes the return of congenital capitalism in Japan. Arcelor Mittal is still 5 times Sumitomo Metal capitalisation (December 2007).

Looking at long-term comparison between German Siemens and Hitachi equity price, Siemens achieved to increase its market value 5 times over 13 years meanwhile Hitachi own market value decreased by 20 % over the same period. Even within world competitive Japanese auto industry the same phenomenon took place. In 1994 Honda market value was twice Volkswagen but by December 2007 end Volkswagen outpaced Honda's market value. Yen nominal weakness and Euro nominal strength can be pointed at but looking at Japanese industries intrinsic value this is another story. Key Point is how to get out of the value trap. One solution is to revert to large M&A. Another way to look at it remain whether domestic institutional investors raise shareholder's rights requesting higher payout ratios. Probably domestic institutional investors hold the key to attract global money into Japanese equities.

Source: Nomura Securities US$ base chart comparison (6501) Hitachi and Siemens since 1994 (Siemens in Blue, Hitachi in yellow)

In the end I personally believe individual investors more than institutional investors hold the key but the retail side of the market requires time and patience although a younger generation is getting on the job.

M&A front

On the cross border M&A front my individual radar spotted with interest the public announcement of (non listed) Nishihara Environment Technology Inc (Tokyo Minato-Ku) outright purchase by Veolia Japan KK (France Veolia water). Veolia boosted its already existing stake from 20 percent (acquired in 2006) to 51 percent. This press statement was published on Nikkei Sunday 3rd February front page. Obviously Veolia hopes to expand its business in Japan by entering in full the Japanese waterworks market and take advantage of Nishihara's nationwide network plus connections to public-sector clients, Nishihara is currently engaged in water-related business for municipalities and registered sales of 15 billion Yen for the year through March 2006. Nishihara is a private company so apart form Nishihara's founder no private investor will take advantage however I repeatedly insisted that Japan had a lot to offer in terms of environmental technology and stakes are high in this business field. Nikkei recalls that World Sewage and waterworks market roughly equals Y1 Trillion 500 Billion. Japan's waterworks itself was liberalized in 2002 allowing local governments to outsource waterworks operations and waterworks outsourcing contracts should expand further. Mitsubishi Corp and J Power already manage sewage outsourcing contracts but worldwide speaking bizarrely no Japanese companies ranks among the leaders (namely Veolia, Suez and Thames water). In turn this could trigger alliances between Japanese companies such as Kurita Water? I would keep a close eye on all listed Japanese players.

I shall be back soon.