



JAPAN : STUCK IN LIMBO

I have written three opinion pieces on Japan, my very first one in October '05, my seventh in April '06 and my nineteenth in April '07. As I continue to be fascinated by what goes on there I thought that I should make it an annual event and keep up the pattern by writing my April '08 piece on how things are progressing.

In my opinion piece of April '07 I wrote the following:

In conclusion my decision to invest in Japan has been based on this idea that there are asset rich companies that are cheap. I now believe that there is a real chance that those cheap companies will be forced to look after their shareholders. This is not a view on the short term direction of the economy. It is not a view on a specific company. It is a long term investment based on value being realised in the broad Japanese stock market.

In order to implement the decision I have bought a Japanese exchange traded fund (ETF). This gives broad exposure to the overall market.

I have invested in Japan. It might not quite be a steal but Steel Partners will help to unlock the cheapness!!!

I have to admit that in the last year foreign investors both activist and private equity have been rebuffed in all their attempts to bring about change. In fact it appears that “traditional” Japan has managed to put in place stronger defences to prevent foreigners (or local mavericks) from getting their hands on any of these cheap companies.

Steel Partners were involved in a hostile takeover bid and legal action with a company called Bulldog Sauce but in the end the legal action allowed Bulldog management to put in place a “poison pill”, an issue of new warrants to “friendly” shareholders that prevented Steel Partners from getting control of the company.

The success of Bulldog Sauce in getting rid of Steel Partners has resulted in the following observation from one commentator:

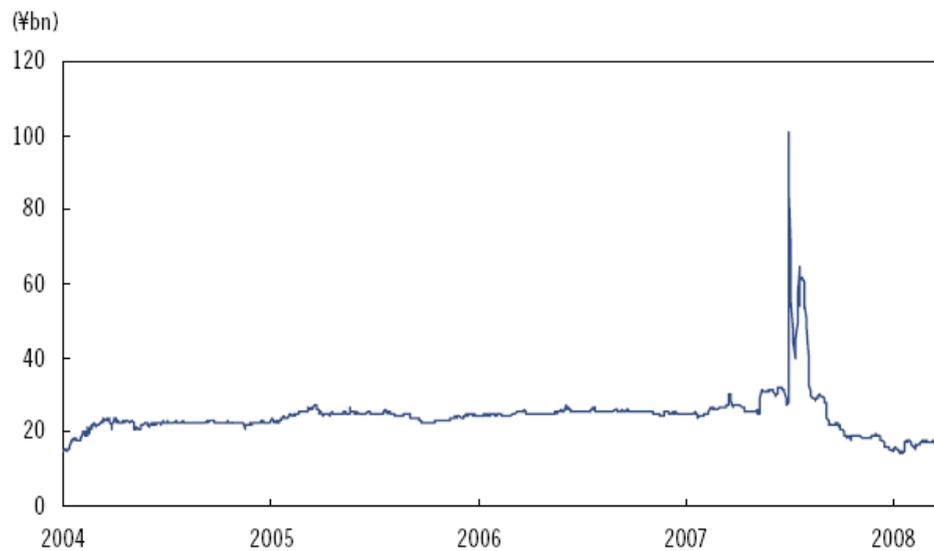
Bull-dog Sauce-style defenses being increasingly adopted

Following the Supreme Court ruling on Bull-dog Sauce in August 2007, the number of companies taking votes on adopting anti-takeover defenses at AGMs has increased. Since September 2007, there have been 86 cases of companies announcing the introduction of anti-takeover defenses (including re-adoptions and revisions), all of which fall under the “early warning” category (as of end-March 2008).

The government did not help sentiment by its own actions. TCI were prevented from taking a 20% stake in J-Power because it was deemed to be a “strategic” industry. Maquarie was prevented from taking control of Japan Airport Terminal again because it was deemed to be a strategic asset.

In other words the barriers to foreigners unlocking the value in those cheap companies has been put in place and so with the benefit of hindsight it now appears that I was premature in my decision to dip a toe in the Japanese market. The chart below shows what happened to the value of Bulldog Sauce over this time:

Figure 1. Bull-dog Sauce's market cap



Before the courts allowed Bulldog Sauce to put in place those defensive measures there was a genuine hope that this could be the start of a process where value would be unlocked. As the chart shows those hopes were well and truly dashed and this I believe partially explains the weakness of the overall market.

Asahi Chemical

In my second opinion piece on Japan I wrote about Asahi Chemical and my experiences with them over the years. It was therefore quite fitting that on April 11th Asahi Chemical gave an update on their Strategic plan “Growth Action 2010”. In that past opinion piece I described Asahi Chemical as a company that had set targets that I believed would be hard to achieve unless tough decisions were taken and I expressed the opinion that those tough decisions were unlikely to be taken.

Asahi Chemical’s results were released recently and I think they have once again shown that you should judge Japanese companies by the results they achieve rather than the forecasts they make.

Asahi Chemical results and forecasts:

	FY 2006	FY 2007			FY 2008 forecast		
		H1	H2	Total	H1	H2	Total
Net sales	1,623.8	830.8	866.0	1,696.8	856.0	954.0	1,810.0
Operating profit	127.8	63.7	64.0	127.7	50.5	77.5	128.0
Ordinary profit	126.5	63.1	57.3	120.5	49.5	75.5	125.0
Net income	68.6	38.0	31.9	69.9	30.0	45.0	75.0

As the table above shows operating profit and ordinary profit was static in the year FY2006 to FY2007 and is forecast to remain static in the year to FY 2008.

This stagnation in profit indicates to me that Asahi Chemical is not a dynamic company and is therefore unlikely to be a great investment.

Unfortunately Asahi Chemical in my opinion is all too representative of Japanese companies in general.

This once again highlights the need for a catalyst to unlock value in the Japanese market because it is unlikely that existing management teams are likely to do it.

Politics

The current Prime Minister Fukuda has become incredibly unpopular. There were rumours of an early election but that may not happen. An election has to take place by September 2009. There is the possibility that the LDP could lose power in that and a more reformist DPJ could lead the next government.

Conclusion

I continue to believe that the cheapness of Japanese companies will attract foreign investors but it appears that hopes of quick progress in unlocking that value have been dashed by the legal system. I therefore have to conclude that I could be waiting a very long time before making decent returns on my Japanese Exchange Traded Fund (ETF) but I believe that the possibility of a new government might be worth waiting for and therefore I will hold on to this investment until the election is over.

THE JAPAN PREMIUM

Does anyone remember the Japan Premium? I certainly do because that was a time when financial commentators were constantly writing about problems in the Japanese banking system.

At one point in 1997 Japanese banks had to pay a substantial premium to borrow money compared to banks in the rest of the world.

The following is an extract from a San Francisco Federal Reserve paper on the subject:

The event leading to the emergence of the Japan premium was the announced failure of Hyogo Bank in August of 1995. Hyogo Bank was the first commercial bank failure in Japan. It was the 38th largest bank, with \$37 billion in assets (Peek and Rosengren 2000). Prior to this date, Japanese authorities had intervened to preclude failure by any commercial bank, arranging the merger of an insolvent bank with a solvent acquiring bank. In return for its acquisition of the insolvent bank, the acquiring bank received its branching rights, which were quite valuable in some Japanese cities. It has also been speculated that the acquiring bank enjoyed preferential regulatory treatment in return for taking the insolvent bank onto its books (e.g., Hoshi 2000).

At that time there were headlines in the western press highlighting falling Japanese property values, falling stock prices, bad debts of potentially enormous size, insufficient capital to absorb those bad loans and management that were trying to hide the true extent of the problem. In other words a crisis of confidence! Sound familiar? Yes, the Japan premium of 1997 reminds me of the western banking crisis of 2008.

The Japanese government eventually helped by providing additional capital and managed to convince the world that large Japanese banks would not be allowed to fail. I wonder whether the rescue of Bear Sterns will be seen with hindsight as the time that the message was sent out that the financial system cannot be allowed to meltdown and in a number of years time the current crisis will just be like the Japan Premium.....a distant memory?

TRIBUTE

I wrote my first opinion piece for the website back in October '05 and I have written one every month since then up until now.

On April 23rd my father in law died and I took some time off work. I have therefore written this opinion piece to cover two months.

I want to use this as an opportunity to pay tribute to my father in law, Tony Smith, because he was a great friend and he will be dearly missed (even though he was a Newcastle United fan!)