FREE KIC NO. 42 APRIL 09

WILL WARREN SUCCEED?
(BUT FOR A CHANGE I'M NOT TALKING ABOUT WARREN BUFFETT)

This month two years ago I wrote about the attempts of foreign investors to unlock value in the Japanese stock market (Opinion Piece 19). In particular I mentioned the leadership role undertaken by Steel Partners an American investment firm. My final sentence was the following:
I have invested in Japan. It might not quite be a steal but Steel Partners will help to unlock the cheapness!!!
At the time I forgot to mention that the head of Steel Partners is a man called Warren Lichtenstein, hence the title of this opinion piece.
I have retained my small investment in Japan because I admire what he is attempting to do and I hope that he will succeed within a reasonable timeframe even though up until now success has been relatively minor.
I admire him because he is trying to do exactly what I have been talking about since 1996 when I came to the realisation that Japanese management engaged in a game of telling foreigners what they wanted to hear rather than telling the truth. I have written about this in previous opinion pieces and I went into detail using the example of Asahi Chemical (Opinion Piece 7).
To summarise what I said about Asahi Chemical I argued that if I was in charge of Asahi Chemical I would think long and hard about breaking it up into logical business units. At a minimum I would want to divest the commodity textile and chemical business units. I believe that Asahi Chemical should concentrate on the high margin, high return on capital divisions and I believe that this would be in the long term interest of all stakeholders including employees. (As an aside I think it is interesting to observe that Berkshire Hathaway started out as a textile company and Warren Buffett realised that he had to get out of that business. I think Asahi Chemical should do the same).
(See the Appendix for details of the progression of profits at Asahi Chemical).

I believe that Warren Lichtenstein is attempting to make logical changes in the companies in which Steel Partners has accumulated large stakes.
On the Steel Partners website you can see the whole list of companies in which they are major shareholders and their analytical work in regard to those companies as well as their recommendations for improvements. (The website is: http://www.spjsf.jp/english.html)
In particular I like their openness in disclosing the analytical work that they have undertaken because it is better than any work I have read from the big investment banks.
I have read with interest their analysis of Noritz a company making water heaters. I recommend this to anyone who has the time and you can read it by following this link: http://www.spjsf.jp/pdf/071213-noritz_Presentation_e.pdf
For people who do not have the time to read this substantial piece of research I have copied part of the cover letter that Steel Partners sent to Noritz management with the report. It gives a sense of what they have identified:

Dear Mr. Kabe:
As you know, Steel Partners Japan Strategic Fund (Offshore), L.P. ("Steel Partners Japan") is the largest shareholder of Noritz Corp. ("Noritz" or the "Company") with a 19.9% interest. We have owned shares of Noritz since February 2004, in line with our philosophy of being long-term, patient shareholders. Given the Company's operating

performance over the four years that we have been a shareholder, we are now deeply concerned about the future of Noritz's businesses.
To highlight the cause for our concern, we note the following:
1. The Company has not met its operating income target in six of past seven years and, based on the Company's recent downward revision of its operating budget, we anticipate that Noritz will miss its operating income target for 2007;
2. Operating income and operating margins have steadily decreased since 2003;
3. Operating margins are significantly below those of Japanese and non-Japanese competitors;
4. Average return on equity ("ROE") from 1996-2006 was 2.3%, well below the 8% target used by the Japan Pension Fund Association to determine whether to support incumbent directors, and, based on the Company's recent downward revision, we anticipate that ROE for 2007 will also be well below 8% and is likely to be negative.
We believe that the Company needs to immediately begin to formulate a new plan to address its complex operational issues and to improve profitability and corporate value.

This letter was written in December 2007. Further letters were sent in January and July of 2008. Noritz management seem to have adopted a strategy of ignoring Warren so last September he decided to try and buy the whole company at a share price of Y1025

The share price rose above Y1025 in November and stayed above that price into 2009 and on March 24th the following was included in a press release:
Steel Partners said it was withdrawing the proposal because Noritz's share price has consistently traded above the offer price since the proposal was made.

There have been no further developments since March and I have no idea what Warren will do if management continue to ignore his recommendations. Will he come back with a higher bid, will he sell out? I just do not know but as I said at the beginning I hope Noritz management will no longer be able to muddle along without having to think about some common sense ways of improving their performance.

Warren and Steel Partners are not the only people trying to bring about change. In the last year the Asia Corporate Governance Association has become more vocal in their attempts to bring about change in Japan.
Members of the Association travelled to Japan to stimulate discussion of a paper they wrote in May 2008.
You can read this paper at the following site:
http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf

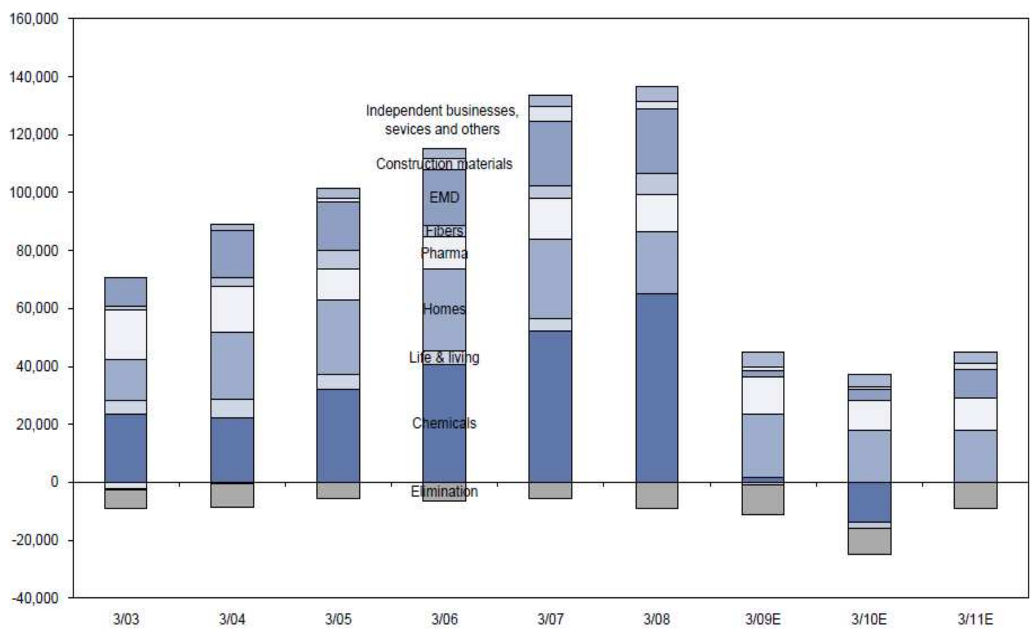
Once again I recognise that this is a long paper to read so to give a flavour of their argument I have copied the following extract:
We believe that sound corporate governance is essential to the creation of a more internationally competitive corporate sector in Japan and to the longer-term growth of the Japanese economy and its capital markets. While a number of leading companies in Japan have made strides in corporate governance in recent years, we submit that the system of governance in most listed companies is not meeting the needs of stakeholders or the nation at large

The other thing I want to highlight is the potential for political change.
An election has to be held by September and the current government is doing badly in the opinion polls.
I am not sure how reformist a new government will be but given the state of the economy this might be the opportunity to be radical by Japanese standards.
I therefore believe that having a couple of percent of my portfolio in a Japanese Exchange Traded Fund (ETF) is appropriate for the time being and if Warren succeeds I might just add to it but if he fails and if the election brings about no fundamental change I might just have to take my loss.


Warren Lichtenstein

APPENDIX: Asahi Chemical Operating profits from 2003

Exhibit 2: Asahi Kasei (3407.T): Segment operating profit trends
¥ mn



The improving profit trend from March 2003 to March 2008 now appears to be linked to a strong global economy. The slowdown in the global economy has resulted in a collapse in profits in the year to March 2009.Chemicals and Fibers will probably lose money in the coming year.
I believe Asahi Chemical is typical of slow moving Japanese companies and if they do not change I believe they will condemn themselves to a future of declining significance in the global economy.