



SOME THOUGHTS ON OLYMPUS

When Olympus appointed an English man to the position of President and Chief Operating Officer I regarded them as a very rare example of a progressive Japanese company that was prepared to be different to most other Japanese companies. I was not alone in thinking this because here is what the analyst at Goldman Sachs wrote:

Restructuring? Really? - Yes, really

One of the primary reasons behind our faith in Olympus is the change in management.

Michael Woodford, who became the company's first non-Japanese president/COO in April this year, recently communicated to the market that (1) management will not allow large losses to emerge in the camera business, (2) SG&A will be reviewed in all regions across all businesses; and (3) there will be a higher level of scrutiny around M&A, which should improve FCF and help the company de-leverage its balance sheet.

Although an outright sale of the underperforming businesses is unlikely in the short-run, as explained later in this report, we believe increased cost scrutiny will create a much leaner Olympus.

Having Michael Woodford as President appeared to set them apart from companies like Tokyo Electric Power (TEPCO). I make the comparison with TEPCO because I wrote about them in April when I wrote about the earthquake and Fukushima nuclear power plant disaster. Back then I wrote the following:

TEPCO is a major Japanese utility but it has a management team and board of directors consisting of old men that have worked in the company all their working lives.

In all there are 20 directors. All of them are Japanese and male. It appears that 18 are lifetime employees. The annual report does not give any of the ages of the directors but I would guess that it is highly unlikely that any director is under 40. Responsibility seems to end up in the hands of people by virtue of their age and not because of their leadership skills. Loyalty to the company creates a culture of secrecy that includes lying about safety and accidents.

In my opinion these old men do not want to change. They seem to want to maintain the status quo and in a world of rapid and dynamic change I believe that Japan is potentially condemning itself to stagnation.

Given the events of the last few weeks it now appears that Olympus was not as different as I thought. It appears that Olympus had a boardroom (excluding the token foreigner) that treated the company as their own little kingdom and totally disregarded shareholders.

What I find particularly fascinating is the fact that Olympus is a company that I thought I knew quite well. I first started researching them in the early 1990s when a broker recommended them to me. I was particularly interested in their medical business because they were world leaders in the highly profitable area of endoscopes. I was not that interested in the camera business because I felt it was a more commoditised product with far greater competition.

I visited them twice and in terms of management they appeared to be a fairly typical Japanese company. I assumed that foreign shareholders were an inconvenience to be tolerated.

I was also aware that their pre-tax profits were significantly lower than their operating profits. This was explained away by analysts as some bad financial investments that were not recurring in nature and would therefore soon disappear.

The following piece of research shows actual numbers from March 1999 to March 2005 and one analyst's estimates from March 2006 to March 2008. The most interesting line items are those called "Others" and Extraordinary Items. This analyst also assumed that the big negative "extraordinary items" would finish but little did he know just how much he was being lied to.

Olympus (7733): Consolidated Income Statement										
(Yn bn)	F98	F99	F00	F01	F02	F03	F04	F05E	F06E	F07E
Sales and operating revenue	413.7	428.6	466.7	528.4	564.3	633.6	813.5	988.2	998.7	997.0
Cost of sales	216.7	238.7	271.4	308.6	293.5	335.1	516.5	663.6	668.1	665.4
Gross profit	197.0	189.9	195.3	219.8	270.8	298.6	297.1	324.5	330.6	331.6
	31.1	32.0	30.8	30.5	34.7	38.7	47.7	49.0	48.5	48.9
Selling, general and administrative	127.8	127.8	128.9	147.0	173.7	196.9	226.2	237.6	240.1	237.3
Operating income	38.2	30.1	35.5	42.3	62.3	63.0	23.1	38.0	42.0	45.4
Interest and dividend income	1.9	2.4	1.6	1.4	1.1	0.6	1.1	1.3	1.2	1.2
Interest expense	9.8	8.9	8.9	8.3	5.9	4.8	6.6	5.4	5.6	4.9
Others	-10.3	-2.9	-5.5	-4.0	-5.2	-3.0	-7.4	-3.8	-3.6	-3.7
Recurring Income	20.1	20.8	22.7	31.4	52.4	55.8	10.2	30.0	34.0	38.0
Extraordinary items	0.0	-16.3	-0.9	-10.9	-9.3	4.2	-4.4	4.0	0.0	0.0
Pretax Income	20.1	4.5	21.8	20.5	43.1	60.1	5.8	34.0	34.0	38.0
Income taxes	11.2	2.6	9.8	10.2	18.6	26.6	17.8	20.4	19.5	21.2
Effective Tax Rate (%)	55.6	58.4	45.1	49.5	43.2	44.3	306.5	60.0	57.4	55.7
Minority interest in income (loss)	-0.0	-0.0	-0.2	-0.1	-0.1	0.1	0.2	-1.5	-1.6	-1.7
Net income	8.9	1.9	11.8	10.3	24.3	33.6	-11.8	12.1	12.9	15.1

In the past I have written about the difficult lesson I learned from visiting Japanese companies. In opinion piece 7 (April 07) I wrote the following:

I bought Asahi Chemical back then believing what I was told. I believed that if textiles remained a terrible business well then they would sell up or shut down. The reality was not what I was led to believe.

In other words I had to learn the hard lesson that I would regularly be lied to.

Michael Woodford also had to learn the hard way and for anyone that wants to read the full story in his own words it can be found on the following link:

http://ajw.asahi.com/article/behind_news/AJ201111260080?imgIX=0&page=1

In the course of writing this article I decided to look back at my collection of business cards to see if I had kept any from my visit to Olympus (yes I have kept lots of old business cards!). There in the middle of them was the business card of the Assistant Manager Finance Department Hisashi Mori. Little did I think when I met him that he would go on to become a director and would ultimately be at the centre of the controversy.



Hisashi Mori

I hope that when the results of the investigation are published I will discover when he knew about the cover up.

Unfortunately as I write this opinion piece there are major developments in the story. Michael Woodford has just resigned as a director and is going to call an EGM to see if he can get shareholder support to put together a new board and management. This is an exciting development because it is going to give us an insight into what Japanese institutional shareholders are prepared to do.

I presume foreign shareholders (and they are some of the biggest shareholders) will vote for Woodford but I am hoping that some Japanese will also give him a chance. I hope companies like Nippon Life (Nissay) will disclose how they vote because all they have said so far is that they want clarity.

If Woodford doesn't succeed it will be an indication that Japan remains stuck in the past. I just cannot wait to see what happens next.

Finally I want to praise one of the heroes of this controversy. As Michael Woodford said himself in a Bloomberg interview, Shigeo Abe the author of the original article that brought everything to his attention is a real hero.

He has been campaigning for years and here is a section of an interview he gave back in 2003.

Abe says irregularities are prevalent among Japanese firms, which went to great lengths to flatter their balance sheets following the bursting of the country's economic bubble 20 years ago.

Back then, as property and share prices collapsed, Japan Inc came under enormous pressure to make big asset write downs but accounting rules at the time, before the era of global fair-value accounting, gave them some room to manoeuvre.

Abe says some of them never lost the habit.

"Since the 1990s corporate governance in Japan has been in a very bad state and disclosure has been incomplete," said Abe.

"This has been one of the main factors leading to the economic malaise of the past 20 years."

I agree with him completely and I wish he was not just seen as a voice on the fringes of Japanese society.



Shigeo Abe

In conclusion I want to say that this is a real opportunity for Japan to start the process of change but as before I worry that they will not take it.