LINDSELL TRAIN

More Observations on Japan

July 2011

Following a recent visit we introduce, reiterate and reinforce some views on Japan three months on from the earthquake.

At a top-down level, we observe that external demand is the only significant source of growth in Japan. The domestic economy remains largely moribund, with reconstruction activity the only source of new demand over the immediate future. As in previous phases of recovery the strength of overseas demand is crucial to maintaining growth and the improved levels of corporate profitability. We worry that with growth in emerging markets (especially China) slowing, as monetary policy is tightened, and with the USA unable to grow at anything like the pace of the past, Japan's growth prospects will in turn diminish.

Real Estate

Vacancy in the Tokyo CBD, a key barometer for the real estate market, remains at a relatively high level of 9% and is continuing to put pressure on rents and capital values. Retail rents are under even more pressure (see our comments on Retail below). The earthquake was a reminder of how vulnerable Tokyo is to seismic activity relative to other urban centres such as Osaka and Kyoto. This renewed assessment could at the margin influence the ongoing migration of the population and businesses to Tokyo that over the last 20 years has been a strong support to the Tokyo economy.

Banking

Banks remain under pressure on a number of fronts. Falling loan balances and rising deposits ensure a continued orientation of balance sheets towards government bonds. This results in reduced spreads and reduced core profitability. Continued ownership of cross shareholdings brings risk of capital losses, no better exemplified than by the 90% fall in the price of Tokyo Electric Power's shares. The continued stagnation of the domestic economy together with any losses associated with the earthquake will impinge on the asset quality of the loan book. Banks probably need more capital in addition to the new equity raised last year in dilutive share issues. The issuance of retail floating rate JGBs might pose additional problems for the banks in the future. These JGBs offer interest rates at two thirds of the average interest rate on 10 year JGBs, recalibrated every six months with the principal guaranteed – a much better rate than on offer for a deposit with a bank and for a better credit. This could divert cheap funding away from banks.

Retail

Subdued levels of consumption have been reflected in falling retail sales over many years. The earthquake has exacerbated this trend in the short term, especially around Tokyo, in consideration of the straitened circumstances of those affected by disaster. Although this short-term trend should moderate in time, low employment growth and stagnant or falling wages continue to have a negative influence on demand.

Electric Power Generation

18 of Japan's 52 nuclear power stations were operational at the end of April. There is a rolling programme of shutdowns that result in around four stations closing every month. Restarts have to be approved by safety inspectors and local Governors. No Governor has approved a restart since the earthquake, instead they demand new nuclear safety standards and laws which will take months to draft and implement. If this situation persists all nuclear power stations are likely to be shut down by spring next year. Unfortunately, nuclear power accounted for c.30% of Japan's electricity generating capacity. Although Japan could probably have avoided blackouts as a direct result of the disabling of the Tohoku power stations in the earthquake, the closing of so much additional capacity (if it occurs) will significantly affect industrial output. Logic would assume that enough restarts will occur to ensure the maintenance of power supplies but public opposition to nuclear is widespread and virulent. As the debate wrangles on without any sign of resolution it is increasingly likely that there will have to be some blackouts to force the public and politicians to address the consequences. Investment in alternative power generation is already underway in Tokyo.

Indeed, Tokyo Electric Power should be at 85% of capacity by August without any contribution from nuclear power. But as a result of a wider demand for alternative facilities there are now bottlenecks in equipment supply, which prevents other companies investing as quickly as they would like.

Industry

Recovery following the disruptions of the earthquake is proceeding faster than initially anticipated. Soon all supply bottlenecks (barring above) will be eliminated. A number of domestic construction and building supply industries are likely to benefit from replacement or rebuilding demand but electricity supply issues and overseas demand will prove to be much bigger influences. Since the earthquake, exports have been weak - probably as a result of supply issues. We reiterate that overseas demand growth is a vital ingredient in supporting corporate profitability but subdued demand in western economies and a slowdown in growth in China threaten that benign expectation. The continued strength of the Yen is positive for Japan as a whole as it helps keep down imported goods costs. But its strength also means that investment in new facilities is prioritised abroad, where labour costs are more competitive.

Politics

Naoto Kan's tenure as prime minister is probably almost over. His successor will be similarly constrained by the lack of an implicit mandate to tackle structural problems. Even though the economy suffers from mild deflation, no growth and spiralling debt, life is tolerable for most citizens whilst employment remains relatively high. As a result, there is no immediate mandate for introducing remedial policies. The after effects of the earthquake might have tipped the balance - it has not as yet, but the situation could change quickly.

When muddling through becomes untenable, a confluence of circumstances that may include corporate failures, rising unemployment, negative growth and financial sector problems would create a sense of crisis that, paradoxically, could provide the mandate necessary for politicians to act more decisively. Then the promotion of restructuring, rationalisation and deregulation as policies of national renewal might prove acceptable. This would involve a sacrifice of living standards for many before the benefits of such policies become evident in providing a platform for future growth in the economy.

Valuations

Corporate valuations have rarely looked more enticing, with non –financial corporate profits only 26% down from the recent peak in March 2008 whilst the market languishes at 55% down from its peak in late 2007. Free cash flow yields of quoted companies at 7.7% are at record highs and compare especially favourably with long bond yields at just 2%.

However average valuations obscure some wide and important differences within the market:

Many quoted companies' profits have been much enhanced by the last two year's recovery in external demand and the profitability of overseas subsidiaries. Domestically facing companies' profits have in general stagnated.

Companies rely on vastly varying levels of debt finance. On average Topix non- financial companies' net debt is 45% of market capitalisation. But for those companies that are geared, net debt is 82% of market capitalisation or 10x annual free cash flow. On the other hand 46% of companies (by number) are ungeared and some have extensive cash reserves (including many in our portfolios).

We think the apparently low valuations of companies that today exhibit cyclically enhanced profitability and/or are reliant on excessive levels of debt finance may be providing a falsely alluring valuation signal. On the other hand many non-cyclical businesses with leading market shares that retain net cash or are prudently levered, and that offer high free cash flow yields, represent excellent long-term value.

Were there to be the sense of crisis referred to above, the share prices of the former would fall markedly. Maybe the continued existence of some would be called into question. Share prices of cash rich companies would probably fall but by less than market averages. And at least managements would have the war chests to enhance their market positions if restructuring presented any opportunities.

Michael Lindsell, Portfolio Manager
Lindsell Train Ltd

NOTES: Financial data quoted in this report is obtained from Bloomberg and the companies mentioned. It is subject to change without notice.

Risk Warning

Lindsell Train Limited
66 Buckingham Gate
London
SW1E 6AU
UNITED KINGDOM

Tel. 020 7808 1210
Fax. 020 7808 1229
www.LindsellTrain.comInfo@lindselltrain.com

Please refer to Lindsell Train's Glossary of Investment terms here.