A Lesson on Japanese Corporate Governance from Third Avenue

Value Investment Institute

Marty Whitman of the firm Third Avenue is a highly respected Value investor. His philosophy of safe and cheap has given the Third Avenue Value Fund (TAVF) a great twenty-year track record:

Since inception, the Fund has returned an average of 12.84% annually, ranking it number one in its current category, for the 20-year period ended November 1, 2010. Comparatively, the S&P 500 Index and the MSCI World Index returned 9.23% and 7.28%, respectively, during the same time period.

In addition to having this great track record, Marty deserves to be praised for his willingness to discuss his investment philosophy and also explain the thinking behind most of his investments. One can therefore go back in time and read about his approach and see how it has evolved over time. This time-stamped 'user manual' is an invaluable resource to value investors. As an example, in his Q3:2000 newsletter he defined his most basic philosophy of safe and cheap:

TAVF management attempts to have the securities in its portfolio consist of common stocks acquired at low price: earnings ratios, say, at present, at under 10 times Fund management's best estimate of earnings for the year 2001; common stocks acquired at huge, say 30% or more, price discounts from reasonable estimates of such asset values; or debt instruments of troubled companies where if a money default were to occur on that debt instrument, TAVF likely would participate on a profitable basis in the reorganization, or liquidation, of that troubled company.

In the early days practically all investments were made in the United States but in the Q1 2005 newsletter he explained that as time progressed he found that more of these safe and cheap investments were available outside America:

TAVF has no prejudice against investing in the U.S., and indeed, other things being equal, would prefer to invest in this country. However, equity pricing in the U.S. is just not as attractive for Third Avenue as is overseas investment. A majority of TAVF's investments are in the common stocks of well-capitalized companies which are selling at material discounts from readily ascertainable Net Asset Values (NAVs). Many such common stocks are available in foreign markets.

Earlier in Q3 2000 he had already mentioned that Japan was one of the main places where he felt he could find these safe and cheap investments:

TAVF is unlikely to be involved in Japan in restructuring troubled companies. However, there *exist gigantic profit opportunities which may be realizable when, as and if healthy Japanese companies start to restructure, especially by realizing some of the values existing in various companies' holdings of marketable securities, the so-called cross-holdings.*

Over time TAVF bought a number of Japanese companies thinking that patience would ultimately see the intrinsic value being reflected. The rest of this article looks at the history of one those investments because it is a fascinating and perhaps typical description of what has happened to many foreign investors in Japan. The investment referred to is Toyota Industries (originally known as Toyoda Automatic Loom and it is a separate company to Toyota Motor).

A small position in Toyota Industries shares (Ticker 6201) was first bought for the TAVF in Quarter 2 of 1998 but it was not until the Quarter 3 newsletter of 2000 that one can read the first detailed discussion of the investment. Here is a small section of that detailed discussion:

TAVF is trying to use whatever powers of persuasion it can muster to cause a reorganization of Toyoda Automatic Loom Works, Ltd. ("TAL"). At best, this seems as if it might be a two-to-four year project. TAVF has become the largest non-Japanese holder of TAL Common having acquired 3,000,000 shares at an average cost of $18.38 per share. The TAVF analysis of TAL is that the Fund has acquired an investment portfolio at a huge discount from NAV, and also absolutely magnificent operating businesses for free, or less than free. TAL is a Toyota affiliate. Toyota owns about 25% of TAL Common and TAL, in turn, is the largest Toyota shareholder with an approximate 5% equity interest in Toyota. TAL is a principal automotive supplier to Toyota. TAL, which originally only manufactured textile equipment, now a minor part of the overall operation, had founded Toyota and spun it off in 1937.

In this we can see how Marty defined Toyota Industries as a cheap company, thus giving TAVF that all-important margin of safety. He also acknowledged that he needed to be patient. This was not a short-term trade; rather it "*might be a two-to-four year project.*"

Four years later in the Q4 newsletter of 2004 we were given a sense of how the "project" was progressing:

We have also held conversations with Toyota Industries' management to discuss methods by which Toyota Industries' holdings of marketable securities and cash could be reduced below 50% of asset values assuming Toyota Industries wanted to do this in order to appeal to American investors. I have no idea as to whether, or not, these talks might go anyplace.

Marty has discovered the joy of dealing with Japanese management. Four years after becoming the biggest foreign shareholder and having bought a further 7,000,000 shares (total then 10,000,000) he admits that he has no idea as to whether management will listen to him. In the same newsletter he goes on to spell out some of the positives and negatives involved in the Toyota Industries investment:

Positives for Toyota Industries Management

- *Toyota Industries is one of the very best, most efficient, manufacturers of old economy* *"metal bender" products (and lately high-tech products also) that has ever existed.*

- *The Toyota name is a great "moat" name, protecting the company from competitive inroads, and probably is as good, or better, a "moat" name than are names such as Coke, Pepsi, Gillette, Ivory Soap or Kodak. The prospects seem pretty good that Toyota Motor will have a greater worldwide market share in the automotive industry than General Motors within a few years.*

Negatives for Toyota Industries Management

- *Corporate Governance leaves a lot to be desired. The Toyota Industries Board of Directors consists solely of Japanese males, and is likely to stay that way.*
- *Corporate Disclosure could be better*

Here Marty told us that Toyota Industries also had that Warren Buffett requirement of an economic moat. He even suggested that the moat might be better than Buffett's beloved Coke. He also recognised the negative that the company was run by a board of directors that was totally Japanese. In other words, Marty knew he had a great cheap company but that it was run by people who treated him with suspicion, with no sign of that changing. Marty then surprises me by writing the following:

The bottom line is that I am pleased with Toyota Industries' management. But I could be wrong.

It is surprising that Marty said he was pleased with management because this very same management had ignored the very things that he said he wanted them to do in his 2000 newsletter. He had not been able to persuade them to reorganise (*"TAVF is trying to use whatever powers of persuasion it can muster to cause a reorganization of Toyoda Automatic Loom Works, Ltd.")* and he had failed to convince them to sell off their marketable securities (*"We have also held conversations with Toyota Industries' management to discuss methods by which Toyota Industries' holdings of marketable securities and cash could be reduced below 50% of asset values"*). One can only guess at what it would have taken to make Marty displeased with management!

He must have been pleased with management because he continued to buy more shares. The following quarter he bought over 1 million shares bringing the total holding to 11,105,000. One would also guess that at this point in time he was pleased with the performance of the share because right around this time it began to 'breakout' (see chart above).

Throughout 2005 the share price continued to go up and many other value investors in a similar situation might have started to sell. In fact Marty continued to buy more shares and by the time he mentions Toyota again in the Q4 2005 newsletter he had 13,500,500 shares, equivalent to over 7% of the fund's total assets and the biggest single holding in the fund. In that Q4 2005 newsletter he once more highlighted his belief that Toyota Industries had built a moat around the company:

TAVF loves to invest in the common stocks of companies which have built a "moat" around their operations, insulating the businesses, at least in part, from pure and perfect competition. Such investments include the common stocks of Toyota Industries

As the share price continued to go up Marty continued buying more shares and by the time the share price peaked in early 2007 the total holding was up to 14,372,600.

When the share price peaked at over Y6000 per share Marty had a substantial unrealised profit, which he chose not to take. He still believed that the stock was too cheap. This is what he had to say in his Q3 2006 newsletter:

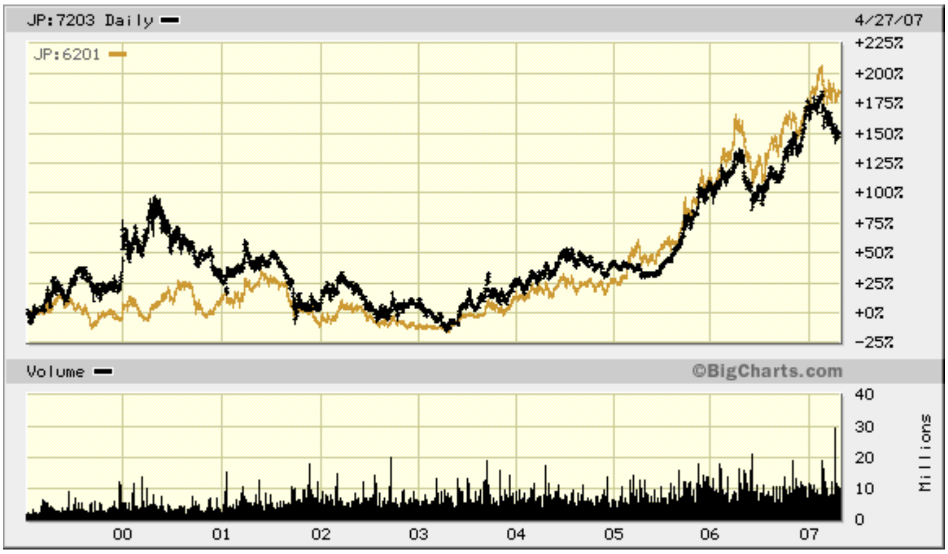
TAVF, in its analyses, uses GAAP as an objective benchmark, adjusting the numbers to reflect an economic reality. For example, over half of Toyota Industries' assets are invested in securities, principally a larger than 5% interest in Toyota Motor Common. Only dividends received from its portfolio holdings are reflected in Toyota Industries' income account, so that on a GAAP basis, Toyota Industries Common is selling at over 27 times earnings. However, if the Toyota Industries' GAAP income account is adjusted to pick up Toyota Industries' share of the portfolio companies' retained earnings (i.e., earnings not distributed as dividends), then

Toyota Industries Common is selling at less than 10 times earnings.

The Toyota Motor share price was going up at the same time as Toyota Industries, so the discount to NAV remained high. Marty continued to use this as a reason to buy even more shares. In Q4 2007 the holding was up to 15,922,200 shares when he stated the following:

The Fund acquired additional shares of Toyota Industries Common during this period. The issue was priced at less than 9 times current earnings on a look-through basis (i.e., adding back to Toyota Industries' earnings the undistributed profits for the period from Toyota Industries' investments in portfolio companies, principally a 5.5% ownership interest in Toyota Motor Common); and a discount of approximately 40% from NAV

Presumably Marty must have thought Toyota Motor was also cheap because if he had been afraid of a collapse in its share price he would surely have sold. As the following chart shows the move in the share price of both companies was virtually the same (Toyota Motor is ticker 7203 and Toyota Industries is ticker 6201):



The peak in the share price at the beginning of 2007 was at a time when there was hope that activist investors would be able to unlock the value in these cheap Japanese shares. These activists were a mixture of young Japanese entrepreneurs and foreign hedge funds. Livedoor and Rakuten were the upstart locals taking on Nippon Broadcasting and Tokyo Broadcasting, while foreigners Steel Partners and TCI were taking on a number of other companies. This period of hope did not last long as the Japanese establishment stepped in to prevent hostile takeovers. This culminated at the end of 2007 in a Japanese Supreme Court ruling involving Steel Partners and Bulldog Sauce. Any short term hope of unlocking value soon disappeared.

TAVF is not an activist fund. They describe themselves as Outside Passive Minority Investors (OPMI). They were therefore never going to be part of this attempt to change control at Japanese companies. They always worked with existing management in the hope that this would prevent hostility. It is therefore not surprising that there is no reference in any of the TAVF newsletters to this Japanese activism. One therefore cannot be sure if Marty saw this activism as the catalyst for the move in the Toyota Industries share price. The fact that this activism failed does not seem to have bothered Marty because as the Toyota Industries share price began to fall Marty was showing his patience by buying more shares. In Q4 2008 he wrote the following:

As of October 31, Toyota Industries Common was selling at 55% of reported net asset value and 5 times our estimate of "look through" earnings, which include the company's share of the undistributed earnings of Toyota Motor and other affiliates.

In Q1 2009 he wrote the following:

TAVF Management likes to focus on common stocks where we think the prospects are good that over the next five years net asset values will be increasing by not less than 10% per year compounded. For example, in the case of Toyota Industries, Toyota Motor's market penetration may be poised to increase dramatically, especially if General Motors, Ford or Chrysler were to cease operations in North America.

The shareholding peaked at 18,576,400 shares in Q2 2008 and at 10.95% of the fund in Q2 2009 (representing the third biggest holding in the fund at that time).

It is not until Q1 2010 that we are given any idea that Marty has any doubts about Toyota Industries and at that point TAVF still held 18,576,400 shares. This was the time when Toyota Motor had to recall millions of cars:

Subsequent to our fiscal quarter end Toyota Motor Corp. ("TMC") recalled 8.1 million vehicles for sudden acceleration problems and has begun a recall program to fix braking problems on some Prius models. These developments caused us to place our investment in Toyota Industries under review.

That review appears to have resulted in Marty selling 1,175,700 shares because in the Q2 and Q3 2010 newsletter the holding was down to 17,400,700. This must have been a frustrating decision to make because it meant selling at prices well below the peak and not that far from where a lot of shares were bought.

The Q4 2010 newsletter highlighted a more significant sale of 2,931,700 shares to 14,469,000 and this is what was said about Toyota Industries:

Toyota Industries had the worst business performance over the last five years of the companies in whose common stocks the Fund has significant investments. Fund Management has been disappointed by both the operating losses incurred by Toyota Industries and Toyota Motor during fiscal 2009 and Toyota Motor's recall issues in 2010. Nevertheless, Toyota Industries' reported net asset value has only declined at an annual rate of approximately 1% since 2005, and Toyota Industries and Toyota Motor continue to have strong financial positions. As of October 31, 2010, Toyota Industries Common traded at a discount of approximately 40% to our estimate of net asset value and represented 8.1% of the Fund's net assets.

Does this sound like enough justification to sell the shares at prices that still represent a 40% discount to NAV (the same discount mentioned when they were buying), or has something else happened? Another part of the newsletter may have been a hint that Marty had begun to get disillusioned with all Japanese companies:

We believe that without prospects for changes of control, market prices in Japan never have to be anything but a random walk. Thus, in recent years TAM funds have lightened up on their holdings of well-financed Japanese companies, because of the belief that managements and control groups tend to be indifferent to the interests of OPMIs. Therefore, Japan's market prices never have to reflect any rational values because, generally, there are no prospects for changes in control. (As an aside, it seems as if the absence of change of control possibilities combined with the indifference toward OPMI interests have been important contributors to Japan's twenty-year long recession).

There is one sentence in the above paragraph that summarises the dilemma now faced by Marty and it is the phrase "*Japan's market prices never have to reflect any rational values".* This appears to be a dramatic conclusion and although Toyota Industries is not specifically referred to, one can only imagine that his experience with Toyota Industries helped him to reach that conclusion.

The Q1 2011 newsletter revealed a substantial reduction in the holding, down by 4,344,400 shares to 10,124,600. This is what was said:

There have been several recent positive developments at Toyota Industries ("Industries"), whose common stock represented 6.3% of the Fund's net assets as of January 31, 2011.

- *The company reported that revenues and operating income for the first nine months of fiscal 2011 (March31 year end) increased 11% and 405%, respectively. The improved results were driven by strong revenue growth in the Materials Handling Equipment (up12%) and Automotive (up 10%) segments, as well as cost benefits from a streamlined corporate structure.*

- *Toyota Motor Corporation ("TMC") reported that revenues and operating income for the first nine months of fiscal 2011 increased by 5% and 708%, respectively, driven by strong growth in Asia ex-Japan (revenues and operating profit increased 34% and 76%, respectively) and improved results in financial services. Industries' 6.4% position in TMC common accounts for roughly half of our estimate of net asset value.*

These positive developments do not appear consistent with having cut the weighting in the fund from 8.1% to 6.3% in Q1 and again to 4.9% (8,129,400 shares) in Q2 2011. It would appear to be a sign that the issues with control and corporate governance have finally forced him to admit that cheap might not mean safe in Japan.

It should have been clear to Marty many years ago that management at Toyota Industries would never sell their Toyota Motor shares because it protects Toyota Motor from potential hostile owners. The Toyoda family appear to believe that it is their company. The current Presidents at Toyota Motor and Toyota Industries are both members of the Toyoda family and they believe that they are maintaining the traditions established by the founder of the company, Sakichi Toyoda. They want to make sure that it will remain this way and no Japanese institutional shareholder is likely to challenge this system. An integral part of these traditions is a belief that employee rights should continue to be put ahead of shareholder rights.

This is the reality that Marty and all value investors face when they invest in Japan. What Marty originally described as a two to four year project has now stretched on for thirteen years and even the most patient investor would have to realise that Japanese attitudes to shareholders may not change within a reasonable period of time. This leaves Marty with the interesting dilemma of what to do with the remaining 8,129,400 shares. Only time will tell but hopefully it will not end up as having been a value trap.

In the Q4 2004 newsletter Marty made the following interesting observation:

While investing in the common stocks of well-managed, well-capitalized companies when those securities are selling at discounts from readily ascertainable NAVs has worked quite well for Third Avenue over the long term, the Fund is prone to misjudgements. It seems to me that the vast majority of TAVF's misjudgements have revolved around being in bed with the wrong management from a Fund point of view, rather than any purely financial factors.

Could it be that Toyota Industries is another misjudgement? Have they got into bed with the wrong management?

In conclusion, it appears that Marty has gone through a Japanese learning curve that all value investors should study because it could provide them with a valuable lesson in avoiding value traps. After all, as Eleanor Roosevelt said: *"Learn from the mistakes of others. You can't live long enough to make them all yourself."*

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