Is Japan a Value Trap?

There are plenty of companies in Japan that sell at a discount to net tangible assets. In other words there are plenty of companies that appear to have a margin of safety built into their current share price. This would appear to be a potential major opportunity for value investors; but is it as straight forward as it may first appear?

One of the first things a value investor is taught is to think like an owner: think like somebody that is in control of the total business and think about the long term intrinsic value of the company. The value investor believes that if you can buy a company at a discount to that long term intrinsic value and hold the shares for the long term well then there will ultimately be a catalyst that will move the share price closer to that intrinsic value.

So why is it that I want to raise the question of whether it is possible for a value investor to think like an owner in the Japanese market?

I think the best way to illustrate my point is with an example; the example I have chosen is of a company called **Shimachu** (8184:JP).

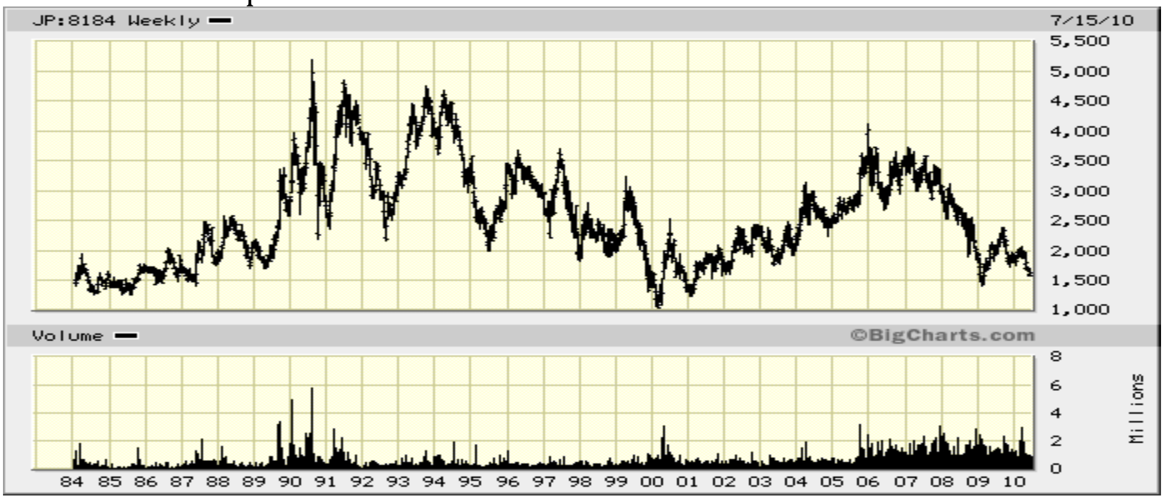
SHIMACHU CO., LTD. is a Japan-based company engaged in the retail business. Together with its subsidiaries, the Company is principally involved in the provision of furniture and home center products in Tokyo, Saitama, Kanagawa, Chiba, Gunma and Tochigi, Hyogo Prefectures and Osaka. The Company provides products including living ware and household products, storage furniture, interior products, pet items, gardening products, living and lighting apparatus, bicycle and car supplies, leisure goods and stationeries, among others.

I first began researching Shimachu about twenty years ago. On one of my earliest trips to Japan I went to visit one of their stores in Kanagawa to the south of Tokyo and on one of my following trips I went on a visit to meet management at their Saitama headquarters to the north of Tokyo.

I was interested in them because they appeared to be a potential leader in a fragmented industry and they had a strong balance sheet with net cash. At the time they were primarily based in the greater Tokyo area and it looked like there was a major opportunity to expand to other urban areas. In other words it looked like an interesting growth story.

Here we are twenty years later and Shimachu has followed a strategy of expanding away from Tokyo. It has closed some smaller stores and opened bigger ones. It has grown sales from Y117bn in 2001 to Y138bn in 2009 but net profits have gone from Y7.1bn to Y6.7bn.

In other words growing sales has not been matched by growing profits. Here is a long term chart of the share price:



Irrespective of why the current share price is where it is, the point that I want to make is that at the current price of Y1,600 I think that Shimachu looks like an interesting value stock. To support my assertion, here is an analysis of the balance sheet from May 2010:

Current Assets	**Ym**	**Ym**
Cash & Securities		29435
Receivables		5008
Inventory		17995
Other current assets		4756
Total Current Assets		57194
Long Term Assets		
Property, Plant & Equipment -Net	116091	
Long Term Investments	25893	141984
Total Tangible Assets		199178
Intangible Assets		463
Total Assets		199641
Current Liabilities		
Payables		27410
Other Current Liabilities		6054
Total Current Liabilities		33464
Long Term Liabilities		3680
Total Liabilities		37144
Shareholders Equity		162497
		199641

From the Balance Sheet above we can calculate a net tangible asset value of Y162bn

($1.8bn). As of July 15th 2010 the market capitalisation of Shimachu was Y80bn ($0.9bn). In other words this is a company that appears to have a significant margin of safety because it trades at a 50% discount to net tangible assets.

Given such an apparent margin of safety, why is it that I do not own any shares? This is where I start to talk about thinking like an owner.

Shimachu is a typical Japanese company:

- All directors are Japanese.
- All directors are male.
- The youngest director is 53.
- My guess would be that most of them have worked for the company for all their careers.
- None of the directors are independent
- The majority of shareholders are Japanese.

From my experience this is where cultural differences come into play. These executives believe that they "own" the company. They see foreign shareholders as short term traders that are an inconvenience. They do not think of foreign investors as owners and there is no way that they will let them act like owners. To support my assertion I think the fact that they do not have an English language website highlights the way that they discourage foreign investors.

Back in 2007 a leading investment bank wrote a report looking at the value of Shimachu in a leveraged buyout (LBO) scenario. They even attempted to look at underlying property values based on the sale of one of their small stores. They concluded that Shimachu was worth Y4,000 per share. Those were the days when there was hope that a buyout might be possible. It was in the days before Japan clamped down on potential buyouts. It was in the days before the **Bulldog Sauce** story had reached a conclusion!

For readers that have not heard the saga of hedge fund Steel Partners' involvement with Japanese company Bulldog Sauce I recommend that they read it on the Steel Partners website[1]. To quickly summarise, I think all I need say is that Bulldog Sauce was trading at a discount to what Steel Partners thought it was worth. They bought a large shareholding and became the largest shareholder. They then tried to buy the whole company, but ultimately after a court battle the existing management were able to retain control of the company.

Steel Partners has also tried to gain control at companies like **Noritz** and **Sapporo Holdings** and they have failed. (They had one success at a company called **Aderans** but I would argue that Aderans is not a main-stream Japanese company)

I would guess that if a foreign investor tried to buy a controlling stake in Shimachu they would suffer the same fate as Steel Partners. Institutional Japanese shareholders and the Japanese legal system have clearly sent out the message that they will not allow foreigners get to the point where they can really be owners. Foreigners are expected to remain passive disenfranchised shareholders with no influence over management. A value investor is therefore left in a dilemma: how can they tell how long it will take for this to change? (It might not change in my lifetime!)

In conclusion I just want to say that I would love to believe that there is a great opportunity to buy "Value" stocks like Shimachu in the Japanese market, but my worry is that they are cheap for a good reason. I think that there are better opportunities in other parts of the world and that if things change in Japan I will hopefully have time to act upon that change.

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