

JAPANESE EQUITY / JULY 2009

Who to Believe

Corporate earnings for fiscal year 2008 in Japan have come and gone. The news was desperate, particularly for those companies largely exposed to the global economic cycle. In aggregate, earnings per share for the TOPIX Index fell into negative territory for the year, driven by massive losses at auto and electronic firms. Only a very few of Japan's leading manufacturers managed to report positive earnings. A look at the companies that did manage to increase corporate value in such a difficult environment suggests a number of commonalities, which we believe point a way for identifying long-term winners. Interestingly, these common features were more related to competitive positioning and management than to the specific industries where these companies competed. In addition, the outlook provided by these companies paints a decidedly different picture of how the environment may trend over the course of 2009 compared to commonly accepted views.

Some of the companies that produced positive absolute earnings during 2008 include Nidec, a maker of spindle motors, Shin-Etsu Chemical, a maker of PVC, Rinnai, a maker of hot water heaters, Makita, a maker of hand tools, and Daikin Industries, a maker of air conditioners. All of these firms enjoy a sizeable market share in the products they make. They also tend to earn money in both the developed and developing markets, providing a more diversified profit base. All of these companies were able to maintain pricing more effectively than their rivals, despite a drop-off in volumes similar to other durable goods makers. All of them acted relatively swiftly to cut costs and lower overall breakeven levels in an effort to support profitability. In summary, we think that the winners tended to have a substantially greater control over their own financial destiny.

In contrast, the firms that produced huge losses were hostages to the environment. As demand for goods dropped, pricing fell precipitously. As the losers tended to be in very competitive industries, already low levels of profitability quickly turned into "red ink." Typically, we believe that managements of these companies were slow to respond to the new environment. As the previous few years had been driven by investments focused on market share gains, we think that most managers felt the downturn was likely to be a temporary event and were unprepared to take immediate steps to cut longer-term investment objectives. The consequence was that, as the slowdown intensified, losses ballooned and a rush to slash production and cut inventories ensued.

As the developments discussed above transpired at exactly the same time financial budgets for the full year 2009 were being put together, we think that a review of what the outlook implies for the rest of the year is instructive. Generally, the stronger companies, which were able to manage profits despite the collapse in demand, are forecasting that 2009 earnings will follow a fairly similar pattern. Most of these companies see little signs of a pick-up in the first half of the year and see only a modest improvement in the second half; because they were generally quicker to cut costs, and have more control over pricing, they forecast profits to remain positive throughout the year. In contrast, the weaker companies, while projecting a small pick-up in the first half of the year, are expecting a rapid "V-shaped" recovery into the second half. This is interesting, as it is a necessary prerequisite for this group to manage to achieve profits for the full year. Thus, in aggregate TOPIX Index earnings are forecast to be down 70% year-over-year in the first half, and up 624% year-over-year in the second half.¹

In essence, the companies that, thus far, have managed the cycle far more effectively have remained resolutely conservative for 2009; those who were overwhelmed by cyclical forces are the most optimists for a recovery. The question of who to believe is finely balanced: the nascent recovery in stock prices would support a "V-shaped" optimism, but it would seem more credible to put faith in those companies that have been ahead of the curve in managing this cycle. If the winning firms are right, investors may expect a healthy dose of second-half earnings disappointment.

Written by:
Timothy Griffen, Director, Portfolio Manager/Analyst

NOTES:

1 Source: CLSA Securities

Published on 6 July 2009.

Past performance is not a reliable indicator of future results.

Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Investments in Japan are subject to certain risks, such as the risks associated with the economy of Japan generally. A portfolio of securities concentrated in one country or geographic region may be subject to greater volatility than a more diversified portfolio.

The securities identified are not necessarily held by Lazard Asset Management for all client portfolios, and should not be considered a recommendation or solicitation to purchase or sell these securities. It should not be assumed that any of the referenced securities were or will prove to be profitable, or that the investment decisions we make in the future will be profitable or equal to the investment performance of securities referenced herein.

This report is being provided for informational purposes only. It is not intended to, and does not constitute, an offer to enter into any contract or investment agreement in respect of any product offered by Lazard Asset Management and shall not be considered as an offer or solicitation with respect to any product, security or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited. The information and opinions presented in this report have been obtained from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions and estimates expressed herein are as the published date, and are subject to change.

© 2009 Lazard Asset Management LLC