Edinburgh Partners

Japan Update **March 2011**

Whilst the tragedy unfolding in Japan is complicated by the threat posed by the situation at the Fukushima Daiichi nuclear facility, there is a precedent for considering the likely economic consequences of the earthquake and tsunami and the impact on corporate earnings over our 5-year forecast horizon.

As one would expect, commentators are making comparisons with the 1995 Kobe earthquake and the stockmarket reaction thereafter. We do not think these comparisons are appropriate. In 1995 the stockmarket was expensive - trading on a (backward-looking) cyclically adjusted PE of over 35x. Currently, the cyclically adjusted PE is less than half the 1995 level and, although earnings growth will be hampered in the near-term by the residual effects of the earthquake and tsunami, it remains reasonably robust.

Our key focus, as always, is assessing the extent to which the tragedy will have a meaningful impact on our long-term earnings forecasts for the companies under our coverage. In most cases the key question is the extent to which production facilities have been affected by the earthquake and its aftermath. For many, where the plant remains intact, we are considering only shorter term supply chain disruptions. In cases such as the construction and power companies we are looking at comparatively larger and more sustained impacts.

Probable impact of temporary disruption upon our earnings estimates

Our analysts expect that, for the following companies under current coverage, our long-term earnings forecasts will not vary by more than 10%.

In general, the price moves for these companies appear excessive to us and we expect that we will see sustained appreciation when the nuclear threat abates and general sentiment improves. Once we are able to confirm our initial findings we will look, where appropriate, to increase the holdings.

Dai Nippon Printing
Bridgestone
Mizuho Financial
Fujikura
Yamaha Motor
Fujitsu
Panasonic
Canon
Mitsubishi Corp
Ricoh
KDDI
Sony
Omron
Tokyo Electron

Stock example - Bridgestone

Production – Bridgestone has 5 plants in the Kanto region; 3 tire manufacturing, 1 steel cord and 1 diversified products. All five were closed while safety was verified, there is no "critical damage" to any of them and production has restarted at one. In context, there are 48 tire manufacturing plants worldwide, 10 are in Japan and 3 are in the affected region. So production looks unlikely to be affected in any direct material way, it is not clear yet whether the power cuts will have a material impact elsewhere in Japan.

Sales - Japan currently represents around 25% of Bridgestone's turnover and some 37% of EBIT. By year five this proportion is forecast to fall to around 22% of turnover and just 26% of EBIT. It seems likely that near term sales will be reduced due to car production issues, but should probably not be affected longer term unless there is a wider impact on the world economy. Profits on sales to the automotive industry are very thin, so it is the impact of consumers (replacement) and the mining companies (speciality) that are more important in group terms.

Costs - The rubber price has fallen around 20% from its highs of early February. Depending on the timing of purchases/forward contracts etc we may see some windfall profits earlier than expected, assuming the recent price hikes are not reversed.

Whilst the short term situation remains somewhat unclear, we are leaving our forecasts unchanged. Subject to no global setback, the long term continues to look reasonable, while the near term may well have some margin upside.

Probable impact of more sustained disruption upon our earnings estimates

In the following companies, we anticipate a potential positive change of more than 10% in our long-term earnings forecasts:

Kajima
Taisei
Obayashi
Shimizu

Notwithstanding damage to production facilities, these construction companies are likely to benefit from a significant increase in public works for the rebuilding of public infrastructure.

Conclusions

In general, the price moves appear to us to be excessive and we anticipate that we will see them recover. The two principal caveats to this relate to nuclear risk on the one hand and bond market risk on the other.

The situation at the Fukushima reactors remains unclear. The current expert appraisals suggest minor contamination at a local level but it is hard to discern and until such time as definitive statements are made by the authorities the concerns will remain.

The reconstruction financing needs form the other concern. There are arguments that repatriation of funds to finance reconstruction will push up the yen, hurting exporters. Another line of thought is that with the existing fiscal deficit and the potential for weaker GDP growth, one will see increasing costs of funding and pressure on government finances. Both arguments are reasonable although it is interesting that there are simultaneous concerns about assets (repatriation) and liabilities (funding). Thus far, the estimates of damage look to be around $100bn with perhaps one quarter to one third being funded by insurance claims. We expect that there will be little or no impact on our two western insurance companies' earnings: Aviva has no direct exposure to the Japanese market and AXA's is negligible.

A different interpretation is that the magnitude of this disaster is such that it will stimulate national unity in the political process and we will see a co-ordinated reaction from the Treasury and the Bank of Japan. Early signs of this are encouraging.

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