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Nihon Equity Report

Analysis of Smaller Japanese Stocks and Their Investment Environment

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Company Note

Intelligence Ltd. Is Strong Play in Recruiting Industry

Japan's human resources service sector (recruiting, staffing, and information providers) is benefiting from (1) economic recovery; (2) shortages of skilled employees; (3) changes in IT that require staff with specific skills; and (4) the end of Japan's life-time employment system. One HR company that offers good value is Intelligence, Ltd. (JASDAQ: 4757, ITKYF), which has recruiting, staffing, and media/job info segments.

Last year the Company (est. 1989) merged with Gakusei Engokai (est. 1956), a publisher of job search info for students and those changing careers. JASDAQ stocks have a reputation for high valuations, but Intelligence's P/E in mid-August was about 14 based on estimated 2/08 profit. The merger and fiscal year-end change (the 2/07 fiscal period was five months long) make comparisons

difficult and may well have investors confused. But estimated 2/08 EPS is Y12,497, about four times that for 9/06, the last full fiscal year. We don't think the current share price fully reflects this advance.

The merger initially caused some issues, including a system glitch in Gakusei Engokai's main recruiting media site "An." But it appears that the synergy from the media presence and recruiting services is working, and first-quarter profits exceeded 50% of the Company's half-year estimate for 8/2007. (Due to planned second-half advertising, however, the full-year profit projection may need to be scaled back.) The share price as of August 17 was Y179,000. Morgan Stanley has a target price of Y360,000, while UBS's is Y486,000.

Investment Trend

Green Investing Becomes More Popular in Japan

Environmental (or green) funds, which have until recently posted strong results in the U.S., are gaining popularity in Japan. Nikkei recently reported that the balance of green funds in Japan at the end of June was Y720 billion (about \$6 billion), double what it was the year before.

The global warming issue has attracted keen interest in Japan, and individual investors are demonstrating their concern by dramatically increasing investments in environmental funds. Two fund companies, Shinko Investment Trust Management and Deutsche Asset Management, have recently launched new green funds. The new Deutsche vehicle started with a high initial

asset balance of Y154 billion, ranking third among new funds established this year.

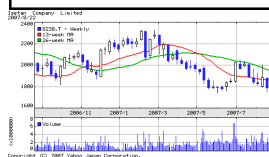
As in the US, the definition of a green fund varies. Some funds are more purely environmental plays than others. The Nihon Securities Journal reports that some of the major holdings by environmental funds include large-caps like Toyota (7203), Kyocera (6971), Denso (6902), and Shimadzu (7701) that are perceived as environmentally friendly, but would not ordinarily be considered green investments. Other funds, however, include stocks that are specifically driven by environmental factors, such as Ibiden (4062), the world's leader of filters for diesel engines.



Mitsukoshi

The Company is the grand dame of Japanese department stores. But it's never recovered from the sharp turnaround in the early 1990s. In recent years it has closed major stores and attempted restructuring, but it has still struggled to recover. Given the high value of its real estate versus its market cap, it was a strong candidate for merger.

A Mitsukoshi-Isetan combination would be something like a merger of Saks and Macy's.



Isetan

The Company has a strong reputation for management systems and in recent years has streamlined its operations. Thus its executive team will likely take the lead in implementing efficiencies in purchasing, logistics, etc. in the merged company. Isetan has also been active in seeking tie-ups, forming alliances with both Tokyu and Meitetsu department stores.

Retail Consolidation

Mitsukoshi and Isetan Set to Merge Operations

Mitsukoshi (2779) and Isetan (8238), the fourth- and fifth-largest department stores in Japan, have agreed to merge. Together the two firms generated ¥1.6 trillion in sales for the February 2007 year. Thus the combined company would be the largest department-store operation in Japan, exceeding Daimaru-Matsuzakaya whose merger into the new firm J. Front Retailing is expected to be completed in September.

A Mitsukoshi-Isetan combination would be something like a merger of Saks and Macy's. Mitsukoshi, whose history extends back to the 17th century, caters to a rich, upscale clientele, while Isetan has a strong following among younger people for its fashion sense. Although some observers suggest that matching the old and rich with the

young and hip makes a nice fit, it would also seem the new company would have to move carefully to avoid alienating either group of core customers.

Geographically, though, the two firms are a good match. Mitsukoshi's historic base in Tokyo is Nihonbashi and it has stores in Sapporo and Nagoya; in total, Mitsukoshi has 20 units. Isetan's Tokyo home is Shinjuku, with six other stores in the Tokyo area, including Kichijoji, Tachikawa, and Urawa (Saitama); it also has four regional stores and eight shops in Asia. Mitsukoshi's units are located throughout Japan and Isetan's are mostly in the Tokyo area, so except in Fukuoka, [there isn't much overlap between them](#). There's also geographic diversity overseas, because Mitsukoshi has more shops in Europe than

more shops in Europe than in Asia.

Mitsukoshi has been having financial difficulties for a long time. The chain depends heavily on seasonal gift-giving by corporate customers, and [sales for this group fell 15.5% last year](#). Japanese department stores suffered heavily during the long business drought of the 1990s, and they have been stung by competition from supermarkets, specialty stores, convenience stores, and other retail formats. Lately things have picked up a bit, however: Department-store sales rose 5.5% in June, the fastest pace in nine years, although much of that may have had to do with starting summer discounts earlier to take advantage of an extra Saturday in the month.

Regulatory Reform

Japan's Gets Ready for Its Own Sarbanes-Oxley (SOX)

The Financial Instruments and Exchange Law is Japan's version of SOX, hence its informal name of J-SOX. Scheduled to go into effect for Japan's 3,800 listed companies and their foreign subsidiaries in April 2008, J-SOX is being adopted by many firms right now.

Japan's regulators have

sought to avoid the missteps of SOX by implementing a less onerous regime based on broad principles that leaves much of the actual procedures up to company managers. This should result in fewer complaints from Japanese companies, but maybe also a lot of confusion about just what they should do to comply.

Among the worries Japanese managers have is finding the personnel to do the work. Japan has only about 17,000 CPAs, a small fraction of the number in the US, and importing Japanese-speaking accountants from abroad does not seem a realistic possibility. Audit automation will thus be critical to the process.