

Nihon Equity Report

Analysis of Smaller Japanese Stocks and Their Investment Environment

Volume 1, Issue 6

September 2007

Company Note

TEPCO (9501) Gains Attention from Small Investors

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The August 21 issue of *Nikkei Money*, a magazine on Japanese investing, had a poll of individual investors regarding their views of the Japanese market and promising stocks. Of the names investors are paying most attention to now, the number-one choice was somewhat surprising. Leading such internationally known blue-chip companies like Toyota, Sony, and Honda was Tokyo Electric Power, or TEPCO (9501, TKECF), the normally stable (and boring) utility that supplies 30% of Japan's electric power.

A poll of individual investors may not be the best authority for stock selection. However, in this case, especially for long-term oriented investors, the current price of TEPCO justifies consideration. After more than doubling in price over the past four years, the stock nose-dived last month after the 6.7 magnitude Nii-gata earthquake hit the Company's Kashiwazaki-Kawari nuclear plant.

In August, the UN nuclear watchdog, the International Atomic Energy Agency, said that the damage to Kashikawazki-Kariwa appeared to be less than expected. TEPCO plans to open and inspect all reactors at the plant by early November to determine the extent of the damage. Company officials declined to speculate when asked in late September when the plant would reopen. However, some analysts have said the plant is likely to remain inoperable at least for a year.

In its July 31 release of 1Q 2008 results (ended June), TEPCO estimated the damage from the incident to be around ¥282 billion and revised its March 2008 net profit estimate downward

from ¥310 billion to ¥65 billion (or ¥230 to ¥48 on a per share basis). The financial damage was so extensive because, in addition to paying for repairs, TEPCO will be forced to replace the lost energy through alternative sources that are expensive due to high oil prices. Indeed, fiscal 2007 fuel oil costs are expected to rise more than ¥500 billion because of growing consumption and surging crude oil quotes.

At a recent price of about ¥2,900 at the start of October, the stock is at the bottom of its calendar 2007 range, compared with a five-year high of ¥4,530 in February. However, investors seem to think the worst is over. The P/E based on 3/2007 net is about 13.2, and the valuation based on the previous, pre-earthquake estimate is 12.6, as compared with the sector average of about 23.

Worst-case scenarios add virtually no risk: this quasi-public supplier of 30% of Japan's power won't be allowed to go out of business, and it has sufficient liquidity and funding sources to turn to. On August 9, Moody's rated TEPCO's bonds Aa2 and said it didn't see any impact on the Company's credit rating from the plant damage.

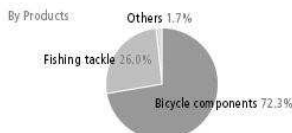
While TEPCO hasn't released the estimated re-start date of the plant yet, over the medium- to long-term we expect reported profits to return to the prior-year level. The trend of steady growth to continue, which should be reflected in the stock price. Although we don't expect a sharp bounce in the stock soon, TEPCO appears to be a good investment for the longer term.



Stock Price

Although Shimano's share price has recently recovered on the back of positive earning news, the current level of ¥4,040 (10/02) is below the previous high of ¥4,330 in June this year. Based on the revised estimate for FY 2007, Shimano has a P/E of 20, not quite cheap but below the average for Japanese bicycle makers of about 25.

Since the 1990s, a majority of the world's professional bicycling teams have used Shimano components.



Product Breakdown

Shimano's product breakdown has remained fairly consistent over the past three years, with bicycle components representing some 72% to 76% of sales. Shimano has made bike parts since 1921; the fishing tackle division began in 1970; and the small Active Sports division including snowboards, was set up in 1997.

Company Note

Shimano (7309): Premium Bike Components Maker

Shimano is a high-end, Japanese bike parts manufacturer that provides an integrated line of products, including shifting gears and driving and braking components. The Company also makes fishing gear and snowboards, but bike components represent more than 70% of sales, the majority of which are in the US and Europe.

The Company has a dominant share in components for racing and mountain bikes; notably, in driving components, it has an 80% share of the global market. Since the 1990s, a majority of the world's professional bicycling teams have used Shimano components, bolstering the Company's reputation for high-performance products. Profitability exceeds the competition's: over the past three years, the Company's operating margin ranged from 12.3% to 17.4%, versus the sector average of 10.8% for Japanese bicycle makers.

Since mid-2006, the share price has become more volatile. The immediate reason is the Company's negative surprise for midyear (June) 2006 results: year-over-year revenue declined slightly and recurring profit fell 34%, causing Shimano to shave its fiscal 2006 estimate. Investors thought that this super-premium niche

manufacturer with worldwide diversified sales should have been better able to estimate profits and punished the stock accordingly.

However, in 2007 the mid-term profit surprise was positive. On August 22, Shimano announced revenue rose 24% to ¥99.8 billion and operating profit gained 47% to ¥14.3 billion, primarily because of robust sales for medium- to high-end mountain bikes in Europe and the US. The Company also raised its fiscal 2007 revenue estimate from ¥184 billion to ¥195 billion.

At this point, we believe the stock's positives outweigh the negatives. The latter includes volatility in the financials. The Company attributed lackluster 2006 revenue to bad weather in Europe. But industry observers tell a different story. The Company initially focuses on gaining market share and, after gaining a certain level of market exposure, it begins to emphasize higher-margin and replacement markets. At the start of the cycle, there is margin pressure due to the aggressive pricing and sales/marketing expense. It seems like 2005 and 2006 -- when Shimano introduced a series of major new products geared to the high-end market -- represented this early phase of the cycle, while

2007 is indicative of a later, more profitable period.

As long as the premium competition and recreational bike market continues to grow, Shimano has a solid position selling parts to bicycle makers. It provides components as a package instead of individually, making them easier for bike manufacturers to install. Thus the cost of switching to other makers from Shimano is high.

One last wild card is the Company's new "Coasting" system which includes a computer that automatically shifts gears. It's like an automatic transmission for bikes, and it's targeted to leisure bikers who prefer not to deal with 30 shift gears. Introduced in 2007, it's put in bikes with prices from \$450 to \$700.

We think it's too early to place this item in the overall profit picture. Even if Shimano sells at the upper end of its estimate of 50,000 to 100,000 units in the initial year, the added revenue to the entire company would be only around 0.5% of the sales. On the other hand, if we hear our mother-in-law start talking enthusiastically about this "entirely new biking experience" and telling all 20 of her cycling friends, we'll be calling all the bike shops to monitor closely the sales trend.