Toshiba ended below ¥1 trillion mkt cap in 2015

Recovery CD-ROM still infected with goodwill virus

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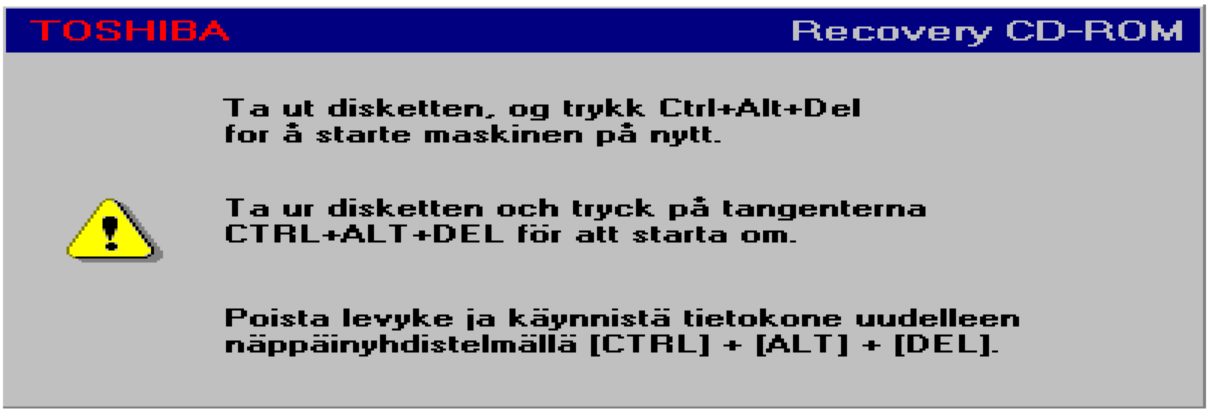


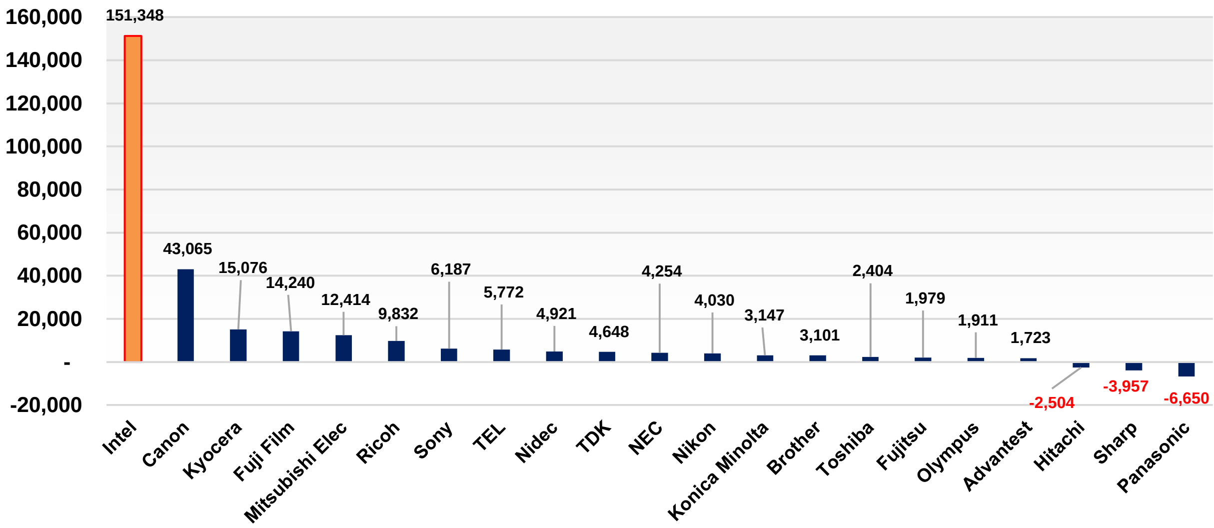
Apple used to trade a Toshiba's market cap on a 5% move. Now it's only 1.4%

I once joked soon after Lehman shock that Apple's overnight move of 5% was the equivalent of the vanquished Toshiba market cap. Now Apple only needs to move 1.29% to increase / decrease the equivalent amount of Toshiba's mkt-cap. It shows just how far the Japanese tech giant (?) has slipped. When we look at reality, the accounting scandal, the appointment of 50%+ independent directors on the board and the likelihood of having to write down goodwill, the former tech giant faces further woes. Toshiba is in dire need of a 'crisis' manager to restore lost fortunes.

Intel made more than top 20 Japanese tech giants combined

We wrote in our previous note, *'Japan's Misguided Matryoshka M&A'* on December 9th, that *"In the last 25 years, Intel Corp on its own has managed to make 31% more net income than all 20 of Japan's largest tech companies combined on a currency adjusted basis. That is right. Intel on its own has thumped the likes of Sony, Panasonic, **Toshiba**, Sharp, Mitsubishi Electric, NEC, Hitachi, Fujitsu, Fuji Film, Konica Minolta, Brother, Nidec, Kyocera, Canon, Olympus, TDK, TEL, Ricoh, Advantest and Nikon combined."*

Fig 1 :Intel vs Japan's Largest 20 Tech firms in the last 25 years (US$mn Net Profit)



Source: Custom Products Research

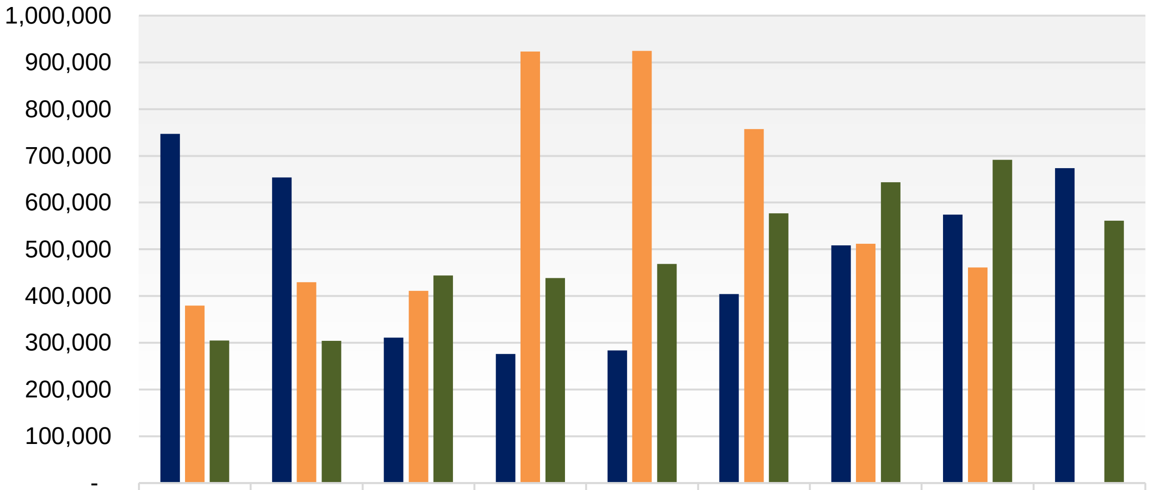
With the most recent revision to forecasts suggesting a ¥550bn loss for FY3/16E, Toshiba will have made in aggregate negative net profit over the last two decades. In the last trading week of 2015, Toshiba's market capitalisation sunk below ¥1 trillion.

Goodwill to think about

Goodwill coming next

Toshiba is now faced with almost ¥680bn in goodwill, a figure that troughed in FY3/11 at ¥276bn. As an aside we note that Sony also has ¥561.2bn of goodwill left on its balance sheet. Panasonic (6752) cleared the decks in FY2014.

Fig 2 : Purging Goodwill



	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Toshiba	746,720	653,910	310,715	276,321	283,453	404,157	508,145	574,520	673,817
Panasonic	379,324	429,902	410,792	923,001	924,752	757,417	512,146	461,191	-
Sony	304,669	304,423	443,958	438,869	469,005	576,758	643,243	691,803	561,255

Toshiba Panasonic Sony

Source: Custom Products Research

We note from Toshiba's November 17th, 2015 press release that as of September 30th 2015,

Toshiba promises to report goodwill impairment quicker

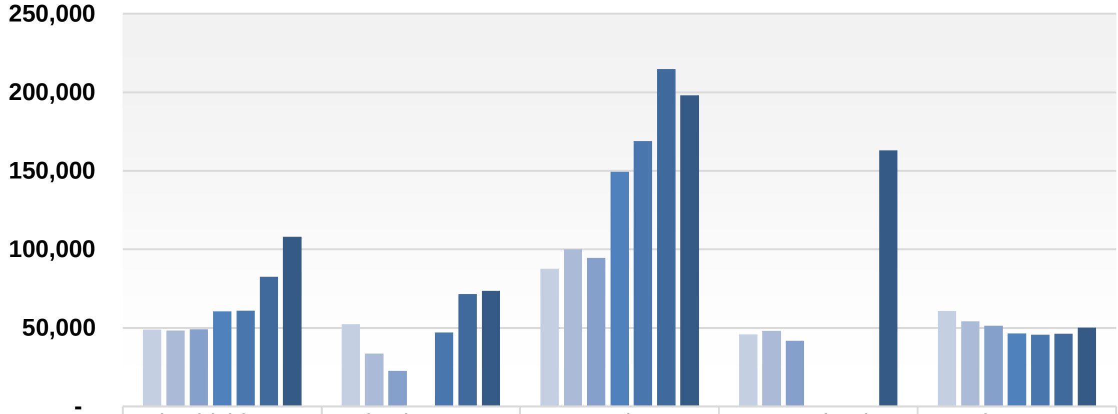
"Westinghouse Group has recorded goodwill of approximately $1,520mn (¥182.8bn) and Toshiba has recorded goodwill of approximately ¥344.1bn in its consolidation…Although impairment recorded Westinghouse Group did not influence Toshiba's financial consolidated statement, impairment recorded by Westinghouse Group in fiscal 2012 fell under the guidelines for timely disclosure and the Company should have disclosed it appropriately at the appropriate timing…Toshiba will henceforth make prompt announcements in respect of any item that requires disclosure and the Company will also proactively disclose information, including on Westinghouse, to the fullest extent possible."

One imagines that goodwill write-offs are next on the menu at Toshiba for investors to dwell on.

Trading house goodwill

We also note that the Japanese trading houses have accumulated an awful lot of goodwill in recent years. Itochu has almost ¥200bn of goodwill, followed by Marubeni at ¥163bn, Mitsubishi Corp at just under ¥110bn with Mitsui and Sumitomo at around ¥73bn and ¥50bn respectively.

Fig 3 : Trading House Goodwill (¥mn)



	Mitsubishi Corp	Mitsui Bussan	Itochu	Marubeni	Sumitomo Corp
FY2008	49,017	52,488	87,560	45,771	60,685
FY2009	48,361	33,640	100,057	48,152	54,305
FY2010	49,206	22,717	94,673	41,790	51,474
FY2011	60,498	-	149,506	-	46,390
FY2012	60,859	47,075	169,066	-	45,725
FY2013	82,535	71,603	214,773	-	46,264
FY2014	108,137	73,502	198,205	163,157	50,164

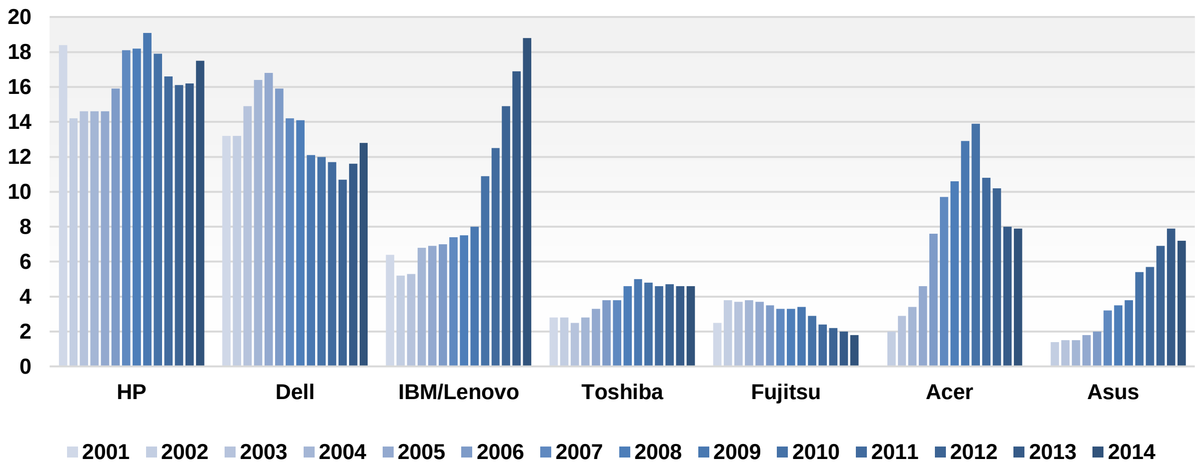
Strategy (or lack thereof)

One would have hoped that the independence of the majority of the board would lead to a heightened sense of urgency and crisis management. The recent news is that Toshiba is in talks with Fujitsu again to merge their loss making PC units where the two share 6% of the global market.

Strategy anyone?

There is a lot of precedent suggesting that this is a fruitless exercise. As one of my colleagues put it best, *"two drowning men together don't make a swimmer"*. One would hope that Toshiba's revived sense of corporate governance would see its board seek more severe action.

Fig 4 : Global PC Market Share (%)



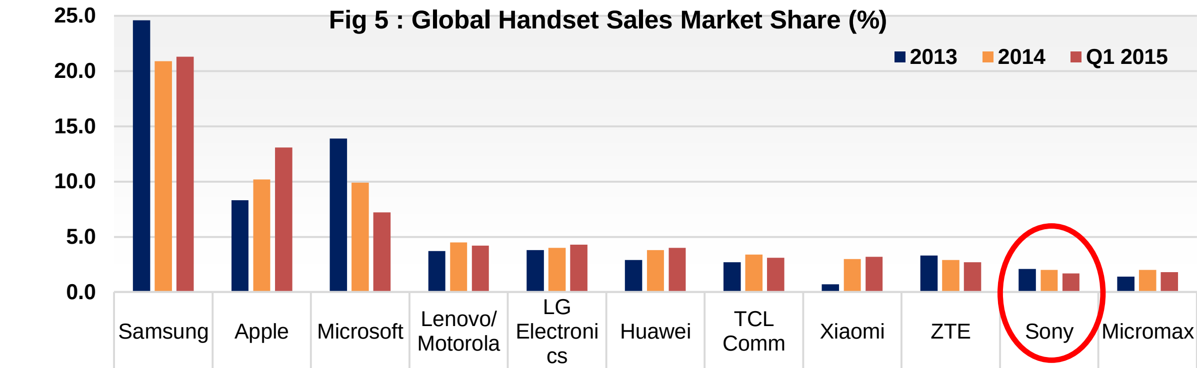
Source: Gartner, Custom Products Research

Lessons from the mobile handset maker mergers in Japan

Lessons from mobile phones

Japanese mobile handset makers have consolidated. Toshiba teamed with Fujitsu (surely a lesson in what a poor decision that has been), NEC with Casio and Hitachi, while Sony (albeit teamed with Ericsson until they merged) has had a rear guard action. Sanyo sold its handset business to Kyocera. Mitsubishi Electric just quit altogether in 2008. I remember a time when Japanese clam-shell phones were amazing. Friends from foreign lands would marvel at the designs, light weight and features versus the clunky Nokia and Motorola offerings of the time. They also were stumped at how these devices could get so much battery life. Alas, Japan kept them largely from overseas markets leaving them without the little scale efficiency from expansion abroad.

Fig 5 : Global Handset Sales Market Share (%)



	Samsung	Apple	Microsoft	Lenovo/ Motorola	LG Electronics	Huawei	TCL Comm	Xiaomi	ZTE	Sony	Micromax
2013	24.6	8.3	13.9	3.7	3.8	2.9	2.7	0.7	3.3	2.1	1.4
2014	20.9	10.2	9.9	4.5	4.0	3.8	3.4	3.0	2.9	2.0	2.0
Q1 2015	21.3	13.1	7.2	4.2	4.3	4.0	3.1	3.2	2.7	1.7	1.8

Source: Gartner, Custom Products Research

Doubling irrelevant market share still irrelevant

As smartphones have caught on, Japanese handset makers have been left further in the dust. Sony has the highest global share among Japanese brands at 1.7% (Q1 2015), however even in the domestic market, Apple and Samsung command the leading shares. Japan's market share in mobile phones globally has slid from 15% a decade ago to less than 4% in 2012. Japanese maker's global share of flat screen TVs slump from 45% to around 20% over the same period. What magic can a Toshiba-Fujitsu PC alliance make?

The time for a 'Crisis' leader not national service

Crisis leader a must

The tolerance to more tweaking is the last thing Toshiba needs. Rearranging the deckchairs on the Titanic did not stop it from sinking. It requires a Carlos Ghosn type visionary who will take to the type of aggressive restructuring that will fix the company rather than repeated use of the puncture repair kit.

Corporate altruism isn't sustainable

On the face of it, Toshiba does not appear to have any 'crisis' captains. We can debate the benefit of Japan Inc's corporate altruism that puts stakeholders and employees ahead of shareholders. However, even now the government realises that the old school way of running companies does not sit well with global financial markets. Now Toshiba does not have the earnings stability to sustain its workforce over the long run.

If it eventually boils down to a fire sale of assets, then the idea of pricing becomes a sticking point and when it comes to industrial companies, book value isn't book value.

Asset sales. Forget getting paid book value for assets

When Nissan was looking to close its Australian car factory the market expected that book value would be achievable with the asset sales. Reality was 10% of asset value was the upper bound. The land was in a factory zoned area and coupled with low demand at the time meant that it was forced to take a large hit. Toshiba may be trading at 0.94x PBR but one again, assuming asset sales start to take off in earnest, investors would do well not to bother about realising the stated value in the books.

Selling medical devices seems telling

Which raises an interesting point. Toshiba is set to sell off its medical device business, which is arguably one of their (no pun intended) healthier businesses from a profitability standpoint. While only 6% of revenue, perhaps it is one of the few assets that will attract a serious enough bidder at a healthy enough price for it to be meaningful. It is a problem when one has to sell the crown jewels to stay afloat. Other businesses will either require aggressive restructuring or closure. Shifting employees to a subsidiary or fiddling around with segmental reporting only obfuscates more.

Firing overseas employees

Nidec to pinch best employees?

Toshiba may be trimming 16,000 odd staff into next fiscal year. Interestingly the decision to cut 6,800 employees from their overseas businesses highlights once again that domestic social harmony takes a front seat to shareholders. We're not saying the action is not well intentioned but in a sense it is hardly the thing which will help get the supertanker turned around in the required time. Interestingly Nidec's Nagamori has offered to hire software, communications and robotics engineers from Sharp and Toshiba to 'help'. So the best engineers from Toshiba and Sharp will sign up for voluntary redundancy (aka tax effective bonus) and land a job with arguably one of the most profit focused Japanese tech companies, further gutting the 'best assets' from the ailing companies.

Of course restructuring is a word which brings 'shame' on Japanese boards. It is widely understood culturally but the reality is that shareholders and the corporate governance code is at odds with the thinking.

On the face of it, if Toshiba continues to manage itself like an old style Japanese corporation it runs the risk of accelerating its obsolescence.

Hitachi to the rescue?

We wonder whether the likes of Hitachi (6501) will be asked to do national service and look to merge elevator or power generation units to weather the storm. There might be synergy to come from such a move. However please recall the trivialities that emerged from the Black Knight that was Sharp (6753) at the time of Terry Guo's activist approach. All we have now is Sharp back where it was then, on the battlefield surgery gurney but with even fewer options to save the patient.

Other names of companies with high goodwill/intangibles

We took another look at other names of Japanese companies with high goodwill. Of course writing down goodwill won't be recorded as a cash charge but none-the-less depending on the extent of amortisation period needs to be accounted for.

We looked at goodwill/intangibles as a percentage of market cap and as a percentage of assets which can be seen in the following two tables.

As a percentage of total assets, we would note the goodwill related to many internet companies (e.g. Infomart, M3 etc.) names suggests a low base of fixed assets.

Pharmaceuticals and tobacco companies would carry a high level of goodwill in brand names. JT recently bought the ‘Native American Spirit’ brand for non-US markets including subsidiaries outside the US that sell the brand from Reynolds American Inc. for $5bn (286x 2014 PBIT). This is compared to an average of 13x PBIT for 79 other tobacco related deals over the last five years according to Bloomberg.

Ticker	Company Name	Sector	Mkt-Cap (¥mn)	Intangibles % of Mkt-Cap	Intangibles% of Total Assets
5202	Nippon Sheet Glass Company, Limited	Producer Manufacturing	88,548.0	229.6	22.4
7419	Nojima Corporation	Retail Trade	68,944.4	128.9	40.4
9984	SoftBank Group Corp.	Technology Services	7,316,824.5	115.1	39.3
6502	Toshiba Corporation	Consumer Durables	947,104.0	111.9	17.1
9375	Kintetsu World Express, Inc.	Transportation	151,488.0	85.7	33.6
7867	Tomy Company, Ltd.	Consumer Durables	70,388.6	65.6	28.6
5938	LIXIL Group Corp.	Producer Manufacturing	851,194.5	62.8	24.8
6141	DMG MORI CO., LTD.	Producer Manufacturing	189,045.9	61.2	20.1
7616	Colowide Co., Ltd.	Consumer Services	137,318.1	52.5	33.3
5012	Tonen General Sekiyu K.K	Energy Minerals	608,135.8	51.7	26.6
4324	Dentsu Inc.	Commercial Services	1,920,810.4	50.4	32.2
3407	Asahi Kasei Corporation	Process Industries	1,093,339.4	49.7	23.1
7752	Ricoh Company, Ltd.	Electronic Technology	894,639.4	48.6	15.4
3197	SKYLARK CO.LTD	Consumer Services	306,499.9	48.4	48.6
6448	Brother Industries, Ltd.	Electronic Technology	387,162.6	47.1	24.9
6457	Glory Ltd.	Producer Manufacturing	249,843.1	44.7	33.2
4559	Zeria Pharmaceutical Co., Ltd.	Health Technology	82,706.6	44.7	32.2
2587	Suntory Beverage & Food Ltd.	Consumer Non-Durables	1,656,240.0	43.9	47.1

Ticker	Company Name	Sector	Mkt-Cap (¥mn)	Intangibles % of Total Assets
4565	Sosei Group Corporation	Health Technology	162,996.7	81.9
2492	Infomart Corporation	Technology Services	77,051.1	56.7
6028	TechnoPro Holdings Inc.	Commercial Services	121,473.8	55.2
2120	Next Co., Ltd.	Consumer Services	181,272.2	53.3
3197	SKYLARK CO.LTD	Consumer Services	306,499.9	48.6
2587	Suntory Beverage & Food Ltd.	Consumer Non-Durables	1,656,240.0	47.1
2914	Japan Tobacco Inc.	Consumer Non-Durables	8,956,000.0	41.0
4502	Takeda Pharmaceutical Co. Ltd.	Health Technology	4,705,592.3	41.0
7419	Nojima Corporation	Retail Trade	68,944.4	40.4
9984	SoftBank Group Corp.	Technology Services	7,316,824.5	39.3
4544	Miraca Holdings Inc.	Health Services	305,572.2	38.9
4980	Dexerials Corp.	Process Industries	81,207.0	38.6
4612	NIPPON PAINT HOLDINGS CO.LTD.	Process Industries	922,841.3	36.8
2181	Temp Holdings Co., Ltd.	Commercial Services	443,385.4	36.8
6098	Recruit Holdings Co., Ltd.	Technology Services	2,046,458.4	35.6
2413	M3, Inc.	Commercial Services	829,141.5	34.5
9375	Kintetsu World Express, Inc.	Transportation	151,488.0	33.6
7616	Colowide Co., Ltd.	Consumer Services	137,318.1	33.3
6457	Glory Ltd.	Producer Manufacturing	249,843.1	33.2
4543	Terumo Corporation	Health Technology	1,416,506.7	32.7
4324	Dentsu Inc.	Commercial Services	1,920,810.4	32.2
4559	Zeria Pharmaceutical Co., Ltd.	Health Technology	82,706.6	32.2

Summary

As we enter 2016, goodwill will undoubtedly become a topic that pervades. Japan’s penchant for overpaying for overseas acquisitions only exacerbates the future write-offs that will be required on that goodwill.

There is a systemic problem from decades of poor advice over acquisition prices. It would seem little has changed and with more corporates headed overseas to fund growth to offset a declining home market we have the recipe for goodwill continuing to climb.

As for Toshiba, the goodwill that remains will provide further headaches for the company to help repair the stunted growth of its business lines. The partial or whole sale of the medical unit is indeed a sad precursor for perhaps what the real value of the tangible assets in other businesses actually is. Throw on the brightest employees who will voluntarily abandon ship to seek refuge in other companies is only going to lead to longer term damage.

While Toshiba flirts with a ¥1 trillion market cap, it would seem that nothing short of a crisis manager can attract the right sort of game changing strategy to resuscitate it. More of the same has not worked to date and is unlikely to work in the future.

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