# AVI Japan Opportunity Trust

Update
**10 April 2019**

## Summary

AVI Japan Opportunity (AJOT) invests in Japanese small-cap stocks, aiming to generate high long-term returns by taking advantage of extremely cheap valuations in that part of the market but also using shareholder activism to supercharge returns.

The £78m trust, launched in October 2018, is run by Joe Bauernfreund, also manager of the £900m British Empire Trust. Joe looks for asset-backed companies on low valuations where he can see a catalyst for a re-rating. In small cap Japan he has found what he believes is an outstanding opportunity. On a look-through basis, the companies in the portfolio have 78% of their market cap in cash or transferrable securities and are trading on 3.9 times EV/EBIT, compared to 8.7 times on the MSCI Japan Small Cap and 18.5 times on the S&P 1500 all-cap index.

AJOT is an activist investor and aims to take advantage of the political and regulatory pressure on Japanese companies to increase the efficiency of their balance sheets. One of the “three arrows” of Abenomics is policies for growth, and in part this means a determined push to put idle corporate cash and cross-shareholdings to more productive use and thereby boost shareholder returns.

In their view, AVI is therefore increasingly pushing on an open door. In the first six months of the trust’s life it has seen nine of its 29 portfolio companies make shareholder friendly moves, be that paying or increasing a dividend, buying back shares or other measures. NAV performance has also been solid, with the trust up 0.3% compared to a 1.6% loss for the MSCI Japan Small Cap index, to the end of March. Although it was aided by it not being fully invested during the global market downturn in November and December, most of the outperformance came when it was fully invested, illustrating the success of the stock-picking.

Following the encouraging start, and to take full advantage of the current opportunity, the company drew down £10.4m in borrowings in April 2019, amounting to gearing of 12.5% of NAV.

The trust has been trading on a premium since launch, in part helped by not being fully invested in the Q4 2018 market slump. The trust is now on a 3.2% premium. The board is yet to seek to address this, but the prospectus does allow for further share issuance if the trust is trading above NAV. AJOT will offer a liquidity option after four years and every two years thereafter, meaning that if returns are disappointing investors can redeem at close to NAV.

There is no specific income objective. However, AJOT’s portfolio currently yields 2.1% (at NAV) and, to retain investment trust status, the board will have to pay out 85% of that after costs. Through 100% charging costs to capital, the majority of the portfolio yield will flow through to shareholders as dividends.

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# Portfolio

AVI Japan Opportunity (AJOT) invests in Japanese small-cap stocks, aiming to generate high long-term returns by taking advantage of extremely cheap valuations in that part of the market. The trust was launched in October 2018 not just because of the egregiously low valuations, but also in order to profit from the trend towards improving corporate governance being forced on companies by the government and regulator. This has led to an increasing number of companies paying or hiking dividends, implementing buybacks or unwinding the infamous cross-holdings, which see Japanese companies invest in other companies' shares with no investment strategy or business purpose.

In the first six months of its life the number of corporate governance "wins" for manager Joe Bauernfreund has demonstrated that this is a real trend: of the 29 holdings in the concentrated portfolio – which is unlikely to grow higher than 30 – ten have announced new or higher dividends, implemented buybacks, announced they will begin to sell off their cross-holdings or other governance improvements.

### Portfolio Characteristics

| | AJOT | MSCI JAPAN SMALL CAP | S&P 1500 | MSCI EUROPE |
|---|---|---|---|---|
| EV/EBIT | 3.9 | 8.7 | 18.5 | 15 |
| Net Cash as % of Market Cap | 50% | 6% | -15% | -15% |
| NFV as % of Market Cap | 78% | 17% | -13% | -11% |
| Free Cash Flow Yield (Equity) | 6.20% | 5.30% | 3.90% | 5.20% |
| Free Cash Flow Yield (EV) | 31.60% | 6.40% | 3.40% | 4.50% |
| Dividend Yield | 2.10% | 1.90% | 1.10% | 2.50% |
| # of companies | 29 | 784 | 1,185 | 346 |
| Zero broker coverage | 66% | 27% | 2% | 1% |
| <= Two broker coverage | 88% | 62% | 10% | 3% |
| Median Market Cap (£m) | 491 | 630 | 2,779 | 14,735 |
| 5 Year Operating Profit Growth (Annualised) | 3% | 8% | 6% | 5% |
| ROE | 7% | 9% | 14% | 14% |
| ROE ex non-core assets | 18% | 10% | 10% | 10% |

Source: Asset Value Investors

The core of the strategy is valuation-driven, with the corporate governance angle the icing on the cake. The valuations in small-cap Japan are often absurdly low and offer the chance of excess returns from a reversion of these multiples alone. We illustrate below the numbers for the portfolio as of end March. Joe has put together a portfolio of stocks trading on an EV/EBIT multiple of just 3.9, less than half that of the MSCI Japan Small Cap market, which is itself cheap compared to global equity comparators. A potential source of AJOT's outperformance is therefore the expansion of these multiples closer to their global peers.

The companies in the portfolio also have on average 50% of their market cap in cash on the balance sheet, and 78% in cash and marketable securities – i.e. cross-holdings in the equity of other companies. This represents cash which is not being put to use in the business and not being returned to shareholders. The investment of or distribution of this cash is the second potential source of outperformance.

As the ROE numbers show, Joe has picked businesses which are strong in their own right. The ROEs ex non-core assets illustrate the operational strength of the core business to generate returns on shareholders' investments. By rights, the valuations of these companies should reflect their higher quality, but this is hidden by the inefficient balance sheet; this is a third potential source of excess returns.

Japanese balance sheets have been inefficient for decades, and the cross-shareholdings reflects an insular culture of management which has sought to protect managers' interests at the expense of shareholders. However, this is potentially changing thanks to a radical reform agenda which has been implemented by the Abe government in response to Japan's demographic decline and stagnant economy.

For example, Japan introduced a Corporate Governance Code in 2015, and then revised it further in 2018. The Code is designed to force management to consider minority shareholder interests in an attempt to make corporate Japan more efficient and boost growth in an economy which has been stuck in deflation for years. One critical obligation managers now have is to explain to shareholders how they plan to unwind their holdings in investment securities.

Crucially, the government has also implemented (2014) and revised (2018) a Stewardship Code which all large investors in Japan have signed up to which obliges them to hold management to account. This dynamic is aided by the Government Pension Investment Fund, the state pension fund and largest pension investor in the world, buying an increasing amount of stocks, making it a significant shareholder in many companies.

This means that when AJOT engages with management to encourage them to unwind their balance sheets and return cash to shareholders, they are unlikely to be a lone voice. Confidentiality means it is impossible to know for sure, but the trends in dividends, buybacks and the sale of transferable securities shows that the new activism is bringing results. Joe and the team tell us that they have sent 16 letters to 11 portfolio companies and, in their view, they are usually pushing on an open door. On only two occasions have they had a reluctant response, and in only one case has management resolutely disagreed with their analysis and proposal. Even then they were listened to constructively, and have not given up on eventual success. Japanese rules mean that it is possible to have a big effect with a relatively small shareholding: less than a 1% shareholding is enough to submit a proposal at an AGM, while just 3% allows the investor to call an EGM.

In the first six months alone, there have been ten corporate governance wins – six buybacks, two dividend hikes and two others, detailed in the table below. We think it is fair to say that Joe has been pleasantly surprised at the early validation of the investment thesis, and that this number of events beat expectations. The intention has always been to be a patient shareholder and the expectation is for the dynamic to unfold over a period of years, but the early signs are that this could represent a real trend and not just a false dawn.

The trust has promised a four-year liquidity option, allowing investors an exit in whole or in part. This was designed in part as a discount control mechanism, but also in recognition that there might be some scepticism as to whether the corporate governance dynamic was real. Joe Bauernfreund is also the manager of the £900 British Empire Trust (BTEM), which is a value-oriented global investment trust, aiming to capture the excess return potential in undervalued businesses. BTEM built up a portfolio of undervalued Japanese Small Caps in 2017 and 2018 and AJOT was launched separately to take full advantage of the opportunity. The smaller pool of capital (£77m net assets) means that AJOT can take meaningful positions in the smallest companies, where the cheapest stocks are. All of the nineteen positions in BTEM, except two legacy positions in runoff, are also held in AJOT. AVI aims to take meaningful positions in its companies, with the largest current ownership of 5.5% in Kanaden. The average ownership level is 2%.

For AJOT, Joe and the team screen for companies with a minimum of 30% net cash and securities and liquidity greater than £20,000 a day, which leaves them with 900 potential investments. They then look for the strongest businesses, the greatest valuation mismatches and the best opportunities for activism to have results. The universe and portfolio is well diversified across different industries but with a natural bias towards the industrial sector and those industries with more tangible rather than intangible assets. There is a strong domestic earnings bias, which means there is little currency risk in the portfolio beyond the translation effect. This and the more defensive tilt to quality characteristics such as low earnings volatility and away from cyclicals means that the portfolio is relatively low beta and should be less exposed

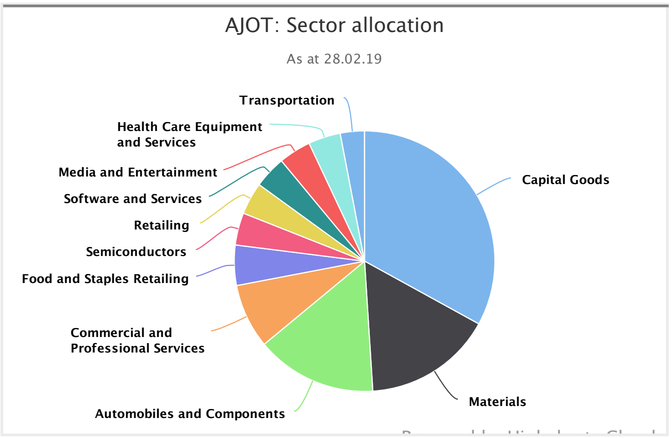
## Corporate Governance Wins In First Six Months

| COMPANY | AVI ENGAGEMENT | OUTCOME | SHARE PRICE | AVI OWNERSHIP |
|---|---|---|---|---|
| | | **BUYBACKS** | | |
| Kanaden | Five meetings; Two letters | 4.0% buyback (reduction of crossshareholdings) | 2% | 5.50% |
| King Corp | Two meetings | 3.0% buyback (in addition to 2.0% last year) | 17% | 1.80% |
| Tachi-S | Three meetings; One letter | 2.8% buyback – first in four years | 3% | 2.70% |
| Kato Sangyo | Four meetings; Three letters | 1.5% buyback (in addition to 1.5% in October) | 14% | 1.90% |
| Secom Joshinetsu | One meeting, One conference call | 6.5% buyback – first ever | -2% | 0.70% |
| Nishimatsuya Chain | One meeting; One conference call | 1% buyback Dec and 2% buyback March | 14% | 2.60% |
| | | **DIVIDENDS** | | |
| Daiwa Industries | One meeting; Three meetings | 2nd dividend hike since 1998. Two fold increase | 1% | 3.40% |
| | | **OTHER** | | |
| TBS | Five meetings; Nine letters | Reduction of cross-shareholdings | | 1.60% |
| Toagosei | Three meetings; Two letters | Cancellation of anti-takeover measures | -3% | 0.50% |

Source: Asset Value Investors

than the Japanese market as a whole to trade with China (and broader trade conflicts).

### Fig.1: Sector Exposure




Source: Asset Value Investors

With a target range of 25 to 30 stocks, the portfolio is highly concentrated, which academic research has shown is strongly correlated with alpha generation potential. In fact, the trust has the fewest stocks of any in the AIC Japan or AIC Japanese Smaller Companies sectors.

The intention is to sell down holdings as net cash as a percentage of market cap declines. If the net cash position on the whole portfolio reduces significantly, meaning the investment objective has been fulfilled, the directors will consider winding up the trust. It is up to the directors' discretion as to when this might be the case.

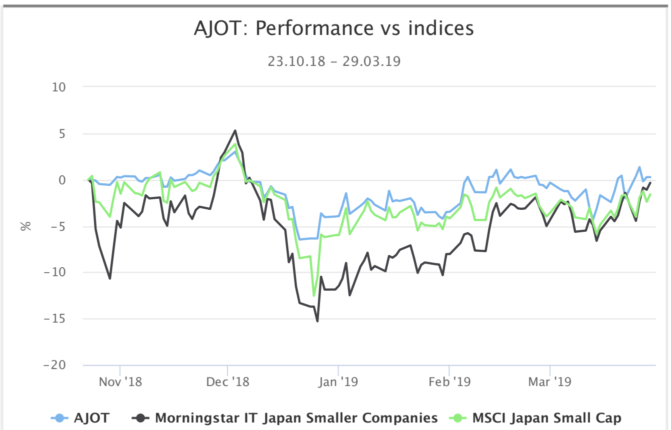
## Gearing

The trust has a revolving credit facility in Yen worth £10.4m which it arranged on 4 April 2019 and has already drawn down in full, meaning it is now 12.5% geared. We believe this reflects the positive start to the trust's life and the quality of opportunities the manager is finding. The gearing is intended to increase the exposure to the stocks already identified rather than dilute the concentration of the portfolio. The deep value stocks bought by the trust are by their nature relatively low beta, so in our view, gearing them up shouldn't lead to excessive volatility. The interest rate payable on the debt is LIBOR plus 0.75%, and the terms on the facility allow the amount to be increased up to the 20% gearing limit stated in the prospectus.

## Performance

The trust's performance numbers have been solid in the first few months of trading, aided by it not being fully invested during the global market downturn in November and December. This helped the trust in two ways: it prevented NAV from falling as much as the market and it also created more favourable valuations at which the team could buy. Overall, the NAV is up 0.3% since launch, compared to losses of 1.6% for the MSCI Japan Small Cap index and 0.3% for the average Japanese small cap fund. Although a high cash weighting during the market downturn in November and December helped, most of the outperformance came when it was fully invested, illustrating the success of the stock-picking.

### Fig.2: Performance Since Launch




Source: Morningstar

The portfolio currently has cash worth 50% of its market cap, which rises to 78% when transferrable securities are included. The EV/EBIT multiple is just 3.9 times, which compares to 8.7 times for the Japanese small cap market, itself on low valuations compared to international peers. The valuation on the portfolio is actually lower than the indicative portfolio when the trust was first launched thanks to the sharp falls in the market in Q4 2018. The "margin of safety" is therefore more significant.

## Dividend

The objective of the trust is to seek total returns rather than an income. However, there is currently a 2.1% yield on AJOT's portfolio, and to retain investment trust status the board will have to pay out 85% of that after costs. As the intention is to charge 100% of costs to capital, this implies a minimum dividend yield of 1.8% on current NAV and c.1.7% on the share price.

As we have highlighted in the portfolio section, Joe and the team have had success in securing the return of cash to shareholders already, sometimes through increased or new dividends.

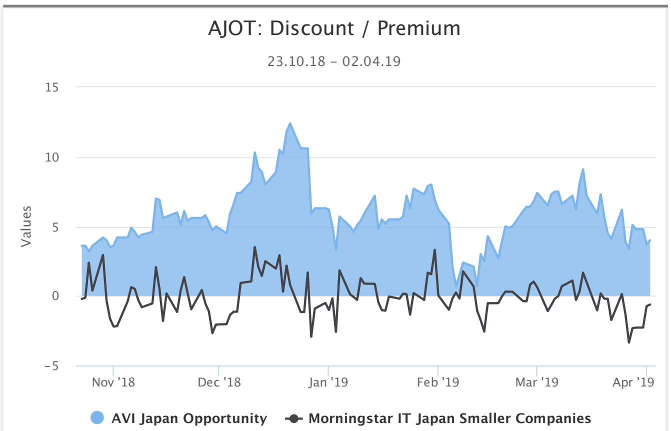
# Management

Joe Bauernfreund is lead manager of AJOT. Joe is CEO and CIO of Asset Value Investors, and has been with the group since 2002, starting as an analyst working on European holding companies. He became co-manager of British Empire in 2013 before becoming sole named manager in October 2015. Joe therefore has 16 years' experience working within the value philosophy of AVI. Under his tenure the performance of British Empire has improved markedly. Joe will be supported by Tom Treanor, head of research, and analyst Daniel Lee, who leads on much of the work on the Japanese holdings across British Empire as well as AJOT. AVI employees have £500,000 of their own money in the trust, and also reinvest 25% of the management fee into AJOT, which indicates a meaningful commitment to the alignment of interests between management and investors and a high degree of confidence in the strategy.

# Discount

Strong demand for the shares has seen the trust consistently trade on a premium since launch; the premium is now 3.2%. In December the premium spiked as high as 12%, although this reflected a relatively stable share price as the NAV fell in the sharp sell-off that month. In February and March 2019, improving investor risk sentiment saw another rally in the premium.

### Fig.3: Discount / Premium




Source: Morningstar

The prospectus allows a share issuance programme to be implemented when the shares are trading at a premium, which we think is likely given the aspiration of the manager to grow the trust. The maximum number of shares that can be issued under the prospectus is 200 million.

In terms of downside risk to the discount, one of the attractive features of the trust is the four-year liquidity offer, offering exit in whole or part after that time, which should be an effective discount control mechanism. After the initial four-year period, a similar offer will be made every two years. The prospectus leaves open exactly how this exit mechanism will be offered, with the intention being to find the most efficient and cost-effective mechanism should it need to be applied.

In the short term, the board can also seek to ensure the trust's discount does not become wide with buybacks, which we understand would be activated should the discount exceed 5%. The board has the ability to purchase up to 15% of the share capital, which could theoretically be renewed multiple times each year if necessary.

# Charges

The management fee is 1% of the lower of market cap or NAV, which aligns the managers interests better with shareholders. AVI reinvests 25% of this fee in shares of the trust, a commitment it made before launch. This is a rare feature and one we think is attractive in increasing the alignment of the manager's interests with other shareholders. Although there is no published OCF as yet (the trust not having published annual results) the KID RIY figure of 1.43% is in line with the 1.4% weighted average of the peer group (although we note that calculation methodologies do vary).

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