AVI Japan Opportunity

AJOT's activist approach has led it to generate highly idiosyncratic, sector-leading returns over the last 12 months...

Update
29 June 2022

Overview

Despite its focus on high-quality Japanese small caps, AVI Japan Opportunity (AJOT) is primarily a strategy looking to unlock shareholder value through active engagement, with its market-cap exposure a reflection of where the best opportunities are for positive engagement outcomes. Importantly, however, each of AJOT's holdings has the ability to stand on its own feet, with the high-quality business models of the holdings granting the prospect of positive returns even in the absence of the team's engagement campaigns.

Headed up by CEO Joe Bauernfreund, the AJOT team have capitalised on the sell-off in Japanese equities by making opportune purchases at depressed valuations, allowing them to increase the overall quality of AJOT's portfolio. We describe the AJOT team's process, and give examples of recent successful engagements, in the **Portfolio section**.

AJOT's idiosyncratic return profile has led it to generate impressive returns since its inception in October 2018, easily outperforming both its benchmark, the MSCI Japan Small Cap Index, and its wider peer group. AJOT's 12-month performance is also impressive, with the trust returning -2.8%, again substantially outperforming its benchmark and magnitudes ahead of its peers' substantial negative returns. This performance has also been matched by sector-leading risk–return statistics, as we highlight under **Performance**. AJOT trades at a narrow Discount of 0.3%, and while this is wider than its historical level, it is still far narrower than its peer group's average discount due to stringent discount control policies.

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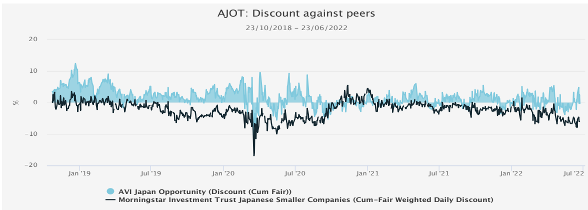
Key Information:

Price (p)	106
Discount (%)	-0.3
OCF (%)	1.54
Gearing (%)	-1
Yield (%)	1.3
Ticker	AJOT
Market cap (£)	145,709,404



Kepler View

We believe that the recent markets show evidence of the benefits of AJOT's idiosyncratic return profile. While the diversification benefits of uncorrelated returns are apparent, we believe it is during periods of clear market uncertainty that AJOT shines. The ability for the team to be 'masters of their own destiny' and be able to partially control the fortunes of their investments via the use of active engagement means that they can still offer upside potential even in the midst of a wider market downturn.

We believe that given the current bear market we are witnessing – one in which all styles of Japanese equities, both growth and value, are being sold off – AJOT's attractions are clear. Not only is the trust still able to generate positive returns, but it has done so without necessitating an overweight exposure to the few sectors which are doing well, such as defensive or energy stocks. This therefore further enhances AJOT's diversification benefits.

AJOT is also an example of the advantages of the investment trust structure, which relieves the team of the burdensome task of providing daily liquidity. By removing the need to do this, the structure gives them the time horizon required to execute their engagement campaigns. Given this, we believe that AJOT is a genuinely unique investment opportunity that investors will seldom be able to find elsewhere. Given the nature of how AJOT generates its alpha, we believe that it is not only a good option for ESG-conscious investors, but also for investors who want to benefit from the diversification benefits that Japanese equity exposure brings but who are not entirely confident in the Japanese economy.

BULL
Idiosyncratic return profile has generated strong returns in the face of market drawdowns
Investment process addresses the most onerous demands of ESG investing
Comparatively low valuations can reduce interest rate sensitivity

BEAR
Can underperform during a growth stock rally
Engagement campaigns can take a long time to realise their potential returns
Highly concentrated portfolio can increase single-stock risk

Portfolio

AVI Japan Opportunity (AJOT) is an example of one of the specialist investment approaches not often found within either the open- or closed-ended universe. The underlying philosophy behind the trust is that through active engagement, substantial upside can be generated within Japanese equities by addressing the inefficiencies brought about by Japan's poor corporate governance practices. AJOT is run by the seven-strong Japanese equity team at Asset Value Investors, headed up by CEO Joe Bauernfreund. Despite the strategy's clear focus on the domestic Japanese economy given its ubiquitous exposure to high-quality Japanese small caps, the team do not take any specific view around the prospects of the broader Japanese economy. Instead, AJOT's focus on Japanese small caps is a reflection of the opportunity for active engagement to generate alpha. As we point out in our **Performance section**, this leads AJOT to generate a very attractive but ultimately idiosyncratic return profile.

One common factor behind AJOT's holdings, other than the potential for effective engagement, is that they are all inherently high-quality businesses, albeit often under-researched due to their size or poor governance structures. In AVI's view, a company's 'quality' is determined by whether a management team can grow a business while still maintaining strong operational margins and highly competitive, if not industry-leading, positions. Statistically, AJOT's quality can be demonstrated by the portfolio having aggregate quality metrics which are superior to those of the benchmark, the MSCI Japan Small Cap Index. According to the manager, AJOT's portfolio currently has a free cash flow yield of 15% (based on enterprise value), an operating margin of 12.4% and a return on equity of 26.5% (ex cash). These figures are all superior to those of its benchmark.

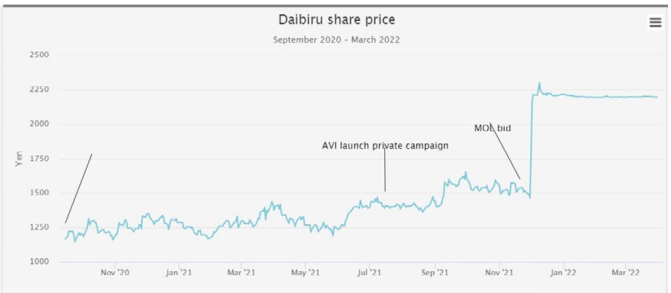
Another common factor behind AJOT's holdings is their very attractive valuations. The figure for the team's preferred valuation metric, EV/EBIT, is currently just over a third of that of their benchmark (5.6 compared to 15.5). While the team's quality bias is intentional, their value bias is more of a reflection of the desire to target companies which have addressable inefficiencies and as such trade at prices that are lower than their intrinsic valuations. This opens up the potential for enhanced returns by narrowing this valuation gap. As well as the team's truly 'small' approach to Japanese equities (with an average market cap of £510m compared to the £824m of its benchmark), one benefit of cheaper companies is that the team can take the substantial position sizes required to enact shareholder reforms. We note that AJOT's small-cap bias, as well as its highly concentrated portfolio of 25 stocks, means that it may represent a source of substantial stock-level diversification, with AJOT's holdings unlikely to be found in other portfolios, in addition to its idiosyncratic return profile.

While each of AJOT's investments should be able to succeed on its own merits, the most promising source of upside for the large majority of them comes through the team's ability to unlock shareholder value through their active engagement campaigns. AVI's engagement campaigns are clearly the major differentiator between AJOT and the majority of its listed equity peers. The team's activist approach is often a substantial undertaking, requiring constant discussion with management, detailed presentations, and – in the most extreme situations – the potential to publicly disclose their concerns around a company. While this approach may instinctively sound like a combative relationship between the AVI team and the management teams of their investments, the reality is often far from that. In fact, we believe that one of AJOT's key advantages is the strength of the relationships that the team have with their underlying company managements. Despite the investment team being located in the UK, the team are capable of having daily conversations with management teams, helped by a team member focused on engagement being in Japan and said teams are often more than happy to act on their advice. This close relationship is a direct result of the team's quality focus, as strong management teams are aware of the positive impact that strong shareholder alignment can have on their companies and appreciate the detailed input.

Given that AJOT is focused on active engagement, the proof should be in the pudding, and AVI can point to a number of engagements successes that have led to share price outperformance. One clear example of this is the team's work with Daibiru, the real estate company. The team identified the opportunity presented by the discount it traded at, which was c. 50% below the reported value of the office buildings it held (due to government policy failings, rather than operational failings). In order to resolve this issue, the team privately engaged with Daibiru's parent company Mitsui O.S.K. Lines (MOL), with the intention of having Daibiru be bought out, thus resolving its discount issue in the process. As can be seen in the below graph, after four months of engagement activities with MOL, including the threat of launching a public campaign, MOL tendered a buyout of Daibiru at a 50% premium. This resulted in a 74% return for AJOT on its initial purchase price. It is exactly this kind of unique opportunity (often kept out of the public eye) that makes AJOT's idiosyncratic returns so attractive. While a buyout is an obvious example of how to generate improved shareholder returns, the team highlight that the more common result of their ongoing engagement activities is a company's increased shareholder disclosure. Even the simple action of improving the information that a company reports can increase the market's awareness of its inherent qualities, resulting in an increased demand for its shares. Another common source of returns is through the redistribution of substantial cash reserves, with many of AJOT's holdings often being overcapitalised, i.e. having an inefficiently large amount of cash on their balance sheets.

Such redistributions typically take the form of share repurchases or increased dividend payouts.

Fig.1: Daibiru Share Price Performance



Source: AVI

When we recently caught up with the team they highlighted a number of transactions which have improved the overall potential of the portfolio, as well as some more examples of engagement activity. Given the recent downturn, the team have taken the opportunity to buy into a number of new companies whose previously high valuations had held them back from investing. The most common factor across all of these newer holdings has been their superior quality relative to some of AJOT's current holdings. In fact, the team believe that it has become increasingly easier to successfully engage with their companies. This is in part due to the team's increasing quality bias and focus on shareholder registers which have fewer companies blindly supporting management, but is also due to the wider awareness across all of corporate Japan of the need for greater shareholder alignment.

One thing the team point out in particular is the differentiated nature of the companies finding their way onto the team's buy lists, as previously expensive companies are now becoming more viable from a valuation basis. A number of more conventional 'growth' opportunities are now entering the team's lists of possible purchases, reflecting their genuine style of agnosticism. Given the greater number of potential purchases, plus the capacity to increase AJOT's gearing to fund said purchases, we understand the team are open to increasing the number of holdings. However, AJOT will still remain a genuinely concentrated portfolio, and currently only has 25 holdings. Of these recent purchases, an example of a more conventional growth stock is the e-commerce company Locondo. The team initiated a position in early 2022 after the shares had fallen c. 65% from their highs of August 2020, when the company had been perceived to be a 'COVID-19 winner'. Despite the company's relatively young age, having IPO'd in 2017, it is Japan's third-largest online fashion retailer and already demonstrates many of the quality characteristics that the team search for, such as low capital expenditure and high margins. The team have therefore used the recent sell-off to purchase a c. 10% stake in the company. These purchases have been funded by the sale of some lower-quality businesses whose management teams were not as responsive to the AVI team's engagement campaigns as had been hoped.

Gearing

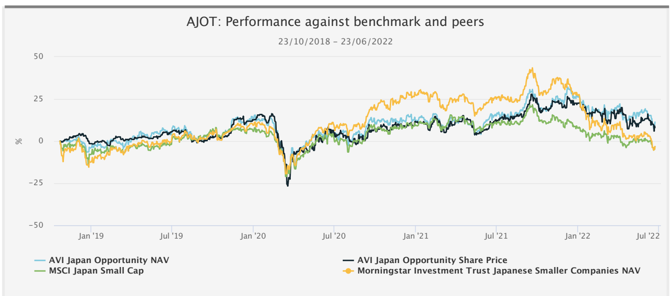
AJOT currently has 0.1% net gearing in place (as at 31/05/2022). This level of gearing is below its average since inception, a reflection of both the recent risk-off environment we have seen and the return of cash from the privatisation of two portfolio companies last year.

AJOT's current gearing is achieved through a total credit facility worth ¥4.33bn, equating to a maximum level of gearing of c. £25.9m (c. 17% of net assets as at 31/05/2022). The debt facility was renewed in February 2022, and interest is payable at a rate of TONAR plus 1.15%. The team use gearing in a strategic manner, either by investing into new positions or by opportunistically increasing their exposure to existing ones, rather than trying to time the broader market. As we note under **Portfolio**, the team are currently open to increasing gearing in the near term so as to capitalise on the valuation opportunities they currently perceive.

Performance

Since its inception on 23 October 2018, AJOT has been able to generate an impressive track record, with an NAV total return of 12.3% and share price return of 8.0%. This represents not only a substantial outperformance against its benchmark the MSCI Japan Small Cap Index, which returned -3.3% over the same period, but also against its peer group, which generated a simple average return of -3.2%. AJOT has even outperformed Japan's all-cap TOPIX Index over this period, which returned 5.5% despite Japanese small caps having failed to outperform large caps in any year between AJOT's inception and 23/06/2022. AJOT's ability to generate such strong outperformance is particularly admirable due to the strategy's strong value bias, which prevented it from capitalising on the huge tailwinds supporting Japanese growth stocks in both

Fig.2: Performance Since Inception



Source: Morningstar

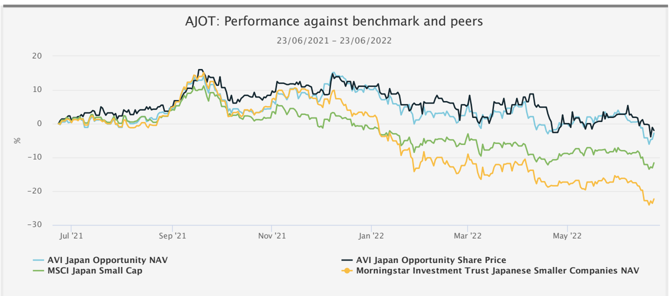
Past performance is not a reliable indicator of future results.

2019 and 2020. Yet as we point out below, it is this lack of growth stock exposure which has led AJOT to avoid much of the recent market drawdown.

While AJOT's track record since inception is impressive, we believe that the last 12 months perhaps best show the advantages of the trust. In the face of mounting selling pressure around risk assets globally, AJOT has largely kept its head above water, generating a 19.5% outperformance against its peers. Over the last 12 months to 23/06/2022 AJOT has produced an NAV total return of -2.8% and a share price return of -2.0%, comparing very favourably to the -22.3% simple average return of its peers and the -11.6% return of its benchmark. In fact, AJOT's return profile is so strong that it is the second best performing Japanese small cap trust over the last 12 months (beaten by less than 0.1%), and the third best performer amongst both the large- and small-cap peer groups.

While AJOT's value bias has clearly aided the trust in recent months given the negative impact that rising interest rates are having on the share prices of highly valued companies, it has been the team's active engagement activities which have been a strong driver to returns. The two largest contributors to AJOT's 12-month returns are Secom Joshinetsu and Daibiru, both of which were targets of successful buyouts by their parent companies. Other major contributors include C. Uyemura, whose shares rallied after the company signalled its shift from a family-orientated management model to one with far greater shareholder alignment.

Fig.3: 12-Month Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Given AJOT's performance, it should come as no surprise that it leads its peer group for risk-adjusted returns over the last three years. AJOT is the only Japanese small-cap strategy to have generated a positive information ratio, while also having the largest Sharpe ratio and alpha over the period, with said statistics shown in the below table. In our view, this shows that the AJOT team have been the most successful in generating value-add for their investors over the period. It is also important to highlight that AJOT's attractive risk–return metrics have not just come via outsized capital growth but also through lower volatility, thanks in no small part to the lower valuation risk of the trust. This may be of particular interest to more cautious investors looking to gain exposure to Japanese equities.

Three-Year Annualised Risk–Return Statistics

	ALPHA	STD DEV	SHARPE RATIO	INFORMATION RATIO
AJOT	3.16	16.24	0.24	0.33
Peer group average	-0.17	20.87	0.07	-0.05

Source: Morningstar, as at 31/05/2022

Past performance is not a reliable indicator of future results

Dividend

AJOT does not have an income objective. The board's policy is to pay out substantially all of the net revenue as a dividend. AJOT's most recent full-year dividend was 1.4p per share, for the 2021 financial-year end. We also note that AJOT's recent interim dividend of 0.7p per share represents an 8% increase on the prior year's. While AJOT does not have a policy of a progressive dividend due to the potential fluctuations of its revenue, its activist approach to investing may be conducive to dividend growth, and as such distributions are a method of returning capital to shareholders. However, this can also take the form of special dividends or share buybacks, which are more likely to enhance total return than long-term dividend growth. AJOT has a current share price yield of 1.3% based on its FY 2021 dividend, which is lower than the 3.4% simple average of its peers (as at 23/06/2022).

Management

AJOT is run by the team at Asset Value Investors (AVI), with CEO and CIO Joe Bauernfreund taking the leading role in AJOT's management, supported by a six-strong Japan-dedicated team. AJOT's legacy goes back far beyond its inception date, as it was launched on the back of its sister trust AVI Global (AGT). AGT has long held a dedicated allocation to Japanese equities, with the AVI team having long ago identified the opportunity presented by Japanese corporate governance reform.

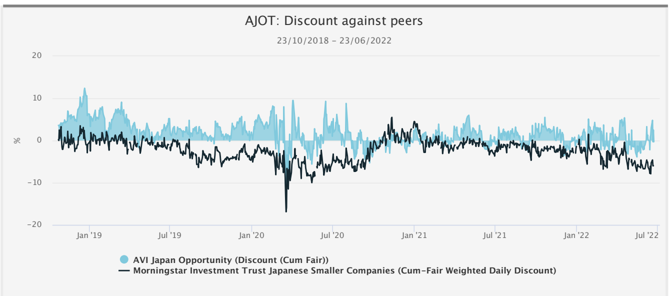
AVI has gone through a substantial period of team expansion over the last year or so. AVI's Japan team is now seven strong, with four of them fluent Japanese speakers. The team is led by Joe Bauernfreund, CEO of AVI, who is closely supported by Daniel Lee, head of Japanese research. There are five further team members: Kaz Sakai (who joined in 2021 and has experience in consultancy from McKinsey Japan), Makiko Shimada (who joined in 2021 from Goldman Sachs Investment Banking's office in Tokyo), Jason Bellamy (who joined in 2020 as a Tokyo-based engagement consultant), Collin Batte (who joined in 2021 as a junior analyst) and Yuki Nicholas (who joined in 2020 as the team assistant).

Discount

AJOT currently trades on a 0.3% discount (as at 23/06/2022). While nominally narrow, it is nonetheless wider than AJOT's average premium since inception of 1.7%. We see the emergence of this small discount as a likely reflection of the wider sell-off of risk assets across the globe.

As at 23/06/2022, AJOT's discount remains the narrowest of any Japanese equity trust in both the large-cap and small-cap sectors. This relatively narrow discount is in large part a reflection of strong shareholder demand for the highly idiosyncratic source of alpha that the AVI team have provided, especially as the trust has been the only source of positive NAV returns in the sector over the last three years, coupled with stringent discount control mechanisms. We also note that the management fee structure incentivises the team to prevent AJOT from trading at a material discount, as the fee is charged on the lower of market cap or NAV. In addition, with at least 25% of the management fees being used to buy AJOT's shares, this serves as a natural source of demand for the shares. The board has only needed to repurchase shares once in the last 12 months, in June 2021. Conversely, the board has managed to issue 5m shares over the last 12 months, equal to 4% of the initial circulation.

Fig.4: Discount Since Inception



Source: Morningstar

Charges

AJOT's ongoing charges figure (OCF) is 1.56%, greater than the AIC Japanese Smaller Companies sector's simple average of 1.22%. AVI is paid a management fee which is 1% of the lower of the market cap or NAV, ensuring that the manager is incentivised to see the trust's shares trade at close to NAV.

AVI reinvests 25% of its management fee in shares of the trust, a commitment it made before launch. The Key Investor Document Reduction in Yield figure of 1.82% is slightly above the 1.76% simple average of the peer group (although we note that calculation methodologies do vary).

The costs of activist activities and engaging with management are borne entirely by AVI, and not by AJOT.

AVI employees have over £2.4m of their own money in AJOT and also reinvest 25% of the management fee into the trust each year, which indicates a meaningful commitment and an alignment of interests between management and investors, not to mention reflecting a high degree of confidence in the strategy.

ESG

AJOT is in our view a perfect example of the limitations of conventional ESG analysis. Even though Morningstar rates AJOT as 'low' for sustainability, compared to its wider Japanese small and mid-cap peer group, it is undoubtedly a sound choice for an ESG-conscious investor because the trust's score is a reflection of its investment process. This is because companies with a poor ESG rating likely have the largest scope for valuation reversal through active engagement and improvement of their ESG scores, and the AJOT team are making huge strides in improving the ESG credentials of their companies.

The team have made clear improvements to the governance of their companies, be that through improving disclosures or shareholder returns. ESG of course covers more than just governance; however, the nature of AJOT's target companies means that the most basic of governance reforms need to be achieved before social and environmental issues can be tackled. The team can nevertheless demonstrate enormous achievements in advancing the social credentials of their companies – for example, they have been successful in placing the first female members on some of their companies' boards. This is a fundamental first step in modernising the ESG credentials of their companies, and it is because of these fundamental yet critical accomplishments that we believe AJOT can easily be recommended to any ESG-conscious investor.

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