Q4 2018 January 2019

AJOT
AVI Japan Opportunity Trust

Portfolio Statistics

Net cash[1] as percentage of market cap	NFV[2] as percentage of market cap	EV/EBIT	FCF Yield	EV FCF Yield[3]	Dividend Yield
48%	84%	1.9	7.1%	54.4%	2.3%

Dear AJOT Shareholders,

We are delighted to write AJOT's first quarterly newsletter. We are grateful to all those investors who saw merit in our thesis and supported the launch of this unique trust. We will do our best to execute our mandate and to exploit what we believe to be one of the most compelling global investment opportunities.

Our quarterly letters will rarely discuss macroeconomics, politics or the state of the world - for we are sure, on these matters, there are more knowledgeable commentators. We will focus on our companies; updating you on operating performance, corporate governance developments and the progress of our engagements. We hope these letters will prove useful in understanding our investment approach and highlighting the remarkable opportunity we see in Japan.

Deployment Update

We launched AJOT to invest in extraordinarily undervalued small-cap Japanese operating companies with substantial amounts of excess cash and investment securities on their balance sheets. Our contention is that the improving corporate governance environment in Japan will result in increasing dividends and buybacks, with our own engagement with managements and Boards serving to accelerate and amplify this process.

The launch of AJOT has proved quite timely. Having raised £80m at the end of October, markets have subsequently been characterised by increased volatility and generally falling asset prices, with the MSCI Japan Small Cap Index falling 10% in JPY. We have been fortunate enough to acquire stakes at valuations even further below our original expectations and had invested 83% of the capital raised at IPO as at end-December (at the time of writing, 11th January, this figure has risen to 89.5% invested). The pace of our investment has been measured, taking care not to push share prices higher while ensuring we have the flexibility to adapt our target weights to changing prices.

With low liquidity, and the underperformance of small-caps vs large-caps, we witnessed large and seemingly irrational price movements in our portfolio companies. Some fell by double digits over a single trading session on no news and despite high levels of cash-backing and solid operations, whilst others hardly moved at all. Fortunately, the fixed nature of AJOT's capital allows us to remain patient and level-headed.

Despite market weakness, some of our investments performed remarkably well. The greatest contributor was Nakano Refrigerators (6411) ('Nakano') whose share price, from our average purchase, appreciated by 23% (in GBP) following a significant and monumental corporate governance development.

[1] Net cash = Cash – Debt – Net Pension Liabilities
[2] Net Financial Value (NFV) = Investment Securities + Net cash
[3] The effective free cash flow yield were non-core assets to be distributed

First Corporate Governance Win

We have been closely following Nakano since February 2018 when the then new President, the first non-family appointee since the company's founding, announced the examination of various measures to increase corporate value. An advisory committee composed of independent outside experts was installed shortly thereafter to evaluate and recommend appropriate actions. We were convinced that the committee's conclusion would involve favourable changes to Nakano's capital structure.

The two pertinent areas for improvement were Nakano's excessive cash holdings and the 43% of outstanding shares held in treasury. At the time of our purchase, Nakano's overcapitalised balance sheet meant that net cash accounted for 89% of the market cap and 58% of balance sheet assets.

Following the acquisition of our stake in November, we wrote to the Board of Directors outlining why such an excessive level of cash was unnecessary and arguing that a substantial portion should be returned to shareholders. We reasoned that Nakano's CAPEX would not be restricted by a return of capital, given cash covered the 5-year average CAPEX spend 120x over and that Nakano's business requires little working capital. We also discussed how holding 43% of shares in treasury was harming Nakano's share price given: a) the perceived overhang and b) that financial data providers do not always adjust market caps for cancelled shares.

We were, therefore, most pleased when at the end of December Nakano announced a commitment to pay out 100% of earnings for the next three years and to cancel all outstanding treasury shares. While our preferred outcome would also have seen the existing cash pile reduced via a special dividend and/or buyback, the new policy meant that Nakano's ongoing dividend yield would be over 5% and this resulted in the share price soaring by 17% on the day of the announcement.

Nakano's decision to take the Corporate Governance code seriously and focus on increasing corporate value shows that attitudes in Japan are changing. It is encouraging that companies are listening to shareholders' concerns and recognising that implementing their suggestions can be value-creative.

Nakano's share price performance highlights the idiosyncratic nature of returns from positive corporate governance events and how, despite weak broader markets, share prices can increase quite significantly when these come to fruition.

Meetings and Engagement

Over the quarter we met or had calls with 25 current and prospective investee companies, sent six letters discussing a variety of issues, and held nine meetings with regulators and other institutional investors discussing the progress of corporate governance reform. Our portfolio companies were mostly upbeat on the economic environment but have suffered somewhat from shrinking margins due to higher raw material and labour costs. Encouragingly, a number of companies are in the process of passing on price increases (including one for the first time in 10 years), although with a lag so profits have yet to benefit.

Regarding corporate governance, we had some encouraging meetings. Having become accustomed to arguing for reducing cross-shareholdings and improving shareholder returns, we welcomed one of our portfolio companies telling us, without prompting, that they plan to sell cross-shareholdings where they can and return the proceeds to shareholders. Our arguments are being met with less resistance and, on the whole, the response from companies with regard to increasing shareholder returns has changed to a matter of *when*, not *if*.

Our engagement is largely focused on companies where the door for change has been left ajar. We typically receive a warm reception from companies and are welcomed back for further meetings. The perception that activist engagement must necessarily be combative is misguided, and we believe a softer approach often yields better results.

We expect our pace of engagement to intensify as our stake sizes, and thus influence, increase. We are willing, and able to launch public campaigns if needs be, although our preference is always to initially engage privately. Our perception and reputation as a long-term shareholder is of the utmost importance.

Beyond Nakano, there were few other corporate actions to note. One investment announced a slight increase in its pace of buybacks and another declared a 20% dividend increase. We would expect to see more announcements at the end of the financial year in March leading up to AGMs.

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We're as excited about the opportunity set as we have ever been. The breadth of the investment universe is increasing as prospective companies reach our eligibility criteria broadening our ability to deploy capital. We initiated an investment at the start of January, buying into a company with a resilient business model that has 90% of its market cap in net cash.

The investments in AJOT's portfolio (on a weighted average basis) have 84% of their market caps covered by listed investment securities and net cash, 48% covered by net cash, trade on 1.9x EV/EBIT, and have a free cash flow yield of 7.1%, rising to more than 50% were cash and non-core assets distributed.

It is important to emphasise that AJOT's performance is not entirely dependent on successful engagements. We believe the companies in our portfolio will generate attractive returns principally from increasing fundamental values (through free-cash-flow generation and growing earnings) and the narrowing of valuation discounts. Our engagement activity is supplementary.

We look forward to updating you next quarter. Please do get in touch before that if you have any questions.

AVI
Asset Value Investors

For performance and portfolio statistics please see monthly factsheet found at www.ajot.co.uk

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The share price can be found under 'INVESTMENT COMPANIES' in The Financial Times.

Information may be found on the following websites.

www.ajot.co.uk
www.assetvalueinvestors.com

IMPORTANT INFORMATION