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
50%	78%	3.5	6%	33%	2.1%

Dear AJOT Shareholders,

There have been a number of positive corporate governance developments in Japan over the past quarter which support our original thesis behind the launch of AJOT last year. The Corporate Governance Code is having a marked impact on the behaviour of companies and shareholders in Japan. Attitudes towards balance sheet efficiency, share-buybacks, and shareholder remuneration are shifting; we expect our portfolio to be a beneficiary of these developments. During the quarter, we conducted a research trip to Japan that confirmed attitudes towards corporate governance are improving.

Corporate Governance Developments

We engage with our portfolio companies through face-to-face meetings and letters, emphasising balance sheet efficiency, stock-based remuneration, and independent board representation. Our arguments are grounded in the principles of the Corporate Governance Code, introduced by regulators in 2015 and revised in 2018.

Over the quarter, a number of our companies (8 of 29) took measures to improve shareholder value; five announced buybacks (one for the first time); one announced only its 2nd dividend hike since 1998 (a two-fold increase); one reduced a portion of its cross-shareholdings; and one, following our recommendation, decided to cancel its anti-takeover provisions.

Kanaden, who we have met six times and to whom we have sent four letters, announced a 4% buyback to the market just as we sat down for a meeting with management in Tokyo. A senior board member explained that their decision was driven by their weak share price and excess cash. This is one of the few times we have heard a smaller company explicitly linking buyback activity to their share price and balance sheet efficiency.

We were especially pleased that the buyback was also targeted at unwinding the cross-shareholding arrangements with Mizuho Bank and Mitsubishi UFJ Trust & Banking, both of whom sold their holdings into the buyback. This is a core objective of the Corporate Governance Code, with a revision in June 2018 explicitly stating that companies should have a policy for reducing cross-shareholdings. As a Kanaden board member agreed, in a testament to changing corporate attitudes, these actions would not have been conceivable a decade ago.

TBS, with whom we have been engaging publicly, is another company whose actions highlight the changing environment. With 85% of TBS' market cap covered by listed securities, it offers one of the most egregious examples of balance sheet inefficiency. After repeatedly being asked to do so by AVI and other shareholders, both foreign and domestic, TBS sold a portion of their cross-shareholding portfolio at the start of March. While only a small start, it is a step in the right direction and pleasing to see that TBS have listened to shareholders' views – despite what many thought of as a hopeless case.

As we have repeatedly commented, the question is not *whether* corporate attitudes in Japan are changing but, rather, how quickly that change will come about now that momentum is beginning to build.

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

Quarterly Results and Meetings

The investment strategy of AJOT is to find undervalued, high-quality companies with improving corporate governance. Our assessment of quality is based principally on the stability and growth potential of earnings. This requires qualitative research and regular meetings with management.

During our visit to Japan at the end of February, we met with 22 AJOT companies, travelling to Tokyo, Osaka and Nagoya. Our companies had just reported quarterly earnings which were generally satisfactory. Excluding companies with lumpy sales or that experienced one-off costs, profits rose +0.2% while sales rose +5.4% year-on-year[4]. The broader market (all Japanese listed companies) experienced a median profit decline of -1.3% and sales growth of +4.0%.

Our companies performed better than the average Japanese business although still suffered from rising labour and raw material costs which explained weaker margins. Management, on the whole, portrayed an optimistic outlook expecting raw material costs to fall in the coming quarters, while hoping to pass on price increases to customers.

On the governance front, rhetoric from management affirmed our thesis that the culture is changing. One company told us that it is not just foreigners who are telling them to improve – they are now hearing the same message from Japanese investors. Even passive managers for GPIF (Government Pension Investment Fund) are incentivised to generate returns through corporate engagement, focusing on companies with the lowest ROEs in the index.

Management in our meetings are not shying away from talking about improvements in corporate governance and are quite open about their thinking. Only one or two companies use the archaic argument that the cash is off limits for a 'rainy day', and even those companies are starting to understand that this stance is fast becoming unacceptable.

Activism in Japan

We engage with companies in private, preferring to build positive relationships with management and reserving a public debate as a last resort. However, we have seen an increasing number of investors air their grievances in public as the stigma surrounding shareholder activism has faded.

In early March this year, a group of shareholders called for the removal of housing product maker LIXIL's CEO. After controversially removing the then-CEO, the Chairman appointed himself CEO. Shareholders' requests for disclosure on the move and board minutes went unanswered and as a group, including Japanese, British and American investors, they took the bold move of calling an Extraordinary General Meeting to remove the new CEO. While the directness of this action is unusual, it is also noteworthy that none of the shareholders are so-called "activists". They are shareholders who, empowered by the corporate governance revolution, have publically spoken out against shareholder abuse.

Another high-profile case comes from King Street, an American hedge fund. They have been publicly engaging with Toshiba, releasing a 127 page presentation last October outlining how Toshiba can unlock a tremendous amount of value through the disposal of non-core assets (we own two Toshiba subsidiaries who could be beneficiaries of this) and conducting a buyback for up to 50% of the company's shares. King Street recently submitted a public letter to Toshiba's Chairman calling for a new slate of majority independent directors, implying that the current board was inadequate.

Finally, at the smaller end of the market cap spectrum, Sanyo Shokai received shareholder proposals from Hibiki Path Advisors, a Singapore-based fund. The proposals sought an increase in the dividend and the introduction of a stock-compensation plan (Sanyo Shokai is in our universe with NFV covering 100% of market cap, but fails our quality test). Sanyo Shokai responded favourably, installing a stock-based compensation plan prior to the AGM.

Activism or 'shareholder engagement' is no longer a rarity in Japan. Attitudes towards shareholder involvement have shifted dramatically since the taboo days of 2005, when activists' arguments were seen as myopic and, without the structure of the Corporate Governance Code, baseless. Companies today are open to shareholder suggestions and, in some cases, we would even go so far as to say, welcome them.

[4] Profit growth would have been +18% and sales growth +9% if all companies in AJOT were included in the calculation

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As AGM season approaches we expect to see positive news on the corporate governance front. One-third of buyback activity occurs in the months of April and May, with companies also declaring final dividend payments.

We are not short of investment ideas in AJOT, with a number of companies vying for entry into the portfolio. Furthermore, the disparity of share price performances within AJOT (since inception the best performer has increased by +37% and the weakest -13%) gives us the opportunity to add to stocks that we know well.

Given the further accumulation of evidence that mindsets are changing, our conviction that there is a significant amount of unlocked value in quality, over-capitalised Japanese companies has only strengthened. We will continue engaging with our portfolio companies and look forward to realising the significant upside that we see today.

Please do get in touch if you have any questions.

AVI
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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