Q2 2019 June 2019

AJOT
AVI Japan Opportunity Trust

Portfolio Statistics

Net cash[1] as a percentage of market cap	NFV[2] as a percentage of market cap	EV/EBIT	FCF Yield	EV FCF Yield[3]	Dividend Yield
49%	81%	2.9	6.1%	24.8%	2.0%

Dear AJOT Shareholders,

Japan continues to be overlooked, underappreciated, and unloved. 2018 saw four straight quarters of foreign selling, and this has continued throughout 2019. Between 2012 and 2015, the introduction of Abenomics drove foreign inflows of JPY22 trillion into Japanese equities; since then, the market has witnessed an almost complete reversal.

Even corporate Japan's buyback spree hasn't been enough to offset foreign outflows (TOPIX buybacks YTD have exceeded the whole of 2018 by 14%). The result is undemanding valuations, with the TOPIX trading on a discount of 26% and 8% to the forward PEs of the S&P 500 and MSCI Europe respectively.

Japanese companies aren't immune from the global trade slow-down, but it's important to bear in mind that the companies in AJOT's portfolio continue to generate cash and take positive actions to improve corporate value. We are confident that, while share prices have stagnated, the investment merit of Japanese equities has not.

Activism in Japan

We have seen an increase in the quantum and success of shareholder activism. At the 2019 AGM season, a record 54 companies with March year-ends were on the receiving end of shareholder proposals (12 more than last year). Additionally, beneath the surface, companies are doing the right thing by shareholders and dialogues with company management are yielding positive signs of shifting attitudes.

In our letter last quarter, we highlighted three companies involved in public engagement with shareholders: LIXIL, Toshiba and Sanyo Shokai. LIXIL, the housing product maker, was subject to shareholders' scrutiny following the controversial removal of its CEO. A group of shareholders demanded an extraordinary general meeting to remove two of the directors believed to have been behind his dismissal. The ensuing media storm which engulfed the company culminated in both directors resigning. Such an explicit attack on named directors is rare in Japan, but the resounding victory for shareholders is hugely encouraging. To further solidify the win, shareholders proposed the appointment of eight directors to the board, all of whom were successfully appointed.

In March, King Street wrote a public letter to Toshiba requesting a new slate of majority independent directors.

[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

Quite unceremoniously and without public resistance, Toshiba obliged. Toshiba successfully proposed a board of 12 directors to its June AGM, who have a wealth of experience including portfolio management, business turnarounds and M&A. 10 of the directors are independent with four hailing from outside Japan: an unheard-of composition for a Japanese board. As an aside, King Street also publicly suggested that Toshiba simplify their subsidiary structure, and, having invested in two of Toshiba's subsidiaries (Toshiba Plant and NuFlare), we are well placed to benefit.

Hibiki Path Advisors' proposals for a higher dividend and stock-based compensation were not approved by Sanyo Shokai's shareholders, gaining just 10% and 12% support. While on the surface this seems disappointing, the outcome was inconsequential. Sanyo Shokai had already acquiesced by installing a stock-based compensation plan and at the start of May announced a 4.0% buyback.

Although not publicly, we are working with our portfolio companies to improve corporate value. Since the launch of AJOT, we have sent 21 letters to 14 different companies and either called or met with our companies 62 times. The response has been broadly positive, and many companies have implemented policies inline with our suggestions.

Now that we have come to the end of the June AGM season, we are writing to our companies anew, outlining a scorecard on which to track their governance improvements over the coming year. Where companies are not making satisfactory steps, we will ramp up our engagement, and, if needs be, submit shareholder proposals.

Private Equity in Japan

A fellow Japanese investor recently remarked to us that private equity funds in Japan will buy anything that moves - that is if management can be persuaded on the merits of privatisation. The amount of cash sitting on balance sheets and the potential for significant margin improvement is uniquely attractive. Indeed, Henry Kravis - the second "K" in "KKR" - commented in a recent interview that "[Japan] is our highest priority right now other than the US…this is the best value today. If you look at value to price of stock and cost of capital, it's here".

KKR isn't alone in its enthusiasm for Japan - other private equity firms are also showing increased interest. Last year, Apollo opened an office in Japan and Blackstone hired a buyout team to add to its existing property operation in Japan. Their presence adds to a roster of established private equity firms in Japan, including Bain, Carlyle and Permira.

For some time, investors have been aware of Japan's abundance of excess balance sheet cash, potential for margin improvement, and cheap financing; however, the changing corporate governance environment is prompting renewed interest. Large conglomerates are being encouraged to sell non-core assets and underperforming management teams are no longer able to rely on their shareholders for unwavering support.

This trend is encouraging for AJOT, principally because the types of companies that we hold are ripe for acquisition. They have no debt, copious excess cash, and generate consistent free cash flow. An excellent example of this was Nitto FC, a company we purchased when AJOT launched. In May it was subject to a takeover offer at a +38% premium by a Japanese private equity firm.

Nitto FC manufactures domestic fertilisers. The pricing for fertilisers in Japan is heavily restricted, with a cooperative (acting on behalf of farmers) controlling 70% of the market. Prices are benchmarked to raw material costs which, although restrictive of Nitto FC's pricing power, also limits downside risk, leading to Nitto FC exhibiting a stable earnings profile. Before the takeover, Nitto FC was trading with 81% of its market cap covered by net cash, on an EV/EBIT of 2.3x, and with a valuable portfolio of commercial real estate.

Nitto FC's management recognised the need to invest in ageing infrastructure but wanted to do it outside of public market scrutiny. They sought an acquirer for the business and, given the valuation, bloated balance sheet, and strong business fundamentals, it was no surprise to see that the ultimate buyer was a private equity firm. This was a fantastic outcome for AJOT, and in just a little over six months the investment made a +56% profit.

While it is hard to predict which companies will be subject to a takeover, we believe our portfolio companies have key attributes that make them more attractive targets than the average Japanese company. Private equity firms are hungry for these assets and further acquisitions of our portfolio companies would be a healthy driver to our returns.

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We spent two weeks in Japan at the end of May, meeting with fellow investors, lawyers, portfolio companies, peers of the portfolio companies, the Financial Services Agency, METI (Ministry of Economy, Trade and Industry), and the Japan Exchange Group.

The message from the governmental and regulatory bodies is the same – they will keep ratcheting up guidelines and regulation to ensure reform continues. They are hugely supportive of both shareholder collaboration and shareholder activism. With this backdrop, and the receptiveness we have received from our portfolio companies, our conviction in the prospects for successful shareholder engagement has only grown.

In April AJOT raised additional capital through a revolving credit facility with Scotiabank for approx.£10m and in May raised a further £13m through an equity placing. By the end of June, we had successfully deployed most of the proceeds from these capital raises, with the Trust being 108% invested across 28 companies. We would like to thank shareholders for their continued support.

Please do get in touch 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

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