Q3 2019 September

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
51%	85%	2.7	6.4%	27.6%	2.2%

Dear AJOT Shareholders,

As we approach AJOT's first anniversary it is interesting to note how difficult this period has been for Japanese equity markets. The MSCI Japan Small Cap has fallen -1% since launch against the S&P 500 which rose +10% and the MSCI Europe which gained +15%[4]. The fractious US-China trade war and the view from foreign investors that Japan is a never-changing, expensive proxy for global growth has continued to take its toll. The EV/EBIT of the portfolio has fallen from 3.2x when AJOT was fully invested to 2.7x, while the percentage of market cap covered by net cash and listed investment securities has grown from 78% to 85%. However, notwithstanding that it is a short period, we saw a more optimistic environment towards the end of the quarter where Japanese markets had their strongest relative performance vs global markets since AJOT's launch.

The divergence between fundamentals and investor perceptions creates exciting opportunities. Over the quarter, we have been adding to positions which suffered from weak share prices despite little deterioration in the fundamentals. Our focus on long-term investing allows us to weather short-term weakness and to remain focused on fundamental value.

Teikoku Sen-i fell -15% following what were perceived as soft quarterly results. Teikoku Sen-i has a highly seasonal business with around 80% of profits earned during the first and last quarter. A weak Q2 has little consequence for the whole year and we, along with company management, found the poor share price reaction perplexing. It now has 75% of its market cap covered by cash and listed securities, up from 52% at the end of March. In response, we increased our shareholding by over a fifth.

SK Kaken was another stock that suffered over the quarter, falling -9%, this time on solid operating results. Operating profits grew +18% with sales growth of +10%, driven by strong redevelopment demand in Tokyo. The non-fundamental driver was more evident in this case, with a large shareholder facing redemptions and being forced to sell in the market. We added a modest amount to our already large holding and think the upside potential from SK Kaken's current 3.6x EV/EBIT valuation is tremendous.

Over the quarter we added to 15 companies in our portfolio all at valuations that we think imply an extremely distressed outlook. We mitigate the risk of value traps by buying high-quality companies whose economic value is increasing year after year. Coupled with this we have the corporate governance revolution underpinning our thesis and providing a catalyst to awaken share prices.

[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
[4] All in local currency

The New Toshiba and AJOT's Subsidiary Investments

As we discussed in previous quarterly letters, Toshiba Corp has been subject to a public activist campaign by King Street. As a result, Toshiba Corp's board was revitalised at the June AGM with seven new independent directors joining the Board. These new directors have a wealth of international experience including investment management, and generally have a more sympathetic view towards shareholders. We have written to the new board to highlight the corporate governance flaws at two Toshiba Corp subsidiaries, NuFlare and Toshiba Plant, both AJOT holdings.

NuFlare manufactures highly specialised semiconductor machinery. Their focus on a niche part of the semiconductor manufacturing process has afforded them a near 100% market share. However, while they have an excellent technical position and a profitable business model, their corporate governance leaves much to be desired. Despite its £800m market cap, NuFlare is listed on the JASDAQ, an exchange intended for young, unestablished companies; all directors are male between the age of 54-60, having started their careers at either Toshiba Corp or Toshiba Machine; and the company has no capital allocation policy with 57% of balance sheet assets being made up of cash. This slack corporate governance drives a market discount with NuFlare trading on a derisory 2.6x EV/EBIT with 60% of its market cap covered by cash.

Toshiba Plant, as the name suggests, designs and constructs power plants along with industrial buildings such as factories. The appealing aspect of this business is the long-term contracts, predominantly coming from decommissioning and maintaining Toshiba Corp's array of nuclear power plants. Since it became a fully integrated EPC (Engineering, Procurement, and Construction) company in 2004, it has only failed to achieve growth in one year (2017) and has grown profits at an annual compound rate of 12%. While Toshiba Plant has a strong business, it is let down by poor corporate governance. Six of the nine inside directors come from Toshiba Corp; the two independent directors have no relevant industry experience; and 38% of balance sheet assets are held in cash with the majority lent to its parent at an interest rate far below Toshiba Plant's cost of capital. Again, the market demands a discount because of this poor governance and Toshiba Plant trades on an EV/EBIT of 4.8x with net cash covering 47% of its market cap.

With the improved oversight at Toshiba Corp and severe undervaluation at these two subsidiaries, we think the market is failing to see the huge potential from either improved corporate governance or a corporate event such as the trade sale of NuFlare or buy-in of Toshiba Plant. It is untenable for the new Board of Toshiba Corp to continue presiding over such appalling corporate governance and we believe they will act. In October, Toshiba Corp stated their intention to sell non-core businesses that do not have synergies in infrastructure and energy, highlighting the importance of Toshiba Plant and insignificance of NuFlare. Following this, Toshiba Plant and NuFlare rallied +8% and +5% respectively against a -0.5% decline in the MSCI Japan Small Cap Index[5].

In addition to our dialogue with the parent company, we have written to the Boards of NuFlare and Toshiba Plant suggesting corporate governance improvements and will press the issues further during our November trip. We expect to see positive developments at both companies and commensurately higher share prices over the coming year.

The issue of parent-child listings and poor protection for minority shareholders is one that is receiving more attention from shareholders and the Government. It has been suggested that listed companies with controlling parent shareholders should be required to have a majority independent board to increase minority shareholder protection. The clear intention is to ultimately reduce the prevalence of parent-child listings, which are rarely seen in developed markets outside of Japan. Whether child subsidiaries improve governance, or the parent company restructures the business, the result should prove a boon to the share price. We have investments in six listed subsidiaries, accounting for 23% of AJOT's NAV.

[5] 01/10/2019 – 10/10/2019

Corporate Change Continues

Corporate governance improvements are quietly continuing. Share buybacks, a metric we follow as a barometer of attitudes to shareholder returns, are rising. For the six months to September, total completed buybacks amongst listed Japanese companies totalled ¥4.7trn, an increase of +96% from the same six months last year, and already exceeding the ¥4.4trn for the whole of 2018.

Encouragingly we saw several companies unwind their cross-shareholdings in Recruit Holdings at the start of September through a large share placement. This amounted to 7% of Recruit's outstanding shares and shows companies realising that they can longer justify these holdings. The current attitude was succinctly put by Hidehiro Tsukano, an executive at Fujitsu, who quipped that "cross-shareholdings are meaningless".

Sony participated in the unwinding of business ties by selling a 5% position in Olympus for $760m, prompted by calls from Third Point to sell non-core positions. It stated that "Sony will continue the business alliance and collaborative partnership with Olympus…regardless of its sale of the shares", echoing the views of Mr Tsukano.

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We are using the months between AGMs to build on our company engagement, with the view to submit shareholder proposals at AGMs should companies not implement progressive change. We are excited by the growing undervaluation of our portfolio which has only increased the upside potential.

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

Further Information

Investment Manager – Joe Bauernfreund, AVI Ltd.
+44 20 7659 4800 **info@ajot.co.uk**

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