Q4 – December 2020

Investment Objective: To achieve capital growth through a focused portfolio of investments, particularly in companies whose share prices stand at a discount to estimated underlying net asset value.

	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
Q4 2020	47%	82%	4.3	5.3%	19.0%	2.1%
Q3 2020	46%	90%	4.0	5.1%	19.1%	2.1%
Q2 2020	51%	93%	3.0	6.2%	23.8%	2.4%
Q1 2020	52%	96%	2.1	7.1%	34.3%	2.5%

MANAGER'S COMMENT

Dear AJOT Shareholders,

Despite improving earnings, increasing levels of corporate activity and buoyant markets, small-cap companies in Japan have been largely ignored by stock market investors. For the quarter ending 31st Dec 2020, the MSCI Japan Small Cap Index, in GBP, returned 2.2% while its larger counterpart, MSCI Japan, returned 9.0%. Foreign capital flows into Japan were positive in November and December – a rare occurrence over the past five years. For the time being much of that capital appears to be going into large cap names, although in time, we expect this to broaden out to include smaller companies too. AJOT's return of 1.0% over the quarter is disappointing considering the very strong earnings recovery reported by portfolio companies, as well as the encouraging backdrop of a recovery in global economic activity. This leaves our portfolio trading at extremely attractive levels in terms of both cash/market cap, as well as earnings multiples. With investor attention increasingly turning towards the Japanese market, and with animal spirits amongst activist investors firing up, we believe our portfolio is extremely under-valued.

This quarter's earnings season showed the resilience of our companies, with weighted sales and profits of our portfolio falling year-on-year by -4.5% and -6.8%, compared to the companies in the MSCI Japan Small Cap Index whose sales and profits fell -4.5% and -19.6%. More importantly is that our companies have shown they are on the path to recovery, with quarter-on-quarter profits increasing by a whopping +55%.

Forward estimates for our companies, which in the absence of sell-side coverage are the only guidance investors have, is overly conservative and by and large has not been upgraded since the worst of the coronavirus-related restrictions. The management of our companies are guiding for profits over the next two quarters to be only +11% higher than the last two which suffered the worst of the impact from the coronavirus, and down -11% year-on-year. We expect guidance for many of our companies to be revised upwards over the coming quarters. In fact, **Alps Logistics** in the middle of December hiked profit forecasts by +17%, with stronger than expected cargo handling orders. Its share price rose +10% to the end of December against a +1% increase in the MSCI Japan Small Cap Index.

In 2020 we saw hyperbolic claims from some journalists that activism in Japan was dead and that Japanese management had been vindicated in holding cash – proving the Japan way of defying shareholders wishes. This view quickly diminished with Suga, the new Prime Minister, declaring that "corporate governance reform is key in raising the value of Japanese companies". Furthermore, despite some shareholders holding back from submitting shareholder proposals this year, the number of companies receiving proposals from "activists" grew to 26 from 16 last year.

The total value of takeover bids in 2020, up until 6th November, was +332% higher than the whole of 2019 and +224% higher than the record high in 2007. Most interestingly, over the quarter we saw what has been claimed as the first successful unsolicited takeover bid in Japan. Nitori Holdings' unexpected, and uninvited, bid for Shimachu, came at a price +31% higher than a bid already accepted and agreed between Shimachu management and DCM Holdings. While this is the first successful unsolicited bid, it is one of an increasing number of unsolicited bids which caught the attention of the FT who wrote an article in December nicely titled "Japan's icy climate for hostile takeovers starts to thaw".

Given the valuations of the companies in our portfolio they are clearly not pricing in the possibility of a change in corporate control. Aside from the 7 listed subsidiaries which account for 21% of AJOT's NAV, all of which have a possibility of being taken over or sold by their parent, there are 3 other companies in our portfolio where we know, and are in contact with, willing private equity buyers. It is our role to help and hasten what we believe will be inevitable take overs of these companies – most likely at substantial premiums to their current share prices.

TSE Market Restructuring

In February 2020, the Tokyo Stock Exchange (TSE) announced that it will be reviewing and restructuring its five market segments, consolidating them into three new segments: the Prime Market, the Standard Market and the Growth Market. It has long been a problem that there are too many companies on the 1st section of the TSE, with the number of companies doubling over the past 30 years to over 2,000. 10% of those companies have market caps of $10m or less and would not qualify for listing on the 1st section today.

[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

MANAGER'S COMMENT

To create a more appropriate market structure the criteria for continued listing on the new Prime and Standard Markets are becoming stricter. For example, in December, the TSE confirmed its intention to exclude shares held by domestic banks, insurance companies, or business corporations from its free float calculation – directly attacking Japan's allegiant shareholder problem, and that companies in the prime market will have to adhere to the 2021 revised corporate governance code – which will place more onerous governance requirements on companies.

The restructuring has created an opportunity for us to engage with the four companies in our portfolio who will be affected, including encouraging management to explore privatisation. **King**, which on account of a low market cap and trading volume fails to meet the requirements to keep its listing on the main market; **NS Solutions**, which has a free float of less than the 35% that is required to be on the prime market; **Secom Joshinetsu**, which has a free float of less than the 25% that is required to be on the standard market; and finally, **SK Kaken**, which fails to meet the minimum number of shareholders for the standard market.

That the TSE is taking steps to directly improve corporate governance, tackle low liquidity and attack allegiant shareholders is evidence that the institutions in Japan are serious about creating a more shareholder friendly environment.

Portfolio Activity

Trading activity over the quarter was reasonably modest, with an annualised turnover of 26%. We took the opportunity to trim our positions in **Pasona** and **Softbank Group** after a period of share price strength. In Pasona's case to ensure it did not become too large a weight in the portfolio and for Softbank Group, due to its discount narrowing to the low 40s from a level greater than 70% in March we successfully sold 50% of our investment in **Kanaden** back to the company through an announced buyback program – which was a helpful source of liquidity.

We continued to build our position in system integrator, **DTS**, to capitalise on the exciting digital transformation theme, and it ended the period as our third largest position.

We built a new and, so far, small position, in an undisclosed company, at the start of December. We were able to purchase our stake at a price similar to that at which we could have purchased during the March sell-off, due to forced selling pressure from a large shareholder. We believe there is an opportunity to engage with management on ways in which to improve the valuation at which the company trades. However, it is early days, and we will wait and see how responsive they are to our suggestions before we build the position further.

Q4 2020 Contributors and Detractors

Pasona was the largest contributor this quarter, adding 140bps to performance. Its +30% share price return benefitted from a +15% share price increase from its 50% stake in Benefit One and a more optimistic outlook on its core recruiting and BPO business, which reported its highest ever quarterly profit. However, the stellar performance of Pasona's core businesses was not fully reflected in Pasona's share price, and our estimated discount that Pasona trades to its fair value widened from 73% to 76%. We believe Pasona's valuation became more compelling which is why, despite the strong performance, it ended the period as our 2nd largest position.

SoftBank Group contributed 90bps to returns, on account of its discount narrowing from 56% to 41%, and although our estimated net asset value fell by -7%, Softbank's share price still rose by +25%. SoftBank Group has proved to be an excellent investment for AJOT, and a prime example of the returns available from successful engagement. During the onslaught from the COVID-induced March sell off when Softbank's discount widened to an astonishing 76%, and its share price fell by over 50%, SoftBank, with pressure from shareholders, announced that it would sell assets and fund a buyback for almost a third of its outstanding shares. Since then, it has taken further actions to narrow the discount including increased board independence, improved transparency, and asset sales.

Our third largest contributor over the period was **Digital Garage**, whose share price increased by +19%, recovering from a period of weak performance. Digital Garage holds assets that should be huge beneficiaries from the increased adoption of digital services, including a portfolio of tech start-ups, a digital advertising business and an ecommerce payment settlement business. Over 2020 Digital Garage's share price fell -6%, compared to the MSCI Japan Small Cap return of +2%, and more importantly, an +86% return from Digital Garage's closet payments peer, GMO Payment Gateway. Given its lagging performance looks increasingly divorced from the positive fundamentals, we believe Digital Garage's share price is poised for a strong 2021.

On the detractors, **Teikoku Sen-I** was the largest, falling -10% and reducing AJOT's overall performance by 80bps. Although profits for this year were expected to be weak, with a difficult comparison year, strong H1 profits, +21% year-on-year, caused an increase in expectations. Earnings for the 3rd quarter, reporting a small loss - a not unexpected occurrence (this quarter is seasonally weak, with Teikoku reporting larger losses in 2017 and 2018) – dashed the market's hopes that management were being overly conservative. We were not so optimistic and since May, with share price strength and Teikoku's weight approaching 9% of AJOT's NAV, we reduced our position by -27%. Teikoku's share price has fallen by -20% from its November peak to leave the company trading on an EV/EBIT of 4.5x. With a planned expansion of their factories and a tailwind from structural demand for disaster prevention infrastructure, we are more sanguine than the consensus seems about its prospects.

Kanaden detracted 60bps from returns as its share price fell -13%, following lacklustre earnings which fell-37% year-on-year, as its clients delayed capital expenditure projects, hitting Kanaden's factory automation division particularly hard. Although we had built a good relationship with management and successfully encouraged them to undertake share buybacks and introduce a compensation and nomination committee, we felt with a difficult trading environment and no obvious event that our capital was better placed elsewhere. As mentioned previously, we sold half of our stake back to the Company.

The third largest detractor was **DTS**, whose share price fell -5%. The company reported respectable results, with sales and profits down only -1% year-on-year and order intake growing +32% quarter-on-quarter (albeit still down -7% over the year).

MANAGER'S COMMENT

Most encouragingly, DTS showed progress on building its Digital Transformation (DX) business, with DX sales growing +17% and accounting for 29% of sales in the first half of the year. DTS is one of our highest conviction ideas. We have been consistently adding to it recently, with the position ending the period at a 6.1% weight.

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At the start of January, we welcomed Makiko Shimada to the team. She will be based in London, but due to COVID-travel disruption is spending the first two months in Tokyo. She joins from Goldman Sachs where she advised companies (ironically!) on how to defend themselves against unwanted shareholder attention.

With an expanded team we are ramping up our engagement activity ahead of the AGM season. We are considering proposals at four companies, although we anticipate that a number of these, hopefully all, will be withdrawn as our suggestions are met. Additionally, in the coming month we expect to send a detailed presentation to another company outlining their underperformance and undervaluation – recommending solutions ranging from restructuring, expanding business lines and improving disclosure.

We feel like the wind is in our sails. Progress to improve corporate governance is continuing, the Japanese market is undeniably undervalued and for investors with a bullish economic outlook, Japan is a highly attractive way to gain exposure to a global recovery. Considering that the companies in our portfolio have lagged global markets in 2020, and that share prices have diverged further from their fundamentals, we are optimistic about future performance.

Quarterly Contributors / Detractors

Quarterly Contributors / Detractors

Largest Contributors	Quarterly Contribution bps	Percent of NAV
PASONA	1.4%	6.3
SOFTBANK	0.9%	4.6
DIGITAL GARAGE	0.7%	5.4

Largest Detractors	Quarterly Contribution bps	Percent of NAV
DTS	-0.5%	6.1
KANADEN	-0.6%	1.5
TEIKOKU SEN-I	-0.8%	5.2

Investment Manager – Joe Bauernfreund

AVI Ltd. +44 20 7659 4800 info@assetvalueinvestors.com

The share price can be found in The Financial Times.

Information may be found on the following websites:
www.ajot.co.uk
www.assetvalueinvestors.com