Q2 - June 2021

**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 |
|---|---|---|---|---|---|---|
| **Q2 2021** | 38% | 83% | 5.0 | 4.6% | 16.3% | 2.0% |
| **Q1 2021** | 43% | 81% | 4.8 | 4.9% | 18.8% | 2.0% |
| **Q4 2020** | 47% | 82% | 4.3 | 5.3% | 19.0% | 2.1% |
| **Q3 2020** | 46% | 90% | 4.0 | 5.1% | 19.1% | 2.1% |

## MANAGER'S COMMENT

Dear AJOT Shareholders,

Over the second quarter, AJOT's NAV rose 3.2% despite the MSCI Japan Small Cap index falling and a 1% headwind from Yen weakness. Over the quarter we benefitted from the take-over of Secom Joshinetsu (5% position in AJOT) at a 66% premium to the pre-announcement share price; five of our companies announcing buybacks; a number improving investor communication and governance; and weighted average profits increased by 13% to above pre-COVID levels.

While the recovery in sales and profits has been strong, many companies have been reluctant to revise up forecasts, which we think reflects a conservatism inherent in Japanese management rather than a weak business outlook. While somewhat frustrating, as this conservatism is misconstrued by the market, we are confident that share prices will follow as earnings continue to grow.

As it has been for all, the last year has been challenging and, with Japan lagging other developed countries in its vaccine rollout, social restrictions are still in place. While the Olympics will go ahead, it is unfortunately, not going to be the spectacle showcasing Japan that it was supposed to be before COVID started. The good news, however, is that Japan is rapidly ramping up its vaccine rollout programme and the expectation is that 50% of Japanese people will have received the first dose by the end of August. Our companies have shown their ability to withstand the disruption and we are optimistic that they will perform well when life returns to normal.

**A review of June 2021 shareholder proposals**

We submitted shareholder proposals to the June AGMs of seven companies - four were withdrawn and we launched public campaigns on the remaining three. We withdrew our shareholder proposals after management agreed to our suggestions and announced various shareholder-friendly measures.

We attended the AGMs of the three companies where our shareholder proposals were made public - Tokyo Radiator, NS Solutions (NSSOL) and SK Kaken. While our proposals did not pass, as was expected, they achieved strong support from minority shareholders. Our shareholder proposals to each company were supported by 39%, 33% and 56% of minority shareholders respectively – sending a strong message to management that we are not alone in calling for change.

At Tokyo Radiator's AGM two individual shareholders stood up and questioned the Board, in what we suspect is the only time some members of the Board have heard feedback directly from shareholders. They, rightly so, criticised Tokyo Radiator's relationship with Marelli, the weak mid-term management plan and highlighted that ISS had supported our shareholder proposals. SK Kaken's and NSSOL's AGMs passed with less drama. However, we were told our shareholder proposals have shaken the board of SK Kaken while we know institutional investors and sell-side analysts have expressed their support of our shareholder proposals to NSSOL.

The intent of our shareholder proposals was to raise awareness of issues weighing on the share price, force management to discuss them, and encourage other shareholders to pressure management to rectify them. To that extent, we believe we have achieved our goal and will continue to engage privately, while we evaluate the possibility of further public action.

**Another listed subsidiary bites the dust – Secom Joshinetsu**

At the end of May our 5% position in **Secom Joshinetsu** was taken private by its parent company, Secom at a 66% premium to the prevailing share price. This marks the fourth AJOT investment, and the third subsidiary, taken private since launch. Given the concentrated nature of our portfolio, it had a meaningful impact on NAV, adding 3.3% to performance.

We commented in AJOT's 2020 annual report that, "given the multitude of potential conflicts of interest with minority investors […] our thesis is that Secom will buy in Secom Joshinetsu. […] With a new President at Secom and some nudging from minority shareholders at Secom Joshinetsu, we think this process can be hastened." Our thesis that Secom Joshinetsu would be privatised ultimately proved right, which was a hugely rewarding result for AJOT - not only from a performance perspective, but also as a positive read-across to AJOT's wider strategy.

Firstly, Secom Joshinetsu's buyout proved that increasing pressure from regulatory and governmental bodies to improve corporate governance can be a powerful force to spur corporate activity. Secom Joshinetsu cited the Tokyo Stock Exchange (TSE)'s upcoming market reform as a motivating factor for collapsing the parent/child structure. Secom Joshinetsu did not meet the minimum free float

[1] Net cash = Cash - Debt - Net Pension Liabilities + Value of Treasury Shares
[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

requirements for listing, nor did it meet many of the stricter criteria of the newly revised corporate governance code which explicitly called attention to governance issues with listed subsidiary structures. Regulatory pressure will continue, and corporate governance standards will increase each year – ultimately, we expect this to lead to greater corporate activity.

Secondly, shareholder engagement, even with a controlling shareholder, can be hugely effective. Although undertaken behind closed doors, we have been engaging with Secom Joshinetsu's senior management and directors since we initiated our position in January 2019. We put forward several measures to address the glaringly low valuation, one of which was to be taken private by Secom. We built a healthy rapport with management, and the President of Secom Joshinetsu took the time to personally thank us for our input after the acquisition. Although time consuming, the Secom Joshinetsu outcome highlights the power of hands-on, persistent, shareholder engagement – and that it can be a real source of alpha.

Finally, the premium offered by Secom was fair and reasonable. Secom approached Secom Joshinetsu with three low offers, each being rejected by the Board of Secom Joshinetsu, before they agreed a price of Y6,350, just Y50 from the Y6,400 that we had previously suggested. While Japanese companies have a long way to go, awareness surrounding shareholder rights is improving, and we think the risk of being squeezed out at a punitive price is diminishing.

This bodes well for our investments but especially for the five listed subsidiary companies in AJOT's portfolio, accounting for 17% of NAV. We are quietly optimistic that at least one of these will undergo some form of corporate event in the near term to crystallise the undervaluation.

**A-One Seimitsu – being the force for change**

Our shareholder engagement efforts transcend the entirety of AJOT's portfolio, even to our smaller 2.9% position in A-One Seimitsu. A-One manufactures collets (used to grip objects) and resharpens tools for clients across a variety of industries. Many of these tools and parts are essential, such that the machines that use them cannot operate without them. Therefore, short lead times are essential, something on which A-One prides itself. By operating a lean employee structure with the same person taking the order, sending it to the factory then writing the invoice, orders can be shipped out on the same day, while competitors can take a week.

A-One's focus on quality and speed has given it a dominant 60% market share, with even some of its competitors sending more specialised orders to A-One. A-One does not compete on price and has generated an average operating margin over the past 10 years of 27%.

The market cap of the company is covered over 100% by net cash on the balance sheet, meaning that we are effectively buying the operating business for free. The low valuation is driven by non-fundamental factors, such as A-One's low liquidity, high cash backing, poor IR efforts (which is defaulted to the already busy President) and simply being too small for most funds.

We have been engaging, rather successfully, with the Company. The President, and other members of the management team, have been receptive to our advances, and we speak with them numerous times each month. Last year they conducted a 2-for-1 stock split to help improve liquidity, increased the dividend by 43% for a 75% payout ratio and agreed to our suggestions on how to modernise the website, which had not been updated since 2001. Unfortunately, these actions have done little to rectify the undervaluation, and the Company, with the higher payout ratio, is trading on a healthy dividend yield of 3.7%.

A-One should be taken private. Such a suggestion is less alien than it might have been in the past, and the environment for privatisation is quite accommodating. We are sure that the management of A-One could privatise the Company with no capital, funded by cash on balance sheet and some debt. A 50% premium would put the Company on an EV/ five-year average EBIT of 7.7x and, excluding cash, a five-year average FCF yield of 10.0%. The hurdle, although not insurmountable, for privatisation is the 82-year-old Founder who controls 26% of the Company. However, we own 10% as does another like-minded shareholder.

While we evaluate options to crystallise the value of A-One we are quite happy holders, exposed to a high-quality business, and we can afford to be patient.

**Q2 2021 Contributors and Detractors**

As discussed, **Secom Joshinetsu** was the largest contributor after being taken over by its parent at a 66% premium, adding 330bps to returns. **C Uyemura,** a manufacturer of chemicals used in the production of electronic devices, was the second largest contributor adding 101bps to performance as its share price rose +20%.

We put in a significant amount of effort to our private engagement, suggesting multiple ways in which C Uyemura could increase its corporate value. It was therefore pleasing that, in May, C Uyemura released a mid-term business plan for the first time, announced a new stock-based compensation scheme for directors, a 2-for-1 stock split to improve liquidity, a 9% buyback over the next 3 years and revised earnings upwards by +22% (to the highest in the Company's history). The market reacted favourably to the news, and we think this could be the start of a change in investors' perception of C Uyemura from a sleepy family-orientated company, to a more progressive shareholder-friendly one.

Despite the strong share price appreciation, C Uyemura still trades on a modest 4.6x EV/EBIT multiple, with net cash and investment securities covering 53% of its market cap. With C Uyemura being a candidate for promotion to the Prime Section under the new Tokyo Stock Exchange market structure, coupled with a strong earnings backdrop, we are optimistic about C Uyemura's prospects.

The second largest contributor last quarter, the **Bank of Kyoto,** was the largest detractor this quarter, reducing returns by 120bps as its share price fell -26%. While the Bank suffered from an increase in COVID-related provisions, management continued its efforts to streamline costs, with operating expenses falling -2.5% after falling -3.7% the year before.

## MANAGER'S COMMENT

Most of the Bank of Kyoto's value resides in its portfolio of blue-chip Japanese stocks which, after tax, accounts for 157% of the market cap. The value of these stocks and our estimated value for the banking business, fell by a modest -3% over the quarter, while the discount widened from 52% to 63%, accounting for -23% of the share price fall. We attribute the discount weakness less to operating reasons and more due to profit taking after the share price rose 27% in the first quarter of the year.

Our investment case in the Bank of Kyoto is predicated on being exposed to an attractive portfolio of blue chip Japanese companies while increasing pressure from regulators to improve regional banks operating performance continues. On a 64% discount, investors are pricing in a low prospect of change and given the upside, we can afford to be patient.

**Konishi** was the second largest detractor from results, with its share price falling -10% and reducing returns by 50bps. While the Company performed well over the past year, with profits growing +2%, a lacklustre outlook for only +2% profit growth next year did little to excite investors. However, we think this is a conservative forecast and we have been impressed by the new CEO, Mr. Oyama, who started in April. He spoke to us about his aggressive growth plans and willingness to undertake shareholder-friendly actions, and his informal target to increase Konishi market cap to Y100bn (Y57bn currently) in four years. Being an Osaka-based company, Konishi flies under the radar of most investors. We do not, however, believe its lowly 5.3x EV/EBIT multiple can be justified given the quality of the business.

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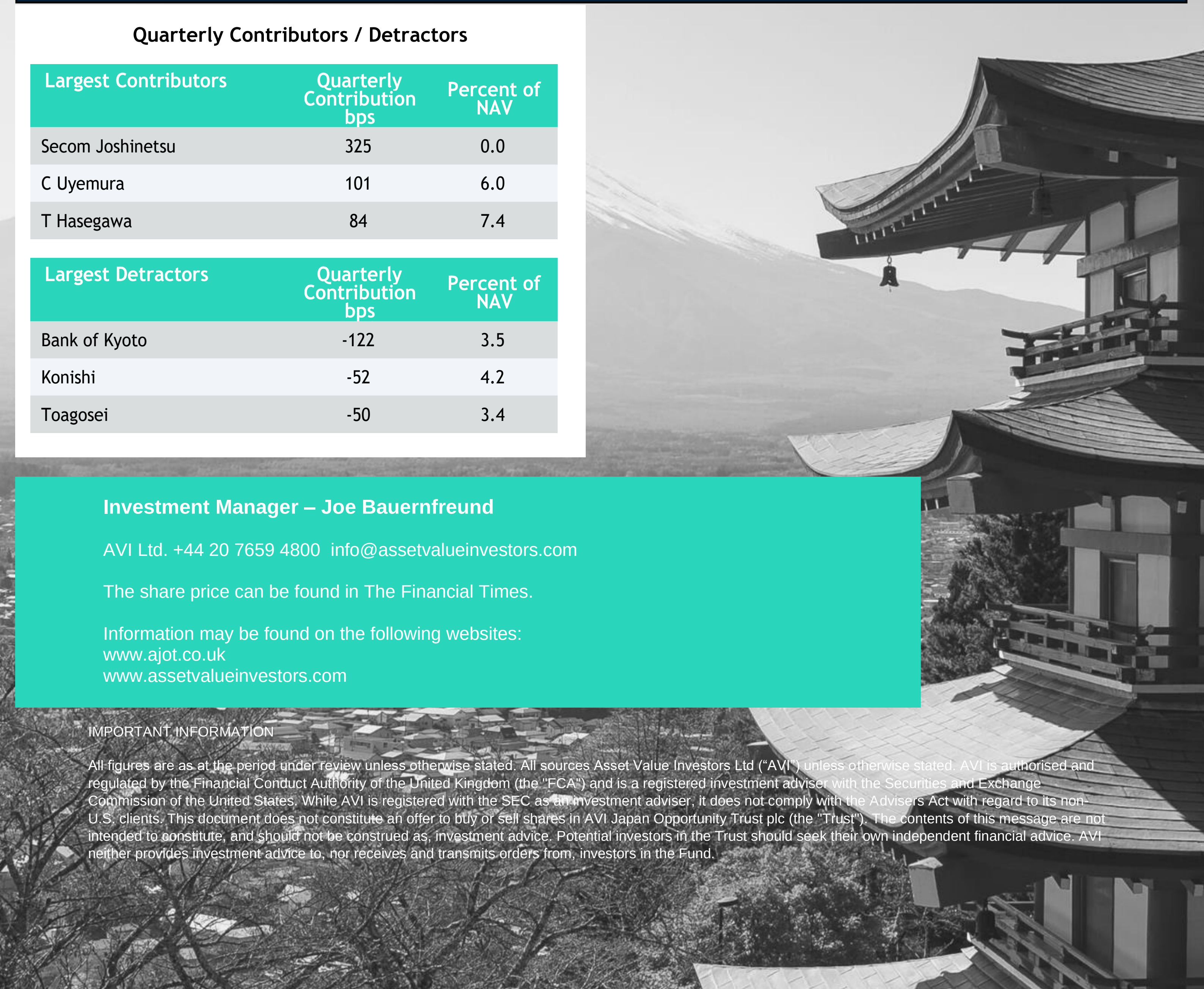
At the start of this year, it seemed everything was going well except share price performance - earnings were rebounding, corporate activity was picking up, and valuations remained compelling. Towards the end of this quarter, we started to see performance catching up with fundamentals. While there is a long way to go, we are confident in the fundamental strength of our portfolio, and that ultimately fundamentals matter. It is just a matter of time before they are more fairly reflected in share prices.

## Quarterly Contributors / Detractors



### Quarterly Contributors / Detractors

| Largest Contributors | Quarterly Contribution bps | Percent of NAV |
|---|---|---|
| Secom Joshinetsu | 325 | 0.0 |
| C Uyemura | 101 | 6.0 |
| T Hasegawa | 84 | 7.4 |

| Largest Detractors | Quarterly Contribution bps | Percent of NAV |
|---|---|---|
| Bank of Kyoto | -122 | 3.5 |
| Konishi | -52 | 4.2 |
| Toagosei | -50 | 3.4 |

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The share price can be found in The Financial Times.

Information may be found on the following websites:
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