AVI Japan Opportunity

AJOT has delivered strong returns to date from a unique and original strategy…

Update
13 April 2023

Overview

AVI Japan Opportunity (AJOT) takes an activist approach to investing in a market with some of the most lowly-valued companies in the world. Japanese small caps are under researched and, due to a variety of reasons, often have exceptionally high amounts of cash and low valuations, even when the underlying businesses are operationally strong. AVI, the manager of AJOT, aims to identify those companies in this universe which have high-quality underlying businesses and scope for engagement to rectify undervaluations.

AJOT was launched in late 2018 and has performed very well since, being almost the top-performing of any Japanese trust over this period (see **Performance**). Returns have been driven by some exceptional single-stock gains, as engagement has been met with action by company management teams and as valuations have expanded.

The management team, led by Joe Bauernfreund, have gradually increased the concentration of the portfolio over the years, aiming to ensure their engagement efforts will have a meaningful impact on NAV when successful, justifying the intensive work they put into each engagement. Engagement is increasingly on the operational side, rather than only focussing on agitating for dividends and buybacks. This shows management teams that AVI is a genuine long-term investor and ensures the returns are potentially even higher over the long run, if operational improvements work alongside valuation uplifts to drive the shares. To the same end, the quality of the portfolio has improved over time. Joe and the team think there is huge upside in many stocks in the portfolio, even for those which have already produced excellent outperformance (see **Portfolio**).

Joe's optimism on the opportunity set means that he is comfortable with increasing gearing above current levels (see **Gearing**), but the trust has been raising cash through issuing shares and recently sold some positions, and the managers are sticking to their discipline of being highly selective regarding new entrants to the portfolio.

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Analyst's View

We think the fact that AJOT has traded close to, or above, par since launch is testament to the trust being a premium product. It has a clear and differentiated strategy, which has worked just as intended, since launch. The team have shown their ability to generate alpha and their thesis has been proven, as companies in Japan have responded to government and regulatory intervention positively, with a revolution in corporate governance underway.

In our view, AJOT would be a worthy addition to many portfolios, thanks to the differentiated source of returns in a market to which many investors are likely to have little exposure. Additionally, we think it is worth bearing in mind that the good performance, so far, has come during a period in which Japan has been out of favour with foreign investors, small-cap companies have underperformed and the Japanese yen has been weak. However, the outlook for Japan is, arguably, more positive than it has been for some time. Inflation in Japan has been modestly above target and the central bank has gingerly begun to tighten monetary policy. With the potential for the US and other developed countries to loosen later in the year, there is a positive backdrop for the currency. And with Japan having only recently released the last pandemic restriction, there is likely to be a spurt of domestic economic activity. A return of confidence and foreign inflows to Japan could provide further impetus for good AJOT returns.

BULL
Highly-differentiated strategy with clear path to adding alpha
Strategy has been proven to work with many individual companies since launch
A reversion of cheap valuation of yen and Japan, having been out of favour, may drive the market higher

BEAR
High concentration brings potential for underperformance, as well as outperformance
Japan and the yen are economically sensitive, so market could be volatile
Intensive engagement strategy requires a lot of work which could spread the team thinly

Portfolio

AJOT is a unique investment proposition, offering exposure to a number of sources of alpha in a package that is likely to offer differentiated returns to the funds in most investors' portfolios. The managers fish in the Japanese small-cap market, looking for high-quality companies with deeply discounted valuations. They then look for those where they can take an activist approach to unlocking the value, working with management teams as long-term shareholders to see operational improvements in the businesses. This should lead to expanding revenues and valuation multiples, plus more generous shareholder returns.

We expect most readers have come across the key argument behind the strategy before, as it has become well-established, thanks partly to AVI's success in implementing it on the trust over the past four and a half years. Full background to the corporate governance reforms in Japan can be found in our past notes **such as this one**. To cut a long story short, Japan is seeing a revolution in corporate governance aimed at increasing the efficiency with which its companies use their capital in order to encourage growth. This revolution began with the Abe government, and has continued under his successors. It has involved placing obligations on companies and shareholders to improve governance by addressing board composition, justifying or selling cross-holdings and focussing on shareholder returns. This has opened the door for investors like AVI to take an activist approach to investing in Japan and know the government and regulators back their goals.

AJOT's portfolio is highly concentrated, with the aim being to hold 20 to 30 companies at any one time. In order to gain traction with management, the team look to take significant shareholdings in the underlying companies, over time. This, and a desire to see the best ideas able to move the needle, has seen the concentration of the portfolio increase, with 68.8% in the top ten positions at the end of February 2023 compared to c. 40% at December 2018. The managers are usually collaborative in their approach, looking to gain the trust of management teams and largely waiting for some time after initiating a position to make proposals to the board. Most contact is private, although the team have conducted some public campaigns to gain support from other shareholders. They take time to develop their proposals for each company, building close relationships with management. All this is time consuming which further justifies a concentrated portfolio and has led to AVI expanding its investment team, adding native Japanese speaking analysts and those with past experience in consulting.

The Japanese small cap market is home to many anomalously cheap companies for a variety of structural reasons, chiefly its **historical development** and lack of investor interest, especially from abroad. This lack of coverage combined with low valuations is a powerful combination when it comes to providing opportunities to add alpha. As the table below shows, AJOT's portfolio is significantly cheaper even than the Japanese small-cap market. Regular readers may notice the valuation metrics have drifted since the trust was launched in 2018. The team tell us they have increasingly been focussing on the quality of the businesses as much as the valuation. The universe of potential investments is so broad that they can be picky, and the focus of engagement is on the operational side of the business. Having an operationally strong business is obviously a key engine of share price appreciation, and by identifying businesses with this potential as well as egregious valuations, Joe and the team can find companies with the potential to make exceptional returns. By holding higher quality companies, there is also more downside protection in the event that engagement is not successful. That said, with net financial value (i.e. cash and transferrable securities) at 63% of market cap and an EV/EBIT multiple of just 7x, the portfolio is still exceptionally cheap.

Portfolio Characteristics

	AJOT	MSCI JAPAN SMAL CAP INDEX
Net cash as % of market cap	40%	-13%
Net financial value as % of market cap	63%	-3%
FCF yield (equity)	5%	7%
FCF yield (EV)	13%	9%
EV/EBIT	7x	13x
Dividend yield	2.2%	2.4%

Source: AVI, as at 31/01/2023

A good example of the focus on quality and valuation working well is the investment in Fujitec. Fujitec manufactures and services elevators and escalators. It is one of the large players in Japan, a market which overseas operators have eyed up for decades. AVI launched a rare public campaign in May 2020, highlighting underperformance versus global peers and undervaluation. Since the campaign launched, and management responded positively, the valuation has risen from less than half that of its peers (on an EV/EBIT basis) to comparable levels. The shares have made 117% while the TOPIX Index rose 36% and Fujitec's peers were up 46%. Yet, there are still gains to be made in the team's view. Governance is still not ideal, and Joe and the team now see a path to a privatisation which could unlock another 30% extra upside, in their estimation.

There are many companies in the portfolio which the team believe can deliver exceptional returns. For example, IT services company DTS Group, the largest holding in the portfolio, of which AVI is the largest single shareholder.

DTS has seen strong EBIT growth in recent years, propelled by the digitisation of the economy, and hits the quality targets Joe and the team insist on. The team have engaged with management heavily over the years, logging over 40 meetings and 20 written letters and presentations. In 2022, the board published a long-term plan with everything the team had recommended, sketching out plans to reduce cash as a percentage of market cap, from 60% to 30%, boost the payout ratio to 90% and create a new board structure with greater diversity and independence, among other objectives. Speaking with the team, it is clear how pleased they are with this outcome, and DTS shares responded positively to the plan, outperforming the market. The team still think there is significant upside, with another 40% to 50% of gains available, if the undervaluation versus peers corrects. As at the end of January, DTS was trading at 9x EV/EBIT, versus an average of 13x for its peers. DTS exemplifies the detailed, consultant-like approach the AVI team are increasingly taking with its investments, and also the positivity with which many engagements are being met. The team tell us there has been a marked increase in the quality of conversations they have been having with investee companies over the past few years, as the new corporate culture develops. In our view, this bodes well for future returns.

Top Ten Holdings

HOLDING	WEIGHT %
DTS	8.5
Nihon Kohden	8.3
TSI Holdings	7.9
Shin-Etsu Polymer	7.2
Konishi	7.1
Wacom	6.7
T Hasegawa	6.0
NC Holdings	5.9
Digital Garage	5.7
Fujitec	5.5
TOTAL	**68.8**

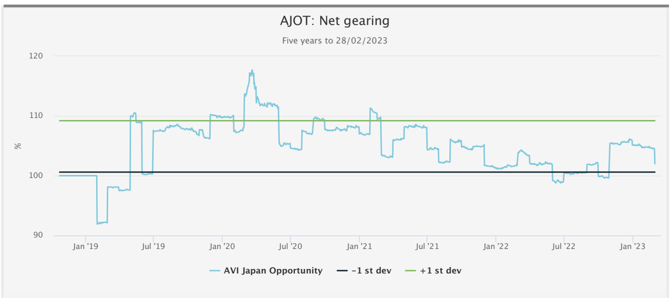
Source: AVI, as at 28/02/2023

Only two new investments made it into the portfolio in 2022, reflecting the high standards of the team and their determination to focus on fewer ideas in order to better take advantage. Medical device manufacturer Nihon Kohden has already become the second-largest position in the portfolio. They estimate a potential 86% upside over the next few years, which could come from an EV/EBIT of 10.9x, approaching the 16.2x peer group average. Potential returns are even higher than that, if margins can expand and overseas growth continues at the annual 15.4% pace achieved over the past decade. Expanding operational margins is one of the objectives in the plan which AVI is developing for the company, working closely with management. The other new idea last year was apparel brand company TSI Holdings, which has a potential upside of 111% in the team's view, with cash, securities and property accounting for 145% of market cap.

Gearing

The board and manager have agreed to use gearing to enhance portfolio performance, with no target level formalised. AJOT has a revolving credit facility, which allows it to draw down up to 2.93bn yen, worth c. £18.6m at the time of writing, or 10.6% of NAV, as at the end of February. Daniel Lee, the head of Japanese research, tells us that the team would like to keep around 5% to 10% gearing over the long run, and the chart below shows that the average level has been around 5% since launch. In practice, however, net gearing levels fluctuate depending on the opportunity set. As the portfolio is concentrated and run with high conviction in each holding, the sale of a handful of companies last year on valuation and operational grounds (see **Portfolio**) has returned cash, shrunk the portfolio and, therefore, reduced net gearing to the lows of its typical range. The managers have high standards for new entrants into the portfolio and so won't invest in new ideas until they are comfortable with them and have a high level of conviction. Nonetheless, we would expect gearing to tick up in future, as new ideas are invested in.

Fig.1: Net Gearing

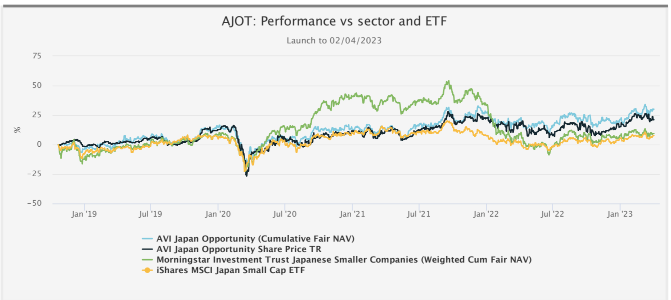


Source: Morningstar, Kepler calculations

Performance

AJOT is the top-performing Japanese small-cap trust and second-best performing trust in the combined AIC Japan and Japanese Small Cap sectors, since it launched in October 2018. Importantly, its return profile has displayed the defensive and low-correlation characteristics that might be expected from a focus on anomalously strong balance sheets and company-specific opportunities. Over the period, AJOT has displayed a beta of just under one, one of only two trusts to do so. It also has the lowest annualised volatility (despite being in the small cap sector where volatility might be expected to be higher) and its r-squared to its benchmark, 80.6%, is in the lowest quartile of the combined peer group. As the chart below illustrates, NAV total returns have been 30% in sterling, versus a weighted average of just 9.4% for the Morningstar Japanese Smaller Companies sector. The MSCI Japan Small Cap Index has returned just 8% over this same period.

Fig.2: Performance Since Launch

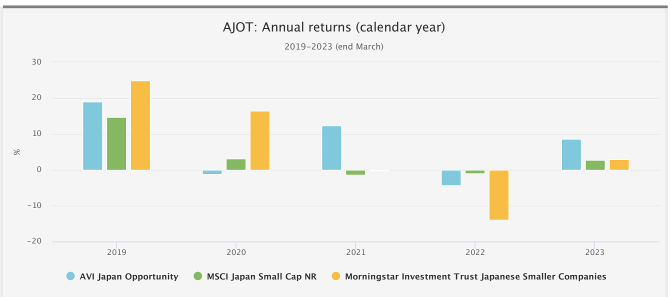


Source: Morningstar

Past performance is not a reliable indicator of future results.

Returns versus the peer group have been aided by the poor performance of growth strategies since mid-2021, as interest rate expectations rose. As the chart below shows, AJOT's only poor year was 2020, when markets were swamped by a flood of capital into technology and ecommerce firms. This was mainly in the large cap space, as a reaction to lockdowns and interest rate cuts. In 2022, the trust did lose more than the market, but outperformed the sector significantly. This underperformance was due to stock-specific factors. Firstly, recruitment company Pasona was caught up in the growth stock sell-off, thanks to its exposure to its subsidiary, Benefit One. Pasona was trading at a significant discount to NAV, but this didn't prevent the market selling it down. Secondly, Wacom had a profit warning, with its exposure to consumer markets weighing on the stock. In both cases, the team didn't believe the investment case changed, but believe these are short-term factors which will fade. They have held on to both companies.

Fig.3: Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

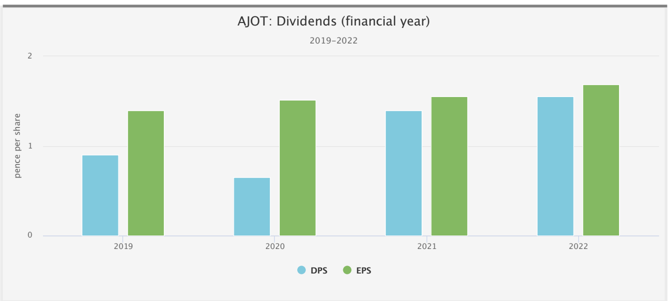
Markets in recent years have been macro-driven, and AJOT is more exposed to the value factor than growth. However, we highlight that in 2019, when growth strongly outperformed value, AJOT generated highly attractive returns. This is because the strategy is focussed on finding idiosyncratic situations, which can allow the managers to unlock value in specific companies. It should be possible to unlock this value, irrespective of short-term macro trends. We think this means AJOT has a clear path to outperform, regardless of the market environment. The concentration of the portfolio over the past year or so has increased (see **Portfolio**), which should increase the importance of stock-specific factors to returns and ensure individual successes have more impact.

That said, we think there are some macro factors investors might like to consider. The yen has been weak in recent years and it could boost returns for AJOT's shareholders, if this were to reverse. We think there is a potential path to this if, as expected, the US hits the peak of its rate cycle while Japan is still tightening monetary policy. Additionally, the Japanese economy has the wind in its sails at the moment, with a late re-emergence from pandemic restrictions, which were really only completed last autumn, leading to a boost in consumer spending and inward tourism. Japan has modest inflation, which the government has been desperate to achieve for years, and modest wage growth is positive for consumer sentiment and spending. Japan has been out of favour with foreign investors for around a decade. AJOT has delivered good returns from its bottom-up strategy, while macro conditions have been, at best, ambiguous in Japan and foreign investors have been scarce. There is, in our view, the potential for even better returns if more foreign investment flows into the country and this could be a catalyst for valuation reversion.

Dividend

The board's policy is to distribute "substantially all" of the net revenue as income each year. There is no objective to pay a high yield or to grow it from year to year, and they advise the payout "may vary substantially from year to year". One of the ways in which company management teams can respond to shareholder demands to make capital work harder for them is to distribute excess cash. While Joe and the team focus their efforts on a variety of areas, improving shareholder returns from their engagement might be expected to see earnings and, therefore, dividends grow from year to year. Apart from 2020, when underlying company earnings were hit by the pandemic, revenues have grown year-on-year, as the below chart shows. The historic yield at the time of writing is 1.3%. At this level, we think it unlikely that the trust will attract income-seekers, although there is the scope for growth in dividends and the board has a revenue reserve of 0.82 times last year's dividends to support payouts, if it desires.

Fig.4: Dividends



Source: AJOT

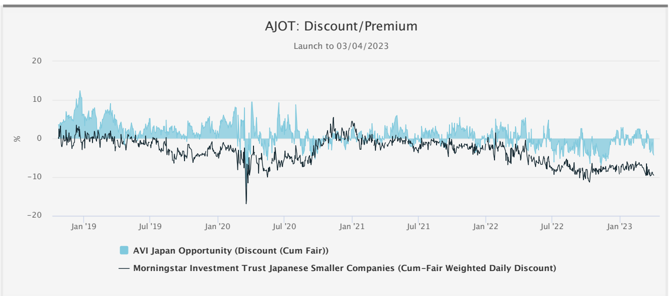
Management

AJOT is managed by Asset Value Investors (AVI). CEO and CIO Joe Bauernfreund is the lead manager, while Daniel Lee, head of Japanese research, has a key role. AVI has invested significantly in the team since the trust launched in 2018, having added three Japan-based analysts and consultants, with a further two to come. Notably, the senior analyst on the team, Kaz Sakai, joined from consultant McKinsey. The team's engagement activities, in focussing on operational improvements, increasingly resemble the sort of work often provided by management consultants.

Discount

Demand for AJOT's shares has been strong since it launched, with them trading at an average premium of 1.1%, despite the volatility seen in global markets. The weighted average for the Japan small-cap sector is a 3.3% discount. We think this is testament to the truly differentiated proposition, which offers a clear path to generating returns less correlated to market directions. Since launch, the shares in issue have grown from 80m to 140m, i.e. by 76%, thanks to regular issuance at a premium.

Fig.5: Discount



Source: Morningstar

Buybacks have been used sparingly. The board bought back 250,000 shares in June 2021, and 400,000 shares in October 2022, which were subsequently reissued. No target level for buybacks has been given. Last year, it consulted with shareholders about whether it should offer an exit opportunity, further to stating in the prospectus that it would. Thanks to positive responses from shareholders, the board did not offer one, and it will next consult in 2024. If the shares continue to trade close to par, we think it is highly unlikely that shareholders would want the trust to bear the costs of such an offer.

Charges

AJOT's latest ongoing charges figure (OCF) is 1.49%, which compares to the simple average for the AIC Japanese Smaller Companies sector of 1.21%. This includes a management fee of 1% of the lower of the market cap or NAV, ensuring that the manager is incentivised to see the trust's shares trade close to NAV.

AVI and its employees have over £2.9m of their own money in AJOT and reinvest 25% of the management fee into the trust each year. We think this indicates a meaningful commitment and an alignment of interests between management and investors, not to mention reflecting a high degree of confidence in the strategy. As at the end of January 2023, AVI and its employees held c. 1.8% of the shares. The costs of activist activities and engaging with management are borne entirely by AVI, and not by AJOT.

The Key Investor Document Reduction in Yield figure of 1.82% is slightly above the 1.76% simple average of the peer group, although we note that calculation methodologies can vary.

ESG

AJOT is, in our view, a perfect example of the limitations of conventional ESG analysis. Even though Morningstar rates AJOT as 'low' for sustainability, compared to its wider Japanese small and mid-cap peer group, it is undoubtedly a sound choice for an ESG-conscious investor. This is because this rating is based on the scores of the trust's underlying assets and, therefore, highlights a key part of its investment process. Companies with a poor ESG rating likely have the largest scope for valuation reversal through active engagement, to embed sustainable practices and improve disclosure, and the AJOT team are making huge strides in improving the ESG credentials of their companies.

The team have made clear improvements to the governance of their companies, be that through improving disclosures or shareholder returns. ESG of course covers more than just governance; and the team engage on all issues. The team can demonstrate enormous achievements in advancing the environmental and social credentials of their companies – for example, they have been successful in pushing companies to appoint their first female board members and submitted shareholder proposals to SK Kaken last year calling for disclosure of scope 1 and 2 emissions data. This is a fundamental first step in modernising the ESG credentials of their companies, and it is because of these fundamental yet critical accomplishments that we believe AJOT can easily be recommended to any ESG-conscious investor.

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