Q3 – September 2023

Investment Objective: To achieve capital growth through investing in a focused portfolio of over-capitalised small cap Japanese equities. Asset Value Investors will leverage its three decades of experience investing in asset-backed companies to engage with company management and help to unlock value in this under-researched area of the market.

	Net cash[1] as a percentage of market cap	NFV[2] as a percentage of market cap	EV/EBIT	FCF Yield	Dividend Yield
Q3 2023	36%	56%	7.4	4.6%	2.5%
Q2 2023	32%	50%	8.6	4.6%	2.2%
Q1 2023	36%	51%	9.0	5.3%	2.2%
Q4 2022	38%	58%	6.7	6.2%	2.4%

MANAGER'S COMMENT

The fund's NAV declined by -2.0% over the quarter (in EUR) in an environment that strongly favoured large-cap value stocks, especially those trading on a low price-to-book ratio (PBR).

Amid the fervour from the Tokyo Stock Exchange (TSE)'s call for companies to improve capital efficiency, especially if trading on a PBR of less than 1x, there seemed to be indiscriminate buying of low PBR companies regardless of quality. We don't pay much heed to PBR, preferring to focus on overcapitalised companies trading on low EV/EBITs, where we see significant upside to peer multiples, and where there is room for us to add value as long-term engaged shareholders. For that reason, some of our companies lagged, but we simply believe this represents a store of future value as market flows normalise. Over the quarter we took advantage of share price weakness to add to existing holdings, while also initiating a new position in a medical diagnostics company.

We visited Japan at the start of September, with a full week of meetings conversing with the CEOs/Chairmen of seven portfolio companies. One company hosted us for lunch at their 120-year-old former headquarters, making us the first foreign company to be given the privilege and highlighting the appreciation companies have for our collaborative engagement approach. Generally, the quality of our meetings continues to improve and with greater awareness around valuations and engagement pressure, there is growing interest from management about how to address weak share prices.

Regulatory pressure continues unabated. Following on from the TSE's impactful corporate governance code revisions at the start of the year, the Ministry of Economy Trade & Industry (METI) finalised its guidelines for corporate takeovers (more on this below), while the FSA's first meeting reviewing the tender offer rule and large shareholder reports took place at the start of June. The direction of travel is clear, with shareholders, regulators and the Government all pushing in the same direction.

It was a mixed picture on the earnings front, as COVID-beneficiaries such as Wacom, Pasona and Alps Logistics saw earnings weakness, while Konishi, JADE GROUP and Digital Garage continued to see strong profit growth (+75%, 53% and +23% respectively). Cost pressures seem to be alleviating and price increases are taking effect, which we suspect will buoy earnings over the coming year.

In August we welcomed the newest addition to the Japan team, Shuntaro Shimizu, joining from Bain & Company's Tokyo office. Prior to that he gained valuable financial experience at the Bank of Japan and holds an MBA from Stanford School of Business. He will be focused on bringing his consulting experience to engaging with our portfolio companies and researching new ideas.

At the end of the quarter, the weighted average EV/EBIT multiple on the portfolio was 7.4x, with net cash and investment securities covering 56% of the market cap. We believe that the lowly valuation of the portfolio does not come close to reflecting both the quality of our portfolio companies, nor the prospects for change.

[1] Net cash = Cash – Debt – Net Pension Liabilities + Value of Treasury Shares
[2] Net Financial Value (NFV) = Net cash + Investment Securities

MANAGER'S COMMENT

Hostile Takeovers – A more fertile environment

At the end of August, METI published its "Guidelines for Corporate Takeover". METI felt an update to previous guidelines was needed given the changing corporate landscape and various governance reforms that are taking place. The guidelines contain encouraging wording that we believe might pave the way for more unsolicited takeover approaches.

While there have been glimmers of hope for a more active takeover market in Japan, to date unsolicited bids have been few and far between. Private equity firms fearful of damaging their reputation and trade buyers who often have cosy relationships with their peers have been unable to take a forthright approach when it comes to takeovers. As METI say in their report, "*an active market for desirable M&A transactions will optimize resource allocation, accelerate industry restructuring, and promote healthy economic metabolism of Japan's capital markets where many participating companies currently have low capital efficiency*." We agree that the threat of M&A is an important component of a healthy functioning capital market, and one that Japan has been lacking.

We have already seen the positive impact of this when during the quarter, Takisawa (6121), a small machine tool manufacturer, announced its support for Nidec's (6594) unsolicited 64% premium tender offer. Nidec's President made an interesting comment that "*there were media outlets who viewed the takeover offer favourably. It may have failed 15 years ago, but times are changing*".

Having participated in the consultation, submitting public comments and meeting with METI officials while they were formulating the guidelines, we have a good understanding of METI's goals. As a participant in the equity market, investing in undervalued and underachieving companies, naturally we are a beneficiary of more active M&A, but we also believe it opens an opportunity for us to conduct tender offers.

Earlier this year we made our first tender offer to a portfolio company, seeking to take a large minority stake. The Company took our approach seriously, appointing deal advisors, and in response hiked their dividend by 33% and announced a share buyback. The share price rose above our tender price, and we exited generating a +32% ROI and a +92% IRR.

The option of putting forward tender offers won't be an appropriate strategy for all our holdings, but we believe the environment has evolved in such a way that unsolicited tenders can now become a valuable tool to add to our engagement repertoire.

Portfolio Trading Activity

Over the quarter trading was modest in what was a reasonably benign period with little volatility. We exited two holdings in Toagosei and ITFOR.

On the purchases side, we added to Digital Garage, NC Holdings, Takuma, TSI Holdings, Aichi and Fuji Soft, while also initiating a new position in an undisclosed medical diagnostics company.

Contributors and Detractors

Takuma (6013), a newcomer to the portfolio earlier in the year, was the strongest performer with a +6.5% share price return adding 72bps to performance. Takuma builds waste treatment plants for local municipalities in Japan, and with a tight labour market there is a trend of outsourcing the operation of these plants to the constructor on decade long contracts. This trend underpins our investment thesis for Takuma, with the business gradually shifting towards recurring maintenance and operation contracts, which we do not believe is recognised in Takuma's 3.8x EV/EBIT multiple. Given relatively high liquidity, we were able to build a sizeable investment in Takuma, with an 7.1% weight making it the 4th largest position in the portfolio. CLSA summed up Takuma's potential in an excellent note over the quarter, which we suspect bolstered the shares. Entitled "Recurring Dream", the author highlighted that Takuma has built 120 waste-treatment facilities in Japan, 60% of which already have operating contracts, leaving room for further upside as the remaining 40% convert. We've built a 2% stake in the Company and have sent a presentation with a variety of measures that we'd like to be included in their mid-term plan next year.

TSI Holdings (3608) share price had a tumultuous quarter but ended slightly higher, with a +2.9% return adding 55bps to performance. We took advantage of the volatility to add to our holding, declaring an increased stake twice during the quarter and ending up as the largest shareholder holding 8.5% of the shares. Continued strong store sales, up +4.4%, +5.2% and +7.4% for June, July and August helped to support the share price.

MANAGER'S COMMENT

Over the quarter we sent a presentation to management on suggestions to address the low market valuation and increase the share price to our Y1,500 target price (+85% upside to the current price). The presentation was well received, and we sense that management are considering actions over the coming year. We're pushing on an open door, with the Company already completing a 3% share buyback this year after purchasing 6.5% of its shares last year.

NC Holdings (NCHD) (6236) share price drifted steadily lower over the quarter on lacklustre earnings and news that NCHD's subsidiary, Nippon Conveyor, along with seven other mechanical car park manufacturers are being investigated on suspicion of violating the antimonopoly act. The share price ended the period down -26% taking 245bps from performance and making it the largest detractor.

While we have no view on the likely outcome of the investigation, it is yet another indicator of NCHD's poor corporate governance. We have raised numerous concerns over NCHD's corporate governance, voting to remove all outside incumbent directors at the last AGM and seeking to install two highly experienced directors with capital markets experience. The Board's decision to fight our eight shareholder proposals when six achieved majority support from shareholders showcases their disregard for shareholders. We hope the continued weak share price, poor operating performance and collusion investigation will highlight to other shareholders that NCHD needs a fresh slate of outside directors with relevant experience to increase NCHD's corporate value.

During our recent trip to Tokyo, we further conveyed to the President that NCHD needs to release a mid-term plan that would allow investors to better appreciate NCHD's prospects. Despite management's hostile approach at the AGM, the meeting was cordial, and the President was receptive to our suggestions, acknowledging the high support for our shareholder proposals. We want NCHD to thrive, and with the right strategy and board experience we believe it will. With the weak share price, we see significant upside.

Shin-Etsu Polymer (7970)'s share price weakened by -10.5% over the quarter, which detracted -124bps from performance. Lacklustre earnings weighed on the share price as profits suffered from a downturn in demand for their wafer carrier cases. Sales grew by +5% YoY while EBIT declined -12%. Pleasingly, Shin-Etsu Polymer announced the sale of its low margin PVC pipe business in August to Sekisui Chemical and two affiliated companies, Tokuyama Sekisui and Vantec, rightly focusing the business on higher margins products.

Trading on an EV/EBIT of just 4.9x with net cash covering 45% of the market cap, Shin-Etsu Polymer's share price is deeply undervalued, owing to its parent/subsidiary structure with Shin-Etsu Chemical, who own over 50% of the shares. With Shin-Etsu Chemical being both a customer and supplier of Shin-Etsu Polymer, there are potential conflicts of interest and the lack of majority board independence and presence of ex-Shin-Etsu Chemical employees as directors raises concerns. We have put forward a simple argument: either treat minority shareholders more fairly by acting in their best interests and improving governance or become a wholly owned subsidiary of Shin-Etsu Chemical. We plan to meet with both parent and subsidiary over the coming months.

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The share price can be found in *www.AJF-fund.com*

Information may be found on the following websites:
www.AJF-fund.com
www.assetvalueinvestors.com