Q4 – December 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
Q4 2023	37%	48%	9.1	4.6%	2.4%
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%

MANAGER'S COMMENT

The funds NAV increased by +12.0% over the quarter taking returns for the year to +18.8%, strongly ahead of the Benchmark (the MSCI Japan Small Cap Index), which returned +3.0% and +9.5% respectively (all in EUR). Performance for the quarter was aided by a modest +1.5% appreciation in the Yen but mostly driven by stock specific events. Nihon Kohden (+21%) gained after a prominent US engagement fund took a 5% stake, Shin-Etsu Polymer (+25%) rallied following further pressure from the TSE on listed parent-subsidiary relationships while JADE Group (+32%) was buoyed by strong earnings. The period also benefitted from a lack of notable detractors, TSI Holdings (-9%) being the only one. In a year that strongly favoured large cap value stocks, where the fund has little exposure, the continued outperformance is testament to the strategy of generating idiosyncratic returns from a concentrated portfolio.

Over the quarter, while our engagement boiled away in private, we took the rare step of releasing a public statement expressing our opposition to Digital Garage's board of directors and their misguided strategy. Critiquing the ill-fated mid-term plan released in May, we announced our intention to vote against all directors at the upcoming AGM. We think our statement was well received and helped raise awareness amongst other investors of the actions Digital Garage needs to take to address its undervaluation. Helpfully, Digital Garage's share price increased +15% over the quarter, although still has a long way to go to recover the losses since May.

The hotly anticipated EGM at Cosmo Energy (a company not held in the portfolio), where management were seeking to install a poison pill to thwart the efforts of a high-profile activist, ended with a whimper. The EGM was cancelled after the fund sold their stake to Iwatani Corp. Still, it was an interesting case study testing the limits of corporate Japan's willingness to use underhand tactics to thwart unsolicited bidders. In this case it ended in a stalemate, but the fund generated attractive returns and implementing the poison pill proved more difficult than we suspect the company had hoped.

At the end of November news broke that Toyota Motors, one of Japan's last holdouts to reform its balance sheet, will partially unwind its cross shareholding in Denso. This was followed shortly after in December with the TSE announcing that it will add further pressure by calling on the over 1,000 companies in parent-subsidiary relationships or that have listed equity-affiliates to increase disclosure around their rationale for having listed subsidiaries and their efforts to ensure their independence.

Combined with the TSE's new disclosure requirements targeting companies trading on low price-to-book ratios and the METI's Guidelines for Corporate Takeovers, the cascade of events in 2023 is, in our view, a seminal moment in the long and winding road to unlocking the enormous value trapped in Japanese companies. We see ample opportunities to exploit mispriced companies in a highly inefficient market and continue working with management to unlock shareholder value.

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

MANAGER'S COMMENT

Eiken Chemical (4549) – New position in medical diagnostics company

We started building a stake in Eiken Chemical in July, but it wasn't until after four months of further research and meetings with the company that we decided to bring the position to a full size. By the end of the quarter Eiken Chemical accounted for 5.7% of NAV, making it the 10th largest position.

Eiken Chemical is a diagnostics company specialising in manufacturing medical chemicals that react with body samples to obtain a diagnosis for cancer, disease or infection. While the overall diagnostics market is dominated by the likes of Roche, Abbott and Siemens, smaller companies can operate in niche markets, as Eiken Chemical does. The market is attractive with high regulatory barriers to entry, a razor/razor blade style business model and stable growth from increased diagnostics healthcare expenditure.

Eiken Chemical has produced a number of niche products, but the most exciting is its Colon Cancer screening test, called FIT (Faecal Immunochemical Test), accounting for around 40% of sales. For any UK readers over the age of 59, you should have received a stool sample kit from the NHS, and with it a sample tube manufactured by Eiken Chemical. Eiken's testing kit, along with its OC-Sensor analyser is utilised in screening or diagnostics programs across 45 countries. Generating low margins from the sale of its analyser, high-margin after sales from the tube and solution thereafter provide recurring sticky income. Eiken Chemical's global dominance is driven by its testing accuracy and consistency, the proprietary technology in its buffer solution, and that the OC-Sensor has been cited in over 100 journals driving brand recognition and trust with healthcare providers.

The appeal of the diagnostics business is not lost on investors, with a set of peers, both domestic and global, trading on an EV/EBIT of 26x vs Eiken's 8x. The disparity, we believe, is driven in part by a misunderstanding of its niche business model, the roll-off from high margin COVID-related reagents, and a bloated balance sheet (32% of assets in net cash). We see almost +100% upside currently and if the Company achieves its 2030 plan, possible with the successful launch of a DNA-based stool test, over +200% upside.

Management seems receptive to our suggestions, and although early in our relationship we are optimistic they will take actions to address the low share price. We look forward to seeing Eiken's true earnings power and realising the significant upside for all stakeholders.

Portfolio Trading Activity

Over the quarter we exited two positions, Fuji Soft and Pasona. Fuji Soft was a short holding for us, building a position in May following an activist campaign from a Singapore-based engagement fund who successfully appointed two outside directors. We felt the considerable upside potential of a privatisation event was not sufficiently priced in, with Fuji Soft trading at a significant discount to its IT peer group. With rumoured news of a privatisation event, the share price increased +17% and trading at an elevated valuation we felt the upside was less compelling. We exited the position generating a +65% IRR.

We exited our long-standing position in Pasona after its share price jumped +37% in November. The shares responded favourably when Pasona agreed to tender its 51% stake in Benefit One to a tender offer by M3 at a 40% premium. With a c.31% corporation tax payable on the gain and Pasona's remaining businesses barely profitable, we exited the position.

On the purchases side, we initiated three new positions: two small special situations and Eiken Chemical (discussed above).

Contributors and Detractors

Starting the quarter as our 2nd largest holding, **Nihon Kohden (6849)**'s +21% share price gain added 191 to performance. Earnings were respectable, and as expected were steady, reporting a +10% and +4% increase in sales and operating profits for the first half of the year. As management work towards a refreshed strategy with their May 2024 mid-term plan, there was an absence of market moving announcements from the company and instead driving the share price was the disclosure from a well-known US activist fund that it had purchased 5% of Nihon Kohden's shares. We have admired this fund's engagement with Nihon Kohden's peer, Olympus (a large-cap Japanese company not held in the portfolio) and referenced the success of Olympus' transformation plan in our engagement to Nihon Kohden.

MANAGER'S COMMENT

While Nihon Kohden's discount to peers has narrowed since we initiated our position, now trading on an EV/EBIT multiple of 15x vs peers' 20x, we do not think this reflects the enormous potential we see for the business. Under the leadership of President Ogino, the Grandson of Nihon Kohden's Founder, we see a pathway to the business improving operating margins from 10% to 15% and shifting its business away from lumpy medical equipment sales to digital services. The transformation is in the early stages, but we are confident it can be achieved. It is encouraging to see another activist investor also recognise the potential, and we look forward to continuing our engagement ahead of the May 2024 mid-term plan. We still see over +100% upside to the prevailing share price.

Shin-Etsu Polymer (7970)'s +25% share price return over the quarter was buoyed by increased scrutiny from the TSE on the archaic practice of listed parent/subsidiary structures. While the business environment this year has been difficult for Shin-Etsu Polymer, with wafer manufacturers adjusting their inventory weighing on demand for wafer carrier cases, the business is performing resiliently with forecasts for modest sales and profits growth of +3% and +2%.

Trading on an EV/EBIT of just 7.3x with net cash covering 36% of the market cap, Shin-Etsu Polymer's share price is still 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 a majority independent board and presence of ex-Shin-Etsu Chemical employees as directors raises concerns. While we appreciate that management have made modest improvements, we do not think they go far enough to rectifying the Company's undervaluation.

We have put forward proposals to both Shin-Etsu Polymer and Shin-Etsu Chemical in private, including asking for independent directors to account for a majority of Shin-Etsu Polymer's board and dissolving the listed structure entirely. We hope both companies will recognise the current shortcomings and take more action to grow corporate value and protect shareholders interests. Pressure from the TSE, shareholders, and wider stakeholders to address conflicts from parent/subsidiary structures will not wane.

It would be remiss not to mention **Jade Group (3558)** (previously LOCONDO) whose share price saw a meaningful +32% jump over the quarter, taking full year returns to +96%, following the continued flawless execution of its acquisition of Reebok. Management have done a fantastic job in improving their shareholder communications, and, not resting on their laurels, have announced another three acquisitions this year already. We trimmed our stake modestly for portfolio allocation reasons but remain excited and supportive of the company's future.

The only meaningful detractor over the quarter was **TSI Holdings (3608)** whose share price drifted -9% lower, albeit after a year in which its share price rose +68%. While earnings performance was lacklustre, with the business suffering from high raw material costs, this was offset by an 8.5% share buyback announcement. Trading below a 1x price-to-book ratio, management need to take more action to raise the share price, and as the largest shareholder we have been proactively engaging on how to achieve this. The response from management and outside directors has been positive, and we are hopeful we will see further shareholder accretive announcements next year.

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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