Q1 – March 2024

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 as a percentage of market cap	NFV² as a percentage of market cap	EV/EBIT	FCF Yield	Dividend Yield
Q1 2024	33%	46%	9.2	5.0%	2.2%
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%

MANGER'S COMMENT

Dear Shareholders,

The fund's NAV increased by +4.8% over the quarter and +4.4% in JPY with most of that performance coming over the last few days of February. Idiosyncratic events at Alps Logistics (+79%, rumour of parent company selling), Beenos (+45%, after AVI stake announcement) and JADE GROUP (+30%, announcing transformative acquisition) drove performance, which again highlights how the returns from a highly concentrated and high conviction portfolio such as the fund's can often be lumpy. Detractors were modest, with share prices failing to keep pace with a strong market, rather than changes to fundamentals, with Nihon Kohden (-10%) and Shin-Etsu Polymer (-7%) being the most notable.

It was another buoyant period for Japanese markets, with the MSCI Japan Small Cap Index and MSCI Japan Index up +12.8% and 19.2% respectively (in JPY). This remarkable performance is especially noteworthy considering this follows the impressive returns of +21.1% and 28.6% in 2023. Similar to last year, performance has so far favoured large cap value stocks, with the MSCI Japan Value Index up a whopping +22.3% during the first quarter. This is attributed, at least in part, to the continued depreciation of the Japanese Yen, with large-cap exporters reaping the rewards. Since the start of 2023, the Yen has weakened 13% against the US Dollar (USD) and 16% against the Euro (EUR), with -7% and -5% weakening over this quarter alone. It is worth reminding shareholders that approximately 83% of portfolio company revenues come from the domestic market and have not benefitted from a weak Yen.

The ongoing weakness of the Yen continues to be driven by the BOJ's accommodative monetary policy stance. Although the BOJ finally ended their negative rate control, the accompanying hike was a modest 10bps, and, suspiciously, well-guided by the Nikkei newspaper in the days preceding the meeting. This year's spring "Shunto" wage negotiations ended with an average 5.3% YoY uplift, marking the highest increase in 33 years. We believe this provides support for the BOJ to continue hiking rates. For now, we still await the much-anticipated potential tailwind from a strengthening Yen, which would be a boon for the fund's NAV.

Investors' focus on large caps has brought to light a plethora of compelling opportunities in overlooked small caps. Over the past six months we have built new positions in nine companies, a significant number considering our portfolio consists of only 25 companies. In each of these cases, we foresee upsides in the order of 50-100%. We would be hard pressed to find anything close to these upsides in mid-and-large cap companies (and we have tried).

During the quarter, we spent a week in Tokyo, where we visited several existing portfolio companies and, most interestingly, private equity firms. Management appear to be actively listening to the strengthening regulations and guidance from TSE and METI last year. Privatisations, for example, previously dismissed out of hand, are now being taken more seriously and there is growing awareness of share prices and valuations. Private equity firms are waiting on the sidelines with open arms, and their optimism regarding the changing environment was evident during our meetings.

We are considering filing shareholder proposals to three portfolio companies. While we hope these proposals don't see the light of day, they are an important tool to instil a sense of urgency in management. Our private engagement efforts continue in earnest, with new portfolio companies receiving detailed presentations and letters. The environment remains as fertile as ever, and despite the buoyant market, we continue to identify plenty of dislocated pricing opportunities. The EV/EBIT of the portfolio was 9.2x and NFV accounted for 46% of market cap. We expect these will become more attractive over the coming months as we continue to realise maturing, more fully valued positions and redeploy into new opportunities.

MANGER'S COMMENT

JADE GROUP (3558) – Showcase of buying a growth company at a value multiple

JADE GROUP (JADE) (previously LOCONDO) has ascended to a top ten position in the portfolio and saw its share price increase +30% over the quarter. Since the date of our first investment, JADE's share price has increased by +138%, generating a healthy ROI and IRR of 108% and 14% respectively.

The shares were propelled higher over the quarter after it announced the acquisition of Magaseek, a leading fashion e-commerce platform owned 75% by DOCOMO and 25% by Itochu. The purchase is expected to double Gross Merchandise Value (GMV) and, although not yet confirmed by the Company, we believe it could also double profits by 2026.

We invested in JADE in November 2021, after its share price had fallen -70% from a COVID-intoxicated high in August 2020. While JADE was viewed as a "growth stock", and not an obvious candidate for a value-driven engagement fund, it had become undervalued with a substantial net cash backing. We understood JADE's business model having had an indirect investment in Zalando, JADE's European equivalent, through our global fund. We watched in marvel as Zalando rolled out its partners program across Europe and recognised a similar potential for JADE in the Japanese market.

Over the subsequent three years, led by President Tanaka and the newly appointed de facto CFO, Shigetoshi, JADE continued its ambitious expansion. As the largest shareholder, we have actively supported management in pursuing its growth strategy. We agreed that the dividend should be scrapped to focus on M&A and share buybacks, and sent letters highlighting JADE's undervaluation. Needless to say, it has been a busy period for management. They have made strides in improving IR communications, reduced the reliance on sales promoted by YouTube influencers, and successfully executed six acquisitions the most notable of which, prior to Magaseek, being Reebok Japan.

The acquisition of Reebok Japan through a 66/34 JV with Itochu marked a pivotal moment for JADE, facilitating the move into direct management and ownership of a well-known brand. Utilising its marketing and logistics expertise, JADE seamlessly integrated Reebok into its existing infrastructure, benefiting from operating leverage which will drive operating profits +77% higher this year (year ending Feb 2024).

Having proved the model with numerous acquisitions, we believe the market is yet to fully comprehend how pivotal the Magaseek acquisition could be. Trading on a lowly 10x forward EV/EBIT, we anticipate that as management communicates the expected impact from the Magaseek acquisition in the coming months, the market will gain a better understanding of its significance and reevaluate accordingly. When asked whether JADE is seeking to complete more acquisitions, management's response was unequivocal: "we absolutely want to do more". With JADE cementing itself as the #2 player in Japan's Y2.4trn fashion e-commerce market, its Y60bn GMV still has a long way to go to catch up with Zozo's Y560bn, not to mention its valuation (18x EV/EBIT).

Alps Logistics (9055) – Another one biting the dust

Continuing the trend of one of our favoured themes - the collapse of parent-child listings – Alps Logistics, an investment we've held since October 2022, saw its share price rise +79% over the quarter as news broke that its 49% shareholder, Alps Alpine, was considering selling its stake. Given the numerous sources cited in the article and the absence of denial from either company, it appears likely that there is substance to the speculation.

Alps Logistics' parent company, Alps Alpine, has seen a deterioration in its business, and to address the cashflow gap in their mid-term plan, they announced earlier in the year their intention to explore asset sales. Although the timing was unexpected, it doesn't come as a huge surprise that Alps Logistics was a candidate for asset sales, which is why we added to our holding earlier in the year.

To achieve the highest price for its stake in Alps Logistics, Alps Alpine will need to structure a deal where a controlling stake is sold to either private equity or a trade buyer, enabling privatisation. At the current share price, Alps Logistics' 14x EV/EBIT valuation represents a slight premium to its peers (12x), however, it falls below the c.22x at which Hitachi Transport was taken private by KKR in May 2022. While we had commented at the end of last month that we were happy to maintain our position, given the recent surge in the share price by +26% over the past month, we decided to moderate our exposure on valuation grounds. At quarter end Alps Logistics was a 3.7% weight.

MANGER'S COMMENT

Portfolio Trading Activity

It was a reasonably busy period for trading, which was not unexpected considering the strong markets presented numerous selling opportunities and left behind plenty of egregiously undervalued small-cap companies. Already this year we have built or are building positions in five new companies, three of which have the potential to become large positions in the portfolio.

BEENOS (3328) was our largest purchase, accounting for 5.2% of NAV by the quarter end. Beenos operates a global e-commerce platform, primarily focused on a service called 'Buyee', which enables customers living abroad to purchase items from popular Japanese e-commerce sites, such as Yahoo! Japan, Mercari and Rakuten. Over the past eight years, Buyee's gross merchandise value has grown at an annual rate of 31.3%.

At the time of our purchase, Beenos was trading at a modest 2.9x EV/EBIT multiple, with net cash and securities comprising over 79% of its market cap. Due to the persistent undervaluation, investment in non-core businesses, and a lacklustre share price, an increasing number of shareholders have expressed opposition to the CEO's reappointment. We see significant upside if management can simplify the structure, exit loss making business lines and return excess cash to shareholders.

Aside from trimming a handful of positions on share price strength, our largest sale was the exit of **Digital Garage (4819)**. After publishing a press release in November, at the end of the year, defiant to the trend of reducing cross-shareholdings, Digital Garage issued 5.3% of its treasury shares to Resona HD, with Resona HD committed to purchasing an additional 4.8% in the market. With a consistently underperforming and mismanaged business, along with the senseless issuance of undervalued shares, we have more promising opportunities to allocate our capital toward. After we sold, Digital Garage's share price limped -8% lower, underperforming a strong market.

Our special situations trade in **Yaizu Suisankagaku (2812)** came to fruition over the quarter when it was subject to a Tender Offer Bid (TOB), 19% higher than the failed TOB at the end of last year. Although only a 1% position, we made a +16% return within a few months, generating an IRR of +129%.

Contributors and Detractors

As discussed above, **Alps Logistics (9055)** was the largest contributor, with a +79% share price increase following speculation that its controlling 48% shareholder, Alps Alpine, was looking to sell its stake.

Our new position in **BEENOS (3328)** performed well, with the share price rising +17% the day following the announcement of our 5% ownership (which we have subsequently increased to 8% ownership). Following our declaration, another well-known engaged shareholder increased their holding to 9%. In less than two months, we have made a return on investment of +44%, and still see significant upside potential.

Nihon Kohden (6849) was the largest detractor over the quarter with a -10% share price reducing returns by 119bps. Aside from profit-taking after a strong share price jump last December, it was difficult to pinpoint the specific cause for the share price weakness, especially considering that over the quarter the MSCI Japan Small Cap Index increased by +13%. Sales were a little soft in the US, although we suspect part of that will be shifted to next year. Our investment thesis doesn't ride on quarterly earnings fluctuations, and focus remains steadfast on the upcoming mid-term plan in May. After sending numerous presentations and letters detailing Nihon Kohden's underwhelming margins, we believe that management are for the first time seriously reviewing their cost structure. Along with an improvement in capital efficiency, governance and digital strategy communication, we have been asking management to put forward a 15% operating margin target. This would mark a significant improvement from the current lowly 10% operating margin. Based on our comprehensive research and analysis of peer cost structure, we are confident that this is achievable (at a minimum) and believe management are starting to be convinced of this. Time will tell, but if the Company fails to put forward a convincing plan, we will consider making our concerns public.

MANGER'S COMMENT

Shin-Etsu Polymer (7970), one of our three parent-subsidiary investments, was the next largest detractor with its share price dwindling -7% lower, reducing returns by 69bps. Shin-Etsu Polymer is a subsidiary of the chemical giant Shin-Etsu Chemical, where we have been engaging on ways to rectify their poor corporate governance and woefully low valuation (6.9x EV/EBIT). During the quarter, we met with Shin-Etsu Polymer's President in Tokyo, and while it was a pleasant and cordial meeting, we found it to be somewhat underwhelming. We didn't get the impression that management had an ambition to grow corporate value nor that the Company is taking adequate steps to address the conflicts and corporate governance shortcomings of its parent-subsidiary relationship. We continue to believe that the parent-subsidiary relationship is harming Shin-Etsu Polymer's corporate value and that, as many listed subsidiaries in Japan have done already, it should be eliminated.

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The share price can be found in *AJF - Asset Value Investors*

Further information may be found on the following websites:
www.assetvalueinvestors.com/ajf
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