AVI Japan Opportunity

AJOT's differentiated strategy has produced another strong year...

Update
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Overview

AVI Japan Opportunity (AJOT) has had another successful year as corporate governance reform continues to drive returns in Japan, while AJOT's constructivist approach has also borne fruit. The trust's strategy is designed to capitalise on a concerted effort by Japanese authorities to push companies to improve shareholder returns. A series of reforms have increased pressure on company management teams to boost their valuations and return on equity, as well as to release excess cash and investment securities held on the balance sheet.

As we discuss under **Performance**, AJOT has consistently had success with its approach since its 2018 launch. Last year, 2023, was particularly strong, and this led to several positions being realised. Manager Joe Bauernfreund and the team have reinvested this cash in a number of small positions, with 12 new additions to the portfolio in 2024, three of which are currently top ten positions. Pleasingly, some of these new ideas are amongst the strongest performers in 2024.

Another common theme in the year has been takeovers, with three portfolio companies being subject to takeover bids and privatised, while a fourth received an unsolicited partial tender offer. The takeover of NC Holdings typifies how the managers have been able to create significant value through taking large positions in small companies and creating the catalyst for unlocking value themselves. The team tell us they see buyouts and privatisations becoming increasingly accepted in Japan. This exciting trend for activist investors illustrates how corporate governance reform continues to revolutionise the Japanese market.

Since inception AJOT has typically traded on a premium and issued new shares, including in 2023 when global markets were weak for much of the year. In 2024, AJOT has slipped onto a discount, which is 1% at the time of writing.

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Analyst's View

Lots of things in markets are cyclical, but – at least in the short term – government policy is not one of them. The corporate governance reform story in Japan has only become more entrenched over time and is resulting in transformations in the operations, governance and valuations of companies across its markets. The trend only seems to be gathering pace, and with 3,000 smaller Japanese companies still under-researched and overwhelmingly cheap, the outlook for AJOT's strategy continues to look compelling in our view. While performance has been good in 2024, and even better in yen terms, AJOT has been trading on a small discount in recent months. We think this presents an attractive entry opportunity given the strong outlook and the trust's history of trading on a premium.

One reason for the discount might be wariness after the market wobble in August, which saw an almost 20% fall in AJOT's NAV in a couple of days that was almost all immediately regained. This seems to have been a liquidity event, in which investors panic-sold Japanese assets due to currency issues – essentially due to an unwind of the 'carry trade', which sees investors borrow in yen and invest in other currencies. The proximal cause of the unwind was the Bank of Japan's decision to increase its benchmark interest rate, which was made in light of the strength of the Japanese economy amidst sustained inflation and rising wages. This is positive for the outlook for Japanese companies' earnings. Similarly, if yen rates were to rise, then this should see an inflow of capital into Japan. As such, we think the macro picture is actually improving, with the short-term volatility over the summer a reflection of leverage, complacency and short-termism.

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 yen valuation could lead investors to favour domestic-facing small caps

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

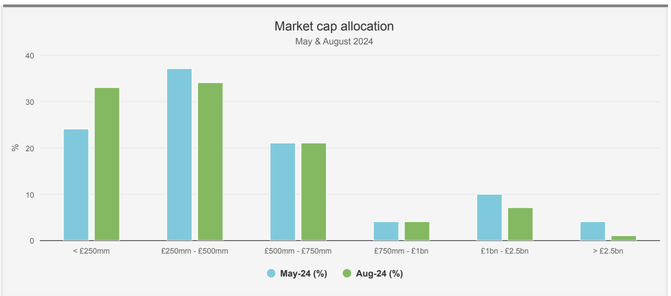
Portfolio

AVI Japan Opportunity (AJOT) was one of the first vehicles set up to take advantage of the extraordinary opportunity in cash-rich Japanese companies. It has become a key economic-policy goal of the Japanese authorities to force companies to improve shareholder returns and therefore growth in the economy by improving governance, becoming more efficient and/or returning cash and securities to shareholders. Joe Bauernfreund and his team saw this opportunity as it developed, and launched AJOT in 2018 to focus on the small-cap area of the market where the valuations can be the most attractive and the chance to add alpha from stock selection is the highest.

AJOT therefore owns a concentrated portfolio of Japanese small caps which the managers think can deliver exceptional returns if they improve operations and rationalise their balance sheets. The team take an activist approach, engaging thoroughly on operational improvements, enhancing IR communications and capital allocation matters. The portfolio is concentrated because the managers want to be able to devote a significant amount of time to each position and to benefit fully when the strategy pays off. Increasingly, their strategy has involved more detailed and closer engagement with companies on operational improvements, and this has helped deliver exceptional returns in the past couple of years.

In particular, 2023 was a strong year for the strategy, as the corporate governance story became increasingly well understood; foreign inflows into Japanese equities hit a ten-year high. Investor attention focused primarily on the large-cap space, perhaps because of its liquidity and ease of access. However, small caps also did well, and AJOT had some significant successes with individual stocks which led to them being sold, having hit their targets. The cash has been reinvested into some fresh ideas in the smaller end of the trust's investment universe. Pleasingly, some of these most recent investments have been amongst the biggest contributors in 2024, as we discuss further in the **Performance section**. An example is Beenos, an operator of ecommerce platforms which allows those overseas to purchase local Japanese products and memorabilia.

Fig.1: Portfolio Market Cap



Source: AVI

Beenos had grown to be the third-largest position in the portfolio as of the end of August. This reflects strong performance, but also the approach of ensuring that positions are sizable, expressing conviction and really allowing the fund to benefit as the value is realised. These moves have resulted in a slight reduction in the average market cap of the portfolio, as the below chart shows. Turnover has also therefore been higher than average, with 12 new positions in the fund over the year, three of which are in the top ten.

Beenos also exemplifies a number of the features of a typical AJOT idea. It is operationally performing well, with compound earnings growth of 27% over the past five years. (We would note that while investors can play the corporate governance reform story in the large-cap space, this sort of operational profile is unlikely to be found there.) However, it also has net cash and securities on its balance sheet which amount to 114% of its market cap. Joe and the team's engagement efforts are focusing on finding a more productive use for the cash and securities, while they think that operationally there are plenty of improvements to be made. Joe and the team think the business has strayed from its core engine of profitability, and they see the potential for their engagement to improve things. The announcement of their stake alone saw the shares jump, indicating the strength of their reputation after years of successful engagements.

The equivalent financial metric for the portfolio as a whole is an aggregate 45.4% of its market cap being held in cash and realisable securities. Cash alone is worth 32.6% of aggregate market cap (both figures as of the end of August). Over time, the team's stock selection research has become more and more focused on finding companies that are of a high quality, in terms of their earnings streams and operational economics, while also having these sort of deep value characteristics. As the numbers suggest,

Top Ten Positions

HOLDING	%
TSI Holdings	9.8
Eiken Chemical	8.6
Beenos	7.9
Kurabo Industries	7.0
Nihon Kohden	7.0
Takuma	5.9
Konishi	5.7
Jade Group	5.7
Aoyama Zaisan Networks	4.8
DTS	4.1
TOTAL	**66.5**

Source: AJOT, as at 31/09/2024

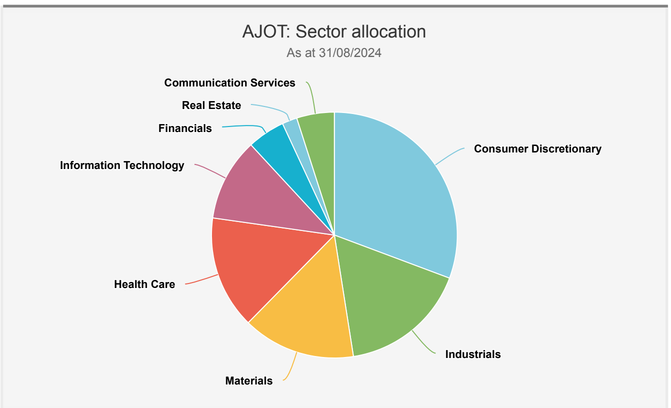
there is still extraordinary value in the Japanese small-cap market, and the team have no problem finding such ideas. Japanese small caps are vastly under-researched and the market is inefficient with many companies misunderstood. There are over 3,000 companies in the opportunity set, and many of them don't publish results in English or have regular communications with shareholders. This is fertile ground for specialist stock-pickers, and AVI have increased their on-the-ground, Japanese speaking presence over the years to enhance their ability to take advantage.

The constructivist strategy involves taking large stakes and engaging for change. Joe and the team complete extensive work on their companies and produce detailed analysis for boards of how they can unlock value. One of the new positions this year is Kurabo Industries, a plastics and synthetic materials business with a conglomerate structure. This is a high conviction position, the fourth-largest, at 7% of the portfolio. Joe and the team are engaging heavily, looking to encourage management to enhance capital efficiency and focus on core business lines that are performing well in electronics and chemicals. The team are sensitive as to how they approach companies, and will often operate quietly and respectfully out of the public eye. But when they don't get a fair hearing, they are not afraid to go public, and have had success with both approaches. A classic example of the public route working well was the public campaign in 2020 encouraging management of Fujitec to reform. The tactic led to a change in strategic direction, and Fujitec's valuation rising from 6x to 20x on an EV to EBIT metric.

One way value can be realised is through takeovers, and AJOT has had three companies taken out from its portfolio this year, adding significant returns to shareholders in each case. Alps Logistics was taken out at a price 194% above the pre-rumour share price. NC Holdings was privatised, with AJOT selling its stake to the bidder before the offer was made. AVI had been the second-largest shareholder behind the bidder. Joe and the team had engaged privately and eventually in public, having some wins, and overall generated an IRR of 22% on its investment. Yaizu Suisankagaku was also privatised this year, with the final tender offer price representing a 71% premium to the undisturbed share price prior to the announcement of the initial bid in August 2023. Sun Corporation also received a partial tender offer for 19% of the shares, with AJOT's position only having been bought earlier in 2024 and the position generating a 25% IRR .

The chart below shows the sector exposure of the current portfolio. It is another piece of evidence that this is not a simple value fund, with heavy exposure to typically higher growth sectors such as consumer discretionary and information technology. One of the recent additions to the portfolio is in the technology sector, Tecnos Japan, and the team have had success there in the past with DTS and NS Solutions to take two examples. The value opportunity in Japan and in AJOT's portfolio really is about balance-sheet and corporate-governance issues rather than cyclical or low duration features. AJOT takes a bottom-up, sector agnostic approach to stock selection and returns are predominantly driven by idiosyncratic events.

Fig.2: Sector Exposure



Source: AJOT

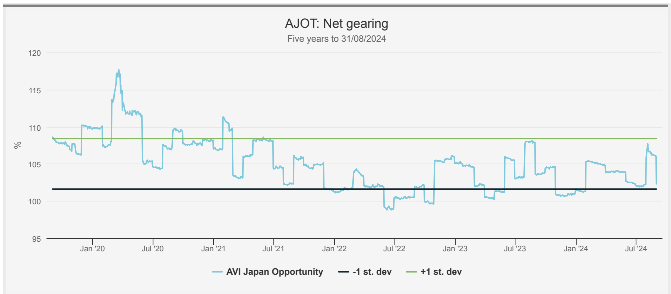
This year, 2024, has been a strong one for the Japanese small-cap market and particularly for AJOT (which has more than doubled the returns of the MSCI Japan Small Cap Index). However, over the summer the market saw a dramatic sell-off which almost immediately reversed. The causes are hard to unpick, but include a decision by the Bank of Japan to allow interest rates to rise slightly. This coincided with weak US economic data which suggested rate cuts might be imminent, with the Fed subsequently cutting its target rate range by -50bps. There was a sharp rise in the value of the yen as a consequence, and the volatility seems to have resulted in investors selling out of equities rapidly too. AJOT sold off more than the market thanks to its small-cap bias, but recovered quickly. Joe and the team took the opportunity to add slightly to a few positions, but with their long-term outlook on their holdings, based on firm-specific fundamentals, there wasn't much turnover at all. In their view, the macro uncertainties aren't significant for the health of the corporate governance story. The team highlight increased overseas investor interest in Japanese real estate as a source of value, much of which lies hidden on corporate balance sheets, and note that the authorities have been backing up their words with deeds: companies are being 'named and shamed' by the Tokyo Stock Exchange for failing to comply with their directives to disclose how they will improve capital efficiency. Additionally, it is worth noting that if we do see a sustained rise in the yen, it could encourage more investment in the country both by domestic and overseas investors. International investors are still underweight Japan on average. And ultimately, the central bank is only able to think about letting rates rise thanks to the strength of the Japanese economy.

Joe and the team argue the opportunity set is as large as ever for their strategy, and despite increased interest, mainly in the large caps, the small-cap market remains extremely under-researched, with half of AJOT's portfolio companies having zero sell-side analyst coverage. Thanks to consolidation in the investment trust sector, there will shortly be only three Japanese small-cap trusts, one of which has a growth strategy, Baillie Gifford Shin Nippon (BGS). The other, Nippon Active Value (NAVF), also takes an activist approach. After growth in its assets thanks to corporate action, the board of NAVF has stated that it will be more flexible with the market cap of investments and therefore invest in larger companies at times. We think this arguably leaves AJOT, which has been following this strategy for over two years longer than NAVF, as the only activist fund fishing solely in the small-cap pool.

Gearing

AJOT has a revolving credit facility which the managers can use 'to enhance portfolio performance'. Gearing levels fluctuate depending on the stock-specific opportunities rather than reflecting a call on the market. As small caps are less liquid and the portfolio is concentrated, changes in the gearing level are often due to individual sell or buy decisions. Formally, net gearing is 25% of NAV at the time of drawdown by the prospectus, but in practice has been much lower, averaging c. 5%, as the chart below shows. As of the end of August, net gearing was 2.3%.

Fig.3: Net Gearing



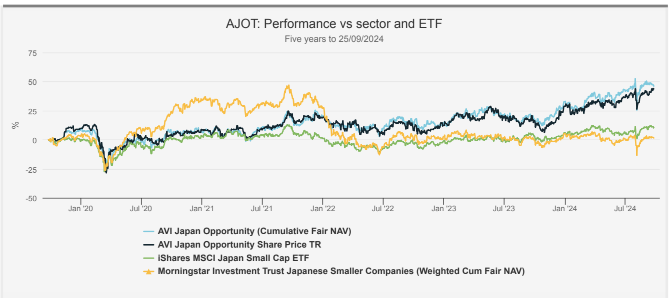
Source: Morningstar, Kepler calculations

The revolving credit facility allows the trust to draw down up to 2.93bn yen, worth c. £16.2m at the time of writing, or c. 8% of end-August NAV. The cost of debt is low in Japan thanks to low central bank rates, and AJOT pays the local overnight bank rate plus 1.15% on any borrowings.

Performance

AJOT has more than doubled the returns of the MSCI Japan Small Cap Index over the past five years, with a NAV TR of 46% versus 11% for the benchmark (in GBP). In local currency terms, which ignores the impact of the weak yen over the period, the outperformance was even more impressive, with AJOT's five-year NAV TR of 111.5% well ahead of the benchmark's 61.4% return (both in JPY). This is by some way the best result in the AIC Japanese Smaller Companies sector, where neither of the other two trusts has come close to matching the index.

Fig.4: Five-Year Performance (GBP)



Source: Morningstar

Past performance is not a reliable indicator of future results.

The trust has just published results for the first half of 2024 which show a particularly impressive return versus the benchmark. The NAV was up 7.7% while the MSCI Japan Small Cap Index was down 0.2% (both in sterling terms). In yen terms, the return was 21.9% versus a benchmark return of 12.9%. The largest contributor to performance was from Alps Logistics. This company had been owned since AJOT launched, and was taken out during the period by KKR-controlled Logisteed at a premium of 194% to the pre-rumour price. We think this is a validation of Joe and the team's view on the true value of the company and the work they had done with management to unlock it. Over the life of the investment, it generated an exceptional 38% IRR and a total 306% return on investment, and in the first half alone added 392bps to performance. The team highlight that they think there are plenty of other companies in their portfolio which could be attractive to private equity buyers, and they have been in dialogue with PE firms regarding several of them.

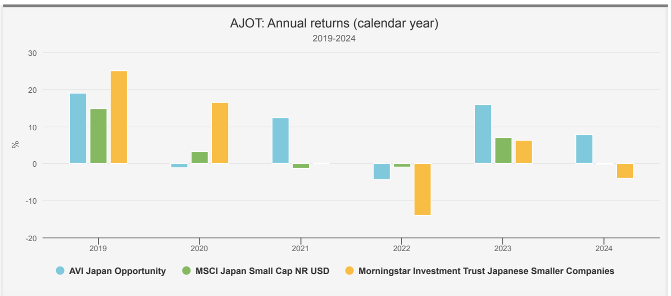
Another major contributor was Beenos, which rose 66% over the period, adding 205bps to performance. Ecommerce platform Beenos is one of the smaller companies which the team have been leaning into in recent months after recycling some winners from last year. The position was initiated in January and has grown to 7.9% of NAV as of the end of August. Even though the share price has done well, Joe and the team highlight that shareholder frustration is growing. They foresee a further 70% upside from the end of August price, and it remains a target for engagement efforts. Eiken Chemical, which makes tests for colon cancer and is the second-largest stock in the current portfolio, also performed well, up 33% and adding 142bps to relative returns. This is another new position, and the team note their engagement is at an early stage.

The company has been buying back shares, but Joe and the team think its profitability is poor and there is plenty to be gained by engagement on the operational side. They see a further 105% upside to the end of August price.

All three are examples of the exceptional returns that can be achieved on single stock positions with AJOT's strategy. There were some poor returns from individual stocks too, and it is worth noting that a concentrated, stock-specific strategy is likely to experience those at times, and critically they were more than outweighed by the positives as they have been over the trust's lifetime. These examples all also show the ability of engagement and improving corporate governance to drive high returns.

This source of alpha should be less dependent on overall sentiment to the underlying market, and AJOT has consistently outperformed since launch in 2018, with the exception of the immediate impact of the pandemic in 2020. In particular, we think it is important to note that AJOT outperformed in 2019, when growth last outperformed value in Japan. While there is a substantial value component to the strategy, the team look first and foremost for quality companies, and this along with the individual catalysts in corporate governance, means it is more than a simple value strategy and will not necessarily have the same sort of return profile.

Fig.5: Returns



Source: Morningstar, 2024 returns are for H1

Past performance is not a reliable indicator of future results.

That said, unlocking the value in cash-rich companies and generating economic growth from the company-level up remains a key strategy of the Japanese authorities, and so AJOT is very much still swimming with the tide. We expect this to support relative and absolute returns for some time to come. One negative factor has been the weakness of the yen, which has reduced returns for UK investors in absolute terms. However, over the summer a change of central bank policy raised the possibility that the Japanese currency might strengthen, particularly considering that the UK looks more likely to cut than raise rates in the coming months.

Returns were particularly good in 2023, with the trust doubling the returns of the index as it has done in the first half of 2024. In 2023, a number of portfolio companies posted double-digit gains in November alone, and the last two months of the year were particularly strong. Joe and the team took profits in a number of the strong performers last year, selling Fujitec, C Uyemura and Teikoku Electric amongst others, achieving IRRs of 32%, 21% and 92% respectively. We think it is encouraging to see that the strongest performers this year have included some of the newest positions, bought with the cash supplied from exiting those previous winners. We think this is indicative of the health of the key theme behind the strategy and is a promising sign for future returns.

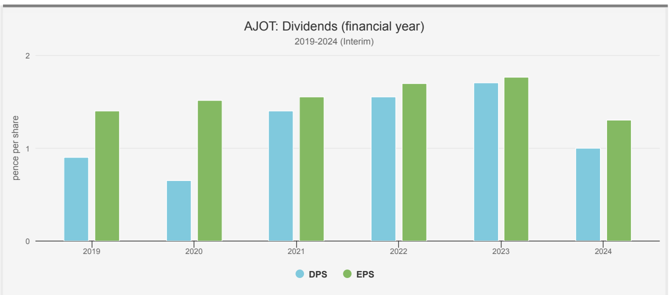
Dividend

AJOT does not have an income objective, so dividends received are a by-product of the investment process rather than a target. The board states it intends to distribute substantially all net revenue each year. As such, the dividend may vary from year to year, and a progressive dividend cannot be counted on.

That said, the investment strategy encourages cash-rich portfolio companies to improve shareholder returns, and one way to do this is distributing dividends. Total dividends distributed in Japan hit record levels in each year from 2021 to 2023 thanks to the impact of corporate governance reform on precisely this issue. AJOT has seen healthy dividend growth over this period, although the managers' main focus is improving operational performance at their portfolio companies.

Over time earnings have increased steadily, as the chart below shows, at an annualised rate of c. 17%. The dividend has been raised each year with the exception of 2020 in the aftermath of the pandemic. For the first half of 2024, the board has just announced a higher interim dividend of 1p per share, up from 0.85p last year (see chart below). This makes the trailing twelve-month yield 1.3%, although the final dividend for 2024 has not yet been announced. The trust had revenue reserves of 0.81 times last year's full payout at the start of 2024.

Fig.6: Dividends



Source: AJOT, interim dividend only in 2024

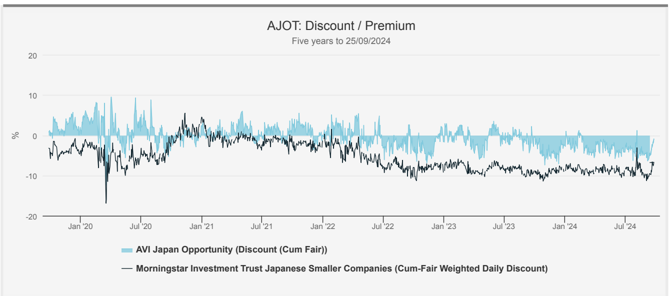
Management

AJOT is managed by Asset Value Investors (AVI), with CEO and CIO Joe Bauernfreund the lead manager. There are six others on the team involved with AJOT, including Kaz Sakai who is Head of Japan Research. Kaz previously worked at consultancy firm McKinsey, and analyst Shuntaro Shimizu worked for Bain, reflecting the team's increasing focus on in-depth engagement on operational improvements that these firms often provide. Another key figure is Jason Bellamy, an engagement consultant with extensive experience in Japan, while there is also a dedicated ESG analyst as well as another investment analyst and a team assistant. A number of the team are Japanese-speaking, with one based in Tokyo.

Discount

AJOT's shares have generally been in high demand since it launched in 2018, but have been trading on a low- to mid-single digit discount for most of 2024. The performance of the portfolio has continued to be strong, with the NAV total return up over 12% as of mid-September, and Japanese equities have been performing well, so it is hard to see a reason for this discount. As such, we think the shares look particularly attractive at this rating, given the trust has a highly differentiated strategy which has delivered strong returns and is one of a decreasing number of options for investors looking for exposure to Japanese small caps. The board has buy-back permissions and the managers are incentivised financially to see the discount close to par given the structure of the **management fee**. Given the importance placed on unlocking value in mispriced shares by the managers' investment strategy, we think the commitment to see this discount close is likely to be particularly high too.

Fig.7: Discount



Source: Morningstar

Shares have been bought back at times, most recently in March 2024, but buy-backs are completed on a discretionary basis and no required level is specified. The regular, quarterly reinvestment of shares by the manager also serves to provide liquidity for sellers. There is also a commitment by the board to offer shareholders an opportunity to exit their investment at a price close to NAV each two years, starting from 2022. In 2022, the board consulted with the majority of shareholders, and they were in favour of avoiding the cost of this exercise and foregoing the opportunity. The board is currently consulting with shareholders once more as to whether they wish such an opportunity to be offered. As the shares trade close to par, we think it is unlikely that shareholders will believe it worthwhile to support such an exit opportunity as they can sell their shares at a price close to NAV in the secondary market.

Charges

AJOT's latest ongoing charges figure (OCF) is 1.5%, the highest of the four trusts in the AIC Japanese Smaller Companies sector (shortly to become three trusts). As it is a specialist, activist strategy, we think it is reasonable to pay a higher management fee, although we note that the costs of activist activities and engaging with management are borne entirely by AVI, and not by AJOT. AJOT's management fee is 1% of the lower of market cap or NAV. This means it is higher than those of its peers in a numerical sense, but as a percentage of NAV it will fall when the trust is on a discount. We like this structure, as it incentivises the manager to see the discount close to NAV, aligning their interests more with shareholders. Additionally, AVI reinvests a quarter of that management fee into shares of AJOT each year, which we think indicates a meaningful long-term commitment and further increases the alignment of interests. As of the end of December 2023, AVI and its employees held just under 2% of the shares. The latest KID Reduction in Yield figure is 1.65%.

ESG

Improving corporate governance is a key aim of the investment strategy, and this is one of the three key pillars of ESG (environmental, social, and governance). As the team look for opportunities to engage in order to improve governance, they may be led into companies which currently have poorer performance on these factors where they think there is scope to improve. However, we think ESG-minded investors may be attracted by the positive change that an engagement strategy can help effect. As would be expected given the activist strategy, it votes at all AGMs, frequently against management and sometimes against the guidance of proxy advisory services, illustrating that the team take an original and thoughtful view on each matter.

Manager AVI is a signatory to the UN Principles for Responsible Investment, and has identified the factors it believes are most material and relevant to its investments across environmental, social and governance metrics.

AVI has built ESG factors into its proprietary database and implemented a number of processes to support the integration of ESG considerations into each stage of the investment process. The commitment of the team is shown by the presence of an analyst dedicated to ESG.

Morningstar doesn't award the trust a rating for sustainability, not having data on enough of the portfolio.

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