AVI Japan Opportunity (AJOT)

AJOT's 2024 success has carried forward into 2025.

Kepler GROWTH 2025

Update
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Overview

AVI Japan Opportunity (AJOT) has delivered exceptional returns since launch in 2018 from a strategy that exploits the opportunities being thrown up by the revolution in Japanese corporate governance. Returns in 2024 were particularly good as some major positions were taken out, delivering huge gains to the portfolio (see **Performance**). So far, 2025 has seen the pressure continue on companies to reform, and many positive disclosures and measures announced by AJOT's portfolio holdings, most notably by the largest position, Kurabo Industries.

Manager Joe Bauernfreund has had no issues reinvesting the proceeds from last year's takeovers, AJOT having fully invested its gearing facilities, adding additional market exposure of around 5% and having a list of potential new buys on the bench. While new positions have been found at the smaller and larger ends of the market, there has been a marginal tilt towards the mid-cap space, and Joe tells us he is finding fertile ground there at the moment. Mitsubishi Logistics and Kokuyo are two mid caps added to the fund in 2025, although the sub-$100m market cap Wakamoto Pharmaceutical was also bought.

AJOT has tended to trade on a modest **Discount** since late 2023, but a tender offer in December 2024 saw just 2.6% of the shares tendered. The board have nonetheless committed to an annual tender offer, which we think should keep the shares trading relatively close to par. AJOT's board has proposed a merger with Fidelity Japan Trust (FJV), which would see the net assets double and is currently being considered by FJV's board along with other options.

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Analyst's View

The last two calendar years have both seen AJOT perform extremely well, boosted by successes with large positions bought under the evolved strategy that sees the team focus as much on the quality of a company and the potential for operational improvement as the value on the balance sheet. AJOT has now performed well in varied economic conditions, the last seven years having seen significant volatility. We think this shows the strength of a strategy that is based on stock-specific catalysts being driven by policy rather than cyclical or temporary economic factors.

That said, the outlook seems to be as good as it has ever been for AJOT: gently rising inflation in Japan is creating an incentive for domestic investors to move from cash to shares, while globally investors are looking to rebalance away from the US. Japan is generally underowned and, therefore, an obvious market to take some of this money. Meanwhile, the portfolio has 80% domestic revenues and therefore little domestic sensitivity to tariffs and trade wars. And with the Japanese authorities continuing to press on companies to boost return on equity and price-to-book, the corporate governance story is clearly far from over.

We think the annual tender option should be welcomed by investors who worry about persistent discounts, although we note it does mean the discount is not likely to be part of the investment case in future.

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) takes an activist approach to investing in undervalued Japanese companies. Japan is in the process of revolutionising corporate governance, with successive governments committing the stock exchange and other regulators to demanding that companies boost their financial performance and make their balance sheets more efficient. This is providing fertile ground for specialist investors like AVI to engage with companies to that end and benefit from strong returns when reforms are enacted.

The Japan team at AVI is led by Joe Bauernfreund, who has managed the portfolio since it launched in October 2018. Returns have been strong (see **Performance**) as more and more investors have realised the opportunity on offer and Japanese companies have steadily conformed. As a result, AVI's dedicated team has grown, and the strategy has become more focussed on providing plans for operational improvements to portfolio companies in a private equity style of engagement, aiming to unlock value through rationalising business lines and structure as much as returning cash to shareholders. To allow this detailed stock-specific work, the portfolio is concentrated, typically running with 20–25 positions and allowing the larger positions to grow to high percentages of the portfolio. As of the end of May, there were 22 holdings in the fund, with 76.9% held in the top-ten positions.

Top-Ten Holdings

COMPANY	PORTFOLIO WEIGHT (%)
Kurabo Industries	12.8
TSI Holdings	10.1
Raito Kogyo	7.5
Eiken Chemical	7.4
Atsugi	7.3
Aoyama Zaisan Networks	6.6
Broadmedia	6.5
Wacom	6.4
Rohto Pharmaceutical	6.4
Sharingtechnology	5.9
Total	**76.9**

Source: AVI, as at 31/05/2025

Large positions allow the team greater influence over company management teams, and this is one reason concentration has crept up. As of the end of May, AVI owned more than 5% of the share capital of 12 of AJOT's holdings, accounting for 75% of NAV. Joe's approach is to show commitment to investee companies, preferring to engage privately rather than combatively in public to earn trust, and taking time to do detailed work on suggested strategic changes. These typically involve focussing a company's efforts on its core, cash-generative business lines and divesting non-core activities, or proposing new expansion plans or marketing plans to drive earnings. Joe and the team will also push on buybacks and dividends but prefer to focus on the operational side of the business first, as they think this will unlock more value. Last year saw some good examples of this process leading to big wins for the trust with companies such as Beenos and Alps Logistics, which are discussed in detail in the **Performance section**. Current top holding Kurabo Industries is another to have already delivered strong returns and is one of which AVI owns over 5% of the shares.

Candidate companies need to be undervalued to start with, with potential catalysts to unlock that value. Joe and the team look for those which have high levels of cash, securities, or other assets on their balance sheets. There are many such companies in Japan, where the corporate culture had been to hoard assets for many years before governments set Japan on a new path. But as well as value, and those catalysts, Joe is looking for a high-quality core business. The level of undervaluation can be estimated by looking at cash and marketable securities as a percentage of the market cap. This was 49.8% as of the end of May. While this would be exceptionally high for a portfolio in the UK or other developed markets, this percentage has declined since we started tracking the portfolio at launch, which reflects the greater importance of a quality underlying business to the investment strategy. It is notable that the past two calendar years have been the best relative to the MSCI Japan Small Cap Index in the trust's life and two of the three best in absolute terms, which we think reflects the success of this amended approach.

AJOT's strategy is really leaning into a well-established trend in Japanese corporate governance, which has become globally recognised in recent years. We have discussed key developments in past notes, so won't reiterate them here. We will add, though, that the pressure continues to build. In January 2024, we saw the Tokyo Stock Exchange (TSE) start to publish a list of companies disclosing measures to improve their share prices, and in November 2024, it started to publish a list of those clinging to bad practices. In 2025, we have already seen new protections announced for minority shareholders in management buyouts, mandated English language reporting, and the tightening of requirements for growth companies listing on the exchange. The success of the new direction has been felt financially, both in terms of multiple record years for buybacks and dividends and in terms of rising M&A.

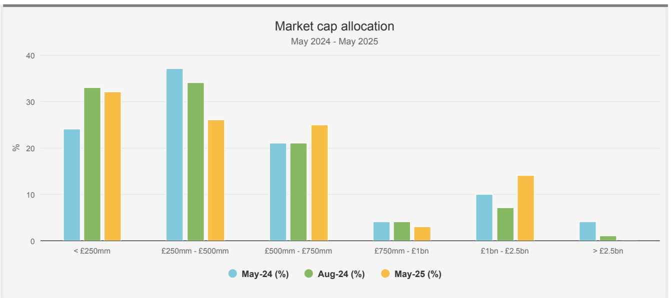
The potential for M&A and/or private equity involvement is one of the things Joe and the team look for when considering potential catalysts. Private equity has been increasingly trawling Japan for opportunities, and over time, AJOT has found itself more and more on the register with them and with other activists, which can be helpful in getting companies to take direction. Such has been the success in fattening up companies for takeovers that turnover has risen dramatically in the past two years. Over 2023, we described it as elevated, but in 2024, it jumped to as high as 68% as a number of the largest positions were taken out, delivering exceptional returns to AJOT's shareholders. This doesn't reflect short-termism, and typically Joe and the team expect their engagements to take some time to come to fruition—they calculate a normalised turnover, correcting for M&A, averaging 35% since launch, implying an expected holding period of three years.

In our view, this high turnover reflects the success of the strategy and the strength of the trends that AJOT is riding. Joe reports no shortage of new ideas, and indeed the trust remains net geared, with cash received swiftly ploughed back into attractive opportunities. In the first four months of 2025, there were five new companies added to the portfolio. These ranged from the relatively large Mitsubishi Logistics, with a market cap of $2.5bn and net financial value of 254%, to $82m Wakamoto Pharmaceutical, NFV 74%, and $834m Maruzen Showa Unyu, NFV 25%. We understand there are a number of other new ideas all but approved in the pipeline too. With over 2,000 companies in the MSCI Japan Small Cap, of which the team estimate 935 could be considered special situations and candidate investments, there is certainly no shortage.

Mitsubishi Logistics, where a large part of the value proposition lies in the extensive real estate portfolio, would be classified as a mid cap, along with another new purchase, Kokuyo (market cap $2bn). Joe tells us that he still finds opportunities in the smaller end of the universe, but he also finds mid caps attractive as their management teams are generally more open to engagement. At £264m in gross assets, £10m in a £100m company could still be a meaningful position (c. 3.8%), but clearly a greater ownership level would be necessary for it to be one of the largest positions in the fund. Joe and the board hope to grow the size of AJOT, and the board proposed a merger to Fidelity Japan Trust (FJV), with the latter currently considering it amongst other options. This would roughly double the size of the trust and may mean more would be invested in the upper end of the MSCI Japan Small Cap. Joe is confident that this could easily be absorbed without changing the strategy. The chart below shows how there has been some reallocation to larger companies over the past year, albeit balanced by a rise in those under £250m too, so certainly no indication of style drift, and indeed two of the new ideas bought this year have had market caps around or below £100m.

The corporate governance story has become well-known over the past two years, but it is far from over. Of those companies with a price-to-book of less than one (a key metric the authorities look at), 76% of them are in the small-cap universe. Meanwhile, overseas investors, particularly private equity, continue to circle. For example, last year The Carlyle Group raised $2.8bn for its fifth buyout fund focussed on Japan, this one larger than the previous iterations and focussed on the smaller end of the market within AJOT's target market-cap range. Yet analyst coverage remains low, providing opportunities for active managers: AJOT's portfolio companies average 1.4 analysts each, compared to 3.3 for the small cap index and 12 for large cap Japan. As much as 86% of the portfolio still hasn't disclosed how it will correct its valuation, as mandated by the TSE. Interestingly, Joe tells us that resistance to overseas investors' input is limited, and if there is any dissatisfaction, then the TSE is seen as the scapegoat, not activists.

Fig.1: Market-Cap Allocation



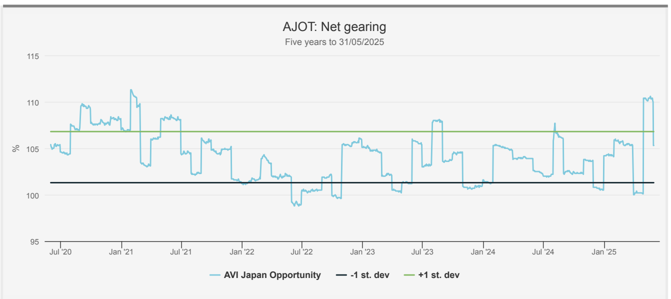
Source: AVI

Despite the positive picture, institutional investors remain underweight Japan, and the country's markets are cheap compared to international peers. As we highlight in the **Performance section**, we think it is striking that AJOT has performed well in varied and volatile economic environments since launch in 2018, indicating that it is stock-specifics driving returns, as would be expected given the strategy. However, we think that the macro environment may be developing into one that favours AJOT's approach even more. With investors looking to rotate away from the US, Japan is an obvious underweight to be filled. Japanese investors are themselves a large source of global liquidity, and with inflation and interest rates ticking up in the country after such a long period of deflation, the incentives for them to invest in equities are rising. Meanwhile, AJOT's domestic focus (80% of portfolio revenues) means that it is not very sensitive to tariffs and trade restrictions, with returns expected to come from idiosyncratic factors, not marginal increases in GDP or trade-linked demand. In our view, the outlook is good for AJOT's strategy to continue its successful run.

Gearing

AAJOT has a revolving credit facility which the managers can use 'to enhance portfolio performance'. As the chart below shows, the managers have tended to run with a modestly geared position, although this fluctuates from month to month depending on stock-specific opportunities and sales rather than short-term calls 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. As of the end of May, net gearing was 5.3%, more or less in line with the five-year average of 4.1%. In March 2025, the trust increased its RCF facility to Y6.6bn, or c. £34m, and this was almost fully drawn down at the end of May, with net gearing at 5.3% compared to a five-year average of 4.1%. Formally, net gearing is 25% of NAV at the time of drawdown by the prospectus, but current facilities wouldn't allow this, and it has never been approached in practice.

Fig.2: Net Gearing

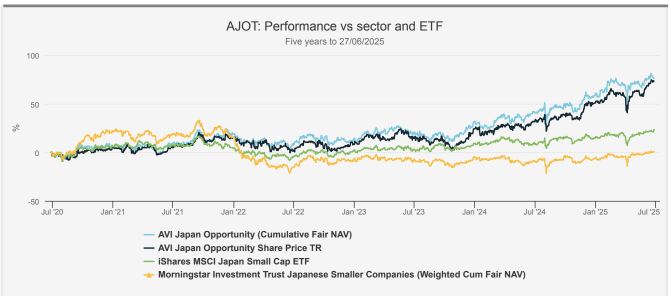


Source: Morningstar, Kepler calculations

Performance

AJOT has delivered strong returns over the past five years. The NAV total return of 76.1% in GBP terms compares to just 23% for the MSCI Japan Small Cap benchmark, so AJOT has much more than doubled the latter's returns. The yen has roughly halved in value versus GBP over the period, so local currency gains have been twice this.

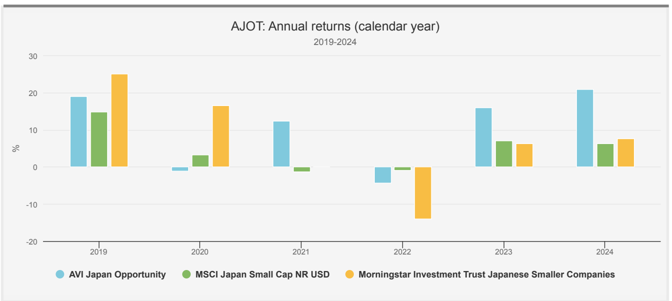
Fig.3: Five-Year Performance (GBP)



Source: Morningstar
Past performance is not a reliable indicator of future results.

Each of the last four calendar years has been particularly strong, including, in relative terms, the falling market of 2022. The Japanese economy has experienced volatile and varied conditions since the pandemic. Its economy opened later than European ones did, its currency has collapsed, while towards the end of the period it has partaken in a surge in inflation, which has led the central banks to raise rates for the first time in decades. Whatever the weather, AJOT has outperformed throughout, its source of alpha being uncorrelated to these economic developments.

Fig.4: Returns



Source: Morningstar
Past performance is not a reliable indicator of future results.

In 2024, the NAV total return of 20.9% was over three times the 6.2% delivered by the index. More than half of these returns came from two positions which typify the sort of resolution Joe is looking for. Beenos, which runs a website allowing Japanese products to be bought abroad, was bought in January 2024, and the team used their 10% position to engage extensively with the company on how to enhance long-term corporate value. AVI were joined by other activist investors on the register, and the shares rose over the year before the company was bid for by LY Corporation at a 19% premium to this higher price. As the year closed, with the deal made but not yet completed, gains of 178% had pushed the position to become the largest in the portfolio at 10.6% and had delivered 7.5 percentage points to the annual return. It's worth noting that e-commerce is not what investors first think of when they hear about a value strategy; this reflects the fact that the sort of opportunity AJOT is looking for is something that is found across the market in Japanese small caps, and not just a function of sector or industry.

This was a very quick crystallisation of the value in a position. A more typically long-term holding period was that of Alps Logistics, which was taken over at a 194% premium to the undisturbed, pre-rumour price by KKR. Alps Logistics had been held since its launch in October 2018, and had already performed well as Joe and the team encouraged it to rationalise the parent/child relationship with Alps Alpine. The position delivered an IRR of 39% over the lifetime of the investment and contributed 4.4 percentage points in 2024.

Beenos was one of the 13 new positions added over 2024, which collectively contributed 16.1 percentage points to performance. A lot of cash was received from takeouts in 2023, which was reinvested, largely into the smaller end of the trust's universe, to good effect already. Another of these new positions was Kurabo Industries, the third-largest contributor to returns over 2024. Having invested in early 2024, Joe and the team pushed the company to improve capital efficiency, rationalise its balance sheet, and focus on the most successful advanced technology and chemicals segments of its varied lines of business. In 2024, Kurabo announced significant buybacks and boosted its dividend, and the shares doubled, adding three percentage points to returns. In March 2025, Kurabo implemented many of AVI's suggestions, including setting a 10% ROE target for 2027 and selling shares and real estate held on the balance sheet. The shares jumped 14% in April, contributing to the company becoming the largest in the portfolio, at 12.8%.

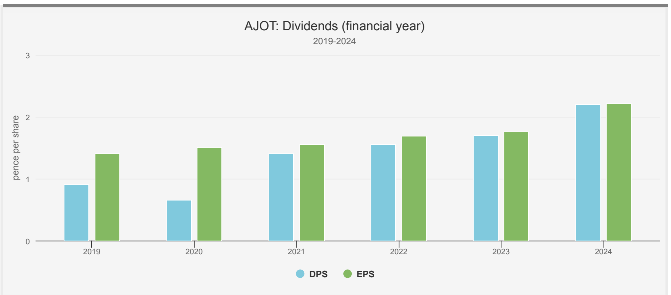
These three are good examples of idiosyncratic features driving returns: self-help stories and takeover bids, neither of which has much sensitivity to market or economic conditions. They show how very high returns can be delivered when stock picks work. Part of the skill of active management is avoiding blow-ups of a similar magnitude, which is where selling discipline comes in. An example of this working well was the sale of Nihon Kohden in February this year. The stock had been held since September 2022, delivering an IRR of 17%. While some engagement successes helped drive the position to a good result overall, over the second half of 2024, the shares sold off due to operational weakening, and Joe decided to move on to better opportunities. With AJOT's portfolio being highly concentrated, recognising when a position isn't working is extremely important.

Dividend

AJOT does not have an income objective, and the historic yield is low at 1%. The board's policy is to distribute substantially all net revenue each year, which means the dividend may well rise and fall from year to year.

That said, the investment strategy encourages cash-rich portfolio companies to improve shareholder returns, and one way to do this is by distributing dividends. The earnings on the portfolio and the dividends paid from them have risen year on year since launch, and it is not impossible that the dividend could become more significant over time. It is the strong capital growth achieved that has prevented this so far, as earnings have grown at around 9% each year.

Fig.5: Dividends



Source: AJOT

For the financial year ending 31/12/2024, the trust paid dividends worth 2.2p, covered by earnings of 2.21p, made up of a smaller interim and larger final dividend. There are revenue reserves worth c. 0.8x the dividends paid for that year.

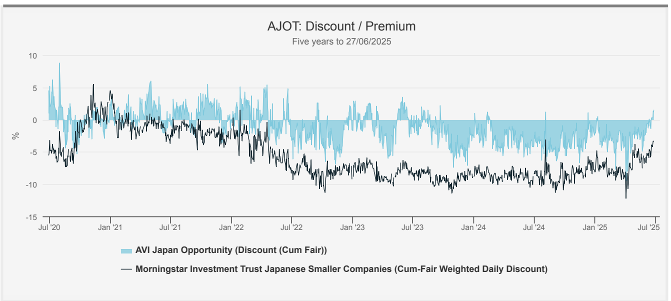
Management

AJOT is managed by Asset Value Investors (AVI). CEO and CIO Joe Bauernfreund is the lead manager, and he is supported by a team of five devoted to Japan research. Nicola Takada Wood joined in January as head of Japan, having run Japan strategies at Redwheel. Kaz Sakai is head of Japan research, having worked with the team since May 2020 and joined full-time in June 2021. Jason Bellamy joined AVI in April 2020 and leads the engagement efforts. There are two additional analysts on the team, and AVI also hires consultants in Japan to aid their research efforts. Kaz and analyst Shuntaro Shizumi both have experience with management consultants McKinsey and Bain, respectively, aiding AVI's increased focus on detailed operational engagement. A number of the team are Japanese-speaking, which is particularly helpful in the small-cap market, where reports and shareholder communication are not always published in English. We think this is a pretty substantial commitment of resources to Japan, supporting an intensive approach to stock analysis and engagement in a concentrated portfolio with high stakes to each position.

Discount

AJOT's shares have generally traded close to or above par since launch, with the board issuing shares into the market at times to soak up demand. However, discounts have been wide in the investment trust sector over 2023 and 2024, which we believe is largely due to do with investors' appetite for risk and concomitant preference for cash and bonds, and AJOT has tended to trade on a discount too. At launch, the prospectus raised the possibility of an exit opportunity in October 2022 and every two years thereafter. In 2022, shareholders and the board decided to forego the exercise, but in December 2024, it was offered. The 100% tender offer saw very little take-up, with just 2.6% of the shares tendered. This is a pretty robust vote of confidence in the strategy, and we think this shows the minor discount the shares trade on is 'organic' and has to do with daily liquidity and wariness about markets rather than indicative of any overhang or dissatisfaction amongst the shareholder base. The economic and political environment has remained troubled in recent months, and the rates outlook, uncertain. The board has committed to a 100% tender offer each year from now on, which should keep the share price close to NAV. This means the discount is unlikely to be a major part of the investment case for the shares, and equally, the downside risk is limited as shareholders know they will likely be able to sell at NAV less costs each year.

Fig.6: Discount



Source: Morningstar

That said, the board are not leaving it at that. They recently proposed a merger with FJV, which would roughly double net assets. Expanding the size of the proposition in this way would make it an option for larger shareholders, which could potentially increase demand and liquidity. The offer is being considered alongside other options by FJV's board.

Charges

AJOT's latest ongoing charges figure (OCF) is 1.5%, which compares to figures of 1.18% and 0.8% for the other two trusts in the AIC Japanese Smaller Companies sector. This includes a management fee of 1% of the lower end of the market cap or NAV, meaning that the charge falls when the trust is on a discount. We like this structure as it creates greater alignment of interests between the manager and shareholders. In fact, the manager's own holding in the trust, which has reached c. 1.5% of the share capital, adds to this alignment. AVI reinvests a quarter of the management fee into shares of AJOT each year, which has seen this position climb. AJOT's latest reported KID RIY is 1%, although we note that regulation in this area is changing and there is currently no consensus on what costs should be disclosed, so comparisons are not helpful at this time.

ESG

Improving corporate governance is a key aim of the investment strategy, and this is one of the three key pillars of environmental, social, and governance (ESG). 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. 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 ESG 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, as it doesn't have data on enough of the portfolio.

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