AVI Japan Opportunity

AJOT invests in Japanese small caps, taking advantage of extremely low valuations and using shareholder activism...

Update
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Summary

AVI Japan Opportunity Trust (AJOT) invests in Japanese small-cap stocks. The investment strategy aims to generate strong long-term returns through investing in high-quality companies at attractive valuations which retain significant excess cash and listed equity investments on their balance sheets. The management team seek to use shareholder activism to exploit market inefficiencies and improve shareholder returns.

AJOT was launched in October 2018 specifically to access a particular opportunity set arising from changes in the regulatory approach to corporate governance in Japan, which it was believed would catalyse a valuation re-rating amongst a group of very lowly valued stocks. This corporate governance reform drive was one of the arrows of 'Abenomics', a concerted attempt to revitalise and reinflate the heavily indebted Japanese economy.

The portfolio trades on a valuation discount to the wider Japanese small-cap market, which is itself at a valuation discount to global markets, even before balance efficiency is improved. Further details of the valuation opportunity can be found in the **Portfolio section**.

Whilst AJOT has commonly traded at a premium since launch, it has moved out to a discount of c. 2.6% as share price returns have lagged NAV gains in recent weeks. AJOT's board offers investors the opportunity to realise their position at NAV after four years have passed since launch. The board believes that there is sufficient opportunity available in this market that they intend, discount allowing, to issue further equity in the future to take advantage of the opportunity set.

As we discuss under **Performance**, both NAV and share price returns have outstripped those of the benchmark index since inception.

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Analyst's View

The resignation of Shinzo Abe might reasonably have caused nervousness amongst investors who viewed a still-nascent opportunity in Japanese stocks as a result of 'Abenomics'. Yet the early signs seem to indicate that 'Abenomics' has deep roots in Japanese governing structures, and there are as yet no apparent indications that the new premiership will seek to turn the governing LDP party away from this route. Ultimately, this perhaps should give greater succour to investors looking to benefit from corporate governance reform, demonstrating that a sustainable shift in corporate culture may well be on the way.

Similarly, on the whole the evidence suggests that Japanese management teams haven't used the exceptional circumstances of the COVID-19 pandemic and related shutdown as an excuse to backtrack on initiatives to improve shareholder returns and make balance sheets more efficient.

In this context, AJOT's investment case seems to be unaffected over the medium to longer term. In the short term, momentum may well weigh against relative returns as the market seems to remain particularly enamoured with high-growth technology companies. Yet this should continue to offer opportunities to build positions in some of the lowliest valued companies in the world. Recent engagement strategies seem to us to demonstrate the that the AJOT team are finding success when it comes to pursuing their interests, with substantial potential upside available from positions from relatively modest targets on valuations, margins and balance sheets.

BULL
Cheap portfolio with significant margin of safety on underlying holdings
Successes in engagement strategies offer prospect of further idiosyncratic gains
Continuation of 'Abenomics' could attract further overseas investors to Japanese market

BEAR
Small-cap stocks are often indiscriminately repriced lower in market sell-off
Stylistic (value) headwinds remain something of an issue at the present time
Gearing can exacerbate downside as well as amplify upside

Portfolio

AVI Japan Opportunity Trust (AJOT) invests in Japanese stocks, mostly in small- and medium-sized companies. Lead manager Joe Bauernfreund aims to generate high long-term returns through investment in operationally robust companies trading substantially below their intrinsic value.

However, it is generally acknowledged that the Japanese market has long appeared optically cheap, without a catalyst materialising to realise the substantial trapped value. Although AJOT's portfolio trades on very depressed valuations on a look-through basis, the stocks which comprise AJOT are not solely considered from a 'value' criterion and many stocks may not be immediately associated with this factor. The team look to ensure they are not just buying lowly rated businesses, but high-quality ones with governance structures where they can see a route to value realisation.

Asset Value Investors (AVI) took the decision to launch AJOT in October 2018 in the belief a tangible catalyst was visible to unlock the potential in these valuations. This catalyst is the ongoing regulatory push in Japan to improve corporate governance, or the 'third arrow' of Abenomics. The Japanese market has long contained a multitude of companies producing world-leading products and services, but corporate governance has frequently not reflected the interests of shareholders in improving returns. However, there has been a growing, and increasingly co-ordinated, push from both the government and regulators to see corporate governance improve. This has an emphasis on encouraging companies to increase payout ratios, return excess capital to shareholders and reduce their cross-holdings of equity in other Japanese companies (which have frequently been held on balance sheets for several years for no readily identifiable strategic or business objective).

AVI also manages the AVI Global Trust (AGT), a global trust with c. £989m of assets. Joe and the team, believing they had identified a catalyst to value realisation in the Japanese market, had started in 2017 to initiate positions in an array of Japanese companies they regarded as undervalued within AGT. However, the perceived opportunity in this area was such that AVI determined that a separate vehicle would be a preferable way to take additional exposure, though AGT retains significant direct exposure to this theme (as we detailed in our **recent research note**).

With a structural trend (corporate governance reform) identified as a source for potential value realisation, the team seek to further catalyse return generation through a strategy of ongoing engagement with management teams. Although historically overseas shareholder activism in Japan has been met with resistance due to perceived abrasiveness and differences in corporate culture, the AVI team have sought to adapt their tactics to better engage with Japanese management teams. This has involved seeking to engage with them collaboratively and, for the most part, in private. Engagements with company management tend to focus on highlighting how the changes to policy, corporate structure or governance that AVI is proposing can help management to be seen as aligning with regulatory pressures from the Japanese government, Japanese FSA and Tokyo Stock Exchange. We have more fully detailed the investment strategy and market backdrop in our previous note **here**.

Whilst the commitment from the Japanese government to continuing the reform agenda has been questioned by some market participants following the resignation of Shinzo Abe as prime minister, the managers of AJOT note that their conversations with company managements remain constructive. They note that managers and directors continue to clearly indicate that they understand the merits of corporate governance reform, and that they remain committed to improving governance and shareholder returns.

Similarly, it may have been reasonable for investors to grow concerned that huge global economic contraction and lockdown in activity amidst the COVID-19 pandemic would cause company management teams in Japan to retrench and retrospectively justify their huge cash piles as necessary ballast against just such an event. Joe and the team note that this has very much not been the case. With all but one of the companies held within AJOT remaining free cash flow positive throughout the crisis, the inherent stability of the businesses held has proved, if anything, that hoarding cash is needless in their view.

Furthermore, the team note that it is not the concept of a cash buffer that they are engaging with. Joe and the team remain positive on companies displaying strong balance sheets, and having disposable assets readily available for corporate opportunism. Despite the impact on Japanese businesses from 'lockdowns' elsewhere in the world, such is the strength of Japanese balance sheets in general that there was no need for government support for companies to the level seen in most developed economies, and companies have largely been able to maintain distribution levels. Indeed, such is the level of strength on Japanese balance sheets that there are signs that M&A activity is picking up, funded from cash, despite the depressed operating environment globally.

Against this backdrop, it is not strong balance sheets, but the sheer quantum of excess net cash and financial assets on company balance sheets that Joe and the team are looking to remedy through engagement. As at the end of July 2020, the team estimate that, on a weighted look-through basis, AJOT's portfolio has net cash of c. 50% of market capitalisation. When other financial securities are included, this rises to c. 91% of market capitalisation.

Ajot: Portfolio Characteristics Vs Indices

	AJOT	MSCI JAPAN SMALL CAP	MSCI EUROPE	S&P 1500
Net Cash as a % of Market Cap	48%	6%	0%	0%
NFV as a % of Market Cap	92%	19%	-72%	-68%
Free Cash Flow Yield (Equity)	5.5%	11.3%	-17.0%	-59.5%
Free Cash Flow Yield (EV)	19.9%	5.8%	10.0%	4.9%
EV/EBIT	3.7	8.9	15.9	20.3

Source: Asset Value Investors, as at 31/08/2020

Although the focus of AJOT's engagement strategy is private and involves collaborative conversations with company management teams, the trust will on occasion conduct more public campaigns, designed to put greater pressure on company management teams by highlighting AJOT's managers' arguments to other shareholders.

This has been seen in the recent campaign involving Fujitec. Joe and the team have been engaging continuously with Fujitec's management since initiating a position (within AGT) in July 2018. In doing so, they have sought to highlight a myriad of corporate governance measures they believe could be improved. Although they initially sought to engage privately with the company management, the recalcitrance of said management caused them to take their campaign public in May 2020.

Fujitec, the world's eighth-largest manufacturer of lifts and escalators, has net cash and securities totalling c. 37% of its market cap (as at September 2020). AJOT's management team argued that the 'strategic' cross-shareholdings in other businesses should be divested, and excess cash used to undertake share buybacks. However, the campaign with Fujitec also pushed for more long-term and far-ranging reforms, including to operational efficiencies, shareholder communication and corporate governance. Joe and the team highlighted that Fujitec lagged global competitors in all relevant performance metrics such as return on equity, profit margins and valuations (noting that Fujitec traded on an EV/EBIT of c. 6x at the campaign's initiation relative to c. 19x for listed global peers; it is now c. 12x EV/EBIT). Meanwhile, profit margins were at around 50% of the level of global peers, suggesting to Joe and the team that there was very substantial upside available from a simple normalisation of the business, and stock valuation.

To remedy this, the team proposed that Fujitec's management address key concerns such as a lack of scale within operations, inefficiencies in the manufacturing process and poor capital allocation decisions, amongst other concerns. Seeking to engage further shareholder support behind their public campaign, the team created and published **a slide deck presentation**, which has since helped consolidate shareholders behind their campaign. They were also joined by fellow activist investor Oasis Management. Subsequently, Joe and the team have commented that they have observed a more constructive approach from Fujitec's management and the initiation of programmes to improve operational efficiency. Ultimately, they believe this will help to address the undervaluation of the business, either by attracting further outside bidders for the company or through greater ability to return excess capital generated to shareholders.

AVI holds over 3% of Fujitec's shares, an important consideration in AVI's engagement with management. Shareholders in Japanese companies can put forward proposals to an AGM if they have held a 1% stake in a company for at least six months. The closed-ended structure of AJOT and AGT has typically allowed them to maintain these positions even in the face of market volatility. Accordingly, turnover has remained low within the portfolio in 2020. However, the team have taken the opportunity to rotate to relative underperformers within AJOT at the margin. Many of the stocks which have underperformed are amongst the smaller companies held within AJOT, and were often marked down indiscriminately by market-makers amidst the tight liquidity conditions seen earlier in the year.

Stocks themselves are selected through a process which involves the utilisation of quantitative screens to narrow a universe of approximately 3,500 stocks down to several hundred. The first stage involves discarding stocks with low levels of liquidity (defined as less than £20,000 of average daily trading volume), which initially leaves around 3,100 companies.

The remaining stocks are then subject to further quantitative screens, assessing balance sheet strength and seeking to identify companies where net cash and securities are greater than 30% of the market capitalisation. This further reduces the available investment pool drastically, leaving several hundred potential investments.

Joe and the team seek to ensure that positions are consequential and that AJOT remains a relatively concentrated portfolio of around 25–30 stocks (AJOT has 28 holdings as at 31/08/2020). As well as ensuring the team's engagement strategy can be focussed and ongoing, this also reflects the need to hold a sufficient stake in a company so that they can propose actions at an AGM. The concentrated nature of the portfolio can be seen in the very substantial proportion of AJOT invested in the top ten positions.

AJOT: Top Ten Positions As At 31/08/2020

HOLDING	%
Fujitec	8.9
Teikoku Sen-I	7.8
SK Kaken	6.7
Pasona Group	5.9
Secom Joshinetsu	5.5
C. Uyemura	5.3
Konishi	5.2
SoftBank Group	5.2
DTS	4.9
Kato Sangyo	4.8
Total:	60.2

Source: Asset Value Investors

In selecting the portfolio companies from the quantitatively filtered universe, the team look at a variety of value and quality metrics. Value assessments look at the relative valuation multiple attached to peers operating more efficient balance sheets or with greater operational efficiency, as we see with Fujitec above, whilst also accounting for the relative growth prospects of different companies. Similarly, the team are keen to eschew overly cyclical companies and look for businesses with stable operations and earnings. With a stable foundation, the identified catalysts to improving stock and business returns can be reasonably expected to produce the desired and anticipated returns.

Should AVI see wholesale reductions in net cash across the index and portfolio, it will consider winding up AJOT, as this would represent the fulfilment of the original investment objective.

Gearing

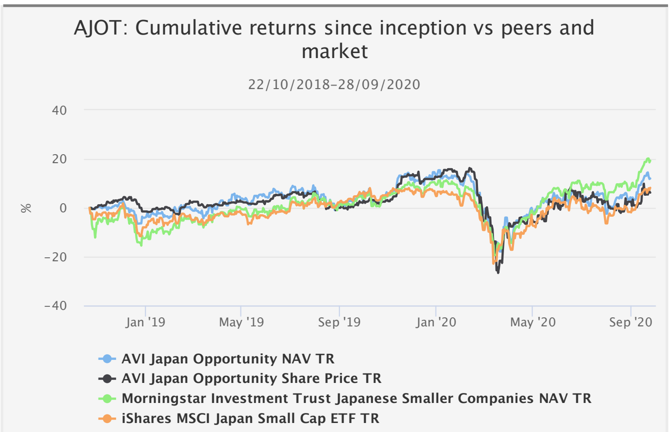
AJOT presently has around 9% of gearing in place. In March 2020 the trust extended a one-year revolving credit facility, and further increased its size. This credit facility now offers the managers access to a total credit facility worth ¥4.33bn, equating to c. £32.3m (or, we estimate, c. 24% of net assets as at 28/09/2020). The interest rate payable on this debt is LIBOR plus 1.25%.

Gearing has typically been employed to increase exposure to existing positions, with the managers aiming to avoid any dilution of portfolio positions. Although the relative illiquidity of some of the underlying positions can sometimes see them incur share price volatility in the short term, we think it is likely that the investment process nonetheless will typically create an investment universe of companies with relatively defensive characteristics.

Performance

AJOT has delivered NAV and share price returns of c. 12% and c. 6.2% respectively since launch to 28/09/2020. This represents underperformance of the wider AIC Japanese Smaller Companies peer group, which has seen average NAV and share price returns of 19.3% and 11.1% respectively over the same time period, dominated by the strong performance of the two high-growth-focussed trusts. However, despite AJOT's valuation-sensitive strategy, it has still outperformed the market. NAV returns have exceeded those of a passive product tracking Japanese smaller companies, which has delivered returns of c. 8.2% over the same period. We note that a Japanese small-cap value index over this same time period would have delivered returns of only c. 1.7% (Source: Morningstar, FE Analytics).

Fig.1: AJOT: Cumulative Returns Since Launch Vs Peers And Market



Source: Morningstar

AJOT targets businesses that are operationally resilient, and which have an inherent margin of error through the quantum of assets and cash on the balance sheet. However, to fully access valuation opportunities and be able to hold stock at scale to drive changes, this naturally leads to a portfolio of smaller companies that are often relatively thinly traded stocks. This is fairly true of AJOT's portfolio even by comparison to peers and the broader universe. As we have noted under **Portfolio**, this has proven to have had a negative impact upon returns in the current year, as in the Q1 2020 sell-off many smaller-company stocks were indiscriminately marked down by market-makers in a manner disproportionate to actual selling pressures.

This has caused AJOT to lag over the 12 months to 28/09/2020, with NAV and share price returns respectively of c. 6.7% and c. 4.1%, against peer group average NAV and share price returns of c. 14.3% and c. 10.8%. Again, however, this represents outperformance of a passive product tracking Japanese smaller companies, which delivered returns of c. 2.3% over this same period.

As well as struggling in the downturn, AJOT has not kept up in the market recovery seen since. We think this can be in large part attributed to an ongoing global preference for 'secular growth' winners which has also been visible in the Japanese market. Although AJOT does hold exposure to companies expected to benefit from structural shifts, this exposure is less pronounced and targeted than that seen in some of the trust's peers. However, as we have previously **highlighted**, there is backtested evidence to suggest that the stock universe from which AJOT's portfolio is constructed has tended to fairly consistently outperform the wider Japanese stock market over the longer term, and despite the stylistic headwinds it has faced AJOT has significantly outperformed the Japanese small-cap market since launch.

Dividend

AJOT targets total returns, and as such income is a secondary consideration and by-product of the investment process. At present, AJOT has a portfolio yield of around 0.8% on a historical basis, having paid out dividends totalling 0.9p per share in the 2019 financial year.

The Japanese equity market has been notable for the resilience of its dividend streams in 2020 compared to those of its developed market peers, due in part to the low payout ratios previously exhibited. AJOT's management team note that across their portfolio distributions have remained broadly flat, and that where cuts in absolute levels have occurred, payout ratios have nonetheless tended to remain consistent.

More broadly we believe there is evidence that, at the market level, there remains a trend towards rising payout ratios as part of general changes in corporate governance approaches which increasingly place a greater emphasis on returning capital to shareholders and creating shareholder value. However, Joe and the team observe that market reactions to increased dividend distributions have tended to be less positive than to buyback announcements, and that company managements tend to prefer buybacks to increased dividend distributions.

As noted above, a significant component of AJOT's investment strategy involves engaging with management to reduce excess cash or assets on balance sheets, with the intention that this excess will be returned to shareholders. If successful, in some instances this could be through special, new or increased dividends - although there is no guarantee here. Accordingly, income flows may rise substantially (albeit there is unlikely to be a neat linear path of progression).

Management

Joe Bauernfreund is lead manager of AJOT. Joe is CEO and CIO of Asset Value Investors, and has been with the group since 2002, starting as an analyst working on European holding companies. He became co-manager of AVI Global (then British Empire) in 2013 before becoming sole named manager in October 2015.

Joe is supported by Tom Treanor, head of research, and analyst Daniel Lee, who leads on much of the work on the Japanese holdings across AVI Global, as well as across AJOT. AVI employees have over £1m of their own money in AJOT, and also reinvest 25% of the management fee into the trust, which indicates a meaningful commitment to the alignment of interests between management and investors and a high degree of confidence in the strategy.

AVI has continued to invest further in the team, and has added new team members, based in Japan, with the specific task of heading engagement with company managements. We understand that two native Japanese-speaking analysts will join the team next year, taking the number of Japanese speakers to four, and the Japan team to eight.

Discount

AJOT presently trades on a discount of c. 2.6% (as at 28/09/2020). This is unusually wide in absolute terms relative to the trust's history, with the trust having traded on a premium on c. 85% of daily occurrences since launch. AJOT's discount has widened in recent months as share price gains have lagged NAV returns; over the three months to 28/09/2020, AJOT saw NAV gains of c. 5.7% whilst the share price fell by c. 0.2% (Source: The AIC).

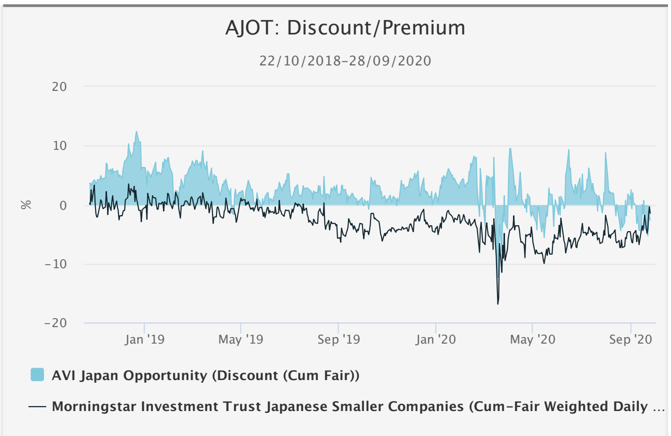
The current level of discount is considerably below the median premium seen in AJOT of c. 2.6% since launch, though with the trust only having been listed in October 2018 this is a relatively limited sample set. Whilst a significant proportion of AJOT's shares are held by relatively few institutional investors, we nonetheless estimate that the spread on shares is below that of all but one of the AIC Japanese Smaller Companies sector peer group at the time of writing (Source: The AIC), suggesting there is a reasonable level of liquidity available.

The premium had reached a high of 12% in December, partly as a result of share price resilience, while NAV fell amidst global market contractions. This contraction in the premium has been a headwind to share price returns since this time, as can be seen in the **Performance section**.

Having initially issued at a fairly constrained level of assets, the board and managers have made it clear that they believe there remains the possibility of increasing scale to the trust. Accordingly, the board has been willing to issue new shares with the trust at a premium, issuing a total of 3,550,000 shares thus far in 2020 (as of 28/09/2020) at a weighted average premium of c. 3.4%.

In addition, AVI itself has used a proportion of its management fee to purchase a total of 175,000 shares in the secondary market thus far in 2020. As discussed under **Charges**, this is part of an ongoing commitment to use 25% of the management fee to purchase shares in AJOT.

Fig.2: AJOT: Discount/Premium



Source: Morningstar

Charges

AJOT currently has an OCF of c. 1.64%, greater than the AIC Japanese Smaller Companies sector average of 1.01%. AVI applies a management fee which is 1% of the lower of market cap or NAV; this ensures that management interests are aligned with those of shareholders, beyond the managers having significant 'skin in the game'.

AVI reinvests 25% of its management fee in shares of the trust, a commitment it made before launch. The Key Investor Document Reduction in Yield figure of 1.82% is slightly above the 1.46% average of the peer group (although we note that calculation methodologies do vary).

The costs of engaging with management and activist activities will be borne internally by AVI. Charges are expected be taken wholly from capital.

ESG

Governance and sustainability concerns are at the heart of the investment process for AJOT. Reforming corporate governance, to ensure it is better aligned with shareholder interests, is a key aim of the trust, with Joe seeking to engage with company management on an ongoing basis in this regard.

Similarly, the investment process emphasises a preference for non-cyclical, resilient businesses with recurring and sustainable revenue streams.

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