AVI Japan Opportunity

AJOT's policy of active engagement means it is primed to capitalise on Japan's incoming governance reforms...

Update
27 April 2021

Summary

AVI Japan Opportunity (AJOT) offers investors a highly differentiated approach to Japanese small-cap investing. The management team led by Joe Bauernfreund aim to generate long-term performance through a portfolio of high-quality companies bought at attractive valuations. What sets AJOT apart is the strategy of active engagement, whereby the managers target companies with inefficient balance sheets and corporate structures in an attempt to convince management to address those issues and increase shareholder returns as a result.

Company management has proved very responsive since AJOT launched thanks to a strong regulatory and political push towards improving corporate governance in Japan, which forms the third arrow of 'Abenomics'. While COVID-19 delayed some of AJOT's engagement plans, 2021 looks to be a promising year with the advent of major policy change to both governance codes and index construction. The team have already prepared numerous engagement campaigns, with 11 of their 27 holdings already in the pipeline for some form of active engagement over the year. In order to be sufficiently resourced to deal with the volume of work, the AJOT team have been significantly expanded with the inclusion of four new Japanese-speaking team members.

AJOT's performance has been in line with its benchmark since its inception in 2018, despite its value-tilted approach being out of favour and the turmoil in markets due to the pandemic. However, on a fundamental level the portfolio remains strong, with the team reporting a V-shaped recovery in sales and profits while the portfolio trades on a highly attractive 4.5x EV/EBIT valuation. With the dichotomy between price and fundamentals, coupled with an active upcoming AGM season, the team are increasingly bullish going into 2021. AJOT trades on a 0.6% premium to NAV.

Analysts:
David Johnson

Analyst's View

Joe and the team at AVI have identified a clear and differentiated source of alpha in the push for corporate governance reform in Japan. When the trust was launched in late 2018 some may have doubted that the reforms would bear fruit but events have validated the thesis, with plenty of activist 'wins' in the AJOT portfolio and in the broader Japanese market, and a growing recognition by other investors of the opportunity.

We think the incoming policy changes to Japan's corporate governance code and index construction (see the **Portfolio section**) show that the opportunity has not passed and that 2021 is likely to present new opportunities. While AJOT has underperformed in the aftermath of the pandemic, its large pipeline of engagement activity for the coming year indicates that there is plenty of scope for it to generate outperformance in a more normalised, post-pandemic environment.

AJOT also offers one of the few true value propositions in a region so often dominated by growth-focussed strategies. We agree with the notion that AJOT has substantial optionality in it, whereby its portfolio of high-quality companies are in unto themselves attractive business opportunities and so therefore the team's active engagement is a mechanism through which AJOT offers substantial alpha potential rather than it being the predominant source of return.

We think the differentiated source of alpha the trust offers is likely why AJOT continues to trade on a slight premium, as it has for most of the time since it was launched.

BULL
Potential for increased shareholder returns through corporate governance reforms
Unique, highly active approach to investing
Underlying portfolio has shown great resilience in sales and profits during COVID-19 crisis

BEAR
Lower exposure to broader tech-related growth trends in Japan
Gearing can exacerbate losses during a market rout
Possibility that engagement campaigns may not succeed

Portfolio

AVI Japan Opportunity (AJOT) offers investors a portfolio of mid- and small-cap Japanese equities, with the objective of maximising capital growth. Run by Joe Bauernfreund, who is supported by a seven-strong team, the strategy is to unlock the unrealised potential in the inefficient balance sheets of a set of high-quality Japanese small caps through divesting non-core assets, distributing excess cash or finding other ways to generate a return on underutilised assets.

AJOT was launched by Asset Value Investors (AVI) in October 2018. The AVI team had identified a substantial cohort of undervalued but high-quality businesses in Japan with hugely ineffective balance sheets. As said holdings having large amounts of cash or liquid assets sitting in their accounts, with their management having little intention to reinvest or return it to shareholders, the team believe the holdings trade at a substantial discount to their potential intrinsic value. In aggregate, AJOT's portfolio currently has high levels of net cash and net financial value relative to its benchmark, the MSCI Japan Small Cap Index, at 46% versus -14% and 83% versus 2% respectively.

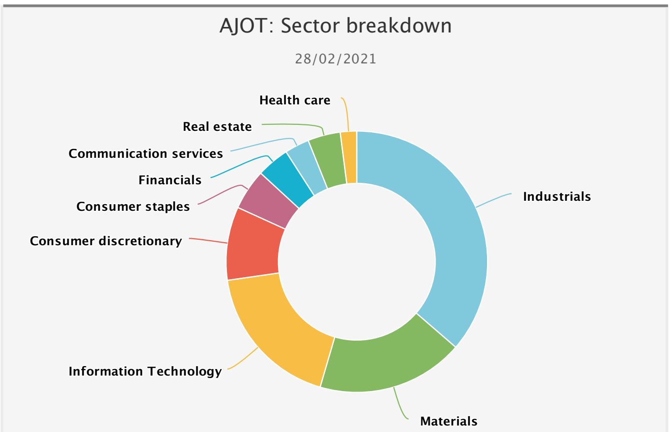
The catalyst for unlocking this value comes through a commitment by the Japanese government to force companies to unwind these inefficient balance sheets and improve the country's return on its assets. This was a key element of former prime minister Shinzo Abe's Abenomics reforms, which have been continued by his successor. The team believe that through active engagement, or via the considerable pressure from policymakers and regulators, they can persuade their companies to return some of their large reserves of liquid capital to shareholders, be it through higher ROIC or direct redistribution. The governance reforms of Japan are widely documented, including in our **recent editorial**, and the team believe that come what may Japan is now on an inevitable path towards positive corporate governance reform. However, the team also view governance reforms and the resulting upside as a form of optionality within their portfolio. AJOT's portfolio consists of sufficiently cheap and high-quality companies that if there were to be zero governance improvements the business models of their investments would still have the potential to generate good long-term returns.

While AJOT does not have an explicit market cap or style restrictions, it has a clear small- and mid-cap bias, for it is in this space that the team believe they can be most impactful, by the simple virtue that it is easier to purchase the minimum position size required to initiate shareholder action. Japan's listing rules allow shareholders with 1% ownership to put proposals forward at annual general meetings, and shareholders of 3% or more can call extraordinary general meetings. Small-cap companies are also under-researched and overlooked, with the market often undervaluing the potential value to be had in corporate reform, allowing for greater value-add by AJOT's analysis. The idea for AJOT developed from research done by the AVI team for its larger global trust, AVI Global Opportunities (AGT). In researching ideas for this trust, the team first identified the opportunity presented by overcapitalised companies with poor analyst coverage in Japan. We outline the process behind AGT and its recent performance in more detail in our **recently published note**.

The team screens the market for deeply undervalued companies and those which are cash rich or overcapitalised. They look for companies which have net cash and listed securities which are greater than 30% of their market capitalisation, which currently translates to a universe of 1,100 companies. The team then makes an assessment of a company's fair value against its less cash-heavy peers, with their preferred valuation metric being EV/EBIT and the aim being to find companies that currently trade on a discount which can be narrowed.

The next step is the assessment of quality, where the team look to identify economically resilient companies rather than corporate zombies (those relying on cheap financing to survive rather than their own profitability). The team aim to find companies with high ROIC, strong balance sheets and good operating margins, while filtering out overly cyclical companies. Outside of avoiding cyclical companies the team are agnostic towards sectors and themes, though in general the high-quality and cash-heavy balance sheets of their investments lend AJOT to having more defensive characteristics. AJOT's largest allocation is in industrials and materials, symptomatic of the poor capital allocation in these sectors.

Fig.1: Sector Breakdown



Source: AVI

The final step is the assessment of a company's ability to improve, and thus the ability for active engagement to add value. This can take the form of reviewing the shareholder register to find companies with a high shareholder base that will be more receptive to the team's recommendations.

It also informs the team of their ability to build a high ownership stake, with the team preferring to have a c. 5% holding where possible. They also assess the past history of corporate reforms, to see whether management is open to change. There are also circumstances where the team will identify a company which is already on the path to corporate reform without shareholder action having been taken. They will be happy to invest in such an opportunity as not every holding needs their active stewardship, so long as they are confident that the holding is on a trajectory towards improving governance and increasing shareholder returns.

The resulting portfolio is highly concentrated, typically ranging from 20 to 30 holdings (currently 27), with each holding having a three- to five-year horizon. The rationale behind this is that the team only want to hold companies which have genuine potential for a positive reversion in their valuation, and that active engagement is a resource-intensive action that is best practised exhaustively on a select group of holdings. Given the resources needed for active engagement, AVI has seen fit to substantially increase the team behind AJOT, something we cover in the **Management section**. AJOT's time horizon in part reflects the minimum amount of time the team believe they need to see whether any material change in the management of a company is possible, where after three years they feel it would be unlikely that their engagement would be able to change management policy if it hadn't already done so before. We highlight to investors that AJOT's concentration is atypical in the small- and mid-cap space, where the conventional wisdom is to have a highly diversified portfolio so as to reduce the increased volatility associated with smaller companies (which can be more sensitive to company announcements and economic shocks).

Top Ten Holdings

NAME	WEIGHT (%)	% OWNERSHIP OF COMPANY
Fujitec	7.8	2.6
DTS	7.1	7.0
Digital Garage	6.1	1.6
SK Kaken	5.3	3.1
C.Uyemura	5.2	1.7
Secom Joshinetsu	4.9	2.3
Kato Sangyo	4.9	1.6
Pasona Group	4.8	4.1
Konishi	4.8	4.2
Bank of Kyoto	4.6	0.3
Total	**55.5**	

Source: AVI, as at 28/02/2021

2020 has undoubtedly been an interesting year for global markets but thankfully the pandemic has not halted the tide of corporate reforms, with there having been over 60 activist events (i.e. shareholder proposals to management) in the Japanese market in 2020, slightly fewer than the 70 in 2019. The team do acknowledge that 2020 has seen slightly fewer formal shareholder proposals at Japanese AGMs, as investors have given management some clemency over the year to deal with COVID-19. Investors should be aware that the nature of activist investing is a sensitive one, with most of the work being done behind the scenes in private discussions between large investors and management, and thus most of the team's engagement activities cannot be fully disclosed. The team's preferred method of engagement is the creation of highly detailed presentations made privately to company management, highlighting potential avenues for improving shareholder returns. The topics the team will raise with company management are numerous, and can range from encouraging share buybacks, improving board diversity, improving capital allocation policy and encouraging corporate actions such as management buyouts or privatising subsidiaries. There have been two public engagement activities over 2020 against Fujitec and Teikoku, with the campaign against Fujitec's underperformance and undervaluation being widely covered in the press and detailed in our **previous note**.

2021 is looking to have even greater potential for active engagement than 2020, with a pipeline of engagement opportunities and regulatory tailwinds supporting Japanese governance reform. Even though we are only a quarter of the way through 2021, the team already have 11 companies in the pipeline for active engagement (for confidentiality reasons they cannot be named), with plans to submit seven shareholder proposals. The highest potential share price upside from any one action is 124%, assuming the company's current discount is eliminated post-engagement and the company trades in line with the potential net asset value as determined by the AJOT team. The team aim to achieve this by helping to shape said company's mid-term plan while also outlining shareholder proposals to increase capital efficiency and corporate governance with the parent company. Other actions include pushing one company to be bought out by its parent, and encouraging a management buyout for another of their holdings. While ideally all of the team's engagement objectives would be successfully implemented behind closed doors, they have four or five public campaigns planned for 2021.

The team believe that the tailwinds which have supported corporate governance reform in Japan will only accelerate in 2021, with the process now at a point of critical mass where even if the Japanese government does not implement further policy, the regulators and companies themselves will carry on the path of reform regardless. Two of the big reforms coming in 2021 are the revision of Japan's Corporate Governance Code and the Tokyo Stock Exchange's planned restructuring. The former will bring with it a number of key revisions, though they would appear fundamental to those used to Western standards of corporate governance. Such reforms include: independent directors making up at least 33% of board members, improvements in staff diversity and the establishment of remuneration committees.

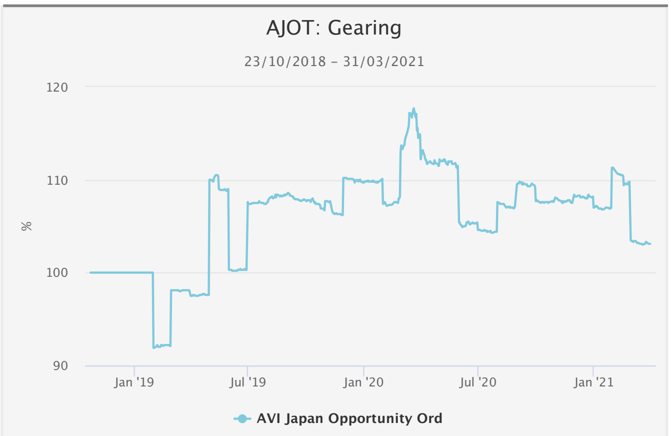
In the case of the Tokyo Stock Exchange reforms, new listing requirements for the various bourses it controls are being introduced, with a ¥10bn market-cap requirement to be included in the prime market and a free-float calculation to exclude companies' strategic shareholdings (i.e. stripping out their equity holdings in their subsidiaries). Both of these changes will materially improve the outlook for many Japanese equities, and will often accelerate many of the initiatives the AJOT team are taking with their investments. In the case of the exchange reforms four specific companies within AJOT's portfolio are likely to be directly affected, presenting further opportunities for engagement.

Gearing

AJOT currently has 11% net gearing in place (as at 31/03/2021). 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. £28.3m (or, we estimate, c. 19% of net assets as at 31/03/2021). The debt facility was renewed on 17 February 2021 and will mature on 16 February 2022. The gearing has been provided at an interest rate of LIBOR plus 0.95%. (Source: JPMorgan, as at 09/04/2021)

Alongside its regular gearing AJOT recently raised £12m in cash in February through a capital-raising campaign. The team expect to use the current dry powder in the same manner as they typically use gearing – either by investing into new positions or tactically increasing their exposure to existing ones. The team are conscious of the slow pace it can sometimes take when investing in their selected holdings, given the small size of their holdings and their desire to have substantial position sizes.

Fig.2: Gearing Since Inception



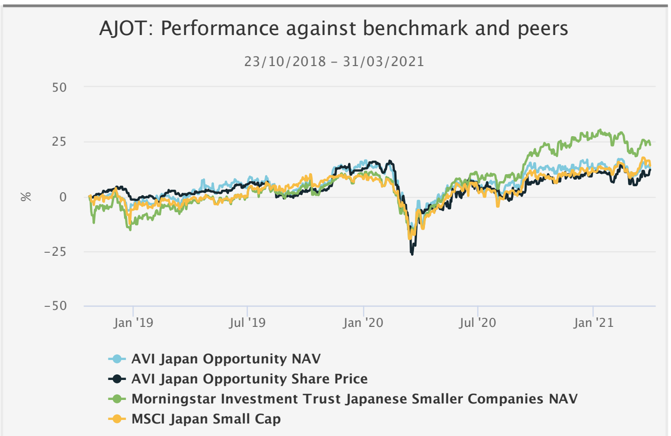
Source: Morningstar

Performance

Since its inception on 23/10/2018 AJOT has generated returns close to those of its benchmark, the MSCI Japan Small Cap Index, with AJOT having generated an NAV total return of 12.3% and share price return of 12.1%, compared to its benchmark's return of 14.0% over the same period. AJOT has, however, significantly underperformed its peers as they returned an average NAV total return of 23.5% over that period. Given AJOT's peer group is dominated by more growth-orientated strategies, the trust has been struggling against a headwind for most of this period, which we think makes its performance creditable. While value has outperformed against growth in the reflationary rally since last autumn – in Japanese small caps, as in global markets overall – it was cyclical and poorer-quality companies which did best, and so AJOT's quality portfolio didn't keep up with the market.

It is important to acknowledge that the nature of AJOT's investment philosophy is one a of a 'slow burn', as the process of making meaningful changes to corporate governance and shareholder returns is a long one. Not only can the process behind management engagement take multiple years, but given the small- to mid-cap nature of AJOT's portfolio there can also be a lag between successful engagement and the border market recognising the impact of the change, due to the low analyst coverage. As a result we feel that the sub-three-year track record may be insufficient to fully reflect the potential of the strategy.

Fig.3: Performance Since Inception

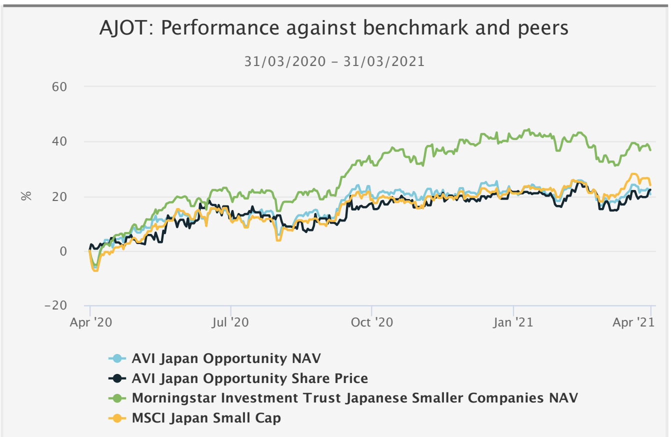


Source: Morningstar

Past performance is not a reliable indicator of future returns

The last 12 months have been difficult for AJOT, as its NAV total return of 20.7% and share price return of 22.3% have underperformed the 24.0% return of its benchmark and the 36.8% NAV return of its peers. This underperformance has been a result of AJOT 'falling between the gaps' of the market forces over that period. AJOT's value tilt prevented it from capitalising on the sectoral tailwinds supporting technology and communications companies which resulted from the impact of the pandemic on day-to-day life. Many of these COVID-19 'winners' were the expensive growth-orientated stocks, which had less of the corporate governance and capital allocation issues of their value peers. However, the quality element of AJOT's portfolio also prevented the trust from fully capitalising on the value rally which resulted from the advent of the global vaccine roll-out, and the consequential decline of the pandemic. The team believe that it was cyclical and deep-value companies which benefitted from the rotation, sectors which the team actively avoid as they were those which suffered most during the crash and for which the market expected a correspondingly strong recovery. However, the largest overall contributor to AJOT's performance over 2020 was the holding of Fujitec, vindicating much of the team's work in active engagement, given the widely published shareholder action taken against the company.

Fig.4: One-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future returns

Valuation and outlook

AJOT's recent performance does not reflect the operational strength AJOT's companies have demonstrated during the pandemic. The team have observed a V-shaped recovery from their portfolio as the aggregate sales figures are up 2% over 2020, while profits are up an impressive 16%. As a result of this strong recovery the aggregate valuation of AJOT's portfolio, adjusting for weight changes, has remained constant across 2020, with AJOT's EV/EBIT ratio (the preferred valuation metric of the team) having been 3.8 times at both the start and end of the year. However, in the case of the MSCI Japan Small Cap Index its valuations have expanded 35% over the year, from 16.6 times to 22.4, making AJOT's portfolio more attractive on a valuation basis. As a result of strength and attractive valuations the team believe AJOT is well positioned for 2020; and so long as the strong rebound continues, there is a good likelihood that AJOT's underlying earnings will revert to their pre-COVID-19 levels. Once the COVID-19 market trends fully play out, such as the surge in demand for technology stocks and the vaccine recovery trade, it is our opinion that investors may return to quality stocks such as those that make up AJOT's portfolio. Such companies can reliably generate growth over varying market cycles, a distinct advantage given that there will no longer be the obvious sectoral tailwinds that were apparent during the pandemic. The team believes that the portfolio valuations are near the cheapest they have ever been. Given the level of valuations in broader markets it is quite remarkable that they have built a portfolio of quality companies with net cash covering 46% of the market cap and 83% when including invested in listed securities.

Dividend

The priority of the team is the maximisation of total return, and so income is a by-product of the team's investment process. AJOT currently has a historical yield of 1.2%, with a total dividend of 1.3p per share paid for the 2020 financial year. While this is below the average 1.3% yield of the sector, the other two trusts which pay a dividend (Atlantis Japan Growth and JPMorgan Japan Small Cap Growth & Income) finance their dividend from capital, whereas AJOT's dividend is solely funded by its underlying revenue. AJOT currently has a revenue reserve coverage ratio of 0.7 times, based on the most recent full-year dividend. (Source: JPMorgan Cazenove, as at 09/04/2021)

Japanese companies have been better able to weather the COVID-19 storm than many of their global peers, with the team observing little if any cuts to their companies' dividends during the pandemic. With the ongoing improvements to corporate governance it is likely that the trend towards rising payouts will only increase. AJOT's policy of active engagement, and specifically its recommendations to companies to increase their payout ratios, has the potential to further increase the dividend paid by the portfolio in particular. Such instances may not always take the form of a long-term increase in dividend payouts but may sometimes take the form of special dividends and share buybacks, which are more conducive to enhancing total return than long-term dividend growth.

Management

Over 2020 AVI has expanded the AJOT team to eight, after hiring four Japanese-speaking professionals. The impetus behind these hires does not only reflect AVI's commitment to the AJOT strategy but also the increased opportunities the team foresee in the near term, as well as providing the required resources to effectively manage their pipeline of engagement campaigns.

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 head of research Tom Treanor and senior 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.

Two new dedicated Japanese full-time analysts have recently joined the team: Makiko Shimada, who brings with her a wealth of corporate engagement experience from her prior role at Goldman Sachs; and Kaz Saki, who will be joining full time from July once he completes his MBA. Jason Bellamy has also joined the team as a part-time consultant analyst based on the ground in Tokyo, bringing with him 25 years of investment experience. The team have also brought on Yuki Nicholas, a Japanese-speaking desk assistant.

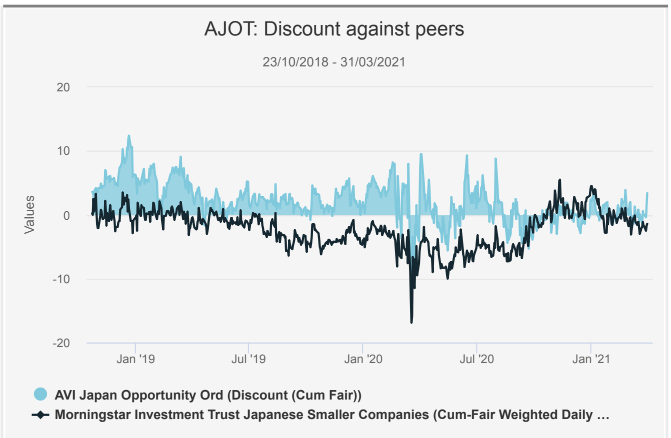
Discount

AJOT currently trades on a 2.2% premium and is one of the few trusts in both the Japan and Japanese smaller company peer groups to do so, with the Japan sector trading on an average discount of 3.1% and the Japanese smaller sector on a 1.2% discount. We believe AJOT's premium is the result of the market's demand for a differentiated source of return, given AJOT's activist investment style and value bias differ from those of its growth-orientated peers and thus offer diversification benefits. Since its inception AJOT has traded on an average premium of 2.1%, in excess of the 2.3% discount of the Japan small-cap peer group.

The demand for AJOT has been so strong that the board was able to raise £12m in February this year, primarily through institutional investors, part of the board and management's intention to scale up the trust. Outside of the capital raise the board has issued 4.8m shares over the last 12 months, equal to 4% of the shares in issue, with the most recent repurchase being made at a 2.4% premium.

AVI has also repurchased 225,000 shares over the past 12 months, part of its commitment to reinvest 25% of its management fee into AJOT's shares.

Fig.5: Discount Since Inception



Source: Morningstar

Past performance is not a reliable indicator of future returns

Charges

AJOT's ongoing charges figure (OCF) is 1.56%, greater than the AIC Japanese Smaller Companies sector average of 0.99%. AVI earns a management fee which is 1% of the lower of market cap or NAV; this ensures that the management company is incentivised to see the trust trade close to NAV.

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 1.43% average of the peer group (although we note that calculation methodologies do vary).

The costs of engaging with management and activist activities are borne internally by AVI. Over the long term the board expects charges to be taken predominantly from capital.

ESG

While AJOT's investment philosophy is focussed around active engagement, one of the most onerous demands of ESG investing, the team do not label the trust as an ESG strategy. For the team the overriding factor is governance believing that corporate governance issues must first be addressed before investors have any chance of addressing environmental issues.

We detail the team's approach to governance analysis in detail in the **Portfolio section**. It is worth highlighting that the topics which the team engage management on are broad enough to address a number of key social issues within ESG. One major social issue which the team actively address, and something which has plagued Japanese companies for decades, is the lack of diversity in boards and management. This does not only reflect the lack of independent directors but also the narrow range of experience of the board members, as well as the age and gender biases which pervade much of Japanese senior management and executive boards, where the majority of them are composed of long-tenured male executives. The AJOT team remarked that in one of their successful engagement campaigns a woman was elected to their investment's board, a modest but still revolutionary change for some Japanese companies which transformed the tone of conversations the board now has for the better.

AJOT is unfortunately a perfect example of the limitations of quantitative ESG screens, as Morningstar has rated the fund as low for sustainability when compared to its peers within the Morningstar Japan Equity peer group. We believe that this rating fails to capture the strong ESG credentials of the trust. This low rating is likely the result of AJOT intentionally targeting companies with low ESG ratings, as those will have the greatest scope for improvements in their capital allocations and governance structures. The team's philosophy of active engagement is one which needs to be both acknowledged and encouraged if we are to see material improvement in the ESG credentials of Japanese equities, as these companies are unlikely to improve without third-party encouragement. Thus we believe that AJOT could easily be appealing to an ESG-conscious investor, despite its low quantitative score.

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