AVI Japan Opportunity

AJOT's concentrated, highly active approach to Japanese small caps has led it to generate strong outperformance over the last 12 months...

Update
25 November 2021

Summary

AVI Japan Opportunity Trust (AJOT) offers investors a highly active approach to Japanese investing. This is not only due to the highly concentrated portfolio of high-quality Japanese equities the trust owns, but also through the large amount of active engagement campaigns the team run. Currently, 85% of AJOT's portfolio is undergoing some form of deep engagement by the team. A key strategy of the managers is to work with companies on creating shareholder value and correcting undervaluations by addressing poor corporate governance, encouraging better utilisation of cash (e.g. shareholder returns, M&A, capital expenditure), improving shareholder communications and working on corporate strategy including a takeover event. Given the team's focus on finding companies which trade on intrinsic discounts, AJOT often has value characteristics. Yet as we describe in the **Portfolio section**, AJOT is still exposed to high-quality companies benefitting from structural growth trends within Japan.

Since its inception in October 2018, AJOT has handily outperformed its benchmark, the MSCI Japan Small Cap Index. However, it has lagged its peer group average due to the peer group's heavy growth bias, which was helpful after the immediate impact of the pandemic. Yet over the last 12 months AJOT's active, idiosyncratic approach to investing has borne fruit, and it is the second best-performing trust in its peer group over the period, as we outline in more detail in the **Performance section**.

AJOT continues to trade on a premium (currently 1.8%) and, as we point out in the **Discount section**, it is one of the few Japanese equity trusts to do so due to best-in-class discount protections.

Analysts:
David Johnson

Analyst's View

AJOT's team, in our view, implement an onerous investment process which requires deep expertise and skill. They aim to proactively create and unlock shareholder value of their investments through active engagement. Not only does this mean AJOT's investment process is a clear differentiator (and source of potential alpha) from many of its Japanese fund peers but, in conjunction with its highly concentrated portfolio, it makes it a strong source of diversification for many investors, even if they have a pre-existing Japanese equity allocation.

While AJOT's concentrated bottom-up process means stock-specific factors will likely dominate its returns, we still believe that the current market environment is a positive one for its relative returns. Not only have many of the tailwinds behind the dominance of growth investing dissipated (these had at times meant that AJOT lagged peers), but Japan's new prime minister most likely means a continuation of the status quo in Japan. This means that Japan's long programme of corporate governance reforms – first initiated in 2014 under Shinzo Abe's leadership – will continue unabated, thereby presenting plenty of opportunities for the AJOT team to exploit.

Besides its attractive diversification characteristics and strong performance over the last 12 months, we also believe that AJOT is a good option for ESG-conscious investors looking to gain exposure to Japan. Activist approaches like AJOT's will be pivotal in righting many companies' poor ESG practices, making AJOT an important driver for better ESG practices. AJOT also demonstrates the limitations of ESG scores, as its own 'low' score is a structural by-product of targeting companies with poor governance.

BULL
Idiosyncratic source of alpha with strong diversification potential
Attractive ESG credentials given the role of active engagement
Strong recovery in underlying earnings post-pandemic

BEAR
Can underperform during periods of growth-stock momentum
Higher OCF than peer group average
Highly concentrated portfolio can increase single-stock risk

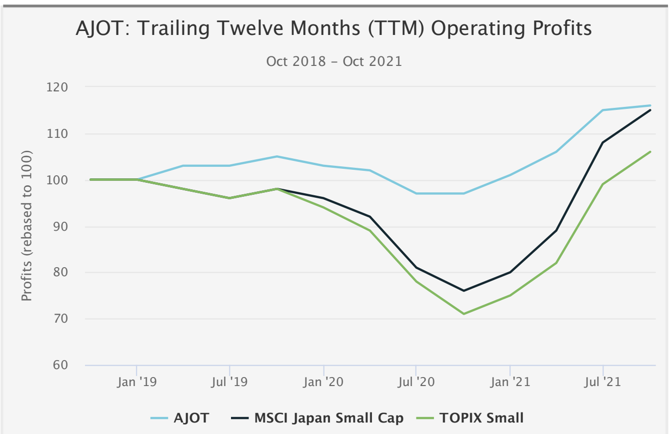
Portfolio

AVI Japan Opportunity Trust (AJOT) owns a highly idiosyncratic portfolio of companies which are primed to benefit from Japan's ever improving corporate governance culture, with the team taking a proactive approach to engagement on these matters. AJOT is run by the specialist team at Asset Value Investors, who look to invest in companies at well below their estimate of intrinsic value.

AJOT's process and portfolio reflect the opportunity set presented by Japan's ongoing corporate governance reforms, whereby the trust's holdings are often high-quality businesses yet with poor corporate structures or approaches to governance. This therefore means there is the potential for shareholder value to be unlocked through reforms. Corporate governance has traditionally been poor in Japan. Furthermore, management teams tend to hold excessive cash balances or shares in other companies with no obvious rationale. There can also be weak board structures or inefficient subsidiary ownership structures, and so a company's return on equity can often be drastically improved through reforms to these matters: for example, by cash reserves being distributed to shareholders or invested through M&A and capital expenditure.

The team's approach is based on two avenues of potential return, the first being the quality of a company. Each of AJOT's holdings reflects a resilient business model operating in a growing industry, able to generate attractive long-term revenue growth without the need for active engagement. While AJOT's holdings trade at discounts to their intrinsic value, they are not 'value traps' (cheap but poor-quality businesses), and are often characterised by high ROIC, strong margins and resilient balance sheets. The importance of the quality factor, the most ubiquitous aspect across all of AJOT's holdings, is apparent by the operating profits of AJOT's companies through the pandemic. The trust's holdings have in aggregate seen a post-pandemic rebound with less cyclicality than both the TOPIX Small and MSCI Japan Small Cap, with operating profits already above their pre-COVID-19 levels, as seen by the graph below.

Fig.1: Portfolio Earnings Growth



Source: Asset Value Investors

The second source of returns is the team's active engagement with company management. The managers believe that AJOT's holdings present an opportunity for creating and unlocking shareholder value through active engagement. A key part of the team's investment selection is their ability to effectively engage with companies, and it is also the reason for AJOT's small-cap focus, as it allows them to take larger positions within a company so that they can effectively influence management.

The team's approach to engagement expands a spectrum of options, ranging from the least intensive verbal engagement to public presentations and campaigns. Each engagement approach is unique to the investment but is initially undertaken privately in a friendly, transparent manner. While AJOT prioritises investments in companies with management teams who are open to engagement, when the pace or magnitude of change falls short of expectations the team's level of engagement is increased. Increased engagement takes the form of formal letters, details presentations, shareholder proposals, public campaigns and tender offers (though this has yet to be utilised). Of the current portfolio, AJOT has undertaken five public campaigns, submitted AGM shareholder proposals to nine companies and sent detailed letters and presentations to 16 companies.

Three Most Recent Public Engagements

TARGET	AVI OWNERSHIP	SHAREHOLDER PROPOSALS
NS Solutions	0.9%	• Increase dividend so that payout ratio equals 50% • Acquisition of 6.6% of treasury shares • Introduction of stock-based remuneration
SK Kalen	3.1%	• Ten-for-one stock split • Cancellation of treasury shares
Tokyo Radiator	5.3%	• Increase dividend to pay out excess cash held by parent company Marelli • Change board structure to one with an audit committee • Introduction of stock-based remuneration • Appointment of advisory compensation and nomination committee

Source: Asset Value Investors

We believe AJOT is a prime example of the benefits of a closed-ended structure, as it frees the team from the onerous liquidity requirements which open-ended structures place on their investment managers. This is an important consideration given the length of time engagement campaigns can take. AJOT also operates with a highly concentrated small-cap portfolio (currently 25 stocks), a level far smaller than that of many of the trust's peers, and the result of the large amount of resources required to effectively engage with companies. The team's numbers have been expanding in order to meet this requirement, as we outline in the **Management section**. While this does lead to an uncommonly high level of concentration risk given the heightened volatility often associated with small caps, it also makes AJOT's portfolio a strong source of diversification thanks to its high active share and distinct source of alpha. In our recent conversations the team have signalled their desire to further increase AJOT's portfolio concentration over time.

Another noteworthy characteristic is AJOT's 'value' bias, whereby its portfolio demonstrates significantly lower valuations than its benchmark, reflecting the intrinsic discount many of these companies are priced at. A key element of the team's investment process is the narrowing of a company's intrinsic discount through active engagement, with stocks often sold once this has occurred. Companies can also exit the portfolio as a result of buyouts, another desirable outcome of the team's engagement. Secom Joshinetsu is one such example, as we outline in the **Performance section**.

Portfolio Valuation Against Benchmark

	AJOT PORTFOLIO	MSCI JAPAN SMALL CAP
EV/EBIT	4.6	18.7
Net financial value as % of market cap*	82%	7%
FCF Yield (based on EV)	26.0%	18.7%
Return on assets	5.7%	4.7%

Source: Morningstar, Asset Value Investors, as at 30/09/2021

*Net financial value is the sum of liquid financial assets on a company's balance sheet, such as cash and shares

Given AJOT's single-stock risk and low turnover, it is always worth highlighting new purchases and key stocks within the trust's portfolio. However, we remind investors that given the sensitive nature of active engagement, a portion of AJOT's portfolio is not publicly disclosed. One of the best examples of the discount opportunity that some of AJOT's holdings represent is Pasona, the recruitment and outsourcing company. While Pasona is well positioned to take advantage of Japan's demographic issues and ever tightening labour market, the team specifically point out the 74% discount it currently trades on, with the company's stake in Benefit One (the corporate welfare outsourcing company) equating to 320% of Pasona's market cap. The team point out that companies which trade on such a wide discount require a relatively small narrowing of the discount to see strong upside. For example, if Pasona's discount were to narrow to a mere 50%, it would still reflect 92% upside to the current share price. As the majority of Pasona's shares are owned by its founder, the team are unable to enact any meaningful engagement, but given the discount opportunity and quality of the business, they can "hold it for 50 years" and still generate a healthy return.

Top Ten Holdings

HOLDING	% OF AJOT'S NAV	AVI OWNERSHIP (%)
T. Hasegawa	7.6	1.8
Pasona	7.3	4.0
Fujitec	7.1	2.6
DTS	6.7	9.0
Digital Garage	6.6	1.7
Daibiru	5.9	0.8
C. Uyemura	5.4	1.7
NS Solutions	4.8	0.9
SK Kaken	4.7	3.1
Wacom	4.5	3.5
Total	**60.6**	

Source: Asset Value Investors, as at 30/09/2021

Despite having the guise of a value portfolio, AJOT includes a number of companies like Pasona that are capitalising on the structural growth opportunities of 'new Japan', including a number of technology companies. One example of these is DTS, an IT system integration provider which is AJOT's fourth-largest position. The team highlight Japan's need for a wide-scale refitting of old legacy IT systems, before what is known as the '2025 Digital Cliff'. 2025 is the year by which many IT systems are due to be upgraded. By then, 60% of Japanese companies' critical IT systems will be over 20 years old, with a number of them reaching the end of their support period. While DTS is well positioned for Japan's technological transition, it is not a 'young' disruptor that investors may associate with this opportunity. DTS was founded in 1972, and as a result of its relative age it has been able to demonstrate the strong, consistent long-term revenue and profit growth which the team demand from their holdings, with average annual revenue growth of 5.2% and operating profit growth of 15.4% p.a. over the past ten years. DTS has also been subject to the team's active engagement, where over the last 19 months the team have sent two formal letters and made three presentations to management about how DTS can improve shareholder returns.

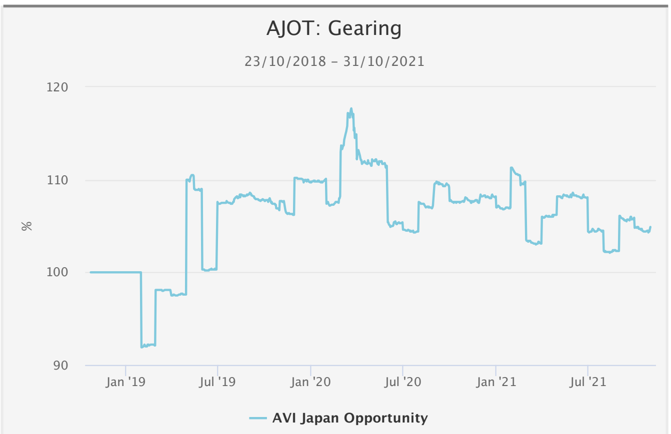
Another example of AVI's engagement activities, as well as of the opportunities the company is finding in the technology space, is Digital Garage, the technology holding company that combines digital payments, advertising and venture capital investment. The team have based their investment case, in part, on the relative underperformance of the company's digital payments business – a service which was well primed for an aggressive growth trajectory post-COVID-19. The team highlight that the company's closest competitor in this space, GMO Payment Gateway, has been able to capitalise on the COVID-19 opportunity, which has seen its share price double since the start of 2020 (compared with an 18% increase for Digital Garage). The AJOT team do not believe that this underperformance is a structural issue, but rather one that can be resolved through strategic initiatives. The team believe that by prioritising its payment business, combined with improving disclosures and investor relations practices, Digital Garage can reverse its underperformance against GMO. The team's beliefs have begun to materialise, and since the start of 2021 Digital Garage has generated share price returns of 31%, compared to the 4% of GMO.

Gearing

AJOT currently has 4.8% net gearing in place (as at 31/10/2021), which represents a fall from the highs of c. 10% seen in January 2021. This reduction is the result of the combination of AJOT's strong performance as well as the increased cash positions resulting from the buyout of Secom Joshinetsu. As the graph below shows, AJOT has had a geared exposure for more than two years now, and we would expect this situation to continue.

AJOT's current gearing is achieved through a total credit facility worth ¥4.33bn, equating to a maximum level of gearing of c. £28.3m (c. 19% of net assets as at 31/10/2021). The debt facility was renewed on 17 February 2021 and will mature on 16 February 2022. Interest is payable at a rate of LIBOR plus 0.95%. The team use gearing in a strategic manner, either by investing into new positions or by opportunistically increasing their exposure to existing ones, rather than trying to time the broader market.

Fig.2: Gearing Since Inception

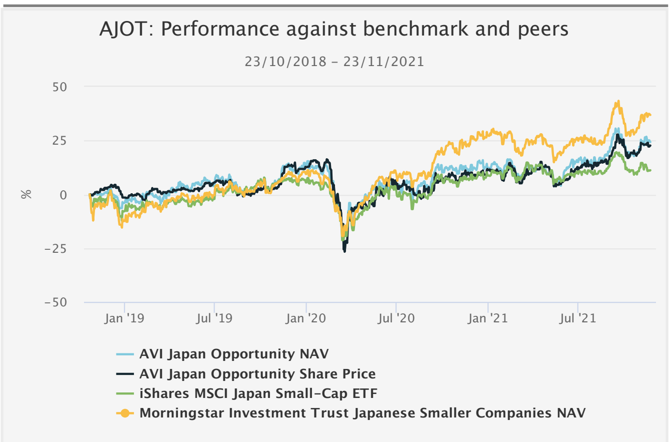


Source: Morningstar

Performance

Since AJOT's inception on 23 October 2018 it has generated an NAV total return of 24.3% and a share price return of 22.7%. It has therefore easily beaten the 11.2% return of its benchmark the MSCI Japan Small Cap Index (as proxied by an ETF in the graph below), despite the fact that the market environment, favouring growth companies, has been against it for much of the period. However, AJOT has underperformed its peer group's simple average NAV total return of 36.9% over the same period thanks to the growth bias of most peers.

Fig.3: Performance Since Inception



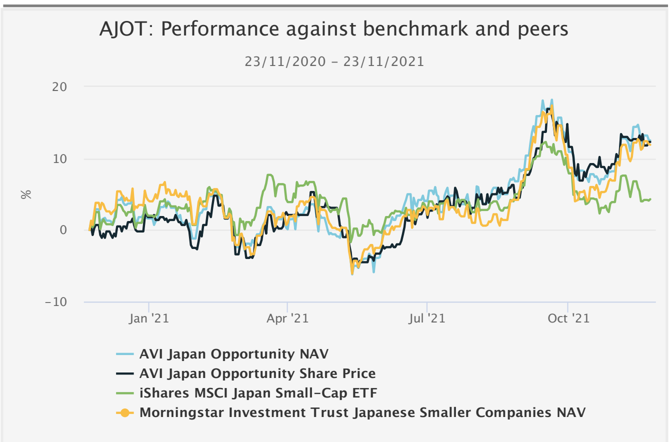
Source: Morningstar

Past performance is not a reliable indicator of future results.

During 2019 and 2020, the Japanese stock market predominantly favoured more expensive growth companies over AJOT's discounted portfolio. This was particularly the case in the period immediately after the emergence of the pandemic. During 2020 AJOT returned -0.7% in NAV terms, compared to its peer group's 16.4%. Growth companies rarely appear on the team's radar, given their lack of earnings history, poor discount opportunities (as pricing in their future growth places them at a high premium to current earnings) and often limited opportunities for active engagement. AJOT's concentrated, small-cap portfolio also worked against it during the worst of the pandemic, due to the selling pressure on illiquid stocks. Once these headwinds had dissipated, AJOT delivered strong outperformance of its peers as well as its benchmark.

In fact, AJOT is the second best-performing Japanese small-cap trust over the 12 months to 09/11/2021. AJOT has generated an NAV total return of 12.5% and a share price return of 12.3% over this period, exceeding the 4.3% of its benchmark and 11.9% NAV return of its peer group. AJOT's strong returns are the result of a number of factors, both stock-specific and macroeconomic. While the team do not account for macro-level factors in their investment process, AJOT was nonetheless a beneficiary of the global 'reflation trade', which saw investors pile into value and cyclical stocks during the fourth quarter of 2020 and the first quarter of 2021. AJOT's 12-month performance was also helped by a number of successful engagement campaigns, which led to a substantial positive stock attribution of 9.8% over the last 12 months (most notably the buyout of Secom Joshinetsu which added +3.5% to returns).

Fig.4: 12-Month Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Some of the team's recent engagement highlights include the buyout of Secom Joshinetsu by its parent company Secom at a substantial 66% premium. This had been a private discussion with the company's management, in which the AVI team recommended that Secom Joshinetsu target a buyout price of ¥6,400 per share, with the management team holding out until their parent proposed a bid of ¥6,350. Such events are a clear source of alpha, but do lead to AJOT having a slightly 'lumpy' return profile, as stocks may suddenly re-rate on the announcement of positive news. This means that AJOT may be best suited to a long-term investor who is able to commit to the length of time that many of AJOT's engagement campaigns require. However, we do note that over the last three years AJOT has generated a lower NAV volatility than its peer group, at 15.6% versus 17.9%.

Looking forward the team remain confident, both on the general outlook for Japan and about the opportunities presented by corporate governance reform. One of the most prominent sources of uncertainty facing Japan is the recent change in political leadership. The team believe that Japan's new prime minister Fumio Kishida will likely maintain the status quo of his predecessor, with little negative impact on the path to corporate reforms in Japan. If anything, the AVI team believe he may open up new avenues of governance reform, particularly on the social side, as he has highlighted his desire to address social inequality within Japan. The team are also optimistic about the roll-out of vaccines in Japan, and thus the country's ability to keep a lid on the pandemic, as Japan's vaccine level has now surpassed that of both the US and EU. The team are also encouraged by the potential ramp-up of corporate engagement activities in 2022, due to COVID-19 having caused practical impediments to prior corporate activity. This pent-up activity has already been realised to some extent, as the first nine months of 2021 saw 10% more buybacks than in all of 2020, as well as 5% more shareholder proposals.

Dividend

AJOT does not have an income objective. The board's policy is to pay out substantially all of the net revenue as a dividend. AJOT's most recent full-year dividend was 1.3p per share, for the 2020 financial-year end. We note that AJOT's recent interim dividend of 0.7p per share represents an 8% increase on the prior year's, and reflects the recovery in Japanese equity stocks – in particular the recovery in earnings for AJOT's companies, as we describe in the **Portfolio section**. We note that while AJOT does not have a policy of a progressive dividend due to the potential fluctuations of its revenue, its activist approach to investing may be conducive to dividend growth, and as such distributions are a method of returning capital to shareholders. However, this can also take the form of special dividends or share buybacks, which are more conducive to enhancing total return than long-term dividend growth. AJOT has a current share price yield of 1.1% based on its FY 2020 dividend, which is lower than the 2.3% simple average of its peers.

Management

AJOT is run by the team at Asset Value Investors (AVI), with CEO and CIO Joe Bauernfreund taking the leading role in AJOT's management, supported by a six strong Japan-dedicated team. AJOT's legacy goes back far beyond its inception date, having been launched on the back of its sister trust **AVI Global (AGT)**. AGT has long held a dedicated allocation to Japanese equities, with the AVI team having long ago identified the opportunity presented by Japanese corporate governance reform.

The resources AVI is able to deploy are of paramount importance as the company's policy of active engagement is an onerous one, often requiring regular – if not daily

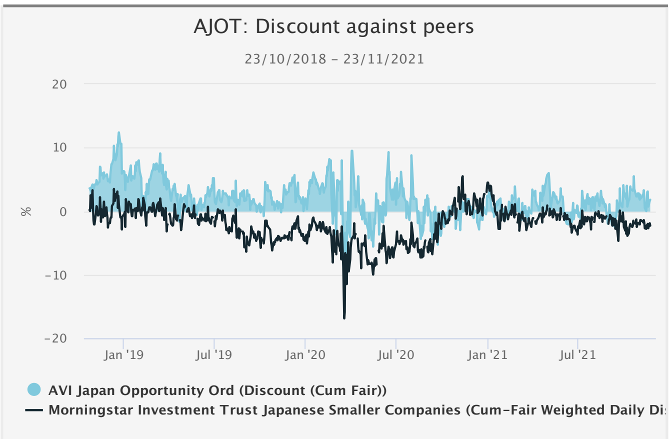
– contact with managers and their peers in order to successfully execute campaigns. To that end the AVI-team has expanded significantly since the launch of AJOT. Joe is supported by a six strong Japan-dedicated team, including Daniel Lee (joined AVI in 2015), Kaz Sakai (joined in 2021 with experience in consultancy from McKinsey Japan), Makiko Shimada (joined in 2021 from Goldman Sachs Investment Banking office in Tokyo), Jason Bellamy (joined in 2020 as a Tokyo-based engagement consultant), Collin Batte (joined in 2021 as a junior analyst) and Yuki Nicholas (joined in 2020 as the team assistant). Kaz, Makiko, Jason and Yuki speak Japanese to a native level which has not only allowed the team to more effectively research companies, but also ensure they are best able to navigate Japanese customs as well as converse with people in their native language. This advantage is all the more important in the universe of Japanese small caps, as few if any will even produce an annual report in English. The team are also able to access Tokyo-based advisers for external support as and when the need arises.

AVI employees have over £2.4m of their own money in AJOT and also reinvest 25% of the management fee into the trust each year, which indicates a meaningful commitment and alignment of interests between management and investors, not to mention a high degree of confidence in the strategy.

Discount

AJOT currently trades on a 1.8% premium. We believe that AJOT's premium is a reflection of its differentiated source of alpha, noting that most of the trusts in the Japanese investment trust sector (both large- and small-cap-focussed) trade on discounts to NAV. We also note that the management fee structure incentivises the team to prevent AJOT from trading at a material discount, being charged on the lower of market cap or NAV. In addition, with at least 25% of the management fees being used to buy AJOT's shares, this serves as a natural source of demand for the shares (300,000 shares have been bought in this way over the past 12 months). As we illustrate in the graph below, AJOT's premium rating has been largely consistent since its inception, trading on an average premium of 2%. AJOT's premium has allowed the board to issue 15.5m shares over the last 12 months, equal to 11.6% of those currently in circulation.

Fig.7: Five-Year Discount



Source: Morningstar

Charges

AJOT's ongoing charges figure (OCF) is 1.56%, greater than the AIC Japanese Smaller Companies sector's simple average of 1.22%. AVI is paid a management fee which is 1% of the lower of market cap or NAV, ensuring that the manager is incentivised to see the trust's shares trade at 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 1.76% simple average of the peer group (although we note that calculation methodologies do vary).

The costs of activist activities and engaging with management are borne entirely by AVI and not AJOT.

ESG

AJOT is, in our opinion, one of the more attractive and complex examples of ESG investing. While the team do not label AJOT as an ESG fund, one of the key components of its investment process is the promotion of good corporate governance. Actively seeking to improve a company's practices – be they related to the 'E', 'S' or 'G' of ESG – is the most onerous requirement of ESG investing, with relatively few strategies seeking to actively engage with companies to the extent that AJOT does. While governance is the primary focus of the team's activity, they do not forsake analysis of social and environmental factors in their investment process. The team utilise their own internal scorecard for environmental and social risks, which are accounted for in determining the quality of a company.

The team do remark that opportunities are more often found in ESG improvers rather than companies that already demonstrate strong ESG metrics, as improving ESG scores are more likely to lead to a positive re-rating. We additionally note that the poor social and environmental ratings of companies can also be the result of poor disclosures, something the team actively seek to resolve as part of their engagement activities.

We believe that AJOT is a prime example of the limits of quantitative ESG ratings. Morningstar has assigned the trust a sustainability rating of 'low', placing it amongst the bottom 10% of Japanese equity strategies (both open- and closed-ended). Yet contrary to what the score might suggest, we believe that AJOT represents one of the most attractive investment strategies for an ESG-conscious investor, given the trust's often pivotal role in improving the ESG scores of its companies. AJOT's 'low' score is a reflection of its investment process, given the fact that companies with a poor ESG rating likely have the largest scope for valuation reversal through active engagement and improvement in their ESG scores. Ultimately we believe that ESG-conscious investors should pay no heed to Morningstar's ESG rating of AJOT, and instead measure the trust and its managers on the success of their engagement campaigns.

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