**Q1 2020** 31st March 2020

AVI Japan Opportunity Trust

| | Net cash[1] as a percentage of market cap | NFV[2] as a percentage of market cap | EV/EBIT | FCF Yield | EV FCF Yield[3] | Dividend Yield |
|---|---|---|---|---|---|---|
| Q1 2020 | 52% | 96% | 2.1 | 7.1% | 34.3% | 2.5% |
| Q4 2019 | 45% | 81% | 3.8 | 5.8% | 22.3% | 2.0% |

Dear AJOT Shareholders,

It has been a turbulent quarter to say the least. The outbreak of COVID-19 and the related lockdowns have led to a broad sell-off in global assets. There have been few safe havens, and although Japan has experienced a lower infection rate to date than Western countries, Japanese equities have suffered nonetheless.

Over the quarter AJOT's NAV decreased by -18.5% (-24.2% in Yen) vs -14.5% return for the MSCI Japan Small Cap Index. While our portfolio's share price performance was slightly amplified by AJOT's gearing (which averaged 8% over the quarter), the fall is quite remarkable given our portfolio began the year with 81% of its market cap covered by net cash and listed investments. Logically, a portfolio of cash-rich quality companies should fare well in the current environment but, at least in the short-term when panic takes over, fundamentals are ignored.

With travel out of the question, our portfolio companies agreed to conduct our usual meetings over conference calls which have been surprisingly efficient. The companies we have spoken to so far haven't seen the levels of disruption suffered by their Western counterparts. Most have seen little to no impact; only a handful expect meaningful sales declines; while one expects to see sales increase.

Stricter isolation measures over the coming weeks will likely have a greater impact on our companies, and in the short-term earnings will suffer. However, the sell-off in some of our positions seems overdone, with what was already a cheap portfolio having become even more so. Our companies will survive, and we have been using the period of volatility to add to positions that have been unjustifiably weak.

**Portfolio Positioning**

Our outlook on the merits of our investment case in Japan remains largely unchanged, and as such, so does the portfolio. After redeploying the proceeds from the Toshiba Plant and NuFlare buyouts at the start of February, we have kept a consistent level of gearing throughout the sell-off within our guided 10-15% range.

With a portfolio comprised of companies with strong balance sheets and multiple angles for value-unlocking engagement, activity levels have not needed to be dramatic. That said, the very sharp price swings suffered by some companies from extreme panic and forced selling pressure gave us the opportunity to add to our highest conviction holdings. This was funded by taking profits in companies whose share prices held up relatively well and selling smaller positions that we were already in the process of exiting.

[1] Net cash = Cash – Debt – Net Pension Liabilities

[2] Net Financial Value (NFV) = Net cash + Investment Securities

[3] The effective free cash flow yield were non-core assets to be distributed

At the end of the quarter we held 28 positions and net gearing was just over 11%. Turnover for the quarter was 8.5%, or 34.4% annualised, slightly higher than our anticipated normalised 20%. We believe that capitalising on short-term dislocations to invest in companies with resilient business models that are trading at severely depressed valuations should bode well for future performance.

**Extreme undervaluation**

Despite a slight bounce back in equity markets at the end of March, the portfolio valuation remains extremely low. Ten companies in AJOT's portfolio have more than 100% of their market cap covered by net cash and investment securities; the portfolio is yielding 2.5% , despite a lowly 28% pay-out ratio ; and is trading on a 2.1x EV/EBIT valuation multiple compared to 3.8x at the end of December.

Perhaps one could argue that anticipated weak earnings are a justification for low multiples, but this is not the case across the entire portfolio. For example, despite earnings which are unlikely to suffer from the COVID-19 outbreak, Fukuda Denshi, Kato Sangyo and Secom Joshinetsu trade on 4.5x, 1.6x and 1.0x EV/EBIT multiples, which for Kato Sangyo and Secom Joshinetsu is lower than the 2.8x they both traded on at the end of December. Fukuda Denshi's multiple has expanded from 3.8x to 4.5x on its exposure to medical equipment, specifically the distribution of ventilators, yet its 4.5x multiple is lower compared to its peers which trades on 11.9.

Given the substantial cash coverage the share price falls of our companies is even more exaggerated. We expect the companies in our portfolio to continue generating free cash flow, even in the current environment, and thus the value of cash remains unchanged. If our portfolio has fallen by -24% and has 50% of its market cap covered by net cash, then the implied reduction in the value of the underlying business is -48%[4].

While perhaps too simple an argument, it is true that fundamentally companies with an abundance of cash should be more insulated from market falls. We have not, however, seen this in our portfolio. In the short-term, our companies' performance is a reflection of their lower liquidity and forced selling pressure. These technical factors will subside and we view the low portfolio valuation as a substantial store of strong future returns.

**Teikoku Sen-i Public Engagement**

Over the quarter we launched a public engagement campaign seeking to improve Teikoku Sen-i's balance sheet efficiency. Our arguments were premised on a high-quality business that is hidden beneath a cloud of excess cash and investment securities.

We submitted two shareholder proposals: 1) for a dividend equivalent to a 50% payout ratio and 2) a buyback for 3% of shares outstanding. Alongside our proposals we launched a public website www.transformingteikoku.co.uk where we outlined our arguments and highlighted the modest nature of our proposals.

We reasoned that with ¥46bn of net cash and investment securities, including a ¥23bn stake in an unrelated real estate company Hulic, that Teikoku could comfortably afford to distribute an additional ¥0.8bn dividend and conduct a ¥2bn buyback. Improving the efficiency of Teikoku's balance sheet in a sustainable manner, could see a ROE improvement from 8% to 20% and a commensurately higher share price.

At the AGM shareholders increased their support for a dividend increase, with our 24.7% approval topping the 22.9% and 20.3% previously achieved from similar shareholder proposals. Our buyback proposal achieved 22.0% support while the approval rating for the President, who ISS said should be held responsible for the Company's questionable capital management, fell to 88.5% from 90.0% the year before.

[4] For simplicity, this analysis ignores underlying listed investments

Given the presence of allegiant shareholders conflicted by their business relationships with the company, we were cognisant there was little prospect of us winning the vote. Rather, following numerous meetings and letters to the Board, our proposals were designed to bring the debate to other shareholders to raise the profile of our arguments. To that extent we believe we have been successful, and the increased support gives us a solid foundation on which to continue our dialogue with management and seek ways to enhance corporate value.

**Investment Team Update**

We want to assure you that the investment team is healthy, our remote working systems are functioning well and, while working virtually, are operating as close to normally as possible.

Despite the disruption we continue to invest in the Japan focused team at AVI. We'd like to welcome Jason Bellamy to the team. He is a native Japanese speaker, based in Tokyo, and will work as a senior consultant supporting our engagement activity and advancing our relationships with our portfolio companies. He has many years' experience working in the Japanese financial services industry. We have also hired a native speaking Japanese intern who will be working with us whilst studying for his MBA in London, and a Japanese speaking assistant to support the investment team in translating and arranging meetings – both based in the London office.

**Concluding Remarks**

We can't predict how long the uncertainty or economic impact surrounding the virus outbreak will last. We are however, confident that the portfolio we have constructed is well placed to weather the downturn. During March, we, through our personal accounts and on behalf of AVI, along with AJOT's Chairman, purchased 189,000 shares in AJOT.

While it is hard to say whether this quarter marked the bottom, the portfolio's extreme undervaluation coupled with cash-rich balance sheets gives us confidence that our companies will survive this crisis without the challenges that overly-leveraged counterparts in other countries face.

The severe economic shock from an unforeseen event like COVID-19 highlights the advantages of investing in resilient companies with solid balance sheets. While in the short-term technical factors might weigh on performance, we are confident that our companies are well positioned for a recovery.

Please do get in touch if you have any questions.

AVI
Asset Value Investors

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For performance and portfolio statistics please see monthly factsheet found at www.ajot.co.uk

## Further Information

Investment Manager – Joe Bauernfreund, AVI Ltd.
+44 20 7659 4800 **info@ajot.co.uk**

The share price can be found under 'INVESTMENT COMPANIES' in The Financial Times.

Information may be found on the following websites.

**www.ajot.co.uk**
**www.assetvalueinvestors.com**

## IMPORTANT INFORMATION

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