Q3 – September 2020

Investment Objective: To achieve capital growth through a focused portfolio of investments, particularly in companies whose share prices stand at a discount to estimated underlying net asset value.

	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
Q3 2020	46%	90%	4.3	5.1%	19.1%	2.1%
Q2 2020	51%	93%	3.2	6.2%	23.8%	2.4%
Q1 2020	52%	96%	2.1	7.1%	34.3%	2.5%

MANAGER'S COMMENT

Dear AJOT Shareholders,

At the end of August Japan's longest serving prime minister, Shinzo Abe, resigned on health grounds. As the driver and key promoter of reforms to improve corporate efficiency, it naturally raises the question - does his resignation mark the end of the policies that have collectively become known as "Abenomics" and within that the so called "third arrow" that focuses on structural reform that has led to a corporate governance revolution in recent years?

Firstly, we believe that corporate governance improvement and greater awareness of shareholders has now become ingrained in the minds of corporate Japan. While Abe's administration pushed reforms in the early days, the heavy lifting was left to the Government agencies (namely METI, FSA) and the Tokyo Stock Exchange (TSE). They have implemented codes and guidelines for companies to follow, tweaking them over time to encourage better behaviour. This has been a successful strategy. For example, in 2015 just 12% of companies on the 1st section of the TSE had 1/3 or more of their board composed of independent directors. Today that stands at 59%. While a government who was less focused on reform might slow the pace of change, it would be near impossible to reverse it, and we believe that beneficial improvements for shareholders will continue unabated.

Secondly, Abe's favoured successor, Yoshihide Suga, who won a landslide victory amongst the ruling party, is keeping the status quo. He was Abe's chief cabinet secretary and widely seen as his right-hand man. His political thinking is aligned with the previous administrations and he has said that he will continue with Abe's signature economic policy of Abenomics. Any company management that had hoped a new government might take the foot off the reform pedal, will be deeply disappointed.

Rather than backtrack, it looks like Suga's administration will build on from Abenomics and continue to push forward reforms. Beyond continued pressure to improve corporate governance we are eagerly watching developments surrounding one of Suga's key policies - digital transformation.

Pulling Japan's IT into the 21st century

Japan's IT systems are outdated, inefficient and in much need of improvement. For example, virtually every government office and company in Japan has a fax machine which relates to Japan's reliance on the archaic practice of hanko stamps – a stamp required for over 11,000 procedures to sign off documents. During the coronavirus pandemic workers would have to go into the office just to stamp paper documents before either mailing or faxing them – a totally useless task.

High profile events over the quarter, including the Toshiba AGM voting scandal and the TSE shutdown, brought the need for digitalisation to the front of investors' minds. Toshiba's voting scandal saw shareholder votes cast at this year's highly contentious AGM invalidated. The voting system is heavily reliant on counting postal votes, and although they arrived before the deadline the paper votes could not be counted in time. Then, on 1st October, the TSE's main system failed and the switch to the back-up system malfunctioned, halting trading for the full day - the worst outage since the exchange shifted to an electronic system in 1999.

Suga has placed digitalising Japan's economy at the centre of his administration. He is legislating for a new digital agency, created a ministerial post for 'digital transformation' and appointed a veteran cabinet minister, Taro Kono, to the role of 'administrative and regulatory reform'. Mr Kono created a system for people to report excessive bureaucracy and within a few hours had received 3,000 emails before he had to suspend the service after being overwhelmed.

For our three IT service providers, this is good for business. AJOT has invested just over 11% of its NAV in DTS Corp, NS Solutions and Kanematsu Electronics (KEL) – all beneficiaries of rising demand for digitalisation. Compared to the US, Japanese companies rely more heavily on the services of third-party IT providers (65% vs 28%). As we approach 2025, a year that METI (Ministry of Economy, Trade and Industry) has coined the digital cliff, Japanese companies will need to increasingly utilise their services.

[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

MANAGER'S COMMENT

Our IT service providers are exposed to the same underlying growth trends of the market, yet, for reasons unrelated to their fundamental outlook, trade at steep discounts. DTS, NS Solutions and KEL trade on EV/EBITs of 6.2x, 8.1x and 7.4x, compared to a sector average of 12.9x.

All three companies suffer from inefficient balance sheets, poor shareholder communications, and weak corporate governance. Furthermore, NS Solutions' & KEL's valuations suffer from being part of a parent/child ownership structure, which creates a lack of incentive for management and poor protection for minority shareholders.

We are engaging with management to address these issues and we believe if they can be improved in line with our suggestions and the valuation normalises, we could see upsides in the order of 50-100%.

Parent/child Structures Back in the News

Since AJOT's launch a key theme within the portfolio has been the collapse of parent/child structures. Pressure from regulators, the Tokyo Stock Exchange and shareholders has forced companies to evaluate the antiquated practise of exerting control over a company without owning 100% of the shares. Minority shareholders get little say in how the subsidiary is run and the lack of independent oversight leads to governance issues and underperformance.

It was, therefore, welcome news when at the end of September NTT announced that they will offer minority shareholders a 40% premium for the 34% of NTT Docomo that they did not already own. NTT cited synergies as the reason for the deal including being better placed to build out its next generation 5G network. While not explicitly mentioning corporate governance, we expect that scrutiny over the structure was a motivating factor. The $40bn transaction was the largest tender offer ever undertaken in Japan bringing the issue of parent/child structures to the forefront of investors' minds.

There are still over 200 listed subsidiaries in Japan, and while that has fallen from over 400[1] at the peak in 2007, it's still significantly more than we see in other developed markets (0 in the UK and 28[1] in the US). We expect further parent/child structures to be collapsed, whether the child is bought out by the parent or sold off to the highest bidder.

We benefited from the buyout of two subsidiaries last November when Toshiba Plant and NuFlare, were taken private by their parent, Toshiba Corp, at premia of 27% and 45%. As of the end of September AJOT had 17% of its NAV invested in listed subsidiaries.

Engagement

Whilst our public engagement was quiet over the quarter with no notable events, this does not mean we were not active in private. In fact, and in a similar vein to our work with Fujitec, we sent detailed presentations and letters to two companies in our portfolio suggesting ways in which to improve corporate value and ultimately achieve a share price +100% higher than where they are today.

One presentation was well received, and management have already agreed, in principle, to implement some of our suggestions while for the other company our presentation was met with some resistance. We are at the early stages of our engagement with these companies and by the time of their AGMs next year we hope that we can point to tangible progress.

It is interesting to note the strong performance from both Teikoku Sen-I and Fujitec, who were the 2nd and 3rd largest contributors to performance over the quarter. We engaged publicly with both companies earlier in the year, submitting two shareholder proposals at Teikoku's AGM and releasing a public presentation on Fujitec. While we prefer to engage in private, our public campaigns show management of our other portfolio companies that if they are not willing to listen and implement changes in line with our suggestions, we have the ability, willingness and knowhow to take our recommendations public. Importantly, especially in Japan, we are careful that our public campaigns are not seen as overly hostile, and that we approach it from a long-term perspective. At both Teikoku and Fujitec we have retained a close and cordial relationship with management, with whom we are in regular contact.

Our first public engagement campaign begun with TBS in October 2017 (prior to the launch of AJOT) when we asked management to sell investment securities and return excess capital to shareholders. After three years of engaging with the company, and although management made small steps in the right direction, including the cancellation of treasury shares, a buyback and stock-based compensation; it became clear that the company would continue resisting change, feeling little pressure from their base of allegiant, passive, cross shareholders. It is, therefore, unlikely that any substantial change is going to happen at TBS in a reasonable time frame. We see better places to invest your capital and over the quarter we took the decision to exit our position.

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[1] Source: Nomura

MANAGER'S COMMENT

While the returns were lacklustre, underperforming the wider Japan market, it has been a useful experience for us in terms of shareholder activism and the significant press attention that our campaign garnered has been helpful for raising our awareness with other investments.

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Our Japan resources continue to grow as we welcome Makiko Shimada to the team. She will be joining from one of the main Tokyo-based investment banks next January. Including Jason Bellamy (based in Tokyo), Yuki Nicholas (London-based assistant) and Kaz Sakai (part-time before joining in July 2021 after completing his MBA) we now have four Japanese native speaking professionals, which is allowing us to accelerate our research and engagement efforts.

COVID might have delayed some aspects of corporate reform in Japan, but it has by no means derailed it. Shareholder engagement activity is increasing year after year, with companies slowly but surely improving their returns for shareholders. Despite this, and the undervaluation of the market, foreigners continue to be net sellers. We are happy to take the other side of their trade and believe that Japan is not a market that should be overlooked.

Quarterly Contributors / Detractors

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Largest Contributors	Quarterly Contribution bps	Percent of NAV
Pasona	168	6.6
Fujitec	107	8.6
Teikoku Sen-I	99	6.6

Largest Detractors	Quarterly Contribution bps	Percent of NAV
Toshiba	-27	1.1
Tokyo Radiator	-15	1.8
Fukuda Denshi	-14	2.9

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The share price can be found in The Financial Times.

Information may be found on the following websites:
www.ajot.co.uk
www.assetvalueinvestors.com