

## Report to the NAVF AGM 10<sup>th</sup> June 2022

### Performance of the Fund for 2020, 2021 and Q1+ 2022:

				Cumulative		
	JPY	Sterling/Yen FX Change	GBP	JPY	FX	GBP
21 February 2020 to 31 December 2020	12.19%	1.39%	13.58%	12.19%	1.39%	13.58%
Year Ending 31 December 2021	34.18%	-12.77%	21.41%	50.54%	-12.64%	37.90%
1st Quarter 31 March 2022	-5.01%	-2.28%	-7.30%	42.99%	-15.15%	27.84%
Year to Date 30 April 2022	-9.28%	-3.73%	-13.01%	36.58%	-16.62%	19.96%

### Methodology

*NAV per share in JPY = NAV per share in GBP x Number of shares x GBPJPY / Number of shares*

Much has been written about Russia's war on Ukraine and its exacerbation of concerns about growing global inflation causing a dramatic weakening in stock markets around the world. The calendar year end 2021 marked the highpoint of the multi-year bull market and share prices everywhere this year have been in full-scale retreat, none more so than those listed on Japan's already ridiculously cheap exchanges. However, ascribing the relatively disappointing performance of NAVF in the first four months of 2022 to the worldwide malaise would be misleading – it is not even the most significant factor!

NAVF is a sterling denominated fund that does not hedge the underlying currency of its yen investments. The pronounced (and deliberate?) decline in the Yen's value against the pound, itself weakening substantially against a dollar reinforced in its role as the world's reserve currency, has cost the Fund over 16% of total return performance as at the end of April this year. Measured in purely Yen terms, NAVF was up over 50% by the end of 2021.

Several investors have asked recently whether we harbour any plans to introduce hedging now. The answer is simple: no. NAVF was conceived as an unhedged vehicle, which is what the prospectus provides for, and, if we changed our minds now, you can bet that, like all attempts at market timing, we would be likely to miss the key moment of the start of the Yen's recovery. What does bear observing though, is that it is hard to imagine any European industrial/trading power being allowed to pursue an overt policy of currency devaluation against the dollar with impunity – the US must calculate that it needs this major ally in SE Asia badly!

### Portfolio Composition

The themes I wrote about in my March report to the Board for year-end and beyond are still ongoing. We have continued to divest from FEFTA Category 3 companies (including Soda Nikka, Teikoku Electric and Nihon Kagaku Sangyo), as well as selected other positions we felt would not contribute to overall returns. The sale of Hirano Tecseed was completed by mid-May, and we continue to lighten

Bunka Shutter and Chiyoda Integre, where despite rejecting our AGM proposals, the Company virtually doubled its dividend and embarked on an ambitious buyback programme over three years, permitting our profitable exit. At the same time, we continue to add, when limit prices permit, to recently initiated purchases in Ihara Science, Meiko Transport and Meisei Industry.

We are currently invested in twenty names. Although the intention is to completely exit several of these over time (see above), we are seeking approval from the Board and the AIFM for new names (5 initially). These are likely to change the complexion of the portfolio, given they come under a new initiative (described below under 'recent developments'), to co-invest in selected stocks already held by Dalton Investments, where there is a view that they would benefit from a more activist approach to the engagement with management.

This Golden Week AGM season, we sent shareholder proposals to fourteen companies, but needed to pull three of these back as our holdings did not satisfy the requirement for greater than six months ownership.

#	Name
1	Daiichi Kensetsu Corp
2	Hirano Tecseed Co Ltd/Kinzoku
3	Ihara Science Corp
4	Ishihara Chemical Co Ltd
5	Konishi Co Ltd
6	Mitsuboshi Belting Ltd
7	Meiko Trans Co Ltd - PULL
8	Meisei Industrial Co Ltd - PULL
9	Nihon Denkei Co Ltd
10	Nippon Fine Chemical Co Ltd
11	Sankyo Seiko Co Ltd - PULL
12	Vital KSK Holdings Inc
13	Teikoku Electric MFG Co Ltd
14	Soda Nikka Co Ltd

Predictably, all the recipients of our proposals (essentially the same: to grant meaningful lumps of restricted stock to management and to undertake a 10% buyback over the next year), rejected them. Nevertheless, three companies responded positively to our suggestions with actions of their own. As a result, and at their request, we were happy to withdraw our proposals before the AGMs. As noted below, our willingness to acknowledge the efforts they had made, allowed for noticeably more constructive meetings with senior management when we were finally able to meet them in person on our recent trip to Japan.

- **Mitsuboshi Belting**

- The company announced its intention to pay Y220 per share divided over two years, and a 100% dividend pay-out ratio, with a target to improve ROE to 8%
- The shares were trading around Y2,000 per share at the time of the announcement, which equates to a 11% dividend yield, making it one of the highest dividend yields in the market.

- As a result of these initiatives, the shares have rallied more than 40% since the announcement
- The shares are still yielding 8%, which suggest further upside, considering many high-paying dividend stocks currently trade around a 6% dividend yield
- **Teikoku Electric**
  - The company announced a 100% pay-out ratio (50% pay-out in dividends and 50% in share buybacks) starting next financial year
- **Ihara Science**
  - The company announced its intention to propose a restricted share compensation programme for the upcoming AGM. The proposed scheme is one-third the size of our proposal, but a large step in the right direction

### Recent Developments

There have been two significant ones which, when combined, may have the effect of altering the future direction of NAVF towards what I will call:

### The inevitable consequence of activist investment in Japan: the bridge to change

When I was a Fellow of one of Cambridge University's oldest colleges, Trinity Hall, the Bursars had a favourite joke to describe the sometime difficulties of moving innovative ideas along amongst their colleagues on the various Governing Bodies. It went like this:

*Q: How many Cambridge Dons does it take to change a light bulb?*

*A: **CHANGE?!?!?!!!***

Japan has been a lot like this. I cannot recall the number of times, when, in describing how cheap the markets are in Japan to a prospective, or even existing, investor, we have been met with the riposte: 'yeah, it's been like that forever!' And so it has. But it could just be, that 'the times they are a-changin' (with every apology to Bob Dylan).

NAVF investors know that the Fund was set-up because the principals of Dalton Investments, who had grown a thriving business predicated on friendly co-investment in owner or entrepreneur-operated Japanese companies, wanted a separate vehicle to pursue the far sleeper and much larger (roughly 85% of all listed companies!) 'salaryman'-run segment of the market. The prevailing logic was that companies run by owners would benefit from shared aspirations and economic alignment with all other shareholders. Thus, their actions would be typified by the efficient use of capital and designed to help the business and shareholder returns grow.

By contrast, the corporate governance reforms and stock exchange restructuring brought about by Prime Minister Abe and his successors would finally give investors the tools and leverage they needed to 'buck-up' the managements of the vast bulk of companies who hugged traditional norms and inertia to their bosoms, while they slept soundly at night on enormous mounds of surplus cash.

Though facile, this description of a divided market has largely been accurate, but now several themes are emerging that might lead to a fusion of both styles of investment and, dare I say it, change.

So, what's new?

Two things immediately spring to mind in the owner-operated portion of the world. First, many founder entrepreneurs are retiring (or dying) and handing on the reins – and not always to managers of the same quality, imagination, and drive. Sometimes, even to the dreaded ‘salarymen.’ Second, and as a logical consequence of the first, and of time passing generally, the principals at Dalton are becoming increasingly frustrated with slow progress, while eyeing jealously their experience with NAVF and its greater ability to influence recalcitrant or just plain lazy managements.

With the test cases of the changes forced at Toshiba and Kitao-san’s surprising successful takeover of Shinsei Bank by SBI, it is obvious that the ever-increasing activism going on at all levels in corporate Japan is only going to expand. The combination of Rising Sun’s tool kit, used on NAVF’s behalf, with the added firepower of Dalton’s investment capacity in individual and carefully chosen counters should result in greatly enhanced leverage when managements are engaged. As has been seen, scale is important in this process, and while NAVF continues to grow slowly, operating with Dalton in specific instances will supercharge its efficacy and, hopefully, returns. To this end, NAVF, Dalton Investment and Rising Sun Management have executed today a comprehensive Memorandum of Understanding (MOU) allowing, under clearly defined conditions, overlapping investments in both directions. This will deliver an order of flexibility NAVF has never enjoyed before.

The timing of this development could not have been more opportune. The other significant driver for change, mentioned above, revealed itself last week to those of us who were finally able to travel to Tokyo for the first time since NAVF was launched back in February 2020. Going there is still not easy. On top of having to secure a visa in person from your local Japanese consulate, then getting a PCR test within 72 hours of departure, which has also to be uploaded to the official Japanese Covid tracing app in a particular arcane form, then getting the app itself to pre-register you so that it goes by turns from red, to orange and finally to green (I sometimes thought the app had a Cambridge academic’s inbuilt resistance to change, even if only of its colour!), you then have the small matter of immigrating once you finally arrive at the airport in Tokyo. This involved showing your documents at eleven different stations, walking at least a mile around the terminal, undergoing another Covid test (this time of the saliva-driven antigen variety – not easy after 14 hours of dehydration on a long-distance flight!) and then waiting for the result. All in all, another three hours to gain entry.

But, boy, it was worth it! During the week, we had meetings, in both Tokyo and Osaka/Kobe, with the CEOs and senior management of the following NAVF portfolio companies:

Ebara Jitsugyo  
Ihara Science  
Intage Holdings  
Chino Corporation  
Mitsuboshi Belting  
Ishihara Chemical  
Meisei Industrial

In addition, we saw a host of other prospective candidates, including several companies where Dalton Investments is already one of the largest shareholders and which may well be suitable targets for acquisition under our new MOU. We also met companies that are themselves the managers of a portfolio of other companies they control, in which we have shared interests, such as Hikari Tsushin and Ai Holdings.

Fascinating though our interactions with our investments were, above all our session with Intage Holdings, it was our meetings with successive professional services providers that revealed an unexpected sea-change in local attitudes. We met a number of Private Equity houses, both locally

and American-owned, and they showed as much enthusiasm for their prospects as we have come to expect. However, putting poorly run companies 'in play' and into the arms of our PE friends, forever keen to be seen as white knights against RSM's 'black hat,' has proven more difficult than we would like. Until now. The real surprise was the banks.

I am not talking about the big three money-centre banks who list most of corporate Japan amongst their clients and for whom they function as principal banker (and often as advisor, as we saw in the case of Sakai Ovex). We saw representatives of two regional second-tier operators and the local branch of a large European behemoth. With varying degrees of commitment (and fees!), they all said the same thing. That a tender offer launched for anything less than a majority of a company's outstanding equity, say up to 48% (as in the case for SBI's offer for Shinsei Bank, surprisingly and happily waved through by the regulators), is deemed to be in a 'grey area'. Clearly, there are varying shades of grey, but all three of the banks we saw, and we believe several others now, were willing, in principle, to finance and front what they termed an 'unsolicited,' rather than 'hostile,' offer. We have initiated detailed discussions with all three under the protection of NDAs, including providing our initial wish-list of companies with which we would like to engage, to see if we can come to terms.

## Outlook

I renamed the last section of this report 'the bridge to change.' For some while, RSM has wished that NAVF had more firepower to intervene in particular situations. By combining with Earle 1927, Michael 1925 (both of which it already advises) and now, crucially, Dalton, it will. If you couple this luxury to take bigger positions and become the largest or one of the largest holders of each target company, with the ability to satisfy the Kanto Finance Bureau (or Japanese equivalent of the UK's Takeover Panel) that you have financing available in an acceptable form, activism moves to the next level. One of the lawyers we met last week in Tokyo, likened the direction of travel for the Japanese activist industry as towards the LBO funds of the US in the nineties. One thing is clear, greater financial firepower and improved facility with the regulators will change public perceptions over time and put recalcitrant managements under ever greater pressure. They are already feeling it. The patient wait of Japanese PE is almost over, their warrant is about to become over-arching, and NAVF and its co-investors will, with other activists, provide the bridge to reach this new land. It will be important to NAVF and its investors to be in the vanguard of this change – we are determined we will be.

Paul ffolkes Davis  
Chairman

3<sup>rd</sup> June 2022