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MANAGEMENT LTD

3rd Quarter 2024 report to NAVF Board of Directors

	JPY	Sterling/Yen FX Change	GBP	JPY	FX	GBP
31/2/ 2020 to 31/12/2020	12.19%	1.39%	13.58%	12.19%	1.39%	13.58%
Year Ending 31/12/2021	34.18%	-12.77%	21.41%	50.54%	-12.64%	37.90%
Year Ending 31/12/2022	3.65%	-1.79%	1.86%	56.04%	-15.58%	40.46%
Year Ending 31/12/2023	36.66%	-16.16%	20.50%	110.01%	-40.76%	69.25%
1st Quarter 2024	12.07%	-6.67%	5.40%	135.36%	-56.97%	78.39%
2nd Quarter 2024	6.94%	-6.42%	0.52%	151.69%	-72.38%	79.31%
3rd Quarter 2024	**3.34%**	**6.22%**	**9.55%**	**160.09%**	**-63.65%**	**96.44%**
2024 Year to date	**23.85%**	**-7.78%**	**16.06%**	**160.09%**	**-63.65%**	**96.44%**

Introduction

In the Japanese capital markets, the third quarter of 2024 will be long remembered. At the beginning of August, the Central Bank finally raised Yen rates above 0% to +.25%. Two days later, on 5th August, all hell broke loose, and we saw the 'flash crash'. Most of the Yen carry trade unwound in hours and the Nikkei closed down 12.4% and the TOPIX down 12.2%, their largest falls since Black Monday. The market had dropped 25% from the all-time high recorded on 12th July. But the damage was short-lived and by the end of the period under review, both main indices had clawed most of their way back, while, happily, the yen remained stronger against the basket of major currencies. Most significantly, from our point of view, we have seen nothing to make us feel that either the fundamentals or momentum which have propelled the success of our recipe of gentle activism all year have changed. Indeed, Nippon Active Value Fund's (NAVF) performance is a testament to both the strength of the formula; whilst our bet that a firmer currency would not harm our portfolio of smaller largely domestic-earning companies while also contributing to our returns, has begun to bear fruit.

Performance

During the period under review, NAVF has outperformed all indices, large or small. Of course, the fund has no official benchmark, nevertheless, it is pleasing to note when we are doing well. NAV was up over 9.5% in sterling terms or 3.3% in Yen, giving us over a 16% or approaching a 24% uplift respectively for the year to date. For the first time since 2020, a strengthening yen has contributed to performance!

Throughout the quarter, the share price's discount to NAV has moved within a range of 2-6%, which, while not ideal, reflects, as much as anything else, the 24-hour lag before the previous day's NAV is published. NAVF remains the top performing UK investment trust operating in the Japanese sector.

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Quarterly attribution

In the table below, the top 5 names represent the best performers over the quarter. The bottom five are the top detractors:

NAVF Q3 2024 Matrix	AVG Weight	Total Return	Contribution
Hogy Medical Co., Ltd.	3.96	72.48	3.35
TRANCOM Co., Ltd.	7.64	25.87	1.83
Bunka Shutter Co., Ltd.	4.62	22.79	1.10
Teikoku Sen-I Co., Ltd.	8.27	11.15	0.88
Eiken Chemical Co., Ltd.	6.23	10.56	0.69
Vital KSK Holdings, Inc.	3.28	-5.03	-0.16
Broadmedia Corporation	1.61	-9.88	-0.17
Yamaichi Electronics Co., Ltd.	0.53	-7.48	-0.18
ASKA Pharmaceutical Holdings Co., Ltd.	5.33	-4.20	-0.21
Nippon Fine Chemical Co., Ltd.	3.66	-10.36	-0.40

On 16th July **Hogy Medical** announced Q1 financial results, as well as presenting a revised mid-term plan under a new management team. The company will target a total shareholder return ratio of 200%, the result of share buybacks and dividends, for the three years from March 2025 to March 2027. This was a positive surprise. Hogy Medical was sitting on a large amount of cash and decided to significantly increase its total shareholder return ratio in order to improve ROE. For FY03/2027, the quantitative targets announced by the company are for an ROE of 6% or more, sales of 46.7 billion yen, operating income of 7.5 billion yen (from 4.6 billion yen in FY05/2025), and operating margin of 16.1% We believe the focus on increasing profits rather than sales is the right direction to go. Plus, the company pledged to achieve ROE of 9% or higher by 2030. In the mid-term plan, the company disclosed that its most important focus was to strengthen the sales force of premium kits. The company will reallocate sales resources, increase customer contact points, and reform the sales organization. They also plan to design a new compensation structure for sales and to expand coverage of premium kits for surgery. Overseas, Hogy Medical disclosed its focus on ASEAN. In Japan plus ASEAN, the kit market is worth 230 billion yen, and the ASEAN market is projected to grow at a CAGR of 9-10%. The company has launched initiatives in Indonesia, Singapore, and Malaysia. Lastly, on cash allocation, the company plans to return 25 to 26 billion yen to shareholders over the next three years, plus plough 14 billion yen into investment for growth, by using operating CF, surplus funds, and interest-bearing debt. Other than the Indonesian plant, there are currently no plans for major investments in the future. As a result of these announcements, the share price has continued a steady rise. We believe there is more to come.

After much dialogue, **Trancom**, a logistics services company specialising in truck and freight matching, and one which Dalton Investments has owned for 12 years, agreed on 17th September to go private in a heavily leveraged MBO led by Bain Capital. NAVF and NAVF Select had joined the 'concert party' with Dalton in May, with a brief to make something happen.

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In the event, our group, which collectively owned 16.45% of outstanding, was able to tender all its shares at over a 40% premium to the previous close and a record high for the stock. As part of the deal, we have also negotiated 10% of the go-private company's equity (at a total cost to the concert part of approximately Yen 1.4 billion or $9.4 million) and for Shiro Hyashi (who runs Dalton KK's office in Tokyo) to join the Board. We believe this is a great investment opportunity given the valuation, quality of the business, and favourable financing package.

We expect a 20% plus Free Cash Flow yield to the equity investors after interest payments, even in the unlikely event there is no value creation going forward.

- Deal Valuation: 7.4x EV/EBITDA and 1.9x PBR based on the TOB price
- Businesses: Stable B to B business with high ROIC (20%). Recurring cash flow
- Financing: 86% of the investment (73 billion yen) will be financed by debt. The weighted average cost is 3.4%

In our view, the company has great underlying businesses, but management lacks a clear understanding of proper capital allocation. There should be significant room for improvement with the help of Bain Capital, and thus for considerably enhanced returns over time. This is the second transaction we have carried out with Private Equity taking a portfolio company into private ownership, and then, in recognition of our role as a catalyst in making this possible, offering us a meaningful part of the resulting entity. We hope both these transactions are helping establish a template for the future as other PE firms take note.

The end of the previous quarter coincided with the year's high for **ASKA Pharmaceutical Holdings**. Its Q1 results released on 6th August were lackluster and the stock was marked down sharply, then recovered and has since drifted lower. We are still believers; indeed, the group owns 12.17% of outstanding, and the Tokyo analysts will be visiting the company's factory in Awaki shortly. We are continuing our dialogue and will be making recommendations to the AGM in due course.

Nippon Fine Chemical has reported two quarters of indifferent earnings. NAVF and NAVF Select now own 4.54% of outstanding. The share price year's high of Yen 3020 was reached on 11th July, but, unfortunately, the stock was negatively affected by the 5th August 'flash crash', when it dropped to Yen 2011, since when it has only partially recovered. We have owned this counter since October 2021, and it has been a strong performer in the past. We will continue our dialogue with the company – there is a lot of room for improvement.

Outlook

At the end of the quarter, Shigeru Ishiba was elected, to the surprise of many commentators, as Japan's new Prime Minister. The market went through a moment of renewed volatility, until the new boss called a snap general election for 27th October and started making stock-friendly remarks. At Rising Sun Management Ltd, we remain convinced that the opportunity set provided by smaller and mid-sized companies suffering with too many under-leveraged assets and too little management dynamism is as great as ever. It is also clear that regulatory and activist pressure on them will only continue to grow. Indeed, we have several long simmering situations we are hoping will come to the boil before year end.

Paul ffolkes Davis
October 2024