N+1 SINGER

Initiation

Atlantis Japan Growth Fund (AJG LN)

Investment Funds | **Current price* 264.0p** | **Corporate**

Small but punchy, with a strong focus on growth

09 October 2020

Atlantis Japan Growth Fund ("AJG") relies upon in-house fundamental research and an intense schedule of company meetings in building a portfolio of under-researched and undervalued growth companies from across the Japanese equity market. This is supported by the Investment Adviser's Tokyo based team and relatively modest level of assets under management, and typically results in a portfolio biased towards small and mid-caps. Lead adviser, Taeko Setaishi, has established a strong track record as lead adviser to the Atlantis Japan Opportunities open-ended fund since 2003 and has had similar success with AJG since being appointed as lead adviser in May 2016. AJG currently trades on a c. 10% discount and has several holdings poised to benefit from the disruptions caused by Covid-19. Further, the Company targets a dividend equivalent to c. 4% of previous FY-end NAV per annum, paid quarterly.

Stock-selection driven all-cap strategy with bias towards small and mid-caps

Lead adviser, Taeko Setaishi, and the wider team at AIRC focus on stock selection driven by fundamental analysis and an intense schedule of company meetings, in order to identify under-researched and undervalued growth companies. Naturally, this approach favours small- and mid-caps, which typically have lower coverage from both buy- and sell-side analysts. Stocks are split into four broad categories: pure growth, cyclical growth, recovery (e.g. in earnings or growth rate), and potential growth (where none may currently exist). This results in a relatively concentrated portfolio of 50-70 holdings, where individual position sizes typically range from 2-3% at initiation and are allowed to grow to 5% before trimming takes place.

Taeko Setaishi also lead adviser to highly rated open-ended fund since 2003

Taeko has also built a long and highly rated track record as lead adviser to the open-ended Atlantis Japan Opportunities fund since October 2003, which was awarded a five star rating for its performance by Morningstar as at 30/09/2020 with total returns ahead of its Morningstar Category (Japan Small/Mid-Cap Equity) and the MSCI Japan Small Cap index over three, five, and ten years*. However, the open-ended fund and AJG are not mirror images, with an overlap of c. 70% currently; the difference largely resulting from AJG's ability to invest further down the market cap spectrum and to employ gearing.

Regular quarterly dividend set at 1% of FY-end NAV

A dividend policy to pay a quarterly dividend set with reference to 1% of average NAV during the final month of each financial year (April) was introduced following approval by shareholders at the September 2019 AGM. Based on the upcoming quarterly dividend payments of 2.17p, this results in a yield on current share price of c. 3.3%. It is worth noting that under normal market conditions (i.e. had financial markets not been so volatile during April 2020) a dividend based on NAV will have its yield enhanced by any discount the shares trade on. Additionally, in terms of discount control measures AJG has a continuation vote held at every fourth AGM (the next in 2023) and the Board of Directors has made use of the Company's buyback authority on an ad-hoc basis in recent years.

**3/5/10 year annualised total returns of +15.5%/+24.8%/+21.0% against +11.0%/+9.5%/+7.9% for the Category and +11.8%/+12.6%/+10.4% for the MSCI Japan Small Cap index.*

** Price as at 13:02 08/10/20 ** Sources: N+1 Singer estimates, Company accounts, FactSet*

Key data

Market cap (£m)	110.3
Enterprise Value (£m)	110.3
Shares in issue (m)	41.8
Free Float (%)	99.7
Avg. daily volume (000)	57.9
Next Event:	17 December 2020 Q2 2021 Earnings Release (Projected)

	1m	3m	12m
Absolute %	38.6	34.8	29.5
Rel. market %	n/m	41.5	63.7

Share price chart

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Investment process

Fundamental analysis supported by c. 600 company meetings a year

The AIRC investment process seeks to identify, and build a portfolio of, growing businesses with clear competitive advantages, strong cash flow generation, and high quality management. The process is driven by fundamental analysis, with in-house research taking advantage of the lack of sell side broker research coverage of small and mid-cap companies, and breaks down into the following steps:

- **Periodic screening:** quarterly screening helps to flag potential investment ideas, with key metrics including annual sales and operating profit growth of 10%+, sustained operating profit margin improvement, trend of return on equity, and valuation metrics (e.g. PB, PEG, EV/EBITDA).

- **Company visits:** meetings with management are crucial for the team to get a better understanding of a company's business model, its strengths and weaknesses, and future strategy. The team typically conduct c. 600 meetings a year, including face-to-face management meetings, conference calls, and results presentations. Additionally, meetings can also feed idea generation, for example when meeting with competitors or trading counterparties to the original subject company of the analysis. Whilst the frequency of meetings fell sharply during Q2 as a result of the pandemic, more recently there has been a gradual increase.

- **Evaluation:** an assessment of the company's long-term sales and earnings growth potential is made via in-house modelling, and an appropriate valuation is determined based on growth measurements (e.g. PE and PEG). Alongside the fundamental considerations, technical factors such as the company's size, trading liquidity, and shareholder register composition are taken into account.

- **Portfolio construction:** a buy list of c. 125 companies is then reviewed at weekly team meetings, where recent company meetings and analysis are formally discussed and any additions/removals decided upon. A watch list of c. 40 companies is also maintained, where the companies are classified as being fundamentally attractive, but are too fully valued to be on the buy list. Portfolio construction then follows from stocks selected from the buy list, with a top holding typically no larger than 3-4% of the portfolio at the point of investment, and the portfolio containing 50-70 holdings. Sell discipline is driven by either a change in fundamentals (e.g. earnings disappoint, a deterioration in operating environment or unjustified change in business model) or trimming to reduce weighting within the portfolio following strong performance. Annual portfolio turnover ranges from 30-70%, depending on market conditions, and risk is mainly managed at the point of stock selection, which subsequently drives sector exposures. Despite the portfolio's bias towards small and mid-caps the liquidity profile is robust: normally over 90% of the portfolio can be sold within 2-3 days.

AIRC's Tokyo based advisory team supported by wider Quaero Capital resource

Atlantis Investment Research Corporation ("AIRC") is the appointed Investment Adviser to AJG, and comprises a team of four based out of the Tokyo office. AIRC's relatively modest total advisory assets under management of c. $400m provides the team with significant flexibility in selecting investments (particularly smaller companies), reduces concentration risk across multiple Japanese equity portfolios, and also widens the investable opportunity set.

- **Taeko Setaishi** joined AIRC in 1996 and until May 2016 was deputy fund adviser to AJG. She had worked at Schroder Investment Management before AIRC as an analyst and fund adviser from 1993, alongside Ed Merner. As lead adviser to AJG, Taeko is responsible for portfolio construction and day-to-day portfolio management. Taeko is also lead adviser to the open-ended Atlantis Japan Opportunities Fund, alongside segregated mandates.

- **Ed Merner** founded AIRC in 1996 having been manager of the Schroder Japan Smaller Companies Fund for 22 years. He now takes the role of deputy fund adviser to AJG, providing research and other support to Taeko alongside portfolio oversight in Taeko's absence. Ed's primary responsibility at AIRC is as lead advisor to the Essor Japan Opportunities Fund, a French SICAV.

- **Robert Burghart** joined AIRC in 2013 with over 30 years of buy and sell side experience and joins Ed in advising the Essor Japan Opportunities Fund, and Taeko in advising segregated mandates.

- **Kyomi Ando** joined AIRC in 2010 and brings 29 years of buy and sell side experience, including roles as a micro-cap and IPO analyst. She provides research support and stock ideas to the team.

In addition to the team at AIRC, Quaero Capital LLP ("Quaero Capital") is the appointed Investment Manager, with two team members contributing to the management of AJG:

- **Rupert Kimber** joined Quaero Capital in 2009 and has overall responsibility for the firm's Japanese business. He is the lead manager to the Quaero Capital Taiko Japan Fund and also liaises with AIRC and provides support to AJG investors.

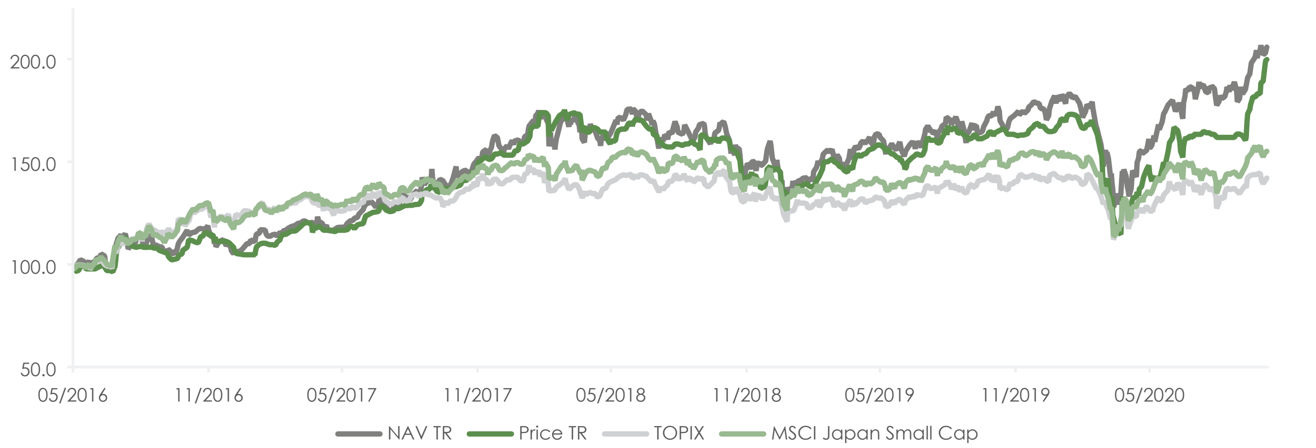
- **Richard Gittus** joined Quaero Capital in 2016 with over 30 years' experience covering Asian Equity markets on the buy and sell side, and his role includes investor relations and investor support for AJG.

Performance

Strong returns under Taeko Setaishi

As highlighted on page 1 AJG has delivered strong returns since the appointment of Taeko Setaishi as lead adviser on 1 May 2016, with a NAV total return of c. +106% being comfortably ahead of the benchmark TOPIX's +42% return, and also ahead of the MSCI Japan Small Cap index's +55% return (source: FactSet, Morningstar, N+1 Singer).

Figure 1: NAV performance ahead of both TOPIX benchmark and MSCI Japan Small Cap index



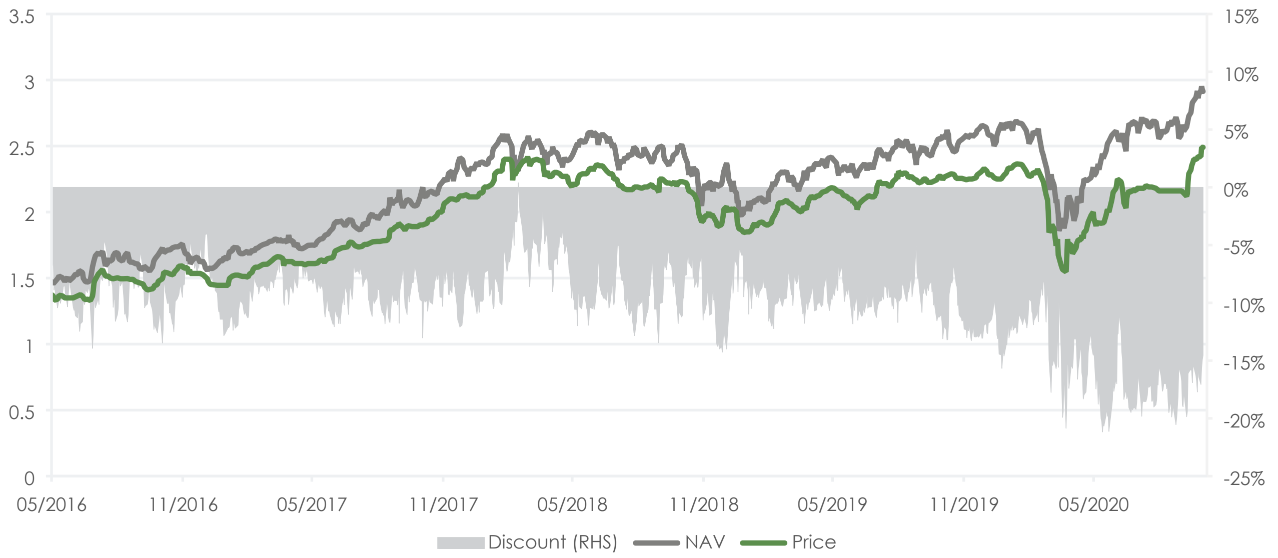
Source: Company data, N+1 Singer estimates

Further, two subscription right exercise points took place since Taeko was appointed lead adviser, in October 2016 and October 2017. These resulted in a superficial dilution to NAV as existing investors were able to subscribe for new shares at a discount to NAV (superficial since the subscription rights were embedded to the shares – meaning that existing shareholders always had the ability to offset the dilution by subscribing as the subscription rights could not be traded separately). To reverse this dilution impact out of the NAV performance figures (including those provided by fund data aggregators such as Morningstar) in order to better reflect the returns achieved by Taeko, a multiplicative adjustment factor of c. 1.07x should be used; for example a return of +50% (1.50x initial investment) would become +61% (1.61x initial investment). This further widens the outperformance noted above, as AJG's NAV return since Taeko's appointment increases to +120%.

Discount stable following Q1 2020 volatility

The discount had previously traded around 10% in the run up to Q1 2020; this was in part due to the existence of a discount triggered continuation vote with a threshold set at 10%. This discount trigger was replaced with a calendar driven continuation vote at every fourth AGM, as part of the structural changes approved by shareholders in September 2019. However, having remained around the 10% level following September 2019, the market volatility during Q1 2020 saw AJG's discount widen to be in excess of 20% on brief occasions. Fortunately, recent months have seen a volatility levels subside, and the discount has now stabilised to be in the range of 10-15%.

Figure 2: Discount stabilised following March 2020 volatility



Source: Company data, N+1 Singer estimates

We note that the next continuation vote is due at the 2023 AGM, and this timeline when combined with the substantial presence of several value-oriented investors on the share register should provide a strong incentive for the Board to narrow the discount, or at least prevent it widening any further from current levels. This in turn presents current and prospective shareholders with substantial upside potential over the next three years should the Board be successful and/or forced to narrow the discount, over and above any NAV returns achieved. In addition to the continuation vote, the Board has the usual permissions to buy back up to 14.99% of the shares in issue in order to actively manage the discount.

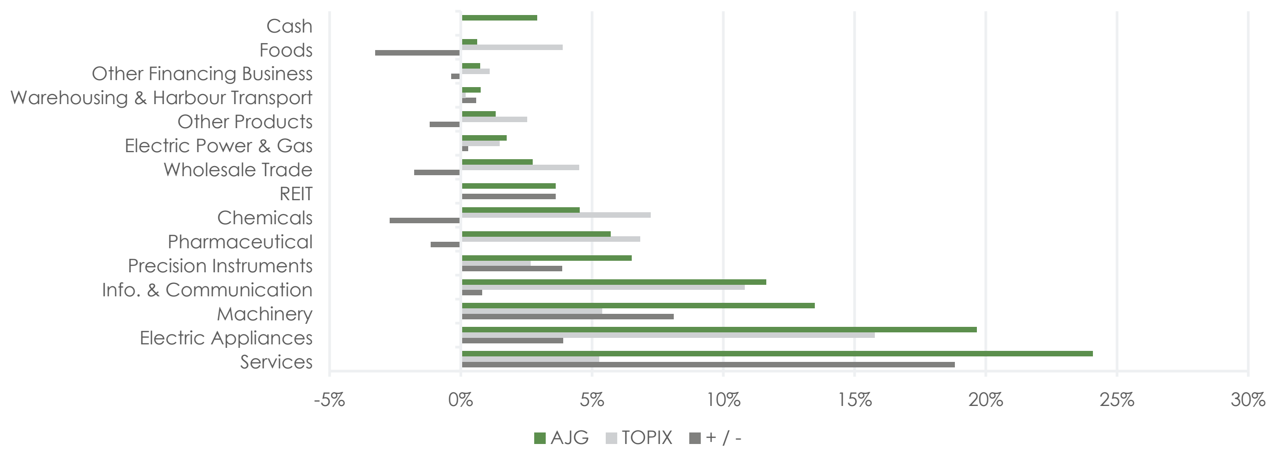
Portfolio positioning and outlook

Although the portfolio is formed as a result of stock selection, common themes across holdings often occur. Currently, these include:

- **Healthcare:** companies that stand to benefit from the ageing Japanese population and corresponding rise in demand for medical devices, medical software solutions, support services, and pharmaceuticals; e.g. Asahi Intec (Precision Instruments – incl. guide wires for surgical treatments).
- **Workplace reform:** service provision companies against a backdrop of companies reassessing their office environments; e.g. S-Pool (Services – incl. outsourcing and HR solutions).
- **Technology:** given Japan's role in the global supply chain of hardware and consumable materials, there are plenty of high growth opportunities within the sector; e.g. Lasertec (Electrical Machinery – semiconductor-related equipment manufacturer).
- **Infrastructure:** companies, particularly within software and systems, that will benefit from a rebound or increase in capex by corporate Japan; e.g. SB Technology (Information & Communication – incl. e-commerce services and cloud based solutions).
- **New business opportunities:** business models that will benefit from the disruption caused by Covid-19 and any increase in M&A activity, e.g. Bengo4.com (Services – websites that include matching lawyers or accountants to potential customers, and online contract signing services).

These themes and representative holdings help to highlight the spread of economic drivers within the portfolio and that the portfolio balances domestically oriented businesses with exporters; indeed, exporters (as defined by overseas sales more than 40% of sales) represented c. 35% of the portfolio as at 31 July 2020.

Figure 3: Sector weightings relative to benchmark – substantial exposure to business services and technology related sectors



Source: Company data, N+1 Singer

If we then look at AJG's portfolio positioning relative to the benchmark TOPIX, AJG has a significant weighting towards business services and technology related sectors. This results in a significant overweight to Services, but is not overly surprising given the strategy's focus on growth and the diversity of opportunities within the Services sector, with several businesses positioned to benefit from the themes mentioned above.

Outlook

The adviser makes no apologies in being cautious on the medium-term outlook against a backdrop of persistent Covid-19 uncertainty, noting the mixed signals from economic data points. However, this is not a scenario unique to Japan, and the adviser draws optimism from the stock specific opportunities available, notably across the technology, healthcare, outsourcing, and consultant services sectors – sectors that are well represented within AJG's portfolio. Further, recently appointed Prime Minister, Yoshihide Suga has committed to continuing the positive structural reform implemented under Shinzō Abe's tenure. If the reality meets expectations over time, this should further increase the appeal of Japanese equities to international investors. Indeed, the headline-grabbing c. $6.3bn investment by Warren Buffett's Berkshire Hathaway in five of Japan's largest conglomerates (Mitsubishi Corp, Mitsui & Co, Itochu Corp, Sumitomo Corp and Marubeni Corp – source: FT.com), first disclosed during August 2020, was a timely example of this. Whilst these companies are too large to be typical investments for AJG, the Berkshire Hathaway investment may prove to be emblematic of a wider shift in investor sentiment following a prolonged period of Japanese equities being under owned by overseas investors.

Appendices

Appendix 1

Key information table for AJG

Name	**Atlantis Japan Growth Fund**
Launch date	May 1996
Investment objective	To provide investors with long term capital growth through investment wholly, or mainly, in listed Japanese equities
Investment policy	The Company's investment policy is flexible, however the portfolio will predominantly consist of listed equities. Investment restrictions include: • up to 20% of NAV in companies listed outside of Japan that are either controlled or managed from Japan, or with material exposure to the Japanese economy; • up to 10% of NAV in unlisted securities -, though none are currently held. • up to 20% of NAV in equity warrants and convertible debt; and • up to 10% of total assets in other closed-end investment funds that do not themselves limit exposure to other closed-end investment funds to 15% of total assets, otherwise up to 15% of total assets. Derivatives will not be used save for the purpose of efficient portfolio management, and no more than 10% of the Company may be invested in any class of securities of an investee company.
Benchmark	TOPIX
Discount management	Alongside a continuation vote being held at every fourth AGM (the next being in 2023 – typically held in September of each year), the Board of Directors generally seeks authority to purchase up to 14.99% of the shares in issue at each AGM, and has made use of the buyback authority on an ad-hoc basis in recent years.
Investment manager	Quaero Capital LLP is the appointed Investment Manager, with Atlantis Investment Research Corporation ("AIRC") having advised AJG's Investment Manager since launch in May 1996
Lead adviser	Taeko Setaishi
Management fee	1.00% p.a. of net assets up to £125m, 0.85% between £125m-£175m, 0.70% for £175m+
Performance fee	None
Ongoing charges	1.64% as at 30 April 2020
Gearing	Gearing is used tactically for investment purposes, up to 20% of NAV at the time of borrowing.
FX hedging	None – although the Company can hedge currency risk it will not typically seek to hedge under normal market conditions.
Dividend policy	Quarterly dividend set with reference to 1% of average NAV during the final month of the preceding financial year.
Life	Unlimited
Domicile / Listing	Guernsey / Main Market (Premium listing)
Website	www.atlantisjapangrowthfund.com

Sources: Company data, N+1 Singer.

Important disclosures

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Recommendation/Target price

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