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## **2023 Year end letter: Japan Capital Appreciation**

Dear Investors,

2023 was a profitable year for equity investors in Japan. The Nikkei and Topix indices had excellent returns. Our Japan capital appreciation strategy returned +23.6% net of fees while the iShares MSCI Japan ETF (EWJ) returned +20.3%.

Since 2017, We have offered this strategy which is solely focused on Japanese public equities. Japan has companies that are classic Ben Graham net nets yet profitable ones. Half the companies trade below book value. One can also find higher quality companies that are very attractively valued. Our portfolio aspires to build about 30 positions mostly from the latter group. These companies have grown revenues and are consistently profitable, attractively valued on an absolute and relative basis, have significant net cash on their balance sheets and pay an attractive growing dividend.

	<b>2023</b>	<b>5 Yrs</b>	<b>Since 2017</b>
<b>Motiwala Capital</b>	23.6%	8.0%	9.2%
<b>EWJ</b>	20.3%	6.6%	5.7%

### **2023 Performance**

Detractors: Currency detracted about 1% from our 2023 performance.

Winners: Equities as a group contributed about 22.8% while treasury ETF contributed 1.5%. Gains were seen across most of the portfolio for the year with only a handful of equities showing MTM unrealized losses. The performance of the top 10 positions is listed in the table on page 2.

Yen vs USD change: Short term interest rates rose sharply in the US through 2023 to 5.5%, while they remained negative in Japan increasing the interest rate differential between the two currencies. The Yen came under additional pressure through most of the year before rebounding slightly from mid-November. The Japanese Yen declined v/s the USD for a third consecutive year going from 131 to 141.4 (low being 151).

Change in approach to Yen: All these years, we chose to go long the Yen. However, based on the interest rate disparity explained above, we decided to borrow ~50% Yen mid-year and invested the USD in an ETF that owns 1-3 months US govt T bills and that currently pays about 5.3% annually. The yen borrowing cost is about 1% leading to a positive carry of 4% for the



borrowed amount. We will continue to monitor interest rates differences to determine any change in stance.

### Portfolio Composition (Dec 29, 2023): Top 10 Positions (~43% of account)

Company	Weight	P/E	EV/EBIT	ROE	Yield	Cash % MCap	2023 perf
JFE Systems	6.7%	11.1	5.2	20.0%	3.2%	32%	65%
Business Brain Showa	4.6%	14.6	5.5	13.0%	3.4%	35%	21%
Naigai Tec Corp	4.5%	8.1	1.7	10.0%	2.5%	70%	8%
Fukuda Denshi	4.3%	11.7	5.8	11.6%	2.2%	30%	67%
Showa System Eng	4.2%	9.0	0.6	14.8%	3.0%	90%	50%
C Uyemura	3.9%	20.8	11.1	10.3%	1.6%	17%	87%
DMW Corp	3.7%	8.4	2.4	8.0%	3.4%	61%	27%
Rasa Corp	3.7%	8.0	5.9	10.7%	4.5%	3%	38%
Ryoyu Systems	3.6%	8.6	5.1	14.6%	3.2%	13%	38%
Fuji Corp	3.6%	7.6	4.5	17.0%	1.8%	19%	30%

As you can see from the table above, the Japanese market is an incredibly rich environment for finding profitable undervalued stocks. Our companies sport rock-solid balance sheets (overly conservative in most cases), pay growing dividends and have decent ROE. While the stocks are cheap on PE ratio basis, they are incredibly attractive in terms of enterprise value to earnings before interest and taxes (EV/EBIT).

So how does value get unlocked in Japan? Over the seven plus years of managing the strategy, we have seen some holdings get acquired by management or in a strategic buyout. We have seen activists take stakes to prod management to improve shareholder returns.

Management teams are also acting to improve shareholder returns via improving operations as well as increased dividends and share buybacks. Stock prices do follow earnings over longer periods of years.

#### Portfolio Exits

Portfolio holding **Ihara Science** had a relative short stay in the portfolio. It was acquired by the Chairman in a management buyout (**MBO**) transaction for 31% premium to the price before the offer was made.

We sold the position in **Computer Management** as operating profits declined despite rising sales.

**Asahi Intelligence** shares were sold as both EPS growth and DPS growth have been relatively anemic compared to the peers in our portfolio.



## Significant Current Holdings

**JFE Systems** is in the systems integration business. JFE reported EPS growth of 21% for FY22 and EPS is up another 16% by 3QFY23. While the stock rose 58% in 2023, it still trades at 11x TTM EPS and increased dividend per share by 22%.

**Fukuda Denshi** engages in the development, manufacture, import, export and sale of medical electronic equipment. Fukuda EPS increased 10% in FY22 and a further 7% in 1HFY23. The stock is up 61%, rising from a depressed P/E of 8x to 12x.

## **Why Japan and incremental improvements in Japan that may aid in unlocking value**

Japan has been considered a value trap for decades. I'd say one needs to dig deeper to see the tremendous value opportunities in Japan. Half the companies trade below book value v/s 20% in the US/Europe. Japan has the most net nets globally. Many of these net nets are better quality – profitable, net cash balance sheets and dividend paying. A large number of Japanese companies are net cash. Corporate governance has been improving over a decade since former PM Abe was in power. It seems to me 2023 was a year of seminal moves in Japan.

On Jan 15 2024, the Tokyo Stock Exchange (TSE) published its first [monthly list of companies](#) that have disclosed their actions to address the valuation discount. This should pressure management teams of companies that are not yet on this list. The TSE has also asked companies with subsidiary listings to increase disclosures. TSE will require all of the approximately 1,600 companies listed on the Prime segment to disclose material information in English from March 2025.

Updates to the NISA, Japanese equivalent of the 401K, **doubled** the amount investors can contribute annually. Japanese households currently invest less in equities than those in US and Europe. This could be a tailwind for Japanese stocks.

New tax rules allow acquirers in M&A deals to deduct up to 100% of acquired company's stock as an expense for tax purposes.

Management led buyouts are increasing. Cross share holdings have been a perennial issue in Japan. With the push to improve ROE, there has been reduction in cross share holdings. Toyota Motor the largest public company has begun unwinding some of these holdings which sends a loud message across the board.

Japan Inc dividends and buybacks are at record highs (again). International investors fund flows in 2023 after many years of outflows.



We continue to be excited by the Japan investment opportunity. Despite the run up in 2023, Japanese equities overall remain very attractively valued on an absolute basis and certainly relative to most global equities. Many efforts are underway by different stakeholders such as Tokyo Stock Exchange, Japan Ministry of Finance, activist investors and the corporates to improve corporate governance and boost shareholder returns (see Appendix at end). We think the Japan investment opportunity is in its early innings and could last several years.

Thank you for the opportunity to manage a portion of your assets. We will continue to work hard to protect and grow your entrusted capital in 2024 and beyond.

Sincerely,

*Adib Motiwala*

Adib Motiwala  
Portfolio Manager

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### **Appendix: Related news**

[Japan Stock Exchange Adopts Name and Shame Regime to Boost Corporate Valuations](#)

[Japan Embraces Management Buyouts as Pressures Mount at Listed Groups](#)

[Japan's Cross-Shareholdings Drop to New Low on Investor Pressure](#)

[Bain Capital Says More Japanese Companies Looking To Delist](#)

[Japan Inc Annual Dividends at Record Levels Again](#)

[As China's Markets Stumble, Japan Rises Towards Record](#)