QUAERO CAPITAL

QCF (LUX) – TAIKO JAPAN

TRIP OBSERVATIONS

September 2023

Conclusion

The Japanese corporate system is clearly dividing into two camps.

Larger companies continue to take market share gains at the expense of smaller companies who are struggling in the face of inflationary pressures.

The major change in the labour market, significant wage hikes for the first time in over 20 years, has caused smaller companies extreme difficulties as the demographic labour shortage becomes more visible and automation efforts are restricted by financial difficulties.

Further developments in 2024, principally the introduction of regulatory overtime restrictions in both the transport and construction industries, will accelerate this divide. The widespread recent introduction, even since our December 2022 visit, of automated checkouts in the hospitality sector and even at Tokyo Airport immigration are a visible reminder of the declining labour market demographic.

Higher wages, reshoring, tight labour market and consolidation

Managements across many industries are talking more openly about domestic industry consolidation and there will be a slew of deals in the next 12-24 months. From the 32 company visits in our trip, the larger companies are in many cases only sharpening their restructuring resolve to deliver improved profitability and cashflow. This is evidenced by a series of 3-year rolling midterm plans through to 2030 which, in many cases, clearly anticipate market share gains. Many more potential spinouts are under discussion to follow in the footsteps of one of our holdings, Digital Hearts. Even a partial success in achieving consolidations would result in very low share price valuations.

Within Japan, rising inflationary pressures that threaten to exceed wage growth, utility and food prices, are creating mixed domestic consumption patterns nationwide. There is a major divergence between the buoyant consumption in Tokyo and more subdued spending in other major cities and especially the regions. Recent gasoline prices have risen to all-time highs as government subsidies to refineries are rolled back. The return of full-fledged inbound tourism, Chinese group tours aside, is clearly a major bonus to the retail sector.

There is widespread unease amongst manufacturing companies over China. Unhappy memories of the Japanese property collapse have been revived by the real estate collapse in Chinese property prices and no quick fix is expected. Of greater importance is the ever more noticeable trend towards local brands taking market share from foreign players. This has clearly wrongfooted Japanese OEMs and suppliers in the auto industry, given their limited business with local OEMs, and consumer goods sectors. Residual supply chain issues from Covid and fears of further trade disruption are clearly causing some managements to downsize their presence, preferring to reshore in Japan and utilise Asian locations such as Vietnam. Fresh investment plans are subdued unless required to satisfy local regulatory requirements.

Monetary policy will progressively tighten but Ueda, the new BOJ governor, is clearly leaning to the view that inflationary pressures may subside later in 2023, hence adopting a cautionary position. With further likely wage inflation in 2024 and signs of higher imported inflation resulting from the weak yen, we continue to expect 1% yields on 10-year JGBs. Given the higher for longer US interest scenario any material yen appreciation appears unlikely near-term although further currency market intervention at cJPY 150/USD cannot be ruled out.

Corporate governance and the stock market

The highly publicised Tokyo Stock Exchange initiative to place pressure on companies to reach book value and the ensuing escalation in activism is widely discussed by corporate managements in our meetings. There is an increasing view that whilst improving shareholder returns is desirable, there is some frustration at companies who feel pressured by short term investors. With many larger companies trading above book value, we expect companies to make innovative changes to their dividend policy, such as the dividend over equity policy, as opposed to high priced share buybacks. We sense that progressively the engagement type investors will hold more sway with corporates and we wonder whether the balance sheet asset stripper activists are close to peak momentum. Shareholder returns in aggregate will continue to rise.

Stock market activity by retail domestic investors remains buoyant with larger high yielding companies the focus of their attention. With the introduction of the super NISA in 2024, this trend appears set to run as these domestic investors can generate a return in excess of both inflation and interest rates as, unlike other developed markets, the risk-free rate in Japan remains almost zero today. We expect to see domestic retail investors continue to mobilise some of their extensive bank deposits into assets. Some of the leading online brokers have finally reduced their trading commission rates to zero this week. Anecdotally, strong inflows are visible at the only listed Robo-Investment advisor that we visited on the trip.

The Tale of the Hokkaido Scallop and the Industry Rollup

Yoshimura Food, a holding in our Taiko fund, has over the last 8 years acquired a portfolio of c30 small regional food companies as owners of these companies are looking for an exit given succession issues. With a preference for an orderly transition and employee welfare, these acquisitions are normally conducted at low prices, c4x EBITDA. Yoshimura-san, the founder, has developed a strong reputation in the food industry as a capable operator who has gently restructured these companies with improved distribution and profitability, and he has only in very isolated cases made any disposals. Throughout Covid, and subsequently, the company has seen a much stronger deal pipeline of increasingly large companies. Until now, these acquisitions have been company and not product specific and hence the portfolio is varied.

Enter the Hokkaido Scallop and a change of strategy.

Throughout 2022, Yoshimura conducted extensive research into the Japanese scallop industry, largely concentrated in Hokkaido, and he embarked on a strategy to build a business with c30% of the market. Historic enmity amongst the small scallop fisheries had prevented any earlier consolidation. Finally in December 2022, the breakthrough moment occurred with the purchase of one of the larger players, Murashiki, whose president importantly is the industry head of the Hokkaido Scallop

Producers Association. This resulted in multiple discussions with other fisheries culminating in the announcement this week of a further acquisition, YS Foods, another major player. The industry is highly fragmented with Marushiki holding a 5% share and the largest player commanding the leading 7% share. Post the acquisition of a 70% stake for JPY 6bn in YS Foods, Yoshimura will have captured over 10% of the market. Intriguingly larger food companies also expressed interest in acquisitions but were rejected as the local players were encouraged by the historic track record at Yoshimura. Whilst we are as yet unsure of the latest transaction multiple, we confirmed at our meeting with Yoshimura-san that the December 2022 Marushiki deal came at 5-6X EBITDA with sales of cJPY 7bn whilst YS Foods generates a 10% OPM on JPY 16bn sales. Consolidation prospects were initially triggered by labour shortages and ageing processing plants with over cJPY 100m replacement costs that are beyond the financial resources of these small fisheries. This trend will only accelerate now due to the very recent Chinese ban on Japanese fish imports following the release of radioactive water at Fukushima. However, the Chinese ban is likely to only affect c5% of sales at these companies and both the Japanese government and TEPCO, the operator of Fukushima, have already pledged financial assistance to the fish industry for any lost sales thereby minimising the financial risks to Yoshimura. Looking into 2024, the scallop producers are facing higher distribution costs due to the higher trucking costs related to the introduction of new regulatory overtime restrictions and this has also encouraged acquisition discussions.

Operational synergies from these acquisitions appear considerable, especially from higher scallop shipments to their Singaporean based food operations, and once the scallop business has been firmly established then other fragmented parts of the food industry will be considered. The company has a wide experience of PMI following acquisitions, so we are not concerned. As part of the due diligence, Yoshimura has taken extensive advice on farming/breeding techniques but also analysis of sea water temperatures and nutrient levels from a Tokyo University research entity.

The Hokkaido Scallop example clearly shows that industry consolidation is possible and is happening and that given sensible acquisition prices, the returns should be very attractive. Our portfolio has many examples in other industries, and this explains why we remain so excited about the long-term prospects for these industry winners who will build both scale and profitability which today is not remotely priced into current share price valuations. This approach remains the key differentiator of our fund and the key to future returns.

Important Information

General: This is a marketing document and is intended for informational and/or marketing purposes only. It is neither directed to, nor intended for distribution or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. This document is neither an offering memorandum, nor should it be considered as a solicitation to purchase or to invest in Quaero Capital Funds (Lux) – Taiko Japan (the "Fund"). Any offer to purchase shares in the Fund based on this document will not be capable of acceptance. The Prospectus, KIID, Articles, annual and semi-annual reports (the "Legal Documents") may be obtained free of charge at the address mentioned below. Please read the Legal Documents before investing and take note of the risk factors listed in the Fund's prospectus that are not intended to be reproduced in full in this document.

Performance: Nothing contained herein shall constitute any representation or warranty as to future performance of any financial instrument, currency rate or other market or economic measure. No assurance can be made that profits will be achieved or that substantial losses will not be incurred. Past performance is not a guide to or indicative of future results. Future returns are not guaranteed and a loss of principal may occur.

Risk: Factors affecting fund performance may include changes in market conditions (including currency risk) and interest rates, as well as other economic, political, or financial developments. The Fund's investment policy allows for it to enter into derivatives contracts. Leverage may be generated through the use of such financial instruments and investors must be aware that the use of derivatives may expose the Fund to greater risks, including, but not limited to, unanticipated market developments and risks of illiquidity, and is not suitable for all investors.

Index: The Fund is actively managed and uses the TOPIX Index Net Total Return for performance comparison. The benchmark has been chosen as it is generally considered to be representative of the investment universe in which the Fund invests. The performance of the Fund is likely to differ from the performance of the benchmark as the holdings, weightings and asset allocation will be different. Investors should carefully consider these differences when making comparisons. The benchmark is provided by an administrator on the European Securities and Markets Authority (ESMA) register of benchmarks which includes details of all authorised, registered, recognised and endorsed EU and third country benchmark administrators together with their national competent authorities.

Country Specific Disclaimers: It is the responsibility of any person/s in possession of this document to inform themselves of, and to observe, all applicable laws and regulations of any relevant jurisdiction. Neither Quaero Capital nor the Fund shall be liable for, and accept no liability for, the use or misuse of this document. If such a person considers an investment in Shares of the Fund, they should ensure that they have been properly advised about the suitability of an investment. All persons interested in investing in the Fund presented are recommended to seek advice from independent legal and tax financial advisors in order to ascertain whether the investment is appropriate to their own objectives.

Notice for Swiss investors: the legal documents may be obtained free of charge in French from the Swiss representative of the Fund. Swiss representative: Fundpartner Solutions (Suisse) SA, route des Acacias 60, CH-1211 Geneva, Switzerland. Swiss paying agent: Banque Pictet & Cie SA, route des Acacias 60, CH-1211 Geneva, Switzerland. Latest prices are available on www.fundinfo.com.

Notice for UK investors: this document has been issued in the United Kingdom by Quaero Capital LLP (authorized and regulated by the Financial Conduct Authority with registration number 434203), the UK representative of the Fund. The legal documents may be obtained free of charge in English at the registered office of Quaero Capital LLP 2-4 King Street, London SW1Y 6 QL.

Notice for other investors: the legal documents may be obtained free of charge in English at the registered office of the Fund 15, avenue J.F. Kennedy, L-1855 Luxembourg. Any reference to QUAERO CAPITAL in this document, should be construed as being a reference to any one or more of the legal entities, listed below, dependent on the particular jurisdiction in which the document is published, subject to the investment products and services referred to herein being available to potential investors or categories of investors in such jurisdictions. Quaero Capital SA, Quaero Capital (France) SAS, Quaero Capital (Luxembourg) SA, Quaero Capital LLP.

Investors' rights: A summary of your rights as investor in the Fund is available **here**.