CC JAPAN INCOME AND GROWTH TRUST PLC – CORONAVIRUS UPDATE

As of Friday, March 20, the TOPIX Total Return Index was down 15.1% in yen in March, and 26.4% year to date for 2020. The NAV of the CC Japan Income and Growth Trust plc (the Trust) has fallen by 28.5% year to date and the share price by 31.2%. The Trust paid a 3.1p final dividend on March 19.

What we have been doing

In total, since February 19, the Coupland Cardiff Asset Management LLP Japan team has conducted over 30 conference calls and 4 face-to-face meetings, many of which have been with companies held in portfolio, and several of which were with the CEO or CFO of the company concerned.

What are our findings?

There is no doubt that sales and earnings will be hit at companies: the global reaction to the coronavirus has seen unprecedented restrictions on human movement and has had a direct impact on business practices. Within the companies we spoke to, there were unsurprisingly varying degrees of impact. Several companies have taken a direct hit, such as hotel operators like **Japan Hotel REIT** (-70% YTD), which saw their revenues per room fall substantially in February and will probably report worse figures for March given the restriction on travel into Japan placed on visitors from China and Korea. However, even at companies like these, where near term earnings declines will be substantial, there are some factors which are worthy of note and which support our view that even if a return to normality may be some time away, extreme share price declines are possibly overdone given that the COVID-19 outbreak appears to under greater control in Asia than in Europe and the US.

Pola Orbis (-25% YTD as of March 20), a company which has been affected by (amongst others) recent changes in shopping patterns from Chinese visitors, mentions that its home-visit based domestic sales channel in Japan has seen an increase in demand as a result of older Japanese consumers being unwilling to go leave their homes. Crucially, despite earnings declines, the company is very clear that it will not cut its dividend.

In the manufacturing sector**, Tsubaki Nakashima** (-65% YTD) has reopened all three of its plants in China, albeit at reduced operational rates.

The impact on other companies is less severe. Companies like **Softbank Corp** (0% YTD) and **NTT** (-12% YTD), in the telecommunications sector, and **Secom** (-20% YTD), in security services, run business models which are based on monthly subscriptions. These companies do not see cancellation of their monthly customer contracts as a result of the fallout from coronavirus. At the margin they will struggle for short term top line growth because their promotional events and sales efforts to win new customers are hampered. However, the core of their recurring revenue stream remains largely intact and over time their businesses are likely to continue to be driven by rising diffusion rates for their services.

REITS

Real Estate Investment Trusts (REITs) have been a significant positive contributor to the Trust since inception both in terms of capital appreciation and contribution to the income and its growth. The low global interest rate environment and the notable shift to negative interest rates in Japan has been a favourable backdrop when combined with the steady recovery of the domestic real estate market.

However, the last week has seen a dramatic sell-off in REIT markets around the globe. The Tokyo Stock Exchange REIT Index has fallen from its recent peak of 2251 on February 20 to its close on Thursday March 19 of 1145, a fall of 49% in 19 trading days. This has occurred despite coordinated interest rates cuts around the world. The seeming defensiveness of REITs, recognised in their strong performance relative to the TOPIX Index which continued to March 6, has apparently disappeared with the index falling to a level last seen in early 2013. With the exception of hotel REITs, whose business has been affected by the slowdown in visitors to Japan and domestic business travel, the rationale is not apparent in the current operating conditions (confirmed by recent conversations of management of office REITs) of the companies themselves. The explanation relates to the sharp rise in credit spreads around the world and the perception that the widening spread above the risk free rate and general lending conditions are a precursor to deteriorating real estate markets. This is well recognised by central banks and maintaining liquidity and reducing credit risk are the focal point of central bank activity and policies in recent days.

The only comparable sell-off of this magnitude was the 2007/08 period suggesting that the market fears a similar credit crunch to the Lehman crisis. The sell-off in Japan has been accentuated by stop-loss rules employed by regional banks, who have been until now major buyers of the domestic REITs. This has resulted in forced selling after the share prices fell 15% in the run up to their fiscal year end in March.

We have been in contact with the management of our largest REIT holding, **Invesco Office REIT** (-56% YTD), regularly over the past three weeks who have confirmed that operating conditions have not changed over this period. There has been no change to banking lending conditions and ongoing refinancing discussions are unaffected by the short term spike in credit financing costs. The company was awarded an AA- credit rating in December 2019 and believes that as a result there is the opportunity to reduce its financing costs. It has a diversified tenant base with no hotels chains, high end retail or airlines as major tenants. It consequently believes the risk of tenant departures is low and with a favourable rent gap (i.e. a lower rent received that the prevailing market rates for its individual properties) is still negotiating upward revisions to its property portfolio. Even assuming no further increases, the company's conservative dividend forecast equates to a dividend yield on the share of close to 8%. With the AA- rating making the shares now eligible for the recently expanded Bank of Japan buying programme and the expectation that yield hungry regional banks will return to the market after the end of the fiscal year, we believe that such attractive valuations will underpin the long term investment opportunity as was the case in the years that followed the prior financial crisis.

Corporate Dividends

We have received annual dividends from companies with a December year end and all of the companies in the portfolio delivered the dividends they had forecast with a few actually exceeding the initial projection made at the beginning of the year. The forecast for the majority of these companies for FY20 was in line with expectations albeit we would say rather cautious given that the coronavirus outbreak was developing as the companies were releasing these new fiscal year forecasts. Tsubaki Nakashima was the one major disappointment as, despite many assurances to the contrary, the management chose to cut the dividend y/y in FY20 (but maintain the same distribution to shareholders by announcing a share buyback). This is not what we had expected or would have preferred (and this has been reflected back to management in our subsequent face to face meeting). There is also some risk in the forecast made by the hotel REITs if the current restricted travel situation is prolonged.

Of the companies whose fiscal year end is approaching on 31 March we currently see little risk in the dividends being cut despite the fact that they compiling forecasts for the next fiscal year in the midst of a global expansion of Covid-19. This is due to a combination of the business structure (eg telco) and the commitment to at least maintaining the dividend (eg financial companies). It seems likely however that companies will be more cautious in their assumptions for the current year than those whose year-end is December as there is much clearer evidence of the coronavirus impact on business conditions. We suspect that many companies will consequently forecast flat year on year given the uncertainty (with the prospect of revising this up later in the year if conditions improve as we all hope).

We would also expect many of these companies to consider share buybacks given the share price weakness (these companies are currently in their 'quiet period' so are restricted from doing so until their results at the end of April/early May). In short, we would expect the portfolio to deliver dividend growth albeit a lower rate than we would have expected after our visits to Japan as recently as February. The scale of the coronavirus impact has been dramatic and is likely to cause an adjustment to the short term growth trajectory of dividends. However, we believe that it does not affect the long term commitment to improving corporate governance and returns to shareholders as this is an important component of the sustainable trajectory for the Japanese economy.

What are our conclusions?

The companies in our portfolio are characterised by strong balance sheets and many of these have significant net cash positions. As such their ongoing survival first and foremost is not an issue. Undoubtedly short term earnings will be affected with varying levels of severity. However, our belief in the long term opportunities for many of these well managed companies remains undiminished. Where we have identified risk to the longer term prospects, which may be a reasonable conclusion for some companies given the possibility of changing behaviour once the corona virus outbreak is contained, the stock holding has been adjusted accordingly.

At times like these, when speculation rather than fundamentals drives markets, it is difficult to pinpoint the precise moment at which share prices bottom. However, many of our holdings have seen extreme price declines. So, given the strength of their balance sheets and management, together with in some cases business models which have recurring annuity-style (i.e. defensive) revenue streams, it seems possible that share price declines of 30%, 40%, 50% and more may be discounting a greater level of long term business interruption than may actually transpire. Make no mistake: earnings will be under significant and severe long term pressure, but our view is that over longer term time horizons the structural following winds and commitment to continuous growth in shareholder return which many of our investee companies have embraced will remain unchanged.

We acknowledge that the impact of the coronavirus is more global in nature, and has resulted in measures on a scale hitherto unseen. However, we remain mindful of the same climate of delirium that swept global markets when SARS struck in 2003. Research by SMBC shows that at that time share prices plunged as the number of daily reported cases continued to grow. However, once the first evidence emerged that the number of new cases of the virus had been contained in the areas most affected – Hong Kong, Singapore and Vietnam in the case of 2003 SARS – markets then bounced rapidly. The bottom line seems to be that as long as the spread of the virus is at some point contained, then pent up consumption and production eventually recover rather than disappear completely, and that shares that decline following a temporary drop-off in consumption and production subsequently rebound. Whilst we have not yet reached the point of containment of the daily number of Covid 19 reported cases , based on past pandemics it seems logical to assume:-

a) that at some point the spread should be contained,
b) thereafter markets will bounce sharply and - most importantly given our investment process-
c) that the future long term value of a well-run company in a growth industry or service is ultimately unaffected by the short term effect on earnings.

24 March 2020