

# Dalton Kizuna Fund

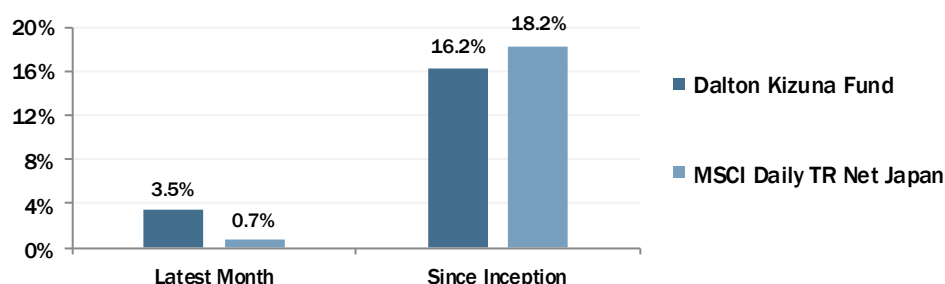
December 2017 Newsletter

## Fund Description

The Dalton Kizuna Fund is an equity fund that invests opportunistically in Japan. The Fund strives to buy shares in companies with good businesses run by management with a strong alignment of interest with shareholders, at prices that reflect a significant margin of safety to intrinsic value. The Fund is expected to be a highly concentrated portfolio (no more than 20 companies) of strong conviction ideas. In addition to performing onsite due diligence and rigorous fundamental analysis, the investment team engages in active collaboration with managements and directors of portfolio companies in order to encourage actions that will lead to revaluation in the equity market.

“Kizuna” is a traditional Japanese word meaning the strong bonds between people; we use the word to reflect our aspiration of pursuing greater good for all stakeholders through our investment practice.

## Fund Performance (Net of Fees)\*



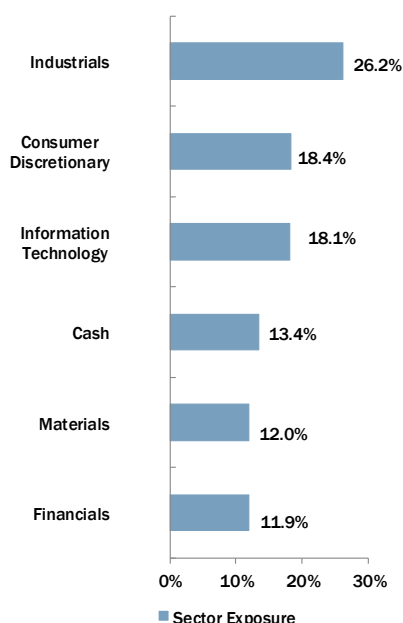
## MONTHLY PERFORMANCE (%) NET OF FEES\*

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	MSCI Japan
2017		-0.44%	1.28%	-2.06%	0.87%	1.47%	2.12%	0.95%	4.18%	3.43%	3.45%	16.17%	18.22%	

## TOP 5 LONG POSITIONS

Company	Sectors	% Equity
Plathome Co Ltd	Information Technology	11.9%
Shinsei Bank Ltd	Financials	9.1%
Kadokawa Dwango Corp	Consumer Discretionary	7.2%
Macnica Fuji Electronics	Information Technology	6.1%
Mitsubishi Heavy Industries Ltd	Industrials	4.7%

## SECTOR BREAKDOWN



## FUNDS AT A GLANCE AS OF DECEMBER 2017

Lead Portfolio Manager .....	James B. Rosenwald III
Investment Style.....	Concentrated Equity
Index.....	MSCI Daily TR Net Japan
Inception Date .....	Mar '17
Fund Assets (December 31).....	\$37 mil
Asian Equity Assets (December 31).....	\$3.5 bil**
Firm Assets (December 31).....	\$3.8bil
Net Asset Value/Share (December 31).....	\$1,161.65
Minimum Investment .....	\$1 mil
High Watermark .....	Yes
Structure.....	Master-Feeder
Administrator.....	Northern Trust
Custodian.....	Northern Trust
Auditor.....	PricewaterhouseCoopers
Liquidity.....	Annual (1-yr Lock-up)***
Management Fee.....	1.0%
Incentive Fee.....	20%

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\*Past performance is no guarantee of future results. All investments involve risk including the loss of principal. Please see final pages for performance disclosures.

\*\*Asian equity assets include all assets managed by James B. Rosenwald III, which include the assets from the Dalton Kizuna Fund, several other Pan-Asia and Japanese separate accounts and other products.

\*\*\*Liquidity terms are more restricted for hard-to-value or illiquid “special securities.” The manager has the authority to designate up to 10% of the fund in special securities, and these investments must be held to realization of investment. Please see fund documents for more information.

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## Commentary

### Performance Update

In the fourth quarter of 2017, the Dalton Kizuna Fund (“the Fund”) increased by +11.48% while the Index increased by +8.49%. Since Inception, the Fund has returned +16.17% (net of fees) while the Index returned +18.22%

### Portfolio Overview

During the latest quarter, we made a new investment in Taisei Oncho, a family-owned company that installs and maintains air conditioning and plumbing in large commercial buildings in Japan and abroad. Unlike major construction companies, maintenance and replacement are the main source of cash flow and that business is enjoying growing demand from renovating existing buildings, NOT new building construction. Renovation demand among buildings constructed during the bubble economy era remains huge. The company also has a strong overseas business - US (Hawaii), China, India, Philippines, and Vietnam - which accounts for 20% of total cash flow. The Mizutani family owns some 20% of the company; we have met with and were impressed by the third generation CEO for his sound crisis management skills and willingness to use new technologies to improve business processes.

We invested in the company when it was trading at 70% of its net cash value and generating highly stable cash flows. The current CEO has focused on restructuring the business since he assumed the position two years ago. We believe that he will allocate capital wisely and aspires to improve shareholder return going forward from its current 20% payout. We see significant upside in the company valuation.

In addition to establishing a position in Taisei Oncho, we added to existing positions in Shinsei Bank,

Kadokawa, and Tenma on stock price weakness.

The top two contributors for the quarter were Plat’ Home and C Uyemura. Plat’ Home, a leading supplier of the IoT (Internet of Things) gateway, continued to attract investor attention as a key beneficiary of “Edge Computing”. Since 2017, the company has benefited from more IoT projects heading towards full implementation than from its previous demonstration/experiment phase. C Uyemura, one of the global leaders in surface treatment chemicals for electronic parts, revised its performance forecast upwards for the current fiscal year. We continue to see significant upside in both companies from current prices.

The top two detractors for the quarter were Mitsubishi Heavy and Tenma. Underperformance of Mitsubishi Heavy, the largest producer of heavy machinery in Japan, reflects the market’s negative sentiment towards thermal power. Renewable energy has attracted significant attention globally as an environmentally responsible replacement for thermal energy. However, we believe that many countries will continue to rely on thermal power, particularly gas, as a source for base-load energy because of low costs. Mitsubishi Heavy has a strong franchise in countries/regions where thermal power will remain a base energy, such as Japan and Southeast Asia. Additionally, our confidence in the current management, who have been tackling a number of legacy issues, remains intact.

Tenma, a manufacturer of plastic household/industrial component products, announced a downward revision in earnings due to price hikes in naphtha/PP, additional expenses in the launch of their Indonesian factory, and lower-than expected sales in China. We are not concerned about the price hikes in naphtha/PP as Tenma’s furniture business has historically been profitable even with naphtha at twice

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today's price. We are comfortable with the underlying fundamentals in the South East Asia market. We took the opportunity to increase our positions on price weakness and will continue to work on engagement with management related to capital allocation - net cash on the balance sheet today accounts for 80% of market capitalization, resulting in a 80%+ equity ratio, implying lots of room for improvement on capital allocation.

### **Stock Highlight**

C Uyemura & Co. is one of the global leaders in surface treatment chemicals for electronic parts such as semiconductor devices and hard-disc drives. Over 60% of sales comes from overseas. The company has enjoyed its increasing dominance in the field supported by the following advantages:

- 1) Growth in total physical surface areas of semiconductor circuits
- 2) Company's technology, while crucial for the quality of customer products, makes up a very small portion of total production costs
- 3) Company's technology, its chemicals recipe, is easier to be made "black box" compared to the alternative of assembled products,
- 4) The worldwide customer market (for semiconductors) is geographically concentrated in nearby Asian regions

As a result, C Uyemura boasts a dominant presence in plating chemicals, accounting for 40% of the global nickel print circuits, 20% for gold plating, 50% of aluminum HDD, etc. The company has been recovering from the slump during the financial crisis with a rather stable 15% ROIC. The founder family owns some 25% of the company. Despite the robust business

model and the promising signs of performance recovery, the stock traded at a P/B ratio below 1.0 throughout 2016, as we were doing research and meeting with company executives and directors. We initiated our investment in January 2017.

We see significant potential for the company to generate value, including the opportunity to improve its capital allocation away from non-core businesses that do not appear to justify their "synergy" impact. C Uyemura's main business, the plating chemicals business, which employs about two thirds of the company's total assets, generates more than 100% of the total profit. Less successful businesses include manufacturing plating machines, chemical coating services, and real estate management. We estimate that simply divesting the real estate business would raise the company's ROIC by about 7 percentage points. It is less straightforward to assess further upside potential by removing other businesses, but it is worthwhile to compare the company's valuation to its peers in the plating chemicals industry, such as JCU Corp and Japan Pure Chemical, that have boasted around 50% ROIC compared with C Uyemura's 15%.

Since our initial investment about a year ago, Dalton has exchanged its views on this company with other asset managers with large stakes and sent out candid questions about the capital allocation and performance impact to management late last year. We are hopeful that the company will respond before too long, and we will thoughtfully consider our next steps in engaging with management.

### **"Dear Chairman" in Japan**

During this quarter, we accelerated our shareholder proposal projects, sending more than 10 letters to the boards of our portfolio companies. The agenda includes

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## Commentary

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business portfolio management, independent outside directors, dividend policy, buybacks, and stock compensation – all customized for each target. As opposed to making official public proposals immediately, we have opted for a less direct approach and which may not be public in many cases. Below is a description of Dalton's strategies in Japan related to engagement.

We have four native Japanese investment professionals based in Tokyo, and they start from bringing (not sending) letters with "DRAFT" marks on the top right, to their counterparts at portfolio companies - from IR managers to CEOs, depending on the circumstances. We explain the message face-to-face, listen to the personal opinions of our counterparts, and inform them the letter will be sent in the future. Such a process is very time and energy consuming, but we believe the approach gives our proposals a much better chance of being well received.

Japan is often described as a "Shame Culture" where people care deeply about what others in their organization think of them, much more so than say God or Buddha. Starting with a private dialogue with our counterparts signals our concern for their "shame", and the letter with "Draft" on the top right means we are open to improving the contents based on their feedback.

In fact, the proposals have been well received by our counterparts and have provided opportunities to dive deeper into the agenda beyond the typical IR meeting. Some middle managers were even excited as they viewed the proposal from outside shareholders as providing a tailwind to their own goals. We believe the evolution of Corporate Governance is a structural trend, but its transformation has to incorporate and include the shame mentality that has been passed down from

generation to generation and surfaces in many ways in corporate Japan.

We are NOT asking for company approval or censorship on our proposals which are ready to be submitted as open public proposals for Shareholder Meetings in 2018. However, our decision either to keep the proposals private or to go public depends on our judgement of the efficacy of either course of action, meaningfully informed by dialogue with our counterparts.

Lastly, we tend to wrap-up the early engagement projects by sending a gift – the Japanese edition of "The Outsiders" by Mr. William N. Thorndike - to portfolio companies. The book discusses CEOs with exceptional track records at capital allocation and was #1 on Warren Buffett's recommended reading list in the Berkshire Hathaway Annual Shareholder Letter in 2012. The ideas in the book are likely to be very unconventional to most Japanese CEOs, but, if they understand the philosophy and adopt some of the ideas from the book then I think we will have made a few long-term friends. In any case, we believe sending gifts rarely backfires.

## Outlook

The Goldilocks market continues to be supported by solid economic fundamentals (e.g. seven consecutive quarters of GDP growth, BOJ diffusion index at a 10-year high, job application ratio at a 43-year high), low interest rates and low volatility. Since the launch of the fund in March last year, our performance has suffered from holding significant amounts of cash while we slowly and carefully allocated capital and did our best to avoid cyclical businesses.

We do not know if we are heading towards a full-scale market bubble, or if risk taking behavior and the economy will stall out in the near future. What we do

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know is that global credit to corporates, real estate, and individuals, currently at historically peak levels and trading at tight spreads, is enlivening speculative spirits. Additionally, the boom in crypto currencies fueled by individual buying and emerging as an asset class reminds us of the days of the "Dot.com" bubble. (By the way, more than 40% of Bitcoin trading is accounted for by the Japanese).

With a sense of caution, we are staying focused on a limited number of opportunities to buy companies with entrepreneurial CEOs managing businesses with a (sometimes hidden) structural growth theme. It's always challenging to buy such companies with a sufficient margin of safety, but preservation of capital remains our top priority. We hope the portfolio provides you with stable and uncorrelated returns to your other investments and will grow substantially over the time. Thank you very much for your long-term support.

## Disclosure

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Returns present hypothetical performance (the “Hypothetical Returns”) for a hypothetical \$1,500,000.00 investment (the “Initial Investment”) made at the inception of the Fund (the “Hypothetical Investor”). The Gross-of-Fees Hypothetical Returns are calculated by applying the Fund’s actual cumulative gross-of-fee returns which include all trading expenses, withholding taxes, custodial fees (if applicable) and other administrative fees but exclude accruals and payments of all management and performance fees to the Hypothetical Investor’s Initial Investment. The Hypothetical Investor’s Returns assume no subscription or redemption and reinvestment of all dividend income. Net-of-Fees Hypothetical Returns are calculated, in reference to any applicable high water mark, by deducting a model 1% management and 20% performance fees (the “Model Fees”) from the Gross-of-Fees Hypothetical Returns. The Model Fees represent the current highest management and performance fee schedule of the Fund. Information regarding year to date and annual Performance Results is compounded. The Hypothetical Results shown do not represent the results of any actual investor in the Fund. Investment results for each investor will vary from the Hypothetical Results shown herein due to, among other factors, differing investment dates and additional contributions or withdrawals. Actual fees may differ due to various factors including, but not limited to, account size. Additional information regarding the Firm’s fees is available upon request and may also be found in Dalton Investments LLC’s Form ADV Part 2. Performance is expressed in US Dollars. To compute currency exchange rates, the Fund uses Bloomberg at 4PM EST close while the Benchmark uses WM Reuters at 4PM GMT close, which may result in differing exchange rates.

The Fund’s benchmark is the MSCI Daily Total Return Net Japan Index (MSCI Japan (USD), symbol: NDDUJN) (the “Benchmark”) and is compiled by Morgan Stanley Capital International, Inc. It is a total return, free float-adjusted, capitalization-weighted index that is designed to track the performance of Japanese securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. Net total return indices reinvest dividends after the deduction of withholding taxes, using (for international indices) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. For comparison purposes, Benchmark returns do not reflect transaction costs, investment management fees or other fees and expenses that would reduce performance in the Fund. It is not possible to invest in the Benchmark. The Fund has held and is expected to continue to hold securities that are not included in the Benchmark and the Firm makes no representations that the Fund is comparable to the Benchmark in composition or element of risk involved.