Aberdeen Smaller Companies Income

ASCI has outperformed over the current managers' tenure...

Update
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Summary

Aberdeen Smaller Companies Income (ASCI) trust aims to provide a high and growing dividend as well as capital growth by investing in UK small- and mid-caps. Managed by Abby Glennie and Amanda Yeaman, who draw on the resources of the wider Aberdeen Standard Investments' (ASI) UK equity team, ASCI's portfolio is comprised of companies which the managers believe are compelling long-term growth stories exhibiting operational momentum.

As discussed under **Portfolio**, ASCI is constructed utilising a mixture of quantitative and qualitative inputs. Abby and Amanda note that recent reporting updates from their holdings show increasingly optimistic signs, with companies beating expectations and upgrading their earnings outlooks.

The team also note the extensive **ESG** input to the investment process is helping them identify where growth opportunities are sustainable, and which areas are experiencing operational momentum. To further aid in this research, they have added an on-desk ESG analyst to the team over the past 12 months.

Abby and Amanda report that all constituent companies are now paying a dividend, despite the challenges that the uncertain macroeconomic backdrop of 2020 posed for revenue generation. ASCI currently has an historic yield of c. 2.4% (as at 07/06/2021); as discussed under **Dividend**, this is notably higher than the average from the AIC UK small-cap sector.

The dividend yield received by new shareholders at present is further boosted by the trust trading at a **Discount** of c. 12.8%, substantially wider than that seen across the sector as a whole. As we discuss under **Performance**, this is despite ASCI outperforming over Abby's tenure (with NAV total returns of c. 35.8% against a sector average of c. 25.3%).

Analysts:

Callum Stokeld
+ 44 (0) 203 795 9719

Analyst's View

ASCI's wide discount continues to look like a potential opportunity to us, and for this reason we continue to include ASCI in our **Discounted Opportunities Portfolio**. If the trust can resume the outperformance seen over the current management team's tenure (and we think the pick-up in performance from the most recent reporting season offers encouragement in this regard), then we believe the market may well re-evaluate this trust and this could potentially drive a further boost to returns from discount narrowing.

Retaining substantial revenue reserves, ASCI's dividend looks to us well placed to ride out any continued challenges to revenue generation from the uncertain macroeconomic backdrop. However, with all constituent companies now paying a dividend and the managers reporting strong operational updates from numerous holdings, we think this may in any event prove unnecessary. For income investors, whilst a headline historic yield of 2.4% may hold relatively limited attractions in an absolute sense, the relative yield premium to the small-cap sector and the potential to grow this further may change perceptions (as well as small- and mid-caps often having endogenous drivers of growth, and thus potentially offering diversification of revenue generation in a balanced portfolio). Although the dividend in FY 2020 was marginally lower, this cut seems to have been undertaken to ensure greater certainty of future income growth. With a wide discount further boosting the effective yield received by new buyers, we think this could be an attractive entry point.

BULL
Team's approach has long-term track record of success
Yield premium to sector with a dividend that looks well supported by revenue reserves
Discount is wide relative to peers and a potential opportunity

BEAR
Small level of assets may deter institutional investors (and prolong wide discount)
Gearing can exacerbate downside (as well as amplify upside)
Likely to lag in strong reflationary cyclical rallies, such as that seen in Q4 2020

Portfolio

Aberdeen Smaller Companies Income (ASCI) trust seeks to provide a high and growing dividend along with capital growth from investment principally in the shares of small- and mid-cap UK companies. Managed by the current team, led by Abby Glennie and Amanda Yeaman, since September 2018 (with Amanda joining in 2019 and appointed co-manager in November 2020), the trust uses the analytical research from across the broader Aberdeen Standard Investments UK equity team. Abby, Amanda, and the team utilise the same process as was brought over from the Standard Life Investments (SLI) UK equity team prior to the merger with Aberdeen Asset Management, with the bulk of the team arriving from SLI at this time. This same investment process has been utilised within Standard Life UK Smaller Companies (SLS) with great success over the longer term, though within ASCI it is combined with a focus on generating income. However, whilst ASCI has an income focus, the managers are primarily focussed on opportunities which can sustainably grow their income at attractive rates as opposed to seeking out solely the highest yielding companies.

This process remains unchanged by the turbulent market conditions and often violent rotations seen within equity markets over recent months. Abby and Amanda continue to head up a process which emphasises a collegiate approach and matches a mixture of quantitative and qualitative inputs to seek the most attractive growth opportunities in high quality companies, building a portfolio of between 40-70 stocks (currently 54). This analytical framework includes the ongoing use of the team's internal 'Matrix' system, a quantitative tool aggregating consensus market expectations for all companies within the investable universe. Using this tool, the team screen companies across 13 factor outputs split between Quality, Growth, Momentum and Value considerations. In doing so, Abby, Amanda, and the team are able to narrow a stock universe to around 300 companies.

From this narrowed universe, the team source ideas where further qualitative analysis is likely to be merited (though the scope of ASI's internal equity coverage is such that they have complete analyst coverage of the FTSE 350 index). The qualitative analysis aims to allow the team to more fully understand the quantitative output and provide further context to numbers surrounding companies. For example, operational momentum, with upgrades to earnings expectations and companies exceeding those expectations, is considered an important factor in both the quantitative and qualitative analysis. Where the former helps highlight companies where this is occurring, the qualitative analysis helps the team understand the degree to which this is arising from natural organic growth driven by strong management strategies, or whether less repeatable factors (such as tax rebates, for example) are at play.

Such growth and momentum factors are, along with a focus on identifying high quality companies, generally considered the key inputs to determining whether a stock is attractive or not. High quality management teams with strong track records of executing strategies and delivering strong returns on capital are particularly desired, whilst the team seek to exclude companies with weak balance sheets (noting that a strong balance sheet typically affords management greater operational flexibility to drive growth in the business). The team similarly prefer to avoid companies where returns are overly exposed to economic cyclicality or which are currently loss-making, preferring high margin businesses with high barriers to entry. Abby, Amanda, and the team conduct numerous ongoing meetings with company managements to ensure business strategy execution remains on track.

Typically, such companies are well placed to pass on costs to end consumers, which the team note is helping in the current reporting season. Within ASCI's portfolio, they are seeing numerous holdings outperforming relative to expectations in the most recent reporting season. Although there is a general preference for more capital light business models, the portfolio's constituent companies are not immune to rising input price pressures (such as elevated freight costs); however, in most cases they are able to pass these costs on. In other instances, such as relatively recent purchase Forterra (the UK's second largest brickmaker), the company is presently absorbing pressure from higher input costs from rising costs of raw materials in the interests of maintaining and further building business relationships and ultimately growing market share. The strong financial position of the company means they are well placed to absorb such short-term pricing pressures.

Forterra itself is seeing strong growth in demand as housing construction accelerates. Abby and Amanda seek to ensure all holdings are themselves delivering sustainable growth. The preference is typically that this growth be organic and where free cash flow generation within the business is sufficient to cover any necessary reinvestment into the business. However, we understand the team have also participated in some equity raises in the past 12 months where they could identify this as a catalyst for potential growth. This could be seen in Hollywood Bowl, for example, where an equity raise improved the financial strength of the company and should, in their view, leave it well placed to take further market share as lockdown policies are eased. However, the team remain cognisant of the risk of overpaying for growth, and continue to utilise value inputs to the quantitative and qualitative process. These are, in general, utilised with a view more to judging market level assessments of growth prospects relative to their own, as opposed to being an exercise in trawling for the 'cheapest' companies. As a result, on a look-through basis we would expect that ASCI will typically trade at a slight valuation premium to the wider market, but is also likely to display a premium level of growth.

As well as long-run growth companies, Abby and Amanda look for those with positive operational momentum.

They note that in April 2021 in particular they started to see stock-specific developments playing an increasingly greater role in portfolio returns when compared with recent, highly factor and macroeconomic driven, months. Notably, they are identifying that stocks strongly aligned with their ESG input are often exhibiting particularly strong operational momentum. Some of these plays are relatively direct, such as asset managers Liontrust and Impax, both of whom are seeing strong growth in their ESG franchises. In Impax's case, Abby and Amanda note that the company has recently passed the three-year anniversary for some of its products in the US market, and that they see this market as likely to be a strong driver of growth going forward.

Portfolio Metrics Relative To Benchmark

METRIC	ASCI	BENCHMARK
Return on Equity (5 Year)	24.06	11.1
Operating Margin	20.88	8.1
Net Margin	14.12	1.88
Debt/Equity	0.66	2.83

Source: Aberdeen Standard Investments, as at 31/05/2021

The focus on sustainable growth in the team's analytical process had historically leant itself relatively strongly to ESG alignment in any event. However, this has become increasingly formalised in recent years and the team have in the past 12 months added an on-desk ESG specialist. This new team member adds to the deep ESG resources of ASI. Increasingly, Abby and Amanda are observing that the ESG analytical input is helping to drive idea generation in a UK market that they view as generally attractively valued in any case (when compared to international peers).

Although the team continue to identify new ideas, they remain keen to keep the portfolio relatively lean and focussed on their 'best ideas'. Abby and Amanda tell us that all portfolio holdings are, at present, paying dividends, though they have also added names where they believe they are likely to see particularly attractive revenue streams (such as the Mortgage Advice Bureau and Synthomer). These names still, however, retain growth potential in their view.

Whilst most ideas originate in the small-cap space, Abby and Amanda are happy to 'run their winners', and this often sees them retain long-standing holdings as they migrate up the market-cap spectrum. Abby and Amanda's preference for 'running their winners', is also reflected somewhat in the top ten holdings where nearer term returns in particular have tended (though not universally) to be stronger in larger positions (as we can see in the table below).

Top Ten Holdings And Historic Performance

HOLDING	%	SIX MONTH RETURNS	12 MONTH RETURNS
Morgan Sindall	4.1	115.3	95.2
Liontrust Asset Management	3.8	30.5	53.1
DiscoverIE	3.6	36.2	62.9
Intermediate Capital Group	3.6	88.6	109.5
Softcat	3.5	74.7	75.0
Games Workshop	3.3	5.7	85.2
Sirius Real Estate	3.2	40.6	55.1
XP Power	2.7	28.5	68.2
Assura	2.7	-0.6	0.8
Unite	2.7	41.1	41.6

Source: Aberdeen Standard Investments, Financial Express Analytics, as at 30/04/2021

Please note that past performance is not a reliable guide to future returns

Gearing

ASCI had net gearing of c. 4% as at 01/06/2021. Gearing is undertaken through a £5m five-year fixed rate loan and a £5m three-year variable rate loan; the latter expired in April 2021 but has been renewed. The total £10m gearing capacity equates to c. 11.3% of current net assets.

Gearing is primarily employed with the aim to enhance income generation and has historically been invested in a mixture of fixed income securities and preference shares. Under the current management team, the preference shares have been exited, but the team retain some small exposure (c. 2.1% of NAV) to fixed income. Gearing is, in total, constrained to c. 25% of net assets, with a further proviso that gearing on the equity portfolio will not exceed 10% at the point of instigation.

The management team prefer to run the portfolio fully invested and as such, fluctuations in the gearing ratio are more likely to reflect changes in the overall value of the portfolio. However, the deployment of gearing is more likely to be undertaken to boost the income, and not with a view to trying to opportunistically time adjustments in net exposure to reflect a broader market outlook.

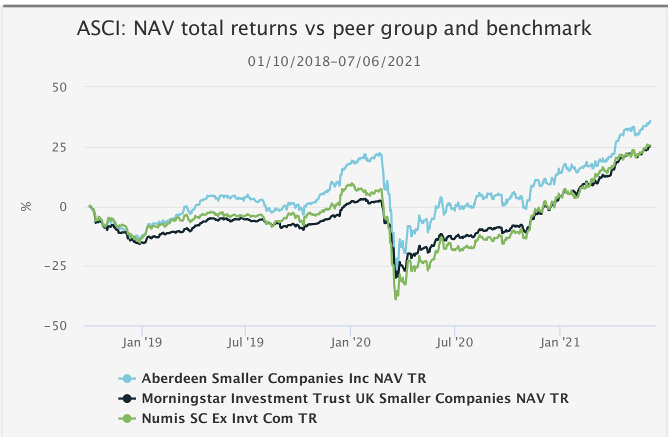
Performance

Abby Glennie was appointed manager of ASCI in September 2018. From 01/10/2018-07/06/2021, ASCI has produced NAV and share price total returns of c. 35.8%

and c. 44.8% respectively. This represents outperformance of the broader unweighted Morningstar UK Smaller Companies peer group on both an NAV and share price total return basis (with a peer group average NAV and share price return of c. 25.3% and c. 29.7% respectively over this period). It also represents outperformance relative to the benchmark Numis Smaller Companies ex-Investment Trusts index over this period, with the index returning 25.5%. Prior to 2020, the trust was benchmarked against the FTSE Small-Cap Ex-Investment Companies Index; we estimate that the composite benchmark (using the FTSE index until 01/01/2020 and Numis thereafter) would have returned c. 19.5% over this period.

As we can see below, ASCI has been ahead of the peer group and benchmark for much of this period, but more recent returns have proven more challenging on a relative basis (though ASCI has continued to generate strong NAV gains). April 2021 saw relative returns picking up once again, and the managers tell us this coincided with constituent companies reporting positive earnings surprises and beating market expectations.

Fig.1: Cumulative Nav Total Returns Vs Peers And Benchmark



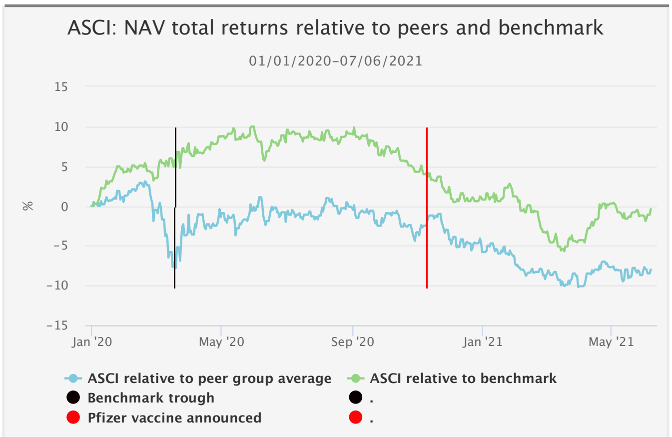
Source: Morningstar

Past performance is not a reliable guide of future returns

We attribute this in part to stylistic considerations, with a very sharp 'value' rally in recent months. Abby and Amanda note that 2020 was very much a year of two halves with regard to performance, with ASCI having outperformed the benchmark in protecting the downside and then during much of the initial market rally after the immediate bounce back, before lagging in H2 2020. However, the more liquid nature of many of ASCI's holdings (with its tendency to tilt towards the mid-cap space) proved detrimental relative to peers, as the generalised nature of the initial sell-off saw many investors realising their most liquid shares in the initial panic.

Relative to the benchmark, however, the emphasis on quality metrics and strong balance sheets proved a tailwind against a highly uncertain macroeconomic backdrop in the initial drawdown, whilst many portfolio companies saw growth trajectories catalysed by the lockdown policies initiated in response to the COVID-19 pandemic. As greater likelihood of a return to 'normality' began to be factored into the market, many 'old economy' companies which had previously lagged started to outperform, to ASCI's detriment (as demonstrated in the graphic below, with the announcement of the first Pfizer vaccine highlighted).

Fig.2: Nav Total Returns Relative To Benchmark And Peers



Source: Morningstar

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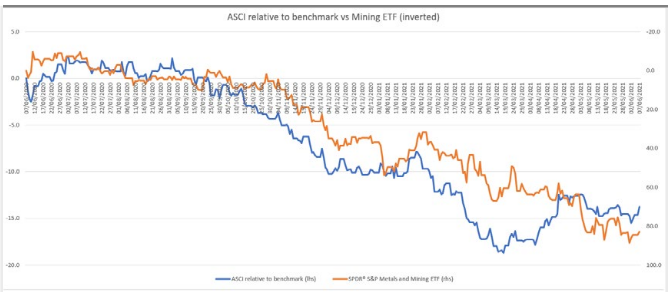
Many of the companies which rallied strongest in this most recent period include highly cyclical businesses such as mining companies, which do not tend to meet the qualitative criteria of the team. This relationship is more incidental and an output of the process but, when we look at the relative performance of ASCI to the benchmark over the past 12 months against the absolute returns of a mining ETF (inverted), we think it serves to illustrate the strong stylistic headwind the trust has faced over

Fig.3: Nav Returns Relative To Benchmark Vs Mining Etf (Inverted)



Source: Morningstar

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this period as a result of the substantial rally in more economically cyclical parts of the market. Ultimately, the team prefer to see company specific factors driving returns rather than trying to position the portfolio to capture short-term variations in the economic cycle, and the recent improvement in relative returns has largely been driven, we understand, by positive reporting from constituent companies.

Over the previous five years to 07/06/2021, ASCI delivered NAV and share price total returns of c. 93.6% and c. 111.6% respectively. This represents significant outperformance of the peer group average (NAV and share price total returns of c. 74.5% and c. 88.9% respectively), and of the Numis index (c. 60.1%).

Dividend

ASCI presently yields c. 2.4% on an historic basis (as at 07/06/2021), paying quarterly dividends in January, April, July and October. This is a premium level of yield compared to the peer group, which has an unweighted average historic yield of c. 1.9% (as at 07/06/2021), many of the constituents of which will likely face challenges in maintaining or growing these historic yields given the challenging market backdrop. The yield received by investors is, at present, boosted by the substantial discount the trust currently trades at.

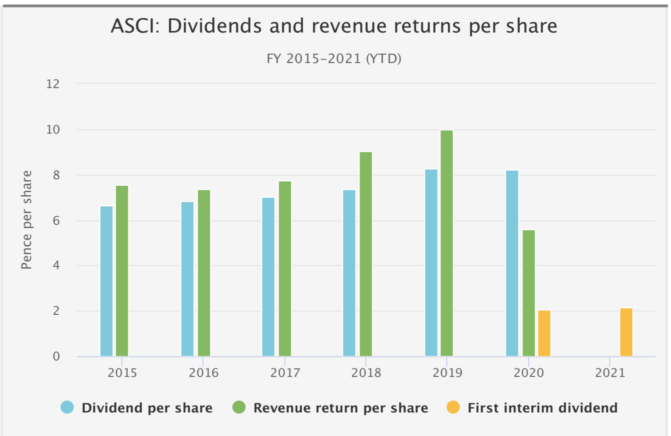
The trust targets a mixture of income generation and income growth, as well as capital growth. Between financial years 2015-2020, ASCI generated annualised dividend growth of c. 4.4% p.a.

Having previously grown the dividend every year since 2011, the board opted to distribute a slightly lower dividend in financial year (FY) 2020 as compared to FY 2019. The total dividends of 8.24p per share over the calendar year were, however, only 0.12% lower than the previous year's dividend, with the board aiming to at least broadly match the dividends. As the board noted, this came against a challenging market backdrop, with a raft of dividend suspensions, reductions and cancellations within the UK market. The board had accrued revenue reserves in previous years.

With revenue returns having fallen by c. 44% over the financial year (broadly in line with Link Group's estimate for the overall fall in UK dividends over the same year), unsurprisingly the board had to access the trust's revenue reserves to support the dividend. Revenue reserves at the end of FY 2020 (31/12/2020) amounted to c. £2.9m, compared to c. £3.6m at the same point the previous year. This, nonetheless, remained a revenue reserve cover of c. 1.61x the FY 2020 dividend.

Subsequently, ASCI has paid a first interim dividend of 2.15p per share, a 4.4% increase on the first interim dividend in FY 2020. After accounting for this, and for the reported differences in the ex and cum-income reported NAV values (as at 07/06/2021), we estimate that ASCI retains revenue reserve cover of c. 1.46x the FY 2020 dividend. This, combined with a supportive board willing to deploy revenue reserves, should, we think, afford the management team greater flexibility to seek what they deem to be the best opportunities for total return and which can generate long-term income growth. Whilst the managers are focussed on opportunities for growing dividends, they nonetheless note that all of their constituent companies at present are currently paying dividends. The portfolio has also benefitted from two special dividends from underlying companies in the current financial year.

Fig.4: Dividend Per Share And Revenue Return Per Share



Source: Aberdeen Standard Investments

Past performance is not a reliable guide to future returns

Management

ASCI is managed by Abby Glennie and Amanda Yeaman, who are two of three UK small-cap managers on the Aberdeen Standard Investments small-cap team which took control of the portfolio in September 2018. They are further supported by Harry Nimmo, who has had a great deal of success in the UK smaller companies space, including with **Standard Life UK Smaller Companies (SLS)**. Abby was also, in 2020, appointed co-manager on SLS and the open-ended ASI UK Smaller Companies OEIC.

Amanda was appointed as co-manager of ASCI last year in recognition of her heavy involvement and contribution to the portfolio in the last couple of years. There are also two European analysts/portfolio managers on the smaller companies team, and three managers analysing other global smaller companies. The team have also in recent months introduced an on-desk ESG specialist, and also have access to the wider ASI ESG team.

The team use their proprietary Matrix screening system, which is overseen by a dedicated senior quantitative analyst. The team run a variety of strategies in UK small caps overseeing considerable AUM, which gives the managers excellent contact with management teams both of prospective holdings and current ones (the team meet twice a year with the companies they own).

Discount

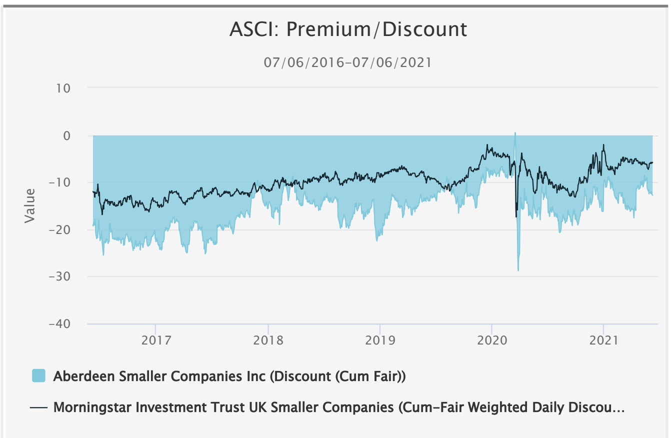
ASCI is currently trading on a discount of c. 12.8% (as at 07/06/2021). As can be seen in the graph below, this is not an anomalous discount level when we look at the previous five years (where we have seen an average discount of -15.9%). However, the discount had previously narrowed over the latter part of 2019 on renewed optimism around the UK market. At this time, there was generally increasing optimism that the UK was embarking on a path of greater political certainty than had been present in the previous few years, and this had generally benefitted UK assets and particularly those, such as UK smaller companies, perceived as more sensitive to the UK domestic economy.

Discounts across the sector have again started to narrow in recent months as optimism has again risen in the UK market. Whilst ASCI's discount has narrowed since Q3 2020, it remains wider than that of the peer group, and has not benefitted to the same degree as the peer group as a whole over this period. Share price gains in ASCI have lagged NAV gains thus far in 2021 (to 07/06/2021), causing the discount to widen slightly. This was particularly true across much of February and March, where steady NAV gains were not matched by any significant move in the share price.

Amongst ASCI's peers is SLS, which is run with essentially the same investment process, and this can be seen in that the two trusts have displayed a median 12-month R2 of 0.92 to 31/05/2021 since the current team took over management of ASCI in September 2018. Over the longer term we believe that a market recognition of the significant stock, style, process, and analytical overlap between the two trusts could see their divergent discounts start to converge, and for this reason we include ASCI in our **Discounted Opportunities Portfolio**. SLS currently has a discount of c. 5.3%, and we believe convergence to a similar level can occur within ASCI.

The board has the authority to repurchase up to 14.99% of ASCI's issued share capital; however, given the relatively small size of the trust, it seems unlikely to us that the board would regard it as in shareholders' interests to conduct extensive buyback activity. There have been no share buybacks or issuance in the current financial year (since 01/01/2021), nor has there been any in recent years. Approximately 33% of shares in issue are held across ASI and the ASI Investment trust savings plans.

Fig.5: Discount/Premium



Source: Morningstar

Charges

ASCI has an OCF of 1.25%, compared to an unweighted average of 1.07% for the UK smaller companies sector (Source: JPMorgan Cazenove). It is worth noting that this is the weighted average in a sector where the average market cap is c. £397.6m at the time of writing, significantly in excess of the c. £79m of ASCI. Larger scale reduces the relative impact of certain, relatively fixed costs, with a greater proportional impact on smaller trusts such as ASCI. The management fee is charged at 0.75% p.a. of net assets. Management fees and the cost of debt are charged to capital (70%) and to revenue (30%), which boosts the income available to be distributed as a dividend compared to charging solely against revenue.

The KID RIY for the trust is 1.98%, in excess of the unweighted sector average of 1.89%. We would caution that calculation methodologies can vary between companies.

ESG

In recent years we understand that the team behind ASCI have increasingly looked to formalise the incorporation of ESG considerations into the stock analytical process. Previously, the investment process had in any event favoured many characteristics usually seen in companies with strong ESG characteristics, such as sustainable growth trajectories and superior corporate governance practices. However, now these are embedded and ESG analysis is incorporated as a structural part of each analyst's company notes.

Both quantitative and qualitative inputs are used on assessing ESG, and the team have recourse to the work of dedicated ESG analysts within the ASI UK equity team. These ESG analysts meet regularly with company management teams, independent of the broader equity analyst teams. In doing so, they are looking to assess and monitor how ESG issues are impacting upon business models, both at the individual company level and across the wider industry. As discussed under **Management**, the team have recently added a further on-desk ESG analyst to further their resource in this area. In addition to on-desk ESG specialists, Abby and Amanda have access to a wider team across ASI of over 50 ESG investment professionals.

The managers tell us that, not only do ESG considerations tie in with characteristics they qualitatively seek out in companies, but that they are increasingly finding ESG related matters to be drivers of operational momentum. A fairly direct example is their position in asset manager Impax, a market leader in ESG and positive-change investment. The team note that their existing presence in the US market offers significant potential should the US market start to catch-up to the UK and European markets on incorporation of ESG strategies.

In terms of the output from the investment process, ASCI currently scores 'above average' on Morningstar Sustainalytics. We think there is strong alignment with ESG-aligned outcomes in the investment process, and that the trust is likely to suit most ESG-conscious investors.

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