Kepler Trust Intelligence

Edinburgh Dragon

Update
12 August 2019

Summary

Edinburgh Dragon (EFM) aims to generate long-term capital returns by investing in Asia Pacific ex-Japan equities, with a focus on quality growth characteristics and a secondary focus on starting valuations. The management team, headed by Adrian Lim, aims to select world-class Asian companies with strong balance sheets that are transforming their sector and setting governance standards.

The trust's net asset value of £583m is the second largest in the AIC Asia Pacific peer group and makes it one of only two trusts over £500m. Aberdeen Standard's 50 fund managers based in the region give it a broad research base and good access to companies.

The trust has performed very strongly over the past year following a series of refinements to the process and portfolio. NAV total returns of 12.9% compare to just 7.1% from the average trust in the Morningstar IT Asia Pacific ex-Japan sector and 3.8% from the MSCI AC Asia ex-Japan index. This is the second-best return in the 13-trust sector over the period, narrowly behind its stablemate Aberdeen New Dawn.

The refinements to the process have centred on making the team quicker to spot problems in portfolio companies, but the intention is to continue to be long-term in outlook and Morningstar data show a turnover consistent with a five-year holding period. The trust has increased its weighting to technology, however, and narrowed its underweight to China. It maintains strong overweights to India and Indonesia, and a focus on quality characteristics that served it well in the 2018 global sell-off.

Despite the improved recent performance, the portfolio continues to trade on a wider discount than the sector average: 10.8% compared to the 6.1% peer group average. A tender offer in January was oversubscribed and the board continues to be active in employing buybacks.

Dividends have grown steadily over the past five years, with compound growth of 16%. The dividends are fully covered and reserves are over three times the payout, although the focus is on total returns and so the yield is only 1%.

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Portfolio

The management team, headed by Adrian Lim pursue an approach which is rigorously bottom-up, with the intention of being a long-term buy-and-hold investor in companies selected for their attractive fundamental characteristics. According to Morningstar data, the average turnover in the past three completed calendar years has been 18.2%, consistent with a five-year holding period. This is despite more activity than normal since 2015 thanks to some substantial changes made to the portfolio, as discussed below. The team places great importance on ESG considerations and takes an active approach to improve corporate governance and unlock value to investors. The team is willing to build a portfolio very different to the index, which in recent years has meant taking significant country bets relative to the benchmark. Most notably this has led to a structural underweight to China and overweight to India. These are outputs of where the stock specific opportunities are rather than macro calls on the countries, however.

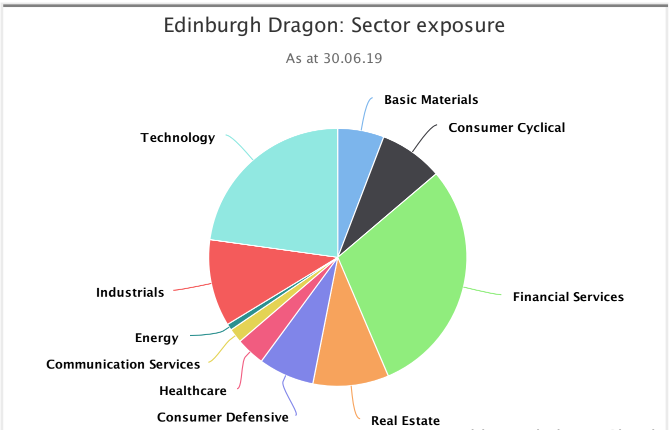
Recent strong results (see performance section) reflect the success of a series of refinements made to the investment process following a poor year in 2015. Although Adrian Lim has ultimate responsibility for this portfolio, there is a collaborative, team-based approach to stock selection. Aberdeen Standard has 37 analysts based in Asia working on Asia Pacific ex-Japan portfolios, including 14 based in Singapore alongside Adrian. The aim is to gain consensus on all stock buys and sells, and be long-term with their investments. However, the team decided they had been slow to sell out of some companies when a change in their fortunes was already evident, the most notable being Standard Chartered. As a result, they have created sector-specialist groups in the analyst team to aid international comparison (rather than specialising by country). This creates more accountability for individual stock picks and is more appropriate for an increasingly globalised investment universe. They have also assigned certain significant holdings to an analyst in a 'Bull' and 'Bear' role in order to focus discussion and help uncover problems with holdings sooner rather than later. This process is implemented for companies where the team feels the need to more vigorously test the investment hypotheses.

There has also been a greater embedding of ESG analysis into the process; dedicated ESG analysts have been taken on in each regional equity team. This aims at integrating ESG risk assessments into the stock selection process, which should help ensure the team is not blindsided by reputational or governance issues.

Meanwhile, they have also increased the weighting to information technology, which the team believes is one of the key growth areas in the future and one they were too little exposed to in the past. Here Tencent is the key holding, added in the middle of 2017. Previously the managers were concerned about its corporate structure, but they have become more comfortable with the treatment of minority shareholders. However, the trust has not bought Alibaba or Baidu, with one of the key reasons being continuing corporate governance concerns. In both cases, the concerns include issues surrounding the quality of the business model and of their capital allocation decisions.

Notwithstanding this, the weighting to technology has risen from around 10% of the trust at the end of 2015 to around 23%. As the sector has become more mature, the team finds it easier to get comfortable with the stocks. Their process prizes being able to see how companies have performed in previous down markets, and so tends to overlook companies that are new to public markets. Financial services remains the largest sector exposure and a slight overweight, although the allocation has come down over the past two years. The trust is underweight energy and materials, but does have holdings in these sectors unlike some of its peers.

Fig.1: Sector Allocation

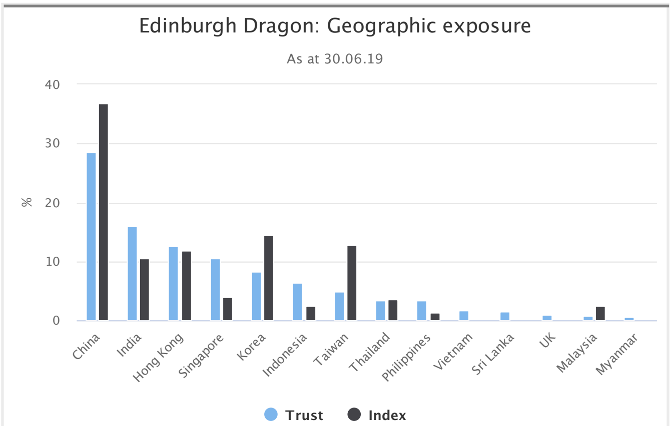


Source: Morningstar

One relatively new addition to the financials portfolio is Ping An, which the team is particularly excited about, believing it to be a 10 to 15-year opportunity. The insurer serves China's growing middle class, which is increasingly demanding sophisticated financial products, and Aberdeen's Asian equity team rates the management highly. The stock is a 3.1% position, having been built up slowly given the higher valuations it was on when initiated. Adrian stresses that Chinese stocks such as Ping An are high-conviction holdings, even though the headline allocation to China is an underweight.

On a country basis, the changes to the portfolio since 2015 have been highly significant. The weighting to China has increased from 5% in 2014 to 29%, with new investments made in the onshore China A-Shares market. Picks here have included China International Travel Services, Hangzhou Hikvision and Kweichou Moutai. The team continues to avoid state-owned enterprises on corporate governance grounds, preferring to invest in privately owned companies with exposure to the Chinese consumer story.

Fig.2: Geographic Allocation



Source: Morningstar

Much of this has come from the company's Singapore and Hong Kong holdings, which were sold down on valuation grounds. However, Adrian has taken some profits on A-Shares this year after their strong run and reinvested in the higher-conviction positions such as Tencent and Ping An. The result has been a portfolio slightly more highly concentrated in the top ten, with these holdings accounting for 37% at the end of June compared to 35% at the end of January. The current average for the AIC Asia Pacific sector is 33%, according to Morningstar.

Top Ten, As At 30 June

COMPANY	COUNTRY	%
Tencent	China	6.3
Samsung Electronics (Pref)	Korea	5.6
TSMC	Taiwan	4.0
AIA	Hong Kong	3.4
Housing Development Finance	India	3.2
Ping An Insurance	China	3.1
Overseas-Chinese Banking Corp.	Singapore	2.9
CITS	China	2.9
Bank Central Asia	Indonesia	2.7
Jardine Strategic	Hong Kong	2.5
TOTAL		**36.6**

Source: Aberdeen Standard

New positions are brought in gradually, with the company generally opening with positions of 50 to 80 basis points. Usually the trust will enter at 1% and then bring the position up in 1% increments, but with the riskier nature of some of the stocks bought in recent years and the gearing on the trust, the managers believe it makes sense to be more cautious.

Overall, Adrian and the team are highly positive about the opportunities in Asia over the long term, thanks to the young population and growing middle class. China in particular looks interesting thanks to the huge volume of reforms in recent years that have helped the 'new economy' of consumer services and technology to mature rapidly. Adrian believes the current portfolio effectively captures the opportunities in this area. They think India also looks exciting, with real steps made to reduce the impact of corruption in the economy. The trust also has a significant overweight to Indonesia, which the management team believes has a reformist government and significant under-utilised capacity in the economy. They like the banks as a way to play this, owning Bank Central Asia and Bank Rakyat. Despite the ongoing concerns about the trade war between the US and China, Adrian says the team sees no reasons for concern on a bottom-up level about portfolio companies' earnings, and have little exposure to exporters which would be directly impacted anyway. In fact, the trust's major holding, Samsung Electronics, could be an indirect beneficiary as a competitor for Huawei.

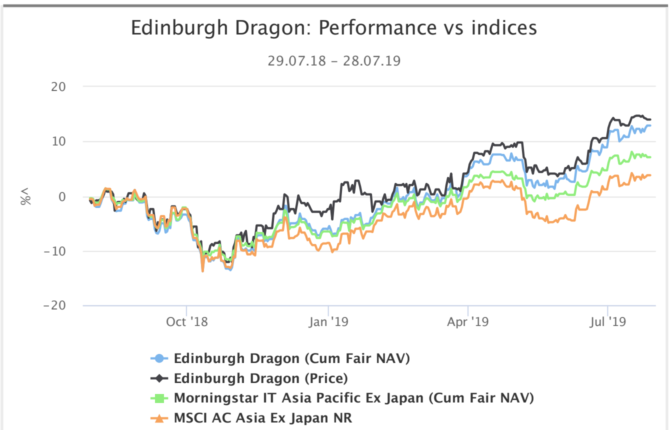
Gearing

The company has £50m of gearing facilities at its disposal, worth 8.2% of NAV in total. Half is structural gearing, having been fixed on 30 July 2019 for three years at a rate of 1.61%. The remainder is a multi-currency revolving credit facility, of which £6m has been drawn down. The trust is therefore 5.1% geared, notwithstanding any cash position, which was 1.1% as of the end of June. The board believes that modest gearing should enhance returns to shareholders. On a net basis, according to Morningstar data, gearing has been below 5% since August 2017.

Performance

Performance in the past year has been particularly strong, with the trust up 12.9% in NAV total return terms, compared to just 7.1% from the average trust in the Morningstar IT Asia Pacific ex-Japan sector and 3.8% from the MSCI AC Asia ex-Japan index. This is the second-best return in the 13-trust sector over the period, narrowly behind its stablemate Aberdeen New Dawn.

Fig.3: One-Year Performance

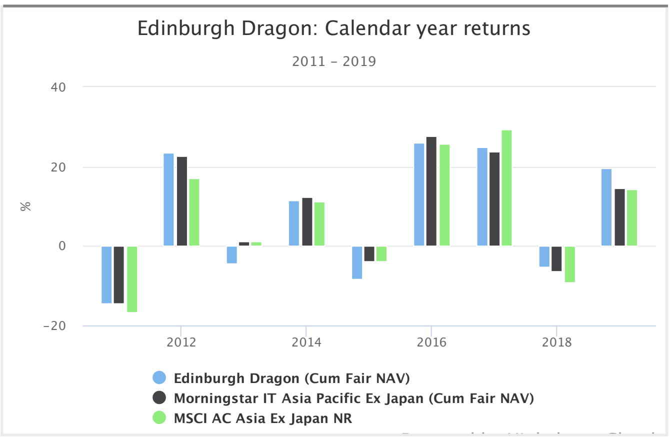


Source: Morningstar

The focus on quality stocks helped the company to outperform in the second half of 2018, while the structural underweight to China also helped. That market sold off after leading the 2016/2017 bull market. The trust has also benefited from its significant overweights to India and Indonesia. Both countries had elections won by their respective market-friendly candidate. While China is an underweight position, it still makes up 28.5% of the portfolio. The trust has benefited from its holdings in China, having limited exposure to the US/ China trade war but being more exposed to the domestic demand story. Tencent, the largest position in the trust at 6.3%, is a prime example. The export stories tend to be in more competitive markets with lower barriers to entry, and therefore don't fit in with the EFM's strategy.

The good results over the past year represent a return to form for the trust, which had a poor 2015 thanks to the collapse in the oil price and poor results from Standard Chartered and HSBC, as well as an overweight to Singapore. It then lagged the market slightly in the strong bull market of 2016 and 2017 thanks to its more defensive, quality positioning and underweight to China.

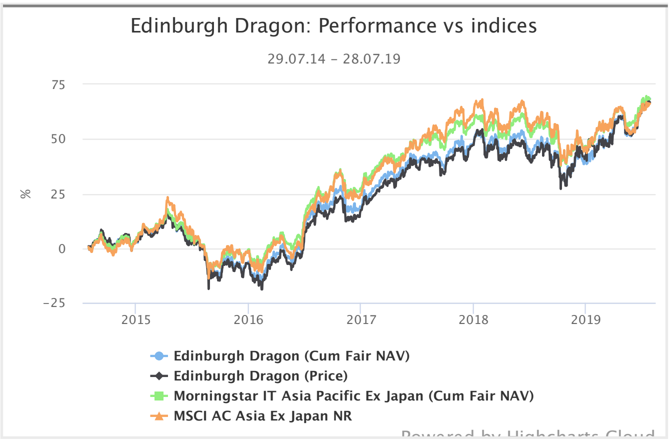
Fig.4: Returns



Source: Morningstar

Despite this rough patch, the trust has now marginally outperformed over five years, with NAV total returns of 68.5% compared to 66.2% for the MSC AC Asia ex-Japan index.

Fig.5: Five-Year Performance

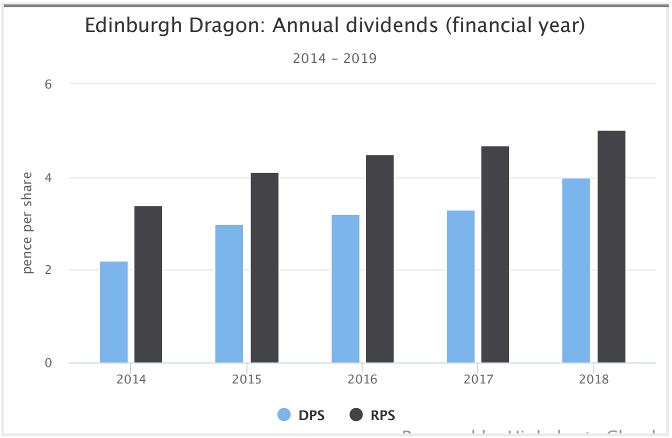


Source: Morningstar

Dividend

Although there is no explicit progressive dividend policy, in practice dividends have grown steadily over recent years, with the five-year dividend growth being 16% p.a. The board's policy is to pay a dividend marginally in excess of the minimum required to maintain investment trust status, which is an 85% payout ratio. The dividend has been fully covered in each of the past five years and the trust has revenue reserves of more than three times last year's dividend.

Fig.6: Dividends



Source: Morningstar

The objective of the trust is to maximise total returns though, so the income is a derivative, and the quality focus of the trust means that its portfolio tends to have a lower running yield than the market – it is currently 1%.

Management

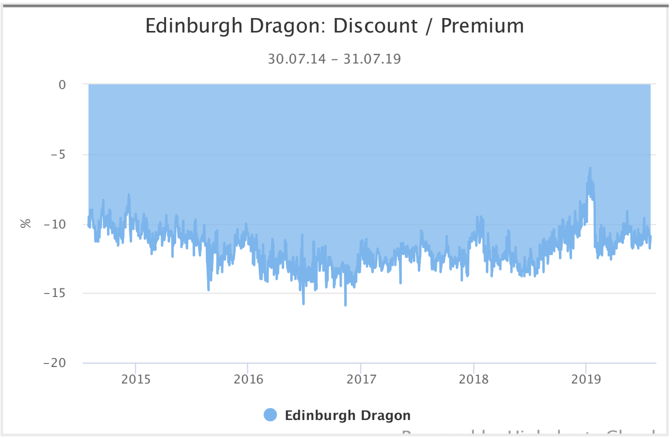
Adrian Lim manages this trust out of Singapore. Adrian has been with Aberdeen since 2000 and is therefore well steeped in the company's quality-led approach. Although Adrian is ultimately responsible for buy and sell decisions for the trust, Aberdeen takes a team-based approach to its portfolios, with the Asia Pacific equities team working together to build consensus views on stocks. Flavia Cheong heads up the Asia Pacific equities team, which includes 50 equity fund managers. In total 20 of these managers, including Adrian, are based in Singapore, where the team includes three dedicated ESG professionals.

The merger with Standard Life Investments in 2017 has not affected management of the trust. The Asian equities team remains in place from Aberdeen, with Aberdeen's strength in this region complementing SLI's greater UK capabilities. Devan Kaloo remains head of equities at the merged entity.

Discount

The trust trades on the widest discount in the AIC's new Asia Pacific sector, at 10.8%, which is significantly wider than the 6.1% average. This is despite the improved performance over the past 12 months, which has led the trust to be the second-best performer out of 13 in the sector over that time. The discount is in line with the 10% to 14% band typical of the past three years.

Fig.7: Discount



Source: Morningstar

The company survived a continuation vote in December 2018, having agreed to conduct a tender offer for 30% of the company, at 2% below NAV less costs, which was oversubscribed. Under the offer, 60.5% of the company's shares were tendered. Although not all of the excess shares tendered were repurchased, 17% were, with 13% remaining in shareholders' hands. After the tender offer, the trust is still of considerable size: net assets are £611m. We note that City of London, which is known for looking to purchase trusts on a discount and find ways to realise the value, still owns roughly 20% of the share capital.

The board has an active buyback policy and is in the market frequently to support the share price.

Charges

The OCF is 0.8%, below the AIC Asia Pacific sector average, and down from 1.03% in 2017 thanks to a substantial cut to the management fee. This fee is now charged as 0.85% on the first £350m of net assets and 0.5% thereafter. There is no performance fee. The KID RIY figure is 1.59%, close to the sector average of 1.39%, although calculation methodologies can vary.

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