Aberdeen Smaller Companies Income

ASCI offers investors both capital appreciation and income from a portfolio of high-quality UK smaller companies...

Update
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Summary

Aberdeen Smaller Companies Income Trust (ASCI) offers investors a chance to access the growth potential of UK smaller companies, whilst enjoying a diversified source of income.

After Aberdeen Asset Management and Standard Life merged, the trust was overhauled by the former Standard Life UK smaller companies team in 2018. Abby Glennie took over the portfolio, incorporating the proprietary screening system (known as the Matrix) developed within Standard Life Investments prior to the merger.

As Abby only took over the portfolio in September 2018, we think it is still early to fairly judge performance. However, signs so far are promising, and the process is based on the approach tried and tested over the long term by Standard Life Smaller Companies Trust (SLS). SLS is run by the renowned manager Harry Nimmo, who also supports Abby with ASCI's portfolio. Alongside capital growth, a key focus for the ASCI team is generating an income for investors, and the yield is currently 3.9%. The most recent full-year dividend was increased by 12.2% from the prior year, and was fully covered by reserves.

The discount narrowed over 2019, likely due to the strong performance relative to peers and continued attractive levels of income. However, the coronavirus pandemic has seen the discount slip to 25.2%.

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Analyst's View

The new team has brought a breath of fresh air to the trust (which was previously part of the Aberdeen stable) since taking over in 2018. We think the distinctive approach, using proprietary screens, allows Abby to be objective and have fewer external biases or influences impacting her investment decisions. The move to focussing on higher-quality companies could also benefit investors during the difficult environment caused by the coronavirus. Although to long-term investors of ASCI this is a totally new approach, it has been tried and tested on Harry Nimmo's Standard Life Smaller Companies Trust (SLS).

Although similar in process, ASCI is different to SLS and the broader UK smaller companies sector in several ways. Firstly, with net assets of £60m the trust is considerably smaller than SLS (£467m) and the sector average (£257m), which allows the manager to be very nimble. Another key difference is ASCI's focus on income. Currently the trust yields 3.9% on a historical basis, in comparison to a dividend yield of 2.6% for SLS and 3.8% for the broader sector.

2019 saw the discount narrow considerably as performance improved, although this has since reversed with concerns surrounding coronavirus and the associated economic slowdown. We think once the dust has settled, if the improvement in performance continues it should over the long term lead to a discount narrower than peers'. Despite the economic picture being exceptionally cloudy, the discount to NAV potentially offers an attractive entry point.

BULL
Utilises the same approach as SLS, an approach which has an excellent track record for capital appreciation
Strong dividend growth and an attractive yield relative to peers
A diversified income stream relative to other equity-income vehicles

BEAR
At c. £65m in net assets, the trust will be too small for some wealth managers
The OCF is above average, a result of the small size of the trust
The 7% gearing increases risks

Portfolio

Aberdeen Smaller Companies Income Trust offers investors a portfolio of predominantly UK smaller companies, with the aim of generating capital growth and income.

Following the merger of Aberdeen Asset Management and Standard Life, in September 2018 the trust was taken over by the former Standard Life smaller companies team. This led to Abby Glennie taking over the running of the portfolio and thereby incorporating the 'quality growth' franchise. Abby is 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 Trust** **(SLS)**.

As with SLS, the trust's investment process revolves around 'the Matrix', Standard Life's proprietary screening system. Through this system, Abby is able to look at numerous financial metrics, including EPS growth, price momentum, P/Es and yields, as well as metrics measuring balance-sheet quality. A final score is then created, but not before key elements including earnings revision and momentum-related characteristics have also been assessed. Interestingly, valuation metrics are considered less important to the team as they believe they can be misleading when looking at smaller companies.

Through the Matrix, Abby looks for three particular characteristics in companies to enhance returns and reduce risk: quality, growth and momentum.

Quality is always at the forefront of Abby's mind, as a company that is high quality will be able to perform strongly throughout the cycle. These companies will typically exhibit strong management and have a good track record, a sustainable competitive advantage, strong financials (including good margins) and returns on capital. An example of this type of company is the international veterinary pharmaceutical business Dechra Pharmaceuticals. The company has a long-term CEO who has been at the helm for more than 30 years, and boasts an ROE of 18.5%. On top of this, the company has achieved high levels of cash flow and has used this to fund acquisitions.

Abby also looks for companies which demonstrate **sustainable growth**, companies that are increasing their market share and growing their margins. Typically, these companies are aware of the threats of new entrants and the impact they can have on the growth of the business. Additionally, Abby shies away from companies whose growth is reliant upon acquisitions, as this can be difficult to maintain throughout the cycle. Midwich, the AV-technology company, is an example of a sustainable-growth holding in the portfolio. The company has consistent revenue and has been growing its profits. Growth has been driven organically and by some acquisitions, as the company has been tilting towards higher-growth categories. This has helped to improve margins and take market share from competitors. Abby therefore sees the company having the ability to consolidate the currently fragmented European market.

The final characteristic, **momentum**, involves having a strong Matrix score and positive earnings revisions. Liontrust Asset Management is an example of a company with this characteristic because it consistently scored strongly on the Matrix, with impressive AUM flows spread across numerous products. This strong performance has supported AUM growth, causing repeated earnings upgrades during 2019. On the portfolio level, the tilt to momentum means running the winners and having conviction in positions.

Alongside these characteristics, due to the income-paying nature of the trust, Abby also considers the dividend-paying ability of companies. This means that the portfolio has a slight defensive tilt, although this has reduced in recent times as the team have added a number of growth stocks to balance the portfolio. As can be seen below, 40.9% of the income is derived from the top ten income-paying companies in the portfolio.

Top Ten Income Contributors

COMPANY	WEIGHTED INCOME CONTRIBUTION (%)
Hollywood Bowl	5.2
Assura	4.9
Chesnara	4.8
Intermediate Capital	4.4
Cineworld	3.8
Telecom Plus	3.8
FDM Group	3.7
Morgan Sindall	3.7
Close Brothers	3.4
XP Power	3.3
TOTAL	**41.0**

Source: Aberdeen Standard Investments

Six of the highest-income-paying companies also sit in the top ten holdings based on NAV, with the top ten making up a little over 35% of the portfolio. Currently the trust is made up of 47 holdings, and this is close to the AIC UK Smaller Companies sector average of 53 holdings.

The trust also has exposure to fixed-income securities. Abby takes an active investment style to fixed income, trying to identify value between individual securities. This is achieved by combining bottom-up security selection with a top-down investment approach. However, at this stage the fixed-income portion of the portfolio makes up just 1.1% of NAV.

Top Ten Holdings

COMPANY	% OF NAV
AVEVA	4.6
Intermediate Capital	4.3
discoverIE	4.1
Assura	4.0
Hollywood Bowl	3.7
XP Power	3.7
Morgan Sindall	3.5
Liontrust	3.4
FDM Group	3.1
Unite	3.1
TOTAL	**37.5**

Source: Aberdeen Standard Investments

Gearing

Gearing is a joint decision between the manager and the board and has been a regular feature of the trust in previous years, with the intention of using it to enhance income. The majority of gearing has historically been invested in investment-grade corporate bonds and preference shares. While the amount drawn down on the facility has remained unchanged, some of these fixed-income investments have now been exited and replaced with companies that exhibit greater growth potential.

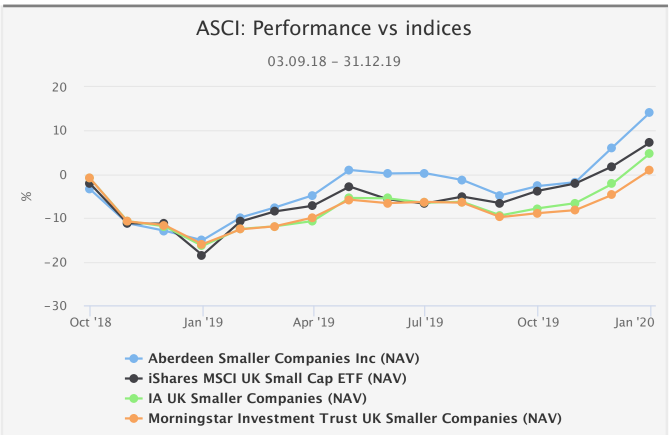
As at 29 February gearing sits at c. 5.6% (net), while the maximum level permitted by the board is 10%.

Returns

Previously, performance has been measured in comparison to the FTSE Small Cap Index, with the managers' key aim being to outperform the benchmark over the long term. However, as of January 2020 the board decided to shift the benchmark to the Numis Smaller Companies ex Investment Trusts Index (NSCI). The NSCI is the most common benchmark for trusts in the sector, and the board believes it has more relevance to the holdings in the trust's portfolio.

The managers only took over the portfolio in September 2018, meaning it is still quite early to judge performance. However, the early signs are promising, with the trust comfortably outperforming the benchmark and the IA and AIC peer groups alike over the year-and-a-half period to the end of 2019. At this point the trust had generated NAV total returns of 14%, in comparison to 3.3% from the benchmark, 1% from the AIC peer group and 4.8% from the IA peer group. The calendar year 2019 saw a particularly strong performance in absolute terms, with the trust delivering NAV total returns of 34.6%.

Fig.1: Performance Since Change In Strategy (To End Of 2019)



Source: Morningstar

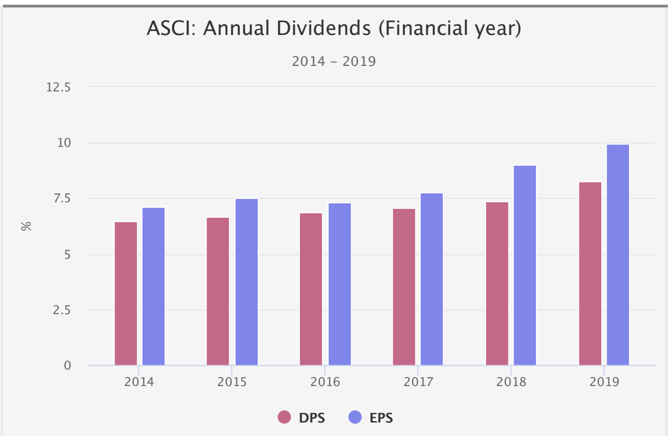
2020, on the other hand, has brought a number of difficulties for the trust, not to mention for the rest of the sector. Since the start of the year to 23 March, the trust has generated NAV total returns of -37.7%. This is favourable in comparison to the benchmark, which has lost more than 40% in NAV total-return terms, but worse than the weighted average for the AIC sector (which has lost 30.2%). Obviously, this difficult period will make some investors nervous; however, the managers choose to take a long-term view on their holdings. Through investing in companies that are high quality with strong balance sheets, they believe that over the long term the trust will continue to perform strongly. The managers believe that their companies will be resilient should we see a recession, and have strong management teams who will be able to guide them through difficult periods.

Dividend

Part of the aim for the team at ASCI is to offer investors a high, and growing, dividend income from their portfolio. Currently the trust yields 3.9%, partly due to the 25.2% discount which could be seen as an attractive opportunity for income-seeking investors looking for a diversified source of income. As we noted in our 2019 research article **'Rethinking UK equity income'**, UK equity income trusts are highly concentrated in a few big names, and this could be a potential cause for concern for income-seeking investors and further reason to hold some income-paying smaller companies.

The board recently announced the 2019 full-year dividend of 8.25p, which was more than 10% higher than the 2018 payout. We note that dividends have continually grown in recent years (5% per annum over the past five years), and the most recent was covered 1.98x by revenue reserves.

Fig.2: Dividends



Source: Morningstar

Management

The trust is now managed by Abby Glennie, who is one of two UK small-cap managers on the Aberdeen Standard Investments small-cap team which took control of the portfolio in September 2018. She is 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**.

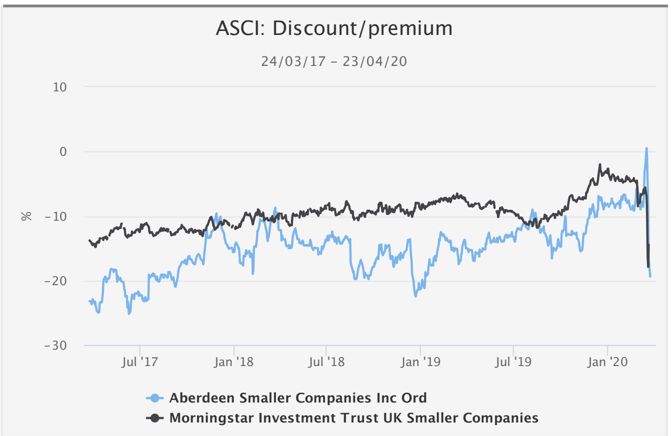
Abby is also supported by Amanda Yeaman, who joined the company in June 2019. Amanda is responsible for providing research support, predominantly for the UK smaller companies strategy but also to the wider smaller companies team. There are also two European analysts/portfolio managers on the smaller companies team.

The team use their proprietary Matrix screening system, which is overseen by a dedicated senior quantitative analyst. The team run over £2bn in UK small caps, which gives Abby excellent contact with management teams both of prospective holdings and current ones (the team meet twice a year with the companies they own).

Discount

2019 saw ASCI's discount narrow meaningfully. Starting the year on a discount of around 20%, the trust ended the year at a discount of close to 5%. However, the coronavirus uncertainty has hit the trust particularly hard and has moved the discount to 25.2%. This compares to an average discount within the UK smaller companies sector of 17.7% which, as can be seen below, has followed a similar pattern over recent months.

Fig.2: Discount



Source: Morningstar

The board has the capacity to buy back shares; however, given the small size of the trust this is unlikely. Over 2019, no shares were bought back or issued.

Charges

The OCF of the trust is 1.2%, compared to 1.06% for the average UK smaller companies trust (Source: JPMorgan Cazenove). The management fee is 0.75% of net assets, around average for the smaller companies sector. Given the trust is quite small, fixed costs are higher as a proportion of net assets, which explains the higher charges ratio. Management fees and the cost of debt are charged to capital (70%) and to revenue (30%).

The KID RIY for the trust is 1.98%, one of the highest in a sector where the weighted average is 1.33%. It is worth noting, however, that calculation methodologies can vary between companies.

ESG

According to Aberdeen Standard Investments, environmental, social and governance (ESG) considerations underpin the investment activities of all its managed funds. For ASCI this means trying to make a positive difference for the trust's clients, society and the wider world while aiming to meet long-term financial goals.

ASCI aims to specifically make a difference through Abby constructively engaging with investee companies on issues of social, community and environmental responsibility. The aim is to positively influence developments in these areas. She also believes that companies that demonstrate a commitment to environmental and social responsibility are likely to have distinct advantages in the long run compared to those that don't.

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