Dunedin Income Growth IT

Update
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Summary

Dunedin Income Growth (DIG) sits in the UK Equity Income sector, aiming to grow capital and income in excess of the FTSE All Share. The trust is unique within the AIC sector due to its large exposure to European stocks, helping the managers to diversify their distributions and take advantage of their extensive knowledge of the Pan-European space.

The trust is run by Ben Ritchie and Louise Kernohan at Aberdeen Standard, who have been implementing a change in strategy since 2016. The portfolio has been shifting towards stocks with more attractive growth characteristics, whilst maintaining the dividend at a high level throughout – the current yield is 4.6%, compared to a sector average of 3.8%.

This has necessarily been a long process as the managers slowly wind down positions in stocks with high current dividends but fewer prospects of growing them. The result is a portfolio with a considerably greater bias to the small and mid-cap end of the market, but with the same tilt to quality characteristics.

The turnaround has started to bear fruit: over 2018 the trust outperformed both the FTSE All Share, its benchmark, and the peer group. This has continued into 2019, and over the first four months of the year the trust has delivered just under 15%, beating both the peer group and the benchmark. This has also begun to be reflected in the discount and, after starting April trading at a discount of around 10%, the trust is now trading at close to 5%.

Alongside this, the trust has grown its dividend at a rate of 2.4% per annum over the past five years, considerably more than the rate of inflation. Dividends are paid out quarterly, and having not seen in the interim pay-out amount change since 2013, 2018 saw a large uptick in order to make the distribution of income more balanced.

In April of 2019, the trust's expensive debenture, which was taken out in 1997 at rates which then appeared favourable, expires. This will dramatically decrease the headline gearing for the trust.

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Portfolio

Dunedin Income Growth aims to generate capital growth and increasing dividends, above that of the FTSE All Share, from a portfolio of mainly UK stocks. The trust also buys European-listed stocks, which is facilitated by the structure of the equity teams at Aberdeen, which are organised on a pan-European basis. The trust is only one of two in the sector to have double digit exposure to Europe, and roughly 20% is invested outside the UK. This means that the portfolio has access to a wider range of dividend paying companies and sectors, along with a far more diversified stream of income from investors.

The managers, Ben Ritchie and Louise Kernohan, look to identify high quality companies at reasonable valuations. This means analysing the strength of balance sheets, management teams and business models, with a high importance placed on face-to-face company meetings. The end result is a portfolio of between 30 and 50 stocks, with the current number being at the upper end of the range. Position sizes are controlled quite rigidly to bring discipline to the process and ensure that positions are constantly reviewed. Stocks are held at 1%, 2%, 3%, 4% or 5% depending on the level of conviction, and are only rarely allowed to stray higher if the managers are convinced the larger position is appropriate. In the fullness of time the 5% positions should represent the highest quality ideas.

Following a poor period of performance in 2015, the management team was reorganised, and Ben and Louise took on more personal control of the portfolio. The decision was made to increase the growth and dividend growth in the portfolio as well as renew the focus on quality. The active share has also been increased, rising steadily from 60% to 72%. The aim is to settle on a turnover of 15% to 20% a year, implying a five-year plus holding period, with the turnover necessarily being a little higher as the restructuring takes place.

The portfolio has therefore steadily shifted to stocks with more attractive growth characteristics, whilst moving away from stocks with high current dividends but little prospects of growing them. This can be illustrated below, where we have seen the portfolio shift over the past five years towards the small and mid-cap end of the market.

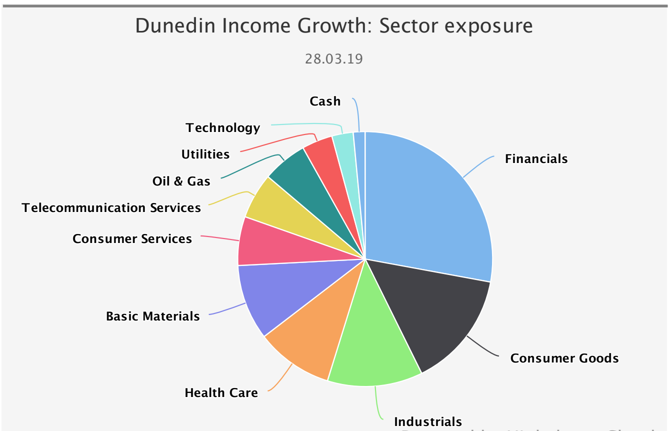
Shift To Stocks In The Small And Mid-Cap Market

	SMALL	MID	LARGE
2016	2.87	16.44	47.09
2017	5.76	68.24	19.28
2018	14.38	65.08	16.54
2019	18.9	50.09	15.9347

Source: Morningstar

As the turnaround has continued to progress over the past year, a number of new holdings have been introduced into the portfolio. Most recently, the managers have added Ashmore, an asset manager that specialises in emerging market debt. Alongside this, Rightmove, the online real estate advertiser; Rentokil, the commercial pest control company; and engineer Spirax Sarco Engineering, which sells critical steam control products to a wide range of end markets, have all been added to the portfolio. Although a wide range of businesses, all share structural drivers that mean they should be able to grow regardless of GDP. They have also all demonstrated their sustainable competitive advantages that should allow them to maintain their growth rate, which in turn translates into strong long-term expansion in cash flow and dividends. The final output can be seen below, where financials, consumer goods and industrials make up the largest sector weights.

Fig.1: Sector Exposure



Source: Morningstar

Alongside the smaller, more high growth-oriented businesses, the managers have also added a couple of high yielding companies. This is to ensure that the income continues to be diverse and examples include Rio Tinto and Telecom Plus.

Towards the end of 2018, the managers took advantage of the depressive effect of Brexit concerns on UK valuations to pick up quality names on a discount, and increase their exposure to domestic earnings. One of the main contributors to this was the addition of Countryside Properties, the UK housebuilder that the managers believe will help to provide a degree of protection from the cyclicality of the new-build housing market. They also picked up Marshalls, the high quality operator in its industry of paving and aggregates, which is involved with a number of lucrative infrastructure projects. However, when we spoke to Ben and Louise they were keen to point out that they view the portfolio as being as “Brexit neutral” as it could be, with neither a strong bias to domestic or overseas earners.

However, the exposure to European stocks has been maintained near its 20% limit. Ben and Louise explain that they find good quality operators in these markets, often in areas where the UK market is light. For example, French oil company Total is a higher quality business than BP, in their eyes. Meanwhile SGS, the Swiss testing company, is a higher quality operator to Intertek, with a stronger balance sheet and higher payout ratio.

Gearing

The trust took out a £28.6m debenture in 1997 at rates which then appeared favourable; it matures this month. As part of the turnaround plan, in December 2015 the board took out a £30m loan which it has invested in a portfolio of investment grade bonds with the same duration as this debenture, neutralising the interest rate exposure and partly offsetting the interest paid. Now that the debenture has been paid, the company will also exit from its bond holdings. This will significantly reduce the headline gearing and simplify the capital structure. We believe that this that this will be extremely beneficial to the trust in changing the misconception of it as being heavily geared.

After the maturing of the debenture, the trust will have 7% structural gearing, with a flexible multi-currency revolving credit facility of £15m offering additional funding sources. Remaining there is £30 million loan notes maturing in 2045 and a £15m multi-currency revolving credit facility that expires in July 2021. The company has the capacity to increase the level of debt on the short-term facility from £15m to £30m at any time should they want to.

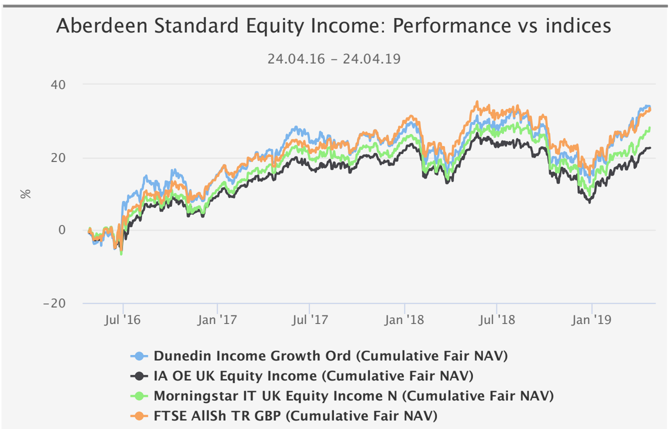
Performance

The trust's portfolio has quality, defensive characteristics which stood it in good stead in 2018, and the trust continues to be well-positioned for a more challenging economic and market environment than the 2016-2017 rally in high growth and momentum.

Over the 2018 calendar year, the trust outperformed the benchmark by 0.5%, the open-ended UK Equity Income peer group by 1.5% and the AIC UK Equity Income sector by 1.5. Stock selection from the managers was strong for the year, and positively impacted the trust's performance (year to January 2019). Edenred offered particularly impressive returns, benefitting from the recovery in its operations in Brazil as well as continued strong growth in its payments and expense management units. Aveva also stood out over the financial year, starting to see synergies from its merger with Schneider and seeing increasing demand from its customers in oil & gas.

Due to the trust's repositioning away from cyclical, low growth companies, one of the main headwinds for the year was from the underweight position in the oil and gas sector which performed robustly over the year.

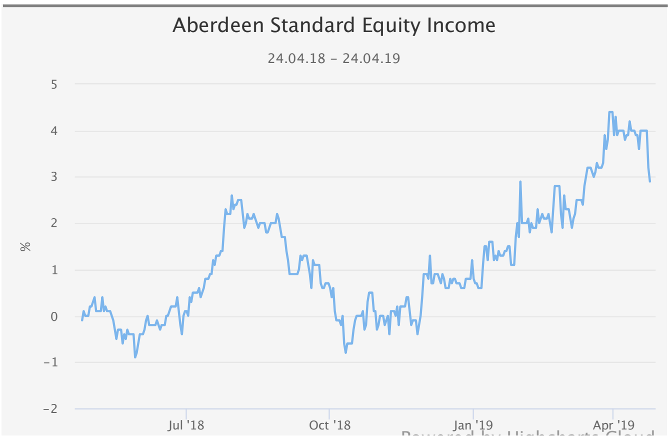
Fig.2: Three Year Performance



Source: Morningstar

The trust has continued the strong relative performance in 2019 (to 25 April 2019), delivering NAV returns of just under 15%. This is c.2% and 0.4% greater than the benchmark and the AIC UK Equity Income sector respectively, and 2.5% greater than the IA peer group. This is encouraging to see, and only adds to the evidence than the turnaround is starting to bear fruit.

Fig.3: One Year Relative Performance



Source: Morningstar

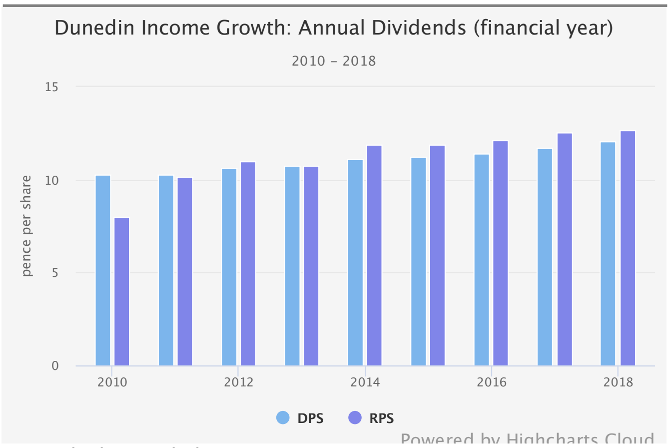
Looking forward, the managers hope to see continued improvement as the portfolio remains to increase the quality of the holdings and make additional increases in allocation to mid and small caps. Although equity markets have recovered since the correction in Q3 and Q4 of 2018, many of the macroeconomic headwinds have not gone away. As such they believe that market volatility will continue to be high, and could provide the managers, and their active approach, opportunities through the year. Supplementing this, the managers will continue to have the capacity to write options, which contributed 6.7% of the total income for the financial year ending January 2019.

Dividend

Over the past few years the portfolio has continued to shift to having a greater focus to higher quality companies with greater dividend growth potential and the managers are committed to at least growing the dividend in real terms. As the company has increased their exposure to mid and small companies, now over 30% of the portfolio, the average dividend growth rate of the companies within the portfolio has increased. Over the past five years, the trust has grown its dividend at an average annual rate of 2.4%, considerably more than the 1.8% average increase of the consumer price index.

The company pay out quarterly dividends, and after leaving the interim dividends unchanged since 2013, 2018 saw the rates of interim dividends increase considerably. The three interim dividends over the year were increased to 3.0p per share, in order to create a more balanced distribution of income. A final dividend of 3.45p has been announced, payable in May, taking the full year 2018 dividend to 12.45p. This is an increase of 2.9% on last year, and represents the 35th year of the past 39 that the company has grown its dividend.

Fig.4: Dividends



Source: Aberdeen Standard

The managers are committed to maintaining the dividend at least, and this has slowed the turnaround plan slightly as they try to find a compromise between the quality and growth characteristics they want to get into the portfolio and the yield. Ben and Louise tell us they expect the dividend to be uncovered in the 2020 financial year as part of their turnaround plan, but as they have 0.93 times last year's dividend in reserve this should not be a risk to the future income of the trust.

Management

The trust is managed by Ben Ritchie and Louise Kernohan. They have maintained an emphasis on the collective approach even after the merger with Standard Life, which requires rigorous peer review by the wider team of holdings before they are bought.

In 2016, as part of the turnaround plan, the management team was reorganised and aided by the appointment of investment director Louise Kernohan. The merger with Standard Life Investments in 2017 has broadened the coverage of UK and deepened the expertise in UK small- and mid-caps, both in terms of personnel and quantitative resources.

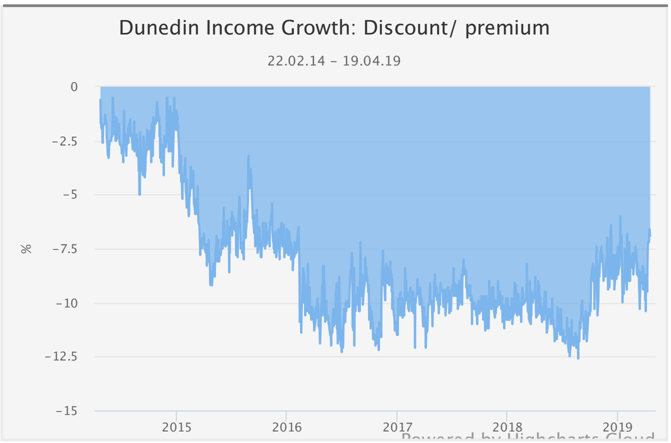
Discount

The company has seen its discount widen over previous years, largely due to poor performance. However, stronger performance in Q4 of 2018 saw the trust re-rate, narrowing from close to 13%, to a discount of around 7%. This trend has continued into 2019, and currently the trust is trading at 5.6%.

The board has an active buyback programme. Although there is no set target for the discount, buybacks have been implemented when the discount has been wider than 10%. Over 2018, 1,561,783 shares were bought to treasury.

The improving numbers this year are encouraging, and we note that the trust's discount is now sitting closer to the middle of the pack. With this said, the trust's discount still remains wider than the weighted average in the peer group.

Fig.5: Discount



Source: Morningstar

Charges

The trust's OCF of 0.61% is below the 0.63% weighted average of the UK Equity Income sector. This is thanks to the tiered management fee, which is charged at 0.45% on the first £225m, 0.35% on the next £200m and only 0.25% on anything over £425m in net assets. Net assets are currently £430m and 60% of the management fee is charged to capital. The KID RIY figure is 1.65, relative to the sector weighted average of 1.15.

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