10 April 2015

Utilico Emerging Markets*

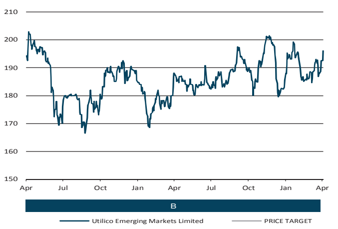
Real assets, real returns

Fund in the spotlight:
Utilico Emerging Markets* (UEM), Buy

UEM NAV vs. Index

Source: Morningstar

Share price & recommendation chart



Source: Westhouse, Factset

Somers Limited is a substantial shareholder (84.6%) in Westhouse Holdings Plc, the parent company of Westhouse Securities Limited. Utilico Emerging Markets Limited and Somers Limited both have a significant common shareholder, Utilico Investments Limited. Charles Jillings is a member of the Westhouse Holdings Plc Board, which is the 100% shareholder of Westhouse Securities Ltd.

Priced at close
7 April 2015

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China's New Silk Road Initiative, highlighted again recently, shows the continued focus on infrastructure as a growth driver in emerging markets. While infrastructure investment in emerging markets can be fraught with uncertainty, partly due to ill-defined property rights, a well-crafted portfolio can more than reflect GDP growth. Utilico Emerging Markets* (UEM) has consistently demonstrated an ability to identify opportunities in emerging markets infrastructure, generating exceptional returns vs. the MSCI Emerging Markets Index. We reiterate our Buy recommendation.

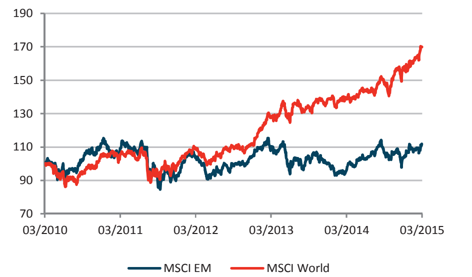
Pivot investments towards infrastructure from commodities

Recently the Chinese government again focused on the Silk Road initiative proposed by President Xi Jinping in September 2013 during a visit to Central Asia. We believe that the investment in infrastructure across Asia will continue, driven by the central theme of urbanisation. It is interesting that while infrastructure companies are attracting investor attention, commodity stocks continue to suffer. As China's economy matures, demand for metals such as iron and copper may fall, even as supply increases. Nowhere is this more apparent than iron ore. Iron ore prices are currently near or lower than breakeven for producers like Fortescue Metals Group (FMG.AX) The head of research at Baosteel said that he expected the bear market for iron ore to last for at least another four to five years as the substantial increase in supply overwhelms demand in China. Investment in commodities as a proxy for emerging markets has once again proved fraught. Other areas of investment that typically attract investors looking to leverage growth in emerging markets are banks and consumer goods companies. However, despite robust GDP growth, several emerging markets have failed to deliver in terms of the performance of their equity markets.

One of the areas that is often neglected is the infrastructure sector, which typically requires specialist knowledge. The team that manages Utilico Emerging Markets* (UEM), led by Charles Jillings, is focused on the transformation that is taking place in the infrastructure space in emerging markets and has demonstrated an ability to identify companies that can translate this GDP growth into returns for minority shareholders. We therefore believe that UEM deserves to be a core holding for investors looking to invest in emerging markets.

Figure 1: UEM NAV vs. Index

Figure 2: MSCI EM vs. MSCI World



Source: Morningstar

Utilico Emerging Markets* (UEM): Exceptional performance

Over the last five years, the performance of emerging equity markets has been lacklustre at best. While the MSCI Emerging Market index is up just 12.6%, UEM's NAV has risen by over 65% over the same period. Over a three-year period, we again see strong outperformance from UEM vs. both the index and the peer group. For example, the NAV of the Templeton Emerging Markets IT (TEM) has risen by 5.6% over the period vs. a NAV return of 33% for UEM.

Buy Utilico Emerging Markets Ltd* (UEM)

Strong performance. Operational businesses rather than greenfield investments

Established in 2005, UEM targets long-term returns from emerging markets by investing in companies active in the utilities, transportation infrastructure and communications infrastructure space. The focus is usually on companies which are asset backed and have a degree of pricing power because of the industry structure. The team almost always favours operational businesses rather than greenfield investments. It also has a strong preference for listed investments rather than unlisted companies.

Investment manager

ICM Limited (ICM) acts as advisor to the company, providing portfolio monitoring and research. ICM is a Bermuda-based fund manager and corporate finance advisor (www.icm.bm). The Group specialises in a number of key areas including utility and infrastructure, financial services, mining and resources and fixed income. ICM advises a number of companies including UEM, its sister fund Utilico Investments* (UTL.L, Buy) and Somers Limited (SOM BH).

Day-to-day management of the portfolio is undertaken by Charles Jillings in conjunction with the investment manager. Jillings is a chartered accountant and has been involved in the running of the fund since its inception in 2005. The portfolio manager is assisted by senior analysts responsible for specific sectors ie, Jacqueline Broers specialises in Transport, Jonathan Groocock in Power, Water and Gas and Mark Lebbell specialises in Communications. The total size of the ICM team is around 35, including analysts in their offices in Brazil, Singapore and London.

A universe of around 900 companies is monitored regularly

The fund monitors and models 900 potential investee companies. In-depth fundamental research, management meetings and frequent site visits help supplement in-house models. The focus is on long-term investments. Critical to the entire decision-making process is the assessment that the manager has towards the operating, legal and regulatory environment of the economy in question, as well as on variables such as the path of economic development and the attitude towards foreign investment.

Real Assets, that pay a dividend. A solid grounding for the portfolio

The fund tries to identify investments whose returns would typically exceed the GDP growth of the country. Having asset backed equities with strong cash flow generation helps the fund monitor and mitigate corporate governance risks. The focus on operational companies that pay a dividend helps the fund pay out a dividend that is significantly higher than its peers or the benchmark index, though some of it may be financed via capital gains. Whilst the portfolio manager is conscious of the performance vs. the index over the long term, index weights are not considered when making investment decisions. The main focus is to identify the best investments, primarily within the infrastructure and utility space. The top ten holdings typically represent about 50% of the fund’s holdings. The fund is unlikely to have more than 75 holdings and uses an IRR of 15-20% pa when considering potential investments.

Looking at UEM’s declared positions over the past five years, it is clear that the team has a high degree of conviction in its positions, with the fund having an annual turnover of c.20-25%. There are no formal exit timetables. The sector teams constantly monitor the companies in the portfolio and developments that may potentially alter the fundamental value of a holding by a certain percentage would trigger a recommendation from the senior analyst. Ultimately, the decision on the portfolio is made by Charles Jillings as he can assess the impact of the developments on both the company and the portfolio.

The team travels to emerging markets on a regular basis to reassess the physical assets held by the company and to meet management. In addition, its internal models are often supplemented by research from local and regional brokers. However, the analysis of the company is done independently by the team. In addition, the team will collect monthly published data from various sources to recalibrate its expectations. Companies in the portfolio as well as those that the team is monitoring actively are reviewed on a monthly basis with Charles Jillings.

The burgeoning middle class drive the growth in companies in the fund's portfolio

According to Charles Jillings, the story behind the fund today is no different to what it was ten years ago and what it will be in another ten years: urbanisation and the increasing aspirations of a burgeoning middle class in emerging markets. The focus on operating businesses with real assets has often led to the fund having escaped some of the regulatory uncertainty typically encountered in the emerging markets and most definitely within the infrastructure space. The fund avoids investing in greenfield projects as they tend to require a lot of planning and regulatory permissions. Equally, the fund has never owned an airline stock or a media company as: 1) airline assets depreciate over time and excessive competition erodes returns as the industry structure lacks appropriate barriers to entry; and 2) the risk profile of media companies, including exposure to volatile advertising revenue, cost of sports/content rights and risks associated with the production of content, does not suit UEM's philosophy. In addition, Jillings generally does not like conglomerates as they tend to lack the focus that the team is looking for. This has been one of the key reasons why UEM has tended to have a low allocation to India. The fund monitors the performance of the companies it invests in against their peers in both emerging markets and developed markets. They will actively engage with the management of the companies they invest in highlighting, for example, how their analysis could lead to better returns for shareholders. One of the key financial variables that Jillings and his team focus on is long-term EV/EBITDA forecasts.

UEM currently does not have a big footprint in Africa

UEM currently does not have a big footprint in Africa. One of the key reasons is the lack of listed entities focused on the infrastructure space. For example, there is only one listed African port (in Egypt) that might fit the fund's criteria. Top down overlay is important and slippage either on top-down or bottom-up parameters invariably leads the fund to pare its position over time. For example, as at 31 December 2010, Brazilian assets accounted for 34% the fund's investments. As at the beginning of January 2015, this figure had decreased to around 13.5%. This is due to the underperformance of several of the equities the fund was invested in, as well as a conscious decision by the fund to reduce its positions in the country. This gradual reduction in the fund's weighting was triggered by macro-economic and political developments, but also by events like water shortages. Currently, the fund's biggest country exposure is in China, but its biggest overweight position vs. an index like MSCI Emerging Markets is Malaysia.

MAHB: Disciplined expansion in capacity constrained markets

This is primarily because two of the fund's top ten holdings, as at the end of February 2015, MyEG Services Berhad (MYEG.KL) and Malaysia Airport Holdings Berhad (MAHB.KL) comprised approximately 15% of the NAV. Apart from owning 39 out of the 40 airports in Malaysia, including KL International airport, where it has just finished building another runway and launched the world's largest purpose built terminal for low cost carriers, Malaysia Airport Holdings is making prudent acquisitions in other emerging markets. It also owns Istanbul's second airport, Sabiha Gökçen International Airport, which is experiencing strong passenger growth. While the recent events involving Malaysia Airlines have dented passenger growth numbers, history suggests that these trends generally reverse themselves over a 12-24 month period. Given that regional airports like Hong Kong, Singapore and Bangkok are facing capacity constraints, Jillings feels that Malaysia Airport Holdings is well positioned to capture market share in the medium term. The company, which has recently been in an investment mode, is expected to see strong earnings growth next year. In addition, it has recently launched a rights issue, the first since 1999, to repay some of its debt.

MYEG: Strong growth, stronger growth prospects

MyEG Services Berhad is a concessionaire for the Malaysian E-Government programme. MyEG's systems allow Malaysian citizens and businesses to transact with the government electronically, as an alternative to visiting government offices or post office counters. Through its portal, MyEG offers a range of services, such as driving licence and car tax renewal, vehicle registration, payment of traffic fines and the renewal of immigrant workers' permits. The company is part of a consortium currently implementing a service tax monitoring system, which will record and report cash register transactions in bars, restaurants and nightclubs, with a wider implementation expected post the introduction of GST in Malaysia in April 2015.

MyEG is a mid-sized company, with a market cap of around US$900m. In recent quarters, YoY revenue growth has been running around 20%, with YoY EBITDA growth of around 30%. The company first appeared on the list of the fund's top ten holdings (3.1%) at the end of May 2013. Since then, the shares of the company have risen by 400%. Given the fund's current holding, it is clear that the management team at UEM continues to see strong potential for MyEG, but it has reduced its holding. To us, this is an example of where the fund has demonstrated its ability to ride the winners in the portfolio but will also adopt a disciplined approach towards risk management.

Table 1: UEM top ten holdings, industry split and geographical split

Top ten holdings	% gross assets	Asset split	(%)	Geographical split	(%)
Malaysia Airport Holdings Berhad	*7.7*	Ports	*15.8*	China (including HK)	*29.9*
MyEG Services Berhad	*7.4*	Gas	*15.4*	Malaysia	*16.7*
International Container Terminal Services	*7*	Water and waste	*10.8*	Brazil	*12.4*
China Gas Holdings	*5.9*	Satellites	*10.5*	Philippines	*8.4*
Eastern Water Resources Development & Mgt	*5.4*	Electricity	*10*	Other Asia	*7.2*
Ocean Wilsons Holdings	*4.9*	Airports	*8.5*	Europe	*7.1*
APT Satellite Holdings	*4.4*	Toll roads	*7.2*	Other Latin America	*6.7*
Asia Satellite Telecommunications Holdings	*3.8*	Infrastructure Investment Funds	*2.6*	Thailand	*6.5*
Gasco SA	*3.8*	Telecoms	*2.3*	Middle East/Africa	*5.1*
China Everbright International	*3.5*	Renewables	*0.9*		
Total top 10	***53.8***	Other infrastructure	*16*	**Total**	***100***

Source: Company data, as at 28 Feb 2015

Secular growth stories in China such as water treatment and natural gas

The fund is relatively sanguine about the holdings in China based on the secular nature of the stories for companies like China Gas Holdings (0384 HK) where Chinese government policy continues to be highly supportive of the natural gas distribution industry and China Everbright International (257 HK), which is involved in waste water treatment. Its waste to energy projects once again fit well with the objectives of the Chinese government. As per the 12th Five-Year Plan, this was ranked first of seven Strategic Emerging Industries in 2013. UEM has been invested in China Everbright since 2009.

Capturing the growth in the telecom space via satellite companies

Stocks like Asia Satellite Holdings Ltd (Asiasat) (1135 HK) and APT Satellite Holdings (1045 HK) provide good growth prospects within the telecom space, while having relatively unleveraged balance sheets. While APT and Asiasat have had mixed performances over the last year, Jillings expects Asiasat to recover over the next 12 months partly due to the launch of two new satellites in 2014. APT on the other hand continues to see good utilisation rates on its three operational satellites and is operating a fourth satellite taken on a short term lease, with a view to replacing this with its own satellite due to be launched in late 2015.

Container terminals: Still a long-term growth story

The Philippines is another big overweight position for the fund, primarily via its exposure to International Container Terminal Services (ICT.PS). Founded in 1987 in the Philippines, the company launched an aggressive international and domestic expansion plan in 1994. Over the last two decades, it has established itself as one of the leading operators in the field. It is currently pursuing an active programme to acquire new terminal concessions across the globe. Over the last two years, it has seen average volume growth of around 15% pa, while revenue growth has averaged 21%. EBITDA grew 17% between 2013 and 2014. Given that the company is in investment mode, earnings have lagged, but Jillings feels that over time the EPS should reflect the operational dynamics as well. By 2017, ICT's management believes that capacity should increase by 41.5% when its prime asset, the terminal in Manila is expanded and operations in Melbourne and Nigeria become operational.

Returns driven by well researched, disciplined stock selection. Investing for the long-term

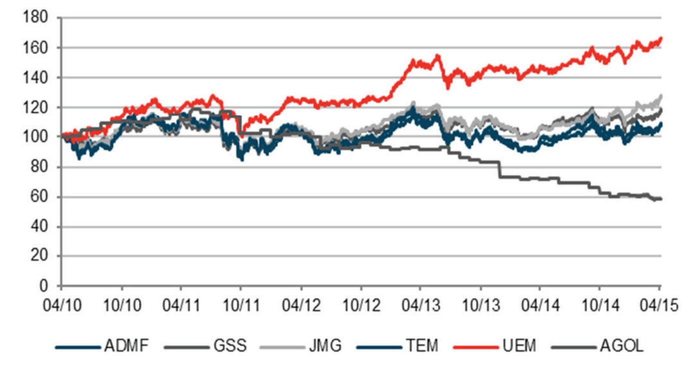
The team tries to mitigate risk by looking for investments that would achieve the same returns but with a lower risk profile. However, the focus is on long-term returns and the team is happy running with a concentrated portfolio. In addition, UEM has no rules on the percentage of the company it can own, but it is usually less than 5% of the free float. Jillings' philosophy is such situations generally resolve themselves over time, as the company grows and expands its free float or the fund exits part of its position. The focus is on long-term value investing and the fund's returns have differentiated it over time. The fund has a £50m borrowing facility that it uses tactically. As at the end of February 2015, the fund's net borrowing was £21.1M, drawn as €25.0M and £3M. Accounting and dealing have been outsourced to F&C, allowing the team to focus on making investment decisions. JP Morgan acts as custodian for the fund.

The emerging markets infrastructure sector is typically fraught with difficulties as monopolistic market structures can suddenly see profits being hurt by regulatory developments. Equally, monopolistic structures can often lead to wastefulness amongst managements as the payoff in the short-term is often independent of the effort level.

Yet several of the companies that the fund holds have demonstrated an ability to innovate despite their regional dominance. In our view, it is UEM's ability to repeatedly identify opportunities that strike that balance between pricing power and growth and hold them over the long-term that has been one of the key drivers of its outperformance vs. its peers (Advance Developing Markets* (ADMF), Ashmore Global Opp (AGOL), Genesis Emerging Markets (GSS), JPMorgan Emerging Markets (JMG) and Templeton Emerging Markets (TEM)).

Figure 3: UEM vs. developed market indices

Figure 4: UEM vs. peers: NAV performance



Source: Morningstar

Focus on real assets has helped mitigate risks from inflation differentials. Should stand investors in good stead going forward

In our view, one of the major problems that has recently plagued emerging markets is lack of productivity growth enhancing structural reform. The inflation differential between emerging markets and developed markets, in the absence of productivity growth has resulted in currencies in countries like Brazil to depreciate sharply. We believe that Jillings' focus on owning companies with physical assets has shielded UEM on several occasions from the higher headline inflation numbers that have often eroded returns in emerging markets. We think this focus on asset backed investments in sectors where there are reasonable barriers to entry should serve UEMs investors well.

A differentiated product. Lower correlation, better returns

The correlation between the monthly NAV returns of UEM and other emerging market funds is around 0.78. While this is not low, it is significantly lower than the correlation that most other funds have with each other. Therefore, we can look at UEM as a vehicle that provides a significant degree of diversification vis-à-vis a corresponding investment in another fund in the same category.

Table 2: Correlation matrix of monthly NAV returns for emerging market funds

	ADMF*	AFMF	GSS	JMG	TEM	UEM*	AGOL
ADMF	1	0.594273	0.956154	0.925212	0.937815	0.837828	0.403512
AFMF	0.594273	1	0.562921	0.480708	0.547035	0.601113	0.173332
GSS	0.956154	0.562921	1	0.94593	0.938746	0.784234	0.426797
JMG	0.925212	0.480708	0.94593	1	0.925552	0.765187	0.341253
TEM	0.937815	0.547035	0.938746	0.925552	1	0.78342	0.423769
UEM	0.837828	0.601113	0.784234	0.765187	0.78342	1	0.365965
AGOL	0.403512	0.173332	0.426797	0.341253	0.423769	0.365965	1

Source: Morningstar, Westhouse estimates. * Westhouse acts as broker and/or adviser to this fund

Based on the NAV performance of UEM, over the last five years, we believe that it deserves to be part of a core portfolio for investors not just looking at emerging markets but global markets as well. The fund has persistently traded at a discount despite superior performance vis-à-vis its peer group, which we believe is unwarranted.

Given the performance differential over the last five years, we would recommend a partial switch from Templeton Emerging Markets (TEM) into Utilico Emerging Markets, even if UEM was trading at parity and TEM was trading at a 12.7% discount. UEM is trading at a 9% discount and the annualised outperformance that UEM has achieved vs. TEM over the last five years is 9.2%, which supports our view that investors should switch into/buy UEM.

Figure 5: UEM NAV vs. Index & TEM

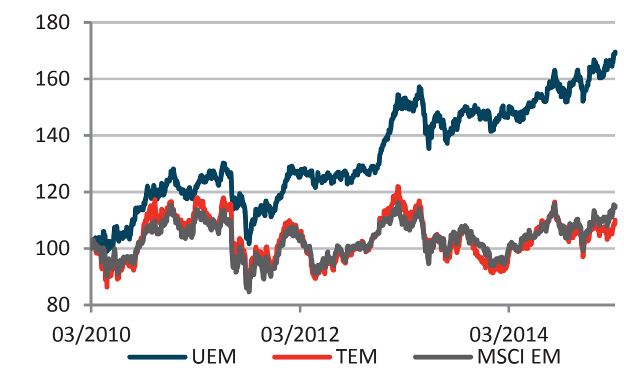
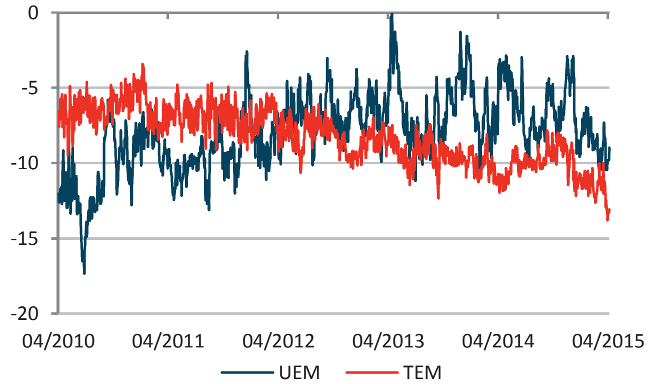


Figure 6: UEM discount



Source: Morningstar

Risks

- The fund invests in emerging markets, where fiscal and monetary risks can be substantial
- Country specific risk
- Sector specific risk. Infrastructure and utility sectors can be abruptly affected by government policy changes
- Currency risk
- Benchmark relative risk (portfolio composition markedly different from market indices)
- Gearing may increase the volatility of the fund's NAV
- The discount to the fund's NAV may widen

Key data

Investment strategy

To provide long-term total return by investing predominantly in infrastructure, utility and related sectors mainly in emerging markets.

Basic data	
Ticker	UEM.L
Launch date	Jul-2005
Net assets (£m)	483.3
Capitalisation (£m)	423.3
Shares in issue (m)	213.2
Website	www.utilicoemergingmarkets.com

Wind up provsions

Shareholders will have an opportunity to vote for the continuation of the Company at the 2016 AGM. The Company also has the authority to make market purchases of up to 14.99% of outstanding shares, subject to annual renewal

Key characteristics	
Stock concentration† (%)	53.8
Gearing† (%)	105.3
Yield dynamics	
Historic Yield† (%)	3.3
Dividend frequency	Quarterly
Financial calendar	
Year end	31-March
AGM	September
NAV	Daily
Fees	
Management fee	0.65% of net assets plus Company Secretarial Fee
Performance fee	15% of outperformance over benchmark subject to high water mark

Source: Company data, Bloomberg, Morningstar. † As at end of February 2015

Investment Funds research disclosures

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Investment funds ratings are explained as follows:

BUY: Total returns expected to be in excess of those from the fund's benchmark

HOLD: Total returns expected to be in line with those from the fund's benchmark

SELL: Total returns expected to be lower than those from the fund's benchmark

Total return is defined as the movement in the share price over the medium- to long-term, and includes any dividends paid.

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Investment Funds recommendation proportions in last quarter

	BUY	HOLD	SELL
Overall Investment Funds coverage excluding AIM	100%	0%	0%
Funds to which Westhouse has supplied investment banking services excluding AIM	100%	0%	0%

Source: Westhouse

The company has seen this research but no material changes have been made as a result.

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Westhouse has been a lead manager in a publicly disclosed offer or placing of securities of Utilico Finance in the last 12 months.

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