

Investment Funds

Idea – Utilico Emerging Markets*

**Today's fund in the spotlight:
Utilico Emerging Markets*
(UEM)**

UEM NAV TR vs. MSCI EM Index



Source: Morningstar

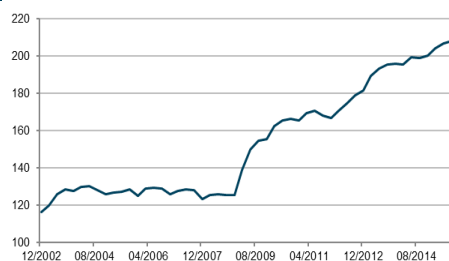
We continue to remain cautious on emerging markets. Within emerging markets we recommend that investors buy Utilico Emerging Markets* (UEM), trading at a 9.8% discount (cum, fair, undiluted). UEM has just announced that it has increased its quarterly dividend payments to 1.625p, for the quarter ending September 2015, which leads us to forecast an annual distribution of 6.4p. With an expected dividend yield of 3.8%, UEM is one of the highest yielding emerging market funds. Its investment in companies which have tangible income producing assets makes it an ideal vehicle for investors looking to maintain or increase their exposure to emerging markets.

Emerging markets: Major dislocation in progress

The credit fuelled expansion in emerging markets is likely to continue to slow down as corporate and household borrowing in countries like China reach levels where further increases are difficult to manage even with easier monetary policy. Growth is slumping across emerging markets. For example, Latin America's economy is expected to contract this year and experience GDP growth of less than 2% per annum over the next two years. The transmission mechanism for monetary policy in emerging markets is under pressure because of bubbles that have emerged in property markets in developing countries. Productivity growth enhancing reforms are required in several emerging markets and it is generally difficult to implement these while the economies are facing a sharp decline in growth rates.

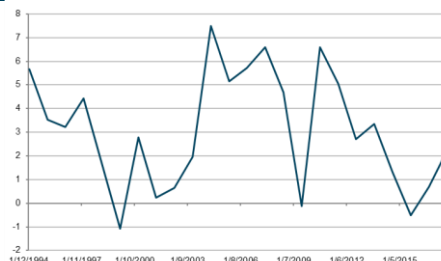
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Figure 1: China total social finance as % of GDP



Source: Bloomberg

Figure 2: Latin America Real GDP growth (Annual YoY %)



Long-term trends still look attractive

While the short and medium term outlook for emerging markets is difficult we believe that the long term growth prospects for emerging markets are still attractive. We continue to recommend that investors buy UEM for their long-term emerging markets exposure. The NAV performance of UEM is significantly better than that of the MSCI Emerging Markets Index. Over the last twelve months UEM's NAV has declined by 7.9% vis-à-vis a 12% decline in the MSCI Emerging Markets Index. The discount of UEM is an anomaly in our view, particularly given the strong long-term performance of the fund and its relatively high dividend yield. When we compare the total returns of the fund to Templeton Emerging Markets Investment Trust (TEM) we find that over the last five years the NAV of UEM has increased by 21%. In sharp contrast, the NAV of TEM has fallen by 27.4%. We also continue to recommend that investors switch from JPMorgan Emerging Markets Income Fund (JEMI), trading at a 1.7% discount into UEM, trading at a 10.2% discount, given the increase in dividend in UEM and its superior long term performance. Over the last three years the NAV of UEM has risen by 14.5% while that of JEMI has fallen by 5.3%.

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Buy Utilico Emerging Markets (UEM)

The Chairman of the Board of UEM, Alexander Zagoreos, believes that while USA and UK central banks continue to edge towards normalisation, Japan and Europe are expected to continue QE for some years. He highlights that China is steadily continuing its transition from an infrastructure led economy to a consumer led economy, a shift with significant ramifications for global markets. These combined factors have to date been very difficult for emerging markets and volatility has increased. The longer term outlook for emerging markets however remains positive. He highlights that most of UEM's investee companies continue to deliver top line growth and bottom line performance. However, the combined effect of weaker markets and currencies has masked this performance in sterling terms.

Charles Jillings, the portfolio manager of UEM, highlighted in the recently released results, for the half year ending 30 September 2015, that the constituents of the top ten saw two changes with Transelectrica SA (TEL RO) and China Resources Gas Group Limited (1193 HK) replacing Asiasat (1135 HK) and China Everbright International Limited (257 HK). The percentage of the portfolio in the top ten holdings fell from 53.7% to 49.4% in the six months to 30 September 2015. This was partly a result of net disposals in the top ten investments. Other contributors were stronger performance from the rest of the portfolio and a significant distribution by Asiasat. Unlisted investments were 2.8% of the gross assets as at 30 September 2015. The number of investments rose as UEM took advantage of weak market prices to invest in attractive opportunities.

As per the report, China (including Hong Kong) continues to be UEM's largest country investment, although decreasing from 30.9%, as at 31 March 2015, to 28.4%, as at 30 September 2015, of the portfolio. This was a result of realisations, investments, market movements and a significant dividend distribution by Asiasat, of which UEM's share amounted to HK\$88.8m (£7.4m), equivalent to 40.0% of the position in sterling terms as at 31 March 2015 of £18.5m. Asiasat was, as at 30 September 2015, UEM's fifteenth largest holding. The China Everbright position was reduced by 51.1%, along with a number of other smaller positions which were mainly exited in the strong market rally in April 2015.

Malaysia continued to be UEM's second largest country investment but had decreased from 17.8% to 14.9% of the portfolio. This is primarily due to market movements. According to Jillings, Malaysia's economy has been negatively impacted by the weakness in commodity markets. This has been reflected in both the equity market and currency. In sterling terms the FTSE Bursa Malaysia KLCI Index was down by 26.6% over the six months to 30 September 2015.

Brazil remained the third largest country investment, as at 30 September 2015, but exposure was reduced from 11.2% to 9.6% of the portfolio, partially due to disposals but predominantly to a weak currency. The Brazilian Real declined a by 21.3% over the six months and the Ibovespa Index was down by 11.9%. In Sterling terms the Ibovespa Index was down by 30.1% over the six months to 30 September 2015.

Romania rose to become UEM's fourth largest country investment increasing from 5.3% to 7.6%. This was due to additional investment and relative outperformance. Romania has performed well as an emerging economy and in sterling terms the local index was up 0.7%.

Thailand remained UEM's fifth largest country investment at 6.9%, up from 6.4%. The Thailand SET Index was down by 10.4% and the Thai Baht was down by 12.1%. The small increase in the weighting reflects relative performance rather than active change in positions. In the six months to 30 September 2015, the SET index was down by 21.4%, in sterling terms.

Select Holdings

China Resources Gas (1193 HK) was a new entry into the top ten at tenth position in the portfolio. CR Gas is a natural gas distribution company which had 21.8m household connections across 213 city gas concessions in mainland China as at 30 June 2015. UEM has been invested in this company since 2011, over which time CR Gas has achieved a compound annual growth rate in connections and EBITDA of 18.4% and 23.0% respectively, partially through acquisition and organic growth. The penetration base of its network remains low at just 43.1%, implying strong future growth potential. Similar to China Gas Holdings, growth has been restrained by the tough market conditions, which should normalise as tariffs re-base and new gas supplies come onstream in several concession areas which are currently lacking gas volumes. In the six months to 30 June 2015 CR Gas reported natural gas volume growth of 10.9% and new connections growth of 9.2%. Group revenues and EBITDA increased by 17.5% and 17.4% respectively, and the interim dividend per share was doubled. In the six months to 30 September 2015, CR Gas' share price fell by 17.5% in-line with other H-share listed gas peers. During the period under review, UEM increased its shareholding in CR Gas by 8.0%, investing £0.7m.

MyEG Services BHD (MYEG MK) was UEM's largest holding, as at 31 October 2015 and reported another set of exceptional results for its year to 30 June 2015. Revenues were up by 28.8% and EBITDA was 28.9% ahead of the previous year. The company continues to report strong results from its online vehicle tax renewal, traffic fine payments and car insurance services. The company has seen strong growth from foreign worker permit renewals. MyEG's online system became the only way to renew these permits from May 2015. The implementation of the cash register monitoring system to verify GST (sales tax) returns has been delayed, but is expected to commence imminently. The company has proposed a 2 for 1 share split by means of a bonus issue, which it intends to implement before the end of Q1 2016. UEM sold 2.6% of its investment over the period realising £0.9m, mostly driven by a decision to balance the portfolio and take profits. MyEG's share price increased by 1.1%, over the six months, to the end of September 2015.

Malaysia Airports Holdings BHD (MAHB MK) is UEM's third largest holding having declined from being the largest. The company reported mixed results in the six months to 30 June 2015. Though revenue from Malaysian operations was up 9.4% on the previous year, core EBITDA declined by 25.1% as its new terminal, KLIA 2, remained heavily underutilised. A combination of weaker passenger growth (flat over the period), and higher costs associated with operations at KLIA 2 continued to weigh on core margins. However, with the full consolidation of Istanbul Sabiha Gökçen airport ("ISG") in 2015, group EBITDA recorded an increase of 54.5% on the previous year. Group earnings declined sharply on increased depreciation and financing costs. ISG is expected to break even in 2015 and begin contributing positively to net earnings in 2016. Management have maintained original EBITDA guidance for both Malaysian and Turkish operations. MAHB's largest client, Air Asia, took legal action against MAHB in July, citing a failure to maintain appropriate operating conditions at KLIA 2. The MYR 409.4m damages claim renewed concerns of ground settlement issues at the new terminal, which has negatively impacted the share price. MAHB's share price decreased by 26.3% over the six months to the end of September 2015 and UEM invested a further £0.2m during the period.

Transelectrica (TEL RO) was a new entry into the top ten, becoming the ninth largest investment. Transelectrica manages and operates the Romanian electricity transmission system and provides the electricity exchanges between central and eastern European countries. It is a wholly-regulated entity which is currently in its third regulatory period which runs from 1 July 2014 to 30 June 2019, and the Romanian government holds a 59.7%

stake in the company. In the six months to 30 June 2015 billed volumes grew by 3.2% which, combined with tariff increases, delivered revenue growth of 8.1%. Higher transmission losses, primarily due to greater export volumes, meant that EBITDA fell by 2.4% and normalised earnings fell by 7.0%. Dividends per share paid from the prior year profits were increased by 25.8%. In the six months to 30 September 2015, Tranelectrica's share price total return was positive up 1.1%. In the period under review UEM increased its shareholding in Tranelectrica by 26.5%, investing £2.3m.

Investment activity increased mainly due to realising China "H share" investments in April 2015. For the six months, investment purchases were £53.4m (£89.3m for the year to 31 March 2015) and realisations were £65.4m (£87.3m for the year to 31 March 2015). Much of this investment was outside the top ten. Bank debt decreased from £31.9m to £18.1m over the six months to 30 September 2015, mainly as a result of realisations but also as a result of Asiasat's increased distribution this year. At the year end this was all drawn in Euros.

In September 2015 UEM announced a one for five bonus issue of subscription shares. This was approved at a Special General Meeting held on 22 September 2015 and approximately 42.6m subscription shares were issued on 24 September 2015. The subscription shares are exercisable on the last business day in each of February and August 2016 and 2017, with the final opportunity to exercise on 28 February 2018. The exercise price for the subscription shares is 183.00p per share.

Figure 3: UEM NAV Performance vs. MSCI EM Index

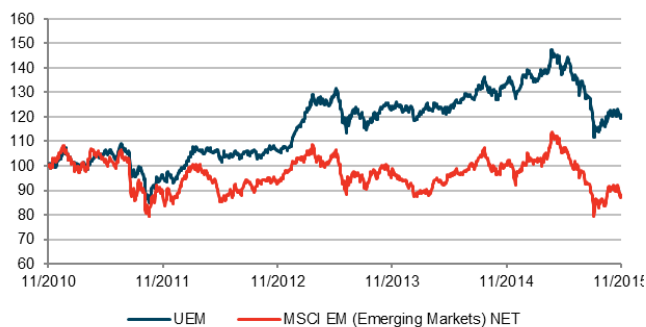
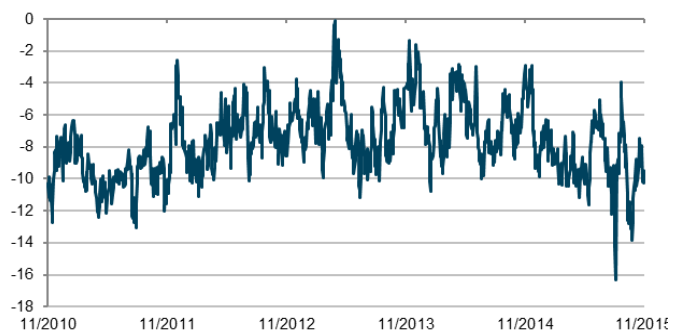


Figure 4: UEM discount



Source: Morningstar

As the chart above demonstrates, the NAV performance of UEM is significantly better than the MSCI Emerging Markets Index. The discount of UEM is an anomaly in our view particularly given the strong long-term performance of the fund and its relatively high dividend yield. When we compare the total returns of the fund to Templeton Emerging Markets Investment Trust (TEM) we find that over the last five years the NAV of UEM has increased by 21%. In sharp contrast, the NAV of TEM has fallen by 27.4% during the same period. Over the last twelve months the outperformance is equally striking. The NAV of UEM has fallen 7.9% as opposed a 23.5% decline in the NAV of TEM. During the same period the MSCI Emerging Markets Index has fallen by 12%. Despite the vastly superior long-term performance of UEM and the significantly higher dividend yield we find the discounts to be at similar levels. We therefore continue to recommend that investors switch from TEM to UEM at current levels.

Table 1: UEM has outperformed JEMI and TEM over the last one, three and five years†

	NAV Total Return (%)		
	1-yr	3-yr	5-yr
Utilico Emerging Markets	-7.9	14.5	21.0
JPMorgan Global Emerging Markets Income Trust	-17.5	-5.3	5.9
Templeton Emerging Market Investment Trust	-23.5	-18.3	-27.4
Morningstar UK IT Global Emerging	-15.0	-8.2	-13.8
MSCI EM Index	-12.0	-4.3	-10.4

Source: Morningstar

In addition to the switch from TEM to UEM, we also continue to recommend a switch from JPMorgan Global Emerging Markets Income Trust (JEMI) to UEM. Our decision is based on the fact that UEM provides an estimated yield of 3.8%. While this is slightly lower than the current dividend yield of JEMI, which stands at 5.3%, the performance of UEM has been significantly better than that of JEMI over one, three and five years. In addition, given the decline in the currencies in emerging markets one might expect the dividends of the stocks in the portfolio of JEMI to fall in sterling terms. We believe UEM's focus on real assets that produce significant amounts of cash flow translates into steadily growing dividends (*Real assets, real returns* <http://www.westhousesecuritiesresearch.com/Research/id/8536>).

Over the last twelve months the NAV of JEMI has declined by 17.5%, underperforming the MSCI Emerging Markets Index by over 500bps. While the long-term performance of the fund is significantly better than the MSCI Emerging Markets Index it is still worse than the performance of UEM. Given that JEMI is trading close to parity (1.7% discount) we continue to recommend that investors switch from JEMI to UEM. As Table 1 above shows, UEM has outperformed both JEMI and TEM over the last one, three and five years.

Table 2: UEM top ten holdings, industry split and geographical split

Top ten holdings	% gross		Geographical split	(%)	
	assets	Asset split			
MyEG Services Berhad	6.9	Gas	17.9	China (including HK)	30.2
China Gas Holdings	6.7	Electricity	14.1	Malaysia	13.8
Malaysia Airport Holdings Berhad	6.1	Ports	13.5	Brazil	9.8
APT Satellite Holdings	5.9	Satellites	10.9	Other Asia	8.3
Eastern Water Resources Development & Mgt	5.6	Water and waste	10.6	Other Latin America	7.9
International Container Terminal Services	5.4	Airports	9.1	Romania	7.4
Ocean Wilsons Holdings	4.4	Other infrastructure	7.2	Philippines	7.1
Gasco SA	2.9	Toll roads	4.7	Thailand	6.9
Transelectrica SA	2.4	Infrastructure Investment Funds	3.2	Middle East/Africa	6.2
China Resources Gas Group Ltd	2.3	Telecoms	2.0	Other Europe	2.4
Total top 10	48.6	Other	6.8	Total	100

Source: Company data, As at 31 October 2015.

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