

Research Update

Research Update:

Investment Company Utilico Emerging Markets Assigned 'BBB/A-2' Ratings; Outlook Stable

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Overview

- We are assigning our 'BBB/A-2' ratings to Utilico Emerging Markets Ltd. (UEM), a Bermuda-incorporated closed-end investment company investing predominantly in infrastructure, utility, and related sectors mainly in the emerging markets.
- Key rating strengths include the absence of redemption risk, as well as our view of the experienced investment management team and its consistent and well-performing investment strategy.
- These strengths are somewhat offset by our view of the concentration and liquidity of the portfolio holdings, the presence of "key man" risk, and the possible limited financial flexibility in periods of market stress.
- The stable outlook reflects our expectation that UEM will continue to manage leverage conservatively, that there will be no increases in investment portfolio concentrations, and that investment performance will remain satisfactory.

Rating Action

On April 10, 2014, Standard & Poor's Ratings Services assigned its 'BBB/A-2' long- and short-term counterparty credit ratings to Bermuda-incorporated closed-end investment company Utilico Emerging Markets Ltd. (UEM). The outlook is stable.

Rationale

The ratings on UEM are supported by our view of its solid and permanent capital base, consistent investment strategy and experienced management team, competitive advantage from its focus on a niche sector, relatively defensive stocks compared to other emerging market funds, and good investment performance in absolute terms. Offsetting these factors are the fund's relatively concentrated investment portfolio holdings and its focus on stocks that are less liquid than those held by higher rated investment trusts. In addition, UEM's leverage will increase following the issuance of a proposed long-term bond, potentially leaving the company close to the maximum leverage specified by its covenants. Finally, we also believe that there is some "key man" risk and that the fund's track record, while solid, is still relatively short.

Launched in 2005, UEM is newer than rated U.K. investment trust peers (although domiciled in Bermuda, UEM is listed on the London Stock Exchange and

has the characteristics of a U.K. investment trust). We consider the absence of redemption risk to be an important ratings factor, reflecting the fund's closed-end status. This factor is particularly important during periods of extreme market volatility. We consider that confidence sensitivity is not a rating constraint for UEM.

With reported gross assets minus current liabilities of £452 million (\$745 million) on Dec. 31, 2013, UEM is a midsize trust and one of very few emerging market funds that targets the niche infrastructure and utility sectors. UEM is managed by ICM Limited, a small investment manager. The investment management team focused on UEM is small, with eight core members, but each is specialized in their field. The portfolio manager, Charles Jillings, is responsible for the day-to-day management of the fund and makes the final decision to purchase or sell securities based on the recommendations of the research analysts. In our view, much of the fund's success to date can be attributed to his knowledge and expertise in stock selection, as well as effective hedging strategies. As a result, and given ICM's small size, we perceive an element of "key man" risk.

UEM has consistently demonstrated positive investment portfolio yields of between 3.3% and 4.7% in the last five years. The portfolio manager and his team conduct a thorough analysis of the portfolio companies and carry out onsite visits to the regions where the companies are located. UEM makes investments in firms in which the team has a strong, long-run conviction.

Certain of UEM's stock picks that have seen the largest gains in value represent an increasingly large share of the portfolio. The result is a less-diversified investment portfolio than those of peers. As of Dec. 31, 2013, the top 10 holdings represented more than 50% of total invested assets, which we believe is a high concentration. Moreover, the largest holding was a high 9.1% of the total. The investment portfolio also exhibits high geographic concentrations. For example, at year-end 2013, 33.5% was invested in China and Hong Kong.

We consider UEM's financial flexibility to be somewhat limited. We understand that the bank loan covenants prescribe a maximum gross debt to adjusted total assets ratio of 25%. According to management, the proposed bond, combined with an expected utilization of a new two-year bank loan facility, could raise this leverage ratio to approximately 20% from the current low levels. The strict debt covenants will limit a significant increase in leverage during market stress, which is supportive for the rating. However, this allows little headroom if equity markets were to fall. The portfolio manager could have to sell assets quite quickly in order to pay down debt and avoid a covenant breach. We also note that the bond may account for the bulk of total debt, and we see an in-market debt buyback as potentially more challenging to execute than repaying a bank loan facility.

Following the proposed bond issuance and utilization of the bank loan facility, we anticipate that our preferred leverage metric of gross debt to shareholder equity could be approximately 20%-25%, which is higher than some

peers but satisfactory for the ratings on UEM, in our view.

We take a positive view of UEM's modest appetite for share buybacks and we expect that the fund will continue to manage leverage conservatively.

Outlook

The stable outlook on UEM reflects our expectation that leverage will remain conservatively managed, that there will be no increase in investment portfolio concentrations, and that investment performance will remain satisfactory. Our ratings assume that gross debt to equity will not rise to more than 25% over a sustained period.

We could lower the ratings if we observe a material increase in risk appetite, decrease in portfolio liquidity, or sustained weaker investment performance. We could also lower the ratings if UEM's leverage increases to more than 25% for an extended period of time.

Over time, we could raise the ratings if we observe a substantial improvement in portfolio diversity, combined with consistently lower leverage.

Related Criteria And Research

- Counterparty And Debt Rating Methodology For Alternative Investment Organizations: Hedge Funds, Sept. 12, 2006

Ratings List

New Rating

Utilico Emerging Markets Ltd.
Counterparty Credit Rating

BBB/Stable/A-2

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