

Full Analysis

Utilico Emerging Markets Ltd.

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Utilico Emerging Markets Ltd.

Major Rating Factors

Strengths:

- Absence of redemption risk, reflecting the closed-end nature of the fund.
- Experienced investment management team and consistent investment strategy.
- Competitive position focused on a niche sector in the emerging markets.
- Stable investment performance.

Weaknesses:

- Relatively high investment portfolio concentrations.
- Focus on emerging market stocks results in less liquid investment portfolio.
- Presence of some "key man" risk and relatively short performance track record.

Counterparty Credit Rating

BBB/Stable/A-2

Outlook

Standard & Poor's Ratings Services' stable outlook on Utilico Emerging Markets Ltd. (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.

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, we 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 £433.4 million (\$721 million) on March 31, 2014, 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 where the team has a strong, long-run conviction in the firm.

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 March 31, 2014, the top 10 holdings represented more than 56% of total invested assets, which we believe is a high concentration. Moreover, the largest holding was a high 8.5% of the total as of March 31, 2014. The investment portfolio also exhibits high geographic concentrations. For example, at March 31, 2014, 32.1% 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%. With a bank loan facility of £50 million and total assets of £430 million as of Sept. 30, 2013, UEM's added debt capacity appears fairly limited. On the other hand, the strict debt covenants will limit any significant increase in leverage, which is supportive of the rating.

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.

Profile And Market Position: Specialist Emerging Markets Fund

Established in 2005, UEM is a global emerging market fund that seeks to identify and invest in undervalued investments in the infrastructure, utility, and related sectors. The fund is of medium size, with reported shareholder funds of £410.3 million as of March 31, 2014. Although infrastructure and utility stocks are generally regarded as defensive, they may be susceptible to political or regulatory risk. UEM's risk profile may be further affected from time to time by the greater vulnerability of emerging markets to large capital flows and the higher volatility associated with emerging market stocks. For these reasons, we consider that UEM's business risk is likely to remain relatively high.

We consider the asset management team to be adequate for the size and complexity of the fund but with some "key man" risk. UEM's board has delegated management of the fund to ICM, a Bermuda-based investment manager with

more than £1.5 billion in assets under administration. ICM has 31 staff located in Australia, Bermuda, Brazil, Hong Kong, Ireland, New Zealand, Singapore, South Africa, and the U.K. UEM utilizes the regional knowledge and research capabilities of the specialists at ICM to help identify potential investment issues and opportunities.

The day-to-day portfolio management is undertaken by a small team of 14 based in Surrey, U.K. Charles Jillings and Duncan Saville are the two senior investment directors on the team. Mr. Jillings makes the final decisions based on recommendations provided by three senior research analysts and their assistants. The same team is also responsible for managing Utilico Investments Ltd., a separate listed fund managed by ICM, which focuses on infrastructure, utility, and related stocks in the developed markets. The number of securities held by UEM is approximately 70 to 80 names, which we consider to be manageable. The research analysts are specialists in their respective sectors and search for operating companies that provide essential services or are monopolies.

Considering that much of the fund's success can be attributed to the portfolio manager's knowledge and expertise in stock selection, as well as effective hedging strategies, we see an element of "key man" risk. The risk is partly mitigated by the presence of the other senior investment director, and the senior research analysts who are familiar with the investment process.

F&C Management Ltd. provides administration services as well as certain risk management functions. The custodian is JP Morgan Chase Bank N.A.

Support and Ownership: Ratings Assume No External Support

We factor no external support into the ratings on UEM.

Registered in Bermuda, UEM is a closed-end Bermuda incorporated investment company. It is listed on the London Stock Exchange. The investment company status exempts UEM from capital gains tax on its investments. Unlike ICM, which is regulated under the Bermudan Authorities, UEM is not regulated. However, it is subject to U.K. Listing Authority compliance.

UEM's wholly independent board appoints the asset manager on a contract terminable by either party, with six months' notice. The board's independence is strengthened by the establishment of the audit committee, the remuneration committee and the management engagement committee, which is responsible for reviewing the performance of the investment manager and the administrator, F&C Management.

The discussions at the quarterly board meeting are on the investment performance of the fund and the individual securities, portfolio diversification and liquidity, leverage, dividend policy, and share price discount to net asset value, among other topics. We view positively the fact that the board also visits the portfolio companies, including the majority of the top 10 holdings.

The largest shareholder is Utilico Investments Ltd. at 27% as of Jan. 24, 2014. Aside from Utilico Investments, the shareholder base is diversified and well spread between retail and institutional clients.

Risk Profile and Management: Adequate Risk Reporting Framework

Standard & Poor's views UEM's risk management as adequate and appropriate given the nature of its risks. The board monitors the financial, market, operational, legal and compliance risks. They regularly review the long-term investment strategy and are responsible for the leverage policy.

UEM's stated policy is that a single issuer must not exceed 20% of gross assets and that exposure to a single country should not exceed 50% of the gross assets, at the time of investment. In practice, UEM's internal limits are typically more conservative at 10% and 30%, respectively. Nevertheless, in recent months the board has approved exposure to China and Hong Kong to rise above 30% to 32.1% on March 31, 2014, but we understand that this does not represent a long-term shift in risk appetite.

Although UEM does not track a benchmark, material underperformance compared to the Emerging Markets Index is monitored by the board. Any large deviation in absolute performance is actively discussed by the management engagement committee and also scrutinized by the board.

Furthermore, to help mitigate tail risk, UEM engages in market risk hedging strategies using equity futures through a segregated account in Bermuda called Global Equity Risk Protection Ltd. They do not take naked short positions or use derivatives to enhance performance. We understand that during the 2008 financial crisis, this hedging strategy was effective and contributed to the fund paying down bank debt. We view UEM's track record of managing leverage as supportive for the rating.

Investment Strategy And Management: Focus On Utility Stocks With Strong Cash Flows

In our view, UEM has demonstrated a consistent, bottom-up investment strategy since its inception. Many of the investments are stocks that are integral to the local economy, and are often supported directly or indirectly by the government. UEM prefers established operating companies that are asset-backed and generate strong cash flows. The sector analysts travel extensively to visit the underlying investment firms, understand the characteristics of the region, and become familiar with the strengths of the management teams. UEM does not materially invest in greenfield projects, nor does it make direct investments in capital goods such as airplanes or nuclear plants. We view this as a positive factor.

The portfolio holdings are formally reviewed monthly. The senior research analysts are divided according to three general subsectors: transport, traditional utilities, and communications. They must justify the continued inclusion of the invested companies and seriously debate new additions or substitutions. The investment director has the final say on whether or not to invest.

Investment Profile: High Issuer And Geographic Concentration

The portfolio is focused on listed stocks with only about 2.5% in unlisted or untraded stocks as of Sept. 30, 2013. Furthermore, the majority of the stocks are income-generating, and provide a stable source of dividends to UEM. We also view positively the fact that UEM invests mainly in ordinary shares. Moreover, UEM uses Hong Kong and New York listings for some of the Chinese and Brazilian stocks, which may support their liquidity. We understand that UEM does not invest in real estate and avoids emerging markets with weaker corporate governance or less established stock markets such as some parts of Africa or Russia.

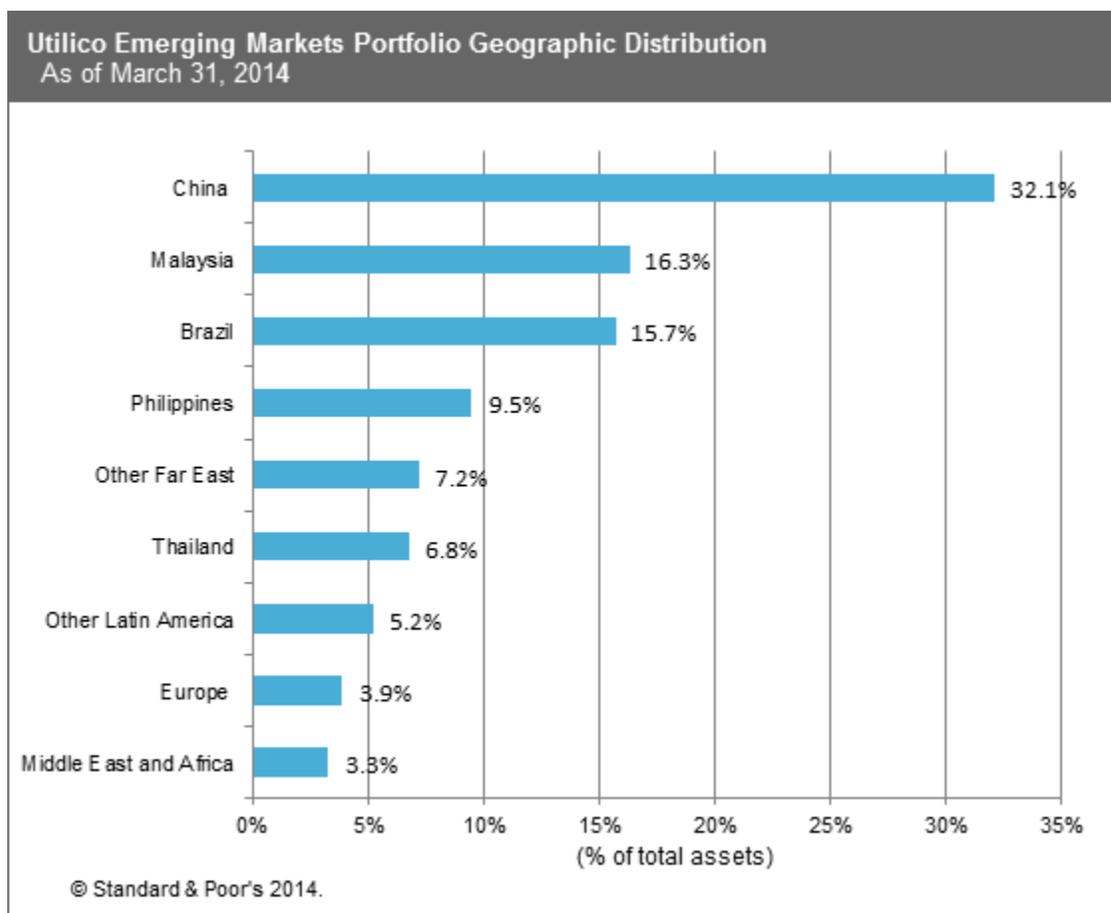
Standard & Poor's deems the high issuer and geographical concentrations as a risk factor. At March 31, 2014, the top 10 largest holdings represented 56.1% of the gross assets (see table 1).

Table 1

Utilico Emerging Markets Portfolio Top 10 Investments		
As Of March 31, 2014		
	Investment	Percentage of total assets
1	International Container Terminal Services Inc.	8.5
2	Malaysia Airport Holdings Berhad	8.4
3	China Gas Holdings Ltd.	6.6
4	Eastern Water Resources Development and Management PCL	6.4
5	Ocean Wilsons Holdings Ltd.	6.2
6	MyEG Services Berhad	5.6
7	Asia Satellite Telecommunications Holdings Ltd.	4.2
8	Gasco S.A.	3.6
9	APT Satellite Holdings Ltd.	3.3
10	China Everbright International Ltd.	3.3
Total	--	56.1

In terms of geographic distribution, China and Hong Kong accounted for 32.1% of investments (see chart 1) followed by Malaysia at 16.3%.

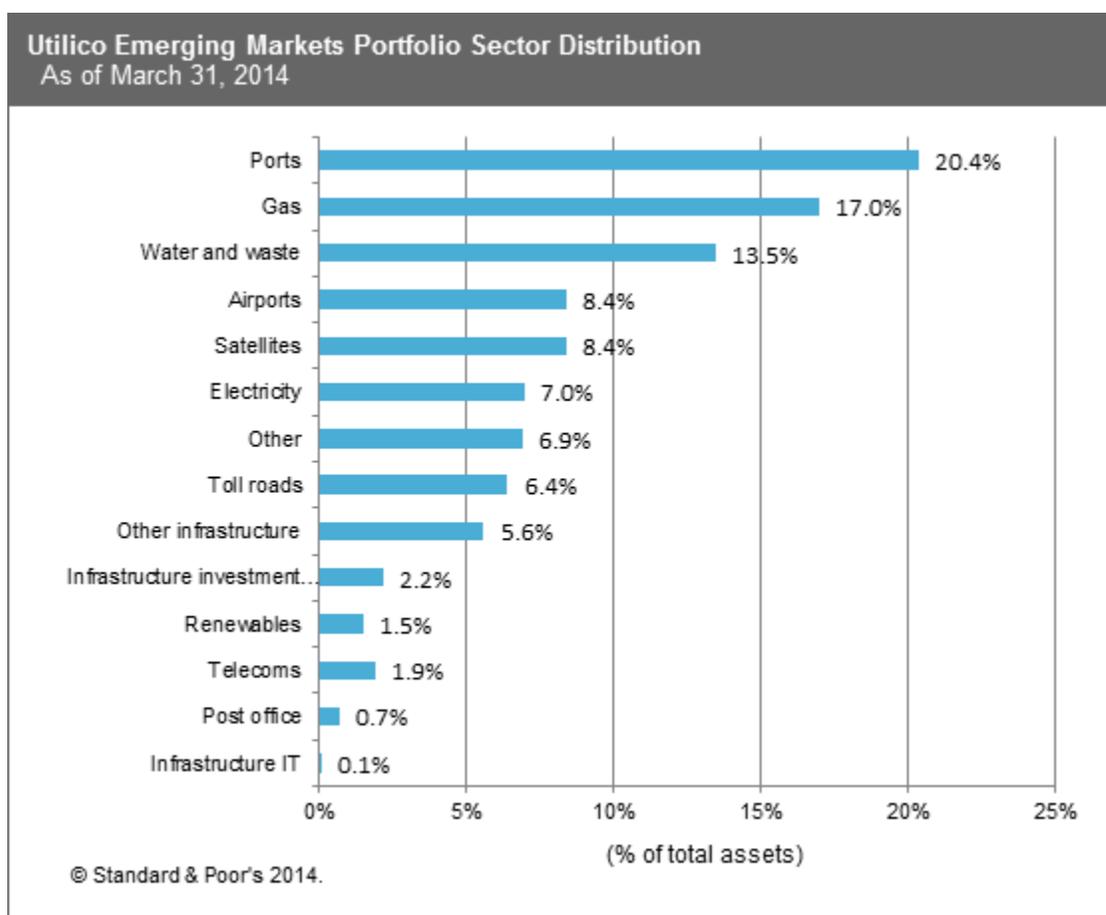
Chart 1



Among the top 10 holdings, some of the more successful stock selections were International Container Terminal Services, a Philippines-based global container port operator, which has doubled in value over the past five years and Eastern Water Resources Development and Management PCL, a Thailand-based water treatment and supply company, which has increased in value almost sixfold over the past four years. Management's ability to select well-performing stocks is positive for the rating.

In terms of sector concentration, the two largest sectors were ports at 20.4% and gas at 17.0%. We do not consider sector concentration risk to be as significant as issuer or geographic concentration risk because many individual stocks in different regions are represented in each sector. This implies greater diversification and lower concentration risk for the sector as a whole.

Chart 2



Liquidity: Relatively Low Liquidity Of Investments

Portfolio liquidity is an important rating factor for investment trusts because asset divestment is a key mechanism to manage leverage in a downturn. This is particularly true for UEM as it aims to be fully invested, and so does not carry high levels of cash or short-term bank deposits. On Sept. 30, 2013, they had £9.45 million in cash and short-term deposits, which represented 2.2% of total assets.

Income from dividends and fixed interest is an additional cash flow source, and has been steady for UEM in recent years. In the year to March 31, 2013, dividend income of £13.9 million more than covered total finance costs of £0.1 million. That said, we do not see dividend income as meaningful mitigant of liquidity risk for UEM, since it does not cover all cash outflows, including dividends to shareholders and the payment of operating expenses.

Liquidity of investments

UEM's investment focus is on stocks in the emerging markets, which we generally consider to be less liquid.

Potentially lower portfolio liquidity is therefore a key weakness compared with higher rated peers, who tend to focus on more-liquid stocks listed in the U.K. or other developed markets.

UEM tries to mitigate liquidity risk in two ways. First, the manager focuses on stocks that are defensive and pay dividends. Second, UEM assesses the potential liquidation period by comparing each investment position with historical market turnover. The investment team is also selective of the regions that they invest in. For countries in which they continue to have a large exposure, namely China and Hong Kong, Brazil, Philippines, Malaysia, and Thailand, they aim for a deep understanding of the regulatory environment, the political and social tendencies, and overall health of the economy. This is supportive of the rating.

We recognize the fact that UEM was able to sell many of its positions during the highly challenging months of September to November 2008 when equity markets fell sharply and market liquidity was especially poor.

Investment Performance: Strong Portfolio Yield And Growth In Net Asset Value

In the relatively short time since launch, UEM has reported stable investment income from its portfolio holdings and high interest coverage due to having low debt or less expensive short-term debt. It has been able to manage through the difficult market conditions by selling assets, profiting from their hedges, and reducing leverage while at the same time reinvesting in some good names to maintain portfolio income.

The portfolio income yield has been positive between 2006 and 2013 and ranged from 2.6% to 4.7% (see table 2).

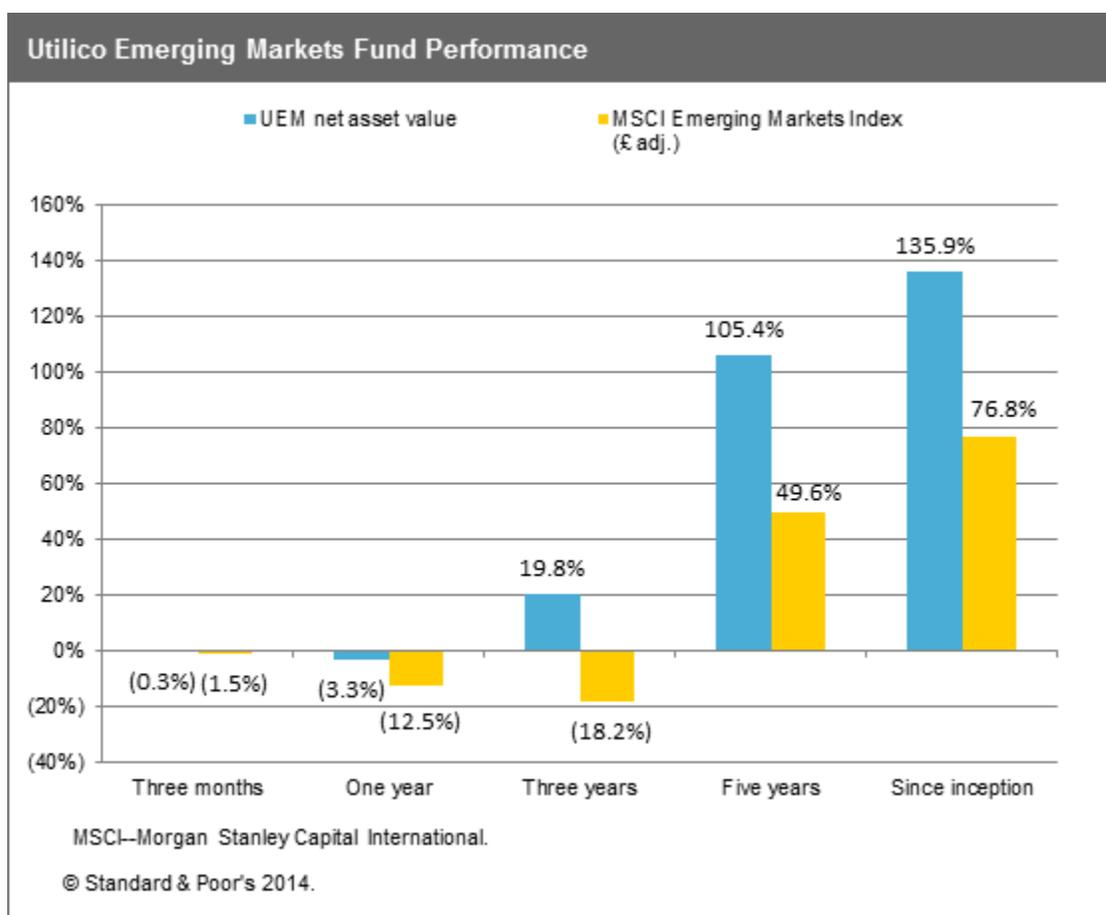
Table 2

Utilico Emerging Markets Portfolio Income Yield				
	Revenue return (£000s)	Investment assets (£000s)	Average (£000s)	Yield (%)
2013	13,945	455,901	415,035	3.4
2012	12,710	374,169	388,598	3.3
2011	15,190	403,026	372,739	4.1
2010	13,671	342,451	293,981	4.7
2009	14,267	245,511	329,739	4.3
2008	12,781	413,967	343,838	3.7
2007	8,457	273,708	190,882	4.4
2006	2,073	108,056	81,043	2.6

UEM also benefits from low expenses, in line with most investment companies. The main expense is the investment management fee of 0.5% of gross assets after deducting current liabilities and a fee paid to the administrator. There is an additional performance-related fee if certain metrics are met.

The total return of UEM's net asset value has outperformed the MSCI Emerging Markets index (sterling adjusted) over the short-to-medium term (see chart 3). Key drivers for this performance are its strong net asset value growth from capital appreciation and low cost base.

Chart 3



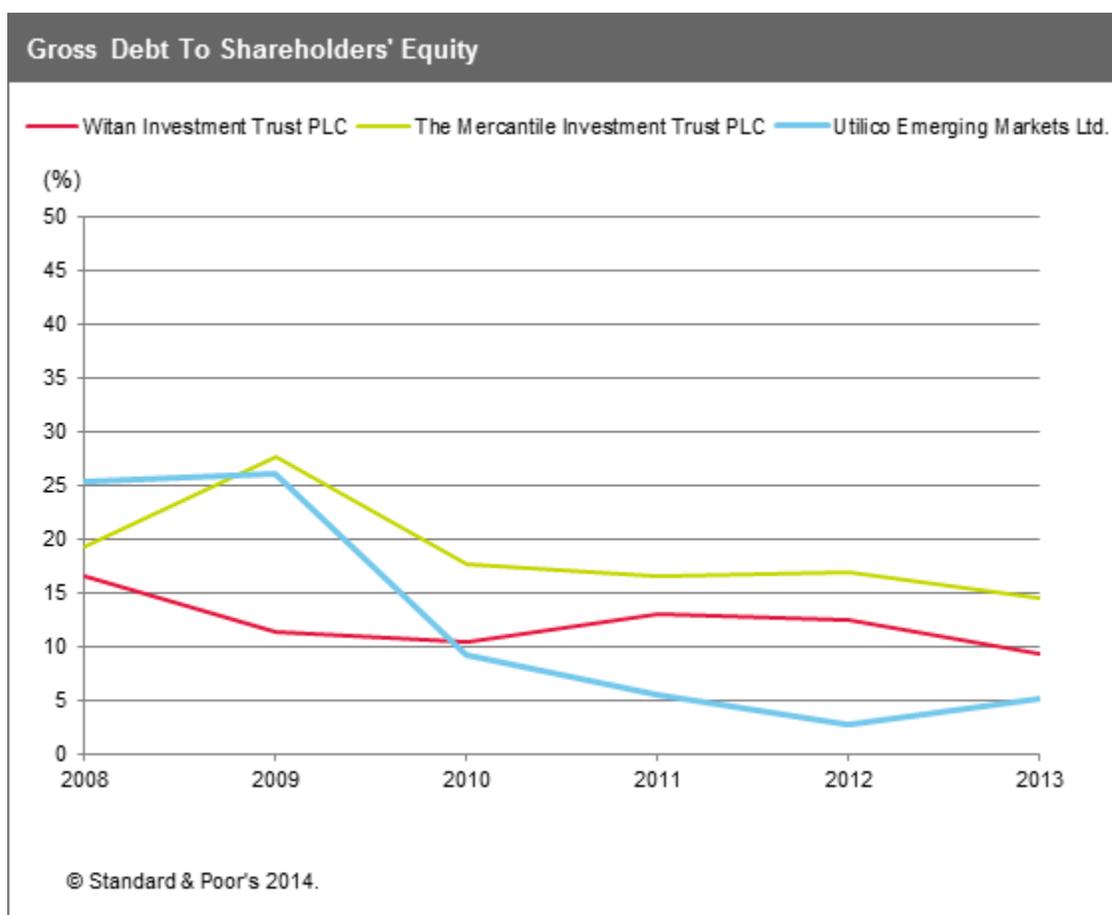
Capital: Low Leverage And Funding Risk

UEM is a well-capitalized institution. Reported equity represented 94% of total assets at Sept. 30, 2013. UEM benefits from a two-year, multicurrency bank loan facility of £50 million, of which £21.7 million was drawn down in the same period. Assuming that this facility is fully drawn, we estimate that gross debt to adjusted assets (adjusted for non-listed investments and assets held in other subsidiaries) could be close to 12%. This leaves some headroom for UEM's bank loan covenants.

For leverage, Standard & Poor's preferred measure is gross debt-to-shareholders' funds. On this basis, UEM's leverage at 5.1% as at year end 2013 is currently in the lower range of higher-rated peers and consistent with the ratings on UEM (see chart 4).

In April 2014, UEM stated it planned to issue a long-term secured bond. Subsequently, following consultation with major shareholders, this strategy was not pursued. We note UEM's potential leverage appetite.

Chart 4



According to Standard & Poor's ratings definitions, we consider that a 'BBB' rated company should generally be able to withstand a 50% decline in equity markets. With only half of the £50 million bank loan facility drawn down and an investment portfolio of £415 million as of Sept. 30, 2013, there is low funding risk. We believe that UEM will be able to meet its obligations in a full and timely manner even if stock markets fell significantly and for an extended period. We take into consideration UEM's proven ability to manage its leverage during a market downturn and the closed-ended nature of the fund.

We consider it unlikely that UEM will engage in opportunistic share buybacks that would adversely increase leverage. Management carried out share buybacks in the past, mostly during times when the fund was a net seller of assets, and on a few occasions to manage the share price discount (gap between the company's share price and its net asset value). The impact of buybacks on capitalization was minimal. In 2013, only 2.3 million shares were repurchased.

Looking forward, we believe UEM has a modest appetite for share buybacks and expect that leverage will remain conservatively managed. Standard & Poor's considers the current level of dividend payments to be sustainable. While UEM relies on asset sales and effective hedging strategies to repay debt, its large capital reserve account provides substantial dividend-paying capacity.

Table 3

Utilico Emerging Markets Financial Ratios						
	--Year ended March 31--					
(£000s)	2014 H1	2013	2012	2011	2010	2009
Assets	430,000	465,506	391,033	407,424	351,802	284,743
Investment assets	415,087	455,901	374,169	403,026	342,451	245,511
Long-term (LT) debt	1,661	2,668	6,789	2,277	26,320	41,810
Cash and short-term deposits	9,450	2,798	387	211	1,974	24,058
LT debt (net of cash)	(7,789)	(130)	6,402	2,066	24,346	17,752
Shareholder funds	403,630	442,887	378,470	383,151	319,882	230,733
Adjusted shareholder funds*	400,378	439,600	374,698	380,026	302,512	178,850
Return before tax on capital account	(37,778)	66,490	3,296	55,440	105,891	(130,695)
Return before tax on revenue account	8,649	11,989	9,615	12,907	10,818	11,397
Net income	(28,775)	77,403	11,459	66,591	113,512	(118,068)
Ratios (%)						
Expenses/net assets	0.81	2.90	0.95	2.49	0.86	1.16
Capital (%)						
Equity/total assets	93.87	95.14	96.79	94.04	90.93	81.03
Leverage (%)						
Gross debt/equity	6.53	5.11	3.32	6.34	9.98	23.41
LT debt/equity	0.41	0.60	1.79	0.59	8.23	18.12
LT debt/adjusted equity	0.41	0.61	1.81	0.60	8.70	23.38
LT debt (net of cash)/adjusted equity	(2.86)	(1.10)	(0.12)	0.08	7.40	3.17
LT debt/total assets	0.39	0.57	1.74	0.56	7.48	14.68
LT debt/investment assets	0.40	0.59	1.81	0.56	7.69	17.03
LT debt (net of cash)/investment assets	(1.88)	(0.03)	1.71	0.51	7.11	7.23
Portfolio concentration (%)						
Individual largest as % of total assets minus current liabilities	9.16	11.46	9.23	10.42	11.63	8.43

Table 3

Utilico Emerging Markets Financial Ratios (cont.)						
Sum of 10 largest as % of total assets minus current liabilities	55.46	56.98	51.61	54.50	50.77	51.27

*Reported shareholder funds minus proposed final dividend.

Related Criteria And Research

Related Criteria

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

Ratings Detail (As Of May 9, 2014)	
Utilico Emerging Markets Ltd.	
Counterparty Credit Rating	BBB/Stable/A-2
Counterparty Credit Ratings History	
10-Apr-2014	BBB/Stable/A-2
Sovereign Rating	
Bermuda	AA-/Negative/A-1+
*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.	

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