British Empire Trust

While British Empire Trust is sitting on a wide discount, the recent sell-off has turned up a wave of new opportunities...

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LAST UPDATE 07 MAY 2019

Kepler View

BTEM has plenty of peers in the Global sector, but none that look anything quite like it. The portfolio is assembled on its value merits, but on an underlying basis, many of the holdings are high quality growth stories. In an age when many investment portfolios are assembled using a "painting by numbers" approach, it is perhaps no wonder that the discount remains stubbornly wide.

We believe the good performance numbers from 2016 onwards are a direct result of the changes that Joe Bauernfreund implemented in late 2015. We think this trust offers excellent diversification benefits, holding investments which are unlikely to be held by the average investor. The activist approach taken by Joe and the team at AVI is also reasonably unusual in a mainstream product.

If interest rates rise, or we see global growth start to falter, we could see a swift rotation in stock market leadership towards stocks exhibiting more of a "value" style. BTEM's nuanced strategy, growth with value elements, is likely to perform well in that scenario. Over the medium term the current discount provides insulation relative to global peers, with the potential for the discount to narrow if the performance track record continues to improve, given the unique strategy.

BULL	BEAR
Strong NAV returns after a management shake-up 3+ years ago	Returns are likely to be lumpy given the concentration and the nature of the investment theses
Unique approach and portfolio make trust a very different animal to most Global investment trust peers	KID RIY is high as one might expect given the strategy, although OCF is competitive
Discount very wide relative to peers	

Gearing

BTEM has recently announced that one of the historic debentures, which paid an interest rate of 8.125%, is being compulsorily redeemed by the company. It will be replaced by a Japanese Yen loan, and together this will mean that the weighted average interest on all borrowings will be reduced to 2.9%, compared with 4.3% currently. This transaction which will be completed in June, will mean the company has loans in Euros, Sterling and Yen. The Chairman comments that replacing the expensive debenture (at a premium) will potentially "marginally enhance both the revenue earnings and capital returns". Following the repayment of the debenture, the trust will have various elements of flexible and structural gearing, which together, if/ when fully drawn would equate to just under 10% of net assets.

As the graph below shows, since Joe took over sole management of the trust, the company has been largely fully invested, and at times deployed all of its gearing. This reflects his views that AVI's ability to time markets, and hold cash, is limited. Within this, gearing levels are driven by the opportunities that the team find on a bottom-up basis.

NET GEARING

Source: Morningstar

Discount

The discount of the company's share price to NAV has remained stubbornly wide. As the graph illustrates, the discount has certainly narrowed since Joe took sole responsibility for the trust in October 2015, and the performance started to improve. Nevertheless, we continue to believe that the discount remaining in high single digits is a reflection of the specialist strategy and that the value style remaining out of favour. Certainly, there have been moments when it looks like the market has started to notice the strong NAV performance, with the discount moving in at times past the 8% mark.

DISCOUNT

Source: Morningstar

However, the difference between the trust's discount (9.1% at the time of writing) and the sector average remains wide, with global trusts now trading close to par thanks to strong appetite for ex-UK assets following the Brexit vote. We continue to see this as a clear inefficiency and something that could revert quite quickly if the world suffers a "growth wobble", or US interest rates start to rise once again.

This is particularly true when we consider the "double discount": given the value approach, the portfolio holdings are also trading on significant discounts. The current look through discount on the portfolio is 32%, meaning that investors in BTEM at the current share price discount, are buying assets for around 62p in the pound.

LOOK THROUGH DISCOUNT

Source: AVI

The managers estimate that around half of the double discount widening since the start of 2018 has been due to the managers selling down successful investments and recycling into cheaper ones with greater potential. However, the other half has been widening discounts on the trust's holding companies, a trend the managers have seen across their universe, not just the trust's picks.

The board is active with buybacks, although it has no target level for the discount. At the time of writing, the last time the board bought shares back was on 19th December 2018, on a discount of 9.9%.

Dividend

The yield on BTEM's shares is 1.8%, which compares to the weighted average for the Global sector of 1.3%. The managers' focus is on achieving total returns, and there is no formal income target. However, the dividend has been increased each year for over three decades, and the board has stated that it would expect it to be at least maintained in the medium term.

DIVIDENDS

Source: AVI

Last year the board paid an uncovered dividend, with revenue per share falling from 14.3p to 10.4p, compared to a dividend of 12.5p. This year, portfolio income has been much stronger, meaning the board was able to contribute to the revenue reserve once again, which we estimate currently stands at 1.66 times the 2018 dividend. It is worth noting that the board has authority to distribute capital as income, so we expect the payout to be protected even in a very bleak year for revenue generation.

Portfolio

British Empire Trust (BTEM) has a very long history as a specialist "value" investment vehicle. Over the course of its history, the managers have always aimed to exploit their niche expertise in identifying listed companies that are trading at well below the manager's estimate of intrinsic value. This focus extends to the closed-end fund universe, as well as family-owned holding companies and asset-backed companies around the world. Often these are under-researched by the wider market, and offer those with the expertise and a willingness to research complicated ownership structures the opportunity to benefit from hidden value. Since Joe Bauernfreund took sole responsibility for the portfolio in October 2015, he has significantly concentrated the portfolio, and focused more on investments which have an identifiable catalyst for a discount to narrow. Increasingly, the managers look to take a "behind the scenes" activist approach which may help unlock value, or bring forward the catalyst. As we discuss in the performance section, this change has made a tangible improvement to performance.

TOP TEN HOLDINGS

	% OF PORTFOLIO
Japan Special Sits	14.9
Pershing Square Holdings (hedged & unhedged)	10.3
EXOR	6.0
Tetragon Financial	5.5
Fondul Proprietatea	5.5
Swire Pacific B Shares	5.3
Jardine Strategic	5.1
Third Point Offshore	5.0
Oakley Capital Investments	4.9
Symphony International	4.6
Total	67.1

Source: AVI, as at 31 March 2019

Asset Value Investors is a specialist asset manager with a dedicated team of six investment professionals, who work together to monitor a universe of around 350 companies globally. They run live models on what they believe underlying NAVs should be, and aim to identify those situations which trade significantly below this value. They then look to identify potential catalysts for a re-rating, which could involve asset sales, changes of management, IPOs, takeovers, or the return of capital to shareholders.

The result is a portfolio of companies which offers diversification on a number of levels. First, the underlying holdings of each stock is often highly diversified, meanings that the portfolio is arguably not as concentrated as it looks. Currently, the top ten investments make up 66% of the portfolio, but given these are mainly funds or holding companies with varied portfolios of their own, the top ten underlying holdings represent 20.6%, a level of concentration similar to many traditional equity funds.

TOP TEN UNDERLYING HOLDINGS

	%
Swire Properties	3.8
Minor International	2.8
Bureau Veritas	2.1
Hidroelectrica SA	2
Partner RE	2
Fiat Chrysler	1.7
TFG Asset Management	1.7
Cosan Logistica	1.5
Ferrari	1.5

Source: AVI, as at 28 February 2019

As one might expect, the managers take portfolio management seriously, and ensure that the portfolio is made up of stocks in a wide variety of industries and geographies, although often united thematically thanks to market inefficiencies opening up in certain sectors. As such the portfolio is likely to be a useful diversifier to a broader portfolio of funds, given that the areas where Joe and the team typically find opportunities are more esoteric and less likely to be in a typical investor's portfolio.

As at 28 February 2019, closed-ended funds make up 48% of the portfolio, up from 38% just before Joe took over in 2015. This increase in weight reflects the greater focus on activism. Within this bucket, key themes include private equity, which currently constitutes two holdings (Oakley Capital Investments and JPEL Private Equity) and 9.1% of NAV. This has been a long-standing area of opportunity after the listed vehicles fell onto large discounts following the 2008 crisis. AVI intend to hold JPEL as the portfolio runs off, and they believe that Oakley Capital Investments is increasingly resembling HgCapital Trust (which trades on a very small discount to NAV), yet Oakley's wide discount reflects corporate governance misdeeds of the past.

Another key theme in the closed-ended fund bracket is investments in other activist investor hedge funds. Both Pershing Square Holdings (10% of NAV, although 4.6% represents a hedged position and has no exposure to the underlying investments – just the discount) and Third Point Offshore Investors (4.8%) continue to trade on wide discounts and AVI believes both represent a significant opportunity – both from an improvement in NAV performance and/or the discount to narrow. AVI contends that it is unsustainable for managers with such high-profile activists to preside over vehicles trading at wide discounts. Pershing Square has completed a number of initiatives, but perhaps of more relevance, the NAV performance so far this year has been very strong indeed (+40% at the time of writing, after having been flat in 2018). Third Point has taken some strong steps towards addressing their discount, including starting to buy shares back, a new chairman and a reduced management fee, down from 2% per annum to 1.25%. Both companies remain on wide discounts.

ASSET ALLOCATION

Source: AVI

As the graph above shows, BTEM continues to have a significant proportion of assets in family-backed companies, usually conglomerates or holding companies – many of which are in Asia. AVI have 5.4% of the portfolio in Jardine Strategic, part of the Jardine Matheson Group which the trust has invested in for 12 years. However, AVI has also been adding to their position in Swire Pacific, which the team view as a turnaround situation. Swire's shares were knocked in part due to weak performance at key asset Cathay Pacific, but also due to a large institution selling down their stake and as such trade well below the AVI sum of parts valuation. AVI believes that Swire Pacific bears all the hall-marks of a classic turn-around story, with structural changes made at the company that are already beginning to bear fruit. AVI believes the Keswick and Swire families have demonstrated an ability to compound wealth over generations, and with the rise of the middle-class in Asia, should retain their tailwinds.

Another more recent holding in the portfolio is Godrej Industries, in which the team are building up a position. The company is a family backed, Indian holding company with exposure to consumer goods and property. The team looked at this opportunity over two years ago, but the long bureaucratic process involved in getting set up to trade Indian stocks delayed their investment. Since then, the share price has failed to keep up with NAV growth and the discount has widened further (the team estimate 43%), and so the team have begun building a position The team rarely find opportunities in the US (hence the MSCI ex US benchmark). However, Cosan is a 4.3% position, and is a US-listed family holding company with Brazilian assets. The stock has been one of the better performing positions in the portfolio, with the family committed to restructuring and consolidating the complexity of the company. AVI's longer-term investment horizon has enabled the trust to invest where many US hedge funds with much shorter-term horizons have not.

Increasingly important to the trust are its holdings in Japanese special situations, which sit in the asset-backed bucket and make up 14.2% of the fund, or 18.4% if Tokyo Broadcasting System is included. Joe and the team see the opportunity in under-researched, asset-rich businesses with deeply inefficient balance sheets, and this has risen as a percentage of the portfolio from 9% when Joe took responsibility for the trust.

The underlying economic exposure of the companies in the portfolio can be very different from their place of listing, as the graph below illustrates.

LOOK THROUGH GEOGRAPHIC BREAKDOWN

Source: AVI

AVI's job is to ensure that the trust is exposed to the most exciting opportunities available to it. Part of this opportunity set can be seen in the look-through discount of the portfolio to AVI's estimate of NAV. In the graph below we show this evolution over time, and we note that following the sell-off in Q4 2018, the weighted average underlying discount of the portfolio is approaching historically wide levels. Clearly part of this is influenced by the portfolio make-up, but it also represents the availability of interesting opportunities on wide discounts.

WEIGHTED AVERAGE DISCOUNT ON PORTFOLIO

Source: AVI

Returns

Over the ten years to the last financial year end (30th September 2018), BTEM has produced a compound average annual net asset value total return of 10.0% versus 9.0% from the MSCI All Country World ex-US Total Return Index in Sterling terms. Notwithstanding this strong long-term track record, there have been periods in the intervening period where BTEM underperformed. However, as we discuss in the portfolio section, performance has visibly improved since Joe Bauernfreund took sole responsibility for the trust. Upon taking sole charge of the portfolio, he chose to concentrate the portfolio, aiming to be fully invested at all times, and concentrate on opportunities which have the clearest catalysts.

The graph below shows relative NAV performance of the trust against the benchmark over the past five years, in which a downward sloping line denotes periods of underperformance, and upward sloping represents outperformance. It is not long after Joe took over that performance turned around. The managers believe that an element of their strong performance highlights the underlying exposure to high-quality growth companies.

RELATIVE NAV PERFORMANCE

Source: Morningstar, Kepler Partners

The historic calendar year returns of the trust can be seen below. During what was a very strong 2016, catalysts played out successfully at key holdings, with a tailwind from their relatively low exposure to sterling revenues and the extra gearing added by Joe after he took over management of the trust. We think it notable that this year the trust has done a good job of keeping up with the index, in what has once again been a strong run for growth stocks.

CALENDAR YEAR NAV RETURNS

Source: Morningstar

Over the short term, whilst the trust has kept up with its benchmark over the past twelve months, it has lagged global peers. On the other hand, it has been considerably less volatile than Global investment trust sector peers, lagging in strong periods for the sector, but falling less far in more difficult periods.

NAV PERFORMANCE

Source: Morningstar

In general, the idiosyncratic nature of the strategy mean that its fortunes can diverge significantly from global markets, and in fact pigeon-holing the trust is sometimes difficult.

Management

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Joe Bauernfreund has been sole named manager since October 2015, when his former co-manager John Pennink stood down. Joe has been with AVI since 2002, starting as an analyst working on European holding companies. He became co-manager in 2013, before his eventual elevation to the leading role, and currently serves as CIO and CEO of AVI. Joe has 16 years' experience working within the value philosophy of AVI, and the stronger performance under his tenure reflects the adjustments he has made to the portfolio. Joe is supported by Tom Treanor, head of research, who has overall responsibility for the closed-ended funds in the portfolio. Tom has been with AVI since 2011 and has a background in closed-ended fund research. Joe and Tom draw on the work of four specialist analysts at AVI.

Charges

AVI are paid a basic management fee of 0.7% of NAV per annum and no performance fee. The OCF is 0.87%, which is wider than the weighted average of 0.56% for global trusts, which reflects the specialist strategy. The KID RIY figure is 3.2% compared to a 1.12% weighted average for the Global sector (according to JPMorgan Cazenove), although we would caution that different managers use slightly differing methodologies to calculate this figure. AVI note that these charges reflect costs of gearing at investee closed-end funds, and contend it is inappropriate to consider solely the costs of leverage without also taking into account its beneficial impact on returns. Similarly, performance fees on underlying holdings inflate these figures yet are reflective of strong returns.

Summary

Investment objective

British Empire's investment objective is to achieve capital growth through a focused portfolio of investments, particularly in companies whose share prices stand at a discount to estimated underlying net asset value.

As at:

06/05/2019

Group/Investment

British Empire

Ticker

BTEM

Management Company

Asset Value Investors

Manager Name

Joe Bauernfreund

Association of Investment Companies (AIC) Sector

Global

12 Mo Yield

1.6%

Dividend Distribution Frequency

Semi-Annually

Latest Market Capitalisation

£815,148,465

Latest Net Gearing (Cum Fair)

9%

Latest Ongoing Charge Ex Perf Fee %

0.86

Turnover Ratio %

37.7

Shares Outstanding

110,904,553

(Discount)/ Premium % (Cum Fair)

-8.9

Daily Closing Price

735p

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Since Joe Bauernfreund took sole responsibility for the portfolio in October 2015, he has significantly concentrated the portfolio, and tried to focus more on ideas which have an identifiable catalyst for a re-rating. Increasingly, the managers look to take a “behind the scenes” activist approach which may help unlock value, or bring forward the catalyst. As we discuss in the performance section, this change has made a tangible improvement to performance.

BTEM’s portfolio of companies offers diversification on a number of levels. First, the underlying holdings of each stock are often highly diversified, meaning that the portfolio is arguably not as concentrated as it looks. Currently, the top ten investments make up 66% of the portfolio, but given these are mainly funds or holding companies with varied portfolios of their own, the top ten underlying holdings represent 20.6%, a level of concentration similar to many traditional equity funds.

In general, the idiosyncratic nature of the strategy means that its fortunes can diverge significantly from global markets, and in fact pigeon-holing the trust is sometimes difficult. Importantly, the trust has very different return drivers from many of its peers.

Following the sell-off in Q4 2018, the weighted average underlying discount of the portfolio is approaching historically wide levels. Clearly part of this is influenced by the portfolio make-up, but it also represents the availability of interesting opportunities the team are finding which have attractive discounts.

Since Joe took over sole responsibility for the trust, performance has measurably improved. After a very strong 2016, the trust has essentially kept up with its benchmark, but is currently lagging global peers over 12 months. On the other hand, it has been considerably less volatile than them, lagging in strong periods for the sector, but falling less far in more difficult periods.

The discount remains wide both in absolute terms, but also relative to other investment trusts. It has certainly narrowed since Joe took sole responsibility for the trust in October 2015, and the performance started to improve. However, the difference between the trust’s discount (9.1%) and the sector average remains wide, with global trusts now trading close to par. This could revert if the world suffers a “growth wobble”, or US interest rates start to rise once again.

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