AVI Global Trust

Update
12 December 2019

Focusing on accessing a diverse array of opportunities globally, AGT seeks companies with high-quality assets exhibiting growth and trading at a discount to fair value...

Summary

AVI Global (AGT- previously British Empire Trust) seeks to generate capital growth for investors through investment in a reasonably concentrated portfolio of listed companies whose shares trade at a discount to the manager's estimate of fair value. AGT is managed by Joe Bauernfreund, CIO of Asset Value Investors.

With a history stretching back over 130 years, this is one of the oldest trusts in the UK, and has seen gradual but ultimately substantial changes to the investment strategy over this time period. Under manager Joe Bauernfreund, who took over in 2015, AGT has evolved its investment strategy, looking to increase portfolio concentration, utilise attractive borrowing rates on long-term debt, and place a greater emphasis on identifying a catalyst for value realisation, amongst other factors.

Holdings can be categorised as either: 1) closed-ended funds, 2) family-backed holding companies, or 3) asset-backed special situations, which currently consists primarily of Japanese cash-rich operating companies. The exposure to Japan has been gradually increasing in recent years, as AVI believes there is a substantial investment opportunity in their investment strategy in this area, so much so that they launched a separate investment vehicle focusing solely on this opportunity.

Despite having outperformed its benchmark under the current manager, AGT has remained fairly stubbornly at a discount to NAV. The board has undertaken share buybacks, and there is evidence that they have been successful at reducing discount volatility in recent years, as detailed in the Discount section. On a look-through basis (i.e. factoring in the underlying discounts on the various holdings), there is a substantial double discount of c.37%.

Whilst a number of AGT's holdings are listed in the UK, it is truly global in its outlook, and has very low exposure to the UK on a look-through basis. This tends to make it sensitive to any fall in sterling (i.e. a decline in sterling tends to positively impact performance), though this is partially mitigated by borrowings in foreign currencies.

Analyst's View

The structural changes implemented in AGT over the past few years seem to have made it well suited to the evolving global financial landscape. Increased concentration and the focus on smaller companies generally means that AGT is a significant shareholder in many of the holdings (especially closed-ended funds or small-cap Japanese companies) within the portfolio, giving it significant influence over company management which it can use to encourage them to realise the latent value in their firms. The focus on high- quality underlying assets and the effectiveness of identifying catalysts can be seen in the sources of returns. For holding companies, c.75% of returns come from NAV growth and c.25%

Key Information:

As at	04/12/19
Price (p)	763
Discount (%)	-8.8
OCF (%)	0.85
Yield (%)	2.2
Gearing (%)	6
Ticker	AGT
Turnover Ratio (%)	28.7
Shares (£)	109,343,695
Market cap (£)	834,292,393

Analysts:

William Heathcoat Amory
+44 (0)203 384 8795

Pascal Dowling
+44 (0)203 384 8869

Thomas McMahon, CFA
+44 (0)203 795 0070

William Sobczak
+44 (0)203 598 6449

Callum Stokeld
+ 44 (0) 203 795 9719

from discount narrowing, according to the managers' calculations. For closed-end funds, the split is c.50:50.

AGT defies easy categorisation, with a highly differentiated strategy. It does not sit easily in a broad-brush asset allocation model, but we believe the sometimes idiosyncratic nature of the sources of return are attractive. The trust may, at first glance, appear to have a value focus because of the emphasis on buying assets at a discount to fair value. However, the underlying assets typically exhibit high-quality, cyclically resilient characteristics, and have generally been able to grow NAV strongly (with the expectation they can continue to do so). The atypical manner (via methods such as tender offers, special dividends or buybacks) in which returns are sometimes generated means periods of outperformance may occur suddenly and sharply.

Analyst's View

BULL	BEAR
Double layer of discounts	Positive sensitivity to falling sterling has been a tailwind, but could reverse
Relatively idiosyncratic return profile	High level of KID RIY
Exposure to an array of otherwise hard-to-access opportunities	

Portfolio

AVI Global investment trust (AGT- previously British Empire (BTEM)) invests in listed equities around the globe, focusing on under-researched and overlooked companies, often with low levels of broker coverage. It takes an approach unconstrained by a benchmark, seeking to build a concentrated portfolio of companies which themselves tend to own high-quality assets, trade at a discount to their intrinsic value, and are likely to be the beneficiaries of a catalyst that will narrow the discount. Although operating a global mandate, the trust is benchmarked against a world index that excludes the US as there is a relative paucity of investment opportunities in the US suitable for the trust's investment approach, largely due to the greater efficiency in US markets.

AGT has an extensive history, having been launched c.130 years ago. However, it has understandably evolved in approach on different occasions as the world changed around it. Most recently, it has been undergoing a gradual strategic transition in the period since 2013, with this process having accelerated when Joe Bauernfreund was appointed sole manager (in September 2015). This has included two instances of rebranding, in 2015 and earlier in 2019.

More specifically, the trust has increased the concentration of positions, gradually reducing the total number of holdings (from c.40 in 2015 to 28 in October 2019, though this counts the Japan basket as one holding) and adjusting the investment process to include a greater focus on identifying a catalysing factor which can drive value realisation. Increasingly, this has also involved greater interaction and activist engagement with the boards on many of their holdings, seeking to themselves help instigate and accelerate value realisation.

As well as reducing the overall number of holdings, there has been increased concentration into higher-conviction positions than was previously the case. This increased concentration is well illustrated in the table below, comparing the top ten positions in October 2019 to those four years prior.

Top Ten Holdings, As At 30/09/15 And 31/10/19

30.09.2015		31.10.2019	
Holding	**% of NAV**	**Holding**	**% of NAV**
Investor AB 'A'	5.8	Japan Special Situations	18.9
Sofina	4.8	Pershing Square Holdings*	7.3**
NB Private Equity	4.5	Oakley Capital	6.4
Harbourvest Global Private Equity	4.3	Sony Corp	5.3
Kinnevik 'B'	4.0	EXOR	5.1
Jardine Matheson	3.9	Jardine Strategic	5
AP Alternative Assets	3.3	Third Point Offshore	4.9
Mitsui Fudosan	3.3	Eurocastle	4.4
DWS Vietnam	3.2	Fondul Proprietatea	4.4
Wendel	3.2	Tetragon Financial	4.0
Total:	**40.3**	**Total:**	**65.7**

Source: AVI

* 25% of the holding in Pershing Square (PSH) is hedged on a pro rata amount of the underlying holdings. Therefore, on the hedged position, AGT is exposed to potential equity-like returns from discount tightening while not taking on additional market risk.

** The notional value of the PSH long position (25% of the long position is held through swaps).

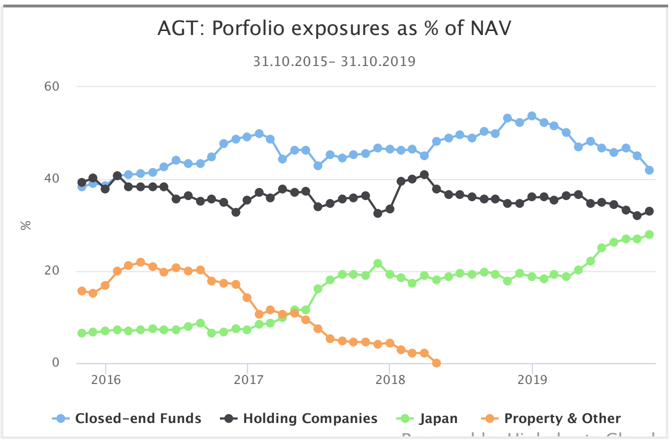
The investment process involves searching for companies that are overlooked or under-researched, and thus liable to pricing inefficiencies. Typically there is low or no broker coverage, and ordinarily a skew towards small or mid caps.

AVI run live models on c.350-400 companies on an ongoing basis to try and ascertain what the net asset value (NAV) of each company should be, and to identify which companies trade at a significant discount to this.

Whilst AGT is value-oriented, it seeks to hold an eclectic array of companies operating across the globe. The companies themselves generally own high-quality assets, and have displayed strong NAV growth or have a strategy in place to drive NAV growth. On a look-through basis, this gives AGT exposure to high-quality growth stocks such as Ferrari, Adidas, Zalando and Starbucks.

Presently holdings fall into one of three categories: 1) closed-ended investment funds, 2) family-backed holding companies, or 3) asset-backed special situations, which currently primarily consist of Japanese cash-rich operating companies.

Fig.1: Thematic Allocation



Source: AVI

Investments into closed-ended funds focus on portfolios of high-quality assets trading at a discount to NAV, with an emphasis on identifying a suitable, high-probability catalyst for a narrowing or removal of the discount. Realising the value from these discounts often involves engagement with management, boards and other shareholders, seeking to develop and enact policies to reduce discounts. AVI estimates c.50% of returns from this category have been driven by discounts narrowing.

As an example, earlier in 2019 AGT invested in closed-end fund Eurocastle Investment (ECT) at an average discount of 21%. ECT holds a concentrated portfolio of Italian assets, where they believe the financial crisis has created a significant investment opportunity due to a supply-demand imbalance driven largely by regulatory pressures. In November, ECT announced that it had resolved to dispose of the majority of its assets (doValue and Italian non-performing loans – subject to approval at an EGM) and return proceeds via a tender offer. This transaction will see shareholders get back the majority of their investment at close to a zero discount to NAV.

When analysing family-backed holding companies, AVI looks for a high-quality portfolio with a book of assets with the potential for sustained, superior long-term growth. They will also have the preference of a controlling family or shareholder who themselves have demonstrated strong capital allocation abilities and the ability to generate superior returns. Joe believes this will ordinarily drive superior NAV growth, and that long-term shareholders offer strategic vision which helps ensure good capital allocation decisions are taken. Investments into these companies are undertaken at a discount to NAV, offering an additional source of potential returns; there is also a preference for a catalyst to drive discount narrowing. AVI estimates that historically c.75% of returns from this category have been derived from NAV growth, whilst the remaining 25% is driven by narrowing discounts.

Some of AGT's holdings in this area have proven to be headwinds in recent months, with Asian listed assets suffering from negative sentiment surrounding trade-war concerns and the escalating situation in Hong Kong. Swire Pacific, for example, has 73% of NAV invested in Swire Properties (AGT's biggest holding on a look-through basis, which owns a prime mixed-use property portfolio in Hong Kong, select Tier 1 cities in China, and Miami). A further 11% of Swire Pacific is invested in Cathay Pacific, the airline operator. Both of these underlying holdings have seen negative impacts upon performance following the escalation of political tensions in Hong Kong, counteracting the benefits seen by strong operational management.

Whilst resolution of these issues remains a distant prospect at this time, Joe notes that Swire is trading at a sizeable discount to the underlying assets of over -46%. He believes the negative outlook priced into the 'B' shares, which AGT holds, is excessive, particularly as the Swire family have almost 50% of their total exposure by value to Swire Pacific in 'B' shares. Joe has been buying into share price weakness.

In recent years AGT has been gradually increasing its exposure to cash-rich Japanese operating companies. This focuses on investment in a portfolio of Japanese companies which hold significant levels of net cash and investment securities on their balance sheets (at present equating to c.82% of their market cap on a weighted basis). AVI believe the ongoing changes in the corporate governance regime in Japan, driven by government pressure as part of the 'third arrow' of Abenomics, offers the opportunity to buy companies with drastically overcapitalised balance sheets, which are in the process of improving balance sheet efficiency and returning capital to shareholders. Joe highlights that in his view these companies are already extremely cheap in absolute and relative terms, and that AGT can build exposure to very high-quality companies at very low valuations. In this context, additional returns from improved balance sheet efficiency serve as a further bonus on returns.

AVI is active in engaging with company management and have noted evidence of trends in improved corporate behaviour towards minority shareholders. Share buybacks in the Japanese market have reached record highs in 2019, and individual company share prices have typically seen strong positive reactions to even small buyback announcements.

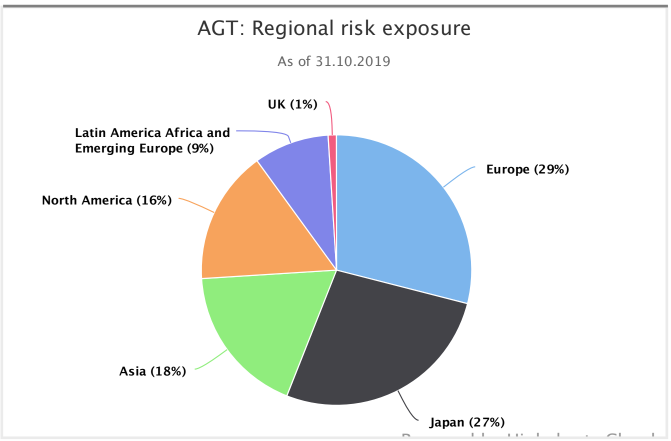
Although AVI regard Sony separately from the broader Japanese special situations basket, it shares some characteristics and potential drivers. Sony operates a multitude of businesses within its umbrella, though there are four core businesses which drive its profitability. These are Gaming, Music, Pictures and Semiconductors. These core businesses, accounting for c.68% of sales, are themselves very high-quality businesses, which AVI believe to be subject to misconceptions about the cyclical and structural business risks they face.

These misconceptions help explain, in AVI's view, why the stock trades at a c.34% discount to their sum-of-the-parts NAV, despite these four businesses having grown at an annual compounded rate of c.24% over the past four years. Joe is engaged alongside other activist investors in this stock, notably Third Point (itself a holding in AGT). They believe there are several avenues for management to better realise Sony's value, including selling listed stakes in Sony Financial, M3 and Spotify. Other options they are pushing for management to explore include spinning-off Sony's semiconductor business, and applying a moderate amount of gearing to increase the rate of buybacks. Sony's management rejected the suggestion that the semiconductor business should be disposed of, but there are suggestions they may not be averse to revisiting the idea in the near future.

So high is AVI's conviction in the Japanese opportunity set that in October 2018 they launched a separate product (the AVI Japan Opportunity Trust (AJOT)) focusing solely on companies meeting these criteria. Whilst there is significant crossover in AGT's holdings in the Japanese market and AJOT's, AGT itself invests directly and tends to have a greater weighting towards larger companies as a result of the larger amount of assets under management. However, the investment thesis and strategy are the same across both products; **further details on the Japanese investment strategy can be found in our recent note on AJOT**.

Although there is a commonality of investment approach across strategies and holdings, the managers seek to ensure that risk is largely a function of stock-specific risk and that the trust is not overly exposed to a particular geographic region or sector, both of which are diversified on a look-through basis.

Fig.2: Look-Through Regional Risk Exposure

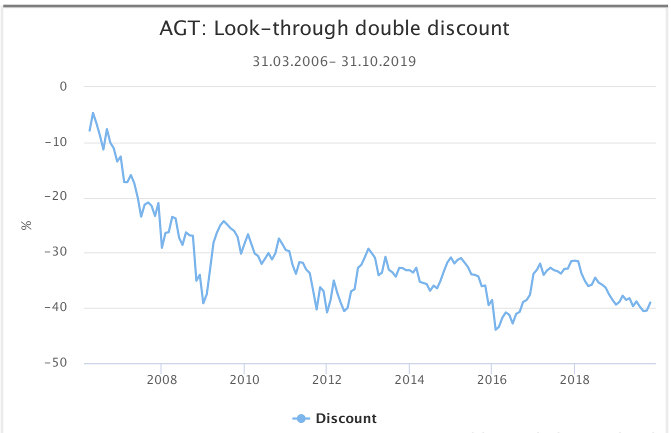


Source: AVI

Currency exposure has not been hedged in recent years, though the managers have the option of doing so. However, gearing tends to be taken out in foreign currencies; this provides something of a hedge in the event of sterling rising, as the relative value of these borrowings falls in sterling terms in line with the underlying assets denominated in overseas currencies.

With the underlying holdings all themselves trading at a discount to fair value, there is a substantial double discount within AGT, currently worth c.-37%.

Fig.3: Double Discount On Look-Through Basis



Source: AVI

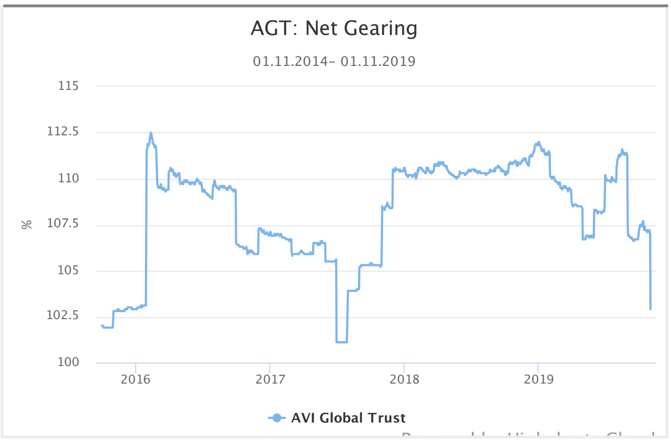
Gearing

Presently AGT has net gearing totalling c.3% in place. This includes long-term debt in sterling and euros, and a ¥4bn revolving credit facility, entered into in April 2019 for a period of three years (equivalent, on the date entered into, to c.£27.7m).

The board used this facility in full, and it was partially used to repay £15m in debenture stock yielding 8.125% at a total cost of £19.9m, with the remainder used to invest into Japanese equities; this has reduced total annual interest payable by c.£930,000. The weighted average interest on all borrowings is presently c.2.9%. In total, the various elements of gearing equate to c.11% of NAV.

As the graph below shows, the company has been largely fully invested, and has displayed tactical flexibility in the deployment of its gearing. Within this, gearing levels are driven by the opportunities that the team find on a bottom-up basis, and not as an attempt to time wider market movements.

Fig.4: Net Gearing

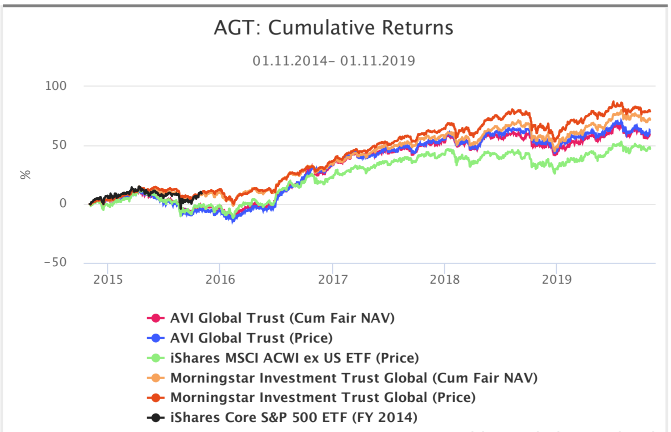


Source: Morningstar

Performance

Joe took over sole management of AGT in October 2015. Over this period, AGT has outperformed the broader peer group and a passive strategy replicating that benchmark, delivering NAV and share price returns of c.72% and c.77% respectively against sector NAV/share price and benchmark returns of c.67%/71% and c.58% respectively.

Fig.5: Five-Year Relative Cumulative Returns

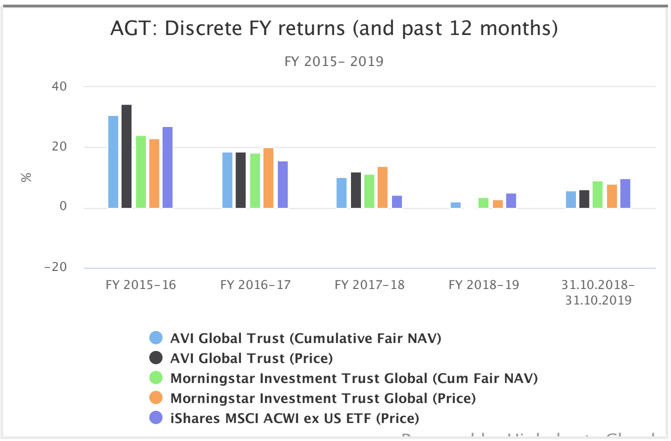


Source: Morningstar

Returns over the past five years have been strong relative to the iShares MSCI ACWI ex US ETF. AGT has, however, lagged the wider peer group; this would seem to be attributable to the fact it operates in an ex-US universe, and the first 12 months of this five-year period (01/11/14-01/11/15) saw the US market, which the peer group will hold significantly greater exposure to, significantly outperform.

Performance over the past 12 months has been more challenging, with AGT trailing and underperforming the ETF for a financial year for the first time under Joe's sole tenure.

Fig.6: Discrete Financial Year Performance



Source: Morningstar

Holdings such as Jardine Strategic and Swire Pacific detracted over the past 12 months, with negative sentiment around the escalating situation in Hong Kong outweighing the reasonable operational performance at these companies. Elsewhere, Riverstone Energy was the single largest detractor, with both share price falls and a widening discount. Canadian Government caps on production impacted the largest holding within Riverstone, and operational performance has been disappointing. However, AVI continues to engage with the board and management of Riverstone, seeking to identify solutions to the wide discount.

More positive has been contributions from holdings such as Cosan Ltd, Fondul Proprietatea and Pershing Square; in the former two, discount tightening and NAV performance both contributed positively. However, whilst NAV performance was strong in Pershing Square, the discount nonetheless widened slightly; this had a doubly negative effect on AGT, as they have hedged a substantial portion of their exposure to this trust, meaning they only benefit from discount narrowing on this proportion. Despite this, the net effect of holding Pershing Square was still positive to returns.

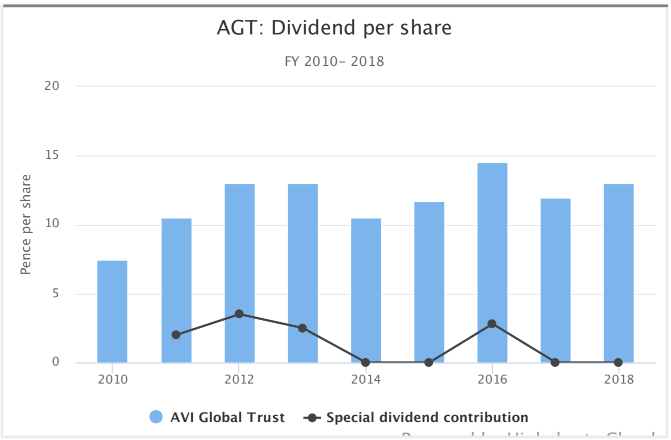
Although it may appear value-orientated in its approach to investment analysis, AGT is not a 'value factor' investment product. Value factor indices are currently highly exposed to cyclical sectors and assets, and likely reliant on global macroeconomic conditions to trigger sustained outperformance. By contrast, AGT is looking for relatively idiosyncratic value-realisation opportunities, and holds exposure on a look-through basis to high-quality, cyclically resilient assets which they expect to continue to enjoy strong NAV growth.

Dividend

Presently AGT yields c.2.2%. The trust targets capital growth, with dividends generally a secondary consideration. Nonetheless, it has a successful record of increasing dividends over the long term.

As noted in the Portfolio section, a significant component of the investment strategy involves engaging with management to reduce excess cash or assets on balance sheets, with the intention that this be returned to shareholders. If successful this will likely, in some instances, be through special, new or increased dividends. Accordingly, there is the possibility that income distributions remain variable over the near future. Shareholders of AGT also agreed in 2017 to amend the articles of association to allow the distribution of capital profits. This allows additional distributions should the company have a surplus arising from the realisation of any investment, a realistic possibility given the activist approach often employed.

Fig.7: Dividend Per Share



Source: Morningstar

Management

Joe Bauernfreund has been sole named manager of AGT since October 2015. Joe is CEO and CIO of Asset Value Investors, and has been with the group since 2002, starting as an analyst working on European holding companies. He became co-manager of AVI Global (then British Empire) in 2013 before becoming sole named manager in October 2015.

Joe is supported by Tom Treanor, head of research and an AVI director since 2017. Tom leads on closed-ended fund research and activism engagement, with significant experience in various roles covering closed-ended fund analysis.

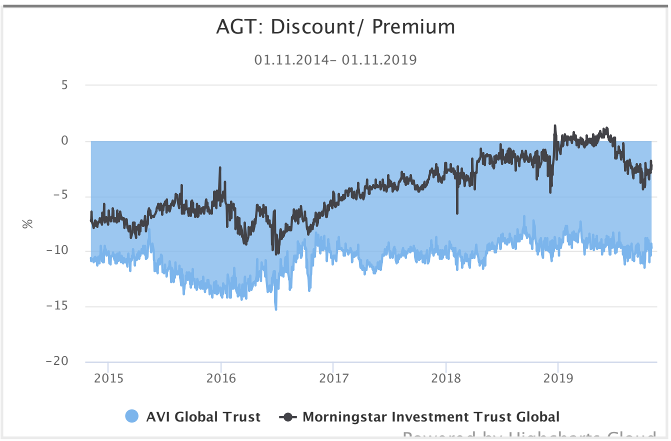
AGT (and BTEM, as it was previously) has seen low managerial turnover, with only three portfolio managers over the previous c.35 years. The board remains involved in oversight of the investment strategy, and whilst there is evolution of the investment process, the board have been keen to ensure that any changes are part of a natural progression. There is substantial investment trust experience on the board.

AVI are an international equity boutique founded in 1985, which is majority-owned by employees. Part of the strategic transition they and AGT have undertaken in recent years has included partnering with Goodhart Partners, an independent multi-boutique that has helped provide resources to support the growth of AVI.

Discount

AGT currently trades on a discount of c.-8.2% (as of 30/11/19). The board continues to use buybacks with the aim of limiting discount volatility. Our calculations suggest the volatility of the discount has indeed declined in recent years.

Fig.8: Discount/Premium



Source: Morningstar

Whilst there is clearly a wide disparity between the discount of the trust and that of the wider AIC Global sector, it is worth highlighting that the peer group discount level is heavily skewed by the sizeable (c.40%) premium attached to the second largest company in this sector, Lindsell Train. Nonetheless, the discount on AGT is wider than all but one of its peers (as of 31/10/19).

Over the most recent financial year (ending 30/09/19) the trust bought back c.1.7m shares, whilst also cancelling 13.5m shares held in treasury. Generally buybacks have occurred when the discount has approached or slightly exceeded -10% over the past 12 months.

Since the end of the financial year, AGT has bought back a further c.782k shares, at an average discount of c.-10.1%. The directors have authority to buy back up to 14.99% of ordinary shares in issue (which excludes shares in treasury), subject to a confirmatory vote at the forthcoming AGM.

Recent years have seen substantial buybacks, though the lower level in the financial year 2018 perhaps suggests the board have embedded in the wider investment community an expectation of lower discount volatility, a key aim of the buyback programme.

Percentage Of Shares Bought Back By Financial Year

FINANCIAL YEAR	% OF SHARES BOUGHT BACK
2018	3.7
2017	7.7
2016	6.3
2015	6.5
2014	6.1
2013	3.2
2012	1.2

Source: AVI

The investment approach highlights companies that are themselves trading at a discount to their intrinsic value; this creates a 'double-discount'. With a weighted average portfolio discount of c.-33% (as of 30/09/19), the double-discount totals c.-43% at present, which is lower than has typically been the case in recent years.

Charges

AVI are paid a management fee of 0.7% of NAV per annum and no performance fee. The OCF is 0.87%, compared to a weighted average of 0.56% for the sector, which reflects the specialist strategy (the sector figure is also skewed by a large outlier to the downside). The KID RIY figure is 3.11%, compared to a 1% weighted average for the global sector, although we would caution that different managers use 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 and are reflective of strong returns.

ESG

Governance and sustainability concerns are at the heart of the investment process for AGT. AVI are active in engaging with the management of the underlying companies to ensure strong corporate governance is in place, and are cognisant of their responsibilities as shareholders.

AVI try to understand the social system that holdings operate within, ensuring that the rights of minority stakeholders are properly respected, and how employees and management are incentivised. Similarly, AVI seek to support policies and/or actions by the companies they hold which aim to support a sustainable environment.

Disclaimer