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Update | Investment companies

6 March 2017

Aberdeen Frontier Markets

Direct investing

On 9 December 2016, the board of Aberdeen Frontier Markets (AFMC) announced that take up of its 100% tender offer had exceeded expectations. After deliberating on the future of the fund, the board is asking shareholders to approve a shift to direct investing in frontier markets. Shareholders still have the opportunity of a cash exit if desired but the manager is injecting up to £10m into the fund to keep it viable.

Direct investment in frontier markets

Going forward (subject to shareholder approval), AFMC will aim to generate long-term capital growth primarily from investment in equity and equity-related securities of companies listed in, or operating in, frontier markets. Frontier market countries are developing countries that don't qualify for inclusion in emerging market indices. Permitted countries may include constituents of the MSCI Frontier Markets Index or additional countries that the investment manager deems to be, or displays similar characteristics to, frontier market countries.

The manager is convinced of the attractions of investing in frontier markets. It says that, at the moment, political and economic uncertainty is putting off investors and therefore this means that valuations are depressed. However, it believes that this is could be an attractive entry point but considers that this fund should be viewed as a long-term investment.

Year ended	Share price total return (%)	NAV total return (%)	MSCI Frontier Markets TR. (%)	MSCI Emerging Markets TR (%)	MSCI World total return (%)
28/02/13	24.3	16.5	19.8	5.9	17.2
28/02/14	10.9	8.4	11.2	(14.6)	10.8
28/02/15	(1.3)	0.8	10.0	14.3	17.6
29/02/16	(12.4)	(9.4)	(7.0)	(14.8)	(0.7)
28/02/17	37.1	29.6	27.3	45.5	36.6

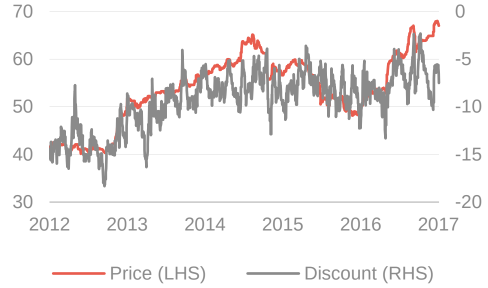
Source: Morningstar

Sector	Global Emerg. Mkts
Ticker	AFMC LN
Base currency	GBP
Price	66.75p
NAV	72.80p
Premium/(discount)	(8.3%)
Yield	1.4%*

* historic, c3% forecast

Share price and discount

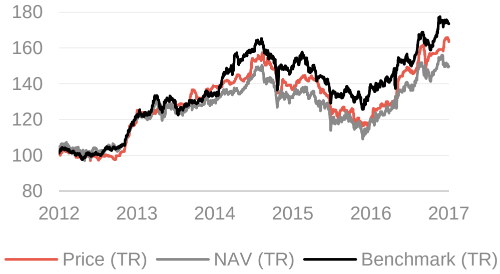
Time period 29/02/12 to 28/02/17



Source: Morningstar, Marten & Co

Performance over five years

Time period 29/02/12 to 28/02/17



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	15 June 2007
Manager (new portfolio)	Mark Gordon-James, Gabriel Sacks
Market cap (GBP)	113m
Shares outstanding	169.0m
Daily vol. (1-yr. avg.)	231,230 shares
Net gearing	(3.4%)

Click here for our initiation note

A new future

The board has formulated new proposals for future of AFMC

As part of AFMC's discount control policy, the company had a long-standing commitment to offer shareholders a 100% exit at the end of 2016 (i.e. any shareholder who wanted to cash in their investment at that time could do so). On 9 December 2016 AFMC announced that the take up of the exit opportunity was such that continuation was not in the best interests of those shareholders who wanted to stick with their investment. The tender was postponed pending the formulation of proposals for the future of the company.

Believing that frontier markets still look like an attractive investment opportunity, Aberdeen Asset Management is injecting up to £10m into AFMC.

An initiation note on the company published on 10 November 2016 (**Long-term growth opportunity?**) set out the manager's case for an investment in the fund. They pointed out that frontier markets offer premium economic growth, low correlation with other equity markets and, being generally less well researched, greater opportunity to identify, what they consider to be, mispriced securities. In addition, frontier markets are on average lowly rated relative to emerging and developed markets. Aberdeen Asset Management (AAM) has decided to inject some of its own money into the fund so that it does not become too small and remains viable. AAM will invest up to £10m in the company but their stake will be capped at 20%.

New fee structure

In addition, to cut the fund's overall expense ratio, the performance fee has been scrapped, the management fee has been reduced to 1% of net assets and, most importantly, the fund will invest directly from now on rather than through funds managed by other managers, removing another layer of management fees. Details of the previous fee arrangements are on page 20 of **the initiation note**.

15% tender at 2% discount if discount exceeds an average 10% between April and June each year

To help control the discount, shareholders will be offered the chance to participate in a tender for up to 15% of the issued share capital at 98% of NAV if the average discount over the three months to the end of June each year is wider than 10%.

An Extraordinary General Meeting will be held on 14 March 2017 to approve the proposals. Shareholders who still want to exit the fund will be able to do so.

New objective

Long-term capital growth from investment primarily in frontier market equities

The investment objective of the company is to generate long-term capital growth primarily from investment in equity and equity-related securities of companies listed in, or operating in, frontier markets. Frontier market countries may include constituents of the MSCI Frontier Markets Index or additional countries that the managers deem to be, or display similar characteristics to, frontier market countries.

New investment policy

You can access the company's website at **www.aberdeenfrontiermarkets.co.uk**

To summarise: AFMC will

- seek to maximise total return (income plus capital growth)
- invest globally in the securities of companies domiciled or listed or quoted in, or exercising the predominant part of their economic activity in, frontier markets.
- not invest more than 10% in an individual company (at the time of investment)

The investment process is described on page 4

No change to dividend policy

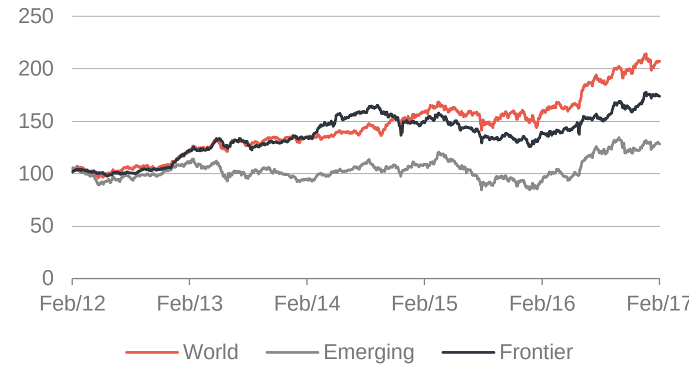
3% yield forecast

AAM's model portfolio for the fund in its new guise suggests a portfolio yield before expenses of 3.5%. The directors say that they will maintain the current level of dividends (this was set to give a 3% yield in December 2016). Dividends will still be paid semi-annually in June and December. Please see page 18 of the initiation note for more detail on this topic.

Background

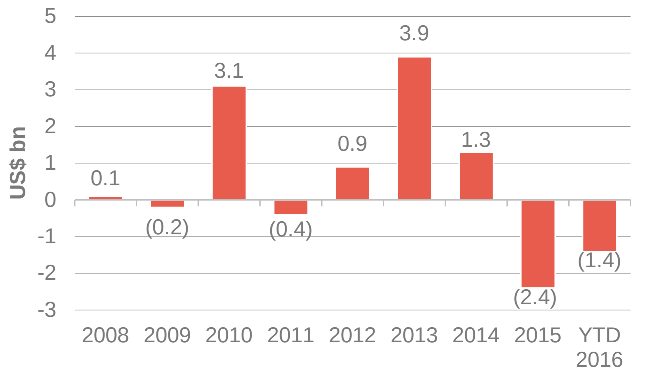
It is fair to say that emerging and frontier markets have, relative to developed markets, been out of favour with investors for some time, as Figures 1 and 2 show. Slowing growth in China has affected demand for exports, notably commodities. The oil price has fallen, adversely affecting countries such as Nigeria that had allowed their economies to become over-reliant on oil revenue. Money has also been flowing out of emerging and frontier markets funds generally (see Figure 2 which has data for both active and passive funds). This has some impact on valuations in frontier markets but AFMC's manager says that the impact is muted because most frontier markets are dominated by domestic investors. This reduces the "hot money" flows that plague some emerging markets where external investors pile into a market, driving up share prices to unsustainable levels, and then reverse the process.

Figure 1: Index performance – developed, emerging and frontier markets



Source: Morningstar, Marten & Co

Figure 2: Regional and country flows for frontier markets



Source: Aberdeen Asset Management (from EPFR Global), figs to end Nov 2016

AFMC's managers says that the main attractions for investors are the low correlations between frontier markets and emerging and developed markets (which means that they do not necessarily move in tandem with one another), low valuations and, often, fairly high GDP growth rates. The countries often benefit from favourable demographics, high levels of entrepreneurship, albeit often not captured by measurements of the formal economy, as well as increasing orthodoxy in economic management and greater political accountability. In the absence of legacy infrastructure, many are leapfrogging stages of development in areas such as the use of mobile telephony and banking infrastructure.

The new Aberdeen Frontier Markets

New management team

Mark Gordon-James and Gabriel Sacks to manage AFMC

AAM is well-known for its emerging markets expertise. The global emerging markets team had assets under management of $41.5bn at the end of 2016 and a roster of investment management personnel to match with offices in seven countries. AAM has been making investments in frontier markets for a number of years. The frontier markets strategy had assets of $543m at the end of December 2016. AAMs funds are managed with a team approach but Mark Gordon-James and Gabriel Sacks (the managers) will have day-to-day responsibility for the new AFMC portfolio.

The managers have suggested to us that the portfolio of Aberdeen Global – Frontier Markets Equity Fund (the open-ended fund) is a good proxy for the portfolio intended for AFMC. We have used data from this fund to illustrate this note. Aberdeen Asian Smaller Companies Investment Trust also has some direct frontier markets exposure.

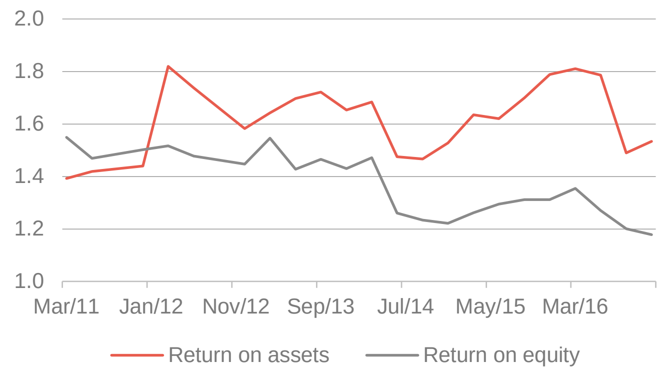
The investment process

The managers say that they do not try to second guess short-term macroeconomic movements, play the economic cycle or invest with the herd. Instead, the focus is on stock selection, getting to know the companies they invest in (via face-to-face meetings – around 180 of them in 2016 in frontier markets) and selecting high-quality companies trading on attractive valuations.

The managers select stocks based on fundamental analysis of companies, looking for long-term appreciation from mispriced value or growth. Market volatility is used as an opportunity to trim or add to positions. Turnover is fairly low at about 10% per annum reflecting the manager's long term, across the cycle, investment horizon.

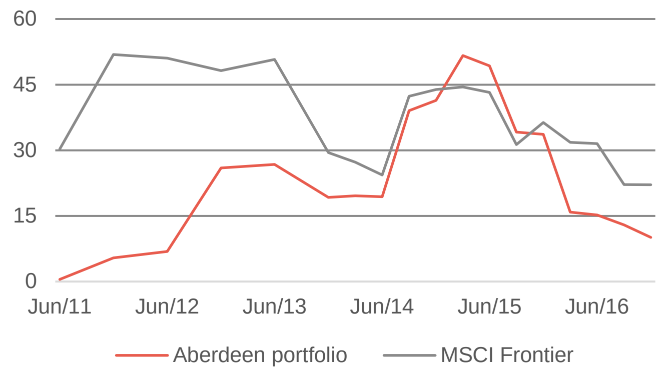
All potential investments are subject to detailed scrutiny. Generally, the companies they invest in will demonstrate higher than average returns on equity and/or returns on assets.

Figure 3: Aberdeen's frontier portfolio relative to MSCI Frontier Markets – Return on Assets and return on equity



Source: Aberdeen Asset Management

Figure 4: Aberdeen's frontier markets portfolio compared to MSCI Frontier Markets – net debt/equity



Source: Aberdeen Asset Management

Figures 3 and 4 show how the open-ended fund's holdings compare, on average, to those of the average stock in the MSCI Frontier Markets Index. Stocks with negative returns on equity have been excluded. As one might expect given that they are targeting firms with high sustainable returns, the open-ended portfolio exhibits consistently higher returns than the average and, for the most part, the open-ended portfolio exhibits a lower debt to equity ratio than the index.

The managers place great importance on governance when assessing a company's quality and worth, and continuous environmental, social and corporate governance analysis is done once they become shareholders in a company, via ongoing engagement. They visit existing holdings at least every 6 months and have a responsible investing analyst as an integral part of the team.

Risk control is about ensuring the portfolio is adequately diversified as well as avoiding low-quality companies. There is a maximum 10% exposure to any one stock at the time of purchase and 15% in any one country. Index benchmark weights are not taken into account when constructing the portfolio and there are no sectoral restrictions. Typically, they expect that the fund will have between 30 to 80 holdings

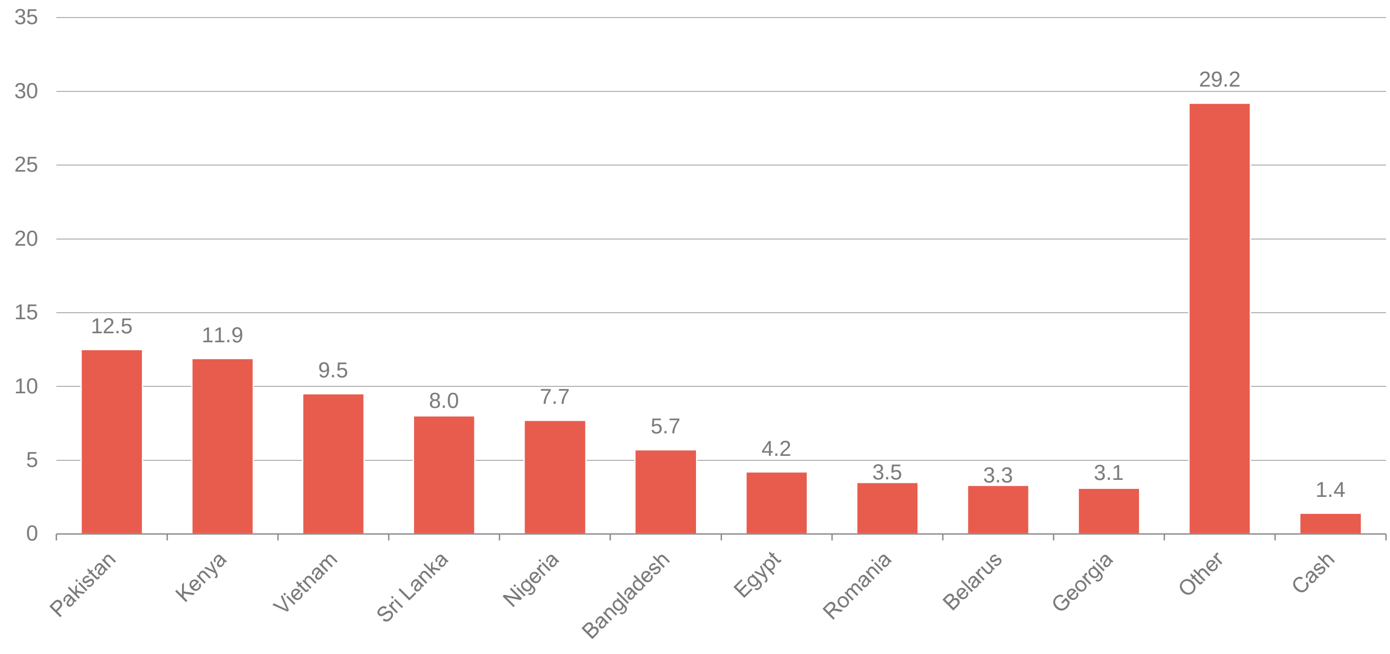
Net cash balances will not generally exceed 10% of NAV and, likewise, net gearing will be limited to 10% of NAV. They are permitted to use derivatives and contracts for difference (CFDs) in the management of the portfolio.

Asset allocation

Geographical weights

Geographical weights arise from the managers' stock selection decisions. Figure 5 looks at the geographical weightings in the open-ended fund at the end of January 2017.

Figure 5: Geographical breakdown of the open-ended fund at 31 January 2017



Source: Aberdeen Asset Management, Marten & Co

A full list of countries within the portfolio would also include South Africa, Turkey, Thailand and the United States. At first glance this would seem to indicate a number of off-benchmark bets within the geographical distribution of the portfolio but the managers say that these often reflect companies that are listed in one market but have operations in frontier markets.

The managers forecast their portfolio to generate earnings growth of 10-15% over the next 3 years despite the challenging economic environment in Africa. They favour Asia and have an overweight exposure to this area relative to the MSCI Frontier Markets Index. They expect robust earnings growth to continue in the region. They note that Vietnam, Bangladesh and Pakistan are taking manufacturing operations from China, not just in low-value items such as clothing but also in areas such as high-end electronic goods. China has been a major investor in many frontier markets. For example, in Pakistan it is investing heavily in power generation and distribution infrastructure as part of its "One belt one road" policy.

AFMC's managers consider that Trump's veto of the Trans-Pacific Partnership treaty (TPP) was a setback for Vietnam in particular but only in the sense of lost opportunities for the future rather than having an immediate impact on exports.

As was the case with the old AFMC portfolio, the open-end fund's portfolio has a significant underweight exposure to Kuwait for the same reasons articulated in the initiation note (see page 13). The managers are also avoiding Argentine banks on valuation grounds. An underweight exposure to Morocco relative to the MSCI Frontier Markets Index reflects their perception that the country's stocks are generally overvalued (they think investors that have to make an allocation to Africa have been crowding into Morocco, seeing it as a safe haven).

Kenya is their largest overweight relative to the index. The managers are not necessarily looking to increase this. They believe the companies they hold are of high quality. However, they acknowledge that there may be some volatility in coming months as this is an election year.

Generally, the team are not fans of former state owned enterprises: these do not often meet their quality and governance standards. This has a big impact on the portfolio positioning relative to the benchmark as, often, these companies are large constituents of the Index.

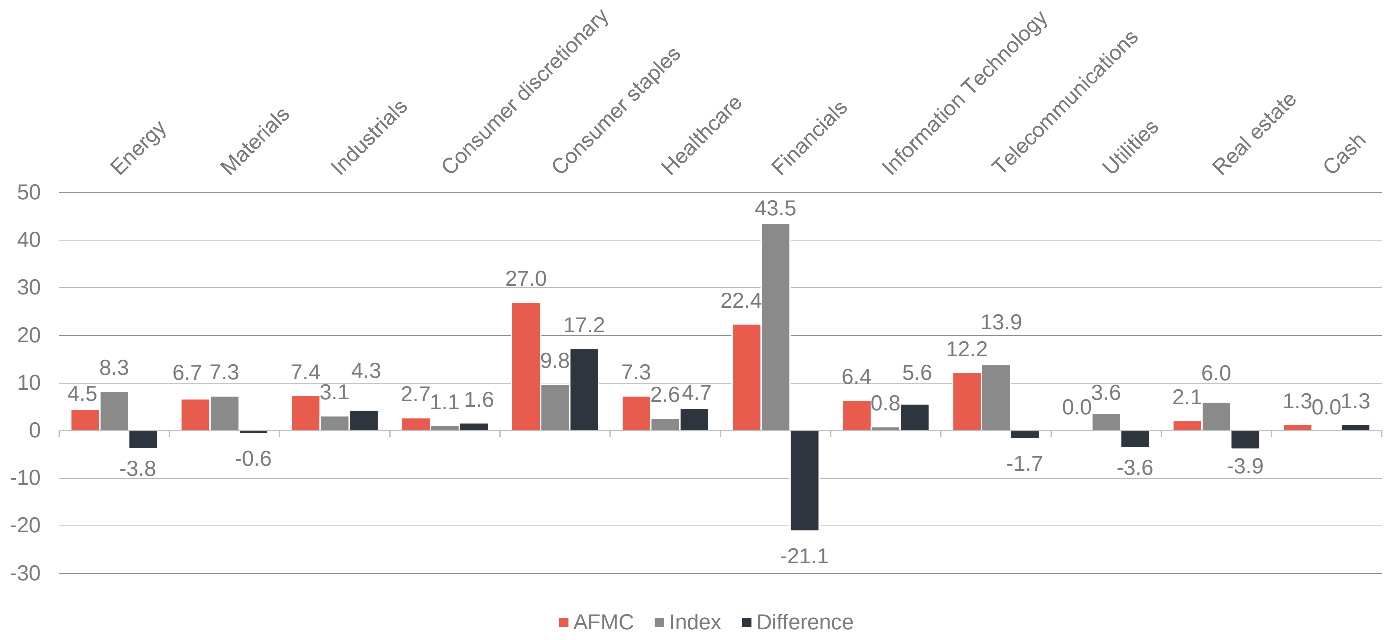
The fund already had some direct investments and the new team will retain these.

Industry sector weights

Figure 6 shows how the fund's industry sector allocation stacked up against the MSCI Frontier Markets Index at the end of 2016.

The sector weights arise from the managers' stock selection decisions but there is a clear bias to consumer staples and away from financials. The former weighting reflects holdings in companies such as Vinamilk and Coca Cola Icecek. The latter weighting reflects the managers' dislike of Argentine and Kuwaiti banks.

Figure 6: Industry weights for AFMC versus MSCI Frontier Markets as at 31 December 2016



Source: Aberdeen Asset Management

10 largest holdings

Figure 7 shows the 10 largest active positions in the open-ended fund relative to the MSCI Frontier Markets Index as they were at the end of December 2016. These 10 holdings then accounted for 39.7% of the portfolio.

Figure 7: Top 10 active positions relative to MSCI Frontier Markets as at 31 December 2016

Holding	Fund (%)	MSCI Frontiers (%)	Difference	No. of years in AAM portfolios
Vietnam Dairy Products	6.3	3.5	2.7	4
Safaricom	4.8	2.2	2.6	7
John Keells	4.6	1.0	3.7	10
Habib Bank	4.0	1.5	2.5	1
EPAM Systems	3.8	0.0	3.8	3
BRD-Groupe Soc. Gen.	3.6	0.5	3.1	7
MTN Group	3.3	0.0	3.3	7
Hikma Pharmaceuticals	3.2	0.0	3.2	7
Coca-Cola Icecek Uretim	3.1	0.0	3.1	2
Bank of Georgia	3.0	0.0	3.0	3

Source: Aberdeen Asset Management, Marten & Co

Looking at the largest holdings in more detail:

- Vietnam Dairy Products (Vinamilk) is Vietnam's largest dairy business but also has operations in countries such as Cambodia, Thailand and New Zealand. In 2016 net profits rose 20.5%.
- Safaricom is a Kenyan based mobile communications business with a strong presence in the m-commerce (mobile commerce) market in that country. Its M-PESA mobile payment business can be accessed almost anywhere in the country.

- John Keells is a Sri Lankan based conglomerate with interests in a diverse range of businesses including transportation, leisure, property, consumer foods and retail and financial services. Q3 figures have just been released showing profits and revenues up 32% and 12% respectively
- Habib Bank (HBL) is the largest private sector bank in Pakistan. It is AAA rated, has a presence in 28 countries and operations in areas such as insurance, life assurance, asset management and micro finance as well as traditional banking. It has recorded 22.8% compound annual growth in deposits since 2011.
- EPAM Systems is a US-listed software company. Its turnover exceeded $1.1bn in 2016, exhibiting year-on-year revenue growth of 29%. Its 22,000 plus employees serve customers in over 25 countries. with operations across the world but notably in Belarus, Ukraine and Russia.
- BRD Groupe Société Générale is a listed subsidiary of the French bank. Its main focus is on the Romanian market. Its profits rose 63% in 2016.
- MTN is a telecoms company based in South Africa but with significant operations in Nigeria, Iran and Ghana. The company's earnings look set to be depressed, temporarily, by a significant fine imposed on their Nigerian business.
- Hikma Pharmaceuticals is a Jordanian company that develops, manufactures and markets a broad range of branded and non-branded generic pharmaceutical products across the US, Middle East, North Africa and Europe. In common with most companies in its sector, its share price has bounced off lows since Trump won the US election.
- Coca Cola Icecek Uretim is a Coca Cola bottling company (the fifth largest) with operations in 10 markets including Turkey, Pakistan, Kazakhstan and Iraq. Turkey accounts for around half their volumes. It delivered an average 19% earnings (EBITDA) growth per annum between 2009 and 2015.
- Bank of Georgia is the largest retail and corporate bank in Georgia. The shares are listed in London.

Performance

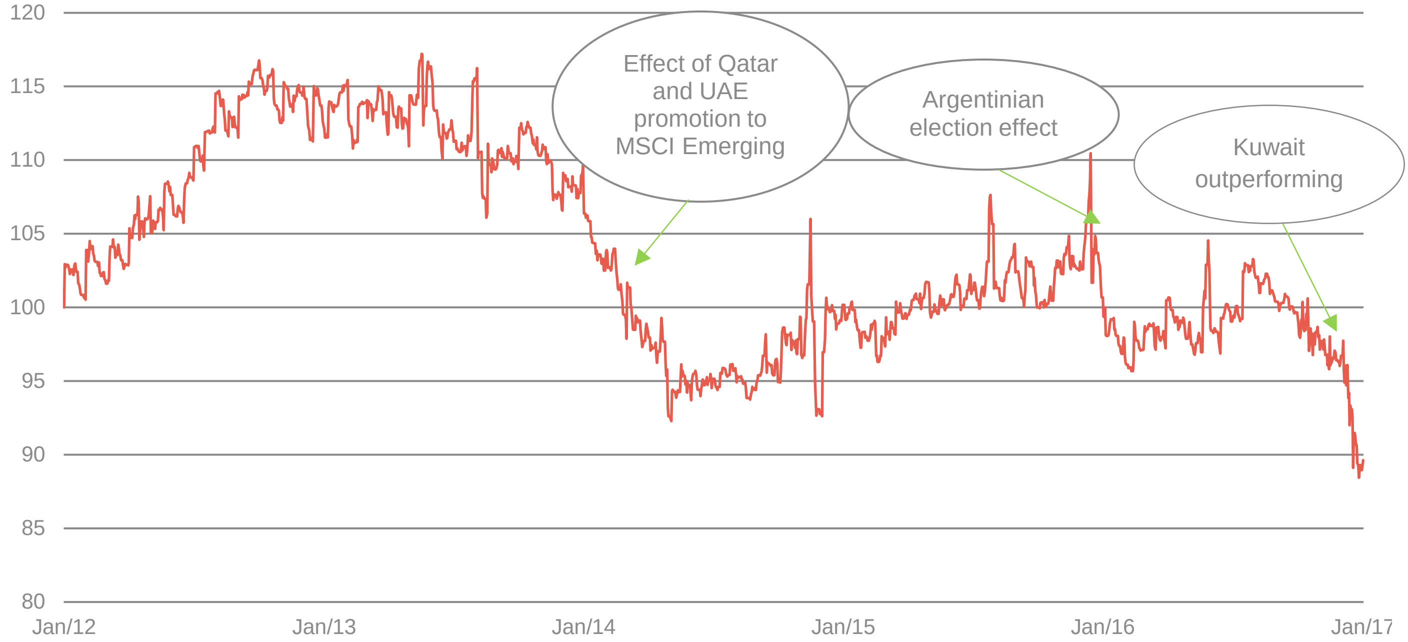
QuotedData.com has more up to date figures and a comparison with AFMC's peers

Figure 8 shows the performance of the open-ended fund versus the MSCI Frontier Markets Index.

The managers believe that, in recent times, frontier markets have been driven by the macroeconomic environment rather than fundamentals (how well companies are doing) and this has cost them some performance relative to the MSCI Frontier Markets Index. The open-ended fund is particularly underweight Kuwaiti stocks relative to the index. However, over the three months to the end of January 2017, the MSCI Kuwait Index returned 24.3% while the MSCI Frontier Markets Index returned 7.6%.

The managers are long-term investors focused on quality and value. They do not try to track any index. This meant that they were underweight Qatar when that index was reclassified from a frontier market to an emerging market. Far more institutional investors will invest in emerging markets than frontier ones (mainly on liquidity grounds). Hot money drove the Qatar index up ahead of the reclassification and caused Qatari stocks to underperform afterwards as it flowed out again. The reclassification of UAE in the same year had a similarly negative impact. The fund also missed out on a large part of the Argentine post-election rally. Whilst some Argentine banks would pass their quality threshold, the managers believe the operating environment remains challenging and these stocks do not meet their valuation criteria.

Figure 8: Total return performance of open-ended fund versus the MSCI Frontier Markets Index



Source: Morningstar, Marten & Co

Previous publications

QuotedData published an initiation note on Aberdeen Frontier Markets Investment Company on 10 November 2016 entitled ***Long-term growth opportunity?*** We have reproduced the contents pages of this note for you below.

Long-term growth opportunity

QuotedData

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