MARTEN & CO

Update | Investment companies

29 November 2018

Aberdeen Frontier Markets

Incentivised to perform

Mark Gordon-James, manager of Aberdeen Frontier Markets (AFMC), has made a material personal investment in the trust, and therefore has shared in the pain experienced by AFMC's shareholders as the fund has underperformed a falling benchmark. He is, however, convinced of the fundamental attractions of the stocks in AFMC's portfolio and believes that these will, in time, be reflected in AFMC's NAV returns.

The board has introduced a performance-driven exit opportunity which will allow shareholders to exit the trust at a price close to NAV if AFMC's share price total return fails to exceed the return on its benchmark over the two years ending 30 June 2020, which we consider a strong incentive to improve relative returns and narrow the discount.

The portfolio offers a quality-tilted, diversified portfolio across more than twenty frontier markets, and trades at an attractive single digit price-to-earnings multiple.

Direct investment in frontier markets

AFMC aims 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 countries within the MSCI Frontier Markets Index or other countries that the investment manager deems to be frontier markets due to their characteristics.

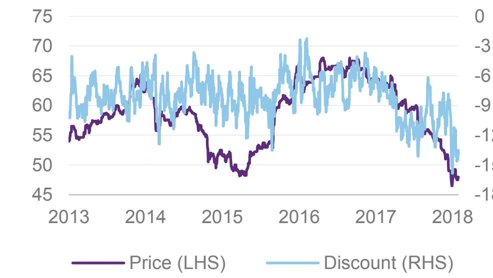
Year ended	Share price total return (%)	NAV total return (%)	MSCI Frontier Markets TR (%)	MSCI Emerging Markets TR (%)	MSCI World total return (%)
31/10/14	18.3	12.2	22.3	1.4	9.7
31/10/15	(19.2)	(15.7)	(14.4)	(11.1)	6.0
31/10/16	29.1	23.4	23.2	38.7	28.8
31/10/17	(0.8)	0.0	17.7	16.7	13.5
31/10/18	(24.0)	(16.1)	(8.4)	(8.7)	5.7

Source: Morningstar, Marten & Co

Sector	Global emerging markets
Ticker	AFMC LN
Base currency	GBP
Price	48.0p
NAV	55.7p
Premium/(discount)	(13.8%)
Yield	3.1%

Share price and discount

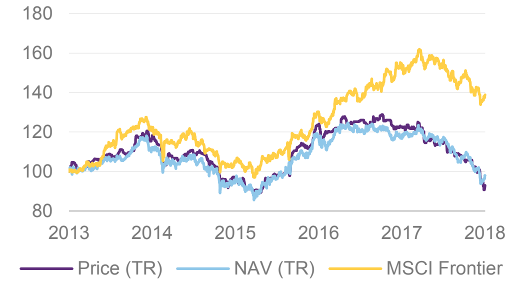
Time period 31/10/2013 to 27/11/2018



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/10/2013 to 31/10/2018



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	15 June 2007
Manager	Mark Gordon-James and Gabriel Sacks
Market cap	38.4m
Shares outstanding	79.9m
Daily vol. (1-yr. avg.)	184.8k shares
Net gearing	Nil

Click here for our annual overview note

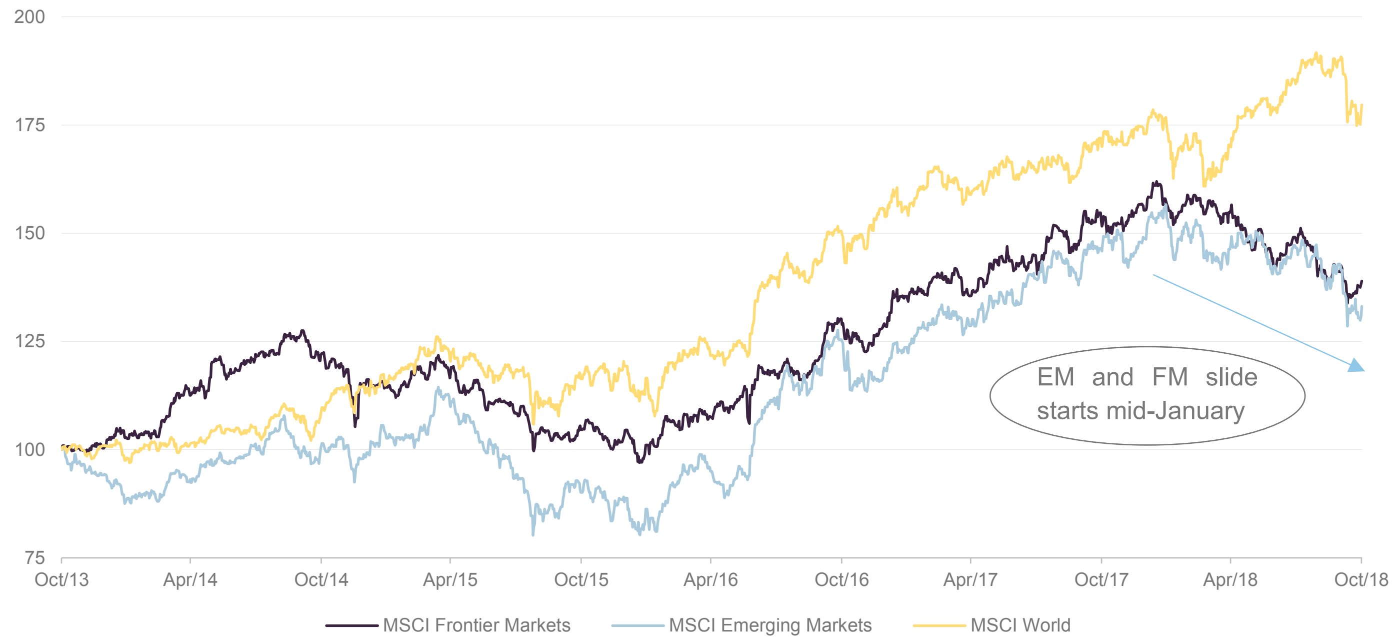
Adverse sentiment means stocks are cheap

More information is available, including the case for frontier market investing and the investment process followed by the manager, in **our previous note**.

The last annual overview note on Aberdeen Frontier Markets (AFMC), that we published in March 2018, set out the long-term case for frontier market investing and, if you are new to this fund, we recommend that you read it.

As Figure 1 shows, emerging and frontier markets have been sliding over the course of 2018. Higher US interest rates and a stronger dollar have encouraged outflows of capital from these areas. Worries about the pace of Chinese growth and burgeoning trade wars with the US have weighed on markets. This has also depressed many commodity prices (affecting those countries reliant on commodity exports as their main source of hard currency). For some time, the oil price was very strong, on the back of President Trump's rejection of the Iranian nuclear deal and imposition of sanctions. Rising oil prices were unhelpful for many frontier markets.

Figure 1: MSCI Emerging, MSCI Frontiers and MSCI World indices over five years to end October 2018, rebased to 100



Source: Morningstar, Marten & Co

Many frontier market countries are in crisis

AFMC's manager points out that many of the portfolio's core markets are in, or emerging from, a period of acute economic disruption. Argentina has seen yet another collapse in its currency, accompanied by soaring inflation and a record-size IMF bailout over the summer; Nigeria only recently limped out of its first recession in 25 years; Pakistan is negotiating its thirteenth bailout with the IMF, a result of a ballooning current account deficit; Egypt has been struggling with high inflation, a consequence of its 2016 IMF bailout which required (amongst other things) that fuel price subsidies be eliminated by the end of 2019; and Sri Lanka is midway through its structural adjustment programme, also overseen by the IMF.

Valuations now look very cheap

It is not all bad news, however. As investor sentiment seems to be set against frontier markets, valuations now look very cheap. The imposition of tariffs on Chinese exports may encourage an acceleration in the shift of manufacturing from China to countries such as Vietnam and Bangladesh. Oil prices are falling again. Mark thinks that US growth may be slowing and the Fed may be less aggressive about raising rates, all of which should be beneficial for frontier markets. He also sees potential for a recovery in corporate earnings.

Belt and Road causing problems?

Both Pakistan and Sri Lanka are facing problems linked to excessive current account deficits and debt associated with China's Belt and Road initiative

Pakistan has been suffering from a current account deficit and has been raising interest rates to help shore up its currency. Imran Khan, the country's new prime minister, has secured some financial support from Saudi Arabia, which will give Pakistan breathing space while negotiations with the IMF continue.

Pakistan is an important link in China's Belt and Road initiative and has reportedly taken on significant Chinese debt to help fund infrastructure improvements. Mark believes these improvements are needed if the country is to develop an export sector.

Further south, Sri Lanka is already trying to cope with an IMF programme, a poor harvest, a current account deficit (also affecting its currency) and, until recently, a high oil price. Again, the debt that the country has run up to pay for its part of the Belt and Road initiative is causing problems. The situation contributed to the abrupt dismissal of the prime minister and the political chaos that has ensued since.

Further index distortion to come from Kuwait?

Investors believe MSCI may upgrade Kuwait to emerging markets status

Our last note discussed the distortive effect of Pakistan's promotion to the MSCI Emerging Markets Index (the EM index) on the MSCI Frontier Markets Index (the FM index). The manager could try to game these moves but does not, believing that it is better in the long run to focus on the fundamentals of the stocks in the portfolio. This time, it looks to be Kuwait's turn to skew the index's returns.

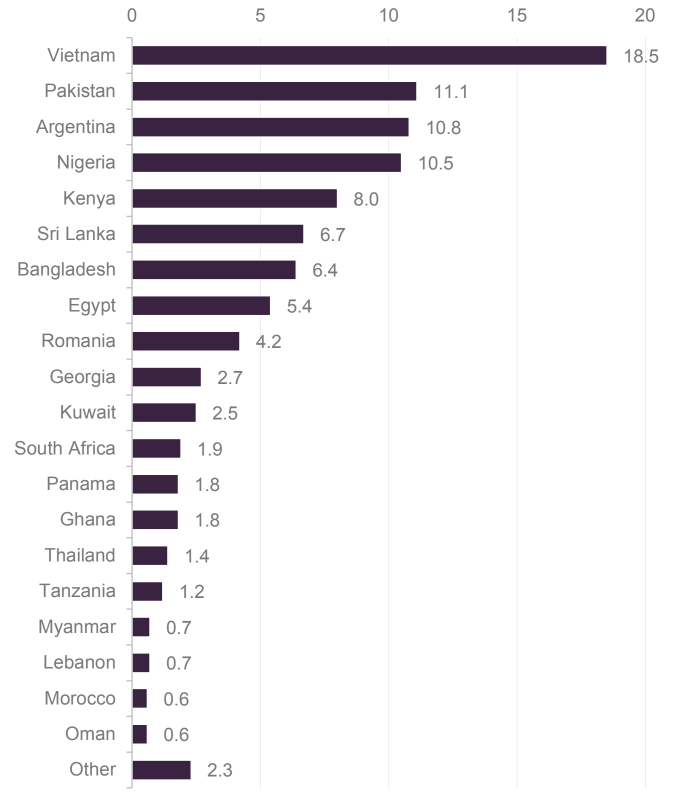
In recent times, not owning stocks in the Gulf region has been a problem for AFMC. These markets tend to be pegged to hard currencies and hence have been seen as a 'safe haven'. Kuwait has been upgraded from a frontier market to an emerging market within the FTSE Russell family of indices and investors think it is likely that MSCI will also upgrade it next year. This is leading to an influx of 'hot money' into this market from investors seeking to front run investment by index-tracking funds and the like. Kuwaiti companies account for a large part (21.5% at the end of September 2018) of the FM index and three Kuwaiti companies (National Bank of Kuwait, Kuwait Finance House and mobile telecommunications company, Zain) make up most of that (15.6% of the FM index).

The distortive effect of Kuwait's promotion could be cushioned if sovereign wealth funds sell stock to speculative investors

AFMC does own one Kuwaiti company, HumanSoft, an education company which operates the American University of the Middle East. This stock does have a high ROE and decent revenue growth. However, Kuwait is a relatively slow growing economy and the manager says the major constituents of its index are neither interesting investments nor of high quality. It is the sort of market which might underperform following its promotion, as the speculative money moves on. Mark also thinks that the sovereign wealth funds that are large investors in Kuwaiti stocks may sell their holdings to meet the demand from short-term investors, dampening any rise in the market.

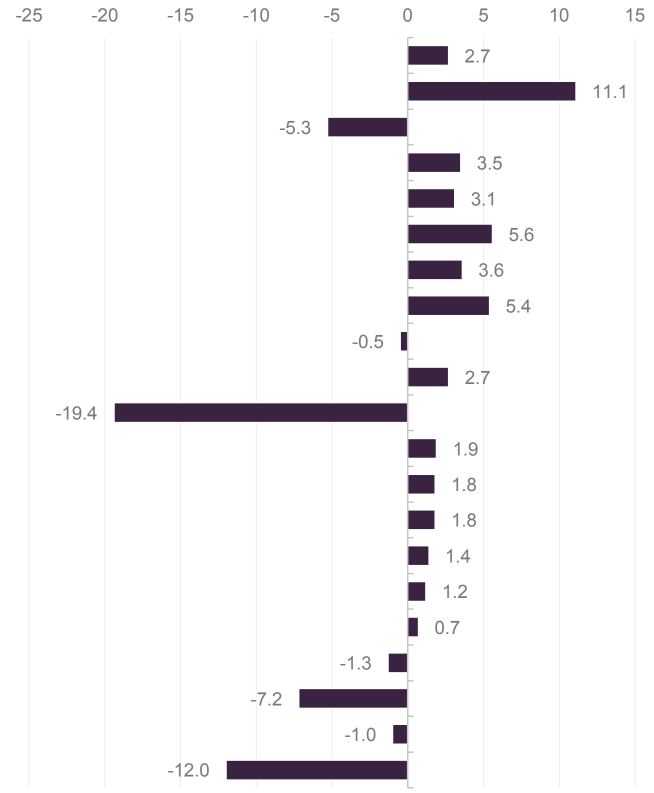
Asset allocation

Figure 2: AFMC asset allocation by country as at 31 October 2018



Source: Aberdeen Standard Investments

Figure 3: AFMC geographic weightings relative to FM Index as at 31 October 2018



Source: Aberdeen Standard Investments

Big increase in Vietnamese exposure since end January 2018

By far the largest shift in AFMC's geographic asset allocation since we last published (using data as at 31 January 2018) has been an increased allocation to Vietnamese equities (from 12.1% of the portfolio in January to 18.5% at the end of October). In part, that reflects the strong relative performance of Vietnam (see Figure 14 on page 8), but, when AFMC held a tender in October 2018 (see page 10), the manager funded this by reducing holdings on a pro-rata basis except for holdings in Vietnamese companies.

As discussed above, AFMC retains its significant underweight exposure to Kuwait and its high, off-benchmark exposure to Pakistan (which is a constituent of the EM Index).

Style analysis

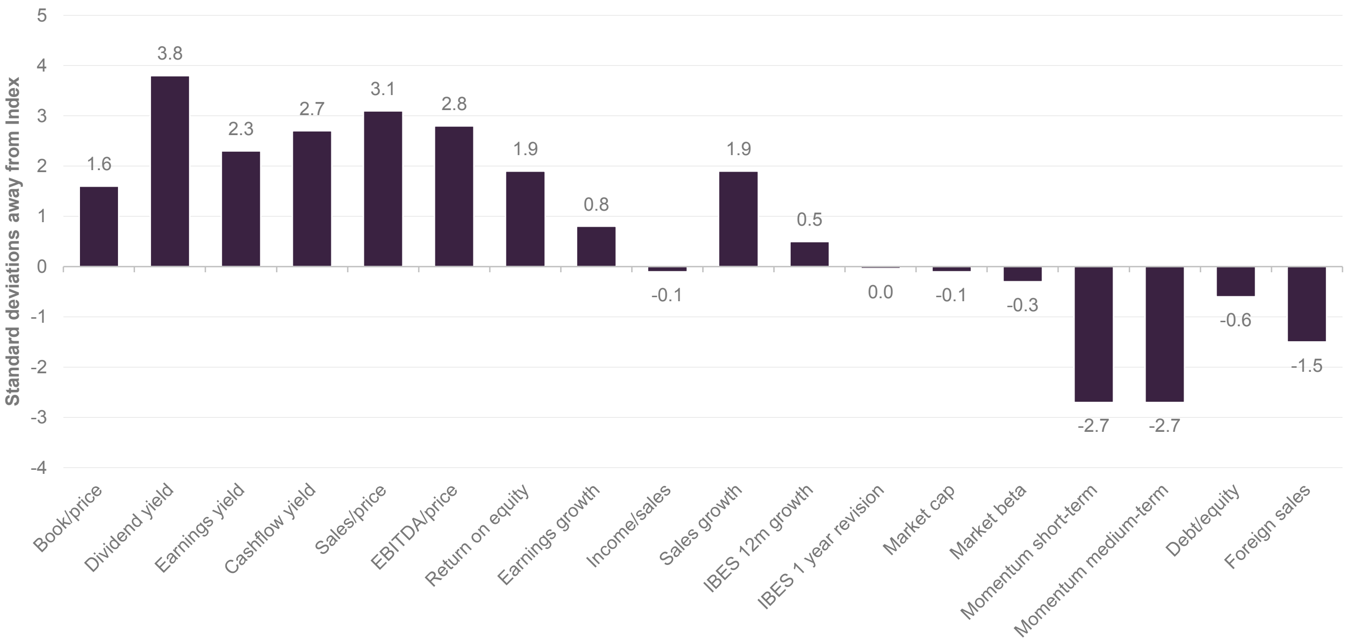
The portfolio is skewed towards smaller cap (under $2.5bn market cap) stocks. A more detailed style analysis is shown in Figures 4 and 5. This shows that the portfolio has a bias towards higher quality companies, relative to the FM Index, while being more attractively valued, on average.

Figure 4: Comparison AFMC and MSCI Indices at 31 October 2018

	P/E 2017	P/E 2018	P/E 2019	P/B	Yield (%)	Debt/ equity (%)	ROE (%)	ROA (%)
AFMC	9.3x	10.3x	9.0x	1.9x	3.9	16.7	28.0	10.4
MSCI Frontier Markets	13.4x	11.4x	10.1x	1.7x	3.9	28.7	21.9	7.1
MSCI Emerging Markets	12.3x	10.9x	10.0x	1.5x	2.9	13.3	17.7	7.8

Source: Aberdeen Standard Investments

Figure 5: AFMC/FM Index style comparison



Source: Aberdeen Standard Investments, Style Research

The portfolio seems to show a clear style tilt towards quality (as evidenced by higher ROE and lower debt), growth (as evidenced by higher earnings growth, sales growth and forward earnings growth) and also value (higher book to price, higher EBITDA to price, higher sales to price and higher dividend yield). This is an attractive combination. What the portfolio lacks currently is stock price momentum, which the manager hopes will turn positive in due course.

Industrial sector analysis

Figure 6: AFMC industrial sector weightings as at 30 September 2018

	portfolio (%)	benchmark (%)	difference (%)
Consumer staples	19.1	9.7	9.4
Information technology	7.3	1.7	5.6
Consumer discretionary	9.6	0.6	8.9
Industrials	5.5	4.3	1.1
Materials	4.3	5.0	(0.7)
Health care	4.1	3.0	1.1
Telecoms	6.8	12.7	(5.9)
Utilities	1.0	3.7	(2.7)
Real estate	5.0	9.2	(4.2)
Energy	2.8	6.0	(3.2)
Financials	32.0	44.1	(12.0)
Cash	2.5	-	2.5

Source: Aberdeen Standard Investments

Bias to consumer and away from financials

AFMC's portfolio retains a bias to consumer-oriented stocks and away from financials. The former offer exposure to the long-term growth of the middle class in FM countries while the latter group includes many companies of dubious quality in the manager's opinion.

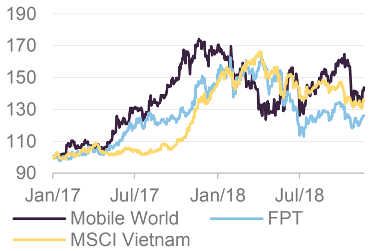
10 largest holdings

Figure 7: Top 10 holdings as at 31 October 2018

Holding	Country	Sector	Allocation 31/10/18 (%)	Allocation 31/01/18 (%)	Percentage point change
BBVA Banco Francés	Argentina	Financials	5.0	4.4	0.6
Mobile World	Vietnam	Telecoms	4.9	3.3	1.6
FPT Corporation	Vietnam	Telecoms	4.6	3.5	1.1
Zenith Bank	Nigeria	Financials	3.8	2.0	1.8
Equity Group	Kenya	Financials	3.2	1.6	1.6
Guaranty Trust Bank	Nigeria	Financials	3.1	4.3	(0.8)
Square Pharmaceuticals	Bangladesh	Health care	3.1	2.3	0.8
John Keells	Sri Lanka	Industrials	3.0	4.3	(1.3)
Maple Leaf Cement	Pakistan	Industrials	2.6	2.2	0.4
Safaricom	Kenya	Telecoms	2.5	4.5	(2.0)
Total top 10 holdings			**35.8**		

Source: Aberdeen Standard Investments, Marten & Co.

Figure 8: Mobileworld, FPT and MSCI Vietnam, rebased to 100



Source: Bloomberg, Marten & Co

Many of the 10 largest holdings have been discussed in previous notes (see page 11 of this note for details of previous publications). In Vietnam, the manager has been trimming the position in Vinamilk (which no longer features in the top 10 holdings), while adding to positions in Mobileworld and FPT. He says that these two stocks look cheap relative to the index, exhibit faster growth and are higher quality than the average.

One reason why these two stocks are attractively valued is that Vietnam's market is distorted by foreign ownership limits. These are fixed by the state in the case of telecoms companies (less strategic companies have the option of eliminating them). Foreign ownership of both these stocks is at its limits and, consequently, money allocated by foreigners into the Vietnamese market passes them by and is focused instead on the largest stocks with no foreign ownership limits, such as Vingroup (see Figure 16).

It is worth pointing out that, where foreign-owned stakes in companies such as FPT and Mobileworld do change hands, this often happens at a premium to the share price. However, such trades must be approved and this takes time. In short, the manager argues that there is a material disconnect between fundamentals and valuations in the case of these two names, which is why they are two of the portfolio's largest positions.

Figure 9: Techcombank share price

Source: Bloomberg, Marten & Co

Elsewhere in Vietnam, AFMC holds Techcombank. The manager describes this stock as sophisticated and profitable. The bank's profitability is transaction driven rather than lending driven; it takes in deposits from the mass affluent, is the leading domestic issuer of Visa credit cards, runs a wealth management service for HNWs, operates a strong life insurance franchise, and also has a profitable corporate advisory business. AFMC first invested when this stock came to the market at IPO. Techcombank hit its foreign ownership limit on its first day of trading in June 2018. Warburg Pincus was a pre-IPO investor, committing $370m to the company in the largest ever private equity investment in Vietnam.

Mark has been adding to positions in Argentina following dramatic falls in that market and has reduced the portfolio's underweight exposure relative to the FM index. He thinks that some value is emerging here, particularly in energy and real estate sectors. The government is undertaking necessary structural adjustments, which should return the economy to a position of expansion again in 2019.

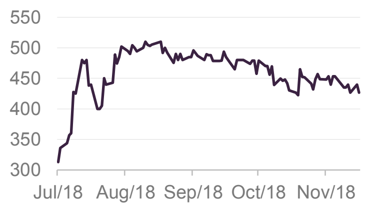
In Pakistan, AFMC owns a number of companies including Shell Pakistan (the local subsidiary of the Anglo/Dutch group), Habib Bank (Pakistan's leading bank by assets and deposits, controlled by the Agha Khan Fund for Economic Development) and Maple Leaf Cement, which has just entered the list of top 10 holdings. All three names trade on forward price-to-earnings ratios of less than 7x.

Figure 10: Maple Leaf Cement share price

Source: Bloomberg, Marten & Co

In Romania, Mark has been building a position in Sphera Holdings, a major local fast food franchisee operating under the KFC, Taco Bell and Pizza Hut brands. Part of the attraction is that the company is expanding into Italy where KFC has just 25 outlets at present. He has also built a stake in Purcari, Romania's number one premium wine brand and the fastest growing winery in the country.

Figure 11: ASA International share price



Source: Bloomberg, Marten & Co

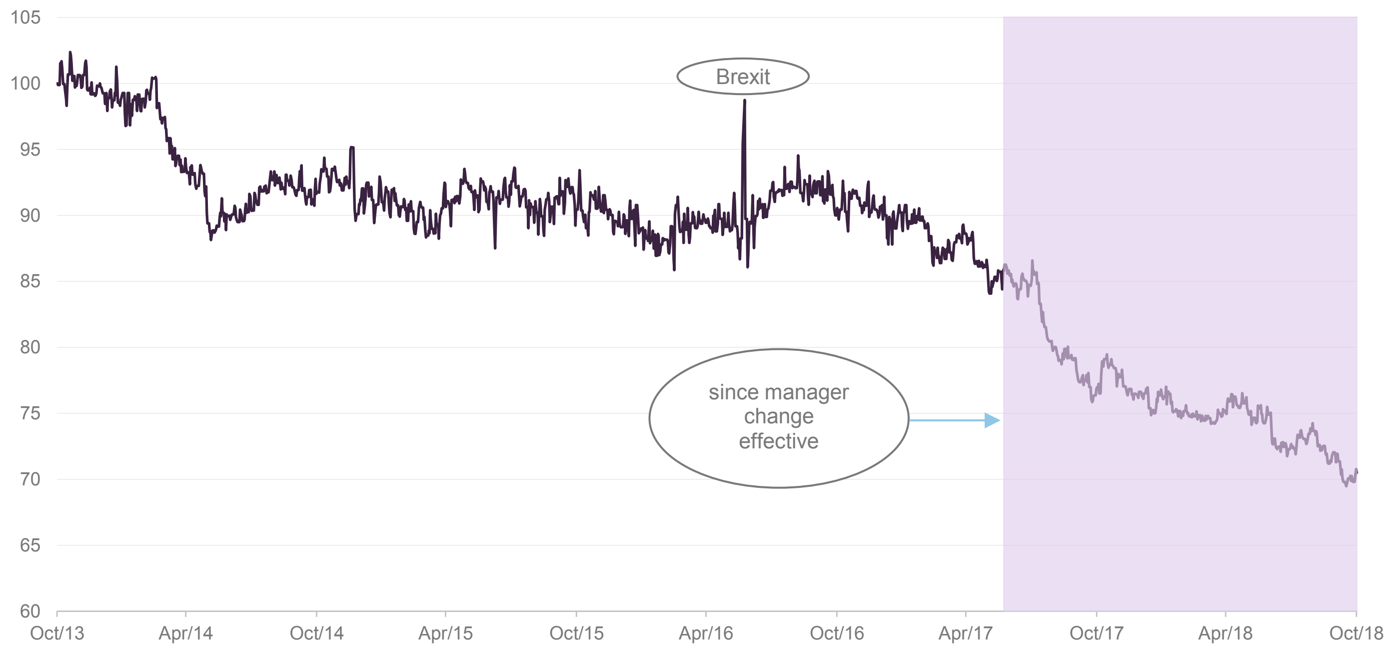
In Bangladesh, Mark has trimmed the holding in Grameenphone but has been adding to a holding in ASA International. This latter stock is a micro lender, with strong ESG credentials. Its business model has been tried and tested in Bangladesh over several decades and ASA International itself has operations in 12 countries across Asia and Africa. It was established in conjunction with the ASA foundation and lends small amounts ($150-$300) to female entrepreneurs. It has performed well during AFMC's ownership and, as noted on page 9, has had a positive influence on AFMC's returns in 2018.

Performance

Visit QuotedData.com for an up to date comparison of AFMC and its peers

As Figure 12 shows, frontier markets have been underperforming developed markets. The manager says that there have been significant outflows of capital from frontier markets in 2018, continuing a trend that has been in place over the past four years. He thinks that foreign participation in many of these markets is now very low, relative to historical norms.

Figure 12: Total return NAV performance of AFMC versus the FM Index



Source: Morningstar, Marten & Co

AFMC's geographic asset allocation has been the largest detractor from its returns in recent years

Figure 12 shows the performance of AFMC in NAV total return terms over five years to the end of October 2018 in comparison with the FM Index.

As Figures 12 and 13 show, AFMC has underperformed the MSCI Frontier Markets Index since the shift to direct investing. The drivers of AFMC's long-term performance were discussed in our last annual overview, where we also discussed the impact of promotions and demotions of countries from the FM to the EM index. AFMC's geographic asset allocation has been the largest detractor from its returns in recent years.

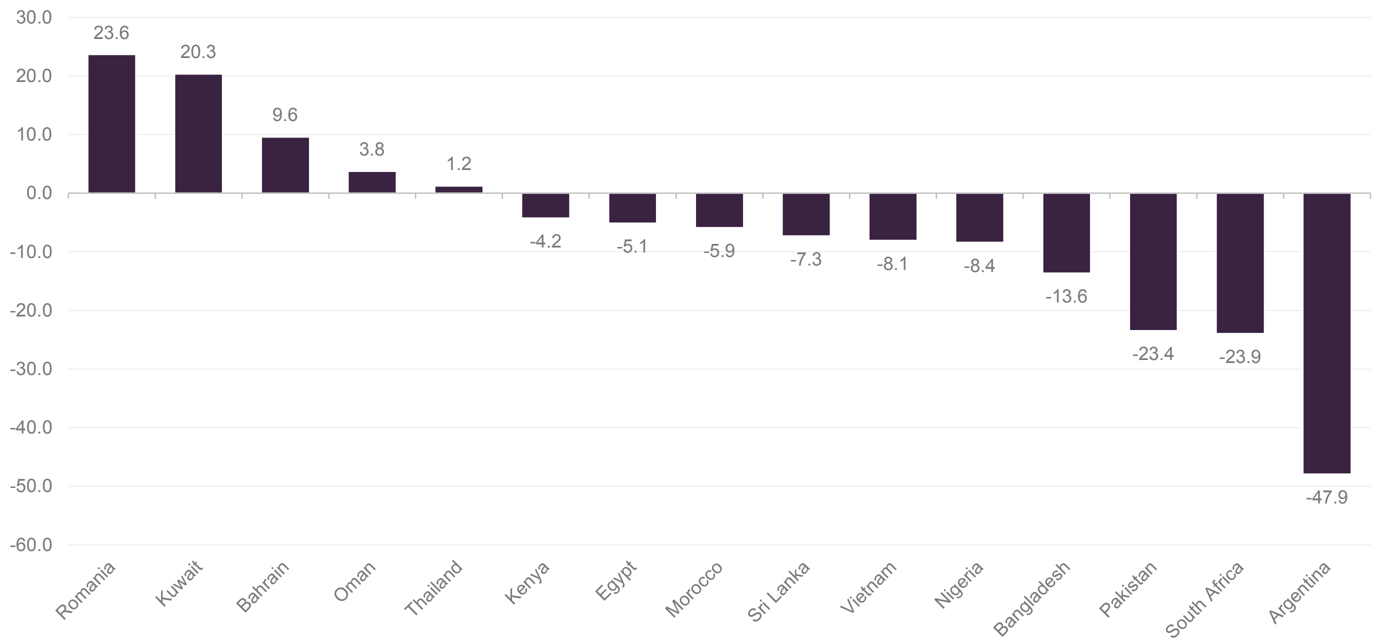
Figure 13: Cumulative performance over periods ending 31 October 2018

	3 months (%)	6 months (%)	1 year (%)	Since 30 June 2017* (%)	3 years (%)	5 years (%)
AFMC NAV (TR)	(3.7)	(9.2)	(16.0)	(16.1)	(19.1)	3.5
AFMC share price (TR)	(7.4)	(12.5)	(18.4)	(24.0)	(25.8)	(2.7)
MSCI Frontier (TR)	(1.5)	(6.3)	(10.6)	(8.4)	(1.9)	32.8
MSCI Emerging (TR)	(6.8)	(9.2)	(9.8)	(8.7)	(0.2)	47.7
MSCI World Index (TR)	(5.4)	(3.1)	5.7	5.7	10.6	54.5

Source: Morningstar, Marten & Co. * date that Mark Gordon-James took control of the portfolio

Figure 14 shows how various MSCI indices of countries relevant to AFMC have performed over the course of 2018, to date.

Figure 14: Year to date changes in markets significant to AFMC (MSCI indices in sterling)



Source: Morningstar, Marten & Co

Underweight exposure to the Gulf countries has been particularly problematic this year

Over the course of 2018, on a regional analysis, the principal detractors from AFMC's performance were its underweight exposure to the Gulf countries of Kuwait, Bahrain and Oman. Its off-benchmark exposure to Pakistan and overweight exposure to Sri Lanka were also unhelpful. A positive contributor to relative returns was AFMC's underweight exposure to Argentina where the manager thought that valuations were looking extended and was proved correct.

Figure 15: Positive stock contributors to relative return in USD (first nine months of 2018)

Stock	AFMC position at 30/09/18 (%)	Benchmark weight at 30/09/18 (%)	YTD change in share price (%)	YTD weighted stock return in AFMC ownership (%)	Contribution to relative return (%)
Grupo Financiero Galicia*	-	2.29	(61.1)		2.44
Banco Macro*	-	1.67	(63.2)		1.93
Pampa Energia*	1.00	1.79	(53.8)		1.21
Telecom Argentina*	-	1.67	(49.0)		1.04
Grupo Supervielle	-	0.40	(73.7)		0.78
ASA International	2.23	-	-		0.68
YPF*	-	2.39	(32.6)		0.61
Green Bay Properties	-	0.63	(52.1)		0.57
Faros Construction Corp	-	0.21	(74.1)		0.46
EPAM Systems	0.56	-		28.1	0.40

Source: Aberdeen Standard Investments. Note: * Argentinian

The impact of geographic asset allocation decisions is evident in Figure 15 where not holding or holding an underweight position in a number of Argentinian stocks had a considerable positive influence on returns.

Figure 16: Negative stock contributors to relative return in USD (first nine months of 2018)

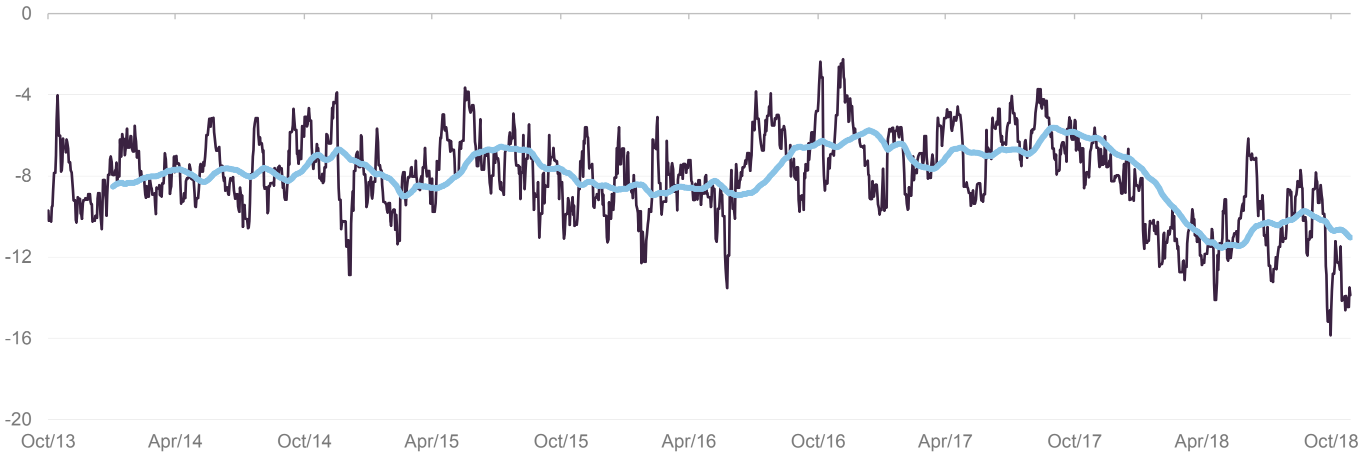
Stock	AFMC position at 30/09/18 (%)	Benchmark weight at 30/09/18 (%)	YTD change in share price (%)	YTD weighted stock return in AFMC ownership (%)	Contribution to relative return (%)
National Bank of Kuwait	-	7.26	23.4		(1.83)
IRSA Properties	2.19	-		(57.1)	(1.46)
BBVA Banco-Francés	4.77	0.73	(53.1)	(51.6)	(1.33)
Vingroup	-	2.94	49.8		(1.26)
Kuwait Finance House	-	5.36	17.0		(1.17)
Yoma Strategic Holdings	0.79	-		(51.4)	(0.76)
Mobile Telecommunications	-	2.99	18.9		(0.74)
Ahli United Bank	-	2.71	16.3		(0.59)
Maple Leaf Cement Factory	2.00	-		(37.3)	(0.54)
Fan Milk	1.73	-		(35.8)	(0.51)

Source: Aberdeen Standard Investments

On the downside, not holding a number of Kuwaiti stocks detracted from AFMC's relative returns as did holding Argentinian stocks such as IRSA Properties (an owner/operator of shopping centres) and BBVA Banco-Francés. Vingroup is one of Vietnam's largest stocks by market cap. Yoma Strategic is a Singapore-listed investor in Myanmar. Fan Milk is a Ghanaian dairy company operating in seven West Africa countries. Vendors of its products went on strike in October in protest of a reduction in their sales commission.

Discount

Figure 17: Premium/(discount) over five years



Source: Morningstar, Marten & Co.

AFMC's discount widened sharply towards the end of October 2018, hitting a new low of 15.9% on 30 October. Over the year to the end of October 2018, the discount averaged 9.9% and moved in a range of 5.3% to 15.9%. At 27 November 2018 the discount was 13.8%.

Tender offer

October's 15% tender offer was oversubscribed

As part of its effort to address its discount and to provide liquidity to shareholders, and in accordance with a policy adopted in March 2017, AFMC conducted a tender offer for 15% of its outstanding shares in October. The tender offer was triggered by AFMC's discount trading at wider than an average of 10% over the three months leading up to AFMC's accounting year end on 30 June. The tender offer was oversubscribed (60.3% of shares were tendered) and so was taken up in full. Following the tender, the repurchased shares were cancelled, leaving 71,910,117 shares in issue.

Performance-driven exit opportunity

AFMC must outperform in share price terms by June 2020 or shareholders will be offered a cash exit

The board proposed and shareholders approved the adoption of a new discount control policy in October 2018. Discount triggered tenders or other discount control mechanisms will no longer be pursued. Instead, if AFMC's share price total return for the period from 1 July 2018 to 30 June 2020 does not exceed the total return in sterling of the FM index, shareholders will be given the opportunity to fully exit their investment in the company. Shareholders could then opt to exchange the shares for cash at the then prevailing NAV less applicable direct costs (including any realisation costs of underlying investments).

The board also intends to seek annual renewal of the usual authority to buyback shares in the market. It will buy back shares where it believes it is in the best interests of shareholders to do so.

Fund profile

Long-term capital growth from markets in the MSCI Frontier Markets Index and those with frontier-like characteristics

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 countries within the MSCI Frontier Markets Index or additional countries that the managers deem to be such due to their characteristics, including many constituents of the MSCI Emerging Markets Index.

You can access the fund's website at www.aberdeen frontiermarkets.co.uk

AFMC is managed by Aberdeen Standard Investment's Global Emerging Market team. Aberdeen Standard Investments (ASI) is well-known for its emerging markets expertise. The global emerging markets team, which is spread across offices in seven countries, had assets under management of $38.4bn at the end of June 2018. ASI has been running a dedicated frontier markets strategy since 2009 and has been investing in the area since the 1980s. The frontier markets strategy had assets of $388m at the end of June 2018.

Previous publications

Marten & Co has published a number of notes on AFMC which can be read by clicking on the links below or visiting our website.

Figure 18: Marten & Co's notes on AFMC

Date	Title	Note type
10 November 2016	Long-term growth opportunity?	Initiation
6 March 2017	Direct investing	Update
26 March 2018	No closet-tracker	Annual overview

Source: Marten & Co

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IMPORTANT INFORMATION