



Henderson High Income / Henderson Diversified Income

Investment companies | Flash note | 4 October 2023

Merger terms agreed

Henderson Diversified Income (HDIV) has agreed heads of terms for a combination with Henderson High Income (HHI). As part of the deal, shareholders in HDIV will have the option to take cash for all or part of their holding if they choose.

In July 2023, HDIV's chairman noted (see our news story [here](#)) that the trust had shrunk through share buybacks, and that this was inflating its average running costs and affecting liquidity in its shares. More importantly, he also made some observations about the fund's investment approach (devised at launch in 2007) and the impact that this might be having on the sustainability of HDIV's income and shareholders' total returns (see page 4).

The HDIV board invited proposals from a number of investment companies with alternative investment processes, and believes that a combination with HHI offers numerous benefits. There are also benefits for HHI shareholders if HHI is able to expand. In addition, as we detail on page 7, Janus Henderson (manager of both trusts) is making a considerable contribution towards the costs of the scheme.

It will be a shame to see HDIV go, but a combination with HHI looks like a sensible option to us. There is little-to-no income dilution for HDIV shareholders, a small immediate capital uplift, and better prospects for capital growth. HHI will still offer some exposure to the higher yields that are now available from bonds, and it should be a bigger, more appealing, more liquid, and more efficient trust.

Sectors	UK Equity Bond and Income / Debt – Loans and Bonds
Tickers	HHI LN / HDIV LN
Base currencies	GBP
Prices	157.0p / 62.6p
NAVs	160.3p / 69.2p
Premiums/(discounts)	(2.0%) / (9.5%)
Yields	6.6% / 7.0%



HHI offers similar yield to that of HDIV, but also access to a growing dividend

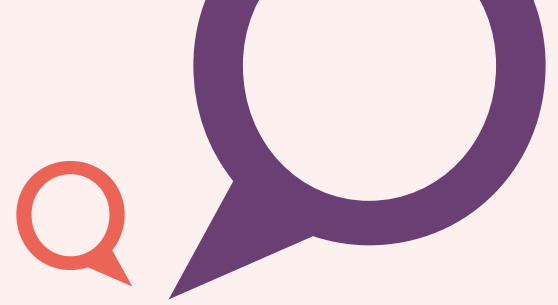


Cash exit for HDIV shareholders that want it



Substantial contribution to costs from Janus Henderson





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Domicile (HHI)	England and Wales
Inception date (HHI)	November 1989
Manager (HHI)	David Smith
Market cap (HDIV / HHI)	114m / 204m
HHI shares outstanding (exc. treasury shares)	129,796,278
HDIV shares outstanding (exc. treasury shares)	182,072,717
Net gearing (HHI / HDIV)	25% / 15%

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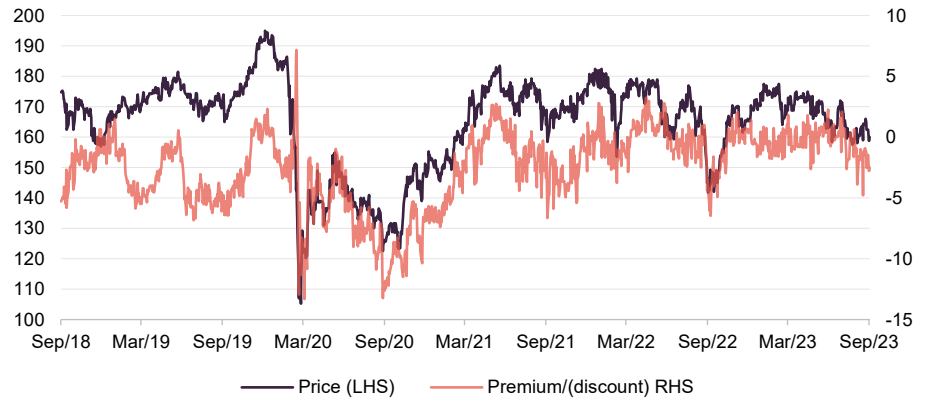


At a glance

HHI share price and premium/(discount)

HHI's shares were knocked – as were almost all funds – by the panic associated with the COVID pandemic. However, they recovered over the following months and since 2021 they have been trading fairly close to asset value.

Time period 30 September 2018 to 30 September 2023

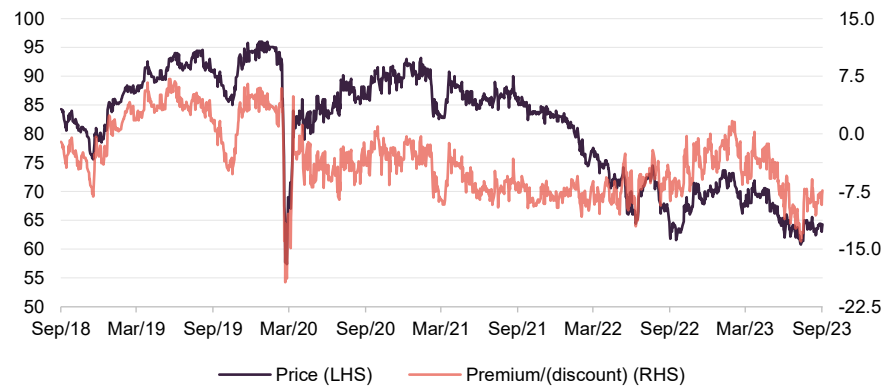


Source: Morningstar, Marten & Co

HDIV share price and premium/(discount)

HDIV was also hit by the pandemic, but its biggest problem was the threat and then the reality of rising interest rates, which reduced the relative appeal of its dividend yield, and weighed on the NAV. The managers' conservative stance has also held back returns.

Time period 30 September 2018 to 30 September 2023



Source: Morningstar, Marten & Co

Year ended	HHI share price total return (%)	HHI NAV total return (%)	HDIV share price total return (%)	HDIV NAV total return (%)
30/09/2019	5.3	4.6	13.1	10.6
30/09/2020	(22.6)	(16.7)	(0.2)	5.4
30/09/2021	42.7	27.3	3.7	7.5
30/09/2022	(9.7)	(6.6)	(20.6)	(22.2)
30/09/2023	18.4	15.8	7.8	8.9

Source: Morningstar, Marten & Co

The proposed combination

The combination of HDIV and HHI needs approval from both sets of shareholders if it is to proceed. It would be effected by way of a scheme of reconstruction and winding up of HDIV under section 110 of the Insolvency Act 1986, which is the most common method for merging two UK listed investment companies.

HDIV shareholders will have the option of rolling over their entire investment into HHI (this will be the default option), or electing to take cash in exchange for part or all of their holding.

Formula asset values (FAVs) would be calculated for each trust. For HDIV, this would be the net asset value (NAV) less its respective costs after the contribution from Janus Henderson (see below) of effecting the transaction. For HHI, this would be the NAV plus a 1% premium, less its respective costs after the Janus Henderson contribution.

The ratio of HHI shares that holders of each HDIV share would be entitled to would be calculated on a FAV:FAV basis.

The cash option would be at a discount of 1% to HDIV's NAV.

All HDIV shareholders, including those electing for the cash option, would be entitled to receive a pre-liquidation interim dividend (equivalent to any net income available after expenses for the current financial year).

Timetable

The current plan:

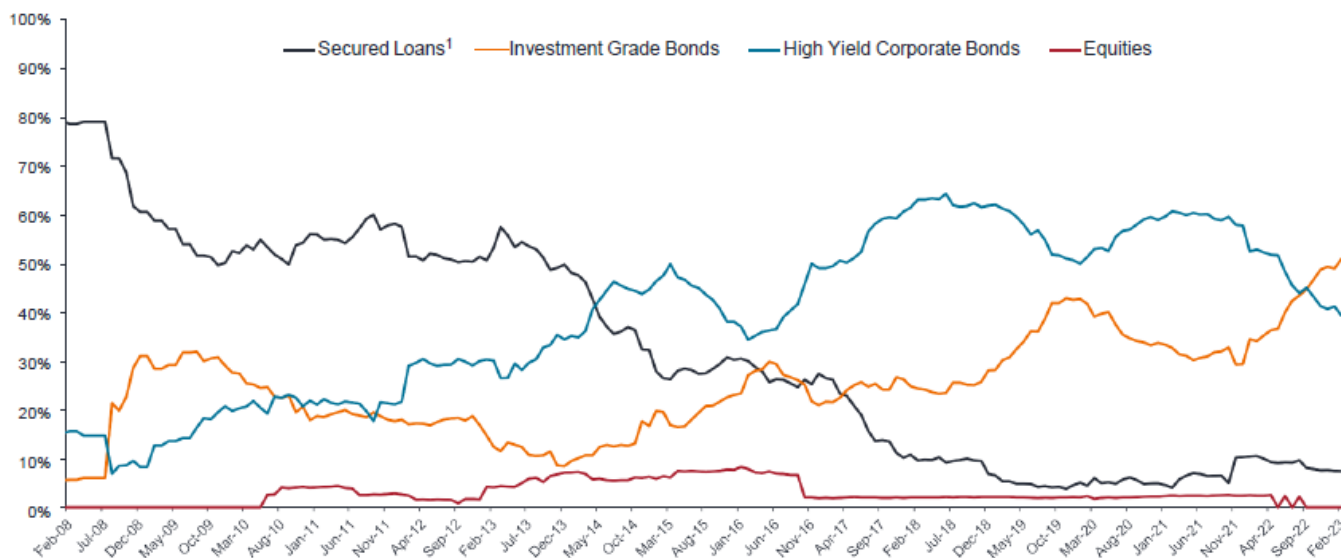
- Shareholder circulars published in December 2023
- Meetings of each trust held in January 2024

How did we get here?

Back in July 2022, when reporting on HDIV's results for the accounting year ended 30 April 2022, its chairman noted that the trust was established with a view that secured loans would form a significant part of the portfolio, particularly when interest rates rose. It was envisaged that this would help protect shareholders from capital losses in times of rising rates and provide some capital growth when rates were falling.

In the event, as Figure 1 shows, exposure to secured loans has fallen over time as the managers became convinced that the returns on offer did not reflect a deterioration in the credit quality of these loans.

Figure 1: HDIV asset allocation over time



Source: Janus Henderson

A year later, in July 2023, the chairman reiterated this point, highlighted the challenge of sustaining HDIV’s yield and the risks necessary to achieve that, pointing out that HDIV’s revenue reserves were much diminished (HDIV’s dividend was uncovered by earnings in its financial year that ended on 30 April 2023).

In addition – against a backdrop of rising rates, Liz Truss and Kwasi Kwarteng’s ‘mini-budget’ in the UK in September 2022 (which triggered a big jump in gilt yields), and the managers’ caution on the global economy – HDIV’s NAV total return had been negative for two successive financial years, underperforming its benchmark in each case. The discount had also widened, and share buybacks undertaken to tackle that had shrunk the trust, which has impacted on its **ongoing charges ratio** and liquidity in trading its shares.

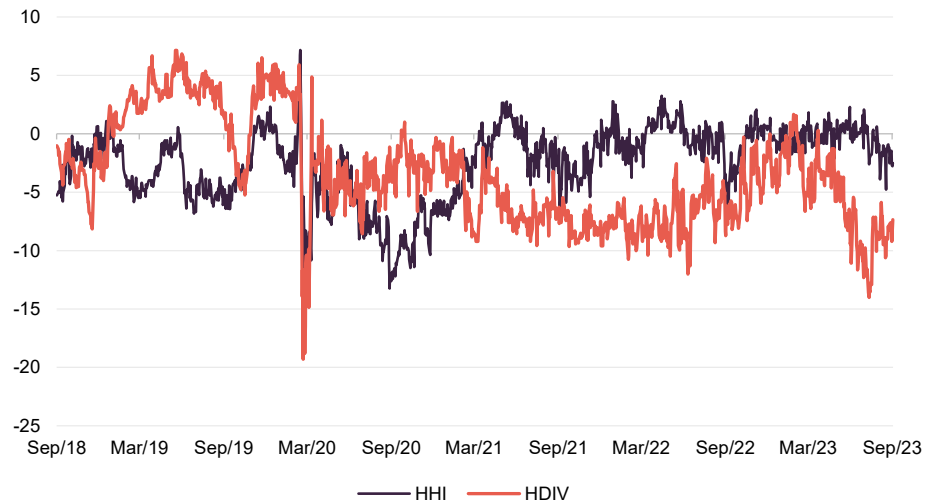
The board concluded that “the structure of the company as originally envisaged does not allow the fund managers to preserve the real value of the capital of its shareholders, and it feels that perhaps an alternative investment process could offer greater scope to provide a more consistent return”.

Benefits of the proposals

The announcement notes a number of benefits for HDIV’s shareholders which we summarise here:

- The unlimited cash exit option at a 1.0% discount to NAV.
- The ability to retain some exposure to HDIV’s managers’ through HHI’s fixed income allocation, while gaining access to the expertise of Janus Henderson’s well-regarded equity income team.
- A potential uplift, given that HHI’s shares have tended to trade at a tighter discount than HDIV’s in recent years – as you can see in Figure 2.

Figure 2: HHI and HDIV's five-year premium/(discount) history



Source: Morningstar, Marten & Co

- HHI has better long-term total returns, as is evident from Figure 3.

Figure 3: HHI and HDIV NAV and share price total returns

	1-year (%)	3-years (%)	5-years (%)	10-years (%)
HHI NAV	15.8	37.7	20.0	81.1
HDIV NAV	8.9	(9.0)	6.1	39.7
HHI share price	18.4	52.5	24.4	71.1
HDIV share price	7.8	(11.3)	0.2	28.0

Source: Morningstar, Marten & Co

- Similar high yield, but HHI has a better record of dividend growth (an average of 2% per year over 10 years, and 10 consecutive years of growing dividends). At close of business on 3 October 2023, HHI was yielding 6.6% and HDIV 7.0%.

Figure 4: HHI and HDIV dividend per share (pence)

FY ended	2019	2020	2021	2022	2023
HHI	9.80	9.90	9.95	10.15	10.30 ¹
HDIV	4.40	4.40	4.40	4.40	4.4

Source: Henderson High Income, Henderson Diversified Income. Note 1) assuming fourth quarterly dividend is maintained at last year's level, it may be higher.

- A lower ongoing charges ratio – HHI's management fee is 0.50% on gross assets up to £325m and 0.45% above, while HDIV's is 0.65% of net assets. HHI's latest ongoing charges ratio is 0.84% to HDIV's 0.98%. As HHI expands, its ongoing charges ratio should fall.

- An enlarged HHI should help improve liquidity in its shares and make the trust more appealing to some investors.
- A significant contribution to costs from Janus Henderson. It will contribute an amount equal to 1.25% of the assets rolling over to HHI, up to a maximum of £1.1m, while waiving the fee due in respect of the termination of HDIV's investment management agreement. The first £550,000 of any contribution will be allocated to covering HHI's costs, with the balance allocated to HDIV.
- The deal gives HDIV shareholders the option of a rollover into HHI without triggering capital gains tax.

HHI's Fund profile

This is taken from our recent note on HHI, which can be read [here](#)

Henderson High Income Trust (HHI) invests in a prudently diversified selection of both well-known and smaller companies, to provide investors with a high income stream while also maintaining the prospect of capital growth.

The majority of HHI's assets are invested in the ordinary shares of listed companies, with the balance in listed fixed interest stocks (no unquoted investments). Investee companies should have strong balance sheets that are capable of paying dividends. There is a focus on well-managed companies whose qualities may have been temporarily overlooked by investors and which offer the potential for capital appreciation over the medium term. A maximum of 30% of gross assets may be invested outside of the UK.

A portion of gearing is invested in fixed interest securities

Gearing is used to enhance income returns, and to help achieve capital growth over time. A portion of gearing is usually invested in fixed-interest securities.

Janus Henderson Fund Management Limited is the company's **AIFM** and it delegates investment management services to Henderson Global Investors (both are subsidiaries of Janus Henderson Group Plc). The lead fund manager assigned to the trust is David Smith. He was made co-manager of the trust in 2014 and has been sole manager since 2015.

Blended benchmark

HHI benchmarks itself, for performance measurement purposes, against a blend of 80% of the FTSE All-Share Index return and 20% of the ICE Bank of America Merrill Lynch Sterling Non-Gilts Index.



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