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British Empire Trust

- A highly-active, benchmark agnostic value-orientated portfolio that focuses on family-controlled holding companies, closed-ended funds and asset-backed special situations
- Performance has improved markedly since manager Joe Bauernfreund honed the investment process in 2015 and even managed to outperform the MSCI AC World index last year despite a clear style headwind thanks to the team's stockpicking, especially in Japan
- Numerous pre-identified events or catalysts have come to fruition over the past 12 months leading, yet the team continue to find wide discount opportunities they believe can drive future returns
- In a market where value stocks are generally under-owned, the trust is an attractive diversifier and looks appealing on its current 10.6% discount – let alone its underlying average discount across the portfolio of 24%

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Summary

British Empire Trust (BTEM) is a highly-active, benchmark agnostic portfolio of global equities that follows a value-orientated investment approach.

The trust differs from most global funds due to the types of companies that it focuses on, which can broadly be split into three buckets: family-controlled holding companies, closed-ended funds and asset-backed special situations – and all of those companies have the common feature of owning portfolios of businesses or assets, either listed or unlisted, that can be independently valued.

Joe Bauernfreund, chief executive and chief investment officer of AVI, is supported by four analysts and has been solely responsible for the portfolio since October 2015 (though Joe has worked on the portfolio since 2002). He honed the investment process at the time and this has been a major contributor to the trust's recent outperformance.

Though it has a strong long-term track record (having more than doubled the returns of its peers and the MSCI AC World index over 20 years), it had largely struggled in the years following the global financial crisis due to the underperformance of value stocks more generally and the trust's historic underweight to the US market – which has performed very strongly. However, when Joe assumed sole responsibility for the portfolio, he honed the process, developing the approach to buying companies that are trading at discounts to NAV but, more importantly, where he and the team have identified a potential event or catalyst for that

value to be realised. He also will typically boost his weightings to holdings that are approaching their final "end game" or event.

Since October 2015 to the end of 2017, the trust's NAV total returns have been 64% - meaning it has comfortably outperformed its average peer, the MSCI AC World index and its own benchmark, the MSCI AC World ex USA index over that time. Though much of that outperformance was generated in 2016 (a year when value investing made a brief return to form following a prolonged period of doldrums), the trust managed to outperform the MSCI AC World index over the course of 2017 with NAV returns of 14.9% despite a clear style headwind. We would argue this shows the benefits of the team's disciplined approach and stockpicking, with major contributors to returns including private equity trusts (where the team's own activism and engagement with the board helped drive shareholder value) and their Japanese holdings, which the team have significantly increased their exposure to over the past 12 months on the back of attractive valuations and a change in attitudes towards corporate governance within the country.

We think the outlook for British Empire continues to look positive. Clearly, its best relative returns will be generated if value investing does indeed come back into favour compared to the recent dominance of growth, but the trust's recent performance shows the team can add value when conditions aren't as conducive. Furthermore, as we note in our latest thematic research, most investors are very unprepared to a prolonged rally in value stocks and, with a discount of 10.6% (and a look through average discount across the portfolio of 25%), we think British



Empire offers an ideal entry point for those looking for greater style diversification within their portfolio.

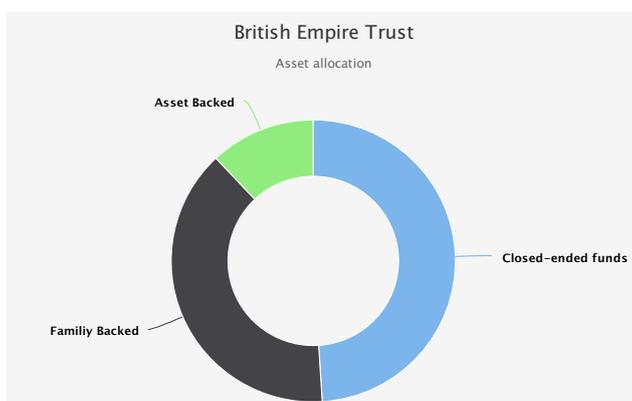
Portfolio

Joe and his team are bottom-up stockpickers who pay next to no attention to the index and while they keep an eye on the macroeconomic backdrop, they do not attempt to “forecast the unforecastable”. They also work closely with the management teams of the stocks they hold in order to drive shareholder value, as we note below.

The investment process boils down to not only finding companies that are trading at discounts to NAV, but also have good potential to appreciate in value, with an identifiable event or corporate catalyst which would serve to reduce or eliminate that discount. These catalysts usually include the winding up of an investment trust, IPOs of unlisted holdings, sales of assets, return of capital to shareholders and potential takeovers.

The trust has been value-orientated since its creation in the 1980s, but when Joe assumed sole responsibility for the portfolio in October 2015, he went about putting his own stamp on the process by reducing the number of holdings and increasing weightings to his highest conviction calls. To make sure the portfolio is working as hard as possible at all times, Joe typically boosts weightings to holdings that are approaching their final “end game” or event. This honing of the process, as we note in the performance section, has paid off for shareholders.

Broadly speaking, the portfolio can be split into three different baskets. The two largest are other closed-ended funds and family-controlled holding companies, which combined account for 80% of the portfolio. The remainder of the portfolio is invested in ‘asset-backed companies’ and special situations – most of which are based in Japan, which as we will come onto later, has been a major source of opportunities and returns for the trust.



Source: AVI

Closed-ended funds account for 49% of the portfolio and one major area of focus within that bucket is listed private equity. The

team’s holdings include the likes of JPEL Private Equity, which has been a strong driver of returns of late. The team originally bought into the trust as it traded on a wide discount of more than 30% and owned high quality assets, arguing that this ‘value’ could be unlocked via certain disposals. JPEL has been in run-off since June 2016 and the discount has since narrowed to 16%, while it has made three capital returns to shareholders at a 0% discount to NAV.

A more recent purchase has been Aberdeen Private Equity, which is a good example of how the team’s own activism can drive returns. Again, the team initiated a position in April 2017 as they viewed its 20% discount as highly attractive and, having met with the board and undertaken their own research into the portfolio, believed that a catalyst for the undervaluation to be realised could come in the form of a change in the shareholder base.

As such, the team built up a 25% position and senior analyst Tom Treanor, who takes the lead on much of the team’s activism/ corporate engagement within the closed- end fund sector, made proposals to the board/ manager that the portfolio be sold in a competitive process. The outcome was a successful one, with Aberdeen Private Equity’s portfolio ultimately sold at a modest premium to NAV with the proceeds to be returned to shareholders and the fund wound-up.

Outside of listed private equity, other recent additions to their closed-ended fund basket include hedge funds Third Point Offshore and Pershing Square Holdings, which are currently trading on discounts of 16.3% and 21.7%, respectively. In both instances, the team are working closely with the board to structurally narrow the discount.

Joe and the team note that it is difficult to be activist investors in family-controlled holding companies. Therefore, in this basket (which accounts for 39% of the portfolio), they focus on stocks with high quality underlying assets and a management team which, itself, is proactive in trying to narrow the discount. Examples include EXOR, the Italian-listed holding company with a strong long-term track record of NAV growth, which the team initially bought on a 25% discount to NAV. They were particularly attracted to one of EXOR’s largest holdings, Fiat Chrysler Automobiles, as they believed it offered significant upside from its low market valuation. EXOR has been working on unlocking value from Fiat Chrysler and, by working closely with soon to be retiring CEO Sergio Marchionne, are eyeing up numerous value accretive spin-out deals (candidates include Maserati and Alfa Romeo).

From a top-down perspective, a major theme within the portfolio is Japan, with the team having increased their position from 6% to 20% over the past 12 months. This, along with a clear



value tilt, is one of the major reasons why the trust is highly differentiated from its peers in the global sector, where the average weighting stands at just 6%.

TOP 10 HOLDINGS			
NAME	% OF NAV	TYPE	DISCOUNT
Japan Special Situations stocks	10.60%	Asset Backed	25.10%
Pargesa	6.10%	Family Backed	33.00%
Tokyo Broadcasting System	5.70%	Asset Backed	15.10%
Exor	5.10%	Family Backed	33.60%
Riverstone Energy	5.10%	Closed-ended funds	18.30%
Third Point Offshore Investors	4.90%	Closed-ended funds	16.3%
Tetragon Financial	4.90%	Closed-ended funds	29.60%
Pershing Square Holdings	4.60%	Closed-ended funds	21.70%
Wendel	4.60%	Family Backed	24.00%
Adler Real Estate	4.40%	Asset Backed	17.60%

Source: AVI

Their bullishness towards the country is due to their belief that valuations in Japan are highly attractive compared to other developed markets. More importantly, though, they believe a recent shift in attitudes towards corporate governance in the country (initiated by Prime Minister Shinzo Abe's reforms) have gone a long way in unlocking that undervaluation – noting how, in particular, there have been examples of foreign investors altering the behaviour of management teams.

They argue Japan is an ideal hunting ground for the trust, given many stocks have huge amounts of cash on the balance sheet but are aiming to become more capital efficient. Joe and the team are accessing Japan via two routes, the first being their more traditional approach of focusing on asset backed companies like Tokyo Broadcasting – a TV production company with a very healthy balance sheet, but a securities portfolio that had made up 100% of its market capitalisation (now 80%) and a decent real estate portfolio. The managers have been engaging with the board to try and unwind the cross holdings in the security portfolio to try and make the company more capital efficient.

However, a new theme within the portfolio is 'Japan Special Situations', which is a group of c20 listed companies that the team argue have high quality underlying assets, generate strong

free cash flow yield but are trading on "derisory" valuations. For each holding, they have identified a catalyst which would serve to reduce or eliminate that discount. In this case, these are either particular events or their own activism.

WEIGHTED AVERAGE PORTFOLIO STATS FOR JAPAN SPECIAL SITS HOLDINGS	
NAME	WEIGHTED AVERAGE ACROSS JAPAN SPECIAL SITUATIONS STOCKS
FCF Yield	7%
EV FCF Yield	17%
Net cash/Market cap	50%
EV/EBIT	4.5x
Discount	-25%
Operating Margin	7.70%
Dividend Yield	1.40%
Market Cap	£706m

Source: AVI

Outside of Japan, the trust has 30% in Europe, 16.5% in Asia, 10% in emerging markets and just 2.2% in the UK. It is worth noting that the trust uses the MSCI AC World ex USA index as a benchmark, meaning that the trust is considerably underweight North America relative to its average peer. The rationale for this skew in the portfolio is that while family-controlled companies do exist in the US, they tend to trade at a tighter discount or premium. Plus, the efficient nature of the US market means discounts don't tend to persist for very long and, at times Joe and the team have also found that corporate governance has not been up to the standards they look for.

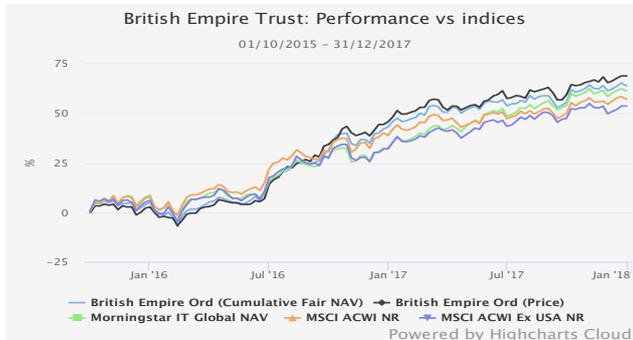
Performance

British Empire Trust has a long track record of outperformance, having more than doubled the returns of its peers and the MSCI AC World index over 20 years. However, on a seven and five-year view, performance is less impressive. The major drivers for that has been the fact the value investing style has been considerably out of favour and the fact it has historically had little exposure to the US (which has rallied strongly and accounts for more than half of the MSCI AC World index) – though Joe also notes that there were frailties within the portfolio/process that had not helped relative performance.

However, it is encouraging to note that since Joe became sole manager and honed the investment process, the trust's relative and absolute returns have improved markedly. Since October 2015 to the end of 2017, for example, the trust's NAV total returns have been 64% - meaning it has comfortably outperformed its

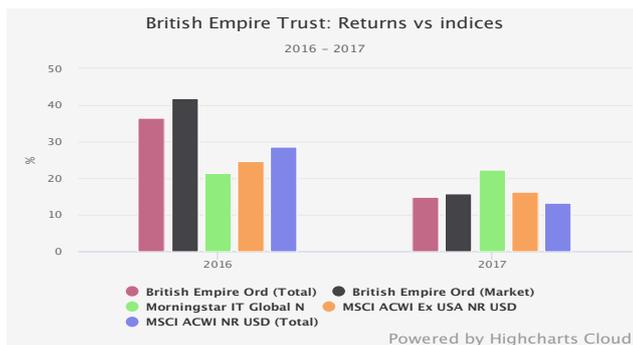


average peer, the MSCI AC World index and its own benchmark, the MSCI AC World ex USA index over that time.



Source: Morningstar

It took full advantage in 2016, a year when value investing made a significant return to form, and generated total returns of 36%. More impressively, however, the trust managed to maintain its outperformance against the MSCI AC World index in 2017 with returns of 14.9% despite a clear style headwind as value stocks generally struggled. Though it ended the year slightly behind its own benchmark (thanks to the strong returns from Chinese technology stocks, which account for a decent proportion of the index but don't feature in the portfolio), its performance relative to global equities more generally is testament to the team's stockpicking. Major contributors to returns include its Japanese holdings, Wendel as well as certain listed private equity holdings more recently (such as JPEL Private Equity and Aberdeen Private Equity).



Source: Morningstar

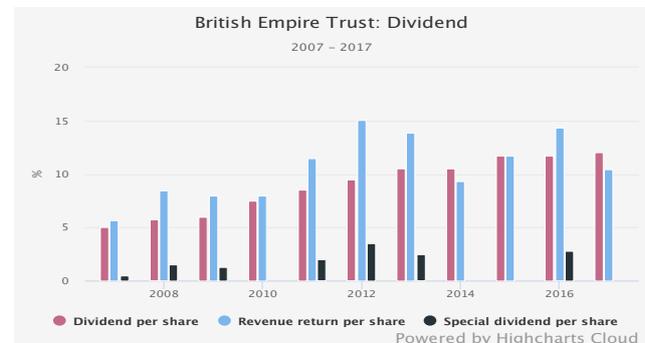
Despite its decent performance of late and a narrowing in the underlying look through discount across the portfolio (which has come in from more than 30% to 24% at the time of writing), the team remain very confident in the outlook for the portfolio. They note how, as cash is being returned to them at 0% discount in many instances (from events/catalysts they had identified), resulting in a significant return on their investments, the team have been able to recycle that capital into wider discount opportunities and continue to have a decent pipeline of investment ideas. Furthermore, they have various holdings in the

portfolio that have upcoming events that will help to drive further discount narrowing such as run offs, M&A deals and potential IPOs.

Dividend

British Empire is predominately focused on capital growth, but has a strong track record of growing its dividend to shareholders, having increased its distributions in each year for more than three decades. The yield is relatively low at 1.6%, but its five-year annualised dividend growth of 2.7% is well above the sector average and the trust has paid out special dividends in recent years such as 2011, 2012, 2013 and 2016.

The board increased the 2017 dividend by 2.5% to 12p, but thanks to recent portfolio changes (including its higher weighting to Japan, which is a low-yielding market), underlying revenue fell from 14.3p to 10.4p. As such, the board had to dip into its substantial revenue reserves to fund the dividend. Nevertheless, its revenue reserve cover (as of the last annual report and taking into account the payment of the final dividend) is still a healthy 1.55x the total 2017 dividend. This means, despite the recent fall in portfolio income, the board expects to "at least to maintain the level of ordinary dividend paid to shareholders".



Source: AVI

Gearing

During his revamp of the portfolio, Joe and the board agreed to add structural gearing (in sterling and euros) to the trust. They issued £53m year fixed-term gearing in the latter stages at the start of 2016. AVI deployed this into the market in the first months of 2016, which in retrospect was excellent timing. Given the team's positivity around their investment universe, however, the board approved a further modest increase in debt of €20m fixed rate notes at an annual cost of 2.93%. Gearing as a proportion of total assets stands at 2%.

Management

This unique mandate relies on a small specialist team led by Joe Bauernfreund, sole manager since October 2015, who has been at Asset Value Investors (AVI) since 2002. Joe is supported



by analysts Darren Gillen and Daniel Lee as well as senior analysts Tom Treanor and Scott Beveridge. AVI have proprietary models on a wide range of quoted investments around the globe, focusing on those which offer what the company describes as “deep value”.

Discount

Though British Empire’s returns have improved on both an absolute and relative basis, its shares have consistently traded at a c.10% discount to NAV. For example, it has traded at a significant discount the AIC Global sector average over five years, with the current discount (as of 10 January) standing at 10.6% (compared to 3.5% for the peer group). This is the trust’s widest relative discount to its peers since late-2015, when Joe assumed sole responsibility of the portfolio.

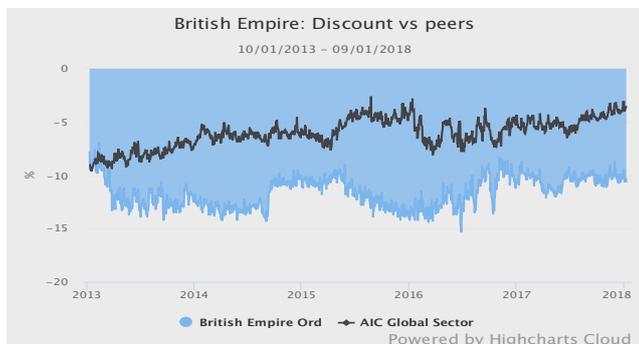
Given its discount was far tighter during the pre-crisis years when value investing was very much in favour and the outlook for the portfolio remains positive, we think the trust continues to look attractive – especially as the board has been proactive in trying to limit discount volatility. Over the last financial year, the board bought back 9.7m shares and currently holds 14m shares in treasury, representing 10.9% of share capital.

(which have come back at 0% discounts or moderate premiums, reflecting a strong return) to top up existing (and fund new) wide discount opportunities.

Charges

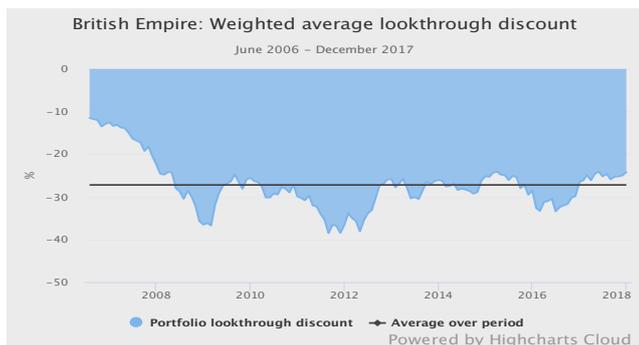
AVI are paid a basic management fee of 0.7% of NAV per annum and no performance fee. The OCF is 0.87%, which is slightly wider than the average seen across the AIC Global sector (0.79%).

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Source: Morningstar

It is also worth mentioning the average weighted discount across the portfolio, which currently stands at 24%. This has narrowed from more than 30% in 2016, further highlighting the success of Joe and the team’s new look approach. While this is slightly narrower than the average seen since 2006 (27%), the team note that they are using the recent capital returns from their holdings



Source: Morningstar



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