Asia Dragon

Update
12 February 2020

DGN has been performing strongly thanks to good stock-picking...

Summary

Asia Dragon (DGN), formerly known as Edinburgh Dragon, aims to identify well-managed, world-class businesses in Asia and buy them when they are on attractive valuations. The management team at Aberdeen Standard Investments, headed by Adrian Lim and Pruksa Iamthongthong, take a long-term approach to investing. They aim to be an active, engaged shareholder, encouraging good corporate governance and alignment with other ESG goals.

The trust has performed strongly since implementing a number of changes to the process in 2017 and 2018, bringing to an end a period of underperformance. The essentials of the process remain the same: identifying companies with low leverage, sustainable earnings and strong competitive positions. Following a period of poor performance in 2015, the analyst team has been reorganised, a greater emphasis placed on examining the downside risks for stocks and the weighting to technology stocks and to China has been steadily increased.

The process is bottom-up, and so companies are picked on their own merits rather than to gain access to a theme, country or industry. Nevertheless, consumption growth, urban development and technology are areas the team find particularly exciting.

DGN is one of the largest Asia-focussed trusts with total assets of £627m. The management team is locally based, with the two managers based in Singapore, and contains over 50 investment professionals, some with extensive experience.

The trust has consistently traded on a double-digit discount in recent years, despite the recent recovery in performance. High-growth strategies have tended to be favoured by the market, while DGN has quality and value exposures which have been less in favour.

The trust has a total return objective, and so the board does not commit to maintain or grow the dividend. Although the payout has grown steadily in recent years thanks to growth in earnings, the board does not explicitly target a growing dividend and the yield is just 1.2%.

Analyst's View

DGN is an attractive core Asia holding, in our view. The quality characteristics of the portfolio should help to drive strong returns over the long run, and offer protection in any bad times. The portfolio is looking more balanced after the changes made in 2016 and 2017, with greater exposure to some growth areas. However, we are reassured that the compromise has not been on quality, but rather the team have become more comfortable with newer markets and companies and picked up exposure on relative share price weakness.

As one of the largest Asian investment trusts, with a highly experienced and well-resourced management team, we think Asia Dragon's approach has the potential to

Key Information:

As at	04/02/2020
Price (p)	408.5
Discount (%)	-10.6
OCF (%)	0.83
Turnover Ratio	17.5
Yield (%)	1.2
Gearing (%)	5
Ticker	DGN
Shares (£)	127,811,737
Market cap (£)	522,110,946

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

generate steady long-term growth from a volatile region. While 2016 and 2017 saw frothy markets, the picture for Asia in 2020 is much cloudier. Trade wars, coronavirus scares and debt levels in China are all potential headwinds which make predicting the course of the markets difficult. A portfolio with low underlying leverage, made up of businesses with strong competitive positions which should grow irrespective of the cycle, is attractive given this outlook.

We think the discount of 10.6% is interesting as an entry point. With corporate action having made little change to the level of discount, we think good performance is likely to be needed for it to close. As such, if the team can continue to deliver on the strong performance shown in 2018 and 2019, we think it only a matter of time till the market wakes up and we see the discount narrow.

Analyst's View

BULL	BEAR
The revamped strategy has led to a period of significant outperformance	The discount has been stubbornly wide despite a fully subscribed tender offer
Deep resources and highly experienced management, with the lowest OCF in the peer group	The yield is low
The quality approach should lead to outperformance in rocky markets	Structural gearing can increase downside risks (while helping on the upside)

Portfolio

Asia Dragon (DGN) aims to generate long-term capital returns by identifying quality businesses in Asia, investing at attractive valuations and holding them for the long term. As a long-term shareholder, the management team is highly active in holding management to account and encouraging positive change in their treatment of shareholders and broader ESG issues. They consider strong corporate governance to be a crucial characteristic of a good long-term company to own.

DGN was formerly known as Edinburgh Dragon, but was renamed in 2019 following a series of refinements made to the investment process in 2017 and 2018, which were intended to improve performance and create a more balanced portfolio. This has involved a greater focus on the downside risks to holdings and exiting lower-conviction holdings earlier, a reorganisation of the management team by sector, and an increase in the weighting to technology and China as these markets have matured. However, the revivified trust remains focussed on finding high-quality businesses. As such, its portfolio companies demonstrate much higher return on equity (ROE) and on assets (ROA) than the market (represented by the MSCI AC Asia ex Japan Index). These portfolio companies also demonstrate much lower levels of debt – in fact, as the below table indicates, on aggregate they have net cash on their balance sheets.

Portfolio Characteristics

	ASIA DRAGON	MSCI ALL COUNTRY ASIA EX-JAPAN
Dividend yield	1.9	2.4
PE 18	18.3	15.9
PE 19	19	14.9
Price/Book	2.3	1.6
ROA	9.2	7.2
ROE	19.2	14.4
Net debt/equity	-1.4	6.3

Source: Aberdeen Standard

The portfolio is built from the bottom up, rather than by taking thematic, country-specific or sector-specific views. However, when we spoke to the management team recently they highlighted particularly exciting areas as being those related to what they call "consumer aspiration", "technology enablers" and "urban development". These come through in the top ten positions, illustrated below. Technology is well represented through stocks such as TSMC and Samsung, and consumer areas are represented through Tencent, insurer Ping An and banks which benefit from growing consumer activity. Similarly, the banks benefit from extending credit for development, and Housing Development Finance Corporation is one of India's leading mortgage lenders.

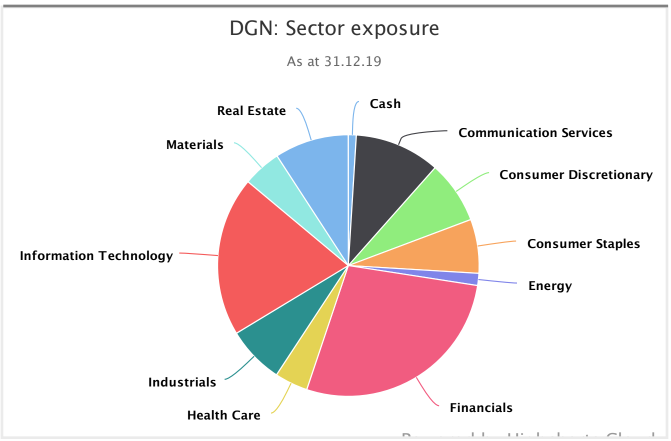
Top Ten Holdings

HOLDING	COUNTRY	%
Tencent	China	7.5
Samsung Electronics	Korea	6.9
TSMC	Taiwan	6.1
AIA	Hong Kong	3.5
Ping An	China	3.5
Housing Development Finance	India	3.3
Bank Central Asia	Indonesia	2.9
China Resources Land	China	2.7
Overseas-Chinese Banking Corp	Singapore	2.5
Tata Consultancy	India	2.2
TOTAL		**41.1**

Source: Aberdeen Standard

One of the major effects of the refinements made in 2017 and 2018 was an increase in the weighting to technology and to China. As the business models of technology companies in China matured, the team were able to have greater visibility on the sustainability of the growth, allowing them to subscribe a higher value to these companies. The process prizes being able to see how companies have performed over the passage of time, particularly in previous down markets, and tends to be relatively more cautious on those which are relatively new to public markets. Technology now makes up 19.7% of the portfolio, up from 14.5% in January 2019 and c. 10% in January 2016. The weighting to China has increased as a result of changes to stock selection and the market (as regards maturity and valuation) rather than any view on the country. Stock picks in both technology and China have led to a marked improvement in relative performance, **as we discuss in the Performance section**.

Fig.1: Sector Allocation



Source: Morningstar

This shift in weighting has also been helped by falls in valuations in the markets. In Q4 2018 Asian markets sold off, with the areas that had led the market falling the most, especially China and the technology sector. The managers took advantage by topping up the positions in some favoured tech stocks over 2019, notably TSMC and Samsung, two of the trust's three largest positions.

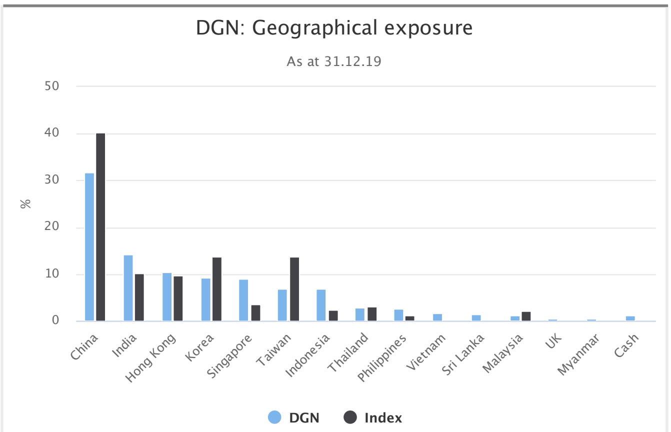
Adrian Lim and Pruksa Iamthongthong (who was appointed co-manager in 2019) have final say on all purchases and sales, but the stock-selection process draws on the work of 50 professionals with responsibilities as analysts and managers and who make up the Aberdeen Standard Asian equities team. They are all based in Asia, with Adrian and Pruksa working in Singapore with the largest contingent. Senior members of the team including Hugh Young, managing director for Asia, and Flavia Cheong, head of Asian equities, have multiple decades of experience. On a corporate level the team has experience going back thirty years.

The team analyse companies in the region, looking for attractive quality characteristics and managing a shortlist of candidate stocks which meet these requirements. They watch the valuations on these stocks and aim to buy at attractive levels. Once positions are in the trust, they are often added to or reduced as they become less or more expensive, but new purchases or sales are ordinarily few and far between. The aim is to identify the best companies in the region, those which are truly world class, and hold onto them for the long term. Turnover has averaged just 15% over the past three years (to 2018, the last data available), according to Morningstar data. This is consistent with a holding period of almost seven years. This is despite there being greater portfolio activity in 2017 and 2018 as a part of the revamp of the process.

The team's attitude could be described as cautious, and it typically takes some time for a company to be approved as meeting the quality requirements. After analysing the financials, the team are diligent in meeting management and coming to conclusions about management's attitudes and abilities because the team place great weight on good corporate governance. Stocks are typically introduced at a low weight and then increased as the team's knowledge and conviction rises. In the past, the team concluded that they have sometimes been too slow to sell out of ideas when their conviction dropped and rectifying this was an element of the changes implemented in recent years. Analysts are now assigned 'bull' and 'bear' roles for stocks on which the team are doing more work, and they then present the case for or against each company to the team. The idea is to avoid becoming attached to portfolio companies and to avoid overlooking changes in the business case for the holdings.

Geographically, the trust remains underweight to China, despite the increased allocation. India and Singapore are other favoured markets thanks to the superior companies the team find there, partly thanks to better standards of corporate governance.

Fig.2: Geographic Allocation



Source: Aberdeen Standard

In the long term, the team believe their portfolio offers exposure to companies with the most exciting sustainable growth trajectories in Asia. In the short term they are cautiously optimistic, while recognising that there are a number of risks and uncertainties which mean the course of Asian markets is likely to be volatile. The coronavirus is the latest, while there could also be more developments in the China-US trade war in a US election year. They believe their companies' solid balance sheets should be protection against any market wobbles, while also providing operational leverage should Asian economies perform strongly.

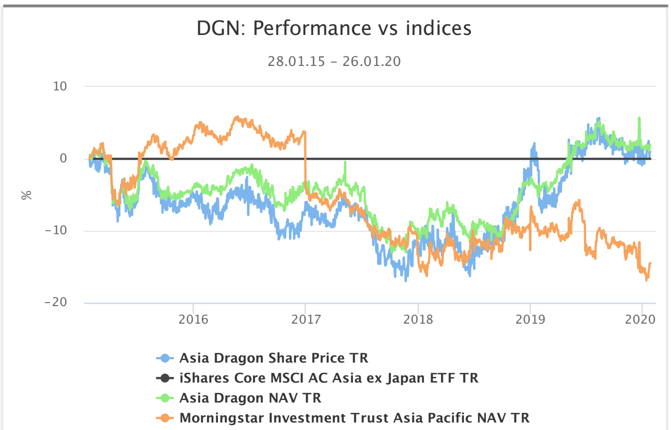
Gearing

DGN has a modest level of structural gearing, with £25m having been borrowed in July 2019 for three years. This amounts to roughly 4% of net assets (£598m). The board believes a modest level of gearing is an appropriate way to enhance returns over the longer term, although we note that it does bring with it the potential for greater losses in falling markets. The managers also have access to a further £25m of short-term debt from a revolving credit facility. As at the end of December 2019 they had drawn down £6m of this, so net gearing was just over 5%. However, the managers held roughly £6m in cash, effectively neutralising the market exposure from the short-term debt.

Performance

Since the middle of 2018, DGN has performed very strongly against the MSCI AC Asia ex Japan Index in terms of both share price and NAV total return. Below we have included a five-year cumulative relative performance graph, with the returns of DGN in NAV (green) and share price (blue) relative to a passive investment in the index via the iShares Core MSCI AC Asia ex Japan ETF (which tracks the company's benchmark of the MSCI AC Asia Pacific ex Japan Index). A rising line indicates relative outperformance, and there is a clear and dramatic uptrend beginning in mid-2018.

Fig.3: Five-Year Performance

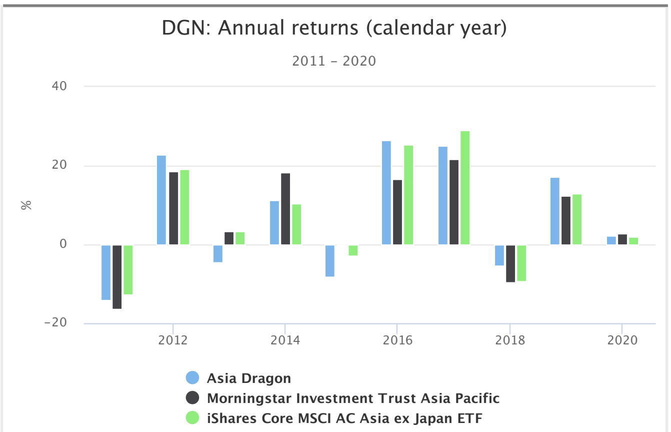


Source: Morningstar

The period of outperformance reflects the success of the changes made to the portfolio, including the increased weighting to technology and to China. Outperformance has been largely generated by stock selection, and although the trust is and has been underweight to China versus the index, the companies it has chosen in that market have done exceptionally well. In the financial year from August 2018 to August 2019, a period which captures most of the outperformance, China International Travel, Shanghai International Airport and Kweichow Moutai were all major contributors. Insurer Ping An was another major winner, while financials in Indonesia (Bank Central Asia) and India (Housing Development Finance Corporation) also did particularly well. The themes of consumer aspiration and urban development come through in these picks.

However, over five years the trust is only marginally ahead of the ETF thanks chiefly to a poor 2015. The sharp rally in Asia in 2016 and 2017 was led by internet- and technology-related stocks, particularly in China, but the trust didn't quite keep up thanks to its preference for high-quality businesses and a cautious approach to valuations. At this time the market was most interested in high growth and momentum. However, the outperformance in 2018 more than made back the 3% net underperformance over those two years, as the below chart illustrates.

Fig.4: Returns

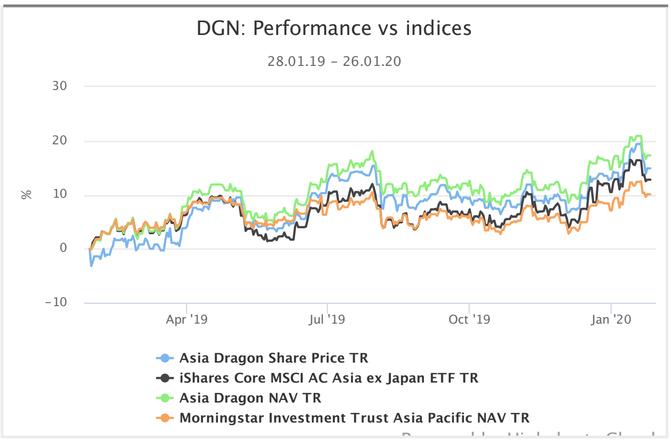


Source: Morningstar

The poor 2015 was thanks to the collapse in the oil price and poor results from Standard Chartered and HSBC, as well as an overweight to Singapore. This period led to some soul-searching on the team and the improvements made to the process (**which are discussed in detail in the Portfolio section**). These changes involved being more decisive on underperformers, as well as closing the historical underweights to China and technology. Performance has certainly improved since then, with the increased weighting to Chinese companies and technology stocks both helping performance.

Over the past 12 months, returns have been marginally ahead of the index (as of 26 January 2020), with the trust's A-shares picks, weighting to Korea and Samsung, and tech stocks all contributing. In the short term, the coronavirus is likely to be a major challenge for the region's markets, with China taking quite drastic steps to curb it which will lead to a reduction in economic activity. The effects of the virus were just starting to be felt in markets at the time of writing. Nevertheless, the team believe the low levels of debt in their portfolio should make it more resilient to a falling market while also providing the ability to expand quickly in a rising market.

Fig.5: One-Year Performance

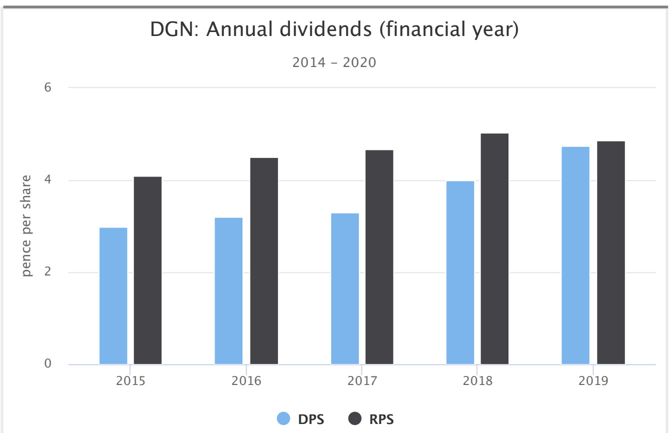


Source: Morningstar

Dividend

Dividends have grown steadily in recent years thanks to earnings growth on the underlying portfolio. However, the board does not explicitly target a growing dividend. DGN's shares currently yield 1.2%, which means they are unlikely to appeal to income-seekers. The board's policy is to pay a dividend marginally in excess of the minimum required to maintain investment trust status (85% of net income), which means that stable or rising dividends cannot be assumed in future.

Fig.6: Dividends



Source: Morningstar

Management

Adrian Lim, a long-serving member of the Aberdeen team before it merged with Aberdeen Standard in 2017, has managed DGN from Singapore since 2013. He was joined last year by Pruksa Iamthongthong as co-manager, after Aberdeen Standard had dedicated greater resources to the trust. Adrian has been with Aberdeen since 2000 and is therefore well steeped in the quality-led approach of the company. Although the managers are ultimately responsible for buy and sell decisions for the trust, Aberdeen Standard takes a team-based approach to its portfolios, with the Asia Pacific equities team working together to build consensus views on stocks. Flavia Cheong heads up the Asia Pacific equities team, which includes 50 equity fund managers. Twenty of these, including Adrian and Pruksa, are based in Singapore, where the team includes three dedicated ESG professionals.

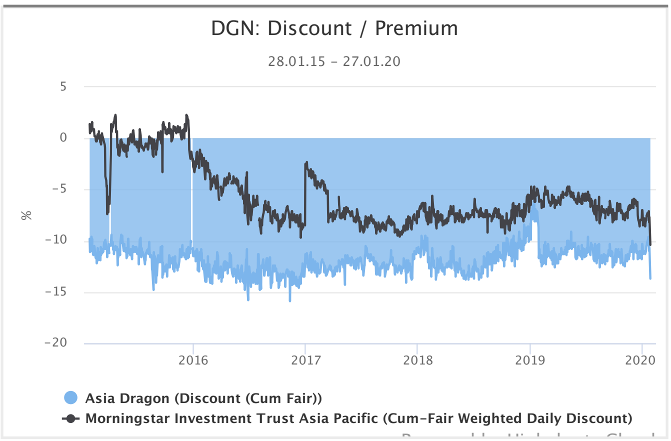
The aim is to gain consensus on all stock buys and sells and take a long-term view with investments. However, the team decided they had been slow to sell out of some companies in 2015 and 2016 when the evidence of a change in the companies' fortunes was already evident (most notably as regards Standard Chartered). As a result, the team have created sector specialist groups in the analyst team to aid international comparison rather than specialising by country. They believe this creates more accountability for individual stock picks and is more appropriate for an increasingly globalised investment universe. They have also assigned certain significant holdings to analysts in 'Bull' and 'Bear' roles in order to focus discussion and help uncover problems with holdings sooner rather than later. This process is implemented for companies where the team feels the need to more vigorously test the investment hypotheses.

The merger with Standard Life Investments (SLI) in 2017 has not affected the management of the trust. The Asian equities team remains in place from Aberdeen, with Aberdeen's strength in this region complementing SLI's greater UK capabilities. Devan Kaloo remains head of equities at the merged entity.

Discount

DGN's shares trade on a 10.6% discount to NAV, which compares to a weighted average of the AIC Asia Pacific sector of 8.9%. Apart from Schroder Asian Total Return, which has a discount control mechanism in place, the two trusts which bring the average down are Pacific Assets (which is much more defensive) and Pacific Horizon (which is high growth). As such, we attribute the discount being wider than peers to the 'core' nature of the trust, and perhaps also due to the historical underperformance. **As we discuss in the Performance section**, the changes to the investment process so far appear to have paid off, and the trust has outperformed thanks in part to them. As such, we think it fair to say that the discount to peers may be unwarranted and could close if the strong performance continues.

Fig.7: Discount



Source: Morningstar

DGN conducted a tender offer in January 2019 which saw 30% of shares repurchased and cancelled. Since then the discount has been marginally tighter, but there has been no major impact. The board has continued to conduct regular buybacks since the tender offer. The board gives no target level, but the discount has consistently been in double digits in recent years. In our view, it is likely to be performance which makes a material change to the discount level, in which light the strong relative performance over the past two years is encouraging.

Charges

DGN is the second-largest trust in the sector, but is the cheapest (in OCF terms) of its peers. The ongoing charges figure (OCF) is 0.83%, which compares to a weighted average for the AIC Asia Pacific sector of 0.95%. This includes a tiered management fee, with 0.85% charged on the first £350m of net assets and 0.5% on the remainder. With net assets at £589m, we calculate the effective management fee to be c. 0.68%. The KID RIY is 1.09%, which compares to a weighted sector average of 1.43%, although methodologies can vary.

ESG

The Asian equities team at Aberdeen Standard believe ESG and sustainability issues are intrinsically linked to the 'quality' of a company and that sustainability in the broader sense is important for the sustainability of a company's earnings. In the past, Aberdeen Standard (and Aberdeen, long before the 2017 merger), was a standard bearer when it came to corporate governance in particular. It has always placed great importance on the incentives and attitudes of management to minority shareholders. In recent years, the team have integrated environmental and social issues more into their assessments. Team members generate their own ESG ratings for candidate stocks and also consider the ratings of external providers in order to understand the difference. Once invested, the team view themselves as long-term partners of management, and encourage companies to improve their behavior vis-à-vis shareholders and stakeholders more widely.

As an additional resource, the team are also able to receive inputs from Aberdeen Standard analysts based in Edinburgh who consider top-down, global issues such as plastic use and climate change. There are also three dedicated ESG analysts sitting with the team in Singapore who cover the Asian region, and their task is to consider what progress is possible and desirable within the regional context.

Disclaimer

This report has been issued by Kepler Partners LLP. **The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR **TERMS AND CONDITIONS**

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 9/10 Savile Row, London W1S 3PF with registered number OC334771.