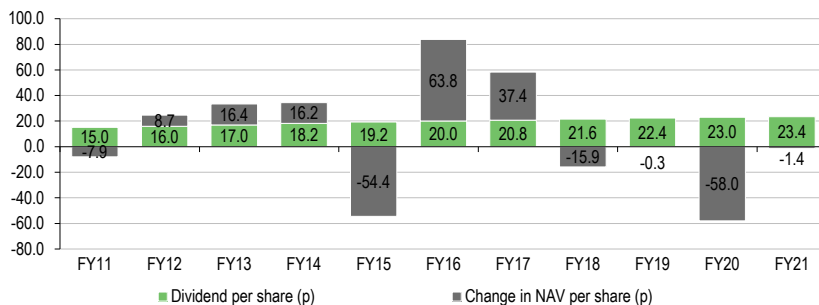


Henderson Far East Income

Compelling income and recovery potential

Henderson Far East Income (HFEL) is differentiated from its Asian income peers by its high dividend yield (c 8% versus a peer average of c 4%), fully covered by income in each of the last 10 years except FY21 (99% covered). During the COVID-19 period, HFEL's capital performance has come under pressure as investors have eschewed the sort of cash-generative companies with high or growing dividends favoured by manager Mike Kerley, preferring the allure of companies promising future growth. However, HFEL's own shareholders remain keen on its consistent income generation, keeping it trading close to par or at a small premium to NAV with more than 8.3m new shares issued in the past 12 months.

Consistent dividend growth underpins HFEL's total returns



Source: Henderson Far East Income, Edison Investment Research

How does HFEL pay such a high yield?

HFEL is the truest 'income' fund in its sector (where some peers pay dividends out of capital, and others have a lower portfolio yield), although it does also aim for long-term capital growth. Its portfolio is split between stocks with a high starting yield and those offering superior dividend growth potential, with the manager able to tilt the portfolio one way or the other in response to value opportunities. The current 7.9% yield is well above the c 4.8% portfolio yield for several reasons. Kerley uses option-writing to generate extra income (7.7% of FY21 revenues) and is 'dividend aware' in the timing of purchases and sales. As share issuance creates a drag on returns per share, the proceeds from new shares may be invested to maximise income. The current share price is also c 5.9% below the 12-month average, further enhancing the yield. HFEL has a healthy revenue reserve of 0.47x FY21 dividends.

The analyst's view

While HFEL's capital performance has suffered since early 2020, its attractive and (almost) fully covered dividend yield continues to attract investors, driving a small average premium to NAV and regular share issuance. We see considerable appeal for those seeking investment income. As an example, a £200k annuity could pay a lifetime income (not index linked) of £7,700 in return for a total loss of capital, whereas the same amount invested in HFEL at a conservative 6% dividend yield would pay an annual income (not guaranteed) of £12,000. Over the long term HFEL seeks capital appreciation as well as income, and £200k invested in the trust 10 years ago would be worth £223k today, having also generated £151k in dividends.

NOT INTENDED FOR PERSONS IN THE EEA

Investment trusts
Asia Pacific income

17 December 2021

Price **297.0p**

NZ\$5.91

Market cap **£448.8m**

AUM **£466.3m**

NAV* 296.9p

Premium to NAV 0.0%

*Including income. At 16 December 2021.

Yield 7.9%

Shares in issue 151.1m

Code/ISIN HFEL/JE00B1GXH751

Primary exchange LSE

AIC sector Asia Pacific Equity Income

52-week high/low 343.0p 288.0p

NAV* high/low 336.0p 288.8p

*Including income.

Gearing

Gross gearing* 6.0%

Net gearing* 4.0%

*At 30 November 2021

Fund objective

Henderson Far East Income aims to provide shareholders with a growing total annual dividend per share and capital appreciation, from a diversified portfolio of investments in the Asia-Pacific region. It has stock market listings in London and New Zealand.

Bull points

- HFEL has one of the highest yields of any equity investment trust, backed up by solid income generation and revenue reserves.
- There is scope for a reversal in the long trend of underperformance of value and income factors.
- Positive economic and demographic drivers underpin Asian growth.

Bear points

- Although HFEL seeks capital growth as well as income, most peers have outperformed on a total return basis over time.
- Asian markets could struggle again in 2022 given dollar strength and geopolitical tensions.
- Buying shares at a premium to NAV may increase downside potential.

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The portfolio: Jam today and more jam tomorrow

Kerley aims to construct a portfolio of Asia-Pacific equities that blends companies on a high starting yield with those that have superior dividend growth prospects. 'The important point from an income perspective is that currently we have a free cashflow yield of over 9% [Exhibit 1], which is higher than the already elevated distribution yield, showing that companies are generating cash in excess of dividends paid,' the manager says, adding that the underlying portfolio yield is forecast to rise by c 8.6% from 4.8% to 5.2% over the coming year. From a valuation perspective, HFEL's average portfolio price/book and price/earnings ratios are below those of the broad Asia-Pacific index (which includes many highly valued and low or non-yielding technology companies). However, they are above those of the regional MSCI High Dividend Yield Index, which by its nature will tend to include some companies whose high yields reflect a fall from grace in share price terms, depressing the 'P' of both P/B and P/E. Forecast earnings growth is higher in the HFEL portfolio than in either index, which should provide support to future dividends.

Exhibit 1: Portfolio characteristics at 31 October 2021

	HFEL	Broad Asia Pacific ex-Japan Index	MSCI AC Asia Pacific ex-Japan High Dividend Yield Index
Price/book (x)	1.4	2.0	1.2
Price/earnings 2022 est (x)	10.4	13.8	8.8
Dividend yield (%)	4.8	2.6	5.6
Dividend yield 2022 est (%)	5.2	2.8	5.6
Free cash flow yield (%)	9.2	4.0	8.8
Return on equity (%)	13.2	11.4	11.8
EPS growth 2022 est (%)	11.9	7.7	2.0
Number of constituents	45	1,876	204

Source: Henderson Far East Income, Edison Investment Research. Note: 2022 estimates are based on consensus forecasts.

Two sectors stand out in their contribution to income in FY21 (Exhibit 3), with both financials and basic materials punching above their portfolio weight (Exhibit 2). Kerley says: 'Almost 40% of our FY21 income came from financials, and we think that is at least sustainable – bank dividends that were cancelled for regulatory reasons in Australia and Singapore will be mostly or fully reinstated this year and into next.'

Exhibit 2: Portfolio breakdown by sector (31/10/21)

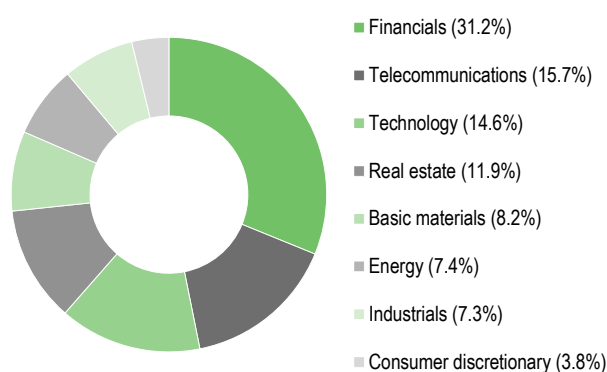
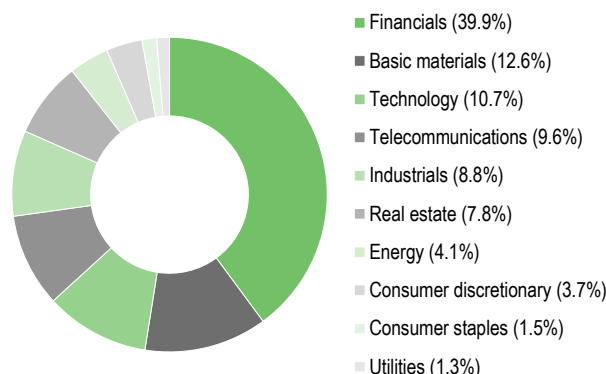


Exhibit 3: Revenue breakdown by sector (31/8/21)



Source: Henderson Far East Income, Edison Investment Research

Following a strong year of regular and special dividend payments, the manager also expects to see basic materials stocks (12.6% of FY21 income) continuing this trend in the next 12 months because of the excess level of commodity prices. 'Materials companies aren't spending on capex or M&A like they used to, so they are returning money to shareholders,' Kerley explains. 'Iron ore and coal are probably the least attractive commodities, but the companies that produce them, such as BHP and Rio Tinto, are also the most likely to pay specials when prices are high, as the commodities are

purely cyclical.’ The manager has reduced exposure to both these companies (which are no longer in the top 10 holdings, having been the second and third largest positions as recently as June 2021), preferring copper – a key material in the energy transition – to iron ore and coal. ‘We have a big position in Oz Minerals, at c 3% of the portfolio, and we have also recently bought into Zijin Mining, which extracts copper, lithium and gold in China,’ he says.

Exhibit 4: Changing sector weightings in HFEL’s portfolio (%)

	Portfolio end-October 2021	Portfolio end-FY21 (31 August)	Portfolio end-FY20 (31 August)
Financials	31.2	27.6	21.3
Telecommunications	15.7	13.7	17.1
Technology	14.6	17.8	16.9
Real estate	11.9	10.6	14.3
Basic materials	8.2	12.5	8.3
Energy	7.4	4.5	1.4
Industrials	7.3	7.3	7.6
Consumer discretionary	3.8	6.0	3.7
Consumer staples	0.0	0.0	5.4
Utilities	0.0	0.0	4.0
Healthcare	0.0	0.0	0.0
	100.0	100.0	100.0

Source: Henderson Far East Income, Edison Investment Research

From a geographical perspective, three countries – China, Australia and Taiwan – were the source of almost two-thirds of portfolio income in FY21 (Exhibit 6). While this dynamic could be expected to change somewhat going forward given a significant decline in HFEL’s Chinese exposure since the start of FY21 (Exhibit 7), it is worth noting that the falling capital values of Chinese shares (China has been the worst performing major equity market in 2021) will not necessarily be mirrored in dividend payouts, which are based on business rather than share price performance.

Exhibit 5: Portfolio breakdown by geography (31/10/21)

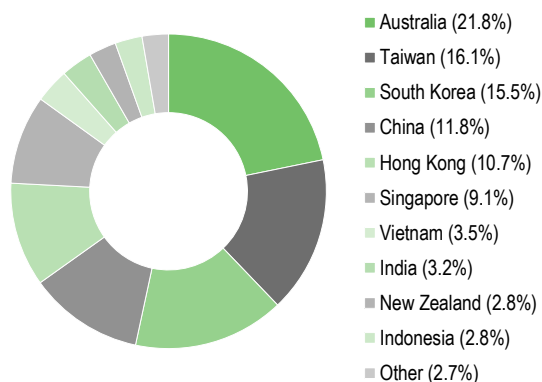
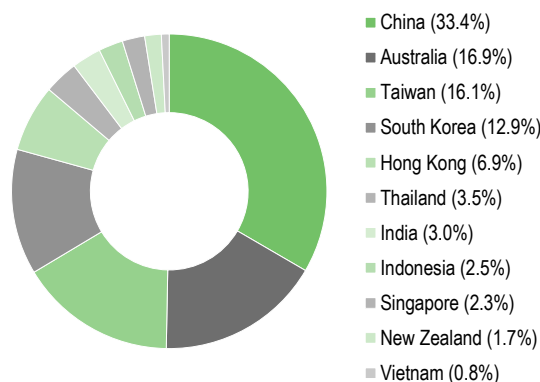


Exhibit 6: Revenue breakdown by geography (31/8/21)



Source: Henderson Far East Income, Edison Investment Research

Exhibit 7: Changing geographical weightings in HFEL’s portfolio (%)

	Portfolio end-October 2021	Portfolio end-FY21 (31 August)	Portfolio end-FY20 (31 August)
Australia	21.8	21.4	16.8
Taiwan	16.1	18.6	18.2
South Korea	15.5	14.4	10.0
China	11.8	15.4	25.5
Hong Kong	10.7	11.8	11.0
Singapore	9.1	5.9	5.4
Vietnam	3.5	3.1	2.4
India	3.2	2.9	0.0
New Zealand	2.8	2.0	2.8
Indonesia	2.8	2.5	2.3
Thailand	N/S	N/S	N/S
United Kingdom	0.0	N/S	N/S
Other	2.7	2.0	5.6
	100.0	100.0	100.0

Source: Henderson Far East Income, Edison Investment Research. Note: N/S=not stated; may be included in ‘other’.

Performance: An end to ‘cash is trash’ mentality?

Exhibit 8: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	MSCI AC Asia Pac ex-Jpn (%)	MSCI AC Asia Pac ex-Jpn HDY (%)	CBOE UK All Cos (%)	MSCI AC World (%)
30/11/17	16.8	14.2	21.6	14.2	13.7	15.7
30/11/18	(2.7)	(1.9)	(2.9)	2.4	(1.8)	5.6
30/11/19	10.1	11.0	8.3	3.8	11.3	12.8
30/11/20	(3.2)	(3.7)	18.0	1.1	(11.2)	12.0
30/11/21	(2.0)	1.9	2.8	6.1	17.1	20.9

Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

While HFEL outperformed both the broad regional index and the high yield subset in the run-up to the COVID-19 pandemic, total returns have been sub-par in both the last two discrete years to 30 November (Exhibit 8), with dividends failing to completely offset declining capital values. Kerley says that while the high yield (as opposed to high dividend growth) element of the portfolio is the backbone of HFEL’s own attractive yield, it has clearly hurt capital performance since the early part of 2020. ‘Although we have the flexibility to buy dividend growth, the high yield part has come under a lot of pressure in terms of performance. We have a process that focuses on cashflow generation – cash is what pays dividends – and in the last two years, no-one has valued cash at all,’ the manager explains. ‘Companies generating excess cash have underperformed because people want structural growth at any price. Loss-making companies have massively outperformed profitable ones – it’s idiotic behaviour that will one day correct.’ With the Omicron variant driving a fresh wave of COVID-19 infections, and high rates of supply-side inflation in the West dampening economic growth prospects, Kerley says he is cautious on the outlook for markets next year, ‘so owning banks, telecoms and REITs seems a good strategy for 2022, with more growth around the edges’.

Looking at the peer group (Exhibit 9), HFEL ranks fifth of five for net asset value (NAV) total return performance over three, five and 10 years, and fourth over one year, with the rankings over all periods having been depressed by the disappointing capital performance since early 2020. Despite this, however, the trust is at the narrowest discount to NAV in the peer group (and in general trades at a small premium), underlining the attraction to investors of its eye-catching 7.9% dividend yield. ‘Our shareholder base has changed massively over the past five years and is now 60% retail,’ says Kerley. ‘Whether short-term capital returns are positive or not, as long as we don’t deplete capital over time, it’s better than many choices for providing income, and as a total return fund we have also delivered long-term capital growth’.

Exhibit 9: Asia Pacific Equity Income peer group as at 16 December 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
Henderson Far East Income	448.7	2.0	10.2	24.5	105.8	1.09	No	(0.2)	104	7.9
Aberdeen Asian Income	393.0	12.1	36.5	52.3	144.2	1.04	No	(13.0)	110	4.1
Invesco Asia Trust	238.7	6.3	43.6	71.0	218.9	0.99	No	(7.5)	100	4.2
JPMorgan Asia Growth & Income	436.7	0.7	35.6	79.0	193.4	0.77	No	(0.3)	101	4.3
Schroder Oriental Income	702.2	7.3	33.2	47.2	188.8	0.85	Yes	(4.5)	105	3.9
Sector average (5 funds)	443.9	5.7	31.8	54.8	170.2	0.95		(5.1)	104	4.9
HFEL rank in sector	2	4	5	5	5	1		1	3	1

Source: Morningstar, Edison Investment Research. Note: *Performance to 15 December 2021 based on cum-fair NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

Outlook: Catalysts for Asian income recovery

Regarding the timing of a return to favour of companies paying sustainable, cash flow-backed dividends, Kerley sees several potential catalysts: ‘The realisation that the ‘recovery’ isn’t that great; taxes going up; less government and central bank support for economies – at that point people might realise it’s silly for markets to be at all-time highs, so they will go back to fundamentals and

companies that generate cash and return it to shareholders. I thought that might happen this year, but the pandemic going on for longer has delayed the return to looking at things normally.'

Indeed, COVID-19 remains one of the biggest threats to markets in the year ahead, along with the fragile geopolitical situation in Asia. 'The biggest COVID-19 risk to us would be something region-specific rather than global,' the manager says, while on the political front, he fears greater alignment between Taiwan and the United States, 'which is probably the only way relations between the US and China could get any worse'. Conversely, the economic picture remains relatively rosy in the region. 'We are not too worried about inflation or interest rates, which weren't cut as far in Asia as in the rest of the world, and are probably already rising in many cases,' he says, adding that Asian economies have not had the same degree of 'life support' as the rest of the world, which is making the return to normality in the West that much more tricky.

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