# BlackRock Emerging Europe

Initiation of coverage

## Outperformance from concentrated fund

Investment trusts

**BlackRock Emerging Europe (BEEP) aims to generate long-term capital growth from a concentrated portfolio of emerging European equities. Managers Sam Vecht and Christopher Colunga are upbeat about prospects for the region due to relatively attractive company valuations and an improving macro backdrop. The trust has outperformed the MSCI Emerging Europe 10/40 index over one, three and five years, and since BlackRock took over management of the fund on 1 May 2009. The board is mindful of its corporate governance responsibilities, and in June 2013 announced that before 21 June 2018, it would offer shareholders the ability to realise their investment in BEEP at NAV minus costs and, if the fund is not liquidated, at five-yearly intervals thereafter.**

| 12 months ending | Share price (%) | NAV (%) | MSCI Emerging Europe 10/40 (%) | MSCI Emerging Markets (%) | MSCI World (%) |
|---|---|---|---|---|---|
| 31/12/13 | 4.4 | 3.0 | (5.5) | (4.1) | 25.0 |
| 31/12/14 | (25.4) | (22.7) | (24.7) | 4.3 | 12.1 |
| 31/12/15 | 1.8 | 1.4 | (9.2) | (9.7) | 5.5 |
| 31/12/16 | 47.6 | 46.5 | 50.9 | 33.1 | 29.0 |
| 31/12/17 | 20.9 | 12.2 | 10.7 | 25.8 | 12.4 |

Source: Thomson Datastream. Note: All % on a total return basis in GBP.

## Investment strategy: Top-down and bottom-up

The managers combine an assessment of the macro environment with thorough company fundamental analysis to construct a concentrated portfolio of 20 to 30 emerging European equities. They are unconstrained by the benchmark geographic and sector weightings. From a geographic perspective, BEEP is currently overweight Russia and underweight Turkey. Gearing of up to 20% of NAV is permitted. At end-December 2017, net gearing was 3.5%.

## Market outlook: Appealing relative valuations

While developed stock markets such as the US and the UK have been hitting record highs, emerging European equities are broadly unchanged (in sterling terms) over the past decade. Valuations in the region are relatively attractive; on a forward P/E multiple basis, emerging European shares are trading at a c 50% discount to world equities, and also offer a meaningfully higher dividend yield. Due to a better macro environment, following a multi-year period of declining corporate earnings in emerging Europe, there has been a positive earnings uptrend since early 2016.

## Valuation: Discount has narrowed meaningfully

Since March 2017, BEEP's share price discount to cum-income NAV has been in a narrowing trend from c 10% to the current 5.7%. This compares to the range of averages over the last one, three, five and 10 years of 8.4% to 10.6%. The recent recovery may reflect the forthcoming redemption opportunity at NAV minus costs. There is scope for the discount to narrow further if the managers are able to build on their record of outperformance versus the benchmark, or if there is increased investor appetite for emerging European equities. The board actively manages the discount, aiming to keep it below 10% in normal market conditions.

**29 January 2018**

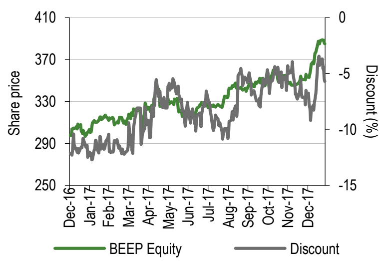
| | |
|---|---|
| **Price** | **385.0p** |
| **Market cap** | **£138m** |
| **AUM** | **£150m** |

| | |
|---|---|
| NAV* | 397.1p |
| Discount to NAV | 3.0% |
| NAV** | 408.3p |
| Discount to NAV | 5.7% |

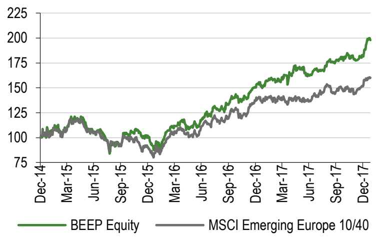
*Excluding income. **Including income. As at 25 January 2018.

| | |
|---|---|
| Yield | 1.5% |
| Ordinary shares in issue | 35.9m |
| Code | BEEP |
| Primary exchange | LSE |
| AIC sector | European Emerging Markets |
| Benchmark | MSCI Emerging Europe 10/40 (net) |

### Share price/discount performance




### Three-year performance vs index




| | | |
|---|---|---|
| 52-week high/low | 389.0p | 300.5p |
| NAV** high/low | 408.3p | 342.4p |

**Including income.

### Gearing

| | |
|---|---|
| Net gearing* | 3.5% |

*As at 31 December 2017.

### Analysts


Mel Jenner +44 (0)20 3077 5720
Sarah Godfrey +44 (0)20 3681 2519
investmenttrusts@edisongroup.com
Edison profile page


***BlackRock Emerging Europe is a research client of Edison Investment Research Limited***

## Exhibit 1: Trust at a glance

**Investment objective and fund background**

BlackRock Emerging Europe aims to generate long-term capital growth principally from investing in companies that do business primarily in Eastern Europe, Russia, Central Asia and Turkey. The trust is benchmarked against the MSCI Emerging Europe 10/40 index (net of withholding taxes).

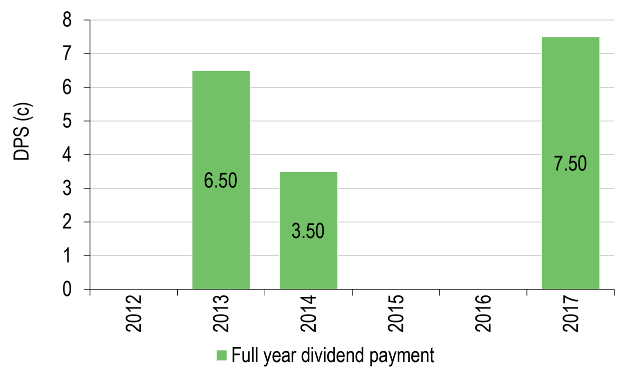
**Recent developments**

- 28 September 2017: Six-month results ending 31 July 2017. NAV TR +8.6% in US$ (+3.7% in £) versus benchmark TR +7.3% in US$ (+2.4% in £). Share price +15.0% in US$ (+9.8% in £).
- 28 March 2017: Annual results ending 31 January 2017. NAV TR +38.2% in US$ (+55.8% in £) versus benchmark TR +31.8% in US$ (+48.6% in £). Share price +39.6% in US$ (+57.4% in £). Announcement of 7.5c final dividend for FY17 (FY16: zero).

| Forthcoming | | Capital structure | | Fund details | |
|---|---|---|---|---|---|
| AGM | June 2018 | Ongoing charges | 1.2% | Group | BlackRock Investment Mgmt (UK) |
| Final results | March/April 2018 | Net gearing | 3.5% | Managers | Sam Vecht, Christopher Colunga |
| Year end | 31 January | Annual mgmt fee | 0.8% | Address | 12 Throgmorton Avenue, |
| Dividend paid | June | Performance fee | None | | London, EC2N 2DL |
| Launch date | 29 November 1994 | Trust life | Indefinite | Phone | +44 (0) 20 7743 3000 |
| Continuation vote | Every three years (next in 2019) | Loan facilities | Overdraft facility (page 10) | Website | blackrock.co.uk/beep |

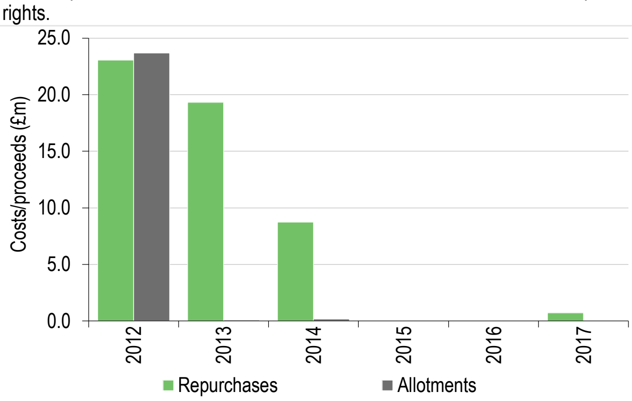
**Dividend policy and history (financial years)**

Dividends, when declared, are paid annually in June in US cents.

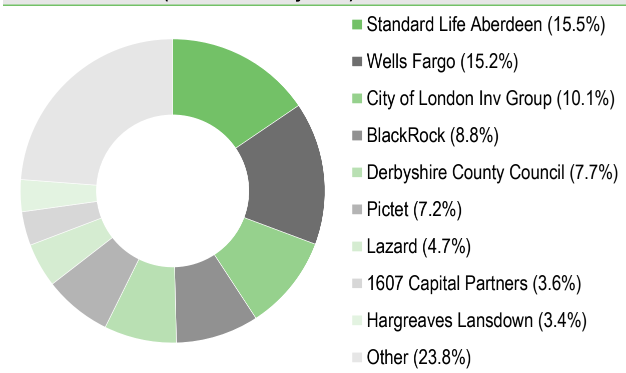



**Share buyback policy and history (financial years)**

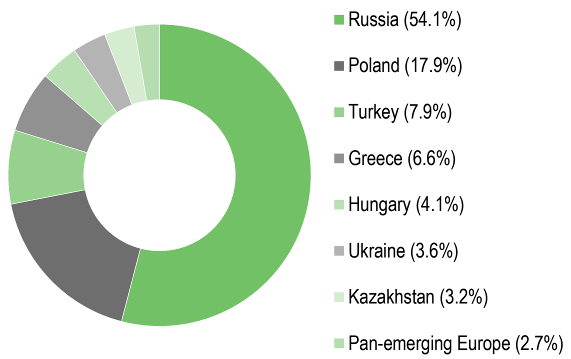
Share repurchases include tender offers. Allotments are exercise of subscription rights.




**Shareholder base (as at 18 January 2018)**




**Portfolio exposure by geography (as at 31 December 2017)**




**Top 10 holdings (as at 31 December 2017)**

| | | | Portfolio weight % | |
|---|---|---|---|---|
| **Company** | **Country** | **Sector** | **31 December 2017** | **31 December 2016*** |
| Sberbank | Russia | Financials | 8.6 | 10.6 |
| Lukoil | Russia | Energy | 8.5 | 6.2 |
| Gazprom | Russia | Energy | 8.3 | 8.9 |
| PKO Bank Polski | Poland | Financials | 7.3 | 3.5 |
| Bank Pekao | Poland | Financials | 5.1 | N/A |
| Novatek | Russia | Energy | 4.9 | 6.7 |
| Lenta | Russia | Consumer staples | 4.1 | N/A |
| Gedeon Richter | Hungary | Healthcare | 4.1 | N/A |
| PZU | Poland | Financials | 3.8 | 3.5 |
| Rosneft Oil Company | Russia | Energy | 3.7 | N/A |
| **Top 10** | | | **58.4** | **58.2** |

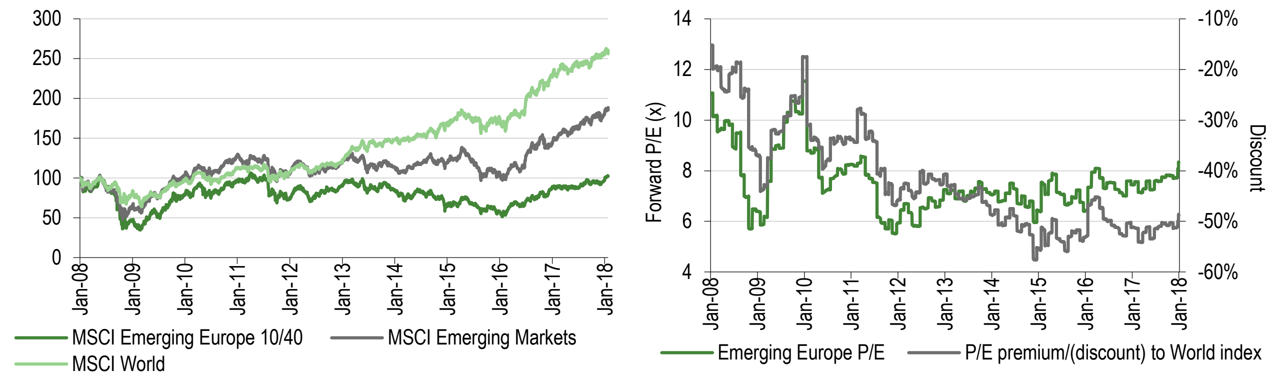
Source: BlackRock Emerging Europe, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in December 2016 top 10.

## Market outlook: Relative valuations are very attractive

Exhibit 2 (left-hand side) shows the performance of indices over the last 10 years in sterling terms. World equities have outpaced those in emerging markets in general and, to a greater extent, emerging European markets by a considerable margin. In recent years the strength of US equities has been a defining factor as the country represents c 60% of the MSCI World index. While emerging European equities have staged a reasonable recovery since the end of 2015, they have yet to make significant headway; in aggregate they are currently trading broadly in line with their levels 10 years ago, despite the recent improvements in macro and earnings environment. This may provide opportunities for investors willing to look further than developed markets for investment in equities.

**Exhibit 2: Market performance and valuation**

**Performance of indices over last 10 years (£)** | **Emerging Europe forward P/E multiple and discount to World index**




Source: Thomson Datastream, Edison Investment Research. Note: Data at 26 January 2018.

The relative attractiveness of emerging European equity valuations is shown in Exhibit 2 (right-hand side) and Exhibit 3. In terms of forward P/E multiples, they are trading at a c 50% discount to world equities, which is wider than the c 42% average discount of the last 10 years. Looking at valuations in more detail (Exhibit 3), emerging European equities are cheaper than emerging markets in general and significantly less expensive than US and UK equities, which are trading at 30% and c 20% above their 10-year averages respectively. In terms of dividend yield, emerging European equities also look relatively attractively valued; in aggregate they are offering distributions that are higher than their 10-year average, unlike the other markets highlighted. In absolute terms, the dividend yield on emerging European equities is in line with than that on the relatively higher-yielding UK market and meaningfully higher than the distributions available from US equities and emerging markets in general.

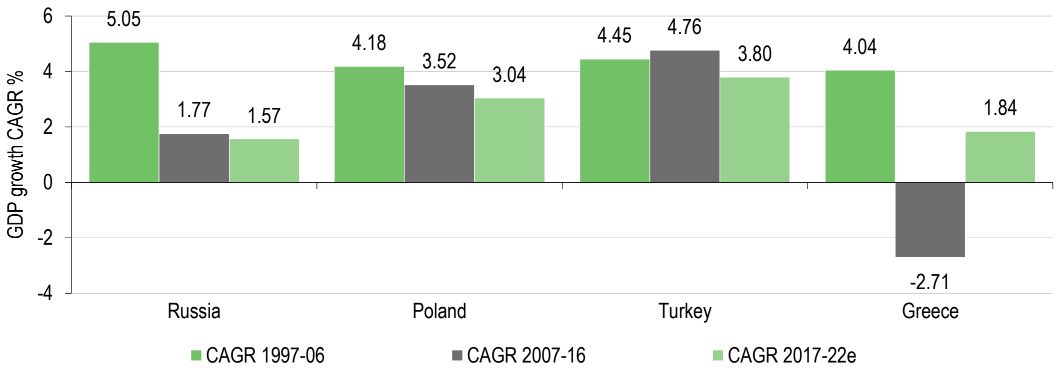
**Exhibit 3: Valuations of Datastream indices (last 10 years)**

| | Last | High | Low | 10-year average | Last as % of average |
|---|---|---|---|---|---|
| **Forward P/E (x)** | | | | | |
| Emerging Europe | 8.3 | 11.6 | 5.5 | 7.5 | 110 |
| Emerging markets | 13.2 | 14.2 | 7.8 | 11.1 | 119 |
| World | 16.3 | 16.3 | 8.9 | 13.1 | 124 |
| US | 19.1 | 19.1 | 9.4 | 14.7 | 130 |
| UK | 14.5 | 15.7 | 7.4 | 12.2 | 119 |
| **Dividend yield (%)** | | | | | |
| Emerging Europe | 3.5 | 5.1 | 1.3 | 3.2 | 108 |
| Emerging markets | 2.5 | 5.0 | 1.9 | 2.9 | 86 |
| World | 2.2 | 4.6 | 2.2 | 2.7 | 82 |
| US | 1.7 | 3.5 | 1.7 | 2.1 | 84 |
| UK | 3.5 | 6.6 | 2.7 | 3.5 | 99 |

Source: Thomson Datastream, Edison Investment Research. Note: Data at 26 January 2018.

Economic growth outlooks for key emerging European countries are highlighted in Exhibit 4. In its October 2017 World Economic Outlook, the International Monetary Fund (IMF) shows meaningful divergences between the four countries' forecast growth between 2017 and 2022. While in aggregate, the economic growth outlooks may not look particularly high, within each country there are individual companies with attractive growth attributes, which are trading on inexpensive valuations. In addition, research from BlackRock shows that in aggregate, annualised equity returns are higher in countries with the lowest levels of GDP growth in the previous year. For investors seeking exposure to the emerging European region, a concentrated fund, with a disciplined investment approach and a good relative performance record, may be of interest.

**Exhibit 4: GDP growth of Russia, Poland, Turkey and Greece**




Source: IMF World Economic Outlook (October 2017), Edison Investment Research

## Fund profile: Focused, unconstrained approach

BEEP was launched in November 1994 as the First Russian Frontiers Trust, managed by Pictet Asset Management; its name was changed to Eastern European Trust in June 2000. After a review by BEEP's board in March 2009, BlackRock was appointed as the trust's investment manager, effective on 1 May 2009. Following shareholder approval at the June 2013 AGM, BEEP now follows a more focused, unconstrained investment approach, aiming to generate long-term capital growth from a concentrated portfolio of emerging European companies. The number of holdings was reduced from 45 to 28 (with a maximum limit of 30), while the average holding position increased from 2.4% to 3.7% of NAV, and the name of the trust was changed to BlackRock Emerging Europe. The trust's financial statements are presented in US dollars, and its shares are traded in sterling on the Main Market of the London Stock Exchange.

BEEP has two co-managers: Sam Vecht and Christopher Colunga. Vecht joined BlackRock in 2000 and is head of its Emerging Europe & Frontiers team; he is responsible for running long-only and long/short portfolios in emerging and frontier markets. He is also co-manager of BlackRock Greater Europe Investment Trust (see our latest report published in August 2017) and BlackRock Frontiers Investment Trust. Colunga is a director in BlackRock's Global Emerging Markets team. He joined the firm in January 2016 and focuses on investing in emerging European markets.

BEEP is benchmarked against the MSCI Emerging Europe 10/40 index (net return, which includes reinvested dividends, net of withholding taxes based on the tax rates applicable to institutional investors who are not resident in the local market). There are investment limits in place, including that, at the time of investment, no single position may be more than 15% of the portfolio. Derivatives are permitted for hedging and efficient portfolio management. BEEP may also run short positions of up to 10% of net assets. Gearing is permitted via the use of derivatives and borrowing, up to a maximum 20% of NAV. BEEP's currency exposure is generally unhedged.

The board monitors BEEP's annual performance via a series of key performance indicators: the change in NAV per share; change in the share price; relative NAV performance versus the benchmark over one and three years; the average discount; and the ongoing charges ratio. BEEP's performance and ongoing charges are also reviewed against a peer group of both closed- and open-ended funds that are focused on emerging Europe.

In keeping with good corporate governance practice, in June 2013 it was agreed that prior to 21 June 2018, the board would offer shareholders the ability to realise their investment in BEEP at NAV minus costs. This may be in the form of a tender and/or another method of distribution. The board will seek to safeguard the interests of continuing shareholders, as well as those seeking to realise their investment. Provided the trust is of sufficient size to continue following the forthcoming redemption option, the board intends to offer shareholders further opportunities to realise their investment in BEEP at NAV minus costs at five-year intervals.

# The fund managers: Sam Vecht, Christopher Colunga

## The managers' view: Bullish outlook for emerging Europe

Vecht and Colunga are very constructive on the outlook for emerging European stock markets in terms of both valuation and economic growth. The MSCI Emerging Europe 10/40 index in sterling terms is at broadly the same level as 10 years ago, which compares with many developed world stock markets that have hit all-time highs. The managers refer to this period as a 'lost decade' and believe that it presents investors with an attractive opportunity to gain exposure to the region, which offers attractive equity valuations and improving economic growth. Investors may be starting to pay closer attention to emerging Europe, as the managers say they have received more enquiries from investors in the last six months than they have in the last six years.

On a forward P/E multiple valuation basis, emerging European equities are trading on a steep c 50% discount to world equities, while offering higher dividend yields (3.5%) than other emerging markets (2.5%) and US equities (1.7%). The managers also note that many companies in emerging Europe are under-researched; this offers opportunities for investors willing to take advantage of mispriced securities.

The managers are encouraged by future economic growth prospects in emerging Europe. They note that following a multi-year period of declines, corporate earnings have been in a positive trend since early 2016. While there were initial concerns about the impact that Brexit would have on the region's economies, subsequent headlines show that emerging Europe is benefiting from jobs shifting away from the UK; some of the emerging European countries now have the lowest levels of unemployment in 25 years. Labour costs in the region remain very competitive compared with developed Europe, which also bodes well for future economic growth. Both regions have similar populations, but GDP per capita in emerging European is significantly lower than in developed Europe. Free-floating currencies in emerging Europe are also attractive for western companies looking to relocate part or all of their operations in the region.

Vecht and Colunga highlight the relatively low stock market correlations in emerging Europe. Data from Bloomberg, for three years ending 31 December 2017, show that stock market correlation within the E7 region (Czech Republic, Greece, Hungary, Poland, Romania, Russia and Turkey) ranges from a very low 0.13 for Greece/Romania and Romania/Russia to a moderate 0.57 for Hungary/Poland. This compares with much higher correlations within the G7 region (Canada, France, Germany, Italy, Japan, the UK and US) of 0.42 for Canada/Japan and Italy/Japan to 0.91 for France/Germany. Of interest to UK investors, the correlation between UK and US stock markets is also high at 0.75.

The managers' unconstrained investment approach means they are able to take advantage of stock price weakness in individual markets; they look to "buy at the sound of cannons and sell at the sound of trumpets". As an example, the managers took advantage of share price weakness in Turkey after the attempted coup in 2016 to add exposure to the country.

Vecht and Colunga are positive on the outlook for Russia. They explain that when the oil price collapsed and economic sanctions started to bite following the annexation of Crimea, the Russian authorities adopted positive monetary policies, including freezing the fiscal budget, which was based on a conservative $40 oil price. The currency was allowed to fully float and disposable income fell meaningfully due to higher inflation. As inflation has declined, interest rates have been reduced; the five-year government bond yield has fallen from c 12% in late 2015 to the current level of c 7%, and should reduce further once inflation expectations come down. Lower interest rates are positive for bank mortgage volumes and asset prices, including equities and real estate. The managers say that in Russia, 75-80% of the population owns property of some sort, and there should be a 'trading-up' effect as asset prices rise, as well as a positive wealth effect, which should lead to higher consumption and hence more robust economic growth.

Companies in Russia offer competitive dividend yields, such as oil companies (6-8%), telecom companies (8-10%) and steel companies (10-12%). The managers say that the dividend payments are well supported by cash flows and do not require a company to take on leverage or conduct asset sales. They believe that the differential between dividend yields and lower interest rates should be a powerful driver for a re-rating in asset prices. Vecht and Colunga suggest that the positive cycle could run for seven to 10 years if government policies continue to be carried out successfully. They believe there is the political will in Russia, the fiscal ability and less reliance on external financing. Higher oil prices will also be positive for the country's finances.

The managers say that Central and Eastern Europe (Hungary, Czech Republic, Poland and Romania) economies have been growing strongly in recent years. Labour markets have tightened, or are in the process of tightening, and unemployment is low versus history. As a result of higher inflation, interest rates will be moving up, which will be very positive for banks' earnings in the region, due to higher net interest margins; earnings are also being boosted by higher mortgage volumes due to robust economic growth.

Vecht and Colunga have been positive on the outlook for Greece for the last two years. They are particularly bullish on the prospects for Greek banks. The country has been adhering to the conditions of its bailouts, and each bailout review is being completed faster than the previous one. The managers are not expecting a 'V-shaped' economic recovery, but note that economic data have been coming through better than expected. They add that banks are now in a position to chase underperforming loans; 15% to 25% of defaulters have done so for 'strategic' reasons, so if banks are able to recover these loans, it will be very positive for their earnings profile. The managers do not believe the Greek banks will need to be recapitalised. The banks are trading on very inexpensive price-to-book multiples of c 0.3x, which Vecht and Colunga believe have the potential to double over the next couple of years. Funding at the government level is also improving, the cost of debt is coming down and the first new government bond was issued in the summer of 2017. As a result of the economic turmoil in Greece, more than €100bn left the Greek banking system; if this were to return, it would provide a significant boost to the economy.

Turkey is viewed by the managers as a more volatile country to invest in. It has fiscal and current account deficits and is dependent on global liquidity; if liquidity is tight, higher Turkish interest rates have a negative effect on economic growth. Having been overweight in Turkey, BEEP currently has an underweight exposure versus the benchmark, as the managers expect interest rates to rise by more than the market expects.

# Asset allocation

## Investment process: Unconstrained by the benchmark

The investment process combines both top-down and bottom-up analysis. Top-down analysis includes political and macroeconomic considerations, plus a review of each country's valuation metrics, while bottom-up analysis seeks to identify companies whose long-term value or growth attributes are not reflected in their current share prices. There is a focus on a company's cash flow growth, which ultimately drives share prices, so it is the responsibility of the managers to determine which companies are able to convert revenue growth into strong free cash flow. Within the emerging European region as a whole, a multi-year declining capex to sales trend is leading to a higher free cash flow yield.

In common with other investment teams at BlackRock, fundamental research of individual companies includes the compilation of a rigorous research template, with each company assigned one of five conviction levels ranging from strong buy to strong sell. Financial models are constructed in-house, rather than relying on third-party research. Idea generation comes from a variety of sources, including frequent trips to the countries where BEEP currently invests or may invest in, and regular input from BlackRock's wide network of contacts in the emerging European region. This network includes high-level diplomatic, political and corporate access, along with meeting a company's customers, competitors and suppliers. This allows the managers to gain an in-depth understanding of individual companies and their management, including the competitive and regulatory environments, as well as a company's growth and return potential. An assessment of a company's corporate, social and governance track record is also taken into consideration. The managers and the BlackRock Emerging Markets team are able to draw on the broad resources of BlackRock's research network, including a proprietary research database. Because of the team's depth of knowledge, the managers have been able to invest in 'hidden gems' across the region. These include Russian healthcare, internet and transportation companies, and opportunities in the financial sector including companies in Romania and Turkey.

The investment approach is flexible, to create a portfolio that is appropriate for the prevailing economic and market cycle. In general, top-down rather than bottom-up considerations become more important when the manager's investment outlook is more bearish. BEEP's resulting portfolio has between 20 and 30 holdings and is unconstrained by the stock and sector weightings of the benchmark; currently around a quarter of the portfolio is held in stocks outside the benchmark. There is a formal review of each potential investment, which is undertaken by the Emerging Markets team. Position sizes are determined by the managers' levels of conviction, perceived share price upside potential and the level of trading liquidity. The trust has a relatively liquid portfolio; at end-December 2017, BlackRock estimated that 95% of the portfolio could be liquidated within 20 days, with the remaining 5% within 20 and 60 days. This is based on the assumption of trading 25% of the 30-day average volume. Risk measurement is a key part of the investment process. BEEP's portfolio is analysed by BlackRock's Risk & Quantitative Analysis team, which monitors a range of market and portfolio risk factors. This function is viewed by BlackRock as particularly important for emerging market portfolios, which are subject to complex stock market correlations.

## Current portfolio positioning

At end-December 2017, BEEP's top 10 investments made up 58.4% of the portfolio, which was broadly in line with 58.2% at end-December 2016; six companies were common to both periods. In terms of geographic exposure (Exhibit 5), considering the trust's four largest country exposures, the largest increase is Poland (+9.9pp), while the largest decline is in Turkey (-10.7pp). Versus the MSCI Emerging Europe 10/40 index, BEEP's largest deviations are overweight Russia (+4.8pp) and underweight Turkey (-8.8pp).

**Exhibit 5: Portfolio geographic exposure vs MSCI EM Europe 10/40 index (% unless stated)**

| | Portfolio end-Dec 2017 | Portfolio end-Dec 2016 | Change (pp) | Index weight | Active weight vs index (pp) | Trust weight/ index weight (x) |
|---|---|---|---|---|---|---|
| Russia | 54.1 | 51.9 | 2.2 | 49.3 | 4.8 | 1.1 |
| Poland | 17.9 | 8.0 | 9.9 | 20.8 | (2.9) | 0.9 |
| Turkey | 7.9 | 18.6 | (10.7) | 16.7 | (8.8) | 0.5 |
| Greece | 6.6 | 7.6 | (1.0) | 5.2 | 1.4 | 1.3 |
| Other | 13.5 | 13.9 | (0.4) | 7.9 | 5.6 | 1.7 |
| | **100.0** | **100.0** | | **100.0** | | |

Source: BlackRock Emerging Europe, Edison Investment Research

BEEP's sector exposure is shown in Exhibit 6. Over the last 12 months to end-December 2017, the largest increases in exposure are energy (+6.2bp) and telecoms (+4.6pp), while the largest decreases are financials (-4.6pp) and industrials (-4.4pp). Versus the MSCI Emerging Europe 10/40 index, BEEP has meaningful deviations in exposure in healthcare (+5.2pp), consumer staples (+3.7pp), materials (-7.1pp) and consumer discretionary (-4.7pp).

**Exhibit 6: Portfolio sector exposure vs MSCI EM Europe 10/40 index (% unless stated)**

| | Portfolio end-Dec 2017 | Portfolio end-Dec 2016 | Change (pp) | Index weight | Active weight vs index (pp) | Trust weight/ index weight (x) |
|---|---|---|---|---|---|---|
| Financials | 36.7 | 41.3 | (4.6) | 34.6 | 2.1 | 1.1 |
| Energy | 32.1 | 25.9 | 6.2 | 31.3 | 0.8 | 1.0 |
| Consumer staples | 8.9 | 6.1 | 2.8 | 5.2 | 3.7 | 1.7 |
| Telecom services | 7.5 | 2.9 | 4.6 | 4.9 | 2.7 | 1.5 |
| Healthcare | 6.3 | 3.1 | 3.2 | 1.1 | 5.2 | 5.9 |
| Materials | 4.5 | 4.2 | 0.3 | 11.6 | (7.1) | 0.4 |
| Information technology | 2.9 | 5.5 | (2.6) | 0.5 | 2.4 | 5.4 |
| Industrials | 1.2 | 5.6 | (4.4) | 2.8 | (1.6) | 0.4 |
| Consumer discretionary | 0.0 | 2.2 | (2.2) | 4.7 | (4.7) | 0.0 |
| Utilities | 0.0 | 3.1 | (3.1) | 3.1 | (3.1) | 0.0 |
| Real estate | 0.0 | 0.0 | 0.0 | 0.4 | (0.4) | 0.0 |
| | **100.0** | **100.0** | | **100.0** | | |

Source: BlackRock Emerging Europe, Edison Investment Research

BEEP's largest sector exposure, with more than a third of the portfolio, is financials. These include holdings in Polish banks such as PKO Bank Polski and Bank Pekao, which are among the most interest rate sensitive, as the majority of loans in the country are floating rather than fixed rate. The manager says that even a modest interest rate hike of c 100bp could lead to an increase in individual banks' earnings of between 20% and 50%. Sberbank is currently BEEP's largest holding; it is Russia's largest bank and is state owned. It has a national branch network and c 50% market share of the retail deposit market. The company's fundamentals are strong due to an improving macro backdrop and an ongoing restructuring. Loan growth should continue, particularly in mortgages, due to lower interest rates as a result of a meaningful decline in inflation in Russia.

Currently the third-largest holding in BEEP's portfolio, Gazprom is Russia's largest gas producer and transporter. The stock has been out of favour with investors; however, the managers believe it is undervalued given the potential for better than forecast cash flow, due to higher volumes and commodity prices, and the shares offer an attractive dividend yield of c 6%.

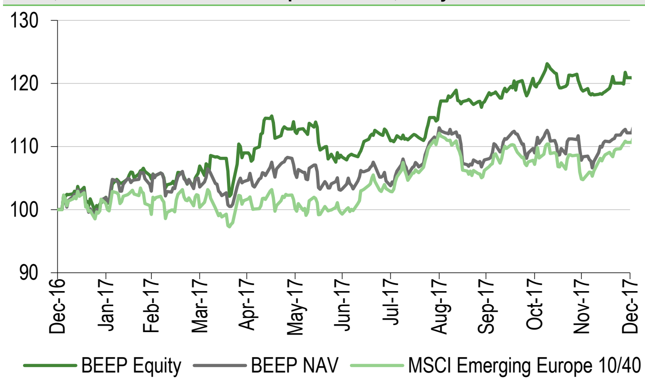
Also in the top 10 list of holdings is Gedeon Richter, which is a generic pharma producer in Central and Eastern Europe and Russia. The company is in the process of transforming into a higher-margin speciality pharma company, with a focus on innovative drugs for women's healthcare and the central nervous system. The company increased its operating margin guidance twice in 2017, and the managers believe there will be further upside guidance. Gedeon Richter is generating strong levels of cash flow, which can be used for acquisitions or returned to shareholders.

## Performance: Ahead of the benchmark

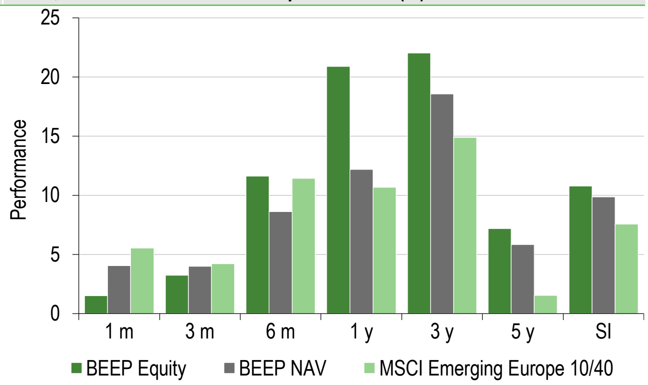
In H118 (ending 31 July 2017), BEEP's sterling NAV and share price total returns of +3.7% and +9.8% respectively outpaced the +2.4% sterling total return of the benchmark. Since the appointment of BlackRock as BEEP's investment manager on 1 May 2009 to end-July 2017, the trust's NAV sterling total return of 116.5% compares to the benchmark's sterling total return of 67.4%. Typically in H117, BEEP's non-index stocks were the greatest contributors to performance, such as Russia's leading social network Mail.Ru, which rallied by 51.6% in US dollar terms over the period, as it is successfully migrating new businesses onto its network. Another significant contributor to performance was Globaltrans, which rallied by 33.2% in US dollar terms over the period. It is Russia's leading independent freight rail transportation company and is benefiting from rising transportation tariffs in the country. The main detractors to performance included an underweight exposure to the Polish refining sector, a holding in non-benchmark Polish real estate company Griffin Premium, which performed poorly following its April 2017 IPO despite the company's attractive valuation, and Russian companies such as Rosneft, despite the oil price rally, and Novatek, which detracted due to disappointing operating performance and lack of an expansion at the Ust-Luga processing complex.

**Exhibit 7: Investment trust performance to 31 December 2017**

**Price, NAV and index total return performance, one-year rebased**




**Price, NAV and index total return performance (%)**




Source: Thomson Datastream, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised. Since inception (SI) refers to the date when BlackRock took over management of BEEP (1 May 2009). All data in £.

Absolute returns are shown in Exhibit 7. Over the last 12 months, BEEP's NAV and share price total returns of 12.2% and 20.9% respectively are ahead of the MSCI Emerging Europe 10/40 index's 10.7% total return. The outperformance of the trust's share price versus its NAV has led to a meaningful narrowing in the discount (see Discount section below).

**Exhibit 8: Share price and NAV total return performance, relative to indices (%)**

| | One month | Three months | Six months | One year | Three years | Five years | SI |
|---|---|---|---|---|---|---|---|
| Price relative to MSCI Emerging Europe 10/40 | (3.8) | (0.9) | 0.2 | 9.2 | 19.8 | 31.0 | 29.1 |
| NAV relative to MSCI Emerging Europe 10/40 | (1.4) | (0.2) | (2.5) | 1.4 | 9.9 | 22.9 | 20.1 |
| Price relative to MSCI Emerging Markets | (2.1) | (3.2) | 0.1 | (3.9) | 20.0 | (6.6) | (0.0) |
| NAV relative to MSCI Emerging Markets | 0.3 | (2.5) | (2.6) | (10.8) | 10.1 | (12.3) | (7.0) |
| Price relative to MSCI World | 0.1 | (1.4) | 4.8 | 7.5 | 18.8 | (34.0) | (24.8) |
| NAV relative to MSCI World | 2.6 | (0.7) | 2.0 | (0.2) | 9.0 | (38.1) | (30.0) |
| Price relative to FTSE All-Share | (3.1) | (1.6) | 4.1 | 6.9 | 36.2 | (13.3) | (7.6) |
| NAV relative to FTSE All-Share | (0.7) | (0.9) | 1.3 | (0.8) | 25.0 | (18.6) | (14.1) |

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-December 2017. Geometric calculation. All data in £.

BEEP's relative returns are shown in Exhibits 8 and 9. It has outperformed the MSCI Emerging Europe 10/40 index over the last one, three, five years and since inception, in both share price and NAV terms. The outperformance has been helped by the managers' ability to shift portfolio exposure based on their own experience, and the team's macro views.

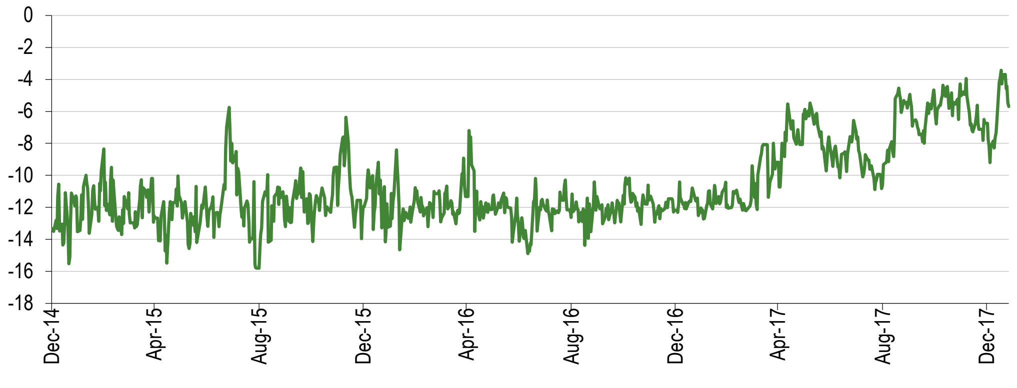
**Exhibit 9: NAV total return rel. to MSCI Emerging Europe 10/40 index over three years (£)**


Source: Thomson Datastream, Edison Investment Research

## Discount: Significant narrowing since March 2017

Looking at Exhibit 10, having generally traded in a relatively narrow band around 12% for more than two years, BEEP's share price discount to cum-income NAV has narrowed meaningfully since March 2017. The current 5.7% discount is towards the low end of the 3.4% to 12.7% range over the last 12 months. It is narrower than the average discounts of the last one, three, five and 10 years of 8.4%, 10.6%, 10.5% and 10.0% respectively. BEEP's board targets a single-digit discount in normal market conditions; in June 2013, shareholders approved the use of periodic returns of capital (tender offers) along with share repurchases, where appropriate, to manage the discount. In FY17, 289k shares were repurchased for cancellation at a cost of £739k. In H118, 12k shares were repurchased (see Exhibit 1) at a cost of £37k (average price of 311.13p); this was at an average discount of 10.6%.

**Exhibit 10: Share price discount to NAV (including income) over three years (%)**




Source: Thomson Datastream, Edison Investment Research

## Capital structure and fees

BEEP is a conventional investment trust with one class of share; there are currently 35.9m ordinary shares in issue with a further 5.4m shares held in treasury. At end-FY17, the trust had an overdraft facility of the lower of $16m and 20% of NAV, which compares with the lower of $20m and 15% of NAV at end-FY16. At end-December 2017, BEEP had net gearing of 3.5%.

Effective from 1 April 2017, Blackrock is paid a management fee of 0.8% of NAV; this is a reduction versus the prior fee of 1.0% of average daily market cap. Following a review by the board, since 1

February 2016 70% of management fees and finance costs have been allocated to capital, with 30% allocated to revenue reserves. Previously 100% of fees were allocated to the revenue account. The change in allocation of costs means higher dividend potential available for BEEP's shareholders. In FY17, the ongoing charge was 1.2%, which was a 0.1pp reduction versus FY16.

## Dividend policy and record

Historically, BEEP did not pay dividends. However, Eastern European companies have started to return capital to shareholders. Cash dividends have been paid to BEEP shareholders in FY13, FY14 and FY17 (see Exhibit 1). In H118, BEEP generated revenue earnings of 13.51c, which was a c 110% increase versus H117. The higher level of income was due to increased exposure to higher-yielding Russian companies. As a result, the board is expected to pay a higher annual dividend in FY18. BEEP's current dividend yield is 1.5%.

## Peer group comparison

There are just two investment trusts in the Association of Investment Companies' Emerging Europe sector. BEEP is the largest, with a market cap of c £140m. Its NAV total return is ahead of its peer over five years, modestly ahead over one year, while lagging over three years. It has a narrower discount, a lower ongoing charge, a similar level of gearing, and a lower dividend yield than its peer.

We also compare BEEP with a selection of open-ended funds that invest in Emerging Europe. Its NAV total return is above the open-ended peer group average over one and three years and significantly above over five years. Its charges are lower than all the open-ended funds, and its dividend yield is modestly lower than the average of the open-ended funds.

**Exhibit 11: Selected peer group as at 26 January 2018***

| % unless stated | Market cap £m | NAV TR 1 year | NAV TR 3 year | NAV TR 5 year | Discount (ex-par) | Ongoing charge | Perf. fee | Net gearing | Dividend yield (%) |
|---|---|---|---|---|---|---|---|---|---|
| BlackRock Emerging Europe | 138.3 | 21.9 | 66.9 | 33.8 | (2.5) | 1.2 | No | 104 | 1.5 |
| Baring Emerging Europe | 115.7 | 21.7 | 73.4 | 22.9 | (10.5) | 1.4 | No | 104 | 3.8 |
| **Simple average (closed end)** | **127.0** | **21.8** | **70.1** | **28.3** | **(6.5)** | **1.3** | | **104** | **2.7** |
| Open-ended funds | | | | | | | | | |
| Aberdeen Eastern European | 20.3 | 10.8 | 43.1 | 7.7 | | 1.9 | No | | 0.9 |
| Baring Eastern Europe | 798.2 | 16.8 | 58.8 | 8.4 | | 2.0 | No | | 1.1 |
| BGF Emerging Europe | 917.9 | 19.9 | 54.0 | 19.2 | | 2.2 | No | | 1.2 |
| HSBC GIF Russia | 209.6 | 2.5 | 85.2 | 9.2 | | 2.2 | No | | 1.3 |
| IP Emerging European | 42.7 | 15.9 | 77.9 | 31.2 | | 1.9 | No | | 1.9 |
| JPM Emerging Europe | 85.0 | 11.9 | 48.1 | 3.4 | | 1.7 | No | | 1.9 |
| Jupiter Emerging European Opps | 106.4 | 18.5 | 57.7 | 9.9 | | 2.0 | No | | 1.4 |
| Neptune Russia & Greater Russia | 198.3 | 10.5 | 83.7 | 9.9 | | 2.1 | No | | 1.9 |
| Pictet Emerging Europe | 132.7 | 18.5 | 57.3 | 4.1 | | 1.9 | No | | 1.0 |
| Schroder ISF Emerging Europe | 988.3 | 24.3 | 71.9 | 34.7 | | 1.9 | No | | 3.0 |
| **Average** | **349.9** | **15.0** | **63.8** | **13.8** | | **2.0** | | | **1.6** |

Source: Morningstar, Edison Investment Research. Note: *Performance as at 25 January 2018. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

## The board

There are five directors on BEEP's board; all are non-executive and independent of the manager. Chairman Neil England was appointed as a director on 21 March 2003 and assumed his current role on 24 June 2009. He is a director of ITE Group, an international emerging markets exhibitions company that has a focus on Eastern Europe. He is also chairman of a number of private businesses and is a fellow of the Chartered Institute of Marketing. The senior independent director is Rachel Beagles, who was appointed to the board on 1 March 2012. She is non-executive chairman of Securities Trust of Scotland and of the Association of Investment Companies, and a non-executive director of the New India Investment Trust. Mark Bridgeman was appointed to BEEP's board on 1 March 2012. He is also on the board of JPMorgan Brazil, The Law Debenture Corporation, North East Finance (a venture capital fund of funds) and a number of charity boards. Philippe Delpal was appointed as a director on 1 January 2012. He is a non-executive director of TSC Bank (Russia), HMS Group and Komercijalna Banka (Serbia). Robert Sheppard was appointed to the board on 1 February 2010. He is founder and chairman of IPM Advisers, an international consulting company providing advice on the oil and gas industry. BEEP's five directors have a broad range of experience including marketing, equity research and sales, fund management, private equity and the energy sector. All of BEEP's directors hold shares in the trust, thus ensuring that the interests of all shareholders are aligned.



| | | | |
|---|---|---|---|
| Frankfurt +49 (0)69 78 8076 960 | London +44 (0)20 3077 5700 | New York +1 646 653 7026 | Sydney +61 (0)2 8249 8342 |
| Schumannstrasse 34b | 280 High Holborn | 295 Madison Avenue, 18th Floor | Level 12, Office 1205 |
| 60325 Frankfurt | London, WC1V 7EE | 10017, New York | 95 Pitt Street, Sydney |
| Germany | United Kingdom | US | NSW 2000, Australia |