Lowland Investment Company

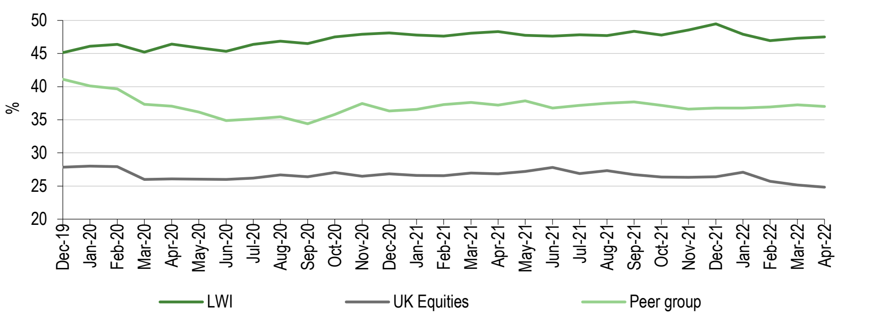
One of the purest UK domestic plays in the sector

Investment trusts
UK equity income

21 June 2022

During the first half of the financial year to the end of March 2022, Lowland Investment Company (LWI) lagged a modestly rising market due to its high weighting in mid- and smaller-capitalised UK companies. These companies found themselves out of favour with investors in a risk-off environment, fuelled by the war in Ukraine, rampant inflation, rising interest rates and slowing economic growth. For all of this, earnings per share for the period was 1.72p, some 34% higher than in this period last year but still below the pre-COVID-19 pandemic level of 2.22p. After a very strong outperformance in 2021, subsequent returns might be expected to consolidate, but the managers feel the portfolio is well positioned to make further gains in income and capital over the coming years.

Exhibit 1: Percentage of UK domestic earnings generated within portfolio



Source: Morningstar. Note: Peers are the Morningstar UK Equity Income category.

Why consider Lowland?

The UK has arguably been one of the most unloved stock markets over the last 10 years. A combination of the mix of industries listed (and those that are not) in the UK and events such as Brexit have conspired to see investors look elsewhere for their equity exposure. This has affected the performance of the wider UK stock market compared to other regions, particularly the United States. This has resulted in substantial regional valuation differences, even after the technology sell off since Q1 this year. LWI not only provides more exposure to UK domestic earnings than its peers and the wider UK market, it is also at a discount on price to its expected earnings. There are many market uncertainties, but LWI provides a diverse range of holdings with substantial valuation support and thus could be an excellent way for a contrarian to invest in a good quality, but cheaply valued portfolio of UK listed dividend-paying companies.

The analyst's view

LWI provides investors with a multi-cap portfolio of predominantly UK dividend-paying companies. It is diversified by holdings but is not quasi passive, with substantial sector and stock positions taken resulting in high levels of tracking error and volatility. Balanced with other strategies, it could provide welcome diversification benefits to a portfolio. Fund managers Henderson and Foll are a well-established team applying a proven mildly contrarian investment process across the whole gamut of UK equities.

NOT INTENDED FOR PERSONS IN THE EEA

Price	**119p**
Market cap	**£322m**
AUM	**£395m**
NAV**	127.8p
Ordinary share discount	6.8%
Including income. At 6 June 2022.	
Yield	5.1%
Shares in issue	270.2m
Code Ord	LWI/GB00BNXGHS27
Primary exchange	LSE
AIC sector	UK equity income

52-week high/low	144.5p	114.5p
NAV** high/low	150.1p	126.1p

**Including income.

Gearing

Net gearing at 30 April 2022	13%

Fund objective

Lowland Investment Company (LWI) aims to give investors a higher-than-average return with growth in both capital and income over the medium to long term by investing in a broad spread of predominantly UK companies. LWI measures its performance against the total return of the broad UK stock market, although its portfolio make-up is markedly different from that of its benchmark index.

Bull points

- Experienced management team.
- Disciplined investment process.
- Exposure to the whole breadth of UK equities.

Bear points

- Procyclical positioning can polarise returns.
- Small-cap bias can result in volatility.
- Volatility necessitates a long-term holding period.

Analyst

David Holder +44 (0)20 3077 5700

investmenttrusts@edisongroup.com

Edison profile page

Lowland Investment Company is a research client of Edison Investment Research Limited

More turbulence ahead?

Investors continue to be preoccupied by the major themes of the war in Ukraine, rising inflation, the associated potential path for interest rates and the Chinese government's COVID-19 policies, which are all causing slowing global economic growth. Over the year to date, these concerns have seen global markets sell off by around 6%. The broad UK equity index has performed relatively well in comparison, producing a modestly positive return. This can be attributable to the valuation support offered by UK equities (according to Janus Henderson Investors, UK equities are trading at the widest discount to global equities in 25 years) relative to other regions and the mix of industries. The broad UK equity market has a weighting of 21.9% in financials, which is expected to benefit from rising interest rates, 20.0% in basic materials and energy, which have been lifted by strong commodity prices, and only 1.3% in technology.

Global growth will likely slow with the current headwinds and the drivers of this trend are not short lived or easily overcome. Higher food, energy and input prices are a substantial tax on consumers and corporates alike, so it will become even more crucial to be able to identify those companies with defendable barriers to entry, strong reoccurring cash flows, solid balance sheets and talented company management able to navigate this landscape. LWI is well placed to achieve this. The wider equity income team at Janus Henderson Investors are highly resourced and have some of the industry's most experienced income investors; Director of UK Investment Trusts and portfolio manager James Henderson has been at the helm since 1990 and has worked with portfolio manager Laura Foll since 2009. The combination of their experience and collegiate approach is likely to be even more important in the coming years.

H122: A more challenging environment for the fund

For the half year ended March 2022 the portfolio returned -0.7% on an NAV basis (3.5% in price terms), compared to 4.7% for the index and 3.1% for peers. The fund's earnings per share were 1.72p over this period (H121: 1.28p), but this still has some way to go to catch up with the pre-pandemic H119 figure of 2.22p.

Exhibit 2: Five-year discrete performance data

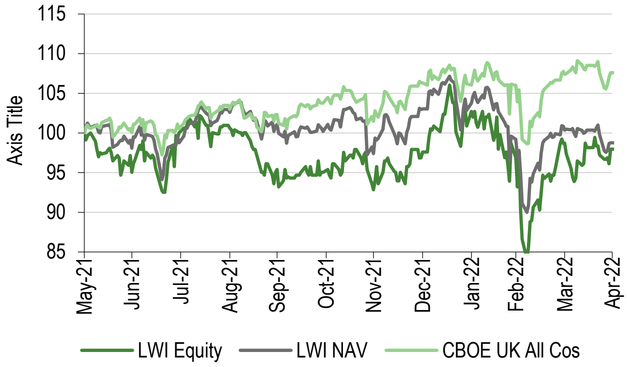
12 months ending	Share price (%)	NAV (%)	CBOE UK All Cos (%)	MSCI UK High Dividend Yld (%)	CBOE UK 250 (%)	CBOE UK Small Companies (%)
31/05/18	2.0	4.8	6.6	3.5	7.6	7.5
31/05/19	(7.9)	(10.7)	(3.4)	(7.3)	(7.6)	(4.4)
31/05/20	(26.5)	(24.3)	(12.0)	(8.9)	(12.3)	(19.6)
31/05/21	58.0	48.5	23.4	16.3	42.9	66.1
31/05/22	(7.2)	(0.5)	8.5	24.5	(9.7)	0.1

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

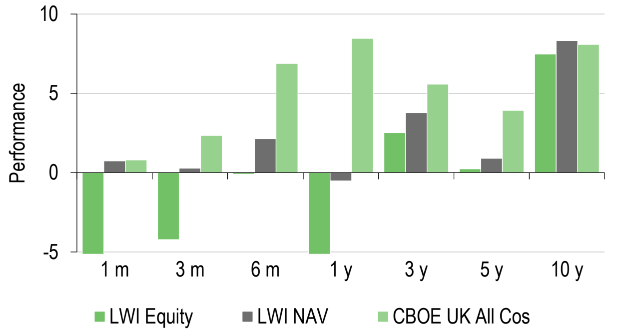
Looking at a slightly longer-term perspective, performance over the 12 months to the end of May 2022 was -0.5% in NAV terms and -7.2% in price versus the 8.5% for the broader UK market. Over this period, higher yielding stocks in the UK performed well versus those that were more growth oriented. As with the interim period, the largest UK listed companies returned 12.4% whereas small and medium-sized companies returned -6.4% and -8.8% respectively. The AIM index was even weaker, returning -21.5% over this period. Within this context the fund's NAV performance was relatively credible, given the high exposure to AIM, mid and small caps.

Exhibit 3: Lowland performance to 31 May 2022

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



Price, NAV and index total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

As shown in Exhibit 4, the portfolio has a bias to smaller and medium-sized companies (normally weightings to the largest 100 UK companies do not account for more than 50% of LWI's portfolio) when compared with the benchmark; this was a source of much of the underperformance during H122.

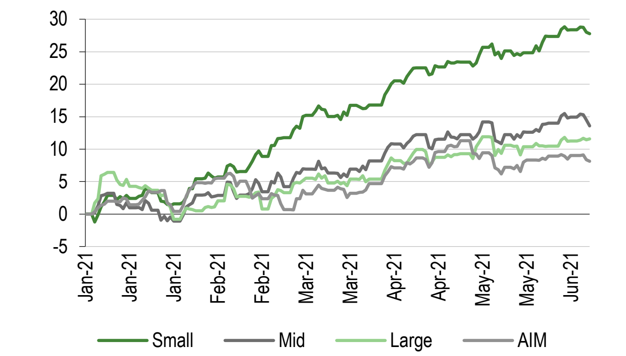
Exhibit 4: Market cap weighting vs benchmark (% unless stated)

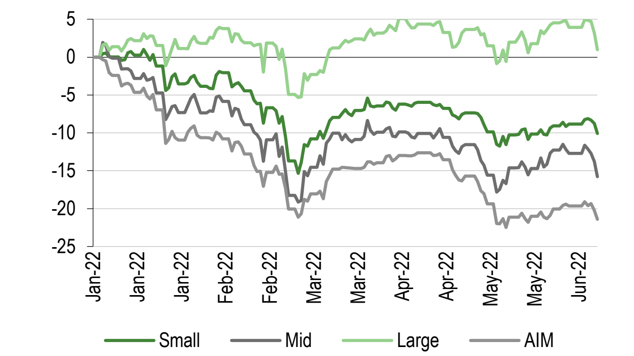
	Portfolio end-March 2022	Portfolio end-March 2021	Change (pp)	Benchmark weight	Active weight vs benchmark (pp)
Largest 100 UK stocks	47.4	43.6	3.8	81.5	(34.1)
Next largest 250 UK stocks	19.8	18.5	1.3	15.4	4.4
Small Caps	12.4	16.2	(3.8)	3.1	9.3
AIM	15.7	16.5	(0.8)	0.0	15.7
Overseas	3.5	3.5	0.0	0.0	3.5
Others	1.2	1.8	(0.6)	0.0	1.2
	100.0	**100.0**		**100.0**	

Source: LWI, Edison Investment Research

Conversely the bias was a major driver of the very strong outperformance in 2021 (Exhibit 5). Smaller companies can often be volatile in times of macro uncertainty and events such as the war in Ukraine, rising inflation and general "risk off" environments can hurt the share price performance of these companies. Their performance can also be seen as a barometer for the sentiment surrounding UK domestic earnings and growth and indeed LWI is more exposed to UK domestic earnings then peers according to work done by Morningstar (Exhibit 1). Whilst the weighting to the largest companies has been towards the upper end of the typical range (Exhibit 4) and has increased from 35% since April 2017, the managers acknowledge that with the benefit of hindsight they could have been raised a little more to add to the defensiveness of the portfolio.

Exhibit 5: Market cap performance in H121 versus H122





Source: Morningstar. Large=largest 100 UK stocks. Mid=Next 250 largest stocks. Small=remainder of stocks listed on the London main market. AIM=companies listed on the Alternative Investment Market.

Unsurprisingly given the robustness of the largest UK companies and rising energy and basic material prices, the three best-performing portfolio holdings over the interim H122 period were Anglo American, Shell and North Sea oil and gas producer Serica Energy. The three largest detractors to performance at the stock level were Studio Retail, Reach and K3 Capital. Studio Retail was a victim of supply chain issues, whereas Reach and K3 previously performed well but saw share price weakness on concerns regarding future economic growth.

Exhibit 6: Top 10 positions versus benchmark (% unless stated)

	Sector	Portfolio end-Mar 2022	Portfolio end-Mar 2021	Change (pp)	Benchmark weight	Active weight vs index (pp)
Shell	Oil and gas	3.8	2.3	1.5	6.6	(2.8)
GlaxoSmithKline	Pharmaceuticals	3.1	2.5	0.6	3.3	(0.2)
Anglo American	Mining	2.8	N/A	N/A	2.0	0.8
Direct Line	Non life insurance	2.7	N/A	N/A	0.2	2.5
Severn Trent	Utilities	2.6	2.1	0.5	0.3	2.3
National Grid	Utilities	2.5	N/A	N/A	1.7	0.8
BP	Oil and gas	2.4	N/A	N/A	2.9	(0.5)
Aviva	Life insurance	2.4	2.0	0.4	0.7	1.7
HSBC	Banks	2.3	2.0	0.3	4.4	(2.1)
Phoenix	Life insurance	2.3	3.0	(0.7)	0.2	2.1
Total		**26.9**	**13.9**			

Source: LWI. Note: N/A denotes not in the top 10 at March 2021.

Transactions were modest through the period, with net sales of £9m. Bellway was sold in January 2022 as the managers had concerns about the affordability of housing in England in a rising interest-rate environment. Scotland has not seen the same magnitude of house price appreciation, so a new position was added in Springfield Properties. New holdings were also added in H221 via Kingfisher and Reckitt Benckiser that, although had both benefited from lockdown trends, have also been making self-help improvements in their respective underlying businesses. More recently banks have appeared more attractive to the managers. Balance sheets are well capitalised and the managers have been adding to Barclays after initiating a new position in Q420. Barclays pays a dividend of 4.8% and trades on price to book of 0.4x. Rising rates provide a tailwind for the banking sector and the fund owns holdings in HSBC, Lloyds, NatWest and Standard Chartered. This is a rare example of investments being identified from a top-down perspective, rather than the overwhelming bottom-up process long eschewed here.

Exhibit 7: Portfolio sector exposure versus benchmark (% unless stated)

	Portfolio end-March 2022	Portfolio end-March 2021	Change (pp)	Benchmark weight	Active weight vs benchmark (pp)
Basic materials	5.8	4.9	0.9	8.8	3.0
Consumer discretionary	9.2	12.0	(2.8)	10.8	(1.6)
Consumer staples	3.1	1.1	2.0	14.6	(11.5)
Energy	8.1	5.1	3.0	9.9	(1.8)
Financials	31.4	33.5	(2.1)	22.6	8.8
Health care	5.3	4.5	0.8	10.9	(5.6)
Industrials	23.5	25.3	(1.8)	12.0	11.5
Real estate	2.7	4.7	(2.0)	3.3	(0.6)
Technology	1.8	2.0	(0.2)	1.4	0.4
Telecommunications	3.4	2.7	0.7	2.1	1.3
Utilities	5.7	4.2	1.5	3.6	2.1
	100.0	**100.0**		**100.0**	

Source: LWI

Cranswick was added in April 2022 and is the pre-eminent UK pork supplier to retailers. It also sells under its own brands and has a foothold in the poultry market. Although input cost pressures are undoubtedly an issue, the strength and durability of its brands and relationships with the major supermarkets puts it in a strong position to pass through costs. The stock was weak over the previous 12 months, offering the manager an attractive entry point on an EV/EBITDA of c 8x. There are other food producers in the portfolio, such as Finsbury Food Group and Devro. Pension consultant XPS Pension Group was another addition in April 2022. XPS Pension Groups gaining market share from larger incumbents via its nimble and bespoke solutions and the managers believe it is well placed to grow earnings while paying an above average dividend. Further capital has also been added to insurer Direct Line and Epwin Group, which provides door and window frames for builders merchants and housebuilders.

The funds for these purchases have come from selling RELX, reducing Randal and Quilter and taking profits from the overweight utilities positions that have performed well in the recent market volatility. Taking a step back, the direction of travel is to reduce the more defensive, earnings transparent, more fully priced elements of the portfolio such as utilities and reinvest the proceeds into more cyclical areas such as banks, housing-related business and food producers, where short-term investor pessimism prevails but the fundamentals are robust. The managers believe the portfolio is well positioned, but for the value to be fully reflected it requires a moderately less volatile economic and geopolitical back drop.

The portfolio has seen external validation of its value with holdings in RSA and St Modwen bought by trade buyers and private equity respectively in the last 18 months, whereas Elementis and Senior have rebuffed approaches from US peers and private equity. Given the value on offer in the portfolio it would not be surprising to see more M&A activity, although this is not something Henderson and Foll particularly welcome as they prefer to benefit from the long-term operational outperformance and share price rerating rather than the immediate benefit to the portfolio from a takeover.

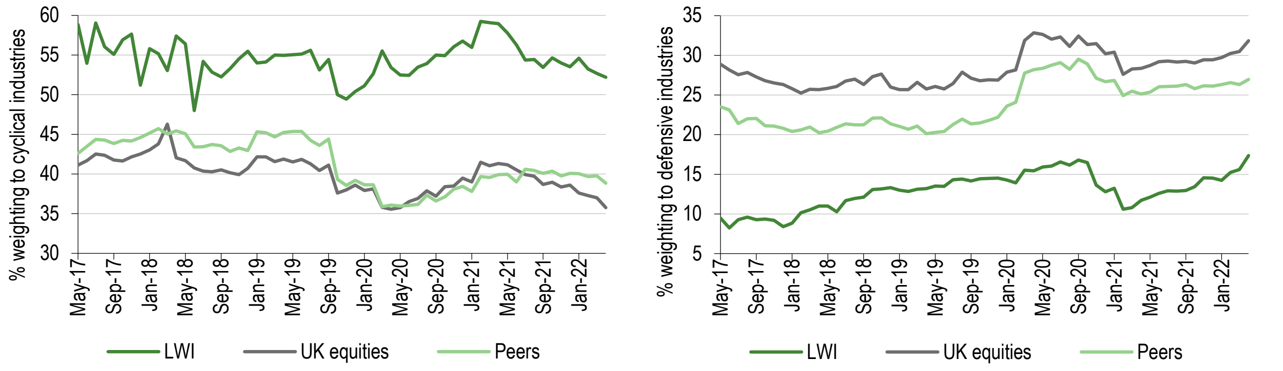
Dividends: Recovery in portfolio income

Since the COVID-19 crisis began in early 2020, the board has been understandably especially prudent in decisions about dividends. Despite the volatile nature of corporate profitability especially in the early phase of the crisis, LWI modestly increased its own payouts to investors. Henderson and Foll are encouraged to see the portfolio’s dividend receipts are recovering and are at the top end of their expectations. In 2021 there were special dividends from resource companies as commodity process soared, in 2022 special dividends have been more broad based via Sabre, Headlam, DFS. In addition, FBD Holdings and Irish Continental have returned to paying dividends for the first time since the COVID crisis began in early 2020. Low market valuations have also prompted company management to buy back shares with portfolio companies Direct Line, Ibstock, DFS and Headlam being notable examples.

Continued bias to cyclicals and away from defensives

Although the managers do not rule out any sector or industry, their emphasis on value, dividends and their growth has long funnelled their focus towards certain areas and away from others. This process has given the portfolio a bias to cyclicals and away from defensive industries. In this case cyclicals are defined as basic materials, consumer cyclicals, financial services and real estate. Defensives are consumer defensives, healthcare and utilities. LWI is well known for its industrials exposure, which is high when compared with the benchmark (Exhibit 8).

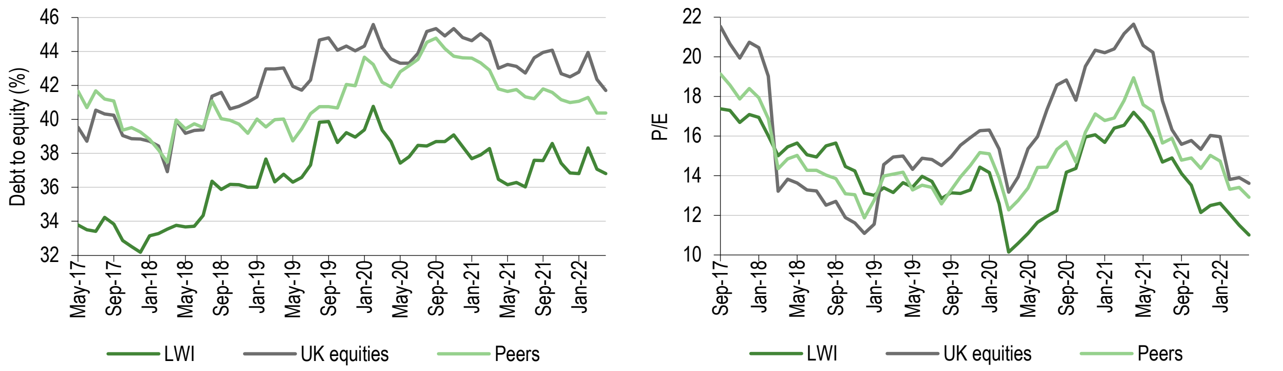
Exhibit 8: Ongoing, almost structural, bias to cyclicals and away from defensives



Source: Morningstar.

Within cyclicals, financials make up the bulk of the weighting with a range of holdings via subsectors such as banks, insurers, asset managers and capital markets. The most prominent of these are Direct Line, Aviva and Phoenix. As a cohort these trade on attractive P/E and P/B valuations with a solid track record of paying dividends (Exhibit 9). Financials are often supported in a rising rate environment and are in a better capital position than previous cycles. Within the very diverse industrials sector there are holdings in industrial transportation via Redde Northgate, aerospace and defence via BAE Systems and electronic equipment producer Ilika. There are some larger individual positions in defensive industries such as healthcare and utilities via names such as GlaxoSmithKline, AstraZeneca, Severn Trent and National Grid. These established dividend-paying large caps balance some of the more growth-oriented, more volatile mid and small caps and give the portfolio some balance and stability.

Exhibit 9: LWI - less debt and cheaper than peers or the wider UK market



Source: Morningstar.

A crucial element of the process looks for robust, well-capitalised businesses able and willing to ride out periods of weaker demand. As Exhibit 9 illustrates, the aggregate level of debt across the portfolio is below that of peers and the wider market. This should give the portfolio an element of resilience in economic downturns, allowing continued investment and for companies to pay dividends.

Outlook: Well positioned for recovery

Ongoing macroeconomic headwinds show few signs of abating and UK equities remain out of favour with investors. Henderson and Foll contrast this negative picture with their own discussions with corporate management who have tended to be more upbeat on their prospects. UK corporates have been buffered by successive crises including Brexit, COVID-19 and the war in Ukraine and may well yet face a modestly recessionary environment. Despite all of these concerns, the managers believe the valuation support and low debt levels mean the portfolio is well positioned to survive the current turbulence, reward investors with their patience via higher and growing dividends and emerge from this market volatility well placed to deliver good capital returns.

General disclaimer and copyright

This report has been commissioned by Lowland Investment Company and prepared and issued by Edison, in consideration of a fee payable by Lowland Investment Lowland Investment Company. Edison Investment Research standard fees are £60,000 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.

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	1185 Avenue of the Americas	Level 4, Office 1205
60325 Frankfurt	London, WC1V 7EE	3rd Floor, New York, NY 10036	95 Pitt Street, Sydney
Germany	United Kingdom	United States of America	NSW 2000, Australia