Scottish Oriental Smaller Companies Trust plc

Investor note

August 2017

This is the fourth semi-annual update on the Scottish Oriental Smaller Companies Trust plc ("The Trust" or "Scottish Oriental"). Our aim is to provide a general update on some of our current thoughts and views, insights about existing holdings and changes to the portfolio over the period.

How we invest

Scottish Oriental is managed by the First State Stewart Asia ('FSSA') team, an independent investment management team within First State Investments. The team manages a range of Asia Pacific equity strategies on behalf of institutional and wholesale clients globally, with offices in Hong Kong, Singapore and Edinburgh.

The Trust aims to achieve long-term capital growth by investing mainly in smaller listed companies across the Asia region; that is companies with market capitalisations of below US$1.5 billion, or the equivalent thereof, at the time of first investment.

We are conviction-based, bottom-up stock selectors with a strong emphasis on high quality proprietary research. Our investment approach adopts an absolute return mind-set and is inherently conservative, focusing on capital preservation as well as capital growth. By focusing on the potential downside (not just the upside) when making any investment decision, the risk to long-term client returns is significantly reduced. We are long-term investors and prefer to invest in quality companies that we can hold on to for many years.

The most significant source of investment ideas for the portfolio comes through country and company visits. As a team, we conduct more than a thousand direct company meetings throughout the year, seeking to identify a small sub-set of quality companies that meet our investment criteria. We place a clear emphasis on frequent visits to countries in the Asia region and on meeting the management of those companies in which the Trust is invested, or might invest.

While cultural, political, economic and sectoral influences play an important part in the decision-making process, the availability of attractively-priced, good quality companies with solid long-term growth prospects is the major determinant of Scottish Oriental's investment policy. Our country weightings bear no relationship to regional stock market indices and we do not consider ourselves obliged to hold investments in any individual market, sector or company. As a result, our asset allocation on a country and industry level is a residual of our stock selection process.

Change in Investment Management Arrangements

In April it was announced that Wee-Li Hee had expressed a preference to step back from her role as lead manager of the Trust and would assume the role of co-manager on return from maternity leave. Vinay Agarwal will therefore remain as lead manager, the role he has performed since Wee-Li took maternity leave last year. With Wee-Li now back at work, Martin Lau will no longer have a formal role with the Trust but will continue to provide company analysis and oversight in his role as joint managing partner of the FSSA team. He also remains very interested by way of being a significant shareholder in Scottish Oriental. Scott McNab remains as deputy manager. Having worked together for several years, both Wee-Li and Vinay are happy with these new arrangements. Vinay is able to continue his work on the Trust, which he has very much enjoyed, and Wee-Li is able to focus on company analysis without such an onerous travel schedule.

Repayment of Scottish Oriental's debt

After discussion with the Board of Directors it was agreed during the period that Scottish Oriental would repay its loan. The cost of early repayment was significant at approximately one year's interest costs. The Trust has raised debt a number of times in its history but most recently we drew down a three year 2.191%, US$32.5m loan in August 2011, which was then refinanced for five years in August 2014 with a £20m, 3.135% loan. We only briefly utilised this gearing (defined as net debt to equity ratio) in 2012 and, since then, the Trust has been net cash. The rationale for taking on debt was that during the Global Financial Crisis (when stocks were cheap and it perhaps would have been an advantage to have had the flexibility to gear Scottish Oriental) banks were most unwilling to lend money. Therefore we concluded that it was best to draw down debt in more benign times to have available as "dry powder" should markets weaken and stocks become cheap. We are still waiting for this to happen.

What has changed over the past few years is that markets are higher than ever and stocks are more expensive so the size of the likely correction that would be required before we felt it sensible to utilise leverage is now higher. We also have high levels of cash reserves as we are finding it a challenge to buy stocks at reasonable valuations. We have therefore already increased cash available to take advantage of any weakness in markets. Finally, with the debt due for repayment in August 2019 we realised that should markets fall sharply, say perhaps in 2018, and we saw a repeat of the tight liquidity conditions from the Global Financial Crisis we would be nervous about utilising the debt unless we could be certain of extending it which would be far from guaranteed in such a scenario.

Weighing these factors, we decided to repay the loan and focus on picking stocks. The management team and Board of Scottish Oriental remain open to the idea of using debt – both on a tactical and a structural basis – and would be interested in hearing shareholders' views on this. Whilst in the medium-term the returns we expect to make from investing in Asian equities are limited, the longer-term prospects appear to remain acceptable. We would hope that over a ten-year period or longer Asian equities would be able to beat the cost of carry on a loan.

Debt in companies – Modigliani and Miller have a lot to answer for

Traditional finance theory explains that, when funding a business, debt is cheaper than equity. However, as debt increases, equity holders demand a higher return for the additional risk this debt brings therefore there is an optimum level of debt which minimises the overall cost of capital. It could be said that this traditional view can be summarised as "debt is good".

In 1958 Professors Franco Modigliani and Merton Miller published a paper outlining a theory (which was subsequently revised in 1963 to account for the tax deductibility of interest payments against corporation tax). The original paper argued that it did not matter whether a company funded itself using debt or equity – the overall cost of capital would remain the same. However, once the tax deductibility of interest payments was factored in the conclusion was different. As the proportion of a business that was funded by debt increased, the lower the overall cost of capital would be. It could be said that the Modigliani-Miller theory can be summarised as "debt is very good".

Following the Global Financial Crisis of 2007/2008, many governments and central banks adopted unorthodox monetary policies including zero interest rates; quantitative easing (also known as money printing); and even negative interest rates in some countries. The result of these policies was that debt has been incredibly cheap with some countries, and even some companies, issuing negative rate bonds – where they borrowed money from the market and in due course will need to repay a sum smaller than they borrowed. The wave of cheap money unleashed by these policies resulted in asset prices being bid up with the opportunity available to fund the purchase of assets with borrowed money at historic low interest rates. It could be said that the result of these policies can be summarised as "debt is wonderful".

We have a slightly different view on debt. Modest levels are unlikely to cause much harm to a company's prospects. It can be sensible to use some debt to fund acquisitions, working capital requirements (particularly when these are volatile) and capital expenditure for growth. However, we would rather companies didn't gear themselves up for the sake of achieving an "optimal capital structure", as such, "optimisation" reduces flexibility to take opportunities that present themselves and increases risk should there be a bump in the road. We are always happy for companies to use cash flows to pay down debt. If a company is net cash and has no plans for this cash, we will be the first in the queue to ask for increased dividends. Our view on debt can be summarised as "debt should be used carefully".

Debt in Asia

Thankfully not everyone in Asia believes that debt is wonderful. A recent research report by HSBC detailed debt levels across Asia as well as how these have been changing. Several countries have total debt as a share of GDP of more than 200% (China, Hong Kong, South Korea, Malaysia, Singapore and Taiwan), whereas India and Sri Lanka are at less than 150% and the Philippines and Indonesia are at less than 100%.

Looking at how debt levels changed during 2016, debt as a share of GDP increased by more than ten percentage points in Hong Kong, Vietnam, Singapore and China; whereas it rose only very modestly within the Philippines; was unchanged in Indonesia; and fell in India and Malaysia.

Given that we tend to favour domestically focused businesses, it is also instructive to look at household debt as a share of GDP. These levels are low in India, Indonesia, the Philippines and Sri Lanka (ranging from 8%-16%) but are much higher in the other major economies. The level has been growing most quickly in China and South Korea.

Whilst we are very much bottom-up stock pickers (meaning we expend most of our energy on finding good quality companies to invest in), we do not ignore the economic conditions that our companies operate in. It should therefore be unsurprising that more than 40% of Scottish Oriental's assets are invested in India, Indonesia and the Philippines. These three countries have reasonable levels of overall debt which is relatively stable - i.e. growth is coming from genuine economic activity as opposed to being fuelled by debt. They also have modest levels of household debt to GDP which leaves plenty of scope for the consumer to grow rather than be constrained by servicing the finance on yesterday's purchases.

Debt in Scottish Oriental's portfolio holdings

As at 30 June 2017, Scottish Oriental owns 68 companies. Eight of these are financial stocks where traditional debt metrics tend not to be applicable. Briefly focusing on these eight companies first, we can look at the simplest measure of leverage for financial companies – assets to equity where a low number equates to a more conservative balance sheet. The average ratio of total assets divided by shareholder equity for these eight stocks is 7.7x with a range of 2.2x to 12.9x. By comparison, Lloyds Banking Group (generally considered to be in reasonable health again) measures 16.8x on the same ratio. We are comfortable with these holdings.

For the remaining 60 stocks in the portfolio, 32 of these have net cash balance sheets. The remaining 28 have an average gearing of 58%. Debt to equity can be a fairly crude measure of financial strength as it pays no heed to the cost of the debt or how much profits a company produces with its shareholders' equity. In terms of the ability to service debt, 30 of the Trust's holdings have net interest expense (interest expense minus interest income) in their most recent annual accounts, with the other 30 having net interest income.

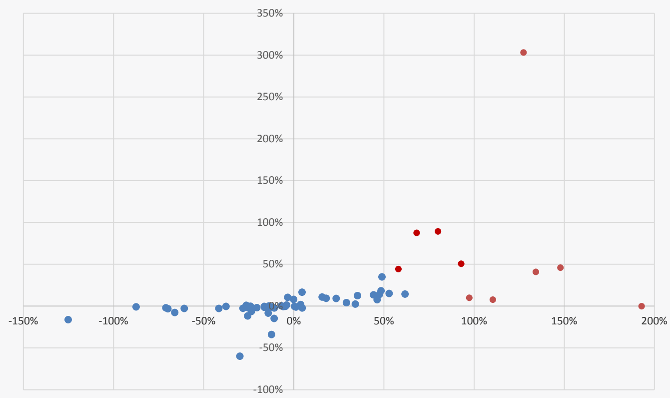
At a company level, dividing net interest expense by Earnings Before Interest and Tax (EBIT) for these 30 holdings produces an average of 29%. Excluding the one loss-making company (which we will discuss later), this gives a more palatable 20% meaning that, on average, 20% of operating profit is used to service debt for the 29 profitable companies Scottish Oriental owns that have a net interest cost. Inverting this 20% gives us an interest cover (a measure of how many times a company's interest expense can increase before it is unable to service its debt) of 5x. This is not too scary.

Whilst by no means bullet-proofed, we feel the balance sheets of Scottish Oriental's holdings are in pretty good shape. It is also worth mentioning that there are many other ways we could have performed this exercise. Although neither gearing nor interest cover factors in cash flows, we should reiterate that we do very much look at cash flows for all companies but particularly for those more encumbered by debt.

Having carried out these calculations for all the Trust's holdings we plotted the results on a graph. The graph in itself is confusing to say the least but a simple interpretation is as follows:

- Don't worry about companies that are close to where the axes intersect – such companies have modest levels of debt and modest servicing costs
- The companies on the far left generally have strong working capital characteristics (temporarily getting to keep customers' cash or delay paying suppliers) which is a positive but doesn't make a business model in itself
- The companies on the bottom have large cash balances but (current) low profitability from their core operations
- We should pay heed to the companies highlighted in red on the right hand side and higher up the chart – they either have high debt levels, high interest expense or both

Figure 1: Net debt to equity (x-axis) plotted against net interest expense/EBIT (y-axis)



Source: First State Investments as at 30 June 2017.

Scottish Oriental's 10 holdings with the most debt concerns

The below table details the 10 companies in the previous chart that were highlighted in red. On first glance it might be troubling that six of these companies are Indian, but this is just a coincidence.

Table 1

	Net Assets (%)	Country	Sector	Net debt to equity	Net interest expense/EBIT	Interest cover
Godrej Properties	1.3%	India	Real Estate	193%	0%	n/a
Godrej Industries	2.4%	India	Materials	148%	46%	2.2x
Gujarat Gas	1.5%	India	Utilities	134%	41%	2.4x
Shoppers Stop	0.3%	India	Consumer Discretionary	127%	303%	0.3x
Posiflex Technologies	1.2%	Taiwan	Information Technology	110%	8%	13.2x
Asia Satellite Telecommunications	0.4%	China	Consumer Discretionary	97%	10%	10.2x
Mitra Adiperkasa	2.6%	Indonesia	Consumer Discretionary	93%	51%	2.0x
XL Axiata	0.6%	Indonesia	Telecommunications	80%	89%	1.1x
Linde India	1.1%	India	Materials	68%	88%	1.1x
HeidelbergCement India	1.3%	India	Materials	58%	44%	2.3x
	12.7%					

Source: First State Investments as at 30 June 2017.

One stock stands out more than any other on the chart and that is **Shoppers Stop** with only 0.3x interest cover - i.e. its profits before interest and tax are not nearly enough to cover the interest payments on its debt burden. It is loss-making. We have only just purchased this company as we see a return to profitability and the company generating sufficient cash flows in due course to both service and repay its debt. **Mitra Adiperkasa** was bought in the previous period for similar reasons, although Mitra Adiperkasa saw a decline in profitability as opposed to an absence of it.

Another stock that stands out on the chart is property developer **Godrej Properties** with almost 200% gearing but no (net) interest expense. This should not be possible. There is a two-pronged explanation – 1) interest income is much higher than would be expected given the company's modest cash balance and 2) interest expense that is accounted for as an actual expense is much lower than would be expected given the company's significant debt levels. The former is caused by intercompany loans within the Godrej Group - i.e. it has a receivable instead of cash but still earns interest on that receivable. The latter is caused by the majority of interest expense not being booked through the income statement but instead being capitalised by being added to the value of properties under development. As a general rule we dislike related party transactions and are equally unenthusiastic about the capitalisation of interest. Company management teams tend to say the auditors make them capitalise interest whereas the auditors will say it's a complex matter requiring accounting interpretation and management judgment. We prefer keeping things simple. Adjusting for this capitalisation of interest costs, Godrej Properties has interest cover of less than 1x. This is clearly not sustainable but the company is investing for growth and has access to the Godrej Group's significant, and highly desirable, landbank which it is busy developing with borrowed money. The access to this landbank makes the intercompany loans acceptable as a quid pro quo along with the simple fact that we trust Adi Godrej, the patriarch of the group, implicitly. The investment in the future makes us willing to overlook the currently unsustainable interest bill as the value of the assets being built will comfortably be able to repay all loans. **Godrej Industries** consolidates the earnings and balance sheet of Godrej Properties, which explains its appearance on the above table as well.

India's largest city gas distributor **Gujarat Gas** also appears somewhat stressed but the company has been investing in its network and we see both revenues and margins growing in the future as the company's network is more fully utilised. Still on the topic of gas (and India), industrial gas company **Linde India** looks particularly poor in the interest cover metric. Its recent profits have been weak with the company's interest expense almost eliminating them entirely. Things are improving and it also has the might of Germany's Linde Group standing behind it, which dissipates the chance of any liquidity crunch. Mobile telephone network provider **XL Axiata** is also weak on interest cover having taken on high levels of debt when it paid too much to buy a competitor over three years' ago. We bought XL Axiata after the acquisition of the competitor expecting the industry to rationalise whereas it has remained fiercely competitive. We took part in a rights issue last year to help reduce this debt burden but the company is finding it incredibly difficult to compete against the country's dominant leader, Telkomsel. This makes profits hard to come by with little cash generated to pay off the debt. This is a stock we have been watching very closely since the rights issue.

Point-of-sale-terminal manufacturer **Posiflex Technologies** has relatively high debt as a result of a recent acquisition but it makes high returns on equity so servicing this debt is not a concern. Satellite operator **Asia Satellite Telecommunications** also apparently has little trouble servicing its debt, however it should be noted that it is another company which capitalises significant amounts of interest (on satellites under construction). Adjusting for this would see interest cover of 4.4x, which is acceptable, but very different to the initially calculated 10.2x. Its small position size reflects a lack of conviction on our part. Finally, **HeidelbergCement India** was only bought last period. The Heidelberg Group have done a tremendous job turning around what had been an over-leveraged and operationally weak cement company since gaining control of it. We expect strong profit growth here making debt servicing much less of a concern.

Recent notable changes to the Scottish Oriental portfolio

Portfolio turnover remained higher than we would expect with 12 new holdings purchased and 15 sold. The number of companies in the portfolio continues to consolidate to a more focused list. The relatively elevated level of portfolio turnover was as a result of us continuing to prune those companies where we see little growth and little likelihood that value will be realised as discussed in our prior note, and there was also a reasonable amount of profit taking given strong equity markets.

Table 2

Country weightings (%)	30-Jun-17	31-Dec-16
China	9.8	13.4
Hong Kong	7.2	6.7
Taiwan	11.6	9.6
Greater China	**28.6**	**29.7**
Bangladesh	1.3	1.1
India	24.0	23.3
Pakistan	0.2	-
Sri Lanka	5.6	4.4
Indian subcontinent	**31.1**	**28.8**
Indonesia	9.0	7.9
Malaysia	3.1	1.1
Philippines	7.9	6.0
Singapore	6.3	8.9
Thailand	2.6	5.6
Vietnam	1.1	0.5
South East Asia	**30.0**	**30.0**
South Korea	2.8	3.5
Gearing	-	-6.2
Cash	7.5	14.2
Total	**100.0**	**100.0**

Source: First State Investments as at 30 June 2017.

Greater China

Our exposure to Greater China reduced during the period. This was at the expense of the Trust's weighting in mainland China whereas we increased exposure to Taiwanese companies.

As per the previous period we sold a number of investments that have not worked well for us. Three of these – nitrogenous fertiliser producer **China Bluechemical** (China, Materials), shipping container manufacturer **Singamas Container** (China, Industrials) and bulk shipper **Pacific Basin Shipping** (Hong Kong, Industrials) – were sold following cyclical rebounds in their share prices. Having added to the latter as its share price had fallen, the Trust made a reasonable overall gain on that investment whereas the former two were sold at a loss. Although all three remain cheaply valued when compared to book value, the earnings outlook seems far from promising. We completed selling **Luthai Textile** (China, Consumer Discretionary) and **Axiomtek** (Taiwan, Information Technology). Both have found it difficult to grow earnings in an increasingly competitive environment. We gave up on **Yashili** (China, Consumer Staples) selling the investment at a loss. The investment rationale for Yashili had been that there should be strong prospects for an infant formula producer backed by a domestic giant (China Mengniu) and an international leader (Danone) following the scandal in 2008 which saw adulterated infant formula. However, neither party seemed to focus much on Yashili, and it has failed to gain market share. We also sold out of Industrial barcode printer manufacturer **Godex** (Taiwan, Information Technology) which had failed to replace some key customer losses. It took a very long time to exit this position undoubtedly impacting the share price as we sold, which we did so at a loss, showing the risks of investing at the very small end of the small cap spectrum. However, following these customer losses we felt the best, and perhaps only, hope for the company was for it to be bought out which was no reason to maintain a holding.

More positively, **Sunny Optical** (China, Information Technology) was completely sold for a healthy profit. It has continued to gain market share with its camera lenses and modules but we felt that the valuation left little margin for error. We reduced the weighting in **Minth Group** (China, Consumer Discretionary), which was once the Trust's largest position. Valuations are no longer as cheap as they were and a change in both CEO and CFO at the company made us feel it was prudent to take some profits.

Three new positions were purchased over the period. Quick service restaurant operator **Fairwood Holdings** (Hong Kong, Consumer Discretionary) is targeting double digit earnings growth by expanding its restaurant count and increasing the utilisation of its central kitchen. **Voltronic Power** (Taiwan, Industrials) is benefitting from the trend to outsource the production of uninterruptible power supplies. **Texwinca** (Hong Kong, Consumer Discretionary) is a former holding of Scottish Oriental. It is both a producer of knitted fabrics and an apparel retailer. Like other fabric producers it has been struggling of late. Given our experience with Luthai Textile it could be said that we are gluttons for punishment buying another textile company, but with a strong, net cash balance sheet and a dividend yield of 13%, we are being paid to wait while an experienced management makes the necessary changes for the business to thrive. In addition to these new holdings, we continued to build up the Trust's positions in **Uni-President China** (China, Consumer Staples), **Sinbon Electronics** (Taiwan, Information Technology) and **Sitronix Technology** (Taiwan, Information Technology).

Indian Subcontinent

Our exposure to the Indian subcontinent edged up. The region continues to be one of our most fertile sources of new ideas.

In India we bought four new holdings. Department store operator **Shoppers Stop** (Consumer Discretionary) and Domino's Pizza franchise holder **Jubilant Foodworks** (Consumer Discretionary) have both been suffering from indigestion following a period of rapid expansion and we are happy to back their respective management teams as they now seek to improve margins. **Healthcare Global Enterprises** (Health Care) operates cancer centres in a number of Indian cities. Treatment for cancer is very limited in the country and we expect strong profit growth as its newer centres mature. We also bought back courier company **Blue Dart Express** (Industrials), which we only sold last period on expensive valuations. The share price has since fallen on concerns it is ceding market share to aggressive upstarts in the e-commerce segment. These upstarts are a long way from profitable so we are happy to own a leading and rationale operator again.

Of note is our first investment in Pakistan. **Indus Motors** (Consumer Discretionary) assembles and markets Toyota brand vehicles in Pakistan with a 30% market share of the domestic passenger car market. Despite operating in a volatile economy, the company has been consistently profitable and its biggest difficulty just now is meeting demand for its vehicles.

In addition to these new holdings we continued to build up our positions in **HeidelbergCement India** (Materials) and **John Keells Holdings** (Sri Lanka, Industrials). We also significantly added to our holding in property developer **Mahindra Lifespace** (India, Real Estate). We had been reducing this position at higher levels but share price weakness made it an attractive investment again in our opinion.

We completely sold out of three holdings. Two of these, **Hexaware Technologies** and **Tata Consultancy Services**, are Indian Information Technology outsourcers where the economics of the industry are getting more difficult. The third sale, **Marico** (India, Consumer Staples), was a difficult decision for us as it is one of our favourite companies with its powerful consumer brands, leading management and strong cash flows. However, following significant share price appreciation, its valuation of approximately 50x historic earnings for 15% medium-term earnings growth was just too rich for us.

We also took profits from several of the Trust's Indian holdings where valuations do not now warrant as large positions. They included **Container Corp of India** (Industrials), **Godrej Industries** (Materials), **Godrej Properties** (Real Estate),

Gujarat Gas (Utilities), **Kansai Nerolac Paints** (Materials), **Linde India** (Materials), **Mphasis** (Information Technology), **Suprajit Engineering** (Consumer Discretionary) and **Tube Investments** (Industrials).

South East Asia

Scottish Oriental's overall exposure to South East Asia was relatively unchanged but there was a reasonable amount of activity on a country level.

We increased the Trust's Indonesian weighting primarily through continuing to build up stakes in recent acquisitions **Astra Otoparts** (Consumer Discretionary) and **Mitra Adiperkasa** (Consumer Discretionary). There was one complete sale during the period, **Acset Indonusa** (Industrials). Although the opportunity for the company is attractive, a country visit made us nervous about the level of capital its management team appeared willing to sink into construction projects given the relatively low margins involved.

The Trust's Malaysian weighting increased partly through the addition to its holding in auto component manufacturer **APM Automotive** (Consumer Discretionary), but primarily through establishing a new position in cement producer **Lafarge Malaysia** (Materials). This company has been held by Scottish Oriental before, most recently in 2009. A weak domestic economy and increased competition caused by competitors adding capacity has seen the share price fall back to 2009 levels. However, the company is the clear leader in Malaysia with more than 40% market share and has a strong balance sheet. It now trades at well below replacement cost, which we feel offers an attractive risk reward profile.

Exposure to the Philippines was also increased. We increased the position in **China Banking Corporation** (Financials), subscribing to a rights issue and also adding on subsequent share price weakness. Given that the company was raising capital to grow we were very happy to increase the position size at attractive valuations. We also continued to add to **Concepcion Industrial** (Industrials) and **Manila Water** (Utilities). This was partly countered by reducing the Trust's holding in **Integrated Microelectronics** (Information Technology). We only purchased the stock in the previous period so this is an unusually short holding period but with the share price more than doubling already in 2017, we felt we had little choice but to take some profits.

We reduced the Trust's weighting in Singapore. Two positions were exited, **Hong Leong Finance** (Financials) and **iFast** (Information Technology). Hong Leong Finance is a well-run finance company but has suffered from falling margins given low interest rates and the decreasing relevance of its business model. It is a prudent lender but it is increasingly difficult to see it ever occupying anything other than a niche in Singapore. iFast was a big disappointment to us. The opportunity was large for this company but we had become increasingly unhappy with the way management were addressing overseas opportunities. We also reduced our position in hospital operator **Raffles Medical** (Health Care). This is a tremendously well-managed company but valuations left little scope for earnings disappointments. These are now happening and are likely to continue given the costs that are being added as its Shanghai hospital's opening approaches.

We also reduced Scottish Oriental's Thailand exposure. **Hana Microelectronics** (Information Technology) was only bought last year when its share price fell on a muted outlook. A year later and after more than 50% share price appreciation, we were happy to exit the Trust's position and, given the volatile nature of this industry, we may be given an opportunity to buy the stock again. We also reduced the Trust's position in **Delta Electronics Thailand** (Industrials) following strong share price performance.

Finally, we added to Vietnam with the purchase of a second company there, **REE Corp** (Industrials). Having evolved from being a state-owned enterprise producing basic freezers into a conglomerate with a private sector mind-set and interests in air conditioning, power, water, and mechanical and electrical engineering, we believe the company is well-positioned to grow along with the Vietnamese economy.

South Korea

We reduced the Trust's weighting in Korea by selling down both **Amorepacific Group** (Consumer Staples) and **Hana Tour Service** (Consumer Discretionary) following temporary rebounds in their share prices. However we initiated two new positions which is a rare level of activity in a country where we have had little success finding promising investments. The first, **Leeno Industrial** (Information Technology) produces pins and sockets used in testing printed circuit boards and integrated circuits. The company has achieved incredibly high margins with its focus on vertical integration and developing its own proprietary technology. With the majority of its sales being exports and a culture that sees everything questioned, the founder Chaeyoon Lee has created a world class company. The second, **Vieworks** (Health Care) is an advanced image solution provider predominantly focusing on medical uses (x-ray imaging) but increasingly expanding into the industrial sector (industrial cameras). With a focus on the retrofit market i.e. replacing x-ray film detectors with digital detectors, Vieworks' market share is only approximately 2-3% so significant growth is possible. The company has a research driven culture which sees strong product development but perhaps leads to a weakness in its sales capability, which we hope to see addressed over the medium-term.

Scottish Oriental investment performance

We invest with a long-term, that is, a three-to-five year mind-set, if not longer; and we hope to be measured over a similar time period (see Table 3). However, we are aware that the long-term is made up of several short- and medium-terms and sometimes it can be helpful to look at what has driven recent performance.

Six month performance

Scottish Oriental underperformed over the first half of 2017, which is disappointing. Nevertheless the Trust generated strong absolute returns. It is also worth noting that the pound strengthened by more than five percent over the period so returns on Asia's equity markets were even higher than they appear once translated into sterling. It would generally be our expectation that we would struggle to keep up with such strong markets given our investment style.

We were again hurt by our relatively low weightings in China and Korea as well as our relatively low weighting in Information Technology stocks. As can be seen in the performance table there has been a recent divergence in the performance of the main Asian index (that we report against, the MSCI AC Asia ex-Japan Index) and its smaller company counterpart (the MSCI Asia ex-Japan Small Cap Index). The biggest driver of this difference has been larger company Korean and Chinese Information Technology companies. Given Scottish Oriental's mandate we are unable to buy these stocks. However, this is a somewhat moot point as other funds that the First State Stewart team manage have little exposure to these companies despite being able to buy them. In some cases, we are unhappy with governance and in others the issue is valuation - and sometimes both. However, rather than writing about stocks which we cannot own, it is more constructive to write about those that we do own.

Our worst performing holding over the period was **Indoco Remedies** (India, Health Care). Recently the US Food and Drug Administration has been targeting Indian pharmaceutical manufacturers and Indoco is one of many to have received a warning letter regarding production standards. To add to the company's woes the company has also seen both product launch delays and increased investment weigh on its recent earnings. We are monitoring the company closely.

Our second-worst performing holding was the Trust's biggest overall detractor from performance given its large position size. **Tong Ren Tang Technologies** (China, Health Care) was highlighted in our last note as being expensively valued and although it reported strong 2016 results, there was a clear slowdown in the second half of the year. The stock is no longer so expensively valued. Another large holding, **Vitasoy** (Hong Kong, Consumer Staples) was also weak for similar reasons. We continue to like both businesses for the long-term.

Other companies where the share price was negatively impacted by weak results were **Delfi** (Singapore, Consumer Staples), **Sitronix Technology**, and **Raffles Medical**. We were fortunate to have reduced the Trust's position in Raffles Medical before the worst of its share price falls and were happy to use the share price weakness to add to Sitronix. Delfi concerns us somewhat as we are increasingly questioning whether the company is doing what it should be to build its brands in Indonesia and we are monitoring it closely.

Two of Scottish Oriental's banks, **Commercial Bank of Ceylon** (Sri Lanka, Financials) and **China Banking Corporation** (Philippines, Financials), were weak because of rights issues. The "technicals" of such share price behaviour confuse us as there is a big difference between raising capital as a bank because you have to (regulatory) and because you want to (growth). In both instances, we believe the latter to be the case.

Finally, **Asia Satellite** (China, Consumer Discretionary) fell on concerns over declining transponder rates; **Hero Supermarket** (Indonesia, Consumer Stapes) was weak as it continued its store rationalisation programme; **Posiflex Technology** (Taiwan, Information Technology) was dull while it digested an acquisition; and **AmorePacific Group** continued to be blighted by the diplomatic spat caused by Chinese objections to the deployment of the American THAAD (Terminal High Altitude Area Defense) system in South Korea.

We have already mentioned that **Integrated Microelectronics'** share price doubled over the period. It was Scottish Oriental's best performing stock during the period as the market began to appreciate the possibility for margin improvement and other synergies from recent acquisitions.

In terms of overall contribution, performance was boosted most by the Trust's holdings in **Godrej Properties** (India, Real Estate) and **Godrej Industries** (India, Materials). The former performed more strongly but the latter is a larger position. Both did near equally well for the Trust. The recent introduction of Goods and Services Tax (GST) in India creates a level playing field for all property companies. Historically the sector has attracted more than its fair share of miscreants, both on the developer side and the customer side. Cash transactions have been common, whereas paying taxes has not been. As arguably the most reputable property developer in India, Godrej Properties is set to benefit from the cleaning up of the sector. Godrej Industries owns the majority of Godrej Properties, but also rose on expectation of it realising a significant gain when its agribusiness subsidiary Godrej Agrovet is listed later this year.

Table 3

	3mth	6 mth	1 year	3 years	5 years	10 years
NAV	1.1	11.1	19.3	37.2	83.2	226.8
NAV – Total Return	1.3	11.4	20.4	41.9	93.3	276.3
Benchmark*	4.4	16.9	30.8	53.8	79.7	139.4
Small Cap Index**	-0.8	10.6	19.3	37.0	68.3	99.4
Share Price	4.0	13.5	23.3	26.0	66.4	206.1
Share Price – Total Return	4.0	13.5	25.0	31.5	78.8	259.4

Source: First State Investments as at 30 June 2017. * MSCI AC Asia (ex-Japan) Index. ** MSCI Asia (ex-Japan) Small Cap Index.

Several of our holdings rose as a result of solid results with **Suprajit Engineering** (India, Consumer Discretionary), **Hemas Holdings** (Sri Lanka, Industrials), **Kansai Nerolac Paints** (India, Materials) and **Concepcion Industrial** (Philippines, Industrials) all performing strongly for us. **Sunny Optical** also rose strong on its results before we sold out.

To round off the best performing stocks, **XL Axiata** (Indonesia, Telecommunications) rebounded on the expectation that the industry is becoming more rational with pricing and **Gujarat Gas** (India, Utilities) rose on volume growth and the expectation that margins will also improve in due course.

Outlook and conclusion

Asian stock markets have continued to perform strongly in 2017 on an improving outlook for global growth. Although interest rates have increased in the US, a recent moderation in inflation has reduced pressure on Asia's central banks to also raise rates, which has allowed domestic policies to remain accommodative. Most Asian countries have seen falling exports for the last two years, whereas export growth has now resumed. This combined with various government-led infrastructure programmes is seeing a tentative return to investment.

Whilst all the above is positive, this improved outlook appears to be priced into stock market valuations – particularly for the quality companies we favour. When we meet with companies we are being told that volume growth is weak and it is difficult to increase prices given the lack of inflation expectations. Earnings growth has improved but in many cases this has been because of falling input costs which is not sustainable. Debt levels in Asia are high, and getting higher. This will act as a significant dampener on Asia's economies when interest rates eventually rise. In the meantime, cheap money has lowered the cost of capital thereby increasing competition.

We are focused on the strength of company balance sheets even more than usual. It is also no coincidence that some of our larger weightings are in India, Indonesia and the Philippines. These three countries have relatively low debt when compared to the size of their economies and recent growth in these domestically-focused countries has come without notable increases in this debt. The Trust has relatively high cash levels and, while we would like to deploy these funds in some of our favourite companies, we would prefer to make such investments at more reasonable valuations.

We trust this update has given you a better understanding of the companies that Scottish Oriental invests in. We would welcome feedback on whether it has been helpful as well as what you would be interested in reading about in the future.

To do so, please email info@firststate.co.uk