

Small Companies Dividend Trust* – a high income play from a diversified equity portfolio **Market Cap £15.8m, mid-price 97.5p, discount 8%.**

- Small Companies Dividend Trust (SDV) offers an above average yield of 6.5% from a portfolio of non-FTSE 100 stocks. This is the highest yield on offer amongst the UK Smaller Companies sub-sector, and the second highest yield in the UK High Income category. SDV's yield is at a 40-50% premium to the market. The Trust, which aims to provide a high income and the opportunity for capital growth, is trading on a discount of 8%, which looks particularly good value compared to the average discount of 6% on the UK high yielders.
- Differentiating SDV from many other income trusts is that it does not use the 'barbell portfolio' approach, instead generating all income from equities rather than having a separate high yielding portfolio. The Manager will not buy a stock unless it has a prospective yield of at least 4% on a 12 month view, and the sell trigger is when a yield falls below 2% as a result of a re-rating or there has been a change in the dividend growth prospects or if dividends are cut or passed. Income is derived wholly from small and mid-cap UK equities, and furthermore, SDV does not invest in mining or oil stocks which account for around 20-30% of its investible universe. The investment approach is very much bottom up, and stock selection incorporates identifying both the ability to pay a dividend through cash flow and balance sheet analysis, and the propensity to do so through underlying management contact.
- Although its last full year's dividend was not covered by earnings, in its Interim Results to 31st October 2011, SDV reported Eps of 3.19p, comfortably covering the interim dividend of 2.7p per share. Furthermore, revenue reserves at that date were equal to 6.7p per share after the payment of the second quarterly dividend, covering the prospective full year dividend of 6.35p per share 1.1x.
- In 2007 just before the market fell, SDV were unable to roll-over their Zero Dividend Preference Share which was due to redeem that year due to the disappearance of the Zero market at that time. This stable form of gearing was replaced by a lower level of bank debt which, as a result of a dramatic deterioration in markets, had to be further reduced by around 60% in 2009 to stay within covenants. As a result of asset sales, SDV's capacity to pay dividends was severely constrained and the absolute rate of dividend was prudently reduced from 13.65p per share to a more sustainable 7.7p. This was further reduced to 6p per share in 2010, but increased to 6.2p in 2011, and is on course to rise again this year. We expect the FY2011 dividend to be at least 6.4p per share, putting the shares on a prospective yield of 6.6% at the current share price.
- Since launch in May 1999, NAV TR is up by 185% as at the end of February 2012, equivalent to an annualised return of 8.5%, comparing well against the equivalent UK Smaller Companies weighted averages of 153.5% and 6.9% respectively.
- The Manager believes that there is now a 'bit of β ' back in the market, and that a rising economy will benefit small and mid-caps. There has been a lot of repair work done on small cap balance sheets since 2008, and investors are now being rewarded as dividends are beginning to flow again, and expectations are that this will last for another two to three years yet.
- **We believe that this stock offers a high and sustainable dividend yield from a relatively attractive discount. Investors in the UK are dependent on a small number of stocks for their income returns (at the end of January 2012, the top 20 stocks in the FTSE 350 produced c.66% of the income, with the top five stocks generating 33%), and SDV's portfolio of 63 equity holdings geared into the improving economy, provides a diversified income stream from a broad range of sectors away from the norm. The portfolio yield is 5.3% and the average rating of the underlying investments is a sub 10x p/e.**
- SDV is managed by David Horner and David Taylor at Chelverton Asset Management. Chelverton is a 'boutique' fund manager focusing on small and mid-cap companies and has approximately £100m of assets under management. This includes the £35m Chelverton UK Equity Income Fund which ranked 3/103 YTD at the end of January 2012, 59/95 over one year and 3/83 over three years in the IMA UK Equity Income tables.

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