Law Debenture

LWDB continues to set itself apart from peers in the sector by utilising its unique structure...

Update
19 December 2024

Overview

Law Debenture (LWDB) offers a highly differentiated equity income proposition in the investment trust sector, combining a predominantly UK-focussed equity portfolio managed by James Henderson and Laura Foll with its Independent Professional Services (IPS) business. The IPS business funds over a third of the trust's total dividends through its steady and recurring revenues which affords the managers greater flexibility in their investment remit. As a result, the **Portfolio** often looks very different compared to more traditional equity income strategies. Over the latest six-month period to June 2024, each IPS segment reported revenue growth, compared to the same period last year, with corporate services leading the way posting an 11.8% growth, compared to 1.9% last year.

Performance has been equally robust. Over the 12 months to 10/12/2024, the trust delivered NAV total returns of 17.6%, outperforming its benchmark's return of 14.1%. Key contributors included NatWest and Barclays, which benefitted from persistently high interest rates boosting their interest margins which, alongside strong results, led to sharp upticks in both companies' share prices. Rolls-Royce also contributed having experienced a significant earnings uplift from cost savings and the recovery in flying hours. Given recent market volatility, the managers have taken the opportunity to trim some portfolio positions where valuations have risen significantly, leaving, in their view, limited further upside, including Rolls-Royce, Marks & Spencer, and BAE Systems.

At the time of writing, LWDB trades at a 1.7% premium, slightly narrower than its five-year average and the UK equity income sector (see **Discount**). Whilst its historical yield of 3.6% remains below the sector average of 4.2% and the FTSE All-Share Index yield of 3.7%, the trust maintains a 44-year track record of either maintaining or increasing **Dividends**.

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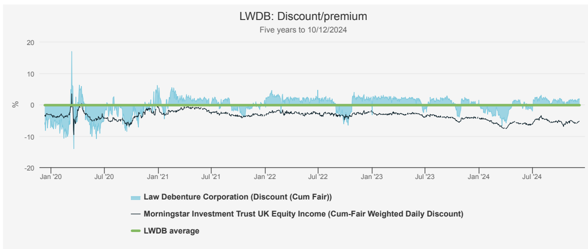
Key Information:

Price (p)	906
Discount/Premium(%)	1.7
OCF (%)	0.48
Gearing (%)	8
Yield (%)	3.6
Ticker	LWDB
Market cap (£)	1,201,298,949



Kepler View

We continue to view LWDB as a highly differentiated and compelling option for investors seeking UK equity exposure in a unique format. Its blend of a listed equity portfolio with the IPS business creates a flexible structure, allowing the managers to explore investment opportunities beyond the constraints of traditional income-focussed strategies. This flexibility has enabled James and Laura to focus on smaller and mid-cap companies, which they believe offer greater re-rating potential, particularly as UK equities remain undervalued relative to global peers.

The IPS business remains a key strength, underpinning the trust's ability to invest in lower-yielding but high-growth potential companies. That said, we acknowledge part of the business, notably its corporate services segment does introduce some cyclicality, with some of the underlying divisions being more reliant on global economic activity, making it susceptible to downturns in corporate activity. However, we believe that the overall resilience and diversification provided through the combination of each IPS segment, and the equity portfolio, helps limit the impact and makes LWDB an attractive choice for long-term investors.

Despite its lower yield and premium valuation, we believe LWDB's combination of a strong performance track record, consistent dividend growth, and exposure to undervalued UK opportunities positions it as an intriguing choice in the sector. Its low OCF of 0.48% further enhances its appeal. As such, LWDB remains a differentiated proposition, offering meaningful diversification and sustainable returns for those seeking exposure to the UK market.

BULL

- The IPS business significantly underpins both the growth in capital and dividend
- Demonstrates a long-term track record of outperformance against the sector and index
- Comparatively low OCF of 0.48%

BEAR

- Lower yield than the peer group average, although its dividend is growing
- Whilst offering a greater return potential, having a greater exposure towards small- and mid-cap stocks can increase risk
- Gearing can magnify gains on the upside but also losses on the downside

Portfolio

Law Debenture (LWDB) stands out in the investment trust landscape due to its distinctive structure, blending a traditional investment portfolio with the wholly owned Independent Professional Services (IPS) business. Despite accounting for only 20% of NAV, the IPS business has played a significant role in the trust's success, offering investors exposure to something unique in the sector.

The IPS business delivers a range of services to help its clients manage complex financial and legal obligations with impartial expertise. These include pension, corporate trust, and corporate governance services, with operations spanning the UK, Ireland, the US, Hong Kong, the Cayman Islands, and the Channel Islands. Together, this robust business model generates steady, recurring revenues underpinned by long-term contracts, such as pension trustee appointments, which typically last nine years.

This cash-generative model has been pivotal in supporting LWDB's **Dividend**, funding around 34% of it over the past decade. Alongside dividend support, the IPS business has delivered consistent earnings growth under the current management team, achieving a five-year compound annual growth rate of 11.3% in net revenue and 8.7% in profit before tax. The valuation of this business has also climbed, reaching £185.1m in 2023, an increase of 111.4% since 2018. This growth has continued in the first half of 2024, with all segments of the IPS business reporting revenue growth, as illustrated below, despite broader market volatility.

Market Cap Allocation

	NET REVENUE 30/06/2024 (£000)	NET REVENUE 30/06/2023 (£000)	GROWTH (%) 2023/2024
Pensions	8,957	8,597	4.2
Corporate trust	6,434	5,818	10.6
Corporate services	10,837	9,693	11.8
Total	26,228	24,108	11.2

Source: Law Debenture Corporation (30/06/2024 latest available data)

These are strong numbers and align with the management team's growth target. However, the pension and corporate services segments have swapped places in terms of reported revenue growth, compared to the same period last year. The pension segment, which provides independent trustee services to manage pension schemes and ensure regulatory compliance—including governance support, strategic advice, and operational oversight—is particularly influenced by regulatory trends. Whilst consistent demand has helped mitigate cyclicality, the managers noted that changes to pension regulations in 2023 created an exceptional year of growth, well beyond targets and which shouldn't be expected each year. However, this has now normalised, with growth returning to what they consider a more steady and consistent range, supported by continued demand for governance and pensions services, with an increase in trustee appointments.

On the other hand, the corporate services segment has surged to the forefront, reporting 11.2% revenue growth compared to 1.9% in the same period last year. This segment provides global entity management, regulatory compliance, and financial services, including corporate secretarial solutions and whistleblowing services. It is arguably the most cyclical part of the business, with its service of process division particularly reliant on global economic activity, making it susceptible to downturns in corporate activity like those in the first half of 2023. However, it has rebounded strongly in the first half of this year, buoyed by increased demand for outsourcing corporate governance functions and growth in its structured finance arm, supported by expanding demand for private credit as an asset class.

We view IPS as a resilient, cash-generative business with a strong record of defensiveness during times of market stress or recessions. Beyond its contribution, though, we also think LWDB's unique structure affords the managers of the investment portfolio—the core focus of the trust accounting for 80% of NAV—greater flexibility in their approach. That said, it always has to be considered that at 20% it is a very large single position in the portfolio, so it brings a high degree of company-specific risk.

James Henderson and Laura Foll manage a portfolio that predominantly focusses on UK-listed companies, complemented by select overseas investments in regions like Japan, the US, and Europe. They employ a disciplined, valuation-driven approach, aiming to balance capital preservation with consistent performance by focussing on high-quality companies with sustainable competitive advantages, leading market positions, and robust financials.

The managers have constructed a well-diversified portfolio of around 150 stocks, which they think help manage the risks to capital and aid consistency of performance. Their disciplined approach means they avoid taking large bets on any individual stock or sector. This is reflected in their largest position, Flutter Entertainment, which constitutes just over 4.0% of the portfolio, with the top 15 holdings collectively accounting for 32.7%. Notably, despite several changes to the portfolio over the last 12 months, the top 15 holdings still represent the same proportion of the portfolio compared to November 2023. However, three new names have entered the top 15 compared to a year ago—Standard Chartered, BT Group, and Herald Investment Trust. These changes result from a combination of positive performance from these stocks and the managers trimming other top holdings on strength.

Top 15 Investment Trusts

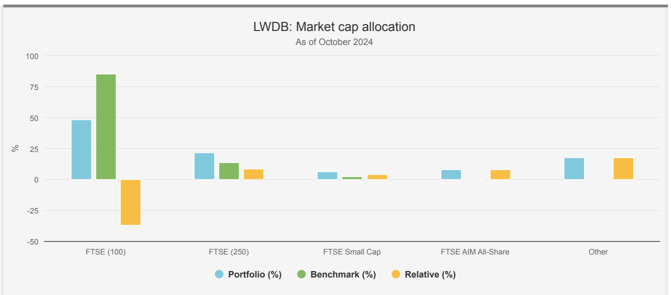
TOP 15 EQUITY PORTFOLIO INVESTMENTS	WEIGHT (%)	12-MONTH CHANGE (%)
Flutter Entertainment	4.1	2.0
HSBC	3.0	0.1
Shell	3.0	-0.5
Barclays	2.9	1.0
Rolls-Royce	2.2	-1.5
BP	2.1	-0.9
GlaxoSmithKline	2.1	-0.1
Marks & Spencer	2.0	-0.2
Tesco	1.8	0.2
Rio Tinto	1.8	-0.4
Standard Chartered	1.8	1.8
National Grid	1.6	0.1
NatWest	1.5	0.0
BT Group	1.5	1.5
Herald Investment Trust	1.3	1.3
Total	32.7	-0.1

Source: Law Debenture Corporation, as of 29/11/2024

With the IPS business shouldering just over a third of the dividend contribution, the managers are not confined or restricted in their investment options, meaning the portfolio often looks very different compared to more traditional equity income strategies. They can pursue opportunities across the market cap, including those low and non-yielding smaller companies.

This area of the market can be a good hunting ground for less well-known opportunities with greater capital and dividend growth potential than their larger counterparts. The managers view this part of the market as undervalued, arguing that many stocks aren't necessarily cheap due to weak fundamentals; instead, many have withstood prolonged macroeconomic pressures that have led, in some cases, to unjustifiably depressed valuations. This has prompted them to build on certain existing positions in the portfolio with strong re-rating potential over the last year, including FTSE 250 stock Ceres Power and AIM stock AFC Energy, maintaining their overweight position, compared to the benchmark, in AIM, small- and mid-cap stocks.

Fig.1: Portfolio Characteristics



Source: Law Debenture Corporationr

Conversely, the managers have taken the opportunity in recent market volatility to trim some portfolio positions where valuations have risen significantly, leaving, in their view, limited further upside. Notable reductions include Rolls-Royce, Marks & Spencer, and BAE Systems, reflecting the managers' recognition of strong earnings recovery and subsequent multiple expansion. Similarly, the managers sold two US-listed stocks, Applied Materials and Caterpillar, after both companies saw sharp upticks in their share prices. The proceeds were reallocated to UK opportunities, where the managers see more compelling value in the current market environment.

Gearing

By policy, LWDB's net gearing ceiling is set at 50% of NAV, though the managers typically operate in the range of 10-20% of NAV. LWDB is structurally geared through four tranches of long-term debt, with a total par value of £165m. These debentures, maturing between 2034 and 2050, currently equate to c. 12.8% of net assets and the weighted average cost payable on the borrowings is 3.96%, attractive in the context of today's higher interest rate environment. Details of the four debentures are provided in the table below and as of the latest factsheet, LWDB's net gearing stands at 13%.

Gearing

ISSUE YEAR	MATURITY DATE	PAR VALUE	INTEREST ON DEBENTURE
1999	2034	£40m	6.125% guaranteed secured bond
2021	2041	£20m	2.54% secured senior notes
2015	2045	£75m	3.77% secured senior notes
2021	2050	£30m	2.53% secured senior notes
	Total	£165m	Weighted average: 3.96%

Source: Law Debenture Corporation

The managers have the flexibility to hold cash against borrowings to manage the effective level of gearing. For example, as of 30/06/2024 (the latest half-year results), LWDB held roughly £27.2m in cash. In addition to this, the trust has access to a £50m unsecured overdraft facility with HSBC, designed to protect against any significant fall in cash flows. However, we understand that this overdraft facility is currently not being used.

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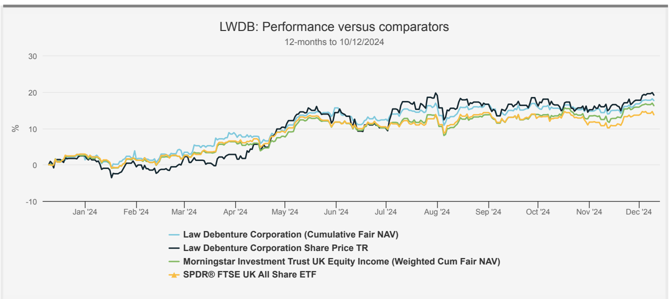
Performance

Overall, it's been a strong year for LWDB, with strong stock selection underpinning performance. Over the 12 months to 10/12/2024, LWDB delivered NAV total returns of 17.6%, outpacing both its benchmark and the AIC UK equity income sector, which returned 14.1% and 16.2%, respectively. For comparison, an ETF tracking the FTSE All-Share Index is shown below.

Fig.2: 12-Month Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Among the top contributors during the past 12 months were NatWest and Barclays. Both companies benefitted from the higher-than-expected interest rate environment through 2024. Whilst inflation has moderated and the Bank of England has cut rates twice this year, interest rates have remained elevated for longer than anticipated. This environment has supported a rise in both banks' net interest margins, which coupled with strong results, have aided in NatWest and Barclays share prices climbing 93% and 86% respectively over the period.

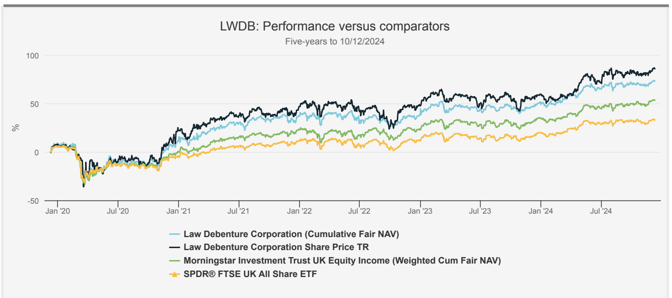
Another standout performer was Rolls-Royce, which experienced an earnings uplift driven by cost savings and an ongoing recovery in flying hours. Rolls-Royce is not a typical holding in traditional equity income portfolios given it does not pay out a dividend. However, LWDB's unique structure, notably the support it receives from the IPS business to its dividend, means the managers can invest in low or non-yielding opportunities. In our view, this strategy helps broaden the sources of income as well as enhance the trust's capital return potential.

On the downside, Vanquis Banking Group was a notable detractor. The company faced unexpected cost pressures, which negatively impacted earnings and weighed on its share price. Despite the challenges, the managers view Vanquis as undervalued, with good potential for re-rating under the new management, and have therefore maintained the position within the portfolio. AFC Energy also detracted from performance, primarily due to broader market factors rather than company-specific issues. The managers argue its share price was largely impacted by concerns stemming from the recent budget, particularly changes to inheritance tax relief, which created added pressure on AIM stocks, including AFC.

Whilst the trust's 12-month performance is encouraging, the managers emphasise longevity, aiming to deliver real growth in both capital and income over the long term rather than fixate on short-term numbers. Over the past decade, it has done just that, delivering NAV total returns of 142.0%, compared to its benchmark returns of 86.6%, and 7.9% compound annual growth of its **Dividend**. The IPS business has also demonstrated robust growth, delivering a five-year compound annual growth rate of 11.3% in net revenue and 8.7% in profit before tax. The valuation of its business has increased materially, reaching £185.1m in 2023, representing a 111.4% rise since 2018, or c. 13% annualised.

For the sake of completeness, we have included LWDB's five-year performance below. The trust has delivered NAV total returns of 73.0%, outperforming its benchmark return of 34.3% and the AIC UK equity income sector return of 53.1%.

Fig.3: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

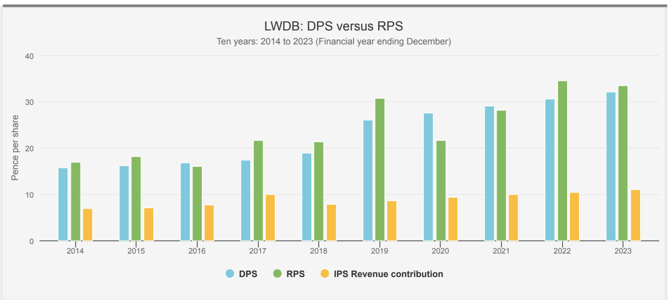
Dividend

In our view, one of the most distinctive features of LWDB, setting it apart from every peer in the sector, is its IPS business. Whilst we delve into this in greater depth in the **Portfolio section**, in short, IPS is a wholly owned business providing corporate services that help clients manage complex financial and legal obligations with impartial expertise. This business has been an integral driver of LWDB's dividend track record.

The chart below illustrates LWDB's robust dividend growth over the past decade, part of a 44-year streak of either maintaining or increasing dividends. The IPS business, represented by the yellow bar, has been instrumental in this success. Despite accounting for only c. 20% of NAV, it has funded roughly 34% of LWDB's dividends over the last decade. This unique business model has also acted as a stabilising force during periods of market volatility.

For example, whilst the trust's overall revenue per share declined in 2020, amid the pandemic which forced companies globally to cut or suspend dividends, the IPS business delivered growth. Its revenue contribution rose by 9.1%, climbing from 8.54p in 2019 to 9.35p per share in 2020.

Fig.4: DPS & RPS



Source: Morningstar

A similar pattern emerged in LWDB's most recent full financial year results, ending December 2023. Revenue per share from the investment portfolio fell from 24.06p to 22.41p per share, reflecting a 3.0% decline, largely due to lower special dividends from the mining and banking sectors. Despite this, the IPS business held strong, with net revenues growing 11.8%, and all three segments—corporate trust, pensions, and corporate services—reporting higher revenue growth than a year earlier.

In the first half of 2024, revenue returns per share from both the investment portfolio and the IPS business increased by 3.6% and 8.4%, respectively, prompting the board to raise the first two interim dividends to 8.0p per share, up 4.8% from the first half of 2023. LWDB's current reserves remain robust, covering approximately 1.2 times last year's dividend.

At the time of writing, LWDB offers a historical yield of 3.6%. Whilst this is lower than the AIC UK equity income sector average of 4.2% and slightly below the FTSE All-Share Index yield of 3.7%, we believe the trust's strong dividend track record, coupled with the IPS business's consistent contribution, makes its dividend profile appealing. For investors seeking steadier and more consistent dividend growth over the long term, we think LWDB presents a resilient and differentiated option.

Management

LWDB's investment portfolio is managed by two experienced portfolio managers, James Henderson and Laura Foll. James joined Henderson Global Investors (now Janus Henderson Investors) in 1983 as Director of UK Investment Trusts. He began working with LWDB's portfolio in 1994 and assumed lead management responsibility in 2003. In addition to LWDB, James manages Lowland Investment Company, Henderson Opportunities Trust, and Henderson UK Equity Income & Growth Fund. Given his extensive experience in the UK market and the overlap in market focus across these strategies, we believe his involvement in multiple mandates is well-managed.

Laura joined Janus Henderson Investors in 2009 and has worked with LWDB's portfolio since 2011, formally becoming a joint portfolio manager in 2019. She also serves as a portfolio within the Global Equity Income Team, a role she has held since 2014 and works closely with James across all their shared strategies, bringing complementary skills and perspectives to the management of LWDB.

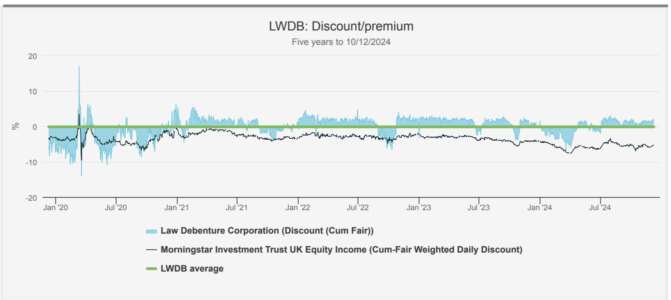
Whilst James and Laura manage LWDB's investment portfolio, the day-to-day management of the IPS part of LWDB is overseen by an executive management team comprising the CEO, COO, CFO, and General Counsel. Denis Jackson, the current CEO, and Trish Houston, the COO, sit on the board of LWDB as executive directors. They work alongside three non-executive directors, a senior independent director, and the chairman, Robert Hingley.

Discount

Discounts across the broader investment trust sector have widened over the past few years. A challenging market backdrop, spearheaded by geopolitical tensions and inflation has weighed heavily on investor sentiment, adding pressure on trusts to deliver strong performance. Additionally, decade-high interest rates have made easy-access savings accounts a more attractive, lower-risk alternative for many investors. However, LWDB has managed to somewhat circumnavigate this trend. At the time of writing, it's trading at a premium of 1.7%, compared to its five-year average discount of 0.2% and sector average of 3.7%.

Over the past five years, LWDB has predominately traded either at a premium or close to par, and when it has widened to a discount, it has typically been much narrower than the AIC UK equity income sector. We believe several factors have underpinned its premium rating, including a consistent track record of **Dividend** increases, strong relative **Performance**, a differentiated investment approach through its combination of the IPS business and investment **Portfolio**, and comparatively low costs (see **Charges**). Together, these attributes have continued to resonate strongly with investors, in our view, offering meaningful diversification within global portfolios and unique exposure to the UK market.

Fig.5: Discount



Source: Morningstar

The board is proactive in issuing shares when the trust trades on a premium and also runs a save-as-you-earn scheme that sees it issue new shares for employees to purchase. Whilst no shares were issued in the six months to June 2024 (its latest half-year results), the board issued 1,963,816, or 1.4% of shares, between the period-end and 10/12/2024. We note that issuing shares at a premium is not only additive to NAV but it also contributes to a lower OCF thanks to economies of scale. With a market capitalisation of just over £1bn, LWDB remains highly liquid, which makes it cheaper for investors to get their hands on shares and helps expand the shareholder register.

Charges

According to the latest factsheet, LWDB's ongoing charges figure (OCF) is 0.48%, which compares favourably to the weighted average OCF of 0.57% for the AIC UK equity income sector. The OCF includes a management fee charged at an annual rate of 0.30% on net assets, excluding the net assets of IPS. This is allocated 25% / 75% between the revenue and capital account and there continues to be no performance fee payable.

According to LWDB's latest Key Information Document (KID), its KID RIY stands at 0.62%. However, we note there are imminent regulatory changes around KID RIYs and a consensus on how they should be calculated has not yet been formed.

ESG

The managers integrate ESG considerations into their investment process as part of a broader commitment to responsible investing. However, they are not positioned as an ESG-focussed fund, nor make any claims to be fully sustainable-focussed. Instead, ESG factors are assessed as a fundamental component of investment risk analysis, evaluating risks that could materially impact a company's prospects, financial condition, or operational performance.

The managers adopt a more qualitative and non-constrained ESG approach. This means there are no hard-and-fast rules preventing investment in any company, with the managers ensuring those with weaker ESG risk profiles are not automatically excluded but are subject to thorough scrutiny. Whilst they do not automatically rule out such investments, they will divest or choose not to invest in companies where ESG risks are mismanaged or where the overall risk-reward balance is deemed unattractive. Proactive engagement plays a crucial role in this, deepening their understanding of each company, and strengthening investment conviction, whilst also enhancing the managers' ability to foster positive change by addressing key ESG issues directly with management.

Beyond the investment portfolio, LWDB's IPS business has also steadily increased its focus on ESG issues. A significant step was taken in 2020, with the move to more sustainable office space, enabling the digitisation of decades of paperwork and the adoption of a paperless working model, which is helping reduce its already small carbon footprint.

As of October 2024, Morningstar scored LWDB two out of five globes on its sustainability scoring system, which is scored across open- and closed-ended funds in the UK equity income sector.

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