

8 April 2010

## The Merchants Trust

12 Months Ending	Total Share Return* (%)	Total NAV Return* (%)	Total Return Benchmark * (%)
05/04/07	+14.5	+11.3	+9.4
05/04/08	(14.4)	(12.6)	(3.6)
05/04/09	(37.5)	(41.7)	(29.3)
05/04/10	+53.4	+63.5	+48.2

Note: \* 12-month rolling discrete performance.

### Investment summary: Quarterly income, defensively positioned with a 6.2% yield

With its recent results announcement The Merchants Trust (MRCH) has once again increased its total year-on-year dividend, providing investors with 28 years of uninterrupted dividend growth. Traditionally the trust has maintained or increased the quarterly dividend. After 18 months with no increase, the board has decided to raise the final quarterly dividend, drawing partly on revenue reserves, for the year ending 31 January 2010, by 0.1p to 5.7p. This reflects the board and manager's views on the long-term sustainability of MRCH's dividend, as well as their confidence that the underlying portfolio will continue to see a recovery in its income generation from a low base. MRCH is managed using a value-driven investment style and remains defensively positioned.

### Investment strategy: Higher yielding FTSE 100 companies

The trust has a significant income requirement. To help meet its dividend objectives, the manager looks to invest mainly in higher yielding FTSE 100 companies while employing a significant level of gearing, currently 26%, to enhance returns over the longer term. Management will look to invest in companies that offer at least a market yield, on an 18-month view. The manager selectively writes covered calls to generate additional income for the trust.

### Sector outlook – Prospects for dividend growth

The manager considers that while significant challenges and risks remain, the outlook has improved considerably. The developed world has moved out of recession, albeit with the assistance of an unprecedented economic stimulus, although the manager expects the recovery to be muted, as a result of the increased indebtedness of consumers and governments. Corporate balance sheets, cash flows and profits have improved and the manager sees the potential for dividend growth going forward.

### Valuation

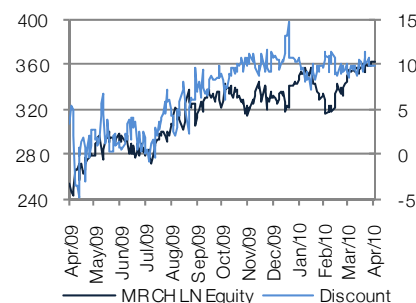
The current discounts of 9.9% (debt valued at par) and 5.8% (debt valued at market) are above MRCH's five-year averages of 8.4% and 1.9% respectively and, as such, we believe the trust potentially offers value. The yield also remains strong, and MRCH may continue to be attractive to investors looking for regular income at an attractive yield, or those looking for a geared exposure to the FTSE 100.

Price	364.7p
Market Cap	£376.4m
AUM	£540.1m
NAV	404.85p*
Discount to NAV	9.9%*
NAV	387.16p**
Discount to NAV	5.8%**
Yield	6.2%

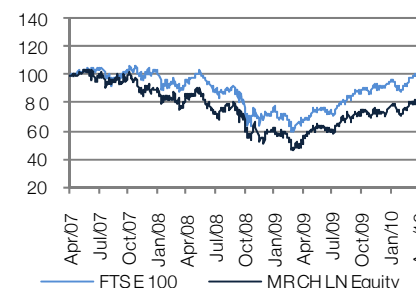
\* Adjusted for debt at par value and excluding income, as at 1 April 2010.

\*\* Adjusted for debt at market value, excluding income, as at 1 April 2010.

#### Share price/discount graph



#### 3-year cumulative performance graph



#### Share details

Code	MRCH
Listing	FULL
AIC Sector	UK Growth & Income
Shares in issue	103.2m

#### Price

52 week	High	Low
Price	367.70p	249.50p
NAV	404.68p	255.03p

#### Analyst

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## Exhibit 1: Trust at a glance

Investment objective and fund background				Developments last quarter	
The investment objective of The Merchant's Trust is to provide an above-average level of income and income growth together with long-term growth of capital through a policy of investing mainly in higher yielding UK FTSE 100 companies.				19 February 2010: 3rd interim dividend of 5.6p paid. 8 April 2010: 4th interim div of 5.7p announced. 8 April 2010: Annual report released.	
Forthcoming		Capital structure		Fund details	
AGM	May 2010	Total expense ratio	0.45%	Group	Allianz Global Investors/RCM (UK)
Preliminary	April 2010	Net Gearing	26%	Manager	Simon Gergel
Year end	31 January	Annual mgmt fee	See pg 7	Address	155 Bishopsgate, London EC2M 3AD
Dividend paid	Quarterly	Performance fee	None		
Launch date	February 1889	Trust life	Indefinite	Phone	0800 317 573
Wind-up date	N/A	Loan facilities	See pg 7	Website	www.merchantstrust.co.uk
Dividend policy and history			Share buyback policy and history		
Quarterly dividends paid in February, May, August and November. MRCH aims to maintain a high and growing dividend.			Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 10% of issued share capital.		
<p>DPS (p)</p> <p>■ Ordinary Dividends ■ Special Dividends</p>			<p>■ Number of shares ('000s) — Total cost (£m)</p>		
Shareholder base (as at 7 March 2010)			Geographic distribution of portfolio (as at 28 February 2010)		
<p>■ Retail investors (80.3%) ■ Insurance companies (6.8%) ■ Mutual funds (5.8%) ■ Pension funds (3.5%) ■ Charities (2.2%) ■ Investment trusts (1.0%) ■ Trading accounts (0.5%)</p>			<p>■ UK Equities (98.5%) ■ Cash (1.5%)</p>		
Portfolio composition (as at 28 February 2010)			Portfolio composition (as at 28 August 2009)		
<p>■ Royal Dutch Shell (8.3%) ■ GlaxoSmithKline (7.6%) ■ Vodafone (7.3%) ■ BP (6.6%) ■ HSBC Holdings (6.2%) ■ BAT (4.2%) ■ AstraZeneca (4.1%) ■ BAE Systems (4.1%) ■ Scot &amp; Southern (3.8%) ■ Unilever (3.7%) ■ Other Quoted (42.6%) ■ Cash (1.5%)</p>			<p>■ Royal Dutch Shell (8.9%) ■ Vodafone (8.2%) ■ GlaxoSmithKline (7.8%) ■ HSBC Holdings (7.1%) ■ BP (6.6%) ■ BAE Systems (3.8%) ■ Scot &amp; Southern (3.5%) ■ BHP Billiton (3.3%) ■ BAT (3.1%) ■ AstraZeneca (3.1%) ■ Other Quoted (42.4%) ■ Cash (2.2%)</p>		

Source: The Merchants Trust/Edison Investment Research

## Exhibit 2: Holdings in portfolio themes at a glance

BAE Systems		Code: BA LN	Market Cap: £13,180.6m
	Div Yield (trailing 12 mths)	4.53%	
	Industry/Sector	Aerospace & Defense/Defense	
Listing	FULL		
Website	www.baesystems.com		
<p>At 4.1% of the portfolio, BAE Systems is one of MRCH's core holdings. This reflects management's views that the valuation of BAE is attractive; and, as a bedrock, MRCH currently retains a number of large core holdings in strong multinational businesses that are well financed and offer good yields.</p>			
Balfour Beatty		Code: BBY LN	Market Cap: £2,013.0m
	Div Yield (trailing 12 mths)	4.30%	
	Industry/Sector	Construction & Mtrls/Heavy Const.	
Listing	FULL		
Website	www.balfourbeatty.co.uk		
<p>Balfour Beatty (BBY) is one of the UK's largest construction companies. It is organised around four key business areas: professional services, construction services, support services and infrastructure investments. MRCH's BBY holding, at 1.0% of the portfolio, reflects management's view that while BBY operates in a cyclical industry, it has leading market positions, a strong balance sheet and good long-term growth prospects.</p>			
Unilever		Code: ULVR LN	Market Cap: £25,372.1m
	Div Yield (trailing 12 mths)	4.63%	
	Industry/Sector	Food Producers/Food Products	
Listing	FULL		
Website	www.unilever.com		
<p>MRCH's Unilever holding, at 3.7% of the portfolio, reflects the manager's view that certain management turnaround and recovery situations are attractive. Unilever's restructuring has been ongoing since 2004, reflecting the size and nature of the business. However, the manager believes the fruits of this process are beginning to show, that there is headroom on the balance sheet and that the company is well positioned moving forward.</p>			
Hammerson		Code: HMSO LN	Market Cap: £2,753.3m
	Div Yield (trailing 12 mths)	3.89%	
	Industry/Sector	Real Estate Inv. Trusts/Retail REITs	
Listing	FULL		
Website	www.hammerson.com		
<p>Hammerson, at 1.1% of the portfolio, is one of a number of holdings that provides MRCH with exposure to high yielding asset classes, such as corporate bonds and real estate, that management finds increasingly interesting. Having not owned real estate companies for 12 months, management took advantage of sectoral weakness in February 2009, buying Hammerson when it announced a rights issue to strengthen its balance sheet.</p>			
Bunzl		Code: BNZL LN	Market Cap: £2,428.2m
	Div Yield (trailing 12 mths)	3.12%	
	Industry/Sector	Support Services/Business Support	
Listing	FULL		
Website	www.bunzl.com		
<p>Active in 23 countries, BUNZL is an international distribution and outsourcing company with a strong presence in Europe, America and Australasia. The sixth-largest net purchase during the last financial year, MRCH's Bunzl holding at 1.2% of the portfolio, reflects the manager's belief that the market's shift in focus from defensive qualities to operational and financial gearing led to an opportunity to buy quality growth companies at good valuations.</p>			

Source: Thomson Datastream/Edison Investment Research

## Fund profile

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Launched in February 1889, MRCH is the oldest trust in the RCM stable. It is an income trust that pays quarterly dividends and has provided 28 years of uninterrupted dividend growth. Simon Gergel, head of RCM's Value Investment Style team, has led the management of MRCH since April 2006.

## The fund manager: Simon Gergel

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### Manager's view

The manager believes the last 18 months have offered some of the most challenging conditions in equity markets but, compared to a year ago, the outlook is now far healthier. The developed world, aided by significant stimuli, has moved out of recession. Corporate profits, cash flows and balance sheets have improved and there are now prospects for significant dividend growth. Despite this, the manager believes economic challenges and risks remain significant. Governments and central banks have a difficult balance to strike between the current need for loose monetary and fiscal policy, to stimulate the recovery, versus the need to raise taxes and control budget deficits. Despite this, the manager's view is that the developed world will continue to recover and that, with capacity constraints not expected before 2013, the risk of inflation remains low. However, he believes growth will be below trend for several years as governments and consumers seek to reduce their levels of indebtedness. The following are key themes currently employed in the management of the portfolio:

- The previous theme of purchasing cyclical survivors (market leaders, in cyclical industries, with strong balance sheets that should survive a protracted downturn and emerge with improved competitive positions) has been largely played out.
- Retain large core holdings in large well financed multinational businesses with good yields – GlaxoSmithKline, Royal Dutch Shell, Vodafone, Scottish & Southern Energy, BAE Systems and National Grid.
- Certain management turnaround and recovery situations are now attractive – Unilever, Compass, Melrose, International Personal Finance and Daily Mail and General Trust.
- High yielding depressed asset classes are now recovering. Companies with exposure include Aviva, Legal & General, Hammerson and Ashmore.
- Continue to limit exposure to mining (because of the effects of a muted recovery) and banks (because of concerns relating to future dividends and government interference).
- Purchase high quality growth stocks on modest valuations with reasonable dividend yields – Reckitt Benckiser, Bunzl and WPP.
- Seek companies with exposure to emerging market consumers – British American Tobacco, WPP, International Personal Finance, Unilever and Ashmore.
- Remain cautious on 'Big Ticket' corporate expenditure (because of the effects of a muted recovery), however, increasingly positive on day-to-day expenditure such as advertising.

## Asset allocation

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### Overview

MRCH has 46 equity investments. The top 10 holdings account for 55.9% of the portfolio, cash accounts for 1.5% of the portfolio, with the remaining 36 equity investments accounting for 42.6% of the portfolio. As displayed in Exhibit 3, MRCH's asset allocation can differ substantially to that of the benchmark index, reflecting the actively managed nature of the trust. As shown in Exhibit 1, apart from the 1.5% of the portfolio held as cash, the remaining 98.5% of the portfolio is fully invested in the UK. It should be noted that, during the year ending 31 January 2010, the concentration of the

portfolio has been reduced. The top four holdings, which accounted for c 39% at the beginning of the financial year, accounted for c 31% at the close.

## Derivatives strategy

To protect the portfolio in the event of a substantial fall in the market, the board announced in the interim report that it had agreed and began a strategy of writing covered call options, on a limited number of stocks within the equity portfolio, and using the proceeds to purchase out of the money put options on the FTSE 100 index. The put options were designed to 'insure' against a significant fall in the market. From January 2010 the board, believing that the risk of a systemic failure of the financial system had reduced, decided to suspend the purchase of further put options. However, it agreed that the manager will continue to write covered call options to generate additional income for the trust, with a maximum exposure of 20% of gross assets at the time of writing.

## Underweights

MRCH is underweight technology, consumer goods, financials, oil & gas and basic materials. Although MRCH's overall financials underweight is marginal, within this the portfolio remains significantly underweight banks. This reflects a lack of dividend yields as well as the manager's cautious view on the prospects for the sector. Within financials, the banks underweight is counterbalanced by the trust's holdings in other financial services.

## Overweights

MRCH's largest overweight is utilities, at 2.6 times the benchmark allocation. This is a defensive position, as is the overweight in healthcare. MRCH continues to have significant overweights in industrials, primarily due to holdings in aerospace and defence, as well as telecommunications. MRCH has a marginal overweight in consumer services.

**Exhibit 3: Sector allocations, as at 28 February 2010**

	Trust weight (%)	Benchmark weight (%)	Trust active weight (%)	Trust weight/benchmark weight
Utilities	9.8	3.8	+6.1	2.60
Industrials	10.4	4.5	+5.9	2.33
Healthcare	11.7	8.7	+3.0	1.34
Telecommunications	9.5	6.6	+2.9	1.44
Consumer services	8.7	8.5	+0.2	1.03
Technology	0.0	0.7	(0.7)	0.00
Consumer goods	10.4	12.2	(1.8)	0.85
Financials	19.6	21.8	(2.2)	0.90
Oil & gas	14.9	20.3	(5.3)	0.74
Basic materials	3.6	12.8	(9.3)	0.28
Other assets/liabilities inc cash	1.5	0.0	+1.5	N/A
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>	<b>N/A</b>

Source: The Merchants Trust/Edison Investment Research

## Current portfolio positioning

As Exhibit 3 illustrates, the investment manager has given MRCH a more defensive allocation than the benchmark by overweighting defensive and underweighting cyclical sectors. However, ultimately MRCH's portfolio would benefit from an increase in domestic and global economic activity.

## Top holdings

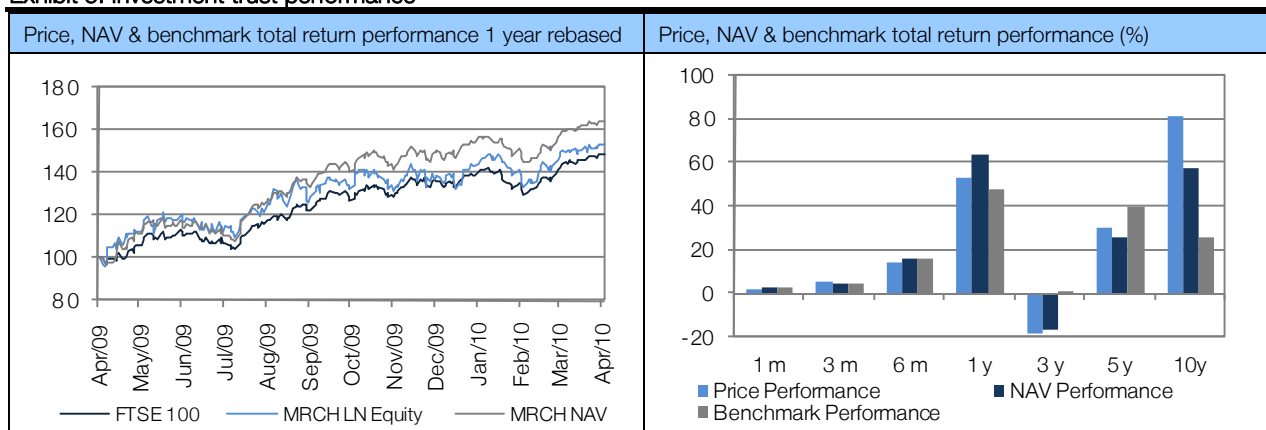
During the past 12 months the benchmark index has risen 48.2%, from a depressed base. As Exhibit 4 shows, seven of MRCH's current top 10 holdings have underperformed the benchmark, which reflects the bounce in cyclical and financials, and the more muted performance of defensives and high yielders, as the market rallied during this period.

**Exhibit 4: 10 largest equity holdings as at 26 February 2010**

Note: FTSE 100 Index one-year performance = +48.2%.

Holding	%	One year total return price performance (%)	Performance relative to FTSE 100 Index (%)
Royal Dutch Shell 'B'	8.3	+28.7	(19.5)
GlaxoSmithKline	7.6	+26.0	(22.2)
Vodafone Group	7.3	+29.3	(18.9)
BP	6.6	+47.2	(1.0)
HSBC Holdings (UK)	6.2	+60.6	+12.3
British American Tobacco	4.2	+52.5	+4.3
AstraZeneca	4.1	+29.9	(18.3)
BAE Systems	4.1	+17.9	(30.3)
Scottish & Southern Energy	3.8	+7.8	(40.5)
Unilever	3.7	+56.2	+8.0
<b>Total</b>	<b>55.9</b>		

Source: Thomson Datastream/The Merchants Trust/Edison Investment Research

**Recent performance****Exhibit 5: Investment trust performance**

Source: Thomson Datastream/Edison Investment Research

As Exhibit 5 illustrates, MRCH's performance has tended to follow that of the benchmark index. Longer-term investors have benefitted from outperformance, in terms of both price and NAV total return, over the 10-year time horizon. However, the underperformance, apparent in the three- and five-year time horizons, reflects MRCH's investment policy, to remain substantially fully invested and geared. This affected performance during falling markets although, more recently, has assisted with MRCH being substantially geared during rising markets. MRCH has outperformed in terms of NAV total return over the one-year time period and in terms of price total return over the three-month and one-year time periods. It should also be noted that MRCH is predominantly held by private investors, as illustrated in Exhibit 1, many of whom are believed to hold it for its regular dividend and robust yield. When compared to its peers in terms of dividend yield, MRCH ranks third out of 19, as shown in Exhibit 7.

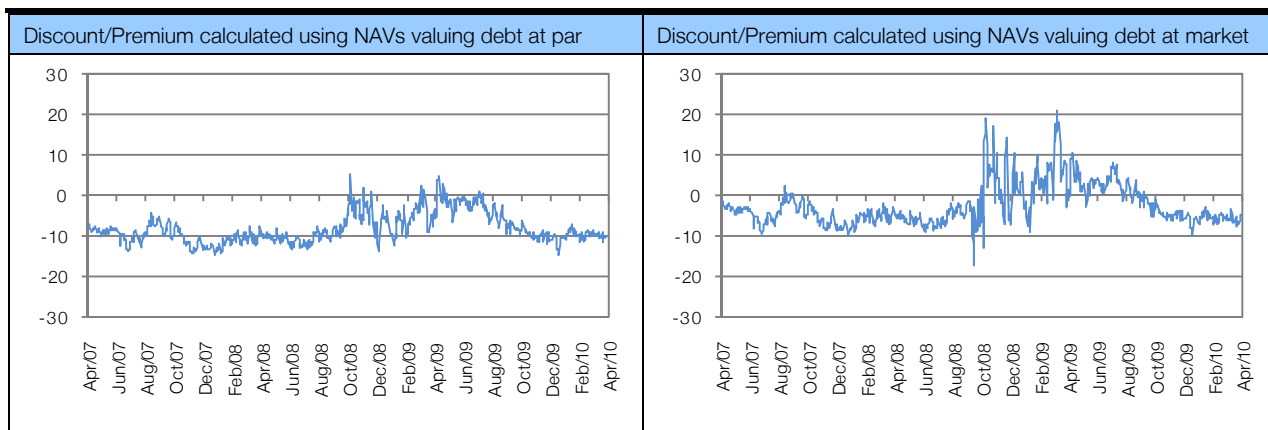
**Discount/Premium**

MRCH has the authority, renewed annually, to allot up to 10% or make market purchases of up to 14.99% of issued share capital, which provides the manager with a mechanism to influence the discount, although an explicit commitment to maintain the discount at a particular level has not been provided. Exhibit 6 illustrates the discount – the first graph is produced using NAVs calculated valuing debt at par and the second values debt at market. It can be seen under both measures that during the six months from September 2008 the discount narrowed and its volatility increased, reflecting the financial climate. During the last year, and particularly the last six months, the discount has widened while its volatility has decreased substantially, so that MRCH now exhibits characteristics

comparable with pre-September 2008 levels. With MRCH frequently trading at a premium during the first part of the year, then at a moderate discount during the last eight months, there has been no need for the trust to use its repurchase authority. As a result, there have been no repurchases during the past 12 months, as illustrated in Exhibit 1. With MRCH trading at discounts c 6% and debt at market value, we do not anticipate use of the repurchase authority. The discount is not unduly high and we do not believe the manager will wish to increase gearing.

#### Exhibit 6: Discount/premium over three years

Note: Positive values indicate a premium; negative values indicate a discount.



Source: Thomson Datastream/Edison Investment Research

## Capital structure

At first glance, MRCH appears to have a complicated capital structure that, in addition to its 25p ordinary shares, comprises 3.65% cumulative preference stock, 4% perpetual debenture stock, 5.88% secured bonds expiring 2029, a fixed interest rate loan and a stepped interest rate loan. However, MRCH is in fact a conventional investment trust. It only has one class of ordinary shares and the remaining instruments are all means of gearing up the trust. MRCH's borrowing are not allowed to exceed its called up share capital and reserves, allowing MRCH considerable flexibility in choosing its gearing policy. The AIC currently calculates that MRCH has gross gearing of 27% and net gearing of 26%. The management fee is 0.35% per year of the value of the assets, calculated quarterly after the deduction of any current liabilities, any loans under one year and any funds within the portfolio managed by RCM. There is no performance fee and the management contract can be terminated at one year's notice. The total expense ratio (TER) was 0.45% for the year ended 31 January 2010 (0.58% for the year ended 31 January 2009), which reflects the economies of scale offered by a trust of this size. As illustrated in Exhibit 7, MRCH's TER ranks fourth out of 19 when compared to its peers. MRCH does not have a fixed life and no specific mechanism exists to wind up the company.

## Dividend policy and record

Dividends are paid quarterly and a key objective is to maintain a high and growing dividend, ie growth in total dividend, year-on-year. With the announcement of its final quarterly dividend, for the year ending 31 January 2010 of 5.7p and thus a total dividend for the year of 22.5p, MRCH has met this objective and provided 28 years of uninterrupted dividend growth since 1982. During this period MRCH increased its dividend by a total of 987%, an average yearly increase of 9.1%, or 8.9% annualised, which is substantially above the rate of inflation. Because of its significant dividend obligations, the board carefully models dividend flows and reviews the income outlook six times annually. Based on this analysis the board and management have considered it appropriate to raise the final quarterly dividend, for the year ending 31 January 2010, to 5.7p. The recent full-year results indicate that while the dividend has been paid partly out of reserves, MRCH has revenue reserves

equivalent to 62% of the total payment to support the dividend if required. MRCH has a policy of investing in companies that provide at least a market yield. However, the ability to maintain the dividend will depend on the performance of the underlying holdings. The concerns previously highlighted in relation to the dividend are 1) the threat of a prolonged recession; 2) financial markets fall substantially, exacerbating pension deficits; 3) the US dollar weakens, eroding sterling cash flows of FTSE 100 companies with significant overseas exposures; and 4) the oil price falls and stays below \$40 a barrel putting a significant amount of the portfolio's dividends at risk. The manager considers that only the US dollar has moved against the trust, and this has lessened recently. Overall, the manager is not unduly concerned and expects dividend growth in the broader market.

## Peer group comparison

As Exhibit 7 illustrates, the AIC sector 'UK Growth and Income' is a comprehensive peer group with 19 constituents. Within this peer group, MRCH ranks seventh over a one-year period, 13th over a three-year period and 10th over a five-year period when considering share price total return.

Exhibit 7: UK growth and income sector, as at 5 April 2010

Company	Share price total return on £100			Volatility (Five year)	Total Expense Ratio	Disc/ Prem	Net Gearing (100 = no gearing)	Dividend yield
	One year	Three years	Five years					
<b>Sector average</b>	<b>147.9</b>	<b>92.6</b>	<b>137.1</b>	<b>25.6</b>	<b>0.74</b>	<b>(5.6)</b>	<b>113</b>	<b>4.82</b>
Merchants Trust	153.4	82.0	130.4	28.8	0.59	(5.5)	126	6.19
British & American	146.6	73.8	103.9	25.8	2.07	(18.1)	135	8.57
City of London	146.5	98.7	150.1	27.5	0.43	(2.0)	107	4.80
Dunedin Income Growth	155.8	82.6	121.4	26.8	0.68	(10.1)	108	5.20
Edinburgh Investment	139.4	97.9	155.0	25.1	0.51	(1.6)	124	5.13
F&C Capital & Income	141.4	99.6	137.1	20.4	0.96	+0.7	108	3.83
Finsbury Growth & Income	157.5	91.7	138.7	19.6	1.07	(4.8)	102	3.30
INVESCO Income Growth	148.0	84.9	135.6	20.6	1.04	(10.5)	111	5.00
JPMorgan Elect Managed Income	146.5	77.9	110.5	17.4	0.92	(0.4)	99	5.26
Lowland	160.2	66.0	108.5	26.2	1.06	(13.0)	114	4.23
Murray Income	147.4	92.1	136.5	27.1	0.83	(7.7)	104	4.90
Perpetual Income & Growth	126.9	97.4	136.2	26.5	0.95	(5.6)	120	4.02
Schroder Income Growth	128.2	95.0	129.3	21.2	1.04	(8.8)	98	4.89
Securities Trust of Scotland	148.6	82.9	114.7	22.9	0.68	(10.0)	113	5.48
Shires Income	189.5	79.9	108.2	28.6	1.20	(3.3)	114	8.09
Standard Life Equity Income	136.4	96.1	144.9	18.5	0.97	(10.0)	111	4.22
Temple Bar	150.0	106.8	140.7	27.0	0.51	(6.4)	105	4.26
Troy Income & Growth	229.9	57.0	88.7	28.8	1.62	(1.1)	100	3.73
Value and Income	193.7	75.5	111.8	23.9	1.30	(22.3)	131	4.48

Source: The Association of Investment Companies

## The board

All directors are non-executive and independent of the investment manager. They are: HA Stevenson (chairman), RA Barfield, Sir James Sassoon, MJE McKeon, HE Staunton and SJ Fraser (directors).

Mr Stevenson retires at the 2010 AGM; Sir James Sassoon is expected to replace him as chairman.

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