The Merchants Trust

New benchmark, same focus on income/growth

Investment trusts

The Merchants Trust (MRCH) aims to generate a high and growing level of income with the potential for long-term capital growth from a relatively concentrated, actively managed portfolio of UK equities. At end-January 2017, the benchmark was changed from the FTSE 100 index to the FTSE All-Share index, reflecting the evolution of the portfolio over several years towards a lower exposure to large-cap equities, giving the manager the opportunity to select from a broader range of dividend-paying companies. MRCH has a competitive yield compared to the UK stock market and also versus its peers. It has a progressive dividend policy and has increased its annual dividend for the last 35 consecutive years.

12 months ending	Share price (%)	NAV (%)	Blended benchmark* (%)	FTSE All-Share (%)	FTSE 100 (%)
31/05/13	46.7	42.4	28.4	30.1	28.4
31/05/14	12.6	9.5	7.8	8.9	7.8
31/05/15	1.3	6.3	5.7	7.5	5.7
31/05/16	(13.2)	(12.0)	(7.2)	(6.3)	(7.2)
31/05/17	27.1	25.1	26.3	24.5	25.5

Source: Thomson Datastream. Note: All % on a total return basis in GBP. *Blended benchmark is FTSE 100 index until 31 January 2017 and FTSE All-Share index thereafter.

Investment strategy: Three pillars to the process

The manager is able to draw on the broad resources of Allianz Global Investors (AllianzGI); he constructs MRCH's portfolio predominantly on a bottom-up basis based on three elements: fundamentals, valuation and themes. Fundamental analysis focuses on the competitive position of the business and its financial strength; valuation considerations are based on absolute and relative metrics and dividend yield; and themes take into account the macroeconomic environment and the stage of the business cycle, along with industry and secular trends. The portfolio is diversified across industries and typically holds c 40-50 positions in primarily larger-cap UK equities. Selective writing of covered calls is used to enhance income, and gearing of between 10-25% of net assets at the time of drawdown is permitted.

Market outlook: Attractive level of income

Despite a recent period of strong equity returns, UK equities still offer an attractive dividend yield. The outlook for dividend growth is positive as company fundamentals improve, especially in the more cyclical areas where some companies were forced to cut their dividends in an environment of weak commodity prices. For investors seeking exposure to UK equities, a fund focused on a high and growing level of income with the potential for capital growth may be of interest.

Valuation: Discount narrowing over the near term

MRCH's current 6.4% share price discount to cum income NAV with debt at market value is modestly wider than the 6.2% average discount of the last 12 months. It is also wider than the averages of the last three, five and 10 years (range of 2.2% to 3.7%). The trust has a progressive dividend policy; its annual dividend has grown for 35 consecutive years and over time it has grown at a higher rate than UK inflation. MCRH currently yields 5.1%.

12 June 2017

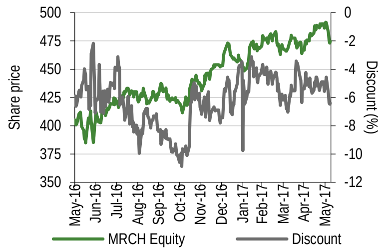
Price	**474.8p**
Market cap	**£516m**
AUM	**£674m**

NAV*	493.6p
Discount to NAV	3.8%
NAV**	507.2p
Discount to NAV	6.4%

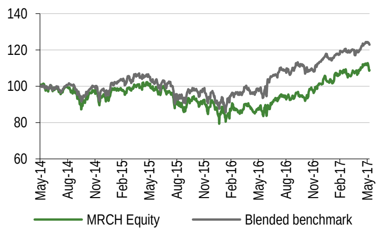
*Excluding income. **Including income. As at 8 June 2017.

Yield	5.1%
Ordinary shares in issue	108.7m
Code	MRCH
Primary exchange	LSE
AIC sector	UK Equity Income
Benchmark	FTSE All-Share index

Share price/discount performance



Three-year performance vs index



52-week high/low	491.5p	384.8p
NAV** high/low	517.4p	393.5p

**Including income.

Gearing

Gross*	19.7%
Net*	17.6%

*As at 30 April 2017.

Analysts

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The Merchants Trust is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

The Merchants Trust's investment objective is to provide an above-average level of income and income growth, together with long-term growth of capital through investing mainly in higher-yielding large-cap UK companies. Since 1 February 2017, the benchmark is the FTSE All-Share index.

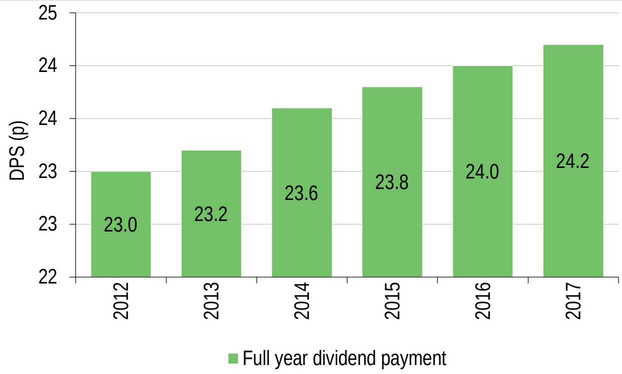
Recent developments

- 27 March 2017: Annual report to 31 January 2017. NAV TR +14.9% versus benchmark TR +21.4%. Share price TR +15.1%.
- 30 January 2017: Retirement of non-executive director Mike McKeon; the role of senior independent director has been assumed by Sybella Stanley.
- 18 January 2017: Announcement of a change in the benchmark from FTSE 100 index to FTSE All-Share index.
- 16 January 2017: Third interim dividend of 6.1p declared.

Forthcoming		Capital structure		Fund details	
AGM	May 2018	Ongoing charges	0.63%	Group	Allianz Global Investors
Interim results	September 2017	Net gearing	17.6%	Manager	Simon Gergel
Year end	31 January	Annual mgmt fee	0.35%	Address	199 Bishopsgate, London, EC2M 3TY, UK
Dividend paid	Quarterly	Performance fee	None		
Launch date	February 1889	Trust life	Indefinite	Phone	+ 44 (0)800 389 4696
Continuation vote	None	Loan facilities	See page 7	Website	www.merchantstrust.co.uk

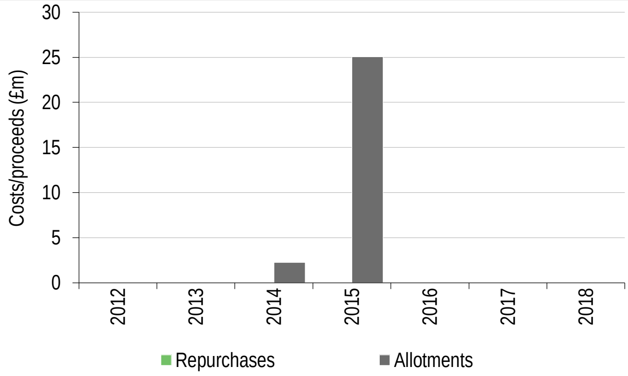
Dividend policy and history (financial years)

Dividends are paid quarterly in August, November, February and May. The annual dividend has increased for 35 consecutive years.

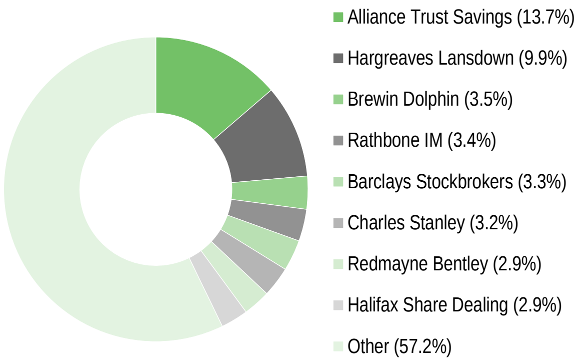


Share buyback policy and history (financial years)

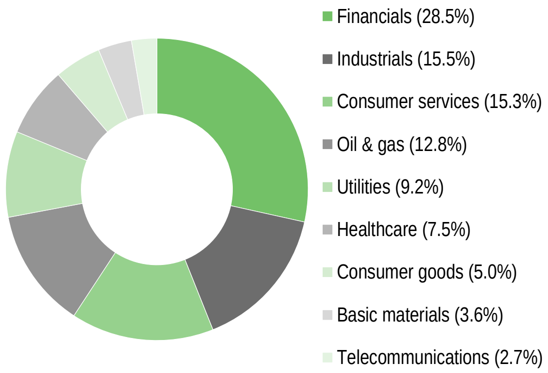
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 30 April 2017)



Portfolio exposure by sector (excluding cash, as at 30 April 2017)



Top 10 holdings (as at 31 May 2017)

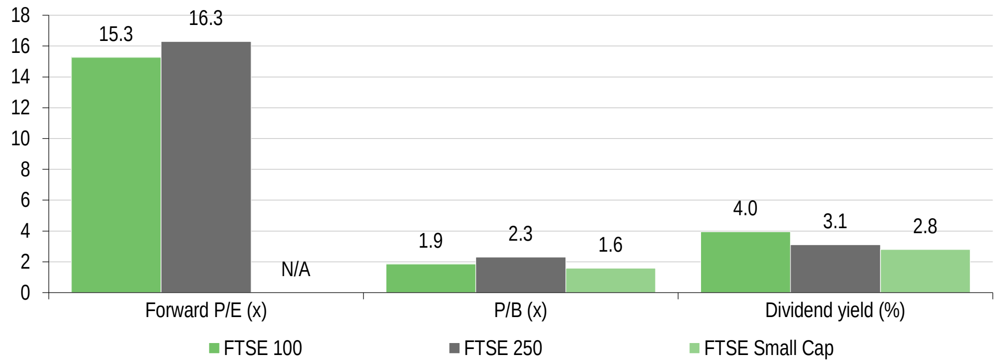
		Portfolio weight %	
Company	Sector	31 May 2017	31 May 2016*
GlaxoSmithKline	Healthcare	7.7	7.5
Royal Dutch Shell 'B' Shares	Oil & gas	7.3	6.9
HSBC	Banks	5.7	5.6
BP	Oil & gas	5.4	4.7
Lloyds Banking Group	Banks	3.3	4.1
UBM	Media	3.3	4.9
Standard Life	Insurance	2.9	N/A
SSE	Utilities	2.8	2.7
Prudential	Insurance	2.7	N/A
BHP	Mining	2.6	N/A
Top 10		43.6	46.1

Source: The Merchants Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in May 2016 top 10.

Market outlook: Positive backdrop for UK equities

UK equities rallied strongly during 2016 (the FTSE All-Share index had a total return of 16.8%), helped by sterling weakness, which boosted the earnings of companies with unhedged overseas operations. So far in 2017, UK shares have continued their upward move, hitting a series of new highs. Exhibit 2 shows the valuation of UK indices. Despite a rerating in recent months, with the forward P/E multiple of the FTSE 100 index rising by 0.5 points to 15.3x and the FTSE 250 forward earnings multiple rising by 1.2 points to 16.3x, dividend yields of 4.0% for large-cap companies and 3.2% for mid-cap companies remain relatively attractive versus UK government bond yields of c 1.0%. In addition, in aggregate, earnings estimate revisions for UK companies are positive, providing a supportive backdrop.

Exhibit 2: Valuation metrics for FTSE 100, 250 and Small Cap indices (as at 1 June 2017)



Source: Edison Investment Research, Bloomberg

Fund profile: Focus on high and growing income

Launched in February 1889, MRCH is one of the oldest LSE-listed investment trusts. It aims to generate a high and growing level of income with the potential for long-term capital growth. Since 2006, MRCH has been managed by Simon Gergel, who is AllianzGI's chief investment officer for UK equities. He runs a relatively concentrated portfolio of c 40-50 positions. Since end-January 2017, MRCH has been benchmarked against the FTSE All-Share index (previously the FTSE 100 index). No single asset may exceed 15% and the portfolio must be invested across at least five sectors with no one sector above 35%. Gearing of 10-25% of net assets is permitted (at the time of drawdown). MRCH pays one of the highest dividend yields in the AIC UK Equity Income sector and its annual dividend has increased for the last 35 consecutive years. To maintain the record of dividend growth, reserves have been used when necessary.

The fund manager: Simon Gergel

The manager's view: Still finding investment opportunities

The manager argues that the UK stock market still offers reasonable value despite hitting new highs; he notes that in absolute terms the FTSE 100 index is only c 10% higher than it was at the end of 1999. He suggests that there are a number of companies offering good value and that the yield on the FTSE All-Share index of c 3.75% compares favourably with government bond yields of c 1.0%; however, he does acknowledge that in aggregate, UK equities are not as cheap as they were and there are macro risks such as the Brexit negotiations. Gergel notes that oil companies reported good Q117 earnings results. He says that the major oil companies are starting to generate cash: for example, Royal Dutch Shell, having cut costs in response to a lower oil price, was able to cover its capex and dividends for the first time in several years. The manager has a positive outlook for other select mega-cap companies such BP, GlaxoSmithKline and HSBC. He argues that HSBC has undertaken some interesting transactions, such as the sale of its peripheral assets in Brazil, and a change in the way that its Chinese subsidiary is accounted for has led to an increase in HSBC's capital base. As a result, analysts have more confidence in the ability of HSBC to pay and grow its dividend.

Asset allocation

Investment process: Bottom-up stock selection

The manager adopts a rigorous bottom-up, high-conviction stock selection process based on three elements: fundamentals, valuation and themes. Fundamental analysis includes an assessment of a company's competitive position, financials and corporate governance, valuations are considered on both absolute and relative bases and themes take into account the macroeconomic backdrop, the stage of the business cycle and industry/secular trends. Gergel explains that while MRCH invests in an actively managed portfolio of primarily large-cap UK equities, the portfolio does not just offer exposure to the UK economy. The majority of UK companies have overseas operations, so investing in their shares affords exposure to wider geographies, but within the robust UK legal framework and strong corporate governance regime.

Stocks are sold if valuation targets are reached, if the original investment thesis is called into question, or if a better investment opportunity becomes available. Two recent examples were Hostelworld and BT. Hostelworld was purchased at its November 2015 IPO for 185p per share. Having appreciated significantly, the manager considered that its shares were no longer attractively valued; the final part of the position was sold at a share price in excess of 300p. The sale of BT shows the rigour and quick response in MRCH's investment process; the stock was sold on the day that it announced a profit warning. The manager believes that the original buy thesis of improving cash flow at BT no longer holds true, so the position was sold and the company has subsequently said that it will be lowering guidance for its dividend growth, which the manager sees as a significant event. As well as the UK equity team, the manager is able to draw on the wide resources of AllianzGI, including its Grassroots™ market research product, which may help him form his investment decisions. A recent report on portfolio holding Inmarsat found that in a survey of 15 maritime distributors or installers of Inmarsat equipment, 14 out of 15 distributors think their relationship with Inmarsat is either satisfactory or very satisfactory.

Current portfolio positioning

As shown in Exhibit 3, MRCH's portfolio weighting to the largest UK equities represented in the FTSE 100 index has continued to reduce. The manager explains that over the last decade, exposure to the FTSE 100 has declined from c 90% to the current level of c 60%. Within that index, the top 10 companies generate c 60% of the total dividend payments, so with MRCH's focus on high and growing income, a higher exposure to smaller-cap companies provides wider yield opportunities with less stock-specific risk to MRCH's potential income.

Exhibit 3: Market capitalisation breakdown (% unless stated)

Index	Portfolio end-April 2017	Portfolio end-April 2016	Change (pp)
FTSE 100	59.3	66.3	(7.0)
FTSE 250	32.1	26.8	5.3
FTSE Smaller Companies	5.7	6.1	(0.4)
Other	0.8	0.0	0.8
Cash	2.1	0.8	1.3
	100.0	100.0	

Source: The Merchants Trust, Edison Investment Research

MRCH's portfolio is unconstrained; this is illustrated in Exhibit 4, where sector exposure can differ markedly from the benchmark. The manager continues to have a meaningful underweight exposure (-10.7pp) to the consumer goods sector (an area favoured by many of MRCH's income peers) as he considers that the majority of these companies are unattractively valued.

Exhibit 4: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-April 2017	Portfolio end-April 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	27.9	24.9	3.0	26.1	1.8	1.1
Industrials	15.2	13.8	1.4	11.3	3.9	1.3
Consumer services	15.0	18.2	(3.2)	11.7	3.4	1.3
Oil & gas	12.5	12.3	0.2	11.5	1.0	1.1
Utilities	9.0	9.9	(0.9)	3.5	5.5	2.6
Healthcare	7.3	7.5	(0.2)	9.1	(1.8)	0.8
Consumer goods	4.9	6.7	(1.8)	15.6	(10.7)	0.3
Basic materials	3.5	2.8	0.7	6.8	(3.3)	0.5
Telecommunications	2.6	3.1	(0.5)	3.7	(1.1)	0.7
Technology	0.0	0.0	0.0	0.9	(0.9)	0.0
Cash	2.1	0.8	1.3	0.0	2.1	N/A
	100.0	100.0		100.0		

Source: The Merchants Trust, Edison Investment Research

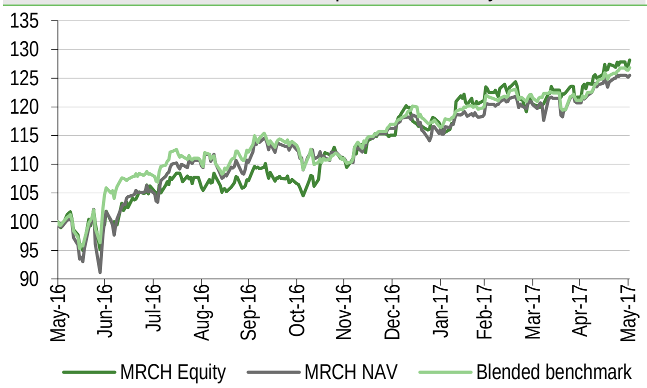
A recent addition to MRCH's portfolio is Meggitt, a manufacturer of aerospace components that operate in high-stress environments such as high temperature or pressure, where product quality is paramount. A high c 75% of revenues are generated from sole-sourced, life-of-programme contracts, which means these contracts are highly profitable and there is less competition for aftermarket sales. The company has been under pressure as airlines had been sourcing refurbished Meggitt products from other suppliers; however, this has been addressed as Meggitt now offers its own refurbished products, along with new aftermarket supplies. The cyclical outlook for Meggitt is also positive as high original equipment manufacturing demand in recent years should feed through into strong aftermarket sales. Although an accounting change will depress earnings growth in 2017, the manager believes that the long-term outlook for the company is encouraging.

Performance: Outperforming over five years

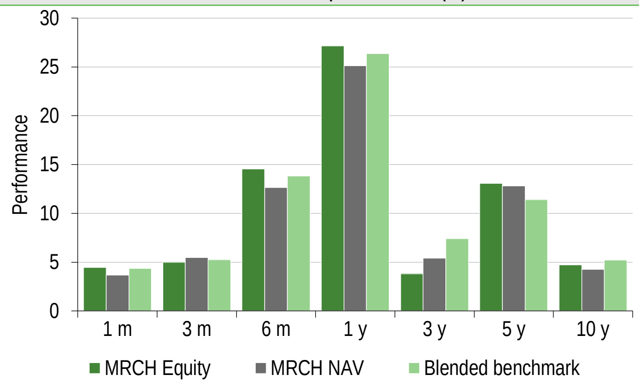
Absolute performance is shown in Exhibit 5. The manager comments that MRCH's NAV performance has benefited from its relatively high level of gearing in a rising market. So far in FY18, the largest positive stock contributor to performance has been Inmarsat. Having performed poorly in FY17 on concerns about higher price competition, the manager has increased confidence in the company's growth outlook following recent contract wins.

Exhibit 5: Investment trust performance to 31 May 2017

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



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised. Blended benchmark is FTSE 100 index until 31 January 2017 and FTSE All-Share index thereafter.

Exhibit 6: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to blended benchmark	0.1	(0.3)	0.6	0.6	(9.7)	7.7	(4.7)
NAV relative to blended benchmark	(0.7)	0.2	(1.0)	(1.0)	(5.5)	6.5	(8.8)
Price relative to FTSE All-Share	0.1	(0.3)	0.8	2.1	(10.8)	4.0	(7.5)
NAV relative to FTSE All-Share	(0.7)	0.2	(0.8)	0.5	(6.6)	2.8	(11.5)
Price relative to FTSE 100	(0.4)	0.3	1.3	1.3	(9.1)	8.5	(4.1)
NAV relative to FTSE 100	(1.2)	0.8	(0.4)	(0.3)	(4.9)	7.2	(8.2)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-May 2017. Geometric calculation.

Relative returns are shown in Exhibit 6. MRCH's NAV total return is ahead of the blended benchmark over five years, while trailing over one, three and 10 years. In share price total return terms, MRCH has outperformed over one and five years, while lagging over three and 10 years.

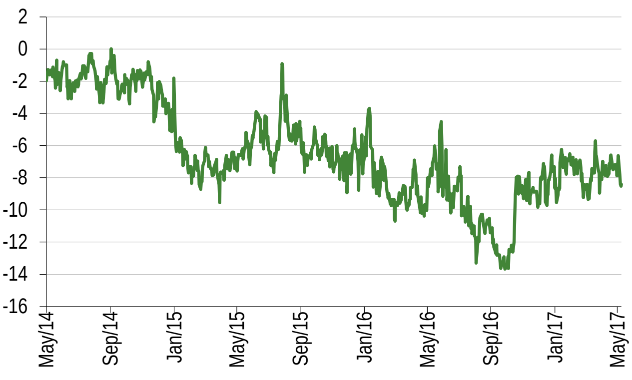
Exhibit 7: NAV total return performance relative to blended benchmark over five years

Source: Thomson Datastream, Edison Investment Research

Discount: Narrower since Q416

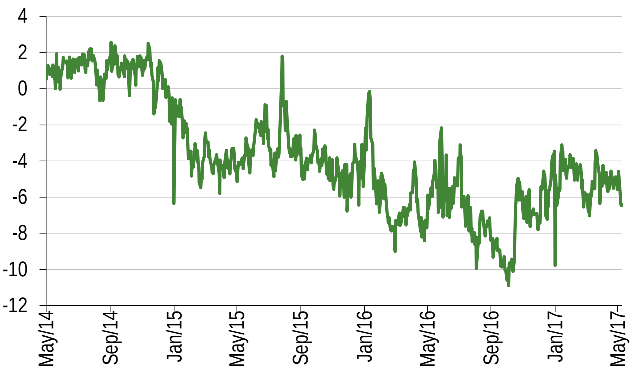
MRCH's current 6.4% share price discount to cum-income NAV with debt at market value is modestly wider than the 6.2% average discount of the last year (range of 2.2% to 10.9%), and wider than the averages of the last three, five and 10 years of 3.7%, 2.8% and 2.2%, respectively.

Exhibit 8: Three-year discount to NAV (debt at par or book value)



Source: Thomson Datastream, Edison Investment Research

Exhibit 9: Three-year cum-income discount (debt at fair or market value)



Source: Thomson Datastream, Edison Investment Research

With interest rates at low levels versus history, the market value of MRCH's debt is higher than its par value (therefore the value of the NAV with debt at par value is higher than the value of the NAV with debt at market value). Hence, the share price discount to NAV with debt at market value is lower than the discount to NAV with debt at par value.

Capital structure and fees

MRCH is a conventional investment trust with one class of share; there are currently 108.7m ordinary shares in issue. It has long-term debt of £108.6m, the majority of which was negotiated when interest rates were considerably higher than they are today. Its main commitments are a £34m 11.125% debenture maturing in January 2018, a £42m 9.25% bond maturing in 2023 and a £30m 5.875% bond maturing in 2029. The board is actively pursuing replacement options for the £34m debenture expiring in January 2018. If it was refinanced at the current level of interest rates, the manager suggests that it would add more than 3% to MRCH's earnings, which would be positive for dividend cover. In recent years, MRCH's NAV and share price total returns have been affected by its high-cost debt. As interest rates have come down, the value of its debt has increased, which has offset the benefit of the pull to par as some of its debt nears maturity.

In FY17, the annual management fee was 0.35%; it is charged to the capital and revenue accounts in a ratio of 65:35 respectively, which reflects the board's expected split of capital and income returns. The ongoing charge in FY17 was 0.63%, which was a 5bp increase versus the prior year, but is still favourable when compared to the peer group average (AIC UK Equity Income sector, see Exhibit 11).

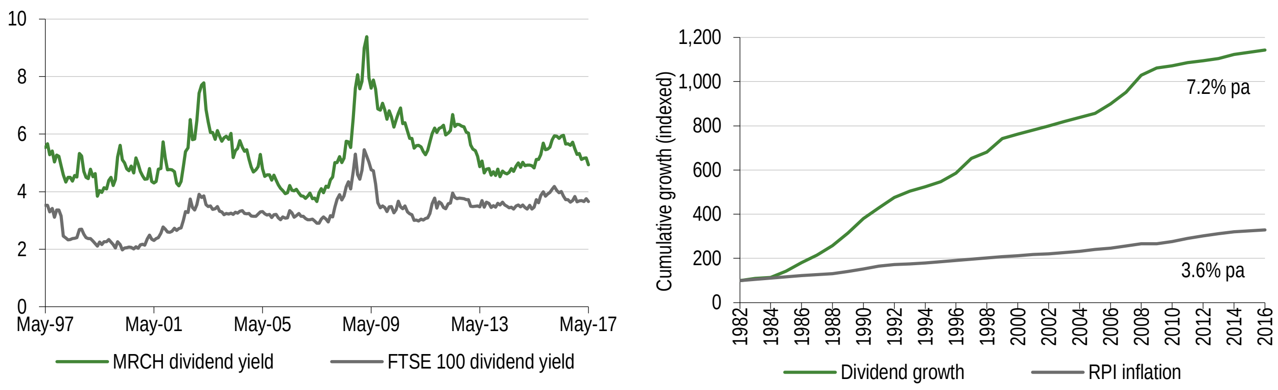
Dividend policy and record

Dividends are paid quarterly in August, November, February and May. MRCH aims to generate a high and growing level of income. MRCH's annual dividend has grown for 35 consecutive years. The FY17 annual dividend of 24.2p was a 0.8% increase versus the prior year and was broadly covered by revenue. At end-January 2017, revenue reserves of £24.8m were equivalent to 0.94x the FY17 dividend payment.

Exhibit 10 (left-hand side) illustrates that over the last 20 years, MRCH's dividend yield is consistently higher than the yield offered by large-cap UK equities, and the right-hand chart shows that its dividend growth has been meaningfully higher than UK inflation during the 35-year period of MRCH's consecutive annual dividend increases.

Exhibit 10: MRCH's dividend yield and growth (%)

Merchants Trust's dividend yield vs FTSE 100 dividend yield | Growth of Merchants Trust's dividend vs UK inflation



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

Peer group comparison

MRCH is a member of the AIC UK Equity Income sector, a relatively large peer group comprising 23 trusts. In Exhibit 11 we highlight the largest seven; they all have market caps higher than £500m. MRCH's NAV total return is above the selected and whole sector averages over one year, ranking ninth out of 23. Over longer time periods, MRCH's performance still lags the peers, after a difficult period where it had less invested in the defensive consumer staples sector in particular. Its ongoing charge is the fourth lowest in the whole sector and no performance fee is payable. MRCH has one of the highest levels of gearing (of which the majority is high cost – see Capital structure and fees section), which may explain why it has one of the widest discounts in the sector. The trust has an attractive dividend yield of 5.1%, which is the fourth highest out of 23 peers.

Exhibit 11: AIC UK Equity Income peer group (market cap above £500m) at 8 June 2017*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
The Merchants Trust	516.2	22.4	14.6	75.3	52.5	(8.2)	0.6	No	118	5.1
City of London	1,457.9	18.6	26.9	89.1	95.9	1.0	0.4	No	106	3.9
Edinburgh Investment	1,478.3	18.5	39.7	109.1	117.6	(6.0)	0.6	No	106	3.4
Finsbury Growth & Income	1,122.1	24.9	48.2	147.8	188.0	1.4	0.7	No	102	1.8
Murray Income Trust	541.4	26.9	22.2	78.4	76.0	(7.2)	0.8	No	102	4.0
Perpetual Income & Growth	954.5	14.1	23.4	103.4	128.7	(7.8)	0.7	No	113	3.4
Temple Bar	850.6	22.4	20.4	83.7	114.9	(5.8)	0.5	No	99	3.2
Selected stock average	988.7	21.1	27.9	98.1	110.5	(4.7)	0.6		106	3.5
Sector average (23 peers)	436.3	19.5	26.8	96.6	82.2	(1.1)	1.2		112	3.8
MRCH rank in sector (out of 23 peers)	7	9	21	19	18	18	20		4	4

Source: Morningstar, Edison Investment Research. Note: *Performance data to 7 June 2017. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

Following the retirement of Mike McKeon on 31 January 2017, there are now five directors on the board of MRCH. All are non-executive and independent of the manager. Chairman Simon Fraser was appointed to the board in August 2009 and assumed his current role in 2010. Sybella Stanley became the senior independent director following McKeon's retirement; she was appointed in November 2014. The other three board members are: Paul Yates (appointed in March 2011), Mary Ann Sieghart (appointed in November 2014) and Timon Drakesmith (chairman of the audit committee, appointed in November 2016). Board members have varied backgrounds with both investment and corporate commercial experience.

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