EDISON

The Merchants Trust

Benefits from announced debt refinancing

Investment trusts

The Merchants Trust (MRCH) adopts a long-term approach to investing in UK equities, aiming to generate an above-average level of income along with long-term capital and income growth. The trust has announced a refinancing of its first tranche of high-cost debt, which will bring its effective cost of borrowing down from 8.5% to 6.1%, saving £2.8m in annual interest costs and locking in low-cost funding for the next 35 years. The board adopts a progressive dividend policy; annual dividends have increased for the last 35 consecutive years and the current 5.0% yield compares favourably with the average of MRCH's peers in the AIC UK Equity Income sector.

12 months ending	Share price (%)	NAV* (%)	Blended benchmark** (%)	FTSE All-Share (%)	FTSE 100 (%)
31/10/13	45.2	36.0	20.7	22.8	20.7
31/10/14	(3.1)	(2.6)	0.7	1.0	0.7
31/10/15	(2.0)	2.6	0.8	3.0	0.8
31/10/16	1.1	9.3	13.7	12.2	13.7
31/10/17	21.5	15.5	13.2	13.4	12.1

Source: Thomson Datastream. Note: All % on a total return basis in GBP. *NAV with debt at market value. **Blended benchmark is FTSE 100 Index until 31 January 2017 and FTSE All-Share Index thereafter.

Investment strategy: Bottom-up stock selection

Manager Simon Gergel is able to draw on the broad resources of Allianz Global Investors (AllianzGI) to construct a relatively concentrated portfolio of c 40-60 UK equities. While benchmarked against the FTSE All-Share Index, he adopts an unconstrained approach, selecting stocks primarily on a bottom-up basis with strong/improving fundamentals, which are trading on reasonable valuations. The largest overweight sector exposure is industrials, while there is a meaningful underweight exposure to consumer staples, as the manager thinks that in aggregate the stocks are unattractively valued. The board's policy is to maintain gearing in a range of 10-25% of net assets, at the time of drawdown.

Market outlook: Time to be more selective

UK equity indices have been hitting new highs. Economic data have been more positive than expected since the result of the UK's European referendum, and investors have been focusing on the improvement in corporate earnings and dividend growth rather than any potential future economic slowdown. Given a positive re-rating, investors seeking exposure to UK equities may be rewarded by a fund investing in attractively valued companies, including turnaround situations.

Valuation: Scope for discount to narrow

MRCH's current 5.3% share price discount to cum-income NAV with debt at market value is towards the low end of the 3.1% to 10.9% range of the last 12 months and compares to the averages of the last one, three, five and 10 years (range of 2.3% to 5.7%). There is potential for the discount to narrow as a result of the debt restructuring or if investment performance continues to improve. MRCH has a progressive dividend strategy; annual dividends have increased for the last 35 consecutive years, and the current yield is 5.0%.

3 November 2017

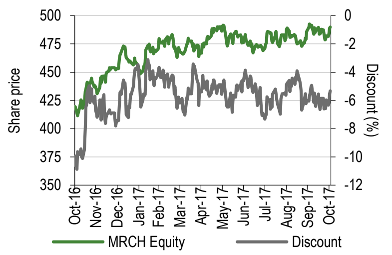
Price	**490.0p**
Market cap	**£533m**
AUM	**£692m**

NAV*	507.6p
Discount to NAV	3.5%
NAV**	517.6p
Discount to NAV	5.3%

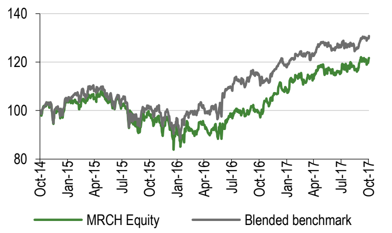
*Excluding income. **Including income. As at 1 November.

Yield	5.0%
Ordinary shares in issue	108.7m
Code	MRCH
Primary exchange	LSE
AIC sector	UK Equity Income
Benchmark	FTSE All-Share

Share price/discount performance



Three-year performance vs index



52-week high/low	492.6p	411.5p
NAV* high/low	522.4p	455.4p

*Including income.

Gearing

Gross*	22.2%
Net*	19.8%

*As at 30 September 2017.

Analysts

Mel Jenner +44 (0)20 3077 5720

Sarah Godfrey +44 (0)20 3681 2519

investmenttrusts@edisongroup.com

Edison profile page

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.

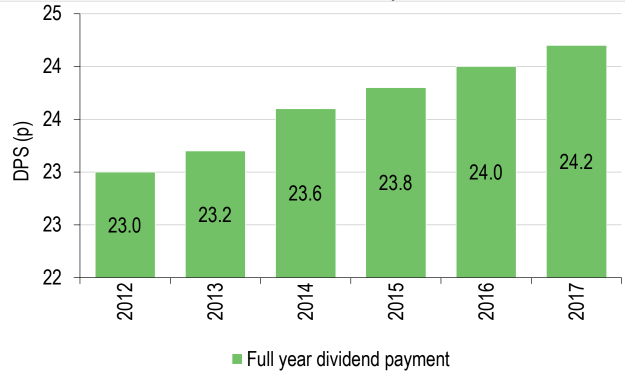
Recent developments

- 23 October 2017: Pricing of £35m fixed rate, 35-year, secured private placement note at 2.96%, effective 18 December 2017.
- 26 September 2017: Interim report to 31 July 2017. NAV TR +9.9% versus benchmark TR +7.1%. Share price TR +6.8%. Second interim dividend of 6.2p declared (+3.3% year-on-year).
- 4 July 2017: First interim dividend of 6.1p declared (+1.7% year-on-year).
- 27 March 2017: Annual report to 31 January 2017. NAV TR +14.9% versus benchmark TR +21.4%. Share price TR +15.1%.

Forthcoming		Capital structure		Fund details	
AGM	May 2018	Ongoing charges	0.63%	Group	Allianz Global Investors
Final results	March 2018	Net gearing	19.8%	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

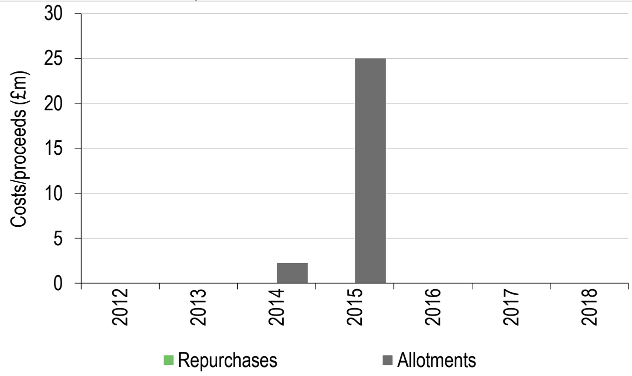
Dividend policy and history (financial years)

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

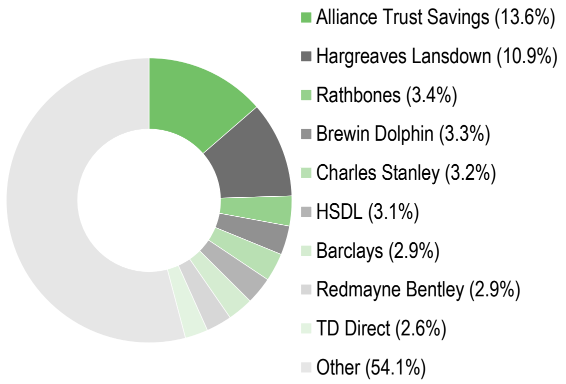


Share buyback policy and history (financial years)

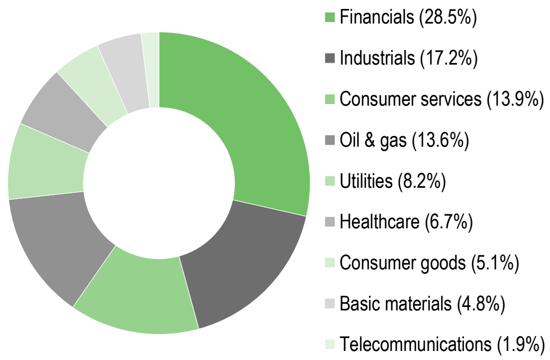
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 30 September 2017)



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



Top 10 holdings (as at 31 October 2017)

Company	Sector	Portfolio weight %	
		31 October 2017	31 October 2016*
Royal Dutch Shell 'B' Shares	Oil & gas	8.2	7.6
GlaxoSmithKline	Healthcare	5.9	7.3
BP	Oil & gas	5.8	5.9
HSBC	Banks	4.7	5.8
Lloyds Banking Group	Banks	3.9	3.5
Standard Life Aberdeen	Insurance	3.4	N/A
BHP	Mining	3.3	N/A
UBM	Media	3.1	4.3
Prudential	Insurance	2.9	N/A
Legal & General	Insurance	2.8	N/A
Top 10		**44.0**	**47.1**

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

Recent developments

On 23 October 2017, MRCH announced that it had priced a £35m fixed rate, 35-year secured private placement note at an interest rate of 2.96%. The effective funding date is expected to be 18 December, with semi-annual interest payments due on 18 December and 18 June. The new note will rank *pari passu* with MRCH's other secured debt and will be used to repay £34m of high-cost (11.125%) borrowings maturing in early January 2018.

Exhibit 2: Effects of debt refinancing

Fiscal year end 31 January	2017	2018 pro forma
Gross debt	£111m	£112m
Effective interest rate (ex-perpetual debt)	8.5%	6.1%
Average duration	7.2 years	15.3 years
First maturity	January 2018	May 2023

Source: The Merchants Trust, Edison Investment Research

As shown in Exhibit 2, the debt refinancing brings down MRCH's average cost of debt and locks in long-term refinancing. Gergel says that the ability to borrow at c 3% and invest in the UK stock market, which is yielding c 4%, is a good long-term proposition for shareholders, as they will be better off even if there is no capital or dividend growth. Interest is charged 65% to the capital account and 35% to the revenue account, so the lower interest rate will save £1.8m and £1.0m in annual interest payments to the respective accounts. The manager says that extending the life of MRCH's debt profile from seven to 15 years is important, as it ensures the manager is able to invest with a long-term view, as befits an investment trust that is nearly 130 years old.

Fund profile: Investing for long-term growth

MRCH was launched in February 1889, making it one of the oldest investment trusts listed on the London Stock Exchange. It is managed by AllianzGI, which has assets under management approaching €500bn. MRCH aims to generate an above-average level of income and income growth, along with long-term capital growth, from a relatively concentrated portfolio (c 40 to 60 holdings) of UK equities. Since 2006, the lead manager has been Simon Gergel, AllianzGI's chief investment officer for UK equities.

MRCH was historically benchmarked against the FTSE 100 Index, but since end-January 2017 the benchmark is the FTSE All-Share Index, reflecting an evolution towards less large-cap exposure. The portfolio must be invested across at least five sectors, with a maximum 35% in any single sector, and no single position may exceed 15%. At the time of drawdown, gearing of 10-25% of net assets is permitted. MRCH has a distinguished dividend history and its yield compares favourably with the average of its peers. The annual payment has increased for the last 35 consecutive years, using reserves when necessary to maintain the dividend record.

The fund manager: Simon Gergel

The manager's view: Finding interesting opportunities

Gergel says that while Brexit is a risk to the domestic economy, a lot of UK companies are exposed to relatively stronger global markets, and so far UK economic data are coming through better than would have been expected following the referendum. The manager says the UK stock market is making steady progress. He notes that overall volatility has been low, although some individual stock prices have been very volatile, which has provided opportunities for those investors able to take advantage of pricing anomalies. Gergel suggests that many UK consumer cyclical companies are under pressure; he is considering whether a number of retail and leisure companies may be attractive opportunities given their relatively low valuations. However, he will only invest if he is confident in a company's fundamental outlook, such as Greene King, where he has added to the position following a period of share price weakness due to a profits warning.

Gergel says that in aggregate investors are becoming more optimistic on the global economy, so have started to buy more cyclical stocks. He notes that if interest rates rise on the back of higher inflation, it will be positive for banks and financials, while having a detrimental impact on 'bond proxies', such as consumer staples, where he is underweight, as he considers that within the sector, company valuations are generally unattractive.

Asset allocation

Investment process: Blend of fundamentals/valuation/themes

The manager is able to draw on the broad resources of AllianzGI, which, along with fundamental equity research, focuses on macroeconomics; environmental, social and governance research; credit analysis and the proprietary Grassroots[SM] market research product. When considering a potential purchase, Gergel considers three elements: fundamentals, valuation and themes. Fundamental analysis includes an assessment of industry dynamics, a company's competitive position, its financials and corporate governance track record. The manager considers valuations on both an absolute and relative basis, while themes takes into account the macro environment, stage of the business cycle and secular trends. A stock may be sold if it has achieved its target price, if there is a change in the investment case or if a better investment opportunity is available.

Style analysis data from AllianzGI highlights the nature of MRCH's relatively concentrated current portfolio. It ranks highly on value metrics, such as dividend, earnings and cash flow yields, but is also not anti-growth, as the portfolio has tilts towards earnings and sales growth. For an actively managed portfolio, MRCH has a relatively low active share of 64%. Active share is a measure of how a portfolio deviates from a benchmark, with 100% reflecting no commonality and 0% full index replication. Gergel explains the low number is due to his positions in index heavyweights BP, Royal Dutch Shell, GlaxoSmithKline and HSBC, which he believes all offer good value.

Current portfolio positioning

As shown in Exhibit 1, over the last 12 months there has been little change in portfolio concentration. At end-October 2017, the top 10 positions comprised 44.0% versus 47.1% at end-October 2016. Over 12 months to end-September 2017 there have been modest changes on a market cap basis, with 3.1pp higher exposure to mid-cap FTSE 250 companies and 2.0pp lower exposure to large-cap FTSE 100 companies (Exhibit 3).

Exhibit 3: Market capitalisation breakdown (%)

Index	Portfolio end-September 2017	Portfolio end-September 2016	Change (pp)
FTSE 100	58.7	60.7	(2.0)
FTSE 250	34.1	31.0	3.1
FTSE SmallCap	4.2	4.7	(0.5)
FTSE Fledgling	0.6	0.7	(0.1)
Cash	2.4	2.9	(0.5)
	100.0	**100.0**	

Source: The Merchants Trust, Edison Investment Research

On a sector breakdown, over the last 12 months, the largest increases in exposure are industrials (+2.7pp) and financials (+2.3pp), with the largest decrease in consumer services (-2.2pp). The structure of the portfolio is broadly similar to our last report published in June 2017, with overweight positions in industrials and utilities and a large underweight exposure in consumer goods stocks, unlike many of MRCH's peers, as the manager considers their valuations unattractive.

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

	Portfolio end-September 2017	Portfolio end-September 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	27.8	25.5	2.3	26.4	1.4	1.1
Industrials	16.8	14.1	2.7	11.3	5.5	1.5
Consumer services	13.6	15.8	(2.2)	11.0	2.6	1.2
Oil & gas	13.3	12.8	0.5	12.2	1.1	1.1
Utilities	8.0	9.8	(1.8)	3.0	5.0	2.7
Healthcare	6.5	7.4	(0.9)	8.5	(2.0)	0.8
Consumer goods	5.0	5.9	(0.9)	15.7	(10.7)	0.3
Basic materials	4.7	3.0	1.7	7.2	(2.5)	0.7
Telecommunications	1.9	2.8	(0.9)	3.6	(1.7)	0.5
Technology	0.0	0.0	0.0	1.1	(1.1)	0.0
Cash	2.4	2.9	(0.5)	0.0	2.4	N/A
	100.0	**100.0**		**100.0**		

Source: The Merchants Trust, FTSE Russell, Edison Investment Research

There are two recent new holdings in MRCH's portfolio: Bovis Homes and WPP. The manager says that fundamentally, Bovis is a standard house builder of c 3,500 homes per annum, primarily in the south of England, outside of London. The company has a good land bank of more than four years and has net cash on the balance sheet. Bovis got into trouble in 2015/16 as the company tried to grow too quickly. It did not have enough skilled employees, which led to problems of missed sales and product quality, resulting in two major profit warnings. In June 2017, the shares were trading at just above book value, which Gergel considered an attractive entry point. There is a new management team in place and the new CEO has delivered a clear strategy to focus on high-quality delivery and lower costs. The manager believes that in recovery situations such as Bovis, there is often the potential for much higher cost reductions than originally envisaged. So far this year, Bovis has fought off two takeover bids from companies attracted to the value of its land bank.

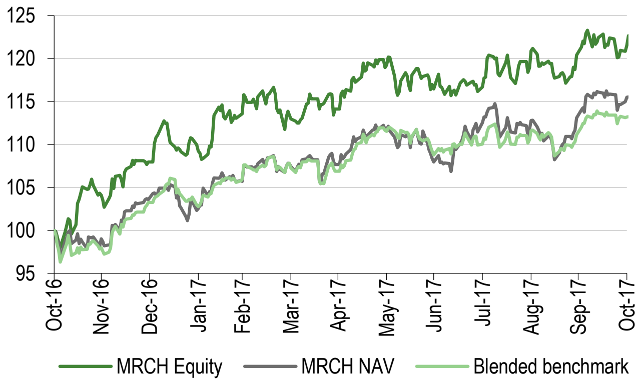
The manager says that the holding in WPP is contentious, as the advertising industry has had a tough H117, due to consumer companies cutting back advertising spending. This has led to questions about a structural change in the industry and how well WPP is positioned for the future. Gergel takes comfort from the fact that following a series of acquisitions, more than 40% of the company's business is digital and 30% of revenues are from higher-growth emerging market regions. He believes WPP's business model is not broken, that its recent business weakness is cyclical rather than structural, and that its stock price can re-rate as investor confidence improves. Unusually, WPP now has a higher dividend yield than the UK stock market, and is trading on a low double-digit earnings multiple, rather than its typical mid-to-high teens level.

Performance: Improving over the near term

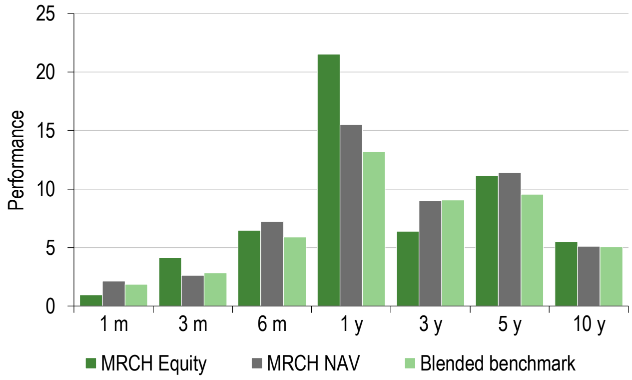
In absolute terms over the last 12 months, MRCH has outperformed the benchmark. Its NAV and share price total returns of 15.5% and 21.5%, respectively, compare to the benchmark's 13.2% total return (Exhibit 5, RHS). Performance has been helped by periods of value rather than growth leadership in the stock market and by not holding some big underperforming stocks, such as Provident Financial. The largest contributors to the positive returns include administration and payment services provider Equiniti, and global investment company Standard Life Aberdeen. Equiniti has benefited from Capita's sale of its share registration business for a full price, which has led to a positive read-through for the value of Equiniti's similar operations. In addition, Equiniti's acquisition of Wells Fargo's US share registry brings opportunities to reduce costs and increase cross-selling opportunities. Gergel says that there is now more excitement about the Standard Life/Aberdeen merger, suggesting that there are huge opportunities for cost cutting. He notes that the limited business overlap means there are less concerns about asset outflows, and Aberdeen's focus on emerging markets is positive, as investor sentiment towards the regions is improving.

Exhibit 5: Investment trust performance to 31 October 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: NAV with debt at market value. Three, five and 10-year performance figures annualised.

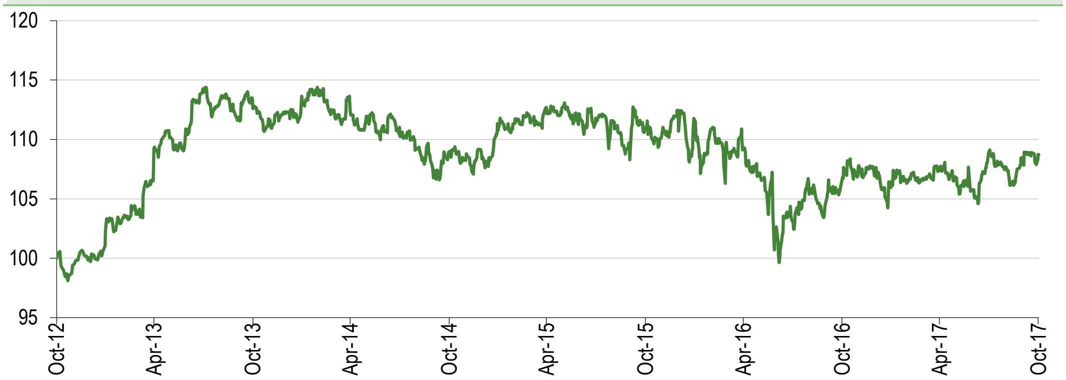
MRCH's relative returns are shown in Exhibit 6. Its improving near-term performance means that the trust is now ahead of the blended benchmark over one, five and 10 years in both NAV and share price terms.

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	(0.9)	1.3	0.5	7.4	(7.2)	7.4	4.2
NAV relative to blended benchmark	0.3	(0.2)	1.3	2.0	(0.2)	8.7	0.2
Price relative to FTSE All-Share	(0.9)	1.3	0.5	7.2	(8.1)	4.3	0.0
NAV relative to FTSE All-Share	0.3	(0.2)	1.3	1.9	(1.2)	5.6	(3.8)
Price relative to FTSE 100	(0.8)	1.3	0.3	8.5	(6.3)	8.5	5.3
NAV relative to FTSE 100	0.3	(0.1)	1.1	3.1	0.8	9.8	1.2

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

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



Source: Thomson Datastream, Edison Investment Research

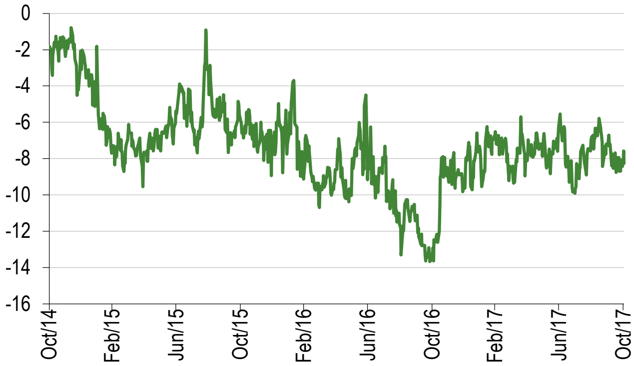
Discount: Potential for narrower discount

MRCH's current 5.3% share price discount to cum-income NAV with debt at market value is modestly wider than the averages of the last one, three, five and 10 years (range of 2.3% to 5.7%). There is scope for the discount to narrow following the recent announcement regarding the restructuring of a large tranche of MRCH's high-cost debt, or if the manager is able to build on the trust's near-term improving investment performance.

The market value of MRCH's debt is higher than its par value due to the current low level of interest rates, which means that the value of the NAV with debt at par value is higher than the value of the

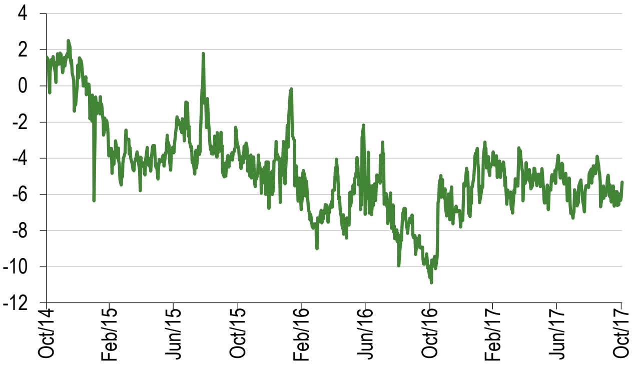
NAV with debt at market value. As a result, the share price discount to NAV with debt at market value is lower than the discount to NAV with debt at par value.

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

Capital structure and fees

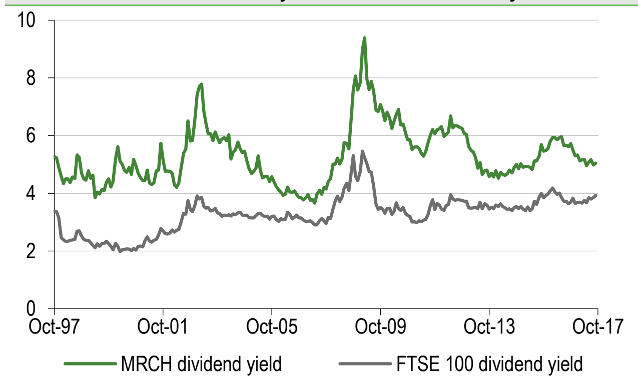
MRCH is a conventional investment trust with one class of share; there are currently 108.7m ordinary shares in issue. Following the debt restructuring highlighted on page 3, MRCH will have the following pro forma £112m debt profile: a c £45m 9.25% bond maturing in 2023, a c £30m 5.875% bond maturing in 2029, a £35m 2.96% note maturing in 2052, a £1.4m 4% perpetual debenture stock and £1.2m 3.65% cumulative preference shares. In FY17, the annual management fee was 0.35%; it is charged 65% to the capital account and 35% to the revenue account, reflecting the board's expected split of capital and income returns. The ongoing charge in FY17 was 0.63%; while 5bp higher than in FY16, the charge remains competitive with the average of MRCH's peers shown in Exhibit 11.

Dividend policy and record

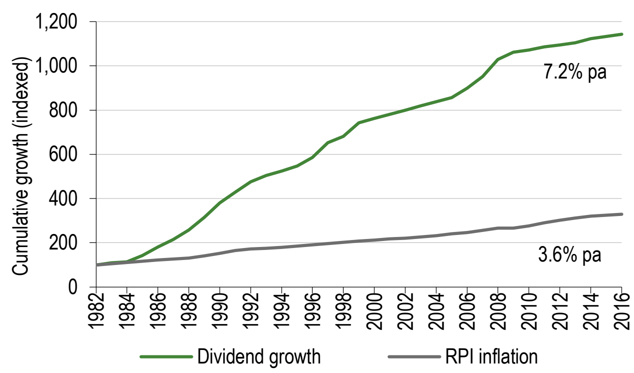
MRCH pays quarterly dividends in August, November, February and May. The trust aims to generate a high and growing level of income, and annual dividends have increased in each of the last 35 years. In FY17, the annual dividend of 24.2p was 0.8% higher than FY16 and was broadly covered by revenue. At end-H118, revenue reserves were £27.9m, which was more than 1x the last four quarterly dividend payments. MRCH's current dividend yield is 5.0%.

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

The Merchants Trust's dividend yield vs FTSE 100 dividend yield



Growth of The Merchants Trust's dividend vs UK inflation



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

MRCH's attractive distribution policy is illustrated in Exhibit 10. The left-hand chart shows that over the last 20 years, MRCH's dividend yield has remained higher than the dividend yield of large-cap UK equities. The right-hand chart compares MRCH's annual dividend growth with the rate of UK inflation. Over the last 35 years of consistent growth, MRCH's dividends have compounded at an annual rate of 7.2%, which is considerably higher than the rate of UK inflation.

Peer group comparison

MRCH is a member of the AIC UK Equity Income sector, which comprises 23 investment trusts. In Exhibit 11, we show the largest seven, which all have market caps in excess of £500m. MRCH's one-year total return is above the selected stock average, ranking second out of seven funds; however, its returns are below average over the other periods shown. The trust's above-average discount may be due to its high level of relatively expensive debt, although the recent refinancing announcement may lead to some narrowing of the discount. MRCH's ongoing charge is in line with the selected peer average, but meaningfully smaller than the whole sector average, and in common with the selected peers, no performance fee is payable. The trust has an attractive dividend yield, which is c 1.5pp higher than the selected group and c 1.0pp higher than the whole sector averages.

Exhibit 11: Selected peer group as at 2 November 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 (%)
Merchants Trust	532.8	14.7	27.5	58.9	61.4	(8.2)	0.6	No	120	5.0
City of London	1,487.1	12.6	30.3	69.8	96.2	0.5	0.4	No	108	4.0
Edinburgh Investment	1,410.8	10.1	33.3	88.7	110.8	(6.9)	0.6	No	112	3.5
Finsbury Growth & Income	1,214.7	18.1	56.2	121.1	210.2	0.4	0.7	No	103	2.0
Murray Income Trust	529.1	13.5	28.0	59.2	73.0	(8.1)	0.7	No	103	4.2
Perpetual Income & Growth	939.1	10.0	23.1	83.9	122.7	(8.2)	0.7	No	113	3.5
Temple Bar	892.8	13.9	29.6	66.1	128.7	(3.2)	0.5	No	98	3.1
Selected stock average	**1,000.9**	**13.3**	**32.6**	**78.2**	**114.7**	**(4.8)**	**0.6**		**108**	**3.6**
Sector average (23 peers)	**442.3**	**15.2**	**32.8**	**77.0**	**90.4**	**(2.1)**	**1.2**		**112**	**4.1**
MRCH rank (out of 23 peers)	**6**	**11**	**19**	**20**	**18**	**18**	**20**		**3**	**3**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 1 November 2017. NAV with debt at par. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

There are five directors on MRCH's board, all of whom are non-executive and independent of the manager. Chairman Simon Fraser was appointed in August 2009 and assumed his current role in 2010. The other board members and their dates of appointment are Paul Yates (March 2011), Sybella Stanley and Mary Ann Sieghart (November 2014) and Timon Drakesmith (November 2016).

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia