The Merchants Trust

High and growing dividend yield

Investment trusts

The Merchants Trust (MRCH) is managed by Simon Gergel, chief investment officer of UK equities at AllianzGI. He says the current uptick in volatility in the UK stock market is providing a lot of opportunities for active stock pickers, with a wide divergence between the valuation of shares in companies with steady growth characteristics and those whose earnings outlook is less clear. Although MRCH's annual dividend has increased in each of the last 36 years, growth in the years following the global financial crisis has been modest. However, the manager says the refinancing of a large tranche of the trust's high-cost debt in January 2018, coupled with higher levels of portfolio income, means the board has increased confidence in growing the dividend at a faster rate, from a starting yield of more than 5%.

12 months ending	Share price (%)	NAV* (%)	Blended benchmark** (%)	FTSE All-Share (%)	FTSE 100 (%)
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	9.1	13.7	12.2	13.7
31/10/17	21.5	15.5	13.2	13.4	12.1
31/10/18	3.3	(1.9)	(1.5)	(1.5)	(0.9)

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

Investment strategy: Valuation-based approach

The manager employs a contrarian approach to stock selection, seeking companies that are trading at a wide discount to their perceived intrinsic value. There are three pillars to the stock selection process – company fundamentals, valuation and external themes – to ensure that companies within the portfolio are high quality, attractively valued and operating in a supportive environment. The resulting fund comprises c 40–60 UK equities, and aims to generate a high and growing level of income and long-term capital growth.

Market outlook: Volatility may continue

UK equities are experiencing much higher levels of volatility compared with the below-average levels in 2017. Given the continued uncertainty over Brexit, this backdrop looks set to continue. However, this environment is creating opportunities – UK companies with domestic operations have seen their share prices under particular pressure, potentially providing rich pickings for long-term investors with a disciplined approach to stock selection.

Valuation: Above-average dividend yield

MRCH's discount has been in a narrowing trend in recent months; its current 0.1% share price premium to cum-income NAV (with debt at market value) compares with a c 6% discount in mid-August 2018. Average discounts over the last one, three, five and 10 years range from 2.3% to 5.4%. The trust has a distinguished dividend history; the annual distribution has increased for the last 36 consecutive years. MRCH currently offers an above-average dividend yield of 5.4% (Exhibit 12).

26 November 2018

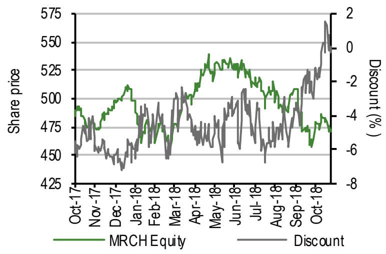
Price	**472.5p**
Market cap	**£514m**
AUM	**£630m**

NAV*	458.1p
Premium to NAV	3.2%
NAV**	472.0p
Premium to NAV	0.1%

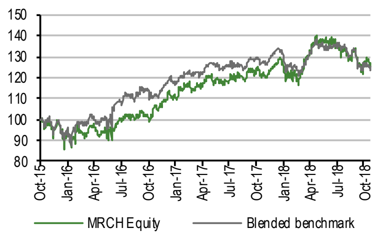
*Excluding income. **Including income. As at 22 November 2018.

Yield	5.4%
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	539.0p	455.0p
NAV** high/low	565.0p	467.6p

**Including income.

Gearing

Gross*	23.0%
Net*	20.7%

*As at 31 October 2018.

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.

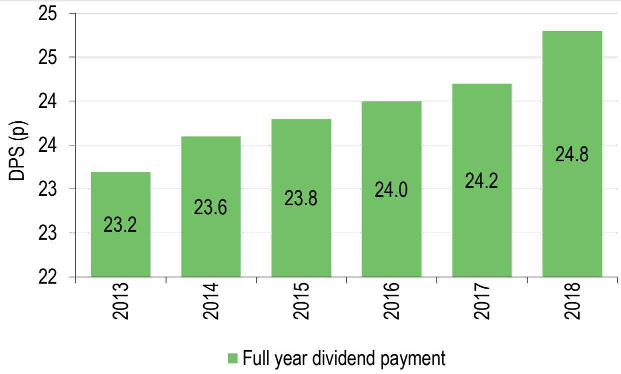
Recent developments

- 24 September 2018: six-month report to 31 July 2018. NAV TR +7.4% versus benchmark TR +5.0%. Share price TR +8.7%. Second interim dividend of 6.5p declared (+4.8% year-on-year).
- 3 July 2018: first interim dividend of 6.4p declared (+4.9% year-on-year).
- 29 March 2018: annual report to 31 January 2018. NAV TR +14.5% versus benchmark TR +11.3%. Share price TR +13.3%. Final interim dividend of 6.3p declared (+3.3% year-on-year).

Forthcoming		Capital structure		Fund details	
AGM	May 2019	Ongoing charges	0.59%	Group	Allianz Global Investors
Final results	March 2019	Net gearing	20.7%	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

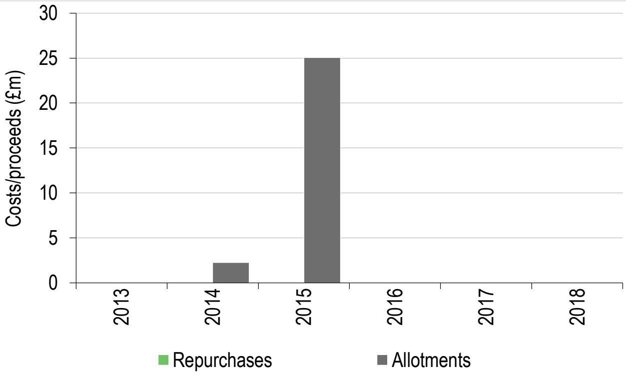
Dividend policy and history (financial years)

Dividends are paid quarterly in August, November, February and May. The annual dividend has increased for 36 consecutive years.

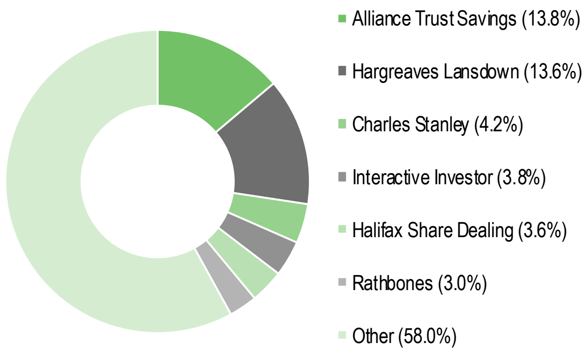


Share buyback policy and history (financial years)

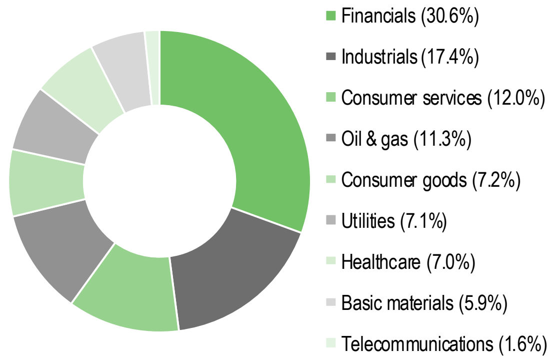
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 31 October 2018)



Portfolio exposure by sector (ex-cash as at 31 October 2018)



Top 10 holdings (as at 31 October 2018)

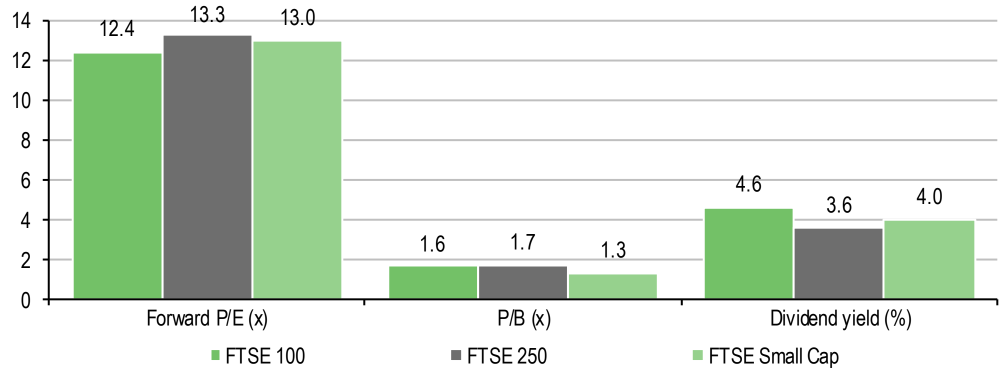
		Portfolio weight %	
Company	**Sector**	**31 October 2018**	**31 October 2017***
Royal Dutch Shell 'B' Shares	Oil & gas	6.9	8.2
GlaxoSmithKline	Healthcare	6.7	5.9
HSBC	Banks	4.2	4.7
BP	Oil & gas	4.0	5.8
BHP Billiton	Mining	4.0	3.3
Legal & General	Insurance	3.2	2.8
Imperial Brands	Tobacco	3.0	N/A
Standard Life Aberdeen	Financial services	2.9	3.4
BAE Systems	Aerospace & defence	2.8	N/A
SSE	Electricity	2.7	N/A
Top 10 (% of holdings)		**40.3**	**44.0**

Source: The Merchants Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-October 2017 top 10.

Market outlook: Volatility providing opportunities

UK equities, along with share prices across the globe, have returned to more normal levels of volatility following a particularly benign period in 2017. Ongoing Brexit uncertainty is putting extra pressure on the UK stock market, particularly for shares in companies with domestic, rather than international operations, while global institutional allocations to UK equities remain very low compared with historical averages. Over the last six months, the valuation of UK equities has become more attractive, with lower multiples and higher dividend yields across the market capitalisation spectrum. Although the current investment backdrop presents challenges, it can also provide opportunities for investors with a disciplined, long-term approach to stock picking.

Exhibit 2: Valuation metrics for FTSE 100, 250 and Small Cap indices (as at 22 Nov 2018)



Source: Edison Investment Research, Bloomberg

Fund profile: Distinguished dividend track record

Launched in February 1889, MRCH is one of the oldest investment trusts listed on the London Stock Exchange. Since 2006 the lead manager has been Simon Gergel, chief investment officer of UK equities at AllianzGI, which has c £460bn in assets under management. He aims to generate an above-average level of income and income growth, and long-term capital growth from a relatively concentrated portfolio of c 40–60 UK equities. The manager has a contrarian approach to stock selection, seeking attractively valued stocks that can be held for the long term. MRCH is benchmarked against the FTSE All-Share index (FTSE 100 index prior to January 2017). There are investment guidelines in place to diversify risk; the portfolio must be invested in at least five sectors (with a maximum 35% in each), and there is a limit of 15% in a single holding. Gearing is permitted in a range of 10–25% of net assets (at the time of drawdown); at end-October 2018, net gearing was 20.7%. MRCH has a distinguished dividend history; annual distributions have increased for the last 36 consecutive years, using reserves to supplement income when required. Its yield compares favourably with the majority of its peers (Exhibit 12).

The fund manager: Simon Gergel

The manager's view: Opportunities in a polarised market

Gergel says that so far in 2018 there have been big swings in sentiment; issues that investors are grappling with include Brexit, the US/China trade dispute, the government budget in Italy, and the pace and magnitude of US interest rate hikes. The manager says an environment of rising interest rates can lead to pressure on equities, as witnessed by weakness in global stock markets in October 2018. He notes a polarisation in the UK stock market, with shares in companies perceived as being able to generate steady growth significantly outperforming the rest of the market. In addition, with continued outflows from UK equities putting pressure on stock prices, the manager is finding a large number of attractively priced investment opportunities. Gergel says the operating environment for UK companies generally remains 'okay', but that commentary from Q318 earnings reports suggests that 'life is getting a little bit tougher' due to rising raw material and labour costs, and there are specific industries under pressure, such as autos and retail. However, he believes there will be pent-up demand in the UK economy if there is a favourable Brexit outcome.

Asset allocation

Investment process: In-depth fundamental approach

At the heart of MRCH's investment process is in-depth fundamental research to identify companies that are trading at a meaningful discount to their perceived intrinsic value. Gergel is able to draw on the well-resourced investment team at AllianzGI to construct a relatively concentrated portfolio of primarily higher-yielding UK equities. He says historical evidence shows that, in aggregate, companies paying above-average dividend yields have delivered higher-than-average total returns as well as a higher level of income. The manager stresses that yield alone is never a sufficient reason to buy a stock, and there is no automatic sale if a company's dividend yield falls below that of the market. MRCH's investment process is centred on three pillars – company fundamentals, valuations and external themes – to answer three critical questions regarding the quality of a company's business, whether its shares are undervalued, and how supportive the operating environment is. Shares are sold when they have reached their target price, if there is a change in the investment thesis, or if there is a more attractive investment opportunity available.

Current portfolio positioning

Exhibit 3: Market capitalisation breakdown (% unless stated)

Index	Portfolio end-October 2018	Portfolio end-October 2017	Change (pp)
FTSE 100	64.9	58.7	6.2
FTSE 250	26.9	35.4	(8.5)
FTSE Small Cap	5.1	4.0	1.1
FTSE Fledgling	0.8	0.6	0.2
Cash	2.3	1.3	1.0
	100.0	**100.0**	

Source: The Merchants Trust, Edison Investment Research

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

	Portfolio end-October 2018	Portfolio end-October 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	29.9	28.0	1.9	25.4	4.5	1.2
Industrials	17.0	16.5	0.5	10.8	6.2	1.6
Consumer services	11.7	14.5	(2.8)	11.2	0.5	1.0
Oil & gas	11.0	14.1	(3.1)	14.7	(3.7)	0.7
Consumer goods	7.0	5.2	1.8	14.1	(7.1)	0.5
Utilities	6.9	7.8	(0.9)	2.7	4.2	2.5
Healthcare	6.8	6.0	0.8	9.8	(3.0)	0.7
Basic materials	5.8	4.8	1.0	7.6	(1.8)	0.8
Telecommunications	1.6	1.8	(0.2)	2.8	(1.2)	0.6
Technology	0.0	0.0	0.0	0.9	(0.9)	0.0
Cash	2.3	1.3	1.0	0.0	2.3	N/A
	100.0	**100.0**		**100.0**		

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

Gergel highlights MRCH's recent initiation of a position in Imperial Brands. He says he avoided the tobacco stocks for the last year, as he was nervous about structural changes in the industry, including a reduction in demand and the proliferation of next-generation products cannibalising the market for traditional cigarettes. The manager became interested in Imperial Brands after its dividend yield doubled from c 4% in 2016 to c 8% in 2018. He believes the sharp sell-off in the company's share price is unwarranted, as although Imperial Brands has lower overall volumes – due to reduced demand and from rationalising its long tail of smaller brands – its premium brands are gaining share. He is also encouraged by the company's line up of next-generation products and its commitment to generate a meaningful percentage of total sales from these products by 2020.

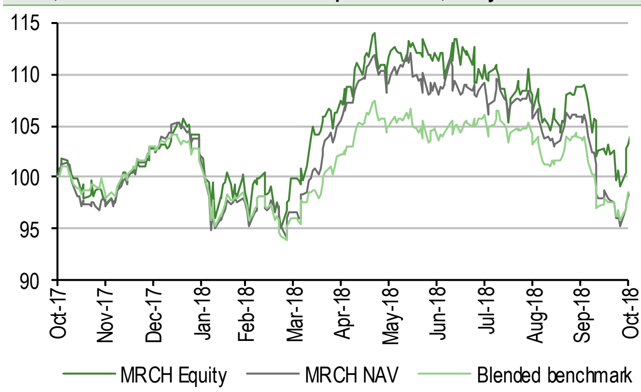
Other new positions in MRCH's portfolio include ITV and Keller. The manager says the position in ITV is controversial because of the structural pressure on its traditional TV business, due to competition from streaming. However, Gergel says that although audiences are fragmenting, ITV owns the only commercial station in the UK where advertisers can reach large audiences, and he is encouraged by the growth in its studio business (around one-third of sales), which is providing companies such as Amazon and Netflix with valuable content. Keller is a smaller company but is the world leader in geotechnical (ground) engineering. The firm is benefiting from urbanisation trends globally and the replacement of ageing infrastructure. Gergel says that local scale is important; equipment used within the industry does not move around much as ground conditions vary with location. Keller is also growing as a result of bolt-on acquisitions. The manager believes that the company's valuation is compelling.

Recent disposals within the portfolio include Diageo and Sainsbury's. Gergel recognises Diageo as a well-positioned, high-quality global spirits company. However, he found the company's valuation unattractive. The stock has outperformed a weak market, so the manager viewed the modest position as a good source of cash. Sainsbury's share price rallied following the announced merger with ASDA. Gergel believes the deal makes financial sense, but he has concerns over the timing of the merger, and whether it will gain regulatory approval without significant asset sales. In addition, the manager is mindful of the risks involved when companies enter into transformational deals.

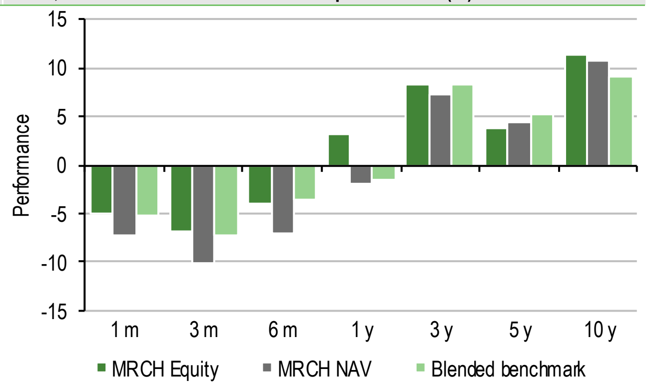
Performance: Outperformance over 10 years

Exhibit 5: Investment trust performance to 31 October 2018

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. Blended benchmark is FTSE 100 index until 31 January 2017 and FTSE All-Share index thereafter.

In H119 (ending 31 July), MRCH's NAV and share price total returns of +7.4% and +8.7% respectively were ahead of the benchmark's 5.0% total return. After taking financing costs and movements in the value of debt into account, gearing contributed 1.1pp to the trust's excess return. In terms of individual share price moves, the largest contributors to relative performance were not owning British American Tobacco (+0.7pp), which suffered from weak industry fundamentals, and the position in UBM (+0.7pp), which performed well ahead of its acquisition by Informa. The largest detractor was Standard Life Aberdeen (-1.0pp), which has continued to experience outflows since Standard Life and Aberdeen merged in August 2017; investors were also unimpressed by the terms of the deal to sell its life assurance business to Phoenix Group in exchange for c 20% of the firm and cash.

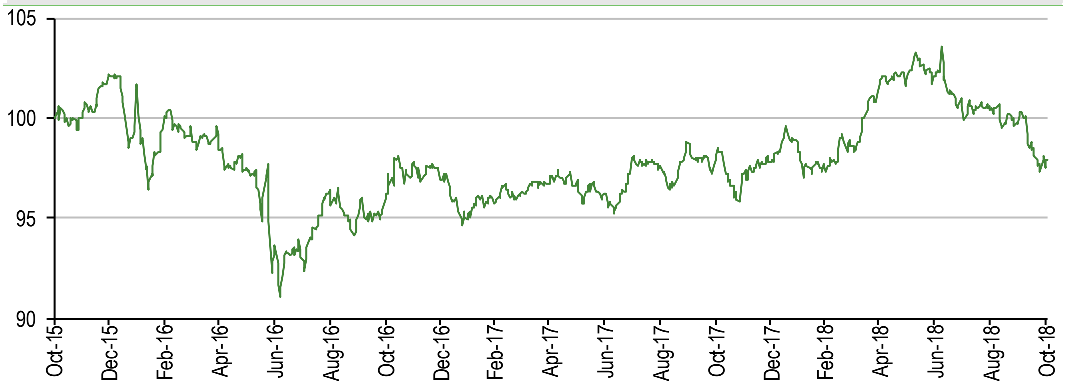
As shown in Exhibits 5, 6 and 7, in recent months MRCH's NAV and share price have been negatively affected by volatility in the UK stock market. However, its share price has outperformed the benchmark over one and three months and over one year.

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	(0.4)	4.8	0.0	(6.4)	22.5
NAV relative to blended benchmark	(2.2)	(3.2)	(3.7)	(0.5)	(2.5)	(4.0)	16.2
Price relative to FTSE All-Share	0.1	0.3	(0.4)	4.8	1.2	(7.6)	14.0
NAV relative to FTSE All-Share	(2.2)	(3.2)	(3.7)	(0.5)	(1.4)	(5.2)	8.2
Price relative to FTSE 100	(0.2)	(0.0)	(0.9)	4.2	0.4	(6.0)	23.0
NAV relative to FTSE 100	(2.6)	(3.5)	(4.2)	(1.1)	(2.1)	(3.6)	16.7

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-October 2018. Geometric calculation.

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

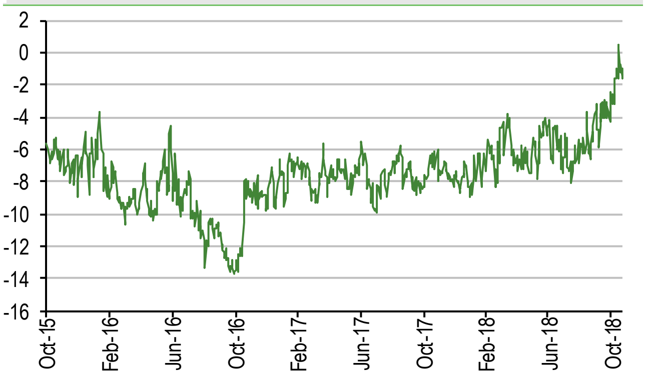


Source: Thomson Datastream, Edison Investment Research

Discount: Meaningful narrowing in recent months

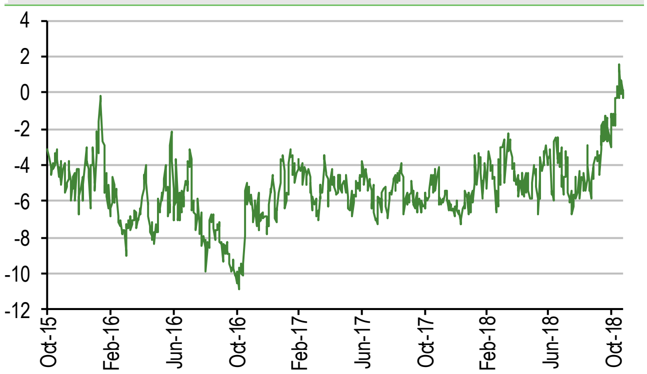
In Exhibits 8 and 9, we show MRCH's discounts over the last three years with debt at book value and market value respectively. Due to the low level of interest rates, the market value of the trust's relatively high-cost debt is higher than its book value, meaning that MRCH's share price discount to NAV with debt at market value is lower than its discount with debt at book value. The trust's current 0.1% share price premium to cum-income NAV (debt at market value) compares with average discounts of 4.5%, 5.4%, 3.5% and 2.3% over the last one, three, five and 10 years respectively.

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



Source: Thomson Datastream, Edison Investment Research

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



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

MRCH is a conventional investment trust with 108.7m ordinary shares in issue. Following the repayment of the trust's £34m, 11.125% debt in January 2018, via a £35m, 35-year private placement note at 2.96%, MRCH's interest costs are considerably lower. Interest is charged 65:35 to the capital and revenue accounts, and costs will be £2.8m pa lower as a result of the debt refinancing. The trust's debt structure is as follows: a c £45m 9.25% bond maturing in 2023; a c £30m 5.875% bond maturing in 2029; the £35m 2.96% note maturing in 2052; along with £2.6m in 3.65% cumulative preference shares and 4.0% perpetual debenture stock.

Exhibit 10: MRCH's debt profile

Financial year ending	31 January 2017	31 January 2018
Gross debt	£111m	£110m
Average interest rate*	8.5%	6.1%
Average duration*	7.2 years	16.8 years
First maturity	January 2018	May 2023

Source: The Merchants Trust, Edison Investment Research. Note: *Excludes modest level of perpetual debt.

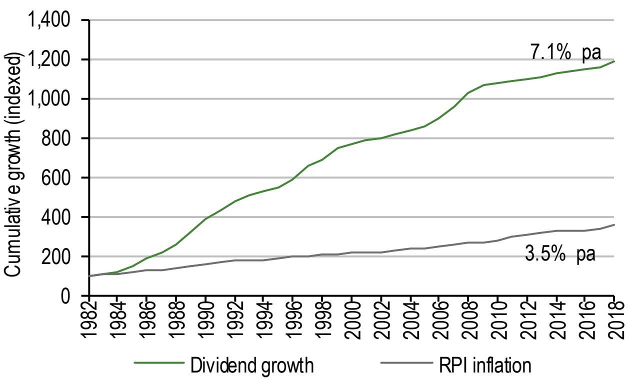
AllianzGI is paid 0.35% per year of the value of MRCH's gross assets (minus current liabilities, short-term loans and any funds within the portfolio managed by AllianzGI), which is allocated 65:35 between the capital and revenue accounts respectively, to reflect the board's expected split of long-term returns between capital and income. In FY18, the ongoing charge of 0.59% was 4bp lower than 0.63% in FY17.

Dividend policy and record

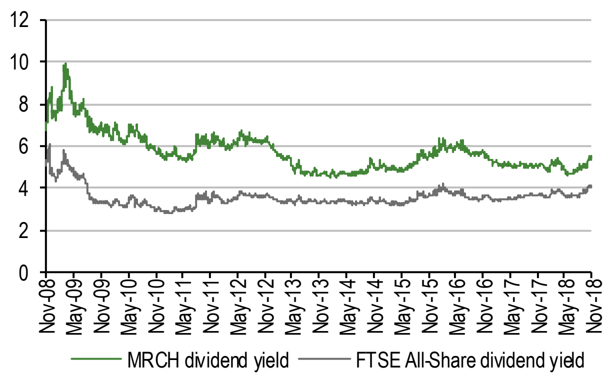
MRCH aims to generate a high and growing level of income; quarterly dividends are usually paid in August, November, February and May. The total H119 distribution of 12.9p is a 4.9% increase compared with H118. After deducting the H119 dividends, at the end of July 2018, MRCH had a revenue reserve equivalent to 14.0p per share (+5.3% y-o-y). The board intends to pay at least 6.5p per share for the third and final interim dividends in FY19; the minimum expected total dividend of 25.9p represents a 4.4% increase compared with FY18, and a prospective dividend yield of 5.5%.

Exhibit 11: MRCH's dividend yield and growth (%)

Growth of MRCH's dividend vs UK inflation



MRCH's dividend yield vs FTSE All-Share dividend yield



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

MRCH's board is proud of the trust's dividend history – annual distributions have increased in each of the last 36 consecutive years, and over this time have compounded at a significantly higher annual rate than the level of UK inflation (Exhibit 11, LHS). As shown in the right-hand exhibit above, over the last decade, MRCH has consistently offered a higher dividend yield than that available on the FTSE All-Share index.

Peer group comparison

MRCH is a member of the AIC UK Equity Income sector, which comprises 24 trusts. In Exhibit 12, we highlight the 12 largest, with market caps in excess of £300m. MRCH's NAV total returns (with debt at par value) are above average over one and three years, ranking third and sixth out of 12 funds respectively, while lagging over five and 10 years. Looking at the whole sector averages, MRCH is again above the mean over one and three years, ranking fourth and seventh out of 24 funds respectively, while ranking 20th out of 24 funds over five years and ninth out of 23 over 10 years. The trust's ongoing charge is below the selected peer group average, and it has a higher-than-average level of gearing. MRCH's dividend yield is the second-highest out of 12 funds (1.2pp above the mean) and fourth out of 24 funds (0.6pp above the mean).

Exhibit 12: Selected peer group as at 21 November 2018*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Merchants Trust	517.5	(2.8)	18.7	18.5	208.9	0.4	0.6	No	121	5.3
BMO Capital & Income	308.0	(4.6)	25.5	36.7	182.7	0.8	0.6	No	107	3.6
City of London	1,431.0	(3.3)	15.4	30.7	213.4	1.3	0.4	No	113	4.5
Diverse Income Trust	364.6	(4.1)	11.9	42.5		(0.3)	1.1	No	100	3.4
Dunedin Income Growth	356.6	(4.2)	20.3	19.2	192.2	(8.9)	0.6	No	118	5.4
Edinburgh Investment Trust	1,227.6	(5.5)	6.4	35.8	207.9	(9.1)	0.6	No	110	4.5
Finsbury Growth & Income	1,361.3	2.5	38.7	71.5	452.9	0.8	0.7	No	103	2.0
JPMorgan Claverhouse	395.1	(5.4)	17.4	30.3	218.0	1.2	0.8	No	112	4.0
Lowland	369.5	(7.4)	17.3	25.9	355.9	(5.7)	0.6	Yes	114	3.9
Murray Income Trust	487.9	(2.2)	23.1	25.5	203.5	(8.6)	0.7	No	108	4.5
Perpetual Income & Growth	784.7	(7.8)	(0.7)	21.3	207.0	(11.7)	0.7	No	116	4.3
Temple Bar	798.5	(5.1)	21.2	19.0	255.6	(6.1)	0.5	No	114	3.6
Selected average (12 peers)	**700.2**	**(4.1)**	**17.9**	**31.4**	**245.3**	**(3.8)**	**0.7**		**111**	**4.1**
MRCH rank (12 peers)	**6**	**3**	**6**	**12**	**6**	**5**	**8**		**1**	**2**
MRCH rank (24 whole sector)	**6**	**4**	**7**	**20**	**9**	**6**	**19**		**3**	**4**

Source: Morningstar, Edison Investment Research. Note: *Performance to 20 November 2018. 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

MRCH's board has five directors, all of whom are non-executive and independent of the manager. Simon Fraser has served as chairman since May 2010, having been appointed to the board in August 2009. He has announced his intention to retire in 2019, so a search for a new chairman is underway. The other four directors are: Paul Yates (appointed in March 2011), Sybella Stanley (senior independent director), Mary Ann Sieghart (both appointed in November 2014), and Timon Drakesmith (appointed in November 2016). The broad prides itself on its diversity in terms of gender, and wide-ranging experience in both investment and corporate commercial environments.

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