MARTEN & CO

Annual review | Investment companies

16 July 2015

Premier Energy & Water Trust

3 years later, in a new league!

Three years ago, James Smith joined the team managing Premier Energy and Water Trust (PEW). His appointment was followed by a seismic shift in approach, which has led to a significant uplift in performance as well as an improved focus on risk. PEW now offers a differentiated investment approach with a substantial weighting to high growth emerging markets and its split capital structure allows for both an enhanced yield and capital gearing. We expect that a significant gearing element will be retained when PEW's ZDPs expire at the end of this year. PEW's yield is also being enhanced by additional dividends through to March 2016 and PEW's shares have recently been trading at a small premium, allowing it to issue ordinary shares and ZDPs to satisfy demand.

PEW invests in equity and equity related securities of companies operating in the utilities and infrastructure sectors with the twin objectives of achieving high income and long term capital growth from its portfolio. Since the change of management and stock selection in June 2012, the portfolio has greater emphasis on emerging markets, smaller companies and special situations and lower weightings to traditional, developed market, utility companies.

12 months ended	Share price total return (%)	NAV total return (%)	FTSE All-World Utilities TR. (%)	FTSE All-World TR. (%)	FTSE All-Share TR. (%)
30/06/11	(7.0)	11.7	11.5	21.7	25.6
30/06/12	(25.2)	(24.6)	(3.7)	(4.0)	(3.1)
30/06/13	50.3	40.0	8.6	21.4	17.9
30/06/14	49.9	32.7	9.6	9.6	13.1
30/06/15	3.7	(5.5)	(0.8)	10.2	2.6

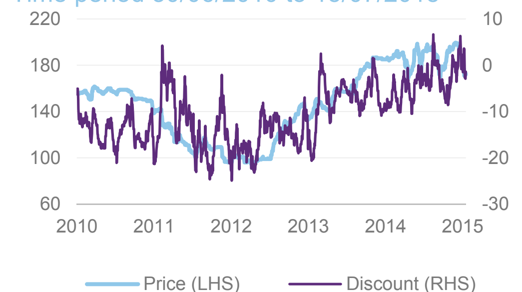
Source: Morningstar, Marten & Co. Note: PEW does not have a benchmark but, for comparison purposes, we have used the FTSE All-World Utilities Index throughout this report. PEW's financial year end is 31 December.

AIC Sector	Split Capital
Ticker (ords/ZDPs)	PEW / PEWZ
Base Currency	GBP
Price (ords)	172.0
NAV (ords)	174.39
Prem./(Disc.) (ords)	(1.4%)
Yield (ords)*	6.0%

*Note: Yield reflects base dividends.

Share price & discount (ords)

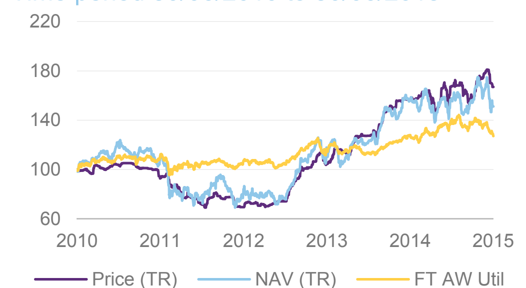
Time period 30/06/2010 to 15/07/2015



Source: Morningstar, Marten & Co.

Performance over 5 yrs (ords)

Time period 30/06/2010 to 30/06/2015



Source: Morningstar, Marten & Co.

Domicile	United Kingdom
Inception Date	November 2003
Managers	J. Smith, C. Long
Market Cap (ords)	30.4m
Ord. shrs outstanding	17.7m
Trading Vol. (1yr avg)	27,618
Net Gearing	150.2%

NB: this marketing communication has been prepared for Premier Energy & Water Trust by Marten & Co (which is authorised and regulated by the Financial Conduct Authority) and is non-independent research as defined under the Financial Services Act 2000 (Financial Promotion) Order 2005. It is intended for use by investment professionals as defined in article 19.(5) of that Order. Marten & Co is not authorised to give advice to retail clients and, if you are not a professional investor, or in any other way are prohibited or restricted from receiving this information you should disregard it. Charts and data are sourced from Morningstar unless otherwise stated. Please read the important information at the back of this document.

Contents

3	**Increasing value in emerging market utilities**
3	Chinese equity valuations – H-share versus A-share
3	Figure 1: Global and emerging utilities Index perf.
3	Figure 2: Global & emerging utilities F12m PE ratios
4	**PEW: Income from utility exposure**
4	3 years since strategy change
4	Current ZDPs expire at the end of December 2015
5	**Managers' view**
6	**Investment process**
7	**Asset allocation**
7	Figure 3: Geographic allocation as at 30 June 2015
7	Figure 4: Sectoral allocation as at 30 June 2015
7	Figure 5: Top ten holdings as at 30 June 2015
8	**Performance**
8	3 years since a successful strategy change was implemented
9	Figure 6: PEW NAV/FTSE AW Utilities – rebased to 100 since 30 June 2010
9	Figure 7: Total Asset TR vs NAV TR
10	Figure 8: Total return performance to 30 June 2015
10	**Dividend**
11	Figure 9: Revenue generation and dividend payment analysis
11	**Discount**
12	Figure 10: Premium/(Discount) over 5 years
12	**Fees & costs**
13	**Capital structure and trust life**
13	**Board**
13	Figure 11: Board member - length of service and shareholdings
13	**Previous research publications**
13	Figure 12: Marten & Co. previously published research on PEW

Increasing value in emerging market utilities

After a good year for global utilities in 2014, their performance, so far, during 2015 has been difficult, with the sector generally underperforming global equity markets. A relatively benign interest rate outlook, coupled with modest growth, saw the US provide much of the gains during 2014 but moving into 2015 investors have become increasingly wary of the potential for interest rate rises as the US government and potentially the UK government curtail and ultimately start to reverse their QE activities. Utilities, with their relatively stable and predictable cash flows, have traditionally been able to carry higher level of debt than other companies that have more volatile revenue streams. However, this has tended to make utilities more sensitive to rising interest rates, at least in the short-term (we explore the longer term impact of rising interest rates on utilities below).

Emerging and developed market utilities are trading at or modestly below their 5-year averages. The MSCI Emerging Market Utilities Index's forward P/E is 11.6x (5-year average is 12.2x). The FTSE All-World Utilities Index's forward P/E is 14.8x. (5-year average is 14.8x).

Within this context, it is not surprising that utility valuations are not particularly stretched. As illustrated in Figure 2, emerging market forward P/E ratios continue to be cheaper than those of developed markets whilst both emerging and developed market utilities have moved away from trading at forward P/Es towards the top end of their 5 year ranges to more average valuations. The FTSE All-World Utilities Index is currently trading at forward P/E of 14.8x (5 year average 14.8x) whilst the MSCI Emerging Utilities Index is trading on a forward P/E of 11.6x (5 year average 12.2x) (Source: Bloomberg).

Looking forward, there are risks within the global financial system (e.g. potential GREXIT, slowing growth in China, the ability of governments that are reliant on oil revenues to service their debt, etc.) and the ability of utilities to pass through cost increases to the end user over the longer term (see below). In this stock selection is key, which in turn hinges on having a deep understanding of the varying regulatory environments and how these are likely to impact a utility's profitability and ability to service debt.

While the threat of higher interest rates is worrying some investors in utilities, taking a medium to longer term perspective, there is much evidence to suggest that the correlation between the performance of the utilities sector and interest rates is weak. A simplistic view might say higher interest rates tend to depress the earnings of indebted companies, such as many utilities, and also increase the discount rate used by the market to ascribe a value to their future earnings, both depressing valuations. However, utilities are largely regulated businesses whose pricing is periodically reset through tariff reviews. Most regulators will allow interest rate movements to be passed through to the end user, thereby offsetting the longer term impact of interest rate rises and allowing them to earn a real return reflective of market conditions. Similarly, in more inflationary environments, which are usually accompanied by rising interest rates, utilities are frequently permitted to increase in their tariffs in nominal terms. Both effects will tend to have a positive impact on earnings and exert upward pressure on valuations. Other sectors may not benefit from such automatic adjustments.

Chinese equity valuations – H-share versus A-share

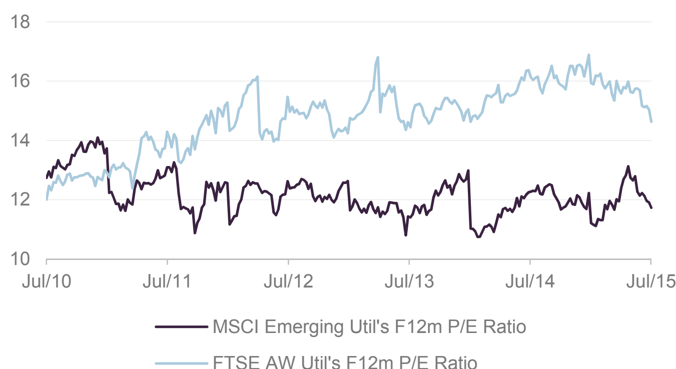
There has also been some concern regarding high demand and therefore the high valuations prevailing within the Chinese stock market. However, this appears to be primarily a concern for the A-share market. The H-share market (Hong Kong) is

principally institutional and is trading at noticeably lower valuations. PEW's Chinese investments are in the H-share market, it holds no A-shares.

Figure 1: Global and emerging utilities Index perf.

Source: Bloomberg, Marten & Co.

Figure 2: Global & emerging utilities F12m P/E ratios



Source: Bloomberg, Marten & Co.

PEW: Income from utility exposure

> Base yield on ordinary share of 6.0%, 7.8% if additional dividends are included.

Premier Energy & Water Trust Plc is a UK investment trust, listed on the main market of the LSE, that invests globally in the equity and equity related securities of companies operating in the utility and infrastructure sectors. It maintains a relatively concentrated portfolio (currently 56 stocks with the top five accounting for 30.4% of gross assets as at the end of June 2015), which includes exposure to both developed and emerging markets (split 44%/56% as at the end of June 2015). PEW aims to pay a high level of income on its ordinary shares (currently a yield of 6.0%, 7.8% if additional dividends are included – see page 11 for further details) and provide long term capital growth. It is aided, in this regard, by the significant gearing provided to the ordinary shares by its zero dividend preference shares (net gearing of 150.2% of the ordinary shares NAV – see below and page 14). www.premierfunds.co.uk

3 years since strategy change

> June 2012 strategy change has seen a marked improvement in performance, accompanied by a narrowing of the discount on PEW's ordinary shares.

James Smith and Claire Long are responsible for the management of PEW's portfolio. They follow a bottom up investment process based on fundamental research. There was a seismic shift in strategy when James joined the Premier team in June 2012 (portfolio turnover was over 90% for the 2012 year; annual turnover is typically between 30% and 40%). This saw the weightings to emerging economies increased, exposure to Europe and the US reduced, exposure to the UK increased, and an increased exposure to what the managers consider to be more interesting smaller companies at the expense of larger cap holdings. Portfolio concentration was also increased, reflecting an increased focus on higher conviction ideas. These changes have borne significant fruit (see pages 9 and 10 for further details of the performance uplift), which we believe has been a contributory factor in the elimination of the discount on PEW's ordinary shares during this period (see pages 12 and 13).

PEW's portfolio has been managed by Premier Fund Managers since its launch in 2003. Premier Funds is an independent asset manager with £3.8bn of assets under management as at 31 March 2015.

PEW's portfolio is managed using a process that is benchmark agnostic.

Readers should be aware that PEW's portfolio is not managed with respect to any particular benchmark (see investment process – pages 6 and 7). However, for the purpose of performance evaluation, the board look at the FTSE All-World Utilities Index, FTSE All-World Index and FTSE All-Share Index. For the purpose of our analysis, we use the FTSE All-World Utilities Index throughout this report.

Current ZDPs expire at the end of December 2015

PEW's ZDPs provide substantial gearing to its ordinary shares.

PEW's ZDPs will be redeemed on 31 December 2015. At current asset values, they represent a significant proportion of PEW's gross assets (£47.2m out of a total of £78.6m as at 30 June 2015) and we believe that existing shareholders would welcome some form of replacement gearing so that PEW can continue with a structure that is similar to its current form. In our view, it seems likely that the existing borrowings will be replaced with another ZDP issue although, if PEW's gross assets remain comparable to their current levels, we would expect the board would take the opportunity to reduce the level of PEW's borrowings. However, it also seems probable that PEW could borrow at a lower effective rate than it is effectively incurring on its current ZDP borrowings. We're expecting an announcement on PEW's future borrowing plans, well in advance of the existing ZDPs maturity, later this year. All of PEW's borrowing is currently provided by the ZDPs. The trust does not have a bank borrowing facility in place.

Managers' view

Prospect of rising interest rates a headwind.

At the beginning of the year, PEW's mangers stated that, with the prospect of interest rates rises, particularly in more developed economies, 2015 was likely to be a tougher market environment not just for equities in general but also for utilities. This has proven to be the case, as discussed on page 3, with PEW itself additionally suffering from Sterling strength and some stock specific issues (see pages 9 and 10). However, despite these, they retain an optimistic outlook for PEW's portfolio.

Managers favour higher growth emerging markets – Emerging market utility valuations are currently attractive versus developed markets.

At the macro level, PEW's portfolio is tilted towards emerging markets utilities, which remain cheap relative to global equities in general and look compelling vs developed market utility valuations. This tilt reflects the managers' longer term strategic view that emerging markets (.e.g. Asia and Latin America) offer superior growth prospects. However, a key consideration is the regulatory environment that a utility faces and whether this supports the sector's profitability. This varies across jurisdictions and can change over time. The managers construct the portfolio based on bottom up fundamental research but there are themes that guide its evolution.

Spanish and German electricity markets face a tough regulatory environment.

For example, the managers are avoiding exposure to Spanish electricity, which they consider to be expensive (a substantial renewables element has driven up total system costs) whilst income per head is lower than the Northern European average – thereby creating pressure on the regulator to be tough on utility companies. They're also avoiding exposure to German electricity, where renewables also account for a large proportion of generation, leading to a relatively tough regulatory environment.

Broadly speaking, the managers like the UK and do not consider the regulatory environment to be unduly onerous. Regulated utilities are generally permitted to pass through costs and earn sensible rates of return. Some consternation has been caused by DECC moves to phase out the Renewables Obligation Certificates (ROC) regime early, as it applies to onshore windfarms, in favour of an auction based CfD scheme, which is expected to lead to lower returns. However, the managers note that grace

periods have been introduced for projects where planning permission has already been approved.

Managers are adding selectively to the US.

PEW was underweight the US at the end of 2014 but valuations have moved back towards average levels and the managers advise that they are seeing opportunities and are adding selectively. Regulation needs to be considered on a state by state basis but generally allows for cost pass through and sensible levels of profitability in the managers' view. They also consider that US utility valuations are factoring in interest rates of c 4.5%, which is overdone in their view, making US utilities broadly cheap. On the managers' numbers, many US utilities are showing 10% div growth for the next few years. They say that the recent investment in Florida based Teco Energy is an example of a utility with a relatively wealthy and growing population, with low tariffs and a benign regulatory environment but with a sensible valuation.

Opportunities from Italian municipal utility consolidation.

The managers continue to see opportunities in the fragmented Italian utility market and favour consolidators able to introduce efficient practices and improve profitability. They generally like the water market, because of the need for investment, as the regulator is allowing tariff increases but are less enthusiastic about electricity as they consider the regulatory stance to be tougher.

Chinese coal fired generation benefitting from falling coal price.

The managers continue to see value in Chinese coal fired power generation, which has benefitted from falling coal prices during the last four years (China Power International is an example). Over investment in coal mining had been adding to capacity at 5-6% per year whilst electricity demand had been growing at 2-3% as year as China becomes more efficient. However, as the economy now slows, the benefit of a falling coal price has outweighed the negative impact of reduced utilisation, which is supporting profitability. Generators face a regulated pricing environment, although, in the managers' view, there is no real visibility over the pricing mechanism. The generators are theoretically supposed to be able to pass on 75% of the movement in coal costs to the end user but when prices were rising this did not happen as the government was concerned about the inflationary impact. The managers believe that the regulator is keen to foster a strong sector that will support further investment and so is allowing the current favourable pricing regime to persist to allow generators to strengthen their balance sheets. However, capex on thermal power stations is beginning to level off (as the economy slows and as China prioritises renewables) and the managers believe that these companies will become increasingly cash generative as capital spending and interest rates fall.

Investment process

Bottom up investment process based on extensive fundamental research.

PEW's portfolio is managed using a bottom-up investment process that is based on extensive fundamental research of potential investments. The investment universe comprises c 300 companies in the global energy, water and waste sectors, which includes a mixture of regulated and competitive businesses. The managers begin by screening out companies that are operating in what they consider to be un-investable locations. These will typically fall into one of two categories – those which have poor records with regards to corporate governance and shareholder rights (for example Greece, Argentina and much of the African continent) or countries where the managers consider the regulatory framework to be detrimental to the sector. This initial step reduces the list to c 100 companies that the mangers follow more closely.

The next step is to conduct a detailed analysis of a company's financials, taking a three to five year view. Considerable emphasis is placed on a company's ability to generate cash (free cash flow yield and EV/EBITDA being key metrics) as is dividend

growth (the managers consider that companies with growing dividends will tend to be those that have growing assets bases and are more appropriately geared).

The managers also undertake an assessment of the risks facing a company prior to investment. This will include an appraisal of the quality of management and board, corporate governance track record, regulatory environment, etc. Another key consideration is the extent to which a utility's product is expensive either in absolute terms or relative to income. The managers consider that, in either scenario, the regulator is more likely to take a tougher stance against utilities to protect consumers.

Portfolio is unconstrained by benchmark but seeks diversification by geography, utility type and regulatory environment.

PEW's portfolio is not constructed with reference to any benchmark, which allows the managers greater freedom to make allocations based on where they see the greatest opportunities. An obvious example is OPG Power Ventures (PEW's largest holding), which represents a large position in a non-index stock. Overall, the managers look to construct a portfolio that has geographic diversification as well as exposure to the full range of utilities (power, water, electricity, etc.) and varying regulatory environments, as well as some competitive businesses. Yield is a secondary but still important consideration as the managers remain mindful that shareholders expect a certain level of income.

With regards to investment restrictions, PEW's portfolio must have a minimum of twenty stocks (currently 56) and the maximum position size is 15% (at the time of investment) although the managers would not expect to allow a position to be much greater than 10% of the portfolio. PEW's policy is to remain fully invested, in normal market conditions but the managers can hedge currencies. However, this has only been employed periodically where the managers are particularly concerned about adverse currency movements.

The mangers monitor the portfolio on an ongoing basis and sales of stocks are usually triggered when they appear to be fully valued or where there has been an adverse change in fundamentals. In terms of portfolio evolution, whilst the portfolio is constructed bottom up based on fundamental research, an evaluation of macroeconomic, political and industry-specific themes does much to shape it.

Asset allocation

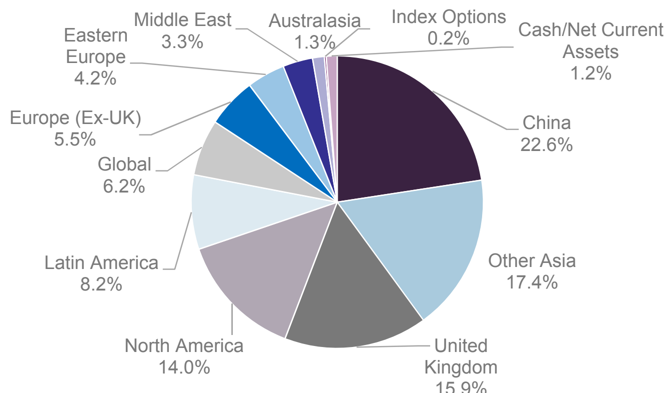
As illustrated in Figure 3, the portfolio continues to be tilted towards higher growth emerging markets. The portfolio's sector and geographic allocations look broadly comparable to their allocations six months ago, which reflects the longer term investment horizon favoured by the managers (portfolio turnover for 2014 was c 37%).

OPG is expected to commence dividend payment.

In terms of its larger holdings, the managers continue to remain positive on OPG Power. OPG made public its intention to commence paying dividends once its existing portfolio was fully delivered. The last of these is a 2 x 150 MW power station in Gujarat, which has been constructed but is presently connected to the grid by a 150 MW temporary transmission line (expected to be upgraded to 300 MW later this year). PEW's managers are not expecting an interim payment in the current financial year (ending 31 March 2016) but think a small final payment could be possible for the March 2017 year. The size of the dividend will depend on OPG's cash requirement as they expand capacity to a target of 3GW (currently 750 MW installed).

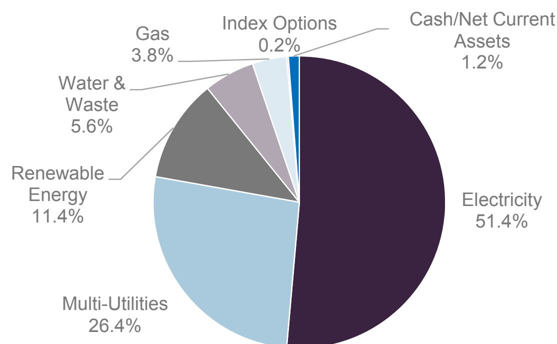
The managers remain positive on China Power International (CPI) despite its strong performance this year. CPI has benefitted from falling coal prices during the last four years, which has outweighed the fall in generation volumes (see page 6).

Figure 3: Geographic allocation as at 30 June 2015



Source: Premier Energy & Water

Figure 4: Sectoral allocation as at 30 June 2015



Source: Premier Energy & Water

Figure 5: Top ten holdings as at 30 June 2015

Holding	Sector	Geography	Allocation 30 June 2015 (%)	Allocation 31 Dec 2014 (%)	Percentage point change
OPG Power Ventures	Electricity	Asia (Ex-China)	10.0	9.6	0.4
China Power International	Electricity	China	7.9	5.0	2.9
Renewable Energy Generation	Renewable Energy	UK	4.8	6.0	(1.2)
Huaneng Power International	Electricity	China	4.1	4.5	(0.4)
First Trust MLP & Energy Inc. Fund	Multi-Utilities	North America	3.6	2.9	0.7
TECO Energy	Multi-Utilities	North America	3.6	0.3	3.3
Ecofin Water & Power Conv. Bonds	Multi-Utilities	Global	3.5	3.4	0.1
Qatar Electricity & Water	Multi-Utilities	Middle East	3.3	3.0	0.3
National Grid	Electricity	United Kingdom	3.2	2.6	0.6
China Everbright International	Water & Waste	China	3.2	3.2	0.0

Source: Premier Energy & Water Trust, Morningstar, Marten & Co.

Renewable Energy Generation is to issue ZDPs to finance build out of existing pipeline.

Renewable Energy Generation (REG) suffered during H1 (falling 19.2%) largely over concerns about the UK government's intention to legislate to close the ROC regime early to new onshore wind generation stations from 1 April 2016. However, PEW's managers consider that the market has overreacted as there is to be a grace period for projects that already have planning permission. This will allow such projects to be delivered prior to March 2017 and still qualify for the ROC system.

Greenko is now undervalued in the managers' view.

The managers have also been adding to Greenko (wind and hydroelectric generation in India) following a period of very difficult performance (Greenko was down 56.7% in local currency terms during H1) as the market began to realise that the convertible financing put in place to fund the build out of new hydro and wind plants could lead to material equity dilution. However, whilst the likely dilution is significant, PEW's managers consider that Greenko has good quality assets, that steps will be taken to improve Greenko's governance and that the market has overreacted to the potential dilution. Greenko are expecting earnings to improve significantly and on PEW's managers' assessment a valuation of c 125p is more appropriate, which makes the shares cheap at their current price of 61p (15 July 2015).

The managers are adding selectively to PEW's US exposure.

The managers have been adding to PEW's US exposure where they are now seeing more attractive valuations (e.g. Teco Energy). They have also been adding to First Trust MLP and Energy Income Fund, a fund of utilities and Master Limited Partnerships (MLPs), which is trading a c 10% discount and offering a yield in excess of 7.5%. The managers are also using a combination of calls and puts to hedge the downside risk on a small proportion of the portfolio.

Sold out of Ecofin convertible bonds in favour of Ecofin's equity.

In terms of sales, PEW's Ecofin convertible bonds were sold in their entirety in early July. When they were purchased, the managers saw very limited downside and potential upside if Ecofin's NAV performed well. However, they do not now think conversion is likely and have been swapping into Ecofin's equity where they see upside potential if the discount closes. Elsewhere, they have been selling the Italian gas utility Snam. Snam has responded positively to falling interest rates but their rates are due to be reset at the end of the year and PEW's managers think the market has overvalued the stock as a result.

Performance

3 years since a successful strategy change was implemented

Please visit QuotedData.com for a live comparison of PEW versus its split cap peer group.

Three years have now passed since James Smith joined PEW's management team in June 2012, which was followed by a significant change of strategy for PEW (see page 4 for details). The managers' approach is inherently longer term in nature and so the passing of the three year anniversary offers an appropriate juncture to review how successful the strategy change has been. However, it should be noted that PEW maintains a concentrated portfolio, which is unconstrained by benchmark and so it is highly probable its performance will deviate significantly from the commonly used benchmarks. We therefore consider that longer-term time frames are the most relevant when evaluating its performance.

Marked improvement in performance since the change of strategy in June 2012.

As illustrated in Figures 6 and 8, there has been a marked uplift in the performance of PEW's ordinary share NAV since the strategy change was implemented in June 2012. The strategy was particularly successful during 2013 with PEW's total assets beating the FTSE All-World Utilities Index by 15.2 percentage points. The gearing amplified the return so that PEW's ordinary share NAV beat this index by 49.2 percentage points.

As illustrated in Figure 7, 2014 was a good year for global utilities. The FTSE All-World Utilities Index returned 20.5% with the US driving much of the gains. PEW's total assets actually underperformed the FTSE All-World Utilities Index returning 17.7% but the positive impact of the gearing saw PEW's NAV total return beat the index returning 26.6% during the year. As Figure 6 illustrates, PEW's NAV performance broadly followed that of the FTSE All-World Utilities Index during the first half of 2014, albeit with some volatility, but underperformed during the second half when the US gains came through with force (PEW being underweight the US at the time).

Figure 6: PEW NAV/FTSE AW Utilities Index – rebased to 100 since 30 June2010

Source: Morningstar, Marten & Co.

Figure 7: Total Asset TR vs NAV TR

Year Ended 31 Dec.	Total Asset Return (%)	NAV Total Return (%)	Share price Total return (%)	FTSE AW Utilities TR (%)*	FTSE All World TR (%)*	FTSE All – Share TR (%)
2010	3.9	4.8	(10.0)	3.8	16.7	14.5
2011	(11.3)	(32.8)	(30.7)	(3.6)	(6.6)	(3.5)
2012	2.9	(4.0)	3.7	(1.6)	11.9	12.3
2013	24.5	58.5	71.8	9.3	20.8	20.8
2014	14.7	26.6	31.6	20.5	11.3	1.2

Source: Premier Energy & Water Trust, Morningstar, Marten & Co. * Note: All figures are in sterling equivalent terms.

Looking at performance for 2015 so far, PEW's NAV has outperformed the FTSE All-World Utilities Index (as illustrated in Figure 6). In terms of attribution, Sterling's strength has almost universally been a headwind (PEW was not currency hedged during the period) although the movements of individual stocks have predominated. China Power International has been the largest single contributor, in share price terms, returning 50.4% in local currency terms (49.0% in sterling terms) and contributing 2.45% to portfolio return. China Everbright has also performed well returning 20.5% in local currency, 19.4% in Sterling. Other significant contributors have been Qatar Electricity & Water, Huaneng Renewables and OPG Power Ventures. The single largest detractor has been Greenko Group, which has fallen 56.7% in local currency terms (56.3% in sterling terms) costing the portfolio 1.2% of return. Other notable detractors are Renewable Energy Generation and GDF Suez.

Figure 8: Total return performance to 30 June 2015 (Performance figures in excess of 1 year are annualised)

	1 month (%)	3 months (%)	6 months (%)	1 Year (%)	3 years (%)	5 Years (%)	Since 30/06/2012 (%)
NAV TR	(11.6)	(4.4)	(5.0)	(5.5)	20.6	8.1	20.6
Share price TR	(9.7)	2.9	(3.0)	3.7	32.7	10.2	32.7
FTSE AW Utilities*	(7.9)	(7.5)	(7.4)	(0.8)	5.7	4.9	5.8
FTSE All-World*	(5.2)	(5.0)	2.2	10.2	13.6	11.4	13.6
FTSE All-Share	(5.7)	(1.6)	3.0	2.6	11.0	10.7	11.0

Source: Premier Energy & Water Trust, Morningstar, Marten & Co. * Note: All figures are in sterling equivalent terms.

Dividend

Quarterly dividends with the objective of paying a high annual dividend.

PEW pays quarterly dividends on its ordinary shares. Historically, these have been structured as three smaller interim payments (paid in June, September and December) with a larger fourth interim payment in March (following the company's financial year end of 31 December). For the 2014 year, PEW paid three interim dividends of 1.9p per share with a final interim payment of 4.7p per share (a total of 10.4p for the year). However, PEW has also been paying an additional dividend of 0.75p per share, per quarter, since its second interim payment for the 2013 year.

Additional dividend (currently 0.75p per quarter) is to continue until the final payment for Q4 2015 in March 2016.

PEW's additional payments commenced following the decision by the board, in August 2013, substantially to run down PEW's significant revenue reserves prior to its then scheduled wind up at the end of 2015. However, to avoid the potential tax implications for shareholders of paying a lump sum, the board opted for a smoothed distribution, hence the additional quarterly payments. The yield impact has been significant - for the 2014 year, PEW's additional dividend totalled 3.0p or 29% of the company's base dividend. The total base dividend over the last twelve months represents a yield of 6.0% on the current share price, whilst the additional dividends represent a further 1.8% (7.8% in total). PEW has announced that it will cease to pay its additional dividends (0.75p per quarter) with the final dividend payment for the 2015 year (in March 2016).

ZDP expiration creates near term uncertainty for income generation.

In terms of income generation going forward, there are a number of considerations. At present, PEW's ordinary shares benefit from the income generated from the significant finance provided by the ZDP borrowings. The ordinary shares incur the cost of financing the ZDP borrowings but this is charged to capital thereby bolstering the revenue account. The ZDPs mature at the end of 2015 and whilst it seems likely that the borrowing will be replaced in some form, detail on the scale and nature of borrowings is yet to emerge. Until further details are available, it is difficult to form a view on the potential impact on PEW's ability to generate income.

Some headwinds to revenue generation in the current year, longer term outlook of between 3% and 5% dividend growth for underlying companies remains attractive.

In terms of revenue generation for the current year, recent sterling strength acts as an overall headwind, which is a reversal of the trend in 2014. The drought in Brazil has had a major impact on the hydroelectric companies there (traditionally large dividend payers), whilst PEW has recently sold its 6% Ecofin Bonds, that were also a decent income generator, on valuation grounds. Income generation in 2014 was also supported by exposure to an Essar convertible bond, which is no longer in the portfolio. However, as we have previously observed, there are some significant positions in PEW's portfolio that are not currently paying a dividend. One is PEW's largest holding, OPG Power Ventures (10.0% of the portfolio), which has made public its intention to commence dividend payment once its new 300 MW power station in Gujarat is delivered (see page 7). PEW's management also say that there are other non-payers that have the potential to commence payment or that some of these positions could be recycle into dividend paying stocks. Medium term the managers expect to see strong dividend growth from the underlying companies – typically between 3%-5% per annum in local currency terms.

Figure 9: Revenue generation and dividend payment analysis

Year ended 31 Dec.	Revenue return per share (p)	Total base dividend (p)	Special/ additional dividends	Total divs. inc. special/ add. divs. (p)	Y/E Rev. reserve per ord. shr (p)	Base dividend yield, on year end ord price (%)	Total dividend yield, on year end ord price (%)
2009	10.19	7.70	1.70	9.40	11.4	4.1	5.0
2010	9.33	8.10	-	8.10	8.6	5.2	5.2
2011	10.90	8.90	-	8.90	12.0	8.5	8.5
2012	11.10	9.30	-	9.30	14.0	9.4	9.4
2013	11.25	10.00	2.25	12.25	14.1	6.4	7.8
2014	*10.11	10.40	3.00	13.40	10.8	5.4	7.0

Source: Premier Energy & Water Trust, Bloomberg, Marten & Co. *Revenue return for the 2014 year was impacted by one off expenses incurred to extend PEW's life beyond the end of 2015. In the absence of these expenses, revenue return would have been 12.55p per share.

PEW retains the capacity to smooth dividends as required (end 2014 reserves were in excess of the 2014 base dividend).

As illustrated in Figure 9, the trend during the last five years has been one of an increasing revenue return (excluding the costs in 2014 for extending PEW's life), whilst the compound annual growth rate in PEW's revenue reserve per share has been 4.4%. As at the end of 2014, PEW had a revenue reserve of 10.8p per share. This was modestly above the total base dividend payment for 2014, which gives PEW good capacity to smooth dividends going forward.

Discount

Daily NAV reporting and improved portfolio visibility should aid NAV estimation going forward.

As illustrated in Figure 10, the broad trend of discount narrowing that has been in place since the change of strategy in June 2012, has continued during the last six months. However, this has been with considerable volatility (the last six months have seen PEW trading between a discount of 8.6% and a premium of 6.6%), which itself has been characteristic of PEW's discount during the last few years There may be a number of underlying causes (e.g. the geared nature of PEW's portfolio, the liquidity of PEW's ordinary shares) but we welcome the recent changes that give the market greater visibility over PEW's portfolio (a move to daily NAV reporting as well as full disclosure of the portfolio twice a year). We believe that this will allow the market to form superior estimates of PEW's NAV going forward and it seems reasonable that better NAV estimation could ultimately lead to lower discount volatility.

Ordinary shares and ZDPs have recently been trading at premiums allowing for share issuance.

PEW's ordinary shares have recently been trading at a modest premiums (currently a mild discount of 1.4%) and PEW was able to issue some stock (both ordinary shares and ZDPs). We believe that the trend towards discount narrowing during the last few years reflects both the significant improvement in PEW's performance since the strategy change as well as the compelling yield that the ordinary shares offer (from both the base and additional dividends that PEW is currently paying). PEW has announced that it will cease to pay its additional dividends (0.75p per quarter) with the final dividend payment for the 2015 year (in March 2016).

However, we observe that the underlying yield from the base dividend remains attractive (currently 6.0%) and is well covered by earnings. It also quite feasible that PEW's shares may see further strong demand once clarity is provided regarding the roll-over of the ZDPs at the end of this year.

Figure 10: Premium/(Discount) over 5 years

Source: Morningstar, Marten & Co.

Fees & costs

Management fee is 1.0% of gross assets, PEW has not paid a performance fee since 2007.

PEW pays a base management fee of 1.0% per annum of its gross assets (i.e. including the assets attributable to the ZDP holders) calculated monthly and paid in arrears. There is also a performance fee, which is triggered for any given accounting year if 1) the dividends paid or proposed to be paid on PEW's ordinary shares equal at least 6.75p and 2) the gross assets at the end of the year exceed the highest level of gross assets at the end of any previous accounting year or (if higher) the initial gross assets adjusted for share buybacks or share issuance, by more than 7.5% (subject to adjustments for changes in capital and other conditions).

Where a performance fee is triggered, it is 15% of the excess but PEW has not paid one since 2007. The low returns latterly provided by the previous investment approach did not reach the necessary hurdle. However, performance has improved since James Smith joined the team making a return to performance fee payment a more realistic proposition. We estimate that PEW's gross assets (£78.6m as at the end of June 2015) would need to experience organic growth of £4.1m to reach the current hurdle.

The base management fee is charged 40% to revenue and 60% to capital whilst the performance fee is allocated between capital and revenue based on the outperformance attributable to them. Premier Asset Management also provide company secretarial and administrative services to the company. Company secretarial fees for the 2014 year were £94k, up from £83k for 2013.

It should be noted that the ZDP holders have a fixed final entitlement and so do not directly benefit, beyond this fixed return, from the returns made on their capital (positive or negative). These returns accrue to the ordinary shareholders who are also liable for the management fees on PEW's ZDP capital. As such, the ongoing charges based purely on the ordinary share's NAV are amplified (5.0% for the 2014 year and 4.4% for the 2013 year on our estimates) and so a better comparison is to look at PEW's ongoing charges based on PEW's total assets (1.5% for 2014, up from 1.4% for 2013). The management agreement can be terminated at 12-months notice by either side.

Capital structure and trust life

Split capital structure, PEW's ordinary shares are geared by its ZDPs.

PEW is a split-capital investment trust with two types of security in issue: ordinary shares and Zero Dividend Preference shares (ZDPs). However, whilst the structure may at a first glance appear complicated, the ZDPs are purely a means of providing (substantial) gearing to the trust's ordinary shares (facilitating both income enhancement and amplifying performance). As at 15 July 2015, the ZDPs had an attributable asset value of 215.38p per share and were trading at 217.0p. They have a final entitlement of 221.78p per share on 31 December 2015, which is equivalent to a gross redemption yield of 4.8% per annum.

Life extended to 2020, 5 yearly continuation votes.

As part of the restructuring implemented to extend PEW's life beyond December 2015 (approved at an EGM on 27 August 2014) some minor changes were made to the ZDPs. Readers interested in the details should see our research notes of June 2014 and August 2014. However, ordinary shareholders are to be given the opportunity to vote on PEW's continuation in 2020, and at five yearly intervals thereafter.

Board

All directors have at least 1.9 years of their fees invested in PEW.

The board comprises four non-executive members that are considered to be independent of the investment manager. All directors stand for re-election at three yearly intervals, unless they have served for nine or more years, after which they stand for re-election annually. Geoffrey Burns, Ian Graham and Michael Wigley have served on the board since PEW's launch in 2003. As illustrated in Figure 11 below, all directors have at least the equivalent of 1.9 years of their fees invested in PEW's ordinary shares, which is favourable in our view.

Figure 11: Board member - length of service and shareholdings

Director	Position	Appointed	Length of service (yrs)	Annual director's fee (GBP)	Share-holding*	Years of fee invested*
Geoffrey Burns	Chairman	12/9/2003	11.8	26,000	80,411	5.3
Ian Graham	Chairman – Audit Committee	12/9/2003	11.8	20,000	22,032	1.9
Michael Wigley	Director	12/9/2003	11.8	18,000	125,150	12.0
Charles Wilkinson	Director	23/2/2011	4.4	18,000	31,223	3.0

Source: Premier Energy & Water Trust, Bloomberg, Marten & Co. *Note: shareholding as at 31 December 2014. Years of fee invested based on PEW ordinary share price of 172.0p as at 15 July 2015.

Previous research publications

Figure 12: Marten & Co. previously published research on PEW

Title	Note type	Date
A step change in performance	Initiation	18 June 2014
Solid interims and plans for the future	Update	7 August 2014
Value in emerging markets	Update	2 February 2015

Source: Marten & Co.

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