Henderson Diversified Income Trust

Investment companies | Update | 16 August 2021

Sticking to its guns

Henderson Diversified Income Trust (HDIV) focuses on high-quality companies with sustainable business models. It was resilient in the face of COVID-19-related market falls, but has not benefitted from the bounce in debt issued by cyclical and low-quality borrowers that has occurred since last November's vaccine news. Nevertheless, its three-year figures are well-ahead of those of competing funds.

Over 2021 to date, HDIV's shares have moved to trade at a discount to NAV. We think that this is unjustified, given HDIV's longer-term track record. As we discuss from page 4 onwards, the managers highlight the disruptive changes underway in many industries that have accelerated recently. They are convinced that the inflation we have been experiencing this year is transitory, that fundamentals will soon reassert themselves, and that HDIV's portfolio positioning will be rewarded.

High income from a flexible fixed income portfolio

HDIV's current objective is to seek income and capital growth such that, on a rolling annual basis, the total return on the NAV exceeds three-month sterling LIBOR plus 2%. Details of HDIV's proposed new benchmark are on page 15. It invests in a diversified portfolio of fixed income assets. The trust may also invest in high-yielding equities and derivatives. The managers use gearing to enhance returns. Dividends, which make up the bulk of returns for investors, are paid quarterly.

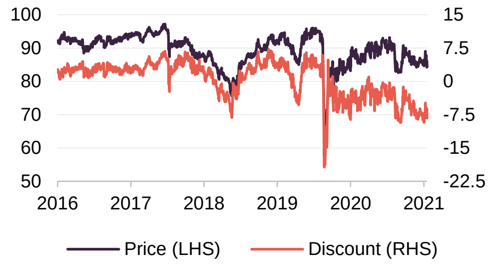
Year ended	Share price TR (%)	NAV TR (%)	Three-month LIBOR plus 2%
31/07/2017	7.1	8.0	2.4
31/07/2018	(1.4)	(1.4)	2.6
31/07/2019	10.2	8.9	2.9
31/07/2020	2.1	7.9	2.6
31/07/2021	(0.1)	7.3	2.1

Source: Morningstar, Marten & Co

Sector	Debt – loans & bonds
Ticker	HDIV LN
Base currency	GBP
Price	84.2p
NAV	93.1p
Premium/(discount)	(9.6%)
Yield	5.2%

Share price and discount

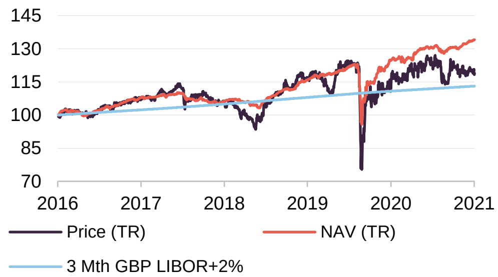
Time period 31/07/2016 to 13/08/2021



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/07/2016 to 31/07/2021



Source: Morningstar, Marten & Co

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Contents

Domicile	United Kingdom
Inception date	18 July 2007
Manager	John Pattullo and Jenna Barnard
Market cap	159.6m
Shares outstanding	189.590m
Net gearing	33.4%

Click for our most recent annual overview note

Click for an updated HDIV factsheet

Click for HDIV's peer group analysis

Analysts

James Carthew
jc@martenandco.com

Matthew Read
mr@martendandco.com

Jayna Rana
jr@martendandco.com

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To recap – a focus on sustainability

Readers may wish to refer to our last note

Our last note – Grounds for optimism – set out the managers' investment philosophy and approach to managing HDIV's portfolio, and readers may wish to refer back to it. However, to recap, HDIV's portfolio is differentiated from peers because the team emphasises preserving capital as well as generating attractive income returns.

Funding sustainable business models

Its managers focus on the long-term sustainability of the issuers that they are funding. In practice, this means excluding whole segments of the market where the underlying business is in structural decline, commoditised industries, those with cyclical and operational leverage, and issuers heavily exposed to emerging markets. The managers also avoid distressed credits and illiquid issues (those less than £250m).

When assessing issuers, the managers focus on metrics based on free cash flow over accounting profits, and returns on capital employed.

ESG analysis is factored into all investment decisions

ESG analysis is factored into all investment decisions. Businesses that score poorly on ESG metrics and show no signs of tackling this will not make it into the portfolio. One indication of this working in practice is that, on average, HDIV's portfolio has far less emissions exposure than the global corporate and high-yield index, aligning it to the 1.5˚C by 2050 carbon budget within the IEA Sustainable Development Scenario.

Market background

As we described in our last note, HDIV's portfolio held up relatively well during the COVID-19-related period of market volatility in March and April 2020. The emphasis on the quality of the underlying businesses meant that HDIV was not exposed to sectors such as airlines, high street retailers, and oil and gas companies which were particularly badly affected.

The additional leverage taken on in the depths of the market panic has proved beneficial to returns

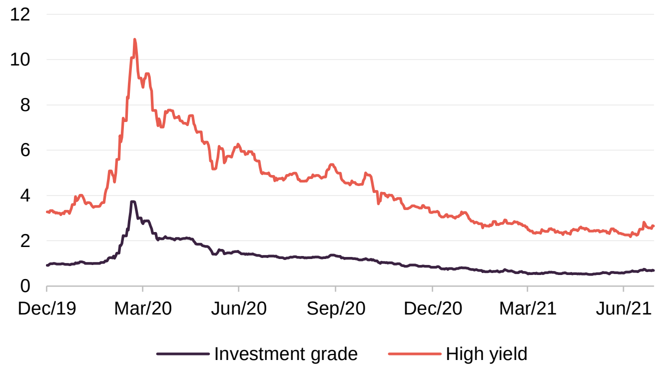
The managers felt confident enough to buck the trend of panic selling, take on additional leverage (with the support of the board), and pick up exposure to good-quality credits on attractive yields. This greatly strengthened the revenue account and enabled a modest increase in revenue reserves.

The pandemic panic last March is obvious in each of the charts in Figures 1 to 3. The policy response was lower interest rates, more quantitative easing and significant fiscal stimulus. The effect has been to supress volatility and push bond yields below pre-pandemic levels. Spreads have tightened, although at the margin they have widened in recent weeks, perhaps as investors fear the potential effects of new variants of the virus. Within HDIV's portfolio, the exposure to investment grade bonds has fallen as the managers feel that they no longer offer attractive yields.

Figure 1: Bloomberg US Corp Bond yield

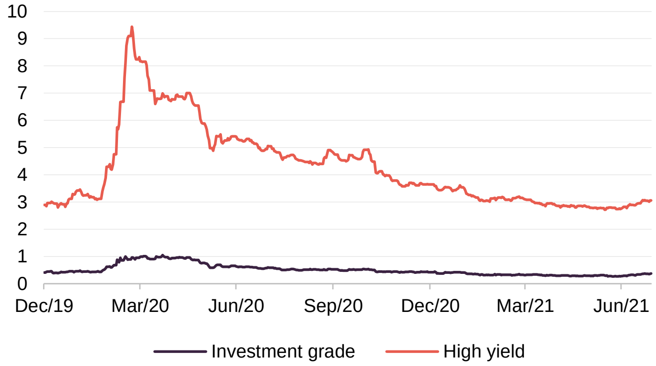
Source: Bloomberg

Figure 2: US investment grade and high yield spreads



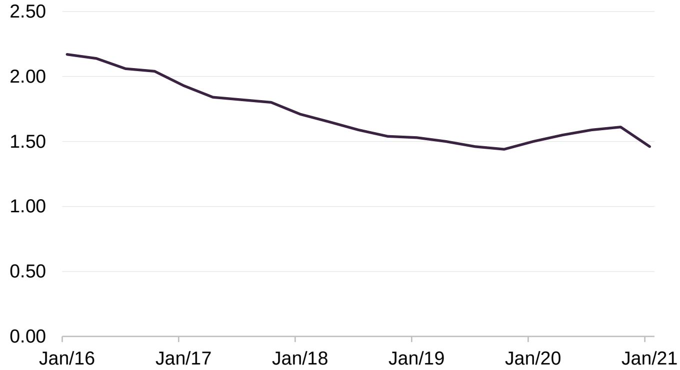
Source: Bloomberg

Figure 3: EU investment grade and high yield spreads



Source: Bloomberg

Figure 4: Delinquency rate on all loans, all commercial banks (US)



Source: Federal Reserve Bank of St Louis

> HDIV's managers believe that the structural challenges faced by many lower-quality businesses will eventually be reflected in higher defaults

Once vaccines offered the prospect of a reopening of economies, more cyclical and lower-quality names rallied strongly and CCC-rated issues did particularly well. By contrast, HDIV's portfolio remained relatively stable and this has held it back relative to its peer group in the short term (as we discuss on page 11). HDIV's managers have stuck to their guns. They remain convinced that over the medium term the structural challenges faced by many lower-quality businesses will be reflected in higher defaults by these companies. However, systemic default rates may continue to be low – JPMorgan has slashed its forecast high-yield default rate to 3.5% (it was forecast to be as high as 14% in March 2020).

Inflation is transitory, disruption has accelerated

From November 2020 onwards, as markets recovered, some investors became fixated on rising inflation numbers and the yield curve steepened. HDIV's managers have kept the duration of the portfolio relatively long. They anticipated that treasury yields would tighten once again (as they have since early June 2021). In their view, inflation is not permanent and not sustainable.

The managers say that, overall, the global economy is still stagnating, albeit with a few bottlenecks. Their model notes that 7m people have not yet returned to work in the US, there is seemingly no real demand for credit, and stimulus cheques have been saved rather than spent.

The managers also note that the recovery has been 'K'-shaped (i.e. some sectors are recovering much faster than others) and inequitable (the gap between the richest and poorest has widened).

Labour has no bargaining power and this should keep a lid on inflation

One principal argument that the managers have against inflation is that labour has no bargaining power. Artificial intelligence and automation are destroying jobs in a wide range of sectors. Technological innovation enables more people to participate in the workforce while simultaneously destroying jobs. The same technology that enabled working from home also allows jobs to shift to lower wage economies.

Disruption is everywhere. The shift to online retail justifies the managers antipathy towards physical retailers, for example. Question marks over the future of business travel threaten the future of airlines and hotels. Streaming and online gaming are replacing cinemas.

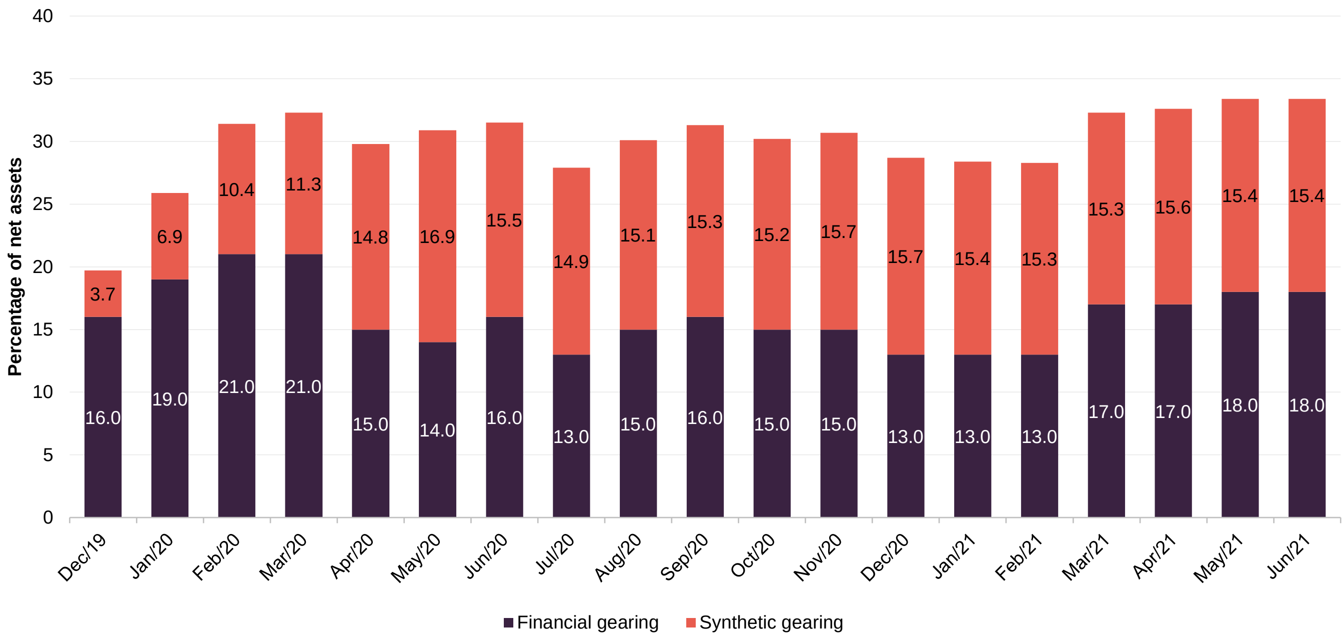
However, it is not all bad news. The managers note that low defaults and stringent regulation mean that bank balance sheets are relatively strong, for example. The surge in pet ownership during lockdowns is supporting growth in a range of related businesses. The shift to working from home triggered a short-term increase in demand for tech equipment, but the market for cyber security is likely to remain strong for a long while yet, in the face of threats such as the SolarWinds hack. As we describe on page 8, this thinking is reflected in HDIV's portfolio.

Leverage

HDIV operates with a mixture of real and synthetic gearing. In addition to gearing provided through a borrowing facility, credit default swaps (CDS) are used to provide gearing to the portfolio. The managers can use derivatives (CDS, interest-rate futures and swaps) in the management of the portfolio – this lets them manage exposures without buying or selling the underlying securities.

Leverage levels, which were raised substantially in Spring 2020, have been fairly stable since, although the managers did increase gearing in March 2021 when many others were worrying about inflation.

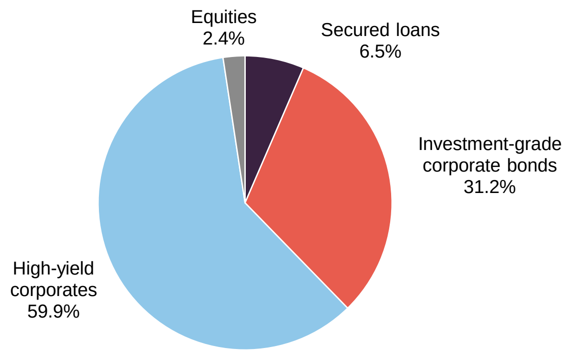
Figure 5: HDIV leverage since end December 2019



Source: Janus Henderson Investors, Marten & Co

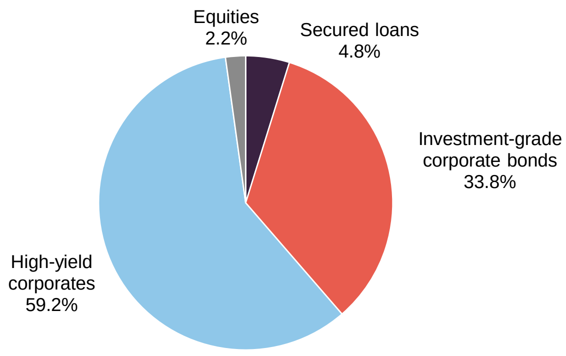
Asset allocation

Figure 6: HDIV sector breakdown as at 31 July 2021



Source: Janus Henderson Investors, Marten & Co

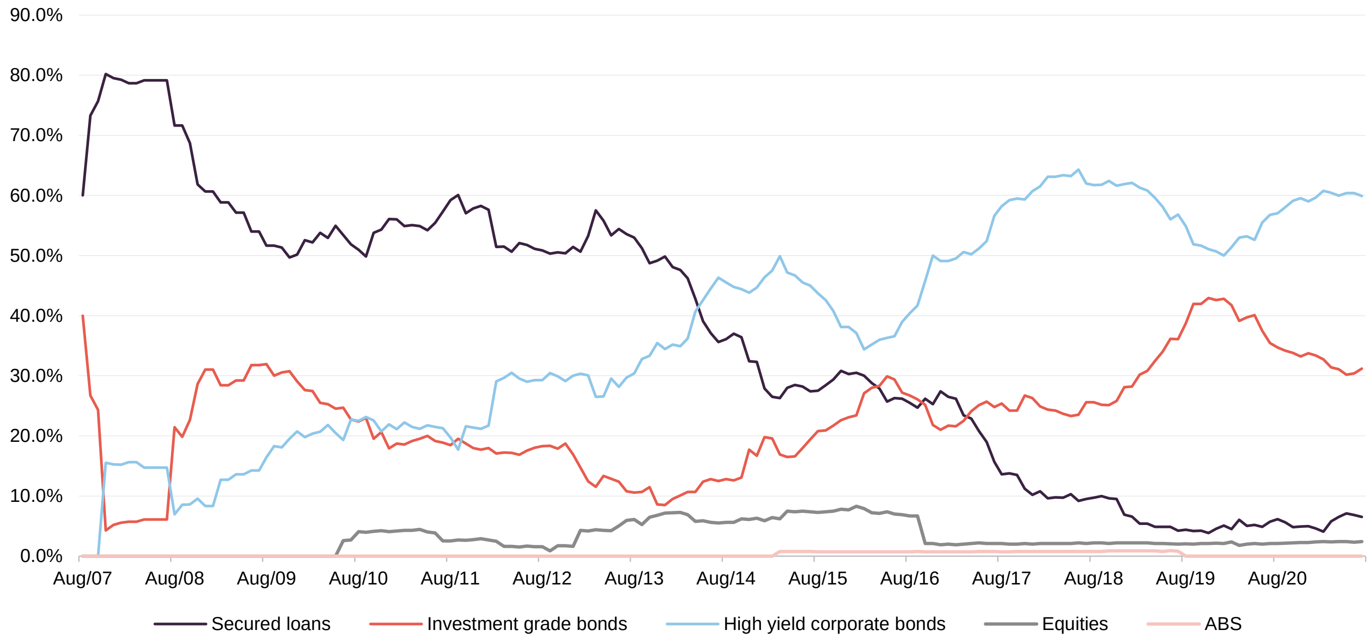
Figure 7: HDIV sector breakdown as at 31 October 2020



Source: Janus Henderson Investors, Marten & Co

The bias of the portfolio is towards high-yield and non-financials issuers. Since we last published, the main change in asset allocation is an ongoing switch away from investment grade loans – as spreads have tightened – into secured loans. This trend is more obvious in Figure 8.

Figure 8: HDIV asset allocation over time to end July 2021 (percentages are of net assets)



Source: Janus Henderson Investors

Figure 8 shows how HDIV's asset allocation has evolved since its launch in 2007 and illustrates the dramatic reduction in secured loans and the corresponding increase in exposure to high-yield bonds.

10 largest exposures to individual issuers

HDIV's portfolio is remarkably stable

HDIV's list of its 10 largest exposures to individual issuers is remarkably stable, reflecting the managers' long-term focus. There are no changes of note since we last published. Aramark has fallen out of the list, to be replaced by Rabobank. The former is still held within the portfolio.

Rabobank

Rabobank is a co-operative bank based in the Netherlands, with strong ESG credentials – it has specialisms in financing sustainable agriculture, measures to tackle climate change, and the transition to a more inclusive society (including the provision of affordable housing).

In July 2021, Moody's Investors Service announced that it had upgraded Rabobank's long-term deposits and senior unsecured debt ratings to Aa2 from Aa3 and with a stable outlook.

Figure 9: 10 largest exposures to individual issuers at 30 June 2021

Holding	Industry	30/06/21 (%)	30/11/20 (%)	Change (%)
Nationwide Building Society	Building society	2.3	2.3	-
Phoenix Group 6.625% 2025	Life assurance	2.1	2.2	(0.1)
Co-operative Group 2011 7.50% 2026	Food retail, funerals, financial services	2.0	2.0	-
IQVIA 5.00% 2026	Healthcare, clinical trials	1.9	2.0	(0.1)
CSC 5.75% 2030	Cable TV and broadband internet	1.6	1.7	(0.1)
Virgin Media Secured Finance 4.125% 2030	Cable TV and broadband internet	1.5	1.5	-
Altice France 5.50% 2028	Mobile telecoms and media	1.5	1.5	-
Crown Castle International 3.65% 2027	Wireless and broadband infrastructure	1.4	1.5	(0.1)
Stichting AK Rabobank Cert 2.1878% 2170	Bank	1.3	n/a	n/a
Service Corp International 4.625% 2027	Funerals	1.3	1.4	(0.1)

Source: BNP Paribas

New additions to the portfolio

Searching for rising stars

In their search for alpha, the managers have been targeting ‘rising stars’ – issues that have a good prospect of being upgraded from non-investment grade to investment grade. Such a move is often accompanied by a rising price/lower yield as the bond becomes suitable for investment by a much deeper pool of capital.

The managers note that the proportion of rising stars relative to ‘fallen angels’ (issues going the other way – from investment grade to non-investment grade) has been rising in recent quarters.

Issuers that have been added to the portfolio in recent months include Ball Corporation, Centene Corporation, Crowdstrike, IVC, Kraft Heinz, LPL Holdings, MSCI and T-Mobile.

Ball Corporation

Ball Corporation (ball.com) describes itself as the world's leading provider of innovative, sustainable aluminium packaging. It is a listed company with a market cap of $29.1bn. HDIV owns its 5.25% bonds maturing on 1 July 2025. Over H1 2021, Ball Corp generated positive cashflow from operations. At the end of June, it had long-term debt of $7.0bn, other long-term liabilities of $2.6bn, and equity of $3.7bn.

Centene Corporation

Centene Corporation (centene.com) is a healthcare management company serving over 25m Americans. It is a listed company with a market cap of $36.8bn. HDIV owns its 2.5% bonds maturing on 1 March 2031. At June 30, 2021, Centene had a debt to capitalisation ratio of 38.9%.

Crowdstrike

Crowdstrike (ir.crowdstrike.com) is a cloud security company which aims to detect cybersecurity threats and stop breaches. It is a listed company with a market cap of $55.6bn. HDIV owns its 3% bonds maturing on 15 February 2029. The fast-growing company had cash and cash equivalents of $1.7bn at end April 2021 and generated record positive free cash flow in Q1 2021.

IVC Evidensia

IVC Evidensia (ivcevidensia.com) is Europe's largest veterinary services company, operating around 1,500 clinics and animal hospitals across 12 countries. The company is backed by private equity firms including EQT and Silver Lake. The last funding round in February 2021 valued the company at €12.3bn. HDIV owns floating rate bonds maturing in February 2026.

Kraft Heinz

Kraft Heinz (ir.kraftheinzcompany.com) owns some of the world's most recognisable consumer brands. It is a listed company with a market cap of $46.4bn. HDIV owns four of its long-dated bonds maturing in 2042, 2045, 2046 and 2049. The panic-buying associated with the COVID-19 outbreak pulled forward sales of its products, but it is achieving organic growth when compared to 2019 figures. Free cash flow is strong at $1.6bn for H1 2021 and its net leverage has fallen from 4.4x EBITDA in 2019 to 3.1x at 30 June 2021.

LPL Financial

LPL Financial (lpl.com) is the largest independent broker-dealer in the US with over $1trn in brokerage and advisory client assets. It is a listed company with a market cap of $11.7bn. HDIV owns 4% bonds maturing on 15 March 2029. Lower interest rates have put pressure on margins but the business remains profitable. The company's net debt/EBITDA ratio rose in Q2 to 2.26x from 2.11x at end March 2021. However, the rise was associated with an acquisition and the ratio is still towards the lower end of its target 2x–2.75x range.

MSCI Inc

MSCI (ir.msci.com) is the company behind the eponymous range of indices and associated products and services. It is a listed company with a market cap of $51.2bn. HDIV owns two of its bonds maturing in 2029 and 2030. Q2 2021 was its best-ever quarter for total net new recurring subscription sales. At 30 June 2021, net debt/EBITDA was 1.8x, while net debt of just under $2bn compares with guidance towards free cash flow of $840m–$890m for 2021.

T-Mobile

T-Mobile (investor.t-mobile.com) is a US telecoms company. It claims to own America's largest, fastest and most reliable 5G network. T-Mobile is a listed company with a market cap of $180.9bn. HDIV owns three of its bonds maturing in 2026, 2028 and 2050. T-Mobile's net debt, excluding tower obligations, at the end of Q2 2021 was $69.9bn, equivalent to 3.0x EBITDA (down from 3.1x at 31 March 2021).

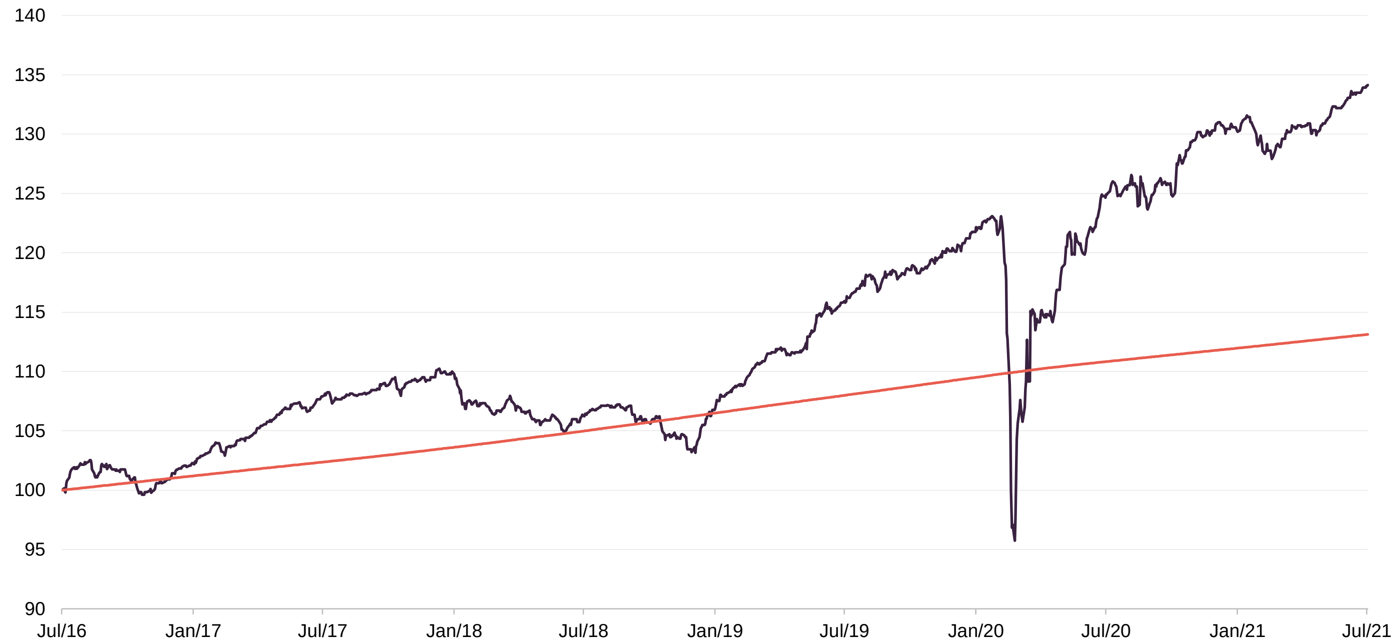
Exits

The managers sold out of HDIV's position in Credit Suisse AT1 on governance grounds. The manager found repeated due diligence failures – including exposure to Greensill Capital and Archegos Capital Management – to be concerning and decided to exit the position.

They also sold HDIV's 4.625% booking.com 2030 bonds on valuation grounds. The price of the bonds rallied by 17 percentage points as investors anticipated a post-COVID return to leisure travel. HDIV also benefitted from the coupon on the bonds.

Performance

Figure 10: HDIV NAV total return performance versus objective over five years ending 31 July 2021



Source: Morningstar, Marten & Co

Relative to its existing LIBOR-based benchmark, HDIV's long-term record is one of impressive long-term outperformance. As we have discussed in previous notes, in 2018, yields rose across HDIV's portfolio in anticipation of inflation which did not materialise. Being resolute in their thinking and keeping the portfolio's duration long; set the seeds for subsequent strong returns. There is an echo of this today.

Last year's panicky markets hit almost all funds, but the strengths of HDIV's portfolio were soon reflected in its NAV and, for it, the hit proved short-lived. The actions that the managers took to ramp up leverage and pick up good quality credits at attractive prices helped spur subsequent returns.

As we described in our last note, the board feels that the present benchmark does not reflect the risks and rewards of investing in bonds and other instruments across the cycle. It proposes the adoption of a benchmark comprised of 60% global high-yield credit (represented by the ICE BofA Global High Yield Constrained Index), 25% global investment grade corporate credit (represented by the ICE BofA Global BBB Corporate Bond Index) and 15% European loans (represented by the Credit Suisse Western European Leveraged Loan Index). Returns will be calculated in sterling.

Figure 11: Total return cumulative performance over various time periods to 31 July 2021

	3 months	6 months	1 year	3 years	5 years
Henderson Diversified Income NAV	2.7	3.0	7.3	26.0	34.1
Henderson Diversified Income price	(2.2)	(2.7)	(0.1)	12.5	18.8
Existing LIBOR-based benchmark	0.5	1.0	2.1	7.7	13.1
New index-based benchmark[1]	0.7	0.4	2.5	13.6	27.5

Source: Morningstar, Marten & Co. Note 1) see above

As Figure 11 shows, had the new benchmark been in place over the previous five years, it would have proved a more challenging target than the previous benchmark, but HDIV would still have outperformed it by a decent margin.

Peer group

Up-to-date information on HDIV and its peers is available on the QuotedData website

HDIV is a constituent of the AIC's debt – loans and bonds sector, and we have used this as a comparator. The funds within the debt – loans and bonds sector encompass a variety of investment objectives and strategies not all of which compare well with HDIV's investment strategy.

Since we last published a note on HDIV, City Merchants High Yield and Invesco Enhanced Income have merged to become Invesco Bond Income Plus.

HDIV's discount is around the middle of the peer group. Currently, only two funds are trading on premiums to net asset value and these are amongst the highest-yielding funds in the sector. HDIV's ongoing charges ratio is one of the lowest in the sector.

The peer group performance data in Figure 13 illustrates the narrative of the past two years. HDIV's focus on the quality of its issuers has stood it in good stead over the longer term. However, in recent months, having fallen less last year, its portfolio has not participated in the rally in cyclical and lower-quality issues that has occurred since last November.

Figure 12: Peer group comparative data as at 12 August 2021

	Premium / (discount) (%)	Dividend yield (%)	Ongoing charge (%)	Market cap (£m)
Henderson Diversified Income	(9.6)	5.2	0.93	160
Axiom European Financial Debt	(9.6)	6.4	1.45	86
CQS New City High Yield	6.6	8.1	1.19	247
CVC Credit Partners Euro Opps EUR	(5.3)	5.2	1.48	99
CVC Credit Partners Euro Opps GBP	(3.0)	4.7	1.48	167
Invesco Bond Income Plus	(3.6)	5.8	0.99	319
M&G Credit Income Investment	(1.6)	3.0	0.88	143
NB Distressed Debt Inv Extended Life	(35.0)	1.4	2.95	35
NB Distressed Debt Investment	(22.4)	0.0	2.95	8
NB Distressed Debt New Global	(35.6)	1.6	2.95	16
NB Global Monthly Income	(6.0)	5.2	1.14	221
TwentyFour Select Monthly Income	3.7	6.3	1.12	183
HDIV rank	8/12	5/12	2/12	6/12

Source: Morningstar, Marten & Co

Figure 13: Peer group comparative data as at 31 July 2021

	3 months	6 months	1 year	3 years	5 years
Henderson Diversified Income	2.7	3.0	7.3	26.0	34.1
Axiom European Financial Debt	3.8	12.8	22.7	29.1	n/a
CQS New City High Yield	1.5	4.6	12.2	22.8	40.1
CVC Credit Partners Euro Opps EUR	2.5	10.1	20.6	16.7	42.1
CVC Credit Partners Euro Opps GBP	1.5	3.2	13.9	3.8	30.6
Invesco Bond Income Plus	3.6	7.3	21.3	12.3	35.1
M&G Credit Income Investment	1.0	2.8	8.8	n/a	n/a
NB Distressed Debt Inv Extended Life	4.6	11.5	22.9	(17.0)	(4.8)
NB Distressed Debt Investment	3.4	5.8	0.5	(41.4)	(25.6)
NB Distressed Debt New Global	8.5	10.1	32.1	(19.9)	(13.9)
NB Global Monthly Income	1.3	3.5	13.4	14.9	23.3
TwentyFour Select Monthly Income	2.1	5.0	18.2	23.2	51.9
HDIV rank	6/12	11/12	11/12	2/11	5/10

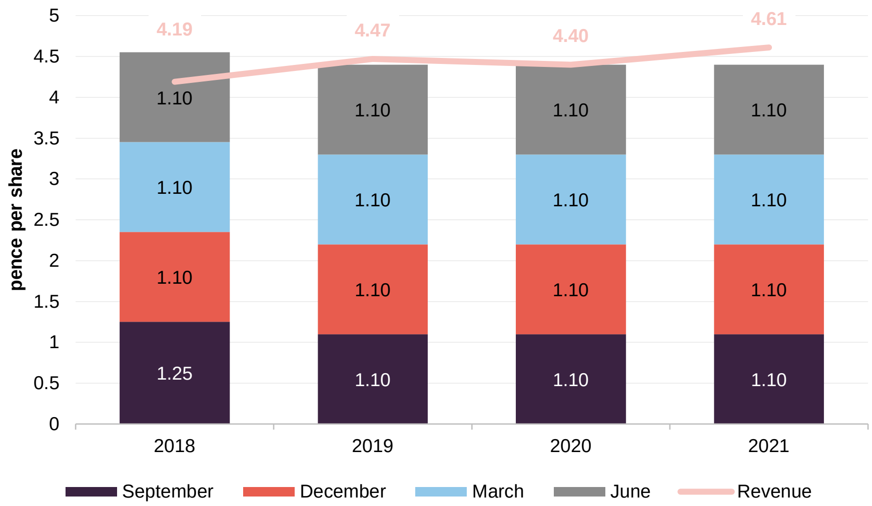
Source: Morningstar, Marten & Co

Quarterly dividend

HDIV's accounting years end on 30 April, and it pays quarterly dividends in September, December, March, and June. Against dividends totalling 4.4p for the year ended 30 April 2021, the revenue per share was 4.61p (up from 4.40p for the prior year). The revenue reserve stood at £2.7m at the end of April 2021 – enough to cover about a third of the annual dividend.

The managers believe that the actions that they took last year should mean that the dividend is sustainable for the immediate future. However, in the longer term, if their secular stagnation theory holds true then it could come under pressure. All similar funds would be likewise affected.

Figure 14: HDIV dividend history – accounting years ended 30 April

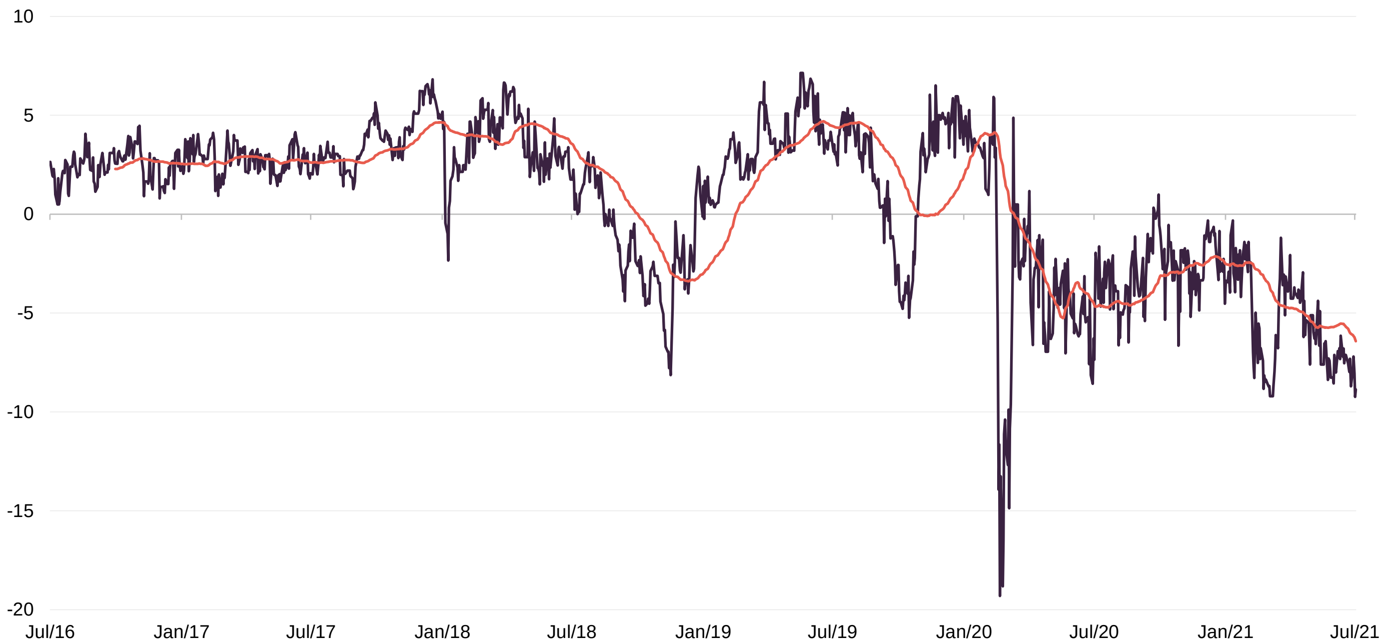


Source: Janus Henderson Investors, Marten & Co

The managers say that, whilst not seeking to forecast the trust's financial results for the current year, the actions that they took in Spring 2020 to increase the trust's gearing and lock in attractive yields should help ensure that the dividend is covered by earnings this year, allowing it to increase its revenue reserve.

Premium/(discount)

Figure 15: HDIV premium/(discount) over five years to end July 2021



Source: Morningstar, Marten & Co

Over the 12 months ended 31 July 2021, HDIV's discount moved within a range of a discount of 9.2% to a premium of 1.0% and averaged a discount of 4.2%. At 12 August 2021, HDIV was trading at a discount of 9.6%.

HDIV has been buying back stock to help address the widening discount. Since we last published, HDIV has bought back 1.7m shares. Unusually, the repurchased shares have been cancelled rather than being held in treasury. At the AGM on 15 September 2020, shareholders approved the issuance of up to 10% of HDIV's then-issued share capital (19,131,824 shares) and the repurchase of up to 14.99% of its then-issued share capital (28,678,604 shares). Shares will only be issued at a premium to NAV and bought back at a discount.

Fund profile

More information is available at the trust's website www.hendersondiversifiedincome.com

Henderson Diversified Income Trust (HDIV) invests selectively across the full spectrum of fixed-income asset classes, including – but not limited to – secured loans; government bonds; asset-backed securities; investment-grade corporate bonds; high-yield corporate bonds; unrated bonds; preference and selective high-yield equity shares; hybrid securities; convertible bonds; and floating-rate notes.

Its objective is to seek income and capital growth such that, on a rolling annual basis, the total return on the NAV exceeds three-month sterling LIBOR plus 2% (but see below). It has a global mandate and the managers use gearing to enhance returns. The company was redomiciled to the UK from Jersey with effect from 27 April 2017.

As described on page 10, the board feels that the present benchmark does not reflect the risks and rewards of investing in bonds and other instruments across the cycle. It proposes the adoption of a benchmark comprised of 60% global high yield credit (represented by the ICE BofA Global High Yield Constrained Index), 25% global investment grade corporate credit (represented by the ICE BofA Global BBB Corporate Bond Index) and 15% European loans (represented by the Credit Suisse Western European Leveraged Loan Index). Returns will be calculated in sterling.

Shareholders will be asked to approve this proposal at the AGM scheduled to be held on 16 September this year.

Previous publications

Readers interested in further information about HDIV may wish to read our last note, which was published on 6 January 2021, as well as our previous notes (details are provided in Figure 16 below). You can read the notes by clicking on them in Figure 16 or by visiting our website.

Figure 16: QuotedData's previously published notes on HDIV

Title	Note type	Date
Onshore, on-message, on-form	Initiation	4 May 2017
Dear Prudence	Update	2 November 2017
Winter is coming	Annual overview	4 October 2018
Death rattle for bull market	Update	3 April 2019
Soft landing likely…	Annual overview	28 November 2019
Favourable style and structure	Update	21 July 2020
Grounds for optimism	Annual overview	6 January 2021

Source: Marten & Co

QuotedData
BY MARTEN & CO

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123a Kings Road, London SW3 4PL
0203 691 9430

www.QuotedData.com

www.martenandco.com

Registered in England & Wales number 07981621,
2nd Floor Heathmans House,
19 Heathmans Road, London SW6 4TJ

Edward Marten (em@martenandco.com)

David McFadyen (dm@martenandco.com)

Colin Edge (ce@martenandco.com)

Nick Potts (np@martenandco.com)

INVESTMENT COMPANY RESEARCH:

Matthew Read (mr@martenandco.com)

James Carthew (jc@martenandco.com)

Jayna Rana (jr@martenandco.com)

Richard Williams (rw@martenandco.com)