EDISON

The Merchants Trust

FY18 outperformance continuing in FY19

Investment trusts

The Merchants Trust (MRCH) is managed by Simon Gergel at AllianzGI. He aims to generate a high and growing level of income, with the potential for long-term capital growth, from a portfolio of UK equities. The manager considers there are great opportunities in the UK stock market for high-yield investors, and that in aggregate UK stocks are looking attractively valued compared to global equities. MRCH has a distinguished dividend history; payouts have grown in each of the last 36 consecutive years. In FY18, the annual distribution was 2.5% higher than in FY17 – a larger growth rate than in recent years, reflecting higher dividend growth from portfolio companies, but also due to MRCH's lower interest costs following the refinancing of a tranche of its high-cost debt in late 2017.

12 months ending	Share price (%)	NAV* (%)	Blended benchmark** (%)	FTSE All-Share (%)	FTSE 100 (%)
30/04/14	20.0	12.6	9.3	10.5	9.3
30/04/15	0.5	6.6	6.4	7.5	6.4
30/04/16	(10.8)	(9.8)	(6.8)	(5.7)	(6.8)
30/04/17	20.2	19.5	21.4	20.1	20.0
30/04/18	14.5	13.3	8.2	8.2	8.5

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

Investment strategy: Contrarian, value based

The manager seeks to construct a portfolio of undervalued companies that generates a higher-than-average dividend yield and has the potential to deliver long-term capital growth. When considering a possible investment, Gergel always looks at a company's total return potential, not just its dividend yield – he focuses on companies with the capability to generate sustainable cash flows. Engagement with portfolio companies to discuss governance issues is an increasingly important element in the investment process. Gearing of up to 25% of net assets, at the time of drawdown, is permitted. At end-April 2018, net gearing was 18.7%.

Market outlook: Room for improved sentiment

As witnessed by low institutional allocations and fund outflows, sentiment towards UK equities is very depressed. While Brexit remains an overhang, any definitive news in negotiations is likely to be viewed favourably. In terms of valuation, UK equities look relatively inexpensive compared to global equities, leaving scope for a rerating of UK shares if there is a positive change in investor perception.

Valuation: Potential for a narrower discount

MRCH's shares are currently trading at a 3.7% discount to cum-income NAV, with debt at market value. This is narrower than the 5.3% averages over both the last one and three years, but wider than the 3.2% five-year average. There is potential for a narrower discount if the manager continues to build on his long-term record of outperformance. MRCH has a progressive dividend policy; annual distributions have increased for the last 36 consecutive years, growing at broadly double the annual rate of UK inflation over this period.

22 May 2018

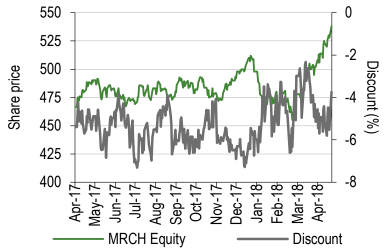
Price	**538.0p**
Market cap	**£585m**
AUM	**£734m**

NAV*	546.8p
Discount to NAV	1.6%
NAV**	558.9p
Discount to NAV	3.7%

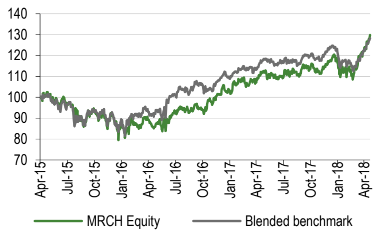
*Excluding income. **Including income. As at 18 May 2018.

Yield	4.6%
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	538.0p	455.0p
NAV** high/low	558.9p	480.7p

**Including income.

Gearing

Gross*	20.9%
Net*	18.7%

*As at 30 April 2018.

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Edison profile page

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

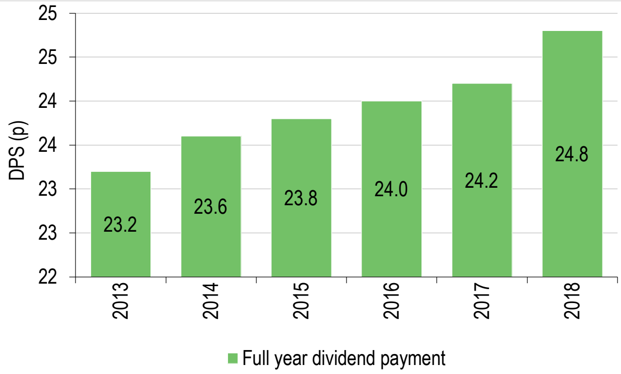
Exhibit 1: Trust at a glance

Investment objective and fund background	**Recent developments**
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.	■ 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). ■ 16 January 2018: Third interim dividend of 6.2p declared (+1.6% year-on-year). ■ 23 October 2017: Pricing of £35m fixed rate, 35-year, secured private placement note at 2.96%, effective 18 December 2017.

Forthcoming		**Capital structure**		**Fund details**	
AGM	May 2018	Ongoing charges	0.59%	Group	Allianz Global Investors
Interim results	September 2018	Net gearing	18.7%	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

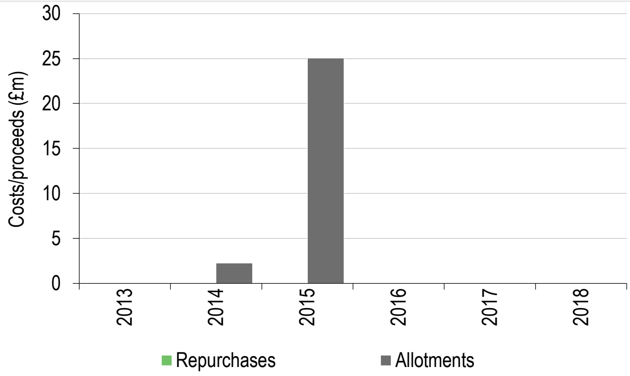
Dividend policy and history (financial years)

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

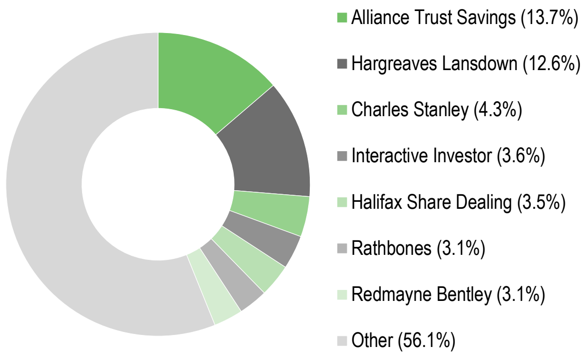


Share buyback policy and history (financial years)

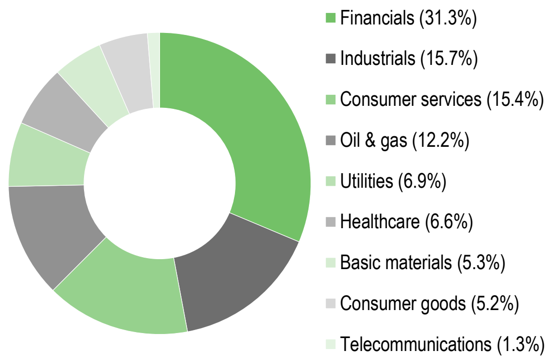
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 30 April 2018)



Portfolio exposure by sector (ex-cash as at 30 April 2018)



Top 10 holdings (as at 30 April 2018)

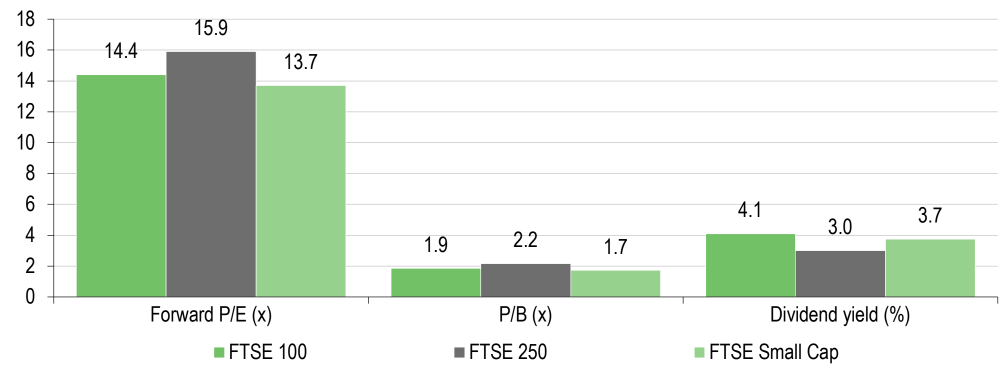
		Portfolio weight %	
Company	**Sector**	**30 April 2018**	**30 April 2017***
Royal Dutch Shell 'B' Shares	Oil & gas	7.5	7.1
GlaxoSmithKline	Healthcare	6.4	7.2
HSBC	Banks	4.3	5.5
BP	Oil & gas	4.2	5.2
UBM	Media	4.2	3.3
Lloyds Banking Group	Banks	3.6	3.6
BHP Billiton	Mining	3.6	N/A
Legal & General	Insurance	3.2	N/A
BAE Systems	Aerospace & defence	3.0	N/A
Standard Life Aberdeen	Insurance	3.0	2.9
Top 10 (% of holdings)		**43.2**	**42.7**

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

Market outlook: Low sentiment may offer opportunities

UK equities in aggregate are currently out of favour. In its recent fund manager survey, Bank of America Merrill Lynch reports that global ownership of UK equities is very low versus history, and data from the Investment Association show continued outflows from UK equity funds. However, this low sentiment towards UK equities may provide opportunities. Within the UK stock market, companies with domestic operations are looking particularly inexpensive compared to their historical averages, and any definitive news regarding Brexit negotiations is likely to be well received. Looking at the valuation of UK indices (Exhibit 2), compared to 12 months ago, UK companies are trading on cheaper forward P/E multiples, offering higher dividend yields and are attractively valued compared with global equities. Investors seeking exposure to UK equities may wish to consider a fund that adopts a contrarian or valuation-based approach to stock selection.

Exhibit 2: Valuation metrics for FTSE 100, 250 and Small Cap indices (as at 21 May 2018)



Source: Edison Investment Research, Bloomberg

Fund profile: Value-based UK equity portfolio

MRCH was launched in 1889 and is one of the oldest trusts listed on the London Stock Exchange. It aims to provide 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. Since 2006, the trust has been managed by Simon Gergel, chief investment officer for UK equities at AllianzGI, which has c £450bn of assets under management. The manager adopts a contrarian approach to stock selection, seeking attractively valued equities. MRCH was historically benchmarked against the FTSE 100 index, but its exposure to the largest UK companies has declined. Reflecting this, the benchmark was changed to the broader FTSE All-Share index, effective from end January 2017. To diversify risk, no single investment may exceed 15% of assets and the portfolio must be invested in at least five of the 10 market sectors, with each sector limited to 35%. Gearing in a range of 10-25% of NAV, at the time of drawdown, is permitted; at end-April 2018, net gearing was 18.7%. MRCH offers an above-average dividend yield (4.6%) and its annual distribution has increased for the last 36 years, using reserves to supplement income when required.

The fund manager: Simon Gergel

The manager's view: Finding plenty of opportunities

Gergel says the UK stock market is inexpensive compared to the global market, with higher-yielding shares looking particularly attractive. He notes that investors were concerned about high payout ratios, but this issue is abating as the large UK banks, oil & gas and mining companies are in a better financial position, so their dividends are less likely to be reduced. The manager suggests that the attractive valuation of many UK companies has led to increased levels of mergers and acquisitions. During FY18, MRCH benefited from takeover bids for two of its holdings: Ladbrokes Coral and UBM. This has continued into FY19, where there have been further bid announcements such as for financial technology firm NEX Group, which received an offer from CME Group, at a c 50% premium to NEX's pre-bid share price. While uncertainties surrounding Brexit will continue, Gergel is constructive on the outlook for UK equities, noting that interest rates remain low, the economy is supportive and, in general, companies are performing well. The manager is finding plenty of attractive investment opportunities, particularly in companies that have domestic operations or are in a recovery situation.

Asset allocation

Investment process: Seeking mispriced UK equities

The manager's fundamental premise is that stock prices are inefficient, providing opportunities to invest in undervalued companies. Historical evidence shows that firms with above-average dividend yields have delivered higher-than-average total returns, as well as higher income. Hence, Gergel focuses on companies that are currently paying higher dividend yields, or have the prospect of doing so in the near future, and are able to generate sustainable cash flows. The manager always considers the total return potential of each position in the portfolio; a high dividend yield in itself is an insufficient basis for investment. Gergel is able to draw on the large resources of AllianzGI, which includes a global team of equity and credit analysts; an environmental, social and governance (ESG) team; and the proprietary Grassroots market research organisation.

When evaluating a company, MRCH's investment process aims to address three questions:

- **How good is the business?** In assessing a company's fundamentals, the manager focuses on its industry dynamics, its competitive position, the strength of its financial metrics and its ESG profile and risks.
- **Are the shares undervalued?** A range of absolute and relative valuation measures is evaluated, including dividend yield, but with a particular focus on cash flow.
- **How supportive is the environment?** Themes considered include the macroeconomic outlook, the stage of the business cycle and industry/secular trends. This element of the investment process can help to identify, and therefore avoid, value traps (companies that are outwardly looking attractively priced, but are unlikely to appreciate in value).

Positions in the portfolio are reviewed regularly and may be sold if: the target price is reached; there is a change in the investment thesis, so that the original reason for purchase is no longer valid; or there is a better investment opportunity available. Portfolio turnover is typically 20-25% pa. The assessment of a company's ESG track record is an increasingly important element of the stock selection process. During 2017, the manager engaged 23 times with 14 different portfolio companies, which in aggregate represented c 30% of holdings.

Current portfolio positioning

Exhibit 3: Market capitalisation breakdown (% unless stated)

Index	Portfolio end-April 2018	Portfolio end-April 2017	Change (pp)
FTSE 100	60.2	59.3	0.9
FTSE 250	31.4	32.1	(0.7)
FTSE SmallCap	5.4	5.7	(0.3)
Other	0.8	0.8	0.0
Cash	2.2	2.1	0.1
	100.0	**100.0**	

Source: The Merchants Trust, Edison Investment Research

MRCH's sector exposure is shown in Exhibit 4. Over the last 12 months there has been an increase in exposure to the financial sector. The trust has recently initiated a position in wealth manager St. James's Place. The manager is encouraged by the company's growth prospects, which are supported by high levels of annual increases in the number of partners (financial advisers) and increased assets under management. The company also has a strong record of dividend growth. Gergel believes that while St. James's Place's current P/E valuation is not cheap, there is insufficient value being placed on the company's new business, which is benefiting from a general lack of available advice for a more affluent population.

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

	Portfolio end-April 2018	Portfolio end-April 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	30.6	27.9	2.7	26.8	3.8	1.1
Industrials	15.4	15.2	0.2	11.0	4.4	1.4
Consumer services	15.1	15.0	0.1	11.5	3.6	1.3
Oil & gas	11.9	12.5	(0.6)	13.7	(1.8)	0.9
Utilities	6.7	9.0	(2.3)	2.7	4.0	2.5
Healthcare	6.5	7.3	(0.8)	8.6	(2.1)	0.8
Basic materials	5.2	3.5	1.7	7.6	(2.4)	0.7
Consumer goods	5.1	4.9	0.2	13.9	(8.8)	0.4
Telecommunications	1.3	2.6	(1.3)	3.4	(2.1)	0.4
Technology	0.0	0.0	0.0	0.9	(0.9)	0.0
Cash	2.2	2.1	0.1	0.0	2.2	N/A
	100.0	**100.0**		**100.0**		

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

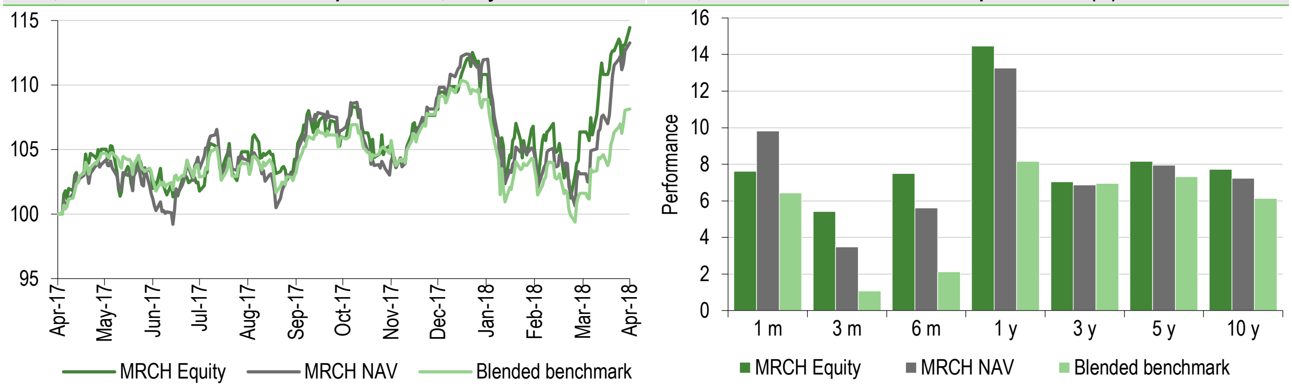
Performance: Improving performance record

In FY18 (ending 31 January 2018), MRCH's NAV and share price total returns of +14.5% and +13.3% respectively were comfortably ahead of the benchmark's +11.3% total return. The main driver of outperformance was stock selection, while gearing added a net 2% to total return over the period. A meaningful contributing factor to MRCH's relative returns was minimal exposure to the underperforming tobacco sector. On a stock-specific basis, the two largest contributors to the trust's performance were Ladbrokes Coral and UBM, which both received takeover offers. Other positive contributors were in the financial sector: IG Group, which stressed the limited impact on its business from new regulation and reported strong trading results; Man Group, which also had positive trading statements; and Standard Life Aberdeen, where the merger between the two companies offers the potential for significant cost savings. Detractors to portfolio performance included Centrica, which issued a profit warning, and GlaxoSmithKline, which downgraded profit forecasts for 2018 and showed a lack of commitment to a progressive dividend policy.

Exhibit 5: Investment trust performance to 30 April 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.

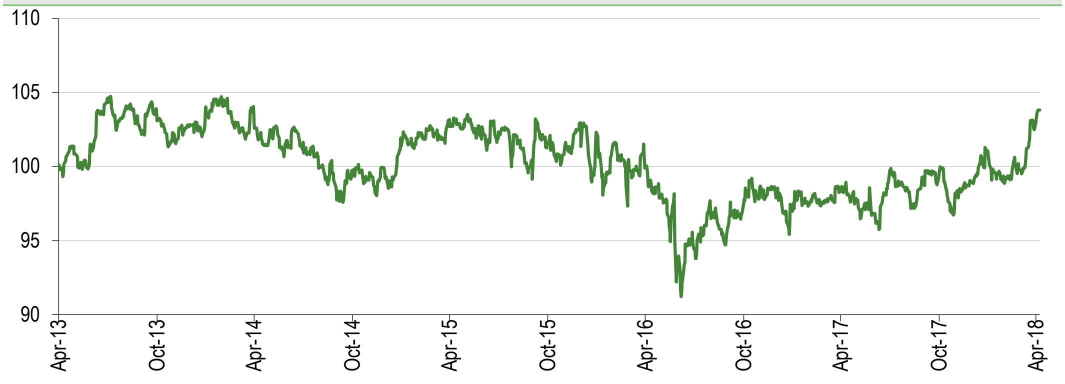
Due to an improvement in MRCH's investment performance in recent quarters, the trust has now outperformed its blended benchmark over nearly all periods shown in Exhibit 6. The only exception is very modest underperformance over three years in NAV terms.

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

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to blended benchmark	1.1	4.3	5.3	5.8	0.3	4.0	16.0
NAV relative to blended benchmark	3.2	2.4	3.4	4.7	(0.2)	2.9	10.7
Price relative to FTSE All-Share	1.1	4.3	5.3	5.8	0.1	1.7	10.3
NAV relative to FTSE All-Share	3.2	2.4	3.4	4.7	(0.4)	0.7	5.2
Price relative to FTSE 100	0.7	4.2	5.1	5.5	1.1	4.9	17.0
NAV relative to FTSE 100	2.8	2.3	3.3	4.4	0.6	3.8	11.7

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

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

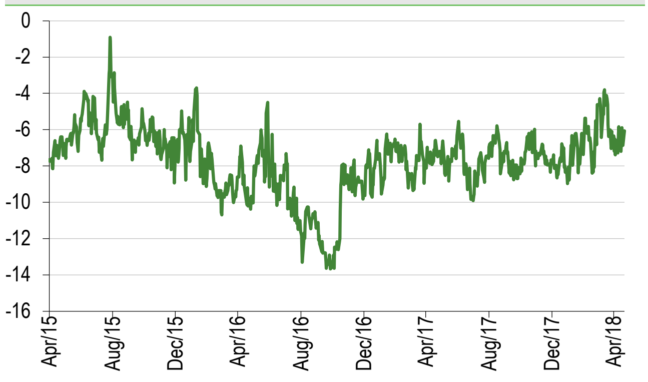


Source: Thomson Datastream, Edison Investment Research

Discount: In the middle of the 12-month range

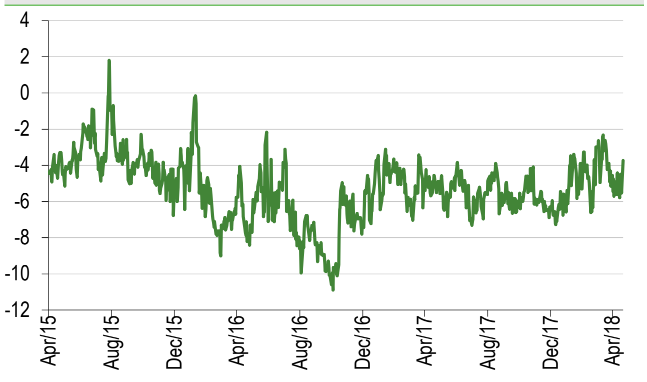
MRCH's current 3.7% share price discount to cum-income NAV with debt at market value compares to the range of discounts over the last 12 months of 2.3% to 7.3%. It is narrower than the averages over the last one and three years of 5.3%, but wider than the 3.2% five-year and 2.5% 10-year averages. There is potential for the discount to narrow if the manager is able to build on MRCH's improving investment track record.

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



Source: Thomson Datastream, Edison Investment Research

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



Source: Thomson Datastream, Edison Investment Research

Due to the current low level of interest rates, the market value of MRCH's debt is higher than its par value, which means the NAV with debt at par value is higher than the NAV with debt at market value. Hence, the share price discount to NAV with debt at market value is lower than the discount to NAV with debt at par value.

Capital structure and fees

MRCH is a conventional investment trust with one class of share; there are currently 108.7m ordinary shares in issue. In October 2017, the trust announced that it had priced a £35m, 35-year private placement note at 2.96% to repay £34m of high-cost (11.125%) debt that was due to mature in January 2018. As shown in Exhibit 10, this refinancing lowers MRCH's average cost of debt from 8.5% to 6.1%. Interest is charged 65% to the capital account and 35% to the revenue account; the lower interest rate will save £1.8m and £1.0m in annual interest payments from the respective accounts. The manager says that the ability to borrow at c 3% and invest in UK equities, which are yielding c 4% on average, and in some cases much more, is a good proposition for shareholders.

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 amount of perpetual debt.

In FY18, the annual management fee was 0.35%. It is charged 65:35 to the capital and revenue accounts respectively, reflecting the board's expected split of long-term capital and income returns. The ongoing charge in FY18 was 0.59%, which was 4bp lower than 0.63% in FY17 and is competitive versus its peers in the AIC UK Equity Income sector (Exhibit 12).

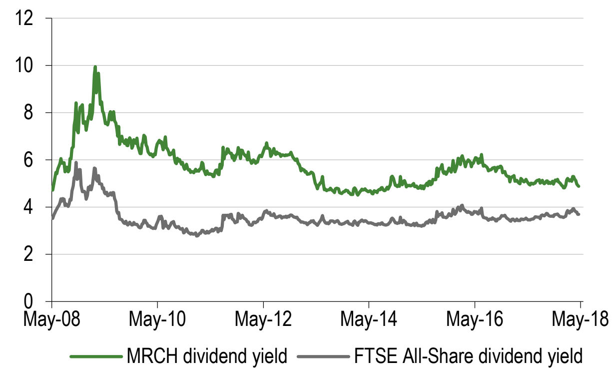
Dividend policy and record

Dividends are paid quarterly in August, November, February and May. MRCH aims to generate a high and growing level of income. Its annual dividend has now grown for 36 consecutive years. The FY18 annual dividend of 24.8p was 2.5% higher than the FY17 distribution and was fully covered by income. The FY18 dividend increase was higher than in recent years due to higher income generation, and the benefit of lower interest costs following the debt restructuring in 2017. At end-January 2018, revenue reserves of £25.9m were equivalent to 0.96x the FY18 dividend payment. MRCH's current dividend yield is 4.6%.

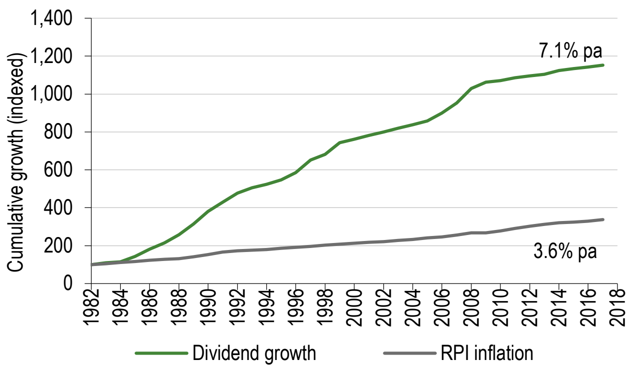
Exhibit 11 illustrates MRCH's attractive dividend policy. Over the last 10 years, the trust's dividend yield has been consistently higher than the dividend yield of the FTSE All-Share index, while the 7.1% average compound annual growth in MRCH's dividend over the last 36 years is significantly higher (broadly double) compared with the average UK inflation rate over the period.

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

The Merchants Trust's dividend yield vs FTSE All-Share dividend yield



Growth of The Merchants Trust's dividend vs UK inflation



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

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Peer group comparison

MRCH is a member of the AIC UK Equity Income sector, a relatively large group of 24 funds. We show the largest seven in Exhibit 12, which all have market caps above £500m. MRCH's improving performance track record is evident. Its one-year NAV total return ranks second out of 24 funds over the last 12 months, a meaningful 7.7pp higher than the sector average, and is also higher than average over three years. The trust is below average over five and 10 years. MRCH's discount to NAV (with debt at par value) is wider than average, which may be due to the historically high cost of debt, although this has now been partially addressed. Its ongoing charge is in line with the selected peer group average; however, it is meaningfully lower than the whole sector average and there is no performance fee. MRCH has an above-average dividend yield, respectively 1.1pp and 0.6pp higher than the selected and whole group averages.

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

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Merchants Trust	585.0	14.3	24.7	41.7	95.1	(6.1)	0.6	No	119	4.6
City of London	1,553.7	5.9	21.5	46.2	117.8	0.5	0.4	No	108	4.0
Edinburgh Investment	1,377.5	(0.8)	17.8	51.9	126.8	(8.0)	0.6	No	110	3.3
Finsbury Growth & Income	1,365.0	14.4	43.9	86.3	290.8	1.0	0.7	No	102	1.8
Murray Income Trust	536.7	3.4	21.2	34.9	91.9	(6.8)	0.7	No	106	4.1
Perpetual Income & Growth	899.2	(1.4)	8.2	41.6	137.9	(9.5)	0.7	No	111	3.7
Temple Bar	900.1	8.7	22.9	40.2	165.4	(5.0)	0.5	No	100	3.2
Selected average (7 peers)	**1,031.0**	**6.4**	**22.9**	**49.0**	**146.5**	**(4.8)**	**0.6**		**108**	**3.5**
Sector average (24 peers)	**443.9**	**6.6**	**22.4**	**51.9**	**119.5**	**(2.0)**	**1.2**		**112**	**4.0**
MRCH rank (out of 24 peers)	**6**	**2**	**8**	**15**	**17**	**15**	**22**		**3**	**3**

Source: Morningstar, Edison Investment Research. Note: *Performance to 18 May 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

There are five directors on the board of MRCH, all of whom are non-executive and independent of the manager. The chairman is Simon Fraser, who was appointed as a director in August 2009, and assumed his current role in May 2010. Sybella Stanley is the senior independent director; she joined the board in November 2014. The chairman of the audit committee is Timon Drakesmith, who was appointed as a director in November 2016. The other two directors and their dates of appointment are: Paul Yates (March 2011) and Mary Ann Sieghart (November 2014). Between them, the directors have a mix of both investment and corporate commercial experience.

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