Earthworm EIS Fund

EW Cap / Thompson Taraz Managers

Summary

The Fund's investment strategy is to invest in a portfolio of EIS qualifying companies that will operate waste management and recycling facilities in the UK; it plans to have operations at eight sites within the next few months.

	Positives	Issues
Why Invest	**Strategy:** Exposure to a portfolio of plants to manage and recycle organic waste: the £86+/tonne Landfill Tax makes traditional disposal a far more expensive option.	**Operations:** Although there will be some heads of terms in place before investment, further contracts and good management will be required to reach target returns.
Investment Advisor	**Team:** EW Cap has a strong team with experience in planning and developing projects in a variety of environmental areas.	**Track record:** EW Cap managed a return of £1.15 over 4 years for the one EIS company that has surpassed the 3-year EIS holding period.

Nuts & Bolts

- **Offer period:** Further tranches will be issued in tax years 2017/18 and 2018/19.
- **Diversification:** The aim is to invest in at least three waste management and recycling companies per investor: the latest tranche is invested in four.
- **Valuation:** Updates will be provided every 6 months.

Specific Issues

- **Fees:** All fees are charged directly to the investee companies. Annual fees are reduced from year 5 onwards.
- **Performance fee:** This fee only applies if the return exceeds the £1.20 per £1 invested threshold. The Fund receives 30% of the investor share of any such surplus on a portfolio basis.
- **Sourcing:** It is expected that Sycamore Planning, which is owned by a former member of the EW Cap team, will be contracted to develop the sites and will be paid accordingly. This arrangement is new and the company is indirectly connected to EW Cap. The non-executive Director will need to ensure this process is managed effectively.

Manager information

Scheme assets	£16m
Scheme target	£25m in 2017/18
EIS assets	£25m
Total FUM	£50m
Launch date:	2016

Risks

- **Target returns:** The Fund has a target return of £1.20 for each £1 invested over a 4-5 year period, exclusive of EIS tax reliefs. In the absence of tax reliefs, the target return may not compensate for the business risk.
- **Waste Management and Recycling Sector:** Although any investment will be a minority stake in each investee company, the potential risk is managed by the Fund having effective board control and rights over any decisions on cash within the investee companies. More specifically, a failure to win sufficient waste management and recycling contracts – at the right price – constitutes a very material risk, though mitigated by having heads of terms in place prior to the investment of EIS capital.

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Table of Contents

Factsheet

Earthworm EIS Fund		
Product name		Earthworm EIS Fund
Product manager		Thompson Taraz Managers
Investment adviser		Earthworm Capital LLP
Promoter		RAM Capital
Tax eligibility		EIS
Target return		£1.20p over 4-5 year period
Target income		None
Type of product		Discretionary portfolio service
Term		Evergreen
Sectors		Waste Management/Recycling
Diversification		
Number of companies		Minimum of 3 per investor
(Expected) Gini coefficient		0.33
Fees	**Amount**	**Paid by**
Initial fees	3.0% (excl VAT)	Investee company
Annual fees	2.0% (excl VAT) Cut to 0.5% (excl. VAT) from year 5	Investee company
Performance fee	30%	Investor share of proceeds over £1.20
Advisor fee facilitation		Yes
Advisor fee amounts		Agreed with investor
HMRC Approved fund?		No
Advance Assurance from HMRC		Yes, unless there is a certificate
Reporting		6 monthly
Minimum investment		£10,000
Current funds raised		£16m
Fundraising target		£25m in 2017/18
Closing date(s)		Evergreen - as required
Expected exit method		Share buy-back, trade sale or other exit route

Source: EW Cap, Hardman & Co research

Fund Aims

The Earthworm EIS Fund is a discretionary portfolio service which aims to invest in a portfolio of companies that will build and operate waste management and recycling facilities, using various risk mitigation measures to bring a lower than average risk for EIS products. The target return is £1.20 over a 4-5 year period. Investor returns will be focussed on capital gains: investors are not expected to receive any dividends. The fund is evergreen, with closures as required.

There are three groups that have an important role in ensuring that the Earthworm EIS Fund prospers:

- **Fund Manager:** Thompson Taraz Managers, who undertake the management of the Fund and the accompanying compliance responsibilities.
- **Investment Adviser:** Earthworm Capital LLP (EW Cap) is the Investment Adviser to the Fund Manager.
- **Promoting and Marketing Adviser:** RAM Capital Partners, who are the Promoter and Marketing Adviser to the Fund.

Summary of Risk Areas

Note: There are generic risks in investing in EIS or unquoted companies aside from the specific risks discussed below. Furthermore, any comments on relative risk refer to other EIS investments - and not to wider investments beyond the EIS space.

Investments

Portfolio Risk

Each investment will be into a waste management and recycling business, which stands to benefit from an increasing demand to treat organic waste. It is planned that each investor will receive shares in at least three such companies. Consequently, if one of the investee companies suffered a major setback, the portfolio impact would be material given the small number of companies involved. Nevertheless, the target return of £1.20 for each £1 invested over a 4-5 year period is appropriate for a strategy that is not overtly risky.

Sourcing and External Oversight

EW Cap will manage the sourcing for the fund, with projects being assessed and brought through development by Sycamore Planning, with EW Cap creating a company and arranging finance. There is a pipeline of potential projects which looks sufficient to satisfy investor demands for the next year.

Thompson Taraz Managers will provide oversight to ensure that its investments satisfy fully the conditions set out in the Information Memorandum. Each company will also have an independent non-executive Director.

Ongoing Support and Monitoring

As well as the non-executive Director, there will be an EW Cap Director who will manage the company. Building and operations will be managed by different companies.

Thompson Taraz Managers will also closely monitor all investments, including at the time of investment and on an ongoing basis.

Exit

The intention is that an exit will materialise in the fourth year of trading. The precise mechanism is inevitably unclear but could involve share buy-backs, a trade sale or flotation; this process will be decided nearer the planned exit time.

Fund Manager / Investment Advisor

Team

EW Cap has specific knowledge of the waste management and recycling sector and has over £50 million of assets in the environmental space. Thompson Taraz Managers is a well established Authorised Fund Manager in EIS investments.

Track Record

The initial Earthworm EIS offer in 2011 raised £2 million and returned £1.15 per £1 invested over 4 years: this is the only EW Cap company to date to have exceeded its minimum EIS holding period.

Product

Advance Assurance will be obtained for all investments, unless they already have EIS tax certificates (which four identified opportunities do).

Manager and Other Parties

The manager of the fund is Thompson Taraz Managers Ltd. It is FCA registered (number 226978) with fund management permissions and its submissions to Companies House appear to be up to date.

EW Cap is an appointed representative of Thompson Taraz, while RAM Capital is FCA registered.

Risk Analysis / Commentary

The risks for the building of the sites have been significantly mitigated. Planning permission will be obtained prior to EIS funds being invested. During construction, payments will be made on achievement of set milestones, with the financial impact of any delays mostly being on the later start of operations, which may also affect potential exit dates.

Each company will have heads of terms in place for about half its capacity, though it is vulnerable if it wins insufficient waste management and recycling contracts to keep its plant working close to capacity – in doing so, it needs to achieve good prices. Indeed, if gate-fees were to fall – and stay low – the Fund's model would certainly look less robust. Controlling operating costs is also crucial although current margins appear to be reasonable. And the avoidance of machinery break-downs is also important given the capacity at which they should be operating.

There is some asset backing, but any sale of the investee company's fixed assets may not achieve current book value given the relatively limited market for such machinery. Investors should also pay attention to governance, with the non-executive Director having to manage several parties, some of whom are connected.

UK Waste Sector Background

The UK waste sector has undergone many changes in recent years, with a powerful momentum being exercised by both the implementation of EU legislation and by the privatisation of the water and sewerage companies in England and Wales in 1989. Major investment has been needed to finance the prevailing trend of moving away from landfill disposal – historically the focus of waste company activity – to other more environmentally-friendly waste recycling processes.

Currently, despite a standard rate Landfill Tax of over £86 per tonne for landfill disposal, just 45% of household waste is being recycled – a figure that has barely changed in recent years.

Nevertheless, despite several major efforts, the UK waste market remains unconsolidated, although a few leading players, such as Biffa, the French-owned Veolia and the Spanish-owned FCC Environment – the latter was created in part from UK Recycling - remain key operators, especially at Local Authority level.

Even so, the waste sector does have clear attractions for potential investors:

- The obvious scope for more recycling, since just 45% of domestic waste currently goes through this process;
- The on-going search by Local Authorities' waste divisions for landfill alternatives, especially those which embrace recycling;
- A surge in new house-build levels, especially in the Midlands, which inevitably leads to increasing waste volumes;
- The established technology processes used in treating waste, which mitigate risk;
- An increasing emphasis on managing and treating waste locally to minimise transport costs.

For smaller operators, such as EW Cap, there are attractive opportunities, since Local Authorities are desperately seeking new waste management solutions.

It is also the case that EW Cap, due to its size, is well 'below the radar' of the major players, so that the competition element – a well-known feature in the waste sector - is far less to the fore. Indeed, EW Cap often undertakes waste management and treatment on behalf of larger companies, including Biffa and FCC Environment: it leases waste sites from the former and has a strategic agreement with the latter.

More specifically, EW Cap's waste management and recycling revenues are based on current prices of c£25 per tonne for food waste and c£20 per tonne for garden waste; these are broadly aligned to the prevailing level of gate-fees. Any prolonged industry-wide decline would inevitably cut EW Cap's projected returns.

Investment Process

EW Cap plans to expand its investment in the UK waste management and recycling market, where it believes there is sharply growing demand as Local Authorities desperately seek alternatives to landfill disposal. It aims to have eight operational sites within the next few months, mostly in the Midlands, as follows:

- **Daventry:** The current facility, designed to treat 21,000 tonnes of organic waste annually in its IVC composter plant, is being re-located to Meriden – and is therefore non-operational at present. Instead, a waste-water treatment plant is being installed on the existing site, along with a small biomass plant which uses imported wood waste – the latter is not part of the Earthworm EIS structure;

- **Meriden:** This site, under a 25-year lease, will become pivotal to EW Cap. With a new IVC composting plant being built there - to operate alongside the transferred Daventry IVC composting equipment - the Meriden site should be able to process over 50,000 tonnes of organic waste each year: currently, there is a contract in place to cover c30,000 tonnes per year. The site will, in time, also house biomass and waste water treatment facilities;

- **Waste-water Technology:** Although almost three-quarters of liquid waste is currently destined for local sewage works, the Fund is investing in waste-water technology to treat leachates in landfill sites and, importantly, has secured a 30,000 tonnes per year contract with FCC Environment;

- **Windrow Sites:** Various windrow facilities are being planned to complement the existing facility at Kilsby, which was previously operated by Biffa.

Sourcing Deals

EW Cap is responsible for sourcing and assessing the prospects for each potential business. Sourcing is largely done in conjunction with three related companies, with Sycamore Planning Limited expected to be the main contractor. The latter is owned by Tony Wehby (see EW Cap team). These companies find the individual projects, with EW Cap creating a SPV company and arranging the necessary finance.

Sycamore will have a further role in building the infrastructure for the new companies and will be paid accordingly. It will be the project manager of the facility and will have responsibility for delivery of the project, though the actual work will be outsourced. Payment during the build will only be made on the reaching of predetermined milestones, with Sycamore being paid a fixed tariff for its role.

We note that until recently the Sycamore role was taken by Larch Group, a company co-owned by, inter alia, Tony Wehby and Ben Prior, the EW Cap Managing Partner. The new arrangement is intended to reduce the conflict of interest this represented, though, as connected parties, it does not remove it entirely.

The actual construction will be outsourced to one of five companies, including Silvertree Environmental Ltd. All the companies are familiar to the EW Cap team and they have had experience of working with them. There will be a tender process for each contract, with final approval by the board of the investee company.

There may also be some sourcing done through EW Cap's network, though this will provide a much smaller number of projects.

The operations of the projects will be managed by Silvertree Environmental Ltd. Its shares appear to be held in trust and Hardman & Co are unable to determine the ultimate ownership, though EW Cap assures us that neither the latter's Directors nor Larch Group have a personal interest.

In undertaking the analysis of projects, EW Cap focuses on several specific issues, including:

- **Planning Approvals:** Investment in waste management and recycling schemes is very much driven by planning issues, with local residents often taking a negative view about any plans for building nearby waste plants. EW Cap devotes considerable time and effort to addressing such planning issues, on which it holds an impressive record – 16 applications made, with just one refusal: similar criteria apply to securing the requisite environmental permits. The applications are funded through SEIS: EIS investment will only take place once planning approval is in place;

- **Location:** Aside from assessing the potential of the local market for waste management and treatment, location – and especially the logistics of waste collection and treatment – is pivotal, with 50 miles generally being considered the furthest acceptable distance. In selecting such a site, EW Cap seeks either to sign a heads of terms agreement for a long-term lease or to secure outright ownership;

- **The Prospects for Securing Waste Management and Treatment Orders:** The Fund's revenues are very dependent upon winning Local Authority contracts as well as orders from other leading waste companies, such as Biffa and FCC Environment. A high priority is given to analysing the potential for winning new contracts, along with any competition-related issues. In particular, EW Cap will look to have heads of terms in place for waste orders representing of approximately 50% of capacity. Actual contracts cannot usually be signed until the facilities are in place, but EW Cap believes these heads of terms can be relied on;

- **Past Issues:** Analysis is undertaken about the prospective site's history – and specifically of any problems that may have been encountered, especially on the transport and logistics front;

- **Plant Construction:** The suitability of the designated site – or lack of it – for constructing new waste management and recycling facilities needs to be carefully addressed;

- **Financial Returns:** Detailed financial analysis and modelling is undertaken to assess the probable returns, based on the likelihood of winning contracts, the prices at which they will be undertaken and the consequential operating costs. Various thresholds, such as EBITDA hurdles, are set to assess whether a project is likely to meet the required financial criteria. EW Cap estimates that the contracts, for which heads of terms are agreed in advance, should be enough to move the company to approximate break-even on a run-rate basis once operational. Prices may be set in a range in these agreements which may lead to a little movement once the actual contracts are signed;

- **Overall Risks:** In-depth risk assessments are crucial, especially with a relatively small number of facilities being involved; these will cover various issues, ranging from order intake levels to mechanical breakdown scenarios.

Decision Making

Against this background, EW Cap will prepare an investment proposal, which is then submitted to the Fund Manager for its initial approval. Once this process has been carried out, EW Cap will undertake detailed due diligence. In particular, the due diligence will cover financial and legal issues: the latter will be integral to the preparation of the necessary documentation for the transaction to proceed.

If any material changes are proposed, the project will then be reconsidered by the Fund Manager. A summary of the due diligence process is reproduced in the final investment document and subsequently submitted to the Fund Manager for independent assessment and execution.

With the investments primarily being in SPVs, almost all the shares will be held by EIS investors. Individual investors will be allocated an equal value of shareholdings in each of three or more companies. Investors should note that EW Cap is also raising money for an SEIS fund with a similar mandate that may invest in some of the same companies as the EIS fund. This money, as referred to above, will be used to finance the set-up costs and planning permissions. There will be only one share class in each company, so SEIS and EIS investors will have the same rights attaching to their investments.

EW Cap plans to hold its investments for a 4-5 year period. At that juncture, an exit is planned, though preparations for the exit process will start before then and may result in something earlier. This is expected to take place primarily through share-buy-backs or via a trade sale; other disposal scenarios, such as a flotation, may feature, especially in respect of a company that has performed well above expectations. In calculating an appropriate exit price, an EBITDA-based or revenue multiple may well be applied. EW Cap believes that the market for such assets will develop over the next few years and potential buyers may include larger waste management companies or institutional funds, though this is inevitably uncertain.

In the event of the company being liquidated, there may be some asset backing for the investment. These assets will be predominantly in plant, most of which will be fixed on site, and generally depreciated over 15 years, though EW Cap hopes that their working life will be longer than that. The initial value of the plant will, of course, be lower than the total investment due to installation costs and fees. There is a limited market for such assets and prices may be affected by demand at the time. Given that liquidation is more likely when a business has struggled, the used nature of the plant and its lack of portability, it is not clear how much value an investor would receive for the assets under such circumstances: it could be significantly lower than the depreciated value of the assets.

The aim is to invest in a minimum of three companies. In the 2016/17 tax year the investment was spread across four companies.

Governance and Post-Investment Monitoring

The Earthworm EIS Fund is an Alternative Investment Fund subject to FCA regulation: it is neither a collective investment scheme nor is it a non-mainstream pooled investment. As such, the Fund Manager acts on behalf of all investors in common by managing the investments described in the EW Cap Information Memorandum, namely those in the waste management and recycling sector.

EW Cap has lined up several prospective investee companies. Some of these have already raised money under EIS and already have EIS certificates. Advance assurance will be received on other investments before funds are committed. They have recently received EIS and SEIS Advanced Assurance for the waste water treatment companies to be invested in during the forthcoming year. There have been another ten companies (five composting and five food production) for which SEIS Advanced Assurance has been granted and which are expected to move to EIS in due course.

Each investee company will have two Directors: a non-executive Director and an EW Cap-nominated Director. The former will be completely independent of EW Cap, though he/she will be brought in through their network. The requirements for both Directors include prior board and EIS experience and they will be salaried. Their role will include monitoring governance and managing the conflicts of interest. Given the indirect links between EW Cap and Sycamore Group, investors will require the non-executive Director to take some care in doing this. During the build, Sycamore Group will only be paid on the achievement of predetermined milestones. The EW Cap-Director will, in essence, be an executive role and will have responsibility for managing the build and operations.

The Fund Manager, Thompson Taraz Managers, will also closely monitor all investments within the Fund, both in respect of their on-going performance and of their potential to deliver the proposed 4-5 year exit on reasonable terms.

Reports will be made on a six-monthly basis, details of which will be passed on to investors. Moreover, investors will be kept informed of any significant events regarding investee companies within their portfolios, such as a planned sale.

In terms of asset valuations, they will be undertaken according to ‘best practice’ as set out within the guidelines published by the International Private Equity and Venture Capital (IPEVC).

Track Record

EW Cap has managed several EIS products since it was established in 2010. The most comparable to the existing fund was a single company EIS which was launched in 2011, which is the only one of their investments that has completed the minimum EIS holding period of three years. The exit was achieved in October 2016, funded by EW Cap, and it delivered a £1.15 per £1 invested return over a four and half year duration, prior to any EIS benefits.

The exit figure was calculated predominantly on declared net asset values, with appropriate allowances being made in respect of existing contracts and secured planning approvals. The £1.15 figure was agreed by seven representatives, although inevitably there was an element of judgment in reaching the final exit figure: although EW Cap effectively set the sale price, it was ultimately accepted by the independent directors and shareholders.

Fees

Details of the fees for the Earthworm EIS Fund are set out on page 3 of this document, with all fees being payable by the investee companies. They are straightforward other than as noted below:

- **Annual fees:** 2% until year 5 when the annual charge falls to 0.5%.
- **Performance fee:** This figure is set at 30% of the investors' share of profits above the target price of £1.20 for each £1 invested on a portfolio basis.

In all the above cases, the VAT charge is excluded.

Fund-raising Targets

Following the close of the initial offering on January 20th 2017, Tranche 1 raised a total of £10.5 million. Additional historic investments have been moved into the fund and assets now total £16m. The minimum subscription was £10,000.

Under the criteria specified for this fund-raising initiative, there is a target of a minimum three investee waste management and recycling companies per investor.

EW Cap Team

Under Ben Prior, EW Cap has assembled an impressive team, with a wide range of experience both within - and outside - the waste management and recycling industry. Most of the individuals referred to below have worked in far larger organisations and have accrued valuable project development experience during their careers.

Ben Prior – Co-Founder & Managing Partner

Following many years in tax enhanced corporate development, Ben Prior co-founded RAM Capital in 2007. Three years later, he left RAM Capital to set up Earthworm with Spencer Burnham: the Daventry IVC composting facility was installed shortly afterwards.

Mike Capewell – Director of Operations

After many years as a consultant to Deloitte, during which time he worked with many leading organisations, Mike Capewell founded his own specialist financial modelling consultancy; to date, he has undertaken due diligence on over 20 renewable energy projects.

Spencer Burnham – Project Development and Investment Oversight

A former London corporate financier, Spencer Burnham left the City to co-found Earthworm with Ben Prior. He was instrumental in establishing the first Earthworm organic waste processing facility in Daventry and has been involved in the waste management and recycling sector since 2008.

Tony Wehby – Project Development and Construction, Owner of Sycamore Planning Limited

Tony Wehby has some 25 years of construction industry experience, much of which was involved in working on complex projects. Significantly, he has been heavily involved in the Midlands and he has considerable experience in local planning issues.

Phil Stephens – Project Development and Investment Oversight

Phil Stephens has many years' experience within the electricity and infrastructure sectors: he has specific knowledge of utility companies. He has also held senior commercial positions with British Energy, Mears Group and within the Asian energy department of PA Consulting.

Neil Drake – Project Development

In recent years, Neil Drake has held various senior positions at EdF Energy, part of the French-owned EdF Group. He had a major role within the company to commercialise nuclear power sales via the successful launch of Blue which supplies B2B customers and some residential households.

Richard Nuth – Project Development

Richard Nuth has acquired extensive experience of working for complex project management schemes, with an expertise in the aerospace sector, notably in the turbine market.

Charlie Morgan – Project Development

Charlie Morgan's career has been primarily in the financial debt markets, where he worked for some 25 years. In 2009, he became a founding partner of Parkwalk which is now a well-respected name in EIS financing; it specialises in developing and commercialising early-stage technology.

Summary

With major changes afoot in the UK waste management and recycling industry, subsequent tranches of the Earthworm EIS offering will provide potential investors – attracted in large part by the EIS-related tax savings – with interesting opportunities.

Appendix 1 – Due Diligence Summary

Summary of core due diligence questions		
Fund Manager		**Validated by**
Company	Thompson Taraz Managers	
Founded	2002	Hardman & Co
Type	Limited Company	Hardman & Co
Ownership	see below	Hardman & Co
FCA Registration	Yes - 226978	Hardman & Co
Solvency	Confirmed	Company
EISA member	Yes	Hardman & Co
Investment Adviser		
Company	Earthworm Capital LLP	Information Memorandum
Founded	2010	Hardman & Co
Type	Limited Liability Partnership	Hardman & Co
Ownership	Equally between Ben Prior and Sarah Prior	Hardman & Co
FCA Registration	Appointed Representative - 668606	Hardman & Co
Solvency	NA	
EISA Member	No	Hardman & Co
Administrator		
Company	City Partnership (UK) Limited	
FCA Registration	Yes – 593293	Hardman & Co

Source: Hardman & Co research

Regulation

The manager of the fund is Thompson Taraz Managers Limited. It is FCA registered (number 226978) with fund management permissions. The balance sheet is healthy for a small firm. At the last accounts (30 April 2016), it had just over £407,000 of shareholders' funds.

Thompson Taraz Managers Limited is wholly owned by Thompson Taraz Group Limited, which in turn is owned by Martin Heffernan and Afshin Taraz (40% each) along with Kelvin Gray. All are directors of the subsidiary, together with Simon Webber and Amir Zaidi.

Earthworm Capital LLP is the Investment Adviser to the Fund and is an Appointed Representative of Thompson Taraz. Returns to Companies House appear to be up to date.

Appendix 2 – Prospective Fee Calculations

The table below calculates the estimated total amount payable to the manager under certain assumptions.

Basic Assumptions	
Term	5 years
Investor amount	£100,000
VAT is reclaimable by investee companies.	

Source: Hardman & Co research

Calculations					
		Hardman & Co Standard			Target
Gross Return		-50%	0%	50%	36%
Amount (pre-tax relief)		£100,000	£100,000	£100,000	£100,000
Initial Fees	**Rate**				
Initial charges	3.0% (excl VAT)	£3,000	£3,000	£3,000	£3,000
Total		£3,000	£3,000	£3,000	£3,000
Net investment		£100,000	£100,000	£100,000	£100,000
Annual Fees					
From company					
Administration charge	2.0% pa (excl VAT) (years 1-4)	£2,000	£2,000	£2,000	£2,000
Mentor fee	0.5% pa (excl VAT) (years 5+)	£500	£500	£500	£500
Total over 5 years		£8,500	£8,500	£8,500	£8,500
Gross fund after investment return and charges		£44,250	£88,500	£132,750	£120,000
Exit fees					
Performance	30% above £1.20	£0	£0	£3,825	£0
Net amount to investor		£44,250	£88,250	£128,925	£120,000
Gain (pre-tax relief)		-£55,750	-£11,500	£28,925	£20,000
Gain (post tax relief)		-£25,750	£18,500	£58,925	£50,000
Total fees paid		£11,500	£11,500	£15,325	£11,500

Source: Hardman & Co research

Note: Post-tax relief figures assume initial income tax relief only. Other reliefs may be available to investors.

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