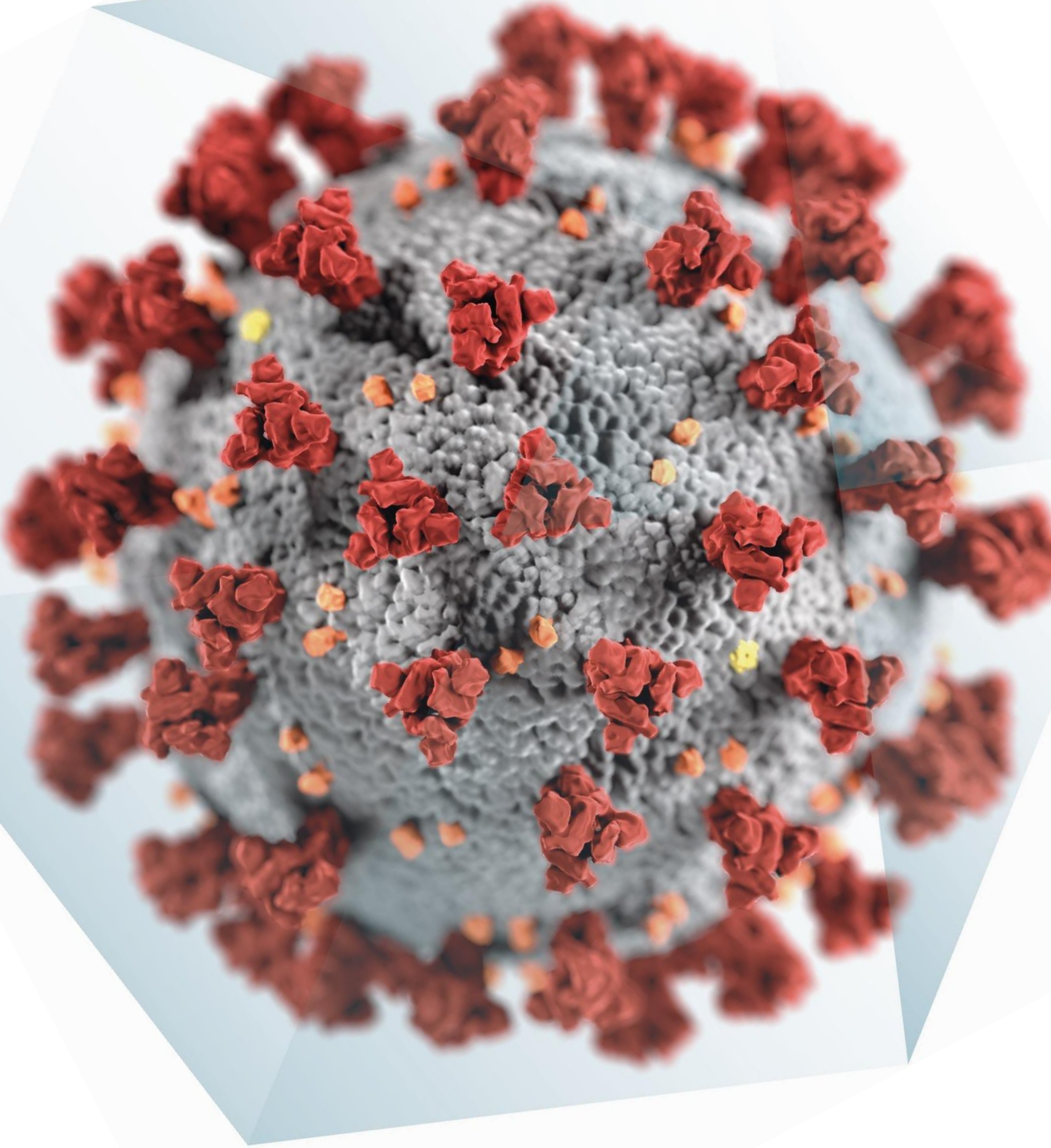

Investing in a pandemic

Changes post COVID-19

by Steve Clapham

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Investing in a pandemic

Changes post COVID-19

This article focuses on two main impacts: effect on companies and the broader macro picture

Much has been written about the effects of the virus on the world and on the stock market. Here is one analyst's take on some of the likely impacts on the way we should look at companies. This article was originally produced as a blog, "10 Changes Post Virus", which was published a few weeks ago.

I have discussed the impacts in two areas – the broader macro picture and what this means for companies. Under macro effects, I discuss financial repression and capital controls, why interest rates will stay low for some time, and what this means, some potential ripple effects, including the potential for inflation, and the need for balance sheet restoration by both corporate and personal sectors.

I then discuss the implications for companies and equity investors, looking at the consequent likely greater desire for stronger balance sheets by the corporate sector, the need to onshore elements of the supply chain and the implications for equity valuation, working capital and income funds. Finally, I discuss how this will lead to corporates 'kitchen-sinking' reserves, and why we believe one result will be that more fraud is exposed.

The macro picture

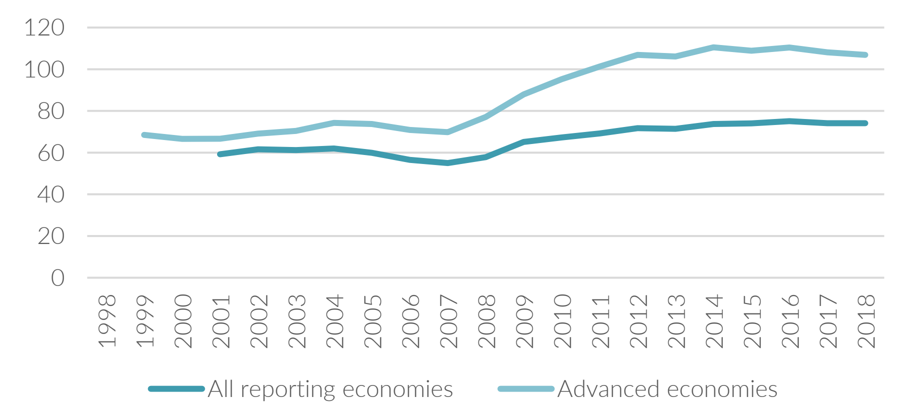
The COVID-19 pandemic has obviously been a massive shock to the financial system, and one clear effect is that almost every government on the planet is likely to have a lot more debt in June 2020 than it did in January – and likely even more by the end of the year. Add to this that the situation at the start of 2020 was not looking particularly attractive, in any case.

Higher debt

Debt larger than GDP not a great situation, and needs to come down

Advanced economies saw a significant increase in debt, above 100%, post the global financial crisis of 2008-09. Reinhart and Rogoff, in their famous book, *This Time Is Different: Eight Centuries of Financial Folly*, advocated caution that debt above 90% of GDP would slow economic growth. Their statistics and conclusions were then undermined, when it was found that there was a mistake in their spreadsheet. It was always unlikely that two academics could predict future economic events on the basis of historical trends.

Government debt as a percentage of GDP (%)



Source: BIS, Hardman & Co Research

But simple common sense says that when debt is larger than GDP, it's probably not great, and you should think about getting it down. It's certain that, when this chart is drawn again, as of the end of 2020, there will be another huge increase. That surely is a cause for concern. One way this might not be a problem is that, if every government has huge debts, there will be no relative disadvantage, and hence perhaps no real risk that they cannot be financed. I am a simple stock analyst, and this is above my pay grade. My guess is that governments will, at some point, feel constrained in what they can spend and they will seek to reduce their debt burdens. Most will surely be forced to (continue to) engage in a policy of financial repression, so that their interest rates are below inflation. This could be required for decades, rather than years, and I think it has important implications for equity investors.

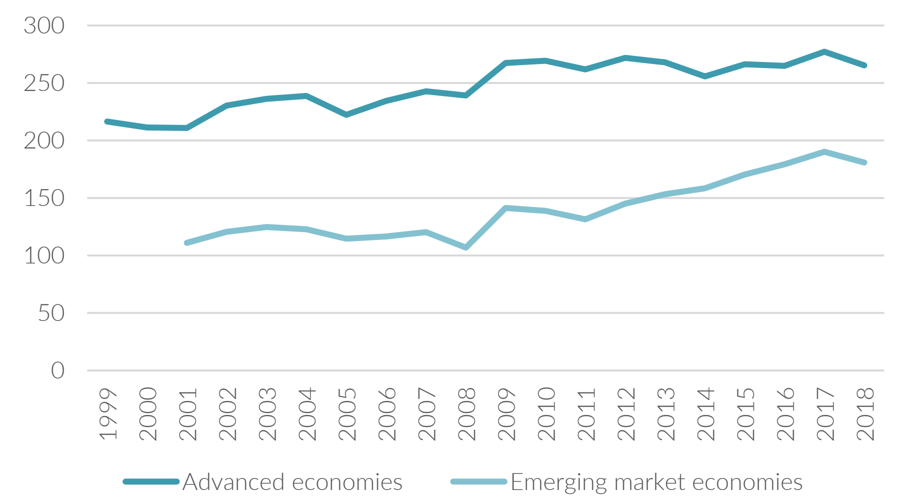
Higher growth best way to reduce debt…

It's worth noting that this is not just a governmental problem; the corporate sector is also highly levered. So total debt, excluding financial institutions, is over 250% of GDP in advanced economies – it will certainly be a lot higher at the end of 2020, irrespective of a V-, W-, U-, or L-shaped recovery – or indeed any other type of recovery.

…and timely fiscal stimulus should be priority for all governments…

The best way of reducing debt to GDP is higher growth – a timely fiscal stimulus should be a priority for all governments, and – correctly delivered – it will get us all out of a mess.

Total debt as percentage of GDP (%)



Source: BIS, Hardman & Co Research

Higher taxes

…with other options being higher corporate and personal taxes

Other options for governments will presumably, at some point, be higher corporate and personal taxes, although there is an economic impact. US hedge fund manager Jim Chanos has opined[1] that if government is to bail out businesses, then businesses will be forced to pay higher taxes as an insurance premium going forward. He calculates that S&P 2021 consensus earnings of $170 (too high an estimate, in my opinion) will need to be revised down to $135, if the US returns to tax rates of the pre-Trump era.

[1] Podcast interview with Barry Ritholz: https://www.bloomberg.com/news/audio/2020-05-02/jim-chanos-on-financial-fraud-podcast-k9pvdxqs

Other options, cited by eminent financial historian, Russell Napier, include an unpalatable menu for investors:

- wealth taxes;
- dividend controls;
- restrictions on investment;
- restrictions on ownership of gold (this happened in the 1930s); and
- capital controls.

The last one is the most interesting, in our view, and raises all sorts of issues that a simple analyst like myself is unable to answer. It seems unimaginable in a global inter-connected financial environment. But what would you do if you were President of, say, Turkey?

The solution for governments must be to engineer higher growth – let's hope they can achieve this, as the alternatives are unpalatable.

Interest rates may stay low

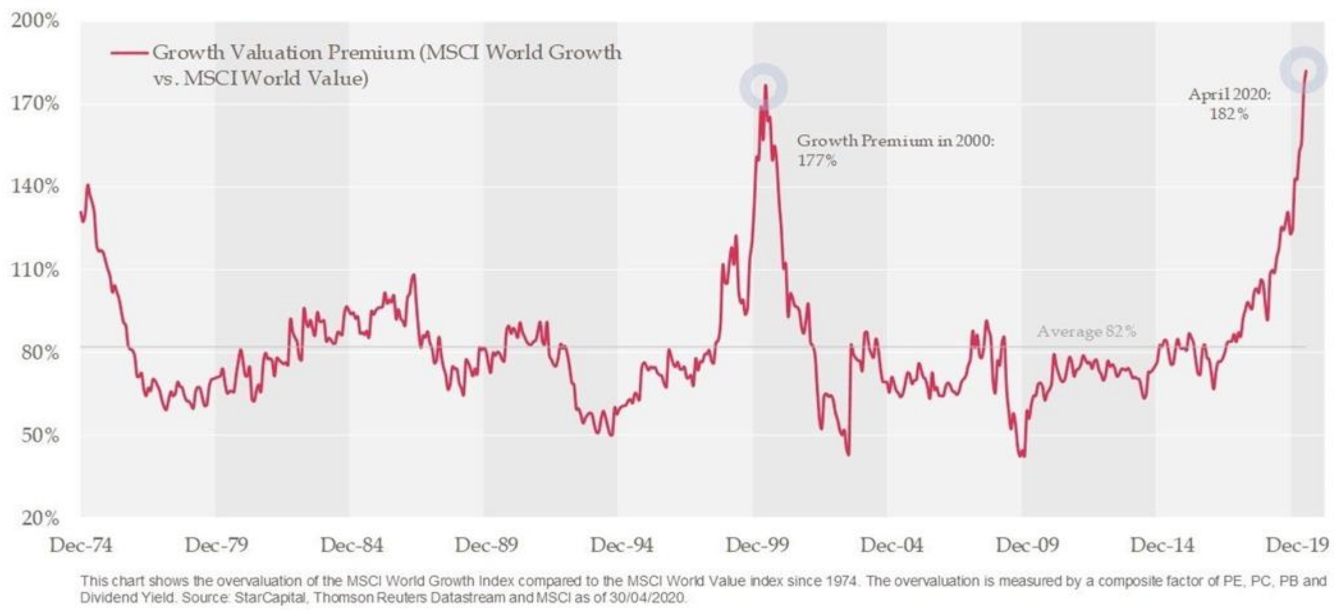
Low interest rates and subdued inflation will affect pension deficits

It seems highly likely that interest rates will stay low for an extended period. My base-case assumption is that, as with the situation post the GFC, inflation will remain subdued (this may well be the surprise of the decade, as inflation eventually returns, as in the mid-1960s).

This will affect pension deficits, which we discuss below, but should, in theory, continue to fuel the valuation of growth stocks. With growth scarcer, this becomes an even more attractive feature, which would suggest that the last decade's winners – tech – should remain winners. I would point out two caveats.

- Firstly, can these valuations grow forever? Trees to the sky? Probably not. And relative valuations have already increased significantly – as of mid-May 2020, the growth vs. value relationship had already surpassed the prior peak.

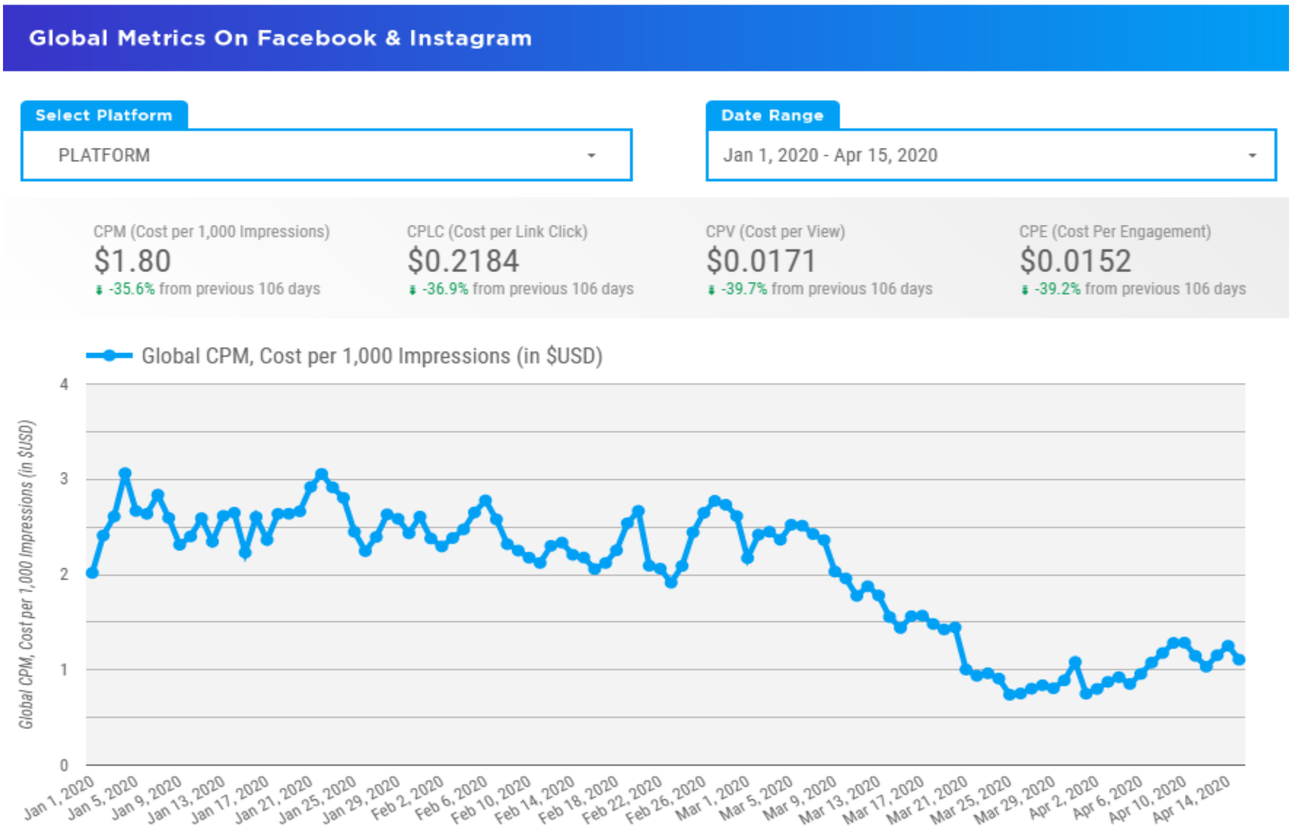
Growth premium to value exceeds tech boom levels



Source: Star Capital

- Secondly, even growth stocks are not immune to the general economic malaise. Internet advertising rates have collapsed, which will – for a period – hurt Alphabet and Facebook, for example.

Internet advertising costs have collapsed



Source: Gupta Media

Ripple effects and inflation

Direct effects of coronavirus crisis across all sectors…

The coronavirus crisis has created huge survivability issues for a number of sectors, notably airlines, travel and hospitality. The duration may be variable – for example, as long as the threat of virus transmission remains, cruise lines may face a long struggle to persuade holidaymakers to take such vacations, but the risk of short-haul air travel may be perceived as lower (although Carnival noted strong bookings for late summer in May 2020, so, somewhat surprisingly perhaps, cruising may recover more quickly).

There has obviously been an indirect effect across all sectors, even internet advertising, as was discussed earlier. A primary impact has been felt in the oil industry, where there initially appeared to be an almost existential crisis, as Saudi and Russia co-operated, possibly to undermine US shale.

…but what will be indirect impacts beyond general economic decline?

These were fairly obvious and direct initial impacts. What we have yet to understand, at this early stage of the crisis, is the indirect impacts beyond the general economic decline. This could be manifested in food shortages, a break in manufacturing supply chains, an inability to pay footballers' wages, the collapse of secondary Formula 1 teams, leading to a death of the sport, or many other potentially more serious impacts, which we have not yet thought of.

My candidate for the most impactful would be an increased propensity to save, which would slow economic growth. Second would be the potential for the imposition of a police state, as track and trace measures are implemented, with the loss of personal privacy, as foreshadowed in Yuval Noah Harari's piece for the FT on 20 March 2020.

Inflation could return in short term…

I alluded earlier to the prospect of a return to inflation. It seems impossible, given the depressed state of demand, but it also looked unlikely in the mid-1960s – yet inflation returned, leading to a dramatic wealth destruction in the following 15 years. This would be the one surprise that would really help governments; could it happen again? There may, after all, be some consequences of freely printing money.

Inflation did not resume in the last decade, in spite of huge bouts of quantitative easing. It could happen this time, however, for two reasons:

- The system has been flooded with more money, on top of its already liquid state.
- Last time around, demand growth was anaemic, and the allowed continued existence of zombie companies meant that the supply impact was lower than it would otherwise be. This time, it's highly likely that there will be multiple bankruptcies and some interruption to supply.

Inflation could well return in the short term, as oil demand returns, causing a sharp increase in oil prices, feeding through to plastic and chemicals, and as sectors of the economy that are hardest-hit see supply shrinkage:

- Airline seats will be scarcer, at least temporarily, as airlines fail, and carriers are slow to re-introduce capacity.
- The restaurant industry will see a sharp reduction in capacity, as demand to eat out returns close to pre-crisis levels (pent-up demand offset by lower affordability).
- Hotels, another mom-and-pop industry, like restaurants, will see a capacity reduction and an ability to push prices.

…probably driven by supply shortage

We will not have cost-push inflation, as labour will be in plentiful supply, nor will it be demand-led. A new form of supply shortage-driven inflation is possible, however, at least in certain sectors, and the problem with inflation is that it's difficult to make it disappear. It should be positive for equities, as long as it is contained to a limited number of sectors, but should inflation return in the medium term (not my central case), levels above 4% could severely impact valuation multiples.

Balance sheet restoration

Balance sheet restoration likely to weigh on economic growth for number of years…

Personal and corporate balance sheets need to be restored. This is likely to weigh on economic growth for a number of years. I pondered whether, in our new caring society "on the other side", bling might become unfashionable, but after reading an article in an Asian edition of Tatler that the Chinese bought a record $2.7m of Hermes Birkins and assorted goods in one day post lockdown, I initially wondered if the world would be that different.

…with most people needing to reduce their spending

My takeaway is that there may be two sorts of consumers immediately post lockdown. Those wealthy employees who have seen no impact on their earnings may well have pent-up demand to spend, in spite of the hit to their savings. They may go out and buy big-ticket items, and trade up in their restaurant choice – they cannot eat the lost meals out, but they can upgrade. My guess is that these will be in the minority, and will be outweighed by the self-employed, the furloughed and the unemployed, all of whom will need to reduce their spending.

Even if luxury is partly immune (and I wonder), large swathes of the lower end of the income distribution and the middle class will be, and will feel, much poorer. If stock markets stabilise at higher levels, the rich won't feel as bad, but many will have suffered losses as business owners and, if markets fall, there will also be a further reverse wealth effect.

Note that this will affect both corporate and personal balance sheets. Companies seem likely to rein in capex and discretionary spending for the 2020-22 period. Consumers will buy fewer and cheaper big-ticket items. This seems inevitable, although the impact is hard to model on corporate earnings at this point – we do know, however, that earnings will be lower than formerly forecast.

The one slightly odd exception to the big-ticket expense may be the leisure sector, where there will be a massive pent-up demand for holidays. Certain "exhausted" people will demand holidays, and this is the one luxury item that many middle-class households, at least, will be loath to sacrifice.

The picture for companies

Fortress balance sheets

One legacy from pandemic may be culture of conservatism and risk aversion

Andrew Smith, former KPMG Chief Economist, told me at the outset of UK lockdown that he was "quite shocked at how limited a financial cushion many businesses seem to have." This is perhaps not so surprising, given that, for the last 40-odd years, investors and speculators have enjoyed a tailwind from falling interest rates. So long as you had the stomach for debt, you basically made money. This culminated in a veritable orgy of buybacks in the last decade.

One legacy of the pandemic may be a culture of greater conservatism and risk aversion. Boards are likely to adopt a more conservative approach – the shock we have just experienced will make even the less risk-averse director appreciate having more cash and more facilities, *just in case*. Boards will likely want some security against another pandemic. This has two important implications for equity investors:

- Corporations have been the single-largest buyer of equities in the 2010s: buybacks may be much less fashionable, even after balance sheets have been restored post the pandemic.
- Return on Equity (RoE) will fall as a consequence: buybacks, even at high prices, usually boosted RoE, as money has been so cheap. It will remain cheap, but more conservative balance sheets will be one factor in lowering RoE.

As Michael Pettis, notable China commentator, put it in a series of tweets in April 2020:

"*When an economy goes through many years of rising real estate and asset prices, surging debt, and loose monetary conditions, business balance sheets tend to get structured in highly speculative ways that effectively "bet" on more of the same – 'inverted balance sheets'.*

Over time the whole economy 'shifts' towards riskier balance sheets. This is likely to be a problem nearly everywhere, and especially in China, where decades of artificially high growth, soaring real estate prices, excess liquidity and surging debt have transformed the balance sheet structures of nearly all businesses.

Inverted balance sheets are highly pro-cyclical. Economies and businesses with highly inverted balance sheets tend to surprise on the upside when conditions are good, often developing a reputation for smart management, and then destroy this reputation when conditions reverse".

China may not have seen the last effects of the pandemic. And if investors in developed markets seek safer balance sheets, companies will be forced to respond. Some investor reaction was under way, even before this crisis. Grant's Interest Rate Observer of 7 February 2020, opened with: "The lowest interest rates, the most accommodating Fed, the shortest junk-bond durations, the highest corporate leverage and the longest business expansion frame the value proposition for junk bonds and the speculative-grade, tradable bank debt styled 'leveraged loans.' 'Hold on to your hats!' is the investment conclusion".

Onshoring supply chains

Companies will want higher stocks and more diversity of supply

ING economist, Mark Cliffe, has suggested that "businesses are likely to shift from lean 'just in time' to bigger 'just in case' inventories. Businesses will be warier of single sources of supply or demand, allowing for a greater ability to switch activities or locations." Clearly, there is an associated cost.

Similarly, Tim Harford wrote in the *Financial Times* on 18 April 2020 that "It is tempting to fight the last war: we built up reserves in banking after the financial crisis, but we did not pay attention to reserve capacity in health…." The risk inherent in just-in-time and diverse supply chains has become more apparent, and companies will surely want higher stocks and more diversity of supply, and will onshore more production as a protection against a recurrence. Again, this will have two implications:

- production costs will rise; and
- returns will fall as inventory and working capital increase.

Pension deficits to increase significantly

Assets down and liabilities up in many cases significantly

The good news is that bonds have increased in value, and, given the growth in deficits, governments have huge incentives to keep yields low. However, the pension deficit (perhaps there is a surplus in the S&P 500 or the FTSE 100, but I haven't seen one for a long time) is the difference between two large numbers:

- Assets have gone down significantly for those with a higher exposure to equity, but less so for those funds with a larger exposure to bonds. Funds with heavy exposure to alternatives may find that the lack of a mark-to-market doesn't help if the private equity portfolio companies sink under the weight of their debt.

- Liabilities have gone up significantly, because the liabilities are discounted to present value, based on bond yields that have collapsed. This means that pension deficits will have increased significantly for most quoted companies. This is almost a straight subtraction from equity values. I looked at one UK retailer whose equity valuation would theoretically halve if bonds were 2% lower at the date of the next accounts. Many companies with large workforces have a high sensitivity to lower rates through the pension exposure.

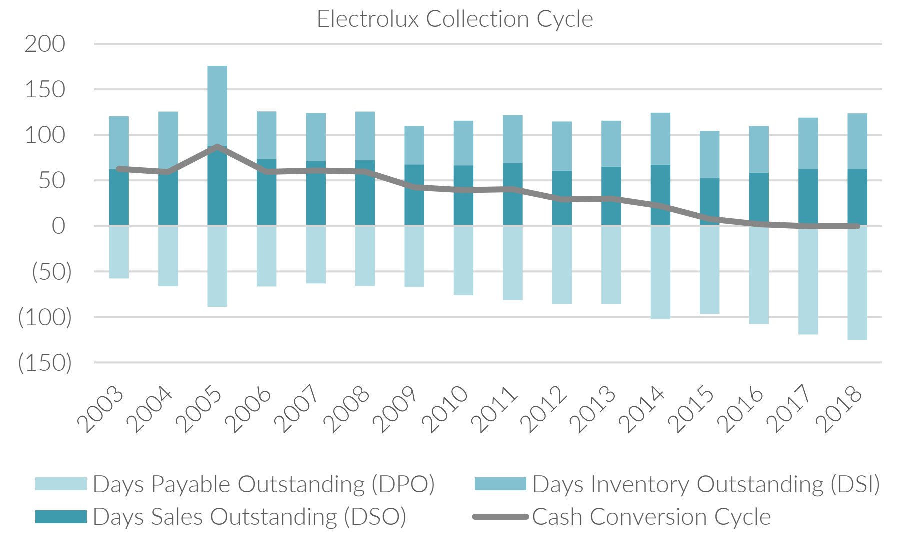
Working capital unwind

Unwind will occur on both sides of balance sheet

An unwind of working capital will occur on both sides of the balance sheet. I have observed a number of industrial companies that have improved working capital tremendously over the last 10-15 years. Many have done this predominantly by failing to pay suppliers on time – unless their supply chains are extraordinarily robust, these companies will be hit by the need for increased inventory and by the need to start paying suppliers more quickly.

The following chart illustrates Electrolux's working capital over the last 15 years or so.

Electrolux – working capital, 2003-18



Source: Hardman & Co Research

The collection cycle (number of days sales tied up in working capital) looks to have achieved a marvellous improvement, from 63 days 15 years earlier, and a peak of 87 days, to zero. But look at how this has been achieved – debtor days have been flat, at 60-ish. Inventory days have actually increased slightly to ca.60 days, while payables days have doubled from ca.60 to ca.120.

Perhaps Electrolux's suppliers are all robust companies in great health, after Electrolux has been so bountiful with its custom. But I doubt it; rather, I suspect many of its suppliers will have been significantly impacted by the lockdown. Unless Electrolux not only pays its bills but pays them in advance, they may be unable to supply – cue a potentially massive working capital unwind for Electrolux; that's assuming that housebuilders are back building houses, or homeowners are refurbishing and making big-ticket expenditure.

I have singled out Electrolux, but this would apply to any of a large number of quoted industrials that have been engaging in this type of financial engineering (spoiler – it's not uncommon).

Where now for income funds?

Recent dividend cuts by major companies may lead to a perception that no company is safe

For many companies, the priority will be rebuilding balance sheets. Dividends will be a secondary issue. For those companies subject to government rescue, dividends are likely to be capped or forbidden until debts are repaid. Income fund managers will have an increasingly narrow repertoire. This is quite an important issue for many UK pensioners (not to mention fund managers).

That British Telecom would use this as an opportunity to rebase dividend expectations was somewhat predictable; less so for Royal Dutch Shell, which was seen as a stalwart in dividend payments, and was perceived by many as the most secure dividend in the FTSE 100. Now that it has cut its dividend, a perception may develop that no company is safe.

A corollary may be that some perennial dividend payers may be rerated, as these funds are forced into a narrower group of stocks. I think this is more likely to happen in the US, where dividends are often paid quarterly and where companies may sacrifice buybacks but continue to pay dividends (which are generally much smaller) – dividend-paying stocks like Apple and Microsoft have seen a strong performance for a long time; less so the Johnson and Johnsons and Proctor & Gambles. These types of stocks may be perceived as safer bets for income investors.

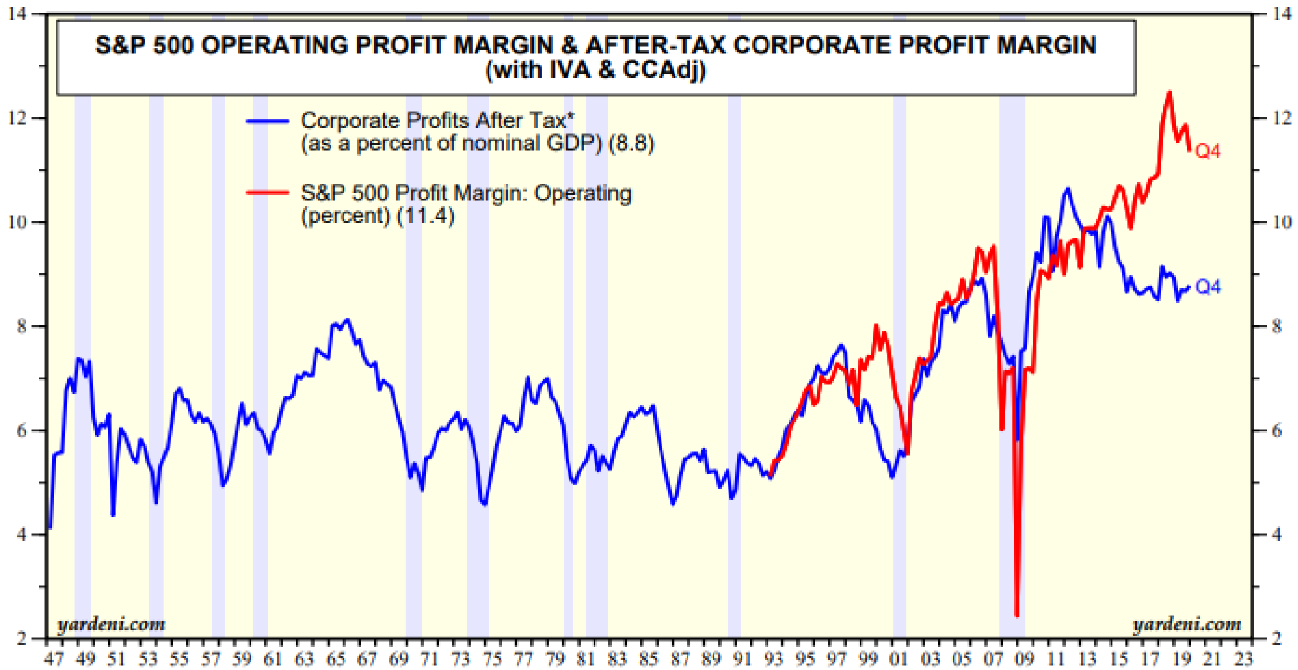
The "bezzle" and the great reset

JK Galbraith coined the term the "bezzle" in his book *The Great Crash, 1929*.

"In many ways the effect of the crash on embezzlement was more significant than on suicide. To the economist embezzlement is the most interesting of crimes. Alone among the various forms of larceny it has a time parameter. Weeks, months or years may elapse between the commission of the crime and its discovery. (This is a period, incidentally, when the embezzler has his gain and the man who has been embezzled, oddly enough, feels no loss. There is a net increase in psychic wealth.) At any given time there exists an inventory of undiscovered embezzlement in – or more precisely not in – the country's business and banks. This inventory – it should perhaps be called the bezzle – amounts at any moment to many millions of dollars. It also varies in size with the business cycle. In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks."

I have been preaching for the last 18 months that too many companies were cooking the books. This has been the "bezzle".

Reported corporate profits looked inflated



Source: yardeni.com

The chart above shows the gap between the S&P profit margins and the NIPA (National Income and Product Accounts) margins, an economic measure. The S&P number has been moving straight up, while the economic margins have been in steady decline. This is exactly what happened in the late 1990s, and it indicates that margins are being goosed – back then, it corrected, when S&P margins fell back to the economic margin level, and this will happen again. (There are some technical reasons why the S&P should be somewhat higher, but not to this degree.)

Earnings for most quoted companies will be reset down

Now finance chiefs have an opportunity, presented by the virus, to engage in the 'Great Reset' – earnings will be reset, and the virus will be the excuse. Even if there were no lasting effects from the virus, earnings for the vast majority of quoted companies would be reset down. They have been stretching the elastic of earnings for some years, and now they have the opportunity to get their books in order. Forecasts will go down, even before you factor in the virus effects.

One final point regarding company profits – the Japanese earthquake in 2011 is the best analogy for an economic halt such as we are currently experiencing. It took industry there a long time to restart the supply chain and return to normal. We are told that China is already nearly there, but that process may take longer in other economies.

Conclusions

Main conclusion: assess resilience of your portfolio to every eventuality

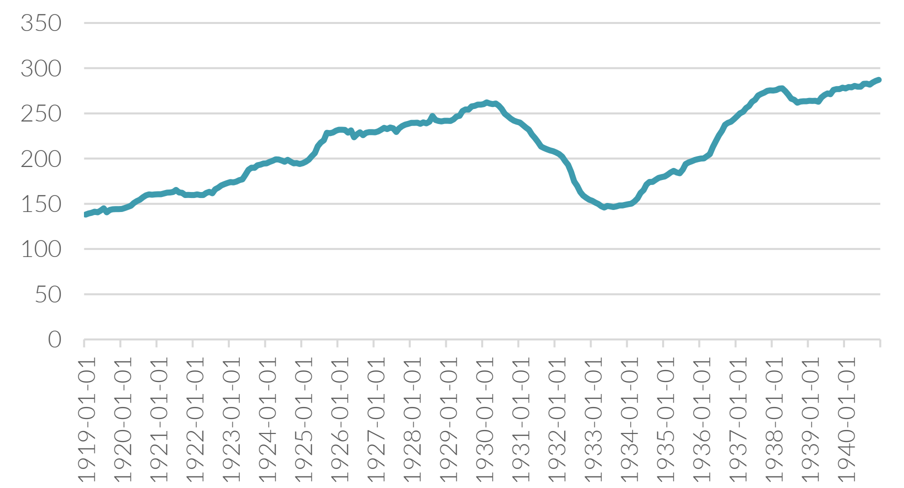
I confess that I don't know where the market will end up. Even doing a forecast for an individual company is incredibly difficult at this point; more difficult than it has ever been in my (long) career, and as difficult as it was post 9/11, when I was researching airline stocks, for example. The good news is that I think there are a lot of great opportunities in current markets on both the long and short sides – rarely does such an opportunity set present itself.

Structural trends will continue, regardless:

- climate change;
- ageing population; and
- an emerging middle class

But we may also see impacts that we don't expect – for example, ice cream sales collapsed by 44% in the 1930s depression, as the chart below illustrates. It took a further 4¼ years to surpass the 1930 peak.

US ice cream production – 12-monthly, m gallons



Source: St Louis FRED, Hardman & Co Research

What we now know, however, is that the impossible can happen – who would have thought that forward oil could trade at a negative price? The single conclusion to take away from this article is that you should assess the resilience of your portfolio to every eventuality – probabilities may be low, but look at the impact that those extreme events at the left tail of the normal distribution can have. Analyst teams should sit down and brainstorm what they think could happen, assign a probability, and assess the impact on portfolios.

One simple example: let's assume that this is indeed a point like 1965, and we see a return to inflation. Interest rates reached 15% in 1982. Now it may not reach that quantum, especially starting from effectively 0. But what would happen to your portfolio if rates reached 10% in 2030 or 2035? Most young investors probably cannot imagine a world in which rates are 15%. Thinking the unthinkable is one of the lessons I am trying to take away from this crisis.

About the author

Steve Clapham is an equity analyst at Hardman & Co

Steve is the founder of Behind the Balance Sheet, an investor training consultancy. He has been an investment analyst for the last 25 years, working on the sell side for a number of investment banks covering the transport, utilities and conglomerates sectors. In 2005, he moved to the buy side, where he was a partner at Toscafund Asset Management LLP, and then Head of Research at Altima Partners LLP.

Steve was part of the group of investors that acquired Hardman & Co in late 2012. He holds a degree in Technology and Business Studies, and is a member of the Institute of Chartered Accountants of Scotland.

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The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com