HARDMAN&CO.

UK Utilities and COVID-19

By Nigel Hawkins

Table of contents

This report was priced at 24 August 2020.

Executive summary

- The COVID-19 pandemic has had a significant impact globally in many areas. While primarily a health issue, it has had wide-ranging implications for stock markets, which have now rallied after the plunge in share prices in mid-March when the full severity of the emerging pandemic became more widely appreciated. Nonetheless, the FTSE-100 Index remains almost 20% off its late February 2020 figure.

- Traditional defensive sectors – food retailing, pharmaceuticals, utilities and tobacco – have, as expected, provided some real protection against falling prices, although Imperial Brands' share price has fallen sharply on the back of a much-reduced dividend.

- COVID-19 has proven to be very challenging for income funds as a raft of companies have either cut or suspended their dividend payments. Leading this group has been the banking sector, where no dividends are currently being paid by those in the FTSE-100 Index. However, the real headlines were made by Shell's historic decision to cut its dividend by two thirds, its first cut since the end of WWII – and a seminal moment for income funds.

- Some stocks have boomed on the back of COVID-19, most spectacularly the NASDAQ-quoted Zoom video-conferencing business, the share price of which has almost trebled since late February 2020. In the US, Apple, now capitalised at over $2,000bn, and Amazon have both prospered, with their shares up by more than 60% over the same six-month period. In the UK, AstraZeneca, at the forefront of the global quest for a COVID-19 vaccine, has performed well – up by 10% since late February 2020.

- Aside from the depressed banking sector, companies in the travel, hotel, leisure and retail sectors have all seen their share prices fall heavily – with a few exceptions. Shares in IAG, dominated by its British Airways component, have plunged by no less than 66% since late February 2020.

- On the utilities front, resilience has been the key feature; only Centrica has been an exception to this trend. Shares in National Grid, despite the ongoing – and pivotal – RIIO-T2 periodic review, Severn Trent, United Utilities and the smaller Renewable Energy Infrastructure Fund (REIF) sector have all held up well, as have their dividends.

- Looking to the future, COVID-19 will undoubtedly bring about profound changes to the UK's economy. A pronounced shift to an online economy, far more home-working – and therefore less demand for office space – and much reduced commuting numbers are obvious features. Consequently, the economics of many infrastructure schemes are sure to be reassessed, including HS2, the third runway at Heathrow Airport and future nuclear generation projects.

Introduction

The March 2020 share price plunge...

The COVID-19 pandemic has inevitably had a major impact on financial markets, especially since the start of lockdown, which saw share prices plunge in March 2020. The FTSE-100 fell by around a third between late February 2020 and the low point of 4,994 on 23 March 2020.

...and subsequent post-March rally

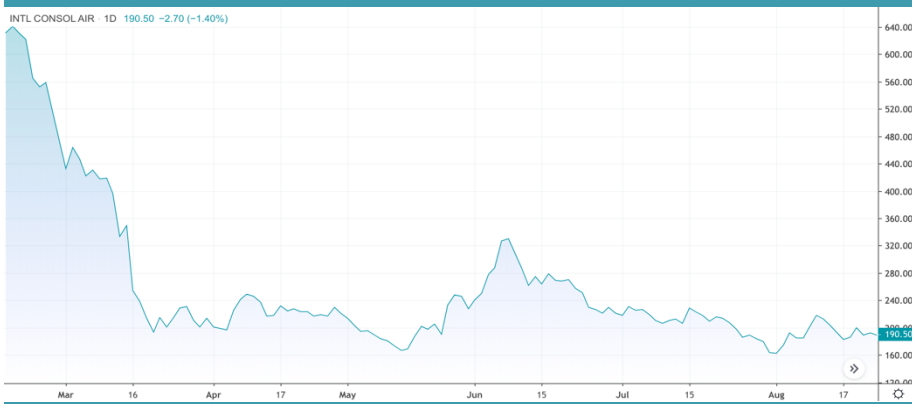
The subsequent recovery of the FTSE-100 Index has been pronounced, with almost half of the post-lockdown decline being regained, as the graph below shows.

FTSE-100: six-month graph

Source: Refinitiv

It should be emphasised, though, that many sectors are seriously struggling, with far higher net debt and much-reduced share prices. The leisure and travel sectors are obvious examples – IAG, the owner of British Airways, has seen its shares plunge by 66% since late February 2020, as the graph below indicates.

IAG: six-month graph



Source: Refinitiv

Shell's historic dividend cut

Oil and gas companies face real challenges, with crude prices being driven down – a trend that pre-dated COVID-19 but which has been accelerated by the far lower use of fossil fuels, due to widespread lockdowns. Furthermore, Shell's 2Q'20 results included a considerable ca.$16.5bn (post-tax) writedown on its oil and gas assets. Crucially, too, Shell has cut its dividend – from $0.47c to $0.16c per share – for the first time since WWII ended in 1945.

BP embracing renewable energy

As for BP, it has halved its dividend, due primarily to depressed oil and gas prices. Furthermore, it confirmed a very pronounced strategic shift towards renewable energy – a sharp move away from fossil fuels, which have driven its finances for more than a century.

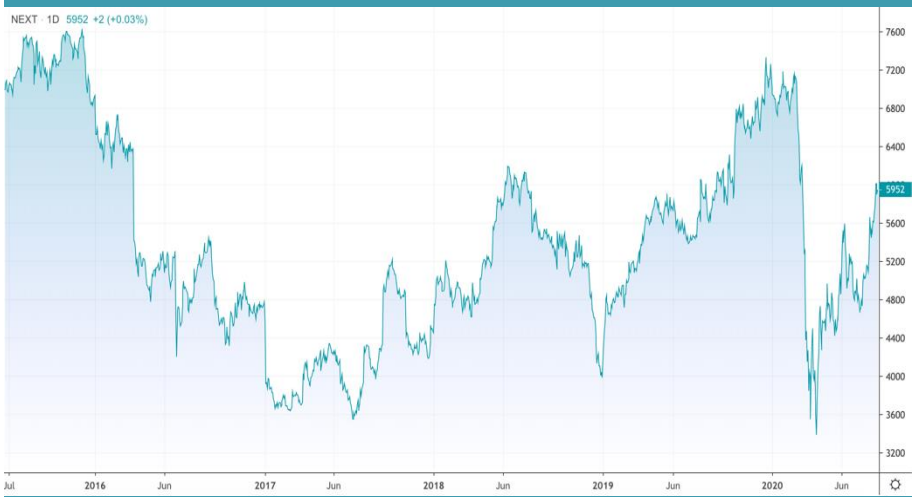
Very low footfall

Widespread doom and gloom on the High Street, especially within the non-food sector, has been apparent – with footfall, until very recently, at desperately low levels. With a few exceptions, leading retail names, such as Marks and Spencer, have seen their valuations plunge.

By contrast, some predominantly online retail businesses have fared better as this segment has taken off on the back of the COVID-19 pandemic. Most notably, Next's latest 2Q'20 trading statement was – given the pronounced impact of the pandemic – quite reassuring. 2Q full price sales were down by 28% on the comparative quarter in 2019, although – within this figure – online revenues increased by 9%.

The graph below shows how investors have responded to Next's impressive trading record over the past five years – at a time when many of its High Street competitors are in real financial trouble.

Next: five-year graph



Source: Refinitiv

The Apple and Amazon phenomena

While the UK market has seen few major stocks trading higher than six months ago as the COVID-19-driven lockdown destroyed economic growth projections, some leading US stocks has prospered in the past six months, most notably Apple and Amazon. Importantly, these two stocks and the other three FAANGs (Facebook, Netflix and Google/Alphabet) have been key in underpinning US stock market valuations, which have markedly outperformed those in most other first-world economies.

$6,000bn FAANG valuation

In fact, the FAANG quintet, which strangely excludes Microsoft, now commands a market valuation of ca.$6,000bn.

More specifically, the share prices of both Apple, now capitalised at over $2,000bn, and Amazon have risen by over 60% since late February 2020 in the face of the COVID-19 pandemic. These stand-out performances are highlighted in the graphs overleaf.

Apple: six-month graph

Source: Refinitiv

Amazon: six-month graph

Source: Refinitiv

Zoom's sensational performance

Other well-known US stocks have also done well, including Microsoft and PayPal. Their respective share price increases since late February 2020 are 25% and 70%. Even more remarkably, on the back of the recent boom in video conferencing, the NASDAQ-quoted Zoom has seen its shares virtually treble during the past six months.

Defensive sectors

When the going gets tough...

Historically, investors have switched into defensive sectors at times of profound economic difficulty – a scenario that COVID-19 has undoubtedly created. Such defensive stocks are expected to outperform falling markets, since many of their products are categorised as being essential, rather than being just desirable. For decades, these sectors have been:

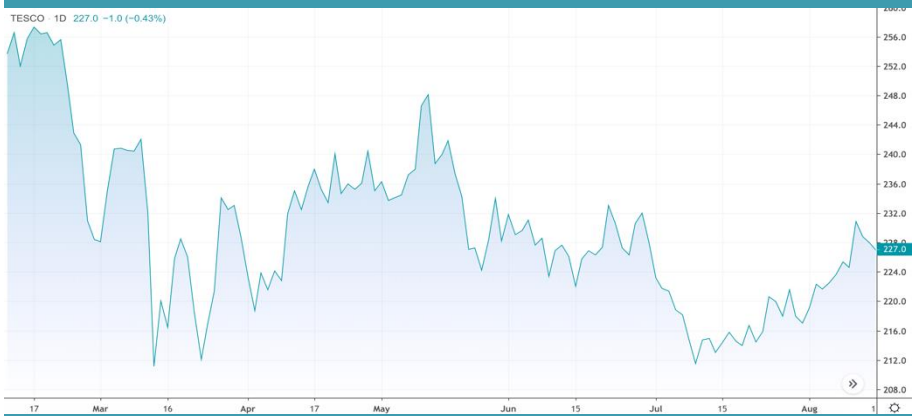
- Food retailing;
- Pharmaceuticals;
- Tobacco; and
- Utilities – we review this sector in more depth below.

Tesco has delivered

In the case of food retailing, online food sales in the UK are now estimated to account for ca.13% of all food sales compared with ca.7% prior to the COVID-19 pandemic. Tesco, in particular, has performed very creditably since the beginning of the pandemic when there was a significant increase in demand for some of its core products. Currently, Tesco accounts for ca.28% of the UK food retailing market, while its controversial Booker's deal has unquestionably boosted its supply chain capability of late.

The graph below shows Tesco's share price over the past six months and highlights how it has recovered from its low point in late March.

Tesco: six-month graph



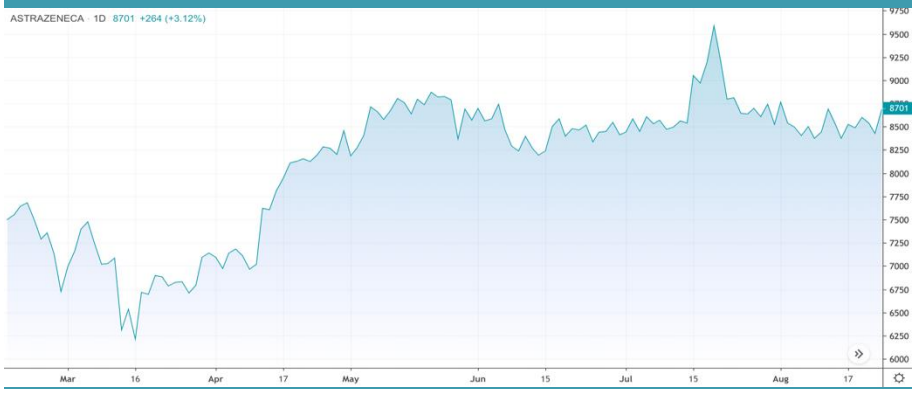
Source: Refinitiv

AstraZeneca at the forefront in the quest for a vaccine

The star on the UK pharmaceutical front has been AstraZeneca, which has been at the forefront of the quest, along with Oxford University, for a viable vaccine for COVID-19. There remains, despite encouraging trials, real doubt as to whether AstraZeneca will achieve its aim of developing an effective vaccine – and, if so, how such a scenario would affect its long-term revenues and profits.

The graph below demonstrates that the market has some confidence that AstraZeneca's COVID-19 research will provide some benefit to investors; its 14% rise in 1H'20 revenues underlines its robust trading position. AstraZeneca is now the UK's second-most valuable quoted company after Unilever.

AstraZeneca: six-month graph



Source: Refinitiv

Imperial Brands struggling

On the tobacco front, Imperial Brands has been unable to reproduce the share price resilience of past economic crises. While the levels of smoking, certainly in the UK, are falling, the COVID-19 pandemic has added a further powerful incentive to abandon smoking on health grounds.

UK Utilities

UK utilities offer defensive earnings but are subject to price regulation and to political intervention. The former remains a very real threat, while the latter is now less of an issue post the General Election in December 2019 – and, more specifically, the commanding ca.80-seat Conservative Party majority.

Resilience is the watchword

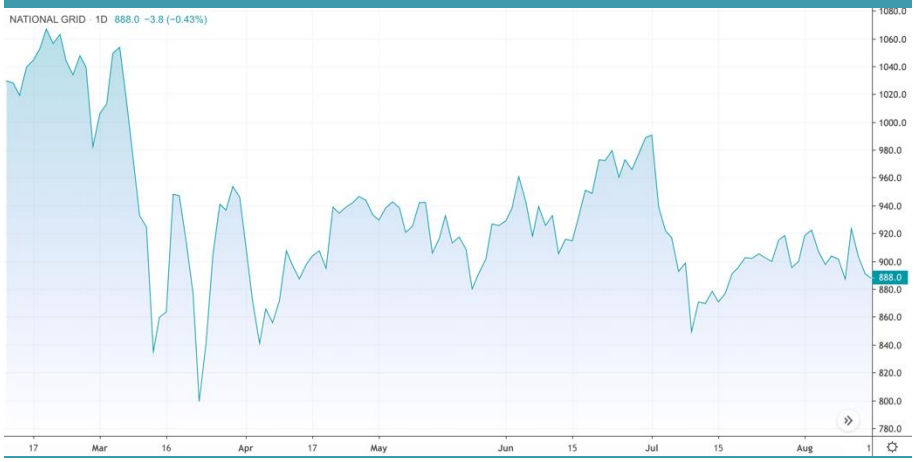
Currently, there are five energy and water companies in the FTSE-100 – all have proven to be resilient investments during the COVID-19 lockdown period, although – for regulatory reasons – National Grid, has underperformed the three water stocks.

RIIO-T2 is pivotal for National Grid – and its shareholders

National Grid is in the throes of a crucial periodic review, RIIO-T2, which will have a profound impact on the returns from its UK electricity transmission and gas transportation businesses. In 2019/20, these two business streams accounted for around half of its underlying operating profit: much of the remainder arose from its US operations.

Ofwat's final RIIO-T2 determination will be announced later in the year, with its rulings due to take effect as from April 2021. Significantly, Ofgem's draft determination in early July knocked 5.5% off National Grid's share price on the day that it was announced: this fall has been partly reversed subsequently, as the graph below shows.

National Grid: six-month graph



Source: Refinitiv

SSE's share price has rallied since March, although low energy prices – which reduce generation returns – are still holding back its share price rating. In recent years, SSE, which is essentially a UK and Irish energy business, has focused on its regulated transmission and distribution activities and on its renewable generation plants.

While profits are under pressure due to COVID-19 and, more specifically, as a result of lower energy prices, a dividend of 80p plus RPI for the 2020/21 financial year is expected, thereby putting the stock on a yield of more than 6%.

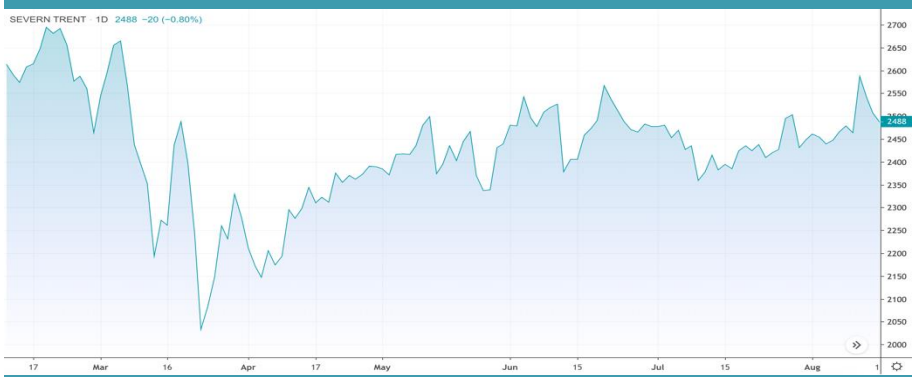
The water sector has been only moderately affected by COVID-19. In fact, it has been PR19, the key five-year periodic pricing review, that has had more of an impact on water company valuations.

Reassuring dividend projections from the water sector

Both Severn Trent and United Utilities, having accepted Ofwat's final determinations, have now confirmed their long-term dividend policies. Dividend increases until 2024/25, which are at least in line with the CPIH inflation figure (this includes housing costs), are projected for both utilities.

As a key defensive stock, shares in Severn Trent have performed robustly – given the circumstances – as the graph below indicates.

Severn Trent: six-month graph



Source: Refinitiv

United Utilities' shares have also performed very solidly now that their finances until 2024/25 are far less opaque than previously.

Viridor's sale value exceeds expectations…

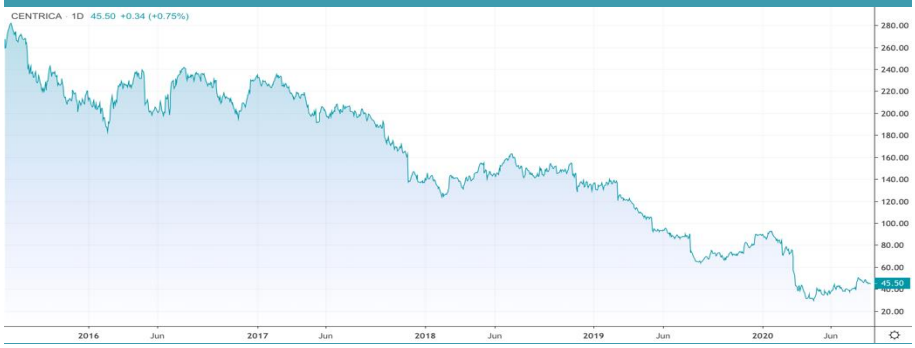
In Pennon's case, its South West Water core business secured a favourable settlement from Ofwat, which was – not surprisingly – accepted. More recently, Pennon has sold its Viridor waste business to KKR, a leading global investment firm, for £4.2bn – a somewhat higher figure than the market expected: its share price responded positively.

…but Centrica's woes continue

Centrica, which is the UK's leading gas supplier, has had a torrid time, due partly to the controversial introduction of the price cap: its shares have fallen sharply since the start of the lockdown. However, confirmation of the sale of its US Direct Energy business to NRG has alleviated debt concerns; the share price has rallied, admittedly from a very low base.

The graph below shows just how badly shares in Centrica – widely viewed as a utility – have performed in the past five years, during which time its dividend has been cut from 12p per share to perhaps nil for 2020; the interim dividend for 2020 was passed. Not surprisingly, Centrica's share price has followed suit.

Centrica: five-year graph



Source: Refinitiv

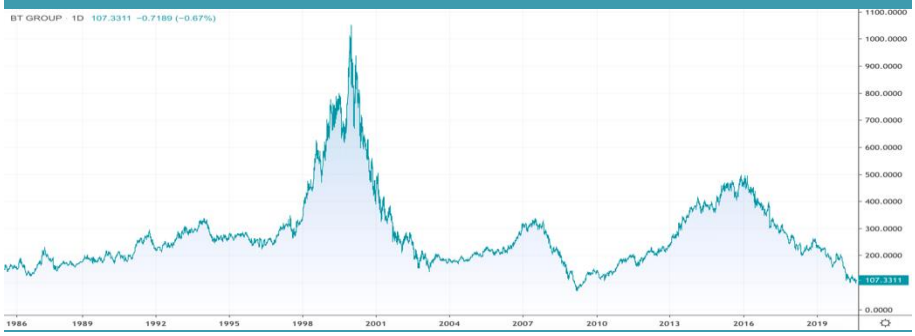
Despite its supposed growth profile, British Telecom is the archetypal utility. Its underlying EBITDA – once allowance is made for the EE mobile phone acquisition in 2016 – has barely changed in a generation.

Nonetheless, in the face of intense political pressure to roll out enhanced broadband capacity, British Telecom is now committed to a £12bn plan to connect 20m homes to fibre optic cable over the next decade. With far more employees now set to work from home, far greater broadband capacity, especially in rural areas, will be much needed.

Soaring net debt in 2019/20

Not surprisingly against this background – notwithstanding net debt of £18bn and a worsening pension deficit – British Telecom's share price has been very weak of late and recently fell below £1 for the first time since 2008, as the graph below indicates.

British Telecom: 1986-August 2020



Source: Refinitiv

Vodafone's resilience

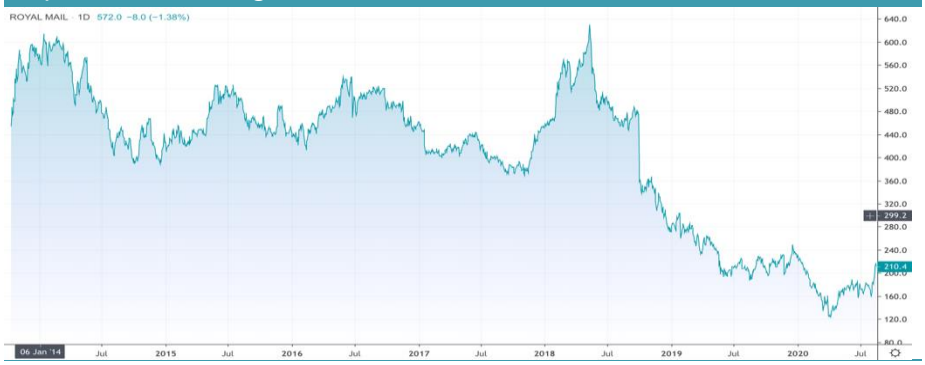
The UK's leading telecoms business, Vodafone, which now has many utility-type features, confirmed that it expects its EBITDA for 2020/21 to be "either flat or slightly down" on its 2019/20 return: Vodafone's financial year runs from April to March. Given the travel-related plunge in its roaming revenues, these projections are quite reassuring.

Struggling Royal Mail

Like British Telecom, Royal Mail has also seen its shares plummet, as letter volumes fall each year. Despite the boom in online deliveries in recent months, Royal Mail seems to have derived comparatively modest benefit, as leading US-based logistic businesses, such as UPS and DHL, have prospered. The one bright spot for Royal Mail is its GLS parcels business.

The fall in Royal Mail's share price since flotation in 2013 is pronounced, as the graph below highlights.

Royal Mail: 2013-August 2020



Source: Refinitiv

REIFs

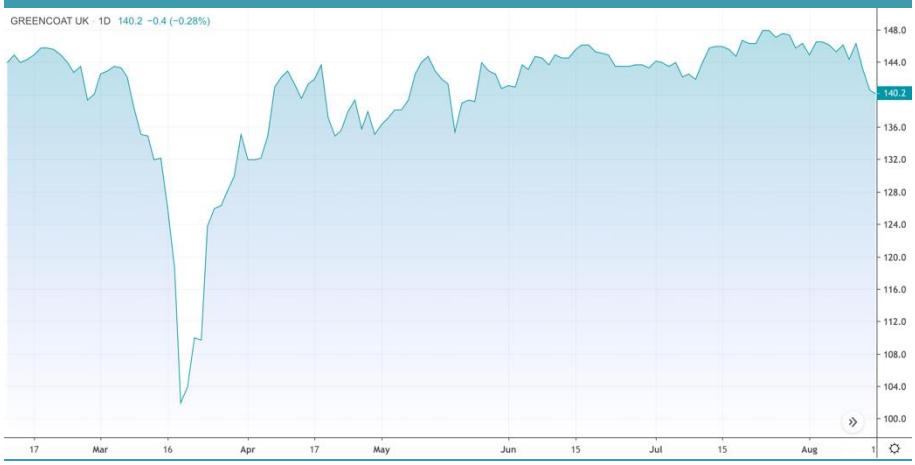
Financial solidity from the REIFs – despite lower NAVs

Elsewhere in the UK energy sector, the 13 quoted REIFs have been very reliable – if low-key – performers, despite lower net asset values (NAVs) brought about mainly by lower long-term energy price projections.

The two leading REIFs – Greencoat UK Wind and TRIG – are currently capitalised at more than £2bn each; their share prices are barely changed from late February 2020. However, during March, their valuations fell appreciably as the market fretted about the impact of COVID-19; but, their share price recovery – to pre-pandemic levels – was quick.

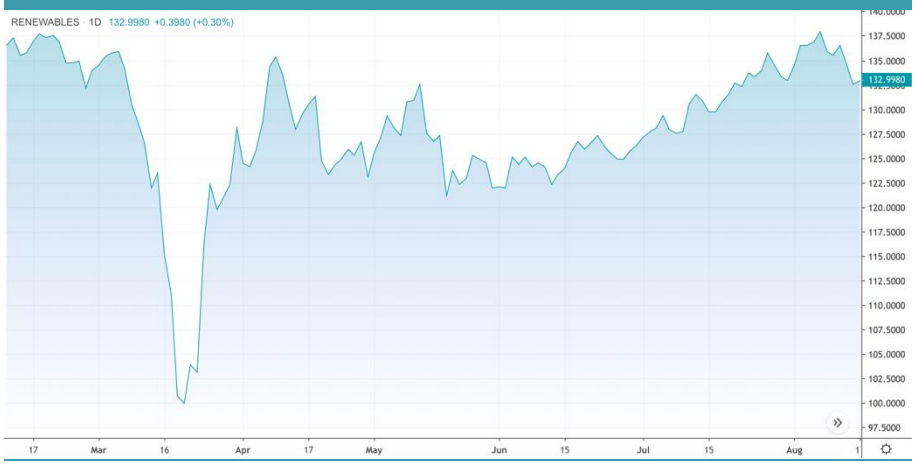
Six-month share price graphs for both Greencoat UK Wind and TRIG are reproduced below – they emphasise how resilient these two stocks have been during the COVID-19 pandemic when so many UK companies faced immense challenges.

Greencoat UK Wind: six-month graph



Source: Refinitiv

TRIG: six-month graph



Source: Refinitiv

In the solar generation sub-sector, both NextEnergy Solar and Bluefield Solar have also demonstrated their financial resilience, abetted by higher-than-expected output levels during the early months of 2020.

Impact of lower energy prices on NAVs

However, for some REIFs, NAVs have fallen by up to 6%, as lower long-term price projections have adversely affected underlying valuations. In the context of the COVID-19 environment, these falls are quite modest.

Reassuringly robust on the dividend front

REIFs have performed particularly well on the dividend front, with solid – and moderately increasing – payments. Not surprisingly, some REIFs, such as NextEnergy Solar, have placed the level of their future dividend payments under review. Compared with Centrica, for example, their dividend payment capacity is distinctly favourable. Moreover. the REIF sector yield is currently between 5% and 6%.

Dividends

When the COVID-19 lockdown began, there were considerable political sensitivities around the payment of substantial dividends. Many large companies deemed it inappropriate to recommend large dividend payments as the UK's economy plunged.

Banks opt out of dividends for the moment

Under severe pressure from the Bank of England, all the UK's leading banks, including HSBC, Barclays, Lloyds and NatWest (formerly RBS) suspended their planned dividend payments during the spring. Once COVID-19 is defeated, dividend payments should resume, although not necessarily at the same level as previously.

Many dividend cuts/suspensions

Many other well-known companies, including Sainsbury, British Telecom, Associated British Foods, Rolls Royce, Land Securities, International Continental Hotels, Whitbread and Persimmon, have either cut or suspended dividend payments.

Shell's historic dividend announcement

However, by far the biggest shock for income funds was Shell's decision to cut its dividend for the first time since the end of WWII in 1945 – the cut was no less than 66% as oil prices seem set to remain very weak.

Centrica's dividend shrinks – again

Elsewhere in the energy sector, Centrica has passed its interim dividend, on the back of very poor full-year results for 2019. Between 2015 and 2019, Centrica's annual dividend payment has fallen from 12p to just 6p – its full-year dividend will probably be lower, if paid at all, for 2020.

SSE has also pared its dividend on the basis that its cover was becoming very low and in the recognition that generation prices are not expected to rise markedly for some years.

The quest for yield

Given that several major dividend payers of the past are now less reliable – both Shell and BP have cut their dividends sharply – income funds will need to invest in quality companies that offer a decent dividend stream on a decent yield. To meet such criteria will be no easy task.

Looking forward

UK net debt now exceeds £2,000bn

Eventually, once COVID-19 is fully tamed, it will become apparent how much of an impact it has had on the UK economy – disastrously so in the case of 2019/20 and 2020/21 – and how long-term this impact will be. In any event, the UK's net debt has already breached the £2,000bn threshold.

Staggering debt pile – 300 years vs. 10 years

It took the UK 300 years to reach the £1,000bn net debt threshold and a further 10 years to double it.

Listed below are several views about the impact of COVID-19: some relate to the British way of life, while others are far more relevant to specific sectors, such as utilities.

- **Many companies will use the COVID-19 umbrella to introduce very radical changes** that might otherwise have not been implemented – the various innovative proposals, some relating to social housing provision, put forward by the unquoted John Lewis partnership, owners of Waitrose, are a case in point.

- **A thorough reappraisal of UK infrastructure projects.** A very pronounced increase in homeworking and the consequential sharp fall in commuting levels makes the case for the controversial HS2 project even weaker. The ca.£100bn cost will surely be reviewed. Also, Heathrow Airport's long-standing aspiration to build a third runway now looks far less robust than previously as air travel levels plunge, not helped either by the financial challenges facing British Airways' parent company, IAG.

- **The surge in homeworking during lockdown.** British Telecom will probably be required to be more aggressive in rolling out enhanced fibre-optic broadband services, especially in rural areas.

- **The long-lasting repercussions of Shell's swingeing dividend cut.** As the first such cut for ca.75 years, other companies, with low dividend covers, will feel freer to go down this route if their finances demand it – a distinctly unwelcome development for income funds.

- **Depressed oil and gas prices.** While oil and gas prices in 2019 were way below the oil peak of almost $150 per barrel in 2008, the seriously adverse impact of the COVID-19 lockdown has driven energy prices lower. It is uncertain how and when they will recover.

- **Bad debts.** In addition to the generous furlough scheme, many government payments were also made to prevent companies failing during the prolonged COVID-19 lockdown. How many of these payments are recoverable is unknown – even by leading banks who also face heavy bad-debt exposure. Furthermore, many companies, such as utilities, may experience higher bad debts as households struggle, especially as the furlough scheme ends and unemployment – as seems inevitable – rises sharply.

- **National Grid.** The UK's largest utility, National Grid, faces a key periodic review covering its UK electricity transmission and its gas transportation businesses. It covers around half of its underlying operating profits. Ofgem's draft determination in July saw 5.5% knocked off National Grid's share price on the day of publication. A bad outcome for National Grid would, almost certainly, see a dividend cut.

- **Small energy suppliers.** Given the immensely challenging energy supply environment, further bankruptcies and/or mergers of small energy suppliers seem inevitable – they would join the many corporate failures within the sector in recent years.

- **Nuclear power.** While the construction of Hinkley Point C is probably too advanced to be stopped, future UK nuclear projects look far less certain, especially those where substantial Chinese investment is expected. Aside from major controversy about the origins of the COVID-19 pandemic and whether China was honest in reporting all the relevant data, its relationship with the UK has seriously deteriorated of late over the issue of the governance of Hong Kong.

- **The water sector post PR19.** The three quoted FTSE-100 water companies, Severn Trent, United Utilities and Pennon, are well placed now since – for them at any rate – PR19 is concluded. No dividend cuts were made, with expectations of some real annual growth between 2020/21 and 2024/25. Some highly geared, but now unquoted, privatised water companies are currently arguing their PR19 case in front of the Competition and Markets Authority.

- **Royal Mail's travails.** As the owner of the UK's largest customer base – virtually every address in the UK – and superb access through the local postman, Royal Mail could expect to have prospered during COVID-19, on the back of far higher online sales. Instead, major US logistic companies have dominated the market, leaving Royal Mail with a declining UK letters' business and its GLS parcels operation; some takeover speculation has been in evidence.

- **The advance of Apple and Amazon.** Having had a remarkably successful time during lockdown, these two US leviathans are now worth a combined $3,800bn. Their substantial influence and global reach seem certain to persist.

Conclusion

Sea changes underway

With the UK economy operating in unprecedented times – against a global pandemic – a sea change is expected once COVID-19 is properly tamed: very different ways of working for millions of people are one obvious example. The ramifications seem certain to be wide-ranging.

Stock selection is paramount

For investors, stock selection will be increasingly key, with some very marked changes in UK shares prices – AstraZeneca vs. IAG, the owner of British Airways, for example – being recorded. Securing resilient dividend streams, with some real growth will be a priority for many funds, and not just those on the income front.

About the author

Nigel Hawkins is the Infrastructure and Renewables Specialist at Hardman & Co.

Nigel specialises in the energy sector, with a particular focus on the expanding renewable generation market, both in the UK and overseas, about which he has written several reports assessing the sector's finances.

He has been involved in analysing the utilities sector since the 1980s. He covered the privatisation of the water and electricity companies for Hoare Govett between 1989 and 1995. Subsequently, he researched the UK and EU telecoms sector for Williams de Broe. He has also written many feature articles for Utility Week magazine since the mid-1990s.

Between 1984 and 1987, Nigel was the Political Correspondence Secretary to Lady Thatcher at 10 Downing Street.

Nigel joined Hardman & Co in February 2016. He holds a BA (Hons) in Law, Economics and Politics from the University of Buckingham and is a senior fellow of the Adam Smith Institute.

Disclaimer

Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.

This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at http://www.hardmanandco.com/legals/research-disclosures. Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.

Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.

Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.

The information provided in this document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.

Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.

This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).

No part of this document may be reproduced, stored in a retrieval system or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission from Hardman & Co. By accepting this document, the recipient agrees to be bound by the limitations set out in this notice. This notice shall be governed and construed in accordance with English law. Hardman Research Ltd, trading as Hardman & Co, is an appointed representative of Capital Markets Strategy Ltd and is authorised and regulated by the FCA under registration number 600843. Hardman Research Ltd is registered at Companies House with number 8256259.

(Disclaimer Version 8 – Effective from August 2018)

Status of Hardman & Co's research under MiFID II

Some professional investors, who are subject to the new MiFID II rules from 3rd January 2018, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'

The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

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

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com