

PEELHUNT

UNINTENDED CONSEQUENCES

THE IMPACT ON THE UK EQUITY
MARKET OF PROPOSED RESEARCH
PAYMENT CHANGES

November 2014



UNINTENDED CONSEQUENCES

The impact on the UK equity market
of proposed research payment changes

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INTRODUCTION

“Unintended consequences”

The regulatory proposal to change the method of payment for research, which form part of the MiFID II legislation due to take effect across the European Union in January 2017, has stimulated an intense debate across the equity investment community.

Such changes are likely to have a considerable impact on the UK Small & Mid Cap market and equally so on the quoted companies, the brokers and the asset managers investing in these stocks. Given the level of debate, we determined that an independent survey of the views of companies and investors would help to inform an understanding of the impact of the proposed changes. We chose to work with Extel on the survey due to their expertise in this area and reputation for rigour and independence. The survey was undertaken from October to November 2014.

The results of this survey highlight the serious concerns held by the companies and the investors over the unintended consequences these regulatory proposals are likely to have on UK Small & Mid Cap companies, investors, asset managers and brokers.

We are delighted with the breadth of responses and are immensely grateful to all those who took the time to participate in this survey. To have 161 buy-side individuals from organisations controlling in excess of £1.7 trillion is a genuinely significant representation of industry views and a clear illustration of the strength of feeling held by the asset management industry. Similarly, to have 69 responses from the great and the good of quoted companies shows just how seriously they are taking these proposals. It is not an exaggeration to say that corporate boardrooms are largely unfamiliar with the machinations of financial services legislation therefore the impact of a reduction in research coverage and the subsequent knock-on effect on potential capital markets activity will likely be felt too late. This survey is intended to bring all the issues to the forefront and stimulate continued debate.

Steven Fine
Managing Partner
Peel Hunt
steven.fine@peelhunt.com

COMMENT FROM EXTEL

“Vivid demonstration of market sentiment”

The depth and quality of response provides, in our significant experience in market research, genuine statistical validity to the findings in this report. We would like to express our thanks to all respondents for their time and their careful contributions. With over 200 additional comments alongside the responses to the question set, the high level of interest is very clear.

As all of the participants are professional market practitioners, by definition their views and contribution is informed and articulate. What has driven such a strong response is the importance and relevance of the issues at hand. The question of payments for research, and the balance to be struck between firm, fair and transparent regulation; and the ability of the market to operate effectively, has been top of the agenda in secondary equities for more than two years.

Against that background, it is especially noteworthy that the strength of opinion is as powerful as it is. On many of the fundamental questions – around market liquidity, the possible decrease in analyst coverage, the challenge faced by new entrants to the asset management business, the greater potential impact on smaller asset managers, and the barriers raised to those companies looking to come to the market – we see 70% or even 80%+ of respondents sharing the same perspective. Any percentage, in a study of this type, above 70% unanimity, is statistically very unusual and a vivid demonstration of market sentiment.

As one of the main tenets of those concerned about the regulatory ‘roadmap’ has been the apparent absence of full cost/benefit analysis of the impact of possible changes, this data, and the strength of opinion it represents, is particularly pertinent.

Steve Kelly
Managing Director
Extel
steve.kelly@weconvene.com

COMMENT FROM THE QUOTED COMPANIES ALLIANCE

“Serious, practical concerns”

This report is timely and most welcome. It sums up the views of companies and investors. It is solid evidence that an entire marketplace has serious, practical concerns about the implementation of a key piece of legislation.

The proposals to change the way research is paid for may be an appropriate initiative for companies covered by 30 or 40 analysts. However, the law of unintended consequences is going to fall heavily on the small and mid-size quoted company community.

The Quoted Companies Alliance is very concerned about the impact these MiFID II proposals will have on the ability of small and mid-size quoted companies to raise the vital equity capital that they need to continue to grow, create jobs and produce long-term value for shareholders.

This report shows clearly that the small and mid-size quoted company community share this view – 85% of quoted company respondents think that small and mid-size quoted companies will be impacted.

The IPO market together with secondary fundraisings will be seriously affected if these proposals see the light of day. And there will obviously be a consequent impact on liquidity in the shares of these engines of growth – 74% of buy-side respondents believe that MiFID II will have an adverse effect on small and mid-size quoted company liquidity.

Research creates transparency and provides a flow of information. It shines a light on the marketplace. It creates liquidity and contributes to the formation of consensus views on a company’s future performance. As markets darken as a result of less research so the opportunities for market manipulation can increase.

These proposals, emanating from ESMA and being championed by the FCA, will potentially create the type of market that the FCA is set up to avoid. The further reduction, perhaps evaporation, of research in this part of the market will mean less scrutiny in that marketplace. This will lead to more volatility with less volume increasing the potential for market abuse.

It will fundamentally affect the ability of companies to join the equity market and make the market much less attractive for those already listed. Access to funding will reduce.

One of the three operational objectives of the FCA is to "protect and enhance the integrity of the UK financial system". The view of the small and mid-size quoted company community indicates that these proposals will do the opposite.

It is time for the FCA and ESMA to revisit their proposals and think very carefully about this "Directive of Unintended Consequences". This report is a formidable statement from the consumers of the equity markets – companies and investors. Regulators should ignore this at their peril.

Tim Ward
CEO
The Quoted Companies Alliance

Peel Hunt & Extel Survey
UNINTENDED CONSEQUENCES

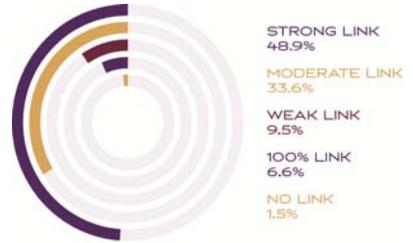
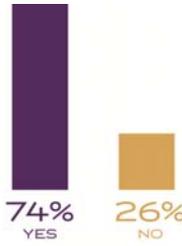
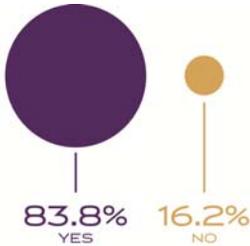
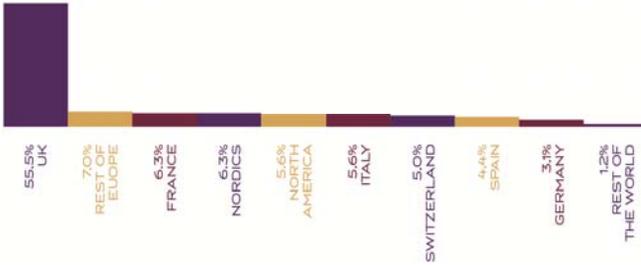


161 BUYSIDE INDIVIDUALS **£1.7** TRILLION AUM REPRESENTATION



69 COMPANY IR INDIVIDUALS **£1.6** TRILLION COMBINED MARKET CAPITALISATION

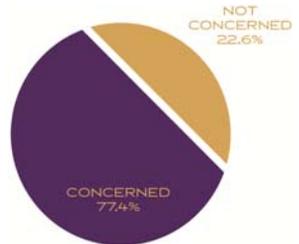
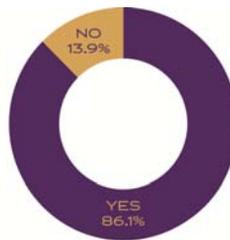
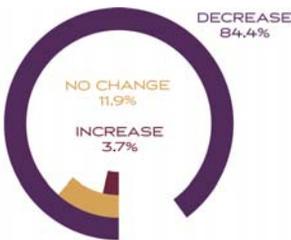
GEOGRAPHIC BREAKDOWN



MiFID II proposals affect the ability of Small Cap companies to access Capital Markets in future

Proposals directly affect the liquidity in UK Small Cap and AIM stocks

Correlation between number of analysts publishing on a company and the liquidity of that company's shares



Proposals will lead to a change in the number of analysts publishing on Small Cap UK stocks

Proposals will impact smaller asset managers more than larger asset managers

Concern over the falling level of sellside research coverage of UK Small Caps

KEY FINDINGS

UK companies: less research, less liquidity and less access to capital markets

- 85% of buy-side respondents fear a decrease in the number of analysts publishing on Small & Mid Cap companies.
- 74% believing the proposals will adversely hit liquidity of Small & Mid Cap stocks.
- 84% of buy-side respondents believe that the MiFID II proposals will affect the ability of Small & Mid Cap companies to access capital markets due to the reduction in liquidity driven by reduced sell-side research coverage.
- 78% of quoted companies responding see a correlation between the number of analysts writing on their company and the liquidity of their shares.

Fund managers: barriers to entry, competitive disadvantages, penalising end consumer

- 84% of buy-side respondents think MiFID II proposals will raise barriers to entry for new asset managers to start up and force further consolidation giving the consumer less choice.
- 86% of the buy-side respondents believe that there will be a greater impact on smaller asset managers compared with the larger managers.
- 32% believe the proposals would lead to higher fund charges.

Research: asset managers should pay for research and cost should be related to value created

- A preponderance of asset managers and corporates feel that asset managers should pay for investment research.
- 70% of the buy-side believe the cost of research should be linked to the value it creates.

Convergence of interests of asset managers and quoted companies

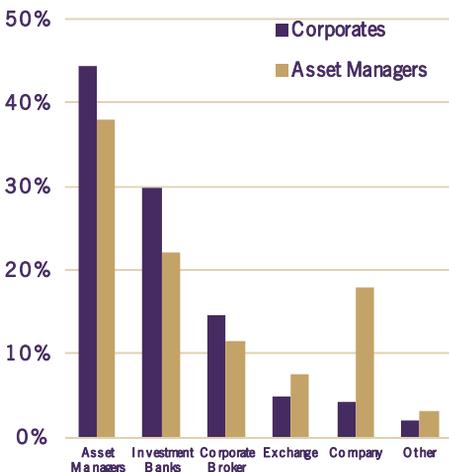
Minimum number of analysts researching a company



Link between number of analysts publishing and liquidity of company's shares



Who should pay for written research on a listed company?



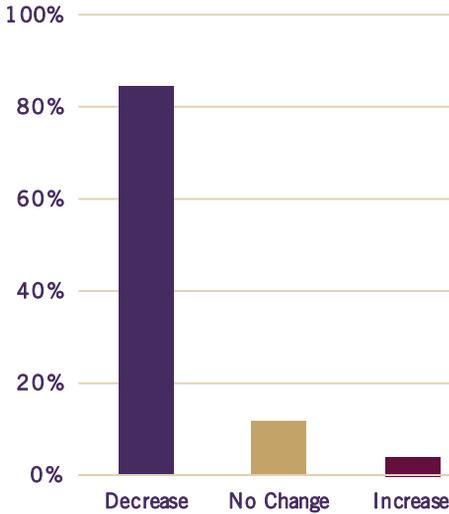
- Both asset managers and quoted companies feel there is a strong link between the number of analysts publishing on a company and the liquidity of that company's shares.
- Over 70% of asset managers felt stocks needs to be covered by more than three analysts for the research to be useful to their investment process; 90% of companies felt that their company also needed to be covered by more than three in order to access investors.
- A prevalence of asset managers and corporates feel that asset managers should pay for investment research.

BUY-SIDE SURVEY

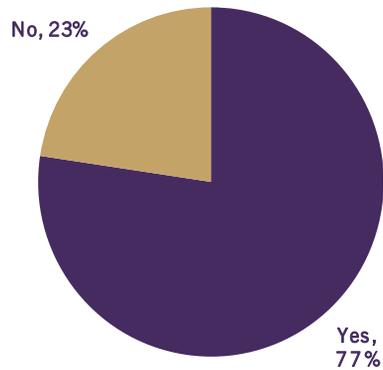
**161 participants
from 137 asset managers
in 10 countries
with a total of £1.7 trillion
assets under management**

Coverage, liquidity & access to capital markets

Will MiFID II proposals lead to a change in the number of analysts publishing on UK Small Caps?



Are you concerned about the level of sell-side research coverage of UK Small Caps falling?



84% of respondents felt that the proposed regulatory changes would result in a decrease in the number of analysts covering UK Small Cap companies, and 77% believe that is a cause for concern.

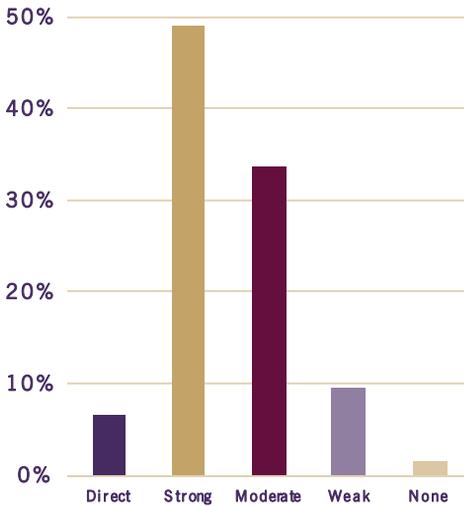
“It is unlikely to be profitable for several analysts to cover the same smaller company, so coverage, liquidity and awareness of companies is likely to drop”.

“...the outcome will be fewer new asset managers, consolidation of those currently operating, a significant decrease in the numbers of analysts covering UK Small & Mid Cap stocks, much reduced liquidity and pricing transparency, and a reduction in the number of corporates wanting to come to the market...”

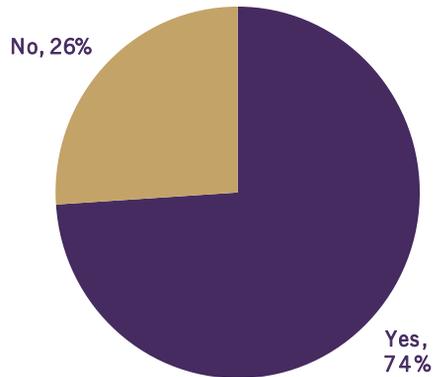
“Aim has been a real success story. This may be at risk – the changes will mean less coverage, less research, less liquidity, and counter-productive for firms thinking of listing”.

Peel Hunt & Extel MiFID II Survey UNINTENDED CONSEQUENCES

Do you see any link between the number of analysts publishing on a company and the liquidity of that company's shares?



Will MiFID II proposals directly affect the liquidity in UK Small Cap and AIM stocks?



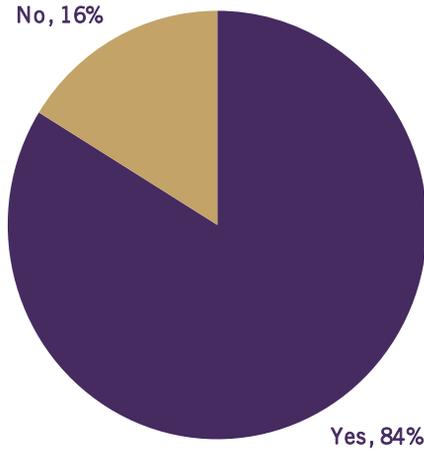
A significant 74% of all respondents felt that the proposed regulatory changes would directly affect the liquidity in UK Small Cap and AIM stocks; and 49% were of the view that there is at least a strong link between the spread of coverage and liquidity.

"In the secondary market small caps research won't pay; that will mean less coverage and less liquidity. Ultimately this will rebound on end investors and damage the UK".

"Brokers will have to increase the fees for small cap capital transactions to compensate for the lack of research commission. Lower liquidity will put the cost of capital up for smaller companies".

Peel Hunt & Extel Survey
UNINTENDED CONSEQUENCES

Will MiFID II affect the ability of Small Cap companies to access capital markets in the future?



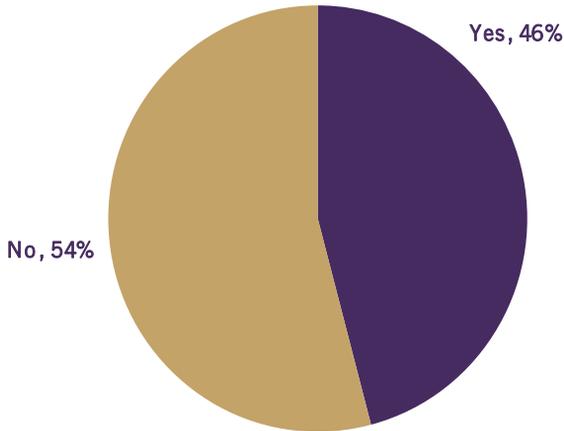
An overwhelming 84% of all respondents felt that the proposed regulatory changes affect the ability of Small Cap companies to access capital markets in the future.

“It will almost certainly reduce the amount and quality of research on Small & Mid Cap companies making pricing even less efficient than it already is, diminish the ability of companies to raise money and make life more difficult to small companies”.

“Implications for small brokerage firms is that they will struggle to be paid appropriately for the research and coverage they provide and, therefore, may shrink/exit that business and so reduce choice and flexibility for small cap companies looking to raise capital.”

Competitive position and consumer choice

Will MiFID II change your company's competitive position vs non-European asset managers?



46% of respondents felt that the proposed regulatory changes would affect their competitive position compared with non-European Asset Managers.

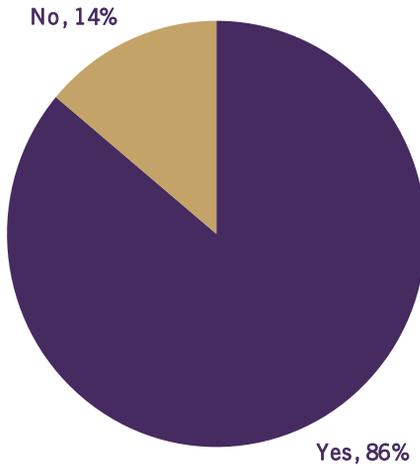
“There will be a dramatic drop in revenue from European Asset Management companies and so the global investment banks and related service providers will cut service, information flow, and corporate access here and allocate more resources to US and Asian clients. The information gap...will be substantial and ... eventually impact returns to investors.”

“The global context is really quite important ... the likely impact ... is going to be consolidation on the buy-side. This will mean less choice for the consumer, with increased inefficiencies ... exacerbated by, without any doubt, less analysis in the market ... This portends to a rather grizzly outcome for ultimate investors.”

“Non-European asset managers will still be able to pay for research via commission...the banning of use of commissions to pay for research increases the risk that relevant research ideas will be missed to the detriment of clients.”

Peel Hunt & Extel Survey
UNINTENDED CONSEQUENCES

Will MiFID II proposals impact smaller asset managers more than larger asset managers?



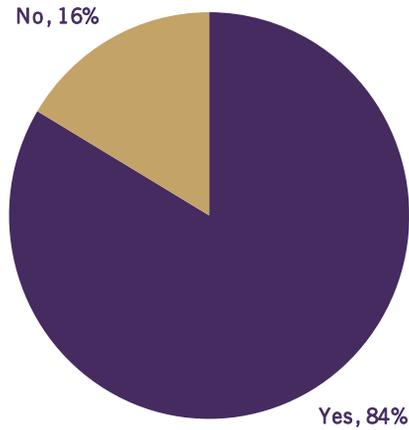
A striking 86% of respondents felt that the proposed regulatory changes would have a greater impact on smaller asset managers.

“It could ultimately have the effect that it reduces competition ... leaving more power in the hands of the big asset managers ... this could work against the interest of customers”

“Expense of research will become a more relevant consideration and force up costs, or oblige smaller asset managers to reduce the research they use.”

“The ability for smaller Asset Managers to access independent research of trusted quality will be greatly diminished. Larger players will still be able to afford to pay for the services, but this won't be an option for smaller managers. The result is that they will be less well-informed and this will impact on the quality of advice and service they can offer their customers. Ultimately the customer will suffer.”

Will MiFID II proposals raise barriers to entry for new entrants to the investment management industry?



A clear 84% of all respondents felt that the proposed regulatory changes would increase barriers to entry.

“The cost base is likely to change, making the EU less competitive.”

“Compliance costs plus a minimum AUM requirement (will be needed) to compete in the industry. [This] will crowd out innovation and entrepreneurs”.

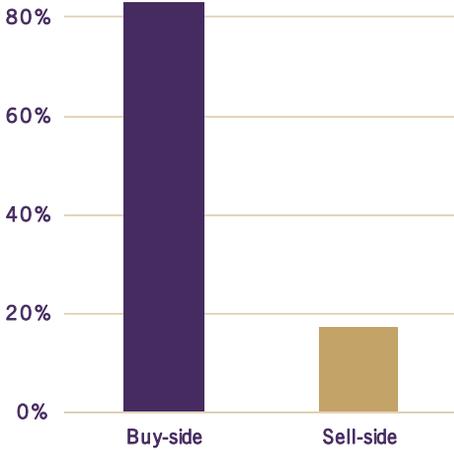
“Any increase in costs acts as a barrier to entry”

“The cost of a new start up will be increased by the need to fund research.”

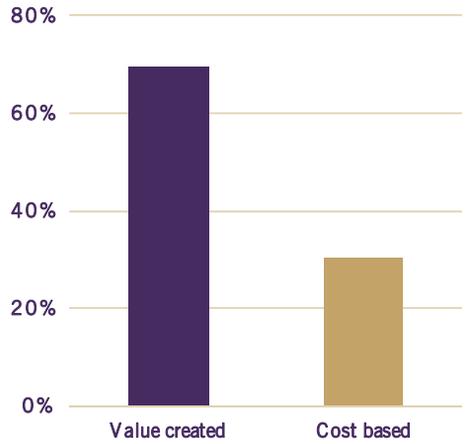
“It would be difficult for a new entrant to gain access to (and pay for) research from enough research houses to form a broad opinion of an investment, if those research houses are under increasing pressure to justify where they send their research to.”

Value, spread of coverage and who should bear research costs

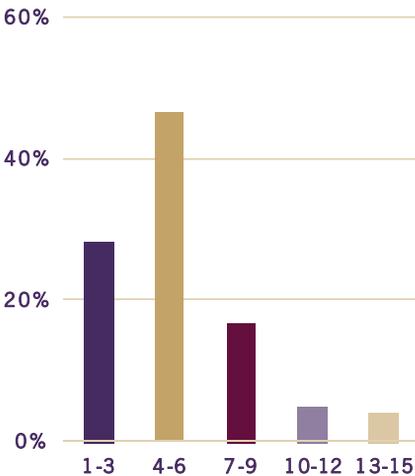
Who should set the value of research?



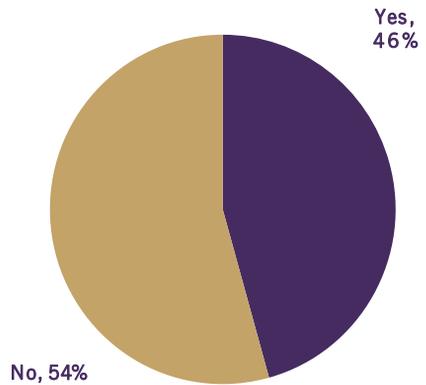
How should sell-side research be valued?



How many analysts do you feel is the minimum to research a company to make it useful to your investment process?

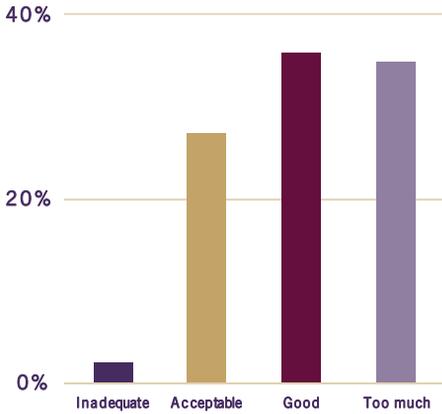


Do you think there is appropriate breadth of coverage of recently listed companies?

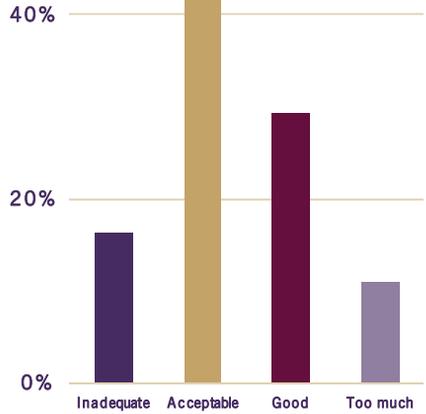


Peel Hunt & Extel MiFID II Survey
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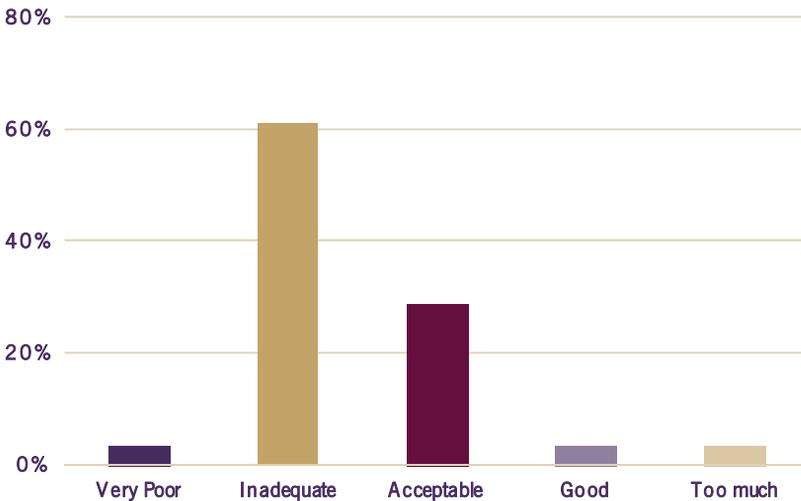
Is the research coverage of FTSE 100 companies appropriate?



Is the research coverage of FTSE 250 companies appropriate?

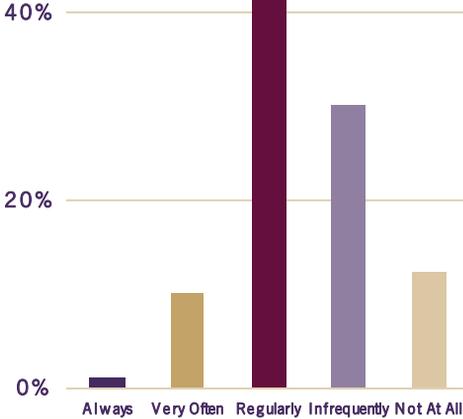


Is the research coverage of FTSE Small Cap/AIM companies appropriate?

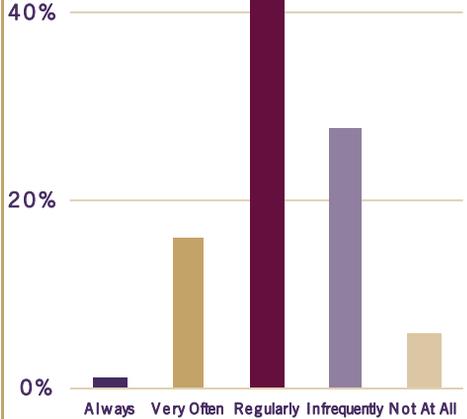


Peel Hunt & Extel Survey
UNINTENDED CONSEQUENCES

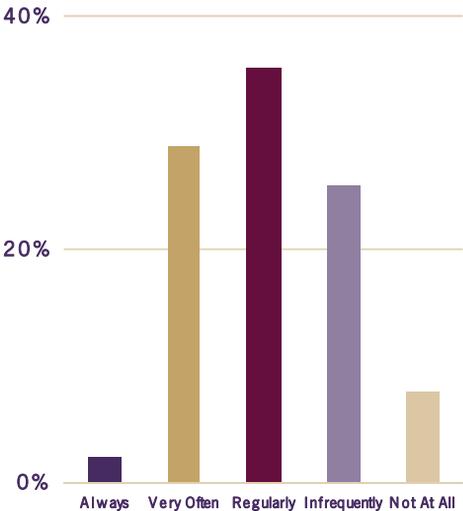
How much does research coverage of FTSE 100 companies add value to your investment process?



How much does research coverage of FTSE 250 companies add value to your investment process?



How much does research coverage of FTSE Small Cap/AIM companies add value to your investment process?

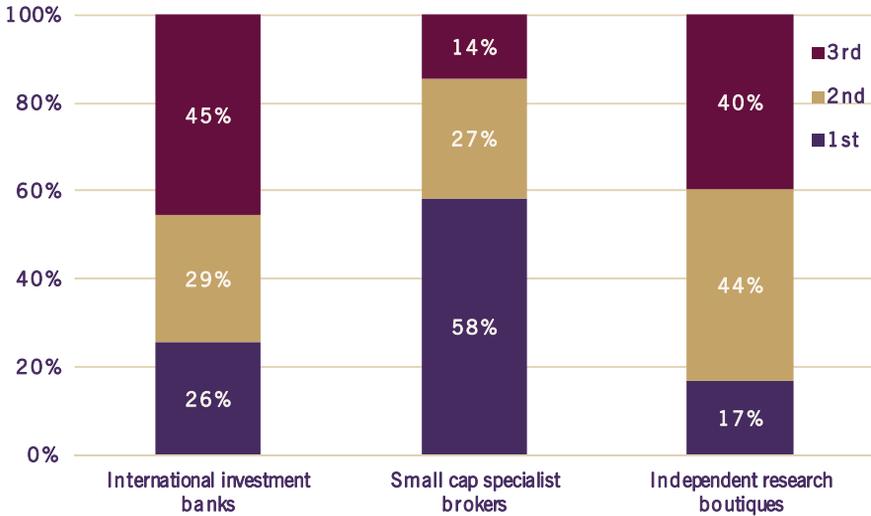


- Over 60% of respondents say that existing coverage of Small Cap/AIM stocks is inadequate ...
- ... while over 65% say that research on Small Cap/AIM companies adds value to their investment process

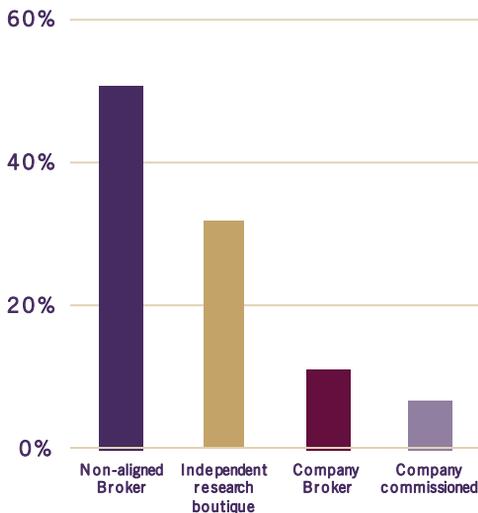
“... the information gap ... will be substantial and ... eventually impact returns to investors.”

Peel Hunt & Extel MiFID II Survey UNINTENDED CONSEQUENCES

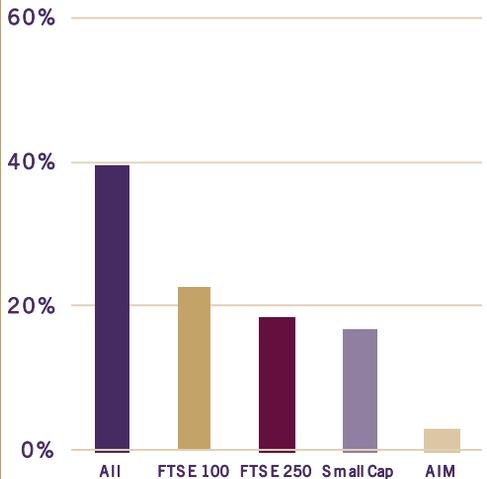
Who do you use most for research on UK Small Cap stocks?



Which research report do you assign the highest value to?

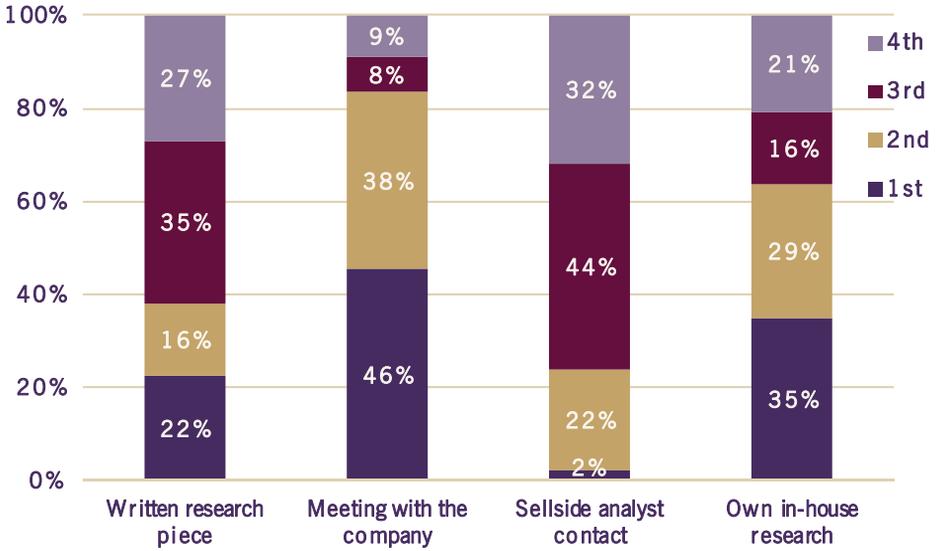


If you have an in-house team, how far down the UK listed market cap do they research?

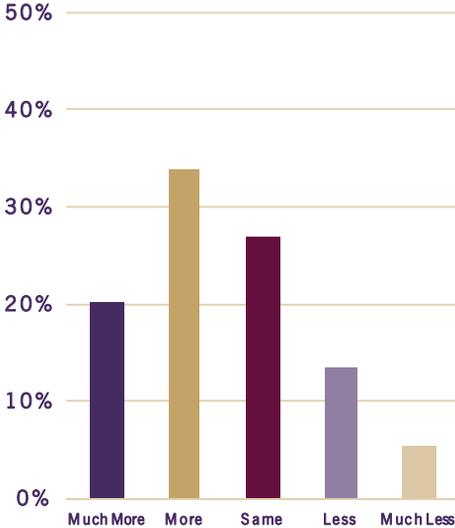


Peel Hunt & Extel Survey
UNINTENDED CONSEQUENCES

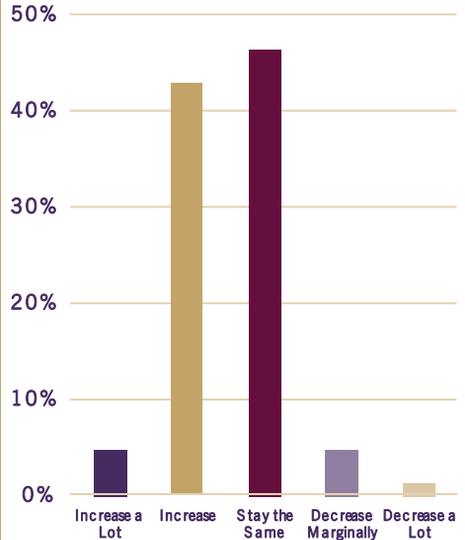
Rate the importance to you of contact with corporates



Do you value your in-house research on Small Cap stocks more or less than sell-side UK Brokers?

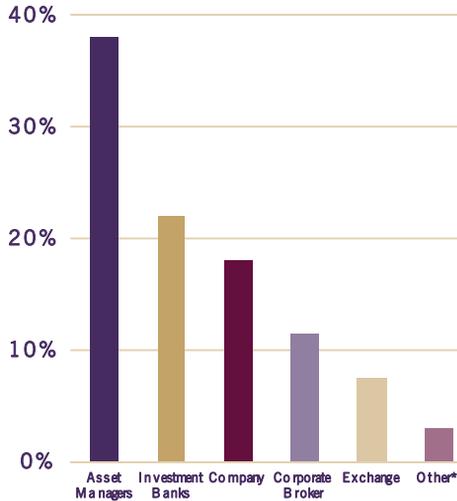


Over the next two years do you expect to change the level of research you conduct in-house?

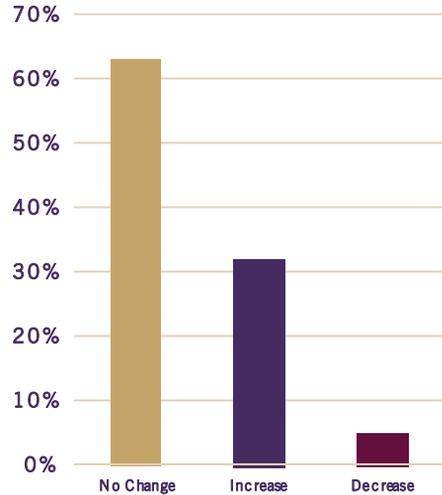


Peel Hunt & Extel MiFID II Survey UNINTENDED CONSEQUENCES

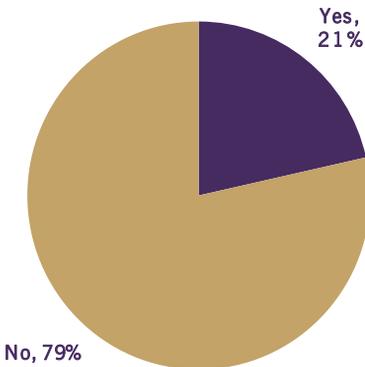
In your opinion, who should pay for written research on a listed company? *ultimate clients



Will MiFID II affect your fund charges?



Do you believe that research associated with the use of dealing commissions is an inducement?



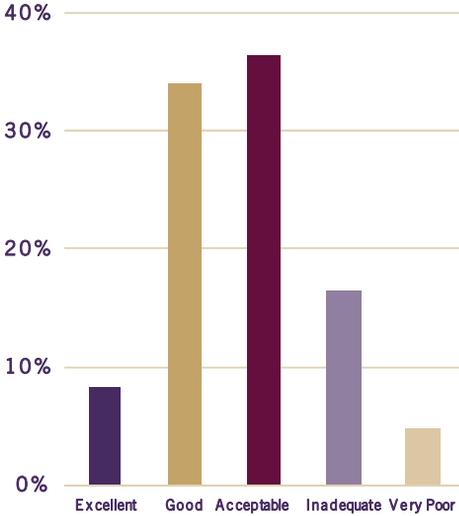
- More than 30% of respondents felt the proposed changes would result in higher fund charges
- 43% of respondents expect to increase their in-house research
- 40% of in-house research does not cover Small & Mid Cap companies.

CORPORATE SURVEY

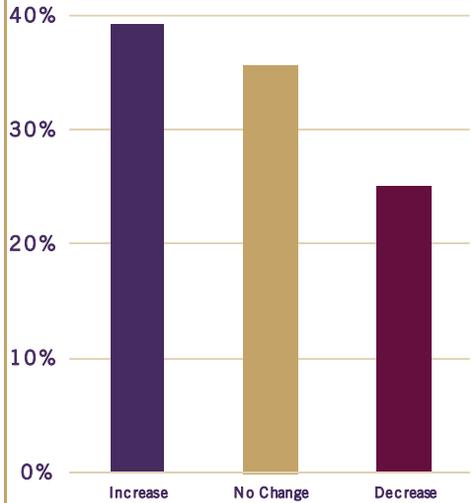
**69 quoted companies
from the EU and UK
with a combined
market capitalisation of £1.6 trillion**

Peel Hunt & Extel Survey
UNINTENDED CONSEQUENCES

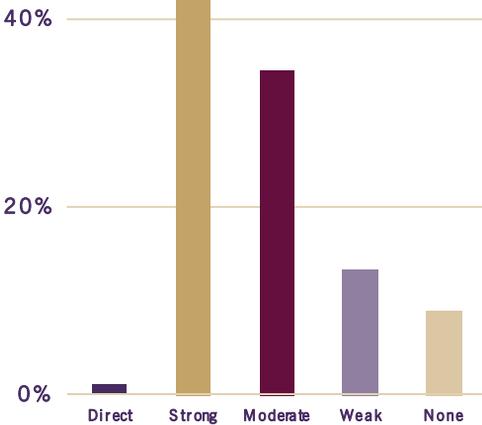
Do you believe the level of research coverage of your company is appropriate?



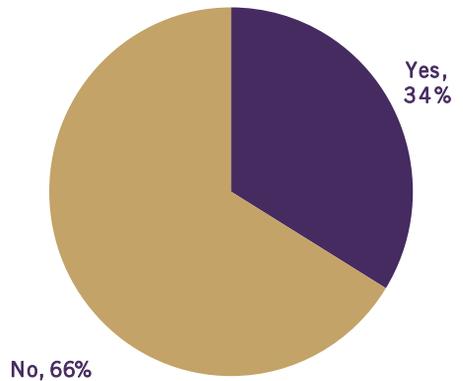
Have you seen in the last two years a change in the amount of research published on your company?



Do you see any link between number of analysts publishing on a company and the liquidity of that company's shares?

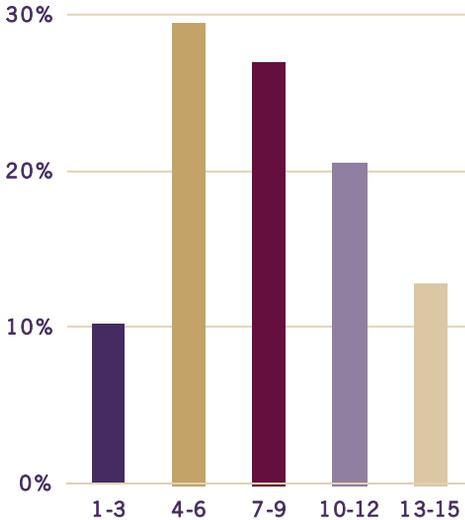


Do you see a correlation between number of analysts publishing on a stock and Retail investors willing to invest in that company?

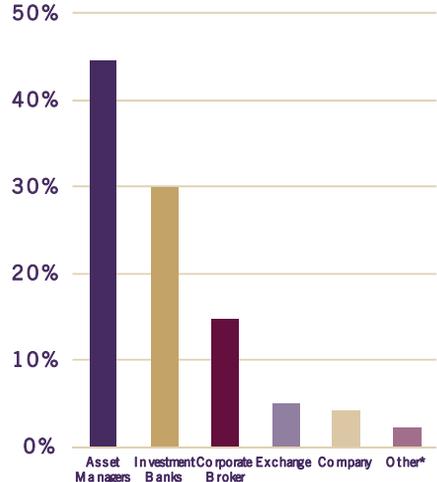


Peel Hunt & Extel MiFID II Survey
UNINTENDED CONSEQUENCES

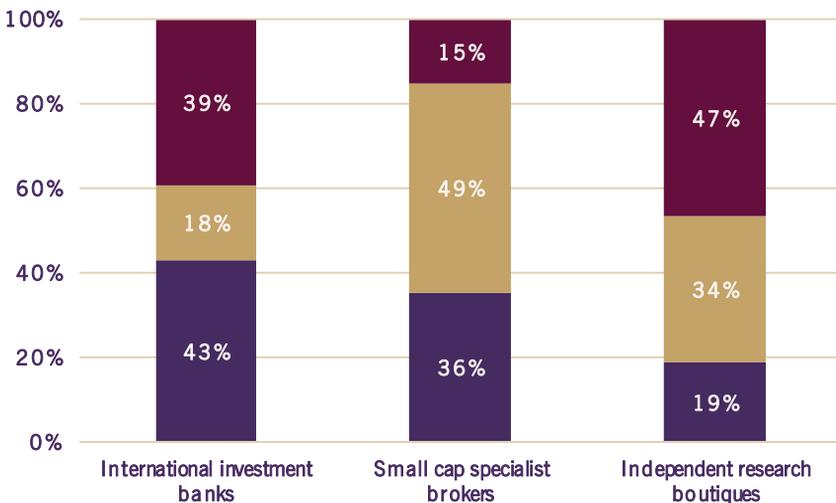
What is the minimum number of analysts needed researching your company to access investors?



Who should pay for written research on a listed company? *
 via commissions



Are you concerned that the changes to how Fund Managers are allowed to pay for third-party company research will affect



APPENDICES

About Peel Hunt

About Extel WeConvene

Survey Methodology

Participants

Peel Hunt

Peel Hunt is an independent corporate broking/advisory house that has highly rated, sector-aligned Research, Sales and Corporate teams.

With over 25 analysts covering over 300 companies, Peel Hunt has the widest broker research coverage of Small & Mid Cap stocks. Peel Hunt has ten UK Analysts ranked top three in the 2014 Extel Survey with top ranked sectors for its Equity Research in Healthcare & Life Sciences and Insurance, in addition to ranking third overall in UK Small/ Mid Caps in 2014.

Peel Hunt has a current retained corporate client list of over 90 listed companies and a trading platform that makes markets in c3,500 equity and fixed income products. In 2013 6.6% of total London market volumes and 2,115 stocks were traded by Peel Hunt; ~£40bn in value.*

Peel Hunt has a unique partnership model with over 75% of equity held by its employees, creating a truly collegiate environment in which its staff are aligned and committed to building long-term relationships with all clients.

www.peelhunt.com

*Source: Bloomberg. 1 Jan 2013 – 31 Dec 2013

Extel WeConvene

In July 2014, Extel became part of WeConvene. The combined new business offers a global corporate access platform, Extel market surveys, bespoke studies and an integrated broker voting service.

About WeConvene

WeConvene is a global corporate access platform for the sell and buy-side community. It offers clients a complete web-based solution that makes organising, managing, tracking and valuing corporate access more efficient and effective. The platform supports the full spectrum of corporate access, including analyst marketing, roadshows, corporate days, conferences, fieldtrips and other investor interactions. WeConvene was founded in 2012 and is headquartered in Hong Kong with offices in London, New York, Sydney & Manila.

www.weconvene.com

About Extel

Extel conducts market studies across all three sides of the investment community throughout Europe, delivering a comprehensive range of rankings, market trends and sentiment insights. With over forty years pedigree, Extel Europe is the largest study of its kind worldwide, with over 16,000 participants from 75 countries casting more than 950,000 individual votes. All rankings in Extel are based purely on weighted votes from the investment community. The scope, branding and professional integrity of Extel is widely recognized by brokerage firms, asset managers and corporates alike.

www.extelsurveys.com

Methodology

Extel undertook this study on behalf of Peel Hunt, specifically as the regulatory issues & potential impacts have become a touchstone for the institutional investment community, especially in the UK but as well on a much wider international basis.

The question sets for the buy-side and for the corporate community were devised and finalized together with Peel Hunt; and the study was conducted from October 6th through to November 10th 2014. Participants could contribute either online at the Extel website, or via PDF forms, with the great majority of responses being received online. Additionally, some direct interviews were conducted.

In collecting and collating responses, and verifying the participants, the standard Extel practices were applied. All participants were verified against the Extel databases, and in cases where data did not match, individual follow-up was undertaken to ensure legitimacy of the participants. In this process we received 12 submissions where we were unable to verify and confirm the participant, and these were therefore excluded from the results.

In total we received from votes from 161 professionals at 137 asset management firms, representing over £1.7 trillion of AUM; and from 69 quoted companies with a combined market capitalization of £1.6 trillion.

All votes and calculations were applied through the well-established Extel vote assessment system, which has been independently assessed and approved.

The aggregated and anonymized data & comments collected were provided to Peel Hunt for this report. No names of any individuals taking part; nor any information on the views and scores provided by any individual were disclosed at any level, other than by aggregation. Extel has a long-earned reputation for data quality & integrity, and clearly those principles extend to this study, in common with all others we conduct.

Given the importance of the issues in the question set, and the potential impact on both smaller buy-side and less capitalized companies, as well as on the more established firms, we did not feel it was appropriate to weight responses.

Participants

Asset Managers

161 responses were received from 137 asset management firms. We list below those firms who indicated they were content to be shown as participants. Due to the inherent sensitivity of the issues in this study, an unusually high percentage of respondents, including a number of the largest fund managers, asked for full confidentiality, which of course we respect.

Abante Asesores	Crédit Agricole (Suisse) Private Bank	JO Hambro Capital Management
Acrevis Bank	Derbyshire County Council Pension Fund	Kames Capital
ADVAM Partners	Deutsche Asset & Wealth Management	Killik Asset Management
Aktia Asset Management	DnB NOR Kapitalforvaltning	Korea Investment Corporation
Alliance Trust	EFG Eurobank Mutual Funds	Korys
Allianz Global Investors	Employees Retirement System of Texas	Lammergeier Research
Anoa Capital	ESAF	LGT Bank
AP-4	Fidelity Worldwide Investment	Lombard Odier Darier Hentsch & Cie
Artemis Investment Management	First State Investments	MCIM Capital
Banca March	Generali Investments	MGS Seguros y Reaseguros
BANOR SIM	Gestifonsa	N+1
Banque de Luxembourg Investments	Gryphon International Investment	Old Mutual Global Investors
BBVA Asset Management	GVO Investment Management	Prudential Financial (US)
Beaufort Wealth	Hedley & Co	Quarz Capital Management
BNP Paribas Investment Partners	Heitman Real Estate Securities	RAB Capital
BNY Mellon Investment Management	Henderson Global Investors	Rathbone Investment Management
Brewin Dolphin	Herald Investment Management	RBC Global Asset Management
Broadwalk Asset Management	Ilmarinen Mutual Pension Insurance Company	Sanford DeLand Asset Management
Candriam	IM Asset Management	Santander Asset Management
Capdistributors	Independent Franchise Partners	Saracen Fund Managers
Castlefield Investments	Inflection Point Capital Management	SG Private Banking
Charteris Treasury Portfolio Managers	ING Powszechna Towarzystwo Emerytalne	Smith & Williamson Investment Mgmt
Cheyne Capital Management	Invesco Asset Management	Société Générale Private Banking
Clerkenwell Capital	Investec Wealth & Investment	SVM Asset Management
CM International	ISIS Equity Partners	TT International
Cologne Advisors	JP Morgan Asset Management	Wesleyan Assurance Society

Peel Hunt & Extel Survey

UNINTENDED CONSEQUENCES

Quoted Companies

69 responses were received, usually from head or IR, CFO or CEO. We list below those firms who indicated they were content to be listed as participants. Due to the inherent sensitivity of the issues in this study, an unusually high percentage of respondents asked for full confidentiality, which of course we respect.

Allocate Software plc	Kingfisher plc
Anite plc	Laird plc
BASF SE	Lonza Group Ltd
BW Offshore	Pearson plc
Bwin.Party Digital Entertainment plc	Petra Diamonds Ltd
Coca-Cola Icecek	Restore plc
COLT Telecom Group	SEGRO plc
CSR plc	SES SA
Diploma plc	Severn Trent plc
Entertainment One Ltd	SGL Carbon AG
Hikma Pharmaceuticals plc	Symrise AG
Hispania Activos Inmobiliarios SA	TAV Airports Holding
Howden Joinery Group	Telefonica Deutschland
Imagination Technologies	Thales
JSC "IDGC of Centre and Volga Region"	The Nomad Group Bhd
K+S AG	Vontobel
Kabel Deutschland Holding AG	

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