31 January 2013

# The Merchants Trust PLC

Annual Financial Report


Allianz
Global Investors

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# Contents



The Merchants Trust aims to provide an above average level of income and income growth together with long term growth of capital through a policy of investing mainly in higher yielding UK FTSE 100 companies.

**The Merchants Trust**
The Merchants Trust was incorporated on 16 February 1889. It was launched by Robert Benson & Co., predecessors of the current investment manager, Allianz Global Investors, and originally invested mainly in American railroads. The initial capital was £2 million, of which half was subscribed.

# Financial Highlights

| Net asset value per ordinary share | Earnings per ordinary share | Dividend | Yield |
|---|---|---|---|
| 466.5p | 22.9p | 23.2p | 5.6% |
| 2012 402.1p | 2012 22.0p | 2012 23.0p | 2012 6.3% |
| **+16.0 %** | **+4.1%** | **+0.9%** | |

# Investment Policy

The company's investment performance is assessed by comparison with other investment trusts within the UK Growth and Income sector. Performance is benchmarked against the FTSE 100 Index, reflecting the emphasis within the portfolio.

## Gearing

The company's policy is to remain substantially fully invested. The company has the facility to gear – borrow money – with the objective of enhancing future returns. Historically, the gearing has been in the form of long term, fixed-rate debentures. The board monitors the level of gearing and makes decisions on the appropriate action based on the advice of the manager and the future prospects of the company's portfolio.

The company's authorised borrowing powers set out in the Articles of Association state that the company's borrowings may not exceed its called up share capital and reserves. In normal market conditions, it is unlikely that gearing (borrowings as a percentage of net assets) will exceed 35%.

## Risk Diversification

The company will aim to achieve a spread of investments, with no single investment representing more than 15% of assets. The company will seek to diversify its portfolio into at least five market sectors, with no one sector comprising more than 35% of the portfolio.

The Merchants Trust PLC

# Overview

Merchants has paid increasingly higher dividends year-on-year for the last 31 years – from 4.2 pence per share in 1982 to 23.2 pence per share in 2013 – providing shareholders with a growing source of income in the form of regular quarterly payments.

# Financial Summary

| Revenue | For the year ended 31 January 2013 | For the year ended 31 January 2012 | % change | |
|---|---|---|---|---|
| Income | £28,312,659 | £27,305,462 | +3.7 | |
| Net revenue return attributable to ordinary shareholders | £23,631,722 | £22,712,211 | +4.0 | |
| Net revenue return per ordinary share | 22.90p | 22.00p | +4.1 | |
| Ordinary dividends per ordinary share | 23.20p | 23.00p | +0.9 | |

| Assets | 2013 | 2012 | Capital return % change | Total return % change |
|---|---|---|---|---|
| Total assets less current liabilities | £592,318,780 | £526,045,683 | +12.6 | - |
| Net assets | £481,464,169 | £415,024,704 | +16.0 | - |
| Net assets (debt at market value) | £448,049,458 | £377,993,834 | +18.5 | - |
| Net asset value per ordinary share | 466.5p | 402.1p | +16.0 | +21.8 * |
| Net asset value per ordinary share (debt at market value) | 434.1p | 366.2p | +18.5 | +24.9 * |
| Ordinary share price | 412.7p | 363.0p | +13.7 | +20.1 |
| FTSE 100 Index | 6,276.9 | 5,681.8 | +10.5 | +14.8 |
| Discount of ordinary share price to net asset value | 11.5% | 9.7% | n/a | n/a |
| Discount (debt at market value) | 4.9% | 0.9% | n/a | n/a |
| Ongoing charges † | 0.7 | 0.6 | n/a | n/a |
| Total expenses ratio † | 0.5 | 0.5 | n/a | n/a |

* NAV total return reflects both the change in net asset value per ordinary share and the net ordinary dividends paid.

† The ongoing charges percentage is calculated in accordance with the explanation given on page 26. The total expenses ratio was reported in last year's Annual Financial Report and is recorded here to enable a comparison with the ongoing charges calculations for this and the previous year. Ongoing charges is the measure to be used in future years.

| Performance Attribution Analysis against FTSE 100 Index | Capital Return % | Total Return % |
|---|---|---|
| Return of Index | 10.5 | 14.8 |
| Relative return from portfolio | 4.3 | 5.3 |
| **Return of portfolio** | **14.8** | **20.1** |
| Impact of gearing on portfolio | 4.3 | 4.3 |
| Expenses charged to capital | -1.8 | -1.8 |
| Other | -1.3 | -0.8 |
| **Change in net asset value per ordinary share** | **16.0** | **21.8** |



← Covent Garden market, London

# Chairman's Statement

## Dear Shareholder

We now have a thirty year history of increasing the dividend and a further modest increase is proposed for this year. With earnings growing faster than dividends, the proposed dividend is close to being covered and this leaves the revenue reserve almost untouched.

### Market Background

Economic growth was subdued in most of the developed world. However, the stock market had a strong year, particularly in the second half, in response to ECB commitment to defend the Euro and US actions to defer the "fiscal cliff" of spending cuts and tax rises. Within the UK stock market the strongest returns were seen in medium sized companies, outside the FTSE 100 Index, as investor risk appetite increased.

### Results

The investment portfolio produced a capital return of 14.8%, ahead of the 10.5% return on the FTSE 100 Index. Including income, the total return of the investment portfolio was 20.1% which was further ahead of the 14.8% total return on the FTSE 100 Index. The net asset value total per share rose by 16.0% to 466.5p. The net asset value total return per share, including dividends paid, was 21.8%.

The company has benefited from the "pull to par" as the company's debt has decreased in value and, using the market value of debt, the net asset value per share rose by 18.5% or by 24.9% including dividends. The full performance breakdown is shown on page 22 of the Annual Financial Report. Over the year, the company's share price rose by 13.7% from 363.0p to 412.7p. The total return on the company's shares including dividends was 20.1%. The fund has performed ahead of the FTSE 100 Index over the past three years. At 25 March 2013, the trust's ordinary shares yielded 5.4% compared with the yield on the FTSE 100 Index of 3.5%. There is more detail on the major contributors to our performance in our Investment Manager's Review starting on page 10 of the Annual Financial Report.

### Net Revenue Return and Dividends

Net Revenue Return per share rose by 4.1% to 22.9p. The board is recommending a final ordinary dividend of 5.8p per share, payable on 15 May 2013 to shareholders on the register on 12 April 2013. This payment would give a total of 23.2p for the year, an increase of 0.9% over the total for the previous year. In order to meet the payment it has been necessary to transfer £313,802 (0.3p per share) from our revenue reserves, compared to a transfer of £1,026,885 (1.0p per share) last year. As at 31 January 2013 and after providing for this transfer and the dividend payment, the trust's revenue reserves amounted to £11,544,018 (11.2p per share).

The outlook for dividend growth is reasonable, with many companies having rebuilt their balance sheets and dividend cover since the economic downturn. The recent decline in the value of sterling, if sustained, should be beneficial to future income prospects. The board and the manager continue to remain focused on providing long term steady income growth.

### Investment trust tax rules

New legislation for investment trusts has recently been introduced and one of the changes has resulted in the removal of the prohibition on the distribution of capital profits by way of dividend.

The board therefore intends to seek shareholder approval at the annual general meeting to amend the Articles of Association to permit the distribution of capital profits by way of a dividend. It should be noted that this does not in any way indicate that there will be a change in the company's dividend policy, or how profits for dividends are generated or calculated, nor that there is any current intention to utilise capital profits in this way. The board believes this change will provide greater flexibility for dividends in the future. Further information is set out in the Directors' Report on page 33.

# Chairman's Statement *(continued)*

## Strategic Report

This year on page 6 we include an introductory Strategic Report. Next year we will expand on this report which will replace the Business Review in the Directors' Report on pages 25 to 32.

## Derivatives

As set out in the previous report, we have continued our policy of selectively writing call options on a limited number of the trust's holdings. Writing options has provided helpful additional income in a period where revenues have been under pressure. At no point in the year did the exposure to derivatives exceed 15% of the portfolio. A more detailed explanation is set out in the Investment Manager's Review.

## Retail Distribution Review

In preparation for the changes to the way individuals can invest in funds brought about by the Retail Distribution Review the board has continued to boost the marketing of The Merchants Trust to generate interest in the company's shares. We have launched a dedicated website www.merchantstrust.co.uk and have increased online and press advertising and we are pleased to have seen this result in wider coverage in the investment press.

## Operating Expenses

During the year the Association of Investment Companies changed the recommended way of reporting the costs of running an investment company from the Total Expenses Ratio to Ongoing Charges. We report against both measures on page 3 and give details and an explanation on page 26.

## AIFMD

Another development to affect our industry is the Alternative Investment Fund Managers Directive. This will introduce additional regulatory oversight for investment trusts and other types of funds and comes into effect later this year. We will review its application during the coming year.

## Gearing

The company continues to have long term debt amounting to £111 million. This is all deployed in the market for investment purposes. At the end of the year our gearing level was 23.0% compared to 26.8% at the start of the year.

## The Board

The current board has four directors and although it is a small board, as you will see from our biographies on page 24, the directors have a range of professional and industrial backgrounds and experience. We meet annually specifically to consider strategy with our managers and advisers, covering a variety of topics relevant to the company and more details can be found in the Strategic Report on page 6.

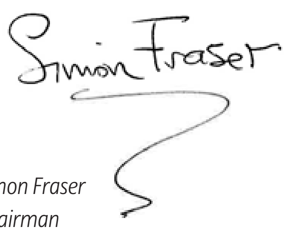
We are each standing for re-election this year and will continue to do this annually.

## Annual General Meeting

The annual general meeting of the company will be held on Friday 10 May 2013 at 12.00 noon at Holborn Bars, 138-142 Holborn, London EC1N 2NQ and we look forward to seeing as many shareholders then as are able to attend.

## Outlook

The economic outlook remains uncertain with growth likely to be constrained in the medium term by high debt levels. Fortunately, there are many strong, UK-quoted businesses with operations around the world, which can progress in this environment. Our fund managers are still able to identify attractive, dividend paying companies trading on sensible valuations. Merchants remains focused on delivering long term dividend and capital growth.



*Simon Fraser*
*Chairman*
*27 March 2013*

Fortunately, there are many strong, UK-quoted businesses with operations around the world, which can progress in this environment.

# Strategic Report

Our objective is to provide shareholders with an above average level of income and income growth together with capital growth over the longer term. This broad strategy has been in place for a long time and remains unchanged although it is regularly under review. We often refer to the well-known phrase 'what it says on the tin' to define what our shareholders want from their investment and to remind ourselves what we aim to deliver.

We measure our success in attaining this objective against the performance of the FTSE 100 Index, both in the short term and over longer time periods. Additionally, we note how the yield on the company's shares compares with the yield of this index and the growth of the dividend itself over time.

For each of the past three years we have held a Strategy Meeting in September outside the normal timetable of board meetings. We plan to have another meeting in 2013. At the most recent meeting the topics covered included:

- the company's market position compared with its peer group, including an analysis of the company's shareholder base
- preparation for the Retail Distribution Review
- an in-depth examination of the investment philosophy
- the stock selection process

In the next Annual Financial Report we will present a full Strategic Report, following company law changes which are expected to become law in October this year. This will incorporate much of the narrative currently included in the Business Review section of the Directors' Report on pages 25 to 32.

## Aims

The Merchants Trust's aims are to:

- consistently meet our growth and income objectives
- appeal to a broad range of investors to ensure the investment company remains relevant and attractive to new investors and investor groups
- ensure the costs of running the company remain reasonable and competitive
- be a widely recommended investment
- engage with shareholders and other relevant stakeholders to understand their needs and take their views into account in the development of future plans and strategy
- understand the implications of changes to future income growth prospects

## Key Performance Indicators (KPIs)

The KPIs which the board uses are:

- performance against the FTSE 100 Index
- the impact on the company's relative performance of factors including stock selection and sector allocation
- the share price of the company relative to its net asset value
- the ongoing costs associated with the running of the company
- the level and growth rate of the dividend

The board measures the company's successes against these aims which aid the evaluation of the company against its peers and against alternative investments. More details of the KPIs can be found in the Business Review on page 25.

## The Future

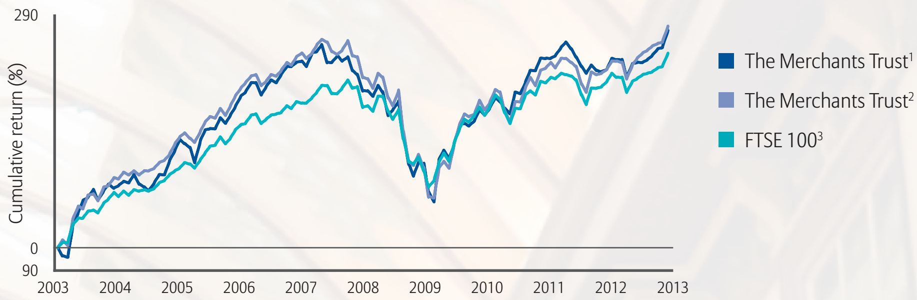
The main trends and factors likely to affect the company in the future are common to all investment companies and include the future attractiveness of investment trusts as an investment vehicle and of the asset class in which the company invests, and the returns available from the market. As background to this, the company has to be aware of the impact of macro-economic factors and the changing regulatory and legislative environment.

The Merchants Trust PLC

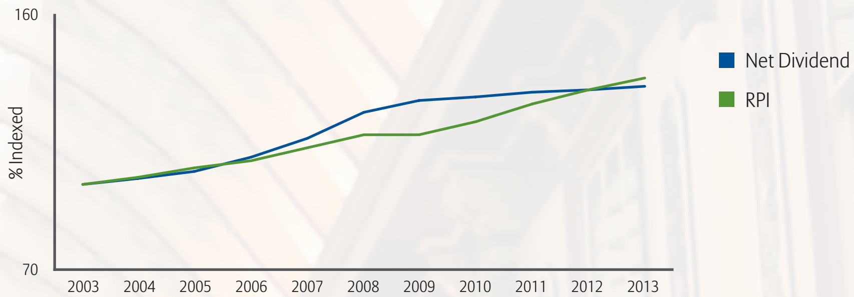
# Investment Manager's Review

# Performance Graphs

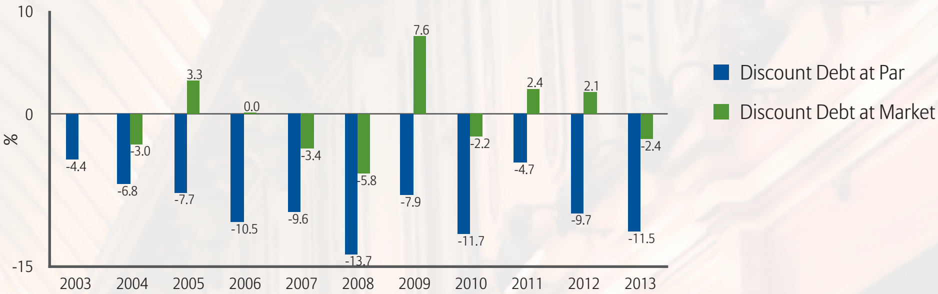
The Merchants Trust 10 Year Cumulative Return compared to FTSE 100 Index



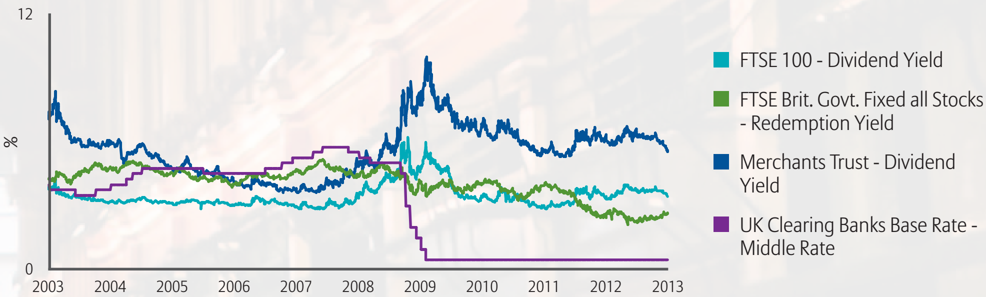

The Merchants Trust 10 Year Net Dividend Growth compared to inflation




The Merchants Trust 10 Year Discount to Net Asset Value as at 31 January




The Merchants Trust Dividend Yield compared to FTSE 100 Index, UK Gilt Yield and Cash




[1] The Merchants Trust (Share Price Total Return). [2] The Merchants Trust (Nav Total Return). [3] FTSE 100 (Total Return).
Source: RCM / Datastream in GBP.

# Investment Manager's Review

Simon Gergel is Chief Investment Officer, UK Equities, RCM (UK), based in London.

## Economic and Market Background

This year has seen a marked contrast between the performance of the economy and that of the stock market. Major stock markets delivered high returns despite a background of muted economic growth. It is, of course, normal for the stock market to anticipate the future and to rise ahead of improving financial conditions. However in the last year the market's rise owed more to a growing belief that authorities had navigated the economic ship around dangerous hazards, avoiding the so-called "tail risks", rather than a belief that conditions were yet on a sustainably improving trend. The underlying issue has been the challenge of dealing with unsustainably high levels of government and consumer debt. During the year markets became more optimistic that this issue is manageable. As we discuss later, it is not yet apparent that there is a clear and credible way to return to historic growth rates.

Around the world, major economies were relatively subdued last year. Consumer confidence remained low in the wake of the global financial crisis. Austerity policies caused overall Eurozone economic activity to contract in 2012 with Germany managing less than 1% growth. The UK economy did not fare much better with minimal growth over the year. Amongst the large Western nations, the USA showed the strongest growth, at around 1.6%, although unemployment levels remained high and the government did not convincingly address the budget deficit.

Emerging markets were not immune to the economic pressures with China seeing a significant slowdown early in the year, but with some recovery after a round of stimulus measures was introduced by the new leadership team. India and Brazil also saw growth rates fade materially during the year.

The stock market was range bound for much of the period, with the FTSE 100 Index remaining in a trading range of around 5000 to 6000 that had stood since late 2009. The market moved in cycles of optimism and pessimism, often referred to as "risk-on" and "risk-off" phases. These cycles mirrored stresses in government and corporate bond markets. Perceived safe haven bond markets in the US, UK and Germany performed well in "risk-off" cycles, with 10 year yields driven to historically

## Investment Manager's Review *(continued)*

low levels of 1.5% or less in the summer as investors feared putting their money anywhere else. Financial repression - the forcing down of interest rates by central bank buying of government debt and other measures - further encouraged this trend to lower bond yields. Whilst bond yields fell in the perceived safe havens, equity markets weakened and yields in peripheral European bond markets rose sharply, with Spanish yields peaking at over 7%. Conversely "risk-on" phases were marked by strong recoveries in corporate and peripheral European government debt markets, with equity markets following in their wake but safe haven bond yields rising again. By the end of the year, UK and US 10 year bond yields had backed up to around 2%, whilst Spanish yields had retreated to around 5%.

Two major events arguably led to the rising tide of optimism that took hold towards the end of the year. Firstly there was a renewed commitment by policymakers to defend the Euro at all costs, backed up by proposals to provide unlimited bond buying power to the European Central Bank and an intention to move towards a banking union. Secondly US authorities managed to temporarily defer the largest portion of a package of spending cuts and tax rises that were due to kick in from January 2013, the so called "fiscal cliff".

The FTSE 100 Index finally broke through the 6000 level at the start of 2013 and closed near to 6300 at the end of January. It produced a 14.8% total return including dividends. Medium and smaller sized companies performed even better in this bullish mood. The FTSE 250 (mid cap) Index gave a 24.6% total return whilst smaller companies rose 27.8%. High yielding shares, as represented by the FTSE 350 Higher Yield Index, returned 16.4%, in line with the broader FTSE All-Share Index.

Sector performances were mixed reflecting a number of different themes during the year. The best performers included financials like banks, life insurance and financial services, consumer cyclicals such as retail, media and travel & leisure, and certain defensives like beverages and food producers. Similarly the weakest sectors were broadly spread, with resources including mining and oil & gas producing negative returns, whilst other defensives like mobile telecoms and pharmaceuticals returned close to zero.

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"In the last year the market's rise owed more to a growing belief that authorities had navigated the economic ship around dangerous hazards, avoiding the so-called "tail risks", rather than a belief that conditions were yet on a sustainably improving trend."

# Investment Manager's Review *(continued)*

## Investment Performance

Merchants' investment portfolio significantly outperformed its benchmark. The capital return of +14.8% was 4.3% ahead of the FTSE 100 Index return of +10.5%. The trust's bias towards high yielding shares improved the overall return further. Including income, the portfolio delivered a total return of +20.1% in the year, 5.3% ahead of the FTSE 100 Index total return of +14.8%. There were a number of drivers of this outperformance. Strong stock selection within medium sized companies, particularly in the media sector, was the clearest theme.

The trust's three large media holdings, Daily Mail & General Trust (DMGT), United Business Media (UBM) and Reed Elsevier all delivered total returns of around 40%

The trust's three large media holdings, **Daily Mail & General Trust** (DMGT), **United Business Media** (UBM) and **Reed Elsevier** all delivered total returns of around 40% as investors warmed to their restructuring strategies and they delivered robust trading results. Other significant outperformers were **Inmarsat**, where satellite communications revenue trends improved, **Britvic**, where a proposed merger with AG Barr was well received, and **Greene King**, which was re-rated along with several other consumer companies in the portfolio.

Another important driver of performance was the portfolio's limited exposure to the weak natural resources sectors. The trust had no investments in **BG**, **Anglo American**, **Rio Tinto** or **Tullow Oil** which all underperformed significantly.

There were fewer negative contributors and these were principally stocks that were not owned or underweighted within the portfolio. The biggest factor was a low exposure to the financial sector which rallied on improved investor confidence, especially in the latter months of the year. Not owning or having underweight positions in **Barclays**, **Lloyds**, **Prudential**, **HSBC** and **Standard Life** were all negative contributors. Elsewhere not owning the beverage companies **Diageo and SABMiller** had the biggest impact as both performed well.

## Portfolio Changes

As our central economic view did not change significantly during the year, portfolio activity generally reflected stock specific considerations. There were many investment opportunities provided by market volatility and major divergences

**Contribution to Investment Performance relative to FTSE 100 Index**

| Positive Contribution | % | Over/under weight | Negative Contribution | % | Over/under weight |
|---|---|---|---|---|---|
| BG | 1.2 | - | Barclays | -0.6 | - |
| Anglo American | 1.0 | - | Diageo | -0.6 | - |
| Daily Mail & General Trust | 0.7 | + | Lloyds | -0.5 | - |
| Rio Tinto | 0.7 | - | Prudential | -0.3 | - |
| UBM | 0.6 | + | SABMiller | -0.3 | - |
| Reed Elsevier | 0.6 | + | HSBC | -0.2 | - |
| Inmarsat | 0.6 | + | Standard Life | -0.2 | - |
| Britvic | 0.4 | + | Arm Holdings | -0.2 | - |
| Tullow Oil | 0.3 | - | IG Group | -0.2 | + |
| Greene King | 0.3 | + | WPP | -0.2 | - |

Over / under weight: Whether proportion of portfolio in stock is higher (+) or lower (-) than its weighting in the FSTE 100 Index.

# Investment Manager's Review *(continued)*

between individual share prices. Over the full year we added eight new companies to the portfolio and coincidentally sold eight others completely. Although decisions were principally stock driven, there were two themes that were quite noticeable during the period.

Firstly, many defensive growth companies performed extremely well as investors looked for relatively safe havens in uncertain times. We believed that some valuations had been pushed too far and future returns were thus likely to be less attractive. We sold out of **Bunzl** and significantly reduced holdings in **Compass**, **Unilever** and **Reckitt Benckiser**. **AstraZeneca** was also sold but due to specific concerns about their prospects rather than their valuation, with the proceeds largely switched into **GlaxoSmithKline**. Not all defensive shares were re-rated however and we were able to increase exposure to **Royal Dutch Shell** and **British American Tobacco**, amongst others, at more attractive prices.

The second noticeable theme was in the financial sector. Whilst many financial stocks have been modestly valued in the wake of the global financial crisis, structural risks are higher and difficult to quantify. Tighter regulation, increased capital requirements and asset price volatility are just some of the risks that financial stocks are exposed to. We have significantly changed the financial holdings within the portfolio over the year, reducing exposure to highly leveraged business models and preferring companies with strong balance sheets and lower sensitivity to market levels. We took advantage of share price rallies to sell the insurers **Aviva** and **Legal & General** and the bank **Barclays** whilst also taking some profits on **HSBC**.

Conversely we added to the positions in insurers **Resolution** and **Catlin** and the emerging markets fund manager **Ashmore** at attractive prices. We also made a new investment in **ICAP**, the world's leading interdealer broker, which facilitates trading activity between major financial institutions. ICAP has a strong balance sheet and a business diversified between voice broking, electronic trading, data provision and other services. Like many financial shares its valuation was depressed and trading conditions have been difficult, but importantly the key driver of the business is transaction volumes rather than market levels.

We have significantly changed the financial holdings within the portfolio over the year, reducing exposure to highly leveraged business models and preferring companies with strong balance sheets and lower sensitivity to market levels.

| Largest Net Purchases | | Largest Net Sales | |
|---|---|---|---|
| **Company** | **£m** | **Company** | **£m** |
| Royal Dutch Shell 'B' | 9.7 | Compass | 9.5 |
| ICAP | 7.3 | AstraZeneca | 8.7 |
| BBA Aviation | 7.1 | Unilever | 8.3 |
| Smiths Group | 6.7 | BT | 8.3 |
| GlaxoSmithKline | 6.4 | Bunzl | 7.9 |
| Marks & Spencer | 6.2 | HSBC | 7.2 |
| Pennon | 6.0 | Aviva | 5.7 |
| CRH | 5.9 | Hammerson | 5.6 |
| British American Tobacco | 5.0 | Reckitt Benckiser | 5.1 |
| BHP Billiton | 4.0 | Barclays | 4.0 |

# Investment Manager's Review *(continued)*

Cineworld is one of the UK's leading cinema companies. The company is lowly valued and generates strong cash flow. After a period of high investment in rolling out digital projectors, the company can now benefit from a number of new initiatives, particularly expansion into new sites and the recently announced Picturehouse acquisition.

We see scope for a significant cyclical recovery in the medium term and potential for cost cutting or industry consolidation to improve returns.

Elsewhere most activity was stock specific. As reported with the interim results, we introduced **BBA Aviation**, **Smiths Group** and **Marstons** into the portfolio. In the second half, as well as ICAP, we made first investments in retailer **Marks & Spencer**, multiplex cinema operator **Cineworld**, building materials company **CRH** and waste and water company **Pennon**.

The investment case for Marks & Spencer rests upon their ability to significantly improve cash flow over the next two to three years as they come to the end of a substantial investment phase. There is also the potential to improve trading in the non-food categories. Starting from a modest valuation level with a well-established market position amongst a growing, mature demographic customer base, there is the potential to deliver attractive shareholder returns whilst receiving a good starting dividend yield.

Cineworld is one of the UK's leading cinema companies. The company is lowly valued and generates strong cash flow. After a period of high investment in rolling out digital projectors, the company can now benefit from a number of new initiatives, particularly expansion into new sites and the recently announced Picturehouse acquisition. Pennon offers exposure to secure regulated returns in the water industry as well as potential growth from several large "Energy from Waste" projects they are building. The shares had fallen back after a profits warning in their traditional waste recycling business, providing the opportunity to buy at a reasonable level.

CRH is a broadly spread building company with activities spanning aggregates, cement, building products and distribution. It has a large US presence, providing exposure to the housing construction market which we expect to show good growth from an extraordinarily low base. CRH's other activities, particularly in Europe, face a more difficult outlook but they are cyclically depressed and offer long term recovery potential. The company's strong cash flow and track record of adding value from bolt-on acquisitions should provide further opportunities.

# Investment Manager's Review *(continued)*

Within the food retail sector we sold out of **Tesco** in the first half of the year following their profits warning and added to **Sainsbury**. Later in the year, we bought back into Tesco amid signs that their restructuring strategy was starting to improve the UK performance. Equally important was an increasing focus on capital discipline as well as cuts to capital expenditure across the industry, which could structurally improve returns for all competitors.

Other notable sales included a significant reduction to the **BT** position after strong performance and the sale of property stock **Hammerson** as the share price approached the net asset value, leaving limited upside potential. We also sold out of the construction and support services company Interserve, which had recovered well from a depressed level after the global financial crisis. The final complete sale from the portfolio was Hays, the recruitment company. Whilst the business has some attractive market positions and opportunities, we were concerned in particular that its biggest profit earner, Australia, could see a material cyclical downturn on the back of difficult trading conditions in the mining industry.

## Derivatives Strategy

The trust operates a covered call overwriting strategy on a limited proportion of the portfolio to generate additional income. In "writing" or selling an option the trust gives the purchaser the right to buy a specific number of shares in a company at an agreed "strike" price within a fixed period. In exchange the trust receives an option premium which is taken to the revenue account. The trust gets the full benefit of any move in the share price up to the strike price but not beyond. If the share price rises above the strike price there is a potential "opportunity" cost (but not cash cost) to the trust as the option holder can exercise their option to buy the shares at the strike price.

The option strategy once again delivered its primary objective of income generation, with approximately £1.9m of option premiums accrued, similar to the previous year. Due to the sharp share price appreciation of a few holdings, particularly towards the end of the year, there was a small net cost of the strategy of around £150,000. This derived from the opportunity cost of selling shares at the strike price rather than the prevailing market price. This compares to a net profit of about £950,000 in the previous year.

Our approach to option writing remains selective and is driven by the investment fundamentals on each stock rather than by a separate derivatives rationale. We write calls on portions of share holdings that we are happy to sell at the strike price, provided that the premium income received is sufficiently attractive. The options written are typically short dated with most under 4 months duration. The total exposure is closely monitored and is limited to 15% of the portfolio value with all option positions "covered" by shares owned. From a holistic view it can be argued that the overall strategy slightly reduces the trust's gearing to the equity market, neutralising some of the financial leverage.

## Future Policy

Our central view is that economic growth will remain constrained by the high levels of debt in the government and consumer sectors in most developed nations. Governments ultimately need to spend less money and / or raise taxation revenues, both of which restrain economic activity and are politically unpopular. At the time of writing, the USA is struggling to agree a plan to address their deficit with Republicans and Democrats diametrically opposed on the issue of whether spending should be cut or taxation raised. In Europe, including the UK, most governments have gone down the austerity path to a greater or lesser extent but there is increasing resistance from vocal opponents who want to see greater spending to boost growth.

In order to help counteract these pressures, financial repression policies are being pursued, whereby authorities are keeping interest rates low. This is helping to lower borrowing costs for governments, companies and consumers, whilst lowering returns for savers. The policy is intended to boost consumption and to force capital into equity investment and into other riskier asset classes that might promote economic growth.

However this is a delicate balancing act with a high risk of policy mistakes. There are two major opposing risks, rising inflation or recession. Quantitative easing, or money printing, and low interest rates could lead to an inflationary shock which could difficult to control once it becomes

Our central view is that economic growth will remain constrained by the high levels of debt in the government and consumer sectors in most developed nations.

# Investment Manager's Review *(continued)*

Whilst the economic outlook is important, the principal driver of each investment decision remains the fundamental strength of the businesses we are analysing, their competitive positioning, financial strength and growth prospects as well as their valuation.

entrenched. Conversely a vicious spiral of falling confidence leading to lower consumption and slower economic growth, feeding back to falling confidence could become self-perpetuating.

At the time of writing, equity markets are taking a relatively optimistic view of these two opposing "tail risks" but we think these risks are significant and investors need to remain vigilant. The implications for investment strategy of either risk are very different. We are therefore not taking too definitive a view on the outlook when constructing the portfolio but trying to consider how investments will behave in different circumstances. For example the risk of inflation is encouraging us to hold shares with an element of inflation protection, whether in the form of inflation linked pricing or a real asset base such as property companies or pub owners.

Whilst the economic outlook is important, the principal driver of each investment decision remains the fundamental strength of the businesses we are analysing, their competitive positioning, financial strength and growth prospects as well as their valuation. The price paid for an investment is closely (and inversely) correlated to the return that investors can expect to receive in the long term. Buying a strong business at an attractive price is a sound proposition in most economic environments.

Fortunately there are many strong businesses quoted in the UK stock market with operations spanning a wide range of industries and geographies. Whilst valuations have moved up over the last year, we are still finding interesting investment opportunities in a wide variety of sectors. There is a mixture of relatively defensive and more cyclical stocks within the portfolio.

Among the defensive sectors there has been quite a divergence of performance so that food producers and beverages stocks are typically highly priced and offer few opportunities. Conversely utilities, telecommunications, pharmaceuticals and the diversified oil companies still offer reasonable or good value, considering their respective operating environments.

# Investment Manager's Review *(continued)*

Within the more cyclical sectors, we still see value in the consumer services areas even after the recent strength of media stocks and pub companies. There are also opportunities in a number of industrial sectors, notably aerospace & defence and construction where current uncertainty over government spending has left many companies trading at depressed valuation levels.

Within financials, as discussed above, we have only a modest exposure to banks but several investments in insurance, real estate and financial services. The other big underweight view within the portfolio is a limited exposure to the mining industry where we still have concerns over the vulnerability of commodity prices to demand shocks and an improving supply outlook.

Dividends in the UK market grew by around 10% in 2012 and current forecasts are for mid-single digit growth this year. Company pay-out ratios have come down since the global financial crisis and balance sheets have been rebuilt so that companies are able to pay a greater proportion of future cash flows out to shareholders. The key risks to these dividend flows remain economic growth and its impact on corporate profitability, oil and commodity prices, financial asset prices and currency movements. The recent fall in Sterling, if sustained, will boost dividend payments in the UK from the many companies that pay dividends in US Dollars or Euros.

Overall we are confident that we can continue to find strong individual companies at attractive valuations that will ultimately produce good growth opportunities for our capital and income.

*Simon Gergel*
*RCM (UK) Limited*

The recent fall in Sterling, if sustained, will boost dividend payments in the UK from the many companies that pay dividends in US Dollars or Euros.

"the risk of inflation is encouraging us to hold shares with an element of inflation protection, whether in the form of inflation linked pricing or a real asset base such as property companies or pub owners."

# Listed Holdings

at 31 January 2013

## Equities

| Name | Value (£) | % of Listed holdings | Principal Activities |
|---|---|---|---|
| Royal Dutch Shell 'B' | 53,525,902 | 9.1 | Oil & Gas Producers |
| GlaxoSmithKline | 44,796,045 | 7.6 | Pharmaceuticals & Biotechnology |
| BP | 39,895,302 | 6.8 | Oil & Gas Producers |
| HSBC | 37,131,819 | 6.3 | Banks |
| Vodafone | 30,234,958 | 5.2 | Mobile Telecommunications |
| British American Tobacco | 23,774,819 | 4.1 | Tobacco |
| BAE Systems | 20,709,290 | 3.5 | Aerospace & Defence |
| SSE | 20,007,900 | 3.4 | Electricity |
| National Grid | 17,868,360 | 3.0 | Gas, Water & Multiutilities |
| Resolution | 16,533,144 | 2.8 | Life Insurance |
| Top Ten Holdings | 304,477,539 | 51.8 | |
| Reed Elsevier | 15,798,637 | 2.7 | Media |
| BHP Billiton | 14,710,740 | 2.5 | Mining |
| Centrica | 13,776,435 | 2.4 | Gas, Water & Multiutilities |
| Daily Mail & General Trust 'A' | 13,118,100 | 2.2 | Media |
| UBM | 12,628,612 | 2.1 | Media |
| Sainsbury (J) | 12,463,620 | 2.1 | Food & Drug Retailers |
| Unilever | 11,423,150 | 1.9 | Food Producers |
| Britvic | 11,068,288 | 1.9 | Beverages |
| Inmarsat | 10,824,042 | 1.8 | Mobile Telecommunications |
| Reckitt Benckiser | 10,589,040 | 1.8 | Household Goods & Home Construction |
| Carnival | 9,472,000 | 1.6 | Travel & Leisure |
| Tesco | 9,156,910 | 1.6 | Food & Drug Retailers |
| BT | 9,066,442 | 1.5 | Fixed Line Telecommunications |
| BBA Aviation | 8,165,564 | 1.4 | Industrial Transportation |
| Smiths Group | 8,036,850 | 1.4 | General Industrials |
| Premier Farnell | 7,993,110 | 1.4 | Support Services |
| ICAP | 7,465,400 | 1.3 | Financial Services |
| CRH | 6,810,000 | 1.2 | Construction & Materials |
| Imperial Tobacco | 6,800,500 | 1.2 | Tobacco |
| Balfour Beatty | 6,319,823 | 1.1 | Construction & Materials |
| IG Group | 6,088,443 | 1.0 | Financial Services |
| Marks & Spencer | 6,075,200 | 1.0 | General Retailers |
| Catlin Group | 6,008,750 | 1.0 | Non-life Insurance |
| Greene King | 5,827,500 | 1.0 | Travel & Leisure |
| Ashmore | 5,811,072 | 1.0 | Financial Services |
| Pennon | 5,741,750 | 1.0 | Gas, Water & Multiutilities |

# Listed Holdings *(continued)*

at 31 January 2013

| Name | Value (£) | % of Listed holdings | Principal Activities |
|---|---|---|---|
| London Metric Property | 5,435,397 | 0.9 | Real Estate Investment Trust |
| Marston's | 5,106,312 | 0.9 | Travel & Leisure |
| Meggitt | 4,950,677 | 0.8 | Aerospace & Defence |
| Close Brothers | 4,775,458 | 0.8 | Financial Services |
| Hiscox | 4,735,000 | 0.8 | Non-life Insurance |
| Cobham | 3,808,800 | 0.6 | Aerospace & Defence |
| Cineworld | 3,664,586 | 0.6 | Travel & Leisure |
| Compass | 3,435,750 | 0.6 | Travel & Leisure |
| Mothercare | 3,339,900 | 0.6 | General Retailers |
| Man Strategic | 2,916,051 | 0.5 | Financial Services |
| Total Equities | 587,885,448 | 100.0 | |

## Written Call Options

As at 31 January 2013, the market value of the open option positions was £(956,913), resulting in an underlying exposure to 8.8% of the portfolio (valued at strike price).

# Distribution of Total Assets

Total assets (less creditors due within one year) £592,318,780 (2012 - £526,045,683)

| | Percentage of total assets at 31 January 2013 | Percentage of total assets at 31 January 2012 |
|---|---|---|
| **Oil & Gas** | | |
| Oil & Gas Producers | 15.8 | 15.4 |
| | **15.8** | **15.4** |
| **Basic Materials** | | |
| Mining | 2.5 | 1.9 |
| | **2.5** | **1.9** |
| **Industrials** | | |
| Aerospace & Defence | 5.0 | 5.5 |
| Construction & Materials | 2.2 | 1.2 |
| General Industrials | 1.4 | - |
| Industrial Transportation | 1.4 | - |
| Support Services | 1.3 | 3.1 |
| | **11.3** | **9.8** |
| **Consumer Goods** | | |
| Beverages | 1.9 | 2.2 |
| Food & Drug Retailers | 3.6 | 2.7 |
| Food Producers | 1.9 | 3.1 |
| Household Goods & Home Construction | 1.8 | 2.5 |
| Tobacco | 5.2 | 4.6 |
| | **14.4** | **15.1** |
| **Health Care** | | |
| Pharmaceuticals & Biotechnology | 7.6 | 8.9 |
| | **7.6** | **8.9** |
| **Consumer Services** | | |
| General Retailers | 1.6 | 0.4 |
| Media | 7.0 | 6.7 |
| Travel & Leisure | 4.6 | 4.0 |
| | **13.2** | **11.1** |

# Distribution of Total Assets *(continued)*

| | Percentage of total assets at 31 January 2013 | Percentage of total assets at 31 January 2012 |
|---|---|---|
| **Telecommunications** | | |
| Fixed Line Telecommunications | 1.5 | 3.0 |
| Mobile Telecommunications | 6.9 | 6.4 |
| | 8.4 | 9.4 |
| **Utilities** | | |
| Electricity | 3.4 | 3.3 |
| Gas, Water & Multiutilities | 6.3 | 5.1 |
| | 9.7 | 8.4 |
| **Financials** | | |
| Banks | 6.3 | 7.0 |
| Financial Services | 4.6 | 2.9 |
| Life Insurance | 2.8 | 4.4 |
| Non-Life Insurance | 1.8 | 1.4 |
| Real Estate Investment Trust | 0.9 | 1.6 |
| | 16.4 | 17.3 |
| Total Investments | 99.3 | 97.3 |
| Net Current Assets | 0.7 | 2.7 |
| Total Assets | 100.0 | 100.0 |

# Historical Record

year ended 31 January 2013

| Revenue and Capital | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| Income (£'000s) | 22,247 | 22,675 | 24,714 | 27,750 | 28,495 | 31,730 | 23,687 | 25,741 | 27,305 | 28,313 |
| Net revenue return per ordinary share | 17.34p | 17.58p | 19.44p | 22.17p | 22.86p | 27.25p | 18.91p | 21.22p | 22.00p | 22.90p |
| Dividends per share | 17.60p | 18.00p | 18.90p | 20.00p | 21.60p | 22.80p | 22.50p | 22.80p | 23.00p | 23.20p |
| Ordinary dividend per share | 17.60p | 18.00p | 18.90p | 20.00p | 21.60p | 22.30p | 22.50p | 22.80p | 23.00p | 23.20p |
| Special dividend per share | - | - | - | - | - | 0.50p | - | - | - | - |
| Tax credit per share | 1.96p | 2.00p | 2.10p | 2.22p | 2.40p | 2.53p | 2.50p | 2.53p | 2.56p | 2.58p |
| Gross dividend per share | 19.56p | 20.00p | 21.00p | 22.22p | 24.00p | 25.33p | 25.00p | 25.33p | 25.56p | 25.78p |
| Total net assets attributable to ordinary capital (£'000s) | 357,442 | 424,511† | 514,713 | 588,835 | 506,187 | 314,804 | 384,747 | 440,846 | 415,025 | 481,464 |
| Net asset value per ordinary share | 350.1p | 415.8p† | 504.1p | 567.5p | 492.3p | 306.2p | 372.8p | 427.1p | 402.1p | 466.50p |
| NAV total return (%)* | +37.3 | +20.8† | +25.6 | +16.4 | -9.6 | -33.4 | +29.2 | +20.7 | -0.5 | +21.8 |
| Retail price index increases (%)** | +2.4 | +2.1 | +2.3 | +4.2 | +4.1 | +0.1 | +4.6 | +5.1 | +3.9 | +3.3 |

## Notes

* NAV total return reflects both the change in net asset value per ordinary share and the net ordinary dividends paid.

** RPIX – excludes the effect of mortgage rates.

† Restated in accordance with Financial Reporting Standards 25 'Financial Instruments: Disclosure and Presentation' and 26 'Financial Instruments: Recognition and Measurement'. Years prior to 2005 have not been restated.

The Merchants Trust PLC

# Director's Review

# Directors, Investment Manager and Advisers

## Directors

The current directors' details are set out below. All directors are non-executive and independent of the manager.

**Simon Fraser (Chairman)**
Joined the board in August 2009. He is Chairman of Foreign & Colonial Investment Trust PLC and a non-executive director of Barclays PLC, Barclays Bank PLC, Ashmore Group plc, Fidelity European Values PLC and Fidelity Japanese Values PLC. He spent his career at Fidelity International Limited, where he held a number of positions, including Chief Investment Officer from 1999-2005, President of Fidelity International's European and UK Institutional business and latterly President of the Investment Solutions Group.

**Henry Staunton (Senior Independent Director)**
Joined the board in May 2008. He is Vice-Chairman and the Senior Independent Director of Legal & General Group plc and a non-executive director of Standard Bank Plc, Capital and Counties Properties plc and W H Smith PLC. He was previously Finance Director at ITV plc and Granada Group plc. He was also a non-executive director of Ladbrokes plc, Emap plc, British Sky Broadcasting Group plc, Independent Television News Limited, Vector Hospitality plc and Ashtead Group plc, of which he was also Chairman between 2001 and 2004. He is a Chartered Accountant.

**Mike McKeon (Chairman of the Audit Committee)**
Joined the board in May 2008. He is Group Finance Director of Severn Trent plc and prior to that, from 2000 until 2005, he was Group Finance Director of Novar plc. He held various senior positions at Rolls-Royce plc from 1997 to 2000. He has extensive experience from a number of overseas roles, having worked at CarnaudMetalbox, Elf Atochem and PricewaterhouseCoopers. He is a Chartered Accountant.

**Paul Yates**
Joined the board in March 2011. He is Chairman of the Advisory Board of 33 St James's and is a non-executive director of Edinburgh UK Tracker Trust plc. He has had a long career in investment management beginning at Samuel Montagu & Co in 1980. He joined Phillips and Drew in 1985 – the year that it was acquired by UBS. He held a number of positions at UBS, covering management, portfolio management, pensions, strategy and client service. He was CEO of UBS Global Asset Management (UK) Limited between 2001 and 2005. After undertaking a number of global roles at UBS he retired in 2007.

## Investment Manager
## RCM (UK) Limited

Represented by Simon Gergel, Portfolio Manager, and Melissa Gallagher, Head of Investment Trusts

## Company Secretary and Registered Office

Kirsten Salt BA (Hons) ACIS,
155 Bishopsgate,
London EC2M 3AD.
Telephone: 020 7065 1513,
Email: kirsten.salt@allianzgi.co.uk

## Independent Auditor

PricewaterhouseCoopers LLP,
Chartered Accountants and Statutory Auditors
7 More London Riverside,
London SE1 2RD

## Bankers

HSBC Bank, Barclays Bank

## Stockbroker

JPMorgan Securities Limited

## Legal Advisers

Herbert Smith LLP

# Directors' Report

The directors present their report and the audited financial statements of the company for the year ended 31 January 2013.

## Business Review

### Business and Status of the Company

The company is an investment company as defined in section 833 of the Companies Act 2006.

The company carries on business as an investment trust and was approved by HM Revenue & Customs as an investment trust in accordance with section 1158 of the Corporation Tax Act 2010 for the year ended 31 January 2012. In the opinion of the directors, the company has subsequently conducted its affairs so that it should continue to qualify. The company will continue to seek approval under section 1158 of the Corporation Taxes Act 2010 each year. The company is not a close company for taxation purposes. Under the new investment trust regime for accounting periods commencing on or after 1 January 2012 an application will be submitted to HM Revenue & Customs for entry into the regime before the end of April 2013 and the company must thereafter demonstrate annually compliance with the regulations.

### Regulatory Environment

The company is listed on the London Stock Exchange and is subject to UK company law, financial reporting standards, listing rules, tax law and its own Articles of Association. In addition to Annual and Half-yearly Financial Reports published under these rules, the company announces net asset values per share on a daily basis for the information of investors. It provides more detailed information on a monthly basis to the Association of Investment Companies, of which the company is a member, in order for brokers and investors to compare its performance with its peer group. The board of directors is charged with ensuring that the company complies with its own objectives as well as these rules. The board is aware of changes to the regulatory environment in the year ahead and the company continues to prepare itself for implementation of the Alternative Investment Fund Managers Directive (AIFMD), the Foreign Account Tax Compliance Act (FATCA) and The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013. The board has appointed RCM (UK) Limited to carry out investment management, accounting, secretarial and administration services on behalf of the company. The company has no employees or premises of its own.

### Investment Objective and Policies

The company's objective is to provide an above average level of income and income growth together with long term growth of capital through a policy of investing mainly in higher yielding UK FTSE 100 companies. The company's investment performance is assessed by comparison with other investment trusts within the UK Growth and Income sector. In addition, it is benchmarked against the FTSE 100 Index.

The company pays quarterly dividends and the board has a policy of making these progressive from year to year, in keeping with the company's stated objective to provide an above average level of income and income growth. Together with the proposed dividend, the dividend has increased every year for the past thirty one years and details of historic dividend payments for the past ten years are set out on page 22.

### Performance

In the year to 31 January 2013 the NAV per share rose by 16.0%. This compares with the capital return on the company's benchmark, FTSE 100 Index, of 10.5%. At 31 January 2013 the value of the company's investment portfolio was £587.9m. The Investment Manager's Review on pages 10 to 17 includes a review of developments during the year as well as information on investment activity within the company's portfolio.

### Key Performance Indicators (KPIs)

The board uses certain financial KPIs to monitor and assess the performance of the company. The principal KPIs are:

- Performance against the benchmark Index

The company's performance is benchmarked against the FTSE 100 Index. This is the most important KPI by which performance is judged.

- Performance against the company's peers

The board also monitors the company's performance with reference to its investment trust peer group.

- Performance Attribution

The performance attribution is considered at each board meeting and enables the directors to judge how the company achieved its performance relative to the benchmark index and to see the impact on the company's relative performance of factors including stock and sector allocation. A performance attribution analysis for the year ended 31 January 2013 is given on page 3.

- Discount to net asset value (NAV)

The board has a share buy back programme which has a role to play in enhancing the NAV for existing shareholders, as shares are bought back at a discount, and in minimising the volatility of movements in the discount. In the year to 31 January 2013 the shares traded between a discount of 3.7% and a premium of 7.2% with debt at fair value.

# Directors' Report *(continued)*

- Ongoing Charges

Ongoing charges are operating expenses incurred in the running of the company, whether charged to revenue or capital but excluding financing costs. The ongoing charges figure is calculated by dividing operating expenses, that is, the company's management fee and all other ongoing charges by the average net asset value (with debt at fair value) over the period. Since May 2012, ongoing charges have been published by the AIC.

Prior to this, the total expense ratio (TER) was calculated and published. The TER was expressed as a percentage of total assets less current liabilities; the difference between the two calculations is that the ongoing charges figure is calculated as a percentage of average net assets which include the debt at fair value. We have included in the table on page 3 both calculations for both periods for comparative purposes. The new methodology is recommended for use by the AIC and takes into account the European rules for open-ended funds, the intention being to allow investors to compare charges on open-ended and closed-ended funds more easily. The ongoing charges figure for the year ended 31 January 2013 was 0.66% (2012 – 0.63%). The TER for the year ended 31 January 2013 was 0.48% (2012 – 0.47%).

Performance over ten years is shown on page 22. The Investment Manager's Review on pages 10 to 17 includes a review of developments during the year as well as information on investment activity within the company's portfolio.

## Revenue

The net return attributable to ordinary shareholders for the year amounted to £23,631,722 (2012 – £23,712,211).

Net revenue return amounted to £23,631,722, or 22.9p per ordinary share. The first and second interim dividends each of £5,986,381 or 5.8p per share have been paid during the year. Since the year end the third interim dividend of 5.8p per share has been paid. The final proposed dividend of 5.8p per share - £5,986,381, subject to shareholder approval, will be payable on 15 May 2013. In accordance with FRS 21 'Events after the Balance Sheet Date', the third interim dividend and final dividend are not recognised as liabilities within the financial statements on the basis that at the year end the third interim dividend had not been paid and the final dividend not approved by the shareholders.

## Historical Record

The distribution of total assets is shown on pages 20 and 21, and the historical record of the company's revenue, capital and invested funds over the past ten years is shown on page 22. Graphs appear on page 9 showing the performance on a total return basis over the past ten years of the net asset value of the company's ordinary shares against the FTSE 100 Index, the growth in net ordinary distributions made by the company against the Retail Price Index, and the company's discount to net asset value over the same period.

## Invested Funds

Sales of investments during the year resulted in net gains based on historical costs of £11,370,747 (2012 – gains of £4,753,833). Provisions contained in the Finance Act 2010 exempt approved investment trusts from corporation tax on their chargeable gains.

## Share Buy Back

There were no shares bought back during the year (2012– nil).

## Future Development

The future development of the company is dependent on the success of the company's investment strategy against the economic environment and market developments. The investment manager discusses his view of the outlook for the company's portfolio in his report beginning on page 10.

The board also believes that the Retail Distribution Review offers opportunities to generate more interest in investment trusts and to demonstrate the advantages over open-ended investments. This should lead to the company continuing to raise its profile with new investors.

## Going Concern

The directors have considered the company's investment objective and capital structure and, having noted that the portfolio consists mainly of securities which are readily realisable, have concluded that the company has adequate resources to continue in operational existence for the foreseeable future. For this reason the directors continue to adopt the going concern basis in preparing the financial statements.

## Net Asset Value

The net asset value of the ordinary shares of 25p at the year end was 466.5p as compared with a value of 402.1p at 31 January 2012.

# Directors' Report *(continued)*

### Payment Policy

It is the company's payment policy for the forthcoming financial year to obtain the best terms for all business and therefore there is no consistent policy as to the terms used. In general, the company agrees with its suppliers the terms on which business will take place and it is our policy to abide by these terms. There are no material trade creditors at the year end (2012 - nil).

### Capital Structure

The company's capital structure is summarised on page 55. The details of the 4% Perpetual Debenture Stock and the 3.65% Cumulative Preference Stock are provided in notes 10(iv) and 10(v) respectively on page 55.

### Principal Risks and Uncertainties

The principal risks identified by the board are set out in the table on this page, together with the actions taken to mitigate these risks. A more detailed version of this table, in the form of a Risk Matrix, is reviewed and updated by the board twice yearly. The principal risks and uncertainties faced by the company relate to the nature of its objectives and strategy as an investment company and the markets in which it operates.

| Description | Mitigation |
|---|---|
| **Investment Activity and Strategy**<br>An inappropriate investment strategy, e.g., asset allocation or the level of gearing, may lead to under-performance against the company's benchmark index and peer group companies, and may also result in the company's shares trading on a wider discount. | The board manages these risks by diversification of investments through its investment restrictions and guidelines which are monitored and on which the board receives reports. RCM (UK) Limited provides the directors with management information including performance data and reports and shareholder analyses. The board monitors the implementation and results of the investment process with the investment manager, who attends all board meetings, and reviews data which show risk factors and how they affect the portfolio. The board reviews investment strategy, including gearing, at each board meeting. |
| **Corporate Governance and Shareholder Relations**<br>Shareholder discontent could arise if there is weak adherence to best practice in corporate governance and which could result in potential reputational damage to the company. | The board receives reports on shareholder activity and on shareholder sentiment on a regular basis and contact is maintained with major shareholders. Details of the company's compliance with corporate governance best practice, including information on relations with shareholders, are set out in the Corporate Governance Statement which can be found on the company's website http://www.merchantstrust.co.uk/Tenants/AGITrusts/Content/Documents/Corporate/Corporate_Governance_Statement.pdf. |
| **Regulatory** | The board is guided by its advisers both within RCM (UK) and external to the manager on matters such as the implementation of AIFMD. |
| **Financial** | The financial risks associated with the company include market risk (price and yield), interest rate risk, liquidity risk and credit risk. Further analysis of these risks can be found in note 17 on pages 58 to 63. |

In addition to the specific principal risks identified in the table above, the company faces risks to the provision of services from third parties and more general risks relating to compliance with accounting, tax, legal and regulatory requirements, which could have an impact on reputation and market rating. These risks are formally reviewed by the board twice each year. Details of the company's compliance with Corporate Governance best practice, including information on relations with shareholders, are set out in the Corporate Governance Statement which can be found on the company's website http://www.merchantstrust.co.uk/Tenants/AGITrusts/Content/Documents/Corporate/Corporate_Governance_Statement.pdf.

The board's reviews of the risks faced by the company also include an assessment of the residual risks after mitigating action has been taken.

# Directors' Report *(continued)*

### Voting Rights in the Company's Shares

The voting rights at 25 March 2013 were:

| Share class | Number of shares issued | Voting rights per share | Total voting rights |
|---|---|---|---|
| Ordinary shares of 25p | 103,213,464 | 1 | 103,213,464 |
| 3.65% Cumulative Preference Stock of £1 | 1,178,000 | 1 | 1,178,000 |
| **Total** | **104,391,464** | | **104,391,464** |

Every member on a show of hands has one vote. On a poll every member who is present in person or by proxy or representative has one vote for every £1 in nominal amount of preference stock or one vote for every ordinary share of 25p.

### Directors

Biographical details of the directors in office during the year and up to the date of the signing of this report are shown on page 24 and all directors served throughout the financial year under review.

All of the directors are retiring by rotation at the annual general meeting and each offers himself for re-election. The board considers each director to be independent of the manager and has the full support of the board in standing for re-election. Following a formal performance evaluation conducted by the chairman it was noted that each director's individual performance continues to be effective and each director demonstrates commitment to his role.

All directors attended all board and relevant committee meetings during the year.

No contracts of significance in which directors are deemed to have been interested have subsisted during the year under review.

Contracts of service are not entered into with the directors, who hold office in accordance with the Articles of Association.

Directors' and officers' liability insurance cover is held by the company and deeds of indemnity have been entered into with the directors.

The current directors and their beneficial interests in the share capital of the company as at 31 January 2013 and 31 January 2012 are listed below:

| | Ordinary shares of 25p 2013 | 2012 |
|---|---|---|
| Simon Fraser | 20,000 | 20,000 |
| Mike McKeon | 5,450 | 450 |
| Henry Staunton | 10,000 | 10,000 |
| Paul Yates | 10,000 | 10,000 |

There have been no changes to directors' interests since the year end.

### Management Contract and Management Fee

The management contract with RCM (UK) Limited (RCM) provides for a fee of 0.35% per annum (2012 – 0.35%) of the value of the assets, calculated quarterly, after deduction of current liabilities, short term loans under one year and any funds within the portfolio managed by RCM. The management contract is terminable at one year's notice (2012 – one year).

The manager's performance under the contract and the contract terms are reviewed at least annually by the Management Engagement Committee. This committee consists of the directors not employed by the management company in the past five years and therefore includes the entire board. During the year, the committee met the manager to review the current investment framework, including the trust's performance, marketing activity and total expense ratio.

The committee also reviewed the terms of the management contract and considered the level of the management fee. The committee was satisfied with its review and believes that the continuing appointment of the manager is in the best interests of shareholders as a whole.

### Individual Savings Accounts

The affairs of the company are conducted in such a way as to meet the requirements for an Individual Savings Account and it is the intention to continue to do so.

### Interests in the Company's Share Capital

As at 25 March 2013 the following had declared a notifiable interest in the company's issued share capital:

### Ordinary Shares

| Name | Number of shares | Percentage of voting rights |
|---|---|---|
| Legal & General Group PLC | 4,099,823 | 3.94 |
| Lloyds Banking Group PLC | 4,086,614 | 3.96 |
| Axa SA | 3,664,667 | 3.55 |

This represents no significant change since the year end.

### Corporate Governance Statement

The board has considered the principles and recommendations of the AIC Code of Corporate Governance (AIC Code) and been guided by the AIC Corporate Governance Guide for Investment Companies (AIC Guide). Both documents can be found on the AIC website www.theaic.co.uk. As confirmed by the Financial Reporting Council, following the AIC Guide enables investment company boards to meet their obligations under the UK Corporate Governance Code and Listing Rules. The company has complied with the current recommendations of the AIC Code and the relevant provisions of UK Corporate Governance Code, except in relation to the UK Corporate Governance Code provisions relating to: the role of the chief executive; executive directors' remuneration; and the remuneration committee and the need for an internal audit function. For the reasons set out in the AIC Guide, and in the preamble to the UK Corporate Governance Code, the board considers these provisions are not relevant to the company as it is an externally managed investment company. The company has therefore not reported further in respect of these provisions.

The full text of the company's Corporate Governance Statement is on the website: http://www.merchantstrust.co.uk/Tenants/AGITrusts/Content/Documents/Corporate/Corporate_Governance_Statement.pdf.

Attendance by the current directors at formal board and committee meetings during the year was as follows:

| Director | Board | Audit Committee | Nomination Committee | Management Engagement Committee |
|---|---|---|---|---|
| No. of meetings | 6 | 2 | 1 | 1 |
| Simon Fraser | 6 | 2† | 1 | 1 |
| Mike McKeon | 6 | 2 | 1 | 1 |
| Henry Staunton | 6 | 2 | 1 | 1 |
| Paul Yates | 6 | 2 | 1 | 1 |

† Invited to attend meetings, although not a committee member.

# Directors' Report *(continued)*

### Special Rights Disclosure

There are no restrictions concerning the transfer of securities in the company; no special rights with regard to control attached to securities; no agreements between holders of securities regarding their transfer known to the company; no agreements which the company is party to that might affect its control following a takeover bid; and no agreements between the company and its directors concerning compensation for loss of office.

The company is not aware of any agreements between holders of securities with regard to control of the company which may result in restrictions on voting rights.

### Conflicts of Interest

The Companies Act 2006 sets out directors' general duties. A director must avoid a situation where he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the company's interests. Directors are able to authorise these conflicts and potential conflicts. The board reports annually on the company's procedures for ensuring that its powers of authorisation of conflicts are operated effectively and that the procedures have been followed.

Each of the directors has provided a statement of all conflicts of interest and potential conflicts of interest relating to the company. These statements have been considered and approved by the board. The directors have undertaken to notify the Chairman and Company Secretary of any proposed new appointments and new conflicts or potential conflicts for consideration, if necessary, by the board. The board has agreed that only directors who have no interest in the matter being considered will be able to take the relevant decision and that in taking the decision the directors will act in a way they consider, in good faith, will be most likely to promote the company's success. The board is able to impose limits or conditions when giving authorisation if it thinks this is appropriate.

The board confirms that its powers of authorisation are operating effectively and that the agreed procedures have been followed.

### Board Committees
### Audit Committee

The Audit Committee Report is on page 36.

### Nomination Committee

The Nomination Committee meets at least once each year and makes recommendations on the appointment of new directors and the re-election of existing directors by shareholders. The committee also determines the process for the annual evaluation of the board. The committee is chaired by Simon Fraser, the Chairman of the board. All directors serve on the committee and consider nominations made in accordance with an agreed procedure. The recruitment process for new directors is for the board to appoint external consultants to nominate candidates for the committee to consider.

The board has issued a statement giving support to the intention of the Davies Review 'Women on boards' to encourage diversity on the boards of companies. There are four directors on the board and as each has served no more than five years there are no current plans to recruit new directors. In the last recruitment exercise, as described in the previous annual report, the board sought to identify a wide spectrum of candidates and to take gender into account. The board's aim is to continue with a policy of shortlisting women in the search for new directors.

### Management Engagement Committee

The Management Engagement Committee meets at least once each year to review the management agreement and the manager's performance. It has defined terms of reference and consists of the non-executive directors and would exclude any directors previously employed by the manager. It is chaired by Simon Fraser, the Chairman of the board.

### Terms of Reference

The terms of reference for each of the committees may be viewed by shareholders on request and are published on the website www.merchantstrust.co.uk.

The board has not constituted a remuneration committee; all directors are non-executive and remuneration matters are dealt with by the whole board.

### Financial Reporting

The Statement of Directors' Responsibilities in respect of the financial statements is on page 35. The Independent Auditor's Report can be found on page 40.

# Directors' Report *(continued)*

### Auditor's Information

Each of the persons who is a director at the date of approval of this report confirms that:

(a) in so far as the director is aware, there is no relevant audit information of which the company's auditor is unaware; and

(b) the director has taken all the steps he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

### Internal Control

The directors have overall responsibility for the company's system of internal control and are responsible for reviewing the effectiveness of the company's systems of internal control. Whilst acknowledging their responsibility for the system of internal control, the directors are aware that such a system is designed to manage rather than eliminate the risk of a failure to achieve business objectives and can provide only reasonable but not absolute assurance against material misstatement or loss.

The board has established an ongoing process for identifying, evaluating and managing the significant risks faced by the company. This process is subject to review by the audit committee and accords with the Turnbull guidance and it is believed that the appropriate framework is in place to meet the requirements of the AIC Code. The process has been fully in place throughout the year under review and up to the date of signing of this Annual Financial Report.

The key elements of the procedures that the directors have established and which are designed to provide effective internal control are as follows:

- The board, assisted by the manager, undertook a full review of the company's business risks and these are analysed and recorded (see page 27). Every six months the board receives from the manager a formal report which details any known internal controls failures, including those that are not directly the responsibility of the manager. The board continues to check that good systems of internal control and risk management are embedded in the operations and culture of the company and its key suppliers.
- The appointment of RCM (UK) Limited (RCM) as the manager provides investment management, accounting and company secretarial services to the company. The manager therefore maintains the internal controls associated with the day to day operation of the company. These responsibilities are included in the management agreement between the company and the manager. The manager's system of internal control includes organisation arrangements with clearly defined lines of responsibility and delegated authority as well as control procedures and systems which are regularly evaluated by management and monitored by its internal audit department. RCM is regulated by the Financial Services Authority (FSA) and its compliance department regularly monitors compliance with FSA rules. The company receives reports at least annually from the manager on its internal controls. The company, in common with other investment trusts, has no internal audit department, but the effectiveness of the manager's internal controls is monitored by Allianz Global Investors' internal audit function.
- There is a regular review by the board of asset allocation and any risk implications. There is also regular and comprehensive review by the board of management accounting information including revenue and expenditure projections, actual revenue against projections and performance comparisons.
- Authorisation and exposure limits are set and maintained by the board.
- The audit committee assesses the systems of controls of third party service providers by reviewing internal control reports of those parties including the manager, the company's registrars, Capita Registrars and the custodian, HSBC Bank plc.

The audit committee has received reports from each of its service providers on the anti-bribery policies of these third parties. It receives reports on compliance with the manager's anti-bribery policy.

The directors confirm that the audit committee has reviewed the effectiveness of the system of internal control. During the course of its review of the system of internal control, the board has not identified nor been advised of any failings or weaknesses which it has determined to be significant.

# Directors' Report *(continued)*

### Relations with Shareholders

The board strongly believes that the annual general meeting should be an event which private shareholders are encouraged to attend. The annual general meeting is attended by the Chairman of the board and the Chairmen of the board's committees, and the investment manager makes a presentation at the meeting. The number of proxy votes cast in respect of each resolution will be made available at the annual general meeting.

The manager meets with institutional shareholders on a regular basis and reports to the board on matters raised at these meetings. The Chairman and, where appropriate, other directors, are available to meet with shareholders to discuss governance and strategy and to understand their issues and concerns. All correspondence with shareholders is reviewed by the board.

Shareholders who wish to communicate directly with the Chairman, the Senior Independent Director or other directors may write care of the Company Secretary, The Merchants Trust PLC, 155 Bishopsgate, London EC2M 3AD.

The notice of meeting sets out the business of the meeting and special resolutions are explained more fully in the Directors' Report. Separate resolutions are proposed for each substantive issue.

### The UK Stewardship Code and Exercise of Voting Powers

The company's investments are held in a nominee name. The board has delegated discretion to discharge its responsibilities in respect of investments, including the exercise of voting powers on its behalf to the manager, RCM (UK) Limited (RCM). The UK Stewardship Code sets out good practice on engagement with investee companies. It provides an opportunity to bring together UK and overseas investors committed to the high quality dialogue with companies needed to underpin good governance.

By creating a sound basis of engagement it should create a much needed stronger link between governance and the investment process, and support the concept of "comply or explain" as applied by listed companies. The Financial Reporting Council therefore sees it as complementary to the UK Corporate Governance Code for listed companies. RCM's policy statement on the Stewardship Code can be found on its website: www.allianzglobalinvestors.co.uk/en/InstitutionalClients/rcm/Consultants/Disclosure/Documents/Stewardship_Policy.pdf . The board has reviewed this policy statement and is satisfied that the company's delegated voting powers are being properly executed and is working with RCM to assess the effectiveness of the Stewardship Code in practice.

The board has noted the manager's statement of its corporate governance aims and objectives, summarised as:

"Our primary corporate aim is to maximise shareholder value through the securing of corporate performance whilst protecting this value through operating within established rules of conformance.

Our primary investment management aim is to meet or exceed our clients' expectations through generating first class returns within the constraint of their risk tolerance.

RCM votes in all markets wherever possible, and strives actively to encourage both improved levels of disclosure among companies and proper voting infrastructure among custodians and agents globally."

In the UK, RCM is a member of the National Association of Pension Funds and the International Corporate Governance Network, and abides by these organisations' founding principles. These guidelines also take into account international codes of corporate governance from a number of sources, including Employment Retirement Income Security Act legislation and Department of Labor recommendations in the U.S. where appropriate.

Where directors hold directorships on the boards of companies in which the company is invested, they do not participate in decisions made concerning those investments.

An extract from the company's voting record in the previous year will be available for inspection at the annual general meeting each year.

### Corporate Social Responsibility

The board has noted the manager's views on social responsibility that it adheres to in engaging with the underlying investee companies and in exercising its delegated responsibilities in voting. RCM has said: "We believe that good corporate governance includes the management of the company's impacts on society and the environment, as these are increasingly becoming a factor in contributing towards maximising long term shareholder value." In its Sustainable Investment Policy Statement, RCM says it "believes that the consideration of environmental, social and governance issues within the investment decision process provides a new and longer-term perspective on evaluating risk and opportunities."

## Annual General Meeting

### Amendment to the Articles of Association

The company conducts its affairs so that it qualifies as an investment trust and an investment company. As an investment trust, the company is not liable to pay corporation tax on any capital gains. Following a consultation process, certain of the statutory rules governing investment trusts and investment companies were amended recently. In particular, the rule which prohibited an investment trust or company from distributing any net gains arising from the realisation of its investments was repealed. It is intended that this will give companies greater flexibility with regard to paying dividends.

In order to comply with the previous statutory regime, the company has a provision in its Articles of Association which expressly prohibits the distribution of any net gains arising from the realisation of investments. In light of the amended statutory rules, the board no longer considers it appropriate to have such a prohibition in the articles and therefore proposes that it is deleted. Resolution 14 will be proposed at the annual general meeting as a special resolution and if passed, will remove this prohibition by amending the articles.

The board believes that the removal of this restriction will give the company greater flexibility in the long term as it will allow distributions to be made from any net gains arising from the realisation of investments should this be considered appropriate in the future. It should be noted that the proposal to amend the articles will not result in any changes in how the company's net revenue is generated or calculated. The company will continue to pursue its policy of paying increasing dividends from net revenue profits. Such profits will be generated from income from portfolio companies and allocating expenses and finance costs between capital and revenue on the basis set out in the accounting policies on page 46.

### Increase in Articles Limit on Directors' Fees

Resolution 10 will be proposed to increase the current cap on the aggregate amount of fees payable to directors in any year, contained in the Articles of Association, to £200,000. The board believes that to enable flexibility in respect of succession planning, and in particular to recruit new directors from time to time, it is prudent to keep remuneration at or around market levels. The board is therefore proposing to increase the Articles cap from £150,000 to £200,000. The cap was last increased, from £100,000 to the present limit, in 2006. The increase will allow new directors to overlap with retiring directors and ensure that any overlap of directors' service does not breach the aggregate fees the company is permitted to pay. The Directors' Remuneration Report on pages 37 and 38 contains further details of the directors' fee policy and remuneration.

### Allotment of New Shares and Disapplication of Pre-emption Rights

Approval is sought for the renewal of the directors' authority to allot relevant securities, in accordance with section 551 of the Companies Act 2006, up to a maximum number of 34,404,488 ordinary shares, representing approximately one third of the existing ordinary share capital. This authority is renewable annually and will expire at the conclusion of the annual general meeting in 2014.

A resolution was passed at the annual general meeting held on 9 May 2012 in accordance with section 570 of the Companies Act 2006, to authorise the directors to allot ordinary shares for cash other than pro rata to existing shareholders. The authority is renewable annually and expires at the conclusion of the annual general meeting in 2013. A special resolution is therefore proposed under special business at the forthcoming annual general meeting to renew this authority until the conclusion of the annual general meeting in 2014 or 10 August 2014 if earlier. This power is limited to a maximum number of 10,321,346 ordinary shares, being approximately 10% of the issued ordinary share capital of the company as at the date of this report, provided that there is no change in the issued share capital between the date of this report and the annual general meeting to be held on 10 May 2013.

The directors may allot shares under these authorities to take advantage of opportunities in the market as they arise but only if they believe it would be advantageous to the company's existing shareholders to do so. The directors confirm that no allotment of new shares will be made unless the lowest market offer price of the ordinary shares is at least at a premium to net asset value, valuing debt at market value.

### Purchase of Own Shares

The board is proposing that the company should be given renewed authority to purchase ordinary shares in the market for cancellation. The board believes that such purchases in the market at appropriate times and prices are a suitable method of enhancing shareholder value. The company would make either a single purchase or a series of purchases, when market conditions are suitable, with the aim of maximising the benefits to shareholders and within guidelines set from time to time by the board.

# Directors' Report *(continued)*

Where purchases are made at prices below the prevailing net asset value of the ordinary shares, this will enhance net asset value for the remaining shareholders. It is therefore intended that purchases would only be made at prices below net asset value, with the purchases to be funded from the capital reserves of the company (which are currently in excess of £400 million). The rules of the UK Listing Authority (Listing Rules) limit the price which may be paid by the company to 105% of the average middle-market quotation for an ordinary share on the five business days immediately preceding the date of the relevant purchase. The minimum price to be paid will be 25p per ordinary share (being the nominal value). Overall, this proposed share buy-back authority, if used, should help to reduce the discount to net asset value at which the company's shares currently trade.

The board considers that it will be most advantageous to shareholders for the company to be able to continue to make such purchases as and when it considers the timing to be most favourable and therefore does not propose to set a timetable for making any such purchases.

Under the Listing Rules, the maximum number of shares which a listed company may purchase through the market pursuant to a general authority such as this is equivalent to 14.99% of its issued share capital. For this reason, the company is limiting its renewed authority to make such purchases to 15,471,698 ordinary shares, representing 14.99% of the issued share capital, provided that there is no change in the issued share capital between the date of this report and the annual general meeting to be held on 10 May 2013.

The authority in accordance with section 701 of the Companies Act 2006, will last until the annual general meeting of the company to be held in 2014 or the expiry of 18 months from the date of the passing of this resolution, whichever is the earlier. The authority will be subject to renewal by shareholders at subsequent annual general meetings.

### Independent Auditor

The directors will place a resolution before the annual general meeting to re-appoint PricewaterhouseCoopers LLP as statutory auditor for the ensuing year. A resolution to authorise the directors to determine the auditor's remuneration will also be proposed at the annual general meeting.

*By order of the Board*
*Kirsten Salt*
*Company Secretary*
*27 March 2013*

# Statement of Directors' Responsibilities

The directors are responsible for preparing the Annual Financial Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Company law also requires that the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the net return of the company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements.

The directors confirm that they have complied with the above requirements in preparing the financial statements.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements and the Directors' Remuneration Report comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The financial statements are published on www.merchantstrust.co.uk, which is a website maintained by the company's investment manager, RCM (UK) Limited. The directors are responsible for the maintenance and integrity of the company's website. The work undertaken by the auditor does not involve consideration of the maintenance and integrity of the website and, accordingly, the auditor accepts no responsibility for any changes that have occurred to the financial statements since they were initially presented on the website. Visitors to the website need to be aware that legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

**Statement under DTR 4.1.12**

The directors at the date of approval of this report, each confirm to the best of their knowledge that:

- the financial statements, which have been prepared in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), give a true and fair view of the assets, liabilities, financial position and net return of the company; and
- the Annual Financial Report includes a fair review of the development and performance of the company and the position of the company, together with a description of the principal risks and uncertainties that it faces.

*For and on behalf of the board*
*Simon Fraser*
*Chairman*
*27 March 2013*

# Audit Committee Report

The principal role of the Audit Committee is to assist the board in relation to the reporting of financial information, the review of financial controls and the management of risk. The committee has defined terms of reference and duties and the terms of reference are published on the company's website. These include responsibility for the review of the Annual Financial Report and the Half-yearly Financial Report, the nature and scope of the external audit and the findings therefrom and the terms of appointment of the auditor, including their remuneration and the provision of any non-audit services by them. Non-audit services of £3,600 in the year were for the auditor's certification of borrowing covenants (2012 - £3,500). These fees are considered by the audit committee to be proportionate to the fees for audit services of £28,915 (2012 - £23,056).

The audit committee consists of all of the independent non-executive directors, with the exception of the Chairman, and has defined terms of reference and duties. The committee considers that, collectively, its members have sufficient recent and relevant financial experience to discharge their responsibilities fully: two of the three committee members are chartered accountants. During the year the committee met twice during which the Annual Financial Report and the Half-yearly Financial Report respectively were reviewed in detail. These meetings were attended by representatives of the manager including their compliance officer. At each meeting the committee received a report from the compliance officer on the operation of financial controls relating to the company and the proper conduct of its business in accordance with the regulatory environment in which both the company and the manager operate. The committee also considered the auditor's report on the annual financial statements, the planning and the process of the audit and the auditor's independence and objectivity. It has also considered the non-audit services provided by the auditor and determined that they have had no impact on the auditor's independence and objectivity. The audit committee believes the performance of the auditor is satisfactory and recommended their reappointment to the board. The audit committee reviews the company's accounting policies and considers their appropriateness. The committee also reviews the terms of appointment of the auditor together with their remuneration. The audit committee continues to believe that the company does not require an internal audit function of its own as it delegates its day to day operations to third parties from whom it receives internal controls reports.

The audit committee has noted the AIC Code provisions relating to the tendering for external audit contracts every ten years. The audit committee is also aware of a number of current deliberations taking place by other bodies such as the EU Commission and the Financial Reporting Council in the UK on the same subject. Our auditor, PricewaterhouseCoopers LLP, has been the company's appointed auditor for many years. It is therefore the intention of the audit committee to review the situation of the company's auditor tenure over the coming year in the light of the settling Code provisions on this matter, with a view to recommend to the board an appropriate policy and future course of action.

As the company has no employees it does not have a formal policy concerning the raising, in confidence, of any concerns about improprieties, whether in matters of financial reporting or otherwise, for appropriate independent investigation. However, any matters concerning the company may be raised with the Chairman or the Senior Independent Director. The audit committee has, however, received and noted the manager's policy on this matter.

*Mike McKeon*
*Audit Committee*
*Chairman*
*27 March 2013*

# Directors' Remuneration Report

This report is submitted in accordance with the Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 8, for the year ended 31 January 2013. An ordinary resolution for the approval of this report will be put to shareholders at the forthcoming annual general meeting.

## The Board

The board of directors is composed solely of non-executive directors and the determination of the directors' fees is a matter dealt with by the whole board. The board has not been provided with advice or services by any person to assist it to make its remuneration decisions, although the directors carry out reviews from time to time of the fees paid to the directors of other investment trusts.

## Policy on Directors' Remuneration

No director has a service contract with the company. The company's policy is for the directors to be remunerated in the form of fees, payable half-yearly in arrears. There are no long term incentive schemes, bonuses, pension benefits, share options or other benefits and fees are not related to the individual director's performance, nor to the performance of the board as a whole.

The company's Articles of Association limit the aggregate fees payable to the board of directors to a total of £150,000 per annum. The directors are proposing an ordinary resolution at the forthcoming AGM (resolution 10) to increase the current limit on the aggregate amount of fees payable in any year to £200,000. A further explanation of resolution 10 appears in the Directors' Report of page 33. Subject to this overall limit, it is the board's policy to determine the level of directors' fees having regard to the level of fees payable to non-executive directors in the investment trust industry generally, the role that individual directors fulfil, and the time committed to the company's affairs. The board believes that levels of remuneration should be sufficient to attract and retain non-executive directors to oversee the company.

## Remuneration

During the year the Chairman's fees were £31,500 per annum, the directors' fees were £21,000 per annum and an additional £3,250 was paid to the Audit Committee Chairman.

These fees have been in place since 1 February 2012 and prior to that the Chairman had been paid at the rate of £30,000, and the directors at £20,000 per annum, with a further £3,000 for the Audit Committee Chairman. Since the year end the board reviewed the fees and in order for the directors' remuneration to keep pace and remain competitive with the fees in the peer group and wider investment company sector, the fees have been increased with effect from 1 February 2013, to £33,000 for the Chairman, £22,000 for the other directors and an additional £3,750 for the Chairman of the Audit Committee.

# Directors' Remuneration Report *(continued)*

## Directors' Emoluments (Audited)

The directors' emoluments during the year and in the previous year are as follows:

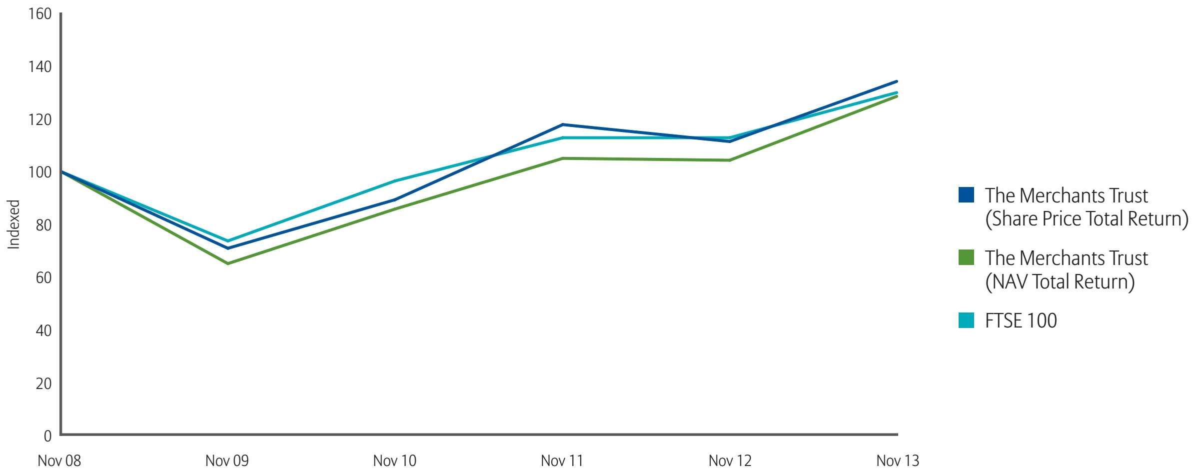
| | Directors' fees | |
|---|---|---|
| | 2013<br>£ | 2012<br>£ |
| Simon Fraser | 31,500 | 31,883* |
| Mike McKeon | 24,250 | 23,000 |
| Henry Staunton | 21,000 | 20,000 |
| Paul Yates** | 21,000 | 17,359 |
| Dick Barfield *** | - | 5,538 |
| Totals | 97,750 | 97,780 |

* Includes a National Insurance Contributions refund of £1,883. ** Appointed to the Board March 2011. *** Retired from the board in May 2011.

## Performance Graph

The graph below measures the company's share price and net asset value performance against its benchmark index of the FTSE 100 Index and is re-based to 100.

The company's performance is measured against the FTSE 100 Index as this is the most appropriate comparator in respect of its asset allocation. An explanation of the company's performance is given in the Chairman's Statement and the Investment Manager's Review.




Source: RCM / Datastream in GBP
Figures have been rebased to 100 as at 30 November 2008

*By Order of the Board*
*Kirsten Salt*
*Company Secretary*
*27 March 2013*

The Merchants Trust PLC

# Auditor’s Report


gagliardifoto / Shutterstock.com

# Independent Auditor's Report to the Members of The Merchants Trust PLC

We have audited the financial statements of The Merchants Trust PLC (the company) for the year ended 31 January 2013 which comprise the Income Statement, the Reconciliation of Movements in Shareholders' Funds, the Balance Sheet, the Cash Flow Statement, the Statement of Accounting Policies and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

## Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 35, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

## Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Financial Report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

## Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 January 2013 and of its net return and cash flows for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

## Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

## Matters on which we are required to report by exception

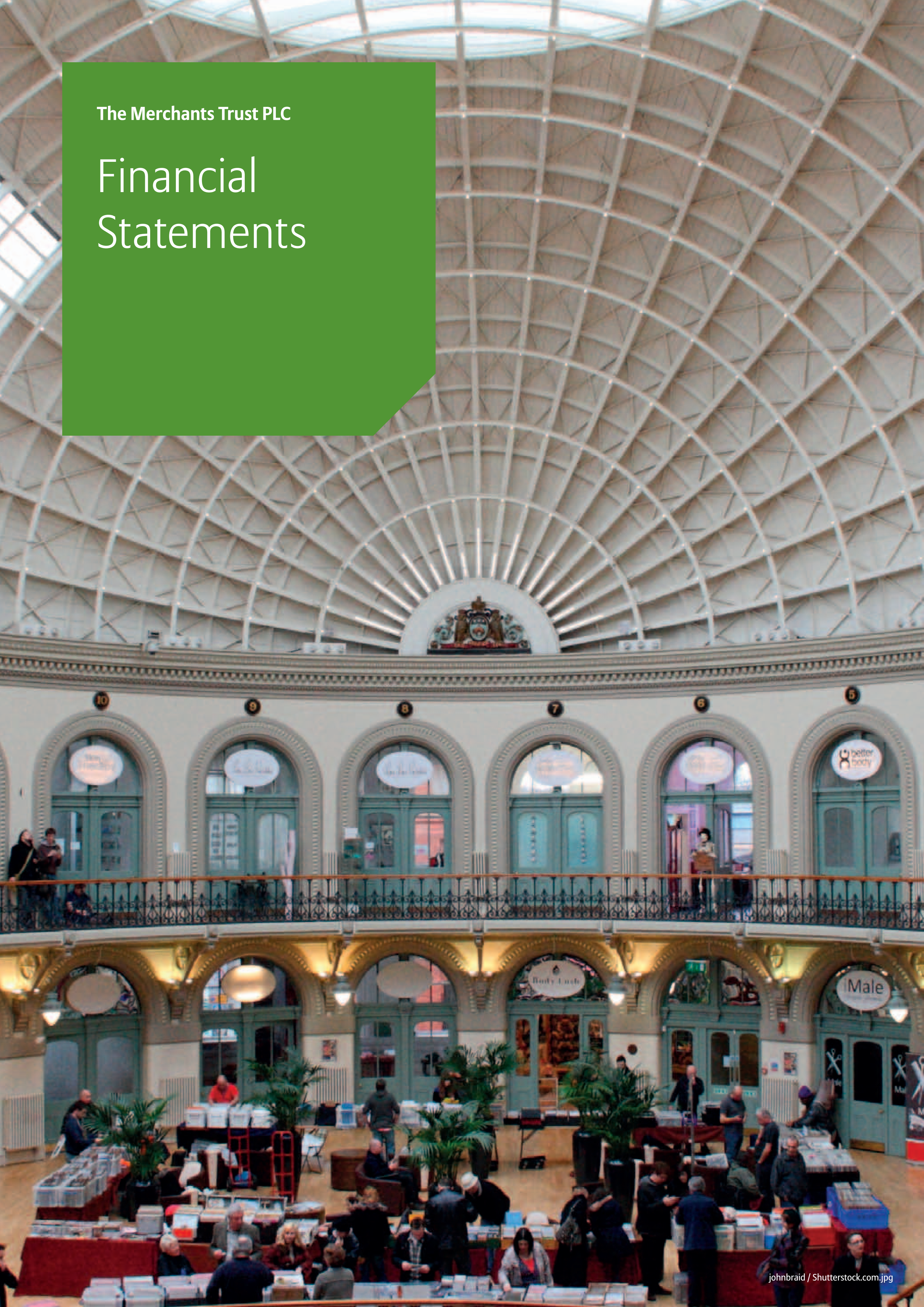
We have nothing to report in respect of the following:
Under the Companies Act 2006 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, set out on page 26, in relation to going concern;
- the parts of the Corporate Governance Statement relating to the company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and
- certain elements of the report to shareholders by the board on directors' remuneration.

*Kelvin Laing-Williams*
*(Senior Statutory Auditor)*
*for and on behalf of PricewaterhouseCoopers LLP,*
*Chartered Accountants and Statutory Auditors, London*
*27 March 2013*




The Merchants Trust PLC

# Financial Statements

johnbraid / Shutterstock.com.jpg

# Income Statement

for the year ended 31 January

| | Notes | 2013 Revenue £ | 2013 Capital £ | 2013 Total Return £ | 2012 Revenue £ | 2012 Capital £ | 2012 Total Return £ |
|---|---|---|---|---|---|---|---|
| Net gains (losses) on investments at fair value | 8 | - | 73,990,109 | 73,990,109 | - | (17,682,904) | (17,682,904) |
| Income | 1 | 28,312,659 | - | 28,312,659 | 27,305,462 | - | 27,305,462 |
| Investment management fee | 2 | (668,352) | (1,241,225) | (1,909,577) | (657,637) | (1,221,325) | (1,878,962) |
| Administrative expenses | 3 | (683,940) | (2,943) | (686,883) | (611,230) | (2,641) | (613,871) |
| **Net return before finance costs and taxation** | | **26,960,367** | **72,745,941** | **99,706,308** | **26,036,595** | **(18,906,870)** | **7,129,725** |
| Finance costs: interest payable and similar charges | 4 | (3,328,645) | (6,101,807) | (9,430,452) | (3,324,384) | (6,093,985) | (9,418,369) |
| **Net return on ordinary activities before taxation** | | **23,631,722** | **66,644,134** | **90,275,856** | **22,712,211** | **(25,000,855)** | **(2,288,644)** |
| Taxation | 5 | - | - | - | - | - | - |
| **Net return on ordinary activities attributable to ordinary shareholders** | **7** | **23,631,722** | **66,644,134** | **90,275,856** | **22,712,211** | **(25,000,855)** | **(2,288,644)** |
| **Net return per ordinary share (basic and diluted)** | **7** | **22.90p** | **64.57p** | **87.47p** | **22.00p** | **(24.22)p** | **(2.22)p** |

Dividends in respect of the financial year ended 31 January 2013 total 23.20p (2012 - 23.00p), amounting to £23,945,524 (2012 - £23,739,096). Details are set out in note 6 on page 51.

The total return column of this statement is the profit and loss account of the company. The supplementary revenue return and capital return columns are both prepared under the guidance published by the Association of Investment Companies.

All revenue and capital items in the above statement derive from continuing operations.

A Statement of Total Recognised Gains and Losses is not required as all gains and losses of the company have been reflected in the above statement.

The Notes on pages 46 to 64 form an integral part of these financial statements.

# Reconciliation of Movements in Shareholders' Funds

for the year ended 31 January

| | Notes | Called up Share Capital £ | Share Premium Account £ | Capital Redemption Reserve £ | Capital Reserve £ | Revenue Reserve £ | Total £ |
|---|---|---|---|---|---|---|---|
| Net assets at 1 February 2011 | | 25,803,366 | 8,523,195 | 292,853 | 381,684,696 | 24,541,906 | 440,846,016 |
| Revenue return | | - | - | - | - | 22,712,211 | 22,712,211 |
| Dividends on ordinary shares | 6 | - | - | - | - | (23,532,668) | (23,532,668) |
| Capital return | | - | - | - | (25,000,855) | - | (25,000,855) |
| **Net assets at 31 January 2012** | | **25,803,366** | **8,523,195** | **292,853** | **356,683,841** | **23,721,449** | **415,024,704** |
| Net assets at 1 February 2012 | | 25,803,366 | 8,523,195 | 292,853 | 356,683,841 | 23,721,449 | 415,024,704 |
| Revenue return | | - | - | - | - | 23,631,722 | 23,631,722 |
| Dividends on ordinary shares | 6 | - | - | - | - | (23,945,524) | (23,945,524) |
| Unclaimed dividends over 12 years | | - | - | - | - | 109,133 | 109,133 |
| Capital return | | - | - | - | 66,644,134 | - | 66,644,134 |
| **Net assets at 31 January 2013** | | **25,803,366** | **8,523,195** | **292,853** | **423,327,975** | **23,516,780** | **481,464,169** |

The Notes on pages 46 to 64 form an integral part of these financial statements.

# Balance Sheet

at 31 January

| | Notes | 2013 £ | 2013 £ | 2012 £ |
|---|---|---|---|---|
| **Fixed Assets** | | | | |
| Investments held at fair value through profit or loss | 8 | | 587,913,417 | 512,069,555 |
| **Current Assets** | | | | |
| Debtors | 10 | 1,951,529 | | 3,047,069 |
| Cash at bank | | 8,660,128 | | 13,398,772 |
| | | **10,611,657** | | **16,445,841** |
| Creditors – amounts falling due within one year | 10 | (5,249,381) | | (2,178,088) |
| Derivative financial instruments | 8 | (956,913) | | (291,625) |
| | | **(6,206,294)** | | **(2,469,713)** |
| Net current assets | | | 4,405,363 | 13,976,128 |
| **Total assets less current liabilities** | | | **592,318,780** | **526,045,683** |
| Creditors – amounts falling due after more than one year | 10 | | (110,854,611) | (111,020,979) |
| **Net assets** | | | **481,464,169** | **415,024,704** |
| **Capital and Reserves** | | | | |
| Called up share capital | 11 | | 25,803,366 | 25,803,366 |
| Share premium account | 12 | | 8,523,195 | 8,523,195 |
| Capital redemption reserve | 12 | | 292,853 | 292,853 |
| Capital reserve | 12 | | 423,327,975 | 356,683,841 |
| Revenue reserve | 12 | | 23,516,780 | 23,721,449 |
| **Total shareholders' funds** | **13** | | **481,464,169** | **415,024,704** |
| **Net asset value per ordinary share (basic and diluted)** | **13** | | **466.5p** | **402.1p** |

The financial statements on pages 42 to 45 of The Merchants Trust PLC, company number 28276, were approved and authorised for issue by the board of directors on 27 March 2013 and signed on its behalf by:

*Simon Fraser*
*Chairman*

The Notes on pages 46 to 64 form an integral part of these financial statements.

# Cash Flow Statement

for the year ended 31 January

| | Notes | 2013 £ | 2013 £ | 2012 £ |
|---|---|---|---|---|
| **Net cash inflow from operating activities** | 15 | | 26,870,216 | 23,792,303 |
| **Return on investment and servicing of finance** | | | | |
| Interest paid | | (9,553,329) | | (9,545,602) |
| Dividends on cumulative preference stock | | (42,997) | | (42,996) |
| **Net cash outflow from servicing of finance** | | | (9,596,326) | (9,588,598) |
| **Capital expenditure and financial investment** | | | | |
| Purchases of fixed asset investments | | (145,822,903) | | (114,624,382) |
| Sales of fixed asset investments | | 147,646,760 | | 128,095,076 |
| **Net cash inflow from capital expenditure and financial investment** | | | 1,823,857 | 13,470,694 |
| Dividends paid on ordinary shares | 6 | | (23,945,524) | (23,532,668) |
| Unclaimed dividends over 12 years | | | 109,133 | - |
| **(Decrease) increase in cash** | | | (4,738,644) | 4,141,731 |

The Notes on pages 46 to 64 form an integral part of these financial statements.

# Statement of Accounting Policies

for the year ended 31 January

1 **The financial statements** – The financial statements have been prepared under the historical cost basis, except for the measurement at fair value of investments and derivative financial instruments, and in accordance with applicable accounting standards, the United Kingdom Law and United Kingdom Generally Accepted Accounting Practice (UK GAAP) and the Statement of Recommended Practice - 'Financial Statements of Investment Trust Companies and Venture Capital Trusts' (SORP) issued in January 2009 by the Association of Investment Companies (AIC).

In order to better reflect the activities of an investment trust company and in accordance with guidance issued by the AIC, supplementary information which analyses the Income Statement between items of a revenue and capital nature has been presented alongside the Income Statement.

The accounting policies adopted in preparing the current year's financial statements are consistent with those of previous years.

The directors believe that it is appropriate to continue to adopt the going concern basis in preparing the financial statements as the assets of the company consist mainly of securities which are readily realisable and significantly exceed liabilities. Accordingly, the directors believe that the company has adequate financial resources to continue in operational existence for the foreseeable future. The company's business, the principal risks and uncertainties it faces, together with the factors likely to affect its future development, performance and position are set out in the Directors' Report, Business Review section on pages 25 to 32.

2 **Revenue** – Franked, unfranked and overseas dividends received on equity shares are accounted for on an ex-dividend basis. UK dividends are shown net of tax credits.

Special dividends are recognised on an ex-dividend basis and treated as a capital or revenue item depending on the facts and circumstances of each dividend. The board review special dividends and their treatment at each meeting.

Where the company has elected to receive its dividends in the form of additional shares rather than in cash, the equivalent of the cash dividend is recognised as income. Any excess in the value of the shares received over the amount of the cash dividend is recognised in capital reserves.

Deposit interest receivable is accounted for on an accruals basis. Commissions in respect of underwriting are recognised when the underwritten issue closes and are generally recognised within the Income Statement as revenue. Where, however, the company is required to take up a proportion of the shares underwritten, the same proportion of the commission received is recognised as capital, with the balance recognised as revenue.

3 **Investment management fees and administration expenses** – The investment management fee is calculated on the basis set out in note 2 to the financial statements and is charged to capital and revenue in the ratio 65:35 to reflect the board's investment policy and prospective split of capital and income returns. The split is reviewed annually. Other administration expenses are charged in full to revenue, except custodian handling charges on investment transactions which are charged to capital. All expenses are recognised on an accrual basis.

4 **Valuation** – As the company's business is investing in financial assets with a view to profiting from their total return in the form of increases in fair value, financial assets are designated as held at fair value through profit or loss in accordance with FRS 26 'Financial Instruments: Recognition and Measurement'. The company manages and evaluates the performance of these investments on a fair value basis in accordance with its investment strategy, and information about the investments is provided on this basis to the board of directors.

Investments held at fair value through profit or loss are initially recognised at fair value. After initial recognition, these continue to be measured at fair value, which for quoted investments is either the bid price or the last traded price depending on the convention of the exchange on which the investment is listed. Gains or losses on investments are recognised in the capital column of the Income Statement. Purchases and sales of financial assets are recognised on the trade date, being the date which the company commits to purchase or sell the assets.

After initial recognition unquoted stocks are valued by the board on an annual basis.

# Statement of Accounting Policies *(continued)*

for the year ended 31 January

5 **Derivatives** – Options may be purchased or written over securities held in the portfolio for generating or protecting capital returns, or for generating or maintaining revenue returns. Where the purpose of the option is the maintenance of capital the premium is treated as a capital item. The value of the option is subsequently marked to market to reflect the fair value of the option based on traded prices. When an option is closed out or exercised the gain or loss is accounted for as capital.

Where the purpose of the option is the generation of income, the premium is treated as a revenue item. The value of the option is subsequently marked to market to reflect the fair value of the option based on traded prices. Premiums received on written options are amortised to revenue over the period to expiry. If an option is exercised early unamortised premiums are taken to capital.

6 **Finance costs** – In accordance with the FRS 25 'Financial Instruments: Disclosure and Presentation' and FRS 26 'Financial Instruments: Recognition and Measurement', long term borrowings are stated at the amortised cost being the amount of net proceeds on issue plus accrued finance costs to date. Finance costs are calculated over the term of the debt on the effective interest rate basis.

Where debt is issued at a premium, the premium is amortised over the term of the debt on the effective interest rate basis.

Finance costs net of amortised premiums are charged to capital and revenue in the ratio 65:35 to reflect the board's investment policy and prospective split of capital and revenue returns.

Dividends payable on the 3.65% cumulative preference stock are classified as an interest expense and are charged in full to revenue.

7 **Taxation** – Where expenses are allocated between capital and revenue, any tax relief obtained in respect of those expenses is allocated between capital and revenue on the marginal basis using the company's effective rate of corporation tax for the accounting period.

Deferred taxation is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date, where transactions or events that result in an obligation to pay more tax or a right to pay less tax in the future have occurred. Timing differences are differences between the company's taxable profits and its results as stated in the financial statements.

A deferred tax asset is recognised when it is more likely than not that the asset will be recoverable. Deferred tax is measured on a non-discounted basis at the rate of corporation tax that is expected to apply when the timing differences are expected to reverse.

8 **Foreign currency** – In accordance with FRS 23 'The Effect of changes in Foreign Currency Exchanges Rates', the company is required to nominate a functional currency, being the currency in which the company predominately operates. The functional and reporting currency is sterling, reflecting the primary economic environment in which the company operates. Transactions in foreign currencies are translated into sterling at the rates of exchange ruling on the date of the transaction. Foreign currency monetary assets and liabilities are translated into sterling at the rates of exchange ruling at the balance sheet date. Profits and losses thereon are recognised in the capital column of the income statement and taken to the capital reserve.

9 **Dividends** – In accordance with FRS 21 'Events After the Balance Sheet Date', the final dividend proposed on ordinary shares is recognised as a liability when approved by shareholders. Interim dividends are recognised only when paid.

10 **Shares repurchased and subsequently cancelled** – Share capital is reduced by the nominal value of the shares repurchased, and the capital redemption reserve is correspondingly increased in accordance with section 733 Companies Act 2006. The full cost of the repurchase is charged to the capital reserve within gains (losses) on sales of investments.

11 **Shares issued** – Share capital is increased by the nominal value of shares issued. The proceeds in excess of the nominal value of shares net of expenses are allocated to the share premium account.

# Notes to the Financial Statements

for the year ended 31 January

## 1. Income

| | 2013 £ | 2013 £ | 2012 £ |
|---|---|---|---|
| **Income from Investments *** | | | |
| Franked equity dividends from UK investments # | | 25,791,894 | 24,789,614 |
| Unfranked dividends from UK investments | | 285,858 | 295,060 |
| Equity dividends from overseas investments | | 266,950 | 344,320 |
| | | 26,344,702 | 25,428,994 |
| **Other Income** | | | |
| Premiums on derivative contracts | 1,944,945 | | 1,858,059 |
| Underwriting commission | 23,012 | | 18,409 |
| | | 1,967,957 | 1,876,468 |
| Total income | | 28,312,659 | 27,305,462 |

* All equity dividends are derived from listed investments.
# Includes special dividend of £115,265 (2012 - £694,730)

During the year, the company received premiums totalling £1,858,577 (2012 - £1,998,313) for writing covered call options for the purpose of revenue generation. Premium income of £1,944,945 was amortised to income (2012 - £1,858,059). All derivatives transactions were based on FTSE 100 stocks or the related index. At the year end there were eighteen open positions with a net liability value of £956,913 (2012 - £291,625).

## 2. Investment Management Fee

| | 2013 Revenue £ | 2013 Capital £ | 2013 Total £ | 2012 Revenue £ | 2012 Capital £ | 2012 Total £ |
|---|---|---|---|---|---|---|
| Investment management fee | 668,352 | 1,241,225 | 1,909,577 | 657,637 | 1,221,325 | 1,878,962 |
| Total | 668,352 | 1,241,225 | 1,909,577 | 657,637 | 1,221,325 | 1,878,962 |

The management contract with RCM (UK) Limited (RCM), terminable at one year's notice, provides for a management fee based on 0.35% (2012 - 0.35%) per annum of the value of the company's assets calculated monthly after deduction of current liabilities, short term loans under one year and any funds within the portfolio managed by RCM. Under the contract, RCM provides the company with investment management, accounting, company secretarial and administration services.

## 3. Administrative Expenses

| | 2013 £ | 2012 £ |
|---|---|---|
| **Auditor's remuneration** | | |
| For audit services* | 28,915 | 23,056 |
| Other services - for certification of loan covenants | 3,600 | 3,500 |
| VAT on auditor's remuneration | 6,503 | 5,311 |
| | **39,018** | **31,867** |
| Directors' fees | 97,750 | 97,780 |
| Marketing costs | 268,593 | 170,814 |
| Other administration expenses | 278,579 | 310,769 |
| | **683,940** | **611,230** |

(i) The above expenses include value added tax where applicable.
(ii) Directors' fees are set out in the Directors' Remuneration Report on page 38.
(iii) In addition to the above, custodian handling charges of £2,943 were charged to capital (2012 - £2,641).
(iv) *Includes an amount of £4,135 which was paid to the auditor for additional reviews of the 2012 Annual Financial Report and this was borne by the company and reimbursed by RCM.

## 4. Finance Costs: Interest Payable and Similar Charges

| | 2013 Revenue £ | 2013 Capital £ | 2013 Total £ | 2012 Revenue £ | 2012 Capital £ | 2012 Total £ |
|---|---|---|---|---|---|---|
| On Stepped Rate Interest Loan repayable after more than five years | 1,339,334 | 2,487,335 | 3,826,669 | 1,335,440 | 2,480,103 | 3,815,543 |
| On Fixed Rate Interest Loan repayable after more than five years | 1,300,271 | 2,414,788 | 3,715,059 | 1,301,309 | 2,416,717 | 3,718,026 |
| On 4% Perpetual Debenture Stock repayable after more than five years | 19,250 | 35,750 | 55,000 | 19,250 | 35,750 | 55,000 |
| On 5.875% Secured Bonds repayable after more than five years | 626,734 | 1,163,934 | 1,790,668 | 625,377 | 1,161,415 | 1,786,792 |
| On 3.65% Cumulative Preference Stock repayable after more than five years | 42,997 | - | 42,997 | 42,997 | - | 42,997 |
| On Sterling overdraft | 59 | - | 59 | 11 | - | 11 |
| | 3,328,645 | 6,101,807 | 9,430,452 | 3,324,384 | 6,093,985 | 9,418,369 |

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

## 5. Taxation

| | 2013 Revenue £ | 2013 Capital £ | 2013 Total £ | 2012 Revenue £ | 2012 Capital £ | 2012 Total £ |
|---|---|---|---|---|---|---|
| **(i) Analysis of tax charge for the year** | | | | | | |
| Overseas taxation | - | - | - | - | - | - |
| Current tax charge | - | - | - | - | - | - |

### (ii) Factors affecting current tax charge for the year

The tax assessed for the year is lower than the standard rate of corporation tax in the UK (24.33%) (2012 - 26.33%).

| Reconciliation of tax charge | 2013 Revenue £ | 2013 Capital £ | 2013 Total £ | 2012 Revenue £ | 2012 Capital £ | 2012 Total £ |
|---|---|---|---|---|---|---|
| Return on ordinary activities before taxation | 23,631,722 | 66,644,134 | 90,275,856 | 22,712,211 | (25,000,855) | (2,288,644) |
| Tax on return on ordinary activities at 24.33% (2011 - 26.33%) | 5,749,598 | 16,214,518 | 21,964,116 | 5,980,125 | (6,582,725) | (602,600) |
| **Reconciling factors** | | | | | | |
| Non taxable income | (6,340,117) | - | (6,340,117) | (6,617,765) | - | (6,617,765) |
| Non taxable capital (gains) losses | - | (18,001,794) | (18,001,794) | - | 4,655,909 | 4,655,909 |
| Accrued income taxable on receipt | - | - | - | 20,537 | - | 20,537 |
| Disallowable expenses | 11,142 | 1,978 | 13,120 | 12,270 | 1,460 | 13,730 |
| Excess of allowable expenses over taxable income | 579,377 | 1,785,298 | 2,364,675 | 604,833 | 1,925,356 | 2,530,189 |
| Current tax charge | - | - | - | - | - | - |

The standard rate of Corporation Tax in the UK changed from 26% to 24% with effect from 1 April 2012. Accordingly the company's profits for this accounting period are taxed at the effective rate of 24.33% and will be taxed at 24% in the future.

The company's taxable income is exceeded by its tax allowable expenses, which include both the revenue and capital elements of the management fee and finance costs. As at 31 January 2013, the company had accumulated surplus expenses of £162.2 million (2012 - £152.4 million).

As at 31 January 2013 the company has not recognised a deferred tax asset of £37.3 million (2012 - £36.6 million) in respect of the accumulated expenses, based on a prospective corporation tax rate of 23% (2012 – 24%). The reduction in the standard rate of corporation tax was substantively enacted on 3 July 2012 and is effective from 1 April 2013. A further reduction to the main rate is proposed to reduce the rate by 1% to 22% in April 2014. Provided the company continues to maintain its current investment profile, it is unlikely that these expenses will be utilised and that the company will obtain any benefit from this asset.

The company will continue to seek approval under section 1158 of the Corporation Tax Act 2010 for the current year and the foreseeable future. The company has not therefore provided for deferred tax on any capital gains and losses arising on the disposals of investments.

## 6. Dividends on Ordinary Shares

| | 2013 £ | 2012 £ |
|---|---|---|
| **Dividends on Ordinary Shares of 25p** | | |
| Third interim dividend 5.8p paid 23 February 2012 (2011 - 5.7p) | 5,986,381 | 5,883,167 |
| Final dividend 5.8p paid 14 May 2012 (2011 - 5.7p) | 5,986,381 | 5,883,167 |
| First interim dividend 5.8p paid 15 August 2012 (2011 - 5.7p) | 5,986,381 | 5,883,167 |
| Second interim dividend 5.8p paid 12 November 2012 (2011 - 5.7p) | 5,986,381 | 5,883,167 |
| | 23,945,524 | 23,532,668 |

Dividends payable at the year end are not recognised as a liability under FRS 21 'Events after Balance Sheet Date' (see page 47 - Statement of Accounting Policies). Details of these dividends are set out below.

| | 2013 £ | 2012 £ |
|---|---|---|
| Third interim dividend 5.8p paid 27 February 2013 (2012 - 5.8p) | 5,986,381 | 5,986,381 |
| Final proposed dividend 5.8p payable 15 May 2013 (2012 - 5.8p) | 5,986,381 | 5,986,381 |
| | 11,972,762 | 11,972,762 |

The proposed final dividend accrued is based on the number of shares in issue at the year end. However, the dividend payable will be based on the numbers of shares in issue on the record date and will reflect any purchases and cancellations of shares by the company settled subsequent to the year end.

Ordinary dividends paid by the company carry a tax credit at a rate of 10%. The credit discharges the tax liability of shareholders subject to income tax at less than the higher rate. Shareholders liable to pay tax at the higher or additional rate will have further tax to pay.

## 7. Net Return per Ordinary Share

| | 2013 Revenue £ | 2013 Capital £ | 2013 Total Return £ | 2012 Revenue £ | 2012 Capital £ | 2012 Total Return £ |
|---|---|---|---|---|---|---|
| Net return after taxation attributable to ordinary shareholders | 23,631,722 | 66,644,134 | 90,275,856 | 22,712,211 | (25,000,855) | (2,288,644) |
| Net return per ordinary share (basic and diluted) | 22.90p | 64.57p | 87.47p | 22.00p | (24.22)p | (2.22)p |

The weighted average number of shares in issue during the year was 103,213,464 (2012 - 103,213,464).

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

## 8. Investments

| | 2013<br>£ | 2012<br>£ |
|---|---|---|
| Listed on the London Stock Exchange at market valuation | 587,885,448 | 512,041,586 |
| Unlisted at fair value | 27,969 | 27,969 |
| **Fixed asset investments** | **587,913,417** | **512,069,555** |
| Derivative financial instruments - written call options | (956,913) | (291,625) |
| **Total investments** | **586,956,504** | **511,777,930** |

| | | |
|---|---|---|
| Market value of investments brought forward | 511,777,930 | 542,931,529 |
| Investment holding gains brought forward | (15,724,039) | (38,259,082) |
| Derivative holding losses brought forward | 5,675 | 155,017 |
| **Cost of investments held brought forward** | **496,059,566** | **504,827,464** |
| Additions at cost | 148,835,225 | 114,624,382 |
| Disposals at cost | (136,186,429) | (123,392,280) |
| **Cost of investments held at 31 January** | **508,708,362** | **496,059,566** |
| Investment holding gains at 31 January | 79,009,589 | 15,724,039 |
| Derivative holding losses at 31 January | (761,447) | (5,675) |
| **Market value of investments held at 31 January** | **586,956,504** | **511,777,930** |

### Net gains (losses) on investments

| | | |
|---|---|---|
| Net gains on sales of investments based on historical costs | 11,370,747 | 4,753,833 |
| Adjustment for net investment holding losses (gains) recognised in previous years | 1,848,146 | (6,942,954) |
| **Net gains (losses) on sales of fixed asset investments based on carrying value at previous balance sheet date** | **13,218,893** | **(2,189,121)** |
| Net losses on derivative financial instruments | (42,377) | (51,037) |
| **Net gains (losses) on sales of investments based on carrying value at previous balance sheet date** | **13,176,516** | **(2,240,158)** |
| Net investment holding gains (losses) arising in the year | 61,437,404 | (15,592,088) |
| Special dividends credited to capital | 131,962 | - |
| Net derivative holding (losses) gains arising in the year | (755,773) | 149,342 |
| **Net gains (losses) on investments** | **73,990,109** | **(17,682,904)** |

Transaction costs and stamp duty on purchases amounted to £972,110 (2012 - £750,078) and transaction costs on sales amounted to £147,274 (2012 - £158,471).

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

## 9. Investments in other companies

The company held more than 10% of the share capital of the following companies, both of which are incorporated in Great Britain and registered in England and Wales:

| Company | Class of Share held | % Equity |
|---|---|---|
| First Debenture Finance PLC (FDF) | 'A' Shares | 50.0 |
| | 'B' Shares | 50.0 |
| | 'C' Shares | 50.0 |
| | 'D' Shares | 50.0 |
| Fintrust Debenture PLC (Fintrust) | Ordinary Shares | 50.0 |

In the opinion of the directors, the company is not in a position to exert significant influence over the financial operating policies of FDF or Fintrust, either through voting rights or through agreement with those companies' other shareholders, due to provisions in FDF's and Fintrust's Articles of Association and in certain contracts between the company and each of FDF and Fintrust. Accordingly, FDF and Fintrust are not considered to be associate undertakings as per FRS 9 and are therefore included in the balance at the director's valuation. FDF and Fintrust are the lenders of the company's Stepped Rate Interest Loan and Fixed Rate Interest Loan, as detailed in notes 10(i) and 10(ii), respectively. Apart from the finance costs, there were no other transactions between FDF, Fintrust and the company during the year.

## 10. Current Assets and Creditors

| | 2013 £ | 2012 £ |
|---|---|---|
| **Debtors** | | |
| Other debtors | 27,880 | 31,184 |
| Accrued income | 1,923,649 | 3,015,885 |
| | **1,951,529** | **3,047,069** |
| **Creditors: Amounts falling due within one year** | | |
| Purchases for future settlement | 3,012,322 | - |
| Other creditors | 901,736 | 843,259 |
| Interest on borrowings | 1,335,323 | 1,334,829 |
| | **5,249,381** | **2,178,088** |
| **Interest on outstanding borrowings consists of:** | | |
| Stepped Rate Interest Loan | 313,728 | 312,004 |
| Fixed Rate Interest Loan | 779,240 | 780,470 |
| 5.875% Secured Bonds 2029 | 207,105 | 207,105 |
| 4% Perpetual Debenture Stock | 13,751 | 13,751 |
| 3.65% Cumulative Preference Stock | 21,499 | 21,499 |
| | **1,335,323** | **1,334,829** |

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

| | | 2013 £ | 2012 £ |
|---|---|---|---|
| **Creditors: Amounts falling due after more than one year** | | | |
| Stepped Rate Interest Loan | 10(i) | 34,034,109 | 34,034,109 |
| Fixed Rate Interest Loan | 10(ii) | 45,074,175 | 45,268,411 |
| 5.875% Secured Bonds 2029 | 10(iii) | 29,193,327 | 29,165,459 |
| 4% Perpetual Debenture Stock | 10(iv) | 1,375,000 | 1,375,000 |
| 3.65% Cumulative Preference Stock | 10(v) | 1,178,000 | 1,178,000 |
| | | **110,854,611** | **111,020,979** |

(i) The Stepped Rate Interest Loan of £34,034,109 (2012- £34,034,109) comprises adjustable Stepped Rate Interest Loan Notes of £5,133,520 and Stepped Rate Interest Bonds of £20,534,079. The Loan Notes and Bonds were issued in 1987 at 97.4% and are repayable on 2 January 2018, together with a premium of £8,366,510.

The initial interest rate on the Loan Notes and Bonds was 7.16% per annum. This increased annually by 7.5% compound until January 1998 when it reached its current rate of 14.75%. This stepped interest rate, when combined with the accrual of the premium, results in an effective interest rate of 11.28% per annum.

Interest on the Loan Notes and Bonds is payable in January and July each year. Interest on the Loan Notes is variable in accordance with the terms of the agreement with the lender, First Debenture Finance PLC (FDF).

FDF has a liability to its debenture stockholders to repay principal and interest on its £52.2 million of 11.125% Severally Guaranteed Debenture Stock 2018. The company has guaranteed the repayment of principal and interest on £34.0 million of FDF's debenture stock. This is in proportion to the principal amounts raised by the company in 1987 in respect of the Loan Notes and Bonds. There is a floating charge on all the company's present and future assets to secure this obligation. The company has also agreed to meet its proportionate share of any expenses incurred by FDF, including any tax liability.

(ii) The Fixed Rate Interest Loan of £42,000,000 is due to Fintrust Debenture PLC (Fintrust). It comprises a loan of £30,000,000 taken out in 1993, and a further amount of £12,000,000 assumed in 1998 from another of Fintrust's borrowers. This loan is repayable on 20 May 2023 and carries interest at 9.25125% per annum on the principal amount. Interest is payable in May and November each year.

As security for this loan, the company has granted a floating charge over its assets in favour of the lender. This charge ranks pari passu with the floating charge noted in 10(i) above.

The loan of £30,000,000 taken out in 1993 is stated at £29,909,019 (2012 - £29,901,038), being the net proceeds of £29,858,947 plus accrued finance cost of £50,072 (2012 - £42,091). The effective interest rate of this portion of the loan is 9.51%.

On assuming the additional loan of £12,000,000 in 1998, the company also received a premium of £5,286,564 to ensure that the finance costs on this additional loan were comparable to existing market interest rates. This premium is being amortised over the remaining life of the loan. At 31 January 2013, the loan is stated at £15,165,156 (2012 - £15,367,373), being the principal amount of £12,000,000 plus the unamortised premium of £3,165,156 (2012 - £3,367,373). The effective interest rate of this portion of the loan is 6.00%.

(iii) The £30,000,000 of 5.875% Secured Bonds is stated at £29,193,327 (2012 - £29,165,459), being the net proceeds of £28,942,800 plus accrued finance costs of £250,527 (2012 - £222,659). The Bonds are repayable on 20 December 2029 and carry interest at 5.875% per annum on the principal amount. Interest is payable in June and December each year. The effective interest rate of this loan is 6.23% per annum.

As security for this loan, the company has granted a floating charge over its assets ranking pari passu with the floating charges referred to in note 10(i) and 10(ii) above.

(iv) The 4% Perpetual Debenture Stock of £1,375,000 is secured by a floating charge on the assets of the company, which ranks prior to any other floating charge. Interest is payable on 1 May and 1 November each year.

(v) The 3.65% Cumulative Preference Stock is recognised as a creditor due after more than one year under the provisions of FRS25 'Financial Instruments: Disclosure and Presentation'. The right of the preference stock holders to receive payments is not calculated by reference to the company's net return and, in the event of a return of capital is limited to a specific amount, being £1,178,000. Dividends on the preference stock are payable on 1 February and 1 August each year. The preference stock is non-redeemable.

## 11. Called up Share Capital

| | 2013 £ | 2012 £ |
|---|---|---|
| **Allotted and fully paid** | | |
| 103,213,464 ordinary shares of 25p (2012 - 103,213,464) | 25,803,366 | 25,803,366 |

The directors are authorised by an ordinary resolution passed on 9 May 2012 to allot relevant securities, in accordance with section 551 of the Companies Act 2006, up to a maximum of 34,401,047 ordinary shares of 25p each. This authority expires on 10 May 2013 and accordingly a renewed authority will be sought at the annual general meeting on 10 May 2013.

During the year the company did not repurchase any ordinary shares for cancellation or holding in treasury, nor have any ordinary shares been repurchased since the year end.

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

## 12. Reserves

| | Share Premium Account £ | Capital Redemption Reserve £ | Capital Reserve* Gains (Losses) on sales of Investments £ | Capital Reserve* Investment Holding Gains (Losses) £ | Revenue Reserve £ |
|---|---|---|---|---|---|
| Balance at 1 February 2012 | 8,523,195 | 292,853 | 340,965,476 | 15,718,365 | 23,721,449 |
| Net gains on sales of fixed asset investments | - | - | 13,218,893 | - | - |
| Net losses on derivative financial instruments | - | - | (42,377) | - | - |
| Net movement in fixed asset investment holding gains | - | - | - | 61,437,404 | - |
| Net movement in derivative holding losses | - | - | - | (755,773) | - |
| Special dividend | - | - | 131,962 | - | - |
| Unclaimed dividends over 12 years | - | - | - | - | 109,133 |
| Transfer on sale of investments | - | - | (1,848,146) | 1,848,146 | - |
| Investment management fee | - | - | (1,241,225) | - | - |
| Finance costs of borrowings | - | - | (6,101,807) | - | - |
| Other capital expenses | - | - | (2,943) | - | - |
| Dividends appropriated in the year | - | - | - | - | (23,945,524) |
| Revenue retained for the year | - | - | - | - | 23,631,722 |
| **Balance at 31 January 2013** | **8,523,195** | **292,853** | **345,079,833** | **78,248,142** | **23,516,780** |

*Under the terms of the company's Articles of Association the capital reserve is distributable only by way of redemption or purchase of the company's own shares, for so long as the company carries on business as an investment company. A proposal to remove this prohibition from the Articles is being proposed for shareholder approval at the AGM. The Institute of Chartered Accountants in England and Wales (ICAEW), in its technical guidance TECH 02/10, states that investment holding gains arising out of a change in fair value of assets may be recognised as realised provided they can be readily converted into cash. Securities listed on a stock exchange are generally regarded as being readily convertible into cash and hence profits in respect of such securities, currently included within the investment holding losses of the capital reserve above, may be regarded as realised under company law.

## 13. Net Asset Value per Share

| | Net asset value per share attributable 2013 | Net asset value per share attributable 2012 |
|---|---|---|
| Ordinary shares of 25p | 466.5p | 402.1p |

| | Net Asset Value attributable 2013 | Net Asset Value attributable 2012 |
|---|---|---|
| Ordinary shares of 25p | £481,464,169 | £415,024,704 |

The net asset value per ordinary share is based on 103,213,464 ordinary shares in issue at the year end (2012 - 103,213,464).

## 14. Contingent Liabilities and Commitments

At 31 January 2013 there were no outstanding contingent liabilities or capital commitments (2012 - nil).

Details of the guarantee provided by the company as part of the terms of the Loans are provided in Note 10(i), 10(ii) and 10(iii) 'Current Assets and Creditors' on pages 54 and 55.

## 15. Reconciliation of Net Return on Ordinary Activities before Finance Costs and Taxation to Net Cash Flow from Operating Activities

| | 2013 £ | 2012 £ |
|---|---|---|
| Net return before finance costs and taxation | 99,706,308 | 7,129,725 |
| Add: Special dividends credited to capital | 131,962 | - |
| Less: Net (gains) losses on investments at fair value | (74,122,071) | 17,682,904 |
| | **25,716,199** | **24,812,629** |
| Decrease (Increase) in debtors | 1,095,540 | (1,012,739) |
| Increase (Decrease) in creditors | 58,477 | (7,587) |
| **Net cash inflow from operating activities** | **26,870,216** | **23,792,303** |

## 16. Reconciliation of Net Cash Flow to Movement in Net Debt

| | Cash £ | Stepped and Fixed Rate Loans £ | 5.875% Secured Bonds 2029 £ | 4% Perpetual Debenture Stock £ | 3.65% Preference Stock £ | Net Debt £ |
|---|---|---|---|---|---|---|
| **(i) Analysis of net debt** | | | | | | |
| At 1 February 2012 | 13,398,772 | (79,302,520) | (29,165,459) | (1,375,000) | (1,178,000) | (97,622,207) |
| Movement in year | (4,738,644) | 194,236 | (27,868) | - | - | (4,572,276) |
| **At 31 January 2013** | **8,660,128** | **(79,108,284)** | **(29,193,327)** | **(1,375,000)** | **(1,178,000)** | **(102,194,483)** |

| | 2013 £ | 2012 £ |
|---|---|---|
| **(ii) Reconciliation of net cash flow to movement in net debt** | | |
| Net cash (outflow) inflow | (4,738,644) | 4,141,731 |
| Decrease in long term loans | 166,368 | 164,295 |
| **Movement in net funds** | **(4,572,276)** | **4,306,026** |
| Net debt brought forward | (97,622,207) | (101,928,233) |
| **Net debt carried forward** | **(102,194,483)** | **(97,622,207)** |

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

## 17. Financial Risk Management Policies and Procedures

The company invests in equities and other investments in accordance with its investment policy as stated on page 1. In pursuing its investment policy, the company is exposed to certain inherent risks that could result in either a reduction in the company's net assets or a reduction in the profits available for distribution by way of dividends.

The main risks arising from the company's financial instruments are: market price risk, market yield risk, foreign currency risk, interest rate risk, liquidity risk and credit risk. The directors determine the objectives and agree policies for managing each of these risks, as set out below. The investment manager, in close co-operation with the directors, implements the company's risk management policies. The company's policy allows the use of derivative financial instruments to moderate risk exposure and to generate additional revenue. These policies have remained substantially unchanged during the current and preceding period.

### (a) Market Risk

The investment manager assesses the exposure to market risk when making each investment decision, and monitors the risk on the investment portfolio on an ongoing basis. Market risk comprises market price risk, market yield risk, foreign currency risk and interest rate risk.

### (i) Market Price Risk

Market price risk arises mainly from the uncertainty about future prices of financial instruments held. It represents the potential loss the company might suffer through holding market positions in the face of price movements.

Where call options are sold (written), in all cases a sufficient position is maintained in the underlying equity to cover any potential option exercise. Whilst the option value can be volatile, price movements should to some extent be offset by opposing movements in the value of the underlying equity. If options are retained until expiry they will either expire worthless or be exercised. The effect of any option exercise is to sell the underlying shares at the strike price of the option. A schedule of the company's listed holdings is shown on pages 18 and 19. Where put options are purchased, the market value of such options can be volatile but the maximum loss on any contract is limited to the original investment cost. No put options were purchased in the year.

Further explanation of this derivative strategy is included in the Investment Manager's Review page 15.

Falls in stock market valuations lead to changes in gearing ratios. The board's procedure for monitoring the gearing of the company is set out in note 18 on page 63. This takes into account the investment manager's view on the market, covenant requirements and the future prospects of the company's performance.

### Market price risk sensitivity

The value of the company's listed investments (i.e., fixed asset investments, excluding unlisted equities) which were exposed to market price risk as at 31 January 2013 was as follows:

| | 2013<br>£ | 2012<br>£ |
|---|---|---|
| Listed investments held at fair value through profit or loss | 587,885,448 | 512,041,586 |
| Derivative financial instruments - written call options | (956,913) | (291,625) |
| Total listed investments | 586,928,535 | 511,749,961 |

The following table illustrates the sensitivity of the return after taxation for the year and the net assets to an increase or decrease of 20% (2012 - 20%) in the fair values of the company's listed investments. This level of change is considered to be reasonably possible based on observation of market conditions in recent years. The sensitivity analysis on the net return after tax is based on the impact of a 20% increase or decrease in the value of the company's listed equity investments at each closing balance sheet date and the consequent impact on the investment management fees for the year, with all other variables held constant.

| | 2013 20% Increase in fair value £ | 2013 20% Decrease in fair value £ | 2012 20% Increase in fair value £ | 2012 20% Decrease in fair value £ |
|---|---|---|---|---|
| **Revenue return** | | | | |
| Investment management fees | (144,032) | 144,032 | (125,450) | 125,450 |
| **Capital return** | | | | |
| Net gains (losses) on investments at fair value | 117,385,707 | (117,385,707) | 102,349,992 | (102,349,992) |
| Investment management fees | (267,488) | 267,488 | (232,979) | 232,979 |
| **Change in net return and net assets** | **116,974,187** | **(116,974,187)** | **101,991,563** | **(101,991,563)** |

### Management of market price risk
The directors meet regularly to consider the asset allocation of the portfolio in order to minimise the risk associated with particular industry sectors. A dedicated investment manager has the responsibility for monitoring the existing portfolio selection in accordance with the company's investment objectives and to ensure that individual stocks meet an acceptable risk reward profile. Call options are only written on stock owned within the portfolio with a maximum exposure of 15% of gross assets at the time of writing the call.

### (ii) Market Yield Risk
Market yield risk arises from the uncertainty about the company's ability to maintain its income objectives due to systematic decline in corporate dividend levels.

### Management of market yield risk
The directors regularly review the current and projected yield of the investment portfolio, and discuss with the investment manager the extent to which it will enable the company to meet its investment income objective.

### (iii) Foreign Currency Risk
Foreign currency risk is the risk of the movement in the values of overseas financial instruments as a result of fluctuations in exchange rates.

### Management of foreign currency risk
The company invests predominantly in UK listed equities and has no significant exposure to currencies other than sterling (2012 - no significant exposure).

Any income denominated in foreign currency is converted into sterling on receipt. The company does not hedge against foreign currency exposure.

### (iv) Interest Rate Risk
Interest rate risk is the risk of movements in the value of financial instruments as a result of fluctuations in interest rates.

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

### Interest Rate Exposure

The table below summarises in sterling terms the financial assets and financial liabilities whose values are directly affected by changes in interest rates.

| | 2013 Fixed rate interest £ | 2013 Floating rate interest £ | 2013 Nil interest £ | 2013 Total £ | 2012 Fixed rate interest £ | 2012 Floating rate interest £ | 2012 Nil interest £ | 2012 Total £ |
|---|---|---|---|---|---|---|---|---|
| Financial Assets | - | 8,660,128 | 587,913,417 | 596,573,545 | - | 13,398,772 | 512,069,555 | 525,468,327 |
| Financial Liabilities | (110,854,611) | - | (956,913) | (111,811,524) | (111,020,979) | - | (291,625) | (111,312,604) |
| **Net Financial (Liabilities) Assets** | **(110,854,611)** | **8,660,128** | **586,956,504** | **484,762,021** | **(111,020,979)** | **13,398,772** | **511,777,930** | **414,155,723** |
| Short term debtors and creditors | | | | (3,297,852) | | | | 868,981 |
| **Net Assets per the Balance Sheet** | | | | **481,464,169** | | | | **415,024,704** |

As at 31 January 2013, the interest rates received on cash balances or paid on bank overdrafts, was nil and 1.35% per annum respectively (2012 - nil and 1.35% per annum).

The fixed rate interest bearing liabilities bear the following coupon and effective rates as at 31 January 2013 and 31 January 2012.

| | Maturity date | Amount borrowed £ | Coupon rate | Effective rate since inception* |
|---|---|---|---|---|
| First Debenture Finance PLC (FDF) - Bonds | 02/01/2018 | 5,133,520 | 14.75% | 11.28% |
| First Debenture Finance PLC (FDF) - Notes | 02/01/2018 | 20,534,079 | 14.75% | 11.28% |
| Fintrust Debenture PLC (Fintrust) - Original Loan | 20/05/2023 | 30,000,000 | 9.25125% | 9.51% |
| Fintrust Debenture PLC (Fintrust) - Additional Loan | 20/05/2023 | 12,000,000 | 9.25125% | 6.00% |
| 5.875% Secured Bonds 2029 | 20/12/2029 | 30,000,000 | 5.875% | 6.23% |
| 4% Perpetual Debenture Stock | n/a | 1,375,000 | 4.00% | 4.00% |
| 3.65% Cumulative Preference Stock | n/a | 1,178,000 | 3.65% | 3.65% |
| | | 100,220,599 | | |

* The effective rates are calculated in accordance with FRS 26 'Financial Instruments: Recognition and Measurement' as detailed in the Statement of Accounting Policies on page 47.

The details in respect of the above loans have remained unchanged since the previous accounting period.

The weighted average effective rate of the company's fixed interest bearing liabilities (excluding the 3.65% Cumulative Preference Stock and the 4% Perpetual Debenture Stock) is 8.54% (2012 - 8.54%) and the weighted average period to maturity of these liabilities is 11.2 years (2012 - 12.2 years).

The above year end amounts are reasonably representative of the exposure to interest rates during the year, as the level of exposure does not change materially. Therefore the company's net return and net assets, are not significantly affected by changes in interest rates.

### Management of interest rate risk

The company invests predominantly in equities, the values of which are not directly affected by changes in prevailing market interest rates. In the year to 31 January 2013, the company held no fixed interest securities. The company's policy is to remain substantially fully invested and thus does not expect to hold significant cash balances. The financial assets have minimal exposure to interest rate risk.

The company finances its operations through a mixture of share capital, retained revenue and long term borrowings. Movement in interest rates will not have a material effect on the finance costs and financial liabilities of the company, as presented in the accounts, as all the borrowings of the company are subject to fixed rates of interest.

### (b) Liquidity Risk

Liquidity risk relates to the capacity to meet liabilities as they fall due and is dependent on the liquidity of the underlying assets.

### Maturity of financial liabilities

The table below presents the future cash flows payable by the company in respect of its financial liabilities.

Cash flows in respect of the principal and interest on the Stepped Rate Interest Loan, Fixed Rate Interest Loan and 5.875% Secured Bonds 2029 reflect the maturity dates as set out in note 10 on pages 53 to 55. The loans are each governed by a trust deed and only if the covenants are breached would early repayment be enforced. Therefore their repayment is not considered to be a likely short term liquidity issue. Cash flows in respect of the 4% Perpetual Debenture Stock and 3.65% Cumulative Preference Stock, which have no fixed repayment date, assumes maturity of 20 years from the balance sheet date. Cash flows have not been discounted.

| 2013 | Three months or less £ | Between three months and one year £ | Between one and five years £ | More than five years £ | Total £ |
|---|---|---|---|---|---|
| **Creditors - amounts falling due within one year** | | | | | |
| Finance costs of borrowings | 21,499 | 9,510,471 | - | - | 9,531,970 |
| Other creditors | 3,914,058 | - | - | - | 3,914,058 |
| Derivative financial instruments | 956,913 | - | - | - | 956,913 |
| **Creditors - amounts falling due after more than one year** | | | | | |
| Amounts payable on maturity of borrowings | - | - | 34,034,109 | 74,553,000 | 108,587,109 |
| Finance costs of borrowings | - | - | 38,127,880 | 45,775,960 | 83,903,840 |
| | 4,892,470 | 9,510,471 | 72,161,989 | 120,328,960 | 206,893,890 |

| 2012 | Three months or less £ | Between three months and one year £ | Between one and five years £ | More than five years £ | Total £ |
|---|---|---|---|---|---|
| **Creditors - amounts falling due within one year** | | | | | |
| Finance costs of borrowings | 21,499 | 9,510,471 | - | - | 9,531,970 |
| Other creditors | 843,259 | - | - | - | 843,259 |
| Derivative financial instruments | 291,625 | - | - | - | 291,625 |
| **Creditors - amounts falling due after more than one year** | | | | | |
| Amounts payable on maturity of borrowings | - | - | - | 108,587,109 | 108,587,109 |
| Finance costs of borrowings | - | - | 38,127,880 | 55,307,929 | 93,435,809 |
| | 1,156,383 | 9,510,471 | 38,127,880 | 163,895,038 | 212,689,772 |

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

### Management of liquidity risk

Liquidity risk is not considered to be significant as the company's assets mainly comprise realisable securities, which can be sold to meet funding requirements if necessary. Short term flexibility can be achieved through the use of overdraft facilities, where necessary. As at the 31 January 2013, the company had an undrawn committed borrowing facility of £10 million (2012 - £10 million).

## (c) Credit Risk

Credit risk is the risk of default by a counterparty in discharging its obligations under transactions that could result in the company suffering a loss

### Management of credit risk

Outstanding settlements are subject to credit risk. Credit risk is mitigated by the company through its decision to transact with counterparties of high credit quality. The company only buys and sells investments through brokers which are approved counterparties, thus minimising the risk of default during settlement. The credit ratings of brokers are reviewed quarterly by the investment manager.

The company is also exposed to credit risk through the use of banks for its cash position. Bankruptcy or insolvency of banks may cause the company's rights with respect to cash held by banks to be delayed or limited. The company's cash balances are held by HSBC Bank PLC, rated Aa3 by Moody's rating agency. The directors believe the counterparties the company has chosen to transact with are of high credit quality, therefore the company has minimal exposure to credit risk.

The table below summarises the credit risk exposure of the Company as at 31 January:

| | 2013 £ | 2012 £ |
|---|---|---|
| Debtors | | |
| Accrued income | 1,923,649 | 3,015,885 |
| Other debtors | 27,880 | 31,184 |
| | **1,951,529** | **3,047,069** |
| Cash at bank | 8,660,128 | 13,398,772 |
| | **10,611,657** | **16,445,841** |

### Fair Values of Financial Assets and Financial Liabilities

With the exception of those financial liabilities measured at amortised cost, the financial assets and financial liabilities, are either carried at their fair value or the balance sheet amount is a reasonable approximation of their fair value. The financial liabilities measured at amortised cost including interest on outstanding borrowings due within one year have the following fair values*:

| | 2013 Book value £ | 2013 Fair value £ | 2012 Book value £ | 2012 Fair value £ |
|---|---|---|---|---|
| Stepped Rate Interest Loan | 34,347,837 | 46,795,527 | 34,346,113 | 48,862,727 |
| Fixed Rate Interest Loan | 45,853,415 | 62,613,559 | 46,048,881 | 63,590,059 |
| 5.875% Secured Bonds 2029 | 29,400,432 | 34,507,808 | 29,372,564 | 35,127,308 |
| 4% Perpetual Debenture Stock | 1,388,751 | 950,013 | 1,388,751 | 1,016,707 |
| 3.65% Cumulative Preference Stock | 1,199,499 | 737,738 | 1,199,499 | 789,877 |
| | **112,189,934** | **145,604,645** | **112,355,808** | **149,386,678** |

The net asset value per ordinary share with debt at fair value is 434.1p (2012 - 366.2p).

* The fair value has been derived from the closing market value as at 31 January 2013 and 31 January 2012.

FRS 29 'Financial Instruments: Disclosures' has been expanded to include a fair value hierarchy for the disclosure of fair value measurement of financial instruments.

As at 31 January 2013, the financial assets at fair value through profit and loss of £586,956,504 (2012 - £511,777,930) are categorised as follows:

| | 2013 £ | 2012 £ |
|---|---|---|
| Level 1 | 586,928,535 | 511,749,961 |
| Level 2 | - | - |
| Level 3 | 27,969 | 27,969 |
| | **586,956,504** | **511,777,930** |

Categorisation within the hierarchy has been determined on the basis of the lowest level input that is significant to the fair value measurement of the relevant assets as follows:

Level 1 – valued using quoted prices in active markets.
Level 2 – valued by reference to valuation techniques using observable inputs other than quoted prices included in level 1.
Level 3 – valued by reference to valuation techniques using inputs that are not based on observable market data.

## 18. Capital Management Policies and Procedures

The company's objective is to provide an above average level of income and income growth together with long term capital growth. It invests in high yielding stocks and receives premium income from options.

The Company's capital at 31 January comprises:

| | 2013 £ | 2012 £ |
|---|---|---|
| **Debt** | | |
| Creditors: amounts falling due after more than one year | 110,854,611 | 111,020,979 |
| | **110,854,611** | **111,020,979** |
| **Equity** | | |
| Called up share capital | 25,803,366 | 25,803,366 |
| Share premium account and other reserves | 455,660,803 | 389,221,338 |
| | **481,464,169** | **415,024,704** |
| **Total Capital** | **592,318,780** | **526,045,683** |
| Debt as a percentage of total capital | 18.7% | 21.1% |

The board, with the assistance of the investment manager, monitors and reviews the broad structure of the company's capital on an ongoing basis. The level of gearing is monitored, taking into account the investment manager's view on the market and the future prospects of the company's performance. Capital management also involves reviewing the difference between the net asset value per share and the share price (i.e. the level of share price discount or premium) to assess the need to repurchase shares for cancellation.

The company is subject to several externally imposed capital requirements; the bank borrowings under the overdraft facility are not to exceed £10m, and as a public company the minimum share capital is £50,000. The company's objective, policies and processes for managing capital are unchanged from the preceding accounting period, and the company has complied with them. The terms of the debenture trust deeds have various covenants which prescribe that moneys borrowed should not exceed the adjusted total of the capital and reserves. These are measured in accordance with the policies used in the annual financial statements. The company has complied with these.

# Notes to the Financial Statements *(continued)*

for the year ended 31 January

## 19. Transaction with the Investment Manager and related parties

The amounts paid to the investment manager together with details of the investment management contract are disclosed in note 2. The existence of an independent board of directors demonstrates that the company is free to pursue its own financial and operating policies and therefore, under FRS8: Related Party Disclosures, the investment manager is not considered to be a related party.

The company's related parties are its directors. Fees paid to the company's board are disclosed in the Directors' Remuneration Report on page 38.

There are no other identifiable related parties at the year end, and as of 27 March 2013.

**The Merchants Trust PLC**

# Investor Information

# Investor Information

The company's ordinary shares are listed on the London Stock Exchange. The market price range, gross yield and net asset value are shown daily in the Financial Times and The Daily Telegraph under the headings 'Investment Companies' and 'Investment Trusts', respectively.

## The Manager

Allianz Global Investors is the marketing name of RCM (UK) Limited, which is authorised and regulated by the Financial Services Authority. Allianz Global Investors are active asset managers operating across nineteen markets with specialised in-house research teams around the globe, managing assets for individuals, families and institutions worldwide. As at 31 December 2012, Allianz Global Investors had €304 billion of assets under management worldwide. Through its predecessors, Allianz Global Investors has a heritage of investment trust management expertise in the UK reaching back to the nineteenth century and it had £0.98 billion assets under management in a range of investment trusts as at 31 December 2012.

Website: www.allianzgi.co.uk

## Registered Number

28276

## Financial Calendar

Year end 31 January.

Full year results announced and Annual Financial Report posted to shareholders in April.

Annual General Meeting held in May.

Interim Management Statements announced in May and November.

Half-yearly Financial Report posted to shareholders in September.

## Ordinary Dividends

It is anticipated that dividends will be paid as follows:

| | |
|---|---|
| 1st Quarterly | August |
| 2nd Quarterly | November |
| 3rd Quarterly | February |
| Final | May |

## Preference Dividends

Payable half-yearly 1 February and 1 August.

## Market and Portfolio Information

The company's ordinary shares are listed on the London Stock Exchange. The market price, price range, gross yield and net asset value are shown daily in The Financial Times and The Daily Telegraph. The net asset value of the ordinary shares is calculated daily and published through the London Stock Exchange Regulatory News Service. The geographical spread of investments and ten largest holdings are also published monthly by the London Stock Exchange Regulatory News Service. They are also available from the manager's Investors Helpline on 0800 389 4696 or via the manager's website: www.allianzgi.co.uk/invtrusts.

## Share Price

The share price for 31 January 2013 was 412.7p.

## Website

Further information about the The Merchants Trust PLC, including monthly fact sheets, daily share prices and performance, is available on the manager's website: www.allianzgi.co.uk/invtrusts, which can also be reached via www.merchantstrust.co.uk.

## How to invest

Alliance Trust Savings Limited (ATS) is one of a number of providers offering a range of products and services, including Share Plans, ISAs and pension products. ATS also maintains services including online and telephone-based dealing facilities and online valuations. More information is available from Allianz Global Investors either via Investor Services on 0800 389 4696 or on the manager's website: www.allianzgi.co.uk/invtrusts, or from Alliance Trust Savings Customer Services Department on 01382 573737 or by e-mail: contact@alliancetrust.co.uk.

A list of other providers can be found on the Allianz Global Investors' investment trusts website: www.allianzgi.co.uk/invtrusts.

# Investor Information *(continued)*

## Payment of Dividends Direct to Bank Accounts

Cash dividends will be sent by cheque to first-named shareholders at their registered address together with a tax voucher. Dividends may be paid directly into shareholders' bank accounts. Details of how this may be arranged can be obtained from Capita Registrars. Dividends mandated in this way are paid via Bankers' Automated Clearing Service (BACS). Tax vouchers will then be sent directly to shareholders at their registered address unless other instructions have been given.

## Dividend Reinvestment Plan (DRIP) for Ordinary Shareholders

The registrars offer a DRIP which gives ordinary shareholders the opportunity to use their cash dividend to buy further shares in the company under a low-cost dealing arrangement. Terms and Conditions and a personalised application form are enclosed with each dividend payment.

## Share Dealing Services

Capita Registrars operate both on-line and telephone dealing facilities for UK resident shareholders with share certificates. Stamp duty and commission may be payable on purchases.

For further information on these services please contact: www.capitadeal.com for on-line dealing or 0871 664 0384 for telephone dealing. Lines are open 8.00 a.m. to 4.30 p.m. Monday to Friday. Calls to the 0871 664 0384 number are charged at 10 pence per minute plus any of your service providers' network extras. Different charges may apply to calls made from mobile telephones and calls may be recorded and monitored randomly for security and training purposes.

## The Share Portal

The Capita Registrars offer shareholders a free on-line service called The Share Portal, enabling shareholders to access a comprehensive range of shareholder related information. Through The Share Portal, shareholders can: view their current and historical shareholding details; obtain an indicative share price and valuation; register for e-comms, amend address details; view details of dividend payments; and apply for dividends to be paid directly to a bank or change existing bank details.

Shareholders can access these services at www.capitashareportal.com and selecting Share Portal (shareholders) from the drop down menu, or alternatively via the Portals: Quick Links, and selecting Share Portal. Shareholders will need to register for a Share Portal Account by completing an on-screen registration form. An email address is required.

## Registrars and Shareholders' Enquiries

Capita Registrars, The Registry, 34 Beckenham Road, Beckenham, Kent BR3 4TU are the company's registrars and maintain the share register. In the event of queries regarding their holdings of shares, lost certificates, dividend cheques, registered details, etc., shareholders should contact the registrars on 0871 664 0300 or +44 20 8639 3399 if calling from overseas. Lines are open 8.30 a.m. to 5.30 p.m. (London time) Monday to Friday. Calls to the 0871 664 0300 number are charged at 10 pence per minute plus any of your service providers' network extras. Calls to the helpline number from outside the UK are charged at applicable international rates. Different charges may apply to calls made from mobile telephones and calls may be recorded and monitored randomly for security and training purposes. Capita Registrars can also be contacted by email: ssd.capitaregistrars.com or by facsimile: 020 8639 2342. Their website is www.capitaregistrars.com.

Capita Registrars offer shareholders a free online service called The Share Portal, enabling shareholders to access a comprehensive range of shareholder related information.

# Investor Information *(continued)*

General enquiries about the company should be directed to the Company Secretary, The Merchants Trust PLC, 155 Bishopsgate, London, EC2M 3AD.

Changes of name and address must be notified to the registrars in writing.

Any general enquiries about the company should be directed to the Company Secretary, The Merchants Trust PLC, 155 Bishopsgate, London, EC2M 3AD. Telephone: 020 7065 1513.
Email: kirsten.salt@allianzgi.co.uk

## International Payment Service

Capita Registrars, the company's registrars, operate an international payment service for shareholders, whereby they can elect either for their dividend to be paid by foreign currency draft or they can request an international bank mandate. This service is only available for dividend payments of £10 or more.

The international payment service will generally cost less than the fees charged by local banks to convert shareholders' sterling dividends into local currency. A £5 administration fee per dividend payment applies. Dividends are paid as cleared funds directly into shareholders' bank accounts or sent as a draft.

Capita Registrars, working in partnership with Travelex, will arrange for your dividend to be exchanged into your local currency at competitive rates based on actual market rates.

To use this service you will need to register online at: www.capitaregistrars.com/international or by contacting Capita Registrars as detailed below.

For further information on this service please contact: +44 20 8639 3405 (from outside of the UK) or 0871 664 0385 (in the UK) (Calls cost 10p per minute plus network extras. Lines are open between 9.00a.m. and 5.30p.m., Monday to Friday) or email IPS@capitaregistrars.com.

## CREST Proxy Voting

Shares held in uncertificated form (i.e., in CREST) may be voted through the CREST Proxy Voting Service in accordance with the procedures set out in the CREST manual.

## Association of Investment Companies (AIC)

The company is a member of the AIC, the trade body of the investment trust industry, which provides a range of literature including fact sheets and a monthly statistical service. Copies of these publications can be obtained from the AIC, 9th Floor, 24 Chiswell Street, London EC1Y 4YY, or at www.theaic.co.uk.

AIC Category: UK Growth and Income.

# Investor Information *(continued)*

## Warning to Shareholders

We are aware that some shareholders may have received unsolicited telephone calls or correspondence concerning investment matters. These are typically from overseas based organisations who target UK shareholders offering to sell them what often turn out to be worthless or high risk shares in US or UK investments. They can be extremely persistent and extremely persuasive. Shareholders are therefore advised to be very wary of any unsolicited advice or offers.

Please note that it is most unlikely that either the company or the company's Registrar, Capita Registrars, would make unsolicited telephone calls to shareholders. Any such calls would only ever relate to official documentation already circulated to shareholders and never in respect of investment 'advice'.

If you are in any doubt about the veracity of an unsolicited telephone call, please call either the Company Secretary or the Registrar on the numbers provided above.

# Notice of Meeting

Notice is hereby given that the annual general meeting of The Merchants Trust PLC will be held at Holborn Bars, 138-142 Holborn, London EC1N 2NQ on Friday 10 May 2013 at 12 noon to transact the following business.

## Ordinary Business

1 To receive and adopt the Directors' Report and the Financial Statements for the year ended 31 January 2013 together with the Auditor's Report thereon.

2 To declare a final dividend of 5.8p per ordinary share.

3 To re-elect Simon Fraser as a director.

4 To re-elect Mike McKeon as a director.

5 To re-elect Henry Staunton as a director.

6 To re-elect Paul Yates as a director.

7 To approve the Directors' Remuneration Report.

8 To re-appoint PricewaterhouseCoopers LLP as Auditor of the company, to hold office until the conclusion of the next general meeting at which financial statements are laid before the company.

9 To authorise the directors to determine the remuneration of the Auditor.

## Special Business

To consider and if thought fit to pass the following resolutions. Resolutions 10 and 11 will be proposed as ordinary resolutions and resolutions 12, 13 and 14 as special resolutions:

10 That the limit on aggregate fees payable to the directors be increased from £150,000 to £200,000.

11 That for the purposes of section 551 of the Companies Act 2006 the directors be generally and unconditionally authorised to exercise all the powers of the company to allot relevant securities (within the meaning of the said section) up to a maximum number of 34,404,488 ordinary shares provided that:

(i) the authority granted shall expire one year from the date upon which this resolution is passed but may be revoked or varied by the company in general meeting and may be renewed by the company in general meeting for a further period not exceeding one year; and

(ii) the authority shall allow and enable the directors to make an offer or agreement before the expiry of that authority which would or might require relevant securities to be allotted after such expiry and the directors may allot relevant securities in pursuance of any such offer or agreement as if that authority had not expired.

12 That the directors be empowered in accordance with section 570 of the Companies Act 2006 (the Act) to allot equity securities (within the meaning of section 560 of the Act) for cash pursuant to the authority conferred by resolution 11 as if sub-section (1) of section 561 of the Act did not apply to any such allotment provided that:

(i) the power granted shall be limited to the allotment of equity securities wholly for cash up to a maximum number of 10,321,346 ordinary shares;

(ii) the power granted shall (unless previously revoked or renewed) expire at the conclusion of the next annual general meeting of the company after this resolution is passed, or 10 August 2014 if earlier; and

(iii) the said power shall allow and enable the directors to make an offer or agreement before the expiry of that power which would or might require equity securities to be allotted after such expiry and the directors may allot equity securities in pursuance of such offer or agreement as if that power had not expired.

13 That the company be and is hereby generally and unconditionally authorised in accordance with section 701 of the Companies Act 2006 (the Act) to make market purchases (within the meaning of section 693(4) of the Act) of ordinary shares of 25p each in the capital of the company (ordinary shares), provided that:

(i) the maximum number of ordinary shares hereby authorised to be purchased shall be 15,471,698;

(ii) the minimum price which may be paid for an ordinary share is 25p;

(iii) the maximum price which may be paid for an ordinary share is an amount equal to 105% of the average of the middle-market quotations for an ordinary share taken from the London Stock Exchange Official List for the five business days immediately preceding the day on which the ordinary share is purchased or such other amount as may be specified by the London Stock Exchange from time to time;

# Notice of Meeting *(continued)*

(iv) the authority hereby conferred shall expire at the conclusion of the annual general meeting of the company in 2014 or, if earlier, on the expiry of 15 months from the passing of this resolution, unless such authority is renewed prior to such time; and

(v) the company may make a contract to purchase ordinary shares under the authority hereby conferred prior to the expiry of such authority which will or may be executed wholly or partly after the expiration of such authority and may make a purchase of ordinary shares pursuant to any such contract.

14 That the Articles of Association set out in the document produced to this meeting and signed by the Chairman of the meeting for the purposes of identification be and are hereby approved and adopted as the Articles of Association of the company in substitution for and to the exclusion of the existing Articles of Association of the company.

*155 Bishopsgate, London, EC2M 3AD*
*27 March 2013*

*By order of the Board*
*Kirsten Salt*
*Company Secretary*

**Notes:**

1. Members entitled to attend and vote at this meeting may appoint one or more proxies to attend, speak and vote in their stead by completion of a personalised form of proxy. Full details on how to complete the form of proxy are set out on the form of proxy. The proxy need not be a member of the company.

2. A proxy must vote in accordance with any instructions given by the member by whom the proxy is appointed. A proxy has one vote on a show of hands in all cases (including where one member has appointed multiple proxies), except where he is appointed by multiple members who instruct him to vote in different ways, in which case he only has one vote for and one vote against the resolution.

3. A personalised form of proxy is provided with the Annual Financial Report. Any replacement forms must be requested direct from the registrar.

4. Completion of the form of proxy does not exclude a member from attending the meeting and voting in person.

5. Duly completed forms of proxy must reach the office of the registrars at least 48 hours (excluding non-business days) before the meeting.

6. Shares held in uncertificated form (i.e., in CREST) may be voted through the CREST Proxy Voting Service in accordance with the procedures set out in the CREST manual on the Euroclear website (www.euroclear.com/CREST).

7. To be entitled to attend and vote at the meeting (and for the purpose of determination by the company of the number of votes they may cast), members must be entered on the company's Register of Members by close of business on Wednesday 8 May 2013 (the record date).

8. If the meeting is adjourned to a time not more than 48 hours after the record date applicable to the original meeting, that time will also apply for the purpose of determining the entitlement of members to attend and vote (and for the purpose of determining the number of votes they may cast) at the adjourned meeting. If, however, the meeting is adjourned for a longer period then, to be so entitled, members must be entered on the company's Register of Members at the time which is 48 hours before the time fixed for the adjourned meeting or, if the company gives new notice of the adjourned meeting, at the record date specified in that notice.

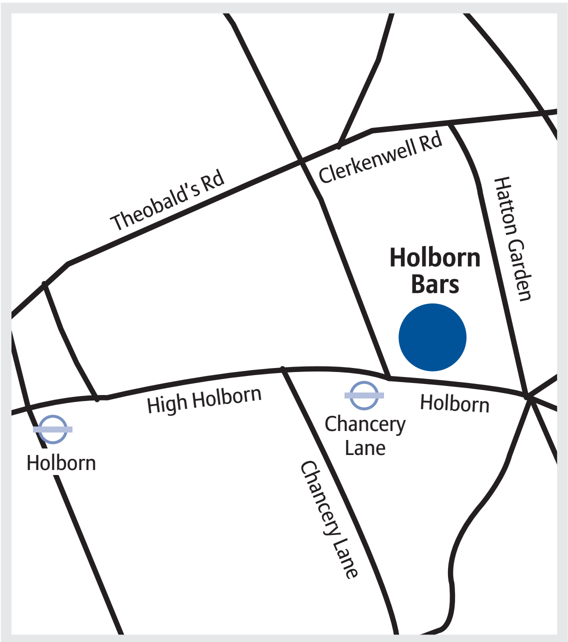
9. The right to appoint a proxy does not apply to persons whose shares are held on their behalf by another person and who has been nominated to receive communications from the company in accordance with section 146 of the Companies Act 2006 (nominated persons). Nominated persons may have a right under an agreement with the registered shareholder who holds the shares on their behalf to be appointed (or to have someone else appointed) as a proxy. Alternatively, if nominated persons do not have such a right, or do not wish to exercise it, they may have a right under such an agreement to give instructions to the person holding the shares as to the exercise of voting rights. Nominated persons should contact the registered member by whom they were nominated in respect of these arrangements.

10. Corporate representatives are entitled to attend and vote on behalf of the corporate member in accordance with section 323 of the Companies Act 2006. Pursuant to the Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632), multiple corporate representatives appointed by the same corporate member can vote in different ways provided they are voting in respect of different shares.

# Notice of Meeting *(continued)*

11. Members have a right under section 319A of the Companies Act 2006 to require the company to answer any question raised by a member at the AGM, which relates to the business being dealt with at the meeting, although no answer need be given (a) if to do so would interfere unduly with the preparation of the meeting or involve disclosure of confidential information; (b) if the answer has already been given on the company's website; or (c) it is undesirable in the best interests of the company or the good order of the meeting.
12. Members satisfying the thresholds in section 527 of the Companies Act 2006 can require the company, at its expense, to publish a statement on the company website setting out any matter which relates to the audit of the company's accounts that are to be laid before the meeting. Any such statement must also be sent to the company's auditor no later than the time it is made available on the website and must be included in the business of the meeting.
13. As at 27 March 2013, the latest practicable date before this notice is given, the total number of ordinary shares and preference stock in the company in respect of which members are entitled to exercise voting rights was 103,213,464 ordinary shares of 25p each and 1,178,000 3.65% Cumulative Preference Stock of £1 each. Each carries the right to one vote and therefore, the total number of voting rights in the company is 104,391,464.
14. Further information regarding the meeting which the company is required by section 311A of the Companies Act 2006 to publish on a website in advance of the meeting (including this notice), can be accessed at www.merchantstrust.co.uk.
15. Contracts of service are not entered into with the directors, who hold office in accordance with the Articles of Association.

**Annual General Meeting venue**



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