



Fidelity China Special Situations



FCSS multi-cap approach could capture China’s stimulus-led rally...

Overview

Update
26 February 2025

Dale Nichols, manager of Fidelity China Special Situations (FCSS), has built a portfolio of equities from across China’s market-cap spectrum, as well as some unlisted holdings, to capture the diverse range of growth opportunities from one of the world’s largest economies.

The Chinese market has undergone a period of notable volatility recently. However, Dale argues the recently announced raft of stimulus measures has put an effective floor on the market and is an acknowledgement by the government of some of the issues the country is facing, as well as providing solutions to addressing them. These announcements have had a significant impact on **Performance** over the past few months. Meanwhile, Dale continues to be focussed on stock-specific factors, which has contributed to significant outperformance over the long term. Recent market moves have led him to take profits from some of his best-performing stocks and rotate into better value ideas elsewhere (see **Portfolio**).

Whilst macro has dominated the headlines, Dale points to improving total shareholder returns as companies increase dividends and buybacks as a positive fundamental factor. This has helped support the **Dividend** growth of the trust, which has increased every year since inception.

The trust has recently changed its approach to **Gearing**, with the board deciding to solely use CFDs for the time being. This has been done to help keep borrowing costs down and improve flexibility. These also allow the manager to take short positions in companies he believes will fall, further adding to the alpha-generating opportunities.

Analyst’s View

The recent stimulus announcement by the Chinese government has significantly changed the outlook for the country in our opinion. After several challenging years, the Chinese government has taken steps to address its key problems on issues such as property, local government debt, and economic growth (see **Portfolio section**). Whilst these may not have met the lofty expectations of some market participants, we believe they greatly improve the country’s outlook. As the largest trust focussed on China, and with an approach of identifying growth opportunities from a diverse range of sources, from household names to unlisted companies, we believe FCSS is well positioned to capture a potential recovery.

The upside potential could be further enhanced by the trust’s high level of structural **Gearing**. Whilst down slightly from the highs at the beginning of 2024, the current level of c. 20% is still significant and therefore poses a potential risk, it would likely support performance should markets rally.

Despite the arguably improved outlook, the **Discount** on the trust has widened in the past few months. The current level of 9.9% is wider than the five-year average and has only been wider in periods of extreme stress such as the first COVID outbreak and the peak ‘zero-COVID’ worry. One potential reason behind this is concerns over the impact of incoming President Trump’s tariffs. However, Dale argues these are unlikely to be as bad on the ground as investors fear. If so, the discount could arguably provide an attractive entry point and allow investors to benefit from mean reversion as well as a potential turnaround in the Chinese economic story.

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BULL

Recent stimulus measures could reverse the economic slowdown and restore growth

Trust has outperformed peers and index over the long term from good stock selection

The current discount is wider than average despite improving macro-outlook

BEAR

Stimulus measures are not a guaranteed fix, with tariffs also a potential headwind

Gearing can amplify losses as well as upside potential

Most recent dividend required reserves to meet growth target

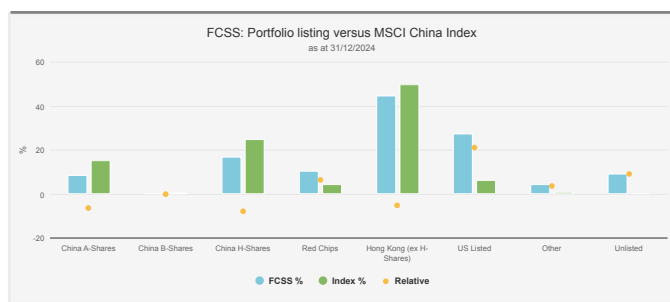


Portfolio

Fidelity China Special Situations (FCSS) owns a portfolio of equities designed to capture the wide range of growth opportunities within China. Manager Dale Nicholls can invest across a broad spectrum of companies including small- and mid-caps, as well as established household names in the country such as Alibaba and Tencent. He has the flexibility to invest in companies wherever they are listed, whether that be mainland China or beyond, so long as the company is set to benefit from the multiple growth opportunities of the country, such as the growing wealth and spending of the Chinese consumer.

Dale can also invest in unlisted companies which we believe helps differentiate the trust from both peers and the benchmark, the MSCI China Index, as well as providing the manager an even wider array of growth opportunities to choose from. We have shown the current split of company listings below. We have explained some of the differences in these markets in a [previous article](#).

Fig.1: Market Listing



Source: Fidelity

In the past year, the Chinese market has undergone a significant change in backdrop. A series of policy stimulus measures announced in September 2024 have led to a sharp market rally. These have been designed to alleviate some of the key issues facing the market and lead to a recovery in economic growth. These measures include an interest rate cut, reductions in mortgage rates, support for local government debt, and incentives for share buybacks. Dale notes these measures have been well coordinated across different departments and are centred on tackling the major issues facing the country, such as deflation and falling property prices, as well as concerns over local government debt.

Dale believes that creating consumer confidence will be key to the success of these measures, and this will come with house price stability. There are tentative signs this is beginning though the measures are early in their implementation.

The manager's active approach when it comes to identifying stocks and constructing the portfolio, and

the support of a wide range of analysts, has helped with the decision-making in this period. That being said, Dale continues to employ a bottom-up process, and therefore the major over- and underweight sectors have had limited change since the beginning of 2024.

Dale has been adding to the industrial sector, which is overweight, although remains quite diversified by subsector. One example is Tuhu Car, China's leading auto maintenance franchise. The company is consolidating an otherwise fragmented industry and implementing technology across the business to improve efficiency. This includes allowing customers to book and monitor their repairs through an app as well as ordering new parts. This has led to high customer loyalty and therefore pricing power.

Whilst Tuhu offers domestic growth, elsewhere, Dale has identified some industrial firms seeing increasing demand internationally, especially from emerging markets. The trust now has a notable allocation to the machine manufacturers subsector. This includes those manufacturing precision equipment for the likes of the aerospace and medical industries such as Precision Tsugami China. Despite being a leader within its niche and a strong reputation for accuracy, the stock continues to be cheaply valued at a PE ratio of c. 7x, with a dividend yield of over 7%. This is arguably indicative of the low valuations seen across China as a result of negative sentiment from investors over a number of years.

Dale has also added to the healthcare sector, following some weakness which we have discussed in [Performance](#). The exposure has mostly been taken through firms that sell medical equipment, as they are less sensitive to economic performance, and valuations are particularly compelling following a sell-off after a regulatory crackdown. Despite this now being over, valuations remain attractive which Dale has been looking to capture. The sector is also set to be a long-term beneficiary of increasing demand for treatments.

Low valuations have also led the manager to add to consumer-exposed companies. As mentioned above, negative headlines over consumer sentiment have affected share prices though Dale does not believe these reflect fundamentals. One example is the education sector. This endured a significant crackdown in 2021, though a number of companies have survived this and have therefore captured market share.

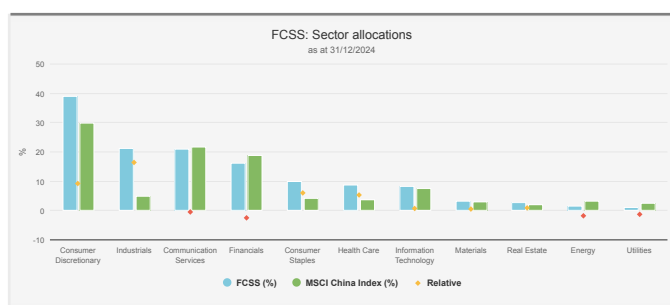
Other examples include game developer NetEase which has a good track record of successful releases, though often sells off ahead of them. Dale is particularly encouraged by the upcoming project slate, leading to an addition to the company on a bottom-up basis. Also



identified on a bottom-up basis has been Mao Geping Cosmetics which IPO'd late in 2024. This is a so-called local champion that has been taking share from Western equivalents and tapping into the growing wealth of Chinese consumers. This is also one example of the bias towards domestic spending, which now makes up around 80% of the portfolio.

As a result of the considerable **Gearing** in the trust, the portfolio has many overweight sector allocations compared to the benchmark, the MSCI China Index. The largest of these are industrial, health care, and consumer discretionary, which the recent additions will have contributed to. The underweight sectors of communications, energy, and utilities are considered 'old economy' sectors with limited growth potential.

Fig.2: Sector Allocations



Source: Fidelity

To fund the new purchases, the manager has sold his best-performing stocks to take profits. One example includes one of the country's leading aluminium producers China Hongqiao. Shares are up significantly on the year on the

back of a recovery in the aluminium price, though as this eased back, the manager trimmed the position and took some profits.

The disposal in financial companies follows a similar trend, having trimmed one of the portfolio's top contributors LexinFintech (see **Performance**), as well as insurance firm China Life, and China Merchants Bank, one of the portfolio's few bank stocks, which rallied on stimulus hopes. The manager has also sold ERA Co, an industry-leading manufacturer of PVC pipes. Despite an improvement in the outlook for the property sector, Dale believes ERA's high exposure could be a drag.

Dale notes that he is finding plenty of very good value opportunities in the market and, therefore is maintaining his price discipline by selling the best performers and rotating the profits into better value opportunities elsewhere.

There has been a change in the proportion of unlisted holdings following the IPO of Pony.ai which has started well on its nascent listed journey. The holding remains a top-ten position, as does another unlisted holding, ByteDance, the parent company of TikTok. This was added to a period of secondary trading in the past year. The company has attracted attention ahead of a proposed US ban, though the election of President Trump could change this. Either way, Dale highlights the US is only 10% of the user base and the company continues to grow elsewhere. The company is in a 3.6% position, and along with the other unlisted holdings such as Venturous Holdings, continues to provide a diverse range of growth opportunities from China.

Top-Ten Holdings

COMPANY	SECTOR	LISTED/UNLISTED	FCSS (%)	INDEX (%)	RELATIVE WEIGHT
Tencent	Communication Services	Listed	13.0	16.4	-3.3
Ping An insurance	Financials	Listed	4.8	2.1	2.7
PDD	Consumer Discretionary	Listed	4.0	3.2	0.9
Alibaba	Consumer Discretionary	Listed	3.8	8.1	-4.3
ByteDance	Communication Services	Unlisted	3.4	0.0	3.4
Pony.ai	Consumer Discretionary	Listed	3.1	0.0	3.1
Hesai Group	Consumer Discretionary	Listed	3.0	0.0	3.0
Meituan	Consumer Discretionary	Listed	2.8	4.5	-1.8
Crystal International	Consumer Discretionary	Listed	2.4	0.0	2.4
Venturous Holdings	Financials	Unlisted	2.3	0.0	2.3
Total			42.6		

Source: Fidelity, as at 31/12/2024

Gearing

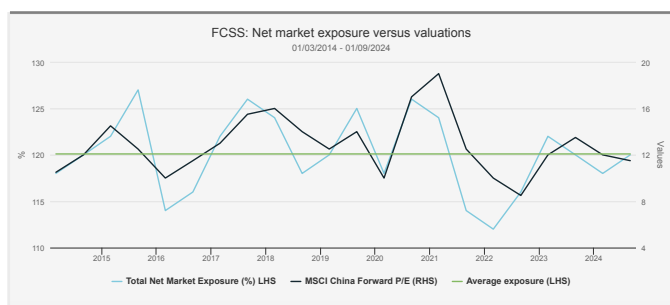
Dale has authority from the board to use gearing in order to enhance the long-term returns on offer from the significant number of growth opportunities within China. Gearing is viewed as one of the key benefits of investment trusts and is therefore likely to be a structural feature of FCSS.

Previously, Dale has had access to both CFDs and a loan facility. However, the latter of these expired in February 2024 and was not renewed leaving CFDs as the sole source of gearing for the time being. CFDs are financial instruments that allow the manager to take more exposure than the amount invested and can also be used to take short positions in stocks. These previously accounted for around two-thirds of the gearing and have been as high as 100% as they were more cost-effective. The board has stated it is open to a new fixed-term facility in the future should interest costs become more competitive.

Net gearing has typically ranged between 110% and 125%, though the board now permits Dale to take net exposure up to 120%, down from the previous 130%. The level of gearing will be determined by the number of opportunities Dale has identified, as well as valuations. The current level, as of 31/12/2024 is 119.9% approximately in line with the 120% average of the past few months. This is a result of the volatility in China (see **Performance**). Gross exposure, which includes short positions, is 122.6%.

In the chart below, we have shown the estimated level of net market exposure versus the forward PE ratio of the Chinese market to show how gearing and market valuations are connected.

Fig.3: Gearing



Source: Fidelity

Performance

Dale's bottom-up approach means that stock selection will likely have a significant impact on long-term relative performance. Furthermore, the bias towards small- and mid-caps, as well as a notable allocation towards private companies, brings the potential to outperform, though smaller companies can often exhibit higher volatility.

Whilst Dale is focussed on bottom-up factors, the macro situation in China has been difficult to ignore over the past few months and we believe it is important to consider the wider macro story when evaluating FCSS's performance. As we have discussed in **Portfolio**, the country continued to face headwinds for most of 2024 due to ongoing low consumer sentiment, mostly stemming from property sector weakness, which had led to a downturn in equity markets. However, the introduction of a raft of stimulus measures by the government in the third quarter of 2024 led to a strong market rally and an improvement in the outlook.

After the stimulus didn't quite match expectations, and amidst concerns about the impact of the US election result, the rally has faded slightly, though both FCSS and the index have delivered handsome positive returns over in the past year of 34.6% (in NAV terms) and 37.2% respectively. As such, this has contributed to a five-year return of 13.2% for FCSS, far in excess of the MSCI China, for which we have used an ETF as a proxy, which has delivered a negative return of 7.1%.

Fig.4: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Whilst the stimulus measures have been broadly positive for the market, Dale believes more is needed to have a prolonged effect, including more direct consumer support. Unemployment, for example, remains an issue. However, the current measures have demonstrated the government has recognised the issues facing the economy and taken steps to address these which is an important step, and Dale argues has put a floor on the market. The impact may take some time to cause meaningful growth, but Dale continues to focus on companies that are taking market share, showing pricing power and can expand overseas to help drive growth and share price performance.

Growth stocks are one area in particular that has benefitted from the stimulus-led rally. This includes Tencent which owns a range of internet companies ranging from video games to messaging to fintech. The stock is up over 50% in the twelve months to 10/02/2025 which includes a sharp rally of over 20% at the end of September though it subsequently fell back. This has helped FCSS in



absolute terms as the largest portfolio constituent, though on a relative basis, its large weight in the benchmark has been a headwind.

Despite the considerable macro influence, stock selection has continued to be the primary performance driver. One example is Crystal International which manufactures clothes for the likes of Lululemon and Nike. The stock had been impacted by weak sentiment earlier in 2024 but rallied significantly later in the year and contributed over 116bps to NAV in the calendar year to 30/11/2024, as a result of the 2.7% off-benchmark position. The manager points to an increase in automation which is supporting positive free cash flow and an attractive 6% yield as reasons to continue owning the company.

Another example is white goods manufacturer Hisense Home Appliances. The company has been increasing its market share in overseas markets, such as through sales of air-conditioning units across Asia. The position, a 2.2% off-benchmark holding, added c. 62bps in the 12 months to 30/11/2024.

However, whilst there were some highlights, the consumer discretionary sector more broadly was a detractor to performance due to the underweight allocations to the likes of the e-commerce and internet names. There have also been some stock selection issues, such as the manager's preference of PDD to Meituan, though Dale has since added to the latter.

The trust's financial holdings have been positive to performance, particularly the consumer finance names. The first and third biggest contributors to performance in the 12 months to 30/11/2024 were LexinFintech and Qifu Technology respectively, both of which have performed well as sentiment has improved in the sector. Despite both stocks having significant rallies in 2024, both up over 150%, they remain small-caps and small parts of the index. As such, these two companies have produced significant alpha for performance and contributed to financial holdings being the largest positives to performance on a stock-selection basis. However, the manager's preference for insurance companies over the likes of the large, often state-owned banks, has detracted from relative performance, after banks rallied significantly on the back of the stimulus measures.

One other factor affecting China's outlook is the prospect of further tariffs following the re-election of President Trump. Dale believes the negativity recently seen in markets won't be reflected in the underlying businesses' performance though, as businesses have been dealing with tariffs in some form since 2018 and have found ways to mitigate them. The percentage of US earnings in the portfolio is only about 6% therefore Dale believes the

impact will be felt more in sentiment than fundamentals, and that there could be some opportunities as manufacturing bases and supply chains get rerouted.

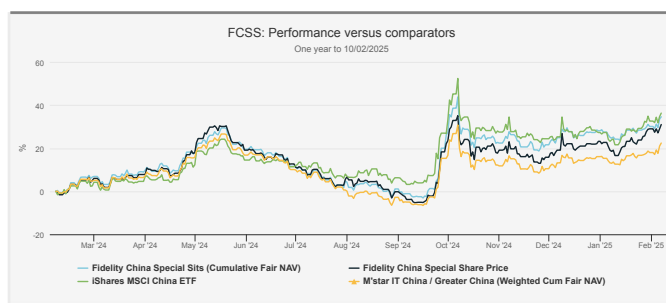
That being said, US regulations have had a notable impact on the Chinese biotech sector through the 2024 Biosecure Act which prevents companies associating with foreign adversaries (of which China is considered) from receiving Federal funds. Whilst this has detracted from performance through the holding of WuXi AppTec, the decision not to hold WuXi Biologics was beneficial and mostly offset this. Dale remains positive on the outlook for the sector due to the regulatory issues likely to lead to an increase in R&D and therefore innovation which should be beneficial over the long term.

One idiosyncratic factor that has affected near-term performance has been the autonomous driving company pony.ai. This was an unlisted holding before its IPO in November 2024. The manager had reduced the valuation before its listing due to slightly weaker than expected revenue, meaning over the course of the year to 30/11/2024, the position is the largest detractor to performance. However, shares are up c. 7.5% since IPO (to 10/02/2025) and the stock has delivered a 40% cumulative return since the trust's first investment.

The significant changes in the investment backdrop have altered the outlook for China significantly. Dale believes the stimulus has effectively put a floor on the market, and that a pickup in corporate activity is supporting the upside potential, which is also supported by very attractive valuations, underpinned by good total shareholder returns from dividends and share buybacks.

This environment has led to positive absolute returns from the market in the past year, although as we have shown in the chart below, FCSS has underperformed on a relative basis due to the strongest rallies coming from the likes of state-owned banks. We have also shown the share price performance in the chart below which has lagged the NAV recovery, as we have discussed in [Discount](#).

Fig.5: One-Year Performance



Source: Morningstar

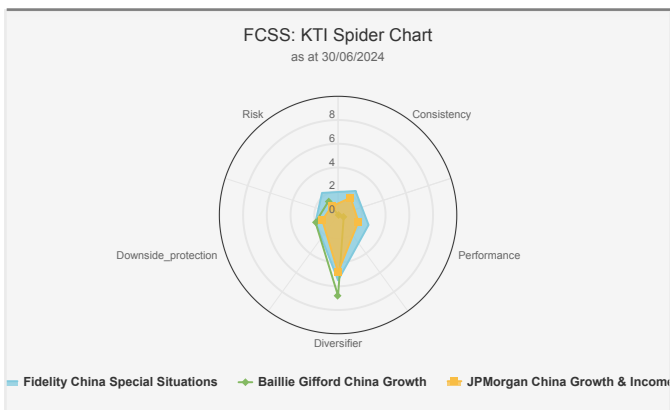
Past performance is not a reliable indicator of future results.



Our proprietary KTI Spider Chart is shown below. This shows how FCSS has performed versus a wider peer group of 22 global emerging market investment trusts over the past five years, in some key categories. Each category is scored out of ten and scores are normalised to the peer group, with a higher score indicating a superior characteristic.

FCSS scores above average as a diversifier. This has been supported by above-average scores for correlation versus equity indices and bond indices which we would expect following the idiosyncratic behaviour of the Chinese market versus wider emerging markets in the past five years. The other four scores are below average, with the lowest being downside protection which we would again attribute to the weakness in the Chinese market, especially versus the likes of India, which is included in the wider peer group, in the past couple of years. In the chart below, we have compared FCSS’s scores versus the two other China-focussed investment trusts, with FCSS outperforming in almost all metrics. We believe this reinforces the view that the wider China difficulties are the primary factor behind the challenging scores, rather than the trust itself.

Fig.6: KTI Spider Chart



Source: Morningstar

Past performance is not a reliable indicator of future results.

Dividend

Whilst Dale is primarily focussed on capital growth, FCSS has a strong dividend growth track record, having grown the dividend every year since inception in 2010 at a compound annualised rate of 25.8%. This has earned the trust a place on the AIC’s “next generation of dividend heroes” list with 13 years of consecutive dividend increases.

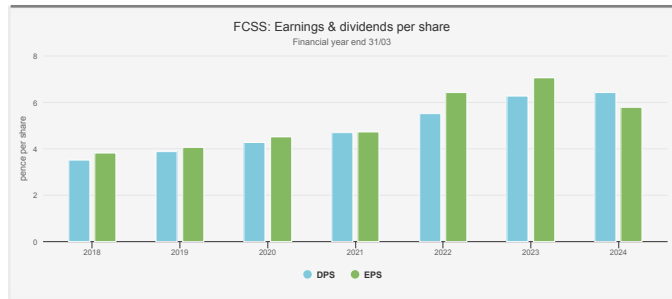
As we have discussed in the **Portfolio section**, Dale has a bias towards small- and medium-sized companies which are typically earlier in the growth journey, therefore use

additional cash to reinvest in the business rather than to pay dividends to shareholders. The trust also has a notable weight to private companies which are unlikely to generate revenue for the trust.

For the most recent financial year, ending 31/03/2024, the trust announced a dividend of 6.4p per share, offering a historic yield of 2.4% as of 07/02/2025. This was an increase of 2.3% on the previous year’s amount, although above the 5.78p per share of revenue generated though, which was impacted by the higher cost of gearing. As such, the trust utilised its revenue reserves to pay the dividend. The remaining reserves total 3.78p per share.

However, whilst the dividend was not covered in the past financial year, Dale notes that investment income has been particularly strong more recently as many firms, notably the large internet companies, have significantly increased their shareholder returns by way of dividends and share buybacks. One contributing factor towards this has been government support which has encouraged firms to up their dividends to make the market more attractive for overseas investors. As such, we understand the underlying income picture for the next financial year is more supportive, although the trust has reserves to use if needs be.

Fig.7: EPS & DPS



Source: Fidelity

Management

Dale Nicholls has been managing FCSS for over ten years, having taken over management from Anthony Bolton, the trust’s first portfolio manager, in April 2014. Dale worked with Anthony for some months before taking over full management responsibilities. He has 29 years of investment experience and also manages the open-ended Fidelity Funds Pacific Fund. This gives him a regional perspective on the markets, which should be helpful in building a picture of the competitive position of companies in China.

Dale spends much of his time speaking to management teams and competitors of companies in which he invests or may choose to invest, engaging with hundreds of



companies each year. He began his career with Fidelity in 1996, working in the Japanese equity analyst team and covering various sectors. Dale was promoted to portfolio manager for the FF Pacific Fund in 2003 and portfolio manager for the FF Asian Smaller Companies Fund in 2011. He is based in Hong Kong and draws on the work of 24 dedicated Greater China analysts based in Shanghai and Hong Kong, as well as their regional colleagues and one dedicated China small-cap analyst.

Discount

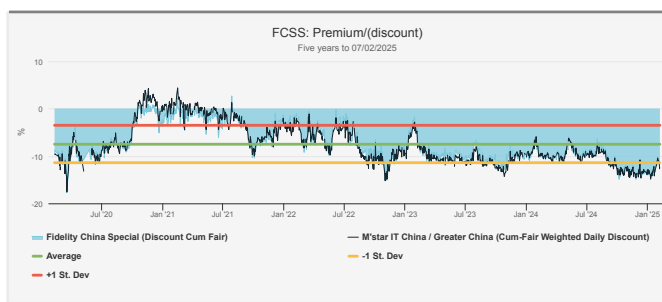
The discount to NAV of FCSS' shares has been volatile in the past five years, reflecting the changing sentiment to China. The trust traded close to NAV and occasionally at a premium in 2021 as China's zero-COVID policy initially looked to have benefitted the economy. However, as the vaccine rollout allowed other economies to reopen, this approach proved a drag on China's economic performance and the discount began to widen out. As such, the trust has been fairly volatile over the past five years, ranging from a 2.7% premium to a 17.7% discount, with a standard deviation of 3.8.

The discount level has widened notably in the second half of 2024 and now stands at 9.9%, wider than the five-year average of 7.5%. We note the discount began widening soon after the market rallied on stimulus hopes, with the trust's share price failing to keep up with the strong NAV performance. The current discount level has only been troubled on occasions such as the initial COVID sell-off, and the peak of the zero-COVID concern in late 2022. As such, we believe the current discount could prove an attractive entry point. Not only could shareholders benefit from an element of mean reversion, but the stimulus-infused market recovery could begin to entice investors back to the Chinese market.

That being said, the election of Donald Trump on a campaign of high tariffs for China could also be contributing to the recent widening of the discount. However, as we have discussed in **Performance**, Dale believes their impact may not be as bad as feared.

The board has been active in trying to narrow the discount through share buybacks, which have been one of the biggest purchases of the trust in the past year. Their policy is to keep the discount in single digits. In the most recent financial year, to 31/03/2024, the board bought back c. 21.7m shares equivalent to 3.5% of issued share capital. In the period since, a further 20.7m shares, or 3.4%, have been bought back.

Fig.8: Discount



Source: Morningstar

Charges

As the largest trust in the AIC China/Greater China sector by some way, FCSS has a charges structure in place that is designed to pass on the benefits of economies of scale to shareholders, as well as having a variable element to further align the interests of management with shareholders.

The current structure was adopted in July 2023, following the merger with ACIC, whereby management fees are charged at 0.85% for the first £1.5bn of net assets, and then 0.65% above this. According to JPMorgan Cazenove, as of 20/12/2024, net assets were £1.1bn.

These fees are variable by 20 basis points depending on performance, meaning the first tier can range from 0.65% to 1.05%. The variable element of the fee increases or decreases by 0.033% for each percentage point of the three-year NAV per ordinary share outperformance or underperformance of the MSCI China Index and is calculated daily. According to the latest factsheet, as of 30/11/2024, the trust had an ongoing charge of 0.88%, which included a 0.18% reduction from the variable element.

Following regulatory changes to cost disclosure rules, **discussed here**, FCSS has not declared a KID RIY in its most recent publication of the document dated 20/11/2024. We note that there are imminent changes due that mean the methodology behind this figure could change.

ESG

ESG considerations are embedded in the investment process, primarily through the implementation of the Fidelity Proprietary Sustainability Rating. This is a forward-looking and holistic assessment of a company's ESG risks and opportunities, based on specific indicators appropriate for companies, depending on the subsector they are located in. Additionally, analysts produce a



Climate Rating, which captures their assessment of which companies are in the best position to transition to net zero, or which have a positive trajectory towards transition. The responsibility falls first on the analysts working on the business fundamentals, but they are supported by a Sustainable Investing Team responsible for consolidating the approach to ESG firm-wide and who assist with ongoing engagement. Managers can also consider external ratings before internal ratings are available, but the internal ratings are ultimately relied upon. Dale is not prohibited from investing in companies which score poorly, but he does have to justify the ESG ratings and carbon footprint of the portfolio in the quarterly fund reviews with Fidelity's CIO, alongside investment risks, such as beta, tracking error, and any concentrated positions.

FCSS scores above average on Morningstar's Sustainability Rating though we note that only c. 69% of the portfolio is covered by their ratings largely due to Dale's bias towards small- and mid-size companies, as well as the private companies in the portfolio.



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