

**Treasury Performance Review and Strategy**

**July 2016**

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1. Treasury Performance Review

**Liquidity and cash balance**

* 1. As at the end of the year;
* Cash balance held in instant access accounts amounted to £3 million.
* £5 million had been placed in term deposits with maturities of up to 3 months
* Available loan facilities (from Santander) with security in place capable of being drawn at short notice amounted to £20 million
  1. The cash balance at £8 million was well above the minimum of £2 million required by the Treasury Policy.

**New financing and refinancing**

* 1. A new loan facility of £17 million was signed with AHF in March 2016. This facility is funded by the European Investment Bank and allows for drawings on or before 31 December 2017 on either a fixed or variable rate basis.
  2. Property was identified and put in charge in April 2016 to fully secure the facility so that it would be available for drawing at a time and on a basis to be agreed by the Board.
  3. A drawdown notice has now been issued for the full amount of the facility. The interest rate was fixed at 1.72%

**Interest rate management**

* 1. No new interest rate derivatives were entered into during the course of the financial year.
  2. As at the 31st March 2016, 54% pf the portfolio was hedged by way of a combination of embedded fixed rate loans and stand-alone hedges (26%). The weighted average maturity of hedged debt was 23 years.
  3. The weighted average cost of embedded hedging was 4.17% at the year end. The repayment of some older high fixed rate loans and the drawdown of the low fixed rate EIB loan will reduce this to 3.19% going forward.
  4. The Mark to Market exposure of Hexagon to stand alone derivatives at the end of the financial year was as set out in the chart below;



* 1. Following the referendum held on the 24th June, swap rates fell sharply resulting in a large increase in mark to market exposures. This is shown in the table below.

**Estimated mark to market exposure as at the 30/06/16.** 

**Counterparty risks**

* 1. In the current uncertain economic environment further falls in swap rates cannot be ruled out. There is therefore a risk that the mark to market exposures under the existing swap portfolio will increase. In the event that market rates for each of the above instruments falls to 0% we estimate that the mark to market exposure would increase to £43.3 million.
  2. As at the end of the financial year the counterparty risk of Hexagon was as follows;

|  |  |  |
| --- | --- | --- |
| **Counterparty** | **Exposure** | **Type of exposure** |
| Santander | £20 million | Undrawn facility |
| NatWest | £3,000,000 | Instant access account |
| Bank of Scotland | £3,000,000 | Term deposit |
| Clydesdale bank | £2,000,000 | Term deposit |

**Prevention of fraud and error**

* 1. Policies for the prevention of fraud or error set out in the Treasury Management have been in operation throughout the year. There have been no treasury-related incidents to report to the Audit & Risk Committee.

**Value for money**

* 1. The average weighted interest rate was 3.25% for 2015/16. This is less than the Value for Money target of 3.74% in the Association’s VFM Strategy. Hexagon has compared average weighted interest rates for 15/16 with its L8 peer group and has achieved the second-lowest interest rate of the 7 associations who contributed their data.

1. Review of current loan portfolio
   1. Hexagon has the following loan arrangements in place [as at 30/06/16];



* 1. A number of the very first private finance deals such as Orchardbrook, THFC and HSL are approaching maturity. These are typically high fixed rate but relatively small value loans. Repayment will result in some small reduction in the average weighted cost of funds.
  2. The remaining bank and building society loans were all arranged before the 2008 financial crisis and benefit from very low credit margins. The anticipated lower for longer variable interest rate environment combined with the low margins will benefit Hexagon so long as rates continue to follow market expectations.
  3. It is well known in the market that Newcastle Building Society is seeking to reduce its exposure to the market. Newcastle has suggested that they might discount the principal amount owing by around 5% if Hexagon agrees to repay early. As Hexagon would have to arrange additional new loans to do this, at a likely credit spread of around 1.5%, this is not a particularly attractive proposition. Our rough estimate is that the discount would need to be closer to 15% for this to make economic sense.
  4. The business plan shows peak debt of just over £210 million in September 2021. The undrawn and available loan facilities are expected to be exhausted by June 2018

1. Annual Treasury Strategy

**Proposals for amendments to the Treasury Policy.**

* 1. The Treasury Policy of Hexagon was reviewed and updated to reflect best practice in September of last year
  2. Capita has reviewed the current policy document and can confirm that no further amendments are required.
  3. One small change is suggested to S1.1 of the policy which requires security to be charged to lenders months 12 months ahead of need. The suggestion is to reduce this time period from 12 months to 6 months to avoid the problem of having to start the charging process before a new facility is in place. In practice this is something that it is not possible to do as the lenders requirements will only be known once a facility has been completed.

**Three year cash flow forecast**

* 1. A three year cash flow forecast, based on the business plan approved by the Board in June 2016, is shown in appendix 1. The business plan includes a new 380-unit development program, of which 72% are for shared ownership or outright sale. The plan also assumes that Hexagon sells 20 homes a year under the voluntary right to buy (vRTB) program. These aspects are particularly uncertain post-Brexit vote, so the forecast may change significantly.

* 1. Nevertheless, the forecast shows that available facilities and cash will be fully utilised by June 2018. More detailed analysis of the rolling monthly cash flow forecast shows that Hexagon would need new to draw new loan finance by September 2017 if no vRTB sales are achieved.
  2. Hexagon’s Treasury Policy requires that sufficient loan facilities are in place to cover at least 18 months forward capital commitments. Given that it can take more than six months to put in place security for a new loan facility, Hexagon is therefore advised to start the procurement process for a new revolving loan before the end of the current calendar year.

**Details of principal borrowing maturities over the next three financial years**

* 1. Hexagon has the following loans due for repayment in the next three financial years;

|  |  |  |
| --- | --- | --- |
| **Lender** | **Amount** | **Repayment Date** |
| THFC | £1,500,000 | 20-11-16 |
| HSL | £5,000,000 | 25-01-19 |
| ORCHARDBROOK (ex HC) | £70,037 | 30-09-16 |

* 1. The scheduled capital repayments are all provided for in the budget and forecast cash flow.

**Maturity ladder of existing borrowings and interest rate fixings**.

* 1. The chart below shows the maturity ladder for embedded fixed rates and stand- alone derivatives.



* 1. As can be seen between 2018 and 2021 Hexagon has maturities of approximately £25 million. These are expiring stand-alone interest rate hedges and not capital repayments. As Hexagon has recently drawn down the £17 million long term fixed rate AHF loan a substantial proportion of these maturing hedges has already been replaced.

**Security strategy**

* 1. Hexagon currently has x units which are uncharged and are suitable for charging. Given the current situation with MTM values of swaps, the priorities for security charging are:
* Charge to Barclays and Lloyds derivative agreements, so as to release cash from deposit
* Top up the security charged to the AHF 2015 bond loan, so that this can withstand reductions in valuation as rents reduce
* Identify properties to charge to the new revolving loan. It may be better to use street properties, rather than new schemes for this, as they are quicker to charge.
* Release properties from charge to THFC when the £1.5m loan is repaid later this year

1. Borrowing strategy
   1. There is a good supply of finance for Registered Providers. Loan finance is available from the following sources;
   * Banks and Building Societies
   * The Capital market for public issues
   * The Capital market for private placements or bilateral loans
   1. The latest cash flow forecast from the business plan shows that new loan finance will need to be in place to draw from June 2018 with a peak requirement of just over £40 million in 2021. In the absence of a new development program the new funding requirement is shown to be repaid in full by 2025.
   2. This funding requirement could be covered with a ten year bilateral loan with a bank or building society. The advantage of this strategy is that the business plan would be fully funded out to 2025. If surplus cash is available bank debt can usually be repaid without penalty. If new opportunities arise the facility limit can be used to the full.
   3. Lending margins on ten year facilities are in the region of 1.75% to 2% with non-utilisation fees set at 50% of the margin. There are fewer banks in the market willing to lend out to ten years meaning less completion for Hexagons mandate. With funds not required until 2019 Hexagon will incur significant costs on a £40 million committed loan facility.
   4. Alternatively Hexagon could seek to arrange a smaller, say £30 million revolving loan facility. The strategy here would be to refinance some or all of this short term debt with long term debt from a capital markets investor. This assumes that Hexagon will have an ongoing development program that would lead to higher on going borrowing requirements than are shown in the business plan.
   5. The lowest cost bank finance is for a three year revolving facility. A three year revolver would seem too short given that facility is only expected to be drawn in 2019 and the policy requirement for committed capital to be in place to cover 18 months development expenditure.
   6. A revolving bank facility allows funds to be drawn and repaid and drawn again as and when required. This structure is more appropriate for development finance as it minimises interest cost and would enable Hexagon to take advantage of the forecast very low LIBOR rates for at least the next two years. If Hexagon has no need for new loans after 2021, as shown in the business plan, the facility can be repaid and cancelled at no cost.
   7. There are a small number of bank lenders offering loans with repayment out to 25 years but these typically include a right to reprice and come with margins in excess of 2%. We would not recommend to Hexagon long term funding from these sources.
   8. Given the timing and nature of the borrowing requirement shown in the cash flow forecast we would recommend Hexagon invites lenders to submit offers for a five year revolving facility of up to £30 million.
   9. There is a good supply of short term revolving facilities from banks and building societies. Revolving loans are ideal for development finance or where requirements are uncertain. They allow borrowers to draw when funds are required, repay when fresh resources become available and redraw again.
   10. We are confident that if Hexagon invited offers for a five year revolving facility of £30 million there would be strong competition for the mandate. Five year facilities are available at margins of between 1.25% and 1.75%. Arrangement fees are typically around 0.75% with non-utilisation fees at 50% of the margin.
   11. Long term finance is increasingly available on a bilateral basis in amounts of £25 million upwards from institutional investors. In recent years these investors have started to offer more flexible drawdown profiles or repayment structures. This would enable Hexagon to avoid the cost of carry normally associated with bond issues that have to be drawn in full on a particular date. Institutional investors are typically looking to lend on fixed or index linked rates for periods up to 40 years. The cost of borrowing is made up of the underlying gilt yield at the time and a credit spread. The difference between the spread on a private deal and a public issue for a well rated RP has fallen sharply over the last 18 months.
   12. By way of indication, current thirty year gilt yields are at 1.62%. Our conservative estimate of a credit spread for Hexagon would be around 2%, giving an all in fixed rate of 3.6%. This type of long term fixed rate loan would only be suitable for Hexagon if an ongoing long term funding requirement were identified in the business plan.
2. The economic and interest rate environment
   1. The vote to leave the European Union has engendered a huge amount of uncertainty about the future path of the UK economy and for interest rates. In the first quarter of quarter of 2016 the rate of growth in the economy slowed to just under 2%. Most economist expect the uncertainty that will now follow as the timing of exit and nature of the new regime are negotiated will lead to a further slowdown in the rate of growth.
   2. In the longer term whether or not new trade arrangements and the lifting of the trappings of EU membership will lead to a rapid return and perhaps faster growth in the economy remains to be seen.
   3. The immediate reaction to this uncertainty has seen a fall in the value of the pound and a dramatic drop in gilt yields as can be seen from the chart below.



**Source: Thomson Reuters**

* 1. The current level of swap yields is shown in the table below.



**Source: Thomson Reuters**

* 1. The following chart shows rates today compared with those one month and one year ago.



**Source: Thomson Reuters**

* 1. As can be seen swap rates have dropped by an unprecedented amount in just one month.



**Source: Thomson Reuters**

* 1. The chart can be interpreted as illustrating the money markets belief that base rate is likely to be cut from the current level of 0.5% to 0.c5% and is expected to stay low until March 2018.

1. Interest rate and inflation forecasts
   1. The recent referendum result has created much greater uncertainty surrounding the future path of interest rates than is normal. The immediate impact on the markets is shown in the tables above. It will take some time for our independent forecasters to fully analyse all the economic consequences of the vote and to produce new forecasts.
   2. The forecasts that we normally include in our treasury strategy reports have all been made redundant by recent events. We have however issued note setting out the implications for interest rates and inflation which is attached as Appendix2.

**Investment of surplus funds**

* 1. As a result of the recent drawing from AHF, Hexagon will have significant levels of cash in the short term.
  2. Investment rates from deposits are currently very low and are likely to fall further if the Bank of England, as expected, cuts base rate to 0.25% at its next meeting. Higher returns are available on term deposits of 12 months or more, but not form banks that satisfy Capita’s credit counterparty criteria.
  3. We therefore suggest that cash resources are used first to meet development expenditure and that drawdown of the £20 million available from Santander is deferred until cash resources are depleted.

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Appendix 1 Cash Flow Forecast

|  |  |  |  |
| --- | --- | --- | --- |
| **Period: 01 April 2016 - 31 March 2046** | **2017** | **2018** | **2019** |
|  | £000's | £000's | £000's |
| **OPERATING ACTIVITIES** |  |  |  |
| **Cash Received From Customers** | 30,719 | 39,356 | 38,941 |
| **Cash Paid To Suppliers** | -16,511 | -19,179 | -26,967 |
| **Cash Paid To Employees** | -3,770 | -3,872 | -4,033 |
| **Net Cash From Operating Activities** | **10,438** | **16,304** | **7,940** |
| **Returns On Investments &** |  |  |  |
| **Servicing Of Finance** |  |  |  |
| **Interest Collected** | 60 | 45 | 106 |
| **Interest Charges** | -5,794 | -6,304 | -6,808 |
| **Net Cash From Investment Returns & Finance Servicing** | -5,734 | -6,259 | -6,702 |
| **INVESTING ACTIVITIES** |  |  |  |
| **Acquisition And Construction Of Properties** | -38,139 | -21,861 | -28,332 |
| **Purchase Of Other Fixed Assets** | -240 | -246 | -251 |
| **Grants** | 3,819 | 2,162 | 2,411 |
| **Sales Of Properties** | 2,351 | 7,715 | 8,782 |
| **Net Cash From Investment Activities** | -32,209 | -12,231 | -17,391 |
|  |  |  |  |
| **Net Cash Before Financing** | **-27,505** | **-2,186** | **-16,152** |
| **FINANCING** |  |  |  |
| **Equity Drawdown** |  |  |  |
| **Loan Draw downs** | 23,116 | 13,884 |  |
| **Capital Repayments** | -2,577 | -1,183 | -9,699 |
| **Loan Working Capital Movements** |  |  |  |
| **Working Capital Loan Drawdown** | 2 |  | 15,325 |
| **Working Capital Loan Repayment** | -2 |  |  |
| **Net Cash From Financing** | 20,539 | 12,701 | 5,627 |
| **BALANCE BROUGHT FORWARD** | **7,976** | **1,010** | **11,526** |
| **INCOME LESS PAYMENTS** | **-6,966** | **10,515** | **-10,526** |
| **CLOSING BANK POSITION** | **1,010** | **11,526** | **1,000** |

Appendix 2 Updated Interest Rate Forecast

**Post EU referendum interest rate review**

* *The outcome of the EU referendum has necessitated a review of our interest rate forecasts. The UK now faces a very different situation from that faced ten days ago - both politically and economically. This mix of both political and economic uncertainty makes this the most difficult interest rate review we have done in recent years owing to the sheer number of unknowns. However, the impact on financial markets in the last ten days has not been as great as some had feared.*
* *This also puts the Monetary Policy Committee (MPC), in a very difficult position in terms of knowing how much the vote for Brexit will impact the real economy. What most forecasters expect is that the first two quarters growth in 2016 of around +0.4% is likely to fall to zero in the second half of the year. However, after the initial shock, the economy may recover some momentum so Capital Economics is forecasting growth of 1.5% for 2017, (after average overall growth for 2016 of 1.5%), and then recovery back to 2.5% in 2018. In his speech last Friday, the Governor of the Bank of England, Mark Carney, made clear that the MPC will consider cutting Bank Rate in the very near future, and will also consider using further quantitative easing (QE – the purchasing of gilts) as a means of providing further stimulus to economic growth by lowering borrowing rates.*
* ***Our own interest rate forecast is based on a cut of Bank Rate of 0.25% in the current quarter; this could come at the next MPC meeting of July 14 or at the next quarterly Inflation Report meeting on August 4. However, we would certainly not rule out a further cut to zero or possibly 0.10%. The first increase in Bank Rate does not then occur until quarter 2 2018 and the pace of increases thereafter has also been slowed down from that in our previous forecast. However, we have to emphasise that there are so many variables over this time period that it is very likely that these forecasts will be subject to significant updating as events evolve on both the political and economic fronts.***
* *Carney’s comments last Friday on the possibility of further quantitative easing caused an immediate fall in gilt yields of around 25 – 37 basis points (bps) in gilts with a tenor of between 10 and 50 years, so it could be said that just the threat of further QE has already achieved a significant drop in gilt yields and so borrowing costs. This, arguably, means that the benefits of actually implementing further QE are reduced. We have, revised down our forecasts to take account of these movements in gilt yields since the referendum. During this period, yields have fallen to all-time lows with 2 year gilt yields even briefly turning negative.*
* *However, Carney did make a strong point that it is not the role of the Bank of England to be the sole participant in helping to stimulate growth of the UK economy and employment by using the monetary policy measures at its disposal. The Government has fiscal policy as a powerful tool to promote growth, and it has various policy measures it could employ.*

**NEWSFLASH**

*Already the Chancellor of the Exchequer has said that the target of achieving a budget surplus in 2020 will need to be put back to avoid austerity measures creating an unwelcome headwind for growth during the near future. In addition, the Chancellor has announced that corporation tax will be lowered to 15% from 20% by 2020 rather than the 17% rate previously planned. Fiscal policy could also include cuts to income tax, national insurance, and VAT to stimulate consumer demand in the economy. However, such cuts will impact the budget deficit.*

* *In addition, the Government could take advantage of the plunge in gilt yields to borrow extra money to invest in infrastructure to improve the productivity of the UK economy.*
* *However, what will be vital will be to ensure that the UK retains the trust of international investors, both because about 30% of all gilts are owned by overseas investors (who will want to be assured that the Government is not borrowing beyond the means of the economy to sustain the ability to pay interest and to repay the debt) and because of the need to maintain the value of sterling against other currencies. The current size of the balance of payments deficit of 6.9% of GDP is a major concern. The fall of 14% in the value of sterling since November 2015 will feed through eventually to stimulate demand for UK exports and to choke off imports into the UK by making home made goods and services more competitive. However, this will take time to feed through into reducing the size of this deficit.*
* *What will make the decision making of the MPC more difficult is that the fall in the value of sterling will feed through over the next 3-4 years into the economy and cause an increase in inflation. But manufacturers and service providers could absorb some of the extra costs from the increased cost of imported inputs, or could increase productivity to offset extra costs, so there is considerable uncertainty about the timing and size of this feedthrough into consumer prices. Capital Economics has revised its interest rate forecast for inflation as follows: 2016 0.6%; 2017 2.2% (was 1.5%); 2018 2.8% (was 2.1%). The MPC’s target for CPI inflation is 2%, but in the past it has looked through temporary spikes of imported inflation on the basis that they will drop out of the calculation of CPI after 12 months. So it is by no means certain that the MPC will take action to counter an increase in inflation arising from currency depreciation.*

*We emphasise that there are several variables that could have a major impact on the UK economy and interest rates over the next four to five years in particular:*

* + *Political uncertainty: the Conservative party is currently facing a leadership election, while there is also uncertainty about the leadership of the Labour party. There is a general election due in May 2020.*
  + *Political uncertainty in the EU if other countries hold referendums or there is a strong growth in anti-EU political parties.*
  + *Uncertainty about when Article 50 will be triggered to start the UK withdrawal from the EU, and what form any final agreement with the EU will take over access to the single market and requirements to conform to EU rules and to contribute to the EU budget. This in turn, could have a major influence on corporates deciding whether to move jobs away from the UK into the EU.*
  + *Whether the potential impact of all of the above could bring to the fore the question of Scottish independence*
  + *Consumer confidence in the UK will have a major impact on consumer expenditure and so on GDP growth; many factors could affect confidence e.g. house prices, inflation rising to outweigh pay inflation and so depressing disposable income, and the outcome of Brexit negotiations.*

We will be undertaking a further review of our interest rate forecast following the release of the Bank of England Quarterly Inflation Report on 4th August where the Bank of England will update all its forecasts for growth, and inflation and will explain its thinking around Bank Rate and QE.

**CAPITA ASSET SERVICES’ FORWARD VIEW**

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts will be liable to further amendment depending on how economic data and developments in the economy and financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow.

The overall longer-run trend is for gilt yields to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities.

We have pointed out consistently that the Fed Funds Rate is likely to go up more quickly and more strongly than Bank Rate in the UK, and recent events have not changed that view, although that the timing of increases may be deferred. While there is normally a high degree of correlation between US and UK government bond yields, we expect to see a decoupling, with US yield rising faster than those in the UK.

The overall balance of risks to economic recovery in the UK remains to the downside. Although economic growth remains relatively steady, only time will tell whether some of the global headwinds sap some of the strength from the UK’s future growth.

We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how volatile bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to emerging market, geopolitical and sovereign debt crisis developments.

Apart from the uncertainties already explained above, downside risks to current forecasts for UK gilt yields currently include:

* Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed Funds Rate increases, causing a further flight to safe havens (bonds).
* Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
* UK economic growth and increases in inflation are weaker than we currently anticipate.
* Weak growth or recession in the UK’s main trading partners - the EU and US.
* A resurgence of the eurozone sovereign debt crisis.
* Recapitalisation of European banks requiring more government financial support.
* Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields, especially for longer term yields include:

* The pace and timing of increases in the Fed Funds Rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
* UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.



**Interest Rate Strategy Group**

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