

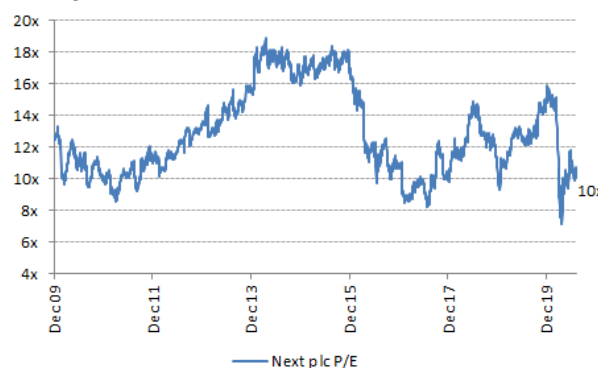
Holland Views – Next plc – Price: £50; MCap: £6.7bn

Agent of Change

Forget your Harvard case studies, Next plc today offers a masterclass in business innovation on this side of the pond and remains one of the best run retailers that we have encountered in our careers. Now back at c.10x PE thanks to Covid-19, investors are getting a great play on innovation and a future business model pivot priced at a good margin of safety.

Next is seen by some (and sometimes priced) as a dodo, i.e. a high street retailer facing extinction. Next *is* a high street retailer, but that is actually only a quarter of the story (literally! it's 23% of profits). More importantly it one of the most-trusted/respected UK retail brands to both consumers *and* we think, importantly, its retail peers. It is also a preeminent e-commerce logistics business that has perfected hybrid retailing and has begun monetising its considerable know-how by selling for third party retailers. Perhaps the analogies with Amazon's AWS, Ocado's licensing business or ASOS' Marketplace seem tenuous to some but Next's track record of proven commercial creativity warrant recognition on the part of investors. One thing is for sure, Next is a survivor as those around it face extinction.

Fig.1: 10x P/E: as cheap as it gets?



Source: Holland Advisors

In this note, almost 10 years on from our first recognition of Next's business innovation (*Phil Fisher under our noses, Oct 2011*), we suggest that Next's innovation is still firing on all cylinders. Unlike other better known innovators however Next has been innovating into a retail headwind rather than having a tailwind.

Next's shares have suffered a 'Covid derating' to 10x P/E as per Fig.1 so the behind the scenes and constant innovation offers much optionality to investors. We cheekily suggested in late 2018 that Next might even be a candidate for Amazon to acquire in order to gain skills it currently misses in own-label clothing and fashion distribution. The underlying logic of that speculative statement has only increased since then.

"Gosh, how did we miss that"?

Everyone knows that Covid-19 has accelerated e-commerce adoption but most seem to assume that the winners of this trend are all US businesses. Shopify, a US lossmaking business that offers e-commerce solutions to retailers (with c.\$2bn of revenues), has seen market cap surge from \$40bn to \$120bn since March. March 2020 also saw the launch of Next's 'Total Platform' which, a bit like Ocado, offers a 'white-label' version of Next's entire logistics operation to third party retailers. Its early days but it's a damn interesting move by Wolfson – and he knows it.

“(Next’s newly launched Total Platform) could be one of those ideas that in five years’ time, people would look back and go, oh my gosh, that was an important moment. Everyone was worrying about Coronavirus and no one noticed the launch of the service. But actually, this is a ground-breaking operation in the UK and could be important to the Group” – **Simon Wolfson, March 2020**

[In this note](#)

The central premise of this note could be summed-up as follows:

“It is not the strongest of the species that survives, nor the most intelligent – It is the one that is most adaptable to change.” – **Darwin**

Next’s track record is a testimony to Darwinism. From the development of its mail order catalogue business to its ‘hybrid’ online model and market-leading logistics platform: Next under Simon Wolfson has always had corporate dynamism sewn in its DNA.

The counter-argument is of course that Next is just running to standstill and the demise of the UK high street is too powerful a headwind to overcome. This may of course be true, but today’s low starting PE (10x historic), and ever reducing share of profits from stores (23%) provides much free optionality. Next, we conclude, can evolve to survive or even thrive post-Covid-19.

We offer three areas to consider.

1. Trusted brand

A ‘trusted brand’ is something of a cliché in the marketing industry but it is still important. Assessments of brand trust are usually between the customer and the retailer but we think such thinking on Next needs to now be broadened to also include the trust it is held in by its peers. Even the best online retailer in the world, loved by consumers for its customer service is still regarded with a fair degree of trepidation by its third-party marketplace and brands sellers; *“Are they promoting my product correctly, or letting it be undercut by others”* they ask themselves. Having a market position where those third party sellers trust you is important.

2. Innovation – it can be all in the detail too

Over the years we have discussed Next’s numerous innovative business practices. We have talked how Next would have impressed investing and business gurus from Phil Fisher to Jim Collins. Innovation gets highlighted in this note again because it can easily be overlooked in a time of crisis. We are intrigued by Next’s total platform and Wolfson’s throwaway comment that it is a ground breaking development in the UK retail market.

3. Next plc’s prospects as a survivor of Covid

Next plc updates investors next week and it would seem unlikely to us that Next would not be a beneficiary of the record e-commerce spending that has been reported by peers in recent weeks (at least in comparison to the terrible trading they were experiencing in May). We elaborate on this and consider how the stage might be set for Next plc post-Covid.

1. Trusted Brand, Trusted business

“We also do cut glass sherry decanters complete with six glasses on a silver-plated tray that your butler can serve you drinks on, all for £4.95. People say, ‘How can you sell this for such a low price?’ I say, because it’s total crap”. – **Gerald Ratner, infamously, 1991**

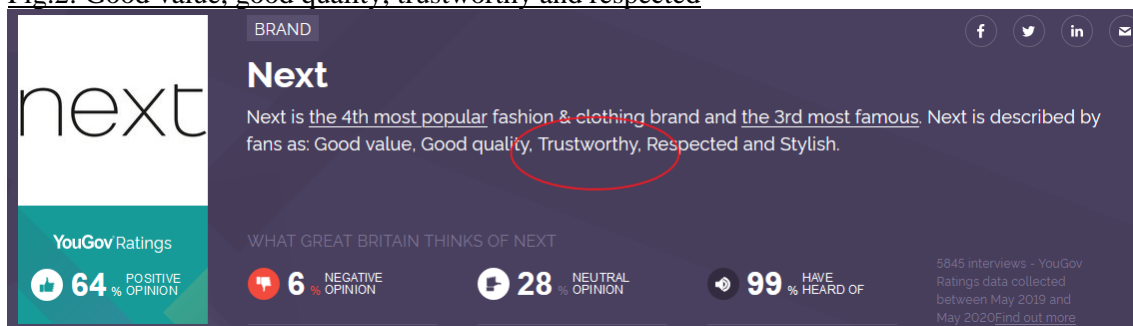
Sports Direct, Ryanair and most recently Boohoo have chequered histories of public relations, what is sometimes termed “bad press”. Sometimes it is fair criticism, sometimes unjustified. Sometimes customers look the other way (as low prices can make customers very forgiving!) and

other times consumer trust can be completely lost in a minute (as per Gerald Ratner's infamous moment of rash honesty above!). Trust is a very valuable intangible asset.

"Next and Asos have dropped Boohoo clothing from their websites after claims that the fast-fashion retailer sold clothes made in factories where staff were paid less than the minimum wage and worked in poor conditions. Boohoo has had more than £1 billion wiped from its share value in the past two days after an article in The Sunday Times alleged that workers in a Leicester factory making clothes destined for Boohoo were being paid as little as £3.50 an hour." – Press Association

We highlight trust as a corporate asset as it is not given much weight by investors as it pertains to Next's standing in the marketplace. From our own families' experience as consumers, Next is a very trusted brand and the branding experts seem to concur (Fig.2).

Fig.2: Good value, good quality, trustworthy and respected



Source: YouGov¹

Why is this important? Apart from the obvious point of consumers prioritising brands with reliable service of quality, value and sustainability – there is a new aspect to this.

Retail distribution continues to consolidate into aggregator platforms. New brands continue to emerge but increasingly are relying-upon (trusting) third party aggregators to handle logistics and much more behind the scenes (see Nestle's 'distribution centre of the future' in the link² below). Amazon and eBay pioneered third party marketplaces for small brands in the last decade but in Amazon's case the marketplace participants have become increasingly wary of placing their fortunes in the hands of a partner that may also allow its competitors to under-cut or replicate similar products.

In some respects, Next is seeking to monetise the peer group trust that it has accumulated over decades into its new aggregator platform – a cornerstone of recent innovation at the company.

2. Innovation (like retail), is detail

We have written so much on Next's innovation. Can we possibly have anything new to say? The point with Next is that innovation is a constant so investors need to keep abreast of what is happening. In times like this, the noisy macro backdrop easily distracts attention away from some significant new developments. In the last decade, the common thread of Next innovations has been in the area of logistics.

"Amateurs talk about tactics, but professionals study logistics." – Old military saying

The clarity of purpose of that logistics innovation focus is crystal clear if one listens closely to Wolfson.

"It's really the final piece synergies that we've been building for some time. And what I'd like to finish is by emphasizing the purpose of our platform. The purpose of our platform

¹ <https://yougov.co.uk/topics/consumer/explore/brand/Next-Brand>

² <https://www.business-live.co.uk/ports-logistics/take-exclusive-look-inside-nestles-17324306.asp>

is to make our own website, the first choice for clothing and homeware for our customers. The second is to make it the most profitable third party route to market for our clients. And the third is to make sure that the service we provide is one that, not only we are proud of, but that our partners are proud of as well. – Simon Wolfson, March 2020 (emphasis ours)

The excerpts below in Fig.3 offer a reminder of that journey of innovation that we have highlighted over the last decade.

Fig.3: Consistent innovation

Next Directory – Growth and innovation

With all the admiration we show to Mr. Buffett another, equally influential investor is sometimes too easily overlooked. Phil Fisher. Fisher was the great exponent of how to identify a growth company. One of his 15 tenets for such a company was whether it was able to internally develop alternative businesses lines or product streams as additions to its core operations. Next directory looks just such a development. Equally a question Charlie Munger often asks is “will technology kill your business or make it?” Arguably technology and retail market changes are in the process of killing many retailers as we write but Next’s development of its Directory division has significantly changed that debate for this group.

Source: Holland Views, Next, September 2011

LABEL – an aggregator winner

We have raved before about the extent of business innovation at Next. We remain of the view that this has been crucial to the company’s past success and think its future role will be just as important. For us there was for too long a debate amongst analysts that wanted to look at the ‘underlying’ numbers, often citing the problems at say Next Retail. This to us always missed the point, i.e. that Next always needed to be considered holistically. That its new developments were minnows in the profitability they created vs. the core led to them being sometimes dismissed, but these once minnows (Online, Overseas and LABEL) are now the drivers (saviours if you like) of the business today.

LABEL we think is worthy of special mention. The reason being that in quite a short space of time it has established a strong position as an aggregator of third-party clothing brands online in the UK. It is not the only one we accept, but we think its prospects are potentially very good indeed. Aggregators need to be great in terms of delivery and logistical efficiency and this is an area where we think Next have real and long lasting expertise.

That they can run a business like this for a c.15% margin is also interesting as they have to keep scaling up but doing so with an eye on efficiency the whole way. How much easier might it be to go for growth telling yourself that when you are bigger the efficiencies will come? Ignoring its brand, Next has for some time arguably been the best, most efficient distributor of online clothing in the UK. It has constantly re-invested and stayed ahead of others trying to catch it. When spending time in front of the Next team one expression clearly come to mind, that...

“retail is detail”

...or more appropriately for the modern world: efficient and profitable distribution is all about detail.

Source: Holland Views, Next, April 2019

Try a lot of stuff...

An innovation is, at its most basic, just a new idea or method that is successfully executed. Thanks to the rise of Silicon Valley, innovation is too-often equated with ‘moonshots.’ In the real world, innovation is more often a combination of many small imaginative improvements.

“Try a lot of stuff and keep what works” – Jim Collins, Built to Last

Here are just some of Next's innovations. On their own, perhaps not that exciting, but taken together, the cumulative effect on the business is transformational.

- Directory as a springboard to e-commerce
- Cannibalising own business: in-house sourcing head-to-head with third party suppliers
- Implementing online returns via high street stores (hybrid retailing)
- Using store staff to increase warehouse returns efficiency
- Shift from high street to out of town
- Technology as core asset – building a scalable website
- Cannibalising own business: LABEL
- Platform plus (third party warehouses)
- Total platform

This last innovation, Total Platform, is we think extremely interesting. The Appendix contains Simon Wolfson's comments on this project in their entirety delivered in March of this year. It is well worth reading. In essence, Next's Total Platform offers a one-stop-shop logistics service to new and existing retailers on a commission (% of sales) basis. In today's vernacular, this could be termed logistics-as-a-service. The service is a zero-capital offer to new brands (such as the first customer www.littlelabel.com) and a lifeline to struggling brands (perhaps Monsoon, Top Shop et al?). As Wolfson outlined, this is a truly compelling offer that runs the whole gamut of services from stock buying, marketing, website management, back end logistics to even credit provision services. This really does sound ground-breaking to us too.

"What that means is that, not only will we run their website, but we will also do all their warehousing, distribution, returns, call centre work, customer credit, international sites, we will do absolutely everything that is involved with selling to customers and servicing those customers for them. In essence, what this does is it leaves the brand to do the bits of running a retail business, running a brand, that brands really enjoy, the design and sourcing of the product, the buying, the marketing, the photography, the web look and feel. It will look and feel as their business, but all the back-end part of the business, everything that involves large CapEx, anything that involves complex systems negotiations or developments, all of that, we will take care of" – Simon Wolfson, March 2020

Despite all these developments, Next is today priced by Mr Market as a dying retailer. At the same moment in time, others in the retail supply chain (Shopify, Ocado, XPL logistics, Clipper, Amazon – all with less historical 'baggage'!) are seen to provide the solution to consumer and online business needs. Ocado is a great example of a pivot in business model that can be implemented when a retailer offers its unique IP and process know-how to the world stage. That Next today offers many of these same globally sought-after skills (albeit in fashion rather than food) whilst that same innovation is overshadowed by its retail history, we find very interesting indeed.

3. Covid as an agent of change

The economic impacts of Covid are both worrying and fascinating. US and UK macro data show personal savings rates at all time-highs, wages (including temporary Government supports) actually above the levels of February 2020 and of course that e-commerce adoption has accelerated. If wages fall and savings rates stay high the widely predicted protracted recession will result. If they do not, the seen-to-be-impossible 'V' recovery might suddenly occur. Whatever the macro outcome, the huge leap in e-commerce adoption is surely an irreversible trend. Indeed we suggest Covid is a textbook example of that overused term: a catalyst.

Fig.4: Covid is a textbook 'agent of change' – a true catalyst

catalyst noun



Save Word

cat·a·lyst | \ 'ka-tə-ləst \

Definition of catalyst

- 1 : a substance that enables a chemical reaction to proceed at a usually faster rate or under different conditions (as at a lower temperature) than otherwise possible
- 2 : **an agent that provokes or speeds significant change or action**

Source: Merriam Webster dictionary

Whilst we were early Covid worriers at the start of this year seeing western markets as dismissive of the threat posed in February, sadly the second order effects (e.g. that it would lead to c.4 years of accelerated ecommerce adoption in just 4 months) we did not come to early enough.

Another accelerated change that is evident is more high street fashion/clothing retailers being pushed closer to the cliff-edge of bankruptcy. For those with decent brands but inefficient cost structures, a lifeline could emerge in the form of a shift to asset light models facilitated by the use of third party logistics.

Thus, whilst short term trading store and website closures inevitably hurt Next during the initial lockdown period, it is arguably now well-placed to be a beneficiary of both:

- a) the further acceleration of the move to online shipping and
- b) the greater difficulty its peers find themselves in, thus their urgent need for a more efficient, non-store, route to market

Thoughts on profitability, liquidity and Next plc post Covid-19

Next's asset light model has been highly attractive during its financial history. It has led to very high returns and thus significant cash generated in excess of the business' requirements. Importantly this is despite a huge commitment to innovation and investment in physical assets like warehouses. As a result, its business' value was largely dependent on the cashflow it generated. Indeed, in world of great asset-light business franchises' like Mastercard or Moody's this is a good and widely credited model. However, in the unprecedented Spring 2020 trading period, businesses like Next and ASOS had nothing to fall back on. The result is a heart attack like situation for a company unable to trade to generate cash. This culminated in an equity raise for ASOS (and indeed many others) and aggressive selling of assets (warehouses) for Next. Were such a trading period to have lasted for a prolonged period such companies might not have survived or at least would have seen further equity dilution. As a result, many investors might see them now as risky.

Who needs analysts?!

However, that very same thinking would also make a freehold pub business seem risky too, despite 200 years of beer drinking history without closure. We must be acutely aware of recency bias in our analytical thinking.

Against such a backdrop Simon Wolfson and team once again did analysts' jobs for them by providing the roadmap for what profits and cash flow might look like in worst case scenarios. We will not summarise this work by Next, the most recent of which was outlined on 29th April (see link³).

³ <https://www.nextplc.co.uk/~media/Files/N/Next-PLC-V2/documents/2020/trading%20statement-april20.pdf>

When not only its stores but even its online operations were shuttered we think such an outlook was both helpful, and in fact for a short while, realistic. However much has changed since these updates were released by Next on 29th April and earlier on 14th April (when it reopened its warehouses). Many other online businesses have shown how strong they have since traded and close peers like ASOS have reported trading that was -25% YOY in April now being +10% YTD.

We are not in the business of projecting what Next will report in the coming weeks, nor how much its customers might buy from it in the coming months. Our interest is to look at:

- What this business might be worth vs. its longer-term intrinsic value,
- To consider whether shorter term trading could be so bad (i.e. losses and cash flow so severe) as to damage the business ahead of any normalisation.

Hand holders need not apply

In late April even were an investor to identify Next as a long-term winner, they might well have concluded that shorter term damage to cashflows could still have heavily impaired equity value. With now much greater evidence of market normalisation and even stronger trading online we are now prepared to state that we do not now believe this is any longer true. Indeed, even were Next to report slow growth in online clothing sales in coming months, such is the increased penetration of sales in other categories that have transitioned to online in this period (e.g. Hot tubs and Motorhomes) that this must ultimately bode well for one of the leading online clothing sellers in the medium term.

The table in Fig.5 shows Next's most recent scenarios. Bloomberg consensus for FY21 suggests that the market forecasts are clustered around the -30% revenue scenario Next outlined (specifically: median consensus is FY21 revenues are -26% YoY with Net Profit of c.£100m. The lower half of the table shows the quarterly progression underlying such a full year sales decline.

Fig.5: Next's latest FY21 (January 2012) scenario

£m (e)	Scenario - 30%	Scenario - 35%	Scenario - 40%
Implied EBITDA	320	170	20
Implied Profit	150	0	- 150
Reduction in year end net debt vs last year	477	372	252

	Scenario - 30%	Scenario - 35%	Scenario - 40%
Full price sales versus last year			
Quarter 1	- 38%	- 38%	- 38%
Quarter 2	- 50%	- 56%	- 62%
Quarter 3	- 19%	- 26%	- 33%
Quarter 4	- 17%	- 22%	- 28%
Full year	- 30%	- 35%	- 40%

Source: Next plc trading update, 29th April 2020

With a complex web of events occurring since May we are prepared to state that we now think such a scenario unlikely (even highly unlikely). We are minded to recall Wolfson's caution during previous weak trading periods when 'Mr Market' sought assurances from him that sales would recover strongly. Wolfson gave no such outlook instead honestly admitted the future was uncertain and that investors knew as much as he did.

Indeed, the attached piece (*Holland Views – Next – You can't handle the truth, March 2017*) spoke to this interplay between a frank Wolfson and a worried group of investors. The shares then rallied strongly from the then low of £40 to £70 (pre-Covid). This is what Next does best, it prepares for the worst and tries to improve its lot. Our view today is not a short term trading call, but just one

that we think gives us a better margin of safety. This improved risk/reward profile was arguably less visible only two months ago when the shares were a similar price.

Conclusion – we believe in ‘Margin of Safety’

We reattach a few older pieces on Next and also our one-page summary of the seminal book Good to Great, by Jim Collins. We hope during these periods of short term trading focus, clients will take a moment to re-look at the traits these pieces highlight. That such innovation traits are demonstrated by the likes of Amazon is not really up for debate. Maybe Shopify lives by them too (and at 60x sales, it needs to!!!). However, as investors just as keen on preserving, as well as growing our capital those US businesses, as good as they are, looked priced for perfection. Next by contrast comes with the pivoting and innovation skills we seek, but at a fraction of the price. Maybe this will only permit them to tread water in the brutal sector they were born into – in which case the shares are fairly priced, or a little cheap.

But maybe, just maybe, a different scenario could emerge where the collective skillset and process-knowhow that Next has built over the years is more appropriately valued by either future customers (ala the Ocado route), Mr Market (ala the Shopify route) or a corporate (ala our aforementioned Amazon route). Any one of those changes in fortune could see the shares become an excellent investment. By the way, we don’t ascribe any value in applying ‘hope’ as an investment strategy – to us these are all just credible scenarios.

Our hunch is that Next trading in the coming month will be a little better than Mr Market is pricing in, but it is only a hunch. With or without any improvement we think we are now being offered a great risk reward with an improved margin of safety in the short-term vs. 10+ years of compounded innovation paying off in the medium term.

Saving the best quotes and wisdom for last

Regular readers will note our penchant for a quote to help get our message across. During lockdown we have seen a little less of each other as a team here at Holland. So one day recently, we pinged Claire an email just to ask how she found Next as a customer these days. Claire is an astute consumer and a straight talker. Her reply we thought was telling:

“To me Next is to clothing and homeware what Amazon is to everything else when looking to purchase online.”

“I am not a shopper and prefer to order online. Next Unlimited delivery makes that even easier. I do not go shopping for clothes, it all gets done online and usually via Next (very rarely shopping on the High Street or in Next shops – unless I’m returning something). The fact it is so easy and arrives next day is just a no brainer for me when I need to buy clothes.”

“I haven’t bought anything new for months, possibly not even this year. I like Next especially now it has the other branded goods available – My kids want these and having them as easily accessible just makes it far more likely we would purchase via Next than with say, SuperDry directly” – Claire Brunt, Holland Advisors (emphasis ours)

Buy Next

Andrew, Mark & Claire

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Appendix

*“I'm now going to talk about a new business idea, **Total Platform**. Our website at the moment, it is integrated with all the other functions within the Platform, warehouses, distribution, online marketing, customer service, credit, and international sites. Recently, we launched a site with a separate URL called Little Label. This site is dedicated to selling very top end children's brands, that wouldn't want to sit on the NEXT web site. So we created a separate website. To the customer, it looks and feels like a separate website. In order to get to it, you go to a different URL. But importantly, it is still linked into all the other services on our platform, in exactly the same way as our own website is. So it still has the 24 hour delivery, it still has the call center, it still has a credit. And everything else that goes with being part of the NEXT platform.*

This year, we intend to take that concept one step further with agreed heads of terms with the business turning over in the order of GBP25 million, GBP30 million. So in the context of NEXT, not a big company, but a very fast growing company and we are going to run their website for them. So the website will have their URL. It will look and feel like their website. They will design it. They will have creative control over it, but it will link into all the other elements of our platform in exactly the same way as our own website does. What that means is that, not only will we run their website, but we will also do all their warehousing, distribution, returns, call center work, customer credit, international sites, we will do absolutely everything that is involved with selling to customers and servicing those customers and we will do that for them. In essence, what this does is it leaves the brand to do the bits of running a retail business, running a brand, that brands really enjoy, the design and sourcing of the product, the buying, the marketing, the photography, the web look and feel. It will look and feel as is their business, but all the back-end part of the business, everything that involves large CapEx, anything that involves complex systems negotiations or developments, all of that, we will take care of.

Now, you could look at this and make the mistake thinking, oh, this is an outsourcing contract or a joint venture. It is not an outsourcing contract and it's not a joint venture and it doesn't come with all the legal complications and potential conflicts of interest inherent in both of those structures. Instead, this is a very simple commission contract. It's a long term commission contract. Basically, the client pays a fixed percentage of sales for all of the services that we provide. There are no extra charges. There is no discount, there is one commission rate on their sales. What that means are two things. First of all, it is a contract and a way of operating that we are very used to. It is the way that we operate with most of our LABEL customers have done for many years. Secondly, it aligns our interests with those of our client, a 100%. If they sell more, we get more commission. If they sell less, we get less commission. It is in our interests to maximize their sales and it's in their interest to maximize their sales.

The development of their business is CapEx-free. It requires no systems investment, and potentially most importantly, it provides them with a 100% variable cost base.

As you hit capacity, as you run close to your maximum throughput, your costs go up very quickly.

For a business that is maybe 1% the size of NEXT, their turnover can double without in any way impacting on our total capacity or ability to operate. So we can accommodate for them huge rates of growth, without any of the normal growing pains associated with very rapidly growing businesses. Equally, in the difficult years and everyone has the old difficult year, in those difficult years, their costs will go down in line with our sales, which means that, their cost base in the years that they most need it to go down, will go down exactly in line with our sales.

So we think that for some businesses, this may be a very, very powerful offer. Now in five years' time, you may look back and go, oh, my gosh, I remember that Total Platform business and it may have come to nothing other than provide one client with a great business. On the other hand, this could be one of those ideas that in five years' time, people would look back and go, oh my gosh, that was an important moment. Everyone was worrying about Coronavirus and no one noticed the launch of the service. But actually, this is a groundbreaking operation in the UK and could be important to the Group. – Next CEO, Simon Wolfson, March 2020

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