

Strategic Growth Plan

18 November 2014

Somero Enterprises

112p

Growth Strategy

Somero Enterprises is the world leader in a niche market, namely precision concrete placing and levelling equipment. As such it achieves very high margins and is highly cash generative. With the US recovery in full flight, the market has become increasingly interested in and excited about the medium to long term growth story in Asian markets, making the Somero investment proposition so much more than a simple cyclical play. In this note we examine the company's strategic growth plan.

About Somero Enterprises

Somero is a leading manufacturer (the company assembles component parts and therefore requires very low levels of ongoing capital expenditure) of laser-guided, technologically innovative machinery used in horizontal concrete surfaces such as industrial warehousing, factories, car parks and big box retail outlets.

The opportunity of significant long term growth

Both a macro and construction market recovery means that Somero is experiencing strong revenue growth and increased product penetration rates. However, Somero's strategy looks way beyond basic economic recovery towards investing in significant medium to long term opportunities, mainly in Asia. In our opinion this strategy offers significant scope for long term EPS and dividend growth.

Self-help story based on increased product penetration and not economic growth

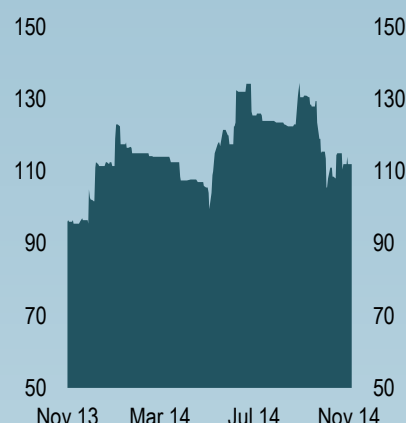
Our analysis suggests that Somero can significantly increase its sales into a number of important emerging markets through the penetration of its products and services and is not therefore reliant on economic growth in these countries. A good example of this is China where total sales are currently smaller than in the US yet the market is potentially 30x larger.

Strategic plan doubles revenues by 2018

Management has in place a strategic plan to double revenue by 2018. With demand continuing to recover in developed markets and very strong potential for growth by increasing the penetration rate of its products in emerging markets such as China, India and South East Asia, we think this is achievable. Indeed, we believe the company will experience significant growth in these markets way beyond 2018.

Valuation looks undemanding

Somero trades on a FY14E PER of 10.3x falling to 9.2x by FY16E, with 15% compound EPS growth between 2013A and 2016E. With upward momentum in market forecasts the shares look good value. The current share price offers a 2.0% dividend yield rising to 2.6% by 2016E, with 20% DPS growth per annum between 2013A and 2016E.



TDIM	SOM
Market cap (£m)	73.6
Dividend Yield	1.7%
Broker	Canaccord Genuity
Listing	AIM

Mark Hughes

mark.hughes@broker-profile.com

+44 20 7448 3244

	Sales (US\$m)	PBT (US\$)	EPS (p)	Net Cash (US\$)	P/E (x)	EV/EBITDA (x)	Yield (%)
FY13a	45.1	6.5	8.1	3.4	13.8	9.9	1.2
FY14e	57.8	12.0	11.7	7.8	10.3	4.9	2.0
FY15e	63.7	13.2	11.4	14.2	9.8	4.0	2.2

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Investment Case

So much more than a simple recovery story

Following the global recession there are many global economic recovery plays in the stock market. Economies expand, company revenues and margins recover, and recovery based growth is the outcome. Whilst Somero's strong market position in its niche segment has enabled it to enjoy a similar recovery in recent years, we believe the medium to long term expansion opportunities that the company is creating in growth economies such as China, India and a number of South East Asian markets make this an entirely different and more exciting investment proposition.

Near 100% market share in its niche segment of the market

As the leading manufacturer (the company assembles component parts and therefore requires very low levels of ongoing capital expenditure) of laser-guided, technologically innovative machinery used in horizontal concrete surfaces, Somero has close to 100% market share. This market share as well as the barriers to entry into this market, offer the company a significant opportunity to increase the penetration of its equipment into important growth economies around the world.

Strategy to double revenues by 2018

This highly knowledgeable and experienced management team has executed its strategic initiatives very well in our opinion. It has in place a strategic plan to double group revenues by 2018 and as part of this it is using key drivers to US and European growth as a roadmap for emerging market expansion. With demand continuing to recover in developed markets such as North America, and very strong potential for growth in emerging markets such as China, India and South East Asia, this is achievable in our opinion. Indeed, we see a growth opportunity in these markets way beyond 2018.

We forecast further margin expansion

Margins have recovered in recent years. However, we believe that margins will continue to rise over the next 2-3 years. Somero is investing in important growth markets including China and India at present in order to take advantage of the medium to long term growth opportunities. As sales to these regions grow and overhead recovery further improves, even higher EBITDA margins will result.

Attractive geographic mix

North America (largest geographic market by sales at present) and China (a big growth market for the group) equate to 83% of sales at present and these are both performing very well. North America continues to recover, leading to very strong growth.

In China, with the company's relationship with CBMF (China Building Materials Federation), it is helping to develop the standard and accreditation for concrete floors. It continues to invest in sales, specification engineering and marketing, including exhibiting at trade shows. The opportunity is massive as China's cement consumption is 30x larger than the US cement consumption, so the prize for increased market penetration could be a transformation of the market capitalisation of the business, and given Somero's opportunity is driven by self help it is not particularly economically sensitive.

Mirroring the strategy in China, with in-country sales, service, and support, the India team's H1 2014 sales were surprisingly strong for a start-up. Given India's cement consumption is more than 3x bigger than that of the US, it is investing in the country and will increase staffing support as demand grows.

The green shoots are emerging in Europe, and momentum should continue in the coming years given the improving economic backdrop. Sales in other markets such as Korea, Scandinavia, Australia and S.E. Asia are also strong.

Valuation

Somero trades on a PER of 10.3x current year numbers falling to 9.2x by 2016E. We forecast 15% compound EPS growth between 2013A and 2016E. With upward momentum in market forecasts and the significant opportunity to expand in Asia, the shares look good value in our opinion.

In terms of dividend yield, the current share price offers a 2.0% yield rising to 2.6% by 2016E. We forecast 20% DPS growth per annum between 2013A and 2016E. The company will pay out 33% of EPS from 2016E, therefore, we can expect further growth beyond 2016E.

Summary

As economies and construction markets recover in a number of the company's key markets, and penetration rates for its products increase, Somero is achieving strong revenue growth. However, the company's strategy looks way beyond basic economic recovery, and it is investing in the significant and exciting medium to long term opportunity in Asian markets. Couple this with very high gross/EBITDA margins and the outcome is a highly cash generative business with significant scope for long term EPS and dividend growth.

About Somero Enterprises

Before we drill down into the company's strategy and growth plans it is worth reminding ourselves what the business does and why it has a dominant position in its business niche.

About Somero Enterprises

Somero is a leading manufacturer (assembling component parts as opposed to traditional manufacturing and therefore it has very low levels of capex) of laser-guided, technologically innovative machinery. The company designs, assembles and sells patented equipment that automates the process of spreading and levelling large volumes of concrete for commercial flooring and other horizontal surfaces such as car parks. The company's innovative, proprietary products employ laser-guided technology to achieve a high level of precision.

Where are the company's products and services used?

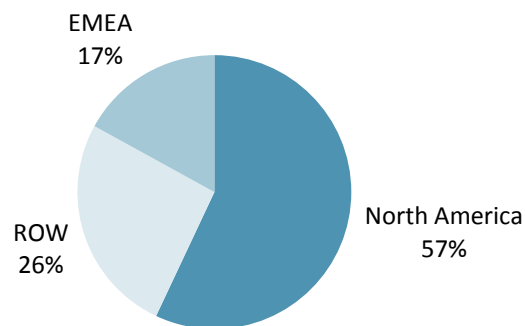
Somero sells primarily to concrete contractors for use in non-residential construction projects in over 90 countries. Laser Screed equipment has been specified for use wherever a flat concrete floor is required, including constructing industrial warehouses, assembly plants, offices, factories, schools, hospitals, sports complexes, big box retail outlets and retail centres.

Somero is a Global Business

Somero markets and sells its products through a direct sales force, external sales representatives and independent dealers. Its products are marketed in North America, Latin America, Europe, the Middle East, South Africa, Asia and Australia.

The split in 2013A sales between North America, EMEA (Europe including Russia and Scandinavia, Middle East, Africa and India) and the Rest of the World (China, Pacific, Latin and South America, Korea and Australia) was as follows.

Exhibit 1: Somero Enterprises – Sales Split 2013A



Source: Somero Enterprises

The company has the following teams in place;

- USA – 10 Direct Sales/Marketing Team – 16 Customer Service Employees
- Europe – 2 Direct Sales Force – 5 Customer Service Employees – 13 independent representatives serving over 27 countries
- China – 12 Direct Sales/Marketing – 4 Customer Service Employees

- Rest of the World (India, Middle East, Turkey, Greece, Africa, Latin America) – 4 Direct Sales Team – 1 Customer Service Engineer – 7 Independent Agents Direct Sales
- Australia and S.E. Asia - Experienced representative group covering 9 countries.

Unmatched customer service and support - cornerstone of the business strategy

In this note we mainly look at the company strategy and management's plan to double revenues between the period 2013A and 2018E. However, before looking at the individual markets, their prospects for recovery, growth or product penetration, it is important to understand that Somero isn't in the business of simply creating machines and products to sell into the concrete placement market. At the centre of the business is an incredibly strong and unmatched customer service offer and ethos. This is very important to the company. If it invented equipment and sold it into the marketplace without its multi-layered approach to customer service (discussed later in this section), although it has numerous patents, potential competitors could attempt to build slightly different or cheaper products and take market share. Unmatched customer service and customer training/advice not only helps Somero maintain a dominant position in this niche, it also helps it to expand this niche.

Creating high barriers to entry

There are significant barriers to entry due to the technology, patents, NPD and service provision adopted by Somero. Indeed, the company has over 99% market share in this niche category. As we elude above, the company promotes customer training, technical support and continuous product innovation towards its global customer base, to which it regularly passes on its knowledge and expertise.

Founded in 1985, the company has grown by delivering industry leading products to an international market. Its products drive efficiency for the end user (reduced construction time, flatter and with fewer people). Therefore, the company's vision is for its technology and processes to be used wherever a redi-mix truck is discharging concrete for a concrete slab.

The importance of investing in People and Training

The company continually invests in people in order to improve quality and productivity across the business. With significant growth in the number of people working for Somero, the company now has 162 employees. Investment in training has therefore been significant in recent years and should support growth in revenues in the coming years. Key company personnel are also actively involved in concrete related organisations and associations such as the ACI and ASCC.

The company also invests in people and training. In particular, in 2014 to date, the company has continued to invest in large markets with strong potential GDP growth such as China and India.

The importance of Research, NPD and Investment

New Product Development (NPD) remains very much customer driven. Somero is committed to constantly improving its current products while researching and developing new technology for better, more innovative products of the future. In our opinion, new product development will remain a key driver of revenue growth outside North America in future.

New products made a strong contribution to the company's financial results in the most recent results (H1 2014A). Indeed, three new models, the new S-22E, S-11M and the S-15R boomed models were the most significant contributors to the company's overall results. The company targets at least one new product a year and spend 2-3% of sales towards product development.

The Simplicity Programme

The company is also dedicated to a Simplicity programme for the broad range of its product lines. This focused programme is designed to aid the customer in operational training and maintenance. In this regard, product development efforts focus on new technology and methods aimed at reducing the amount of time and skill that is required to operate the company's equipment. We believe it is particularly important in many emerging markets. Therefore, going forward, the Simplicity programme is to be one of Somero's main goals when developing new products. Given the benefits this offers the customer, this programme should further solidify the company's competitive advantage.

Products with Patents that protect the technology

The company has 56 patents at present with numerous patent applications pending. Its innovative, proprietary products include the large S-22E Laser Screed, CopperHead, Mini Screed™-C, S-840 Laser Screed, S-15M Laser Screed, S-11M Spreader, 3D Profiler and S-485 which employ laser-guided technology to achieve the highest level of precision.

The Customer Offer

Somero has years of experience working with customers to solve the toughest application and maintenance problems associated with Laser Screed concrete levelling equipment. The company offers customers using its equipment expert help, 24/7 in all languages. The service offer would be difficult to replicate, particularly for any business that might attempt to use price: lower margins to grab a foothold in the market

Somero equipment is designed and built to provide maximum productivity and operational economy throughout its working life. In this regard it works with customers to help maintain the equipment's built-in value with a variety of services which again both defends market share and offers growth opportunities. These services include;

Train For Success

Concrete construction sites can be complicated and stressful locations. If a client has a new operator or if it wants to brush up on some finer skills, the company can dispatch one of its trained professionals to provide on-site service. To this end it helps clients to find ways to improve efficiencies, enhance job site safety and cut costs.

In 2013, Somero increased customer training via the customer service team by c100%. Coupled with customer feedback, it led to the development of the SCC (Somero Concrete College) with a view to increasing customer knowledge about higher quality flooring installation as well as increase customer loyalty. This is initially being offered into the Chinese market and will be rolled out to India over time.

Equipment Evaluation / Mechanical Repairs

Setup, calibration and adjustment to Somero's equipment can restore optimum performance to its precision equipment. Somero can assist clients' mechanics with repairs or perform the repairs themselves. A trained technician provides a detailed evaluation of parts and services required to make clients machines run like new, delivering maximum value and increased customer loyalty.

Service Contracts / Extended Warranties

The company offers extended warranty and service contracts to its customers.

Instant Troubleshooting and Service Partners

The company offers 24/7 service coverage for its machines. It finds that troubleshooting over the phone is the fastest way to get an expert technician in touch with clients and get equipment up and running quickly. In many cases the supplier of components on Somero equipment can be serviced locally by the dealer or original supplier of the component. The company's customer service representatives are always available to assist with whatever issues customers may be having.

Refurbished equipment

Somero offers a selection of Factory Certified Refurbished Equipment. These products offer Somero's labour saving technology at an affordable price. All refurbished equipment is upgraded to the most advanced operating technology as on current model year and comes with a warranty.

Softer improvements across the business over the past year

The company has significantly improved the way that it deals with customer feedback both in terms of process and responsiveness, and invested in IT systems, storage and processing. In addition it launched the Somero Culture Programme which defines the company's core values. This is aimed at improving the understanding and experience of both employees and customers.

Strategic Plan

A plan to double Revenue by 2018

Somero developed a Strategic Plan designed to double revenues from those reported in 2013A (\$45.1m) by 2018E (to over \$90m). This equates to an average increase in revenues per annum of \$9.1m. It aims to continue growing its business in established markets such as the US, whilst investing in some important growth economies. Key drivers to US and European growth are being used by the company as a roadmap for emerging markets expansion.

The key drivers and initiatives include;

- Taking advantage of the demand for better floors,
- Increased performance measurement across the business (systems introduced and accepted)
- A focus on Customer Support,
- Operator training,
- Job site consulting,
- Product demonstrations,
- New innovations and regular new-product launches,
- Retention of Key Employees,
- Marketing,
- Third-party Financing,

Looking at the strategy and financial targets from a regional perspective;

US (Target = 100% growth)

In the US the company's strategic target is to more than double revenue by 2018. There is significant pent-up demand for residential construction post the recession. Indeed, the Portland Cement Association report of November 2013 had output forecast to peak at some point after 2022. Elsewhere, the Portland Cement Association forecasts non-residential cement consumption to increase by 131%, so there is plenty of scope for volumes to surpass the 2007 peak over the next decade.

The company believes that average selling prices will increase as the economy continues to grow, evidenced by previous cycles. Indeed, Large Line average selling prices increased by 42% over the previous recovery; Small Line average selling price increased 25% over the same period. US total sales at the previous peak (in 2007) were \$40m. If we used an average of these two growth rates (34%) through the current cycle, we would arrive at US peak sales of \$53.6m simply based on price increases. That said, US Sales were \$25.5m in 2013A (the starting point for measuring the company's performance relative to its strategic objectives) so clearly our assumptions include a continued recovery in volumes out to 2018E, and beyond.

- We forecast US Sales of \$58m in 2018E and further growth after that.

Technological advancement, New Product launches and replacement demand will be key drivers in the territory. We are confident that the company will achieve this based on its record. Somero innovations have resulted in 28 new patented products since the company was founded and the flow of new innovations has been consistent with yearly new product introductions.

To support this growth the company has a highly experienced 10 person sales and marketing team with an average of 12 years experience each in the US. It also has a 24/7 Customer Support team of 19 experienced engineers providing technical support with a combined 99 years of service.

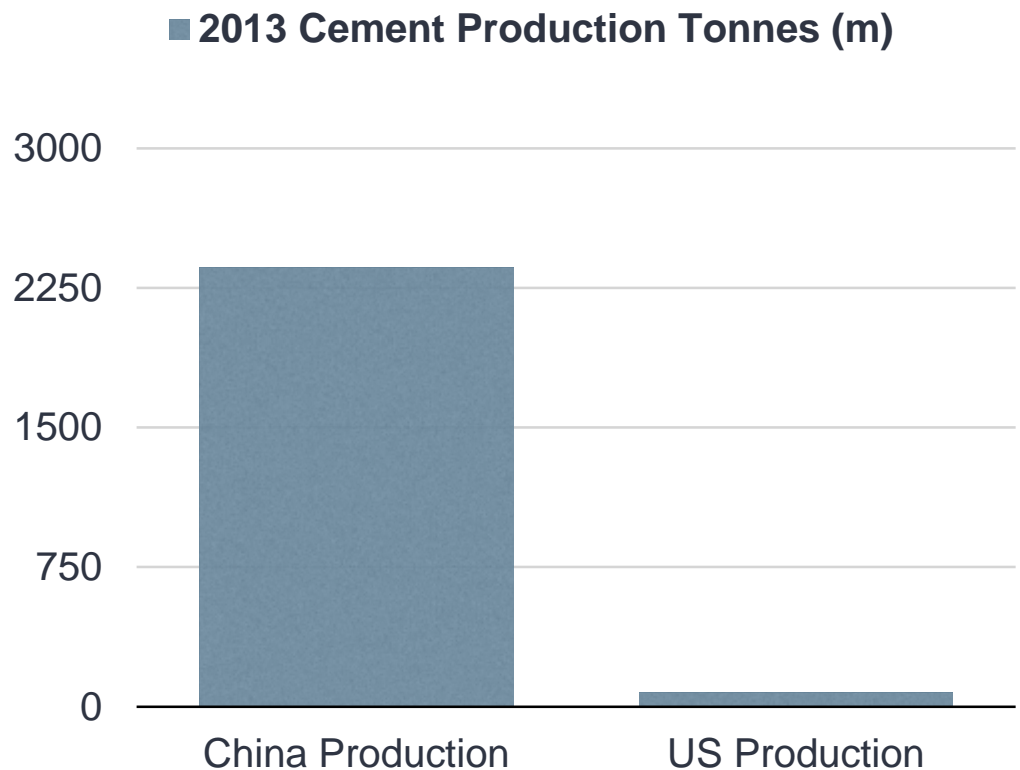
China (Target = 200% growth)

Management's target is to more than triple revenue by 2018 in China to \$20m. The opportunity is massive. Total cement consumption in China is 30 times larger than that of the US (source: CEMBEAU and US Geological Survey). Therefore the total market opportunity is far greater than that of the 2007 peak sales in US. Indeed the data suggests that the potential market is \$1,200m. We arrive at this number by multiplying the peak sales in the US market of \$40m by 30x.

At present Somero Sales in China (2013A) are just \$6.6m ie 0.55% of the potential. Even if we look at 2013A China Sales relative to a market 30x larger than US Sales in 2013A (\$25.5m), we arrive at just 0.9% penetration and a market that is potentially worth \$765m.

The following chart shows Chinese cement production versus US cement production in 2013.

Cement Production Tonnes

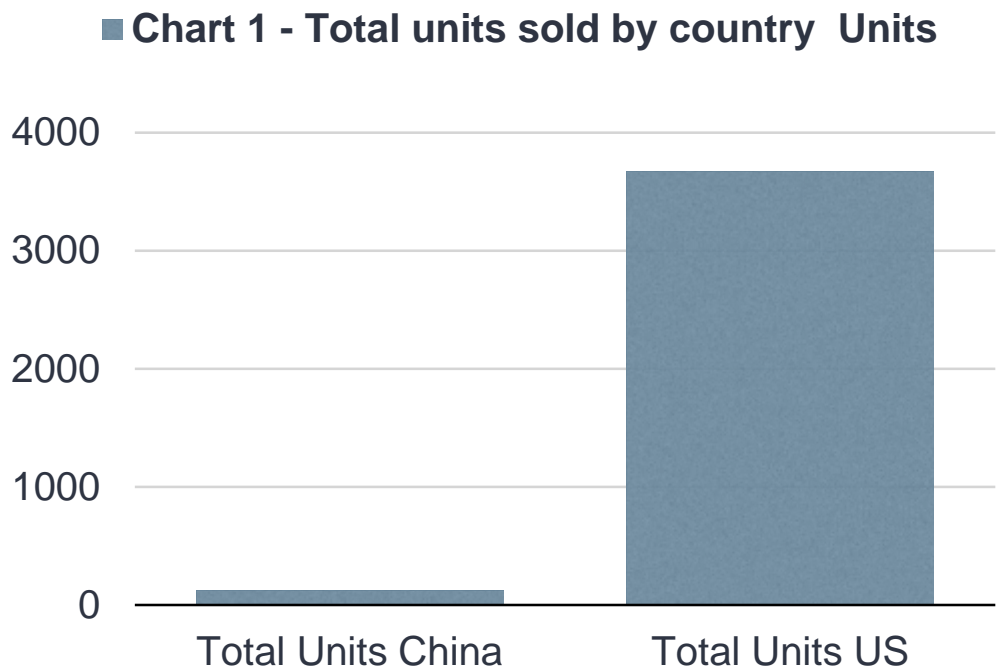


Source: Portland Cement Association, US Geological Report, Broker Profile

Having established that the potential market in China is many times greater in size than the US market, it is perhaps surprising that at present the company actually sells around 30x more product into the US (despite the Chinese market being 30x greater in terms of cement consumption).

The next chart demonstrates how embryonic the market is. It compares total unit sales in the US compared to China in the last financial year and shows Somero selling many times more units into the US at present.

Total units sold by country Units



Source: Portland Cement Association, US Geological Report, Broker Profile

This is interesting because it suggests that the opportunity for Somero will be driven by the company's own ability to increase penetration rates in the concrete flooring industry and not by economic or construction industry growth, making Somero a self-help story and not a simple proxy of Chinese economic fortunes. Indeed we can ignore economic growth in our forecasting.

So we have outlined that market penetration for Somero's product is very low at present but the company is investing in product, staff and training in order to further penetrate the market. The China Flooring Association has implemented the US flatness and levelness system as the concrete flooring specification, which should significantly increase the potential for the company.

The company is focused on developing a comprehensive support programme in China with four Somero trained employees. The Somero Concrete College was set up to educate all customers on all segments of installation of high-quality concrete floor, and the Simplicity Programme for all products is further designed to assist customers in being able to use Somero products.

The company has a dedicated specification engineering team which focuses on educating building owners, engineers and specifiers on wide-placement floors and flatness specifications. From a Sales perspective, the hiring and training programme has, in the company's opinion, helped produce very effective employees. Going forward new product launches will also be an important driver of growth.

India (Target = Exponential Growth)

From its current embryonic position a large opportunity exists in India. Based on cement consumption data from CEMBEAU and the US Geological Survey, total cement consumption is over 3 times larger than that of the US. Indeed cement consumption is second only in the world to China. Market penetration is just beginning as the company only the established a specification engineering and support office in 2013. It has three new employees focused on flatness specifications, sales and customer support. The Somero Construction College system will again be used in this potentially significant market to educate all customers on all segments of installation of high quality concrete floor.

We estimate the company will achieve 2014E Sales of \$510,000 in India. Therefore, if we use 3x the 2007 US market peak sales of \$40m, we arrive at a potential market of \$120m and a market penetration rate of just 0.4%. Using the 2013A US Sales data we would arrive at a market worth a potential \$77m and a penetration rate of 0.7%. Therefore again, we can ignore economic and construction market growth in our forecasting and valuation and focus on penetration and pricing. It is clear to us that the India business should have a growth path similar to China.

Europe (Target = 200% growth)

The management target is to more than triple European revenues by 2018. Although it has been slow and at times patchy, it appears that the economic recovery has begun and in our opinion will slowly accelerate over the next 3-4 years.

The company is well established in many parts of Europe and positioned firmly to take advantage of the recovery having a seasoned sales team of two direct and thirteen independent representatives with 87 years of combined service. The company also has a customer support team of five people with 69 years of combined service.

A combination of new product launches and increasing demand for replacement product will drive growth.

Other regions (Target = 40% growth)

Elsewhere, in Russia, Scandinavia, the Middle East, South America, Australia, Southeast Asia and Korea, management's target is to grow revenue by more than 40% by 2018. All regions are experiencing economic growth.

Somero expects the seasoned and experienced salesforce it has in place, new product launches and a strong, experienced 24/7 support team to facilitate this growth out to 2018.

Summary

We believe a significant growth opportunity exists for Somero in a niche segment of the market, a market that the company dominates due to its innovation and NPD, as well as its unmatched customer service offer. Having assessed the company's strategic growth plans we believe the growth targets are achievable and the assumptions in reaching those targets robust. Our overall revenue forecasts out to 2018E are as follows. (Table 3 in model)

Forecasts

In this section, we have published detailed forecasts for the Income Statement, Cash Flow and Balance Sheet.

Growth drivers

Growth drivers for the company include the following;

- Global GDP growth
- Growth in global construction activity
- New product development
- Customer training and support
- Economic recovery in the US
- Growth in China. A combination of strong economic growth and increased product penetration is resulting in strong revenue growth for Somero and in our opinion this will continue for a number of years.

Valuation and catalysts

Based on our forecasts, the company is trading on a PER of 10.3x current year numbers falling to 9.2x by 2016E. We forecast 15% compound growth in EPS between 2013A and 2016E and therefore from a PER perspective, given the upward momentum in market forecasts the shares look good value.

In terms of dividend yield, the current share price offers a 2.0% yield rising to 2.6% by 2016E. We forecast 20% average growth per annum in the dividend between 2013A and 2016E. Again, on this measure we would argue that Somero looks good value.

Income statement

Year End 31 December, US\$m	2012A	2013A	2014E	2015E	2016E
Total Revenues	32.2	45.1	57.9	63.8	70.2
<i>Growth %</i>		40.1%	28.0%	10.2%	10.0%
Gross Profit	15.7	23.5	31.3	34.9	39.0
<i>Gross Margin %</i>	48.8%	52.1%	54.0%	54.7%	55.5%
Total Operating Costs	-14.2	-17.1	-19.3	-21.7	-24.3
EBIT	1.4	6.4	12.0	13.2	14.7
<i>EBIT margin %</i>	4.3%	14.2%	20.7%	20.7%	20.9%
EBITDA	3.9	9.0	14.3	15.7	17.2
<i>EBITDA margin %</i>	12.1%	20.0%	24.5%	24.6%	24.6%
Interest	-0.2	0.1	0.0	0.0	0.1
Forex and Other	0.1	-0.2	0.3	0.0	0.0
PBT – reported	1.2	6.5	12	13.2	14.8
PBT - adjusted	3.7	8.5	14.1	15.2	16.7
Tax	-0.2	-1.1	1.0	-4.0	-4.7
<i>Tax %</i>	-16.7%	-16.9%	8.0%	-30.0%	-32.0%
PAT - adjusted	3.4	7.4	15.0	11.1	11.8
Shares in issue	56.43	56.43	56.35	56.50	57.10
Shares in issue (Fully diluted)	61.59	60.73	60.92	60.92	60.92
EPS (c) (pre-amortisation)	6.0	13.1	26.6	19.7	20.7
EPS (c) (pre-amortisation, FD)	5.7	12.2	24.6	18.3	19.4
EPS (c) (basic)	1.8	9.7	23.1	16.4	17.6
EPS (c) (Fully diluted)	1.6	9.1	21.4	15.2	16.5
EPS (c) adj for tax benefit			19.0		
EPS (p) Adjusted diluted	3.8	8.1	11.7	11.4	12.2
DPS (c)	0.8	2.2	3.5	4.0	4.6
DPS Cover (x)	2.2	4.4	5.4	4.1	3.8

Source: Broker Profile, Somero Enterprises

Cash flow

US\$m	2012A	2013A	2014E	2015E	2016E
Profit	1.0	5.4	13.0	13.2	14.8
Depreciation & Amortisation	2.6	2.4	2.4	2.4	2.3
Gross Cash Flow	3.6	7.8	15.4	15.6	17.1
Working Capital	-0.6	-0.1	-1.0	-1.0	-1.0
Operating Cash Flow	3.0	7.7	14.4	14.6	16.1
Tax	0.1	0.1	-3.5	-4.0	-4.3
Net Cash Flow	3.1	7.8	10.9	10.7	11.7
Capex	-0.6	-0.8	-0.9	-1.0	-0.9
Other	0.2	0.0	0.0	-0.2	-0.2
Net Cash Flow pre Financing	2.7	7.0	10.0	9.5	10.6
Dividends	0.0	-1.0	-2.0	-2.3	-2.6
Equity	0.0	-0.6	0.0	0.0	0.0
Other	0.2	0.1	-3.5	-0.8	0.0
Borrowings	-1.7	-0.5	0.0	0.0	0.0
Forex	-0.1	-0.2	-0.2	0.0	0.0
Net Movement in Cash	1.1	4.8	4.4	6.4	8.0
Cash	1.2	6.0	10.4	16.8	24.8
Net Cash	-1.9	3.4	7.8	14.2	22.2

Source: Broker Profile, Somero Enterprises

Balance Sheet

US\$m	2012A	2013A	2014E	2015E	2016E
Non Current Assets	14.3	13.3	11.8	10.4	9.0
Current Assets	12.6	18.8	28.2	35.6	45.1
Total Assets	26.9	32.1	39.9	46.0	54.1
Current Liabilities	-4.2	-6.8	-8.8	-9.1	-9.4
Non Current Liabilities	-2.6	-1.4	-4.9	-8.2	-8.6
Total Liabilities	-6.8	-8.2	-13.7	-17.2	-18.0
Net Assets	20.1	23.9	26.2	28.7	36.1

Source: Broker Profile, Somero Enterprises

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Augustine House
6A Austin Friars
London EC2N 2HA
www.brokerprofileresearch.com



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