

## New City Energy

### Focusing on shale oil and gas

New City Energy (NCE) provides exposure to the energy sector with a specific focus on unconventional shale oil and gas where the managers see the most attractive investment opportunities. The portfolio is focused on cash-generative companies with potentially undervalued shale assets where the managers see scope for technological advances to improve production capacity. Currency moves and non-shale investments weighed on performance in 2012 and 2013. By contrast, 2014 has seen a positive start benefiting from rising oil and gas prices and abating currency headwinds. Underpinned by fixed-income investments, dividends are paid quarterly and NCE's 5.5% yield ranks it at the top of the peer group.

12 months ending	Total share price return (%)	Total NAV return (%)	S&P/TSX Energy TR (%)	S&P ASX 200 Energy TR GBP (%)	S&P Global 1200 Energy TR GBP (%)	FTSE AW Oil&Gas TR GBP (%)
31/05/11	43.2	23.9	17.3	30.4	23.6	19.0
31/05/12	(35.2)	(27.0)	(21.0)	(23.3)	(11.7)	(13.2)
31/05/13	(0.8)	(16.4)	14.8	8.0	21.7	20.4
30/05/14	(3.9)	0.3	7.8	(0.9)	8.3	6.1

Note: \*Twelve-month rolling discrete performance.

### Investment strategy: Shale oil and gas focus

NCE's investment objective is to deliver attractive returns principally in the form of capital growth with some prospect of income, predominantly through investing in the energy sector. Over the last two years there has been an increasing focus on the faster-growing shale oil and gas sector. The managers' investment process is primarily based on bottom-up stock selection drawing on industry experience, management meetings and valuation analysis. This is supported by a top-down overlay and attention to broader themes. The managers use fixed-income investments to support dividend payments and gearing is roughly equivalent to this element of the portfolio.

### Sector outlook: Unconventional developments

The unconventional shale oil and gas sector has grown rapidly over the past decade to represent 30-40% of US crude oil and natural gas production. Across the oil and gas industry, capital allocations are increasingly focused towards shale exploration projects that enjoy a more favourable risk-reward profile than conventional offshore projects. Technological advances are expected to extend the life of producing shale operations and increase the potential scale of undeveloped commercially viable shale projects. Major shale resources have been identified outside the US and countries including Argentina, Columbia and Poland are considered likely to advance the development of shale projects in the near term.

### Valuation: Discount higher than 12-month average

After narrowing to c 5% in early 2014, the discount has subsequently widened to 21%, above the 15% average and close to the 22% peak level of the last 12 months. NCE has a yield of over 5% and ranks at the top of the five dividend-paying trusts in the peer group.

### Investment trusts

4 June 2014

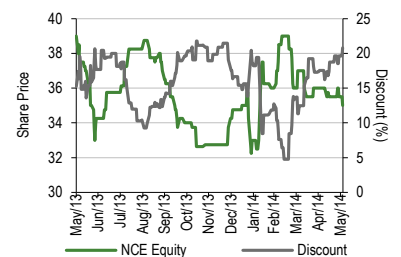
<b>Price</b>	<b>35.0p</b>
<b>Market cap</b>	<b>£19m</b>
<b>AUM</b>	<b>£27m</b>

NAV*	44.2p
Discount to NAV	20.8%
Yield	5.5%

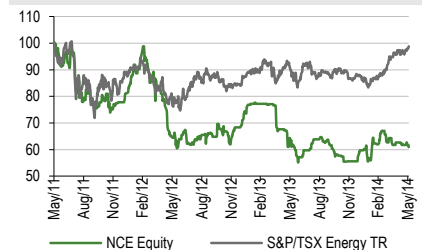
\*Adjusted for debt at market value, including income as at 23 May 2014.

Ordinary shares in issue	53.6m
Code	NCE
Primary exchange	LSE
Secondary exchange	Channel Islands SX
AIC sector	SS: Commodities & Natural Resources

### Share price/discount performance\*



### Three-year cumulative perf. graph



52-week high/low	39.0p	32.3p
NAV** high/low	45.4p	39.5p

\*\*Including income.

### Gearing

Gross*	21.0%
Net*	21.0%

\*As at 30 April 2014.

### Analysts

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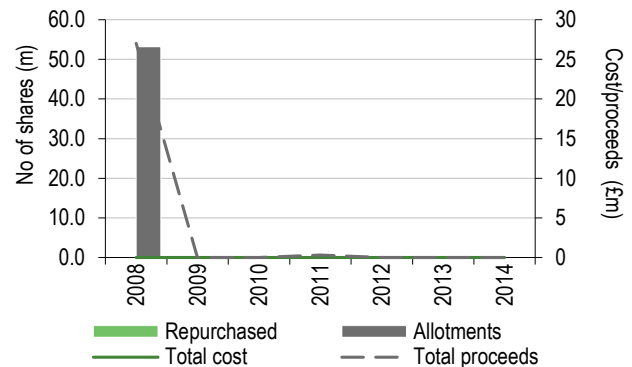
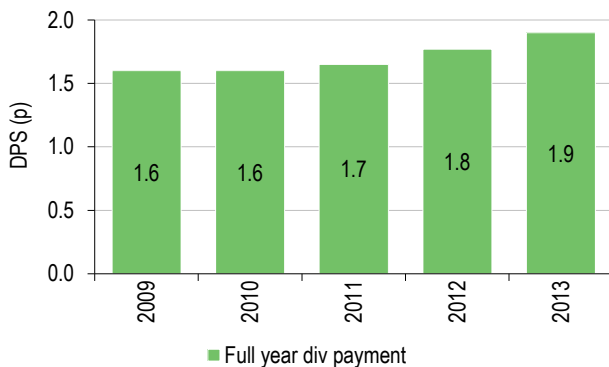
[Edison profile page](#)

### Exhibit 1: Company at a glance

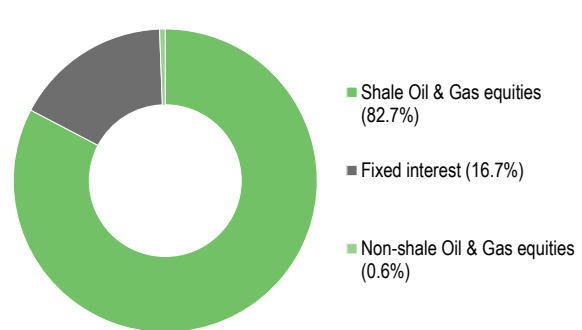
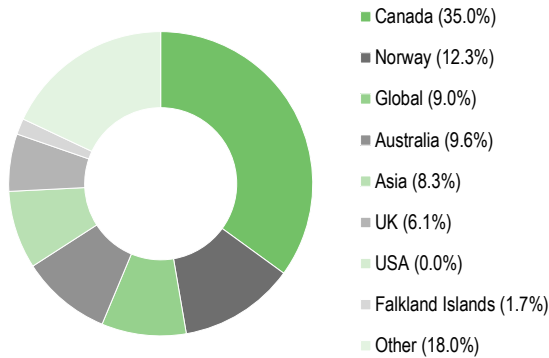
Investment objective and fund background	Recent developments
NCE's investment objective is to deliver attractive returns to shareholders principally in the form of capital growth, yet with some prospect of income, predominantly through investing in the shale oil and gas sector.	10 February 2014: Expiry of subscription share rights and cancellation of subscription shares CISX listing. 20 December 2013: Management fee reduced from 2.0% to 1.375% with effect from 1 January 2014.

Forthcoming		Capital structure		Fund details	
AGM	March 2015	Ongoing charges	3.35%	Group	New City Investment Managers
Interim results	June 2014	Net gearing	21.0%	Managers	Will Smith, Ian Francis
Year end	30 September	Annual mgmt fee	1.375% of gross assets	Address	5th Floor, 33 Chester Street, London SW1X 7BL UK
Dividend paid	Quarterly	Performance fee	20% above 8% pa hurdle	Phone	+44 (0)20 7201 6900
Launch date	February 2008	Company life	7 years	Website	<a href="http://www.ncim.co.uk">www.ncim.co.uk</a>
Continuation vote	Annually from 2014	Loan facilities	Up to 35% gearing		

Dividend policy and history	Share buyback policy and history
NCE pays quarterly dividends and has maintained or increased the level of dividend for each financial year since launch.	Subject to annual renewal, NCE is authorised to allot ordinary shares at a premium to NAV and to repurchase up to 14.99% of its ordinary shares.



### Distribution of portfolio by geography (as at 30 September 2013) | Distribution of portfolio by value (as at 30 April 2014)



### Top 10 holdings (as at 30 April 2014)

Company	Country	Portfolio weight %	
		30 April 2014	30 September 2013
Vermilion Energy	Canada	9.2	4.5
PHX Energy Services	Global	7.7	5.7
ARC Resources	Canada	6.1	3.5
Secure Energy Services	Canada	4.5	3.6
Crescent Point Energy	Canada	4.4	3.1
Baytex Energy Trust	Canada	4.2	2.9
Alkane Energy	UK	3.7	3.8
Surge Energy	Canada	3.6	1.9
Gran Tierra Energy	Canada	3.4	2.7
Canacol Energy	Canada	3.3	1.2
<b>Top 10</b>		<b>50.1</b>	<b>32.7</b>

Source: New City Energy

## Sector outlook: Unconventional opportunities

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Unconventional shale oil and gas resources have had an increasingly significant influence on global energy markets over the last decade, particularly in the US, where the US Energy Information Administration (EIA) reports that in 2012 they provided 29% of total crude oil production and 40% of total natural gas production. Technological advances have enabled abundant shale oil and gas resources to be exploited commercially, significantly increasing potential global oil and gas market supply and altering global trade flows as the US has become increasingly energy self-sufficient. Independent exploration and production (E&P) companies have led the development of shale projects with major integrated oil and gas companies having continued to focus primarily on conventional offshore exploration, which is where the majority of their expertise lies. Looking ahead, the potential for further production growth is signalled by rising estimates for US tight oil (which includes shale) and shale gas output. The EIA's 2014 outlook projects 108% and 42% increases in tight oil and shale gas output from 2012 levels by 2021. These forecasts are significantly ahead of the EIA's 2013 outlook, suggesting that technological advances could lead to further increases to forecasts.

Significant variation in geology across shale formations and access to transport infrastructure affect economic recoverability of the contained oil and gas resources. The selection of favourably positioned companies is therefore vital for investors in this sector. While large-scale low-cost production is generated from the Permian, Eagle Ford, Bakken, Marcellus and Niobrara shale resources in the US, there are numerous US shale gas resources such as Fayetteville and Haynesville, where production is uneconomic at current market prices.

Shale oil and gas resources have been developed most rapidly in the US, where companies are required to fulfil significant well-drilling commitments to maintain exploration licences thus encouraging high levels of development expenditure. Outside the US, the slower development of unconventional projects has been due to a combination of factors including environmental concerns and local market dynamics. Despite the slower pace of development, substantial shale oil and gas resources have been identified in a number of countries including China, Argentina, Algeria, Canada and Mexico.

A level of geopolitical risk premium continues to support oil and gas prices with ongoing disruption in output from oil-producing countries such as Libya and concerns surrounding Russian exports resulting from political tensions over Ukraine. Even though there are continuing concerns over slowing Chinese economic growth, global activity has been broadly strengthening and is expected to improve further in 2014-15, as highlighted in the IMF's April 2014 World Economic Outlook. This provides a positive fundamental backdrop for near-term oil and gas demand and prices. Taking a medium-term view, it should be recognised that increasing supply from shale oil and gas projects could weigh on oil and gas prices.

## Fund profile: Focus on shale oil and gas

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New City Energy (NCE) was launched in February 2008 with an initial life of seven years, extended by one year at the 2014 AGM, and this can be extended by an additional year subject to shareholder approval at each subsequent AGM. NCE's investment objective is to provide attractive returns principally in the form of capital growth with some prospect of income predominantly from investing in companies involved in the exploration, development and production of energy, and related service companies. In December 2013, the board gave approval to the increasing focus of the portfolio on shale oil and gas. The managers are permitted to invest up to 30% of gross assets in companies operating in other sectors and a fixed-income element of the portfolio is maintained to

support the payment of dividends. There is no specific performance benchmark. NCE has been managed since inception by natural resources and high-yield specialist, New City Investment Managers (NCIM), owned by CQS, a global multi-strategy asset manager with US\$13bn under management. The portfolio is co-managed by Will Smith and Ian Francis, who are supported by Keith Watson and Rob Crayford. Will Smith is primarily responsible for equity investments in the portfolio, while Ian Francis focuses on fixed-interest securities.

## **The fund managers: Will Smith and Ian Francis**

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### **The manager's view: Natural progression to shale oil and gas**

Will Smith sees the fund's current focus on the shale oil and gas sector as a natural progression given the energy sector's characteristics. Given the greater returns that are considered to be achievable by unconventional oil and gas projects compared with conventional oil and gas, coal and uranium projects, the portfolio has become more exposed to shale oil and gas investments over the past two years and a significant restructuring of the portfolio has not been implemented.

The managers consider that shale oil and gas projects currently offer the greatest returns across the energy sector, with internal rates of return in excess of 50% considered achievable compared with typical conventional oil and gas project returns of 17-20%. Unconventional onshore exploration projects are favoured where the manager considers there are greater chances of exploration success than for conventional offshore projects. While capital allocations are moving away from conventional to unconventional exploration projects, overall capital expenditure is increasing across the oil and gas sector and services companies in the portfolio such as PHX Energy Services are expected to benefit from this trend.

The manager's view is that gas prices remain capped by large-scale recent discoveries increasing market supply, although current prices should be supported by the replenishment of gas storage from historically low levels and ongoing oil supply disruptions in a number of the leading producing countries are expected to support the oil price at around current levels. In the longer term, there is expected to be some downward pressure on gas prices due to increasing supply from shale projects. Given this outlook, the managers' preference is to invest in companies with relative oil:gas exposure of around 70:30 (North American oil:gas weighting is closer to 85:15 in the portfolio).

NCE's largest portfolio holding, Vermilion Energy, provides a good example of the investment characteristics sought by the managers. Vermilion is growing production at its conventional oil and gas operations across Canada, Europe and Australia and has significant interests in shale oil and gas resources. The managers consider that the market is not attributing significant value to Vermilion's unconventional oil and gas assets outside Canada and, although political factors may delay their development, these offer significant potential valuation upside. The managers consider that shale oil and gas projects outside the US will increasingly be approved for development as technological advances are made that substantially increase the scale of economically viable resources. Argentina, Columbia and Poland are seen as countries where major shale projects are likely to be developed in the near term as there is strong government support and sufficient exploration drilling has been completed to determine the geological characteristics of the resources.

## **Asset allocation**

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### **Investment process: Bottom-up with top-down overlay**

NCE's investment process is primarily based on bottom-up stock selection supported by a top-down overlay. An assessment of the macroeconomic environment through fundamental research and

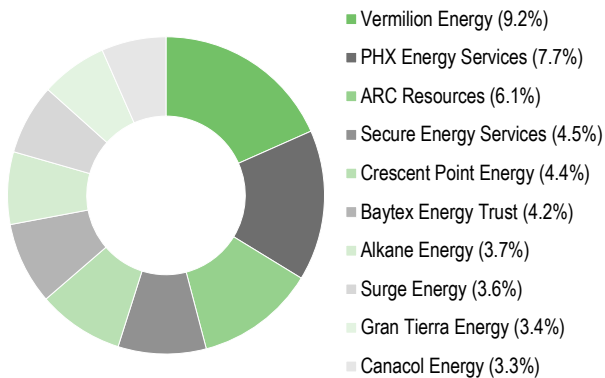
interaction with CQS trading teams identifies broader themes that are taken into consideration in the stock selection process including geopolitical concerns, currency trends, market liquidity and sentiment. Additionally, sector analysis is performed addressing global demand factors to establish an asset allocation overlay. Stock selection is performed by NCIM's experienced investment team with extensive industry knowledge and is based on management meetings and detailed valuation analysis. A range of valuation metrics are considered to identify undervalued assets and valuations are stress-tested at a range of commodity price forecasts.

## Current portfolio positioning

Overall portfolio concentration has been broadly stable since NCE's year end with the total number of equity and fixed-income issues in the portfolio reduced marginally from 68 at 30 September 2013 to 65 at 30 April 2014. The top 10 holdings weighting has increased slightly from 49.3% to 50.1%, with strong performances from Vermilion Energy and PHX Energy in particular increasing their weightings and offsetting the departure from the top 10, following disposal of Coastal Energy, which represented over 10% of the portfolio at 30 September 2013 (see Exhibit 3). Investments are focused on mid-cap stocks and the manager estimates the average market cap of the top 10 holdings at c US\$1bn.

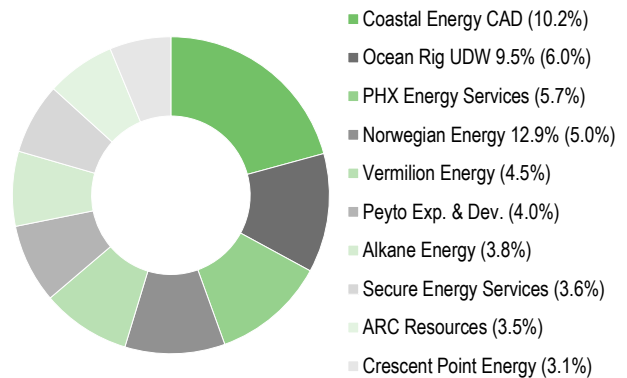
At 30 April 2014, shale oil and gas equities represented 83% of the portfolio and 99% of the equity holdings, reflecting the current investment focus. The portfolio has c 30% exposure to shale oil and gas projects outside the US. The manager reports that shale-related equities represented 76% of the portfolio at 31 March 2013, tending to confirm that the move towards shale was already well under way by September 2013. While only six of the current top 10 holdings featured in the September 2013 top 10 (see Exhibits 2 and 3), all 10 holdings were in the portfolio (see Exhibit 1).

**Exhibit 2: Top 10 holdings at 30 April 2014**



Source: New City Energy, Edison Investment Research

**Exhibit 3: Top 10 holdings at 30 September 2013**



Source: New City Energy, Edison Investment Research

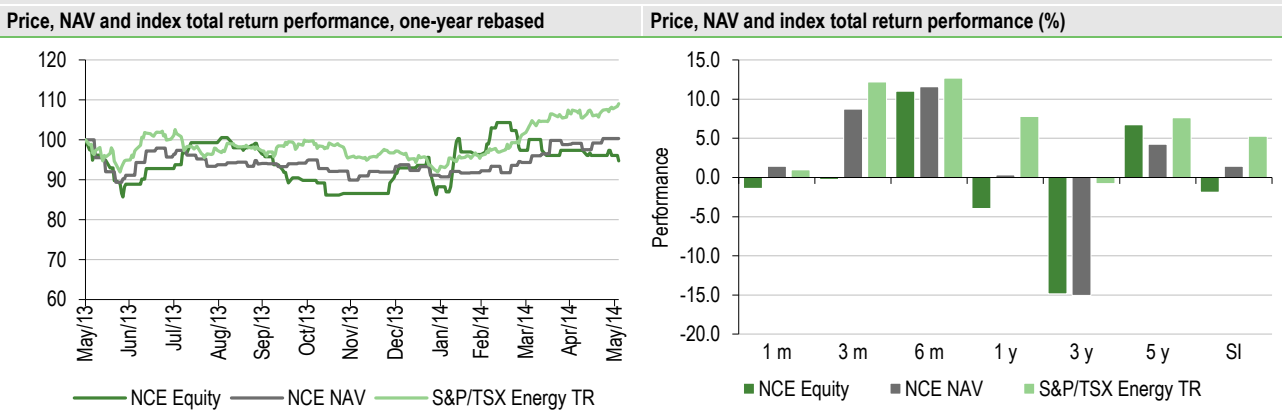
Fixed-income securities represented 17% of the portfolio at 30 April 2014 compared with 27% at 30 September 2013 and gearing reduced from 24% to 21% reflecting the managers' use of gearing broadly in line with the fixed-income element of the portfolio. Fixed-income investments are focused primarily on the energy sector with additional exposure to the broader resources sector. Eight unlisted equity securities are held, which represented 7.5% of the portfolio at 30 September 2013 compared with 6.7% at 31 March 2013. The manager does not expect to add to the unlisted equities in the portfolio, which have been held for over three years and provide roughly equal exposure to conventional and unconventional oil and gas projects.

## Performance: Weakness during the past two years

As Exhibit 4 illustrates, NCE has underperformed the S&P/TSX Energy index in terms of NAV total return over one, three and five years and since launch in February 2008. As illustrated by Exhibit 6,

a weak relative performance from April 2012 to July 2013 has outweighed the strong relative performance achieved during the period from May 2009 to January 2011. Factors contributing to the weaker recent performance include the decline of the Canadian and Australian dollars against sterling and the poor performance of individual holdings exposed to conventional oil and gas exploration, uranium and coal sectors, including former top 10 holdings Wessex Exploration and Coalspur Mines. NCE's substantial outperformance from May 2009 to January 2011 coincides with a period during which small-cap resources shares outperformed their large-cap peers. In terms of risk-adjusted returns, NCE's Sharpe ratios over one and three years are negative, but not substantially different from peer group averages. Over five years NCE's Sharpe ratio of 0.4 is low, but ahead of the peer group average.

#### Exhibit 4: Investment company performance



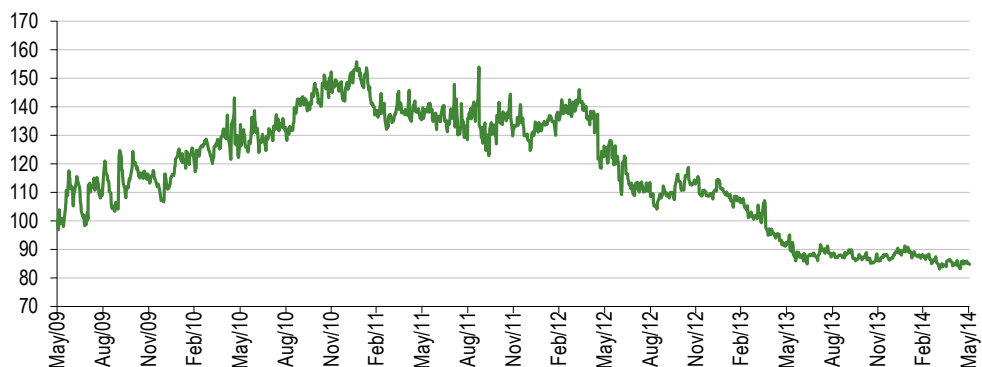
Source: Thomson Datastream, Edison Investment Research. Note: Three- and five-year and SI (since inception) performance figures annualised.

#### Exhibit 5: Share price and NAV total return performance, versus indices (percentage points)

	One month	Three months	Six months	One year	Three years	Five years	Since launch
Price versus S&P/TSX Energy	(2.4)	(12.4)	(1.7)	(11.7)	(35.9)	(5.8)	(49.4)
NAV versus S&P/TSX Energy	0.4	(3.4)	(1.1)	(7.4)	(36.4)	(21.2)	(29.0)
Price versus S&P ASX 200 Energy	(5.5)	(10.7)	(0.4)	(3.1)	(20.3)	13.0	(61.3)
NAV versus S&P ASX 200 Energy	(2.7)	(1.7)	0.2	1.2	(20.7)	(2.4)	(41.0)
Price versus S&P Global 1200 Sec Energy	(3.0)	(9.4)	2.2	(12.3)	(54.7)	(22.2)	(66.3)
NAV versus S&P Global 1200 Sec Energy	(0.2)	(0.4)	2.8	(8.0)	(55.1)	(37.6)	(45.9)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-May 2014 and indices £ adjusted.

#### Exhibit 6: NAV total return performance relative to S&P/TSX Energy index



Source: Thomson Datastream, Edison Investment Research

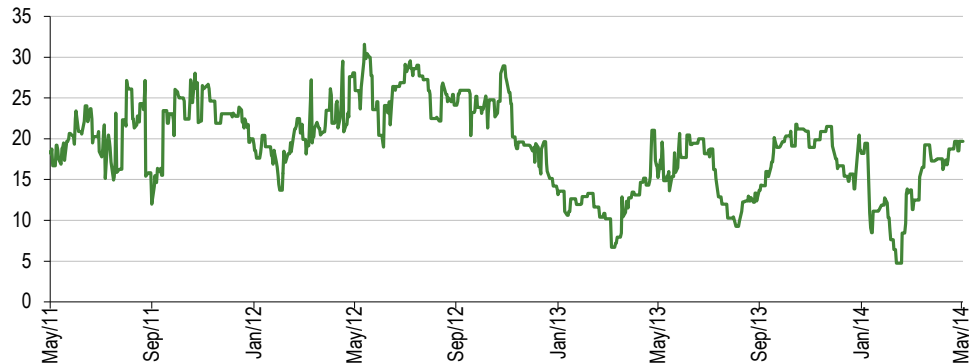
## Discount: Above the long-term average

NCE has authority to both allot and repurchase shares, although the board has not provided any commitment to maintain the discount at a particular level. Exhibit 7 illustrates that, after narrowing



to c 5% in early 2014, the discount has subsequently widened back to a level similar to its three-year average of 19%. The current 21% discount stands above the 15% average and close to the 22% peak level of last 12 months.

**Exhibit 7: Discount over three years (%)**



Source: Morningstar, Edison Investment Research. Note: Positive values indicate a discount.

## Capital structure and fees

NCE has 53.6m ordinary shares in issue. Following their expiry and cancellation in February 2014, there are no longer any subscription shares in issue. An overdraft facility is available allowing borrowing up to a maximum 35% gearing limit. In practice, the managers work to a maximum 25% level and gearing has generally been maintained in the range of 20% to 25% broadly in line with the fixed-income element of the portfolio. The managers do not anticipate any significant change from current gearing levels.

The board has been focused on reducing the costs of running the fund and agreed with NCIM a reduction in the management fee from 2.0% to 1.375% with effect from 1 January 2014. In addition, NCIM is entitled to an annual performance fee at the rate of 20% of outperformance above an 8% pa hurdle with a high watermark provision. No performance fees were payable for FY12 or FY13. The 3.35% FY13 ongoing charge could be expected to fall below 3% in the current financial year benefiting from the lower management fee.

## Dividend policy

While NCE does not have a specific objective with respect to paying dividends, the board recognises the importance of an income stream to investors and has maintained or increased the total dividend paid for each financial year since inception. NCE pays quarterly dividends with three equal interim payments usually followed by a larger final payment. A total dividend of 1.90p was paid for the year to September 2013, representing a 7.3% increase on the previous year. The first two interim dividends in FY14 have been increased by 2.4% from FY13 indicating the board's intention to increase the total dividend in the current financial year. The board has confirmed that, after giving its approval in December 2013 for the manager to focus the portfolio on shale oil and gas, it does not anticipate a reduction in the annual dividend.

## Peer group comparison

Exhibit 8 illustrates a closed-ended peer group comparison across the commodities and natural resources sector. We use the AIC specialist commodities and natural resources sector constituents

excluding CEB Resources (which distorts the averages) as the peer group. Although only marginally positive over one year and negative over three years, NCE's NAV total returns rank it in the top three of the peer group. Over five years NCE's NAV total return ranks it as one of the two leading performers, with its 26.5% return significantly ahead of the negative peer group average. NCE's historical ongoing charge of 3.35% is similar to the peer group average and this will benefit from the reduction in the management charge from 2.0% to 1.375% of gross assets effective from January 2014. NCE's 5.5% yield ranks it as one of the top dividend-paying trusts in the peer group.

**Exhibit 8: Commodities and natural resources sector peer group**

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 Year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
New City Energy Ord	18.8	3.5	(35.7)	26.5	(26.7)	3.35	Yes	101	5.5
Altus Resource Capital Ord	28.0	(13.1)	(61.7)		(13.3)	2.47	Yes	92	
Baker Steel Resources Ord	27.0	(38.9)	(51.1)		(23.8)	2.17	Yes	101	
BlackRock Commodities Income Ord	112.6	1.9	(12.9)	37.0	3.0	1.39	No	107	5.4
BlackRock World Mining Trust Ord	819.6	(9.2)	(42.4)	9.8	(1.2)	1.37	No	115	4.5
City Natural Resources Ord	94.0	(14.3)	(54.5)	(1.1)	(9.1)	1.47	No	125	3.9
El Oro Ord	47.1	8.4	(34.4)	15.5	(29.5)	1.70	Yes	144	4.9
Geiger Counter Ord	19.8	(16.9)	(70.3)	(46.3)	(9.8)	2.96	Yes	101	
Global Resources Ord	23.7				(11.7)		Yes	113	
Golden Prospect Precious Metal Ord	20.0	(22.9)	(62.9)	(7.2)	(17.9)	2.37	Yes	101	
International Oil & Gas Techno Ord	6.7	(55.8)	(58.3)	(57.0)	(65.9)	4.44	Yes	97	
Praetorian Resources Ord	4.1	(2.3)			(57.8)	3.62	Yes	117	
RAB Special Situations Ord	6.1	(12.1)	(49.9)	(56.3)	(48.0)	4.31	Yes	96	
Riverstone Energy Ord	627.2				(7.7)	0.67	Yes	8	
Tiger Resource Finance Ord	2.2	(19.9)	(51.4)	(38.1)	(19.0)	17.48	No	54	
<b>Simple average</b>		<b>(14.7)</b>	<b>(48.8)</b>	<b>(11.7)</b>	<b>(22.6)</b>	<b>3.56</b>		<b>98</b>	<b>4.9</b>
<b>Weighted average</b>		<b>(9.1)</b>	<b>(41.8)</b>	<b>10.0</b>	<b>(6.0)</b>	<b>1.27</b>		<b>78</b>	<b>2.7</b>

Source: Morningstar 3 June 2014. Note: TR=total returns, TER=total expense ratio. Net gearing is total assets less cash/cash equivalents as percentage of shareholders' funds.

## The board

The board consists of four non-executive directors. David Norman (chairman), Douglas Breen and Graeme Ross were appointed in January 2008 with Craig Stewart appointed as an additional director in February 2009. Graeme Ross and Craig Stewart are also directors of R&H Fund Services (Jersey) 3077, which provides fund administration services to NCE.

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