20th February 2018

hardman&co

City of London Investment Group

Still correcting upwards

City of London published its interim results yesterday morning, covering 1HFY2018. The headline figures were given in January's trading statement. As of 31 January 2018, FUM had risen to $5.8bn, although we note that the market weakness since then has probably pushed this back to closer to $5.5bn. Cash balances have risen to £15.6m, a 49% increase over the same figure a year ago. A new Deputy CEO has been appointed, with the existing COO Tom Griffith now working alongside Barry Olliff as the latter moves towards retirement at the end of 2019.

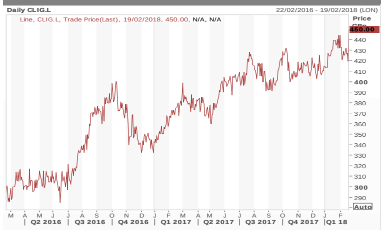
- **New business**: The pipeline is indicated at being over $400m across all products. In City of London's financial template, its assumption is $100m of net new assets in Emerging Markets (EM) CEF and $250m in the other areas. In EM, gross new business may be stronger but rebalancing remains a drag.
- **Fund performance:** The report gives more detail on the underperformance in EM CEF in the first half. The composite was up 6.1%, compared with benchmarks of 7.4%-7.6%. City of London has identified several factors behind this. We note that the long term track record remains very strong.
- **Valuation:** The prospective P/E of 10.2x times is at a significant discount to the peer group. The historical yield of 6.0% is very attractive and should, at the very least, provide support for the shares in the current markets.
- **Risks:** Although emerging markets can be volatile, City of London has proved to be more robust than some other EM fund managers, aided by its good performance and strong client servicing. Further EM volatility may increase the risk of such outflows however.
- **Investment summary:** Having shown robust performance in challenging market conditions, City of London is now reaping the benefits in a more supportive environment. The valuation remains reasonable. FY2017 saw the first dividend increase since FY2012 and, unless there is significant market disruption, more should follow in the next few years.

Financial summary and valuation

Year-end June (£m)	2015	2016	2017	2018E	2019E	2020E
FUM ($bn)	4.20	4.00	4.66	5.61	6.07	6.56
Revenue (£m)	25.36	24.41	31.29	34.27	35.88	37.94
Statutory PTP	8.93	7.97	11.59	13.25	14.20	15.32
Statutory EPS (p)	26.4	23.3	36.9	41.3	44.0	47.4
DPS (p)	24.0	24.0	25.0	27.0	30.0	33.0
P/E (x)	15.9	18.0	11.4	10.2	9.5	8.8
Yield	5.7%	5.7%	6.0%	6.4%	7.2%	7.9%

Source: Hardman & Co Research

Financial Services



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**CLIG**
Price (p)	419.0
12m High (p)	444.0
12m Low (p)	360.0
Shares (m)	26.9
Mkt Cap (£m)	112.8
EV (£m)	97.2
Market	LSE

Description

City of London is an investment manager specializing in using closed end funds to invest in emerging markets.

Company information

CEO	Barry Olliff
CFO	Tracy Rodrigues
Chairman	David Cardale

www.citlon.com

Key shareholders

Directors & staff	16.2%
Blackrock	9.9%
Cannacord Genuity	7.9%
Polar Capital	4.1%

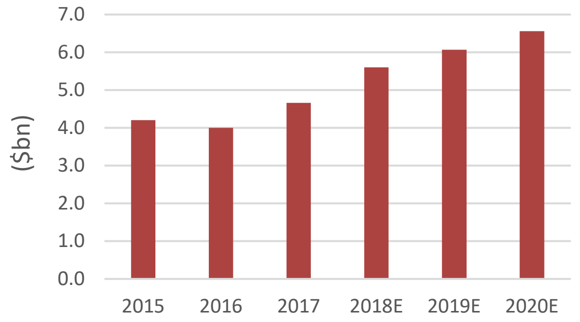
Next event

1 Mar 18	Interim ex-div date
16 Mar 18	Interim div payment
18 Apr 18	3Q FUM announcement
17 Jul 18	Pre-close trading statement

Analysts

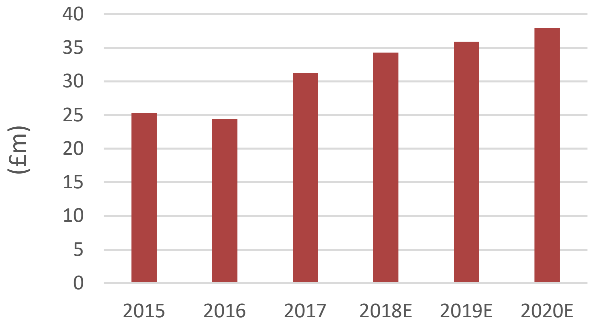
Brian Moretta 020 7194 7622
bm@hardmanandco.com

Funds under Management



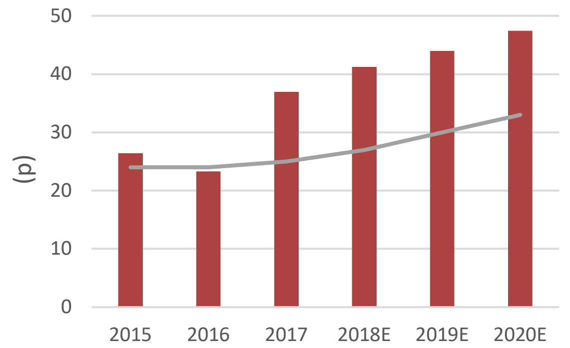
- Net inflows since 2014
- Market weakness in 2016 substantially offset by new business flows
- Assumed steady new business flows and market growth of 5% p.a.

Revenues



- Revenues linked strongly to FUM
- Slight decrease in revenue margins from new business
- Some currency effects, particularly from strong US Dollar from 2015 to 2017

EPS (bar) and dividend (line)



- Profitability historically maintained by cost flexibility
- Currency movements led to step change in 2017 EPS
- Dividend shortfall in 2016 covered from reserves
- Final dividend increased in 2017 as well as at 2018 interims - we expect steady increases in the dividend over the next couple of years

Source: Company data; Hardman & Co research

Interim 2018 results

The interim statement gave added detail on the trading statement that was given in January this year. The first half of FY2018 was positive from a market perspective, with City of London also getting positive net new business flows. At the time of the statement it was noted that $110m of new business was expected to be funded in the first quarter. This probably contributed to the growth in FUM to $5.8bn at 31 January. This, unfortunately, was one day after the market peaked and the MSCI Emerging Markets Index on 16 February was 4.4% lower.

Although emerging markets have now had a two year bull market, this seems to be something of a mixed blessing. Institutional clients, who constitute the majority of City of London's clients, have been actively rebalancing. This means reducing their weights in the areas that have outperformed, such as emerging markets. Although City of London continues to win new business in this area, the rebalancing has offset that growth. This trend is expected to continue.

The City of London template, which gives a model for future profits and dividend cover, now has the non-EM CEF strategies bringing in $250m of new business p.a. This compares with $100m for EM CEF in FY2019. While our assumption is lower than this, it does appear to sensibly reflect the relative prospects for each.

Within the results, expenses were sharply higher at £9.5m – a 12% increase on the previous year. About 70% of this increase is profit share and the EIP. We also note the assumption in the template has increased to 7% overhead growth in FY2019. Given profit growth and how tightly City of London has been run, this is not a concern.

Unlike many fund managers, City of London sees little direct effect from the introduction of MIFID II and no discernible effect on its P&L. It does believe that this should reduce pressures on fee margins, as other managers bear extra costs and cannot push down fees. We note that movements in City of London's fee margin also depends on which areas of new business bring new funds. With some of the diversifying products having lower fee margins, the aggregate may still decrease in the future.

Investors should also note that City of London's cash balance has risen to £15.6m. While having a strong balance sheet is a positive, this seems to be in excess of City of London's requirements. We also expect it to continue to grow in the future as the business continues to be cash-generative. Acquisitions are very unlikely to fit with the company's strategy, so there may be increased scope for shareholder returns at some point in the next few years.

Management update

The current CEO, Barry Olliff, gave five-year notice of his intended retirement on 31 December 2019. The company has been taking steps towards preparing for that, including appointing a CIO and a progressive reduction of Mr Olliff's shareholding.

Tom Griffith, who is currently COO, has been appointed Deputy CEO. This would appear to position him to take over when Mr Olliff retires.

Estimate updates

The increased detail in the report has allowed us to fine-tune some assumptions, but with little effect on our figures. The slightly higher than expected FUM has given a small boost. We have also slightly increased our new business assumptions for the new products. On the downside, with City of London getting the vast majority of its revenues in US Dollars, the strengthening of sterling has had a negative effect. The net effect is a small downgrade to our 2018E EPS, from 41.9p to 41.3p, while 2019E increases from 43.3p to 44.0p.

As is usual, we have introduced 2020E with these figures. The assumptions underpinning these are almost identical to those for 2019E.

There has been an interim dividend increase this year, and in expectation of the usual split we have increased our full-year 2018E DPS to 27p. We have pushed out 2019E to 30p and introduced 33p for 2020E. Although our estimates give 1.4-1.5x cover in each year, on a rolling five-year basis this would be 1.3x – only slightly above the company's target of 1.2x.

Financials

Summary financials						
Year – end June	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**
FUM ($bn)	4.20	4.00	4.66	5.61	6.07	6.56
P&L (£m)						
Revenue	25.36	24.41	31.29	34.27	35.88	37.94
Expenses	16.63	16.66	19.79	21.03	21.69	22.64
Operating profit	8.73	7.76	11.51	13.24	14.19	15.30
PBT	8.93	7.97	11.59	13.25	14.20	15.32
Earnings	6.61	5.85	9.14	10.26	10.94	11.80
EPS (p)	26.4	23.3	36.9	41.3	44.0	47.4
DPS (p)	24.0	24.0	25.0	27.0	30.0	33.0
Key metrics						
	2015	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Growth (%)						
FUM		-4.8	16.5	20.3	8.3	8.0
Revenue		-3.7	28.2	9.5	4.7	5.7
Operating Profit		-11.1	48.4	15.0	7.2	7.9
EPS		-11.7	58.4	11.8	6.6	7.8
DPS		0.0	4.2	8.0	11.1	10.0
Operating margins (%)						
Net FUM fee margin	0.86	0.86	0.84	0.83	0.82	0.82
Operating margin	34.4	31.8	36.8	38.6	39.5	40.3
Tax rate	26.0	26.5	21.1	23.0	23.0	23.0
Dividend cover	1.1	1.0	1.5	1.5	1.5	1.4
EPS sensitivity						
				2018E	**2019E**	**2020E**
No net new business						
EPS (p)				41.0	42.2	43.9
% change				-0.6	-4.0	-7.4
0% market growth (was 5% pa)						
EPS (p)				40.9	40.7	40.6
% change				-1.0	-7.4	-14.3

Source: City of London Investment Group, Hardman & Co research; £1 = $1.40

Notes

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Hardman & Co Research Limited (trading as Hardman & Co)
35 New Broad Street
London
EC2M 1NH

+44 (0) 20 7194 7622
Follow us on Twitter @HardmanandCo

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Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman research and, specifically, whether it can be accepted without a commercial arrangement. Hardman's company research is paid for by the companies about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are' (b) 'written material from a third party that is commissioned and paid for by an[sic] corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public;'

The fact that we are commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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Hardman team

Management Team			
+44 (0)20 7194 7622			
John Holmes	jh@hardmanandco.com	+44 (0)20 7194 7629	Chairman
Keith Hiscock	kh@hardmanandco.com	+44 (0)20 7194 7630	CEO
David Banks	db@hardmanandco.com	+44 (0)20 7194 7622	Corporate Finance

Marketing / Investor Engagement		
+44 (0)20 7194 7622		
Richard Angus	ra@hardmanandco.com	+44 (0)20 7194 7635
Max Davey	md@hardmanndco.com	+44 (0)20 7194 7622
Antony Gifford	ag@hardmanandco.com	+44 (0)20 7194 7622
Ann Hall	ah@hardmanandco.com	+44 (0)20 7194 7622
Gavin Laidlaw	gl@hardmanandco.com	+44 (0)20 7194 7627
Vilma Pabilionyte	vp@hardmanandco.com	+44 (0)20 7194 7637

Analysts

+44 (0)20 7194 7622

Agriculture		**Bonds / Financials**	
Doug Hawkins	dh@hardmanandco.com	Brian Moretta	bm@hardmanandco.com
Yingheng Chen	yc@hardmanandco.com	Mark Thomas	mt@hardmanandco.com
Thomas Wigglesworth	tcw@hardmanandco.com		
Building & Construction		**Consumer & Leisure**	
Tony Williams	tw@hardmanandco.com	Steve Clapham	sc@hardmanandco.com
Mike Foster	mf@hardmanandco.com	Jason Streets	js@hardmanandco.com
Life Sciences		**Media**	
Martin Hall	mh@hardmanandco.com	Derek Terrington	dt@hardmanandco.com
Dorothea Hill	dmh@hardmanandco.com		
Grégoire Pavé	gp@hardmanandco.com		
Mining		**Oil & Gas**	
Paul Mylchreest	pm@hardmanandco.com	Angus McPhail	am@hardmanandco.com
Property		**Services**	
Mike Foster	mf@hardmanandco.com	Mike Foster	mf@hardmanandco.com
Special Situations		**Tax Enhanced Services**	
Steve Clapham	sc@hardmanandco.com	Brian Moretta	bm@hardmanandco.com
Paul Singer	ps@hardmanandco.com	Chris Magennis	cm@hardmanandco.com
Technology		**Utilities**	
Milan Radia	mr@hardmanandco.com	Nigel Hawkins	nh@hardmanndco.com

Hardman & Co

35 New Broad Street
London
EC2M 1NH

Tel: +44(0)20 7194 7622

www.hardmanandco.com