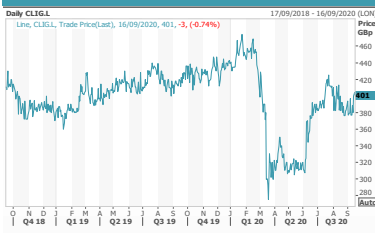




17 September 2020

Financial Services



Source: Refinitiv

Market data

EPIC/TKR	CLIG
Price (p)	401.0
12m High (p)	474.0
12m Low (p)	275.0
Shares (m)	26.6
Mkt Cap (£m)	106.5
EV (£m)	91.9
Market	LSE

Description

City of London is an investment manager specialising in using closed-ended funds to invest in emerging and other markets.

Company information

CEO	Tom Griffith
Head of Finance	Deepnanjan Agrawal
Chairman	Barry Aling
	+44 207 860 8312
	www.citlon.com

Key shareholders

Directors & staff	18.0%
APQ Capital	6.2%
Blackrock	5.4%
Cannacord Genuity	5.0%
Eschaton Opportunities Fund Management	4.8%
Polar Capital	3.0%

Diary

7 Oct	1Q FUM statement
19 Oct	AGM
19 Jan	2Q FUM statement
15 Feb	Interim results

Analyst

Brian Moretta 020 7194 7622
bm@hardmanandco.com

CITY OF LONDON INVESTMENT GROUP

Solid results, with surprise dividend increase

City of London has announced its full-year results for FY'20. As previously indicated, over a volatile year, FUM grew to \$5.51bn. This led to a 4% increase in fee income to £33.3m. With cost control excellent, as usual, this led to a 9% increase in operating profits to £11.6m. Earnings were impacted by exceptional costs for the Karpus transaction and losses on the seed investments in the new REIT strategies, and fell 19% to £7.37m. The final dividend was increased from 18p to 20p, giving 30p for the full year. This leaves cover ahead of the target cover over a rolling five-year period of 1.2x.

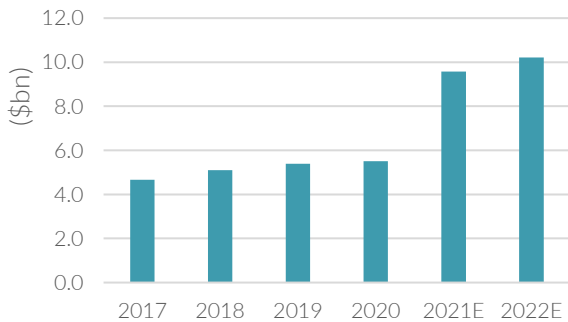
- ▶ **Karpus expenses:** There will be £3m of exceptional expenses for the Karpus transaction, plus £1m of capitalised share issuance costs. Of these, £1.25m of the expenses were charged in the 2020 accounts, while the remainder will be incurred in FY'21.
- ▶ **Board:** City of London's founder, Barry Olliff, will stay on the board for another year, while the senior independent director, Susannah Nicklin, will not seek re-election at the AGM. City of London acknowledges that, in the short term, there will be a minority of independent directors, but it will address this soon.
- ▶ **Valuation:** The 2021E P/E of 9.6x is at a discount to the peer group. The underlying 2021E yield of 8.2% is attractive, in our view, 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 could raise the risk of such outflows, although increasing diversification is also mitigating this.
- ▶ **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. After a special dividend in FY'19, FY'20 saw another dividend increase. With the expected EPS boost from Karpus in 2021, the prospects for future dividend increases look very good.

Financial summary and valuation

Year-end Jun (£m)	2017	2018	2019*	2020	2021E	2022E
FUM (\$bn)	4.66	5.11	5.39	5.51	9.58	10.21
Revenue	31.29	33.93	31.93	33.26	50.68	59.45
Statutory PTP	11.59	12.79	11.40	9.41	22.38	29.91
Statutory EPS (p)	36.9	39.5	34.9	30.3	41.7	48.8
DPS (p)	25.0	27.0	27.0	30.0	33.0	36.0
Special dividend (p)			13.5			
P/E (x)	10.9	10.2	11.5	13.2	9.6	8.2
Dividend yield	6.2%	6.7%	10.1%	7.5%	8.2%	9.0%

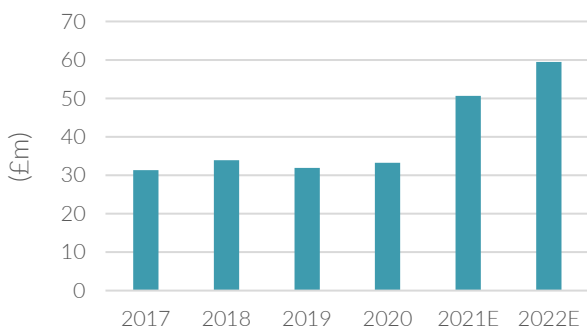
*2019 figures include a special dividend of 13.5p; Source: Hardman & Co Research

Funds under management (FUM)



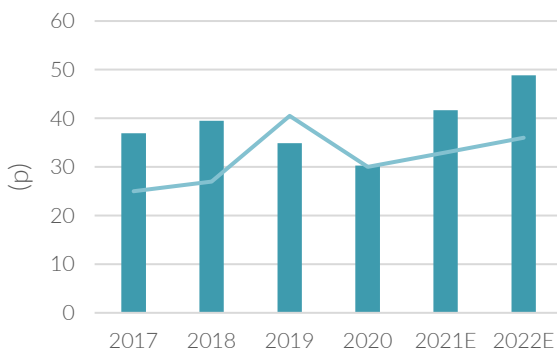
- ▶ Net inflows since 2014
- ▶ Addition of Karpus in 2021
- ▶ Market recovery in 2Q has offset the 1Q market fall
- ▶ Assumed steady new business flows and market growth of 5% p.a.

Revenue



- ▶ Revenue linked strongly to FUM
- ▶ Ongoing decrease in revenue margins from new business
- ▶ Karpus revenue margin higher than City of London's
- ▶ 2020 growth affected by volatile markets and reduction of revenue margins

EPS (bar) and DPS (line)



- ▶ Profitability historically maintained by cost flexibility
- ▶ Exceptional transaction costs affect 2020 and 2021E
- ▶ Special dividend of 13.5p in 2019
- ▶ Dividend increased in 2017, 2018 and 2020; we believe our forecasts for 2021 and 2022 are conservative

Source: Company data, Hardman & Co Research

Results commentary

Although markets were even more volatile in FY'20 than in FY'19, and the company has been preparing a major transaction, City of London has not taken its eyes off its operations. Despite net profitability being affected by the market volatility, overall, City of London reported a solid set of results in the circumstances.

Funds

Note that, with this report, the Developed Markets strategy has been renamed "International". A new category of "Other" is also introduced, which includes the REIT strategy, as well as some other, small, historical strategies.

Funds under management (FUM)				
(\$m)	June 2020	June 2019	Net flows	Other movements
Emerging Markets	3,828	4,221	-279	-114
International	1,244	729	551	-36
Opportunistic Value	256	233	46	-23
Frontier Markets	175	206	16	-47
Other	9	7	5	-3
Total	5,512	5,396	338	-225

Source: Hardman & Co Research

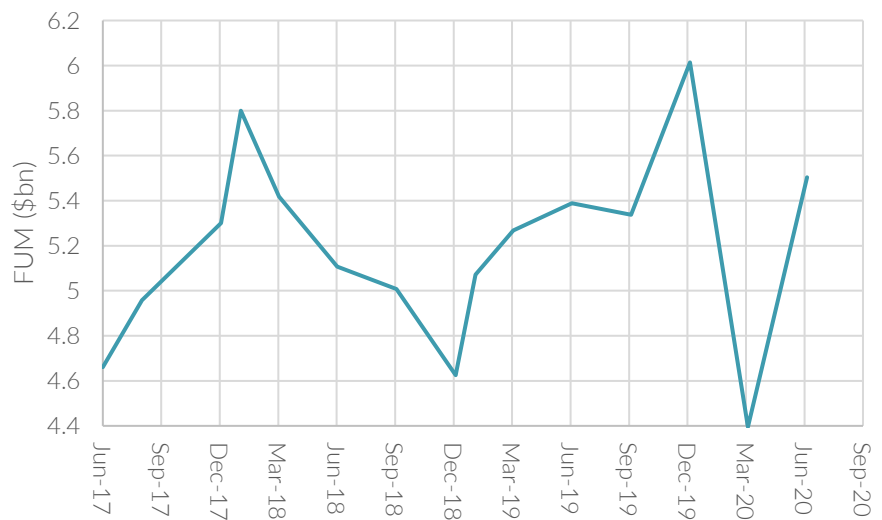
As previously indicated, the growth in City of London's FUM, to \$5.51bn, was attributable to net inflows, with markets having a negative effect on all strategies. Performance remains good across the strategies, with the five-year figures for EM and International being second-quartile and Opportunistic Value being first-quartile. Although Frontier Markets are third-quartile, this area is the smallest strategy and also has the most limited capacity.

The two REIT strategies are also performing well against a weak backdrop for the asset class. Although an existing client has invested a small amount in them, they are only 18 months-old, and it will still be a few years before the track record is long enough for the strategies to attract meaningful assets.

In the EM strategy, rebalancing remains a consistent feature. There seems to be tighter monitoring of allocations to what are perceived to be higher-risk areas. Any outperformance is offset by a selling of assets. In the market downturn earlier this year, City of London also experienced clients using the area as a source of liquidity to pay expenses. It seems likely that rebalancing will remain a feature in the future, with City of London now aiming to keep the amount of EM assets, broadly, around current levels.

The largest source of new funds in each of the last couple of years has been the International strategy. Having grown FUM in this area almost 7x in the last three years, active marketing has been paused until the end of 2020, during which time the capacity of the strategy will be reappraised.

FUM progress over FY'18 to FY'20



Source: Company data, Hardman & Co Research

The above chart shows the effect of market volatility on total FUM. High volatility seems to be the norm, rather than the exception, although FY2020 can be seen as even more extreme than the preceding years. Nevertheless, based on quarterly year-ends, the average FUM for the year was \$5.3bn, vs. \$5.1bn in FY'19.

Karpus's FUM increased to \$3.6bn as of 31 August, from \$3.4bn at 31 May.

Finances

The increase in average FUM was reflected in fee income, which increased 4% to £33.3m. It was also aided by sterling being somewhat weaker in FY'20.

Offsetting this is the ongoing fee margin pressure. The margin had dropped from 76bps a year ago to 74bps as of 30 June 2020. The average during the year declined from 76bps to 75bps. Although the forthcoming Karpus transaction will raise the group average, further, steady, declines are expected within CLIM. The main areas of new business growth are lower-margin than the legacy EM business. Even within the latter, there is turnover with some new business offsetting the rebalancing assets. This is also adding to the fee pressure.

For the last few years, City of London has been paying reducing amounts of commission from a distribution agreement that terminated almost a decade ago. These reduced from \$1.3m in 2012 to \$0.3m in the last financial year. Although due to run through to October, City of London made an early concluding payment, and the arrangement is now finished.

As usual, City of London continues to maintain its excellent cost control, with administrative expenses (pre-profit share) up 1%. Within this, staff costs increased 2%, while other administrative expenses were reduced by IFRS16, which moved property rental costs to depreciation.

Other figures were in line with previous years, other than interest income and investment gains. The former is affected by the new accounting rules for leasing; without this adjustment, the net interest income would have been £0.061m. Investment losses of £0.89m mostly reflect the negative effect of market movements on the seed investments that City of London has made into its REIT strategies.

Karpus costs

City of London had previously indicated that there would be expenses of £3m for the Karpus transaction. These will be allocated £1.25m to FY'20, with the balance in FY'21. There is an additional £1m for share issuance costs that will be capitalised in the 2021 accounts.

Profits

With the exceptional costs and investment losses, earnings showed a decline year-on-year. The total of £7.37m was a 19% decline on the previous year. If we look at the operating profit level, which is perhaps a fairer reflection of operations, then there was a rise of 9% to £11.6m. This illustrates that, with City of London's tight cost control and operational gearing, a small increase in fee income translates into good profit growth.

As usual, City of London's cash conversion was excellent, with cash from operations of £12.9m, or 111% of operating profit.

On the balance sheet, cash and equivalents increased 6% to £14.6m. This is a very healthy level, even when taking account of the fact that Karpus will have little in the way of available cash at the time of the merger. For example, it would be enough to fund the current dividend for the enlarged share capital after completion.

Working capital showed smaller changes than in previous years, with a small net benefit of ca.£70,000. There are various changes to the balance sheet, due to IFRS16 and lease-accounting. This is not significant operationally, but does add almost £2m to the total assets. Additional external investments into the EM REIT mean that it is no longer fully consolidated into the balance sheet, but that change is mainly presentational.

To our slight surprise, the final dividend was increased to 20p, for a full-year total of 30p. We had allocated the £3m of Karpus expenses to FY'20, but the actual allocation means that an increase can be funded, and the rolling cover, at 1.24x, is in excess of the 1.2x target. Although the record date for the final dividend is after the scheduled date for completion of the merger, it will not be paid to the former Karpus shareholders.

Board

There are two board announcements. Barry Olliff has agreed to stay on for an additional year to provide his experience and support over the merger period. Additionally Susannah Nicklin, the senior independent director, will be stepping down at the next AGM, due to other commitments. The search for her replacement has been initiated, although is unlikely to yield a replacement before the AGM.

Once the Karpus merger is complete, there will be two additional board members. The net effect is that the independent directors will be in the minority on the board. City of London will announce plans to rectify this later in the year, but note that those on the board will have deep experience of the businesses and will be well placed to supervise the merger process.

The plans for Barry Olliff's share sales remain in place, with 330,613 remaining at 450p and a further 500,000 at each of 475p and 500p.

Estimate updates

With most lines coming in close to our expectations, we have made only minor adjustments to our forecasts for operating items and exchange rate movements. Perhaps the most notable change is the reduction of our new business forecast for

FY'21, to \$100m, reflecting the temporary suspension of active marketing for the International strategy.

However, our allocation of the exceptional costs for the Karpus transaction was incorrect. With our FY'21 forecasts now incorporating the correct proportion of these, we have lowered our 2021 EPS estimate from 45.2p to 41.7p. For 2022, our reduction is 0.6%, from 49.1p to 48.8p, which better reflects the scale of operational adjustments. Given the uncertainty over both COVID-19 and the policy responses to it, further market volatility does seem likely, and investors should look at our sensitivity figures too. For example, reducing our 5% market growth estimate to zero will reduce 2021E EPS to 40.4p, a 3% reduction.

We have also raised our dividend estimates – from 30p in 2021 and 33p in 2022 to 33p and 36p, respectively. These would leave the rolling cover closer to 1.3x.

Financials

Summary financials						
Year-end Jun	2017	2018	2019*	2020	2021E	2022E
FUM (\$bn)	4.66	5.11	5.39	5.51	9.58	10.21
P&L (£m)						
Revenue	31.29	33.93	31.93	33.26	50.68	59.45
Expenses	19.79	21.40	21.43	21.66	26.52	29.56
Operating profit	11.51	12.53	10.50	11.60	24.16	29.89
Statutory PTP	11.59	12.79	11.40	9.41	22.38	29.91
Earnings	9.14	10.06	9.05	7.37	17.90	23.92
Statutory EPS (p)	36.9	39.5	34.9	30.3	41.7	48.8
DPS (p)	25.0	27.0	40.5	30.0	33.0	36.0
Key metrics						
	2017	2018	2019*	2020	2021E	2022E
Growth (%)						
FUM		9.6	5.5	2.1	74.1	6.6
Revenue		8.4	-5.9	4.2	52.4	17.3
Operating profit		8.8	-16.2	10.4	108.3	23.7
EPS		7.0	-11.6	-13.2	37.5	17.2
DPS (excl. special div.)		8.0	0.0	11.1	10.0	9.1
Operating margins (%)						
Net FUM fee margin	0.84	0.80	0.76	0.75	0.75	0.75
Operating margin	36.8	36.9	32.9	34.9	47.7	50.3
Tax rate	21.1	21.4	20.6	20.0	20.0	20.0
Dividend cover (x, excl. special div.)	1.5	1.5	0.9	1.0	1.3	1.4
Rolling 5-year cover (x, excl. special div.)	1.1	1.2	1.3	1.2	1.3	1.3
EPS sensitivity					2021E	2022E
No net new business						
EPS (p)					41.4	47.8
change					-0.7%	-2.0%
0% market growth (was 5% p.a.)						
EPS (p)					40.4	45.1
change					-3.0%	-7.7%

*2019 figures include a special dividend of 13.5p; Source: Company data, Hardman & Co Research
£1=\$1.29

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