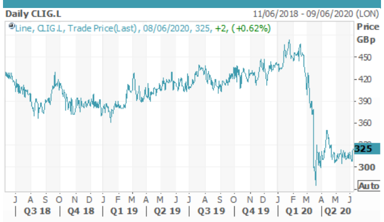
9 June 2020

## Financial Services




*Source: Refinitiv*

## Market data

| | |
|---|---|
| EPIC/TKR | **CLIG** |
| Price (p) | **325.0** |
| 12m High (p) | 474.0 |
| 12m Low (p) | 275.0 |
| Shares (m) | 26.6 |
| Mkt Cap (£m) | 86.3 |
| EV (£m) | 73.8 |
| 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 | Deepranjan Agrawal |
| Chairman | Barry Aling |

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## 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

| | |
|---|---|
| 14 Jul | Pre-close update |
| 14 Sep | Preliminary results |
| 7 Oct | 1Q FUM statement |

# CITY OF LONDON INVESTMENT GROUP

## Karpus transaction looks a winner

**City of London has announced a merger with Karpus Management Inc, a US SEC-registered investment adviser. Based in upstate New York, it is focused on wealth management for HNW individuals and, as of end-March, it had FUM of $3.22bn. Like City of London, it primarily invests through funds. Its primary focus is closed-end funds (CEFs) but it also uses mutual funds, ETFs and other vehicles. With a range of balanced mandates, on an underlying basis, 39% of assets are equities, predominantly in the US, and 61% fixed income. City of London will be significantly diversifying its exposure by asset class and client type.**

- **Finances:** Private client management has a higher revenue margin than City of London's institutional business. Karpus is also run very efficiently and, ex the compensation of the departing founder, generates a higher profit with an estimated adjusted PBT of $16.0m in FY'19 and $8.9m in 1H'20.
- **Earnings upgrades:** We have significantly upgraded our earnings estimates. We estimate Karpus will enhance EPS by 15% in 2021 and 14% in 2022. There are also significant increases from market improvements. In addition, we have upgraded our dividend forecasts and have restored increases in 2021 and 2022.
- **Valuation:** The 2021E P/E of 6.9x is at a discount to the peer group. The 2021E yield of 9.2% is very 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. FY'17 and FY'18 both saw dividend increases. With the EPS upgrades from Karpus, the prospects for future dividend increases look very good.

## Financial summary and valuation

| Year-end Jun (£m) | 2017 | 2018 | 2019* | 2020E | 2021E | 2022E |
|---|---|---|---|---|---|---|
| FUM ($bn) | 4.66 | 5.11 | 5.39 | 5.44 | 9.60 | 10.24 |
| Revenue | 31.29 | 33.93 | 31.93 | 32.35 | 52.26 | 61.81 |
| Statutory PTP | 11.59 | 12.79 | 11.40 | 8.75 | 25.40 | 31.79 |
| Statutory EPS (p) | 36.9 | 39.5 | 34.9 | 28.0 | 47.1 | 51.8 |
| DPS (p) | 25.0 | 27.0 | 27.0 | 28.0 | 30.0 | 33.0 |
| Special dividend (p) | | | 13.5 | | | |
| P/E (x) | 8.8 | 8.2 | 9.3 | 11.6 | 6.9 | 6.3 |
| Dividend yield | 7.7% | 8.3% | 12.5% | 8.6% | 9.2% | 10.2% |

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


## Analyst

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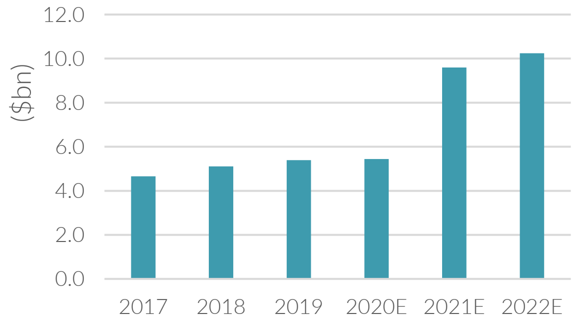
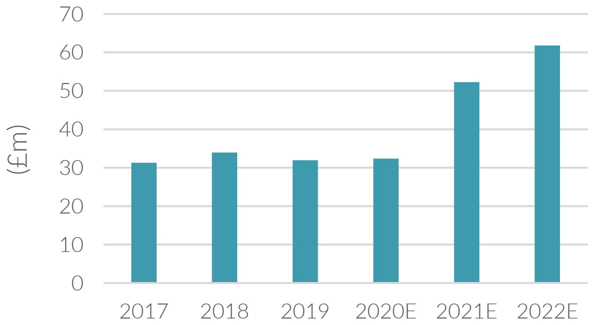
## Funds under management (FUM)



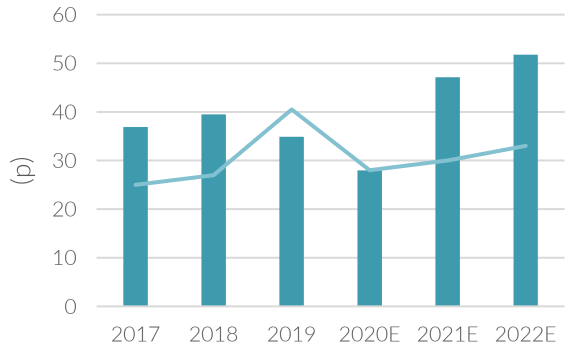

- Net inflows since 2014
- Addition of Karpus in 2021
- Market recovery since April has offset much of the 1Q market fall
- Assumed steady new business flows and market growth of 5% p.a.

## Revenue




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

## EPS (bar) and DPS (line)




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

*Source: Company data, Hardman & Co Research*

# Outline of transaction

City of London's strong financial position has led to speculation over the years about whether it will combine with another asset manager. We understand it has considered many options in the past, but has not found anything that it considered suitable. That it has finally done so suggests that this is a very considered decision.

City of London will be merging with Karpus Management Inc, a US SEC-registered investment adviser, in an all-share transaction. An aggregate of 24.12m shares will be issued to Karpus shareholders, making the deal worth £79m at the 8 June closing price of 325p. Post the deal, there will be a total of 50.67m shares in issue and the group's market capitalisation would be £165m.

Once the transaction is complete, City of London will become a holding company with two divisions: one with the existing operations of City of London Investment Management (CLIM) and the other with those of Karpus. The latter will largely be run independently from CLIM, with the key investment and relationship management functions remaining in place.

The principal benefits to City of London will not accrue from cost cutting. There will be some economies of scale in shared areas such as finance, but this is more likely to translate as slower cost growth. It does bring diversification benefits, both in terms of the asset classes to which the group has exposure and the type of clients.

Financially, the deal is substantially earnings-enhancing and will increase dividend cover, enhancing prospects for future increases.

## Karpus Management Inc

Founded in 1986, Karpus is based near Rochester in upstate New York with a sales office in Naples, Florida. Founded and majority-owned by George Karpus, the transaction is taking place as he steps back from the business.

Karpus' clients are entirely US-based. Most of them are HNW individuals or families, with its main offering being a range of balanced mandates, although there is also some Individual Retirement Account business. As of 31/03/20 it had 2,273 client accounts with just over 800 client relationships. Like City of London, it primarily uses funds in its investment strategies. Closed-ended funds currently make up over half of assets, but Karpus makes great use of ETFs, open-ended funds and other instruments then City of London.

An indication of its asset breakdown can be seen from the data below. The figures from earlier dates are based on data from composites, which do not include all assets.

**Funds under management (FUM)**

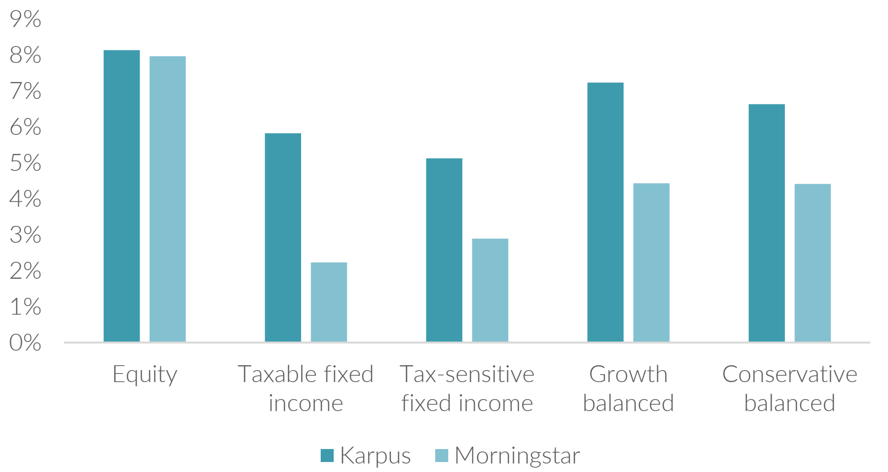
| ($m) | 31/12/17 | 31/12/18 | 31/12/19 | 31/03/20 |
|---|---|---|---|---|
| Equity | 1,059 | 953 | 1,111 | 39% |
| Taxable fixed income | 655 | 633 | 679 | 61% |
| Tax-sensitive fixed income | 644 | 660 | 865 | |
| Other asset classes | 790 | 817 | 1,014 | |
| Growth balanced | 873 | 797 | 884 | |
| Conservative balanced | 964 | 946 | 1,178 | |
| Other mandates | 1,311 | 1,320 | 1,607 | |
| Total | 3,148 | 3,063 | 3,669 | 3,220 |

*Source: Karpus, Hardman & Co Research*

All the funds that Karpus invests in are US-domiciled, although the underlying assets may include some international exposure. We understand this is small and virtually all developed market exposure. For the group as whole, this will take the emerging markets proportion from the current 74% to under 40%.

Since end-March 2020, the S&P500 has risen by ca.20% and aggregate bond indices risen by low single digits, suggesting FUM is currently ca.$3.5bn. Assuming all the assets come across (see below), this would take current group FUM to almost $9bn.

Karpus composite performance – 5 years to 31/12/19




*Source: Karpus, Hardman & Co Research*

Karpus' performance has been excellent. The five-year chart shows that all its principal composites have outperformed its peers. The pictures for three years and ten years are almost identical. The only blemish is slight underperformance in the equity composite over one year.

## Investment processes

At a high level, the Karpus investment process has some similarities with the existing City of London one. The emphasis is very much on being process-driven rather than relying on star fund managers. There are some philosophical commonalities, too, with Karpus also taking an active role in CEF corporate governance when required. One key difference is the investment objective. As a private wealth manager, Karpus has an emphasis on capital preservation while CLIM's institutional mandates look for relative performance.

Every two months, the Karpus investment committee meets to discuss asset allocation. The balanced portfolios have a spread of ten risk categories, with most clients being in the middle with around 40% equity exposure. Within each strategy, the equity/bond/cash exposure does not change much, but there is some variation in exposure within each category. For example, on bonds, the asset allocation may consider duration or Treasury/corporate exposure.

This has much in common with CLIM's processes, but there can be a difference in execution. Karpus also takes a view on how discounts in CEFs may move. This underlies its use of other assets, with increased usage when discounts are expected to widen. While CEF exposure at 31/03/20 was 59% of assets, over the past five years, it has been as low as 26%.

## Client diversification and retention

Broadly speaking, HNW money is usually pretty sticky as long as a manager performs reasonably and maintains sufficient client servicing. Karpus appears to fulfil both those criteria. It has steadily grown its FUM from $2.0bn in 2010 to the latest figure of $3.2bn. While some of this reflects rising markets, it has shown an ability to retain and grow clients.

Under SEC rules, the change of ownership will require client consent, with any that do not approve at risk of leaving. We understand that around three-quarters of clients simply need to be informed and would need to be proactive to leave. Any losses among these is likely to be small.

The remainder are required to give written consent to have their assets transferred across. Given the circumstances and Karpus' good performance, it should be expected that few clients will object to the change, but the requirement for paperwork may mean some losses. The plan is for Karpus' client servicing to be proactive in reassuring its client base and obtaining the appropriate consents.

In order to protect against the risk that this does not go well, City of London has negotiated a potential discount if the actual FUM is meaningfully lower than expected. If, at the date of completion, the transferred FUM is less than $3.0595bn, the number of shares being paid will be reduced. The ratio will be 95% less the ratio of $3.2205bn less actual FUM divided by $3.2205bn. This also has the effect of giving some protection against drastic market falls.

## Shareholdings, management and staffing

The current shareholder base of Karpus is as follows:

Karpus shareholders

| | Proportion of Karpus | Proportion of City of London after transaction |
|---|---|---|
| George Karpus | 66.1% | 31.5% |
| Family of George Karpus | 13.3% | 6.3% |
| Staff | 10.6% | 5.0% |
| Charitable foundations and university | 10.0% | 4.8% |

*Source: Karpus, Hardman & Co Research*

There will be a lock-up arrangement with all Karpus shareholders with a commitment to not sell any shares for 12 months after completion. Any sales in the following 12 months will be made through City of London's broker, Zeus Capital, to ensure an orderly market. Unfortunately, this means there is unlikely to be a meaningful increase in share liquidity any time soon.

George Karpus will be retiring from his executive roles within Karpus upon completion, although he will be offered a consultancy role. The board of City of London will see the addition of one non-executive director and one executive director from Karpus. Below this, there will be a group management committee with members from both businesses.

Within Karpus, other than the retiral of George Karpus, the existing management team will remain in place. City of London is keen to keep the existing Karpus staff in place. It will take measures to do so, including giving staff the opportunity to participate in the company's Equity Investment Programme. In this, the company matches employee share purchases and it has had a strong take-up in the existing company.

# Finances

An outline of Karpus' finances is set out below. The balance of operating profit after fee income and other expenses equates to management bonuses. With the retirement of George Karpus, the majority of this will no longer be paid.

**Karpus financial information**

| | Full year | | Half year | |
|---|---|---|---|---|
| ($m) | To 30/06/18 | To 30/06/19 | To 31/12/18 | To 31/12/19 |
| Net fee income | 25.0 | 25.7 | 12.8 | 13.7 |
| Admin expenses | -25.3 | -25.9 | -13 | -13.1 |
| Est management bonuses | -15.1 | -15.5 | -7.7 | -8.3 |
| Operating profit | 14.8 | 15.3 | 7.5 | 8.9 |
| Other income | 0.1 | 0.7 | -0.1 | 0.7 |
| PBT | 14.9 | 16.0 | 7.4 | 9.6 |
| Total assets | 5.8 | 7.3 | 6.7 | 0.3 |

*Source: Hardman & Co Research*

Although Karpus has a smaller FUM than City of London, the fee margins on managing HNW money are better than on institutional business. The estimated gross fee margin is 85bps, compared with a current level of 74bps. There is good reason to believe this is more stable too. While there is fee pressure across all segments of the industry, City of London's diversification strategy has meant new business is at a lower fee rate.

Karpus is also run efficiently. The company is based well away from large financial centres, and an operating profit margin of almost 60% is excellent. The net result is that the deal will be earnings-enhancing for City of London. Pro forma, the first-half profit for FY'20 after tax would have been almost £11m, 120% larger than the actual figure with 91% more shares.

City of London will incur transaction costs of £3m that will be taken in the current quarter.

We note that Karpus will bring limited assets. There is a provision to return working capital on completion over $550,000 to Karpus shareholders, up to a maximum of $550,000. With City of London bringing a strong balance sheet, this will not be a problem as there will still be more than adequate capital and surplus cash. We also note that both revenues and expenses from Karpus are entirely US Dollar denominated and City of London's sensitivity to the exchange rate will increase.

# Estimate updates

Before adjusting for Karpus, we should note that markets have remained volatile since our most recent report in April 2020. On this occasion, the volatility has mostly been of the good kind. City of London's FUM at the end of May was $5.0bn, ahead of our last financial year-end estimate. In addition, the MSCI Emerging Markets Index is up 8% so far in June. Offsetting this has been some weakness in the US Dollar exchange rate. The net effect, without Karpus, would be to add roughly 15% to our EPS estimates for 2021 and 14% in 2022.

Completion of the merger will take a little time and we have assumed it will take place on 1 October 2020, the end of the first quarter. In our estimates, we have three quarters of FY'21 with Karpus included and only in FY'22 will shareholders see a full year of earnings. The following table gives our updated estimates.

| Old and updated estimates | | | | | | |
|---|---|---|---|---|---|---|
| | Previous estimates | | Updated for market | | Updated for Karpus | |
| ($m) | 2021E | 2022E | 2021E | 2022E | 2021E | 2022E |
| AUM ($bn) | 5.30 | 5.42 | 5.92 | 6.05 | 9.60 | 10.24 |
| Revenue | 31.64 | 34.21 | 34.08 | 36.75 | 52.26 | 61.81 |
| Expenses | 20.57 | 21.72 | 21.32 | 22.50 | 26.88 | 30.04 |
| Earnings | 8.87 | 10.01 | 10.22 | 11.41 | 20.32 | 25.43 |
| Statutory eps | 35.4 | 40.0 | 40.8 | 45.6 | 47.1 | 51.8 |
| Diluted eps | 35.3 | 39.8 | 40.7 | 45.4 | 47.0 | 51.7 |

*Source: Hardman & Co Research*

We have assumed that, with Karpus having significant fixed-income exposure, the annual market growth rate for its assets will be 2.5%, half that of what we assumed for City of London. Because of that, its FUM will grow slower and, as a consequence, EPS are enhanced more in 2021 than in 2022. The effect of the merger is to boost 2021E EPS by 15% and 2022E EPS by 14%. Financially, this looks like an excellent transaction for City of London.

With the exceptional costs for the transaction, our 2020E EPS is reduced to 28p.

The Karpus shareholders will not receive any of the dividend declared for FY'20. This includes the final dividend, which is still to be declared and may be paid after completion. With the transaction being EPS-enhancing, the dividend cover is improved. As a consequence, we have increased our 2021E dividend to 30p and 2022E to 33p, although keeping our 2020E at 28p. These estimates leave the rolling five-year cover at 1.2x this year, rising above the target thereafter.

# Summary

This appears to be an excellent transaction for City of London. Strategically, it diversifies the company's exposure to asset classes and new client areas. With no synergies required, the execution risk is minimal and there is a hedge in place should FUM fall short of expectations. It works well financially, too, with meaningful EPS enhancement and enhanced dividend prospects.

# Financials

**Summary financials**

| Year-end Jun | 2017 | 2018 | 2019* | 2020E | 2021E | 2022E |
|---|---|---|---|---|---|---|
| FUM ($bn) | 4.66 | 5.11 | 5.39 | 5.44 | 9.60 | 10.24 |
| **P&L (£m)** | | | | | | |
| Revenue | 31.29 | 33.93 | 31.93 | 32.35 | 52.26 | 61.81 |
| Expenses | 19.79 | 21.40 | 21.43 | 20.62 | 26.88 | 30.04 |
| Operating profit | 11.51 | 12.53 | 10.50 | 11.73 | 25.38 | 31.78 |
| Statutory PTP | 11.59 | 12.79 | 11.40 | 8.75 | 25.40 | 31.79 |
| Earnings | 9.14 | 10.06 | 9.05 | 7.00 | 20.32 | 25.43 |
| Statutory EPS (p) | 36.9 | 39.5 | 34.9 | 28.0 | 47.1 | 51.8 |
| DPS (p) | 25.0 | 27.0 | 40.5 | 28.0 | 30.0 | 33.0 |

**Key metrics**

| | 2017 | 2018 | 2019* | 2020E | 2021E | 2022E |
|---|---|---|---|---|---|---|
| **Growth (%)** | | | | | | |
| FUM | | 9.6 | 5.5 | 1.0 | 76.4 | 1.7 |
| Revenue | | 8.4 | -5.9 | 1.3 | 61.5 | 18.3 |
| Operating profit | | 8.8 | -16.2 | 11.7 | 116.4 | 25.2 |
| EPS | | 7.0 | -11.6 | -19.9 | 68.5 | 9.8 |
| DPS (excluding special div.) | | 8.0 | 0.0 | 3.7 | 7.1 | 10.0 |
| **Operating margins (%)** | | | | | | |
| Net FUM fee margin | 0.84 | 0.80 | 0.76 | 0.75 | 0.77 | 0.77 |
| Operating margin | 36.8 | 36.9 | 32.9 | 36.3 | 48.6 | 51.4 |
| Tax rate | 21.1 | 21.4 | 20.6 | 20.0 | 20.0 | 20.0 |
| | | | | | | |
| Dividend cover (x, excluding special div.) | 1.5 | 1.5 | 1.3 | 1.0 | 1.6 | 1.6 |

**EPS sensitivity**

| | 2020E | 2021E | 2022E |
|---|---|---|---|
| **No net new business** | | | |
| EPS (p) | 27.7 | 45.1 | 48.3 |
| change | -1.1% | -4.4% | -6.6% |
| **0% market growth (was 5% p.a.)** | | | |
| EPS (p) | 27.9 | 45.1 | 47.1 |
| change | -0.3% | -4.4% | -9.1% |

**2019 figures include a special dividend of 13.5p; 2020E include £3m of exceptional transaction costs*
*Source: Company data, Hardman & Co Research*
*£1=$1.27*

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