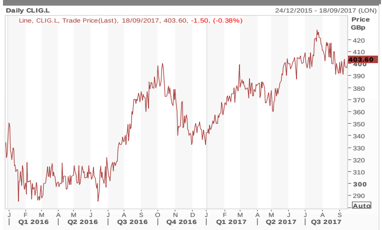
City of London Investment Group

Entering a new phase

Financial Services



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	CLIG
Price (p)	396.5
12m High (p)	429.0
12m Low (p)	332.5
Shares (m)	26.9
Mkt Cap (£m)	106.7
EV (£m)	92.8
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	20.3%
Blackrock	10.0%
Hargreave Hale	4.9%
Polar Capital	3.3%
Slater Investments	3.0%

Next event

9 Oct 17	Q1 trading update
12 Oct 17	Ex-div date
23 Oct 17	AGM
23 Oct 17	Capital Markets Day

Analysts

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City of London has published its full results and Annual Report for FY2017. With the headline figures having already been announced, there are no surprises in the new information. With Emerging Markets performing well, assets under management have grown significantly to $4.7bn at the year end. When combined with beneficial exchange rate movements, profitability has improved significantly, with earnings up 57% to £9.14m. With dividend cover back at a comfortable level, City of London has put a difficult period behind it and is able to move forward from a position of strength.

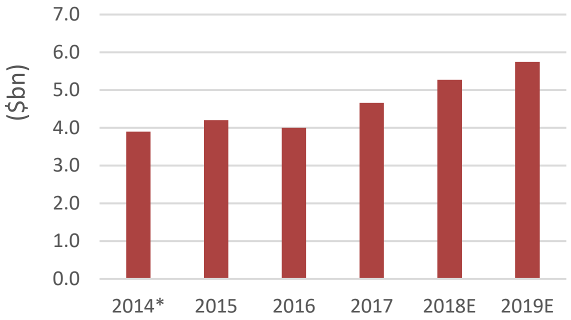
- **New business flows**: Although City of London attracted reasonable new business inflows during the year, these were offset by redemptions. For the Emerging Markets this led to net outflows of $306m, while the diversification products achieved a net inflow of $26m.
- **Cash:** Cash conversion as always was excellent and cash balances reached a new high of £13.9m. The company can comfortably fund the increased dividend cost, with scope for further increases in the future unless markets experience another severe dislocation.
- **Valuation:** The prospective P/E of 9.7 times is at a significant discount to the peer group. The historic yield of 6.3% is very attractive and should at the very least provide support for the shares in the current volatile markets.
- **Risks:** Although Emerging Markets can be volatile, City of London has proved to be more robust than some other emerging market 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 come in the next few years.

Financial summary and valuation

Year end Jun (£m)	2014*	2015	2016	2017	2018E	2019E
FUM ($bn)	3.90	4.20	4.00	4.66	5.28	5.75
Revenue (£m)	24.22	25.36	24.41	31.29	34.66	35.41
Statutory PTP	7.24	8.93	7.97	11.59	13.23	13.67
Statutory EPS (p)	20.7	26.4	23.3	36.9	40.9	42.3
Dividend (p)	24.0	24.0	24.0	25.0	26.0	27.0
P/E (x)	19.2	15.0	17.0	10.7	9.7	9.4
Yield	6.1%	6.1%	6.1%	6.3%	6.6%	6.8%

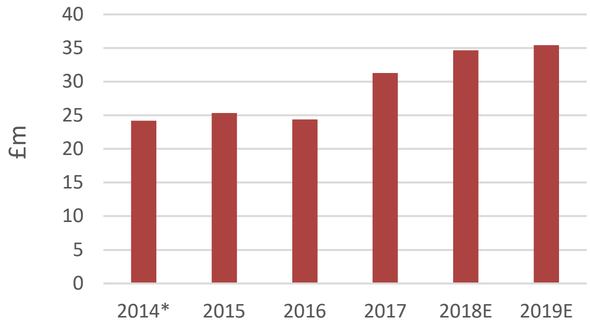
Source: Hardman & Co Research
** 2014 had 13 months in financial year.*

Funds under Management



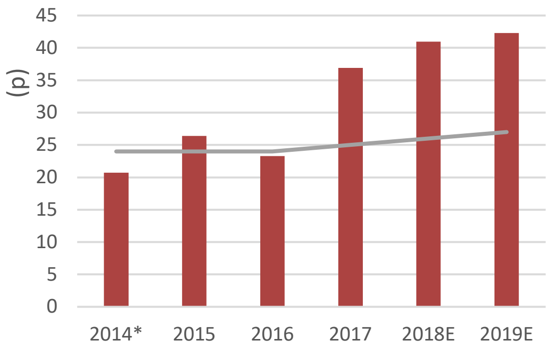
- Net inflows from 2014
- Market weakness in 2016 substantially offset by new business flows
- Assumed steady new business flows and market growth of 5% pa in 2018 and 2019

Revenues



- Revenues strongly linked 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 lead to step change in 2017
- Dividend shortfall in 2014 and 2016 covered from reserves
- Dividend increased in 2017 with cover of 1.46 and we expect steady increases over the next couple of years

Source: Company data; Hardman & Co Research

Operations

It is some time since we updated on City of London's operations. In this section we do so.

Investment Process

The vast majority of City of London's assets are invested in Closed End Funds (CEFs). For most of its history it focussed almost exclusively on Emerging Markets, but over the last few years is has started to diversify into other areas.

The portfolios are invested using a combination of top down and bottom up processes:

- **Top down**: Using macroeconomic analysis, 35 emerging markets are ranked using 13 key criteria;
- **Top down**: Rankings are then adjusted on the relative pricing of each country's securities. Note this may be relative to its own history as well as other countries;
- **Bottom up**: The managers of the CEFs are assessed for expertise and performance;
- **Bottom up**: The discount to net asset value of each fund is tracked and assessed relative to its own history;
- **Bottom up**: Any specific factors for a fund that may impact the discount, such as corporate activity or liquidation dates, are included.

These factors are combined to build a portfolio in which (ideally) the portfolio is overweight relative to the benchmark in desirable economies, and underweight less desirable ones, through funds that are well managed but trading at a discount that is larger than normal. In practice, there may be tradeoffs – for example, an attractive country may be equal or underweight if appropriate funds are expensive.

It should be noted that how positions are taken does vary. For some funds, for example a special situation, a position may be bought when the fund is attractive and sold when the situation is resolved. Other funds can be more long term holdings, with the weighting being increased or decreased according to the factors described above.

Even in an era where markets are assumed to be mostly efficient, anomalies in discounts or valuation often remain for very similar funds that perhaps have different domiciles or listings. Some of these are illustrated below.

Selected closed end fund discounts with different domiciles

Geographical Area	Fund	Discount	Listing	Fund	Discount	Listing
Russia	EOS Russia	-34%	Stockholm	JP Morgan Russia	-15%	London
China A	HSBC China Dragon Fund	-21%	Hong Kong	Morgan Stanley China A Share Fund	-13%	New York
China	Fidelity China Special Situations	-13%	London	JPMorgan China Region Fund Inc	-1%	New York
Asia Regional	Aberdeen New Dawn Investment Trust	-13%	London	Asia Pacific Fund Inc	-6%	New York
Asia Regional	Morgan Stanley Asia Pacific Fund	-12%	New York	Pacific Assets Trust	-1%	London
India	JPMorgan Indian Investment Trust	-11%	London	Excel India Growth & Income	-1%	Toronto
Global Emerging Markets	Morgan Stanley Emerging Markets Fund Inc	-11%	New York	Fundsmith Emerging Equity Trust	+2%	London
South Korea	Korea Fund Inc	-10%	New York	Weiss Korea Opportunity Fund	-3%	London
Asia Regional Income	Voya Asia Pacific High Dividend Equity Fund	-9%	New York	Henderson Far East Income	+3%	London
Emerging Markets Income	Voya Emerging Markets High Income Dividend Equity Fund	-8%	New York	Jupiter Emerging & Frontier Income Trust	+6%	London
Russia	EOS Russia	-34%	Stockholm	JP Morgan Russia	-15%	London

Source: CLIM, as of 30 June 2017

Overall, the investment philosophy is very process driven, with no star managers, and bonuses are paid via communal pool of 35% of operating profit, of which 5% is for the Employee Investment Plan. It is also very successful, with consistent performance above the benchmark and its peers. More details are available on City of London's website and in its Annual Report.

Two of the diversification products use the same process but applied to Frontier and Developed markets. Both of these now have five year track records and are top quartile. The other strategies such as Global Tactical Asset Allocation and Tactical Income are slightly different and have shorter track records, but have also outperformed their benchmarks to date.

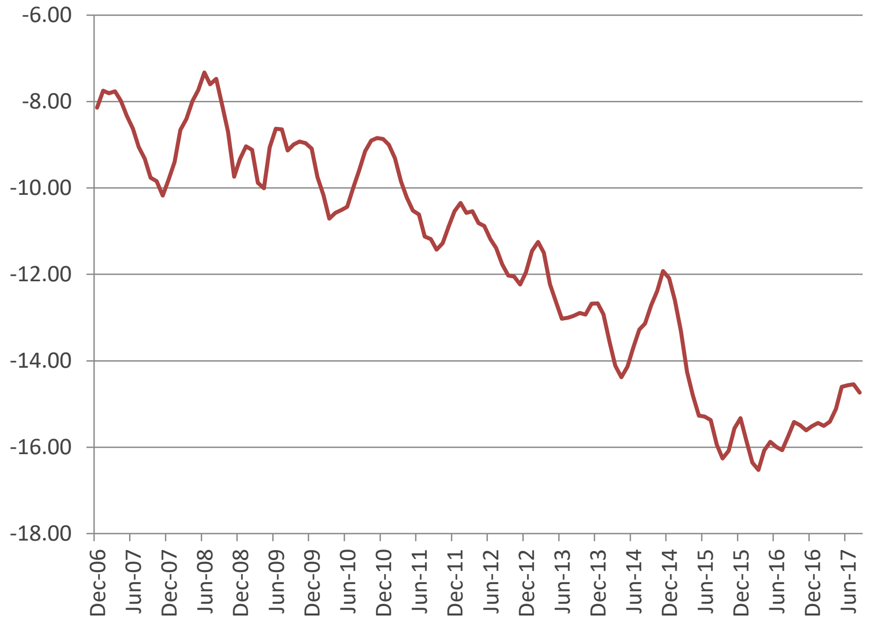
Company

The vast majority, 99%, of City of London's fund investors are institutional investors, with most of them based in the United States. To service these they have two offices in the US, one of which is also one of the main investment management centres. The company's headquarters in London is the other, with smaller investment offices in Dubai and Singapore. Combined they give 24 hour market coverage.

While the company is tightly managed, like most fund managers its fortunes are to some extent dependent on the markets. For several years preceding 2017, Emerging Market equities were largely disappointing. The early part of this decade saw a decline in assets under management, which was also influenced by a period of poor performance. A review of the latter led to greater discipline in the application of the investment process, and performance since then has been good relative to the market.

A measure that City of London cite frequently is the size weighted average discount. This is measured over the portfolio of a typical fund. It can be seen that from roughly 2008 to 2015 the average discount steadily widened, probably due to emerging markets falling out of favour. That City of London still posted good performance over much of this period despite steady cheapening of their universe suggests their process is pretty robust.

3-month rolling size weighted average discount – Emerging World Fund



Source: CLIM

Over the last few years the company has exhibited excellent cost control. This is partly due to the profit-share being a proportion of profits, and hence adjusting automatically. There has also been some small reduction in staff numbers over that period. This has been important as the reduced profitability affected the dividend cover, which from FY2013 to FY2016 was between 0.86 and 1.08 times covered. This has recovered to 1.5x in FY2017.

Exchange rate exposure is significant, with movements in the sterling to US Dollar rate being very significant. Almost all the group's revenue and just over half of expenses are denominated in US dollars. The large move in the exchange rate post the Brexit vote has boosted profitability significantly and helped restore a good margin on the dividend cover.

The company has a strong balance sheet, with year end cash being a little over £10m in each of the last four years. This is more than adequate to pay a year's dividend while keeping capital adequacy strong.

Results Commentary

With the main figures having been announced in July's trading statement, the main interest is the additional detail that the full Annual Report provides.

Assets under management grew to $4.66bn at the year end from $4.0bn, of which 10% is now in the diversification strategies compared to 9.1% a year ago. The growth of 17% was less than the 24% of the MSCI Emerging Markets TR Index. Performance in the main Emerging Market strategies was marginally behind the benchmark, but the main effect was from redemptions, with some investors rebalancing as Emerging Markets performance improved. While gross inflows of $178m were close to our assumption, the redemptions of $484m gave a net outflow of $306m.

Net new business in the diversification strategies did better, with gross inflows of $141m and net inflows of $26m. There is another $126m of inflows that have been confirmed in the new financial year and total FUM have now reached $4.9bn. There is little guidance on new business strength – while we believe City of London will likely be successful in getting inflows of funds, it is not clear if there could be further rebalancing.

Profitability

The rising markets and a beneficial move in the exchange rate a year ago have led to a large jump in profits. Revenues were up 28% to £31.3m. Despite the inflows of new business, revenue margins have held up well and remain at 0.84%.

Administrative expenses, influenced most notably by the exchange rate, grew by 22% leading to a growth in operating profit of 48% to £11.5m. We note that there has been some underlying growth. The report highlights investment being made in information technology, including cyber security. Though this is important for the business, we understand the actual amounts are relatively small. We do not expect a significant acceleration going forward.

There was a one-off tax adjustment for the year of £0.4m and there has been guidance that a rate of 23% can be expected for FY2018.

As indicated above, the dividend for the year has been increased by 1p to 25p and dividend cover for the year is 1.5x.

Balance Sheet

The most notable change on the balance sheet is an improvement in the year-end cash position to £13.9m. While the growth in this from £10.2m is mostly due to the improved profitability, there is also £1.1m that has been generated from the realisation of seed investments.

Cash Flow

As usual for City of London, cash conversion is excellent with operating cash flow at 98% of operating profit. With the employee share option trust being a net seller of shares during the year, the amount of the dividend paid was up a little to £6.05m. Assuming no change in the interim dividend, this will increase to £6.3m in FY2018.

Estimate Updates

With the main figures having been incorporated into our July update there have only been minor adjustments to our estimates, most notably from the additional detail on expenses. Our 2018E eps is reduced 0.1p to 40.9p and 2019E increases 0.1p to 42.3p.

We note that dividend cover is now in a position to be much more robust to adverse market movements. The growth in FUM means that a return to a pre-Brexit exchange rate, for example, would not leave the dividend uncovered. Similarly, the exchange rate move means that the FUM would have to fall 25-30% before the cover is threatened. We note that this probably understates this, as the company would take other action. This is a long way of saying that without a large market dislocation there seems to be plenty scope for further dividend increases in the next couple of years.

Underpinning this is management's statement that they would look to grow reserves by an average of £1m per annum. With cash generation this year at £2.5m more than the cost of the dividend, there would seem to be plenty of room to meet that objective while still growing the dividend and maintaining the target average cover of 1.2x.

Share sales

Barry Olliff, the founder of the company and CEO is planning towards his retirement. He is a very large shareholder, with 8.5% of the equity (2.3m shares). In order to ensure an orderly market, he has been progressively selling down his stake as the share price has increased.

In the Annual Report he has announced an update to his plans. Previously he was selling 500,000 at every 50p increment in the share price. Future sales will be of 250,000 at 25p increments, subject to close periods. The next sale will be when the share price reaches 425p. This should be smoother, but there may still be short term effects on the share price when each sale happens.

Financials

Summary Financials

	June Year End					
	2014*	2015	2016	2017	2018E	2019E
FUM ($bn)	3.90	4.20	4.00	4.66	5.28	5.75
P&L (£m)						
Revenue	24.22	25.36	24.41	31.29	34.66	35.41
Expenses	17.22	16.63	16.66	19.79	21.45	21.76
Operating Profit	7.00	8.73	7.76	11.51	13.21	13.65
PBT	7.24	8.93	7.97	11.59	13.23	13.67
Earnings	5.20	6.61	5.85	9.14	10.19	10.53
eps (p)	20.7	26.4	23.3	36.9	40.9	42.3
dps (p)	24.0	24.0	24.0	25.0	26.0	27.0

Key Metrics

	2014*	2015	2016	2017	2018E	2019E
Growth (%)						
FUM		7.7	-4.8	16.5	13.2	9.0
Revenue		4.7	-3.7	28.2	10.8	2.2
Operating Profit		24.7	-11.1	48.4	14.8	3.3
EPS		27.5	-11.7	58.4	11.0	3.3
DPS		0.0	0.0	4.2	4.0	3.8
Operating Margins (%)						
Net FUM fee margin	0.88	0.86	0.86	0.85	0.84	0.84
Operating Margin	28.9	34.4	31.8	36.8	38.1	38.6
Tax Rate	28.2	26.0	26.5	26.0	26.0	26.0
Dividend cover	0.9	1.1	1.0	1.5	1.6	1.6

eps Sensitivity

	2018E	2019E
No net new business		
eps (p)	40.2	41.0
% change	-1.7	-3.0
0% market growth (was 5% pa)		
eps (p)	40.0	40.7
% change	-2.2	-3.8

Source: City of London Investment Group, Hardman & Co Research
** 13-month year as year end change.*

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