18 September 2019

CITY OF LONDON INVESTMENT GROUP

Another solid year

City of London has announced its results for FY2019. The headline figures of £11.4m PTP and undiluted EPS of 34.9p were in line with July's trading statement, meaning the interest for investors was in the details. Although FUM ended the year up by more than 5%, at $5.39bn, average FUM for fee collection was slightly lower ($5.1bn in FY2019 compared with $5.2bn in FY2018). Combined with the ongoing decline in fee rates from the increase in the diversification areas, revenue declined almost 6% to $31.9m. Staff costs increased with the recruitment of the new REIT team, with offsets from reduced commissions and other administrative costs.

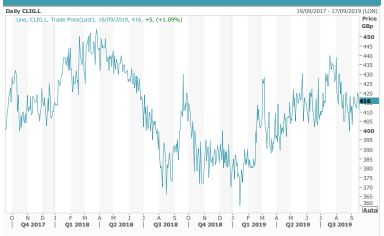
- **EM strategy:** Market performance gave a slight boost to FUM, although the EM strategy outperformance was more significant. More detail on flows shows that EM is still attracting new funds, but rebalancing remains a hurdle to growing FUM in this area.
- **Cash:** Cash conversion was, as usual, excellent, at 114% of earnings (boosted by working capital changes). Cash on the balance sheet declined due to REIT strategy seed funding, the special dividend and buybacks. At £13.8m, it is still more than adequate, and there remains scope for further return of capital.
- **Valuation:** The 2020E P/E of 9.4x is at a significant discount to the peer group. The underlying 2020E yield of 6.6% 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. FY2017 and FY2018 both saw dividend increases and, unless there is significant market disruption, more should follow in the next few years.

Financial summary and valuation

Year-end Jun (£m)	2016	2017	2018	2019*	2020E	2021E
FUM ($bn)	4.00	4.66	5.11	5.39	5.79	6.21
Revenue	24.41	31.29	33.93	31.93	35.76	37.94
Statutory PTP	7.97	11.59	12.79	11.40	13.72	14.79
Statutory EPS (p)	23.3	36.9	39.5	34.9	43.9	47.3
DPS (p)	24.0	25.0	27.0	27.0	27.0	27.0
Special dividend (p)				13.5		
P/E (x)	17.7	11.2	10.4	11.8	9.4	8.7
Dividend yield	5.8%	6.1%	6.6%	9.8%	6.6%	6.6%

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

Financial Services



Source: Refinitiv

Market data

EPIC/TKR	**CLIG**
Price (p)	**411.5**
12m High (p)	440.0
12m Low (p)	360.0
Shares (m)	26.6
Mkt Cap (£m)	109.3
EV (£m)	95.5
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
CFO	Tracy Rodrigues
Chairman	Barry Aling

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Key shareholders

Directors & staff	17.2%
Blackrock	10.1%
Cannacord Genuity	8.0%
Eschaton Opportunities Fund Management	4.8%
Polar Capital	4.1%

Diary

9 Oct	1Q FUM announcement
10 Oct	Ex-div. date for final
14 Jan	2Q FUM announcement
17 Feb	Half-year results

Analyst

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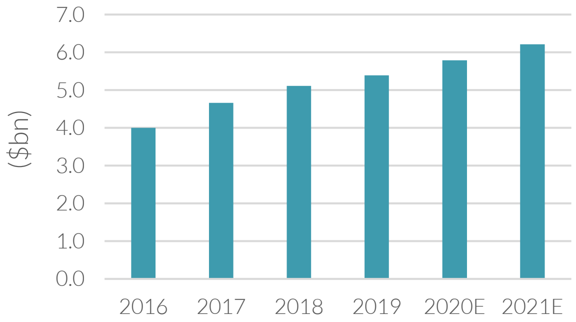
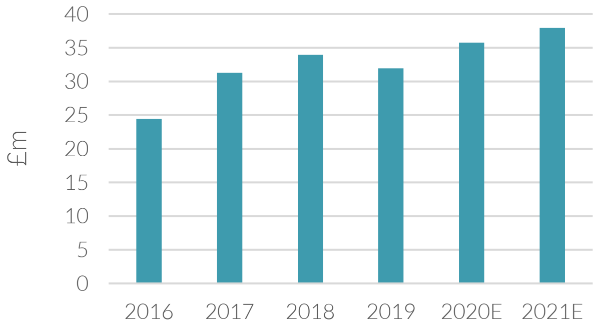
Funds under management (FUM)



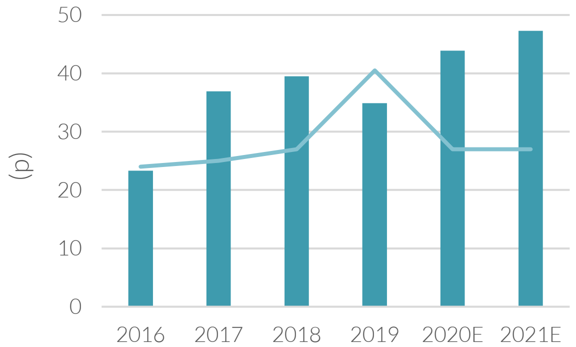
- Net inflows since 2014
- Market weakness in 2016 substantially offset by new business flows
- Market recovery in 3Q'19 completely offset weakness in preceding quarter
- Assumed steady new business flows and market growth of 5% p.a.

Revenue



- Revenue strongly linked to FUM
- Ongoing decrease in revenue margins from new business
- Some currency effects, particularly from a strong US dollar, between 2015 and 2017
- 2019 growth affected by reduction of revenue margins, as well as volatile markets

EPS (bar) and DPS (line)



- Profitability historically maintained by cost flexibility
- Currency movements led to step change in 2017 EPS
- Dividend shortfall in 2016 covered from reserves
- Special dividend of 13.5p in 2019
- Dividend increased in 2017 and 2018; however, with recent market volatility, we are now forecasting a flat dividend for 2020 and 2021, excluding the special dividend

Source: Company data, Hardman & Co Research

Results commentary

Although markets were volatile in FY2019, City of London continued to make steady progress, with the planned changes in management appearing to have gone smoothly too. The principal figures were presaged in July's trading statement, so this note focuses on strategy and some of the details.

Funds

Funds under management (FUM)

($m)	June 2019	June 2018	Net flows	Other movements
Emerging Markets	4,221	4,207	-184	198
Developed Markets	729	481	253	-5
Frontier Markets	206	245	-21	-18
Opportunistic Value	233	174	48	11
Total	5,389	5,107	96	187

Source: Company data, Hardman & Co Research

As a fund manager, City of London's performance as a company is linked directly to its underlying funds. FY2019 proved to be a volatile year for markets, with falls in the first half being more than offset in the second half. The MSCI Emerging Markets index finished the year slightly up, at 1.2%. Developed Markets, which suffered a larger fall during the year, saw a similar net increase, at 1.3% (MSCI ACWI ex US).

Performance in each strategy saw a reversal of the short-term patterns of last year. The EM strategy, which had a challenging 2018, recovered strongly in the second half of FY2019 and finished the year up 3.9%, with outperformance of 268 basis points. The largest factor in this was a narrowing of closed-ended fund discounts, which reduced from an average of almost 17% to under 15%. Good country allocation also added significantly.

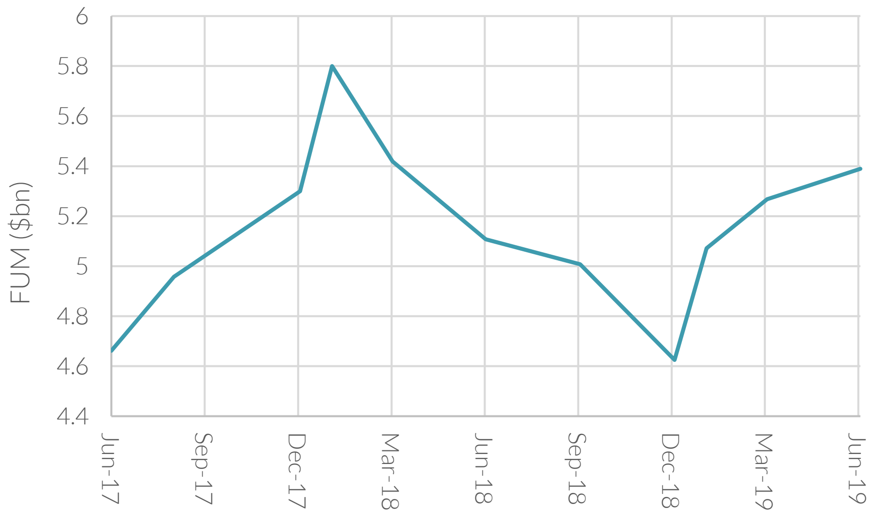
Developed Markets (DM) and Opportunistic Value (OV) strategies have consistently performed well in recent years, but they underperformed in FY2019. Frontier Markets have been less consistent, and underperformed substantially over the year. All these have sufficient historical good performance to ensure that their longer-term track records remain good.

In contrast to performance, flows saw a continuation of recent trends. Inflows of $164m into the EM strategy were more than offset by outflows of $348m. Rebalancing after good EM performance in the first half of CY2019 appears to be to blame.

Meanwhile, DM and OV continued to attract more assets. Inflows of $398m and outflows of $118m produced a net gain of $280m. The net effect is that diversification strategies now represent 22% of FUM, up from 18% a year ago. We expect this trend to continue.

City of London has recruited a team to run a REIT strategy, using a very similar methodology to that used for the other CEF strategies. The company has seeded two funds to establish a track record, and it appears that performance so far has been good. Although this has only been running since 1 January 2019, an existing client has invested some funds. This is a strong indication of confidence in City of London's processes.

FUM progress over FY2018 and FY2019



Source: Company data, Hardman & Co Research

The net effect is that FUM rose over the year from $5.11bn to $5.39bn, an increase of 5.5%, albeit the total fell to $4.6bn in December.

Finances

Fee income fell in FY2019, from £33.9m to £31.9m, a decline of 5.9%. Although FUM finished the year higher, the market weakness earlier meant that the average on which fees were paid actually fell slightly, from $5.2bn to $5.1bn.

Two other factors affected the revenues. As has been noted before, the fee rate on the diversified areas is lower than that for the existing EM book. The ongoing rise of the former as a proportion of the total means that the average fee rate is declining. Offsetting this was another fall in Sterling.

FY2020 will see the end of the run-off of commission payments. Some time ago, City of London used a third-party marketing agent that brought in significant assets. Although the arrangement was terminated when City of London brought the entire function in-house, the third party was entitled to ongoing payments for a period. The last of these will be in 2020. The expected amount of £0.2m is a large reduction from the £2.9m expected payment in FY2014, when Hardman & Co commenced coverage of City of London.

Although City of London indicated in the first half that it would look to reduce costs in the light of weak markets, they rose over the year. Some of this is a currency effect on US costs, and also reflects the recruitment of the new REIT team. City of London has always had strong cost control and, in the absence of market weakness and currency movements, costs are likely to rise more slowly.

Other figures were more or less in line with expectations, apart from investment income. The investment in the new REIT strategies showed a gain of £0.8m, of which £0.2m was attributable to third-party investors. It seems likely that this line will be more volatile than in recent years while this investment remains in place.

The net result is a decline in post-tax profits, from £10.1m in FY2018 to £8.8m (after minorities). Net, a decline in commission and other administrative costs, together with the profit share and REIT gain, offset some of the decline in revenue.

As usual, the conversion rate of profits to cash was excellent, at 114%, with a boost from working capital movements as trade payables increasing by £0.975m.

Cash on the balance sheet saw a significant decline, from £19.7m to £13.8m. Two items drove this change:

- The most significant was the investment in the new REIT strategies. The initial investment of £3.9m had grown to £4.5m by the end of June 2019. The £7.70m balance sheet figure for Other Financial Assets reflects the third-party investments, as well as the City of London stake. This consolidation also has a small effect on some other lines in the accounts, but these are not significant.

- The other factor reducing the available cash was the returning of cash to shareholders. The special dividend of 13.5p per share drove the total dividend cost up £3.6m to £10.2m. The company also spent £1.17m on buying back shares.

Despite the reduction in the cash level, we note that City of London remains more than adequately capitalised and is still capable of returning further cash to shareholders above the expected dividends.

Director changes

The changes to both senior management and the board discussed in the Annual Report have already taken place, and we have described these in earlier reports. The message is very much one of continuity from what has gone before, with the new CEO and CIO having been with the company for some time, and having been active over a transition period.

We also note that Barry Olliff, the former CEO, will be available in a consultative capacity for the next couple of years. He remains a major shareholder, and his previously declared intention to reduce this through sales is still in place. The current commitment is to sell 500,000 shares at each of 450p, 475p and 500p.

There has been one small change in the Key Performance Indicators (KPI) targeted. Previously, the company's target was to outperform its peers. This group had become less relevant, with growth in other areas and mergers leading to none having meaningful exposure to emerging markets. The new target will be one of two options:

- compound the total return by 7.5% to 12.5% p.a.; or
- double the cumulative total return of the most relevant Emerging Markets index, which is M1EF.

These are to be achieved across a cycle, which City of London deems to be five years for practical purposes. Hardman & Co sees this change as more evolutionary than revolutionary and unlikely to meaningfully impact shareholders in itself.

Given City of London's growth in the diversified areas, in time, a pure emerging markets benchmark may no longer be appropriate. We would expect the second target to be reviewed when necessary.

Estimate updates

With figures being in line with our estimates, we have made only small changes to our operational figures. There is a small adjustment for the weakness in Sterling. The net effect is that the Hardman & Co 2020E EPS is increased by 5% to 43.9p and 2021E by 4% to 47.3p.

We continue to keep our forecasts for a flat dividend in place. We do note that, particularly in 2021, our forecasts would allow an increase, while keeping the rolling five-year cover (excluding the special dividend) above the company's 1.2x target. The prospects may also depend on the amount of buybacks that the company makes and how these could affect the surplus cash.

Financials

Summary financials

Year-end Jun	2016	2017	2018	2019*	2020E	2021E
FUM ($bn)	4.00	4.66	5.11	5.39	5.79	6.21
P&L (£m)						
Revenue	24.41	31.29	33.93	31.93	35.76	37.94
Expenses	16.66	19.79	21.40	21.43	22.06	23.16
Operating profit	7.76	11.51	12.53	10.50	13.71	14.77
Statutory PTP	7.97	11.59	12.79	11.40	13.72	14.79
Earnings	5.85	9.14	10.06	9.05	10.98	11.83
Statutory EPS (p)	23.3	36.9	39.5	34.9	43.9	47.3
DPS (p)	24.0	25.0	27.0	40.5	27.0	27.0

Key metrics

	2016	2017	2018	2019*	2020E	2021E
Growth (%)						
FUM		16.5	9.6	5.5	7.5	7.3
Revenue		28.2	8.4	-5.9	12.0	6.1
Operating profit		48.4	8.8	-16.2	30.5	7.8
EPS		58.4	7.0	-11.6	25.7	7.8
DPS (excluding special)		4.2	8.0	0.0	0.0	0.0
Operating margins (%)						
Net FUM fee margin	0.86	0.84	0.80	0.76	0.76	0.76
Operating margin	31.8	36.8	36.9	32.9	38.3	38.9
Tax rate	26.5	21.1	21.4	20.0	20.0	20.0
Dividend cover (x, excluding special dividend)	1.0	1.5	1.5	1.3	1.6	1.8

EPS sensitivity

	2020E	2021E
No net new business		
EPS (p)	43.2	45.4
change	-1.5%	-3.9%
0% market growth (was 5% p.a.)		
EPS (p)	42.1	41.9
change	-4.0%	-11.4%

£1=$1.24

**2019 figures include a special dividend of 13.5p*

Source: Company data, Hardman & Co Research

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(Disclaimer Version 8 – Effective from August 2018)

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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 a 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…'

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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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