20 September 2018

# City of London Investment Group

## Strengthening cash position to boost returns

**City of London has released its annual results for 2018. As headline figures were given in the July trading statement, there are no big surprises in these results. FUM grew 9.5% in US Dollar terms over the year to $5.1bn. With Sterling strengthening relative to the US Dollar and lower fee margins, revenue growth was a little behind this at 8.4%. Total expenses grew at 8.2%, giving a net 8.9% growth in operating profit to £12.5m. EPS growth was 7.0%, lower than the 10% increase in earnings due to fewer shares being held by employee benefits schemes.**

- **Cash**: City of London usually has excellent cash conversion. The 2018 figure of 120% was boosted by changes in working capital, notably a £1.4m increase in trade payables. The year-end cash balance of £19.7m is more than 40% up on a year ago, with suggestions that some might be returned to shareholders.

- **Management and board changes:** The coming year is going to see significant changes. In early 2019, Tom Griffith, who is currently Deputy CEO, will become Group CEO in advance of Barry Olliff's retiral at the year end. David Cardale will also be stepping down as Chairman, to be replaced by Barry Aling.

- **Valuation:** The prospective P/E of 10.3x is at a significant discount to the peer group. The historical yield of 6.3% is 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 could increase the risk of such outflows, however.

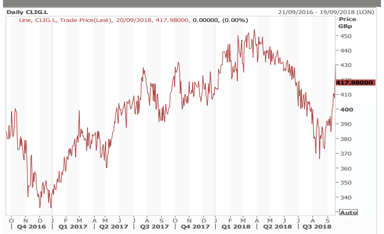
- **Investment summary:** Having shown robust performance in challenging market conditions, City of London is now reaping the benefits in a more supportive environment. The valuation remains reasonable. FY2017 and FY2018 both saw dividend increases and, unless there is significant market disruption, more should follow in the next few years.

### Financial summary and valuation

| Year-end June (£m) | 2015 | 2016 | 2017 | 2018 | 2019E | 2020E |
|---|---|---|---|---|---|---|
| FUM ($bn) | 4.20 | 4.00 | 4.66 | 5.11 | 5.55 | 6.01 |
| Revenue | 25.36 | 24.41 | 31.29 | 33.93 | 34.31 | 36.34 |
| Statutory PBT | 8.93 | 7.97 | 11.59 | 12.79 | 13.15 | 14.26 |
| Statutory EPS (p) | 26.4 | 23.3 | 36.9 | 39.5 | 41.8 | 45.3 |
| DPS (p) | 24.0 | 24.0 | 25.0 | 27.0 | 30.0 | 33.0 |
| | | | | | | |
| P/E (x) | 16.3 | 18.5 | 11.7 | 10.9 | 10.3 | 9.5 |
| Yield | 5.6% | 5.6% | 5.8% | 6.3% | 7.0% | 7.7% |

*Source: Hardman & Co research*

### Financial Services



*Source: Eikon Thomson Reuters*

### Market data

| | |
|---|---|
| EPIC/TKR | **CLIG** |
| Price (p) | 430.0 |
| 12m High (p) | 454.0 |
| 12m Low (p) | 366.0 |
| Shares (m) | 26.9 |
| Mkt Cap (£m) | 115.7 |
| EV (£m) | 96.0 |
| Market | LSE |

### Description

City of London is an investment manager specialising 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 | 16.3% |
| Blackrock | 9.9% |
| Cannacord Genuity | 7.9% |
| Eschaton Opportunities Fund Management | 4.7% |
| Polar Capital | 4.1% |

### Diary

| | |
|---|---|
| 8 Oct | 1Q FUM announcement |
| 11 Oct | Ex-div. date for final dividend |
| 22 Oct | AGM |
| 16 Jan | 2Q FUM announcement |

### Analyst

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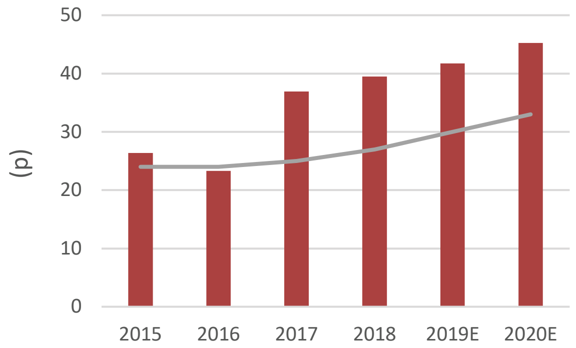
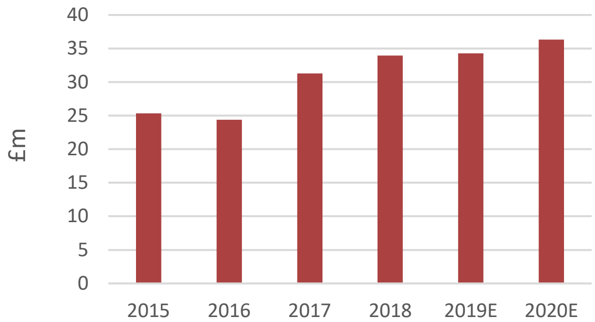
## Funds under Management



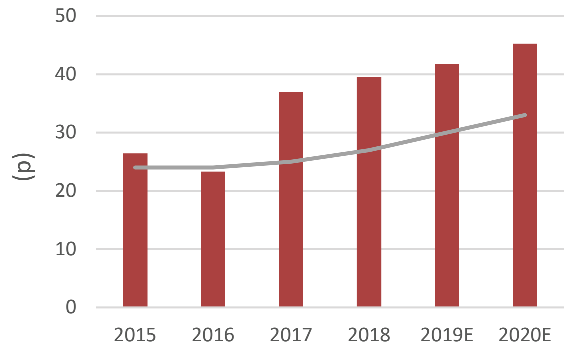

- Net inflows since 2014
- Market weakness in 2016 substantially offset by new business flows
- Assumed steady new business flows and market growth of 5% p.a.

## Revenue




- Revenue linked strongly to FUM
- Slow ongoing decrease in revenue margins from new business
- Some currency effects, particularly from strong US Dollar between 2015 and 2017
- 2019E growth affected by reduction of revenue margins

## 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 and 2018 – we expect steady increases in the dividend over the next couple of years

*Source: Company data; Hardman & Co research*

# Commentary on FY2018 results

Although City of London has successfully diversified its FUM through growth in its newer strategies, the results mostly depend on the core Emerging Markets (EM) strategy. Although emerging markets rose in the year to end June, the peak was in January and EM indices have steadily declined since then.

As previously noted, new business generally has a lower revenue margin than the existing average. This is particularly true of the Developed Market and Opportunistic Value (formerly Global Tactical Asset Allocation) strategies, but new EM business is also at a lower margin. Between mix changes and new business, 2018 has seen a faster decline in the margin than in previous years, from 84bps to 80bps.

Average FUM for FY2018 was $5.2bn, an increase of 21% over the preceding year's figure of $4.3bn. Revenue growth lagged this at 8.4%, with the margin decline one of two big contributors. The other was a decline in the US Dollar relative to Sterling, with an average rate of $1.35 vs. 1.27 in the preceding year.

Costs increased at a faster pace than in previous years, with an 8.2% increase to £21.4m. Custody fees increased by more than we expected, reflecting the higher average FUM. The Employee Incentive plan has gained traction, the cost of which increased to £0.5m from £0.1m.

The core overhead saw additional costs from MIFID II and the set-up of new funds for the diversification strategies.

There were also some exceptional legal costs related to the China Fund investment, details of which are in the annual report. While City of London successfully defended the action, it still has to bear its own costs. While we would like to think this is an isolated event, litigation in the US in particular continues to increase and an active corporate investor may find itself in the firing line, no matter how unreasonable it may seem to a dispassionate observer. Legal costs on this occasion were ca.£0.3m.

Income received a small boost from realising a seed investment, as well as other small changes.

Corporation tax mostly reflects the US rate, which has been reduced to 21%. The net effect is that profit after tax increased to £10.1m from £9.1m. EPS saw a smaller gain to 39.6p, with the number of shares being held in employee schemes (which are not counted for EPS calculations) reducing over the year.

## Cash and shareholder returns

Cash conversion for City of London has always been excellent. The 2018 figure of 120% was boosted by beneficial changes in working capital, with an increase of £1.4m in trade payables. Excluding this still gives a conversion rate of 101%.

The interim and final dividend were each increased by 1p during the year, taking the total to 27p per share. Diluted cover for the year was 1.46 times, although on a rolling five-year basis it is 1.18 times, almost exactly at the target of 1.2 times.

The strong cash generation and dividend cover, plus the working capital changes, meant that cash on the balance sheet increased from £13.9m to £19.7m. With an annual dividend cost of slightly under £7m and the business requiring little cash input, other than funding seed investments, City of London would appear to have a comfortable surplus over its requirements.

The potential use of this is discussed in the report. Management have considered purchasing another asset manager, but have not found anything suitable. This is not surprising: both the investment strategy and the way the company is run are somewhat different from other asset managers. Adding a firm with a different strategy might not produce meaningful synergies, and could dilute management focus. Adding a firm with a different culture could be disastrous for one or both businesses. This is not to say that a suitable company does not exist, but Hardman & Co sees a transaction as unlikely.

With its current operations, City of London seems well placed for organic growth. While the core EM strategy continues to have its new business wins offset by redemptions from rebalancing, the diversifying strategies are performing well and drawing in enough new business to more than offset that. The announcement that a team has been recruited to develop a REIT strategy akin to that used for existing CEFs is a welcome development too. It should be noted that the other diversifying strategies took a few years to start contributing meaningfully, and the new strategy should be viewed in that context.

It is suggested that the surplus cash could be returned either through share buybacks or special dividends. In August, 175,000 shares were bought back at 370p, almost £650,000 worth. With our forecasts giving free cash generation of more than £3m in FY2019, a return of £10m would still leave the company in a strong financial position in 12 months' time. The previous prudence of the board suggests a slower rate is more likely, although this should not stop shareholders looking forward to something significant.

## Fund performance

**City of London strategy performance in FY2018**

| Strategy | FY'2018 performance | FY2018 benchmark | Difference | Benchmark index (USD) |
|---|---|---|---|---|
| Emerging Markets | 4.3% | 8.2% | -3.9% | MSCI Emerging Markets |
| Developed Markets | 11.2% | 7.3% | +3.9% | MSCI ACWI ex US |
| Frontier Markets | 4.2% | 4.5% | -0.3% | S&P Frontier EM 150 |
| Opportunistic Value | 8.3% | 6.0% | +2.3% | 50/50 MSCI ACWI/Barclays Global Aggregate Bond |

*Source: City of London, Hardman & Co Research*

The July trading statement indicated that the EM strategy had underperformed in 2018. There are two main causes behind this. Firstly, is a general widening of discounts in the sector. The Size-Weighted Average Discount (SWAD) widened significantly since the EM market peaked in January. At over 16%, the SWAD is the widest it has been for many years. Any reversal would be beneficial to City of London. Management also believes that the size of discounts will also create pressure for corporate activity to increase.

Secondly, the balance of the underperformance has mostly come from being overweight small cap stocks, and underweight IT, particularly in China. Although 2018 was a disappointing year, the long-term record remains good with performance vs. peers being first or second quartile over 3 and 5 years.

With the potential for adding assets in Frontier Markets being limited, the focus for new business in diversifying strategies will be on Developed Markets and

Opportunistic Value. In each, the good performance in FY2018 builds on previous positive results and we'd expect to see good progress in adding assets.

## Management changes

Some time ago, Barry Olliff, City of London's CEO, announced plans to retire at the end of 2019. Tom Griffith was recently made Deputy CEO, with a clear intention to become CEO in due course. This transition will now take place in early 2019, in order to provide a handover period.

Barry Olliff reiterated his intention sell 500,000 shares at each of 450p, 475p and 500p.

There will also be a change of Chairman, with Barry Aling taking over from David Cardale as the latter retires. The former is already the senior non-executive director, so the new Chairman should bring continuity.

## Estimate adjustments

With the average FUM for FY2018 being above the year-end figure and margins having declined, forecast revenue and earnings growth for FY2019 is weaker than recent times. The revisions to Hardman & Co forecasts have mostly been favourable, with a lower cost increase assumption, reflecting, inter alia, the exceptional legal fees in 2018, and a slight strengthening of the US Dollar since July.

The net result is Hardman & Co undiluted FY2019 EPS estimate has increased by 8% to 41.8p, with FY2020 estimate up by the same amount to 45.3p. The dividend forecasts have again been left unchanged, although there would seem to be a good chance of a special dividend or further share buybacks in the near future.

# Financials

| Summary financials | | | | | | |
|---|---|---|---|---|---|---|
| **Year-end June** | **2015** | **2016** | **2017** | **2018** | **2019E** | **2020E** |
| FUM ($bn) | 4.20 | 4.00 | 4.66 | 5.11 | 5.55 | 6.01 |
| **P&L (£m)** | | | | | | |
| Revenue | 25.36 | 24.41 | 31.29 | 33.93 | 34.29 | 36.32 |
| Expenses | 16.63 | 16.66 | 19.79 | 21.40 | 21.15 | 22.08 |
| Operating profit | 8.73 | 7.76 | 11.51 | 12.53 | 13.14 | 14.24 |
| PBT | 8.93 | 7.97 | 11.59 | 12.79 | 13.15 | 14.26 |
| Earnings | 6.61 | 5.85 | 9.14 | 10.06 | 10.39 | 11.26 |
| EPS (p) | 26.4 | 23.3 | 36.9 | 39.5 | 41.8 | 45.3 |
| DPS (p) | 24.0 | 24.0 | 25.0 | 27.0 | 30.0 | 33.0 |

| Key metrics | | | | | | |
|---|---|---|---|---|---|---|
| | **2015** | **2016** | **2017** | **2018** | **2019E** | **2020E** |
| **Growth (%)** | | | | | | |
| FUM | | -4.8 | 16.5 | 9.6 | 8.6 | 8.3 |
| Revenue | | -3.7 | 28.2 | 8.4 | 1.1 | 5.9 |
| Operating profit | | -11.1 | 48.4 | 8.8 | 4.9 | 8.4 |
| EPS | | -11.7 | 58.4 | 7.0 | 5.7 | 8.4 |
| DPS | | 0.0 | 4.2 | 8.0 | 11.1 | 10.0 |
| **Operating margins (%)** | | | | | | |
| Net FUM fee margin | 0.86 | 0.86 | 0.84 | 0.80 | 0.79 | 0.80 |
| Operating margin | 34.4 | 31.8 | 36.8 | 36.9 | 38.3 | 39.2 |
| Tax rate | 26.0 | 26.5 | 21.1 | 21.0 | 21.0 | 21.0 |
| Dividend cover (x) | 1.1 | 1.0 | 1.5 | 1.5 | 1.4 | 1.4 |

| EPS sensitivity | | |
|---|---|---|
| | **2019E** | **2020E** |
| **No net new business** | | |
| EPS (p) | 40.8 | 42.3 |
| % change | -2.4 | -6.5 |
| **0% market growth (was 5% p.a.)** | | |
| EPS (p) | 40.1 | 40.1 |
| % change | -4.0 | -11.5 |

*Source: City of London Investment Group, Hardman & Co research; £1 = $1.31*

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*(Disclaimer Version 8 – Effective from August 2018)*

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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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