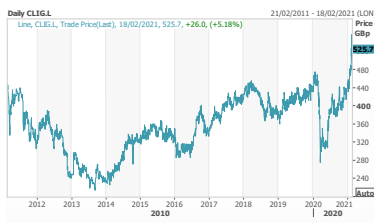


18 February 2021

Financial Services


Source: Refinitiv

Market data

EPIC/TKR	CLIG
Price (p)	502.0
12m High (p)	556.0
12m Low (p)	275.0
Shares (m)	50.7
Mkt Cap (£m)	254.4
EV (£m)	236.9
Market	LSE

Description

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

Company information

CEO	Tom Griffith
CFO	Deepranjan Agrawal
Chairman	Barry Aling
	+44 207 860 8312
	www.citlon.com

Key shareholders

George Karpus	31.5%
Barry Olliff	2.5%
Directors & staff	11.7%

Diary

4 Mar	Interim ex-dividend date
20 Apr	3Q FUM statement

Analyst

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bm@hardmanandco.com

CITY OF LONDON INVESTMENT GROUP

Karpus benefit coming through strongly

City of London has announced its interim results for FY'21. The merger with Karpus took place in the middle of the reporting period, which, together with strong market performance, has had a strong beneficial effect. Gross revenue grew to £23.7m, an increase of 37% over the figure from the same period a year ago. Statutory profit also showed a strong increase, even after the exceptional transaction costs and introduction of amortisation. On an underlying basis, earnings grew 81% to £8.82m, while underlying EPS was up 23%, from 19.4p to 23.8p. An interim dividend increase to 11p had been announced previously.

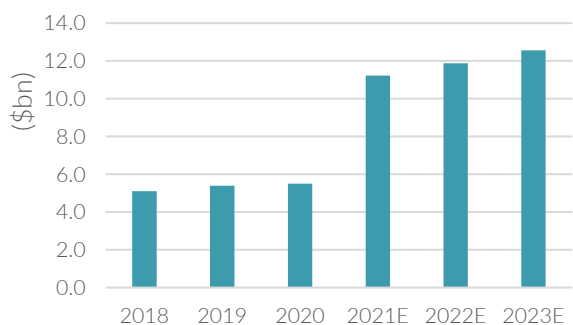
- ▶ **FUM:** City of London provided some further details on fund flows and performance. Both the retail and institutional assets within Karpus saw net outflows, reflecting rebalancing more than transaction disruption. Five of its six strategies outperformed in the last quarter.
- ▶ **Amortisation and estimates:** The transaction introduces a large amortisation figure: £1.1m for the last quarter. We have moved our forecasts to an underlying basis, with 2021E EPS now 47.1p, an increase of 24% over 2020 EPS. We have also introduced 2023 estimates.
- ▶ **Valuation:** Despite the recent good performance, the 2022E P/E of 11.9x remains at a discount to the peer group. The 2022E yield of 7.2% is attractive, in our view, and should, at the very least, provide support for the shares in the current markets.
- ▶ **Risks:** Although City of London has reduced its relative emerging markets exposure, it is still 47% of assets. It has proved to be more robust than some other fund managers, aided by its good performance and strong client servicing. Market volatility remains a risk, 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, a dividend increase in FY'20 and with the EPS boost from Karpus in 2021, the prospects for future dividend increases look very good.

Financial summary and valuation

Year-end Jun (£m)	2018	2019*	2020	2021E	2022E	2023E
FUM (\$bn)	5.11	5.39	5.50	11.22	11.88	12.56
Revenue	33.93	31.93	33.26	54.59	64.91	68.35
Statutory PTP	12.79	11.40	9.41	21.88	28.64	30.81
Statutory EPS (p)	39.5	34.9	30.3	36.5	42.0	45.4
Underlying EPS (p)	39.5	34.9	38.0	47.1	50.8	54.1
DPS (p)	27.0	27.0	30.0	33.0	36.0	39.0
Special dividend (p)		13.5				
P/E (x)	12.7	14.4	16.6	13.8	11.9	11.1
Dividend yield	5.4%	8.1%	6.0%	6.6%	7.2%	7.8%

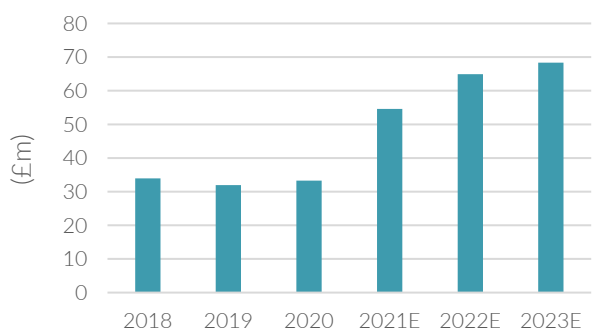
*2019 figures include a special dividend of 13.5p; Source: Hardman & Co Research

Funds under management (FUM)



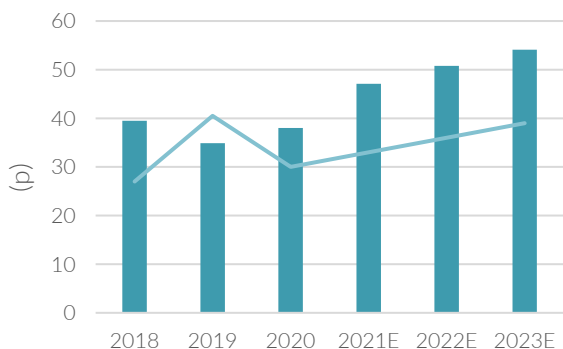
- ▶ Net inflows since 2014
- ▶ Addition of Karpus in 2021 added \$3.58bn
- ▶ Market recovery since spring 2020 has more than offset sharp market fall
- ▶ Assumed steady new business flows and equity market growth of 5% p.a.

Revenue



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

Underlying EPS (bar) and DPS (line)



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

Source: Company data, Hardman & Co Research

Results commentary

These results are the first since the Karpus merger, which was completed on 1 October 2020, exactly in the middle of the reporting period. As a consequence, 1Q was for CLIM (City of London Investment Management) only, while 2Q includes KIM (Karpus Investment Management) and will give a better reflection of the group going forward. This, inevitably, distorts the simple comparisons with previous reporting periods. City of London has separated some figures out, so we can see how CLIM has developed.

The merger has also brought some accounting changes, notably the exceptional costs for the transaction, the introduction of intangible assets acquired and their amortisation. As usual, the headline figures were previewed in the January trading statement, so this report will focus on the additional disclosure.

Funds

Funds under management (FUM)				
(\$m)	Dec'20	Jun'20	Net flows	Other movements
Emerging Markets	5,196	3,828	-47	1,419
International	1,700	1,244	-12	468
Opportunistic Value	306	256	-5	55
Frontier	14	175	-169	8
Other/REIT	13	9		4
CLIM total	7,229	5,512	-233	1,954
Karpus retail	2,630	2,401	-62	291
Karpus institutional	1,077	1,087	-99	89
Karpus total	3,707	3,488	-162	380
Total	10,936	9,000	-395	2,334

Source: Hardman & Co Research

The FUM figures give some additional segmentation from the earlier trading statement. The expected withdrawals in the Frontier strategy have left it only slightly larger than the newer REIT assets. Nevertheless, a longer track record may give it a relative marketing advantage, albeit this is very much a niche area for City of London's main target clients.

The KIM figures cover a quarter before and after the merger. While a small amount of assets were lost due to the change, rebalancing appears to have had a stronger effect. With 60% of assets in bonds, market growth was proportionately weaker than for CLIM.

KIM has six strategies, five of which outperformed in the last quarter. The exception was international equities. The fixed-income strategies had several sources of performance, while the equity strategies benefited from being overweight small-caps and discount narrowing. City of London intends to add to KIM's marketing resources, which hopefully will have a beneficial effect on its inflows.

Financial results

Revenue is the only line where separate CLIM and KIM figures are supplied. Net fee income in the half was £22.6m, of which £5.1m came from KIM, meaning the underlying CLIM total was £17.5m. This compares with £16.4m a year ago, a 7% increase. While CLIM's FUM growth over the period was 31%, its average FUM of \$6.2bn represented an 11% increase over the average of \$5.6bn in 1H'20. Adverse exchange rate movements and ongoing gradual average fee rate declines account for the difference.

Total employee and other administrative expenses rose, in total, from £9.95m to £10.99m, a 10% increase compared with the 38% net revenue growth. The different cost structure of KIM, combined with City of London's usual excellent cost control, accounts for much of this difference. With KIM being entirely US-based, its expenses increase the group proportion that is US dollar-denominated. The dollar weakness will also have had a beneficial effect.

After the adverse movements in early 2020, interest and gains returned a positive figure of £0.40m. The £0.45m of gains were primarily on the seed investments in the REIT strategies.

On a statutory basis, PBT for the period was £8.82m, and earnings were £6.58m, but this makes no allowance for the transaction. City of London has introduced an underlying profit calculation, which excludes gains on investments (£0.45m in 1H), the exceptional transaction costs (£1.74m) and amortisation on the acquired intangibles (£1.08m). This looks like a very sensible set of adjustments and should not be controversial.

Allowing for these, underlying PBT was £11.19m, an increase of 82% over the previous year's figure. Underlying 1H'21 EPS of 23.8p was 23% higher than for 12 months ago. Although supportive markets have helped, the financial benefits of the KIM transaction are clear.

Cash conversion is usually excellent, and this half was no exception. The cash from operations of £10.3m was 92% of operating profit plus amortisation. Despite the increased dividend and the transaction costs, cash on the balance sheet, at £17.54m, was 20% higher than the June figure of £14.59m. In addition, the seed investments in the REIT strategies are £4.3m.

The estimated full-year dividend cost for 2021, based on our estimate of 33p per share, is £14.3m, compared with 2021E earnings before amortisation of £19.0m. The dividend cost is a little reduced in 2021, as new shareholders will get 75% of the full amount, reflecting the period of their ownership. City of London has a very strong balance sheet, and we expect it to continue to improve this in the absence of a large market dislocation.

Management changes

Along with the results, City of London has announced two management changes: Deepranjan Agrawal, who has been managing the group's finance function since January 2020, has been made CFO of the group; Alan Hoyt, who has been with City of London since 2009, has been appointed CTO.

Since our last report, there has also been a new board appointment: Tazim Essani has had corporate development and strategy roles at GE Money, Close Brothers and Santander UK and, as an independent NED, will improve the balance of the board after the merger.

Estimates

The advent of Karpus has required significant changes to our financial model. We have reviewed several of our key assumptions and, given it is some time since we outlined them in full, we thought this would a good chance to update them. We have also, as is usual with the interim results, added 2023 forecasts.

New business

For the past couple of years, we have assumed no net inflows into the EM strategy. This has been overly optimistic, as rebalancing has continued to drag on FUM in this area. We have now assumed an annual withdrawal rate of \$100m.

The diversifying strategies, International and Opportunistic Value, have shown more consistent net inflows. Until last year, we had assumed an annual rate of \$250m for some time. With the review of the International strategy, we reduced this to a \$100m rate in FY'21 and \$200m thereafter. These assumptions remain unchanged.

With Karpus having been in transition in the last year, we are reluctant to read too much into its recent flow figures. Our initial judgement was annual net inflows of 1% of assets, which was \$35m. With the increase in FUM, we have increased that to a \$40m annual rate for the rest of the year, or \$10m in each quarter. As City of London intends to add marketing resource, we have now doubled that for 2022 and 2023, to \$80m a year.

Market movements

For some time, we have assumed an annual market growth rate of 5% for CLIM's assets. We see no reason to change this assumption. KIM has 60% bond exposure and, with interest rates being where they are, we assume an annual growth rate of 2.5%. As the table on page 6 shows, the market growth assumptions account for twice as much EPS growth as the new business assumptions.

Operational assumptions

We keep the fee rate assumptions in line with City of London's latest disclosure, with a slow, steady decline in CLIM driven by new business flows. Tax rates follow a similar pattern, with KIM raising the future tax rate to 24%. We have pushed up our expense growth for FY'21 to 3%, in line with City of London's model from the 2% we had previously. Future years are left at 2%.

Estimate changes

Although changing the above assumptions affects our estimates, actual market movements and exchange rates tend to have a larger effect on estimate changes. Net inflows have a lagged effect, generally having more effect on future years than the year in which they arrive or leave.

Although we will continue to disclose our statutory EPS estimates, our focus will move to the underlying figures. The underlying basic EPS for 2020 was 38.0p. We are now forecasting 47.1p in 2021, 50.8p in 2022 and 55.1p in 2023.

We note that City of London has put the dividend target of 1.2x rolling cover under review. We suspect that an adjustment away from the statutory basis will be appropriate. We have left our dividend estimate unchanged, although we have introduced a forecast for 2023 of 39p – a further 3p increase over 2022. This would give a five-year average cover of 1.15x on a statutory basis and 1.32x on an underlying basis. Knowing the management's tendency to be conservative and retain a margin in case of market volatility, we think that, if markets continue to perform well, then special dividends may be more likely than an accelerated dividend increase.

Financials

Summary financials						
Year-end Jun	2018	2019*	2020	2021E	2022E	2023E
FUM (\$bn)	5.11	5.39	5.50	11.22	11.88	12.56
P&L (£m)						
Revenue	33.93	31.93	33.26	54.59	64.91	68.35
Expenses	21.40	21.43	21.66	31.37	36.29	37.56
Operating profit	12.53	10.50	11.60	23.22	28.62	30.79
Statutory PTP	12.79	11.40	9.41	21.88	28.64	30.81
Earnings	10.06	9.05	7.37	15.77	20.72	22.37
Statutory EPS (p)	39.5	34.9	30.3	36.5	42.0	45.4
Underlying EPS (p)	39.5	34.9	38.0	47.1	50.8	54.1
DPS (p)	27.0	40.5	30.0	33.0	36.0	39.0
Key metrics						
	2018	2019*	2020	2021E	2022E	2023E
Growth (%)						
FUM		5.5	2.1	103.9	5.8	5.8
Revenue		-5.9	4.2	64.1	18.9	5.3
Operating profit		-16.2	10.4	100.2	23.3	7.6
Underlying EPS		-11.6	8.9	24.0	7.8	6.6
DPS (excl. special div.)		0.0	11.1	10.0	9.1	8.3
Operating margins (%)						
Net FUM fee margin	0.80	0.76	0.75	0.75	0.74	0.74
Operating margin	36.9	32.9	34.9	42.5	44.1	45.1
Tax rate	21.4	20.6	21.7	23.0	24.0	24.0
Dividend cover (x, excl. special div.)	1.5	0.9	1.0	1.1	1.2	1.2
Rolling 5-year cover (x, excl. special div.)	1.2	1.3	1.2	1.3	1.2	1.1
Rolling u/l 5-year cover (x, excl. special div.)			1.2	1.3	1.3	1.3
Underlying EPS sensitivity						
				2021E	2022E	2023E
No net new business						
EPS (p)				47.1	50.2	52.7
change				-0.1%	-1.1%	-2.7%
0% market growth (was 5% p.a.)						
EPS (p)				46.7	48.0	48.4
change				-0.8%	-5.5%	-10.5%

*2019 figures include a special dividend of 13.5p; Source: Company data, Hardman & Co Research
£1=\$1.36

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