CITY OF LONDON INVESTMENT GROUP

Results full of cash

City of London has issued its annual report for FY'21. While the headline figures remain impressive after the Karpus transaction last October, it is some of the underlying figures that are the news here. The most eye-catching one for most investors will be the rise in the cash balance, at £25.5m, 75% more than the £14.6m from a year ago. Both the businesses are strongly cash-generative and, unless markets have a strong correction, this will increase further over the next year. At the very least, this will provide a robust balance sheet in the event of any market downturns, but may also provide options for further cash returns.

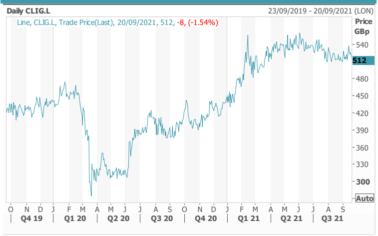
- **ESG:** With ESG rising in investors' minds, we take a look at City of London's improved disclosure in this area. It has long had a strong governance approach in its investment process, but it is broadening out its perspective. Corporately, there is a commitment to review the board composition over the next year.
- **Estimates:** The main changes to our estimates reflect City of London's ongoing excellent cost control, with small reductions to our assumed future expenses. The net result is small upgrades to our forecasts, with both our 2022E and 2023E EPS increasing by 1%.
- **Valuation:** Despite the recent good performance, the 2022E P/E of 12.1x remains at a discount to the peer group. The 2022E yield of 6.9% 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, dividend increases in FY'20 and FY'21, and with the EPS boost from Karpus, the prospects for future dividend increases look very good.

Financial summary and valuation

Year-end Jun (£m)	2018	2019*	2020	2021	2022E	2023E
FUM ($bn)	5.11	5.39	5.50	11.45	12.09	12.78
Revenue	33.93	31.93	33.26	55.12	65.39	68.83
Statutory PTP	12.79	11.40	9.41	22.25	29.39	31.56
Statutory EPS (p)	39.5	34.9	30.3	39.4	43.4	46.7
Underlying EPS (p)	39.5	34.9	38.0	50.0	52.2	55.5
DPS (p)	27.0	27.0	30.0	33.0	36.0	39.0
Special dividend (p)		13.5				
P/E (x)	13.3	15.0	17.3	13.3	12.1	11.2
Dividend yield	5.2%	7.7%	5.7%	6.3%	6.9%	7.4%

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

Financial Services



Source: Refinitiv

Market data

EPIC/TKR	**CLIG**
Price (p)	**524.0**
12m High (p)	560.0
12m Low (p)	388.0
Shares (m)	50.7
Mkt Cap (£m)	265.6
EV (£m)	240.0
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

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Key shareholders

George Karpus	31.5%
Aberforth Partners	7.1%
Hargreaves Lansdown	6.5%
Interactive Investor	5.0%
Barry Olliff	2.4%
Other directors & staff	9.9%

Diary

14 Oct	1Q FUM statement
18 Oct	AGM

Analyst

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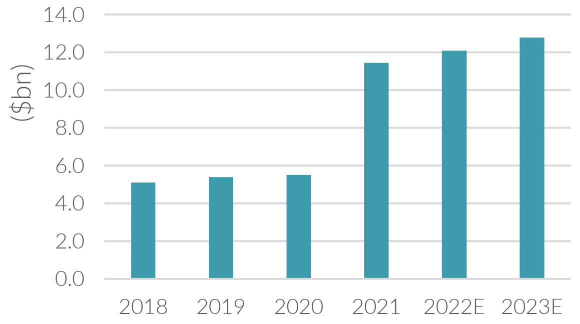
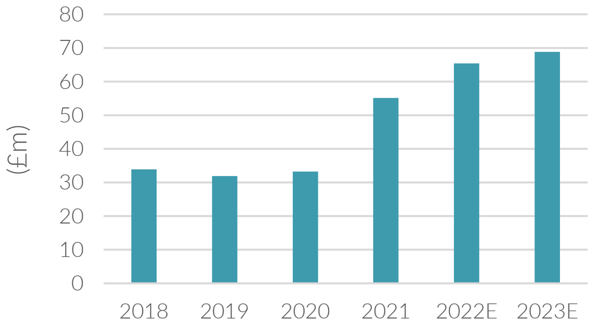
Funds under management (FUM)



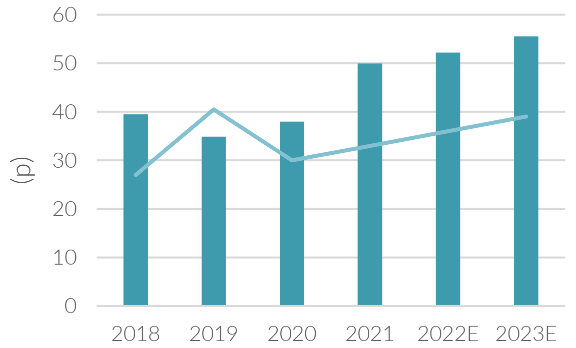
- Net inflows from 2014 to 2020, but net outflows in 2021.
- Addition of Karpus in 2021 added $3.58bn.
- Market recovery since spring 2020 has more than offset sharp market fall.
- Assumed steady new business flows and equity market growth of 5% p.a.

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.
- 2021 boosted by Karpus and strong markets.

Underlying EPS (bar) and DPS (line)



- Profitability maintained historically by cost flexibility.
- Exceptional transaction costs reduce statutory 2020 and 2021 EPS.
- Special dividend of 13.5p in 2019.
- Dividend increased in 2020 and 2021; we believe our forecasts for 2022 and 2023 are conservative.

Source: Company data, Hardman & Co Research

2021 results

With the headline figures for FY'21 having been previewed in July's trading statement, the main interest in City of London's annual results is in the details below the headline figures. Of course, the results are dominated by the merger with Karpus (KIM), which completed last October. The timing means that KIM is included for three quarters of FY'21 – so FY'22 will be the first full year of inclusion.

The headline figures reflect this: revenue up 65% to, £55.1m, through to-post tax profit up 131%, to £17.0m. However, this latter figure includes exceptional costs for the acquisition and ongoing amortisation of intangibles. The underlying profit figures, excluding these, are fairer measures of progress, with underlying EPS up from 38.2p to 48.1p, a rise of 26%.

Commentary

Revenues were aided by very supportive markets, but more challenging fund flows. Underpinning these figures is further good performance across most of the strategies. Over five years, the Emerging Markets strategy is towards the top of the second quartile, while International and Opportunistic Value are top quartile.

Funds under management (FUM)

($m)	Jun'21	Jun'20	Net flows	Other movements
Emerging Markets	5,393	3,828	-275	1,840
International	1,880	1,244	-14	650
Opportunistic Value	231	256	-103	78
Other/REIT	26	184	-169	20
CLIM total	**7,530**	**5,512**	**-561**	**2,588**
Karpus retail	2,804	2,401	-104	507
Karpus institutional	1,115	1,087	-131	158
KIM total	**3,919**	**3,488**	**-235**	**665**
Total	**11,449**			

Note: KIM figures for 12 months, including pre-merger quarter; Source: Hardman & Co Research

Within City of London Investment Management (CLIM), FUM grew 37% to $7.53bn. The fund flows had several headwinds during the year. This included the closing of the International strategy to new business in 2020 (it has re-opened in 2021). The Emerging Markets strategy also suffered from ongoing rebalancing, as clients reduce exposure when the sector performs well and relative performance is good.

Both Opportunistic Value and Frontier strategies lost their largest client. The former was due to changes at the client, which outsourced management. Frontier has been a more challenging area in global markets, and the client moved away strategically. With some recent weak relative performance too, the prospects for the latter recovering soon are not promising. However, given that its FUM was £180m, it is a small loss in the context of the larger group, at 1.5% of the total.

It is important to note that these flows are net figures. City of London notes that over $500m of new business was gained during the year. Paradoxically, a period of weaker markets could be better for net inflows in the Emerging Markets strategy, suggesting that there may be some natural dampening of market growth.

KIM added $3.6bn of FUM on 1 October 2020. Its fee margin is slightly higher than CLIM's, at 77bps vs. 73bps. Offsetting this for the revenue line was a strengthening of sterling by an average of ca.8%. This resulted in a net increase of 65%, to £55.1m.

Good cost management has been a long-term feature of City of London, and it is pleasing that rising markets and a larger company have not distracted from this. Preprofit share overheads grew by 29%, to £16.7m, a rate that is less than half the growth in revenue. This is helped by a favourable cost/income ratio at KIM, but we also estimate that underlying CLIM cost growth was ca. 2%, aided by the exchange rate. We note the closing of the Seattle office, albeit that was only one person, as increased use of remote meetings has made it unnecessary. Overall, the cost/income ratio has fallen from 41% in 2020 to 32% this year.

Other income lines

The EIP was offered to KIM employees from 1 January, with 73% participation. This was £1.0m in 2021, an 11% increase on 2020. The timing means that it will show a further relative increase in 2021, but this is small overall.

At the time of the 2020 results, markets had only partially recovered from the sharp falls in the spring of that year, whereas 2021 has been largely a strong bull market. Given this, it is not surprising to see the seed REIT investments turn a £0.9m loss in 2020 to a £0.5m gain this year.

Balance sheet and cash

The balance sheet is also greatly changed from the 2020 version, but most lines have simply increased roughly in proportion to the addition of KIM. There are two notable exceptions:

- There are now £101.0m of intangible assets. Of these, £41.6m represents the value of KIM's customers, brand and distribution. These will be amortised over 7-15 years. The balance is goodwill for the acquisition from the issuance of shares at a premium to tangible assets.
- The share capital has increased from £18.9m to £120.1m, again reflecting the share issue.

Cash generation remains excellent, with operating cash flow at 103% of pre-tax profit. This had some help from positive working capital movements.

Although overall cash generation was affected by costs from the KIM transaction, net cash generation, after paying £9.74m in dividends, was £11.0m. This leaves a cash balance of £25.5m at the year-end. Given City of London's capital requirements are low single digits, this is a very comfortable level.

KIM shareholders were not eligible for the final dividend last year – so we estimate that the dividends paid will rise sharply in 2022, to ca.£16.7m. Nevertheless, we are forecasting over £25m of underlying (cash) earnings, meaning that we expect the cash balance to grow further. Capital requirements as of June 2020 (for CLIM only) were £2.1m. Given that this is determined largely by overheads, rather than FUM, the new requirement will be ca.£3m – well below City of London's cash availability.

If markets remain robust, then the question will increasingly turn to what City of London will do with its surplus cash. While the rolling dividend cover, at 1.29x, allows some scope for stronger dividend increases than we are forecasting, we note management's view that markets are somewhat frothy. There is clearly a desire to keep a robust balance sheet ahead of any potential market downturn. Given the usual conservatism with which City of London is managed, we would regard accelerated ordinary dividend increases as the least likely option. If there is an additional cash return then either buybacks or special dividends seem the more likely options.

Estimate updates

With the main figures being previewed in July, we have made only small adjustments to our forecasts. These are primarily on expenses, where KIM's expenses are a little lower than our assumptions. Our underlying 2022E EPS has increased from 51.6p to 52.2p, a 1% increase, and underlying 2023E EPS also increases by 1%, to 55.5p.

Although the cash balance is rising, we have not allowed for any additional return in our forecasts, as it is difficult to anticipate its timing, amount and format.

ESG

City of London has changed its outsourced company secretary to Prim Cosec, which appears to be part of a wider updating of corporate governance. With ESG playing an increased role in investor decisions, we will briefly review City of London's position. Like all listed fund managers, there is a double-sided aspect, as ESG applies to both the corporate level and underlying investment process.

Corporate ESG

Environment

Although City of London has offices around the globe (London, east and west coast USA, Dubai and Singapore), the majority of communication has been remote for some time. For example, the long-standing Wednesday investment meeting has been conducted over video-conference for many years. KIM has already been integrated into the CLIM internal video-conference system. Nevertheless, business travel flights constituted two-thirds of associated emissions in FY'20.

These have had to fall away in FY'21, while other emissions grew with the combination with KIM. Both CLIM and KIM have continued to implement initiatives with positive environmental impacts. Overall, estimated per capita CO_2 emissions have dropped from 5.3 tonnes to 1.7 tonnes.

Social

Broadly speaking, CLIG is considered to be a good employer. Informally, this analyst has met several staff who considered themselves lucky to work at CLIM when compared with other city companies. The emphasis on process-driven investment, rather than star managers, probably helps avoid some of the issues with egos that some other fund management companies have experienced.

More formally, City of London has documented, in this year's Annual Report, several policies that have been in place for some time. As with most workplaces, this is still being improved, with additional policies on anti-harassment/complaints and diversity/inclusion being implemented during the year. A Diversity Working Group has also been established.

Overall, 36% of staff are female, slightly up from 34% a year ago, while, at a senior level, the ratio has fallen from 40% to 31%. Board level is probably the area that could do with improvement, with just 18% of directors being female. It is likely that this will change shortly, as discussed in the next sub-section.

Governance

When the transaction with KIM was announced last year, this included several board changes. The intention was to add additional directors from KIM, while retaining the existing directors. The aim of this was to have available the deep experience, in particular from the two founders (Barry Olliff and George Karpus), to smooth over the integration of the two companies. In practice, there has been a little turnover in the non-executives over this period.

The current board includes seven non-executive directors, of which the two founders are non-independent, and four executive directors. This is larger than would be normal for a company of City of London's size. It also has a majority of non-independent members.

With the integration now being largely complete, the exceptional circumstances are almost over. There is additional pressure for change from the Hampton-Alexander Review and the FCA, who recently issued a consultation paper on board composition for listed companies. City of London has also implemented a board diversity policy, with recent appointees making progress towards its goals.

City of London has announced that, over the next year, it will propose a plan to update the board, which will likely include improving independence, size and diversity. To ensure stability, these will likely be implemented over a longer timescale than one year.

Investment ESG

City of London's focus on closed-ended funds (CEFs) has meant that its investment process has had a strong governance aspect, almost from its inception. While UK investment trusts went through a governance revolution in the 1980s and 1990s, equivalent standards are still not applied uniformly around the world. Discount management, in particular, is a focus of many investments, often with pressure to implement policies where none existed before. More radical steps have occasionally been required, and City of London has been rather public about some of these.

With ESG increasing in investors' priorities, City of London is aware that the managers of the CEFs in which it invests are increasingly expected to demonstrate ESG compliance. It looks for managers to have published ESG policies and, increasingly, transparency on the ESG characteristics of the underlying investments.

Financials

Summary financials						
Year-end Jun	2018	2019*	2020	2021	2022E	2023E
FUM ($bn)	5.11	5.39	5.50	11.45	12.09	12.78
P&L (£m)						
Revenue	33.93	31.93	33.26	55.12	65.39	68.83
Expenses	21.40	21.43	21.66	31.55	36.02	37.28
Operating profit	12.53	10.50	11.60	23.57	29.37	31.54
Statutory PTP	12.79	11.40	9.41	22.25	29.39	31.56
Earnings	10.06	9.05	7.37	16.99	21.29	22.95
Statutory EPS (p)	39.5	34.9	30.3	39.4	43.4	46.7
Underlying EPS (p)	39.5	34.9	38.0	50.0	52.2	55.5
DPS (p)	27.0	40.5	30.0	33.0	36.0	39.0

Key metrics	2018	2019*	2020	2021	2022E	2023E
Growth						
FUM		5.5%	2.1%	108.1%	5.6%	5.7%
Revenue		-5.9%	4.2%	65.7%	18.6%	5.3%
Operating profit		-16.2%	10.4%	103.2%	24.6%	7.4%
Underlying EPS		-11.6%	8.9%	31.5%	4.4%	6.4%
DPS (excl. special div.)		50.0%	-25.9%	10.0%	9.1%	8.3%
Operating margins						
Net FUM fee margin	0.80%	0.76%	0.75%	0.75%	0.75%	0.74%
Operating margin	36.9%	32.9%	34.9%	42.8%	44.9%	45.8%
Tax rate	21.4%	20.6%	21.7%	23.6%	24.0%	24.0%
Dividend cover (x, excl. special div.)	1.5	0.9	1.0	1.2	1.2	1.2
Rolling 5-year cover (x, excl. special div.)	1.2	1.3	1.2	1.3	1.2	1.2
Rolling u/l 5-year cover (x, excl. special div.)			1.2	1.4	1.4	1.4

Underlying EPS sensitivity	2022E	2023E
No net new business		
EPS (p)	51.6	53.4
change	-1.2%	-3.8%
0% market growth (was 5% p.a.)		
EPS (p)	50.7	51.2
change	-2.7%	-7.9%

**2019 figures include a special dividend of 13.5p; Source: Company data, Hardman & Co Research*
£1=$1.38

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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: https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2031-EN-F1-1.PDF

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