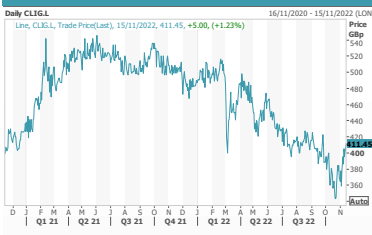




15 November 2022

## Financial Services



Source: Refinitiv

## Market data

EPIC/TKR	CLIG
Price (p)	405.0
12m high (p)	530.0
12m low (p)	343.5
Shares (m)	50.7
Mkt cap (£m)	205.3
EV (£m)	180.7
Country of listing	UK
Currency	GBP
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 (0)207 711 0771
	<a href="http://www.clig.com">www.clig.com</a>

## Key shareholders

George Karpus	31.5%
Hargreaves Lansdown	7.4%
Aberforth Partners	7.1%
Interactive Investor	5.7%
Barry Olliff	2.1%
Other directors & staff	9.8%

## Diary

31 Dec	Half-year end
30 Jun	Year-end

## Analyst

Brian Moretta +44 (0)203 693 7075  
bm@hardmanandco.com

## CITY OF LONDON INVESTMENT GROUP

## Solid profits in tough markets

In this note, we review City of London's annual results for 2022 and its trading update for 22'Q1. The headline full-year figures were announced in July's trading statement, and allowance needs to be made for the inclusion of Karpus for the full year. The weakness of markets in the second half did affect results, with net fee income up 11%, to £58.2m. City of London's underlying profit before tax rose 4%, to £27.9m, while underlying EPS (on City of London's basis) declined 9%, to 44.2p. Cash conversion, as usual, remained excellent, at 108% of underlying profit, while the cash balance remained very strong, at £22.7m, as well as £7.4m of seed investments.

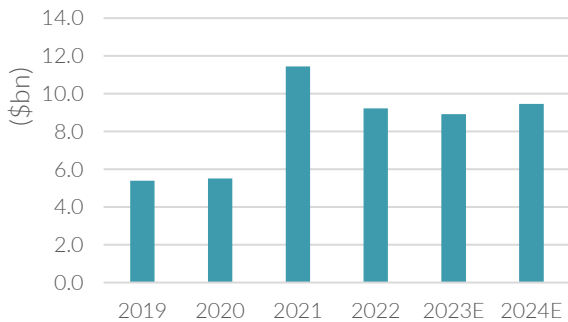
- ▶ **Q1:** Weak stock markets continued to dominate movements in FUM. With both emerging and developed markets declining significantly, FUM reduced by 8%, to \$8.51bn. For the monthly run-rate operating profit, exchange rate movements offset some of this, and the decline was from £2.8m to £2.7m.
- ▶ **Estimates:** We have made some minor adjustments to our expense assumptions, but also aligned our underlying estimate more closely with City of London's. However, the main changes come from the decline in FUM, with some currency offset.
- ▶ **Valuation:** Despite the recent good performance, the 2023E P/E of 14.6x remains at a discount to the peer group. The 2023E dividend yield of 8.9% 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 40% 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 maintained good long-term investment performance and operational control, City of London is well-placed to grow organically. We believe the valuation remains reasonable. After the EPS boost from the Karpus transaction, the prospects for future dividend increases may be more market-dependent.

## Financial summary and valuation

Year-end Jun (£m)	2019*	2020	2021	2022*	2023E	2024E
FUM (\$bn)	5.39	5.50	11.45	9.22	8.91	9.46
Revenue	31.93	33.26	55.12	61.29	57.11	59.33
Statutory PTP	11.40	9.41	22.25	23.17	19.06	20.28
Statutory EPS (p)	34.9	30.3	39.4	36.9	27.5	29.4
Underlying EPS (p)	34.9	38.0	50.0	44.2	33.8	35.7
DPS (p)	27.0	30.0	33.0	33.0	36.0	39.0
Special dividend (p)	13.5			13.5		
P/E (x)	11.5	13.3	10.2	10.9	14.6	13.7
Dividend yield	10.1%	7.5%	8.2%	11.6%	8.9%	9.7%

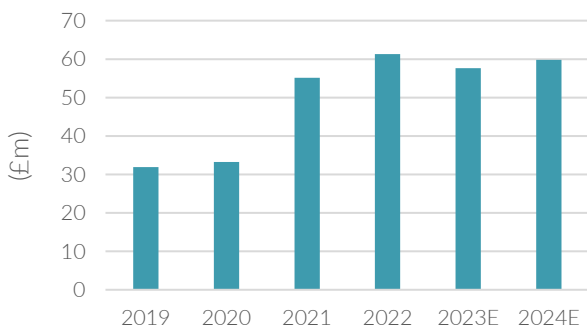
\*2019 and 2022 figures include a special dividend of 13.5p; Source: Hardman & Co Research

Funds under management (FUM)



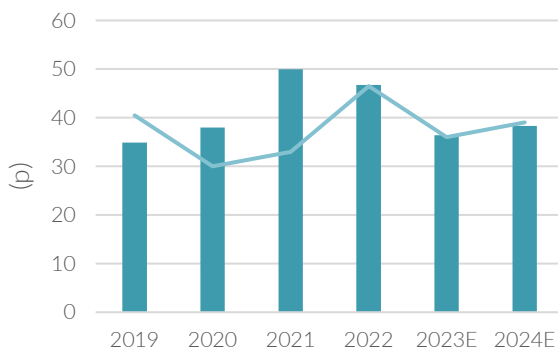
- ▶ Net inflows restored in 2022 after a weaker 2021
- ▶ Addition of Karpus in 2021 added \$3.58bn
- ▶ More normal market conditions should see a return to steadier growth
- ▶ Assumed steady net new business flows and equity market growth of 5% p.a.

Revenue



- ▶ Revenue linked strongly to FUM
- ▶ Ongoing slow decrease in revenue margins from new business
- ▶ Karpus's revenue margin higher, and probably more robust, than CLIM's
- ▶ 2021 and 2022 boosted by addition of Karpus (latter is first full year)

Underlying EPS (bar) and DPS (line)



- ▶ Market movements drive changes, but profitability supported historically by cost flexibility
- ▶ Exceptional transaction costs reduced statutory 2020 and 2021 EPS
- ▶ Special dividend of 13.5p in 2019 and 2022
- ▶ Dividend increased in 2020 and 2021 - future increases subject to market conditions

Source: Company data, Hardman & Co Research

# 1Q trading update commentary

## Funds

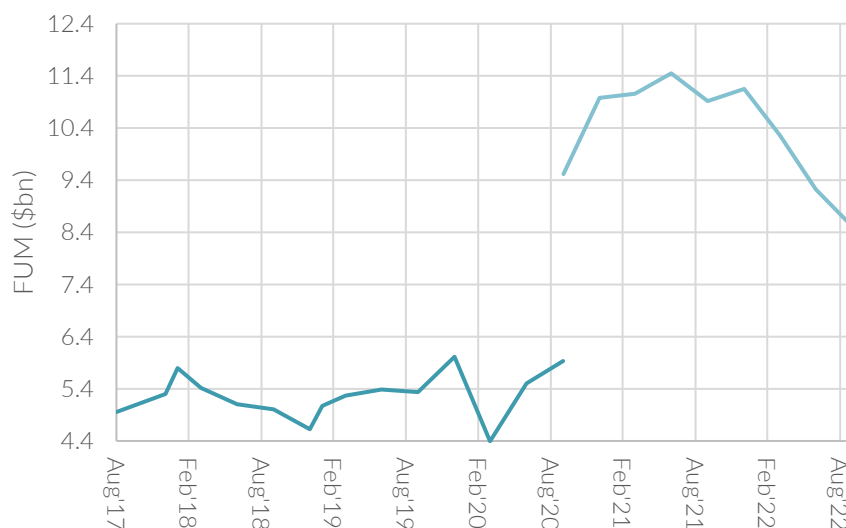
1Q funds under management (FUM) movements				
(\$m)	Sep'22	Jun'22	Net flows	Other movements
Emerging Markets	3,249	3,703	-31	-423
International	1,642	1,812	20	-190
Opportunistic Value	234	193	57	-16
Other	78	83		-5
<b>CLIM total</b>	<b>5,791</b>	<b>5,791</b>	<b>46</b>	<b>-634</b>
<b>KIM total</b>	<b>3,309</b>	<b>3,433</b>	<b>-6</b>	<b>-118</b>
<b>Total</b>	<b>8,512</b>	<b>9,224</b>	<b>40</b>	<b>-752</b>

Source: Hardman & Co Research

The strongest impact on City of London's FUM in 1Q'23 was stock market performance, which largely continued its bearish trends from the first half. The Emerging Market and International strategies were also slightly behind their benchmarks, as discounts in the underlying closed-end funds widened. Opportunistic Value outperformed due to positive allocation effects. Both of KIM's main strategies also beat their benchmarks.

Given the environment, net inflows of \$40m is a good result. The trends were similar to the past couple of years, as inflows came into the International and Opportunistic Value strategies, while Emerging Markets and KIM saw outflows.

## City of London's FUM progress since FY'18



Note: Jump at Sep'20 due to Karpus transaction; Source: Company data, Hardman & Co Research

## Operations

Revenue run rates of 76bps for KIM and 71bps for CLIM are unchanged. Fixed costs ticked up to £1.8m per month, from £1.7m at the year-end, due mostly to a 10% strengthening of in the US Dollar versus Sterling. This has benefited revenues, which are almost entirely in USD, and the monthly run-rate for operating profit, before profit share and amortisation, has reduced only slightly, from £2.8m to £2.7m.

# Annual results commentary

## Funds

Funds under management (FUM)				
(\$m)	Jun'22	Jun'21	Net flows	Other movements
Emerging Markets	3,703	5,393	-316	-1,374
International	1,812	1,880	453	-521
Opportunistic Value	193	231	1	-39
Other	83	26	74	-17
<b>CLIM total</b>	<b>5,791</b>	<b>7,530</b>	<b>212</b>	<b>-1,951</b>
Karpus retail	2,419	2,804	-106	-279
Karpus institutional	1,014	1,115	-3	-98
<b>KIM total</b>	<b>3,433</b>	<b>3,919</b>	<b>-109</b>	<b>-377</b>
<b>Total</b>	<b>9,224</b>	<b>11,449</b>	<b>103</b>	<b>-2,308</b>

Source: Hardman & Co Research

In a year that had very challenging markets, City of London did well to get net inflows. The star was the International strategy, which brought in a net \$453m. It is now 19% of the group's total.

The Emerging Markets strategy continued to experience rebalancing, leading to net outflows. Sentiment was against it, with the Russia/Ukraine conflict and China/Taiwan tension causing aversion among asset allocators (although we note emerging markets outperformed developed markets ex US). Nevertheless, City of London saw a slowing in the second half, as the sector clawed back some relative performance – so maybe there is cause for optimism.

Within the other areas, Opportunistic Value was the right side of net neutral for inflows, while Frontier saw further withdrawals of \$5m. Within Other, the main inflows came from special situations.

Karpus saw net outflows over the year from both the retail and institutional lines. In the former, market volatility weighed in the second half and quickened outflows. The latter did see net inflows of \$16m in the second half. The Karpus Conservative Balanced strategy had a good relative year and, over five years, is among the best-performing in its category. City of London management is aware that, with this strong performance, Karpus should be performing better in attracting assets, and will look to address this in the near future.

Net, the market movements in KIM were smaller than for CLIM, with the bond exposure in the latter bringing diversification benefits. City of London notes that, for the first time in over two decades, all the eight main asset classes to which it has exposure saw negative performance over the year. Hopefully, it will be at least as long before we see it again.

Relative performance within most, but not all, of the CLIM strategies was weak during the year. For some time, the Emerging Markets strategy has had a slight overweight to Russian equities. These being written down to zero provided a headwind. The Emerging Markets strategy underperformed by 2.4% for the year.

Weaker NAV performance from underlying closed-end fund managers was a general feature, with International suffering from an underlying bias towards small, high-growth stocks. It underperformed by 4.2% in the year. Discounts also widened over the period. The newer REIT strategies had good relative performance, with the Emerging Markets strategy also outperforming developed markets.

Despite the short-term underperformance, CLIM's strategies retain strong long-term performance. City of London notes that over 95% of its assets are ahead of both the benchmark and peer group over five years. Both Emerging Market and International strategy composites are second quartile relative to their peers, although Opportunistic Value has slipped to third quartile.

Looking forward, City of London has seeded a new Global investment strategy. With the International strategy not including the US, which has outperformed both developed ex US and emerging markets over the past decade by a wide margin, this should bring further opportunities. It notes the strong market for new issuances of closed-end funds over the past 12 months (over \$30bn). It has also seeded a new SPAC strategy (Special Purpose Acquisition Company). In addition, it is looking increasingly at ESG factors – something institutional clients are requiring more and more.

## Finances

With the headline profitability figures having been provided in July's trading statement, the main interest in the accounts is in the details. It should be noted that this is the first full financial year with Karpus, and the 2021 figures included it for only three quarters. This clearly distorts comparisons somewhat.

The strengthening of the US Dollar over the period has also had an effect. Over the year, it has moved from \$1.39/£ to \$1.21/£. With much of this move happening towards the end of the year, the average moved just a couple of percent, from \$1.35 to \$1.33. This has a small P&L effect in FY'22, but has a more dramatic effect on the balance sheet and our forecasts.

Gross fee income rose 11%, to £61.29. Commission increased from £1.1m, to £1.6m, due primarily to a full year of Karpus, while custody fees fell slightly. Net fees also rose, by 11%, to £58.2m.

Overheads increased 18%, to £19.7m, with Karpus again the main source of the increase. With the market weakness reducing fees in the second half, the cost:income ratio increased slightly, from 32% in 2021 to 34% in 2022. Note that, with the acquisition of Karpus, a greater proportion of expenses are now in US Dollars. This reduces the mismatch with revenues, which are almost entirely dollar-based, which will slightly reduce the P&L effect of currency movements.

The market weakness affected the seed investments, which, during the year, were primarily the holdings in the new REIT strategies. Losses of £0.66m were recorded.

The best YoY comparison for profitability is using the EPS figures. Basic EPS declined 6%, to 36.9p, while our underlying figure (slightly different from City of London's version<sup>1</sup>) declined by a similar amount, to 46.7p.

Cash conversion, as usual, was excellent, at 108% of underlying profit.

### *Balance sheet*

On the balance sheet, there are a couple of items worth noting. The cash position remains very strong, at £22.7m as of 30 June 2022. This compares with £25.5m a year earlier, with the £2.8m decline much less than the cost of the special dividend (£6.6m).

Intangibles remain the largest single item on the balance sheet. These increased to £110m, due primarily to exchange rate effects.

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<sup>1</sup> The main difference is that we exclude investment gains or losses from the seed investments.

The seed investments increased over the year, from £4.37m to £7.43m. This is due primarily to additional seed investments in the new Global and SPAC strategies, each of which got \$2.5m of investment, or £3.8m in total. Offsetting this were the investment losses.

## Dividend

The proposed final dividend for the year is 22p. While this is unchanged on 2021, the special dividend means that the payout for the year will be 46.5p, compared with 33p in 2021. This takes the five-year rolling cover, excluding special dividends, to 1.22x, which is almost exactly in line with the 1.2x target.

## Estimate updates

Following the detail in the accounts, we have made some minor adjustments to our expense assumptions. We have also aligned our underlying estimate more closely to City of London's. However, the main changes come from the decline in FUM, offset somewhat by moving the exchange rate for the US Dollar to \$1.14/£. This has led to upgrades, with our 2023E and 2024E underlying EPS both increasing by 1%, to 33.8p and 35.7p, respectively.

We note that we have kept in place our dividend forecasts, with 3p rises in each of the next two years. While whether markets recover or not will influence matters, we note that the City of London board does lean towards being conservative. It may well prefer to continue with the distribution pattern of 2022, with a flat ongoing dividend and further cash distributions through special dividends. City of London has also bought back shares in the past. We think our forecasts represent a fair estimate, on average.

# Financials

Summary financials						
Year-end Jun	2019*	2020	2021	2022*	2023E	2024E
FUM (\$bn)	5.39	5.50	11.45	9.22	8.91	9.46
<b>P&amp;L (£m)</b>						
Revenue	31.93	33.26	55.12	61.29	57.11	59.33
Expenses	21.43	21.66	31.55	37.34	37.93	38.92
Operating profit	10.50	11.60	23.57	23.95	19.18	20.41
Statutory PTP	11.40	9.41	22.25	23.17	19.06	20.28
Earnings	9.05	7.37	16.99	18.09	13.51	14.44
Statutory EPS (p)	34.9	30.3	39.4	36.9	27.5	29.4
Underlying EPS (p)	34.9	38.0	50.0	44.2	33.8	35.7
Total DPS (p)	40.5	30.0	33.0	46.5	36.0	39.0
Key metrics						
	2019*	2020	2021	2022*	2023E	2024E
<b>Growth</b>						
FUM		2.1%	108.1%	-19.4%	-3.4%	6.2%
Revenue		4.2%	65.7%	11.2%	-6.8%	3.9%
Operating profit		10.4%	103.2%	1.6%	-19.9%	6.4%
Underlying EPS		8.9%	31.5%	-8.1%	-23.6%	5.6%
DPS (excl. special div.)		11.1%	10.0%	0.0%	9.1%	8.3%
<b>Operating margins</b>						
Net FUM fee margin	0.76%	0.75%	0.75%	0.73%	0.73%	0.72%
Operating margin	32.9%	34.9%	42.8%	39.1%	33.6%	34.4%
Tax rate	20.6%	21.7%	23.6%	24.0%	24.0%	24.0%
Dividend cover (x, excl. special div.)	0.9	1.0	1.2	0.8	0.8	0.8
Rolling 5-year cover (x, excl. special div.)	1.3	1.2	1.3	1.2	1.1	1.0
Rolling u/l 5-year cover (x, excl. special div.)		1.2	1.4	1.3	1.2	1.2
Underlying EPS sensitivity						
				2022	2023E	2024E
<b>No net new business</b>						
EPS (p)					33.6	34.7
change					-0.8%	-2.8%
<b>0% market growth (was 5% p.a.)</b>						
EPS (p)					33.2	32.7
change					-1.9%	-8.4%

\*2019 and 2022 figures include a special dividend of 13.5p; Source: Company data, Hardman & Co Research  
£1=\$1.14

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