

Source: Eikon Thomson Reuters

**Market data**

EPIC/TKR	CLIG
Price (p)	371.5
12m High (p)	389.0
12m Low (p)	285.0
Shares (m)	26.9
Mkt Cap (£m)	100.0
EV (£m)	89.8
Market	LSE

**Description**

City of London is an investment manager specializing in using closed end funds to invest in emerging markets.

**Company information**

CEO	Barry Olliff
CFO	Tracy Rodrigues
Chairman	David Cardale

[www.citlon.com](http://www.citlon.com)**Key shareholders**

Directors & staff	20.3%
Blackrock	9.2%
Hargreave Hale	4.9%
Slater Investments	3.3%
Polar Capital	3.0%

**Next event**

10 Oct 2016	1 <sup>st</sup> Quarter update
13 Oct 2016	Ex-div date
17 Oct 2016	AGM
31 Oct 2016	Final dividend payment

**Analysts**

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**City of London Investment Group****Exchange rate moves give big boost**

The full year results from City of London showed no surprises following the trading statement in July. Weaker markets were the dominant feature, with lower funds under management compared to FY2015 leading to a fall in revenues and profits in FY2016. Revenues declined 4% over the previous financial year to £24.4m and operational gearing led to a larger 11% fall in pre-tax profits to £8.0m. As usual, cash conversion was excellent with net operating cashflow at 96% of profits.

- ▶ **Market improvements:** The final quarter of FY2016 saw a recovery in Emerging Markets which has continued since the financial year end. FUM have grown to \$4.4bn, a 10% improvement since the year end.
- ▶ **Dividend:** The dividend for the full year has been kept unchanged. It was marginally uncovered for the year as a whole at 0.97x, but was covered on a run rate basis in the final quarter. With cash balances back over £10m there is more than ample reserve to cover the small shortfall.
- ▶ **Valuation:** After the recent upgrades the prospective P/E of 11.4 times is now at a discount to the peer group. The yield of 6.5% is very attractive and should at the very least provide support for the shares in the current volatile markets. At current market levels we'd expect dividend cover to be restored in 2017.
- ▶ **Risks:** To date, City of London has not experienced the sort of outflows that some other emerging market fund managers have, aided by its good performance and strong client servicing. Further EM volatility may increase the risk of such outflows however.
- ▶ **Investment summary:** City of London has continued to show robust performance in challenging market conditions. The valuation remains reasonable. At current FUM and exchange rates, dividend cover will be restored in FY2017 adding to investors comfort.

**Financial summary and valuation**

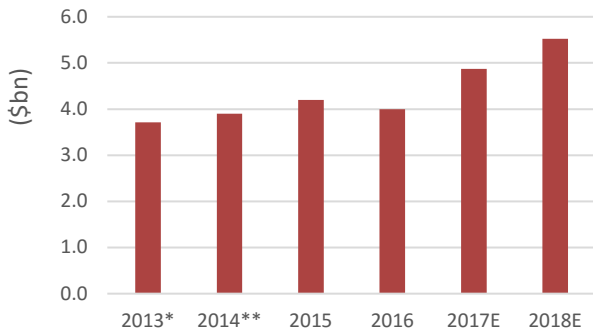
Year end Jun (£m)	2013*	2014**	2015	2016	2017E	2018E
FUM (\$bn)	3.71	3.90	4.20	4.00	4.87	5.53
Revenue (£m)	29.36	24.22	25.36	24.41	29.37	33.11
Statutory PTP	6.27	5.20	6.61	5.85	8.11	9.74
Statutory EPS (p)	24.9	20.7	26.4	23.3	32.6	39.1
Dividend (p)	24.0	24.0	24.0	24.0	24.0	24.0
P/E (x)	14.9	17.9	14.1	15.9	11.4	9.5
Yield	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%

Source: Hardman &amp; Co Research May year ends. 2014 had 13 months in financial year

## Table of Contents

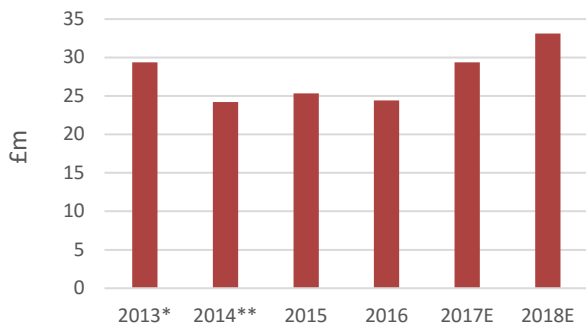
Review of Results .....	4
Looking Forward.....	4
Financials.....	6
Disclaimer .....	7
Hardman Team.....	8

### Funds under Management



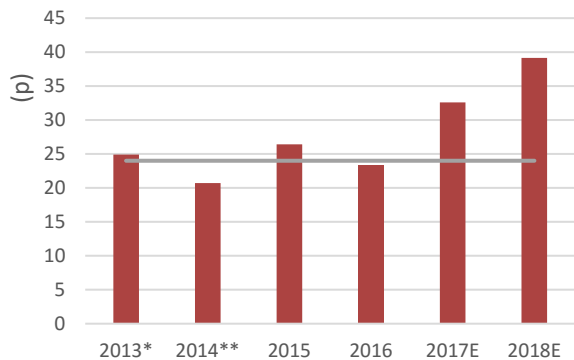
- ▶ After a difficult period, there have been net inflows since 2014
- ▶ Market weakness in 2016 being offset by new business flows
- ▶ Assumed steady new business flows and market growth of 5% pa in 2017 and 2018

### Revenues



- ▶ Revenues strongly linked to FUM
- ▶ Forecast a slight decrease in revenue margins from new business
- ▶ Some currency effects, particularly from strong US Dollar from 2015 to 2017

### eps (bar) and dividend (line)



- ▶ Profitability has been maintained by cost flexibility
- ▶ Dividend shortfall in 2014 and 2016 covered from reserves
- ▶ If market remains at current levels then we'd expect dividend to be covered in 2017

## Review of Results

### Income

As is normal for an asset manager, the main drivers of revenue this year have been the movements in the market and new business flows. The overall position for City of London can be best described as good under the circumstances. Average Funds under Management (FUM) were down 7% compared to the previous year. From year end to year end they fell 5%. This compares favourably to a fall in the MSCI Emerging Markets of 12%. With their core strategy outperforming by 2.4% over the year, the balance derived from new business.

New business flows		
	Emerging Markets	Other products
Gross inflows	\$374m	\$112m
Outflows	\$259m	\$92m
Net Inflows	\$115m	\$10m

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

As the table above shows, the net inflows were a somewhat behind our expectations, particularly in the diversification area. The latter nevertheless increased to 9.1% of assets from 8.5%. However, our forecast decline in the revenue margin as new business comes in has not materialised and this has remained at 86bps.

### Expenses

As usual, City of London's cost control was excellent, though camouflaged somewhat by movements in exchange rates. Overall expenses increased by 6% in sterling terms. With only 40% of its costs in sterling, the strength of the US dollar is largely responsible for this rise. However, with almost all of its revenues being in US dollars the movements have been of significant net benefit to City of London.

It is worth noting that despite an 18% move in the exchange rate, the value of the outstanding commission payments in dollar terms has remained unchanged. These are linked to the market value of the appropriate assets and their retention. While recent market movements have increased their value in the short term, it is worth noting that there will effectively be a £1.4m boost to City of London's PBT over the next 4 years.

### Cash

Net operating cashflow corresponded closely to earnings again at £5.6m. With no other significant changes, the cash and equivalents balance was £10.1m at the year end. This keeps the balance sheet in an exceptionally strong position.

## Looking Forward

There is little news on new business flows. Last year's addition of the office in Settle to service clients should be a positive in time and the CEO's statement says the company continues to have a robust pipeline.

There will be a change to the staff bonus arrangements. Shares in the ESOP do not receive the dividend, which is a substantial part of the return for shareholders, which has been a slight disadvantage to staff. The bonus pool has for some time been at 30% of PBT (pre bonuses). It is proposed to raise that to 35% for four years, with the

additional 5% offered as part of a new employee incentive scheme, so long as the employees match fund.

Investors should note that the dramatic moves in the exchange rates after the Brexit vote will have further impact on City of London's figures in the 2017 accounts. With the move happening towards the end of June there will continue to be strong beneficial effect on the revenue, expense and cashflow figures. The balance sheet, of course, already reflects the movements.

## Forecasts

We have only made two adjustments to our forecasts. We have adjusted the profit share percentage to reflect the changes described above. We have also adjusted for the increase in FUM as of the reporting date to \$4.4bn. The latter has led to net upgrades.

It is clear that recent equity and exchange rate market movements have been favourable for City of London. We are cautious in extrapolating those trends and our forecasts essentially reflect a stable projection, though we do show some sensitivity figures to allow investors to make their adjustments as future moves occur. City of London have produced a matrix of profitability based on current expenses and the stated exchange rate and FUM assumptions.

FX/Post-Tax Profit Matrix					
FUM \$bn	3.0	3.5	4.0	4.5	5.0
US\$/£	Post-tax (£m)				
1.20	4.8	6.7	8.5	10.4	12.2
1.25	4.5	6.3	8.1	9.8	11.6
1.30	4.2	5.9	7.6	9.4	11.1
1.35	4.0	5.6	7.3	8.9	10.6
1.40	3.7	5.3	6.9	8.5	10.1

*Source City of London, Hardman & Co Research  
It should be note that these are not forecasts.*

The cost of the dividend is slightly under £6m, and we have highlighted the cells where it would be uncovered. Based on the above table, run rate profitability is currently in the £8.5-9.0m range. We cannot rule out market movements that would lead to an uncovering of the dividend, there is clearly a substantial buffer before that happens.

If market conditions remain as they are for the next twelve months then there may be the possibility of a dividend increase. We are not forecasting that as yet, and if there is we believe it would unlikely to be more than 1p. But in the absence of adverse changes it is something investors will start to think about.

## Financials

### Summary Financials

	2013*	2014**	June Year End 2015	2016	2017E	2018E
FUM (\$bn)	3.71	3.90	4.20	4.00	4.61	5.25
<b>P&amp;L (£m)</b>						
Revenue	29.36	24.22	25.36	24.41	29.37	33.11
Expenses	21.01	17.22	16.63	16.66	18.28	19.79
Operating Profit	8.36	7.00	8.73	7.76	11.08	13.32
PBT	8.86	7.24	8.93	7.97	11.10	13.34
Earnings	6.27	5.20	6.61	5.85	8.11	9.74
eps (p)	24.9	20.7	26.4	23.3	32.6	39.1
dps (p)	24.0	24.0	24.0	24.0	24.0	24.0

### Key Metrics

	2013*	2014**	2015	2016	2017E	2018E
<b>Growth (%)</b>						
FUM		5.0	7.7	-4.8	21.8	13.5
Revenue		-17.5	4.7	-3.7	20.3	12.8
Operating Profit		-16.3	24.7	-11.1	42.9	20.2
EPS		-16.9	27.5	-11.7	39.8	20.1
DPS		0.0	0.0	0.0	0.0	0.0
<b>Operating Margins (%)</b>						
Net FUM fee margin	0.92	0.88	0.86	0.86	0.85	0.84
Operating Margin	28.5	28.9	34.4	31.8	37.7	40.2
Tax Rate	29.3	28.2	26.0	27.0	27.0	27.0
Dividend cover	1.0	0.9	1.1	1.0	1.4	1.6

### eps Sensitivity

	2017E	2018E
<b>No net new business</b>		
eps (p)	32.0	34.8
% change	-1.7	-11.0
<b>0% market growth (was 5% pa from June 2016)</b>		
eps (p)	32.1	36.0
% change	-1.6	-8.1

Source: City of London Investment Group, Hardman & Co Research

\* May year end

\*\* 13-month year as year end change.

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*(Disclaimer Version 2 – Effective from August 2015)*

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