CITY OF LONDON INVESTMENT GROUP

Careful management allows special dividend

City of London has announced its results for 1H of FY'19. With the headline revenue and profitability figures having been given in January's trading statement, the main headline is the announcement of a special dividend of 13.5p. This will be paid at the same time as the interim dividend and will cost £3.4m. Given the company had £18.7m of cash at 31 December, this will still leave it with a more than comfortable capital position. Although City of London has increased its dividend over the last couple of years, it has still been accumulating additional cash, so this return of some surplus will be welcomed.

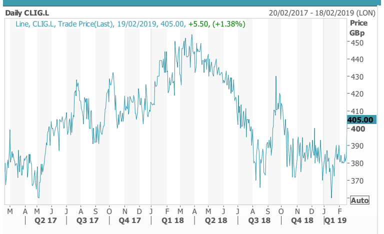
- **Operations:** City of London has indicated that, with the pressure on the market last year, it will look to reduce its expenses. In particular, the target is to get the monthly fixed costs down to £1.0m from £1.1m, with this likely to take effect in FY2021. Further market weakness may lead to more reductions.
- **New product:** Having recruited a team to manage a new REIT product, City of London has launched two funds in this area – International and Emerging Markets. These have been seeded with $5m of capital by City of London to allow them to develop the track record required to attract external assets.
- **Valuation:** The prospective P/E of 11.8x is at a significant discount to the peer group. The historical yield of 6.8% 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, although increased 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. FY'17 and FY'18 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 Jun (£m)	2016	2017	2018	2019E*	2020E	2021E
FUM ($bn)	4.00	4.66	5.11	5.17	5.56	5.97
Revenue	24.41	31.29	33.93	31.00	33.03	35.05
Statutory PTP	7.97	11.59	12.79	10.61	11.79	12.79
Statutory EPS (p)	23.3	36.9	39.5	33.8	37.5	40.7
DPS (p)	24.0	25.0	27.0	40.5	27.0	27.0
P/E (x)	17.1	10.8	10.1	11.8	10.7	9.8
Dividend yield	6.0%	6.3%	6.8%	10.1%	6.8%	6.8%

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

Financial Services



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**CLIG**
Price (p)	**399.5**
12m High (p)	454.0
12m Low (p)	360.0
Shares (m)	26.9
Mkt Cap (£m)	107.5
EV (£m)	88.8
Market	LSE

Description

City of London is an investment manager specialising in using closed-end funds to invest in emerging and other markets.

Company information

CEO	Barry Olliff
CFO	Tracy Rodrigues
Chairman	Barry Aling

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Key shareholders

Directors & staff	16.7%
Blackrock	10.0%
Cannacord Genuity	8.0%
Eschaton Opportunities Fund Management	4.8%
Polar Capital	4.1%

Diary

7 Mar	Interim ex-dividend date
16 Apr	3Q FUM announcement
16 Jul	Pre-close trading statement
16 Sep	Preliminary results statement

Analyst

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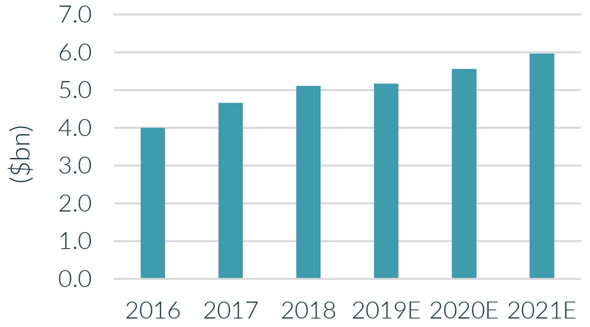
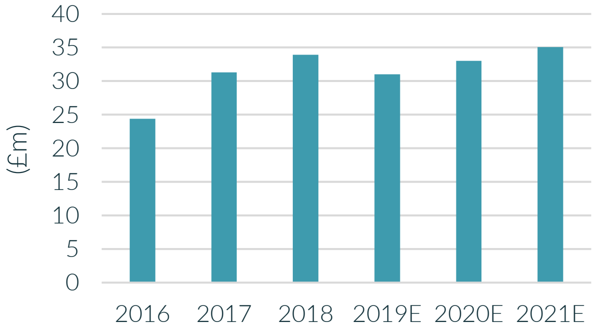
Funds under management



- Net inflows since 2014
- Market weakness in 2016 substantially offset by new business flows
- Market weakness from late 2018 impacting 2019
- Assumed steady new business flows and market growth of 5% p.a.

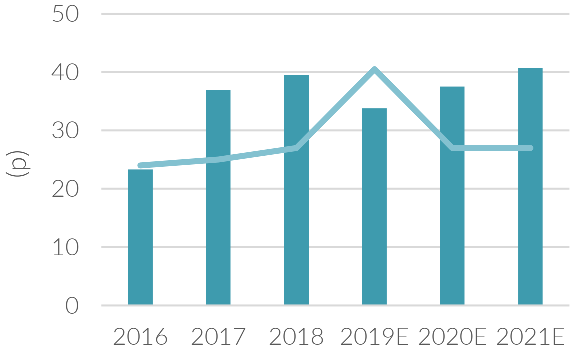
Revenue



- Revenue strongly linked to FUM
- Ongoing decrease in revenue margins from new business
- Some currency effects, particularly from a strong US dollar between 2015 and 2017

  2019E growth affected by reduction of revenue margins, as well as weak markets

EPS (bar) and DPS (line)



- Profitability historically maintained by cost flexibility
- Currency movements led to step change in 2017 EPS
- Dividend shortfall in 2016 covered from reserves
- Special dividend of 13.5p in 2019
- Dividend increased in 2017 and 2018 but, with recent market falls, now forecasting a flat dividend excluding the special

Source: Company data, Hardman & Co Research

Commentary

The headlines in the results were as indicated in January's trading statement. There are some details that are perhaps worth highlighting:

- Cash conversion, as usual, was excellent at 115% of earnings, although this was boosted by a £0.54m improvement in working capital.

- City of London's KPI has historically been to aim for its shares to outperform its peers on a total return basis (see page 6 of this note). This is being changed to a twin target of outperforming the M1EF index (the MSCI Emerging Markets total return) and maintaining a compound return across a five-year cycle of an annualised 7.5% to 12.5% p.a.

- The size-weighted average discount for emerging market funds has widened further, and is now just under 17%, a decline of over 200bps from a year ago. This has been a significant part of the challenges to City of London's EM strategy performance.

- REITs are potentially a positive addition to the range of strategies, with much in common with the existing CEF strategies. The company notes both the large supply of developed market REITs and the rapid growth, from a smaller level, of EM REITs. While adding a new strategy is welcome, the other diversifying strategies needed a three-year track record to start getting significant market traction, and it seems likely that the new funds will need the same amount of time.

While the recent recovery in markets may take some of the pressure off City of London in terms of managing its expenses, we note that consistent cost control over time has been a strong feature of the company's strategy. While it remains to be seen whether the recent market recovery will be sustained, we expect expenses to continue to be kept under a tight rein, regardless.

Management changes

As previously indicated, Tom Griffith will become CEO of City of London with effect from 1 March, with Mark Dwyer becoming the Group CIO, with Barry Olliff stepping back ahead of his retirement as of the end of the year. Mr Olliff will remain on the City of London Board until then.

Estimate updates

With the headline figures having been announced in January, there are only two assumption changes that have been made to the Hardman & Co earnings estimates. Given the indication of cost cuts to come, our expense estimates have been trimmed. A larger effect has come from the bounce-back in markets, with City of London's January- end FUM up to $5.07m.

Both will have had a positive effect on earnings. There has also been a small, beneficial currency adjustment. The net effect is to raise 2019E EPS from 31.8p to 33.8p, an increase of 6.3%, and 2020E EPS from 31.8p to 37.5p, up 17.9%.

As usual with the interim results, we are introducing a 2021 forecast. Our core assumptions for net inflows and market growth are the same as for the other years. Our forecast is for EPS of 40.7p.

Our ongoing dividend forecasts have been left at a flat dividend of 27p (excluding the effect of the special dividend). Should results work out as per our forecasts, then there may be scope to increase the dividend before 2021, in line with the rolling five-year target of 1.2x cover. However, with market volatility currently quite strong in both directions, it is difficult to make these calls with confidence.

Further special dividends are equally hard to forecast. They remain a possibility in the future; we note that City of London retains a strong cash position and, currently, appears to have no strong uses for this, other than returning it to shareholders. This is likely to grow – for example, under CLIG's own Dividend Cover Template, the cover would generate an additional £2.5m over FY2020 and FY2021. On our forecasts, it would take to FY2021 to recover the cost of the special dividend just declared.

Financials

Summary financials						
Year-end Jun	**2016**	**2017**	**2018**	**2019E***	**2020E**	**2021E**
FUM ($bn)	4.00	4.66	5.11	5.17	5.56	5.97
P&L (£m)						
Revenue	24.41	31.29	33.93	31.00	33.03	35.05
Expenses	16.66	19.79	21.40	20.40	21.25	22.28
Operating profit	7.76	11.51	12.53	10.60	11.77	12.77
PBT	7.97	11.59	12.79	10.61	11.79	12.79
Earnings	5.85	9.14	10.06	8.49	9.43	10.23
EPS (p)	23.3	36.9	39.5	33.8	37.5	40.7
DPS (p)	24.0	25.0	27.0	40.5	27.0	27.0

Key metrics						
	2016	**2017**	**2018**	**2019E***	**2020E**	**2021E**
Growth (%)						
FUM	-4.8	16.5	9.6	1.2	7.6	7.4
Revenue	-3.7	28.2	8.4	-8.6	6.5	6.1
Operating profit	-11.1	48.4	8.8	-15.4	11.1	8.5
EPS	-11.7	58.4	7.0	-14.5	11.1	8.5
DPS	0.0	4.2	8.0	50.0	-33.3	0.0
Operating margins (%)						
Net FUM fee margin	0.86	0.84	0.80	0.77	0.76	0.76
Operating margin	31.8	36.8	36.9	34.2	35.6	36.4
Tax rate	26.5	21.1	21.4	20.0	20.0	20.0
Dividend cover (x)	1.0	1.5	1.5	0.8	1.4	1.5

EPS sensitivity			
	2019E	**2020E**	**2021E**
No net new business			
EPS (p)	33.8	36.7	38.7
change	-0.1%	-2.1%	-4.8%
0% market growth (was 5% p.a.)			
EPS (p)	33.7	35.1	35.0
change	-0.3%	-6.3%	-14.1%

Source: City of London Investment Group, Hardman & Co Research
£1=$1.29
**2019 figures include a special dividend of 13.5p.*

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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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