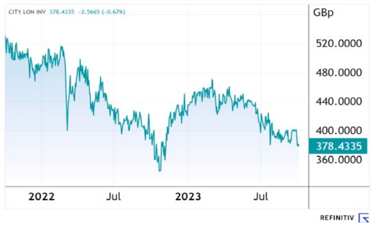
3 October 2023

Financial Services



Source: Refinitiv

Market data

EPIC/TKR	**CLIG**
Price (p)	**381.0**
12m high (p)	470.0
12m low (p)	343.5
Shares (m)	50.7
Mkt cap (£m)	193.1
EV (£m)	170.6
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
Chair	Barry Aling

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www.clig.com

Key shareholders

George Karpus	31.5%
Hargreaves Lansdown	7.6%
Aberforth Partners	7.1%
Interactive Investor	6.0%
AJ Bell	2.8%
Other directors & staff	10.0%

Diary

13 Oct	1Q FUM announcement
23 Oct	AGM
31 Dec	Half-year end

Analyst

Brian Moretta bm@hardmanandco.com

CITY OF LONDON INVESTMENT GROUP

Performance pays dividends

City of London has announced its final results for FY'23. The headline figures were in line with those announced in the July trading statement. Weaker markets weighed on profitability, offset by outperformance across the majority of assets. A stronger US dollar also generally supported fee income. The lower average FUM led to a 6% reduction in net fee income to £54.6m. Costs were adversely affected by exchange rates and some adjustments for staff changes. This led to underlying EPS declining from 44.2p to 36.5p, a 17% reduction. The final dividend, as previously indicated, is 22p, bringing the full-year figure to 33p.

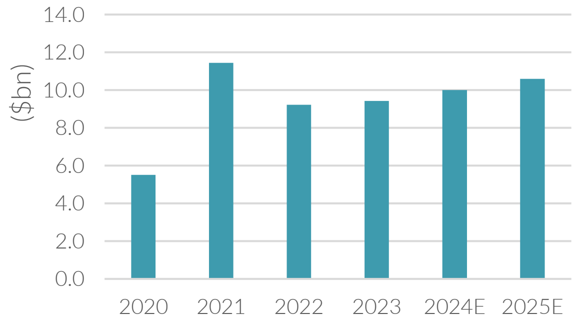
- **Funds:** City of London experienced net outflows over the year, although CLIM's Opportunistic Value and KIM institutional strategies saw net inflows. Performance was generally good, with Emerging Markets, Opportunistic Value and several KIM strategies outperforming, despite widening discounts in closed-end funds.
- **Estimates:** We made mostly minor adjustments to our estimates. Exchange rate movements led to a 6% increase in our 2024 and 2025 EPS estimates, to 36.1p and 38.1p respectively. With the change in reporting currency to dollars, we also introduce dollar forecasts of 44.4¢ for 2024 and 46.9¢ in 2025.
- **Valuation:** After the recent performance, the 2024E P/E of 13.2x is roughly in line with that of the peer group. The 2024E dividend yield of 8.7% 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 38% 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. Now that the Karpus transaction has settled down, the prospects for future dividend increases may be more dependent on markets and the ability to attract new business.

Financial summary and valuation

Year-end Jun (£m)	2020	2021	2022*	2023	2024E	2025E
FUM ($bn)	5.50	11.45	9.22	9.42	10.00	10.59
Revenue	33.26	55.12	61.29	57.33	56.50	59.36
Statutory PTP	9.41	22.25	23.17	18.60	18.78	20.09
Statutory EPS (p)	30.3	39.4	36.9	30.2	29.0	31.0
Underlying EPS (p)	38.0	48.1	44.2	36.5	36.1	38.1
DPS (p)	30.0	33.0	33.0	33.0	33.0	33.0
Special dividend (p)			13.5			
P/E (x)	12.6	9.7	10.3	12.6	13.2	12.3
Dividend yield	7.9%	8.7%	12.2%	8.7%	8.7%	8.7%

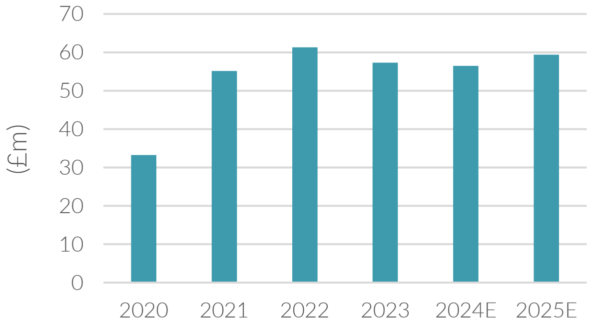
*2022 figures include a special dividend of 13.5p; Source: Hardman & Co Research

Funds under management (FUM)



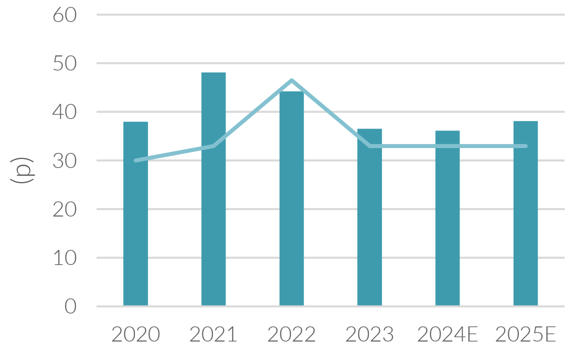
- Net outflows in 2023, after positive 2022
- Addition of Karpus in 2021 added $3.58bn
- More normal market conditions should see a return to steadier growth
- Assumed steady net new business flows and equity market growth of 5% p.a.

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 was first full year)

Underlying EPS (bar) and DPS (line)



- Market movements drive changes, but profitability supported historically by cost flexibility
- Volatile markets weighed on 2022 and 2023 results
- Special dividend of 13.5p in 2022
- Ordinary dividend flat since 2021

Source: Company data, Hardman & Co Research

Commentary

As usual, the main figures of the annual results are in line with those announced in July's update. In this report we focus on the additional detail.

Funds

Funds under management (FUM) movements during year				
($m)	Jun'23	Jun'22	Net flows	Other movements
Emerging Markets	3,580	3,703	(206)	83
International	1,983	1,812	(51)	222
Opportunistic Value	244	193	35	16
Frontier	9	9	0	0
REIT/other	88	74	(6)	20
CLIM total	**5,904**	**5,973**	**(228)**	**341**
KIM retail	2,441	2,419	(141)	164
KIM institutional	1,079	1,014	13	52
KIM total	**3,520**	**3,494**	**(129)**	**216**
Total	**9,424**	**9,224**	**(357)**	**557**

Source: Hardman & Co Research

Over FY'23, FUM grew by 2% from $9.22bn to $9.42bn. In aggregate, market movements and, to a lesser extent, relative performance were supportive offset by net outflows, although this pattern was not true for all strategies.

Following a weak 2022, markets bounced back in 2H'23 with all the benchmarks showing positive returns. Developed markets were much stronger than emerging markets with the MSCI World ex US index up 18.0% and the S&P500 increasing by 19.9% over the year. Emerging markets managed a weaker 2.1%. While the bond benchmarks were positive in H2, only municipal bonds managed a positive return for the full year.

City of London notes that emerging markets have consistently underperformed developed markets for over a decade. Recently, China concerns have weighed heavily and there is no sign of these alleviating in the near term. Nevertheless, City of London believes the strong US dollar makes emerging markets a good opportunity for those willing to be patient. With good long-term performance, City of London is well placed to capture opportunity, but it may take longer than it would like.

Rising interest rates have provided an additional challenge for fund flows. With US short-term risk-free rates exceeding 5%, fixed income deposits are much more attractive than they were 12 months ago, especially on a risk-adjusted basis.

Performance

City of London's main strategies mostly performed well during the year, albeit by small amounts. Within CLIM, the main reasons were as follows:

- Emerging Markets: outperformed by 0.1% (net of fees) with strong NAV performance in the first half, offset by widening discounts.
- International: underperformed by 0.7% with NAVs underperforming and widening discounts offset by good country allocation.
- Opportunistic Value: outperformed by 2.1%.

The smaller Frontier strategy underperformed with weak country allocation, while both the new REIT strategies outperformed due to good stock selection. Over five years, the three main strategies are comfortably outperforming their benchmarks and are around the medians of their peers. The newer REIT strategies have also outperformed consistently: while it is still too early to actively market them, it does bode well for when that is possible in the next year or two.

At KIM, the fixed income, conservative balance and SPAC strategies outperformed, while equity and growth balanced underperformed their benchmarks.

A consistent feature across all strategies has been the widening of CEF discounts. Across many segments, these are the widest they have been for several years. Given this drag, City of London's performance is all the more credible. It also suggests potential performance that could be realised if discounts normalise. However, we are aware that City of London and Hardman & Co have both made that argument for emerging markets for several years, during which discounts have widened further. Nevertheless, it should give investors more comfort than if discounts were narrower.

As noted below under "Finances", City of London has recruited to enhance business development for KIM. This took place in 2H'23, so it is too early for City of London to see the benefit in its inflows. We hope to see an improvement in FY'24.

Finances

Income statement

The key driver for City of London's finances is its FUM. Although the year-end figure was up 2% on 2022, the average FUM over the year decreased 12% from $10.5bn to $9.2bn. Gross fee income declined by a smaller amount, 7%, from £61.3m to £57.3m, benefiting from stronger dollar versus sterling. The latter will recur throughout our commentary.

Total overheads of £22.5m were up 14% on the 2022 figure of £19.7m. While much of this can be attributed to exchange rates (ca. 65% of expenses are in dollars and the appreciation in the average exchange rate was 9%) there have also been some cost increases. Some of this reflects salary increases in an inflationary environment, some more one-off adjustments.

Other administrative costs saw greater travel post-covid and additional IT spend, some of which is technology upgrades and price increases by vendors.

Investment gains of £0.6m reflect the good performance of the seed investments in the REIT and new Global Equity strategies. Interest income of £0.4m, compared with an expense of £0.1m last year, reflects the benefit of higher interest rates. We would anticipate a further improvement this year.

The net figures on profit were in line with those in July's trading statement. Pre-tax profit before amortisation was £23.2m, a 15% decline on 2022's £27.2m. Post-tax statutory profits declined 19% to £14.7m. On an underlying basis, EPS declined from 44.2p to 36.5p, a reduction of 17%.

Cash and balance sheet

As usual, cash conversion was excellent at 130% of earnings, helped by the ongoing amortisation. Total cash on the balance sheet declined slightly from £22.7m to £22.5m. The level still remains more than adequate for the company. For example, dividend payments in 2022 cost £16.1m, so City of London has more than enough to pay the same amount again. It also has seed investments of £3.8m.

Intangible assets on the balance sheet were £101m. There were no other cash items that were worth noting, with only small changes in receivables.

As noted in the previous trading statement, after this report City of London will change its reporting currency to US dollars. It has provided income, balance sheet and cash flow statements in dollars for FY'22 and FY'23.

Dividend

While there is some discussion of the dividend policy in the annual report, this reflects our previous comments that the current dividend gives rolling five-year cover in line with the target of 1.2x. This was last reviewed in 2019, so there may be further commentary next year, although at the moment Hardman & Co doesn't see any reason for this to change.

Estimate updates

With results being flagged in advance, we have only made minor changes to our estimates. The main change is the strengthening of the dollar from $1.28/£ to $1.24/£. The other noticeable change is an increased interest rate on cash holdings.

These changes would increase our EPS estimates. For FY'24, this would be from 33.9p to 36.1p and, for FY'25, from 35.8p to 38.1p, increases of 6%. With the move to reporting in dollars going forward, we introduce dollar forecasts too. Our underlying EPS estimates are 44.4¢ for 2024 and 46.9¢ in 2025.

In our financial tables below, we give both the sterling and dollar versions. Note for the latter that we only have two years of history. The dividend will remain payable in sterling, with US shareholders retaining an option of being paid in dollars.

Financials

Summary financials						
Year-end Jun	2020	2021	2022*	2023	2024E	2025E
FUM ($bn)	5.50	11.45	9.22	9.42	10.00	10.59
P&L (£m)						
Revenue	33.26	55.12	61.29	57.33	56.50	59.36
Expenses	21.66	31.55	37.34	39.75	38.30	39.85
Operating profit	11.60	23.57	23.95	17.58	18.20	19.51
Statutory PTP	9.41	22.25	23.17	18.60	18.78	20.09
Earnings	7.37	16.99	18.09	14.74	14.14	15.13
Statutory EPS (p)	30.3	39.4	36.9	30.2	29.0	31.0
Underlying EPS (p)	38.0	48.1	44.2	36.5	36.1	38.1
Total DPS (p)	30.0	33.0	46.5	33.0	33.0	33.0

Key metrics						
	2020	2021	2022*	2023	2024E	2025E
Growth						
FUM		108.1%	(19.4%)	2.2%	6.1%	6.0%
Revenue		65.7%	11.2%	(6.5%)	(1.4%)	5.1%
Operating profit		103.2%	1.6%	(26.6%)	3.5%	7.2%
Underlying EPS		26.7%	(8.1%)	(17.5%)	(1.1%)	5.6%
DPS (excl. special div.)		10.0%	0.0%	0.0%	0.0%	0.0%
Operating margins						
Net FUM fee margin	0.75%	0.75%	0.73%	0.72%	0.71%	0.70%
Operating margin	34.9%	42.8%	39.1%	30.7%	32.2%	32.9%
Tax rate	21.7%	23.6%	24.0%	24.0%	24.7%	24.7%
Dividend cover (x, incl. special div.)	1.0	1.2	0.8	0.9	0.9	0.9
Rolling 5-year cover (x, excl. special div.)	1.2	1.3	1.2	1.1	1.0	1.0
Rolling u/l 5-year cover (x, excl. special div.)	1.2	1.3	1.3	1.3	1.2	1.2

Underlying EPS sensitivity		
	2024E	2025E
No net new business		
Underlying EPS (p)	35.1	35.1
change	(2.8%)	(8.0%)
0% market growth (was 5% p.a.)		
Underlying EPS (p)	34.9	34.6
change	(3.2%)	(9.4%)

**2022 figures include a special dividend of 13.5p; Source: Company data, Hardman & Co Research £1=$1.24*

Financials in dollars

Summary financials

Year-end Jun	2020	2021	2022*	2023	2024E	2025E
FUM ($bn)	5.50	11.45	9.22	9.42	10.00	10.59
P&L ($m)						
Revenue			81.55	68.73	69.77	73.30
Expenses			49.63	47.82	47.25	49.17
Operating profit			31.92	20.90	22.52	24.14
Statutory PTP			30.88	22.13	23.22	24.84
Earnings			24.11	17.50	17.49	18.70
Statutory EPS (¢)			44.9	38.4	35.8	38.3
Underlying EPS (¢)			57.4	44.5	44.4	46.9
Total DPS (p)	30.0	33.0	46.5	33.0	33.0	33.0

Key metrics

	2020	2021	2022*	2023	2024E	2025E
Growth						
FUM		108.1%	(19.4%)	2.2%	6.1%	6.0%
Revenue		65.7%	47.9%	(15.7%)	1.5%	5.1%
Operating profit		103.2%	35.4%	(34.5%)	7.8%	7.2%
Underlying EPS		26.7%	19.3%	(36.5%)	21.7%	5.6%
DPS (excl. special div.)		10.0%	0.0%	0.0%	0.0%	0.0%
Operating margins						
Net FUM fee margin	0.75%	0.75%	0.73%	0.72%	0.71%	0.70%
Operating margin	34.9%	42.8%	39.1%	30.4%	32.3%	32.9%
Tax rate	21.7%	23.6%	24.0%	24.0%	24.7%	24.7%
Dividend cover (x, incl. special div.)	1.0	1.2	0.8	0.9	0.9	0.9
Rolling 5-year cover (x, excl. special div.)	1.2	1.3	1.2	1.1	1.0	1.0
Rolling u/l 5-year cover (x, excl. special div.)	1.2	1.3	1.3	1.3	1.2	1.2

Underlying EPS sensitivity

	2024E	2025E
No net new business		
Underlying EPS (p)	43.2	43.2
change	(2.8%)	(8.0%)
0% market growth (was 5% p.a.)		
Underlying EPS (p)	43.0	42.5
change	(3.2%)	(9.4%)

**2022 figures include a special dividend of 13.5p; Source: Company data, Hardman & Co Research*
£1=$1.24

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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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