1 January 2020

Corp

Ticker	CIN:AIM
Financial Services	
Shares in issue (m)	39.8
Next results	FY May
Price	**140.0p**
Target price	300.0p
Upside	114%
Market cap	**£55.7m**
Net debt/(cash)	-£15.8m
Other EV adjustments	£0.0m
Enterprise value	£39.9m

What's changed?	From	To
Adjusted EPS	-2.9	n/c
Target price	300.0	n/c

Share price performance

%	1M	3M	12M
Actual	1.8	-3.4	1.8

Company description

Asset financing, equity release, ongoing banking license application

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City of London Group*

Ready, steady, go

After two years of detailed preparation and significant investment, 2020 looks set to be the year where COLG's subsidiary, Recognise, gets its banking licence and starts trading. The market is attributing limited value to Recognise at this pre-licence stage. However, once the licence is in place and Recognise opens for business, a much higher chance of reaching the earnings goals is likely to be reflected in the group valuation. We see more than 100% upside to the current share price once the value of Recognise becomes more tangible.

- **What are the underlying industry dynamics?** Bank lending to UK SMEs stands at around £160bn, of which around two-thirds still sits with the 'Big Four'. (RBS, Lloyds, Barclays and HSBC). However, the Big Four are losing share in the SME market, where the need to improve group profitability, legacy IT systems and outdated service-models, continues to put pressure on product and service. Research show that a large share of UK SMEs are unhappy with their current bank and are considering changing provider. Published results show that new, SME-focused banks can become profitable in a short time frame if the product offering and execution is right.
- **Why is City of London Group going to perform well in 2020?** With the licence application submitted in November 2019, 2020 looks set to be the year Recognise gets its licence, starts operations and moves from business idea to operating bank. The detailed preparations made over the past years, management's significant SME banking experience, clear and realistic strategic goals and economic targets combined with the weakness of the Big Four, point to a successful launch in 2020.
- **Why do we think the shares are cheap?** At the current group valuation, little value is attributed to Recognise. Using the current market cap and valuing published net assets at only 50% of their balance sheet value, points to a c£40m implied value for Recognise. The implied value for Recognise suggests a modest ~15% chance of it reaching its 2024 goals. The group's own 2024 profit goal indicate a £290m value of Recognise at 12x earnings.
- **Where could we be wrong?** The 2024 financial goals set by the group are built on Recognise showing income, cost and capital efficiency in line with UK SME-focused peers, once it reaches a £1.1bn loan book. The key risk to our forecasts is slower than anticipated lending growth in the early period. However, as the group aims to distribute mainly (~70%) through brokers in the early part of operations, management has a range of options available to mitigate this risk and secure early momentum.

Key estimates Year end:		2017A Mar	2018A Mar	2019A Mar	2020E Mar	2021E Mar
Revenue	£m	2.6	5.8	7.5	7.2	8.9
Adj EBITDA	£m	-0.1	2.9	3.0	1.9	-2.4
Adj EBIT	£m	-0.1	2.9	3.0	1.9	-2.5
Adj PBT	£m	-1.3	-0.2	-2.0	-3.1	-7.1
Adj EPS	p	-8.5	-2.2	-7.0	-2.9	-6.8
DPS	p	0.0	0.0	0.0	0.0	0.0
Key valuation metrics						
EV/EBIT (adj)	x	-767.9	14.0	13.2	20.8	-16.2
P/E (adj)	x	-16.4	-64.3	-19.9	-48.2	-20.6
Dividend yield	%	0.0%	0.0%	0.0%	0.0%	0.0%
Free cash yield	%	-1.3%	8.8%	16.3%	-3.2%	-7.7%
Pre-tax ROCE	%	-5.2%	12.0%	8.8%	3.3%	-2.9%

Income statement		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Sales	£m	5.8	7.5	7.2	8.9
Gross profit	£m	5.8	7.5	7.1	8.9
EBITDA (adjusted)	£m	2.9	3.0	1.9	-2.4
EBIT (adjusted)	**£m**	**2.9**	**3.0**	**1.9**	**-2.5**
Associates/other	£m	0.0	0.0	0.0	0.0
Net interest	£m	-3.1	-5.0	-5.0	-4.7
PBT (adjusted)	**£m**	**-0.2**	**-2.0**	**-3.1**	**-7.1**
Total adjustments	£m	-1.1	-1.7	-3.5	0.0
PBT (stated)	£m	-1.3	-3.7	-6.6	-7.1
Tax charge	£m	-0.1	-0.1	1.2	1.3
Minorities	£m	0.0	0.0	0.0	0.0
Reported earnings	£m	-1.4	-3.8	-5.3	-5.8
Adjusted earnings	**£m**	**-0.3**	**-2.1**	**-1.8**	**-5.8**
Shares in issue (year end)	m	15.0	29.3	62.5	85.0
EPS (stated)	p	-9.3	-17.1	-11.6	-7.8
EPS (adjusted, fully diluted)	**p**	**-2.2**	**-7.0**	**-2.9**	**-6.8**
DPS	**p**	**0.0**	**0.0**	**0.0**	**0.0**

Growth analysis		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Sales growth	%	125.1%	29.9%	-4.7%	24.6%
EBITDA growth	%	n/m	5.5%	-36.0%	-225.3%
EBIT growth	%	n/m	5.3%	-36.3%	-228.3%
PBT growth	%	84.6%	-907.6%	-54.1%	-132.8%
EPS growth	%	74.5%	-223.3%	58.8%	-134.6%
DPS growth	%	n/m	n/m	n/m	n/m

Profitability analysis		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Gross margin	%	99.9%	99.8%	99.8%	99.8%
EBITDA margin	%	49.8%	40.4%	27.2%	-27.3%
EBIT margin	%	49.5%	40.1%	26.8%	-27.6%
PBT margin	%	-3.4%	-26.4%	-42.7%	-79.8%
Net margin	%	-5.7%	-27.5%	-25.3%	-64.9%

Cash flow		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
EBITDA	£m	2.9	3.0	1.9	-2.4
Net change in working capital	£m	5.1	11.6	0.0	1.5
Other operating items	£m	0.0	-0.5	0.0	0.0
Cash flow from op. activities	**£m**	**8.0**	**14.1**	**1.9**	**-1.0**
Cash interest	£m	-3.1	-5.0	-5.0	-4.7
Cash tax	£m	0.0	0.0	1.2	1.3
Capex	£m	0.0	0.0	0.0	0.0
Free cash flow	**£m**	**4.9**	**9.1**	**-1.8**	**-4.3**
Acquisitions / disposals	£m	0.0	0.0	0.0	0.0
Dividends	£m	0.0	0.0	0.0	0.0
Shares issued	£m	0.0	0.0	30.0	30.0
Other	£m	0.0	0.0	0.0	0.0
Net change in cash flow	**£m**	**4.9**	**9.1**	**28.2**	**25.7**
Opening net cash (debt)	£m	1.8	6.7	15.8	40.4
Closing net cash (debt)	**£m**	**6.7**	**15.8**	**40.4**	**75.7**

Cash flow analysis		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Cash conv'n (op cash / EBITDA)	%	277.1%	463.4%	100.0%	n/m
Cash conv'n (FCF / EBITDA)	%	170.9%	298.8%	-91.9%	176.5%
U/lying FCF (capex = depn)	£m	4.9	9.1	-1.8	-4.3
Cash quality (u/l FCF / adj earn)	%	n/m	-439.0%	100.0%	74.8%
Investment rate (capex / depn)	x	0.0	0.0	0.0	0.0
Interest cash cover	x	2.6	2.8	0.4	n/a
Dividend cash cover	x	n/m	n/m	n/a	n/a

Working capital analysis		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Net working capital / sales	%	169.2%	191.4%	200.8%	144.8%
Net working capital / sales	days	618	699	733	528
Inventory (days)	days	n/a	n/a	n/a	n/a
Receivables (days)	days	780	830	871	639
Payables (days)	days	163	132	138	111

Balance sheet		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Tangible fixed assets	£m	44.9	41.1	41.1	41.1
Goodwill & other intangibles	£m	2.2	3.5	3.5	3.5
Other non current assets	£m	32.6	32.3	32.3	32.3
Net working capital	£m	9.8	14.4	14.4	12.9
Other assets	£m	3.2	2.4	2.4	56.8
Other liabilities	£m	-75.5	-75.3	-75.3	-138.2
Gross cash & cash equivs	£m	6.7	15.8	40.4	75.7
Capital employed	**£m**	**23.8**	**34.2**	**58.8**	**84.1**
Gross debt	£m				
Net pension liability	£m				
Shareholders equity	£m	23.8	34.2	58.8	84.1
Minorities	£m				
Capital employed	**£m**	**23.8**	**34.2**	**58.8**	**84.1**

Leverage analysis		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Net debt / equity	%	net cash	net cash	net cash	net cash
Net debt / EBITDA	x	net cash	net cash	net cash	n/a
Liabilities / capital employed	%	n/a	n/a	n/a	n/a

Capital efficiency & intrinsic value		2018A	2019A	2020E	2021E
Year end:		**Mar**	**Mar**	**Mar**	**Mar**
Adjusted return on equity	%	-1.4%	-6.0%	-3.1%	-6.9%
RoCE (EBIT basis, pre-tax)	%	12.0%	8.8%	3.3%	-2.9%
RoCE (u/lying FCF basis)	%	20.6%	26.5%	-3.1%	-5.1%
NAV per share	p	158.5	116.6	94.2	98.9
NTA per share	p	144.0	104.7	88.6	94.9

Investment case

- The Big Four banks (Lloyds, RBS, Barclays and HSBC) still hold around two-thirds of the UK SME lending market, equal to c£105bn of lending. All four are, however, battling with low interest rates and legacy IT infrastructure, while facing cost-cutting and capital optimisation demands in order to improve profitability, which for all four is currently running below the implied cost of capital, resulting in the market value being below NAV. As a result, their SME operations increasingly look like cost and capital-intensive operations sitting between the 'big-ticket' large corporate customers and the standardised products that can be offered at relatively low cost to retail customers.
- Empirical evidence shows that new UK SME focused banks can be set up, grow their loan books and become profitable in a relatively short space of time. Going after the UK SME banking opportunity is not without risk, however. Many potential challengers fall at one of the many regulatory and operational hurdles along the way from concept to operating a profitable bank at scale.
- COLG's banking subsidiary, Recognise, is at a stage where the risk of not getting to the operating/ income generating stage is largely eliminated after two years of hard work and investment. Instead, investors now get 1) a bank that has submitted its bank licence application and now seems highly likely to get the banking licence in 2020; 2) a management team that has successfully built profitable SME loan books at other institutions; and 3) a modern, flexible, scalable, and cost-efficient IT infrastructure that has been specifically designed for Recognise and is being built out.

Valuation

- Our valuation method for lenders is: (ROE-g)/(r-g) = book value multiple. Starting with the targeted credit risk profile (based on peer comps) and using a peer group of 13 UK SME focused banks to determine the likely income, cost and capital given the targeted credit risk, we get an ROE by 2024 of 19.6% resulting in a value of £290m for Recognise. Our 2024 ROE is based on a 2024 PBT of £29.7m (company target is 2024 PBT >£30m). At a 19% tax-rate our valuation is equal to 12x 2024 net earnings.
- To fund the capital needed to back of 2024 £1.1bn loan book at a CET1 ratio of 18%, we assume three £30m capital raisings in early 2020, 2020 and 2022. Conservatively assuming that all three capital raisings are done at the current price, this points to a 300p target price.

Attractive valuation given our assumptions

	ROE	g	r	Mult.	BV (£m)	Value (£m)
Recognise	19.6%	3.0%	10.0%	2.4	123	290

Source: finnCap

- At 30 September 2019, group equity stood at £31.4m. Current lender valuations indicate that equity is valued at around 50% of book value if it does not generate net earnings. Assuming no net earnings on current equity hence points to a value of the current stated equity of c£16m. At the current £56m market cap, this points to an implied value for Recognise of around £40m, equal to less than 15% of our estimated £290m value, hence suggesting that the market is still putting a relatively low probability on Recognise reaching its 2024 goals.
- We believe the risk of Recognising not reaching its goals is much smaller than indicated by the current valuation and believe the implied risk will reduce significantly once Recognise gets the banking licence and starts trading. We therefore see significant value in getting in early before Recognise achieves more milestones as it moves towards the £290m value.

City of London Group – company overview

Company activities & operations

City of London Group provides financial services to UK SMEs and individuals through three currently operating subsidiaries. CAML is a business-to-business provider of debt finance to SMEs. PFS offers property and bridging loans for acquisitions, refinancing, refurbishments and development to commercial customers. Acorn to Oaks is an all-of-market broker offering mortgage, commercial lending, insurance, life protection, wealth management, pension and financial planning advice to private clients and SMEs. In addition, the group contains Milton Homes, which is no longer writing new business, but holds a portfolio of home reversions, and Recognise, which is the subsidiary that in November 2019 applied for a banking licence and is expected to start trading as an SME focused bank in the second half of CY 2020.

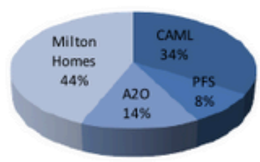
Company strategy

Recognise is set to become the centre of the group's operations. CAML will write new business as part of the bank, PFS will be fully moved into the bank, while Acorn to Oaks will provide white labeled all of market broker to the bank. Recognise targets an underserved customer population based on business understanding, responsiveness, expertise, accessibility, flexibility and fairness, and enabled by a market-leading IT platform.

Key products/services

Product	Description
CAML	Business-to-business provider to UK SMEs
PFS	Property bridging ad development finance for commercial customers
Acorn to Oaks	FCA authorised, independent whole of market financial broker
Recognise	Will provide banking services to SMEs once operational - expected H2 2020
Milton Homes	Equity release provider. Does not currently take on new customers

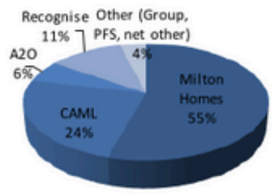
Split of FY 2020E revenues:



Management and Board

Name	Description
Colin Wagman	Group Chairman. Deputy Chairman Delancey. NED of Alpha Plus and Minerva
Michael Goldstein	Group CEO. Former senior Audit partner in BDO
Phil Jenkins	Recognise Chairman. Former Chairman and NED at Charterhcourt Group
Jason Oakley	Recognise CEO. Former MD at Metro Bank, head of SME at NetWest & RBS
Bryce Glover	Recognise deputy CEO. Former MD at Santander UK, NED at Newcastle BS

30 September 2019 NAV split:



Company's stated objectives

Timing	Description
Short term	Obtaining banking licence, start banking operations
Medium term	£1.1bn bank loan book and £1.3bn deposit book by March 2024
Long term	Continue to profitable grow Recognise's footprint in UK SME market

Share price drivers

Probability	Description
high	Getting banking licence, Recognise starts trading
medium	Initial loan book growth ahead of plan
low	Not obtaining the banking licence during 2020

Major shareholders

Name	%
DV4 Limited	47.5%
Max Barney Investments Ltd	37.9%

Upcoming events

Date	Description
Jun-20	Fyll year to 31 March 2020 result

Recent corporate action

Date	Description
Mar-19	£14.7m equity capital raising
Apr-19	£0.5m equity capital raising

Other information
Website: www.cityoflondongroup.com
Location of HQ: London, UK

Source: finnCap