Record

Operationally geared to grow

Initiation of coverage

Investment companies

Record is an established currency manager focused on passive and dynamic hedging strategies. Since its IPO in 2007, it has grown the assets under management equivalents (AUME) of its hedging strategies by c 7.0% pa. Our forecast compound EBITDA growth of 16% over the next two years assumes no new mandates other than those already announced and the inherent operational leverage within the business. Our fair value of 37p also assumes no new mandates, but increases to 56p if we assume $2bn pa of new dynamic hedging mandates.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/12	20.3	7.0	2.3	1.5	15.1	4.3
03/13	18.3	6.1	2.1	1.5	16.5	4.3
03/14e	20.5	7.3	2.5	1.5	13.8	4.3
03/15e	22.4	8.4	2.9	1.7	11.9	4.9

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments. EPS are diluted.

Independent and specialist

With c $38bn of client currency exposures and operating since 1983, Record is an established, specialist, independent currency manager. It provides both currency hedging and Currency for Return products for institutional clients. Although majority owned by employees, it listed on the LSE in 2007, which we believe brings added transparency to clients, while aligning the interests of staff and shareholders.

Focused on currency hedging

95% of client exposures are in hedging mandates where demand is supported by perennial macro-uncertainty, a trend towards targeted volatility reduction in investment products, and the longer-term trend towards geographic asset diversification. Record seeks to compete on service as well as execution, protecting revenue margins with individual rather than pooled customer solutions.

Successfully repositioned

At IPO, Record's profitability was dominated by a single Currency for Return strategy that, despite a long-term track record and theoretical underpinning, became ineffective during the crisis. During the adjustment period, the hedging business was grown and the product set broadened. Investment continued while costs were managed down, softening the impact of a lower revenue mix. The balance sheet remains strong while profitability is lower but healthy, and we believe has stabilised. On page 10 we explore the operational gearing to further customer wins.

Valuation: Discount and geared to grow

Record trades on a 29% CY14e P/E discount to smaller UK asset managers, and a larger (36%) EV/EBITDA discount; the latter reflecting a strong balance sheet with free cash resources equivalent to c 33% of market cap. We estimate fair value of 37p for the existing business alone, assuming no new mandate wins.

25 October 2013

Price	**34.62p**
Market cap	**£77m**
	US$/£1.5774
Net cash (£m)	25.4
Shares in issue	221.4m
Free float	47%
Code	REC
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	1.5	(6.8)	37.3
Rel (local)	(0.8)	(8.5)	16.3
52-week high/low		34.50p	25.50p

Business description

Record is a specialist currency manager, providing currency hedging and return-seeking mandates to institutional clients. Services include passive and dynamic hedging and return-seeking currency strategies via funds or segregated accounts.

Next events

H1 results	15 November 2013
Q3 trading update	17 January 2014

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Record is a research client of Edison Investment Research Limited

Investment summary

Record has been through a period of product, operational and financial repositioning since the global financial crisis struck soon after the December 2007 IPO. During the global financial crisis, the core of Record's then profitability, its forward rate bias Currency for Return product, became ineffective, leading to significant AUME outflows and a 72% reduction in revenues (FY08-13). Management worked hard to maintain investment in core skills, systems and marketing, and broaden the product offering, simultaneously reducing costs to offset a negative shift in revenue mix, protect profitability and maintain balance sheet strength. Passive and dynamic hedging now (H113) represents 95% of the group's AUME (Q313) and 87% of revenues, which gives an indication of the strategic progress that has been made in refocusing the business on its more traditional strategies.

The US market could generate significant upside

The focus of Record's current customer base is the UK, Europe (mainly Switzerland and Germany), and North America, with an overall bias towards defined benefit pension schemes. Management sees opportunities to grow in each of these markets but sees particular potential in the US market. US investors have shown a similar inclination towards more globally diversified investment and more tightly managed volatility as in many other regions; additionally, relative US$ weakness over the past decade has materially boosted local currency returns on non-US equity investment (see page 5).

Exhibit 1: Historical and forecast performance

	2008	2009	2010	2011	2012	2013	2014e	2015e
AUME ($'000s)	55,700	31,500	34,000	31,400	30,900	34,800	47,310	48,693
Revenue (£'000s)	65,933	46,785	33,424	28,094	20,283	18,331	20,531	22,351
Operating profit (£'000s)	39,266	25,857	16,452	12,354	6,853	5,988	7,120	8,205
Operating margin (%)	59%	55%	49%	44%	33%	32%	34%	36%

Source: Company data, Edison Investment Research

Valuation

Record trades at a 29% CY14e P/E (CY15e 17%) discount to smaller UK asset managers and a 17% (CY15e 15%) discount to larger UK asset managers. The CY14e EV/EBITDA discount is even larger at c 36% and 35% respectively, in our view reflecting a strong balance sheet, with prudent free cash resources equivalent to c 33% of market cap. We would not expect the company to distribute this cash surplus but shareholders should benefit if it continues to provide stability to the business and support new customer acquisition. We estimate a fair value for the existing business (using a 10% discount to the average CY15e P/E for its peer group of 13.9x) of 37p, without assuming any new mandate wins (other than the $8-10bn passive hedging mandate already expected to start in Q3 of FY14). Our upside scenario ($2bn in new dynamic hedging mandates pa) generates a CY15e fair value of 56p, while our downside scenario ($2bn in outflows from dynamic hedging mandates pa) generates a fair value of 19p.

Sensitivities

The main sensitivities (discussed in more detail on page 9) are:

- **Client and product concentration** is high, with the top two clients representing 42% of FY13 revenues. Record is focused solely on currency hedging and Currency for Return strategies.
- **Reputational damage** could impact the ability to retain and/or mandates
- **Retention of key personnel** is crucial to the performance of the business.

Constant focus on currency management

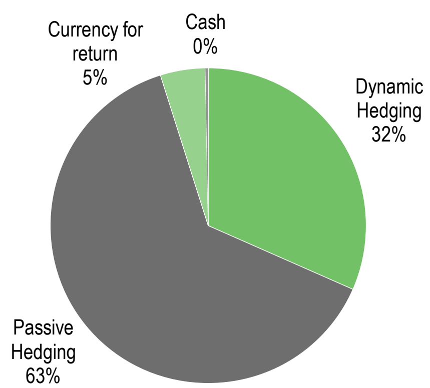
Record was established in 1983 in Windsor, by Neil Record, the current chairman. Neil had previously worked at the Bank of England and at Mars Group, in currency and commodity financing and hedging. The early growth of Record was not dissimilar to Record's business today, largely based on hedging for corporate and institutional clients. However, from 2003, Record's return-seeking currency business began to grow with the launch of the "Currency Alpha" product. The product grew rapidly on the back of investment success, allowing the very successful launch of a Dublin-based pooled fund range of currency return products in 2005. The success of this highly profitable product set grew Record to a size that it could list on the main market of the London Stock Exchange in 2007. The advantages of the listing, which management believes hold true today, are the enhancement of the corporate profile (visibility, transparency, corporate governance), the ability to reward and retain key staff with ownership, and the creation of a liquid market for those shares. The IPO raised no new capital but Neil Record reduced his holding to 32% in the offering to meet the free float requirements; employees and management still hold a majority of the shares (53%).

The exceptional circumstances of the global financial crisis created a set of market conditions where the Currency Alpha product returns, based on a forward rate bias strategy, fell away. This negatively affected performance and led to a significant reduction in high-margin customer funds. Since 2009, the corporate strategy has focused on continuing to grow customer hedging activity, while increasing the diversity of the Currency for Return product in particular (eg Emerging Markets Currency was launched in 2009 and Currency Momentum and Currency Value in 2012).

Currency specialist in the UK, Europe and North America

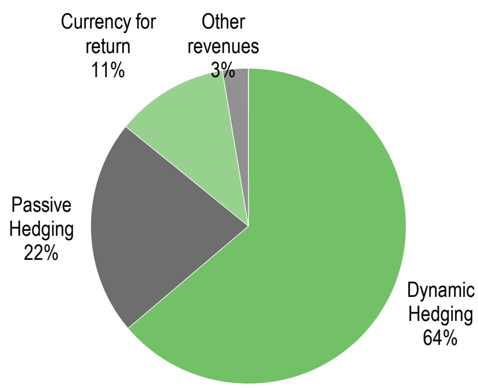
At end 2013, hedging AUME represented 95% of the total, and hedging accounted for 86% of revenues. As a currency manager, Record is managing only the impact of currency movements on its clients' assets and not the underlying assets, as is the case with a conventional asset manager. The notion of AUME is to make this distinction and is quoted in US dollars. This represents the aggregate nominal amount of passive hedges actually outstanding, while for dynamic mandates this is extended to include all of the assets of a client's portfolio that could be hedged, not just those that are being hedged. Currency for Return is slightly different in that AUME refers to the maximum aggregate nominal amount of outstanding forward contracts on a client's portfolio.

Exhibit 2: FY13 AUME split by product ($34.8bn)



Source: Company data

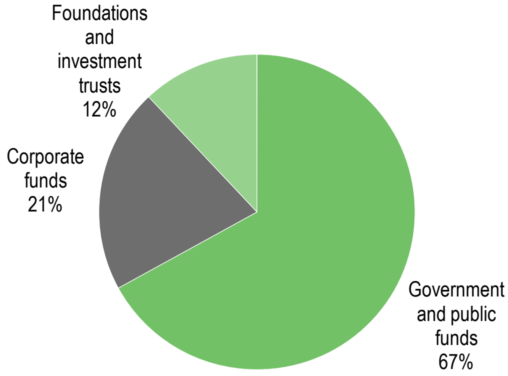
Exhibit 3: FY13 net revenues split by product (£18.3m)



Source: Company data

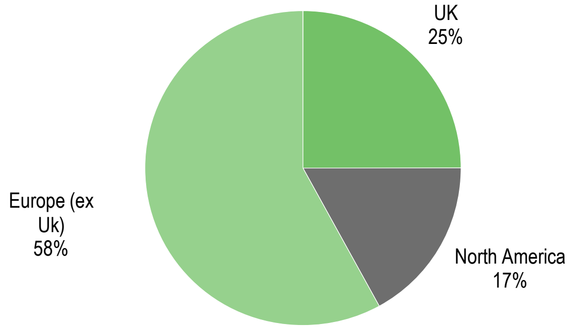
Clients are all institutional and are generally government and public pension funds, predominantly located in the core markets of the UK, Europe (in particular Switzerland) and North America. Record's marketing efforts continue to be focused on these geographies, and it sees further business opportunities in each, but especially the US (see page 5). Record only acts as an agent on behalf of its clients, transacting with a diversified group of financial institutions, and never as principal.

Exhibit 4: FY13 AUME by client type



Source: Company data. Note: As at 31 March 2013.

Exhibit 5: FY13 AUME by client location



Source: Company data. Note: As at 31 March 2013.

The distribution strategy is focused both on direct marketing (an in-house client team and existing client referrals) as well as the investment consultants that advise clients in different markets. In the UK, target clients tend to work very closely with consultants, particularly the larger groups such as Mercer, Towers Watson and AON Hewitt, with which Record has longstanding relationships. In Europe, Switzerland and to a lesser extent Germany are the important markets for Record. There is a full-time sales representative based in Switzerland, where Record has an existing strong position with the large defined benefit pension fund sector. It seeks to build further on this, also developing relationships with key local investment consultancy firms. Outside Switzerland and Germany, Record's experience is that markets are less open to independent providers or (eg the Netherlands) are acutely price competitive. Investment in US marketing was significantly increased two years ago with the appointment of Chris Adair, Head of Americas, and Record now has two employees permanently based there, with regular support from senior management (the CEO is in the US around once a month).

Experienced leadership team

Neil Record, current chairman, has been an active participant in currency markets for 30 years. In addition, the six executive committee members have an average of over 13 years at Record and 23 years employed in currency markets and related areas. The majority of employees (73%) hold shares in the company, which has helped Record to maintain the talent required to create a sustainable and market-leading currency investment management franchise and to maintain low levels of staff turnover. There are currently 67 employees, with the overwhelming majority employed in the main Windsor office. The board has eight members, three of whom are independent. The senior independent director is Cees Schrauwers, who was previously MD of Aviva International and MD of CGU Insurance.

Systematic trading process with experienced oversight

Record's approach to currency management is broadly systematic, rather than discretionary. Its accumulated investment skills are largely applied in the design of its fundamental processes and systems, using its own proprietary investment management software. The process of adjusting hedges to changes in clients' portfolios and shifting currency exposures is generally conducted at least daily, although it may be as much as monthly and may depend on whether exposure data are received automatically from the custodian or manually from the client. Manual data input is monitored by two analysts working independently in parallel, to avoid errors.

Management recognises an expectation by many clients that it should apply an experienced and informed manual override when market conditions suggest this is appropriate. For example, in periods of significant market dislocation from fair value, management may override positions that are deemed to add an undue level of risk. This is done to preserve the respective mandate's risk characteristics rather than speculatively seek incremental return. Any overrides are based on macroeconomic, political, and other risks, which Record finds most often (though not exclusively) apply to emerging market currencies. Managers may also intervene in Dynamic Hedging strategies when they see a breakdown of historical trends.

The drivers of customer hedging activity

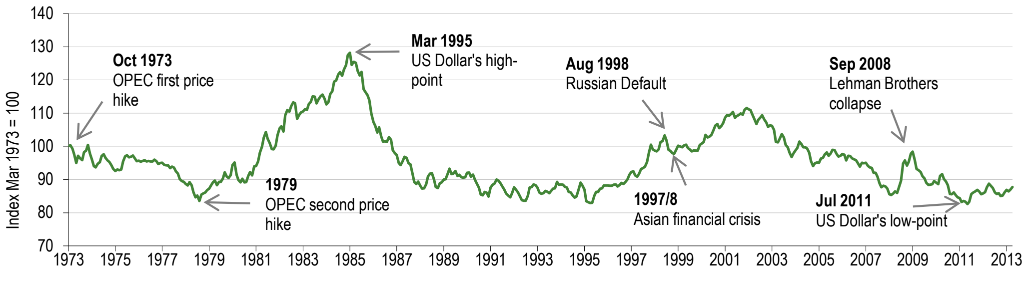
A trend increase in overseas asset allocation by investors (declining 'home bias') and a desire to manage risks and volatility of returns are important drivers of hedging activity. There has been a steady increase over the last decade in the weight of foreign equities in global pension assets, which has risen from 35% in 1998 to 54% in 2012 (source: Towers Watson Global Pensions Asset study, 2013). In the US, it has risen from c 15% to c 40% now, and in the UK from c 25% to c 60%. Investors who hold international assets are exposed to swings in currency movements that increase the volatility of portfolio returns. Even though these swings have a tendency to even out over the long term, investors are unrewarded for heightened volatility in the meantime. Statistically, it can be shown that hedging a proportion of the currency risk on, say, a portfolio of equities can meaningfully reduce volatility and improve risk adjusted returns.

Hedging currencies may also be beneficial for investors that have a view on an asset, but not necessarily the currency in which it is denominated (for example, MSCI Japan Index increased 66% one year to September 2013 but JPY/US$ declined c 25%) or investors that have a need to match assets and liabilities in different currencies (such as pension funds) that invest globally but make payments in one currency. For those investors with shorter investment horizons that may not benefit from the longer-term mean reversion of currencies, hedging can reduce portfolio volatility.

Opportunity for US investors to hedge

Record believes there is a particular opportunity for US investors to benefit from a hedging strategy resulting from the weakness of the US$ on a trade-weighted basis since 2001 (Exhibit 6). As a result, US investors holding assets denominated in foreign currencies have benefited from additional currency returns, over and above those of the underlying assets. There is evidence that the US$ is fundamentally cheap (eg on a purchasing power parity basis) and that this cycle may reverse. This would erode the additional unhedged gains that US investors have enjoyed over the period. In this context, currency hedging achieves not only the strategic objective of volatility reduction, but also the tactical one of protecting currency returns built up over the last decade.

Exhibit 6: US dollar near the bottom of long-term cycle



Source: Company data. Note: US dollar trade-weighted exchange rate, 31 March 1979 to 28 June 2013

Currency management products

As we have shown in Exhibit 2, 95% of AUME is accounted for by hedging products. These are split between passive hedging (63%) and dynamic hedging (32%). The remaining 5% of AUME is in active return-seeking currency products.

Passive hedging targets risk elimination

Passive hedging is intended to eliminate (or part eliminate depending on the proportion of risk hedged, or the hedging ratio) losses and gains from unmanaged currency exposure. The principle of passive hedging is relatively simple and programmes can be relatively low cost to operate. A 50% hedging ratio is a widely adopted strategic position as it can be shown to capture and eliminate much of the overall currency risk. The 'hidden cost' of passive hedging can be the volatility of the cash flow movements over time. Depending on currency movements, an investor may receive cash if the hedged currency weakens (the forward contracts will be in the money) or be required to pay cash if the hedged currency strengthens (forward contracts will be out the money). Record's programme uses a series of overlapping forward contracts to effect a similar hedge in a way that is designed to smooth out the cash flows throughout the hedge, making it easier for the client to manage. To be able to do this, Record offers an individual account solution to clients, rather than a more generic pooled fund solution. Even at what appears a modest 3bp average revenue margin on AUME for passive hedging mandates, Record is more expensive than pooled solutions, often as low as 1bp. However, it believes that the combined benefits of cash flow smoothing and its low spread, independent execution capability more than compensate.

Dynamic hedging manages risk with upside potential

Dynamic hedging seeks to provide substantial protection against a decline in the hedged currency while still providing the potential to benefit from an increase. The intention is to both reduce portfolio risk and add modest returns. The dynamic hedging process systematically varies the hedge ratio as a result of movements in the spot rate. The process seeks to identify trends, systematically reducing the hedge ratio to gain exposure to positive price trends and increasing it to protect against adverse trends. There is an added benefit of improved cash flows compared with passive hedging; there should be less cash outflow from fewer forward contracts being used if foreign currencies appreciate (ie a lower hedge ratio is used), but similar positive cash flows should be generated as foreign currencies weaken (ie a higher hedge ratio).

In dynamic hedging, Record is seeking to differentiate itself and its processes by generating a positive performance outcome. This comes in addition to competing off its acquired know-how and efforts to offer superior customer execution and service. The simulated data in Exhibit 7 illustrate the additional returns that could have been generated from a dynamic hedging strategy compared with a passive hedging strategy, with a similar level of volatility. Since 1979, Record estimated its dynamic hedging strategy would have generated an annual gross return of 8.3% on the MSCI EAFE Index with volatility of 16.1%, significantly outperforming unhedged or passive hedging strategies.

Exhibit 7: Dynamic hedging generated the best risk-adjusted returns on MSCI EAFE Index

	Unhedged return on MSCI EAFE Index	50% passive hedge	100% passive hedge	Record dynamic hedge
Gross return	6.8%	6.7%	6.5%	8.3%
Volatility	17.7%	16.2%	15.6%	16.1%
Return/volatility	0.38	0.41	0.42	0.52

Source: Company data. Note: Data from December 1979 to June 2013. MSCI EAFE (price) hedged indexes are simulated with index weighted currency hedging contributions from JPY, €, £ and CHF (totalling 88% long-term average of index weight) for a US$ base investor as of 30 June 2013.

Building a multi-strategy Currency for Return platform

In contrast to passive and dynamic hedging, Currency for Return has the primary objective of generating an investment return. Record sits firmly within a growing part of the investment community that views currency investment as an asset class, just like investing in bonds and equities. The premise is that currency trading strategies can generate consistent profit streams and provide an alternative, uncorrelated source of alpha. The forward rate bias has always been Record's core investment process, and was the basic strategy behind the substantial earlier growth of its Currency for Return business. Since 2009, creating a broad range of alternative strategies has been a key strategic focus, with a number of new launches that are increasingly building a track record. As at March 2013, Record was managing five Currency for Return strategies, which can also be combined to generate multi-strategy products for clients.

Competitive landscape

Record's competitors are a mixture of independent specialists (for example Millennium Global), divisions of larger investment managers (BlackRock etc), and divisions of other financial service firms such as investment banks and custodian banks firms (SSGA, JP Morgan, Insight, which is a BNY Mellon subsidiary). The barriers to entry include the challenge of building a team of experienced currency trading professionals, with proprietary systems and processes, and the need to build a credible history of successful implementation. Customers will typically work with one hedging partner (while they may have a broad range of asset managers) and this makes the choice of partner a very important decision.

Record is able to differentiate through its status as an established, independent manager. Management believes its experience, systems and scale provide greater flexibility than may be the case, for example, for a larger banking or custodial group, in offering leading price identification and execution across the market. Small changes in transaction pricing in the sometimes opaque foreign exchange markets can make a big difference to performance.

Valuation remains modest despite price gains

Record's share price has risen strongly (240%) since the low point of April 2012, which coincided with a $2.5bn reduction in dynamic hedging AUME in Q312 (December 2011). However, it still trades at a notable P/E ratio discount to larger peers (17% CY14e, 15% CY15e) and smaller peers (29% CY14e, 17% CY15e). The discount to its smaller peers on an EV/EBITDA basis is starker (36% CY14e, 18% CY15e), in our view reflecting a strong balance sheet, with prudent free cash resources equivalent to c 33% of market cap. We would not expect the company to distribute this cash surplus but shareholders should benefit if it continues to provide stability to the business and support new customer acquisition. If the business continues to grow, as we expect, we see no reason for the cash surplus to increase.

On this basis, we believe a P/E comparison is the better measure for Record and our central case fair value of the existing business (assuming no new mandate wins, other than inception of the $8-10bn passive hedging mandate in Q3 of FY14) is 37p. This assumes a 2015e P/E of 12.5x, a 10% discount to the average for the smaller asset managers; the discount allows for Record's concentrated client list and product portfolio and the challenges in forecasting new mandate wins/losses. We include modest growth of 3% pa in the AUME of existing mandates to reflect estimated annual market performance of the underlying assets being hedged (see page 10). Together, the revenue impact of the one new mandate and market performance generates an improvement in operating margin reflected in forecast EBITDA growth of 16% (FY13-15e).

Exhibit 8: Trading at a discount to both smaller and larger peer group

	Market cap (£m)	EV/EBITDA		P/E ratio		Dividend yield	
	current	2014e	2015e	2014e	2015e	2014e	2015e
Aberdeen	5,113	8.5	7.1	12.9	11.6	4.1%	4.5%
Ashmore	2,970	9.9	9.0	14.2	13.9	4.1%	4.5%
Henderson	2,348	10.3	8.8	15.2	13.9	4.0%	4.4%
Jupiter	1,838	9.5	8.3	14.4	13.0	3.9%	4.7%
Schroders	7,235	11.8	10.4	17.5	16.0	2.3%	2.6%
Man	1,633	5.7	5.0	14.3	13.2	5.9%	6.2%
Average larger asset managers		**9.3**	**8.1**	**14.8**	**13.6**	**4.0%**	**4.5%**
Charlemagne*	42	4.8	3.1	20.4	15.3	5.3%	6.5%
Polar Capital*	409	12.9	9.5	19.5	14.5	4.6%	6.0%
Impax AM*	47	--	--	13.5	12.2	2.2%	2.5%
Liontrust AM*	94	10.7	7.3	15.2	11.1	1.1%	1.6%
Miton Group*	70	--	--	18.0	16.6	1.4%	1.4%
Average smaller asset managers		**9.4**	**6.6**	**17.3**	**13.9**	**2.9%**	**3.6%**
Average for all asset managers		9.4	7.4	16.0	13.8	3.5%	4.0%
Record	**77**	**6.0**	**5.4**	**12.3**	**11.6**	**4.9%**	**5.1%**

Source: Edison Investment Research, Bloomberg. Note: *Based on Bloomberg consensus estimates as at 23 October 2013. All data has been calenderised to yearend.

Given the large institutional mandate nature of Record's business, new customer wins (and losses for that matter) can have a significant impact on earnings, but are difficult to predict in timing and quantum. Dynamic hedging revenues are around two thirds of the total revenues with nine clients at H114 (see Exhibit 12); the passive hedging customer base is slightly more diversified with 26 clients. For that reason we also show positive and negative scenarios, based principally on potential client gains and losses, alongside our central case.

Clearly, there are many different potential scenarios that could be modelled. For our upside scenario we have modelled an incremental $2bn (£1.5bn) of new mandates annually into the key product of dynamic hedging ($4bn in total by FY15e). We have chosen this product because it is likely to be the primary driver of future growth. Flows into lower revenue margin passive hedging would need to be much larger to make a meaningful difference, and it is still too early to anticipate significant flows into Currency for Return products. We estimate increments of $2bn pa during FY14 and FY15, at the existing AUME margin of 17bps, would, on a full-year basis, increase revenues by c £4.5m in FY15e. We have assumed no increase in fixed costs as we believe the current infrastructure can accommodate this level of AUME and we estimate that variable costs would increase by just £1.4 m. This lifts CY15e EPS to 4.5p and, using the same 10% discount to smaller asset managers, this upside scenario valuation is 56p per share.

Exhibit 9: Historical progression of P&L and scenario analysis

			Downside	Central case	Upside
AUME ($'m) change			(4.0)		4.0
AUME (£'m) change			(2.7)		2.7
Margin (bp)			17		17
Estimated impact on revenue			(4,533)		4,533
	FY08	**FY13**	**FY15e**	**FY15e**	**FY15e**
Revenue ($'m)	65,933	18,331	17,818	22,351	26,884
Fixed costs ($'m)	(9,867)	(9,943)	(10,630)	(10,630)	(10,630)
Variable costs($'m)	(16,800)	(2,400)	(2,156)	(3,516)	(4,876)
Operating profit ($'m)	39,266	5,988	5,032	8,205	11,378
Margin %	60%	33%	28%	37%	42%
NPAT($'m)	27,913	4,680	3,979	6,395	8,812
EPS - Fiscal year end	12.62	2.14	1.82	2.92	4.02
% difference to base case EPS			**-38%**	**0%**	**38%**
EPS - Calendarised			1.49	2.98	4.47
Fair value (p)			**19**	**37**	**56**

Source: Company data, Edison Investment Research

In the downside scenario, we have modelled a similar scenario but of $2bn in annual outflows from dynamic hedging mandates ($4bn in total by FY15e). The annualised reduction in revenue that this generates (£4.5m) compares with the £5.6m generated by Record's single largest client in FY13. We assume no decrease in fixed costs, but variable costs to fall from £3.5m to £2.2m to reflect the group's flexible variable remuneration scheme (see page 10). Although we do not assume fixed costs fall, a sustained reduction in AUME could prompt a reduction in fixed costs that would mitigate our downside estimate effect. Our downside scenario CY15e fair value is 19p (CY15e EPS 1.5p and 10% discount to CY14e average P/E ratio for smaller asset managers 12.5x).

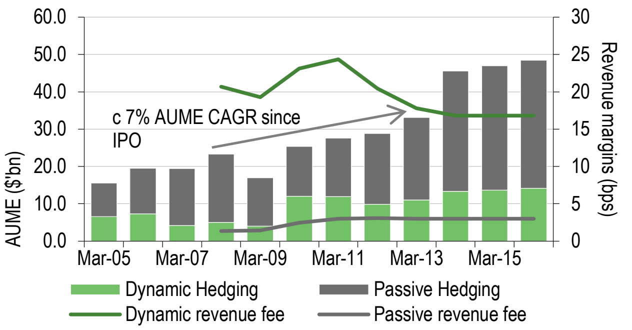
Sensitivities

- **Concentrated client base** – The top two clients represent 42% of FY13 revenues while the top 10 clients represent 72% of AUME and 87% of total revenue.
- **Concentrated product portfolio** – Record is focused solely on currency hedging and Currency for Return strategies. As highlighted by the sharp decline in the Currency for Return AUME, Record is vulnerable to further reductions in profits should its hedging strategies suddenly stop performing in line with expectations.
- **Reputational damage** – Much of Record's growth is dependent on its reputation as a reliable and efficient currency hedging manager. Any damage to this reputation would dramatically reduce its ability to win new mandates and/or keep existing clients.
- **Retention of key personnel** – Although trading systems are largely systematic, experienced management is key to the generation of new ideas and to identifying the difference between trading noise and a structural change in historical trading strategies.
- **Adverse market conditions** – Increased volatility and a lack of sustained trends would increase the costs of hedging and limit the effectiveness of its dynamic hedging strategies.
- **Trading error** – Record's proprietary investment management software may fail, resulting in a loss of revenue.

Financials

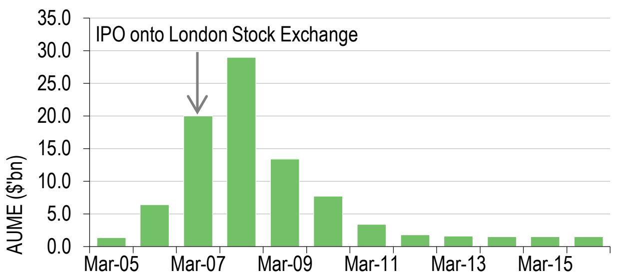
When Record listed in 2007 its Currency for Return products accounted for £38m of revenue compared with our forecast £2m for FY14 on a smaller but more diversified AUME base. Meanwhile, hedging AUME has grown 7% annually to $33bn (95% of AUME) and such revenues have grown from £5.9m in 2007 to a forecast £18.7m in FY14 (see Exhibit 1 for full results history).

Exhibit 10: AUME and margin progression



Source: Company data

Exhibit 11: Currency for Return is no longer dominant



Source: Company data

As a result of this decline in higher margin Currency for Return products, Record's revenues have declined 72% to £18.3m between FY08 and FY13 while total costs have been reduced by 54%.

Operating profits have fallen 85% to £5.9m. Despite cost reductions, staff numbers have only declined from 72 in FY11 to 67 now, as the group has worked to maintain its core skills and capacity. Staff costs have shown themselves to be variable with the group paying out a fairly consistent 30% of operating profit before variable expenses to employees. If AUME flows continue the more positive trend of recently, we believe this operational leverage will begin to work in Record's favour once again. We estimate operating margins will increase from 32% in FY13 to 34% in FY14e before rising to 36% by FY15e.

The most recent quarterly figures (Q214 to 30 September 2013) show a small increase in dynamic hedging AUME ($100m), which is largely offset by lower Currency for Return AUME of $100m. Positive market performance of $1.3bn was due to favourable FX rate movements of $1.5bn being partially offset by negative movements of global markets of $200m. Included in our forecasts is the $8-10bn passive hedging mandate that is expected to incept in the current quarter. Beyond that mandate, due to the irregular timing and significant variation in mandate size, we do not forecast any new mandates until they have been announced. We do estimate AUME of both dynamic and passive hedging strategies to increase 3% per annum, reflecting our assumption of a gradual improvement in global markets and hence in the value of the asset exposures that are being hedged. This is consistent with our general asset management sector assumption of c 5% equity gains, applied to an estimated two-thirds of hedged assets being equities.

Exhibit 12: Dynamic hedging new client AUME and flows are concentrated

	FY10	FY11	FY12	FY13	H114
Opening no of clients	7	10	10	9	8
Client wins	3	0	1	0	1
Client lost	0	0	-2	-1	0
Closing no of clients	**10**	**10**	**9**	**8**	**9**
New client AUME wins ($'m)	8,323		1,115		1,089
New client AUME losses ($'m)			(1,836)	(35)	
Average Dynamic AUME ($'m)	9,480	11,540	10,820	10,100	12,800
Dynamic Revenue as % of total revenues	43%	62%	66%	64%	66%

Source: Company data, Edison Investment Research. Note: New client AUME wins/losses do not include existing client AUME net flows contained within the total. H114 revenue split is based on FY14 estimates.

As we show in Exhibit 10, average revenue margins for dynamic hedging have reduced from a peak of 24bp in FY11 to 17bp in FY13. Average passive revenue margins have actually increased, from 1.4bp in FY08 to 3.0bp. We understand Record continually strives to apply similar fees to similar mandates, and as such there should be no material "back book" or average stock versus marginal flow issues. In FY11 (fully affecting FY12) the fees for a very large client were renegotiated to a tiered structure, which rebased this account to fee levels where each tier more closely matches clients of a similar size. While clearly a sensitivity for forecasts, we have assumed stable product margins, reflecting current trading conditions and the fact that Record is not actively competing on fees to win new business, but is instead focusing on offering an enhanced service and product delivery.

Regulatory capital needs for the group are relatively low (we estimate c £9m). Meanwhile, the FY13 net cash balance of £25m (excluding the £3.6m non-controlling interest) is 33% of market cap, although it does include c £2.0m tied up as seed capital for new active return funds. The cash balance, broadly covering two years of operating expenses, has provided welcome stability for the business during its difficult adjustment period. We do not expect it to be reduced, but see no need for it to grow, even as the business does. Record does not maintain an explicit dividend policy, but over the last five years has paid out 50%-114% of earnings each year (average 80%). We are forecasting a dividend increase in FY15e from 1.5p to 1.7p (a payout ratio of 60%), which could well prove conservative as it results in continuing growth in forecast cash balance (FY15e £30.5m).

Exhibit 13: Financial summary

Record	£'000s	2011	2012	2013	2014e	2015e
March		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		28,094	20,283	18,331	20,531	22,351
Operating expenses		(15,549)	(13,324)	(12,060)	(13,192)	(13,961)
EBITDA (norm)		12,545	6,959	6,271	7,340	8,390
Depreciation & amortisation		(191)	(106)	(283)	(220)	(185)
Operating profit (norm)		12,354	6,853	5,988	7,120	8,205
Goodwill and amortisation of acquired intangibles		0	0	0	0	0
Exceptionals		(1)	(299)	(68)	0	0
Other		0	0	0	0	0
Operating Profit		12,353	6,554	5,920	7,120	8,205
Net Interest		184	155	158	180	194
Other		0	0	0	0	0
Profit Before Tax (norm)		12,538	7,008	6,146	7,300	8,399
Profit Before Tax (FRS 3)		12,537	6,709	6,078	7,300	8,399
Tax		(3,603)	(1,803)	(1,450)	(1,741)	(2,004)
Profit After Tax (norm)		8,935	5,125	4,680	5,558	6,395
Profit After Tax (FRS 3)		8,934	4,906	4,628	5,558	6,395
Average Diluted Shares Outstanding (m)		221.3	220.3	219.1	219.6	219.6
Basic EPS - Company reported		4.0	2.2	2.0	2.5	2.9
Diluted EPS - Company reported		4.0	2.2	2.0	2.5	2.9
Adjusted diluted EPS - Edison		4.0	2.3	2.1	2.5	2.9
Dividend per share - proposed (p)		4.6	1.5	1.5	1.5	1.7
Revenue Margin - AM (%)		14.3	11.3	8.5	8.0	7.4
EBITDA Margin norm. (%)		44.5	32.4	33.4	35.3	37.1
Operating Margin norm. (%)		43.8	33.4	32.3	34.3	36.3
BALANCE SHEET						
Fixed Assets		4,404	2,398	1,108	937	792
Intangible Assets		1,085	1,140	963	813	687
Tangible Assets		227	183	140	118	100
Investments		3,092	1,075	5	5	5
Current Assets		31,632	29,675	34,637	37,394	40,922
Debtors		6,904	5,070	5,569	6,238	6,790
Cash		24,728	24,572	29,025	31,114	34,089
Other		0	33	43	43	43
Long Term Liabilities		0	(15)	0	0	0
Long term borrowings		0	0	0	0	0
Other long term liabilities		0	(15)	0	0	0
Current Liabilities		(5,938)	(3,442)	(3,457)	(3,775)	(4,038)
Creditors		(4,089)	(2,494)	(2,672)	(2,990)	(3,253)
Short term borrowings						
Other		(1,849)	(948)	(785)	(785)	(785)
Net Assets		30,098	28,616	32,288	34,556	37,676
CASH FLOW						
Operating cash flow		8,241	2,393	5,609	5,427	6,291
Capex		(85)	(52)	(63)	(48)	(41)
Cash flow from investing activities		(491)	93	149	0	0
Dividends		(5,723)	(7,371)	(1,645)	(3,290)	(3,283)
Other financing activities		925	784	403	0	0
Other		0	0	0	0	0
Net Cash Flow		2,867	(4,153)	4,453	2,089	2,967
Opening unrestricted net debt/(cash)		(21,861)	(23,728)	(22,372)	(25,425)	(27,514)
Decrease / (increase) debt		0	0	0	0	0
Other		1,000	(2,797)	1,400	0	0
Closing unrestricted net debt/(cash)		(23,728)	(22,372)	(25,425)	(27,514)	(30,489)
FUM						
Opening FUM		34	31	31	35	47
Net new money flows		(4)	0	2	11	0
Investment performance		1	(1)	2	2	1
Other		0	0	0	0	0
Closing FUM		31	31	35	47	49

Source: Company data, Edison Investment Research

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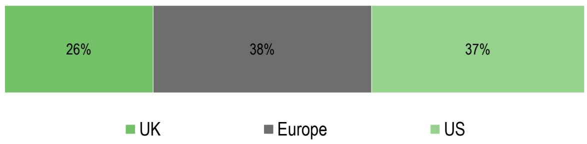
Revenue by geography



CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 11-15e	N/A	ROCE 14e	83.3%	Gearing 14e	83.3	Litigation/regulatory	◖
EPS 13-15e	16.9%	Avg ROCE 11-15e	101.1%	Interest cover 14e	101.1%	Pensions	○
EBITDA 11-15e	N/A	ROE 14e	18.0%	CA/CL 14e	N/A	Currency	●
EBITDA 13-15e	15.7%	Gross margin 14e	98.8%	Stock days 14e	N/A	Stock overhang	◖
Sales 11-15e	N/A	Operating margin 14e	34.3%	Debtor days 14e	N/A	Interest rates	○
Sales 13-15e	10.4%	Gr mgn / Op mgn 14e	2.9	Creditor days 14e	N/A	Oil/commodity prices	○

Management team

Chairman: Neil Record

Neil Record founded Record in 1983 and has been its principal shareholder and executive chairman since then. Before founding Record he was an economist at the Bank of England and worked in the commodity and currency trading department at Mars Inc's UK subsidiary.

CFO: Steve Cullen

Steve Cullen joined Record in October 2003 as financial controller, and was promoted to associate director of finance in January 2005. Before joining Record, he qualified as a chartered accountant in 1994 and gained 15 years of audit experience within practice.

CEO: James Wood-Collins

James Wood-Collins joined Record in 2008 as a senior member of the client team. He was appointed CEO in October 2010. He was previously at JP Morgan Cazenove where he had been a managing director.

Chief Investment Office: Bob Noyen

Bob Noyen joined Record in 1999 with responsibility for investment and research. He has spent 14 years at Record and previously worked as assistant treasurer for Minorco (part of Anglo American).

Top five shareholders	(%)
Neil Record	32.06
Schroder	18.32
Leslie Hill	6.86
Bob Noyen	3.97
Mike Timmins	3.14

Companies named in this report

Aberdeen Asset Management, Ashmore Group, Henderson Group, Jupiter Fund Management, Schroders, Man Group, Charlemagne, Polar Capital, Impax AM, Liontrust Asset Management, Miton Group