EDISON

Record

H1 trading update

The US is the land of opportunity

Financial services

Record's underlying PBT increased 21% in H1 due to growth in AUME and operational leverage. Although the recently announced reduction in average fees on existing business will reduce the revenue run rate, Record has done this to position itself for future expected growth; it is hopeful that new client wins will more than compensate. New business enquiries are at their highest level since 2008. Record has announced it is in advanced discussions relating to a 'handful' of new hedging mandates ranging in size from $1-10bn. Our fair value of the existing business is 33p. This increases to 49p 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	20.5	6.7	2.2	1.5	14.6	4.7
03/13	18.3	5.8	2.0	1.5	16.1	4.7
03/14e	20.0	6.7	2.3	1.5	14.0	4.7
03/15e	20.8	7.1	2.5	1.6	12.9	5.0

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

Growing pipeline of potential new mandates

Enquiries have picked up, particularly in the US where the prospect of a strengthening US dollar has encouraged many investors to explore ways of mitigating their large exposures to foreign currencies. Record has invested in building client and consultant relationships in the US over the last two years.

Advanced discussions on a 'handful' of mandates

Management has said discussions are at an advanced stage for a 'handful' of US mandates currently out to tender. These are primarily for dynamic hedging and we believe there is currently $10-15bn up for tender. Some of these have set timelines for completion, suggesting progress could be made by this fiscal year end.

Positive H1, but growth is expected to slow in H2

Underlying PBT increased 21% to £3.4m (excl. £0.3m of minority losses) in H114 as it benefited from the 13% increase in AUME in FY13. This was supported by an improvement in operating margins from 31% in H113 to 33% in H114, reflecting the inherent operational leverage within the business. Our unchanged estimates already include the full impact of the previously announced reduction in fees in H2 (see page 3), but do not assume any new business wins. We estimate a c $2.5bn increase in dynamic hedging AUME would offset the reduction in dynamic hedging fees, a fraction of the size of some of the mandates currently out to tender.

Valuation: Trading at a discount to peers

Record trades on a 27% CY14e P/E discount to smaller UK asset managers and a 38% EV/EBITDA discount; the latter reflecting a strong balance sheet with free cash resources equivalent to c 40% of market cap. We estimate a fair value of 33p (previously 37p) for the existing business alone, assuming no new mandate wins.

25 November 2013

Price	**32.16p**
Market cap	**£71m**
	US$£1.5774/£
Net cash (£m) as at 31 March 2013	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	(8.7)	(15.1)	11.5
Rel (local)	(8.1)	(17.9)	(5.0)
52-week high/low		38.0p	27.9p

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 event

Q3 trading update	17 January 2014

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Edison profile page

Record is a research client of Edison Investment Research Limited

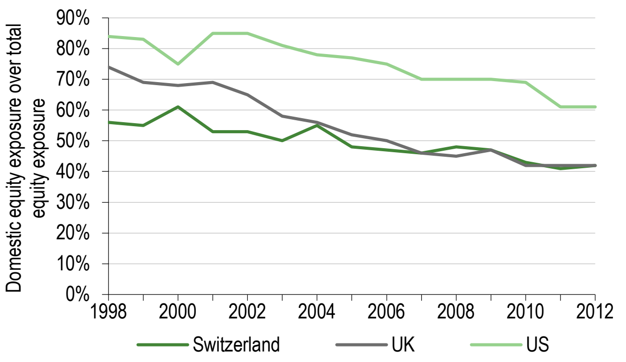
Growing pipeline of potential new mandates

The group is currently experiencing its highest level of new business enquiries since the global financial crisis. This has been largely driven by the US, as the prospect of a strengthening US dollar has encouraged many investors to explore ways to mitigate their exposure to foreign currencies. Management has said discussions are at an advanced stage for a ‘handful’ of US mandates currently out to tender. These mandates are primarily for dynamic hedging and range in size from $1bn up to $10bn. We estimate there is c $10-15bn currently up for tender. Some of these mandates have set timelines for completion, suggesting progress could be made by the end of the current fiscal year. However, as we discuss below, we are not including any of these in our forecasts until they are announced.

Pension funds are investing more in foreign markets, increasing FX exposure

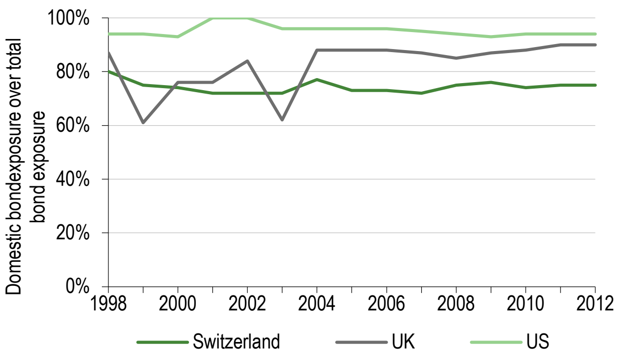
A trend increase in overseas asset allocation by investors (declining ‘home bias’) and a desire to manage risks and volatility of returns are important drivers of hedging activity. There has been a steady increase over the last decade in the weight of foreign equities in global pension assets, which 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, Record has shown that hedging a proportion of the currency risk on, say, a portfolio of equities can meaningfully reduce volatility and improve risk-adjusted returns.

Exhibit 1: Global pension funds have been reducing exposure to domestic equities…



Source: Towers Watson

Exhibit 2: …but exposure to domestic bonds has remained largely unchanged

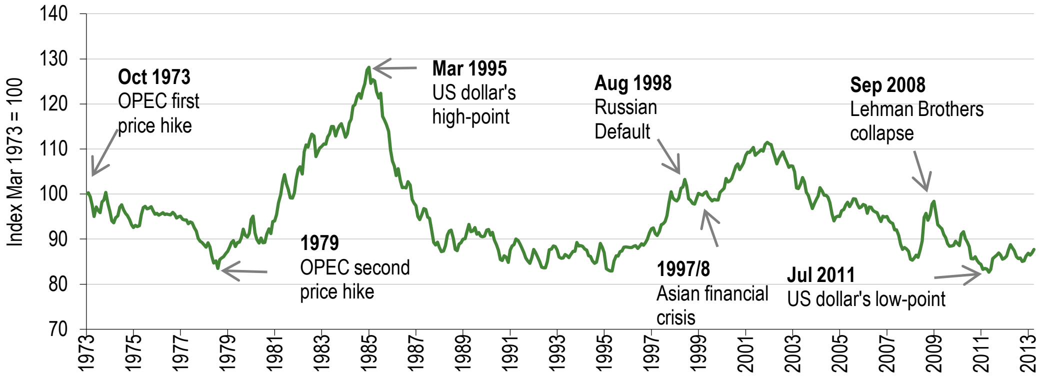


Source: Towers Watson

Weak US dollar creates an incentive 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 dollar on a trade-weighted basis since 2001 (Exhibit 3). 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. On a purchasing power parity basis, the US dollar appears fundamentally cheap. However, this cycle may reverse, potentially eroding the additional unhedged gains 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 3: 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.

Positive H1, but growth is expected to slow in H2

Underlying revenues increased by 16% to £10.2m in H114, benefiting from a19% increase in average AUME during the previous financial year. Headline revenues actually increased 13% to £9.9m, but this includes £0.3m of losses attributable to minorities (there is no tax impact on minorities). Headline revenues include the consolidation of all funds in which Record is deemed to have a controlling interest under IFRS. To calculate the performance of the underlying business, we have excluded the non-controlling investors in these seed funds on a line-by-line basis. AUME increased 8% during H114, which is positive for H2 revenues and goes some way to offsetting the recently announced reduction in average fees. Underlying profit before tax increased 21% to £3.4m, as an improvement in operating margins from 31% in FY13 to 33% in H114 offset a reduction in finance income.

Reduction in dynamic hedging fees creates headwinds for H2

The scale of opportunity in the large US market is attracting competition and creating some fee pressure. On 7 November, Record announced a reduction in the average fee it will charge both new and existing dynamic hedging clients from c 17bp to c 14bp, so that it competes effectively for new business in the large US market and maintains its policy of charging similar fees for similar mandates. In our previous update note, we adjusted our estimates to reduce annualised management fee income by c £2.6m and profit before tax by £1.8m. FY14e is affected for five months (revenues -£1.1m, PBT -£0.8m). We estimate that dynamic hedging AUME needs to increase by c $2.5bn to offset these reduced fees, a fraction of the size of some of the mandates currently out to tender (see page 2).

No new changes to estimates

We have not changed our forward estimates from our previous update note, which adjusted for the reduced fees and new mandate wins. Included in our forecasts is the $12bn in passive hedging mandates (containing one mandate that is larger than the $8-10bn indicated earlier in the year), which have started in the current quarter (Q314). We estimate this will add c £0.9m in revenues in H214 and £2.2m in FY15e (already in our numbers). Beyond this, we forecast no new mandates until they have been announced due to the irregular timing and significant variation in mandate size. However, we forecast some modest growth in AUME as a result of expected market appreciation of the underlying assets being hedged. Our assumption is 3% pa for all hedging mandates, which is consistent with our general asset management sector assumption of c 5% equity gains, applied to an estimated two-thirds of hedged assets that are equities.

Exhibit 4: 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 total 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.

Valuation and scenario analysis

Record continues to trade at a sizeable discount on a P/E basis to smaller asset manager peers (CY14 27%). The discount on an EV/EBITDA basis is starker (38% CY14), in our view reflecting a strong balance sheet, with prudent free cash resources equivalent to c 40% 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.

Fair value of the existing business (central case)

Our central case fair value of the existing business (assuming no new mandate wins) has fallen from 37p to 33p, reflecting the lower dynamic hedging fees. This assumes a CY15 P/E of 13.1x, 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. Together, the revenue impact of the one new mandate and market performance generates an improvement in operating margin reflected in forecast EBITDA growth of 7% (FY13-15e).

Exhibit 5: Trading at a discount to both smaller and larger peer group

	Market cap (£m)	EV/EBITDA		P/E		Dividend yield	
	current	2014e	2015e	2014e	2015e	2014e	2015e
Aberdeen	5,699	8.6	7.2	13.1	11.7	4.0%	4.5%
Ashmore	2,745	8.9	8.1	13.0	12.7	4.5%	4.9%
Henderson	2,478	10.3	8.8	15.5	14.2	3.8%	4.2%
Jupiter	1,796	9.3	8.1	14.1	12.7	4.0%	4.8%
Schroders	6,750	10.7	9.5	16.1	14.9	2.5%	2.8%
Man	1,530	5.4	4.8	14.0	12.9	6.1%	6.4%
Average larger asset managers		**8.9**	**7.7**	**14.3**	**13.2**	**4.1%**	**4.6%**
Charlemagne*	42	4.7	3.1	20.2	15.1	5.4%	6.6%
Polar Capital*	408	13.3	9.8	20.1	15.0	4.4%	5.8%
Impax AM*	47	--	--	13.5	12.2	2.2%	2.5%
Liontrust AM*	109	12.1	7.8	16.7	12.0	1.1%	1.5%
Miton Group*	78	--	--	20.1	18.6	1.2%	1.2%
Average smaller asset managers		**10.0**	**6.9**	**18.1**	**14.6**	**2.9%**	**3.5%**
Average for all asset managers		9.4	7.3	16.2	13.9	3.5%	4.1%
Record	**73**	**6.2**	**5.8**	**13.1**	**12.7**	**4.9%**	**5.1%**

Source: Edison Investment Research, Bloomberg. Note: *Based on Bloomberg consensus estimates as at 20 November 2013. All data has been calenderised to year end.

Scenario analysis

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 terms of timing and quantum. Dynamic hedging revenues are around two-thirds of the total revenues, with nine clients at H114 (see Exhibit 4). For that reason, we also show positive and negative scenarios, based principally on potential client gains and losses, alongside our central case.

Upside scenario fair value: 49p

Clearly, there are many different scenarios that could be modelled. For our upside scenario, we have modelled an incremental $2bn (£1.4bn) of new mandates annually into the key product of dynamic hedging (cumulative $4bn by FY15). We estimate that increments of $2bn pa during FY14 and FY15, at the reduced fees of 14bp (previously 17bp), would increase revenues by c £3.7m in FY15. 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 £1.2m. This lifts CY15 EPS to 3.7p, and using the same 10% discount to smaller asset managers, this upside scenario valuation is 49p per share. This is lower than our previous value of 56p due to the revised dynamic hedging fee scale.

Exhibit 6: Historical progression of P&L and scenario analysis

			Downside	Central case	Upside
AUME ($bn) change			(4.0)		4.0
AUME (£bn) change			(2.7)		2.7
Margin (bp)			14		14
Estimated impact on revenue (£000s)			(3,733)		3,733
	FY08	**FY13**	**FY15e**	**FY15e**	**FY15e**
Revenue (norm) ($000s)	66,229	18,258	17,077	20,811	24,544
Fixed costs ($000s)	(9,867)	(9,943)	(10,630)	(10,630)	(10,630)
Variable costs($000s)	(17,096)	(2,689)	(2,182)	(3,228)	(4,422)
Operating profit ($000s)	39,266	5,626	4,265	6,953	9,492
Margin %	59%	31%	25%	33%	39%
NPAT($000s)	27,913	4,404	3,394	5,441	7,374
EPS – fiscal year end	12.62	2.01	1.55	2.48	3.36
% difference to base case EPS			**-38%**	**0%**	**36%**
EPS – calendarised			1.28	2.53	3.73
Fair value (p)			**17**	**33**	**49**

Source: Company data, Edison Investment Research. Note: Excludes minority interests.

Downside scenario fair value: 17p

In the downside scenario, we have modelled a similar scenario, but with $2bn in annual outflows from dynamic hedging mandates (cumulative $4bn by FY15). The annualised reduction in revenue this generates (£3.7m) compares with the £5.6m generated by Record's single largest client in FY13. We assume no decrease in fixed costs, but a fall in variable costs from £3.2m to £2.2m to reflect the group's flexible variable remuneration scheme (see our initiation note). 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 CY15 fair value has reduced from 19p to 17p (CY15 EPS 1.3p and 10% discount to the CY14 average P/E for smaller asset managers of 13.1x).

Exhibit 7: Financial summary

Record	£'000s	2011	2012	2013	2014e	2015e
March		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue (norm)		28,169	20,542	18,258	19,953	20,811
Revenue		28,196	20,535	18,552	19,953	20,811
Operating expenses		(15,652)	(13,875)	(12,349)	(13,184)	(13,672)
EBITDA (norm)		12,517	6,667	5,909	6,768	7,138
Depreciation & amortisation		(191)	(106)	(283)	(220)	(185)
Operating profit (norm)		12,326	6,561	5,626	6,549	6,953
Goodwill and amortisation of acquired intangibles		0	0	0	0	0
Exceptionals		27	(7)	294	0	0
Other		0	0	0	0	0
Operating Profit		12,353	6,554	5,920	6,549	6,953
Net Interest		184	155	158	180	192
Other						
Profit Before Tax (norm)		12,510	6,716	5,784	6,728	7,145
Profit Before Tax (FRS 3)		12,537	6,709	6,078	6,728	7,145
Tax		(3,603)	(1,803)	(1,450)	(1,605)	(1,705)
Profit After Tax (norm)		8,915	4,911	4,404	5,123	5,441
Profit After Tax (FRS 3)		8,934	4,906	4,628	5,123	5,441
Average Diluted Shares Outstanding (m)		221.3	220.3	219.1	219.1	219.1
Basic EPS - Company reported		4.0	2.2	2.0	2.3	2.5
Diluted EPS - Company reported		4.0	2.2	2.0	2.3	2.5
Adjusted diluted EPS – Edison*		4.0	2.2	2.0	2.3	2.5
Dividend per share - proposed (p)		4.6	1.5	1.5	1.5	1.6
Revenue Margin - AM (%)		14.3	11.3	8.5	7.4	6.4
EBITDA Margin norm. (%)		44.4	32.5	32.4	33.9	34.3
Operating Margin norm. (%)		43.8	31.9	30.8	32.8	33.4
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	36,849	39,273
Debtors		6,904	5,070	5,569	5,989	6,247
Cash		24,728	24,572	29,025	30,816	32,983
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)	(3,657)	(3,779)
Creditors		(4,089)	(2,494)	(2,672)	(2,872)	(2,994)
Short term borrowings						
Other		(1,849)	(948)	(785)	(785)	(785)
Net Assets		30,098	28,616	32,288	34,128	36,286
CASH FLOW						
Operating cash flow		8,241	2,393	5,609	5,122	5,491
Capex		(85)	(52)	(63)	(48)	(41)
Cash flow from investing activities		(491)	93	149	0	0
Dividends		(5,723)	(7,371)	(1,645)	(3,283)	(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	1,791	2,167
Opening unrestricted net debt/(cash)		(21,861)	(23,728)	(22,372)	(25,425)	(27,216)
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)	(27,216)	(29,383)
FUM						
Opening FUM		34	31	31	35	50
Net new money flows		(4)	0	2	14	0
Investment performance		1	(1)	2	2	1
Other		0	0	0	0	0
Closing FUM		31	31	35	50	52

Source: Company data, Edison Investment Research. Note: Adjusted excludes minorities.

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