Record

HY results to September 2014

Steady profits in H115

Financial services

Underlying profits in H115 were flat compared with H114. Revenue from mandate wins in H214 together with cost savings went some way in offsetting revenue declines from re-pricing Record's dynamic hedging product and the previously known loss of a large dynamic hedging client on 1 April 2014. Record reports it is experiencing a good level of new business enquiries across all geographies and products. More divergent monetary policy and wider interest rate differentials could produce more currency volatility and demand for its hedging and currency for return strategies. Our estimates do not include new mandate wins (or losses) and would benefit from any conversion of this increased market interest.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/13	18.3	5.8	2.01	1.50	17.9	4.2
03/14	20.3	6.9	2.43	1.50	14.8	4.2
03/15e	19.1	6.0	2.19	1.50	16.4	4.2
03/16e	19.6	6.1	2.22	1.50	16.2	4.2

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

H115 highlights

Record overcame the negative effects of the loss of a large dynamic hedging client at the start of H115 and the full half-year impact of lower fees on its key dynamic hedging contracts to produce pre-tax profits just 2% lower than those of H2 of the previous year. Good cost control, net inflows in passive hedging mandates from existing clients and movements in equity and other markets increasing the size of mandates contributed to this performance.

Outlook

Record notes that a more divergent monetary policy environment and the resultant increase in interest rate differentials and currency volatility could increase demand for its hedging and currency for return strategies. It continues to market its services actively and reports an increased level of enquiries. Its more recent higher-margin currency for return product initiatives have produced good performances and are approaching the three-year track record of performance, which many consultants and investors consider necessary before they make an investment. It has high hopes for its flagship multi-strategy product, though at the moment it is small.

Valuation: Discount to peers if cash is included

Record is currently trading on a P/E ratio for the current year of around 16x, similar to the average for the current year of other UK asset managers, though there is a wide range of 9-27x according to Bloomberg data. Record's EV/EBITDA of around 9x for the current year is 17% less than its UK peers, though there is a wide range of 7-21x. Its yield of around 4% is in line with the sector average.

27 November 2014

Price	**35.9p**
Market cap	**£80m**
	US$1.62/£
Net cash (£m) at 30 September 2014 (including restricted cash and short-term money market instruments)	27.7
Shares in issue	221.4m
Free float	47%
Code	REC
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	11.2	13.0	10.8
Rel (local)	5.7	13.8	9.7
52-week high/low		43.8p	28.3p

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 update (estimate)	January 2015

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Edison profile page

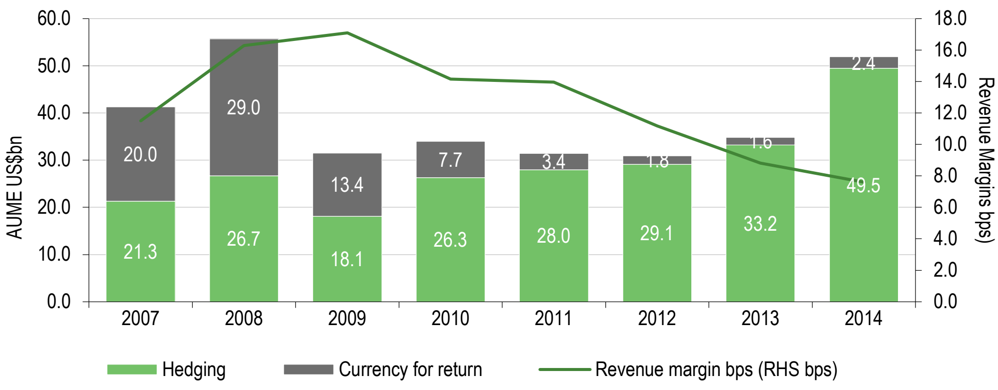
Record is a research client of Edison Investment Research Limited

Strategic update for Record

When Record was listed on the LSE in 2007 it had a fast-growing 'Currency Alpha' product to attract investors. 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. Record was not the only organisation to suffer a fall in high-margin 'Quant type' funds, with MAN Group's AHL also suffering from adverse investor sentiment following a period of performance less than anticipated by investors.

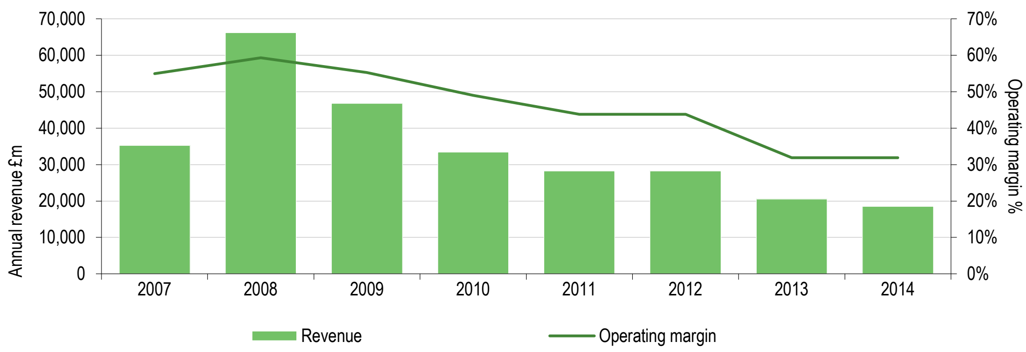
Since 2009, Record has focused on continuing to grow the hedging customer base, while increasing the diversity of its currency for return strategies, as we explain below. At the same time it has been rigorous in controlling costs, especially performance bonuses. The overall result has been an impressive performance from Record to recover from the loss of assets from its most profitable mandates, as we show in the following charts. Since 2008 its revenue margin (excluding performance fees) has declined from 16bp to 8bp in the year to 31 March 2014. The current operating margin of around 30% is comparable to other asset management firms.

Exhibit 1: Record AUME $bn, 2007-14



Source: Record, Edison Investment Research

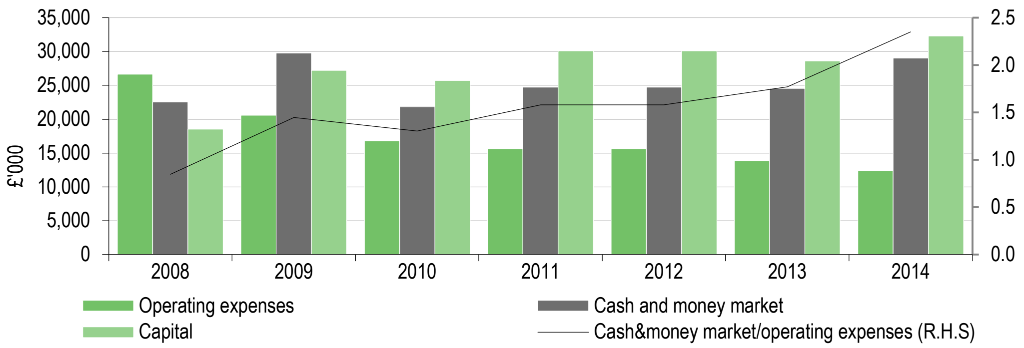
Exhibit 2: Record revenue and operating margin 2007-14



Source: Record, Edison Investment Research

Record has also been successful at managing its capital base and cash resources, which it considers vital to reassure its customers. For asset managers like Record, regulators compare capital resources to operating expenses to ensure that if a firm fails it has enough resources to make an orderly wind-down of its business. Record has built up its capital resources so they are the equivalent of 2.4x operating expenses (including variable compensation), considerably in excess of the regulatory requirements of 25% of operating expenses (excluding variable compensation). The chart below shows its progress.

Exhibit 3: Record capital resources and operating expenses



Source: Record, Edison Investment Research

H115 results

The key financials from the H115 results are shown on the following page. The key features are:

- Record overcame the negative effects of the loss of a large dynamic hedging client at the start of H115 and the full half-year impact of lower fees on its key dynamic hedging contracts to produce pre-tax profits just 2% lower than those of H2 of the previous year. Good cost control, net inflows in passive hedging mandates from existing clients and movements in equity and other markets increasing the size of mandates contributed to this performance.
- Average AUME in H1 of this financial year was up 45% compared with the comparable period of the previous year and up 11% compared with the second half of the previous year, which saw good inflows into hedging products that have not recurred in H1 of this financial year.
- The average fee rates for Record in H1 of this financial year were 32% lower than in the comparable period of the previous one. This was predominantly the result of the reduction in dynamic hedging fee scales announced in November 2013, intended to align existing clients' fees with those being proposed to potential new clients, as well as the gradual shift in product mix towards the lower-margin passive hedging product. Passive hedging accounted for 74% of average AUME in H115 versus 61% in H114.
- The combination of rising average AUME but lower average fee rates results in underlying revenues 3% lower in H115 compared with H114. However, once revenue for non-controlling interests in seed funds is included, total revenue rose 2% H115 on H114 and was flat compared with H214. Like many asset management firms, Record invests in various seed funds to produce a track record of performance to show to potential clients. Accounting rules require it to consolidate all the revenues of these funds while it still owns a majority of the funds, with the non-controlling interest deducted lower down the profit and loss account in determining net profit attributable to shareholders.
- After deducting the revenue from non-controlling interests in seed funds, underling PBT was flat H115 on H114 and slightly down, by 2%, on H214.

Exhibit 4: Record H115 results

	H114	H214	H115	H115/H114	H115/H214
End-period AUME $bn					
Dynamic hedging	12.0	11.3	10.6	(12%)	(6%)
Passive hedging	22.9	37.9	39.1	71%	3%
Currency for return	2.6	2.4	2.6	0%	8%
Cash	0.2	0.3	0.3	50%	0%
Total	**37.7**	**51.9**	**52.6**	**40%**	**1%**
Average AUME $bn					
Dynamic hedging	11.7	11.9	11.0	(6%)	(8%)
Passive hedging	22.4	33.2	39.3	75%	18%
Currency for return	2.4	2.6	2.5	4%	(4%)
Cash	0.2	0.2	0.3	50%	50%
Total	**36.7**	**47.9**	**53.1**	**45%**	**11%**
Average management fee bp (annualised)					
Dynamic hedging	18	14	14	(22%)	0%
Passive hedging	3	3	3	0%	0%
Currency for return	18	17	16	(11%)	(6%)
Cash	0	0	0		
Average	**9**	**6**	**6**	**(33%)**	**(9%)**
Average rate £1=$	1.55	1.56	1.60	3%	3%
Reported profit and loss account (£000s)					
Dynamic hedging	6,558	5,314	4,722	(28%)	(11%)
Passive hedging	2,357	3,371	3,825	62%	13%
Currency for return	1,425	1,246	1,160	(19%)	(7%)
Management fees	10,340	9,931	9,707	(6%)	(2%)
Other income	(127)	122	193		
Underlying revenue	10,213	10,053	9,900	(3%)	(2%)
Revenue from non-controlling interests in seed funds	(341)	(3)	158		
Total revenue	9,872	10,050	10,058	2%	0%
Cost of sales	(100)	14	(64)		
Gross profit	9,772	10,064	9,994	2%	(1%)
Administrative expenses	(6,769)	(6,643)	(6,497)	(4%)	(2%)
Operating profit	3,003	3,421	3,497	16%	2%
Finance income	50	63	70		
Profit before tax	3,053	3,484	3,567	17%	2%
Taxation	(781)	(713)	(717)		
Profit after tax	2,272	2,771	2,850	25%	3%
Minority interests	333	31	(158)		
Attributable net profit	2,605	2,802	2,692	3%	-4%
Underlying					
Underlying revenue	10,213	10,053	9,900	(3%)	(2%)
Cost of sales	(100)	14	(64)		
Gross profit	10,113	10,067	9,836	(3%)	(2%)
Administrative expenses	(6,769)	(6,643)	(6,497)	(4%)	(2%)
Finance income	50	63	70		
Profit before tax	3,394	3,487	3,409	0%	(2%)

Source: Record, Edison Investment Research

Opportunities

Record hopes that divergence in global monetary policy will lead to greater demand for its hedging and currency for return products as interest differentials and currency volatility increase. It also hopes that a prolonged period of US dollar strength will encourage US clients to use Record to hedge any gains they have made in their foreign assets. Record has been putting considerable effort into selling its services to potential US clients, and given the size of the US market, the opportunity is clearly large. It sees a particular opportunity among the US endowments and foundations, which have comparatively large exposure to international equities.

Record has been expanding its produce suite in recent years, especially as regards the relatively high-margin currency for return products, as we show in the following table. These products are currently around 5% of AUME ($2.6bn), but in the past have been much higher, over 50% in 2008. Record believes that currencies can be considered as a separate asset class by investors and can produce good returns in their own right. Record does not attempt to predict currencies, but rather looks for systematic features of currency markets that it can exploit to produce consistent returns for its customers.

Exhibit 5: Currency for return diversification

Strategy	First live programme
FRB Alpha	February 2003
FRB Beta	September 2009
Emerging markets	November 2009
Currency momentum	July 2012
Currency value	July 2012
Multi-strategy	July 2012

Source: Record

Record's first currency for return product, and the one with which it initially had so much success, was the FRB Alpha strategy. This was the 'forward rate bias' – the tendency of higher-yielding currencies to outperform lower-yielding ones. The 'beta' version was introduced in 2009 when a series of forward rate bias indices were developed in conjunction with FTSE. Other strategies it has introduced include:

- the emerging markets strategy, which attempts to capture the long-term appreciation potential of emerging market currencies;
- the currency momentum strategy, which attempts to exploit the observation that tomorrow's price movement is likely to be in the same direction as today's;
- the currency value concept, which attempts to utilise the concept that developed market currencies typically vary around a long-term 'fair value'; and
- the multi-strategy funds, which invest in all of these currency for return strategies.

Performance has been good for the recently introduced funds, as we show in the table below.

Exhibit 6: Performance of currency for return strategies

	Inception to date	Inception to date
	Cumulative	Annualised
FRB	4.4%	2.0%
Emerging markets	4.1%	1.9%
Currency momentum	5.7%	2.6%
Value	5.4%	2.4%
Multi-strategy	5.5%	2.5%

Source: Record

An annualised return of around 2% is relatively modest by historical standards of asset returns, but it is comparable if not slightly higher than many developed market bond yields at the moment and offers investors diversification benefits. Furthermore, because currency mandates can be run on an "unfunded basis", they lend themselves well to gearing, with a consequent increase in returns (and risk).

If Record were to increase the amount invested in its currency for return strategies by say £1bn, at an average margin of 16bp annualised revenue would increase by around £1.6m, 8% of expected revenue in the year to March 2015. We have not included such growth in our forecasts as we are waiting for more signs that it will occur, but it represents potential upside to our forecasts.

Valuation

Record is currently trading on a P/E ratio for the current year of around 16x, similar to the average for the current year of other UK asset managers, though there is a wide range of 9-27x according to Bloomberg data. Record is trading at around 9x EV/EBITDA for the current year, which is around 17% less than its UK peers, although there is a wide range of 7-21x. Its yield of around 4% is in line with the sector average.

Financials

Estimate update and outlook

We have revised our forecasts after these results and have increased our EPS forecasts by 15% for the year to March 2015 and 16% for the year to 2016, but now expect an unchanged dividend for the next two years. The higher EPS forecasts are the result of slightly higher revenue expectations, largely because of the weakness of sterling vs the US dollar, cost control slightly better than we expected and a slightly lower tax charge.

Our forecasts for 2015 and 2016 do not include any new mandates, other than those announced in H115, average underlying fund performance of 2.4% in 2015 and 2.9% in 2016 and an average revenue margin fall from 8bp in 2014 to 6bp in 2015, after which we expect it to stabilise in 2016. We expect a slight fall in cost in 2015 of 1%, but a resumption of cost growth in 2016 or around 4%. We expect that Record will pay an unchanged dividend of 1.5p per share, which will be covered by earnings, with cash and equivalents and money market instruments showing a slight rise to £29m at the end of March 2015.

Exhibit 7: Earnings revisions

	Revenue (£m)		% chg.	PBT* (£m)		% chg.	EPS* (p)		% chg.	DPS (p)		% chg.
	Old	New		Old	New		Old	New		Old	New	
03/14	20.3	20.3		6.9	6.9		2.43	2.43		1.50	1.50	
03/15e	18.4	19.1	4	5.4	6.0	11	1.90	2.19	15	1.57	1.50	(4)
03/16e	18.7	19.6	5	5.4	6.1	13	1.92	2.22	16	1.62	1.50	(7)

Source: Company data, Edison Investment Research. Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Exhibit 8: Financial summary

£000s	2012	2013	2014	2015e	2016e
Year end March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue (norm)	20,542	18,258	20,286	19,107	19,604
Revenue	20,535	18,552	19,922	19,265	19,604
Operating expenses	(13,875)	(12,349)	(13,190)	(13,003)	(13,478)
EBITDA (norm)	6,667	5,909	7,096	6,104	6,125
Depreciation & amortisation	(106)	(283)	(308)	(312)	(163)
Operating profit (norm)	6,561	5,626	6,788	5,881	5,962
Normalised operating margin %	31.9%	30.8%	33.5%	30.8%	30.4%
Goodwill and amortisation of acquired intangibles	0	0	0	0	0
Seed fund consolidation adjustment	(7)	294	(364)	158	0
Other	0	0	0	0	0
Operating Profit	6,554	5,920	6,424	6,039	5,962
Net Interest	155	158	113	140	140
Other					
Profit Before Tax (norm)	6,716	5,784	6,901	6,021	6,102
Profit Before Tax (FRS 3)	6,709	6,078	6,537	6,179	6,102
Tax	(1,803)	(1,450)	(1,494)	(1,242)	(1,220)
Profit After Tax (norm)	4,911	4,404	5,324	4,811	4,882
Profit After Tax (FRS 3)	4,906	4,628	5,043	4,937	4,882
Average Diluted Shares Outstanding (m)	220.3	219.1	218.7	219.5	219.5
Basic EPS - Company reported (p)	2.2	2.0	2.5	2.2	2.2
Diluted EPS - Company reported (p)	2.2	2.0	2.5	2.2	2.2
Adjusted diluted EPS - Edison (p)	2.23	2.01	2.43	2.19	2.22
Dividend per share - proposed (p)	1.50	1.50	1.50	1.50	1.50
Revenue Margin - AM (%)	11.2	8.8	7.6	5.9	5.9
EBITDA Margin norm. (%)	32.5	32.4	35.0	31.9	31.2
Operating Margin norm. (%)	31.9	30.8	33.5	30.8	30.4
BALANCE SHEET					
Fixed Assets	2,398	1,108	3,732	3,524	3,371
Intangible Assets	1,140	963	734	559	426
Tangible Assets	183	140	86	53	32
Investments	1,075	5	2,912	2,912	2,912
Current Assets	29,675	34,637	32,835	32,982	33,143
Debtors	5,070	5,569	5,646	5,460	5,556
Cash	24,572	29,025	11,503	13,475	15,179
Money market instruments	0	0	15,488	15,488	15,488
Other	33	43	198	198	198
Long Term Liabilities	(15)	0	0	0	0
Long term borrowings	0	0	0	0	0
Other long term liabilities	(15)	0	0	0	0
Current Liabilities	(3,442)	(3,457)	(3,660)	(3,578)	(3,620)
Creditors	(2,494)	(2,672)	(2,706)	(2,624)	(2,666)
Short term borrowings	0	0	0	0	0
Other	(948)	(785)	(954)	(954)	(954)
Net Assets	28,616	32,288	32,907	34,566	36,171
CASH FLOW					
Operating cash flow	2,393	5,609	5,167	5,125	4,851
Capex	(52)	(63)	(25)	(15)	(9)
Cash flow from investing activities	93	149	(18,376)	140	140
Dividends	(7,371)	(1,645)	(4,898)	(3,278)	(3,278)
Other financing activities	784	403	610	0	0
Other	0	0	0	0	0
Net Cash Flow	(4,153)	4,453	(17,522)	1,972	1,704
Opening unrestricted net debt/(cash)	(23,728)	(22,372)	(25,425)	(11,503)	(13,475)
Decrease / (increase) debt	0	0	0	0	0
Other	(2,797)	1,400	(3,600)	0	(0)
Closing unrestricted net debt/(cash)	(22,372)	(25,425)	(11,503)	(13,475)	(15,179)

Source: Edison Investment Research, company accounts

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