AFH Financial Group

2014 results

Acquisition and organic opportunities

Financial services

AFH has shown that being an IFA consolidator can work. 2014 saw heavy investment in control functions (which should now increase at a much slower pace) and the FCA review of regulatory authorisations taking much longer than expected (a market-wide phenomenon). Despite these drags, profits still grew, and looking forward much more of the revenue growth is expected to drop down to profit. At end October the group had £5.7m in cash to fund further acquisitions. There has been evidence of organic growth. In 2014 c 15% of the recurring revenue increase was due to acquisitions made during the year.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
10/13	10.8	1.1	5.80	1.25	26.3	0.8
10/14	15.0	1.4	5.83	1.50	26.2	1.0
10/15e	19.0	2.0	8.21	1.75	18.6	1.1
10/16e	23.4	2.9	11.95	2.00	12.8	1.3

Note: *PBT and EPS are normalised, excluding intangible amortisation (a significant item for trends in AFH), exceptional items and share-based payments.

2014 results

Revenue was up 40% to £15.0m with recurring revenue up c 50% to £8.2m. Organic growth was the key driver, with just £0.4m of the £2.7m increase in recurring revenue from deals completed in the year. The costs of sales ratio was 48.7% (2013 47.8%) while the administration expenses ratio was 41.7% (2013 41.4%). The amortisation of intangibles rose to £343k (2.3% of revenue in 2014, 0.8% in 2013) reflecting the full period effect of historic deals. It was a little below our forecasts (£500k) as there were no acquisition write-downs in the period. Statutory profit was £861k including £197k of AIM listing costs. Adjusting for this, profit before tax increased marginally. The dividend was 1.5p, up 20%. Cash was £5.7m at 31 October 2014 (2013: £4.3m). We believe over £2m has already been deployed in deals this year. Adviser numbers increased to 136 (31 October 2013 122) and funds under management exceed £1 billion in January 2015.

2015 outlook

Since the year end, one deal completed in November and four deals in February; total consideration of £4.8m. We estimate these will add at least £1.6m to full year revenue and pre-tax profits of £0.4m - £0.5m. There remain considerable resources for further deals. We are forecasting organic revenue growth of 15% driven by additional advisers recruited individually via AFH's business development team, and increased customer activity post changes in pension rules. Having invested in infrastructure in 2014 we expect improved operational gearing in 2015.

Valuation: Upside from deploying cash

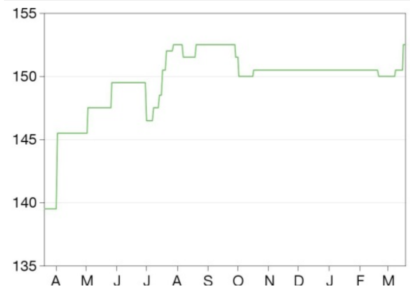
We continue to forecast an existing business basis (ie we only include acquisitions when made). The average of our valuation approaches is 201p, which has increased since our last report (153p) largely due to (i) inclusion of deals and (ii) rolling forward the valuation point by a year. We believe deploying existing cash resources could add 20-30p to the valuation.

20 March 2015

Price	**152.50p**
Market cap	**£30m**

Net bank cash (£m) at end October 2014 (adjusted for cash paid for deals and equity issue since)	3.7
Shares in issue	19.5m
Free float	32%
Code	AFHP
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.3	1.3	9.3
Rel (local)	0.0	(5.2)	3.2
52-week high/low		152.50p	139.50p

Business description

AFH Financial Group is a national independent financial advisory (IFA) and discretionary wealth management firm based in Bromsgrove. It has actively consolidated in the fragmented IFA market, making 29 acquisitions since floating in June 2011

Next events

AGM	23 April 2015

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Investment summary

Company description: Market growth and IFA consolidator

AFH is an AIM-listed, Midlands-headquartered national IFA and wealth manager. We believe this market has double-digit long-term growth potential. AFH has c 40k clients (c 20k active) and funds under management in excess of £1bn, including nearly £180m in self-run funds. AFH is growing both organically and through consolidation. Organic growth is being driven by a development team targeted to add an additional three to five advisers per month. On acquisitions, AFH is achieving economies of scale (mid and back offices centralised in Bromsgrove). Recent deals have had around 50% of consideration linked to achieved earnings (typically over two years) with the vendor bearing the financial risk of underperformance. There is careful target selection (to ensure cultural fit) and due diligence (to ensure no material prior mis-selling risk).

AFH's 136 (end 2013 122) advisers all operate under the same brand, culture and risk control systems with economies of scale from centralised administration and compliance. AIM-quoted networks such as Lighthouse are more dependent on a network of individual businesses operating much more independently and buying services from the cheapest network provider. Private equity backed companies such as Moneygate have been active consolidators, but have had a much more aggressive stance to gearing.

Valuation: Upside from acquisitions

Our forecasts continue to reflect organic growth and completed deals only. This is highly conservative given that AFH has already raised equity and bond finance to fund further acquisitions. Our stand alone value is 201p (up from our last report as we have rolled forward valuation years and included the effect of announced deals). We expect further deals, as at end FY14 AFH had £5.7m of cash supplemented by a £2.1m bond issue and a £0.2m equity issue (both of which are in our forecasts). These new funds have been partially deployed in deals involving initial cash consideration of c £2.2m.

We estimate that every £1m of cash deployed could see incremental ongoing revenue of c £0.3m and profits of £0.1m (assuming better than average margin given economies of scale). Deploying all the existing cash would thus see an uplift of approximately a quarter in 2016e profits and still leave the group with 28% debt to equity gearing and a 2015e EBITDA interest coverage of nearly 10x.

Financials: Upside from organic growth and acquisitions

Looking forward, our forecasts comprise 15% organic revenue growth in 2015 and 20% in 2016, which should prove conservative given expected mid-single digit market volume growth and the effort AFH has put into its business development team. We have included nothing for deals other than those already announced where we have built in revenue at approximately one third of the total consideration. After a year of investment in infrastructure in 2014, we expect improvements in operational gearing going forward.

Sensitivities

The key sensitivities are: mis-selling (claims to date have been minimal and the risk in acquired portfolios is largely kept by the vendors), acquisition risk (the track record has been good with consideration significantly deferred and based on actual performance, and AFH has pre-funded acquisitions with equity issuance rather than introducing excessive gearing), regulation (which also provides opportunities), investor confidence and stock illiquidity.

Company description

AFH provides a broad range of traditional IFA individual services, including investment advice, planning and tax management through 136 self-employed advisers. Unusually, it also provides discretionary and advisory investment management services and the regulatory hurdles that AFH went through in 2007 now present a major barrier to entry for smaller IFAs trying to copy this vertically integrated model. Total employed staff of 160 provide the investment management service as well as administration, compliance, and advice control for the advisers. Management has been investing heavily in organic growth, among other things, building a business development team to recruit IFAs. We believe the majority of the growth has come from acquisitions. AFH has no ambitions for mega deals but rather adds sequentially in digestible bites (largest deal to date < 5% of the market capitalisation at the time). Cultural and operational fit are important and AFH has built an experienced team in managing integration. Several deals have been of portfolios rather than whole business, which together with the expected careful due diligence, should moderate the risk of prior mis-selling charges.

Services

AFH offers a broad range of services, primarily to the personal sector in the UK.

- Independent financial advice for personal customers including investment advice, planning for retirement, funding for long-term care, life- and non-life insurance, mortgage/re-mortgages, and equity release. This unit accounts for the significant majority of revenue.
  - AFH views itself as a branded, national IFA where the self-employed advisers are part of a corporate culture, with compliance, risk and branding functions all centralised. AFH does not micro-manage its advisers (for example it does not monitor the number of meetings). This approach contrasts with a ‘network’ such as Lighthouse, where independent IFAs use a central resource for compliance, IT and insurance indemnity support but typically operate individual brands and product prioritisation. Network providers to the independent IFAs are seeing margins come under pressure, as IFAs seek the lowest-cost provider. AFH currently provides full independent advice using bought-in computer software combined with technical and investment teams to identify investments and product providers that fit the ‘best’ for its clients. The business has been classified by the FCA as C4 – its lowest risk assessment.
  - The AFH fee structure is outlined in separate fee agreements with the customer and includes ad valorem (ie % AUM) upfront intermediation fees (typical average 2.1-2.2% marginally down on 2013 2.4%) for specific investment decisions. Ad valorem fees are considered appropriate because risk is likely to be related to the size of the investment (rather than fees being administration cost based); ongoing ad valorem intermediation fees for specific investment decisions (typically c 1%). Recurring revenue is currently running at c £8m annually and accounted for 55% of FY14 revenue (£5.5m and 50% in 2013); and non-intermediation (ie advice) fees, which can be time based, number of meetings based or fixed fee (the majority of the customers choose the latter). Procedures are in place to ensure there is broad equivalency between the charging options so all customers are treated fairly.
  - AFH offers an intermediate service (eg limited meetings) for portfolios up to £50k, with full service beyond that.
  - AFH has 136 self-employed qualified IFAs who receive a revenue share of 60% of self-originated business and 40% of AFH generated business. To grow organically, AFH has business development managers actively seeking individuals to recruit at a target rate of

three to five new advisers every month. Our forecasts have been conservatively set below this level allowing room for upgrades.

- Discretionary and advisory investment management, including stockbroking services (since late-2009), where it has 20 staff in investment management. AFH is unusual in offering discretionary management services (less than 2% of IFAs in the UK are currently authorised to do so). The capital adequacy requirements and minimum professional staff training requirements mean many smaller IFAs will not consider it. AFH believes it helps capture the whole value chain and as a service, not a product, it does not conflict with its independent adviser status. Management fees are typically 1% of AUM for either discretionary or advisor services.
- Funds: We estimate the group earns a run-rate revenue of over £1m from fund management.
  - "AFH Strategic Core Fund", has c £180m in funds, provides access to the discretionary investment management team for investors with relatively modest portfolios. It also means that all clients with investments in this fund are simultaneously re-positioned at the same price. This avoids the problem of trying to change a number of portfolios individually, which could see prices move against later transactors. The fund also allows access to more sophisticated products than individual investors may access.
  - In November 2012, the group launched an open-ended high-yield fund, the "AFH High-Yield Property Fund", with current balances around £26m (2013 £17m). The fund has target yields of between 6% and 8% looking at properties with a value of £2-5m, ie a scale above most private investors, but below major property funds.
- Tax and estate planning, including estate preservation and trust planning, inheritance tax planning, and tax-efficient investment solutions. AFH's technical team is 20 strong.
- AFH launched its legal division in July 2013. It has recruited a solicitor who has been working in the technical team, supporting advisers in trust and estate planning work. We believe revenue remains modest from this ancillary service.
- Corporate solutions, including pension planning for directors, company pension schemes, insurance protection for business and key personnel, business financing solutions, and assistance with government grants. This unit accounts for 2-3% of group revenue.

Financial performance compared with selected peers

Exhibit 1 shows some of the key financial indicators for AFH and some of its quoted IFA peers and those that investors may consider as having the nearest business models. We highlight that AFH is clearly differentiated from its peers:

- AFH's cost income ratio is below the peer average.
- AFH has shown better than peer-average growth.
- Relative to peers, especially consolidators, AFH has an extremely high net asset base.
- There remains considerable upside potential (taking Saunderson House (SH) as an example). SH is focussed on London professionals but its model of building and growing both clients and staff, have read across to AFH.

Moneygate and Bellpenny remain the more active consolidators in the IFA space and are backed by private equity. Moneygate was loss making in FY13 but, as reported in the Citywire article, it had moved into profitability in Q413 and had FUM of £1.25bn. Perspective Financial changed its strategy early in 2014 (after an aborted AIM float) and ceased buying new businesses at that time. The weakness in this operation only emphasises how differently it has been managed versus AFH.

Exhibit 1: Peer comparators using latest published information

(£m)	AFH			Lighthouse Group		Frenkel Topping*		Saunderson House		Moneygate		Perspective Financial Group**	
	2012	**2013**	**2014**	**2013**	**2014**	**2012**	**2013**	**2012**	**2013**	**2012**	**2013**	**2012**	**2013**
Revenue	7.2	10.8	15.0	47.9	46.8	4.8	5.5	18.5	20.7	8.3	13.5	20.4	16.9
Cost of sales	(3.5)	(5.2)	(7.3)	(32.9)	(33.4)	(1.9)	(2.0)	0.0	0.0	(5.7)	(10.6)	(1.3)	(1.5)
Administration expenses	(3.4)	(4.6)	(6.6)	(15.3)	(12.7)	(1.8)	(2.1)	(14.4)	(16.7)	(5.6)	(4.5)	(18.1)	(19.1)
Operating profit	**0.3**	**1.1**	**1.1**	**(0.3)**	**0.7**	**1.0**	**1.4**	**4.1**	**4.0**	**(3.0)**	**(1.5)**	**1.0**	**(3.7)**
Financing costs	0.0	0.0	0.0	(0.1)	(0.1)	0.0	0.0	0.0	0.0	(0.1)	(0.4)	(1.5)	(1.3)
Pre-exceptional profits	0.3	1.0	1.1	(0.4)	0.6	1.0	1.4	4.1	4.0	(3.1)	(1.9)	(0.5)	(5.0)
Other gains/loss and exceptionals	0.0	0.0	(0.2)	(1.3)	0.0	0.0	0.0	(0.3)	0.0	0.0	0.5	(0.9)	(0.4)
Pre-tax profit	**0.3**	**1.0**	**0.9**	**(1.6)**	**0.6**	**1.0**	**1.4**	**3.8**	**4.0**	**(3.1)**	**(1.4)**	**(1.5)**	**(5.4)**
Amortisation of intangibles	0.0	(0.1)	(0.4)	(0.4)	(0.4)	0.0	0.0	0.0	0.0	(0.9)	(0.4)	(4.1)	(3.4)
Net assets	**4.0**	**7.3**	**10.5**	**5.6**	**6.0**	**6.1**	**7.5**	**2.7**	**3.5**	**(2.6)**	**(2.4)**	**(6.5)**	**(11.6)**
Average number of staff	67.0	101.0	141.0	166.0	157.0	51.0	47.0	107.0	109.0	56.0	54.0	250.0	225.0
Ratios													
Revenue per employee (£k)	107.5	106.9	106.4	288.5	298.1	93.8	117.0	172.9	189.9	148.2	250.0	81.5	75.1
Costs per employee (£k)	(102.4)	(96.3)	(98.6)	(290.2)	(293.8)	(72.5)	(87.2)	(134.6)	(153.1)	(201.8)	(277.9)	(77.6)	(91.3)
Profit per employee (£k)	5.1	9.9	6.4	(9.5)	3.5	19.6	29.8	35.5	36.7	(55.4)	(25.7)	(6.0)	(24.1)
Cost income ratio (%)	95%	90%	93%	101%	99%	77%	75%	78%	81%	136%	111%	95%	122%
Cost income ratio ex amortisation intangible (%)	95%	89%	90%	100%	98%	77%	75%	78%	81%	125%	108%	75%	102%

Source: Company report and accounts (for non-public companies latest available at Companies House). Note: *Frenkel Topping 2014 results due 23 March. **PFS changed estimation techniques of new business in 2013 reducing revenue by £2.2m.

UK IFA market

Some commentators predicted that RDR would cripple the IFA market, but the evidence to date suggests it has not. We believe AFH's market offers long-term double-digit growth in investable assets. There remains a strong market from those needing advice, but have below the typical £100k+ portfolios targeted by wealth managers. The key drivers to this growth are:

- The ageing UK population has a need for self-provision for an increasing number of years in retirement. Defined benefit schemes are in terminal decline and much of the £250,000 average value per historic scheme will now have to come from personal savings. Changes to public sector pensions could have a dramatic effect.
- The retirement funds in initial years are small. A customer saving £250 per month for retirement starting at 30 would build a pot of £270k at 65 (assuming 5% CAGR returns), but this fund does not exceed £100k until the 21st year (ie when the customer is over 50). Some investors will be happy with platform solutions, but we believe that many will be uncomfortable managing material portfolios completely on their own, and will therefore seek advice. Capturing a retirement saver early is likely to generate a long-term relationship.
- Wealth is increasingly being passed between generations ahead of death. While many gifts will be used to repay debt or move house, the nominal amount being transferred to the younger generation will not necessarily lead to that customer thinking of themselves as a candidate for wealth management firms.

We note that the most recent Aviva "Adviser Barometer" survey of 1,500 IFAs, published in November 2014, was very positive about near-term trends reporting: 69% have increased the size of their active client base (up from 64% in May 2014 and just 28% in September 2013); and 61% say they have seen an increase in the number of people aged 55+ seeking advice since the pension reforms were announced in March 2014. Interestingly regulatory fees (49%) and professional indemnity costs (43%) remain the biggest concern for advisers, both areas where AFH has a competitive advantage.

RDR came into effect on 1 January 2013 but we believe that its impact on advisers started well before this. We note IFA numbers registered with the FSA/FCA fell from 25.6k end 2011 to 20.5k end 2012 but since RDR has been introduced, numbers have actually risen (October 2014 21.5k). Banks and building societies have seen a more dramatic and sustained decline in the number of their advisers (December 2011 8.7k, December 2012 4.8k, October 2014 3.2k). Market commentary that up to 10,000 IFAs would leave the industry as a result of the RDR appear to be overstated. At AFH, there have been a limited number of adviser departures (mostly early retirements), but the leavers have been replaced by new advisers. Management reports there has been no change in the overall level of upfront fees since RDR was introduced. The vast majority of AFH customers have signed on-going management contracts where AFH receives a fee of c 1%. Historically trail commissions were credited to client accounts, reducing the amount paid by the customer. Under new clean classes, AFH will receive the whole 1% fee from the client as there will be no trail offset. While the customer will pay AFH more, the fund manager's annual management charges will be reduced, leaving the total customer cost largely unchanged.

We note that on 06 February 2015 Standard Life launched a wholly-owned, UK-wide, financial advice business. Standard Life acquired Skipton Building Society's stake in Pearson Jones, an IFA with c £1.1bn of client assets. Pearson Jones has served customers in the North of England for more than 40 years and has 39 advisers in a team of 102 employees. While life companies appear more interested in this route to customer, it is likely they focus on larger opportunities than AFH and so we believe are unlikely to affect pricing of deals materially.

Growth options

Acquisition opportunity

We note that for AFH, inorganic growth is an option not a requirement, as it has built an infrastructure to deliver strong organic growth. However, we believe the market opportunity means that AFH is likely to do more deals. AFH declines the vast majority of deals it is offered and we regard some key aspects of the acquisition strategy as:

- Targeting IFAs where the founder wants to leave the industry. (i) RDR opportunity – smaller IFAs have been squeezed out by lower fees and higher compliance costs. Regulation is a constant dynamic creating several years of market disruption; and (ii) normal attrition – retirement, ill health and lifestyle choice all lead to a number of IFAs leaving the market in a normal year. Market surveys highlight that the average age of IFA principals is mid-50s. It is reasonable to assume around 500-1,000 smaller practices will look to leave the market each year. Investors will note the balance in Exhibit 2 below, that for a number of AFH acquisitions, advisers have not remained once the deal is done but they will still want their customers to be well served. This is one of AFH's competitive advantages when approaching advisers exiting the market.
- Avoiding legacy issues – buyer be compensated has replaced caveat emptor in retail financial services. AFH typically buys the books of business from an IFA not a legal entity, ensuring that any mis-selling liability sits with the vendor. The exceptions to the rule have been Elgar Financial (2012 £5.2m funds under influence (FUI) and since renamed St Johns Asset Management) and Shape Financial (2013 £60m FUI). St Johns will become the legal vehicle for discretionary management services, and risk of mis-selling before the acquisition is incrementally covered by an indemnity from the vendor. Shape Financial continues to be licensed as a provider of advice, an FCA authorisation AFH wants to continue, but also typically a writer of much less complex business (and so less risk of mis-selling).

- Having manageable sized deals – Shape Financial was AFH's largest deal as a proportion of its market capitalisation (and still under 10%). KL Plester, the largest nominal deal at £1.7m was just over 5% of the market capitalisation, of which under 3% was up-front consideration. The total maximum consideration is under half the market capitalisation of the group.
- We note that the group's policy of deferring at least half the consideration, typically over two years (actual record to date 65%), limits AFH's risk exposure and ensures that the risk of under-performance against the vendors plans is borne by the vendor.
- Limiting gearing – AFH has historically run its acquisition strategy without gearing, using internal cash generation and equity fund raisings before they are required. We note that with the latest deal (CIB Wealth Management) c 10% of the consideration is being paid in shares.

Exhibit 2: Summary of acquisitions since ISDX float

Date	Name	Location	Advisers kept	FUI (£m)	Price vs recurring income	Recurring income (£k)	Max consid'n (£k)	Upfront consid'n (£k)	Deferred consid'n (£k)	Upfront (% total consid'n)	Total (% FUI)
01/10/2011	Prevision	Evesham		6	3	31	93.0	46.5	46.5	50%	1.6%
01/10/2011	WTRFP	Warwick	Y	13	3	65	227.5	113.8	113.8	50%	1.8%
31/10/2011	AJ Lutwyche	Stourbridge		3	3	17	51.0	25.5	25.5	50%	1.7%
01/12/2011	Chapelhouse FS	Redditch		6	2	45	90.0	45.0	45.0	50%	1.5%
01/12/2011	Peter Smith	Telford		5	3	26	76.9	37.5	39.4	49%	1.5%
01/04/2012	Thompson Independent	Kidderminster		3	2	10	20.0	10.0	10.0	50%	0.6%
01/04/2012	Arden Court	Nottingham	Y	100	2.8	328	924.0	362.0	562.0	39%	0.9%
22/06/2012	Specialist Solutions	Cheltenham	Y	80	3	N/D	725.0	100.0	625.0	14%	0.9%
10/09/2012	Elgar Financial	Herefordshire		5	3.43	35	120.0	60.0	60.0	50%	2.3%
01/10/2012	Chartwell Associates	Egham	Y	32	3	N/D	480.0	0.0	480.0	0%	1.5%
01/12/2012	Seager Financial Consultancy	Redditch		2	3	10	30.6	15.3	15.3	50%	1.5%
14/12/2012	Racol Financial Services	Wales		16	3	80	240.0	120.0	120.0	50%	1.5%
21/12/2012	Lawrence Flanagan & co	Wolverhamp'n		6	2.4	32	76.3	0.0	76.3	0%	1.3%
21/06/2013	Shape Financial	Taunton	Y	60	3	N/D	1,500.0	125.0	1375.0	8%	2.5%
30/09/2013	CH Financial	Hemel Hempstead	Y	70	3	333	1,000.0	360.0	640.0	36%	1.4%
31/10/2013	Origin Financial	Hagley	Y	88	3	275	1,100.0	412.0	687.0	37%	1.3%
21/11/2013	AG Financial Planning*	Bridgend	Y	28	3	141	421.9	195.0	227.0	46%	1.5%
25/11/2013	Robert Magee & Associates	Leominster		27	3	136	408.0	204.0	204.0	50%	1.5%
10/12/2013	Michael Mac Wealth Management	Stratford		8	3	83	250.4	58.5	191.9	23%	3.0%
15/01/2014	SR Wealth Management	Stoke		10	3	63	199.5	94.5	105.0	47%	2.0%
16/05/2014	Omega Consulting	Norwich		14	3	39	117.0	28.5	88.5	24%	0.8%
28/07/2014	Finlay Gow	Edinburgh	Y	40	3.9	175	675.0	337.5	337.5	50%	1.7%
12/09/2014	Hindsight	Northampton	Y	15	N/D	N/D	281.3	140.6	140.6	50%	1.9%
12/09/2014	Jeff Seward and Partners	Cardiff		N/D	N/D	N/D	45.0	N/D	N/D	N/D	N/D
03/11/2014	Knight O'Byrne	Cornwall	Y	51	N/D	N/D	1,200.0	525.0	675.0	44%	2.4%
02/02/2015	Roxborough Consultancy Limited	Didcot		55	N/D	N/D	911.8	476.8	545.0	52%	1.7%
02/02/2015	First Class Financial Management Ltd	West Bromwich	N/D	N/D	N/D	N/D	84.0	N/D	N/D	N/D	N/D
10/02/2015	K.L. Plester Financial Services	Kidderminster	Y	N/D	2.9	600	1,717.2	745.2	972	43%	N/D
27/02/2015	CIB Wealth Managemnt	Rochester	Y	41	N/D	N/D	973.4	500.9	472.5	51%	2.4%
	Total			**785**		**2,524**	**14,039**	**5,139**	**8,880**	**37%**	**1.8%**

Source: AFH, Edison Investment Research. Note: N/D is non-disclosed.

Other issues include:

- Managing geographic exposure – AFH's business model is to close target offices and centralise back office functions in Bromsgrove, while keeping the self-employed IFAs working remotely. Management advise AFH's existing offices could service several year's growth in advisers.

- Focusing on core business – the deals to date have been in the core IFA market. AFH has not fallen into the trap of buying into new business lines where the management may lack knowledge of the risks involved.
- Making the culture fit – for AFH this is critically important and can only be established by directly meeting the vendors and staff. We note there are major private equity backed buyers (Moneygate, Bellpenny) or parts of bigger groups (eg Sanlam) that may offer higher prices to vendors, but whose business models may not be as attractive for the IFAs. We note that AFH's target market has been lifestyle choice sellers.

It is important to differentiate AFH's implementation of deals from the numerous examples of professional financial services businesses with acquisition-led strategies that have failed. We believe that RSM Tenon, in the accountancy space, historically bought too many large, non-core businesses, introducing excessive financial gearing and failing to integrate them operationally (it entered administration on 22 August 2013). Perspective Financial Services took on a level of gearing that is alien to AFH's culture and its current difficulties reflect this risk.

Organic growth

AFH is already reporting strong organic growth. We note that the total maximum consideration for deals since 2011 is c £14m against AFH's £29m market capitalisation. We also note management comments that in 2014, recurring revenue increased by £2.7m of which just £0.4m came from deals completed in that year. Clearly 2013 acquisitions will have added more but splitting what was organic and what was acquired has many shades of grey.

History

AFH's headquarters are in Bromsgrove, Worcestershire, and it was founded in 1990 by Alan Hudson, a chartered financial planner. The business has grown with the aid of a number of carefully chosen acquisitions, including the financial services arm of the West Bromwich Building Society (October 2009). AFH underwent a major reorganisation when floating on the Plus market in June 2011 and then AIM on 30 June 2014. Since June 2011 it has made 29 acquisitions.

Sensitivities

The key sensitivities are:

- Mis-selling – advice providers need to have systems in place that are transparent, fair and prove that the world-relevant market has been reviewed for its clients. We note that in AFH's entire history, it has provided minimal compensation to a single-digit number of claimants. We also note that the vast majority of acquisitions are of portfolios of business where any mis-selling liability sits with the seller. Compliance processes are bought in from specialist providers Sesame Bankhall and subject to regular audit. Central staff review all documentation and regular customer surveys monitor selling processes and risks.
- Acquisition risk – for AFH, we see a window of opportunity to gain economies of scale, a prudent approach to risk and a core business with good long-term organic growth. We also note that AFH has adopted a very prudent approach to cash deployed in acquisitions. The policy is to have at least half the consideration deferred and tied to EBITDA performance, which means it should be paid by the cash generated by the target. Additionally it has raised equity and bond financing in advance of deals with end October 2014 balance sheet cash of £5.7m. Post that date it has raised £2.14m in a bond issue and £0.2m in new equity.
- Regulation is a threat (higher compliance costs), but also an opportunity. AFH now has sufficient scale to be a consolidator as greater regulation squeezes out smaller players. We

note that AFH follows the industry model in having self-employed IFAs. There is a risk that HMRC views these staff as employed, although AFH has recently renewed all contracts and this factor was part of the review process, it remains the predominant model in the sector.

- Investor confidence/equity markets – most of AFH's income is dependent on the non-residential wealth of its customers. It generates both ad valorem fees and activity related income, both of which are weaker when equity markets are low and stable. We note that through the early stages of the financial crisis, AFH remained profitable, unlike many peers.
- Stock illiquidity – on the migration from ISDX to AIM new shares were issued and the CEO sold down part of his holding. However, he still holds c 40% of the shares, with staff, advisers and customers holding a further 55%. Equity issuances before the AIM listing were offered under the tax-advantageous Enterprise Investment Scheme (EIS), which is likely to see these investors largely locked in for at least three years from their investment.

Valuation

The average of our valuation approaches for the existing business is 201p per share, equivalent to 16.8x 2016e earnings, reflecting the long-term double-digit growth story. Any benefits from further inorganic growth are incremental and we believe on the existing base a reasonable acquisition strategy could add a further 20-30p per share. Over time, delivery of earnings and a continued effective execution of the acquisition strategy are the most likely catalysts to a higher share price.

Peer comparisons

Exhibit 3: Peer valuation comparatives

	Market cap (£m)	2015e P/E (x)	2016e P/E (x)	2015e yield (%)
AFH*	30	18.6	12.8	1.1
IFA businesses				
Lighthouse Group	8	10.2	6.8	4.9
Frenkel Topping	26	N/A	N/A	N/A
Professional service groups				
IFG Group*	134	16.5	11.3	3.5
Mattioli Woods (may following year)	104	17.3	15.1	2.1
Wealth managers				
Brooks MacDonald (June)	197	15.7	13.4	2.1
Charles Stanley (March)	173	23.4	15.0	3.4
St James Place	5,046	27.6	22.8	3.0
Platform Providers				
Hargreaves Lansdown	5,640	34.1	29.5	2.9
Share plc**	56	24.5	17.1	1.9

Source: Thompson Reuters, Edison Investment Research. Note: *Edison Investment Research forecasts, **Edison cash-adjusted basis. Prices as at 20 March 2015.

For the reasons identified above, we believe AFH business model is differentiated from peers. The companies above should only be taken as illustrative of particular aspects of AFH's business.

Discounted cash flow: 247p

We explicitly forecast operating cash generation until 2016, then apply a 5% growth rate for 10 years and a 10x multiple to the final year to establish the terminal value and add this to existing cash balances. This is then discounted at cost of capital (10% assumed), generating a fair value of 247p (up from our previous estimate of 162p). We have rolled forward our valuation base by one year and 2016e cash generation growth (54%) is well ahead of our long term assumed growth forecast (5%) driven by strongly cash generative acquisitions and operational gearing. Additionally we have adjusted a previous understatement of our forecast cash flows (effect 10p). As cash raised in recent equity and bond issues is deployed in further value adding deals, we expect it to generate a recurring cash stream well above the current par value.

Gordon's growth model: 154p

We believe that a skill-based business, with suitable economies of scale, should be able to generate returns safely above its cost of capital. We assume AFH's long-term return will be c 15%, against a cost of capital of 10% and long-term growth of 5%. The base case indicates it should therefore trade at c 2x book. We then apply a premium for near-term performance as despite recent equity raisings, the normalised 2014-15 ROE is only slightly below our long-term estimates, and the equity growth rate well above. This indicates a fair value of 154p (up from previous estimate of 143p due to the profitability generated from now-included acquisitions, the issue of shares above NAV, and rolling forward the valuation one year). The sensitivities are given below.

Exhibit 4: Gordon's growth model and sensitivity

	Base	1% ROE	1% g	1% COE
ROE	15.0%	16.0%	15.0%	15.0%
Growth	5.0%	5.0%	6.0%	5.0%
COE	10.0%	10.0%	10.0%	11.0%
P/B	2.0	2.2	2.3	1.7
2016e NAV	0.67	0.67	0.67	0.67
Implied price	1.34	1.47	1.51	1.12
Discount for near-term performance	15%	15%	15%	15%
Fair value	1.54	1.69	1.73	1.28
Difference		0.15	0.19	-0.26

Source: Edison Investment Research

Financials

Exhibit 5: Estimates changes

	Revenue (£m)		%	Adjusted PBT (£m)		%	EPS (p)		%	Dividend (p)		%
	Old	New	Chg	Old	New	Chg	Old	New	Chg	Old	New	Chg
FY14	15	15.0	0%	1.7	1.4	-13%	7.25	5.83	-20%	1.50	1.50	0%
FY15e	18.0	19.0	6%	2.3	2.0	-13%	9.50	8.21	-14%	1.75	1.75	0%
Fy16e	N/A	23.4	N/A	N/A	2.9	N/A	N/A	11.95	N/A	N/A	2.00	

Source: Edison Investment Research.

The timing, price and size of potential deals remain uncertain and are excluded from our forecasts.

- Acquisitions: we assume that deals since our November report will added c £1m to 2015 and £1.4m to 2016 revenue. We have nothing for incremental deals which is likely to prove very conservative. Organic growth has been assumed at 15% (and 20% in 2016 reflecting more demand for pension advice post regulatory changes but also the benefit of new advisers).
- The pay-out to advisers (in cost of sales) deteriorated modestly from 47.8% in 2013 to 48.7% in 2014 with a mix of greater IFA originated business (net effect £0.2m against estimates). We have carried forward the 2014 ratio to 2015/2016e seeing costs worsen by £165k relative to the old ratio and knocking 10% off our assumed adjusted pre-tax profit growth.
- The administration costs were in line with forecasts (£6.3m) and as a proportion of income was broadly stable (41.7% vs 41.4%). This was due to substantial investment in support costs where we do not expect the same incremental increase going forward. Accordingly we continue to assume operational gearing and this ratio to fall to 40% in 2015e and 38% in 2016e.
- The mix of costs materially impacts our adjusted profit estimates. In 2014 amortisation and share based costs were below forecast, meaning there were lower adjustment credits (reducing adjusted profits and EPS). In 2015e we have carried forward the lower share based costs (£39k v £200k previously) again seeing the adjusted pre-tax profit estimates cut by c 10%. We

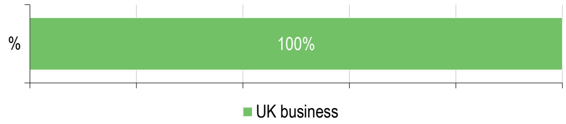
have left our 2015e amortisation at £500k and 2016e stable at just over 6% of opening client relationship intangibles.

- Interest costs have been increased to reflect the £2.14m bond issue announced in February 2015 (coupon 7.5%).
- Number of shares: on 5 February 2015, AFH issued 137,997 new ordinary shares at 150p to eight advisers, none of whom were currently existing shareholders and 31,500 shares were issued as part consideration to the owner of CIB. Shares currently in issue: 19.49m.
- The expected cash generation of the business is strong with forecast cash generation well ahead of profit (primarily due to the non-cash amortisation of intangibles and share-based payments). We expect cash generation to cover any deferred consideration currently due.

Exhibit 6: Financial summary

£'000s	2012	2013	2014	2015e	2016e
Year end 31 October					
PROFIT & LOSS					
Revenue	7,201	10,797	15,037	18,993	23,391
Cost of Sales (exc amortisation and depreciation)	(6,907)	(9,726)	(13,598)	(17,350)	(20,984)
EBITDA	294	1,071	1,439	1,642	2,407
Depreciation	(29)	(54)	(84)	(100)	(115)
Amortisation	(51)	(91)	(259)	(400)	(584)
Operating profit (pre-exceptional)	213	926	1,096	1,142	1,707
Exceptionals	0	0	(196)	0	0
Other	0	0	0	0	0
Investment revenues	1	(22)	(39)	(169)	(220)
Profit Before Tax (FRS 3)	214	904	861	973	1,488
Profit Before Tax (norm)	541	1,140	1,439	2,012	2,926
Tax	(127)	(245)	(260)	(302)	(437)
Profit After Tax (FRS 3)	168	804	601	1,171	1,750
Profit After Tax (norm)	357	875	1,061	1,602	2,341
Average Number of Shares Outstanding (m)	14.3	15.1	18.2	19.5	19.6
EPS - normalised (p)	2.50	5.80	5.83	8.21	11.95
EPS - FRS3 (p)	1.18	5.33	3.31	6.00	8.93
Dividend per share (p)	1.00	1.25	1.50	1.75	2.00
Cost sales as % revenue	-48%	-48%	-49%	-49%	-49%
Admin cost (exc amortisation) as % revenue	-47%	-41%	-42%	-40%	-38%
EBITDA Margin (%)	4.1%	9.9%	9.6%	8.6%	10.3%
Operating Margin (before GW and except.) (%)	3.0%	8.6%	7.3%	6.0%	7.3%
ROE	4.7%	14.2%	6.7%	10.6%	14.1%
Normalised ROE	10.0%	15.4%	11.9%	14.4%	18.9%
BALANCE SHEET					
Fixed Assets	4,496	7,628	9,987	12,499	11,810
Current Assets	2,923	6,959	8,127	9,594	9,960
Total Assets	7,420	14,587	18,114	22,093	21,769
Deferred consideration due >1 yr	(606)	(1,839)	(2,266)	(3,200)	(1,500)
Other current liabilities	(1,873)	(2,456)	(2,650)	(3,052)	(3,687)
Deferred consideration due <1 yr	(853)	(2,220)	(1,866)	(1,250)	(500)
Other LT liabilities	(16)	(786)	(794)	(2,934)	(2,934)
Net Assets	4,072	7,285	10,538	11,657	13,148
NAV per share	0.28	0.43	0.54	0.60	0.67
CASH FLOW					
Operating Cash Flow	(197)	811	1,581	2,184	3,315
Net cash from investing activities	(2,383)	(3,139)	(2,761)	(3,005)	(3,033)
Net cash from (used in) financing	1,780	5,739	2,499	1,963	(317)
Net Cash Flow	(799)	3,411	1,319	1,141	(35)
Gross Cash	2012	2013	2014	2015e	2016e
Opening	1,722	923	4,334	5,653	6,794
Change in cash	(799)	3,411	1,319	1,141	(35)
Closing balance sheet	923	4,334	5,653	6,794	6,760
Cash, debt and deferred consideration analysis					
Closing cash	923	4,334	5,653	6,794	6,760
Closing financial debt	(225)	(802)	(752)	(2,892)	(2,892)
Closing balance sheet net cash	698	3,532	4,901	3,902	3,868
Closing deferred consideration<1 yr	(606)	(1,839)	(2,266)	(3,200)	(1,500)
Closing deferred consideration >1 yr	(853)	(2,220)	(1,866)	(1,250)	(500)
Closing net debt	(761)	(527)	769	(548)	1,868

Source: AFH accounts, Edison Investment Research

Contact details	Revenue by geography
AFH House Buntsford Drive, Stoke Heath Bromsgrove, Worcestershire B60 4JE, UK 01527 577775 www.afhfinancialgroup.com	

CAGR metrics 2014-16e		Profitability metrics		Balance sheet metrics 2015e		Sensitivities evaluation	
Normalised EPS	43%	ROE 2014	12%	Gross cash	6.8	Litigation/regulatory	●
Revenue	25%	ROE 2016e	19%	Cash less debt	3.9	Pensions (opportunity)	●
Cost of sales	25%	Operating margin 2014	7%	Cash less debt/def cons	1.9	Currency	○
Admin costs	19%	Operating margin 2016e	10%	Cash less debt/def cons 2015e	(0.5)	Stock overhang/illiquidity	◖
EBITDA	47%	Admin CIR 2014	42%	Debtor days	50	Interest rates	◖
Normalised post tax profit	49%	Admin CIR 2016e	38%	Def consid as % liabilities	23%	Equity Market sensitivity	◖

Management team

Non-Executive Chairman: John Wheatley

John qualified as a chartered accountant in 1974 with Peat Marwick Mitchell. He left KPMG at the end of 1998 to set up his own practice. He has held a number of non-executive directorships in public and private companies. John has been with the group since November 2008 and was the group's finance director from November 2008 to February 2014 following which he assumed the role of non-executive chairman. John is chairman of the group's audit committee and a member of the company's remuneration committee.

CEO: Alan Hudson

Alan Hudson is a chartered financial planner and founded the business operated by AFH Financial Group in 1990 and the principal operating business, AFH Independent Financial Services, in 2002. Alan is responsible for the day-to-day running of the group and continues to act as financial adviser to a select but small number of clients, pursuant to which he continues to receive a fee share in accordance with the group's standard financial adviser terms. Alan is a member of the group's remuneration committee.

CFO: Paul Wright

Paul qualified as a chartered accountant with KPMG in London, before moving into the wholesale financial services sector with Exco International, where he spent 10 years working in London and Asia-Pacific. Since 1995, Paul has been group CFO of a number of UK listed companies, including several technology companies serving the UK financial markets. Most recently, Paul was instrumental in securing the MBO of Workplace Systems International, an AIM quoted company.

Executive Director and CIO: Toby Denne

Toby has over 25 years' experience as a financial services professional. Until January 2011, Toby was a director of Allium Capital, which he cofounded in 2009 to help IFA firms build and launch their own fund management companies. Prior to his role at Allium Capital, Toby was the director of relationship management at Octopus Investments. Toby is also a non-executive director of Flight Calibration Services, Bonne Saveurs and African Alpha Business Angel Syndicate.

Principal shareholders (as of 5 February 2015)	(%)
Alan Hudson	38.82
Phillip Mobberley	15.25
Paul Connor	10.28
Other Directors	3.68

Companies named in this report

Lighthouse Group (LGT), Frenkel Topping (FEN), IFG Group (IFP), Mattioli Woods (MTW), Brooks MacDonald (BRK), Charles Stanley (CAY), St James Place (STJ) Hargreaves Lansdown (HL.), Share (SHRE).