AFH Financial Group

Business review and H114 interim results

Geared for growth

Financial services

21 July 2014

AFH is delivering its strategy of organic and inorganic growth with H1FY14 on H1FY13 revenue up 50%, administration expenses up 47%, EBITDA up 97% and pre-tax profit up 55%. The cost growth included heavy investment for future growth as well as the impact of historic acquisitions (including intangible amortisation). AFH's business model is differentiated from other quoted IFAs and its low gearing differentiates it from private equity backed consolidators. We see the shares close to fair value on the existing business with upside from deploying recently raised equity in deals.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
10/12	7.2	0.5	2.50	1.00	60.2	0.7
10/13	10.8	1.1	5.80	1.25	25.9	0.8
10/14e	15.0	1.7	7.25	1.50	20.8	1.0
10/15e	18.0	2.3	9.50	1.75	15.8	1.2

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments. IFRS basis (previous note UK GAAP).

H114 results key messages

Revenue grew 50% on H113 driven by both acquisitions and organic growth. Administration expenses were up 47%, reflecting continued heavy investment in organic growth strategies, and a marked increase in intangible amortisation. EBITDA rose 97% with the EBITDA margin rising to 11.1% from 8.5%. Statutory EPS was up 30% to 2.47p. We note heavy investment in organic growth with c £250k incremental cost and a reinvigoration of the business development team. In the period four acquisitions were completed (total maximum consideration £1.3m over two year earn out). Gross cash at end April was £4.9m (net cash £4.1m). At the end of June AFH listed on AIM (previously ISDX) raising £1.46m gross proceeds and enhancing liquidity with the founder-CEO reducing his stake to 40%.

Differentiated business model

AFH's 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 Perspective Financial Services or Moneygate have been active consolidators, but have had a much more aggressive stance to gearing (indeed the last Companies House filings for both – end 2012 – saw each having negative net assets).

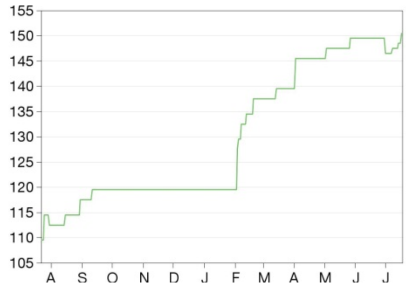
Valuation: Upside from deploying new capital

We conservatively value the business on the basis of no future deals. This may be especially harsh bearing in mind the significant recent equity raising in early April and June, which may be expected to be deployed in value-added acquisitions. Our existing business approaches indicate an average fair value of 153p, around the current price.

Price	**150.5p**
Market cap	**£29m**

Net cash (£m) at end April 2014	4.1
Shares in issue	19.3m
Free float	30%
Code	AFH
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	0.7	3.4	37.4
Rel (local)	1.1	2.2	34.3
52-week high/low		150.5p	109.5p

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 21 acquisitions since floating in June 2011.

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FY results	March 2015

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Investment summary

Company description: Market growth and IFA consolidator

AFH is an AIM-listed, Midlands-headquartered IFA and wealth manager, a market we believe has double-digit long-term organic growth potential. AFH has put a structure in place to organically take market share as well as consolidate smaller IFAs whose business models are unlikely to be profitable under the new regulatory regime. The business model is differentiated from traditional IFA networks in its branding, service proposition, advice control and culture, with the result that it has proved significantly more profitable. Management is investing heavily for organic growth and now has a business development team of four focused on attracting individual IFAs to the business. In H114 organic growth made a significant contribution. When fully operational, this should generate additional advisers at a run rate of three to five per month against the current 122 advisers in place. On acquisitions, economies of scale and the linkage of consideration to earnings, together with careful target selection and due diligence, are designed to ensure value is added. Details on the 21 acquisitions since ISDX listing are given later. At end-June, AFH had nearly 35k clients (over 15k active) and funds under management of c £800m, including nearly £140m in self-run funds.

Valuation: Upside from acquisitions

Last year our existing business valuation methodologies gave an average fair value c 146p and we commented that value-added acquisitions could add 20-30p. Deals since our last report, and the dilutive effect of recent equity raised, sees our existing-business valuation increase to 153p. Our forecasts continue to be organic growth and completed deals only. This is highly conservative given that AFH has already raised equity to finance further acquisitions, which we expect to complete through 2014 and 2015. Assuming bought recurring income of £50k per adviser and initial consideration 1.5x recurring income, if AFH deployed £3m of cash it would add 40 advisers. On current margins this would add over 20% to FY15 EPS estimates giving a reasonable incremental valuation upside of 20-30p.

Financials: Upside from organic growth and acquisitions

Looking forward, our revised estimates have 20% organic revenue, 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 deliberately been conservative as the new team is as yet untested. We are forecasting administration costs in H214 to reflect further investment but to then grow slower than revenue to reflect operational gearing. We have included nothing for deals.

Since our last report, the basis of accounting has changed, with the first time adoption of IFRS accounting. Comparisons with previous estimates are thus of little value. In underlying terms, there has been an uplift to estimates from including deals announced since our last report. We believe there will have been an improvement in efficiency ratios with the associated operational leverage. The group has also raised equity (April 2014 £1.6m, June £1.5m) at 140p, a price well above NAV. The organic growth in advisers has been somewhat behind our expectations but there is now a new team in place and senior management time will now be focused on this rather than the AIM listing.

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 122 self-employed advisers (94 in October 2012, 53 on flotation in June 2011). 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 147 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. The group also has been an active consolidator, concluding 21 deals since floating in mid-2011.

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 under pressure, as IFAs seek the lowest-cost provider.
  - The AFH fee structure is outlined in separate fee agreements with the customer and includes: (i) Ad valorem (ie % AUM) upfront intermediation fees (typical average 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). (ii) Ongoing ad valorem intermediation fees for specific investment decisions (typically c 1%). Recurring revenue is currently running at c £8m annually and accounted for 54% of H114 revenue. (iii) 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) up to £50k, with full service beyond that.
  - AFH has 122 self-employed qualified IFAs who receive a revenue share of 60% of self-originated business and 40% of AFH generated business. To organically grow this team, AFH has four (new) business development managers actively seeking individuals to recruit. This team is new and as yet untested, with the previous head having emigrated, and has been set the target to bring three to five new advisers to the group 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", nearly £140m 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 £20m. The fund has target yields of between 6% and 9% looking at properties with a value of £1-8m, 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: Peer comparators using latest published information

	AFH		Lighthouse group		Frankel Topping		Saunderson House		Moneygate		Perspective Financial Group	
	2012	**2013**	**2012**	**2013**	**2012**	**2013**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**
Revenue	7.2	10.8	55.0	47.9	4.8	5.5	19.2	18.5	5.0	8.3	18.0	20.4
Cost of sales	(3.5)	(5.2)	(40.0)	(32.9)	(1.9)	(2.0)	0.0	0.0	(3.2)	(5.7)	(1.2)	(1.3)
Administration expenses	(3.4)	(4.6)	(14.4)	(15.3)	(1.8)	(2.1)	(15.5)	(14.4)	(3.9)	(5.6)	(16.6)	(18.1)
Operating profit	0.3	1.1	0.7	(0.3)	1.0	1.4	3.7	4.1	(2.1)	(3.0)	0.2	1.0
Financing costs	0.0	0.0	0.0	(0.1)	0.0	0.0	0.0	0.0	(0.1)	(0.1)	(1.2)	(1.5)
Pre-exceptional profits	0.3	1.0	0.7	(0.4)	1.0	1.4	3.7	4.1	(2.2)	(3.1)	(1.0)	(0.5)
other gains/loss and Exceptionals	0.0	0.0	(5.3)	(1.3)	0.0	0.0	0.0	(0.3)	0.1	0.0	(1.0)	(0.9)
Pre-tax profit	0.3	1.0	(4.6)	(1.6)	1.0	1.4	3.7	3.8	(2.1)	(3.1)	(2.0)	(1.5)
Amortisation of intangibles	0.0	(0.1)	(0.7)	(0.4)	0.0	0.0	0.0	0.0	(0.6)	(0.9)	(2.9)	(4.1)
Net assets	4.0	7.3	7.2	5.6	6.1	7.5	2.4	2.7	(0.1)	(2.6)	(5.2)	(6.5)
Average no of staff	67.0	101.0	161.0	166.0	51.0	47.0	103.0	107.0	45.0	56.0	238.0	250.0
Ratios												
Revenue per employee (£k)	107.5	106.9	341.9	288.5	93.8	117.0	186.5	172.9	110.5	148.2	75.7	81.5
Costs per employee (£k)	(102.4)	(96.3)	(337.6)	(290.2)	(72.5)	(87.2)	(150.3)	(134.6)	(157.2)	(201.8)	(74.7)	(77.6)
Profit per employee (£k)	5.1	9.9	(28.4)	(9.5)	19.6	29.8	36.3	35.5	(46.3)	(55.4)	(8.3)	(6.0)
Cost: income ratio (%)	95%	90%	99%	101%	77%	75%	81%	78%	142%	136%	99%	95%
Cost: income ratio ex amortisation intangible (%)	95%	89%	97%	100%	77%	75%	81%	78%	130%	125%	83%	75%

Source: Company Report and Accounts (for non-public companies latest available at Companies House)

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. Moneygate and Perspective Financial Group were among the more active consolidators in the IFA space and are backed by private equity. We highlight that AFH is clearly differentiated from its peers:

- AFH is more profitable than peer average.
- AFH has shown better than peer average growth.
- Relative to peers, especially consolidators, AFH has an extremely high net asset base.
- AFH is markedly different from Lighthouse Group in every aspect of its business performance.
- There remains considerable upside potential (taking Saunderson House as an example).

UK IFA market

Key market highly attractive long term

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 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.
- However, 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. An Aviva survey in spring 2010 showed 46% of adults have received a pre-inheritance gift, compared with 37% who had received a traditional inheritance. While many gifts will be used to repay debt or move house, the scale of transfer will not necessarily lead to the 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 May 2014, was very positive about near-term trends reporting: (i) 64% have increased the size of their active client base, (ii) 35% of advisers looking to hire new staff in the next 12 months, and (iii) 86% think proposed pension reforms are positive. Interesting regulatory fees remain the biggest concern for half of advisers (48%) and this is likely to be hardest felt by smaller advisers.

Impact of RDR

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 (January 2014 21.9k). Banks and building societies have seen a more dramatic and sustained decline in the number of their advisers (December 2011 8,658, December 2012 4,810, January 2014 3,556). 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. Charging structures are transparent and let the customer choose the basis for the fees. 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. However, while the customer will pay AFH more, the fund manager's annual management charges will be reduced, leaving the total cost largely unchanged

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 FCA as C4 – its lowest risk assessment.

Competition challenges from below and above, but not banks

The structure and profit dynamics mean IFAs are facing structural challenges from both execution-only platform providers and wealth managers. We believe that one of the FCA's objectives for RDR was to ensure that retail investors with relatively simple needs were not (mis-)sold unnecessary complex products. It is driving the mass market to low-cost, index-linked solutions without advice, a market best served by technology led platform providers such as Hargreaves Lansdown or Share. Discretionary fund managers are becoming increasingly professional and looking at all opportunities for growth. A few years ago, the only wealth manager servicing IFAs was Brooks MacDonald, but now all the major firms target this market. We note that while most wealth managers claim to have a minimum portfolio size of £100k (ideally £250k), they are increasingly offering managed funds that give smaller investors access to the IFA market. One positive feature for IFAs has been the material withdrawal of the banks from providing face-to-face advice for customers with relatively modest portfolios with adviser numbers more than halving since end 2011.

Exhibit 2: Changing structure for main providers

Investable assets (£)	Historic providers	Current providers	Future providers
<100k	Small IFAs, banks	Small IFA/platforms	Larger IFAs, platforms
<250k	Larger IFAs, wealth mangers	IFAs, platforms, wealth mangers	IFAs, platforms, wealth mangers
<1m	Wealth mangers, private banks	Wealth mangers, private banks	Wealth mangers, private banks
1m +	Wealth mangers, private banks	Wealth mangers/private banks	Wealth mangers/private banks

Source: Edison Investment Research. Note: We would classify AFH as a larger IFA.

Growth options

Organic growth

AFH is already reporting strong organic growth. AFH now has four business development managers whose function is to identify and hire individual IFAs. The total investment in this process is running at c £250k pa. While in H114 the growth in advisers was modest, the team has only just been appointed (the previous head having emigrated) and some management resource had been diverted to the AIM process. Looking forward, we may reasonably expect a much faster hiring process. In addition, AFH has a number of smaller product lines that are expanding rapidly, including its legal services and investment management arms.

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 for acquisitions (driven by the factors outlined below) is such that AFH is likely to continue to make them for the foreseeable future. There would be no other reason for AFH raising the equity it has other than for acquisition, as organic profitability and existing capital are well above regulatory requirements. 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. As noted above, we see AFH's strategy as different in nearly every regard.

Exhibit 3: Summary of acquisitions since ISDX float

Date	Name	Location	Advisers kept	FUI	Price vs recurring income	Recurring income	Max consid'n	Upfront consid'n	Deferred consid'n	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/A	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/A	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	Wolverhampton		6	2.4	32	76.3	0.0	76.3	0%	1.3%
21/06/2013	Shape Financial*	Taunton	Y	60	3	N/A	1500.0	125	1375	8%	2.5%
30/09/2013	CH Financial	Hemel Hempstead	Y	70	3	333	1000.0	360	640	36%	1.4%
31/10/2013	Origin Financial*	Hagley	Y	88	3	275	1100.0	412	687	37%	1.3%
21/11/2013	AG Financial Planning*	Bridgend	Y	28	3	141	421.9	195	227	46%	1.5%
25/11/2013	Robert Magee & Associates	Leominster		27	3	136	408.0	204	204	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	47%	2.0%
16/05/2014	Omega Consulting	Norwich		14	3	39	117.0	28.5	88.5	24%	0.8%
	Total			**583**		**1749.0**	**8151.1**	**2413.1**	**5737.2**	**30%**	**1.4%**

Source: AFH, Edison Investment Research * Share purchases

We note AFH declines the vast majority of deals it is offered. This selectivity reflects the following:

- 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 (eg RDR will be subject to a formal review in 2014) creating several years of market disruption. (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. While RDR will have accelerated this somewhat, 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 the exhibit above between where advisers have remained or not.
- 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 (£5.2m FUI and since renamed St Johns Asset Management) and Shape Financial (£60m FUI). The latter 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). The former 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.
- 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. We note that AFH's new offices could service around double the current number of advisers.

- Having manageable sized deals: Shape Financial is AFH's largest deal to date, but still represented under 10% of market capitalisation at the time.
- We note that the group's policy of deferring at least half the consideration, typically over two years (actual record to date a little higher and longer than this), limits AFH's risk exposure 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. With the recent equity raisings we do not believe further issuance is likely in the near future.
- 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 into which it is buying.
- Making the culture fit: The cultural fit for AFH is critically important and can only be established by directly meeting the vendors and staff. We note there are major private equity backed buyers (Perspective Financial Group, 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.

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). It saw a major reorganisation when floating on the Plus market in June 2011, since which time it has completed 21 acquisitions, more than doubling the number of advisers to 122.

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 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 required 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 in advance of deals with end April 2014 balance sheet cash of £4.9m.
- Regulation: 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 and 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/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.

Valuation

The average of our valuation approaches for the existing business is 153p per share, around 16x 2015e earnings, reflecting the long-term double-digit growth story. Any benefits from inorganic growth are incremental and we believe on the existing base a reasonable upside could add a further 20-30p per share.

Peer comparisons

Exhibit 4: Peer valuation comparatives

	Market cap (£m)	2014e P/E (x)	2015e P/E (x)	2014e yield (%)
AFH	28	20.3	15.5	1.0
IFA businesses				
Lighthouse Group	5	19.2	13.1	1.2
Frenkel Topping	25	18.2	15.2	1.8
Professional service groups				
IFG Group*	138	16.9	12.1	3.1
Mattioli Woods (May following year)	89	16.5	14.9	2.0
Wealth managers				
Ashcourt Rowan (March next year)	68	12.0	8.7	0.3
Brooks MacDonald (June next year)	190	17.1	14.5	1.7
Charles Stanley	177	12.6	9.8	3.3
St James Place	3,871	22.2	18.6	2.9
Platform Providers				
Hargreaves Lansdown	5,194	32.0	28.4	2.8
Share plc**	55	23.0	18.3	1.6

Source: Thompson Reuters, Edison Investment Research. Note: As at 18 July 2014. *Edison Investment Research. **Assets under administration as Share is execution only.

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

Discounted cash flow: 162p

We explicitly forecast operating cash generation until 2015, 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 162p (up from our previous estimate 150p given the inclusion of value-adding acquisitions). The cash raised in recent deals is included at par – once it has been deployed in value adding deals it will become a recurring cash stream and thus will be valued on a multiple of this.

Gordon's growth model: 143p

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 somewhat below our long-term estimates, and the equity growth rate well above. This indicates a fair value of 143p (up from previous estimate of 142p as the profitability generated from now-included acquisitions, and issue of shares above NAV offsets the effect of lower equity on conversion to IAS accounting and the effect of a higher equity base reducing ROE. As recently raised equity is deployed into deals, the profits generated will further increase the equity base generating a higher valuation. The sensitivities are given below.

Exhibit 5: 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
2013 NAV E	0.62	0.62	0.62	0.62
Implied price	1.25	1.37	1.40	1.04
Discount for near-term performance	15%	15%	15%	15%
Fair value	1.43	1.58	1.61	1.19
Difference		0.14	0.18	-0.24

Source: Edison Investment Research

Financials

Outlook

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

- Our revenue forecast growth reflects organic growth (4% H2 on H1) and full-year contributions from previous deals (H2 up £100k on H1). For FY15 we have assumed 20% organic growth as we believe there will be an acceleration in adviser recruitment although it will take time for the incremental advisers to generate revenue and note the business development team is still new. We have nothing for incremental deals – likely to prove a very conservative assumption.
- The pay-out to advisers remains a constant 48% of income. Advisers receive 60% of self-generated business and 40% for AFH generated business and we assume an unchanged mix.
- AFH has reached a scale where it has to build central controls (eg new finance director) as well as invest in growth opportunities. The full period effect in H214 of initiatives started in H113 is likely to see a modest deterioration in administration expenses to revenue ratio before the inherent operational gearing sees it improve in 2015. The AIM costs have been treated as an exceptional item.
- Number of shares – we note that at 31 October 2013 there were 798k options to staff and contractors (ie advisers) total 511k at a strike price of 37p, 287k at 100p, the vast majority of which may be expected to vest. However, with average vesting periods of 7.6 and 8.8 years the likely slippage each year is likely to be modest. We have grown the number of shares by 50k pa. After the recent equity raise on the AIM listing, management has indicated surplus capital exceeds £1m and we are not forecasting any equity raise to meet regulatory requirements.
- Other deals could reasonably add, say, 10% and 25% to 2014 and 2015 adviser numbers and FUI, and upside to our estimates. When note that a deal is concluded an intangible asset based on the full expected consideration is generated (with an associated creditor liability for the deferred consideration). If the targets are not met, the intangible and creditors are written down (2013 write down £778k). It is important to recognise that this intangible write-down is not value destroyed for AFH shareholders, or a sign of over-payment, as it is matched by reduced creditors. The price is tied to performance, and a lower consideration means the vendor takes the pain of under-performance.
- 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. This effectively leaves the current net cash balance (£4m) as being funds available for acquisitions.

Exhibit 6: Financial summary

£'000s	2012	2013	2014e	2015e
Year end 31 October				
PROFIT & LOSS				
Revenue	7,201	10,797	15,000	18,000
Cost of Sales (exc amortisation and depreciation)	(6,907)	(9,726)	(13,476)	(16,311)
EBITDA	294	1,071	1,524	1,689
Depreciation	(29)	(54)	(54)	(54)
Amortisation	(51)	(91)	(446)	(446)
Operating profit (pre exceptional)	213	926	1,024	1,189
Exceptionals	0	0	(400)	0
Other	0	0	0	0
Investment revenues	1	(22)	(63)	(63)
Profit Before Tax (FRS 3)	214	904	561	1,126
Profit Before Tax (norm)	541	1,140	1,661	2,326
Tax	(127)	(245)	(118)	(341)
Profit After Tax (FRS 3)	168	804	443	1,285
Profit After Tax (norm)	357	875	1,318	1,845
Average Number of Shares Outstanding (m)	14.3	15.1	18.2	19.4
EPS - normalised (p)	2.50	5.80	7.25	9.50
EPS - FRS3 (p)	1.18	5.33	2.44	6.62
Dividend per share (p)	1.00	1.25	1.50	1.75
Cost sales as % revenue	(48%)	(48%)	(48%)	(48%)
Admin costs as % revenue	(47%)	(41%)	(42%)	(40%)
EBITDA Margin (%)	4.1%	9.9%	10.2%	9.4%
Operating Margin (before GW and except.) (%)	3.0%	8.6%	6.8%	6.6%
ROE	4.7%	14.2%	4.9%	11.3%
Normalised ROE	10.0%	15.4%	14.6%	16.2%
BALANCE SHEET				
Fixed Assets	4,496	7,628	8,800	8,395
Current Assets	2,923	6,959	8,079	8,544
Total Assets	7,420	14,587	16,879	16,939
Deferred consideration due >1 yr	(606)	(1,839)	(1,638)	(1,500)
Other current liabilities	(1,873)	(2,456)	(2,268)	(2,591)
Deferred consideration due <1 yr	(853)	(2,220)	(1,500)	0
Other LT liabilities	(16)	(786)	(752)	(752)
Net Assets	4,072	7,285	10,721	12,096
NAV per share	0.28	0.43	0.55	0.62
CASH FLOW				
Operating Cash Flow	(197)	811	1,522	2,258
Net cash from investing activities	(2,383)	(3,139)	(3,256)	(1,788)
Net cash from (used in) financing	1,780	5,739	2,780	(105)
Net Cash Flow	(799)	3,411	1,045	365
Gross Cash				
Opening	1,722	923	4,334	5,379
Change in cash	(799)	3,411	1,045	365
Closing balance sheet	923	4,334	5,379	5,744
Cash, debt and deferred consideration analysis				
Closing cash	923	4,334	5,379	5,744
Closing financial debt	(225)	(802)	(802)	(802)
Closing bal sheet net cash	**698**	**3,532**	**4,577**	**4,942**
Closing deferred consideration<1 yr	(606)	(1,839)	(1,638)	(1,500)
Closing deferred consideration >1 yr	(853)	(2,220)	(1,500)	0
Closing net debt	(761)	(527)	1,439	3,442

Source: AFH accounts, Edison Investment Research

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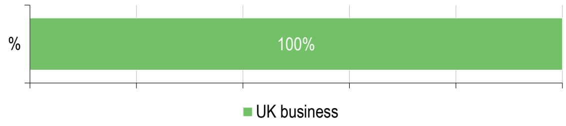
Revenue by geography



CAGR metrics 2013-15e	
Normalised EPS	28%
Revenue	29%
Cost of sales	29%
Admin costs	27%
EBITDA	37%
Normalised post tax profit	45%

Profitability metrics	
ROE 2013	15%
ROE 2015e	16%
Operating margin 2013	10%
Operating margin 2015	9%
Admin CIR 2013	41%
Admin CIR 2015	40%

Balance sheet metrics 2013e	
Gross cash	4.3
Cash less debt	3.5
Cash less debt/def cons	(0.5)
Cash less debt/def cons 2015e	3.4
Debtor days	89
Def consid as % liabilities	56%

Sensitivities evaluation	
Litigation/regulatory	●
Pensions (opportunity)	●
Currency	○
Stock overhang/illiquidity	◖
Interest rates	◖
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	(%)
Alan Hudson	40.9
Phillip Mobberley	15.4
Paul Connor	10.4

Companies named in this report

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

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