EDISON

AFH Financial Group

FY15 results to end October

Delivering on acquisitions and organic growth

Financial services

AFH's FY15 EPS was up 80% on FY14, driven by a 40% increase in turnover. Management highlights that organic revenue growth was c 20%. The group continues its conservatively executed acquisition strategy and we expect the £6.2m of recent net equity placement proceeds to be deployed in deals relatively quickly. Management confidence is highlighted by the 50% increase in dividend.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
10/14	15.0	1.4	5.83	1.50	28.5	0.9
10/15	21.0	2.7	11.30	2.25	14.7	1.4
10/16e	27.5	3.7	12.68	3.00	13.1	1.8
10/17e	31.0	5.0	16.20	4.00	10.3	2.4

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

FY15 results: Beating expectations on organic growth

The key surprise in FY15 was the rapid organic revenue growth (20% on FY14) despite relatively anaemic organic growth in H115. Management highlights that after the tax year, investors then delayed investment decisions until after the general election. Historic initiatives, which focused on recurring rather than initial income, are now delivering revenue. We also understand that the largest 20 advisers (by funds) outperformed the firm as a whole, helping to pull up average revenue growth. Management comments that 75% of recurring revenue was generated internally (including advisers acquired in previous years but not the current year). Funds under management (FUM) doubled to £1.8bn, with £0.7bn acquired and £0.2bn inflows from existing and new clients. Client retention was around 97%. There was some operational leverage, with administration costs as a percentage of revenue dropping to 40% from 42%. The dividend was raised by 50% to 2.25p and was still covered 2.6x by normalised earnings. Balance sheet group cash reserves were c £8m on the reporting date.

Outlook: Significant potential uplift from deals

Our forecasts remain highly conservative. We have included the £6.4m of equity recently raised, but give no credit for its deployment in acquisitions until such time as a deal is completed. We would expect further earnings enhancement from this process in H116. Cash on the balance sheet (£8m currently) could, allowing for regulatory requirements and on a half-upfront consideration basis, fund several deals with total consideration of c £10m (nearly a quarter of AFH's current market capitalisation). After a pause in H215 to integrate H115 deals, we expect the company to be announcing further acquisitions over the next few months.

Valuation: c 35% upside with no credit for new deals

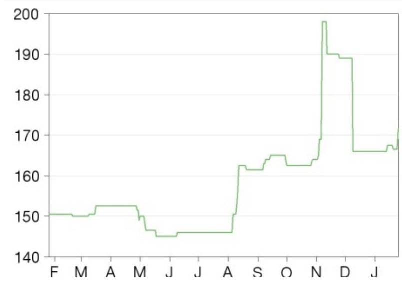
The average of our approaches implies a value of £2.32, which represents c 35% upside from the current price. This does not provide any benefit for deploying recently raised equity, which we believe could add more than 10% to our value.

26 January 2016

Price	**171.5p**
Market cap	**£41m**

Net cash (£m) at 25 January 2016	6
Shares in issue	24.0m
Free float	44%
Code	AFH
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	3.3	5.5	14.0
Rel (local)	10.2	15.1	29.2
52-week high/low		198.0p	145.0p

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 11 acquisitions in FY15.

Next event

AGM	April 2016

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Acquisitions update

During FY15 AFH completed 11 acquisitions at an average capped consideration of slightly above £1m. Deal activity in H215 was a little slower than H115, as management focused on integrating its H115 deals. We believe this integration process is now well advanced and that AFH is looking to complete a number of deals over the next six months. At this stage, we do not expect any to be transformational, although the successful integration of IFS may encourage management to consider deals somewhat larger it has in the past (historically, no deal was more than 10% of the market capitalisation of the group at the time). Management reports that pricing remains stable (maximum c 3x recurring revenue) in the deals that have recently been considered.

Exhibit 1: Key financial dynamics from acquisitions made in FY15 (£000s)

Date	Name	Income multiplier	Recurring income	Max consideration*	Upfront	Deferred	Upfront	Consideration as % FUM
03/11/2014	Knight O'Byrne	N/D	N/D	1,200.0	525.0	675.0	44%	N/D
30/01/2015	Roxborough Consultancy	N/D	N/D	970.0	535.0	545.0	55%	1.8%
02/02/2015	First Class Financial Management	3.0	28	84.0	42.0	42.0	50%	N/D
09/02/2015	K L Plester Financial Services	3.1	600	1,833.0	860.2	972.8	47%	N/D
27/02/2015	CIB Wealth Management	N/D	N/D	973.4	500.9	472.5	51%	2.4%
01/04/2015	Clarendon Financial Solutions	N/D	N/D	483.0	252.5	230.5	52%	1.9%
30/04/2015	IFS	N/D	2,600	4,100.0	605.0	3,650.0	11%	N/D
27/07/2015	Quest Financial Management**	N/D	N/D*	585.0	292.5	292.5	50%	N/D
27/07/2015	Phoenix Independent Financial Services**	N/D	N/D*	489.0	240.0	249.0	49%	N/D
06/08/2015	Davisons Financial Management	N/D	N/D	2,865	1,071	1,680	37%	N/D

Source: AFH, Edison Investment Research. Note: *As announced. On completion there have been small NAV adjustments typically increasing the consideration. **In total, Quest and Phoenix are expected to add c £320k to recurring income, implying an aggregate 3.35x multiple. N/D = not disclosed. FUM = funds under management.

Exhibit 2: Key business dynamics from acquisitions made in FY15 (£000s)

Date	Names	Location	Advisers kept	FUM (£m)	Client portfolio (£000s)	As % consideration
03/11/2014**	Knight O'Byrne	Cornwall	Y	51	N/D	N/D
30/01/2015*	Roxborough Consultancy	Didcot	N	55	916	94%
02/02/2015**	First Class Financial Management	West Bromwich	Y	N/D	N/D	N/D
09/02/2015*	K L Plester Financial Services	Kidderminster	Y	N/D	1,717	94%
27/02/2015**	CIB Wealth Management	Rochester	Y	41	N/D	N/D
01/04/2015*	Clarendon Financial Solutions	Nottingham	Y	25	461	95%
30/04/2015*	IFS	National (Stroud)	Y	N/D	4,100	96%
27/07/2015**	Quest Financial Management	Derby	N	N/D	N/D	N/D
27/07/2015*	Phoenix Independent Financial Services	Blackburn	N	N/D	N/D	N/D
06/08/2015**	Davisons Financial Management	Devon	Y	N/D	N/D	N/D

Source: AFH, Edison Investment Research. Note: *Acquisition accounted. **Asset purchase accounted.

IFS (UK)

IFS (UK) was acquired by AFH Group on 30 April 2015. Not only was it the largest deal of the year but, by some margin, the largest ever undertaken by AFH. The scale and nature of IFS meant it was treated differently from the other deals. It was not immediately integrated into AFH's existing infrastructure and AFH incurred the full existing cost base of IFS for this period. The reason for this was that there was much more uncertainty than usual over the retention of advisers, given that the proportion of those who held equity was lower (giving them less of a deal benefit), and staff were accustomed to a different remuneration structure and working practices. IFS provided a different service proposition to its advisers and paid them accordingly (cost of sales mainly paid to advisers typically 70% against AFH average of c 48%). The existing arrangements were continued until 1 November 2015 to give both parties time to examine the fit. AFH had built into the deal structure with a much lower upfront consideration, with the right to review the maximum consideration after six months. AFH announced in the trading statement that the number of advisers who have been authorised under AFH, and hence the price to be paid for IFS UK, has reduced from the maximum level. The best estimation is that the total consideration will now be £2.9m.

Exhibit 3: Key financial metrics re IFS acquisition

£000s	Provisional fair value to be recognised on acquisition	Fair value adjustments	Previous carrying value
Client portfolio	2,750	2,750	-
Trade and other receivables	511	-	511
Cash at bank	71	-	71
Assets	**3,332**	**2,750**	**582**
Trade and other payables	147	-	147
Provisions and other payables	259	-	259
Liabilities	**406**	**-**	**406**
Total identifiable net assets at fair value	2,926		
Initial cash consideration	450		
Deferred contingent consideration	2,300		
Net assets adjustment to initial consideration	176		
Total acquisition cost	**2,926**		

Source: AFH, Edison Investment Research

The contingent consideration is payable in three tranches (16 November 2015, 31 December 2016 and 31 December 2017) and is subject to an earnout based on future turnover. On 1 December 2015 AFH announced that an earnout consideration comprising a cash payment of £357k and the issue of 218k shares (52k new shares, 166k from treasury, total value £357k) had been made. This implies that the current expectation is that the full £2.3m deferred consideration will be earned.

The post-acquisition revenue for the period ended 31 October 2015 was £1.7m and the post-acquisition profit for the period ended 31 October 2015 was £180k. If the acquisition had taken place on 1 November 2014, management estimates that the revenue would have been £3.4m and there would have been a profit of £250k, which implies a post-tax, pre-synergy multiple on the £2.9m total acquisition cost of 14.6x current. We would expect this to drop to well under 10x once cost savings are fully realised (the exceptional cost of integrating the business was £240k). These ratings compare with AFH's own FY15 PE rating of 14.7x.

December 2015 placement

AFH structures its deal so that the deferred consideration, which is performance related, is paid from the cash by the business acquired. This has led to rapid growth in cash generation and in FY15 EBITDA (net cash generation from trading excluding non-cash, share-based payments) increased by 115% from £1.3m to £2.8m.

The upfront consideration for new acquisitions comes largely from equity issue carried out ahead of the deals (debt remains a very modest 28% of equity). To this end, AFH announced in December that it had raised gross proceeds of £6.37m (net £6.16m) through the issue of 3.8m shares at a price of 165p. With upfront consideration typically at around one-half of total consideration, and with some deals now involving equity consideration, we believe that the December raise should fund deals through 2016. The opportunity was taken to broaden the shareholder base (new shareholders included the River and Mercantile UK Micro Cap Investment Company and Octopus Investments), with the aim of enhancing liquidity down the line.

Other issues

Market sensitivity

There is a range of sensitivities to market movements:

- Lower fees: AFH indicates that a 10% move on the FTSE would see a 4% change in the average portfolio valuation and, with most charges ad valorem, a similar drop in fees. Of this, advisers will bear nearly half the nominal cost through lower fees/cost of sales.
- More volume: the volume outlook is uncertain.
  - In uncertain times there may be increased demand for advice as investors seek capital protection rather than growth/income.
  - There could also be greater activity around managing capital gains tax through tax years.
- Vendor appetite to sell: falling markets may see more IFA vendors looking to sell and a shift down in expected pricing.

At this early stage of the year, we have not changed estimates for recent market falls.

Competition

We note that after many years of banks withdrawing from lower-end retail advice Santander may now be dipping its toe back in the market. We note that its typical customer had a lower portfolio than the average AFH customer. While some advisers may be tempted to switch back to a salaried employment, they are likely to be those who have been least successful in AFH's fee structure.

Valuation

The average of our valuation approaches for the existing business is 232p (previously 217p) per share, equivalent to 14x 2017e earnings, reflecting the long-term, double-digit growth story and the potential benefits of deploying further resources into acquisition opportunities. This multiple is below AFH's broad peer group. Our value gives no benefit for deploying available equity in deals, which is likely to drive significant earnings upgrades. Over time, delivery of earnings and a continued effective execution of the acquisition strategy are the most likely catalysts for a higher share price.

Discounted cash flow: 240p, previously 272p

We explicitly forecast operating cash generation until 2017, 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. We have also taken the balance sheet cash and added £6.2m for the equity raise. All cash flows are then discounted at the cost of capital (10% assumed), generating a fair value of 240p (down from our previous estimate of 272p). The December equity was issued at 165p (ie below our previous implied valuation). It is included in the calculation at par pending deployment, thus reducing the average valuation compared with our previous estimate. The cash generated from future deals should increase this valuation significantly.

Gordon's growth model: 223p, previously 161p

We believe that a skills-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 that it should therefore trade at c 2x book. We then apply a premium for near-term performance as, despite recent equity raisings, the normalised 2016-17e ROE is below our long-term estimates, but the equity growth rate is well above. This indicates a fair value of 223p (up from our previous estimate of 161p). In this methodology we valued the equity issued in December at 2x book, hence this valuation has increased. The marginal equity generated from new deals is likely to see only a modest uplift to this valuation. The sensitivities are given below.

Exhibit 4: Gordon's growth model and sensitivity

£s	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	0.97	0.97	0.97	0.97
Implied price	**1.94**	**2.13**	**2.18**	**1.62**
Premium for near-term performance	15%	15%	15%	15%
Fair value	**2.23**	**2.45**	**2.51**	**1.86**
Difference		0.22	0.28	-0.37

Source: Edison Investment Research

Peer comparisons

Exhibit 5: Peer valuation comparatives

		P/E (x)		Yield (%)
	Market cap (£m)	2016	2017e	2016e
AFH*	40	13.1	10.3	1.8
IFA businesses				
Lighthouse Group	12	10.7	N/A	4.0
Frenkel Topping	43	26.5	N/A	1.9
Professional service groups				
IFG Group*	162	17.0	N/A	3.2
Mattioli Woods (May following year)	157	22.2	19.3	2.0
Wealth managers				
Brooks Macdonald (June)	245	18.4	N/A	1.8
Charles Stanley (March following year)	155	22.4	12.8	1.8
St James's Place	4,769	24.0	N/A	2.8
Platform providers				
Hargreaves Lansdown	6,230	33.8	N/A	2.5
Share plc**	40	17.9	N/A	3.2

Source: Thompson Reuters, Edison Investment Research. Note: *Edison Investment Research forecasts, **Edison cash-adjusted basis. Priced at 22 January 2016.

For the reasons identified above, we believe AFH's business model is differentiated from peers. The companies above should only be taken as illustrative of AFH's business, but it appears to be on a lower rating than peers.

Financials

Changes to estimates

On the upside, FY15 revenue was £477k ahead of expectations. Despite this, the cost of sales (fees to advisers) was a little higher than expected by £188k, driven by the mix of business. Administration costs were also higher (£449k), with the administration cost ratio of 39.8% against our forecast of 38.5%. Overall pre-tax profits were £195k ahead of our forecast. We have carried these trends forward into 2016e. The FY15 tax rate was also a little better than expected, but we have assumed standard taxes going forward. The EPS estimates have fallen because we have included the equity raised in December 2015, but no benefit for its deployment in due course. On a one-half upfront consideration, this equity could finance acquisitions of nearly £10m, around a quarter the current market capitalisation providing significant scope for estimate upgrades. Our new organic 2017e show modest growth with tight cost control.

Exhibit 6: Estimates changes

	Revenue (£m)			Adjusted PBT (£m)			EPS (p)			Dividend (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
FY15	20.5	21.0	2	2.6	2.7	4	10.56	11.30	7	1.75	2.25	29
FY16e	27.0	27.5	2	3.6	3.7	4	13.93	12.68	(9)	2.00	3.00	50
FY17e	N/A	31.0	N/A	N/A	5.0	N/A	N/A	16.20	N/A	N/A	4.00	N/A

Source: Edison Investment Research

Exhibit 7: Financial summary

£'000s	2014	2015	2016e	2017e
Year end 31 October				
PROFIT & LOSS				
Revenue	15,037	20,977	27,500	31,000
Cost of Sales (exc amortisation and depreciation)	(13,514)	(18,002)	(23,359)	(25,622)
EBITDA	1,523	2,975	4,141	5,378
Depreciation	(84)	(108)	(291)	(263)
Amortisation	(343)	(764)	(1,336)	(1,242)
Operating profit (pre exceptional)	1,096	2,103	2,514	3,873
Exceptionals	(196)	(240)	0	0
Other	0	0	0	0
Investment revenues	(39)	(161)	(217)	(217)
Profit Before Tax (FRS 3)	861	1,702	2,297	3,656
Profit Before Tax (norm)	1,439	2,714	3,749	5,014
Tax	(260)	(421)	(727)	(980)
Profit After Tax (FRS 3)	601	1,173	1,570	2,677
Profit After Tax (norm)	1,061	2,229	2,999	4,011
Average Number of Shares Outstanding (m)	18.2	19.7	23.7	24.8
EPS - normalised (p)	5.83	11.30	12.68	16.20
EPS - FRS3 (p)	3.31	5.95	6.64	10.81
Dividend per share (p)	1.50	2.25	3.00	4.00
Cost sales as % revenue	-49%	-49%	-47%	-44%
Admin cost (exc amortisation) as % revenue	-42%	-40%	-40%	-40%
EBITDA Margin (%)	10.1%	14.2%	15.1%	17.3%
Operating Margin (before GW and except.) (%)	7.3%	10.0%	9.1%	12.5%
ROE	6.7%	10.1%	9.3%	11.8%
Normalised ROE	11.9%	19.2%	17.7%	17.7%
BALANCE SHEET				
Fixed Assets	9,987	21,863	20,436	19,131
Current Assets	8,127	8,172	15,063	16,792
Total Assets	18,114	30,035	35,500	35,923
Deferred consideration due >1 yr	(2,266)	(4,321)	(2,843)	(1,442)
Other current liabilities	(2,650)	(4,370)	(4,870)	(5,977)
Deferred consideration due <1 yr	(1,866)	(5,238)	(3,000)	(1,000)
Other LT liabilities	(794)	(3,477)	(3,477)	(3,477)
Net Assets	10,538	12,629	21,309	24,027
NAV per share	0.54	0.63	0.90	0.97
CASH FLOW				
Operating Cash Flow	1,581	(1,254)	3,384	4,159
Net cash from investing activities	(2,761)	(4,594)	(3,260)	(2,958)
Net cash from (used in) financing	2,499	3,961	6,156	(170)
Net Cash Flow	1,319	(1,887)	6,279	1,031
Gross Cash	2014	2015e	2016e	2017e
Opening	4,334	5,653	3,766	10,045
Change in cash	1,319	(1,887)	6,279	1,031
Closing balance sheet	5,653	3,766	10,045	11,076
Cash, debt and deferred consideration analysis				
Closing cash	5,653	3,766	10,045	11,076
Closing financial debt	(752)	(3,495)	(3,432)	(3,432)
Closing bal sht net cash	4,901	271	6,613	7,644
Closing deferred consideration<1 yr	(2,266)	(4,321)	(2,843)	(1,442)
Closing deferred consideration >1 yr	(1,866)	(5,238)	(3,000)	(1,000)
Closing net cash / (debt)	769	(9,288)	770	5,202

Source: AFH, Edison Investment Research

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