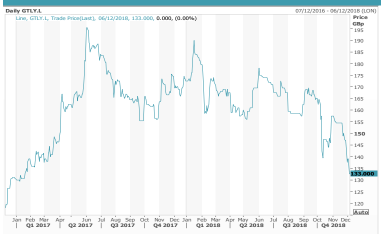
7 December 2018

HARDMAN & CO.

GATELEY (HOLDINGS) PLC

Strong trading and industry opportunity

Business Support Services



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**GTLY**
Price (p)	**132.5**
12m High (p)	193
12m Low (p)	130
Shares (m)	108
Mkt Cap (£m)	147
EV (£m)	148
Free Float*	ca.40%
Market	AIM

**As defined by AIM Rule 26*

Description

Gateley provides legal and related professional services predominantly through its UK offices. In 2015, it was the first full-service commercial law firm to float.

Company information

CEO	Michael Ward
Finance Director	Neil Smith
Chairman (non-exec)	Nigel Payne

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Key shareholders

Directors	5.5%
Liontrust	10.6%
Miton	7.2%
Premier	3.8%

Diary

8 January 2019	Interims

Analyst

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Gateley's trading statement in respect of 1H 2019 was sparkling, with 20% revenue growth in 1H and a highly confident outlook for 2H. We expect to revise our forecasts up by £2m at the revenue line and by more than £0.5m in EBITDA with the interims, a highly positive picture 7 months into the financial year, after upward revisions with the finals. A broad-based law-led professional services group, it is a leader in serving the UK mid-market. It is delivering on its pre-IPO plan, growing revenue, profit, breadth of service offering and geographical footprint since flotation. The opportunity for long-term growth at Gateley is substantial.

- **Current trading:** The trading statement highlighted profitable 20% growth in revenues, half from acquisitions and half organic, which continues its strong organic growth record since IPO. Moreover, the company delivered a confident outlook statement with revenue of more than £102m expected and maintained EBITDA margins, above our estimates.

- **Deals:** The statement was extremely positive about the two deals done this year, which added 10% to group revenues. The group also made encouraging comments about all of its acquisitions and we are keen to learn more about progress in these businesses with the interim results.

- **Sector:** The legal sector is growing profitably, and more firms are coming to the market, following Gateley's lead. A larger sector is a positive for the group, as it improves investor understanding, and affords the opportunity for comparison. This should favour the now established Gateley, which has improved from 48th to 44th in the latest rankings, and where we forecast continued profitable growth.

- **Valuation:** The 2019E P/E is 11.6x, falling to 10.0x in 2020E, on numbers we expect to revise up at the interims. We forecast the dividend yield to surpass 6% in FY20E, and it should continue to grow. The group also offers an attractive free cashflow yield with strong cash generation thanks to limited capex requirements, with working capital being the main cash draw as the business grows.

- **Investment summary:** Gateley is a fully invested, consistent performer in a new and exciting space, which is likely increasingly to attract investor attention. It is a high-quality professional services group with significant growth potential, an excellent track record of delivery, a strong management, and a strategy to diversify further in complementary professional services.

Financial summary and valuation

Year-end Apr (£m)	2016	2017	2018	2019E	2020E
Sales	67.1	77.6	86.1	100.1	110.0
EBITDA*	12.9	14.9	16.5	18.9	21.9
PBT adjusted	12.0	13.8	14.1	15.9	18.3
EPS (adjusted, p)	9.1	9.4	10.6	11.5	13.2
DPS (p)	5.6	6.6	7.0	7.5	8.1
Net cash	-4.2	-4.8	-0.7	-1.0	6.4
P/E	14.6	14.1	12.5	11.6	10.0
EV/EBITDA	11.1	9.8	8.6	7.8	6.4
Dividend yield	4.3%	5.0%	5.3%	5.7%	6.1%

Source: Hardman & Co Research
**Pre-share-based costs*

Trading update

Gateley issued its trading update in respect of the six months to October, 2018 on 23 November.

"The Board is delighted with the strong performance of the Group in the period with strong growth evidenced from the successful execution of both our organic and acquisitive growth strategy and the well-balanced nature of our resulting expanded service lines. Group revenue for the six months ended 31 October 2018 is expected to be not less than £46.4m, an increase of 20% as compared to £38.6m for the six months ended 31 October 2017. Revenue growth attributable to the acquisitions of GCL Solicitors and Kiddy & Partners announced in May and July 2018, respectively, accounted for approximately half of this increase.

Current activity levels remain encouraging despite the backdrop of political and economic uncertainty and the Board has continued to invest for the future with total staff numbers rising from 791 as at 30 April 2018 to 928 as at 31 October 2018. Acquisitions of complementary nonlegal businesses remain a core part of the Group's growth strategy to enhance its service lines and cross sell to a widening group of its clients. The Board is delighted with the contributions all four post IPO acquisitions have made to the Group to-date.

The Board looks forward to the second half of the financial year with confidence and now expects the Group to generate revenues of not less than £102m for the year ending 30 April 2019 with an EBITDA margin comparable with that achieved in 2018."

This was a seriously strong trading statement at a time when more than half of companies in the European earnings season have come in below estimates. We would flag the following issues:

- Revenue growth of over 20% is commendable.
- Half of this comes from acquisitions, and the progress here is hard to assess, given that we do not know the seasonality of the acquired businesses. We are keen to hear how these deals are bedding in, and of progress of its first two acquired companies, Capitus and Hamer. The statement sounds very positive in this respect.
- This leaves an organic revenue growth of ca.10%, which is extremely strong, and continues the group's robust performance since flotation.
- Staff numbers are a key metric as this has a direct relationship to revenue generation capacity and numbers are up 17% in 1H, indicating revenue per employee is increasing.
- The outlook statement is really positive and suggests that both our revenue and EBITDA estimates will need to be revised up by £2m, and more than £0.5m, respectively. We will introduce these revisions with the interim results on 8 January 2019.

Overall, this is a sparkling trading update from Gateley and the CEO made the following comments in the statement:

"Our strong financial performance continues to enable the Board to invest in the future of the Group. It's been a busy six months, including the acquisitions of GCL Solicitors and Kiddy & Partners, in a sector showing opportunities for further strategic consolidation. These acquisitions, together with our strong underlying organic growth, demonstrate the increasing momentum across our business and the successful execution of our focused strategy. Client service remains at the centre of our ethos and I continue to be impressed with the dedication and skill sets of all our staff as we continue to deliver on our stakeholder promises."

Final FY18 results

Profits came in well ahead of our expectations. EBITDA of £16.5m pre-share-based costs compared with our forecast of £16.0m. The dividend was in line with our expectation while EPS was slightly better – we have changed our presentation to conform with the company's basis. Previously, we had shown EPS before amortisation of customer lists and we think that this is the better number for investors to use. However, it's confusing showing estimates on a different basis to that presented by the company – please bear in mind that the earnings are therefore understated.

P&L

Year-end April (£m)	2017	2018	2019E	2020E
Sales	77.6	86.1	99.7	109.6
Other income	0.4	0.4	0.4	0.4
Total revenue	78.0	86.4	100.1	110.0
Staff costs	45.6	52.6	55.3	60.8
Other opex (net)	17.9	17.5	19.8	20.8
Adjusted EBITDA (preshare based)	14.9	16.5	18.9	21.9
Depreciation	0.8	1.0	1.1	1.1
Share based payments	0.3	0.7	1.0	1.2
Financial income	-0.2	-0.2	-0.3	-0.3
PBT	13.6	14.6	15.9	18.3
Exceptionals	0.0	0.5	0.0	0.0
PBT reported	13.1	14.6	15.9	17.1
Tax rate %	23.3	19.5	20.0	20.0
EPS (Adj., co basis, post amortisation.) (p)	9.4	10.6	11.5	13.2
DPS (p)	6.6	7.0	7.5	8.1
Cover	1.4	1.5	1.5	1.6
Weighted average shares (m)	106.7	106.9	110.8	110.8

Source: Hardman & Co Research
Not all lines shown so some lines do not add

Main highlights of the financial year were:

- Strong organic revenue growth, with group revenue increasing at 11%, including the benefit of a full year of acquisitions and some lateral hires. Organic revenue growth was an impressive 9.5%, excluding the benefit of acquisitions. Revenue per fee earner was £169k (£170k), down 0.5%. Fastest growing segments were property +18%, helped by the impact of last year's two acquisitions, and corporate, +14%. Business services also showed double-digit growth. None of the segments showed a decline in revenue, although the Dubai office was noted as having shrunk, but has now moved from a loss-making position last year to breakeven.

- Average staff numbers increased by 11.4%, to 509, and the wages and salaries bill rose by 15.5%. The number of legal and professional staff increased by 11.4%, while administrative staff rose by just 3.4%, an indication of the potential operational gearing in the business. Direct personnel costs – those charged to operating segments – were up by 18%, while indirect or overhead actually fell by 3.4%. There could be some change in the basis of allocation or in time spent by indirects on legal work. Investors should note that the number of professionals and their seniority are increasing, which should result in an increase in the fee-earning capacity of the business. Personnel costs to revenue increased from 58.7% to 61.1% last year.

Segment splits

	Revenue 2017	Revenue 2018	EBIT 2017	EBIT 2018	Rev chg 18 vs. 17	Margin 2017	Margin 2018
Property	28.6	33.7	13.0	15.8	18.0%	45.4%	46.8%
Banking finance	15.1	15.5	6.3	5.8	2.3%	41.6%	37.2%
Corporate	14.1	16.0	4.1	4.3	13.8%	29.0%	27.1%
Business services	10.9	12.2	4.5	5.1	11.7%	41.5%	41.4%
Pensions and benefits	7.1	7.5	2.6	2.8	5.4%	37.1%	37.5%
Unbilled movement, etc.	1.7	1.1	1.7	1.1	-33.7%		
TOTAL	77.7	86.1	32.3	34.9	10.8%	41.6%	40.5%

Source: Company, Hardman & Co estimates

- Operating expenses other than staff costs fell by 2.2%, after an exceptional credit of £0.5m, partly the release of a provision for contingent consideration on the Gateley Hamer acquisition, and partly a credit for a lease incentive, the result of terminating a property lease. Excluding these exceptionals, the underlying trend was a small increase of 0.9%, again illustrating the potential for operational leverage.

- Interest costs amounted to £179k, as the group generated strong cashflow. Acquisitions already completed in the current year mean that the group will not build a large cash balance. Depending on further acquisition activity, the year-end position is expected to remain at a marginal net debt position, before moving to a net cash position next year. This is after a significant spend on acquisitions (half funded by equity) in the current year and an assumption of zero next year.

- The underlying tax rate fell to 20%, a useful boost to EPS, which on the company basis — after amortisation of customer lists, and excluding exceptional items — rose by 11%. The dividend has been increased to 7.0p per share, up 6.1%.

- A majority of staff now own equity in the business, and there are three employee share schemes in operation. Partner level employees saw their first share scheme vesting in June (SARS – Stock Appreciation Rights Scheme).

- The group has made two recent acquisitions since year-end.

- Share-based costs increased from £0.1m 2 years ago to £0.3m the previous year and £0.7m last year. As the benefits of share incentivisation spreads and the share performance underpins the attractiveness of this to the retention and motivation of staff, the level should see a trend of further increases. This is a real positive factor and a distinguishing feature of the business vs. its predominantly unquoted peers.

- Cash generation was excellent with net cash flow from operations post tax up 59% year-on-year to £12.2m. The comparative was slightly depressed by an exceptional working capital performance at the year-end two years ago.

Cashflow (£000s)	2017	2018	2019E	2020E
EBITDA (pre-share based)	14,928	16,517	18,948	21,929
Contingent consideration release		-362		
Other adjustments	2	544		
Cash from operations pre-working capital	14,930	16,699	18,948	21,929
Increase in receivables	-5,041	-2,330	-2,500	-2,500
Increase in payables	636	851	500	500
Decrease/(increase) in provisions	-5	14		
Cashflow from operations pre-tax	10,520	15,234	16,948	19,929
Tax paid	-2,844	-3,051	-2,853	-3,173
	7,676	12,183	14,095	16,756
Capex	-1,485	-791	-1,000	-1,000
Acquisitions	-228	-179	-7,470	
Cash spent on investing	-1,713	-970	-8,470	-1,000
Dividends paid	-6,342	-7,042	-7,980	-8,313
Interest receivable	237	233	200	200
Interest payable	-420	-412	-480	-200
Repayment of loans from former partners	-4,552	-551		
Cash from lock-in arrangements	159			
Sale of own shares		361	2,294	
Own shares acquired (buybacks)	-164	-217		
Cash from financing	-11,082	-7,628	-5,966	-8,313
Net cash/debt movement	-5,119	3,585	-341	7,443
Repayment of bank loans	-1,980	-1,980		
Net cash/debt movement	-7,099	1,605		
Closing net (debt)/cash	-4,793	-658	-999	6,444

Source: Hardman & Co Research
Note: Historical date per cashflow, forecasts are movements in net debt

Model estimates

- EBITDA margins were flat at 19.2% (pre-share-based payments, as is the company's preferred measure) and we expect a small decline in the current year, which is partly the impact of factoring in the new acquisitions. Margins were better than we had originally assumed but we are taking a conservative stance for the current year.

- Noteworthy is that share-based costs are rising. These share-based costs, for accounting reasons, could exhibit some volatility.

- We estimate strong cash generation (£14m free cashflow FY19E) and consider our estimate of £1m net debt at end FY18E and particularly £5m net cash at end FY19E to be conservative. Note that our model includes only modest deferred consideration elements. The company is in the process of increasing its debt facilities by £3m, and we would expect further acquisitions in due course.

- Our model includes no further acquisitions, beyond the two announced since the financial year-end. We expect these to be an ongoing feature of the strategy of Gateley, although the company may feel that two deals is sufficient to manage for the moment, unless something compelling emerges.

Conclusions

With its final results, Gateley reinforced the investment message that it is a solid and consistent performer. Its spread of activities, whether it be by sector, client, geography or legal discipline is extremely broad-based, which gives it an unusual resilience, and protection against a downturn in a single area. Its largest client is less than 2% of turnover. This was reinforced by its positive trading statement covering the first six months of the current year.

Increasingly, fees are not being charged hourly, although the company operates a rigorous discipline in costing on a per-hour basis, allowing it to price more effectively. While big legal customers tend to be using centralised procurement for legal services and focusing on price, not quality, Gateley's exposure is mainly to the mid-market, where service quality and personal relationships are paramount.

Gateley has completed two acquisitions this year, financed broadly 50:50 debt and equity, and the group is currently increasing its debt facility. Its recent acquisitions are encouraging. Legal services firm GCL gives it an increased exposure to the south, and in the housebuilding and property sectors, higher property prices give it an opportunity for increased margin.

The acquisition of Kiddy, a people business, gives it exposure to large corporates, and a business where customers pay in advance and there are no bad debts; and most of its business is on a retainer basis. It is a similar business, albeit smaller in scale, to the recently floated Mind Gym, which is trading at a much higher multiple, suggesting that Gateley has achieved a well-priced transaction. The acquisitions are in the areas of real estate, people and business services and it would appear that Gateley is gradually positioning itself as a broader professional services organisation, rather than a pure legal services business.

Therefore, Gateley is positioned as a broad-based commercial law and complementary professional services group. It is a leader in the UK mid-market, and has seen double-digit revenue and profit growth over a period of more than 10 years. Its FY18 results were better than market expectations and confirmed its position as a well-diversified legal and related service business with more than 500 fee earners at last year-end, a broad spread of diverse operations and a business with consistent delivery, and a cautious but progressive acquisition strategy.

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