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Evaluation of the takeover offer for AFH Financial Group plc

16/2/2021

Summary: In our view AFH's stock may be worth £12.20 in five years. In our view AFH is in a position to restart acquisitions at attractive multiples without the need for external equity capital. We estimate that acquisitions together with organic growth will lead to cash flow growth rates of 24% for the next five years. Accordingly, we find no compelling reason to accept the offer of £4.63 per share.

On 25 January 2021 AFH Financial Group plc (AFH) announced a recommended cash acquisition of the company by Cortina Bidco Limited, a newly formed company controlled by funds managed by Flexpoint Ford LLC, a US private equity company.

This document evaluates the attractiveness of the offer of **£4.63 per share**. At the time of the announcement the number of shares issued were 42.98m which gives a market cap of £199m. Together with 1.9m in options and 3.6m for outstanding convertible bonds, the total number of shares to be issued is 48.5m, resulting in a total offer price of £224.5m.

For more information about our assessment of the company please see our Write-Up on AFH from September 2020 ([link](#) to website).

Comparison with historic stock prices:

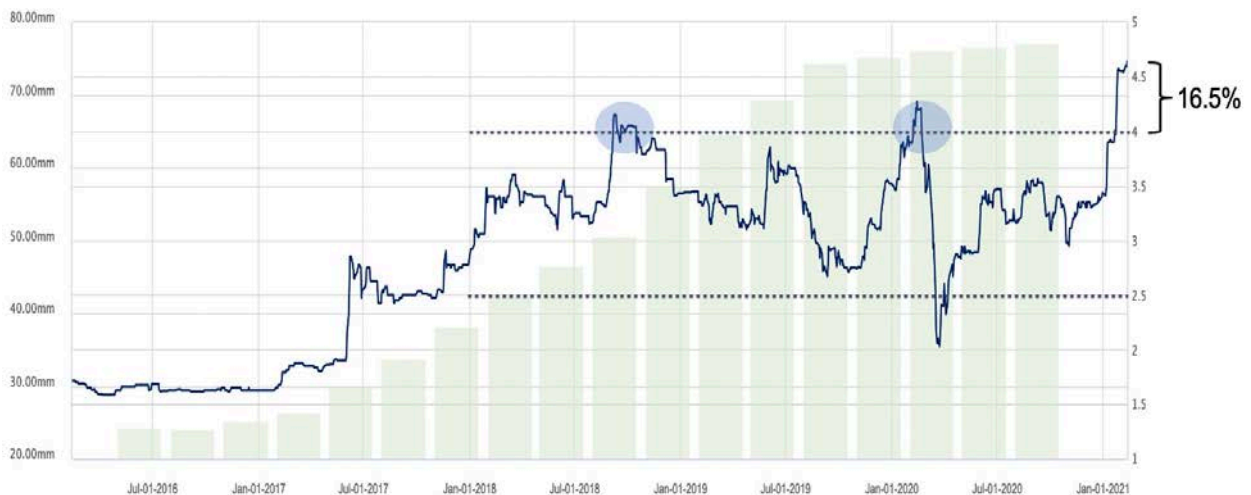


Figure 1: AFH stock price (right axis in £) and revenue (left axis in £) over 5yrs. Source CapitalIQ and own annotations.

The offer price is 16.5% above the last trade before the announcement. Over the last three years, the stock has traded in a range of around £2.50 to £4.00. The stock reached £4.00 in mid 2018 and traded as high as £4.30 before the COVID outbreak. Over the last three fiscal years the company has grown revenues by 129%. Since October 2019 growth has slowed as

AFH voluntarily opted to pause acquisitions and consolidate. During the past year it has paid down debt, reduced its outstanding contingent considerations, hired more advisors and has grown AuM despite a tough environment. Accordingly, we believe that the company is worth a lot more today than a year ago and that the stock had considerable upside potential at ~£4.00.

⇒ **The offer price offers little upside compared with historic stock prices. (Note, this also implies that the price is unlikely to fall significantly if the takeover attempt fails.)**

Comparison with trading multiples of listed peer companies:

	Share price on acquisition announcement date (£)	CapIQ normalized 2021 CY EPS est.*	Multiple CY 2021
<u>Advice Firms</u>			
St. James's Place	11.80	0.61	19.3x
Mattioli Woods	7.48	0.43	17.4x
AFH (@ takeover price)	4.63	0.32	14.5x
Average			17.1x
<u>Platforms</u>			
AJ Bell	4.43	0.10	44.3x
IntegraFin	5.42	0.16	33.9x
Hargreaves Lansdown	16.58	0.57	29.1x
Nucleus Financial**	1.88	0.08	23.4x
Average			32.7x
<u>Wealth Managers</u>			
Brewin Dolphin	2.90	0.23	12.6x
Charles Stanley	3.12	0.25	12.5x
Rathbone Brothers	15.60	1.30	12.0x
Brooks Macdonald	18.82	1.57	12.0x
Average			12.3x
<u>Other</u>			
Quilter	1.53	0.09	17.0x
Average of all firms			20.7x

Figure 2: Multiples of comparable public companies. Source CapitalIQ and own calculations.

*For St. James's Place we use 2021 CY cash EPS estimate from CapitalIQ because it considers the income generated from AuM maturing from gestation. Using the Cash EPS results in a lower multiple (19.3x) than if we used the normalized EPS (22.3x).

**Nucleus Financial data is as of Feb 9th, 2021, date of acquisition announcement by James Hay.

Within wealth management, companies operate in different segments of the value chain. In our view, the most appropriate peer companies are those that generate the majority of their revenues from direct advice to end customers. This aspect is important because the profitability in the value chain usually moves towards the end customer. That's where AFH sits. AFH's advisers build trusting relationships with their clients that often last for many years. Platforms and asset managers, in contrast, tend to compete directly on fees. Platforms need scale to survive, and fund managers have to contend with low-cost passive providers.

Two public companies in the UK with a comparable advice-based business model are St. James's Place and Mattioli Woods. Both trade at higher multiples based on consensus earnings estimates for 2021.

Note: In the Scheme Document (p. 13) the chairman states that the offer represents a price-to-earnings multiple of 21.0x. This multiple assumes maximum dilution from all outstanding instruments and does not adjust earnings for non-economic costs such as amortisation. In its annual reports the company uses adjusted earnings as a key performance indicator (which in our view is indeed closer to economic truth). According to their 2020 annual report adjusted EPS was 34.1p. On that basis the offer would represent a multiple of 14.7x.

Investment platforms, such as AJ Bell, IntegraFin, Hargreaves Lansdown and Nucleus Financial earn the majority of their revenues from platform and transaction fees but do not typically offer financial planning advice. Wealth Managers, such as Brewin Dolphin, Charles Stanley, Rathbone Brothers and Brooks McDonald provide discretionary fund management solutions to advisors, institutional investors, and end clients, and generate the majority of their revenue from investment management fees. Quilter is a vertically integrated business combining fund management and a platform with restricted financial advice. The average multiple across all firms is 20.7x.

⇒ **The offer price in our view is low relative to trading multiples of comparable companies.**

Comparison with estimates of future cash flows:

The value of any business is the present value of its future cash flows. Forecasting future cash flows is difficult and inevitably involves making assumptions. The following information forms the basis of our forecast.

When discussing the 2020 results, management informed the market that after a year of consolidation they are ready to start acquisitions again. AFH historically paid between 4-5x EBITDA for acquisitions. According to management those multiples are still achievable. Acquisitions at those multiples imply a return on incremental capital of 20-25% before tax. With little or no depreciation, a modest level of debt financing (~1x EBITDA) and low interest expense (AFH's debt facility costs 2.75% over LIBOR) the after-tax ROI will be 20-25%. Acquisitions at those multiples may create significant shareholder value. (Note: we rarely find businesses with similar characteristics that trade at P/E multiples of less than 25x.)

Based on historic guidelines and management information we use the following inputs for our future cashflow model:

- Organic growth of 9% (6% net organic AuM growth plus 3% market beta)
- Dividend payout of 25% of free cashflows
- 75% reinvestment rate of FCFs in acquisitions @ 20% ROIs generating CF growth of 15%
- No new equity raises
- No changes to margins

Year	2020	2021	2022	2023	2024	2025
FCF (GAAP NI + D&A -Capex, in £m)	13.7	17.0	21.1	26.1	32.4	40.2
<i>yoy growth</i>		24%	24%	24%	24%	24%
Dividend (£m)	3.4	4.2	5.3	6.5	8.1	10.0
Reinvestment in M&A (£m)	10.3	12.7	15.8	19.6	24.3	30.1

FY 2025 FCF (£m)	40.2	
Exit multiple	14.5	held constant
Mcap (£m)	582.4	
DVD Future Value (£m)	38.8	DVD payouts reinvested at 8%
Total Future Value (£m)	621.2	
Est. Shares outstanding FY 2025	51.0	Assuming further dilution
Value per share FY 2025 (£)	12.2	

Figure 6: Future cashflow model based on own estimates

Based on the model the free cashflow in 2025 is £40.2m. If we simply hold the multiple constant at 14.5x, we arrive at a future market cap of £582m (although as a much larger company and with such a growth profile, we believe the multiple is likely to be higher). We add the dividends to get a total future value of £621m. Considering some further dilution in addition to the convertibles and outstanding option plans we get a future value per share of £12.20.

⇒ **The offer price in our view is low compared with the estimated value of AFH's growth opportunity.**

Conclusion:

We compared the offer price to historic stock prices, to trading multiples of comparable public companies and to our estimate of future cashflows. We find no compelling reason to accept the offer. AFH has a market leading product offering and is well positioned to compound earnings at attractive levels over the following without equity dilution. In our view the no-deal alternative may be worth ~£12 in five years.

We prefer to remain owners of shares that will be worth in our view ~£12 in five years' time, using realistic assumptions, than to receive £4.63 in cash today.

An attractive offer needs to appropriately value the business on a current basis and reflect some value of the compounding opportunity going forward. We take the future value of £12.20 per share and work backwards by using an appropriate discount factor reflecting cost of capital and risk. Discounted with 12% we get a present value of £6.90. That price would imply a 2021 normalised P/E ratio of 21.6x.

An offer price of £6.90 would be sufficiently attractive compared with no-deal in our view.

Note 1: Management and the board lament that access to financing is a bottleneck and the main reason for the acquisition. Specifically, the chairman believes that capital funding is not currently available, without “material changes to the capital structure and dividend policy of AFH” (Scheme document, p. 14). As the board is responsible for capital allocation it should consequently retain the dividend and invest more cash in value-creating acquisitions. We have proposed this to management, unsuccessfully. In the past, management preferred to raise equity to finance acquisitions and apparently had challenges in doing so. Our view is that the company won’t need external equity capital and only modest amounts of debt going forward. We believe AFH will be able to fund organic growth and acquisitions with adequate levels of debt.

Note 2: AFH can be separated into Wealth Management and Protection. The Protection business comprises the brokerage of insurance products. It does not have the same recurring revenue characteristics as AuM-driven wealth management, and an individual valuation would therefore result in a lower multiple. Last year, sales from the Protection segment accounted for 22% and EBITDA for 24% of total results. Although the business is run separately, advice on insurance is part of a holistic financial planning offering. Moreover, since AFH established the Protection business in 2017, it has grown revenues significantly from £3m to £17m. In FY 2020, the business grew at 21% and management expects double-digit growth going forward. Therefore, we see no reason for AFH to be valued at a discount to peers due to the Protection segment.

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