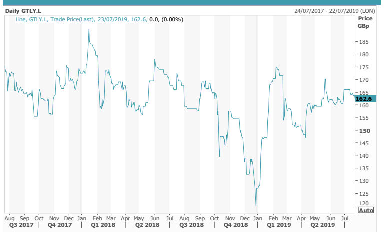
30 July 2019

Business Support Services



Source: Refinitiv

Market data

EPIC/TKR	**GTLY**
Price (p)	164
12m High (p)	177
12m Low (p)	118
Shares (m)	110.8
Mkt Cap (£m)	182
EV (£m)	185
Free Float*	>40%
Market	AIM

**As defined by AIM Rule 26*

Description

Gateley provides legal and 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
CFO	Neil Smith
Chairman	Nigel Payne

+44 121 234 0000
www.gateleyplc.com

Key shareholders

Executive Directors	4.9%
Liontrust	10.3%
Unicorn	5.8%
Miton	4.4%

Diary

Sep'19	AGM
Nov'19	Trading update
Jan'20	Interim results

Analyst

Steve Clapham 020 7194 7622
sc@hardmanandco.com

GATELEY (HOLDINGS) PLC

Excellent full-year results

Gateley reported another strong set of results, again beating market expectations, underlining its consistency and predictable performance. A broad-based, legal and professional services group, Gateley is a leader in serving the UK mid-market. It continues to deliver on its pre-IPO plan, growing revenue, profit, breadth of service offering and geographical footprint since flotation. Strong cash generation and organic revenue growth were highlights, with 10.7% of revenues coming from acquisitions. Gateley made two strategic acquisitions this year, for shares and cash, which enhances its long-term excellent organic growth performance. A recent strategic placing improved liquidity and further expanded its institutional shareholder list.

- **Strategy:** Gateley has proved itself a consistent performer in this new and exciting sector, with solid organic growth, boosted by complementary legal and professional services acquisitions. A high-growth core business with strong cash generation, is led by a seasoned management team with a track record of delivery, pre and post-IPO.

- **Results:** Results were strong, with EPS of 11.8p, up 7%, vs. our forecast of 11.3p, and accompanied by a generous 14.3% hike in the dividend. The outlook comment was extremely positive – "the Group is well positioned to make even greater progress in the current financial year" – this after a 20% revenue growth year!

- **Valuation:** The valuation, based on our forecasts, is shown in the table below, and the stock is clearly modestly rated, given the track record, attractive dividend yield and resilience. Particularly attractive are the inherently strong financial characteristics, with good cash generation and a limited investment requirement.

- **Risks:** This is a people business. People can leave. Gateley's record, since IPO, in lateral hires and limited losses is impressive, with retirees handing over to the next generation and securing clients. Any new CEO is also a risk, but the change is being closely managed, planned a long way out, and strategy will be unchanged.

- **Investment summary:** Gateley is a quality player in a new and exciting space, which is increasingly attracting investor attention. It is a high-quality legal and professional services group with significant growth potential, an excellent delivery track record, a strong management team, and a strategy to diversify further in complementary professional services. Its valuation is far from demanding, in our view.

Financial summary and valuation

Year-end Apr (£m)	2017	2018	2019	2020E	2021E
Sales	77.6	86.1	103.5	111.2	120.1
EBITDA*	14.9	16.5	19.1	21.3	22.9
PBT (adjusted)	13.8	14.1	16.0	17.7	19.3
EPS (adjusted, p)	9.4	10.6	11.8	13.0	14.2
DPS (p)	6.6	7.0	8.0	8.8	9.7
Net cash	-4.8	-0.7	-3.2	2.0	4.6
P/E (x)	17.4	15.4	13.9	12.6	11.6
EV/EBITDA (x)	12.1	10.7	9.7	8.4	7.8
Dividend yield	4.0%	4.3%	4.9%	5.4%	5.9%

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

Final results

Highlights

The headlines from the final results are:

- revenues up over 20%, half organic;
- company-adjusted EBITDA up 16%;
- basic EPS up 7%;
- dividend up 14%, with payout still under 70%; and
- new year has started strongly.

Management was in a positive mood at the analysts' meeting, and the new CEO presented well and gave a confident performance. We go into some more detail on the numbers below.

P&L

Revenue grew by 20.2% for the year, vs. 20.1% growth in 1H. Of this, 9.5% was organic – a slight reduction on the 10.2% organic growth seen in 1H. This is a very solid performance in an uncertain UK economy that could create further opportunities for Gateley due to its service line balance and resilience. The segmental analysis is as shown in the table below.

Gateley – segment revenue and profit

	Revenue	Revenue	EBIT	EBIT	Rev. chg.	EBIT margin
	2018	2019	2018	2019	2019 vs. 2018	2019
Property	33.7	43.4	15.8	19.8	28.9%	45.6%
Banking Finance	15.5	17.0	5.8	6.4	9.6%	38.0%
Corporate	16.0	16.9	4.3	5.0	5.6%	29.5%
Business Services	12.2	13.4	5.1	6.0	9.9%	44.6%
Employment, pensions and benefits	7.5	11.1	2.8	4.0	47.6%	36.0%
Unbilled movements, etc.	1.1	1.6	1.1	1.6	41.8%	100.0%
Total	**86.1**	**103.5**	**34.9**	**42.9**	**20.2%**	**41.4%**

Source: Hardman & Co Research

Property benefited from the acquisition of GCL Solicitors in Guildford during the year, while Employment, pensions and benefits (EPB) now includes the successful and overachieving Kiddy acquisition. We estimate that the underlying growth in Property was closer to 11% and in EPB 8%. Gateley now has 21 individual service lines, up from 15 at IPO, and it is the diversity and breadth of activities with a clear focus on client service that give security of revenue and growth – the CEO commented at the analysts' meeting that the business had seen revenue growth every year for the past 30 years, which is truly impressive.

Costs have grown a little faster than revenues, as the group continues to invest. New hires are a significant feature, with average staff numbers rising by 20% and personnel costs rising by a similar amount. There is some investment in overheads, including the transition to a new enterprise resource planning system, which is setting up the business (legal and non-legal) and infrastructure for the next decade, and perhaps even beyond.

The growth in staff numbers was 7.4% organic (58 staff) and 12.4% through acquisitions (94 staff), with a roughly equal balance between fee earners and support staff – there looks to have been some investment ahead of future growth.

Gateley – personnel trends

	2018	2019	% chg.
Legal and prof. staff nos.	509	610	19.8%
Administrative staff nos.	248	297	19.8%
Wages and salaries (£000)	45.825	54.341	18.6%
Personnel costs (£000)	52.621	63.412	20.5%
Avg. salary (£000)	60.535	59.913	-1.0%

Source: Hardman & Co Research

Depreciation and amortisation saw a large pick-up, from £1.5m to £2.5m, which was largely the impact of the acquisitions in the year, while other operating expenses saw a 25.7% increase to £22m. This reflects the investment in infrastructure ahead of growth, as well as acquisitions, including the additional GCL office in Guildford.

This led to margins dipping slightly, from 19.2% to 18.5%, at the company's preferred measure of adjusted EBITDA, which excludes share-based payments. The FD confirmed that he believed this to be a temporary dip, and we expect that these margins should trend closer to 20% in the medium term as synergies and expansion on an already well-established UK platform comes through.

This is a pretty attractive level for most businesses, and given Gateley's limited capital expenditure requirements, it is a metric that affords the opportunity for excellent returns to investors. Capex has been running at just over £1m p.a. on a sales base of over £100m. This will likely pick up somewhat as the company invests in its new ERP system, but a business with revenues of over £100m, generating pretty stable EBITDA margins of 20% going forward, and with such limited capex, will be generating cash before working capital of £18m, we estimate – that's a highly cash-generative business.

Balance sheet

While capex is very low by the standards of most service businesses, working capital is typically significant for law firms, and we understand that Gateley is considerably better than the industry average, in part a reflection of its prudent approach to recognition of work in progress. Management is arguably less aggressive in its commentary here than certain of the peer group, with Gateley recognising that client relationships are the foundation of the business and that sometimes clients need some flexibility from their suppliers. Nevertheless, lockup, which is the total of invoiced and unbilled revenue, is improving, as shown in the table below.

The picture will be affected at the margin level by acquisitions, especially the non-legal businesses, which may have different profiles, and likely shorter payment terms. A more subtle point is that the acquisitions can in the short term push up the level of debtor days, as there is a full amount of debtors at year-end but only part of a year's sales. We doubt that this is a significant effect, but one to note.

Two other points are noteworthy in this area. First, there is a prudent accounting change, but the level of provisioning remains at 7%-8% of gross debtors, slightly up YoY – this is consistent with an increase in the proportion of the book over 120 days past due. Second, the level of unbilled revenue is conservatively stated, as Gateley does not account for work in progress on contingent fee cases. Hence there is an additional "hidden" asset in the balance sheet, representing significant work undertaken to date, which may result in future fees.

Working capital – lockup	2017	2018	2019
Receivables days	123	121	120
Unbilled days	49	45	38
Lockup	172	166	157
Current	65.6%	59.3%	57.9%
Past due 0-30 days	6.6%	10.6%	11.2%
Past due 31-120 days	11.4%	14.2%	11.0%
Past due >120 days	16.4%	15.9%	19.9%
Provided	7.1%	7.2%	7.6%

Source: Hardman & Co Research

This is an attractive feature of the group's conservative accounting approach, and represents real value to shareholders – it would increase net assets by over 70% and represents a potential asset of over 20p/share.

Net assets are up by one third to £30m – acquisitions have been financed broadly 50:50 debt:equity, leading to increased equity, as well as retained profits. Net debt at the year-end stood at a modest £3.2m, up from £0.7m last year – this partly reflects the cash element of acquisitions during the year, plus loans to the former partners of GCL – liabilities taken on at the time of the acquisition for which Gateley borrowed another £3m of term debt. We expect the group to be cash-positive by the next year-end if no further acquisitions are undertaken. Management is keen to point out that it does not feel restricted by the size of acquisitions it may make in the future. A small acquisition may need additional debt whereas a larger acquisition could be entirely for shares.

Operations

An exciting investment is being undertaken in a new ERP system, which is an important development for the expanding group structure. The CEO indicated that the pipeline of potential acquisitions was strong, and comprised both legal and non-legal firms. We expect the group to pass the milestone of 1,000 employees this year – hence the need for the increased infrastructure spend and operational investments. This should position the group well in terms of employee attractiveness and for further lateral hires, where the group has been extremely successful especially since its change in 2015 from a traditional partnership model to a plc.

The company is engaged in discussions with senior employees on a new five-year Orderly Market Agreement, which should be announced in the next several months. A new long-term incentive plan (LTIP) is also being introduced, having taken into account comments from shareholders in relation to their existing Stock Appreciation Rights Scheme, from which they are moving away. If EPS growth is sub-5%, none of the shares will vest, and more than 10% EPS growth is required for full vesting (we understand that this may be post acquisitions).

Outlook

The CEO commented in the meeting that the year had started off positively, and management appears confident about the current year, in spite of Brexit fears often being voiced elsewhere. We have kept our forecasts reasonably conservative, as it is early in the year, and the impact of a potential hard Brexit is hard to gauge, although Gateley management consistently emphasises the solid track record and earnings power of the group through difficult historical economic times, the resilience of the broad income streams and counter cyclical service lines. We certainly do not expect any significant impact on Gateley, even in a hard Brexit scenario.

New CEO

Ahead of the results, Gateley announced that Rod Waldie, who is currently the Senior Office Partner of the Manchester office, had been chosen to succeed Michael Ward as the new CEO, when Michael Ward stands down from the role on 30 April 2020.

This is demonstrating good corporate governance with a clear succession plan. The other point made was that Michael Ward, after relinquishing the CEO role, will remain a main board director and will be responsible for the non-legal businesses within the group. The announcement indicated that he will also retain a significant shareholding in Gateley for the foreseeable future.

Rod Waldie is as a key member of the group's management board, and is head of the national property team, an important segment for Gateley. He joined Gateley via the acquisition of the Manchester office of Halliwells LLP in 2010, and has been involved in the successful integration of a number of Gateley's post-IPO acquisitions, including Gateley Capitus, Gateley Hamer and GCL Solicitors.

Rod will shadow Michael on CEO-related activities in the run-up to his official appointment and will join the Board as CEO on 1 May 2020. He will be introduced to investors at the group's final results roadshow in July 2019 and will attend the company's AGM on 19 September 2019 – again demonstrating good governance. Gateley's website lists his expertise as leading a team of real estate lawyers handling a mixture of work. Rod was part of the management team that led Gateley through its 2015 IPO and will continue the present strategy.

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The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com