21st September 2017

Gateley (Holdings) Plc

FY 17 results and initiation

Business support services

Source: Eikon Thomson Reuters

Market data

EPIC/TKR	GTLY
Price (p)	160
12m High (p)	196
12m Low (p)	109
Shares (m)	106.9
Mkt Cap (£m)	171.0
EV (£m)	175.6
Free Float*	34.3%
Market	AIM

**As defined by AIM Rule 26*

Description

Gateley provides legal services through offices in the UK and one in Dubai. In 2015, it was the first full-service commercial law firm to float.

Company information

Non Exec Chairman	Nigel Payne
CEO	Michael Ward
FD, Secretary	Neil Smith

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www.gateleyplc.com

Key shareholders

Directors (incl Mssrs Davies, COO and Ward, CEO)	6.1%
Liontrust	9.5%
Miton	7.2%
Premier	5.7%
Peter Davies esq (dir)	2.8%
Michael Ward esq (dir)	2.8%

Next event

Sept-17	AGM
Nov-17	Trading update
Dec-17	Interim results

Analysts

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Gateley is a broad-based UK legal services firm. It floated on AIM in mid-2015. It is a leader in the UK mid market, having grown strongly over the last decade through one of the most difficult ever trading environments for professional services businesses. With 14% compound growth in revenues at stable profit margins over that period, its strategy is to continue this organic growth, fuelled by lateral hires and new office openings, complemented by selective bolt-on acquisitions in adjacent business service lines. The reasoning behind the IPO has been amply justified.

- **Current Trading:** The company reported final results to April, 2017 on 11th July, which showed growth in revenue of over 15% (13% organic) and in operating profit of 18%. It has made two acquisitions since flotation, both complementary existing service lines generating cross-sales potential and additional channels to market.
- **Forecasts:** We forecast growth in revenue of 7% this year and 8% in the following year, leading to earnings per share growth of 9%, then 8%. We believe these forecasts are conservative and have not factored in any new office openings or further acquisitions.
- **Valuation:** It is in the nature of a new sector that the stock market will often ascribe a conservative valuation, and as market participants become more familiar with the industry, the valuation has potential to grow. The current p/e is 16.1x, falling to 14.9x next year, on very conservative numbers.
- **Risks:** The company has broad exposure to the UK economy, primarily to SMEs. Earnings were resilient during the global financial crisis, and we would expect an economic slowdown to result in a drift in working capital more than an earnings slump. The main risk is that this is a people business, although management have highlighted incentivisation as a key goal and believe the Plc structure best addresses their long term plan of encouraging early and widespread equity ownership.
- **Investment summary:** Gateley is a high quality professional services company with significant growth potential as it has a small share of a growing and consolidating market. It has a good track record, a strong management team, and considerable growth potential. It offers a dividend yield of over 4%.

Financial summary and valuation

Year end April (£m)	2015	2016	2017	2018E	2019E
Sales	60.9	67.1	77.6	83.3	90.0
EBITDA	11.3	12.9	14.9	16.2	17.5
Financial income	0.0	-0.2	-0.2	-0.1	0.0
PBT Adj (pre share based, excl, amort.)	10.5	12.0	13.8	15.4	16.7
EPS (Adj., p) [1]	8.3	9.1	10.1	11.4	12.3
DPS (p)	5.1	5.6	6.6	7.0	7.4
Free cash flow	3.0	13.4	6.0	12.8	11.5
Net assets [2]	0.0	12.7	17.4	20.9	25.3
Net cash	-19.2	-4.2	-4.9	-0.1	3.2
PE	19.3	17.6	15.9	14.1	13.0
EV/EBITDA	15.9	13.3	11.8	10.6	9.6
Div yield	3.2%	3.5%	4.1%	4.4%	4.6%

[1] 11.5p FY19E POST share based payments [2] LLP basis 2015
Source: Gateley accounts, Hardman & Co Research

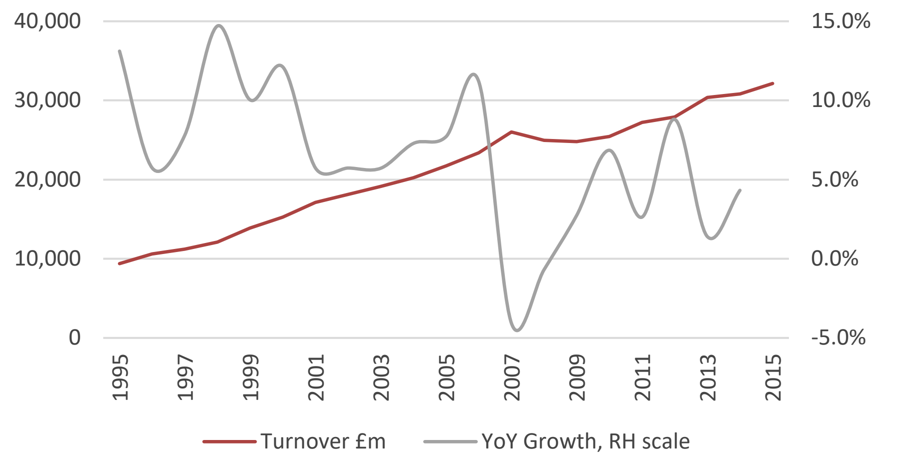
Contents

Gateley's Business

The UK Legal Services Market

The UK Legal Services Market is a huge market which has seen considerable long term growth. The chart shows that the sector has tripled in size in the last 20 years to over £30bn. Its rates of growth have varied, but only once has there been a contraction, during the Global Financial Crisis (GFC) the industry shrank by 4.1% in 2008 and by 0.7% in 2009. Growth has slowed from a double digit level in the 1990s, and has averaged 4.5% p.a. since the GFC.

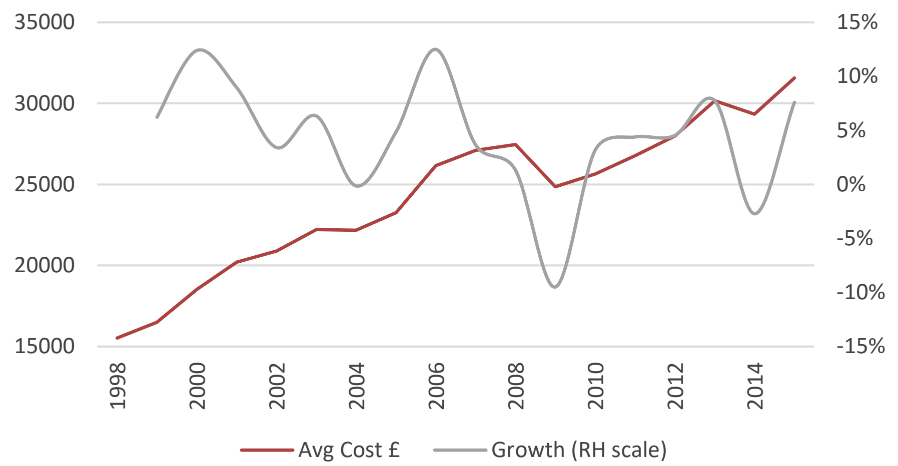
UK Legal Services Turnover



Source: ONS, Hardman & Co

Legal services is a people business and the two main elements of cost for all participants are salaries and rents. The chart shows the trend in employment costs (excluding partners), which have grown at an average 4.4% since 1998, with falls of 10% in 2009 and 3% in 2014, likely reflecting top line fee pressures.

UK Legal Services Average Employee Cost Trend



Source: ONS, Hardman & Co

This total market includes many services beyond those provided by solicitors such as Gateley, including barristers, patent attorneys, etc. However, solicitors comprise by far the majority of this market, but good data on the constituents is harder to find. Not all of the market for solicitors is accessible to Gateley, as the market comprises three tiers:

- The Magic Circle/Global firms: these large-scale international operations serve Fortune 500, FTSE 100 and global institutions. The "core" projects and transactions on which they advise command very significant fees and include major M&A deals, international financings and high-profile litigation. National firms like Gateley have very little presence in this market, but by the same token the Magic Circle, with much higher fee requirements given their significantly higher cost-base, have little presence in the national market and regional mid-market served by Gateley.

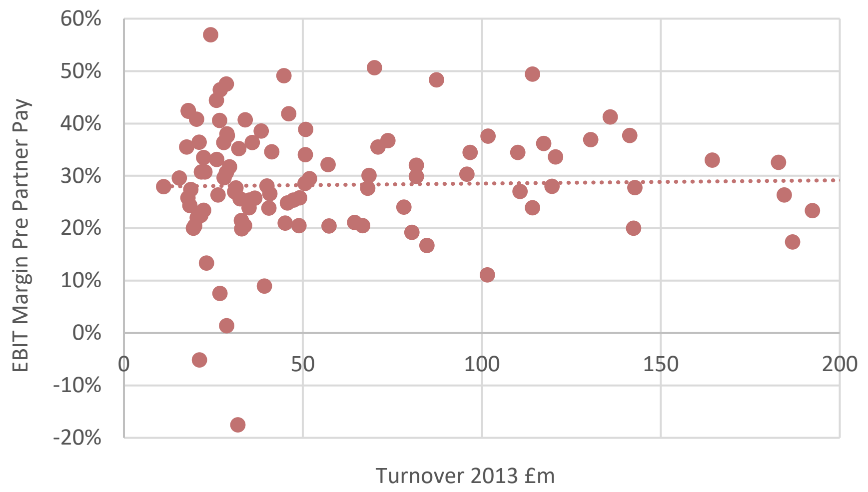
- The Mid-Market: This is where Gateley operates, in competition with a large number of regional firms and a smaller group of national firms. These businesses serve predominantly commercial clients, including domestic banks and other institutions, mid-market private equity and real estate developers and investors. The larger operators in this tier (of which Gateley is one) aim to serve all of their clients' legal requirements, as opposed to focussing more on high-value, but fewer "trophy" projects and transactions. This model requires a focus on quality of service and value, generating close relationships between the client and the legal team supporting their needs.

- The High Street: This tier mainly consists of smaller "mom and pop" businesses, typically advising private individuals on their personal legal requirements, such as domestic conveyancing, wills and probate, and small claims. In the vast majority of cases these firms are smaller, local operations owned by the partners of that business, although in recent years there have been instances of larger groups, sometimes backed by outside capital, entering the market and seeking to establish national brands and reap the benefit of economies of scale. This is not a target market for Gateley and it has no real presence within it.

All three tiers of the market are highly competitive and all three have different financial characteristics and requirements which over time has resulted in an ever-clearer demarcation between the three, and the emergence of three distinct types of operator.

We believe that the legal services market is unusual in that the middle market is attractive, in contrast to many industries, for example retail, where the internet has fostered price transparency, and the middle market players are under threat, with luxury offers stealing custom from above, and low cost offers creating price pressure from below. We see this across many different industries in the stock market; the UK legal market is unusual in that the middle market is a distinct and highly profitable opportunity, without such threats from above or below.

UK Solicitors Do Not Have Economies of Scale



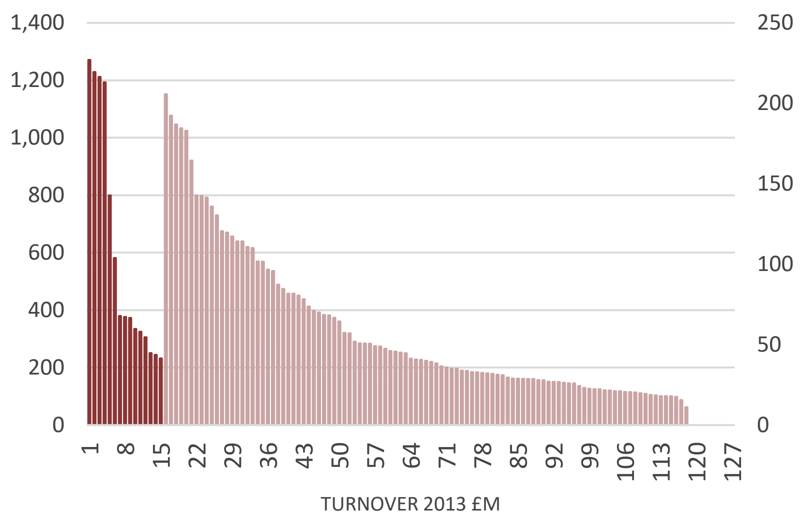
Source: behindthebalancesheet.com

Gateley is a top 50 UK legal business (by sales, including Magic Circle/global firms) and has scope for significant growth, although it has no aspirations to reach the top 10. Unlike most industries, where there are economies of scale, legal services in the past has not generated significantly higher margins through scale, as the chart above shows, with some limited operating leverage on the fixed elements of the cost base. Sector consolidation nevertheless provides opportunity for Gateley.

Gateley's Position in UK Legal Services

The chart shows the turnover of the top legal firms on two scales, in order to separate out the Magic Circle and global firms from the national operators; the bottom of the first series is the top of the second series, at around £200m.

Top Law Firms: Revenue Distribution



Source: behindthebalancesheet.com

The intention is to show that

- the Magic Circle firms operate in a worldwide market with each achieving revenues of £1bn and more;
- the next tier down (11 to 25) comprises mainly London-centric firms with revenues from £250m to £800m;
- the national and regional firms have revenues from £25m to £200m, with a group of c.40 firms in a range above £50m. In this sample, using 2013 data, the analysis showed Gateley at number 55, while in the Lawyer rankings, it usually comes out at 45-50. Although these surveys were based on combined figures of Gateley and an affiliated by brand legal business, HBJ Gateley, more recent tables excluding HBJ would still place Gateley within the top 50.

Technology is playing an increasing part in the legal services business, and is most effective in repeat-task/volume legal services such as domestic conveyancing and small claims work. Artificial intelligence systems do not yet exist and the timetable for the delivery of such systems is likely longer term. Gateley is not a volume business, its clients pay for legal solutions to their problems typically delivered through a personal, high quality service.

It's clear that although there have not been economies of scale in the past, there is likely to be an optimum size in future, below which technology investments become a much greater burden. We expect that the top 50 firms will have sufficient scale to compete, and that the sector will continue to have many operators because of the personal relationships critical to the business.

We recommend the book 'The Future of the Professions' by Richard and Daniel Susskind, for those investors with a particular interest in this subject. Gateley is well positioned to benefit from changing technology. Hence this is likely to be a positive structural influence on long term value creation.

The Opportunity in Legal Services

This is a fragmented industry, which is growing, but at the same time undergoing some structural changes. The industry has effectively had a "Big Bang", albeit one which has been both smaller and quieter than in financial services. Recent deregulation under the Legal Services Act permitted outside investment in law firms, for the first time in the history of the English legal profession, and the industry looks ripe for consolidation.

The losers in such a process are likely to be mainly the mom and pop players; firms in the number 50-150 range will likely see the greatest push for combinations and mergers, although deals in the top 50 are also likely. There has already been a trend of combinations, and Gateley, as the only quoted UK firm, is in pole position to play a role in this process, although we would expect any moves to be measured and gradual.

Gateley is an attractive investment without the business making any further acquisitions, yet its unique position to pursue selective acquisitions provides more opportunities to fuel growth. Its scale and diversity gives it strength and protection in this potentially fluid environment.

Gateley – The Firm

History

Gateley was established in the 19th Century, and has over 400 legal advisors across eight offices in the UK and an office in Dubai. Gateley provides legal services to over 4,000 corporate and 1,500 private clients in its core areas of Banking & Financial Services, Corporate, Business Services, Employment, Pensions & Benefits and Property.

In 2014, Gateley was one of the early firms to take advantage of changes to the law in England and Wales to adopt an Alternative Business Structure (ABS), allowing non-lawyers to own and invest in law firms.

Profile of Activities

Gateley reports under five segments, and the table below shows the analysis as reported for last year. We do not forecast on this basis, and we do not consider the distinctions particularly important to external investors, other than giving a feel for trends, as each category includes a range of work and an individual client could well span multiple segments. But it helps to give a flavour of the business and we therefore include it here.

Revenue and Contribution Analysis 2017

	Banking and Financial Services	Corporate	Business Services	Employees, Pensions and Benefits	Property	Total Segments	Other	Group
2017 Revenue	15,146	14,074	109,46	7,130	28,562	75,858	1,729	77,587
% Total	19.5%	18.1%	14.1%	9.2%	36.8%	97.8%	2.2%	100.0%
2017 Contribution	6,306	4,082	4,542	2,645	12,978	30,553	1,729	32,282
% Total	19.5%	12.6%	14.1%	8.2%	40.2%	94.6%	5.4%	100.0%
Margin	41.6%	29.0%	41.5%	37.1%	45.4%	40.3%	n.a.	41.6%

Source: Gateley, Hardman & Co Research estimates

The categories cover the following activities:

- **Banking and Financial Services:** Provision of legal advice in respect of asset finance, banking and corporate recovery services.
- **Corporate:** Provision of legal advice in respect of corporate, private client, family and taxation services.
- **Business Services:** Provision of legal advice in respect of commercial, commercial dispute resolution, litigation, regulatory, shipping, transport and insurance services.
- **Employees, Pensions and Benefits:** Provision of legal advice in respect of employment and pension services, including Entrust Pension Limited's trustee advisory services.
- **Property:** Provision of legal advice in respect of construction, planning, real estate and residential development services; the two acquired businesses,

Gateley Capitus (tax incentives services) and Gateley Hamer (property consultancy services) are included here.

The company has a broad spread of activities, without the characteristics sometimes associated with the Magic Circle (financial services concentration) or London focused firms (dependence on financial services including volatility in capital markets transactions and exposure to fx/global trends by virtue of cross-border operations). These encompass a spread of sectors, clients, legal disciplines, and geographies; Gateley is not exposed to capital markets or Government, while there is effectively no fx risk in its reported revenues. This diversification of activities is one of the strengths of the investment.

Strategy

The group strategy is to grow organically, via

- retention of existing partners and fee earners - their commitment to Gateley and the opportunities at the firm are evident from the fiveyear lock-in arrangements the existing partners have entered into;
- internal organic growth, through more work for existing customers – adding services and building on existing relationships – and adding new customers and growing corporate teams in each region, in particular Leeds and Reading;
- lateral hires – bringing in partners from other firms, attracted by Gateleys' unique quoted structure. Since IPO, 15 new partners have joined, a sign of success. Hiring discussions have benefitted from the offer of a wider spectrum of remuneration possibilities (salary plus bonus plus, potentially and on a case-bv-case basis, options) than would have been the case for a hiring into the old partnership;
- opening new offices – for example, the Leeds office which opened in 2012 is growing strongly, while the Reading office, which opened in December 2015, is an example of an entry into a new regional market - the Thames Valley;
- there are also new cross-selling opportunities afforded by the adoption of an ABS. Legal services will remain the heart of the business, but there is logic to adding complementary business services, such as regulatory advice, compliance and professional training, alongside Gateley's existing legal service offering.

The strategy is to add to organic growth by taking advantage of being the first UK law firm to have a public listing, and participating in consolidation within the UK legal services sector. We see a significant opportunity within the legal sector, and this can be supplemented by the acquisition of complementary professional services businesses. We discuss below the first deals which happen to be of complementary businesses, but Gateley is likely to have a first mover advantage in its plc status to do deals within the sector.

Indeed, it's possible that other firms may take time to float, as 1) only Australia and the UK allow outside ownership, a barrier for the Magic Circle firms; 2) some firms have capital and financing structures which may require a longer transition before any float; and 3) cultural barriers remain in many firms.

A broader set of services will increase the potential for cross-selling to existing clients and represent a stronger sales proposition for potential new clients. To date, Gateley has made two acquisitions, both of which are in niche areas which are little known to the market, but which fit extremely well with the existing legal services business:

1. Gateley Capitus, acquired in April 2016, is a tax incentives advisory business which on acquisition was a £1.2m turnover business with 3 employee shareholders, and 5 further employees. The purchase price was 4.7x EBIT and the business made a 28% EBIT margin, well above Gateley's.

   This niche business has highly specialist tax trained Chartered Surveyors. Its highly technical nature needs expert focus, the broad absence of which has resulted in billions of pounds of unclaimed allowances and reliefs, across the UK. Capital Allowances for real estate, the principal product, can be claimed by anybody investing capex in real estate, meaning practically all of Gateley's existing clients are possible sales for this business. On the sale of a property, the lawyer has to consider the capital allowances implications of the sale, so there is useful scope to offer this service to existing clients.

2. Gateley Hamer, acquired in September 2016, is a specialist property consultancy business, providing expert advice across the UK relating to Easements and Wayleaves for utilities' infrastructure, and compulsory purchase and compensation. The purchase price of £2m was up to 4x EBIT (depending on earn-out) of which 50% is deferred. The business made revenues of £1.2m and EBIT of £0.292m in the year to March 2016.

   The Hamer Associates' Easements and Wayleaves team advises property developers and other land owners on negotiations in relation to the removal or redirection of utility infrastructure (pylons, cables, pipes etc) from development sites, and negotiates compensation for loss of development value where that infrastructure remains in-situ.

   The Compulsory Purchase and Compensation team advises project promoters on all aspects of compulsory purchase, from initial consultation through to settlement of claims; facilitating housing, regeneration, infrastructure and energy projects. The team also represents landowners and businesses affected by compulsory purchase (examples include High Speed 2, Crossrail and the Thames Tideway Tunnel).

   Gateley already provides legal services to 17 of the top 20 UK housebuilders. Gateley Hamer represents a solid product proposition to that industry (where it already has a much smaller presence) with potential for further cross-sales to Gateley's broader real estate developer and investment client-base.

Gateley, as you might expect from a legal services firm, has approached the subject of acquisitions thoughtfully. This is not a newly privatised state firm with money burning a hole in its pocket. There are no guidelines to offer as to what to expect next, whether it's a law firm in a new region or another niche services firm, but the pace is likely to remain careful and measured.

Management

The Board has a broad range and depth of experience.

- **Nigel Payne,** aged 57, Non-Executive Chairman, previously CEO of Sportingbet. He has over 30 years' experience as director of public and private companies. Nigel is presently the Non-Executive Chairman of AIM quoted companies, Stride Gaming plc, EG Solutions plc and ECSC Plc.

- **Michael Ward**, aged 58, is CEO and has over 30 years' experience as a corporate lawyer. He joined Gateley in 1987 and has been instrumental in the development of the business. He was elected as Senior Partner in 2001. He has considerable experience in corporate transactions (acting for sellers, buyers and debt or equity providers), corporate restructuring and shareholder disputes.

- **Peter Davies**, aged 59, Chief Operating Officer. Peter has considerable experience in construction disputes, acting for developers, contractors, sub-contractors and construction professionals.

- **Neil Smith**, aged 41, Finance Director and Company Secretary. Joined in 2008 from Grant Thornton, where he spent 14 years as an auditor and adviser across a range of sectors including both public and private companies. CFO since 2011.

- **Joanne Lake**, aged 53, Non-Executive Director with investment banking expertise. Joanne is non-executive chairman of AIM quoted wealth management group, Mattioli Woods plc, and deputy chairman of Main Market listed land management and construction group, Henry Boot PLC. She is a non-executive director of AIM quoted non-standard finance provider, Morses Club PLC and tissue converter, Accrol Group Holdings PLC, as well as being a trustee of The Hepworth Wakefield.

- **Michael Seabrook**, aged 65, Non-Executive Director, with over 30 years' experience as a solicitor, nearly 25 of which were served as a partner in Eversheds LLP. Since then he has held Non-Executive Director roles at Steelite International Holdings Limited, Springboard Corporate Finance Limited, West Midlands Enterprise Limited and other businesses, and is a trustee of the Queen Elizabeth Hospital Birmingham Charity. Mike is stepping down and retiring at the AGM.

Gateley's recent announcement revealed that, following five years of service with the Group (including two years as a director of the plc following its admission to AIM), having reached 65, Michael Seabrook will not be offering himself for re-election at the forthcoming AGM and will stand down as a Director. It was announced that Suki Thompson would replace him with effect from 27 September 2017. Suki sits on the Centaur Media Plc Management Board, has been a Trustee for Macmillan Cancer Support for the past six years and is also the CEO and Co-founder of Oystercatchers, a marketing management consultancy.

Underneath the PLC Board is the strategic board which comprises eight members of senior management, including Paul Hayward; Brendan McGeever; Rod Waldie; and Callum Nuttall, corporate, corporate restructuring or real estate partners and recently appointed Group HR Director Victoria Garrad.

Responsibility for acquisitions lies with Nick Smith, aged 49, Acquisitions Director, who joined Gateley in 2009. He has more than 20 years' experience in national and international corporate finance, capital markets, private equity and mergers and acquisitions. He was formerly co-head of Nomura's Integrated Finance Group.

Financial analysis

Track Record

Over the ten years to 2017, Gateley has produced over 13% pa compound growth. This was almost entirely organic, albeit including the "creation" in July 2010 of the Manchester office, which was a significant individual expansion, and the two small acquisitions last year. The Manchester office was a large fully functioning business acquired out of Halliwells, and is an example of Gateley's valuable experience of integrating acquisitions/teams. Note that excluding the acquisitions, the growth figure still rounds to 13% CAGR. The conversion from LLP to PLC in 2015 on IPO was clearly a significant event and a comparison of operating profit across these two business models would not be appropriate.

We therefore assess growth in operating profit prior to partner (selling shareholder) salaries and bonuses over the period 2006 (when our modelling begins) to 2015 the last full year as a partnership. The operating profit CAGR on this basis is 13.1%, in line with revenue growth.

- Last year, 95% of revenue derived from UK.
- Operating margins have been stable over this eight year period under the LLP structure. We use the operating margin prior to partner salary and bonus up to and including 2014 (Gateley changed to PLC 2015). The lowest outcome was 28.0% 2009, median 33.8%, achieved in 2013. Clearly partner pay is a significant component of the cost structure.
- Since PLC conversion, margins have also been robust and steady, ranging between 17.2% and 18.0% (pre share based costs or 17.2% and 17.7% respectively post such costs).

Revenue and margins

Year end April (£m)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Sales	22.8	27.3	29.7	33.7	43.7	45.3	51.4	54.6	60.9	67.1	77.6
Other income	0.4	0.4	0.7	0.4	0.3	0.3	0.6	0.4	0.4	0.4	0.4
Total revenue	23.2	27.7	30.4	34.1	44.0	45.6	52.0	55.0	61.3	67.5	78.0
Growth on previous year	14.8%	19.7%	8.8%	13.5%	29.7%	3.7%	13.5%	6.2%	11.5%	10.2%	15.6%
Operating margin [1]	36.2%	31.8%	28.0%	38.4%	29.0%	30.0%	33.8%	37.1%	n.a. (PLC)	n.a. (PLC)	n.a. (PLC)

Source: Gateley, Hardman & Co Research estimates

[1] Operating profit BEFORE partner salary and bonus – stated for the years as LLP structure

Key historic performance drivers

- The past ten years' growth includes the period to 2015 when 100% of its profits were distributed to partners.
- Although 2009 operating margins fell to 28.0% (from 31.8% 2008 and 36.2% 2007), this provides evidence that the business mix generates a robust outcome in a year of extreme macro-economic dislocation.
- 2010 saw a significant rise: to 38.4%. This was a particularly strong mix of business so is not necessarily regularly repeatable. Nonetheless, for this to be achieved in a period where the UK economy was still impacted by the aftermath of the GFC demonstrates that the business is well-balanced and we view this as encouraging.
- In 2010 (Manchester) and 2012 (Leeds) new offices were opened in order to grow by acquisition and organically, with the latter resulting in a front loading of costs, as the office and infrastructure expenses come online in full while the revenue is being built.

Revenue account

Year end April (£m)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Sales	22.8	27.3	29.7	33.7	43.7	45.3	51.4	54.6	60.9	67.1	77.6
Other income	0.4	0.4	0.7	0.4	0.3	0.3	0.6	0.4	0.4	0.4	0.4
Total revenue	23.2	27.7	30.4	34.1	44.0	45.6	52.0	55.0	61.3	67.5	78.0
Adjusted EBITDA [1]	8.9	9.2	8.9	13.6	13.8	14.7	18.7	21.4	11.3	12.9	14.9
Depreciation	0.5	0.4	0.4	0.5	1.0	1.0	1.1	1.0	0.8	0.7	0.8
Operating profit [1]	8.4	8.8	8.5	13.1	12.8	13.7	17.6	20.4	10.5	12.2	14.0
Financial income	0.2	0.2	0.2	-0.1	-0.1	-0.1	-0.2	0.0	0.0	-0.2	-0.2
Operating margin [1]	36.2%	31.8%	28.0%	38.4%	29.0%	30.0%	33.8%	37.1%	n.a. (PLC)	n.a. (PLC)	n.a. (PLC)
Exceptionals, intangibles (2015-16) / members' profit share (2012-14)	-8.6	-9.0	-8.7	-13.0	-12.7	-13.5	-17.1	-20.4	-0.7	-0.9	0.0
Amort acquired intangibles	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.5
PBT reported [2]	0.0	0.0	0.0	0.0	0.0	0.1	0.3	0.0	9.8	11.0	13.1

Source: Gateley, Hardman & Co Research estimates

[1] Pre share based costs, exceptionals and partner salary and bonus – stated for the years as LLP structure

[2] Post share based costs, amortisation (including acquisition goodwill) exceptionals (i.e. including acquisition costs etc)

Final Results FY 17

Gateley reported final results for the year to April 2017 in mid-July. The main features being:

- Strong organic revenue growth;
- Similar levels of profit growth with profits constrained by the opening of the new Reading office, and boosted by the two acquisitions;
- Higher growth at the bottom line;
- Slightly higher levels of working capital;
- The company was clearly pleased with its maiden public company results and the dividend was raised by an impressive 17%.

2017 Results: P&L

£000s	2017	2016
Revenue	77,587	67,061
Other operating income	445	442
Personnel costs	(45,558)	(38,951)
Depreciation and amortisation	(1,291)	(687)
Other operating expenses	(17,871)	(16,605)
Operating profit	13,312	11,260
Adjusted EBITDA	14,928	12,928
Share based payment charges	(325)	(125)
Depreciation and amortisation	(1,291)	(687)
Non-underlying items		
One off professional costs		(101)
Admission costs		(755)
Net financing expense	(199)	(226)
Profit before tax	13,113	11,034
Taxation	(3,058)	(2,448)
Earnings	10,055	8,586
Other comprehensive income FX difference	81	
Earnings + Other comp income	10,136	8,586
Statutory Earnings per share		
Basic	9.43p	8.18p
Diluted	9.35p	8.18p

Source: Company, Hardman & Co

Looking at this in more detail:

- Strong organic revenue growth, at 13%, well ahead of the likely ongoing organic expansion which we model at some 7 – 8% pa. This excludes the benefits of acquisitions which were all included in the property segment (see the table below), where underlying growth was still excellent but not the 28% shown. The newer Reading office was a contributor to revenue growth, but was loss-making last year, and is expected to move to break-even in the current fiscal year. Growth was spread across product types and offices, albeit the Employment segment delivered a sideways move; management were positive for the outlook for this segment and indeed across the group.

Revenue and Contribution Analysis 2017

	Banking and Financial Services	Corporate	Business Services	Employees, Pensions and Benefits	Property	Total Segments	Other	Group
2017 Revenue	15,146	14,074	10,946	7,130	28,562	75,858	1,729	77,587
% Total	19.5%	18.1%	14.1%	9.2%	36.8%	97.8%	2.2%	100.0%
2017 Contribution	6,306	4,082	4,542	2,645	12,978	30,553	1,729	32,282
% Total	19.5%	12.6%	14.1%	8.2%	40.2%	94.6%	5.4%	100.0%
Margin	41.6%	29.0%	41.5%	37.1%	45.4%	40.3%	n.a.	41.6%
Yoy Growth in revenue	11.8%	24.1%	6.3%	-2.0%	27.8%	17.0%	-23.1%	15.7%

Source: Gateley, Hardman & Co Research estimates

- Successful integration of the two acquisitions was achieved, and management were pleased that they seem to be realising opportunities to cross sell services (of these property-related) operations into other skill sets and verticals in Gateley as a whole. Importantly, the cross-selling, which has not yet hit the revenue line, has been in both directions, with Gateley winning new legal clients from the acquired businesses' client pool and existing clients taking advantage of the new services offered. We felt this was impressive, as it suggests management have identified the right type of acquisitions, which is encouraging for the development of the business.

2017 Results: Contribution vs EBITDA

£000s	2017	2016
Revenue	77,587	67,061
Contribution (divisional level)	32,282	28,335
Other operating income	445	442
Unallocated Personnel Costs	(5,391)	(3,882)
Other operating expenses	(12,742)	(12,092)
Depreciation & Amortisation	(1,291)	(687)
Net financing expense	(199)	(226)
Profit before tax, excl. items	13,113	11,890

Source: Company, Hardman & Co

- The table reconciles the divisional results to the P&L, and shows that unallocated operating costs were kept flat while there was an increase in the unallocated personnel costs. Depreciation and amortisation also rose sharply in percentage terms, although it remains a minor cost for the group, and most of the increase was the amortisation of customer lists in acquired companies.
- EBITDA margins were broadly stable at 19.2%, which is a level ahead of FY15. We note that circa 10% of staff costs are discretionary / bonus based.
- Share based costs rose from £0.1m to £0.3m and will likely increase further going forward; this is a positive as the firm is the only UK legal firm able to offer the benefits of share incentivisation; hopefully, the share price performance will further increase the attractiveness of this to improve recruitment as well as the retention and motivation of existing staff.
- Cash generation was good, although debtor days drifted upward slightly, given an exceptional working capital performance at the previous year end.

Management indicated that they were broadly comfortable with the level and did not expect any further upward drift.

- The dividend rose an encouraging 17% and Gateley's strategy on dividend cover is clear. We note the normal split is 1/3rd 2/3rd for interim and final.

- The CEO, Michael Ward, made a very positive comment on the outlook: "Trading in the second half of the financial year ended 30 April 2017 was excellent and we are pleased to report that trading in the first two months of the current financial year has continued well. We are confident that our business is well-balanced and resilient and we remain focused on delivering another year of growth in our core services, whilst continuing to look for complementary acquisitions."

FY18E, FY19E model estimates

- We outline our growth metrics in a table within the Financial Analysis section. Top line expansion of 7 – 8% organic is anticipated. Whilst FY17 as reported showed strong growth, we see FY18E demonstrating continuing good revenue momentum, albeit not at quite the same rate. The market is providing a backdrop where Gateley can progress well across the board.

- EBITDA margins have been strong in the past two years and we model for a slight reduction this year, stable into FY19E. This is more to do with investing for the future rather than any concerns on pricing, which is currently not a constraint / concern. The EBITDA margin FY18E is estimated to rise very slightly but it is worth noting that it is set to retrace to a sustainable 18.3% post share-based costs)

- Share based costs are rising (this being a recent phenomenon, directly related to the stock market flotation and performance of Gateley as a quoted PLC). PBT post these share based costs (which for accounting reasons may exhibit some volatility) are estimated to grow at around 5% pa.

- We estimate strong cash generation (£12.8m free cash flow FY18E) and consider our estimate of £0.1m net debt end FY18E (then cash FY19E) to be conservative. Note that our model includes deferred consideration elements.

- Our model includes no acquisitions but we anticipate these to be a feature of the strategy of Gateley.

Prospects

Revenue account

Gateley's business model is growth-focused, and will remain so. The business is essentially cash generative, with limited physical capital, and an uneven working capital requirement (likely easier to collect debtors in better economic times, harder when customers are themselves under pressure). Dividend growth is likely to be an important attraction of the shares, both for external shareholders and the former partners who are likely to perceive share price appreciation and dividend income as an alternative to their former profit shares; and we expect dividend growth to be driven by the reported earnings growth trend.

FY17 dividend was 6.6p, up from 5.639p FY16.

Revenue account

April Year end £m	**2012** [1]	**2013** [1]	**2014** [1]	**2015**	**2016**	**2017** [6]	**2018E**	**2019E**
Sales	45.3	51.4	54.6	60.9	67.1	77.6	83.3	90.0
Other income	0.3	0.6	0.4	0.4	0.4	0.4	0.4	0.4
Total revenue	45.6	52.0	55.0	61.3	67.5	78.0	83.7	90.4
Staff costs [2]	18.5	20.0	19.8	35.6	39.0	45.2	48.8	52.6
Above includes share based	*0.0*	*0.0*	*0.0*	*0.0*	*0.1*	*0.3*	*0.4*	*0.6*
Other opex (net)	12.4	13.3	13.8	14.4	15.7	18.3	19.6	21.4
Adjusted EBITDA [3]	14.7	18.7	21.4	11.3	12.9	14.9	16.2	17.5
Depreciation	1.0	1.1	1.0	0.8	0.7	0.8	0.7	0.8
Operating profit (note [3[)	13.7	17.6	20.4	10.5	12.2	14.0	15.5	16.7
Financial income	-0.1	-0.2	0.0	0.0	-0.2	-0.2	-0.1	0.0
PBT (Adj., (note [3])	13.6	17.4	20.4	10.5	12.0	13.8	15.4	16.7
Exceptionals / members' profit share (2012-14)	-13.5	-17.1	-20.4	-0.7	-0.9	0.0	0.0	0.0
Amort acquired intangibles	0.0	0.0	0.0	0.0	0.0	-0.5	-0.8	-1.2
PBT reported (post share based)	0.1	0.3	0.0	9.8	11.0	13.1	13.7	14.4
Tax rate % [4]	n.a.	n.a.	n.a.	21.2	20.6	22.0	21.0	21.0
EPS (Adj., note [3].) (p)	n.a.	n.a.	n.a.	8.3	9.1	10.1	11.4	12.3
EPS (Adj., note [5].) (p)	n.a.	n.a.	n.a.	8.3	9.1	9.9	10.7	11.5
DPS (p) [7]	n.a.	n.a.	n.a.	5.1	5.6	6.6	7.0	7.4
Average shares in issue (m)	n.a.	n.a.	n.a.	100.0	104.9	106.7	106.9	107.4

Source: Gateley accounts; Hardman & Co Research estimates

[1] Pre PLC incorporation, members' profit share taken 'below the profit line', among other implications
[2] Adjustment in 2012 excluding recently acquired Manchester (costs added to member profit share).
Note circa 10% staff costs indicatively are bonus/ discretionary related.
[3] Pre share based payments, exceptionals, amortisation of acquisition intangibles
[4] Tax % rate on adjusted profit levels
[5] EPS on the same adjusted basis but POST share based costs
[6] FY17 includes loss of £0.4m, Dubai
[7] FY16 dividend totalled 5.639p per share

Our estimates show conservative organic sales growth in a range around 8%+. Considering the history of over 13% CAGR over the cycle, this could prove a conservative estimate. Our model makes no allowance for further expansion in the number of offices, nor for further acquisitions, and this too may prove conservative.

There is some debate as to the implications of Brexit, which we feel could have potential benefit to law firms, with work generated by whatever the new arrangements might be; understandably, management have played this down, and were there to be a slowdown in economic activity there might be an adverse impact. While we anticipate the coming years will provide a rich environment for Gateley's wide spread of capabilities, we have not factored in the possibility of large and profitable acquisitions.

Growth metrics

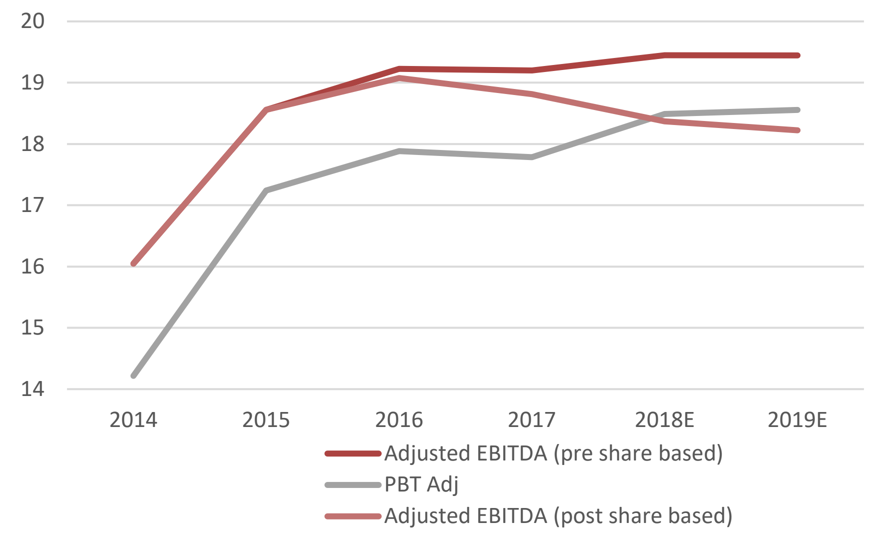
April Year end £m	2013	2014	2015	2016	2017	2018E	2019E
Sales	13%	6%	12%	10%	16%	7%	8%
Sales (organic)	13%	6%	12%	10%	13%	7%	8%
Adjusted EBITDA (pre share based)	27%	14%	-47%	14%	16%	9%	8%
EBITDA (organic)	27%	14%	-47%	14%	12%	9%	8%
PBT Adj (pre share based and excl.)	28%	17%	-49%	14%	15%	12%	8%
PBT reported (post share based)	n.a.	n.a.	n.a.	12%	19%	5%	5%
EPS (Adj., pre share based and excl.) (p)	n.a.	n.a.	n.a.	10%	11%	13%	8%
DPS (p)	n.a.	n.a.	n.a.	11%	17%	6%	6%

Source: Gateley accounts; Hardman & Co Research estimates
The above is not currency adjusted but currency fluctuation impact is immaterial

Our margin estimates allow for possible expansion in staff overhead ahead of further likely growth in new offices, although we do not factor these in to our revenue estimates. Moreover, our estimates assume growth in spite of the fact that Brexit may negatively impact general economic growth in the next 2-3 years.

Note that post flotation, the strategic growth of Gateley is supported through share based payments which are an essential element of senior staff compensation. These we consider to be designed to accelerate the medium term prospects for the group so during the modelling period to 2019E we are being conservative, highlighting their cost in this chart below.

Profit margins (%)



NB Figures exclude the minor element of 'other income'
Source: Company, Hardman & Co

Balance sheet

As is customary in an LLP, Gateley had previously distributed 100% of its profits to partners. The net assets growth post 2016 is a function of the policy decision to build up an element of retained profits by distributing circa 70% net earnings to shareholders as dividends.

Although working capital can be a pressure for smaller firms, Gateley has a track record of low volatility in trade receivables and unbilled work, and we expect this to continue to be the case. Note that the trade receivables are very similar in quantum to trade and other payables. The main component of working capital is unbilled revenue, £10.5m in total at the last balance sheet. We are strongly of the view that this is a conservative number. It is to be noted that the benefit of the unbilled revenue at the point of the IPO, in 2015 of conversion to PLC all passed to the shareholders in Gateley. This reflects the cost of employees generating this unbilled revenue being incurred by the Partnership prior to IPO through payroll payments to staff.

Balance sheet

April Year end £m	2014 [1]	2015 [1]	2016	2017	2018E	2019E
Tangible: non current	1.7	1.7	1.7	2.4	3.2	3.9
Intangible: non current	0.0	0.0	2.5	3.8	3.0	1.8
Total non-current assets	*1.7*	*1.7*	*4.2*	*6.2*	*6.2*	*5.7*
Trade receivables, current	19.0	21.2	20.7	26.1	25.0	28.0
Unbilled revenue	7.3	8.7	9.9	10.5	11.5	12.5
Pre-pay and accrued income, current	2.6	1.8	3.1	2.5	3.0	3.0
Cash [2]	2.0	2.7	9.8	2.7	4.6	5.9
Total current assets	*30.9*	*34.4*	*43.5*	*41.8*	*44.1*	*49.4*
Trade other payables, current	-13.6	-13.7	-20.3	-22.5	-24.0	-26.4
Members and other liabilities, current	-19.1	-16.8	-4.6	-0.6	0.0	0.0
Term Debt, current	0.0	0.0	-2.0	-2.0	-2.0	-2.0
Overdraft [3]	-0.3	0.0	0.0	0.0	0.0	0.0
Total current liabilities	*-33.0*	*-30.5*	*-26.9*	*-25.0*	*-26.0*	*-28.4*
Other payables, non-current	-0.3	-0.2	-0.4	-0.2	-0.4	-0.4
Provisions, non-current liability	-0.3	-0.4	-0.3	-0.4	-0.3	-0.3
Debt, non-current [4]	0.0	-5.1	-7.4	-5.0	-2.7	-0.7
Total non-current liability	*-0.6*	*-5.7*	*-8.1*	*-5.6*	*-3.4*	*-1.4*
Net assets	-0.9	0.0	12.7	17.4	20.9	25.3
Net cash [5]	-17.4	-19.2	-4.2	-4.9	-0.1	3.2

Source: Gateley accounts; Hardman & Co Research estimates

[1] LLP, therefore cash and balance sheet (particularly cash held, undistributed) is materially, structurally different to PLC structure
[2] June 2015 Partners' cash was partially repaid – conversion from LLP
[3] See note 10, 2016 accounts, £6.4m from former members (partners), falling progressively: £4.6m end 2016
[4] Includes a de minimis amount due to former partners
[5] 2015 Pro-forma post conversion, stated in 2016 accounts, £7.8m

Returns in the legal sector are dependent on the working capital reported in the year-end balance sheet. While most firms incentivise their partners to 1) send out bills before year–end, and 2) to try to collect the cash quickly, the fact is that working capital is highly variable in the sector. One financial controller at a top 75 UK firm told us that he despaired sometimes because his colleagues did not see cash collection as a priority – this is a quite traditional industry but one which is undergoing change. The Plc environment and needs should refocus efforts on this issue.

Clients are often in no hurry to pay their legal bills and sometimes, the partner involved will extend credit to clients having cash flow difficulties, to help build long term relationships. This is a relationship business and the incidence of bad debts is low, and where for example an entrepreneur does go bust, he will often “make it up” to the partner when he starts up his next venture through loyalty in his advisor of choice.

Because of the spread of clients and sectors at Gateley, we would expect its working capital to be more stable, but sometimes work-in-progress can build up on a particular litigation case or debtor days can extend and there is no offset as the main suppliers are the employees. Hence working capital, which, in the form of unbilled work, is the main component of capital employed, can vary. For Gateley the past variance has been modest and this is expected to continue to be the case.

- Cash conversion (cash from operations pre-tax and interest as a ratio to EBITDA) was 70% 2017, compared to an above-trend 119% in 2016. The working capital cash generation in 2016 was a healthy £3.1m which reverted to a cash outflow of £4.4m in 2017. The 2015 figure is not comparable as the conversion to PLC was a material factor. Going forward, we anticipate the ratio to run in the high 90s% (as such working capital requirements as there may be should be relatively modest).

- Gateley is the only firm in its peer group which is not a partnership and is therefore the only firm retaining profits and cash in its balance sheet for future investment, through retained earnings. Conventional partnerships pay out their entire earnings to partners and should they need additional funds to do an acquisition or to increase investment, they will either need to borrow or to call on partners to contribute capital out of taxed income. This could be an important differentiation factor for Gateley in a world subject to greater technological change.

Cash flow

Gateley generates cash whilst growing

- 2016 was a particularly strong year for cash generation, boosted by tight management of working capital. While there was a cash outflow on working capital in 2017, we expect working capital to sales to remain broadly flat.

- We expect capital expenditure to increase, mainly on IT. We estimate Gateley will register a net cash positive figure in 2019.

- A modest amount of deferred share issuance takes place but this of course does not register in the cash flow forward estimates.

- We forecast free cash generation (post tax, capital expenditure and interest) of £24.3m over the next two years, over £10m pa on a steady state growth basis.

Cash flow

April Year end £m	2014 [1]	2015 [1]	2016	2017	2018E	2019E
EBITDA	7.4	23.7	12.9	14.9	16.2	17.5
Other adjustments	-0.7	-17.9	-0.8	0.0	0.0	0.0
Working capital	-2.7	-2.9	3.1	-4.4	1.1	-1.6
Cash from operations	4.0	1.2	15.3	10.5	17.3	15.9
Tax	0.0	0.0	-1.0	-2.8	-2.9	-2.9
Interest	0.0	0.0	-0.2	-0.2	-0.1	0.0
Capex	-0.6	-0.8	-0.7	-1.5	-1.5	-1.5
Free cashflow	3.4	0.4	13.4	6.0	12.8	11.5
Acquisition [2]	0.0	0.0	-1.2	-0.2	-0.7	-0.5
Share issue	0.0	0.0	4.9	0.0	0.0	0.0
Partner loans	-1.4	0.7	-9.9	-4.6	-2.9	-2.0
Term loans	0.1	-0.3	2.0	-2.0	0.0	0.0
Dividend	0.0	0.0	-2.0	-6.3	-7.4	-7.7
Change net cash	2.1	0.8	7.2	-7.1	1.8	1.3
B/fwd cash	*note [1]*	*[1]*	2.7	9.8	2.7	4.6
Closing cash, cash equivalent	*[1]*	*[1]*	9.8	2.7	4.6	5.9
Term loans	*[1]*	*[1]*	-14.0	-7.6	-4.7	-2.7
Net cash (incl loans)	*[1]*	*[1]*	-4.2	-4.9	-0.1	3.2

Source: Gateley accounts; Hardman & Co Research estimates

[1] LLP, therefore cash and balance sheet (particularly cash held, undistributed) is materially, structurally different to PLC structure
[2] Figures for FY18E and FY19E comprise estimates of deferred consideration on existing, historic transactions
Note: unbilled revenue runs at circa 50 days
Note: Total loans from former members £0.6m end FY17, vs £5.1m end FY16.

Notes

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