Fairpoint Group

Respect the law

19 September 2016

Progress in H1 pivoted on successful integration of newer parts of the group's Legal Services division, its growing scale and achievement of key strategic targets. This is driving Fairpoint's transformation into a focused legal services business with well-defined strategies and visible growth targets.

The lower contribution from Debt Management activities (DM) was expected, but the shares dipped initially on news that conveyancing (8% of legal division turnover) had come in below forecast as the UK housing market paused post the Brexit vote, and mortgage approvals fell to a 15-month low. Legal Services is increasingly well-diversified but conveyancing had a disproportionate impact on earnings, as we discuss later. We have reduced our full year adjusted PBT forecasts by c £1m to reflect this, but **even on new forecasts the shares' rating looks attractive**.

Simpler, focused model

The shift to Legal Services continues as DM is wound down and acquisitions bolted on. Group H116 revenue was 24% up y-o-y on the back of acquisitions and c 4% organic growth attributed to marketing initiatives. Fairpoint aims to build a top five consumer legal services business to compete for an estimated £10bn pa of fragmented industry revenues; industry sources put the current No.5 operator at £60m pa turnover.

Financials: Legal Services revenue was £21.5m in the first half, 90% up y-o-y post acquisitions; adjusted segment PBT was £3.1m (H115: £1.4m). Margin growth from 13% to 14% was achieved despite conveyancing performance and we see potential for further material progress over the next few years. Income from this division is now well-diversified, balanced across seven discrete revenue streams with distinct cash generation timeframes and margins. Operations have been harmonised under a single brand, with marketing, administration and new business increasingly integrated.

Valuation: We have factored in a lower than expected contribution from conveyancing in H2 and 2017, pending more clarity on UK residential market trends over the remainder of this year. The group may decide to cut costs in this area; it hasn't done so yet as specialist expertise would be hard to replace in a hurry. Elsewhere, performance is on track overall. We anticipated the wind-down of debt management and soft IVA volumes. Other than conveyancing, Legal Services revenues are growing, and long term facilities are available to fund organic growth and acquisitions. The interim dividend was held and distributions remains very well covered. **On new FY'16 forecasts the yield on the shares is a healthy 6.7%, and the PER just 7.5x.**

Summary forecasts

Year end 31 Dec	2013A	2014A	2015A	2016E	2017E
Adj Pre-tax, £'000s	8,051	9,255	10,464	7,750	8,770
EPS, p	15.0	17.2	19.3	13.7	14.5
PER	6.8	5.9	5.3	7.5	7.0
Div, p	6.0	6.4	6.8	6.8	7.0
Yield	5.9%	6.3%	6.7%	6.7%	6.9%

Source: Group report & accounts and ED estimates

Company Data

EPIC	FRP
Price	102p
52 week Hi/Lo	195p / 95p
Market cap	£43.1m

Share Price, p

Source: ADVFN

Description

Fairpoint Group provides a range of consumer targeted professional services. The group's core business is a consumer legal operation (76% of H116 revenues), supported by legacy debt solutions services.

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Interim results

The core first half message was continued transition away from low growth/higher margin debt solutions businesses, towards provision of higher growth/lower margin Legal Services.

There are compelling distinctions between the two markets. Debt solutions has gone backwards over the last few years on challenging macro-economic indicators, and as increased regulation added complexity. Conversely, consumer legal services is a fragmented £10bn pa revenue market and the group has a clear strategy to grow via acquisitions and promote services at transparent cost to address customer concern over potential expense.

Revenue 24% ahead of FY'15, on acquisitions and organic growth

Progress against that strategic plan was reflected in an aggregate 24% increase in group revenue to £28.3m, driven by the acquisition of Colemans in August 2015 and organic growth at Simpson Millar. Legal Services division revenues alone were £21.5m (H115: £11.3m), 76% (H115: 49%) of aggregate group revenue despite the lower than expected contribution from conveyancing, in a quieter post -Brexit vote housing market.

Summary results

To end June, £m	H1 2016	H1 2015
Revenue	28.3	22.9
Gross profit	14.3	11.5
Adjusted PBT	4.0	4.1
PBT	0.8	1.3
Adj. basic EPS	7.03p	7.38p

Source: Fairpoint interim report

Adjusted profit before tax at £4.0m (H115: £4.1m) reflected the strength of consumer Legal Services income other than conveyancing, adverse Debt Solutions market conditions and higher finance costs £0.47m (H115: £0.24m) post acquisitions.

The adjustment to £0.8m reported PBT (H115: £1.3m), adds back the £2.5m (H115: £2.3m) net of tax effect of amortisation of acquired intangible assets, £0.4m (H115: £0.4m) unwinding of the discount on contingent consideration and £0.3m (H115: nil) of exceptional acquisition costs which relate to the acquisition in May 2016 of a small market leading practice specialising in child abuse cases. Adjusted basic EPS was 7.03p (H115: 7.38p), basic EPS 1.44p (H115: 2.33p).

The group has used a bank facility provided by AIB to finance acquisitions. That is reflected in higher net debt and at the mid-year there was £8.6m of cash and undrawn debt available. The arrangement consists of a £17m revolving credit facility and £8m term loan. The latter is amortising, with £5m due for repayment by the facility expiry at May 2019. Headroom to allow execution of the group's growth strategy remains ample.

Borrowings

£m	H1 2015	FY 2015	H1 2016
Principal bank debt	(7.8)	(18.4)	(19.7)
Cash	2.6	4.8	4.1
Net debt	**(5.2)**	**(13.6)**	**(15.6)**

Source: Fairpoint interim results

Revenues from IVA, DMP and claims management activities were, as foreseen, below H115 and Fairpoint did not invest in marketing activities in these areas.

DMP exit to complete during H2

Revenue from the combined Debt Solutions was much lower at £6.9m (H115: £11.6m). The second half contribution is due to fall again as provision of debt management plans is being wound down in an orderly fashion, with full exit planned during the second half. Fairpoint decided to exit this component of its debt business as regulatory changes negatively affected the business model and potential profitability. It will, however, protect the interests of its DMP customers by transferring them to a 'fee free' operator.

As the DMP exit is completed it will reduce ongoing group expenses, subject to c £2.5m of exceptional costs and a £5.5m non-cash DMP intangible asset impairment in H216. This will simplify the business model and allow focus on higher growth legal services. On the basis that the debt solutions market will remain challenging the focus will, post exit from DMP, remain on cash recovery from its IVA and claims businesses, as both continue to contribute to cashflow and profit. Over time, some components may be absorbed into legal services.

Legal services: revenue & profit up, but conveyancing slower

The majority of legal services businesses traded in line with expectations, but conveyancing volumes fell on the back of lower housing market transactions. This appears to be related to the EU Referendum in June, after which mortgage approvals have fallen to a 15-month low.

Whereas the group originally expected conveyancing growth to resume in H2 and largely preserved its service capability to meet demand, it now expects H2 to be slightly below H1, which would point to a more material reduction for the full year, much of which drops to the bottom line as capacity has been left in place, for now at least. We have assumed that this situation will not change significantly in coming months and if that is the outcome, we may see management seek to cut operational capacity to reduce expenses.

Lower cash from operations reflects debt solutions activity

The group generated £2.2m (H115: £5.5m) cash from operations. That reflects working capital movements associated with lower debt solutions activity, and cash outflows associated with exceptional costs of £0.3m (2015: £nil). There was an increase in WIP days within legal services to 118 (FY 2015: 104) which reflected a changed mix of legal work undertaken during the period. We anticipate that this will be lower by the year end.

Investment of £1.7m during the period (H115: £0.7m) included £0.6m software development and £0.6m in other IT infrastructure. These are designed to improve and integrate systems and process, particularly within the legal services segment.

New CFO takes over with immediate effect

David Broadbent has been appointed as Chief Financial Officer to replace John Gittins who has fulfilled the role for the last four years, and will remain on hand to complete the hand over before the end of September. The new CFO joined Fairpoint at the beginning of August. He has spent over 20 years in professional and financial services and joined the group from International Personal Finance plc, where he was FD and Chief Commercial Officer. His previous career was at Provident Financial Plc and PwC.

Divisional Review – Legal Services

Expansion of legal portfolio taking shape

The transition of the business towards legal services will create a leading provider within a large scale, fragmented marketplace. It will simultaneously drive operating efficiencies and margins by applying process to a professional service and create structural competitive advantages.

The legal services market has seen significant regulatory change intended to improve consumer choice and value. This has encouraged industry consolidation and the introduction of new business models, which Fairpoint sees as an opportunity to deliver more competitive consumer offerings. Since the acquisition of Simpson Millar in June 2014 and Colemans in August 2015 it has invested in software and IT infrastructure to support organic growth and simplify integration of complementary acquisitions.

The first half statement confirmed that the consumer legal services business has been transformed into a provider of a diverse range of legal services from 12 UK offices. It is building Simpson Millar into a recognisable consumer brand and launched "The law of" website (www.thelawof.co.uk) in H1'16 to further enhance brand awareness. The table below illustrates how successfully Fairpoint has built its service portfolio and balanced revenues across product lines, cash generation timings and margins. The focus is now organic growth, supported by possible further value enhancing, complementary acquisitions.

Wide range of legal services offered

	Share of division revs	Cash profile	Relative margin	Comments
Family & Personal	19%	Fast	Medium	Growing; good marketing traction
Conveyancing	8%	Fast	Low	Growing but strong headwind, relies on third party distribution
Legal Processing	17%	Moderate	Low	Fee levels for Road Traffic Accident work at risk but new models emerging which suit a low cost operating model
Holiday	18%	Moderate	High	Market leader in a flat market Strong litigation track record Conditional fee work
Clinical Negligence	11%	Slow	High	Strong litigation track record Conditional fee work
Complex Litigation	19%	Slow	High	Strong litigation track record Conditional fee work
Business Services	8%	Moderate	Moderate	Provides services for legal related work both internally and to third parties

Source: Company

Strategic move towards a single platform for legal services

Development of a coherent, consistent platform should enable the group to build the scale of its legal services division, and integrate and harmonise new brands. This focuses on (a) increasing consumer access to legal services, (b) developing the division's marketing and distribution capabilities and (c) deploying a production-orientated operating platform.

During the first half activity was focused on:

- Investment in common processes, software and IT infrastructure to operate more efficiently and provide a better service to consumers.
- Defining a pricing tariff for over 70 legal products, to enable it to communicate a price point for a fixed schedule of services at the outset
- Launching "The law of" website and brand, increasing consumer awareness and interest in group legal services.

Each of these aims to support a goal to make legal services more accessible to consumers. Other areas of material progress towards that are:

- 80% of group products by volume are now administered on a single IT platform
- Introduction of a comprehensive product range, at fixed prices for defined service schedules
- Extension of the product range via an acquisition of a market leading practice specialising in child abuse cases
- Advertising resulting in substantial coverage

More growth to come

The plan is to establish a strong foundation to build upon, and systems which enable it to gauge the impact and refine ways in which it markets and distributes core services, manages campaigns and handles new business enquiries. Feedback generated is used to evolve advertising and media campaigns to attract better quality enquiries, understand how to handle them efficiently and qualify leads prior to fee-earner involvement.

From that point the planned operating platform will assess performance from case inception to management, and contribute to continuous improvement.

The division now operates a balanced portfolio of consumer-focused legal services from 12 offices around the UK. It continued to implement new systems and process changes in H1 designed to support organic growth and simplify integration of new acquisitions.

Further investment in the period included a small acquisition for an initial £0.4m, of a specialist in child abuse cases. The comparison with the first half of 2015 is necessarily impacted by acquisitions, but nonetheless illustrates how the group has added scale in key areas (see next table).

Significant revenue increases visible (£'000)				
Service Line	**H1 2016**	**H1'16 split**	**H1 2015**	**H1'15 split**
Family & Personal	4,079	19%	2,898	26%
Clinical Negligence	2,423	11%	2,639	23%
Complex Litigation	4,012	19%	2,518	22%
Holiday	3,906	18%	1,252	11%
Legal Processing Centre	3,711	17%	471	4%
Conveyancing	1,764	8%	202	2%
Business Services	1,574	7%	1,335	12%
Total	**21,469**	**100%**	**11,315**	**100%**

Source: Company

It also confirms progress against another core strategic target, to provide a broad, balanced portfolio of consumer legal services. The breakdown of divisional revenues at the half year illustrates progress in this respect, with income broadly derived from seven discrete areas, with different cash generative profiles, margins and prospects.

Fairpoint is building services with the scale to achieve the necessary profile and competitive advantages to compete in their specific niches, which in turn limits its exposure to issues such as that currently affecting conveyancing, whether cyclical or politically inspired.

Conveyancing weak, road traffic claims less of an issue

Areas of immediate concern include conveyancing. At the time of the group's AGM in May 2016 there were signs that conveyancing activity i.e. housing market transactions had been disrupted by uncertainty during the run up to and immediately post the EU Referendum. There was however an expectation that the operation would be able to capitalise upon its strong competitive positioning in this area as the market returned to normal.

In the event, transaction volumes have remained weak and mortgage approvals at a 15-month low. Management intends to review this activity, particularly the cost base if the residential market and mortgage approvals remain weak over the remainder of this year.

One other source of sensitivity may have diminished in importance. Fairpoint noted in its 2015 results that the government had proposed changes to the operation of whiplash claims relating to road traffic accidents, subject to consultation.

The group believes that its legal processing centre will work to its advantage, and enable it to manage such legal work at low cost. In the event however, the timetable for implementation appears to have fallen behind the critical path for a scheduled start in April 2017. The start of the consultation process is still awaited.

Debt Solutions

Non-viable elements in orderly wind down

Elements of the group Debt Solutions division are either in wind down or largely retained as a source of reliable cash flows.

The Debt Management Plan operations will be wound down during the second half. H116 DMP revenues were £2.6m (H115: £3.9m), adjusted PTP £0.8m (H115: £1.5m). A lower 29% adjusted margin (H115: 39%) reflects the impact of the regulatory agenda i.e. increased call handling times, customer attrition and higher risk and compliance overheads. There were 13,252 DMPs under management at the half year (H115: 20,730). An orderly wind down is on track with anticipated exceptional restructuring costs of c £2.5m in H216 and a £5.5m non-cash impairment of the debt management intangible asset.

IVA services revenues were £3.0m in the first half (H115: £5.6m), adjusted PTP £0.4m (H115: £1.0m). That reflects lower levels of new cases in line with lower debt solutions marketing spend. Total fee paying IVAs under management at end June 2016 were 13,811 (H115: 16,889), with 238 (2015: 795) new IVAs written in the first half. The average gross fee per new IVA was £3,150 (H115: £3,036). Claims management revenues were £1.3m (H115: £2.1m) and segment adjusted pre-tax profit £0.3m (H215: £0.4m). As this operation largely services Fairpoint's IVA and DMP customer base, the reduced y-o-y result year largely reflects declining customer numbers.

The outlook for IVA solutions remains challenging and the group has taken a decision to put marketing activity on hold. This situation may prevail unless a base rate increase adversely affects the financial circumstances of home owners.

In conclusion

Chris Moat, CEO, neatly summarised prospects:

"Fairpoint has delivered double digit revenue growth compared to last year, despite challenging market conditions.

"Looking forward the Board will continue to transition the business towards legal services. The scale and fragmented nature of this marketplace presents ***a significant opportunity*** *for Fairpoint to deploy its core skill of applying process to a professional service, and thereby create a structural competitive advantage relative to existing market incumbents."*

A major shift in strategy takes time to effect, and the unforeseen conveyancing slow down impacts results in the short term. Nonetheless, Fairpoint is diligently building secure foundations and infrastructure for a legal business that offers major growth potential.

The shares offer high dividend yield on a low forward PER. To us, that seems to reflect the past rather than an exciting future.

FINANCIALS

Forecasts					
Year end Dec , £'000	**2013**	**2014**	**2015**	**2016E**	**2017E**
Revenue	28,357	38,324	54,121	55,900	53,000
Cost of sales	(13,245)	(18,000)	(25,553)	(27,950)	(25,400)
Gross profit	**15,112**	**20,324**	**28,568**	**27,950**	**27,600**
Gross margin	53%	53%	53%	50%	52%
Other administrative expenses	(9,828)	(12,988)	(19,229)	(20,300)	(19,000)
Amortisation of acquired intangibles	(1,585)	(3,272)	(4,781)	(5,500)	-
Exceptional items	(592)	(2,534)	(10,452)	(2,800)	-
Total administrative expenses	**(12,005)**	**(18,794)**	**(34,462)**	**(28,600)**	**(19,000)**
Finance income - unwinding of disc. on IVA revenue	3,092	2,332	1,581	900	900
Finance income - other	7	93	198	100	70
Profit (loss) before finance costs	**6,206**	**3,955**	**(4,115)**	**350**	**9,570**
Finance costs	(332)	(506)	(654)	(900)	(800)
Finance costs - related to exceptionals			(881)		
Profit (loss) before taxation	**5,874**	**3,449**	**(5,650)**	**(550)**	**8,770**
Adjusted pre-tax profit (loss)	**8,051**	**9,255**	**10,464**	**7,750**	**8,770**
Tax (charge) credit	(1,694)	(1,839)	(1,900)	(1,407)	(1,764)
	-21%	-20%	-18%	-20%	-20%
Tax (charge) credit - related to exceptionals	506	1,248	1,205	-	-
	(1,188)	(591)	(695)	(1,407)	(1,754)
Profit after tax	**4,686**	**2,858**	**(6,345)**	**(1,957)**	**7,016**
Adjusted profit after tax	**6,357**	**7,416**	**8,564**	**6,343**	**7,016**
Comprehensive income (loss) for the year	**4,686**	**2,858**	**(6,345)**	**(1,957)**	**7,016**

Source: Company historic data, ED estimates

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