Tatton Asset Management

Scale-up train on track

17th October 2019

Tatton's trading statement for the half-year ending 30 September 2019 confirmed continued momentum in AUM growth, which increased to £7.0bn, up 14.8% over the half-year (from £6.1bn on 31 March 19) and 23% year-on-year. The group's first acquisition since its 2017 listing (a strategy made explicit at that time) has also been announced, which contributed £135m of the £0.9bn AUM increase. Organic AUM growth was 12.5%. We see significant opportunity for the asset management side of the business to scale quickly and be the primary driver of strong future earnings growth as operational leverage kicks in.

The statement also confirmed that the number of consulting clients had reduced slightly from 390 to 385 member firms, principally due to consolidation activity, while the mortgage business, still the smallest business unit, continued to impress with member firms growing from 1,392 to 1,466 over H1.

Servicing Independent Financial Advisers

Tatton Investment Management (TIML), the largest of the three group business units, sources funds exclusively through UK-based, FCA 'directly authorised' independent financial advisers (IFAs). IFAs place client assets into a range of TIML investment portfolios through the 'WRAP' platform of their choice (a WRAP platform is an on-line administrative service that combines all client investments into a single account – such as Nucleus, Transact, and Aviva). TIML is platform-agnostic. The 'sweet spot' target market of the group is the smaller IFA firm, with the client base having, on average, three individual advisers.

TIML is the growth engine of the group, is highly profitable, and is set to benefit from further economies of scale. It makes up 50% of group revenue (£8.7m in FY19), AUM has increased from £3.9bn at the end of FY17 to £7.0bn at the end of H1 2020, and contribution margins have risen from 28% in FY17 to 53% in FY19.

Paradigm Consulting (PPC) was the genesis of the group in 2007, and provides regulatory and compliance consulting and outsourcing services to IFAs.

PPC 'members' pay a recurring fee for a suite of services such as compliance process set-up and monitoring, advice, training, manuals, technical support and general business consultancy. Ad-hoc consultancy projects are also undertaken.

It is a mature business, with members increasing slowly but steadily from 352 at the end of FY17 to 390 at the end of FY19, but is both financially and strategically important. PPC revenue (£6.0m in FY19) accounts for 35% of the group's total and its contribution margins have consistently been around 50% over the last three years. PPC members are also an important source of AUM for TIML (contributing 75% of AUM in FY19).

In addition, according to group CEO Paul Hogarth, the PPC business is the 'glue' that binds all three businesses together, and provides deep insights into current IFA needs and trends, which in turn helps with new service and product design across the group.

Company Data

EPIC	TAM
Price (last close), p	210
52 week Hi/Lo, p	274/179
Market cap	£117m

Share Price, p

Source: ADVFN

Description

Tatton Asset Management was founded in 2007 and provides three services to smaller, UK-based Independent Financial Advisers: discretionary asset management; regulatory and compliance consulting and outsourcing; and also mortgage and protection insurance aggregation.

Aggregate AUM at end Sept 2019 was £7.0bn.

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Paradigm Mortgage Services (PMS) is a mortgage distribution business that allows IFAs and intermediaries to source mortgages and protection insurance and obtain better pricing from the bulk buying power of PMS.

It dates back to 2009, but received a boost in 2014 following the Mortgage Market Review that drove distribution towards intermediaries and intermediaries towards distributor businesses. Between 31 March 2017 and 30 September 2019, member firms increased from 1,069 to 1,466.

PMS now makes up 15% of group revenue (£2.7m in FY19, 50% up on FY17). It is highly profitable, with a contribution margin of 58% in FY19, up from 46% in FY17.

Asset management - the growth engine

Tatton Investment Management has an opportunity, which, if captured, could see its earnings dwarf that of PPC and PMS in a few years' time. Its target clients are moving more and more of their assets onto discretionary fund management platforms: TIML has carved out a market-leading proposition in this space; it has tried-and-tested methods of winning new clients and capturing a higher share of their AUM; and its operational leverage should see margins improve further.

Assets under management on investment platforms in the UK have doubled from £250bn in 2013 to £500bn in 2018. Consumers place £189m directly, with advisers placing £311bn[1]. Around £48bn[2] of these assets are placed in 'model portfolios', typically preselected, diversified portfolios of funds, known as *Discretionary Fund Management* (DFM) or *Model Portfolio Services* (MPS).

DFM and MPS is Tatton's hunting ground, and is a market that has grown from £5bn AUM in 2011[1] to £48bn in 2019. Tatton is the largest DFM 'on platform' in the UK[2].

This growth is primarily down to advisers moving away from selecting investments for clients themselves and towards outsourcing this function. This is because of restrictions on their commission-based remuneration, post the Retail Distribution Review (RDR), and the additional regulatory burdens and risks associated with MiFID II. Their core focus has shifted much more towards providing financial advice and planning, not investment management.

TIML has a powerful offering in this market and is a leader on the top two most important criteria advisers use to select a DFM: fees and investment performance[2].

It is in fact the very best performer when it comes to fees:

[1] FCA, Investment Platforms Market Study, March 2019
[2] Platforum, DFM Distribution Dynamics, July 2019

Comparison of DFM (on-platform) charges	
Provider	**Annual fee % (including VAT)**
Tatton Investment Management (on 11 UK adviser-led platforms)	0.15
AJ Bell Investments	0.18
LGT Vestra	0.3
Momentum	0.3
FE Invest	0.33
Seven Investment Management	0.36
Bordier UK	0.36
Brewin Dolphin	0.36
Brooks Macdonald	0.36
Charles Stanley	0.36
Liontrust	0.36
Morningstar	0.36
Tilney Investment Management	0.36
Waverton Investment Management	0.4
Portfolio Metrix	0.42
Wellian Investment Solutions	0.42
Albert E Sharp	0.6

Source: Platforum, DFM Distribution Dynamics, July 2019

…with impressive investment performance compared to the relevant benchmarks.

TIML Fund Performance (%) – core product set				
	TIML Active	**TIML Tracker**	**TIML Hybrid**	IA Sector*
Defensive	**4.8**	**5.1**	**5**	4
Cautious	**6.6**	**6.4**	**6.6**	5.2
Balanced	**7.8**	**7.6**	**7.8**	6.2
Active	**9**	**8.9**	**9.1**	7.2
Aggressive	**9.7**	**10.1**	**9.8**	7.2

(1/1/2013 - 31/03/2019, annualised, after DFM charge and fund costs)
** IA – Investment Association managed fund peer group with comparable asset allocation characteristics*
Source: Tatton Asset Management - Investor and Analyst Presentation June 2019

Armed with this strong asset management offering, TIML can pull five main levers to grow AUM organically:

First, win new TIML-direct (non-consulting) clients. TIML had grown this client base to 256 as at 31 March 2019 and a core strategy is to grow it further. The UK market has over 5,000 directly authorised adviser firms, leaving TIML with significant scope to increase its market share.

Second, and probably most importantly, capture a larger share of TIML-direct clients' AUM. Without a pre-existing consulting relationship, the migration of direct clients' AUM to TIML is slower than 'dual' consulting-and-asset-management clients. The average AUM per direct client was £5.9m as at end FY 19, compared to £24.3m for dual-clients.

But TIML clients have, on average, £40m placed through the platform(s) they use[3]. This presents a significant opportunity to increase share-of-client-AUM and is a key focus.

If the average AUM of the existing direct client base of 256 were to increase to dual-client levels, then the result would be *an additional AUM of £4.8bn i.e. the potential exists to exceed £10bn of AUM without adding a single new client.*

Third, win corporate mandates. Rather than winning individual IFA clients one-by-one, TIML also has an opportunity to do this en-masse through corporate mandates. For example, in June 2019, it won a three-year mandate to provide a Managed Portfolio Service through Tenet, one of the UK's largest adviser support groups, giving TIML access to 474 additional IFA firms, with the corresponding opportunity to rapidly boost AUM.

Fourth, convert more consulting-only clients to become consulting-and-asset-management clients. Of the 390 PPC member firms as at 31 March 2019, 189 (48%) were TIML clients as well. With deep and established relationships already in place, TIML will be looking to win new clients from the remaining 52%.

Fifth, capture a larger share of 'dual-client' AUM. TIML is looking to get closer to the £40m average AUM per client over the medium to long term.

Since listing in 2017, management has said it is on the lookout for strategic acquisitions, with the most important criteria being that any move on this front would need to increase AUM and be earnings enhancing. It has previously cited possible targets as smaller, sub-scale discretionary fund managers or the like.

Tatton has now announced its first acquisition, Sinfonia Asset Management Limited (SAM), which was a wholly owned subsidiary of the Tenet Group. SAM runs five funds with a total AUM of £135m. The entire issued share capital of SAM has been purchased for up to £2.7m (£2.0m payable on completion, the balance payable against AUM targets in two equal instalments at the end of years one and two post completion). The acquisition will be funded out of existing cash resources. Full details of the financial impact of the transaction have not yet been disclosed, but notably the initial acquisition-price-to-AUM ratio of SAM (1.5%) is roughly in line with the market-cap-to-AUM ratio of Tatton Asset Management plc (1.7%[4]).

IF TIML grows its AUM rapidly through the successful execution of some or all of the above strategies, it should have a disproportionately positive impact on the bottom line as operational leverage kicks in. This has already been evident as contribution margins have increased from 28% in FY17 (when AUMs stood at £3.9bn) to 53% in FY19 (when AUMs reached £6.1bn). Further margin improvements should be possible. According to CFO Paul Edwards, the business should be able to accommodate £10bn of AUM without incurring significant further investment in infrastructure (such as in systems) or investment teams, but would incur some variable administrative and compliance costs.

While Paradigm Consulting is a financially attractive business and a strategically important part of the group, we see only modest earnings growth potential. New member growth is comparatively low (5-6% p.a. over the last 3 years), annual spend per member is somewhat volatile (£16.7k in FY17, £18.8k in FY18, and £16.0 in FY19), and margins are largely static at around 50%. This type of business does, however, tend to enjoy 'sticky' client relationships.

[3] Tatton Asset Management - Investor and Analyst Presentation June 2019
[4] Based on market cap of £117m (as at market close on 16 October 2019) and AUM of £7.0bn.

Paradigm Mortgages, meanwhile, has higher earnings growth potential. The number of member firms continues to grow at a respectable clip (14% between 30 September 18 and 30 September 19), as does the gross lending per member firm (up 16% from £4.7m in FY18 to £5.5m in FY19), while contribution margins remain attractive at 58%. However, it is a much smaller business than PPC and TIML and is also exposed to the vagaries of the housing market, which will inevitably result in periods of revenue and earnings volatility.

Solid investment case

Successful execution of these revenue and earnings growth opportunities has the potential to provide investors with significant capital appreciation. Its current price-earnings ratio of 17 is not a particularly demanding valuation metric in view of the growth potential.

The shares also offer an attractive income profile. Dividends have increased by 75% over the last two years, from 4.8p in FY17 to 8.4p in FY19, translating to a dividend yield of 4.0% in FY19. The stated dividend policy is to declare around 70% of adjusted earnings as a dividend, paid one-third as an interim and two-thirds as a final. If the business meets our forecasts and maintains this declaration policy, dividends of 9.2p and 11.1p would be expected in FY20 and FY21 respectively, translating to yields of 4.4% and 5.3%.

The business is conservatively financed, with no debt. At the end of FY19, net assets stood at £13.9m and net cash at £12.2m, the bulk of which comes from the 2017 IPO, which raised £10m, earmarked for "future capital investments to support growth and any potential acquisitions that fit the profile and strategic direction of the Group." The SAM acquisition will reduce the available cash by £2.0m, and possibly by a further £0.7m should the maximum acquisition price be paid (if the growth targets of SAM are met).

Investors in Tatton are exposed to the typical risks associated with small-cap stocks (key-man importance, price volatility etc), as well those affecting nearly all businesses (internal or third party system failures, cyber-risks etc). One business-specific key risk that investors should bear in mind is the impact that a significant downturn in financial markets could have.

While key individuals in the business have decades of experience and have navigated market cycles, Tatton's Asset Management business has not been through a significant downturn, and the reaction of clients to such an event – such as withdrawing funds – is unknown.

The group is also in a highly competitive market space, and to an extent, does compete on price (in addition to investment performance, level of service, reputation etc). Competitors, particularly larger-scale competitors, could intensify price competition and harm growth.

The group CEO, Paul Hogarth, holds 18.7% of the shares with his interests well aligned to those of external shareholders. Although the balance of the senior management team holds just under 2% of the shares, we would expect this to increase as additional share options are allocated and vest. The group has also built up a credible institutional shareholder base, some of which have taken significant stakes in the group, including[5]: BlackRock[6] (15.3%), Liontrust Investment Partners (12.1%), Chelverton Asset Management (6.4%), Legal & General Investment Management Limited (6.0%), Lombard Odier Investment Managers[7] (4.9%), Kames Capital (4.3%), and Rathbone Investment Management (3.2%).

[5] As at 3 June 2019, according to Tatton Asset Management Annual Report 2019
[6] Funds and accounts under management by direct and indirect investment management subsidiaries of BlackRock, Inc.
[7] Accounts managed on a discretionary basis by Lombard Odier

Summary forecasts							
Year end 30 March	**FY 2017A**	**FY 2018A**	**H1 2019A**	**FY 2019A**	**H1 2020E**	**FY 2020E**	**FY 2021E**
AUM end-of-period, £bn	3.9	4.9	5.7	6.1	7.0	7.5	8.7
Revenue, £m	11.9	15.5	8.4	17.5	9.5	19.6	22.2
Revenue growth, y-o-y	30%	31%	16%	13%	12%	12%	13%
Adjusted Op. Profit, £m	4.5	6.5	3.4	7.3	4.2	8.8	10.7
Operating Profit, £m	2.0	3.6	3.0	5.9	3.8	7.7	9.6
Profit attributable to s/h	1.2	2.3	2.4	4.9	3.1	6.2	7.8
Adjusted EPS (Basic), p	6.4	9.6	5.0	11	6.3	13.1	15.9
EPS growth		45%	14%	14%	27%	19%	21%
Fully diluted EPS, p	6.4	9.1	4.6	10.0	5.7	11.8	14.3
Dividend, p	4.8	6.6	2.8	8.4	3.1	9.2	11.1
Yield	2.3%	3.1%	1.3%	4.0%	1.5%	4.4%	5.3%
Dividend cover	1.3x	1.4x	1.8x	1.3x	2.1x	1.4x	2.3x
Net assets, £m	3.1	13.6	13.9	15.3	16.7	16.4	17.9
Net cash, £m	0.7	10.6	11.6	12.2	11.6	10.9	12.2
PER	33	22	21	19	17	16	13

Source: Group report & accounts and ED estimates

Next events

We now look forward to the release of Tatton's interim results in November 2019, to see how AUM growth has filtered down to the revenue and earnings lines, and to the disclosure of further financial details of the SAM acquisition.

Investor Access

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