EDISON

Lighthouse Group

Well-established adviser with a specific angle

Initiation of coverage

Financial services

Lighthouse is a financial adviser and aims to provide well-researched solutions to individuals and corporates. It is differentiated by its leading position in serving the members of affinity partners, where it has 21 relationships with unions and other organisations. There is a significant opportunity to increase penetration in this area and success could generate earnings surprises, given the investment already put in place to support the activity.

Year end	Revenue (£m)	PBT (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/16	47.9	1.9	1.13	0.27	33.6	0.7
12/17	54.1	2.5	1.49	0.42	25.6	1.1
12/18e	55.2	2.7	1.60	0.50	23.7	1.3
12/19e	56.6	3.0	1.79	0.55	21.3	1.4

Note: *EPS are normalised and fully diluted, with tax credits excluded and a standard tax charge applied.

Resources and experience to serve Middle Britain

Lighthouse sets out to provide holistic advice to what it characterises as Middle Britain. This fits well with its affinity-based business that accounted for 18% of sales and 50% of EBITDA (ex-central costs and wealth management loss) last year. Profitability is higher here because Lighthouse provides the client leads to advisers, so the pay away to them is lower. The group has invested in the IT and central functions needed to support this area, which also strengthens the proposition offered by its employed and self-employed advisers in other areas of the business and reduces risks for the business and customers. Once acquired, clients tend to be sticky and recurring revenue accounted for 46% of total revenue in 2017.

Outlook: In the right place

The industry background for financial advisers appears positive. Forecasts point to an ageing population with greater longevity. This is combined with a number of factors that mean individuals have to make more decisions and bear greater risk in relation to long-term saving for retirement. There has also been a period of changing tax rules on pensions that has increased the prevailing tax complexity. All this tends to push people to seek financial advice. Even though many may be reluctant to pay an economic price, there is still a large population of relatively affluent potential clients. Automated (robo) advice is cited as a potential risk but the FCA has recently underlined the challenges of delivering such a service in a compliant manner and it may be that incumbents can take advantage of a hybrid offering to address a wider audience.

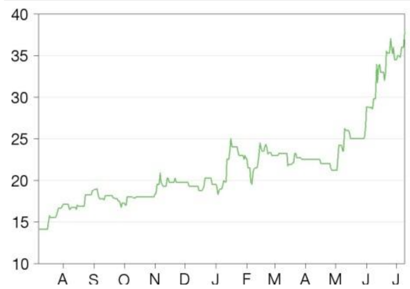
Valuation

We have assessed the valuation of Lighthouse shares by reference to a group of peers with financial advice activities and a DCF model (page 11). Balancing these, we see a value of 44p as reasonable, while further upside could emerge if development of the affinity business in particular generates positive surprises.

10 July 2018

Price	**37.8p**
Market cap	**£48m**
Net cash (£m) at end 2017	8.7
Shares in issue	127.7m
Free float (1 May 2018)	80%
Code	LGT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	26.9	68.0	167.6
Rel (local)	27.2	57.3	154.7
52-week high/low		37.8p	14.1p

Business description

Lighthouse comprises a diverse group of UK financial advice firms serving individuals and businesses. The main focus is on Middle Britain and contracts with 21 affinity groups are an important revenue and profit contributor. Wealth management serves a high net-worth client base while Luceo Asset Management provides an in-house fund offering.

Next events

H118 results	4 September 2018

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Edison profile page

Lighthouse Group is a research client of Edison Investment Research Limited

Investment summary

Financial advice with an affinity partner focus

Lighthouse is a well-established financial adviser that provides holistic advice to both individuals and corporate customers. It is organised into three divisions with the national Lighthouse Financial Advice (LFA) advisers operating under the LFA brand. This area includes the 21 affinity partnerships under which Lighthouse acts as the preferred financial adviser for the union or corporate partner membership. Wealth Management serves a high net worth client base and incorporates employee benefit and other workplace benefit services. The Network division includes those advisers that operate under their own brands. Finally, there is the recently launched Luceo Asset Management business that offers a range of funds tailored to different risk profiles. The group's strategy is to focus on development of the affinity business with Wealth Management and Luceo Asset Management expected to augment growth.

Financials: Strong balance sheet

Historical and estimated numbers for revenue and EBITDA are summarised below showing an improving margin over recent years, which we expect to continue as earlier investment in providing resources to support the affinity business is leveraged.

Exhibit 1: Revenue and EBITDA evolution

£m	2014	2015	2016	2017	2018e	2019e
Revenue	46.8	48.9	47.9	54.1	55.2	56.6
EBITDA	1.2	1.6	2.2	2.8	3.0	3.3
EBITDA margin	2.6%	3.3%	4.6%	5.2%	5.5%	5.9%

Source: Lighthouse, Edison Investment Research

At the end of 2017 the group had no debt and cash and cash equivalents of £8.7m. After regulatory and working capital requirements, there was excess cash of £4.7m providing both additional resilience and the means to take opportunities to add to the business through acquisition should an appropriate opening occur. We expect cash flow to strengthen as payments related to earlier provisions taper from 2019.

Sensitivities

The business background for Lighthouse appears favourable given an ageing population, increasing longevity, the move from defined benefit to defined contribution pensions and complexity in rules relating to pensions and tax. Nevertheless, adverse surprises in market sentiment and the economic background in the UK would have a negative impact. Regulatory changes or individual lapses in the quality of advice (something which Lighthouse seeks to manage closely) could also have an adverse effect. Automated advice or robo advice could be disruptive for traditional financial advisers but recent comments from the FCA highlight the challenges in operating such platforms, and we see potential for technology to be an opportunity for incumbents to support face-to-face advice and broaden their market reach in due course. With its affinity relationships and target of serving Middle Britain, Lighthouse should be well placed if the market evolves in this way.

Valuation

We have considered the valuation of Lighthouse shares in the context of a peer group comparison and the outputs of a DCF model. We see a value of c 44p as striking a reasonable balance with upside possible, particularly if development of the opportunity within the affinity area generates positive surprises.

Financial adviser with established affinity business

Lighthouse is one of the largest financial advice firms in the UK with a combined history that extends back well before its formation and listing on AIM in 2000. Some key events in the group's history are highlighted in Exhibit 2. Among these we would pick out the agreement with Liverpool Victoria (LV=) in 2007, which provided the basis of the advisory business serving affinity groups, an important and growing contributor to Lighthouse results. Also, while there have been acquisitions, including the merger with Sumus in 2008, Lighthouse has not been as active an acquirer of businesses as some of its peers in the industry, instead focusing on developing the business organically.

Exhibit 2: Selected key events

Year	Event
2000	Lighthouse formation and listing on AIM.
2003	Recruitment of consultants and acquisition of certain assets of RJ Temple.
2005	Acquisition of Carrwood Barker (main business now within Wealth division).
2007	Agreement with LV=, which gave exclusive access to provide financial advice to certain affinity groups.
2008	Merger with Sumus (formed 1983 and AIM quoted from 2005), significantly increasing the scale of the group.
2009	Acquisition of Godfrey Pearson adding to affinity business.
2013	Decision to close Exeter office and concentrate operations in Stockport and enlarged Woodingdean (Brighton) offices. The plc office is in London which also houses a number of advisers.
2016	Approach and indicative offer for Lighthouse from AFH of 13p per share. Rejected and subsequently withdrawn.

Source: Edison Investment Research

Divisions

The business is organised in three divisions: Lighthouse Financial Advice, Wealth Management and and Lighthouse Advisory Services.

Lighthouse Financial Advice (LFA) is an advisory business with national coverage providing financial advice to what is described as Middle Britain. Advisers are self-employed but work under the LFA brand. LFA has contractual agreements with 21 affinity partners as a preferred provider of financial advice (see below for more detail). There are about 140 financial advisers including a number of dedicated mortgage advisers within this division.

Wealth Management provides advice to a high net worth client base through two businesses: LighthouseCarrwood and Lighthouse Wealth. LighthouseCarrwood has employed and Lighthouse Wealth self-employed advisers. LighthouseCarrwood has contractual relationships with c 45 accountancy firms to provide financial advice to their clients. The group's employee benefits and workplace solutions business (part of LighthouseCarrwood) sit within this division.

Lighthouse Advisory Services is the group's network of self-employed advisers who work under their own brands supported by the same software and researched solutions as used by other advisers within the group.

In addition to these activities is **Luceo Asset Management**. This was launched in September 2016 to offer an actively managed range of fund of funds (currently five) tailored to different risk profiles. The aim is to provide a wide range of clients with access to high-quality diversified investment portfolios. Octopus acts as investment adviser to the funds. At end 2017, assets under management at Luceo was £37m, compared with £4m at the prior year end.

Revenue generation

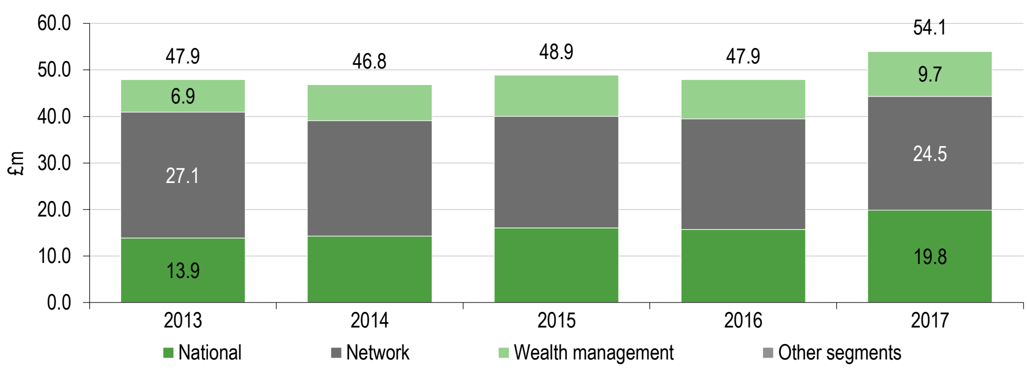
Following the implementation of the Retail Distribution Review (RDR) from 2012 to 2013 (see appendix, page 13 for further discussion) most of the Lighthouse revenue from financial advice has been in the form of fees rather than commission. Reflecting client preferences and in line with the market as a whole, the majority of these are charged on the basis of a percentage of assets under advice (AUA) although in some instances charges may be based on an hourly tariff.

As an indication, the fee for initial advice including a holistic report on a client's financial situation will tend to be in the range of 2-3% of AUA. The ongoing service fee for advice in subsequent years is likely to be between 0.5% and 1.0%. For FY17 recurring revenue was nearly 46% of the total, modestly above the prior two years but a step up from 40% for 2014.

Not all commission payments were precluded under the RDR so commission payments have continued for pre-RDR retail investment products held outside a platform, while Lighthouse also earns commission from other products including insurance protection products and mortgage advice. Approximately 12% of group revenue arises from commissions including pre-RDR trail commission that is set to continue generating commission until the products are liquidated.

Exhibit 3 shows how revenues have grown between 2013 and 2017. The key features here are that LFA (National) and Wealth Management revenues have grown strongly (9% compound annual growth in both cases) while Network revenue has contracted modestly. This reflects the group's focus on the more profitable divisions where it provides greater input to advisers and exercises more oversight. We discuss group and divisional profitability in the financial section but note here that while the Network division was the largest revenue contributor over this period it only made a modest net contribution to EBITDA profit reflecting the lower productivity and profitability of some advisers in this area.

Exhibit 3: Group revenue analysis 2013-2017



Source: Lighthouse Group, Edison Investment Research

The affinity business, operated within LFA, was an important contributor to the growth in divisional and group revenues shown above and we discuss this area in more detail in the next section.

Affinity business: A differentiating and profitable business area

As mentioned, the agreement with LV= provided the basis for this activity, which forms an important part of the group and the Lighthouse Financial Advice division. In 2017 affinity-based enquiries generated revenue across the group equivalent to nearly 18% of the group total while the EBITDA contribution was over 50% of the total, excluding central costs and the loss arising in Wealth Management from investment in its auto-enrolment product. As noted earlier, the higher profitability reflects the lower amount paid to advisers where the group provides the client lead.

There are 21 affinity relationships, which are detailed in the next table, showing a range of union and corporate organisations, giving a mix of sector exposures and diversity of membership, which totals around six million individuals. The relationships position Lighthouse as a preferred supplier of financial advice. Lighthouse agrees service levels over the life of the agreement with the affinity partner and will provide a short free initial meeting with individuals, and runs group presentations and clinics in the workplace to discuss particular topics including, for example, mid-career financial advice, mortgage clinics, pre-retirement planning and, on occasion, advice arising from restructuring situations.

Having the affinity relationship does not guarantee any level of business and the environment is likely to remain competitive both in terms of winning an individual's business and securing affinity partners. However, Lighthouse is well placed by dint of having already secured over 20 relationships, the investment it has made in IT systems, call centre support and event organisation staff and the experience it has built up in this part of the market. Arguably this creates something of a 'defensive moat'.

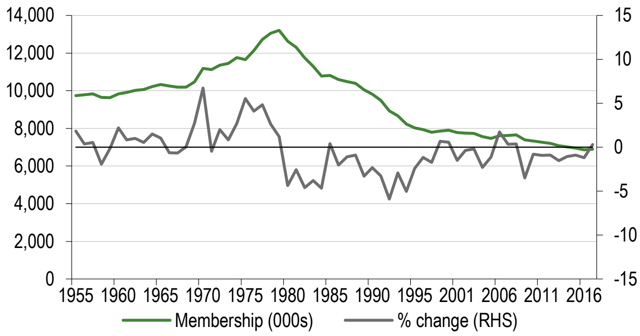
Exhibit 4: Lighthouse affinity partners

Organisation	Membership	Notes
Education		
ATL	170,000	Union
University and College Union (UCU)	over 110,000	Union
Association of School and College Leaders (ASCL)	over 19,000	Union
Healthcare professionals		
The Social Workers Union (SWU)	12,000	Union
The Royal College of Midwives	over 39,000	Union
Foster Talk	c 20,000	Not for profit company
Royal College of Nursing (via RCN Xtra)	Over 435,000	Union
Public services		
Public and Commercial Services (PCS)	c 200,000	Union
Boundless (CSMA)	over 250,000	Membership benefit club
Multiple sectors		
GMB	nearly 639,000	Union
Usdaw	over 429,000	Union
Bakers Food and Allied Workers Union (BFAWU)	c 19,000	Union
Unison	1,216,000	Union
Unite	1,340,000	Union
Prospect	c. 140,000	Union
Fire Brigades Union (FBU)	35,800	Union
Corporate and collectives		
GFTU	c 214,000	General Federation of Trade Unions
FDA	Over 18,000	Union (civil service)
Perkbox	N/A	Reward and motivation platform
BA Clubs	N/A	Sports, leisure club for current and former BA Group employees
Parliament Hill	N/A	Benefit management for over 90 UK-based membership associations

Sources: Lighthouse, TUC, affinity partner websites, Edison Investment Research

Given the prominence of unions in this partnership list, we have provided some background data on UK union membership in Exhibits 5 and 6. The chart shows that although union membership has fallen sharply from its peak of over 13 million in 1979 to under seven million last year, there has been a flattening out in the decline and even a small increase in 2017. The table draws together some of the characteristics of union members compared with equivalent statistics for workers who are not union members. Features include a relatively older age profile, higher public-sector exposure (including education and healthcare), higher educational attainment and more professional occupations than for non-union employees. The high public-sector exposure may reduce the opportunities to offer pension-related advice, but this does not apply in all cases and many of the other characteristics can be regarded as favourable.

Exhibit 5: Long-term union membership evolution



Source: Department for Business, Energy & Industrial Strategy

Exhibit 6: Union membership characteristics

% of:	Union members	Non-members
Aged over 50	39.8	27.5
Public sector	56.8	16.0
Full-time	78.5	72.5
Over 10 years' service	51.5	25.4
Degree or equivalent	43.9	33.1
Female	54.6	48.2
Workplace size – over 50	71.4	48.2
Professional occupations	37.9	16.2
By sector:		
Education	23.5	7.7
Healthcare	23.8	11.6
Manufacturing	7.5	10.6

Source: Department for Business, Energy & Industrial Strategy

The demographic of Lighthouse's affinity partners may differ from this union-wide summary but it is likely to be indicative. It should also be remembered that Lighthouse is in contact with c 15,000 new individuals a year drawn from the six million affinity partners so there should be substantial scope to increase penetration even if there are sections of the membership who are unlikely to be in the market for paid-for financial advice. Lighthouse notes that approximately one in three of the people they present to become fee-paying clients. As we will see in the next section, an important element of the group's strategy is to continue to increase the level of engagement with affinity partner membership to drive client growth.

In Exhibit 7 we collate the financial disclosure that Lighthouse has provided for the affinity business. This shows compound annual revenue growth of 21% between 2014 and 2017 while new business revenues in 2017 were double the 2015 level. The EBITDA margin benefited from the revenue uplift increasing to nearly 20% in 2017.

Exhibit 7: Affinity business financial results

£m	2014	2015	2016	2017
New business revenues		2.5	2.9	5.2
Recurring revenue		4.1	3.9	4.4
Revenue (across group)	**5.4**	**6.6**	**6.8**	**9.6**
EBITDA			1.1	1.9
EBITDA margin %			16.2	19.8
% of group revenue	11.5	13.5	14.2	17.7

Source: Lighthouse, Edison Investment Research

Group strategy

Lighthouse identifies LFA and its affinity business as its key growth driver, reflecting the investments made, experience gained and market-leading position held in this area.

To increase penetration of the affinity partner membership, the main objective is to increase the number of engagements with new potential clients from this group. Currently around 100 events are arranged each month, putting the company in contact with c 15,000 individuals per year. The aim is to increase this to 20,000 then 30,000.

The group continues to focus on delivering a high-quality service to clients with the development of centrally researched but individually tailored solutions that should be instrumental in winning and retaining clients.

Wealth Management is seen as a stable and growing contributor with its mix of employed advisers serving clients from professional relationships (primarily with accountancy firms) across the UK and entrepreneurial self-employed advisers with a client base comprising high net worth individuals in the City of London and the South-East.

The Network business has been managed to a point where it has been profitable at the EBITDA level for the last two years with risks to clients, the group and network advisers minimised through use of the same IT infrastructure and financial solutions used in other parts of the group.

The Luceo Asset Management business has already increased its range of funds to cover a broader spectrum of risk appetites and is expected to add new fund management partners in due course in order to extend the options further. In the near term, accumulation of assets should progressively move the existing funds to a profitable size.

The group has a number of dedicated mortgage advisers and potential is seen here to increase lead generation, helped by the affinity business and add to the number of advisers to expand this area of activity.

Finally, although M&A has not recently been a feature in the group's development, on the right terms management would not rule out a transaction that added capability to the service offering. The main potential stumbling block is a disciplined approach to pricing in a market where consolidators have been active for some time.

In the next section we summarise some of the broad industry drivers that appear positive and should support Lighthouse as it implements its strategy.

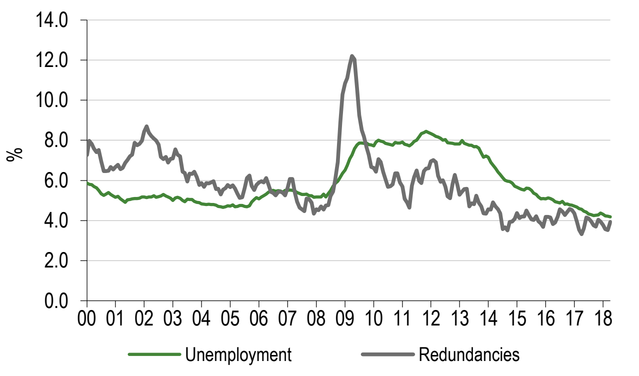
Industry outlook: Broadly supportive

There is a range of demographic, legislative and economic factors that appear likely to create a favourable background for the financial advice industry and Lighthouse.

- Population forecasts project a progressive ageing of the UK population, with those aged over 60 increasing from 24% of the population last year to 27% by 2027.
- Increasing longevity contributes to this. Both the increased number of people approaching or in retirement and the need to save to finance a potentially longer period of decumulation seems likely to drive increased demand for advice.
- Many people may not be willing to pay for financial advice but the population of affluent and mass affluent categories is substantial at an estimated five million and 10 million respectively.
- The shift from defined benefit to defined contribution pensions in the private sector has transferred decisions and market risks to individuals.
- Pension freedoms introduced in 2015 removed the requirement to purchase an annuity on retirement, presenting retirees with welcome but complex choices on how to draw down funds.
- Changes in pension contribution allowance rules and interaction of choices on drawdown with inheritance tax are examples of tax complexity that encourage people to seek financial advice.
- Increased ISA allowances create larger scope to employ this tax wrapper for long-term savings.

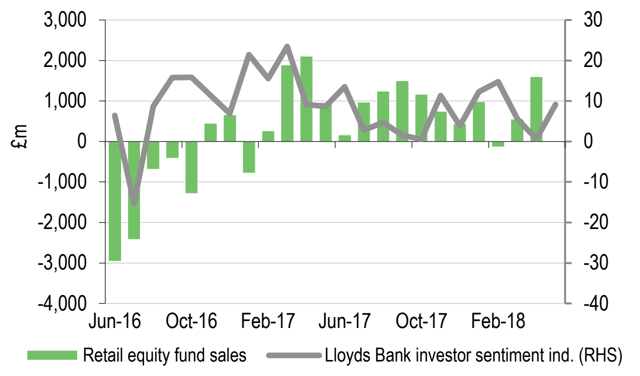
While the need for financial advice is related to the kind of structural factors highlighted above, the economic cycle and market sentiment is likely to affect appetite and ability to engage in financial planning activity. UK economic growth did slow in the first quarter and growth projections are more muted than previously, but Treasury-collected consensus expectations are still for GDP growth of 1.4% and 1.5% for this year and next.

Exhibit 8: UK unemployment and redundancy rates



Source: ONS

Exhibit 9: UK retail investor confidence indicators



Source: IMA, Lloyds Bank Investor Sentiment Index

Unemployment and redundancy rates (Exhibit 8) are running at historically low levels and indicators of retail investor sentiment are fluctuating but appear to be in neutral to positive territory (Exhibit 9).

On the **supply side,** the number of financial advisers fell by 16% following the implementation of the RDR in 2012 and has only recently returned closer to the levels seen previously (over 26,000). This can be seen as helpful for industry participants in that the market is not over-supplied but may make recruiting to support growth more challenging and potentially contributes to higher pricing in M&A transactions.

There is a potential advice gap for consumers dealing with the kind of decisions outlined above and one possible route for meeting this need is automated or **robo advice**. This has the support of the FCA, which sees innovation and competition as a potential contributor to good outcomes for consumers. A Deloitte report on automated advice sees potential for development of such services in the UK. The main positives are the potential to lower costs compared with face-to-face advice, increased convenience for the consumer, increased efficiency for the provider, consistency and a clear audit trail. Prominent barriers to development of such services are high customer acquisition costs, low fees and uncertainty over regulation. The last point hinges on the need to navigate between giving guidance and regulated advice with the latter carrying increased risks for the provider.

While the FCA is keen to see innovation, the challenge for the regulator and providers in this area have been very clearly highlighted in May this year by an FCA report, Automated investment services – our expectations. This reviewed seven firms providing online discretionary investment management and three automated retail investment advice companies. It reported a number of significant shortcomings; for the advice companies, these included inadequate fact finding and clients undertaking a different transaction from that which was recommended. There were also governance weaknesses at the firm level. This seems to point up the difficulty of finding the right balance between limiting potential harm to consumers and facilitating cost-effective services for a broader population.

From the perspective of an existing, purely face-to-face adviser such as Lighthouse, the development of automated advice can be seen as both a threat and an opportunity. The threat is that new suppliers with algorithms and lower fees pressure the conventional business model, while the opportunity is for incumbents to exploit technology to deliver cost-effective advice to a broader audience. Lighthouse has offered a pilot online advice service for one of its affinity partners but ended this experiment following very limited take up. It remains open to adopting an automated offering (perhaps in partnership) when the circumstances are right. Even if automated advice does gain greater traction, for more complex decisions such as those surrounding pension draw-down, face-to-face advice seems likely to remain important in ensuring the client's requirements have been properly assessed and they have understood the options available to them.

In **summary**, the industry background does appear supportive and even the apparent disruptive threat of automated advice could provide an additional avenue for growth serving a wider customer base. Further discussion of the industry background can be found in the appendix on page 14. As outlined above, Lighthouse's strategy is focused on realising the opportunity provided by its affinity relationships, delivering stable growth in wealth management and increasing the funds under management of the Luceo Asset Management business. In the next section we discuss our estimates for the business and its financial position.

Financials

We begin by summarising our divisional estimates for revenue and EBITDA in Exhibit 10. Our forecasts for the National business (LFA) assume revenue growth of 8.5% for 2018 and 2019, which appears low following the 26% growth seen in 2017. However, we have taken into account the incidence of fees last year associated with advice provided to affinity partner members affected by potential corporate changes in pension provision, and have assumed that these will not recur at the same level in the forecast periods. We expect further gentle erosion in the number of advisers in the Network division to be reflected in modestly lower revenue, but this should be ameliorated at the EBITDA level as those retained are likely to be more profitable, allowing the margin to increase slightly. Wealth Management is expected to see revenue growth of around 6.5%, which should progressively offset the costs invested in supporting the auto-enrolment offering. The small amount of revenue under the other segments heading reflects the Luceo Asset Management activity, where we have assumed that assets under management continue to build at a fast pace (from a small base).

Exhibit 10: Divisional estimate analysis

£000	2016	2017	2018e	2019e
Revenue				
National	15,717	19,840	21,526	23,356
Network	23,780	24,452	23,276	22,038
Wealth management	8,422	9,653	10,280	10,949
Other segments	0	166	129	224
Total	**47,919**	**54,111**	**55,211**	**56,567**
EBITDA				
National	2,688	2,849	3,121	3,387
Network	64	941	908	882
Wealth management	(323)	(348)	(206)	(109)
Other segments	(221)	(640)	(798)	(842)
Total	**2,208**	**2,802**	**3,025**	**3,317**
Group				
Profit before taxation	**1,893**	**2,521**	2,750	3,024
Earnings	2,643	2,721	2,750	2,449
less tax credit and standard tax	(1,129)	(685)	(550)	0
Adjusted earnings	**1,514**	**2,036**	**2,200**	**2,449**
Revenue per adviser (£) calculated	116,450	138,215	144,533	152,061
Revenue per adviser (£) reported	99,000	122,000		
Gross margin (%)	30.2	27.1	27.0	27.0
EBITDA margin (%)	4.6	5.2	5.5	5.9

Source: Lighthouse, Edison Investment Research

Other points to mention in this table are that we have included a line for adjusted earnings. This deducts tax credits where these have arisen and applies a standard rate tax charge; for 2019 there is no adjustment. Second, we have shown two figures for revenue per adviser. The first is calculated from total revenue and inferred adviser numbers and the second (for historical periods) is the reported number. The reported number is lower because some income, including continuing trail income, is not allocated to advisers and this boosts our calculated number.

Looking at the balance sheet (see Exhibit 14) the group is in a strong position with remaining debt paid down in 2017 and cash and cash equivalents standing at £8.7m at the year end. Out of total assets of £24.4m there were £5.1m of intangibles which mainly comprised goodwill relating to the National and Wealth Management divisions. Software development costs and adviser contracts were the other small items. The only other feature we would highlight is the provisions balance, which stood at £3.9m at end 2017 but was as high as £10.5m in 2015. Within the £3.9m figure, £2.5m related to the expected cost of settling customer complaints and £1.3m to clawback of commissions by providers where products are cancelled. For both items Lighthouse makes a gross provision but can claim against the relevant advisers or insurers and recognises an asset within trade and other debtors to reflect this (£2.3m for complaints and £0.96m for commission in 2017). Prospectively we have assumed the level of provisions falls further as historical liabilities are settled.

This leads us to the simplified cash flow table for 2016-19e below. This shows that we expect cash outflows relating to provisions to tail off in 2018 and 2019. This contributes to an improvement in operating cash flows.

Exhibit 11: Simplified cash flow analysis

£000s	2016	2017	2018e	2019e
Operating profit	1,909	2,528	2,742	3,009
Working capital	2,901	338	(638)	(631)
Change in provisions	(4,493)	(2,132)	(922)	(500)
Tax	0	0	0	(575)
Other incl depreciation, amortisation and share-based payments	351	649	669	693
Operating cash flow	**668**	**1,383**	**1,851**	**1,997**
Tangible & intangible investments	(203)	(329)	(342)	(335)
Dividends paid	(319)	(383)	(600)	(651)
Change in net cash	**146**	**671**	**908**	**1,010**

Source: Edison Investment Research

The **regulatory capital** requirement for Lighthouse is calculated as a percentage of turnover. Lighthouse reported that at the end of 2017 its cash position in excess of regulatory and working capital requirements would have been £4.7m, implying those requirements were about £4m. It also noted it had been released from undertakings to the FCA to maintain assets and seek prior approval for distributions by its regulatory subsidiaries. These undertakings were made in 2012 following historical issues in two subsidiaries that had ceased trading. The board has indicated its intention to hold the excess cash in short-dated deposits for the time being.

Sensitivities

We have referenced a number of trends and expectations in the industry background and financials sections that are areas of sensitivity for the development of the group.

- Market sentiment and economic development is an obvious area of uncertainty with risks surrounding Brexit perhaps the most salient feature.
- As highlighted, technology-based innovation could pose a threat but, given the FCA's strictures and the importance of face-to-face meetings to deal with more complex matters, it could equally prove supportive for incumbent advisers.
- Competitor behaviour could become more aggressive, but the apparent limitation on the growth in the number of advisers in the industry would seem to argue against this.
- Regulatory developments could be helpful or otherwise. Changes can impose additional costs/administrative burdens on companies. Lighthouse continues to have a constructive

working relationship with the regulator. This applies at a time when the FCA has been warning pension trustees against unscrupulous advisers.

- Addition of new affinity partnerships and greater success in penetrating the existing membership could produce positive earnings surprises.
- The group has made considerable investment in technology and central administrative support: positive surprises in terms of growth should demonstrate operational gearing but the reverse would be the case in a less favourable scenario.

Valuation

In this section we consider the valuation of Lighthouse shares in the light of a peer group comparison and the outputs of our DCF model. We conclude the shares are moderately valued and see a value of 44p as reasonable balance between near-term earnings multiples and the potential for positive surprises if the company can secure faster growth, most probably through increased penetration within its affinity group partners.

Peer group comparison

We have used quite a wide range of comparators for Lighthouse in the table below, including financial advice companies, discretionary fund managers and wealth managers (which we have grouped separately). Each has different characteristics and there is a wide range of market capitalisations. Nevertheless, investors interested in financial advice and retail investment might also consider these companies. Compared with what we have labelled the adviser/discretionary fund manager average, Lighthouse trades on a slightly above-average rating. The traditional wealth managers trade on lower prospective P/Es.

Exhibit 12: Peer group comparison

	Market capital (£m)	P/E current year (x)	P/E following year (x)	Yield (%)
Lighthouse Group	**49**	**23.7**	**21.3**	**1.1**
AFH	123	16.8	14.6	1.5
Frenkel Topping	35	14.6	13.0	3.0
Harwood Wealth	106	24.3	19.1	2.1
Mattioli Woods	213	22.3	19.6	1.7
Mortgage Advice Bureau	348	26.3	22.5	3.6
St James's Place	6,198	24.4	20.3	4.3
Tatton	129	20.4	16.8	2.9
Adviser/DFM average		**21.3**	**18.0**	**2.7**
Brewin Dolphin	982	15.8	14.0	4.7
Brooks Macdonald	271	18.2	14.4	2.5
Charles Stanley	191	16.1	11.3	3.1
Rathbones	1,419	18.3	16.5	2.5
Wealth manager average		**17.1**	**14.0**	**3.2**

Source: Bloomberg, Edison Investment Research. Note: Priced as at 9 July 2018.

DCF valuation

Our discounted cash flow valuation factors in the explicit estimates outlined in the finance section and assumes long-term growth of 3%. Factoring in a discount rate of 9% gives a valuation of c 44p. Exhibit 13 shows the sensitivity of this valuation to different discount rates and assumed long-term growth rates.

Exhibit 13: Discounted cash flow valuation sensitivity (pence per share)

Discount rate (right) long-term growth	7%	8%	9%	10%	11%
1.0%	48.0	44.6	41.5	38.7	36.2
2.0%	49.5	45.9	42.7	39.8	37.2
3.0%	51.0	47.3	44.0	41.0	38.2
4.0%	52.6	48.8	45.3	42.2	39.3
5.0%	54.3	50.3	46.7	43.4	40.4

Source: Edison Investment Research

Taking into account both the peer comparison and the discounted cash flow outputs a valuation of around 44p seems reasonable, with the potential for this to rise as delivery of growth derived from the affinity partners is reported.

Exhibit 14: Financial summary

Year end 31 December (£000)	2015	2016	2017	2018e	2019e
Profit and loss					
National	16,074	15,717	19,840	21,526	23,356
Network	23,978	23,780	24,452	23,276	22,038
Wealth management	8,829	8,422	9,653	10,280	10,949
Other segments	0	0	166	129	224
Total revenue	48,881	47,919	54,111	55,211	56,567
Cost of sales	(34,057)	(33,452)	(39,439)	(40,304)	(41,294)
Gross profit	14,824	14,467	14,672	14,907	15,273
Operating expenses	(13,214)	(12,259)	(11,870)	(11,882)	(11,956)
EBITDA	1,610	2,208	2,802	3,025	3,317
Depreciation and amortisation	(552)	(299)	(274)	(284)	(308)
Operating profit	1,058	1,909	2,528	2,742	3,009
Finance income	14	11	3	8	15
Finance costs	(206)	(27)	(10)	0	0
Profit before taxation	866	1,893	2,521	2,750	3,024
Taxation	0	750	200	0	(575)
Non-controlling interest	0	0	0	0	0
Earnings	866	2,643	2,721	2,750	2,449
Adjusted earnings	866	1,514	2,036	2,200	2,449
Basic EPS (p)	0.68	2.07	2.13	2.15	1.92
Dil EPS (p)	0.68	1.97	1.98	2.01	1.79
Adjusted EPS (p)	0.68	1.19	1.59	1.72	1.92
Dil adjusted EPS (p)	0.68	1.13	1.49	1.60	1.79
Dividends (p)	0.24	0.27	0.42	0.50	0.55
Dividend cover - dil adjusted EPS (x)	2.8	4.2	3.5	3.2	3.2
EBITDA margin (%)	3.3	4.6	5.2	5.5	5.9
Return on equity - adj earnings (%)	13.8	19.5	19.7	17.0	16.0
Balance sheet					
Non-current assets	6,555	7,220	7,478	7,544	7,586
Intangible assets	5,284	5,230	5,131	5,177	5,201
Property, plant & equipment	1,271	1,240	1,397	1,417	1,435
Available for sale investment	0	0	0	0	0
Deferred tax asset	0	750	950	950	950
Current assets	21,655	17,505	16,920	18,370	19,945
Trade and other receivables	13,266	9,004	8,187	8,729	9,293
Cash and cash equivalents	8,389	8,501	8,733	9,641	10,652
Total assets	28,210	24,725	24,398	25,914	27,530
Current liabilities	17,254	12,307	11,635	10,693	10,376
Borrowings	34	34	0	0	0
Trade and other payables	10,629	9,268	8,789	8,693	8,626
Provisions	6,591	3,005	2,846	2,000	1,750
Non-current liabilities	4,395	3,454	1,076	1,000	750
Borrowings	439	405	0	0	0
Provisions	3,956	3,049	1,076	1,000	750
Total liabilities	21,649	15,761	12,711	11,693	11,126
Net assets	6,561	8,964	11,687	14,221	16,404
Cash flow					
Operating profit	1,058	1,909	2,528	2,742	3,009
Depreciation and amortisation	552	299	274	284	308
Share-based payments	0	79	385	385	385
Change in receivables, payables	(2,415)	2,901	338	(638)	(631)
Change in provisions	2,270	(4,493)	(2,132)	(922)	(500)
Finance costs paid	(404)	(27)	(10)	0	0
Income taxes refunded/paid	0	0	0	0	(575)
Net cash flow from operating activities	1,061	668	1,383	1,851	1,997
Purchase of PPE	(119)	(126)	(307)	(200)	(200)
Purchase of intangibles	(69)	(88)	(25)	(150)	(150)
Finance income received	14	11	3	8	15
Net cash flow from investing activities	(174)	(203)	(329)	(342)	(335)
Dividends paid	(255)	(319)	(383)	(600)	(651)
Change in loans	(1,307)	(34)	(439)	0	0
Net cash flow from financing activities	(1,562)	(353)	(822)	(600)	(651)
Change in cash	(675)	112	232	908	1,010
Change in loans/other	1,505	34	439	0	0
Change in net cash	830	146	671	908	1,010
Closing net cash	7,916	8,062	8,733	9,641	10,652

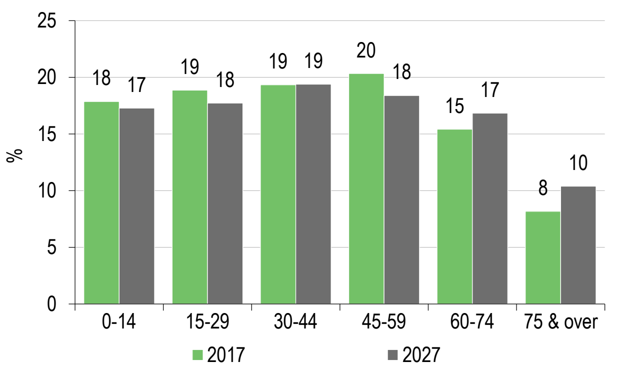
Source: Lighthouse Group, Edison Investment Research

Appendix: Additional industry background

In this section we set out selected industry background information to provide additional context for the Lighthouse business. We have highlighted the ageing UK population profile as contributing to a favourable background for Lighthouse and others in the financial advice industry (see ONS estimates for the UK age profile in 2017 and 2027 in Exhibit 15). Combined with the shift from defined benefit to defined contribution pensions in the private sector (Exhibit 16), this has increased choice over how pension funds may be withdrawn, and tax complexity generally appears set to create a growing need for financial advice.

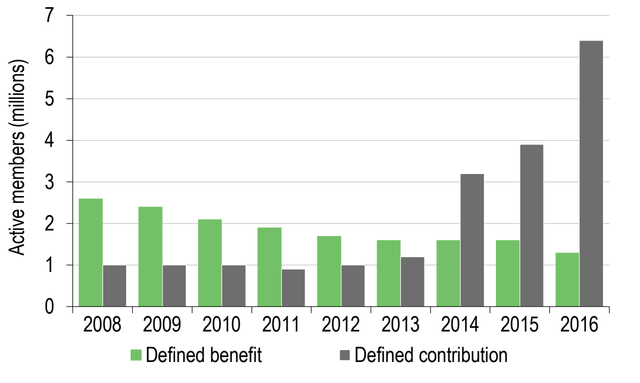
Even though a large part of the population may not be prepared to pay an economic price for financial advice, the scale of the potential UK market is still significant with Quilter, for example, citing a GlobalData study that indicates there are five million people with liquid assets of £0.1-£5m. With its Middle Britain focus and affinity partners, Lighthouse is likely to be addressing a broader group and it does not set a formal lower limit on assets under advice. GlobalData estimates there are a further 10 million people with assets of between £30,000 and £100,000.

Exhibit 15: Expected changes in UK population profile



Source: ONS

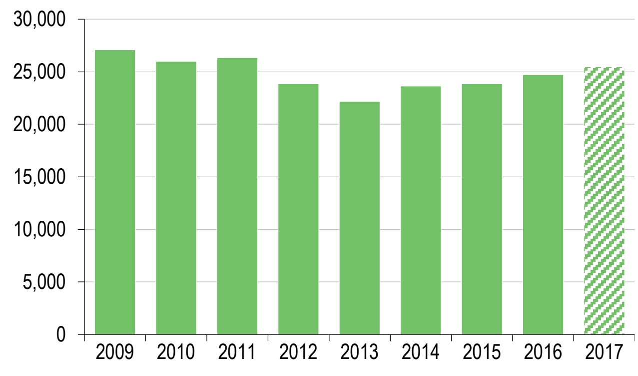
Exhibit 16: Private sector pension scheme type



Source: ONS

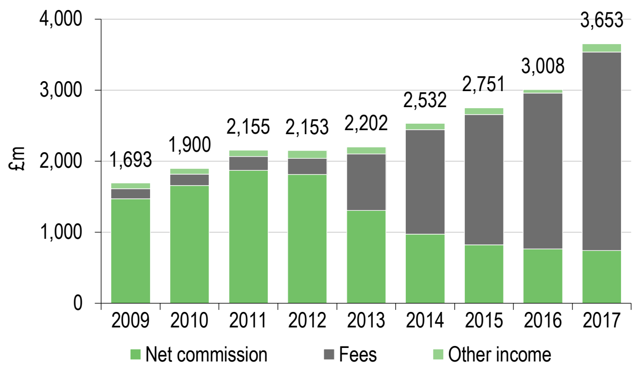
Capacity in the industry, as measured by the number of advisers, was negatively influenced by the RDR (2012). RDR restricted the payment of commissions on retail investment products to remove the potential for bias, increased disclosure and introduced measures to raise standards of advice. This resulted in an initial drop in the number of advisers as some (typically those approaching the end of their careers) chose not continue under the new regime with its minimum qualification requirements (see Exhibit 17). The more recent trend, as shown in Exhibit 17, has been for a gentle recovery in the number of advisers but this is only just beginning to return the level close to the figures seen in 2009-2011.

Exhibit 17: Number of advisers



Source:APFA 2009-16, and FCA for 3% growth applied in 2017

Exhibit 18: Revenue from retail investment advice



Source: APFA 2009-16, 2017 based on FCA data

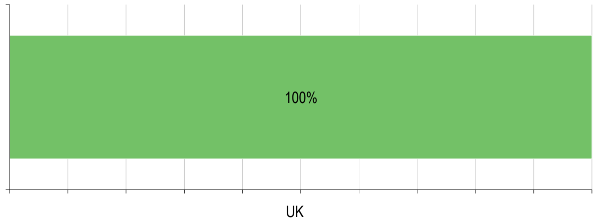
The change in the mix of adviser income from commission to fees in the wake of the RDR is evident in Exhibit 18 with fee income now accounting for 76% of the total and commission 20%. Overall revenue as recorded by the FCA has grown at a compound rate of 11% between 2013 and 2017.

To give an indication of the distribution of financial advice groups within a relatively fragmented market, we have shown the top 26 companies ranked by CF30 advisers (based on the FT Adviser Top 100, 2017). There are two companies with over 2,000 CF30s (St James's Place and Old Mutual Wealth: now Quilter which has recently been listed) and then a modest number in the 300-1000 range, including Lighthouse. Consolidation has been a feature in the industry reflecting the burden of increased regulatory requirements and overhead costs on smaller firms. Scale benefits are particularly relevant for platform or integrated businesses that can leverage their IT capabilities or capture vertical synergies.

Exhibit 19: Ranking of financial advisers

Company	Gross sales ranking	CF30's	Company	Gross sales ranking	CF30's
St James's Place	1	4,206	Close Brothers Asset Management	26	270
Old Mutual Wealth*	2	2,369	Harwood Wealth Management Group	20	255
Openwork	4	946	Smith & Williamson	31	237
The Tenet Group	6	624	Lloyds Banking Group	21	217
Tilney Bestinvest	18	569	Barclays Group	16	214
In Partnership	10	517	Willis Towers Watson	56	209
Lighthouse Group	19	493	Best Practice Group	34	206
TRUE Potential	88	453	Chase De Vere	27	195
Brewin Dolphin Securities	5	422	Fairstone Group	25	192
Investec Group	8	395	Tavistock Financial	35	178
Succession	7	391	CanaccordGenuity Ltd	58	176
Prudential Group	30	311	Sense Network Ltd	22	174
Charles Stanley	15	279	AFH Financial Group	67	162

Source: FT Adviser in association with Strategic Insight, extract from Top 100 financial advisers 2017. Note: *Now Quilter. The number of CF30s for Lighthouse is inflated by double counting: the actual figure is c 390.

Contact details	Revenue by geography
26 Throgmorton Street London EC2N 2AN UK 020 7065 5640 www.lighthousegroup.plc.uk	

Management team

Non-executive chairman: Richard Last	Chief executive: Malcolm Streatfield
Richard Last joined the board in 2007 and was appointed chairman in 2012. An FCA, Last has more than 20 years' experience in senior roles at information technology companies. He is also non-executive chairman at ITE Gamma Communications and Arcontech and a non-executive director at Corero Network Security.	Malcolm Streatfield joined Lighthouse in 2002 with the acquisition of BWA Group where he was chief executive. He was appointed as chief executive at Lighthouse in 2003. Streatfield has been involved in financial services since 1976, has been a member of the council of the Association of Professional Financial Advisers since 2002 and held roles in other industry bodies.
Chief financial officer: Peter Smith	**Group compliance and risk director: Ken Paterson**
Peter Smith (FCA) joined Lighthouse when it merged with Sumus in 2008. Previously a corporate finance and assurance partner at KPMG, he has considerable financial services experience. Smith's responsibilities include finance, treasury, legal, company secretarial and strategic initiatives.	Ken Paterson was appointed to the board in 2014 bringing more than 20 years' experience in UK financial services compliance, risk and regulatory matters to the role. He has held senior positions in regulatory bodies, life companies and advisory businesses.

Principal shareholders (as at 1 May 2018)	(%)
Helium Rising Stars Fund	18.7
Allan Rosengren	15.8
MI Discretionary Unit Fund	13.8
Liverpool Victoria FAS	6.5
Cavendish Asset Management	5.6
Old Mutual Wealth Management	4.4

Companies named in this report

AFH (AFHP), Frenkel Topping (FEN), Harwood Wealth (HW/),Mattioli Woods (MTW), Mortgage Advice Bureau (MAB1), St James's Place (STJ), Tatton (TAM), Quilter (QLT), (Brewin Dolphin (BRW),Brooks Macdonald (BRK), Charles Stanley (CAY), Rathbones (RAT).

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