Impax Asset Management Group

Non-independent Research – Marketing Communication

A genuinely transformational acquisition

28 September, 2017

Impax looks to have secured an acquisition which delivers key components of its longer term strategic growth plan in one fell swoop, while minimising execution risk, and enhancing EPS and dividend cover.

It has agreed to acquire 100% of US based Pax World Management LLC for US$52.5m initially, plus up to US$37.5m in contingent payments payable in 2021, subject to performance. This combines complementary businesses with aligned strategies and business cultures, and a successful partnership for over a decade on the design and management of the US$511m Pax Global Environmental Markets (GEM) Fund.

The acquisition extends Impax's profile as a specialist manager in a rapidly growing niche. Scale benefits are predicated on enlarged product range, coverage, strategies, client base and marketing reach, rather than cost savings or rationalisation. It plans to run the investment teams independently (with some exchange of ideas for best practice) and progressively build collaboration, and more rapidly integrate some support functions.

Price is attractive, with strong medium-term upside

We see two key attractions to this acquisition. The first is readily quantifiable, the second less so but potentially, the more valuable.

Firstly, Impax has agreed a keen purchase price based on underlying revenue/EBITDA run rate, below its valuation just prior to the announcement, without assumed benefits from cost savings or synergies. On that basis Pax will enhance EPS in the first full year, by above our forecast if Impax's higher share price holds as it will result in less dilution, and the acquired entity continues to perform in a vibrant market. Pro-forma AUM for the enlarged group at end August 2017 was **£10.3bn (US$13.4bn),** vs £7.25bn for Impax alone **(up 61% in the first 11 months of FY17).**

The second benefit lies in the longer-term potential delivery of a **step-change in AUM growth rates and profitability**. The existing partnership helps make Pax a known quantity with a similar business culture, complementary products, services and market profile. We still expect progressive distributions despite the use of cash/debt towards this transaction, with potential for strong positive cash generation to compensate. Despite strong gains, IPX shares still seem attractively priced relative to prospects:

Summary forecasts

Year end 31 Sep	2014A	2015A	2016A	2017E	2018E[1]
Revenue, £m	20.4	19.7	21.1	31.4	54.6
Op. Profit, £m	5.3	3.1	4.2	8.2	14.5
EPS, p	2.8	3.1	3.7	5.4	9.0
PER	50	44	37	26	15
EV/NOPAT	30	68	44	22	13
Yield, %	1.0	1.2	1.5	2.0	2.2

Source: Group report & accounts and ED estimates ([1]FY18 forecasts are proforma, and includes 9-month contribution from Pax)

Company Data

EPIC	IPX
Price	138p
52 week Hi/Lo	144p / 44p
Market cap	£180m

Share Price, p

Source: ADVFN

Description

Impax is a market leading manager of both listed and private equity funds, which invest in ways that take advantage of more environmentally sustainable corporate and economic growth globally. Aggregate AUM at end August 2017 was £7.25bn.

The group has won many prestigious awards including:

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Strategically significant acquisition

Impax has entered into agreements to acquire 100% of US-based asset manager Pax World Management LLC. The transaction, projected to complete by end Q1 2018, will build assets under management or advice (AUM) to $13.4bn (£10.4bn), from c$9.4bn (£7.25bn) at the end of August. It will also extend the group's investment management, research and client service capabilities in the US.

The acquisition will combine two leading asset managers focused on the transition to a more sustainable economy. Both have capitalised as asset owners globally seek to allocate capital to high growth, sustainable investment opportunities.

In addition to greater scale, the enlarged group has a broader, more diversified AUM base than either individually. On a pro-forma basis at the end of August 2017 Pax would have represented around 32% of the enlarged group AUM. As at end July 2017, it generated 41% of its aggregate run-rate revenue.

UK and US based fund managers, with complementary portfolios

Impax's HQ is in London, with offices in the New York metropolitan region, Portland (US) and Hong Kong. AUM at end August was £7.25bn (US$9.37bn), focused mainly on actively managed global public equity and private equity strategies, primarily for the institutional market. Pax's HQ is in Portsmouth (NH), US. It had £3.48bn AUM (US$4.496n) at end August, and offers active and passively managed equity and fixed income strategies, predominantly for domestic retail investors.

Pax's portfolio is complementary. AUM has grown by 70% since 2012 and comprises eleven US mutual funds valued at US$4.496m as at end August 2017. These include actively managed and fixed income (75% of AUM), and passive equity strategies (25%).

Pax financial performance

Year ended 31 December	2014	2015	2016
AUM (US$ bn)	3.4	3.6	4.1
Average AUM (US$ bn)	3.3	3.6	3.9
Net revenues (US$ m)	21.1	24.8	26.3
EBITDA (US$ m)	2.6	4.1	4.4
PBT (US$ m)	2.2	3.9	4.3

Source: Impax presentation

Enhanced earnings and growth prospects

The terms of the acquisition combine a fixed initial consideration and a contingent consideration based upon future performance. These are (a) a purchase and sale agreement to buy 83.3% of the equity and (b) put and call option arrangements to acquire the other 16.7% currently held by Pax management, post an earn out period. The respective investment teams will remain intact and continue to operate independently.

The agreed US$52.5m initial payment for Pax is equivalent to 9.0x EBITDA and 1.17% of AUM, which we estimate falls to 7.0x EBITDA and 1.13% AUM if earn out targets are achieved by end 2020 or earlier. We have assumed a conservative 25% improvement in Pax's EBITDA margin if it achieves the target 78% increase in AUM to US$8bn. The price agreed compares with Impax's valuation just prior to the announcement, at 12.4x EBITDA and 1.90% of AUM.

We expect the acquisition to **enhance (by c 11% above previous forecasts) group EPS** in FY18e assuming completion at end December 2017, net of exceptional items such as transaction costs, and the impact of intangibles amortisation. The acquisition will generate c £38.5m of goodwill and intangible assets. As a result, the enlarged group will have a capital deficit on consolidation under the FCA's capital adequacy rules, and will therefore make a capital waiver application. Due to the change of control, the closing conditions also include approval by the shareholders of the mutual funds managed by Pax.

Forecasts: currently assume nine-month contribution in FY18

Our forecasts assume the acquisition closes at end December 2017. The statement projects completion between end October 2017 and February 2018. However, discussions with management suggest that the latter may be cautious, but to include some flex in the forecasts we have assumed that (a) shares will be issued at 110p (vs c 140p currently) and (b) that Pax contributes nine months to FY18 revenues and earnings.

Based upon current run rates provided by Impax, Pax generates a lower EBITDA/AUM margin (0.13% vs 0.15% for Impax). Discussions with management suggest that for Impax, this reflects the benefit of recent growth, and that there is potential for Pax's returns to improve as it grows AUM.

It is therefore reassuring that Impax and Pax are already well known to each other, so can attest to similar business cultures. The acquisition builds on a successful ten-year relationship. Impax and Pax have collaborated on the design and management of the Pax Global Environmental Markets Fund since 2007. At end August 2017, GEM had net assets of US$511m.

Pax will change its name to Impax Investment Management (US) LLC and continue to manage Pax World Funds. The latter will retain their names, and become the new group's US-based mutual fund division. Pax's President & CEO will continue to lead the renamed company, report to Impax's Chief Executive, and join the Impax Asset Management Ltd board.

Compelling logic underpins proposed combination

The combination of the two groups has strong strategic logic and will improve resources and services for existing/prospective clients. They have complementary investment management, product and geographic structures, underpinned by aligned investment strategies.

Enhanced proposition

Asset class	Style	Strategy	Impax	Pax
Listed equity	Active	Global thematic	*	
		Global unconstrained	*	
		US	*	*
		Europe	*	
		Asia	*	
	Passive	Global thematic		*
		US		*
Private equity			*	
Fixed income				*

The above table illustrates these complementary investment capabilities, notably the addition of passive funds and fixed income to the group portfolio.

Impax's core focus is on small and mid-cap global public equity and private equity strategies, Pax on equities and bonds issued by US companies. The combination builds depth and extends the range of investment solutions offered to clients.

Impax runs commingled funds and segregated accounts, primarily for institutions. It has a mainly European client base, but a growing institutional presence in the US. Pax has a well-developed mutual funds business, directed mainly at US based financial advisors. The integrated group will be able to offer a broader range of investment solutions to both institutional and retail investors.

Initial Consideration

The initial consideration values Pax at US$52.5m (£40.6m). Impax has agreed to pay c US$44.2m (£34.2m) of upfront for 83.3% of Pax's equity, US$8.3m for the remaining 16.7%, and deferred, contingent payments worth potentially another US$37.5m (£29.0m) over a multi-year period to 2021, subject to Pax hitting specific performance targets. There is scope for advanced payment in respect of the latter to be paid in 2019.

- The US$44.2m will be settled in cash (US$38.1m) and new shares (US$6.1m). The final figure payable is subject to certain balance sheet adjustments, which relate to net working capital, debt and transaction expenses.
- The new shares will be issued on completion at the average share price over the previous 20 trading days. They will be subject to a 12-month lock-up post completion, then an orderly market provision for another year.
- The cash will be funded from existing group resources and a new US$26m debt facility.
- Impax has agreed terms for US$26m of new facilities with RBS. Subject to certain conditions precedent, RBS will provide a US$13m three-year term loan facility and a US$13m five-year revolving facility. These will be used to finance the acquisition, the latter also for general corporate purposes. Interest will be charged at LIBOR plus 2.9% (term loan) and 3.3% (revolving loan). These facilities will require shareholders' prior approval at a general meeting on 18 October 2017.
- Pax management will retain the other 16.7% until 2021, when they or Impax can exercise the put and call option. Impax will acquire the entire holding for US$8.3m (£6.4m), settled via an issue of new shares at the prevailing share price at that time and/or cash (Impax to decide).

Contingent Consideration

The purchase agreement includes payment of up to US$37.5m, of which US$31.3m (£24.2m) will be paid to selling shareholders upon completion, and US$6.2m to Pax's management within 45 days of 1 January 2021, subject to achievement of specific growth targets.

The amount payable will depend upon Pax's average AUM at 30 June, 30 September and 31 December 2020. If Pax's average AUM is:

- US$5.5bn or less, no further consideration will be due

- US$8.0bn or above, US$37.5m will be payable
- For AUM between US$5.5bn and US$8.0bn, payment will be adjusted pro-rata
- If Pax achieves these AUM targets earlier (tested at end December 2018, March 2019 and June 2019, up to US$10m of the contingent consideration will be paid, within 45 days of end June 2019.

Impax expects to cover the contingent consideration from ongoing cash flow, or the new revolving credit facility.

Acquisition - valuation and sensitivities

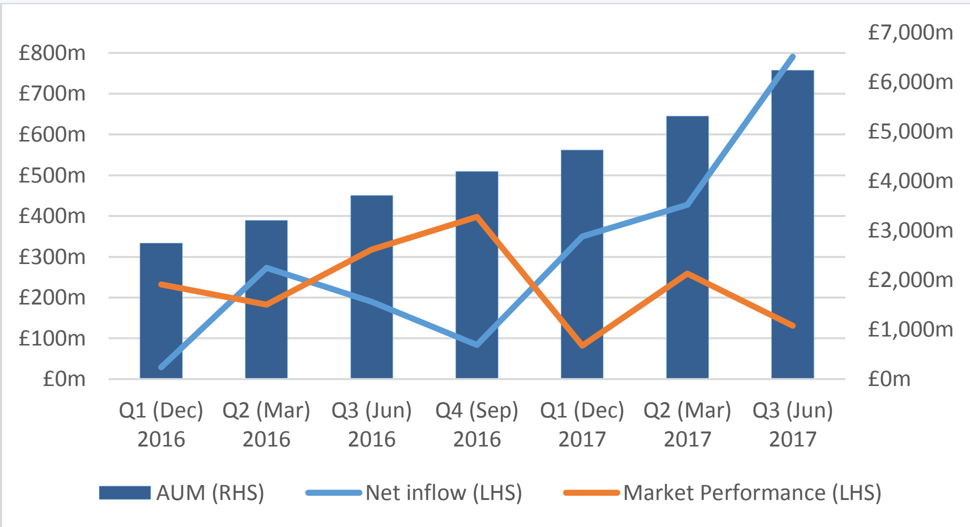
The agreed US$52.5m initial payment for Pax is equivalent to 9.0x EBITDA and 1.17% of AUM, which falls to 7.0x EBITDA and 1.13% AUM if earn out targets are achieved by end 2020 or earlier. That compares with Impax's valuation just prior to the announcement, at c 12.4x EBITDA and 1.90% of AUM.

Various moving parts could influence the forecasts. These relate to the size and timing of any deferred consideration, forex rates and the prevailing Impax AM share price at each stage of the transaction, for that part of the consideration settled in shares.

Ignoring these sensitivities, we regard the terms, both initial and deferred, as attractive based upon revenue and EBITDA run rates set out in the announcement. Although these underpin the financial logic of the transaction however, **the upside lies in the transformational potential if Impax successfully leverages the benefits of an enlarged product portfolio, improved global profile and additional investment management expertise, and its broader marketing and distribution capacity.**

In our view, the exceptional recent growth in Impax AUM, the momentum of which has been maintained over the course of the first eight months of 2017 (up 43% y-o-y), **is not fully reflected in the above valuations,** although the share price has shifted materially higher since the acquisition was announced.

Impax AM - AUM growth, new investment and fund performance



Source: Company

In addition, Impax has not provided any further breakdown of the split between listed and higher margin private equity since end June 2017. There may be more detail on the current private equity fundraising - which closes in February 2018 - in the year-end report but the near-term growth and potential may not yet be built into our forecasts, or valuation multiple.

AUM movement – Impax AM funds

Total AUM, £m	Listed Equity funds	Private Equity funds	Property funds	Total
1 October 2016	**4,195**	**285**	**22**	**4,502**
Net inflows	778	90	-	868
Market movement and performance	341		-	341
31 March 2017	**5,313**	**375**	**22**	**5,710**
Net inflows	791	49		840
Market movement and performance	131			131
30 June 2017	**6,235**	**424**	**22**	**6,681**
31 August 2017				**7,250**

Source: Impax RNS

We have adjusted FY18 forecasts to include a nine-month contribution from Pax, based upon what we regard as a pragmatic view on completion timing. The latter will also enable us to incorporate accurate data in respect of shares issued, and use of cash/debt.

Sensitivities

We have assessed the financial implications of the transaction, subject to sensitivities which will work their way through over the next two to three years. Comments on valuation and multiples are based upon the terms as announced, subject to the following factors (the impact of at least some of which may well become clearer over the next two to three months):

- We have assumed that the transaction completes at the end of December 2017, in which case Pax will make a nine-month contribution to FY18 (i.e. for the 12 months to end September 2018), and its first full contribution in FY19.
- The acquisition terms include an agreed upfront payment and deferred amounts based upon achievement of AUM growth by the end of 2020. Our view on valuation assumed that AUM targets are fully achieved by the end of that period, after the end of FY18. Cash payments will be due if that occurs in a shorter timeframe.
- Part of the consideration for deferred payments may be settled in cash or new shares at Impax's discretion, issued at the average price prevailing at that time. We expect recent strong growth in AUM (61% first 11 months of FY17) to translate into free cash flow, which could be used to settle future obligations. If, however, the higher share price since the acquisition was announced is maintained, or grows further, the potential EPS dilution from equity issued will diminish.
- The revenue and EBITDA run rates for Impax relate to AUM at end August 2017, and we assume relatively modest further growth driven by investment flows and fund performance. Impax's own AUM has increased materially this year and our forecasts incorporate 10% growth in equity funds for the 12 months to end September 2018. It is premature to predict the benefits of the combination of a larger portfolio, stronger US marketing and distribution, but this could underpin growth rates. Also,

we have at this stage not included further growth in private equity AUM beyond that announced at the end of June (Q3), which arguably doesn't reflect the full potential of the new fund launched this year, which closes in February 2018.

- We have assumed that growth in Pax's aggregate AUM will be in proportion to its current fund complement and profile, and generate similar fee rates. We do however, assume a 25% increase in EBITDA margin, based upon the targeted 78% increase in AUM to US$8bn. We see that growth as quite conservative considering the potential scale benefits, even ignoring any potential cost savings or efficiencies generated from the combination of the two operations. Although such savings are not a component of the rationale for this acquisition, we would expect to see benefits from a raised profile and improved distribution reflected in higher margins.

- Other variables include the impact on reported GBP revenues and earnings of significant shifts in USD/GBP, as the enlarged group is expected to generate significantly higher proportion of its income in North America. We have assumed steady exchange rates.

FINANCIALS

Key forecasts / metrics					
To end Sept, £'000s	**2014**	**2015**	**2016**	**2017**	**Proforma 2018e**
Revenue	**20,359**	**19,726**	**21,067**	**31,445**	**54,592**
Operating costs excluding legacy LT incentive schemes	(15,039)	(16,616)	(16,915)	(23,269)	(40,090)
Operating profit	**5,320**	**3,110**	**4,152**	**8,176**	**14,502**
Operating margin	26%	16%	20%	26%	27%
Credits/(charges) related to legacy LT incentive schemes	(539)	1,285	27	(242)	0
Fair value gain/(loss) on investments	(1,460)	615	989	(538)	0
Investment income	207	228	319	363	320
Finance cost					(678)
Change in third-party interest in consolidated funds	7	(101)	(288)	(163)	0
Profit before taxation	**3,535**	**5,137**	**5,199**	**7,596**	**14,144**
Taxation	(279)	(1,504)	(1,022)	(1,443)	(3,112)
Profit after tax	**3,256**	**3,633**	**4,177**	**6,152**	**11,032**
Profit attributable to owners of the company					10,602
Non-controlling interests					430
Profit after tax					**11,032**
Earnings per share					
Shares in issue (basic) k	117,314	115,133	111,794	112,904	118,092
Shares in issue (diluted) k	117,733	115,909	114,399	114,698	119,886
Basic EPS, p	**2.78**	**3.16**	**3.62**	**5.45**	**9.00**
Diluted EPS, p	**2.77**	**3.13**	**3.65**	**5.36**	**8.85**
Interim dividend	0.00	0.40	0.50	0.70	0.85
Final dividend	0.00	1.20	1.60	2.10	2.25
Dividends per share, p	**1.40**	**1.60**	**2.10**	**2.80**	**3.10**
Dividend cover	**2x**	**2x**	**1.7x**	**1.9x**	**2.9x**

Source: Company historic, ED estimates

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