Financial review

Strong performance

A challenging end to the year

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Financial overview

The Board recognises that the financial performance for the year ended 30 April 2020 ('FY20') was severely affected by COVID-19 in Q4, at a point in the year when the significant investments made since IPO were expected to support revenue growth. Despite these headwinds, revenues have grown by 10.9%, albeit with some short-term dilution to gross and net margins as a result of the shortfall in Q4 revenues, impacting profitability.

International and Connected Services continue to be the 'growth engines' of the business, with International growing 53.2%, helped by the acquisitions of K&L Gates in Poland and RCD in Spain. Connected Services grew by 13.0%, with good performances across the majority of the businesses, albeit overall growth was held back by underperformance in one practice group, which has since been restructured.

In addition to the COVID-19 disruption, a number of entities in these two divisions underperformed during the year, and we announced the decision to close Singapore and Brussels, and slim down Dubai and Cologne, on 9 July 2020. These changes will have a significant positive impact in FY21 and beyond, by eliminating losses and reducing cash consumption. In the FY20 accounts, we have only treated Cologne as a discontinued business as the decisions regarding the other locations were made after the year end.

While revenues have grown, reported gross profit declined by 0.8% on the previous year, due to a 24.3% increase in direct costs from acquisitions, and investments in additional partners and fee earners. That said, some of the reduction comes from the revised remuneration model implemented at IPO. The increase in underlying gross profit of 3.8% indicates what growth would have been had the revised compensation model always been in place. Underlying adjusted administrative expenses increased in line with revenues, with most of this increase relating to acquisitions, professional indemnity insurance and an increase in provision for doubtful debt. The cost to income ratio improved by 0.1 ppt to 42.6% in FY20.

The shock impact of COVID-19, combined with growth in direct and administrative costs, resulted in an underlying adjusted EBITDA figure of £21.8m, a 21.6% reduction on the previous year. Underlying adjusted PBT is £13.8m, a 32.4% decrease on FY19. Reported Profit Before Tax (PBT) is £18.2m, a 39.6% increase on prior year, with the increase largely due to the gain on bargain purchase for Poland, RCD and Mindcrest. This gain being the difference between the element of the purchase price treated as consideration and the fair value of the assets acquired. This gain is treated as a non-underlying item as it is not recurring.

As announced in April and May, we have effected a series of cost-cutting initiatives, with a combined impact of £15m in the year, to ensure the business operates with an improved level of efficiency.

Working capital

Working capital (measured using 'gross lock-up days') has remained a key area of focus, and closing net debt was £64.9m at the year end. Although this was above management's expectations (prior to the impact of COVID-19), strong April collections helped to mitigate the level of increase.

Gross lock-up days comprise two elements: Work-in-progress ('WIP days'), representing the amount of time between performing work and invoicing clients; and debtor days, representing the length of time between invoicing and cash collection.

The Group is pleased by its performance for WIP days, which remained flat year over year at 81 days and improved by 15 days since the half year in October 2019. This is a result of the divisions working to bill earlier, combined with billing-process improvements, which are beginning to reflect in performance.

The Group's debtor days increased by 4 days as a result of two issues: Firstly, a delay in February billing due to some teething issues in upgrading the practice management system; and secondly, slower collections activity in Q4, which was mainly the result of COVID-19 related interruptions. The billing delay was a one-off issue that has since been resolved, but had a knock-on effect on the timing of collections. FY21 collections are encouraging, as countries come out of COVID-19-related lockdown, but the Board acknowledges this may be tempered if the situation in any location reverses.

The Group continues to focus on efficient lock-up management, and believes there is a significant opportunity to reduce lock-up days. Previously published targets signposted a five-to-ten-day reduction in the medium term. Internally, we have set more demanding targets for FY21 in the expectation that we can achieve a higher reduction. While Q4 turbulence delayed some operational initiatives, the Group is now re-focussing on standardising the global process for billing and collections, billing automation, and partner accountability, to improve working-capital performance.

Any improvement in lock-up days will have a knock-on effect on net debt, with each day of lock-up reduction affecting cash favourably, by over £1m.

The Group has an £80m RCF facility and during the height of the COVID-19 pandemic secured an additional £15m contingency facility as a precaution against any further unexpected impacts from the pandemic. There are also a number of ancillary working capital facilities available for use. The Group does not expect to use the contingency facility based on current forecasts, expects to continue to operate within its banking covenants, and has seen strong free cash flow generation over the course of Q1 of FY21 as trading normalises after the COVID-19 impacts seen in Q4 of FY20.

Revenue

Revenue (excluding discontinued operations) was £297.2m for the year, compared to £268.1m in FY19, an increase of 10.9%. Three out of four divisions grew, with Insurance growing 5.2% and Connected Services growing 13.0%, all organic. International grew by 53.2%, boosted by acquisitions. The organic growth in International was 11.1%, as strong results in locations such as Australia and France were diluted by weaker performances in Dubai, Singapore, Germany and Brussels. We have since closed or scaled back these territories as part of the cost-rationalisation measures mentioned above. Similarly, Connected Services' growth was diluted by some challenges in the DWF 3Sixty software business, which we have now restructured. Commercial Services, however, felt the deepest impact from COVID-19 due to a drop in transactional activity, contracting by 4.1% compared to FY19.

Direct costs

Direct costs, including partner remuneration, were £155.0m compared to £124.7m in the previous year, an increase of 24.3%. This increase was due to investment in 160 additional fee earners and 20 partners on an organic basis, and the addition of 44 partners and fee earners through M&A.

Gross profit

Gross profit decreased marginally, by 0.8%, compared to the previous year, at £142.2m (FY19: £143.4m). This reflects a decrease in gross profit margin of 5.6ppts. While Insurance maintained underlying gross margin at FY20 levels (FY20: 48.1%), the other three divisions all saw margins dilute due to the impact of COVID-19 on Q4 activity levels and the previously mentioned underperforming entities we have now restructured. We expect the level of margin dilution reflected in the FY20 figures will reverse during FY21, and have seen this in trading performance since the year end. Managed Services also remains an opportunity, with cost savings signposted on the acquisition of Mindcrest expected to provide further support for a recovery in gross margin.

Divisional performance

Commercial Services

Commercial Services had a challenging year, with the first half performance of its transactional teams in Corporate Services and Real Estate affected by uncertainties around the timing of Brexit and the general election. The second half was expected to be stronger in those areas, and there were some signs of a recovery in Q3.

However, the effect of COVID-19 on the division in Q4 was material – more than on any other division. A combination of larger client projects being put on hold, lower levels of corporate transactional activity generally and WIP write-offs resulted in lower than normal productivity and consequently a severe, albeit short term, reduction in revenue. Even Litigation, which had performed strongly for the majority of the year, was not unaffected with courts closing and a moratorium being placed on certain court proceedings. Overall, the division ended the financial year having contracted by 4% and with an underlying gross margin decline of 11% (underlying gross margin percentage decline of 3.4ppts).

Given the speed with which COVID-19 impacted, and the proximity to the Group's April year end, it was not possible to take sufficient mitigating actions to protect underlying gross margin for FY20. Indeed, as well as retaining capacity on the expectation of a post-election recovery towards the end of Q3 and into Q4, the division had made a number of lateral hires during the year, several of whom arrived during Q4. The new data protection team was launched and other partner lateral hires joined in Q4 in the corporate, commercial, banking and restructuring teams. These investments had a dilutive effect on the FY20 underlying gross margin, exacerbating the COVID-19 impact, but are expected to contribute to more profitable revenues in FY21. For example, the data protection team has already gained a strong market profile, with a number of new wins and panel appointments secured which are helping to drive H1 performance.

In addition, actions have now been taken to remove excess capacity across the division whilst the medium term impact of COVID-19 on the division can be better understood. Q1 of FY21 has seen a recovery in activity levels – not to pre-COVID levels, but to a level which, along with the cost savings being implemented, is expected to lead to a recovery in the gross margin contribution of the division.

As we move into Q2 of FY21, client demand for the teams in Litigation remains strong, with recent significant wins in both 'complex' and 'volume' work. In particular, the commercial, finance and regulatory litigation teams are demonstrating strong levels of activity and growth. Although, activity levels in Corporate Services have picked up since the end of FY20, the outlook for Corporate Services and also Real Estate remains cautious given the ongoing impact of the pandemic. Each of Corporate Services, Litigation and Real Estate remains focused on developing opportunities with Managed Services and Connected Services. In particular, Managed Services, including the new Mindcrest business, have been working closely with both Litigation and Real Estate on several client projects. Corporate Services has also been working closely with Connected Services to develop products that allow the smooth and more efficient completion of transactions remotely throughout the pandemic. These initiatives, together with the current levels of activity and the implemented cost savings, are delivering improved gross margin.

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Insurance Services
The Group's Insurance Services business delivered revenue growth of 6% for the year, despite the COVID-related impact of the lockdown. The sudden transition to home working and the added challenge for many of childcare and home schooling resulted in a significant reduction in activity levels. This, combined with a slowdown in instructions in the important end of year month impacted on revenue growth for the year, and diluted previous gains in profitability with FY20 delivering a broadly flat underlying gross margin at 48%. Insurers are seeing a changing frequency of claims and mix, with some move away from Motor, General Liability and some transportation sector work and this will continue to be impacted by COVID-19, but we are seeing already increased exposure to other insurance sector legal work. The Group believes prospects for this division remain resilient given the annuity type nature of these services and the counter-cyclical nature of litigation services.

The Professional Indemnity and Commercial, and CAT PI & Occupational Health practice groups both delivered revenue growth in the year, with PI in particular performing strongly as a result of recent partner hires and related client wins. Motor, Fraud, RL & IHT was flat in year as expected as the legal and insurance industries geared up for the implementation of the so-called whiplash reforms (now further postponed).

The Insurance division has long-term, annuity relationships with some of the largest Insurers in the UK and this is demonstrated by our being retained by two of our biggest clients to advise them in connection with the FCA proceedings for a declaration on various policy wordings relating to business interruption claims arising from COVID-19. It is a privilege to be the trusted advisor in one of the most important cases for many insurers for centuries, joining an exclusive circle of legal advisers for the insurance industry which includes magic circle and silver circle firms.

The Group expects demand for Insurance services to remain strong in particular in relation to COVID-19 related claims. In addition to the business interruption claims being handled by the commercial insurance team, the first COVID-19 fatal and injury claims have been received from the care and food sectors with the expectation of substantial numbers of claims to follow. The potential for fraudulent claims is huge and the division's award winning Fraud team is ideally placed to advise and assist with those claims. There is a pipeline of targeted partner hires in addition to recent partner joiners which will support continued profitable growth in the division. The ongoing recruitment of a team in Southampton is also expected to contribute to revenues in FY21.

Connected Services
The Group's Connected Services division delivered revenue growth of 13.0% for the year compared to 23.3% in the prior year. FY20 growth was less than targeted, predominantly driven by lower demand for services within the DWF360 software development business, which saw a number of large projects either cancelled or put on hold, and the impact of COVID-19 towards the end of the financial year. Excluding this, the other businesses delivered combined growth of c.18.5% year-on-year, in line with expectations.

Awareness of Connected Services capabilities has continued to develop in the financial year with businesses becoming more established and mature and delivering improving performances. In particular, there has been strong growth in Vueity (50%), Adjusting (141%) and Forensic (187%) albeit these are all businesses which were in build mode in the prior year. Advocacy grew by 19% but was impacted by the disruption to the court system from COVID-19 at the end of the financial year. The Claims business, which accounts for just over a third of revenue in the Division, has shown modest growth of 5%. A business restructuring was undertaken towards the end of the financial year which provides a strong platform for continued growth in revenue and profitability in all territories (UK, Australia, Canada, France, Ireland, Italy and USA) in the coming year, particularly as insurers see the volume of COVID-19 related business interruption claims increase. Performance in USA and Italy in FY20 was particularly strong with growth of 153% and 15% respectively driven by team expansion. The newly launched Regulatory Consulting business finished the year with a well-developed pipeline which bodes well for FY21.

The underlying gross margin development of the Connected businesses was delayed by the disruption from COVID-19 preventing what would likely have been a small year on year improvement. However, a number of cost saving and restructuring measures have been effected in order to support positive margin development in FY21 as the businesses continue to mature, growing revenues on a controlled cost base.

International
The International division grew by 53% in FY20, delivering revenues of £76.2m compared to £49.7m in the previous year. Poland and Spain contributed the majority of this growth, with both acquisitions performing well. Underlying organic growth was 5%, with some relatively flat performances across the rest of the International locations and contraction in a small number of locations with Dubai being the most material drag on growth, contracting by 38%. Australia was a standout in terms of growth, with revenues of £16.4m being 43% ahead of prior year.

Performance across a number of locations was impacted by COVID-19 in the final quarter, with previously forecast revenues falling away as transactions stalled and instructions slowed. Given the investment in partner headcount in FY19 and H1 of FY20, some of the locational performances were nevertheless disappointing and a number of cost saving measures were triggered at the half year to right-size the cost base and tackle areas of underperformance. The benefit from these savings takes some time to be realised due to notice periods being served, but are expected to be delivered early in FY21. In addition, since year-end, the decision has been taken to cease operations in Singapore and Brussels and slim-down operations in Dubai and Cologne. This will save costs without having a material impact on revenues.

The underlying gross margin percentage for the division fell by 2.8pts to 40.7% as a result of the COVID-19 revenue impact, the underperformance of certain locations, and the level of investment carried into Q4 in the direct cost line. The cost saving measures that have been implemented are expected to deliver a stronger margin in FY21.

Whilst some operations have been closed or slimmed down, the International division remains a key growth opportunity for the Group. In Germany, Düsseldorf will become our regional centre now that Cologne has been substantially slimmed down. In Australia, real estate hires in Sydney and Melbourne, and employment and commercial teams in Melbourne, have hit the ground running despite the challenges of COVID-19. Elsewhere, selective investments in partner hires in Poland, Italy and Paris will help to drive further organic growth. As highlighted at the time of IPO, we will continue our international expansion in priority countries through either future associations or additional acquisitions in legal markets which we would like to enter with the USA, Canada, Hong Kong and the Netherlands all being locations where we will continue to look for opportunities. The timing of any future M&A will be determined by ongoing FY21 performance as the impact of the pandemic becomes clearer.

Administrative expenses

Reported administrative expenses have reduced compared to the previous year, moving from £128.3m in FY19 to £120.1m in FY20. However, this movement is skewed by three factors: the impact of acquisitions, non-underlying items and share-based payment expenses:

- The accounting for acquisitions creates a gain on bargain purchase due to the difference between the fair value of the assets acquired and the element of the purchase price treated as consideration
- Acquisitions have also impacted non-underlying items by £2.9m due to the fact that there are elements of the purchase price paid for RCD and Mindcrest that link to continuing employment obligations. They are therefore treated as remuneration rather than consideration and are non-underlying as they cease after the end of the lock-in period during which there is an ongoing employment obligation
- The majority of the remaining non-underlying items are the transaction costs related to Poland, Mindcrest, RCD and the costs of an aborted acquisition due to COVID-19
- Share based payment charges have increased as a result of a full year of the vesting of IPO related share awards and an element of the acquisition purchase price for RCD being accounted for as employment linked expense settled in the form of shares

On an adjusted basis, administrative expenses increased by £8.6m, or 7.5%, which mainly related to additional premises costs, an increase in PI insurance costs, and an increase in the doubtful-debt provision due to COVID-19. This increase is a result of an increase in the aged debtor balance which triggers a higher expected future loss. The table below breaks out the split of the reported numbers:

	2020 £'000	Represented 2019 £'000
Net revenue	**297,231**	268,136
Administrative expenses	**120,084**	128,264
Amortisation of intangible assets – acquired	**(1,510)**	–
Impairment	**(382)**	–
Gain on bargaining purchase	**25,084**	–
Non-underlying expenses	**(7,632)**	(12,569)
Share-based payment expenses	**(12,570)**	(1,202)
Impact of transition to IFRS 16	**3,492**	–
Adjusted administrative expenses	**126,566**	114,493
Cost to income ratio	**42.6%**	42.7%

On an adjusted basis, the cost-to-income ratio has reduced from 42.7% in the previous year to 42.6% in FY20, reflecting good control of costs despite revenue dropping away sharply in Q4. There are, nevertheless, opportunities for savings, which we are looking in to and executing in H1 of FY21, and there are substantial COVID-19-related savings from reduced travel, reduced office consumables and reduced business development expenditure. Opportunities to learn from the flexible working enforced by COVID-19, and the impact this has on the need for office space for the Group, may offer future savings.

Net finance expense

Net finance expenses were £1.9m in FY20, compared to £2.1m in FY19, a decrease of 10.6%, a result of better structuring of the Group's borrowing arrangements. FY20 now includes interest payable on leases (disclosed separately from net finance expenses in the income statement) of £2.0m, reflective of the accounting changes arising following the transition to IFRS 16.

Profit before tax

Reported PBT was £18.2m, compared to £13.0m in FY19, an increase of 39.6%. The reported PBT is affected by the same items that skew administrative expenses (acquisition related gains and expense, share-based payments and non-underlying charges). Underlying adjusted PBT is stated before the impact of these items together with the impact of the change to IFRS16 and the revised compensation model. Underlying adjusted PBT of £13.8m in FY20 compares to £20.3m in FY19. The year-on-year reduction of £6.6m, or 32.4%, is due to the aforementioned factors affecting gross margin dropping through to bottom-line profit, as the COVID-19 revenue impact came too late in the year to be able to mitigate with cost savings. As described above, we have acted on direct costs and administrative expenses to help improve margins.

Taxation

The overall tax charge for the year is £3.6m, which represents an effective tax rate of 19.9%.

The reported profit before tax includes net non-underlying credits of £15.6m, which largely consist of gains on bargain purchases offset by acquisition-related expenses. These items have been treated as non-taxable and non-deductible respectively, resulting in a reduction in the effective tax rate. These were offset by other non-deductible items relating to Australian members' remuneration treated locally as dividends, share-based payment charges relating to the consideration shares issued for the acquisition of RCD, amortisation of intangible assets arising on consolidation and other disallowable trading expenditure to reduce the overall tax charge by £1.4m.

Tax losses generated in a nil-tax jurisdiction and tax charges incurred in higher tax jurisdictions such as Spain (£0.9m), and tax losses in entities where the recognition criteria for associated tax assets have not been met (£0.7m), have increased the overall tax charge.

The acquisitions of law firms in Poland, Spain and Australia, as well as the acquisition of the Mindcrest business, have given rise to deferred tax liabilities of £8.8m as at 30 April 2020 in respect of intangible assets recognised on consolidation. These deferred tax liabilities are increased by short-term timing differences in Australia (£0.2m) and offset by deferred tax assets recognised in respect of tax depreciation timing differences (£0.8m), estimated tax deductions for share-based payments (£1.8m) and tax losses in Australian and the UK (£0.5m) to give a net deferred tax liability at 30 April 2020 of £5.9m.

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Adjustments in respect of prior periods of £0.1m relate to minor differences in the final corporate tax returns compared to the amounts provided for in the prior period accounts.

The Group's current tax expense of £6.1m mainly relates to its entities in the UK (£4.7m) and Spain (£1.3m). In line with the payment profile of tax liabilities in these territories payments of £3.6m have been made in the year ended 30 April 2020, of which £0.5m was in respect of the prior period current tax expense.

With the exception of an open transfer pricing enquiry in India relating to a pre-acquisition period of the Mindcrest business, for which the Group has adequate indemnification from the sellers, there are no open tax audits or investigations across the group. In line with group's tax strategy, it is not considered that any aggressive or materially uncertain tax positions have been adopted by any of the group entities. As such, the level of tax risk faced by the group is considered to be low.

Dividend

The Group's dividend policy is to retain sufficient capital to fund ongoing operating requirements, and to invest in the Group's long-term growth. The previously stated dividend strategy for the Group was, from FY20, to target a dividend-pay-out ratio of up to 70% of DWF Group plc's profit after tax. Given the stronger-than-expected recovery in Q1 of FY21, the Board will increase the pay-out ratio to c.90% for FY20, to allow a final FY20 dividend of 0.75 pence per share. This underscores the Board's confidence in the improving financial outlook, and the commitment of the Group to deliver compelling shareholder returns while also achieving the Group's growth strategy. This final dividend is subject to approval at the AGM on 21 October 2020 and, if approved, will be paid on 5 November 2020.

Balance sheet

Group net assets increased to £69.2m in FY20 compared to £41.8m in 2019. The increase is due to:

- an increase in gross lock-up (work in progress, trade & other receivables and disbursements) of £35.2m (23.2%), which has grown due to acquisitions, net revenue growth and an increase in lock up days;
- a £19.6m increase in prepayments from the accounting treatment of part of the purchase price of the Group's acquisitions, as remuneration is expensed to the income statement over the lock-in period of five years post completion.

There has also, however, been an increase in liabilities:

- £29.6m increase in net debt
- £7.2m increase in deferred consideration
- £5.7m opening net assets impact of the transition to IFRS 16, principally due to the recognition of a £70.3m right-of-use asset and a £78.1m lease liability, both replacing the £10.5m operating lease incentive liability.

Capital expenditure ('capex')

The Group's operating structure is not capital intensive, and FY20 was no exception. Expenditure in the period was primarily focused on IT infrastructure and replenishment, and building the Managed Services platform. The investment in the Managed Services platform increased overall capex by £2.0m from £5.4m in FY19 to £7.4m in FY20.

Conclusion

The Group expected to achieve profitable growth in the year, from a combination of organic performance and M&A contribution. While some units saw a degree of underperformance, the adverse impact of COVID-19 was the material factor in the lower-than-expected revenues, which dropped away sharply on lockdown, and left a shortfall in profit contribution due to the short amount of time the Group had to react to a very dynamic environment. Cost-saving initiatives are currently underway to secure target savings of £15m in FY21 and £18.5m from FY22 and, in addition, we have closed or slimmed down a number of underperforming units to protect margins and cash.

COVID-19 came after a period of heavy investment, with the majority of the 64 additional partner joiners brought into the business in the year hired by the end of Q3 (pre-COVID) and £16.7m of cash outflows committed to M&A, in the expectation that a strong Q4 would see the business de-leverage quickly. While Q4 working capital performance was stronger than expected, it fell short of a normal year end, leading to a higher leverage position than anticipated before the impact of COVID-19. We expect that the cost-saving measures and working-capital drive will help reduce the leverage and improve the net-margin positions seen in the FY20 accounts, and current trading to end of August FY21 reflects both this de-leveraging effect and materially improved profitability. We are managing, and will continue to manage, working capital and net debt tightly, and this represents an opportunity to reduce borrowings in the medium term.

The acquisitions in Poland, RCD in Spain, and Mindcrest, reflect important strategic steps for the Group and we expect them to make a significant contribution to performance in FY21 and beyond. We will continue to consider carefully organic and, at the appropriate point, inorganic growth opportunities. We expect profitable growth in FY21 as we return to more normal trading conditions, albeit the Board remains cautious given the uncertain economic environment.

Chris Stefani
Chief Financial Officer
7 September 2020