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Aggressive UK strategy drives Slater & Gordon
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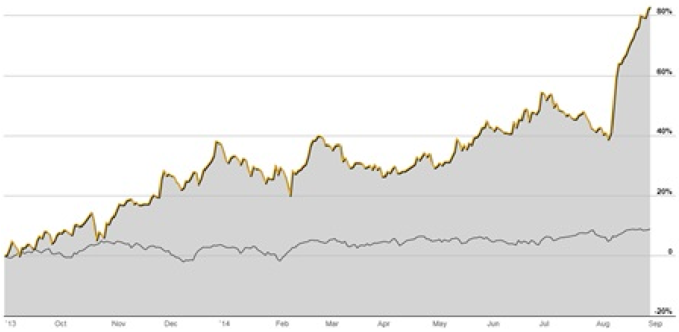
by Russell Muldoon

Over the past 12 months, shares in **Slater & Gordon Limited (SGH)** have risen almost as aggressively as its acquisition strategy. Had you owned SGH shares around the start of September last year, you would have experienced an 82% increase in share price from $3.52 to $6.42, giving the company a market capitalisation approaching $1.3 billion, and collected 6.85c in fully-franked dividends along the way. It's now trading closer to $6.15 but with an additional 5c dividend to be paid shortly, this has lead to handsome outperformance over the ASX All Ordinaries Index over the same period.

Slater & Gordon Limited (SGH)



Firm favourite

Slater & Gordon was one of the standouts this reporting season, reporting strong growth in both revenue and earnings per share – up 40.4%, and 26.8% respectively. Not bad for a business that's effectively a commoditiser of legal services.

Having already established a strong brand and cash-generative business in Australia via industry consolidation, the company now has identified an opportunity to undertake a similar acquisition strategy in the highly fragmented UK law industry. When one considers the fact that the UK is almost five times bigger than Australia, you can quickly see the attractiveness of this opportunity.

As well as continued smaller bolt-on acquisitions at home (like the just-announced Nowicki Carbone and Schultz Toomey O'Brien purchases) likely to continue, when analysing the future prospects of the business, our attention quickly turns to what it is doing in the UK. Indeed, we count a number of acquisitions that Slaters has already made – including Pannone, Goodmans and Fentons, Claims Direct, Taylor Vinters and Russell Jones & Walker – as acquisitions, which are set to continue.

In their 2014 full-year results, Slater & Gordon management has confirmed that the integration of the UK acquisitions is going to plan, that it has already consolidated circa 5% share of the UK market, with absolutely no intention of slowing down. Management is guiding for its market share to increase to 10-15% in the coming years, noting that it has a seemingly rushed desire to put daylight between itself and its closest competitor in the next few years, something that clearly can't be achieved organically.

The UK strategy

Slater & Gordon therefore appears to be on an aggressive growth strategy, and its goal is relatively simple: to lead the consolidation of the UK personal legal services market; a market which has undergone radical changes in recent times. These UK operations already have forecast annualised revenue of $230 million from the UK: almost at the scale of Australia's $270 million – which took years to build. In total, Slater & Gordon generated $423 million of group revenue in FY14, and is forecasting $500 million in FY15.

Just as it has in Australia, Slater & Gordon's ambition is also to become a household name in UK consumer law, and position itself for a tsunami of disruptive innovation in the global law industry.

The UK has more than 10,000 law firms, with almost two-thirds of them owned by one or two partners with poor scale opportunities and hence profitability. The obvious solution has been industry consolidation as firms merge to create scale, or larger firms buy smaller rivals – a pronounced trend in the global legal industry in recent years. But most UK law firms had low access to capital, little experience in acquiring other firms, a weak brand in the consumer market, and no clear, sustainable competitive advantage over rivals.

This has created a huge opportunity for Slater & Gordon, which, with its access to capital since its Initial Public Offering (IPO) in 2007 and its long experience in acquiring and integrating firms, now has 25% of the Australian personal-injury market.

The UK legal services market is also undergoing rapid consolidation, as difficult trading conditions post-global financial crisis (GFC) and regulatory reform have shaken what some commentators describe as a "cottage industry". Clients want lower fees, better service and greater value; the UK government wants greater competition. This plays into Slater & Gordon's strategy perfectly.

Some caution

But while it's an exciting story and the business at the moment has bright prospects, it's not without its risks. With a bigger business comes lots of additional challenges in sustaining that growth and when that growth is coming largely via acquisition, add in integration risk (which is not a word we throw around lightly) and the risk of disappointment will grow larger and larger at some point down the track.

We have a simple saying at Montgomery, and that's roll-ups work until they don't. The stock market is littered with past acquisition-driven business models that worked for a time, but don't any longer. QBE is a poster child of what challenges management teams face when the acquisition momentum slows and they are left trying to work out how to salvage what they have.

While this doesn't appear to be on the cards for Slater & Gordon for some time, they are still a long way from an opportunity we estimate to be as high as $800 million revenue in under five years' time, it's certainly something to look out for. For while the music is playing loud right now, at some point it almost always stops.

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