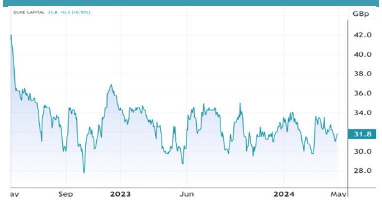
29 April 2024

HARDMAN & CO.

## Financials



*Source: LSEG*

## Market data

| | |
|---|---|
| EPIC/TKR | **DUKE** |
| Price (p) | **31.25** |
| 12m high (p) | 35.5 |
| 12m low (p) | 28.5 |
| Shares inc. Treasury (m) | 421.5 |
| Mkt cap (£m) | 131.7 |
| EV (£m) | 191.6 |
| Free float* | 81.62% |
| Country/Ccy of listing | UK/GBP |
| Reporting currency | GBP |
| Market | AIM |

**As defined by AIM Rule 26*

## Description

As a long-term strategic partner, Duke Capital (DUKE) offers bespoke and flexible capital to help SMEs achieve their growth potential through non-control transactions, while generating attractive risk-adjusted returns for shareholders.

## Company information

| | |
|---|---|
| CEO | Neil Johnson |
| CIO | Charlie Cannon Brookes |
| Chairman | Nigel Birrell |
| CFO (contact) | Hugo Evans |

https://dukecapital.com/
https://dukecapital.com/investors/

## Key shareholders (5 Feb'24)

| | |
|---|---|
| Retail on Hargreaves Lans. II and AJ Bell platforms | 25.45% |
| M&G | 8.71% |
| Gresham House | 6.29% |
| Columbia Threadneedle | 5.85% |
| Allianz Global | 5.57% |
| GLG | 5.07% |
| Directors (shares only) | 4.39% |
| Axa Framlington | 3,54% |

## Diary

| | |
|---|---|
| Early Jun'24 | Trading update |

## Analyst

Mark Thomas mt@hardmanandco.com

# DUKE CAPITAL

## Meeting customer needs, giving investors returns

**DUKE's unique product provides SMEs across diversified sectors with hybrid capital, allowing the existing team to retain control. By optimising the best of equity and debt, DUKE aims to achieve equity-type returns with debt levels of risk. The loan and participating preference share elements support DUKE shareholders' high (2024E: 9.0%), growing (2026E: 7% above 2024), and covered dividend. Early exit fees and equity stakes should generate ongoing capital growth as the portfolio matures. PE-style due diligence before providing capital, and board participation after, reduces downside risk. Management and shareholder interests are aligned.**

- **Growth options:** DUKE's earnings can grow with i) more revenue in the existing book as clients grow revenue, ii) positive inflation gearing, iii) gross advances (new clients and follow-on investments), iv) operational leverage, v) exit fees, vi) increasing value in equity stakes, and vii) high barriers to entry limit competition.

- **Downside protections:** Risk appears well managed with i) a highly selective approach to new deals, ii) appropriate counterparty assessment and excellent ongoing monitoring, iii) portfolio diversity and senior security, iv) active management of problem situations, and v) a floor to annual revenue adjustment.

- **Valuation:** The FY'24E dividend yield is currently 9.0%. On the long-term assumptions outlined later in this report (growth 5%, RoE 14%, CoE 12%), our valuation approaches indicate GGM growth 47.0p, discounted cashflow 71.1p, and dividend discount 36.9p, with an average of 51.6p.

- **Risks:** Counterparty risk is core to any finance provider. Currently, there is adverse sentiment to most speciality finance businesses. We see a short-term dependence on key staff. Many investors are unfamiliar with the product, there are few comparators, and the underlying assets are likely to be illiquid.

- **Investment summary:** By having a unique proposition, which adds value to clients, and with high barriers to entry, DUKE is able to generate strong returns and so pay a high, consistent dividend. The way the product is structured provides multiple levers for both income and capital growth, as well as limiting the downside risk. DUKE has invested in new staff in FY'24 to optimise the opportunity while showing good discipline in the pacing of new investments.

### Financial summary and valuation

| Year-end March (£m) | 2021 | 2022 | 2023 | 2024E | 2025E | 2026E |
|---|---|---|---|---|---|---|
| Total cash revenue | 11.0 | 18.7 | 21.9 | 30.5 | 32.6 | 41.2 |
| Recurring cash revenue | 8.8 | 15.4 | 21.9 | 24.3 | 30.6 | 39.2 |
| Free cashflow | 6.9 | 11.4 | 12.8 | 18.8 | 20.7 | 25.8 |
| Accounting pre-tax | 16.1 | 21.4 | 20.4 | 20.3 | 22.8 | 27.7 |
| EPS (p) | 5.75 | 5.95 | 4.92 | 4.43 | 4.35 | 4.71 |
| DPS (p) | 2.3 | 2.3 | 2.8 | 2.8 | 2.8 | 3.0 |
| Hybrid capital assets | 85,301 | 160,479 | 191,333 | 204,791 | 256,881 | 320,751 |
| Equity investments | 3,495 | 10,820 | 13,529 | 11,279 | 11,279 | 9,779 |
| Cash | 1,766 | 5,707 | 8,939 | 4,208 | 7,899 | 12,376 |
| Shareholders' funds | 85,786 | 132,941 | 164,259 | 172,193 | 218,288 | 230,135 |
| PER | 5.4 | 5.3 | 6.3 | 7.1 | 7.2 | 6.6 |
| Dividend yield | 7.2% | 7.2% | 9.0% | 9.0% | 9.0% | 9.6% |

*Source: Hardman & Co Research*

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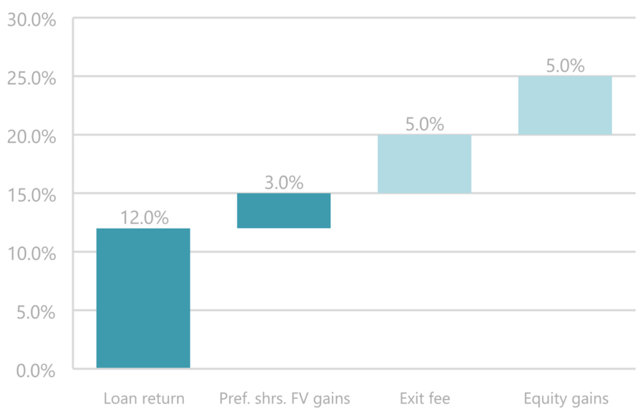
# Executive summary

**DUKE's hybrid capital product has unique features, bringing customers significant benefits**

DUKE provides hybrid capital to UK, European and North American SMEs and, by bringing clear benefits to its customers, it creates value for its shareholders. Finance is provided by way of a loan and linked preference share, which, for accounting purposes, are consolidated as a single item. Additionally, there is an early exit fee and, in most cases, some equity stake/warrant is taken, but not one which compromises the customer's control of the business or their upside potential. DUKE thus has four "pillars" to its returns.

**Mature portfolio expected IRR by four pillars of returns (%)**




**Comment**

- Loan element: i) committed long-term finance (25- to 30-year term), ii) no bullet repayment of principal at maturity, iii) an initial yield of, typically, 12%-14%, and iv) senior secured. Generates high income to pay dividend (2023E interest receipts ca.2x dividend).
- Preference share: participates in borrower's revenue growth. (interest payments can change up to +/- 6% p.a. compounded on annual reviews). Over time, higher customer income leads to more revenue for DUKE to pay higher dividends. Fair value accounted.
- Exit fees: average of ca.20% of initial advance. Exit is allowed after three years (or at any time with a change in control). High IRR if early in life. Provides capital growth upside.
- Equity stake ongoing fair value adjustments are driven by borrower's performance and market ratings. Exit uplift gains are likely to be volatile until the portfolio is more mature. Provides capital growth upside.

*Note: DUKE estimates equity return contribution 5%+ over long term. Source: DUKE estimates, Hardman & Co Research*

**The different elements of the product should generate stable income, more than covering dividend, and capital growth**

In terms of these return "pillars", investors should consider i) the fixed coupon on the loan is stable and relatively predictable – with good credit assessment and monitoring, it should more than cover the high dividend yield, and ii) DUKE's cash receipts should grow as the participating preference shares are aligned to the borrower's revenue growth (on average 3.4% CAGR to date). This supports a growing dividend over time. The average ca.20% exit fee return depends on when it is exercised (it is higher in early years to discourage early repayment then). There is an element of stability to underlying returns as, over time, the preference share contribution should grow while there is a falling IRR contribution from the exit fee. Equity gains reflect ongoing valuations and uplifts on exits. DUKE, to date, has achieved an average 25% IRR (excluding a COVID-19-related exposure of -1.4% IRR and the 200%+ IRR on Instor). The key customer benefits are outlined below.

**Key characteristics of the different elements of the capital stack**

| | Debt | DUKE hybrid capital | Private Equity |
|---|---|---|---|
| **Key benefits** | | | |
| Term (years) | Typically, 3-7 | 30 | Permanent |
| Re-financing pressures | Significant bullet repyts. | None | Pressure to exit |
| Equity dilution | Minimal with interest cost | Most upside with current shareholders | Significant |
| Control | Existing board | Existing board | PE manager |
| Certain cost at outset | Yes | Significantly yes | Dependent on performance |
| Free cashflow impact (years 1-5) | Significant | Light | Light |
| **Other benefits** | | | |
| Aligned financial interests | Limited | Yes | Yes |
| Tax deductible cost | Yes | Yes | No |
| Sector limits limiting finance | Often | No | No |
| Security | Typically, senior | Typically, senior | None |
| Restrictive covenants | Typically, significant | Cov-sensible | Cov-lite |

*Source: Hardman & Co Research*

**Hybrid target customer base underserved by others…**

DUKE's target market is underserved by financers. It focuses on businesses with revenue of £10m-£50m, EBITDA £2m-£10m and with steady revenue streams. These are too late-stage for venture capital but too small for institutional owners. Mainstream banks in this space are focused on simple, mass-market lending products.

**…with multiple earnings growth options**

For DUKE to earn equity-type returns over the long term, it must grow. In the detailed sections below, we show how DUKE can generate earnings growth through:

- more revenue in the existing book, as clients grow revenue;
- positive gearing from inflation;
- gross advances (new clients and follow-on investments);
- operational leverage;
- early exit fees;
- increases in the value of equity stakes; and
- the benefit of high barriers to entry, restricting competition.

**Managing counterparty risk requires skill and the right culture, which DUKE appears to have, thus limiting downside risk**

We believe the key drivers to achieving a debt level of risk lie in the initial assessment, building strong relationships (once the finance has been provided) to identify problems quickly, and the rapid resolution of problem situations.

- In our view, the first is driven by some basic principles (sometimes referred to as the Canons of Lending or the acronym CAMPARI – character, ability, means, purpose, amount, repayment and insurance), which require that the financer should understand the customer. We believe DUKE complies with these canons.
- DUKE is actively engaged with customers post the provision of finance by having the right to attend all board meetings and receive monthly management accounts. The portfolio is diverse (by customer, geography and sector), and sectors where the customer has limited control over revenue are avoided.
- In terms of problem situations, DUKE has adopted an active engagement with the customer. Its covenants ensure it has the control necessary to limit losses.

**Managers aligned to shareholders and have built a credible following**

Other investment positives include i) management interests are aligned with shareholders, ii) credible institutional investors in, and debt provider to, DUKE, and iii) recently enhanced communication.

**Neutral issues include accounting, ESG**

We have classified the following as investment-neutral factors: i) accounting (more detail is given in the Appendix, but, as a hybrid player, DUKE is unhelpfully forced to shoehorn its product into more mainstream product accounting, which is not always helpful – we believe transparency is good and the approach conservative; ii) ESG; iii) contractual payments, generally mid-90%; iv) the impact of a rising rate environment; and v) loan investments.

**Close to self-funding**

DUKE is close to self-funding, on our estimates, and more equity uplifts on exits such as the *Fabrikat* one, announced on 7 March 2024, will help further. There may still be additional equity raises, which means i) some funding growth is partially outside DUKE's control, ii) there may be dilution of NAV, iii) paying dividends at the same time incurs some costs, but we believe it is what shareholders want, iv) should assist share trading liquidity, and v) should achieve further economies of scale and stability in returns.

**Key risks are counterparty weakness, sentiment to all financing businesses, a lack of familiarity with the unique product, key personnel dependency, and illiquid assets**

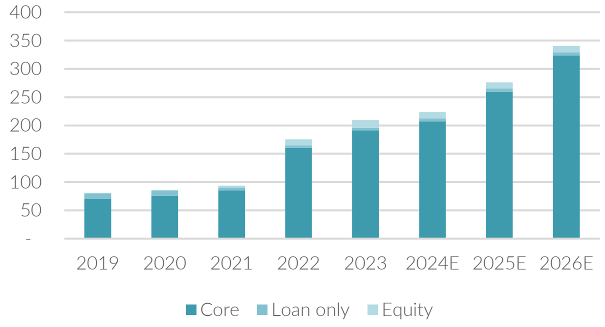
When it comes to risks, investors should consider:

- Counterparty risk – our review concludes that DUKE has the appropriate policies and practices in place to effectively manage counterparty risk, but this is the key for any finance business.
- There is currently an adverse sentiment to all financing businesses, and this may put a drag on the share price until macro conditions improve.
- Investors are not generally familiar with DUKE's hybrid capital offering and, for some, this may be a deterrent to investing. In our view, familiarity will breed comfort not contempt.
- There is a dependence on key personnel, which will moderate as the business grows.
- DUKE's assets are illiquid and so likely to be difficult to realise.

**On the assumptions we detail in this report (RoE 14%, CoE 12%, growth 5%), significant upside to valuation**

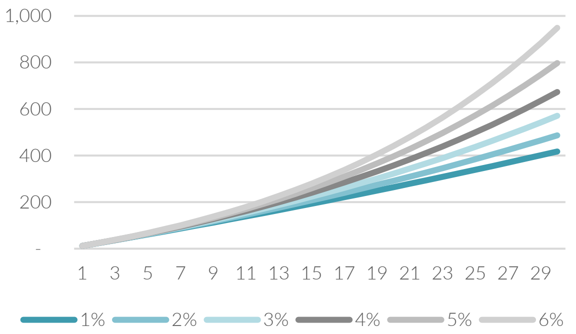
We apply a range of different valuation approaches in the section below and give some of the key sensitivities to our assumptions. Our Gordon Growth Model (GGM) indicates a fair value of 47.0p, the discounted cashflow model (DCF) 71.1p and the dividend discount model (DDM) 36.9p, an average of 51.6p. We believe the differences in strategy and business model make comparisons, with even the closest listed "peers", of limited value.

## Long-term growth in investments




- DUKE's hybrid product (consolidated loan and preference share) is expected to show steady growth from here.
- A large (ca.£50bn) and long-established market in similar products is offered by single-sector providers, primarily based in North America.
- DUKE's finance is used for: Buy-and-Build capital; debt refinancing,; management buyout and shareholder restructuring.

## Cumulative cash received, assuming an advance of 100 and 12% initial yield under different annual uplift options




- The model has significant growth potential from its existing book as revenue grows with customers' revenue/EBITDA (current average assumption is 2%, which is just over half the average growth seen FY'19-FY'23).
- In practice, most facilities are expected to be repaid early.
- The link to customer revenue means DUKE has positive gearing to inflation.
- Other revenue/profit growth options include new business origination, the benefit from operational leverage, early exit fees and equity participation.

## Downside protections built in

Highly selective on deals

Counter-party assessment and monitoring

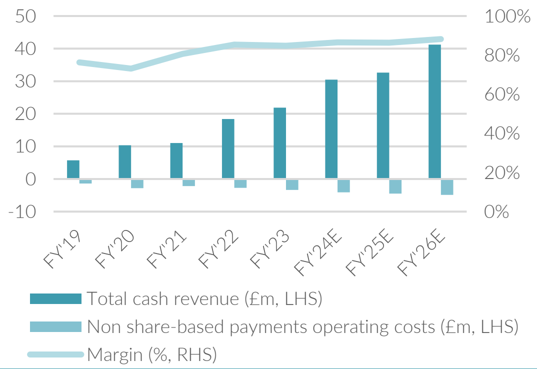
Portfolio characteristics
- Diversity
- Customer profile
- Conservative initial coverage of payments
- Security taken

Floor to revenue decline

Management of problem situations

- At present, only 1% of applications are seen through to completion.
- DUKE has the right to attend all client board meetings in addition to receiving monthly financials.
- The portfolio is diverse by customer, sector and geography. Initial financial coverage is high and broad security is taken to ensure DUKE has control over assets if operational performance becomes challenging.
- There is a -6% floor to the annual adjustment.

## Trend has been for strong growth in cash revenue and margins with operational leverage




- Our forecast total cash revenue in FY'26 is ca.7.2x that of FY'19. Recurring cash revenue is expected to grow 6.9x, as DUKE sees more equity and early exit fees as the book matures.
- Non-share-based payment costs forecast to be up 3.6x.
- Operating leverage expected to see margin increase from 76% to 88% by FY'26E. The dip in FY'23 reflects a conservative approach to new business origination in uncertain times and investment, especially in new people.

*Source: Company data; Hardman & Co Research*

# What DUKE does

Fills funding gap between equity and debt:

- 30-year term
- No bullet repayment
- Initial yield, typically, 12%-14%
- Payments can change up to +/-6% p.a. with borrowers' revenue change

DUKE, uniquely, fills the funding gap for UK, European and North American SME businesses by offering a product that sits between equity and debt. This allows company owners to get access to growth capital while still keeping control of their business and without refinancing risk. The key product features are:

- DUKE provides a lump sum of capital to a company with a term of, typically, 30 years. Customers thus get certainty in long-term finance.
- There is no bullet repayment at the end of the term, with the principal being amortised through the annual payments over the life of the facility. Customers thus avoid having a re-financing wall to worry about. DUKE's total obligation can be serviced out of current cashflow, without the need for large principal repayments.
- The initial yield is, typically, ca.12%+ of capital. This is then adjusted, once per year, with a collar of +/-6% of the amount due, driven by the customer's organic revenue growth or decline.
  - The rate is above what the company is likely to pay for senior debt, but it is below the cost of equity.
  - As the table below shows, DUKE's change in payment occurs the year after the customer; so, there is a modest lagging effect (see later section on operational leverage).
  - The +6% annual increase cap means that all the revenue upside above this level is retained by the customer, giving them the majority of the benefit of good performance and not diluting their stake in the way new equity would. The table below illustrates a company, which, in most years, generates 15% growth but, in some years, sees a decline. Over the period shown, the company's revenue grows 56% while the DUKE payments are up only 18%.
  - The floor of -6% provides DUKE with an element of downside protection. DUKE thus gets a relatively stable income stream (its revenue decline in down years was only half that of the company).
  - In the accounts, the uplift is achieved via a participating preference share, which is fair valued for each period (see Appendix).

**Theoretical illustration of corporate revenue and DUKE's payments across different growth scenarios**

| Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|---|---|---|---|---|---|---|---|---|---|
| Company revenue | 100 | 115 | 101 | 116 | 134 | 154 | 135 | 156 | 171 |
| Company revenue change (%) | | 15% | -12% | 15% | 15% | 15% | -12% | 15% | 10% |
| Payment to DUKE | | 50 | 53 | 50 | 53 | 56 | 59 | 56 | 59 |
| DUKE change (%) | | | 6% | -6% | 6% | 6% | 6% | -6% | 6% |

*Source: Hardman & Co Research*

Customer revenue is a good benchmark, as it is less volatile than earnings and less exposed to accounting risk

- Revenue has been chosen as the metric to generate growth because:
  - It has less volatility than earnings. DUKE invests with companies that have significant control over their revenue growth rather than ones being sensitive to factors significantly outside their control. It does not, for example, have exposure to the mining sector, where the price of the commodity is a key revenue driver.

- DUKE has less exposure to customers' accounting risk. For most customers, revenue and cash receipts are in close alignment. Where they are not (for example, an office fitout business, which books revenue as the fitout progresses with receipts at staged dates), DUKE has invested the time to fully understand the accounting dynamic. By choosing revenue as the growth metric, and closely monitoring the businesses, DUKE reduces risk.

- Given a 30-year term and no principal repayment at maturity, investors should note that the rate includes an element for principal amortisation as well as providing a risk-adjusted return. On an exit, DUKE's investments currently have to repay cost, not an amortised value, which would support recognising 100% of payment as income/recurring cash.

**Facility can be bought back after three years for an exit fee (or earlier if change of control)**

- The company can buy back the capital after a three-year, non-call period. If this option is exercised, DUKE receives an exit fee, which, to date, has averaged ca.20% of the initial advance. In the first years, it usually starts at a higher level to discourage early buyouts, but the buyback can be granted at any time upon change of control. Looking forward, the exit fee is likely to be based off amortised principal, but as the amortisation in the first 10 years is modest, this will be close to the original advance.

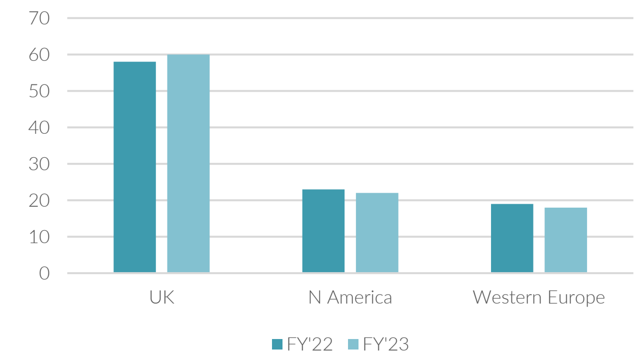
- The deal structure, in about two thirds of cases to date, has included an element of equity/warrants but not to a scale which gives DUKE any control over the business. The customer keeping control is a key attraction of the product.

DUKE's offering is especially appealing to customers who want growth capital but do not want to lose control of their businesses. Consequently, it has been used for buy-and-build strategies (about half total), management buyouts, shareholder restructuring and debt financing. 60% of total cost was invested in UK companies, 22% in North Americas and 18% in Western Europe, giving reasonable geographical diversity.

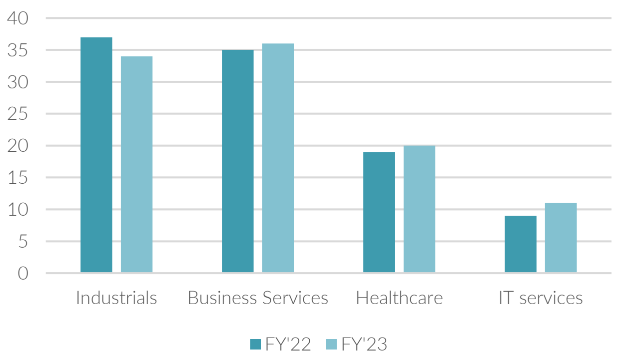
## Portfolio

The charts below show the latest portfolio mix (as at end-FY'23). Since the FY, Instor Solutions, Fairmed Healthcare AG and Fabrikat are all no longer part of the portfolio, and there has been an $11m investment into Glasshouse, a US-based glass manufacturer and a £14.5m agreement with Integrum Care-Clearbrook Limited, which operates six elderly nursing care homes in Kent and East Sussex.

**Mix of portfolio, by geography (%)**




**Mix of portfolio, by sector (%)**




*Source: Hardman & Co Research*

## Summary of hybrid capital partners, at end-FY'23 (adjusted for exits)

| Partner | Initial investment | Use of capital | Fair value (£m) | | | |
|---|---|---|---|---|---|---|
| | | | Mar'20 | Mar'21 | Mar'22 | Mar'23 |
| **Industrials** | | | | | | |
| Atlas Signs | Dec'21 | Debt re-financing | n/a | n/a | 16.1 | 18.5 |
| Creō-tech Industrial Group | Jul'21 | Buy-and-Build | n/a | 4.7 | 11.4 | 11.3 |
| Trimite Global Coatings | Mar'18 | Equity buyout | 9.0 | 9.8 | 10.3 | 10.2 |
| United Glass Group | Apr'18 | Buy-and-Build | 6.4 | 12.4 | 13.2 | 13.2 |
| Glasshouse | Jul'23 | Management buyout | | | | $11.5* |
| **Business services** | | | | | | |
| BVPA (Ireland) | Sep'18 | Buy-and-Build | 8.5 | 8.5 | 13.6 | 14.3 |
| Lynx Equity (UK) | Oct'17 | Buy-and-Build | 11.6 | 13.1 | 14.9 | 15.3 |
| Miriad Products | Feb'19 | Management buyout | 9.0 | 13.7 | 19.3 | 17.2 |
| New Path Fire and Security | Dec'22 | Growth capital | n/a | n/a | n/a | 5 |
| Step Investments | Jun'18 | Growth capital | 4.1 | 6.6 | 8.9 | 9.1 |
| **Healthcare** | | | | | | |
| InterHealth Canada | Aug'18 | Growth capital | 9.4 | 10.7 | 10.8 | 11.8 |
| Integrum Care | Mar'24 | Buy-and-Build | | | | 14.5* |
| **IT services** | | | | | | |
| Intec Business Solutions | Jul'21 | Buy-and-Build | n/a | 9.9 | 17.1 | 20.5 |
| **Specialist care** | | | | | | |
| Tristone Healthcare | Dec'21 | Buy-and-Build | n/a | n/a | 14.4 | 19.2 |

**New partners added in July 2023 and March 2024; we have included it in March 2023 column for completeness.*
*Source: Hardman & Co Research*

# Bull 1: investors benefit from high yield and potential capital growth

**2024E dividend yield 9.0% on current share price**

In normal times, DUKE expects to pay out between 60% and 75% of fully invested recurring free cashflow through quarterly dividends. The table below shows how it has evolved since June 2017. On the LTM dividends (2.8p), the yield on the current share price (31.25p) is 9.0%. The chart illustrates how the board is meeting its objective of paying a dividend that is "healthy".

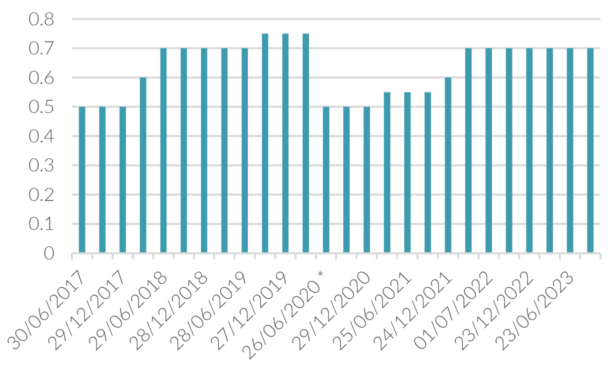
**Dividend sustainability**

A second aspect of the dividend policy is that the quarterly payments should be "steady". Excluding the impact of COVID-19, the chart again shows this has been achieved. Looking forward, we believe the key consideration is the likely recurring cashflow generated from the loan element of the product and the uplift to cash received from the participating preference share.

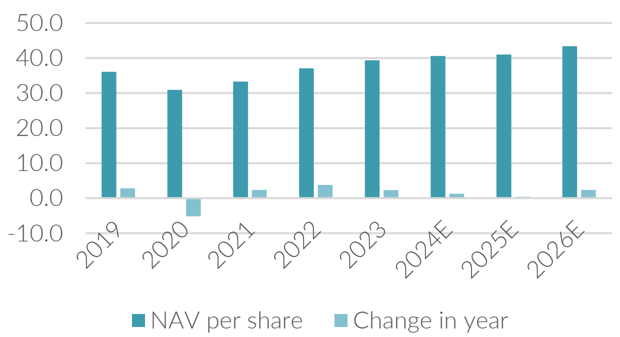
**Capital growth**

The second aspect of investor return is capital growth. The chart below shows the historical levels, and that resulting from our forecasts. As can be seen, despite the impact of COVID-19, the March 2023 NAV was 9% above the March 2019 level. As the book matures, the one-off gains from equity realisations and early exit fees may be expected to grow.

**Quarterly dividends (p)**




**NAV per share and change in year (p)**




*Source: DUKE website, Hardman & Co Research*

# Bull 2: product adds value to customers

## What customers get from DUKE's hybrid capital financing

DUKE's offering has characteristics of both equity and debt, and so brings real benefit to customers

The table below explores a wide range of characteristics of debt, DUKE and PE finance. As noted in the section, above, on "*What DUKE does*", the key benefits to customers are i) long-term finance with no re-financing wall at the end, ii) aligned interest with their funder, given the annual cap/collar mechanism, iii) the majority of the operational upside is retained by the customer, and iv) the existing board continues to control the destiny of the business, free from outside control. As the table shows, DUKE's unique proposition has many of the benefits of both debt and PE financing without many of the costs.

Key characteristics of the different elements of the capital stack

| | Debt | DUKE hybrid capital | Private Equity |
|---|---|---|---|
| **Key benefits** | | | |
| Term (years) | Typically, 3-7 | 30 | Permanent |
| Refinancing pressures | Significant bullet repayments/refinance | None | Pressure to exit |
| Equity dilution | Minimal with interest cost | Most upside with current shareholders | Significant |
| Control | Existing board | Existing board | PE manager |
| Certain cost at outset | Yes | Significantly yes | Dependent on performance |
| Free cashflow impact (years 1-5) | Significant | Light | Light |
| **Other benefits** | | | |
| Aligned financial interests | Limited | Yes | Yes |
| Tax deductible cost | Yes | Yes | No |
| Sector limits limiting finance | Often | No | No |
| Security | Typically, senior | Typically, senior | None |
| Restrictive covenants | Typically, significant | Cov-sensible | Cov-lite |

*Source: Hardman & Co Research*

Most appealing to businesses wanting growth capital but to retain control

With an effective cost above that of simple debt, DUKE's hybrid capital offering will not appeal to all borrowers. As the table on page 8 shows, it is likely to be of most interest for those wanting growth capital to fund acquisition (either M&A or buyout) or strategic growth and where the existing shareholders want to retain control of the business.

The lower/mid private company market (revenue £10m-£50m, EBITDA £2m-£10m) is DUKE's sweet spot. Typically, these companies are owner-operated, family, i.e. "non-sponsored" businesses where retaining control is important and where refinancing risk is top of mind and the owners are distrustful of banks.

# Bull 3: upside opportunities supporting equity-type returns

Multiple options to generate earnings growth

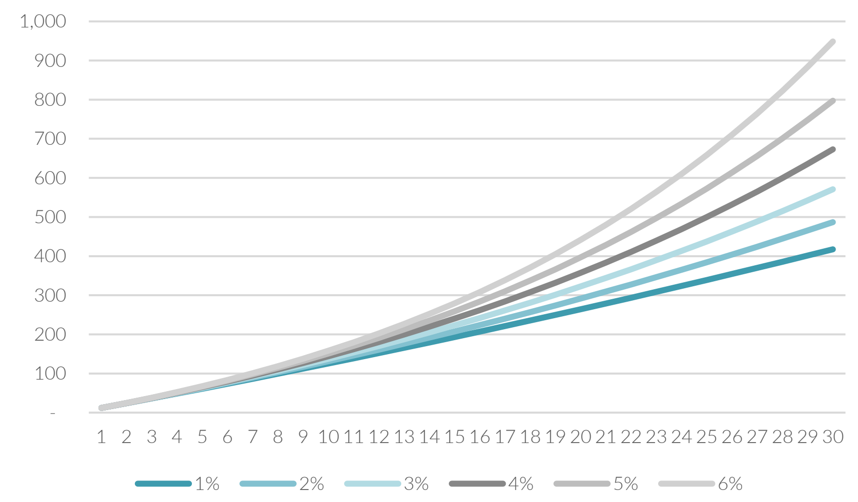
In the sections below, we show how DUKE can generate earnings growth through i) more revenue in the existing book as clients grow revenue, ii) positive gearing from inflation, iii) gross advances (new clients and follow-on investments), iv) operational leverage, v) early exit fees, vi) increases in the value of equity stakes, and vii) high barriers to entry.

## Growth in existing recurring revenue as clients grow revenue

Annual adjustments of 6% p.a. would compound to see 2.3x the cash received of ones with 1% annual adjustments

We highlighted above that the second pillar of DUKE's returns is the participating preference share, which captures the annual change in customer revenue in its fair value adjustments (see Appendix 1 for accounting). The chart below shows the nominal payments received by DUKE, assuming an advance of £100 and 12% initial yield, under different revenue growth by its customers. If there was 1% p.a. growth, DUKE would receive back nominal payments of £417 over the term of the facility. The compounding benefit means that a 6% growth company would pay £949. Clearly, one of DUKE's objectives is to identify companies with the best sustainable growth opportunities.

**Cumulative cash received assuming an advance of 100 and 12% initial yield, under different annual uplift scenarios**




*Source: Hardman & Co Research*

Current assumption for post year 3 growth is inflation; i.e. 2%

In valuing its capital investments, DUKE makes assumptions as to what future growth will be. The initial three years are explicitly forecast and thereafter revenue is conservatively assumed to grow at 2% p.a. (i.e. around long-term inflation). The upside lies in performance against this assumption. We note, on average, and despite COVID-19 effects, FY'19-FY'23 growth has been 3.4%, compared with the 2% assumption.

## Revenue from existing deals is positively geared to inflation

Importantly, this link to customer revenue brings a positive gearing to inflation, which is seen in both more income and fair value adjustments

In a high inflation environment, customers' revenues are likely to rise and the annual adjustment means that this increases DUKE's income. There is evidence of this in the fact that, in FY'23, DUKE had nine out of a possible 10 +6% adjustments while, in most years, it has seen an average ca.3.4% increase. Most of the partner companies are B2B, which DUKE believes is helpful to their ability to pass on inflation (the investment with the most B2C exposure was the sole investment not to have a +6% adjustment in FY'23).

Likely to see both income uplift in period and positive FV adjustment

The table below gives a simplified example of the effect of year 1 annual adjustment being 2% above that built into expectations. As can be seen, there is the immediate income uplift from the higher revenue/EBITDA of the customer. Of equal importance is that the new, higher base means there is a FV gain from discounting future cashflows. This is a one-off benefit in the year of the annual adjustment. These are only partially offset by higher administration costs and interest expense.

Simplified example of impact on P&L from 2% higher inflation in year 1 as a % of hybrid capital payments

| | P&L impact | Comment |
|---|---|---|
| **Ongoing impact** | | |
| DUKE revenue | +200bp | Higher inflation leads to larger annual adjustment |
| Administration costs | -30bp | Assumed cost income ratio: 15% |
| Interest costs | -60bp | Assuming interest costs up 200bp, and 30% gearing |
| DUKE FV adjustment | +196bp | One-off in year 1 (assuming 15% discount and 2% ongoing annual adjustments) |
| **PBT** | **+306bp** | |

*Source: Hardman & Co Research*

## Gross advances to new clients and follow-on investments)

Recent investment in incremental staff. Infrastructure can now support business 2x current book.

In FY'23 and FY'24, DUKE has and will continue to invest in new staff, including three new associates to assist the three investment principals (see the profiles of the DUKE team here). Management believes that it can now reasonably support £50m-£100m of gross new deals p.a. in five to seven deals (deal sizes can vary). Infrastructure has been put in place to support a book of £400m, twice the current level.

Top-ups to existing customers may add £20m in gross balances in a typical year. In periods of uncertainty, this is low-risk growth.

DUKE is seeing a regular flow of incremental finance requests from existing customers as they undertake further acquisitions/balance sheet refinancings. In a typical year, this may generate £20m gross advances. Such lending may be considered lower-than-average risk, as it is to counterparties with a proven track record of making payments to DUKE and businesses that are well known to DUKE. In FY'23 and FY'24, when DUKE adopted a very cautionary approach to new customers, incremental facilities to existing clients accounted for the vast majority of gross advances.

Adding new partners too

In addition, DUKE aims to add new partners (see page 8 for current ones). The more the brand/product awareness increases, the more referrals DUKE has been seeing directly. In addition, DUKE mines its own network of direct contacts, many in the corporate finance arena, and DUKE staff frequent a lot of conferences in the US and Canada where they also network with middlemen.

Processes ensure rapid decision-making with material independent input

DUKE has partnered with top-tier management consulting firms to supplement due diligence and aims to complete transactions within three months. In our view, giving customers a rapid decision (including negative ones) is extremely helpful to them. The advisers bring a breadth of knowledge unavailable to many finance providers.

## PE market growth opportunities

Current PE conditions offer specific opportunities:
- SME finance availability reduced
- Large player fund too big for DUKE's target market
- PE firms increasing structured equity in their deals
- Exits may be deferred, but DUKE still earning good return

We see opportunities from the current PE market conditions. noting:

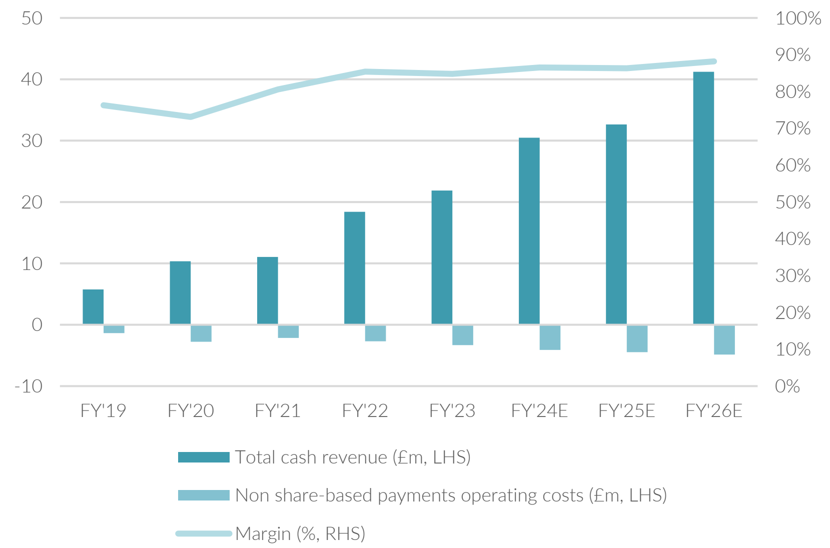
- The slower-than-usual PE market activity means that the already underserved SME market is suffering from an even greater scarcity of capital. DUKE can drive more favourable terms in the current market and with a higher-quality pipeline.
- Larger players (e.g. Apollo, Ares) have ramped up their "Hybrid" and "Structured" debt and equity products, showing that they recognise both the gap in current financing options, and that it is an attractive product for customers and investors. However, they are not active in the middle- and lower-middle market levels, and the structure of their products is somewhat different. The drawback in the provision of SME private equity financing is not being filled by competing structured products.
- The slower PE market has not changed DUKE's view on exit fees and buyout premiums. One of DUKE's USPs is the long-dated nature of its capital, and its investment partners are able to wait out the current economic climate until such time as an attractive exit opportunity presents itself. DUKE continues to receive an attractive yield on investments in the meantime.

## Operational leverage

On our forecast, 12% improvement in cash revenue/non-share-based payment cost margin FY'19-FY'26E

DUKE has a largely fixed cost model, with new facilities each year generating significant revenue growth but with modest servicing requirements. Consequently, we are expecting additional portfolio growth, to improve the cash revenue/non-share-based payment cost margin further (from 76% in FY'19 to 88% in FY'26E).

Cash revenue (£m), costs (£m) and margin (%) FY'19-FY'26E




*Source: Hardman & Co Research*

Leverage gains not seen in FY'23, given limited new advances in uncertain times, inflation pressure on costs ahead of annual revenue adjustments, and increased investment in new staff

Investors will note the absence of leverage gains in FY'23. This reflects:

- DUKE pulled back on deployments, reflecting the challenging macro environment,
- FY'23 was a period of unprecedented inflation, putting pressure on costs throughout the year. The revenue is adjusted once a year and so, in many cases, lagged cost increases.
- There has been an increase in the pace of investment (especially in staff) to generate new deployments, once conditions improve.
- FY'23 opex (excluding bonuses) was only £12k higher than it was in FY'20, so DUKE's own cost increases are under control.

## Exit fees

Hybrid capital payments can be bought after three years. Early years have a higher fee.

The contractual term of the financing is usually 30 years, but, as noted above, its cost is typically more than senior debt. Some companies have an ongoing and growing need for finance, but others move to a position where alternative financing becomes an attractive option. DUKE caters to this preference with its post-year-three buyout option, which, to date, has averaged ca.20% of the initial advance. Examples of exits include Welltel (December 2020 after three years), bhp insurance (August 2021 after three years) and xtremepush (September 2020 after two years). In general, management expects repayments to peak in years three to 10.

## Equity participation

In two thirds of deals, so far, the structure has included some equity/warrants

In around two thirds of cases to date, as part of the deal, DUKE has taken either shares or equity warrants. At end-March 2023, these were in 11 hybrid capital companies. As can be seen in the table below, there have been substantial uplifts to valuations; the closing value, at end-March 2023, of cumulative unrealised gains was more than twice the cost of investments. The main driver to the Fabrikat IRR of 36% was the gain on the equity stake.

Income of equity investments held at fair value through profit or loss (FVTPL, £000)

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024E | 2025E | 2026E |
|---|---|---|---|---|---|---|---|---|
| Unrealised gain | (23) | (670) | 1,224 | 7,095 | 2,209 | 0 | 2,000 | 2,000 |
| Realised gain | 88 | 0 | 345 | 2,583 | 0 | 750 | 0 | 0 |
| Dividend income | 0 | 0 | 0 | 0 | 3 | 0 | 0 | 0 |
| **Total income** | **65** | **(670)** | **1,569** | **9,678** | **2,212** | **750** | **2,000** | **2,000** |

*Source: Hardman & Co Research*

## High barriers to entry

Market wide, private capital has witnessed spectacular growth in recent years and investors should consider why some of it isn't being deployed in direct competition to DUKE's hybrid capital offering. We believe:

**Bespoke product requiring specialist skills**

- DUKE's offering is highly bespoke, and the structuring of the deals can be complex, requiring specialist skills.

**DUKE is multi-sector and with whole-company revenue focus; it has unique skill set**

- Royalty finance ties returns to customer revenue, but the differences from providers of that product make it hard for them to compete directly with DUKE. In particular, we note:
  - DUKE is active across a range of sectors and so it is not exposed to single-sector volatility. Single-sector providers do not currently have the skill base to assess multi-sector exposures.
  - DUKE is effectively providing capital against the whole revenue of a borrower and not just a single asset. Again, this requires a different skill set to assess counter-party risk and it also means DUKE is not exposed to single product development, as seen in many life sciences/song royalty companies.
  - DUKE is profitable.
  - The structure of DUKE deals is relatively simple with one loan and one preference share. We understand that some hybrid capital providers, based in Canada and offering US facilities, have up to seven tranches within their structures for regulatory/tax reasons.

**Too long a product for many funds and scale to being self-funding creates major problems. Potential PE structured product offering too big to deploy in DUKE's SME space.**

- The long-dated nature of the product means it is hard to put into a fund, which generally have shorter-term, fixed durations. Any evergreen structure would need at least £500m of assets to become self-funding (or else would need to be able to raise new equity). Raising a significant amount of capital up front is suboptimal as it would take time to deploy and earn returns. The structured products being offered by some of the largest PE houses have been multi-billion in size (Apollo's *Hybrid Value strategy* had $13bn under management at end-September 2023) and, realistically, funds of this scale cannot be quickly deployed in DUKE's target SME market.

- In recent years, there has been rapid growth in both private equity and private debt strategies. We believe this has been driven by the costs and regulations for listed equities and capital constraints on bank finance. The direct lending element has been an especially positive feature of private credit, and DUKE is likely to benefit from growing customer acceptance of non-traditional finance. Many providers of private credit, though, have strategies unrelated to DUKE in sectors (especially real estate and infrastructure) or size, and we do not see the market growth as a competitive threat.

# Bull 4: profit and capital downside protections – debt level of risk

## Summary

**Need to consider initial assessment, ongoing monitoring and problem account management. DUKE appears to have appropriate policies and practices for all three.**

As noted above, DUKE aims to have equity-like returns but with a debt level of risk. In our view, the key drivers to managing risk to this level lie in i) the initial counter-party assessment, ii) building strong relationships once the finance has been provided to identify problems quickly, and iii) the rapid resolution of problem situations. Additionally, the portfolio is diverse (by customer, geography and sector), and sectors where the customer has limited control over revenue are avoided.

In looking at counterparty risk:

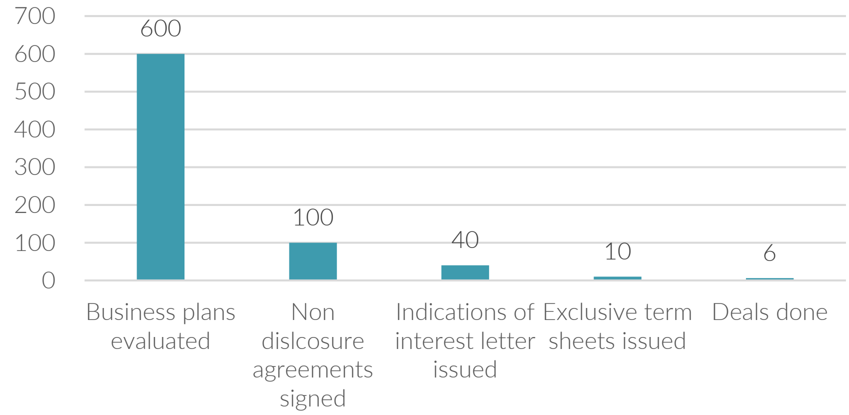
- In our view, a good initial assessment is driven by some very basic, and ubiquitous, principles (sometimes referred to as the Canons of Lending or the acronym CAMPARI – character, ability, means, purpose, amount, repayment and insurance). At heart, they require that the financer understands the customer. We believe DUKE complies with these canons. The CAMPA element is covered by the target customer profile, due diligence and well-covered payment profile, and the RI by the terms of security, and floored revenue declines. We note that only 1% of applications are turned into completed deals.
- DUKE is actively engaged with customers post the provision of finance, having either a board seat or the right to attend all board meetings and receive monthly management accounts.
- In terms of problem situations, it has adopted an active engagement with the customer and its senior-security covenants ensure DUKE has the control necessary to limit losses.

## Highly selective on new deals

**1% conversion rate of plans submitted to actual deals is evidence of selectivity**

The chart below shows the number of new deals recently considered by DUKE. As can be seen from the 600 plans that are initially reviewed, only 40 see indications of interest letters issued and just six are converted to actual deals. Customers must have a demonstrable track record of profitability and are usually well-established. A major reason for proposals not advancing is that DUKE has set a high bar for management expertise and control functions, such as finance. As many of the potential customers are long-established family businesses, this may or may not be present. At times, DUKE has set a condition before the deal advances of new managers; for example, a CFO. Compared with a PE investor, though, it is not taking direct control of the business.

Current funnel of new business opportunities reviewed




*Source: Hardman & Co Research*

**Conservatism also evident by less risky financing in uncertain times**

We also note that the scale of new investment in uncertain times is significantly lower than in good times. In FY'23, there was just £23.8m of hybrid capital advanced, compared with £74.6m in FY'22. As noted above, there is also a much higher proportion of lower-risk, add-on lending to existing partners than facilities for new customers.

## Counterparty assessment and monitoring

**Key controls include: ownership of advances culture, experienced management team, small number of advances, independent investment committee and external due diligence**

How a finance provider understands its client reflects both its processes and culture. In considering this for DUKE, we note:

- Management is closely aligned with the performance of the portfolio with i) a direct financial interest (see section below), and ii) the individuals making the advance being the ones who have to sort out problems if they emerge. The latter gives ownership of the exposure in a way that many lenders/equity investors do not. We believe such a culture is a material support to good credit assessment.
- The biographies in the Appendix show the experience of the key management team, who each have decades of experience working in this and related markets.
- The number of customers is relatively modest, meaning that even a small team has the resource to understand each customer well. SME lending can use some technology in the assessment of creditworthiness, but a personal understanding of the customer and its markets, is critical. It is much more of a relationship decision than mass-market personal lending.
- In addition to executive management, there is an independent investment committee (biographies also in Appendix), where an experienced team of business professionals must give approval before a deal progresses.
- In addition to all these internal controls, the company commissions external due diligence, usually with large, global, consulting firms, who get paid, typically, 3% of DUKE's revenue for the first 10 years and only for successful investments.

Ongoing involvement with company at board level and with flow of financial information

Being close to investments, after they have been made is an important factor in both minimising risk and also ensuring appropriate valuations. DUKE is not trying to run the business (as a PE shareholder would). However, 100% of its customers give DUKE access to board meetings (where it does not have board seats, it has rights of attendance). This greatly enhances the timely review of the customer's progress and strategic thinking. In addition, typically, DUKE receives monthly management accounts, which can be assessed against the most recent plans, which also will have been seen.

# Portfolio characteristics

## Diversity

DUKE shows diversity by geography, sector, reason for finance and counterparties

Despite being a relatively new business, the page 8 portfolio charts illustrate that DUKE has already achieved good diversity by:

- Geography (the intent is to reduce the UK weighting with further deals in North America and Europe).
- Sector: Noticeable, by their absence, are sectors such as mining, or life sciences. DUKE considers them less appealing, given that their revenue streams can be erratic and subject to drivers outside management control.
- Reason for finance.
- Largest single customer concentration. With a typical deal size of £5m-£25m, the concentration in the largest names is quickly diluted by portfolio growth. The largest single deal, in March 2023, was 11% of the book.

## Customer profile

DUKE has a low-risk customer profile:

Customer base made up of well-established, profitable businesses

- DUKE's customer base is made up of established, profitable businesses with robust market positions and the potential to grow strongly. It is not in early-stage venture finance, nor finance for real-estate companies. The achieved annual adjustments, of 3.4% CAGR to date, is indicative of the well-established nature of DUKE's customers.

Conservative coverage of payments

- Initial payment coverage of at least 2.0x EBITDA is standard and where there is other debt, DUKE seeks inter-creditor agreements or paydown of existing debt. In its latest presentation, management advises that the portfolio debt service cover was 2.2x, despite the recent rises in interest rates.
- DUKE has focused on family/privately owned businesses over more levered PE-sponsored deals.

## Security

DUKE takes good quality security. We note:

High-quality security taken on covenants, which gives DUKE control should the situation deteriorate

- DUKE will always either be sole senior lender or allows another debt provider into the capital structure, whereby the other party is secured against a specific asset, (like a debtor book or real estate). In the latter case, i) inter-creditor agreements will be put together, and ii) DUKE limits the quantum of the third-party debt to a manageable size, so it is then able to take out that other lender in a distressed situation and ensure it has control of the situation at all times.

- Where possible, senior security is taken over the fixed assets of the company. Debentures over all assets are also common. DUKE will take full security on whatever assets are available; although, we note, DUKE's counterparties tend to be asset-light businesses.

- DUKE's covenants focus on the important items such as serviceability/minimum liquidity/permitted liens, etc.; and it sees its facilities as covenant-sensible rather than covenant-lite. In our view, market-wide documentation is less restrictive on borrowers than in the past. This may allow a customer in difficulty to trade through to better times, or achieve an exit, which reduces the probability of default. However, it may also defer corrective action by DUKE, which may increase the loss, given default.

Full cross-company guarantee structures put in place

The *February 2024* investor presentation (slides 12-13) shows how the exposure to the 15 partners was diversified across 63 underlying operating companies. For example, the New Path Fire and Security partner had 10 underlying companies with whom DUKE has an exposure. All borrowing group subsidiaries and companies become obligors via cross-guarantee arrangements and provide debentures, thereby limiting the risk of a partner having business in one company but not the legal entity that is borrowing from DUKE.

## Sectors avoided

DUKE avoids sectors where customer revenue is significantly outside its control; e.g. commodity prices' impact on mining

DUKE is multi-sector and, strategically, is agnostic to new investments outside particular no-go areas (such as oil and gas, biotech, mining and startups). The common theme to the areas avoided is that they are sectors where management has limited control over a major pricing point. By way of example, a gold miner can see huge volatility around the gold price and DUKE does not want exposure to this. Recent deals have tended to be more in the industrials/business services space, due to the nature of the macro environment. Some sectors – for example, leisure – have been hit much harder in the past two to three years, and DUKE's risk aversion means it has tactically avoided new exposures in these areas.

# Management of problem situations

Proven track record of managing problem accounts, a material factor in limiting ultimate loss

In our view, having customers face difficulties is an inevitable part of any finance provider's business. Just as the probability of such events reflects management actions (and can be reduced), the scale of loss is also significantly under their control. In addition to identifying problems early through a close ongoing relationship, and the taking of security to give a claim on tangible assets, it is important that problem situations are actively managed. This requires specialist skills and expertise and a willingness to be flexible, as required. For DUKE, we note:

DUKE commits its own resources to fully understand the issue from the inside

- A willingness to engage directly with the business and commit significant DUKE management resource to better understand the situation. DUKE gets into the business to know it from the inside, and fully appreciates if the problem is temporary (e.g. short-term liquidity) or systemic (with, say, major loss of share). By way of example, we reviewed what DUKE did when Temarca (DUKE's only negative IRR investment to date) got into difficulties because of the effects of COVID-19. At the time of investment, the order book for this river cruise business was full for two years ahead. With the pandemic, this changed, and DUKE's engagement with the company meant that it felt there was no way back. DUKE took the decision to exercise the security over Temarca's boats. It did not bankrupt the business to do so and, indeed at one stage, was considering leasing the vessels back to Temarca. In the event, a competitor bought them, limiting the loss to a negative 2% IRR.

Flexible, when required, but on terms that should support strong IRRs

- During COVID-19, DUKE reduced its own cashflows as the result of granting forbearance to five companies, giving them liquidity breathing space by stopping payments for five or six months. In return, DUKE either accrued or equitised this forgone revenue, so it was not “lost”, merely deferred. In the case of the equitised revenue, management hopes, in due course, to make multiples over what was given up at the time.

## Floor to DUKE’s revenue decline

Floor to annual adjustment gives some downside protection while aligning interests to customers

The structure of payments, outlined on page 6, means that DUKE’s income will fall if the customer’s revenue declines on an annual basis. This gives an alignment of interests and a modest mitigation for customers in challenging conditions. However, there is a floor to the reduction on the annual review of 6%, limiting DUKE’s income downside risk.

# Bull 5: other investment positives

## Management interests aligned with shareholders

Managers aligned to shareholders with current shareholdings, options, performance bonuses

Management is aligned with shareholders through multiple means:

- As of 1 August 2023, the directors hold 18.5m shares (4.4% total), with Neil Johnson holding 7.1m, and Charles Cannon Brookes 10m. The total was up from 15.1m in March 2023, driven by the 100% vesting of March 2020 LTIP awards.
- The criteria for vesting of LTIP awards are weighted 50% to total shareholder returns (i.e. dividends plus share price growth) and 50% on total cash available for distribution (i.e. a free cashflow/business performance measure). As of 30 September 2023, total LTIPs outstanding were 9.7m shares, including 3.7m awards made on 28 July 2023 (Neil Johnson 0.8m, Charles Cannon Brookes 0.8m). To put this into perspective, the accounting costs for the LTIP represented ca.100% of basic fees for the executive directors in FY'23.
- The annual cash bonuses as a percentage of basic fees were Neil Johnson (FY'23 100%, FY'22 45%) and Charles Cannon Brookes (100% and 51%, respectively). The timing of bonuses is delayed by a year as they are only paid once DUKE has finalised annual results (so, bonuses paid out in FY'23 reflect performance for FY'22). This short-term incentive is based on the increase in total free cashflow, not earnings; so, if DUKE does not increase cashflow YoY, management does not receive a bonus. By linking to free cashflow, distortions around FV accounting are eliminated.

Related-party fee for operational expenses, not alternative director renumeration

Investors may note DUKE's related-party disclosure, which notes a couple of businesses that provide "vertical partner relationships, office rental" and "assisting the Board with the selection, execution and monitoring" of partners and performance. We understand the fees being paid to these businesses are for operational expenses and fees relating to remuneration of staff in North America, which, for historical and practical reasons, have been routed through companies caught by the accounting rules as related parties, and they should not be considered as an alternative renumeration for the directors.

## Credible institutional investors

Highly credible institutional shareholder list and substantial finance provider

The front page of this report lists DUKE's major shareholders, which include a broad range of global institutions, including M&G, Allianz and Axa Framlington. The presence of such a broad range of large shareholders is likely to be seen as a badge of credibility for other investors. Similarly, the fact that DUKE's debt is provided by a global insurance company (Fairfax Financial has more than $90bn of assets), rather than a marginal finance provider, adds further credibility.

## Enhanced communication

DUKE's evolution now recognised in communication

In mid-January 2024, DUKE announced a re-branding, moving away from its previous name of Duke Royalty. The new positioning recognises the products' unique characteristics and DUKE's evolution, and should bring clarity to investors. At the same time, DUKE upgraded its website and employed Hardman & Co to broaden its communication reach.

# Investment neutral

## Accounting

Strong evidence of conservatism in accounting

In Appendix 1, we give a detailed review of the accounting adopted by DUKE. We believe market-wide investor interest in having comfort that the approach taken is realistic/conservative has never been higher. The key conclusion we draw from the detail in the Appendix is that DUKE's approaches are conservative, noting actual revenue growth has been ahead of plan and there have been uplifts on equity exits.

The mainstream accounting rules are unhelpful for DUKE's hybrid business. The key points are: i) the FV accounting approach that DUKE is required to adopt introduces significant volatility, and ii) there may be lumpy one-off gains related to equity sales until the portfolio is large and mature enough for such realisations to become business as usual. We expect these to be part of the long-term returns, but, until the portfolio reaches a certain scale, they are likely to be irregular and lumpy.

Cashflow vs. free cashflow

- Management's preferred accounting metric is free cashflow. As the table below evidences, this metric has seen, and is expected to see, steady growth, free from the FV adjustments noise.

Recurring cash

- Management's key other metric is recurring cash. The table below shows how this has evolved in recent periods, and the adjustments made to get to it.

**Total cash revenue and recurring cash revenue (£000)**

| Year-end March | 2019 | 2020 | 2021 | 2022 | 2023 | 2024E | 2025E | 2026E |
|---|---|---|---|---|---|---|---|---|
| Net cash inflows from operations | 4,110 | 6,783 | 8,936 | 11,167 | 17,115 | 22,285 | 24,285 | 29,856 |
| Cash gains from sale of equity investments | 89 | - | - | 2,883 | - | 2,600 | 2,000 | 3,500 |
| Less interest paid on borrowing | (172) | (1,425) | (1,409) | (1,649) | (3,976) | (5,372) | (4,765) | (6,635) |
| Less investment costs | (624) | (548) | (634) | (972) | (357) | (755) | (830) | (913) |
| **Free cashflow** | **3,403** | **4,810** | **6,893** | **11,429** | **12,782** | **18,759** | **20,691** | **25,808** |
| Receipts from royalty investments (from C/F) | 5,097 | 8,977 | 9,931 | 14,701 | 21,364 | 27,325 | 30,051 | 37,088 |
| Receipts of interest from loan investments (from C/F) | 257 | 1,268 | 667 | 580 | 339 | 376 | 413 | 450 |
| Other operating receipts (from C/F) | 309 | 90 | 438 | 543 | 176 | 176 | 176 | 176 |
| **Equity sale receipts** | 89 | | - | 2,883 | - | 2,600 | 2,000 | 3,500 |
| **Total cash revenue** | **5,752** | **10,335** | **11,036** | **18,707** | **21,879** | **30,477** | **32,640** | **41,214** |
| Exit fees (from P&L) | - | - | (1,862) | (714) | - | (3,000) | (2,000) | (2,000) |
| Cash gains on sale of equity invest. (from P&L) | (88) | - | (345) | (2,583) | - | (3,200) | - | - |
| **Recurring cash revenue** | **5,664** | **10,335** | **8,829** | **15,410** | **21,879** | **24,277** | **30,640** | **39,214** |

*Source: DUKE Report and Accounts, Hardman & Co Research*

## ESG

ESG core ahead of and during investment period

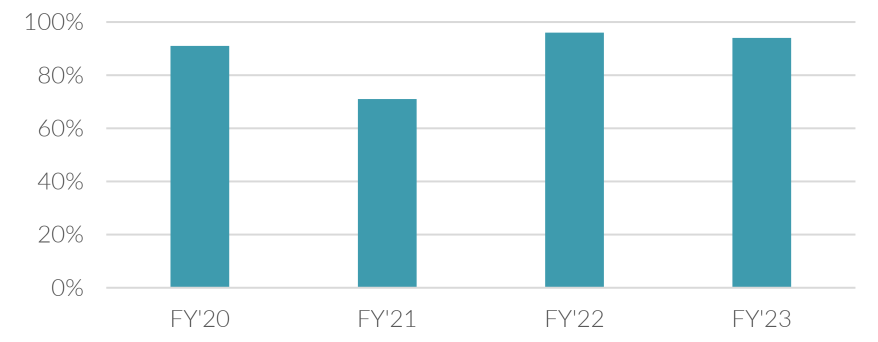
As is to be expected, DUKE has a Responsible Investment Policy, which is detailed here and was last updated in March 2021. We note the comment "*our investment products are structured over decades, we believe that long-term success as a business is directly correlated to the way that business approaches and manages their place relative to environmental, social and governance considerations*". In practice, it means that certain partners are excluded from consideration, ESG is a core part of the due diligence ahead of completing a deal and that, post completion, there is an external ESG assessment to see if further input is required.

## Contractual payments recovered quickly from COVID-19

Quick recovery post pandemic

One measure of the creditworthiness of the borrowers is the way they meet contractual payments due to DUKE. The chart below shows that this has stood at around 95% in recent years and, even in the worst period for the pandemic, was still 71%. The key message from the chart is that a recovery to the normal run rate was seen quickly after the pandemic.

Contractual payments made




*Source: DUKE, Hardman & Co Research*

## Impact of rising rate environment

The rising interest rate environment has a number of consequences:

Inflation increases in borrowing products will see higher income for DUKE on annual adjustment

- To the extent that borrowers can pass on inflationary increases, DUKE's income directly benefits from higher capital payments on the annual adjustments.

DUKE portfolio companies have good debt service cover (FY'23: 2.2x)

- DUKE could, of course, be adversely affected if rising interest rates were to adversely compromise its borrowers' overall financial strength. In FY'22 and FY'23, the portfolio companies' net leverage was 4x, with debt service cover of 2.3x and 2.2x, respectively. We expect a further modest decline in FY'24, with the full-period impact of higher rates. While there is decline from historical levels, debt service is likely to remain well covered.

Low leverage in DUKE balance sheet gives positive gearing to rising rates

- With a balance sheet primarily financed by equity (debt gearing is relatively modest, with a cap at 40% equity as a general rule) and most of the assets adjusting to inflation, there is positive gearing to higher inflation/interest rates.
- Higher rates may reflect a more uncertain macro environment, at which times competitor pricing typically widens. Management highlighted a recent term sheet from a competitor where pricing had widened to an 8% spread over SONIA, a 3.5% arrangement fee, and a 5% compounding PIK, making it much more expensive than DUKE's proposition.

Reduction in spread that DUKE pays will offset nearly half the market rate increase

As an offset to rises in market rates, we note that the spread DUKE has been paying for its own funding has reduced as it has built an increasingly diversified portfolio. The January 2023 refinancing (see here) saw the spread on DUKE's debt financing reduce by 2.25%, from 7.25% to 5%. This offsets nearly half the increase in market rates from their low. On our end-2024 forecast debt levels (£65m), every 1% change in overall financing rates costs/benefits the profit and loss by £0.65m p.a., ca.4.6% of the 2024 pre-tax forecast.

## Loan investments

Two legacy loan investments

The DUKE story is marginally complicated by the presence of two simple loans in its portfolio. These investments may be considered as a legacy issue rather than the strategic ambition. DUKE acquired a business called Capital Step in 2019, and its deals were structured differently from DUKE. The balance of loans has been reducing and, now, there are just £4.6m of loans remaining. Of this, £2.1m was put in place to securitise a £2.1m equity realisation in FY'22, which was deferred. This loan has a zero coupon as it is effectively deferred consideration. No definitive plans have yet been put into place as to the repayment on maturity of both loans, which could be in the form of equity or cash.

## Potential equity raise

Potential equity raise as DUKE close to, but not yet, self-funding

- Funding growth outside DUKE's control
- May see dilution of NAV
- Paying dividends at same time as equity raise is what shareholders want
- Should assist share trading liquidity

As DUKE grows, it will be increasingly close to self-funding but, on our estimates, will need a further equity raise in FY'25. This raises the following considerations:

- ► The funding of growth is outside DUKE's control to the extent that, if equity markets are challenging, it may not be able to raise the funds it wants to at an acceptable price. However, the conditions that are likely to see a sustained weak equity market are also likely to be periods when DUKE's conservative approach to risk means it has less appetite to make new advances. This has been evident in the past 12-18 months.
- ► Dependent on the price, investors may face a dilution of NAV per share. The current price is below the NAV and so an issue today would see such an effect.
- ► At the same time as raising equity, DUKE is paying a healthy dividend and is thus paying away incremental broker issuance fees. In considering this cost, investors should note:
    - o On our forecasts, in FY'24-FY'25, the dividend cost will be ca.£25.8m against £40m of capital raised in FY'25E.
    - o Paying a dividend aligns shareholders returns with the recurring returns generated by the business. As noted above, the largest source of DUKE's revenues and returns is regular coupon payments.
    - o We believe most shareholders have invested for the yield. To change the policy could cause significant and potentially volatile churn in the register.
- ► New issues will allow shareholders to invest larger sums than is readily achievable in the market. In 2023, the average monthly value of shares traded on the LSE was just £3.1m, with an average bargain size of £4,591. The potential volatility in the share price of investors making large purchases is significant. Increasing the free float is also likely to help ongoing share trading liquidity.

# Investment negatives

## Counterparty risk

Counterparty risk core and requires focus, noted earlier. Only loss situation to date -2% IRR.

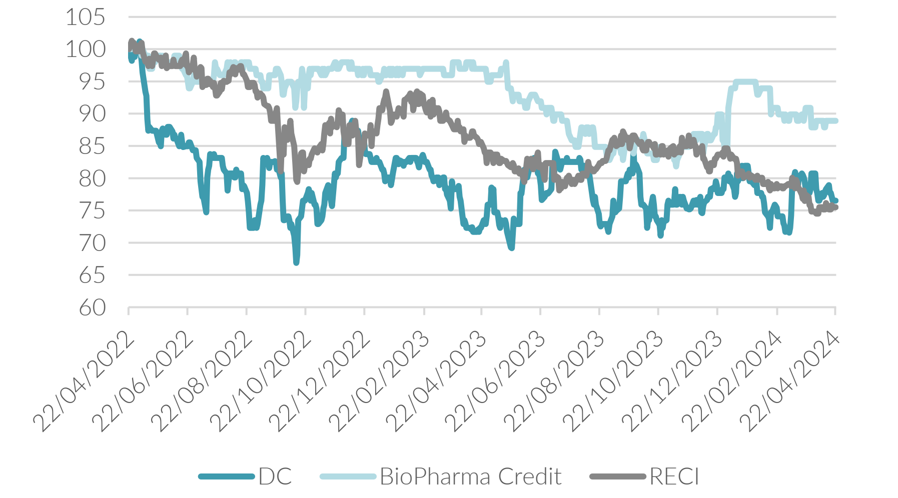
We have reviewed in detail (above) how DUKE manages counterparty risk. However, it is a feature of any financing business that its performance is dependent on the continued health of its customers. Actions can be taken to limit the probability of default and the loss in the event of default, but it remains the key risk. We note that, despite the pandemic and following macroeconomic uncertainty, to date, DUKE has had only one exited investment with a negative IRR, of -2%, and FV losses in FY'20 were recovered in subsequent years.

## Adverse sentiment to many financing businesses

Sentiment to financing companies weak

In a higher-rate environment, with recurring concerns about the risk of a recession, many financing businesses have seen share price weakness. The chart below shows a range of different finance specialists by sector and size, all of which have seen falling share prices over the past two years. In our view, there has been an element of indiscriminate negative sentiment affecting all finance businesses without taking full consideration of the riskiness of their exposures.

**Share price performance of range of specialist lenders over two years, indexed to 100**




*Source: Refinitiv accessed 25/4/24, Hardman & Co Research*

## Dependence on key personnel

Dependence on key personnel

The key executives are given in Appendix 3. However, the dependence on individual personnel is shrinking as the business grows. In FY'23-FY'24, DUKE will have hired three associates to allow the more experienced business development principals to focus on growing the business.

# Investor familiarity with DUKE's hybrid capital offering

As a first-mover, investor knowledge of DUKE's hybrid capital offering limited

DUKE's hybrid capital offering is a different product with different drivers compared with, say, a bank or other finance companies. Additionally, as discussed in the accounting section below, shoehorning a specialist lender into mainstream accounting brings its own nuances. Not only does DUKE provide products that investors may not be familiar with, but also the equity investments can distort reported statutory performance in any given period. Accordingly, we believe investor familiarity with DUKE is relatively low and perceived complexity could be a sentiment concern. In our view, familiarity will breed comfort not contempt, but investors need to be willing to take the time to understand the business.

No competitors for investors to benchmark DUKE

It is telling that *Interactive Investor* lists DUKE's peers as Premier Miton, IP group, Impax Asset Management, Intuitive Investments and Foresight Group. In our view, none of these are actually comparable companies. While this lack of comparative model is not relevant to absolute investors, we believe that most investors like to know how a business compares with peers. Additionally, the time spent getting to know the nuances of the market is a higher sunk cost for a single investment than when it can be spread over several positions. We give some more details of potential comparators in the *Valuations* section below, but we do not believe that any are close enough to credibly assist the understanding of DUKE.

# Illiquid assets

Assets are illiquid with valuation and realisation implications

The contractual term of facilities is, typically, 30 years, making cashflows long term (a key attraction for borrowers) and illiquid. There is not currently a secondary market for hybrid capital payments across DUKE's spectrum of sectors, so any sale would be by bi-lateral agreement. Given it is probable that DUKE would be seen as a willing seller, and due to the limited potential numbers of buyers, in our view, any price is likely to be what may be regarded as a fair value. It is, of course, this very illiquidity that makes DUKE's product unattractive to non-evergreen vehicles, like funds, and very suited to the permanent capital of a listed vehicle.

# Financials

| Cashflow | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Year-end March (£000)** | **2019** | **2020** | **2021** | **2022** | **2023** | **2024E** | **2025E** | **2026E** |
| Receipts from hybrid investments | 5,097 | 8,977 | 9,931 | 14,701 | 21,364 | 27,325 | 30,051 | 37,088 |
| Receipts of interest from loan investments | 257 | 1,268 | 667 | 580 | 339 | 376 | 413 | 450 |
| Other operating receipts | 309 | 90 | 438 | 543 | 176 | 176 | 176 | 176 |
| Operating expenses paid | (1,392) | (2,811) | (2,154) | (2,487) | (3,306) | (4,095) | (4,461) | (4,862) |
| Payments for royalty participation fees | (161) | (168) | (81) | (115) | (112) | (112) | (112) | (112) |
| Tax paid | - | (573) | 135 | (2,055) | (1,346) | (1,385) | (1,781) | (2,884) |
| **Net cash inflow from operating activities** | **4,110** | **6,783** | **8,936** | **11,167** | **17,115** | **22,285** | **24,285** | **29,856** |
| | | | | | | | | |
| Hybrid investments advanced | (25,033) | (20,983) | (22,708) | (74,586) | (23,809) | (36,258) | (61,720) | (77,889) |
| Hybrid investments repaid | | 3,232 | 14,354 | 2,938 | - | 29,000 | 16,350 | 17,194 |
| Loan investments advanced | (3,057) | (2,661) | (1,145) | (3,192) | (2,500) | (2,500) | (2,500) | (2,500) |
| Loan investments repaid | | - | 2,370 | 3,949 | 2,000 | 2,000 | 2,000 | 2,000 |
| Equity investments purchased | | - | (653) | (530) | (500) | - | - | - |
| Equity investments sold | 89 | | - | 2,883 | - | 2,600 | 2,000 | 3,500 |
| Equity dividends received | | | - | - | 3 | - | - | - |
| Payment for acquisition of subsidiaries | (4,274) | (321) | | | | - | - | - |
| Business combination costs | (268) | | | | | - | - | - |
| Receipt of deferred consideration | | | - | 7,679 | - | - | - | - |
| Investments costs paid | (624) | (548) | (634) | (972) | (357) | (755) | (830) | (913) |
| **Net cash outflow from investing activities** | **(33,167)** | **(21,281)** | **(8,416)** | **(61,831)** | **(25,163)** | **(5,912)** | **(44,700)** | **(58,608)** |
| | | | | | | | | |
| Proceeds from share issue | 44,010 | 17,454 | - | 35,000 | 20,000 | - | 40,000 | - |
| Share issue costs | (2,398) | (1,048) | (1) | (1,936) | (1,115) | - | (2,070) | - |
| Dividends paid | (4,023) | (6,013) | (3,013) | (7,270) | (10,979) | (11,802) | (13,887) | (14,950) |
| Proceeds from loans | 3,500 | 16,250 | 15,200 | 38,200 | 71,250 | (3,930) | 5,000 | 55,000 |
| Loans repaid | (9,109) | (11,650) | (13,926) | (7,500) | (61,450) | - | - | - |
| Interest Paid | (172) | (1,425) | (1,409) | (1,649) | (3,976) | (5,372) | (4,765) | (6,635) |
| Other finance costs | | (534) | (95) | (181) | (2,426) | - | - | - |
| **Net cash inflow from financing activities** | **31,808** | **13,034** | **(3,244)** | **54,664** | **11,304** | **(21,103)** | **24,278** | **33,414** |
| | | | | | | | | |
| **Net (decrease)/increase in cash and cash equivalents** | **2,751** | **(1,464)** | **(2,724)** | **4,000** | **3,256** | **(4,731)** | **3,863** | **4,662** |
| | | | | | | | | |
| Cash and cash equivalents at beginning of period | 3,165 | 5,894 | 4,481 | 1,766 | 5,707 | 8,939 | 4,208 | 8,072 |
| Forex effects | (22) | 51 | 9 | (59) | (24) | | | |
| Cash and cash equivalents at end of period | 5,894 | 4,481 | 1,766 | 5,707 | 8,939 | 4,208 | 8,072 | 12,734 |
| | | | | | | | | |
| **Cash revenue** | **5,752** | **10,335** | **11,036** | **18,707** | **21,879** | **30,477** | **32,640** | **41,214** |
| **Recurring cash revenue** | **5,664** | **10,335** | **8,829** | **15,410** | **21,879** | **24,277** | **30,640** | **39,214** |
| **Free cashflow** | **3,403** | **4,810** | **6,893** | **11,429** | **12,782** | **18,759** | **20,691** | **25,808** |

*Source: DUKE Report and Accounts, Hardman & Co Research*

## Profit and Loss

| Year-end March (£000) | 2019 | 2020 | 2021 | 2022 | 2023 | 2024E | 2025E | 2026E |
|---|---|---|---|---|---|---|---|---|
| Hybrid investment income | 5,611 | (2,994) | 19,344 | 18,037 | 28,266 | 30,382 | 31,628 | 39,121 |
| Loan investment income | 256 | 1,235 | 636 | 533 | 339 | 376 | 413 | 450 |
| Impairment loss on loan investments | - | (2,947) | - | - | - | - | - | 0 |
| Equity investment income | 65 | (670) | 1,569 | 9,678 | 2,212 | 750 | 2,000 | 2,000 |
| Other operating income | 209 | 90 | 93 | 543 | 176 | 176 | 176 | 176 |
| **Total income** | **6,141** | **(5,286)** | **21,642** | **28,791** | **30,993** | **31,684** | **34,217** | **41,746** |
| Transaction costs | (983) | (448) | (447) | (631) | (66) | (73) | (80) | (88) |
| Due diligence costs | (526) | (95) | (103) | (1,113) | (620) | (682) | (750) | (825) |
| Hybrid participation fees | (432) | - | - | - | - | - | - | - |
| Total investment costs | (1,941) | (543) | (550) | (1,744) | (686) | (755) | (830) | (913) |
| Administration and personnel | (651) | (1,725) | (1,675) | (2,060) | (2,627) | (3,250) | (3,575) | (3,933) |
| Legal and professional | (509) | (584) | (367) | (405) | (456) | (550) | (578) | (606) |
| Other operating costs | (203) | (471) | (99) | (151) | (223) | (275) | (289) | (303) |
| Expected credit losses | | - | - | (72) | (20) | (20) | (20) | (20) |
| Share-based payments | (483) | (409) | (806) | (930) | (969) | (1,150) | (1,380) | (1,656) |
| **Total operating costs** | **(1,846)** | **(3,189)** | **(2,947)** | **(3,618)** | **(4,295)** | **(5,245)** | **(5,841)** | **(6,518)** |
| **Operating profit** | **2,354** | **(9,018)** | **18,145** | **23,429** | **26,012** | **25,684** | **27,546** | **34,315** |
| Net foreign currency movement | (42) | 246 | (542) | (60) | 66 | - | - | - |
| Finance costs | (396) | (1,607) | (1,539) | (1,996) | (5,644) | (5,372) | (4,765) | (6,635) |
| **Profit before tax** | **1,916** | **(10,379)** | **16,064** | **21,373** | **20,434** | **20,312** | **22,781** | **27,680** |
| Taxation expense | (119) | 1,481 | (2,111) | (982) | (842) | (1,727) | (1,936) | (2,353) |
| **Profit after tax** | **1,797** | **(8,898)** | **13,953** | **20,391** | **19,592** | **18,586** | **20,845** | **25,327** |
| | | | | | | | | |
| No shares (exc. treasury) | 163 | 214 | 243 | 342.8 | 398.0 | 419.5 | 479.7 | 537.9 |
| **EPS (p)** | **1.10** | **(4.16)** | **5.75** | **5.95** | **4.92** | **4.43** | **4.35** | **4.71** |
| **Adjusted EPS (p)** | **1.83** | **2.44** | **2.70** | **3.81** | **3.13** | **4.15** | **4.06** | **4.44** |
| **DPS (p)** | **2.7** | **2.9** | **2.25** | **2.25** | **2.8** | **2.8** | **2.8** | **3.0** |

*Source: DUKE Report and Accounts, Hardman & Co Research*

## Balance sheet

| @ 31 March (£000) | 2019 | 2020 | 2021 | 2022 | 2023 | 2024E | 2025E | 2026E |
|---|---|---|---|---|---|---|---|---|
| Goodwill | 203 | 203 | 203 | 203 | 203 | 203 | 203 | 203 |
| DUKE's hybrid capital offering investments | 61,989 | 59,435 | 71,107 | 139,648 | 158,540 | 171,998 | 217,529 | 273,529 |
| Loan investments | 8,993 | 4,418 | 4,370 | 3,172 | 4,652 | 5,152 | 5,652 | 6,152 |
| Equity investments | 1,178 | 507 | 3,495 | 10,820 | 13,529 | 11,279 | 11,279 | 9,779 |
| Trade and other receivables | 0 | - | 5,618 | 2,141 | - | - | - | - |
| Deferred tax assets | 0 | 675 | 158 | 156 | 200 | 200 | 200 | 200 |
| **Total non-current assets** | **72,363** | **65,238** | **84,951** | **156,140** | **177,124** | **188,832** | **234,863** | **289,863** |
| DUKE's hybrid capital offering investments | 8,065 | 16,124 | 14,194 | 20,831 | 32,793 | 32,793 | 39,352 | 47,222 |
| Loan investments | 632 | 5,099 | 580 | 1,000 | - | - | - | - |
| Trade and other receivables | 178 | 142 | 4,422 | 53 | 2,290 | 1,000 | 1,000 | 1,000 |
| Cash and cash equivalents | 5,894 | 4,481 | 1,766 | 5,707 | 8,939 | 4,208 | 7,899 | 12,376 |
| Current tax assets | 0 | 567 | - | - | 373 | - | - | 0 |
| **Total current assets** | **14,769** | **26,413** | **20,962** | **27,591** | **44,395** | **38,001** | **48,251** | **60,598** |
| **Total assets** | **87,132** | **91,651** | **105,913** | **183,731** | **221,519** | **226,833** | **283,114** | **350,461** |
| | | | | | | | | |
| Royalty debt liabilities | 173 | 133 | 114 | 160 | 154 | 154 | 154 | 154 |
| Trade and other payables | 714 | 318 | 267 | 423 | 433 | 433 | 433 | 433 |
| Borrowings | 326 | 172 | 161 | 362 | 441 | 441 | 441 | 441 |
| Current tax liability | 248 | - | 1,163 | 87 | 0 | - | - | 0 |
| **Total current liabilities** | **1,461** | **623** | **1,705** | **1,032** | **1,028** | **1,028** | **1,028** | **1,028** |
| Royalty debt liabilities | 1,193 | 1,040 | 917 | 951 | 988 | 988 | 988 | 988 |
| Trade and other payables | 440 | 431 | 402 | 1,067 | 1,314 | 2,624 | 7,810 | 8,310 |
| Borrowings | 11,365 | 15,517 | 17,103 | 47,740 | 53,930 | 50,000 | 55,000 | 110,000 |
| Tax | 565 | | | | | | | |
| **Total non-current liabilities** | **13,563** | **16,988** | **18,422** | **49,758** | **56,232** | **53,612** | **63,798** | **119,298** |
| Share capital | 102,044 | 118,479 | 120,870 | 153,974 | 172,939 | 172,939 | 210,869 | 210,869 |
| Share-based payment reserve | 333 | 742 | 1,548 | 2,478 | 3,447 | 4,597 | 5,977 | 7,633 |
| Warrant reserve | 265 | 265 | 265 | 265 | 3,036 | 3,036 | 3,036 | 3,036 |
| Retained losses | (30,534) | (45,446) | (36,897) | (23,776) | (15,163) | (8,379) | (1,594) | 8,597 |
| **Total equity** | **72,108** | **74,040** | **85,786** | **132,941** | **164,259** | **172,193** | **218,288** | **230,135** |

*Source: DUKE Report and Accounts, Hardman & Co Research*

# Valuation

Range of valuation approaches, including GGM, DCF and DDM

Average of all is 51.6p

We apply a range of different valuation approaches below and give some of the key sensitivities to our assumptions. Our Gordon Growth Model (GGM) indicates a fair value of 47.0p, the discounted cashflow model (DCF) 71.1p and the dividend discount model (DDM) 36.9p. We believe the differences in strategy and business model make comparisons, with even the closest listed peers, of limited value.

## GGM

GGM valuation, at 47.0p, captures value added and growth

We believe the GGM recognises well both the growth prospects and value added by a business. In essence, it looks at whether a business is adding value over its cost of capital, and recognises that a growing, profitable business has more value than a stable business. The calculation is: price-to-book value (P/BV) = (return on equity (RoE) – Growth (G))/(cost of equity (CoE) – Growth (G)). Thus, if a business earns a 15% RoE, has a 10% CoE and is growing at 5% p.a., it should trade at 2x P/BV (i.e. (15-5)/(10-5)). All of the return, cost and growth assumptions should be long-term, sustainable measures, and there can be an adjustment when short-term performance differs from the long-term assumptions.

Looking at DUKE, our assumptions are:

14% RoE; i.e. we expect value added

- **RoE:** In essence, we believe it will add value to shareholders and earn returns above its cost of capital. The company target is mid-teen RoE. In deciding on 14%, we considered:
    - it is in line with the average of the actual RoE earned in 2021-23. Arguably, this could be increased as the business grows and so gains the operational efficiencies we noted in the bull point 2 section, above.
    - 14% also looks appropriate in light of likely IRRs. If we consider the chart on page 7 – the gross IRR target, before costs and interest expense and equity kickers, is ca.20%. This needs to be reduced for costs (FY'23 2.5% average total assets but forecast to fall to 1.9%), finance costs (our forecasts assume approximately one third debt-to-equity gearing, which, on current interest rates, would reduce returns by ca.4%) and the fact that part of the gross IRR is effectively paying down principal.

12% CoE, as GGM based off long-term assumptions

- **CoE:** We believe a market-based capital asset pricing model (CAPM), based off a risk-free rate and equity-risk premium, is likely to have a cost of equity (CoE) in the low teens. We note the individual assets on the hybrid capital investment portfolio are discounted at rates of 14.0%-17.7%, but there should be some reduction to this for DUKE itself, given portfolio benefits.

Modest growth to perpetuity of 5%

- **Growth:** We assume a growth rate of 5%. This is clearly above the level that is probable out to perpetuity, as it suggests a business growing faster than UK GDP, but we are comfortable that this reasonably reflects both the near- and medium-term opportunities.

- **Discount/premium re near-term performance:** In the short term, the organic growth in equity is in line with our long-term average expectations. However, the return on equity is averaging 10% (FY'25E: 26%) after 8% in FY'24E. Overall, therefore, we have applied a 10% discount for near-term performance against forecasts.

| GGM and key sensitivities | Base | +1% RoE | +1% CoE | +0.5% G |
|---|---|---|---|---|
| RoE | 14 | 15 | 14 | 14 |
| CoE, post-tax | 12 | 12 | 13 | 12 |
| G | 5 | 5 | 5 | 6 |
| P/BV (x) | 1.3 | 1.4 | 1.1 | 1.3 |
| Disc./prem. re near-term performance | -10% | -10% | -10% | -10% |
| P/BV (x) | 1.2 | 1.3 | 1.0 | 1.2 |
| BV Mar'25E (p/sh) | 40.6 | 40.6 | 40.6 | 40.6 |
| Valuation (p/sh) | 47.0 | 52.2 | 41.1 | 48.7 |
| Variance (p/sh) | | 5.2 | -5.9 | 1.7 |

*Source: Hardman & Co Research*

## DDM

**DDM valuation 36.9p**

We explicitly forecast dividends out to 2027, at which stage we then apply the same growth as for the GGM for a 20-year model. We then apply a multiple of 20 to establish the terminal value. We have used the cost of capital to determine the discount rate to all dividends. Using these assumptions, the implied valuation on the DDM is 36.9p. The terminal value accounts for 29% of the total value. In terms of sensitivity to assumptions, an 11% CoE (rather than our 12% base) would imply a value of 41.6p.

## DCF

**DCF valuation 71.1p**

A DCF analysis is complicated by DUKE, as is the case for any lender, needing to use cash as its working capital. For the purposes of valuation, therefore, we take our forecast "net cash inflow from operating activities," but we deduct 3.3% of the hybrid capital portfolio as a proxy for the cash required to fund the balance sheet. Having taken the explicit estimates for 2024-26, we then grow them at our standard growth rate to 2041, before applying a terminal value (again 20x) and discounting at our CoE (12%). The terminal value accounts for 30% of the value (pre-balance sheet allocation). In terms of sensitivity to assumptions, an 11% CoE, the value would be 80.6p.

## "Peer" companies

**For what it is worth, DUKE appears to be in the middle of the peer ratings range**

We do not believe that DUKE has any directly comparable peers. Looking at a wider group where the businesses have some similarities:

Specialist SME lenders/product providers would include names like Time Finance, Orchard Funding (specific issues affecting this company), or Funding Circle. None of these businesses has the equity-like properties within DUKE's product and appear weak comparators.

Intermediate Capital has some similarity in that it provides hybrid capital, but the business mix, scale, target customer base and inclusion in benchmark indices all make it a very different investment proposition.

In terms of the closest North American corporate royalty companies, we recommend that investors treat the following with a high degree of caution given the range of valuations and different product offering. Alaris is currently trading on a forward PE of 8.3x and Diversified Royalty 13.8x (DUKE on 7.2x, on our forecasts). The former has a current dividend yield of 8.7%, the latter 9.0%, against DUKE's 9.0%.

# Appendices

## Appendix 1: valuation of assets

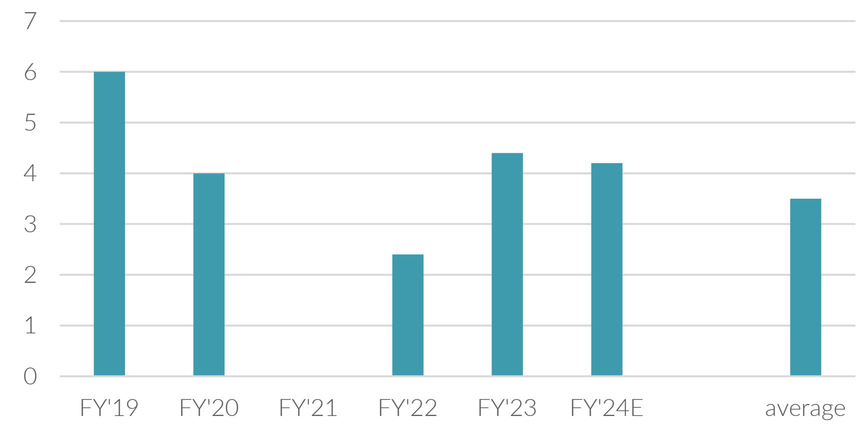
We believe that investor focus on the valuation of private assets in listed companies has never been higher. While, by its nature, not simple (DUKE's unique position means that some accounting principles were better designed for other businesses), we believe its approaches are both sensible and realistic and there is sufficient disclosure for investors to flex the numbers to their own assumptions, if desired.

### *Hybrid capital investments*

The key assets to value are the hybrid capital investments. As noted in the section *What DUKE does*, above, facilities, typically, are granted by way of a term loan and preference share. This is fair valued, as on a consolidated basis (not the two separately) using a discounted cashflow analysis. The key variables are:

- The initial assessment of fair value takes account of three years explicit forecasts for the company revenue followed by inflation-like growth (typically 2%). The forecasts are taken from the base case scenario in the investment thesis (which also includes the management scenario and a stress test).
- Annual adjustment:
    - At each annual review, the following three-year forecast revenue is explicitly included and there may be a FV uplift if the final year of this plan has faster revenue growth than the previously assumed inflation increases. The forecasts are company-specific and, in most years, the range has been the full -6% to +6%. In FY'22, it was somewhat higher (+1.8% to +6%), reflecting a COVID-19 bounce-back effect. The range (+6% to -6%) reflects the spread of expectations on individual customers – as DUKE grows its customer numbers, it is more probable there will be outliers generating the extremes of this range.
    - The valuation is also adjusted for the actual performance in the year against plan.
        - To date, the base case scenario used in the initial valuation has been consistently conservative. This has resulted in positive fair value adjustments as actual performance has been ahead of plan. The chart below shows the average increases across the portfolio, which is nearly double the 2% long-term inflation assumption. This is despite the effects of the pandemic. Given the experience to date, we understand that management believes a positive variance in the first years of each new facility is likely.
        - The actual performance against plan adjustment introduces some cyclical volatility into the FV process. Periods of macro uncertainty leading to a below-plan actual performance may then be recouped in the subsequent period of recovery with above-plan performance. By way of example, the 2020 FV writedowns were driven by a swing in the adjustment rates on account of COVID-19 when the majority of businesses suffered a fall in revenue, with many workplaces shut down for three months. Losses were then recovered in FY'21-FY'22, as there were a slew of +6% adjustments.

Portfolio average annual growth in customer revenue (%)




*Source: DUKE, Hardman & Co Research*

- As an offset to these positive factors, should a facility run its entire course, there is no capital repayment at the end. The fair value would thus trend to zero. In the initial stages of a facility, the amortisation adjustment is small with an increasing impact expected over the life of the facility.

- The table below shows the range of discount rates applied in recent years. These rates are determined by company-specific factors and, typically, do not vary that much for each customer. The low-high range reflects which companies are in the portfolio rather than changes to specific facilities. The fall in the upper end of discount rates is due to Capital Step investments, which had significantly higher discount rates, as they were, generally speaking, higher-yielding products. As these facilities have been repaid/restructured, the exposures at the upper end of the range of discount rates are removed. It is not a reflection of a change in accounting by DUKE. The impact of a change in the discount rate is also in the table. The increased nominal sensitivity reflects book growth.

Range of discount rate assumption in hybrid capital investment valuations (%)

| | FY'19 | FY'20 | FY'21 | FY'22 | FY'23 |
|---|---|---|---|---|---|
| Low | 12.4 | 13.9 | 14.8 | 14.8 | 14.7 |
| High | 18.8 | 23.6 | 17.4 | 17.4 | 17.7 |
| Impact of +25bp (£m) | (0.9) | (0.8) | (1.1) | (2.2) | (2.2) |

*Source: DUKE Report and Accounts, Hardman & Co Research*

- From an accounting perspective, DUKE assumes facilities are held to term; however, in reality, it expects them to be bought out at some point. There is a three-year, non-call covenant, except if there is a change of control, as DUKE does a lot of work upfront and doesn't want to be treated as a bridge loan. The most likely period to being bought out is at any time from years three to 10.

- The investments are not going to be valued above cost + exit fee, so there is a cap (of ca.20% above cost) to the aggregate FV adjustments. If, for example, the revenue growth was 6% for five years instead of the 2% built into the initial valuation, then any further outperformance would not be reflected in a FV uplift.

Looking at the significance of the FV adjustments, we detail in the table below the drivers to change in investment portfolio value over recent years. The factors include new agreements, repaid ones and changes in fair value. By far, the biggest driver is additions (FY'19-FY'23: £188m) with the cumulative fair value adjustments being £7.5m.

| Change in hybrid capital investment portfolio (£000) | FY'19 | FY'20 | FY'21 | FY'22 | FY'23 |
|---|---|---|---|---|---|
| Opening | 23,569 | 70,054 | 75,559 | 85,301 | 160,479 |
| Additions | 45,793 | 20,983 | 22,708 | 74,586 | 23,809 |
| Buybacks | - | (3,233) | (21,434) | (2,939) | - |
| Profit at FVTPL | 692 | (12,245) | 8,468 | 3,531 | 7,045 |
| Closing | 70,054 | 75,559 | 85,301 | 160,479 | 191,333 |

*Source: DUKE Report and Accounts, Hardman & Co Research*

For forecasting purposes, the FV change we have assumed is 1% of opening asset valuation to reflect the conservative initial expectations being beaten by actual performance, and an increasing element of amortisation on historical positions. Investors should note that this is a very theoretical number as macro conditions and company-specific performance will be the drivers in any given period. A regular 1% return is a very unlikely outcome.

### *Equity investments*

The range of assumptions and sensitivity is given below. For businesses that are expected to show reasonable growth, these do not appear unreasonable and are based on "market transactions". Where possible, DUKE tries to find comparable market transactions, preferably private market ones. Where this is not possible, it looks at listed market transactions and multiples, and applies a discount. Management also advises that if it were to get to a point where an individual equity stake became material, it would be likely to use a third party to value them. An overvaluation, followed by a writedown, would be unwelcome. The management rating is overlaid by auditor and board valuation checks. We understand the exits, to date, have been above carrying values. Overall, we consider this a very tried and tested methodology, which has proven to be conservative.

| Range of EBITDA assumptions in equity investment valuations (x) | FY'21 | FY'22 | FY'23 |
|---|---|---|---|
| EBITDA low | 5.7 | 5.0 | 5.3 |
| EBITDA high | 9.25 | 7.8 | 10.0 |
| Impact of + 1 multiple in current year EBITDA (£m) | 0.4 | 1.6 | 1.4 |
| Impact of + 1 multiple in forward year EBITDA (£m) | 0.8 | 1.7 | 1.6 |

*Note: pre-FY'21 not disclosed as not material, Source: DUKE Report and Accounts, Hardman & Co Research*

There has been an element of volatility in the valuation of equity investments. FV gains (cumulative FY'19-FY'23: £12.7m) are ca.3x the whole investment cost (£4m) and already realised gains of £3m nearly equate to it. The table below shows the changes in the valuation of the portfolio (the realised gain shows as a loss in the table because, on exit of a position, the portfolio is reduced in value).

| Change in equity investment portfolio (£000) | FY'19 | FY'20 | FY'21 | FY'22 | FY'23 |
|---|---|---|---|---|---|
| Opening | - | 1,177 | 507 | 3,495 | 10,820 |
| Additions | 1,200 | - | 1,764 | 530 | 500 |
| Repayments | | - | | (300) | - |
| Realised gains (deducted from portfolio value on exit) | | - | (345) | (2,583) | - |
| Profit at FVTPL | (23) | (670) | 1,569 | 9,678 | 2,209 |
| Closing | 1,177 | 507 | 3,495 | 10,820 | 13,529 |

*Source: DUKE Report and Accounts, Hardman & Co Research*

# Appendix 2: summary of exited deals

Summary of exited hybrid capital partners

| Partner | Sector | Use of capital | IRR (%) |
|---|---|---|---|
| BHP Insurance | Financials | Management buyout | 29 |
| Welltel | Telecoms | Buy-and-Build and debt refi. | 27 |
| extremepush | IT | Buy-and-Build | 22 |
| Temarca BV (+Carmen, Verdi &Rigoletto) | Leisure | Growth capital and debt refi. | (2) |
| Berkley | Recruitment | Management buyout | 16 |
| Fairmed Healthcare AG | Healthcare | Growth capital | 19 |
| Fabrikat | Manufacturing | Management buyout | 36 |
| Instor | Business services | Management buyout | Triple digit |

*Source: Hardman & Co Research*

# Appendix 3: company matters

### *Registration*

Duke Capital Limited is a company limited by shares, incorporated in Guernsey under the Companies (Guernsey) Law, 2008.

### *Directors, management and investment committee*

The biographies of key staff can be found here with a brief summary below:

## Board of Directors

### *Nigel Birrell – Non-executive Chairman*

Nigel Birrell is a Non-Executive Director and Chairman of the company and works with the Executive Directors on deal origination and overall strategy. He has extensive public company experience and investment banking expertise in the gaming, media, banking and insurance sectors.

### *Neil Johnson – Executive Director, Chief Executive Officer*

Neil Johnson is an Executive Director and DUKE's Chief Executive Officer with responsibility for the overall strategic direction and performance of the company. Working closely with the other board members and the Investment Committee, he leads all deal origination, due diligence and structuring. Mr. Johnson has over 30 years of experience in investment banking, merchant banking, and research analysis in both the Canadian and UK capital markets. He ran investment banking at Canaccord Genuity and founded a Canadian-listed investment company previously.

### *Charles (Charlie) Cannon Brookes – Executive Director, Chief Investment Officer*

Charlie Cannon Brookes is an Executive Director of the company and is focused on deal origination, due diligence, execution and monitoring as well as UK plc responsibilities. Charlie has over 20 years investment experience and has advised and sat on the boards of several different funds, trusts and other publicly traded investment companies.

### *Matthew Wrigley – Non-Executive Director*

Matthew is a non-executive director and legal consultant, with a 20-year career in a variety of legal, compliance and commercial roles. He also sits on several fund and general partner boards, with strategies spanning private equity, infrastructure and real estate.

### *Maree Wilms – Non-Executive Director*

Maree Wilms is a Non-Executive Director of the company. She is responsible for the oversight of the company's corporate obligations in Guernsey. Maree brings extensive corporate governance, fund management and structuring experience to the group. She is co-founder and CEO of Zeta Asset Management ICC Limited ("Zeta"), a Guernsey-domiciled entity specialising in the creation of regulated asset management companies in Guernsey and fund structures across offshore jurisdictions.

## Key management

### *Hugo Evans – CFO*

Hugo Evans is responsible for all of DUKE's finance and treasury operations and has oversight of DUKE's corporate governance and UK plc responsibilities. Prior to joining Duke, Mr. Evans spent two years as the Group Finance Director of Kingswood Wealth Group, an AIM-Listed retail wealth management business. Before KWG, he spent six years at boutique fund management firm Ocean Dial Asset Management.

## Investment Committee

In addition to Neil Johnson and Charlie Cannon Brookes, the Investment Committee comprises:

### *Jim Webster – Independent chair of committee*

From 2017 until 2021, Mr. Webster was the Chief Investment Officer of Duke Capital. Prior to joining the company, between 2003 and 2009, he was Managing Partner and Chair of the Investment Committee for Capital Royalty Partners LLC (now CRG L.P.), and, from 1993 and 2002, was a senior member of the world's first public pharmaceutical-based royalty company, listed on the Toronto Stock Exchange.

### *Andrew Carragher – member*

Andrew Carragher is a Founder and Managing Director of DW Healthcare Partners, a private equity company. DW Healthcare Partners has invested in 44 healthcare companies to date and currently manages more than $1.6bn in institutional capital across six funds.

### *Justin Cochrane – member*

Justin Cochrane is a member of DUKE's Investment Committee. He works with the Executive Directors on deal origination and structuring. Mr. Cochrane is the founder and CEO of Carbon Streaming Corporation, listed on the Cboe Canada, and

President of Nickel 28 Capital Corp. Prior to this, Mr. Cochrane was a key part of Sandstorm's team as it grew into one of the largest royalty and stream financing companies in Canada.

### *John Romeo – member*

John is a Managing Partner with Oliver Wyman. He founded and leads Oliver Wyman's Private Capital business, working with leading Private Equity funds, family offices and alternative asset managers on business model strategy, deal generation, diligence and value creation. He also leads the Oliver Wyman Forum, the firm's platform for engaging key business, public policy and societal leaders to act on shared challenges.

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