HARDMAN & CO.

18 November 2024

DUKE CAPITAL

Taking Duke Capital to the next level

In our April 2024 *initiation*, we highlighted that DUKE, by optimising the best of equity and debt, aimed to achieve equity-type returns with debt levels of risk. We highlighted four pillars of returns, namely: i) term credit; ii) participating preference shares, which support DUKE's high, covered and growing dividend yield (2025E 10.0%, 2026E 10.7%, 2027E 11.4%); iii) early exit fees; and iv) equity stakes. Here, we update investors on how management will take DUKE to the next level, noting i) a £20.2m+ equity issue to fund short-term growth, and ii) the progress made towards a third-party capital model, negating the need for further raises.

- **Equity raise:** Instead of the £40m raise we had been forecasting in FY'26, DUKE seeks to raise £20.2m+ now, and indicates greater confidence that further issues will not be necessary. The risk of dilution is thus lower than it was before this announcement. The current raise is to fund expected client buy-and-build deals.
- **Third-party capital model:** Using third-party capital potentially brings revenue, gearing, risk, liquidity, capital and income benefits. The constraint, to date, has been that DUKE's innovative product was little known. As a track record has been built, confidence has grown, and DUKE has made significant progress.
- **Valuation:** The FY'25E dividend yield is 10.0%. On the assumptions outlined in the *initiation* report, our valuation approaches indicate GGM 44.2p, discounted cashflow 72.3p, and dividend discount 43.1p, with an average of 53.2p against the current share price of 28.1p.
- **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 thus 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)	2022	2023	2024	2025E	2026E	2027E
Total cash revenue	18.7	21.9	30.3	26.9	38.6	41.8
Recurring cash revenue	15.4	21.9	24.3	26.9	31.6	34.8
Free cashflow	11.4	12.8	17.9	13.2	22.4	24.0
Accounting pre-tax	21.4	20.4	12.3	17.3	24.1	25.6
EPS (p)	5.95	4.92	2.81	3.67	4.59	4,88
DPS (p)	2.3	2.8	2.8	2.8	3.0	3.2
Hybrid capital assets	160	191	211	235	262	314
Equity investments	11	14	16	19	18	18
Cash	6	9	3	23	17	4
Shareholders' funds	133	164	165	189	199	210
PER	4.7	5.7	10.0	7.6	6.1	5.8
Dividend yield	8.0%	10.0%	10.0%	10.0%	10.7%	11.4%

Source: Hardman & Co Research

Financials

Source: LSEG, 2024

Market data

EPIC/TKR	**DUKE**
Price (p)	**28.1**
12m high (p)	35.5
12m low (p)	26.95
Shares inc. Treasury (m)	421.5
Mkt cap (£m)	118.4
EV (£m)	188.8
Free float*	79.07%
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

www.dukecapital.com
www.dukecapital.com/investors

Key shareholders (30 Sep'24)

Retail on Hargreaves Lans. II, AJ Bell and HSDL platforms	31.97%
M&G	8.60%
Gresham House	6.29%
Allianz Global	5.57%
GLG	5.02%
Chelverton	3.65%
Directors (shares only)	4.52%

Diary

12 Dec	Interim Results

Analyst

Mark Thomas mt@hardmanandco.com

Theme 1: equity raise to fund short-term growth

Equity-raising details

Less dilution than expected – DUKE raising £20.2m+ now vs. our forecast £40m in FY'26. Short-term funding for identified M&A for customers. In longer term, more confidence in third-party capital.

We had been expecting a £40m share issue in FY'26 (year to March 2026); however, DUKE has announced that it aims to raise £20.2m+ now, through the issue of shares at 27.5p.

- The reason for the raise going ahead before we had expected is that existing customers (*inter alia*, BPVA, United Glass Group and Tristone Healthcare) have advanced their buy-and-build strategies, and there are identified targets.
- The lower amount being raised reflects increasing confidence in the third-party capital opportunities (see Theme 2).

Open to institutional and retail investors…

The issue is being structured as both an institutional and retail offering (nearly a third of the existing shares are held on four retail platforms only). Full details are available on RNS: *Placing, Subscription & Broker Option*, *Retail Offer to raise up to £3.0 million via Bookbuild Platform* and the *Result of placing*. In summary:

- The placing and subscription:
  - A placing has been conducted by way of an accelerated bookbuild process which started on 14 November 2024 with the results announced on 15 November. This raised gross proceeds of £17.2m, an over-subscription against the announced target of £15m+.
  - Directors (and related parties) subscribed for 2.9m shares of the total 62.5m shares under this part of the equity raise.
- The broker option:
  - There is a broker option to the joint brokers, offering other institutional investors and private client brokers the opportunity to participate in the fundraising at the issue price, following the closing of the accelerated bookbuild, up until midday on Friday 22 November 2024.
- The retail offer:
  - A retail offer has been launched to raise up to an additional £3m, to enable other retail investors to participate in the fundraising at the issue price up until midday on Friday 22 November 2024. Investors should note that financial intermediaries may have earlier closing times, and the retail offer may close early if it is oversubscribed.
  - DUKE is making the retail offer available in the United Kingdom through the financial intermediaries which will be listed, subject to certain access restrictions, at the following link: *Authorised intermediaries*.
  - Existing retail shareholders can contact their broker or wealth manager to participate in the retail offer. Each intermediary must be on-boarded onto the BookBuild platform.

...and will allow extra £10m debt

We note that the equity raise will mean that DUKE can draw down the final £10m of its debt facility and so has an incremental £25m firepower.

Volume growth and upside for DUKE from accretive client M&A

Modest growth recently, with DUKE taking cautious approach to new customers

While DUKE has made a number of advances to existing customers and one new borrower, it has also seen redemptions. Additionally, DUKE has been cautious regarding new customer growth, reflecting the market-wide economic and political uncertainties. This has resulted in low, double-digit percentage annual growth in hybrid credit finance investments in FY'23 and FY'24. We had expected this to continue for a while and, so previously, built in an equity raise in FY'26.

Number of existing clients (lower risk than new ones) advancing buy-and-build strategies, potentially bringing many benefits to DUKE

The reason for the equity raise happening now is that a number of clients have become more active in M&A. DUKE is confident that these buy-and-build strategies will add value. We note that a number of listed private-equity companies have also highlighted this opportunity, especially in the small-/mid-market areas where DUKE's clients operate. If customers' financials are improved, this has a range of benefits for DUKE, including:

- more advances generating revenue;
- lower risk of default;
- more debt repayments (with exit premiums);
- uplifts in carrying equity value, based off higher earnings;
- higher equity exit uplifts, as customers are larger, more profitable businesses; and
- DUKE has operational leverage with operational expenses, as a percentage of revenue; in FY'24, just over half the level seen in FY'20. Accelerated volume growth, therefore, has a very positive impact on earnings growth.

Rapid deployment expected

We understand that around half of the amount being raised is for identified targets, many of which appear to be well advanced in their discussions. The residual amounts appear likely to be deployed in relatively quick order.

Investors' concerns addressed with equity raise

Page 25 of our initiation noted the risks and benefits of DUKE raising more equity. Taking some of the risks:

All investors will be able to participate in equity raise

- To address the concern that an issue below NAV is dilutive to existing shareholders, DUKE has included a retail element of the offering, so that ALL its existing holders can participate. With the option to buy shares in the issue, investors' dilution risk is reduced.

Lower amount raised than we had previously forecast, reducing dilution effect

- By raising £20.2m+ now, rather than £40m in our FY'26E, DUKE has actually reduced the risk of dilution.

Probability of future raises reduced

- The prospect that this issue becomes just one of a steady flow of raises, with the risk of ongoing dilution, should moderate given the company's statements on moving towards a more balanced asset management business model and balance sheet (see Theme 2). This strategic shift means that DUKE becomes self-funding much sooner.

- As we noted in our initiation, DUKE believes that most investors value the dividend highly; therefore, the option of a lower dividend and lower equity raise was unappealing. As we detail, below, the move to a mixed balance sheet/third-party capital model increases the dividend cover per share, with fewer shares in issue.

Fund raise to take near-term opportunities

- Management emphasise this is a discretionary fundraise to take advantage of near-term, attractive opportunities which will help well-known, existing customers, with their already identified buy-and-build M&A strategies. The deployment of funds is expected to be relatively rapid, supporting this view. As we note below, in the longer term the third-party capital mandate will mean such opportunities can be taken without further equity issuance.

Theme 2: move towards third-party capital model

Established track record opens option to move to third-party capital model

DUKE has examined using third-party capital in the past but had felt it was premature. Its hybrid capital product occupies a near unique space in financing and the chances of finding a partner/partners who had confidence in a new product, and DUKE's delivery of it, appeared modest. DUKE now has an eight-year track record – importantly, demonstrating the resilience of the model in difficult times such as the pandemic. This is likely to see increasing confidence in the product from third-party capital providers; and, with the equity raise, DUKE outlines progress made in delivering this option. Third-party financing is beneficial in a number of ways (see below) including, importantly, being committed finance which removes the need for equity raising in what can be fickle markets.

Significant progress made in terms of turning intention into practice

Specifically, we note:

- DUKE has engaged a placement agent who has been approaching capital providers, starting early September.
- Currently, indicative term sheets are being received from multi-billion-dollar capital providers.
- The intention is to raise ca.£100m in a new special purpose vehicle/joint venture structure. For the initial vehicle, DUKE would prefer a single counter-party and, once it is fully deployed, the intention is to provide new vehicles with the same or more partners.
- DUKE expects to continue with the same hybrid credit product, without conflict of interest, because it will be also directly invested in the vehicle. The final structure of the vehicle remains to be finalised, but DUKE currently expects to contribute 20%-30%.
- Existing DUKE assets may be considered for the vehicle, but no decision has been made on this yet. Management is very aware of potential conflicts of interests and keen to avoid them.

At this stage, we characterise DUKE as intending to move to this model. The SPV is not yet established and while there appears to be investor interest in it, and considerable progress over the past few months, the structure is not yet complete.

Investors get:

- **Lower share issuance with capital and income benefits to existing shareholders**
- **More stable revenue stream**
- **Reduced cash drag**
- **Operational gearing**
- **More diversification/reduced risk**
- **Higher valuation rating**

The implications for investors are:

- A reduction in the potential overhang of dilutive share issues gives shareholders a capital benefit. Less frequent, if any, share issues also means that the dividend pool is divided among fewer shareholders, giving them a potential income benefit of higher dividends or greater cover of the dividend.
- It creates a committed funding structure that removes the need for equity financing, a source which can prove volatile and less certain.
- A recurring, and more stable, revenue stream from assets managed. Like for like, there will not be the same volatility from marking the preferred shares and equity holdings to market as DUKE has seen to date.
- A lower cash drag, from DUKE needing to have its own finance in place before funding customers.

- More facilities can be provided for the same DUKE capital, which will generate operating gearing and efficiencies for DUKE.

- Assuming the vehicle accelerates growth, there will be more asset diversification, thereby reducing risk.

- We believe that investors will give a higher rating to the model:

  - Businesses with both balance sheet commitments and third-party capital mandates have higher ratings than those with a balance sheet model alone. This reflects the recurring revenue and risk profiles. It is only one factor in the valuation; however, we note 3i, with a mix of balance sheet and third-party capital, trades at a 50% premium to its NAV while most of the PE sector trades at discounts of 20%-40%.

  - We believe the reduced probability of future dilutive equity issues will remove a potential concern about the company.

Financials

At this stage, we take greater comfort in our forecasts rather than change them significantly

As we noted, above, we had been expecting an equity raise in FY'26, which has been brought forward a year. At this stage, rather than increasing investments, we have taken greater comfort that our 10% growth in hybrid capital investments and 6% growth in equity investments (both net of exits) will be delivered. Given we are well advanced in year and no exits have been seen yet, we have removed them from our forecasts, reducing cash revenue. We expect this line to be volatile and lumpy. The assets retained generate more revenue, but this has been offset by timing issues, with new advances being skewed to later in the year against our simple assumption of them being split evenly. This sees a small net negative impact on recurring income but a positive impact later on when the full year's benefit of the higher balances is visible.

Overall, fewer shares issued than expected, which boosts FY'27E EPS but reduces cashflow (more debt so higher interest cost)

Apart from the numbers of shares in issue (against our forecasts: higher in FY'25, broadly unchanged forecast for FY'26 and lower in FY'27), there are some minor effects around timing and cash dividend paid. As the amount issued is less than we expected, FY'27E earnings per share are higher, but there is a small adverse impact on free cashflow, with higher interest costs (more debt to replace the equity previously expected to be raised).

Changes to estimates

Year-end March (£m)	2025E			2026E			2027E		
	Old	New	% change	Old	New	% change	Old	New	% change
Total cash revenue	32.8	26.9	-18%	37.1	38.6	4%	39.9	41.8	5%
Recurring cash revenue	27.3	26.9	-2%	30.1	31.6	5%	32.9	34.8	6%
Free cashflow	19.4	13.2	-32%	22.4	22.4	0%	23.9	24.0	0%
Accounting pre-tax	21.7	17.3	-20%	24.0	24.1	0%	25.5	25.6	0%
EPS (p)	4.9	3.7	-24%	4.8	4.6	-4%	4.6	4.9	7%
DPS (p)	2.8	2.8	0%	3.0	3.0	0%	3.2	3.2	0%
Hybrid capital assets	235	234.7	0%	261.7	261.7	0%	314.2	314.2	0%
Equity investments	16.9	18.9	12%	16.4	18.4	12%	15.9	17.9	13%
Cash (£000)	3.4	22.8	566%	24.7	17.2	-31%	10.2	3.7	-64%
Shareholders' funds	176.1	189.0	7%	223.3	199.2	-11%	233.2	210.2	-10%

Source: ABG, Hardman & Co Research

Profit and Loss

Year-end March (£000)	2020	2021	2022	2023	2024	2025E	2026E	2027E
Hybrid capital investment income	(2,994)	19,344	18,037	28,266	23,014	28,461	36,806	40,108
Term credit investment income	1,235	636	533	339	453	520	589	658
Impairment loss on term credit investments	(2,947)	-	-	-	-	-	0	0
Equity investment income	(670)	1,569	9,678	2,212	1,925	2,000	2,000	2,000
Other operating income	90	93	543	176	195	195	195	195
Total income	**(5,286)**	**21,642**	**28,791**	**30,993**	**25,587**	**31,176**	**39,591**	**42,961**
Transaction costs	(448)	(447)	(631)	(66)	(475)	(523)	(575)	(632)
Due diligence costs	(95)	(103)	(1,113)	(620)	(645)	(710)	(780)	(858)
Hybrid capital participation fees	-	-	-	-	-	-	-	-
Total investment costs	**(543)**	**(550)**	**(1,744)**	**(686)**	**(1,120)**	**(1,232)**	**(1,355)**	**(1,491)**
Administration and personnel	(1,725)	(1,675)	(2,060)	(2,627)	(3,072)	(3,379)	(3,717)	(4,089)
Legal and professional	(584)	(367)	(405)	(456)	(533)	(560)	(588)	(617)
Other operating costs	(471)	(99)	(151)	(223)	(370)	(389)	(408)	(428)
Expected credit losses	-	-	(72)	(20)	14	14	14	14
Share-based payments	(409)	(806)	(930)	(969)	(938)	(1,126)	(1,351)	(1,621)
Total operating costs	**(3,189)**	**(2,947)**	**(3,618)**	**(4,295)**	**(4,899)**	**(5,439)**	**(6,049)**	**(6,741)**
Operating profit	**(9,018)**	**18,145**	**23,429**	**26,012**	**19,568**	**24,505**	**32,186**	**34,729**
Net foreign currency movement	246	(542)	(60)	66	(22)	-	-	-
Finance costs	(1,607)	(1,539)	(1,996)	(5,644)	(7,255)	(7,247)	(8,129)	(9,131)
Profit before tax	**(10,379)**	**16,064**	**21,373**	**20,434**	**12,291**	**17,259**	**24,057**	**25,599**
Taxation expense	1,481	(2,111)	(982)	(842)	(683)	(959)	(1,337)	(1,423)
Profit after tax	**(8,898)**	**13,953**	**20,391**	**19,592**	**11,608**	**16,300**	**22,721**	**24,176**
No shares (exc. treasury)	214	243	342.8	398.0	413.0	443.6	494.9	494.9
EPS (p)	**(4.16)**	**5.75**	**5.95**	**4.92**	**2.81**	**3.67**	**4.59**	**4.88**
Adjusted EPS (p)	**2.44**	**2.70**	**3.81**	**3.13**	**4.85**	**3.37**	**4.35**	**4.68**
DPS (p)	**2.9**	**2.25**	**2.25**	**2.8**	**2.8**	**2.8**	**3.0**	**3.2**

Source: DUKE Report and Accounts, Hardman & Co Research

Cashflow								
Year-end March (£000)	**2020**	**2021**	**2022**	**2023**	**2024**	**2025E**	**2026E**	**2027E**
Receipts from hybrid capital investments	8,977	9,931	14,701	21,364	27,267	26,177	34,344	37,455
Receipts of interest from term credit investments	1,268	667	580	339	453	520	589	658
Other operating receipts	90	438	543	176	195	195	195	195
Operating expenses paid	(2,811)	(2,154)	(2,487)	(3,306)	(4,015)	(4,313)	(4,699)	(5,120)
Payments for hybrid capital participation fees	(168)	(81)	(115)	(112)	(130)	(130)	(130)	(130)
Tax paid	(573)	135	(2,055)	(1,346)	(673)	(804)	(1,868)	(1,954)
Net cash inflow from operating activities	**6,783**	**8,936**	**11,167**	**17,115**	**23,097**	**21,645**	**28,432**	**31,105**
Hybrid capital investments advanced	(20,983)	(22,708)	(74,586)	(23,809)	(42,012)	(19,012)	(51,000)	(76,379)
Hybrid capital investments repaid	3,232	14,354	2,938	-	17,636	-	28,500	28,500
Term credit investments advanced	(2,661)	(1,145)	(3,192)	(2,500)	(750)	(750)	(750)	(750)
Term credit investments repaid	-	2,370	3,949	2,000	-	-	-	-
Equity investments purchased	-	(653)	(530)	(500)	(3,799)	-	(1,000)	(1,000)
Equity investments sold		-	2,883	-	2,326	-	3,500	3,500
Equity dividends received		-	-	3	48	-	-	-
Payment for acquisition of subsidiaries	(321)				-	-	-	-
Business combination costs					-	-	-	-
Receipt of deferred consideration		-	7,679	-	1,512	-	-	-
Investments costs paid	(548)	(634)	(972)	(357)	(1,344)	(1,232)	(1,355)	(1,491)
Net cash outflow from investing activities	**(21,281)**	**(8,416)**	**(61,831)**	**(25,163)**	**(26,383)**	**(20,994)**	**(22,105)**	**(47,620)**
Proceeds from share issue	17,454	-	35,000	20,000	-	20,200	-	-
Share issue costs	(1,048)	(1)	(1,936)	(1,115)	-	(1,045)	-	-
Dividends paid	(6,013)	(3,013)	(7,270)	(10,979)	(11,524)	(12,858)	(13,848)	(14,838)
Proceeds from term credits	16,250	15,200	38,200	71,250	15,000	20,228	10,000	27,000
Term credits repaid	(11,650)	(13,926)	(7,500)	(61,450)	-	-	-	-
Interest Paid	(1,425)	(1,409)	(1,649)	(3,976)	(6,222)	(7,247)	(8,129)	(9,131)
Other finance costs	(534)	(95)	(181)	(2,426)	-	-	-	-
Net cash inflow from financing activities	**13,034**	**(3,244)**	**54,664**	**11,304**	**(2,746)**	**19,278**	**(11,977)**	**3,031**
Net (decrease)/increase in cash and cash equivalents	**(1,464)**	**(2,724)**	**4,000**	**3,256**	**(6,032)**	**19,928**	**(5,650)**	**(13,484)**
Cash and cash equivalents at beginning of period	5,894	4,481	1,766	5,707	8,939	2,896	22,824	17,175
Forex effects	51	9	(59)	(24)	(11)			
Cash and cash equivalents at end of period	4,481	1,766	5,707	8,939	2,896	22,824	17,175	3,691
Cash revenue	**10,335**	**11,036**	**18,707**	**21,879**	**30,241**	**26,892**	**38,629**	**41,809**
Recurring cash revenue	**10,335**	**8,829**	**15,410**	**21,879**	**24,337**	**26,892**	**31,629**	**34,809**
Free cashflow	**4,810**	**6,893**	**11,429**	**12,782**	**17,857**	**13,166**	**22,448**	**23,984**

Source: DUKE Report and Accounts, Hardman & Co Research

Balance sheet								
@ 31 March (£000)	2020	2021	2022	2023	2024	2025E	2026E	2027E
Goodwill	203	203	203	203	203	203	203	203
DUKE's hybrid capital offering investments	59,435	71,107	139,648	158,540	177,589	195,384	214,468	266,992
Term credit investments	4,418	4,370	3,172	4,652	5,382	6,132	6,882	7,632
Equity investments	507	3,495	10,820	13,529	15,904	18,882	18,382	17,882
Trade and other receivables	-	5,618	2,141	-	1,574	-	-	-
Deferred tax assets	675	158	156	200	408	408	408	408
Total non-current assets	**65,238**	**84,951**	**156,140**	**177,124**	**201,060**	**221,009**	**240,343**	**293,117**
DUKE's hybrid capital offering investments	16,124	14,194	20,831	32,793	33,359	39,352	47,222	47,222
Term credit investments	5,099	580	1,000	-	-	-	-	-
Trade and other receivables	142	4,422	53	2,290	843	843	843	843
Cash and cash equivalents	4,481	1,766	5,707	8,939	2,896	22,824	17,175	3,691
Current tax assets	567	-	-	373	155	-	0	0
Total current assets	**26,413**	**20,962**	**27,591**	**44,395**	**37,253**	**63,019**	**65,240**	**51,756**
Total assets	**91,651**	**105,913**	**183,731**	**221,519**	**238,313**	**284,028**	**305,582**	**344,872**
Hybrid capital debt liabilities	133	114	160	154	170	170	170	170
Trade and other payables	318	267	423	433	461	461	461	461
Borrowings	172	161	362	441	632	632	632	632
Current tax liability	-	1,163	87	0	-	-	0	0
Total current liabilities	**623**	**1,705**	**1,032**	**1,028**	**1,263**	**1,263**	**1,263**	**1,263**
Hybrid capital debt liabilities	1,040	917	951	988	934	934	934	(566)
Trade and other payables	431	402	1,067	1,314	1,063	2,829	4,160	6,991
Borrowings	15,517	17,103	47,740	53,930	69,772	90,000	100,000	127,000
Tax								
Total non-current liabilities	**16,988**	**18,422**	**49,758**	**56,232**	**71,769**	**93,763**	**105,094**	**133,425**
Share capital	118,479	120,870	153,974	172,939	172,939	192,094	192,094	192,094
Share-based payment reserve	742	1,548	2,478	3,447	4,385	5,511	6,861	8,482
Warrant reserve	265	265	265	3,036	3,036	3,036	3,036	3,036
Retained losses	(45,446)	(36,897)	(23,776)	(15,163)	(15,079)	(11,638)	(2,766)	6,573
Total equity	**74,040**	**85,786**	**132,941**	**164,259**	**165,281**	**189,002**	**199,225**	**210,184**

Source: DUKE Report and Accounts, Hardman & Co Research

Valuation

Range of valuation approaches, including GGM, DCF and DDM

Average of all is 53.2p

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 44.2p, the discounted cashflow model (DCF) 72.3p and the dividend discount model (DDM) 43.1p. We believe the differences in strategy and business model make comparisons, with even the closest listed peers, of limited value. We detailed the logic behind our long-term assumptions (ROE 14%, 12% CoE and growth 5%) in our initiation.

GGM

GGM valuation, at 44.2p, captures value added and growth

We believe the GGM recognises well both the growth prospects and value added by a business. Looking at DUKE, our assumptions are:

GGM and key sensitivities

	Base	+1% RoE	+1% CoE	+0.5% G
RoE	14%	15%	14%	14%
CoE, post-tax	12%	12%	13%	12%
Growth	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)	38.2	38.2	38.2	38.2
Valuation (p/sh)	44.2	49.1	38.7	45.8
Variance (p/sh)		4.9	-5.5	1.6

Source: Hardman & Co Research

DDM

DDM valuation 43.1p

Using the assumptions we outlined in the initiation, the implied valuation on the DDM is 43.1p. The terminal value accounts for 30% of the value. An 11% CoE (rather than our 12% base) would imply a value of 48.8p.

DCF

DCF valuation 72.3p

Using the assumptions we outlined in the initiation, the implied valuation on the DDM is 72.3p. The terminal value accounts for 30% of the value (pre-balance sheet allocation). An 11% CoE, the value would be 82.0p.

"Peer" companies

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

We do not believe that DUKE has any directly comparable UK peers (for the reasons behind this, see our initiation again). Looking at a wider group where the businesses have some similarities, 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 P/E of 9.3x and Diversified Royalty on 15.9x (DUKE on 7.6x, on our forecasts). The former has a current dividend yield of 7.0%, the latter 8.3%, against DUKE's 10.0%.

Appendix 1: executive summary from our initiation

The following three pages give the executive summary, extracted from our 29 April 2024 Initiation of Coverage: Meeting customer needs, giving investors returns on Duke Capital. The 39-page note goes into each of the issues in more detail.

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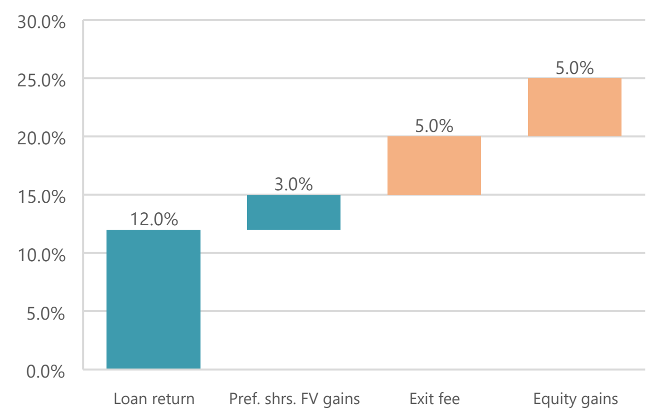
DUKE's hybrid capital product has unique features, bringing customers significant benefits

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 (*November 2024 update now £2m-£6m*) 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.

Appendix 2: portfolio

Slides 14 to 19 of the *results presentation* provide detail on the end-June portfolio. The table, below, shows the diversity by hybrid capital partner. Underlying these names, the exposure is diversified across 75 operating companies. The slides also focus on the IRRs on exits, which we discussed in Appendix 2 of our initiation. Other than a low outlier (a river cruise business, due to COVID-19) and a high outlier (200%+ IRR on a rapid exit where the founder had consolidated the equity ahead of an early PE deal), they range from 16% to 36%, giving comfort in the expected long-term returns of around 20%. They also offer a couple of case studies of how specific deals (with different structures) might achieve returns.

Summary of hybrid capital partners, at end-FY'24

Partner	Initial investment	Use of capital	Fair value (£m) Mar'20	Mar'21	Mar'22	Mar'23	Mar'24	Equity stake (%)
Industrials								
Atlas Signs	Dec'21	Debt re-financing	n/a	n/a	16.1	18.5	17.6	0
Creō-tech Industrial Group	Jul'21	Buy-and-Build	n/a	4.7	11.4	11.3	15.4	100
Trimite Global Coatings	Mar'18	Equity buyout	9.0	9.8	10.3	10.2	13.0	30
United Glass Group	Apr'18	Buy-and-Build	6.4	12.4	13.2	13.2	17.3	74
Glasshouse	Jul'23	MBO					9.9	10
Business services								
BVPA (Ireland)	Sep'18	Buy-and-Build	8.5	8.5	13.6	14.3	21.0	30
Lynx Equity (UK)	Oct'17	Buy-and-Build	11.6	13.1	14.9	15.3	17.3	0
Miriad Products	Feb'19	MBO	9.0	13.7	19.3	17.2	19.3	30
New Path Fire and Security	Dec'22	Growth capital	n/a	n/a	n/a	5.0	11.6	15
Step Investments	Jun'18	Growth capital	4.1	6.6	8.9	9.1	9.6	0
Healthcare								
InterHealth Canada	Aug'18	Growth capital	9.4	10.7	10.8	11.8	11.1	0
Integrum Care	Mar'24	Buy-and-Build					14.5	49
IT services								
Intec Business Solutions	Jul'21	Buy-and-Build	n/a	9.9	17.1	20.5	26.4	30
Specialist care								
Tristone Healthcare	Dec'21	Buy-and-Build	n/a	n/a	14.4	19.2	23.9	14

Source: DUKE Report and Accounts, Hardman & Co Research

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