investors CHRONICLE alpha

15 February 2019

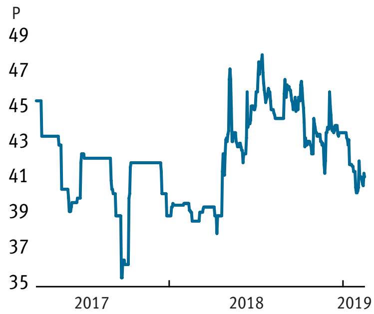
Duke Royalty: A royal high-yielding investment

The niche speciality finance company not only offers investors the opportunity to lock in an attractive 8.7 per cent prospective dividend yield, but to also gain exposure to the European royalty financing market just as it is starting to gain traction

Duke Royalty Limited (DUKE)

Ticker	DUKE
Current price (p)	41.6
Target price (p)	55
Market cap (£m)	83.1
52-week high (p)	50.1
52-week low (p)	38
Net cash (£m)	29
Shares in issue (m)	199.8
Financial year-end	31 Mar
Next event	2019 full-year results in May 2019
Company website	dukeroyalty.com

Duke Royalty share price



Source: Bloomberg

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Simon Thompson's view:

Royalty financing may be a relatively new funding source for businesses seeking alternative forms of capital investment, but it's tried and tested in North America where the market is now worth £50bn. Duke Royalty has spotted an opportunity to replicate the success of the royalty financing business model in the untapped UK and European markets, and has put together a well experienced management team to do so. With the backing of three of the top 10 fund managers in the world, and a cash-rich balance sheet, the company looks well set to capitalise on the opportunity this niche speciality finance market offers.

Bull points

- Sustainable high-yielding dividend backed by strong cash flow.
- Undeveloped European royalty financing market.
- Strong competitive advantages.
- Portfolio progressing well and first royalty partners achieving revenue targets to boost Duke Royalty's annual distribution.
- Recent acquisition de-risks portfolio and takes out the UK rival.
- Exclusive collaboration agreements support deal flow.
- Experienced management team.
- Stringent decision making process before any investment is sanctioned.
- Tax-efficient domicile.
- Supportive institutional shareholders.
- Directors and senior management team have significant shareholdings.

Bear points

- Short operating history.
- Portfolio still small so high concentration of royalties.
- Dependent on financial health of royalty partners to support distributions.
- Economic risk.
- Liquidity.

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Alternative Investment Market (Aim)-traded **Duke Royalty Limited (DUKE)** may be under the radar, and operates in an area of finance that few of us will be acquainted with, but the company has made very smart progress in developing a portfolio of royalty partners since listing its shares on London's junior market in March 2017. And it's the distributions from these royalty partners and a policy of declaring between 80 to 100 per cent of the company's free cash flow as dividends that supports the bumper quarterly payout on the shares. In fact, the company is one of the highest yielders on Aim.

The Royalty Finance opportunity

The founders of Duke Royalty identified an under-serviced segment in the European capital markets that lies between traditional debt and equity financing and can be serviced through offering royalty financing to partner companies. In a nutshell, Duke Royalty provides capital to companies in exchange for rights to a small percentage of their future revenues, and focuses on intellectual property assets and businesses with stable cash flows.

Advantages of Royalty financing

	Royalty financing	Debt financing	Private equity financing
Term	Typically very long term (in excess of 25 years or even perpetual)	Short to medium term	Permanent dilution of equity shareholders' interests
Refinancing risk	None	Significant	Pressure to exit
Control	Passive	Passive	Loss of control
Covenants	Covenant-light	Significant	Covenant-light
Cost of financing/debt	12-15 per cent	Senior debt: 4-8 per cent; mezzanine debt: 15-20 per cent plus	20 per cent plus
Security	Senior debt, so ranks higher than equity	Typically senior debt ,so ranks higher than equity	None

Source: Duke Royalty Limited Aim Admission Document

The benefits to the royalty partners over the alternative of raising equity is that this type of financing arrangement preserves their ownership rights, so is non-dilutive to existing shareholder interests. The owners continue to own and control their company and Duke Royalty doesn't take a seat on the board of its royalty partners, so is a passive investor.

Moreover, the arrangement offers royalty partners access to public investors without the expense, disclosure and dilution of an IPO. It also aligns the objectives of the business owners with the royalty company to drive profitable growth, so they retain a greater proportion of the upside from this growth. This means that the royalty partners are not being forced to focus on short-term profit maximisation. Also, they are not pressured to seek an exit or liquidity event as would be the case if private equity investment is taken.

Furthermore, the royalty partner retains the ability to issue equity and, in certain circumstances, additional debt. And because the royalty agreement is long term in nature, the royalty partner is in a prime position to access additional capital from the royalty company at a later date if required.

Royalty finance has several advantages over debt finance too:

- Variable payment structure. Distributions fluctuate with a royalty partner's revenue, there is no repayment of principal at end of life of royalty, and the term is extended over many years.
- Covenant-light capital. Less restrictive than debt financing, collateral package less intrusive than debt, and can subordinate to senior debt with no personal guarantees required.
- Streamlined deal execution. Faster due diligence and approval processes.
- Alternative channel of financing. Royalty financing can be made available in situations where traditional forms of debt are difficult to obtain.

"This form of finance is becoming an attractive proposition for privately-owned growth companies"

Given these advantages over debt and private equity funding, royalty finance can be used as an alternative source of finance to potential royalty partners who are looking for growth capital; acquisition finance; to fund minority, management or private equity shareholder buy-out; balance sheet recapitalisation or debt refinancing; estate planning; or taking listed companies private.

This type of finance has been used extensively in North American capital markets since the 1980s, and is now a £50bn sector with an established ecosystem of public companies, executives and advisors. However, the royalty financing sector is significantly smaller and much less developed in the European market, hence the opportunity to apply the North American royalty finance model in the region. The unwillingness of banks to lend to small and medium sized enterprises (SMEs) means that this form of finance is becoming an attractive proposition for privately owned growth companies that wish to retain control of their businesses.

However, whilst there is now a well-established publicly quoted royalty finance sector in the North American market, there is only one UK-quoted royalty company **Anglo Pacific (APF)**, and it is solely focused on the natural resources sector. This means that Duke Royalty is the only UK-quoted royalty finance company that specifically targets businesses within the hospitality, leisure & gaming, technology & media, health & life sciences, power & utilities and industrial sectors in order to build a portfolio of royalty partners with a diversified risk profile. It has no exposure to start ups, or businesses operating in the following industries: oil and gas, mining or biotechnology. It also side steps companies that are for sale, and concentrates on only those with at least 10 years operating history and backed by management with a track record.

Duke Royalty (Aim: DUKE)

Ord Price: 41.6p
Touch: 41-41.6p
Dividend Yield: 8.7%
Net Asset Value: 36.5p

Market Value: £83.1m
12-Month High: 50.1p **Low:** 38p
PE Ratio: 11
Net Cash: £29m (see text)

Year to 31 Mar	Revenue (£m)	Pre-tax profit (£m)	Earnings per share (p)	Dividend per share (p)
2017	nil	-1.40	-15.8	nil
2018	1.8	-0.86	-1.4	2.1
2019**	6.1	4.60	2.4	2.8
2020**	10.5	8.50	3.8	3.6
% change	72%	85%	58%	–

Normal market size: 1,500 SETSqx
**Cenkos Securities forecasts. Pre-tax profits and fully diluted EPS stated before exceptional items
Source: Duke Royalty annual report, London Stock Exchange

Differentiating the business model

Duke Royalty's directors believe that their business model is differentiated by an exclusive collaboration agreement the company has with Oliver Wyman, a global management consultancy firm wholly-owned by **Marsh & McLennan Companies (NYSE: MMC)**, for the sourcing of royalty financing opportunities in the pharmaceutical and healthcare sectors. Under this collaboration, Oliver Wyman provides Duke Royalty with deal origination and undertakes due diligence work on potential royalty partners in the pharmaceutical and healthcare-related market in exchange for a share of the future distributions received by Duke Royalty from royalty partners once the royalty financing has been completed. Oliver Wyman's Health & Life Sciences practice has offices around the world, and has a global network of professionals with clinical, health, and risk expertise. They also have a successful track record of valuing biopharmaceutical and other healthcare intellectual property for its Fortune 1000 clientele.

Moreover, outside of the pharmaceutical and healthcare sectors, Oliver Wyman has more than 35 years of experience consulting with leading companies in industries such as financial services, media and technology, leisure and energy. The consultancy has more than 1,000 professionals employed in over 50 cities across 26 countries in the Americas, EMEA, Asia and Australia. The strategic relationship with Oliver Wyman combines a global, respected source of deep knowledge with a publicly-quoted royalty company to create a unique offering to potential royalty partners and public investors.

It's not the only service provider that Duke Royalty has, it signed an advisory agreement 15 months ago with **Partners Value Investments (PVI)**, one of its largest shareholders, to provide input on transaction sourcing and capital raising activities. In consideration for entering into the advisory agreement, PVI was issued 2m call warrants to subscribe for shares at an exercise price of 42p per share (which expire in 2022).

PVI is an investment partnership whose principal investment is an equity stake in **Brookfield Asset Management Inc (NYSE:BAM)**, a global asset manager focused on real assets. PVI also has a growing portfolio of investments in companies that demonstrate an ability to produce consistent and durable cash flows and profits in growing markets. The advisory agreement with PVI is complementary to the strategic collaboration with Oliver Wyman, and means that Duke Royalty has two relationships with companies offering global reach and expertise, which far exceeds anything its in-house team could replicate.

The other major differentiating factor in Duke Royalty's business model is that by creating an operational structure with a low-cost base and a tax-efficient domicile, it can deliver high margin post-tax returns to shareholders. Indeed, the company is registered in and managed from Guernsey, a jurisdiction that is subject to lower rate of corporate tax than its Canadian diversified royalty company peers. This enables the company to lower the cost of capital to its royalty partners, thereby making its finance offering more attractive to them. It also means that Duke Royalty can pay out between 80 and 100 per cent of its free cash flow in the form of quarterly dividends. This explains why analysts predict that the payout of 2.8p a share for the 2019 financial year to end March 2019, will rise to 3.6p a share in the new financial year. On this basis, the prospective dividend yields are 6.7 per cent and 8.7 per cent, respectively.

Importantly, Duke Royalty's senior management team have extensive experience in royalty management and the UK capital markets, another major bull point given the company's short operating history.

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Meet the management

■ **Chief executive, Neil Johnson**, has over 25 years of experience in investment banking, merchant banking, and research analysis in Canadian and UK capital markets. In 2012, he co-founded and became chief executive of Difference Capital Financial, a Canadian-listed merchant bank. Prior to that he helped Canadian companies raise over £3bn of capital during his tenure as head of corporate finance at Canaccord Genuity's UK operation.

■ **Chief investment officer, Jim Webster**, was a senior officer of the first public pharmaceutical royalty investment company, Drug Royalty Corporation, which listed on the Toronto Stock Exchange. During his tenure, in which he became president, chief executive and chairman of the Investment Committee, the company had an internal rate of return of 32.1 per cent. Mr Webster oversaw the firm's growth from its start-up phase through to its eventual sale in for C$133m. Subsequently, between 2003 and 2009, he was managing partner and chairman of the investment committee for Capital Royalty Partners LLC (now CRG L.P.), which raised a C$325m initial fund.

■ **Charlie Cannon Brookes** is an **executive director** and works alongside Mr Johnson on deal origination, due diligence and structuring. In addition, he is the company's liaison with UK institutions and advisors, and has oversight of Duke Royalty's corporate governance and UK plc responsibilities. Mr. Cannon Brookes has over 20 years investment experience. He has extensive fund management experience, having held roles at Jupiter Asset Management, ABN Amro and Barclays de Zoete Wedd.

■ **Executive director and a member of Duke Royalty's investment committee, Justin Cochrane**, has 17 years royalty financing and investment banking experience. Previously, he spent five years as an executive vice president of corporate development for **Sandstorm Gold (SSL:TOR)** a public mining royalty company listed on the Toronto Stock Exchange, which has a market capitalisation of C$1.3bn.

■ **Other notable directors** include **Matthew Wrigley** who was previously a partner at asset management advisory firm, **MJ Hudson**. Having worked for over 15 years in alternative assets, his experience includes serving as general counsel for an Australian-listed fund management company with over AUD$1bn assets under management; as chief operating officer of an investment trust listed on the Singapore Securities Exchange with a market capitalisation of SGD$600m; and with leading global law firm, Baker McKenzie. He also sits on several fund and general partner boards, with strategies spanning private equity, infrastructure and real estate.

■ **Chairman Nigel Birrell** works with the executive directors on deal origination and structuring. He has extensive public company experience and expertise in the gaming, media and insurance sectors. He was a group director at bwin.party digital entertainment plc, the world's leading listed on-line gaming business, where he was responsible for all its mergers and acquisitions, business development and managing its investment portfolio.

■ Importantly, the directors have significant skin in the game. Mr Johnson holds 3.5m shares, or 1.76 per cent of the issued share capital, Mr Cannon-Brookes has an interest in 5.3m shares, or 2.67 per cent of the share capital, Mr Birrell owns 800,000 shares, or 0.4 per cent of the share capital, and Mr Cochrane hold 740,000 shares, or 0.37 per cent of the share capital. The first three directors all backed Duke Royalty's £44m equity raise at 44p a share last summer, purchasing 750,000 shares between them at the time. In total, the directors and senior management control around 10 per cent of the issued share capital, thus aligning their interests with outside shareholders.

■ I also like the fact that board's remuneration was only £144,315 in the first half of the 2018/19 financial year, so their main source of financial reward is derived from capital appreciation on their shareholdings, dividend income and upside from share options. Indeed, dividends paid to the directors totalled almost £125,000 in the six-month trading period.

The Duke Royalty financing model

Duke's Royalty financing structure is not difficult to understand. The company aims to provide royalty partners with long term financing (typically growth funding but also potentially as part of a refinancing package) which is expected to have a term of between 25 and 40 years (or even, in certain circumstances, a perpetual term).

The terms of the royalty agreements are such that in the first year, the royalty partner typically pays Duke Royalty a monthly distribution or royalty equal to 12 to 15 per cent per annum of the financing amount. In the second year, and each year going forward, the monthly distribution would be linked to the year on year growth in the revenue of the royalty partner, collared at six per cent per year of the total increase or decrease in the royalty partner's revenue over the prior year.

The table below illustrates a typical royalty financing structure for a £10m royalty financing. If Duke Royalty provides a royalty partner with £10m of funding with an initial distribution in year one of 13 per cent, the annual distribution or royalty to be paid to Duke in year one would be £1.3m. Assuming the revenue in year one was five per cent higher from the previous year, Duke is entitled to an annual payment which is five per cent more than year one's payment to give an annual distribution of £1.37m in the second year.

However, to incentivise the royalty partner to grow revenue strongly, which reduces the investment risk to Duke Royalty, there is a cap in place on the maximum increase in distribution. So, for instance, in the third year, if the royalty partner's revenue increases by 17 per cent, the distribution or royalty payable to Duke would only be increased by six per cent (the cap) on the prior year's payment to give an annual distribution of £1.45m in the third year.

The Duke Royalty financing model

	Year 1	Year 2	Year 3	Year 4	Year 5
Hypothetical Royalty Financing by Duke	£10m				
Hypothetical revenue of Royalty Partner	£50m	£58.5m	£64.4m	£63.1m	£65.6m
Hypothetical change in Royalty Partner revenue from previous year	5%	17%	10%	-2%	4%
Change in distribution (Collar +/–6%) for following year	5%	6%	6%	-2%	4%
Hypothetical yearly royalties based on initial 13 per cent cash-on-cash yield	£1.3m	£1.37m	£1.45m	£1.53m	£1.50m
Annual cash–on–cash yield to Duke Royalty per year	13.0%	13.7%	14.5%	15.3%	15%
Cumulative return for Duke Royalty	13.0%	26.7%	41.2%	56.5%	71.5%

Source: Duke Royalty

Equally, to make sure that Duke Royalty is protected in the event of revenues falling, there is a collar on the percentage (6 per cent in a typical example) that the distribution can decline by.

The point being that the cumulative return for Duke

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Royalty's shareholders from a typical royalty finance agreement can be significant, which is why the company is able to pay out such a high dividend to them.

Structuring the royalty financing agreement

The structure is designed to attract potential royalty partners by offering finance at a reasonable cost of capital that is both non-dilutive to their existing owners and which doesn't result in refinancing risks. In addition, the royalty finance model allows current owners and managers to stay in control of their businesses due to passive management involvement by Duke Royalty through monthly reporting. The royalty financing provides capital on day one, and a repayment model that is scheduled over the long term, usually between 25 and 40 years (thereby minimising short or medium term refinancing risk).

Unlike private equity financing, there is no pressure imposed by the company on the royalty partner to exit the royalty financing arrangement, but they typically retain a buy-back option during the life of the agreement to redeem up to 100 per cent of the royalty provided by Duke Royalty. This buy-back payment will be the greater of a pre-determined fixed amount specified in the royalty agreement and/or a multiple of the annualised royalty payment from the royalty partner to Duke Royalty on the date of exercise of the buy-back option.

Typically, Duke Royalty's funding has fewer negative covenants relative to debt although the company does mitigate risk by targeting companies that have an established track record. Duke Royalty looks for companies that have been going for ten or more years; have a defensible business model; and management with a track record of delivering.

Duke Royalty also takes senior security on the royalty partners' available assets, so ranks above equity shareholders in the enterprises it is lending to. This means that even if the royalty partner's trading deteriorates, Duke Royalty's investment has some degree of protection. Also, the company only lends to lowly geared royalty partners, and where other debts exist, it seeks inter-credit agreements to protect its capital investment.

The royalty agreement is structured so that Duke Royalty can monitor the royalty partner through access to monthly management financial and operating statements; annual budgets; quarterly unaudited statements and annual audited financial statements. In the event of a default, the royalty agreements provide the company with the right to demand full repayment of its invested capital and, in the circumstance of continued default of payment obligations, Duke Royalty can seek redress through the exercise of its security interest, and instigate legal action.

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Decision-making process

Duke Royalty's selection methodology is significantly different from the traditional forward-looking venture capital model, with a key focus on the age, historical track record and stability of potential royalty partners. Given that the company will generally be exposed to risks which are principally related to a potential royalty partner's top-line revenue and free cash flow generation, the due diligence process is principally focused on the overall sustainability and growth prospects of the potential royalty partners' revenue stream and free cash flow.

Since the company was formed it has reviewed over 200 investment prospects worth more than £1.5bn in deal value. The targeted deal size is £5m to £20m and the near-term pipeline of prospects is valued at £30m, thus offering prospects for Duke Royalty's cash pile to be invested in high yielding investments.

The selection policy takes into account:

- Management team. Quality of the royalty partner's management team is assessed.
- Level of ownership. This entails an analysis of the investment held by the royalty partner's management team.
- Historical revenues. Specific criteria is applied to revenue generation of the potential royalty partner to ascertain its sustainability.
- Revenue pipeline. This must demonstrate the royalty partner's ability to meet its distribution obligations under the royalty agreement.
- Coverage ratio. Operating cash flow of a royalty partner should be at least double the royalty payment where practicable.
- Intellectual property. Where this is an important asset, the ability to defend IP assets is taken into account.
- Cash flow control. In particular, with respect to the flexibility with which a royalty partner can lower operating expenses under adverse revenue circumstances.
- Portfolio diversification. The intention here is that new royalties will reduce any concentration of risk relating to any one sector or geography.

Case study: Temarca - Duke Royalty's first royalty partner

Within weeks of raising £13.8m net of expenses at 40p a share when shares in Duke Royalty were admitted to trading on Aim in March 2017, the company announced its inaugural royalty financing agreement with Temarca, an established family-owned European river cruise provider.

Founded in 1997, the Netherlands based river cruise provider offers luxury four-star multi-day riverboat cruises on Europe's main rivers, the Rhine and Danube, covering an area stretching from the North Sea to the Black Sea. The riverboats dock in ports typically in the heart of each city so offer a destination-focussed experience for passengers. Port cities on the Danube and Rhine include Vienna, Bratislava, Budapest, Belgrade, Cologne, Strasbourg, Rotterdam and Basel. The €8m (£7m) initial tranche of financing enabled Temarca to purchase two of its three boats that had previously been leased, refurbish a portion of its fleet and repay existing creditors.

In terms of the business model, Temarca works with 28 different travel agencies across Europe, North America, and South Africa to design unique trips for its customers. These travel agencies buy boat capacity 12 months in advance of sailing and are then responsible for selling rooms on board the river vessel (between 60 to 75 rooms per boat) for their selected trips, meaning they conduct almost all of the marketing and sales effort. The travel agency then pays for its trip in full over the course of the year, with the final balance of payment received by Temarca a month before sailing. The arrangement with travel agencies provides strong visibility of forward sales.

The international river cruise industry growth is supported by a growing retirement age population, growing demand for more land-based exploration, and increasing popularity of riverboats with younger generations. To capitalise on these dynamics, Temarca is planning a further expansion of its riverboat fleet from three vessels to five vessels over the next five years in order to keep up with the growing demand for European river boat cruises. That should be good news for its revenue growth, and the distributions to Duke Royalty.

Terms of the Temarca royalty financing agreement

Under the terms of the 25-year financing agreement, Duke Royalty provided €8m (£6.9m) of royalty financ-

ing to Temarca with an option at Duke's sole discretion to provide a further €2m (£1.8m) for a period of 12 months.

The first tranche of capital entitled Duke to monthly distributions beginning in May 2017 which total over €1m on an annual basis, equating to a cash-on-cash yield of 13 per cent. The distribution is adjusted annually with the first adjustment on 1 July 2018 based on the percentage change in Temarca's gross revenues for the year to 31 December 2017 compared to the prior year. The annual adjustment in the distribution is subject to a collar. Duke Royalty provided Temarca with a buy-back option too. In terms of collateral, Duke has a fixed and floating charge over certain assets of Temarca.

The royalty financing arrangement has gone well. Temarca exceeded the 6 per cent revenue target in its first year's trading which meant that the distribution to Duke Royalty was reset at €1.06m from July 2018, implying a cash-on-cash yield of 13.3 per cent on its original €8m investment. It's hardly surprising as before Duke Royalty's investment, Temarca had reported €1.2m of Ebitda on revenues of €4.6m in the 2015 financial year. So, with the significant savings made on lease payments on the two vessels, and space now being sold on refurbished cruise boats, operating cash flow would have improved no end and easily provided more than two times cash flow cover on the €1m annual distribution payment to Duke Royalty.

Importantly, Temarca's owners have retained 100 per cent equity ownership, so are heavily incentivised to continue to grow the business, the upside of which is further increases in the annual distribution to Duke Royalty. In fact, in August 2018, they tapped Duke Royalty for €1m of additional financing.

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Accelerated cash flow expansion supports bumper cash dividends

Having proved the business model to the investors who backed the £15m equity raise at 40p at the time of the March 2017 placing when the shares were re-admitted to Aim (the company was a cash shell with 7.87m shares in issue), Duke Royalty returned to the market in December 2017 when it raised £20m at the same price, and in July 2018 when the company raised £44m at 44p a share.

By the end of 2018, the company had entered into royalty financing agreements with five companies which accounted for £44.3m of the company's last reported net asset value of £73m on 30 September 2018. Duke Royalty had £29m free cash for further investments.

Duke Royalty's royalty financing portfolio

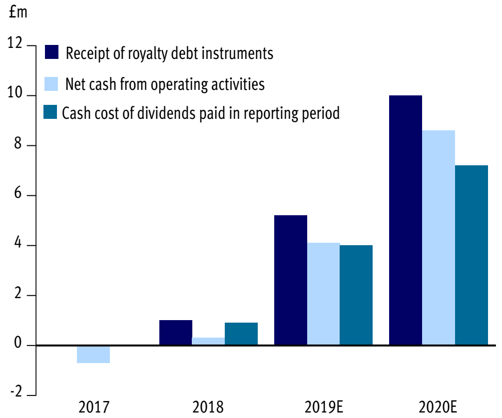
	Date of initial investment	Total investment	Term (years)	Annualised royalty distribution	Cash-on-cash yield
Temarca	Apr 2017	£7.8m	25	£1.0m	12.9%
Lynx Equity	Oct 2017	£10m	Perpetuity	£1.2m	12.8%
Trimite	Mar 2018	£9m	30	£1.1m	12.2%
Brownhills	Apr 2018	£7.5m	30	£1.06m	14.1%
InterHealth Canada Holding Corp	Aug 2018	£10m	30	£1.35m	13.5%
Total		**£44.3m**		**£5.71m**	**12.9%**

Source: London Stock Exchange RNS, Duke Royalty annual report

The portfolio is generating an average cash-on-cash yield of 12.9 per cent on the £44.3m Duke Royalty has invested to produce annualised distributions of £5.7m. Based on 199.8m shares in issue, this supports the 0.7p a share quarterly dividend which has an annualised cash cost of £5.6m. Prospects for hikes in the distribution from these portfolio companies look well underpinned too.

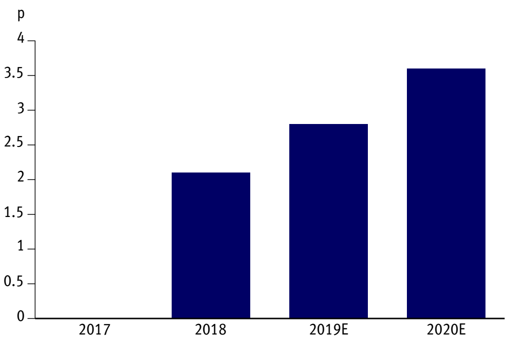
For instance, Lynx Equity is a Toronto-based private firm that seeks to acquire, own and operate mature, old-economy businesses in a diverse range of industries. Over its 10-year history, Lynx has made over 40 acquisitions and grown revenue to over C$300m per annum for its financial year ended 31 July 2017. Duke Royalty became Lynx's preferred European capital provider to provide Lynx with up to £15m of capital to allow it to roll out its proven and successful North American acquisition strategy across Europe. The financing is perpetual, and has senior secured position over all present and after-acquired property and assets of Lynx. There is also a guarantee by Lynx UK's parent company, providing significant downside protection for Duke Royalty. Lynx exceeded the 6 per cent revenue growth target for the first 12-month reporting period post Duke Royalty's investment, thus triggering a 6 per cent increase in the annualised distribution.

Duke Royalty's improving operating cash flow



Source: Duke Royalty annual report; Cenkos Securities estimates as at 4 Feb 2019

Duke Royalty's improving operating cash flow



Source: Duke Royal annual report; Cenkos Securities estimates as at 4 Feb 2019

It's not the only royalty partner that is over-delivering. In March 2018, the company entered into a royalty finance agreement with Trimite, a Birmingham-based specialist coatings manufacturer established in the 1940s. Based on management accounts received by Duke Royalty for the accounting period to the end of September 2018, the year-on-year revenue performance for Trimite, was up by more than 6 per cent since Duke Royalty's investment. As such, Duke's directors are confident of a positive distribution reset when Trimite completes its first adjustment periods.

In April 2018, Duke Royalty made a £6.5m initial investment in Brownhills, one of the UK's leading independent glass merchants and processors, established in the 1970s. Revenues for that company have hit the 6 per cent hurdle growth rate at the end of 2018, so there will be a positive distribution reset on the first anniversary of Duke Royalty's investment.

Duke's fifth investment is a £10m royalty financing arrangement with InterHealth Canada, a leading healthcare organization specialising in the development, commissioning and management of healthcare facilities, which was signed less than six months ago.

Duke Royalty's improving operating cash flow

	Receipt of royalty debt instruments	Net cash from operating activities	Cash cost of dividends paid in reporting period
2017	£0.0m	-£0.7m	£0.0m
2018	£1.0m	£0.3m	£0.9m
2019E	£5.2m	£4.1m	£4.0m
2020E	£10.0m	£8.6m	£7.2m

...which is good news for shareholders' dividends

	Declared dividend per share
2017	0.0p
2018	2.1p
2019E	2.8p
2020E	3.6p

Source: Duke Royalty annual report; Cenkos Securities estimates 4 February 2019

So, with the annual distributions being reset upwards on the first four portfolio companies, and £29m free cash to invest in a £30m pipeline of investment opportunities, dividends were already set to increase for the 2019-20 financial year. And that was before Duke Royalty made an important earnings-accretive acquisition.

“Strategically, it’s a smart move as it adds six royalty partners”

Capital Step acquisition scales up and de-risks portfolio concentration

In early February 2018, Duke Royalty announced the acquisition of Capital Step, the company’s only known competitor in the UK royalty financing market. Strategically, it’s a smart move as it adds six royalty partners to more than double Duke Royalty’s existing portfolio from five to 11 royalty partners, and diversifies both company and industry specific risk. Capital Step’s six portfolio partners operate in new complementary investment sectors: telecom services, media, recruitment, insurance broking and technology solutions.

The acquisition also strengthens Duke Royalty’s management team by adding three new experienced staff to its team, and at a low cost as it only adds £400,000 to operating costs. Furthermore, Capital Step has developed a proprietary origination network across the UK and Ireland and its team has identified a number of new investment opportunities which will be evaluated by the enlarged group.

The £21.65m enterprise valuation placed on Capital Step will be funded by a £10m cash payment from Duke Royalty’s cash rich balance sheet, of which £5m will be used to immediately repay an expensive credit line Clear Step has with Sandown Ventures. Duke Royalty will then assume £11.65m of Capital Step’s other borrowings which are drawn from a £20m debt facility provided by Honeycomb Investment Trust (HONY), a £445m market capitalisation credit fund which has Pollen Street Capital as Investment Manager. Pollen Street Capital was a spin-out of RBS in 2013 and manages £2.6bn of assets. This new credit line enables Duke Royalty to fund future investments through debt before having to raise additional equity, thus avoiding dilution to shareholders. It also means that Duke Royalty will carry less low yielding cash on its balance sheet, thus maximising investment returns for its own shareholders. There is £1.5m of deferred consideration based on Capital Step hitting certain performance targets in the financial year to end 31 March 2020. So, what is Duke Royalty getting for its money?

Capital Step has a £16m portfolio of investments across six royalty partner companies and holds equity stakes or warrants in four of these royalty partners which Duke’s management team believe are worth £3m to £5m, thus providing potential for valuation uplifts over time if the portfolio companies perform well. In its most recent financial quarter, Capital Step generated a £1.5m annualised run rate of royalty revenues net of debt service costs. This implies a minimum cash-on-cash royalty of 15 per cent per annum on the £10m upfront cash payment Duke is making. That’s an attractive return.

Capital Step Royalty financing partners

Royalty partner company	Royalty investment	Original date of royalty agreement
Recruitment Company	€1.3m	Jun-17
Telecom Services Company	€5.3m	Jun-17
Technology Solutions Company	£2m	Feb-18
Media Company	£2.5m	Jun-18
Insurance Brokerage Company	€4.6m	Aug-18
Recruitment Company	€1.87m	Sep-18

Source: Duke Royalty, 4 February 2019

Interestingly, Capital Step's core investments are structured either by way of perpetual royalties or 'unitranche' investments, which are perpetual royalties alongside senior secured loans. The royalty agreements are slightly different to Duke's which fluctuate with revenue changes and are structured with a floor and a cap of cash-on-cash yields. Capital Step's investment floors are above the initial cash yields of Duke's royalty agreements, adding to the attractiveness of the acquisition. In addition, Capital Step's portfolio offers potential to make follow-on investments to its royalty partners over time.

Importantly, Jonathan Schneider, the founder of Capital Step, has entered into a consultancy agreement for a minimum period to 31 March 2020 in order to assist in the origination and agreement of royalty transactions, portfolio management and debt negotiations. Mr Schneider has a successful track record of building companies and managing debt funds. He was the founder and manager at Novator Credit Opportunities Fund, a special situation credit fund with assets under administration of US$500m.

Supportive shareholder base

The reason why Duke Royalty has been scaling up its operation and has raised £79m of equity since the IPO in March 2017 is a reflection of a highly supportive shareholder base including three of the top 10 largest fund managers in the world. The company's top 10 shareholders own 72 per cent of the issued share capital.

This institutional backing means that the company's free float is below average. However, it's still possible to deal in large bargains. For instance, there were several blocks of 250,000 shares that went through the market at the 41p price level on Wednesday, 13 February 2018. Smaller investors were able to deal between the bid-offer spread in bargain sizes as large as 50,000 shares, so it should be possible to build a large position.

Duke Royalty major shareholders

Shareholder	Shareholding	% of issued share capital
Hargreave Hale	30.58m	15.30
Directors, management and insiders	19.9m	10.00
Blackrock	19.88m	9.95
Axa Investment Managers	18.25m	9.13
Downing	12.72m	6.37
GLG Partners	10.21m	5.11
Janus Henderson	9.00m	4.50
Partners Value Investments	8.75m	4.38
Capital Group	8.52m	4.27
Hadron	6.67m	3.34
Total		**72.35**

Source: London Stock Exchange RNS, Duke Royalty

Peer group comparison

Having just taken out its sole UK rival, Duke Royalty has a free run in the UK royalty financing market. This makes direct comparisons with competitors difficult. However, what is not in doubt is that there is value on offer as the shares are only priced on a 13 per cent premium to net asset value of 36.5p a share, based on the last reported shareholders funds of £73m and an issued share capital of almost 200m shares. This is an attractive entry point for a company that is set to report adjusted earnings per share (EPS) of 2.8p in the financial year to end March 2017, rising to 3.8p a share in the 2019-20 financial year. This implies a forecast earnings yield (the reciprocal of the price-to-earnings (PE) ratio) of 10.4 per cent to underpin a forecast dividend yield of 8.7 per cent, highlighting the policy of the board to pay out a very high percentage of cash flow back to shareholders by way of cash dividends.

Furthermore, as the balance of last summer's equity raise is deployed to provide capital to new royalty partners, and distributions on existing royalty agreements are reset upwards, shareholders can expect to not only benefit from a progressive dividend policy, but for the shares to be re-rated as EPS rise strongly too. This is exactly what has happened to overseas listed royalty companies that are using the proven North American Royalty Financing model.

For instance, Toronto Stock Exchange-listed **Alaris Royalty Corporation (TOR: AD.)** is a C$700m (£409m) market capitalisation company that had an IPO in 2008 and is five times the size of Duke Royalty. Alaris has 14 employees and 15 holdings, and has deployed over £700m of capital since inception. In the past decade, it has produced a capital gain of over 200 per cent for shareholders, not to mention a 28 per cent running dividend yield on their initial investment. The shares trade at a 16 per cent premium to book value and offer an 8.7 per cent prospective dividend yield, both of which are similar to Duke Royalty.

However, Duke Royalty is at a much earlier stage of its development, so has far greater potential to scale up its business model as the operational gearing kicks in and replicate the long-term investment returns that Alaris has made for its shareholders that got in on the ground floor. It's worth flagging up too that, whereas Alaris' Ebitda cover on royalty financing distributions is close to parity, Duke Royalty targets cover above two times so is less exposed to deterioration in the cash flow of a royalty partner. Also, by being domiciled in Guernsey, Duke Royalty is able to apply beneficial rates of tax on its earnings and dividends.

The other direct overseas comparable is Toronto Stock Exchange-listed **Diversified Royalty Corporation (TOR: DIV)**, a C$328m (£191m) market capitalisation company that came to the market in 2014 and has three employees and three holdings. It has deployed around £175m of capital since IPO in 2014 and produced a 109 per cent capital gain for shareholders, and a 13 per cent running dividend yield on their initial investment. The shares trade on a 66 per cent premium to book value and offer a 7.2 per cent dividend yield, so Duke Royalty offers a higher dividend yield and is priced on a far lower price-to-book value.

Arguably, Duke Royalty shares should be trading on a price-to-book value somewhere between the ratings of these two North American royalty financing companies. After all, its high level of operational gearing should deliver accelerated profit and EPS growth from a low base, and deliver high annualised returns to shareholders.

A fairer valuation for Duke Royalty's shares at this stage of its development is a price-to-book value multiple of 1.5 times, implying a market capitalisation of £110m, or 55p a share. This would place the shares on a 2019-20 forward PE ratio of 14.5 based on analysts' EPS estimates of 3.8p, and give a prospective dividend yield of 6.5 per cent.

Offering almost 33 per cent share price upside to my fair value target price of 55p, and with the opportunity to lock into an 8.7 per cent prospective dividend yield, Duke Royalty shares may be under the radar, but they are priced to generate healthy long term returns for shareholders as the royalty financing model gains traction and recognition in the investment community in UK and Europe. **Buy**.

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Risk assessment
Of course, there are a number of risk factors to consider before making any investment, and in the case of Duke Royalty there are several to take into consideration:

■ **Limited operating track record:** Duke Royalty is still at an early stage of its development and there can be no guarantee that the investments it has made will continue to produce distribution uplifts, nor for that matter that it will identify suitable new royalty partners to invest its excess cash in.

■ **Dependence on royalty partners:** The company will have 11 royalty partners following the acquisition of Capital Step, so has diversified concentration of risk. However, if one partner gets into financial difficulty then it will still represent a significant exposure to the company given the relatively small number of royalty partners.

■ **Ability to recover from royalty partners for defaults may be limited:** Royalty Agreements are largely contractual in nature and parties do not always honour terms. Royalty partners may not have sufficient cash flow at a particular payment date to honour the contractual terms or they may enter insolvency, bankruptcy or other similar processes in the jurisdictions in which they are incorporated or conduct their operations.

Additionally, the royalty partners may breach their representations, warranties or covenants or may not comply with their obligations to provide information or to allow Duke Royalty to exercise audit rights. To the extent that they do not abide by their contractual obligations, the company would be required to take legal action to enforce its contractual rights. Such litigation may be time consuming and costly and there is no guarantee of success or that the royalty partner will have sufficient assets to cover the company's loss.

If royalty partners do not honour their contractual obligations (either by choice or due to financial difficulties or bankruptcy) or if the company is unable to enforce its contractual rights, it may have a material financial adverse effect on the business.

■ **Material facts or circumstances not revealed in the due diligence process:** Prior to making or proposing any royalty financing, Duke Royalty undertakes legal, financial and commercial due diligence to a level considered reasonable and appropriate by the directors on a case by case basis. However, these efforts may not reveal all material facts or circumstances which would have a materially adverse effect upon the value of the royalty.

In undertaking due diligence, the company needs to utilise its own resources and will be required to rely upon its service providers, Oliver Wyman, Partners Value Investments and other third parties to conduct certain aspects of the due diligence process. Any due diligence process involves subjective analysis and there can be no assurance that due diligence will reveal all material issues related to a potential royalty financing, or royalty partner.

■ **Collaboration with Oliver Wyman may be terminated:** The agreement with Oliver Wyman was entered into for an initial term of five years from August 2015 to August 2022 and is subject to automatic 12 month renewals, unless earlier terminated in accordance with the terms of the agreement. This provides the parties with termination rights upon the occurrence of certain events. These include the rights to terminate the agreement upon a material breach which is not remedied within 30 days of notification and upon 90 days' prior written notice if certain key individuals (David Campbell of Oliver Wyman and Neil Johnson of Duke Royalty) cease to be active full time employees of Oliver Wyman or Duke Royalty. Additionally, after the expiry of the initial term of five years, the agreement may be terminated for any reason whatsoever by either party upon three months' prior written notice.

Termination of the agreement with Oliver Wyman could have a material adverse impact on the operation of the company, its ability to identify or complete royalty financings, or to fully invest its available capital. In addition, should the agreement with Oliver Wyman be terminated, there is a risk that suitable and effective replacements may not be found. Therefore, the business, financial condition and results of Duke Royalty may be adversely affected, if the services provided by Oliver Wyman cease to be available to the company.

■ **Economic conditions:** The business of each of royalty partner is subject to changes in their relevant domestic economic conditions, including but not limited to, recessionary or inflationary trends, equity market levels, consumer credit availability, interest rates, consumers' disposable income and spending levels, job security and unemployment, and overall consumer confidence.

Market events and conditions 10 to 11 years ago, including disruptions in the international credit markets and other financial systems led to a deterioration of global economic conditions, causing a loss of confidence in global credit and financial markets. This resulted in the collapse of, and government intervention in, major banks, financial institutions and insurers and created a climate of greater volatility, less liquidity, widening of credit spreads, a lack of price transparency, increased credit losses and tighter credit conditions.

Notwithstanding various actions by governments and renewed optimism reflected in the financial markets since the Global Financial Crisis in 2008, concerns remain about the general condition of the capital markets, financial instruments, banks, investment banks, insurers and other financial institutions. Although economic conditions have improved, the recovery from the recession has been slow in various jurisdictions including in Europe and has been impacted by various ongoing factors including sovereign debt levels and high levels of unemployment, which continue to result in high volatility in stock markets. These factors have negatively impacted company valuations and will impact the performance of the global economy going forward.

In addition, economic conditions in Europe, North America and globally may be impacted by political events that cause disruptions in the financial markets. Any negative impacts could have an adverse effect on the company's royalty partners' businesses.

■ **Competition from investment banks and investment entities:** Duke Royalty competes with a large number of private equity funds and mezzanine funds, investment banks, equity and non-equity based investment funds, and other sources of financing, including the public capital markets. Some of its competitors are substantially larger and have considerably greater financial resources than the company. Rivals may have a lower cost of funds and many have access to funding sources that are not available to the company.

In addition, some of its competitors may have higher risk tolerances or adopt different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships and build their market shares. As a result of this competition, the company may not be able to take advantage of attractive opportunities and there can be no assurance that it will be able to identify and complete royalty financings that satisfy its business objectives.

■ **Financial asset valuations:** Royalty investments are debt instruments classified at fair value through profit or loss under IFRS 9. The return on these investments is linked to a fluctuating revenue stream and thus, whilst the business model is to collect contractual cash flows, such cash flows are not solely payments of principal and interest. Such assets are recognised initially at fair value and revalued at each reporting date. The change in fair value is recognised in the income statement and is presented within the 'net change in fair value on financial assets and financial'. The fair value of these financial instruments is determined using discounted cash flow analysis.

There can be no guarantee that the capital invested by Duke Royalty will not be impaired. However, the company applies due diligence and has rules on royalty coverage. Royalty coverage is at least two times Ebitda, so the distribution made to Duke Royalty represents a minority of the royalty partners' cash flow. The company also takes senior security on the royalty partners' available assets, so ranks above equity shareholders in the enterprises it is lending to.

■ **Foreign exchange risk:** Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign currency exchange rates. The functional and presentation currency of Duke Royalty is sterling. The company is exposed to foreign exchange risk arising from foreign currency transactions, primarily with respect to the Euro. Foreign exchange risk arises from future commercial transactions in recognised assets and liabilities denominated in a currency that is not the functional currency of the company. Foreign exchange risk is not significant for Duke Royalty as around 60 per cent of the capital deployed prior to the recently announced acquisition of Capital Steps has been made to UK-based companies.

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Registered office: Number One, Southwark Bridge,
London SE1 9HL. ISSN 0261-3115.