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Pengana Capital Group (PCG)

24 February 2022

Result Preview; Private Equity Drives Growth

Trading Update

In mid-January, PCG announced 1H22 gross performance fees of $29.1m, almost double our $15m estimate and well above the $10.4m in pcp. After paying $9.6m to fund managers under profit share agreements, PCG received net $19.5m. PCG splits performance fees with its fund managers ~50/50 in all but its two listed funds – PE1.ASX & PIA.ASX. This implies $9.9m of gross and net performance fees came from the two listed funds – we understand almost all of this to be from the Pengana Private Equity Fund (PE1). Full result to be announced February 25th.

Our View

PCG's H1 performance highlights the operating leverage and importance of performance fees in the business model. Prior to markets retreating in January, most of its funds were at, or approaching high watermarks and therefore near-term potential for further performance fees remain. PCG provides a multi-strategy offer with numerous fund managers whilst only accepting retail capital. We believe this structure reduces single-strategy and key-man risk whilst providing stickier FUM than wholesale capital. Importantly, PCG's diversified product offering has created a structure where performance fees are somewhat uncorrelated across the range of strategies. This includes ethical, impact, global and private equity.

Forecasting fees can be futile in volatile markets and whilst we believe our estimates to be realistic, we also discount our future period performance fee estimates by 40% to further mitigate risk. With 1H22 already having delivered $29m of performance fees and our H2 forecast only comprising $5.6m (after 40% discount), we are confident PCG can achieve our FY22 expectations. We expect a payout ratio of 70-90% on underlying earnings to be maintained which implies substantially higher dividends with an FY22E yield of 11.3%. Trading on 7.5x our FY22E EPS we think PCG is undervalued and believe an 11x multiple is current fair value given the growth profile and differentiating factors that set it aside from peers. This implies a $2.99 share price. See page 6 for our valuation breakdown.

Key Points

Performance fee growth driven by Private Equity Fund (PE1)

1H22 net performance fees of $19.5m have outstripped our forecasts by almost 100% and pcp by 180%. We estimate ~$10m to have been generated by PE1 and most of the remainder generated by the Australian emerging companies fund. Investments within the fund are only revalued at liquidity events and we understand some meaningful investments to be approaching IPO or capital events in 2022. PE1 is an absolute return fund where PCG receives 19.5% above an 8% return. PCG receives 100% of this performance fee. We view the 8% return hurdle as regularly obtainable given private equity valuations tend to increase more rapidly than listed investments. We note PE1 invests in numerous other private equity funds which subsequently provides exposure to >350 underlying companies. We will provide greater insight into PE following the 1H22 result.

Update to financial forecast methodology

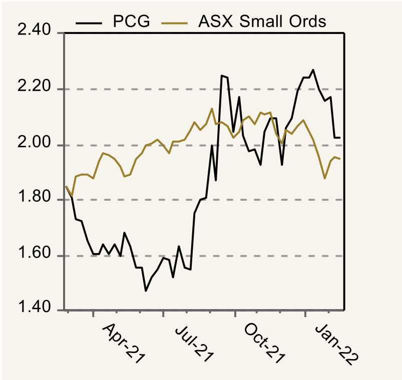
Given market volatility and the uncertain nature of performance fees, our forecasts now outline two scenarios. The first only includes management fee revenue which we believe gives investors the bear case assuming FUM remains relatively stable. The second includes performance fee revenues. These are pivotal to the return profile, balance sheet and distributions to shareholders. Performance fees are forecast based on our understanding of individual fund high-watermarks in conjunction with their respective long-term average returns. Further, we apply a 40% discount to these estimates to build in further conservatism and allow for potential market volatility.

Recommendation: Outperform

Summary (AUD)

Market Capitalisation	**$219m**
Share price	**$2.01**
52 week low	$1.45
52 week high	$2.50

Share price graph (AUD)



Key Financials (AUD)

	FY21A	FY22E	FY23E
Management Fee	40.3	45.8	50.1
Performance Fee	28.0	34.7	24.5
Total Revenue	69.9	82.0	76.2
Operating EBITDA	**19.2**	**37.4**	**28.4**
EBITDA Margin	27.5%	45.6%	37.3%
NPAT Adj.	15.3	29.7	23.5
EPS Adj.	14.2	27.2	21.6
PE Ratio	14.2	7.5	9.3
EV/EBITDA	**10.6**	**5.2**	**6.2**
EV/EBIT	10.8	5.2	6.3
Dividend	13.0	23.0	18.0
Div yield	6.5%	11.4%	9.0%

.NB: Our performance fee forecasts are discounted 40% to account for the uncertain nature of these revenues. FY22E is above FY23E as 1H22 Performance fees have already been announced.

See pages 3 and 4 for more detail on performance fee structures and page 6 for our valuation breakdown.

Pengana Capital Group - Financial Summary — Price $ 2.01

P&L SUMMARY (A$m) - BASE CASE (Excludes Performance Fee Forecasts)				
Period	FY20A	FY21A	FY22E	FY23E
Management fee revenue	37.5	40.3	45.8	50.1
Other fees	1.4	1.6	1.6	1.6
Other Income	1.0	1.0	0.6	0.6
Total Base Case Revenue	**39.9**	**42.9**	**48.0**	**52.3**
Base expenses (to generate above revenues)			38.0	41.3
Base Case EBITDA			**10.0**	**11.0**
Depreciation & Amortisation			(3.2)	(3.2)
Net Interest			0.2	0.4
PBT			**7.0**	**8.2**
Tax			(2.1)	(2.5)
Base Case NPAT			**4.9**	**5.7**
Base Case EPS			**4.5**	**5.3**
PCG Base Case EV/EBITDA			**19.3**	**16.1**
PCG Base Case PE Ratio			**44.7**	**38.2**

P&L SUMMARY (A$m) - Inclusive of Performance Fee Forecasts				
Period	FY20A	FY21A	FY22E	FY23E
Management fee revenue	37.5	40.3	45.8	50.1
Other fees & income	2.9	4.7	2.2	2.2
Performance fee revenue	*6.2*	*28.0*	*38.4*	*40.8*
Performance fee weighting			*90.3%*	*60.0%*
Performance fee revenue after weighting	6.2	28.0	34.7	24.5
Total Revenue	**46.5**	**69.9**	**82.0**	**76.2**
Expenses - inclusive of fund manager profit share	36.4	53.1	49.2	52.4
Total EBITDA	**10.1**	**16.8**	**32.8**	**23.8**
Depreciation & Amortisation	(3.5)	(3.1)	(3.2)	(3.2)
Net Interest	(0.3)	(0.2)	0.2	0.4
PBT	**6.3**	**13.6**	**29.8**	**21.0**
Tax	(0.4)	(4.8)	(9.0)	(6.3)
Reported NPAT	6.0	8.8	20.9	14.7
Reported EPS	5.5	8.1	19.2	13.5
Operating EBITDA	**9.9**	**19.2**	**37.4**	**28.4**
Adjustment for interest earnt on LSP	2.0	1.5	1.5	1.5
Underlying NPAT	**10.3**	**15.3**	**29.7**	**23.5**
Underlying EPS	**9.5**	**14.2**	**27.2**	**21.6**

NB: Our performance fee forecasts are discounted 40% to account for the uncertain nature of these revenues. FY22E is above FY23E as 1H22 Performance fees have already been announced and therefore are 100% accounted for.

BALANCE SHEET SUMMARY (A$m)				
Period	FY20A	FY21A	FY22E	FY23E
Cash	15.3	19.9	29.7	44.3
Contract Assets	3.8	21.5	15.4	16.3
Investments	6.9	7.2	7.3	7.3
Equity Investment in Financial Assets	9.1	10.5	11.0	11.5
Intangibles	66.7	61.0	60.6	60.2
Other Assets	4.3	4.3	4.8	4.5
TOTAL ASSETS	**106.1**	**124.5**	**128.8**	**144.2**
Trade and Other Payables	11.3	23.5	18.0	16.8
Deferred Tax	4.9	3.9	3.9	3.9
Other Liabilities	5.5	9.0	8.2	6.9
TOTAL LIABILITIES	**21.6**	**36.4**	**30.1**	**27.6**
TOTAL EQUITY	**84.5**	**88.1**	**98.7**	**116.7**

CASH FLOW SUMMARY (A$m)				
Period	FY20A	FY21A	FY22E	FY23E
Net Cash - Operating Activities	6.72	10.38	37.36	41.18
Net Cash - Investing Activities	4.18	2.91	(0.05)	0.05
Finance Cost	(0.29)	(0.15)	(0.20)	(0.20)
Net Cash from Financing Activities	(9.71)	(8.73)	(27.47)	(26.62)
Net Cash Flow	1.19	4.56	9.84	14.60
Opening Cash Balance	14.45	15.31	19.90	29.74
Closing Cash Balance	15.31	19.90	29.74	44.34

VALUATION RATIOS & MARGINS				
Period	FY20A	FY21A	FY22E	FY23E
Operating EBITDA margin	21.9%	27.5%	45.6%	37.3%
EV/EBIT	23.5	10.8	5.2	6.3
EV/EBITDA	21.2	10.6	5.2	6.2
All figures utilise underlying earnings				

EARNINGS AND DIVIDENDS				
Period	FY20A	FY21A	FY22E	FY23E
Weighted Average Units on Issue	107.93	108.00	109.02	109.02
Underlying EPS (c)	9.53	14.17	27.23	21.58
PE Ratio (x)	21.09	14.18	7.38	9.31
Underlying Dividend Payout Ratio	83.9%	91.7%	84.5%	83.4%
Reported Dividend Payout Ratio	99.7%	91.7%		
Dividend (c)	8.00	13.00	23.00	18.00
Dividend Yield (%)	4.0%	6.5%	11.4%	9.0%

Our forecasts present PCG on an operating basis. That is, we calculate an Operating EBITDA figure then our NPAT is calculated by deducting depreciation, interest and tax. Similar to adjusted figures reported by the company, we do not deduct amortisation to calculate adjusted NPAT and EPS as the majority of amortisation relates to the gradual write-down of acquired relationships. Further, our per share figures all include the 24.3m Treasury shares used for the loan funded share plan. The loan funded shares gradually come out of escrow from mid-2022 and the loans are payable within two years from the escrow release date. As we are including the treasury shares in our per share figures, we also include the interest earnt on the loan funded share plan (which utilises the treasury shares) in our operating NPAT and EPS forecasts. We think presenting the figures this way provides the clearest picture of PCG's current operating model.

We also note that our fee revenue is calculated based upon FUM assumptions. These FUM assumptions do not include the impact of investment performance nor the impact of distributions from the funds within the PCG portfolio to the respective investors. Investment performance and specific fund distributions may impact FUM positively or negatively.

Finally, we wish to point out that whilst the interest from the loan share plan is included in our forecasts, the loan balance ($29.6m) is off balance sheet. When the loans are repaid, this cash will sit on the balance sheet and will be utilised to increase shareholder value. We speculate that this could be through a special dividend, a buyback or further investment into PCG's listed vehicles.

PCG Funds

Below we outline the funds managed by PCG and the specifics of management and performance fees with respect to the portfolio of funds.

Code	Fund Name	Strategy	Investment Team	FUM ($m)	TC est. FUM Cap ($m)	Mgmt Fee	Performance Fee
	Pengana Australian Equities	Australian Multi Caps	Internal	987	1,100	1.0%	10.25%*
	Pengana Emerging Companies	Australian Small Caps	Internal	956	1,000	1.3%	20% above ASX Small Ords
	Lizard Global Small	Global Multi Caps	Internal	483	2,000	1.0%	a range of fee structures
	Pengana Axiom International Ethical	Global Multi Caps	JV	434	10,000+	1.3%	n/a
PIA.ASX	Pengana International Equities Ltd	Global Multi Caps	JV	379	10,000+	1.2%	15% above MSCI World
PE1.ASX	Pengana Private Equity	Global Private Equity	JV	333	10,000+	1.2%	19.5% above 8%
	Pengana Global Small Companies	Global Small Caps	Internal	179	500	1.3%	20% above MSCI AC World SMID
	Pengana Harding Loevner International	Global Multi Caps	JV	69	10,000+	1.0%	n/a
	Pengana WHEB Sustainable Impact	Global Impact Investing	JV	286	800	1.3%	n/a
	Pengana Israel Alpha	Global Market Neutral	JV	37	500	1.5%	20% above 4%
	Pengana High Conviction Equities	High Conviction	Internal	45	200	1.8%	15% above RBA Cash + 3% p.a.
	Pengana High Conviction Property	Australian Multi Caps	Internal	8	700	0.7%	14.6% above ASX300 A-REIT

*10.25% of increase in net asset value subject to the Australian cash rate plus 6% p.a and high water mark, paid half yearly

Note: FUM figures fluctuate and are a broad indication only.

PCG's funds are deliberately style agnostic so that financial advisers can see they offer genuine diversification and make sense for client portfolio construction. PCG's investment managers utilise a bottom-up investing approach where the impact of macro events is designed to have limited impact on investment performance.

Management fee key points

- PCG pays 30-40bps of the management fee to the external investment team when a JV is in place. When an internal investment team is utilised, the management fee is generally split 50/50 – that is, after direct expenses are applied.

Performance fee key points

- Generally, performance fees are split 50/50 with external investment teams. However, PCG receives 100% of performance fees from its listed vehicles, PIA and PE1. Performance fees are also split 50/50 with internal investment teams.
- 9/12 funds are subject to performance fees – this equates to 77% of FUM or $3.1bn as of the end of FY21.
- Of the 9, three of the funds ($1.36bn) are subject to absolute return hurdles. This is important as these performance fees are quite stable as the funds do not have to outperform a benchmark to achieve a return.
- Performance fees are spread across largely uncorrelated strategies, providing a degree of stability to income.
- We expect performance fees attributable to PCG to grow due to:
    - an increasing proportion of funds utilising external investment teams and the favourable structures in place with these teams.
    - As PCG has grown, bargaining power has improved and therefore economics of strategies are more favourable. Bargaining power is also improved when developing strategies without FUM caps as both sides can generate greater gross fees as FUM increases.
    - PE1 tracking above its absolute hurdle and PCG receiving 100% of the fees for this product.

Further key points

- Although internal investment teams share the economics of both management and performance fees 50/50, PCG allocates costs to these teams before the split is determined, essentially making this a profit share arrangement.
- Pengana Harding Loevner International Fund and Pengana International Equities (PIA.ASX) have both received “Recommended” ratings from Lonsec in late 2021. This was in addition to recent “Recommendation” ratings from Zenith. This is an improvement in rating for both funds and is notable having only brought Harding Loevner on board in May 2021. This will increase the number of platforms these funds are included in.
- Any new strategies will have large FUM capacity – management are highly focused on not capping growth potential.

Platforms

PCG funds are approved and included on approximately half of Australia’s retail investment platforms. This will increase following the upgrade in Lonsec ratings on the international funds as mentioned above. Coverage across all platforms is unrealistic however there is room for greater penetration of PCG funds and therefore a wider clientele base to target.

Our View

Whilst JV’s with external investment teams offer PCG more attractive economics on management and performance fees, we believe they are also more attractive to financial advisers, particularly across the international funds. External managers with a long history of outperformance, boots on the ground in the respective markets and larger teams are, in our opinion, likely to deliver greater returns than teams based in Australia. We think this opinion is supported by the upgraded rating from Lonsec on PIA.ASX and the Harding Loevner International Fund. The rating improvement is also likely to open more opportunities for FUM growth as these funds will be added to larger platforms.

We understand over the last few years PCG has focused on adapting the funds to better suit the demands of the market with the focus being on how they add value to an adviser and a client portfolio. This has helped build awareness of the group but importantly has provided advisers with a compelling reason to add PCG product to a clients portfolio. Poor performance is inevitable at some point (contracting markets) but importantly, we think the communication to advisers regarding value add and diversification will help limit ouflows in such a situation. We think PCG now have an attractive, leverageable structure in place to generate significant FUM growth over a prolonged period.

Peer Group Analysis

Below we outline a selection of PCG's peers listed in the Australian market.

			FUM %			Portfolio Exposure		FY21 Actual			FY22 Consensus Estimate		FY23 Consensus Estimate	
Company	Code	Mkt Cap	FUM	Retail	Whole-sale	Inter-national	Ethical	EBITDA	EBITDA margin	PE (x)	EBITDA margin	PE (x)	EBITDA margin	PE (x)
Pinnacle Investment Mgmt	PNI	$2.1bn	$91bn	25.3%	74.7%	Yes	Yes	67.0	n/a*		n/a*	24.4	n/a*	20.1
Magellan Financial Group	MFG	$3.8bn	$101bn	27.0%	73.0%	Yes	Yes	612.0	85.0%	19.2	82.0%	8.9	83.0%	10.4
Platinum Asset Mgmt	PTM	$1.5bn	$22bn	71.0%	29.0%	Yes	Yes	200.0	74.0%	16	75.0%	11.8	75.0%	11.8
Australian Ethical Investment	AEF	$864m	$6.7bn	70.0%	30.0%	Yes	Yes	17.3	30.0%	74				
Microequities Asset Mgmt	MAM	$115m	$497m	100%	0.0%	No	No	19.4	85.0%	9.1				
VGI Partners**	VGI	$315m	$2.6bn	100%	0.0%	Yes	No	44.6	70.0%	14.2				
Contango Asset Mgmt	CGA	$36m	$1.14bn	100%	0.0%	Yes	No	n/a	n/a	n/a				
Clime Investment Mgmt	CIW	$44m	$5.1bn	100%	0.0%	No	Yes	3.2	20.0%	22.5				
Pengana Capital Group	PCG	$220m	$3.9bn	100%	0.0%	Yes	Yes	19.2	27.5%	14.3	45.6%	7.5	37.3%	9.4

NB:
*PNI uses affiliates so total revenue is not disclosed and a true margin can not be calculated
**VGI actual figures are FY20 as it has a Dec year end
PCG forward estimates are TC estimates
Retail FUM is a broad definition and may include HNW, family offices, charitable foundations

Our research has made clear that Australian listed investment managers are a bespoke group of companies with wide-ranging mandates, strategies and reporting metrics. There is no obvious peer for PCG however we note the following key points:

- **High earnings growth managers are rewarded with high PE multiples**. This is highlighted by PNI growing EBITDA >20% and trading on ~25x vs. PTM growing at <5% and trading on ~12x, despite PTM operating at a higher margin.
- **Ethical themes trade at a premium**. A sharp increase in demand for ethical investing in recent times has helped valuations and FUM inflows. AEF is the standout in this regard trading on ~75x earnings however, all the remaining managers with ethical offerings still trade at a premium to those without an offering.
- **High operating margins don't necessarily lead to higher valuations**. CIW generates a 20% margin and trades on ~20x forward vs. VGI with a 70% margin trading on ~14x.

A distinction to make clear is that PCG has set up a cost-base and structure to grow FUM to levels comparable to larger peers such as PNI and PTM. For this reason, PCG's margin is lower than most peers, however, as highlighted above, this is not a pre-requisite for premium valuation. Additionally, PCG is only now beginning to realise notable operating leverage from its cost structure and is well positioned for margins to expand even further than exhibited in H1. We note that more profitable peers with similar FUM (such as VGI) are not set up to bring in new capital and therefore are reliant on investment performance to achieve meaningful FUM growth. This limits the ability to generate EPS and dividend growth and therefore share price appreciation for investors.

With our significant FY22E operating EBITDA growth forecasts, PCG clearly fits in the high earnings growth category similar to PNI. PCG also ticks the box of offering meaningful ethical exposure with five of its 12 funds utilising a form of impact, ethical or ESG investing.

Acknowledging PCG is smaller in terms of FUM, when we put these factors together, we see a strong case for PCG to trade at multiples in line with or closer to higher growth peers such as PNI.

Valuation

We believe our FY22E operating EBITDA growth forecast represents a high growth investment manager. When coupled with the defensive nature of earnings, we believe PCG is befitting of a market multiple and with the ASX Small Ords forward earnings multiple of 16x, we see scope for revaluation as PCG continues to grow FUM and earnings.

Below we provide implied share prices based on varying levels of earnings and multiples. The PE multiple matrix is most relevant given our peer comparisons on the prior page.

Although peer comparisons are difficult, we highlight EV/EBITDA multiples and varying levels of EBITDA for clarity's sake as this emphasises the operating business without adjustments. Additionally, investors can make EV/EBITDA multiple comparisons to other companies growing at double digits with defensive earnings.

For each multiple and EBITDA combination we use our FY22E cash and debt levels. The current share price, our current underlying EBITDA forecast and the implied multiple are in bold.

		FY22 PE Multiple (x)								
		4	6	**7.4**	8	10	12	14	16	18
FY22E underlying EPS ($m)	18	$0.72	$1.08	$1.33	$1.44	$1.80	$2.16	$2.52	$2.88	$3.24
	20	$0.80	$1.20	$1.48	$1.60	$2.00	$2.40	$2.80	$3.20	$3.60
	22	$0.88	$1.32	$1.62	$1.76	$2.20	$2.64	$3.08	$3.52	$3.96
	24	$0.96	$1.44	$1.77	$1.92	$2.40	$2.88	$3.36	$3.84	$4.32
	26	$1.04	$1.56	$1.92	$2.08	$2.60	$3.12	$3.64	$4.16	$4.68
	27.2	$1.09	$1.63	**$2.01**	$2.18	$2.72	**$3.27**	$3.81	$4.36	$4.90
	28	$1.12	$1.68	$2.07	$2.24	$2.80	$3.36	$3.92	$4.48	$5.04
	30	$1.20	$1.80	$2.21	$2.40	$3.00	$3.60	$4.20	$4.80	$5.40
	32	$1.28	$1.92	$2.36	$2.56	$3.20	$3.84	$4.48	$5.12	$5.76
	34	$1.36	$2.04	$2.51	$2.72	$3.40	$4.08	$4.76	$5.44	$6.12
	36	$1.44	$2.16	$2.66	$2.88	$3.60	$4.32	$5.04	$5.76	$6.48
	38	$1.52	$2.28	$2.81	$3.04	$3.80	$4.56	$5.32	$6.08	$6.84

		FY22 EV/EBITDA Multiple (x)								
		2	3	4	**5.2**	6	7	8	9	10
FY22E underlying EBITDA ($m)	28	$0.77	$1.03	$1.29	$1.58	$1.80	$2.06	$2.32	$2.57	$2.83
	30	$0.81	$1.09	$1.36	$1.68	$1.91	$2.19	$2.46	$2.74	$3.01
	32	$0.85	$1.14	$1.44	$1.77	$2.02	$2.32	$2.61	$2.90	$3.20
	34	$0.89	$1.20	$1.51	$1.87	$2.13	$2.44	$2.76	$3.07	$3.38
	36	$0.92	$1.25	$1.58	$1.96	$2.24	$2.57	$2.90	$3.23	$3.56
	37.4	$0.95	$1.29	$1.63	$2.03	$2.32	$2.66	$3.01	$3.35	$3.70
	38	$0.96	$1.31	$1.66	$2.06	$2.35	$2.70	$3.05	$3.40	$3.75
	40	$1.00	$1.36	$1.73	$2.15	$2.46	$2.83	$3.20	$3.56	$3.93
	42	$1.03	$1.42	$1.80	$2.25	$2.57	$2.96	$3.34	$3.73	$4.11
	44	$1.07	$1.47	$1.88	$2.34	$2.68	$3.09	$3.49	$3.89	$4.30
	46	$1.11	$1.53	$1.95	$2.43	$2.79	$3.21	$3.64	$4.06	$4.48
	48	$1.14	$1.58	$2.02	$2.53	$2.90	$3.34	$3.78	$4.22	$4.66

PCG currently trades on 7.5x our FY22E EPS forecast. This represents a 53% discount to the current ASX Small Ords multiple of 16.0x.

We believe a fair value multiple for PCG in FY22 is 11x, implying a share price of $2.99. With earnings growth still occurring and major FUM growth potential still to come, this multiple implies a continued discount to peers and the market for the short-term. We see no reason why PCG should not trade at a market multiple or a premium to the market in the long-term.

We highlight that our forecasts do not account for investment performance and therefore positive investment performance provides upside to our FUM forecasts and subsequent years earnings forecasts.

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