Hennessy Advisors

Note: Due to its small market capitalization and lack of liquidity, this is an idea most appropriate for personal accounts or very small funds.

Summary:

We believe that Hennessy Advisors (HNNA), due to its small size, is below the radar of most investors. In addition we believe the market is unaware of how accretive Hennessy's purchase of FBR funds will be. As quarterly results begin to show the higher earnings power of the company we believe they will be a catalyst resulting in the stock price rising from its current $4 per share to at least $8 per share and could potentially reach $12 or more within six months. We believe Hennessy is one of the most attractively priced stocks we have seen since the severe market decline in 2009.

FBR Acquisition:

In June 2012 Hennessy agreed to acquire the FBR funds. At the time of the agreement the FBR funds had $1.9 billion in assets under management (AuM), which grew to $2.2 billion at the actual closing in late October. The purchase price came to $32.8 million, with 60% payable up front and 40% payable upon the one year anniversary. The one year anniversary payment is based on AuM at that date. Hennessy paid varying rates on each of the acquired funds. In aggregate the acquisition price worked out less than 1.5% of AuM, which is very attractive for full paying actively managed equity funds.[1]

The FBR acquisition is highly accretive for Hennessy. By adding $2.2 billion in AuM to the $900 million it was already managing, it more than tripled the size of the firm. By taking advantage of the low interest rate environment, Hennessy was able to substantially grow the firm without any equity dilution. The FBR funds have historically been better performers than the prior acquisitions by Hennessy. In addition, Hennessy is keeping the same portfolio managers via sub-advisory agreements and hiring the staff. This should make it much more likely that the acquired AuM will remain in the funds.

Industry:

The asset management industry has performed very well historically. Stocks like Eaton Vance (EV), Franklin Resources (BEN), and T Rowe Price (TROW) have compounded at excellent rates for more than 30 years. The primary reason for this, in our opinion, is the excellent characteristics of the industry. The industry has stable pricing power, negligible capital requirements, excellent margins, and the potential for sales growth. In general, there are minimal costs to service additional accounts in relation to the additional fees the accounts generate. Moreover, as the stock market rises, additional money tends to flow into mutual funds, thus assets under management (AuM) can grow at a faster rate than

[1] For reference, Epoch Holdings (EPHC), who primarily functions as an equity sub-advisor charging 46 basis points recently agreed to be acquired by TD Bank for $28 per share, which works out to an EV to AuM of 2.6%. A similar value for Hennessy would result in $9.60 per share. Hennessy charges 50% higher fees (72 basis point average) but currently has lower profit margins than Epoch. If margins increase with the FBR acquisition it is reasonable that Hennessy would be worth more on an EV to AuM basis than Epoch.

the overall market (in a declining market the opposite is also true). These factors allow for excellent free cash flow generation which a good manager will use in ways that will create shareholder value - dividends, debt reduction, share repurchases, or acquisitions.

The end result is that asset managers can trade at significant multiples to accounting book value since so little cash is needed in the business. The real assets are the branding and the portfolio managers themselves. Due to the risk of portfolio managers leaving companies do pay them well, often incorporate a team approach, and try to develop future managers.

Historical Results:

Year	AuM	Revenue	Net Inc.	EPS	Dividends	Share Price	EV % AuM
2004	1,222,073	9,545	2,765	$ 0.48	$ -	$ 7.19	3.47%
2005	1,807,472	11,997	3,139	$ 0.53	$ 0.04	$ 11.56	3.90%
2006	2,056,253	16,934	4,403	$ 0.70	$ 0.06	$ 16.67	4.60%
2007	1,720,763	16,072	4,133	$ 0.73	$ 0.08	$ 10.90	3.31%
2008	876,069	10,275	1,611	$ 0.28	$ 0.09	$ 5.05	2.56%
2009	923,404	5,813	-195	$ -0.03	$ 0.09	$ 3.19	1.34%
2010	892,465	7,723	913	$ 0.16	$ 0.09	$ 2.35	0.95%
2011	749,310	7,644	1,215	$ 0.21	$ 0.17	$ 3.00	1.52%
2012	919,262	7,072	971	$ 0.17	$ 0.13	$ 2.85	1.05%
2013E	*3,100,000*	*23,300*	*4,250*	*$ 0.74*	*$ 0.13*	*$ 4.00*	*1.51%*

Note: EV % AuM for 2103 estimate includes $13.1 million due on FBR acquisition in late October 2013.

Company History:

- ***1996*** Launched first mutual fund, the Hennessy Balanced Fund.
- ***1998*** Launched the second mutual fund, the Hennessy Total Return Fund.
- ***2000*** Completed first asset purchase. Became the manager to the O'Shaugnessy Cornerstone Growth & Value Funds, now called the Hennessy Cornerstone Growth Fund and the Hennessy Cornerstone Value Fund. The purchased assets totaled approximately $197 million.
- ***2002*** In May, completed a self-underwritten initial public offering of their stock by raising $5.7 million at a split adjusted price of $2.97 (HNNA.OB) and changed firm name to Hennessy Advisors, Inc. Assets at the time of the IPO were $358 million.
- ***2003*** In September, launched fifth mutual fund, the Hennessy Cornerstone Mid Cap 30 Fund (formerly the Hennessy Focus 30 Fund). Purchased and reorganized $35 million in assets from the SYM Select Growth Fund into this new fund.
- ***2004*** In March, purchased the management agreements for five funds managed by Lindner Asset Management, Inc. (the Lindner Funds). The assets of these funds were reorganized into four existing Hennessy funds. The combined assets of the Linder Funds were approximately $301 million.
- ***2005*** In July, purchased the management agreement for the Henlopen Fund and changed the fund name to the Hennessy Cornerstone Growth, Series II Fund. At the time of the purchase, The Henlopen Fund had approximately $299 million in assets. As of October 28, 2011, the assets of the Hennessy Cornerstone Growth, Series II Fund were combined into the Hennessy Cornerstone Growth Fund.

- ***2009*** In March, purchased the management agreements for two funds managed by RBC Global Asset Management (U.S.) Inc.: the Tamarack Large Growth Fund and the Tamarack Value Fund (the Tamarack Funds). Shares of the Tamarack Large Growth Fund were exchanged for Hennessy Cornerstone Large Growth Fund and shares of the Tamarack Value Fund were exchanged for shares of the Hennessy Large Value Fund. The combined assets of the Tamarack Funds were approximately $158 million. RBC Global Asset Management (U.S.) Inc. became the sub-advisor to the Hennessy Large Value Fund.
- ***2009*** In September, purchased the management agreements for two funds managed by SPARX Investment & Research, USA, Inc., and sub-advised by SPARX Asset Management Co., Ltd.: the SPARX Japan Fund and the SPARX Japan Small Cap Fund (the SPARX Funds). Shares of the SPARX Japan Fund were exchanged for the Hennessy Japan Fund and shares of the SPARX Japan Small Cap Fund were exchanged for shares of the Hennessy Japan Small Cap Fund. The combined assets of the SPARX Funds were approximately $74 million.

Hennessy has a mixed record on their acquisitions. Overall they have acquired $1.06 billion in AuM and yet only had AuM of $900 million, prior to the FBR acquisition. Sparx AuM has declined from $75 million to $25 million. Henlopen acquisition went from $300 million to $25 million before fund was merged into another existing fund. Lindner AuM is hard to separate since it was joined into existing funds, but I would estimate that AuM went from $300 million to $170 million. Tamarack has performed well as AuM has risen from $158 million to $240 million.

The Henlopen acquisition involved a strategy change thus it was by far the most risky and performed the worst. Sparx AuM was negatively impacted by the earthquake in Japan. The Tamarack acquisition kept the same mangers via a sub-advisory agreement, and has performed the best. It would seem that the sub-advisory approach is the most likely to succeed. The FBR acquisition is split nearly 50/50 between sub-advisory and bringing management in house (which Hennessy has not tried before but should logically function similar to sub-advisory). If the cost of bringing personnel in house is too high, it is likely that Hennessy will convert the employees to a sub-advisory structure.

Projected Financials:

There are two simple ways to project financial results for Hennessy. The simplest is to read their debt covenant requirements. Hennessy borrowed $16.4 million bringing their total debt to $18.4 million. The interest rate is prime plus 75 basis points. Hennessy has pledged to maintain a maximum debt to EBITDA ratio of 2.5, meaning annual EBITDA will be at least $7.36 million.

Minimum Earnings and Cash Flow

	Minimum	Mid Range	Most Likely
EBITDA	$ 7,360,000	$ 8,500,000	$ 9,000,000
Interest	$ (750,000)	$ (750,000)	$ (750,000)
Depreciation	$ (100,000)	$ (100,000)	$ (100,000)
Pre-tax Income	$ 6,510,000	$ 7,650,000	$ 8,150,000
Taxes (42%)	$ (2,929,500)	$ (3,442,500)	$(3,667,500)
Net Income	$ 3,580,500	$ 4,207,500	$ 4,482,500
Deferred Tax	$ 1,200,000	$ 1,200,000	$ 1,200,000
Cash Flow	$ 4,780,500	$ 5,407,500	$ 5,682,500
EPS	$ 0.62	$ 0.73	$ 0.77
CF/share	$ 0.83	$ 0.93	$ 0.98
EV/EBITDA	6.52	5.65	5.33

Since it is obvious that Hennessy would not agree to covenants that they did not believe that they could easily meet, it is reasonable to assume that Hennessy believes it will run approximately 20% higher EBITDA.

Under the simple method, Hennessy would earn a minimum of $0.62 per share under the maximum debt covenant, and more likely $0.75 to $0.80 per share. Due to the benefit of deferred taxes (gained through the amortization of acquired management contracts for tax purposes), cash flow should be $1.2 million higher per annum. Principal payments on the debt would equal approximately $1.8 million annually, leaving free cash flow of nearly $4 million annually which could be used to further pay down debt, pay dividends, repurchase shares, or make additional acquisitions.[2]

The second, more complicated way to project Hennessy's future results is to take the AuM of each fund and multiply it by the management advisory fee in order to estimate Advisory Revenues. The same can be done for shareholder service fees. Combined the two will equal total revenues. While we have the historical costs of both firms, Hennessy will eliminate a portion of the costs that FBR was incurring by reducing overhead, moving some of the employees to sub-advisory contracts, and gaining the benefits of synergy.

While the acquisition brought 10 additional employees into Hennessy's structue, it is reasonable to assume that Hennessy will not pay much more for them than what they would pay under a sub-advisory agreement. We estimate a $23.5 million run rate for revenues, $15.3 million for operating expenses, resulting in an industry average 35% operating margin. After deducting interest costs, it results in pre-tax income of $8.2 million, and net income of $4.3 million, or approximately $0.75 per share. EBITDA under this method was $8.4 million.

Risks:

The most obvious risk for Hennessy is retaining the acquired assets. As noted earlier, the sub-advisory and in house approach should increase the chances of success; however, a material loss of AuM through poor fund specific performance, an overall market decline, or redemptions, could result in the deal not being accretive. Another major concern is liquidity. On some days there may be tens of thousands of shares near the bid or ask, while the next day there may be only a few hundred. A buyer or seller must be patient and use limit orders.

Conclusion:

The buyer at $4 per share is paying just five times earnings, and four times cash flow, for a relatively stable cash flow generating business. As Hennessy uses its free cash to pay down debt, pay dividends, and repurchase shares, we believe the stock should rise to $8 per share or more within six to nine months.

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[2] Hennessy's debt covenant allows for the repurchase of up to one million shares. Hennessy currently has 5.76 million shares outstanding, thus if they were to start repurchasing while the price is still low, it could be highly accretive. On the risk side it would reduce the amount of available cash for the anniversary payment related to the FBR acquisition.