

K2 Asset Management

HOLD

Current price:	A\$0.70
Target price:	A\$0.71
Previous target:	A\$
Up/downside:	2.2%
Reuters:	KAM.AX
Bloomberg:	KAM AU
Market cap:	US\$116.3m A\$162.3m
Average daily turnover:	US\$0.03m A\$0.05m
Current shares o/s	233.6m
Free float:	35.0%



Price performance	1M	3M	12M
Absolute (%)	-10.9	-0.7	36.3
Relative (%)	-8.1	-1.5	40.6

Scott MURDOCH

T (61) 7 3334 4516

E smurdoch@morgans.com.au

A performance driven model

- K2 Asset Management (KAM) is an Australian based, boutique equity fund manager with around A\$825m of funds under management. Established in 1999, the group has a strong investment track record across Australian and Global equity markets.
- KAM is a 'performance driven' model, with funds typically managed on an index unaware basis; and only generating performance fees on absolute performance (ie, after a high water mark is achieved). KAM's fund offering is primarily focused on providing individual investors and SMSFs access to asset classes and strategies not easily implemented and providing portfolio diversification (eg, global shares).
- We initiate coverage with a Hold recommendation. Investors in KAM are highly aligned with directors and key staff who own a combined ~80% of the business. Given the reliance on performance fee generation, KAM's earnings have the potential to be relatively volatile compared to other asset managers; however, over the longer term continued investment performance is likely to drive solid dividend returns for shareholders.

KAM overviews

K2 Asset Management (KAM) is an Australian based boutique equity fund manager, employing ~25 staff (including nine portfolio managers). The group was established by Campbell Neal in 1999 and listed on the ASX in 2007. KAM manages A\$823m, predominantly for retail investors and self-managed superannuation funds (SMSFs). The group manages six funds, with its largest three funds accounting for ~84% of FUM. KAM's investment philosophy centres on long-term investing and capital protection, which has resulted in exceptional investment returns from its funds.

A 'performance driven' model

KAM's three core funds (Australian Absolute; Select International; and Asian Absolute) have all outperformed their relative markets by over 5% pa over the past 10 years. Aligned with fund investors, KAM's focus is purely on performance. Reflecting this strategy, KAM funds are typically index unaware (not benchmarked against an index); and earn performance fees on absolute (positive) performance. Additionally, staff are remunerated based on performance and funds are typically kept relatively small to stay 'nimble'. Over the past three years, KAM has achieved ~5% pa compound FUM growth.

Exchange traded funds (KII and KSM) - a new platform for growth

In 1H16, KAM launched two 'exchange traded funds' (KII and KSM), listed versions of the Global High Alpha fund (24.6% return pa since inception) and the Australian Small Cap fund (18.6% return pa since inception). Unlike traditional LICs, the exchange traded fund offers live pricing and liquidity to enable investors to access the fund at net asset value (NAV). From listing in July, KII has raised ~A\$43m in FUM and we expect these products to gain more traction given the ease of access and market-based pricing.

Initiation of coverage - Hold

We initiate coverage with a Hold recommendation value KAM at A\$0.71ps, based on an equally blended DCF/PE methodology. In our view, trading on 13.8x FY17F PE (a more 'average' earnings year), KAM is fairly valued at this point. Given market/fund performance in 1H16, we expect KAM to report a relatively subdued 1H16 result of A\$2.4m NPAT and 1cps DPS.

Financial Summary	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
Revenue (A\$m)	41.10	45.29	19.67	30.66	32.51
Operating EBITDA (A\$m)	23.00	26.66	9.94	16.09	17.54
Net Profit (A\$m)	16.44	18.89	7.26	11.48	12.50
Normalised EPS (A\$)	0.070	0.081	0.031	0.049	0.054
Normalised EPS Growth	24.5%	14.9%	(61.6%)	58.1%	8.9%
FD Normalised P/E (x)	9.87	8.59	22.35	14.14	12.99
DPS (A\$)	0.080	0.085	0.030	0.050	0.055
Dividend Yield	11.5%	12.2%	4.3%	7.2%	7.9%
EV/EBITDA (x)	6.34	5.25	14.08	8.67	7.90
P/FCFE (x)	6.91	8.09	12.57	14.79	12.96
Net Gearing	(131%)	(128%)	(187%)	(177%)	(172%)
P/BV (x)	12.93	9.30	13.69	12.65	11.89
ROE	103%	126%	50%	93%	94%
% Change In Normalised EPS Estimates					
Normalised EPS/consensus EPS (x)			0.66	0.93	0.88

SOURCE: MORGANS, COMPANY REPORTS

Figure 1: Financial Summary

Profit and loss					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
Revenue	41.1	45.3	19.7	30.7	32.5
Total Operating Costs	18.1	18.6	9.7	14.6	15.0
EBITDA	23.0	26.7	9.9	16.1	17.5
Depreciation	-0.1	0.0	0.0	0.0	0.0
Amortisation & impairments	0.0	0.0	0.0	0.0	0.0
EBIT	22.9	26.6	9.9	16.1	17.5
Net Interest	0.7	0.4	0.5	0.3	0.3
Pre-tax Profit	23.6	27.0	10.4	16.4	17.9
Tax	-7.2	-8.1	-3.1	-4.9	-5.4
Normalised Profit	16.4	18.9	7.3	11.5	12.5
Exceptional items	0.0	0.0	0.0	0.0	0.0
Reported Profit	16.4	18.9	7.3	11.5	12.5

Cash flow statement					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
EBITDA	23.0	26.7	9.9	16.1	17.5
Net interest	0.7	0.4	0.5	0.3	0.3
Tax	-7.2	-8.1	-3.1	-4.9	-5.4
Changes in working capital	7.0	1.2	5.7	-0.5	0.0
Operating cash flow	23.5	20.1	13.0	11.0	12.6
Capex	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	23.5	20.1	12.9	11.0	12.5
Acquisitions and divestments	0.0	0.0	0.0	0.0	0.0
Other Investing cash flow	0.0	0.0	0.0	0.0	0.0
Investing cash flows	0.0	0.0	0.0	0.0	0.0
Increase / decrease in Equity	0.0	0.0	0.0	0.0	0.0
Increase / decrease in Debt	0.0	0.0	0.0	0.0	0.0
Dividends paid	-33.3	-9.3	-12.8	-10.5	-11.7
Other financing cash flows	0.0	0.0	0.0	0.0	0.0
Financing cash flows	-33.2	-9.3	-12.8	-10.5	-11.7
Cash Increase/(Decrease)	-9.8	10.8	0.1	0.5	0.9

Balance Sheet					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
Assets					
Cash And Deposits	16.5	22.5	22.6	23.1	23.9
Debtors	1.8	24.1	9.7	17.6	17.8
Inventory	0.0	0.0	0.0	0.0	0.0
Other current assets	0.2	0.2	0.2	0.2	0.2
Total Current Assets	18.4	46.8	32.5	40.9	41.9
Fixed Assets	0.1	0.1	0.1	0.1	0.1
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	0.0	0.0	0.0	0.0	0.0
Intangibles	0.0	0.0	0.0	0.0	0.0
Other non-current assets	1.3	1.6	1.6	1.6	1.6
Total Non-Current Assets	1.4	1.6	1.7	1.7	1.7
TOTAL ASSETS	19.8	48.4	34.1	42.6	43.6
Liabilities					
Short Term Debt	0.0	0.0	0.0	0.0	0.0
Creditors	0.5	9.2	0.5	8.0	8.2
Other current liabilities	2.3	12.8	12.8	12.8	12.8
Total Current Liabilities	2.8	22.0	13.3	20.8	21.0
Long Term Debt	0.0	0.0	0.0	0.0	0.0
Other Debt (inc hybrids)	0.0	0.0	0.0	0.0	0.0
Other Non-current liabilities	2.1	1.9	1.9	1.9	1.9
Total Non-Current liabilities	2.1	1.9	1.9	1.9	1.9
TOTAL LIABILITIES	4.9	24.0	15.3	22.7	22.9
Equity					
Issued capital	2.0	2.1	2.1	2.1	2.1
Retained earnings	10.5	15.4	9.8	10.8	11.6
Other reserves and FX	0.0	0.0	0.0	0.0	0.0
TOTAL EQUITY	12.6	17.4	11.9	12.8	13.7

Valuation details					
Share Price	\$0.68	Market Cap: A\$159m			
Price Target	\$0.71				
Total shareholder return	WACC		11.5%		
Multiple Weighting Value per share					
DCF	14x FY17	50%	\$0.73		
PE	14x FY17	50%	\$0.69		
Blended Valuation	\$0.71				

Key metrics/ multiples					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
P/E	9.7	8.4	21.9	13.8	12.7
Yield	11.8%	12.5%	4.4%	7.4%	8.1%
PEG		0.6	-0.4	0.2	1.4
EV/EBITDA	6.9	5.0	14.1	8.6	7.9
EV/EBIT	6.9	5.0	14.1	8.6	7.9
Price/ Book Value	12.6	9.1	13.4	12.4	11.6
Price/ Net Tangible Assets	12.7	9.1	13.4	12.4	11.6
Operating cash flow yield	14.8%	12.7%	8.2%	6.9%	7.9%
Free cash flow yield	14.8%	12.6%	8.1%	6.9%	7.9%

Per share data					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
Diluted shares on issue	233.5	233.5	233.6	233.6	233.6
Reported EPS (A\$)	0.07	0.08	0.03	0.05	0.05
Normalised EPS (A\$)	0.07	0.08	0.031	0.049	0.054
Dividends per share (A\$)	0.08	0.09	0.03	0.05	0.06
Payout ratio	113.6%	105.1%	96.5%	101.7%	102.8%

Result quality					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
Cash flow (gross) conversion	130.6%	104.5%	157.0%	97.0%	100.3%
FCF vs. NPAT	142.9%	106.2%	177.8%	95.6%	100.2%
Gross dividends vs FCF	46.3%	99.5%	95.7%	93.2%	101.9%

Gearing					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
Net Debt (cash)	-16.47	-22.54	-22.60	-23.07	-23.92
Net debt (cash) - WC adjuste	0.00	-24.59	-18.99	-19.94	-20.75
Net Debt / Equity	0.0%	-141.0%	-160.1%	-155.4%	-151.9%
Net Debt / EBITDA (x)	0.00	-0.92	-1.91	-1.24	-1.18
EBIT interest cover (x)	-35.13	-76.00	-22.01	-47.37	-50.60
Enterprise Value	158.8	134.2	139.8	138.9	138.1

Growth ratios					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
Revenue	14.6%	10.2%	-56.6%	55.8%	6.0%
Operating costs	3.7%	2.9%	-47.8%	49.7%	2.8%
EBITDA	24.8%	15.9%	-62.7%	61.8%	9.0%
EBIT	25.0%	16.1%	-62.7%	61.9%	9.0%
NPAT	24.5%	14.9%	-61.6%	58.1%	8.9%
EPS	24.5%	14.9%	-61.6%	58.1%	8.9%
DPS	60.0%	6.3%	-64.7%	66.7%	10.0%
Operating cash flow	180.1%	-14.6%	-35.6%	-14.9%	14.1%

Margin analysis					
	Jun-14A	Jun-15A	Jun-16F	Jun-17F	Jun-18F
EBITDA Margin	56.0%	58.9%	50.5%	52.5%	53.9%
EBIT margin	55.8%	58.8%	50.4%	52.4%	53.9%
NPAT margin	40.0%	41.7%	36.9%	37.5%	38.5%
ROE	130.9%	108.3%	61.2%	89.5%	91.5%

SOURCE: MORGANS RESEARCH, COMPANY

Initiation of coverage

Investment thesis

KAM is a boutique equity fund manager, with six investment funds focused on Australian, Asian and International equity strategies. The business was founded in 1999 by Campbell Neal (Managing Director and a Senior Portfolio Manager) and Mark Newman (Chief Investment Officer). KAM has strong in house investment capability, with 10 investment staff based in Melbourne. KAM funds are open to retail and institutional investors; however, the current A\$823m of FUM is predominantly managed on behalf of retail investors with a focus on the SMSF market.

KAM's business model is focused firstly on performance, which is at the core of KAM's success to date. Across all funds, exceptional long-term performance is supported by KAM's philosophy of capital protection. Growth in absolute FUM is also a focus, however the group maintains a 'nimble' approach which has aided strong performance since inception.

We initiate coverage on KAM with a Hold recommendation and A\$0.71ps price target. We are positive on KAM's boutique market positioning and track record of returns. However, we note given KAM's performance fee based model, earnings are likely to be more volatile than other fund managers. In the short term, with volatile market performance over the past six months and three years of strong performance, KAM now hurdles high water marks (HWMs), which are unlikely to be met in 1H16 and therefore likely faces a material fall in FY16F EPS and DPS.

Investment highlights

- **Highly aligned management team** – directors and staff of KAM own ~80% of issued capital, with Campbell Neal having a 35% interest. Additionally, staff remuneration is highly aligned to the underlying performance of the funds (performance fee generation) with up to 50% of performance fees paid to investment staff if certain criteria are met.
- **Performance driven model with a very strong track record** – the KAM business model focusses primarily on performance. Investment funds are index unaware; performance fees are generated against a positive performance hurdle (ie, performance above the cash rate or 6% pa, however performance must be above a high water mark); can actively manage net equity exposure (ie, can hold any level of cash and can use short strategies); and staff are incentivised on a percentage of performance fees. This focus on performance has resulted in a strong performance track record in all six funds managed by KAM, with an average ~10% absolute performance of the core funds over the past 10 years.
- **Diversification across investment strategies** – KAM manages six investment funds, focused on differing strategies including: Australian equities; Asian equities; International equities and small caps.
- **New 'exchange traded funds' (KII and KSM) to drive FUM inflows** – KAM launched the listed 'K2 Global Equities Fund' (KII) in July 2015 and the 'K2 Australian Small cap Fund' in December 2015. The funds are an exchange traded version of the high performing 'Global High Alpha' and Australian Small Cap funds. KII initially raised ~A\$17m, with a further A\$18.8m of net inflows over the following four months. Given the ease of access (ASX listed); liquidity; and market based pricing of the new exchange traded structure (versus traditional LICs), we believe KAM has initiated a new platform for fund inflows over the medium term.
- **Strong balance sheet and cash flow** - KAM has ~A\$17m of net assets (cash) on balance sheet. Given minimal capex requirements, KAM is able to sustain a 100% dividend payout ratio leading to solid dividend returns for shareholders.

Risks to consider

- **Key man risk/loss of investment staff:** Investment performance, retention of FUM and attracting new FUM is highly reliant on KAM's key investment staff.
- **High reliance on performance fees:** Over the past three years, performance fees have accounted for an average 68% of total revenue. If KAM does not achieve adequate performance and performance fees are low, KAM's earnings and dividends will be negatively impacted.
- **Poor investment performance:** Sustained poor investment performance is likely to lead to FUM outflow and reduced management and performance fees.
- **Market performance:** KAM's short-term earnings performance is impacted by market performance; volatility and investor sentiment.
- **Competitive environment:** The funds management industry is highly competitive, with a significant number of operating businesses. Increased competition may impact KAM's ability to attract and retain FUM or put pressure on fee margins.
- **Regulatory risk:** Changes to the Australian superannuation legislation or increased financial services regulation domestically and globally may impact KAM's financial performance.

Key upside catalysts include: higher-than-expected FUM net inflow; and better-than-expected performance leading to higher FUM and performance fees.

Key share price downside risks include: sustained investment underperformance and/or market volatility leading to FUM outflow; lower-than-expected performance and therefore performance fees; and the loss of key investment staff.

Valuation and peer compco

Valuation and price target

We value KAM at A\$0.71ps using a blended DCF/PE based valuation.

Figure 2: Blended valuation

	Weighting	Valuation	Weighted per share
DCF	50.0%	0.73	0.36
PE	50.0%	0.69	0.34
Weighted valuation			\$0.71
Implied FY16F PE (x)			22.7

SOURCES: MORGANS, COMPANY REPORTS

PE valuation

Our PE valuation of A\$0.69ps is based on applying a 14x multiple to FY17F EPS. Our multiple is set broadly in-line with KAM and small cap peers (HFA Holdings (HFR) and Pacific Current Group (PAC)) long-term averages.

We have based our PE valuation on FY17F EPS, which we believe reflects a more 'average' earnings year for KAM (based on performance fees that closer reflect long-term average fund performance).

Figure 3: PE valuation (x)

Year	EPS	Multiple	Valuation
FY17	4.9	14	\$0.69

SOURCES: MORGANS, COMPANY REPORTS

DCF valuation

Our DCF valuation of A\$0.73ps is derived using a WACC of 11.2% (RFR 4.25%; MRP 6.0%; Beta 1.15x) and a LTGR of 2.5%.

Figure 4: DCF valuation

Valuation per share	\$0.73
Valuation inputs	
WACC	11.2%
Market risk premium	6.0%
Risk free rate	4.3%
Target gearing (D/D+E)	0.0%
Equity beta	1.15
Long term growth rate	2.5%

SOURCES: MORGANS, COMPANY REPORTS

Historical PE band

Figure 5: KAM FY1 PE



SOURCES: MORGANS, COMPANY REPORTS

Peer comparison

We view KAM's closest peers as the small-cap fund managers including HFA, Blue Sky Alternative Investments (BLA) and PAC. Figure 6 also outlines the metrics of the broader domestic listed fund managers.

Figure 6: Peer Compco

Name	Mcap \$M	Last Price	P/E			EV/EBIT			EPS growth (%)			Dividend yield		
			FY1	FY2	FY3	FY1	FY2	FY3	FY1	FY2	FY3	FY1	FY2	FY3
Domestic Asset Managers														
Henderson Group	6,644	5.87	16.2x	14.6x	13.0x	12.6x	11.2x	9.8x	NA	NA	NA	2.7%	3.0%	3.3%
Platinum Asset Management Ltd	4,318	7.36	18.6x	17.1x	16.1x	12.3x	11.2x	10.6x	7.8%	9.0%	6.0%	3.8%	4.1%	4.4%
Magellan Financial Group Ltd	3,906	24.31	22.7x	19.9x	18.5x	17.3x	15.5x	14.0x	5.2%	14.3%	7.4%	2.5%	2.8%	3.1%
BT Investment Management Limited	3,653	12.24	21.7x	19.7x	17.4x	14.0x	12.7x	11.3x	28.4%	10.2%	12.7%	2.8%	3.1%	3.5%
loof Holdings Ltd	2,677	8.92	14.4x	13.3x	12.2x	11.0x	10.4x	9.4x	3.4%	7.9%	9.1%	4.5%	4.9%	5.3%
Perpetual Limited	2,024	43.45	16.1x	14.9x	13.6x	8.2x	7.6x	6.9x	1.9%	7.6%	9.5%	4.1%	4.4%	4.8%
HFA Holdings Limited	462	2.85	18.1x	16.6x	16.0x	13.1x	10.2x	10.0x	0.8%	8.8%	4.0%	4.0%	4.4%	4.5%
EQT Holdings Ltd.	397	19.97	16.5x	14.6x	13.0x	10.5x	9.1x	8.0x	37.9%	13.3%	12.4%	3.7%	4.1%	4.6%
Blue Sky Alternative Investments Limited	369	6.52	26.1x	20.5x	18.5x	17.1x	13.3x	11.9x	25.7%	32.7%	36.2%	2.2%	3.0%	3.3%
Pacific Current Group Ltd	177	6.30	11.2x	9.4x	9.9x	na	na	na	-22.7%	18.8%	-5.1%	4.5%	5.4%	5.2%
AVERAGE			18.1x	16.1x	14.8x	12.9x	11.3x	10.2x	9.8%	13.6%	10.3%	3.5%	3.9%	4.2%
K2 Asset Management Holdings Ltd	159	0.68	21.9x	13.8x	12.7x	14.1x	8.6x	7.9x	-64.7%	66.7%	10.0%	4.4%	7.4%	8.1%

SOURCES: FACTSET, MORGANS FORECASTS (BTT, BLA and KAM), COMPANY REPORTS

Company overview

Key aspects of the KAM model

- **Focus on absolute performance:** KAM's primary focus is on absolute performance within its funds. Funds are typically index unaware; can actively manage net equity exposure (ie, can hold any level of cash); and derive performance fees on absolute performance (ie not benchmarked against an index and earn performance fees only after a high water mark is reached). This performance focus is also reflected in KAM's business model, with ~68% of revenue over FY13-15 consisting of performance fees.

Figure 7: Performance 31 October 2015 (net of all fees)

Fund	FUM	1 Year %	3 Year % p.a.	5 Year % p.a.	7 Year % p.a.	10 Year % p.a.	Since Inception % p.a.
K2 Australian Fund	386.9	4.20%	11.40%	7.10%	10.30%	8.80%	12.10%
K2 Select Int Fund	217.1	24.80%	18.60%	11.50%	13.60%	11.80%	12.10%
K2 Global Alpha Fund	106.4	28.10%	29.20%	22.00%	-	-	24.60%
K2 Asian Fund	87.3	13.70%	16.50%	7.50%	11.60%	9.40%	11.20%
K2 Australian Small Cap Fund (KSM)	25.7	15.70%	-	-	-	-	18.60%

SOURCES: MORGANS, COMPANY REPORTS

Figure 8: K2 Global funds performance vs major domestic listed peers

	1 year %	3 year %	5 year %	Since Inception
K2 Global High Alpha	31.9%	32.5%	27.4%	25.0%
K2 Select International	31.7%	20.9%	14.1%	12.4%
Magellan Global Fund	29.5%	26.4%	19.6%	12.0%
Platinum International Fund	21.8%	26.8%	12.3%	13.4%

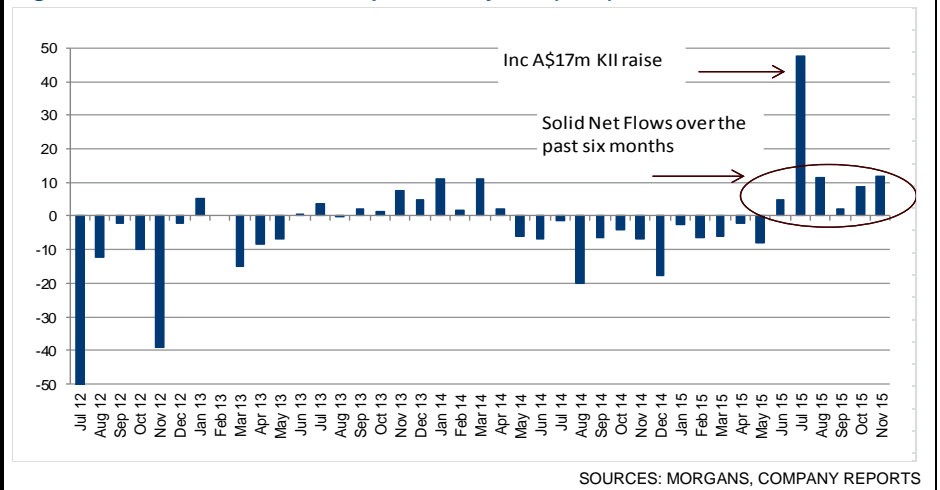
SOURCES: MORGANS, COMPANY REPORTS

- **Six funds with differentiated strategies:** KAM has developed its investment strategies to offer differentiated products to individual investors and SMSFs. KAM funds are designed to offer exposure to regions and/or investment strategies and segments that aren't typically the focus of broader investment advice or are difficult for individual investors to implement directly (eg, direct international shares). These include:
 - **K2 Australian Fund:** a long/short fund focused on domestic equities; capital protection; and absolute returns.
 - **K2 Asian Fund:** invests in the major regions of Asia and Australia (ex Japan). The fund has a 'long bias'; however, can take short positions.
 - **Select International:** invests long and short in equity markets across global markets.
 - **Global High Alpha:** invests long and short in equity markets across global markets. The KII fund (separate fund, however the portfolio closely replicates the Global High Alpha fund) allows investors to transact easily via an ASX-listed share structure.
 - **Australian Small cap (KSM):** the fund can invest long and short with a key focus on Australian small/mid cap companies. KSM is also an exchange traded fund.
- **Retain relatively small and nimble fund sizes:** To maintain performance, KAM looks to maintain relatively small fund sizes to ensure investment decisions can be executed in a timely manner.

Key drivers of growth

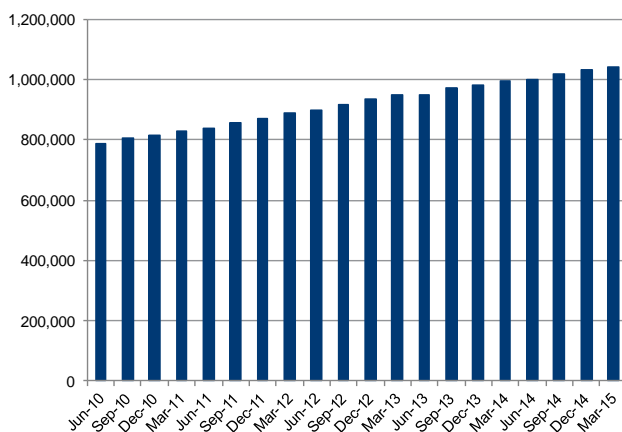
- **Ongoing performance should attract FUM:** As with any manager, ongoing investment performance is key to retaining and growing FUM. Given the more recent under-performance of the broader equity market (index linked funds), we believe actively managed funds with solid performance are well positioned to attract FUM.
- **Targeting differentiated products:** KAM's listing of the K2 Global Equities Fund and Australian Small Cap fund via an exchange traded structure highlights KAM's focus on providing a differentiated product. KAM's listed exchange traded funds offer:
 - live liquidity and pricing on the ASX, with KAM acting as the market maker;
 - no minimum investment; and
 - exposure to segments of the equities market that are relatively difficult for individual investors to access, but complements a broader/ traditional investment in domestic equities.

Figure 9: Net FUM flows over the past three years (A\$m)



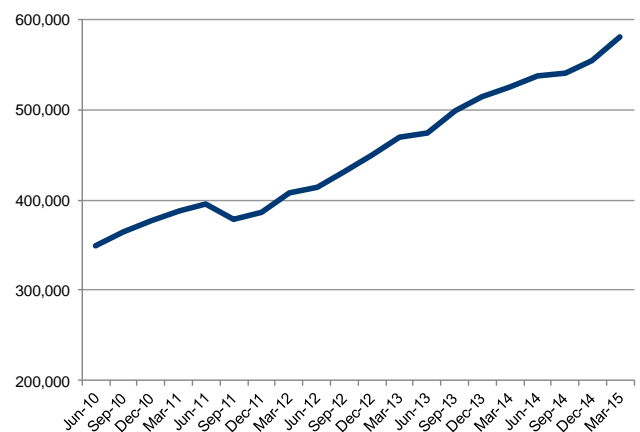
- **Targeting the SMSF sector:** The exchange listed structure is also reflective of KAM's focus on the growing SMSF segment. Domestic investors broadly remain underweight global equities; while the listed structure enables ease of transacting the fund; and the transparency of daily pricing. As highlighted in Figure 10 and 11, the SMSF market continues to grow, reaching A\$580bn in net assets as at Mar-2015.

Figure 10: Total members of SMSFs



SOURCES: MORGANS, ATO

Figure 11: SMSFs – net assets under management



SOURCES: MORGANS, ATO

Fund overviews

Figure 12: Performance 31 October 2015 (net of all fees)

Fund	FUM	1 Year %	3 Year % p.a.	5 Year % p.a.	7 Year % p.a.	10 Year % p.a.	Since Inception % p.a.
K2 Australian Fund	386.9	4.20%	11.40%	7.10%	10.30%	8.80%	12.10%
K2 Select Int Fund	217.1	24.80%	18.60%	11.50%	13.60%	11.80%	12.10%
K2 Global Alpha Fund	106.4	28.10%	29.20%	22.00%	-	-	24.60%
K2 Asian Fund	87.3	13.70%	16.50%	7.50%	11.60%	9.40%	11.20%
K2 Australian Small Cap Fund (KSM)	25.7	15.70%	-	-	-	-	18.60%

SOURCES: MORGANS, COMPANY REPORTS

Global Funds: K2 Select International Absolute Return Fund & K2 Global High Alpha Fund (including KII)

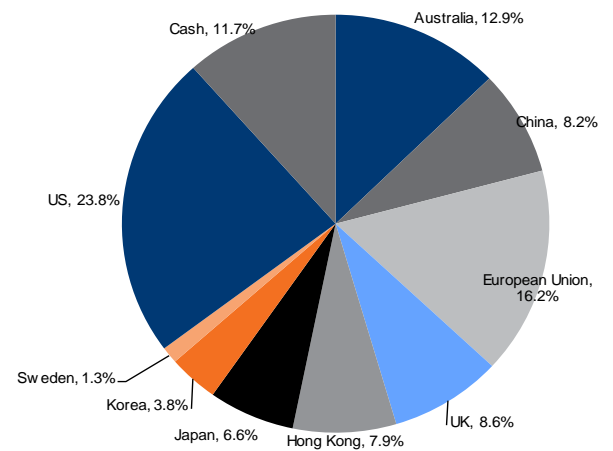
- The K2 Global Funds (Select International and Global High Alpha/KII) provide investors with diversification through global equity markets. The funds have a mandate to invest both long and short in equity markets, and have the flexibility to invest in cash. The funds seek to provide investors with absolute returns, through actively managing three key calls – equity, cash exposure and currency hedging. Since inception, the Select International Fund has returned 12.1% pa net of fees (since 2005) and the Global High Alpha has delivered 24.6% pa net of fees (since 2009).

Figure 13: FUM – Select International



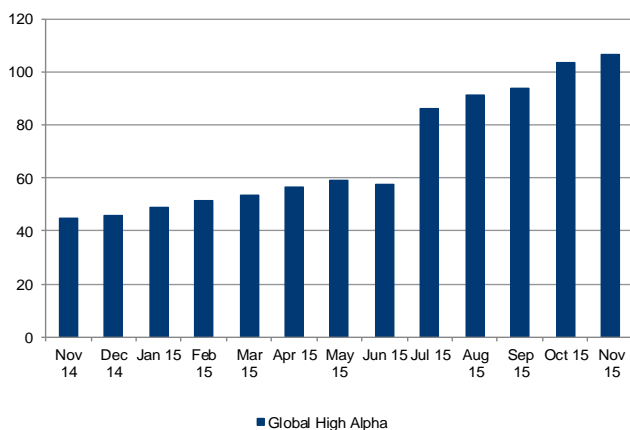
SOURCES: MORGANS, COMPANY REPORTS

Figure 14: Geographic allocation (Nov-2015)



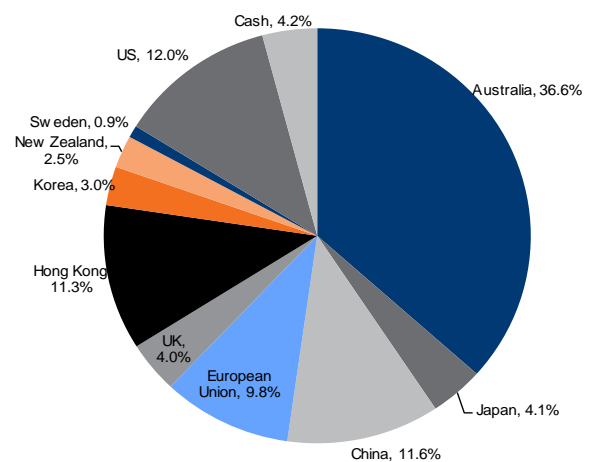
SOURCES: MORGANS, COMPANY REPORTS

Figure 15: FUM – Global High Alpha



SOURCES: MORGANS, COMPANY REPORTS

Figure 16: Geographic allocation (Nov-2015)

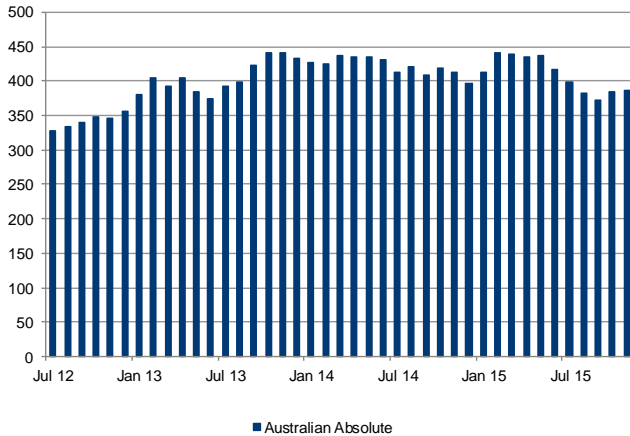


SOURCES: MORGANS, COMPANY REPORTS

K2 Australian Absolute Return Fund

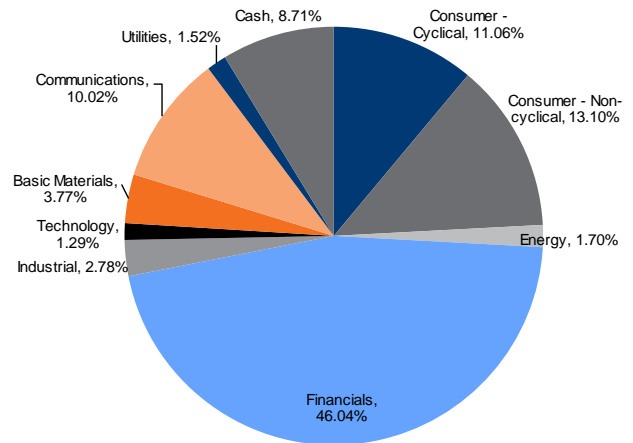
- The K2 Australian Fund provides investors the opportunity of diversification through the use of shorting, cash to protect capital and building a portfolio in a benchmark unaware manner. The K2 Australian Fund has a mandate to invest both long and short in equity markets, with the added flexibility of investing in cash. Since inception in 1999, this strategy has delivered clients with +12.1% pa (net of fees) – significant outperformance above the broader domestic market.

Figure 17: FUM – Australian Absolute Return



SOURCES: MORGANS, COMPANY REPORTS

Figure 18: Sector allocation (Nov-2015)

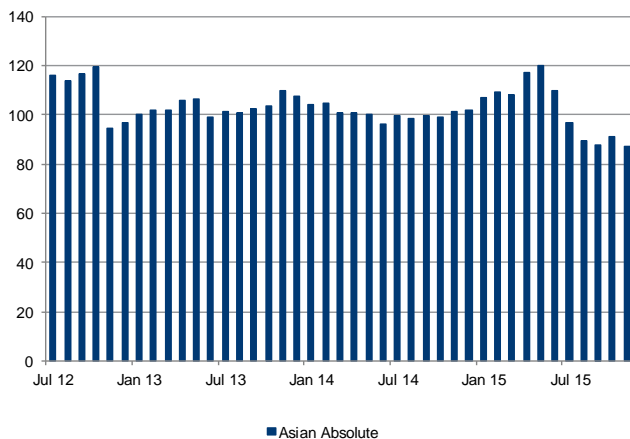


SOURCES: MORGANS, COMPANY REPORTS

K2 Asian Absolute Return Fund

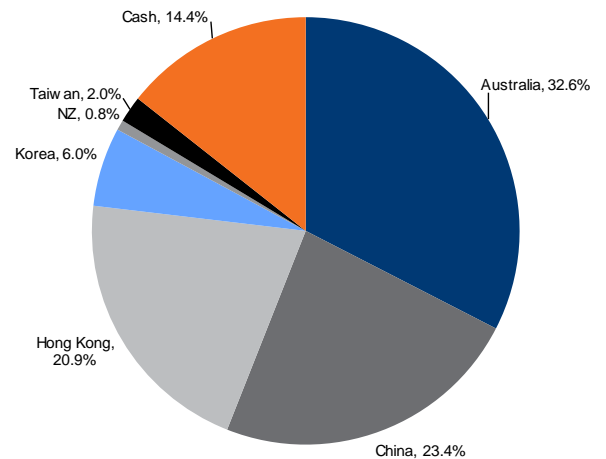
- The K2 Asian Fund has a mandate to invest both long and short in Asian / International equity markets. Since inception in 1999, this strategy has delivered clients with +11.2% pa (net of fees).

Figure 19: Asian Absolute



SOURCES: MORGANS, COMPANY REPORTS

Figure 20: Geographic allocation (Nov-2015)

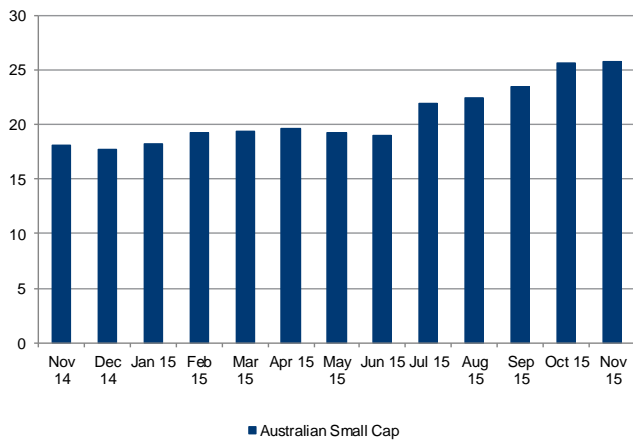


SOURCES: MORGANS, COMPANY REPORTS

K2 Australian Small Cap Fund / KSM

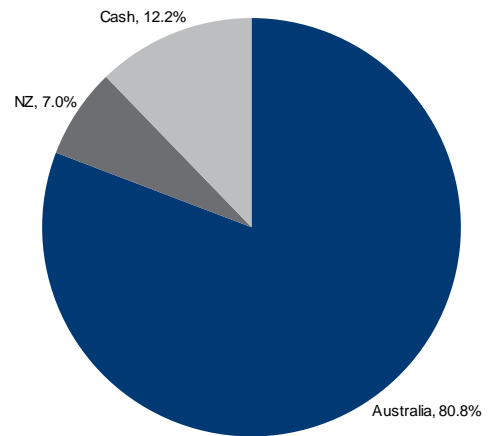
- The K2 Australian Small Cap Fund provides investors diversification through Australian Small / Mid cap equity markets. Since inception in late 2013, this strategy has delivered clients with +18.6% (net of fees).

Figure 21: Australian Small cap



SOURCES: MORGANS, COMPANY REPORTS

Figure 22: Funds allocation (Nov-2015)



SOURCES: MORGANS, COMPANY REPORTS

Financials overview

Key drivers and assumptions

Key drivers

- Funds under management growth (driven by equity markets performance; funds performance; net funds flow; and growth in strategies/funds offered);
- FUM / management fee margin mix;
- Performance fee generation; and
- Cost to income ratio.

Forecast and assumptions overview

Figure 23: Key forecasts (A\$m)

	FY14A	FY15A	1H16F	2H16F	FY16F	FY17F
KAM						
Management fees	12.9	12.8	6.2	6.5	12.7	13.8
management fee margin	1.50%	1.57%	1.53%	1.53%	1.53%	1.53%
Performance fees	27.7	31.9	0.8	5.5	6.4	16.3
Other revenue	0.5	0.6	0.3	0.3	0.6	0.6
Operating costs	18.1	18.6	4.0	5.7	9.7	14.6
Cost/income ratio	43.4%	40.8%	55.2%	46.1%	49.5%	47.5%
EBIT	22.9	26.6	3.3	6.6	9.9	16.1
EBIT margin	55.8%	58.8%	44.5%	53.7%	50.4%	52.4%
GROUP CASH NPAT	16.4	18.9	2.4	4.8	7.3	11.5
Cash EPS (cps)	7.0	8.1	1.0	2.0	3.1	4.9
DPS (cps)	8.0	8.5	1.0	2.0	3.0	5.0
Dividend payout ratio	114%	105%	96%	98%	96%	102%

SOURCES: MORGANS FORECASTS, COMPANY REPORTS

Figure 24: FUM assumptions (A\$m)

	FY15A	1H16F	2H16F	1H17F	2H17F
FUM - closing by fund					
Australian Absolute	415.7	386.9	410.7	423.2	436.0
Asian Absolute	109.8	87.3	92.7	95.5	98.4
Select International	250.1	217.1	230.5	237.5	244.7
Global High Alpha	57.6	63.6	67.5	69.6	71.7
Australian Small Cap	19.0	25.7	27.3	28.1	29.0
Global Equities Alpha (KII)	0.0	42.8	45.4	46.8	48.2
GROUP FUM	852.2	823.4	874.1	900.6	928.0
growth for the half		-3.4%	6.2%	3.0%	3.0%

SOURCES: MORGANS FORECASTS, COMPANY REPORTS

Summary of FY16 and FY17 forecasts

- **FY16:** We forecast FY16 NPAT of A\$7.3m, down ~62% on the pcp. Our 1H16 NPAT forecast of A\$2.4m assumes A\$0.8m in performance fees (with Global High Alpha/KII ~4% above HWM and the Small Cap fund ~9.6% above HWM as at mid-December). Our 2H16 forecast assumes A\$5.5m of performance fees, equating to ~6.5% absolute performance across the total FUM base (we note the Asian Absolute NAV is currently 11% below its HWM, so excluding this FUM the absolute performance is ~7% across the remaining FUM). We forecast a 3cps dividend, equating to a 96% payout ratio.
- **FY17:** We forecast 6% FUM growth in FY17 resulting in base management fee growth of 8.7% (to A\$13.8m). Our performance fee assumption (A\$16.3m) is based on an average ~9% performance across the FUM base. Our performance assumption is based on KAM's historical performance returns, noting that the past three-year performance has tracked higher than the longer-term average and may be difficult to sustain at an elevated level.

P&L overview

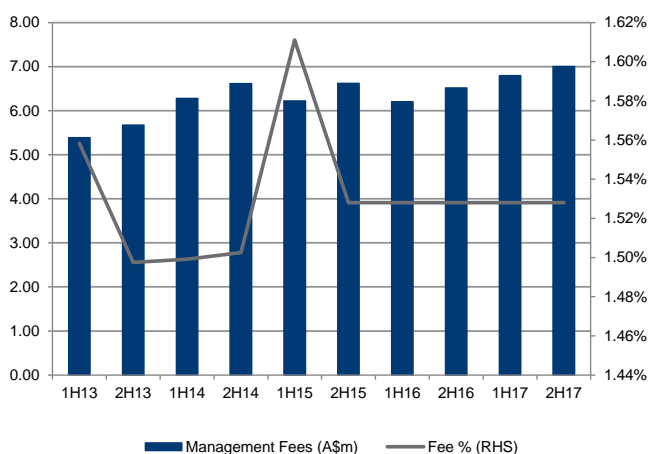
- Management fees:** KAM management fees are typically set at 1.5% (the three largest funds) or 2%. As seen in Figure 27, management fees per half have ranged between A\$5.4m – A\$6.6m (with the fee margin consistent at (1.5% - 1.6%). From FY16, we forecast a consistent 1.53% management fee margin, with some gradual increase achievable over the medium term as the KII and small-cap funds attract higher net inflows (both funds at 2% management fee).
- Performance fees:** All of KAM funds attract a performance fee (summarised in Figure 25). On the back of strong performance over the past three years across all funds, KAM has achieved material performance fees (FY13: A\$24.3m; FY14: A\$27.7m; FY15 A\$31.9m), resulting in ~68% of total revenue over the period comprising of performance fees. Given KAM is an ‘absolute’ manager, performance fees are only generated after a HWM has been met. On this basis, we forecast significantly lower performance fees in FY16, with 84% of FUM under the respective HWMs as at mid-December. We forecast A\$0.8m performance fees in 1H16 (predominantly the Small cap fund), and A\$5.5m in 2H16 (assuming an average 7% performance on FUM ex the Asian Fund). From FY17, we assume ~9% average performance across the FUM base, broadly in-line with longer-term performance.

Figure 25: Performance fees

Fund	Performance fee generation
Australian Fund	20% on total performance above the HWM (if >6% performance is achieved)
Asian Fund	20% on total performance above the HWM (if >6% performance is achieved)
Select International	20% on total performance above the HWM (if performance > cash rate up to 6%)
Global High Alpha	20% of performance above the HWM
Australian Small Cap (KSM)	20% of performance above the HWM
Global Equities Alpha (KII)	20% of performance above the HWM

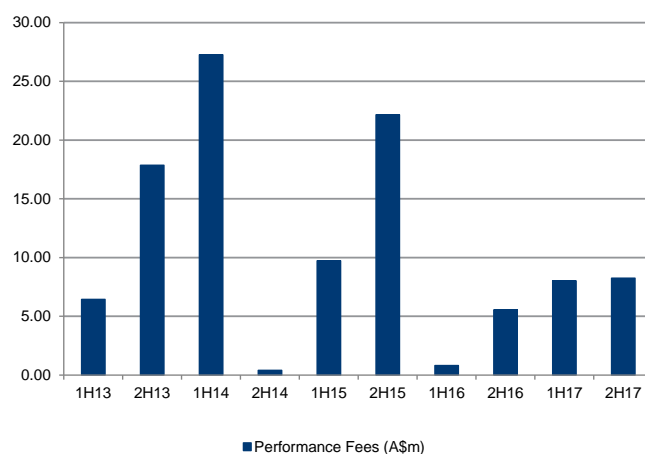
SOURCES: MORGANS, COMPANY REPORTS

Figure 26: Management fees (A\$m) and % fee margin



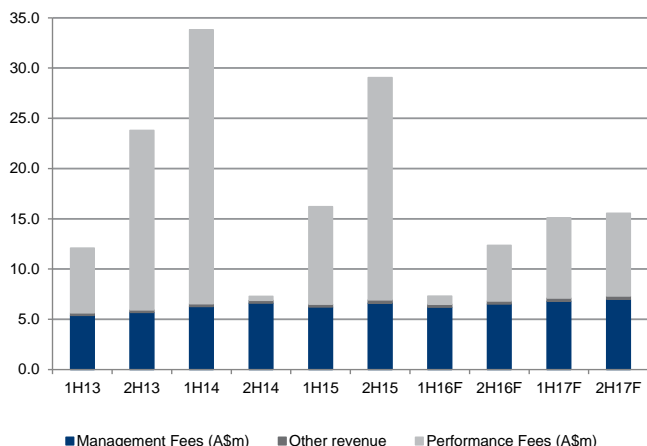
SOURCES: MORGANS FORECASTS, COMPANY REPORTS

Figure 27: Performance fees per half (1H13 – 2H17F)



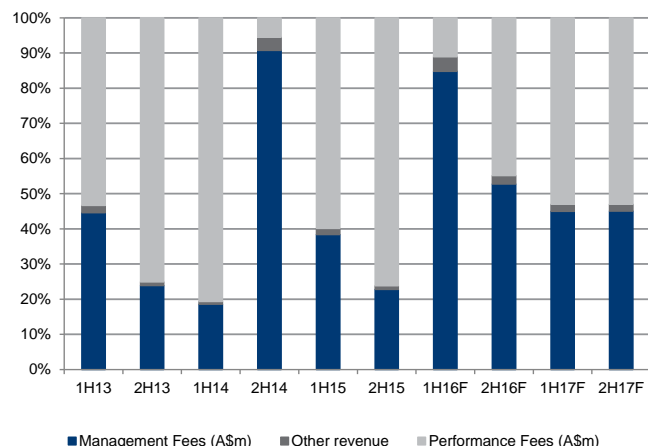
SOURCES: MORGANS FORECASTS, COMPANY REPORTS

Figure 28: Revenue composition (A\$m)



SOURCES: MORGANS FORECASTS, COMPANY REPORTS

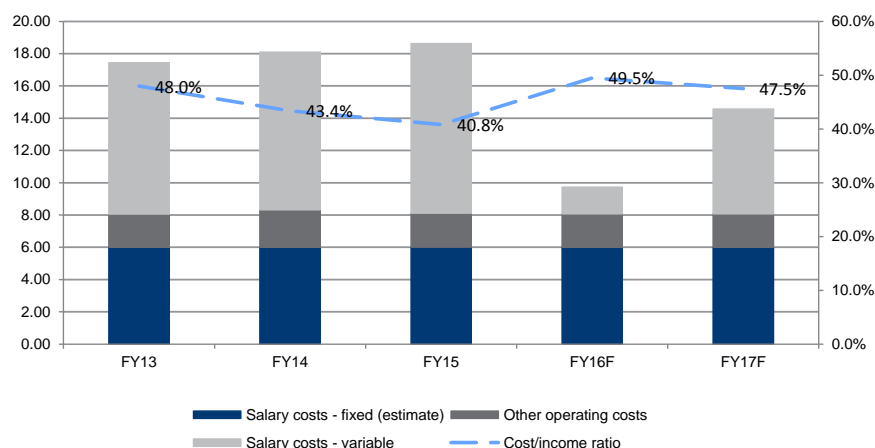
Figure 29: Revenue composition (%)



SOURCES: MORGANS FORECASTS, COMPANY REPORTS

- Cost base and cost/income ratio:** We estimate KAM has a fixed cost base of A\$8m pa, with fixed salaries of ~A\$6m (75% of the cost base). KAM has a set policy to maintain a cost-to-income ratio of <50%, with an employee/executive bonus pool only created if this criteria is met. Other criteria include the company achieving budgeted results and the investment funds achieving sufficient returns, ensuring discretionary bonuses are linked to directly to financial performance. Over FY12-15, KAM's cost-to-income ratio has ranged from 40.8% to 56.5% (with higher performance fee levels leading to a lower cost/income). In FY16, we forecast a cost/income ratio of 49.5% given lower assumed performance fees.

Figure 30: Cost base (A\$m) and cost/income (%)



SOURCES: MORGANS FORECASTS, COMPANY REPORTS

- What happens if no performance fees are generated?** We estimate KAM's NPAT at A\$3.5m based on current FUM and if no performance fees are generated. Under this scenario, KAM would deliver 1.7cps EPS and DPS.
- Dividends:** Given a strong balance sheet/cashflow and low capex requirements, KAM's dividend payout ratio tracks at ~100%.

Cashflow and balance sheet

- **Strong cash flow conversion:** KAM's gross cash flow conversion typically tracks close to 100%, averaging 104% over the past four years.
- **Minimal capex requirement:** Maintenance capex is minimal, being A\$42k in FY15.
- **Net assets of A\$17.4m:** KAM has a very simple and clean balance sheet, with A\$17.4m in net assets. As at June 2015, KAM had A\$22.5m in cash (including A\$6.7m in fund applications held in trust) and no debt. KAM does not typically invest in the underlying funds and holds no investments on balance sheet.

Board of Directors

Figure 31: Board of Directors

Board member		Shareholding
Campbell Neal (Managing Director, CEO, Chairman)	Campbell is a co-founder and Managing Director of K2 Asset Management. In conjunction with this role, Campbell spends a portion of his time as a Senior Portfolio manager in the Australian and Asian investment team. Campbell was a barrister and solicitor of the Supreme Court of Victoria before moving into financial services in 1986, when he became an Institutional Equities Dealer for Citicorp Scrimgeour Vickers. Prior to founding K2, Campbell was an Executive Vice President of Bankers Trust Australia Ltd, where he was Head of Australian Equities Distribution (Melbourne and Asia).	35.0%
Mark Newman (Chief Investment Officer, Executive Director)	Mark is a co-founder and Executive Director of K2 Asset Management, and is the CIO for the three K2 investment strategies. In conjunction with his responsibilities as CIO, Mark dedicates a portion of his time managing an allocation of the Asian equity strategy. Mark has many years of Asia-Pacific funds management experience and was previously a senior fund manager with the Abu Dhabi Investment Authority, where he was responsible for Asia ex Japan equity investments. Prior to this Mark was a Director with HSBC Asset Management Hong Kong, where he also specialised in managing Asian portfolios, and an Investment Manager at Wardley Investment Services (Australia) Ltd.	22.1%
Hollie Wight (Chief Financial Officer, Executive Director)	Hollie is Chief Financial Officer and an Executive Director of K2, responsible for all financial accounting and report preparation. Hollie was previously an accountant/auditor at PricewaterhouseCoopers. Hollie is a CPA and has a Bachelor of Business (Accountancy) from RMIT.	2.2%
Robert Hand (Non Executive Director)	Mr Hand joined K2 in October 2001 as Executive Director and Senior Portfolio Manager. Joining the finance industry in 1986 with National Australia Bank, Robert commenced in the bank's fund management company in 1989 working on Asian portfolios and subsequently European and Australian portfolios, ultimately as head of Australian equities. As of 4 October 2013, Rob resigned as an Executive Director and commenced a Non-Executive role with the board of K2.	5.8%

SOURCE: COMPANY REPORTS

Queensland

Brisbane	+61 7 3334 4888
Stockbroking, Corporate Advice, Wealth Management	
Brisbane: Edward St	+61 7 3121 5677
Brisbane: Tynan Partners	+61 7 3152 0600
Bundaberg	+61 7 4153 1050
Cairns	+61 7 4222 0555
Caloundra	+61 7 5491 5422
Emerald	+61 7 4988 2777
Gladstone	+61 7 4972 8000
Gold Coast	+61 7 5581 5777
Ipswich/Springfield	+61 7 3202 3995
Kedron	+61 7 3350 9000
Mackay	+61 7 4957 3033
Milton	+61 7 3114 8600
Mt Gravatt	+61 7 3245 5466
Noosa	+61 7 5449 9511
Redcliffe	+61 7 3897 3999
Rockhampton	+61 7 4922 5855
Spring Hill	+61 7 3833 9333
Sunshine Coast	+61 7 5479 2757
Toowoomba	+61 7 4639 1277
Townsville	+61 7 4725 5787
Yeppoon	+61 7 4939 3021

New South Wales

Sydney	+61 2 9043 7900
Stockbroking, Corporate Advice, Wealth Management	
Armistdale	+61 2 6770 3300
Ballina	+61 2 6686 4144
Balmain	+61 2 8755 3333
Bowral	+61 2 4851 5515
Chatswood	+61 2 8116 1700
Coffs Harbour	+61 2 6651 5700
Gosford	+61 2 4325 0884
Hurstville	+61 2 9570 5755
Merimbula	+61 2 6495 2869
Neutral Bay	+61 2 8969 7500
Newcastle	+61 2 4926 4044
Newport	+61 2 9998 4200
Orange	+61 2 6361 9166
Port Macquarie	+61 2 6583 1735
Scone	+61 2 6544 3144
Sydney: Level 7 Currency House	+61 2 8216 5111
Sydney: Level 9	+61 2 8215 5000
Sydney: Hunter St	+61 2 9125 1788
	+61 2 9615 4500
Sydney: Reynolds Equities	+61 2 9373 4452
Wollongong	+61 2 4227 3022

Victoria

Melbourne	+61 3 9947 4111
Stockbroking, Corporate Advice, Wealth Management	
Brighton	+61 3 9519 3555
Camberwell	+61 3 9813 2945
Carlton	+61 3 9066 3200
Farrer House	+61 3 8644 5488
Geelong	+61 3 5222 5128
Richmond	+61 3 9916 4000
South Yarra	+61 3 8762 1400
Southbank	+61 3 9037 9444
Traralgon	+61 3 5176 6055
Warrnambool	+61 3 5559 1500

Australian Capital Territory

Canberra	+61 2 6232 4999
----------	-----------------

Northern Territory

Darwin	+61 8 8981 9555
--------	-----------------

Tasmania

Hobart	+61 3 6236 9000
--------	-----------------

Western Australia

West Perth	+61 8 6160 8700
Stockbroking, Corporate Advice, Wealth Management	
Perth	+61 8 6462 1999

South Australia

Adelaide	+61 8 8464 5000
Norwood	+61 8 8461 2800

Disclaimer

The information contained in this report is provided to you by Morgans Financial Limited as general advice only, and is made without consideration of an individual's relevant personal circumstances. Morgans Financial Limited ABN 49 010 669 726, its related bodies corporate, directors and officers, employees, authorised representatives and agents ("Morgans") do not accept any liability for any loss or damage arising from or in connection with any action taken or not taken on the basis of information contained in this report, or for any errors or omissions contained within. It is recommended that any persons who wish to act upon this report consult with their Morgans investment adviser before doing so. Those acting upon such information without advice do so entirely at their own risk.

This report was prepared as private communication to clients of Morgans and is not intended for public circulation, publication or for use by any third party. The contents of this report may not be reproduced in whole or in part without the prior written consent of Morgans. While this report is based on information from sources which Morgans believes are reliable, its accuracy and completeness cannot be guaranteed. Any opinions expressed reflect Morgans judgement at this date and are subject to change. Morgans is under no obligation to provide revised assessments in the event of changed circumstances. This report does not constitute an offer or invitation to purchase any securities and should not be relied upon in connection with any contract or commitment whatsoever.

Disclosure of interest

Morgans may from time to time hold an interest in any security referred to in this report and may, as principal or agent, sell such interests. Morgans may previously have acted as manager or co-manager of a public offering of any such securities. Morgans affiliates may provide or have provided banking services or corporate finance to the companies referred to in the report. The knowledge of affiliates concerning such services may not be reflected in this report. Morgans advises that it may earn brokerage, commissions, fees or other benefits and advantages, direct or indirect, in connection with the making of a recommendation or a dealing by a client in these securities. Some or all of Morgans Authorised Representatives may be remunerated wholly or partly by way of commission.

Regulatory disclosures

This report was prepared solely by Morgans Financial Limited. ASX did not prepare any part of the report and has not contributed in any way to its content. The role of ASX in relation to the preparation of the research reports is limited to funding their preparation, by Morgans Financial Limited, in accordance with the ASX Equity Research Scheme. ASX does not provide financial product advice. The views expressed in this research report may not necessarily reflect the views of ASX. To the maximum extent permitted by law, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by ASX as to the adequacy, accuracy, completeness or reasonableness of the research reports.

Recommendation structure

For a full explanation of the recommendation structure, refer to our website at http://www.morgans.com.au/research_disclaimer

Research team

For analyst qualifications and experience, refer to our website at <http://www.morgans.com.au/research-and-markets/our-research-team>

Stocks under coverage

For a full list of stocks under coverage, refer to our website at <http://www.morgans.com.au/research-and-markets/company-analysis/ASX100-Companies-under-coverage> and <http://www.morgans.com.au/research-and-markets/company-analysis/EX-100-Companies-under-coverage>

Stock selection process

For an overview on the stock selection process, refer to our website at <http://www.morgans.com.au/research-and-markets/company-analysis>

www.morgans.com.au

If you no longer wish to receive Morgans publications please contact your local Morgans branch or write to GPO Box 202 Brisbane QLD 4001 and include your account details.