HENNESSY ADVISORS INC
Form 10-Q
May 05, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended March 31, 2014

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period From ______ to ______

Commission File Number 001-36423

HENNESSY ADVISORS, INC.

(Exact name of registrant as specified in its charter)

California **(State or other jurisdiction of incorporation or organization)**	**68-0176227** **(IRS Employer Identification No.)**
7250 Redwood Blvd., Suite 200 **Novato, California** **(Address of principal executive office)**	**94945** **(Zip Code)**

(415) 899-1555

(Issuer s telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ¨	Accelerated Filer ¨
Non-accelerated Filer ¨	Smaller Reporting Company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of April 24, 2014, there were 5,909,818 shares of common stock issued and outstanding.

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PART I: FINANCIAL INFORMATION

Item 1: Unaudited Condensed Financial Statements

Hennessy Advisors, Inc.

Balance Sheets

(In thousands, except share and per share amounts)

	March 31, 2014 (Unaudited)	September 30, 2013
Assets		
Current assets:		
Cash and cash equivalents	$ 4,101	$ 8,406
Investments in marketable securities, at fair value	7	7
Investment fee income receivable	2,928	2,402
Prepaid expenses	245	269
Deferred income tax asset	142	162
Other accounts receivable	407	436
Total current assets	7,830	11,682
Property and equipment, net of accumulated depreciation of $519 and $438, respectively	250	258
Management contracts	62,489	62,431
Other assets, net of accumulated amortization of $199 and $159, respectively	433	363
Total assets	$ 71,002	$ 74,734
Liabilities and Stockholders Equity		
Current liabilities:		
Accrued liabilities and accounts payable	$ 2,931	$ 3,085
Income taxes payable	4	44
Deferred rent		32
Current portion of long-term debt	3,750	1,840
Current portion of payment due on purchase of management contracts		7,468
Total current liabilities	6,685	12,469
Long-term debt, net of current portion	24,847	15,027
Long-term portion of payment due on purchase of management contracts		11,626
Deferred income tax liability	6,695	5,825
Total liabilities	38,227	44,947

Commitments and Contingencies (Note 9)		
Stockholders equity:		
Adjustable rate preferred stock, $25 stated value, 5,000,000 shares authorized: zero shares issued and outstanding		
Common stock, no par value, 15,000,000 shares authorized:		
5,909,818 shares issued and outstanding at March 31, 2014 and 5,898,756 at September 30, 2013	10,140	9,948
Retained earnings	22,635	19,839
Total stockholders equity	32,775	29,787
Total liabilities and stockholders equity	$ 71,002	$ 74,734

See accompanying notes to unaudited condensed financial statements

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Hennessy Advisors, Inc.

Statements of Income

(In thousands, except share and per share amounts)

(Unaudited)

	Three Months ended March 31, 2014	Three Months ended March 31, 2013	Six Months ended March 31, 2014	Six Months ended March 31, 2013
Revenue				
Investment advisory fees	$ 8,083	$ 5,726	$ 15,776	$ 10,215
Shareholder service fees	227	221	455	435
Total revenue	8,310	5,947	16,231	10,650
Operating expenses				
Compensation and benefits	1,877	1,850	3,647	3,262
General and administrative	1,207	698	2,255	1,372
Mutual fund distribution	523	351	1,096	619
Sub-advisor fees	1,464	950	2,859	1,661
Amortization and depreciation	60	45	120	83
Total operating expenses	5,131	3,894	9,977	6,997
Operating income	3,179	2,053	6,254	3,653
Interest expense	286	179	532	317
Other expense (income), net	(1)	(1)	(1)	109
Income before income tax expense	2,894	1,875	5,723	3,227
Income tax expense	1,135	758	2,507	1,342
Net income	$ 1,759	$ 1,117	$ 3,216	$ 1,885
Earnings per share:				
Basic	$ 0.31	$ 0.20	$ 0.55	$ 0.33
Diluted	$ 0.30	$ 0.20	$ 0.55	$ 0.33
Weighted average shares outstanding:				
Basic	5,724,821	5,714,559	5,816,649	5,757,333
Diluted	5,805,340	5,714,559	5,893,427	5,757,333

See accompanying notes to unaudited condensed financial statements

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Hennessy Advisors, Inc.

Statements of Changes in Stockholders Equity

Six Months Ended March 31, 2014

(In thousands, except share data)

(Unaudited)

	Common Shares	Common Stock	Retained Earnings	Total Stockholders Equity
Balance at September 30, 2013	5,898,756	$ 9,948	$ 19,839	$ 29,787
Net income			3,216	3,216
Dividends paid			(420)	(420)
Employee stock options exercised	11,062	74		74
Deferred restricted stock unit compensation		96		96
Tax effect of stock option exercises		22		22
Balance at March 31, 2014	5,909,818	$ 10,140	$ 22,635	$ 32,775

See accompanying notes to unaudited condensed financial statements

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Hennessy Advisors, Inc.

Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended March 31, 2014	Six Months Ended March 31, 2013
Cash flows from operating activities:		
Net income	$ 3,216	$ 1,885
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	120	83
Deferred income taxes	890	681
Tax effect from restricted stock units and stock options	22	289
Restricted stock units repurchased for employee tax withholding		(1)
Deferred restricted stock unit compensation	96	3
Realized loss on liquidation of available for sale security		108
(Increase) decrease in operating assets:		
Investment fee income receivable	(526)	(1,474)
Prepaid expenses	24	(570)
Other accounts receivable	29	(237)
Other assets	42	1
Increase (decrease) in operating liabilities:		
Accrued liabilities and accounts payable	(154)	1,141
Income taxes payable	(40)	(48)
Deferred rent	(32)	(24)
Net cash provided by operating activities	3,687	1,837
Cash flows provided by (used in) investing activities:		
Purchases of property and equipment	(72)	(145)
Payments related to acquisition of management contracts	(19,152)	(19,960)
Proceeds on liquidation of available for sale security		404
Net cash used in investing activities	(19,224)	(19,701)
Cash flows provided by (used in) financing activities:		
Principal payments on bank loan	(1,556)	(665)
Proceeds from amended bank loan	13,287	16,525
Loan fee payments and other acquisition costs related to amended bank loan	(153)	(224)
Proceeds from exercise of employee stock options	74	4
Dividend payments	(420)	(361)
Net cash provided by financing activities	11,232	15,279

Net decrease in cash and cash equivalents		(4,305)		(2,585)
Cash and cash equivalents at the beginning of the period		8,406		8,730
Cash and cash equivalents at the end of the period	$	4,101	$	6,145
Supplemental disclosures of cash flow information:				
Cash paid for:				
Income taxes	$	1,593	$	984
Interest	$	491	$	261

See accompanying notes to unaudited condensed financial statements

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HENNESSY ADVISORS, INC.

NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS

(1) Basis of Financial Statement Presentation

The accompanying condensed balance sheet as of September 30, 2013, which has been derived from audited financial statements, and the unaudited interim condensed financial statements as of March 31, 2014 have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and include the accounts of Hennessy Advisors, Inc. (the Company). Certain information and footnote disclosures in these unaudited interim condensed financial statements, normally included in financial statements prepared in accordance with generally accepted accounting principles, have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission for Quarterly Reports on Form 10-Q. In the opinion of management, the unaudited interim condensed financial statements reflect all adjustments, consisting only of normal, recurring adjustments, necessary for a fair presentation of the Company s financial position at March 31, 2014, the Company s operating results for the three and six months ended March 31, 2014, and the Company s cash flows for the six months ended March 31, 2014. These unaudited interim condensed financial statements and notes should be read in conjunction with the Company s audited financial statements and notes thereto for the year ended September 30, 2013, which are included in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2013.

The Company s operating activities consist primarily of providing investment advisory services to sixteen open-end mutual funds (the Hennessy Funds). The Company serves as the investment advisor to all classes of the Hennessy Cornerstone Growth Fund, the Hennessy Focus Fund, the Hennessy Cornerstone Mid Cap 30 Fund, the Hennessy Cornerstone Large Growth Fund, the Hennessy Cornerstone Value Fund, the Hennessy Large Value Fund, the Hennessy Total Return Fund, the Hennessy Equity and Income Fund, the Hennessy Balanced Fund, the Hennessy Core Bond Fund, the Hennessy Gas Utility Index Fund, the Hennessy Small Cap Financial Fund, the Hennessy Large Cap Financial Fund, the Hennessy Technology Fund, the Hennessy Japan Fund, and the Hennessy Japan Small Cap Fund. The Company also provides shareholder services to some of the Hennessy Funds.

The Company s operating revenue consists of contractual investment advisory and shareholder service fees paid to it by the Hennessy Funds. The Company earns investment advisory fees from all of the Hennessy Funds through portfolio management of the Hennessy Funds. The Company earns shareholder service fees from some of the Hennessy Funds by assisting investors in such funds in purchases, sales, distribution and customer service. These fee revenues are earned and calculated daily by the Hennessy Funds accountants at U.S. Bancorp Fund Services, LLC. The fees are computed and billed monthly, at which time they are recognized in accordance with Accounting Standard Codification 605 Revenue Recognition.

The Company waives fees with respect to some of the Hennessy Funds to comply with contractual expense ratio limitations. The fee waivers are calculated daily by the Hennessy Funds accountants at U.S. Bancorp Fund Services, LLC and are charged to expense monthly by the Company as an offset to revenue. The waived fees are deducted from investment advisory fee income and reduce the amount of advisory fees that the Hennessy Funds pay in the subsequent month. To date, the Company has only waived fees based on contractual obligations, but the Company has the ability to waive fees at its discretion to compete with other mutual funds with lower expense ratios. If the Company were to elect voluntarily to waive fees, the decision to waive fees would not apply to previous periods, but would only apply on a going forward basis. As of March 31, 2014, the Company has never voluntarily waived fees and has no current intention to voluntarily waive fees.

The Company s contractual agreements for investment advisory and shareholder services provide persuasive evidence that an arrangement exists with fixed and determinable fees, and the services are rendered daily. The collectability is probable as the fees are received from the Hennessy Funds in the month subsequent to the month in which the services are provided.

(2) Management Contracts Purchased

The Company has purchased assets related to the management of open-end mutual funds from time to time throughout its history. Prior to September 30, 2012, the Company had completed several purchases of assets related to the management of thirteen different mutual funds, some of which were reorganized into already existing Hennessy Funds. On October 26, 2012, the Company purchased the assets related to the management of the entire family of ten FBR funds (the FBR Funds), adding approximately $2.2 billion in assets under management. The purchase was consummated in accordance with the terms and conditions of that certain Asset Purchase Agreement, dated as of June 6, 2012, between the Company and FBR Fund Advisers, Inc. The purchase price was comprised of two payments: (i) an initial payment of $19,692,137 made on October 26, 2012 based upon the net asset value of the FBR Funds as of October 25, 2012 and (ii) a contingent payment of $19,193,595 made on November 5, 2013 based upon the net asset value of the FBR Funds as of October 28, 2013. The initial payment was funded with $3.4 million of available cash and $16.3 million of debt proceeds that were obtained pursuant to an amendment and restatement of the Company s then-existing loan agreement with U.S. Bank National Association that allowed the Company to borrow the additional amount due. The additional capitalized transaction costs of $1.2 million, of which $0.2 million was capitalized in the fiscal year ended September 30, 2012 and the remaining $1.0 million was capitalized in the fiscal year ended September 30, 2013, include legal fees, printing fees and other costs related to the purchase.

The contingent payment due under the Asset Purchase Agreement was determined to be $19,193,595 as of October 28, 2013. The amount of the liability was booked as of September 30, 2013 because it was measurable. The contingent payment was funded in part with $13,286,666 of debt proceeds that were obtained pursuant to an amendment of the Company s then-existing loan agreement with U.S. Bank National Association that allowed the Company to borrow such amount, with the remainder of the payment being funded out of available cash. Of the $13,286,666 of debt proceeds, $11,625,883 was shown as a long-term liability on the balance sheet as of September 30, 2013 because it was funded by U.S. Bank National Association on a long-term basis. During the six months ended March 31, 2014, additional transaction costs related to the purchase in the amount of $58,232 were capitalized.

Management contracts balance at September 30, 2013 (inclusive of a contingent purchase price for assets related to management of the former FBR Funds of $19,193,595)	$ 62,431,018
Capitalized transaction costs in the six months ended March 31, 2014	58,232
Management contracts balance at March 31, 2014	$ 62,489,250
Contingent purchase price payment allocation at September 30, 2013	
Current portion	$ 7,567,712
Long-term portion	11,625,883
Total contingent purchase price	$ 19,193,595

In accordance with guidance issued by the Financial Accounting Standards Board (FASB), the Company periodically reviews the carrying value of its purchased management contracts to determine if any impairment has occurred. The fair value of management contracts are based on management estimates and assumptions, including third-party valuations that utilize appropriate valuation techniques. The fair value of the management contracts was estimated by applying the income approach. As of March 31, 2014, no events or changes in circumstances had occurred that indicated potential impairment of the management contracts.

Under the FASB guidance on Intangibles Goodwill and Other, intangible assets that have indefinite useful lives are not amortized but are tested at least annually for impairment. The Company reviews the life of the management contracts each reporting period to determine if they continue to have an indefinite useful life. The Company considers the mutual fund management contracts to be intangible assets with an indefinite useful life as of March 31, 2014.

(3) Investment Advisory Agreements

Effective February 28, 2014, the Hennessy Funds completed an internal reorganization that resulted in all sixteen Hennessy Funds being a series of Hennessy Funds Trust, a Delaware statutory trust. Prior to the reorganization, (i) each of the Hennessy Cornerstone Growth Fund, the Hennessy Cornerstone Mid Cap 30 Fund and the Hennessy Cornerstone Value Fund was a series of Hennessy Mutual Funds, Inc., (ii) each of the Hennessy Total Return Fund and the Hennessy Balanced Fund was a series of The Hennessy Funds, Inc., (iii) each of the Hennessy Japan Fund and the Hennessy Japan Small Cap Fund was a series of Hennessy SPARX Funds Trust and (iv) each of the remaining nine Hennessy Funds was already a series of Hennessy Funds Trust. As a result of the reorganization, the Company now has management contracts only with Hennessy Funds Trust. Pursuant to these management contracts, the Company provides investment advisory services to all classes of the sixteen Hennessy Funds.

The management contracts must be renewed annually by (i) the Board of Trustees of Hennessy Funds Trust or by the vote of a majority of the outstanding shares of the applicable Hennessy Fund and (ii) by the vote of a majority of the trustees of Hennessy Funds Trust who are not interested persons of the Hennessy Funds, except that the management contract for the Hennessy Cornerstone Growth Fund, the Hennessy Cornerstone Mid Cap 30 Fund, the Hennessy Cornerstone Value Fund, the Hennessy Total Return Fund, the Hennessy Balanced Fund, the Hennessy Japan Fund and the Hennessy Japan Small Cap Fund has an initial period of two years, which commenced on February 28, 2014, to be renewed annually thereafter. If the management contracts are not renewed as described above, they will terminate automatically. In addition, there are two other circumstances in which the management contracts would terminate. First, the management contracts would automatically terminate if the Company assigned them to another advisor (assignment includes indirect assignment, which is the transfer of the Company s common stock in sufficient quantities deemed to constitute a controlling block). Second, each management contract may be terminated prior to its expiration upon 60 days notice by either the Company or the applicable Hennessy Fund.

As provided in the management contracts with the sixteen Hennessy Funds, the Company receives investment advisory fees monthly based on a percentage of the respective Hennessy Fund s average daily net assets.

The Company has entered into sub-advisory agreements for the Hennessy Focus Fund, the Hennessy Large Value Fund, the Hennessy Equity and Income Fund, the Hennessy Core Bond Fund, the Hennessy Japan Fund, and the Hennessy Japan Small Cap Fund with the same asset management companies that managed such Hennessy Funds prior to the Company s purchase of the assets related to the management of such funds. Under each of these sub-advisory agreements, the sub-advisor is responsible for the investment and re-investment of the assets of the applicable Hennessy Fund in accordance with the terms of such agreement and the applicable Hennessy Fund s Prospectus and Statement of Additional Information. The sub-advisors are subject to the direction, supervision and control of the Company and the Board of Trustees of Hennessy Funds Trust. The sub-advisory agreements must be renewed annually in the same manner and are subject to the same termination provisions as the management contracts, except that the sub-advisory agreement for the Hennessy Japan Fund and the Hennessy Japan Small Cap Fund have an initial period of two years, which commenced on February 28, 2014, to be renewed annually thereafter.

In exchange for the sub-advisor services, the Company (not the Hennessy Funds) pays a sub-advisor fee to the sub-advisors, which is based on the amount of each applicable Hennessy Fund s average daily net assets.

(4) Investment in Available for Sale Security

On October 30, 2007, the Company invested $0.5 million in the Hennessy Micro Cap Growth Fund, LLC (the Micro Cap Fund). The Micro Cap Fund was closed on December 14, 2012 and the investment was liquidated, resulting in a realized loss of $0.1 million. The loss was included in other expense on the income statement for the six months ended March 31, 2013.

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(5) Bank Loan

The Company has an outstanding bank loan with U.S. Bank National Association. On October 26, 2012, the loan, which then had an outstanding principal balance of $1.9 million, was amended and restated to provide an additional $16.3 million to purchase the assets related to the management of the FBR Funds. The balance of the loan immediately following the amendment and restatement was $18.4 million. On November 1, 2013, in connection with the contingent payment for the purchase of assets related to the FBR Funds, the Company entered into an amendment to the loan agreement with U.S Bank National Association that increased its total outstanding loan balance by $13.3 million to $30.0 million. The amended loan agreement requires 47 monthly payments in the amount of $312,500 plus interest at the bank s prime rate (currently 3.25%, in effect since December 17, 2008) plus 0.75% (effective interest rate of 4.00%) and is secured by the Company s assets. The final installment of the then-outstanding principal and interest are due October 26, 2017.

The amended and restated loan as of October 26, 2012 was considered substantially different from the original loan per the conditions set forth in Emerging Issues Task Force (EITF) 96-19 Debtor s Accounting for a Modification or Exchange of Debt Instruments. The Company did an evaluation of the debt modification under EITF 96-19 and determined that the financial impact of the modification on the prior principal was not material to the overall financial statements and accordingly no adjustment was made. The amendment to the loan as of November 1, 2013 was not considered substantially different from the original loan and therefore an evaluation under EITF 96-19 was not necessary.

The amended loan agreement includes certain reporting requirements and loan covenants requiring the maintenance of certain financial ratios. The Company is in compliance with the loan covenants as of March 31, 2014 and September 30, 2013.

In connection with securing the financings discussed above, the Company incurred loan costs in the amount of $376,226. These costs are included in other assets and the balance is being amortized on a straight-line basis over 60 months. Amortization expense during the six-month periods ended March 31, 2014 and 2013 was $40,079 and $20,719, respectively. The unamortized balance of the loan fees was $309,941 as of March 31, 2014.

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(6) Income Taxes

The provision for income taxes was comprised of the following for the six months ended March 31, 2014 and 2013:

	3/31/2014	3/31/2013
Current		
Federal	$ 1,263,300	$ 574,600
State	364,500	85,100
	1,627,800	659,700
Deferred		
Federal	735,300	540,600
State	143,900	141,100
	879,200	681,700
Total	$ 2,507,000	$ 1,341,400

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities as of March 31, 2014 and September 30, 2013 are presented below:

	3/31/2014	9/30/2013
Current deferred tax assets:		
Accrued compensation	$ 26,800	$ 19,900
Deferred rent		12,600
Capital loss carryforward	10,600	110,400
State taxes	114,700	129,300
Gross deferred tax assets	152,100	272,200
Less: disallowed capital loss	(10,600)	(110,400)
Net deferred tax assets	141,500	161,800
Noncurrent deferred tax liabilities:		
Stock based compensation	38,100	
Property and equipment	(39,600)	(46,000)
Management contracts	(6,693,900)	(5,779,000)
Total deferred tax liabilities	(6,695,400)	(5,825,000)
Net deferred tax liabilities	$ (6,553,900)	$ (5,663,200)

The Company s effective tax rates for the six months ended March 31, 2014 and 2013 were 43.80% and 41.56%, respectively, and differ from the federal statutory rate of 34% for the following principal reasons:

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	3/31/2014	3/31/2013
Federal tax at statutory rate	34.00%	34.00%
True-up of prior year s tax provision	3.64%	0.00%
State tax at statutory rate	5.83%	5.83%
Permanent differences	0.33%	0.38%
Disallowed capital loss	0.00%	1.35%
Effective Tax Rate	43.80%	41.56%

The effective tax rate, which is normally about 40%, was higher for the period ended March 31, 2014 as a result of a one-time tax charge to true-up the prior year tax provision due to the inability to deduct for income tax purposes certain compensation expenses under Section 162(m) of the United States Internal Revenue Code of 1986, as amended. The effective tax rate was higher for the period ended March 31, 2013 due to a disallowed capital loss carryforward created by a realized loss on the sale of the available for sale investment.

(7) Earnings per Share and Dividends per Share

Basic earnings per share is determined by dividing net earnings by the weighted average number of shares of common stock outstanding, while diluted earnings per share is determined by dividing net earnings by the weighted average number of shares of common stock outstanding adjusted for the dilutive effect of common stock equivalents.

All common stock equivalents were dilutive and therefore included in the diluted earnings per share calculation for the six months ended March 31, 2014. There were 207,006 common stock equivalents, consisting of unexercised options, excluded from the per share calculation for the six months ended March 31, 2013 because they were anti-dilutive.

Quarterly cash dividends of $0.03125 and $0.04 per share, respectively, were paid on December 9, 2013 to shareholders of record as of November 15, 2013 and on March 10, 2014 to shareholders of record as of February 14, 2014.

(8) Stock-Based Compensation

Effective January 17, 2013, the Company established, and the Company s shareholders approved, the 2013 Omnibus Incentive Plan providing for the issuance of options, stock appreciation rights, restricted stock, restricted stock units, performance awards, and other equity awards for the purpose of attracting and retaining executive officers, key employees, outside directors and advisors and increasing shareholder value. The 2013 Omnibus Incentive Plan replaced the 2001 Omnibus Plan that the Company had previously adopted and had in place. On March 26, 2014, the Company adopted, and the Company s shareholders approved, the Amended and Restated 2013 Omnibus Incentive Plan (the Plan), pursuant to which amounts that a Plan participant is entitled to receive with respect to certain types of awards were increased as compared to the limitations included in the 2013 Omnibus Incentive Plan. The maximum number of shares that may be issued under the Plan is 50% of the number of outstanding shares of common stock of the Company, subject to adjustment by the compensation committee of the Board of Directors of the Company upon the occurrence of certain events. The number of shares of common stock subject to awards that remain outstanding under the 2001 Omnibus Plan reduces the number of shares available for issuance under the Plan. The 50% limitation does not invalidate any awards made prior to a decrease in the number of outstanding shares, even if such awards result or may result in shares constituting more than 50% of the outstanding shares being available for issuance under the Plan. Shares available under the Plan that are not awarded in one particular year may be awarded in subsequent years.

The compensation committee of the Board of Directors of the Company has the authority to determine the awards granted under the Plan, including among other things, the individuals who receive the awards, the times when they receive them, vesting schedules, performance goals, whether an option is an incentive or nonqualified option and the number of shares subject to each award. However, no participant may receive options or stock appreciation rights under the Plan for an aggregate of more than 50,000 shares in any calendar year. The exercise price and term of each option or stock appreciation right is fixed by the compensation committee except that the exercise price for each stock option that is intended to qualify as an incentive stock option must be at least equal to the fair market value of the stock on the date of grant and the term of the option cannot exceed 10 years. In the case of an incentive stock option granted to a 10% or more shareholder, the exercise price must be at least 110% of the fair market value on the date of grant and cannot exceed five years. Incentive stock options may be granted only within ten years from the date of adoption of the Plan. The aggregate fair market value (determined at the time the option is granted) of shares with respect to which incentive stock options may be granted to any one individual, which stock options are exercisable for the first time during any calendar year, may not exceed $100,000. An optionee may, with the consent of the compensation committee, elect to pay for the shares to be received upon exercise of his or her options in cash, shares of common stock or any combination thereof.

The exercise price of all options granted under the 2001 Omnibus Plan was equal to the market price of the underlying common stock on the grant date and all options were granted and fully vested on the grant date. There were no options granted under the Plan or the 2001 Omnibus Plan during the six months ended March 31, 2014 and 2013, respectively.

Under the Plan, participants may be granted restricted stock units (RSUs), representing an unfunded, unsecured right to receive a share of the Company s common stock on the date specified in the recipient s award. The Company issues new shares of its common stock when it is required to deliver shares to an RSU recipient. The RSUs granted under the Plan vest over four years, at a rate of 25 percent per year. The Company recognizes compensation expense on a straight-line basis over the four-year vesting term of each award. There were 32,800 RSUs granted during the six months ended March 31, 2014 under the Plan and none granted during the six months ended March 31, 2013 under the 2001 Omnibus Plan. RSU activity for the six months ended March 31, 2014 was as follows:

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	Restricted Stock Unit Activity Six Months Ended March 31, 2014	
	Number of Restricted Share Units	Weighted Fair Value Per Share Each Date
Non-vested Balance at September 30, 2013	59,375	$ 8.61
Granted	32,800	9.22
Vested (1)	(11,050)	8.74
Forfeited	(1,500)	9.01
Non-vested Balance at March 31, 2014	79,625	$ 8.84

(1) The restricted share units vested includes partially vested shares. Shares of common stock have not been issued for the partially vested shares, but the related compensation costs have been charged to expense. There were no shares of common stock issued for restricted stock units vested in the six months ended March 31, 2014.

Restricted Stock Unit Compensation Six Months Ended March 31, 2014	
	(In Thousands)
Total expected compensation expense related to Restricted Stock Units	$ 2,952
Compensation expense recognized through March 31, 2014	(2,252)
Unrecognized compensation expense related to RSU s at March 31, 2014	$ 700

As of March 31, 2014, there was $0.7 million of total RSU compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted-average vesting period of 3.5 years.

(9) Commitments and Contingencies

The Company s headquarters is located in leased office space under a single non-cancelable operating lease at 7250 Redwood Blvd., Suite 200, in Novato, California. The lease expires on March 31, 2017, with one five-year

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extension available thereafter. The Company also has leased office space under a single non-cancelable operating sub-lease at 100 Federal Street, 29th Floor, Boston, Massachusetts 02110. The sub-lease expires on January 15, 2015, but is subject to earlier termination in the event the prime lease is earlier terminated. There were no other commitments or contingencies as of March 31, 2014.

As of March 31, 2014, there were no material changes in the leasing arrangements that would have a significant effect on future minimum lease payments reported in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2013.

(10) Fair Value Measurements

The Company applies the FASB standard Fair Value Measurements for all financial assets and liabilities, which establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It also establishes a fair value hierarchy consisting of the following three levels that prioritize the inputs to the valuation techniques used to measure fair value:

Level 1 quoted market prices in active markets for identical assets or liabilities that are accessible at the measurement date.

Level 2 from other than quoted market prices that are observable for the asset or liability, either directly or indirectly (namely, similar assets or from markets that are not active).

Level 3 unobservable and shall be used to measure fair value to the extent that observable inputs are not available (namely, reflecting an entity s own assumptions).

Based on the definitions, the following table represents the Company s assets categorized in the Level 1 to 3 hierarchies as of March 31, 2014:

	Fair Value Measurements at Reporting Date (amounts in thousands)			
	Level 1	Level 2	Level 3	Total
Money market fund deposits	$ 2,470	$	$	$ 2,470
Mutual fund investments	7			7
Total	$ 2,477	$	$	$ 2,477
Amounts included in:				
Cash and cash equivalents	$ 2,470	$	$	$ 2,470
Investments in marketable securities	7			7

Total	$ 2,477	$	$	$ 2,477

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(11) New Accounting Pronouncements

In July 2012, the FASB issued amendments to Accounting Standards Update (ASU) No. 2012-02 Testing Indefinite-Lived Intangible Assets for Impairment. The objective of the amendments is to reduce the cost and complexity of performing an impairment test for indefinite-lived intangible assets by simplifying how an entity tests those assets for impairment and to improve consistency in impairment testing guidance among long-lived asset categories. The amendments permit an entity first to assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test in accordance with Subtopic 350-30, Intangibles Goodwill and Other General Intangibles Other than Goodwill. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Previously, an entity was required to test at least annually. The guidance provided by this update was effective for fiscal years beginning after September 15, 2012 (the Company s fiscal year 2013). The standard was adopted October 1, 2012, and may allow the Company to forego its next annual impairment analysis if the more-likely-than-not threshold is met as of September 30, 2014.

In February 2013, the FASB issued an update to ASU No. 2013-02 Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendment improves the reporting of reclassifications out of accumulated other comprehensive income by requiring an entity to report the effect of the reclassification on a respective line item in the financials. The guidance provided by this update was effective for reporting periods beginning on or after December 15, 2012 (the second quarter of the Company s fiscal year 2013). The adoption of this standard did not impact the Company s financial condition, results of operations or cash flows.

In July 2013, the FASB issued an update to ASU No. 2013-11 Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. The amendment provides that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The guidance provided by this update is effective for reporting periods beginning on or after December 15, 2013 (the second quarter of the Company s fiscal year 2014). The adoption of this standard is not expected to impact the Company s financial condition, results of operations or cash flows.

There have been no other significant changes in the Company s critical accounting policies and estimates during the six months ended March 31, 2014 as compared to what was previously disclosed in the Company s Annual Report on Form 10-K for the year ended September 30, 2013.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This report contains forward-looking statements within the meaning of the securities laws, for which we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. In some cases, forward-looking statements can be identified by terminology such as expect, anticipate, intend, may, plan, will, should, could, would, assume, believe, estimate, predict, potential, similar expressions, as well as statements in future tense. We have based these forward-looking statements on our current expectations and projections about future events, based on information currently available to us. Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or means by, which such performance or results will be achieved.

Our business activities are affected by many factors, including, without limitation, redemptions by mutual fund shareholders, general economic and financial conditions, movement of interest rates, competitive conditions, industry regulation, fluctuation in the stock market and others, many of which are beyond the control of our management. Further, the business and regulatory environments in which we operate remain complex, uncertain, and subject to change. We expect that such regulatory requirements and developments will cause us to incur additional administrative and compliance costs. In addition, uncertainties regarding economic stabilization and improvement remain for the foreseeable future. As we continue to confront the challenges of the current economic and regulatory environments, we remain focused on the investment performance of the Hennessy Funds and on providing high quality customer service to investors.

The success of our strategies to address the challenges of the current economic and regulatory environments may be influenced by the factors discussed in the section entitled Risk Factors in our Annual Report on Form 10-K. Statements regarding such strategies and the following subjects are forward-looking by their nature:

- our business strategy, including our ability to identify and complete future acquisitions;
- market trends and risks;
- our assumptions about changes in the market place, especially with the volatility in the global and U.S. financial markets; and
- our ability to retain the mutual fund assets we currently manage.

Forward-looking statements are subject to risks, uncertainties and assumptions, including those described in the section entitled Risk Factors and elsewhere in our Annual Report on Form 10-K for the year ended September 30, 2013 filed with the Securities and Exchange Commission, that could cause actual performance or results to differ substantially from those expressed in or suggested by the forward-looking statements. Management does not assume responsibility for the accuracy or completeness of these statements. There is no regulation requiring an update of any of the forward-looking statements after the date of this report to conform these statements to actual results or to changes in our expectations.

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Overview

Our primary operating activity is providing investment advisory services to sixteen open-end mutual funds (the Hennessy Funds). We derive our operating revenue from investment advisory fees and shareholder service fees paid to us by the Hennessy Funds. These fees are calculated as a percentage of the average daily net assets in each of the Hennessy Funds and vary from fund to fund. The fees we receive fluctuate with changes in the total net asset value of each of the Hennessy Funds, which is affected by each fund s investment performance, purchases and redemptions of the fund s shares, general market conditions and the success of our marketing and sales efforts. For the three-month period ended March 31, 2014, our average assets under management were $4.62 billion, an increase of 43.2% or $1.39 billion versus the prior comparable period. For the six-month period ended March 31, 2014, our average assets under management were $4.44 billion, an increase of 56.5% or $1.60 billion versus the prior comparable period.

Total assets under management as of March 31, 2014 were $4.77 billion, an increase of 40.2%, or $1.37 billion, versus the prior comparable period. Growth in assets under management over the past year was due to both strong net inflows into the Hennessy Funds and to strong market appreciation in the portfolio securities held by the Hennessy Funds.

The following table illustrates the changes in total assets under management from March 31, 2013 through March 31, 2014:

	Total Assets Under Management At Each Quarter End, March 31, 2013 through March 31, 2014				
	3/31/2013	6/30/2013	9/30/2013 (In Thousands)	12/31/2013	3/31/2014
Beginning assets under management	$ 3,024,068	$ 3,406,426	$ 3,593,673	$ 4,034,181	$ 4,480,322
Organic inflows	312,272	478,377	494,665	378,057	553,204
Redemptions	(297,363)	(345,921)	(267,770)	(235,723)	(329,274)
Market appreciation (depreciation)	367,449	54,791	213,613	303,807	69,977
Ending assets under management	$ 3,406,426	$ 3,593,673	$ 4,034,181	$ 4,480,322	$ 4,774,229

A portion of our expenses are fixed, and historically they have varied only minimally. As a result, substantial fluctuations in our revenue can impact our net income from period to period.

The principal asset on our balance sheet, management contracts, represents the capitalized costs incurred in connection with the purchase of assets related to the management of mutual funds. As of March 31, 2014, this asset had a net balance of $62.5 million.

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The principal liability on our balance sheet is the bank debt incurred in connection with the purchase of assets related to the management of mutual funds. As of March 31, 2014, this liability had a balance of $28.6 million.

Three Months Ended March 31, 2014 Compared to Three Months Ended March 31, 2013

The following table sets forth items in the statements of income and comprehensive income as dollar amounts and as percentages of total revenue for the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31,			
	2014		2013	
	(In thousands, except percentages)			
	Amounts	Percent of Total Revenue	Amounts	Percent of Total Revenue
Revenue:				
Investment advisory fees	$ 8,083	97.3%	$ 5,726	96.3%
Shareholder service fees	227	2.7	221	3.7
Total revenue	8,310	100.0	5,947	100.0
Operating expenses:				
Compensation and benefits	1,877	22.6	1,850	31.1
General and administrative	1,207	14.5	698	11.7
Mutual fund distribution	523	6.3	351	5.9
Sub-advisor fees	1,464	17.6	950	16.0
Amortization and depreciation	60	0.7	45	0.8
Total operating expenses	5,131	61.7	3,894	65.5
Operating income	3,179	38.3	2,053	34.5
Interest expense	286	3.4	179	3.0
Other income, net	(1)	(0.0)	(1)	(0.0)
Income before income tax expense	2,894	34.9	1,875	31.5
Income tax expense	1,135	13.7	758	12.7
Net income	$ 1,759	21.2%	$ 1,117	18.8%

Revenues Investment Advisory Fees and Shareholder Service Fees

Total revenue increased 39.7% from the prior comparable period to $8.3 million in the three months ended March 31, 2014, due to increased average assets under management. Investment advisory fees increased 41.2% from the prior comparable period to $8.1 million in the three months ended March 31, 2014, and shareholder service fees increased 2.7% from the prior comparable period to $0.2 million in the three months ended March 31, 2014. We earn investment advisory fees from all of the Hennessy Funds, but we only earn shareholder service fees from some of the Hennessy Funds. The increase

in investment advisory fees is due to increased average daily net assets of the Hennessy Funds, while the increase in shareholder service fees is due to increased average daily net assets of the Hennessy Funds from which we earn shareholder service fees.

Average daily net assets of the Hennessy Funds for the three months ended March 31, 2014 increased by $1.39 billion, or 43.2%, to $4.62 billion from $3.23 billion in the prior comparable period due to strong net inflows into the Hennessy Funds and to strong market appreciation in the portfolio securities held by the Hennessy Funds.

The Hennessy Funds generate revenue at a rate ranging between 0.40% and 1.20% of average daily net assets. The Hennessy Funds with the largest average daily net assets for the three months ended March 31, 2014 were the Hennessy Focus Fund, with $1.46 billion, and the Hennessy Gas Utility Index Fund, with $1.38 billion. The Hennessy Focus Fund generates revenue at a rate of 0.90% of average daily net assets; however, the Company pays a sub-advisory fee of 0.29% to the fund s sub-advisor, which reduces the net impact to the Company s financial operations. The Hennessy Gas Utility Index Fund generates revenue at a rate of 0.40% of average daily net assets.

Total assets under management at March 31, 2014 were $4.77 billion, an increase of $1.37 billion, or 40.2%, from $3.40 billion as of the end of the prior comparable period. The increase in net assets is attributable to strong net purchases into the Hennessy Funds of $726 million and to strong market and investment appreciation of $642 million. Redemptions as a percentage of assets under management decreased from an average of 3.2% per month during the three-month period ended March 31, 2013 to 2.4% per month during the three-month period ended March 31, 2014, which may indicate that investor hold times in the Hennessy Funds have increased from period to period.

During the three months ended March 31, 2014, purchases of the Hennessy Funds outpaced redemptions of the Hennessy Funds and net inflows were $224 million. Additionally, there was market appreciation of $70 million.

The markets and the U.S. economy continue to show positive momentum, and we believe the inflows we have seen signal that investors are beginning to return to the equity markets after many years of investing in fixed income products. We remain confident in the fundamentals of Corporate America. Corporate profits continue to be at record high levels, and balance sheets remain strong. If investors remain on this current path, we expect to see the recent success of the stock market continue.

We believe net asset flows of over $726 million into the Hennessy Funds during the period from March 31, 2013 to March 31, 2014 were due, among other factors, to the following:

As of March 31, 2014, all sixteen Hennessy Funds had positive annualized returns for the 1-year, 3-year, 5-year, 10-year and since inception periods. Net inflows for the three months ended March 31, 2014 were led by the Hennessy Gas Utility Index Fund ($184 million), the Hennessy Focus Fund ($85 million) and the Hennessy Large Cap Financial Fund ($10 million).

The Hennessy Gas Utility Index Fund was named the 2014 Lipper Winner for 3- and 5-year risk-adjusted performance. 2014 marks the third consecutive year that the Fund has received both 3- and 5-year performance awards.

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The continuation and expansion of our marketing and distribution program, including the following:

- a rigorous public relations program;
- a comprehensive and consistent marketing and communications program targeted to over 100,000 financial advisors and to retail clients and prospects;
- expanding relations