Scale research report - Update

Ernst Russ

Diversified financials

13 June 2018

Focus on real estate and shipping markets

Ernst Russ (ERAG) continued its efforts towards a strategic shift, with real estate (revenues grew by c five times y-o-y in FY17) and shipping (sales up 8.1% y-o-y) acting as the key drivers post acquisition. Management guided to modest revenue growth powered by ship and asset management, and real estate but flat operating earnings in FY18 vs FY17 (€3.9m). Due to the previous volatility in shipping markets and lack of immediate earnings momentum implied by current management guidance, ERAG's market cap/AUM ratio continues to lag the peer average.

FY17 results driven by real estate revenues

ERAG's net profit declined to €5.6m in FY17 from €6.2m in FY16, primarily due to increased costs related to crewing services and a decline in other operating income. Group revenues reached €44.0m, led by higher contribution from the real estate business (15.5% vs 3.5% in FY16) and an 8.1% y-o-y increase in shipping revenues, which was primarily assisted by first-time recognition of crewing activities revenues (up by €3.0m y-o-y) for the full year, partially offset by a decline in sales/profit fees, and revenue from asset management. Revenue in the real estate business grew from €1.4m to €6.8m, driven by commissions for property sales, new tenancy agreements, fund management fees and the sale of land in Leipzig.

Management guides to moderate revenue increase

Management guided to moderate revenue increases across all segments in FY18. The shipping segment is expected to rise slightly, assisted by the relatively positive outlook for container ships, bulkers and tankers. Real estate segment revenues could double in FY18 (although assisted by non-recurring effects). ERAG's corporate planning for the investor management segment assumes lower revenues y-o-y in FY18. The company expects its operating income to be near its FY17 figure of €3.9m. Several investments planned in the shipping and real estate segments are likely to reduce the cash balance moderately in 2018.

Valuation: Still trading at a discount to peers

ERAG's valuation in terms of its market cap/AUM ratio (0.7%) remains below the peer group average. If we assume flat y-o-y EPS in 2018 (as ERAG guides to flat operating earnings), the shares trade at a P/E of c 7.1x 2018e, well below the listed asset managers. This may be partly due to its focus on the challenging shipping sector and persistent litigation risk related to ERAG's legacy funds, as well as unfamiliarity with the group's significant business transition on the part of investors.

Historic financials

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/14	19.7	(1.6)	0.0	0.0	N/A	N/A
12/15	20.7	(6.6)	0.0	0.0	N/A	N/A
12/16	40.0	10.2	0.2	0.0	7.1	N/A
12/17	44.0	9.3	0.2	0.0	7.1	N/A

Source: Ernst Russ accounts

Price	€1.21
Market cap	€39m

Share price graph

Share details

Code	HXCK
Listing	Deutsche Börse Scale
Shares in issue	32.4m
Last reported net debt as at 31 December 2017	€8.4m

Business description

Ernst Russ (formerly HCI Group) is a listed asset and investment manager, with AUM of c €6.3bn, focused on shipping. The group was transformed in 2016 by the acquisitions of Ernst Russ Reederei and König & Cie, positioning it as a provider of a full range of services, including technical and commercial ship management.

Bull

- Strengthened investment and asset management offering.
- Strong maritime and real estate focus and position.
- Rising property values and rentals.

Bear

- Challenging maritime conditions.
- Eroding legacy closed-end fund base.
- Legal risks attached to legacy funds.

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Edison profile page

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Financials: FY17 results released

The company recorded a 10% y-o-y increase in revenues at €44.0m in FY17 bolstered by revenue growth in the real estate and shipping segments, as described above. Investor management revenues fell 18.4% y-o-y in FY17 due to a decline in the trustee business, while revenues from the alternative investments segment were flat y-o-y at €1.4m in FY17. Cost of materials and services rose by €8.8m from €6.1m in FY16 to €14.9m in FY17 due to the increase in expenses for purchased services related to crewing activities for which the company booked higher expenses (€5.7m) in FY17. The cost of repairs for two acquired container ships was €1.3m, while costs related to the sale of property in Leipzig were €1.0m. These factors contributed to the increase in the cost of materials and services. The other operating expenses were lower in FY17 vs FY16 due to a reduction in impairment losses and write-downs on receivables, as well as lower legal and advisory costs. Other operating income declined from €35.0m in FY16 to €23.6m in FY17. Net income from investment in associates reversed a loss of €4.0m in FY16 to a profit of €4.0m in FY17, assisted by the positive performance of a real estate investment fund, whose property was sold in FY17. The net effect of increased costs resulted in a lower net income after minority interests of €5.6m in FY17 compared to €6.2m in FY16. The cash balance was reduced in FY17 (€17.8m) vs FY16 (€28.3m) due to the payment of €9.0m for the purchase of a shipping investment in FY17. Net debt increased to €8.4m at end-December 2017 vs net cash of €16.1m in FY16, due to the financing of two container ships.

Exhibit 1: Results highlights

€000s	FY17	FY16	Y-o-y % change
Revenue	**44,040**	**39,955**	**10.2**
Increase/(decline) in unfinished products	15	(119)	N/M
Other operating income	23,578	34,969	(32.6)
Cost of materials and services	(14,923)	(6,126)	143.6
Personnel expenses	(18,777)	(20,578)	(8.8)
D&A and impairment	(12,346)	(7,862)	57.0
Other operating expenses	(16,027)	(20,619)	(22.3)
Net income from investments in associates	4,388	(3,990)	N/M
Income from equity interest	1,556	976	59.4
Income from loans held as financial investments	109	72	51.4
Other interest and similar income	1,720	2,117	(18.8)
Amortisation of financial investments and securities	(3,020)	(7,557)	(60.0)
Interest and similar expenses	(1,039)	(1,064)	(2.3)
Operating earnings	**3,900**	**3,300**	**18.2**
EBT	**9,274**	**10,174**	**(8.8)**
Income taxes	(2,929)	(3,715)	(21.2)
Earnings after tax	**6,345**	**6,459**	**(1.8)**
Other taxes	(108)	(76)	42.1
Net profit (including minorities)	**6,237**	**6,383**	**(2.3)**
Minorities	(679)	(157)	N/M
Net profit (ex-minorities)	**5,558**	**6,226**	**(10.7)**

Source: Ernst Russ accounts

Exhibit 2: Revenue by operating segment

€m	FY17	% of group revenues	FY16	% of group revenues	Y-o-y % change
Shipping	21.3	48.4	19.7	49.3	8.1
Investor management	12.4	28.2	15.2	38.0	(18.4)
Real estate	6.8	15.5	1.4	3.5	385.7
Alternative investments	1.4	3.2	1.4	3.5	0.0
Other services	2.1	4.8	2.3	5.8	(8.7)
Total	**44.0**	**100**	**40.0**	**100**	**10.0**

Source: Ernst Russ accounts

Outlook

Industry experts such as Alphaliner and Clarksons expect demand for container ship capacity to grow by 5% in 2018, with supply-side growth at 4.1% y-o-y (Clarksons) or 5.6% (Alphaliner). In the charter market, rates are expected to rise on the back of improved market conditions. According to Clarksons, growth in demand of 2.7% could exceed growth in supply of 1.8% in 2018 for bulker fleet. Moreover, growth in demand for product tankers should be roughly equal to the increase in capacity for 2018 (Clarksons). In the German real estate market, the trend of rising property prices and rentals could continue in 2018 (source: Deutsche Bank Research), and there could be a moderate increase in interest rates during the year. Moreover, management expects rents and property prices in German metropolitan areas such as Berlin, Hamburg and Frankfurt to increase rapidly in 2018, despite new house completions.

ERAG's shipping segment revenues are likely to be higher y-o-y in 2018, accounting for the largest share of total revenues. Real estate segment revenues, primarily driven by fund and asset management income, could increase significantly in 2018, as the company continues its investments in this segment (management expects sales to double on the back of non-recurring effects). With regard to the investor management segment, ERAG cautiously incorporates only contracts that have already been funded in its corporate planning, which could result in a revenue decline in 2018. It also expects further write-downs of receivables in this segment. Alternative investments sales could be higher y-o-y in 2018. Overall, the company projects its total revenues to increase modestly y-o-y in 2018 and believes that its operating income will be flat y-o-y (FY17: €3.9m).

Valuation

We compare ERAG to a broad peer group of listed asset managers in Europe and North America, including private equity, specialist and conventional asset managers. Noting management guidance of flat operating earnings in 2018, we have used the 2017 net earnings figure as a guide for the current year. We note that there could be a significant variance in the ratio of 2018 net income to operating profit vs 2017. ERAG's EPS in 2017 was €0.17, which puts the shares on a P/E of c 7.1x, substantially below the peer group median of c 12.7x and implying potential undervaluation. ERAG's return on closing equity was c 15% in 2017, somewhat lower than the peer group median, but this seems to be more than reflected in a lower P/BV (based on last reported equity) at c 1.0x.

Exhibit 3: Peer group comparison

	PE (x)		ROE (%)		P/BV	Dividend yield (%)
	2018e	2019e	2018e	2019e	2017	2018e
Private equity (Partners Group, Blackstone, KKR, 3i Group)	10.7	9.4	27%	25%	2.4	2.8%
Specialist (Apollo, Ashmore, Man Group, Patrizia, Lloyd Fonds, MPC, Deutsche Beteiligungs)	13.2	9.8	13%	14%	1.9	4.3%
Conventional (Azimut, Janus Henderson, Jupiter, Schroders)	12.8	11.9	21%	20%	3.0	5.5%
All	**12.7**	**9.8**	**16%**	**16%**	**2.3**	**4.3%**

Source: Company accounts, Bloomberg data as at 24 May 2018

In Exhibit 4 we compare ERAG with close local peers, Lloyd Fonds, MPC and the real estate-focused manager, Patrizia. While the market cap and market cap/AUM seem to be directly related, the market cap/AUM valuation placed on ERAG is considerably lower than Lloyd Fonds, which has a lower market capitalisation and lower revenue/AUM ratio. It may just be an indication that the market is undervaluing ERAG's earnings potential.

Exhibit 4: Market cap/AUM and revenue/AUM comparison with close local peers

	Market cap (€m)	2017 AUM (€bn)	Market cap/ AUM (%)	2017 revenues (€m)	Revenues/ AUM (%)
Patrizia	1,706	38.7	4.4	249.6	0.64
Lloyd Fonds	35	1.4*	2.5	9.5*	0.68
MPC	161	5.1	3.2	59.6	1.17
Ernst Russ	39	6.3	0.7	44.0	0.73

Source: Company data. Note: *Revenues and AUM for Lloyd Fonds as of FY16. Market cap as at 24 May 2018.

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