Scale research report - Update

Ernst Russ

Diversified financials

13 May 2019

Shipping and real estate are growth drivers

Ernst Russ (ERAG) continues to reposition itself to focus on the shipping and real estate segments, while at the same time retaining a focus on cost efficiencies and funding restructuring. However, the weakness in the shipping markets seen in the second half of 2018 (as illustrated by the decline in charter rates) has provided some headwinds. Having said that, these markets seem relatively balanced now. In the real estate area, Ernst Russ was able to conclude a number of successful transactions and is exploring new opportunities in the area of subsidised housing.

Results in line with guidance, but include one-offs

ERAG met its FY18 management guidance, reporting a c 20% y-o-y improvement in revenue driven by a sustainable increase in the shipping segment (including higher charter income from an expanded ship fleet in direct and co-investments), as well as high transaction volumes in the real estate area. EBIT reached €4.2m (vs €3.9m in FY17) while pre-tax profit stood at €6.1m (vs €9.3m in FY17). However, ERAG's figures contain a number of one-off items, which we discuss later in this report. We estimate that, adjusted for these, pre-tax profit was c €2.9m (vs €0.4m in FY17). In FY19, ERAG expects further improvement in sales on the back of the maritime business expansion, with the bottom line slightly below FY18 results.

Lower AUM in restructured portfolio

Following H118, when AUM remained broadly flat at c €6bn vs end-2017, the company reported a decrease to €5.2bn in H218 resulting from disposals and the erosion of the closed-end fund base. While ERAG expands its own fleet held directly and through joint ventures (in particular the ElbFeeder JV), the total number of ships managed within ERAG funds went down, translating into a total of 90 managed at end-2018 compared with 150 at end-2017. As Ernst Russ increases its focus on asset and investment management in the maritime and real estate segments, it has sold all business activities in the solar segment, as well as the technical ship manager, HAMMONIA Reederei.

Valuation: Deep discount to peers

ERAG is trading at a 75% and 72% discount to the peer group on FY18 P/E and EV/EBITDA numbers, respectively. We believe this reflects the ongoing business repositioning and uncertainty in the shipping markets. ERAG's market cap represents 0.5% of its AUM, which is below its main competitor, MPC Capital (1.5%), as well as Corestate Capital (2.8%) and Patrizia Immobilien (4.2%).

Historical financials

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/15	20.7	(6.6)	0.0	0.0	N/A	N/A
12/16	40.0	10.2	0.2	0.0	4.1	N/A
12/17	44.0	9.3	0.2	0.0	4.1	N/A
12/18	52.7	6.1	0.2	0.0	4.1	N/A

Source: Ernst Russ accounts

Price	€0.82
Market cap	€27m

Share price graph

Share details

Code	HXCK
Listing	Deutsche Börse Scale
Shares in issue	32.4m
Last reported net debt as at 31 December 2018	€5.7m

Business description

Ernst Russ is a listed asset and investment manager and asset investor, with AUM of c €5.2bn, focused on shipping and real estate. Currently, the Ernst Russ Group manages a fleet of around 90 container, tanker and bulker ships as well as total of 41 real estate properties at 28 sites. The company has offices in Hamburg, Bremen, Cologne and London.

Bull

- Strengthened investment and asset management offering.
- Repositioning to focus on core maritime and real estate segments.
- Rising property values and rentals.

Bear

- Maritime market revival is early stage.
- Eroding legacy closed-end fund base.
- Legal risks attached to legacy funds.

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Financials: Top-line increase despite declining AUM

In FY18, Ernst Russ met its management guidance of at least 10% y-o-y revenue growth, reporting €52.7m in sales, implying a 19.8% y-o-y increase. This improvement was driven by the shipping and real estate segments, with the former benefiting from higher charter income (€7.0m vs €1.0m in FY17) on the back of the employment of three additional container ships. However, it was partially offset as ship management fees declined by €2.5m, with crewing income down by €0.8m and technical management down by €1.5m amid ship disposals by fund companies. Results in the real estate segment have been shaped mainly by transaction activity, both on the company's part and on behalf of its clients (more details in the next section). Moreover, the company faced some currency headwinds from the weakening US dollar.

ERAG reported an operating profit of €4.2m compared with the FY17 result of €3.9m, which is broadly in line with management guidance of FY18 EBIT being close to the FY17 figure. The company's net interest and investment income were down at €1.0m (vs €5.2m in FY17) due to the pro rata loss of the ElbFeeder JV, although we understand that it was a result of one-off transaction costs. Consequently, reported pre-tax profit reached €6.1m vs €9.3m in FY17. It is important to note that the company's bottom line in both periods was largely influenced by several one-off factors (both positive and negative), including impairment losses/amortisation of assets, a write-down on receivables and realisation of receivables previously written off, income from debt restructuring and deconsolidation of subsidiaries, reversal of provisions and negative goodwill, etc. When adjusted for all these items, ERAG's pre-tax profit was €2.9m compared to €0.4m in FY17, according to our estimates.

ERAG booked a positive tax effect of €0.4m and, as a result, net income excluding non-controlling interest for the period reached €6.2m (compared to €5.6m in FY17). As the company pays no dividend at the moment, this amount was allocated to retained earnings, moving the total equity amount to €51.1m. Together with reduced liabilities on the back of restructuring and refinancing of loans, this led to an improved equity ratio at 49.4% in FY18 from 38% in FY17.

Exhibit 1: FY18 results highlights

€m	2018	2017	y-o-y %
Revenue	52.7	44.0	19.8%
Change in inventory	0.1	0.0	N/M
Total Revenue	**52.8**	**44.0**	**20.0%**
Other operating income	9.7	15.5	(37.4%)
Cost of materials and services	(23.1)	(14.9)	55.0%
Personnel expenses	(15.3)	(18.7)	(18.2%)
Other operating expenses	(15.1)	(14.4)	4.9%
Depreciation, amortisation and impairment	(4.8)	(7.6)	(36.8%)
Operating earnings	**4.2**	**3.9**	**7.7%**
Neutral result	0.9	0.2	N/M
Net interest and investment income	1.0	5.2	(80.8%)
Earnings before taxes (EBT)	**6.1**	**9.3**	**(34.4%)**
Income taxes	0.4	(3.0)	N/M
Other taxes	(0.1)	(0.1)	0.0%
Consolidated net income before non-controlling interest	**6.4**	**6.2**	**3.2%**
Profit attributable to non-controlling interests	(0.2)	(0.6)	N/M
Consolidated net income after non-controlling interest	**6.2**	**5.6**	**10.7%**

Source: Ernst Russ accounts

Management expects group revenue to increase significantly in FY19 on the back of further development in the shipping business. Prudent cost management will be a key issue in the period as not all budget targets were met in FY18. As a result, group earnings before neutral result, net interest, investment income and taxes in FY19 should fall just short of the FY18 level, but remain positive. Cash at the end of the period is expected to remain flat compared to end-December 2018.

Segment financials and outlook

ERAG's AUM as at end-December 2018 stood at €5.2bn, of which €0.3bn represented assets where the company was investor or co-investor. Consequently, AUM decreased compared to €6.0bn at end-2017 and €6.1bn at end-June 2018, as new asset acquisitions in H218 did not offset the decline from disposals.

Shipping segment

The shipping segment recorded a more than 20% y-o-y increase in revenues in FY18, reaching €25.6m and nearing half of the company's total revenue (49%). This was achieved even though the total fleet under ERAG's management decreased from c 110 vessels held at end-H118 to 90 at end-FY18. This comprised 33 vessels held as direct investments and co-investment (vs c 36 at end-June 2018) and 57 fund ships, down by c 17 over a six-month period. The increase in sales was driven by improved charter income, which stood at €7.0m following a y-o-y increase of €6.0m, on the back of ERAG's ElbFeeder JV expanding its fleet to seven ships. This provides potential for further purchases as the company targets a fleet size of six to 12 vessels. Additionally, 12 container ships have been actively managed by an entity in the Ernst Russ Group via a joint venture. Moreover, ERAG purchased a 3,091 TEU vessel entirely on its own book in July 2018, refinanced its two direct vessel investments made in 2017 and acquired a 49% stake in a general-purpose cargo vessel in December 2018. As part of its strategy to focuson asset management in the shipping industry, the company sold its 31.37% stake in HAMMONIA Reederei, a technical ship manager for bulkers, container vessels and multipurpose vessels.

In FY19, the shipping business should represent the majority of the company's revenues, according to management. Its development will be dependent on success in sourcing additional assets and efficiency in managing existing investments. This should be funded by further disposal of non-core business units and equity interests. The company plans to further develop its fleet and expects a rebound in the shipping market in the medium and long term after a significant downturn in H218, which caused ERAG to terminate its partnerships with Pareto Securities and Ecofin Group.

ERAG states that the shipping business should be supported by consolidation among shipping companies along with eliminations of excess capacity. Management considers the IMO 2020 regulation a catalyst for the changes, as the need for refits should temporarily reduce available tonnage. Ships will be equipped with scrubbers, which will help limit the sulphur content of fuel to a maximum of 0.5% (vs 3.5% currently). ERAG is still in the testing phase with respect to possible solutions, including conversion to environmentally friendly LPG propulsion. However, based on a conversation with the company's management we understand ERAG is confident that it will complete the IMO 2020 preparations before end-2019.

Real estate segment

Revenues in the real estate segment more than doubled in the reporting period, reaching €14.9m (or 28% of total group sales). The result in this segment was primarily boosted by transaction activity, including the disposal of the property in Lützowstraße in Essen, which provided €7.9m of proceeds and yielded a €2.4m gain, as well as the acquisition of the Cologne Trust portfolio, which translated into fees of €1.8m. Another €2.0m came from fees related to the sale of the RWI4 property in Düsseldorf, which generated c 750% of total pre-tax capital return for fund investors. Moreover, ERAG concluded disposals in Amsterdam, The Hague and Hanover. As a result, real estate assets under ERAG's management currently consist of 41 properties in 28 sites, with a total asset value of c €1.4bn, which declined from €2.0bn as at end-December 2017.

ERAG also continues its efforts in the area of subsidised housing. Following completion of the first project of this type in 2018, the second project was successfully integrated at the beginning of 2019 and should assist 2020 results. The company aims to further develop this business activity as both project developer and service provider to third-party entities. However, as FY18 was driven by particularly high transaction volumes, management expects revenue from fund and asset management to fall slightly in FY19.

Non-core business activities

While the company plans to focus on the real estate and shipping segments, the importance of investor management, alternative investments and other services is being reduced accordingly. The revenues from investor management declined in FY18 to €9.0m compared to €12.4m in FY17. None of the remaining business areas has exceeded a 5% share of ERAG's overall performance in FY18, with total revenue from these activities amounting to €3.2m. As part of its strategy, ERAG disposed of all its business activities in the solar segment, which will contribute c €1m to operating profit in FY19. ERAG also sold the remaining 18% share in eFonds, an online platform focused on the distribution of closed-end real assets investment funds.

Valuation: Deep discount to peers

We believe the relevant peer group for Ernst Russ should contain local asset managers active in the shipping and/or real estate domain. We have selected five peers, with MPC Capital being the closest competitor. Due to the lack of consensus estimates for ERAG, we have based our analysis on FY18 results. Please note that these figures contain a certain amount of distorting one-off items, which are hard to eliminate completely. ERAG is trading at a 75% and 72% discount to the peer group on FY18 P/E and EV/EBITDA numbers, respectively. We believe this reflects the ongoing business repositioning and current uncertainty in the shipping markets following the decline in charter rates in H218. We would also note ERAG's relatively small market cap compared to the selected peer group.

Given that ERAG's earnings are largely dependent on the size of its AUM, it may also be instructive to examine the market cap/AUM ratios for the company and its peers based on last reported asset figures. ERAG's market cap represents 0.5% of its AUM, which is below the figures for MPC Capital (1.5%), Corestate Capital (2.8%) and Patrizia Immobilien (4.2%).

Exhibit 2: Peer group comparison

	Market cap	P/E (x)			EV/EBITDA (x)		
	(€m)	2018	2019e	2020e	2018	2019e	2020e
MPC Capital	66.1	N/A	N/A	21.2	7.8	N/A	38.8
Corestate Capital	697.2	5.1	5.1	4.8	3.1	3.3	3.1
Patrizia Immobilien	1721.9	32.7	17.8	16.4	14.0	11.8	11.1
TLG Immobilien	2668.9	20.5	13.0	13.8	23.5	22.8	21.7
VIB Vermögen	692.4	11.6	11.2	10.6	14.9	16.0	15.6
Peers Average		**17.5**	**11.8**	**13.4**	**12.7**	**13.5**	**18.1**
Ernst Russ	26.6	4.3	N/A	N/A	3.6	N/A	N/A
Premium/(discount) to peers		**(75%)**			**(72%)**		

Source: Ernst Russ, Refinitiv consensus as at 7 May 2019

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