Ernst Russ

Diversified financials

25 September 2020

Ship utilisation remains high

In H120, Ernst Russ (ERAG) recorded a 39% increase in revenues, mainly driven by the accounting effect of the full consolidation of the Elbfeeder JV, following the acquisition of an additional 2% stake in July 2019. The positive impact from expanding ERAG's own fleet to 14 vessels, which more than doubled the income in the shipping segment, was partially offset by the disposals of non-core activities as part of streamlining the business. Together with the headcount reduction and other cost-cutting measures, it translated into an operating profit and net profit for the period of c €1.8m, against losses reported in H119. Management guides for a positive operating result in the low single-digit millions for FY20.

Operating focus skewed towards shipping

At 30 June 2020, ERAG held assets under management (AUM) of €1.9bn, a slight decline from €2.0bn at end-2019. Within the shipping segment (c 91% of group revenues in H120), ERAG manages a fleet of 70 vessels with 14 fully consolidated ships, a further 14 where it has significant interests and 42 ships which are subject to ERAG's fund management and other asset management services. In the real estate segment, it manages 29 properties on 17 sites through 24 investment funds.

Subdued macroeconomic outlook

According to Moody's, the container shipping market outlook remains uncertain due to a lower trade volume of finished and semifinished goods in advanced economies. However, the capacity adjustments made by the largest European liners helped them retain healthy EBIT margins at c 5% in Q120. Meanwhile, in the German real estate market, investment volumes declined by c 15% y-o-y to €14.7bn in Q220 according to JLL, with an increasing share of investment in residential properties, which are considered as the most resilient segment. Still, overall investor demand for German properties remains solid, especially for properties with long-term lease contracts.

Valuation: Trading at discount to peers

As consensus data for the company are unavailable, we have compared the 12-month figures to end-June 2020 with a group of local asset investors and managers active in the shipping and/or real estate area. Based on P/E and EV/EBITDA multiples, ERAG is trading at significant discount to its peers. The market cap to AUM ratio brings a similar conclusion as it sits at 1.0% against MPC Capital of 1.2%, Corestate Capital at 1.6% and Patrizia at 4.5%.

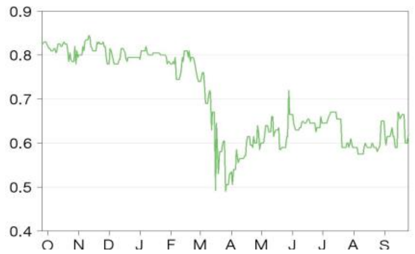
Historical financials

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/16	40.0	10.2	0.20	0.00	2.8	N/A
12/17	44.0	9.3	0.17	0.00	3.3	N/A
12/18	52.7	6.1	0.19	0.00	3.0	N/A
12/19	58.8	3.5	0.05	0.00	11.3	N/A

Source: Ernst Russ, Edison Investment Research

Price €0.57
Market cap €18m

Share price graph



Share details

Code	HXCK
Listing	Deutsche Börse Scale
Shares in issue	32.4m
Last reported net debt at 30 June 2020	€40.6m

Business description

Ernst Russ is a listed asset and investment manager and asset investor, with AUM of c €1.9bn, focused on shipping and fund management (particularly real estate). The Ernst Russ Group manages a fleet of 70 container, tanker and bulker ships, as well as 24 real estate funds. The company has offices in Hamburg, Cologne and London.

Bull

- Strengthened investment and asset management offering.
- Repositioned to focus on maritime segment.
- Highly experienced team from the maritime sector.

Bear

- Negative global trade growth forecasts.
- Higher risk aversion weighing on asset values.
- Eroding legacy closed-end fund base.

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H120 financials: Increasing share of shipping revenues

Even though ERAG recorded a minor decline in AUM in H120, from €2.0bn at the beginning of the period to €1.9bn at 30 June 2020 (€2.5bn at 30 June 2019), H120 revenue increased by c 39% y-o-y, reaching €28.9m, against €20.8m in H119. The improvement was mainly driven by expanding and chartering its own, fully consolidated fleet, which sat at 14 ships throughout the whole of H120 compared to three ships at the start of H119 and six at the end. It is worth noting, however, that to a significant extent it is an accounting effect from the full consolidation of the Elbfeeder JV after ERAG increased its stake by 2% to 52% on 31 July 2019.

Despite the coronavirus-driven disruption to global trade, ERAG reported a ship utilisation ratio of 95.1% in H120 versus 94.6% in H119. Consequently, the shipping segment contributed c €26.3m to the total revenue for the first six months of 2020 (c 91% share), against €12.8m in the first half of 2019. We note that in addition to its own fleet, ERAG provided fund management and asset management services covering 42 ships at end-June 2020 with related ship management and asset management income remaining broadly stable between H119 and H120. A further 14 ships, in which Ernst Russ holds significant interest, contributed to the increase in income from equity interests from €1.5m to €2.0m in H120. It is important to note that at this stage, ERAG has not recognised any write-offs on its shipping investments, commenting that valuations are based on long-term planning over the residual life of the ship.

Exhibit 1: Financial highlights

€000s, unless otherwise stated	H120	H119	y-o-y
Revenue	**28,929**	**20,793**	**39.1%**
Shipping	*26,344*	*12,775*	*106.2%*
Real estate	*1,713*	*3,524*	*-51.4%*
Alternative investment	*719*	*761*	*-5.5%*
Other services	*153*	*400*	*-61.8%*
Investor management	*0*	*3,333*	*N/M*
Decrease/increase in unfinished products	(1)	(365)	-99.7%
Other operating income	2,221	4,386	-49.4%
Cost of materials and services	(18,329)	(8,923)	105.4%
Personnel expenses	(3,779)	(6,395)	-40.9%
Depreciation	(5,490)	(2,638)	108.1%
Other operating expenses	(2,377)	(7,995)	-70.3%
EBIT*	**1,800***	**(900)***	**N/M**
Net income from investment in associates	0	(10)	N/M
Income from equity interests	1,958	1,451	34.9%
Income from loans held as financial securities	16	0	N/M
Other interest and similar income	764	791	-3.4%
Amortisation of financial assets and current securities	(351)	(13)	N/M
Interest and similar expenses	(1,630)	(875)	86.3%
Income taxes	(233)	(779)	-70.1%
Earnings after tax	**1,698**	**(572)**	**N/M**
Other taxes	(48)	(30)	60.0%
Net profit/loss	**1,650**	**(602)**	**N/M**
Net profit/loss attributable to non-controlling interests	173	(7)	N/M
Net profit/loss after non-controlling interests	**1,823**	**(609)**	**N/M**

Source: Ernst Russ. Note: *Estimated amounts as shown in the Consolidated Management Report.

In H120 the first six months of 2020, ERAG also continued to manage 24 real estate funds (including 29 properties on 17 sites), which generated management fee income comparable to H119. However, total revenue of the real estate segment declined from €3.5m to €1.7m in H120, as the previous year's figures included significant one-off fees relating to new lettings and disposals. It is worth noting the company divested its housing properties development business as part of streamlining its operations. In March and April 2020, ERAG sold a project in ILO Park in Pinneberg and its Bad Oldesloe project, which both had been acquired with joint-venture partners in 2019. We also note the investor management segment, which was disposed of in June 2019, contributed c €3.3m to the H119 revenue. Meanwhile, other operating income in H120 fell c 49% to €2.2m, with the previous year figure inflated by profit from deconsolidation of the Solar segment, amounting to €1.2m. The reduction was also driven by minor declines in income from the reversal of provisions (€0.6m in H120 vs €1.0m in H119) and realisations of already written-off receivables (€0.1m vs €0.4m) among others. The other operating expense has also declined significantly in H120 to €2.4m on the back of the investor management segment disposal, assisted by lower legal fees and €1.3m decrease in impairment of receivables.

Expanding volume of shipping operations resulted in an increase in ship operating costs in H120 to €13.2m from €4.0m in H119 and total cost of materials to €18.3m from €8.9m. Furthermore, ERAG recognised c €5.5m depreciation in the first six months of 2020 (against just €2.6m in H119), with €2.7m attributable to intangible assets (vs €0.8m). On the other hand, ERAG was able to significantly lower personnel expenses, which fell from €6.4m to €3.8m in H120, together with the average employee capacity dropping from 130 to 66 positions, mainly due to the disposal of the investor management segment.

Based on the consolidated management report data, ERAG recorded c €1.9m operating profit in H120 (EBIT), against a €0.9m loss in the corresponding period last year. With a more asset-heavy business model, net debt increased to €40.6m at end-June 2020 (against €29.8m a year earlier), driving an increase in interest and similar expenses to €1.6m in H120 from €0.9m in H119. Consequently, consolidated net profit after non-controlling interests for the period reached €1.8m, against €0.6m loss in H119. We note that ERAG's cash and equivalents were up to €13.3m from €10.0m at end-2019, supported by divestments, including the sale of its Residential Housing Projects business (as part of its strategy to focus on the shipping segment) in particular.

Given the recent cost-cutting measures (including personnel costs) and the 95.1% level of own fleet capacity utilisation in H120, management forecasts a positive operating result at the low single-digit million level for FY20. Consequently, management anticipates a moderately to significantly higher level of cash and cash equivalents at end-2020 vs end-2019 (ERAG's operating cash flow in H120 stood at €3.1m vs close to null in H119). Regardless of the pandemic's impact on ERAG's results, management highlights a possible year-on-year decline in the company's revenues from higher comparative base, as H219 figures include the sale of a directly held property for €8.6m.

Uncertain outlook for the container shipping market

At 30 June 2020, ERAG managed a fleet of 70 vessels, including 42 ships which are subject to ERAG's fund management and other asset management services, 14 co-investments and 14 fully consolidated ships. Container ships are the most important vessel class from the company's revenue perspective as there are 13 fully consolidated ships.

The outlook for the global shipping sector for the next 12–18 months remains subdued, as reaffirmed by Moody's in July 2020. The ratings agency expects aggregate EBITDA of rated shipping companies to fall c 16–18% y-o-y in 2020, compared to its previous forecasts from March 2020 of a 6–10% drop. Moody's highlights that supply is likely to exceed demand in the dry bulker and container shipping segments, with the latter being mostly affected by lower trade volume of finished and semifinished goods in the advanced economies in North America and Europe. According to Moody's, this is not only the result of the global economic downturn, but also of regulatory challenges as over 90 countries banned or imposed restrictions on exports of medical and food supplies to avoid domestic shortages.

The container shipping segment responded to the headwinds by limiting the available capacities through blank sailings (a scheduled sailing that has been cancelled by a carrier or shipping line so a vessel skips certain ports or even the entire route). Reduced supply helped the largest European liners preserve healthy margins, which were around 5% in Q120, according to Moody's. The freight rates measured by the China Containerised Freight Index exceeded the prior-year levels, recording a year-to-date increase of 12.1% due to strong rebound that started in June 2020. According to ERAG, considerably more ships are again chartered and for steadily rising average periods.

Lower investments and take-up in office real estate

While investment volumes in the German real estate market declined by c 15% y-o-y to €14.7bn in Q220 (based on JLL data), the market has so far remained quite resilient to the COVID-19 crisis, with investor interest remaining strong (particularly in the core segments), fuelled by monetary easing and declining government bond yields. Properties in the living segment (residential, student accommodation, micro apartments etc) were especially sought after in the investment market as investors seem to perceive them as a safe haven. This is reflected in the segment's share of 35% of total real estate investment in H120, according to JLL.

In contrast, the share of office real estate in the overall investment volume declined from c 40% in FY19 to 22% in H120, according to JLL. During the first six months of 2020 c 1.28m sqm of office space was either let to tenants or sold to owner-occupiers in seven largest German cities, which constitutes a c 36% y-o-y drop. It is worth noting that Q220 saw the weakest second-quarter take-up since 2009. We also note that the overall impact of the pandemic on the sector could be delayed due to the stimulus package launched by the government, which helped preserve job positions and avoid termination of lease agreements. According to JLL, the aggregate vacancy rate as at end-June 2020 remained very low, at c 3.2%, helping the rental prices stay on par with the pre-coronavirus levels. In contrast, demand for office space could be reduced due to the increasing popularity of work-from-home business model. According to ERAG's management, this would impact the vacancy rate, rent levels and in turn the returns on investments in office real estate.

Valuation: Market cap to AUM ratio at c 1%

We compare ERAG to a group of local asset investors and managers active in the shipping and/or real estate domain for valuation purposes. With an operating focus skewed towards shipping, we believe MPC Capital is the closest competitor to ERAG. Due to the lack of similar listed companies in the local market, we have supplemented the peer group with companies operating in the real estate segment. As consensus estimates for ERAG are unavailable, we have used reported figures calculated for the last 12 months ending 30 June 2020 to compare the valuation of the group. Based on P/E and EV/EBITDA multiples, the company trades at a significant discount to its peers of c 46% and 67% respectively, which is in line with management's stance on significant undervaluation of ERAG. We note that ERAG's earnings partly depend on the size of its AUM, therefore it is instructive to examine the market cap/AUM ratios for the company and its peers based on last reported figures. ERAG's market cap represents c 1.0% of its AUM, below the figures for MPC Capital (1.2%), Corestate Capital (1.6%) and Patrizia (4.5%). In this context, we note that this comparison is somewhat distorted by the different leverage levels applied to shipping and real estate investments.

Exhibit 2: Peer group comparison

	Market cap (€m)	P/E				EV/EBITDA			
		H120 LTM	2020e	2021e	2022e	H120 LTM	2020e	2021e	2022e
MPC Capital	54	NM	NM	20.9	13.9	10.4	NM	17.1	7.1
Corestate Capital	437	6.0	6.0	4.0	3.4	7.0	10.0	6.8	6.4
Patrizia	2,058	44.0	31.3	25.7	23.0	15.9	15.3	13.4	12.4
VIB Vermogen	736	11.0	11.2	10.0	10.2	14.4	18.6	17.4	16.3
TLG Immobilien	1,896	3.8	40.2	10.1	11.7	6.3	24.0	21.9	21.8
Peer group median		**8.5**	**21.2**	**10.1**	**11.7**	**10.4**	**17.0**	**17.1**	**12.4**
Ernst Russ	18	4.6	N/A	N/A	N/A	3.5	N/A	N/A	N/A
Discount to peers		**(46%)**				**(67%)**			

Source: Ernst Russ, Refinitiv

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