EDISON **Scale research report - Update**

Ernst Russ

Diversified financials

28 September 2018

Market outlook supports further repositioning

Ernst Russ (ERAG) is making steady progress in repositioning as an asset and investment manager and asset investor, with the legacy business representing around 40% of the group's operations at end-June 2018 compared with 80% in 2016. However, ERAG's assets under management (AUM) increased only slightly to €6.1bn in H118, as new investments (especially in fleet expansion) were offset by disposals. Management reaffirmed the earlier FY18 guidance of at least 10% y-o-y revenue growth and operating profit close to the FY17 figure of €3.9m.

H118 results reflect several one-off effects

ERAG reported an operating profit (adjusted by the company for some non-operating items) at €3.3m in H118 (up from €2.1m in H117), while at the same time recording a 14% y-o-y decline in pre-tax profit to €2.9m. This is because the company's earnings continue to be influenced by a number of one-off factors (which we discuss in more detail below). We estimate that adjusted for these, ERAG's pre-tax loss stood at €0.6m compared with a loss of €0.8m in H117.

Fleet expansion coupled with disposal gains/fees

As the shipping markets continue their gradual revival fuelled by solid global trade volumes, the company is investing on its own and through the recently established joint venture (JV) Elbfeeder in expanding its fleet of predominantly container ships. Once the acquisition of two vessels scheduled for September is complete, ERAG should participate (as investor or co-investor) in income streams from a fleet of 10 ships. The company is also benefitting from the buoyant conditions in the European real estate markets through disposal gains and fees related to several transactions in Germany and the Netherlands.

Valuation: Trading below last reported book value

ERAG is trading at a 34% discount to peers on LTM EV/EBIT, respectively. Assuming an operating profit in FY18 stable vs FY17 levels (in line with management guidance), the company trades at a 29% discount to peer group on FY18e EV/EBIT. Simultaneously, ERAG's shares trade below its last-reported book value per share (€1.40), which assumes further equity erosion through accumulated losses and/or asset impairments or write-downs. If the company is able to successfully progress with the business turnaround while end markets remain supportive, the current valuation might prove an attractive entry point.

Historical 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	4.8	N/A
12/17	44.0	9.3	0.2	0.0	4.8	N/A

Source: Ernst Russ accounts

Price €0.96

Market cap €31m

Share price graph

Share details

Code	HXCK
Listing	Deutsche Börse Scale
Shares in issue	32.4m
Last reported net debt at 30 June 2018	€8.1m

Business description

Ernst Russ is a listed asset and investment manager and asset investor, with AUM of c €6.1bn, focused on shipping and real estate. 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

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

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Financials: Impact of asset deals and one-off items

ERAG reported an operating profit (excluding non-operating items as classified by the company) of €3.3m in H118 compared to €2.1m in H117. Pre-tax profit came in at €2.9m, which is about 14% below last year. The company's bottom line in both H118 and H117 was influenced by a number of positive and negative one-time effects, which are summarised in Exhibit 1. These include reversal of provisions and negative goodwill, insurance indemnification, write-down of receivables and realisation of receivables previously written off. H117 results also include income from restructuring of liabilities to banks, income from deconsolidation of two former subsidiaries, as well as impairment losses. When adjusted for these items, ERAG's H118 pre-tax loss reached €0.6m compared with a loss of €0.8m in H117. The H118 results also include a loss from investments in associates of €0.6m (vs close to null in H117).

Exhibit 1: ERAG's adjusted pre-tax profit calculations

€000s unless otherwise stated	H118	H117
Reported pre-tax profit	**2,893**	**3,361**
Reversal of provisions	1,799	811
Income from reversal of negative goodwill	1,588	2,424
Insurance indemnification	1,095	353
Realisation of receivables previously written off	465	865
Income from the restructuring of liabilities to banks	0	2,872
Income from deconsolidation of subsidiaries	0	550
Write-downs on receivables	(1,028)	(2,077)
Impairment losses included in D&A	0	(1,219)
Amortisation of goodwill	(400)	(400)
Adjusted pre-tax profit	**(626)**	**(818)**

Source: Ernst Russ, Edison Investment Research

Group revenues increased 34.5% y-o-y to €27.9m, driven predominantly by the real estate business, where sales went up to €10.8m vs €1.7m in H117. The result in this segment was primarily boosted by revenue from the disposal of a property in Essen (which yielded a disposal gain of €2.4m), as well as transaction fees from the disposal of three fund properties in Amsterdam, The Hague and Hanover. After the report date, ERAG also finalised the sale of the RWI4 property in Düsseldorf, which translated into fees in excess of €2.0m (to be recognised in Q318) and generated a total capital return of c 750%. Revenues in the shipping business rose slightly by 2.1% y-o-y. Through its JV with Pareto Securities, ERAG has disposed of two tankers in February (placed by Pareto in the Norwegian market), which generated transaction fees of €1.0m (of which half is attributable to ERAG). In line with management expectations, the scope of the Investor Management, Alternative Investments and other services (which include a fair amount of legacy business) is gradually being reduced. In particular, the number of funds under fiduciary management continued to decline. The reported (non-adjusted) net profit stood at €2.1m, down 34% from €3.1m in H117.

On the operating expense side, the considerable increase in ERAG's material expenses (€14.0m vs €3.1m in H117) is the consequence of the Essen property disposal (€5.5m), the increase in expenses from crewing subcontractors as ERAG seized to employ own maritime personnel (€3.5m, with a corresponding €3.6m decline in personnel expenses) and the operating expenses associated with the two ships acquired last year (€2.0m). This was somewhat offset by the decline in expenses for third-party services related to sub-management of ships (€1.3m compared with €2.0m in H117). Importantly, the company completed the merger of its sites into a new headquarters in Hamburg. This will translate into savings in rental expenses and more streamlined business processes.

The risks related to claims against ERAG in conjunction with its legacy business seem to be gradually diminishing and currently all claims associated with ERAG's liabilities for the prospectus or status as founding partners of the funds categorised by ERAG as unlikely or highly unlikely. The corresponding provisions declined to €0.3m from €1.3m at end-2017. Moreover, the value of repayable liquidity distributions from ERAG's funds as at end-June 2018 amounted to €15.1m, down from €16.4m at end-2017.

Exhibit 2: H118 results highlights

€000s	H118	H117	y-o-y change
Revenue	**27,907**	**20,756**	**34.5%**
Increase/decline in unfinished products	195	(170)	-214.7%
Other operating income	6,038	9,084	-33.5%
Cost of materials and services	(13,983)	(3,138)	345.6%
Personnel expenses	(7,723)	(11,748)	-34.3%
D&A and impairment	(3,504)	(3,924)	-10.7%
Other operating expenses	(6,343)	(8,277)	-23.4%
Net interest and investment income	306	778	-60.7%
EBT	**2,893**	**3,361**	**-13.9%**
Income taxes	(731)	(135)	441.5%
Earnings after tax	2,162	3,226	-33.0%
Other taxes	(58)	(42)	38.1%
Minorities	(34)	(52)	-34.6%
Net profit	**2,070**	**3,132**	**-33.9%**
EPS (€)	**0.06**	**0.10**	**-33.9%**

Source: Ernst Russ, Edison Investment Research

Stable AUM with declining share of legacy business

ERAG's AUM as at end-June 2018 stood at €6.1bn (vs €6.0bn at end-2017), of which €0.4bn represents assets where the company is investor or co-investor. This was divided into shipping (€2.8bn with a fleet of c 110 ships under management), real estate (€1.6bn) and alternative investments (€1.7bn). AUM increased only slightly versus end-2017, as new asset acquisitions and M&A activity was able to offset the decline from disposals. Importantly, ERAG estimates that the share of its legacy business declined to 40% at end-June 2018 compared with 80% in 2016.

The company continues to expand its fleet through the recently established JV Elbfeeder, with the acquisition of two further ships in April 2018. Moreover, ERAG acquired a 3,091 TEU vessel entirely on its own book in July 2018. Clarksons' data suggests prices of 10-year-old second-hand container ships bottomed out in late 2016/early 2017 and grew further in 2017 and early 2018, remaining stable in recent months. Prices for 2,500 TEU ships are currently close to 2013–2015 levels. Thus, it seems that ERAG was able to start ramping up its shipping portfolio in late 2017/early 2018 at a relatively fortunate (even if not optimal) entry point. The company plans to finalise the acquisition of two additional ships through Elbfeeder in September, which will bring the total owned fleet (including JV) to 10 ships. Importantly, the company holds a 49.99% stake in Elbfeeder, but it is in discussions to acquire a majority stake. On the divestment front, apart from the earlier mentioned real estate and shipping transactions, ERAG sold its 29.98% stake in Marenave Schiffahrts in March 2018. In addition, as part of the capital group restructuring, ERAG has also sold its 18% stake in eFonds (an online platform focused on the distribution of closed-end real assets investment funds) and will recognise a disposal gain of c €1.5m in Q318.

Outlook

Management reiterated its FY18 guidance of at least 10% y-o-y revenue growth and positive operating profit at last year's level (€3.9m). ERAG intends to stabilise the AUM around €6.1bn through the addition of new assets and portfolios, as well as new asset management mandates. This should be supported by the favourable conditions in the shipping markets, which benefit from continuing growth in global trade (IMF forecasts are 4.8% for 2018 and 4.5% for 2019), backed by the solid macro environment (IMF expects global GDP growth at 3.9% in both 2018 and 2019). Mutual trade tariffs recently introduced by the US, China and Europe have not significantly influenced trade volumes so far, although they pose a risk for the shipping industry. According to

Clarksons' data, the outlook remains positive in the container market segment (particularly in the segment of 1,000 to 5,000 TEU), where demand growth (5.1%) should outstrip supply growth (4.8% after scrapping). The historically low level of order book (ie the global pipeline of new container ships being built), which stands at 13.3% of current supply (as per Ernst Russ), suggests a potential slowdown in container ship supply growth. Time charter rates are generally rising across all container sectors this year and only 1.6% of available container capacity (as per Alphaliner) is unemployed. Although rates have eased recently, this is in line with the normal seasonal pattern. A downside risk over the rest of the year is the recent increase in idle tonnage, resulting not only from the low-season effect, but also new-built tonnage and low scrapping activity. Moreover, it seems the usual pass-through mechanism of fuel cost hikes has not yet been restored after the crisis.

In the bulker market, supply and demand looks relatively balanced at the moment. As scrap activity is relatively subdued, Clarksons expects fleet growth at 2.5% in 2018. This compares with their demand growth expectations at 2.7% in 2018, assisted by the expected increase in iron ore and coal imported by the sea, which should be driven by higher consumption in China. The charter rates were quite volatile recently, with the Baltic Dry Index's 52-week low and high at c 948 and 1774 points, respectively and the current level of 1,434 (as at 24 September).

The tanker segment, which was the weakest part of the shipping markets in recent years, is gradually improving. Supply growth remains modest with expectations (according to ERAG) for 2018 at 0.8% and 1.5% for crude oil and product tankers, respectively. However, there seems to be a certain degree of oversupply in the product tanker fleet based on ERAG's comments. Demand should be stronger, with 2.4% and 2.6% y-o-y growth in 2018, respectively. Tanker charter rates lag the other segments and are still at relatively low levels in H118, despite being slightly higher y-o-y.

Valuation

We believe a relevant peer group for Ernst Russ should contain local asset managers active in the shipping and/or real estate domain. We have selected six peers, with MPC Capital and Lloyd Fonds the closest competitors. Due to the lack of consensus estimates for ERAG, we have based our analysis on LTM numbers and management guidance of FY18 operating profit in line with FY17 levels (€3.9m). 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 62% and 34% discount to peer group on LTM P/E and EV/EBIT numbers, respectively. Moreover, the company's EV/EBIT ratio based on management guidance for FY18 is around 29% below peer group. Also, ERAG's shares trade below last reported book value per share (P/BV) at 0.7x. The valuation looks relatively undemanding given the potential future benefits of ERAG's ongoing transformation and the good prospects for shipping markets. 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 (3.0%), Corestate Capital (4.0%) and Patrizia (4.0%).

Exhibit 3: Peer comparison

	Mcap (€m)	P/E (x)			EV/EBIT (x)		
		LTM	2018	2019	LTM	2018	2019
MPC Capital	154.0	12.5	10.7	8.8	8.7	9.8	8.3
Lloyd Fonds	55.0	36.4	18.8	14.0	nm	14.1	10.0
Corestate Capital	871.3	10.8	7.3	6.6	12.4	10.7	9.8
Patrizia	1,583.8	19.9	21.6	16.1	13.0	14.9	11.6
VIB Vermogen	620.5	11.8	12.8	12.1	14.9	14.8	15.3
TLG Immobilien	2,315.0	15.0	10.9	14.5	7.9	18.3	18.4
Peer Average	**-**	**17.8**	**13.7**	**12.0**	**11.4**	**13.8**	**12.2**
Ernst Russ	30.2	6.7	N/A	N/A	7.5	9.8*	N/A
Discount / premium	**-**	**(62%)**	**N/A**	**N/A**	**(34%)**	**(29%)**	**N/A**

Source: Company accounts, Bloomberg consensus as at 24 September 2018, Note: * Based on management guidance for FY18 operating profit in line with FY17 number (€3.9m).

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