

Ernst Russ

Maritime investment solutions

In the past 18 months Ernst Russ (ERAG) (formerly HCI) has been transformed into an investment and asset manager focused on the maritime sector. The 2016 acquisitions of König & Cie, Ernst Russ Reederei and WestFonds have completed the group's full service ship management offering and built scale in asset management and trustee services. The group's ability to win new investment and asset management mandates across a range of asset classes should be significantly enhanced, offsetting the drag of legacy closed end (KG) fund run-off. A recovery in shipping markets would have a strong positive effect on the group's consolidated earnings.

Acquisitions significantly boost 2016

Acquisitions had a significant impact on the group's assets, earnings, and cash position in 2016. The revenue contribution of c €22m helped reported revenues increase by 93% to c €40m with net attributable profit reaching €6.2m (2015: €1.0m). Balance sheet items showed strong increases with equity growing to €39m and cash to €28m. Consolidation effects and one-off items obscure the underlying trends, but for the current year management expects revenues to be moderately higher than in 2016, with net profits at least at the 2016 level, implying a strong operational performance without one-off items as seen in 2016.

Attractive partner for growth

ERAG's positioning in investment and asset management is significantly strengthened in shipping and across a range of assets, while its income streams are diversified to include ship management, both for internal funds and external third-party ship owners/operators, where a market recovery would be highly beneficial. ERAG's ability to grow AUM is enhanced and the larger, more competitive trust services offering has the ability to win third-party mandates, while both mitigate the impact of a continuing run-off of existing closed (KG) funds.

Valuation: Modest valuation of earnings potential

The market appears to be placing a modest valuation on the earnings potential of the group (illustrated by a very low 0.5% market cap/AUM ratio). This may partly be due to ERAG's focus on the challenging shipping sector as well as investor unfamiliarity with the significant changes in the group. Management guides to a broadly flat operating performance this year despite one-off gains from 2016 falling away. This suggests a still modest P/E in absolute terms and compared with peers.

Historical financials

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/13	25.8	0.5	0.01	0.0	87.1	N/A
12/14	19.7	(1.6)	0.00	0.0	271.1	N/A
12/15	20.7	(6.7)	0.04	0.0	32.3	N/A
12/16	40.0	10.2	0.20	0.0	5.9	N/A

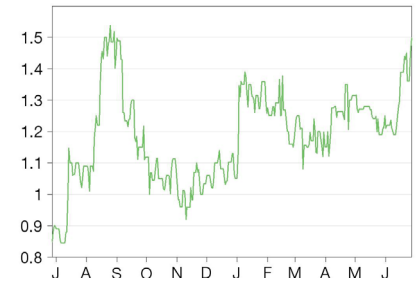
Source: ERAG

Fund management

28 June 2017

Price €1.50
Market cap €49m

Share price graph



Share details

Code HXCK
Listing Deutsche Börse Scale
Shares in issue 32.4m
Last reported net cash as at 31 December 2016 €16.1m

Business description

Ernst Russ (formerly HCI Group) is a listed asset and investment manager, with AUM of c €6.5bn, 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 focus and position.
- Strengthened balance sheet.

Bear

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

Analyst

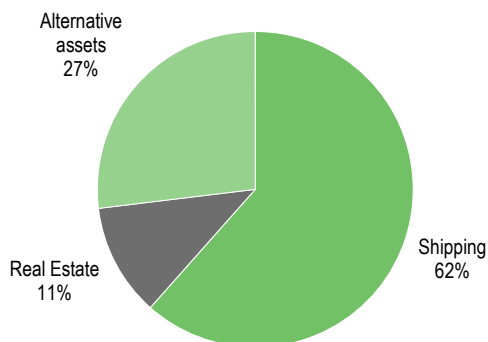
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Company description: One-stop shop

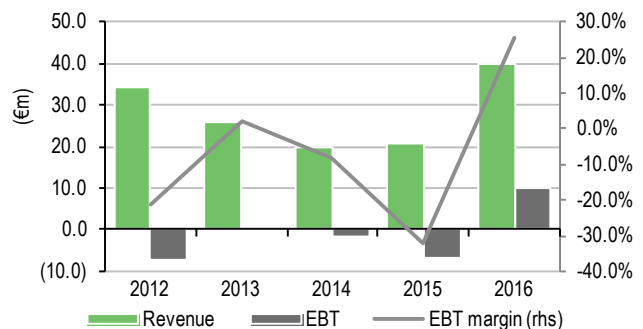
Ernst Russ (ERAG) is a listed asset and investment manager with a focus on shipping assets. The maritime asset management activities provide a complete range of services including technical and commercial ship management, which ERAG provides to a fleet of c 180 vessels. The fleet includes 140 vessels controlled by ERAG closed-end funds or structures as well as vessels managed on behalf of third-party ship owners/operators. Its asset and investment management activities include approximately 200 active funds with invested equity of c €3bn and, allowing for gearing within the funds, an investment volume (assets under management, AUM) of more than €6.5bn (AUM is the sum of €3bn equity raised plus associated debt). The group in its current form is the product of a three-way combination in 2016 that merged König & Cie (the terms of which have not been disclosed), a provider of institutional focused ship asset and investment management services, and the ship owner and operator Ernst Russ Reederei, into the former HCI Group, whose roots were in initiating and issuing retail focused closed-end ship funds via banks and other intermediaries. The group also boosted its real estate asset management scale and capabilities with the acquisition of WestFonds (terms also not disclosed). The significant strategic repositioning of the group is aimed at restoring it to a growth path after the challenges of recent years, brought about by the collapse of closed-end fund issuance since the global financial crisis as a result of market conditions and regulatory changes.

Exhibit 1: Breakdown of total AUM



Source: ERAG

Exhibit 2: Five-year summary of revenues and EBT



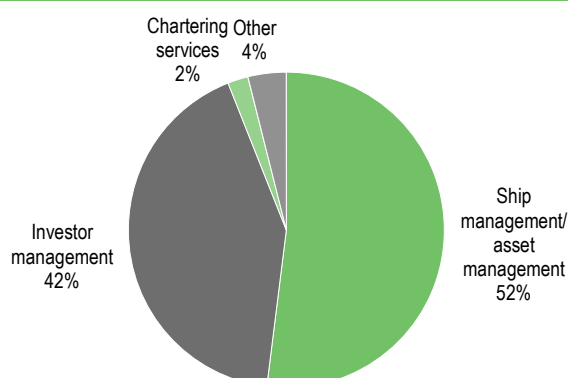
Source: ERAG. Note: EBT stands for earnings before tax.

The newly formed group has adopted a ‘three pillar’ business strategy that provides a full range of investment fund services including asset sourcing, fund initiation and distribution; a full range of asset management services; and investor/trustee services, an approach that the group refers to as “a one-stop shop”:

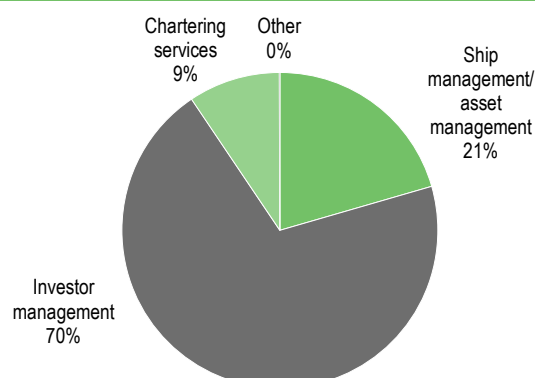
- **Asset management:** the financial and strategic management of funds and complex investment structures, primarily for ships but also real estate and other alternative assets such as structured products, private equity and renewable energy.
- **Ship management:** a full range of shipping services including technical management (eg crewing) and commercial management (eg chartering) for in-house and third-party controlled vessels.
- **Investor management:** equity raisings with capital market access in Germany and the UK, distribution of retail and institutional alternative investment funds and the administration of funds and related activities. While ship and asset management are dealing with the financial and operational side of the asset, investor management is essentially providing the investor with information materials on the asset, annual reports and meetings.

Revenues and profits both showed a material increase in 2016 as a result of the first time consolidation of the newly acquired businesses (Exhibit 2), while the 2016 revenue split shows a

significant shift towards ship management and asset management. A full year contribution from the acquired business is expected to further increase these revenues in 2017.

Exhibit 3: Revenue mix 2016


Source: ERAG

Exhibit 4: Revenue mix 2015


Source: ERAG

A brief history of strategic development

ERAG has been built around HCI Capital AG, which was founded in 1985 as an issuer of ship fund investments primarily to retail investors, and listed in 2005. HCI grew rapidly to become a leading issuance house and expanded its business to include further asset classes such as property, private equity and alternatives. Since it was founded it has issued more than 500 funds and raised an aggregate c €6bn in equity to support, with fund debt, an aggregate initial investment volume of c €15bn. HCI focused on identifying suitable investment assets and bringing them together with investors by creating, structuring, and arranging financing for investment vehicles with a strong focus on equity issuance to retail investors through partners such as banks and IFAs (Independent Financial Advisers). Asset management in this context included the financial and strategic management of the assets, exercised by managing partner positions within the closed-end limited liability (KG) fund structures, but did not extend to the operational management of the assets, primarily ships. The financial model was highly dependent on high upfront issuance fees with a more modest contribution from recurring fees based on asset management and fund administration, including investor fiduciary/trustee services. Along with other issuers of closed-end funds in Germany, HCI was hit hard by the global financial crisis and its effects on global growth and the shipping sector in particular. The crisis brought issuance activity to an abrupt halt and in its aftermath, changed market conditions and a new regulatory framework meant the old model was no longer successful.

Exhibit 5: Long-term revenue trends (€000s)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Distribution & origination	105,358	92,187	18,136	9,256	6,301	7,604	4,000	49	0	0
Ship management/asset management	1,823	2,724	5,909	5,297	7,815	7,474	4,645	4,422	4,249	20,767
Investor management	22,631	22,682	21,391	21,834	19,027	18,899	17,107	15,212	14,516	16,789
Chartering services	0	0	0	0	0	0	0	0	1,937	835
Other	7,487	2,370	73	375	17	153	0	0	15	1,564
Total revenues	137,299	119,963	45,509	36,762	33,160	34,130	25,752	19,683	20,717	39,955
% change		-13%	-62%	-19%	-10%	3%	-25%	-24%	5%	93%

Source: ERAG, Edison Investment Research

HCI initially focused on preserving the fund base that it had built up and the fiduciary services revenues that these would generate, and gaining regulatory approval as an Alternative Investment Fund Manager (AIFM), while seeking ways to capture more of the asset management value chain by broadening its competence in technical and operational shipping management in particular. At the same time, HCI set about diversifying its distribution and with demand from retail investors severely depressed it began building up its institutional investor and semi-professional investor

relationships. During 2015 the group acquired its first container ship as a proprietary investment and decided, together with other experienced partners, to acquire further ship assets and finance them through joint venture structures managed by the group. The container ship was sold with a profit of c €500k at the beginning of 2016. ERAG currently controls and manages 13 ships through these structures in a JV.

The first major realignment of the group came in early 2016 with the acquisition of 90% of König & Cie in January 2016, which enabled the group to offer a complete range of ship management services, in particular technical and commercial management, while increasing its scale in asset and investor management. The acquisition of the long established shipping company Ernst Russ Reederei completed the group's ability to provide a full range of ship management services.

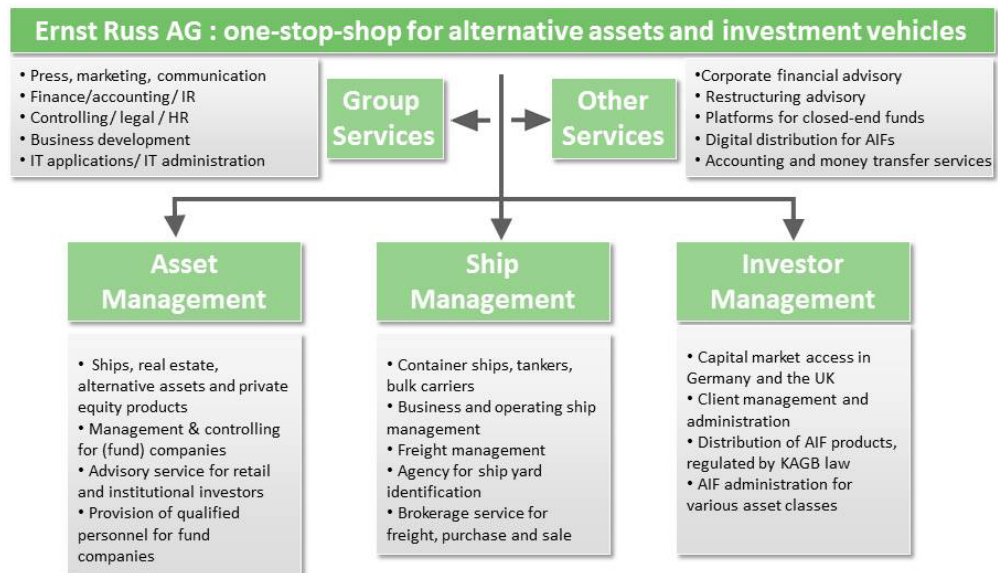
The group was repositioned primarily as a maritime asset and investment manager and changed its name from HCI to Ernst Russ.

The business platform and model

ERAG divides its services into asset, ship and investor management. The ship management business is responsible for the operational support of the ships bought by investors through the closed-end funds originated by investor management, while the asset management unit runs the financial management of these funds. Administration and reporting of the closed-end funds is the task of the investor management unit, which could also include certain distribution functions. ERAG also offers these services for other asset classes, such as real estate, alternative investments and PE in particular.

Exhibit 6 summarises the group's business model: its fully integrated 'one-stop shop' concept covers all aspects of the value chain.

Exhibit 6: ERAG's business model

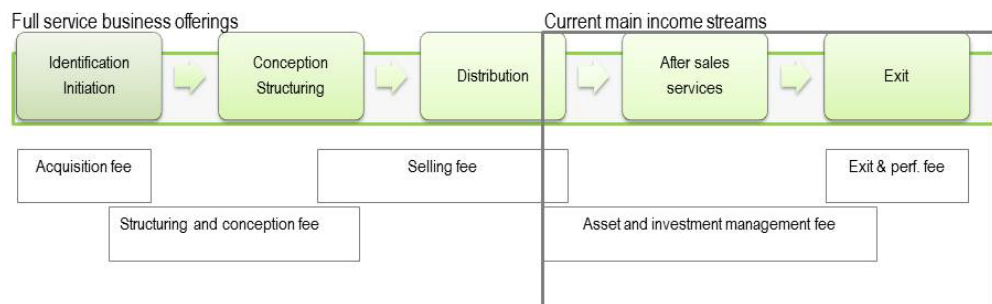


Source: ERAG

Before discussing the operating units that support the three pillars of the group's strategy, it is worth considering the business strategy from an economic viewpoint. The group is involved at all stages of the investment process (for ships, real estate and other asset classes), beginning with the identification and sourcing of suitable assets, structuring them into an investment proposition (eg an AIF, or some other complex structure), and then arranging finance including equity investment from

investors and partners as well as debt. The historical focus was on closed-end (KG) funds, the bulk of the current AUM, and for which the group provides trustee services (investor management) on behalf of the investors, generating a significant, but declining, fee stream over the remaining life of the funds, which management hopes to partly offset by providing similar services to third parties. ERAG's intention is to replace these maturing legacy assets with new funds, AIFs and other complex institutional products, generating a higher level of fee revenue from a deeper participation in the management of the assets. This deeper participation is most evident in shipping, where the group can now provide a full range of ship management services in-house, but also in real estate where the WestFonds acquisition has added scale and breadth. Ship management is itself a pillar of strategy, given its significance and the fact that it is provided to 'in-house' funds and structures and external third-parties alike.

Exhibit 7: Ernst Russ– income structure



Source: Edison Investment Research

As we show in Exhibit 3, ERAG now reports ship management and asset management revenues as a block, and investor management revenues separately.

The group's asset management activities in the maritime sector have all been grouped under **Ernst Russ Maritime Management** (ERMM), providing a full range of services to c 110 active shipping funds and structured investments managed by the group with an investment volume of c €4.0bn, as well as around 40 vessels owned by third-party ship owners/operators.

Assetando Real Estate is similarly positioned to provide a full range of real estate investment services, although it does not extend to the technical management of individual properties. AUM has grown to c €750m including c €540m of funds acquired with WestFonds.

HCAM is responsible for the group's alternative assets under management including c \$350m in structured funds managed through an umbrella structure in nearly 50 partner funds. There are also 15 funds invested in German and UK traded life assurance funds with an AUM of close to €600m, as well as investments in solar parks, aircraft, private equity and infrastructure.

Since 2015, **HCV Hanseatische Capital Verwaltung** has been the fully authorised asset manager for the group (the KVG – fully licensed capital administration company), which allows it to issue closed-end domestic public AIFs (aimed at individual investors) and special AIFs directed at institutional investors. Additionally, since 2016 the group has partnered with Pareto Securities AS, a leading full service investment bank from Norway, to design and offer structured products for institutional investors, including debt products.

The group's existing trust company activities and those acquired from König & Cie have all been grouped together under PECURA Anleger und Treuhandservice GmbH, which offers trustee services for a total of 12 internal and external trust companies. PECURA manages 200,000 closed-end fund certificates for more than 140,000 clients. The fiduciary fees that are earned on the majority of the existing limited partnership closed-end funds are long-term in nature, recurring annually (on the equity participation of investors or 'managed trust capital') over the life of those funds. ERAG continues to support the funds and safeguard the revenue stream, and particularly in

the area of shipping funds, restructuring teams work with the funds and the banks to provide solutions for those funds that are stressed by the continuing weak shipping markets. Managed trust capital increased during 2016, from c €3.1bn to c €3.6bn. The increase is attributable to the acquisition of König & Cie, which added c €1.3bn, while fund insolvencies and asset realisations continued to erode the underlying position. PECURA has invested in digitalising its processes with the aim of successfully competing for external contracts that will help to offset the run-off of internal KG funds.

Shipping markets now key

Conditions in the international shipping markets are obviously a key sensitivity for the business, with an impact on fee revenues from ship services, investor and asset management, as well as the value of investments and, potentially, receivables values. The protracted weakness in the shipping market, with oversupply and fierce competition a persistent feature, continued through 2016, and in particular in the container, bulker (unpackaged bulk cargo, eg coal), and product tanker (refined products) areas that are most relevant to ERAG. Summarising ERAG's comments from the 2016 annual report, which cite industry data from Clarkson, a shipping industry research firm, container demand grew modestly but not enough to absorb available capacity and time charter rates were at similar low levels to 2009. With older ships being scrapped, bulker capacity growth slowed to the lowest level for many years, but still exceeded demand growth. The Baltic Dry Index (BDI), a price index for bulk dry goods, has continued to show characteristic volatility, falling from a 2015 high of c 1,200 in August 2015 to a year's low of 688 in February before recovering to a 2016 high of 1,257 in November. We note that it has recently been quoted in the 800-850 range. Fleet growth in product tankers also exceeded demand growth. The Baltic Clean Tanker Index (BCTI), a key industry index, also fluctuated significantly through 2016 and into 2017; increasing from 535 to a high of 716 in early 2016, falling back to 352 by September before rallying to 678 at the end of the year. We note it has recently been quoted at around the 550 level.

ERAG management anticipates that ongoing consolidation among ship owners will support a reduction in the supply surplus and help to restore balance to the market over time. The group is now positioned to benefit significantly from any upturn, both in the areas of asset management and shipping services. Meanwhile, in cooperation with Pareto it seeks opportunities to provide corporate finance advice to shipping owners and operators.

The prospects for new fund launches remains relatively muted although economic improvement and continued low interest rates are creating more optimism. Changes in regulation and the market environment mean that new issuance of the traditional KG limited partnership closed-end funds is extremely challenging. However, there are signs that the global recovery and continued low interest rates may begin to stimulate retail interest in closed AIFs. A survey in January 2017 by the Federal Association of Property and Investment Assets (the BSI e.V) found that 60% of capital management companies consider the prospects for closed public AIF issuance as good or very good. The survey pointed to an estimated planned investment activity of c €1.4bn, focused on real estate. With its partnership with Pareto, ERAG seeks to launch institutionally focused products such as Special AIFs and other capital markets products including bonds. Management seeks opportunities in both shipping and German real estate, where demand from both private and institutional investors continues to be supported by a stable economy, rising employment and the continued low interest rate environment.

Management, corporate governance and shareholders

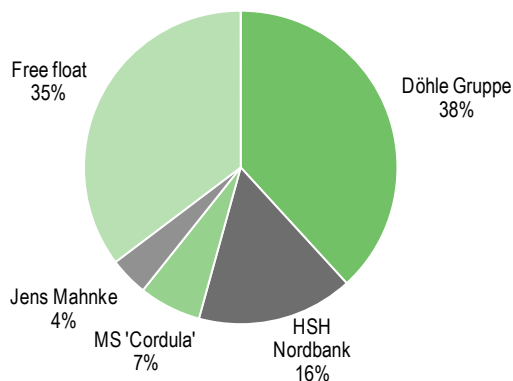
The ERAG management board has considerable industry and commercial experience. CEO **Jens Mahnke** joined the group through the acquisition of König & Cie, where he had also held the position of CEO since 2008. He brings strong industry experience to ERAG, having worked in the shipping industry, including a number of senior positions, for more than 25 years. The CFO is **Ingo Kuhlmann**, who joined the group through HCI in 2008, joining the board in 2012. The third member of the management board is **David Landgrebe**, who joined the group in June 2013 from Peter Döhle Schiffahrts-KG. He has previously worked at HSH Nordbank, a historically significant maritime lender, including four years as restructuring director, and has experience in real estate.

As a listed German company, ERAG is overseen by a supervisory board of four members, chaired by Alexander Stuhlmann. The other members of the supervisory board are Jochen Thomas Döhle, Robert Lorenz-Meyer and Robert Gärtner.

Shareholders and free float

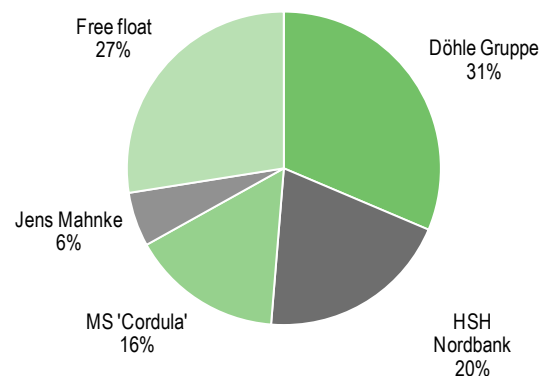
The main driver of the changes in the shareholder structure during 2016 was the issue of 6.2m new shares (24% of the total outstanding before the issue, increasing equity by c €9.5m and equivalent to €1.53 per share) as payment to the previous owners of Ernst Russ Reederei, Döhle Group, the Hamburg-based ship operator and shipping services group, and MS Cordula, also Hamburg based. HSH Nordbank is currently a 16% shareholder. The bank is owned by the states of Hamburg and Schleswig-Holstein, which are required to sell the bank by 28 February 2018. Both Döhle Group and MS Cordula were already shareholders in the group (as HCI). The free float is now 35%.

Exhibit 8: Recent shareholder structure



Source: ERAG

Exhibit 9: 2015 shareholder structure



Source: ERAG

Financials

ERAG reports under German GAAP (the German HGB code). The acquisitions, König & Cie, Ernst Russ Reederei and WestFonds, are all consolidated in the 2016 accounts for the first time and have a significant impact on the group assets, earnings and cash position. We provide a summary in Exhibit 10, which shows both the year-on-year changes and the half-yearly development over the period. Reported 2016 revenues increased 93% to c €40m with net attributable profit reaching €6.2m (2015: €1.0m). On the balance sheet, total assets increased 71% to €103m and net assets increased to €39m (equity assets ratio is 37.3% compared with 35.5% in 2015). The closing cash position was €28m or €16.1m net of consolidated debt as the company has just €12.2m in bank debt.

Exhibit 10: Financial summary

Year to 31 December (€000s)	2015	2016	H115	H215	H116	H216
	HGB	HGB	HGB	HGB	HGB	HGB
INCOME STATEMENT						
Ship management/asset management	4,249	20,767				
Investor management	14,516	16,789				
Chartering services	1,937	835				
Other	15	1,564				
Total revenue	20,717	39,955	9,952	10,765	17,029	22,926
Change in work in progress	0	(119)	0	0	0	(119)
Other operating income	8,310	34,969	3,428	4,882	11,989	22,980
Cost of materials/purchased services	(1,632)	(6,126)	(579)	(1,053)	(2,852)	(3,274)
Personnel expenses	(9,130)	(20,578)	(4,625)	(4,505)	(7,791)	(12,787)
Depreciation & amortisation	(1,010)	(7,862)	(334)	(676)	(3,445)	(4,417)
Other operating expenses	(20,886)	(20,619)	(6,800)	(14,086)	(10,182)	(10,437)
Operating profit	(3,631)	19,620	1,042	(4,673)	4,748	14,872
Income from equity investments	506	976	117	389	1,633	(657)
Other interest & similar income	1,000	2,189	378	622	1,185	1,004
Write-downs on financial assets	(3,064)	(7,557)	(214)	(2,850)	(4,869)	(2,688)
Interest & similar expenses	(1,194)	(1,064)	(406)	(788)	(531)	(533)
Share of profit of associates	(270)	(3,990)	0	(270)	89	(4,079)
Earnings before tax	(6,653)	10,174	917	(7,570)	2,255	7,919
EBT margin	-32.1%	25.5%	9.2%	-70.3%	13.2%	34.5%
Tax	7,627	(3,791)	25	7,602	(1,419)	(2,372)
Consolidated net profit	974	6,383	942	32	836	5,547
Non-controlling interest	0	(157)	0	0	(8)	(149)
Consolidated attributable net profit	974	6,226	942	32	828	5,398
EPS (€)	0.04	0.20	0.04	0.00	0.03	0.17
BALANCE SHEET						
Financial assets	21,992	22,387	25,673	21,992	30,009	22,387
Intangible assets	287	25,431	320	287	26,194	25,431
Property, plant & equipment	5,702	456	5,917	5,702	424	456
Cash & equivalents	12,775	28,273	11,995	12,775	12,110	28,273
Other current assets	19,600	26,932	16,556	19,600	21,608	26,932
Total assets	60,356	103,479	60,461	60,356	90,345	103,479
Financial liabilities	(18,590)	(12,167)	(18,250)	(18,590)	(9,275)	(12,167)
Other liabilities	(20,456)	(52,727)	(20,957)	(20,456)	(49,464)	(52,727)
Minorities	0	(623)	0	0	(1)	(623)
Shareholders' equity	21,310	37,962	21,254	21,310	31,605	37,962
CASH FLOW						
Cash flow from operating activity	379	4,584	367	12	5,048	(464)
Cash from investing activity	(8,973)	14,333	(9,720)	747	(4,228)	18,561
Cash flow from financing activity	(93)	(3,342)	36	(129)	(1,339)	(2,003)
Other	1,149	(77)	1,000	149	(146)	69
Net change in cash	(7,538)	15,498	(8,317)	779	(665)	16,163
Closing cash	12,775	28,273	11,996	12,775	12,110	28,273
Closing net cash/(debt)	(5,815)	16,106	(6,254)	(5,815)	2,835	16,106

Source: ERAG. Note: HGB = German GAAP.

Exhibit 11: Effect of acquisitions on end 2016 balance sheet and 2016 P&L

2016 balance sheet effects, €000s	König & Cie	Ernst Russ Reederei	WestFonds	Total
Goodwill	4,256	2,966	0	7,222
Value of service contracts	14,690	1,125	0	15,815
Financial assets	1,619	5,392	1,584	8,595
Stocks	0	0	7,664	7,664
Cash	3,803	1,535	10,306	15,644
Difference arising from capital consolidation	0	0	7,528	7,528
Pension provision	0	(1,941)	0	(1,941)
Other provisions	(3,829)	(387)	(6,141)	(10,357)
Debt	(2,872)	0	(7,350)	(10,222)
2016 P&L effects, €000s				
Revenues	12,433	8,036	1,712	22,181
Cost of materials/purchased services	(3,179)	(1,619)	(140)	(4,938)
Personnel costs	(3,059)	(5,466)	(1,366)	(9,891)
Other operating expenses	(2,667)	(586)	(399)	(3,652)
Interest & similar expense	(438)		(84)	(522)

Source: ERAG

In Exhibit 11 we show the details provided by ERAG on the 2016 impact of the three acquisitions. There will be further impacts on underlying earnings in 2017 as the acquisitions have a full year impact: full consolidation of König & Cie took effect on 31 January 2016 so it made a c 11-month contribution; Ernst Russ (30 April 2016) contributed c eight months; and WestFonds (31 July 2016)

contributed almost five months. In aggregate, the acquisitions added €22.2m to 2016 revenues. Revenues from existing businesses appear to have declined from €20.7m in 2015 to €17.8m mainly due to asset sales, such as the container ship in early 2016.

The data provided by ERAG imply an EBT contribution from the acquisitions of c €3.2m, leaving c €7.0m for the existing business. While acquisitions added c €55m in total assets, assets from the existing business declined by around c €12m, which was largely related to depreciation and asset disposals. The acquisitions added €31.6m in long-term assets, including €7.2m goodwill, €15.8m in capitalised business contracts, and €8.6m in financial assets. The impact on group cash flow was strongly positive with an aggregate €15.6m in cash, largely due to WestFonds.

In addition to retained profits, shareholder equity increased by €9.5m with the issue of 6.2m new shares (taking the total to 32.4m) as payment in kind for Ernst Russ Reederei.

In addition to the significant changes in the financial statements that result from the acquisitions, the 2016 results also include some material non-recurring items. Other operating income increased by €26.7m, which management indicates was primarily the result of the write-back of provisions and the booking of income from loan settlements of €13.3m. During the year ERAG successfully concluded an agreement with banks that settled ERAG's end 2015 liability of €12.5m in return for a cash payment of €2.5m, generating €9.0m in other operating income in the process. A similar transaction involving the successor to the Wölbern bank reduced the end 2015 liability of c €6.0m to c €2.0m, generating a gain of c €4.3m. ERAG stated at the AGM for the business year 2016 that it intends to focus on strengthening the balance sheet by retaining profits for the next three years, ie defer from paying any dividends.

Earnings outlook

It is beyond the scope of this note to provide forward looking estimates for the group and we note that there is currently no market consensus to refer to. Helpfully, management has given some guidance to its expectations for the current year. For 2017 it expects higher revenues from ship management and asset management and for revenues overall to be moderately higher than in 2016. Ship management and asset management revenues should be the main beneficiaries of a full year contribution from the acquisitions. The König & Cie contribution to investor management revenues was substantially recognised in its 11-month contribution in 2016 and we interpret management guidance as indicating ongoing revenue pressure from the trend run-off in managed trust capital. In terms of profitability, and barring unforeseen events, management guides to a positive net result that reaches the prior year level. We would expect group costs to continue to benefit in 2017 from the cost reductions that were made to the enlarged cost base during 2016. The headwind for 2017 operating profit compared with 2016 is the balance of other income and expenses. Management has indicated that it expects to make further significant impairments in relation to trustee services and investor management receivables in 2017, while it will not benefit from the high level of non-recurring income earned in 2016.

There are plans to invest further in the maritime and real estate sectors which may include further own investment in assets; on this basis management anticipates a small reduction in cash balances by the end of 2017 vs 2016, but still representing a high enough level to allow the company to act on opportunities as they arise.

Valuation

In this section we comment on the valuation of ERAG shares in the context of a broad peer group of listed asset managers, including private equity, specialist and conventional asset managers in Europe and North America, using consensus data sourced from Bloomberg. The lack of forward looking consensus data for ERAG is a handicap in this respect, especially at a time of significant

strategic and operational change. Although 2016 net earnings include substantial one-off income, noting management guidance of a moderate increase in current year operating earnings we have decided to use 2016 net earnings data as a guide to the current year. Readers should be aware that there could be a significant variance in the ratio of 2017 net income to operating profit vs 2016; with net income including the contribution from associates, income from investments and other financial income/costs, as well as taxes, all of which may differ greatly from 2016 levels.

The average of the consensus P/E multiples for the current year and next is surprisingly similar across each of the sub-groups despite the significant difference in business models that are represented. However, the spread within groups is larger. ERAG EPS in 2016 was €0.20 which puts the shares on a P/E of c 6.0x, substantially below the peer group average and implying the potential for significant undervaluation. We estimate the 2016 ERAG return on closing equity to have been c 16%. While this includes the one-off items referred to above it does not include a full year contribution from acquisitions. Although 16% is lower than the peer average this seems to be more than reflected in a lower P/BV at around 1x.

Exhibit 12: Peer valuation data

	Share price (local cur)	Mkt. cap (US\$m)	Current year P/E (x)	Next year P/E (x)	Current year ROE (%)	Next year ROE (%)	Last reported P/BV (x)	Dividend yield (%)
Private equity group								
Partners Group	600	16,351	28.3	25.8	35.3	34.5	9.6	2.6%
Blackstone	33.37	39,896	11.4	10.5	25.6	32.8	5.8	5.0%
Fortress	7.99	3,094	8.0	7.8	N/A	N/A	N/A	5.8%
KKR	18.96	15,409	8.5	7.8	16.4	17.9	1.4	3.4%
3i Group	9.305	11,363	10.0	9.6	14.7	14.0	1.4	2.8%
Specialist group								
Apollo	27.43	11,149	10.8	9.8	33.8	69.1	6.9	4.6%
Ashmore	3.597	3,227	17.1	17.3	22.2	19.3	3.5	4.6%
Man Group	1.556	3,256	10.4	8.2	13.8	18.5	1.5	5.8%
Patrizia	17.705	1,640	23.0	18.4	8.2	9.5	1.8	0.0%
Lloyd Fonds	3.551	36	8.7	79.3	16.6	15.7	1.4	4.5%
MPC	6.001	209	15.0	11.3	12.8	15.1	1.8	0.0%
Ernst Russ	1.19	35	N/A	N/A	N/A	N/A	1.0	N/A
Deutsche Beteiligungs	39.25		7.9	11.2	19.4	12.0	1.5	3.1%
Conventional group								
Aberdeen	2.912	4,867	13.4	12.9	13.8	14.1	2.2	6.7%
Azmut	18.09	2,870	13.7	13.0	28.8	28.5	3.5	5.5%
Janus Henderson	31.71	6,355	23.2	17.9	12.7	10.7	1.9	0.0%
Jupiter	4.972	2,876	14.8	14.3	24.4	22.7	3.5	3.0%
Schroders	31.39	10,566	15.9	15.0	17.2	16.9	2.5	3.0%
Averages								
Private equity			13.2	12.3	23.0	24.8	4.6	3.9%
Specialist			14.2	24.0	17.9	24.5	2.8	3.2%
Conventional			16.2	14.6	19.4	18.6	2.8	3.6%
All			14.5	17.4	19.8	22.6	3.1	3.6%

Source: Bloomberg data as at 8 June 2017

In the absence of forward-looking estimates it may be useful to consider the valuation that the market is placing on the group's potential earnings base as measured by AUM (although this would not capture any value for the third-party maritime asset management activities). In Exhibit 13 we compare ERAG with close local peers Lloyd Fonds and MPC, as well the real estate focused manager Patrizia.

Exhibit 13: P/AUM and revenue/AUM comparison with close local peers

	Mkt. cap (€m)	AUM (€bn)	Mkt cap/AUM (%)	2016 revenues (€m)	Revenues/AUM (%)
Patrizia	1,482	18.6	8.0%	818	4.40%
Lloyd Fonds	32	1.4	2.3%	9.5	0.68%
MPC	183	5.1	3.6%	53.8	1.05%
Ernst Russ	32	6.5	0.5%	40.0	0.61%

Source: Company data, Bloomberg

While there appears to be a positive relationship between the level of valuation and the market capitalisation (the larger the market cap, the higher the ratio of market cap to AUM), the market

cap/AUM valuation placed on ERAG is considerably lower than Lloyd Fonds which has a similar market capitalisation. We also note that both companies generate similar levels of revenues as a percentage of AUM. While this observation should not be taken as confirmation of undervaluation, it is a further indication that the market is undervaluing the earnings potential within ERAG.

Sensitivities

The prospects for the group are particularly dependent upon the shipping markets. While the current challenging conditions in the shipping market may provide opportunities for ERAG to participate in restructuring situations and potential consolidation (providing advice, financial solutions, or engaging in M&A), a sustainable recovery in the market is needed to significantly boost the group's fortunes. Meanwhile, revenues and the value of assets and receivables remain sensitive to volatile charter rates. In addition we would highlight the following:

- **An increase in interest rates and/or an economic slowdown** could be expected to have a dampening effect on investor demand for real assets in general (including real estate) making it more difficult for ERAG to offset the impact of the decline over time in existing closed-end fund managed trust capital.
- **An economic slowdown** would be likely to reduce the returns available on real assets, limiting returns on existing funds and investor appetite for new investments.
- **Currency risks** are a feature of shipping assets in particular (where revenues are typically US\$ denominated) with the potential to affect revenues as well as asset and receivables values. In some cases these risks are hedged although no details or sensitivities have been disclosed.
- **Legal risks**, in particular related to the prospectus based issuing process of retail focused funds can create issues many years after fund issuance if the information provided can be shown to be incomplete, inaccurate, or misleading. The annual report provides details of outstanding legal claims. Briefly, total claims from investors outstanding at the end of 2016 were €147m (2015: €129m) of which €110m have proceeded to court (2015: €82m). Claims are regularly evaluated and at the end of FY16 management's assessment was that 87% of claims were either 'unlikely' or 'very unlikely' to be successful with a statistical probability of 1–30%. Including an impact from the companies acquired, ERAG has provisions of €5m (2015: €1m) to cover claims in excess of the group's insurance arrangements.
- An additional legal risk, primarily to liquidity, arises from the historical distribution of closed-end fund liquidity against future expected earnings that have not materialised. The ERAG group, as limited partner, is potentially liable for settling claims by fund creditors, later reclaiming against fund investors. The issue, detailed in the annual report, covers liquidity payments of €274m as at the end of 2016 (2015: €258m) for which ERAG has a potential risk of €46.6m (2015: €49.7m), meaning that €46.6m is paid out and €41.2m is collected thereafter. ERAG continues to work on financial restructuring solutions for struggling funds that reduce the amount of liquidity potentially at risk, sometimes significantly. Taking into account the ability to reclaim any amount against fund investors, ERAG estimates a net risk of unenforceable claims on those investors of €5.4m for which €2.5m has been provided for as accruals on the balance sheet.
- ERAG has issued guarantees for equity raised in certain fund products, largely ship funds. These guarantees are linked to the maturity of loans provided by the financing banks and are backed by zero and bearer bonds. The potential payments are linked to the performance of the funds. ERAG ended negotiations on the maximum draw at the beginning of the year, leading to a reduction in accruals from €4.5m in 2015 to €1.0m in 2016.
- ERAG has also provided certain guarantees in relation to the placement of funds. ERAG said that there is a potential 'significant' risk to ERAG's financial position if these guarantees are drawn.

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