EDISON

Scale research report - Update

Ernst Russ

Fund management

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Preparing for a rebound in maritime market

Ernst Russ (ERAG) continued its efforts related to the shift in strategy, with the key drivers of the new group post acquisition being ship management (revenues more than doubled y-o-y in H117) and asset management (sales up 35.2% y-o-y). Management maintained its guidance for 2017 operating earnings at least in line with FY16 (€3.3m), amid some recovery in the container ships and bulker markets. ERG's market cap/AUM ratio remains below the peer average, suggesting investor caution partly related to ongoing volatility in shipping markets.

H117 results reflect strategic repositioning

ERAG reported net profit of €3.1m in H117 (vs €0.8m in H116), which largely reflects the consolidation of König & Cie, Ernst Russ Reederei and WestFonds. Group revenues reached €20.8m, with a considerably higher contribution from the shipping business (41.2% vs 23.9% in H116). Personnel expenses increased by 50.8% y-o-y to €11.7m as a result of higher headcount (mostly attributable to seamen employed at Ernst Russ Reederei). Net cash remained a broadly stable €15.7m at end-June 2017 vs 16.1m in FY16.

Positive signs in the container and bulker markets

Management reiterated its earlier guidance for 2017 of operating earnings to be at least in line with FY16 (€3.3m). ERAG's performance should be driven by the revival in global trade as WTO forecasts 3.2-3.9% y-o-y growth in 2017 vs 1.3% in 2016. Shipping markets show some signs of tighter pricing, with low growth in supply of container ships (4.3% vs demand growth of 5.2% in 2017) assisting charter rates and the bulker market gradually returning to equilibrium (reduced ship order book, improving trade volumes of selected bulk products). However, elevated supply continues to put pressure on tanker charter rates.

Valuation: AUM pricing below close peers

ERAG's valuation in terms of its market cap/AUM ratio (0.8%) remains below the peer group average. If we assume flat y-o-y EPS this year, the shares trade at a 2017 P/E ratio of 8.1x, well below the listed asset managers. This may partly be due to the company's focus on the challenging shipping sector and persistent litigation risk related to ERAG's legacy funds, as well as investor unfamiliarity with the significant business transition in the group.

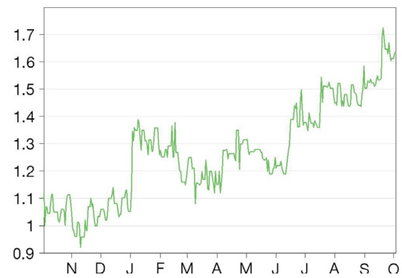
Historical financials

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/13	25.8	0.5	0.01	0.0	N/A	N/A
12/14	19.7	(1.6)	0.00	0.0	N/A	N/A
12/15	20.7	(6.7)	0.04	0.0	40.8	N/A
12/16	40.0	10.2	0.20	0.0	8.1	N/A

Source: Ernst Russ accounts

Price	€1.63
Market cap	€53m

Share price graph



Share details

Code	HXCK
Listing	Deutsche Börse Scale
Shares in issue	32.4m
Last reported net cash as at 30 June 2017	€15.7m

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.

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Financials: H117 results released

ERAG's pre-tax profit in H117 was €3.4m, significantly higher than H116 (€2.3m), which was the result of last year's acquisitions of König & Cie, Ernst Russ Reederei and WestFonds in conjunction with the major repositioning of the business. Group revenues increased by 21.9% y-o-y to €20.8m, with the ship management segment constituting 41.2% of total sales (H116: 23.9%). Revenues were assisted by container and bulker charter rates, which after peaking in March stabilised or somewhat trailed off towards the end of the first half of 2017, but remained ahead of last year's averages. One-year tanker rates remained at low levels or declined further in selected segments, most likely as a result of continuous tanker oversupply.

Personnel costs increased 51% y-o-y reflecting the higher headcount that came with the acquisition of Ernst Russ Reederei on 30 April 2016. Other operating expenses declined by 18.7% y-o-y to €8.3m as legal and one-off advisory costs dropped out. Other operating income decreased as well, down 24.2% y-o-y to €9.1m, mostly due to lower provision reversals than last year (€0.8m vs €7.6m in H116). All the above translated into a net income improvement to €3.1m vs €0.8m in H116.

The company is regularly re-assessing the legal risks associated with the prospectus based issuing process of retail focused funds and recently conducted a downward revision of claims which are "very unlikely" or "unlikely" to be successful (currently 79% vs 87% at end-2016). However, ERAG's level of provisions to cover the claims remained the same at €5.0m. In addition, potential claims related to liquidity distributions (after accounting for the recourse claims) stood at €3.3m (vs €5.4m at end-2016), with the related provisions at €2.3m (vs €2.8m at end-2016).

Operating cash flow was €-2.4m vs €+5.0m in H116, which was due to the use of provisions created last year and income tax payments related to prior years. Net cash as at end-June stood at €15.7m, broadly in line with FY16 (net cash of €16.1m).

Exhibit 1: Results highlights

€'000s	H117	H116	y-o-y % change
Revenue	**20,756**	**17,029**	**21.9%**
Decline in unfinished products	(170)	0	N/M
Other operating income	9,084	11,989	-24.2%
Cost of materials and services	(3,138)	(2,852)	10.0%
Personnel expenses	(11,748)	(7,791)	50.8%
D&A and impairment	(3,924)	(3,445)	13.9%
Other operating expenses	(8,277)	(10,182)	-18.7%
Net income from investments in associates	19	89	-78.7%
Income from equity interest	664	1,633	-59.3%
Income from loans held as financial investments	54	0	N/M
Other interest and similar income	991	1,185	-16.4%
Amortisation of financial investments and securities	(653)	(4,869)	-86.6%
Interest and similar expenses	(297)	(531)	-44.1%
EBT	**3,361**	**2,255**	**49.0%**
Income taxes	(135)	(1,417)	-90.5%
Earnings after tax	**3,226**	**838**	**285.0%**
Other taxes	(42)	(2)	N/M
Net profit (incl. minorities)	**3,184**	**836**	**280.9%**
Minorities	(52)	(9)	N/M
Net profit (ex-minorities)	**3,132**	**827**	**278.7%**

Source: Ernst Russ accounts

Exhibit 2: Revenue by operating segment

€'000s	H117	% of group revenues	H116	% of group revenues	y-o-y % change
Investor Management	6,476	31.2%	8,079	47.4%	-19.8%
Asset Management	4,710	22.7%	3,484	20.5%	35.2%
Ship Management	8,553	41.2%	4,070	23.9%	110.1%
Charter income	0	0.0%	835	4.9%	n.m.
Other	1,017	4.9%	561	3.3%	81.3%
TOTAL	**20,756**	**100.0%**	**17,029**	**100.0%**	**21.9%**

Source: Ernst Russ accounts

Outlook

ERAG expects FY17 operating earnings to be at least at the level of FY16 (€3.3m), which is broadly in line with previous guidance. Recently, WTO has made a significant upward revision of its world merchandise trade volume forecast for 2017 and now expects a y-o-y growth rate of 3.2-3.9% (vs 1.8-3.6% previously and 1.3% in 2016). The revision is largely the result of a solid H117, in particular the revival in Asian trade flows (amid intra-regional shipments pick up) and import demand in North America. Growth in 2018 is now forecast at 1.4-4.4% (from 2.1-4.0%).

The bulker market seems to be gradually moving towards equilibrium. The Baltic Dry Index rebounded sharply to around 1,400-1,500 points and thus surpassed the previous 2017 high from late-March. ERAG expects bulker rates to go down in the short- and mid-term after the strong increase in Q117. However, the limited expected fleet growth (3.2% and 1.0% in 2017 and 2018 respectively, according to ERAG), as well as growing iron ore, coal and soybean trading volumes should assist charter rates going forward. According to ERAG, expected growth in supply in the container market stands at 4.3% in 2017 vs container trade volume growth of 5.2%. The number of available ships is currently relatively low, which bodes well for charter rates in H217. The one-year charter rates for large units (4,250 TEU) as at 14 September 2017 improved by 14.2% compared with end-June levels, while rates for 1,000 TEU and 1,700 TEU units rose by 2.8% and 7.1% respectively. The supply of oil and product tankers is forecast at 6.8% and 4.6% in 2017 respectively and remains ahead of expected demand (4.5% and 3.0% respectively).

Post the reporting date, ERAG sold a land plot in Leipzig and will recognise operating income of €291,000 on the transaction. Moreover, the company will transfer €0.8m of negative goodwill accumulated earlier on the balance sheet as the corresponding gain to its P&L. The company will also benefit from the disposal of an 18% stake in eFonds AG, which yielded a gain of €1.5m. The company retains the remaining 18% stake and will recognise the holding at acquisition costs (previously the entity was consolidated using the equity method).

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. The lack of forward looking consensus 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 flat or moderately increasing operating earnings in 2017 we have used the 2016 net earnings figure as a guide for the current year. We note that there could be a significant variance in the ratio of 2017 net income to operating profit vs 2016.

ERAG EPS in 2016 was €0.20 which puts the shares on a P/E of c. 8.1x, substantially below the peer group median and implying potential undervaluation. We calculate that the 2016 ERAG return on closing equity was c 16%, which includes the one-off items discussed above but only partial contribution from acquisitions. ERAG's ROE is 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 1.3x.

Exhibit 3: Peer valuation data (median values)

	PE (x)		ROE (%)		P/BV	Dividend yield
	2017e	2018e	2017e	2018e	2016a	(%) 2017e
Private Equity (Partners Group, Blackstone, Fortress Investment Group, KKR, 3i Group)	9.4	9.2	32.2	27.7	2.0	3.4%
Specialist (Apollo, Ashmore, Man Group, Patrizia, Lloyd Fonds, MPC, Deutsche Beteiligungs)	12.7	11.7	17.0	15.2	1.9	4.7%
Conventional (Aberdeen, Azimut, Janus Henderson, Jupiter, Schroders)	14.6	14.1	19.9	20.2	3.4	5.6%
All	**12.7**	**11.8**	**19.9**	**20.2**	**2.4**	**4.5%**

Source: Company accounts, Bloomberg data as at 29 September 2017.

In the absence of forward-looking statements we consider the valuation that the market is placing on the group's potential earnings base as measured by AUM (although this does not capture any value for the third-party maritime asset management activities). In Exhibit 4 we compare ERAG with close local peers Lloyd Fonds and MPC and the real estate-focused manager, Patrizia.

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

	Market cap (€m)	2016 AUM (€bn)	Mkt. cap/AUM (%)	2016 revenues (€m)	Revenues/AUM (%)
Patrizia	1,480	18.6	8.0%	325.4*	1.75%
Lloyd Fonds	25	1.4	1.8%	9.5	0.68%
MPC	201	5.1	3.9%	53.8	1.05%
Ernst Russ	52	6.5	0.8%	40.0	0.62%

Source: Company data. Note: *Adjusted for the contribution from the Harald transaction and the performance-related fees from the sale of SÜDEWO. Market cap as at 29 September 2017

While there appears to be a positive relationship between the valuation and the market capitalisation (the larger the market cap, the higher the ratio of market cap to AUM), the MCap/AUM valuation placed on ERAG is considerably lower than Lloyd Fonds which has a lower 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.

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