

Scherzer & Co

Asset management
18 April 2019

Subdued FY18 results reflect market trends

Scherzer & Co's (PZS) NAV declined by 12.6% in FY18 and a further 1.3% in Q119. The company increased its income from dividends and writing options, but significant write-offs in the portfolio and a relatively high tax burden resulted in negative EPS of €0.03. Consequently, the company will not pay a dividend, compared to a DPS of €0.10 paid from FY17 profits. PZS's portfolio of extra compensatory claims (ECS) increased to €103.8m (€116m including Allerthal-Werke and RM Rheiner Management) in FY18, mainly due to the addition of €8.4m attributable to PZS's stake in Oldenburgische Landesbank.

Negative EPS on write-offs and taxes

PZS reported negative EPS of €0.03 in FY18 vs positive EPS of €0.26 in FY17. The loss was caused mainly by net unrealized losses (€9.7m vs €2.9m in FY17) – reflecting negative developments in German equity markets in H218. Two sizeable disposals from PZS's 'old' current assets led to a high tax burden of €1.6m (FY17: €0.03m), which should diminish in time due to regulatory changes. The company reported a profit on realized transactions of €9.4m (-27% y-o-y), further assisted by a 44% y-o-y increase in income from dividends at €2.6m, and reduced personnel expenses.

NAV performance in Q119 below broader market

While PZS's NAV performance in FY18 (-12.6% in total return terms) was ahead of both the MDAX (-18%) and SDAX (-20%), it did not rebound in Q119 (-1.3%) despite these indices showing a positive c 15% return. During FY18, PZS has not seen any significant ECS rulings, but expanded its portfolio by €10.6m to €103.8m in tender value (€116m including ECS held by portfolio companies). With the recent minority squeeze-out in Linde (21% of PZS portfolio at end-March 2019), the ECS portfolio could increase by a further c €21m. While the outcome and timing of such claims is uncertain, they provide a potentially strong 'NAV kicker'.

Valuation: Slight premium to NAV

PZS has long traded at discounts to NAV to the tune of 15% but, following positive catalysts, eg the successful sale of FIDOR Bank in 2016, its shares are now trading broadly in line with NAV. An additional stock driver could be the pending AXA ECS case. The latest valuation report by the auditor indicates potential income for PZS of €18.8m or €0.63 per share from the case. Importantly, NAV does not include any income from potential ECS profits.

Consensus estimates

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/17	18.8	7.9	0.26	0.10	9.3	4.1
12/18	12.4	0.7	(0.03)	0.00	N/A	0.0
12/19e	6.2	5.4	0.18	0.05	13.4	2.1
12/20e	6.4	5.6	0.19	0.06	12.7	2.5

Source: Scherzer & Co, Refinitiv consensus based on two analysts as at 11 April 2019.

Price €2.42
Market cap €73m

Share price graph



Share details

Code	PZS GY/PZSG
Listing	Deutsche Börse Scale
Shares in issue	29.9m
Last reported net debt at end FY18	€23.7m

Business description

Scherzer & Co (PZS) invests its funds mainly in domestic equities. PZS looks for companies that are unknown or unloved, and special situations. The focus is on special situations, where the downside is perceived to be limited. In addition, it acquires value stocks, mainly below book value. These stocks need to demonstrate strong business models.

Bull

- Strong management, well known in the market.
- 'Hidden' NAV kicker through special compensatory rights, albeit with binary outcomes.
- Well diversified portfolio with attractive risk/return pattern, built over a number of years.

Bear

- Dependent on market environment.
- Still relatively small.
- For the strategy, market size is limited.

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Financials: Valuations weigh on results

PZS reported a net loss of €0.9m (vs €7.9m profit in FY17), which translates to EPS of -€0.03 (vs positive €0.26 in FY17). The loss was mostly driven by lower market valuations, as well as a higher tax expense at €1.6m compared to €0.03m in FY17 and a five-year average of €0.5m.

Consequently, PZS will not pay a dividend, compared to a DPS of €0.10 paid from FY17 profits.

Income from financial instruments of €12.1m was down 32% y-o-y mainly on lower disposals of assets classified as non-current (Scherzer differentiates assets depending on the expected holding period), which contributed €2.6m (down 68% y-o-y). The corresponding expenses related to financial instruments were 45% lower y-o-y, which resulted in an overall net result on financial instruments of €9.4m (down 27% y-o-y). Net gains on the portfolio (both current and non-current) remained the main income contributor at €6.6m (FY17: €10.5m). Importantly, PZS was able to realize a profit on writing options at €2.7m (FY17: €0.8m), which constituted a certain offsetting factor in an adverse stock market environment.

PZS posted an EBIT of €0.9m (down 89% y-o-y from €8.2m). However, this was largely the result of net unrealized losses on the portfolio at €9.7m (FY17: €2.9m). These losses were partially offset by lower personnel expenses at €0.7m (FY17: €2.7m) as a result of lower bonuses to management and employees, as well as higher dividend income from the portfolio at €2.6m (FY17: €1.8m).

According to the management, the higher than average tax burden in FY18 came from two significant disposals from the current portfolio of assets that were bought before 2017. The gain on disposal of shares is exempted from income tax up to 95% of value since 2017. Prior to that, only shares acquired with the intention of long-term holdings (booked in fixed assets) were tax-exempt. Taxation will apply to any disposals of assets in the current portfolio that were bought before 2017. PZS does not disclose the amount of such assets, but the tax burden should diminish over time.

Following the decline in personnel expenses and broadly stable other operating expenses, PZS's expense ratio (measured as a percentage of average NAV during the period) declined to 1.7% in FY18 vs 4.8% in FY17. Despite the significant decrease in Q418, average NAV in FY18 was 6% higher y-o-y, also contributing to the lower expense ratio. Net debt decreased slightly to €23.7m (down 2% y-o-y), but as PZS's equity was down as well, the net debt to equity ratio increased slightly to 42% from 40% at the end of last year.

Exhibit 1: FY18 results highlights

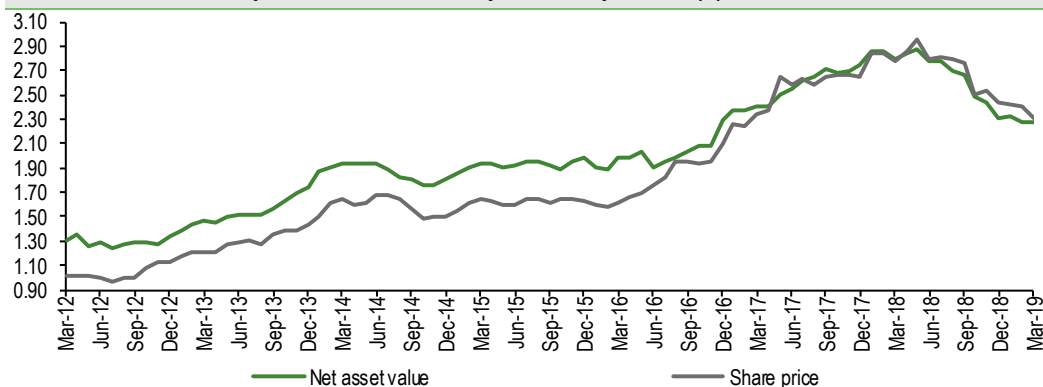
€000s, unless otherwise stated	FY18	FY17	y-o-y
Income from financial instruments	12,132	17,819	-32%
Expenses related to financial instruments	(2,727)	(4,937)	-45%
Result on financial instruments	9,403	12,882	-27%
Other operating income (excluding value adjustments)	69	30	127%
Personnel expenses	(688)	(2,686)	-74%
Other operating expenses	(716)	(976)	-27%
Income from dividends	2,586	1,801	44%
Unrealized gains (losses)	(9,742)	(2,883)	283%
D&A	(18)	(11)	70%
EBIT	907	8,161	-89%
Other interest and similar income	113	80	42%
Interest and similar expenses	(317)	(297)	7%
EBT	703	7,944	-91%
Income and other taxes	(1,558)	(43)	N/M
Net profit for the period	(855)	7,911	N/M
EPS (€)	(0.03)	0.26	N/M

Source: Scherzer & Co accounts, Edison Investment Research

PZS's NAV decreased during FY18 by 12.6% in total return terms including the €0.10 dividend paid. The company still managed to outperform the German small- (SDAX) and mid-cap (MDAX) markets, which declined 20% and 18%, respectively. However, since the end of 2018, German

equity markets rebounded significantly, gaining 15% to end-March. At the same time, PZS's NAV went down slightly by 1.3%. PZS's NAV progression (ex-dividends) is shown in Exhibit 2. One of the contributors to this was the weaker performance of shares in GK Software.

Exhibit 2: PZS's NAV per share and share price comparison (€)



Source: Scherzer & Co accounts

The NAV progression does not fully reflect the ECS portfolio. On the one hand, earnings realized from successful closures are reflected in the NAV, and the returns are at least partially reinvested in the portfolio. On the other hand, ECS held currently are not included in NAV. Having said that, the outcome and timing of monetisation for potential claims is uncertain. During FY18, Scherzer generated €12.7m in new ECS, of which the largest squeeze-outs were Oldenburgische Landesbank (€8.4m) and Buwog (€2.8m), bringing the total value of the ECS portfolio to €103.8m at end-2018 (FY17: €93.2m). During the year, two cases were closed and yielded a minor profit of €0.1m based on an ECS value of €2.1m (Edison estimate). Following the recent squeeze-out at Linde, the ECS portfolio could expand by further c €21m. Also recently, Zeal announced its intention to acquire Lotto24 in exchange for its own shares (PZS holds a 0.63% stake in Lotto24 valued at c €2m).

Portfolio developments

The main portfolio components weighing on PZS's NAV development in FY18 and Q119 were GK Software and freenet, which made up 23% of the portfolio at the beginning of 2018 with their combined share declining to 16% at end-2018 (and remaining at the same level at end-Q119).

GK Software share price declined 40% during 2018 and further 4% in Q119. The company offers software solutions for international retail chains. In 2018, GK Software revenues increased to €103–106m (preliminary) from €90.5m in 2017. It developed on the US market winning three new customers. On the other hand, the company moves further away from achieving its target of reaching 15% EBIT margin by 2020. In 2018, EBITDA decreased to €3–6m (FY17: €8.8m) on the back of product development costs. The company calculates its adjusted EBITDA margin in the range of 8-11%.

Freenet is a German telecommunications and web content provider. PZS holds a 0.2% stake in this €2.6bn market cap company. Freenet's share price declined 45% in 2018, but rebounded subsequently by 13% in Q119. The company met its FY18 guidance on EBITDA and free cash flow. In recent years, it has made several acquisitions, including Media Broadcast (100%), EXARING (50.01%), Sunrise Communications Group (24.95%) and Ceconomy (9.15%).

Linde became PZS's largest holding in January 2019 and subsequently its weight in PZS's portfolio increased further amid purchases in recent months. Following the merger with Praxair, the company (as a new entity called Linde plc) is the world's largest industrial gas company with a market cap close to €36bn, with Linde being one of its subsidiaries. Subsequently, Linde plc performed a squeeze-out on the minority shareholders of Linde with the price at €189.46 per share,

finalised on 10 April 2019. We estimate that the cash inflow from this transaction could amount to c €21m for PZS.

Exhibit 3: PZS's top 10 holdings list				
Company	% of total (Mar 19)	% of total (Dec 18)	% of total (Dec 17)	Opportunistic/safe
Linde	20.99%	10.83%	N/A	Safe
GK Software	10.19%	11.38%	13.72%	Opportunistic
freenet	5.37%	5.07%	9.10%	Opportunistic
Audi	4.92%	5.15%	3.73%	Opportunistic
Allerthal-Werke	4.43%	4.41%	4.88%	Safe
Horus	3.76%	4.39%	4.02%	Opportunistic
Mobotix	3.37%	3.38%	2.92%	Opportunistic
AG f. Erstellung billiger Wohnh. in Winterthur	2.96%	3.24%	N/A	Opportunistic
Weleda AG PS	2.55%	N/A	N/A	Opportunistic
N.N.	2.22%	N/A	N/A	
Total top-10 holdings	55.97%	55.83%*	54.17%*	-

Source: Scherzer & Co, Edison Investment Research. Note: *Includes holdings not in top 10 as at end of period.

Valuation

The most recently reported NAV stands at €2.28 per share as at end-March 2019. In the past, PZS's shares traded at prices below the stated NAV. The share price appeared to be a function of the net asset value minus the capitalised management costs, which were c 10% of revenues. As such, the average discount to NAV before 2016 was c 15%. Since the successful Schering ECS ruling in 2015 and subsequent newsflow, the discount has declined and the stock now trades slightly above the last reported NAV at €2.42. This suggests improved acceptance of potential gains resulting from the ECS portfolio. There is no visibility of future gains, which may explain why PZS has been trading well below market averages in the past five years based on the P/E ratio.

	P/E (x)						
	2014	2015	2016	2017	2018	2019e	2020e
DAX	16.6	22.0	19.0	14.6	12.9	13.1	11.9
MDAX	20.0	19.2	28.8	17.6	13.4	18.4	16.4
SDAX	30.9	28.0	23.5	23.4	13.8	17.5	14.9
Arithmetic average	22.5	23.1	23.8	18.5	13.4	16.3	14.4
PZS	11.9	9.2	13.6	10.0	loss	13.0	12.3
PZS discount	47%	60%	43%	46%	N/A	20%	14%

Source: Bloomberg as at 10 April 2019, PZS reports, PZS forecast is Refinitiv consensus based on two analysts. Note: P/E ratios based on year-end prices.

Asset management company valuations are commonly based on asset value, which can be demonstrated by the price to book (P/BV) value. We have looked at the development of P/BV ratios over time, and a decline in PZS's discount to market has been apparent since 2015, and reached 17% at end 2018. Since 2017, PZS has traded at a premium to its equity value per share.

Under PZS's reporting standards, NAV development is not fully reflected on the balance sheet. While a decrease in the market price of portfolio is reflected through write-offs, the increases are recognized on disposals. The company can only report positive value adjustments by reversing write-offs, and in effect the book value of the portfolio cannot exceed the initial investment.

	P/BV (x)						
	2014	2015	2016	2017	2018	2019e	2020e
DAX	1.7	1.7	1.7	1.9	1.4	1.5	1.4
MDAX	2.1	2.3	1.9	2.1	1.6	1.7	1.6
SDAX	1.9	2.0	1.7	1.8	1.6	1.6	1.5
Arithmetic average	1.9	2.0	1.8	1.9	1.5	1.6	1.5
PZS	0.8	0.8	0.9	1.3	1.3	1.1	1.0
PZS discount	58%	60%	49%	32%	17%	33%	33%

Source: Bloomberg as at 10 April 2019, PZS reports, PZS forecast is Refinitiv consensus based on two analysts. Note: P/BV ratios based on year-end prices.

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