Scherzer & Co

Asset management

8 September 2020

Successful conclusion of AXA case

Scherzer's (PZS) NAV at end August 2020 increased by 12.6% ytd, ahead of German equity markets, which were roughly flat compared to end FY19. The main NAV uplift came from profit derived from the ECS portfolio and Audi's squeeze-out price announcement. The impact of PZS's portfolio management on its P&L was only marginally positive, as valuations remain depressed and companies reduce dividends in uncertain times. Under current accounting standards, PZS's NAV growth may lag that of the broader market until investments are realized. Also, a significant part of the portfolio is 'locked' in anticipation of squeeze-outs, which on execution will have a positive impact on the P&L and enhance the ECS portfolio.

AXA rights sold for an €8.5m profit

During H120, PZS sold one of its largest ECS positions in AXA. The transaction resulted in a €9.1m cash inflow and €8.5m positive P&L impact, part of which was recognised in interest income. Consequently, PZS's ECS portfolio decreased to €113m (from €139m at end FY19). The ECS portfolio is likely to be enlarged through new transactions, as squeeze-outs are expected in some of the largest positions, eg Audi (15.9% of the portfolio) and MAN (9.2%). While ECS results are highly uncertain, we note that the initial squeeze-out proceeds can be reinvested in currently volatile markets.

Muted trading result and dividend income in H120

During H120 PZS's NAV increased by 7.4% compared to a 7.8% decrease by the SDAX in total return (TR) terms. While the EPS of €0.09 was achieved mostly on the AXA case, PZS also reported a €0.9m profit on active trading in stocks. However, unrealized losses on held positions stood at €4.9m and income from dividends declined by 80% as many companies decided to refrain from or delay dividend payments (in some cases due to postponed AGMs) given the current economic climate. PZS ended H120 with €2.3m in cash (FY19: €0.7m) and a net debt to equity ratio at 34% – in line with the long-term average.

Valuation: Share price lagging NAV growth

PZS's shares have been trading close to par over recent years, which we believe stems from the 'hidden value' of the ECS portfolio, which is not included in the NAV. Strong support from the AXA ECS disposal was recognized in June and as the share price did not increase accordingly, PZS's discount now stands at 11%.

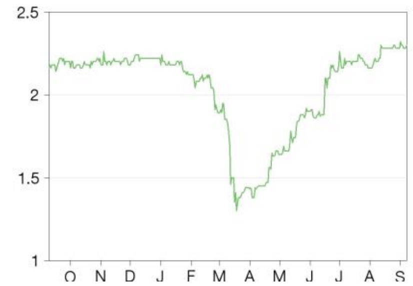
Consensus estimates

Year end	Revenue (€m)	EBITDA (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/18	12.1	0.9	(0.03)	0.00	N/A	N/A
12/19	5.2	(2.1)	(0.08)	0.00	N/A	N/A
12/20e	9.1	4.9	0.06	0.00	38.3	N/A
12/21e	6.9	7.0	0.16	0.05	14.4	2.2

Source: Scherzer & Co, Refinitiv consensus based on three analysts at 8 September 2020.

Price	€2.30
Market cap	€69m

Share price graph



Share details

Code	PZS GY/PZSG
Listing	Deutsche Börse Scale
Shares in issue	29.9m
Last reported net debt as at end H120	€19.3m

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 driver through extra compensatory claims (ECS), 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.

Analysts

Milosz Papst +44 (0) 20 3077 5700
Michal Mordel +44 (0) 20 3077 5700

financials@edisongroup.com
Edison profile page

Financials: ECS disposal driving profits

PZS reported €2.7m net income (EPS of €0.09) in H120, which was achieved in a volatile pricing environment for public assets and compares to break-even in H119. The largest profit was realized on PZS's ECS portfolio, where the disposal of AXA rights represented a major part of the €5.7m gain from ECS (with no major cases in H119). The result loss on realized transactions amounted to €0.1m (H119: €0.9m gain), as the €0.9m gain on equities (H119: €0.6m) was offset by a €1.0m loss on derivatives. Consequently, the result on financial instruments was €5.7m vs €1.0m in H119. Meanwhile, overall weak macroeconomic conditions weighed on the portfolio valuation. Unrealized downward value changes on held positions amounted to €4.9m (H119: €1.4m), which, paired with lower income from dividends and higher operating costs led to an EBIT loss to the tune of €0.4m (€0.4m profit in H119). Other operating costs increased to €1.1m from €0.4m in H119 on the back of higher legal and consulting costs. The disposal of AXA rights also resulted in financial income (through the recognition of interest accrued on the claim) contributing to H120 net financial income of €3.4m (H119: -€0.1m).

ECSs are claims relating to companies that have performed a squeeze-out at their listed subsidiaries where PZS was a minority shareholder. PZS attempts to prove in court that a squeeze-out was performed at a price below fair value and receives compensation if successful. In the AXA situation, the squeeze-out was performed in 2006 at €144.68 per ordinary share, and in August 2019 the first ruling set the fair value of the shares at the time at €177.58. In June 2020, PZS sold its claims against AXA to a third party before the final ruling, receiving €9.1m in cash, and recognized an €8.5m profit (split between gain on disposal and 'interests and similar income').

PZS ended H120 with €2.3m in cash (FY19: €0.7m) which, together with €21.5m financial debt, implies a net debt position of €19.3m, down from €22.6m at end-FY19. The net debt to equity ratio decreased to 34% from 42% at end-FY19, which is in line with PZS's long-term average of 38%.

Exhibit 1: FY19 results highlights

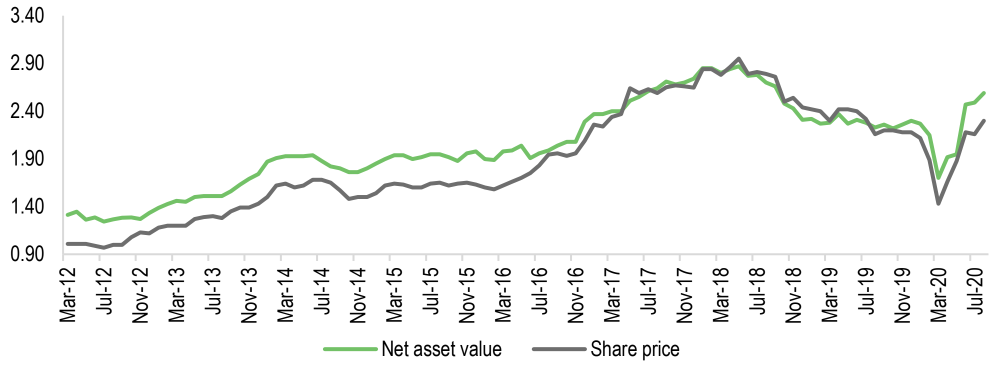
€000s, unless otherwise stated	H120	H119	y-o-y
Gains from financial instruments	9,950	2,193	339%
Losses from financial instruments	(4,280)	(1,226)	249%
Result on financial instruments	**5,670**	**967**	**446%**
Other operating income (excluding value adjustments)	10	33	N/M
Personnel expenses	(336)	(308)	9%
Other operating expenses	(1,104)	(363)	204%
Income from dividends	320	1,524	(79%)
Unrealized gains (losses)	(4,935)	(1,434)	244%
D&A	0	(8)	N/M
EBIT	**(374)**	**410**	**N/M**
Other interest and similar income	3,465	51	6738%
Interest and similar expenses	(93)	(109)	(15%)
EBT	**2,998**	**351**	**753%**
Income and other taxes	(235)	(342)	(31%)
Net profit for the period	2,763	9	N/M
EPS (€)	**0.09**	**0.00**	**N/M**

Source: Scherzer & Co accounts, Edison Investment Research

PZS's end-August 2020 NAV per share was €2.59 (based on market values), which implies a 12.6% ytd return. This represents strong outperformance vs German equity indices, with the DAX posting a 2.3% fall in TR terms over the period. The growth was strongly supported by the 26.7% m-o-m return (or €0.52 accretion per share) in June, when PZS booked €8.5m in income from the favourable AXA ruling. Additionally, its major portfolio component, Audi, had posted a 52% share price rally. We calculate that Audi's price performance in June contributed c 6.5pp to ytd NAV performance. PZS's share price rebounded more moderately, which resulted in a widened discount to NAV. While the ECS portfolio is not included in NAV, the successful closures support NAV through realized gains. After deducting €25.6m in AXA shares, the ECS portfolio stood at €113m at end August 2020 (€105m excluding ECSs held by portfolio companies). As a reminder, the ECS portfolio is presented at the initial value received under squeeze-outs and other corporate actions, and is not adjusted for developments in legal proceedings until conclusion.

We note that PZS's portfolio development is not fully reflected on its income statement and balance sheet. Under German reporting standards, a decrease in the market price of a portfolio holding is reflected in write-offs, while 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 unless the holding is sold. This includes Audi's recent price performance.

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



Source: Scherzer & Co accounts

Portfolio developments

Scherzer specialises in investing in undervalued companies, which management believes comes from a lack of understanding by the general market. Its targets are stocks with little to no research coverage, business models that are difficult to evaluate or companies in special situations such as restructuring or M&A. PZS structures its portfolio in two categories: 'safe', which consists of companies with high asset quality and sustainable earnings (including squeeze-out candidates), and 'opportunistic' with companies in other special situations, growth stocks and those with disruptive business models. At end H120, 54% of PZS's portfolio was classified as safe (FY19: 36%).

Scherzer's portfolio is relatively condensed, with 10 holdings representing 64% of the portfolio at end August 2020. **Audi** remains the largest holding, making up 16% of the portfolio. On 31 July 2020, Audi's AGM approved the squeeze-out by Volkswagen at the price of €1,551 per share (while at end FY19 the share price was €800). We calculate that on completion PZS will receive c €10m in proceeds and understand that the shares will increase PZS's ECS portfolio. As a reminder, the recent Audi share price rally is not reflected in PZS's income statement, and the profit will be recognised only on execution of the squeeze-out. Until then, 16% of PZS's portfolio is 'locked' with limited deviation from the announced transaction price.

The second largest investment at end August 2020 is **MAN**, representing 9% of the portfolio. Scherzer significantly increased its holding in the company during May, after Traton (a subsidiary of Volkswagen, which holds a 94.4% stake in the company) confirmed its intention to squeeze out the remaining shareholders. While the final squeeze-out price has not yet been set, MAN's share price increased by 33% following the announcement. We understand that the transaction will be included in PZS's ECS portfolio.

The development of portfolio value is also affected by illiquid stocks trading on the OTC markets (eg Weleda and AG für Erstellung billiger Wohnhäuser in Winterthur), and majority-owned companies with adjacent business models (eg Horus).

Exhibit 3: PZS's top 10 holdings list				
Company	% of total (Aug 20)	% of total (Aug 19)	Change (pp)	Opportunistic/ safe
Audi	15.87%	5.57%	10.30	Safe
MAN	9.22%	N/A	N/A	Safe
GK Software	8.49%	10.21%	(1.72)	Opportunistic
freenet	7.96%	8.12%	(0.16)	Opportunistic
Allerthal-Werke	4.60%	4.79%	(0.19)	Safe
ZEAL Network	4.28%	N/A	N/A	Opportunistic
Weleda	3.77%	4.38%	(0.61)	Opportunistic
Lotto24	3.67%	N/A	N/A	Safe
Horus	3.03%	3.87%	(0.84)	Opportunistic
AG f. Erstellung billiger Wohnh. in Winterthur	2.93%	3.62%	(0.69)	Safe
Total top-10 holdings	**63.82%**	**50.22%***	**-**	**-**

Source: Scherzer & Co, Edison Investment Research. Note: *Top 10 holdings as at end of August 2019.

Valuation

At the end of August 2020, PZS's NAV per share stood at €2.59 and the current share price of €2.30 implies a 11.2% discount. For the three years before the COVID-induced sell-off, PZS shares traded at par on average (2017–19 average discount of 0.4%). The current discount may seem relatively high, but we should emphasise that the AXA case accounted for 20% of the ECS portfolio at end FY19 and its potential has already been realized. We calculate that disposal of the AXA rights amounted to €0.28 pre-tax profit per share, compared to overall post-tax EPS of €0.09 in H120.

PZS shares delivered a ytd return to 7 September of 5.5%, strongly outperforming German equity indices. The DAX, MDAX and SDAX delivered total returns between a 2.6% decrease (MDAX) and a 0.6% decrease (SDAX). PZS currently trades broadly in line with the market on a P/E ratio basis, at a FY20 premium of 11%, while historically it traded at close to a 50% discount. We believe this may stem from somewhat outdated consensus and not all contributors considering recent developments at AXA, as the mean estimate of FY20 EPS amounts to €0.06, ranging from a €0.06 loss to a €0.20 profit.

Exhibit 4: Comparable market P/E ratios (x)

	2015	2016	2017	2018	2019	2020e	2021e
DAX	22.0	19.0	14.6	12.9	22.7	21.5	15.3
MDAX	19.2	28.8	17.6	13.4	26.1	42.0	25.4
SDAX	28.0	23.5	23.4	13.8	32.1	40.1	16.8
Arithmetic average	**23.1**	**23.8**	**18.5**	**13.4**	**27.0**	**34.5**	**19.2**
PZS	9.2	13.6	10.0	loss	loss	38.3	14.4
PZS discount	60%	43%	46%	N/A	N/A	(11%)	25%

Source: Refinitiv at 7 September 2020, PZS reports. Note: PZS forecast is Refinitiv consensus based on three analysts. P/E ratios based on year-end prices, forward ratios based on current prices.

On a P/BV ratio, the narrowing of PZS's discount to the market has been apparent since 2015, reaching 13% at end 2018. However, recent performance has driven the discount to 28% on FY20e book value.

Exhibit 5: Comparable market P/BV ratios (x)

	2015	2016	2017	2018	2019	2020e	2021e
DAX	1.7	1.7	1.9	1.4	1.6	1.6	1.5
MDAX	2.3	1.9	2.1	1.6	2.1	1.9	1.8
SDAX	2.0	1.7	1.8	1.6	1.5	1.3	1.3
Arithmetic average	**2.0**	**1.8**	**1.9**	**1.5**	**1.7**	**1.6**	**1.5**
PZS	0.8	0.9	1.3	1.3	1.2	1.1	1.1
PZS discount	60%	49%	32%	13%	30%	28%	29%

Source: Refinitiv as at 7 September 26 August 2020, PZS reports. Note: PZS forecast is Refinitiv consensus based on three analysts. Historical P/BV ratios based on year-end prices, forward ratios based on current prices.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia