EDISON **Scale research report - Update**

Mutares

Financials

28 June 2018

Buy-and-build strategy fuels expansion

Successful turnarounds supported by add-on acquisitions allowed Mutares (MUX) to post record FY17 results. Improvements across the P&L resulted from profitable exits as well as bargain purchases. The shift in strategy towards platform investments is expected to further validate the benefits of the buy-and-build approach originally introduced in STS Group. MUX is now trying to replicate the concept for Balcke-Dürr Group and La Meusienne. Despite the recent positive developments, MUX's shares have been under pressure and currently trade at a 30.0% discount to last reported NAV.

Successful M&A driving earnings growth

MUX posted solid FY17 results, with sales growing by 38.4% y-o-y to €899.7m and EPS reaching €2.9 (up 65% y-o-y). This was largely driven by six portfolio exits (in particular EUPEC Germany and A+F) translating into disposal gains and four acquisitions resulting in income from bargain purchases. Earnings growth was also assisted by operational improvements in the automotive (STS Group, Elastomer Solutions) and engineering & technology (Balcke-Dürr, A+F) segments.

Strategy shift to focus on platform investments

MUX continues the transition from standard business turnarounds based solely on operational improvements to building more complex platform investments as part of a buy-and-build strategy, initiated in 2016. The company aims at add-on acquisitions for selected portfolio companies (such as STS Group, Balcke-Dürr and La Meusienne) to create value through synergies and economies of scale. MUX is also exploring other approaches towards divestments, as it has recently conducted its first ever partial exit through an IPO of STS Group. Finally, MUX intends to narrow its sector focus and look for opportunities mainly in technology and industrial manufacturing going forward. On top of progressive specialisation, MUX is aiming for geographic expansion into UK and Nordics.

Valuation: Discount despite downward NAV revision

MUX's portfolio NAV at end-December 2017 stood at €398.6m, up 29.5% from end 2016. However, more conservative valuation assumptions led to a NAV decline to €260.4m at end March 2018. Still, MUX's shares trade at a 30% discount to this value. The recently announced dividend of €1.00 implies an 8.5% yield.

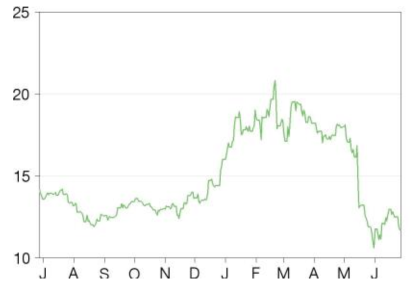
Historical financials and consensus estimates*

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/16	650.1	50.5	1.73	0.35	6.8	3.0
12/17	899.7	67.1	2.85	1.00	4.1	8.5
12/18e	1,157.5	66.8	1.57	0.92	7.5	7.8
12/19e	1,440.0	59.8	0.93	0.90	12.6	7.7

Source: Bloomberg consensus estimates as at 20 June 2018.
Note: *Consensus figures based on the estimates of two brokers only.

Price	**€11.7**
Market cap	**€181m**

Share price graph



Share details

Code	MUX
Listing	Deutsche Börse Scale
Shares in issue	15.5m
Last reported net debt as at 31 December 2017	€60.8m

Business description

Founded and listed in 2008, Mutares acquires special situation companies that are underperforming and can be turned around through financial and operational restructuring. It currently owns multiple companies across five focus industries.

Bull

- Exposure to a diversified portfolio of potentially high-growth recovery companies actively managed by experienced industry professionals.
- Prospect of high dividends following exits.
- Attractive discount to NAV.

Bear

- Narrowing sector focus increases the risk due to decreasing diversification.
- Turnaround investments are inherently risky.
- Outstanding litigation.

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Financials: M&A and operational efficiencies

Mutares released robust FY17 results, recording a 38.4% y-o-y improvement in revenues and a 32.9% y-o-y growth in EBITDA. The main driver for the c €150m increase in sales (€899.7m in FY17 vs €650.1m in FY16) was the company's M&A activity, as well as operational improvements in the automotive and engineering & technology segments. Mutares concluded six exits in FY17, four of which (A+F, Grosbill, FTW, Geesinknorba) were complete exits and two (EUPEC Germany and Société Savoisienne de Metaux) represented partial disposals. The most important transactions include the sale of EUPEC Germany in February 2017 for €19.5m (plus €12.5m of potential earnouts until 2019) and the disposal of A+F in December 2017 for €20.5m (with €4.5m of potential earnouts until 2019). The latter transaction was executed at a money multiple of 8.5x (or 10.0x assuming Mutares will receive the full amount of earnouts). The proceeds from divestments have been used to fund four new acquisitions and will also allow the company to pay an attractive dividend of €1.00 per share (vs €0.35 paid for 2016). The company made three add-on acquisitions in FY17, including two additions to the STS Group described below and one addition to the Balcke-Dürr Group. Moreover, Mutares acquired Aperam Stainless Services & Solutions Tubes Europe (renamed La Meusienne). For FY18, MUX targets the completion of at least three transactions.

The successful transaction activity translated into a healthy increase in other operating income of 66% y-o-y to c €156.4m. This was driven by income from bargain purchases (ie badwill) of €87.3m (FY16: €76.0m), which the company started to recognize following the conversion to IFRS, as well as net disposal gains of €30.9m (none in FY16). As a result, group EBITDA reached €67.1m in FY17 vs €50.5m in FY16 and net income increased by 65% y-o-y to €44.2m in FY17, implying an EPS of €2.85. Operating cash flow stood at -€29.1m in FY17 compared with -€34.1m a year ago. The negative balance has been offset by expansion of external financing in the form of factoring and loans. Consequently, net debt as at end-2017 stood at €60.8m vs €38.4m in FY16.

In Q118, organic growth and add-on acquisitions in the automotive and engineering and technology segments remained the main drivers of group revenue improvement, which reached €228.9m compared with €208.2m in Q117. A low season effect, lack of earnings from bargain purchases and exits, as well as involvement in the restructuring of Donges SteelTec, resulted in negative EBITDA of €3.4m (in line with the company's expectations).

Exhibit 1: FY17 results highlights

€m	FY17	FY16	Y-o-y
Revenues	**899.7**	**650.1**	**38.4%**
Reduction or increase of finished goods and work in progress	(4.1)	(3.0)	36.7%
Other operating income	156.4	94.2	66.0%
Cost of materials	(569.6)	(430.6)	32.3%
Personnel expenses	(251.6)	(160.0)	57.3%
Other operating expenses	(163.7)	(100.2)	63.4%
D&A	(27.1)	(15.9)	70.4%
EBITDA	**67.1**	**50.5**	**32.9%**
EBITDA margin	7.5%	7.8%	-31bp
Other interest and similar income	3.4	0.3	N/M
Interest and similar expenses	(7.9)	(6.4)	23.4%
Income taxes	8.4	(2.1)	N/M
Consolidated net income	43.9	26.4	66.3%
Net margin	4.9%	4.1%	82bp
Profit attributable to minority interest	(0.3)	(0.4)	-25.0%
Group share of consolidated income	**44.2**	**26.8**	**64.9%**
EPS (€)	**2.85**	**1.73**	**64.9%**

Source: Mutares accounts

Exhibit 2: Segment analysis

€m	Revenues				EBITDA	
Segment	2017	% share	2016	% share	2017	2016
Automotive	344.1	38%	166.1	26%	56.8	12.6
Engineering & technology	213.2	24%	129.1	20%	17.4	36.3
Construction & infrastructure	65.1	7%	28.0	4%	7.3	(6.3)
Wood & paper	178.8	20%	155.8	24%	(4.5)	13.8
Consumer goods & logistics	98.6	11%	171.3	26%	(18.1)	(1.6)

Source: Mutares accounts

Portfolio overview

Sales in the largest **automotive segment** more than doubled to €344.1m in FY17, predominantly driven by the full consolidation of the global truck supplier STS Group, as well as the subsequent add-on acquisitions of Plastic Omnium Group and the Brazilian production facility of Swiss Autoneum Group. As a result of these deals, STS Group's FY17 pro forma sales and EBITDA now stand at €425.2m and €24m, respectively. The company is also developing organically amid strong demand translating into robust order backlog (€1.9bn as at end-January 2018) and is expanding its production footprint with the Polish site setup completed in Q417 and the Chinese facility to be opened in Q418. Elastomer Solutions (ESG) posted a considerable increase in sales and significant positive operating income. ESG uses external financing for its development and due to unexpected one-off event has breached one of the covenants. The necessary steps have been already taken to meet the requirements. Segment EBITDA improved to €56.8m in FY17 vs €12.6m in FY16, although this was partially the result of the one-off income from bargain purchase.

Further expansion of STS Group into China, North America and Eastern Europe should be assisted by the €24.0m gross proceeds from the recently completed IPO. The offering consisted of 1m new shares from capital increase and 1m shares held by Mutares, which, based on an over-allotment option, has been extended by additional 300k shares. As a result, Mutares collected €31.2m of exit proceeds, but remains the majority shareholder with a 62% stake (and a 12-month lockup).

The engineering and technology business saw significant divestments in FY17, including Geesinknorba, FTW and A+F. As a result, the segment (which generated sales of €213.2m and EBITDA at €17.4m in FY17) now consists solely of Balcke-Dürr Group, the manufacturer of components for energy efficiency and emission reduction, acquired in December 2016. The recently completed restructuring process has led to improved cost-effectiveness, which should allow the company to successfully compete in the market through attractive pricing and thus grow its market share, according to Mutares management. Importantly, Balcke-Dürr is considered a new platform for add-on acquisitions (similarly to STS Group), with the first addition of the steel construction company Donges SteelTec completed in October 2017 and another one (Heat Transfer Products division of Salvatore Trifone e Figli) expected to be completed in June 2018.

The construction and infrastructure segment reported FY17 sales of €65.1m, up from €28.0m in FY16, mostly due to consolidation of La Meusienne. This transaction (on top of cost base adjustments at EUPEC) has also driven EBITDA to a positive territory at €7.3m, compared to an EBITDA loss of €6.3m in preceding year. Mutares intends to develop La Meusienne into a platform investment. Furthermore, Mutares sold EUPEC Germany in February 2017 for a €19.5m consideration (with potential earn-outs at €12.5m). However, the sustainability of the positive changes needs to be monitored as the segment remains impacted by the restrained investment activity in the oil and gas industry. Importantly, BSL Pipes & Fittings as an example, may face going concern issues in case of delayed settlement related to a large delivered project.

The wood & paper segment recorded an increase in sales of 14.8% y-o-y to €178.8m, assisted by organic growth of Zanders (revenues up 11% y-o-y) and the contribution from full consolidation of Cenpa (acquired in 2016). However, segment EBITDA loss stood at €4.5m and was down from

€13.8m in FY16 due to positive one-offs booked in FY16, but also cost pressures from rising pulp prices affecting Zanders. Importantly, Mutares highlighted that if raw materials prices remain at high levels (the NBSK pulp price has increased by c 20% year to date), Zanders will require external support to sustain its liquidity.

Revenues in **the consumer goods and logistics segment** decreased by 42.4% y-o-y to €98.6m (€171.3m in FY16), accompanied by a higher EBITDA loss of €18.1m compared with a loss of €1.6m in FY16. This was largely due to the divestment of Grosbill (which sold to its founder). Mutares intends to entirely exit this segment and focus on the technology and industrial manufacturing sectors, which we believe is in line with the team's core expertise. On the other hand, narrow sector focus in conjunction with expansion of investment platforms at the expense of standard turnaround investments may lead to increase portfolio concentration.

Valuation

Mutares's portfolio NAV at end-December 2017 amounted to €398.6m (or €25.72 per share based on Edison estimates), up 29.5% from the end December 2016 level. In Q118, MUX applied a more conservative approach towards asset valuation, including a reduced growth rate for the terminal value (0.5% vs 1.5% previously) and a 25% higher weighted average cost of capital in the construction and infrastructure segment. Reported NAV was €260.4m and reflected the revaluation of STS Group on the basis of the IPO price. At the current share price of €11.7, Mutares is trading at a 30.0% discount to its last reported NAV. This high discount is a result of the recent slump in share price, which started in the first half of May 2018 – around the time when the company disclosed details of STS Group's planned IPO. Over the subsequent month, Mutares has lost c 25% of its market capitalization (reversing earlier gains from late 2017/ early 2018), accompanied by the announcement of STS's IPO price of €24, which was below the initial price range of €26 to €32.

The recently proposed dividend at €1.00 per share represents an attractive yield of 8.5%. However, it must be noted that future dividend levels will depend on further gains from successful exits. As the company considers the current share price as a good buying opportunity, it decided to launch a buyback programme amounting to €3m and limited to 283,019 shares. The programme has already been completed with 255.863 shares repurchased.

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