EDISON Scale research report - Update

Ernst Russ

Diversified financials

11 May 2020

Sailing through the storm

In FY19 Ernst Russ (ERAG) strategically repositioned itself to focus on its investor and asset manager activities in shipping and fund management (particularly real estate). Over the year assets under management (AUM) decreased from €2.9bn to €2.0bn, driven by disposals of non-core business units. Although management expects further improvement in FY20 shipping segment revenue, it is likely to be fully offset by the absence of sold businesses. In light of current adverse markets, it guides to lower overall performance and operating income, although the extent will depend on economic and market conditions. Therefore, the key focus for 2020 is to secure liquidity, targeting stable cash levels over the year.

Financials: Increasing share of shipping sales

Expansion of ERAG's fully consolidated fleet from three to 14 vessels in FY19 resulted in an over 50% y-o-y increase in shipping segment revenues and a 11.6% top-line improvement to €38.5m and €58.8m, respectively. The figures were particularly boosted by full consolidation of the Elbfeeder JV after ERAG increased its stake by 2% to c 52%. The strategic streamlining led to reduced revenue from non-core businesses and to improved operating costs, leading to a slight y-o-y EBIT growth of c 5%. On the back of increased interest expense (on higher debt driven by a more asset-heavy business model) and higher income tax, net profit reached €1.5m against €6.2m in FY18.

Stalled global trade to compromise shipping

Policy measures applied by governments against the coronavirus significantly limit global trading and therefore hit the shipping industry (including container shipping to which ERAG has the highest exposure). Limited business activity and travel resulted in a severe drop in demand and oil prices. Consequently, tankers are now increasingly used as storage units. While OPEC's recent agreement to reduce oil output by c 10% globally should provide some support to pricing, it seems likely that tanker charter rates could worsen.

Valuation: Market cap to AUM ratio c 1%

As ERAG's earnings partly depend on the size of its AUM, it is instructive to examine the market cap/AUM ratios for the company and its peers based on last reported figures. ERAG's market cap represents c 1.0% of its AUM, below the figures for MPC Capital (1.1%), Corestate Capital (1.5%) and Patrizia (4.3%).

Historical financials

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/16	40.0	10.2	0.20	0.00	3.0	N/A
12/17	44.0	9.3	0.17	0.00	3.5	N/A
12/18	52.7	6.1	0.19	0.00	3.2	N/A
12/19	58.8	3.5	0.05	0.00	12.8	N/A

Source: Ernst Russ, Edison Investment Research

Price	**€0.60**
Market cap	**€19m**

Share price graph

Share details

Code	HXCK
Listing	Deutsche Börse Scale
Shares in issue	32.4m
Last reported net debt at end-2019	€44m

Business description

Ernst Russ is a listed asset and investment manager and asset investor, with AUM of c €2.0bn, focused on shipping and fund management (particularly real estate). The Ernst Russ Group manages a fleet of around 71 container, tanker and bulker ships, as well as 27 real estate properties. The company has offices in Hamburg, Cologne and London.

Bull

- Strengthened investment and asset management offering.
- Repositioning to focus on maritime segment.
- Highly experienced team from the maritime sector.

Bear

- Negative global trade growth forecasts.
- Higher risk aversion weighing on asset values.
- Eroding legacy closed-end fund base.

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Edison profile page

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Financials: Streamlining the business

In FY19 Ernst Russ reported an 11.6% y-o-y increase in revenues to €58.8m, driven by an over 50% improvement in shipping segment sales, now c 65% of the total. While the improvement is attributable to the expansion of its own fleet and the resulting increase in charter income (€24m in FY19 against €7m in FY18), to a significant extent it is an accounting effect from full consolidation of the Elbfeeder JV after ERAG increased its stake by 2% to 52% on 31 July 2019. Real estate segment sales remained broadly stable, reaching €14.8m in the reporting period and, similar to the previous year, included significant income from asset disposals. The sale of property in Schnieringshof in Essen concluded in October 2019 and contributed €8.6m to the top line. ERAG's strategic refocusing included the sale of almost all non-core business units, which now represent a minor part of its overall performance (9% of revenue in FY19). The business streamlining resulted in lower other operating income and expenses, including lower recognition in FY19 of write-downs on assets and write-down reversals. It has also driven down personnel costs by c 32% y-o-y to €10.4m, leading to an overall slightly higher EBIT of €4.0m (€3.8m in FY18).

As the company moved to a more asset-heavy business model, increased capex (€13.1m in FY19, against €0.1m in FY18) and acquisition costs helped push net debt to €44m (from €29.8m at end June 2019); hence interest and similar expense almost doubled in FY19 against FY18. After c €1.7m income tax expense (vs a credit in the prior year), consolidated net profit after minorities was €1.5m, down from €6.2m in FY18.

Exhibit 1: Financial highlights

	FY19	FY18	y-o-y
Revenue	**58,793**	**52,705**	**11.6%**
Shipping	*38,471*	*25,601*	*50.3%*
Real estate	*14,757*	*14,914*	*-1.1%*
Investor management	*3,333*	*9,029*	*-63.1%*
Alternative investments	*1,577*	*2,147*	*-26.5%*
Other services	*655*	*1,014*	*-35.4%*
Decrease/increase in unfinished products	(729)	100	NM
Other operating income	7,881	19,072	-58.7%
Cost of materials and services	(32,446)	(23,079)	40.6%
Personnel expenses	(10,374)	(15,262)	-32.0%
Depreciation	(7,374)	(9,273)	-20.5%
Other operating expenses	(12,000)	(17,704)	-32.2%
EBIT	***4,000****	***3.800****	***5.3%****
Net income from investment in associates	91	(1,495)	NM
Income from equity interests	1,824	2,868	-36.4%
Income from loans held as financial securities	18	0	NM
Other interest and similar income	1,673	1,710	-2.2%
Amortisation of financial assets and current securities	(1,151)	(2,012)	-42.8%
Interest and similar expenses	(2,734)	(1,507)	81.4%
Earning before tax	3,472	6,123	-43.3%
Income taxes	(1,706)	368	NM
Earnings after tax	**1,766**	**6,491**	-72.8%
Other taxes	(66)	(108)	-38.9%
Consolidated net income including non-controlling interest	**1,700**	**6,383**	-73.4%
Consolidated net profit/loss attributable to non-controlling interest	(181)	(167)	8.4%
Consolidated net income after non-controlling interest	**1,519**	**6,216**	-75.6%

Source: Ernst Russ, Note: *estimated amounts reported in Consolidated Management Report

Although the macroeconomic environment in FY20 will be shaped by the coronavirus pandemic, ERAG expects to improve revenues in the shipping segment. Even if unfavourable market conditions limit fleet expansion, the consolidation of its currently held 14 vessels for a full 12-month period would significantly increase segment sales. Based on various scenarios and depending on the extent and duration of the pandemic, management expects a moderate to significant operating earnings decline in FY20, including the possibility of it turning negative. Therefore, management focuses on securing liquidity in the period, targeting cash and cash equivalents to remain at least stable over the year. At end-December 2019, ERAG held cash and cash equivalents amounting to €10m and its equity ratio stood at 46.2% (previous year: 49.4%).

Repositioning portfolio to match new business model

As part of refocusing on shipping and fund management (in particular real estate), ERAG sold non-core assets that did not fit with its new operating strategy. Consequently, AUM declined to c €2.0bn at end-FY19 from €2.9bn at end-December 2018. We note that both figures reflect the new AUM calculation method based on their current value rather than on managed equity and external capital at initially invested values. The change of methodology is related to the recent conversion of ERAG into an asset and investment manager.

The repositioning process began in February 2019, with disposal of three subsidiaries as well as a fund and asset management contract in the solar power division. This was followed by the sale of ERAG shares in the ship management company, Hammonia Reederei, completed the same month. In June 2019, ERAG successfully disposed of its investor management segment, which comprised 29 fiduciary and sales companies. This significantly reduced the complexity of the organisational structure and liability risks as well as personnel and material costs. The business streamlining also included the sale of private equity and infrastructure funds, as well as 20 ship funds under management.

At end-2019, ERAG's **shipping segment** portfolio consisted of 71 vessels of all types, including container, tanker, bulker and roll-on/roll-off ships, against 90 at the end of FY18. The company holds significant interest in 28 of these vessels and fully consolidates 14 of them in its financial statements. This is a visible increase from just three fully consolidated ships at end-FY18 and is mainly due to the acquisition of an additional 2% stake in the Elbfeeder JV (bringing ERAG's stake to 51.995%) concluded in H219, adding seven container ships. Furthermore, in H119 the company acquired a 4,200 TEU container ship and majority shareholding in a portfolio consisting of a handymax bulker and a 3,100 TEU container ship. Finally, in October 2019 ERAG bought a 700 TEU feeder container ship that was built in 2007. The remaining 43 ships are held by investment funds for which ERAG provides fund and asset management services.

In the **real estate segment**, which is divided into fund and asset management and housing construction project sub-segments, ERAG held 27 properties at end-December 2019. However, the company decided to focus on the former business and disposed both of its remaining housing developments at the beginning of FY20. These were the ILO Park project in Pinneberg acquired in February 2019 and the Bad Oldesloe property purchased with a joint venture partner in August 2019.

Global trade on hold due to the coronavirus outbreak

Global economic development in 2019 was dominated by trade friction, mainly between the US and China, resulting in gradual but steady deterioration of trade growth forecasts, with the World Trade Organization (WTO) eventually reporting a 0.1% in world merchandise trade for the year. The subsequent unprecedented nature of the coronavirus pandemic in 2020 and the associated market collapse are reflected in the latest WTO release (8 April 2020), which forecasts a year-on-year decrease in global trade of 13–32%. Although it expects a rebound in 2021, there is no certainty as it depends mainly on the duration of the pandemic and the effectiveness of global policy responses. Measures already taken include closing land borders, banning non-essential movement and closing non-essential shops and business activity. All these restrictions materially impact global trade directly or indirectly by limiting production output.

Meanwhile, against a backdrop of oversupply the economic effect of the pandemic drove oil demand and prices down steeply. More oil is consequently having to go into storage and fears of insufficient storage is leading some firms to rent tankers to store the oil instead of deliver it. Reuters reports that 160m barrels of oil were stored on ships in mid-April; both supertankers (which able to hold 2m barrels each) and smaller vessels have been employed as storage units. The OPEC decision in May to cut oil output by a record 9.7m barrels a day, equivalent to c 10% of global supply, should add some support to pricing. However, charter rates for tankers are likely to be affected.

In January 2020, the IMO 2020 regulation came into force, banning bunker fuel with a sulphur content of more than 0.5%, thus increasing the cost per tonne for shipping companies by $200 to $300 per tonne, based on ERAG estimates. To continue using the old fuel ships need to install scrubber systems, which require large financial investments. Some shipping companies, such as ERAG and its partners, switched to fuel with a lower sulphur content rather than bear the scrubber costs, deciding there was an unfavorable risk/reward profile and questionable overall environmental impact of using scrubbers.

The early stage of the pandemic and subsequent economic crisis makes it difficult to predict the impact on the real estate segment. According to Deutsche Bank Research, both residential and commercial properties prices are expected to decline in the short term, due to limited demand from businesses and households operating in 'crisis mode'. However, this effect should be partially offset by investment capital fleeing to safe havens, such as real estate assets in developed economies, Germany in particular. Although the residential segment is normally considered more resilient to market downturns, commercial properties in attractive locations may prove to be somewhat defensive as well.

Valuation: Market cap to AUM ratio below peers

We believe the relevant peer group for ERAG should contain local asset investors and managers active in the shipping and/or real estate domain, with an operating focus skewed towards the former asset class. Consequently, we believe MPC Capital is the closest competitor to ERAG. Due to a lack of similar listed companies in the local market, we have supplemented the peer group with companies operating in the real estate segment. As consensus estimates for ERAG are unavailable, we have used actual 2019 results to compare the valuation of the group. Based on P/E and EV/EBITDA multiples, the company trades at a slight premium to its peers. It is worth noting, however, that 2020 consensus estimates for MPC Capital assume a decline in earnings, driven by the coronavirus impact, which is in line with ERAG management's guidance of lower earnings in FY20, although the extent of this is difficult to predict.

As ERAG's earnings partly depend on the size of its AUM, it is instructive to examine the market cap/AUM ratios for the company and its peers based on last reported figures. ERAG's market cap represents c 1.0% of its AUM, below the figures for MPC Capital (1.1%), Corestate Capital (1.5%) and Patrizia (4.3%).

Exhibit 2: Peer group comparison

	Market cap	P/E (x)			EV/EBITDA (x)		
	(€m)	2019	2020e	2021e	2019	2020e	2021e
MPC Capital	48	NM	NM	20.4	NM	NM	15.0
Corestate Capital	402	3.7	3.8	3.1	5.1	6.3	5.3
Patrizia	1,865	35.1	21.6	20.4	11.9	10.8	10.5
VIB Vermogen	698	11.0	11.0	9.6	14.7	16.9	15.7
TLG Immobilien	1,809	3.0	11.0	9.9	4.7	21.2	20.3
Peer average		**13.2**	**11.9**	**12.7**	**9.1**	**13.8**	**13.4**
Ernst Russ	19	12.8			7.1		
Premium/(discount) to peers		**(3%)**			**(22%)**		

Source: Ernst Russ, Refinitiv. Note: Priced at 4 May 2020.

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