EDISON

Mercia Asset Management

A safe haven for investors awaiting the upturn

Company outlook

Investment companies

As a regionally focused specialist asset manager, Mercia does not expect to experience the same highs and lows in valuations seen in more international growth markets. Mercia offers a defensible UK regional proposition, well aligned to the government's levelling-up and SME agendas, with its venture portfolio supplemented by private equity and debt funds, investing across the digital media, software, life sciences and engineering sectors. With recurring fee income from FUM of £758m at 31 March 2022, Mercia has demonstrated that its model is sustainably profitable net of central costs. This allows management to offer a progressive dividend policy, with an FY22 dividend yield of 2.7%. Management's strategy is to grow FUM organically, supplemented by M&A, further building recurring fee income. Mercia's shares trade at a steep discount to NAV and on an FY22 P/E of just 5x.

Period end	Net cash* (£m)	Direct investments (£m)	FUM (£m)	NAV (£m)	NAV per share (p)	P/NAV (x)
03/20	30.2	87.5	658.0	141.5	32.1	0.92
03/21	54.7	96.2	764.0	176.0	40.0	0.74
09/21	52.1	110.3	762.0	186.4	42.4	0.70
03/22	61.3	119.6	758.0	200.6	45.6	0.65

Note: *Includes liquid securities but not funds held on behalf of fund investors.

FY22 a record year for Mercia

Mercia reported revenue (excluding performance fees) of £20.6m in FY22, with 95% of revenues from its fund management operations and 87% contracted and recurring. For a second year, revenues comfortably exceeded group administrative expenses (FY22: £16.6m), making Mercia structurally profitable. PAT of £26.1m was boosted by a gain on disposal of £9.9m from the sale of Faradion (4.2x ROI, IRR of 72%), with EPS of 5.93p. Mercia reported cash and short-term liquidity investments of £61m and declared a total dividend of 0.8p, offering a yield of 2.7%.

Outlook: Vision 20:20 sets the agenda

Mercia has delivered a direct investment portfolio IRR of 15% from its IPO in 2014 and a NAV per share CAGR of 19% in FY20–22 (following acquisition of the Northern VCT fund management business in 2019). FY22 was Mercia's first year under its three-year Vision 20:20 strategy, targeting average annual PBT of £20m in FY22–24e (£60m total over the three-year period) as well as average growth in AUM of 20%. Mercia's FY22 PBT was £27.4m, with AUM of £959m, passing the £1bn mark post year-end. By our calculations, Vision 20:20 implies a 25% CAGR to reach AUM of £1.5bn by FY24. M&A would make the AUM target easier to achieve.

Valuation: 0.65x NAV, 5x P/E, 2.7% yield in FY22

Mercia trades on 0.65x its FY22 NAV/share (45.6p), placing it towards the middle of our field of direct investment peers, which largely trade between 0.4x and 0.75x NAV. This is before considering the incremental value of the third-party funds business, which we estimate adds 7p per share at 4% of FUM. Mercia trades on a P/E of 5x FY22 EPS (vs consensus FY22 P/E multiples for Gresham House and Intermediate Capital Group of 16x and 12x, respectively), as well as offering a 2.7% historical dividend yield. Mercia has substantial cash reserves (FY22: £61.3m) to support its portfolio and for further M&A, which would drive growth in FUM and fee income.

29 July 2022

Price	**29.5p**
Market cap	**£130m**
Net cash (£m) at 31 March 2022	61.3
Shares in issue	440.1m
Free float	73%
Code	MERC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	0.7	(11.9)	(14.5)
Rel (local)	0.0	(9.7)	(15.3)
52-week high/low		43.25p	28.25p

Business description

Mercia Asset Management is a regionally focused specialist asset manager. Its stated intent is to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m.

Next event

AGM	September 2022
H123 interim results	December 2022

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Edison profile page

Mercia Asset Management is a research client of Edison Investment Research Limited

Investment summary

A scaling, structurally profitable, specialist asset manager

Mercia is a specialist asset manager with a stated intent to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m. Mercia tends to invest in businesses with relatively modest capital needs, up to c £20m in total across multiple funding rounds. The upside of targeting regional markets is that competition for investments is lower and these markets tend to be less exposed to the extreme valuation swings (as we are experiencing) in mainstream markets through the economic cycle.

Mercia provides growth capital to private companies in the UK's regions. It offers a blended investment model, with net fee income from its third-party managed funds (valued at a percentage of funds under management) allowing it to commit to a progressive dividend policy, while its maturing portfolio of direct balance sheet investments (valued relative to net asset value) now offers an evergreen balance sheet where future investments are covered by net portfolio realisations.

At its simplest, net fee income covers operational costs, while realisations from the balance sheet direct portfolio offer the opportunity for super-returns. We do not believe the market adequately recognises the value of Mercia's risk-balanced strategy, nor does it appear to assign full value for the fund management business.

Three-year strategy, Mercia's 20:20 vision

In 2021, management set out its strategic goals for FY22–24 in Vision 20:20, including average annual growth in AUM of 20% over the period (with a target for AUM to reach £1.5bn by FY24) and average PBT of £20m per year, or total PBT of £60m over the three-year period.

Growth in AUM will be driven by returns on direct balance sheet holdings, as well as growth in third-party funds under management (FUM). Returns from the direct investment portfolio will also contribute to the £60m of combined PBT targeted in FY22–24, of which it has achieved 46% in the first year of the strategy. With the greater cash resources available following recent exits, management intends to increase the size of its average equity holdings, taking direct investment stakes of at least 10% in a diversified portfolio of up to 30 companies (versus 20 at 31 March 2022). The group also intends to grow FUM organically, including providing seed funding for the launch of new funds, as well as through M&A.

If Mercia can achieve these strategic objectives, we anticipate it would lead to further substantial share price gains in the period up to FY24.

Mercia, a defensive proposition for challenged markets

Valuations for the direct investor sector have fallen significantly over the last six months, with concerns over rising interest rates, high technology valuations, inflation and the war in Ukraine. This has caused discounts to NAV in the sector to widen materially (now 0.43–0.86x historical NAV). However, in a more challenged investment scenario, Mercia's model has identifiable downside protection, with its broad regional footprint aligned with the government's levelling-up agenda, offering an investment portfolio diversified across both asset class and sector, and a model that is sustainably profitable and dividend generating. UK regional investment multiples remain far more subdued than investments in more competitive, global markets and Mercia has the cash to support its portfolio, as well as to take advantage of lower investment pricing. Finally, Mercia's balance sheet portfolio has a relative lack of public market exposure, with only around 1% of its direct investments (by value) quoted.

Financials: Cash generative, profitable and scaling

Mercia reported a 2% rise in AUM to £959m in FY22 (FY21: £940m), a resilient performance considering that distributions to investors came to £90m and given the market falls seen in 2022. Third-party FUM fell by 1% to £758m in FY22 (FY21: £764m), with £87m of the distributions noted above again a key factor. Net assets for FY22 were £201m (FY21: £176m), with unrestricted cash and liquid investments of £61m (FY21: £55m) and NAV per share growing by 14% to 45.6p (FY20: 40.0p). Hard NAV (portfolio fair value plus net cash) rose by 20% to £181m for H122 (41.1p per share) from £151m (34.3p per share) for FY21.

19% NAV/share CAGR in FY20–22

Mercia's NAV per share track record was interrupted by the acquisition of the Northern VCT fund management business in December 2019, when the company placed shares at a discount to NAV to part fund the acquisition. However, Mercia has delivered a direct investment portfolio IRR of 15% from its IPO in 2014 to 31 March 2022, as well as annual growth in NAV per share of 19% over the last two years (FY20–22). Mercia's Vision 20:20 strategy targets FY24 closing AUM of £1.5bn, implying a CAGR of 25% in FY23–24. Mercia trades on an historical FY22 P/E multiple of 5x.

Focus increasingly moving towards M&A

With £61m of unrestricted cash on the balance sheet as at 31 March 2022 and a cash-generative model, management has indicated that it will look to supplement organic growth with M&A around the group's core and/or complementary competencies. Having demonstrated the success of the acquisition of the Northern VCT funds in 2019 for £25m (£270m FUM, 6.3x PBT) and Enterprise Ventures Group in 2016 for £11m (£200m FUM, 7.9x PBT), we believe Mercia has the means and the rationale to target further M&A opportunistically, without recourse to the markets. Acquisitions are expected to be earnings enhancing, targeting businesses with similar fee structures that will increase UK market FUM and therefore recurring fee income.

Scale will allow Mercia to fully benefit from its hybrid model

Management has carried out the majority of the work of scaling a regional investment franchise, having built a sustainably profitable, cash-generative specialist asset manager. This model delivers high levels of contracted recurring revenue (87% of FY22 fee income) that fully offset central costs, as well as seeding the market to provide a filtered pipeline of opportunities for Mercia's direct investment portfolio. For these reasons, we believe Mercia offers investors an attractive balance of risk and reward as a cash-generative business, with increasing upside from portfolio realisations (eight cash exits to date) and a proven, mature business model.

Sensitivities

Mercia has successfully built a broad-based and resilient business, deploying capital into private companies based on a UK regional footprint. As a people-based business, the company remains reliant on its senior investment team, the team's network and its market reputation to attract the best businesses in which to invest. The direct investment portfolio relies on Mercia's managed funds as an effective sourcing network. As the direct portfolio builds in scale and maturity, the company will need to ensure efficient recycling of capital to deliver its evergreen funding model. Realisations depend critically on the state of the market, the valuations of quoted peers and investor appetite to continue to fund high-growth companies.

Valuation: A highly resilient layered model

Mercia trades on 0.65x its FY22 NAV/share (45.6p), placing it towards the middle of its direct investment peers, which trade between 0.43x and 0.86x NAV. This is before considering the incremental value of Mercia's third-party funds business, which we estimate adds an additional 7p per share at 4% of FUM. Mercia trades on a P/E of 5x FY22 EPS (versus consensus FY22 P/E multiples for Gresham House and Intermediate Capital Group (ICG) of 16x and 12x, respectively), as well as offering a 2.7% historical dividend yield. Mercia has substantial cash reserves (FY22: £61.3m) to support its portfolio as well as for further M&A, to drive growth in FUM and fee income through acquisitions. We believe these characteristics (broad regional footprint, profitable model with high recurring revenue, ability to scale through M&A) make Mercia an attractive investment for investors positioning ahead of the upturn.

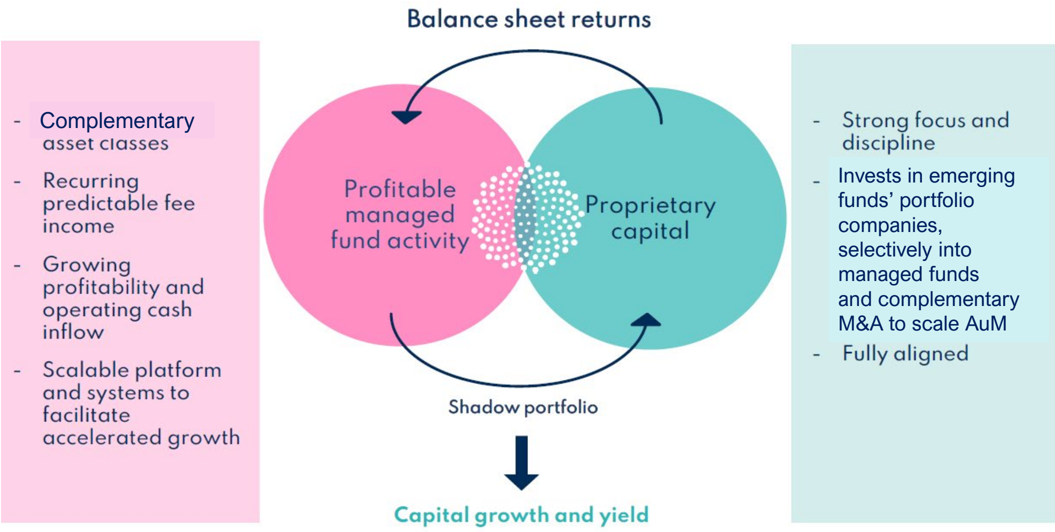
Specialist asset manager focused on the UK regions

Mercia is a specialist asset manager with a stated intent to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m. It targets businesses in its regional markets (in England, the North, North East, North West, Midlands and Scotland) with relatively modest capital needs, generally up to c £20m in total, across multiple rounds.

Mercia's 'Complete Connected Capital' model

Mercia's diversified investment model means it can offer the right type of capital for high-growth businesses at different stages of maturity. It also offers investment options, whether for private investors interested in tax-efficient saving via Mercia's enterprise investment scheme (EIS) or Northern VCT (venture capital trust) funds, or institutional investors seeking investment in long-term debt, private equity or VC (venture capital) funds. Any investor can also become a shareholder in Mercia Asset Management PLC, allowing multiple channels to invest in the group.

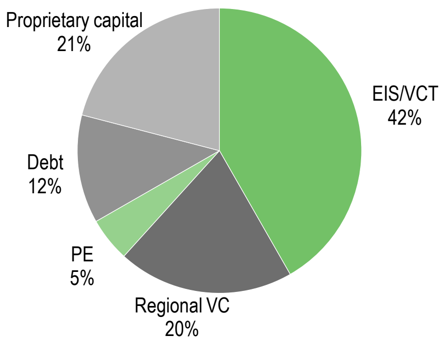
Exhibit 1: Funds and balance sheet offer a complementary model



Source: Mercia, FY22 results presentation

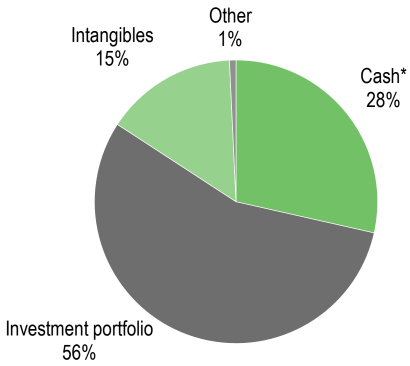
Mercia's investment model is to target appropriately priced regional businesses seeking modest capital, in part, to protect Mercia from major cyclical price corrections. The group offers a spectrum of capital including, SEIS, EIS, VCT, VC, private equity and debt funding.

Exhibit 2: FY22 AUM breakdown



Source: Mercia

Exhibit 3: Breakdown of FY22 total assets



Source: Mercia. Note: *Cash includes liquid assets.

Mercia invests from four pools of owned or managed capital (Exhibit 2):

- PLC balance sheet (FY22: £120m portfolio fair value, £61m unrestricted cash).
- Venture (including Northern Venture Manager (NVM) VCT fund management business) (FY22: £592m).
- Private equity (FY22: £48m).
- Debt (FY22: £118m).

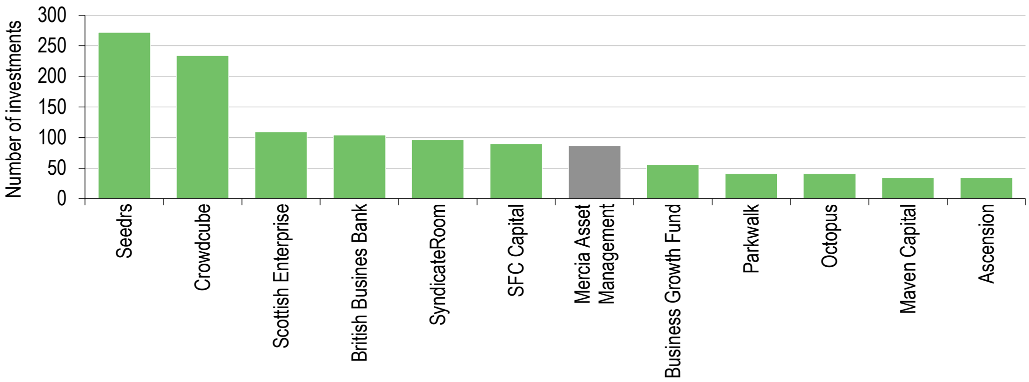
Venture, including the NVM VCT fund management business, EIS and proprietary capital, represents the substantial majority (FY22: 62%) of group AUM. Proprietary capital, including direct investment portfolio (later-stage venture) and balance sheet cash makes up a further 21% of assets, taking the total venture allocation to 83% of AUM. This leaves private equity (5%) and debt (12%) representing the remaining minority.

In FY22, AUM rose 2% to £959m (FY21: £940m), a resilient performance considering total distributions of £90m in the year, as well as the market falls seen in 2022. Third-party FUM fell by 1% to £758m in FY22 (FY21: £764m), including distributions to outside investors of £87m.

Strategy: A scaling specialist asset manager

Mercia has set itself a target of being one of the leading regional providers of supportive balance sheet, VC, private equity and debt capital in transaction sizes typically below £10m in its targeted regional markets (in England, the North, North East, North West, Midlands and Scotland). Research from Beauhurst (The Deal 2021) shows that Mercia was, once again, one of the most active VC investors nationally in 2021 (as it was in 2020). Ahead of Mercia in Beauhurst's 2021 rankings (Exhibit 4) are three crowdfunding companies, two government funds and one angel network.

Exhibit 4: The most active UK investors in 2021



Source: Beauhurst, The Deal 2021

Deal sourcing: Direct investing and fund deal flow

Mercia's third-party fund business is critical to the group's overall success as its direct balance sheet investments are all sourced through its third-party fund investments. Mercia's strategy allows management to identify the best opportunities from the regions to bring to its balance sheet.

Historically, Mercia has been closely associated with IP commercialisation, using its university links and partnerships to attract and qualify deal flow. Through its 19 ongoing university partnerships, IP commercialisation remains an integral element of Mercia's overall investment proposition. However, this categorisation no longer reflects the growth of the business nor the diversity of its deal sourcing. Today the IP commercialisation channel represents only one of five principal sources of deal flow, the others being direct sourcing from Mercia's own network, client referrals, adviser referrals and investee company cross-referrals.

Mercia's direct portfolio

The value of Mercia's direct investment portfolio at FY22 year-end rose to £120m, a 24% increase year-on-year (FY21: £96m), with Mercia making gross investments of £18.4m (£8.5m net investment) into 15 portfolio companies (FY21: £4.9m net realisation, 18 portfolio companies). In line with previous reporting periods, Mercia's top 20 direct investments represented 99% of total portfolio value at 31 March 2022, with the top 10 representing 81% of total portfolio value. Mercia weights its efforts accordingly, with £11.1m of the £18.4m total investment committed across the top 10 assets.

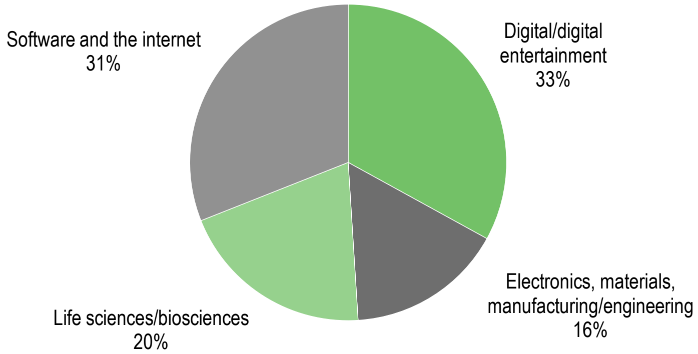
Diversified sector focus

The group divides its portfolio into four principal sectors:

- **Software and the internet:** artificial intelligence, cybersecurity, SaaS, analytical tools, adtech.
- **Digital and digital entertainment:** VR, augmented reality, gaming/content, serious games.
- **Electronics, materials, manufacturing/engineering (EMME):** energy, communications, high-value electronics, manufacturing applications.
- **Life sciences and biosciences:** diagnostics, digital health, medical devices, synthetic biology.

The direct investment portfolio is balanced across these four sectors.

Exhibit 5: Direct investment portfolio balanced across sectors (FY22 by value)



Source: Mercia, Edison Investment Research

Current focus areas for Mercia's investment team include digital health, business efficiency, energy transition and enabling technology.

Portfolio driven by sale of Faradion and a major up-round for nDreams

Although half the top 20 holdings recognised increases in fair value in FY22, the sale of Faradion and an up-round for nDreams were the two major highlights (Exhibit 7). The value of Mercia's top 10 holdings increased by 28% over FY22.

In January 2022, Mercia announced the sale of its second largest holding, Faradion (a leading sodium-ion battery technology company), for £100m to Reliance New Energy Solar, a subsidiary of India's Reliance Industries. Mercia received total cash proceeds of £19.4m from the sale, an uplift of approximately 50% over Faradion's carrying value of £12.9m at 30 September 2021. The sale delivered a 4.2x return on Mercia's direct investment cost of £4.4m and an internal rate of return (IRR) of c 72%.

Mercia's largest direct investment, nDreams, a VR games developer and publisher, completed a £20.0m third-party funding round with Aonic (aonic.co) a Stockholm-based video games investor (Mercia invested £1.3m in a prior round during the year). At year-end, Mercia held a 33.2% stake in nDreams valued at £25.8m, a rise of £6.7m from its FY21 carrying value.

Exhibit 6: Following its latest funding round, nDreams is targeting VR market leadership

Source: Mercia, nDreams

At the other end of the spectrum, the publicly traded share price of MyHealthChecked (COVID-19 travel tests, £2.9m write-down) remained under pressure, although its financial results have remained positive.

Further details on Mercia's top 10 direct holdings can be found in the appendix.

Exhibit 7: Direct investment portfolio at 31 March 2022 (£000s)

Holding	Year of first direct investment	Net value 1/4/21	Net cash invested FY22	Investment realisations FY22	Realisations FY22	Fair value change FY22	Net value 1/4/22	Holding as % of total portfolio fair value	Cumulative holding as % of total
nDreams	2014	17,726	1,301	-	-	6,734	25,761	21.5	22
Intechnica	2017	9,996	1,531	-	-	2,884	14,411	12.1	34
Voxpopme	2018	8,845	1,500	-	-	166	10,511	8.8	42
Impression Technologies	2015	8,622	1,750	-	-	-	10,372	8.7	51
Medherant	2016	8,105	534	-	-	350	8,989	7.5	59
Warwick Acoustics	2014	4,255	1,039	-	-	1,012	6,306	5.3	64
Ton UK (Intelligent Positioning)	2015	4,913	660	-	-	501	6,074	5.1	69
VirtTrade (Avid Games)	2015	2,812	1,096	-	-	1,479	5,387	4.5	73
Locate Bio	2018	3,006	1,664	-	-	188	4,858	4.1	78
Invincibles Studio (Soccer Manager)	2015	3,553	-	-	-	1,047	4,600	3.8	81
Eyoto Group	2017	1,813	1,147	-	-	-	2,960	2.5	84
W2 Global Data Solutions	2018	2,300	200	-	-	-	2,500	2.1	86
Sense Biodetection	2020	945	909	-	-	625	2,479	2.1	88
sureCore	2016	2,417	-	-	-	-	2,417	2.0	90
Edge Case Games	2015	2,300	-	-	-	-	2,300	1.9	92
PsiOxus Therapeutics	2015	2,407	-	-	-	(627)	1,780	1.5	93
Forensic Analytics	2021	-	1,750	-	-	-	1,750	1.5	95
MyHealthChecked	2016	4,488	-	-	-	(2,856)	1,632	1.4	96
MIP Discovery	2020	302	1,147	-	-	-	1,449	1.2	97
Pimberly	2021	-	1,375	-	-	-	1,375	1.2	99
Faradion	2017	5,693	738	(16,309)	9,878	-	-	-	99
Other direct investments	N/A	1,722	43	-	-	(118)	1,647	1.4	100
Total		**96,220**	**18,384**	**(16,309)**	**9,878**	**11,385**	**119,558**	**100**	

Source: Mercia Asset Management, Edison Investment Research

New direct investments and Mercia's 'shadow portfolio'

Mercia made two new investments during the year, taking its total portfolio to 23 companies. These investments were a £1.8m direct investment into Forensic Analytics, alongside a £2.7m investment by the Northern VCTs. In November 2021, Mercia's third-party managed fund portfolio company, Pimberly, completed a £4.3m funding round to expand into the US market and accelerate its growth in the UK, with Mercia investing £1.4m from its balance sheet.

Mercia's 'shadow portfolio' comprises companies from the group's broader, third-party managed fund portfolio, which Mercia is tracking closely and which may become future direct investments.

Exhibit 8: Management has identified six companies in its latest 'shadow portfolio'

Source: Mercia

Within Mercia's shadow portfolio are Axis Spine Technologies (next-generation spinal implants for anterior lumbar fixation), Nova Pangaea Technologies (uses steam to convert biomass waste into fuel and chemical precursors), Uniphy, a business developing smart surface technology aimed at the human/machine interface, Mindtech, a platform that offers a novel approach to training artificial intelligence to recognise visual images, Tribosonics (smart sensing technology for industrial use) and Dxcover, a cancer diagnostics company aiming to be a world leader in liquid biopsy and artificial intelligence for early detection of cancer and other diseases.

Management expects a number of companies to move from the shadow portfolio to the direct portfolio over the course of FY23, as the group grows its portfolio to c 30 investments.

Broadening track record of attractive exits

Mercia has a growing track record of successful exits, having received approximately £70m to date from eight full cash exits since its 2014 IPO, three of which were from its software and e-commerce portfolio, with four from life sciences investments and one company from the EMME portfolio. Mercia's latest profitable exits have included Faradion (January 2022, £9.9m gain, 4x return, 72% IRR), Oxgene (March 2021, £18.0m gain, 5x return, 51% IRR), Clear Review (October 2020, £1.0m in cash, 2x return, 72% IRR) and Native Antigen Company (July 2020, £2.5m gain, 8x return, 65% IRR). IRR and RoI figures for earlier exits are not available.

Exhibit 9: Growing track record of attractive realisations

Date	Company	Acquiror	Enterprise value	Mercia holding	Carrying value	Sale proceeds	Gain/(Loss) on exit	IRR	RoI
Dec-21	Faradion	Reliance New Energy Solar	£100m	16.4%	£9.5m	£19.4m	£9.9m	72%	4.4x
Mar-21	Oxgene	WuXi App Tec.	£96m	32.1%	£12.7m	£30.7m	£18.0m	51%	5.0x
Oct-20	Clear Review	Advanced	£26m	4.0%	£0.5m	£1.0m	£0.5m	72%	2.0x
Jul-20	Native Antigen Company	LGC	£18m	29.4%	£2.7m	£5.2m	£2.5m	65%	8.4x
Q220	Crowd Reactive	MBO	£1m	22.6%	£2.3m	£0.2m	£(2.2)m	-	-
Mar-18	Science Warehouse	Advanced	£17m	62.6%	£9.9m	£10.5m	£0.6m	-	-
Feb-17	Abzena	Sale of holding post-IPO	-	-	£0.2m	£0.2m	£0.0m	-	-
Dec-16	Allinea	ARM	£18m	16.6%	£1.9m	£3.0m	£1.1m	-	-
Total					**£40m**	**£70m**	**£31m**		

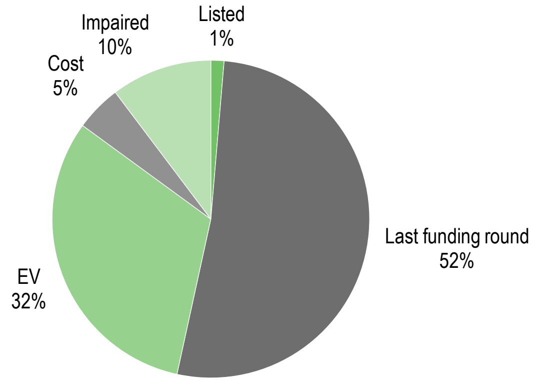
Source: Mercia, Edison Investment Research

A prudent 'hand-on-the-heart' approach to valuation

Mercia follows the International Private Equity and Venture Capital Valuation (IPEV) Guidelines, which set out best practice where private investments are reported at 'fair value'. As can be seen from Exhibit 10, more than half of the FY22 portfolio value was based on the price of the latest investment round, with 5% held at cost and 10% at impaired valuations. Mercia's balance sheet portfolio has a relative lack of public market exposure, with only around 1% of its direct investments (by value) quoted.

The remaining 32% of valuations use calibrated valuation approaches, including a discounted cash flow (DCF), but with a 'hand-on-the-heart' final review meaning that management believes a reasonable change in estimate would not result in a material change in the value of an investment.

Exhibit 10: Valuation approach for the direct investment portfolio (FY22)



Source: Mercia

The price of the latest funding round is still the most relevant technique to measure fair value for early-stage investments. However, the group also takes into consideration time elapsed since the investment round, the company's performance and external market factors to help inform its judgements.

Mercia applies the price of a recent investment for up to six months after the last funding round, subject to there being no material change in the investee company's prospects. Beyond six months, Mercia seeks assurance that the investee company is progressing against its development milestones. After 18 months from the last funding round, Mercia looks to a calibrated valuation using a DCF methodology.

ESG: Making a positive impact in the regions

Management is committed to evolving its responsible investment agenda, guided by the UN's Principles for Responsible Investment, recognising that environmental, social and governance (ESG) awareness is associated with better business performance. Mercia's history of making a positive impact in the regions (both in terms of investment and employment) reflects its core corporate values as well as its motivation to enhance financial returns.

Over the last 12 months:

- Mercia has established a dedicated ESG team representing all parts of the group, led by Jill Williams, a director in the private equity team, and including Mark Payton, Mercia's CEO.
- Mercia has been accredited carbon-neutral.

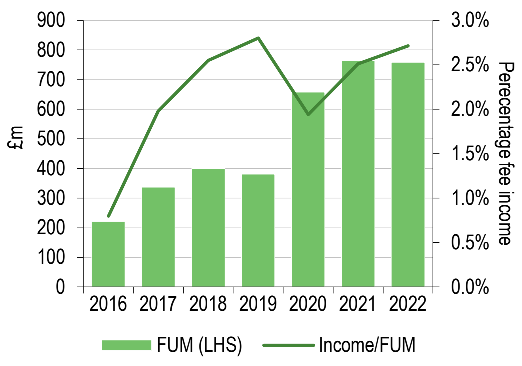
- The group has launched its first EIS-qualifying Knowledge-intensive Impact Fund, expected to be the first in a series of annual funds. The fund will invest in businesses that generate a positive impact, providing solutions to social or environmental challenges.
- Mercia has already delivered improved diversity and inclusion in its business, with 39% of staff being female (of its 120 employees across eight regional offices), including 20% of the investment team and two of its five NEDs.

Financials

Predictable third-party fund management revenues

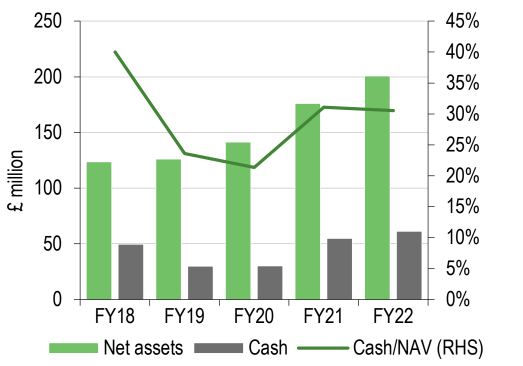
Mercia reported record gross performance fees in FY22 of £2.6m (FY21: £4.2m) and net performance fees of £1.6m (FY21: £3.8m), based on the continuing strong market conditions seen in 2021. Excluding these performance fees, group revenues increased 7% to £20.6m (FY21: £19.2m), with 95% of revenues (FY21: 96%) coming from its fund management activities and 87% (FY21: 88%) of revenues contracted and recurring. Fund management fees represented 2.7% of closing FY22 FUM (FY21: 2.5%).

Exhibit 11: Fee income as % of FUM



Source: Company, Edison Investment Research

Exhibit 12: Mercia retains a solid cash buffer



Source: Company, Edison Investment Research. Note: Cash includes liquid investments.

Administrative expenses (adjusted for performance fees) increased by 5% to £16.6m (FY21: £15.9m), more than covered by Mercia's recurring management fees for a second successive year. Adjusted operating profit more than doubled to £8.4m (FY21: £3.3m), mainly due to net finance income soaring to £4.4m in FY22 (FY21: £0.05m), partly as a result of the disposal of Mercia's stake in Faradion, which crystallised convertible loan interest and provided a redemption premium. For the record, adjusted operating profit is defined as operating profit before performance fees net of variable compensation, realised gains on disposal of investments, fair value movements in investments, share-based payments charge, depreciation, amortisation of intangible assets, movement in fair value of deferred consideration and exceptional items. It includes net finance income.

Mercia's recurring fee income is not captured by a NAV valuation

Research carried out by Marco Bigelli and Fabio Manuzzi (The valuation of asset management firms, 2019) found that the average value of asset management firms was 3% of assets under management (AUM) based on average annual fees of 1% of AUM, with higher valuations significantly positively correlated to higher fee percentages.

As set out above, Mercia's average fees of 2.7% of FUM in FY22 are materially above the benchmark. On this basis, we would propose to reflect the value of the group's fee-earning funds business at 4% of FUM. With FUM of £758m, this implies a valuation for the funds business of £30m, or 7p per share, on top of the FY22 NAV of 45.6p.

Aggregated PBT for FY21 and FY22 in excess of £61m

On an IFRS basis and against a very tough comparator in FY21, FY22 operating profit fell by 32% to £22.9m (FY21: £34.0m), with PBT of £27.4m (FY21: £34.0m) and PAT falling to £26.1m (FY21: £34.5m). This was despite FY22 gains on disposal of £9.9m (from Faradion), which were still lower than the £20.3m of gains in FY21 (from Oxgene, Native Antigen Company and Clear Review).

Mercia's tax losses now substantially used up

FY22 was the first year that Mercia paid meaningful tax (4.6%), as historical tax losses have now largely been used up, although a potential deferred tax asset of £4.4m (FY21: £5.7m) for cumulative unrelieved management expenses and other tax losses has not been recognised in the FY22 accounts as its future use is uncertain. The majority of the FY22 tax charge relates to an allowance for the increase in corporation tax from 19% to 25% from 1 April 2023, with the group's deferred tax liability calculated at a rate of 25% at 31 March 2022 (from 19% previously). However, despite the impending increase in corporate tax rate and paucity of remaining tax losses, gains on disposal by a company like Mercia are often exempt from corporation tax as they are sheltered by the substantial shareholding exemption.

Record levels of cash provide a valuable strategic buffer

In FY22, the group held cash and short-term liquidity investments of £61m (FY21: £55m). Mercia's record balance of cash and liquid investments represents 28% of FY22 total assets (Exhibit 3), offering a significant buffer to support the existing portfolio, make new investments as well as for potential future M&A.

FY22 dividend of 0.8p offers a 2.7% dividend yield

As part of a progressive dividend policy, Mercia declared a final dividend of 0.5p (FY21: 0.3p), taking the total dividend for FY22 to 0.8p (FY21: 0.4p). At the current share price, Mercia's shares offer a yield of 2.7%.

FY22 net assets rose 14% to £201m, with NAV/share of 45.6p

FY22 net assets rose by 14% y-o-y to £200.6m (FY21: £176.0m), with unrestricted cash and short-term liquidity investments of £61.3m (FY21: £54.7m) and total liquidity across the group of c £297m. Hard NAV (portfolio fair value plus net cash) rose by 20% to £180.8m in FY22 (41.1p per share) from £150.9m (34.3p per share) in FY21, rising at a 24% CAGR in FY20–22. Net assets per share rose by 14% to 45.6p (FY21: 40.0p), with a two-year CAGR of 19% in FY20–22.

Valuation: 0.65x NAV, 5x P/E, 2.7% yield in FY22

As a specialist fund manager, Mercia's financial performance centres around realised gains, the growth in fair value of its direct investment portfolio on its balance sheet, together with the growth in FUM and the predictable, recurring management fees that result. Mercia is unusual in that its fee income more than covers central costs, meaning that it can point to a growing stream of post-tax profits and sustain a progressive dividend policy.

Valuations for the direct investor sector have fallen significantly over the last six months, with concerns over rising interest rates, high technology valuations, inflation and the war in Ukraine. However, in a more challenged investment scenario, Mercia's model has identifiable downside protection, with its broad regional footprint aligned with the government's levelling-up agenda, offering an investment portfolio diversified across both asset class and sector, and a model that is sustainably profitable and dividend generating. Mercia's balance sheet portfolio also has a relative lack of public market exposure, with only around 1% of its direct investments (by value) quoted.

Exhibit 13: Quoted peer group

	Price	Currency	Market cap (£m)	Last NAV reported (£m)	Net cash/ (debt) (£m)	NAV per share (p)	NAV premium/ discount
Mercia Asset Management	29.5	GBp	128	201	61	45.6	0.65
Specialist asset managers							
Gresham House	867.0	GBp	328	148	40	366.6	2.36
Intermediate Capital Group	1415.5	GBp	4,070	1,995	461	696.0	3.89
Mean							**3.13**
Direct investors							
Augmentum Fintech	113.3	GBp	201	295	61	155.2	0.73
Forward Partners	45.0	GBp	60	140	31	104.0	0.43
HgCapital Trust	372.5	GBp	1,689	1,984	(136)	433.1	0.86
IP Group	79.0	GBp	809	1,436	270	139.0	0.57
Molten Ventures	442.4	GBp	670	1,434	48	937.0	0.47
Oakley Capital Investments	427.5	GBp	752	1,020	180	571.0	0.75
TMT Investments	3.85	USD	121	283	19	9.00	0.43
Mean							**0.61**
Median							**0.67**

Source: Company accounts, Refinitiv. Note: Priced at 28 July 2022.

Mercia trades on 0.65x its FY22 NAV/share (45.6p), placing it towards the middle of our field of direct investment peers, which trade between 0.43x and 0.83x NAV. This is before considering the incremental value of the third-party funds business, which we estimate adds an additional 7p per share at 4% of FUM. However, when we look at forward multiples (which take into account the full extent of recent market turbulence) for specialist asset managers such as Gresham House (with no material balance sheet investments) and ICG, trading at consensus FY22 P/E multiples of 16x and 12x, respectively, we can see there is plenty of upside potential ahead as FUM scale. Mercia trades on a P/E of 5x FY22 EPS and offers a 2.7% historical dividend yield.

Given Mercia's defensive characteristics, the strength of its business, its structural profitability and underlying operating model, we believe it remains undervalued at these levels.

Adjusted NAV/share of 52.5p including the funds business

Thanks to the fees it charges on its third-party managed funds (2.7% of FUM), of which c 87% were contracted and recurring in FY22, Mercia is structurally profitable and can sustain a progressive dividend policy. A NAV-based valuation fails to capture the incremental value of this fund management business, an ever-widening gap as FUM increases.

We continue to estimate the value of Mercia's embedded fee-earning funds business at 4% of FUM (at what we believe is a conservative valuation considering Mercia's attractive fee margins) on top of the NAV-based valuation of its direct investment business. Given the last reported FUM was £758m, this delivers a valuation for the funds business of c £30m, or 7p per share on top of the FY22 NAV of 45.6p per share, implying a hybrid valuation of 52.5p per share.

Risk factors

A summary of the principal risk factors relating to Mercia is set out below:

- **Early-stage business risk:** the early-stage nature of Mercia's portfolio businesses carries a high degree of risk, with Mercia also exposed to risks related to non-controlling investments. Not all of the fund investments will achieve their hoped-for potential.
- **Portfolio concentration:** Mercia holds a relatively concentrated portfolio of investments. Realisations and investor returns may be dominated by a small number of investee companies.

- **Reputation and deal flow:** Mercia is reliant on the reputation of its senior investment team, its strategic contacts and ecosystem to source appropriate deal flow and deliver the quality of investment opportunity to drive attractive investment returns.
- **Sector risk:** the company is subject to risks associated with developments in the digital entertainment (33% by value), software and services (31% by value), life sciences (20% by value), and engineering and materials (16% by value) sectors, including the cyclicality of sector valuations, as well as other unforeseen future developments.
- **Valuation risk:** Mercia's investments are difficult to value accurately, with valuation methodologies subject to significant subjectivity. There can be no assurance that the reported values of the company's investments will be realised.
- **Liquidity events:** exits are uncertain and difficult to predict and proceeds from trade sales/IPOs are likely to vary substantially from year to year, with the potential for liquidity events to slow if valuations fall.

Exhibit 14: Financial summary

Year end 31 March	£'000s	2018	2019	2020	2021	2022
INCOME STATEMENT		IFRS	IFRS	IFRS	IFRS	IFRS
Revenue		10,197	10,675	12,747	23,410	23,183
Cost of Sales		-	-	-	-	-
Gross Profit		10,197	10,675	12,747	23,410	23,183
Operating costs		(10,633)	(12,115)	(12,661)	(16,554)	(17,857)
Adjusted operating profit/(loss)		(81)	(794)	518	3,337	8,395
Fair value changes		2,823	3,916	(15,844)	9,723	10,863
Realised gains		871	-	-	20,251	9,878
Normalised operating profit		3,258	2,476	(15,758)	36,830	26,067
Amortisation of acquired intangibles		(301)	(301)	(852)	(2,317)	(2,033)
Exceptionals		(1,125)	-	(695)	-	-
Share-based payments		(497)	(171)	(528)	(543)	(1,109)
Reported operating profit		1,335	2,004	(17,833)	33,970	22,925
Net Interest		274	562	220	48	4,437
Profit Before Tax (norm)		3,532	3,038	(15,538)	36,878	30,504
Profit Before Tax (reported)		1,609	2,566	(17,613)	34,018	27,362
Reported tax		54	54	159	440	(1,262)
Profit After Tax (norm)		3,532	3,038	(15,538)	36,878	27,454
Profit After Tax (reported)		1,663	2,620	(17,454)	34,458	26,100
Net income (normalised)		3,532	3,038	(15,538)	36,878	27,454
Net income (reported)		1,663	2,620	(17,454)	34,458	26,100
Basic average number of shares outstanding (m)		302	303	341	440	440
EPS - basic normalised (p)		1.17	1.00	(4.55)	8.38	6.24
EPS - diluted normalised (p)		1.13	1.00	(4.55)	8.38	6.12
EPS - basic reported (p)		0.55	0.86	(5.11)	7.83	5.93
Dividend (p)		0.00	0.00	0.00	0.40	0.80
Revenue growth (%)		53.1	4.7	19.4	83.7	-
Gross Margin (%)		100.0	100.0	100.0	100.0	100.0
Normalised Operating Margin		32.0	23.2	(123.6)	157.3	112.4
BALANCE SHEET						
Fixed Assets		77,428	98,724	124,899	131,171	152,443
Intangible Assets		11,213	10,912	36,705	34,388	32,355
Tangible Assets		145	153	125	107	113
Right of use assets		-	-	598	456	417
Investments		66,070	87,659	87,471	96,220	119,558
Current Assets		53,965	31,180	31,951	61,269	62,358
Stocks		-	-	-	-	-
Debtors		1,057	782	1,298	4,060	1,074
Unrestricted cash		42,908	24,581	23,971	54,491	56,049
Restricted cash		3,473	629	467	2,484	-
Short term liquidity investments		6,527	5,188	6,215	234	5,235
Current Liabilities		(7,760)	(3,730)	(6,659)	(9,827)	(9,989)
Creditors		(7,760)	(3,730)	(4,805)	(8,127)	(6,963)
Lease liabilities		-	-	(118)	(122)	(157)
Short term borrowings		-	-	-	-	-
Other (including deferred consideration)		-	-	(1,736)	(1,578)	(2,869)
Long Term Liabilities		(163)	(109)	(8,731)	(6,592)	(4,223)
Long term borrowings		-	-	-	-	-
Lease liabilities		-	-	(473)	(351)	(295)
Other long-term liabilities		(163)	(109)	(8,258)	(6,241)	(3,928)
Net Assets		123,470	126,065	141,460	176,021	200,589
Minority interests		-	-	-	-	-
Shareholders' equity		123,470	126,065	141,460	176,021	200,589
NAV per share		40.71	41.56	32.14	39.99	45.58
Hard NAV per share		38.08	38.72	26.73	34.30	41.09
CASH FLOW						
Op Cash Flow before WC and tax		3,258	2,476	(15,758)	36,830	26,291
Depreciation and amortisation		81	84	212	212	224
Gain on sale of direct investments		(871)	-	-	(20,251)	(9,878)
Fair value movements in direct investments		(2,823)	(3,916)	15,844	(9,723)	(10,863)
Working capital		(87)	(3,724)	695	(1,457)	3,600
Exceptional & other		-	-	(695)	-	-
Net operating cash flow		(442)	(5,080)	298	5,611	9,374
Capex		(75)	(92)	(45)	(52)	(76)
Acquisitions/disposals		10,618	1,711	(12,400)	-	-
Net interest		260	531	245	(2)	(1)
Direct investments		(21,282)	(19,384)	(15,656)	21,640	2,363
Equity financing		-	(196)	30,000	-	-
Dividends		-	-	-	(2,540)	(2,540)
Other		25,000	4,812	(3,052)	5,863	(5,137)
Net Cash Flow		14,079	(17,698)	(610)	30,520	3,983
Opening net debt/(cash)		(28,829)	(42,908)	(24,581)	(23,971)	(54,491)
Other non-cash movements		-	(629)	-	-	-
Closing net debt/(cash)		(42,908)	(24,581)	(23,971)	(54,491)	(58,474)
Closing net debt/(cash) including short-term liquidity investments (not VCT/EIS funds)		(49,435)	(29,769)	(30,186)	(54,725)	(61,284)

Source: Company accounts

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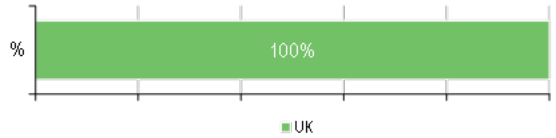
H121 revenue by geography



Management team

CEO: Dr Mark Payton

Mark has extensive private investment and scale-up experience. Since co-founding Mercia he has led the sales of Hybrid Systems (to Myotec) to create PsiOxus Therapeutics, Warwick Effect Polymers (to Polytherics) to create Abzena and led the founding investment in Allinea Software (sold to ARM).Prior to Mercia, Mark played a leading role within Oxford University Innovation (OUI, the technology transfer operation of the University of Oxford), spinning out BioAnalab (sold to Millipore), Oxford Immunotec (listed on NASDAQ), Oxitec (sold to Intrexon) and Natural Motion (sold to Zynga). Following his time at OUI, Mark was the vice president of corporate development at Oxxon Therapeutics, prior to its sale to Oxford Biomedica. He gained his PhD jointly from the University of Oxford and the University of London (King's College). Mark also has an MBA from the University of Warwick, is a Sainsbury Management Fellow for Life Sciences and was awarded the 2015 EY Entrepreneur of the Year (regional and national).

CFO: Martin Glanfield

Martin has significant public markets and business experience. He is a KPMG qualified chartered accountant with more than 20 years' experience as chief financial officer of listed, private equity-backed and privately owned technology-led businesses. He joined Forward Group in 1993 and was group financial director from 1995 until its sale for £129m in 1997. In 1999, as deputy chief executive of Symonds, Martin led the public to private of this main market-listed technology group, backed by NatWest Equity Partners. The group was successfully restructured and sold within 12 months to a Nasdaq-listed US electronics group. He was chief executive of the private equity business Forward Group from 2003 to 2005 and since then has been group finance and IT director of the large international food processing group Boparan Holdings and a private equity-backed building services business. Martin has an honours degree in business from Aston University.

CIO: Julian Viggars

Julian joined Mercia through the 2016 acquisition of Enterprise Ventures, where he was head of technology investments. He has been Mercia's CIO since April 2018 and has over 20 years of VC experience, including the successful listings of companies such as Blue Prism Group and OptiBiotix Health. Julian leads the equity investment team as well as managing the pipeline of Mercia's direct investments. Alongside his wide investment experience, he played a leading role in securing the managed funds contracts awarded by the British Business Bank and North East Fund. Julian has a geology with chemistry degree from the University of Southampton and qualified as a chartered accountant with accountants Smith & Williamson.

Non-executive chair: Ian Metcalfe

Ian has over 25 years' experience of advising businesses on their growth activities, as well as deep corporate governance experience. He was appointed senior independent director in January 2017, before becoming non-executive chair in July 2019. Ian is a qualified solicitor who retired as managing partner of international law firm Wragge & Co in 2014, after 14 years as a corporate partner, acting for public and private companies and private equity houses on a wide range of transactions. He is currently a director and chair of Commonwealth Games England, a director of the Board of the Organising Committee of the Birmingham 2022 Commonwealth Games and the host city representative on the Commonwealth Games Federation Executive Board. He is also a non-executive director of the global waste management group TRRG Holdings and a non-executive director of the AIM-listed Arena Events Group. Ian has an MA in law from Cambridge University.

Principal shareholders	(%)
Invesco	14.34
Forward Innovation Fund	8.92
Ruffer	6.97
Canaccord Genuity	5.08
Forward Group	4.95
Chelverton Asset Management	4.54
BlackRock	3.43
Hargreaves Lansdown AM	3.24
Bank of Montreal	3.13
The Hargreaves No.11 Settlement	3.18
NFU Mutual	3.03
Librae Holdings	3.00
Tchenguiz Family Trust	3.00
GPIM	3.00

Appendix

Exhibit 15: Mercia's top 10 holdings (one to five)

	nDreams	intechnica	Voxpopme	Impression Technologies	Medherant
Investment value	£25.8m	£14.4m	£10.5m	£10.4m	£9.0m
% direct holding (excludes FuM)	33.2%	24.1%	17.6%	67.3%	33.1%
Initial year of investment	2014	2017	2018	2015	2016
Description	VR developer	E-commerce/ web security	Video analytics	Aluminum pressing	Patch delivery
Board representation	Yes	Yes	Yes	Yes	Yes
Key metrics	Revenue, partnerships	Revenue, ARR	Revenue, ARR	Licences, partnerships	Regulatory, clinical, partnerships
Highlights FY22	£20.1m investment, growth	Separation of Netacea, growth	30% growth	Progress in battery boxes/ recycled aluminium	3 partners+ internal pipeline
Valuation change	↑	↑	↑	=	↑

Source: Mercia Asset Management

Exhibit 16: Mercia's top 10 holdings (six to 10)

	Warwick Acoustics		Everything	locate bio	Invincibles Studio
Investment value	£6.3m	£6.1m	£5.4m	£4.9m	£4.6m
% direct holding (excludes FuM)	40.0%	29.9%	40.6%	18.1%	39.0%
Initial year of investment	2014	2015	2015	2018	2015
Description	Flat speaker tech	Business intelligence	Mobile digital trading cards	Orthobiologics	Mobile soccer management game
Board representation	Yes	Yes	No	Yes	Yes
Key metrics	Licences, partnerships	Revenue, ARR	Revenue, partnerships	Revenue, partnerships	Revenue, partnerships
Highlights FY22	Market awareness/ OEM progress	Return to growth	Significant game revenue growth	Clinical progress	Authenticity with licenses, growth
Valuation change	↑	↑	↑	↑	↑

Source: Mercia Asset Management

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