

Mercia Asset Management

Excellent results despite the tough market

FY22 results

FY22 was the first year of Mercia's Vision 20:20 strategy, and a year of real progress for the group. Mercia reported FY22 PBT of £27.4m, with AUM rising marginally to £959m, passing the £1bn mark with £45m of VCT and EIS funds raised post-year-end. Mercia exited Faradion, its second largest holding (4.2x ROI, IRR of 72%) and also completed a major up-round for nDreams, helping to drive net assets up 14% to £200.6m and NAV per share to 45.6p. Mercia trades at 0.65x FY22 NAV/share and at 0.56x adjusted NAV/share (52.5p, including our estimate for the fund management business of 7p per share at 4% of FUM). Based on FY22 EPS of 5.9p (FY21: 7.8p), Mercia trades on a trailing P/E of 5x. With cash of £61.3m at year end, Mercia remains well placed for a downturn, with the potential for opportunistic M&A in FY23.

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 EIS investors.

FY22 results underpinned by fee income

Revenue (excluding performance fees) increased 7% to £20.6m (FY21: £19.2m), with 95% of revenues (FY21: 96%) coming from fund management fees and 87% (FY21: 88%) contracted and recurring. PAT fell 24% to £26.1m (FY21: £34.5m), largely due to lower gains on disposal of £9.9m in FY22 (FY21: £20.3m), from Faradion (4.2x ROI, IRR of 72%). EPS also fell 24% to 5.93p (FY21: 7.83p). Mercia reported cash and short-term liquidity investments of £61m (FY21: £55m). The company declared an FY22 dividend of 0.8p (FY21: 0.5p), offering a yield of 2.7%.

An electric first year for the Vision 20:20 strategy

FY22 was another year of real progress for Mercia, its first year under its three-year Vision 20:20 strategy. Mercia reported FY22 PBT of £27.4m (46% of the FY22–24 target) and a 2% rise in AUM to £959m (achieving the £1bn mark post year-end), a resilient performance given £90m of investor distributions and the market falls seen in 2022. Third-party FUM fell by 1% to £758m in FY22 (FY21: £764m), with £87m of investor distributions again a key factor. Following its acquisition of the Northern VCT fund manager, Mercia has now delivered a NAV/share CAGR FY20–22 of 19%.

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

Mercia trades on 0.65x its FY22 NAV/share (45.6p), placing Mercia 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 an additional 7p per share at 4% of FUM. Mercia trades on a P/E of 5x FY22 EPS (vs average FY21/22 P/E multiples for Gresham House and ICG of 16x and 7x, 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.

Investment companies

15 July 2022

Price **29.5p**
Market cap **£130m**

Net cash (£m) at 31 March 2022	61.3
Shares in issue	440.1m
Free float	69%
Code	MERC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	2.6	(12.6)	(16.9)
Rel (local)	5.0	(4.5)	(13.2)
52-week high/low		43.3p	28.3p

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

Analysts

Richard Williamson	+44 (0)20 3077 5700
Rob Murphy	+44 (0)20 3077 5700

tech@edisongroup.com

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Investment Research Limited**

FY22 results

Predictable third-party fund management revenues

Mercia recorded 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 fund management fees and 87% (FY21: 88%) of revenues contracted and recurring. Fund management fees represented 2.7% of closing FY22 funds under management (FUM) (FY21: 2.5%).

Exhibit 1: Mercia's key financial figures

31 March 2022:	£20.6m Group revenue*	£8.4m Adjusted operating profit	£27.4m Profit before taxation	£61.3m Unrestricted cash**	45.6p NAV/share
31 March 2021:	£19.2m*	£3.3m	£34.0m	£54.7m**	40.0p

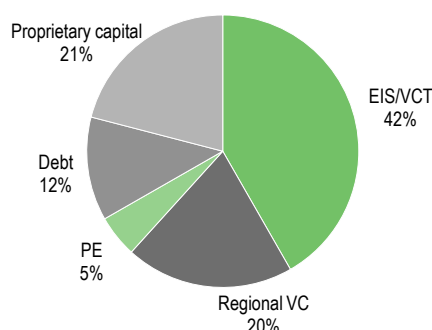
Source: Mercia Asset Management. Note: *Excludes performance fees. **Excludes funds held on behalf of EIS/VCT investors.

Admin 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 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.

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

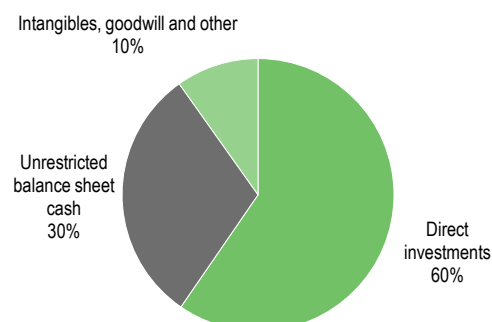
On an IFRS basis and against a very tough comparator in FY21, operating profit fell by 32% to £22.9m (FY21: £34.0m), with PBT of £27.4m (FY21: £34.0m) and PAT falling to £26.1m (FY21: £34.5m). This was despite FY22 gains on disposal of £9.9m (from Faradion), which were still lower than the £20.3m of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

Exhibit 2: Breakdown of FY22 AUM



Source: Mercia Asset Management

Exhibit 3: Cash as % of FY22 NAV



Source: Mercia Asset Management

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% as 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](#) (SSE).

Record levels of cash provide a valuable strategic buffer

The group held cash and short-term liquidity investments of £61m (FY21: £55m), part of which we expect to be deployed towards M&A in due course. Mercia's record balance of cash and liquid investments represents 30% of NAV, offering a significant buffer to support the existing portfolio, make new investments as well as support potential future M&A.

FY22 dividend of 0.8p offers a 2.7% dividend yield

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

Vision 20:20: PBT of £27.4m, AUM and FUM broadly flat

FY22 was another year of real progress for Mercia, and its first year under its three-year Vision 20:20 strategy (which targets average annual PBT of £20m FY22–24 as well as to grow assets under management (AUM) by 20% on average over this period). Mercia reported FY22 PBT of £27.4m (FY21: £34.0m) and AUM rose marginally (2% y-o-y) to £959m in FY22 (FY21: £940m), passing the £1bn mark and post-year-end, with a further £45m of [VCT](#) and [EIS](#) funds raised. The group also returned £90m of distributions to investors, including £3m of dividends to shareholders.

Third-party FUM were also largely unchanged (down 1%) over the course of FY22 at £758m (FY21: £764m), although also affected by £87m of the distributions noted above. Of FY22 FUM, 83% of funds are committed to various stages of venture (EIS, VCT, venture capital (VC) and proprietary capital) with private equity (5%) and debt (12%) the remainder.

NAV per share of 45.6p (FY20–22 CAGR of 19%)

Net assets and NAV per share both rose 14% in FY22, to £200.6m (FY21: £176.0m) and 45.6p (FY21: 40.0p), respectively, driven by the sale of Faradion (Mercia's second largest holding), a major up-round for nDreams and valuation uplifts for 10 of Mercia's top 20 holdings. Hard NAV (portfolio fair value plus net cash) and hard NAV per share climbed 20% to £180.8m and 41.1p per share (FY21: £150.9m, 34.3p per share), respectively.

Mercia trades at 0.65x FY22 NAV/share of 45.6p and at 0.56x adjusted NAV/share (52.5p, including the value of the fund management business at 4% of FUM). Following the acquisition of the Northern Venture Trust's fund manager, Mercia has delivered an FY20–22 NAV/share CAGR of 19% as well as a 24% CAGR in hard NAV/share.

Adjusted NAV/share of 52.5p including the third-party funds business

Thanks to the fees it charges on its third-party managed funds (2.1% of FUM), of which c 87% were contracted and recurring in FY22, Mercia is structurally profitable and able to sustain a progressive dividend policy. An 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. With last reported FUM of £758m, this

implies 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.

Direct investment 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) 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 total investment being invested across the top 10 assets.

Exhibit 4: 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

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

Although half the top 20 holdings recognised increases in fair value, the sale of Faradion and an up-round for nDreams were the two major highlights in FY22. 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.

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

Mercia made two new investments during the year, including 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, with Mercia investing £1.4m from its own balance sheet.

Outlook: Vision 20:20 off to a strong start

Mercia has delivered a direct investment portfolio IRR of 14% from its initial public offering in 2014 to 31 March 2022, as well as annual growth in NAV per share of 24% over the last two years, following completion of the acquisition of the Northern VCT fund management business.

Mercia's Vision 20:20 strategy targets average annual growth in AUM of 20% between 2022 and 2024 (closing AUM of £1.5bn, implying a CAGR of 25% FY23–24) and average PBT of £20m per year, or total PBT of £60m over the three-year period – of which it has achieved 46% in the first year of the strategy. Management intends to increase the size of its equity holdings, taking stakes of 10–30% in a diversified portfolio of up to 30 companies (versus 23 at 31 March 2022).

M&A appears to be front of mind

With £61m of unrestricted cash on the balance sheet as at 31 March 2022, and a cash-generative model, management has indicated 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 (£270 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, with similar fee structures, increasing UK market FUM.

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

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 quoted.

Exhibit 5: 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	130	201	61	45.6	0.65
Specialist asset managers							
Gresham House	803.0	GBp	307	148	40	367	2.19
Intermediate Capital Group	1355.0	GBp	3,937	1,995	461	696	3.89
Mean							3.04
Direct investors							
Augmentum Fintech	116.0	GBp	208	295	61	155	0.75
Forward Partners	47.5	GBp	64	102	32	104	0.46
HgCapital Trust	326.0	GBp	1,494	1,980	(93)	433	0.75
IP Group	71.7	GBp	741	1,436	270	139	0.52
Molten Ventures	412.8	GBp	632	1,434	48	937	0.44
Oakley Capital Investments	397.0	GBp	705	1,020	180	571	0.70
TMT Investments	3.70	USD	116	283	19	9.00	0.41
Mean							0.57

Source: Company accounts, Refinitiv. Note: Priced at 11 July 2022.

Mercia trades on 0.65x its FY22 NAV/share (45.6p), placing Mercia towards the middle of our field of direct investment peers, which largely trade between 0.4x and 0.75x NAV. This is even 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 specialist asset managers such as Gresham House and Intermediate Capital Group, trading at consensus FY22 P/Es of 15x and 11x, respectively, we can see there is plenty of upside potential ahead as FUM scale. Mercia trades on a P/E of 5x FY22 EPS as well as offering 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 Mercia remains undervalued at these levels.

Exhibit 6: Financial summary

Year end 31 March	£'000	2018	2019	2020	2021	2022
INCOME STATEMENT						
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
Joint ventures & associates (post tax)		0	0	0	0	0
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
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
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
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)
FX		-	-	-	-	-
Other non-cash movements		-	(629)	-	-	-
Closing net debt/(cash)		(42,908)	(24,581)	(23,971)	(54,491)	(58,474)
Closing net debt/(cash) inc short-term liquidity investments (not EIS)		(49,435)	(29,769)	(30,186)	(54,725)	(61,284)

Source: Company accounts

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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