EDISON

# Mercia Asset Management

H121 results

## The hybrid model – halfway home

Investment companies

**Mercia has demonstrated real progress on its three-year strategic plan to achieve operating profitability, expand AUM to £1bn and 'evergreen' the balance sheet by end FY22. AUM have increased to £872m, with third-party, fee-earning FUM of £722m. The group delivered an operating profit of £8.0m (H120: £2.1m), an adjusted operating profit (ex-realisations, fair value gains, etc) of £1.1m (H120: £0.6m loss) and H121 EPS of 1.87p (H120: 0.69p). Revenues are sustainable, with 87% recurring, allowing Mercia to initiate a progressive dividend policy, with a maiden interim dividend of 0.1p per share. Despite progress, Mercia's shares continue to trade at a material 20% discount to NAV (0.80x), before considering the incremental value of the third-party funds business (we estimate at 3% of FUM, or 4.9p).**

| Period end | Net cash* (£m) | Direct investments (£m) | FUM (£m) | NAV (£m) | NAV per share (p) | P/NAV (x) |
|---|---|---|---|---|---|---|
| 03/18 | 49.4 | 66.1 | 400.0 | 123.5 | 40.7 | 0.67 |
| 03/19 | 29.8 | 87.7 | 381.0 | 126.1 | 41.6 | 0.66 |
| 03/20 | 30.2 | 87.5 | 658.0 | 141.5 | 32.1 | 0.85 |
| 09/20 | 24.9 | 101.6 | 722.0 | 149.9 | 34.1 | 0.80 |

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

## Direct investment portfolio: 6% H121 NAV growth

H121 reported net assets were £149.9m (FY20: £141.5m), with unrestricted cash and liquid securities of £24.9m (FY20: £30.2m). Net assets per share grew by 6% over the period from 32.1p to 34.1p. Mercia invested £10.9m (net) into 14 portfolio companies, helping the direct investment portfolio fair value rise 16.2% to £101.6m (FY20: £87.5m). The company also delivered a profitable exit during the period (The Native Antigen Company: £1.7m gain, 8x return, 65% IRR) and another post period end (Clear Review: £1.0m in cash, 2x return, 72% IRR).

## Fund management: Scaling the hybrid model

AUM have increased to £872m up 78% from H119, with third-party, fee-earning FUM of £722m, a rise of 100% y-o-y. The group delivered a 51% increase in revenue to £8.4m (H120: £5.5m), of which 87% is annual recurring revenue from fund management and monitoring fees. Adjusted operating profit (ex-realisations, fair value gains, etc) was £1.1m (H120: £0.6m loss), with H121 EPS of 1.87p (H120: 0.69p). A profitable business, with £2.0m of operating cash flow in H121, has allowed management to initiate a progressive dividend policy, with a maiden interim dividend of 0.1p per share. We value Mercia Fund Managers (MFM) at a percentage of FUM today, but should shortly be able to value it on a multiple of earnings.

## Valuation: 0.80x NAV + £22m/4.9p for MFM

Mercia is increasingly ticking the boxes – operating profitably, scaling AUM, with a sustainable dividend policy and building towards a mature, evergreen balance sheet. Despite demonstrable progress, Mercia's shares trade at 0.80x NAV, even before considering the incremental value of MFM, which we estimate to be worth an additional 4.9p/share (from 4.5p/share) on top of NAV. Catalysts for a re-rating include further scaling of the business, revenue/earnings growth, commercialisation of the direct investment portfolio and/or successful exits.

**3 December 2020**

| | |
|---|---|
| **Price** | **27.35p** |
| **Market cap** | **£120m** |

| | |
|---|---|
| Net cash (£m) at 30 September 2020 | 24.9 |
| Shares in issue | 440.1m |
| Free float | 69.1% |
| Code | MERC |
| Primary exchange | AIM |
| Secondary exchange | N/A |

### Share price performance


| % | 1m | 3m | 12m |
|---|---|---|---|
| Abs | 42.5 | 45.9 | (14.5) |
| Rel (local) | 24.2 | 33.0 | (5.5) |
| 52-week high/low | | 28.3p | 13.8p |

### 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

| | |
|---|---|
| FY21 results | July 2021 |

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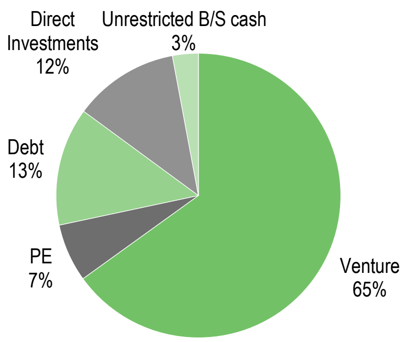
# H121 results review

## Reaping the benefits of increasing scale

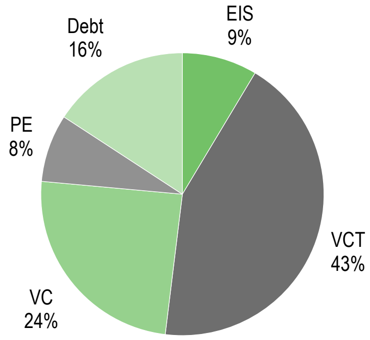
Mercia reported a 9% rise in assets under management (AUM) to £872m in H121 (FY20: £798m), highlighting the group's resilience as performance has improved across the breadth of the group's funds from the start of the COVID-19 pandemic. Third-party funds under management (FUM) rose by 10% to £722m in H121 (FY20: £658m). Growth of AUM and FUM over the last 12 months has been 78% and 100%, respectively, reflecting the contribution from the acquisition of the Northern VCT fund management business.

**Exhibit 1: H121 AUM breakdown**




Source: Mercia

**Exhibit 2: H121 FUM breakdown**




Source: Mercia

With a proportion of Mercia's revenues directly linked to asset prices, at the start of the lockdown in March 2020, management had anticipated some contraction of its revenue base. However, the group has subsequently performed better than management had expected. Mercia's performance has been achieved without any government-backed financial support, furloughing or redundancies.

Group revenues increased by 51% y-o-y to £8.4m (H120: £5.5m), reflecting a full six-month contribution from the Northern VCT fund management business acquired in December 2019, of which 87% is annual recurring revenue from fund management and monitoring fees. Revenues comprised £6.2m from fund management fees, £0.7m from initial management fees and £1.4m from portfolio director fees, as well as £0.1m in other consultancy revenues. Despite the large increase in revenues, staff and administrative expenses increased by a lower 16.5% to £7.3m (H120: £6.3m), despite an increase in headcount from 93 staff at FY20 to 100. Cost growth was restrained as the pandemic slowed recruitment and through savings in travel-related costs.

Adjusted operating profit (ex-realisations, fair value gains, etc) was £1.1m (H120: £0.6m loss). Together with the sale of The Native Antigen Company (NAC: £1.7m realised gain, H120: zero) and net fair value gains (£6.7m, H120: £3.2m), this led to PAT of £8.2m (H120: £2.1m) and EPS of 1.87p (H120: 0.69p).

### Implementation of a progressive dividend policy

As a profitable business, with £2.0m of operating cash flow in H121, management has felt able to implement a progressive dividend policy, with a maiden interim dividend of 0.1p per share.

### NAV: 6% rise to £149.9m over the six-month period

H121 reported net assets were £149.9m (FY20: £141.5m), with unrestricted cash of £24.9m (FY20: £30.2m) and NAV per share growing by 6% over the period to 34.1p from 32.1p. Hard NAV (portfolio fair value plus net cash) rose by 7.5% to £126.5m for H121 (28.7p per share) from £117.7m (26.7p per share) for FY20.

## Portfolio review: Stronger outturn than anticipated

The value of Mercia's direct investment portfolio at period-end rose to £101.6m, an increase of 16.2% over FY20 (£87.5m), with Mercia investing £10.9m (net) into 14 portfolio companies, together with net fair value gains during the period of £6.7m (H120: zero). Mercia delivered a profitable exit during the period (NAC: £1.7m gain, 8x return, 65% IRR) and another post period end (Clear Review: £1.0m in cash, 2x return, 72% IRR).

This performance highlights the resilience of Mercia's business, with long-term contracted fund management fees, diversified portfolios and good liquidity across the group. Investors have also favoured sectors seen to benefit from lockdown where Mercia is active, such as software, digital entertainment, medtech, digital healthcare, diagnostics and biotech.

## 15 of Mercia's top 20 holdings are funded through FY21 and beyond

In line with previous reporting periods, Mercia's top 20 direct investments represented 98.6% of total portfolio value at 30 September 2020, with the top 10 representing over 80% of total portfolio value. Mercia weights its efforts accordingly.

**Exhibit 3: Direct Investment Portfolio (£000s)**

| | Holding | Net value 1/4/20 | Net cash invested H121 | Realisations | Fair value change H121 | Net value 30/9/20 | % held at 30/9/20 | Holding as % of total portfolio | Cumulative % of total portfolio |
|---|---|---|---|---|---|---|---|---|---|
| 1 | nDreams | 16,120 | 1,000 | - | 606 | 17,726 | 36.4 | 17% | 17% |
| 2 | Oxford Genetics (OXGENE) | 11,743 | 1,000 | - | 3,351 | 16,094 | 30.2 | 16% | 33% |
| 3 | Intechnica | 7,177 | 1,250 | - | 1,568 | 9,995 | 27.5 | 10% | 43% |
| 4 | Medherant | 6,705 | 1,400 | - | - | 8,105 | 30.1 | 8% | 51% |
| 5 | Voxpopme | 6,030 | - | - | 1,012 | 7,042 | 17.1 | 7% | 58% |
| 6 | Impression Technologies | 4,294 | 1,750 | - | - | 6,044 | 25.9 | 6% | 64% |
| 7 | Ton UK (Intelligent Positioning) | 4,354 | 750 | - | (203) | 4,901 | 29.9 | 5% | 69% |
| 8 | Faradion | 4,025 | 500 | - | (2) | 4,523 | 15.6 | 4% | 73% |
| 9 | Warwick Acoustics | 3,656 | 500 | - | - | 4,156 | 48.3 | 4% | 77% |
| 10 | Locate Bio | 2,250 | 750 | - | 6 | 3,006 | 16.7 | 3% | 80% |
| 11 | VirtTrade (Avid Games) | 2,200 | 615 | - | (3) | 2,812 | 20.3 | 3% | 83% |
| 12 | Soccer Manager | 2,534 | - | - | - | 2,534 | 34.8 | 2% | 86% |
| 13 | Edge Case Games | 2,300 | - | - | - | 2,300 | 21.2 | 2% | 88% |
| 14 | W2 Global Data Solutions | 2,000 | 300 | - | - | 2,300 | 16.3 | 2% | 90% |
| 15 | Eyoto Group | 1,752 | 500 | - | - | 2,252 | 15.7 | 2% | 92% |
| 16 | PsiOxus Therapeutics | 2,193 | - | - | (4) | 2,189 | 1.4 | 2% | 94% |
| 17 | sureCore | 2,167 | - | - | - | 2,167 | 22.0 | 2% | 97% |
| *18* | *Clear Review** | *500* | - | - | *530* | *1,030* | *4.0* | *1%* | *98%* |
| 19 | Concepta | 475 | 200 | - | - | 675 | 14.6 | 1% | 98% |
| 20 | MIP Diagnostics | - | 300 | - | 2 | 302 | 3.3 | 0% | 99% |
| | *The Native Antigen Company*** | *3,493* | - | *(3,493)* | - | - | - | - | *99%* |
| | Other direct investments | 1,503 | 95 | - | (133) | 1,465 | N/A | 1% | 100% |
| | Total | 87,471 | 10,910 | (3,493) | 6,730 | 101,618 | | 100% | |

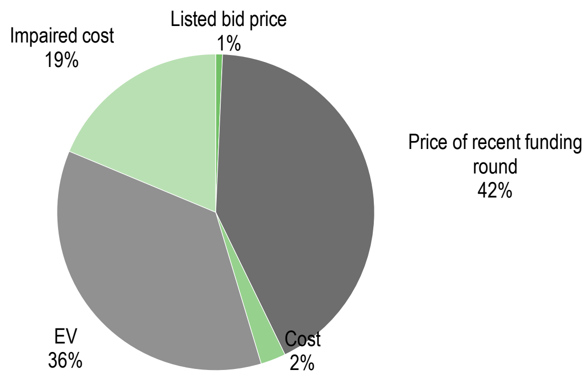
Source: Mercia. Note: *Exited after period end. **Exited during H121.

Of the top 10 portfolio companies within the direct investment portfolio, nDreams (VR game developer) had a small rise in valuation (£0.6m) following the release of its VR game Phantom: Covert Ops; OXGENE (gene therapy) rose 29% (£3.4m), driven by continuing strong revenue growth, the launch of a new product and a funding round; Intechnica (SaaS technical services, £1.6m) and Voxpopme (video analytics, £1m) both saw strong revenue growth; and Intelligent Positioning (SEO platform) was the only business in the direct investment portfolio to experience a setback in valuation of c 5% (a drop of £0.2m) due to high churn, which has since stabilised.

The valuations of the other five businesses in the top 10 holdings were largely unchanged, although Warwick Acoustics completed a syndicated funding round shortly after period end (see below) and, as has been discussed previously, Mercia achieved profitable exits from NAC (£1.7m gain) during H121 and Clear Review (£0.5m gain, see below) post period end.

The value of Mercia's top 10 holdings has risen by 23% over the six months since 31 March 2020, by 6% over the 12 months since 30 September 2019 and by 51% since 31 March 2019.

**Exhibit 4: Valuation methodology applied across Mercia's direct portfolio**




Source: Mercia

Post year-end developments include:

- **Warwick Acoustics, 7 October 2020:** Warwick Acoustics secured £2.1m of syndicated investment, including £0.5m from Mercia. The company has also secured a £0.4m grant from Innovate UK, in conjunction with the University of Warwick. Warwick Acoustics is one of Mercia's earliest investments, becoming a direct investment in December 2014. It develops highly innovative audio products for both the automotive audio market and the personal and studio headphone market. The funding is sufficient to support expansion plans for at least the next 15 months.
- **Clear Review, 19 October 2020:** sale of Clear Review for a total cash consideration of up to £26.0m. Mercia held a 4.0% fully diluted holding in the company and will receive cash proceeds of £1.0m, a 2x return on its investment and a 72% IRR. Clear Review is a SaaS tool providing organisations with data and systems to improve performance management. It was sold to Advanced Business Software and Solutions, a software and services company.
- **Sense Biodetection, 30 October 2020:** Mercia made a £0.9m new direct investment in Sense Biodetection as part of a US$50m syndicated funding round, with investors including KDT Sense Holdings, Cambridge Innovation Capital and Earlybird Health and private investors including Abcam founder, Jonathan Milner. Sense is focused on the development of rapid, instrument-free, point-of-care molecular diagnostics testing for a range of bacterial and viral infections. In March 2020, Sense announced an accelerated programme to launch a diagnostic test for COVID-19. Following its investment, Mercia holds a 1.2% fully diluted stake in Sense, with its third-party managed funds holding 9.1%.

# Strategy: Scaling, sustainable and evergreen

## Specialist asset manager

Mercia is a specialist asset manager with a stated intent of becoming the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m. Given its financial resources, Mercia targets businesses with relatively modest capital needs, typically up to c £20m in total across multiple rounds.

Management's three-year strategic plan is to achieve adjusted operating profitability, increase assets under management to at least £1bn and to 'evergreen' the group's balance sheet. In its H121 results presentation, Mercia stated its strategic goals for the next 18 months as follows:

- **Continued growth in adjusted operating profit:** Mercia delivered adjusted operating profit (before fair value adjustments, realisation gains, amortisation and share-based payment charges) of £1.1m, with 87% of revenues recurring. This sustainable revenue stream should scale with FUM and in H121 already covers the group's central costs.
- **Grow AUM to £1bn+:** the AUM target delivers the scale that management believes is necessary to deliver a fully sustainable, evergreen business model. With AUM of £872m at 30 September 2020, this implies an annual growth rate of >9.6% to achieve this target by FY22.
- '**Evergreen' the balance sheet:** an evergreen model is one where annual portfolio realisations are greater than net investment, with management fees covering other operational costs. With a maturing investment portfolio, management believes it has sufficient capital with cash and liquid assets of £24.9m at 30 September 2020, together with organic growth and anticipated portfolio realisations, to achieve the goal of an evergreen balance sheet by FY22 without the need for further recourse to the markets.
- **Follow a progressive dividend policy:** management has declared a 0.1p maiden interim dividend, but has yet to clarify the structure of its progressive dividend policy.
- **Become the number one provider of capital in its target markets:** to become the 'go-to' source of capital, management is looking to build a share of 20%+ in its targeted regional markets (in England: the North, North-East, North-West, Midlands, and Scotland). Management estimates that the group currently has a share of c 18% of these markets.

## Valuation: Hybrid model undervalued at 0.80x NAV

To fund the acquisition of the Northern VCT fund management busines, Mercia completed a share placing at 25p in December 2019. Since then, Mercia has traded at a widened discount to its NAV, due in part to the NAV/share erosion that the deal entailed, exacerbated by uncertainties around the COVID-19 pandemic. However, following its H121 results, having demonstrated the value of the Northern VCT fund management business within the group (43% of FUM, £6m+ recurring revenues), the shares have risen above the placing price and, with the business now trading profitably on a sustainable basis, investors could further reassess the group's future prospects.

Currently, Mercia trades at a 20% discount to the H121 NAV (34.1p), while a number of its immediate peers trade at a premium to NAV, reflecting consistent, strong NAV growth and the latent value of their portfolio. Given the strength of Mercia's business, its structural profitability, the performance of its portfolio and its underlying operating model, we believe Mercia remains undervalued at these levels.

### Funds business: An additional c £22m/5pps on top of NAV

Thanks to the fees it charges on its third-party managed funds (c 2% of AUM), of which c 87% are recurring, Mercia is now structurally profitable, with management targeting an evergreen funding model by FY22. As FUM continues to grow as a proportion of the business, generating incrementally larger revenues for the group, this underlines why a NAV-based valuation does not reflect the incremental value of the fund management business within Mercia.

We continue to estimate the value of Mercia's embedded fee-earning funds business at 3% of FUM (a conservative valuation considering Mercia's fee margins) on top of the NAV-based valuation of its direct investment business. With last reported FUM of £722m, this implies a valuation for the funds business of c £22m (vs c £20m before), or 4.9p per share (4.5p per share), on top of the H121 NAV of 34.1p per share.

## Exhibit 5: Financial summary

| £'000 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| Year end 31 March | IFRS | IFRS | IFRS | IFRS | IFRS | IFRS |
| **INCOME STATEMENT** | | | | | | |
| Revenue | 508 | 1,755 | 6,660 | 10,197 | 10,675 | 12,747 |
| Cost of Sales | (10) | (79) | (92) | 0 | 0 | 0 |
| Gross Profit | 498 | 1,676 | 6,568 | 10,197 | 10,675 | 12,747 |
| Operating costs | (1,495) | (4,011) | (9,051) | (10,633) | (12,115) | (12,661) |
| Fair value changes | 3,934 | 896 | 4,268 | 2,823 | 3,916 | (15,844) |
| Realised gains | 0 | 0 | 839 | 871 | 0 | 0 |
| Normalised operating profit | 2,937 | (1,439) | 2,624 | 3,258 | 2,476 | (15,758) |
| Amortisation of acquired intangibles | 0 | (17) | (301) | (301) | (301) | (852) |
| Exceptionals | (1,018) | (372) | (1,125) | (1,125) | 0 | (695) |
| Share-based payments | (44) | (230) | (395) | (497) | (171) | (528) |
| Reported operating profit | 1,875 | (2,058) | 803 | 1,335 | 2,004 | (17,833) |
| Net Interest | 93 | 361 | 186 | 274 | 562 | 220 |
| Joint ventures & associates (post tax) | 0 | 0 | 0 | 0 | 0 | 0 |
| Profit Before Tax (norm) | 3,030 | (1,078) | 2,810 | 3,532 | 3,038 | (15,538) |
| Profit Before Tax (reported) | 1,968 | (1,697) | 989 | 1,609 | 2,566 | (17,613) |
| Reported tax | 0 | 0 | 54 | 54 | 54 | 159 |
| Profit After Tax (norm) | 3,030 | (1,078) | 2,810 | 3,532 | 3,038 | (15,538) |
| Profit After Tax (reported) | 1,968 | (1,697) | 1,043 | 1,663 | 2,620 | (17,454) |
| Minority interests | 0 | 0 | 0 | 0 | 0 | 0 |
| Discontinued operations | 0 | 0 | 0 | 0 | 0 | 0 |
| Net income (normalised) | 3,030 | (1,078) | 2,810 | 3,532 | 3,038 | (15,538) |
| Net income (reported) | 1,968 | (1,697) | 1,043 | 1,663 | 2,620 | (17,454) |
| Basic average number of shares outstanding (m) | 212 | 212 | 224 | 302 | 303 | 341 |
| EPS – basic normalised (p) | 1.43 | (0.51) | 1.26 | 1.17 | 1.00 | (4.55) |
| EPS – diluted normalised (p) | 1.43 | (0.51) | 1.21 | 1.13 | 1.00 | (4.55) |
| EPS – basic reported (p) | 0.93 | (0.80) | 0.47 | 0.55 | 0.86 | (5.11) |
| Dividend (p) | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Revenue growth (%) | (29.7) | 245.5 | 279.5 | 53.1 | 4.7 | 19.4 |
| Gross Margin (%) | 98.0 | 95.5 | 98.6 | 100.0 | 100.0 | 100.0 |
| Normalised Operating Margin | 578.1 | -82.0 | 39.4 | 32.0 | 23.2 | -123.6 |
| **BALANCE SHEET** | | | | | | |
| Fixed Assets | 27,121 | 50,103 | 63,693 | 77,428 | 98,724 | 124,899 |
| Intangible Assets | 2,455 | 11,815 | 11,514 | 11,213 | 10,912 | 36,705 |
| Tangible Assets | 49 | 145 | 151 | 145 | 153 | 125 |
| Right of use assets | 0 | 0 | 0 | 0 | 0 | 598 |
| Investments & other | 24,617 | 38,143 | 52,028 | 66,070 | 87,659 | 87,471 |
| Current Assets | 54,349 | 31,730 | 64,576 | 53,965 | 31,180 | 31,951 |
| Stocks | 0 | 0 | 0 | 0 | 0 | 0 |
| Debtors | 716 | 798 | 747 | 1,057 | 782 | 1,298 |
| Cash & cash equivalents | 23,633 | 20,932 | 28,829 | 42,908 | 25,210 | 24,438 |
| Short term liquidity investments | 30,000 | 10,000 | 35,000 | 10,000 | 5,188 | 6,215 |
| Current Liabilities | (631) | (1,521) | (6,698) | (7,760) | (3,730) | (6,659) |
| Creditors | (631) | (1,521) | (6,698) | (7,760) | (3,730) | (4,805) |
| Tax and social security | 0 | 0 | 0 | 0 | 0 | 0 |
| Lease liabilities | 0 | 0 | 0 | 0 | 0 | (118) |
| Short term borrowings | 0 | 0 | 0 | 0 | 0 | 0 |
| Other (incl deferred consideration) | 0 | 0 | 0 | 0 | 0 | (1,736) |
| Long Term Liabilities | 0 | (271) | (217) | (163) | (109) | (8,731) |
| Long term borrowings | 0 | 0 | 0 | 0 | 0 | 0 |
| Lease liabilities | 0 | 0 | 0 | 0 | 0 | (473) |
| Other long-term liabilities | 0 | (271) | (217) | (163) | (109) | (8,258) |
| Net Assets | 80,839 | 80,041 | 121,354 | 123,470 | 126,065 | 141,460 |
| Minority interests | 0 | 0 | 0 | 0 | 0 | 0 |
| Shareholders' equity | 80,839 | 80,041 | 121,354 | 123,470 | 126,065 | 141,460 |
| **CASH FLOW** | | | | | | |
| Op Cash Flow before WC and tax | 2,943 | (1,406) | 2,700 | 3,339 | 2,560 | (15,685) |
| Working capital | (20) | 650 | 5,250 | (87) | (3,724) | 533 |
| Exceptional & other | (4,952) | (1,268) | (5,107) | (3,694) | (3,916) | 15,149 |
| Depreciation of right-of-use assets | 0 | 0 | 0 | 0 | 0 | 139 |
| Tax | 0 | 0 | 0 | 0 | 0 | 0 |
| Net operating cash flow | (2,029) | (2,024) | 2,843 | (442) | (5,080) | 136 |
| Capex | (27) | (113) | (82) | (75) | (92) | (45) |
| Acquisitions/disposals | (11,563) | (20,939) | (8,779) | (10,664) | (17,673) | (28,056) |
| Net interest | 22 | 397 | 165 | 260 | 531 | 245 |
| Equity financing | 67,230 | (22) | 38,750 | 0 | (196) | 30,000 |
| Dividends | 0 | 0 | 0 | 0 | 0 | 0 |
| Other | (30,000) | 20,000 | (25,000) | 25,000 | 4,812 | (3,052) |
| Net Cash Flow | 23,633 | (2,701) | 7,897 | 14,079 | (17,698) | (772) |
| Opening net debt/(cash) | (39) | (23,633) | (20,932) | (28,829) | (42,908) | (25,210) |
| FX | 0 | 0 | 0 | 0 | 0 | 0 |
| Other non-cash movements | (39) | 0 | 0 | 0 | 0 | 0 |
| Closing net debt/(cash) | (23,633) | (20,932) | (28,829) | (42,908) | (25,210) | (24,438) |
| Closing net debt/ (cash) inc short-term liquidity investments (not EIS) | (53,633) | (30,932) | (59,601) | (49,435) | (29,769) | (30,186) |

Source: Mercia Asset Management accounts

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