

Mercia Asset Management

Interims + M&A

Huge stride towards an evergreen model

In parallel with its H120 interim results, Mercia has announced the acquisition of NVM's VCT business for up to £25m in cash and equity, funded by a £30m placing at 25p per share (a 22% discount). Subject to shareholder approval, the acquisition increases AUM to £760m and moves Mercia towards being the UK's number one regional investor. The deal expands Mercia's shareholder register, further dilutes existing major shareholders and means Mercia should be profitable before fair value adjustments, closer to its target of an evergreen model (c £1bn AUM). In its H120 results, Mercia's direct investment portfolio increased to £102.0m, with £11.1m of cash invested in 16 companies and a fair value uplift of £3.2m. Mercia has £17.8m of unrestricted balance sheet cash (pre-placing) and the shares continue to trade at a significant discount to NAV.

Period end	Net cash* (£m)	Direct investments (£m)	FUM (£m)	NAV (£m)	NAV per share (p)	P/NAV (x)
03/17	59.6	52.0	336.5	121.4	40.0	0.71
03/18	49.4	66.1	400.0	123.5	40.7	0.70
03/19	29.8	87.7	381.0	126.1	41.6	0.68
09/19	17.8	102.0	361.3	128.4	42.3	0.67

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

Interim results

Mercia reported H120 net assets of £128.4m (FY19: £126.1m). The direct investment portfolio grew by 16.4% to £102.0m (FY19: £87.7m), with £11.1m of cash invested in 16 companies and a fair value uplift of £3.2m. Funds under management fell 5.2% to £361m and net expenses rose to £0.9m (H119: £0.7m). Management reiterated its strategic plan to double AUM to c £1bn and achieve an evergreen balance sheet by end FY22.

Acquisition of NVM VCT Fund management contracts

Mercia also announced the acquisition of NVM's VCT business for up to £25m, comprising £16.6m upfront (75%/25% cash/equity) and a three-year deferred contingent consideration of £8.4m (75%/25% cash/equity). The acquisition brings AUM of £270m, increasing Mercia's total AUM (H120: £490m) by c 50% to £760m. The deal is expected to be earnings enhancing in FY21, funded by a £30m institutional placing at 25p per share, a 22% discount to the closing price of 32p on 2 Dec 2019. Funds will be used to meet the initial cash payment for the acquisition, with the remainder (net of expenses) used to strengthen the balance sheet.

Valuation: NAV discount does not reflect progress

With the acquisition of NVM's VCT business, Mercia has made significant strides towards becoming the UK's number one regional investor and achieving an evergreen balance sheet. In the process it has extended its cash runway, strengthened its share register, increased the free float and reduced its perceived share overhang. Yet Mercia's shares continue to trade at a discount to NAV (0.67x, 0.80x adjusted for the placing and acquisition), even before considering the embedded value of Mercia's fund management business (an additional c 12p).

Investment companies

5 December 2019

Price **28.3p**
Market cap **£86m**

Net cash (£m) at 30 September 2019 17.8

Shares in issue (excludes placing, NVM shares) 303.3m

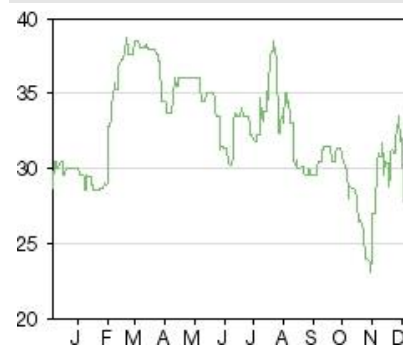
Free float 47.3%

Code MERC

Primary exchange AIM

Secondary exchange N/A

Share price performance



%	1m	3m	12m
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Abs	1.1	(4.1)	(7.2)
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Rel (local)	2.7	(3.7)	(10.8)
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52-week high/low	38.7p	23.1p
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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 events

General Meeting	20 December 2019
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Expected completion of NVM acquisition	27 December 2019
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Preliminary results	July 2020
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Half year results

A steady rise in net assets

Mercia reported a net asset value of £128.4m (FY19: £126.1m) or 42.3p per share (FY19: 41.6p), representing a small rise of 2% in H120. Direct investment of £11.1m was made into 16 portfolio companies (H119: £9.2m, 11 companies) during the period, including one new direct investment of £0.5m into Clear Review (HR and performance management software). Unrestricted cash and short-term liquidity investments fell to £17.8m (FY19: £29.8), although this will be supplemented by proceeds from the share placing (we estimate c £15m net of the initial cash payment for NVM and net of expenses) assuming the acquisition is approved at the general meeting set for 20 December 2019.

Funds under management (FUM) fell by 5.2% to £361.3m (FY19: £381.0m), partly attributable to the final winding up of the successful RisingStars Growth Fund (lifetime IRR of 15%, total value to paid-in capital (TVPI) of 528%), as well as returns from a mature PE fund (2.4x return, 19% IRR).

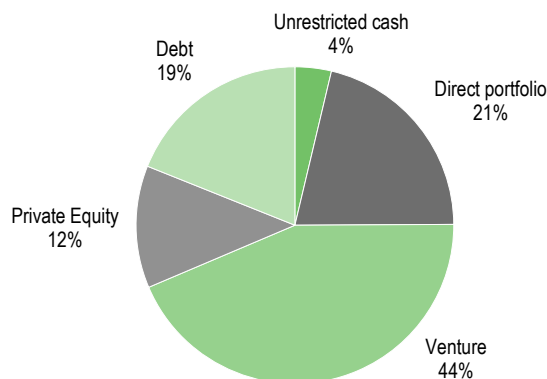
Group revenues increased by 5.1% to £5.5m (H119: £5.3m), while net expenses rose to £0.9m (H119: £0.7m), due to investment in a central services platform, internal corporate advisory and the increase in headcount reported at FY19 to manage prior fund mandate wins.

Management also reiterated its intention to achieve a profitable trading position (which the acquisition of the NVM VCT business delivers) and an evergreen balance sheet.

Portfolio review: Direct investment up 16.4% from FY19

Mercia invests in growing both its pipeline and its existing portfolio companies through four pools of capital under management: balance sheet (NAV of £128m, including £102m portfolio fair value and £18m unrestricted cash), venture (£210m), private equity (£60m) and debt (£91m). In aggregate, the company manages assets under management (AUM) of c £490m, of which third-party FUM, accruing management fees, represent £361m.

Exhibit 1: Breakdown of AUM



Source: Mercia Asset management, Edison Investment Research

Mercia's direct investment portfolio grew by 16.4% to £102.0m (FY19: £87.7m), with £11.1m of cash invested in 16 companies (H119: £9.2m, 11 companies) and a fair value uplift of £3.2m (H119: £2.6m). Similar to previous reporting periods, Mercia's top 20 direct investments represented 97.5% of total portfolio value (FY19: 98.4%), with a single new direct investment during the period (Clear Review) and Concepta dropping out of the top 20 holdings.

Notable fair value uplifts since FY19 have included: Voxpopme (£2.0m) – a common holding with NVM; Oxford Genetics (£1.6m); Crowd Reactive (£0.5m); Intechnica (£0.5m); and Soccer Manager

(£0.1m), whose prospects improved with an acceleration in revenues following an intervention by Mercia. Holdings that attracted a write-down in value included PsiOxus (£0.3m) and The Native Antigen Company (£0.2m).

Mercia's major H120 cash investments included:

- Voxpopme – £2.0m in a £7.5m syndicated round to fund overseas expansion
- Locate Bio – £1.8m of a £2.0m syndicated round
- Medherant – £1.5m of a £2.4m syndicated round
- Warwick Acoustics – £1.1m to allow continued automotive product development
- Clear Review – a new £0.5m direct investment focused on the HR technology sector

Exhibit 2 below sets out the latest portfolio analysis.

Exhibit 2: Mercia's direct investment portfolio								
Company	Sector	Net value	Net value	Net cash	Fair value	Net value	Holding at	Total equity
		1/4/18	1/4/19	invested	change	30/9/19	30/9/19	valuation
		£000	£000	£000	£000	£000	%	£000
nDreams Ltd	Digital/digital entertainment	12,979	15,120	-	-	15,120	37.1	40,755
Oxford Genetics (OXGENE)	Life sciences/biosciences	9,090	10,161	-	1,582	11,743	30.2	38,884
Warwick Acoustics Ltd	EMME	6,152	7,904	1,065	-	8,969	52.9	16,955
Intechnica Ltd	Software and the internet	4,021	6,677	-	509	7,186	27.5	26,131
Voxpopme Ltd	Software and the internet	1,000	3,026	2,000	2,015	7,041	17.1	41,175
Medherant Ltd	Life sciences/biosciences	3,453	5,205	1,500	-	6,705	31.1	21,559
Impression Technologies Ltd	EMME	3,107	5,381	600	-	5,981	31.5	18,987
Ton UK (Intelligent Positioning)	Software and the internet	4,216	5,473	250	-	5,723	28.2	20,294
VirtTrade Ltd t/a Avid Games	Digital/digital entertainment	2,538	3,938	400	-	4,338	28.1	15,438
Faradion Ltd	EMME	1,299	3,525	500	-	4,025	16.4	24,543
The Native Antigen Company	Life sciences/biosciences	1,942	2,863	-	(184)	2,679	30.6	8,755
Soccer Manager Ltd	Digital/digital entertainment	1,199	2,099	300	135	2,534	34.8	7,282
Crowd Reactive Ltd	Software and the internet	1,650	1,589	214	517	2,320	22.6	10,265
Edge Case Games Ltd	Digital/digital entertainment	2,000	2,300	-	-	2,300	21.2	10,849
Locate Bio Ltd	Life sciences/biosciences	-	500	1,750	-	2,250	17.4	12,931
PsiOxus Therapeutics Ltd	Life Sciences/biosciences	2,377	2,377	160	(344)	2,193	1.5	146,200
sureCore Ltd	EMME	1,500	1,834	333	-	2,167	22.0	9,850
LM Technologies Ltd	EMME	1,913	1,913	250	-	2,163	39.4	5,490
Eyoto Group (Aston Eyecare)	Life sciences/biosciences	1,750	1,755	250	-	2,005	15.7	12,771
W2 Global Data Solutions Ltd	Software and the internet	-	2,000	-	-	2,000	15.2	13,158
Other direct investments	-	430	2,019	1,553	(993)	2,579	-	-
Total		62,616	87,659	11,125	3,237	102,021	-	

Source: Mercia Asset Management. Note: EMME is Electronics, Materials, Manufacturing and Engineering. Excludes post year-end investments.

Acquisition of NVM VCT business

Alongside, its interim results, Mercia also announced the acquisition of the VCT fund management business from NVM, including the fund management contracts for Northern Venture Trust PLC, Northern 2 PLC VCT and Northern 3 PLC VCT, which together consist of c 60 portfolio companies, including 17 listed companies, 27 private venture companies and 16 private equity companies. The consideration is up to £25m, comprising £16.6m upfront (75/25 cash/equity) and a three-year deferred contingent consideration of £8.4m (75/25 cash/equity) – a two-thirds, one-third split. The acquisition increases Mercia's total AUM (H120: £490m) by £270m, c 50%, to £760m.

The implied multiples assume a maximum consideration of 3.5x revenue (based on pro forma revenues of £7.2m to March 2019) and 6.25x pro forma EBITDA/net income to March 2019 (£4.0m). The deal is expected to be earnings enhancing in FY21 and will be funded by a £30m institutional placing at 25p per share, a 22% discount to the closing price of 32p on 2 December 2019, conditional on shareholder approval at a general meeting set for 20 December

2019. Funds will be used to meet the initial cash payment for the acquisition (£12.4m), with the remaining c £15m (net of expenses) used to strengthen the balance sheet.

Exhibit 3: Pro forma NVM deal analysis				
	Mercia Asset Management	NVM VCT	Pro forma	Uplift
	£m	£m	£m	%
Turnover	10.7	7.2	17.9	67
Net income	(1.4)	4.0	2.6	nm
Assets under management (AUM)	490	270	760	55

Source: Mercia Asset management, Edison Investment Research

The acquisition of the NVM VCT fund management contracts represents a carve-out of the VCT funds from NVM Private Equity, with a team of nine specialist staff transferring across.

As well as the strategic benefits of the deal (increased scale, an additional investment product, an enhanced team, a portfolio of more mature VCT investee companies), NVM also brings additional revenue (£7.2m, of which £6.3m is recurring revenue) that means the combined business will be profitable before fair value adjustments, realisation gains, amortisation and share based payment charges. This removal of the monthly cash burn is a significant step towards Mercia developing a fully sustainable model, with management targeting an evergreen model by FY22.

Both Mercia and NVM are significant regional investors in UK technology, with some portfolio overlap (eg Voxpopme). As such, Mercia has added a VCT string to its bow and in the process cemented its position as the 'number one regional provider of capital to SMEs'.

Exhibit 4: NVM and Mercia, the number one regional provider of capital to SMEs				
Venture	NVM VCTs	Private equity	Debt	Balance sheet
Total portfolio 194	Total portfolio 60	Total portfolio 17	Total portfolio 120	Total portfolio 23
Total FuM £210m	Total FuM £270m	Total FuM £60m	Total FuM £91m	NAV £128m
Total invested 2002-2019 £182m	Total venture invested 2016-2019 £92m	Total invested 2004-2019 £48m	Total invested 2002-2019 £82m	Total invested 2014-2019 £95m
Returns 'to date' £120m	NAV total return (10 yrs) 2.2x	Returns 'to date' £27m	Returns 'to date' £62m	Returns 'to date' £14m
Liquidity £69m	Liquidity £83m	Liquidity £26m	Liquidity £53m	Liquidity £18m

Source: Mercia Asset Management

Significant reduction in the share overhang

Following two recent block trades, one at the end of October (at 25p) and the other in early November (at 27p), we understand that a substantial part of the overhang over Mercia's shares has now been resolved. Following the intervention by Link Fund Solutions, BlackRock (now managing the remaining Woodford Investment Management stake) has reduced its stake to c 11% and Invesco has also reduced its holding to c 19.5%.

Under the placing announced in parallel with the NVM VCT acquisition, we estimate these stakes will dilute further, to c 8% and 14%, respectively, assuming neither fund manager participates in the placing to a material extent.

Valuation does not reflect Mercia's progress

In line with Mercia's remit as a leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m, we have broadened Mercia's valuation peer group to include a range of specialist asset managers, direct private equity and venture capital investors, and reduced the IP commercialisation comparator group as the majority of these are balance sheet-only investors. With the growth of Mercia's third-party fund management business, we will reconsider the most appropriate comparator universe in future notes.

In Exhibit 5, we include analysis for Mercia as at the end of H120 and then include adjustments for the placing and acquisition to provide a pro forma estimate of Mercia including the acquisition of the NVM VCT fund management contracts, assuming shareholder approval at the general meeting on 20 December 2019.

Post-acquisition, Mercia trades at a 20% discount to the adjusted H120 NAV (see Exhibit 5: adjusted for the placing and acquisition of NMV), below its technology peer group and well below the valuation of other specialist asset managers. In our view, this represents an unwarranted discount given the progress the business has made and the strength of its underlying operating model, and this also ignores the value of the embedded fund management business.

Exhibit 5: Peer group comparison						
	Price (p)	Market cap (£m)	NAV (£m) (last reported)	Cash/(debt) (£m)	NAV multiple	NAV per share (p)
Mercia Asset Management	32.0	97	128	18	0.76	42.3
<i>Placing (net of expenses)</i>	<i>25.0</i>	<i>127</i>	<i>156</i>	<i>45</i>	<i>0.82</i>	<i>36.8</i>
<i>Theoretical post-placing price</i>	<i>30.0</i>	<i>127</i>				
<i>NVM VCT Fund contracts</i>	<i>25.0</i>	<i>4</i>	<i>-</i>	<i>(12)</i>		
<i>Mercia post placing + M&A</i>	<i>28.3</i>	<i>132</i>	<i>156</i>	<i>33</i>	<i>0.80</i>	<i>35.4</i>
Specialist Asset Managers						
Intermediate Capital	1548	4 500	1,427	1,126	3.1	500
Gresham House	571	159	89	12.9	1.9	300
Direct Technology investors						
HgCapital	252.5	1,020	984	79	1.03	245.0
Augmentum FinTech	102.5	120	131	29	0.91	112.2
Draper Esprit	490.0	566	677	46	0.85	574.0
Oakley Capital	237	485	651	96	0.75	318.0
IP Group	59.9	634	1,172	71	0.54	110.6
				Mean	0.82	
				Median	0.85	

Source: Refinitiv data, Edison Investment Research. Note: Priced as at 4 December 2019.

Implications of an evergreen balance sheet

The acquisition of the NVM VCT business is already a transformative deal in that the additional revenue (and profit) that it brings (see Exhibit 3) means that Mercia no longer burns cash on an operational basis. This delivers the first part of management's three-year strategic plan, to put Mercia on a sustainable footing – and also starts to deliver the scale that management believes will allow it to operate an evergreen model by FY22.

An evergreen model is where annual portfolio realisations are greater than net investment, meaning that Mercia will no longer be dependent on the market for further fund-raising, but will become self-

sufficient and fully sustainable. Management believes that the headroom from the latest £30m fund-raising, together with organic growth and anticipated portfolio realisations, should be sufficient to achieve the goal of an evergreen balance sheet without the need for further recourse to the markets.

NAV excludes the embedded funds business

As set out in Exhibit 1 (even before the acquisition of the NVM VCT business), Mercia is now more of a fund manager with a direct investment arm (an 80/20 business split), than a direct investor with a fund management business.

As Mercia moves towards its goal of an evergreen balance sheet, this further underlines that the NAV-based valuation does not properly reflect the embedded value of Mercia's growing fund management business, whose fees (post the acquisition of the NVM VCT business) will more than cover the group's net expenses. Placing these fees (£17.9m) on a relatively conservative 3x EV/sales multiple implies a value of £54m or 12.2p per share (adjusted for the placing and the acquisition of the NVM VCT business) for Mercia's fund management business (from 10.6p previously).

The 12.2p for the fund management business represents incremental value not captured under the existing NAV valuation methodology. Adjusting the NAV calculation for this embedded value would suggest that Mercia trades at an even deeper discount to fair value (0.59x) than a pure NAV calculation indicates.

In our view, this level of discount does not reflect either the strategic positioning of the portfolio, the probability of material exits in the next 12-18 months, or the strength of Mercia's underlying operating model.

Exhibit 6: Financial summary

	£000	2015	2016	2017	2018	2019
Year end 31 March		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		508	1,755	6,660	10,197	10,675
Cost of Sales		(10)	(79)	(92)	0	0
Gross Profit		498	1,676	6,568	10,197	10,675
Operating costs		(1,495)	(4,011)	(9,051)	(10,633)	(12,115)
Fair value changes		3,934	896	4,268	2,823	3,916
Realised gains		0	0	839	871	0
Normalised operating profit		2,937	(1,439)	2,624	3,258	2,476
Amortisation of acquired intangibles		0	(17)	(301)	(301)	(301)
Exceptionals		(1,018)	(372)	(1,125)	(1,125)	0
Share-based payments		(44)	(230)	(395)	(497)	(171)
Reported operating profit		1,875	(2,058)	803	1,335	2,004
Net Interest		93	361	186	274	562
Joint ventures & associates (post tax)		0	0	0	0	0
Profit Before Tax (norm)		3,030	(1,078)	2,810	3,532	3,038
Profit Before Tax (reported)		1,968	(1,697)	989	1,609	2,566
Reported tax		0	0	54	54	54
Profit After Tax (norm)		3,030	(1,078)	2,810	3,532	3,038
Profit After Tax (reported)		1,968	(1,697)	1,043	1,663	2,620
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		3,030	(1,078)	2,810	3,532	3,038
Net income (reported)		1,968	(1,697)	1,043	1,663	2,620
Basic average number of shares outstanding (m)		212	212	224	302	303
EPS - basic normalised (p)		1.43	(0.51)	1.26	1.17	1.00
EPS - diluted normalised (p)		1.43	(0.51)	1.21	1.13	0.96
EPS - basic reported (p)		0.93	(0.80)	0.47	0.55	0.86
Dividend (p)		0.00	0.00	0.00	0.00	0.00
Revenue growth (%)		(-29.7)	245.5	279.5	53.1	4.7
Gross Margin (%)		98.0	95.5	98.6	100.0	100.0
Normalised Operating Margin		578.1	-82.0	39.4	32.0	23.2
BALANCE SHEET						
Fixed Assets		27,121	50,103	63,693	77,428	98,724
Intangible Assets		2,455	11,815	11,514	11,213	10,912
Tangible Assets		49	145	151	145	153
Investments & other		24,617	38,143	52,028	66,070	87,659
Current Assets		54,349	31,730	64,576	53,965	31,180
Stocks		0	0	0	0	0
Debtors		716	798	747	1,057	782
Cash & cash equivalents		23,633	20,932	28,829	42,908	25,210
Short term liquidity investments		30,000	10,000	35,000	10,000	5,188
Current Liabilities		(631)	(1,521)	(6,698)	(7,760)	(3,730)
Creditors		(631)	(1,521)	(6,698)	(7,760)	(3,730)
Tax and social security		0	0	0	0	0
Short term borrowings		0	0	0	0	0
Other		0	0	0	0	0
Long Term Liabilities		0	(271)	(217)	(163)	(109)
Long term borrowings		0	0	0	0	0
Other long term liabilities		0	(271)	(217)	(163)	(109)
Net Assets		80,839	80,041	121,354	123,470	126,065
Minority interests		0	0	0	0	0
Shareholders' equity		80,839	80,041	121,354	123,470	126,065
CASH FLOW						
Op Cash Flow before WC and tax		2,943	(1,406)	2,700	3,339	2,560
Working capital		(20)	650	5,250	(87)	(3,724)
Exceptional & other		(4,952)	(1,268)	(5,107)	(3,694)	(3,916)
Tax		0	0	0	0	0
Net operating cash flow		(2,029)	(2,024)	2,843	(442)	(5,080)
Capex		(27)	(113)	(82)	(75)	(92)
Acquisitions/disposals		(11,563)	(20,939)	(8,779)	(10,664)	(17,673)
Net interest		22	397	165	260	531
Equity financing		67,230	(22)	38,750	0	(196)
Dividends		0	0	0	0	0
Other		(30,000)	20,000	(25,000)	25,000	4,812
Net Cash Flow		23,633	(2,701)	7,897	14,079	(17,698)
Opening net debt/(cash)		(39)	(23,633)	(20,932)	(28,829)	(42,908)
FX		0	0	0	0	0
Other non-cash movements		(39)	0	0	0	0
Closing net debt/(cash)		(23,633)	(20,932)	(28,829)	(42,908)	(25,210)
Closing net debt/ (cash) inc short-term liquidity investments (not EIS)		(53,633)	(30,932)	(59,601)	(49,435)	(29,798)

Source: Mercia Asset Management

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