

Scherzer & Co

Asset management
8 May 2018

FY17 results aided by good market sentiment

Scherzer (PZS) posted a NAV total return of c 22% to €2.74 in FY17 as it was able to benefit from the favourable market environment in Germany (MDAX +18%, SDAX +25% and TecDAX +40% last year). The NAV discount disappeared completely and the shares now trade at a 1% premium to the last reported NAV of €2.84 (as at end-April 2018). PZS's portfolio of extra compensatory claims (ECS) stood at €93.2m (or €3.11 per share) as at end-March 2018 and still represents important additional NAV upside potential. Management proposed a total dividend payment of €0.10/share from FY17 earnings, including a special dividend of €0.05/share.

Stronger impact of realised gains on earnings

PZS reported an FY17 EPS of €0.26 compared to €0.15 in FY16, assisted by net disposal gains of €10.5m (FY16: €5.7m), higher net income from writing options of €0.8m (FY16: €0.3m) and a slight increase in dividend income, which stood at €1.8m (up 8% vs €1.7m in the prior year). Moreover, PZS has realised income from ECS of €1.2m in FY17 (vs a negligible amount in FY16), with two arbitration rulings resulting in additional income to PZS. The company's net debt to equity ratio was higher at 40% vs 34% in FY16.

Overall positive developments across top 10 holdings

The majority of PZS's top 10 holdings reported earnings growth in FY17, including GK Software (whose share price almost doubled last year), freenet (though mostly due to the consolidation of Sunrise), Horus, Audi, K+S, Innogy (soon to be acquired by E.ON) and Lotto24 (reporting positive earnings for the first time in its history). Mobotix is undergoing restructuring, while Oldenburgische Landesbank's shares are currently subject to a 'squeeze-out' procedure. Allertal-Werke's management proposed a solid dividend rise to €1.35 per share (vs €0.50 paid from FY16 earnings), which implies an increase in dividend inflows to PZS of c €0.2m in 2018.

Valuation: Discount to NAV diminished

PZS has long traded at discounts to NAV to the tune of 15% but, following positive catalysts such as the successful sale of FIDOR bank in 2016, its shares are now trading broadly in line with NAV. An additional stock driver is the recently updated valuation report on AXA, which implies potential income from PZS's AXA shareholding of €18.8m or €0.63 per PZS share. It must be noted that the NAV does not include any income from potential ECS profits.

Consensus estimates

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/16	7.6	4.5	0.15	0.05	19.0	1.8
12/17	18.8	5.4	0.26	0.10	11.0	3.5
12/18e	10.1	6.0	0.18	0.05	15.8	1.8
12/19e	10.4	8.3	0.18	0.05	15.8	1.8

Source: Scherzer & Co accounts, consensus based on two analysts as at 2 May 2018

Price €2.85
Market cap €85m

Share price graph



Share details

Code	PZS GY/PZSG
Listing	Deutsche Börse Scale
Shares in issue	29.9m
Last reported net debt as at 31 December 2017	€24.0m

Business description

Scherzer & Co (PZS) invests its funds mainly in domestic equities. PZS looks for companies that are unknown and unloved, and special situations. The focus is on special situations, where the downside is perceived to be limited. In addition, it acquires value stocks, mainly below book value. These stocks need to demonstrate strong business models.

Bull

- Strong management, well known in the market.
- 'Hidden' NAV kicker through special compensatory rights, albeit with binary outcomes.
- Well diversified portfolio with attractive risk/return pattern, built over a number of years.

Bear

- Dependent on market environment.
- Still relatively small.
- For the strategy, market size is limited.

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Financials: Considerable increase in net realised gains

PZS reported an FY17 net profit at €7.9m, which is 77% ahead of the previous year (€4.5m). The company was able to realise net gains from the disposal of both non-current and current financial assets of €10.5m (vs €5.7m in FY16). In FY17, PZS executed complete disposals of several holdings, of which the most important contributors to group results were Data Modul, Wüstenrot & Württembergische (these two were among the top 10 holdings as at end 2016), as well as Strabag. PZS has also carried out some partial disposals, eg Lotto24, where the company realised a gain of €3.0m. Net income from writing options was €0.8m in FY17, up from €0.3m in the prior year, while dividend income reached €1.8m (up 8% y-o-y). Net write-ups and write-downs of held positions reached -€2.9m (vs -€0.9m). In this context, it is worth noting that the German accounting standards allow only write-ups of holdings that were previously written down, up to the level originally recognised on the balance sheet.

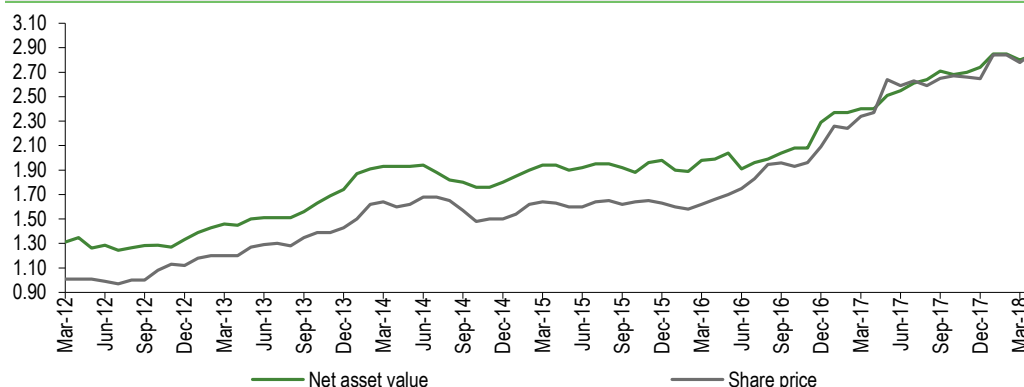
Personnel expenses increased to €2.7m in FY17 from €1.3m in FY16, mainly on the back of higher bonuses to management and employees (€2.1m vs €0.7m in FY16). In conjunction with other operating expenses of €1.0m (although these are somewhat distorted by FX gains/losses) and compared with PSZ's reported NAV as at end 2017, this translates into an expense ratio of 4.3%. The company's net debt to equity rose to 40% from 34% in FY16.

Exhibit 1: Results highlights			
€000s	FY17	FY16	y-o-y
Revenues	4	0	N/M
Income from financial instruments	17,819	6,718	165%
Gains on sale of non-current financial assets	8,002	2,931	173%
Gains on sale of current financial assets	7,022	3,512	100%
Gains on derivatives	1,228	265	N/M
Extra compensatory claims (ECS)	1,567	11	N/M
Other operating income	943	910	4%
Expenses related to financial instruments	(4,937)	(730)	576%
Loss from sale of securities	(4,490)	(730)	N/M
Loss on derivatives	(447)	0	N/M
Personnel expenses	(2,686)	(1,278)	110%
Other operating expenses	(976)	(581)	68%
Income from dividends	1,801	1,664	8%
Write-offs on current and non-current financial assets	(3,796)	(1,809)	110%
D&A	(11)	(7)	42%
EBIT	8,161	4,885	67%
Other interest and similar income	80	144	(45%)
Interest and similar expenses	(297)	(287)	3%
EBT	7,944	4,741	68%
Income and other taxes	(43)	(276)	(84%)
<i>Effective tax rate</i>	1%	6%	N/M
Net profit for the period	7,901	4,465	77%
EPS (€)	0.26	0.15	77%

Source: Scherzer & Co accounts

Income from ECS stood at €1.2m in FY17 (vs close to zero in FY16), with four arbitration rulings announced last year. Scherzer's ECS portfolio as at end 2017 represented a total volume of €93.2m, slightly down from €95.8m as at end 2016. ECS related to convert Immobilien Invest, Strabag and IVG Immobilien representing a volume of €2.3m were added to the portfolio, while ECS leaving the portfolio stood at €7.2m. When we include the ECS of Allerthal-Werke and RM Rheiner Management, the total portfolio value equals €110m. This did not change until end-March 2018, as no legal proceedings/'squeeze-outs' were completed in 2018 ytd.

PZS was able to benefit from favourable market conditions in 2017, with NAV up by c 22% y-o-y to €2.74 per share in 2017, compared to MDAX, SDAX and TecDAX performance of 18.1%, 24.9% and 39.6%, respectively. PZS's NAV improved by a further 3.6% to April 2018 (see Exhibit 2), amid the mixed performance of major German indices.

Exhibit 2: PZS's NAV and share price comparison


Source: Scherzer & Co accounts, Bloomberg

Exhibit 3: PZS's top 10 holdings list

Company	April 18	December 17	December 16	Opportunistic/safe
GK Software AG	14.02%	13.72%	8.72%	Opportunistic
Oldenburgische Landesbank AG	7.92%	5.78%	n/a	Safe
freenet AG	7.59%	9.10%	7.51%	Opportunistic
Allerthal-Werke AG	5.02%	4.88%	5.05%	Safe
Horus AG	3.95%	4.02%	n/a	Opportunistic
Audi AG	3.90%	3.73%	n/a	Opportunistic
Innogy SE	3.80%	n/a	n/a	Safe
K+S AG	3.61%	4.00%	3.41%	Opportunistic
Mobotix AG	3.38%	2.92%	5.11%	Opportunistic
Lotto24 AG	2.72%	n/a	6.72%	Opportunistic
Total top-10 holdings	55.91%	54.17%	53.91%	

Source: Scherzer & Co, Edison Investment Research. Note: *Also includes holdings that were not in top 10 as at March 2018.

Valuation

The most recently reported NAV stands at €2.84 per share as at end March 2018. In the past, PZS's shares traded at prices below the stated NAV. This appears to be a function of the asset value minus the capitalised management costs, which were c 10% of revenues. As such, the average discount to NAV before 2016 was c 15%. Since the successful ECS transaction in 2015 and subsequent newsflow (eg the AXA valuation case and successful sale of the FIDOR Bank stake), the discount has declined and the stock now trades slightly above the last reported NAV at €2.85. This suggests improved acceptance of potential gains resulting from the ECS portfolio. However, there is no visibility of future gains, which may be why PZS has traded well below market averages in the past five years based on the P/E ratio. However, the discount disappeared recently and PZS currently trades broadly in line with the market on 2018e P/E.

Exhibit 4: Comparable market P/E ratios

	P/E (x)						
	2012	2013	2014	2015	2016	2017	2018e
DAX	17.3	18.4	16.6	22.0	19.0	14.6	13.3
MDAX	17.9	27.8	20.0	19.2	28.8	17.6	18.2
SDAX	N/M	54.7	30.9	28.0	23.5	23.4	16.3
Arithmetic average	17.6	33.6	22.5	23.1	23.8	18.5	15.9
PZS	loss	7.2	11.9	9.2	13.6	10.8	15.9
PZS discount	loss	79%	47%	60%	43%	42%	0%

Source: Bloomberg as at 2 May 2018, Scherzer & Co reports. Note: P/E valuations based on year-end prices

PZS's valuation is mainly based on asset value, also demonstrated by the price to book (P/B) value. We have looked at the development of market P/B ratios over time, and a decline in PZS's discount to the market has been apparent since 2015. Importantly, PZS has achieved positive

absolute returns each year since 2012, documented by the increase in NAV (even after dividend payment).

Exhibit 5: Comparable market P/B ratios

	P/B (x)						
	2012	2013	2014	2015	2016	2017	2018e
DAX	1.5	1.8	1.7	1.7	1.7	1.9	1.8
MDAX	1.8	2.3	2.1	2.3	1.9	2.1	2.1
SDAX	1.3	1.7	1.9	2.0	1.7	1.8	1.5
Arithmetic average	1.5	1.9	1.9	2.0	1.8	1.9	1.8
PZS	0.8	0.8	0.8	0.8	0.9	1.3	1.4
PZS discount	48%	59%	58%	60%	49%	32%	21%

Source: Bloomberg as at 2 May 2018, Scherzer & Co reports. Note: P/E valuations based on year-end prices

In addition, the NAV progression does not fully reflect the ECS portfolio. On the one hand, earnings realised from successful closings are reflected in the NAV, as the returns are partially reinvested in the portfolio; on the other hand, the outcome and the timing of the claims are uncertain.

However, the AXA case highlights the potential; while it is unclear whether the new valuation report will be fully accepted and finally turn into payments to those shareholders who tendered in the AXA shares in 2006, a potential gain of €103 per AXA ordinary share represents a pre-tax gain for PZS of c €18.8m, or €0.63 per PZS share (before taxes and other costs). The €0.63/share gain is equal to a 23% increase in the current NAV.

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