

Scherzer & Co

Asset management
23 April 2020

Further squeeze-outs of portfolio holdings

Scherzer & Co's (PZS) NAV closed FY19 almost flat y-o-y, lagging the broader market recovery over 2019. On the other hand, the rapid sell-off amid the coronavirus lockdown drove Q1 NAV down by 26% by end March, in line with main DAX indices. In FY19, PZS reported an 88% y-o-y lower result on financial instruments and 36% y-o-y lower income from dividends, which led to a net loss for the period of €8c per share. We note that PZS is focused on lesser-known stocks, which may take time to unlock value. A potential NAV kicker may come from its €139m (as at end-March 2020) portfolio of extra compensatory claims (ECS).

Active in ECS portfolio

Following the squeeze-out at Linde in April 2019, PZS received €22.8m in cash, which allowed for some deleveraging and enlarged its ECS portfolio to a nominal value of €139m. During 2019 only minor cases were resolved (Strabag, SCA Hygiene and Röder). On the other hand, the first ruling on the 2006 AXA case in August 2019 implies a potential profit for PZS of c €8m (c €0.27 per share). Volkswagen recently announced its intention to squeeze out minority shareholders in PZS's largest portfolio holding, Audi which, on completion, will increase the ECS portfolio. While ECSs represent a potentially significant value kicker, processes are lengthy and their outcomes hard to estimate until the final rulings.

2019 flat NAV performance followed by a sell-off

During FY19 PZS delivered a NAV decline of 0.4% compared to a total return of above 30% posted by both the MDAX and SDAX. Part of the portfolio was 'locked' in anticipation of squeeze-outs, eg Linde (21% of portfolio at end-March 2019), Audi or Lotto24 (11% and 4% at March 2020). Meanwhile, GK Software (8% of PZS portfolio at end March 2020) reported a profitable FY19 and maintained its guidance for FY20. The 2020 market turmoil, amid the coronavirus outbreak, has driven PZS's NAV down 26% in Q120, in line with the broader market.

Valuation: Rapid widening of discount

PZS's shares have been trading close to par over recent years, which we believe stems from the 'hidden value' of the ECS portfolio, which is not included in the NAV. Recent weak broader market performance weighed on PZS's price (down 30% ytd), driving the discount to 14%. We note that since end-March, German equity markets started to rebound. However, market volatility continues as the extent of the slowdown caused by the pandemic is still uncertain.

Consensus estimates

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/18	12.1	0.7	(0.03)	0.00	N/A	N/A
12/19	5.2	(2.3)	(0.08)	0.00	N/A	N/A
12/20e	6.4	5.8	0.17	0.00	9.0	N/A
12/21e	6.5	6.2	0.18	0.00	8.5	N/A

Source: Scherzer & Co, Refinitiv consensus based on two analysts as at 22 April 2020.

Price €1.53
Market cap €46m

Share price graph



Share details

Code	PZS GY/PZSG
Listing	Deutsche Börse Scale
Shares in issue	29.9m
Last reported net debt at end 2019	€22.6m

Business description

Scherzer & Co (PZS) invests its funds mainly in domestic equities. PZS looks for companies that are unknown or 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 driver through extra compensatory claims (ECS), 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: Weaker trading result in FY19

PZS reported a net loss of €2.3m compared to a net loss of €0.9m in FY18. The company realized €5.2m gains from financial instruments (down 57% y-o-y), while securities sold at a loss contributed -€4.1m (FY18: -€2.7m). In the ECS portfolio, PZS reported a minor profit of €91k (down 16% y-o-y, included in gains from financial instruments), which stemmed from closing small cases. This resulted in an 88% y-o-y decrease in the result on financial instruments to €1.1m. Income from dividends came in at €1.6m (down 36% y-o-y). Operating costs remained broadly flat, with personnel expenses of €0.7m (flat y-o-y) and other operating expenses of €0.7m (lower 2% y-o-y). However, with a lower NAV, the expense ratio increased to 2.0% of average NAV from 1.7% in FY18. Net unrealised losses on securities owned at end-FY19 amounted to €3.5m (FY18: €9.7m), which brought EBIT to a negative €2.2m compared to €0.9m profit in FY18.

PZS bore a lower burden from interest (€0.3m, down 20% y-o-y), as it lowered its leverage during the year. Overall, the net loss was €2.3m, translating into €0.08 per share, compared to a loss of €0.9m and €0.03 in FY18, respectively. We note that prior year results were negatively affected by an abnormally high income tax charge as described in [our previous note](#). PZS ended 2019 with a lower cash position of €0.7m (FY18: €2.1m), which translated into net debt of €22.6m (down 2% y-o-y). Management will recommend not paying any dividend at the AGM to be held in May.

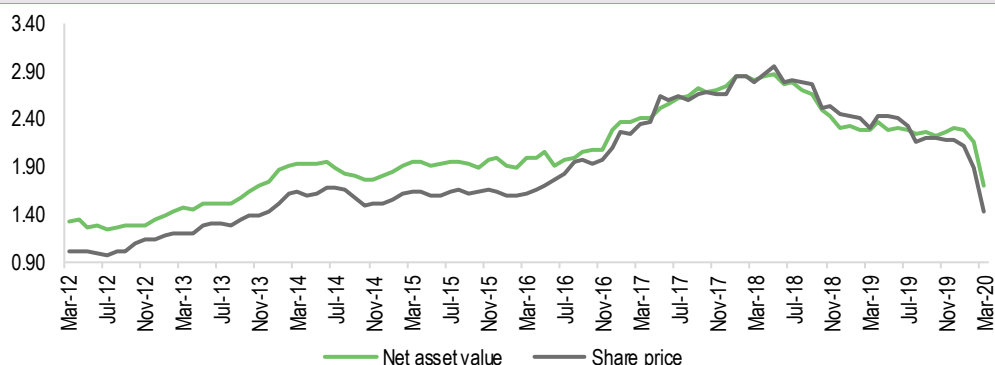
Exhibit 1: FY19 results highlights

€000s, unless otherwise stated	FY19	FY18	y-o-y
Gains from financial instruments	5,225	12,132	-57%
Losses from financial instruments	(4,135)	(2,727)	52%
Result on financial instruments	1,090	9,405	-88%
Other operating income (excluding value adjustments)	65	78	-16%
Personnel expenses	(690)	(688)	0%
Other operating expenses	(700)	(716)	-2%
Income from dividends	1,644	2,586	-36%
Unrealized gains (losses)	(3,546)	(9,742)	N/M
D&A	(18)	(18)	3%
EBIT	(2,155)	907	N/M
Other interest and similar income	86	113	-24%
Interest and similar expenses	(253)	(317)	-20%
EBT	(2,322)	703	N/M
Income and other taxes	(8)	(1,558)	N/M
Net profit for the period	(2,330)	(855)	N/M
EPS (€)	(0.08)	(0.03)	N/M

Source: Scherzer & Co accounts, Edison Investment Research

PZS ended 2019 with NAV per share of €2.30, which implies a deterioration of 0.4% over the year, clearly underperforming the broader German equity market. In Q120, PZS's NAV followed the broader market sell-off, and at end-March 2020 NAV per share was €1.70 after a 26% decline, in line with both the SDAX and MDAX.

Exhibit 2: PZS's NAV per share and share price comparison (€)



Source: Scherzer & Co accounts

PZS's ECS portfolio is not included in the NAV, but is reflected in NAV on successful closures in the amount of income realised. Returns are at least partially reinvested in the portfolio and contribute to long-term NAV development. During FY19, the portfolio expanded to €139m (or €126m excluding ECSs held by portfolio companies), due to the squeeze-out at Linde in April 2019, for which Scherzer received €22.8m. We remind readers that the ECS portfolio is presented in the initial value received under squeeze-outs and other corporate actions. Having said that, once lengthy processes are concluded, they can constitute a significant NAV trigger, although it is difficult to estimate value and timing. As a reference point, in August 2019 the first instance court ruling confirmed that the fair value of AXA shares was above the price of the squeeze-out in 2006. While the ruling is not final, we calculate that if resolved according to that ruling, it would translate to at least a €0.27 per share impact on PZS's NAV including interest.

Portfolio developments

Scherzer specializes in investments in undervalued companies, which its management believes comes from a lack of understanding by the general market. The targets are stocks with little to no research coverage, business models that are difficult to evaluate or in special situations such as restructuring or M&A. PZS presents its portfolio in two categories: 'Safe', which consists of companies with high asset quality and sustainable earnings (including squeeze-out candidates), and 'Opportunistic' with companies in other special situations, growth stocks and with disruptive business models. As at end-2019, 64% of PZS's portfolio was classified as opportunistic (FY18: 53%).

At end-March 2020, the largest portfolio holding is **Audi** following a significant increase in value during March. On 2 March 2020 the majority shareholder, Volkswagen (96.64% stake), announced the proposed squeeze-out of minority shareholders. In 2019, Audi achieved its guidance with 4% y-o-y growth in revenues, and 28% y-o-y growth in operating income (albeit supported by a low base effect). The squeeze-out is subject to agreement at the AGM, planned for July/August (postponed due to the COVID-19 pandemic) and the squeeze-out price has not been announced yet. Nevertheless, the announcement triggered an appreciation in Audi's share price, which currently stands at €985 (up 21% since end-February). If the transaction were to be closed at the current share price, we calculate PZS could receive a high single-digit million euro amount in cash and would recognize a profit on its income statement. We understand that the transaction will be included in PZS's ECS portfolio.

At the same time, we note that under German reporting standards, NAV development is not fully reflected on the balance sheet. Although a decrease in the market price of a portfolio holding is reflected in write-offs, the company can only report positive value adjustments by reversing write-offs, and in effect, the book value of the portfolio cannot exceed the initial investment unless the holding is sold. Consequently, the Audi share price rally, while reflected in PZS's NAV, will not be accounted for in PZS's accounts until the squeeze-out is completed.

The share price of **GK Software** (PZS's second-largest holding with a 7.7% share) has decreased 15% ytd and during 2019 the stock lagged broader market performance, reflecting concerns on profitability after weak H119 results as a result of product development costs. However, the company reported a profitable FY19 and maintained its guidance of reaching a 15% EBIT margin by 2020, highlighting good business performance in Q120.

Finally, we note that PZS has a number of less liquid stocks in the portfolio, such as **Weleda** and **AG für Erstellung billiger Wohnhäuser in Winterthur**, which are trading on the OTC markets. In addition, PZS holds significant stakes in companies with similar or adjacent business models, eg **Allerthal-Werke**, **RM Rheiner Management** and the majority-owned **Horus**. Moreover, stocks held with the intention of expanding the ECS portfolio have limited room for growth above the expected squeeze-out price, eg **Lotto24** and **Innogy**. As PZS specializes in investments in special situations, current conditions should create opportunities to expand its portfolio. PZS recently (February 2020)

acquired a 21.5% stake in Arcandor, which is currently in the process of insolvency. The intention is to revitalise Arcandor as an operating company.

Exhibit 3: PZS's top 10 holdings list

Company	% of total (Mar 20)	% of total (Mar 19)	Change (pp)	Opportunistic/safe
Audi	10.70%	4.92%	5.78	Safe
GK Software	7.65%	10.19%	-2.54	Opportunistic
Allerthal-Werke	5.87%	4.43%	1.44	Safe
Weleda AG PS	5.47%	2.55%	2.92	Opportunistic
freenet	5.36%	5.37%	-0.01	Opportunistic
AG für Erstellung billiger Wohnh. in Winterthur	4.61%	2.96%	1.65	Safe
Horus	4.21%	3.76%	0.45	Opportunistic
ZEAL Network	3.96%	N/A	N/A	Opportunistic
Lotto24	3.68%	N/A	N/A	Safe
Mobotix	2.96%	3.37%	-0.41	Opportunistic
Total top-10 holdings	54.47%	60.76%*	-	-

Source: Scherzer & Co, Edison Investment Research. Note: *Includes holdings not in top 10 as at end of March 2020.

Valuation

At the end of March 2020, PZS's NAV per share stood at €1.70 and the current share price of €1.53 implies an extraordinary 14% discount, compared to the 2017–19 average of 0.4%. The widening of the discount was coupled with PZS's NAV deterioration on the back of the broader market sell-off. Q1 (end-March), NAV decreased by 26.1% (in line with the German stock market), while its share price fell by 34.4%. We note that since the end of March, the market has rebounded, delivering an 8% TR on the SDAX and 6% on the MDAX. In April, both management board members acquired 0.3% of PZS's shares in total.

Historically, PZS's has traded at around a 15% discount, which was narrowed to trading close to par after the successful sale of FIDOR Bank in 2016, and the Schering ECS ruling in 2015. We believe the ruling improved investor acceptance of potential gains from ECS portfolio. Having said that, there is no visibility on future gains from the ECS portfolio.

Exhibit 4: Comparable market P/E ratios (x)

	2015	2016	2017	2018	2019	2020e	2021e
DAX	22.0	19.0	14.6	12.9	22.7	16.1	11.6
MDAX	19.2	28.8	17.6	13.4	26.1	28.8	19.4
SDAX	28.0	23.5	23.4	13.8	32.1	23.2	13.1
Arithmetic average	23.1	23.8	18.5	13.4	27.0	22.7	14.7
PZS	9.2	13.6	10.0	loss	loss	9.0	8.5
PZS discount	60%	43%	46%	N/A	N/A	60%	42%

Source: Refinitiv as at 22 April 2020, PZS reports, PZS forecast is Refinitiv consensus based on two analysts. Note: P/E ratios based on year-end prices, forward ratios based on current prices.

On a P/BV ratio, the decline in PZS's discount to the market has been apparent since 2015, reaching 17% at end 2018. However, recent performance has driven the discount to 44% on FY20e book value.

Exhibit 5: Comparable market P/BV ratios (x)

	2015	2016	2017	2018	2019	2020e	2021e
DAX	1.7	1.7	1.9	1.4	1.6	1.2	1.2
MDAX	2.3	1.9	2.1	1.6	2.1	1.5	1.5
SDAX	2.0	1.7	1.8	1.6	1.5	1.1	1.1
Arithmetic average	2.0	1.8	1.9	1.5	1.7	1.3	1.2
PZS	0.8	0.9	1.3	1.3	1.2	0.7	0.7
PZS discount	60%	49%	32%	17%	30%	44%	44%

Source: Refinitiv as at 22 April 2020, PZS reports, PZS forecast is Refinitiv consensus based on two analysts. Note: Historical P/BV ratios based on year-end prices, forward ratios based on current prices.

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