Scale research report - Update

Scherzer & Co

H121 NAV return above market average

Scherzer's (PZS's) NAV increased 28.2% to end-August 2021 in total return terms, vastly outperforming the German equity markets, where the main indices posted 15–17% gains. The H121 EPS was 48% higher year-on-year at €0.14 per share, despite a higher base as a result of the one-off gains from the conclusion of the AXA case, which was accounted for in H120. Owing to strong results, PZS reintroduced a dividend pay-out, distributing €0.05 per share (ex-div in May 2021), implying a yield of 1.6%.

Continuation of strong results

PZS reported €4.1m net income in H121, up 48% y-o-y. The drivers of the strong results included a €4.9m net gain on trading (H120: €0.1m loss) and a €1.0m net gain on the currently-held portfolio (€4.9m write-downs in H120). Notably, PZS recognises gains on its portfolio only on disposal, owing to its accounting policy (holdings can appreciate back to original cost from previous write-downs). This may lead to the financial statement results not fully reflecting portfolio developments. In H121, NAV (reported at the actual value of the portfolio) increased 20%, whereas the book value of equity rose 4%. H221 results will include the recent squeeze-out at MAN, with a c €5m pre-tax profit.

'Hidden value' in ECS portfolio

At end-August 2021, PZS's extra compensatory claim (ECS) portfolio was €120m (FY20: €112.6m), which is likely to increase by €14m with the squeeze-out at MAN. ECS represents ongoing court cases, where PZS is attempting to prove the squeeze-out was priced below fair value. The portfolio value is presented in the amount of initial squeeze-out value and not in PZS's NAV. Any successful conclusions could act as a potential value kicker. In H121, PZS reported a €1k gain from ECS (H120: €5.7m) as the €2.6m Sky Deutschland case concluded without compensation.

Valuation: Discount to NAV and equity markets

PZS's shares have been trading close to par for several years but the discount widened in early 2020, and is currently at c 13% to end-August 2021 NAV. We believe the narrow discount could have reflected the market expectation of AXA case success, which materialised in H120. Although PZS trades at a 25% discount to German equity indices on FY21e P/E ratio, the actual figure may be higher as we believe consensus may be out of date.

Consensus estimates

Year end	Revenue (€m)	EBITDA (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/19	5.2	(2.1)	(0.08)	0.00	N/A	0.0
12/20	21.2	9.3	0.42	0.00	7.4	0.0
12/21e	6.9	5.6	0.20	0.05	15.8	1.6
12/22e	7.1	5.8	0.21	0.05	15.1	1.7

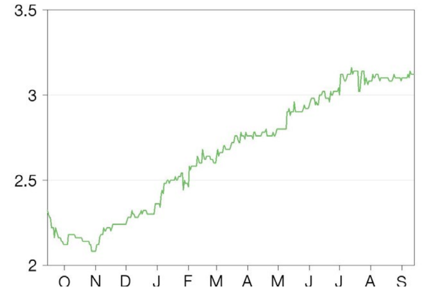
Source: Scherzer & Co, Refinitiv consensus based on estimates from three analysts (EPS, DPS), two analysts (Revenue), and one analyst (EBITDA).

Asset management

14 September 2021

Price	€3.12
Market cap	€93m

Share price graph



Share details

Code	PZS
Listing	Deutsche Börse Scale
Shares in issue	29.9m
Last reported net debt as at end H121	€16.7m

Business description

Scherzer & Co invests its funds mainly in domestic equities. It 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, 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: 50% y-o-y increase in EPS

In H121, PZS's net income increased 48% y-o-y, predominantly because of net gains on trading in securities (including derivatives), which amounted to €4.9m compared with €0.1m loss in H120. We note that comparable H120 results benefitted from the successful conclusion of the AXA ECS case (c €8.5m pre-tax profit, of which €5.7m gains were from instruments and c €2.8m was interest income). The net impact of write-downs and reversals additionally amounted to a €1.0m gain compared with €4.9m loss in H120. PZS benefitted from healthy equity market performance. The DAX index increased 13.2% in H121 versus a 7.1% decline in H120, owing to challenges caused by the COVID-19 pandemic. In H121, PZS also recognised €0.9m income from dividends compared with €0.3m in H120 – while significantly higher year-on-year, the increase was from a low base as companies chose to mostly secure their liquidity needs in H120 instead of opting for distributions.

Operating costs increased 87% y-o-y to €2.7m, predominantly attributable to €1.8m provisions for employee bonuses made in H121 following strong results. Net financial cost was €0.07m compared with €3.4m income in H120, which stemmed from the AXA case. As a result, net income was €4.1m (H120: €2.8m). We note that after the reporting date, the squeeze-out at MAN was concluded and PZS will recognise c €5m gain on the transaction in H221.

In H121, PZS did not report significant gains on its ECS portfolio (€1k) as none of the ongoing larger cases reached conclusion. The ECS represents positions where PZS was squeezed out by a majority shareholder and PZS is attempting to prove in court the squeeze-out was priced below fair value. When successful, PZS receives compensation for the difference, which acts as a potential value kicker to PZS's NAV. Having said that, the legal proceedings are lengthy, and the outcome is uncertain. The latest successful case (AXA) took c 14 years to conclude.

At end-H121, PZS had net debt position of €16.7m, which implied a net debt-to-equity ratio of 24% (compared with 22% at end-FY20). The ratio was below PZS's long-term average of 36% and will be strengthened by c €14m cash proceeds from the squeeze-out at MAN.

Exhibit 1: H121 results highlights

€000s, unless otherwise stated	H121	H120	y-o-y
Gains from financial instruments	**6,864**	**9,950**	**(31%)**
o/w securities	6,447	4,005	61%
o/w ECS	1	5,730	N/A
o/w derivatives and other	415	214	94%
Losses from financial instruments	**(1,919)**	**(4,280)**	**(55%)**
o/w securities	(713)	(3,100)	(77%)
o/w derivatives and other	(1,206)	(1,180)	2%
Result on financial instruments	**4,945**	**5,670**	**(13%)**
Other operating income (excluding value adjustments)	19	10	77%
Personnel expenses	(2,150)	(336)	541%
Other operating expenses	(532)	(1,104)	(52%)
Income from dividends	861	320	169%
Unrealised gains (losses)	1,023	(4,935)	N/A
EBIT	**4,165**	**(374)**	**N/A**
Other interest and similar income	13	3,465	(100%)
Interest and similar expenses	(81)	(93)	(13%)
EBT	**4,097**	**2,998**	**37%**
Income and other taxes	(21)	(235)	(91%)
Net profit for the period	4,077	2,763	48%
EPS (€)	**0.14**	**0.09**	**48%**

Source: Scherzer & Co accounts, Edison Investment Research

Squeeze-out of largest portfolio holding in H221

PZS invests in companies that management believes are undervalued owing to lack of understanding by the general market. It focuses on companies with difficult-to-evaluate business models and companies undergoing restructuring or M&A. It also positions itself in the shareholding structure of the company in anticipation of a squeeze-out to strengthen its ECS portfolio. PZS categorises its portfolio into two pools: 'opportunistic', with growth stocks and those with disruptive business models and companies in other special situations, which represented 47% of the portfolio at end-H121; and 'safe', comprising companies with high asset quality and sustainable earnings, which also includes squeeze-out candidates (53% of the portfolio).

PZS's portfolio is concentrated, with the 10 largest positions representing 52% of its portfolio, and is focused on stocks with limited trading volume. That said, portfolio value development rarely reflects broader market trends in the short term. In the long term, however, it aligns with the trajectory of the German equity markets, with nine-year NAV total return (to end-August 2021) at 13.8% pa, 4.3pp over the DAX (0.2pp and 1.1pp below MDAX and SDAX, respectively).

At end-August 2021, the largest portfolio holding was MAN, representing 10.3% of the portfolio. On 31 August 2021, TRATON successfully completed the squeeze-out of MAN shares, which is likely to be reflected in its end-September ECS portfolio. The transaction resulted in €14m cash inflow to PZS and €5m gain on disposal to be recognised in H221. Also, in Lotto24 (4.5% of portfolio value), the majority shareholder (ZEAL Network, 93% shareholding) recently announced a delisting purchase offer at €381 per share.

The second-largest position in PZS's portfolio is Rocket Internet (7.7%), which is also a squeeze-out candidate, with the take-private process first beginning in September 2020. The company is a start-up incubator focused on internet-based businesses globally, with current market capitalisation at c €3.1bn. After the initial repurchase offer (carried out by Rocket Internet itself), Global Founders owns 62% of the shares, which are traded on the Hamburg Stock Exchange. The remaining shares are held by Elliott International (19.0%) and Merrill Lynch (8.3%), as well as smaller shareholders including PZS. PZS estimates the current equity value per share amounts to c €39.00, while initial repurchase offer was carried out at €18.57 per share.

PZS's largest holdings have remained broadly the same since our last report in April 2021. In the top 10, there are three 'opportunistic' stocks that are characterised by higher liquidity. Freenet shares delivered 27% year to date return as it delivered growth in its results and increased its FY21 EBITDA guidance and GK Software's share price increased 69% in the year to date as it delivered a fourfold year-on-year rise in operating profit in H121 and confirmed its 2023 target. However, ZEAL **Network** shares decreased 12% over the year to date.

Exhibit 2: PZS's top 10 holdings

Company	% of total (Aug 21)	% of total (Aug 20)	Change (pp)	Opportunistic/ safe
MAN	10.3	9.2	1.1	Safe
Rocket Internet	7.7	N/A	N/A	Safe
Allerthal-Werke	6.6	4.6	2.0	Safe
GK Software	5.3	8.5	(3.2)	Opportunistic
Lotto24	4.5	3.7	0.8	Safe
freenet	4.4	8.0	(3.6)	Opportunistic
RM Rheiner Management	3.5	N/A	N/A	Safe
Weleda	3.3	3.8	(0.5)	Safe
Kabel Deutschland Holding	3.3	N/A	N/A	Safe
ZEAL Network	3.2	4.3	(1.0)	Opportunistic
Total top-10 holdings	**52.1**	**63.8**	**(11.7)**	**-**

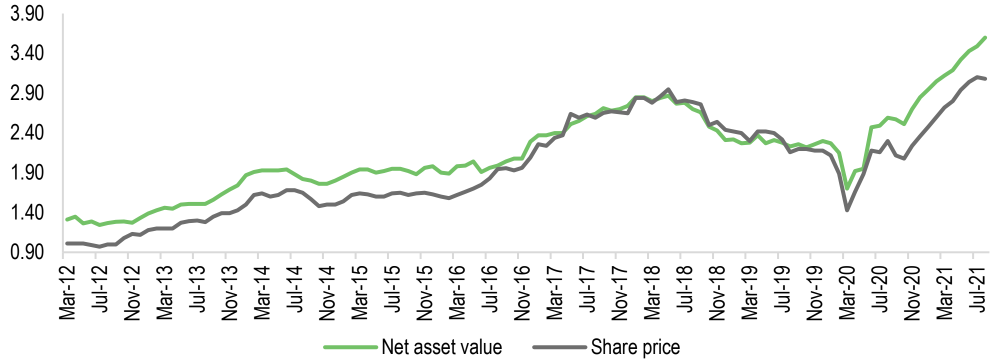
Source: Scherzer & Co, Edison Investment Research. Note: *Top 10 holdings at end of August 2020.

The ECS portfolio was €110.1m at end-August 2021 versus €112.6m at end-FY20. This was attributable to the €2.6m Sky Deutschland case (started in September 2015), which concluded with no additional compensation for minority shareholders and was excluded from the portfolio. We highlight that PZS presents its ECS portfolio in the amount of received compensation on corporate action (mostly squeeze-outs), which has limited informational value for potential outcomes because they are difficult to predict. That said, the ECS portfolio is likely to be increased by c €14m due to the recently concluded squeeze-out at MAN. The values of the largest ECSs are Linde €22.8m, HVB €17.2m and Audi €16.9m.

Valuation: Trading at 13% discount

At end-August 2021, PZS's NAV per share was €3.60 after a strong 28.2% total return in the year to date. The share price of €3.12 implies a 13.3% discount. For the three years before the COVID-19-induced sell-off, PZS's shares traded at par on average. The current discount may seem relatively high, but we should emphasise that the AXA case accounted for 20% of the ECS portfolio (€25.6m) at end-FY19 and its potential was realised in H120. We believe positive newsflow related to currently owned ECS may contribute to a narrowing in the discount in the future.

Exhibit 3: PZS's NAV per share and share price comparison (€)



Source: Scherzer & Co accounts

Although there is no appropriate peer group, we note that PZS shares delivered a year-to-date return to 3 September of 33.6%, sharply outperforming the German equity indices; the DAX, MDAX and SDAX delivered returns between 15.0% (DAX) and 17.1% (MDAX). PZS trades at a 13% discount to the indices' average on FY22e P/E multiple, which is considerably lower than its historical value. However, it is unlikely PZS's consensus estimates (published in April to June 2021 by three analysts) reflect the strong H121 results and recent developments. To put that into perspective, FY21 net income consensus stands at €5.8m, whereas PZS reported H121 net income at €4.1m and recently announced that H221 figures will include gain on the MAN squeeze-out at c €5m pre-tax. PZS trades on FY22e P/BV ratio of 1.2x, a 32% discount against indices, and in line with the long-term average 42% discount.

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

	2016	2017	2018	2019	2020	2021e	2022e
DAX	19.3	15.4	14.4	23.2	42.7	14.5	13.7
MDAX	17.5	16.8	15.5	27.0	loss	30.8	21.7
SDAX	24.0	18.1	16.4	29.4	76.6	18.2	16.4
Arithmetic average	**20.3**	**18.5**	**15.4**	**26.6**	**59.6**	**21.2**	**17.2**
PZS	14.0	10.2	loss	loss	7.4	15.8	15.1
PZS discount	31%	45%	N/A	N/A	88%	25%	13%

Source: Refinitiv on 7 September 2021, PZS reports. Note: PZS forecast is Refinitiv consensus based on three analysts. P/E ratios based on year-end prices, forward ratios based on current prices.

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