EDISON Scale research report - Initiation

German Startups Group

Financials

1 June 2017

Specialist German venture capital investor

German Startups Group is a venture capital investment company that provides investors access to technology start-ups in Germany through a venture capital portfolio of 43 companies. It also has majority ownership of Exozet, a digital agency. Management believes 13 of its companies are ready for exit and, meanwhile, is motivated to realise portfolio gains this year to demonstrate its ability to add value, pay down debt and narrow the shares' 24% discount to NAV. The NAV is likely understated and investors looking for exposure to this sector may find this company of interest.

Technology focused, broad portfolio

Established in 2012, German Startups Group (GSG) is a Berlin-based venture capital investment company founded by CEO Christoph Gerlinger, an experienced internet entrepreneur. GSG's focus is on technology start-ups and currently 24 of its holdings, accounting for 91% of total value, are of particular significance, 13 of which it believes are ready for exit to realise value.

Further successful transactions can realise value

The company recently reported losses of €3.3m for 2016 (€3.8m profit in 2015). This reflects write-downs of four significant investments, including Auctionata, which filed for insolvency, and an exceptional write-off associated with costs incurred for a capital increase in 2016 that did not take place. Since the start of 2017, GSG has announced several profitable sales and Q117 has returned to profit, while management is also confident for Q2 profitability. Management is motivated to achieve further sales this year to demonstrate its ability to add value, pay down debt and narrow the discount to NAV.

Valuation: NAV likely understated

GSG trades at a 24% discount to its end 2016 IFRS net asset value. This is likely understated as many of the portfolio companies' valuations were more than seven months old at that time, while recently crystallised gains are yet to be reflected. Given 13 companies are viewed by management as ready for exit, further revaluations may occur for the remainder of 2017. Majority owned Exozet is also likely to have significant hidden reserves as, post consolidation in June 2015, under IFRS the company cannot be revalued but has grown significantly.

Consensus estimates

Year end	Revenue (€m)	Net profit (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/15	5.6	3.8	0.49	0.00	3.8	N/A
12/16	10.9	(3.3)	(0.29)	0.00	N/A	N/A
12/17e	11.5	2.9	0.24	0.00	7.8	N/A
12/18e	12.1	5.7	0.47	0.00	4.0	N/A

Source: Bloomberg

Price	**€1.86**
Market cap	**€22m**

Share price graph

Share details

Code	GSJ
Listing	Deutsche Börse Scale
Shares in issue	12.0m
Last reported net debt as at 31 December 2016	€6.5m

Business description

German Startups Group (GSG) is a Berlin-based venture capital investment company, primarily focused on providing investment to technology businesses in German-speaking countries. The company currently holds 43 companies in its investment portfolio and a majority stake in digital agency Exozet.

Bull

- NAV likely understated.
- The company intends for more realisations this year.
- Listed exposure to a diversified portfolio of technology start-ups in Germany.

Bear

- Low liquidity.
- VC investments are inherently high-risk; earnings can be volatile.
- Potentially constrained by capital.

Analyst

Helena Coles +44 (0)203 3077 5700

Rob Murphy +44 (0)203 3077 5733

financials@edisongroup.com

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Technology start-ups specialist

German Startups Group (GSG) is a Berlin-based venture capital investment company, primarily focused on providing investment to technology related businesses in German-speaking countries. The company was founded in summer 2012 by CEO Christoph Gerlinger, a well-established internet entrepreneur (biography on page 5). Since inception GSG has become one of the most active VC investors in Germany (sources: CB Insights 2015, Pitchbook 2016) and currently has 43 minority investments, including some of Germany's most successful start-ups such as Delivery Hero, Mister Spex, Scalable Capital and SoundCloud.

While GSG primarily takes minority stakes in its investments, it holds a 50.5% stake in Exozet, a digital media and software company. The decision to make an exception was driven by the potential strategic advantages that could be gained from a majority holding. Exozet is a creative digital agency with strong capabilities in brand development; software development, including creating apps for iOS and Android platforms; and digital marketing campaigns. It has a quality client base including Audi, ZDF and Deutsche Telekom. In GSG's view, these services can be invaluable to start-ups and can materially enhance the success of its portfolio companies. Concurrently, GSG's ability to give companies access to these services is a positive distinguishing factor to entrepreneurs.

GSG listed in November 2015, issuing 3.72m new shares at €2.50, raising €9.2m.

Venture capital strategy

GSG provides venture capital with a focus on the following industry segments:

- B2C internet services,
- B2B internet services, and
- hardware and others.

In particular, it looks for companies with products or business models with the potential for disruptive innovation; that are highly scalable; and backed by a strong founder and founder teams, preferably with prior history of start-up success (what it describes as serial entrepreneurs). 23 of GSGs minority investments are in companies where the founder has had such start-up successes.

For entrepreneurs, GSG believes it has a strong investment proposition, which distinguishes it from traditional VCs:

- GSG provides what it describes as "smart money". It is able to provide support to its investment companies in the form of experience, know-how and network.
- Investment horizons are flexible and it is stage agnostic. The company broadens its opportunity set by being able to invest from seed to growth stages. It has the flexibility to invest over multiple financing rounds and can therefore be viewed as "patient capital".
- GSG has the ability to invest in secondary shares. VC funds often do not buy shares in the secondary market, yet GSG believes this offers attractive opportunities. Shares purchased in the secondary market are often offered at significant discounts, while the companies also tend to be closer to exit stage than primary share investments.
- GSG is a well-known name with a good reputation. GSG is acknowledged as one of the most active VCs in Germany and is well-known within the start-up and VC communities. Testament to this is the large deal flow of 929 pitches received in 2016.

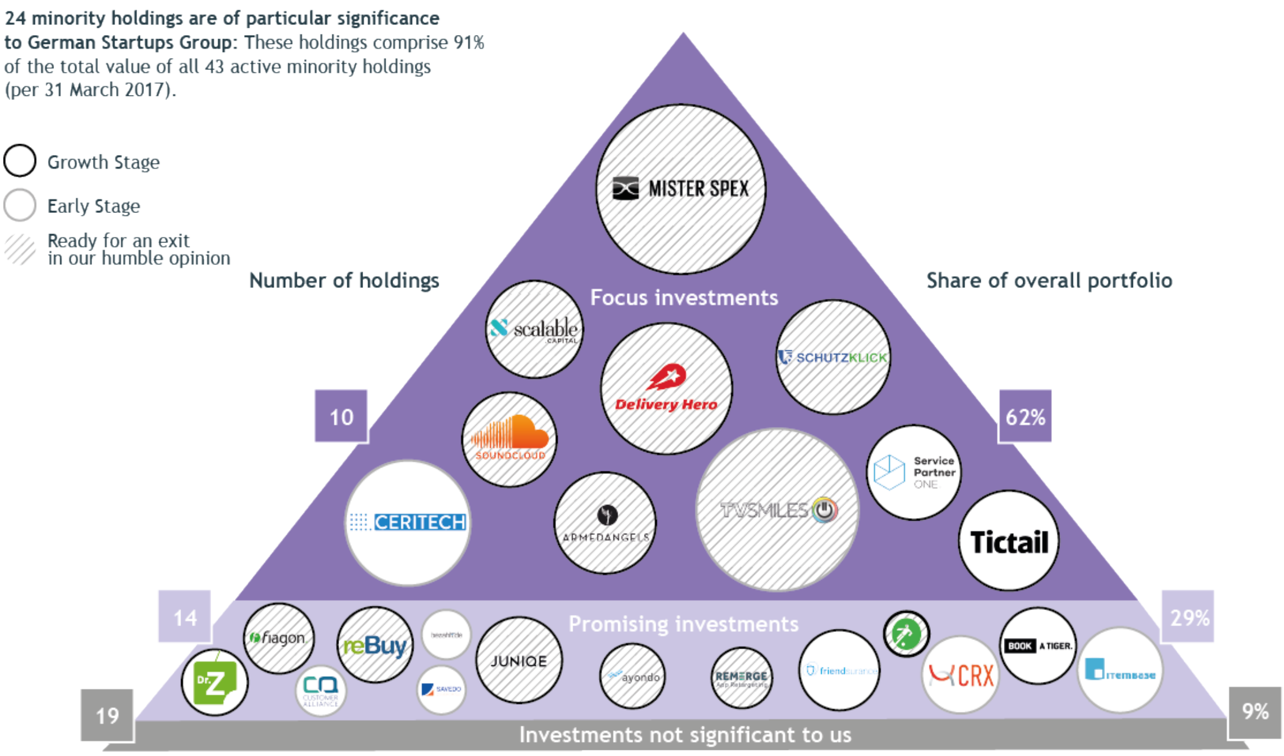
For VC investments, GSG's strategy is to own a diversified portfolio of minority shareholdings. It does not 'build' companies, which requires significant time and resources, and it recognises the limited influence it will have as a small minority shareholder. GSG believes risk is best mitigated through backing entrepreneurs with a track record of previous success and investing alongside other capital providers sharing the same vested interests. Co-investing with others also enables the company to access a larger pool of potential investments and leverage off the niche expertise of co-investors.

GSG targets a return of 20-30% on average invested capital and a net return on equity of 15-20% over time.

Portfolio composition

GSG currently has 43 active minority investments in its portfolio (as shown in Exhibit 1). Of these, 24 are classified as of 'particular significance' in terms of their size and potential, and account for 91% of the total portfolio value. Under the 'investments not significant to us' are very early and seed stage investments, which tend to be small in size and less likely to have an impact on the portfolio. Successful ones will move into early and then growth categories. Within GSG's portfolio are some of the most well-known and successful start-ups in Germany, including Delivery Hero, SoundCloud, Mister Spex, Scalable Capital and Onefootball. The company believes 13 of its investments are ready for exit, although, as it is a minority shareholder with no influence on the companies, the timings of these exits are unknown.

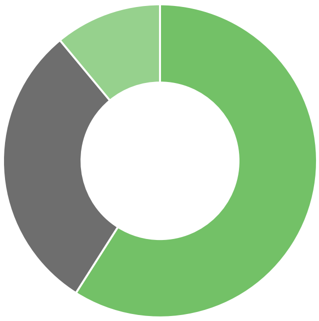
Exhibit 1: GSG's portfolio, as at 31 March 2017



Source: German Startups Group

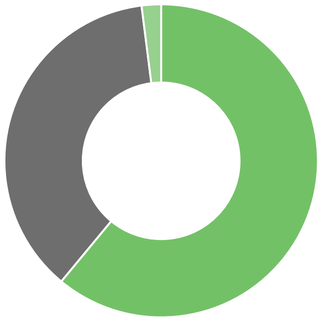
Most of the portfolio, in terms of IFRS fair value, is in the growth or early stages, at 61% and 37%, respectively (Exhibit 3). B2C internet services is the most important segment of the portfolio at 59%, while B2B internet services represent 30% of the portfolio and hardware & others 11% (Exhibit 2).

Exhibit 2: Portfolio breakdown by segment, end March 2017



Source: German Startups. Note: Based on IFRS fair value.

Exhibit 3: Portfolio breakdown by development stage, end March 2017



Source: German Startups. Note: Based on IFRS fair value.

Recent news and upcoming catalysts

GSG recently announced 2016 results, which reported a loss of €3.3m (€3.8m profit in 2015) due to several write-downs and an exceptional loss. These are discussed further in the financials section of this report (page 6).

Since the start of 2017, GSG has had a number of profitable transactions.

Two profitable sales were announced in January (Pyreg and realbest) at values representing annual internal rates of return (IRR) of 7% and 27%, respectively. Together, the sales proceeds of €800,000 will help bolster the company's cash position.

In April, GSG announced several transactions[1] including the sale of one of its 'of particular significance' category companies, realising proceeds of nearly €1m, representing an exit multiple of 2.5x capital invested, an annual IRR of 60% and capital gains of €550,000. It also made a partial sale in a company in the same category, which will allow it to book capital gains of €60,000 and receive a cash inflow of over €350,000. The remaining shareholding has been written up in value and, in aggregate, these transactions are expected to generate over €700,000 in gains on the income statement (realised and written up).

At the end of the Q117, GSG held investments in 13 companies it deemed ready for exit. It intends to do more sales this year to demonstrate its ability to add value and highlight the hidden value in its portfolio, which, in turn, should help narrow the discount to its NAV. In addition, the sales proceeds would allow it to repay early around €3m of a loan facility granted by major shareholders.

GSG is planning to extend the scope of its business to enable it to generate more recurrent revenues and cash flows. It has identified a gap in the German market for a platform to trade secondary market shares in unlisted companies, noting that this has been successful in other countries (for example SharesPost in the US) and that there is demand for such a service. GSG proposes to do this with partners that have the required regulatory licences and aims to earn commissions from transactions. In addition, GSG has identified potential interest for investors to participate in the growth of individual start-ups within its portfolio. It proposes to issue participation rights for these companies, for which it would earn a carry on the profitability of the rights. Both these proposed new businesses will be subject to approval at the company's next annual general meeting on 8 June 2017.

[1] GSG is not always able to disclose names and details of transactions for reasons including legally binding non-disclosure agreements, completion dates and price sensitivity.

Market overview

Venture capital investment in Europe has significantly lagged the US. In GSG's view, this represents a structurally underfinanced sector, which creates opportunities. In 2016 venture capital invested in the US was $69bn, while in Europe it was $16bn[2] despite Europe's population size being double that of the US. Meanwhile, GSG's base in Berlin is establishing itself as the hub for start-up activity in Europe. In 2015, Berlin became the largest VC investment city with €2.3bn invested, exceeding London (€1.9bn invested).[3] According to GSG, more than half of all German start-ups are located in Berlin and it believes it is well-placed to leverage its network and brand to attract investment opportunities. Its 2016 pitches from over 900 companies attests to the vibrancy of the start-up community in Berlin and to GSG's ability to attract opportunities.

Management, organisation and corporate governance

Supervisory board and management board

German corporate law requires all public companies to have two boards: a management board and a supervisory board. The board of management is executive and responsible for the management of the company. The supervisory board is made of non-executives whose role is to oversee the board of management.

Management board

- Christoph Gerlinger, CEO and founder, has over 17 years' experience in the internet industry and is a seasoned entrepreneur. He was the co-founder, CFO and a member of the executive board of CDV Software Entertainment AG, a video game publisher. During his tenure, the company listed in April 2000 on the Frankfurt Stock Exchange. Gerlinger later went on to found and manage Frogster Interactive Pictures AG in 2005 as CEO, an online games publisher that was listed in 2006 and subject to a friendly takeover by Gameforge AG in 2010.

Supervisory board

- Gerhard Koning (chairman) has over 35 years of banking experience, and has been involved in more than 40 IPOs. He was CEO of AXG Investment Bank for over 10 years and head of corporate finance at Commerzbank.
- Martin Korbmacher (deputy chairman) is the founder and managing director of a corporate finance advisory and investment company. He is the former head of investment banking at Credit Suisse Germany and Austria and served on the executive board of Dresdner Kleinwort's investment bank. He has a wealth of experience in mergers and acquisitions and as a business angel.
- Andreas von Blottnitz was a founder of AOL Europe in 1995, which became, at the time, one of the most successful exits when sold to AOL Time Warner in 2000 for $6.75bn. He went on to found Expertcity and the GoTo products, which were sold to Citrix Systems. He has been directly involved in exits to companies such as Hewlett Packard, Best Buy and Red Hat.

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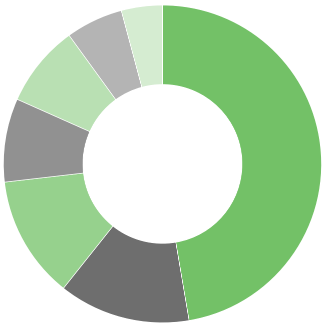
2 Venture Pulse Q4'16, Global Analysis of Venture Funding, KPMG Enterprise

3 Source: www.businessinsider.de/venture-capital-investments-in-european-startups-by-city-2016-7?=US&IR=T

Exhibit 4: Major shareholders



Source: IPREO

Financials

Income statement

The company recently reported a loss for 2016 of €3.3m (€3.8m profit in 2015). The main reasons for the loss were write-downs in the valuations investments of €6.3m (not offset by write-ups of €4.4m) and the booking of an exceptional loss of €1.5m.

The write-downs were largely attributable to four portfolio investments. The most significant was Auctionata, which filed for insolvency in January 2017. GSG's investment was fully written-down (around €2.5m) and the company bears no further risks with this holding. Following the write-downs in 2016, GSG believes the valuations on its portfolio to be conservative.

The exceptional loss of €1.5m is the write-off of costs associated with a planned capital increase that was aborted last year due to unfavourable market conditions. The company does not want to raise capital at a significant discount to NAV.

Exozet was consolidated for a full year in 2016, which means the income statement is not comparable against 2015 (Exozet was consolidated for only the second half of 2015). This company continues to perform well and generated 17% revenue growth to €10.9m, EBITDA of €1.4m and EBIT of €694,000 in FY16.

Since the start of 2017, the company has had several sales and a number of portfolio company activities are likely to lead to write-ups. GSG announced in May that it returned to profit in Q117, generating a low six-figure net profit and management expects Q217 to also be profitable.

Balance sheet and cash flow

GSG's balance sheet grew to €40.6m in 2016 (€35.9m in 2015), which largely reflects an increase in long-term investments of around €6.6m. Following the decision to abandon a capital raising during the year, the company arranged a one-year subordinated flexible loan facility from its shareholders of €8m, of which around €6.5m has been drawn down. Under the terms of the facility, half of the drawn funds need to be paid back within one year in order for the remaining €3.25m to be rolled over for a further year. It held cash and cash equivalents of €1.6m. Post year end, this position has improved following the sales of Pyreg, realbest (discussed above) and one other undisclosed company allowing it to repay early around €3m of its facility and reduce interest expenses. The cash position can be expected to improve further as other announced transactions complete.

Management is unlikely to raise capital for the foreseeable future as its current strategy is to realise portfolio gains through sales in preference to making new investments. Furthermore, it is reluctant to sell shares at current price levels, which it believes are at a significant discount to NAV. The company recently received interest from a potential buyer of its shares at €2.40, which is below the 2016 IFRS NAV of €2.45 per share. This was rejected by its major shareholders, which believe the NAV to be materially higher.

Exhibit 4: Financial summary

	€000s	2014	2015	2016
Year end 31 December		IFRS	IFRS	IFRS
Income statement				
Revenue		72	5,602	10,909
Profit Before Tax (as reported)		1,468	3,581	(5,372)
Net income (as reported)		1,435	3,844	(3,342)
EPS (as reported) – (€)		0.32	0.49	(0.29)
Dividend per share (€)		0	0	0
Balance sheet				
Total non-current assets		10,012	25,084	33,826
Total current assets		4,744	10,870	6,780
Total assets		14,757	35,954	40,606
Total non-current liabilities		278	2,137	2,165
Total current liabilities		360	3,360	8,990
Total liabilities		638	5,497	11,155
Net assets		14,118	30,458	29,451
Shareholder equity		14,118	30,458	29,451
Cash flow				
Net cash from operating activities		(0.8)	0.3	(0.8)
Net cash from investing activities		(4.1)	(7.2)	(8.8)
Net cash from financing activities		4.8	9.7	6.7
Net cash flow		(0.1)	2.8	(2.9)
Cash & cash equivalent end of year		1.8	4.5	1.6

Source: German Startups

Valuation

As at end 2016 the IFRS net asset value of the company was €29.5m (€30.5m in 2015), including goodwill and intangibles. The shares are trading at a 24% discount to NAV. However, the current NAV and discount are likely understated for the following reasons:

- Portfolio companies are valued, where possible, at independent third-party valuations, which reflect prices achieved in recent transactions and follow-on investment rounds. These can be out of date at the December year end and management believes around half its investments' valuations were over seven months old at that time.
- Following the write-down of four investments in 2016, management believes its portfolio to be conservatively valued on its balance sheet.
- Portfolio activity since the end of 2016 has been positive including profitable sales and revaluations of portfolio companies. The sales of Pyreg and realbest (discussed above) and other positions have crystallised profits. Further revaluations may take place given the company believes 13 companies are ready for exit. Recent press reports suggest Delivery Hero is preparing for IPO this summer. Under IFRS, Exozet cannot be revalued post consolidation on 30 June 2015. Since that time, the company's revenues have increased from around €6.5m to nearly €11m. This should normally result in a higher valuation, suggesting potential hidden reserves for Exozet. Management believes digital agencies can command valuations of between 1-3x revenues. Assuming 1x revenue can be achieved on 2016 revenues, the increase to NAV would be around €2.5m to €32m. This would suggest the shares are trading on a 30% discount to NAV before consideration of the above other factors.

Earnings multiples and absolute earnings levels in any given year are less useful in assessing valuation given the volatile nature of VC investing. Shareholder value is created over time as underlying company growth and profitable realisations boost NAV.

Sensitivities

- Investment risk. The companies in which GSG invests are high risk and some are expected to fail. As illustrated by Auctionata, when this happens GSG's share price performance will be negatively affected, often by a greater magnitude than the economic impact of a failure. Failures may also have an impact on the credibility of management, the liquidity of the company and ultimately the viability of GSG.
- Market conditions and liquidity. GSG's business model is dependent upon being able to raise financing and sell investments. If market conditions are unfavourable, GSG may be unable to achieve either, or only on terms that are unfavourable to the company and shareholders.
- Shareholder dilution. GSG had planned to issue an additional 27m shares during 2016, however as market conditions were unfavourable, it secured a flexible bridging loan of €8m from investors instead. If market conditions improve, GSG may be tempted to raise capital and, if issued at a discount to NAV, this would be dilutive for existing shareholders. Management is not in favour of raising capital because it views the company's share price to be undervalued and does not believe it needs more capital given the current focus on divesting and crystallising hidden value.
- Key person risk. The connections and know-how of the CEO is key to the success of the company, from attracting suitable investments to supporting the existing portfolio companies. The loss of a 'key person' would negatively affect the share price and the company's underlying prospects.
- Lack of influence as a minority shareholder. GSG has little or no influence over the companies in which it holds a minority interest, and while it believes 13 companies are ready for exit, it has no control over the timing nor pricing of transactions. In turn, this could result in the company trading at a deeper discount to NAV.

Frankfurt +49 (0)69 78 8076 960	**London** +44 (0)20 3077 5700	**New York** +1 646 653 7026	**Sydney** +61 (0)2 8249 8342
Schumannstrasse 34b	280 High Holborn	295 Madison Avenue, 18th Floor	Level 12, Office 1205
60325 Frankfurt	London, WC1V 7EE	10017, New York	95 Pitt Street, Sydney
Germany	United Kingdom	US	NSW 2000, Australia