

Mercia Asset Management

FY21 results

FY21 a breakthrough year, with more to come

FY21 was the year Mercia's business model as a specialist asset manager matured. The group largely achieved its FY22 strategic goals a year ahead of target (assets under management, AUM, of c £1bn, evergreen balance sheet and sustainable profitability), with NAV per share climbing 24% y-o-y to 40p and AUM rising 18% y-o-y to £940m at year end. Given this progress, a new plan has been set, Mercia 20:20, aiming for average annual growth in AUM of 20% and average PBT of £20m between FY22 and FY24. Mercia is now profitable (FY21 EPS of 7.83p, a 4.8x P/E), with an FY21 dividend yield of 1.1%. Despite evident progress, Mercia's shares continue to trade at a discount to NAV (0.94x), even before considering the embedded value of the third-party fund management business (c 6.9p/share at 4% of AUM).

Period end	Net cash* (£m)	Direct investments (£m)	FUM (£m)	NAV (£m)	NAV per share (p)	P/NAV (x)
03/19	29.8	87.7	381.0	126.1	41.6	0.90
03/20	30.2	87.5	658.0	141.5	32.1	1.17
09/20**	24.9	101.6	722.0	149.9	34.1	1.10
03/21	54.7	96.2	764.0	176.0	40.0	0.94

Note: *Includes liquid securities but not funds held on behalf of EIS investors. **H121 interim results

FY21 results: 84% y-o-y rise in revenues

Mercia reported an 18% rise in AUM to c £940m, with a 16% rise in funds under management (FUM) to £764m. This growth contributed to revenues increasing 84% to £23.4m (ex performance fees, y-o-y revenue growth was 51%), reflecting a full-year contribution from the NVM VCT fund management contract. Adjusted operating profit increased to £3.3m. With £30.0m of fair value changes and realised gains (including an £18m cash gain on the sale of OXGENE), Mercia delivered FY21 PBT of £34.0m and EPS of 7.83p. Mercia reported net assets of £176.0m or 40.0p per share, a rise of 24% over the year, with four realisations in FY21. The company ended the year with £54.7m of unrestricted cash and short-term liquidity investments, as well as total group liquidity of £314m.

Revised strategic goals: Mercia 20:20 vision

Having substantially achieved the goals set out in its prior three-year strategy to FY22 a year ahead of schedule, the board has set a new three-year plan, Mercia 20:20. This targets growth in AUM of 20% per year on average over FY22–24, as well as average PBT of £20m per year over the period. Assuming Mercia can achieve these strategic objectives, it should deliver substantial shareholder returns. As well as organic growth, we expect Mercia to consider potential M&A opportunities to accelerate growth.

Valuation: 40p NAV + c 6.9p for fund management

Mercia's shares continue to trade at a discount to NAV (0.94x) and its peers. This is before considering the incremental value of the fund management business, which we estimate could add at least an additional c 6.9p per share to the FY21 NAV of 40.0p. Based on Mercia's current share price of 37.5p, the shares trade on an FY21 P/E of 4.8x and offer a 1.1% yield.

Investment companies

7 July 2021

Price 37.5p
Market cap £165m

Net cash (£m) at 31 March 2021	54.7
Shares in issue	440.1m
Free float	69.1%
Code	MERC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	12.6	22.0	90.1
Rel (local)	11.2	14.7	58.5
52-week high/low		37.5p	17.8p

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 event

AGM	September 2021
Half-year results	December 2021

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FY21 results

Strong, sustainable, profitable growth

FY21 was a year of organic growth, hampered initially by the impact of the COVID-19 pandemic but benefiting significantly from the first full-year contribution from the NVM VCT fund management business (acquired in December 2019) and the 'super-profits' from portfolio company realisations – principally the £18m cash gain made from the sale of OXGENE (covered in more detail in [The UK's top regional investor](#)).

Mercia reported a 16% rise in FUM to £764m (FY20: £657m), contributing £18.2m in revenues (FY20: £11.7m). Overall group revenues increased by 84% to £23.4m (FY20: £12.7m), reflecting a full-year contribution from the NVM VCT fund management contract. Revenues comprised £13.1m from fund management fees, £1.4m from initial management fees, £3.1m from portfolio director fees as well as £4.2m of one-off performance-related fees arising from the NVM VCT funds. Performance-related fees aside, 85% of fee income from fund management and monitoring is contracted and recurring.

Administrative expenses rose by 31% to £16.6m (FY20: £12.7m), with staff costs increasing 22% to £10.7m (FY20: £8.8m), with the majority of the increase reflecting the incremental operating costs of the NVM VCT fund management business. Headcount increased by 8%, from 93 to 100 employees over the year. Despite the impact of COVID-19, no staff were furloughed or made redundant and Mercia did not receive any direct government support, although its portfolio companies received £11.8m in matched funding from the Future Fund.

Exhibit 1: Interview with Dr Mark Payton, Mercia Asset Management CEO



Source: Edison Investment Research

As a recognised metric for specialist asset managers, Mercia reports adjusted operating profit, the difference between revenues and total operating costs, excluding realised gains on disposal of investments, unrealised fair value movements, one-off items and non-cash charges. Adjusted operating profit excluding net performance fees increased to £3.3m (FY20: £0.5m) largely as a result of the first full-year contribution of the NVM VCT fund management business. With AUM expected to grow by 20% on average over each of the next three years (under Mercia 20:20) and assuming Mercia's net fee income remains at c 2% of AUM, this suggests continuing revenue growth and strong growth in adjusted operating profits over the medium term. Reflecting £30.0m of

fair value changes and realised gains (FY20: £15.8m fair value reduction), Mercia reported FY21 PBT of £34.0m (FY20: £17.5m loss) and EPS of 7.83p (FY20: 5.11p loss). At Mercia's current share price of 37.5p, its shares are trading on an FY21 P/E ratio of 4.8x and with a proposed 0.3p final dividend, added to the 0.1p interim dividend, they offer a 1.1% dividend yield.

Although tax losses are not carried on the balance sheet, we understand Mercia's historic tax losses are likely to be sufficient to offset taxable gains reported over the medium term, when taken together with the [substantial shareholding exemption](#) minimising tax on capital gains.

Mercia reported net assets of £176.0m (FY20: £141.5m) or 40.0p per share (FY20: 32.1p), a rise of 24% over the year. Net direct investments of £15.4m were made into 19 portfolio companies (FY20: £15.7m into 18 companies) during the year, including two new direct investments, Sense Biodetection and MIP Diagnostics. After the year end, Mercia invested a further £0.5m in Medherant and £0.3m in Eyoto, both existing direct investments.

The company ended the year with £54.7m of unrestricted cash and short-term liquidity investments (FY20: £30.2m) as well as total group unrestricted liquidity of £314m.

Portfolio review: £37m of cash realisations in FY21

Focusing on the direct investment portfolio, Mercia had 23 direct investments at 31 March 2021, with four exits during the year and two new investments. In line with previous reporting periods, Mercia's top 20 direct investments represented 98.5% of total portfolio value at 31 March 2021, with the top 10 representing almost 80% of total portfolio value.

Exhibit 2: Mercia's direct investment portfolio ordered by carrying value (£000s)

Company	Year of first direct investment	Net value 1/4/20	Net cash invested FY21	Realisations FY21	FY21 realised gains	FY21 fair value change	Net value 31/3/21	% held at 31/3/21	Holding as % of portfolio fair value	Cumulative % of total
1 nDreams	2014	16,120	1,000	-	-	606	17,726	35.4	18.4	18.4
2 Intechnica Group	2017	7,177	1,250	-	-	1,569	9,996	27.5	10.4	28.8
3 Voxpopme	2018	6,030	1,191	-	-	1,624	8,845	17.6	9.2	38.0
4 Impression Tech	2015	4,294	2,401	-	-	1,927	8,622	67.3	9.0	47.0
5 Medherant	2016	6,705	1,400	-	-	-	8,105	29.0	8.4	55.4
6 Faradion	2017	4,025	500	-	-	1,168	5,693	15.6	5.9	61.3
7 Intelligent Positioning	2015	4,354	750	-	-	(191)	4,913	29.9	5.1	66.4
8 MyHealthChecked	2016	475	504	-	-	3,509	4,488	14.6	4.7	71.1
9 Warwick Acoustics	2014	3,656	500	-	-	99	4,255	35.8	4.4	75.5
10 Soccer Manager	2015	2,534	775	-	-	244	3,553	39.0	3.7	79.2
11 Locate Bio	2018	2,250	750	-	-	6	3,006	16.7	3.1	82.3
12 Avid Games	2015	2,200	615	-	-	(3)	2,812	20.3	2.9	85.2
13 sureCore	2016	2,167	250	-	-	-	2,417	22.0	2.5	87.7
14 PsiOxus Therapeutics	2015	2,193	250	-	-	(36)	2,407	1.4	2.5	90.2
15 EdgeCase Games	2015	2,300	-	-	-	-	2,300	21.2	2.4	92.6
16 W2 Global Data	2018	2,000	300	-	-	-	2,300	16.3	2.4	95.0
17 Eyoto Group	2017	1,752	500	-	-	(439)	1,813	15.7	1.9	96.9
18 Sense Biodetection	2020	-	945	-	-	-	945	1.2	1.0	97.9
19 MIP Diagnostics	2020	-	300	-	-	2	302	3.3	0.3	98.2
20 LM Technologies	2015	250	-	-	-	-	250	47.4	0.3	98.5
<i>OXGENE</i>	<i>2015</i>	<i>11,743</i>	<i>1,000</i>	<i>(30,696)</i>	<i>17,953</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>
<i>Native Antigen Co.</i>	<i>2015</i>	<i>3,493</i>	<i>-</i>	<i>(5,248)</i>	<i>1,755</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>
<i>Clear Review</i>	<i>2019</i>	<i>500</i>	<i>-</i>	<i>(1,043)</i>	<i>543</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>
Other investments		1,253	216	-	-	3	1,472	-	0.3	1.5
Total		87,471	15,397	(36,987)	20,251	10,088	96,220	-	100.0	100.0

Source: Mercia Asset Management. Note: Entries in italics denote exits realised during FY21.

With asset values substantially recovering in H121, before continuing to move forward in a strong private company funding environment in H221, the value of Mercia's direct investments rose to £96.2m (2020: £87.5m). This 10% increase came after FY21 net investment of £15.4m (FY20: £15.7m), as well as four cash realisations, returning £37.0m to the group, delivering £20.3m of

realised gains: Crowd Reactive (-), The Native Antigen Company (£1.8m), Clear Review (£0.5m) and OXGENE (£18.0m), with a fair value of £15.9m at 31 March 2020.

Mercia continued to support its top holdings with two thirds of net direct investment allocated to the top 10 assets. This was topped up with a further £11.8m in matched funding from the Future Fund. The principal contributors to the £10.1m fair value gain were MyHealthChecked (£3.5m), Impression Technologies (£1.9m increase, after a £3.1m reduction in fair value in FY20), Voxpopme (£1.6m), Faradion (£1.2m), nDreams (£0.6m) and Soccer Manager (£0.2m).

The diagnostics, biotech and software sectors put in a strong performance in FY21, while certain businesses in deep tech and clean tech, including in the automotive sector, were negatively affected by the COVID-19 pandemic. However, the automotive-related assets, primarily Warwick Acoustics (£0.1m fair value gain in FY21) and Impression Technologies (£1.9m fair value gain), are now seeing renewed interest from original equipment manufacturers. Eyoto (remote platform eyecare) has experienced delays in Food and Drug Administration approval for its slit lamp product, which has affected revenues, necessitating a £0.4m write-down in fair value.

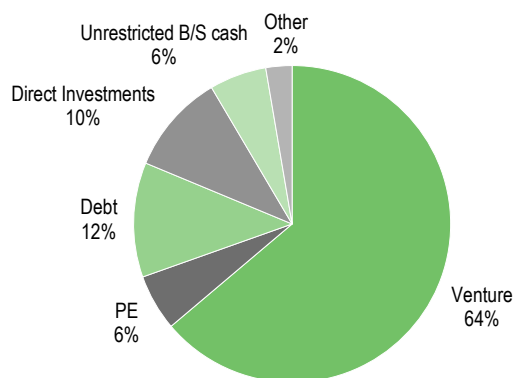
Fund overview

In aggregate, Mercia manages AUM of c £940m, of which third-party FUM account for over 80%, approximately £764m, operating through four pools of capital under management:

- Balance sheet (£96.2m portfolio fair value, £54.7m unrestricted cash)
- Venture (including NVM) (FUM £600m)
- Private equity (FUM £54m)
- Debt (FUM £110m).

Venture, including the NVM VCT fund management business, EIS and IP commercialisation, represents the majority (FY21: 64%) of the group's AUM, with private equity (6%) and debt (12%) representing a much smaller proportion of overall funds. The remainder relates to the group's balance sheet, the direct investment portfolio (10% of AUM), balance sheet cash (6% of AUM) and other (2% of AUM, principally intangible assets), set out in Exhibit 3.

Exhibit 3: Balance of Mercia's business (FY21 breakdown of AUM)



Source: Mercia Asset Management, Edison Investment Research

Strategic goals: Mercia 20:20 vision

Having substantially achieved the goals set out in its prior three-year plan to FY22 a year ahead of schedule, Mercia's board has set a revised three-year target, Mercia 20:20. It aims to:

- grow AUM by an average of 20% per year over the next three years; and
- deliver average PBT of £20m per year over the next three years.

If Mercia is able to achieve these strategic objectives, we would expect it to lead to substantial shareholder returns over the next three years.

Valuation: Fund management warrants a premium

As Mercia has successfully built its third-party fee-earning fund business, charging an average c 2% of AUM, it is now expected to generate a positive adjusted operating profit as it scales, allowing investors to attribute additional value to these earnings. Management has signalled the sustainability of this income stream (FY21: 85% of fund management and monitoring fees are contracted and recurring), by proposing a maiden dividend of 0.4p for FY21, offering a 1.1% dividend yield.

With annual AUM growth of 20% targeted over the next three years, generating incrementally larger revenues, we believe an NAV-based valuation alone no longer adequately reflects the additional value of the fund management business within Mercia.

We estimate the value of Mercia's embedded fee-earning funds business at 4% of FUM (a conservative valuation considering Mercia's attractive blended fee margins of 2%) in addition to the NAV-based valuation of its direct investment business. We provide a sensitivity analysis below highlighting the valuation impact for the funds business at 3% and 5% of FUM (Exhibit 4).

Exhibit 4: Valuation sensitivities		
	Base case	High case
FY21 FUM	£764m	£764m
Valuation of FM arm (as % of FUM)	3%	5%
Implied value of FM arm	£22.9m	£38.2m
Value per share	5.2p	8.7p
FY21 NAV per share	40.0p	40.0p
Implied hybrid valuation per share	45.2p	48.7p
Current share price	37.50p	37.50p
Current share price / hybrid valuation	83%	77%
Discount to hybrid valuation	17%	23%

Source: Edison Investment Research

With last reported FUM of £764m, this implies a valuation for the fund business of £23–38m, or c 5–9p per share. When added to the FY21 NAV of 40.0p per share, this implies a revised valuation of c 45–49p per share. Based on our hybrid approach, Mercia's shares trade at a 17–23% discount to this valuation, based on the current share price.

Market waking up to private technology investment

Valuations of many of Mercia's peers have risen significantly over the last 12 months, with portfolios based around technology and life sciences investments benefiting from strongly rising valuations following the initial impact of the COVID-19 pandemic.

A premium is often applied where the company owns an income-generating asset management arm (eg 3i, Gresham House, ICG, Mercia), whereas for many other direct investors, either the management vehicle is held separately from the investment vehicle (eg HgCapital, Oakley) or fees have yet to deliver structural profitability (eg Draper Esprit, IP Group).

Currently, Mercia trades at a 6% discount to the FY21 NAV (40.0p), with a number of its immediate peers trading at a premium to NAV. However, as we have set out above, we believe Mercia's hybrid valuation, including the fund management business, lies between 45p and 49p per share, implying it is trading at a discount closer to 17–23%.

Exhibit 5: Peer group analysis

	Price	Currency	Market cap (£m)	NAV (£m) (last reported)	Net cash / (debt) (m)	NAV per share (p)	NAV premium/discount
Mercia Asset Management	36.0	GBp	158.4	176.0	55	40.0	0.90
Specialist asset managers							
Gresham House	940.0	GBp	308.7	97	22	300.6	3.13
Intermediate Capital Group	2,204.0	GBp	6,296.0	1,617	297	566.0	3.89
					Mean		3.51
Direct investors							
Augmentum FinTech	139.8	GBp	196.6	183	27	130.4	1.07
Draper Esprit	927.0	GBp	1,429.0	1,033	161	743.0	1.25
HgCapital	370.0	GBp	1,611.0	1,291	188	336.3	1.10
IP Group	118.0	GBp	1,265.0	1,332	203	125.3	0.94
Oakley Capital	362.0	GBp	654.0	728	223	403.0	0.90
TMT Investments	10.70	USD	312.3	178	23	6.53	1.64
					Mean		1.15
					Median		1.09

Source: Refinitiv. Note: Priced at 6 July 2021.

Decoupling from NAV and moving to P/E

As the fund management business grows, the link to NAV becomes less relevant, as highlighted by Gresham House and ICG (Exhibit 5), with these specialist asset managers trading on more than a 20x CY21 P/E multiple.

Based on an average PBT of £20m over the next three years as targeted under Mercia's 20:20 vision, Mercia's shares trade on an implied targeted average FY22–24 P/E of 8x. This assumes the tax charge over the period on a blend of income and realised gains (offset by the substantial shareholding exemption) can be substantially offset by the group's historic tax-losses carried forward.

Given the group's increasing scale, leading to growing profitability, the performance of its portfolio, its attractive underlying operating model and the initiation of a progressive dividend policy, this leaves scope for considerable share price upside as the valuation decouples from a simple NAV premium/discount.

Exhibit 6: Financial summary

31-March	£'000	2017	2018	2019	2020	2021
INCOME STATEMENT						
Revenue		6,660	10,197	10,675	12,747	23,410
Cost of Sales		(92)	0	0	0	0
Gross Profit		6,568	10,197	10,675	12,747	23,410
Operating costs		(9,051)	(10,633)	(12,115)	(12,661)	(16,554)
Adjusted operating profit/(loss)		(2,221)	(81)	(794)	518	3,337
Fair value changes		4,268	2,823	3,916	(15,844)	9,723
Realised gains		839	871	0	0	20,251
Normalised operating profit		2,624	3,258	2,476	(15,758)	36,830
Amortisation of acquired intangibles		(301)	(301)	(301)	(852)	(2,317)
Exceptionals		(1,125)	(1,125)	0	(695)	0
Share-based payments		(395)	(497)	(171)	(528)	(543)
Reported operating profit		803	1,335	2,004	(17,833)	33,970
Net Interest		186	274	562	220	48
Joint ventures & associates (post tax)		0	0	0	0	0
Profit Before Tax (norm)		2,810	3,532	3,038	(15,538)	36,878
Profit Before Tax (reported)		989	1,609	2,566	(17,613)	34,018
Reported tax		54	54	54	159	440
Profit After Tax (norm)		2,810	3,532	3,038	(15,538)	36,878
Profit After Tax (reported)		1,043	1,663	2,620	(17,454)	34,458
Net income (normalised)		2,810	3,532	3,038	(15,538)	36,878
Net income (reported)		1,043	1,663	2,620	(17,454)	34,458
Basic average number of shares outstanding (m)		224	302	303	341	440
EPS - diluted normalised (p)		1.21	1.13	1.00	(4.55)	8.38
EPS - basic reported (p)		0.47	0.55	0.86	(5.11)	7.83
Dividend (p)		0.00	0.00	0.00	0.00	0.40
Revenue growth (%)		279.5	53.1	4.7	19.4	83.7
Gross Margin (%)		98.6	100.0	100.0	100.0	100.0
Normalised Operating Margin		39.4	32.0	23.2	-123.6	157.3
BALANCE SHEET						
Fixed Assets		63,693	77,428	98,724	124,899	131,171
Intangible Assets		11,514	11,213	10,912	36,705	34,388
Tangible Assets		151	145	153	125	107
Right of use assets		0	0	0	598	456
Investments		52,028	66,070	87,659	87,471	96,220
Current Assets		64,576	53,965	31,180	31,951	61,269
Stocks		0	0	0	0	0
Debtors		747	1,057	782	1,298	4,060
Unrestricted cash		28,829	42,908	24,581	23,971	54,491
Restricted cash		4,228	3,473	629	467	2,484
Short term liquidity investments		30,772	6,527	5,188	6,215	234
Current Liabilities		(6,698)	(7,760)	(3,730)	(6,659)	(9,827)
Creditors		(6,698)	(7,760)	(3,730)	(4,805)	(8,127)
Lease liabilities		0	0	0	(118)	(122)
Short term borrowings		0	0	0	0	0
Other (incl deferred consideration)		0	0	0	(1,736)	(1,578)
Long Term Liabilities		(217)	(163)	(109)	(8,731)	(6,592)
Long term borrowings		0	0	0	0	0
Lease liabilities		0	0	0	(473)	(351)
Other long term liabilities		(217)	(163)	(109)	(8,258)	(6,241)
Net Assets		121,354	123,470	126,065	141,460	176,021
Minority interests		0	0	0	0	0
Shareholders' equity		121,354	123,470	126,065	141,460	176,021
NAV per share		40.37	40.71	41.56	32.14	39.99
CASH FLOW						
Op Cash Flow before WC and tax		2,700	3,339	2,560	(15,546)	37,042
Gain on sale of direct investments		(839)	(871)	0	0	(20,251)
Fair value movements in direct investments		(4,268)	(2,823)	(3,916)	15,844	(9,723)
Working capital		5,250	(87)	(3,724)	695	(1,457)
Exceptional & other		0	0	0	(695)	0
Depreciation of right-of-use assets		0	0	0	139	142
Tax		0	0	0	0	0
Net operating cash flow		2,843	(442)	(5,080)	437	5,753
Capex		(82)	(75)	(92)	(45)	(52)
Acquisitions/disposals		3,049	10,618	1,711	(12,400)	(2,100)
Net interest		165	260	531	245	68
Direct investments		(11,828)	(21,282)	(19,384)	(15,656)	21,590
Equity financing		38,750	0	(196)	30,000	0
Dividends		0	0	0	0	(440)
Other		(25,000)	25,000	4,812	(3,052)	5,843
Net Cash Flow		7,897	14,079	(17,698)	(471)	30,662
Opening net debt/(cash)		(20,932)	(28,829)	(42,908)	(24,581)	(24,110)
Other non-cash movements		0	0	(629)	0	0
Closing net debt/(cash)		(28,829)	(42,908)	(24,581)	(24,110)	(54,772)

Source: Mercia Asset Management

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