Deutsche Beteiligungs

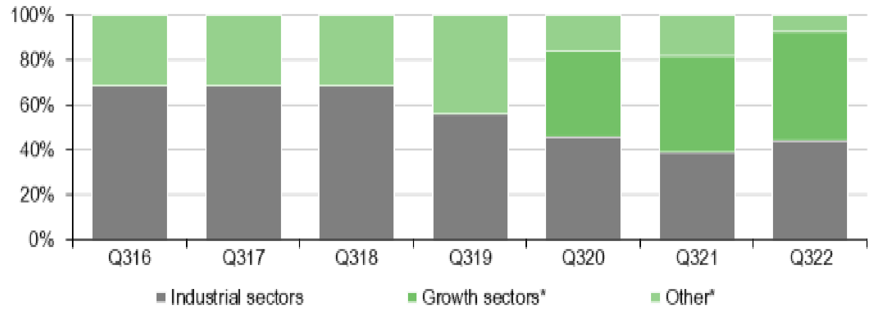
Fall in public multiples reduced portfolio value

Investment company
Private equity

22 August 2022

Deutsche Beteiligungs (DBAG) reported a net loss of €78.3m in 9M22 (ending June 2022), which translated into an 11.7% NAV decline (in total return terms), less than the 28% fall in the SDAX during the period. The contraction of public multiples used to value its portfolio outweighed positive earnings contributions. The fund services segment generated €9.4m profit in 9M22 from managing €2.5bn assets, and DBAG confirmed its segment guidance of €14–16m profit in FY22. DBAG also continued its high acquisition activity with €127m spent on seven new investments so far in FY22 (of which four are in IT services and software) and 23 add-ons by portfolio companies (with a €12m equity support from DBAG).

DBAG has consistently expanded its sector exposure over recent years



Source: DBAG. Note: *'Growth sectors' were separated from 'other' in Q419.

Why consider DBAG now?

DBAG is a well-established player in the German private equity (PE) mid-market segment and a go-to partner for private company owners, especially families and founders. This is illustrated by the share of families and founders in DBAG's management buyouts (MBOs) in 2012–21 at 57% (vs 46% for the broader German mid-market segment) and its overall robust investment activity (with over 200 investment opportunities reviewed in the first nine months of FY22 (9M22)). DBAG shares are trading at a 12% discount to NAV (compared to a five-year average premium of 13%). This is despite the NAV not reflecting the value of its fund services segment, which generates considerable recurring income. Additionally, the current share price implies a healthy 5.8% dividend yield.

The analyst's view

Assuming that DBAG's fund services segment is valued in line with listed alternative asset management peers, DBAG's current market capitalisation implies a c 55% discount to DBAG's private investments portfolio, compared to a 29% peer average discount. We understand that this may come from its still significant exposure to the German industrials sector (44% of portfolio), which has been facing macro and geopolitical challenges that now include uncertainty over a potential halt in imports of natural gas from Russia. Having said that, we also note that its exposure to growth sectors rose to 49% of the portfolio (currently valued at 1.7x acquisition cost on average) with DBAG's recent emphasis on IT and services companies, which made up 20% of DBAG's portfolio at end-June 2022.

Price Ord.	**€27.70**
Market cap	**€521m**
NAV*	**€589m**
NAV per share*	€31.32
Discount to NAV*	11.6%

*At end-June 2022. Defined as equity.

Yield		5.5%
Shares in issue		18.8m
Code		DBAN
Primary exchange		Frankfurt
AIC sector		Flexible Investment
52-week high/low*	€40.50	€24.60
NAV** high/low	€37.16	€31.32

*A-shares. **Including income.

Gearing

Net cash at end-Q322	1.2%

Fund objective

Deutsche Beteiligungs is a Germany-based and listed private equity investment and fund management company. It invests in mid-sized companies in Germany and neighbouring German-speaking countries via MBO transactions and growth capital financings. It focuses on growth-driven profitable businesses valued at €50–250m. DBAG's core objective is to sustainably increase net asset value.

Bull points

- Solid track record, with an average management buyout exit multiple of 2.7x.
- Growing exposure to broadband, IT and healthcare.
- Stable and recurring cash flow from fund services.

Bear points

- Significant exposure to German industrials facing headwinds from geopolitical tensions and a potential recession.
- Public markets downturn translating into lower PE deal volumes and in turn more limited exit opportunities.
- Increasing interest in the German mid-market segment from global PE players in the long run.

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9M22 results: Reflecting the bear market in equities

DBAG's net loss amounted to €78.3m in 9M22, which stemmed predominantly from the revaluation of its portfolio, with the PE investments segment generating an €88m loss. This has translated into a net asset value (NAV, defined as equity value per share) decrease in total return terms of 11.7%, which compares to a 28.0% decrease in German public equities (SDAX). The PE investments segment loss on revaluation of €97.6m was partially offset by a reduction in accrual for carried interest (recognised in DBAG's accounts as a €20m income). The unfavourable market conditions have led DBAG to update its net loss guidance on 15 July 2022 to €70–85m from €15–25m (based on end-March 2022 valuations), which was reaffirmed at the time of the publication of its 9M22 results. Meanwhile, the fund services segment delivered a €9.4m profit (down 32% y-o-y), which, however, was affected by one-off expenses, and management reiterated its FY22 profit guidance for the segment of €14–16m (implying a Q422 profit of €4.6–6.6m, up 25–80% vs Q322). Fee income was broadly flat year-on-year (€33m), as increasing fees from DBAG Funds VII and VIII were offset by lower fees from DBAG Fund VI and DBAG ECF. This is in line with expectations as new investments of top-up funds increase the fee-earning assets, while funds in divestment phase reduce their assets under management (AUM) through disposals. The increased costs of the segment were related to team expansion (including hiring costs), higher consultancy expenses and one-off expenses related to the departure of a board member.

Exhibit 1: Income statement by segment (€m)

	9M22	9M21	Change y-o-y
Net income from investment activity	(78.8)	126.8	N/A
Other income/expenses	(9.1)	(8.8)	4%
Private equity investments profit	**(87.9)**	**118.0**	**N/A**
Fund services income	32.9	32.5	1%
Other income/expenses	(23.5)	(18.6)	26%
Fund services profit	**9.4**	**13.9**	**(32%)**
Consolidated net profit	**(78.3)**	**131.2**	**N/A**

Source: DBAG

Lower peer multiples offset positive earnings impact

The contraction of multiples in public markets resulted in a €169.4m negative valuation impact in 9M22, of which €74m was in Q322 (ending June) alone. Most of DBAG's portfolio is valued using the multiples method (30 companies), with the remaining seven being new acquisitions still valued at cost, and two minor exposures valued at agreed disposal price. Meanwhile, the valuation effect from change in earnings was a positive €109m (of which €86.2m was in Q322 alone), coming mainly from a positive earnings contribution of industry and industrial technology, IT services and software, and industrial services companies. Part of this was due to improving long-term earnings assumptions, as DBAG values some of its holdings based on earnings likely to be generated over the long term (while others are valued based on the current year's budget). Further positive impact came from add-on acquisitions. This was partially offset by negative adjustments to budgeted results (through a risk haircut) for some holdings stemming from rising input costs. At the same time, DBAG recognised a €51.5m negative valuation impact from additional debt incurred by portfolio companies, mostly to finance new acquisitions and higher working capital requirements (due to price inflation and the build-up of higher inventory levels to hedge against supply chain disruptions).

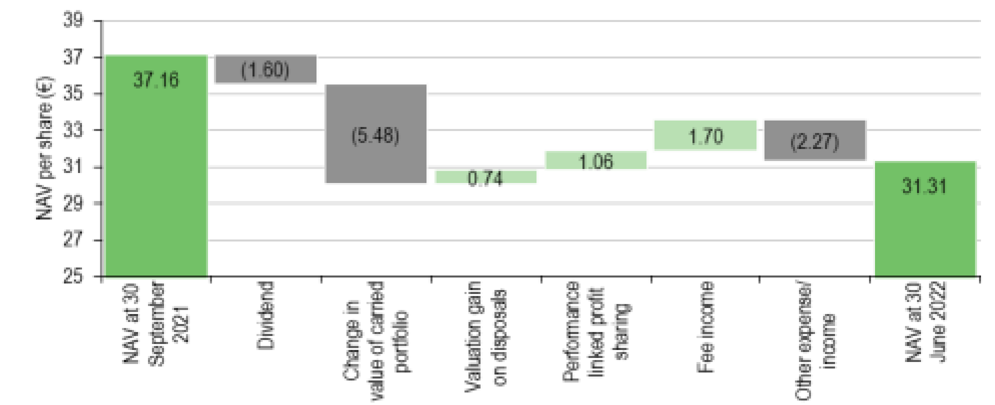
Exhibit 2: Net gains and losses on portfolio measurement and derecognition (€m)

	H122	H121
Change in fair value of unlisted investments	(111.1)	121.9
Change in earnings	*109.0*	*113.4*
Change in debt	*(51.5)*	*(28.1)*
Change in multiples	*(169.4)*	*35.1*
Change in exchange rates	*0.7*	*(0.4)*
Change, other	*0.1*	*1.9*
Net result of disposal	13.9	19.8
Other	(0.4)	(0.3)
Total	**(97.6)**	**141.5**

Source: DBAG

In 9M22, DBAG recognised a gain of €13.6m from the partial disposal of Telio and the refinancing of von Poll Immobilien, which we described in our previous note (no disposals were performed in Q322). After the reporting date, DBAG agreed the sale of its remaining stake in Pfaudler (of which 80% was sold in FY21 at a 1.3x money multiple) at a price in line with the valuation agreed upon the sale of the majority stake.

Exhibit 3: DBAG's NAV* per share development in 9M22



Source: DBAG, Edison Investment Research. Note: *Defined as equity value.

DBAG maintains a high volume of new investments

DBAG has completed a record-high value of new investments so far in FY22, with €151m gross value added to the portfolio, compared to the €57m average annually over the last 10 years. DBAG has invested €127m of equity so far in FY22. This includes six MBOs performed by DBAG-managed funds and two long-term investments made from DBAG's own balance sheet. During Q322, DBAG closed previously announced investments (Metalworks, Akquinet and Green Datahub) and agreed to provide €4m to Solvares and BTV Multimedia to finance their acquisitions. After the reporting date, DBAG made its fourth long-term investment of €25m in a 20% stake in VHF, a manufacturer of computer-aided milling machines for dentistry and industrial applications. Moreover, DBAG's portfolio companies executed seven add-on acquisitions in Q322 (with DBAG's equity contribution at c €4m). Having said that, DBAG's management highlighted the reduced level of new investment opportunities between April and June 2022, which it expected given the sell-off in public markets due to recessionary sentiment.

DBAG's available financial resources at end-June 2022 stood at €113.7m and consisted of cash on hand (€48.0m) and a €65.7m undrawn part of its credit line. While this represents a significant decrease from €219.5m available at end-September 2021, we note that it was paired with a proportional decrease in DBAG's investment commitments. As a result, the difference between co-investment commitments alongside DBAG funds and available resources remained broadly stable and stands at €53.3m (FY21: €53.9m). Overall, DBAG invested €70.1m while receiving €39.8m from disposals during 9M22, implying a net cash outflow of €30m from transactions (the net cash outflow in Q322 was €47m). On the other hand, DBAG's cash position was supported by the receipt of a deferred DBAG Fund VII management fee of €27.8m. We also note that DBAG has drawn €41m from its credit line (which was undrawn at end-FY21). After including post-reporting date events and financial resources available in subsidiaries, we calculate DBAG's current available resources at €100m, which compares to its mid-term investment target of €114m on average per annum in FY22–24 (based on planning as at November 2021). We consider this sufficient liquidity to pursue new opportunities (despite maintained dividend payouts, c €30m paid out this year), given that DBAG's fee income from fund services broadly covers its group operating costs. Moreover, management highlighted during the recent earnings call that it expects to close one disposal by the end of the current calendar year (most likely after the end of its fiscal year, ie end-September).

Russia spoiling the sentiment towards German industrials

The ongoing political conflict between the West and Russia casts a shadow over German natural gas supply, including reduced Russian gas exports through Nord Stream 1 to Germany recently and the risk of a complete cut-off later this year. Germany covers roughly half of its natural gas needs through imports from Russia and, according to the European Stability Mechanism team, a sudden halt in deliveries from August 2022 would fully deplete German gas reserves by end-2022. This would require gas rationing from early 2023, which the German government would likely impose on corporate rather than retail gas consumers.

DBAG highlights that the five of its holdings with the highest gas consumption represent only 3% of the portfolio value (we believe this includes, among others, the foundries Gienanth and Silbitz). Nevertheless, a significant part of the gas demand in Germany comes from its large chemical sector, as well as automotive companies, foundries and rubber producers. Potential cuts in their production output could cause widespread disruptions across the value chain of the German industrial sector. Importantly, if industrial furnaces cool down suddenly, the molten materials harden and the systems may break, which would cause long-lasting interruptions. Deutsche Bundesbank estimates that German GDP could contract over 9% in Q123 due to production cutbacks, with c 3.5% from a direct shock and the remainder from the amplification through supply chains. Consequently, DBAG's portfolio holdings from the industrial sector could be affected by both input shortages and a decline in customer orders.

Valuation: Trading at a discount to NAV

DBAG's NAV (defined as equity value) basically reflects its PE investments portfolio. Having said that, DBAG manages third-party assets of c €2.0bn (AUM at end-June 2022 amounts to €2.5bn, which includes DBAG's investment portfolio) and generates considerable fees. DBAG's shares regularly trade at a premium to NAV (five-year average of 13%), which we believe is due to the market-implied value of the fund services segment (Exhibit 4). Given the recent strong decrease in DBAG's share price (33% since end-2021) it currently trades at an unusual 12% discount to NAV, still narrower than most peers despite NAV underperformance.

Exhibit 4: Share price premium (discount) to NAV over five years (%)

Source: Refinitiv, Edison Investment Research

We estimate the market-implied value of both DBAG segments in two scenarios: the implied value of PE investments, assuming fund services are valued in line with peers; and the implied value of the fund services segment, assuming the PE investments are valued in line with peers. As peers to DBAG's fund services segment, we use a group[1] of listed asset managers with exposure to alternative unlisted assets, such as real assets, PE or infrastructure (as described in detail in our August 2021 note). In the case of PE investments, we use the peer group as presented in Exhibit 6 below, excluding 3i (which also manages third-party capital and generates fee income).

Exhibit 5: Analysis of DBAG's market value by segment

Fund services in line with peers	
Earnings multiple applied to fund services segment's valuation	17.1x
Implied value of fund services segment*	€256.5m
Implied value of private equity investments segment	€264.4m
Implied discount of private equity investments value to DBAG's NAV	55%
Private equity investments in line with peers	
Discount applied to private equity investments value to DBAG's NAV	28.7%
Implied value of private equity investments segment	€419.9m
Implied value of fund services segment	€101.0m
Implied FY22e earnings multiple of fund services segment*	6.7x

Source: DBAG, Edison Investment Research. Note: *Based on the midpoint of management guidance.

Given the high visibility in terms of income generation in the asset management business, valuation multiples in the sector were less volatile in recent months compared to the greater uncertainty about the value of underlying companies in PE portfolios. Assuming the fund services segment is valued in line with peers (ie at a 17.1x FY22e earnings multiple), the implied value of PE investments is €264m, ie 55% below its NAV, while DBAG's peers currently trade at a 29% discount (see Exhibit 6, excluding 3i).

The wider discount may be at least partially justified by DBAG's high exposure to the German industrials sector, which has been experiencing market headwinds for a prolonged time, even before the pandemic. It now faces significant challenges related to a weakening demand outlook, high material costs and supply chain disruptions, as well as the risk of natural gas supply being cut off by Russia (see above). We believe that this is an important factor behind DBAG's underperformance versus its peers. As at end-June 2022, 44% of DBAG portfolio is still allocated to industry, industrial technology and industrial services sectors, which are currently valued at 0.9x acquisition cost on average.

At the same time, however, we note that DBAG's portfolio valuations are based on forward earnings, while most of its peers value their investments using last 12-months figures. Moreover,

1 Blackstone, EQT, Partners Group, Intermediate Capital, Tikehau Capital and Cohen & Steers.

most peers are subject to a varying degree of valuation lag, which may result in an overstated discount to NAV (suggesting that the difference in discount to NAV between DBAG and its peers is even wider). Only Princess Private Equity, 3i and Oakley Capital Investments, like DBAG, reported NAV figures that fully incorporate the recent market downturn to end-June 2022. The remaining peers have their most recent portfolio valuations at end-March or end-April. Finally, we think it is worth noting that DBAG offers the second-highest dividend yield in the group, with the most recent (annual) payment of €1.60 per share distributed in February 2022.

Exhibit 6: Listed private equity investment companies peer group at 19 August 2022*

% unless stated	Region	Market cap £m	NAV TR 1y	NAV TR 3y	NAV TR 5y	NAV TR 10y	Price TR 1y	Price TR 3y	Price TR 5y	Price TR 10y	Premium/ (discount)	Dividend yield
Deutsche Beteiligungs	**Europe**	**439.6**	**(3.8)**	**18.9**	**37.6**	**194.6****	**(23.8)**	**(15.1)**	**(20.5)**	**174.1**	**(11.6)**	**5.8**
3i	Global	12,068.6	36.9	82.1	171.8	672.9	(1.7)	11.0	46.8	718.2	(11.8)	3.8
HgCapital Trust	UK	1,695.1	32.1	115.3	197.8	413.9	(5.3)	62.9	118.2	380.4	(14.6)	1.9
ICG Enterprise Trust	UK	746.8	27.7	74.0	122.3	273.1**	4.9	32.3	63.4	257.2	(38.1)	2.5
Oakley Capital Investments	Europe	739.2	34.7	98.2	147.4	240.7	7.0	76.7	146.6	283.5	(33.5)	1.1
Princess Private Equity	Global	665.2	(5.1)	29.3	57.6	178.7	(0.0)	45.6	55.3	324.6	(17.2)	6.3
abrdn Private Equity Opps	Europe	668.8	31.1	79.8	123.3	302.3	3.1	53.5	67.9	369.1	(40.2)	3.2
Average		**2,764.0**	**26.2**	**79.8**	**136.7**	**346.9**	**1.3**	**47.0**	**83.0**	**388.8**	**(25.5)**	**3.1**
Rank		**7**	**6**	**7**	**7**	**6**	**7**	**7**	**7**	**7**	**1**	**2**

Source: Refinitiv, Edison Investment Research. Note: TR = total return. *12-month NAV performance in sterling terms based on end-June 2022 NAV, or latest earlier available ex-par NAV (end-April for ICG Enterprise Trust, and end-March for HgCapital Trust). **Last available NAV at the beginning of the 10-year period was end-January 2012 for ICG Enterprise, and end-July 2012 for DBAG due to reporting period change during the period.

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