Funkwerk AG

Update report | Funkwerk remains one of the cheapest market leaders due to Hörmann-discount

02 May 2021

Dear Reader,

When I published my initial [research report] on February 9, 2021, the stock was trading at €22. On Friday, April 30, 2021, the stock closed at €24.3 (bid price). This corresponds to performance of 10.5% in 80 days. It is only a matter of time until the share price breaks through the all-time high at around €25.

(Chart taken from ariva.de)

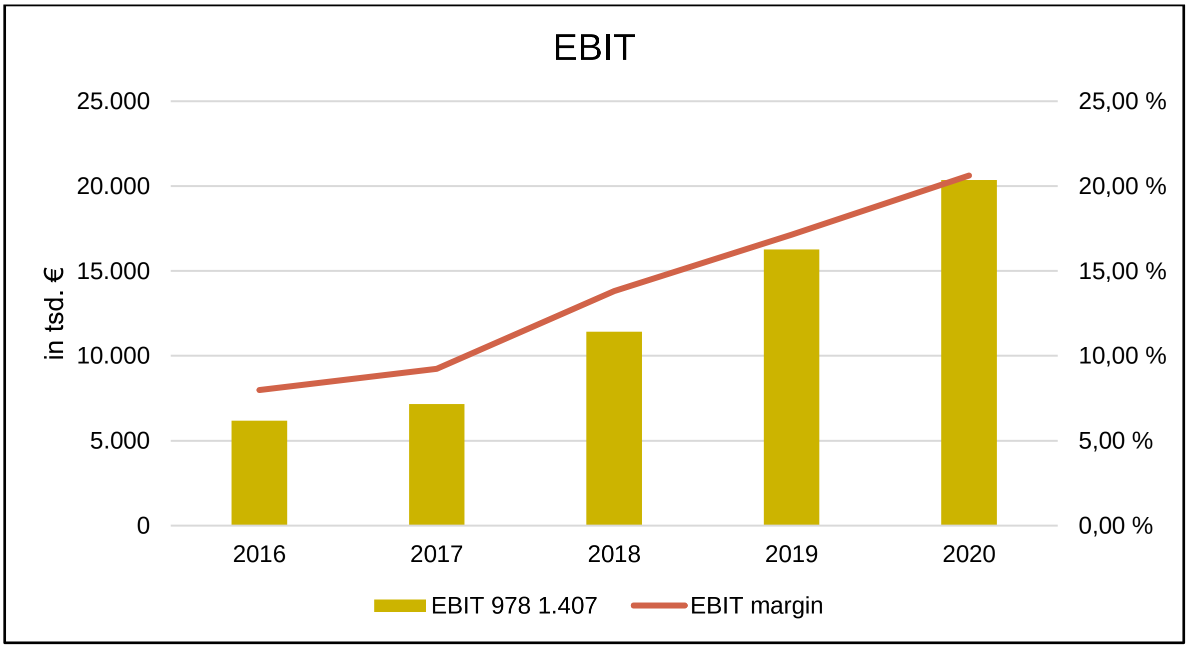
Funkwerk exceeds guidance (once again)

A few days ago, Funkwerk published its annual report for 2020. As always, the management was able to significantly exceed the guidance:

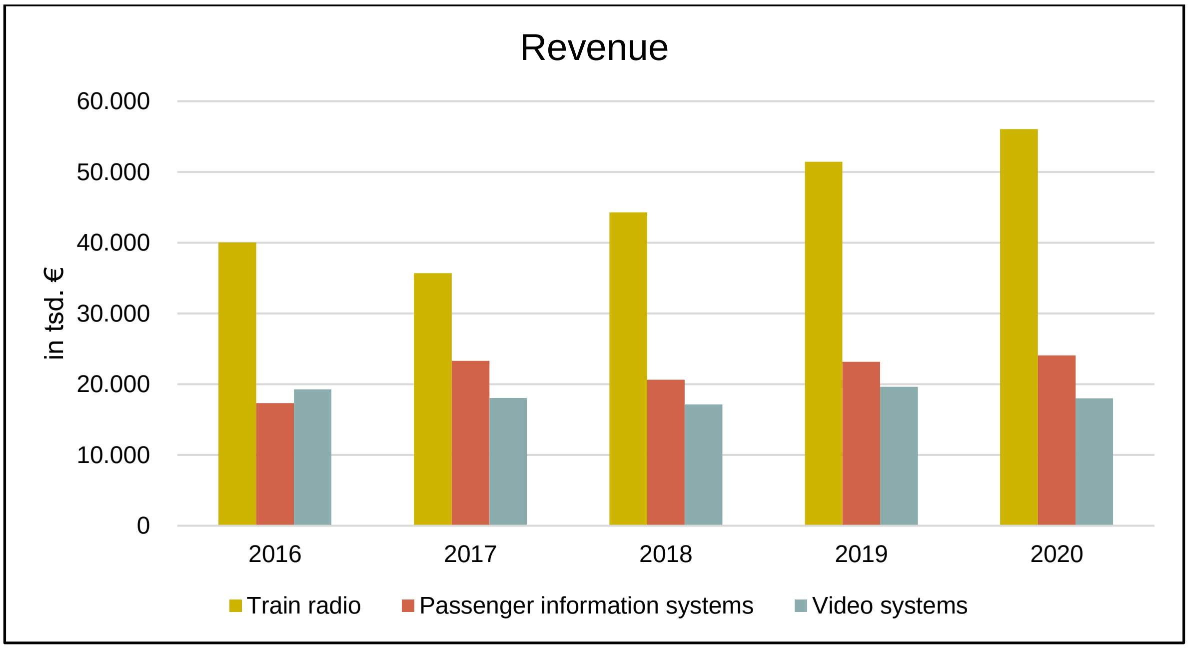
- Revenue came in at €98.8 million, slightly above the guidance of €93-97 million given in August 2020.[1]

[1] Half year report 2020, p. 7

- In August 2020, Funkwerk also expected EBIT to 'likely maintain the high level of the previous year'.[2] EBIT in 2019 was €16.3 million. The actual EBIT achieved in 2020 was €20.4 million, exceeding guidance by 25%.



Funkwerk managed to increase the EBIT margin from 5.35% in 2015 to 20.62% in 2020. Unfortunately, the management only discloses the revenues on a segment basis but does not disclose the segment profits.



Since revenue in the passenger information segment and video systems segment is growing at a slower pace than in the train radio segment, it is apparent that the main driver of profit

[2] Half year report 2020, p. 7

is the train radio segment. This insight is of particular importance concerning the revenue guidance for 2021 given below.

German government's subsidy program leading to higher revenue

First, I want to quote from the Annual Report 2020 (p. 7; underlining added by me):

'In Germany, the paradigm shift in environmental awareness is also becoming apparent, for example in the 2021 budget. The declared aim of the German government is to drive economic growth and climate protection in equal measure, with rail transport playing a key role. For example, the German government's economic stimulus package, which was launched to help the German economy through the crisis, provides for high investment in the rail industry. It consists of many individual measures with a total volume of €50 billion, some of which will also benefit Funkwerk AG. For example, the federal government is supporting the improvement of mobile communications reception along rail routes with a program that will run until the end of 2021, for which train radios are being modernized and upgraded to interference-resistant GSM-R components and systems. As one of the leading suppliers of this technology, we will be able to benefit from the subsidy project and expect it to generate a one-off additional revenue volume in the current fiscal year. [...] In fiscal 2021, despite the current overall economic situation, we expect revenue to grow to €105 million - €110 million due to the one-time orders from the German government's subsidy program. Operating profit in 2021 could once again reach the level of the fiscal year 2020 as a result of the revenue growth.'

If we assume that the other two segments will remain fairly stable and that the majority of the targeted revenue growth (~€10 million) will come from the very high-margin train radio segment, why should we only achieve EBIT at the level of the previous year? I estimate a marginal EBIT margin of at least 30% in the train radio segment so that EBIT ceteris paribus should be at least another €3.0-3.5 million higher than in 2020. Let's come back to that in a moment.

Balance sheet accounting policy: goodwill and provisions

Did the management pursue boundless balance sheet accounting again in 2020?

In my opinion:

Yes.

Yes.

Yes.

Goodwill:

I quote again from the 2020 Annual Report (p. 24; underlining added by me):

'Depreciation and amortization increased from €1.6 million to €2.3 million. This increase is related to the acquisition of the train radio business unit from SISS. The goodwill acquired as part of the asset deal for products and product rights was impaired by €0.7 million in the reporting year in the context of the planned harmonization with the Funkwerk Group's portfolio of services.'

Whatever that means and whatever the reason for this goodwill impairment was: without this impairment, EBIT would have been €21 million.

Other provisions:

As usual to Funkwerk, other provisions were also increased substantially from €28.6 million (December 31, 2019) to €34.0 million (December 31, 2020). The addition to provisions must exceed €8.3 million since management reversed €2.6 million of provisions through P/L. EBIT was thus reduced by a net amount of €5.4 million from the addition to other provisions.

According to German GAAP, provisions are to be recognized in the amount required to settle the obligation according to reasonable business judgment (in German: in Höhe des nach vernünftiger kaufmännischer Beurteilung notwendigen Erfüllungsbetrages). What is reasonable and what is not is at the discretion of management, but with a ratio of other provisions compared to the balance sheet total exceeding >35% and with an annually increasing level of provisions in absolute terms, one may wonder whether this is not an overstatement. Particularly, as provisions are increasing at a significantly higher rate than revenue itself.

Revenue is up 20% from 2018-2020, while other provisions rose by 35%, almost twice as much. How comes? To be honest, I don't know.

Let's assume that the addition to provisions is 'reasonable' in percentage terms to the extent of the revenue growth of the train radio segment only. In this scenario, provisions would have been overstated by €2.9 million in 2020 (leaving aside the fact that the prior-year figure is probably already inflated as well).

The 'real' EBIT for 2020 would then be calculated as follows

€20.4 million reported EBIT + €0.7 million (goodwill impairment) + €2.9m (excessive additions to provisions) = €24 million.

Although this scenario is only hypothetical, it does show the actual earnings situation, which is confirmed by the cash flow statement and the balance sheet (you can't hide the cash...). Let's come back to this in a moment.

At least the goodwill impairment will no longer occur in 2021 (if Ms. Schreiber runs out of creativity as to why the remaining amount of €369 thousand could also be impaired). If we also add the potential additional earnings of €3.5m from the special business cycle, an EBIT of ~€24.5 million should be achieved in the current year (after additions to provisions!).

Based on the last closing price of €24.7 (Tradegate), Funkwerk has a market capitalization of €200 million. Taking into account pension provisions of €6.3 million and a cash position that has meanwhile grown to €51.5 million, the Enterprise Value (EV) is ~€155 million. Thus, the share is currently trading at an EV/EBIT of 6.3 for the current year.

Of course, the development of revenue in 2022 is debatable. Management expects to return to the prior level (maybe 2020 revenue?).

Please note that an FCF approach for 2021 would lead to unsustainable results, as Funkwerk is building an extension at the Kölleda site in the current year and will invest €6 million for this purpose.[3]

Free cash flow before the M&A acquisition was €18.6 million in 2020, which was mainly driven by earnings and not by positive working capital effects reversing in the future. The terminal value for a WACC of 8% and terminal growth of 2% is accordingly €18.6 million / 0.06 = €310 million. Adding cash and subtracting pension provisions, this very simple approach yields an equity value of ~€354 million or €42 per share. I do not need to repeat where the share is trading currently.

What about dividends?

As in the previous year, management will propose a dividend of €0.3 per share to the Annual General Meeting in July 2021. With 8,059,662 shares outstanding, this corresponds to a total dividend payout of €2.4 million after deduction of treasury shares.

In Germany, the amount of the dividend is always based on the balance sheet profit of the parent company, i.e. Funkwerk AG. It's just a pity that most of Funkwerk's revenues and profits are generated by its subsidiary Funkwerk Systems GmbH.

According to the annual financial statements of Funkwerk Systems GmbH published in the electronic Federal Gazette (Bundesanzeiger), the subsidiary achieved revenues of €73 million and a profit (before profit transfer) of €13 million in 2019. According to the consolidated financial statements, revenue in 2019 was €95 million and net income was €13.5 million.

The balance sheet profit of the parent company Funkwerk AG was only €2.4 million in 2019, but the consolidated balance sheet profit was €20.9 million. The majority of the revenues and profits are generated in the subsidiary Funkwerk Systems GmbH, but the balance sheet profit in Funkwerk AG remains relatively small at €3 million.

This means that management can claim that it will pay out a total dividend of €2.4 million from Funkwerk AG's balance sheet profit of €3.1 million in 2021, which makes the payout ratio look high at 77%. However, only 17% of the net income of €13.6 million according to the consolidated P/L will be paid out in 2020.

Conclusion

In the current year 2021, the record results from 2020 are likely to be exceeded due to the special business cycle. The outlook and momentum for the following years should also remain favorable in the medium and long term due to massive investments in rail transport worldwide (e.g., due to ETCS and FRMCS; for more information, please refer to my research report).

The stock remains cheap due to the 'Hörmann-discount' (also widely discussed in my research report).

---

[3] Annual Report 2020, p. 47

As long as the operating performance remains positive, I expect the share price to creep upwards sooner or later.

Disclaimer

Risk warning and terms of usage

The material published in this report is part of a website that is a personal blog. Most of the investments discussed on this website are part of the personal portfolio of the author. This website is not issuing any buy or sell recommendations.

All information contained in this report and its corresponding website, www. stock-market-research. com, are for information purposes only.

Information from external sources is indicated appropriately. The author does not assume any liability or responsibility for the correctness, accuracy, and completeness of this information, even though he deems it to be reliable.

My full-time job is as a buy-side analyst for Paladin Asset Management InvAG based in Hanover (Germany). I would like to point out that I run Stock-Market-Research privately in my spare time. There is no overlap between the investment universe of Paladin Asset Management and Stock-Market-Research. Furthermore, this blog is not a publication of the Paladin Group and I am responsible for the ideas and content presented here. In this respect, there will be no conflict of interest between Paladin and Stock Market Research.

The reference to the analyzed company within this presentation is neither an offer nor a request to subscribe to shares of this company. The information provided is for information gathering only and is not considered as a recommendation for investment. Before making use of the contents you must extensively assess if the information is suitable for your purpose and is compatible with your individual goals. The opinions presented are those of the author at the time of publishing and may not agree with the information provided at a later time. This blog and its articles, research reports, social media postings, media appearances, and any related content serve purely to inform and inspire readers to look out for new investment opportunities and research them themselves; a process for which any reader should then also consult a variety of other sources and never base any decisions on this report or the content of its corresponding website.

This report is not a solicitation or inducement to buy, sell, subscribe, or underwrite securities. The author does not make investment recommendations. Any valuation given in this report is the theoretical result of a study of a range of possible outcomes and not a forecast of a likely share price. The author does not undertake to provide updates to any opinions or views expressed in this document.

The performance in the past does not necessarily provide any indication of future performance. The value of investments and their possible returns are not guaranteed and may increase as well as decrease. Potential investors or interested persons are strongly advised to consult their personal professional advisor for the evaluation of the investment risk and the investment strategy to determine the appropriateness of an investment based on their personal situation.

The author is not paid or otherwise compensated by any of the companies discussed in these reports. The author is likely to be invested in the investments discussed in these reports. The author is under no obligation to update readers about any purchases or sales of his investments. He commits himself not to sell privately any shares of the companies concerned in the temporal context of (positive) blog posts.

Using any of the information contained in this report or on the corresponding website www. stock-market-research.com is at the reader's own risk. There is no advisory relationship between the user and the author. It is prohibited to re-publish the content of this website or reports without the express written permission of the author.

Author's ownership disclosure: At the time of publishing this research report I hold shares in Funkwerk AG.