

Edel

Media
23 May 2017

All-round entertainer

Edel AG is unusual in combining extensive entertainment content (owned and/or licensed) with the ability to manufacture physical assets and distribute both physical and digital formats. The resurgence of demand for vinyl has boosted its recent manufacturing earnings, while the breadth and diversity of the overall offering provides considerable portfolio benefits. The group is majority family-owned, with limited market liquidity. This partially explains the modest rating, at a discount to global entertainment content and publishing companies and carrying an attractive yield.

Full service model

Edel's operations cover a wide range of formats and content. By investing in its systems and production facilities and avoiding becoming over-reliant on any one of the global music industry behemoths, it has been able to build a strong business. It services and supplies many different aspects of the consumer entertainment sector, both in physical formats and in its digital offering, which builds in a further level of resilience to the inevitable shifts in its markets. Although best known for its music, Edel is also a prominent book publisher (with high-quality, in-house production) and has film and family entertainment activities that allow it to leverage its marketing and distribution expertise.

Music back in growth

The music market in Germany had trended down, halving over the 15 years to 2015 by value. It has since reversed the pattern, moving back into growth. Physical product still represented over 60% of the market in 2016 and this remains an important area for Edel. In terms of scalability, digital has inherent attractions and the group has built an enviable portfolio of digital assets, most notably in heritage rock acts, such as Deep Purple and Status Quo.

Valuation: Discount to content, publishing

The combination of manufacturing, logistic services, and marketing and distribution complicates the task of trying to find relevant quoted comparators. We have therefore compared the rating of the company with the global media subsectors of entertainment content and publishing. Edel's shares trade on a significant discount on EV/Sales, most likely reflecting the manufacturing contribution. On forward EV/EBITDA, the discount is 37%. On a P/E basis, the multiple is 16.1x vs 18.3x.

Consensus estimates						
Year end	Revenue (€m)	PBT (€m)	Adjusted EPS (€)	DPS (€)	P/E (x)	Yield (%)
09/15	168.3	3.6	0.12	0.10	21.4	3.9
09/16	180.2	6.0	0.15	0.10	17.1	3.9
09/17e	186.2	5.9	0.16	0.11	16.1	4.3
09/18e	192.1	6.3	0.17	0.12	15.1	4.7

Source: Edel accounts, broker estimates (Montega)

Price €2.57
Market cap €58m

Share price graph



Share details

Code EDL
 Listing Deutsche Börse Scale
 Shares in issue 22.73m
 Last reported net debt as at 30 Sept 16 €36.0m

Business description

Edel AG is one of Europe's leading independent media groups. It is both a publisher and a producer. Edel offers the music, film and book industry a unique full-service model, covering marketing and production as well as the distribution of audio content, video content and books.

Bull

- Diversity of revenue streams.
- Full-service third party offering.
- Resurgence of vinyl.

Bear

- Small free float.
- Lack of comparators for valuation.
- Spotify dominance in streaming.

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Company description: Entertaining content

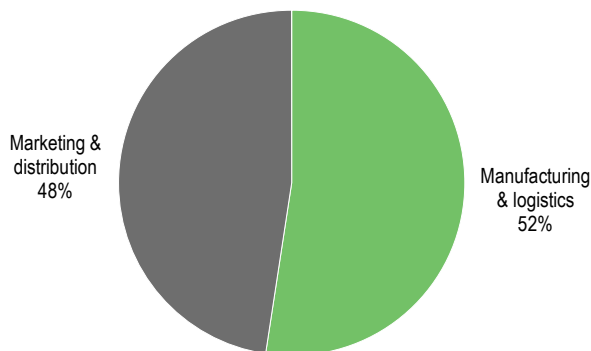
Edel was founded in 1986 by Michael Haentjes as a mail order catalogue business, initially selling film soundtracks then broadening to selling vinyl albums, predominantly imported from the US and the UK. It has since expanded to become a major European independent provider of services to the music and entertainment industries. Encompassing both physical and digital product, it handles both its own content and manufactures and distributes content for third parties. The combination of the marketing and distribution operations with the physical manufacture and logistics operations is unusual in the industry, where the two functions are increasingly separated. While music remains the largest element of content, Edel also produces and distribute books and films.

As the company grew through its early years and built up its catalogue of recordings and artists, there was a growing frustration over supply chain issues (Edel's small and independent status tended to push it down the queue), which led to the company looking at its options. This process culminated in the decision in 1990 to set up its own CD manufacturing facility north of Berlin, now Optimal Media. Vinyl presses were added in 1995.

As the 1990s progressed, the group's ambitions towards becoming a global music industry major developed. The group listed in September 1998, raising around DM60m, and embarked on an ambitious phase of acquisitions. However, the crisis of the Neuer Markt and the lack of further funding opportunities on the capital markets led to a reorganisation in 2001/02. This had two elements: refocusing on Europe and then particularly on German-speaking countries for the group's own subsidiaries; and a restructuring of the German operations, widening the product portfolio and adding and/or expanding Edel:Kids, Edel:Motion, the digital business via Kontor New Media and the book publishing activities. The number of subsidiaries was reduced from over 100 to about seven key operating companies. This repositioning of the business took a number of years, during which time digital became a significant factor in the development of the market.

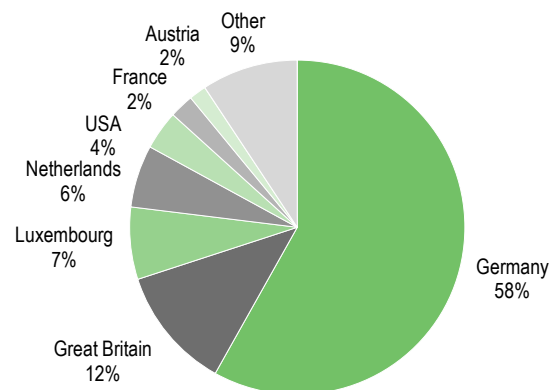
Having right-sized, closed or disposed of businesses that no longer fitted with the strategy, management then looked to broaden the stable of content with complementary acquisitions. These brought it into adjacent fields such as book publishing, DVD, video and family entertainment. Published figures do not separate revenues from these activities, simply the split between manufacturing and logistics and marketing and distribution, as shown below. Germany continues to represent the largest proportion of revenues by some way.

Exhibit 1: Revenues by segment

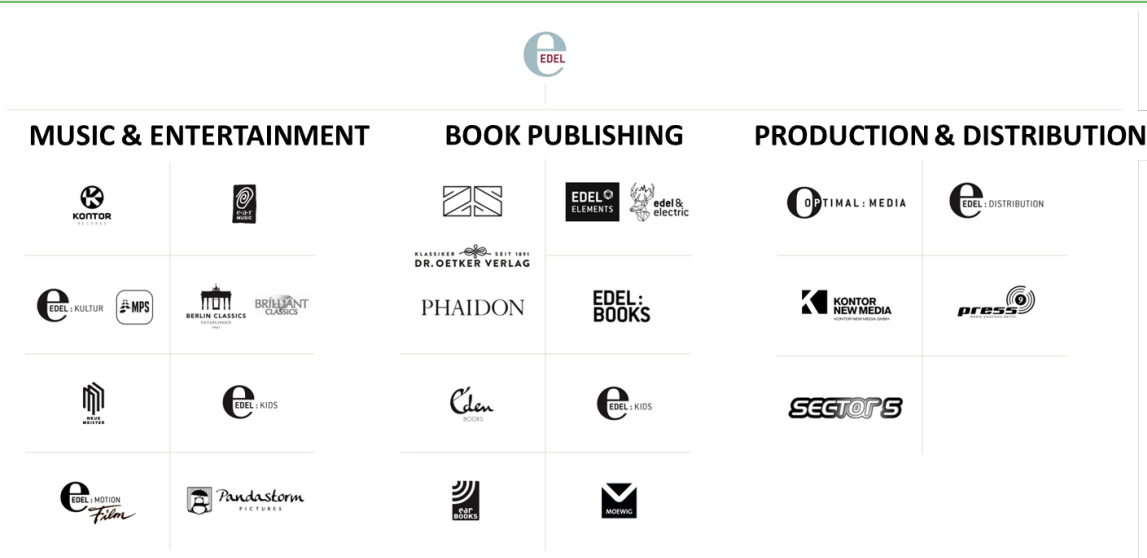


Source: Edison Investment Research

Exhibit 2: Revenues by geography



Source: Edison Investment Research

Exhibit 3: Edel Group AG key brands and operations


Source: Edel. Note: Kontor Records is 66.8%-owned.

Marriage of content and production

Edel's key brands are shown above, split across its fields of activity. The current structure of the group represents a broad base of consumer content, with an emphasis on evergreen artists and properties.

The largest single element of the group is **Optimal Media**, which comprises the bulk of the manufacturing and logistics. From the original CD manufacturing, it added DVD and Blu-Ray, vinyl pressing and book printing. Optimal is one of the leading independent service providers to the European entertainment and media industry. Less than 15% of Optimal's production output is on behalf of other group companies. Financially, the group has gained good advantage from the resurgence in the popularity of vinyl, where it acts as a partner to both large and independent record labels. Over recent years, the achievable price of producing CDs had been drifting, although volumes had held up surprisingly strongly. The rediscovery of vinyl, which has grown from the dance music segment, has led to an unprecedented increase in demand across back and front lists. Optimal has production capacity for 120m CDs and is known for the high quality of its output, with modern, efficient equipment. It has over 700 employees. Its printing capability, originally for the purpose of printing CD/DVD inserts, is again geared up to produce top-end illustrated books as well as more standard stock.

The group has invested over the years in efficient platforms and systems for both production and for post-production: warehousing, pick and pack, delivery and logistics, a complex operation given the high number of SKUs often in relatively modest runs.

Edel Germany is the umbrella for a number of different operations, encompassing the group's content, IP and service capabilities. Edel Germany GmbH covers music, crime, children's content/family entertainment and books, under the brands as shown in Exhibit 3 above. **Kontor Records** (67%-owned) is a major label in dance music, with a high-ranking YouTube channel (currently number four in Germany in terms of subscribers at 4.2 million and with the top ranking for number of video views at 3.9 million (according to SocialBlade monitoring, as at 19 May 2017). Other group-owned music labels cover a range of genres, including classical and rock. **ZS** is one of Germany's largest publishers of cookery books, while the family entertainment activities, under the brand **Edel:Kids**, work with global majors such as DreamWorks and Mattel, which prefer to use independent external partners. Its best-known property is *Pettersson und Findus*, which has become an evergreen and for which Edel Germany holds a wide range of rights.

Both Edel and Kontor had digital assets, which were combined to form Kontor New Media (**KNM**). KNM generates €32m of revenues, on which it earns a 10% EBIT margin. It is a dominant independent digital service provider in European markets and globally across all the key routes to market, including iTunes, Spotify, Napster, YouTube, Amazon and Musicload. It does not have its own end-user channel. In addition to music tracks, it also distributes music video, films and TV shows and audio books, which are an important category in the German market. KNM holds the rights to more than 1.5m titles for thousands of label customers. It has a sophisticated rights management system (DMB) providing state-of-the-art content and sales information to customers.

Edel Germany typically looks to assemble and exploit the rights of evergreen/heritage acts such as Deep Purple and Status Quo, where – although the likelihood of a major chart breakout hit is low – revenues will continue to roll in. It also holds an extensive classical catalogue.

Recent newsflow and upcoming catalysts

The latest published financials are those for the year ended September 2016, which were released to the market in November 2016, with the consolidated report and accounts published in January 2017.

Also in November, the group announced a refinancing of €21m, replacing a bearer bond ahead of schedule with debt finance, described in the financial section below.

Results for the first six months of FY17 have recently been outlined, with the publication of the full interim report due before the end of June 2017. Revenues for H117 were up by 5% to €98.6m, while EBITDA advanced by 9% to €9.1m.

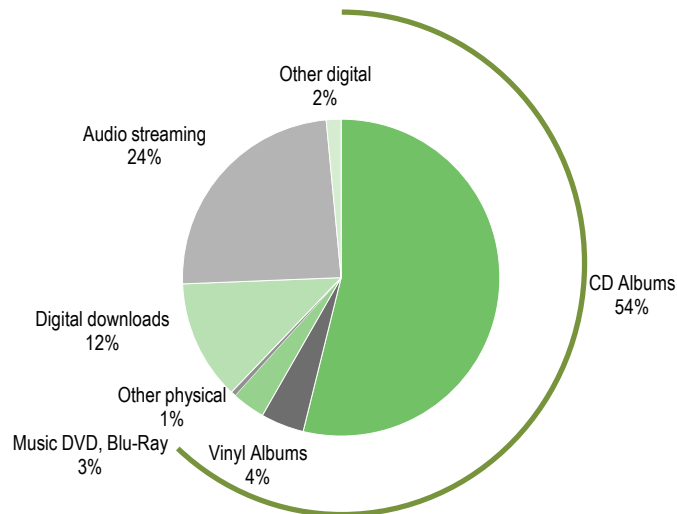
Recent press releases from Optimal Media confirm that it now has approval to upload content onto Apple systems – one of a small handful of European companies authorised to do so. More recently it has announced that it is now (as of February) working closely with Universal Music, responsible for warehousing and worldwide logistics services of all UMGI vinyl products. This is a clear endorsement of Optimal's capabilities. It is also benefiting from EDC (a producer of CDs for Universal) going out of business. Other opportunities may open up as larger overseas players concentrate more closely on their core capabilities.

Market overview

The global music industry has been valued by the industry body IFPI at \$15.7bn (€17.4bn) in 2016. Growth of 5.9% year-on-year was driven by streaming revenues, with the digital share having now climbed through 50%. Revenues are dominated by three key players: Universal Music; Sony Music; and Warner Music. Industry blog MIDiA estimates that they control 28.9%, 22.4% and 17.4% of the overall music market respectively, with independents accounting for the balance of 31.3%.

Germany and Japan are unusual in having significantly higher levels of revenues stemming from sales of physical product. Despite streaming revenues growing at 73% in 2016, digital still only accounts for 37.9% of the market (Source: BVMI). Shares by format are shown in Exhibit 4, below.

Exhibit 4: Germany – share of music market 2016



Source: BVMI

The retail market in Germany is much dispersed, without the dominant category retailers that exist (or did exist) in other European territories within the music segment, such as HMV or FNAC. Important routes to market in Germany would include retailers that sell a broad range of products, such as Media Markt, drugstores or Amazon.

Unlike many other markets, the German book market still operates under a fixed price regime. There are a large number of physical bookstores (estimated at about 6,000, source: [AdB-Online](#)), which account for about 48% of the total market for physical books (online retailers have an estimated 17% market share). The largest chains include Thalia, Weltbild and Hugendubel. Overall book retail sales have been in slight decline of 1-2% for the last few years. The market size, though, is significant, with estimates of its value at over €9bn for 2015.

Management, organisation and corporate governance

Supervisory board and management board

German companies are required to have a clear separation of management and supervisory functions. The management board is responsible for managing the company and representing it in its dealings with third parties. It is overseen by the supervisory board, which also appoints its members. Members of the supervisory board may generally not be involved in the day-to-day management of the company, but their prior consent must be obtained on decisions or actions having a fundamental impact on the assets, financial or profit situation of the company. Edel's supervisory board has been chaired by **Dr Markus Conrad** since October 2016. He is the MD of CERF GmbH and a member of supervisory and advisory boards of German family-owned companies. Most recently he was CEO of Tchibo GmbH; prior to that he was MD of Libri GmbH, Hamburg. He was previously a partner at Bain & Company, most recently as a partner. Other members the supervisory board are **Christian Schantz** (appointed May 2016), who has extensive experience in the media industry and in physical production, mostly at Bertelsmann, and **Joel H Weinstein**, a US-based lawyer with a major entertainment industry practice.

Management team

The group's founder, **Michael Haentjes**, remains the CEO, sole management board member and majority shareholder. He is a notable industry figure and was a member of the International

Federation of the Phonographic Industry (IFPI) for many years. From 2005 to 2007 he was chairman of German music industry associations (Federal Association of the Phonographic Industry, German National Group of the IFPI, Deutsche Phono-Akademie).

Timo Steinberg joined as director of business development in 2002, reorienting the business model and broadening the base across more content areas, including book publishing. He was appointed COO in 2004 and CFO in 2010. His background was in corporate strategy, working for Roland Berger in Munich and London on various restructuring projects.

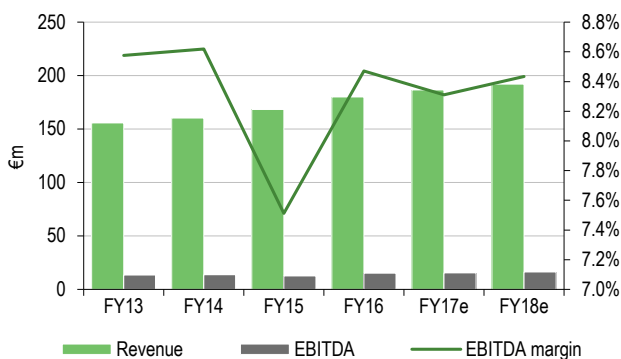
Dr Jonas Haentjes (son of Michael Haentjes) joined the group as director of corporate development last year, with the intention that he takes over from his father as CEO in due course. In the meantime, he will be working alongside his father and Mr Steinberg in determining future corporate strategy. A qualified medical doctor, he also worked at Roland Berger and at Deloitte on strategic projects in the pharma and medtech sectors.

Shareholders and free float

The company is majority owned by Michael Haentjes and family, with 64%. The free float is 30.4%.

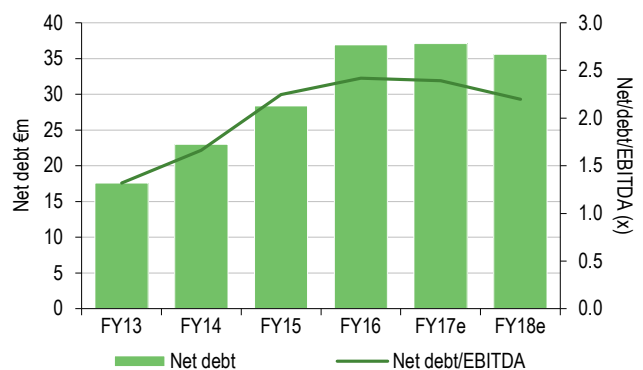
Financials

Exhibit 5: Revenue and margin progression



Source: Edel accounts, Montega forecasts

Exhibit 6: Net debt progression



Source: Edel accounts, Montega forecasts

Income statement

Over recent years, Edel has generated growing revenues, with a 2012-18e CAGR (including the broker forecast period) of 4.3%. This period covers the meteoric rise of music and video streaming. The investment across the business in both production capacity and in the sales and marketing functions has held back the margin in the period up to FY15. The improvement in FY16 reflects the returns on this investment starting to come through, but also demonstrates the benefit of the re-emergence of vinyl records, where Edel's position as one of the few remaining manufacturers with high quality in the European market has stood in very good stead.

Broker forecasts show more modest top-line growth of 3.5% for FY17e and 3.0% for the year after, with the group EBITDA margin staying in the 8.3-8.4% range.

Exhibit 7: Financial summary

€000s	2012	2013	2014	2015	2016
Year end 30 September	HGB/German GAAP	HGB/German GAAP	HGB/German GAAP	HGB/German GAAP	HGB/German GAAP
Income Statement					
Revenue	146,869	155,651	160,418	168,290	180,162
EBITDA	13,745	13,348	13,826	12,641	15,261
Profit Before Tax (as reported)	5,568	4,553	4,734	3,584	6,030
Net income (as reported)	4,411	3,589	3,626	2,841	4,165
EPS (as reported) – (€)	0.16	0.13	0.14	0.12	0.15
Dividend per share (€)	0	0	0	0	0
Balance Sheet					
Total non-current assets	42,568	44,172	43,599	45,191	47,129
Total current assets	68,714	75,601	76,067	75,914	86,133
Total assets	111,282	119,773	119,666	121,105	133,262
Total non-current liabilities	(49,163)	(55,813)	(55,971)	(41,369)	(65,301)
Total current liabilities	(32,847)	(34,650)	(34,399)	(51,309)	(38,102)
Total liabilities	(82,010)	(90,463)	(90,370)	(92,678)	(103,423)
Net Assets	29,272	29,310	29,296	28,427	29,839
Shareholder equity	28,355	28,312	28,292	28,104	28,926
Cash flow					
Net cash from operating activities	18,380	15,188	6,979	10,413	6,377
Net cash from investing activities	(7,410)	(9,097)	(6,396)	(9,468)	(9,667)
Net Cash from financing activities	(3,740)	(4,452)	(8,634)	(5,137)	4,270
Net Cash Flow	7,230	1,639	(8,051)	(4,192)	980
Cash & cash equivalent end of year	11,776	12,818	6,540	5,329	7,807

Source: Edel accounts

Balance sheet and cash flow

Just before the end of 2016, Edel raised €21m of financing with maturities of between three and five years and at various fixed or variable coupons. This was used to repay and replace a bearer bond of €21.25m, which carried a coupon of 7.0%. While the transaction costs will mean that the benefit to earnings in FY17 will be minimal, management's expectation is that interest savings of around €0.8m should accrue from the transaction in FY18. Overall net debt at the year end was €36m and net interest payable in FY16 was €2.68m. Net debt/EBITDA was 2.4x in FY16.

Valuation

A sensible valuation framework for Edel is difficult to put in place, as the company's activities cover such a broad range of physical and virtual product and range, from the pressing of CDs for third parties through children's animated TV to being the market-leading publisher of cookery books and handling logistics and services for the world's largest music publishers. For this reason, any peer group comparison will inevitably be flawed. Given that we are not producing our own forecasts or model, using a DCF has too much subjectivity to be of genuine value. There is also considerable value in the IP owned and licensed by the business, which is unlikely to be fully reflected on the face of the balance sheet.

Given these constraints, rather than pick out a set of inadequate peers, we have looked globally across the key subsectors in which Edel operates, particularly entertainment content and publishing at key valuation metrics. We have stripped out the unprofitable companies from the EV/EBITDA and P/E calculations, as well as any obvious distortive outliers.

Exhibit 8: Sectoral valuations for related activities

	Current EV/sales (x)	Next EV/sales (x)	Current EV/EBITDA (x)	Next EV/EBITDA (x)	Current P/E (x)	Next P/E (x)
Entertainment content	3.0	2.9	10.9	10.4	18.4	17.9
Publishing	1.9	1.8	12.5	9.2	18.3	18.7
Edel	0.5	0.5	6.3	6.2	17.1	16.1

Source: Bloomberg, Edison Investment Research

It would be expected that the multiple to sales would be lower due to the large volumes of third-party revenues, which will also distort margin comparisons. In this context, Edel's share price looks to be well below the global market, partly reflecting its comparatively modest size and limited liquidity.

Sensitivities

- **GDP growth.** All of Edel's consumer entertainment output, physical and digital, is dependent on the economic environment and household disposable income. Relatively small ticket entertainment items, such as music and books, have traditionally been a resilient area of spending and one of the last areas to be cut back when incomes are under pressure. GfK's index of German consumer confidence has been rising; retail sales have been edging up with unemployment falling. This trajectory may be interrupted by the forthcoming elections.
- **Competitive landscape.** Shifts in the competitive landscape can have a material impact, both positively and negatively. Major industry players withdrawing from manufacture and logistics can offer attractive opportunities. On the other hand, alterations to algorithms determining playlists can reduce visibility on the catalogue.
- **Mix of physical and digital; mix of distribution to manufacturing.** The mix of revenue type within a particular period will have a notable effect on the financial returns, with the physical market offering higher returns. The return to fashion of vinyl has had a positive impact on financial performance over recent years.
- **Format changes.** Over the period of Edel's history, the way that entertainment content has been consumed has changed almost beyond recognition. New or altered formats could emerge and take large parts of the market.
- **Regulations regarding copyright.** The difficulties over artists obtaining a fair share of the value of their own-originated content across digital distribution channels has focused attention on how and who makes the money in the online/mobile/streaming/video space. The area is complex and it will be difficult to draw up regulation to achieve the desired outcome and it may be disruptive in its implementation.
- **Cost base.** With a substantial manufacturing and distribution business, traditional elements of cost management (labour, materials, etc) have a clear impact on the financial performance. Investment in platforms over recent periods should mean a good degree of scalability.
- **Capacity.** Again, increases in capacity within manufacturing should lead to positive operational gearing.
- **Management transition.** The intended intergenerational transfer could lead to a change in strategy or emphasis.

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