STEINHOFF'S RED FLAGS

It was one of the biggest corporate collapses in South African history. But should investors have seen the warning signs?

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It is more than a year since Steinhoff announced the forensic investigation into accounting irregularities and the resignation of Markus Jooste as CEO of the company on 6 December 2017. Since then, the company has issued 125 announcements via the JSE's Stock Exchange News Service (SENS), updating the market on various aspects of the investigation and restructuring of the group; three joint Parliamentary Portfolio Committee hearings into Steinhoff's demise have been held; and two books have been written about the company and its controversial ex-CEO.

At the time of writing, Steinhoff's market capitalisation stands at R7 billion, having peaked at R372 billion in April 2016. Investors have lost an astounding R365 billion from its highs.

To date, there has been limited information as to the exact nature of any fraud or accounting irregularities committed. We know that Jooste has been reported to the Hawks in terms of the Prevention and Combatting of Corrupt Practices Act, 2004. The financial results released by Steinhoff on 29 June 2018 also revealed that the previously released financial results at March 2017 were materially and irregularly misstated* as follows:

• Equity was overstated by €10.9 billion (R156 billion). Of this, the accounting irregularities and overstatement of assets and income comprised €6.9 billion (R98.6 billion); over-valuation of property €1.3 billion (R18.9 billion); and the overstatement of intangible assets €2.4 billion (R34.3 billion);
• Operating profit for the six months to 31 March 2017 was overstated by €920 million (R13.4 billion) as a result of accounting irregularities, with the company actually making an operating loss (before interest and tax).

* STEINHOFF'S RESULTS ANNOUNCEMENT REFERS EXTENSIVELY TO "ALLEGED ACCOUNTING IRREGULARITIES"

Steinhoff recently announced a further delay in the conclusion of the PwC forensic investigation to February 2019, and the expected release of audited results by April 2019. Given the numerous legal proceedings against the company, we are concerned that (our understanding of) previous commitments to full transparency by the company may not materialise. If criminal prosecutions are not initiated against Jooste and others, we may never know the exact nature of the alleged corruption, fraud or accounting irregularities. This is a sobering thought.

Pressure Point: Former Steinhoff CEO Markus Jooste testifies in Parliament after the retailer's collapse.

NEGATIVE ON STEINHOFF FOR A DECADE

Prudential has been very negative on the Steinhoff investment opportunity due to a number of fundamental concerns based on our detailed financial analysis of the company. We have been outspoken in our views, and communicated this to clients as far back as 2010 and even earlier. We therefore thought it appropriate to highlight what we believed to be the red flags over the past decade, and whether investors could realistically have seen this coming.

It needs to be understood quite clearly that were this blatantly obvious, or if there had been one easy-to-spot big issue, then every analyst or fund manager that bothered to do their homework would have come to the same conclusion. A lot more time and effort than a mere "30 minutes" was required, and in many cases evidence had to be gathered over a number of years, and information pieced together. But ultimately, the collapse of a large entity like Steinhoff has shown the value of conducting detailed fundamental analysis, and of avoiding accidents by holding an underweight position in our funds to minimise performance drawdowns for our clients.

> ***We were recently reminded by a client who recalled one of our portfolio managers giving an opinion that 'directors will be going to jail here'."***

This article will initially highlight certain of the numerous red flags, and then progress to some of the more fundamental financial issues which caused us to be negative on Steinhoff. To clarify, our use of the term "red flags" refers to the warning signs and danger signals which were not necessarily issues on their own, but by their very nature were of concern to us, and in our view should have led to analysts digging deeper and adopting a more sceptical approach. Often these are the issues that were obvious with the benefit of hindsight. It's easy to be wise after the event, but we will limit ourselves to the red flags we identified and discussed internally, as well as actually communicated to our clients in justifying our substantial underweight holding.

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0 OF THE “REDDEST” RED FLAGS

So then, what were these red flags? We’ll limit these to 10 of the reddest.

> *Steinhoff’s audit fee was always disproportionately high relative to other industrial companies”*

1 CEO: Markus Jooste was a dominant CEO who demanded respect and ruled with an iron fist. It appeared that fellow executives seldom questioned his views or chosen course of action.

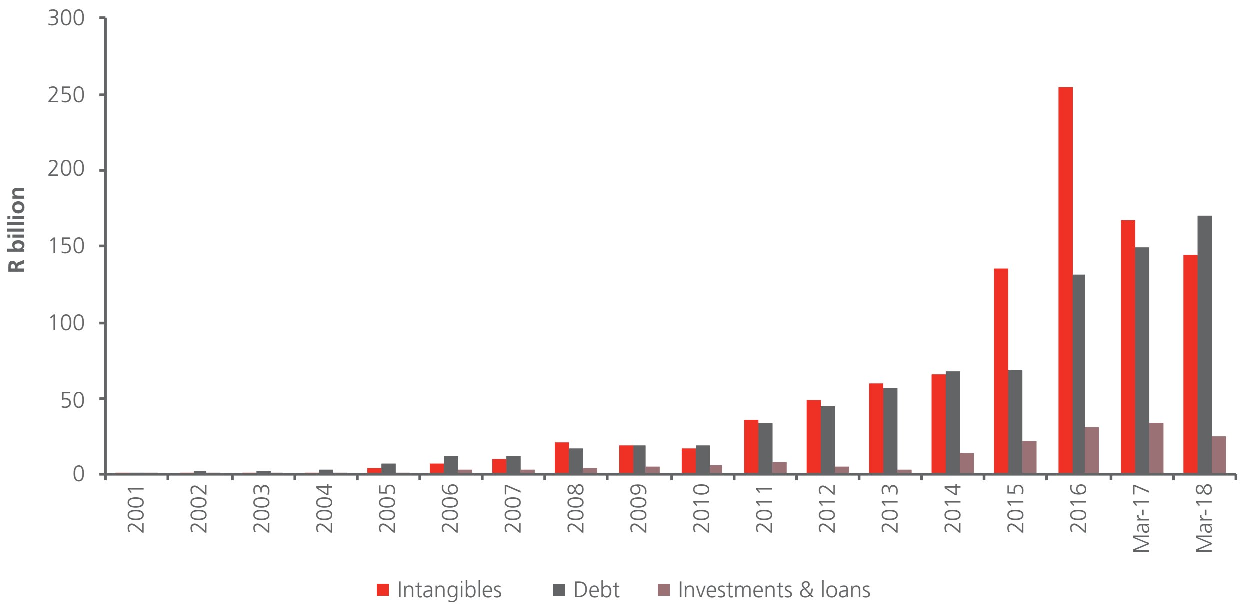
2 CHAIRMAN: It was our impression that Len Konar was overly supportive of and loyal to the CEO, and thus an ineffective chairman (up to his replacement by significant shareholder Christo Wiese in May 2016). In turn, Wiese’s significant shareholding in Steinhoff and ongoing proposed deals with Shoprite and Pepkor, made it hard to conclude that he was an independent chairman.

3 AUDITORS: Steinhoff’s audit fee was always disproportionately high relative to other industrial companies, even when it was a relatively small company. We were concerned that this could potentially impair the independence and objectivity of the group auditors when signing off the accounts. We were also very concerned that a relatively unknown firm of localised auditors (Commerzial Treuhand) audited a substantial part of Steinhoff Europe. The fact that the group auditors did not audit the entire group was a major issue in our view, particularly given the significant intra-group transactions.

4 ACQUISITIONS: The constant stream of acquisitions – which appeared to become an obsession in 2016, when they purchased Home Retail Group, Darty, Poundland and Mattress Firm in quick succession – made year-on-year comparability of Steinhoff’s results exceptionally difficult. Importantly, acquisitions of majority stakes in subsidiary companies permit the acquiring company to make pro-forma pre-acquisition provisions in respect of the acquiree. If subsequently released through the consolidated group income statement, these create non-economic earnings for the group. It is important to highlight that not every company that is acquisitive is another Steinhoff.

Storm Brewing: Christo Wiese appears with other Steinhoff executives at a parliamentary hearing.

GRAPH 1: RISING DEBT, INTANGIBLES AND "INVESTMENTS AND LOANS"
STEINHOFF BALANCE SHEET



Source: Company financials and Prudential

> ***The manufacturing and sourcing business was a 'black box' about which very little was known or communicated."***

5 STRUCTURE, NATURE AND TIMING OF TRANSACTIONS:

Apart from the sheer number of acquisitions, many of Steinhoff's transactions were not straightforward. For example, the acquisition of Freedom Group (with which Steinhoff already had a JV) in Australia was structured via an intermediate company called Bravoscar, in which Steinhoff initially held 25%.

Steinhoff then lent AUS$115 million to Freedom Group management via Bravoscar to buy out the minorities in Freedom Group, and later acquired the remaining 75% in Bravoscar for the equivalent of R515 million. Similarly, the Hemisphere property transactions: In June 2008, Steinhoff initially sold its European properties to Hemisphere in exchange for a 45% stake and balance via loan account, plus management and administration fees to be payable to Steinhoff. In July 2009, Steinhoff then acquired the remaining 55% in Hemisphere by issuing 72.1 million shares to Fihag Finanz (see point 5 under Financial Concerns). Other transactions structured in complex ways include JD Group, KAP International, PSG and kika-Leiner, to name but a few. The key issue here is that the more complex a transaction, the easier it is to structure it in a way that could "manufacture" earnings for the group. From an accounting perspective, generally the important percentage ownership bands are: below 20% (accounted for as an investment); 20-50% (equity accounted as an associate); and 50%+ (consolidated as a subsidiary). Steinhoff's transactions often crossed these key levels and back again, providing interesting accounting and earnings opportunities. In addition, a vast number of transactions (Hemisphere, JD Financial Services, kika-Leiner, Mattress Firm, Poundland, et al) were concluded on the last day of Steinhoff's financial year. We found this extremely peculiar.

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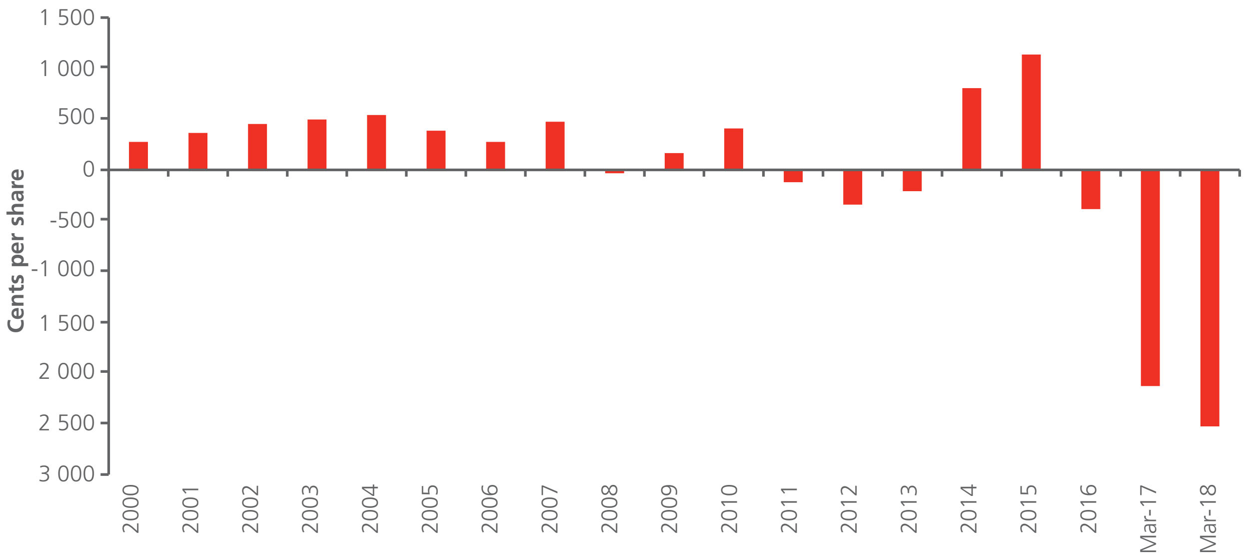
GRAPH 2: STEINHOFF'S TANGIBLE NAV MOVES SHARPLY NEGATIVE



Source: Company financials and Prudential

6 SENS ANNOUNCEMENTS: A number of Steinhoff's transactions were never announced via Stock Exchange New Service (SENS) announcements, as is required under JSE rules. For example, Steinhoff's June 2008 results were released and presented including the consolidation of ERM, despite no announcement ever being made about this acquisition. Equally, the acquisition of Pepkor was announced in November 2014 without a prior cautionary announcement, despite the seller Brait issuing a cautionary more than two months earlier that it was in unspecified negotiations.

7 RESULTS PRESENTATIONS: For many years Steinhoff was the only JSE Top 40 company that did not take questions at its results presentations.

8 DISCLOSURE: Steinhoff's underlying businesses were opaque and disclosure was poor. The manufacturing and sourcing business, for example, was a "black box" about which very little was known or communicated. There were also a significant number of transactions with unknown private entities.

9 TAX RATE: Since its listing, Steinhoff's tax rate was unusually low, ranging between 5% and 15% despite a number of its underlying operations paying a full tax rate. Although it benefited from manufacturing tax incentives in various countries such as Poland, as well as exposure to low tax jurisdictions, the sustainability of this low overall tax rate was always an overhang on the share. Steinhoff was also suspected of shifting income from high to low tax jurisdictions via brand management and royalty fees. It will be revealing to see what real tax rate emerges in the audited financial statements following the conclusion of the PwC forensic investigation, and what tax liabilities may yet arise.

10 ROYALTIES AND BRAND MANAGEMENT: The intra-group royalties paid to other entities within the group were significant and not only achieved a low effective tax rate, but were also used to justify the valuation of ever increasing trademarks. It is well-recognised that trademarks and other types of brand recognition are difficult to value accurately given their esoteric nature.

In our view, these 10 red flags were enough, at the very least, to set alarm bells ringing. Possibly the biggest red flag at the very end was the delay in the release of Steinhoff's September 2017 financial results, in particular when the company initially indicated it would release unaudited results.

6 FINANCIAL CONCERNS

On top of all of these red flags, there were also a number of concerning fundamental issues with the company's finances, which we summarise below.

1 INTANGIBLE ASSETS: These represent assets that are not physical in nature, such as goodwill, brands, trademarks and customer relationships, as opposed to tangible assets like property, equipment and inventory. Steinhoff's disclosed intangible assets ballooned from around R5 billion in 2004 to over R250 billion in 2016, as shown in Graph 1, largely as a result of ongoing acquisitions and other transactions. Importantly, these assets were largely funded by debt on Steinhoff's balance sheet. Questionably, they were also considered to have an indefinite useful life, hence were not amortised through the income statement (where their value is written off over time). The fair value of the underlying net assets acquired via Steinhoff's seven largest acquisitions (Unitrans, Homestyle, ERM, Conforama, Pepkor, Poundland and Mattress Firm) amounted to R23.3 billion, of which a staggering R21.4 billion was intangible in nature, for a tangible net asset value of only R1.9 billion. Any guesses as to how much Steinhoff paid to acquire these assets? Try R135.3 billion, representing (we believed excessively high) goodwill of R112.0 billion (premium at acquisition) plus the R23.3 billion.

Meanwhile, in a number of years Steinhoff's tangible net asset value was negative, including in 2016 when it amounted to 394 cents per share (cps). At March 2017, the tangible net asset value was restated to a staggering 2132cps, which grew to -2523cps by 31 March 2018, as shown in Graph 2.

2 DEBT: Steinhoff relied on the constant supply of debt funding, which remarkably it was able to obtain at extremely attractive interest rates. In essence, however, debt funders were predominantly funding the intangible assets on the balance sheet referred to in point 1 above. The debt was also financing dividend payments to shareholders (see point 5 below). Ultimately it was the burden of debt of just under R160 billion (see Graph 1) in conjunction with the alleged accounting irregularities that triggered the demise of Steinhoff.

3 QUALITY OF EARNINGS: As a result of numerous factors such as the release of pre-acquisition provisions, foreign exchange gains (remarkably always a credit to the income statement irrespective of the direction of currency moves), creation of deferred tax assets, revaluation of forestry assets and most importantly interest and profit participation gains on loans (see point 5 below), we calculated that almost 50% of Steinhoff's profits were of extremely poor quality, and not backed by true underlying cash flows.

4 INVESTMENTS AND LOANS: The growing balance of unlisted investments and loans disclosed was a major concern. Importantly, interest and profit participation charged on these loans were credited to the income statement and capitalised to the loans, rather than being received in cash. These investments and loans either subsequently disappeared as part of the cost of acquisitions made,

Under Fire: Acting Steinhoff CEO Danie van der Merwe.

or were being used to remove losses and other items off the balance sheet; they were a major tool to overstate income and cash flows. The existence and size of these loans were highly unusual for a cash-hungry group such as Steinhoff. Subsequent revelations appear to indicate that the balance of these loans was even higher, given that certain intra-group guaranteed loans were disclosed as cash and cash equivalents.

5 OVERSTATED OPERATING CASH FLOWS: Investors have always maintained that cash flows can never be manipulated. Our analysis of Steinhoff's free cash flows and the deployment thereof revealed significant concerns that operating cash flows were materially overstated, mainly through the use of the investments and loans described in point 4 above. The substantial gap between (the disclosed) operating cash flows and dividends paid to shareholders highlighted the problem. In reality however, even these paltry dividends were being funded by debt. By our calculations, operating cash flows were overstated by a staggering R38.8 billion between 2005 and 2016. Even this number appears to have been conservative given recent revelations in Rob Rose's book Steinheist.

6 FRONT-RUNNING OF TRANSACTIONS: In the 2000's, court cases brought and won by SARS revealed that the company and insiders, including Jooste, had benefited from certain minority buyout transactions involving the flipping of assets acquired on behalf of Steinhoff at a significant profit to these entities, ultimately benefiting insiders, including Jooste. Subsequent press revelations appear to indicate that these transactions were just the tip of the iceberg, and that the involvement of insiders was even more extensive.

In conclusion, we remained extremely concerned about Steinhoff for many years, based on our detailed analysis of the company and the red flags we identified. When the news first broke on 6 December 2017, we cautioned that the forensic investigation would take months, if not years, to be concluded.

Nevertheless, we have to concede that the extent of the accounting irregularities disclosed in the recently released re-statement of Steinhoff's March 2017 results, took even us by surprise.

Based on all of the above, we do not think it unreasonable to conclude that there were sufficient red flags and fundamental financial concerns to warrant extreme caution by analysts, fund managers and others. However, similar cases around the world (think Enron, Madoff, et al) have shown that when company management want to hide questionable dealings from the outside world, it can be very difficult for others to get to the truth.

UPDATE: On 19 March PwC released its 10,000-page forensic report on Steinhoff which uncovered €6.5 billion (roughly R100 billion) in irregular transactions with eight different firms between 2009 and 2017. These allowed the company to artificially boost profits, property values and inflate the amount of its cash flow. It also named eight people responsible for accounting fraud. It is heartening to know that some progress is being made.