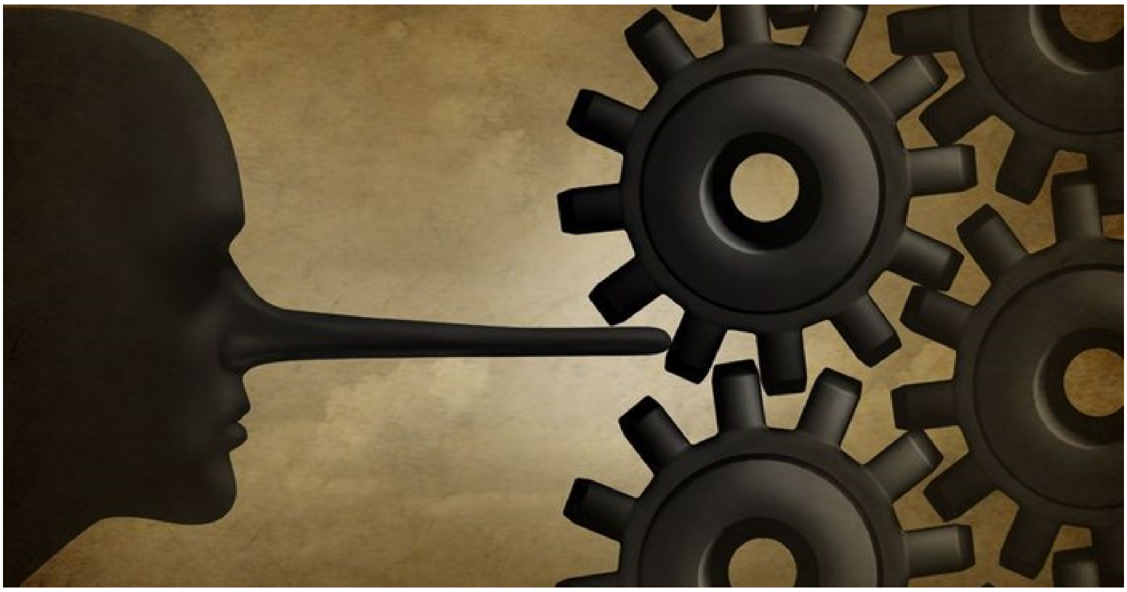
Claims against Steinhoff uncover revolving tangle of dodgy deals

By Hanna Ziady

14 Dec 2017

The Steinhoff International management stands accused of cooking the books to hide losses and inflate earnings. But what exactly might it have done and how?



©lightwise 123rf.com

A report by Viceroy Research " published on the same day Steinhoff admitted to financial wrongdoing and its longtime CEO, Markus Jooste, resigned " provides some indication as to how the financial engineering apparently took place.

The mystery authors admit the report is opinion based on "publicly available facts, field research, information and analysis through our due diligence process". They also had a short position in Steinhoff, meaning they would profit from the company's share price falling.

They say their anonymity is related to the fact that there have been past issues "that go beyond the realm of legality", where short sellers had been targeted.

"Viceroy spends its time researching companies with signs of questionable accounting practices and serious fraud. Steinhoff has been on the radar for months, however, we really knuckled down at the start of November," they say.

While Viceroy appears to have done its homework as far back as 2007, then-JP Morgan researcher Sean Holmes released a report in which he raised concern over the quality of Steinhoff's earnings "given its poor financial disclosure and lack of transparency".

Steinhoff "has been on an aggressive acquisition crusade over the past six years, which makes it extremely difficult to establish how well the underlying business units are performing," Holmes said.

"Despite the R13.5bn spent on investments over the past six years, the company has failed to improve profitability."

Steinhoff still has a penchant for big deals: in 2016 it spent about R70bn acquiring Mattress Firm (US), Tekkie Town (SA), Poundland (UK) and Fantastic Holdings (Australia). These transactions followed the 5.5bn acquisition of Pepkor in 2015 and the 1.2bn acquisition of Conforama in 2011.

Keith McLachlan, fund manager at AlphaWealth, says Steinhoff's return on capital employed appears to have been falling over the past decade, which can occur when businesses are highly acquisitive.

While it would be reasonable to argue that Steinhoff is in the process of consolidating its acquisitions and that returns will come down the line, if there has been fraud that may no longer be a reasonable explanation, McLachlan says.

So, if there has been fraud, how did it happen? It seems by using three off-balance-sheet related party entities: Campion Capital, Southern View Finance - controlled by entities linked to chairman Christo Wiese - and Genesis Investment Holdings.

Steinhoff lent money to these entities to buy its unprofitable businesses and then booked interest revenue on these loans, says Viceroy. The picture that emerges is of a company consistently on both sides of a transaction.

Loans to off-balance-sheet related party entities

The claim: Steinhoff funded the sale of certain of its own businesses to related third-party companies, without disclosing that these were related entities. It then booked interest revenue on these loans.

Steinhoff funded the sale of its subsidiaries - GT Global Trademarks and JD Consumer Finance - to Campion Capital, a Swiss-based private equity firm incorporated by, among others, former Steinhoff Europe CEO Siegmar Schmidt. Steinhoff did not disclose this loan as a related party transaction but booked healthy interest income from the loan, which, argues Viceroy, "will never be repaid in cash".

When questioned by analysts, Steinhoff had claimed these loans were to Chinese suppliers, but at the same time had outstanding trade payables (debts owed to suppliers) amounting to nearly 2.3bn. The group's high days-payable-outstanding also suggests it didn't pay suppliers timeously (let alone lend them money).

This could also explain Steinhoff's rising cost of debt, which McLachlan describes as "bizarre". "Steinhoff was going into Europe, where debt is pretty much free."

Either it suggests its lenders view the business as risky, or that "there is not enough debt" - that is, it is hiding debt off its balance sheet on which it is paying interest, he says.

Disguising losses

The claim: Steinhoff moved JD Group's consumer finance division, JD Consumer Finance, off its balance sheet to disguise its nonperforming loans.

JD Consumer Finance, JD Group's unsecured lender, was sold in January 2016 to Wands Investments, ultimately a subsidiary of Campion Capital. This moved an entity that posted losses of 155m in 2015 off Steinhoff's balance sheet.

A second unprofitable consumer loans business - Southern View Finance (SVF) UK, operating under the name Capfin, which had a run-in with the national credit regulator (NCR) in 2015 - was also sold to Campion. A Wiese-controlled company, Capfin primarily provided loans to customers of companies owned by Pepkor, including Pep and Ackermans.

The national credit regulator found it guilty of reckless lending, leading to a settlement and the sale of the business to Campion.

SVF helped boost sales at Steinhoff group companies by granting loans to its customers, generally at high interest rates, Viceroy claims.

According to SVF UK's annual report, Steinhoff was one of its funders. Viceroy argues that by keeping consumer finance entities off-balance sheet Steinhoff was able to:

- Boost sales through predatory consumer loans;
- Book interest income on the loans used by Campion to purchase the consumer finance businesses; and
- Obscure impairment losses.

Steinhoff recently bought SVF UK's loan administration and debt collection units, enabling the group to "book further gains off nonperforming loans held by off-balance-sheet entities", says Viceroy.

Steinhoff appears to have acquired SVF UK earlier in 2017, creating a somewhat puzzling "round-trip" transaction.

Genesis Investment Holdings and kika-Leiner

The claim: Steinhoff facili-tated the purchase of Austrian discount furniture retailer kika-Leiner by Genesis Investment Holdings, using shareholder funds to enrich management.

Steinhoff, says Viceroy, financed the acquisition of kika-Leiner by Genesis Investment Holdings, another Schmidt-controlled entity in which it had no interest, by issuing 120-million shares at 3.12 a share.

Steinhoff then loaned Genesis 375m to acquire 100% of kika-Leiner, only to purchase kika-Leiner's property portfolio from Genesis for 452m six months later.

Prior to the Steinhoff-funded acquisition of kika-Leiner, Genesis had no notable operations.

It later became the reverse takeover vehicle through which Steinhoff listed in Frankfurt.

"We question why Steinhoff felt the need to acquire the kika-Leiner business in such a way. Viceroy believes this scheme was enacted purely to enrich management," says Viceroy.

Steinhoff management failed at least one asset manager's test. "Although we held Steinhoff in the past, developments at the company over the last number of years resulted in the company no longer making it through our management checklist," said PSG Asset Management fund manager Paul Bosman.

Tax and depreciation

Viceroy points to unusually low depreciation charges: Steinhoff's property, plant and equipment has an implied average lifespan of 24 years, relative to average lifespans of four to 14 years among peers.

Its tax rate is also unusually low, considering that the companies it bought paid far higher tax rates before and operations had not changed meaningfully post acquisition.

Ownership disputes

Steinhoff is locked in a legal battle with Andreas Seifert, the owner of German household goods retailer XXXLutz.

Steinhoff denies Seifert's equity claims on Poco and Conforama, two of its acquisitions, and the matters are before a court.

If any of the above claims turn out to be true, Steinhoff may soon rank among SA's greatest corporate scandals.

Steinhoff is not responding to requests from media, saying it is not in a position to comment until it gets feedback from PwC and Deloitte on "allegations of accounting irregularities" and the release of its financial statements, respectively.

Source: Business Day