Korner Perspective
Steinhoff
Dissecting the situation

DECEMBER 2017

We were very shocked by last week's announcement that Markus Jooste had resigned as CEO of Steinhoff, with the board appointing PWC to investigate potential accounting irregularities.

While we had been growing a little wary of the quantum, scale and prices paid by Steinhoff in their recent acquisitions, we concluded that Steinhoff management were aggressive but not reckless.

We also took comfort in the following:

1. The fact that Steinhoff had a history (over decades) of making good (albeit smaller) acquisitions.
2. Steinhoff had demonstrated an ability to turn around acquisitions (this was evidenced by the financial results showing acquisitions like Conforama producing pleasing results after being acquired).
3. Steinhoff is a significant player in many countries, evidenced (for example) by the fact that Steinhoff is the 2nd largest home furniture retailer in the world.
4. Our belief that the active positioning of the Steinhoff group in the value segment would offset disposable income pressure in key markets (e.g. France, Austria, and the UK).
5. The fact that the incorporation of Christo Wiese's Pepkor not only diversified the group, but opened exciting new synergistic opportunities (e.g. in Eastern Europe)
6. The incorporation of Pepkor also introduced a shareholder of reference who is not only able to financially support Steinhoff, but added a level of comfort given his reputation as a very astute investor and very strong personality.
7. The fact that the massive debt was not only manageable (given the very low funding rates) but more than covered by a massive shareholder equity base.
8. That the debt was long term and at low rates. This is evidenced by the fact that Steinhoff were able to raise EUR 800 mil. bonds with a maturity of seven and a half years (in the Euro bond market) in July at a rate of only 1.87%.
9. Very solid medium-term earnings forecasts (in Euro terms) and an undemanding PE, and
10. A highly competent and experienced supervisory board of directors, with six highly experienced chartered accountants on the supervisory board.

What we know about Steinhoff

While there is a great deal of speculation, the reality is that we frankly don't really know a lot about what went wrong at Steinhoff or why it was done.

All we can really do in forming a view on the future is to start with what we know, and work from there. At this stage we feel we know the following:

1. Steinhoff is a real business. It has operations in many countries and is dominant/ strong in a number of these markets (e.g. Pep in South Africa, Mattress Firm in the US etc.).
2. While the value of Steinhoff's asset values is subject to debate, there are real assets (e.g. property and plant, and stakes in listed entities).
   - We estimate the property portfolio to be worth roughly R 10 per share.
   - The current value of listed holdings (STAR, KAP and PSG), after the sell-off is worth roughly R 17.
3. Christo Wiese has effectively consolidated the bulk of his assets into Steinhoff/ Steinhoff Africa Retail. While he remains a significant investor in Brait, Invicta and Stella, by far the bulk of his invested wealth now sits in the Steinhoff group.
4. Steinhoff has strong anchor shareholders/ Christo Wiese owns roughly 23% of Steinhoff and the PIC almost 10%. Steinhoff is also a very widely held share, with a most of the bigger South African fund managers (e.g. Coronation, Foord, Investec and Old Mutual) all holding significant positions
5. The share fell from R 45 to R 18 on the news of the scandal, with the share in volatility auctions for most of Wednesday morning.
6. Steinhoff was engaged in bidding wars for a number of their acquisitions/ targeted acquisitions and there has been a fair amount of corporate action in the retail space in Europe and the UK.

What we think we know

1. We believe that the accounting scandal surprised the board as much as the market. While this is concerning on one level, it suggests that the fraud was perpetrated by a few individuals and is not reflective of a company rotten to the core.
2. We believe the problems in Steinhoff's accounting relate to off balance sheet vehicles that we suspect were used to inflate profits/ mask losses or impairments. Indications are that this amount may be roughly EUR 6 bn.
3. The PWC forensic investigation will take some time, such that we may only really have a clear picture of the state of Steinhoff's financial affairs in early January 2018.
4. There is likely to be a liquidity squeeze on the short term.
5. We believe that there will be buyers for most of Steinhoff's assets, albeit at lower prices than they may have paid.
6. The anchor shareholders (Christo Wiese and the PIC) will probably have no choice but to help fund a transition period (to realise value), as failure to do so may result in further value destruction.
7. We estimate (based on a number of crude assumptions) that Steinhoff is worth at least R 20 per share.
8. Steinhoff will need to sell off assets quite quickly (they have already received offers for roughly EUR 1 bn. worth of non-core assets).

Our summary of the situation

The scale of the (assumed) fraud and value destruction is almost incomprehensible. EUR 6 bn. (the suggested fraud) translates into almost R 100 bn., making the fraud alone as big as the gross market capitalisations of Amplats, Nedbank, Discovery or BidCorp.

Steinhoff impacts almost all South African investors, from government employees (invested via the PIC), to investors in local general equity funds and even investors in tracker funds.

Our conclusion is that the board must and will move quickly to realise cash and make plans to secure the funding necessary to continue operating (a task complicated by recent rating downgrades) to avoid the sale of assets at prices well below fair value.

While a write off of EUR 6 bn. is a huge number, it is roughly 20% of total assets and approximately 40% of shareholder equity.

While the persistent selling of the share suggests that many question the likelihood that Steinhoff will survive, we believe that Steinhoff will probably survive, albeit quite a different looking company in the future.

We have concluded therefore not to sell Steinhoff until we have a clearer picture, mainly because we sense it is probably worth quite a bit more than the current share price.

We will monitor the situation closely and consider future actions (including a possible rights issue) very carefully.