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Coverage Initiation

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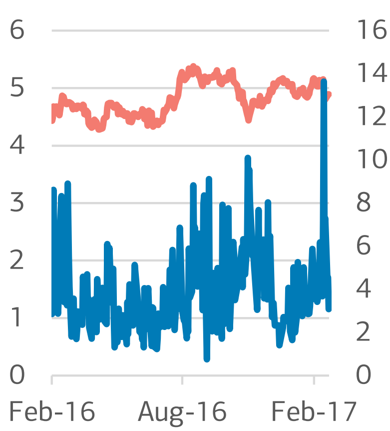
Harvey Norman (HVN ASX)

Price	AUD 4.89
Rating	**SELL**
Price Target	**AUD 2.91**
Market Cap	5.44 mln
Avg. Volume	5.4 mln
TTM PE	12.94

Harvey Norman (HVN ASX) last share price in AUD (blue) and volume (pink, in bln shares)



Source: Bloomberg

Harvey Norman Holdings Ltd. (HVN ASX)

Australia's Circuit City

Overstated Revenue

We estimate that Harvey Norman (HVN) is overstating revenue from franchisees by about AUD 150 mln per year, or 8% of consolidated revenue. That money comes straight off the bottom line and would mean a 30% overstatement of profit. In poor years, the overstatement may have reached 50% of profit.

Statement Manipulation

HVN was a pioneer in big-box retailing and property development and grew spectacularly until the early 2000s when internet and other competition started to bite. We believe that the company reacted starting in 2004 by manipulating financial statements. In that year, HVN increased franchise fees by 66%, or from 9% to 15% of franchisee gross sales, and began a program of "tactical support" to franchisees to make up the portion of the fee that the struggling affiliates could not pay. What may have started as a temporary adjustment to smooth a rough patch stayed in place, as the business went into structural decline.

Profit Ported off the Balance Sheet

If our analysis is correct, the excess "profit" reported is ported off the balance sheet as phantom property investments and receivables from franchisees. Overstatement of assets since 2002 may have been in the range of AUD 1.6-1.7 bln.

Future Threats

We believe that most HVN franchisees are breakeven or loss making. An industry shock like a property downturn or challenge by an internet competitor like Amazon could crush margins and send franchisees and HVN stores out of business.

Valuation

We value Harvey Norman at AUD 2.91 and recommend that clients SELL.

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Instead of coming up with new business strategies, Harvey Norman, has been overstating revenue, around AUD 150 mln a year.

What Happened to Harvey Norman?

The electronics retailer Harvey Norman is as Australian as shrimp on the barbie, a household name and ubiquitous in malls across the country. But high times are over for HVN. The era of the consultative electronics sale, when buyers sought assistance from commissioned sales reps in choosing sound systems and computers, is a thing of the past. Unfortunately, HVN seems not to have accepted that reality.

Instead, in looking at the riddle of HVN accounts, we have come to the conclusion that Harvey Norman has been in denial for a dozen years about the decline in its business. Instead of taking the hit and coming up with new business strategies, Harvey Norman, it seems, has been overstating revenue, and the overstatement now is around AUD 150 mln a year. We estimate that at least AUD 75 mln in each years operating cash does not exist.

Although the business is breaking even and still able to pay a dividend, the sharks are circling. Critics are publicly taking bites out of the HVN story, and journalists and analysts have been chipping away at the truth behind the Byzantine franchise system. It is almost a joke in Australia at how HVN continues to get away with its fraud.

Now, external headwinds are pushing against HVN's model. As Amazon (AMZN US) establishes local operations in Australia, traditional electronics retailer margins will shrink by a few percentage points and collapse HVN's already fragile business model.

Introducing Harvey Norman

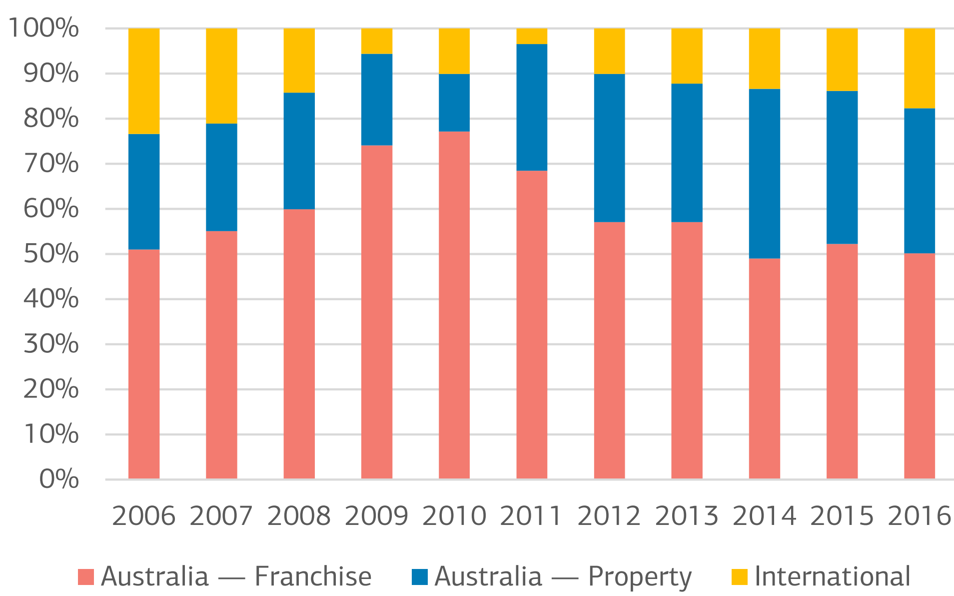
Harvey Norman is an international electronics and furniture retailer similar to Best Buy (BBY US) or the now-defunct Circuit City, but with a furniture division. HVN's core retail brand is Harvey Norman, and it has three furniture brands: Joyce Mayne, Domayne, and Space. The company reported AUD 1.78 bln in 2016 revenue and AUD 349 in profit, with AUD 140 mln of cash in the bank. It is an AUD 5.44 bln stock trading at 13x forward earnings, similar to other retailers in its class.

In Australia, HVN's largest market, the company operates the retail business through a network of franchisees. It owns about 50% of store locations and rents the premises to the franchisees. The HVN Australian property portfolio is now valued at AUD 2.6 bln.

Internationally, the company owns and operates its businesses and operates in Ireland, New Zealand, Singapore, Slovenia, and Croatia. HVN made an ill-fated move into Ireland at the peak of the boom. It overpaid for assets and has been loss-making ever since. New Zealand has been a steady performer. Operations in Singapore, Slovenia, and Croatia are relatively small.

The company reports its business in three divisions: Australia-Franchise, Australia-Property, and International.

Chart 1. Share of EBITDA by Division



Source: Company reports

HVN was a pioneer of big-box retailing in Australia. It operates 192 retail stores through 673 franchisees. A typical Harvey Norman store has four departments, each operated by a separate franchisee: audio visual and electronics, computers and IT, furniture, and bedding. Smaller Harvey Norman stores sell only electronics, and the other retail brands sell only furniture.

The HVN Australian property division was built around the retail operations of the company. HVN has excelled at generating value from its property division. The core strategy is to buy cheap commercial land and develop it into a big-box retail destination for its own stores and, often, for other third-party home decoration and renovation brands. Having created a destination, HVN can charge higher rent to all tenants and therefore raise the value of the investment significantly. In this report, we contend that most of the value of the portfolio was created more than a decade ago and that HVN has been overstating its purchases of property in the past 10 years and has suppressed the value of existing properties to hide the fact.

The Fraud: Our Theory

The focus of our research has been on the highly profitable Australian division, which has delivered between 80-90% of profit over the last decade. In Australia, it looks as if HVN has been overcharging franchise fees to improve the company's margins. Since franchisees cannot actually pay, HVN accumulates trade receivables and overstates payments for property investments. Conservatively, the revenue overstatement since 2002 would be AUD 1.6–1.7 bln and could be as high as AUD 2.2 bln.

We estimate that HVN Franchisees had a net margin of around 3% in the early 2000s when HVN charged a franchise fee equal to 9% of a franchisees gross sales. Then, suddenly, in 2004, HVN jacked up the franchise fee to around 15% of gross sales. Franchisees could not pay the cash for these increased fees; it looks like an on-paper fee hike to improve HVN's accounts. HVN could then report higher revenue but would have had "phantom" cash. So the company used three offsets: booking high trade receivables, offsetting fee income with a "tactical support" expense, and over-reporting property investment.

We think it worked like this:

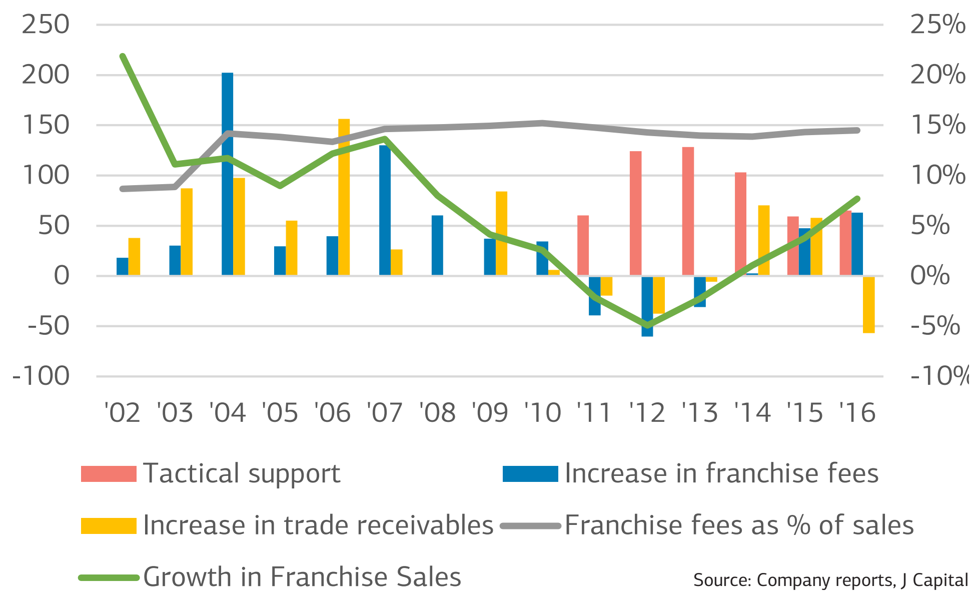
1. From 2002 to 2010, trade receivables rose by the same amount as franchise fees increased. Over nine years, the increment in franchise fees totaled AUD 581 mln, and trade receivables rose by AUD 551 mln. In 2016, HVN disclosed that trade receivables are actually 89% "financial accommodations" to franchisees. This is how overstated revenues were hidden on the balance sheet.

2. From 2011 until present, the company has been expensing overstated franchise fees as "tactical support." Franchisee gross sales went into decline from 2011. Growth in trade receivables can be justified as growth in working capital as sales increase but when sales decrease that logic does not work. So HVN started to pay tactical support.

Tactical support over the past six years has totaled AUD 541 mln. When the overstated revenues could not be hidden on the balance sheet they were expensed.

3. We calculate that payments for investment in properties has been overstated by around AUD 580 mln since 2007. We believe HVN has undervalued its investment property portfolio over the past decade to hide the overstated payments for investments in properties in those years. The years of high overstatement of payments for property investment, 2008-2013 match the years of decline in franchisee sales growth. This is the mechanism for tunneling the "excess" cash created by overstated revenue off the balance sheet.

Chart 2. Growth in Franchise Fees, Trade Receivables and "Tactical Support" (AUD mln)



Source: Company reports, J Capital

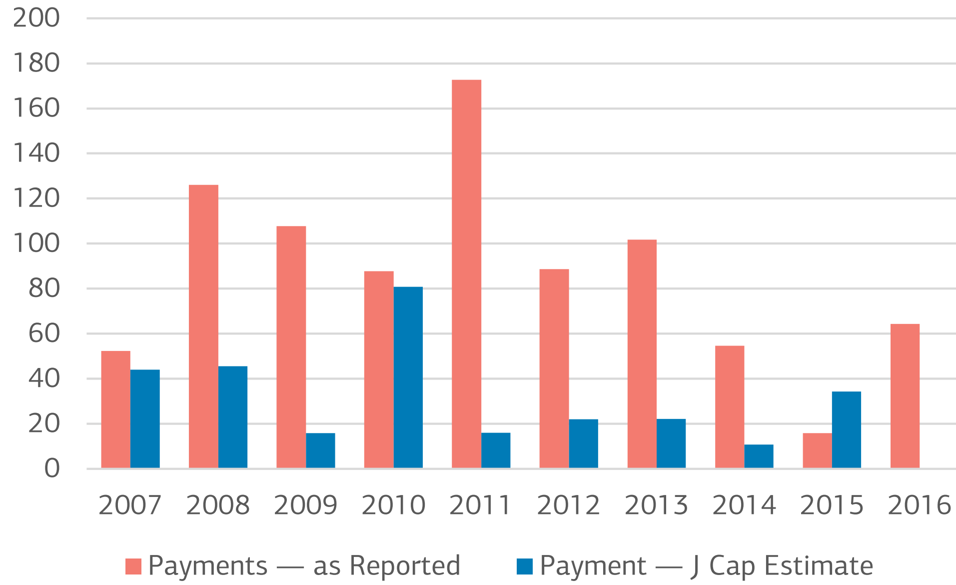
Overstatement of franchise fees is at least 3% of gross franchise sales, or approximately AUD 150 mln per year.

The tell: impossible margins

Given the high franchising fee, 15% of gross sales, we estimate that the average franchisee would be making a loss of 3% if it were actually paying the fee. If that is the case, then overstatement of franchise fees is at least 3% of gross franchise sales or approximately AUD 150 mln per year.

We arrive at this conclusion by first establishing that the gross margin of the average Harvey Norman franchisee is around 24%. Electronics retailers in Australia and the United States have gross margins in the range of 22-24%. We estimate the Harvey Norman electronics franchises have a

Chart 3. Payments for Investment Properties – Reported vs. Estimated (AUD mlns)



Source: Company reports, J Capital

gross margin of 23%. Furniture margins are higher. Vertically integrated furniture manufacturing and retailing businesses have gross margins of 40–55%. Harvey Norman's furniture franchisees are not vertically integrated, and our interviews suggest that the gross margin of the furniture franchisees is between 24 and 28%. We estimate that furniture and bedding is around 20% of gross revenue, and so we have added 1% to the average Harvey Norman franchise to estimate the average gross margin at 24%.

Table 1. Comparable Gross Margins

Company		FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Best Buy Co Inc (BBY US)	Electronics retailer	24.4%	23.9%	24.4%	24.5%	25.2%	24.8%	23.3%	22.8%	22.4%	23.3%
JB Hifi (JBH AU)	Electronics retailer	22.1%	21.9%	21.6%	21.8%	22.0%	21.1%	21.5%	21.7%	21.9%	21.9%
Fantastic Holdings (FAN AU)	Furniture manufacture and Retailer	42.1%	43.5%	44.9%	45.7%	47.5%	48.2%	47.0%	44.5%	44.5%	43.5%
Harvey Norman Franchisee - Estimate	Electronics and furniture retailers	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%

Source: Bloomberg, Company Reports, J Capital

JB Hifi is the nearest competitor to HVN. We have broken down JB's income statement by percentage of sales in order to model Harvey Norman.

Table 2. JB Hifi Income Statement as a Percentage of Sales

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
JB Hifi - Gross Margin - Actual	22.1%	21.9%	21.6%	21.8%	22.0%	21.1%	21.5%	21.7%	21.9%	21.9%
JB Hifi Sales, General and Admin and other - actual	13.4%	12.7%	11.9%	11.7%	11.5%	11.8%	11.9%	11.9%	12.0%	11.9%
JB Hifi -Rent - Actual	3.7%	3.6%	3.6%	3.7%	3.9%	4.1%	4.2%	4.3%	4.4%	4.4%
JB Hifi EBITDA Margin - calculated	5.1%	5.6%	6.1%	6.4%	6.6%	5.2%	5.4%	5.5%	5.5%	5.6%

Source: Company Reports, Bloomberg, J Capital

The core cost differences between JB Hifi and the average Harvey Norman franchisee are two: first, the HVN franchisee pays a franchise fee of 15% of gross sales. Second, to be conservative, we have estimated sales, general admin and other for the franchisee at 8% compared to 12% for JB Hifi. That is because, as a smaller business it does not pay corporate overhead, payroll tax, or above-the-line advertising expenses and has lower costs. We know that a franchisee's salary expense is 6% of gross sales, and so we have given them another 2% for all other costs.

The result from this approach is that a franchisee must be making a loss of around 3% of gross sales if it is actually paying the franchise fee to HVN.

Table 3. Harvey Norman Average Franchisee Estimated Income Statement as a Percentage of Sales

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Harvey Norman Franchisee Gross Margin - Estimate	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%
Harvey Nornan Franchisee Fee - actual	14.6%	14.8%	14.9%	15.2%	14.8%	14.3%	14.0%	13.9%	14.3%	14.5%
Harvey Norman Franchisee rent - Actual	3.6%	3.6%	3.7%	3.8%	4.0%	4.6%	4.8%	4.9%	4.6%	4.3%

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Harvey Norman Franchise Sales, General and Admin and other - Estimate	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Harvey Norman Franchise EBITDA Margin Estimated	-2.2%	-2.4%	-2.6%	-3.0%	-2.8%	-2.9%	-2.8%	-2.8%	-3.0%	-2.8%

Source: Company Reports, J Capital

The Mechanism, Part 1: Fake Franchises?

The franchise system is Byzantine and opaque. HVN reports the total franchise fees, rent and interest it collects from the network and very little else. In this report, we contend that HVN overstates the performance of its Australian retail operations and uses the complexity of the franchise system to obfuscate.

HVN uses the unconsolidated franchisees and its 1,216 subsidiaries as a mechanism to overstate revenue without being subject to scrutiny or audit.

HVN purports to operate an electronics and furniture retail business as a network of franchised business that are independent of HVN and therefore not subject to consolidation. HVN claims that it charges franchisees a franchise fee, rent, and interest on loans. Instead, HVN controls the franchisees in an operational sense and has created a legal structure to provide the optics of independence. We believe that HVN uses the unconsolidated franchisees and the some 1,216 subsidiaries it controls as a mechanism to overstate revenue without being subject to scrutiny or audit.

HVN makes it clear in Note 1 to its 2016 Annual Report that it does not believe it controls the franchisees:

> "In determining whether the consolidated entity has control over an entity (investee) and should consolidate the results of the investee, the consolidated entity assesses its exposure to / rights to variable returns from its involvement with the investee and whether it has the ability to affect those returns through its power over the investee.
>
> "Assets, liabilities and the results of each franchisee in Australia are not consolidated by the consolidated entity on the basis that the consolidated entity does not control any franchisee. The equity and

voting rights in respect of each franchisee isheld by an independent third party and the consolidated entity has no interest in the equity or voting rights in respect of that franchisee. **The assessment of whether Harvey Norman®, as Franchisor, controls a franchisee or the operations of that franchisee, involves judgment in assessing whether the Franchisor has sufficient power through its rights under the franchise agreement to direct the relevant activities of the franchisee that most significantly affect the returns of the franchisee.**" [our emphasis]

Interviews and discussions tell us that HVN does in fact control franchisees in an operational sense. Strictly speaking, legal control remains with the franchisee, but HVN can pressure franchisees in the manner of a "shadow director" with excessive allocation of costs, transfer pricing, and claims for payment greater than the assets of the franchisee.

How the franchise system works

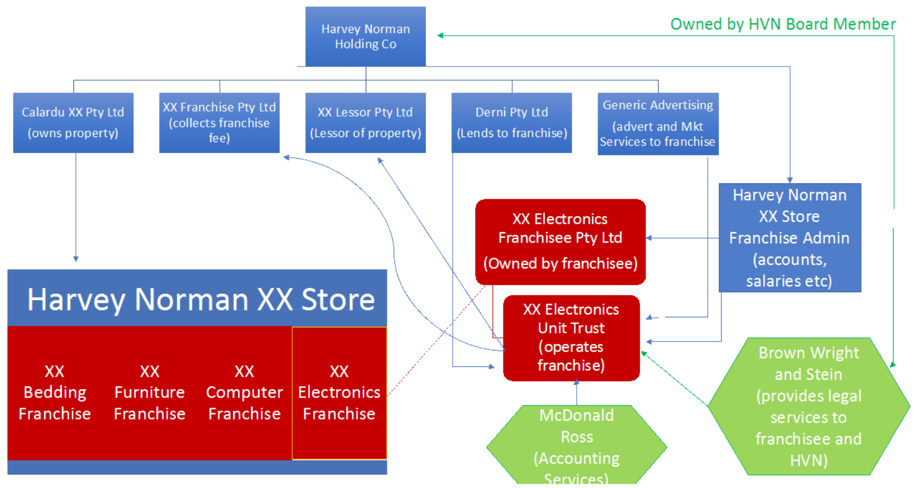
HVN operates each of its stores through four franchises; Computers/IT, AV/Electronics, Bedding, and Furniture, with 673 franchisees operating 192 stores and a couple of websites. In the 1980s, HVN may have created this system to work around the Sunday trading restrictions in Western Australia. Now the key reason for all the franchises could be to avoid paying payroll tax of around 5% on salaries. Each State and Territory in Australia has different rules on exemptions and rates of payroll tax, but, essentially, if you have a small company with10 employees or fewer, you are not required to pay payroll tax. Four franchisees per store could keep employee numbers below that threshold.

Franchisees also isolate the parent from breaches of the Australian consumer and advertising laws. Responsibility resides with the franchise, which can be shut down when required.

Ultimately, the fragmented franchises enable HVN to inflate revenue, charge above-market rates for rent, and exert control over non-consolidated entities. No one franchisee has knowledge or control over any one store. With the store broken into several smaller entities, rent can be charged at rates appropriate to a small retailer rather than a large retailer, which can generally negotiate rents 30% lower than for small retailers. It is unclear if the franchisees actually pay these higher rents or if they are expensed as tactical support.

To make things worse, franchisees get pushed out of one franchise and into another one. It is not uncommon for one person to have moved to three or

HVN Retail and Franchise Network Structure



Source: Source: J Capital Research

four franchises over a 5– 10-year period. Seldom does a franchisee hold control over a franchise in the same location for more than a few years. Often HVN places pressure on franchisees to move. They are recycled and moved on.

Company town: how the franchises work

HVN typically owns the store or has control of the main lease agreement and charges rent to the franchisee via a separate "lessor company." HVN charges franchise fees via a separate "franchisee company." The HVN subsidiary Derni Pty Ltd is used to process sales orders and purchases on behalf of the franchisees. If the franchisee does not have sufficient funds to meet payments during the month, then Derni advances the funds to the franchisee.

HVN stipulates that franchises may use only McDonald Ross for all accounting needs and Brown Wright and Stein for all legal needs. Chris Brown, a board member since 1983, is the senior partner at Brown Wright and Stein, which has provided legal advice to HVN for decades. A franchisee may place advertising and produce catalogues only through the HVN advertising company, called Generic Advertising. HVN controls the bank account of the franchisee. Purchases are processed through the bank account of the franchisee. HVN sweeps the funds out of the bank account on a regular basis and allocates costs to the company. HVN employs an administrative staff member, whose compensation is charged back to the franchises, at each store location to manage the accounts for each franchise. The franchise agreement states that a franchisee can be pursued personally for any losses or unpaid receivables, but the company says they never do that and we heard of no occasion when that has happened.

The franchisees do not pay any up-front fee to join the network other than a nominal AUD 1-10 for the paid-in capital of the registered company, then the franchisee can sell the franchise only to a company or individual as directed by HVN and only for the amount of the paid-in capital contribution. There are no entry or exit costs, and, while legally responsible for debts, in practice, franchisees are never pursued. One former franchisee said, “You are really acting like an agent selling on behalf of HVN.”

Operations

When a franchisee takes over from a previous franchisee, it inherits the workers, who sign new employment contracts if a new entity has been created. The franchisee is required to keep those employees for one year. Employees get paid the minimum award wage plus commissions, typically around 20% of base pay, but it is possible to get 50 or 100%. Better store locations mean better commissions for employees. Commissions are higher for higher-profit products. High-profit items are kitchen electronic appliances, bedding, furniture, and premium electronics (like Miele brand white goods). Powerful brands like Apple, Dyson, and Samsung have lower profits. Telco services and tablets also have low profits.

Franchisees are told when and what to order. A franchisee places orders using an online ERP system. The franchisee raises a purchase order through the system, then the supplier is paid by HVN. HVN gets all the rebates from the supplier. Prices to franchisee are consistently high even in a declining price environment because HVN demands, and keeps, a high rebate payment from suppliers. At no time can the franchisee deal directly with a supplier. HVN charges franchisees for warehousing the stock. If anything happens to the products, such as theft or damage, then the franchisee is responsible.

A franchisee gets a set of management accounts at the end of each month. Back around 2007, the management report back around 2007 was a one page report with around six lines of income and 20 lines of expenses. The report is now three pages long due to the large number of new expense categories charged to each franchise by HVN. A franchisee can see the management accounts on the online ERP system for three days per month. A franchisee is shown the balance sheet only once a year at tax time. Taxes are filed 12 months after the end of the tax year.

If the company is profitable in the month after paying HVN for the stock, rent, advertising, ad hoc expenses, and franchisee fees, then the franchi-

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see may be entitled to profit distribution. Profit is calculated quarterly and then paid six months later. If in subsequent months the franchisee breaks even or makes a loss, the distributions get wiped out. If HVN even expects difficulty in the future, the payment will be withheld. Franchisees are not getting a profit distribution they are getting a bonus at the discretion of HVN.

A franchisee operator gets a basic wage called a "drawing" of around AUD 65-80,000/year plus the use of a leased corporate car and mobile phone.

A franchisee is expected to stay within a set salary budget provided by head office, which must be below 6% of gross revenue. The franchisee submits a file to head office via the local HVN administration person for hours worked by staff.

A franchisee does not operate its own accounts: at most, a franchisee would put money in the safe at closing and have a checkbook to pay small local costs for an amount up to AUD 500.

Some franchisees claimed rent was charged at above market rates. Those franchisees estimated that rents were typically 30% higher than comparable locations nearby. Rents increased by 4-7% each year and interviewees said that if a franchise makes too much money, the company backdates a rent increase to soak up profits.

Performance

Our research indicates that electronics and computers account for 70-80% of all sales volume at lower margins in the range of 18 – 21% and furniture and bedding have 15-25% of turnover but higher margins of 24-28%.

Table 4. Franchisee Revenue and Margin

Turnover (Highest to Lowest)	Margin (Highest to Lowest)
AV/Electronics 40-45%	Bedding 24 – 28%
Computers/IT 30-35%	Furniture 24 – 28%
Furniture 10-15%	AV/Electronics 19 – 21%
Bedding 5-10%	Computers IT 18-19%

Source: J Capital

We estimate that 25% of franchisees are profitable some 50% break-even or make a small profit and that 25% make losses. Better locations will have more chance of success. So new franchisees are started in weaker locations. If they fail then they leave the system if they do well they get shifted to

We question if the receivables from the franchisees of HVN may ever be repaid and should therefore be written down.

better locations.

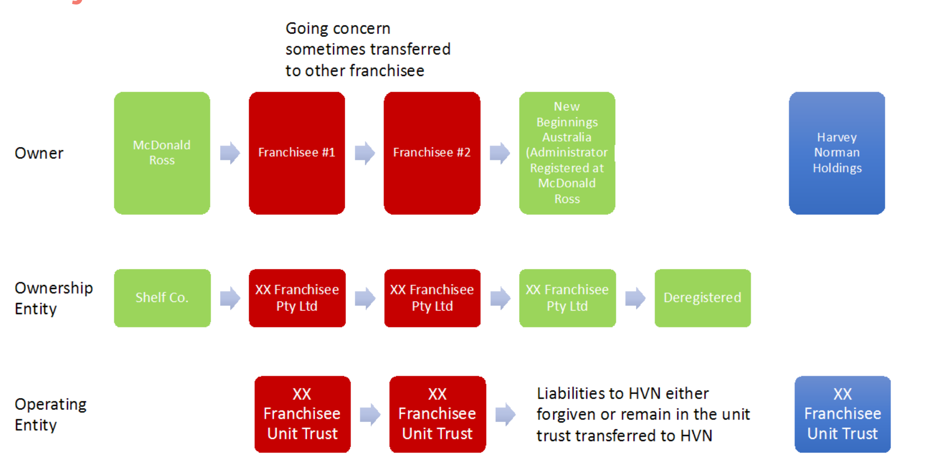
The former franchisees that we spoke with stated that franchise profits peaked in 2008 and then fell by around 65% by 2010 and have decreased slowly since that time to around the level of an award wage. This matches the decline in sales of franchisees for the whole company and the period when we believe HVN ramped up overstating revenues.

Who is responsible for HVN's receivables?

HVN as of December 2016 had AUD 1.145 bln in receivables from franchisees. We speculate that they may never be repaid. Only in 2016 did HVN reveal that trade receivables were actually "financial accommodations," not loans, to franchisees. We did not find any franchisee that had signed a loan agreement with Derni or any other HVN entity. It would appear the franchise agreement has a clause that states that a franchisee may be pursued personally for any amounts owing to HVN but it is also clear that, when a franchisee makes a loss and is shut down, any amounts owing are forgiven.

For this reason, we question if the receivables from the franchisees of HVN may ever be repaid and should therefore be written down. Many franchisees do not make money: around 115, or about 17% of the 673 franchisees, exit the network each year. Most made losses and accumulated payables to Derni. How are these writedowns accounted for on the books of HVN? It could not be "tactical support," as that is for franchisees that are in business not for franchisees that are being closed. We speculate that they may linger in receivables from franchisees or perhaps in some off-balance sheet entity.

Lifecycle of a Franchise



Source: AFR, J Capital

Starting life as franchisee

A franchise begins its legal existence at McDonald Ross as a shelf company before being transferred for a nominal fee to the franchisee. A unit trust is then set up under the franchise company to operate the business. A loss-making franchise will generally be closed down if its owner transfers or leaves the system. Ironically for a company whose sole purpose is to euthanize franchises, the holding company that purchases failing franchises is called New Beginnings Australia Pty Ltd and is registered to the same address as accounting firm McDonald Ross. The unit trust, where the payments due to HVN would be held, is transferred to HVN.

What does HVN do with that trust and those payables? That remains a mystery and shareholders deserve some sort of disclosure.

How does the accounting work?

HVN reports that it charges franchise fees, rent and interest to franchisees, but when we speak with franchisees, they have a much longer list of charges. One particular cost sticks out – advertising and marketing fees. Franchisees tell us that they must pay Generic Advertising for catalogues and advertisements in local newspapers. They also complain that HVN keeps the rebates from media outlets.

When we look at HVN marketing expenses, they roughly match the advertising revenue of Generic Advertising. So HVN appears to claim it pays the marketing expenses, but we know that franchisees pay at least part of those marketing expenses. It is worth noting that Generic Advertising is not audited by Ernst and Young, HVN's auditors, but by a second-tier company, MGI Sydney. Generic Advertising makes a modest profit of AUD 3.5 mln each year but it does not pay a dividend in cash to its parent: it just adjusts intercompany receivables. Auditors were recently changed but it appears to be the same group just using a different legal entity. You can download the Generic Adverting financial report here.

Table 5. HVN Marketing Expenses vs Generic Advertising Revenue

	2016	2015
HVN Marketing Expenses	AUD 385	AUD 370
Generic Advertising Revenue	AUD 353	AUD 337

Source: Company reports

Franchise conclusions: would you want to be one?

If you cannot control the bank account, costs, product ordering, employment choices, management reporting, or sale price of a business, then you are not in control. HVN controls the franchise company and not the franchisee. HVN use the control of these companies to do as it wishes with the operations and accounting of the franchise network. This enables HVN to overstate revenue.

We believe HVN must consolidate the franchise accounts into the holding company. Should HVN be required to do that, then there may be significant tax consequences for the company. By using franchisee companies to operate the network, charging franchisee fees at a high rate, then advancing funds to the franchisee because they make a loss and later forgiving the obligation, this could be considered by the Australian Tax Office as a scheme to avoid paying income tax. At the very least, HVN would be required to pay payroll tax and may be asked to pay retrospectively.

The Mechanism, Part 2: Fake Property Investments?

HVN can be considered a property company that has a retail business to support it. HVN has AUD 2.6 bln in property assets but reveals almost no details on the composition of that portfolio. There is no list of properties owned, no details on acquisitions and disposals in any year. There was one partial release of properties in the 2012 Annual Report presentation and then silence since. Any listed real estate company of that size in Australia would release such details. Not HVN. Stocklands (SGB AU) a listed property company with investments greater than AUD 20 bln release a property portfolio report each half year that details, for each property it owns, the information on the date acquired, cost of acquisition, current valuation, tenants name and lease contract terms.

How property works

The HVN property strategy is to create big-box destination shopping malls for home decoration and renovation. Ideally, HVN purchases a low-priced parcel of land on the outskirts of a growing regional or urban center. It then builds a complex and anchors the new development with the Harvey Norman and Domayne stores, taking 25–50% of the floor space and renting out the rest.

HVN is then able to charge higher rents and therefore has the opportunity to revalue the properties at a significantly higher value than the cost, should they choose to. As the Harvey Norman store is normally rented out to at least four franchisee operators they average rent charged is higher than for a normal store of that size that could attract a discount.

This is a great scheme for creating value unless somebody else builds a bigger and better center with a better anchor tenant. Then your tenants leave and you have to move the Harvey Norman store to that location to survive. Then your old location is vacant, and the value falls back to the land value.

Similarly, if Harvey Norman stores start to struggle and close due to internet or other competition then the value of the land holding will fall with it.

HVN also has single store locations but it is the large multi-tenant complex in major cities in Australia where all the value of the property portfolio resides.

Property disclosure and J Cap primary research

We have built a model of the property portfolio of 115 properties owned by HVN (HVN reports it owns 93 sites) and 116 leased properties (HVN reports 100 leased sites). We believe that we have identified most, if not all, of the properties owned by the company.

A full list of the HVN property database we have constructed may be downloaded here.

We did this using the following methods:

- Searching all states and territories in Australia for property companies used by HVN to hold properties. HVN typically uses a company with a name that includes the name Caladu, however, there are others.

- We checked the ownership of all current sites that HVN claims to carry out business using data from the company annual reports and business locations online.

- Searching the ownership data for joint venture properties.

- Internet searches for Harvey Norman property transactions that included increasing ownership of joint venture properties.

We then obtained the following data for each property:

- Legal identifier

- Ownership data
- Date acquired
- Consideration
- Current land value
- Size of property

For some properties, we could obtain the following:

- Valuation as of June 2012
- Mortgage data
- Tenancy data
- Current valuation

The above methods are not perfect. HVN controls 1,216 companies and we did not search ownership records for each company in each state. We searched only the core property entities. HVN has traded properties between subsidiaries, which may mean that we have not correctly identified the year in which the group acquired the property. However, it would mean in all such cases that it was in a year prior to the year we have assumed. An example is Yoogalu Pty Ltd selling 164 Adderley St Auburn to Calardu Auburn Pty Ltd, which is also an undisclosed property. The most valuable properties are places were Harvey Norman has a business operation and the highest value are shopping complex where it also rents out space to other tenants. We have all that information in our checks. We may not have captured all of the properties but we have captured the ones that count.

Table 5: Sample Data for a property in the ACT

Region	ACT
Suburb	Fyshwick
Business Type	Harvey Norman
Harvey Norman Ownership	Owned
Ownership %	100%
Address in Annual Report 2016	yes
Verified address	Cnr Barrier & Ipswich Streets Fyshwick 2609
Title Reference 1	1412/91
Registered Proprietor	Calardu Pty Limited

Classification	Major
Site Valuation AUD mln 2016 (or most recent)	AUD 3.00
Land Size/Lettable Space	20,972 m2
Acquisition Year (on or before)	2000
Consideration	
Company ACN	003 477 558
Mortgage No.	1640136
Mortgagee	ANZ Fiduciary Services Pty Limited
Valuation as reported by HVN in 2012	AUD 29.50
Capitalisation rate:	8.45%
Car parking spaces:	281
Total Space	12,911
Total Space Owned by HVN	12,911
Total Space Leased to HVN Franchise	12,911
Total Space Leased to Others	-
HVN Leased space as % of total	100%

Potentially AUD 618 mln was not spent on properties. If so, this would be a channel for tunneling fake cash from overstated revenues out of the company.

Clearly overstated payments for property investments in last 10 years

We cannot value the entire portfolio, but the database of the properties leads to clear inferences about the payments for properties. HVN has invested AUD 872 mln in property investments over the last 10 years, according to the reported cash flow statements. Our research on the property portfolio can identify only approximately AUD 292 mln in new investments and divestments of AUD 38 mln for a net increase of AUD 254 mln over the same period. We believe that potentially AUD 618 mln was not spent on properties. If so, this would be a channel for tunneling fake cash from overstated revenues out of the company.

Table 6: Expenditure on Investment Properties (AUD mlns)

		J Cap Estimates				
	Payments for Investments Reported HVN Cash Flow	Acquisitions	Increased Ownership	Divested Property	Total Net Property Investment	Variance with Reported
2007	52	44		1	43	-9
2008	126	46		1	45	-82
2009	108	16			16	-92
2010	88	47	34		81	-7
2011	173	16			16	-157
2012	89	7	15	6	16	-73
2013	102	17	5		22	-80
2014	55	11			11	-44
2015	16	34			34	19
2016	64			30	-30	-94
Total	872	238	54	38	254	-618

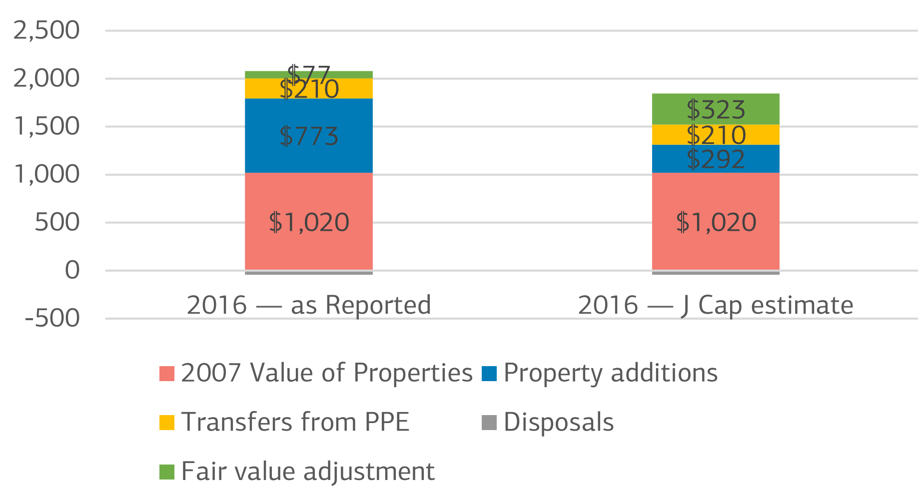
Source: Company reports, J Capital

Property portfolio: fair value adjustment of portfolio understated by AUD 250 mln

The problem with overstating payments for property investments is that the total property value will not match reported property asset value. We estimate that HVN overstated payments for property by around AUD 580 mln. However, we estimate that the property portfolio is undervalued by only around AUD 250–300 mln. This is because HVN has consistently suppressed fair-value adjustment of the property portfolio. In most years, fair-value adjustment was down and not up. The company reports that, in the 10 years from 2007, the fair value of the portfolio was adjusted up by only AUD 77 mln. We used the annual capital increase for commercial property as published by the Property Council/MSCI to estimate that the real fair value increase should have been closer to AUD 323 mln. HVN held back increasing the value of the property portfolio to hide the fact that payments for properties were less than they reported.

We also note that the additions to investment properties over the past 10 years as listed on the balance sheet notes is AUD 773 mln and payments for the same total AUD 872 a difference of AUD 100 mln over 10 years cannot be explained with a mismatch of payments.

Chart 4. HVN Total Investment Property Portfolio Valuation vs J Cap Estimate (AUD mlns)



Source: Company reports, The Property Council/MSCI Commercial Property Index, J Capital

In 2012, Paul Skamvougeras at Perpetual Investments commissioned an independent valuation of the property portfolio and discovered that the value of the portfolio matched the companies reported value. There had been market speculation about the valuation of the property portfolio, which was poorly disclosed. On the basis of that report, he invested in

HVN.

We also believe that HVN has assets of about the same value as it reports. We just believe they had most of those assets a decade ago.

The HVN annual reports in 2015 and 2016 list 15 stores that have not operated for at least the past two years at those locations. There are 207 store locations listed in the 2016 annual report and therefore 7% of the listings are inaccurate. This might be deliberate, to obfuscate the property portfolio, or simply demonstrate incompetence. This business is too complex for management and the auditors to keep track of the details of 1,216 operating business entities.

Table 7: Phantom Stores Listed in 2015 and 2016 Annual Report

Region	Suburb	Business Name	Address
NSW	Batemans Bay	Harvey Norman	Shop 5 Bay Central 1 Clyde Street Bateman's Bay 2536
NSW	Bathurst	Harvey Norman	Sydney Road Kelso 2795
NSW	Port Macquarie	Harvey Norman	140 Lake Road Macquarie 2444
NSW	Albury	Harvey Norman	430 Wilson Street Albury 2640
NSW	Gunnedah	Harvey Norman	117 Conadilly Street Gunnedah 2380
NSW	Maitland	Harvey Norman	557 High Street Maitland 2320
NSW	Maitland	Domayne	557 High Street Maitland 2320
NSW	Mudgee	Harvey Norman	33 Castlereagh Highway Mudgee 2850
QLD	Mt Gravatt	Harvey Norman	2049 Logan Street Upper Mt Gravatt 4122
QLD	Browns Plain	Harvey Norman	Unit 3 28 - 48 Browns Plains Road Browns Plains 4118
QLD	Hervey Bay	Harvey Norman	134 - 136 Boat Harbour Drive Hervey Bay Road Hervey Bay 4655
TAS	Burnie	Harvey Norman	64 Mount Street Burnie 7320
VIC	Dandenong	Harvey Norman	141 - 165 Frankston - Dandenong Road Dandenong 3175
WA	Albany	Harvey Norman	136 Lockyer Avenue Albany 6330
WA	Kalgoorlie	Harvey Norman	Southland Shopping Centre Oswald Street Kalgoorlie 6430

HVN's other investments: red flag for tunneling cash out of the company?

HVN has made some low-quality investments in recent years. HVN invested AUD 60 mln in mining camps and has written down over half of that amount to date. We expect it will all be written down eventually. HVN invested AUD 34 mln for a 50% share of a dairy farm, Coomboona, which is set to make annual losses of over AUD 6 mln in 2017. HVN has advanced

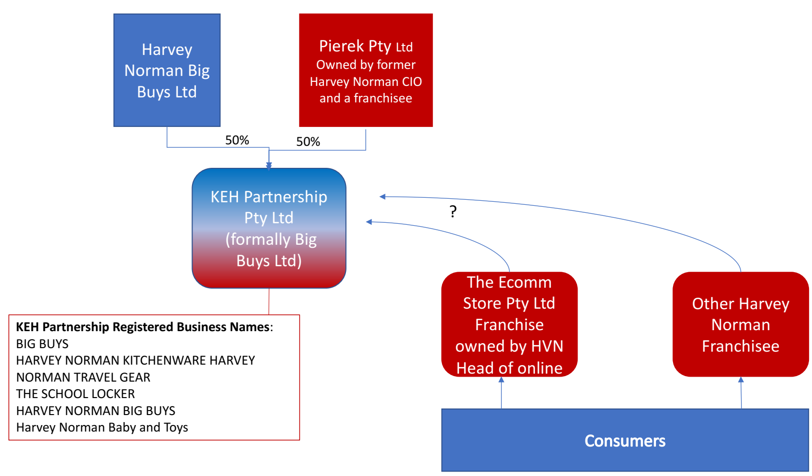
HVN has invested AUD 100 mln in developing something for the internet but we are not sure what it is.

around AUD 100 mln in total to its 50% joint venture with KEH Partnership Pty Ltd, which appears to be responsible for developing HVN's internet business. At least AUD 30 mln of that amount has been impaired and written off. And yet HVN tells us nothing about its operations. We have to suspect that HVN is 'creating' joint ventures with trusted employees to keep the activities of the ventures out of the scrutiny of the auditors of the consolidated entity. Over spending on investments followed by significant write-downs is often a red flag for fraud and a method to tunnel fake cash out of a company. We do not know HVN is doing that but lack of transparency leaves the company open to such suspicion.

How is HVN operating its internet assets?

HVN's future is imperiled by internet competition. Amazon's entry to the Australian market will hammer HVN margins and threaten the future of the company. So what could be more important than a strong internet strategy? We know HVN has invested AUD 100 mln in developing something for the internet but we are not sure what it is.

Structure of Internet Operations and Sales



Source: J Capital

KEH Partnership Pty Ltd began life as Big Buys Ltd, a 100% subsidiary of HVN. In 2013, HVN gave 50% of the company to its then-CIO and former franchisee. KEH holds the rights to the business names that correspond to the main ecommerce websites that HVN operates. The revenue from this "retail joint venture" is supposedly going to Other Non-Franchised Retail. When you look at the fine print at the bottom of a HVN website, you see that KEH is actually operated by The Ecomm Store Pty Ltd, a franchise owned by HVN's Head of Online. When we speak with franchisees around Australia, they tell us that they get orders from the online sites, which are then picked up by customers in their store. The franchisee gets the revenue and is charged for the product. So we are wondering, how does the online business operate? HVN needs to disclose where the AUD 100 mln has gone.

Catalysts

Forced disclosure of detailed property portfolio

HVN has been dragged screaming into disclosing further details about its operations. The best example has been restating the trade receivables, a AUD 1 bln asset, as receivables from franchises in 2016. This will reveal that payments for properties have been overstated. The only way for HVN to refute this report is to release full details on each individual property in its portfolio just like all the other listed property companies in Australia. We expect a regulator, the tax office, or investors will force such a disclosure.

The Australian Securities and Investment Commission (ASIC) is currently investigating HVN for compliance with the reporting requirement of the Corporations Act 2001. We understand that this is routine surveillance and that ASIC investigates 320 listed companies on a rotating basis each year. Given the level of media interest and open criticism of the company by analysts and investors we could reasonably expect that there will be some action taken by the regulator.

Forced consolidation of franchises into the holding company

The auditors, Ernest and Young have just changed responsible partners in the last six months after five years of having the same person in charge. We expect by the time of the FY2017 report that the auditors will be requiring this change. We also expect ASIC to question the independence of the HVN franchise network. HVN would then need to consolidate those entities into the consolidated accounts. This would make the franchise system redundant and cause the company to restructure. We believe the transparency that consolidation would bring will lead to a restating of the accounts.

Australian Tax Office (ATO) investigation

Should ASIC or the auditors determine that HVN "controls" the franchisees then the ATO will require that HVN pay payroll tax (levied at approximately 5% in most states and territories for companies that employ more than 10 employees). We estimate this will add around AUD 15- 20 mln to HVN costs each year and potentially leave the company liable to back payment of around AUD 235 mln over the last 20 years.

It is also possible that the ATO taxes action against HVN for unpaid income taxes from the scheme of using a network of franchise that made losses.

Internet competition: Amazon is coming

We believe that Amazon will enter the Australian market with its own central warehouses in the next 12 months and will progressively roll out services. Amazon has appointed agents to identify warehouse locations and one of Goodman's Sydney locations is expected to be selected soon.

HVN's- main competitor JB Hifi sells low to mid-level electronics, as does the Australia online company Kogan. Kogan stocks generic or private label products and has excellent after sales service. JB Hifi already has strong online competition.

HVN sells mid- to high-end products. Amazon sells these types of products and will engage in a price war that will have a big impact on HVN.

Property downturn

HVN retail sales are highly correlated to property sales. Should the Australian property market slow or decline as is expected then this would reduce HVN revenue. As HVN margin and franchise margin is weaker than the company has projected then this will have a much harder impact on HVN. We could expect a large number of stores to close and for the value of the property investments to fall significantly.

Valuation

We believe Harvey Norman is materially overstating revenue which is collected from its franchisees. Our critical assumption in valuing HVN is based on our belief that the company is actually collecting franchisee fees of only 11% of franchise GMV sold, while reporting a 14-15% take rate. The implications on HVN's earnings from this discrepancy are substantial as franchise fees comprise roughly half of HVN's EBIT.

We value Harvey Norman at 13x our estimate of HVN's 2018 earnings. On this basis, we come up with a target price of AUD 2.91, or 40% down from where HVN trades today. Our differentiation from street estimates is entirely predicated on the assumption that HVN is actually only collecting 11% of GMV sales from its franchisees. Independent of this assumption, our estimates are reasonably close to the street. We note that our price target is based on a stable gross margin profile, stable OPEX, and ~5% sales growth in franchise GMV / HVN's operated stores.

Our current valuation implies a market capitalization of approx. AUD 3.2 Bln, versus today's current market cap of AUD 5.4 Bln. We believe our valuation is generous. We are assuming no write-downs on HVN's likely fabricated receivables, and we are using a multiple in line with the market's current multiple of 14x 2018 earnings. If our allegations are correct and HVN's credibility comes under question, HVN's multiple is likely to compress further.

Risks

- We did not identify all of the properties.
- HVN brushes off the criticism, regulators are slow and hesitant to take action and HVN continues to operate in an opaque manor. The company has been subject to withering criticism over the past 12 months and the stock price is still up 7%.
- The property market continues to boom.
- Amazon delays or does not enter the Australian market.

Appendix: Pro Forma Financials

HVN Income Statement (AUD mlns)

In Millions of AUD	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Total Revenue	1,344	1,556	1,407	1,323	1,514	1,617	1,796
Cost of Goods Sold	-968	-1,130	-1,025	-944	-1,065	-1,127	-1,232
Gross Profit	376	427	382	379	449	490	564
Other Operating Income	1,097	1,122	1,061	1,036	1,034	1,101	1,230
Total Revenue received from franchise	1,024	989	946	916	922	964	1,030
Total Other Operating Income	73	133	116	119	112	137	200
Sales/Marketing/Advertising Expenses	-355	-373	-355	-341	-349	-389	-420
General and Administrative Expenses	-374	-448	-404	-393	-428	-447	-511
Net Other Operating Expenses	-358	-354	-456	-492	-405	-377	-369
Profit Before Income Taxes	386	374	227	188	301	378	494
Income Tax Expense (Benefit)	-148	-114	-51	-43	-89	-109	-142
Net Income	231	252	172	142	212	268	349

Source: Company Reports

HVN Balance Sheet (AUD mlns)

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Cash and Equivalents	157	163	172	162	145	186	140
Accounts Receivable And Other Receivables	1,082	1,065	1,018	1,054	1,062	1,111	1,097
Inventories	262	337	263	269	298	298	316
Other Current Assets	56	63	45	47	45	50	53
Total Current Assets	1,557	1,627	1,499	1,532	1,550	1,645	1,606
Receivables	25	15	11	13	65	72	74
Property Plant & Equipment - Net	439	512	536	549	569	553	581

Investment In Affiliates/Joint Ventures	141	159	158	16	25	21	25
Other Non-Current Assets	54	89	94	73	94	100	100
Real Estate Investments	1,489	1,602	1,654	1,854	1,904	1,936	2,046
Total Non-Current Assets	2,148	2,377	2,453	2,533	2,656	2,682	2,826
Total Assets	3,705	4,004	3,952	4,065	4,206	4,327	4,432
Short-Term Borrowings	154	105	235	172	470	408	453
Other Current Liabilities	67	34	36	50	52	61	79
Trade Payable And Other Payables	740	855	647	612	741	782	746
Total Current Liabilities	961	994	918	834	1,262	1,251	1,279
Long Term Debt	347	546	544	648	238	290	201
Deferred Income Taxes (Liabilities)	185	208	199	194	189	199	226
Other Noncurrent Liabilities	54	27	24	25	26	30	37
Total Noncurrent Liabilities	586	781	767	867	453	519	464
Total Liabilities	1,547	1,776	1,685	1,701	1,715	1,770	1,743
Net Assets	2,157	2,228	2,267	2,364	2,491	2,557	2,689
Share Capital & Additional Paid In Capital	260	260	260	260	260	380	385
Retained Earnings (Accumulated Deficit)	1,787	1,901	1,957	2,009	2,109	2,043	2,125
Minority/Non Controlling Int (Stckhldrs Eqty)	54	35	31	34	20	20	22
Total Reserves	56	33	19	62	103	113	156
Total Shareholders Equity	2,157	2,228	2,267	2,364	2,491	2,557	2,689

Source: Company Reports

Cash Flow Statement (AUD mlns)

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Total Cash Flows From Operations	387	359	201	239	339	340	438
Total Cash Flows From Investing	(163)	(367)	(171)	(208)	(113)	(82)	(180)
Dividends Paid	(138)	(138)	(117)	(90)	(112)	(334)	(267)
Total Cash Flows From Financing	(184)	26	(9)	(47)	(235)	(221)	(307)
Cash and Cash Equivalents (Beg of Period)	61	101	119	140	125	115	153
Cash and Cash Equivalents (End of Period)	101	119	140	125	115	153	104

Source: Company Reports

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Disclaimer