JCAP

Retail
Australia

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Company Update

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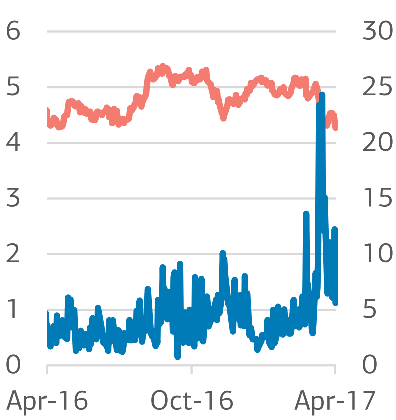
Harvey Norman (HVN ASX)

Price	4.27
Target Price	**2.11**
Difference	**-50%**
Rating	**Sell**
Mkt Cap	4.75 mln
TTM PE	11.30
SI	8.1%

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



Source: Bloomberg April 7, 2017

Harvey Norman Holdings Ltd. (HVN ASX)

Failed Retail Locations

- **HVN is propping up failed retail outlets located in properties it owns**
  We estimate around 40 retail locations would have been closed absent the strategy of hiding losses via franchisee churn.

- **Closing those outlets would halve the dividend**
  We estimate HVN revenue would fall AUD 160 million and cash flow AUD 117 million less if these 40 retail locations were closed.

- **Property write downs of over AUD 300 mln**
  We estimate the value of HVN properties at these 40 retail locations at AUD 500 million. Most are in regional Queensland and Western Australia and would struggle to find an anchor tenant to replace Harvey Norman. For that reason, we expect the property portfolio would take a write down of around two thirds the value or AUD 333 million.

- **Unit trusts of failed franchisees harvested for tax losses and inventory**
  HVN takes control of the unit trusts associated with the failed franchisee in order to take possession of the inventory for resale then, most importantly, to utilize the tax losses of the franchisee. We estimate that HVN can obtain a benefit of around AUD 200,000 per failed franchisee by utilizing the tax loss and selling the inventory.

- **Valuation: we lower our price target to AUD 2.11**
  We revise our target price down to reflect that we expect up to 40 retail locations to be closed when HVN is forced into consolidating franchisee.

Propped Up by Franchise Churn

HVN is circling the wagons under attack from the media, auditors, regulators and short sellers.

We have previously demonstrated that HVN is overstating revenue by around AUD 150 million each year and hiding it as growing receivables and overstated capex. So what? The company had sufficient cash to pay and could continue to pay a high dividend. We now know that this overstatement has been focused on keeping failed retail outlets alive. Most of the 100 franchisees that close each year are concentrated in 40 retail outlets, mostly operating in properties owned by HVN. As franchisees are ostensibly operated as independent third parties, HVN can keep them alive like bacteria in a petri dish by pouring in capital that it hides on its balance sheet or ports off with fake capex. These failing retail outlets can be harvested for cash racking up debts to HVN they will never repay. When they fail HVN can recover about 2/3 of the losses by taking control of the trusts used to operate the franchisee and applying the tax losses to offset tax in one of its profitable subsidiaries and by selling the remaining inventory to the next franchisee. We estimate these 40 retail outlets kept alive through this process deliver over net AUD 100 million in cash. When they close then HVN will be forced into halving its dividend.

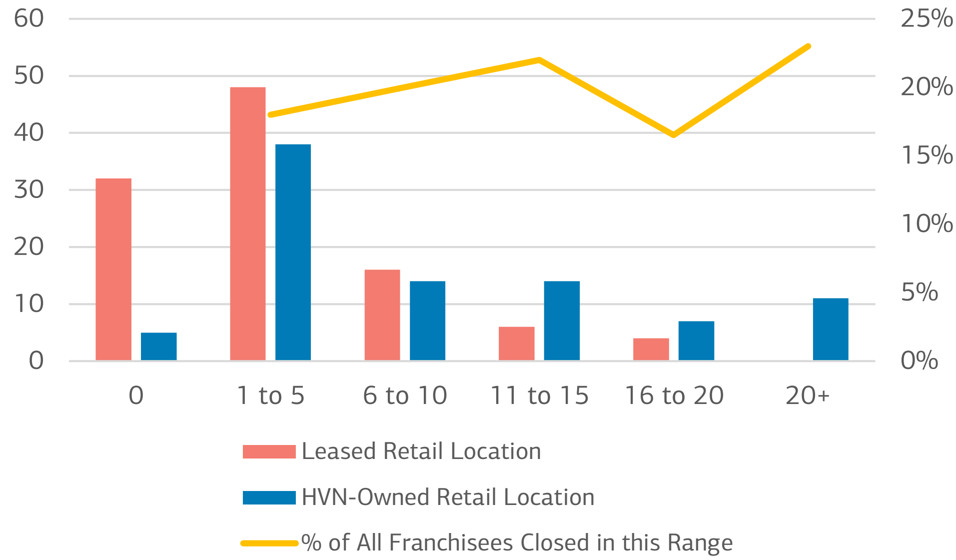
HVN is circling the wagons under attack from the media, auditors, regulators and short sellers. The company is under increasing scrutiny. The opportunity to continue to run old schemes like expanding receivables are overstating capex are increasingly limited now that all eyes are focused on these previously opaque activities. As a result we expect HVN to be forced to close persistently underperforming retail locations.

HVN retail empire has been in significant decline for the past 10 years they have just been hiding it in plain sight.

Sustaining Failed Retail Locations

We built a database of all the failed HVN franchisees since 2008 and discovered a concentration in retail locations and properties owned by the company. If a franchisee fails because they are operated by poor business people then we should expect a random distribution of failed franchisees. The worst 10 retail locations, with the greatest number of failed franchisees, are all retail outlets where the property is owned by the company. Retail locations owned by the company have more than twice the number of failed franchisees across the network. 32 leased retail locations have not had any failed franchisees, only 5 owned retail locations have the same unblemished track record.

Chart 1. Distribution of Closed Franchisees by Retail Locations



Source: J Capital, ASIC Company Records, Harvey Norman Company Reports, ABN Registry

Table 1. Key Data from Closed Franchisee Data

	Retail Outlets	Franchisee Closed	Average/ Retail Outlet
Total Franchisees Closed	178	1170	6.6
By Property Ownership			
Outlet owned by HVN	80	679	8.5
Outlet leased by HVN	74	385	5.2
Outlet closed	24	85	3.5
Unidentified Retail Location		24	
By Regional Distribution			
Queensland	40	481	12.0
Western Australia	26	64	2.5
New South Wales	42	134	3.2

Table 1. Key Data from Closed Franchisee Data, cntd.

	Retail Outlets	Franchisee Closed	Average/ Retail Outlet
By Regional Distribution, cntd.			
Victoria	26	64	2.5
South Australia	11	105	9.5
Tasmania	6	13	2.2
Northern Territory	2	14	7.0
Australian Capital Territory	1	4	4.0
By Year Franchisee Failed			
2008		108	
2009		114	
2010		115	
2011		314	
2012		85	
2013		98	
2014		106	
2015		109	
2016		72	
Unidentified Year		51	

Source: ASIC, J Capital, HVN Company Reports, ABN Registry

Propping Up Property Values

The top 20 retail locations, with the highest number of failed franchisees accounted for 40% of all failed franchisees. The top 10 are all retail outlets where HVN owns the property. They all have an average of around 2 or more franchisees fail each year, with most retail outlets having 4 franchisees that is 50% of the franchisees each year fail. They all have had failed franchisees in at least 7 of the last 9 years. Some have had more than 6 fail in one year — which means they have turned over all the franchisees 1.5 times in one year. It is clear that at least these top 20 retail outlets, absent this propping up of franchisees by HVN, should have been closed over the last 10 years.

Harvey Norman Loganholme: Is this the worst store in the network? 26 failed franchisees in the past 9 years. | Source: Google Streetview, February 2017

It is unlikely these retail locations could ever command the same rental income following the closure of the HVN stores.

We estimate the value of the worst 10 retail outlet properties at AUD 261 million. We believe those HVN stores would be closed if the company is forced into consolidating the franchisees into their accounts. It is unlikely those retail locations could ever command the same rental income following the closure of the HVN stores. They would most likely be largely vacant. For that reason, we expect the value to fall by around two thirds or by AUD 174 million. In a similar way, we estimate the property value for the worst 40 retail locations at around AUD 500 million and the value write down of around two thirds the value or AUD 333 million should they be closed.

Please see Appendix 1 for a breakdown of the worst outlets as ranked by the highest number of failed franchisees.

Franchisee Database Methodology

We built a database of the failed HVN franchisee company's and their associated trusts for the years 2008 to 2016 using the following methodology:

1. Franchise Company Records

When HVN determines that a franchisee is no longer viable then the company is put into receivership by Joseph Deen's company New Beginnings Australia Pty Ltd. Ownership of the company is transferred from the franchisee to Joseph Deen. We obtained the ASIC records for all the companies that Joseph Deen has acted as a director or a secretary. Prior to Joseph Deen, Kevin Clifton Anderson fulfilled a similar role. We obtained the ASIC records for all the companies that Kevin Clifton Anderson has acted as a director or a secretary.

2. Franchise Unit Trusts

When a franchisee is placed into receivership the associated unit trust established for the franchisee company is transferred to HVN. HVN lists the unit in the annual report and newly acquired unit trusts are marked as such.

3. Matching Company and Trust Records

The franchisee company name and unit trust name share a similar naming structure. For example, Furnap Pty Ltd has an associated trust Furnap No 2 Trust. We used the similar naming structure to match the company and unit trust records in each year and to confirm the company deregistered by New Beginnings Australia Pty Ltd was in fact an HVN franchisee company.

4. Matching Franchisee Company with Trust to Retail Location and HVN ownership

We then took the matched data and searched the Australian Business Number (ABN) database to obtain the trading name of the company and/or the postcode of operation to determine which HVN retail store the franchisee was associated with. For example, Furnap Pty Ltd trading name was Harvey Norman Furniture Aspley and the operating postcode 4034 so we could then identify the franchise as being part of the HVN retail outlet in Aspley Queensland. Using our HVN property portfolio database we could then identify if the retail location was owned or leased by HVN and in some instances, estimate the valuation of the property.

How HVN Benefits from Failed Franchisees

HVN takes over the unit trusts of the failed franchisee to get control of two assets; the inventory and the tax losses. The inventory is then “sold” to the new franchisee that replaces the failed one. The units in the trust is then assigned to one of the 1,216 subsidiaries of HVN that can utilize the losses. The Australian corporate tax rate is 30% and therefore HVN can claw back 30% of the franchisee losses via tax credits.

We have modeled how HVN benefits from a failed franchisee and how keeping a failed retail location operating can have positive cash flow benefits for HVN. We have used an example of a franchisee with revenue of AUD 4.2 million (half the average franchisee revenue) with a loss of AUD

We believe this loss of AUD 336,000 is either stuffed into growing receivable balances that are never paid, or are tunneled off as property investments that are never made.

336,000 (typically losses are around AUD 300 – 400,000). We estimate inventory at AUD 100,000 (historical cost of around 300 – 500 items) and liabilities for the stock and unpaid fees to HVN of AUD 336,000. When the franchisee is closed the operating company is closed down without any assets or liabilities. The trust, that owns the assets and liabilities, is transferred to a subsidiary of HVN that will take ownership of the inventory (inventory that was owned by the franchisee) and can utilize the tax loss. The subsidiary can sell the inventory for AUD 100,000 and get a tax credit of around AUD 100,000 for the loss transferred. This additional AUD 200,000 in cash can be paid to the HVN consolidated entity.

HVN's consolidated entity may have lost AUD 336,000 from the failed franchisee but it has gained AUD 200,000 from taking the assets from the unit trust. As we pointed out in our initiation we believe the loss of AUD 336,000 is either stuffed into growing receivable balances that never get paid or are tunneled off the balance sheet through capex spend as property investments that are never made. Keeping alive a failed retail location is actually cash flow positive for HVN, when you consider the franchisee fees and rents that are collected along the way.

Figure 1. How We Estimate HVN Hoovers up the Benefits from the Failed Franchisee

Franchisee Financial Statements when closed (estimate)

Income Statement		
Revenue	100.0%	4,200,000
COGS	80.0%	3,360,000
Gross Profit	20.0%	840,000
Franchise Fees	14.5%	609,000
Rent	4.5%	189,000
Sales, General, Admin and Other	9.0%	378,000
Net Profit (Loss)	-8.0%	(336,000)
Income tax		0
Balance Sheet		
Current Assets		
Inventory		100,000
Current Liabilities		
Advance for inventory		100,000
Unpaid franchise fees		236,000
Equity		
Retained earnings		(236,000)

HVN Subsidiary that becomes the Unit Trust holder of closed franchisee (estimate)

Income Statement	
Losses from Unit Trust	(336,000)
Income tax benefit value (a)	100,800
Balance Sheet	
Inventory transfered (b)	100,000
Cashflow Impact	
Net Cash Gain after inventory sold (a+b)	200,800

Net Gain for HVN Consolidated Entity (estimate)

Income Statement	
Total Revenue from Closed Franchisee (c)	998,800
Franchisee Fees	609,000
Rent	189,000
Net Revenue Gain from Subsidiary	200,800
Balance Sheet	
Receivable from franchisee (d)	336,000
Cashflow Impact	
Net cash from closed franchisee (c - d)	662,800

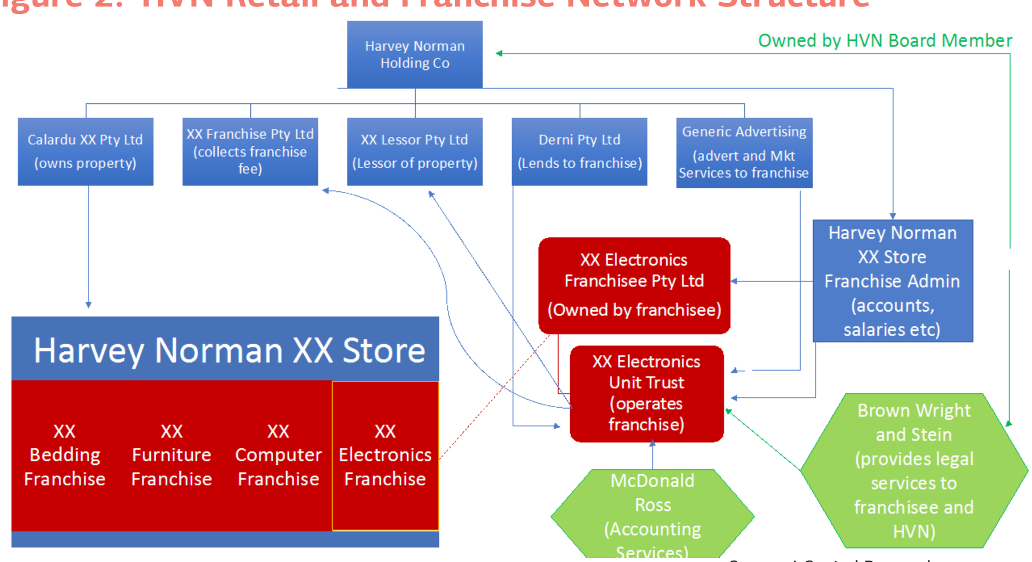
Source: J Capital Research

Recapping: How HVN Operates its Retail Franchise Network

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.

Figure 2. HVN Retail and Franchise Network Structure



Source: J Capital Research

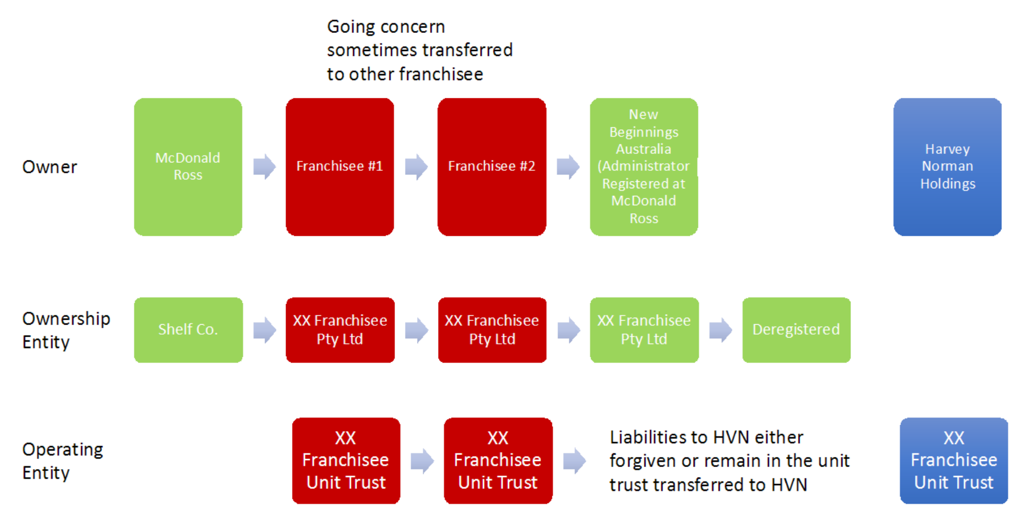
The franchisees do not pay any up-front fee to join the network other than a nominal AUD 1-10 for the paid-in capital of the registered company, then the franchisee can sell the franchise only to a company or individual as directed by HVN and only for the amount of the paid-in capital contribution. There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

Recapping: What Happens to a Franchisee When it is Closed Down?

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 if its owner transfers or leaves the system. The holding company that purchases a company from a failing franchisee is called New Beginnings Australia Pty Ltd and is registered to the same address as accounting firm McDonald Ross. The unit trust, where the liabilities (payments due to HVN) would be held and the tax losses embeded, is transferred to an operating subsidiary of HVN.

Each franchise signs a "charge" a legal document that gives HVN the right to claim any liabilities be repaid and/or to hand over assets like the unit trust. A sample of the charge may be downloaded here. This gives HVN the legal right to take control of the unit trust and inventory. Harvey Norman never pursues the franchisees they just take possession of the trust. As

Figure 3. Lifecycle of a Franchisee



Source: J Capital Research

Gerry Harvey said in a 2003 interview “We take losses on franchises. We might have subsidised him with a franchise — no rent, no something else, and he made a AUD 300,000 loss for the year. We've had plenty of those over the years. They just walk away. We cop the loss. We don't chase them for the 300 grand. Never.”

Impacts on HVN Profits and Cash

It makes sense for HVN to sustain the operations of failed retail outlets as they can make positive cash flows from them. Using our estimates for one franchise and extrapolating to the 20 retail locations that would most likely and the 40 that would probably be closed we can see that the company can get a cash gain of AUD 58.5 and AUD 117 million respectively. The overstated revenue of AUD 150 million per year we identified in our initiation is being partially used to sustain these failed retail outlets and maintain potentially AUD 117 million in cash flow. When the overstatement stops then these retail outlets will fail. HVN revenue and profits will fall more than the AUD 150 million in overstatements it will fall by a total AUD 267 million.

We believe that a further 20 outlets may be at or close to break-even as at least one franchisee is closed each year. HVN retail business is much more fragile than we previously identified and vulnerable to competition.

Please see Appendix 2 for the breakdown of our estimate of how much cash gain HVN achieves per year by keeping failed retail locations operating.

Catalysts

Regulator Investigation Confirmed.

It is now clear that ASIC has escalated its routine review of HVN accounts to an investigation. On the 18 March the Australian Financial Review reported that HVN was being investigated by ASIC. On the 21 March HVN reported to the stock exchange that the report was false. On 22 March ASIC contacted the company and asked them to clarify that statement to the stock exchange. On 23 March, after trading closed for the day, HVN was forced into disclosing that it is being investigated by ASIC. The AFR has an article reviewing the ASIC investigation here.

We believe the new responsible audit partner at Ernest and Young is very concerned about the reputational risk to Ernest and Young and is reviewing HVN accounts closely and has been present when ASIC interviewed HVN about its accounts.

Amazon entering Australia

HVN retail business is much more fragile than previously identified and vulnerable to competition.

There are now confirmed reports that Amazon will have its Amazon Fresh service, the grocery delivery business, operational by the end of 2018. See this article for details.

There is no confirmation of when Amazon will start selling electronics in Australia. We believe it should be before Amazon Fresh as the logistics are less complex.

Amazon is clearly expanding in Australia. They leased another 5 floors of an office building in Sydney and they are advertising 100 new positions in Sydney. Some of these positions are for corporate capacity building like legal, HR and training but most are for Amazon Web Services. We have seen no positions for operations such as warehouse staff.

Valuation

We reiterate SELL and revise our price target to AUD 2.11.

When Harvey Norman closes these 40 stores, the company can no longer sustain its dividend. On our estimates, Harvey Norman will have to at least halve their dividend. The value of HVN's property portfolio will also be marked down.

Factoring in a reduction of AUD 100 million in EBIT when HVN closes 40 stores, we now reduce our price target from AUD 2.91 down to AUD 2.11. We have used an earnings multiple method to arrive at this price target. We believe this estimate probably errs on the conservative side, as we do not factor in multiple compression as a result of a dividend cut, or a one-off earnings hit from a property portfolio devaluation.

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See final page for disclaimers.
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Appendix 1: Worst 20 Retail Outlets by Number of Failed Franchisees

Rank	Store Location	Ownership	Failed Franchisees	State	Avg Closed per Year	Property Value Estimate (AUD mlns)
1	Maroochydore	Owned	29	QLD	3.2	25
2	Aspley	Owned	28	QLD	3.1	20
3	Loganholme	Owned	26	QLD	2.9	20
4	Browns Plains	Owned	25	QLD	2.8	35
5	Toowoomba	Owned	22	QLD	2.4	34
6	Cannington	Owned	22	WA	2.4	37
7	Rockhampton	Owned	21	QLD	2.3	10
8	Bundaberg	Owned	19	QLD	2.1	8
9	Mackay	Owned	19	QLD	2.1	10
10	City West	Owned	19	WA	2.1	62
11	Warwick	Leased	19	QLD	2.1	
12	Capalaba	Leased	18	QLD	2.0	
13	Armadale WA	Owned	18	WA	2.0	9
14	Townsville	Owned	18	WA	2.0	6
15	Everton Park	Leased	17	QLD	1.9	
16	Morayfield	Owned	17	QLD	1.9	9
17	Mt Gambier	Owned	17	SA	1.9	3
18	Noarlunga	Owned	17	SA	1.9	8
19	Fortitude Valley	Leased	16	QLD	1.8	
20	Albany	Owned	15	WA	1.7	4

Source: J Capital, ASIC, HVN Company reports, ABN Registry

Appendix 2: Estimate of Cash Gain per Year from Keeping Failed Retail Locations Operating

Failed Retail Outlet Numbers	Franchisee/ Retail Outlet Estimate	Franchisee Sales Revenue Estimate (AUD 4.2 mln/ Franchisee)	HVN Franchisee Fees and Rent (14.5% and 4.5%)	HVN Benefit from Transferred Unit Trust (0.2 mln/ Franchisee)*	HVN Loss from Closed Franchisee (0.336 mln/ Franchisee)*	HVN Net Cash Gain
20	4	(20x4x4.2) = AUD 336	(AUD 336*19%) = AUD 64	(20*2*0.2) = AUD 8	(20*2*0.34) = AUD 13.5	64+8-13.5 = AUD 58.5
40	4	(40x4x4.2) = AUD 672	(AUD 672*19%) = AUD 128	(40*2*32) = AUD 16	(40*2*0.34) = AUD 27	128+16-27 = AUD 117

* Assuming an average of 2 failed franchisees per year

Source: J Capital

Disclaimer