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August 28, 2017  
Company Update

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## Harvey Norman Holdings (HVN AU) HVN's Captive Media Buyer

▶ **Generic manipulation**

We've found that Harvey Norman pushes costs of USD 10-20 mln per year onto franchisees illegitimately by using a subsidiary called Generic Publications.

▶ **Audit irregularities**

Despite revenues of USD 350 million, Generic Publications is audited not by HVN's auditor, Ernst & Young, but by a third-tier company called MGI Sydney. To avoid a legal requirement to change auditors, GP shifts its business every five years to a different MGI affiliate.

▶ **Preparing a defense**

HVN Director Chris Brown has hired a top legal firm to defend him against potential ASIC charges.

▶ **Annual results August 31?**

The company has said there will be no delay of its annual results but we remain skeptical. We expect a substantial restatement of results.

# Generic Publications: An Engine for Manipulation

Generic Publications (GP), Harvey Norman’s in-house advertising agency, is a private company captive to HVN that appears to manipulate HVN margins by pushing corporate costs onto franchisees. The maneuvers are aided by the fact that GP is audited by a third-tier company called MGI Sydney.

GP designs and places advertisements for all the brands and stores in the group in Australia, New Zealand, Ireland, and Singapore. It also operates the Instant Images business, which is the in-store and online photographic printing services.

Advertising in Australia on behalf of the franchise retail network dominates GP business. GP has posted a cute 2010 [mockumentary](#) on Youtube demonstrating to franchisees how to order advertising through GP. Advertisements may be placed by the group or at the request of a franchise. All advertising costs are allocated back to the franchisees and to company-owned stores. By managing advertising for both company-owned stores in New Zealand, Singapore, and Ireland and for the franchise network in Australia, GP can overcharge franchisees and undercharge company-owned stores.

Harvey Norman spends half of its advertising on newspaper ads, followed

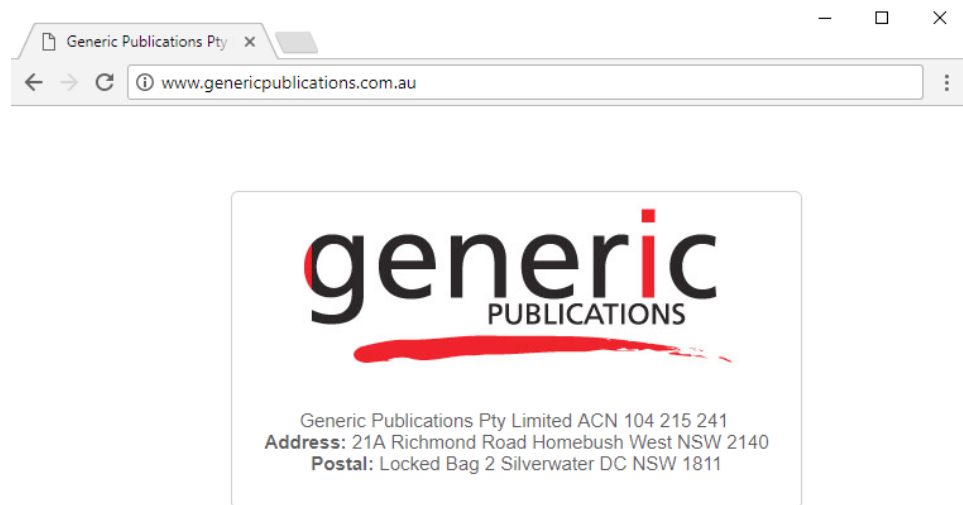
**Table 1. Harvey Norman Estimated Advertising Spend**

	Share of spend	Spend (mlns)
<b>Metro Press</b>	42%	129
<b>Regional TV</b>	18%	56
<b>Magazines</b>	12%	37
<b>Metro Radio</b>	11%	36
<b>Other</b>	10%	31
<b>Regional Press</b>	7%	22
<b>Total</b>		310

Source: Nielsen, Generic Publications and HVN reports

We believe that HVN uses GP to overcharge marketing expenses to franchisees, offsetting marketing or other expenses in its directly owned business.

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**Screenshot of the Generic Publications website, which has only this page** | Source: J Capital, August 2017.

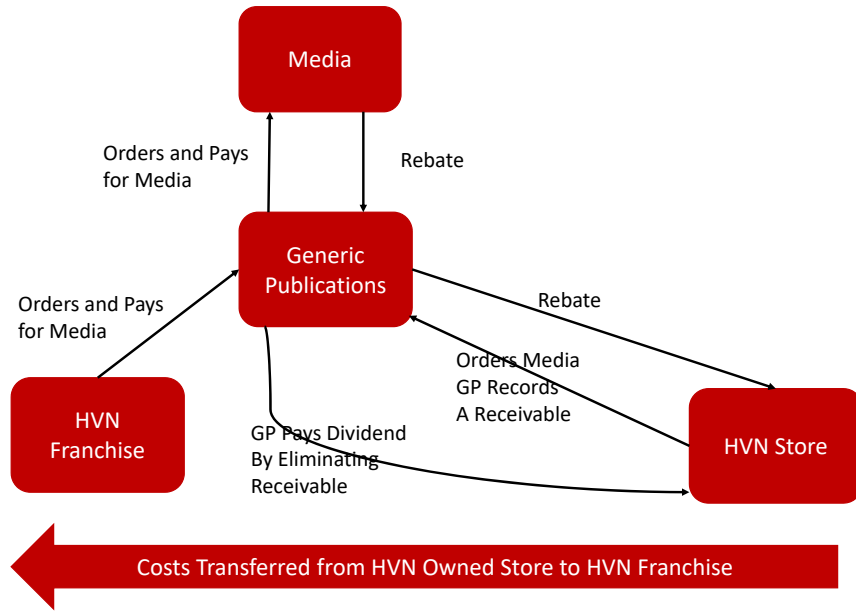
by regional TV, magazines and radio. Nielsen states that Harvey Norman is the third-largest advertiser in Australia after the retailers Wesfarmers and Woolworths. Generic Publications has operated in relative secrecy, without a web presence until early in 2016 when it rebranded as GP Advertising and put up a single-page website at <http://www.gpadvertising.com.au/>.

### Milking Franchises

We believe that HVN uses GP to overcharge marketing expenses to franchisees, offsetting marketing or other expenses in its directly owned business. After reviewing the GP published accounts, we believe there are two simple mechanisms for transfer pricing:

1. **Overcharging:** A franchise will order and pay the full cost of an advertisement. HVN directly owned stores will order advertisements but not pay GP and instead record either trade receivables or a loan receivable for the store. GP will then pay a dividend to the HVN store or a related entity but do it not in cash but by canceling out the receivable debts.
2. **Rebates:** Advertising agencies typically give a rebate to large advertisers at the year-end based on volume of advertisements placed. This is around 8-9% of total billings. GP either does not return the rebate to the franchisees or it allocates the rebate to one of the directly owned subsidiaries by canceling a receivable.

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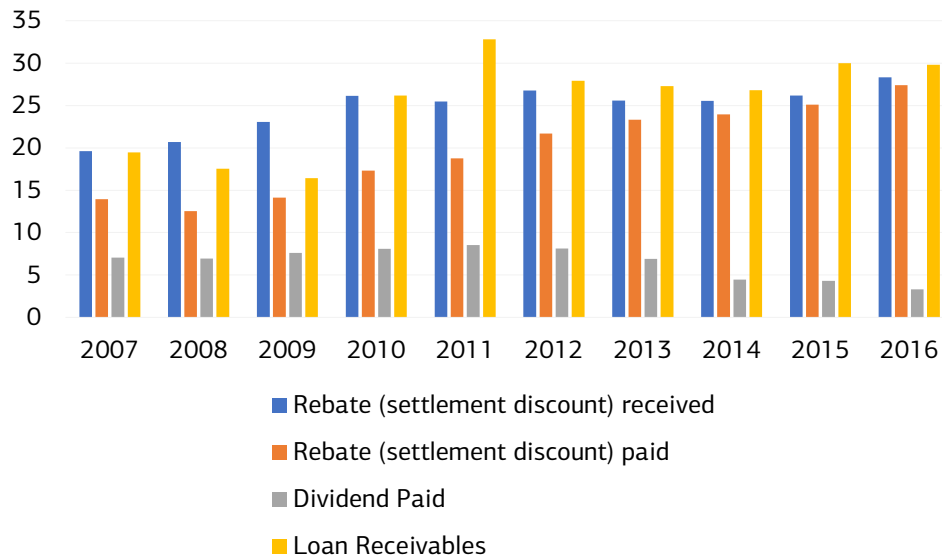


Network of HVN costs | Source: J Capital, August 2017.

We believe that the franchise network is subsidizing other directly owned HVN companies by anywhere from AUD 10–20 mln per year.

Our checks with current and former HVN franchisees indicate that many marketing expenses are randomly allocated to the franchisees. Some are clear and requested by the franchisees, like an advertisement in the local

### Chart 1. Generic Publications, Rebates, Dividends and Loan Receivables



Source: Generic Publications Financial Statements

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We expect Ernst & Young, under pressure from ASIC, and out of fear of the potential reputational risk, may insist that they audit GP in the future.

paper or a catalogue produced and printed but others are randomly charged to the franchisee.

Almost all franchisees said that rebates were not paid to the franchisees.

We have obtained the financial reports for Generic Publications from 2007 until 2016. You can download the financial statements [here](#).

From 2007 to 2009, GP had negative cash flows from operations and survived through substantial bank borrowing, but managed to pay dividends equal to profit. From 2011, dividends paid out were greater than profit, and, at the same time, trade receivables built up on the balance sheet. This is typically a red flag for fraudulent activity. Revenues are overstated by inflating the balance sheet and then assets are tunneled off the balance sheet through dividend payments. GP never pays dividends in cash. Dividends are paid by reducing the receivables owed to other subsidiaries in the HVN group.

### HVN Auditors Don't See the GP books

Consolidation of franchisees into the HVN Group would potentially halt this transfer mechanism. This particular strategy artificially boosts net margins by about 0.5%, so consolidation would impact net margins.

GP has its low-ranked auditor for 10 years, which is against audit regulations: Australian rules require companies to change auditors every five years. To avoid switching, the GP shifts its auditor to one or another MGI Sydney related party: from 2007 to 2012 the auditor was MGI Sydney Partners, then in 2012 it changed to MGI Sydney Assurance Services Pty Ltd. Strictly speaking, the audit company changed, but it is still the same auditors. In 2016, the auditor resigned and we expect another MGI entity to appear as the auditor this year.

We expect Ernst & Young, under pressure from ASIC, and out of fear of the potential reputational risk, may insist that they audit GP in the future.

### HVN Wins "Most Consumer Complaints" Title

The largest state in Australia, New South Wales, publishes a list of companies that have more than 10 consumer complaints a year. Harvey Norman has been [top of the list](#) every year since the list has been published. Most complaints are related to refusal to honor warranty by Harvey Norman stores.

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### HVN Director Afraid of ASIC Investigation

Chris Brown, a board member of HVN since 1987, has hired Leon Zweir of Arnold Bloch Leibler as his personal legal counsel. Leon Zweir is known as the “ASIC Whisperer” as he has defended companies under investigation by ASIC including HIH, Elders IXL, and Slater and Gorton. Chris Brown was recently required to reveal that he had effective control of 16.5% of HVN via control of the estate of late founder Ian Norman. Chris Brown is not only a director of Harvey Norman but a partner in Brown Wright Stein, HVN’s legal advisor. Brown Wright Stein has also been appointed legal advisor for all the HVN franchisees. Chris Brown is most likely the architect of the legal structures that make the HVN franchises appear independent, legally, when in practice they are not.

### HVN Due to Report Annual Results on August 31

HVN is due to report its Annual Results on August 31. We called HVN IR, and they confirmed that results would be published on Thursday, August 31. We believe there are three likely scenarios next Thursday:

1. The auditors and the company have not reached agreement on the results, and a delay is announced.
2. The results are announced and there is a substantial restatement of accounts, such as the consolidation of the franchises into HVN. Potentially there is more detail released on the property portfolio.
3. Business as usual, with no substantial changes to the way HVN reports.

We believe that one of the first two scenarios is most likely, most likely with a delay followed by a restatement of accounts.

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