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Update
HVN ASX

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Company Update

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Harvey Norman Holdings Limited
(HVN ASX)

Black Holes in the Annual Report

- **Where is the property?**
  We speculate that around AUD 100 mln in the 2017 AR is phantom revenue. We don't think HVN spent AUD 114 mln on property investments in FY 2017, and the inflation was probably to shuffle inflated revenue off the books. We can find only one property purchase, for AUD 17.6 mln, and property disposals of around AUD 26 mln.

- **Constructive obligation?**
  In its preliminary results, HVN said it does not have an obligation to pay the debts of franchisee to suppliers. Then Gerry Harvey in a national TV interview said yes, it does.

- **Why did the cash fall so much?**
  We think under pressure from regulators and auditors the schemes HVN used to inflate revenue have collapsed. They can no longer hide revenue as growing receivables and using the losses of failed franchisee unit trusts seems to have come to an end.

- **In trouble with the ACCC?**
  We believe that HVN's use of Generic Publications to shift company costs onto franchisees is in breach of the Australian Competition and Consumer Commissions' Franchisor Code of Conduct. .

With the contortions around franchise obligations, HVN is trying to have its arm's-length cake and eat it too.

Where Are the New Investment Properties?

We Cannot Find Them

HVN appears to have made around AUD 114 mln in new property investments in FY 2017 and disposed of around AUD 26 mln (we assume the AUD 28.6 mln in proceeds from sale of PPE and properties held for sale was mainly from property investments).

Table 1. Key Property Investment Data FY 2017

AUD Thousands	H1 2017	H2 2017	FY 2017
Balance Sheet			
Property Investments - Net Additions	80,520	7,557	88,077
Property Investments - Net Increase in Fair Value	75,743	31,639	107,382
Cash Flow			
Proceeds from sale of PPE and Properties held for sale	531	28,061	28,592
Payments for Purchase of Property Investments	80,739	34,013	114,752

Source: Company Reports

We have searched the land titles database in every Australian state and territory and have found only one purchase by Harvey Norman in FY 2017. Harvey Norman, via its subsidiary Calardu Macgregor, purchased 572 Kessels Road, Macgregor Queensland 4109 for AUD 17.6 mln in October 2016 and paid for the purchase on February 7, 2017. We also checked two reports of major retail property transactions published by Savills and JLL and did not find any transactions by HVN.

We do not believe HVN paid cash of AUD 114 mln for property investment in FY 2017; we believe it was more like AUD 20 mln.

In addition, HVN raised AUD 26 mln from property sales. The net cash from property transactions was most likely AUD 6 mln. We postulate that around AUD 100 mln in property investments were phantom investments to hide inflated revenue.

HVN warehouse at 572 Kessels Road Macgregor for which HVN paid AUD 17.6 mln in February 2017 | Source: Google.

Does HVN have a “Constructive Obligation” to Pay Franchisee Supplier Debts?

HVN has been tying itself in knots trying to pretend that franchisees are independent. Will the auditor accept that?

The biggest shock in HVN’s FY2017 Preliminary Annual results was the AUD 407 mln reduction in franchisee receivables and a related AUD 483 mln reduction in liabilities. Note 7 a) of that report explains that Derni, a subsidiary of HVN, “has no legal obligation to discharge the liabilities of a franchisee to suppliers of that franchisee. However, a constructive obligation arose,” since Derni had done that in the past and it was established practice. Derni then informed suppliers that, since the suppliers and not Derni were doing business with the franchise, Derni had no obligation to discharge the debt.

But Gerry Harvey was interviewed on Sky News a week later and said, “If a franchisee failed and didn't pay the account, we are under no obligation to pay it. But, guess what? For our reputation, sure we pay it. Every supplier knows that."

HVN has been under pressure from ASIC and auditors Ernst & Young to demonstrate that the franchise network is independent of HVN. These receivables and liabilities, which represented a constructive obligation under International Financial Reporting Standards, were proof that the franchise network was not independent of HVN. Hence Derni’s renouncement of the obligation and the substantial change in receivables and liabilities.

Will E&Y sign off on the Annual Report? Or, as Gerry Harvey says in the interview, is it just “bullshit”?

If you are unfamiliar with Gerry Harvey’s arrogance and contempt for short sellers, this interview is a must-watch.

If you’re unfamiliar with Gerry Harvey’s contempt for short sellers, his recent Sky News interview is a must.

Why Did Cash Flow Fall So Much?

HVN reported a 29% increase in profit, yet cash flows from operations fell by 2.9%. What is worse, the conversion of franchise revenue into cash receipts fell from 103% in H1 2017 to 59% in H2 2017. This is a massive decline. And yet we believe that the property investments may not be real, and so the real cash flow decline may be even greater.

We believe there are two changes that may have reduced cash flow. The first is the unwinding of the “constructive obligation.” The liabilities change was AUD 80 mln more than the asset change. It is not clear why this was the case, but something in those transactions had an AUD 80 mln hit on cash flow.

Table 2. Cash Conversion from Franchises

AUD Millions	H2 FY2017	H1 FY 2017	FY 2017	FY 2016	FY 2017 Growth
Cash Flow Statement Items					
Cash Flow from Operations					
Net receipts from franchisees	302,938	579,538	882,476	946,242	-7%
Net Cash flows from operations	145,636	279,504	425,140	437,691	-3%
Income Statement Items					
Revenues from franchise fees	381,200	430,201	811,401	772,476	5%
Rent from franchisees	114,928	116,805	231,733	230,146	1%
Interest from franchisees	14,333	14,152	28,485	27,146	5%
Total revenue received from franchisees	**510,461**	**561,158**	1,071,619	1,030,219	4%
Cash Conversion Rate	**59%**	**103%**	**82%**	**92%**	-10%

Source: Company Reports

Second is the use of unit trust losses. In our HVN update on April 10, we illustrated how HVN may be using the losses in the failed trusts to reduce taxes. Each year, around 100 franchisees go out of business, and the unit trusts associated with them are taken over by HVN. We believe those entities are then attached to a company operating retail businesses, and the losses can then be used to offset tax. We checked those unit trusts today on the Australian Business Register and found that hundreds of those trusts that were reported in the HVN 2016 annual report were canceled on April 13, 2017 effective December 31, 2016. The tell will be when the 2017 annual report is published: the trusts associated with failed franchisees will be gone.

HVN's In-House Advertising Company in Breach?

In a recent HVN update, we analyzed the HVN marketing company, Generic Publications, which provides services to franchises and company-owned stores. We believe that HVN may be using Generic Publications to transfer company cost to the franchise network. It has been pointed out to us that this is in breach of the Australian Competition and Consumer Commissions' Franchise Code of Conduct. We understand that the ACCC may now be reviewing HVN's marketing practices and the operations of Generic Publications.

The relevant section of the Franchise Code of Conduct is Section 31 part 2:

"(2) If a franchisor operates one or more units of a franchised business, the franchisor must pay marketing fees and advertising fees on behalf of each unit on the same basis as other franchisees."

What to Look for in the AR

The Harvey Norman Annual Report will be released on September 30. Watch for these issues:

1. Have the unit trusts from the failed franchises been disposed of? We expect to see them all removed from the annual report, as HVN has shut them down.

2. Will HVN be forced into revealing any more detail about its property portfolio?

3. Will E&Y sign off on the "constructive obligation" or will there be a qualification of the audit?

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