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Company Update

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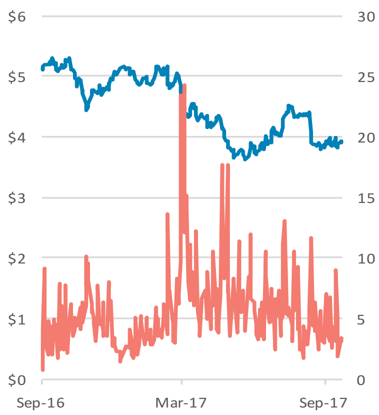
Harvey Norman Holdings Ltd. (HVN AU) last share price in AUD (left, blue) and volume in mln shares (right, pink).



Source: Bloomberg October 10, 2017

Harvey Norman Holdings Ltd. (HVN AU)

Delaying the Day of Reckoning

- **Squeaking by:** HVN has moved past the immediate threat of a crash in its share price and, before the Interim, only regulatory action will provide a clear negative catalyst. But the annual report betrays accommodation to auditors, regulators, and investors that limit the schemes the company can use to inflate performance and that will force HVN to show eroding earnings.

- **Buyback?** HVN says it's considering a share buyback. Considering the sharp fall in cash flow and the dividend cut, a buyback would have to be financed by selling assets. We see this as the biggest potential risk to the short thesis.

- **Phantom property purchases of AUD 55 mln:** We have a high level of conviction that AUD 55 mln of the reported FY 2017 property investments did not occur.

- **The trust scam is finished:** HVN has used the assets in failed franchise trusts, such as inventory and tax losses, to double claim costs and create cash flow. That door appears to be shut now and this is crushing cash flow.

- **Regulator not finished:** Normally, ASIC announces the end of an investigation and it has not done so.

- **Weakening:** HVN has 10 very weak retail locations and we expect several of them to close over the next 12 months. Furniture and bedding has seen a downturn in sales.

- **Revenue this half to be flat:** We expect H1 2018 revenue from franchises to be flat. We expect net profit margin to fall from 12% to 8-10%. The lower end of the margin depends on the wild card of property revaluation. We expect cash conversion from franchises to fall from 103% in H1 2017 to 80% in H1 2018 which means a fall in cash flow from operations of AUD 116 mln. We expect this to cause the interim dividend to halve, from AUD 0.14 per share to AUD 0.07 per share.

Phantom Property Purchases

HVN continues to use its opaque property portfol io to hide fake revenue and is now using the property portfolio to shore up its shrinking cash flow.

We have identified AUD 55 mln in missing property investments (a revision down from AUD 100 mln after we found two more properties). After another exhaustive round of checking Australian property records against Harvey Norman subsidiary companies, we have a high conviction that around AUD 55 mln in property purchases did not occur.

Property revaluation great for profit and margin bad for cash flow as you have to pay cash tax.

Key Property Investment Data

AUD Thousands	H1 2017	H2 2017	FY 2017
HVN Reported 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
HVN Reported 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
Assets Identified by J Cap			
Property Investments - Net Additions	43,450	-12,400	31,050
Variance from the HVN Balance Sheet	-37,070	-19,957	-57,027
Cash Flow Identified by J Cap			
Payments for Purchase of Property Investments	43,450	17,600	61,050
Variance from the HVN Cash Flow Statement	-37,289	-16,413	-53,702

Source: J Capital, Company Reports

Properties Purchased	Date	Amount	Payment
Property Transaction Identified by J Cap			
Harvey Norman Warehouse and adjacent factory 572 Kessels Road Macgreggor QLD 4109	7-Feb-17	17,600	17,600
Rocklea Homemaker Centre (no Harvey Norman retail), 239 High Street Kangaroo Flat VIC 3555	24-Nov-17	35,000	35,000
Harvey Norman Alice Springs, 1 Colson Street Alice Springs 0870	15-Jul-16	8,450	8,450
Sold Properties			
Vacant land, Crows Nest 55 Falcon Street Crows Nest 2065	7-Jun-17	30,000	26,000
Payments for Purchase of Property Investments	80,739	34,013	114,752

Source: J Capital, Company Reports

HVN eliminated 326 trusts and failed to report 38.

HVN revalued the property portfolio by AUD 107 mln in 2017. This is great for net profit as it comes at a 100% margin, but it's bad for cash flow, since you have to pay cash tax at 30% on the revaluation.

Trust Scam Broken: Key to the H2 Cash Decline

HVN historically acquired the trusts from failed franchises, stripped out the inventory, and utilized losses for tax credits. In our April 2017 HVN update we calculated that HVN can obtain a cash benefit of at least AUD 20 mln from this process from the more than 100 franchisees that fail each year. We believe H1 2017 was the last period in which HVN was able to utilize this benefit.

HVN began to frantically vest these trusts from November to March 2017 following reports in the Australian Financial Review in November 2016 and March 2017 revealing the mechanics of this process and using the trust list published in HVN's annual report as confirmation. We estimate that HVN vested 326 trusts from December to March 2017, although the 2017 annual report indicates 373 were vested. We found 37 trusts listed in the 2016 Annual Report that remained active but not reported by HVN, some 23% of the total reported in 2017. HVN had completely vested all of the failed franchise trusts reported in the 2016 Annual Report. The unreported trusts were related to HVN subsidiaries. We identified an additional 42 franchises that failed in the first four months of FY 2017. HVN acquired the trusts before closing them by March 2017 to avoid disclosure. The trust analysis is here.

We believe that HVN held the trusts on its books to maximize the tax

Franchise numbers restated down 20%.

losses over time. Vesting such a large number of trusts (the equivalent of three years of failed franchises) in H1 2017 would have wasted much of the tax benefit potential of those trusts.

The auditors, Ernst & Young, are responsible for auditing the financial statements, including the notes where the list of these trusts appears. With such a material change in the volume of trusts reported, you would expect the auditors to complete a detailed check of the trusts reported. They missed 38 unreported trusts. This brings into question the diligence of EY in the audit process. Considering how widely reported the use of these franchise trusts was in the media and analyst reports we would suggest EY was either willful or negligent. EY did not even flag this as a key area of concern.

This is even more curious because HVN significantly restated the total number of franchisees down from 673 to 532 in 2016 and from 678 to 547 in 2015. It turns out the higher number was the number of directors of franchises not the number of franchises. This fall in franchise numbers makes the failure of 100 plus franchise each year even more significant as it raises the failure rate from 15% to 19%. That is a very high percentage for any franchise network globally. Franchises are legal placeholders manipulated by HVN.

HVN Reported Trusts

	HVN Annual Report 2017	HVN Annual Report 2017	Variance
Total	540	167	373
Vested Prior to July 2015	10		10
HVN Unit trusts not reported	1	38	-37
Adjusted Total	531	205	326
% incorrect data	2%	23%	
Vacant land, Crows Nest 55 Falcon Street Crows Nest 2065	7-Jun-17	30,000	26,000
Payments for Purchase of Property Investments	80,739	34,013	114,752

Source: Company Reports

Covering up Decline

HVN continued to prop up failed retail locations in FY 2017 by churning through failed franchises. Each year over the past decade, around 100 franchises have failed. We know this from pulling the company registration

Property revaluation is great for profit and margin, bad for cash flow since you have to pay taxes in cash.

data for Joseph Deen, the man who cleans up failed franchises, and comparing it with the trust data that HVN publishes each year. Deen deregisters the companies, and HVN takes over the unit trust to harvest the inventory and losses. Now that HVN has been caught out in this process and appears to no longer be able to use the trusts, this channel of information has gone dark. Before it did, we had data on 42 companies that Deen had taken control of in the first four months of FY 2017 and extrapolate that 120 Harvey Norman franchisees failed in FY 2017. Data on the failed franchises and associated trusts tell us the following:

- Failing Retail Locations: The core of HVN shenanigans is keeping alive failed retail locations, where it owns the properties. This is to maintain property value. Harvey Norman owns 49% of its 194 retail locations and leases 51%. From this data, we see that 15 (36%) of the failed franchises were in leased premises and 27 (64%) were in premises owned by Harvey Norman. Clearly, support is greatest to locations the company owns. More importantly, of the 27 franchisees that failed in owned premises, 18 were at locations where more than 10 franchises had failed in the last nine years and 10 where more than 20 had failed in the same period. Without the capacity to utilize the tax losses from the franchises, it will be harder for HVN to keep poor-performing retail locations operating. We should expect a number of store closures over the next 12 months and potential write downs and/or sale of the associated properties.

- Furniture and Bedding Declined: The failed franchise data reveals the weakness of HVN's furniture and bedding business. 28 (62%) of the failed franchises were furniture or bedding franchises. We estimate that fewer than 40% of all franchisees include furniture and bedding. 18 of these failed franchises had been in business for more than three years, with an average of 7.5 years. Clearly the furniture business has taken a sharp downturn in the past 12 months, as many well established franchises have failed. Gerry Harvey is always quick to point out that furniture is his competitive advantage over Amazon. That part of his business appears to be the weakest.

Please see [this analysis] of the franchises.

Does ASIC Believe the Franchises Are Independent?

So now we know that EY agrees with HVN that the franchisees are independent. EY signed off on the independence of the franchisees after forcing HVN into eliminating the "constructive obligation" of HVN to suppliers. That obligation amounted to AUD 407 mln in franchisee receivables and a

Expect store closures now the trust scam is shut down.

related AUD 483 mln reduction in HVN liabilities.

Yet Gerry Harvey scoffed, saying that the company would always pay supplier debts. And checks have confirmed that suppliers invoice an HVN subsidiary called Derni and not the franchisees. That is an odd kind of independence.

We do not believe that ASIC has closed its investigations. Normally when ASIC has publicly acknowledged that they are investigating a company they publish a statement that the investigation is complete. Here is an example of statement from ASIC closing an investigation into Seven West Media.

Working through the practicalities of the supposed changes from unwinding the constructive obligation, it looks like liabilities of AUD 483 mln, which means inventory, have been transferred to the franchisees. With 542 franchisees, that means each franchise on average must hold AUD 900,000 in inventory. Did EY check the inventory?

From our interviews with franchisees, we do not believe they are holding such high levels of inventory.

And if suppliers deal directly with franchises, that will cut out HVN's ability to take supplier rebates that we estimate are worth at least AUD 20 mln a year. Suppliers will be legally obliged to provide the rebates to the franchisees.

Catalysts

- **Scrutiny of the property portfolio:** Suspicion around the property portfolio remains focused on the valuation. We believe there has been no public scrutiny of the phantom property purchases. This topic remains a catalyst for further downside to the stock.

- **Regulator action:** We believe the regulator remains unsatisfied with HVN accounting of franchises.

- **Poor retail climate:** Australians have a high level of mortgage debt, and this is dragging on consumption. HVN furniture sales are clearly in decline. We expect HVN to be unable to prop up the weaker stores. A number of store will close over the next 12 months.

- **Amazon's entry into market:** This may come may be sooner than expected. Amazon is recruiting suppliers and customer-management

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staff in Sydney. Amazons' Melbourne operation should soon recruit operations staff for the first warehouse.

ASIC not finished with HVN yet.

- **We expect cash flow in H1 2018 to be poor:** We think the dividend will fall further when the half year results are announced in February. Cash flow will deteriorate, as the schemes HVN has had in place like churning franchises, using franchisees losses, keeping supplier rebates, phantom property investments are all being closed as avenues of manipulation.

Risks

- **Share Buy Back:** HVN announced with the release of the Preliminary Annual Report that they are planning a share buyback. With poor cash flow, rising debt, and a declining dividend, the only clear path to achieving that goal is an asset sale.

- **HVN may sell off properties** or spin some or all investment properties into a joint venture that they control.

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