THE ANALYST

Steinhoff: Down the Rabbit Hole
SHORT @ €3.11

Steinhoff – View All Notes and Models

Recommendation: **Short (Initiation of Coverage)**		
Price: **€3.11**	Market Cap: **€13.3bn**	Ticker: **SNH GR**
3m Average Daily Volume: **€29m**	2 Year price target: **€1.86**	Forecast Return: **-40%**
Valuation Metric: **FY'17e EV/EBIT**	Current Multiple: **EV/EBIT 10.4x**	Target Multiple: **8.5x**

Investment Thesis

- **The company is run by a deal-hungry CEO and a dominant Chairman who sees Steinhoff as a personal vehicle to get his fortune out of South Africa.**
- **We find evidence of over-earning as Steinhoff is not recognising minority interests in the European business. The company is in dispute with the 50% JV partner that co-owns Poco and recognises 100% of the partnership profits. An ongoing court case could trigger a material settlement.**
- **Unexplained related-party transactions with little commercial substance remain unquestioned by the sell side.**
- **We estimate that Steinhoff is close to breaching debt covenants and the company's bonds could lose their investment grade rating.**

This note provides our thoughts on Steinhoff's business model as well as our concerns on corporate governance and the growing debt. In addition, we unfold the related party transactions that shaped Steinhoff into its current form to find out an unreconciling minority interest from the 50% JV partner in Europe. We worry that Steinhoff is close to breaching debt covenants while it prepares to buy another South African retailer owned by the Chairman.

A Retail Conglomerate Relying on Bricks and Mortar

Steinhoff is a bricks and mortar retailer that sells value furniture, clothes, and general merchandise. It operates under more than 40 different brands across Europe, Africa, Australia, and the US. We see competitors like Ikea and B&M as better placed to gain market share in the value segment of the market, as a single-brand strategy helps these companies drive a material cost advantage. For example, IKEA earns twice the net margin that Steinhoff generates (12% vs. 6%) and operates under a single name, whereas Steinhoff uses more than 18 store brands to sell furniture. We see weaker consumer sentiment and margin pressure in South Africa, where Steinhoff generates more than a quarter of its revenue. We see continued margin pressure in the US as Mattress Firm repositions the brand as well as increased uncertainty in Europe as management takes the dispute with the former JV partner to the Dutch court.

Exhibit 1: Revenue segments and brands

Segments Household goods	Brands	Description	% of Revenue	EBIT margin %
Iberia, France, Italy	Conforama	Furniture, white goods in central Europe	19%	6.0%
Germany, Austria, Eastern Europe	Kika-Leiner, Pepco, Poco Lipo, Abra Meble, Extreme Digital (ERM)	Furniture, electronics in eastern Europe	12%	10.8%
UK	Bensons, Harveys, Fantastic Furniture, Plush,	Beddings and furniture	3%	7.1%
Australasia	OMF Mattress, Freedom, Snooze	Beddings and furniture	3%	7.7%
Africa	Bradlows, Rochester, Russells, Sleepmasters, HiFi Corp, Incredible Connection, Poco, Steinbuild	Furniture, white goods, building materials	5%	1.9%
Supply chain and properties		Retail 79% , Warehouse 9%, Manuf.12%	5%	44%
US - Mattress Firm	Mattress firm, Sleepy's	Bed and mattress retailer in the US	15%	4.5%
General merchandise	**Brands**	**Description**	**% of Revenue**	**EBIT margin %**
Africa	Pep, Ackermans, Dunns, Tekkie Town, Power sales, John Craig, Shoe city	Discount and value retails	14%	13.2%
Europe	Poundland, Dealz, Pepco	Discount and value retailers	14%	5.3%
Australasia	Best & Less, Harris scarfe, Mozi, Postie, Store & Order	Clothing value retailers	3%	-0.6%
Africa Automotive	Hertz, Unitrans	Car rentals	7%	3.0%

Source: Steinhoff company financials and The Analyst estimates

Acquisitive Growth

The South-Africa-focused Steinhoff was admitted to the Frankfurt stock exchange in December 2015 after a reverse merger with the German Kika-Leiner. Trying to reduce exposure to South Africa, the group managed to grow revenue in developed markets by €7bn, spending €5.9bn on acquisitions and €2.6bn in CAPEX. In the process the company raised €3.8bn in debt and €3.2bn in equity. We see little scope for synergies across the most recent acquisitions:

- Poundland (UK): September 2016, acquired for £475m on EV/Sales 0.45x and EV/EBITDA 23x.
- Mattress Firm (US): September 2016, acquired for $3.75bn on EV/Sales 1.2x.
- Fantastic Holdings (Australia): December 2016, acquired for AU$330m on EV/Sales 0.6x and EV/EBIT 20x.
- Showroomprive (France): May 2017, acquired a 17% stake in the listed company (SRP FP) for €157m at €27 per share; the stock is down 60% since then.

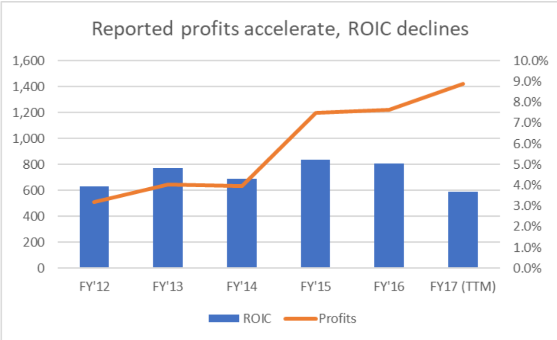
Exhibit 2: Cash flow generation and capital raised

Free cash flow	FY'12	FY'13	FY'14	FY'15	FY'16	H1'17	Total
Operating cashflow	773	691	1,240	1,777	1,309	650	6,440
CAPEX	-505	-589	-351	-341	-416	-208	-2,410
Acquisitions	-491	-61	-486	-1,002	-3,281	-616	-5,937
Increase in investments	371	-11	-360	-211	-273	79	-405
Free cash flow	148	30	43	223	-2,661	-95	-2,312
Proceeds from new shares	0	0	0	1,471	1,716	7	3,194
Proceeds from new loans (net of repayments)	326	172	499	321	1,275	1,208	3,801

Source: Steinhoff company financials and The Analyst estimates

Acquisitions have helped Steinhoff to report strong earnings momentum. Reported profits climbed from €0.5bn in FY'12 to €1.2bn in FY'16. Despite the €8.7bn spent on acquisitions and investments, return on invested capital (ROIC) remains between 4%-5% and appears below the cost of equity for a company with significant exposure to emerging markets. We notice that the remuneration policy awards earnings growth and remains silent on improving ROIC.

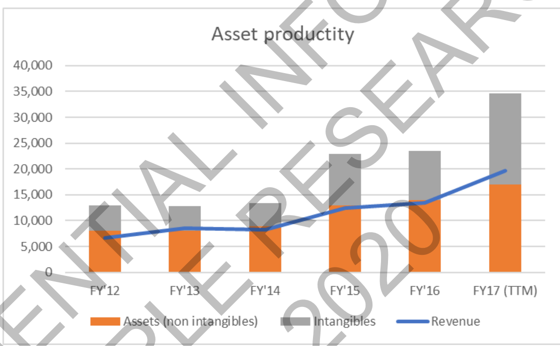
Exhibit 3: Return on invested capital versus profits



Source: Steinhoff company financials and The Analyst estimates

The low return on invested capital is partially explained by the rapid growth in intangibles (goodwill) as Steinhoff unfolds its acquisitive strategy. Currently, intangibles amount to €17.7bn, making up half of the total assets. Between FY'12 and FY'17 revenue has grown by €13bn to €19.7bn but total assets have grown faster – by €21.8bn to €34.7bn. It appears Steinhoff needs to deploy increasing amounts of capital to drive a marginal increase in revenue.

Exhibit 4: Asset growth versus revenue



Source: Steinhoff company financials and The Analyst estimates

Corporate Governance Concerns

What Steinhoff has been able to do exceptionally well is to help the current Chairman channel his capital out of South Africa and into developed markets. Mr. Wiese sold his Pepkor business, a South African retail chain, at a punchy valuation. In turn, Steinhoff acquired Poundland in the UK and Mattress Firm in the US. Pepkor was acquired for €4.9bn on 32x earnings and enabled Mr. Wiese to become the main shareholder, controlling 23% of the group.

Major related party transactions:

2013 Two years before the reverse-merger with the DAX-listed Genesis, Steinhoff facilitates Genesis to acquire Kika-Leiner, issuing €375m worth of shares. The sole director of Genesis was Siegmar Schmidt (former CFO of Steinhoff Europe).

2014 Steinhoff acquires the Austrian property portfolio of Kika-Leiner for €452m.

2014 Steinhoff sells its brands portfolio (GT Global Trademarks) for €488m to Campion, a private equity fund where Siegmar Schmidt is a director. The transaction was made via a Campion subsidiary called Fulcrum. We see this disposal as an undisclosed related party transaction aiming at improving liquidity and working capital. The market reacted negatively when Reuters reported the story; the stock dropped by 4.6%. We see limited commercial substance behind this transaction as trademarks could be used as a barrier to entry.

Exhibit 5: Steinhoff sells trademarks portfolio to ex-director

Global Trademarks and Steinhoff Retail

The group entered into an arrangement to sell GT Global Trademarks, registered in Switzerland, at its carrying value of €488 million. The agreement makes provision for the continued use by the group of the trademarks as well as potential future benefits resulting from the wider marketing of the trademarks by the management company. Steinhoff Retail made payment of a contingent purchase consideration in respect of previously acquired businesses that resulted in additional goodwill of €430 million which was treated in terms of IFRS 3 – *Business Combinations* (2004).

Source: Steinhoff listing prospectus

2015 Steinhoff acquires Pepkor for €4.9bn, controlled by the chairman Christo Wiese. We find Steinhoff paid a punchy valuation at 32x earnings and 1.5x EV/Sales. It appears the Chairman owes the South African Tax Authorities about $245m in unpaid taxes and an investigation was triggered once he tried to get on a plane with $1m in cash flying from London to Luxembourg. After selling Pepkor, Mr. Wiese became the largest shareholder in the group.

2015 Steinhoff listed in Frankfurt after a reverse merger and acquired Kika-Leiner.

2016 Steinhoff disposes the problematic consumer credit business JD Group finance to Campion via an investment vehicle named Wands. The former CFO of JD Group becomes a director at Fulcrum.

2017 At the beginning of the year Steinhoff tries to buy Shoprite, a South African retailer owned by the Chairman. The transaction was cancelled after a shareholder revolt. Steinhoff re-lists the South African arm (SRR SJ) in Johannesburg to raise approximately $1.6bn in cash while retaining a 75% stake. We believe that Steinhoff currently plans to complete the Shoprite (SHP SJ) acquisition indirectly. The listed subsidiary, Steinhoff Africa Retail, shall pay R35.5bn ($2.6bn) to acquire a 23% stake in Shoprite on a punchy earnings multiple (28x). We find this transaction dilutive to Steinhoff common shareholders, as the stock trades on a lower earnings multiple. In the meantime, the chairman reduced his interest in Steinhoff. In October 2015, his listed investment vehicle Brait (BAT SJ) sold all of its 5% stake in the group.

Unreconciled Minority Interests

Steinhoff is in dispute with the JV founding partner, Andreas Seifert, who owns a 50% stake in the core European business (Conforama and Poco). The dispute was disclosed in Steinhoff's IPO document back in 2015. We find it controversial that Steinhoff does not recognise a minority interests on profits generated in Europe though the 50% joint venture partner has a claim on these profits. The disclosure on the admission document (page 130) confirms that the JV partner has the "unconditional right to be indemnified". According to the Manager Magazin, Mr. Seifer puts the value of the dispute at €400m. A separate case is filed in the Dutch court.

Exhibit 6: Un-redeemed interest of 50% JV partner

Redemption of shares held by the Former JV Partner

The Former JV Partner was a 50 per cent. shareholder in a European furniture and household goods retailer. The Group, through one of its subsidiaries, held the remaining 50 per cent. shareholding in this business and certain control arrangements. As a result of alleged serious breaches by the Former JV Partner of its fiduciary duties towards the underlying business and the Group, steps were taken by the Group under applicable law which resulted in the Former JV Partner's 50 per cent. shareholding being redeemed by the legal entity concerned by way of a shareholder resolution (the "**Redemption**"). As Management expected legal action to ensue, the Redemption has not yet been implemented. The Group has received advice from external legal counsel confirming that the Redemption was effective, and, as a consequence, the Group now indirectly owns 100 per cent. of the business concerned. The Group was advised that the Redemption should be confirmed through current legal proceedings, but that the Former JV Partner has an unconditional right to be indemnified for the fair value of its shares redeemed in the Redemption (such fair value shall be determined by the competent court). The implementation of any determination will, however, remain subject to approval of the relevant anti-trust authorities, where required.

Source: Steinhoff listing prospectus, 07 August 2015

In the Q3 revenue update call, management replied that a provision regarding the dispute with the JV partner is booked in accounts payable. We worry that reported operating cashflow is overstated by provisions booked as cash owed to suppliers.

Exhibit 7: Classifying liability provisions as payables

<**A - Markus Johannes Jooste**>: Simon, the provisions that were made at the time when we and the ex-partner terminated our relationship were done at that time, so they are historic and they don't increase other than interest that we provide for it. It is well below that percentage of assets now, and you can appreciate that from a strategic and a negotiation point of view, it would be totally inappropriate to disclose such amounts in such a civil dispute, and they are well in line with the advice that we have from our specialists and lawyers in terms of what need to be paid, and they are provided for under accounts payable and provisions where they belong.

Source: Bloomberg transcript, Steinhoff 3Q FY'17 Revenue update

We estimate that the European retail chain in dispute, Poco, will contribute about €200m in operating profit in FY'18 and €100m would be the minority interest of the 50% JV partner. This corresponds to 6% of our FY'17 estimated operating profit.

Covenants at Risk

Moody's rates Steinhoff debt Baa, the lower end of the investment rate range. According to Moody's rating criteria, investment grade companies are expected to report Operating Cashflow to Net debt above 25% and Debt to EBITDA above 2.5x.

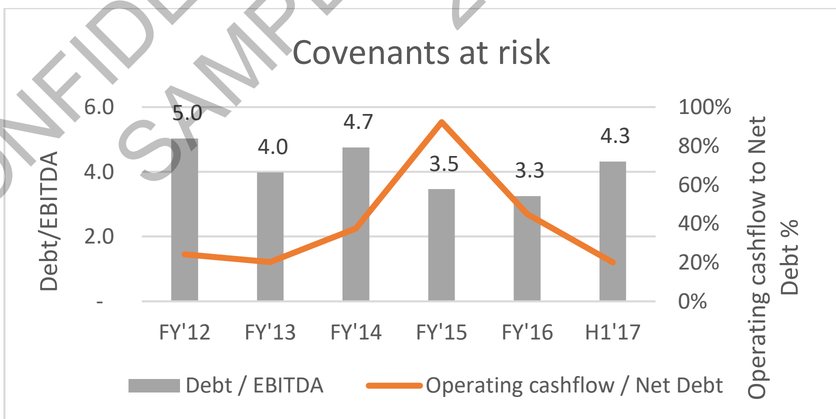
Exhibit 8: Moody's classification criteria

Sub-Factor	Sub-factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
EBIT / Interest Expense	15%	≥ 20x	12x - 20x	6x - 12x	4x - 6x	2.25x - 4x	1x - 2.25x	0.5x - 1x	<0.5x
RCF / Net Debt	15%	≥ 100%	50% - 100%	35% - 50%	25% - 35%	12.5% - 25%	5% - 12.5%	0% - 5%	<0%
Debt / EBITDA	15%	<0.75x	0.75x - 1.5x	1.5x - 2.5x	2.5x - 3.5x	3.5x - 4.5x	4.5x - 6.5x	6.5x - 8x	≥ 8x

Source: Moody's research (moodys.com), accessed 29 November 2017

We predict that Steinhoff is at risk of breaching these covenants and could be de-rated from investment grade. We find that in 1H FY'17 Debt to EBITDA is above 4x, well above the 3.5x limit and Operating cashflow to Net Debt is 20%, well below 25%.

Exhibit 9: Steinhoff debt ratios



Source: Steinhoff company financials and The Analyst estimates

We find that Steinhoff is close to or is already breaching one of the covenants assigned to the 2019 senior notes. The senior notes require that unencumbered assets should remain below 1.5x times unsecured debt; we estimate this rate currently stands at 1.3x. We are looking forward to re-calculating the headroom on debt covenants for the FY'17 annual report, expected to be published on 06 December 17.

Exhibit 10: Steinhoff debt covenants

The notes indenture contains various covenants, including the following:

- We will not be able to incur additional Debt if the aggregate principal amount of our outstanding Debt is greater than 60% of Adjusted Total Assets.
- We will not be able to incur any additional Secured Debt if the aggregate principal amount of our outstanding Secured Debt is greater than 40% of Adjusted Total Assets.
- We will not be able to incur additional Debt unless our Consolidated Income Available for Debt Service is at least 1.5 times our Annual Debt Service.
- We will maintain Total Unencumbered Assets of at least 1.5 times our Unsecured Debt.

Source: Steinhoff 2019 senior notes prospectus

Steinhoff has €1.6bn of debt maturing in FY'18. We estimate that if Steinhoff's debt loses its investment grade status, rolling forward the maturing bonds would cost an incremental €16m in interest costs.

Convertible Overhang

Steinhoff has two convertible bonds close to the current stock price. The first one is already in the money, with conversion price at €3.24 per share. According to Bloomberg, €56m of this €467.5m bond is still outstanding, or about two days of trading volume. The second bond converts at €3.85, or 12% above the current stock price, and has €465m outstanding or 16 days of trading volume. We see these convertibles as an overhang on stock price performance.

US Turnaround Takes Longer

Mattress Firm contributes 15% of group revenue and 8% of EBIT and we see increased margin pressure in FY'18. Steinhoff has repositioned the US mattress business towards lower prices. Mattress Firm in the US phased out the upmarket Tempur Sealy brands in the beginning of the third quarter and replaced them with the more affordable Serta Simmons. In the meantime, Steinhoff is in dispute with the former mattress supplier. Management aims to reposition Mattress Firm from luxury (>$2k) to mid-tier segment ($500-$2k). We see Steinhoff entering into direct competition with online sellers offering 'bed in the box' offers.

We view management's guidance for 6.5% EBIT margin on $3.8bn revenue in FY'18, implying 20% yoy growth, as highly optimistic. Almost half of the top line was driven by the Tempur Sealy brand and replacing it with the mid-tier Serta Simmons triggered a profit warning. We remain sceptical in light of a) lost sales due to the unavailability of Tempur Sealy branded products (the second biggest mattress brand in the US) and b) margin pressure from destocking discontinued inventory. We remain sceptical of management guidance that an incremental increase in marketing spent by $100m, in addition to the $300m spent last year, could trigger a $750m increase in revenue.

Valuation

Currently Steinhoff trades at 10x next year's consensus EBIT of €2bn. We estimate FY'18 EBIT at €1.8bn, which is €200m below consensus, to account for the unreconciled minority interest in European business and lower margins in the US. We value Steinhoff at a lower 8x EV/EBIT, but still in line with European peers, to account for increased exposure in emerging markets, higher borrowing costs, and increased litigation risk. Our target EV is estimated at €14.4bn, extracting €6.5bn of net debt yields an equity value of €7.9bn, or €1.86 per share, at a 40% discount to the current market cap.

Exhibit 11: Relative valuation

Name	Ticker	Market cap. (Eur bn)	EV/EBIT '18
Dunelm	DNLM LN	1.4	12
Bed Bath & Beyond	BBBY US	2.9	5.5
Howdends	HWD LN	3.1	11
DFS Furn.	DFS LN	0.4	9.3
Dixons	DC/ LN	2.1	4.8
Average			**8.5**
Steinhoff - consensus	SNH GR	14.5	10.4
Steinhoff - The Analyst			8.5

EBIT bridge	FY18
Consensus EBIT	2,000
Adjustments	
Minority interest	-100
The Mattress Firm	-100
The Analyst EBIT	1,800

Source: Steinhoff company financials and The Analyst estimates

Conclusion

Steinhoff starts to look cheap as the stock moves lower but is still trading more than 1x sales with single digit margins and a levered capital structure. We see -40% downside from the current stock price after taking a more prudent view on reported profits and assigning a lower earnings multiple. Our three main concerns are:

1. The company is run by a deal-hungry CEO and a dominant Chairman who sees Steinhoff as a vehicle to channel his fortune out of South Africa.

2. Management demonstrates a litigious behaviour, currently in legal dispute with: the German tax authorities for tax evasion, former joint venture partners for inflating revenue, and former strategic mattress supplier (Tempur Sealy) over breach of contract.

3. Unexplained related party transactions with little commercial substance remain unquestioned by consensus.

We hence initiate with a short recommendation and 40% downside to a €1.86 target price.

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