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ACCOUNTING FRAUD SERIES

STEINHOFF INTERNATIONAL

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Steinhoff International Holdings N.V. ("Steinhoff" or "the Company") was founded in 1964 as a furniture distributor in Germany. Over the next 50 years, Steinhoff, primarily through acquisitions, expanded significantly as management pushed for vertical integration, added new business lines, and entered new geographies. From 2000 to 2016, reported revenue grew from $677m to $14.8bn and the Company's market capitalization increased from $717m to $22.1bn, corresponding to a compound annual growth rate of 24% over 16 years. By 2016, Steinhoff was one of most valuable businesses listed in South Africa and became the second largest European furniture retailer, behind only Ikea.[1]

In December 2017, the board announced the resignation of the long-time CEO and the launch of an independent investigation related to accounting irregularities.[2] Over four short months, $20bn of market value evaporated. In March 2019, Steinhoff released summary findings of the independent investigation, revealing that the Company had recorded $7.4bn in fictious transactions from 2009 to 2017, representing 7% and 85% of the Company's cumulative revenue and operating income over the period.

STEINHOFF'S BUSINESS

History

In 1964, Bruno Steinhoff founded the Company as a low-cost furniture distributor that bought cheap furniture in East Germany to resell in the relatively more affluent West Germany.

Over the decade following its founding, Steinhoff expanded its procurement radius by sourcing in countries such as Bulgaria, Romania, Russia, and Czechoslovakia.[3] In the 1970s, Steinhoff began producing its own furniture, a move that further accelerated in 1989, after the fall of the Iron Curtain provided Steinhoff the opportunity to buy East Germany upholstery and bedding factories at very favorable prices.

Steinhoff also expanded into South Africa, and in 1998, Steinhoff began trading on the Johannesburg Stock Exchange ("JSE").

After subsequently building additional manufacturing and distribution capacity, Steinhoff turned to acquisitions and other investments to integrate retail into its business model. The Company pushed into new geographies, spanning 32 countries by 2016, and added new business lines, including apparel, consumer electronics, variety retailing, consumer finance, and industrial businesses.

Additionally, in 2015, the Company became listed in Germany on the Frankfurt Stock Exchange, becoming the year's largest offshore listing.[4]

Business Description

Steinhoff became a patchwork of retail brands across many categories and geographies. Steinhoff sold household goods, general merchandise, and automotive rentals under more than 40 local brands across 32 countries. The Company's main brands included Conforama (France), Pocco (Germany), Homestyle (UK), Poundland (UK), Kika-Leiner (Austria), Pepkor (South Africa), and Mattress Firm (US). Additionally, unlike a traditional retailer, Steinhoff vertically integrated into both manufacturing and property ownership. Approximately half of Steinhoff's manufacturing revenue came from serving internal needs, and the Company's

[1] https://www.forbes.com/profile/bruno-steinhoff/?sh=2f31beba5e6a
[2] https://www.reuters.com/article/steinhoff-intlnl-ceo-idUSL3N1O559K
[3] https://www.cnbcafrica.com/2018/steinhoff-rise-fall/
[4] 2016 Annual Report

retail operations relied on Steinhoff's internal manufacturing to produce ~20% of its own product inputs. Steinhoff also had a branding business.

SUCCESSES

Steinhoff's rapidly accelerating M&A strategy grew the Company. While it took Steinhoff seven years to double sales, from $5.5bn in 2008 to $11bn in 2015, the Company managed to double revenue again in the following two years. Shareholder sentiment increased alongside Steinhoff's own earnings growth; the multiple of the stock price to broker estimates of next twelve-month earnings doubled from 8x in mid-2013 to 16x in 2015 (Appendix I). During this period, Steinhoff starkly outperformed the JSE (Appendix I) and added $22bn in market value. Steinhoff eventually became the fourth largest furniture company globally behind Ikea, Walmart, and Home Depot, and ranked in the Top 40 most valuable public companies on the South African Index.[5]

STRESSORS

Macroeconomic Conditions

Steinhoff faced rising demand pressures. As a brick-and-mortar retailer, Steinhoff was becoming increasingly pressured by the rapid rise of online forces such as Amazon and eBay. Further, just as these headwinds began to accelerate and Steinhoff continued its M&A activity, the furniture market in Steinhoff's largest markets (i.e., France, Germany, UK, and South Africa) began to turn (Appendix II).

Leverage

Steinhoff's vertical integration and property ownership along the supply chain (manufacturing plants, distribution centers, and retail space) required more financial leverage. Following the acquisition of the underperforming Mattress Firm asset in 2016, Steinhoff's net debt position increased from $1.6bn (1.1x Net Debt / LTM EBITDA) at the end of 2015 to $7bn (3.5x Net Debt / EBITDA) by August 2017.[6]

Operational Challenges

Steinhoff's expansion into new markets naturally magnified the complexity involved in planning, management, and reporting of its business operations and performance. As Steinhoff's absolute size ballooned, sell-side analysts began to recognize and comment on this rising complexity (Appendix III), which was compounded by Steinhoff's strategy of buying underperforming assets in new markets. A short seller report highlighted that Steinhoff had acquired a plethora of companies that had "slowing or negative growth," as well as wide geographic and product diversity; however, Steinhoff had not attempted to integrate these acquisitions.[7]

[5] https://www.reuters.com/article/jse/update-1-jse-drops-discovery-from-top-40-adds-steinhoff-idUKLA70581720090910
[6] Net Debt = short-term borrowings & current portion of long-term debt + long-term debt + net pension obligation – cash and short-term investments. EBITDA = Revenues – Cost of Revenues – SG&A – Other OPEX + D&A. Both figures pulled from CapIQ
[7] https://viceroyresearch.org/2017/12/06/steinshoffs-skeletons-off-balance-sheet-entities-inflating-earnings-obscuring-losses/

RED FLAGS

Governance

Steinhoff's CEO, Markus Jooste, had held the role for nearly 20 years and in addition to being one of South Africa's wealthiest people, was considered a "charismatic" leader and a "retail star."[8] At Steinhoff's peak in April 2016, Jooste held approximately $400m worth of Steinhoff stock.

While Steinhoff's Board of Directors contained seven directors that appeared to be legally independent, many of Steinhoff's Board members held close ties to Jooste or were involved in related parties of the Company. In an interview in 2017, Jooste described Steinhoff's board as "a club of friendship and trust" and had also been reported to say that ten of his fellow executives were his best friends.[9]

Further, management's compensation was structured as an all-or-nothing rather than a scaled model, with long-term targets based on earnings growth, cash generation, and return on capital. The cash generation metric focused on operating cash flow only, and therefore did not consider the impact of non-operating cash flows like debt or capital expenditures.

Financial Reporting

While the Company's increasing complexity would make it difficult to analyze its financial performance, management's opaque disclosures enhanced this difficulty. Steinhoff did not disclose like-for-like growth nor the contribution from acquisitions consistently over time. Management also rarely divulged their expectations of synergy capture, nor did they report on progress against their initial expectations of an acquisition.

In addition to M&A, other management actions—including several capital raises, a secondary equity listing in Europe (2015), a shift in its fiscal year end from June to September (June 2016), and an attempted spin-off of its South African business in the weeks before its collapse (October 2017)—obfuscated performance.

Steinhoff's financial results exhibited several signs of potentially aggressive accounting:

- Free cash flow that significantly trailed underlying net income, a discrepancy that increasingly diverged
- Unusually high rates of interest income
- Unusually high capital expenditures relative to depreciation
- Unusually high working capital ratios
- Effective tax rates that were far lower than the statutory rates in any country in which they operated (This discrepancy was a potential catalyst for the German tax authorities raiding the corporate offices in November 2015.)

Steinhoff also had several pages of related-party transactions in its annual report. Many such transactions involved a small network of individuals with ties to Jooste, including the former CFO of Steinhoff Europe, many of whom also shared the same addresses. Even if these related-party transactions were appropriately and completely disclosed, related-party payments can increase the risk of unreliable financial statements (e.g., because related-party transactions cannot be presumed to be at arm's length) or misuse of company funds. Further, an investigation would later reveal that there were even more related-party transactions that were not appropriately and completely disclosed.

[8] https://www.cnbcafrica.com/2018/steinhoff-rise-fall/
[9] https://www.cnbcafrica.com/2018/steinhoff-rise-fall/

THE UNRAVELLING

On August 24th, 2017, a German business magazine published an article warning that German authorities were investigating the Steinhoff CEO, another high-ranking officer, and two others for accounting fraud. According to the article, the officials suspected that "excessive revenues have been included in the financial statements of group-owned companies."[10] Steinhoff released a statement the same day denying the allegations.[11]

A month later, in October 2017, Steinhoff raised €1b in cash by listing 23.19% of its ownership in Steinhoff Africa on the JSE. [12]

In November 2017, Reuters published an article reporting that Steinhoff "did not tell investors about almost $1 billion in transactions with a related company despite laws that some experts believe require it to do so" based on the transaction magnitude and the fact the counterparty was a related party. The reporting focused on a $810 million loan made to GT Branding Holding that came shortly after Steinhoff acquired a 45% stake in the business in 2015. Steinhoff responded by denying that the transaction was material. [13] For reference, the entire (restated) non-current liabilities balance for July 1, 2015 was only €1.187 billion[14] (approximately $1.304 billion[15]).

After the market closed on December 5th, 2017, Steinhoff announced an investigation into accounting irregularities, a delay in the publication of its financial statements, the hiring of an accounting firm to begin an independent investigation, and the resignation of Markus Jooste.[16]

In March 2019, Steinhoff released the summary findings of the independent forensic investigation. The investigation had found that Steinhoff had recorded fictious transactions amounting to $7.4bn over the period from 2009 to 2017. The investigation noted that a small group of senior management recorded fake transactions with "entities purported to be independent third parties to create the illusion of income used to hide losses at the company's operating units."[17] The $7.4bn figure represented 7% and 85% of the Steinhoff's cumulative revenue and operating income over the period.

In aggregate, from August 2017 to March 2019, Steinhoff lost 97%, or $21bn of its market value as investors reacted to the news.

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[10] https://www.manager-magazin.de/unternehmen/artikel/steinhoff-ermittlungen-gegen-markus-jooste-wegen-bilanzfaelschung-a-1164191.html

[11] https://www.bloomberg.com/press-releases/2017-08-24/dgap-adhoc-steinhoff-international-holdings-n-v-response-to-press-statement-published-by-manager-magazin

[12] https://www.bloomberg.com/press-releases/2017-10-02/dgap-news-steinhoff-international-holdings-n-v-steinhoff-raises-eur1-billion-by-listing-and-placing-23-19-of-its-interests

[13] https://www.reuters.com/article/steinhoffintlaccounting-disclosure/steinhoff-didnt-tell-investors-about-nearly-1bln-in-deals-idUSL8N1MK1JT

[14] 2017 Steinhoff Annual Report

[15] https://www.exchangerates.org.uk/EUR-USD-spot-exchange-rates-history-2015.html

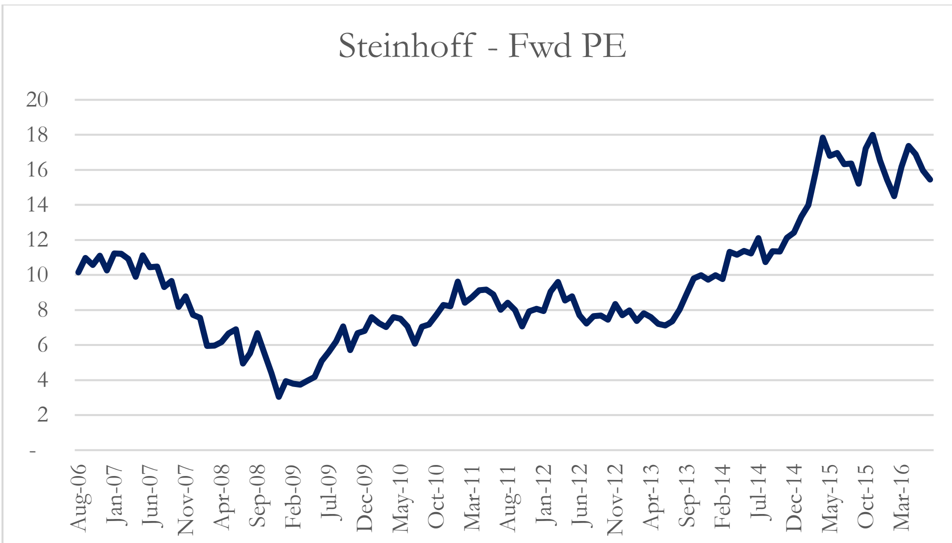
[16] Press Release 5-December-2017

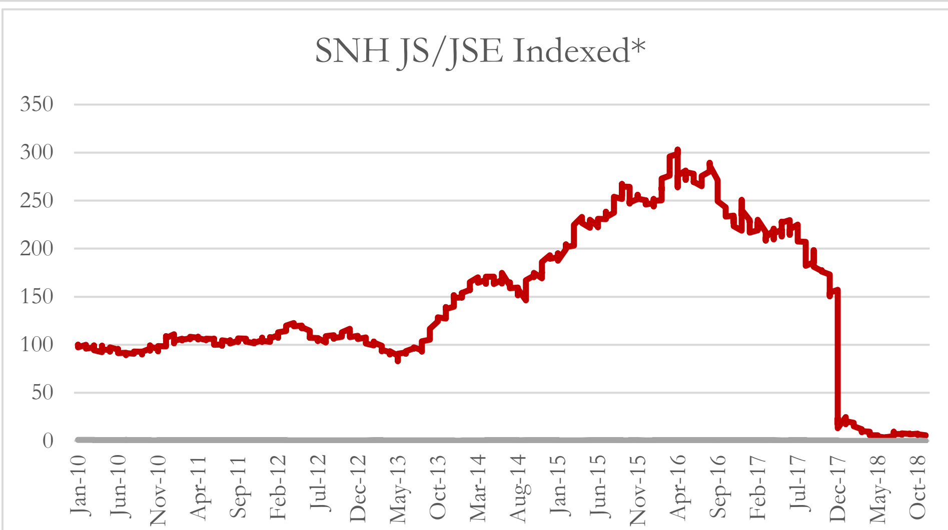
[17] https://www.reuters.com/article/us-steinhoff-intln-accounts-idUSKCN1QW2C2

DISCUSSION QUESTIONS

1. Put yourself in the shoes of an investor. What were the "red flags" that could have prompted suspicion about potentially fraudulent activity?
2. What incentive(s) existed that could have encouraged fraudulent behavior at Steinhoff? Consider the nature of the metrics used to determine compensation, market pressures, and other factors.
3. Consider the governance structure of the company. What opportunities existed that could have enabled fraudulent behavior to occur and avoid detection?

Appendix I: Steinhoff's Growth

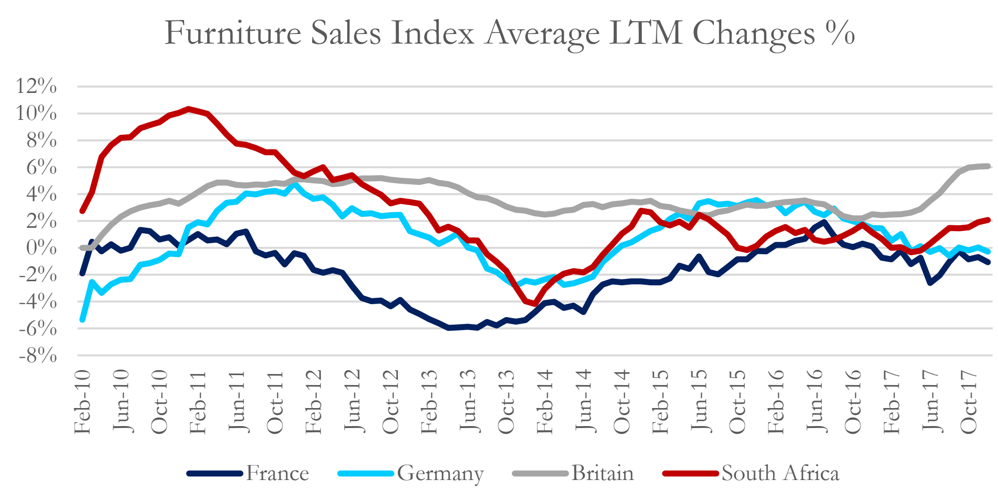




* Shows Steinhoff's share price rebased to 100 divided by the Johannesburg Stock Exchange rebased to 100

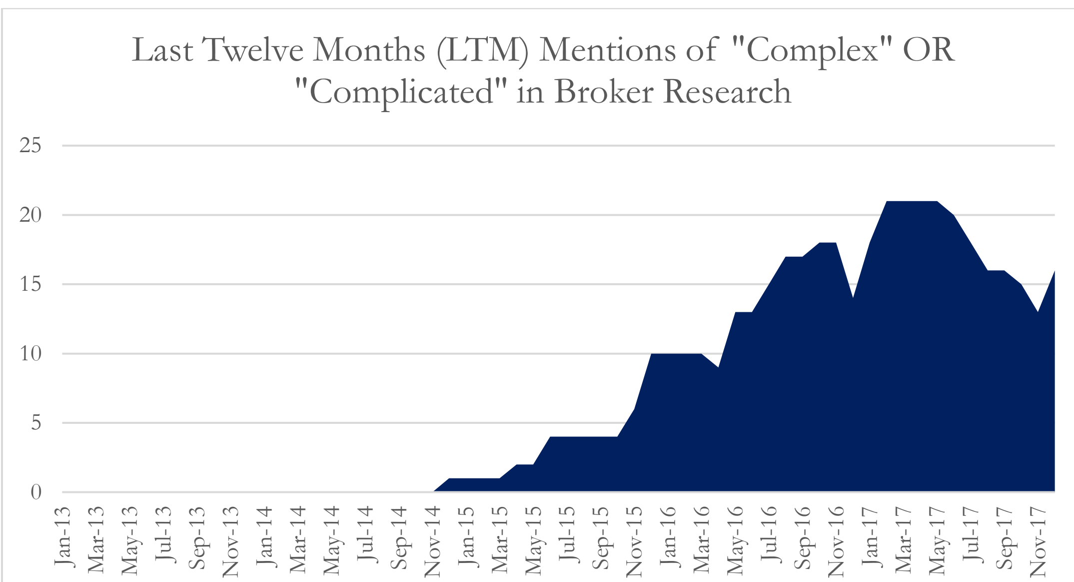
Source: Bloomberg and Capital IQ

Appendix II: Furniture Sales Index (Industry Demand)



Source: Bloomberg

Appendix III: Complexity of Steinhoff



Source: AlphaSense