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FINANCIAL SERVICES

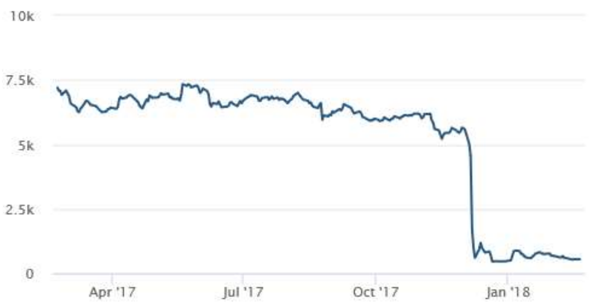
Investment Update

LATEST DEVELOPMENTS REGARDING STEINHOFF INTERNATIONAL HOLDINGS NV

Background

The implosion of JSE-listed Steinhoff International Holdings NV ("Steinhoff") has received a significant amount of attention since the spectacular collapse of its share price early in December 2017.

In case you missed it, in the week ending on Friday, 8 December 2017, Steinhoff's share price dropped by 89.3%, thereby obliterating over R200 billion in shareholder value (a significant portion thereof being retirement savings that were invested in Steinhoff shares).



(For more background on Steinhoff, please read our Investment Update of 8 December 2017.)

Why did this happen?

Steinhoff's external auditor, Deloitte, refused to sign off on Steinhoff's 2017 financial statements. This led to the resignation of its long-time CEO, Markus Jooste and former Steinhoff CFO and then head of Steinhoff Africa Retail (Star), Ben la Grange.

At the same time as announcing the resignations, the Steinhoff board indicated that information had also come to light relating to "*accounting irregularities*" and that they had appointed PwC to investigate the matter further.

No details of these accounting irregularities were provided. Some commentators have suggested that the "*accounting irregularities*" are in fact blatant instances of fraud perpetrated to overstate the group's revenues and understate its liabilities. However, to date, this has not been confirmed by neither Steinhoff nor PwC.

At the heart of some of these rumours are three Swiss and German companies — Campion Capital, Genesis Investment Holdings and Southern View. According to a 21 December 2017 Financial Mail article, "*Deloitte refused to sign the accounts because they feared those companies were secretly run by people close to Steinhoff, who may have helped the furniture retailer overstate its revenues and understate its liabilities*".

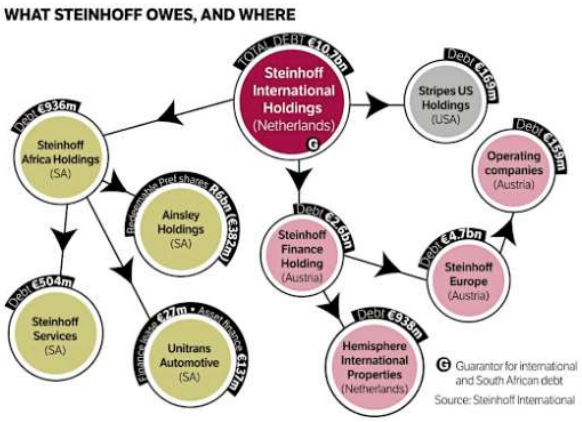
The resultant frenzy by some Steinhoff shareholders to off-load Steinhoff shares caused the implosion of Steinhoff's share price.

Steinhoff's Liquidity Scare

In the wake of the dramatic events in December 2017, Steinhoff's credit lines dried up as creditors' concerns with the company's credibility increased in the wake of Moody's downgrading Steinhoff by four notches since 7 December, leaving it deep in "Junk Status" territory. Moody's cited, *inter alia*, concerns with Steinhoff's complicated structure and the "uncertainty" around what its accounting irregularities entail.

Whilst indications are that Steinhoff didn't appear to have an immediate solvency problem, as its assets still exceed its liabilities, they experienced a liquidity problem, as short-term credit facilities were being withdrawn.

To overcome this liquidity crisis, Steinhoff had to raise a significant amount of cash, partly to provide operating capital to some of its subsidiaries but more importantly, to ensure that it had the required reserves to service its rapidly increasing debt book, specifically a €1bn debt repayment due in the second half of 2018. In addition, Steinhoff reportedly owed €9.6bn to lenders and another €5.2bn to trade creditors at last count.



Steinhoff has asked some creditors for waivers, "*to continue to create a window of stability until 30 June 2018*", to allow management to focus on maintaining the trading performance of the individual business units and development of strategic options, such as asset sales.

Steinhoff and some of its subsidiaries had to raise new money through extension of existing credit lines and new credit lines as well as the sale of some assets (such as PSG Group shares).

In a 26 January 2018 presentation to creditors, Steinhoff reported that "*immediate operational liquidity requirements have largely been addressed*". It also provided clarity on how the proceeds from the sale of the PSG shares were going to be applied.

Status of Investigations and Legal Action

As it stands, Steinhoff's external auditors, Deloitte, has stated that they cannot finalise their audit of Steinhoff's 2017 financial statements until the findings of the PwC investigation have been made available.

Of great concern is the acknowledgement by the Steinhoff board that already-published financial results as far back as 2015 "*would need to be restated and could not be relied on*". They have subsequently issued further warnings suggesting that a restatement of financial statements prior to 2015 would also "*likely be required*".

In January 2018, acting chairperson of the Steinhoff Board, Heather Sonn, informed Parliament that the company had reported a fraud case against former Steinhoff chief executive Markus Jooste with the Hawks, a unit of the South African Police Service, on suspicion that he committed offenses under the Prevention and Combating of Corrupt Activities Act.

Other than this, Sonn, along with former board chairperson and major shareholder Christo Wiese and head of the board's audit committee Steve Booysen said they could not answer any questions on what led to the scandal, saying they too were waiting for the PwC report.

The Financial Services Board said earlier this year that it was also probing the Steinhoff matter and is taking it seriously, but added that it awaited the report from PwC.

According to a Business Report article of 14 February 2018, PwC has reportedly given a presentation to Steinhoff executives on "*the scope and focus of their forensic investigations*". Bloomberg reported that Steinhoff did not provide any details of what PwC indicated they would probe.

Whilst much hinges on the PwC investigation, CEO of PwC Southern Africa, Dion Shango, apparently recently admitted that PwC has no idea how long its forensic investigation of Steinhoff's accounts will take.

Independent Regulatory Board for Auditors (IRBA) chief executive Bernard Agulhas told Parliament that they opened a case against Steinhoff and requested information from among others the company's auditors - Deloitte. He advised that IRBA had received a response from Deloitte and that they would commence with their investigations in February 2018.

In addition, he explained that IRBA was in talks with its German and Dutch counterparts as Steinhoff's main listing is in Frankfurt and has its corporate seat in Amsterdam.

Other current investigations into Steinhoff, or related to Steinhoff include:

- The South African Financial Services Board (FSB) is investigating two cases of possible insider trading involving Steinhoff and one case of possible false and misleading reporting.
- The Department of Trade and Industry and the Companies and Intellectual Property Commission launched investigations into Steinhoff "*so far as they relate to non-compliance with the Companies Act and Regulations*".
- The German Financial Market Authority has launched a formal open-ended investigation into insider trading at Steinhoff following a precursory analysis that was completed towards the end of January.
- An investigation that was launched two years ago by prosecutors in Oldenburg, Lower Saxony, of former and current managers of Steinhoff for tax evasion, document falsification and fraud is still ongoing.
- The Dutch Authority for the Financial Markets (AFM) has decided to launch an investigation into the role of Deloitte in the audit of the financial statements of Steinhoff.
- In a case brought by former partners of Steinhoff, Andreas Seifert's OM Handels and MW Handels businesses, the Amsterdam Enterprise Chamber ruled on 19 February 2018 that Steinhoff should amend its accounts for 2016 to account properly for the correct ownership structure of POCO (one of Steinhoff's European subsidiaries) and pay OM Handels' legal costs of 3,398 euros ($4,215). The lawsuit was initiated prior to the reporting by Steinhoff of financial wrongdoing.

In addition to these investigations, several civil cases are also being initiated by disgruntled investors. This ranges from class action lawsuits in Europe against the company and its directors, claims of gross negligence on the part of asset managers that held Steinhoff shares in their portfolios, threats of legal action against asset managers that held Steinhoff shares and even criminal charges against some of those asset managers.

Investor Reaction

Steinhoff's legal headwinds will take many years to settle. Time will tell whether shareholders will be able to recover any of the losses that they have suffered.

The international flavour of Steinhoff's operations will further complicate the legal wrangling in the years ahead.

While the various investigations (in particular the PwC investigation) runs its course, the absence of reliable information on what the actual financial position of Steinhoff is makes it extremely difficult for investors to make informed decisions with regards to Steinhoff.

Unsurprisingly, the position of investors regarding what to do with their Steinhoff shares has been varied.

Passive / Index Tracking Investors

The Steinhoff exposure of passive investment products that track the main JSE equity indices would have been equal to the proportion that Steinhoff made up in that index. (For example, a Swix 40 index tracker fund would have had around 3.9% of its assets exposed to Steinhoff).

With the free-fall in Steinhoff's share price and the resultant reduction in its market capitalisation, Steinhoff's proportion of the indices reduced, and as a result, the product's exposure to Steinhoff had to reduce in line with the revised composition of the index.

The managers of these products / portfolios had no choice but to reduce their exposure to Steinhoff.

Active Investors

The decision- making by active managers have been much more complicated.

Investors are generally happy to pay active managers a higher fee to achieve returns in excess of the index. To achieve this, it is assumed that the active manager will research each share thoroughly before it buys that share.

The drama that unfolded around Steinhoff in early December 2017 caused an information vacuum for investors and asset managers. As much of the investment decision-making process involves analyses of the company's financial statements, Steinhoff's announcement that its financial statements dating as far back as 2015 may have to be restated without providing any detail, caused an information vacuum. It effectively removed the foundation on which much of the investment decision-making process was based.

Some active asset managers decided to exit their positions in Steinhoff, as they were uncomfortable in retaining Steinhoff shares, irrespective of the price.

Their rationale was that the financial information at their disposal was now known to be incorrect, the actual levels of debt was unknown and as a result, it was simply not possible to place any value on the business.

Other managers argued that the lack of alternative financial information did not enable them to make a value decision on the share and that it would be irresponsible to transact until they are able to make an informed decision.

One manager even suggested that at current values the share now offers value and that investors should consider increasing exposure to Steinhoff.

Conclusion

The biggest single domestic losers from the Steinhoff fall-out thus far has been Christo Wiese and the Public Investment Corporation (who manages the pension funds of government employees). Wiese's total losses are rumoured to be as much as $4 billion and the PIC as much as $1 billion.

Most South African retirement funds with exposure to domestic equities would most probably have had some exposure to Steinhoff.

The investment return earned by members of defined contribution funds that had such exposure would have been detrimentally affected, depending on the level of exposure to Steinhoff shares in the portfolios that their retirement savings were invested in.

Trustees of retirement funds are unlikely to be equipped to anticipate and react in time to events such as these. History will show that even the most seasoned investors and asset managers were not able to foresee the implosion of Steinhoff.

At times like these it is critical for retirement fund trustees to ensure that they seek proper advice to help them navigate the murky waters of investment decision-making they are forced to deal with.

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Prepared by:
Ensimini Financial Services (Pty) Ltd
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