INGHAM ANALYTICS
Equity Research and Advisory Services

# INSIGHT

1st of August 2014

**Mark N Ingham**

South Africa Equity

Reason for note: capital raising and a German listing

| Listing data | |
|---|---|
| JSE code | SHF |
| Name | Steinhoff |
| JSE sector - Home Furnishings | |
| Current price ZAR | 5400 cents |
| Shares post rights issue | 2 372 million |
| Market cap ZAR | R128 billion |
| Market cap USD | $12 billion |
| Effective free float band | 80% |
| Major shareholder | Directors 18% |
| **Recommendation** | |
| Traders: | Above fair value |
| Portfolio investors: | Above fair value |
| **Key estimates for 2014 - June year end** | |
| NAV forecast per share | 3800 cents |
| Shareholders' equity forecast | R90 billion |
| Revenue forecast | R139 billion |
| EBITDA forecast | R17 billion |
| Earnings forecast | R9,8 billion |
| **Valuation metrics** | |
| EV/EBITDA | 10,0x |
| Rolling exit PE | 10,6x |
| Three year PEG ratio | 0,83x |
| Gross dividend yield | 1,9% |
| Net dividend yield | 1,6% |
| Dividend cover on earnings | 5,0x |
| Return on opening equity | 15,0% |
| Price to Book | 1,4x |
| Fair value | 4000 cents |
| Target price | 4000 cents |

| Earnings and Dividends per share in ZAR ce | | % chg |
|---|---|---|
| EPS (a) F2013 | 394,5 | 25,0% |
| EPS (a) H1 F2014 | 243,0 | 41,0% |
| EPS (f) F2014 | 503,0 | 27,5% |
| EPS (f) F2015 | 578,0 | 14,9% |
| EPS (f) F2016 | 623,0 | 7,8% |
| Three year CAGR for EPS | 16% | |
| DPS (a) F2013 | 80,0 | |
| DPS (f) H1 F2014 | nil | |
| DPS (a) F2014 | 102,0 | |
| DPS (f) F2015 | 118,0 | |
| DPS (f) F2016 | 127,0 | |

*Steinhoff, the predominantly pan-European retail trading group with an international supply chain, has received formal approval to seek a prime standard listing on the Frankfurt Stock Exchange. A rights offer is underway as a precursor to this and will be dilutive. Steinhoff will be listed on the JSE through an inward listing. The share has run up in recent months, but one should not necessarily assume that a structural rerating has occurred. There is a lagging earnings and currency aspect to it too as the comparative price earnings ratio had fallen well below the mean PE of the past eleven years. Reported rand earnings are being bolstered by rand weakness relative to the euro. As to whether there is a value trap here is a moot point; the properties are integral to the group, generate a fair yield and are an asset underpin so an unbundling may not be an obvious angle to follow. A creative brand management structure, inter alia, keeps the tax rate very low. There are several assumptions to consider for future exposure. A conundrum is that Steinhoff tends to be rated as an ex-growth stock that does not compensate with a chunky yield; historically, it has been beguilingly cheap. The stock is overvalued in relation to fair value.*



# Steinhoff

## Frankfurt beckons

### Dual listing on the cards

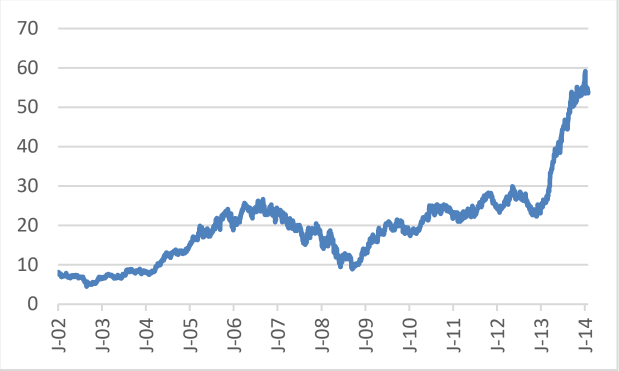
On the 23rd of June 2014, almost as an aside in an announcement to place shares in subsidiary KAP, Steinhoff let it be known that the South African Reserve Bank had given the company formal approval to seek a prime standard listing on the Frankfurt Stock Exchange.

This confirmed what some suspected could be a logical progression for a while. Steinhoff has become a predominantly pan-European retail trading group. The recent flurry of corporate activity, including a buy-out of furniture retailer JD Group, a reduced holding in KAP Industrial from 61,8% to 45%, convertible bond conversion and issuance plus a rights issue, create the backdrop for a European listing possibly in Q4 of calendar 2014.

The run up in the share price, which gathered momentum following release of the results for the year ended June 2013 in September last year but then steadily ran out of steam as the months went by, has been a bit of a buy on rumour sell on fact situation.

Today, the stock is roughly double where it was a year ago.

*SHF in ZAR per share*



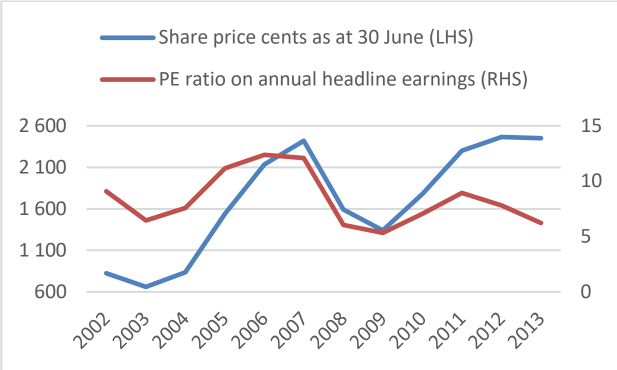

### Stock price ascent follows a lag

This stock price ascent has a lagging earnings and currency aspect to it too as the comparative price earnings ratio had fallen well below the mean PE of the past eleven years.

Taking the June fiscal year end closing price and headline earnings per share from 2013 back to 2002 the Steinhoff PE ratio has an arithmetic mean of 8,3x.

Based on the 30 June 2013 share price of 2452 cents the PE ratio has fallen to 6,2x or 25% below the eleven-year mean. In fact, the 30 June 2012 share price of 2465 cents was little different to the share price a year later and the PE ratio was also below the mean at 7,8x.

The graph below shows the fiscal year-end share price and the price earnings ratio since 2002.




*The price earnings ratio has been in a declining trend*

The price earnings ratio has been in a declining trend for seven years up until 2013 and in fact getting to a rating lower than it was a decade before.

In the eleven-year period up until June 2013 the share price had trebled. However, earnings per share in South African cents more than quadrupled - going from 90,8 cents per share in F2002 to 394,5 cents per share in F2013.

**Historic PE ratio back in line with multi-year mean**

The recent run in the share price has had the effect of bringing the rating back in to line with the multi-year arithmetic mean. At 5400 cents the trailing PE has increased from 6,2x as at 30 June 2013 to 13,7x. If that rating of 13,7x applied for a full year it would result in a twelve year mean of 8,7x.

**Impact of a weak rand**

*Earnings bolstered by rand weakness*

Nevertheless, the forward PE ratio is perhaps more relevant. The reported rand earnings are being bolstered by rand weakness relative to the euro and acquisitive activity that grows the amount of euro earnings.

So, the six-month result ended 31 December 2013 had headline earnings per share up by 41% to 243 cents. The result was driven by a 17,9% rise in euro profits from international operations which corresponded to a 47,5% rise in rand.

This should not have been too much of a surprise – after all, in the prior year first half EPS grew by a modest 5% but second half EPS grew by 49% for an annual 26% increase.

For the year ended 30 June 2014 I estimate headline earnings per share of 503 cents, which is 27,5% growth for the year and 16,7% growth for the second half.

The weighted number of issued shares will be higher for F2014 by at least 7% compared with the 1 803 million weighted shares in 2013.

The forward PE at 5400 cents thus falls to 10,7x from a trailing PE of 13,7x. One year on to June 2015 takes it to 9,3x and then 8,7x for June 2016.

The run in the stock after at least a three year period of the price not doing much is in fact a catch up to reflect a rand which was far weaker over a two year period than may have been previously anticipated and the fact that the rating, as measured by the price earnings ratio, had become too cheap relative to the stock's own history and well below the All Share Index forward PE of around 16x.

**Europe and the euro are key**

It is important to take an external sanity check in euro. Not only is a substantial proportion of revenue generated in Western and Eastern Europe, principally in euro or linked to euro, but Steinhoff also has large euro borrowings and is angling for a Frankfurt listing precisely because of this overwhelming European influence. At this point we don't know the listing sub-sector.

In Steinhoff's own words it has stated that it "is an investment holding company with profits from its international operations currently comprising in excess 90% of its global profits." "Given that the majority of Steinhoff's profits are generated outside South Africa, a listing on a major European stock exchange would more accurately reflect the geographic location of Steinhoff's revenues, customers and store locations and enhance the company's ability to access global capital markets, to further support the expansion of its European operations and growth opportunities available in the international markets."

This is not a recent phenomenon either.

In fact, even going back to 2002 revenue from outside South Africa was 70% of the total, with 44% alone in the European Union and 22% in Eastern Europe. Over 75% of profits were external to South Africa as were 72% of net assets.

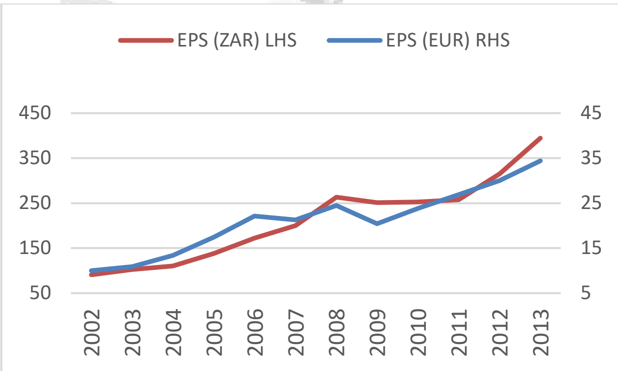
*International operations are 87% of trading profits*

As at 31 December 2013, international assets accounted for effectively 87% of trading profits and 81% of long-term assets with continental Europe accounting for 75% alone. With the recent acquisition of Kika-Leiner the proportion of revenue out of continental Europe will be around 60% on a pro forma basis.

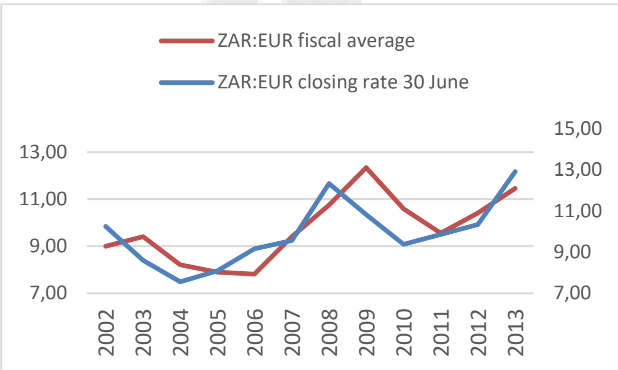
To a large extent the results Steinhoff reports in rand are a translation of results in foreign currencies.

If I take the euro denominate earnings per share, based on the prevailing average ZAR:EUR exchange rate for the respective fiscal years, then EPS went from 10-euro cents to 34,4-euro cents or just over a threefold rise.

This is depicted graphically below.



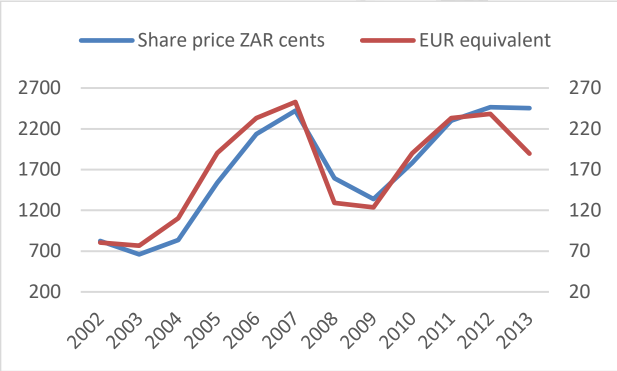

The average exchange rate and closing exchange rate of the rand vs. the euro for the Steinhoff fiscal year ended June is depicted below.




For the year ended 30 June 2014 the average exchange rate will be R14,00 to the euro with the closing rate at R14,45. This is 22% and 12% weaker respectively than the R11,46 and R12,92 of 2013. For the first six months the average rate was 25% less at R13,55 and 12% less on closing at R14,50.

The gyrations of the ZAR vs. the EUR over this prolonged period gives us a sense too of what the share price has done translated in to euro based on the closing rate at the fiscal year end.

As at June 2013, the euro equivalent share price was 25% below that in June 2007.



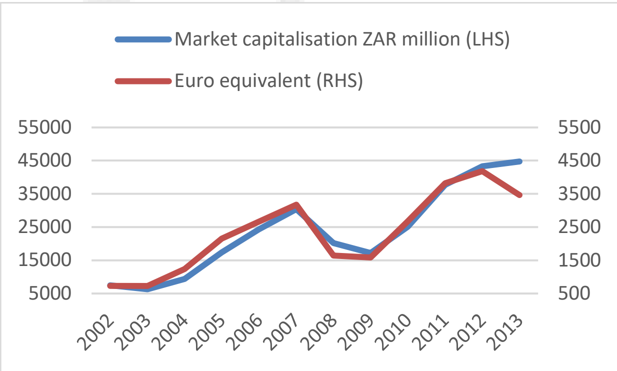

**Shares in issue keep rising**

The total market capitalisation in euro though does a bit better due to the substantial rise in the number of shares.

*There are 60% more shares in issue compared with 2006 and double the shares in issue in 2002*

As at June 2006 there were 1 141 million shares in issue net of treasury shares, which then increased to 1 256 million at 30 June 2007 and then increased steadily each year to 1 825 million as at 30 June 2013, 60% more than in 2006 and in fact over double the number of shares in issue in 2002.

The quantum of earnings has risen, from attributable income of R659 million in 2002 to R7,3 billion in 2013 or an elevenfold rise. Measured on an earnings per share basis the rise is fourfold.




**Is a period of relative rand stability behind?**

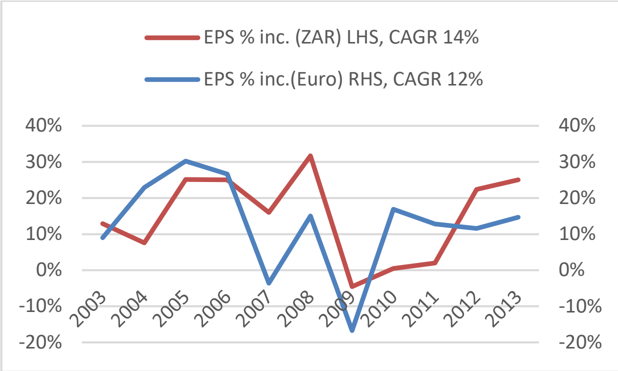
What is also worth noting is the trend in EPS. Steinhoff reports in South African rand with a substantial proportion of revenue generated in Europe and principally in euro. Nonetheless, since 2002 there has not been a huge difference in the euro growth relative to rand EPS growth.

EPS has grown at a compound rate of 12% in euro and 14% in rand since 2002. In the five years to 2013 the compound growth rate in EPS has been 7% in euro and 8% in rand. Over time, the ups and downs of currency have pretty much been a wash. But that has also coincided with a relatively steady currency range, certainly compared with the sharp deviation in the past two years.

For the eleven years to June 2013 the average rate has been just under R10 to the euro. If we take 30 June 2012 through 30 June 2014 the average is R12 to the euro.

The question is whether the sharp fall from around R10 in 2011 and 2012 to R14 will be retraced somewhat or if it is a symptom of a greater economic malaise locally.

1 August 2014




## Acquisitions and lots of real estate

Steinhoff has been increasing its European presence in retail and the recent Kika-Leiner and Mobilier Européen deals enhance the international supply chain benefits of the business model.

Conforama, which Steinhoff bought from Pinault-Printemps-Redoute (now named Kering) for a cash amount of €1.2 billion effective 18 March 2011, has been a particularly astute buy. At a stroke it doubled sourcing purchasing power. Conforama generates total revenue €3,2 billion through Europe and now Turkey and I estimate total operating profit of €160 million in F2014.

The Conforama deal translated to R11,81 billion of which R6,21 billion was net goodwill. €300 million of the funding was subsequently repaid with cash raised through a vendor placement of 131.9 million Steinhoff shares worth R2,94 billion.

The Kika-Leiner acquisition, effective 28 November 2013, adds a further combined revenue of €1.2 billion at an acquisition cost €375 million by means of an issue of 120 million Steinhoff shares as vendor consideration placement.

*€2,5 billion in property…*

With this has come property – lots of it. The group owns roughly €2,5 billion worth of property at book value in Europe. This is R35 billion at the current rate of exchange.

*…27% of post rights issue market cap*

The book value of the property is thus 27% of the pro forma post rights issue market capitalisation of R128 billion, assuming 2 372 million shares net of treasury stock. It also amounts to 1475 cents per share.

Intra-group property rentals are reflected as a separate segment and reflects the retail properties that Steinhoff trades from, warehouses and manufacturing facilities. The idea, other than for the fact some licenses to trade in Europe are linked to a property, is to control lease liabilities and escalations.

*Intragroup property rental expenses distort underlying margin*

Operating profit recorded includes intra-group property rental expenses, which distorts the true retail margin. Conforama for example shows a 5,2% margin for the six months ended December 2013 but the true retail margin is probably over 6% as I estimate rentals are around €30 million per annum.

In the first six months of F2014 property generated both revenue and profit of €92 million or 24% of the international operations profit and 20% of group profit. The annual rental yield on properties averages 7%.

## A property value trap is not screamingly apparent

*Unbundling property may not be an obvious angle to follow*

As to whether there is a value trap here is a moot point. The properties are integral to the group, generate a fair yield and are an asset underpin. An unbundling may not be an obvious angle to follow.

If the assumption is that the market is discounting the property at a higher yield – say over 10% and in line with the forward PE – then there is some case for arguing a value trap, but it is not screamingly apparent. The profit is in any event captured and at one-fifth of group profits it is material.

## Minimising tax exposure

*Creative accounting and structuring inflate earnings and asset value*

There is also a taxation aspect when assessing Steinhoff as a whole. Steinhoff owns and manages its brands via Switzerland, where taxation on intellectual property holding companies is 8% to 12%.

Brand management revenue is earned from royalties received from customers and group entities. The Swiss brand management investments are valued at €500 million and yield 8%.

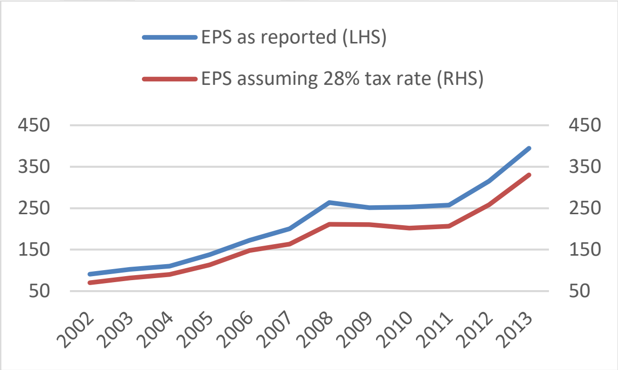
As a result, Steinhoff routinely records a very low tax rate 11,1% in the first half of F2014, 14,7% in the corresponding period in F2013 and 13,8% in F2013. The group tax rate has been between 7% and 14% since 2002 and will probably remain under 15% for the foreseeable future.

The effective rate of corporate tax is between 30% and 33% in Germany, Poland has a 19% rate, Turkey 20%, Croatia 20% and France a minimum of 38% at present. In Eastern Europe there are some tax incentives too for inward investment.

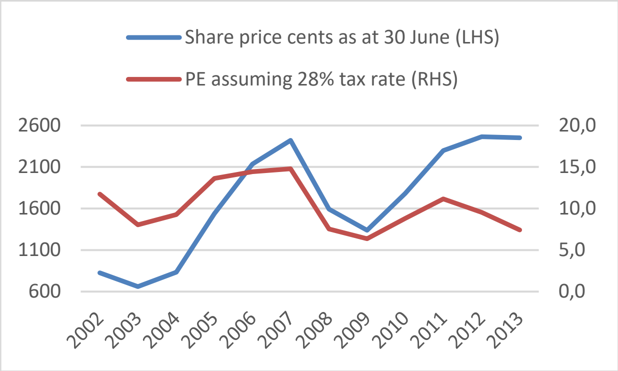
What this means is that Steinhoff will have a tax charge in F2014 R1,5 billion lower than the South African standard rate of 28%. That is about 75 cents per share extra at the earnings line in F2014.

The effect of different statutory taxation rates of foreign subsidiaries in Switzerland and other countries in Eastern Europe is an effective 14% saving.

The differential over the years is indicated in the graph below which restates earnings per share on the basis that a normal South African tax rate would have been charged. On average, for the period 2002 through 2013, EPS would have been 18% lower than reported.




The effect on the price earnings ratio, all else equal, is to increase the arithmetic mean over the period from 8,3x to 10,2x.




## Nearly R18 billion rights offer underway

Steinhoff is currently in the process of a rights issue that closes on 1 August with rights offer shares issued 4 August.

*Rights offer R18 billion with 350 million shares issued*

Net proceeds from the rights offer are estimated at R17,8 billion on 350 million ordinary shares at 5200 cents each.

There is an irrevocable renunciation by Steinhoff shareholders representing 50% of the issued share capital of their rights and a concurrent placing through an accelerated bookbuild to international institutional investors of 150 million Steinhoff ordinary shares plus the right to subscribe for an extra 25 million shares in the rights offer.

The reason is that Steinhoff has agreed to repatriate funds as part of the Frankfurt listing process having previously expatriated funds. The proceeds of the accelerated bookbuild together with the rights offer proceeds from foreign investors will be repatriated to South Africa.

Steinhoff will be listed on the JSE through an inward listing and the Reserve Bank Financial Surveillance Department has agreed to a Holdco AG vehicle managed from South Africa.

On a pro forma basis this would reduce finance charges by R1 billion over a full year assuming an interest rate of 6%.

Net debt as at December 2013 was R50 billion or 70% of ordinary share capital. Net EBITDA interest is around 7x.

**Dilutive effects**

There are thus 17% extra shares based on ordinary shares in issue of 2 022 million versus 2 372 million shares to service after the rights issue.

*Significant dilution*

But if we compare this with a weighted average of 1 803 million shares in F2013 there is a significant dilution. This would mean that, excluding interest savings, EPS of 394,5 cents in F20013 would be 300 cents on the new share capital or 24% less.

If I assume interest savings of R1 billion less 28% corporate tax in South Africa, then the net effect is to reduce the dilution to 330 cents or 16%.

**Do I stay, or do I go now?**

Going in to the future the influence of the rand versus the euro will be a defining influence on the share price, as it has been of late.

Assuming €700 million in earnings for the year ended 30 June 2014 that would equate to R9,8 billion. This compares with €620 million and R7,1 billion respectively in F2013. EPS is thus estimated at 503 cents for F2014 up from 394,5 cents in F2013.

If the rand had to strengthen hypothetically back to R10 to the euro from R14 to the euro for a full year it effectively means that what would be a 38% rise in rand earnings becomes zero growth in rand earnings.

Even if we assume interest savings from the rights issue at R720 million then EPS is 325 cents on the higher number of shares in issue or a decline of 17,6%. The decline is 25% if no interest is assumed.

Taking the current share price of 5400 cents the implied F2014 PE is 10,7x and the forward PE 9,3x. If we have a strengthening currency scenario, from R14 to the euro to R10, together with a higher number of shares in issue then a share price of about 3500 cents would equate roughly to 5400 cents currently. If the market caps had to remain the same based on euro valuations, then around 3800 cents is indicated in this scenario.

If one had to consider a scenario of a more modest strengthening to say R12 to the euro and interest savings from the rights issue, then EPS is 385 cents on F2014 figures based on the higher number of shares. That is still below F2013 and even if the share price remained static it inflates the PE to 14x.

*Investors need to be cautious about Steinhoff, there are things more apparent than real and it is not the screaming value it appears to be at face value*

Bearing in mind that compound growth in EPS in euro was 7% from 2008 to 2013 it is a leap of faith to suggest that a figure materially higher than that is doable in a mature, low inflation, albeit consolidating European furniture and household goods market.

***The run up in the share price has presented an opportunity to take money off the table for some or maybe a reason for reinforcing the faithful to stay the course.***

***Steinhoff has been one of those deep value plays for years. Always seemingly cheap but with devotees awaiting the day for its true value to be finally realised.***

If one is bearish on the rand then there is a good underpin at these levels, irrespective of whether substantial real earnings growth materialises.

If one has a view that there is more international growth in the next few years to be achieved from the proven Steinhoff strategy, then irrespective of the ups and downs of the rand there is reason to remain invested.

If one is seeking future yield from dividends, then one needs to remember that one dividend is declared annually in September.

And the dividend is almost 5x covered so quite thin. After 15% withholding tax, the yield on my F2014 dividend forecast of 102 cents is 1,6%.

Capitalisation shares were awarded last time with a cash alternative.

So, if the yield is thin and paid once a year you need to believe in Steinhoff as a growth stock – and a pretty high growth stock too.

***The conundrum though is that Steinhoff tends to be rated as an ex-growth stock that does not compensate with a chunky income yield.***

If we had to assume a retention policy of 50% or 2x dividend cover then based on my EPS estimate of 503 cents for F2014 that means a dividend of 250 cents or 212,5 cents after withholding tax. At 5400 cents that gives a 4% yield, which is attractive and not out of line with some other companies of similar ilk.

The price to the pro forma post rights issue book value is 1,4x – seemingly good value at face value but as at June 2013 the same ratio was 0,8x so the share price was less than book value.

The enterprise value is inflated because of interest bearing debt and so the EV/EBITDA multiple is 10x, not especially cheap but fair for a largely European asset base. As at June 2013 this ratio was 6,8x.

*Fair value of R40 per share is below the share price*

***My fair value, on the assumption the rand remains in current territory, is 4000 cents for new money and target price on a one-year view is 4000 cents. The stock is overvalued in relation to fair value.***