Australian Shareholders' Association Limited
Suite 301 90 Pitt Street Sydney NSW 2000
GPO Box 359 Sydney NSW 2001
t 02 9223 8811
f 02 9223 3964
e share@asa.asn.au
ABN 40 000 625 669

18 March 2016

Dr Jane Thomson
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

ASA SUBMISSION – SENATE COMMITTEE INQUIRY INTO THE CAUSES AND CONSEQUENCES OF THE COLLAPSE OF LISTED RETAILERS IN AUSTRALIA

Dear Dr Thomson

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. The ASA is an independent not-for-profit organisation funded by and operating in the interests of its members, primarily individual and retail investors, self-managed superannuation fund (SMSF) trustees and investors generally seeking ASA's representation and support. ASA also represents those investors and shareholders who are not members, but follow the ASA through various means, as our relevance extends to the broader investor community.

We refer to the invitation to make a submission in relation to the Senate Economics References Committee inquiry into the causes and consequences of the collapse of listed retailers in Australia, which we understand has been initiated primarily as a result of the recent Dick Smith collapse.

While the scope of the inquiry extends to corporate takeovers and consumer-related issues, we comment only on items (a) and (b) to the extent they relate to the involvement of private equity (PE) firms in the listing of retail companies (often referred to as PE-backed IPOs), whether those retailers have "collapsed" or not, and the role of the Australian Securities and Investments Commission (ASIC) in overseeing these transactions. We do not intend to comment on the consumer-related concerns raised by the inquiry.

Dick Smith and Myer are two prominent examples of PE-backed retail IPOs which have performed poorly in recent years. Other recent examples of PE-backed retail IPOs include Burson Group and Lovisa. It is worth noting that Burson Group's share price is currently about 250% of the listing price, whereas Lovisa is 16.5% higher than its listing price. There are other examples of PE-backed IPOs which are not retail companies which have performed well since listing. Of course, there are also companies such as Spotless where results have been disappointing.

Conduct of PE firms

Often a corporate takeover of a business by a PE firm involves acquiring the business at a low price, a turnaround of the business and its accounts and then selling it off for a profit. Costs are cut and assets written down which increases EBITDA, but not necessarily in a sustainable way. The PE firm may also invest further capital and management time with the aim of improving the business.

Lack of understanding of the financial statements

Our main concern is that, having regard to the investment timeframe of PE firms and the large number of financial and operational changes that are often introduced during the holding period, the financial statements of the company to be listed may not necessarily reflect the company's true financial position and future prospects. There is a lack of understanding by prospective shareholders of the changes implemented by PE firms and their impact on the financial statements. It is also quite possible that the financial strength and prospects of the company are artificially boosted in order to make the investment more attractive to potential investors on sell-down, especially in the short term.

A PE "clean up" of a retail company generally involves writing off large amounts of inventory. This was clearly evident in Dick Smith's case, where Anchorage wrote down the value of old inventory and increased the cash flow from the sale of that inventory. In addition, a number of onerous leases and other assets were written down. In the case of Myer, following TPG's acquisition, we understand there was a large sale, which resulted in the sale of a significant portion of its inventory. The Melbourne flagship store was sold and leased back for a lower annual amount.

These changes resulted in at least the appearance of increased future earnings potential, profitability and cash flow of the companies. Given this is what investors look for, such a business would look like a reasonable investment for the less informed investor. However, as a result of the PE firms' changes as noted above, inventory levels eventually need to be replenished and borrowings increased to pay for the new inventory (and in Dick Smith and Myer's case, growth and expansion of the business) – these changes occur only after the IPO, leading to higher debt levels and possibly a decline in profitability.

Irrational decision-making by less informed investors

Where the company in question is a retail company, there is an element of emotional bias which may impede a private investor's ability to make a rational investment decision because the investor is more likely to have some form of attachment to the retail brand. This would be exaggerated by highly persuasive marketing of the IPO. With a retail business, it is arguable that there is a greater opportunity to stretch the limits of acceptable pre-float marketing, by purporting to promote the business and brand as opposed to the merits of the offer.

Unsophisticated investors would be unlikely to distinguish the two. Whereas a financially astute investor may be able to read between the lines in the financial statements to decipher the changes made during the PE ownership period, this may not be clear to the ordinary investor who is rational, let alone the less informed investor.

As an example, Myer listed at $4.10 per share in 2009 raising $2.2 billion. Its current market capitalisation has dropped to approximately $900 million. There was a specific share offer available to Myer One members, Myer's shopper programme. It was quite clear the Myer prospectus was heavily marketed to the less informed investor – it included a photograph of then popular Jennifer Hawkins on the front cover, as well as pictures of the retailer's offerings, many of which people would be able to relate to as shoppers. The front cover also contained the words "my piece of Myer".

A review of Myer's indicative distribution schedule of shareholders provided to ASX in 2009 on listing shows that 28,089 shareholders held under 1,000 shares and another 24,538 shareholders held between 1,001 and 5,000. This gives a total of 52,627 shareholders with a holding of less than $20,500 at listing. Contrast these numbers to a PE-backed IPO of a *non-retail* company of similar market capitalisation:

- Link Group listed in 2015 with a total of 2,803 holders with a parcel of less than 5,000 shares ($31,850);
- Nine Entertainment listed in 2013 with a total of 3,034 holders with a parcel of less than 10,000 shares ($20,500); and
- Spotless listed in 2014 with a total of 960 holders with a parcel of less than 10,000 shares ($16,000).

The number of holders with a relatively small holding in these companies is nowhere near the numbers seen in the Myer IPO. The high number of retail shareholders suggests that at least some of those investors who became Myer shareholders on listing applied via the Myer One retail offer and were attracted to the idea of owning a share of the department store they frequented. We question whether those shareholders really understood what they were investing in.

Role of ASIC in reviewing prospectuses and IPO selling material

In relation to the role of ASIC, we understand that ASIC currently reviews prospectuses and IPO selling materials. This includes a review of the historical, pro-forma and forecast financial information included in the prospectus. However unless ASIC is approached prior to formal lodgement of a prospectus, which we understand occurs from time to time in the case of PE-backed IPOs, ASIC only has a very short 7 day exposure period to vet the prospectus (although we note that period can be extended to 14 days after lodgement if needed).

We believe there is merit in expanding ASIC's role to include the pre-lodgement review of the draft prospectus and selling materials in the case of all PE-backed IPOs (not just retail companies), in much the same way ASIC reviews the disclosure materials for hybrid securities prior to formal lodgement. ASIC would continue to focus on the financial information as it would normally for prospectuses.

Investors would also benefit from the disclosure of any significant financial and operational changes which have been made to the business by the PE firms whilst they were the owners of the

business. There may also be scope for placing further restrictions on IPO selling materials and the manner in which brokers and promoters sell securities to retail investors.

The role of directors and management

Much of the attention in Dick Smith's case has been focussed on the involvement of Anchorage and the banks. We believe the directors and management must also share in the responsibility where a company, regardless of which stage in the business lifecycle it is in, fails to perform to expectations.

In the cases of Dick Smith and Myer, we believe the Board and management failed to successfully navigate the businesses' challenges. New store openings and the use of private labels were part of the Dick Smith and Myer's strategies – were these part of the PE legacy or should a decision have been made sooner to abandon these strategies? In both cases, it is possible that the situation might have been avoided if a different Board of directors and management team were in place.

The role of investigating accountants

The historical and forecast financial information in the Myer prospectus was reviewed by accounting firm PricewaterhouseCoopers. In the case of Dick Smith, Deloitte was the investigating accountant. Both PricewaterhouseCoopers and Deloitte are leading accounting firms in Australia and internationally.

We question whether the basis of preparation of investigating accountant's reports is useful to potential investors. Further we believe there is merit in expanding the scope of such reports to include a detailed explanation of any adjustments to prior years' accounts and asset values, as well as the impact on the company's future results. This information should be drawn to the attention of investors and signed off by the audit firm.

Please do not hesitate to contact me if you have any queries.

Yours faithfully,

Diana D'Ambra
Chairman, Australian Shareholders' Association