Closing the Book on Dick Smith

Dear Mr Boyd,

I take it from the tone of today's Chanticleer article that we have upset you. We don't have an agenda to push here and are not blaming anyone for Dick Smith's collapse. We simply found it extraordinary that Anchorage took $20m of their own money and turned it into $520m (that fact doesn't seem to be in dispute). You could say we were amazed, and simply wanted to explain how they had done it.

At the time, October last year, the share price had fallen significantly and we were looking at it as a potential buying opportunity. We didn't buy it – a few too many hairs for us – but we also didn't know that it was going bust.

Yet the story has taken on a life of its own and here we are today writing more and more about a stock that we have never had an interest in. So this is it for me, I'm done with Dick Smith.

I do want to clear up this depreciation issue before I move on though. The, "litany of factual errors" you cite seems fairly small in the scheme of a $520m float, but the depreciation issue is a meaningful one. You wrote:

> Forager said that $55 million in plant and equipment write-downs in 2012 reduced the annual depreciation charge by $15 million.
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> "Throw in a few onerous lease provisions and the like, totalling roughly $10 million, and you can fairly easily turn a $7 million 2013 profit into a $40 million forecast 2014 profit," Forager said.
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> But page 55 of the prospectus shows the 2012 deprecation [sic] and amortisation was $12.5 million. The 2014 depreciation was higher than 2013 at $12.8 million reflecting the 45 per cent increase in fixed assets in the year due to investment in new stores and the takeover of David Jones Electronics department.
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> Forager's $15 million depreciation number is plainly wrong. It suggests an average life of assets of less than four years whereas page 61 of the annual accounts says the useful life is five to 10 years for leasehold improvements and plant and equipment.

Those numbers on page 55 of the prospectus are pro-forma. They have *already* been adjusted to reflect the new written down values of PP&E and don't tell us anything about what the depreciation charge would have been in the absence of the write downs.

Our point is that, had the values not been written down, the depreciation charge would have been significantly higher. How much higher is, we agree, open to interpretation. All we did was assume that, because they had halved the value of the net PP&E, they halved the depreciation charge.

You go on to say we have used an ‘average live of assets of less than four years’, which proves our number is far too high. As I’m sure you are aware, average lives refer to the original cost of the PP&E, not the current written down value. If you buy a table for $1,000 and depreciate it over 10 years, you will report $100 of depreciation expense every year. After five years, half of the table’s useful life, you will have a written down value of $500 on the balance sheet and still be reporting $100 per annum of depreciation. The older the table gets, the more depreciation you report as a percentage of the current value.

So if you assume that, on average, Dick Smith’s PP&E was half way through its 5-10 year useful life, there is nothing strange about assuming depreciation of 25% of net PP&E. Indeed, that’s fairly close to what the company has reported historically.

To be clear, we have made some assumptions and could easily be out by a few million here or there. And we’re not for a second arguing that the writedowns were illegal or completely baseless. As your colleague Trevor Sykes has written on inventory, charges like this are notoriously rubbery and open to discretion. What we are saying is that the reported profit was substantially higher than it would have been had the adjustments not been made. If you compare capital expenditure since listing to depreciation, that certainly bears this out:

Year ended 30 June	2013 (10 months)	2014	2015
Depreciation	**(7)**	**(13)**	**(15)**
Net purchases	2	30	29

In any case, you are spot on about the performance of that International Fund of ours. It has done its job – 14.4% per annum since inception – but we won’t have the tailwind of a falling AUD forever, it needs to be much better, especially now that turbulent markets are giving us many more opportunities.

Don’t worry too much about those “anonymous supporters” of ours, though, most of them are invested in our Australian Fund too. You must have missed it when poking around our website, but the Australian Fund has been around much longer and the performance is excellent.

As far as I can tell they are a happy bunch. And I don’t think it has historically been the AFR logo on our website that has been the deciding factor in their decision making. It is there because of my monthly column for AFR Smart Investor and no, we don’t pay for it. But I am happy to remove it if you wish?

Again, apologies for any offence caused. We are just a small company trying to do our best for clients. Running around upsetting people is a relatively new pastime for us and one we don’t intend on maintaining.

Kind regards and have a nice weekend,

Steve

Want to know more about the style of investing we practice at Forager? Check out our page what is value investing

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