

---

## Dick Smith is the Greatest Private Equity Heist of All Time

Want to know how to turn \$10m in to \$520m in less than two years? Just ask Anchorage Capital. The private equity group has pulled off one of the great heists of all time, using all the tricks in the book, to turn Dick Smith from a \$10m piece of mutton into a \$520m lamb.

Having spent the morning poking through the accounts, we're going to show you how it all happened.

Firstly, Anchorage set up a holding company called Dick Smith Sub-holdings that they used to acquire the Dick Smith business from Woolworths. They say they paid \$115m, but the notes to the 2014 accounts show that only \$20m in cash was initially paid by the holding company.

### 20. BUSINESS COMBINATIONS

On 26 November 2012, Dick Smith Sub-holdings Pty Limited acquired 100% of the share capital of DSE Holdings Pty Limited ("Dick Smith") trading as Dick Smith the online and store retailer from Woolworths Limited for \$115,208,000.

#### (a) Consideration transferred

	26 November 2012 \$'000
initial cash payment	20,000
Working capital adjustments	21,208
Buy-out of contingent consideration <sup>(i)</sup>	
Cash paid	50,000
Deferred consideration <sup>(ii)</sup>	24,000
<b>Total consideration transferred</b>	<b>115,208</b>

It doesn't look like they even paid that much, because they acquired the Dick Smith business with \$12.6m in cash *already in it*. Dick Smith Sub-holdings was formed with only \$10m of issued capital and no debt, and that is most likely Anchorage's actual cash commitment.

So if Woolworths got paid \$115m and Anchorage only forked out \$10m, where did the rest of the cash come from?

The answer is the Dick Smith balance sheet, and this is always the first chapter in the private equity playbook: pull out the maximum amount of cash as quickly as you can.

In this case, first they had to mark-down the assets of the business as much as possible as part of the acquisition. This was easy enough to do with a low purchase price. You can see in the table below, that \$58m was written-off from inventory, \$55m from plant and equipment, and \$8m in provisions were taken.

**(b) Assets acquired and liabilities assumed at the date of acquisition**

	Book value 25 November 2012 \$'000	Fair value adjustments \$'000	Fair value 26 November 2012 \$'000
<b>Current assets</b>			
Cash and cash equivalents	12,617	–	12,617
Trade and other receivables	29,151	–	29,151
Inventories	370,550	(58,475)	312,075
Other current assets	1,594	–	1,594
<b>Non-current assets</b>			
Plant and equipment	119,444	(54,765)	64,679
Deferred tax assets	4,460	37,832	42,292
<b>Current liabilities</b>			
Trade and other payables	(172,505)	(2,195)	(174,700)
Current Provisions	(12,383)	(348)	(12,731)
<b>Non-current liabilities</b>			
Non-current provisions	(5,812)	(8,109)	(13,921)
<b>Fair value of net assets acquired</b>			<b>261,056</b>

**(c) Discount arising on acquisition**

	26 November 2012 \$'000
Fair value of identifiable net assets acquired	261,056
Consideration transferred	(115,208)
<b>Discount arising on acquisition</b>	<b>145,848</b>

Prior to the acquisition there were no operations of Dick Smith Sub-holdings Pty Limited.

The inventory writedown is the most important step in the short term. They are about to sell a huge chunk of inventory but they don't want to do it at a loss, because these losses would show up in the financial statements and make it hard to float the business. The adjustments never touch the new Dick Smith's profit and loss statement and, at the stroke of the pen, they have created (or avoided) \$120m in future pre-tax profit (or avoided losses).

Now they can liquidate inventory without racking up losses. And boy did they liquidate.

At 26 November 2012, Dick Smith had inventory that cost \$371m but which had been written

down to \$312m. Yet by 30 June 2013, inventory has dropped to just \$171m.

	Note	As at 29 June 2014 \$'000	As at 30 June 2013 \$'000
<b>Current assets</b>			
Cash and cash equivalents	15	29,944	46,538
Trade and other receivables	6	46,688	10,404
Inventories		253,814	170,796
Financial assets	19	–	5,633
Other current assets	7	5,460	7,834
<b>Total current assets</b>		<b>335,906</b>	<b>241,205</b>
<b>Non-current assets</b>			
Plant and equipment	8	78,764	60,259
Deferred tax assets	5	36,501	42,881
<b>Total non-current assets</b>		<b>115,265</b>	<b>103,140</b>
<b>Total assets</b>		<b>451,171</b>	<b>344,345</b>

That points to a very big clearance sale, and the prospectus confirms that sales in financial year 2013 were exaggerated by this. The reduction in inventory has produced a monstrous \$140m benefit to operating cash flow, basically from selling lots of inventory and then not restocking.

The cash flow statement shows that Anchorage then used the \$117m operating cash flow of the *business* to fund the outstanding payments to Woolworths, rather than funding it from their own pockets (note that the pro-forma profit was only \$7m during this period).

	Note	Year ended 29 June 2014 \$'000	10 month period ended 30 June 2013 \$'000
<b>Cash flows from operating activities</b>			
Receipts from customers		1,316,364	890,363
Payments to suppliers and employees		(1,261,131)	(772,397)
Interest and other costs of finance paid		(2,854)	(2,311)
Tax (paid)/received		(721)	858
Interest received		519	1,108
Net cash provided by operating activities	15(a)	<b>52,177</b>	<b>117,621</b>
<b>Cash flows from investing activities</b>			
Payments for plant and equipment		(30,523)	(2,492)
Proceeds on sale of plant and equipment		518	–
Payment for acquisition of business, net of cash acquired	15(b)	(24,000)	(78,591)
Net cash used in investing activities		<b>(54,005)</b>	<b>(81,083)</b>

And that, my friends, is a perfectly executed chapter 1: How to buy a business for \$115m using only \$10m of your own money.

Chapter 2 involves selling a \$115m business for \$520m, and it's a little more nuanced. The good news is that, while private equity are focused on cashflow, equity market investors aren't really focusing on how much cash has been ripped out of the business. All they seem to care about is profit.

So the focus now turns from the balance sheet to the profit and loss statement, and it's time to make this business look as profitable as possible in the year following the float (allowing them to sell it on a seemingly attractive "forecast price earnings ratio").

The big clearance sale in financial year 2013 leaves them with almost no old stock to start the 2014 year. That's a huge (unsustainable) benefit in a business like consumer electronics which has rapid product obsolescence.

Remember that marked down inventory? Most of it was probably sold by 30 June 13 but there would still be some benefit flowing through to the 2014 financial year.

Remember the plant and equipment writedowns? That reduces the annual depreciation charge by \$15m. Throw in a few onerous lease provisions and the like, totaling roughly \$10m, and you can fairly easily turn a \$7m 2013 profit into a \$40m forecast 2014 profit. That allows Anchorage to confidently forecast a huge profit number and, on the back of this rosy forecast, the business is floated for a \$520m market capitalisation, some 52 times the \$10m they put in.

---

Anchorage were able to sell the last of their shares in September 2014 at prices slightly higher than the \$2.20 float price and walk away with a quiet half a billion. Private equity are renowned for pulling off deals, but if there's a better one than this I haven't heard about it.

### **Chickens home to roost**

Of course, all of the steps taken above have consequences. By the end of 2014, inventory had increased to \$254m, with new shareholders footing the bill for repurchasing inventory. This should have resulted in poor operating cash flow, but most of this was funded by suppliers at year-end, with payables increasing by \$95m.

Come the end of 2015 financial year, however, it really comes home to roost. Operating cash flow was negative \$4m, as inventory increases further and suppliers demand payment, decreasing accounts payable. The business is required to take on \$71m in debt to fund a more sustainable amount of working capital. As the benefit of prior accounting provisions taper-off, profit margins fall, and the company reports a toxic combination of falling same-store sales *and* shrinking gross margins in the recent trading update.

Following a profit downgrade yesterday, the shares are now valued by the market at \$0.77, and investors in the float are sitting on a 65% loss of capital from the \$2.20 float price.

This float, as we pointed out in [Dick Smith Takes A Bath, Comes Out Nice and Clean](#), smelled funny from the very beginning. Sorry Dick Smith investors, you've been had.

---

**Want to know more about the style of investing we practice at Forager? Check out our page [what is value investing?](#)**

---