
Healthzone Horribly Out of Shape

We've seen a lot of companies fall from grace spectacularly in the last five years, but the recent [demise of Healthzone Limited \(HZL\)](#) deserves special mention.

On 20 October this small-cap health food operator raised [nearly \\$10m](#) in fresh equity. It didn't look stupidly indebted to start with – \$17m of debt versus \$7m of EBIT – but investors presumably assumed that the extra \$10m of equity would leave the balance sheet indestructible. A month after the capital raising, Commonwealth Bank forced the company into receivership.

In [Dissing the Bluescope Capital Raising](#) I wrote about the folly of throwing more money after a lost cause, but a month after the capital raising? Wow.

It's all too easy in hindsight, of course, but it's worth looking for lessons. I sent Intelligent Investor Funds' new analyst, Matt Ryan, off with the [Healthzone's 2011 annual report](#) to look for warning signs. Here are his notes and a few of my comments:

Reading the annual report, Healthzone reported profits in both 2011 and 2010. Putting aside the veracity of reported earnings, it is worth noting at the outset that even a legitimately profitable company can become insolvent if it cannot repay or refinance debt that comes due.

The Healthzone income statement looks quite unusual though and is probably the first signal to investors that all is not well. The company suffered a 17% fall in revenue in 2011, yet reported a 20% *increase* in gross profit. That seems quite unlikely, although the company attributed it to a margin mix restructure and a push into own brand and own store sales. In a year in which sales were down, we can see huge increases in employee benefit expenses, operating lease expenses and marketing expenses.

SJ: A definite warning sign. Transitioning from wholesale to retail would explain the higher gross margins, but the segment information in note 4 shows a 40% fall in turnover, excluding intersegment sales, in the much larger wholesale business. Hugely concerning.

The balance sheet shows negligible tangible book value, equity being nearly all accounted for by goodwill. The cash balance of \$701k also looks very slim for a company with \$90m turnover (salaries alone are \$240 thousand per week). Total borrowings of \$16.7m however don't appear excessive at first glance for a company that has reported \$7.2m and \$8.7m in EBIT in 2011 and 2010 respectively.

The cash flow statement is more worrying. Cash flow from operations is negative despite the headline profit. Even worse, it's also despite the fact that \$3.6m of interest

and finance charges have been stated as financing cash flow. Receipts from customers lines up closely with revenue from the income statement, but payments to suppliers of \$94.5m is far in excess of the \$84.5 cash operating expenses reported in the income statement.

SJ: Hints of financial difficulties almost always show up on the cashflow statement. Lots of funny business can take place on the income statement but cash is much harder to fudge.

Things get worse still once we get into the notes to the financial statements. Note 2 reveals that whilst total financial liabilities had declined from \$49m to \$45m, *interest bearing* liabilities increased from \$22m to \$31m. Only \$17m of this \$31m was shown as *borrowings* on the balance sheet, which as reported by the *Herald* is pretty objectionable.

Note 2 further shows that the company had almost no undrawn finance facilities available, and the liquidity risk section shows \$33.6m financial liabilities maturing within 1 year, against \$25m of maturing financial assets. From reading the cash flow statement above we know the difference was unlikely to be met by operating cashflow. This difference was even larger the year before, which may be why the company had raised capital over the previous 12 months.

SJ: How they got away with this I have no idea. Interest bearing liabilities that aren't borrowings? Unbelievable.

Pushing on, interest charges in note 6 look too high for the stated debt (\$3.3m interest against \$17m debt = 17.6% implied interest). In note 7 we can see the tax expense in 2011 mostly consists of deferred tax liabilities, suggesting that despite the headline profit there was little taxable income for the year, and in note 14, the pre-tax discount rate of 12% used to test for impairment looks far too low for a small-cap retailer.

SJ: There are a couple of good pickups in here. The tax point is excellent but the interest charges relative to the debt is a big warning sign. It's essential to remember that the balance sheet reflects the company's financial position on one day out of 365, and the accountants often shift things around – from receivables and payables to the amount of debt outstanding – to show the company in the best possible light as at 30 June.

The real clincher however is the jaw dropping disclosure in note 16 and 17 that \$14m of trade payables were *secured liabilities*, and were in fact secured by a *registered mortgage* over the company and its subsidiaries. The auditor also provided a 'qualified' opinion because of an inventory reassessment in relation to a prior acquisition (with more of the acquisition price attributed to goodwill).

SJ: The qualification from the auditor is interesting. By attributing more of the acquisition cost to goodwill and less to inventory, the company is able to report lower cost of goods sold and more profit when it sells that inventory. So the auditor is suggesting profit is overstated to the tune of \$1m. Also, auditors will do everything they can to get the company to change its accounting before issuing a qualified audit opinion.

They don't look good for company or auditor. Healthzone must have had a very strong reason for not wanting to report lower earnings, perhaps because it was hard up against its debt covenants.

Despite the fact that some of Healthzone's accounting looks a little on the aggressive side, there was plenty in this annual report to cause shareholders consternation, particularly after the directors asked for another \$10m.

Of course Matt has gone through this exercise with the prior knowledge that the company has gone down the gurgler. I wonder how many of these red flags we would overlook or brush aside for a business that we viewed favourably?