

**CONFIDENTIAL**

25 January 2018

Mr Yunus Carrim  
Chairperson: Standing Committee on Finance  
Parliament of the Republic of South Africa  
Standing Committee of Finance  
Cape Town  
8000

Your Reference:

**DR DANIEL MATJILA**

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Dear Mr Carrim

**STEINHOFF INTERNATIONAL LIMITED REPRESENTATION – RECENT ACCOUNTING  
IRREGULARITIES**

1. I refer to your letter dated 12 December 2017 regarding Steinhoff and would like to apologise for the delayed response. This letter serves to present the PIC's assessment of reported alleged financial irregularities by Steinhoff International Limited "(Steinhoff)" including corporate governance concerns and the impact the recent share price decline has had on the funds managed by the PIC on behalf of the Government Employee Pension Fund ("GEPF").

**BACKGROUND**

2. On 4 December 2015, Steinhoff confirmed that one of its German subsidiaries, Steinhoff Europe Group Services GmbH (SEGS), had been the subject of an investigation focusing on the adherence to arms' length valuation and proper accounting pursuant to German GAAP. Furthermore, Steinhoff was involved in a dispute with a joint venture partner in Europe, relating to alleged breaches arising from agreements;

3. On 24 August 2017, Steinhoff issued a public response to allegations made by Manager Magazin, a German publication, of improper conduct and floating company disclosure and financial irregularities. Steinhoff rejected the allegations of dishonesty by the magazine. Steinhoff's Management indicated that it had adequately provided for the related liabilities that could result from the dispute in the consolidated results. Management further confirmed that no other litigation was anticipated to have material, adverse effects on the group;
4. On the 18th September 2017, Steinhoff issued further statements that strongly rejected allegations that it, or any of its subsidiaries, had received qualified audit reports from its auditors. Allegations were connected to the furniture retailer, JD Group, whereby JD Consumer Finance business (JD FS) was arguably sold to an "independent third party" during the 2016 financial year;
5. From October to date, Steinhoff has been reporting through SENS announcements on the progress of the developments in the media around its financial irregularities and progress on the matters before the courts. On December 4<sup>th</sup> 2017, Steinhoff issued a public statement advising Shareholders that the 2017 financial results would be released on the 6<sup>th</sup> December as had been previously advised;
6. On 6 December 2017, however, Steinhoff International Limited ("Steinhoff"), in a SENS announcement confirmed the resignation of its CEO, Mr Markus Jooste, and the postponement of the release of the 2017 financial results. Steinhoff also announced the establishment of an independent investigation by PwC into the reported financial irregularities at Steinhoff;
7. Mr Christo Wiese, Steinhoff's Chairman and largest shareholder (22.8% ownership of Steinhoff) has been appointed as interim acting Steinhoff CEO. The CFO, Mr Ben La Grange retains his position as CFO, but has, however, resigned from his role as CEO for Steinhoff Retail Africa (a subsidiary of Steinhoff), which also listed on the JSE in September 2017;
8. Steinhoff is purported to have been involved in round tripping losses incurred in its subsidiaries by dealing with related companies that are managed by ex-Steinhoff executives and associates. As a result, related party loans were allegedly issued without the necessary disclosures to shareholders to hide losses;

## OVERALL GEPF EXPOSURE TO STEINHOFF

9. As at 5 December 2017, the GEPF exposure through internally and externally managed funds was 9.9% of Steinhoff's issued shares. The GEPF exposure as at 12 December 2017 is 9.4% due to exits in the stock made by external managers. Furthermore, the GEPF has an additional 2.7% indirect exposure in Steinhoff through Unlisted Investments (Private Equity and SIPS).
10. The price decline of 74% between the 5<sup>th</sup> December 2017 and 12<sup>th</sup> December 2017 resulted in R12 billion unrealised losses of the overall listed exposure and R5 billion of the unlisted exposure. The sections below details the respective positions of the different investment strategies with exposures to Steinhoff.

### 11. Internally Managed Listed Exposure

- 11.1 As per the GEPF mandate, the GEPF Internal Funds are managed on a passive basis. The funds are broken up into index-tracked funds, which constitute about c.80% of the internally managed, with the balance managed by way of enhanced index tracking. The index tracked funds held Steinhoff shares in the same weight as the benchmark. The enhanced index tracking funds (c.20% of the GEPF Internal funds) expressed an underweight position in Steinhoff reflecting the research work of the team. As a result, the net exposure in Steinhoff was -0.14% underweight position.

Table 1 – Internally Managed Fund Positioning (GEPF)

| STEINHOFF INTERNATIONAL LIMITED |               | 5th Dec 2017 | 12th Dec 2017 | Price movement |
|---------------------------------|---------------|--------------|---------------|----------------|
| Closing price                   |               | 45.65        | 11.76         | -74.2%         |
| Total Shares in Issue           | 4,309,727,144 |              |               |                |

| Portfolio      | Quantity    | % of Steinhoff | Market Value   | Market Value  | Unrealised       |
|----------------|-------------|----------------|----------------|---------------|------------------|
|                |             |                | 5th Dec 2017   | 12th Dec 2017 | Losses/Gains     |
| GEPF Internal* | 332,256,192 | 7.7%           | 15,167,495,165 | 3,907,332,818 | (11,260,162,347) |

Source: PIC Listed Equities Estimates

## 12. Externally Managed Listed Exposure

**Table 2 – Externally Managed Fund Positioning (GEPF) – Local Equity**

| STEINHOFF INTERNATIONAL LIMITED |               | 5th Dec 2017 | 12th Dec 2017 | Price movement |
|---------------------------------|---------------|--------------|---------------|----------------|
| Closing price                   |               | 45,65        | 11,76         | -74,2%         |
| Total Shares in Issue           | 4 309 727 144 |              |               |                |

| Portfolio     | Quantity<br>5 Dec 2017 | % of<br>Steinhoff | Market Value 5th<br>Dec 2017 | Quantity<br>12 Dec 2017 | Market Value 12th<br>Dec 2017 | Realised<br>Losses/Gains | Unrealised<br>Losses/Gains |
|---------------|------------------------|-------------------|------------------------------|-------------------------|-------------------------------|--------------------------|----------------------------|
| GEPF External | 96 100 285             | 2,2%              | 4 386 978 010                | 61 473 614              | 722 929 701                   | (1 576 519 602)          | (2 615 381 896)            |

Source: PIC External Managers Team Estimates

12.1.1 The GEPF mandate, allows for the appointment of external managers, with active strategies, to manage listed equity mandates on their behalf. While the appointed external manager's positioning in Steinhoff has varied during the year, we represent the positioning of each manager as at 5 December 2017, i.e. prior to the price movement, and as at 12 December 2017.

12.1.2 Four managers in the GEPF composite did not hold any units in Steinhoff. These managers are Aeon, Sentio, First Avenue and Benguela, and demonstrated their focus on ESG in their selection criteria.

12.1.3 The managers that had exposure to Steinhoff amounted to R4.3bn on 5 December 2017, with the bulk of the allocation in the Industrials mandates, managed by Coronation and Sanlam, due to the size of their mandates, and the higher allocation to Steinhoff in the Industrials benchmark.

12.1.4 Managers had varying risk mitigating strategies. While some saw too much risk and exited the position, others moved to a neutral allocation. The realized losses are calculated based on the managers average cost in the stock vs the sale price. Realised losses amounted to R1.5bn, while unrealized losses (remaining shares held) amount to R2.6bn on 12 December 2017.

12.1.5 Table 3 is a summary of all manager positions and movements over this period.

**Table 3 – Local Equity Manager Positioning (GEPF)**

|  | UNITS<br>5 Dec 2017  | Steinhoff MV<br>5 Dec 2017 | Units Bought<br>(5-12 Dec 2017) | Units Sold<br>(5-12 Dec 2017) | Realised<br>Losses    | UNITS<br>12 Dec 2017     | Steinhoff MV<br>12 Dec 2017 | Unrealised<br>Losses<br>(5-12 Dec 2017) |
|--|----------------------|----------------------------|---------------------------------|-------------------------------|-----------------------|--------------------------|-----------------------------|---|
| <b>Sector Funds - BM weight = 3,25%</b>    |                      |                            |                                 |                               |                       | <b>BM Weight = 0,87%</b> |                             |   |
| Cora Ind                                   | 37 156 600           | 1 696 198 790              | -                               | -                             | -                     | 37 156 600               | 436 961 616                 | -1 259 237 174                          |
| Sanlam Ind                                 | 18 379 999           | 839 046 954                | -                               | -4 225 820                    | -87 940 873           | 14 154 179               | 166 453 145                 | -479 685 126                            |
| Ind Tracker*                               | 11 054 789           | 532 041 116                | -                               | -                             | -                     | 11 654 789               | 137 060 319                 | -394 980 799                            |
| <b>General Equity - BM weight = 2,05%</b>  |                      |                            |                                 |                               |                       | <b>BM Weight = 0,55%</b> |                             |   |
| Mazi                                       | 11 676 269           | 533 021 680                | -                               | -11 676 269                   | -615 108 173          | -                        | -                           | -                                       |
| Argon                                      | 8 879 029            | 405 327 674                | -                               | -8 879 029                    | -333 450 113          | -                        | -                           | -                                       |
| Vunani                                     | 4 467 451            | 203 939 138                | 163 310                         | -2 304 770                    | -112 786 686          | 2 325 991                | 27 353 654                  | -78 827 835                             |
| Mergence                                   | 3 437 352            | 156 915 118,80             | -                               | -889 592                      | -39 302 249           | 2 547 760                | 29 981 657,60               | - 86 343 586,40                         |
| Kagiso                                     | 3 213 101            | 146 678 061                | -                               | -913 288                      | -55 282 640           | 2 299 813                | 27 045 801                  | -77 940 663                             |
| Oasis                                      | 2 813 016            | 128 414 180                | -                               | -2 813 016                    | -178 413 661          | -                        | -                           | -                                       |
| Perpetua                                   | 2 290 760            | 104 573 194                | -                               | -                             | -                     | 2 290 760                | 26 939 338                  | -77 633 856                             |
| Mvunonala                                  | 1 126 075            | 51 405 324                 | -                               | 1 126 075                     | -30 997 120           | -                        | -                           | -                                       |
| Legacy                                     | 721 818              | 32 950 992                 | -                               | -341 400                      | -16 643 250           | 380 418                  | 4 473 716                   | -12 892 366                             |
| Urnthombo                                  | 571 095              | 26 070 487                 | -                               | -571 095                      | -29 948 222           | -                        | -                           | -                                       |
| Akwani                                     | 547 107              | 24 975 435                 | -                               | -547 107                      | -28 939 904           | -                        | -                           | -                                       |
| Afena                                      | 502 520              | 22 940 038                 | -                               | -502 520                      | -26 359 303           | -                        | -                           | -                                       |
| Mianzo                                     | 318 093              | 14 520 945                 | -                               | -                             | -                     | 318 093                  | 3 740 774                   | -10 780 172                             |
| Aeon                                       | -                    | -                          | -                               | -                             | -                     | -                        | -                           | -                                       |
| First Avenue                               | -                    | -                          | -                               | -                             | -                     | -                        | -                           | -                                       |
| Sentlo                                     | -                    | -                          | 3 266 850                       | -3 266 850                    | -18 070 101           | -                        | -                           | -                                       |
| Benguela*                                  | -                    | -                          | 177 690                         | -177 690                      | -3 277 306            | -                        | -                           | -                                       |
| <b>Total GEPF External<br/>- Steinhoff</b> | <b>96 100 285,00</b> | <b>4 386 978 010,25</b>    | <b>3 607 850,00</b>             | <b>-38 234 521</b>            | <b>-1 576 519 602</b> | <b>61 473 614,00</b>     | <b>722 929 700,64</b>       | <b>-2 615 381 896</b>                   |

## 12.2 Manager Positioning – Global Equity

12.2.1 Table 4 shows the exposure Blackrock, the global emerging market manager had over the given period. The exposure was negligible.

12.2.2 The portfolio is managed on an Enhanced passive basis and Blackrock held a position in-line with the MSCI Emerging Markets index.

12.2.3 The manager incurred an unrealized loss of R27million.

**Table 4 – Externally Managed Fund Positioning (GEPF) – Global Equity**

| <b>STEINHOFF INTERNATIONAL LIMITED</b> |                                | <b>5th Dec 2017</b>                  | <b>12th Dec 2017</b>            | <b>Price movement</b>                 |                                    |
|--|--------------------------------|--------------------------------------|---------------------------------|---------------------------------------|------------------------------------|
| Closing price                          |                                | 45,65                                | 11,76                           | -74,2%                                |                                    |
| Total Shares in Issue                  | 4 309 727 144                  |                                      |                                 |                                       |                                    |
| <b>Portfolio</b>                       | <b>Quantity<br/>5 Dec 2017</b> | <b>Market Value 5th<br/>Dec 2017</b> | <b>Quantity<br/>12 Dec 2017</b> | <b>Market Value 12th<br/>Dec 2017</b> | <b>Unrealised<br/>Losses/Gains</b> |
| GEPF - Blackrock EM                    | 799 841                        | 36 512 742                           | 799 841                         | 9 406 130                             | (27 106 611)                       |

### 12.3 Manager Positioning – Local Bonds

12.3.1 Steinhoff has been a significant issuer in the local debt capital markets and GEPP, through allocation to Aluwani Capital Fixed Income portfolio, had limited exposure to Steinhoff debt, through issuer Steinhoff Services Limited.

12.3.2 The exposure is to a single bond, SHS30, maturing in April 2020, and constituted 1% of the Aluwani Capital portfolio, i.e. approximately R101million (as at 5 December 2017) and R96million as at 12 December 2017.

### 13. Private Equity Exposure

13.1. The Private Equity division has been exposed to the Steinhoff Group through two transactions. The first being Project Sierra (“the Initial Transaction” or “Project Sierra”) and a subsequent corporate action that saw the creation of STAR otherwise known as Project Blue Buck.

#### 13.2 Project Sierra – Loan facility to BEE Company (Lancaster)

13.1.1 In August 2016, the PIC Investment Committee (“IC”) approved a R9.35 billion loan facility to Lancaster 101 (Pty) Ltd (“L101”) and a further R50 million equity contribution to capitalise L101. The proceeds were used to facilitate a BEE transaction to acquire a 2.75% equity stake in Steinhoff.

13.1.2 At the same time L101 concluded a ratio collar (“Ratio Collar”) with Citibank Global Markets Limited (“CGML”). The ratio collar was entered into in order to protect the PIC’s capital investment of R9.35 billion in line with the Structured Investment Products (“SIPs”) strategy.

13.1.3 Overall the PIC’s loan facility to L101 was secured by:

- Primary cession and pledge over any Steinhoff shares not pledged to CGML (25% of total);
- Reversionary cession over Steinhoff shares pledged to CGML (75% of total); and
- Cession and pledge of the put proceeds under the Ratio Collar, thus offering PIC downside protection on its loan.

13.1.4 In terms of the Ratio Collar, L101:

- bought 118 million Steinhoff put options at a strike price of R78.93 from CGML;

- sold 88 million Steinhoff call options at a strike price of R127.50 to CGML; and
- The put and call option would expire or be exercised and settled in the tranches from Year 3.

13.1.5 PIC's rationale for entering into the transaction at the time was based on:

- the strength of the management team;
- a compelling internationalization strategy that would drive higher returns;
- Introduction of a strong BEE partner that would drive PIC's empowerment and transformation strategy as evidenced by the KPI's that PIC set for BEE sponsor.

13.1.6 Subsequent to the 5<sup>th</sup> of December significant aspects of our investment thesis, particularly the internationalization strategy and the quality of the Steinhoff management team have proven to have been incorrect as a result of what appears to have been fraudulent behaviour on the part of the management team.

### 13.3 Project Blue Buck

13.1.7 Since December 2016, there has been a significant decline in Steinhoff share price, which resulted in PIC recognising an impairment to PIC's loan facility to L101. In May 2017, PIC began considering options of enhancing the PIC's position in Project Sierra. This led to corporate action on Project Sierra which entailed L101 acquiring an equity stake in Steinhoff Retail Africa Limited ("STAR"). No additional capital was required from PIC.

13.1.8 Rationale for Project Blue Buck:

- **Higher returns:** Project Blue Buck is expected to yield higher returns than Project Sierra. In the base case scenario Project Blue Buck is expected to yield an IRR of 13.79% which is higher when compared to an IRR of 11.60% under Project Sierra.
- **Attractive dividend payout:** the combination of 100% of STAR assets and 22% of Shoprite is expected to yield higher dividends. The table below illustrates the forecasted dividends for Steinhoff Holdings (Euro and Africa). Shoprite and STAR On absolute terms, STAR is expected to pay higher dividends than Steinhoff.

- **Accelerated debt repayment:** A higher dividend yield as shown above will result in an accelerated repayment of PIC's loan under Project Sierra. The repayment date of PIC's loan is expected to change from February 2023 to March 2022.

13.1.9 The transaction was facilitated in the following manner:

- CGML advanced a loan of R6.5 billion to L101 to acquire 302 million shares in STAR;
- Steinhoff advanced a loan of R4 billion to Lancaster 102 (Pty) Ltd ("L102") to acquire 196 million shares in STAR.

13.1.10 The revised PIC security package as a result of Project Blue Buck is as follows:

- Primary cession and pledge of L101's shares in STAR;
- Reversionary cession and pledge of L102's shares in STAR;
- Reversionary cession and pledge on the put proceeds under the Ratio Collar; and
- Reversionary cession and pledge of SNH shares pledged to CITI.

13.1.11 The Global Master Securities Lending Agreement ("GMSLA") between GEPF and CGML in relation SNH shares was also maintained under Project Blue Buck.

## IMPACT ON PRIVATE EQUITY EXPOSURE

14. The analysis below is based on market parameters at the close of 1 December 2017 and 7 December 2017 and compares the L101 and GEPF position. Using 1 December 2017 as a "pre contagion" date i.e. prior to the announcement of the Steinhoff CEO's departure which caused the selloff in both shares i.e. SNH and STAR.

15. PIC believes that STAR is a better quality investment with good prospects and this was borne out by STAR share price performance since listing. It would appear that market participants are currently concerned that Steinhoff might have to sell its share in STAR in order to repay some of its loans. Furthermore, the PIC believes that STAR's fair value is around R23 which represents c.50% upside from current level.



16. Market participants are currently awaiting confirmation of STAR's involvement in alleged accounting irregularities which has caused an overhang on the share price but is not reflective of the company's fundamental value.
17. The PIC's position as at 1 December 2017 is shown in the table below. As at 1 December 2017 the implementation of Blue Buck enhanced the PIC's position given that the net residual value in the structure was positive relative to if the PIC has not implemented Blue Buck.

Figure 2: PIC's economic position as at market close on 12 December 2017

| Steinhoff International Holdings N.V |                  |                        |
|--------------------------------------|------------------|------------------------|
|                                      | With Blue Buck   | Without Blue Buck      |
| <b>Loan</b>                          | (10,335,819,731) | (10,335,819,731)       |
| <b>Security</b>                      |                  |                        |
| SRR Shares                           | 7,775,707,307    |                        |
| SNH Shares                           | -                | 6,610,818,621          |
| Collar Claim                         | 1,219,972,279    | 1,369,113,706          |
| L102 residual position               | 1,019,466,345    |                        |
| Cash                                 | 330,000,000      |                        |
| <b>Surplus/(Shortfall)</b>           | <b>9,326,201</b> | <b>(2,355,887,403)</b> |

18. The figure above indicates the following:
- The loan amount under both scenarios is the same;
  - Steinhoff shares were valued at R 6.6bn vs the CGML loan outstanding of R6.7bn;
  - With Project Blue Buck CGML would therefore have a claim of an additional R100m in the R1.3bn collar proceeds. PIC would have a reversionary claim on the remaining R1.2bn;
  - Furthermore, with STAR's performance as at that date PIC would have a residual claim on the additional STARS shares that are held in L102;
  - The reflected cash balance relates to the enforcement reserve and R100m equity injection into the SPV;

- Under the “No Blue Buck” scenario the collar value of R1.3bn would be payable to PIC but the value of the SNH shares would not be sufficient to cover the shortfall and PIC would have made a loss of R2.3bn.

19. The table below outlines the PIC’s economic position as at 12 December 2017. The analysis illustrates that the economic position under Project Sierra and Blue Buck are R3.3bn and R4.6bn, respectively.

**Figure 3: PIC’s economic position as at market close on 12 December 2017**

| Steinhoff International Holdings N.V |                        |                        |
|--------------------------------------|------------------------|------------------------|
|                                      | With Blue Buck         | Without Blue Buck      |
| <b>Loan</b>                          | (10,335,819,731)       | (10,335,819,731)       |
| <b>Security</b>                      |                        |                        |
| SRR Shares                           | 4,784,585,360          |                        |
| SNH Shares                           | -                      | 1,392,998,154          |
| Collar Claim                         | 236,579,434            | 5,619,613,679          |
| L102 residual position               | -                      |                        |
| Cash                                 | 330,000,000            |                        |
| <b>Surplus/(Shortfall)</b>           | <b>(4,984,654,937)</b> | <b>(3,323,207,898)</b> |

20. PIC highlights that this analysis has been performed based on a STAR share price of R15.82 per share which is 31% below PIC’s fair value of R23 per share. Furthermore, the “indifference point” (the price at which the options yield the same result) is R21 per share.

21. As at 12 December 2017, the PIC’s unlisted position is as follows:

- PIC’s loss under the current status quo is R4.9bn. The combined value of Steinhoff shares of R1.3bn and the mark to market value of R5.6bn of the Ratio Collar is below the outstanding balance of CGML loan of R10.3bn. Since PIC has a reversionary cession and pledge of SNH shares and the Ratio Collar, PIC will not receive any proceeds from Steinhoff shares and the Ratio Collar;
- PIC’s economic position is partially protected by the value of L101’s STAR shares of R4.7bn.

22. Assuming that the PIC did not conclude Project Blue Buck, the PIC’s economic position under Project Sierra would be a loss of R3.3bn represented by:

- The value of the Ratio Collar of R5.6bn, which is the present value of the put option proceeds and the value of SNH shares of R1.3bn.

## **ACTIONS TAKEN BY THE PIC**

### *Internally Managed Listed Equity*

23. Over the past two AGM's, PIC voted against resolutions that sought to authorize the Board to limit or exclude pre-emption rights, the re-appointment of directors whereby independence of directors and tenure was questioned.
24. PIC has previously pointed out structural issues to the Board at the 2017 AGM around the material shareholding of the Steinhoff and Wiese families which is perceived to create dominance of controlling shareholder representatives on the Board and as a result, potential conflict of interest.
25. PIC highlighted its discomfort with the lack of independence of the Board including the possible conflict of interest by Christo Wiese as interim CEO to independently conclude the terms of reference of the investigations. Wiese has subsequently resigned from the Board.
26. Furthermore, the absence of a clear outline of the relationship between risks and the group strategy as the company has become progressively complex due to the acquisitive strategy of ailing businesses.

### *Private Equity*

27. As per paragraph 8 above, and key to the ratio collar, the PIC entered into a Global Master Securities Lending Agreement ("GMSLA") with CGML. The purpose of this standardized legal agreement is to regulate the stock lending activities that are a contingent part of managing the change in price of the derivative structure being the ratio collar between the parties.
28. As a result of this agreement, PIC has consented to the stock borrow (c43.4 million SNH shares) in terms of the GMSLA, up to a maximum of 51,526,717 loaned securities.
29. Had the PIC not honoured its obligation under the GMSLA, CGML would have had the right to unwind the collar, and impose punitive charges on the PIC.
30. PIC is of the view that the stock lent to CGML would not result in a further significant downward pressure on the SNH share price.

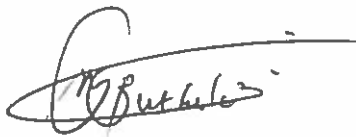
## **RECOMMENDATIONS**

31. PIC maintains a cautious to negative outlook on Steinhoff given the corporate governance issues. It is recommended that the PIC urgently engages with the JSE, the Board of Steinhoff, including management of Steinhoff's subsidiaries and all other related parties to the resolution of the impasse.
32. Given the possible undervaluation of STAR at current spot share price, and the long term nature of PIC's investment horizon, it is believed that there is still significant value unlock that can be achieved from the STAR shares.
33. In relation to SNH, PIC is of the view that the value of SNH is not zero (0) and that the Board will be under pressure to demonstrate their ability and willingness to unlock value within SNH.

## **STANDING COMMITTEE ON FINANCE (SCOF)**

34. A PIC delegation will do a presentation at the SCOF meeting that is scheduled for 31 January 2018. The presentation will deal with the latest available information on Steinhoff.

Yours sincerely



**SFISO BUTHELEZI**  
**CHAIRMAN OF THE BOARD**  
**PUBLIC INVESTMENT CORPORATION SOC LTD**

26/01/2018