LIGHTHOUSE ADVISORS
Keeping Your Capital Safe

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Public Newsletter for the period ended 31 December 2022

Welcome to the Lighthouse Advisors newsletter for December 2022. No newsletter was published for the quarter ended 30 September 2022, so this letter will cover the 6-month period from 1 July 2022 through 31 December 2022.

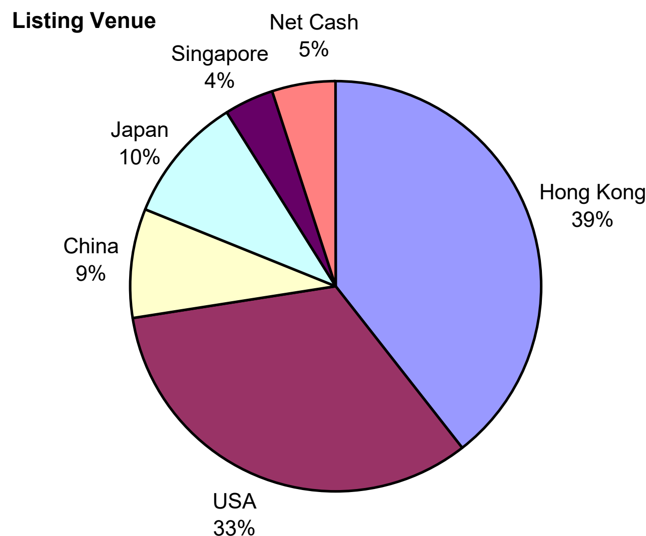
1. **Summary**
2. **Market Commentary**
3. **Portfolio Review**
4. **Licensing and Franchising**

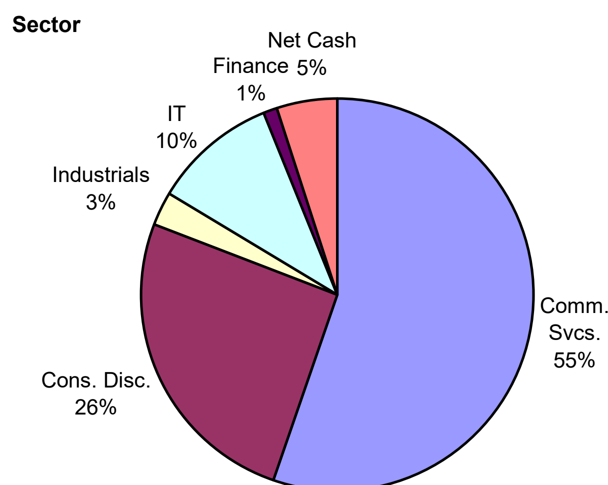
1. Summary

The NAV for December 2022 was USD 57.43 (SGD: 76.95). Full-year return was -30.7% (SGD: -31.1%).

Market Index	1Q	2Q	3Q	4Q	2022
Hang Seng Tech	-19.6%	+6.9%	-29.2%	+19.7%	-27.2%
NASDAQ	-9.1%	-22.4%	-4.1%	-1.0%	-33.1%
Fund	**-14.8%**	**-9.3%**	**-16.8%**	**+7.8%**	**-30.7%**

21 securities made up 95% of the Fund's holdings, with the balance in cash and cash equivalents. The following charts show the approximate exposure by place of listing and GICS sector (percentages may not add up or match exactly due to rounding).





NAV values (USD and SGD) are tabled in Annex II.

2. Market Commentary

2022 was an eventful year by any measure. Outbreak of war in Europe, meltdown in the financial markets, supply chain disruptions, inflation at record highs. The list goes on.

Fortunately for those who stayed invested, the tide has turned. The lifting of Covid-19 measures worldwide has allowed resumption of business activities, notably manufacturing

and travel. Many airlines and airports are now struggling to cope with a surge in demand.

The Russia-Ukraine war is now a proxy war between Russia and the West, but so far it has not escalated beyond Ukraine. The main effect globally has been inflation in energy and food prices. Russia was an important supplier to Europe for oil (34%) and gas (40%), while Ukraine was a key global exporter of sunflower oil (42%), wheat (9%), barley (10%), and corn (16%). Until the war ends, prices for these commodities and their substitutes will be elevated.

In China, the lifting of Covid-19 measures will unleash a flood of Chinese tourists this year. The relaxation of the clampdown on real estate will see a revival of general economic activity, as real estate and related sectors are estimated to account for anywhere from 15% to as much as 30% (!) of China's GDP. Exposure to China should be a must in 2023.

After a very bad 2022, 2023 is starting off on a much brighter note. I hope the next newsletter will bring better news.

Benjamin Koh
Chief Investment Officer
Lighthouse Advisors
26 January 2023

3. Portfolio Review

To protect the interest of clients, detailed discussion is confined to the client-only version of this newsletter. Client newsletters are embargoed for one year, after which they are made available online.

4. Licensing and Franchising

Many businesses have appetites for expansion that exceed their financial resources. A common solution is to license their intellectual property, or franchise their business operations.

Licensing usually involves a domain in which the brandowner lacks expertise. For example, **Disney** produces films and operates theme parks. But it is not an expert in merchandising apparel, so it licenses the images of its characters to apparel companies who can produce, market and sell such clothes. It is a win-win: Disney benefits from the increased brand exposure, while the apparel companies can boost their sales. Likewise, **Caterpillar** manufactures construction equipment, but licenses its brand to **Wolverine** to sell Caterpillar-branded footwear.

Franchising, on the other hand, is typically used to expand the core business in a non-core market. In exchange for the right to operate under the brand of the franchisor and receive the profits thereon, the franchisee usually pays a licensing fee and is sometimes required to purchase only from approved suppliers, ostensibly for quality control but also to allow the franchisor to earn additional profits, for example by selling key ingredients like soup concentrate.

Fast food ("quick service") restaurants are the classic form of franchising, with **McDonald's** perhaps the most famous example.

Franchising can also be used in the fashion industry. For example, **Giordano**, a retailer of casual clothing, operates through multiple channels. Most of its stores are directly operated, but in parts of China it sells on a wholesale basis to franchisees. While it tracks franchisees' inventory to understand trends and to monitor performance, these franchisees are ultimately responsible for their own operations.

Now we turn to a different kind of retail: electronics. And we also see a different kind of franchising.

Harvey Norman is an Australian retailer of home appliances and electronics. Founded by Gerry Harvey and Ian Norman in 1982 with a single store, today it has 195 locations across Australia, and another 109 spread over New Zealand, Malaysia, Singapore, Slovenia, Croatia, Ireland and Northern Ireland.

So far, so boring. But a few things are different about Harvey Norman:

a. Controversial Corporate Governance

It was reported Harvey Norman has lost money on non-core businesses such as a dairy farm, a

farmer's market, and even mining camps[1]. In its annual reports, the company does not list the individual valuations of its properties. And in 2 prior capital raisings, it used minority-unfriendly 1-for-17 ratios.

b. Very High Profit Margins

Appliance and electronics retailers operate in a cut-throat environment. Without exclusive products, they must compete on service and price. Net margins of 3-5% are common, while EBITDA margins range from 5-10%.

Yet, Harvey Norman has managed to sustain net margins of 10% or higher, and EBITDA margins run at 15-20%, in recent years reaching 27%. Something is going on… which brings us to the next section.

c. Unusual Accounting

Like many retailers, Harvey Norman uses commissions to drive sales. This is nothing new: pay-for-performance is a proven way to operate. But unlike other retailers, Harvey Norman treats its core Australian operations as *franchises*. This will be our focus.

Normally, a franchisor self-operates on its home turf where it has expertise, and uses franchisees in other regions, where it wants or needs local partners.

Why would Harvey Norman give up the profits from operating its own stores at home and only earn franchising fees?

The answer lies in how Harvey Norman franchises actually work. Each store in Australia is carved out by department into separate franchises: electrical goods, furniture, appliances, bathroom and tiles, carpets and flooring, and so on.

The "proprietors" running these franchises pay rent to Harvey Norman, plus franchise fees depending on their sales. Officially, these proprietors are independent franchisees who are responsible for their own profits and losses. Thus, the company accounts for its core Australian business as a "franchising operation" from which it receives rent and franchise fees.

[1] *Harvey Norman chief defends governance as investor concerns stack up*, **The Sydney Morning Herald**, 22 November 2019

But… numerous reports indicate that the dealings between Harvey Norman and these proprietors are far more intimate than an arms' length franchisor-franchisee relationship.

In theory, a franchise agreement gives the franchisee an operating framework, but with a large degree of autonomy in day-to-day operations. This allows the franchisee to allocate resources in pursuit of profits. If the franchisee fails, the franchisor is not liable for the franchisee's liabilities.

Harvey Norman's franchise operations are highly atypical:

First, franchise agreements only run for 30 days[2], and the franchisees can be moved to another location[3] or terminated with a day's notice. In conventional franchising, the agreements run for years, and a franchisee cannot be moved elsewhere on short notice.

Second, franchisees pay no material consideration for a franchise, and if they are loss-making, they can draw sums equivalent to a salary and/or vehicle allowance[4]. Inventory is financed by Harvey Norman. Usually, franchisees pay a significant upfront fee to buy a franchise, they draw no salaries, and they must self-finance their working capital needs.

Third, Harvey Norman sweeps franchisees' cash accounts daily and pays their employees via the head office. These wages are then billed back to the franchisee. Normal franchisors do **not** have access to franchisees' cash, and do **not** pay franchisees' employees on their behalf.

Fourth, when a franchisee is terminated, any amounts due are not pursued, but written off as "tactical support". When franchisor and franchisee are truly independent, debts due from the other party should be claimed.

[2] *Harvey Norman: Leave This Retailer on the Shelf*, **Barrons**, 15 March 2017

[3] *Harvey Norman Franchisee Moves Leading to Divorce & Broken Marriages*, **ChannelNews**, 31 March 2022

[4] *Serious Questions Raised About Harvey Norman Franchisees*, **ChannelNews**, 2 November 2016

Since 2011, Harvey Norman has booked over A$700m of "tactical support" aid to franchisees instead of letting them fail. In 2017, after investigations by the Australian Securities and Investment Commission over whether Harvey Norman should consolidate these franchisees, the company declared that it would no longer guarantee franchisees' debts.

Clearly, if Harvey Norman guarantees the debt of franchisees, it controls them and should consolidate them. But even after stating it would not guarantee franchisee debts, it *still* rescued a franchisee in 2018[5].

"If it looks like a duck, walks like a duck and quacks like a duck, then it just may be a duck."

- Walter Reuther

Despite what the company says, its behaviour towards (and support of) franchisees indicates they are **commissioned salespeople**, not independent contractors. So an investor should consolidate the franchisees, even if the company does not. An investigative article in *The Australian Financial Review* concluded:

"…franchisees function like commission salesmen – Harvey Norman controls how they work, where and when they work, and it picks up the tab on their losses[6]."

The company does disclose franchisee sales, which allows the investor to reconstruct some information. Specifically, EBITDA from the franchising and retailing segments should be added together, and then divided by total "system sales" (franchisee sales plus directly operated store sales) in order to derive the underlying EBITDA margin.

These adjustments allow a fair comparison of Harvey Norman against its peers and competitors. In Australia the obvious peer is **JB Hi-Fi**. In the US, there is **Best Buy**. In Singapore, on a much smaller scale, there is **Challenger Technologies**.

Adj. EBITDA Margin	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**
Harvey Norman (as reported)	17.7%	15.3%	24.9%	27.1%	23.5%
Harvey Norman (retail, using system sales)	6.1%	5.5%	8.7%	11.5%	11.0%
JB Hi-Fi	6.0%	6.0%	8.8%	10.7%	10.9%
Best Buy	6.0%	6.2%	6.5%	6.8%	7.6%
	2017	**2018**	**2019**	**2020**	**2021**
Challenger Technologies	7.0%	8.4%	7.1%	10.6%	8.1%

Once EBITDA margins are recalculated to take into account the franchisee sales, the magic unravels. Harvey Norman's impressive margins are revealed to be rather ordinary: for all its complicated accounting, there is nothing particularly special about Harvey Norman.

Harvey Norman's sales slogan quips that it is "Hardly Normal". This is definitely true about its accounting. But at the operating level, its profitability is actually "Very Normal".

❧ End ❧

[5] *Harvey Norman shells out $7.8 million for struggling franchisee*, **Inside Retail**, 12 October 2018

[6] *Inside Harvey Norman's losing franchises: Gerry Harvey's mystery Mr Fixer*, **The Australian Financial Review**, 13 November 2016

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Annex I

NAV in USD (Official)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2008										34.16	33.49	35.62	**4.3%**
2009	34.57	33.52	33.37	36.69	46.20	46.00	50.06	49.68	52.66	54.17	56.68	59.94	**68.3%**
2010	59.05	61.09	65.17	68.27	64.14	65.69	70.65	72.24	81.06	83.56	85.10	90.30	**50.6%**
2011	87.21	86.29	88.13	92.81	90.85	91.35	91.17	83.69	69.04	78.23	73.00	72.88	**-19.3%**
2012	77.40	82.90	82.52	83.32	76.36	77.25	77.27	77.91	80.57	79.44	82.70	84.92	**16.5%**
2013	91.43	97.36	99.96	100.24	99.14	95.09	98.50	100.00	100.86	102.24	102.63	102.93	**21.2%**
2014	99.15	101.78	99.80	101.84	105.45	106.57	109.05	108.58	103.60	103.91	101.87	99.94	**-2.9%**
2015	97.97	98.16	97.74	103.80	103.69	100.99	96.17	85.91	84.17	88.91	86.20	86.35	**-13.6%**
2016	81.56	83.81	88.82	92.18	91.50	91.52	94.48	94.86	94.87	93.34	91.92	90.20	**4.5%**
2017	93.18	97.08	101.10	101.39	105.74	107.11	109.67	108.57	109.35	112.57	108.28	109.41	**21.3%**
2018	113.04	109.56	109.03	105.39	109.62	104.37	101.26	93.71	94.25	85.19	86.83	86.66	**-20.8%**
2019	91.98	92.36	90.04	90.21	82.80	84.21	82.57	78.45	76.52	77.82	78.75	82.80	**-4.5%**
2020	78.58	75.37	67.15	71.23	70.50	77.22	82.23	88.36	84.97	86.77	90.34	93.20	**12.6%**
2021	99.54	99.36	94.98	99.37	96.76	96.86	86.54	87.88	85.09	90.51	85.32	82.81	**-11.1%**
2022	78.21	74.05	70.58	65.87	65.29	64.03	61.31	60.68	53.29	46.97	56.74	57.43	**-30.7%**

Note: The Net Asset Value of the Fund has been linked to the rebased NAV of the Reference Account, which had the same investment style. Until the launch of the Fund, the Reference Account served as the model portfolio for all the separately-managed client accounts. Its trading records were distributed to clients as proof that the Manager's interests were fully aligned with those of the clients. The Reference Account was started at the end of 2008 and became inactive following the launch of the fund on 1 September 2013.

The following data is for the convenience of SGD-based investors and is for reference only.

NAV in SGD (for reference only)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2008										50.68	50.69	51.20	**2.4%**
2009	52.22	51.91	50.74	54.21	66.70	66.59	72.06	71.60	74.19	75.67	78.50	84.15	**64.4%**
2010	83.11	85.83	91.17	93.55	89.79	91.72	96.10	97.84	106.70	108.12	112.34	115.86	**37.7%**
2011	111.57	109.76	111.06	113.64	112.11	112.14	109.75	100.70	89.85	97.91	93.64	94.48	**-18.5%**
2012	97.39	103.46	103.79	103.05	98.44	97.76	96.12	97.20	98.89	96.95	100.95	103.74	**9.8%**
2013	113.19	120.44	124.03	123.50	125.34	120.54	125.55	127.49	126.57	126.83	128.86	127.81	**23.2%**
2014	124.51	128.55	125.58	127.84	132.26	132.85	135.95	135.58	132.14	133.61	132.91	132.34	**3.5%**
2015	132.68	133.74	134.11	137.66	139.74	136.08	131.71	121.30	119.78	124.68	121.53	122.26	**-7.6%**
2016	116.13	117.82	119.59	123.86	126.08	123.36	126.71	129.30	129.32	129.95	131.79	130.54	**6.8%**
2017	131.35	135.81	141.22	141.04	146.29	147.44	148.75	147.28	149.30	153.38	146.00	146.32	**12.1%**
2018	148.13	145.04	142.95	139.64	146.74	142.24	137.76	128.59	128.83	117.98	119.13	118.06	**-19.3%**
2019	123.77	124.86	123.01	122.81	113.88	113.93	113.02	108.85	105.83	105.92	107.71	111.33	**-5.7%**
2020	107.23	105.02	95.47	100.41	99.64	107.68	112.93	120.15	116.02	118.55	121.20	123.14	**10.5%**
2021	132.30	132.32	127.74	132.16	127.85	130.26	117.21	118.19	115.50	122.11	116.41	111.73	**-9.3%**
2022	105.70	100.32	95.63	91.14	89.43	88.99	84.64	84.78	76.49	66.51	77.25	76.95	**-31.1%**