

# HASTIE GROUP LIMITED: DID THE ANNUAL REPORTS *provide any warning signals?*



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*Whenever Australia experiences a significant corporate collapse, the question is asked: why weren't we warned? Notwithstanding the best efforts of the brokers' analysts, it is clear that many such collapses come without warning. In hindsight, it is often very apparent that, for several years before, there were plenty of warning signals in the annual accounts. It appears that brokers are so dedicated to looking for 'winners' that they often neglect to identify potential losers.*

McRobert and Hoffman<sup>1</sup> have outlined a number of causes of corporate failure including companies seeking to achieve growth at all costs, companies whose boards seem to think that they could achieve greatness in whatever sector they choose, companies that cannot adapt to a changed competitive environment and, of course, gearing (a feature found in almost corporate collapses).

This article examines whether any of the identified causes of failure were apparent in the history of Hastie as a public company. If they were, the question then follows: why were brokers and commentators not able to identify these potential causes before, rather than afterwards?

As in a previous article on ABC Learning Centres Limited,<sup>2</sup> this article focuses on the annual reports themselves. Most retail investors do not have regular access to the companies in which they invest. They do have an opportunity at the annual general meeting, but few retail investors actually attend the AGM or pay attention to continuous disclosure releases by companies. For the most part, retail investors' major sources of information are brokers' reports and the annual report. By the time brokers' reports began to highlight Hastie's problems, the group was already well down the road to collapse.

## Background

Hastie Group Limited (referred to throughout this article as 'Hastie') listed on the Australian Securities Exchange on 29 March 2005. The 2006 annual report clearly disclosed the intention of the directors of Hastie (p. 1):

The group's strategy is to expand, through organic growth and acquisitions, its range of building services to the commercial, industrial and infrastructure sectors and its geographic coverage.

Table 1, drawn from the 2005–2011 annual reports,<sup>3</sup> indicates the extent to which Hastie was able to fulfil this strategy.

Does the 'growth at all costs' issue apply to Hastie? It certainly looks that way.

## Business model

Initially, Hastie's focus was on specific target sectors, mostly in Australia and New Zealand. It is, however, significant that it took until 2010 for Hastie to report that the group had 'moved to standardised estimating packages, complementing its existing uniform Group-wide IT platform' (p. 19). In other words, notwithstanding 33 acquisitions between 2005 and 2010, there is no evidence that Hastie had attempted to achieve any synergies in its program of acquisitions. The following figures

**TABLE 1: Acquisitions (\$'000)**

For year ended:	30 June 2005	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
Total acquisition costs (\$000)	23,800	36,930	56,118	326,737	31,397	20,054	7,340
Number of business 100% acquired	2	4	7	11	4	5	1



**TABLE 2: General & administrative expenses**

For year ended:	30 June 2005	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
General and administrative expenses	49,661	51,000	74,461	129,356	186,195	180,485	190,023
G&A expenses as a percentage of revenue	13.4%	10.6%	9.6%	10.2%	10.5%	10.9%	10.3%

reinforce this suggestion (see Appendix for further details).

Table 4 illustrates Hastie’s dramatic growth in revenue over the time that it was listed. Given growth at this rate, one would have expected the G&A expense ratio to have significantly declined over time. Anecdotal evidence indicates that, apart from the costing system, there was little or no attempt to standardise operating procedures or gain access to potential economies of scale. Indeed, one would have to question whether acquisition of a diverse range of electrical, plumbing, air conditioning, fire and refrigeration companies scattered across Australia and New Zealand (let alone the UK and the Middle East) could generate the opportunity for economies of scale.

Does this reflect the failure of Hastie to generate economies of scale from integrating its enormous number of acquisitions? There are two possible explanations:

- > the Board and management were incapable of generating the economies of scale or
- > the nature of the business meant that economies of scale were simply not available. If this is the case, it would invalidate the objective of Hastie’s aggressive expansion strategy.

**Large-scale projects**

Hastie was a group that proudly talked about the very large developments with which it was associated, in each of the three regions. However, the ‘downside’ of continuously working on very large developments is that a company is vulnerable to very significant cost overruns and defaults. Engineering contracting is a high-risk business: every sale is up for tender; there are few if any repeat sales; profit margins are thin at best; and sponsors penalise cost or time overruns.

In 2011, the sort of major impacts experienced by Hastie through the strategy of focussing on large-scale developments included:

- > the Dubai downturn and the resultant diminution in the profitability and the value in Hastie’s balance sheet of Rotary<sup>4</sup>
- > a very significant bad debt in the Turks & Caicos Islands.

**Discretionary expenditure**

Hastie also disclosed in 2011 that it had been adversely affected by:

- > extreme weather and the Christchurch earthquake
- > low discretionary maintenance expenditure
- > tightening credit terms from suppliers and looser terms demanded (or taken) by customers
- > depressed market demand with the downturn in retail expenditure
- > project delays.

These are all what McRobert and Hoffman in *Corporate Collapse: An Early Warning System for Leaders, Investors and Suppliers*<sup>5</sup> referred to as ‘normal business hazards’. Hastie boasted that it had an active and dynamic risk management system. Does the fact that these normal business hazards had such a major impact on the group cast doubt on the effectiveness of this risk management system?

Certainly, the vulnerabilities suggest that there was a mismatch between the aggressive expansion strategy, both in terms of revenue growth and geographically, and the relatively aggressive financial structure that Hastie maintained. Arguably, gearing of 2.51:1 does not sit well with the degree of risk pursued by Hastie.

**Geography**

At various times over the period that Hastie was listed, it revealed that, in addition to the three major areas of operations, it was undertaking projects in: Russia, China, Iran, Thailand, Hong Kong, Vietnam, Algeria, Iraq, Singapore, Gibraltar, Papua New Guinea and Turks & Caicos Islands. One can only wonder what specialist expertise Hastie thought that it could bring to projects in Russia, Turks & Caicos Islands and Gibraltar? What specific experience did the group have in such countries? How did these projects relate to any strategy of controlled and focused international expansion?

**Financial statements**

Having examined Hastie’s business model, let us now turn to the financial statements.

### Reorganisation

For any person attempting to make sense of Hastie's financial statements over a period of time, the company did not make things easy. The financial statements featured continuous restatements in the financial accounts themselves:

- > The 2006 annual report contained a material restatement of fixed assets (\$1.6m), described as 'reallocation to correct classes'. There was a further minor (\$24,000) reallocation in the 2009 accounts.
- > In 2010, the reallocation of \$1.1b out of fixed assets was described as 'reallocation to Intangibles'.
- > The reductions in goodwill in the 2007, 2008, 2009 and 2010 annual reports were attributed to 'Reassessment of deferred consideration for prior year acquisitions'. These were substantial: \$1.7m in 2007, \$0.8m in 2008, \$23.3m in 2009 and \$1.9m in 2009.
- > The 2007, 2008, 2009 and 2010 annual reports also contained \$3.1m, \$3.2m, \$4.3m and \$6.3m, respectively for reductions in the provision for warranty claims, attributed to 'Re-measurement or settlement without cost'.
- > The 2008, 2009, 2010 and 2011 annual reports contain \$5.4m, \$4.9m, \$2.3m and \$3.8m adjustments to the income tax provision attributed to Over-provision in prior years in relation to Research & Development Allowance.

Reassessment of deferred consideration for prior year acquisitions would have had a negative impact on the P&L. By contrast, reductions in the provision for warranty claims and adjustments to the income tax provision in respect of the Research & Development Allowance would have positively impacted the P&L. However, in neither case was there any specific disclosure of the impact of these adjustments in the notes to the accounts on the P&L. All of these items, and the fact that the word 'consistent' never appears in the Statement of Accounting Policies might perhaps have provided some grounds for concern about the reliability of the financial statements. When comparing results between years for any company, unless there is consistency in the preparation of the accounts,

there is a risk that numbers prepared on different bases may not actually be comparable. Comparing apples to oranges in financial analysis is just as dangerous as in any other sphere of life.

Apparently, the auditors (Deloitte) were satisfied, because the accounts were not qualified in any year up to the collapse of Hastie.

### Goodwill

Table 3 examines the relationship between Hastie's valuation of goodwill and solvency.

Goodwill is treated in financial statements as a non-current asset, the value of which is required to be assessed by the directors every year and written down if they consider it to be overstated. The last row in Table 3 recalculates Hastie's gearing on the assumption that the goodwill was, in fact, worthless. As many liquidations have shown, goodwill is, in very many cases, only valuable as long as a company continues to operate. Moreover, when the total value of goodwill exceeds shareholders' funds, the capacity of the company to demonstrate that it is still solvent is wholly dependent on assumptions regarding the valuation of goodwill.

In Hastie's case, it is clear that, from the outset, the group's capacity to demonstrate that it was solvent was completely dependent on the valuation of goodwill. Hastie's valuation of goodwill was based on assumptions as to the level of profitability of each of the key operating units within the group. The author has undertaken an analysis of these assumptions.<sup>7</sup> This analysis demonstrates that those assumptions were completely inconsistent with Hastie's actual performance.

In its 30 June 2011 annual report, Hastie reported a massive write-down of goodwill. Belatedly, it seems, Hastie was acknowledging what is apparent from the analysis: they had paid too much for their massive expansion program, and the investments were not generating the anticipated profits.

And what did the goodwill and other intangibles generate for the receivers? Nothing.

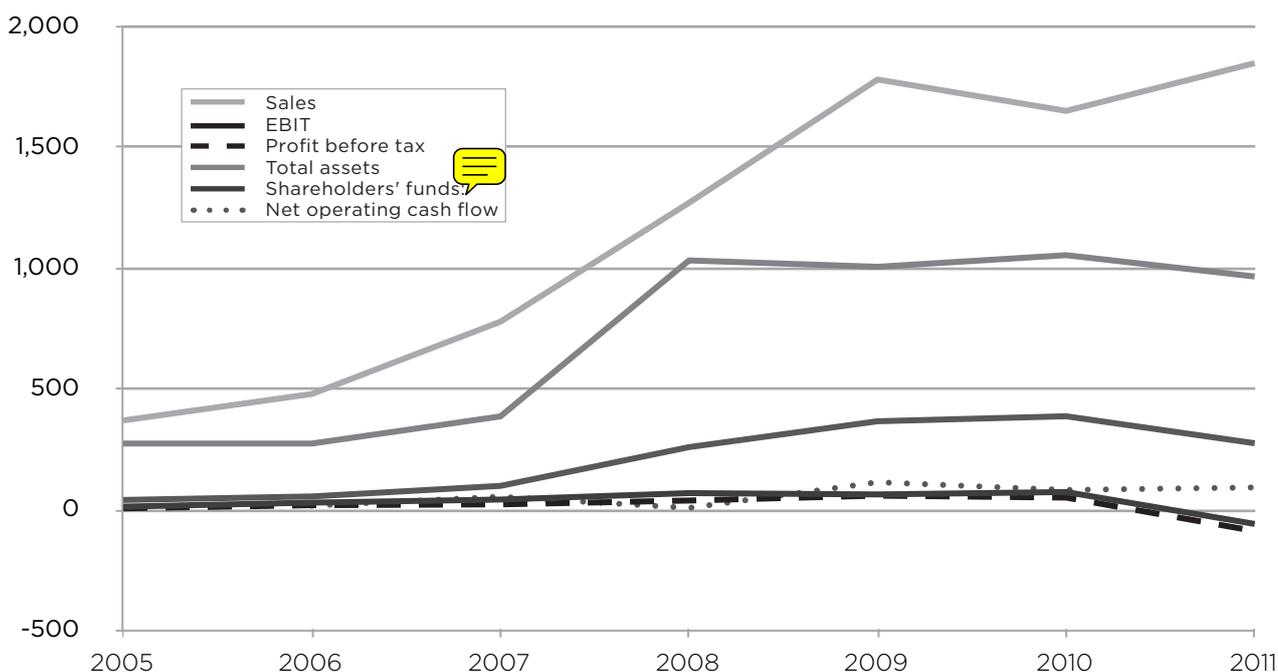
**TABLE 3: Goodwill & other intangibles related to shareholders' funds**

For year ended:	30 June 2005	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
<b>Gearing</b>							
Total liabilities/shareholders' funds	3.27	3.96	2.90	2.98	1.74	1.72	2.51
<b>Gearing, excluding goodwill</b>							
Total liabilities/shareholders' funds	-13.15	-7.68	-9.06	-5.38	-13.53	-18.11	-15.48

**TABLE 4: Debt service capacity of operating cash flow**

For year ended:	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
Net cash provided by operating activities (before interest expense)	21,408	31,328	80,386	35,027	51,609	-27,186
Cash debt service coverage ratio	4.07	2.14	2.92	1.49	2.45	∞
Cash debt service coverage ratio, including operating leases	2.40	2.00	2.64	1.09	1.65	∞

**FIGURE 1: Summary of profitability, (A\$000)**



**Performance**

Figure 1 summarises Hastie’s profitability over the period that the group was listed.

Hastie was clearly able to maintain its gross margins in the face of the significant growth in revenue and, until 2009, EBIT. However, growing gross profits is not the same as growing net profits. Failing to control the level of overheads (as discussed in relation to Table 2) meant that Hastie was, in effect, trading water. The author’s analysis shows that net profit/shareholders’ funds peaked in 2006 and declined every year after that. Why didn’t the brokers, who were busy recommending Hastie as a ‘buy’, highlight this trend?

**Cash flow and debt service capacity**

Table 4 relates Hastie’s net operating cash flow to (i) interest expense and other associated finance costs and (ii) interest expense and other associated finance costs PLUS operating lease expense.<sup>8</sup> The Australian Accounting Standards Board is currently considering a proposal from the International

Accounting Standards Board to treat operating leases the same as finance leases, i.e. bring them into the balance sheet and P&L. From an analyst’s perspective, operating and finance leases are effectively both forms of structured secured lending. Therefore, it is valid to calculate Hastie’s debt capacity to service over its time as a listed company, its interest on loans and finance leases and the payments on its operating leases.

Table 4 discloses that, on a cash basis, Hastie was generally ‘close to the line’ in cash debt service capacity. At the end of the day, it is net operating cash flow that pays the bills, not profits. Hastie’s very thin cash debt service cover is remarkable, in view of the positive statements of the directors throughout this period and, of course, the consistently bullish analyses of Hastie issued by brokers.

## Conclusions

1. Hastie aggressively pursued growth in business, much of it with large-scale projects, and in an astonishing range of countries.
2. Hastie failed to generate the economies of scale that could have been anticipated from the acquisition program and the very substantial growth in revenue throughout its time as a listed company. Failure to achieve economies of scale meant that profit growth was always very substantially less than revenue growth.
3. There were, over the eight years, an extraordinary number of adjustments to provisions, fixed and intangible assets that do not inspire confidence in (and should not have inspired reliance on) the reliability of the published figures in the annual accounts.
4. The assumptions on which the valuation of goodwill was based were flawed, resulting in the continued overvaluation of goodwill. Indeed, given the discrepancy between the valuation basis of goodwill and the actual results achieved from the acquisitions, it appears that Hastie consistently overpaid for its acquisitions and failed to achieve any significant synergies from them.
5. The aggressive strategy of revenue and geographic expansion was not matched with a prudent conservative financial structure appropriate to such a strategy.
6. Debt service capacity, particularly when measured on an operating cash flow basis and including servicing of operating leases, was weak and declining.

Unlike many such analyses of failed companies, there is no 'smoking gun' in the case of Hastie. But this analysis suggests that Hastie combined the financial profile of a start-up, the risks of a large diversified multi-national and an inadequate level of high-level expertise to manage their strategy. Under the circumstances, was it such a surprise that this high-wire act should come unstuck?

Trying to avoid the perils of hindsight, this article therefore concludes that there were two sets of failures:

- > failure by the Board and management of Hastie which directly led to the collapse of the group
- > failure by brokers who failed to identify the emerging disaster during the time that Hastie was listed.

Companies are always going to fail, and failure is an integral part of the process whereby the economy renews and refreshes itself. However, it is clear that every corporate collapse can be attributed to one or more of the well-documented causes of failure. And it is clear that a few simple calculations

and the determination to read and think beyond the purple prose set out by the directors (and the brokers) will, in very many cases, identify a company heading inexorably towards failure. ■



## Appendix

### Hastie Financial Statements

For year ended:	30 June 2005	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
Sales	369,891	479,393	778,633	1,270,672	1,781,049	1,651,081	1,848,843
EBIT	13,113	29,716	42,450	69,050	93,690	73,555	-58,569
Profit before tax	6,306	19,073	22,531	38,388	58,698	40,578	-87,826
Total assets	174,243	274,260	386,571	1,032,269	1,005,907	1,053,929	965,701
Shareholders' funds	40,776	55,305	99,003	259,421	366,521	387,228	275,453
Current ratio	1.2	1.4	1.3	1.2	1.3	1.3	1.4
Total liabilities/ shareholders' funds	3.27	3.96	2.90	2.98	1.74	1.72	2.51
Interest cover	3.24	5.29	3.85	3.14	3.78	3.40	-1.65
Gross margin	19.7%	18.3%	16.9%	17.2%	17.0%	17.0%	14.9%
Net profit after tax/sales	1.7%	4.0%	2.9%	3.0%	3.3%	2.5%	-4.8%
EBIT/Total assets	7.53%	10.83%	10.98%	6.69%	9.31%	6.98%	-6.06%
Sales/fixed assets	36	32	37	25	31	30	37

### Notes

1. **Corporate Collapse: An Early Warning System for Leaders, Investors and Suppliers** by Andrew McRobert and Ronnie Hoffman, originally published in 1997; 2nd edition to be published in 2013.
2. 'ABC Learning Centres Limited: Did the annual reports give enough warning?', **JASSA**, issue 1, 2009.
3. The full financial analysis is available by contacting Andrew McRobert at amra@amcrobertandassoc.com.au
4. Rotary was a large UK-based provider of mechanical, electrical and hydraulic services for commercial, industrial and infrastructure projects acquired by Hastie during the 2008/09 financial year. Hastie used Rotary as the vehicle for expanding into the Middle East and other locations.
5. Corporate Collapse op. cit.
6. Hastie's treatment of goodwill and other intangibles is discussed in more detail in the next section.
7. This analysis is also available by contacting Andrew McRobert at amra@amcrobertandassoc.com.au
8. The accounting treatment of finance expenses in the cash flow statement changed in 2008. The 2006 and 2007 figures in Table 5 have been adjusted from the figures in Hastie's annual reports to ensure consistency of treatment. The 2009/2011 figures for operating leases have been estimated, as from 2009 Hastie ceased to disclose the P&L impact of operating leases in the group.