

# ALEZOR Research

## ***A note on earnings quality: Patisserie Holdings***

Patisserie Holdings is a bakery company based in the UK, which went into administration in January 2019 before being bought by Causeway Capital Partners a private equity firm. The company offers cakes, coffees, teas and the like.

Given the fact that Patisserie Holdings operates a basic business, we could have expected the accounting to be straightforward and it seems astonishing that this company succeeded in committing fraudulent accounting.

We applied part of a simple earnings quality check-list to test if there was any chance to flag some poor earnings quality before the company's fraud became public.

### **Free cash flow vs reported earnings**

Usually a first red flag in terms of earnings quality starts with a company reporting a positive net income while having a negative free cash flow and increasing debt. **In the case of Patisserie Holdings, a first glance at the accounts indicated that the company seemed to generate a consistent positive free cash flow and no interest-bearing debt was reported during the past three years.**

### **Then we start to see some red flags appearing: building fluff in the balance sheet**

Reported free cash flow seemed pretty closed to reported net income during the past three years, but if we look at the 7 year-average figure, we see that on average reported net income stood at 11.5% of sales compared to a free cash flow averaging 4.2%. One could argue that part of this difference could have been justified by growth and its subsequent working capital requirements.

Free cash flow was particularly lower than net income during the period 2011-2014, the bulk of the difference coming from working capital investment and Capex. Concurrently with this working capital investment one asset in particular started to balloon in the company's balance sheet: **Prepayments and accrued income**. According to the company, prepayments and accrued income was mainly related to prepaid rents and rates, this is usual accounting for many companies like Patisserie Holdings, what is exceptional is the size of this line item: £11.3m or 11% of total assets and growing faster than sales:

| Patisserie Holdings K€ - year end in September | 2011  | 2012  | 2013  | 2014  | 2015  | 2016  | 2017   |
|--|-------|-------|-------|-------|-------|-------|--------|
| Prepayments and accrued income                 | 3 011 | 3 338 | 4 445 | 6 802 | 7 712 | 9 641 | 11 316 |
| as a % of total assets                         | 9,3%  | 9,0%  | 10,1% | 11,0% | 10,6% | 11,3% | 11,4%  |
| as a % of sales                                | 7,4%  | 6,7%  | 7,4%  | 8,9%  | 8,4%  | 9,3%  | 9,9%   |

What the accounts are telling us is that the company is making payments in advance, and that is why its free cash flow has been somewhat lower than reported income, then, the difference is being reported as an asset in the company's balance sheet.

Greggs a peer company, also based and operating in the UK, also has prepayments reported as assets in its balance sheet, but we can see that it represents less than 4% of total assets and that it does not tend to increase at a higher rate than sales:

| Greggs - K£ - year end in December | 2012   | 2013   | 2014   | 2015   | 2016   | 2017   |
|------------------------------------|--------|--------|--------|--------|--------|--------|
| Prepayments                        | 14 142 | 14 961 | 12 268 | 13 638 | 13 722 | 16 611 |
| as a % of total assets             | 4,3%   | 4,5%   | 3,3%   | 3,5%   | 3,3%   | 3,8%   |
| as a % of sales                    | 1,9%   | 2,0%   | 1,5%   | 1,6%   | 1,5%   | 1,7%   |

### Operating lease: an usual accounting restatement

Patisserie Holdings accounts were not completely debt free, financial analysts usually restate operating lease rents as debt, our estimate of the company's financial debt is £91m. This figure not only implies that Patisserie Holdings was not completely debt-free, but it also affects our view on the company's Asset turnover ratio as per below.

### Looking for more fluff in Patisserie Holdings balance sheet: asset turnover ratio

Patisserie Holdings has an asset turnover ratio (Sales / Total assets) on average at 1.2x compared to 2.2x for Greggs, meaning Patisserie Holdings uses many more total assets than Greggs for any single £ in sales, the difference between the two companies is very large, and it should be taken into consideration together with the ballooning prepayments.

Once we add the off-balance sheet asset implied by the company's operating lease, we found that Patisserie Valerie has an asset turnover ratio on average at 0.6x which is clearly too low for its industry (Greggs' adjusted figure stands at 1.3x).

### Balance-sheet based accruals ratio

The purpose of this ratio is to detect the proportion of accruals in the company's balance sheet

$$\text{Balance-sheet based accruals ratio} = \frac{(NOA_t - NOA_{t-1})}{(NOA_t + NOA_{t-1})/2}$$

$$\text{Where } NOA_t = [(Total\ Assets_t - Cash_t) - (Total\ liabilities_t - Total\ debt_t)]$$

|                                | 2012  | 2013  | 2014    | 2015   | 2016  | 2017  |
|--------------------------------|-------|-------|---------|--------|-------|-------|
| Patisserie Holdings - Accruals | 1,5%  | 1,7%  | -179,8% | 321,4% | 74,1% | 47,4% |
| Greggs - Accruals              | -0,7% | 10,7% | 67,6%   | -1,6%  | 6,9%  | 17,0% |

In the case of Patisserie Holdings the Balance-sheet based accrual ratio is consistently higher than 30% which in our view is a red flag in terms of earnings quality.

After discussing Patisserie Holdings' poor earnings quality, we think investors could be somewhat skeptical when it reported 17,6% operating margin in 2017 (16.7% average during the past three years) which is more than double the figure reported by Greggs at 7.5% (8.2% average reported during the last three years).

#### Patisserie Holdings

| - Income statement K£ - Yearend in September | 2012          | 2013          | 2014          | 2015          | 2016           | 2017           |
|--|---------------|---------------|---------------|---------------|----------------|----------------|
| <b>Revenue</b>                               | <b>49 511</b> | <b>60 112</b> | <b>76 641</b> | <b>91 925</b> | <b>104 141</b> | <b>114 197</b> |
| % Change                                     | +22,3%        | +21,4%        | +27,5%        | +19,9%        | +13,3%         | +9,7%          |
| Costs of goods and services sold             | 11 192        | 13 148        | 17 363        | 20 884        | 22 832         | 24 931         |
| Administrative expenses                      | 30 847        | 37 379        | 48 007        | 56 457        | 64 099         | 69 121         |
| <b>Operating income</b>                      | <b>7 472</b>  | <b>9 585</b>  | <b>11 271</b> | <b>14 584</b> | <b>17 210</b>  | <b>20 145</b>  |
| Operating margin %                           | 15,1%         | 15,9%         | 14,7%         | 15,9%         | 16,5%          | 17,6%          |
| Finance Costs                                | 1 232         | 1 356         | 858           | 27            | 6              | 36             |
| Other financial income (expenses)            |               |               |               |               | 0              | 44             |
| <b>Profit before tax</b>                     | <b>6 240</b>  | <b>8 229</b>  | <b>10 413</b> | <b>14 557</b> | <b>17 204</b>  | <b>20 153</b>  |
| Income tax                                   | 1 587         | 1 427         | 1 512         | 3 152         | 3 469          | 3 789          |
| Income tax rate                              | 25,4%         | 17,3%         | 14,5%         | 21,7%         | 20,2%          | 18,8%          |
| <b>tax % FFO</b>                             | <b>22,5%</b>  | <b>16,3%</b>  | <b>14,3%</b>  | <b>19,4%</b>  | <b>18,2%</b>   | <b>17,2%</b>   |
| <b>Net profit</b>                            | <b>4 653</b>  | <b>6 802</b>  | <b>8 901</b>  | <b>11 405</b> | <b>13 735</b>  | <b>16 364</b>  |
| Net profit % sales                           | 9,4%          | 11,3%         | 11,6%         | 12,4%         | 13,2%          | 14,3%          |
| <b>Attributable to the Group</b>             | <b>4 653</b>  | <b>6 802</b>  | <b>8 901</b>  | <b>11 405</b> | <b>13 735</b>  | <b>16 364</b>  |

#### Greggs

| - Income statement M€ - Yearend in December   | 2012           | 2013           | 2014           | 2015           | 2016           | 2017           |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| <b>Revenue</b>                                | <b>734 502</b> | <b>762 379</b> | <b>803 961</b> | <b>835 749</b> | <b>894 195</b> | <b>960 005</b> |
| % Change                                      | +4,8%          | +3,8%          | +5,5%          | +4,0%          | +7,0%          | +7,4%          |
| Costs of sales                                | 287 193        | 305 914        | 309 865        | 305 116        | 324 289        | 348 098        |
| Distribution selling and administrative costs | 395 461        | 414 970        | 436 012        | 457 520        | 489 561        | 529 732        |
| Exceptional charges                           | -1 445         | 8 137          | 8 516          | 0              | 5 177          | 9 862          |
| <b>Operating income</b>                       | <b>53 293</b>  | <b>33 358</b>  | <b>49 568</b>  | <b>73 113</b>  | <b>75 168</b>  | <b>72 313</b>  |
| Operating margin %                            | 7,3%           | 4,4%           | 6,2%           | 8,7%           | 8,4%           | 7,5%           |
| Finance Costs                                 | -49            | 206            | -175           | 85             | 26             | 368            |
| <b>Profit before tax</b>                      | <b>53 342</b>  | <b>33 152</b>  | <b>49 743</b>  | <b>73 028</b>  | <b>75 142</b>  | <b>71 945</b>  |
| Income tax                                    | 12 775         | 8 963          | 12 187         | 15 428         | 17 149         | 15 039         |
| Income tax rate                               | 23,9%          | 27,0%          | 24,5%          | 21,1%          | 22,8%          | 20,9%          |
| <b>tax % FFO</b>                              | <b>17,9%</b>   | <b>14,9%</b>   | <b>15,3%</b>   | <b>14,9%</b>   | <b>15,7%</b>   | <b>13,4%</b>   |
| <b>Net profit</b>                             | <b>40 567</b>  | <b>24 189</b>  | <b>37 556</b>  | <b>57 600</b>  | <b>57 993</b>  | <b>56 906</b>  |
| Net profit % sales                            | 5,5%           | 3,2%           | 4,7%           | 6,9%           | 6,5%           | 5,9%           |
| <b>Attributable to the Group</b>              | <b>40 567</b>  | <b>24 189</b>  | <b>37 556</b>  | <b>57 600</b>  | <b>57 993</b>  | <b>56 906</b>  |

#### Conclusion

A quick look into Patisserie Holdings' accounts should have raised some red flags. These red flags are actually part of a simple earnings quality check-list. A reader of the company's financial statements could have asked some questions and engage a critical conversation with the company's management before investing.