BLUE ORCA CAPITAL

"The Markets Need More Skeptics"

\- *The Economist on Wirecard*

COMPANY: SEEK Ltd | ASX: SEK
INDUSTRY: Business/Consumer Services

Seek Ltd (ASX: SEK) is a growth stock without the growth. In our investment opinion (the "Report") published on October 29, 2020, we detailed our extensive investigation indicating that Seek's most important business, Chinese online recruiting platform Zhaopin, is inundated with **zombie resumes** and **fake job postings**.

On November 2, 2020, Seek issued a flimsy, 2-page response (the "Response") to our Report in which it failed to meaningfully address any of the substantive evidence of fake posts and zombie resumes raised in our Report. Seek even admitted in its Response that it did "**not wish to engage in detail**" with our allegation. Why not? Because we are right.

Seek's actions speak louder than its words. **Since our report, Zhaopin has removed 64 of the 66 employers on its platforms we identified as likely fake, which we believe is clear validation of our work**. Recall that in the markets we sampled, these employers accounted for almost 20% of the posts on these platforms, making it a significant admission of rot on Zhaopin.

In our opinion, Seek refuses to engage with our Report because our evidence is compelling. But investors deserve a straight answer, not a Company which is trying to sweep under the rug a discussion which would obviously undermine the market's confidence in its critical Chinese platform.

Seek's only response of substance is that Zhaopin is a "strong business with a long history" because it "continues to generate strong operating cash flows." Seek argues that investors should have faith in Zhaopin, despite all of our evidence of zombie resumes and fake posts, because it generates cash. But if that is the case, then how does Seek explain the absence of cash flows from the Zhaopin business?

1. Where is Zhaopin's Cash?

On paper, Zhaopin accounted for 46% of Seek's free cash flows in FY 2020. The proportion of free cash flows reportedly generated by Zhaopin has increased materially over time, underscoring Zhaopin's central importance to Seek's business and its stock price.

AUD M	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	Cumulative
Seek Free Cash Flow	279	204	279	248	178	1,187
Zhaopin cash flows from operating activities	93	111	113	77	109	504
Zhaopin Capex	7	12	24	34	26	104
Zhaopin Free Cash Flow	86	99	89	43	83	400
% of Seek's free cash flow	**31%**	**49%**	**32%**	**17%**	**46%**	**34%**
Zhaopin net profits	62	31	92	48	55	287

Source: Seek's Annual Reports

If Zhaopin has really generated so much free cash flow, why does Zhaopin's indebtedness keep increasing?

In the past five years, Seek claims that Zhaopin generated AUD 400 million of free cash flow and AUD 287 million of net profits. We would expect that a growing, cash producing business would not need to borrow more and more money from the capital markets.

Yet over that time, Zhaopin's **debt increased** from AUD 35 million in FY 2016 to AUD 467 million in FY 2020, an increase of AUD 432 million in five years. Inexplicably, Zhaopin's cash balance fell over that period.

AUD M	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
Zhaopin Borrowings	35	34	342	436	467
Zhaopin Cash (excluded funds on deposit)	419	506	141	147	246
Zhaopin Net Debt	**(384)**	**(472)**	**201**	**288**	**221**

Source: Seek Annual Reports

Growing businesses generating robust free cash flows and healthy profits shouldn't need to keep raising debt from the capital markets. But Zhaopin's debts increased by **10x** during a five-year period in which, according to Seek, Zhaopin had more than enough idle cash sitting around to run its business.

2. Where are Zhaopin's Dividends?

The Company's defenders argue that Seek can be trusted because it pays a dividend. By this logic, Zhaopin's failure to pay dividends is a major red flag.

For all the cash flows and profits supposedly generated by Zhaopin, it only paid a dividend twice in ten years.

AUD M	FY2011	FY2012	FY2013	FY2014	FY2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	Cumulative
Zhaopin Net Profit	16	29	20	31	48	62	31	92	48	55	431
Zhaopin Dividend Payments	**0**	**0**	**0**	**25**	**0**	**0**	**0**	**133**	**0**	**0**	**158**
Zhaopin Payout Ratio	**0%**	**0%**	**0%**	**80%**	**0%**	**0%**	**0%**	**145%**	**0%**	**0%**	**37%**

Source: Seek Annual Reports

Notably, Zhaopin funded the only recent dividend (FY 2018) by drawing on newly created debt facilities.[1]

(ii) Loan facilities - Zhaopin Limited

Zhaopin utilises entrusted loan facilities. As announced on 6 October 2017, SEEK Limited received proceeds of US$176.4m in relation to the Zhaopin privatisation transaction, of which US$173.0m was subsequently used to repay existing SEEK Limited bank debt. As part of this transaction, Zhaopin drew down on newly created debt facilities.

Source: Seek FY2018 Annual Report

If Zhaopin's business generated so much cash and profits, why would it need to borrow to fund this dividend? Moreover, **if Zhaopin has really generated so much free cash flow, why doesn't it pay dividends upstream to help Seek service or pay down its near toxic levels of debt?**

Zhaopin is even more of an outlier when compared to Seek's other businesses, such as Online Education Service ("OES"), which pays a steady dividend almost every year. Historically, OES's net profits were 64% less than Zhaopin's. Yet OES pays a dividend. OES's dividend payout ratio increased in the past two years because Seek needed to take more and more money out of the business.

OES Financials Reported by Seek

AUD M	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	Cumulative
Net Profit	24	24	21	19	16	102
Dividend Payments	**10**	**36**	**0**	**47**	**37**	**130**
Payout Ratio	**42%**	**152%**	**0%**	**249%**	**239%**	**127%**

Source: Seek Annual Reports

Why does OES, which generates a fraction of the profits and cash flows of Zhaopin, make proportionally larger (and more consistent) dividend payments up to the parent company?

Seek's investors believe that the Company's debts will be serviced by cash generated by Zhaopin. But if that is the case, then why doesn't Zhaopin pay dividends? There is some urgency to this question, as Seek almost breached its

[1] Zhaopin declared another dividend payment in April 2014, two months before raising AUD 93 million from its IPO.

covenant limits this year. Seek admitted to the market that it obtained covenant relief from creditors until June 2021 – but why is such relief necessary if Zhaopin produced so much free cash and had ample cash on its balance sheet?

Debt metrics to remain within increased covenant limits: While we expect SEK's debt metrics to reach levels which would be uncomfortable under normal circumstances (with CSe for Borrower Group Net Debt/EBITDA of 3.7x in FY21), the increase in covenant limits up to the June 2021 testing date likely provides the company with headroom. Receipt of dividends from Zhaopin also remains an option (with Zhaopin having immediate access to cA$250m of cash) – **we estimate the receipt of A$50mn of dividends from Zhaopin would lower SEK's leverage ratio by 0.6x**.

Figure 7: Calculation of leverage ratio (covenant purposes)

	FY20	1H21F	FY21F	FY22F
Borrower Group Net Debt (A$mn)	1,144	1,132	1,091	965
less Subordinated Notes (A$mn)	-150	-225	-225	-225
add Derivative instruments (A$mn)	49	40	40	40
Net debt (covenant purposes) (A$mn)	**1,043**	**947**	**906**	**780**
Borrower Group EBITDA (A$mn)	263	224	206	297
Cash dividends from subsidiaries (A$mn)	40	40	40	40
EBITDA (covenant purposes) (A$mn)	303	264	246	337
Net Debt/EBITDA (covenant purposes)	**3.4x**	**3.6x**	**3.7x**	**2.3x**

Source: Company data, Credit Suisse estimates

Source: Credit Suisse Research Report, August 13, 2020

The sell side clearly counts on dividends from Zhaopin to help Seek. So where are they?[2] And why did Seek so urgently need relief on covenants from creditors if Zhaopin already had the cash?

A company under a cloud of suspicion can allay such fears by either paying dividends or paying off debts. Zhaopin does neither.

[2] Nor can Seek rely on dividends from OES. Local filings show that OES's cash has decreased from AUD 62 million in FY 2018 to AUD 36 million in FY 2019 because Seek has taken so much out of the business.

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