Hexagon AB –Tax Investigations & Auditor Change

Viceroy's ongoing investigations of Hexagon's "several ongoing tax audits" with "local taxing authorities" provides light reading in the wake of management's non-response.

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July 28, 2023 – In further investigation of Hexagon's subsidiaries, we highlight that "**several ongoing tax audits**" with **"local taxing authorities"** were highlighted by auditors EY in 2019. **Not one other analyst** appears to have acknowledged the significance or even questioned these audits/investigations.

Tax

Hexagon operates through subsidiaries in a number of jurisdictions and all cross-border transactions are normally a tax risk because there are no global transfer pricing rules. Local tax authorities follow their own local transfer pricing rules and authorities interpret transfer pricing guidelines differently. Hexagon frequently interacts with local taxing authorities and frequently has several ongoing tax audits in progress.

Figure 1 – Hexagon Annual Report from 2019 onwards

This has taken considerable portions of Viceroy's capacity in our ongoing investigations. Had analysts not been asleep at the wheel, they would have also picked up on this risk. **"Tax audits" have not been a subject of any Hexagon conference calls since the disclaimer appeared. We know tax audits are a red flag for companies like Hexagon.** These tax audit disclosure should be considered in conjunction with all our future and present findings. We encourage people to read are previous reports available here.

Further to this disclaimer in 2019, we note that E&Y likely faced significant hurdles in its audit of aggressive-acquirer Hexagon when imposed with IFRS 15 changes in 2018, and IFRS 3 changes in 2020. We believe all of the above have had, and will have, sweeping changes in Hexagon's reporting going forward, or at least should.

We believe that Hexagon AB should be 50% below where it is currently trading, before allowing for the risks associated with poor governance, tax audits and regulatory investigations.

Business Combinations

- Acquiring a going concern manufacturing business with retained staff, generally speaking is a business combination, and can be subject to goodwill.
- Acquiring a manufacturing business subject to insolvency proceedings whose only discernable assets are manufacturing equipment and do not have staff is, generally speaking, an asset purchase. The transaction cannot accrue goodwill and assets will be subject to depreciation (or amortization in the event of intangibles).

This is potentially problematic for Hexagon who:

  - Acquires a significant number of businesses, notably for their assets, from insolvency proceedings.
  - Acquires a significant number of distributors, whose only discernable assets appear to be customer relationships, and does not take on their staff.

We suspect that in retrospect, an earlier introduction of IFRS 3 amendments would have created sweeping differences on Hexagon's balance sheet as:

- Acquired distributor relationships would be subject to amortization, and not held indefinitely on the balance sheet as unimpaired goodwill.
- Amortization expenses would have materially impacted earnings (which would, frankly, bring Hexagon in line or below comps).

IFRS 15 – Revenue Recognition

Broadly speaking, the matter of Revenue Recognition changes under IFRS 15 have been broadly reported. We will not re-report the issues here, but include the link to EY's own IFRS 15 changes and adoption:

https://www.ey.com/en_gl/ifrs-technical-resources/a-closer-look-at-ifrs-15-the-revenue-recognition-standard-october-2020

It is important to recognize subtle changes to the recognition of licensed revenues, and the distinction between right-to-access (**R2A**) licenses and right-to-use (**R2U**) licenses.

From a short-term perspective, R2U revenues are preferable as the users are buying stand-alone software and use it in that form for the licensing period. Revenue can effectively be booked upfront. Theoretically, R2U revenues can be brought forward in many different kinds of ways (i.e. discounts for early renewals).

R2A assets provides customers with the most recent form of IP during the license period. Think SaaS subscription software. This revenue must be booked over the period of the contract.

Hexagon disclosures do not provide enough detail to substantiate a claim that R2U assets inflate revenues. In fact, most company disclosures do not. But this is a key audit matter and should be subject to further scrutiny.

Auditor Change

In our investigations, we note that sporadic subsidiaries have highlighted mandatory Public Interest Entity audit firm changes in 2020 in line with EU legislation. We note that Hexagon's move to PwC may have been due to requirement or impending transition due to PIE audit firm rotation regulations.

This update has no significant impact on our findings or conclusions, nor our views on the hurdles faced by Hexagon or its current auditors.

While our investigation into Hexagon's subsidiaries and tax investigations is ongoing, we make this clarification to our original report, Six Sides to Every Story, in order to keep readers abreast of issues.

Key takeaways

There is no doubt in our minds that Hexagon has made some great acquisitions of best-in-class assets. Similarly, we have no doubt that many acquisitions and internally generated IP have been profitable. We even firmly believe that Hexagon can genuinely provide synergies in the acquisitions it has made. This is not in dispute.

Hexagon is not a zero, but it has major problem:

- The finesse of a streamlined tech-savvy business is lost on hundreds of acquisitions of distributors which appear to underperform post-acquisition and revenue run-off streams of mature market operators.
- The premise of vast organic growth repeatedly represented by management is simply untrue. Hexagon buys safe, mature revenues, acquires R&D, and reaps earnings over relatively short technological life cycles. **It is an industrials conglomerate.**
- Hexagon's short technological life cycles appear to accelerate the redundancy and inefficiency of its assets, as dictated by asset turnover.
- It is not in the management's interest to generate organic growth or spend money on R&D. It is in their interest to acquire earnings, as this dictates management bonuses.
- Acquisition of distributors may not have a significant impact on revenue immediately but will impact margins.
- **Hexagon has enormous governance issues, and its management appears to be committing fraud.**

We believe that **Hexagon AB should be 50% below where it is currently trading,** before allowing for the risks associated with poor governance. **Viceroy believes this report details significant downside to the share price and enormous risk in HEXA-B.**

Attention: Whistleblowers

Viceroy encourages any parties with information pertaining to misconduct within Hexagon, its affiliates, or any other entity to file a report with the appropriate regulatory body.

We also understand first-hand the retaliation whistleblowers sometimes face for championing these issues. Where possible, Viceroy is happy act as intermediaries in providing information to regulators and reporting information in the public interest in order to protect the identities of whistleblowers.

You can contact the Viceroy team via email on viceroy@viceroyresearch.com.

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