Part (a)	**Criticise the free cash flow valuation of Metaverse for the proposed 80% share purchase.** • **Do not reperform the valuation.** • **Assume all amounts are correctly calculated.**	**Marks**
1	The forecasted revenue growth does not seem to be in line with global expectations of industry growth of 7.9% *(acceptable to make reference to CAGR of 9%)* up to 2027 before tapering off to 2%. The revenue growth should be a combination of industry anticipated growth, and the market share gains the company anticipates it can achieve.	1 1
2	The revenue forecast appears to be based off the 2023 year, which was affected by non-recurring load shedding. which is not representative of future revenue expectations. The increase then appears to be at a rate of 5% for two years which is not justified adequately as an assumption (and it is not in line with the anticipated 30% growth). The forecast period is therefore too short and should be extended to include all years until stability in cash flows is achieved, in other words 2027 at the earliest. The anticipated revenues from new developments have not been estimated and included, and risk relating to new revenues not adjusted for. The revenues should be adjusted to reflect the anticipated 30% growth for the next three years, with a perpetuity growth thereafter of 5%.	1 1 1 1 1
3	The anticipated revenue from the new developments have not been included. Was the intention to value the new developments separately from the existing business? The growth of mobile gaming also does not appear to be factored into the revenue forecasts, this should be estimated and incorporated.	1 1
4	As the cost of sales are predominantly fixed costs, the forecasts should not have reduced to the extent that they did. It seems that the forecast has incorrectly treated these costs as being variable, the growth from 2024 to 2025 being 5% (same as the growth in revenue). The cost of sales should be included as fixed costs or analysed and split into fixed and variable components for the forecasting.	1 1 1
5	The depreciation is non-cash and would *normally* be removed from the cash flows as a non-cash item. The depreciation on server infrastructure and software however approximates replacement, and therefore it is appropriate not to remove as it estimates the replacement of the capital cost of these assets. The depreciation on the solar installation is however non-cash, and therefore should be removed as non-cash. The solar installation will need replacing after 10 years, as such the estimated capital expenditure that will then be likely will need to be forecasted.	1 1 1
6	There is no justification or calculation for the foreign currency gain/loss forecast. This is a volatile item and should be considered more carefully, as it is not possible to forecast these cash flows. As such this item should be removed from the free-cash flow forecasts.	1
7	The dividends from the exchange traded fund (ETF) included in other income should be removed from the cash flows as they are exposed to different risks. The ETF shares should be valued separately at R10.25 mil and added to the value of the enterprise.	1 1
8	Finance costs should not be included in the forecast as they would have been included in the weighted average cost of capital (WACC). There is no overdraft	

	facility, therefore none of this interest is operational and therefore not in WACC.	1
	The short–term loan relates to the interest-bearing borrowings and is considered part of the financing, therefore should not be included as part of the working capital base.	1
9	The interest on permanent cash surplus should not have been included in the free-cash flow forecasts. The permanent cash surplus on valuation date should have been added as additional value to the value of the enterprise.	1
	As such it is incorrect to include the entire cash and cash equivalents in the calculation of the movement in working capital; only the portion of the cash surplus relating to the operations of Metaverse should be included in the calculation of the movement in working capital.	1
10	It is evident that no cash tax has been calculated and included in the calculation of the free-cash flows.	1
	It would be more correct to adjust the cash tax amounts forecasted for the tax payable at the beginning and the end of each year, than it is to include the movements in the tax payable as part of the movement in the working capital.	1
11	The working capital base being the movement is correct (excluding the short–term loan portion, tax payable and permanent cash surplus noted above), the forecast should however continue for each of these items, and the movement should be used as the cash flow. To address this, the respective items for part of working capital should be expressed as a percentage of revenue (for a normal year) and applied to the forecast revenue for each year of the forecasts in order to forecast the working capital needs and consequently the movement therein.	1
12	The value of the perpetuity (terminal value) has not been discounted back to the start of 2024, being the valuation date. The free-cash flow should be adjusted for the growth into perpetuity (5% p.a.) before capitalising it.	1
13	The WACC of XS Gaming will not reflect the same risks as Metaverse; the WACC of Metaverse should be calculated.	1
14	The cost of equity (its derived beta-factor) has not been adjusted appropriately for the specific risks that the company faces: • The company only has one product, although there are others in development, the rate should be increased for the dependency risk associated with having a single product, and not having diversified revenue streams.	1
	• The company has unique skills and technologies / potential new products, therefore revenue potential; rate should be decreased.	1
15	As Metaverse is unlisted, the value of its equity should have been adjusted for a discount to reflect the fact that its shares are not marketable and funding not being as accessible as is the case for a listed company.	1
16	As a controlling stake is being valued, the value of the equity should have been adjusted for a control premium.	1
17	The intangibles should not be added at cost, instead a fair value should be determined by forecasting the revenues and costs which they would generate.	1
18	The valuation does not calculate the amount for the transaction by multiplying by 80%, as only a part of the company is being purchases.	1
19	Are the interest-bearing borrowings deducted at fair value? As they were on average sourced at fixed rates, the fair value of the borrowings will need to be determined.	1
	Available	**34**
	Maximum	**19**
	Communication skills – logical argument	*1*
	Total for part (a)	**20**

Part (b)	**Calculate and advise the management of XS how the acquisition should be financed, considering the related funding needs of the company.** • **Include an analysis of the characteristics of each financing option and conclude with a recommendation.** • **Fur purposes of the calculation do not offset any amounts of the cash balance.**						**Marks**
Loan and equity calculations							
Origin Bank Loan	**0**	**1**	**2**	**3**	**4**		
Loan receipt	500.00						½
Transaction cost	-5.00						½
Loan repayment					-815.24		1
Tax shield (S24O)		17.55	19.83	22.41	25.32		1P
Net cash flow	**495.00**	**17.55**	**19.83**	**22.41**	**-789.91**		
Rate after tax (IRR)	9.75%						1P
Interest calculation		65.00	73.45	83.00	93.79		1P
Genesis Bank loan	**0**	**1**	**2**	**3**	**4**	**5**	
Loan receipt	500.00						½
Transaction cost	-5.00						½
Interest		-70.00	-70.00	-70.00	-70.00	-70.00	½
Tax shield (S24O)		18.90	18.90	18.90	18.90	18.90	½
Loan repayment						-500.00	½
Net cash flow	**495.00**	**-51.10**	**-51.10**	**-51.10**	**-51.10**	**-551.10**	
Rate after tax (IRR)	10.49%						1P
Rights issue							
Number of rights 100mil/10	10	mil					1
Issue price (30.4*80%)	24.32						1
Amount raised	R243.2	mil					1P
						Calculation marks	*11½*
Strategic considerations							
Cash balance							
The cash balance of R382 million is not sufficient to finance the full value of the R500 million required, although it is sufficient for the equity investment per the valuation of R70.85 million x 80%, assuming this is the agreed transaction value.							1
The remaining funding required for integrating the operations may be required over a period, and as such the company may be able to accumulate the cash over that period from trading activities.							1
One would however need to consider the cash utilised by the existing operations so as not to expose XS Gaming Limited to undue liquidity risk. It is important to consider the impact that the boom in the gaming industry due to the COVID-19 pandemic; with the world returning to some form of “normality”, the era of “super-profits” has passed, and it would be advisable for to retain its free cash flow.							1

Origin Bank Loan	
As South Africa has likely reached the peak of the interest rate cycle, interest rates are likely to drop in the interest rate market in the near term; the Origin Bank loan having a variable interest rate would impact positively on the finance charges incurred on said loan (alt: the Genesis Bank loan would expose XS Gaming Limited to interest rate risk given that the interest rate on the loan is fixed, resulting in no benefit for the company when interest rates start dropping).	1
Repayment of the loan by means of one bullet repayment at end of four-year term is beneficial from a cash flow perspective; no cash outflows until the end of the loan term, resulting in a positive cash saving annually.	1
The flip-side is that it also creates a risk of not being able to afford the single bullet repayment – should it not match cash inflows with outflows.	1
A S24O tax shield on interest incurred will arise; this tax benefit will not arise should the cash surplus or rights issue be used to finance the investment and integration costs.	1
The security which encumbers inventory and receivables will reduce the cost of the loan, but does reduce debt capacity going forward, which is not the case with the Genesis loan.	1
The covenants on interest cover and debt equity may become a constraint in future; the company is however performing well at present and therefore the loan covenants would not be an issue at this stage.	1
Genesis Loan	
Longer term of the loan being five years is favourable, as XS Gaming Limited has an additional year to settle the capital outstanding on the loan.	1
Rights issue	
The benefit from a cash flow perspective of neither having an interest commitment (although dividends may be a softer commitment as it won't want to reduce these) nor needing to return capital over the 4-/5-year term respectively, needs to be considered.	1
While it is a rights issue, it will not necessarily dilute the existing shareholders' stakes in unless they are unable to take up the rights. Assess whether shareholders would have the capacity to exercise the rights.	1
The potential dilution is on a 10: 1 basis, therefore it would not be a significant dilution if existing shareholders are not in a position to exercise the rights.	1
The XS Gaming Limited shares are viewed as being undervalued at present; the timing of the issue is not favourable and as such issuing equity at present would not be advisable until the share price picks up, resulting in the higher proceeds from an equity issue in future (or fewer shares having to be issued in future to raise the same amount of funding).	1
The amount likely to be raised is not sufficient for the R500 mil required.	1
Conclusion	
Recommendation is to use up some of the cash resources, as these would not be yielding sufficient return equalling at least the WACC of XS.	1
Fund the remainder with debt, which is cheaper (the after-tax cost of the Origin Bank loan of 9.75% p.a. is less than the cost of equity of 22%) and creates a more efficient capital structure as XS' gearing levels are currently low, and it would avoid a dilution resulting from the issuing of shares while the share price is low.	1
The Origin Bank loan would be favoured as it is cheaper and more flexible, and the covenants and encumbrances are not necessarily qualitatively material based on the profitability and financial status of XS Gaming Limited at present.	1
Discussion	*18*
Available	**28½**
Maximum	**19**
Communication skills – appropriate style	*1*
Total for part (b)	**20**

Part (c)	Discuss any concerns you may have with respect to the conversation that Jessica overheard about the new game launch. • Ignore the SAICA Code of Professional Conduct in your discussion.	Marks
	Good for Self and Others	
1	In the short-term, going ahead with the release tomorrow will be good for XS Gaming Limited as this conduct will ultimately increase its revenue and uphold its reputation as a Company that adheres to its commitment to the public.	1 1
2	It will also be good for the company's marketing staff in the short-term whose incentive bonus will increase because of the game's launch.	1
3	However, in the long-term there will be negative consequences for XS Gaming Limited as those who have purchased the game experience issues such as losses of data, viruses etc. and this will result in reputational damage and losses in future sales.	1 1
4	If any customers are adversely affected by security breaches (i.e., they could have confidential information breached), legal action could be taken, and this could result in future litigation and legal fees, and financial compensation having to be paid.	1
5	Since XS Gaming Limited is listed on the Johannesburg Stock Exchange (JSE), the above governance challenges have the potential to affect its listing.	1
6	All the above repercussions may ultimately negatively affect XS Gaming Limited's shareholders as the company value will potentially decline.	1
	Companies Act	
7	The CEO and COO are not acting in the best interest of the company as is required and may thus be in breach of Section 76, as they could be seen to not be acting honestly and with the degree of care, skill and diligence, having failed to properly test the new game before launching it.	1
8	The CEO and COO are not acting in the best interest of the company as is required and may thus also be in breach of Section 22, if it can be proven that they acted with gross negligence in launching a product that could have major security issues or resulting in a loss of personal information for the Metaverse customers.	1
9	As a result, the CEO and COO can be held personally liable for losses suffered by XS Gaming Limited in terms of Section 77, for not having acted in the best interests of the company.	1
	King IV	
10	Should the launch go ahead tomorrow, XS Gaming Limited's governing body will be in breach of Principle 1 'Ethical and effective leadership' - due to their actions of not being honest and transparent.	1
11	Should the launch go ahead tomorrow, XS Gaming Limited's governing body will be in breach of Principle 3: 'The governing body should ensure that the organisation is, and is seen to be, a responsible corporate citizen' - due to not having properly tested the new game and going ahead and launching it, this would not be the case.	1

12	Should the launch go ahead tomorrow, XS Gaming Limited's governing body will be in breach of Principle 12.13d: 'The governing body should exercise ongoing oversight of technology and information management and in particular see that it results in the following: proactive monitoring of intelligence to identify and respond to incidents, including cyberattacks and adverse social media events' - given that the new game could result in security weaknesses on the customers' devices.	1
13	Furthermore, the company's governing body may be in breach of Principle 13, as they are required to ensure compliance with all Laws and Regulations, yet they will have breached Section 76 of the Companies Act and POPIA.	1
14	In terms of the Triple Context / Six Capitals, XS Gaming Limited's governing body will not be considering all their stakeholders / not be following a stakeholder inclusive approach, with various stakeholders ultimately losing out as a result of the launch.	1
	Available	**16**
	Maximum	**10**
	Total for part (c)	**10**
	TOTAL FOR QUESTION 1	**50**

