

1 Background

Shop-for-IT Holdings Ltd ('Shop-4-iT') is a South African multinational premium food and beverage retailer. The company services a niche market with its quality mix of local house-brand products as well as imported products from Europe and America. The company is focused on creating sustainable value for its stakeholders through growth in its operations within markets across Africa. Shop-4-iT is also committed to good governance in accordance with the King IV Report on Corporate Governance for South Africa. The company has a 31 December financial year end.

In 2016, Shop-4-iT instituted a Pan-African growth strategy, aiming to create more value for its shareholders. In pursuit of this strategy Shop-4-iT targeted retail companies across the African continent for acquisition. The aim was to rebrand them to become Shop-4-iT retailers and then stock them with its house-brand products. They would be embedded with Shop-4-iT's standards of quality and efficient customer service.

Shop-4-iT acquired its first retail company outside South Africa in Namibia and found great success in the Namibian market. Despite this success, Shop-4-iT has struggled to achieve a similar level of success with its acquisition strategy in other African countries.

2 Acquisition of Stay-Fresh (Pty) Ltd

In January 2018, Shop-4-iT acquired 80% of the shares in Stay-Fresh (Pty) Ltd ('Stay-Fresh'), a well-known Nigerian food retail chain which is headquartered in Lagos, Nigeria. The remaining 20% of the shares in the company are held by a small number of individual investors from Europe. The investment in Stay-Fresh represented Shop-4-iT's first and thus far only venture into the West African market.

Nigeria was chosen as Shop-4-iT's entry point to the West African market because it is Africa's largest economy with a fast-growing and young population. Although Shop-4-iT considered acquiring various other retailers in Nigeria, Stay-Fresh was regarded to be the most suitable target company because of its relatively low asking price.

At the time of its acquisition, Stay-Fresh had 18 retail stores situated in small shopping centres throughout the country. Its target market was middle- to low-income households, and the company marketed itself as a budget-friendly retailer of locally grown fruits and vegetables. These products were purchased from local farmers as this helped the company to ensure that it retained its loyal customer base.

In June 2018, Shop-4-iT appointed Mr Dereck Frazer as Stay-Fresh's new chief executive officer (CEO). Dereck worked for one of Shop-4-iT's competitors in South Africa as the human resources manager for 15 years before joining Shop-4-iT in 2017.

Upon his appointment as CEO in 2018, Dereck immediately rebranded Stay-Fresh to Shop-4-iT Nigeria ('S4N') and moved all the company's existing retail stores to large shopping malls in affluent areas in Nigeria's three largest cities. The new S4N shops were larger, and they offered a mix of imported products and locally produced goods. As part of the rebranding, Dereck also cancelled several distribution contracts that the company had with local suppliers and signed new contracts with some of Shop-4-iT's existing European, American and South African suppliers.

At present S4N employs 1 500 people in all its retail stores and distribution warehouses and the company has 22 retail stores in Nigeria.

3 Extract of the minutes of shareholders' meeting

At a shareholders' meeting held on 5 January 2024, the shareholders of Shop-4-iT expressed several concerns to the newly elected board of directors about Shop-4-iT's continued investment in Nigeria. The most pressing concerns were the following:

- Nigeria has proven to be a difficult economic trading environment since Shop-4-iT first entered the market in 2018, due to the country's growing list of structural and economic problems. Furthermore, several other South African retailers had already disinvested from the country because of similar concerns.
- S4N's growing debt burden is believed to have negatively impacted the value of Shop-4-iT and the shareholders believe that this increase in gearing is likely to continue to be problematic.
- Due to the ongoing issues in Nigeria and the impact on management's time, Shop-4-iT has lost valuable market share in South Africa. Consequently, the shareholders would like the board to focus more on its South African operations.

In view of the concerns of its shareholders, the directors of Shop-4-iT instructed an independent company to draft a report on the current operating environment of S4N as well as a report on the performance of the company. The aim of the reports is to help the board to decide on the best course of action regarding the investment in Nigeria.

4 Extracts of the information supplied by the independent company

4.1 Extracts from the management accounts of S4N

S4N's functional currency is the Nigerian naira (NGN).

Extract of profit and loss for the year ended 31 December			
	Notes	2023	2022
		NGN million	NGN million
Sales revenue		43 573	33 020
Cost of sales		(13 072)	(8 255)
Gross profit		30 501	24 765
Administration and general expenses		(6 268)	(3 020)
Earnings before interest, tax, depreciation and amortisation (EBITDA)		24 233	21 745
Depreciation		(6 790)	(6 940)
Earnings before interest and tax (EBIT)		17 443	14 805
Finance costs		(9 000)	(5 000)
Income tax expense at 30%		(2 533)	(2 942)
Profit for the year		5 910	6 863

Extract of financial position as at 31 December			
	Notes	2023	2022
		NGN million	NGN million
Total assets		279 550	279 890
Equity			
Ordinary share capital		12 000	12 000
Retained earnings		170 310	181 350
Non-current liabilities			
Interest-bearing borrowings	1	52 500	35 000
Deferred taxation		–	3 950
Current liabilities			
Current portion of interest-bearing borrowings	1	10 170	11 670
Bank overdraft	2	510	–
Trade and other payables		29 430	30 790
Provisions		4 630	5 130
Total equity and liabilities		279 550	279 890

Notes

- Most of S4N's debt arose in 2019 from the violent attacks on South African businesses in Nigeria. The attacks were the result of retaliation against similar attacks on Nigerian-owned businesses in South Africa. The debt arose as Shop-4-iT's group insurance cover did not cover the company against damage caused by riots or civil unrest in a foreign country. S4N also had to take out loans to pay for its move from the company's original retail store locations to the new locations in shopping malls. These loans were refinanced in 2022.
- The bank overdraft is considered to be a long-term source of finance.

4.2 Extract of the report on the state of the Nigerian economy and S4N

State of the Nigerian economy

Economic conditions in Nigeria have worsened over the past few years due to several structural and economic problems. The major driver of these problems is the country's high inflation rate, which now stands at over 20%. Furthermore, inflation in the country has caused the Central Bank of Nigeria to increase interest rates to their highest levels in nearly two decades. The rise in inflation is driven by numerous factors, most significantly by the increase in the price of imported food products, poor economic growth, and the weakening of the NGN.

Moreover, the unemployment rate in the country is now over 30%.

There has also been a significant delay in the repatriation of funds¹ from Nigeria, due to a United States dollar (USD) shortage in the country.

¹ The repatriation of funds is the process of transferring money or earnings from a foreign country back to the home country.

Government spending on debt over the past year has risen to 12% of its gross domestic product (GDP) and the GDP growth rate has been recorded at 3,6%. The country currently has a shrinking middle class, and the population growth rate is now 2,4% per year.

Nigeria has also begun to experience an increase in financial crimes, such as fraud, bribery and non-payment of taxes.

There is a significant threat of continued political instability due in part to the election of a new president who faced several legal challenges over the election results.

Nigeria's sea ports are known to be slow to clear consignment goods. The cost of clearing these consignment goods has increased significantly due in part to an introduction of a private security company which has been tasked with securing the country's sea ports. Payments to this company are denominated in USD and the Nigerian government is known to pass these costs on to users of the ports.

State of S4N

Regardless of the external challenges in Nigeria, S4N has also not been without its own internal issues. Most of these internal issues have arisen due to the company's failure to properly understand the Nigerian retail market. This market is characterised as highly competitive, and consumers are starting to favour the use of e-commerce services for their purchases, which S4N currently does not offer.

S4N's market share in Nigeria has declined due to a preference by consumers for more affordable local goods. Rental agreements in the country are also denominated in USD and the weaker NGN exchange rate coupled with the move to larger, more expensive retail spaces has severely impacted company profitability.

S4N currently contributes 8% to the total profit of Shop-4-iT, in part because of the weakening of the NGN.

5 Extract of the minutes from the special meeting of the board of directors of Shop-4-iT held on 22 January 2024

The board of directors of Shop-4-iT deliberated on the reports on the state of S4N and the Nigerian economy. Based on the findings in the reports, the board is considering two potential plans of action.

Option 1: Completely disinvest from S4N. This would mean Shop-4-iT would sell its majority holding in S4N. The board believes that the current maximum price that Shop-4-iT is likely to receive for S4N is NGN80 billion.

Option 2: Shop-4-iT should sell all its current physical retail S4N stores in Nigeria and launch a new e-commerce platform in the country that allows consumers to purchase Shop-4-iT goods online. The company would in such a case retain the use of one of its warehouses and the goods sold would be similar to the ones that the company currently offers.

6 Media release

The *Premier Times*, Nigeria's largest newspaper, recently published an article about rumoured job cuts at S4N. The article blamed Shop-4-iT for its poor handling of its investment in Nigeria, stating that Shop-4-iT had never truly invested in the Nigerian people. The article noted that Shop-4-iT's decision to introduce more plastic into the country, because most of its house-branded beverages are packaged in plastic, has had a negative effect on the environment. The article accused the company of not participating in any notable socio-economic measures to improve the state of the country. The article laid most of the blame on the current CEO, accusing him of focussing only on monetary growth instead of nation building.

The article was a concern to Shop-4-iT's board of directors, given that the decision on the strategic direction on its investment in S4N had not been taken yet. The directors noted that, although the article did not paint the company in a good light, they believe that the best course of action would be not to respond. The directors further decided not to inform the company's shareholders of the article until it finalised its decision on the way forward.

7 Additional information

- Exchange rates as at 31 December

	2022	2023
USD : NGN	1 : 450	1 : 900
ZAR : NGN	1 : 26	1 : 50

- The company tax rate in Nigeria is 30%.

INITIAL TEST OF COMPETENCE, JANUARY 2024

PROFESSIONAL PAPER 4

**This paper consists of two questions.
Answer each question in a separate answer book.**

PAPER 4 QUESTION 1 – REQUIRED		Marks	
		Sub-total	Total
(a)	Evaluate, with reference to sections 3 and 4, the financial risk of S4N by –		
	(i) calculating five relevant financial risk ratios for both years <ul style="list-style-type: none"> • Round all final amounts to one decimal; and (ii) analysing the capital structure based on the ratios calculated and concluding on the level of financial risk to which S4N is exposed.	10	14
(b)	Critically evaluate the acquisition and subsequent rebranding of Stay-Fresh to S4N.	9	
	<i>Communication skills – appropriate style</i>	1	10
(c)	Discuss the merits and pitfalls of the two potential plans of action suggested for S4N by the board of directors of Shop-4-iT.	18	
	<i>Communication skills – logical argument</i>	1	19
(d)	Discuss, with regard to the board’s responsibility for good governance, the decision by the board of directors of Shop-4-iT to not respond to the news article.	7	7
Total for question 1			50