Part (a) Perform, outlining key assumptions, an EBITDA multiple earnings-based valuation for Petrus' shareholding as at 31 December 2023.		**Marks**
Determination of maintainable EBITDA	**R'000**	
The company is stable, and therefore, it would appear to be reasonable to use the 2023 figures as a starting point. (Or appropriately justify using an average.)		1
Operation profit for 2023	159 096	1P
Less: Other income	(507)	1
Add back: Depreciation	19 246	1
Add back: Petrus Mahlangu salary	4 000	1
Less: Strategic manager salary	(1 000)	1
(No tax adjustment as it is EBITDA)		
Less: Market-related salary adjustment	(6 000)	1
Market-related rental Australian operations	(5 000)	1
Maintainable EBITDA	**169 835**	
EBITDA multiplier	**Multiplier**	
Multiplier of similar company: EurekaPet (same country, same market) *Alternatively: Multiplier of similar company: Organica (same market, more than one country)*	8	1 1
Adjust down for lower anticipated growth *Alternatively: Adjust upwards for higher anticipated growth*	–1	1
Ultra Canin is a larger company – market power	+1	1
Valuation is for a minority interest of 33.33%, but it would give the acquiring shareholder control, therefore this should be considered to be a premium*	+1	1
Other valid adjustments *(max 3 marks for adjustments)* Listed - access to funding, marketability of the securities, Management - loss of Petrus/experience, Country risk - in case where Organica chosen, Competition - not adjusting for competition, and Geographical - presence in Australia versus Eureka	+/-	3
Adjusted multiplier	7	
Multiplier x maintainable EBITDA	**1 188 845**	1P
Add: Investment in SunSolar	15 200	1
CGT on SunSolar (Proceeds 15 200 – Base Cost 10 000) (1) x 80% x 27% (1)	(1 123)	2
Add: Excess cash and equivalents (inclusion) (Cash required 10%*871 214 = 87 121) (Excess cash therefore 297 927 – 87 121 = 210 806)	210 806	1P 1 1
Less: Shareholder's loan (debt)	(165 967)	1
Less: Outside shareholders' share (10% x R31 million)	(3 100)	1
Less: Once-off moving cost	(3 000)	1
Taxation consequence on moving cost (below the EBITDA line) (R3 million x 27%) *ALT:* capital in nature, therefore Rnil adjustment	810	1
Company value	1 242 471	1P
One third share for Petrus Mahlangu	414 157	1P

The management account numbers should be used with caution, as they have not yet been audited. The price should perhaps be conditional on confirmation of the numbers once audited.		1
Restriction on the transferability of shares may require an adjustment, it is not clear if, after the refusal of the shareholders, the shares could be sold without limit.		1
	Available	**31**
	Maximum	**17**
	Communication skills – layout and structure	*1*
	Total for part (a)	**18**

Part (b)	**Identify and explain the key strategic considerations for Ultra Canin resulting from Petrus leaving the company.**	**Marks**
1.	The **relationship with the funder** and the relationship with his chain of organic stores will be lost in the future. This has brought synergistic benefits in the past. 1.1 Any **additional funding** Ultra Canin may require would **not be as easily available**, and it would lose much of its cash in the sale transaction, having to repay the shareholder loan. 1.2 The **ability to partner with the chain of organics stores would be lost**, therefore it would be more challenging and costly to expand the business without the benefit of sharing resources.	1 1 1
2.	There is **an element of flexibility** that the remaining shareholders will now have without the constraints of Petrus, for instance the decisions will be taken between two shareholders versus the three.	1
3.	The **remaining** shareholders would have a **bigger share of the company**, therefore they would earn more returns, if each of the remaining two shareholders acquire an equal share of Petrus's shareholding.	1
4.	There will be a **loss of key strategic input and skills** from the accomplished director, as the company seems to be **replacing** the director with a lower-level resource in the form of a strategic manager (as indicative from the lower salary). Therefore, they may lose the level of strategic input, and there is the **advantage of the savings on the salary** and services to the company, provided by a cheaper resource.	1 1
5.	The **links** that the director provided in logistics and retail may be hard to **maintain without his influence**, and this may affect business operations negatively.	1
6.	This is an experienced director who is leaving versus the relatively lower **experience** of the remaining directors (Sihle and Penny).	1
7.	The **savings on rental income in Australia will be** lost if the company loses the connection.	1
8.	The **remaining two directors** will have an **increased workload**, and they will miss a third voice of reason.	1
9.	The **8% funding cost on the shareholder loan is beneficial**. If the prime rate is 11,75%, Ultra Canin would presumably **lose this benefit** if Petrus leaves.	1
10.	To assist the current directors and the new strategic manager, Ultra Canin can consider **requesting Petrus to still be involved on a part-time** or consultancy basis after his resignation. This will assist in maintaining the vital relationships with the retail and logistics portions of the business and enable other individuals to build relationships in the interim.	1
11.	**Petrus's departure would also potentially cause an immediate cash flow, and it should be considered if the company would be able to** afford the cash outflow (e.g repaying back of the shareholder loan).	1
	Available	**14**
	Maximum	**7**
	Total for part (b)	**7**

Part (c)	**Critically evaluate the two performance incentive options and advise the directors which of the two you would recommend.** • **Do not consider the tax consequences for either the employees or Ultra Canin.**	**Marks**
1	**Share option scheme**	
1.1 1.2 1.3	The company is a **private company**, therefore share options are **less attractive** as the **market value of the shares cannot be determined as readily** and cannot be tracked as one would do in a listed company. Employees would also **not be able to dispose** of the shares **with ease**, which means it would be more **difficult to realise their value**. **Valuations would need to be performed regularly**, which may be **costly** and could detract from the use of these instruments as a remuneration tool.	1 1 1
1.4	The share options would **align the interests** of the **employees** with those of the **shareholders**, which would limit agency costs.	1
1.5	The granting of the **share options** at market value would be **appropriate** because if no value is added by the staff to the company and the share price does not increase, they would not receive any reward either.	1
1.6	The **vesting requirement** that the employees would need to **remain in the employ** of the company for **three years** would be **appropriate**, as this would ensure the **company retains the skills for that period**. It encourages long-term behaviour, rather than short-term profiteering to the detriment of long-term profitability.	1
1.7 1.8 1.9	The requirement of maintaining an accounting ratio in the form of **ROI is not optimal. Economic measures should rather be used.** **Accounting measures** can be focused on in the **short term** and **manipulated** by actions that destroy value, such as selling assets for a profit, which also decreases the investment base. While this will result in a higher ROI, it damages long-term profitability. In addition, the **10% benchmark ROI does not seem to have any justification** and seems arbitrary. This would **demotivate employees.**	1 1 1
1.10	Depending on the **quantum**, this would also **dilute the existing shareholders'** investment holdings in the long run, which may create control or other shareholding issues.	1
1.11	Would employees be **attracted to the long term** and are employees willing to stay for such a long period? The **younger managers may want cash immediately** for their needs?	1
1.12	The benefit of the scheme is that there is **no cash outflow**, as it is **settled in shares.**	1
1.13	It is **not clear how the allocation** between employees **would work** and whether there is a level of subjectivity. It could cause issues with the remaining staff if **allocations are considered to be unfair**.	1
1.14	The **condition that options lapse** if the company fails to achieve a 10% ROI in any single year **could be seen as too stringent**. Even a temporary setback or a challenging economic environment could nullify the options, **demotivating employees** who might have otherwise contributed significantly to the company's success. Employees may feel that it is **unfair** that they could **lose their shares** if performance drops / because of **decisions made by top management**, especially where they have **no control over** / input into the performance measures.	1 1

2	**Bonus bank – balanced scorecard**	

2.1	The balanced scorecard metric would be **more appropriate for lower-level** employees who do not have control over all aspects of this business, as they would be **measured on elements that are within their sphere of control.**	1
2.2	The **employees would not need to lay out cash to exercise the options**, as they would with a share option (pay the exercise price), which would be more appropriate.	1
2.3	The **bonus bank is appropriate** as this would result in the **employees** having to **stay for four years** to earn their whole bonus, thus retaining the skills.	1
2.4	The **entire bonus falling away hardly seems fair**, especially to lower-level employees with limited decision-making powers. A **slight reduction** may be more appropriate.	1
2.5	The **employees** would be **incentivised to take a long-term view**, so as to not jeopardise long-term performance for a short-term gain, which would be adverse to the shareholders.	1
2.6	The **bonus bank would encourage consistent performance**, as the consequence of missing their targets in any one year would have a massive impact. They would lose all current and previously accumulated bonus amounts, as these would be forfeited.	1
2.7	**Allocations may be subjective** and based on the **importance of a role**. This may create issues with employees who disagree with allocations and become disgruntled.	1
2.8	The **cash payments are more attractive** to the employees who receive their reward earlier and directly in cash, with **no need to exercise and purchase shares.**	1
2.9	However, **the company does not receive the cash for the shares purchased**, therefore it has a **cash negative effect** for the company.	1
2.10	**The company** furthermore has to **pay out the bonuses**, which means that there is a double **negative cash impact** compared to the options.	1
2.11	There is **less risk** for **employees** as they are **remunerated regularly**, and therefore there is less risk related to their future service.	1
2.12	The **criteria** for the balanced scorecard appear to be **very generic** without information on how employees would be evaluated against the criteria. This may be a **cause for concern for employees if the evaluation criteria is unclear** or appears to be **unfair**.	1
2.13	A **balanced scorecard** can be **tailored to different roles and levels** within the company - employees are therefore evaluated based on criteria relevant to their specific roles and contributions, which is not necessarily the case with the share option scheme.	1
3	**Conclusion**	
3.1	**Both of the alternatives are good options**, but applicable to different types of employees. The share option rewards would be **better suited to the senior employees who have influence over all aspects of the business.**	1P
3.2	The **balanced scorecard and bonus bank option** would be a **better** fit for the **employees at lower levels** who cannot control all aspects of the performance.	1P
	Available	**30**
	Maximum	**10**
	Total for part (c)	**10**

Part (d)	**Discuss the normal tax and employees' taxation consequences of –** • **the share option scheme; and** • **the bonus bank scheme** **for Ultra Canin and for its employees.**	**Marks**
Share option scheme – normal tax consequences		
1	***Ultra Canin***	
1.1	The **issue of shares** is **not 'expenditure'**, and therefore **no s11(a) deduction** can be claimed for this (Labat). *ALT:* The **issue of shares does not lead to a diminution of net assets**, and therefore, it is **not "expenditure"** in terms of section **11(a),** and therefore, **not deductible**.	1
1.2	The granting of an option and the issue of shares is **not a disposal for CGT purposes** as indicated in terms of par 11(2)(*b*) of the Eighth Schedule, hence, **Ultra Canin will not have any CGT consequences**.	1
1.3	The **funds** (market value of the shares at the date of granting the option) **received** by Ultra Canin when the **options are exercised** are **excluded** from Ultra Canin's **gross income** as they are **capital in nature** (s1(1) – gross income definition).	1
1.4	These funds will **increase** Ultra Canin's **'contributed tax capital'** as they are proceeds from the issue of shares.	1
2	***Employees***	
2.1	The share options would be considered to be an **'equity instrument'** as defined in **s8C**(7)) (para. (a) of that definition) as they constitute **options to acquire shares in a company**.	1
2.2	The share options would be considered to be a **'restricted equity instrument'** (s8C(7)) as the employee would **need to remain in the employ** of Ultra Canin for the **three-year period**, and the options would lapse if the company earned an accounting return on investment of less than 10% in any of the years.	1
	Date the options are granted	
2.3	A **gain**, which is the **difference** between the **market value** of the share options when issued and the **consideration paid** of Rnil by the employee, would have to be included in **gross income**.	1
2.4	The **gain** would be **exempt** from income as the equity instrument has **not yet vested** (s10(1)(nD)).	1
	Date the options vest	
2.5	The share option **vests** when the **restrictive conditions are lifted**, which is in **year four**. *Note to markers: this point can be addressed as part of normal tax or employees' tax.*	1
2.6	Upon vesting, a **gain**, which is the difference between the **market value** on the **date of vesting** (being the market value of the shares) and the **consideration paid** by the employee (the market value on the date the options were granted) must be included in **gross income** in terms of s8C(2)(a)(ii) read with par (n) of the gross income definition.	1
2.7	Should the **share options lapse**, the **employee dispose** of the **share option** or **die**, **before the restrictions are lifted**, the share options would **vest** on that date. Should the **employee resign**, **no tax implications** would arise.	1
2.8	Although the gain is **capital in nature,** as the employees **held** the **share options** for a period of **at least three years**, the **gain** on vesting will be	

	included in **gross income** in terms of s8C(2)(a)(ii) read with par (n) of the gross income definition, as s8C applies notwithstanding the provisions of s9C and s23(m).	1
2.9	The share options would **not** be considered a **taxable fringe benefit** as equity instruments contemplated in s8C are not considered as such (para. 2(a) of the **7th Schedule excludes any qualifying equity share** acquired by an employee as contemplated in **s8C**). Therefore, there would be no inclusion in gross income in terms of par (i). *ALT:* The amount is **not** included in **gross income** in terms of **par (c)** of the gross income definition despite there being a causal relationship between the services rendered and the shares received, as **s8C is excluded** from the provisions of par (c).	1
2.10	Any **capital gain**/capital **loss** on the share option realised by an employee upon the **exercise** of a **share option** needs to be **disregarded** in terms of par 58 of the Eighth Schedule.	1
2.11	The **base cost** of the **shares** is equal to the **market value** of the **shares** at the **date of vesting** in terms of par 20(1)(h) of the Eighth Schedule.	1
Bonus bank scheme – normal tax consequences		
3	***Ultra Canin***	
3.1	The **bonus** that would be paid (be it 25% or 75% that may be paid in later periods) would be **deductible** in terms of **s11(a)**, as it meets the requirements of s11(a).	1
3.2	However, Ultra Canin may only **deduct** the bonus when it is **actually paid** (s7B(2)) because this bonus is **variable remuneration**.	1
4	***Employees***	
4.1	**25%** of the **bonus** that the employee is entitled to in the immediate year would be included in **gross income** (para. (c) of the gross income definition read together with s7B).	1
4.2	However, the bonus will only be included in **gross income** when it is **paid** to an employee (s7B(2)).	1
4.3	The **remainder** of the bonus (i.e., **75%)** will only be included in **gross income** when an employee becomes **unconditionally entitled** to the amount (when the requirements of the balanced scorecard metric are met), **and** in terms of s7B, it will only be included in gross income when it is **paid**.	1
Employees' Tax consequences		
5.1	Employees' tax withheld must be **paid over to SARS** by the **7th day** of the month **following** the **month** in which the employees' tax was **withheld**.	1
Share option scheme		
	Ultra Canin and Employees	
	Date the options are granted	
5.2	On the granting of the share options, the gain, as explained above, would **not** be considered as **'remuneration'** as there would be **no 'income'**. The **gain** would have been **exempt** when the share options were issued in terms of s10(1)(nD).	1
5.3	Therefore, **no employees' tax** would be withheld by Ultra Canin on the date the options are granted.	1
	Date the options vest	
5.4	In terms of par (e) of the definition of "remuneration", the **gain** that arises at the **time of vesting** in year four is included in **income** in terms of s8C and, therefore, regarded as **"remuneration"**.	1
5.5	Therefore, **employees' tax** must be **withheld** by Ultra Canin at the time the **share options vests**.	1

5.6	In terms of par 11A(4) of the Fourth Schedule, Ultra Canin must obtain a **directive** from SARS **determining** the amount of **employees' tax**.	1
Bonus bank scheme		
	Ultra Canin and Employees	
6.1	The **bonus** would be regarded as '**remuneration'** in terms of par (a) definition of 'remuneration' of the Fourth Schedule.	1
6.2	Therefore, **employees' tax** must be **withheld** by Ultra Canin at the time the **bonus is paid** in terms of par 2(1B) of the Fourth Schedule.	1
7	***Employees***	
7.1	The **employees' tax withheld** would **reduce** the **normal tax liability** of the **employee** on assessment. *Note to markers: this can be discussed as part of the share options or bonus scheme.*	1
	Available	**29**
	Maximum	**14**
	Communication skills – clarity of expression	*1*
	Total for part (d)	**15**