

**1 Background**

Ultra Canin (Pty) Ltd ('Ultra Canin') is a South African tax resident company that manufactures and sells premium pet food in the South African and Australian markets. The company has a 31 December year end.

Two university friends, Ms Sihle Ndlovu and Ms Penny Brand, have a shared passion for animals and organic nutrition for pets and therefore decided to create an organic pet food company, Ultra Canin.

Penny designed the product offering, and Sihle created a business plan which they presented to a group of angel investors. Mr Petrus Mahlangu, founder of a chain of health food stores, offered to provide the start-up capital as well as share business links he had with the logistics side of the business. Sihle, Penny and Petrus agreed to each take an equal share of the business.

The company was immediately successful and started breaking even after only two years, experiencing incredible growth and gaining a reputation for excellence. The Covid-19 pandemic raised awareness around the benefits of healthy eating for everyone, pets included. As a result, during the last three years, growth in revenue and gross profit has averaged 20% per annum but is expected to decrease to a rate of 10% as the market stabilises.

Recognising this shift in pet ownership dynamics, the company seized the opportunity to expand its business. This expansion included additional production capacity and an entrance into the Australian market in the 2020 financial year (FY2020). The Australian expansion was primarily driven by Petrus, who was entering the same market with his health store chain. The products in the health shop and pet food market required the same infrastructure and similar supply chains, resulting in shared overhead costs.

**2 Investment exit**

During a recent shareholders' meeting, Petrus announced that he wanted to retire and sell his shares. The Ultra Canin shareholders' agreement includes a clause that the shares had to be offered to existing shareholders first.

The shareholders agreed that a valuation should be prepared, and Sihle suggested they use a market-based valuation approach using an EBITDA multiple.

The following are extracts from the group annual financial statements of Ultra Canin for the past three years:

<b>Ultra Canin (Pty) Ltd</b>				
<b>Statement of financial position as at 31 December</b>				
	Note	Audited	Audited	Draft management accounts
		2021	2022	2023
		R'000	R'000	R'000
<b>Assets</b>				
<b>Non-current assets</b>		<b>88 226</b>	<b>95 459</b>	<b>110 050</b>
Property, plant and equipment	1	84 248	83 152	96 230
Investment in marketable securities	2	–	10 000	10 000
Deferred tax asset		3 978	2 307	3 820
<b>Current assets</b>		<b>221 572</b>	<b>316 923</b>	<b>410 907</b>
Inventory		45 266	87 145	110 878
Trade and other receivables		4 398	1 751	2 102
Cash and cash equivalents	3	171 908	228 027	297 927
<b>Total assets</b>		<b>309 798</b>	<b>412 382</b>	<b>520 957</b>
<b>Equity and liabilities</b>				
<b>Equity</b>		<b>141 744</b>	<b>218 743</b>	<b>306 373</b>
Share capital and reserves		140 479	217 354	304 335
Non-controlling interest	4	1 265	1 389	2 038
<b>Liabilities</b>				
<b>Non-current liabilities</b>		<b>146 094</b>	<b>157 901</b>	<b>170 274</b>
Shareholder loan	5	142 290	153 673	165 967
Deferred tax liability		3 804	4 228	4 307
<b>Current liabilities</b>		<b>21 960</b>	<b>35 738</b>	<b>44 310</b>
Trade and other payables		19 232	32 851	41 032
Provisions		906	787	911
Current tax payable		1 822	2 100	2 367
<b>Total liabilities</b>		<b>168 054</b>	<b>193 639</b>	<b>214 584</b>
<b>Total equity and liabilities</b>		<b>309 798</b>	<b>412 382</b>	<b>520 957</b>

<b>Ultra Canin (Pty) Ltd</b>				
<b>Statement of comprehensive income for the year ended 31 December</b>				
	Note	Audited	Audited	Draft management accounts
		2021	2022	2023
		R'000	R'000	R'000
Revenue		605 010	726 012	871 214
Cost of sales		(301 700)	(363 030)	(434 550)
<b>Gross profit</b>		<b>303 310</b>	<b>362 982</b>	<b>436 664</b>
Other income	2	0	1 802	507
Administrative expenses		(29 011)	(31 167)	(36 602)
Other operating expenses	6	(189 001)	(208 546)	(241 473)
<b>Operating profit</b>		<b>85 298</b>	<b>125 071</b>	<b>159 096</b>
Finance income	7	8 054	12 015	14 546
Finance costs	5	(10 540)	(11 383)	(12 294)
<b>Profit before taxation</b>		<b>82 812</b>	<b>125 703</b>	<b>161 348</b>
Taxation		(26 470)	(33 365)	(39 078)
<b>Profit and total comprehensive income for the year</b>		<b>56 342</b>	<b>92 338</b>	<b>122 270</b>

## Notes

- 1 Depreciation on property, plant and equipment of R17 645 000 for 2021, R16 630 000 for 2022, and R19 246 000 for 2023 is included in the other operating expenses and cost of sales line items.
- 2 The investment in marketable securities relates to shares purchased in SunSolar Ltd, a listed company that manufactures solar panels and inverters, as a growth investment for the company. The market value of these shares is currently R15,2 million. Other income relates only to this investment.
- 3 The company requires cash and cash equivalents to support the operations of the company, amounting to approximately 10% of the relevant year's revenue.
- 4 The non-controlling interest relates to an investment in a small subsidiary that manufactures vitamins and minerals that are used in the production of the pet food. The company owns 90% of this subsidiary, and the original founder owns the remaining 10%. The market value of this subsidiary was estimated to be R31 million at 31 December 2023. This value has not yet been adjusted in the draft management accounts.
- 5 The shareholder loan is the original loan provided to the company by Petrus. The loan bears interest at a rate of 8% per annum and interest is capitalised to the loan balance annually.
- 6 Petrus is employed as a strategic director, and normally receives a salary of R4 million per annum. If his shares are sold, he will resign from his position as strategic director, and a new strategic manager will be employed at an expected cost of R1 million per annum.
- 7 Finance income relates to interest earned on cash and cash equivalents. The company has on average earned interest of approximately 6% per annum on these cash balances.

## Additional information

- All three shareholders are directors of the company. The shareholders had agreed that they would take reduced bonuses in the FY2023, and rather pay out a dividend in lieu of bonuses. This created an overall tax saving between the company and the directors, as the sum of the income tax paid by the company and the dividends tax levied on the dividends is less than the maximum marginal rate. The directors are currently all at the maximum marginal tax rate for individuals. A dividend of R6 million was agreed to by the directors and each shareholder therefore received a dividend of R2 million.
- The Ultra Canin operations in Australia are housed, rent free, in the factory and office space of Petrus' health store chain. This arrangement will only be in effect for as long as Petrus is a shareholder of Ultra Canin. Ultra Canin would incur a once-off moving cost for all machinery and office equipment of R3 million if it moved to its own premises. It is expected that rental of the office space would amount to R5 million per annum.
- The following information was sourced from listed competitors currently trading on public markets:

Company	Description	P/E ratio	EBITDA multiple
Organica International Inc.	An American organics company that manufactures and sells organic pet foods on a global basis, including in South Africa, as an import product.	13	6
Pets R Us Ltd	A pet food and related products company that manufactures and sells a diversified range of pet products in the South African market.	12	5
Eureka Pet Ltd	A South African company that operates in the South African market, manufacturing and selling organic pet food. The company had revenue of R230 million in the current year.	15	8
Retail sector, Johannesburg Stock Exchange (JSE)	The average ratios for the South African retail sector for companies listed on the JSE.	10	6

- In the last few years following the growth in the industry, the market has become fiercely competitive, and this trend is expected to continue as new companies enter the market. This is an anticipated new trend and has not been priced into the market as yet.
- The expansion into the Australian market has been regarded as a great success and was seen by the directors as a test of the product in the global market. Ultra Canin is planning to expand to other countries soon.

### 3 Performance incentive scheme

In the last two years several staff members had left Ultra Canin to join competitors, where they were offered lucrative positions. The directors are considering the introduction of a performance incentive scheme to incentivise younger managers within the company. The following two options are currently being considered:

### **3.1 Share option scheme**

The staff would be granted share options, with the exercise price being the market value of a share on date of grant. This is not a broad-based employee share scheme. The share options can be exercised in the fourth year after being granted. The holders are expected to exercise their options and buy their shares if the share price increases. The staff would need to remain in the employ of the firm until they exercise their options as a vesting condition, and the options would lapse if the company earned an accounting return on investment of less than 10% in any of the years during the holding period prior to vesting.

### **3.2 Bonus bank**

The alternative would be cash remuneration, based on a balanced scorecard metric. This scorecard would have the following core criteria:

- The job description of the employee; and
- The importance of the employee's role to the overall strategy of the company.

Any bonus earned on the balanced scorecard metric would be placed into a bonus bank. The employee would be entitled to 25% of that bonus in the year in which it is awarded, and then 25% in each of the following three years. This would be subject to them still meeting the requirements of the balanced scorecard metric in the following years. If not met, the remaining amount in the bonus bank for all years would fall away.

**INITIAL TEST OF COMPETENCE, JUNE 2024**

**PROFESSIONAL PAPER 2**

**This paper consists of two questions.**

**Answer each question in a separate answer book.**

<b>PAPER 2 QUESTION 1 – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	Perform, outlining key assumptions, an EBITDA multiple earnings-based valuation for Petrus’ shareholding as at 31 December 2023.	17	
	<i>Communication skills – layout and structure</i>	1	18
(b)	Identify and explain the key strategic considerations for Ultra Canin resulting from Petrus leaving the company.	7	7
(c)	Critically evaluate the two performance incentive options and advise the directors which of the two you would recommend.	10	
	<ul style="list-style-type: none"> <li>Do not consider the tax consequences for either the employees or Ultra Canin.</li> </ul>		10
(d)	Discuss the normal tax and employees’ tax consequences of –		
	<ul style="list-style-type: none"> <li>the share option scheme; and</li> <li>the bonus bank scheme</li> </ul> for Ultra Canin and for its employees.	14	
	<i>Communication skills – clarity of expression</i>	1	15
<b>Total for question 1</b>			<b>50</b>