

1 Background

Build Ltd ('Build') is a JSE-listed retailer of building materials and associated products that it sells directly to its customers through its stores in Southern Africa. Build prides itself on selling a quality product range at competitive prices to meet the needs of homebuilders and contractors.

Prior to the outbreak of the Covid-19 pandemic, the building sector in general had seen a decline of its largest market, South Africa, largely driven by slow growth in South Africa. After the initial lockdown, there was an increase in the demand for building materials, due to a renewed interest by home-owners in undertaking home improvements.

The trend is expected to continue in the near future as the shift to remote working continues. The increased consumer spending led to double-digit turnover growth for Build during the lockdown. Its share price increased by almost 4% following the release of strong results for the year ended 31 December 2021 (FY2021). The company has recently appointed a new chief executive officer (CEO), Mukuru Mpumwire, to execute future growth initiatives.

2 Possible acquisition

The management of Build plans to grow by expanding into additional segments of the building supplies market and through geographic expansion. Build accordingly wishes to bid for 100% of the equity of National Building Supplies (Pty) Ltd ('NBS'). NBS is a building materials wholesaler that provides building materials to the commercial and industrial markets. NBS is owned by a large conglomerate that is seeking to divest from the building materials sector.

NBS experienced the same surge in growth after the initial South African lockdown. Consequently, the management of NBS would like to increase capital expenditure and open new stores during the next four years.

The following are extracts from the financial statements of NBS for FY2021 and forecast information for FY2022 and FY2023:

| NBS | | | | |
|--|------|----------------|----------------|----------------|
| Statement of financial position as at 31 December | | | | |
| | Note | Actual | Forecast | Forecast |
| | | 2021 | 2022 | 2023 |
| | | R'000 | R'000 | R'000 |
| Assets | | | | |
| Non-current assets | | | | |
| Property, plant and equipment | | 184 428 | 183 152 | 196 230 |
| Intangible assets | | 42 154 | 41 916 | 41 686 |
| Investment property | 1 | – | 3 000 | 3 000 |
| Deferred tax asset | | 13 978 | 12 307 | 13 820 |
| Current assets | | | | |
| Inventory | | 145 266 | 187 145 | 210 878 |
| Trade and other receivables | 2 | 14 398 | 1 751 | 2 102 |
| Prepayments | | 3 615 | 2 878 | 3 101 |
| Cash and cash equivalents | | 171 908 | 228 027 | 297 927 |
| Total assets | | | | |
| | | 575 747 | 660 176 | 768 744 |
| Equity and liabilities | | | | |
| Equity | | | | |
| Share capital and reserves | | 140 479 | 217 354 | 304 335 |
| Non-controlling interest | | 1 265 | 1 389 | 2 038 |
| Liabilities | | | | |
| Non-current liabilities | | | | |
| Long-term loan | | 142 290 | 130 822 | 128 890 |
| Deferred tax liability | | 3 804 | 4 228 | 4 307 |
| Current liabilities | | | | |
| Trade and other payables | | 269 157 | 287 567 | 307 697 |
| Short-term loans | | 16 024 | 15 929 | 18 199 |
| Provisions | | 906 | 787 | 911 |
| Current tax payable | | 1 822 | 2 100 | 2 367 |
| Total liabilities | | | | |
| | | 434 003 | 441 433 | 462 371 |
| Total equity and liabilities | | | | |
| | | 575 747 | 660 176 | 768 744 |

| NBS | | | | |
|--|-------------|---------------|-----------------|-----------------|
| Statement of total comprehensive income | | | | |
| for the year ended 31 December | | | | |
| | Note | Actual | Forecast | Forecast |
| | | 2021 | 2022 | 2023 |
| | | R'000 | R'000 | R'000 |
| Revenue | | 1 205 010 | 1 385 762 | 1 593 626 |
| Cost of sales | | (891 255) | (1 029 569) | (1 185 492) |
| Gross profit | | 313 755 | 356 193 | 408 134 |
| Other income | 3 | 1 317 | 1 802 | 507 |
| Administrative expenses | | (29 011) | (31 167) | (36 602) |
| Other operating expenses | | (189 001) | (208 546) | (241 473) |
| Operating profit | 4 | 97 060 | 118 282 | 130 566 |
| Finance income | | 8 054 | 8 015 | 11 546 |
| Finance costs | | (16 946) | (16 057) | (16 053) |
| Profit before taxation | | 88 168 | 110 240 | 126 059 |
| Taxation | | (26 470) | (33 365) | (39 078) |
| Profit and total comprehensive income for the year | | 61 698 | 76 875 | 86 981 |

| NBS | | | | |
|--|-------------|---------------|-----------------|-----------------|
| Relevant information from the statement of cash flows | | | | |
| for the year ended 31 December | | | | |
| | Note | Actual | Forecast | Forecast |
| | | 2021 | 2022 | 2023 |
| | | R'000 | R'000 | R'000 |
| Purchase of investment property | 1 | – | (3 000) | – |
| Purchase of property, plant and equipment | 5 | (1 679) | (16 299) | (27 447) |
| Proceeds on disposal of property, plant and equipment | | 1 690 | 3 344 | – |
| Finance income | | 8 054 | 8 015 | 11 546 |

Notes

- During FY2021, NBS entered into an agreement with a leading property developer to acquire a retail unit in a shopping centre in Gauteng. As part of this agreement, NBS agreed to pay the full purchase price of R3 million in FY2022. NBS intends to let the unit once completed. The shopping centre is under construction and is expected to open for trading early in FY2023.
- As a result of the economic environment, management undertook to tighten credit conditions in future periods.
- Other income includes the following:

| | Actual | Forecast | Forecast |
|---|---------------|-----------------|-----------------|
| | 2021 | 2022 | 2023 |
| | R'000 | R'000 | R'000 |
| Income from investment property (see note 1) | – | – | 405 |
| Insurance recovery (timing of expected receipt) | 202 | – | 102 |
| Profit on disposal of property, plant and equipment | 1 115 | 1 802 | – |

- 4 The operating profit for the year was determined after taking the following items into account:

| | Actual | Forecast | Forecast |
|--------------|---------------|---------------|---------------|
| | 2021 R'000 | 2022 R'000 | 2023 R'000 |
| Depreciation | 13 129 | 14 429 | 14 369 |
| Amortisation | 241 | 238 | 230 |

- 5 The capital expenditure is for building and installing infrastructure for new stores, store refurbishments and/or relocations.

The management of Build asked the financial manager to perform a preliminary valuation to determine a reasonable offer price for NBS. The results of the valuation are set out below:

| 'Free cash flow to operation' valuation of NBS as at 31 December 2021 | | | | |
|--|------|-------|----------|-----------|
| Free cash flows | Note | 2021 | 2022 | 2023 |
| | | R'000 | R'000 | R'000 |
| Operating profit | | | 118 282 | 130 566 |
| Add back: Depreciation | a | | 14 429 | 14 369 |
| Tax saving on wear and tear | a | | 4 040 | 4 023 |
| Finance income | | | 8 015 | 11 546 |
| Taxation | b | | (33 087) | (38 811) |
| Add back: Non-recurring item | c | | 116 | – |
| Movement in deferred tax liability | | | (424) | (79) |
| Movement in current assets: | | | | |
| Inventory | | | (41 879) | (23 733) |
| Trade and other receivables | | | 12 647 | (351) |
| Prepayments | | | 737 | (223) |
| Cash | | | (56 119) | (69 900) |
| Trade and other payables | | | 18 410 | 20 130 |
| Short-term loans | | | (95) | 2 270 |
| Provisions | d | | – | – |
| Current tax payable | | | 278 | 267 |
| Purchase of property, plant and equipment | | | 16 299 | 27 447 |
| Add back: Non-controlling interest | e | | 1 389 | 2 038 |
| | | | 63 038 | 79 559 |
| Terminal value $[(155\,843 \times 1,1)/(0,15 - 0,1)]$ | | | | 3 428 546 |

| | Note | 2021 |
|-------------------------------|------|-----------|
| | | R'000 |
| Discounted cash flows at 15% | f | 114 974 |
| Terminal value | f | 3 428 546 |
| Less: Long-term loan | | (142 290) |
| Add: Cash balance | | 171 908 |
| Add: Intangible assets | | 42 154 |
| Add: Investment property | | 3 000 |
| Add: Non-controlling interest | | 1 265 |
| Value of equity | | 3 619 557 |

Notes to the free cash flow valuation

- (a) Depreciation is added back as this is not a cash flow item. However, the tax saving on the wear-and-tear allowance is a cash saving and therefore included in the free cash flow calculation.
- (b) The actual tax paid was determined as follows:

| | 2022 | 2023 |
|--|---------|---------|
| | R'000 | R'000 |
| Tax payable: Opening balance | 1 822 | 2 100 |
| Tax from statement of comprehensive income | 33 365 | 39 078 |
| Tax payable: Closing balance | (2 100) | (2 367) |
| Taxation paid | 33 087 | 38 811 |

- (c) NBS secured a contract for the delivery of construction material that exceeds the size that NBS's own delivery vehicles can handle. The non-recurring item refers to the cost of delivering this material of abnormal size to a customer. This type of delivery is not expected to occur again in the future.
- (d) Movement in provisions was not included as this is not a cash-flow item.
- (e) The non-controlling interest was added back as the purpose of the valuation is to value only the equity of the company.
- (f) The discount rate used for the valuation was the average cost of capital for listed companies in the construction sector.
- (g) All calculations of the valuation are arithmetically accurate.

3 Financing

Build intends to fund the largest part of the acquisition of NBS with debt financing. The following alternatives have been identified:

1 R2 billion loan from Tselane Ventures (debt fund)

| | |
|---------------------------|--|
| Interest | At Johannesburg Interbank Agreed Rate (JIBAR) (currently 5%) plus 4% |
| | Compounded annually in arrears |
| | Capitalised to the outstanding loan balance |
| Upfront transaction costs | 3% of the principal amount |
| Principal amount | Repayable in a single payment at the end of five years |

2 R2 billion loan from Ace Bank

| | |
|---------------------------|---|
| Interest | Fixed interest rate of 9% per annum |
| | Calculated and paid annually in arrears |
| Upfront transaction costs | Arrangement fee of 1% of the principal amount |
| Principal amount | Repayable in five equal annual capital payments at the end of each year |

Additional information

- Tax payments or allowances are made in the same year as the relevant cash flow that created the tax liability / saving;
- Assume the company tax rate is 28%;
- All cash flows occur at the end of the year, unless stated otherwise;
- Build generates sufficient other income to utilise any tax losses in the year that these are incurred; and
- All initial transaction and financing costs are tax deductible.

4 Performance incentive scheme

Mukuru requested that a performance incentive scheme be implemented from FY2022 to FY2024 to incentivise him to drive value creation for Build's shareholders. He proposed that the scheme be set up as follows:

- At the end of each financial year, 2,5% of the increase in the market capitalisation of Build from the base date is determined. The base date is the date of Mukuru's appointment, namely 1 January 2022.
- The vesting amount is calculated as follows:
 - On 31 December 2022: 60% of the increase calculated on this date
 - On 31 December 2023: 80% of the total increase calculated on this date
 - On 31 December 2024: 100% of the total increase calculated on this date
- Mukuru is then paid, in cash, the difference between the vested amounts annually. Payment is to take place one day after each financial year end.

Subsequent to Mukuru's proposal, the board of directors of Build received the following information, prepared by an independent research analyst, regarding the expected share price and number of issued shares of Build for the years ending 31 December:

| | 2021 (actual) | 2022 | 2023 | 2024 |
|-------------------------------|----------------------|-------------|-------------|-------------|
| Share price (R) | 311 | 360 | 345 | 370 |
| Number of shares in issue | 20 275 448 | 20 275 448 | 20 275 448 | 20 500 000 |
| Market capitalisation (R'000) | 6 305 664 | 7 299 161 | 6 995 030 | 7 585 000 |

The share price decrease in FY2023 is based on the expectation of constrained consumer income following the introduction of additional taxes.

**INITIAL TEST OF COMPETENCE, JUNE 2022
PROFESSIONAL PAPER 2**

| PAPER 2 QUESTION 2 – REQUIRED | | Marks | |
|--------------------------------------|--|------------------|--------------|
| | | Sub-total | Total |
| (a) | Criticise the free cash flow valuation performed by the financial manager. | 19 | |
| | <ul style="list-style-type: none"> Do not re-perform the valuation. <p><i>Communication skills – appropriate style</i></p> | 1 | 20 |
| (b) | Calculate and conclude which of the two financing alternatives would be the most cost effective way for Build to raise the required financing to acquire NBS. | 15 | |
| | <ul style="list-style-type: none"> Round your answer to two decimal points. | | 15 |
| (c) | In relation to the incentive scheme proposed by Mukuru – | | |
| | (i) calculate the amounts due in cash to Mukuru at the end of each financial year from FY2022 to FY2024; and | 6 | |
| | (ii) discuss the advantages and disadvantages of the proposed incentive scheme from Build’s perspective. | 8 | |
| | <ul style="list-style-type: none"> Ignore taxation for the purposes of the calculation. <p><i>Communication skills – layout and structure</i></p> | 1 | 15 |
| Total for question 2 | | | 50 |
| TOTAL FOR PAPER 2 | | | 100 |