

QUESTION 1

100 marks

Minkam College (Pty) Ltd ('Minkam') owns and operates three private schools in the Gauteng province. The first school was opened in 2002 and two further schools were opened during 2007 and 2010 respectively. Minkam's vision is to provide world-class education to its learners at an affordable price. Each school caters for learners from grade 0 to grade 12.

Minkam is registered with the Independent Examinations Board (IEB) and its grade 12 pupils write the IEB examinations. Minkam has achieved a 100% pass rate in the IEB examinations over the past ten years and most of its learners qualify for admission to tertiary education.

Minkam also offers a range of sporting and cultural activities to learners to ensure they receive a balanced education. The following are the core values of Minkam schools:

- Respect for self and others;
- Critical thinking;
- Accountability;
- Spirituality; and
- Community service.

Mr Matthew Minkam provided the initial capital to start Minkam in 2001. Mr Minkam retains a 30% shareholding in the company. The remaining shareholders of Minkam are as follows:

- New Growth Fund III, a private equity fund (30%);
- Ms Isabella Bortcelli, the chief executive officer (CEO) of Minkam (20%);
- Mr Rubin Isaacs, the chief financial officer (CFO) of Minkam (10%); and
- The Minkam Staff Trust, the beneficiaries of which are the Minkam schools' teachers (10%).

New Growth Fund III subscribed for 30% of the shares in issue of Minkam at par value in 2008 and provided an interest-bearing shareholder's loan of R40 million to Minkam. The loan balance at 31 March 2014 was R12 558 000.

Growth strategies

Given the demand for private schooling in South Africa, Minkam intends to expand its presence in Gauteng and enter other provinces. The company could either open new schools or acquire existing private schools. Acquiring existing schools is the preferred option, as the company would acquire going concerns with track records.

Opening new schools involves considerable time and effort. For new schools to be potentially viable, the following conditions need to be present:

- The population density within a radius of 20 km around the new school needs to be high enough to enable Minkam to attract sufficient learners to the school;
- The families of potential learners need to earn sufficient income to afford Minkam's fees;
- There should be limited competition from other schools in the area (demand for private education needs to exceed existing supply from other private schools and from government schools providing quality education); and
- Land to be acquired has to be relatively flat and large enough to make it possible to erect school buildings and sports fields in order to cater for at least 1 000 learners. Minkam estimates that vacant land of at least 7 ha is required for a new school.

Minkam intends listing on the Johannesburg Stock Exchange (JSE) within the next three years. Education businesses listed on the JSE are currently trading on high price earnings (PE) multiples. Minkam hopes to build critical mass ahead of listing to attract sufficient

interest from fund managers and the investing public. The main aim of listing is to raise capital on attractive terms to fund future expansion. In addition, listing would allow shareholders to readily sell their shares and realise value for past efforts. New Growth Fund III, in particular, is keen to sell some of its shareholding.

Potential acquisition of Arrow College

The CEO of Minkam has been in discussions with the shareholders of Arrow College for the past year regarding the possible sale of their shareholding in this company to Minkam. Arrow College is a private school based in Mpumalanga and currently has 650 pupils enrolled. Salient details of Arrow College are summarised in the table below:

Year end: March	2014	2013
	R'000	R'000
Revenue	17 225	15 360
Earnings before interest, taxation, depreciation and amortisation (EBITDA)	3 275	2 765
Earnings before interest and taxation	2 920	2 415
Profit after taxation	1 590	1 140
Land, buildings and equipment	17 500	18 500
Net interest-bearing debt	9 600	10 500
Total equity	6 090	4 500
Number of learners	650	640
Total number of staff	108	110

The CEO of Minkam is excited about the acquisition opportunity as it would represent geographic diversification for the company and Minkam could achieve cost savings of at least R400 000 annually through shared infrastructure (finance, administration, human resources and credit control functions).

The shareholders of Arrow College have indicated that they would be prepared to sell 100% of the shares in the company for R33 800 000. They have derived their valuation of Arrow College as follows:

Average PE multiple of similar listed companies	24,0
Adjustments	
Unlisted status of Arrow College	(3,6)
Smaller size of Arrow College	(2,4)
Appropriate PE multiple for Arrow College	18,0
	R'000
Profit for the year – 2014	1 590
Cost savings (after tax) – 2015	288
Pro forma profit for the year	1 878
Resultant valuation of 100% of the shares of Arrow College	33 804

The board of directors of Minkam has indicated that it is not prepared to offer more than R20 million for 100% of the shares of Arrow College. This is based on their estimate of the cost of erecting a school of a similar size in Mpumalanga.

Minkam financial results

The abridged financial results and financial position of Minkam for the year ended 31 March 2014 ('FY2014') are summarised in the tables below:

MINKAM (PTY) LTD			
STATEMENTS OF COMPREHENSIVE INCOME			
Year end: March		2014	2013
	Notes	R'000	R'000
Revenue	1	77 650	70 800
Other income	2	1 010	850
Operating expenses	3	(61 665)	(57 182)
Earnings before interest, taxation, depreciation and amortisation		16 995	14 468
Depreciation		(1 750)	(1 670)
Earnings before interest and taxation		15 245	12 798
Interest income		245	275
Finance costs	4	(5 412)	(6 121)
Profit before taxation		10 078	6 952
Taxation		(2 822)	(1 947)
Profit for the year		7 256	5 005

MINKAM (PTY) LTD			
STATEMENTS OF FINANCIAL POSITION			
Year end: March		2014	2013
	Notes	R'000	R'000
Non-current assets			
Land		35 000	35 000
Buildings		46 550	45 000
Furniture, fittings and equipment		8 700	8 500
Current assets		7 158	7 615
Trade and other receivables		2 550	2 110
Cash and cash equivalents		4 608	5 505
Total assets		97 408	96 115
Ordinary share capital		10 000	10 000
Retained income		33 706	26 450
Total equity		43 706	36 450
Non-current liabilities			
Long-term loans	4	33 900	41 287
Current liabilities		19 802	18 378
Short-term loans	4	7 387	6 589
Taxation		670	540
Income received in advance	5	6 870	6 899
Trade and other payables		4 875	4 350
Total equity and liabilities		97 408	96 115

Notes to the abridged financial information

- 1 Revenue represents tuition fees received and receivable. Details of the number of learners and average tuition fees are summarised in the table below:

	2014	2013
Total number of enrolled learners	2 415	2 400
Average number of learners per school	805	800
Average tuition fee per learner	R32 153	R29 500

- 2 Other income represents fees charged for aftercare services provided to learners.
- 3 Operating expenses comprise the following:

	2014	2013
	R'000	R'000
Employee costs	50 155	46 800
Bad debts	1 080	1 062
Other operating costs	10 430	9 320
Total operating expenses	61 665	57 182

The total number of staff (teachers and support staff) at 31 March 2014 was 258 (2013: 260).

It is estimated that 50% of other operating costs are fixed in nature.

- 4 Interest-bearing debt comprises the following:

	2014	2013
	R'000	R'000
Mortgage bond		
Closing balance	28 729	32 173
Short-term portion	(3 771)	(3 444)
Non-current portion	24 958	28 729
Shareholder's loan		
Closing balance	12 558	15 703
Short-term portion	(3 616)	(3 145)
Non-current portion	8 942	12 558

The mortgage bond bears interest at a fixed rate of 9,5% per annum (this would be 10% per annum if a variable rate was in effect) and is repayable in annual instalments in arrears of R6 500 000. The mortgage bond is due to be fully repaid on 31 March 2020.

The unsecured shareholder's loan bears interest at 15,0% per annum and is repayable in annual instalments in arrears of R5 500 000. This loan is due to be fully repaid on 31 March 2017.

- 5 Minkam receives tuition fees from certain parents in advance. These amounts are recognised in revenue over the period that tuition is provided.
- 6 Minkam paid no dividends in FY2014.

Board meeting held on 30 May 2014

The board of directors of Minkam met on Friday, 30 May 2014. Various matters were discussed and the following was noted:

- The commercial bankers of Minkam are not prepared to advance further loans to Minkam for the purpose of acquiring Arrow College while the company's debt to equity ratio is higher than 50%;
- New Growth Fund III is not prepared to invest any further capital in Minkam. Instead, the fund wishes to sell its shareholding in the company over the next three years;
- The CEO and CFO of Minkam have met with various potential investors to fund potential acquisitions and/or organic growth. The most promising prospect is Infinity Capital (Pty) Ltd ('Infinity'), which has offered to subscribe for new shares to the value of R30 million in Minkam; and
- A letter was received from a group of 20 parents of learners enrolled at Minkam in March 2014. The letter expressed outrage that Minkam is generating profits at the expense of learners and parents. Their view is that Minkam should rather use profits generated to reduce tuition fees or to provide bursaries for underprivileged learners.

Potential investment by Infinity

Infinity has tabled an offer to subscribe for new shares to the value of R30 million to be issued by Minkam, based on the following valuation principles:

- The appropriate cost of equity for Minkam is deemed to be 13,2% based on prevailing long-dated government bond yields, the estimated market risk premium and beta coefficients of educational businesses listed on the JSE;
- The free cash flows generated by Minkam in FY2014 are forecast to grow by 8% per annum for the next three years and by 4% per annum thereafter;
- The target capital structure of Minkam is assumed to be 30% debt and 70% equity, based on market values, for the foreseeable future; and
- A discount of 30% is to be applied to the derived free cash flow valuation of Minkam to take into account the unlisted status of the company and its smaller size compared to similar listed companies.

Infinity also expressed reservations about the valuation presented by the shareholders of Arrow College. Their view is that the current high PE multiples of similar listed companies represent the market's expectations of high growth in earnings of these companies. The earnings of Arrow College are not expected to grow significantly unless it receives a capital injection to build new schools. In any event, the returns from capital invested in new schools need to exceed the weighted average cost of capital of Arrow College to generate wealth for its shareholders.

According to the research performed by Infinity, the long-term average earnings before interest and taxation (EBIT) multiple (enterprise value divided by EBIT) of educational businesses listed on the JSE is 9.

REQUIRED		Marks	
		Sub-total	Total
(a)	Calculate the key ratios that the board of directors of Minkam should use in analysing the financial performance for FY2014 and financial position at the end of FY2014, of Minkam.	15	15
(b)	Identify and describe the key business risks faced by Minkam. <i>Communication skills – clarity of expression</i>	16 1	17
(c)	Identify and explain the merits and pitfalls of either acquiring existing schools or building new schools. <i>Communication skills – logical argument</i>	14 1	15
(d)	Prepare a brief report to the board of directors of Minkam in which you critically assess the potential acquisition of Arrow College. <i>Communication skills – presentation; clarity of expression</i>	12 2	14
(e)	Estimate the valuation range that Infinity is likely to place on 100% of the ordinary shares in issue of Minkam for the purposes of its investment in the company.	23	23
(f)	Outline the advantages and disadvantages of Minkam listing on the JSE. <i>Communication skills – clarity of expression</i>	8 1	9
(g)	Advise the board of directors of Minkam on how it should respond to the concerns raised by the outraged parents.	7	7
Total			100