Chief executive officer's report

Although we have had some strong performers in the Group, most notably Vega Properties, Prima Interactive, Formex, Romatex Home Textiles and the Empire Group, it's safe to say that the year ended 31 March 2018 proved to be a difficult year.

We mentioned in our results to 31 March 2017 that the Group had a number of loss-making businesses that were weighing on the Group's results. We have taken decisive action with regard to these businesses and a number of restructuring processes have been completed during the current financial year. The results for the current financial year are significantly influenced by these restructuring initiatives. In certain instances, the restructuring affects separately identifiable pieces of businesses and where this is the case, the results for these pieces are reflected as discontinuing operations. There are other processes that affect certain product ranges and parts of continuing businesses, and in these cases the costs of exiting these areas remain within the continuing operations.

The restructuring processes affected the following three businesses in the main:

- Winelands Textiles – This business comprised two manufacturing facilities in the Western Cape: one in Paarl and one in Worcester. During the course of the year we have completed a restructuring process that resulted in these two facilities being consolidated into a single facility in Worcester. The consolidation significantly reduces the overheads and breakeven point, which will allow the business to focus on more viable product lines. The restructure will also release around R50 million of capital that was tied up in unproductive working capital;
- the Group's office automation business – The Group has decided to concentrate this business on the Gauteng market. We have made good progress with the orderly disposal of the outlying branches. The restructure allows the businesses to unlock better efficiencies and it will release a significant amount of capital that was tied up in the long-term debtors book; and
- our branded sporting goods business – This business has been placed under the control of new management that has been working on discontinuing loss-making brands, improving operational efficiencies and effectiveness and optimising management structures. The result of these initiatives has seen the break-even point drop significantly. The focus now is to grow the brands that remain.

CONTINUING OPERATIONS

Although turnover grew by 12% to just over R3 billion, this growth was derived from the following acquisitions:

- Formex Industries was acquired from our holding company HCI with effect from 1 August 2017. This business manufactures specialised pressing and tubing components for the automotive market;
- New Just Fun Group was acquired with effect from 13 December 2017. New Just Fun is a South African toy distributor and holds the distribution rights to some of the world's leading toy brands; and
- the formation of HTIC (Hong Kong). This business sources goods from Asian manufacturers primarily for its South African client base, including our own Group companies. The business has a long association with the Group, but in prior years it acted as a sourcing agent. As from January 2017, it is classified as a subsidiary. The effect of this is that we now account for all the revenue and all the costs as opposed to just accounting for commissions earned as was the case previously.

If one excludes the revenue from these acquisitions, the remaining businesses saw revenues decline by 2%. Most of this decline is attributable to our own decisions to discontinue unprofitable product lines, but it does reflect some of the difficulties experienced in the retail and construction markets in particular.

Gross margins also came under pressure and declined by 400 basis points to 22,8%. This decline is due in part to the new revenue streams from HTIC and the acquisition of Formex, both of which operate a high volume, low margin business model. The discontinuation of certain product lines and weaker sales into the retail market meant that we needed to clear or provide for the related inventory. Furthermore, certain of the businesses experienced quite significant increases in raw material prices which could not be entirely passed on to customers. These price increases came about through international shortages in the underlying raw materials. The situation started to normalise towards the end of the financial year.

Overhead costs remain tightly controlled. The 11% increase in total costs, as reflected, is largely due to the costs in the businesses acquired. Excluding the new acquisitions, overhead costs increased by just 3% year-on-year.

The net interest expense increased by R23 million to R93 million as a result of higher debt levels from the share buyback completed in September 2016 and the interest-bearing debt assumed with the acquisitions of Formex and New Just Fun Group.

Certain of our subsidiaries have moved from being loss-making to having realistic expectations of being sustainably profitable. This has meant that the Group is required to recognise deferred tax assets on historic tax losses, which resulted in the Group reporting taxation income of R73 million in the current period.

Overall, although the year under review proved to be difficult, we believe that the actions taken see the Group emerge in a stronger position than it began. As we continue to find solutions for the underperforming businesses, it will result in improved operating margins going forward or further capital releases.

ACCOUNTING FOR GOVERNMENT GRANTS

Shareholders are advised that the Group's results contain a prior-year adjustment relating to a change in the accounting treatment of government grants.

During the prior periods, the grants were deemed to be earned through compliance with their conditions and meeting the envisaged obligations. Where the qualifying conditions gave rise to future envisaged obligations, the benefits were allocated against the historic costs of complying with the conditions as well as the future related obligations. Where no envisaged obligations were identified, the grants were recognised in other income when there was reasonable assurance that the Group would comply with all the conditions attached to the grants and that the grants would be received.

The Group's new auditors believe that the relevant statement should be interpreted differently and that the above accounting treatment was incorrect. It is their view that if the benefit derived from the grant is used to acquire a depreciable asset, the benefit should simply be matched against the depreciation expense related to the asset acquired.

The new accounting treatment has the effect of taking the income derived from the government grants that had previously been released through the income statement and placing it back on the balance sheet by creating a R116 million (net of taxation) deferred income "liability".

The new accounting treatment has the consequence that our results as presented deviate from the underlying commercial reality. We hold this view as the result of the following:

- the acquisition of an asset is not a primary condition of the scheme. In any given year, the Group has a variety of expenditures that could qualify to be refunded by the applicable government grant. These expenses include staff training, spend on process improvement initiatives, equipment upgrades, etc. It is administratively more efficient for the Group to claim the government grants for equipment upgrades and this has been the chosen route. A different administration choice would lead to the grant being recognised in different periods;
- the assets acquired have been tested for impairments on an annual basis. As there has been no indication of any impairments, we can conclude that the assets meet the general definition of an asset productively employed and that there are no onerous obligations attached to holding and operating the assets in the future;
- the deferred income "liability", on the other hand, does not meet the general definition of a liability in that there is no current obligation that is likely to result in an outflow of economic benefit in the future. The "liability" is not owed to anybody nor is there any future onerous obligations to which this benefit could be matched; and
- this "liability" will be released into the income statement by matching it against the relevant depreciation charge associated with the applicable asset acquired. The Group's assets have varying useful lives with the longest being 25 years.

The result of this is that the deferred income "liability" can be expected to grow for the next few years and then will be unwound through the income statement over quite a long period. All things remaining equal, the Group's results will continue to deviate from the underlying commercial reality for many years into the future. In order to provide shareholders with more useful information we will include adjusted earnings, adjusted headline earnings and adjusted net asset value calculations in each year. The different accounting treatments have no effect on cash flows.

Stuart Queen
Chief executive officer
18 July 2018