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# MARCH 2008 Newsletter

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## Learning the ABCs of growth

The journey from high flyer to entrepreneur in crisis is a quick and savage path.

When ABC Learning Centres (ABC) revealed a 42% fall in half-year earnings to \$37.1 million their share price was in trouble. The news that a number of the directors including CEO, Eddie Groves were subject to margin calls on their shareholding triggered a major sell off with prices plunging by as much as 70%. The company suspended trading on 28 February, allowing for a joint venture brokered with Morgan Stanley Private Equity for the sale of 60% of its US business for \$775 million. The JV which is expected to complete by April will enable the company to reduce their syndicated bank debt by \$750 million.

Market speculation and rumour surrounding a potential breach of financial covenants requiring the company to maintain a minimum capitalisation of \$2 billion continued despite the company's fervent denial. The media maintained the message that the company simply 'grew too fast too quickly'. Off the back of a dropping share price Eddie Groves and his estranged wife received margin calls to pay up, sell, or secure the margin against other assets. Groves did not respond to the margin call and as a result, the collateral stock was sold by Citigroup's margin lending department. A second margin call left Groves with just under four thousand shares.

While the market's concern about ABC's financial position may not have been accurate, the high octane growth of ABC from Australian success story to international conglomerate was enough to fuel the uncertainty. The aggressive push into the US through strategic acquisitions saw ABC become the number two child care operator at a cost close to A\$800 million. The consolidation and investment in the child care industry is a vision shared by more than just Eddie Groves. Last May, Temasek Holdings, the Singapore Government's investment vehicle paid \$400 million for a 12% stake in the company.

Maintaining the balance between debt, growth and opportunity is an issue that affects all business people regardless of size. In ABC's case the market appeal of the stock was its growth profile. This same profile elevated the risk of the stock, and the market allowed no room for error. At the first sign of risk elevating and growth easing, the market turned on its former darling. Every year, hundreds of small and medium sized businesses deal with the same issue. Surely growth is good and more is better. The typical SME entrepreneur chases growth with a passion, but doesn't always have a good eye for risk. This risk will typically:

- Significantly increase the cost of funds;
- Limit the business' ability to take up new opportunities;
- Cause the failure of the business; and
- Expose the owners to significant personal loss.

The key to managing risk is to be able to identify the early warning signs. Once you recognise them, the next step is to do something about it; even if that means taking the foot off the business growth accelerator and consolidating your position for a while.

### ***Measuring by the numbers***

While there are no absolutes there are ways that you can test your level of risk. Often your financial statements will tell the story. Here are some quick ratios to help you understand where you stand:

- **Debt to equity ratio** - ideally no more than one to one. When you have more of the bank's money than your own in the business this is a sure sign of an increased risk exposure.
- **Interest cover** – how many times does your net profit cover your interest bill? Three times cover should be considered a minimum.
- **Working capital ratio** – this is your current assets divided by your current liabilities. Ideally this should be better than 2:1. Below 1.5:1 is a warning sign and less than 1:1 means your business is at risk.
- **Net profit to revenue ratio** – this will vary depending on the type of industry you are in. Normally, it will sit somewhere between 5 - 20%. Less than 5% is another risk sign.

Keep in mind that growth is not the only driver of risk. If you have tested yourself against these numbers and the results don't look good this does not automatically mean that you are growing too quickly; it could mean that you don't have enough capital or there is something wrong with your business model. However, if the numbers aren't looking good and you are growing at more than 20% per annum, the signs are there that growth may be contributing to the problem.

Indicators in our current market suggest that economic conditions could get a bit rocky. Interest rates are pushing upwards, and there are signs that inflation and the sub prime debt problems may cause a flow through with credit being assessed more tightly. Don't get caught in the belief that good business conditions will just keep getting better. Most markets work in cycles and trading conditions will change.

Yes, growth is good, but it needs to be managed. Balance your growth while keeping a close eye on your risk position. Quality businesses often emerge in tougher markets and great opportunities present themselves if you are ready to take them.

*If you need advice on how your business is travelling, call your adviser. A quick business health check could save you from problems down the track. It's as simple as ABC.*

## **Quick guide to FBT**

### ***Managing motor vehicles***

For motor vehicles, it's important to have a record of what cars are subject to FBT, when things change, periods of usage and the method being used to calculate FBT. There are two methods of reporting FBT for motor vehicles:

- **Statutory method** – Make sure that you do an odometer reading on 31 March.
- **Operating cost method** – Ensure that your log books are current.

It's worth reviewing the method that you are using to ensure that it is providing the lowest FBT liability for your business and employees.

### ***Are you at risk of an ATO audit?***

The first step is to make sure that your FBT records are in order. If your business is ever audited, this is the first thing that the tax office will look for – the paperwork to back up what you have been telling them. Key areas of interest identified by the ATO include business owned cars (particularly luxury cars) and entertainment expenses.

Informal arrangements between employers and employees can unintentionally give rise to an FBT liability for the employer, including the following:

- Allowing employees to use company cars for private use (eg over the weekend);
- Allowing employees to occasionally use a car park which is located on business premises;
- Allowing employees to use business assets for their personal use;
- Allowing employees additional time to repay amounts owing to the employer; and
- Allowing employees to use housing owned by the employer while not in the course of undertaking employment duties.

### ***From 1 April 2007***

**Reportable fringe benefits** - Employers need to report fringe benefits on an employee's payment summary where the value of those benefits across the FBT year exceeded \$2,000 (up from \$1,000).

**Minor fringe benefits** - The threshold for minor benefits (infrequent benefits such as gifts under the threshold amount) increased to \$300.

**In house fringe benefits** - The threshold for in house fringe benefits (a good or service provided to an employee that is identical or similar to those that the employer supplies to the public) increased to \$1,000 before FBT applies.

### ***From 1 July 2007***

**FBT and superannuation** - Employer contributions in cash to superannuation funds for the benefit of an employee are not subject to FBT. Previously, in specie contributions (non-cash such as shares and property) made by an employer were subject to FBT. From 1 July 2007, FBT does not apply to in specie contributions made to superannuation funds.

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