To be published by Deon Basson Research CC, 55 Strydom Street,
Birchleigh North, Kempton Park
First Edition: 2008

EDITOR: Chris Davies
COVER DESIGNER: Sybil Basson Smit
LAYOUT ARTIST: Sybil Basson Smit

Annexure 12: Waterglen's shenanigans

1. Introduction

- The prospectus for Waterglen Shopping Centre Holdings ran from 24 November 2005 to 23 February 2006. It is noteworthy that the first financial statements cover the period 1 January 2006 to 30 June 2006 implying that trading had started several weeks before the prospectus had closed.

- The company raised R80m from the public through an offer of linked units of R1 000. Each unit consisted of one ordinary share of 1c and one unsecured floating rate debenture of R999,99.

- Shortly before the launch of the prospectus an estate agent from Pam Golding Properties, Ms MJ Jorgenson, entered negotiations with the then owners to sell the property to companies including RMB Properties, Investec and others. The representative of the sellers, Mr Ettienne Lewis, was satisfied that the property should sell for R52m. Then Sharemax suddenly arrived on the scene and Waterglen Shopping Centre Investments (a subsidiary of Waterglen Shopping Centre Holdings) bought the property for R62m.[1] It was then syndicated for R80m.

- This is significant in view of the fact that valuer Richard Currie quite co-incidentally and independently valued the property in December 2005 at R51,7m.[2]

- Much later, in May 2007, Waterkloof Shopping Centre Holdings instituted a separate court action against me, basically because I had published Currie's views about the property. His name was not mentioned in the summons, but it was stated that the views expressed in the article prejudiced the company and its shareholders because, at the time, the property was not marketable at a realistic price. If the property were to have been sold, it "would be for a lessor amount".[3]

- Based on information published in the prospectus and the cash flow statement in the financial statements for the period to 30 June 2006 the consolidated "opening balances" of the company, following capital raising, the acquisition of property and wholly-owned subsidiary Waterglen Shopping Centre Investments (Pty) Ltd, should have been as follows:

[1] email from MJ Jorgenson, 4 July 2006
[2] Basson, Deon. *Incredible property valuations.* Finweek, 14 December 2005 www.finweek.co.za
[3] Transvaal Provincial Division of the High Court. *Waterglen Shopping Centre Holdings vs Deon Basson.* Case number 18534/2007.

Table 1: Opening balances

Item	Assets	Liabilities
Investment property	62 000 000 [4]	
Goodwill acquired	14 878 319	
Balancing number: Cash and/or accounts receivable	3 121 681	
Share and debenture capital raised		80 000 000

2. Reserve funding

- The balancing number (R3 121 681) in the table above is exactly equal to the sum of the following items disclosed in the prospectus:

Table 2: Reserve funds created in terms of prospectus

Reserve fund (working capital) [5]	100 000
Cash flow shortfall fund [6]	2 321 681
Revamp costs [7]	500 000
Electricity deposits [8]	200 000
Total	**3 121 681**

- Yet, there is no meaningful disclosure of the detail of items listed above in the financial statements for 2006 and 2007. The only possible exceptions are unidentified deposits of R306 172 shown on the balance sheet on 30 June 2006. This amount was no longer on the balance sheet a year later.[9]

- There are no accounting policies viz-a-viz the treatment of these items in the financial statements. Neither is there any explanation or highlighting of the existence of these items which had been disclosed earlier in the

[4] This number is contentious as the actual purchase price was R61m to which R1m was added as commissions – R500 000 to Intrax (a company in which Sharemax MD Willie Botha is interested) and R500 000 to a private entity belonging to one of the directors of the seller. The director in question is Mr Ettienne Lewis

[5] Earmarked for working capital. Prospectus, p. 10

[6] To fund cash flow shortfalls on interest payments to investors. Prospectus, p. 11

[7] Reserve fund for upgrading of the Waterglen Shopping Centre. Prospectus, p. 11

[8] For payment to the local authority as a electricity deposit. Prospectus, p. 11

[9] Financial statements, 2006, p. 18 and 2007, p. 18

prospectus. Any reader of the financial statements who'd not been reading the prospectus would be totally unaware that such funds and reserves (equal to 3,9% of the total funds raised) had been created.

- On 30 June 2006 cash shown in the balance sheet was R2 058 333.[10] Without the initial amount of R3 121 681 there would have been no cash in the balance sheet. But let's rather observe the total cash flow situation:

Table 3: Cash flows [11]

	12 months to 30 June 2007	6 months to 30 June 2006
Net cash from operating activities	-1 678 476	-755 121
Net cash from investing activities	-689 655	-77 213 546
Net cash from financing activities	403 469	80 026 200
Net cash movement for the period	**-1 694 692**	**2 057 533**

- The net cash movement for the entire period of 18 months was a positive R362 841. Without the support of the initital R3 121 681 the negative cash movement would have been R2 758 840.[12]

3. Cash flows

- The negative net cash flow from operating activities for the entire period of 18 months was R2 433 597.[13]

- On 30 June 2007 cash of only R93 641 was reflected on the balance sheet.[14]

- Property loan stock companies normally fund interest payments to holders of linked units from operating

[10] Financial statements, 2006, p. 7
[11] Financial statements, 2007, p. 9
[12] Ibid
[13] Ibid
[14] Financial statements, 2007, p. 6

profits. Waterglen Shopping Centre Holdings was, at the outset, unable to fund the projected interest payment from its operating profits and for that reason the so-called cash flow shortfall fund had been created.[15]

- Before comparing actual with projected operating performance it is first necessary to reconcile the operating profits with cash generated from operations and the net cash flow from operations

Table 4: Cash flow vs. operating profits [16]

	12 months to 30 June 2007	6 months to 30 June 2006
Operating profit per income statement	**16 444 497**	**-9 450 793**
Less: Fair value adjustments to property	-10 933 560	-1 000 000
Plus: Goodwill written off		14 878 318
Operating profit after writing back capital items	**5 510 937**	**4 427 525**
Interest received	-77 251	-2 684
Movement in operating lease assets	33 387	-910 020
Recoveries	-285 241	-584 165
Changes in working capital		
Trade and other receivables	550 054	-916 619
Trade and other payables	254 280	373 576
Cash generated from operations	**5 986 166**	**2 387 613**
Interest paid to linked unitholders	-8 027 134	-3 729 583
Interest income	77 251	2 684
Recoveries	285 241	584 165
Net cash from operating activities	**-1 676 476**	**-755 121**

- Note that for the entire period of 18 months the operating profits were R9 938 462 but the cash generated from operations was only R8 373 779. This is a reality check as to the quality of operating profits.

- Note the positive effect that movements in working capital[17] had on cash flow in 2007. This cannot be

[15] Prospectus, p. 14
[16] Financial statements, 2007, pp. 7, 9, 20 &23
[17] Ibid, p. 21

considered a sustainable source of cash flow for the future.

- In fact, on 30 June 2007 the group only had current assets of R460 206 compared to current liabilities of R627 857.[18] The current ratio is 0,73 which is significantly less than the norm of 1,00. It points to cash flow strain.

- It would appear that the reserve amount of R3 121 681 has been exhausted.

- As was stated above, there is no electricity deposit of R200 000 on the balance sheet.[19]

- The reserve fund of R100 000 appears to have been exhausted.

- The reserve fund of R500 000 for the upgrading of the property also appears to have been depleted. There is no clear evidence that any money was spent on "upgrading". The income statement shows that R401 685 was spent during the entire period of 18 months on "maintenance".[20] Maintenance and upgrading are patently different things.

- The cash flow shortfall fund of R2 321 681 also appears to have been depleted. According to the projections in the prospectus it should have been applied as follows:

[18] Ibid, p. 6
[19] Ibid, p. 18
[20] Ibid, p. 24

Table 5: Projected use of cash flow shortfall fund [21]

Year	Shortfall funding
2007	1 231 321
2008	878 773
2009	471 943
2010	90 391

- Despite the obvious cash flow strain the balance sheet shows a loan of R335 228 on 30 June 2006 to promoter Sharemax Investments (Pty) Ltd.[22] On 30 June 2007 this loan had grown to R1 024 915.[23] There are no fixed repayment conditions.[24] This appears to be misappropriation of funds set aside for specific purposes in the prospectus.

- A loan of R430 469 was outstanding to Sharemax Investments (Pty) Ltd on 30 June 2007. There are no fixed repayment conditions.[25] It was not disclosed in the earlier prospectus that the group might need loan funding from Sharemax Investments (Pty) Ltd to meet interest payment commitments.

4. Comparing with prospectus forecasts

- The prospectus forecasts are for periods of 12 months starting on 1 February 2006.[26] Notably the first period starts before the prospectus had closed and does not coincide with the periods dealt with in the financial statements. The financial statements dealt with the periods 1 January 2006 to 30 June 2006 and then with 1 July 2006 to 30 June 2007.

[21] Prospectus, p. 11
[22] Financial statements, 2006, p. 17
[23] Financial statements, 2007, p. 17
[24] Ibid
[25] Ibid, p. 18
[26] Prospectus, p. 14

This obstructs meaningful comparison of the prospectus forecasts with the financial statements.

- However, giving the group the benefit of the doubt, let's compare the forecast for the period 1 February 2006 to 31 January 2007 with the actual performance for the period 1 July 2006 to 30 June 2007. The latter period is five months later and given the fact that the group had been forecasting rising profits, this comparison should not be prejudicial:

Table 6: Prospectus forecast vs. actual performance [27]

	Prospectus forecast: 1 February 2006 to 31 January 2007	**Actual performance: 1 July 2006 to 30 June 2007**
Rental and parking income	8 415 469	7 449 216
Recoveries	393 421	285 241
Straight line income accrual		-33 388
Interest income		77 251
Total income	**8 808 890**	**7 778 320**
Less: Expenses	-2 024 122	-2 267 383
Vacancy provision (1%)	-88 089	Nil
Operating profit	**6 696 679**	**5 510 937**
Shortfall to be funded	1 231 321	2 516 123
Interest payment to investors	**7 928 000**	**8 027 060**
Interest rate earned	8,37%	6,89%
Subsidy	1,54%	3,14%
Interest rate paid	**9,91%**	**10,03%**

- The prospectus stated that the projections were based on the rentals and escalations reflected in the current lease agreement. The prospectus showed that rental income would grow by 10% per annum.[28] Clearly these forecasts were not realistic.

- Actual expenses were about 12% higher than the forecast.

[27] Prospectus, p. 14 and financial statements, 2007, pp. 7, 23 & 24
[28] Prospectus, p. 14

- No provision had been made in the financial statements for vacancies.

- As was noted before, the cash flow shortfall fund was exhausted by 30 June 2007.

5. Valuation of property

- Despite the weaker than projected operating performance the valuator, Mr Sarel Eloff of New World Valuation, saw it fit to increase the valuation of the property from R63m to R73 933 560.[29] Clearly he was riding on the wave of a buoyant property market. The financial statements merely state that the valuation was based on open market value for existing use and that the assumptions were based on current market conditions.

- It should be noted that despite revaluation of the property, Waterglen Shopping Centre is factually insolvent, with liabilities exceeding assets by R6 164 289.

- With the exhaustion of the cash flow shortfall fund the creative funding options have probably halted. For valuation purposes it is anyway not prudent to rely on such funding mechanisms. Operating profits should be the basis when calculating yields.

- Based on the operating profit of R5 510 937 for 2007 and Eloff's valuation of R73 933 560 on 30 June 2007, the historic yield was 7,45%.

- The listed property landscape has changed significantly since 30 June 2007.

[29] Financial statements, pp. 15 & 16

Table 7: Change in property landscape

	30 June 2007	31 July 2008	% change
General indicators			
Prime rate	13%	15%	
R157 government stock	8,50%	9,25%	
Average rolled yield of listed SA property	6,77%	9,48%	
Clean share prices			
Growthpoint	1455c	1233c	-15,3
Fountainhead	645c	521c	-19,2
SA Corporate	380c	264c	-30,5
Hyprop	4305c	3506c	-18,6
Redefine	732c	585c	-20,1
Emira	1069c	889c	-16,8
Apexhi-B	1680c	1561c	-7,1
Resilient	2440c	1934c	-20,3
Apexhi-A	1393c	1252c	-10,1
Historic yields on clean share prices			
Growthpoint	6,34%	8,65%	
Fountainhead	6,43%	9,12%	
SA Corporate	7,71%	11,76%	
Hyprop	5,68%	8,35%	
Redefine	6,80%	9,28%	
Emira	7,72%	9,66%	
Apexhi-B	9,28%	10,52%	
Resilient	5,34%	8,17%	
Apexhi-A	9,16%	10,73%	
Premium/discount to NAV	**30 June 2007**	**30 April 2008**	**% change**
Growthpoint	38,0%	-10,2%	
Fountainhead	23,3%	-17,1%	
SA Corporate	16,0%	-25,7%	
Hyprop	37,6%	0,9%	
Redefine	14,1%	-13,0%	
Emira	16,0%	-25,8%	
Apexhi-B	132,1%	78,9%	
Resilient	71,9%	4,6%	
Apexhi-A	52,4%	17,8%	

Sources: Catalyst Fund Managers. Listed Property Sector Monthly Review, July 2007 and April 2008

- SA Corporate, the third largest listed property fund, traded on 30 June 2007 at a yield of 7,71% and on 31 July 2008 at 11,76%.

- In an ironic sense SA Corporate is actually an appropriate benchmark for Waterglen Shopping Centre and other properties managed by Sharemax. In 2007

Sharemax sold ten properties to SA Retail for about R1bn. Subsequently SA Retail was taken over by SA Corporate. As an upshot of acquiring the ten Sharemax properties SA Retail revalued its own portfolio of properties to bring it in line with the valuation of the Sharemax properties. This revaluation was reflected in the balance sheet of SA Corporate after the takeover.

- It is significant that the decline in SA Corporate's unit price is much higher than any of the other nine big listed property companies. SA Corporate (and SA Retail) followed an aggressive acquisition strategy where size, instead of value ,was the overriding criterion.

- The market has now punished SA Corporate for this strategy. The discount to NAV of 21,1% is indicative of this. The market is actually saying that the valuations done by SA Retail at the time of the Sharemax acquisition were too optimistic.

- At the time SA Retail issued shares at R11,00 per share to pay for the Sharemax portfolio. With the takeover by SA Corporate, these shares converted into SA Corporate shares at the ratio of 3,05 SA Corporate shares for each SA Retail share. That valued each SA Corporate share at R3,60. At a share price of 274c on 21 May 2008, 24% of the value had been lost.

- Taking the changing landscape into account, it is difficult to justify a yield of anything less than 10% (being generous) for Waterglen Shopping Centre at present. It is, after all, a single property where the risks of investors aren't spread. Even if one optimistically assumes that the operating profit will grow by 6% in 2008, the value of the property, at a historic yield of 10%, will only be R58,3m. This is 21,6% lower than the current balance sheet valuation and 27,5% lower than the syndication value. Here are a few other scenarios:

Table 8: Scenarios for value of Waterglen: Growth in operating profit vs. historic yield

	Historic yields		
Growth in operating profit	**10%**	**11%**	**12%**
0%	R55m	R50m	R45,8m
1%	R55,6m	R50,5m	R46,3m
2%	R56,1m	R51m	R46,8m
3%	R56,7m	R51,5m	R47,3m
4%	R57,2m	R52m	R47,7m
5%	R57,8m	R52,5m	R48,2m
6%	R58,3m	R53m	R48,6m
7%	R58,9m	R53,5m	R49,1m
8%	R59,4m	R54m	R49,5m