CA2 – Project SB01

POTENTIAL ACQUISITION OF ACCOUNTMOBILE BY ACTUARIAMOBILE

Purpose and Background

The purpose of this project is to project the expected cashflows from AccountMobile's mobile phone business over the next 10 year licence period, 2010 to 2019 inclusive.

A base price is calculated as the net present value of the projected cashflows using ActuariaMobile's cost of capital. The impact on the net present value of implementing a new administration system and switching some of AccountMobile's customers to higher margin contracts is assessed. In addition, the internal rate of return, allowing for payment of the base price, is calculated following the proposed changes.

The impact of funding by Titans Investment Bank on ActuariaMobile's internal rate of return is also examined.

Data

The information used to model the cashflows is taken from the Information Memorandum issued by AccountMobile and is assumed to be accurate. The data used will need to be verified as part of any due diligence process. In addition, information supplied by ActuariaMobile's CEO has been used as provided without challenge.

The following key data was used:

Current phone contracts (at 30 June this year):

Call Package	Monthly Tariff	Monthly Margin	Number of Contracts	Annual Cancellation Rate	Annual Growth in number of contracts
A	Act$ 10	Act$ 0.40	200,000	2%	0%
B	Act$ 15	Act$ 0.90	120,000	5%	3%
C	Act$ 20	Act$ 1.80	150,000	8%	5%
D	Act$ 25	Act$ 2.40	100,000	10%	15%
E	Act$ 30	Act$ 3.20	80,000	15%	25%

AccountMobile's fixed administration costs are Act$ 500,000 per month.

The cost of converting the administration system is taken as Act$15,000,000 with the fixed administration costs halving after the new system is implemented.

ActuariaMobile's cost of capital is taken as 10% per annum and this rate is used to determine the net present values.

Initial Assumptions

- The data provided are all accurate.

- There will be no change to the tariff rates or costs over the 10 year projection period (or that future changes in call packages will produce margins consistent with those assumed).

- Cancellation and growth rates will be unchanged over the 10 year projection period.

- Cancellation and growth rates are independent annual rates.

- Cashflows are modelled on a monthly basis and are assumed to occur at the beginning of each calendar month.

- The purchase price is paid on 31 December 2009.

- Allowance for tax is not included as we have been told that ActuariaMobile's tax assets combined with accumulated tax losses in AccountMobile will it very unlikely that any tax will be paid during the projection period.

- Inflation has been taken as zero in line with experience in Actuaria over many years.

Calculation of Base Price

The margin in each calendar month generated by each call package is taken as the number of contracts in force at the start of the month multiplied by the monthly margin given in the data.

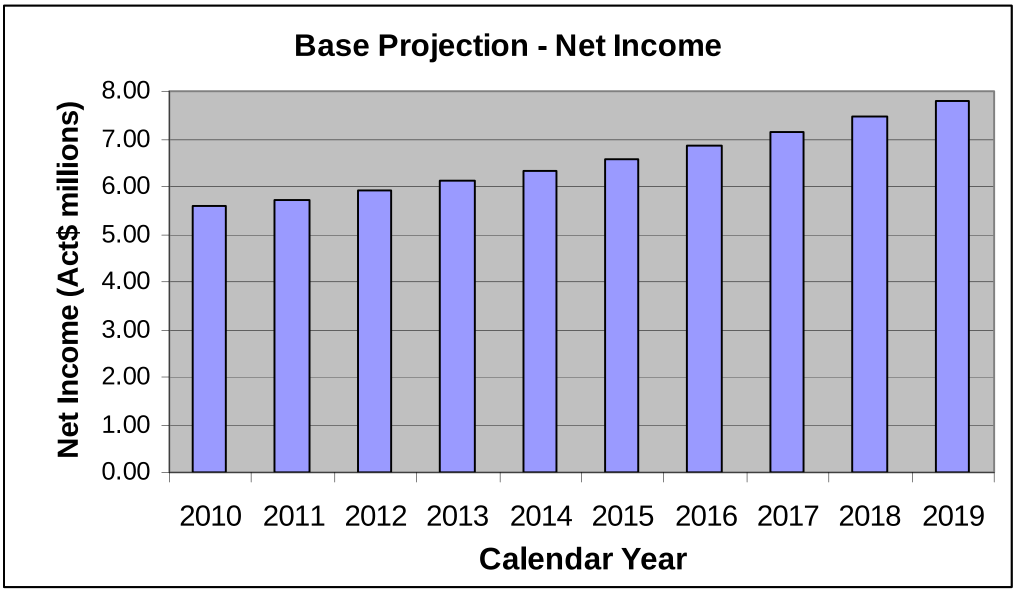
The number of contracts in force in each month is taken as the number in the prior month multiplied by (1 + monthly growth rate) * (1 – monthly cancellation rate).

True monthly rates were derived from the annual rates provided in the data.

As the initial data is given as at 30 June 2009, it was necessary to roll forward the data to 1 January 2010 using the growth and cancellation rates provided.

Once the margin for each call package is calculated, the total in each month is found and the monthly fixed administration cost is deducted to give the net income in each future month.

The following chart illustrates the net income in each future year.



This shows a slow growth in net income each year. This reflects the large number of contracts on call packages A & B which give a small margin to AccountMobile but which are not growing in the case of package A and only slowly in the case of package B.

Using ActuariaMobile's cost of capital of 10% p.a., the net present value of the cashflows is Act$41.137 million as at 31 December 2009. This is taken as the base price for the transaction.

Impact of Proposed Changes

The first proposed change is to move AccountMobile contracts on to ActuariaMobile's administration system during 2010. While the cost of the move is Act$15 million, the cost of using the ActuariaMobile system once the change is implemented will be half that of using the AccountMobile system.

For modelling purposes it is assumed that the cost of the switch will be incurred over 2010 and that the benefit will emerge at the beginning of 2011. This means that the model charges the full cost of AccountMobile's administration system in 2010 and then the reduced amount from 2011 onwards.

The net present value of the revised cashflows is Act$43.318 million. This is higher than the base price showing that the investment in changing the administration system pays for itself over the projection period.

Allowing for the payment of the base price, the internal rate of return of the revised cashflows is 10.96% p.a. This is higher than ActuariaMobile's cost of capital and, again, shows that the investment in changing the administration system pays for itself over the projection period. The higher internal rate of return is consistent with the increase in the net present value of the cashflows.

The second proposed change is to switch those AccountMobile customers in the lowest margin call packages (A & B) to higher margin contracts. This would take place in 2011 after the change in administration system. It is proposed to offer customers a 50% discount on their new tariff for 6 months as an inducement to stay with the company. The CEO of ActuariaMobile has given the following assumptions for what customers will do:

Proportion of customers who cancel completely	40%
Proportion of customers who move the cheapest package now available	30%
Proportion of customers who upgrade to the most expensive package	30%

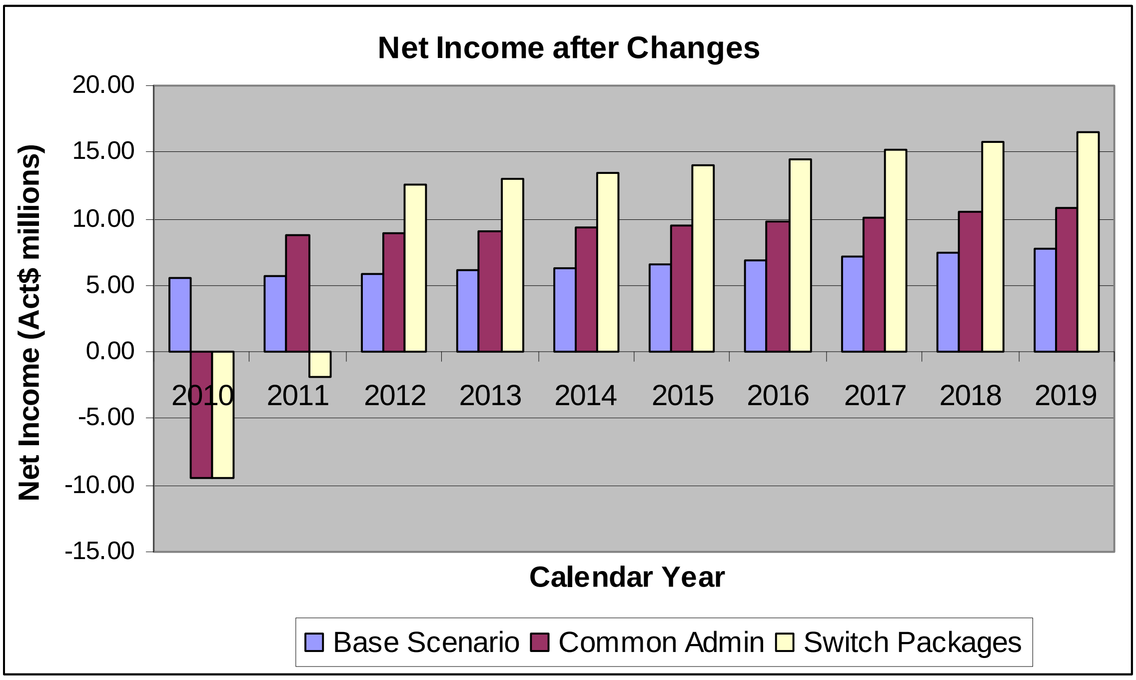
It is assumed that all switches would take place as at 1 January 2011. The cost of the discount offered is calculated separately and deducted from the total cashflows.

It is also assumed that the cancellation and growth rates will remain unchanged after the switch. This is not realistic since the newly switched customers may be more likely to cancel their new contracts and keeping the same rate of growth on a bigger number of higher margin call packages is unlikely. However, without any further details of ActuariaMobile's prior experience in this area there is no meaningful alternative available.

Revised cashflows are calculated allowing for the cost of the change of administration system in 2010 and the cost incurred from the contract switch in 2011. The net present value of these revised cashflows is Act$54.579 million, showing that the cost of the inducements to switch contracts will pay for itself over the projection period although this figure also reflects the strong assumption on continued growth rates on a higher number of contracts.

Allowing for the payment of the base price, the cost of the change of administration system in 2010 and the cost incurred from the contract switch in 2011, the internal rate of return increases to 14.72% p.a. This is much higher than the rate of return calculated from just the change in administration system as would be expected given the size of the increase in the net present value.

The revised cashflows are compared against the base scenario in the following chart.



The chart shows that the net income increases substantially after each of the proposed changes. Also, the switch of contracts shows a much higher rate of income growth from 2012 onwards – this is due to the assumption that growth & cancellation rates are unchanged even if the number of contracts is much higher.

The chart also shows the cashflow strain from implementing the proposed changes. ActuariaMobile should consider the impact of these cashflow strains on its funding requirements.

Impact of Loan from Titans Investment Bank

We have considered the impact of Titans Investment Bank funding part of the purchase price by making a loan to ActuariaMobile on 31 December 2009. The following assumptions have been made:

- Titans advances 50% of the base price, i.e. an amount of Act$20.569 million.
- The loan interest is 6% p.a. and is charged as a true monthly rate on the loan amount outstanding at the start of each month.
- All of ActuariaMobile's net income in each year is used to repay the loan until the loan is fully repaid.

Under the base scenario, the loan is fully repaid at the end of 2013. The internal rate of return to ActuariaMobile is 10.99% p.a. This is higher than the cost of capital which is reasonable given that the loan interest rate is lower than the cost of capital so that the loan gears up the return to ActuariaMobile.

Under the scenario where the administration system is changed and customers are switched to higher margin contracts, the loan is actually repaid some 9 months earlier than in the base scenario. This reflects the higher margins being earned by ActuariaMobile following the switch of contracts. The internal rate of return in this scenario is 16.49% p.a.

Conclusions

The base price is Act$ 41.137 million as at 31 December 2009 but it should be borne in mind that the calculation of this figure is based on some strong assumptions.

The ActuariaMobile CEO's suggestions both increase the net present value of the cashflows which shows that the investments made pay for themselves.

A loan of half the base price from Titans Investment Bank is repaid quickly, within 3 or 4 years and increases the rate of return to ActuariaMobile.

Possible next steps

Validate the data/assumptions as part of any due diligence process.

For example Tariff "E" has extremely high growth and cancellation rates that may not be sustainable in the long term.

Investigate cancellation experience by how long a contract has been held.

Investigate trends in mobile phone tariffs – as new and innovative tariffs enter the market, growth rates for A to E are likely to decline and cancellation rates increase.

Investigate whether an additional licence would be required to cover AccountMobile's portfolio and at what cost or could the entire combined portfolio be run on one licence.

Model different tariffs and costs. There is considerable "gearing" within the margins which will be sensitive to tariffs charged and underlying costs of providing services.

Investigate the likely tax position of a combined company and adjust the model where appropriate.
Include an inflation assumption consistent with the levels of interest rate used.

Consider the value of the cashflows over shorter projection periods than 10 years.

Look at other project appraisal metrics, such as the payback period, for the various investments made by ActuariaMobile.

Examine the possible value of the combined company at the end of the ten year licence period.

Sensitivity test the assumptions, in particular the assumed savings from the change in administration system, the proportions of contract customers who switch to each of the different packages, the timing of the switch program, and the length of the reduced call tariffs after the switch.

Include other costs associated with the switching exercise, i.e. marketing to existing customers, costs associated with stopping tariffs A&B.

Test different growth/cancellation rates after the switch of call packages.

Look at different interest rates on the loan and different loan amounts relative to the base price.

Consider the tax impact of the loan interest.

Consider other issues which might affect the price to pay, e.g. value of goodwill, brand name of AccountMobile, assets and liabilities (eg bad debts), pension scheme, scandals associated with health risks of mobile phone usage