Ethiopian Investment Company case study

Michael (Mike) Wells prepared this case study to support class discussion designed to foster the development of a cohesive understanding of measuring fair value in general purpose financial information in the investment sector and as a basis for developing capacity to make the judgements necessary to prepare/audit/regulate/analyse such financial information.

On 1 February 2005 the Ethiopian Investment Company (EIC)[1] is founded by three Ethiopian venture capitalist (nicknamed 'the Ethiopian Dragons') who each provide initial share capital of ETB40 million and 100 smaller unrelated investors (including you) who each contribute ETB1 million share capital upon the formation of EIC.

EIC prepares financial information in accordance with International Financial Reporting Standards.

On 30 June 2007 with the unanimous support of its shareholders EIC purchased all of the shares previously owned by one of its founding Dragon's estate. EIC continues to hold those shares.

From its inception EIC experiences uninterrupted and exceptional growth in the value of its investments. EIC's policy never to pay dividends to its shareholders ensures that all of its realised gains are invested in new domestic investment opportunities. You understand that should you need cash you would simply sell some of your EIC shares to the existing shareholders (who, in accordance with the constitution of EIC each hold a proportional right of first refusal on the sale of any EIC shares) or potential new shareholders (of which there are many in waiting).

In 2013, with a view to providing more relevant information to its investors, EIC applies early the investment entity amendment to IFRS 10 *Consolidated Financial Statements*. You see the market value of its investments, rather than the assets underlying those investments measured using a confusing array of complicated measurements, each of which you feel only a professional accountant might have some prospect of understanding. You study with heightened interest the disclosures about the models and inputs to those models that EIC uses to measure the fair value of those of its investments none of which trade in active markets. From analysing information about management's significant judgements and estimates, you understand much better the risks and rewards your investment is effectively exposed to. On the basis of your analysis you feel more confident in your decision to continue holding your EIC shares.

Information about a selection of EIC's assets is set out below.

Shares

At 31 December 2015 EIC owns shares in fifty Ethiopian companies whose shares do not trade in a public market. Most of those holdings in individual companies are between 5% and 60% of a company's issued share capital. EIC has an excellent track record in profiting generously from providing venture capital to these higher risk start-up companies.

[1] The names of individuals, entities and places in this case study are fictitious. Any resemblance to people, entities or places is purely coincidental.

Some of the companies that EIC controls are diversified widely by business. Nevertheless, you recall that EIC has committed to you and its other investors that its only business purpose is to invest funds solely for returns from capital appreciation and investment income.

EIC owns less than 5% of Zombie's equity. On 30 September 2015, following revelation by a leading private investigative journalist of a 'pyramid scheme' being operated by Zombie, the court suspended trading in Zombie shares. Before the airing of the investigative journalist's 'Zombie' documentary, EIC was unaware of these wrongdoings. The Ethiopian Government's Serious Fraud Office investigations are underway.

EIC has a comprehensive exit strategy for each of these investments.

Ethiopian Government and corporate debt

EIC owns significant quantities of:

- Ethiopian Government ETB denominated fixed-rate short-term (91-day and 182-day) treasury bills;
- Ethiopian ETB denominated fixed-rate and variable-rate corporate bonds. The original term to maturity of those bonds ranges from 1 year to 10 years.

EIC does not intend to hold any debt to its maturity.

Addis Abba investment property

In early 2005 EIC purchased a development of single storey residential properties for ETB100 million (ETB10 million for the remaining 90 year land use right and ETB90 million for the buildings). It holds the property development mainly in anticipation of capital appreciation but also to earn rental income. The development operator pays EIC fixed annual rentals. Subject to an eight-month notice period, the agreement with the operator is cancellable by either party.

By 2015, a number of the world's most prestigious hotel chains began developing high-rise luxury hotels on land adjacent to EIC's development. On 30 December 2015 EIC received an unsolicited offer from a prestigious high-end hotel chain to purchase its entire development for ETB2,000 million. On the basis of the high price being offered for similar nearby developments, EIC expects that the hotelier would demolish the existing buildings to make way for a high-rise luxury hotel resort on the leasehold-property.

In June 2010 EIC purchased the indefinite right of use of farmland (farmland) at the outskirts of Addis Ababa. It holds the land mainly in anticipation of capital appreciation but also to earn rental income.

Although, at 31 December 2015, the construction of buildings on its farmland remains forbidden, because the most rapidly expanding upmarket residential neighbourhood of Addis Ababa has reached the border of EIC's farmland, residential property developers are actively seeking to acquire EIC's farmland with a view to constructing high-end residential homesteads on the land.

In late December 2015 the relevant regulatory authority unexpectedly indicated that it is considering relaxing its property rezoning laws to facilitate the further expansion of Addis Ababa. Consequently, some speculate that EIC's farmland might soon qualify for such rezoning.

EIC commissioned an independent valuation of its farmland use rights as at 31 December 2015, 2014 and 2013. The valuation is performed on a vacant land basis (ie ignoring the value of the eucalyptus trees planted thereon).

In summary the valuator estimated what the fair value of the EIC's land use rights would be under the following scenarios:

	As at 31 December 2015	*As at 31 December 2014*	*As at 31 December 2013*
Valuation assumption:	**ETB per hectare**	**ETB per hectare**	**ETB per hectare**
• assuming with 100% certainty that the land will soon be rezoned for residential housing construction	250,000	200,000	180,000
• assuming that the land will always be zoned agriculture only (ie buildings will never be permitted to be constructed on the land)	50,000	40,000	36,000

British farmland

In early 2010 when the currency exchange rate was GBP1 = ETB26, EIC acquired a plot of agricultural land in England. It holds the land mainly in anticipation of capital appreciation but also to earn rental income.

Since 2010, UK farmland has been one of EIC's best performing investments. In part because at 31 December 2015 the currency exchange rate was GBP1 = ETB30 but mainly because in 2014 the GBP(£) denominated price of farmland reached record levels of over £10,067 per acre, according to the latest RICS/RAU Rural Land Market Survey.[2]

However, some industry experts[3] have downgraded their forecasts of UK farmland for the next five years in light of recent market evidence and the short to medium-term expectations for commodity prices (and therefore farm profitability).

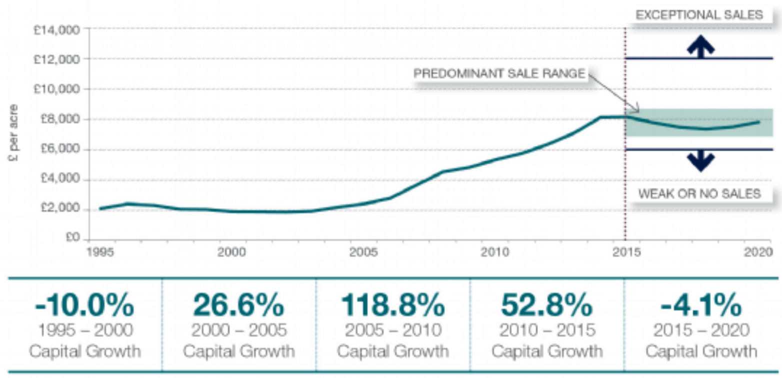
These industry experts expect:

- rural property values to be much more varied than in the past five years
- this market will last three to four years until commodity prices start to recover, following stronger global growth
- that the short supply of UK farmland and competing land uses and ownership motives in the UK will all support farmland value growth in the long-term.

[2] Source: http://www.rics.org/ie/news/news-insight/press-releases/land-prices-reach-10000-per-acre/

[3] For example, Ian Bailey, Director Rural Research, Savills introducing *Savills Spotlight: Key Themes for UK Real Estate in 2016* (see http://www.savills.co.uk/research_articles/196909/197377-0)

Savills' (UK) farmland values per acre[4]



Nevertheless, EIC plans to continue holding its UK farmland because it anticipates further price increases in the short-term. However, management is mindful of the significant uncertainties including:

- the outcome of forthcoming UK referendum on EU membership (management expect the UK will remain in the EU)
    - "Given that Brussels' subsidies make up a huge proportion of UK farm incomes, the result of David Cameron's promised 2017 in/out referendum on EU membership could be pivotal for the agricultural sector. While EU bureaucracy is largely despised by farmers, it is hard to see them receiving the same level of support if the UK were to leave Europe."[5]
- strong domestic demand for UK grown food (management expect such demand will remain for the foreseeable future)
    - "agricultural land takes up over two thirds of the total land area at 17.2 million hectares or 71% and due to intensive farming techniques still provides around 60% of the country's total food needs"[6]
    - the manifesto of the newly (2015) elected Conservative Party promised to create a 25-year plan for the farming industry that would "grow more, buy more and sell more British food"[7]

Appendices

The appendices that follow set out selected recent UK property experts' reports in chronological order.

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[4] Extracted from Savills Spotlight: Key Themes for UK Real Estate in 2016 (see http://pdf.euro.savills.co.uk/uk/residential---other/spotlight-key-themes-for-uk-real-estate-2016.pdf)

[5] Source: Andrew Shirley, Head of Rural Property Research, Knight Frank introducing the knight frank Rural bulletin Spring 2015 (see http://content.knightfrank.com/research/96/documents/en/spring-2015-2888.pdf)

[6] Source: RICS website 01/09/2015 (see http://www.rics.org/uk/knowledge/glossary/agricultural-land-prices/)

[7] Source: Andrew Shirley, Head of Rural Property Research, Knight Frank introducing the knight frank Rural bulletin Spring 2015 (see http://content.knightfrank.com/research/96/documents/en/spring-2015-2888.pdf)

Encouraged by the transparency of the information provided in EIC's 2013 and 2014 annual financial statements, EIC is encouraged and authorised by the Ethiopian Government to issue corporate bonds to the Ethiopian diaspora. On 1 January 2015, EIC issues the following corporate bonds with interest payable annually in arrears on 31 December each year:

- ETB denominated 5-year fixed-rate interest bonds;
- GBP denominated 10 year fixed-rate interest bonds; and
- USD denominated 10-year bonds bearing interest at LIBOR + 2%.

QUESTIONS FOR CLASS DISCUSSION

1. What are the economics of EIC's operations?
2. When you are contemplating buy-hold-sell decisions over your EIC shares, what information would you want about its assets as a basis for informing your investment decision?
3. What accounting does International Financial Reporting Standards specify for EIC?
4. Is that specified accounting consistent with the objective and underlying concepts as set out in the IASB's Conceptual Framework?
5. What judgements would EIC make to measure the fair value at 31 December 2015 of each of:
   - (i) the corporate bonds that it has issued;
   - (ii) its investments in unquoted equity instruments;
   - (iii) its investment in debt instruments: government bonds and corporate bonds;
   - (iv) its Addis Ababa property development (consider the fair value of the land-use rights separately from the fair value of the buildings);
   - (v) its Addis Ababa farmland-use rights; and
   - (vi) its British farmland?
6. How, in accordance with IFRS would EIC account for the EIC shares that it holds (treasury shares)?
7. What judgements would you make to measure the fair value of the EIC shares you hold?
8. How would the measurement of the fair value of your holding in EIC differ from that of the holding of one of the remaining Dragons?

APPENDIX 1:[8]

Simon Rubinsohn, Chief Economist (RICS) 5 February 2015 commenting on RICS/RAU Rural Land Market Survey H2 2014

Farmland continued to outpace supply in the final six months of 2014, with land prices rising by 8.3% over the year to reach over £10,067 per acre, according to the latest RICS/RAU Rural Land Market Survey.

During the second half of last year, the average cost of farmland rose to £10,067 per acre* across England and Wales, hitting a record high for the eleventh consecutive period.

During the same period in 2013 an acre cost, on average, £9,294. Despite anecdotal evidence that the recent fall in commodity prices is starting to temper the pace of demand – particularly for smaller areas of land in all parts of the country - prices are expected to continue to rise over the next 12 months.

The increase in demand from 'lifestyle' buyers that began in H2 2013 continued throughout the whole of 2014 with this trend being noticed across most parts of the UK. This is adding to price pressures and keeping price expectations in positive territory in all areas.

Anecdotal evidence also seems to suggest the continued presence in the market of investor purchasers seeing land as a safe haven. Across the UK the supply of commercial farmland has remained flat or decreased in nine of the ten areas, while demand has continued to grow in all but one part of the UK.

According to surveyors, average annual arable land rents decreased in H2 for the first time in six years but remain 0.8% higher over the year. Pasture lands rents, on the other hand, rose by 3.4% in H2 and by 7.8% over the year to reach £107 per acre.

The highest annual price growth in the UK was seen in Scotland, despite uncertainty driven by the referendum and CAP review. Prices in Scotland rose almost 17% over the year, although at just £4,375 per acre, prices in Scotland are still 47% below the national average with the price of pasture land at least 40% cheaper than any other part of the UK. It remains to be seen whether the recent announcement on plans to overhaul tenant farming will have any effect on land prices.

Yorkshire and Humber and Wales also witnessed particularly strong price growth during 2014 with arable land in both areas driving the rises.

Our analysis

Farmland price growth continues to grow and is expected to remain positive even with commodity prices starting to fall. Competition for land if fierce, especially in neighbouring plots, and the demand from lifestyle farmers and investors also remains positive.

It remains to be seen whether fluctuations in commodity prices, the forthcoming general election and a possible exit from the EU will impact the rural land market and affect the number of transactions, but our members remain largely positive on continued growth over the next twelve months.

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[8] Source: http://www.rics.org/ie/news/news-insight/press-releases/land-prices-reach-10000-per-acre/

APPENDIX 2:[9]

Market in Minutes: UK Farmland Market Q2 2015

29 July 2015, words by Ian Bailey, *Director Rural Research*, Savills

Growth in arable values has steadied in some locations.

- Farmland values in Great Britain increased by 0.2% during the first half of 2015, continuing their long-term trend although the rate of increase is slowing.
- The market has become more finely balanced, with a greater range in farmland values than in the recent past, with prices very dependent on local supply and the number of potential buyers.
- 5% more land was publicly marketed across Great Britain in the first half of 2015 compared with 2014 but this is 1% less than the five-year average. In England, there was 13% more for sale but 7% less in Scotland and over 50% less in Wales.
- Non-farmer buyers have overtaken farmers as the main type of buyer, with the proportion of farmers falling slightly, due to weaker sentiment of some farmers due to lower current commodity prices. Farmer buyers are now at their lowest proportion since 2003.
- However, the fundamentals of land ownership still remain secure and the medium term (five-year) outlook for commodity prices is relatively positive.

[9] Source: http://www.savills.co.uk/research_articles/141557/190631-0

APPENDIX 3:[10]

LAND PRICES - RICS H1 2015 (Published 7 September 2015)

Pasture

- The average price for pasture land in England and Wales stood at £18,306/hectare in H1-2015, an increase of £637 (3.6%) from H1-2014. A percentage increase of 2.1% was recorded between periods H2-2014 and H1-2015.
- The lowest price for pasture land in H1-2015 was £8,031/hectare, which was recorded in Scotland. This was still an 8.3% price increase against the price of land in H1-2014. No price change has been recorded between H1-2014 and H2-2014 for the region.
- The highest price for pasture land in H1-2015 was £21,004/hectare, which was recorded in the North West region. This was a 7.9% price increase against the price of land in H1-2014. A 3% Increase has been occurred between H2-2014 and H1-2015 for the region.
- Over the period since H1-2014 to H1-2015, Wales saw the largest price decrease of £1,853 (9.4%) per hectare for pasture land although there was only a £927 (4.9%) decrease per hectare between H2-2014 and H1-2015 for the region.

Arable

- The average price for Arable land in England and Wales stood at £23,354/hectare in H1-2015, an increase of £1,154 (5.2%) from H1-2014. A percentage increase of 2.9% was recorded between periods H2-2014 and H1-2015.
- The lowest price for arable land in H1-2015 was £13,591/hectare, which was recorded in Scotland. This was still an 8.3% price decrease against the price of land in H1-2014. A price change of -4.3% has been recorded between H2-2014 and H1-2015 for the region.
- The highest price for arable land in H1-2015 was £24,711/hectare, which was recorded in the Eastern region, the South East region and the West Midlands.
- Over the period since H2-2014 to H1-2015, the North West saw the largest price increase of £3,089 (16.7%) per hectare for arable land.
- The average price for arable land in Wales for H1-2015 stood at £22,239/hectare, which was a fall of £618 (2.7%) in comparison to H1-2014. There was no price movement between H2-2014 and H1-2014.

[10] Source: http://dairy.ahdb.org.uk/market-information/farm-expenses/land-prices/land-prices-rics/#.Vo-7voS8_FI

APPENDIX 4:[11]

Agricultural Spotlight: Key Themes for UK Real Estate in 2016

10 December 2015 Ian Bailey, Director Rural Research, Savills commenting on Savills

With the drop in commodity prices and the potential for UK exit from the EU, the future for farm incomes remains uncertain

Forecasting future values for the farmland sales market is far from easy, particularly following a year when a wide range of sale prices were achieved.

Agricultural incomes are under pressure as some commodity prices are back to 2008/2010 levels. The key global forecasting organisations, including the FAO, USDA and IMF, have all cut their already pessimistic forecasts for commodity prices in the medium-term to 2020. Lower energy and feed costs will partially offset lower output prices but the strong pound makes exports less competitive.

Debt may increase the number of farms coming to the market although if this is the case it is likely to be smaller farms. Overall, we don't expect supply to increase significantly unless there is a threat to direct farm subsidies from UK exit from the European Union or a significant negative change in the capital tax treatment of farmland. Both of these factors remain threats to watch but are unknown at present. UK exit could have a significant negative impact on farm incomes and land values, depend on how the UK Government supports farming, which is currently unknown.

In 2015, our research recorded falls in arable land values in the eastern counties of England, where values have been highest. Grassland values, which have lagged behind arable values, have continued to increase and this land type is still regarded as good value by large livestock and dairy operations which are trying to expand to spread costs. This demand will help support prices in this segment of the market.

Localised demand

In the short-term, demand for farmland will be more localised, with areas of strong and weak demand, often quite close to one another. Top-performing farmers will continue to be in the market for the right opportunities. Non-farmer demand, and the expected growth in prime country residential markets over the next five years will continue to support prices especially on residential and amenity-type farms but investor demand may weaken as the performance of alternative assets improves. An increase in buyers with rollover cash is likely to follow increased development activity and will add to the mix of local demand.

Downgraded forecast

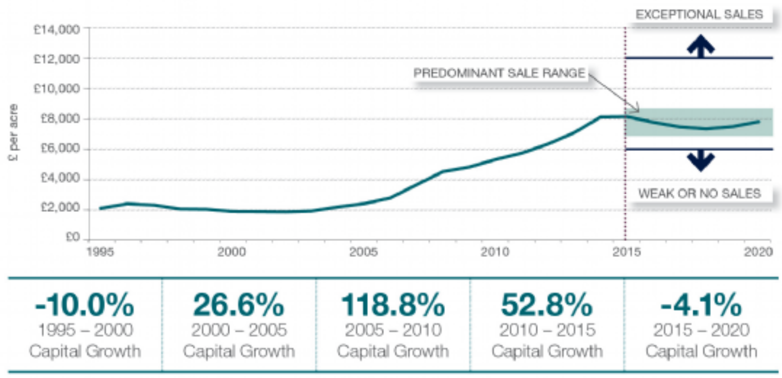
In the light of recent market evidence, the short to medium-term expectations for commodity prices and therefore farm profitability, we have downgraded our forecasts for the next five years. We expect values to be much more varied than in the past five years. Exceptional prices may still be achieved if all the right factors come together but conversely it is very

[11] Source: http://www.savills.co.uk/research_articles/196909/197377-0 and the full report http://pdf.euro.savills.co.uk/uk/residential---other/spotlight-key-themes-for-uk-real-estate-2016.pdf

likely that there will be more farms where potential sale prices fail to reach expectations or they fail to sell, as illustrated on Figure 3. We expect this market will last three to four years until commodity prices start to recover, following stronger global growth.

However, the fundamental factors driving UK farmland value growth remain. Supply is historically low, the product is finite, competing land uses and ownership motives will all support farmland values growth in the long-term.

FIGURE 3
Farmland value forecasts



Source: Savills Research