# ABC Learning Centres Limited – did the annual reports give enough warning?

**Following the demise of ABC Learning Centres, lenders and investors have faced the question of whether its financial statements provided sufficient warning signals. Careful reading of the accounts indicates that despite disclosure of ABC's relentless growth, the accounts showed no material strengthening of its financial position. And, more detailed analysis reveals ABC's increased gearing, and the decline in shareholder returns and its capacity to service the group's debts, with the inevitable and predictable outcome.**

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**WHEN ONE.TEL COLLAPSED IN 2001,** Lachlan Murdoch and James Packer were reported as asking 'Why weren't we warned?' This question is very often asked in the aftermath of a dramatic corporate collapse. Research suggests that, in very many cases, thorough cash flow analysis and careful reading of the historical financial statements will provide at least one period's warning of the deterioration in a company's financial position and financial performance.

Is this the case with ABC Learning Centres ('ABC')? Were there any other warning signals? Is it possible to identify any patterns in the collapse of ABC that have been experienced elsewhere, or was ABC a dramatic one-off? This article seeks to answer some of these questions from the approach of an investor or lender without access to inside information, and who is only able to review ABC's position through the annual reports.

Table 1 briefly summarises the dramatic growth of ABC in the period between listing in 2001 and its collapse in 2008.

## Strategic position

Arguably, there were significant flaws in the ABC business model. The business is, by its nature, hard to scale: each centre has only a finite capacity, preventing ABC from spreading its very substantial fixed costs over a larger number of 'clients' in each centre. The decision taken by the board to expand by acquisition meant that ABC was paying enormous amounts out in what were classified in the balance sheet as 'childcare licences ($2.4 billion by 30 June, 2007), amounts which were intangible and not income-generating. There was little opportunity to cross-sell other services – even the acquisition of the toy importer and manufacturer had only limited synergies

TABLE 1: **ABC Learning Centres Limited, key financial data, as at 30 June**

| Year ended: | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| # of centres at year end | 43 | 94 | 187 | 327 | 660 | 1257 | 2238 |
| # of directors | 4 | 5 | 6 | 6 | 7 | 7 | 7 |
| Total assets (A$ mn.)* | 28.5 | 55.9 | 157.0 | 314.1 | 1,165.5 | 2,323.3 | 4,067.1 |
| Total debt* | 10.3 | 20.6 | 55.6 | 103.0 | 200.1 | 260.4 | 1,758.8 |
| Total shareholders' funds* | 13.2 | 27.4 | 89.1 | 202.6 | 845.5 | 1,837.7 | 1,901.6 |
| Profit after tax* | 3.3 | 6.8 | 12.1 | 21.4 | 52.3 | 81.0 | 143.1 |
| Return on equity | 24.7% | 24.9% | 13.5% | 10.5% | 6.2% | 4.4% | 7.5% |

* Before the adjustments discussed below

TABLE 2: **ABC Learning Centres Limited, returns to shareholders, as at 30 June**

| For year ended: | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| Net profit after tax/total revenue | 25.6% | 28.9% | 29.8% | 26.6% | 21.0% | 13.3% | 8.6% |
| ROE (adjusted) | 24.7% | 24.9% | 13.5% | 14.1% | 6.6% | 4.4% | 7.5% |

with ABC's existing business. Very high maintenance costs – referred to in the 2005 & 2006 annual reports – also cut into the profitability of ABC's business.

The impact of this on returns to shareholders can be seen in Table 2.

Did ABC reach the limits of 'natural' growth in 2004? Certainly, with the rapid fall in ROE, ABC would have had had difficulty in raising straight equity. But, does this explain the introduction of redeemable convertible preference shares (2004-2006) and redeemable convertible reset notes (2007)?

## Accounting issues

In 2005 and 2006, ABC split the proceeds of its redeemable convertible preference share and redeemable convertible reset note issues between debt and equity components. However, from a lender's perspective, both issues give rise to mandatory debt service obligations. For the purposes of analysis, 100% of the proceeds have been treated as debt.

Having regard to the fixed nature of the operating lease obligations to ABC's landlords, 100% of the outstandings under the operating leases has been treated as debt, with the corresponding assets included in fixed assets.

Finally, the asset and liability impacts of acquisitions have been removed from the cash flow statement, to determine what ABC's own cash flow generation capacity was without those impacts.

Apart from these restatements, the figures in the financial statements have been taken at face value. There is no evidence from the annual reports and financial analysis that ABC was indulging in deliberate cosmetic accounting. Subsequent comments in the financial press have suggested that ABC's gross revenue figures may have been overstated through the inclusion of developer rebates in gross revenue. In 2005, the notes to the accounts disclose that consideration on disposal of properties and investments has been included in gross operating revenue. Note 1 r to the accounts contained a curious note stating that goodwill on consolidation is eliminated by progressively reducing carrying values and that once the discount passes zero, any remaining balance is treated as revenue.

Given what has subsequently become alleged about the rebates from developers, it is arguable that the 2005 notes are a first warning that ABC's figures for operating revenue may have been overstated. Certainly, alert analysts could have used this as an opportunity to ask the company about the make-up of its operating revenue.

## Financial analysis

Table 3 contains key ratios emerging from this analysis[2].

The findings can be summarised as follows:

1. Bringing the operating leases onto the balance sheet emphasises the extent to which ABC was heavily geared. Disclosed gearing in 2007 was 1.14:1; restated gearing was 2.03:1.
2. More significantly the capacity of cash flow from operations to service this debt was very materially overstated. Net operating cash flow to current liabilities (i.e. including *only* the current portion of operating lease obligations) covered only about 30% of current liabilities.
3. Going beyond these simple figures, Table 4 provides some early warnings of impending catastrophe:
   - It is clear from this table that ABC's capacity to service its current obligations was never impressive, and showed signs of deterioration during the seven years that it was listed.
   - One wonders whether the banks would have so enthusiastically supported ABC, had they calculated this level of cash interest and operating lease rental cover.

TABLE 3: **ABC Learning Centres Limited, key financial ratios, as at 30 June**

| Year ended | | Total assets | Total debt | Total liabilities/ shareholders' funds | Total intangibles/ shareholders' funds | Net operating cash flow | Net operating cash flow/ current liabilities | Cash interest & operating lease rental cover |
|---|---|---|---|---|---|---|---|---|
| 2001 | As presented | 28.5 | 10.3 | 1.17 | 153.8% | | | |
| | Adjusted | 62.3 | 44.1 | 3.73 | 153.8% | | | |
| 2002 | As presented | 55.9 | 20.6 | 1.04 | 150.2% | 11.5 | 91.5% | 1.5 |
| | Adjusted | 142.8 | 107.5 | 4.21 | 150.2% | 11.5 | 58.5% | 1.5 |
| 2003 | As presented | 157.0 | 55.6 | 0.76 | 137.9% | 28.0 | 214.8% | 2.0 |
| | Adjusted | 289.1 | 187.7 | 2.24 | 137.9% | 12.0 | 46.3% | 0.9 |
| 2004 | As presented | 314.1 | 103.0 | 0.55 | 116.9% | 19.0 | 71.6% | 0.7 |
| | Adjusted | 501.3 | 340.9 | 2.30 | 155.9% | 19.0 | 39.4% | 0.7 |
| 2005 | As presented | 1,165.5 | 200.1 | 0.38 | 114.3% | 190.7 | 289.8% | 3.0 |
| | Adjusted | 1,581.4 | 666.6 | 0.99 | 121.5% | 183.1 | 146.8% | 2.9 |
| 2006 | As presented | 2,323.3 | 260.4 | 0.26 | 92.9% | 201.0 | 130.3% | 1.5 |
| | Adjusted | 3,532.2 | 1,469.4 | 0.92 | 92.9% | 170.3 | 64.2% | 1.2 |
| 2007 | As presented | 4,067.1 | 1,758.8 | 1.14 | 152.0% | 593.5 | 40.8% | 1.7 |
| | Adjusted | 5,754.8 | 3,446.5 | 2.03 | 152.0% | 512.2 | 30.5% | 1.5 |

TABLE 4: **ABC Learning Centres Limited, debt service capacity[3]**

| Year ended 30 June | Net operating cash flow to current liabilities | Cash interest & operating lease rental cover |
|---|---|---|
| 2002 | 58.5% | 1.5X |
| 2003 | 46.3% | 0.9X |
| 2004 | 39.4% | 0.7X |
| 2005 | 146.8% | 2.9X |
| 2006 | 64.2% | 1.2X |
| 2007 | 30.5% | 1.5X |

TABLE 5: **ABC Learning Centres Limited, impact of writing down value of intangibles, as at 30 June, (calculated after adjustments discussed in this article**

| For year ended: | 2001 (A$ mn) | 2002 (A$ mn) | 2003 (A$ mn) | 2004 (A$ mn) | 2005 (A$ mn) | 2006 (A$ mn) | 2007 (A$ mn) |
|---|---|---|---|---|---|---|---|
| **Write down intangibles by:** | | | | | | | |
| 25% | -5.1 | -10.3 | -30.7 | -59.2 | -241.5 | -426.8 | -722.8 |
| 50% | -10.1 | -20.6 | -61.5 | -118.4 | -483.1 | -853.7 | -1,445.6 |
| 75% | -15.2 | -30.9 | -92.2 | -177.6 | -724.6 | -1,280.5 | -2,168.3 |
| **Adjusted shareholders funds** | | | | | | | |
| Written down by 25% | 8.1 | 17.1 | 58.4 | 92.7 | 553.4 | 1,410.9 | 1,178.8 |
| Written down by 50% | 3.0 | 6.8 | 27.7 | 33.5 | 311.9 | 984.1 | 456.1 |
| Written down by 75% | -2.0 | -3.5 | -3.1 | -25.7 | 70.3 | 557.2 | -266.7 |
| **Adjusted gearing** | | | | | | | |
| Written down by 25% | 6.06 | 6.7 | 3.4 | 3.8 | 1.4 | 1.2 | 3.3 |
| Written down by 50% | 16.14 | 16.9 | 7.2 | 10.4 | 2.5 | 1.7 | 8.4 |
| Written down by 75% | -24.37 | -33.2 | -65.3 | -13.6 | 11.2 | 3.0 | -14.4 |

4. The ability of ABC to present positive shareholders' funds was 100% dependent on its valuation of its intangibles. The analysis in Table 5 explores the impact on shareholders' funds and gearing of more conservative valuations. Clearly, depending on how aggressive a view one takes on the value of intangibles (of which the vast majority is directors' valuations of childcare licenses), ABC could have been deemed to be significantly more highly geared and significantly closer to technical insolvency as early as 2001.

The annual accounts disclose relentless growth in number of centres, revenue and assets. What they do not disclose is any material strengthening of ABC's financial position from this growth. What is quite clear from more detailed analysis of the financials is that ABC's gearing grew, its return on sales and equity fell progressively, the returns to shareholders deteriorated, and the capacity of operating cash flow to service the group's debts shrank, with the inevitable and predictable *denouement*.

Certainly, there are arguments that ABC's business model was flawed, or that it was not translatable into different business environments, that the group seems to have failed to implement reporting and controls commensurate with its size, and so forth. These issues are beyond the scope of this article.

**Given what has subsequently become alleged about the rebates from developers, it is arguable that the 2005 notes are a first warning that ABC's figures for operating revenue may have been overstated. Certainly, alert analysts could have used this as an opportunity to ask the company about the make-up of its operating revenue.**

What is clear from this analysis is that there were plenty of warning signals *from the financial analysis alone* that ABC's financial performance and financial position were unsustainable. Like One.Tel, IPEC, National Safety Council, Bond Corporation and so many others, ABC was a victim of its founders' relentless ambition and obsession with growth.

## Notes

1 The author acknowledges the invaluable input into this article from Norman Sturrock.
2 The full financial analysis is available by contacting Andrew McRobert at amra@amcrobertandassocs.com.au
3 All figures in this table are *after* the adjustments discussed in this article.