

Hudaco Industries Limited

("Hudaco" or "the company")

Incorporated in the Republic of South Africa

Registration number: 1985/004617/06

Share code: HDC

ISIN code: ZAE000003273

## **SETTLEMENT OF TAX CHALLENGE AND TRADING STATEMENT**

- 1 During 2007 the Hudaco group ("**Hudaco**") entered into a leveraged empowerment transaction that enabled empowerment shareholders to acquire a 15% unencumbered interest in the main operating subsidiary, Hudaco Trading Proprietary Limited ("**Hudaco Trading**") with Hudaco Industries Limited, (the listed company) retaining the remaining 85% interest. A key objective of the empowerment transaction was to introduce the empowerment shareholders in such a way so as to avoid the need for them to have to borrow money on onerous terms wherein their ability to repay such debt would have been dependent on the receipt of dividends from Hudaco Trading or the increase in the value of their shares in Hudaco Trading. The structure of the empowerment transaction meant that the empowerment shareholding was sustainable and was not dependent on the economy tracking upwards or a constant dividend flow to settle the purchase price.
- 2 In implementing the empowerment transaction, Hudaco Trading acquired most of the operating businesses from the old Hudaco structure. Hudaco Trading funded the purchase price through the issue of a R2.2bn subordinated debenture held by a company within the Morgan Stanley group. The proceeds of the sale were placed in a ring-fenced subsidiary, Barbara Road Investments Proprietary Limited ("**BRI**"), part of the old Hudaco structure, and invested in preference shares in a company within the Cadiz Financial Services group.
- 3 The corporate advisor of Hudaco to the transaction was Bravura Equity Services ("**BES**"), part of the Bravura group ("**Bravura**") in South Africa. They *inter alia* arranged the participation by Morgan Stanley and facilitated the preference share investment that was made by BRI with the Cadiz group. The Hudaco management at the time sought extensive expert advice as to whether these transactions would

stand up to tax scrutiny. They were advised by, amongst others, senior counsel that it would do so. In the process it was indicated that, whilst not fatal to the ultimate tax consequences of the transaction, round-tripping should be avoided. Pursuant to this advice, Hudaco ensured that the mandate given to the Cadiz group provided that the Cadiz group was not permitted to invest any of the funds with Morgan Stanley. In addition, BES confirmed in a letter to Hudaco that, to the best of their knowledge, there was no flow of cash arising from the money invested by BRI with the Cadiz group to any member of the Morgan Stanley group and that the cash would ultimately be used to purchase government bonds issued by the South African Government. BES received a fee from Hudaco for acting as the corporate advisor to the empowerment transaction.

- 4 To the great surprise of Hudaco, SARS informed it in November 2012 that, after extensive investigations both locally and internationally, SARS had uncovered a highly elaborate web of arrangements that were established at the time by various Bravura-related entities, individuals related to BES and its associates (“the **Bravura Transactors**”). The investigations of SARS revealed that the Cadiz group immediately invested the proceeds from the preference shares issued to BRI with one of the Bravura Transactors. The funds were thereafter transferred through means of a number of local and international entities such that government bonds were indeed ultimately purchased. However, these government bonds were given as out-and-out security to Morgan Stanley, which sold them on the same day that they acquired the debentures issued by Hudaco Trading. This effectively means that the funds flowed in a circular fashion and that no real external funding was introduced by any third party. These facts were not known to Hudaco at the time.
- 5 The investigation by SARS revealed that, pursuant to the role played by the Bravura Transactors, interest was effectively converted into preference dividends, apparently without significant tax being paid in any country. Had the transaction run over its intended ten-year life, the difference between the amounts that were received by these entities and the amounts they would have paid would have been approximately R300 million.
- 6 BES prepared the brief to the tax advisors at the time on behalf of Hudaco and Bravura representatives, including their executive directors, attended meetings Hudaco had with senior counsel. At no time during these meetings or in the copious briefings was any reference made to the complex structure that existed behind the investment in

preference shares issued by the Cadiz group company or to the role played by the various Bravura Transactors.

- 7 During February 2013 SARS issued revised assessments against BRI for the years ended 30 November 2007 to 2011 on the basis, amongst others, of the transactions being simulated and falling foul of the general anti-avoidance rule (“GAAR”). The basis relied upon by SARS for the revised assessments has been described in detail in a SENS announcement at the time and in results announcements and integrated reports since then. After receiving these assessments, Hudaco took steps that resulted in the termination of the financing arrangements on 28 February 2013. At 31 May 2014 the contingent liability for the worst case scenario, including penalties and interest up to that date, was disclosed at R1.4 billion.
- 8 The Hudaco board remains confident in its legal position, given Hudaco’s ignorance of the wider transaction and non-participation therein. However, it recognises that, as a result of the role of the Bravura Transactors, which included the use of special purpose vehicles with no apparent commercial role but to effectively convert interest into exempt preference dividends and to provide cross security, there are significant risks associated with the transaction that were not apparent at the time the transaction was entered into in 2007. These now include so-called round tripping and simulated transactions. Furthermore, having the tax challenge hanging over Hudaco for an extended period has been a negative factor for Hudaco in many aspects of its activities and for its shareholders. The Hudaco board believes that there is considerable value in having the matter closed.
- 9 In discussions with BES since the issuing of the assessments against BRI, the existence of the wider funding transaction was confirmed. Hudaco will evaluate in due course its prospects of recovery in this context.
- 10 Hudaco has held extensive discussions with representatives of SARS about resolving the matter. A particular complexity was the fact that the loss to the fiscus, for which the assessments were issued, was far larger than the benefit to Hudaco given the substantial difference between monies to be received and to be paid by the Bravura Transactors. After constructive discussions with SARS, a compromise was reached whereby the parties have agreed that Hudaco will pay in full and final settlement, an amount of R312 million in respect of the tax challenge to the financing arrangements for the empowerment transaction, up to and including the termination of these financing arrangements in 2013. This approximates the present value of the benefit

received by Hudaco over the five and a half years concerned. R120 million has already been paid under the “pay now, argue later” provisions and the balance of R192 million is payable by 31 March 2015.

- 11 It is important to note that Hudaco Trading’s BEE shareholders are not affected by this settlement and that Hudaco Trading’s BEE credentials remain in place.
- 12 The board recognises that the settlement represents a large sum of money but is of the view that, given the benefit Hudaco received, the negative impact of protracted litigation on Hudaco and the risks involved, it is an appropriate solution that will allow Hudaco management to move forward with its full focus on growing the business in the current difficult trading environment.

## **TRADING STATEMENT**

The settlement will result in a charge to the statement of comprehensive income of R312 million (986 cents per share) for the year ended 30 November 2014 and a concomitant decrease in basic and headline earnings. Consequently, earnings per share (“eps”) and headline earnings per share (“heps”) are expected to decrease by between 98% and 100% (being to between 20 cents and nil for both eps and heps) from those of 2013 (eps of 930 cents and heps of 928 cents). Comparable earnings (which exclude the effects of the financing arrangements for the empowerment transaction, the tax settlement and fair value adjustments on vendor earn-out liabilities) will not be affected and no guidance is required to be provided thereon. The forecast financial information has not been reviewed or reported on by the company’s external auditors.

Hudaco’s results for the year ended 30 November 2014 will be released on SENS on 30 January 2015.

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