LearnFast UK Ltd v The Republic of Kaylia

Background and Case Summary

Dramatis Personae

Claimant

LEARNFAST UK LTD	Claimant
DIPFIELD AND SLATER SOLICITORS LLP	Solicitors acting on behalf of the Claimant
MR JOHN PETERS	Shareholder of Claimant
LEARNFAST KAYLIA	Wholly owned subsidiary of Claimant
SAM SMITH	Expert Accountant instructed on behalf of the Claimant

Respondent

REPUBLIC OF KAYLIA	Respondent
HUGHS AND ASSOCIATES	Solicitors acting on behalf of the Respondent
CHRIS BROWN	Expert Accountant instructed on behalf of the Respondent

General Background

The Claimant and the Respondent

1.1 The Claimant is a UK registered privately owned company called LearnFast UK Ltd (the "**Claimant**" or "**LearnFast**"). LearnFast is 100% owned by a citizen of the UK, Mr John Peters ("**Mr Peters**"). Mr Peters is an experienced businessman and has operated six successful learning centres in the UK and in Western Europe over the past ten years. Mr Peters has a successful track record of running these centres and witness evidence submitted by Mr Peters has highlighted his ability to budget revenues and costs at these centres with a relatively high degree of accuracy – with budgeted profits typically within +/- 2.5% of actual for any given year.

1.2 International learning centres differ from traditional schools in a number of ways. The primary different is that international learning centres are not bound by local educational standards and curricula. This frequently allows international learning centres to offer more diverse and vocational educations for students, which has shown to be an attractive basis for education to potential employers.

1.3 The Respondent in this matter is The Republic of Kaylia (the "**Respondent**" or "**Kaylia**"). Kaylia is a developing Asian country with a population of around 20 million people. Of this population, around 18 per cent are aged 16 years or below. Kaylia has enjoyed rapid economic and social development over

the past decade, with its GDP growth averaging around 10% per annum and increasing amount of foreign direct investment into Kaylia taking place.

Background to the claim

The investment decision and the Investment License

1.4 Based on the success of the learning centres that he had built in the UK and Western Europe, in early-1999 Mr Peters began to seek opportunities for further overseas expansion of his learning centre business. Around June 1999, Mr Peters visited English learning centres within schools in The Republic of Kaylia and following this visit, decided to seek to establish an independent English learning centre in Kaylia.

1.5 Kaylia had been identified by Mr Peters as a rapidly developing country, with leading international organisations (e.g. The World Bank) and many market commentators speaking of the huge growth potential in Kaylia, combined with the need for large scale social investment. In particular, with large inflows of foreign investment, there was increasing demand in Kaylia for educated individuals for employment within the many firms that had begun (or were planning to) investing in the country.

1.6 In 1999, Kaylia still had a relatively undeveloped educational system, focused solely on local students. Mr Peters' experience of developing international schools elsewhere, combined with the growing market demand, enable him to identify what he believed was a strong opportunity for a differentiated educational offering in Kaylia – focused on providing education to a combination of local and international students and offering a wider and more vocational curriculum based on the courses that he ran at his other centres in Western Europe.

1.7 Between July and October 1999, Mr Peters scoped the technical, financial and other factors associated with his proposed project to assess its viability. Having satisfied himself as to the viability of the project, Mr Peters began to develop more detailed plans for the project and by November 1999 had created a design for a learning centre in Kaylia. During this period, Mr Peters had numerous conversations with Kaylian Government officials. Mr Peters alleges that the authorities of Kaylia were keen to establish a network of learning centres as opposed to a single standalone centre. Mr Peters alleges that this was an important factor in his investment decision.

1.8 Based on the learning centres within the schools that he visited in Kaylia, and on his own experience in this industry, Mr Peters therefore developed plans for a mixed learning centre in Kaylia – accepting both local and foreign students. In his witness statement submitted in this dispute, Mr Peters explains that this was for a number of reasons. Firstly, the existing learning centres in Kaylia were only targeted at local students; Mr Peters believed that there was a gap in the Kaylian education market. By creating a local/foreign mixed learning centre, Mr Peters would therefore not (in his opinion) be in direct competition with the existing school based learning centres in Kaylia.

1.9 Further, Mr Peters alleges that the market demand opportunities in Kaylia meant that an educational offering would be very popular with foreign students. The benefit of attracting foreign students to the learning centre was that a premium can be charged on their education services, allowing a more profitable business to be developed.

1.10 In preparation for the development of the centre in Kaylia, Mr Peters set up a parent company in the UK and LearnFast UK Ltd was formed in January 2000. At the same time (as required under Kaylian foreign investment law), a local entity was also established in Kaylia, LearnFast Kaylia. LearnFast Kaylia is 100% owned by LearnFast.

1.11 Kaylia's Department of Education (the "DoE") identified a plot of land on which the learning centre could be built. The property was located at 19 Preston Park Close, Kayton City. The DoE offered to construct a building on the land and then lease it to the Claimant. The Claimant and the DoE entered into a Tenancy Agreement (the "Tenancy Agreement") on 5 April 2000, which set out the terms and conditions of their landlord-tenant relationship. It is understood that the Claimant paid US$46,000 upon signing the Tenancy Agreement on 18 May 2000.

1.12 On 20 May 2000, under the Law on Foreign Investment in Kaylia, the Claimant applied for an investment license to set up LearnFast Kayton City Learning Centre, an establishment for the provision of private English tuition in the form of a company with 100% foreign investment. The license application included a feasibility study for the project (the "Feasibility Study") for the creation of one learning centre.

1.13 The Investment License authorising the establishment of a 100% foreign-owned learning centre was granted on 20 December 2000 for a period of 25 years.

1.14 The Feasibility Study originally anticipated the centre opening on 1 January 2001 with temporary lessons to be provided from a nearby facility, as the main centre was completed. However, various regulatory delays (including the application processes for various licenses required to operate the centre) meant that the opening of the school was delayed until September 2002. LearnFast alleges that these delays were not reasonably foreseeable at the date of the Feasibility Study.

Circular 10

1.15 On 22 May 2001, the DoE issued Circular 10: Guiding Foreign Investment in Kaylia ("Circular 10"). The effect of this on the Claimant was that it was required to convert the status of the international learning centre to a Kaylian school and to operate as a "functioning school" similar to the national schools already being run by the DoE.

1.16 As a result of Circular 10, the investment license had to be updated to reflect the status of the centre as a school. An application to amend the investment license was made on 20 February 2002. The DoE issued a new Investment License (the "2002 license") on 24 July 2002. This effectively changed the operation from an international learning centre to a local school.

Opening of the school

1.17 By August 2002 the construction of the building was completed and all required regulatory approvals for its operation had been obtained. The DoE issued the School's Operating License on 26 August 2002. LearnFast International School opened on 5 September 2002.

Legal issues with the DoE and school closure

1.18 The claimant initiated the present arbitration proceedings under the UK–Kaylian bi-lateral investment treaty (the "UK-Kaylian BIT"). The dispute was submitted to an UNCITRAL arbitration administered by the LCIA, in accordance with the dispute provisions contained in the UK-Kaylian BIT.

1.19 Following an inspection by the DoE on 10 June 2006, the LearnFast school announced officially that all the teaching activities had been terminated. The building was handed over to the DoE on 15 August 2006.

1.20 On 26 July 2006, LearnFast Kaylia filed for bankruptcy and the company was put into liquidation.

Quantum

The Claimant's case

1.21 The Claimant alleges that the Kayton Project (and subsequently the Network Project) was severely hampered by the Respondent through the enactment of Circular 10 and other unexpected administrative measures put in place. As a result, the Claimant alleges that these issues destroyed the value of its investment in the Kayton Project and therefore the Network Project.

1.22 Specifically, the Claimant alleges that it incurred incremental costs as a result of the requirement to operate as a school, which were not planned in the 2000 Feasibility Study, including the acquisition of additional equipment and the recruitment of additional teachers and teaching assistants (which significantly increased the school's operating costs). Further, the planned educational materials that Mr Peters planned to use at the international learning centre (which were based on the materials in use at the other learning centres operated by Mr Peters) had to be substantially revised in order to comply with Kaylian education standards. The Claimants also allege that the introduction of Circular 10 and the transition from a learning centre to a local school made the proposition less appealing to international students and meant that LearnFast was unable to charge premium prices for the lessons offered.

1.23 Mr Peters and the Claimant allege that this had a significant impact on the revenue and gross profit margin of the Kayton Project, leaving the Claimant in a position whereby revenues were lower and costs of sale had become far higher than expected, rendering the business loss making.

1.24 The Claimant has quantified their damages on under the following three heads of claim:

- the wasted costs of their investment in the project;
- the lost value of the Kayton City Project; and
- the lost value of the Network Project.

1.25 These heads of claim are separate and the Claimant asserts that there is no overlap between each head of claim. The table below summarises the Claimant's quantum of claim:

	Low case $	**Base case $**
Kayton City Project claim	768,000	1,563,000
Network Project claim	1,126,000	7,669,000
Invested capital	1,204,000	1,204,000

The Respondent's case

1.26 The allegations made by the Claimant are denied by the Respondent. With regard to the invested capital claim, the Respondent asserts that the Claimants have failed to demonstrate that the alleged capital invested was (i) in fact invested; and (ii) was spent by LearnFast Kaylia on the Kayton City Project. The Respondents highlight the fact that the Claimant's expert has relied upon partially qualified financial statements as a basis for valuing the lost invested capital. Based on their expert's review of LearnFast Kaylia's financial statements, the Respondents have valued the lost invested capital at around $763,000.

1.27 The Respondent alleges that the Claimant falls short of the requirement to prove lost profits due to a lack of sufficient history of favourable results. With regard to the first learning centre at Kayton City, the Respondent asserts that Circular 10 would not have had a significant impact on the gross profitability of the learning centre. Instead, based on their expert's report, the Respondents assert that Mr Peters had over-estimated the profitability of the learning centre in the 2000 Feasibility Study and that, regardless of whether the building was used as a learning centre or a local school, it was unlikely to have been a profitable venture and therefore no loss has been suffered.

1.28 The Respondent also argues that there was not an agreed plan for a wider network of learning centres in Kaylia (and no evidence thereof) and that, even if this had been the case, this wider network would also have been loss making and again, Mr Peters is over optimistic in his revenue and cost expectations.

1.29 Accordingly, the Respondent has valued the lost profits in respect of both the Kayton City Project and the Network Project at nil.

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Expert Report of Sam Smith
3 August 2019

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I Introduction

1. Fair Forensics Partnership ("Fair Forensics") has been asked by LearnFast UK Ltd ("LearnFast" or "Claimant") through their instructing solicitors Dipfield and Slater Solicitors LLP ("Dipfield") to prepare this report in connection with the arbitration proceedings commenced against the Republic of Kaylia ("Kaylia" or "Respondent"). LearnFast and Kaylia together are referred to as the "Parties".

2. Fair Forensics is an independent financial consultancy firm specialising in large public-private projects (telecoms, construction and infrastructure), utilities (electricity, water and waste) and the oil, gas and mining industries.

3. This report has been prepared by a team of Fair Forensics professionals led and supervised by me, Sam Smith. Although I have been supported by members of my team in preparing this report, I have personally overseen the work performed and all of the opinions expressed herein are my own.

Curriculum Vitae

4. I am a qualified chartered accountant specialising in auditing and financial management analyses. Over the past 15 years, I have led numerous audits, financial valuations, due diligence missions and operational consultancy projects for the "Big 4" audit firms and now, Fair Forensics. I have extensive knowledge of professional audit standards (US GAAS, IF AC, Sarbanes-Oxley, etc.) and financial accounting principles (US GAAP, IFRS, OHADA).

5. I am currently the lead partner within Fair Forensics' Education Audit Division, responsible for the audit of numerous UK based and international educational institutes, including schools, international learning centres and universities. I have been appointed as an expert witness on a number of occasions, providing written and oral testimony in front of the UK High Court, as well as various arbitral tribunals.

6. I am a lecturer at the London Business School and am a Fellow of the Institute of Chartered Accountants of England and Wales.

Background

7. The background to this matter has been set out in the various filings made in the course of this arbitration. I have therefore not repeated, in detail, the background to this matter in my report. For full details of the background to this matter, please refer to the Claim Summary document.

I set out below a brief overview of the key background information that I consider relevant to my report.

8. I understand that between 1999 and 2000, several discussions were held between Mr John Peters
("Mr Peters"), founder of LearnFast, and governmental authorities of Kaylia regarding the need for the creation of a network of international learning centres in the country, and the contemplated cooperation between the Parties for LearnFast to implement this network (the "Network Project"). LearnFast also discussed with Kaylia's Department of Education (the "DoE") the conditions of a lease agreement for a building to host the first LearnFast learning centre in Kayton City, the capital of Kaylia. By the end of 2000 and based on the above preambles, Kaylia granted an investment license to LearnFast for the creation of the first international learning centre in Kayton City (the "Kayton City Project").

9. Mr Peters is an experienced operator of international learning centres, having successfully built and run two international learning centres in the United Kingdom, and four other international learning centres in Western Europe, during the 1990s.[1] Based on his experience in this industry, I understand that towards the end of the 1990s, Mr Peters began to search for other investment opportunities outside of Europe.[2] In the course of doing so, Mr Peters identified Kaylia as a country with high levels of demand for a skilled workforce and hence, in turn, the need for rapid improvements to its education system.[3] Mr Peters' assessment of the need for improvements to the Kaylian education system, as well as the potential market opportunity that existed in Kaylia, is consistent with various contemporaneous evidence. I summarise this evidence below.

10. Around 2000, Kaylia was experiencing a period of rapid growth and record levels of Foreign-Direct Investment ("FDI"). Kaylia's gross domestic product ("GDP") had grown by an annual average of around 10% between 1990 and 2000.[4] Over the same period, FDI into Kaylia had been growing by almost 8% per annum.[5] Whilst numerous market commentators had begun to recognise this rapid growth[6], some concern was also expressed that a rapid improvement in

[1] First Witness Statement of Mr Peters.

[2] First Witness Statement of Mr Peters.

[3] First Witness Statement of Mr Peters.

[4] *World Bank Report: The Rapid Growth of the Kaylian Economy.*

[5] *World Bank Report: The Rapid Growth of the Kaylian Economy.*

[6] For example, see *PwC Country Analysis: The tiger growth of the Kaylian Economy* (1999) and the *Fair Forensics 2000 Report: The continued boom of the Kaylian economy*. See also: *World Bank Report: The Rapid Growth of the Kaylian Economy.*

Kaylia's social infrastructure was also needed in order to provide the skilled labour and wider infrastructure to service the growth demands in Kaylia.[7]

11. Potential and new investors in Kaylia also recognised this challenge. For example, the President of United Global Bank (the largest investment bank in the world and one of the largest investors in Kaylia during the 1990s and 2000s) said in 2001: "*I see Kaylia as one of the key growth markets for our business. Its location and investment incentives mean it's a hugely attractive opportunity. We, like so many others, are continually increasing our presence there. However, we are rapidly reaching the point where our demand for skilled and educated labour cannot be met by the country's population. For the record growth that we have seen in Kaylia to be sustained, a longer term vision needs to be implemented by the Kaylian Government. At the forefront of this vision must be an urgent improvement in the quality and volume of education in the country so that its future labour force can fill the huge labour demand gaps which will soon appear in Kaylia*".[8]

12. Mr Peters' first learning centre in Kaylia was originally scheduled to open on 1 January 2001. In fact, the learning centre actually opened on 5 September 2002. I understand that this delay was due to a number of unforeseen issues encountered by Mr Peters in obtaining the required approvals and permits to be able to operate the learning centre.[9]

13. By the time the learning centre opened, the Kaylian government had enacted certain new measures (further details of which are set out below) which changed the potential overall profitability of the learning centre. The new measures introduced by the Kaylian government (referred to as "Circular 10 and Other Unexpected Measures" below and throughout this report) in effect meant that Mr Peters' business could no longer operate as an international learning centre. Instead the centre had to operate as a local school and it had to comply with the Kaylian education curriculum and other education requirements (which meant that a local curriculum had to be used which was different to the international curriculum that Mr Peters had planned to introduce and which was and is used by Mr Peters at his other learning centres in Western Europe and also, for example, required higher levels of tutor to student ratios than would otherwise be applied in a learning centre).[10]

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[7] For example, see *PwC Country Analysis: The tiger growth of the Kaylian Economy* (1999) and the *Fair Forensics 2000 Report: The continued boom of the Kaylian economy*.

[8] *United Global Bank press release: June 2001.*

[9] First Witness Statement of Mr Peters.

[10] First Witness Statement of Mr Peters.

14. Nonetheless, Mr Peters continued to operate the school until 19 June 2006, when the school was handed back to the Kaylian government as a result of the continued and increasing losses being experienced by the school.[11] None of the other planned network learning centres/schools in the Network Project were opened by Mr Peters. Mr Peters alleges that the Kaylian government's wrongful introduction of Circular 10 and Other Unexpected Measures resulted in both the closure of the Kayton City Project and prevented Mr Peters from developing the wider Network Project. This is the basis of Mr Peters' claim for damages.[12]

15. During the period of almost four years over which the school did in fact operate, the fact that it had to operate as a local school rather than an international learning centre meant that the overall profitability of the school was significantly impacted. For example, new educational materials had to be prepared so that the school complied with the Kaylian national curriculum, resulting in greater upfront costs of running the school and hence a lower gross profit margin. In addition, the requirement for the school (under the Kaylian laws that were introduced) for higher teacher numbers and the requirement to introduce a local, rather than an international, curriculum, which limited the prices that Mr Peters was able to charge for placements at the school (and limited the attractiveness of the school to foreign students), therefore reduced further the gross profitability of the school. This meant that the school failed to generate the gross profit margins of over 80% that Mr Peters had anticipated and instead, the school generated a gross profit margin of slightly below 45% each year.[13] This lower gross profit margin, as well as rising operating costs, meant that the Kayton City Project was marginally loss making in each of its years of actual operation.

Scope of Work

16. I understand that the Claimant considers the sound development of the Kayton City Project to have been severely hampered by Kaylia and its governmental subdivisions through the enactment of Circular 10 and Other Unexpected Measures which came into effect on 22 May 2001.

17. Specifically, I understand that the Claimant considers that Circular 10 and Other Unexpected Measures effectively destroyed the value of its investment in the Kayton City Project.

[11] First Witness Statement of Mr Peters.

[12] Statement of Claim.

[13] See the Kayton City Project Management accounts, Appendix 4.

18. In this context, Dipfield has instructed me to quantify the damages suffered by the Claimant under three heads of claim. Specifically, I have been instructed:

    a. to determine the compensation value for the lost investment made by LearnFast on the Kayton City Project (**Section III**);

    b. to determine the compensation level for the value of the Kayton City Project, if LearnFast had not been confronted with Circular 10 and Other Unexpected Measures and been able to sustain its development based on initial expectations (**Section IV**); and

    c. to determine the compensation level for the value of the LearnFast Network, had the Kayton City Project – which constituted the expected foundation asset for the development of the Network Project – not been rendered valueless by Circular 10 and Other Unexpected Measures (**Section V**).

19. I have been instructed by Dipfield that the compensation values I am requested to determine must be calculated as at 22 May 2001, i.e. the day on which Circular 10 and Other Unexpected Measures came into effect (the "Date of Breach"). I understand that pre-award interest applied to the amounts that I calculate in this report will have to be determined in due time, for the period between May 2001 and the date of the damage compensation. However, I have been instructed that this calculation is outside of the scope of this report. As required, I will provide this information separately to the Tribunal following any decision with regard to damages.

20. My work is based on documents and material provided by the Parties in this arbitration proceeding, as well as other publicly available materials. This report has been prepared based on the information available to me as of 3 August 2014; it could consequently be subject to updating, should any new relevant information be brought to my attention.

21. I am generally aware of the legal claim put forward by LearnFast; yet, this report is not intended to address any legal argument advanced by LearnFast or by Kaylia. My work only intends to propose an economic and financial analysis of the values of the compensations claimed by LearnFast.

22. My work has been conducted impartially and independently in compliance with the International Standards established by the International Valuation Standards Council. The sole purpose of the views that I express in this report is to assist the Tribunal.

II Executive Summary

Introduction

23. In this section I summarise my calculations and my key findings. My more detailed calculations and findings are set out in the remaining sections of this report. This Executive Summary should therefore be read in conjunction with the other sections of this report.

Summary of my key findings

24. Based on the Claimant's audited financial statements it appears that the Claimant had invested around $1.2 million in development in Kaylia before the LearnFast Kayton City learning centre closed and the LearnFast subsidiary in Kaylia ("LearnFast Kaylia") had to file for bankruptcy and company liquidation in July 2006.

25. Had LearnFast not been confronted with Circular 10 and Other Unexpected Measures, in my opinion the investment in the Kayton City project would have been fully recovered and would have generated a net discounted cash flow (valued as at the Date of Breach) of between $0.77 million and $1.56 million.

26. Further, had Mr Peters been able to generate the wider network of international learning centres that he had originally planned for, in my opinion the LearnFast Network Project that was to follow the development of the Kayton City Project would have generated net cash flows (valued as at the Date of Breach) of between $1.1 million and $7.7 million.

27. In total, my estimate of the value of the compensation claimed by LearnFast (under the bases that I have been instructed to calculate damages) is presented as follows:

My compensation estimate	**Low Case**	**Base Case**
(as at Date of Breach)	**$'000**	**$'000**
Capital Invested	1,204	1,204
Kayton City Project	768	1,563
Network Project	1,126	7,669

III My calculation of the compensation value for the investment made by LearnFast in the Kayton City Project

28. In this section I set out my calculation of the value of the investments made by LearnFast in the Kayton City Project. I first explain the data sources that I have relied upon in my calculation, before then setting out the outcome of my calculation.

29. Since LearnFast Kaylia filed for bankruptcy and entered into liquidation, I understand that Mr Peters' access to the documents and records of LearnFast Kaylia has been severely restricted. As part of this current matter, I requested (through Mr Peters and his instructing solicitors) copies of LearnFast Kaylia's underlying financial records and books. However, the joint liquidators of LearnFast Kaylia (one of whom I understand is a member of the Kaylian Department of Finance) refused to provide access to the information that I had requested. Accordingly, the information available to me to allow me to assess the level of actual investment made by LearnFast in Kaylia has been very limited and I have instead had to rely upon publically available information. In particular, I have relied upon the audited financial statements of LearnFast Kaylia.

30. Given this restriction on the information available to me, in my opinion the audited 2005 financial statements of LearnFast Kaylia (the local subsidiary of LearnFast) provide the best basis for assessing the actual level of expenses incurred by LearnFast on the Kayton City Project. These accounts were prepared six months before LearnFast Kaylia had to file for bankruptcy and company liquidation and, in the absence of other information, provide the best source of financial data prior to the bankruptcy of LearnFast Kaylia. Further, as I explain below, these financial statements have been independently audited and were contemporaneously prepared.

31. I understand from Mr Peters that LearnFast's investments in the Kayton City Project were made through (i) an initial capital contribution paid into LearnFast Kaylia; and (ii) various loans which were made by LearnFast to LearnFast Kaylia, but which were never repaid by LearnFast Kaylia.

32. As summarised in the table below, LearnFast Kaylia's 2005 audited financial statements indeed show both unrepaid borrowings from the Claimant (plus accrued interest) and the capital contribution that was paid by LearnFast into LearnFast Kaylia.

Table 1: Kayton City Project – Invested Amounts[14]

Short-term loans		**$**
Borrowing from LearnFast UK Ltd		779,780
Accrued interest		8,429
Borrowing from Mr Peters		15,378
Total short-term loans	[a]	803,587
Legal capital		
Paid-up capital (historical value)	[b]	400,000
Invested capital	[a] + [b]	**1,203,587**

33. As shown in the table above, the audited financial statements show that LearnFast had loaned a total of $0.8 million to LearnFast Kaylia by 2005, with this balance remaining outstanding. In addition, the financial statements show that accrued interest of $8,429 was owed on this amount and that Mr Peters himself had also loaned monies (which were not repaid) of $15,378 to LearnFast Kaylia. In addition, the share capital contributed by the Claimant to LearnFast Kaylia was $0.4 million. In my opinion (and in the absence of any underlying books and records) these liabilities represent the best indication as to the value of the unrecovered loans and investments made by the Claimant in the project in Kaylia and, accordingly, the $1.2 million total value of these amounts represents the best estimate of the Claimant's lost investment in the Kayton City Project.

34. In Appendix 1 of this report I summarise the profit and loss data and the audit opinions that were presented in LearnFast Kaylia's 2003, 2004 and 2005 audited financial statements. I note that the audit opinions were partially qualified in each of these years since the auditors appear to have been unable to obtain sufficient evidence in respect of around $0.5 million of recorded borrowings. Based on my review of these financial statements, it appears that these borrowings of $0.5 million relate to those shown as "Borrowing from LearnFast UK Ltd" in the table above.

35. Whilst the issuance of a qualified audit opinion indicates that there was a lack of evidence available to the auditors in respect of $0.5 million of these loans, in my opinion this does not necessarily mean that the financial statements were incorrect. Rather that the auditors had access to limited documentation. In my experience, in countries such as Kaylia, it is not uncommon for there to be limited documentary evidence retained by local companies and therefore available to auditors.

[14] All Table 1 data taken from LearnFast Kaylia – 2005 Audited Financial Statements, 31 December 2005.

36. Further, I have also reviewed the audited financial statements of LearnFast itself and I note that these financial statements, for 2005, show a loan to LearnFast Kaylia of $779,780, consistent with the loan value recorded in LearnFast Kaylia's own financial statements. Given LearnFast's audited financial statements were not qualified, and show the corresponding entry (and matching value) for the loan to its Kaylian subsidiary, this provides me with additional comfort that the amounts shown in LearnFast Kaylia's financial statements are correctly stated, despite the qualified audit opinion that was issued in respect of these financial statements.

Summary 1

Audited financial statements indicate that the Claimant had invested $1.2 million before the LearnFast Kayton City learning centre closed and the LearnFast subsidiary in Kaylia had to file for bankruptcy and company liquidation in July 2006. Based on the information that is currently available in this matter, in my opinion this amount represents the value of the Claimant's lost investment in the Kayton City Project.

IV Compensation level for the value of the Kayton City Project, had LearnFast not been confronted with Circular 10 and Other Unexpected Measures

37. In this section, I set out my calculation of the Claimant's damages in respect of the impact of Circular 10 and Other Unexpected Measures on the Kayton City Project. I first set out an overview of the 'but for' scenario that I have adopted in my calculations (i.e. the scenario 'but for' the introduction of Circular 10 and Other Unexpected Measures). I then set out details of how I have calculated the Claimant's damages, based on this 'but for' position.

A. Overview of the financial scenarios for the Kayton City Project, "but for" Circular 10 and Other Unexpected Measures

38. On 20 May 2000, Mr Peters prepared a "Technical and Economic Feasibility Study" ("the Feasibility Study") which set out his business plan for the Kayton City Project and includes a detailed financial forecast for the planned international learning centre in Kayton City. Relevant extracts from the financial forecasts in this study are included in the appendices to this report. I have performed a detailed review of the Feasibility Study in order to understand the assumptions contained therein and to consider these assumptions against the actual financial performance details of the Kayton City Project that Mr Peters has set out in his witness statements that have been submitted in this matter.

39. I understand that the Feasibility Study was based on a standard industry business plan and the assumptions in it were based on the proven experience of Mr Peters in the industry of learning centres. In particular, Mr Peters used his experience of running and managing similar international learning centres in Western Europe to develop the financial projections set out in the Feasibility Study. I understand that the revenue growth projections (including both projected student numbers, student mix (between local and international students) and lesson prices), as well as the profit margin forecasts and operating cost forecasts that Mr Peters used in the Feasibility Study were based on the actual operations of the learning centres that he runs in Western Europe and are consistent with the actual results reported for these centres in their management accounts.[15]

40. I have been provided with copies of the management accounts for Mr Peters' other European based international learning centres, and I note that Mr Peters has a track record of accurately forecasting profitability at these centres, to within a +/- 2.5% level of accuracy for any given

[15] First Witness Statement of Mr Peters.

year.[16] From reviewing these management accounts, I have also been able to confirm that the assumptions set out in the Feasibility Study are consistent with the actual price, volume and cost data for Mr Peters' other learning centres in Western Europe.

41. Further, I understand from Mr Peters' witness statement (and from the management accounts provided to me) that the learning centres that he operates in the UK and in Western Europe typically generate a gross profit margin of around 80%, consistent with the long-term forecast gross margin of 82% in the Feasibility Study.[17]

42. I understand from Mr Peters that the degree of uncertainty in projecting the revenues and costs of an international learning centre project is limited, since the economic structure of such operations is standard.[18] I have therefore used the above features to gain comfort over the accuracy and reasonableness of the financial projections which Mr Peters included in the Feasibility Study. I also note that the Feasibility Study was provided to the Kaylian government. I am not aware of any disagreement or challenge from the Kaylian government over the projects that Mr Peters included in the Feasibility Study.

43. Having satisfied myself with the reasonableness of the assumptions and projections set out in the Feasibility Study (and, given this study was prepared contemporaneously by Mr Peters, prior to any contemplation of the current dispute and prior to the introduction of (and/or awareness by Mr Peters of) Circular 10 and Other Unexpected Measures), in my opinion, the Feasibility Study therefore provides a reasonable basis for projecting cash flows under the 'but for' scenario.

44. Having established that there are reasonable contemporaneous financial projections to allow me to accurately develop cash flows under a 'but for' scenario, I now move to consideration of the best approach to adopt in order to use this information to value the Claimant's damages. Reflecting the above, my approach to valuing the damages suffered by LearnFast under this head of claim is based on the Discounted Cash Flow ("DCF") approach. The DCF basis for valuing damages involves comparing the value of the actual scenario in which the Claimant finds itself in (the "actual scenario") against the position that the Claimant would have been in but for the alleged wrongful actions of Kaylia (i.e. the introduction of Circular 10 and Other Unexpected Measures on 22 May 2001) (the "but for scenario" that I discuss above).

[16] First Witness Statement of Mr Peters, appendix 1.

[17] First Witness Statement of Mr Peters.

[18] First Witness Statement of Mr Peters.

45. With regard to the actual scenario, as I set out in Section 1, the school that Mr Peters opened in Kayton was marginally loss making during the years in which it operated, up to its closure in 2006 (see Appendix 1 for further details). From 2006 onwards, once the school had closed, the value of the actual scenario is therefore zero. Prior to 2006, the losses made by the school were only marginal (a total of around $48,000, per Appendix 1). Theoretically, these losses should be included in my valuation of the actual scenario and compared against the (higher, positive) value of the "but for" scenario. However, given these losses were only marginal and in order to be prudent in my quantification of LearnFast's damages, I have assumed a zero value for the actual scenario throughout in my calculations. Consequently, in the remainder of this report, I have focused only on valuing the "but for" scenario in order to establish the damages suffered by LearnFast.

46. Based on this understanding and on my instructions, I have modelled the "but for" financial scenario of the Kayton City Project through an *ex-ante* analysis (*i.e.* the most likely scenario, had LearnFast not been confronted with Circular 10 and Other Unexpected Measures). As set out above, in my opinion, the Feasibility Study provides a useful starting point for the *ex-ante* analysis. It is a contemporaneous document which was prepared at a time when litigation was not being contemplated and is based on the actual financial performance of other international learning centres that Mr Peters has managed and operated. Further, Mr Peters, who prepared the Feasibility Study, has a proven track record of accurately (and repeatedly) forecasting the financial performance of each of the international business schools that he operates.

47. For the purposes of this report, I have assessed the quantum of the "but for" financial scenario under two scenarios: (1) based on the *ex-ante* level of revenues and costs as set out in the Feasibility Study (which I refer to as my 'base-case scenario'); and (2) an adjusted version of the base case scenario to reflect a series of prudent adjustments (referred to as my 'low-case scenario'). Below I explain in more detail how I have assessed the projected revenues and costs for the Kayton City Project under this 'but for' scenario.

<u>Determination of the level of revenues of the Kayton City Project under my "but for" scenario</u>

48. I understand that the primary initial uncertainty in education projects relates to the number of students expected, which directly defines the level of revenues. Revenues for a learning centre are calculated as follows:

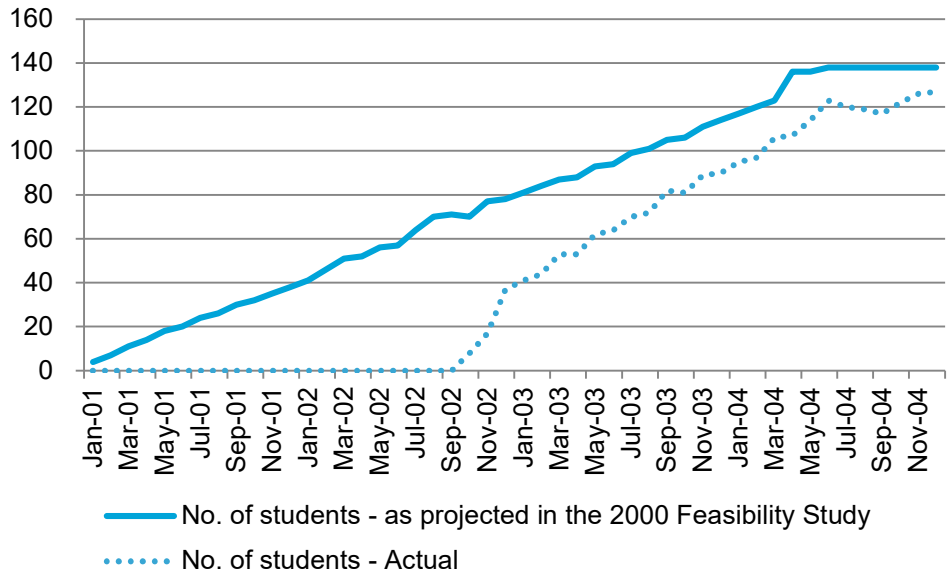
Table 2: Kayton City Project – Example Calculation of Monthly Revenue

	Unit	Calculation	Month 1
Number of students per month	No.	[a]	4
Number of lessons per student per month	No.	[b]	14
Total number of lessons in month	No.	[c] = [a] x [b]	56

Price per lesson	$	[d]	150
Revenue for month	$	**[e] = [c] x [d]**	**8,400**

49. I have conducted a review of the *ex-ante* student expectations of the Kayton City Project, as set out in the Feasibility Study, in comparison with the actual numbers of students received. The results of the review are set out in Appendix 2 and are illustrated in Figure 1 below.

Figure 1: Kayton City Project – Feasibility Study vs Actual Student Attendance



50. As shown in Figure 1, the trend of actual student attendance in 2003 and 2004 - although affected by delays incurred in the opening of the Kayton City learning centre - was in line with the initial expectations of the Feasibility Study. Further, by mid-2004, actual student numbers had already caught up with and were broadly in line with the long-run level of students projected in the Feasibility Study.

51. This analysis therefore provides me with comfort that the projected student numbers presented in the Feasibility Study were achievable. Indeed, the projections may even be prudent since the introduction of Circular 10 and Other Unexpected Measures would most likely have impacted the attractiveness of the school, in particular to foreign students. Yet despite Circular 10 and Other Unexpected Measures, student numbers at the school were still broadly consistent with Mr Peters' expectations as set out in the Feasibility Study.

Price, volume and student mix

52. Other key assumptions that drive the forecast revenues are:

a. Average price per lesson;

b. Number of lessons; and

c. Mix of students.

53. Most courses offered to students were offered at different prices depending upon whether the student was a Kaylian student or an International student. I have analysed the forecast assumptions and compared them to the actual results achieved. This analysis is summarised below and is set out in detail in Appendix 3:

Table 3: Kayton City Project – Analysis of Learning Centre Revenue

	F. Study	Actual	F. Study	Actual	F. Study	Actual
	2001	**2003**	**2002**	**2004**	**2003**	**2005**
No. lessons to Kaylian students	2,870	9,200	8,570	16,475	14,321	20,140
% of total lessons	85%	88%	90%	92%	94%	97%
Revenue (total from lessons)	208,025	533,530	554,850	879,205	827,350	967,400
Weighted average price per lesson	61.58	51.07	58.04	49.10	54.55	46.59

54. As shown in Table 3 above, the actual level of lessons provided to Kaylian students was higher than had been projected in the Feasibility Study. I understand that the reason for this was that the introduction of Circular 10 and Other Unexpected Measures prevented the Kayton City Project from being an international learning centre and instead required it to operate as a local school. Accordingly, this was a more attractive educational institute for local, Kaylan students, but a less attractive option for international students. Thus, whilst in Table 3 total actual student numbers may have been similar to those projected in the Feasibility Study, the mix of these students was dramatically impacted by Circular 10 and Other Unexpected Measures, resulting in a far higher proportion of local students compared to international students.

55. A key consequence of the above is that the local students pay far less for each lesson than international students do. Consequently, the actual weighted average price per lesson was significantly lower in each year of operation than had been projected in the Feasibility Study. As I explain further below, this lower price per lesson had a significant impact on the gross profitability of the school in Kayton City and was one of the key causes for the failure of the Kayton City Project. Furthermore, I consider it reasonable to assume that the reduced attractiveness of the learning centre to international students would result in an inability to charge those students the premium prices that the centre could have charged but for Circular 10 and Other Unexpected Measures.

56. In summary, from the above analysis, one can deduce the following:

    a. the number of lessons actually taught were higher than forecast;

    b. total revenue actually achieved was higher than forecast; and

    c. the weighted average price per lesson actually achieved was approximately 85% of the forecast price, a reduction of 15%.

57. As explained above, I understand that a lower weighted average price per lesson was actually achieved because of a change in the mix of Kaylian and International students and because of lower prices actually achieved for all lessons. However, one can observe a clear correlation between the lower than forecast price and the higher than forecast volume, resulting in a higher level of total revenue than forecast, despite the change between the forecast and actual mix of student/lessons, which was caused by the introduction of Circular 10 and Other Unexpected Measures.

58. Although the actual weighted average prices were lower than forecast for the first three years of operation, it is reasonable to assume that this is the result of the reduced attractiveness of the school caused by Circular 10 and Other Unexpected Measures. Further, in my opinion there is no reason to assume that actual prices would not have risen over time to the levels forecast in the Feasibility Study had it not been for Circular 10 and Other Unexpected Measures.

Conclusion

59. Based on the above analysis, I consider it reasonable to use the *ex-ante* level of activity and associated revenues set out in the Feasibility Study for the base-case "but for" financial scenario of the Kayton City Project. Actual revenues achieved at the school, following the introduction of Circular 10 and Other Unexpected Measures were higher than those forecast in the Feasibility Study. In the absence of Circular 10 and Other Unexpected Measures, it is Mr Peters' evidence that the school would have operated as an international learning centre and would have been able to attract a higher proportion of foreign students and attract a higher price for all lessons. Revenues in the "but for" scenario are therefore likely to have been even higher than the actual revenues achieved. Using the lower revenue projections set out in the Feasibility Study therefore represents a prudent position.

60. One may also consider it prudent to reduce revenues by 2% in the low-case "but for" scenario to take account of the fact that forecast prices were not actually achieved. As higher than forecast volumes and revenues were achieved, I do not consider it appropriate to reduce

revenues by as much as 15% (being the actual difference between forecast and achieved prices per lesson).

61. Learning Centre revenue accounts for 63% of the total Kayton City Project revenue so I consider it appropriate to apply the 2% reduction to total revenue.

Determination of the level of costs of the Kayton City Project under my "but for" scenario

62. The Feasibility Study sets out four main categories of cost:

    a. Direct running costs of the school (which are deducted from revenue in order to reach gross profit);

    b. Payroll (which are deducted from revenue in order to reach gross profit);

    c. General and administrative expenses ("G&A expenses") (which are treated as operating costs, and applied after gross profit has been calculated); and

    d. Depreciation and amortisation (which are treated as operating costs, and are applied after gross profit has been calculated).

63. Direct costs include operational costs that vary directly with sales, such as learning materials and payroll. As set out in Section 1, one of the main consequences of the introduction of Circular 10 and Other Unexpected Measures was that Mr Peters was required to substantially revise the learning materials for the school. I understand that prior to the introduction of Circular 10, Mr Peters had intended to utilise the learning materials that he was using at his learning centres in Western Europe.[19] However, the requirement under Circular 10 for learning materials to be updated to comply with Kaylian educational standards increased direct costs, resulting in a lower actual gross profit margin than Mr Peters had previously forecast.

64. Payroll includes all costs relating to teachers and teaching assistants, including basic pay and taxes.

65. G&A expenses include other costs that no not vary directly with sales, such as rental fees and running costs.

66. Depreciation and amortisation relates to the start-up costs and fixed assets.

[19] First Witness Statement of Mr Peters.

67. Some *ex-ante* costs, such as rental fees, were highly unlikely to be different in the actual development of the Kayton City Project: rental fees were obviously already determined with the DoE and, in fact, remained the same. However, the number of staff and payroll were subject to changes as the Kaylian DoE requirements under Circular 10 required higher levels of staffing at the school (as compared to a learning centre) meaning actual payroll costs were higher than had been forecast.

68. I therefore consider it reasonable to use the *ex-ante* level of G&A expenses as set out in the Feasibility Study for the "but for" financial scenario of the Kayton City Project. The actual costs of the school appear to have been directly impacted by the introduction of Circular 10, as illustrated by the lower actual gross and operating profits margins as compared to forecast (see Appendix 4). This is particularly true at the gross margin level, with payroll costs and direct costs having a significant impact on the actual gross profit margin as compared to Mr Peters' expected gross profit margin as set out in the Feasibility Study.

69. Other *ex-ante* costs (such as direct costs and depreciation and amortisation), although considered through professional experience and industry standards, certainly could involve a degree of uncertainty and be subject to potential changes.

70. *Ex-ante* levels for these other costs may therefore be kept at the level set out in the Feasibility Study, yet one may also prudently consider them with a potential contingency mark-up rate that I have set at 20%.

71. The "but for" cost scenario may therefore be defined under two hypotheses: (i) scenario one where the *ex-ante* level of costs as set out in the Feasibility Study should define a base-case scenario; and (ii) scenario two where a 20% mark-up level on direct costs and depreciation and amortisation (and capital expenditure) should define a low-case scenario.[20]

<u>Reasonableness of the chosen "but for" financial scenarios</u>

72. The *ex-ante* analysis of the main revenue and cost components of the Kayton City Project, as well as the careful consideration of base-case and low-case situations, limit, to a reasonable extent, the speculative nature of my "but for" financial scenarios.

73. These scenarios may therefore plausibly be used to determine cash flow hypotheses within a DCF (Discounted Cash Flow) valuation of the Kayton City Project.

[20] In my calculation, direct costs are first reduced in line with the 2% reduction in revenue, then the resulting amount is increased by 20%.

B. Determination of the NPV (Net Present Value) of the Kayton City Project under my "but for" scenario

74. I have applied the DCF method to the cash flows under my "but for" financial scenarios. To do so, I have used a discount rate of 10% which I consider prudent in comparison to industry standards[21].

75. The detailed DCF calculations for the two cash flow scenarios I have calculated are set out in Appendices 5 and 6 respectively and are summarised below:

Table 4: Kayton City Project – Net Present Value: Base Case

	Total for period 2000 to 2026	**Value as at May 2001**
	$'000	**$'000**
Revenues	44,972	
Direct costs	(8,180)	
Gross margin	**36,792**	
Other costs	(27,657)	
Depreciation and amortisation	(1,300)	
Operating profit before tax	**7,835**	
Tax	(783)	
Operating profit after tax	**7,051**	
Add back: depreciation and amortisation	1,300	
Less: capital expenditure	(1,300)	
Free cash to firm	**7,051**	
Net present value (at a discount rate of 10%)		**1,563**

[21] Professor A. Damodaran presents a 9% WACC (weighted average cost of capital) for the educational services industry in the 2000s.

Table 5: Kayton City Project – Net Present Value: Low Case

	Total for period 2000 to 2026	**Value as at May 2001**
	$'000	**$'000**
Revenues	44,072	
Direct costs (increased by 20%)	(9,619)	
Gross margin	**34,453**	
Other costs	(27,330)	
Depreciation and amortisation (increased by 20%)	(1,560)	
Operating profit before tax	**5,562**	
Tax	(556)	
Operating profit after tax	**5,006**	
Add back: depreciation and amortisation	1,560	
Less: capital expenditure (increased by 16%)	(1,560)	
Free cash to firm	**5,006**	
Net present value (at a discount rate of 10%)		**768**

76. As set out in Tables 4 and 5 above, the Net Present Value of the Kayton City Project under the "but for" circumstances may be estimated between $0.77 million (low case scenario) and $1.56 million (base case scenario).

Summary 2

Had LearnFast not been confronted with Circular 10 and Other Unexpected Measures, the investment of the Kayton City Project would have been fully recovered and have generated a net discounted cash flow that can be reasonably estimated between $0.77 million and $1.56 million.

V Compensation level for the value of the LearnFast Network Project, had the Kayton City Project not been rendered valueless by Circular 10 and Other Unexpected Measures

A. Establishing the 'but-for' scenario in respect of the wider Network Project

77. I understand that the Kayton City Project was the foundation to serve for the development of a wider number of international learning centres in Kaylia and neighbouring country Janeway: referred to in this report as the Network Project.

78. I understand that the financial forecasts for years 2005 to 2009 for the Network Project were set out by Mr Peters in a Network Financial Forecast, based on similar industry business plans and his experience in the industry of learning centres.

79. I also understand that the financial scenario presented in the Network Financial Forecast was sufficiently credible to reach the attention of reputable financial institutions, such as the International Finance Corporation - World Bank Group.

80. Given the apparent credibility of this business plan and, as with the Feasibility Study, given Mr Peters' experience and given these forecasts were prepared contemporaneously, prior to any contemplation of litigation, in my opinion they provide a reasonable basis for the projection of the 'but-for' cash flows in respect of the Network Project. I have reviewed the Network Financial Forecast and confirmed that it is consistent with the Feasibility Study and that the assumptions contained in it are consistent with Mr Peters' other learning centres (as set out in the management accounts for these centres that I have reviewed).

B. Valuation of the Network Project under the "but for" scenarios

Determination of the NPV (Net Present Value) of the Network Project in "but for" scenarios

81. I have applied the DCF method with a discount rate of 10%, similar to the NPV calculation conducted in the Kayton City Project in Section IV of this report, in order to value the 'but-for' scenario in respect of the Network Project. The base case calculation (Appendix 7) relies upon the unadjusted figures set out in the Network Financial Forecast prepared by Mr Peters, the results of which are set out in Table 6 below. In the absence of any other information, the low case scenario (Appendix 8) applies the same adjustments to revenues and costs that were applied to the Kayton City Project low case scenario, the results of which are set out in Table 6 below.

Table 6: Network Project – Net Present Value: Base Case

	Total for period 2004 to 2030	**Value as at May 2001**
	US$'000	**US$'000**
Revenues	207,478	
Direct costs	(81,876)	
Gross margin	**125,602**	
Other costs	(56,866)	
Depreciation and amortisation	(7,353)	
Operating profit before tax	**61,382**	
Tax	(6,138)	
Operating profit after tax	**55,244**	
Add back: depreciation and amortisation	7,353	
Less: capital expenditure	(10,747)	
Free cash to firm	**51,850**	
Net present value (at a discount rate of 10%)		**7,669**

Table 7: Network Project – Net Present Value: Low Case

	Total for period 2004 to 2030	**Value as at May 2001**
	US$'000	**US$'000**
Revenues	203,328	
Direct costs (increased by 20%)	(96,286)	
Gross margin	**107,042**	
Other costs	(56,866)	
Depreciation and amortisation (increased by 20%)	(13,085)	
Operating profit before tax	**37,091**	
Tax	(3,709)	
Operating profit after tax	**33,382**	
Add back: depreciation and amortisation	13,085	
Less: capital expenditure (increased by 16%)	(12,897)	
Free cash to firm	**33,570**	
Net present value (at a discount rate of 10%)		**1,126**

82. As set out in Tables 6 and 7 above, the Network Project, had the Kayton City Project not been abandoned, had a value as at the Date of Breach of between $1.1 million (low case scenario) and $7.7 million (base case scenario).

Adjustment for additional risk

83. The NPV valuation I have calculated bears some risk in relation to the uncertainty regarding the actual implementation of the Network Project. Unlike the Kayton City Project, this wider Network Project had not commenced and LearnFast had not invested in this wider project.

84. As a consequence, the tribunal may want to mitigate my computed NPV by what would be the chances of success of the Network Project implementation, had LearnFast not been confronted with Circular 10 and Other Unexpected Measures.

85. The maturation stage of the Network Project in 2006 can be described as follows:

a. Business planning completed

b. Interest from financial partners proven

c. Feasibility study not completed

d. Investment license not granted

86. With such considerations, the tribunal may consider, like me, that chances of success for the Network Project are set within a range from 20% to 50%.

87. As highlighted in Table 8 below, adjusting the Net Present Values previously, through a chance of success factor, would lead to the consideration of an expected value (*i.e.* a mitigated value) of between $0.2 million and $3.8 million.

Table 8: Network Project – NPV (full and mitigated)

	Low Case	**Base Case**
	US$'000	**US$'000**
NPV (10%)	1,126	7,669
50% mitigation factor	563	3,835
20% mitigation factor	225	1,534

Summary 3

The value of the LearnFast Network Project that was to follow the development of the Kayton City Project would have been set between $1.1 million and $7.7 million. This value may be mitigated when considering the uncertainty regarding the Network Project implementation, even if Circular 10 and Other Unexpected Measures had not come into force.

VI Expert's Declaration

88. I understand that my overriding duty is to assist the Tribunal in matters within my expertise, and that this duty overrides any obligation to those instructing me or their clients. I confirm that I have complied with that duty and will continue to do so.

89. Except as disclosed in this report I have no conflict of interest of any kind.

90. I have included in my report those matters, of which I have knowledge or of which I have been made aware, that might adversely affect the validity of my opinion.

91. I have indicated the sources of all information I have used.

92. I have not without forming an independent view included or excluded anything which has been suggested to me by others (including my instructing lawyers).

93. I will notify those instructing me immediately and confirm in writing if for any reason my existing report requires correction or qualification.

94. I understand that:

    a. My report, subject to any corrections before swearing as to its correctness, will form the evidence to be given under oath or affirmation;

    b. I may be cross-examined on my report by a lawyer assisted by an expert; and

    c. I am likely to be the subject of adverse criticism if the Tribunal concludes that I have not taken reasonable care in trying to meet the standards set out above.

95. I confirm that I have not entered into any arrangement where the amount or payment of my fees is in any way dependent on the outcome of the case.

96. I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.

Signature……S. Smith…… Date…3 August 2019……

LEARNFAST UK LTD -v- THE REPUBLIC OF KAYLIA
Expert Report of Sam Smith
Appendix 1: Extracts from the audited financial statements of LearnFast Kaylia

	2003 **$**	**2004** **$**	**2005** **$**
Revenue	880,325	1,459,480	1,586,536
Direct Operating Costs	(603,903)	(845,039)	(874,181)
Gross Profit	**276,422**	**614,441**	**712,355**
Gross Profit Margin (%)	***31.40%***	***42.10%***	***44.90%***
Operating Costs	(292,356)	(619,403)	(739,008)
Profit Before Taxation	(15,934)	(4,962)	(26,654)
Operating Profit Margin (%)	-1.81%	-0.34%	-1.68%

Nature of audit opinion	Partially Qualified	Partially Qualified	Partially Qualified
Extract from the audit opinion	We planned our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. However, the evidence available to us was limited because $515,000 of the company's recorded borrowings and account payables relate to liabilities for which no documentation could be provided and over which there was no system of control on which we could rely for the purpose of our audit. There were no other satisfactory audit procedures that we could adopt to confirm that these borrowings and account payables had been correctly recorded.	We planned our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. However, the evidence available to us was limited because $515,000 of the company's recorded borrowings and account payables relate to liabilities for which no documentation could be provided and over which there was no system of control on which we could rely for the purpose of our audit. There were no other satisfactory audit procedures that we could adopt to confirm that these borrowings and account payables had been correctly recorded.	We planned our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. However, the evidence available to us was limited because $515,000 of the company's recorded borrowings and account payables relate to liabilities for which no documentation could be provided and over which there was no system of control on which we could rely for the purpose of our audit. There were no other satisfactory audit procedures that we could adopt to confirm that these borrowings and account payables had been correctly recorded.

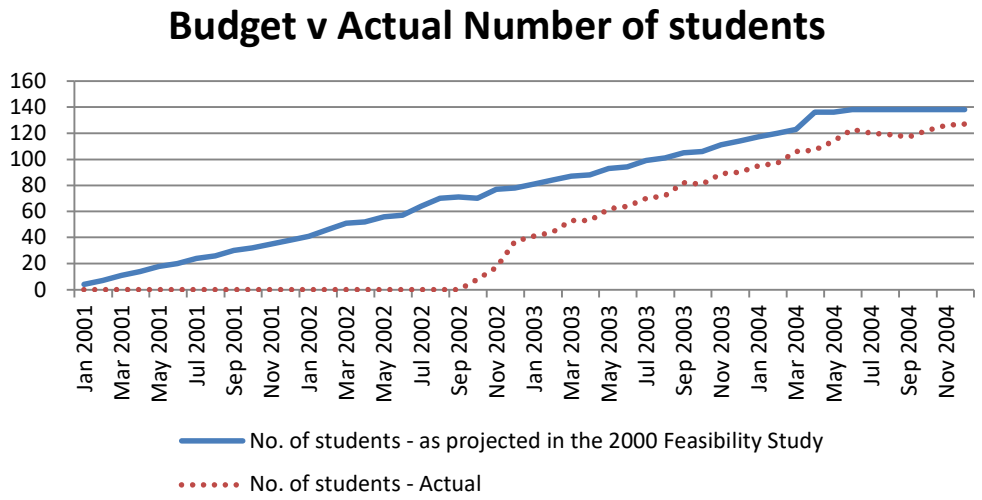
LEARNFAST UK LTD -v- THE REPUBLIC OF KAYLIA
Expert Report of Sam Smith
Appendix 2: Number of students at the Kayton City Project - forecast v actual

Number of students	2001	2002	2003	2004	2005	2006
No. of students - as projected in the 2000 Feasibility Study	259	733	1,163	1,598	1,656	552
No. of students - Actual	-	62	801	1,373	1,592	356

Year on year comparison of forecast/actual student numbers	Year 1	Year 2	Year 3
Projected	259	733	1,163
Actual	801	1,373	1,592

CAGR in number of students	Year 1	Year 2	Year 3
Feasibility Study	23%	6%	3%
Actual	24%	3%	1%

Number of Learning Centre lessons	FS 2001	Actual 2003	FS 2002	Actual 2004	FS 2003	Actual 2005
Number students	259	801	733	1,373	1,163	1,592
Lessons / student	13.04	13.04	13.04	13.04	13.04	13.04
Number of lessons	3,378	10,447	9,560	17,907	15,168	20,763



LEARNFAST UK LTD -v- THE REPUBLIC OF KAYLIA
Expert Report of Sam Smith
Appendix 3: Analysis of forecast and actual revenue at the Kayton City Project (from lessons - note - analysis exlcudes other revenue streams such as private tutoring etc)

		YEAR ONE				YEAR TWO				YEAR THREE			
		Forecast		**Actual**		**Forecast**		**Actual**		**Forecast**		**Actual**	
	Unit	**2001**		**2003**		**2002**		**2004**		**2003**		**2005**	
Learning Centre													
No. lessons - Kaylian Students	No.	2,870	85%	9,200	88%	8,570	90%	16,475	92%	14,321	94%	20,140	97%
No. lessons - International Students	No.	275	8%	730	7%	547	6%	895	5%	534	4%	512	2%
No. lessons - High Standard	No.	234	7%	517	5%	443	5%	537	3%	313	2%	110	1%
Total number of lessons	No.	3,378	100%	10,447	100%	9,560	100%	17,907	100%	15,167	100%	20,762	100%
Price per lession - Kaylian Students	$	50		45		50		45		50		45	
Price per lession - International Students	$	150		100		150		100		150		100	
Price per lession - High Standard	$	100		90		100		90		100		90	
Revenue - Kaylian Students	$	143,500		414,000		428,500		741,375		716,025		906,300	
Revenue - International Students	$	41,175		73,000		82,050		89,500		80,025		51,200	
Revenue - High Standard	$	23,350		46,530		44,300		48,330		31,300		9,900	
Revenue	$	**208,025**		**533,530**		**554,850**		**879,205**		**827,350**		**967,400**	
Weighted average price	$	61.58		51.07		58.04		49.10		54.55		46.59	
Difference (forecast versus actual)	*%*			*-17%*				*-15%*				*-15%*	

LEARNFAST UK LTD -v- THE REPUBLIC OF KAYLIA
Expert Report of Sam Smith
Appendix 4: Kayton City Project - Analysis of forecast versus actual costs and profitability

	Year One	Year Two	Year Three	Year Four	Year Five
Year 1 to 3 actuals					
Revenue	880,325	1,459,480	1,586,536		
Operating costs (direct running costs incl. teacher payroll)	(603,903)	(845,039)	(874,181)		
Gross profit	276,422	614,441	712,355		
Operating costs (rent, running costs, depreciation and amortisation)	(292,356)	(619,403)	(739,008)		
Net profit	(15,934)	(4,962)	(26,654)		
Gross Profit Margin					
Actual	31.4%	42.1%	44.9%	n/a	n/a
As projected in the 2000 Feasibility Study	90.0%	88.0%	84.0%	83.0%	82.0%

LearnFast UK Ltd -v- The Republic of Kaylia

Expert Report of Chris Brown

3 December 2019

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Appendices

I Introduction

1.1 My name is Chris Brown and I am a partner in the London office of the United Kingdom firm of Finance Masters LLP ("Finance Masters"). I am a Fellow of the Institute of Chartered Accountants of England and Wales and have acted as an accounting expert witness on 20 occasions.

1.2 I have been instructed to prepare a reply report to the expert report of Sam Smith ("Claimant's Expert report"). My report will address the following heads of claim addressed in the Claimant's Expert report:

(i) Compensation for the value of the investment made by LearnFast UK Ltd ("the Claimant") in the Kayton City Project;

(ii) Compensation for the loss of value of the Kayton City Project, caused by the alleged breaches; and

(iii) Compensation for the loss of value of the LearnFast Network Project, caused by the alleged breaches.

1.3 For the purposes of my report I have been instructed to assume that the Claimant's allegation that the enactment of Circular 10 and various other unexpected measures ("the alleged breaches") constitute a breach of the UK – Kaylian Treaty is upheld by the Tribunal. I understand that the Respondent denies this.

1.4 I am instructed to act as an expert witness and not a witness of fact.

1.5 I have been assisted in my work by members of my firm's staff whose work I have supervised personally. However, the opinions expressed herein are my own.

1.6 I set out the remainder of my report under the following headings:

	Section
Executive Summary	II
Compensation for the investment made in the Kayton City Project	III
Compensation for the value of the Kayton City Project	IV
Compensation for the value of the LearnFast Network Project	V
Expert's declaration	VI

1.7 This report has been prepared for and only for Hughes and Associates and The Republic of Kaylia in accordance with the terms of the engagement letter between Finance Masters and Hughes and Associates dated 26 October 2013. Finance Masters does not accept or assume any liability or duty of care for any other purpose or to any other person to whom this report is shown or into whose hands

it may come save where expressly agreed by us in writing. I understand that Hughes and Associates and the Republic of Kaylia may share this report with the Claimant and its advisers and with the Tribunal. I consent to this report being so provided for the purposes of conducting the proceedings between the parties. However, I accept or assume no liability to the Claimant or its advisers or to any other party as a consequence of them being provided with this report.

1.8 In preparing this report I have examined and relied upon the parties' submissions, the Claimant's Expert Report and the Claimant's witness statement in so far as they relate to the matters that I have been asked to consider.

II Executive Summary

Value of investment

2.1 Neither the Claimant nor Sam Smith has provided sufficient evidence to enable me to confirm independently the amount allegedly invested by the Claimant in the Kayton City Project (of $1.2 million). Sam Smith relies upon a qualified audit opinion in order to assess the alleged value of the lost investment. This in itself creates an uncertainty around the reliability of the financial data to which the audit opinion relates. Further, Sam Smith has not performed any steps to assess how any monies provided by the Claimant to LearnFast Kaylia were spent and/or to evidence that any such expenditure was in direct relation to the Kayton City Project and was then also wasted. On this basis, and given the lack of information provided by Sam Smith, in my opinion there is not enough information to be able to reliability assess the value of the investment in the Kayton City Project that was made by the Claimant.

Value of Kayton City Project

2.2 Sam Smith adopted a discounted cash flow ("DCF") methodology to estimate the value of the Kayton City Project, but for the alleged breaches. Whilst DCF is a well-recognised methodology for the calculation of value (and loss of profits), a DCF model is only a tool. The credibility of a DCF model's output depends wholly on the reliability of the underlying forecast profits and cash-flows that are used as inputs to the DCF model. Sam Smith appears to have largely relied on and accepted the theoretical forecasts set out in the 2000 Feasibility Study prepared by Mr John Peters ("Mr Peters", a shareholder in LearnFast UK Ltd), with limited testing of the reasonableness of those forecasts. Whilst Sam Smith has provided a "low case" scenario valuation, which assumes lower average prices and higher costs than forecast in the 2000 Feasibility Study, (s)he has provided limited analysis supporting the reasonableness of the "low case" scenario.

2.3 Sam Smith has not fully taken into account the actual performance of the Kayton City Project during the period in which it operated. Whilst I understand it is alleged by the Claimant that the performance of the Kayton City Project was impacted in some respects by the alleged breaches, the actual track record is relevant and should not be ignored. It is possible to isolate the impact of the alleged breaches from the normal operation of the Kayton City Project. However, Sam Smith has not done this. Similarly (s)he has not provided any other analyses or evidence to support the reasonableness of the forecasts (s)he used to calculate the net present value of the profits that would purportedly have been made by the Claimant.

2.4 I have carried out an assessment of the key assumptions underpinning the financial forecasts in the 2000 Feasibility Study (which was the basis of Sam Smith's DCF calculation). In particular, I have

considered the assumptions for gross profit and specifically, the gross profit margin. In my opinion, the forecast profits in the 2000 Feasibility Study were overly optimistic and unachievable. The gross profit margin rate assumed in the 2000 Feasibility Study is significantly higher than could reasonably have been achieved. But for the alleged breaches, it is more probable that the Claimant would have incurred losses (rather than made profits) from its investment. My assessment of the net present value ("NPV") of the Claimant's cash-flows from its investment in LearnFast Kaylia is that it (the NPV) would have been negative (i.e. the Claimant would have incurred losses), in the range of $3.4 million to $3.6 million.

Value of the Network Project

2.5 As accepted in the Claimant's Expert report, the Claimant made no investment in the Network Project nor had it obtained the necessary licenses to invest in the Network Project. Whilst the Claimant had prepared some hypothetical projections of the revenues and costs of the Network Project, there is little evidence to support the reasonableness of those projections and whether they were likely to be achieved. In my view, this element of the Claimant's claim is speculative and unsupported.

2.6 Sam Smith has then suggested that the probability of success of the Network Project was between 20% and 50%. Sam Smith has applied these percentages to the calculation of the net present value of the Network Project to arrive at a valuation range of $225,000 to $3,835,000[1]. However, in reality, there is no basis for these notional discounts. Applying a probability factor to speculative forecasts does not render the resulting amounts any less speculative.

2.7 Moreover, Sam Smith's calculation of the net present value of the Network Project suffers from similar deficiencies as the calculations for the Kayton City Project. In particular, the assumed gross profit margin used in the projected cash-flows for the Network Project, whilst lower than that forecast for the Kayton City Project, is still significantly higher than the gross profit margin actually achieved by LearnFast Kaylia in the Kayton City Project. By way of comparison, it is also considerably higher, without any rationale or explanation, than the gross profit margin reported by comparable established education service providers. Adjusting the gross margin alone to a more supportable level would result in the net present value of the Network Project being reduced to a negative value of $728,000 to $2,886,000.[2]

[1] Claimant's Expert report, page 25.

[2] Before any deduction for probability of success.

III Compensation for the investment made in the Kayton City Project

3.1 Sam Smith has quantified this head of claim as follows [3]:

	$ 31 December 2005
Short term loans:	
Borrowing from LearnFast UK Ltd	779,780
Accrued interest	8,429
Borrowings from Mr John Peters	15,378
Total	803,587
Legal capital:	400,000
	$1,203,587

Reliance on the audited financial statements

3.2 Sam Smith has derived the amounts shown above from the last available audited financial statements of LearnFast Kaylia, the financial statements for the year ended 31 December 2005 ("the 2005 financial statements").

3.3 In my view, the 2005 financial statements cannot be relied upon to prove the amount of the loans that were allegedly provided by the Claimant to LearnFast Kaylia. The 2005 financial statements were qualified by the auditors on the basis that the auditors were not satisfied that the evidence provided to them confirmed $515,000 of the company's recorded borrowings and accounts payable balances in LearnFast Kaylia's financial statements.

3.4 Furthermore, the auditor's qualification does not appear to have been simply an issue of evidence not being made available to them for the 2005 financial statements. The audited financial statements for the years ended 31 December 2003 and 31 December 2004 were qualified in the same manner. Given the auditors' qualified report, I do not consider the 2005 financial statements provide sufficient evidence to substantiate all of the $779,780 of the Claimant's alleged loans to LearnFast Kaylia.

[3] Claimant's Expert report, page 10.

Evidence has not been provided to support the full amount of Claimant's alleged investment and loans

3.5 Other than the LearnFast Kaylia financial statements, the Claimant has not provided any additional evidence to confirm that loan capital was given to LearnFast Kaylia[4]. Such evidence might include, for example, bank statements confirming transfers to LearnFast Kaylia or the registration of the loans with the Bank of Kaylia[5]. On this basis, and given the qualifications in LearnFast Kaylia's financial statements, it is not possible to establish the amount, if any, that was invested by the Claimant in LearnFast Kaylia and/or how any monies invested were then also spent by LearnFast Kaylia (and whether or not this expenditure was on the Kayton City Project). Accordingly, and as set out below, I have sought to establish other bases of evidence to ascertain any levels of investment made by the Claimant in LearnFast Kaylia and how any such investment was utilised by LearnFast Kaylia.

Claimant appears to have formed a view that its investment was unlikely to be recovered as at 31 December 2003

3.6 The financial statements of LearnFast UK Ltd as at 31 December 2003 show that the Claimant recorded a full provision for its entire investment in LearnFast Kaylia. A provision is recorded when it is believed that the underlying balance may not be recovered or has no value. Thus, it appears that at 31 December 2003 the Claimant considered that it was unlikely that it would recover the investment it had made in LearnFast Kaylia. LearnFast Kaylia's audited financial statements for the year ended 31 December 2003 show that LearnFast UK Ltd had invested $400,000 of legal capital and loan capital of $460,618. I note that per LearnFast Kaylia's financial statements, its borrowings from LearnFast UK increased from $460,618 as at 31 December 2003 to $779,780 as at 31 December 2005. In my opinion, this raises a question of why the Claimant continued to invest in LearnFast Kaylia after 31 December 2003 if it considered that it was unlikely to be able to recoup its investment.

How the funds were invested

3.7 Putting aside the uncertainty over the amounts invested by the Claimants, Sam Smith does not consider how the alleged invested funds were in fact spent or attempt to prove that those funds were spent on the Kayton City Project.

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[4] The Claimant has provided a "loan consolidation agreement" which appears to list various loans purportedly given by the Claimant to LearnFast Kaylia. However, it is not clear who prepared this document and it does not provide independent evidence that these amounts were in fact loaned.

[5] It is my understanding that under the current regulation of Kaylia it is compulsory to register the loans with the Bank of Kaylia for loans with duration of 12 months or more.

3.8 I have attempted to quantify the Claimant's investment by reference to the value of assets purchased and expenses incurred by LearnFast Kaylia that were stated to have been paid with funds provided by the Claimant.

3.9 The 2005 financial statements provide some information in this regard. Specifically, they state that investment in fixed assets and "set up" expenses amounted to $956,000, of which 50% ($478,000) had been financed by capital and the remaining 50% through leasing.

3.10 In addition, the 2005 notes to the audited financial statements also state that "*an amount of $285,000, corresponding to one year of rent payments and 20% of the purchasing price of the equipment... was deposited before the opening of the learning centre*". The 2005 financial statements do not specifically state that this amount was funded through funds provided by the Claimant. Assuming that it had, in total it appears that an amount equivalent to $763,000 of shareholder funded capital was invested in fixed assets, "set up" expenses, and the building deposit. There may have been other expenses funded through capital provided by the Claimant. However, based on the information available, I am unable to confirm these amounts.

Summary

3.11 Sam Smith concludes that "*financial statements indicate that the Claimant had invested $1.2 million before the LearnFast Kayton City learning centre closed and the LearnFast subsidiary in Kaylia had to file for bankruptcy and company liquidation in July 2006*[6]." However, I do not agree with this conclusion. There is evidence that suggests that the Claimant funded assets and expenses of LearnFast Kaylia amounting to $763,000, being the value of fixed assets, rent deposit paid to the Department of Education ("DoE") and various set up expenses. However, there remains uncertainty over when and how the residual balance of $425,000 was spent. In my opinion, and based on the information that I have been able to review, the value of any investment which was made by the Claimant was $763,000.

[6] Claimant's Expert report, page 11.

IV Compensation for the value of the Kayton City Project

4.1 In this section, I consider the methodology applied by Sam Smith to quantify the value of the Kayton City Project, the key drivers of the claim, including the discount rate, my assessment of these variables and their impact on the claim.

Methodology and key drivers underpinning the claim

4.2 Sam Smith calculates the compensation for the value of the Kayton City Project by using an income approach, i.e. calculating the present value of expected future cash-flows using a discounted cash flow ("DCF") methodology. Sam Smith has prepared a DCF model that calculates the net cash-flows that the Kayton City Project would have purportedly generated by:

- Projecting revenues (which requires an estimate of the number of students and prices to be charged for each lesson to be provided);
- Deducting the estimated direct costs of providing the different services to students (including payroll);
- Deducting other estimated expenses of running the business (such as general costs, depreciation and amortisation); and
- Applying a discount factor to derive a net present value of forecast cash-flows.

4.3 The appropriateness of using a DCF methodology fundamentally depends on whether the underlying revenues and costs and resulting cash-flows can be estimated reliably. The output of a DCF model will only be as good as the inputs (evidence and assumptions) going into the model.

4.4 In order to derive the cash flows for his DCF calculation, Sam Smith has used the estimated revenues and costs included in LearnFast Kaylia's Forecast 2000-2026. These amounts appear to have been taken from the 2000 Feasibility Study.

4.5 It is my understanding that the 2000 Feasibility Study and the projections contained therein were prepared by Mr Peters. Sam Smith notes Mr Peters' prior experience of running learning centres[7]. I understand that Mr Peters based the projections in the 2000 Feasibility Study on the experience and data that he had from running learning centres in the UK and Western Europe, updated to take account of Kaylian conditions. However, the 2000 Feasibility Study does not set out how Mr Peters adapted

[7] Claimant's Expert report, page 4.

the projections to take account of local market factors applicable in Kaylia such as pricing, direct costs or other costs. Given Mr Peters does not appear to have had any prior experience of operating a business in Kaylia when he prepared the 2000 Feasibility Study, it is not clear to me how he adjusted the projections in this study to allegedly reflect 'local conditions'.

4.6 Sam Smith states "*that the degree of uncertainty in projecting the revenues and costs of an international learning centre project is limited, since the economic structure of operations is standard*[8]". Sam Smith does not provide the source of this assumption. In my opinion, it is necessary to assess the robustness of the revenue and cost projections in the 2000 Feasibility Study in order to consider if they are a reliable basis for the Claimant's alleged losses in these proceedings.

4.7 Sam Smith has carried out the following analysis to assess the appropriateness of the projections in the 2000 Feasibility Study:

- Compared the number of students forecast in the 2000 Feasibility Study to the actual number of students taught at the learning centre and concluded that the trend of actual student attendance in 2003 – 2004 was in line with expectations in the 2000 Feasibility Study.

- Compared the revenue forecast to actual revenue achieved in the corresponding period (assumed to be two years later) and the forecast weighted average price per lesson to the actual weighted average price per lesson. On this basis, adopted the revenues forecast in the 2000 Feasibility Study for the base case scenario.

- Provided a second scenario (low case) for the DCF calculation in which revenues are decreased by 2% and then applied increases in some of the costs forecast in the 2000 Feasibility Study by 20%[9]. However, the basis for these percentages is unexplained.

4.8 Sam Smith compares actual to forecast revenues and concludes that the revenues forecast in the Feasibility Study were reasonable. However, Sam Smith does not appear to have carried out a qualitative assessment of a key assumption underlying the cash-flow forecast in the 2000 Feasibility Study, namely the assumed gross profit margin. The Claimant's assumptions on gross profit margin are vital to the Claimant's claim. As I explain below, in my opinion, the Claimant's assumptions are overly optimistic and contrary to actual experience, with the result that those assumptions have materially overstated the quantum of the claim presented by the Claimant.

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[8] Claimant's Expert report, page 13.

[9] This increase has been applied to direct costs, depreciation and capital expenditure.

Gross profit margin

4.9 Gross profit margin is the difference between revenues from lessons being delivered and the direct cost of achieving those revenues. The gross profit margin is a key indicator of the profitability of a business and underpins its ability to generate a profit in the long term. The 2000 Feasibility Study estimated that the Kayton City Project would achieve a gross profit margin between 83% and 90% of revenues in the first four years of operation. Thereafter, margin was forecast to remain constant at 82% of revenues (Appendix 4 of Sam Smith's report). This appears to be very high, particularly in the early years of trading. It is also significant as the success of the proposed Kayton City Project was heavily dependent on generating a high gross profit margin.

4.10 The Claimant alleges that the running costs and capital expenditure required to run the Kayton City Project were impacted by the introduction of Circular 10 and other measures. However, based on my reading of the Claimant's submissions, the witness statement and financial statements it appears that the breaches alleged by the Claimant (which are denied by the Respondent) did not impact the gross profit margin potential of this businesses. I acknowledge that there may have been some incremental one-off costs in year one as certain materials were prepared for the school. However, I would not expect these to be recurring costs and I would not expect these to be significant costs. In my opinion, it is possible therefore to use financial information available from the period during which the learning centre operated to assess the reasonableness of gross profit margin projections built into the cash-flow forecast of the 2000 Feasibility Study as there should be no significant difference between the gross profit margin in the actual and "but for" scenarios. Further, it is not clear to me as to why Circular 10 was have required the school to incur significantly higher payroll costs, certainly not to the extent that is now claimed in these proceedings.

Gross profit

4.11 In the 2000 Feasibility Study, Mr Peters forecast that the Kayton City Project would generate a gross profit of 90% in its first year and would achieve a maintainable gross profit margin of 82% by year 5 of operation.

4.12 As explained above, the gross profit margin achieved does not appear to have been significantly impacted by the alleged breaches. On this basis I have reviewed the actual gross profit margin achieved and compared this with the assumed gross profit margin in the 2000 Feasibility Study.

4.13 In order to break even over the 25 year term (i.e. generate a net present value of cash-flows close to zero) based on the 2000 Feasibility Study, the Kayton City Project would have had to generate a minimum gross profit margin of 70% (base case) (See Appendix 4). In fact, during its period of operation, it generated a gross profit margin that was consistently below 45% (Appendix 3). Thus, even before taking account of the impact of any incremental costs imposed by the alleged breaches,

my analysis shows that LearnFast Kaylia would have made a loss because it could not generate a sufficiently high gross profit margin for it to cover other forecast expenses (e.g. rent).

4.14 The significant difference between forecast gross profit margin and actual gross profit margin casts considerable doubt on the reliability of the projections contained in the 2000 Feasibility Study and consequently the basis of the Claimant's claim.

4.15 In my opinion, a gross profit margin forecast of 80% appears to be too high compared to actual performance. In support of this view, I have therefore looked for evidence of gross profit margins for comparable businesses.

4.16 I have not been able to obtain comparable information from other private schools in Kaylia as this information is not publicly available. However, I have considered levels of gross profit margin achieved by a number of other international private schools, located in Janeway, a neighbouring country to Kaylia, for which information is publicly available. The information I have obtained about the operations of two established providers of private schools in Janeway, indicates a gross profit margin of around 40%. These schools are of a similar size and nature to the proposed learning centre in Kaylia. An overview of these schools is set out in Exhibits A and B to this report. Even taking into account different demographics, cost and pricing factors, this gross profit margin is significantly lower than the 80% maintainable margin forecast in the 2000 Feasibility Study. I have not seen any evidence to explain why the market in Kaylia would be so much more profitable, as assumed by the Claimant, than comparable schools in neighbouring countries. Instead, the comparable data that I have identified supports my view that the cost structure of the Kayton City Project was not significantly impacted by the introduction of Circular 10. Instead the actual gross profit margin generated by Mr Peters' school in 2003, 2004 and 2005 was as would also have been generated by an international learning centre in Kaylia as well and is consistent with the gross profit margin at comparable learning centres that I have identified.

4.17 If DCF is to be used as a methodology for valuing Claimant's alleged loss of profits, then in my view it is necessary to adjust the gross profit margin assumed in the 2000 Feasibility Study to reflect more realistic projections. To assist the Tribunal, I have considered how Sam Smith's calculation could be adjusted to reflect more realistic projections of gross profit margin.

4.18 One way to adjust Sam Smith's DCF calculation would be to replace the gross profit margin forecast for the first three full years of operation (i.e. 2001 to 2003 per the 2000 Feasibility Study) with the actual gross profit margin achieved (adjusted for material costs) in monetary terms in 2003, 2004 and 2005 – that is $276,422, $614,441, and $712,355 – while holding all other assumptions constant.

4.19 This results in a revised DCF valuation of $371,000, compared with Sam Smith's base case scenario of $1,563,000. It also results in a loss of (-$308,000) compared with the Sam Smith's low case scenario of $768,000 (see Appendices 4 and 5).

4.20 It is then necessary to adjust the gross profit margin assumed in the 2000 Feasibility Study beyond year three. Adjusting Sam Smith's DCF calculation to reflect a gross profit margin of 45% (which is slightly higher than the actual gross profit margin percentage achieved at any point in time between 2003 and 2005) for year four and year five onwards as well results in a negative DCF between $3.4 million (base case scenario) and $3.6 million (low case scenario). This would result in no profit and no claim in these proceedings (see Appendices 6 and 7).

Costs below gross profit margin

4.21 The Claimant's position is that the alleged breaches resulted in the Claimant incurring additional unforeseen costs in order to run a school, instead of a learning centre. Those additional costs are alleged to have included: higher cost of leasing equipment, higher set up costs and higher administrative and other running costs. It is not possible, based on information made available to me, to calculate the impact of these alleged breaches on the actual running costs of the school (i.e. costs below gross profit margin). In the absence of publicly available information on costs incurred by other schools (both private and public) in Kaylia, it is not possible for me to form an independent view of the reasonableness of forecast non-direct costs in the 2000 Feasibility Study. However as detailed above, I note that even without adjusting for any changes in these costs, if the gross profit margin assumed in the Feasibility Study is reduced below 70% (and as set out above, I consider it should be reduced to around 45%) then even on Mr Peters' own forecast of operating costs in the Feasibility Study, the Kayton City Project would not have been profitable.

Discount factor

4.22 Sam Smith has applied a discount factor of 10% to calculate the net present value of forecast cash-flows[10]. However, based on my experience, I would consider a discount rate of 18% to be more appropriate (see Appendix 14). Adjusting Sam Smith's DCF by applying a WACC of 18% (instead of the 10% used) and leaving all other elements of Sam Smith's DCF valuation unchanged results in a net present value of $417,000 to -$114,000 (compared to Sam Smith's $1,563,000 base case and $768,000 low case, respectively) (see Appendices 8 and 9).

[10] Claimant's Expert report, page 20 states that it has relied upon a discount rate applicable for the educational services industry in the 2000's.

Summary

4.23 Sam Smith concludes that but for the alleged breaches, "*the investment of the Kayton City Project would have been fully recovered and have generated a net discounted cash flow that can be reasonably estimated between $0.77 million and $1.56 million*". However, Sam Smith appears not to have assessed the reasonableness of some key assumptions underpinning his DCF calculation or to use in the calculations the evidence of the actual performance of the Kayton City Project, which showed substantially different results from those assumed in the 2000 Feasibility Study. In my opinion Sam Smith's net DCF calculation is based on assumptions of the profitability of LearnFast Kaylia that are, at best, optimistic and contrary to actual experience.

4.24 Adjusting Sam Smith's DCF calculation for a gross profit margin that reflects more closely the actual gross profit margin achieved (which is not alleged to have been affected by the alleged breaches), results in a negative net cash outflow over the life of the project of $3.4 million to $3.6 million. In other words the project was not likely to be profitable and the projected profits shown in the 2000 Feasibility Study are based on underlying assumptions that were unreasonable and overly optimistic.

V Compensation for the value of the Network Project

5.1 The Network Project refers to a network of seven learning centres to be built in Kaylia over a period of three years, starting in 2004. Consistent with the Kayton City Project, the Claimant planned to find sites on which learning centres could be built and leased by the Claimant.

5.2 I understand that, as at the time of the closure of LearnFast Kaylia in 2006:

- no investment had been made in the Network Project (other than its investment in the Kayton City Project);
- no licenses had been obtained;
- no contracts had been entered into for the construction and leasing of the learning centres; and
- the Claimant had started discussions with possible providers of finance for the project, but actual financing had not been secured.

Methodology

5.3 Sam Smith calculates the net present value of the Network Project using a DCF calculation similar to that used for the Kayton City Project. The DCF calculation is based on "Projected 5 year Financial Performance for LearnFast Kaylia Network (2005-2009)" ("the Network Project plan") a document that I understand was prepared by Mr Peters. It is not clear when this document was prepared nor for what purpose.

5.4 Sam Smith adopts a DCF approach to calculate the value of the project based on the forecasts provided in the Network Project Plan.

5.5 Given the speculative nature of the project at this stage I do not believe that a DCF approach is appropriate. There is no objective evidence to suggest that the Network Project would have proceeded or indeed would have generated profits.

5.6 As with his approach to the Kayton City Project valuation, Sam Smith does not appear to have assessed robustly whether the Network Project plan was a reasonable basis for a DCF calculation.

5.7 As shown in Section IV, above, leaving aside the alleged breaches, it is doubtful that the Kayton City Project would have made a profit. It is therefore not a reliable basis for projecting the reported performance of the Network. Given the high uncertainty that exists over the Network Project's profitability, it is not appropriate to adopt DCF as a methodology in respect of this head of claim.

5.8 Sam Smith has acknowledged the speculative nature of the project by applying a probability factor to the range of values that (s)he derives from his DCF calculation of the net present value of the estimated cash-flows of the Network Project. Sam Smith considers that the *"chances of success for the Network Project are set within a range from 20% to 50%"*[11]. However, it is not clear what (s)he bases these percentages on. In any event, applying probabilities to the estimated cash-flows does not render the result (i.e. that the Network Project would have been profitable) any more certain or less speculative.

Projections used for the valuation of the Network Project appear overly optimistic

5.9 Even if DCF was an appropriate methodology for calculating this head of claim, the underlying projections used will suffer from similar short-comings as those for the Kayton City Project. In particular, the gross profit margin assumed in the projections for the Network Project Plan, whilst lower than that forecast in the 2000 Feasibility Study, is in the order of 60%. Given the actual track record of the Kayton City Project and the results reported by other providers of learning centres in Western markets, a 60% gross profit margin appears to be overly optimistic and not consistent with the comparable gross profit margins earned by other learning centres in neighbouring countries (which as I set out above, is around 40% for the comparable centres that I have been able to obtain financial information for).

5.10 Adjusting Sam Smith's DCF calculation to reflect a gross profit margin of 45% would reduce the base case scenario (before application of the probability of success percentages) from a positive cash-flow of $7,669,000 to a negative cash-flow of $728,000 (and positive cash-flow of $1,126,000 to a negative cash-flow of $2,886,000 for the low case scenario) (see Appendices 10 and 11).

5.11 In summary, I believe this head of claim is both remote and speculative and is not supported by any evidence. In any event, I do not consider that Mr Peters would have been able to create a profitable (and therefore of value) wider network of schools/learning centres in Kaylia. The operating cost model that Mr Peters was projecting, when considered in the context of a realistic gross profit margin, could not be supported in Kaylia.

[11] Claimant's Expert report, page 25.

VI Expert's Declaration

6.1 I understand that my overriding duty is to assist the Tribunal in matters within my expertise, and that this duty overrides any obligation to those instructing me or their clients. I confirm that I have complied with that duty and will continue to do so.

6.2 Except as disclosed in this report I have no conflict of interest of any kind.

6.3 I have included in my report those matters, of which I have knowledge or of which I have been made aware, that might adversely affect the validity of my opinion.

6.4 I have indicated the sources of all information I have used.

6.5 I have not without forming an independent view included or excluded anything which has been suggested to me by others (including my instructing lawyers).

6.6 I will notify those instructing me immediately and confirm in writing if for any reason my existing report requires correction or qualification.

6.7 I understand that:

- My report, subject to any corrections before swearing as to its correctness, will form the evidence to be given under oath or affirmation;
- I may be cross-examined on my report by a lawyer assisted by an expert; and
- I am likely to be the subject of adverse criticism if the Tribunal concludes that I have not taken reasonable care in trying to meet the standards set out above.

6.8 I confirm that I have not entered into any arrangement where the amount or payment of my fees is in any way dependent on the outcome of the case.

6.9 I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.

Signature……C. Brown…… Date……3 December 2019……

Appendix 14 – Discount Rate

Introduction

1.1 In this appendix, I set out my calculation of the applicable WACC to be applied to the discounting of LearnFast UK Ltd's future cash flows.

1.2 When applying the DCF approach to calculate lost profits, it is necessary to discount LearnFast UK Ltd's future projected cash flows to a present value as at the date of breach. In order to do this, a rate of return is used which reflects the relative risk of the investment/cash flows, as well as the time value of money. This return, known as the WACC, is calculated by weighting the required returns on interest-bearing debt and ordinary equity capital in proportion to their estimated percentages in an expected capital structure.

Overview of the WACC calculation

1.3 The cash flows set out in this report are on a post-tax basis and are denominated in Kaylian Dollars. Accordingly, I have calculated a post-tax WACC using the following formulae:

WACC = (Ke * We) + ((Kd * (1-T)) * Wd)

Where:

Ke = Cost of equity

Kd = Cost of debt

We = Weight of equity

Wd = Weight of debt

T – Rate of corporation tax

1.4 Below, I set out my calculation of each of these components of the LearnFast UK Ltd applicable WACC.

Cost of equity

1.5 I have determined the levered cost of equity by reference to the Capital Asset Pricing Model ("CAPM") which has been applied as the cost of equity. The CAPM is a generally accepted method for estimating the yield that an investor would require if investing in a given security.

I have calculated the cost of equity using the following formula:

Ke = Rf + *β(Rm)* + CRP

Where:

Rf = Risk free rate of return (for US)

CRP = Country Risk Premium (for Kaylia)

Rm = Equity Market Risk Premium

β = Levered Beta (risk) coefficient

1.6 Below, I consider each of these components of this cost of equity formula.

Risk free rate of return

1.7 The risk free rate represents the theoretical rate of return of an investment with zero risk. This risk free rate therefore represents the interest that an investor would expect from an absolutely risk free investment (within a relevant economy/market) over a specified period of time.

1.8 It is often hard to estimate an emerging market's risk free rate due to: (1) emerging markets sovereign debt is not risk free (often below investment grade) and (2) emerging markets sovereign debt is traded in an illiquid market. Accordingly, I have used the yield on 20 year US Government Bonds as a proxy for the risk free rate and applied an additional country risk premium to account for any discrepancy in the risk ratings between the two countries.

1.9 The long term nominal yield on 20 year US treasury bonds as at 31 July 2006 is 5.17%.

Country risk premium

1.10 The risk free rate set out above is calculated based on US treasury bonds. To reflect the fact that there are different levels of risk associated with cash flows outside of the US and, specifically for this case, in Kaylia, I have included a country risk premium in my calculation of LearnFast UK Ltd's applicable cost of equity.

I have made an adjustment of 2.75% to the risk free rate to reflect the different risk ratings between the US and Kaylia. This adjustment is based on the country risk premium of Indonesia, which has the same sovereign rating as Kaylia (Ba2). The average default risk spread on sovereign bonds (when compared to US sovereign bonds) is 2.75%. The average default spread in the CDS market is 2.06%. In my opinion, I consider the average default risk spread of 2.75% a more appropriate measure for the country risk premium for Kaylia.

Equity market risk premium

1.11 The Equity Market Risk Premium ("EMRP") is the expected return in excess of the risk free rate which investors generally require for investing in equities as an asset class.

1.12 Historic evidence collated from the early parts of the last century suggests that equities have generated average annual returns that are higher when compared to government bonds. This evidence suggests that an appropriate equity risk premium expected by investors in emerging markets is 6.13%.

Beta

1.13 Beta is a measure of the covariance of the movement in the returns on an investment in an individual security (or, in the case of an industrial beta, a class of securities) and that on the equity market as a whole. A security with a beta of 1.0 is as volatile and risky as the market as a whole.

1.14 A security with a beta of 1.25 is 25% more volatile and risky than the market as a whole. Conversely, a security with a beta of 0.75 is 25% less volatile and risky than the market as a whole.

1.15 Since LearnFast UK Ltd is an unlisted entity, I have calculated a beta of 1.93 using the average beta from three comparable publically traded companies that I consider to have similar risk characteristics.

WACC calculation

Component	**Value**	**Notes and sources**
Risk free rate (Rf)	5.17%	US Department of Treasury – daily yield rates on 20 year treasury bonds as at 31 July 2006
Country risk premium (CRP)	2.75%	Bloomberg
Equity market risk premium (RM)	6.13%	Finance Masters LLP
Levered beta	1.93	Average beta from three comparable companies extracted from Bloomberg
Weight of equity	89%	Based on the Company's outstanding debt as at 31 July 2006 and its Market Capitalisation as at the same date
Post-tax Cost of Equity (Ke)	**19.75%**	**Ke = Rf + *β(Rm)* + CRP**
Tax rate	25%	
Weight of debt	11%	Based on the Company's outstanding debt as at 31 July 2006 and its Market Capitalisation as at the same date

Component	Value	Notes and sources
Pre-tax Cost of Debt (Kd)	**5.5%**	Interest rate on the most recent loan granted to LearnFast UK Ltd
WACC	**18%**	**Post-tax WACC = (Kd *(1-T)x Wd) + (Ke x We)**