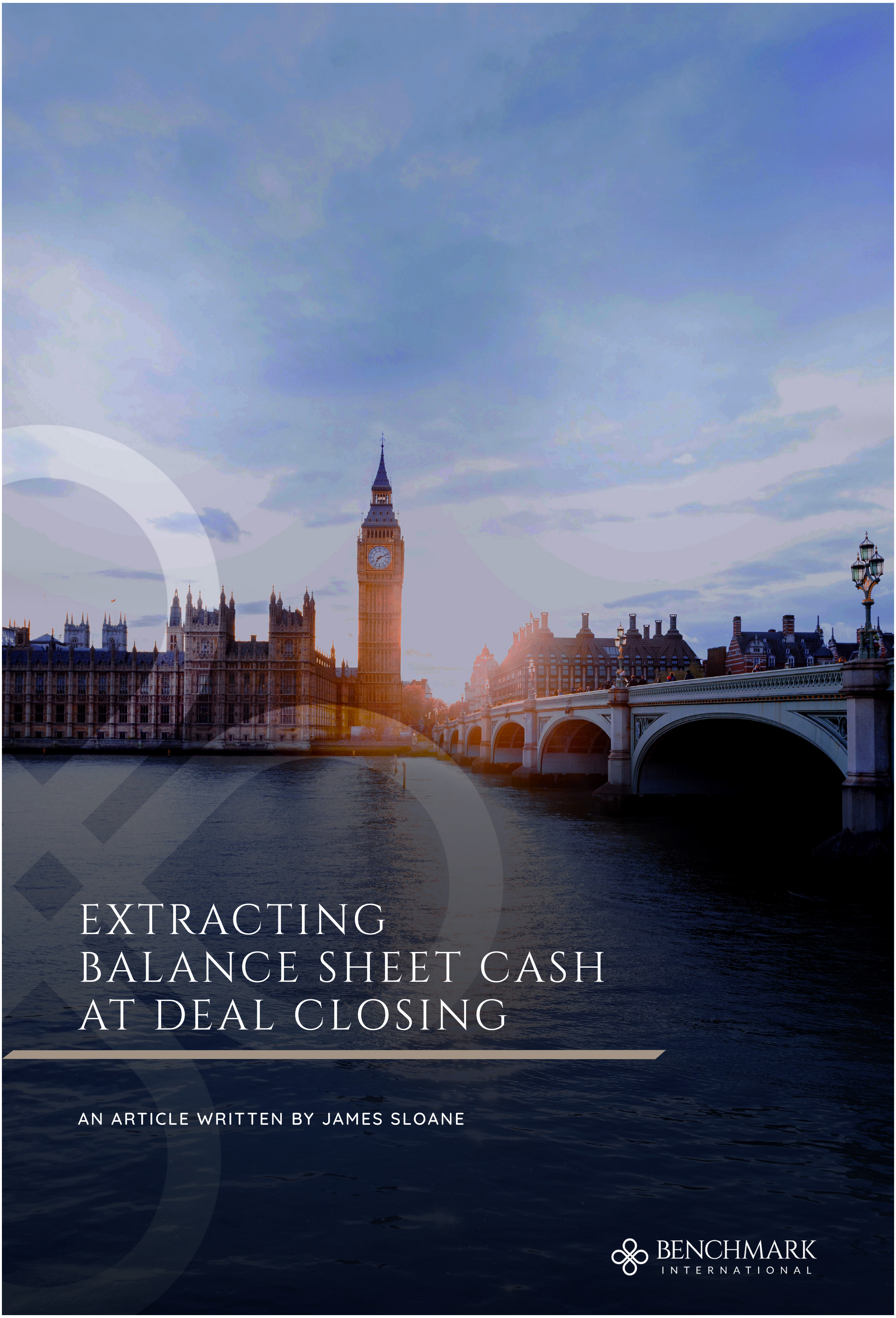

EXTRACTING BALANCE SHEET CASH AT DEAL CLOSING

AN ARTICLE WRITTEN BY JAMES SLOANE

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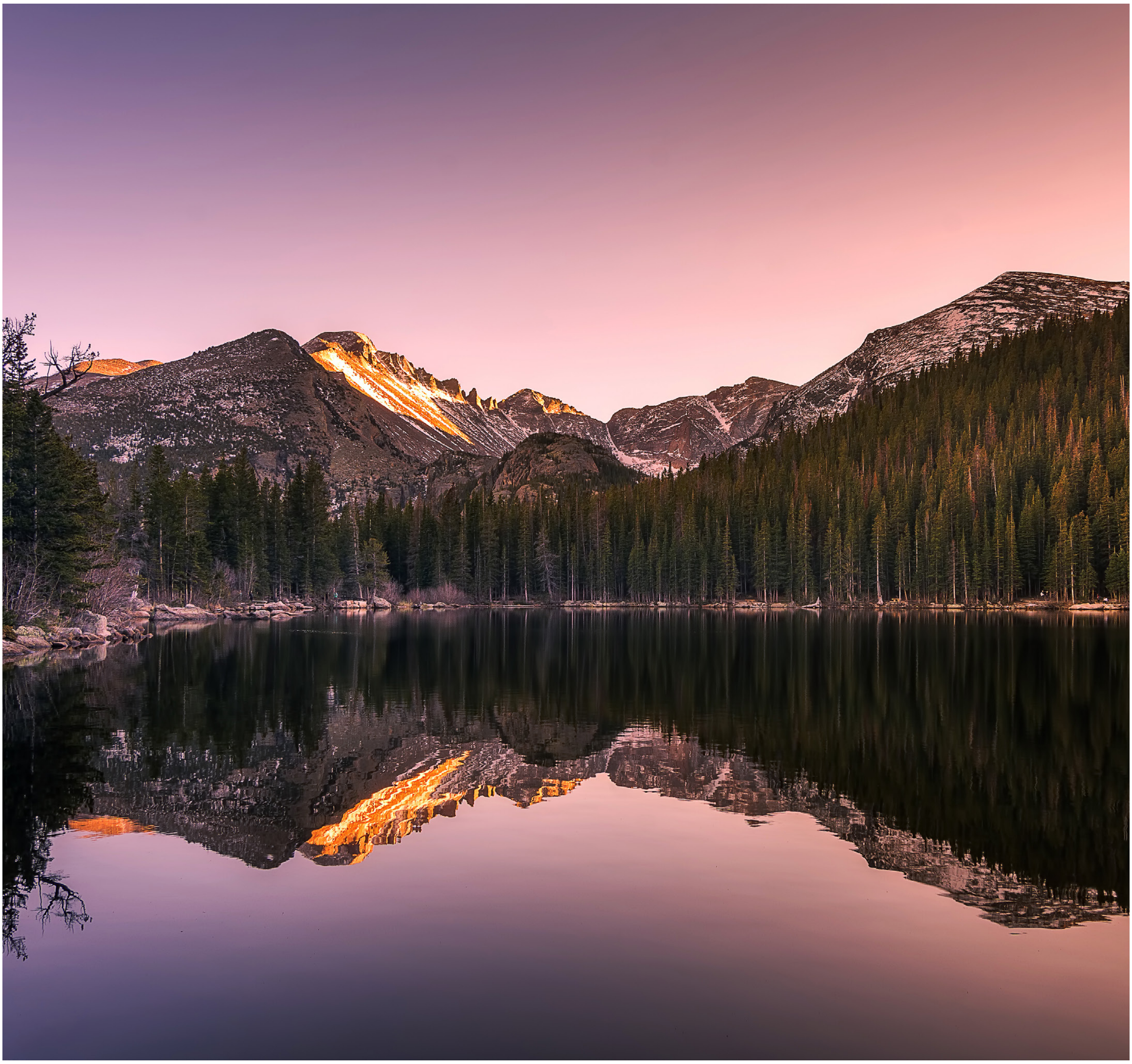


INTRODUCTION

Most deal valuations are set out as a multiple of earnings, plus surplus assets. Nick Hulme's article, Valuing Companies, is a great read for more detail on this.

As he mentions in the article, surplus assets come in many forms, and can include lump sums of cash sitting on the balance sheet, the company's premises/real estate (if the sellers are going to keep these personally post-close) and even the yacht or Bentley in some cases.

Following are some simple rules for sellers to keep in mind when considering Free Cash, the most common surplus asset we encounter on our deals.

RULE #1: HAVE REALISTIC EXPECTATIONS

A BUYER WILL ONLY ALLOW YOU TO EXTRACT CASH AT COMPLETION THAT IS TRULY SURPLUS TO THE REQUIREMENTS OF THE BUSINESS GOING FORWARD.

Think, perhaps, in terms of how much cash you could extract yourself without affecting the ongoing operations of the business, and how much you'd ordinarily want to leave in the business to guard against mid-month and month-to-month fluctuations in cash requirements.

In some cases, this cash can be extracted in a tax efficient manner (for example, in the UK where Capital Gains Tax is presently significantly lower than Income Tax, subject to certain conditions being met).

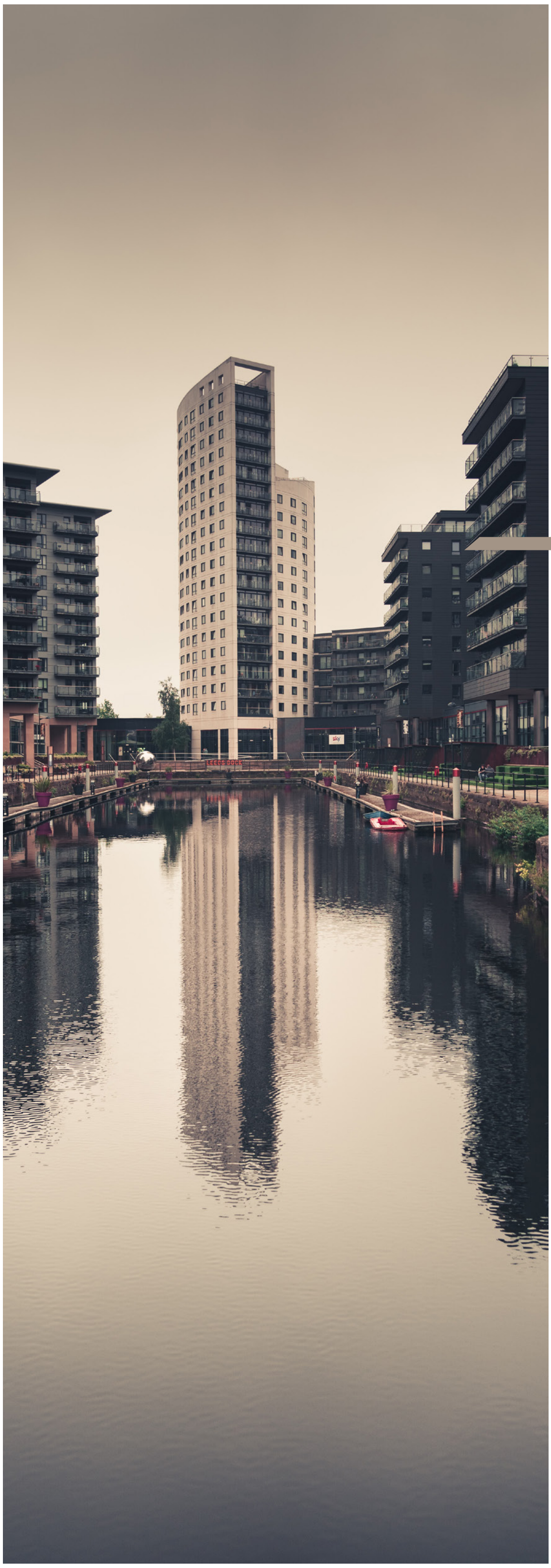
RULE #2: YOU CAN'T BEAT THE SYSTEM. UNLESS...

A BUYER WILL NOT ALLOW YOU TO ARTIFICIALLY MANIPULATE THE COMPANY'S FREE CASH POSITION AT CLOSE IN ORDER TO MAXIMISE YOUR OWN SALE RECEIPTS.

All buyers will engage in a financial due diligence exercise leading up to deal closure, and as part of this they will scrutinise the company's working capital requirements – working capital being the net trading assets of the company that are required to underpin trading and earnings at current levels (excluding cash). As a result of this, they will set what is referred to as a NWC (net working capital) target or 'peg', which will be tested against NWC that is actually delivered at close. If closing NWC is lower than this agreed target, some of the Free Cash will be deducted in order to allow the buyer to effectively top-up the company's working capital, and if closing NWC is higher, your advisers will argue the excess should be added to the final Free Cash number.

The only way to beat the system is to manage your working capital very tightly in the periods running up to the start of the sale process, and certainly at least a year before close, then convince the buyer this is sustainable.

Note always that NWC and cash, despite being intrinsically linked, are not one and the same. 'Cash is cash' and working capital specifically excludes cash!



RULE #3: NEGOTIATE WELL

DO NOT UNDERESTIMATE THE AMOUNT OF HARD NEGOTIATION THAT WILL GO INTO AGREEING THE NWC TARGET.

Buyers will always be motivated to agree as high as possible NWC target in order to increase the amount of cash you as a seller will need to leave in the company at completion. Buyer strategies will play around with the methodologies and timescales used to set the NWC target, and the treatment of anomalies, with the specific aim of enhancing their position.

As pure sell-side advisers, Benchmark International's deal teams are used to facing up to these challenges and optimising the outcome for our clients.

An example of this could be the insistence that the Free Cash number is agreed and fixed ahead of closing, often based on the NWC in a previous balance sheet and rolled forward to the date of closure (through the use of a cash-based 'profit ticker'). This is effected using what is referred to as a locked-box mechanism, where the cash on the balance sheet is treated as being locked in and adjustments agreed for payments outside an agreed list (known as permitted leakage). The clear advantage for both seller and buyer is that there are no distracting ongoing negotiations, and for the sellers, the Free Cash number is known at close.

The negotiations to protect the Free Cash number start as early as the agreement of the term sheet (or letter of intent). This may require bringing all issues to the fore at that stage or deliberately leaving negotiations to a later date, clearly on a case-by-case basis.

RULE #4: EVERYTHING IS 'IN THE ROUND'

IT'S OFTEN NOT POSSIBLE TO AGREE A FREE CASH NUMBER WITHOUT TAKING ACCOUNT OF HOW THE OVERALL DEAL HAS BEEN ARRIVED AT.

Where, for example, a buyer is paying a multiple of earnings that factors in high growth (or future earnings that are higher), it's likely they will ask for some cash to be left in the business to support this growth. On the other hand, where the multiple being paid is within normal bounds, an attempt to reduce the Free Cash number may be seen as a 'cash grab', and should be fiercely defended.

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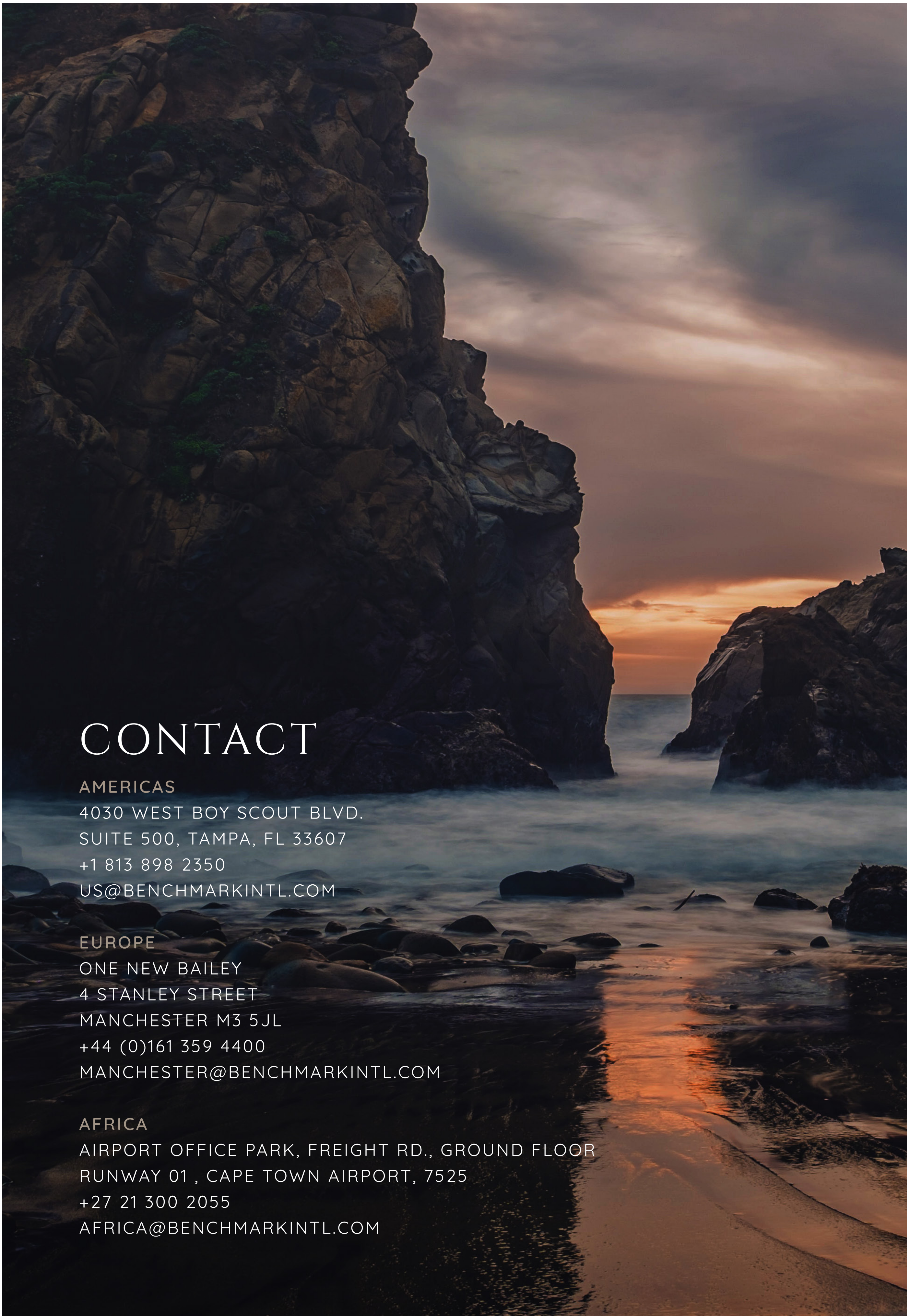

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