NAVIGATOR

A business overview and financial guide for stakeholders in the SME market

ABC Limited (“the Company”) – Report for XYZ Commercial Finance (“XYZ”) 7 March 2013

CORPORATE STRATEGIES
A FRESH APPROACH TO CORPORATE TURNAROUND

Introduction & Scope

Background and letter of engagement

Mr ABC and Mr ABC commenced their business in 1983 after canvassing local residents around Citytown, following a noticeable increase in demand for farm-fresh bottled milk. The Company now supplies fresh milk to over 300 outlets across Countyshire. It operates from its new state of the art premises located in Citytown, employing 100 staff, produces a range of dairy products, and supplies to supermarkets, shops and schools.

XYZ provides an Invoice Discounting facility to the Company with an initial payment rate ("IP") of 80%, up to a maximum funding limit of £1.6 million. In addition XYZ Banking Group ("the Bank") provides an overdraft facility of £700k and term loans amounting to c£2.6m relating to the trading premises and the recent installation of the production lines. The Company has also received grant funding from the government in relation to this.

The Bank is secured by way of:

- A debenture containing fixed and floating charges over the Company's assets, registered on 5 March 2002;
- Specific Legal Mortgages on plant and machinery registered, on 14 January 2009 and 24 April 2010; and
- A Chattels mortgage on certain items of plant and machinery, registered on 3 February 2011.

XYZ is secured by way of a debenture containing fixed and floating charges over the Company's assets, registered on 17 January 2012. We are advised that the Directors have given personal guarantees to the Bank and XYZ, supported by their Farm also located in Citytown.

Over the past 12 months, the Company has been in negotiations with Customer Limited ('Customer') with regards to a new 12 month rolling contract, that would significantly increase turnover (by c£14m per year) and for the purpose of supplying Countryshire milk to Asda stores located in Countryshire.

In anticipation of formally agreeing the contract, the Company has incurred significant capital expenditure on its production facilities to meet Customer prospective demand. In addition, Customer have invested funds to implement a new IT System to undertake the health and safety requirements as part of the production facility. The contract was due to commence at the end of November 2012 but was delayed due to quality issues regarding shelf life.

Given the level of capital expenditure and the delay in commencing the work with Customer, the Company has experienced significant cash flow pressure. An understanding of this has been hampered by poor management information as regards the financial position of the Company. The Company has remained within its overdraft facility, but XYZ has temporarily increased the IP rate to 95%, to alleviate cash flow pressure. This was agreed to with our recommendation, to fund the additional working capital requirement of the staff recently recruited to service the Customer contract, ahead of commencement in January 2013.

It is against this backdrop that we have been engaged by the Company to undertake the scope of works contained in our letter of engagement attached at Appendix 1.

Sources of information, Scope of Work and Limitations

The information contained in this report is based primarily on explanations provided by Management, Management Accounts and Management's forecasts attached at Appendix 2..

As stated in the terms of reference, the scope of work is different from that of an audit and it cannot therefore be relied upon to provide the same level of assurance as an audit. We have relied upon explanations and information provided to us by the Company.

Unless specifically stated we have not sought to establish the reliability of information presented to us by reference to independent evidence. However, we have reviewed the information and sought explanations for key trends and salient features identified. We have also satisfied ourselves that the information presented is consistent with other information available to us.

Whilst we may comment on the Company's projections, we have not prepared them. Consequently, Management remain solely responsible for these projections and the underlying assumptions on which they are based.

This report is issued on the understanding that Management have drawn our attention to all matters of which they are aware concerning the financial position of the Company which may have an impact on our report.

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Trading review and performance risks

The Company forecasts a significant increase in turnover as a result of securing the Customer contract. Forecast profits before tax are expected to increase from £486k in 2013 to £1.36m in 2014.

Historic trading (Y/e 31/03/11, Y/e 31/03/12, P/e 31/12/12)

- There was a slight increase in turnover from 2011 to 2012. However there was a noticeable decrease in the Gross Margin by c5% during the same period, which can be attributed to a price increase in materials (7% up on the previous year as a percentage of turnover). We are advised that these prices have now stabilised.
- The gross margin has remained static at c24.5% over the 21 month period ended 31 December 2012.
- Forecast outturn for turnover to 31 March 2013 has increased to c£16m as a result of the commencement of the Customer contract in January 2013.
- Prior to the commencement of the Customer contract, overheads have remained stable and are controllable. Included within the Profit and Loss Account to December 2012 is an amount of c£1.8m that relates to capital expenditure that should be accounted for on the Balance Sheet. After making this adjustment, forecast outturn on overheads to 31 March 2013 are expected to increase to c£3.2m from c£2.6m in the prior year, which is attributable to increased wage costs for staff taken on in relation to and ahead of the commencement of the Customer contract.

Forecast trading (Y/e 31/03/13, Y/e 31/03/14)

- Forecasts have been prepared on the assumption of the expected increase of turnover in relation to the Customer contract (£14m turnover to 2014), which has now commenced, and the Costa contract which is expected to be signed in the next 2 months (c£1.2m turnover per annum). We are advised negotiations in relation to this are advanced.
- Forecast turnover for the year ending 31 March 2013 is anticipated to increase by 35% from the previous year, and a further 93% in the year ending March 2014. This is in line with intended volumes notified to the Company by Customer, Costa, and other secured milk sales that commenced in December 2012.
- Gross Margin for the year ending 31 March 2013 is expected to decrease by 0.1% to 24.3% from the previous year. The gross margin is forecast to decrease to 21.3% in the following year to March 2014. This is due to an anticipated full year of trading the Customer contract, which has higher packing and delivery costs attached to it. Please note that we adjusted forecast margin as the company includes output VAT as sales in its forecasts.
- Overheads are expected to increase from £3.2m (2013) to £4.9m (2014) which can be attributed to the additional staff, packaging and logistical costs required to service the Customer and Costa contracts.
- Given the increase in trading with Customer and Costa, net profits are expected to rise to c£1.4m in y/e 31/03/14 from £486k in the year to March 2013.

	Y/e 31/03/11 Audited £'000	Y/e 31/03/12 Audited £'000	2012 M'ment (9 mths) £'000	Jan 2013 – Mar 2013 Forecast £'000	Y/e 31/03/13 Outturn Forecast
Sales	11,568	11,729	9,299	6,541	15,840
Cost of Sales	(8,129)	(8,869)	(6,991)	(4,996)	(11,987)
Gross profit	3,440	2,860	2,308	1,545	3,853
GM %	29.7%	24.4%	24.8%	23.6%	24.3%
Overheads	(2,726)	(2,636)	(3,955)	(1,088)	(5,043)
Interest	(47)	(92)	(Customer)	(45)	(168)
Other income	42	35	-	-	-
PBT/(LBT)	**709**	**167**	**(1,770)**	**412**	**(1,358)**

	Forecast Y/e 31/03/13	Capital Expenditure Adjustment	Forecast Y/e 31/03/13	Forecast Y/e 31/03/14
Sales	15,840	-	15,840	30,501
Cost of Sales	(11,987)	-	(11,987)	(23,979)
Gross profit	3,853	-	3,853	6,522
GM %	24.3%	-	24.3%	21.3%
Overheads	(5,043)	1,844	(3,199)	(4,991)
Interest	(168)	-	(168)	(168)
PBT/(LBT)	**(1,358)**	1,844	**486**	**1,363**
NP %	**(8.6%)**		**3.1%**	**4.5%**

Trading review and performance risks (cont.)

The Forecast assumptions appear achievable given the commencement of the Customer contract at the volumes anticipated, and the controllable nature of overheads in relation to wages. In addition, gross margins are protected contractually against increases in milk prices, which would be passed on to customers.

Performance risks on base forecast

- The forecast turnover increases appear reasonable. Pre January 2013 milk sales are at a similar level to the prior year, and include the recent price increases with the dairies under contract. Furthermore non Customer milk sales are anticipated to increase given contracts secured commencing December 2012 (c3.2m litres per annum). In addition to the milk sales, approximately 32 million litres are to be provided under the contract with Customer. The Company also expects to shortly secure its contract with Costa (c£1.2m turnover per annum).
- Gross margins to March 2013 are in line with prior years. Whilst the margin is expected to decrease to c21% in the year to March 2014, we are advised the rates and costs are in the majority of cases are fixed under contract, with dairy suppliers and customers. We have not formally reviewed these contracts but are in receipt of analysis as to formulas applied to customer prices in the event of increased milk costs.
- Overheads are expected to significantly increase. We are advised that this is due to the increase in staff numbers to service the Customer contract. The additional headcount is 40 staff and amounts to £1m per annum. In additional there are anticpated processing and logistical costs on the Asda and Costa contracts being the majority of the balance.

	Assumption in Forecasts	Performance Risk
Turnover	↑ 35.0% (2013) ↑ 93.0% (2014)	**Low/Medium risk** – Customer contract secured and volumes are in line with those notified to the Company. The Costa contract is expected to be signed in the next 2 months.
Gross Margin	↓ 0.1% (2013) ↓ 3.0% (2014)	**Low/Medium risk** – Milk costs increases are largely passed on via increased sales prices to all customers, under contractual terms. Reduction in 2014 due to higher logistical costs contracted with Customer.
Overheads	↑ 21.4% (2013) ↑ 56.0% (2014)	**Low/Medium risk** – the increase in overheads relate to increased processing & labour costs for the Costa and Customer contracts and appear controllable.

Cash Position and Funding Requirements

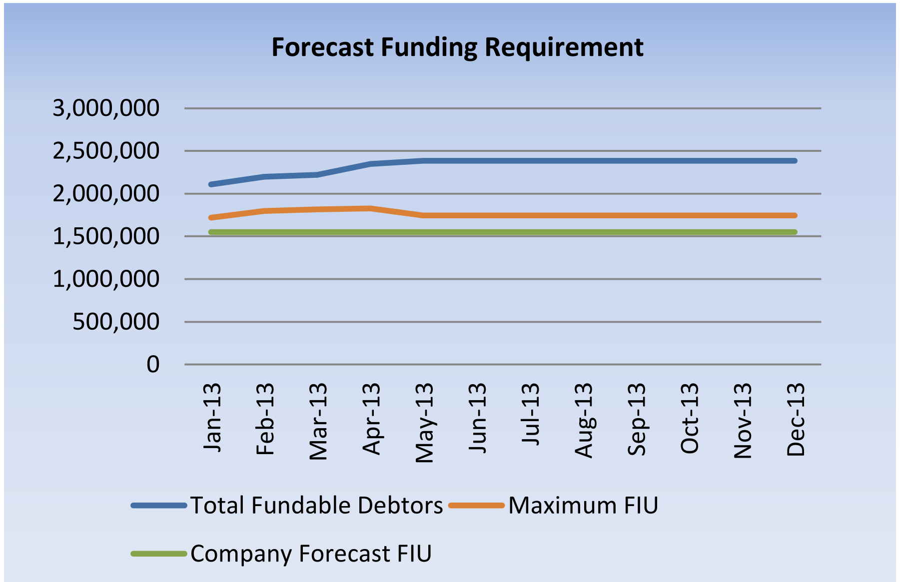
The Company forecasts it can remain within the overdraft facility limits, however the present 95% IP can only be reduced to 85% by April 2013, and 80% thereafter. In addition, in the short to medium term the funding cap of £1.6m should be increased to £1.8m.

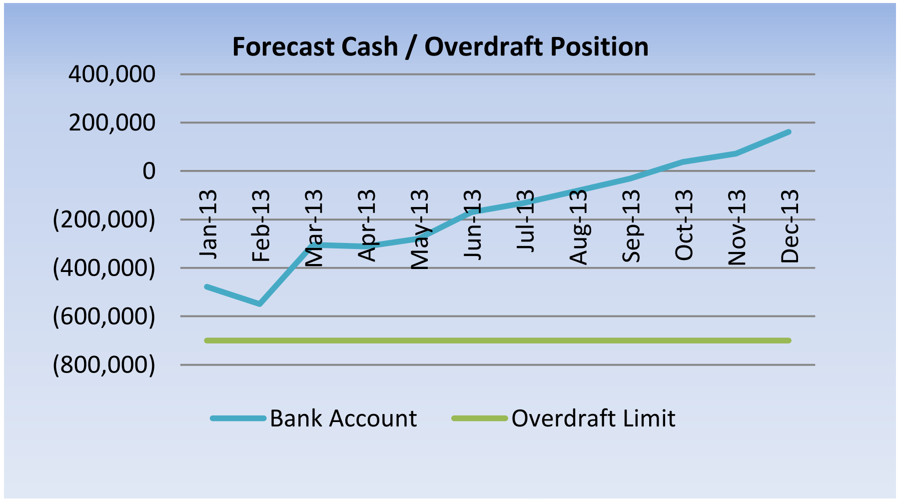
Forecast cash requirement

- The current Invoice Finance facility has an IP rate of 80%, with a funding limit of £1.6m of total funds in use allowed at any one time.
- There is however a temporary IP rate in place of 95%, with a funding limit of £1.8m. The current (December-February) funds in use have been averaging £1.7m.
- The forecasts have been prepared on the assumption that the IP rates are ratcheted down from 95% in February to 90% in March and 85% in April 2013, and 80% thereafter. Reserves for aged debts are estimated at £200k in each month, reflecting actual levels.
- The forecasts also assume that the Company recovers payment from Customer each month (c£1.2m) ahead of making payment to Customer for the supply of their own milk (c£1m per month). This has now been formally agreed under contract and therefore the Customer debts are not envisaged to be funded by XYZ. In addition, the forecast assumes Costa volumes at c3m litres/£1.2m per annum commencing March 2013 (more likely to be April 2013).
- There will still be a requirement for the £700k overdraft to service the large farmer payments around 17th to 20th of each month.
- It is noted that, from April 2013 onwards, the Bank overdraft reduces month on month which can be attributed to the realisation of profits from the Customer contract (c£60-70k/month), and given the 14 day payment terms.

Medium to Long term funding

- The forecast suggests that a limit of £1.8m may be sufficient until September 2013. Based on the present assumptions regarding the IP rate, the forecast and tables opposite show that from April 2013 throughout the year the Company can:
  - Operate within existing overdraft limits of £700k. The account is expected to operate in credit beyond September 2013 as a result of the realisation of profits on the Customer contract. However, intra month cash requirements may increase due to payments to Farmers (c£750k each month), under contract;
  - Generate total fundable debtors which are anticipated to increase given the introduction of Costa, which in turn suggest a maximum funds availability during the year of £1.8m; and
  - Operate at a funding cap of £1.55m. However, given the overdraft levels during the year from January to June 2013, the cap may be required to be raised to the maximum level of £1.8m, to deal with intra month payments to Farmers mentioned earlier.





Current Financial Position – Company Balance Sheet

The Company's Farmplan Accounting System is unreliable. The Farmplan Balance Sheet is materially misstated, understating the Net Asset position by c£2.8m to that estimated by the Company's consultant.

Balance Sheet

We have sought to obtain an up to date and accurate Balance Sheet from the Company, with the purpose of establishing the current financial position of the Company. In particular, we have sought to determine the adequacy of the Bank's and XYZ's security.

The Company and their advisor have been unable to provide a detailed and accurate Balance Sheet from the Company's Farmplan accounting records, and consequently have had to provide an estimated forecast Balance Sheet as at 31 March 2013.

We summarise opposite a table of the items that have material variances between the Company's Balance Sheet per the Farmplan accounting records, and the estimated position per Consultants Consulting. We note that c£2.6m is payable to the government per Farmplan. We are advised that these funds are not due.

For the purposes of the forecasts and the estimated outcome statement, we have relied solely upon the figures produced by Consultants Consulting. Whilst we have relied upon the Consultants Balance Sheet for analytical purposes, we cannot conclude that the Company's accounting systems are accurate or properly maintained. We would therefore recommend that significant work is undertaken to overhaul Farmplan, such that it gives a true and fair view of the Company's financial position.

	Farmplan 31/03/13 £'000	Consultants 31/03/13 £'000	Variance (-)/+ £'000
Assets			
Fixed Assets	9,046	9,083	(37)
Stock	250	350	(100)
Debtors	2,735	2,956	(221)
Other	124	-	124
			(234)
Creditors			
Customer Creditor	-	550	(550)
Government Grant	2,599	-	2,599
Hire Purchase	95	562	(467)
Bank	3,145	3,308	(203)
Tax and Accruals	246	-	246
Net Assets per Farmplan			1,530
Net Assets per Consultants			4,322
Understated net asset value			2,792

Current Financial Position – Estimated Outcome to XYZ and the Bank

XYZ and the Bank appear to be fully secured on their lending. However, we note their ultimate reliance on Property, Plant and Machinery and Fixtures. Given the poor accounting records of the Company, we would recommend that formal valuations of these assets are undertaken.

XYZ and the Bank have the benefit of debentures containing fixed and floating charges over the Company assets.

- Trade debtors - A balance of £2.96m is due to the Company. An estimate to realise value of 90% has been applied on a going concern basis and 75% in a cessation. We note the payment arrangements under contract with Customer result in the Company having little exposure to unpaid debts with them.
- Buildings and fit out of new production line – We have estimated to realise values of 80% on a going concern basis and 50% realisable value in a forced sale scenario, for illustrative purposes only.
- Motor Vehicles – an estimated to realised value of 90% on a going concern basis and 80% realisable value in a force sale scenario. We understand that some of the vehicles are subject to hire purchase.
- We note that an amount of £562k is due on Hire Purchase. We have applied this against Plant and Motor Vehicles but have been unable to apply to specific assets.
- Stocks – These are made up of plastic, trolleys and milk in store. We have estimated to realise a value of 75% on a going concern basis and a 50% realisable value in a force sale scenario.
- Based on the Company's estimates of the Balance Sheet, XYZ and the Bank appear to be fully secured on their lending in a best and worst case scenario. We note that both funders have little recourse to realisations from assets under their floating charge, and are reliant on those realisations from fixed charge.
- Given the paucity of the accounting records, and although Management can identify the amount recently spent on the Plant and Machinery/Buildings, we believe a formal valuation of the Company's assets should be undertaken. This will identify the true value of the assets on the bases we have outlined, which in turn will provide additional assurance to the Bank and XYZ.

		Forecast Consultants Book Value 31/03/13	Going Concern ETR	Forced Sale ETR £'000
		£'000	£'000	£'000
Assets Subject to Fixed Charge				
Fundable Debtors (90%/75%)		2,Customer	1,910	1,592
Non Fundable Debtors (90%/75%)		833	750	625
Available to XYZ		2,956	2,660	2,217
Less due to XYZ		(1,727)	(1,727)	(1,727)
Surplus c/d	(a)	1,229	933	490
Buildings and Plant & Machinery (80%/50%)		8,833	7,066	4,417
Motor Vehicles (90%/80%)		250	225	200
		9,083	7,291	4,617
Less: Hire Purchase liability		(562)	(562)	(562)
		8,521	6,729	4,055
Less due to Bank		(3,309)	(3,309)	(3,309)
Surplus c/d	(b)	5,212	3,420	746
Assets subject to Floating Charge				
Stock (75%/50%)		350	262	175
Fixed Charge Surplus (a) + (b)		6,441	4,353	1,236
		6,791	4,615	1,411
Costs		-	(150)	(100)
Preferential Creditors /Employee Claims (Est)		-	-	(100)
Floating Charge Surplus		6,791	4,465	1,211

Options and Recommendations to XYZ and the Bank – Retain Connection

We recommend XYZ and the Bank provides continued support to the Company, conditional on the terms outlined below.

Option		Benefit		Risk		Risk Assessment	Recommended Option
Unconditional Support – Continue to provide the temporary advance rate of 95% and the present overdraft facility until April 2014	⇨	This will allow the Company to service key supplier payments	⇨	Vulnerability to full collect out	⇨	**LOW**	
				Lack of control over facilities		**HIGH**	
				Management not incentivised to manage cash adequately		**HIGH**	
Conditional support – XYZ and the Bank should provide continued support, subject to the following conditions being met • IP rate 95% to 90% in March to 85% in April 2013 and 80% thereafter. • Temporary increase in the cap of maximum FIU to £1.8 million until June 2013. The facility is then to be reviewed thereafter (pending Costa volumes). • Present overdraft facilities are maintained – to be reviewed in September 2013 once sufficient funds materialise to return the facility into credit. • XYZ and the Bank receives a satisfactory valuation of the Company's Property, P&M, and Fixtures, to give assurance on their security position. • Accurate monthly Management Accounts in the correct format are submitted. • The Company engages a relevant consultant to overhaul the Farmplan accounting systems as soon as possible, and to agree the correct monthly disclosure of management information.	⇨	Continuity and growth of the Business	⇨	Failure is still possible but unlikely	⇨	**LOW/MEDIUM**	✔ **Our Recommendation**

Options and Recommendations to The Bank – Exit Connection

In order to exit the connection, XYZ and the Bank should consider a refinance of its lending as opposed to an insolvency process, which is not recommended.

Option		Benefit		Likelihood		Risk Assessment	Recommended Option
• Insolvency Exit of the Company	⇨	We currently see no reason why the Company should enter an insolvency process.	⇨	• Unlikely at this stage given no external creditor pressure, and securing the profitable Customer contract	⇨	**HIGH RISK Strategy that would impact on realisations in the event a buyer for the business could not be found**	
Manage-away	⇨	Less reputational risk and continuity of operations	⇨		⇨	**MEDIUM**	✔ **But only in the event of XYZ and the Bank wishing an exit**
• Re-Bank				• Possible			
• VC/ PE/Private				• Possible			
• ABL				• Probable given strength of the ledger			

Options and Recommendations to ABC Limited

The Company and Management should ensure it provides more accurate and timely management information such that financial control and reporting is strengthened.

Issue		Benefit		Risk		Achievability
Capital expenditure should be correctly stated within the balance sheet rather than the profit and loss account. VAT should only be accounted for on the Balance Sheet	⇨	• Greater visibility on trading • Application of correct depreciation policies	⇨	• Incorrect/ misleading reporting to the stakeholders • Improper accounting for tax assessments/planning purposes • Distribution of reported gross margins.	⇨	**HIGH**
Management accounts to be produced on a monthly basis	⇨	• Control of trading by management • Visibility to funder and stakeholders	⇨	• Contract performance & overheads are not monitored in a timely manner	⇨	**HIGH**
Consider the full time employment of a Financial Controller	⇨	Greater financial control in particular on: • Monthly management reporting • Costing • Overhaul and maintenance of the Farmplan accounting system • Reduction in consultancy/professional fees	⇨	• A lack of regular financial control/monitoring • Incorrect/untimely contract costing • Incorrect/misleading reporting to stakeholders	⇨	**HIGH**
Consider a valuation of the property and production facilities	⇨	• Assurance on the security position to Shareholders, XYZ and the Bank	⇨	• Overvaluation of fixed assets • Alignment of depreciation policies not correct	⇨	**HIGH**
Consider the engagement of a relevant consultant/professional to overhaul Farmplan accounting systems	⇨	• Correct opening balance sheet items • Maintenance of ongoing accounting systems	⇨	• Incorrect accounting • Loss of financial control	⇨	**HIGH**

Letter of Engagement

Appendix 1

Management's Forecasts

Appendix 2