The Art of Business Acquisitions

The Fundamentals of M&A

Denver – August 19, 2004

Axiomate, Inc. & Hensley Kim & Edgington, LLC

Introduction and Understanding Specific Interests

- Instructors
  - Eric Edwards – Axiomate, Inc.
  - Darren Hensley – Hensley Kim & Edgington, LLC
- What Participants Hope to Get from Seminar
- Rules of Engagement
  - Share
  - Question
  - Listen

Purpose of Class

- Understand the basics of evaluating the target
- Understand the objectives of due diligence
- Introduction to various acquisition agreements
- Comprehend varieties of deal structures
- Consider business integration

	52	$178.4	70	$262.4	9	$20.6
	63	44.7	62	39.9	12	7.8
et						
n	107	37.7	150	52.7	16	6.0
n	235	36.1	302	46.7	51	8.4
	221	15.9	325	23.4	65	4.7
	302	10.8	348	12.4	67	2.4

The Process

- Contemplation and Approach
- Confidentiality Agreement
- Exchange of Information / Evaluation
- Preliminary Negotiation and Letter of Intent (LOI)
- Due Diligence
- Definitive Agreements
- Financing
- Close

Our Day

- Walkthrough the Deal Process
- Discuss Each Major Step of the Process:
  - What are the objectives of the step
  - Essential elements
  - Tips and cautions
  - Experiences, comments & questions
- Preliminary View of Integration Challenges

The Target

Why Acquire a Business?

- Marketing
  - Revenue Enhancement
- Operational
  - Economies of Scale
- Financial
  - “Market” Appeal
- Ego
  - Bigger is Better

Why Acquire a Business? Marketing

- Territorial Expansion
- Broaden Product Lines
- Increase Market Share
- Increase Customer Base
- Increase Distribution Channels

Why Acquire a Business? Operational

- Increase Economies of Scale
  - Better buying clout
  - Efficient use of facilities, distribution channels, sales and marketing channels
- Eliminate Redundancies
  - Factories and facilities
  - Distribution
  - Management
- Smooth Business Cycles or Mitigate Market Risk

Why Acquire a Business? Financial

- Increase Market Valuation
  - Attaining “Critical Mass”
  - Usually the result of increasing market share, revenue mass or achieving operational efficiency
- Increase Earnings Per Share (see marketing or operations)

The Financial Reasons are the Logical Consequence of the Business Reason

Choosing the Target

- Should have Accretive Component
  - We will be better, stronger, more profitable and/or more valuable after doing the deal?
  - There should be obvious synergies
    - There should be hidden synergies
- Should be a Logical Extension of our Business
- Should be a Good Fit (Culture, Organization)
- Should be Doable
  - Do they want to sell?
  - Can they sell?
  - Can we finance?

Distance Diligence – Initial Homework

- Find out what you can about the Target
  - Website
    - Press Releases
    - General web search
  - Hoover's / Edgar (if public)
  - Dun & Bradstreet
  - "The Street" – Industry info
  - I-Bankers
  - Accountants & Lawyers

Distance Diligence – Initial Homework

- Building the Dinosaur from Bones
  - Extrapolate revenue based upon number of employees
  - Estimate cost allocation based upon industry standards, what you know about the industry and anything you may have learned about the Target
  - Piece together info from observations, press releases and other sources

Approaching the Target

- Generally, Direct is Best
  - Warmest and least expensive
  - Phone call, informal meeting
    - Gauge interest and sketch relative terms
- Soft Intermediaries
  - Accountants, Lawyers, Bankers
- "Hard" Intermediaries – Investment Bankers
  - Very expensive

The First Meeting

- A Vision of the Combined Enterprise
  - Why does the combination make sense?
    - Especially if stock is a part of the intended consideration.
- Generally Drive toward Seller Motives
  - What Type of Deal Makes the Most Sense?
- If Buyer Approaches Seller, Buyer Usually must make Compelling Case (and Ultimately Offer)
- Caution: Negotiation has Begun

Deal Motivations

	Buyer	Seller
Logic	▪ Market share ▪ Revenue enhancement ▪ Attain critical mass ▪ Economies of scale ▪ Diversification of product line ▪ Eliminate redundancies ▪ Price paid has good ROI	▪ It's time to sell • Cost of competition is high • Product cycle dictates significant investment required • Owner wants to retire; shareholders want to liquidate ▪ The price is right
Emotion	▪ Conquering the competition ▪ Bigger is better	▪ Seller may have significant pride of ownership ▪ Selling to competitor is accepting defeat ▪ Concern for continuing employees/friends ▪ Wants to retire/move on

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Your Reasons for Doing the Deal

Your Reasons

Emotion ⟷ **Logic**

"You must recognize Logic and Emotion as a part of every deal. You must also manage them or they will manage you!"

Their Reasons for Doing the Deal

Their Reasons

Emotion

Logic

"At some point, in almost every deal, the emotion will rule the day"

Evaluating the Deal

Evaluation

- Understanding the Fit of a Business into Your Own
  - Buy at Market (Fair Value of Business)
  - Looking for "Accretion" of Value to your Business
  - Synergies
    - Customer acquisition
    - Lessen competitive pressures
    - Technology or product integration
    - Reduction of overhead

The SWOT Analysis

Strengths

Weaknesses

Opportunities

Threats

Purpose of SWOT Analysis

- Your Active "Sanity" Check on the Transaction
- The SWOT needs to be Dynamic
  - The SWOT will be expanded and refined as the transaction develops and more information is acquired
- The SWOT is a Tool.
  - At your side and the basis of your diligence
    - Challenge, validate and understand the strengths and opportunities
    - Explore, challenge, quantify and accept the weaknesses
    - Develop plans for opportunities, weaknesses and threats

SWOT – Preliminary

Strengths

1. Company has 5 years of increasing revenue and profits
2. Core product is considered the most technologically advanced on the market
3. Product is being sold through Walmart and Target

Weaknesses

1. Walmart's accounts for 60% of sales
2. Current ratio is only 1 to 1
3. Weak international sales operation, trying to run international business from Denver HQ

Opportunities

1. Competitors usually receive 60% revenue from international sales. Company has only 10% international revenue
2. US Sales primiarily through 2 major chains, other chains have not been developed
3. Company has not taken advantage of offering accessories to core product
4. Company has not fully exploited its Target & Walmart relationship

Threats

1. Chief competitor, QuasiModo, just completed public offering and raised $100M
2. Walmart contract is up in December
3. Labor contract is up in November
4. Margins are trending down

Fundamentals of Valuation

The ART and SCIENCE of Business Valuation

Fundamentals of Valuation

- What you will need
  - Historic Financial Performance (3 to 5 years.)
  - Forecast for Next 3 to 5 Years
  - Current Balance Sheet and Interim Financial Statements
  - Any Other Tidbits of Business Intelligence You have
  - Your Calculator (Spreadsheet)

What they will tell you

- Historic Financial Statements
  - Identify and Understand Trends
    - Sales trends (are revenues trending up at same rate?)
    - Gross margin trends (are margins predictable?)
    - Expense trends (any particular expense rising?)
      - Is the business managing costs?
    - Bottom line trends (generally composite of above)
    - Cash flow (see EBITDA discussion)

What they will tell you

- Financial Forecast
  - Identify and Understand Assumptions
    - How do assumptions compare with history?
    - Identify the “leaps of faith”
    - Identify leading indicators on assumptions
      - Are they currently managed? Metrics?
    - Identify and “embrace” the fundamental condition precedent
    - Cash flow (realistic with history?)

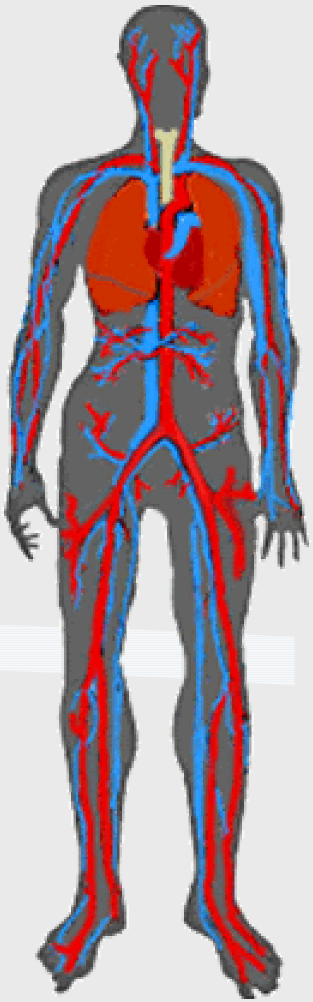
What they will tell you

- Interim Financial Statements
  - The bridge between historic results and the forecast
  - Current state of the business
    - What is the current financial condition of the business we propose to buy?
      - We will need to verify the assets
      - We will need to understand the liabilities and satisfy ourselves that the list is complete
      - How is cash flowing? AR or AP problems?
    - How are they tracking to the forecast?
      - If the forecast has merit, the interim numbers should track reasonably well
      - If not, they may have major problems

Cash is……

The lifeblood of a business. It nourishes all of the arms of an organization. It keeps it alive!

(Revenue is the heart in this body. It is revenue that must continually pump the cash into and through the system.)



Building an Evaluation Model

- Work with Seller Forecasts, but Your Variables
  - Important due diligence step as it will force you to be “intimate” with the dynamics of the numbers, the assumptions and “leaps of faith.”
- You Should be Able to Forecast 5 Years of P&L and Cash Flow
  - EBTIDA vs. Cash Flow

Business Comparables

- Pricing Metrics: Every Industry has its Own Unique "Rule of Thumb"
- If You do not Know Pricing Metrics for Your Industry, You can Find Out from a Financial Intermediary
- Public Company Comparables:
  - How do public companies in the industry get priced in open market? Revenue, cash flow or earnings multiple?

Business Comparables – Companies that do what you do

		Ticker	Share price	Revenue	Shares	Mkt Cap	Cash Flow	NI	Mkt Cap/Rev	Mkt Cap/Cash	Mkt Cap/NI
			5/24/04								
Software companies _ ERP											
						$ -					
American Software	Web based ERP	AMSWA	$ 6.43	$ 64.6	22.44	$ 144.3	$ 14.4	$ 7.2	2.23	10.02	20.04
Bottomline Technologies	Web based AP/AR/e-payment	EPAY	$ 8.89	$ 71.3	16.59	$ 147.5	$ (2.8)	$ (27.9)	2.07	(52.67)	(5.29)
HealthAxis	solutions for health insurance admin	HAXS	$ 2.29	$ 19.8	2.77	$ 6.3	$ (7.0)	$ (25.0)	0.32	(0.91)	(0.25)
Impac Medical Systems	ERP solutions for clinics	IMPCE	$ 11.87	$ 61.1	9.76	$ 115.9	$ 10.7	$ 6.4	1.90	10.83	18.10
MAPICS	ERP for manufacturing	MAPX	$ 9.43	$ 161.3	23.19	$ 218.7	$ 19.9	$ 3.8	1.36	10.99	57.55
Pervasive Software	Database and database tools	PVSW	$ 5.90	$ 39.2	16.89	$ 99.7	$ 8.4	$ 6.8	2.54	11.86	14.65
QAD	ERP for manufacturing	QADI	$ 10.10	$ 195.2	25.45	$ 257.0	$ (7.6)	$ 3.1	1.32	(33.82)	82.92
				$ 612.5		$ 989.4	$ 36.0	$ (25.6)	**1.62**	**27.48**	**(38.65)**
Software companies _ CRM											
Art Technology	CRM software	ARTG	$ 1.25	$ 101.5	51.80	$ 64.8	$ (22.0)	$ (29.5)	0.64	(2.94)	(2.19)
Astea International	CRM software	ATEA	$ 8.65	$ 16.8	13.50	$ 116.8	$ 0.1	$ (1.3)	6.95	1,167.75	(89.83)
Blue Martini	CRM software	BLUE	$ 4.45	$ 33.6	10.60	$ 47.2	$ (51.0)	$ (58.9)	1.40	(0.92)	(0.80)
Choridiant Software	CRM software	CHRD	$ 4.12	$ 73.8	67.60	$ 278.5	$ (24.9)	$ (32.3)	3.77	(11.19)	(8.62)
FirstWave Technologies	CRM software	FSTW	$ 3.11	$ 14.4	2.30	$ 7.2	$ 4.2	$ 2.7	0.50	1.70	2.65
Indus International	Asset management/supply chain	IINT	$ 2.17	$ 117.2	41.60	$ 90.3	$ (33.8)	$ (25.2)	0.77	(2.67)	(3.58)
Onyx Software	CRM software	ONXS	$ 3.82	$ 69.3	45.80	$ 175.0	$ (7.2)	$ (13.7)	2.52	(24.30)	(12.77)
ServiceWare Technologies	ERP/CRM software for service co	SVCW.OB	$ 0.58	$ 10.2	24.20	$ 14.0	$ (3.3)	$ (6.8)	1.38	(4.25)	(2.06)
Total for group				$ 1,661.8		$ 2,772.4	$ (65.9)	$ (216.2)	**1.67**	**(42.07)**	**(12.82)**
	Without hi/lo			1,032.50		1,782.99	(50.90)	(164.50)	**1.73**	**(35.03)**	**(10.84)**
	Only companies with revenue less than $50M			94.80		191.48	(57.00)	(89.30)	**2.02**	**(3.36)**	**(2.14)**

Business Comparables – Companies that do what you do

	#	Ticker	LFY Date	Share price 8/10/04	52 wk Hi-Lo	% in range	Shares	Mkt Cap	Enterprise Value	Book Value	Previous Fiscal Year Revenue	Previous Fiscal Year Cash Flow	Previous Fiscal Year NI	F Revenue
Specialized Investment Banks														
GMP Capital Corp	1	GMP	Jan-04	$ 11.48	$ 23 - $ 14	-22%	28.0	$ 322	$ 322	$ 96	$ 100	$ 25	$ 24	$ 123
Greenhill & Co	2	GHL	Jan-00	$ 19.94	$ 22 - $ 18	39%	30.8	$ 613	$ 619	$ 109	$ 139	$ 64	$ 27	$ 165
Legg Mason	3	LM	Mar-03	$ 77.80	$ 100 - $ 68	31%	66.8	$ 5,197	$ 5,297	$ 1,640	$ 1,615	$ 459	$ 191	$ 2,570
Jefferies Group	4	JEF	Dec-03	$ 31.30	$ 40 - $ 28	30%	57.2	$ 1,792	$ 1,795	$ 950	$ 927	$ 257	$ 84	$ 1,050
Sanders Morris Harris Group	5	SMHG	Dec-03	$ 11.79	$ 15 - $ 9	49%	17.6	$ 207	$ 178	$ 121	$ 104	$ 19	$ 10	$ 130
Lehman Bros. (Howard Weil)	6	LEH	Nov-03	$ 70.84	$ 90 - $ 63	30%	276.9	$ 19,616	$ 66,398	$ 13,025	$ 17,287	$ 3,339	$ 1,699	$ 10,960
Friedman, Billings, Ramsey	7	FBR	Dec-03	$ 16.57	$ 29 - $ 15	11%	168.2	$ 2,787	$ 7,614	$ 1,692	$ 832	$ 347	$ 285	$ 1,040
Group Total								$ 30,533	$ 82,222	$ 17,634	$ 21,005	$ 4,510	$ 2,321	$ 16,038
Online Auctions														
E-Bay	7	EBAY	Dec-03	$ 75.74	$ 94 - $ 50	58%	657.4	$ 49,788	$ 48,531	$ 5,765	$ 2,165	$ 825	$ 442	$ 3,021
RB Ritchie	8	RBA	Dec-03	$ 27.70	$ 30 - $ 20	74%	34.2	$ 948	$ 831	$ 270	$ 162	$ 69	$ 37	$ 192
Adesa	9	KAR	Dec-03	$ 16.91	$ 26 - $ 17	1%	94.9	$ 1,604	$ 1,889	$ 1,025	$ 921	$ 282	$ 120	$ 1,000
Group Total *								$ 2,552	$ 2,720	$ 1,295	$ 1,082	$ 351	$ 157	$ 1,192
Vertical Software														
Sungard Data	1	SDS	Dec-03	$ 22.82	$ 32 - $ 23	3%	288.50	$ 6,584	$ 6,875		$ 2,955	$ 681.7	$ 370.3	$ 3,770.0
Fiserv	2	FISV	Dec-03	$ 33.56	$ 41 - $ 32	15%	194.60	$ 6,531	$ 7,027		$ 3,033	$ 500.0	$ 315.0	$ 3,850.0
The Sage Group (UK)	3													
Lawson Software	4	LWSN	May-03	$ 7.06	$ 10 - $ 6	21%	98.1	$ 693	$ 493		$ 364	$ 30.7	$ 8.0	$ 413.0
Keane	5	KEA		$ 14.16	$ 18 - $ 13	27%	65.8	931	$ 931		$ 805	$ 16.2	$ 29.2	$ 1,010.0
Cognizant	6	CTSH	Dec-03	$ 25.66	$ 29 - $ 14	79%	129.6	3,326	$ 3,131		$ 368	$ 84.7	$ 57.4	$ 790.0
								$ 18,064	$ 18,458	$ -	$ 7,525	$ 1,313	$ 780	$ 9,833
Indian Outsoucing														
Wipro	7	WIT	Mar-03	$ 15.98	$ 20 - $ 7	70%	694.3	11,095	$ 10,801		$ 900	$ 226.9	$ 170.1	$ 1,660.0
Infosys	8	INFY	Mar-04	$ 48.58	$ 51 - $ 25	90%	267.5	12,994	$ 12,589		$ 1,063	$ 376.2	$ 270.3	$ 1,490.0
Satyam	9	SAY	Mar-03	$ 19.27	$ 35 - $ 10	36%	157.3	3,031	$ 2,970		$ 459	$ 85.1	$ 79.2	$ 767.0
Group Total								$ 27,120	$ 26,360	$ -	$ 2,422	$ 688	$ 520	$ 3,917
ERP Companies														
Oracle Corporation	1	ORCL	May-04	$ 10.60	$ 16 - $ 10	9%	5,170.0	$ 54,802	$ 46,384		$ 9,475	$ 4,200.0	$ 2,681.0	$ 10,091.0
SAP	2	SAP	Dec-03	$ 38.48	$ 46 - $ 27	3%	1,245.9	$ 47,941	$ 44,531		$ 8,872	$ 2,514.0	$ 1,356.7	$ 10,150.0
PeopleSoft	3	PSFT	Dec-03	$ 16.08	$ 24 - $ 15	3%	366.9	$ 5,899	$ 4,319		$ 2,267	$ 314.3	$ 85.4	$ 2,880.0
								$ 108,643	$ 95,235		$ 20,614	$ 7,028	$ 4,123	$ 23,121
Oil Field Services (technology based)														
Haliburton		HAL	Dec-03	$ 29.83	$ 33 - $ 22	76%	439.0	$ 13,095	$ 15,096		$ 16,271	$ 848.0	$ (820.0)	$ 19,200.0
Schlumberger		SLB	Dec-03	$ 61.60	$ 67 - $ 45	88%	588.7	$ 36,261	$ 38,141		$ 14,059	$ 2,369.0	$ 383.0	$ 12,300.0
Group Total								$ 49,357	$ 53,238		$ 30,330.2	$ 3,217.0	$ (437)	$ 31,500
Total for group								$ 218,204	$ 259,774	$ 18,929	$ 75,453	$ 15,795	$ 6,684	$ 75,768

	Forward '04 Revenue	Forward '04 Cash Flow	Forward '04 NI	TTM Price to Book	TTM Mkt Cap/Rev	TTM EV / EBITDA	TTM PE	Forward Mkt Cap/Rev	Forward Ent Val / EBITDA	Forward PE
Specialized Investment Banks										
GMP Capital Corp	$ 123	$ 47	$ 29	3.36	3.20	12.80	13.28	2.62	6.89	10.03
Greenhill & Co	$ 165	$ 78	$ 38	5.60	4.40	9.72	22.46	3.72	7.97	16.50
Legg Mason	$ 2,570	$ 675	$ 381	3.17	3.22	11.54	27.22	2.02	7.84	13.75
Jefferies Group	$ 1,050	$ 305	$ 115	1.89	1.93	6.98	21.30	1.71	5.88	15.59
Sanders Morris Harris Group	$ 130	$ 25	$ 16	1.71	1.99	9.62	19.91	1.59	7.22	14.15
Lehman Bros. (Howard Weil)	$ 10,960	$ 3,758	$ 1,954	1.51	1.13	19.89	11.55	1.79	17.67	9.88
Friedman, Billings, Ramsey	$ 1,040	$ 418	$ 350	1.65	3.35	21.93	9.77	2.68	18.20	7.63
Group Total	$ 16,038	$ 5,306	$ 2,882	1.73	1.45	18.23	13.15	1.24	15.49	10.59
Online Auctions										
E-Bay	$ 3,021	$ 1,432	$ 1,011	8.64	23.00	58.84	112.72	16.48	33.89	49.26
RB Ritchie	$ 192	$ 88	$ 53	3.52	5.87	12.01	25.89	4.94	9.40	18.05
Adesa	$ 1,000	$ 299	$ 121	1.56	1.74	6.69	13.37	1.60	6.32	13.31
Group Total *	$ 1,192	$ 387	$ 173	1.97	2.36	7.74	16.30	2.14	7.02	14.75
Vertical Software										
Sungard Data	$ 3,770.0	$ 797	$ 454		2.23	10.08	17.78	1.75	8.63	14.50
Fiserv	$ 3,850.0	$ 576	$ 372		2.15	14.05	20.73	1.70	12.21	17.91
The Sage Group (UK)										
Lawson Software	$ 413.0	$ 40	$ 27		1.90	16.06	86.61	1.68	12.42	25.66
Keane	$ 1,010.0	$ 33	$ 47		1.16	57.49	31.87	0.92	28.23	19.68
Cognizant	$ 790.0	$ 144	$ 114		9.03	36.97	57.94	4.21	21.73	29.15
	$ 9,833	$ 1,589	$ 1,015		2.40	14.05	23.16	1.84	11.62	17.80
Indian Outsoucing										
Wipro	$ 1,660.0	$ 432	$ 369		12.33	47.60	65.23	6.68	25.01	30.04
Infosys	$ 1,490.0	$ 405	$ 476		12.23	33.46	48.07	8.72	31.08	27.28
Satyam	$ 767.0	$ 170	$ 163		6.60	34.90	38.27	3.95	17.50	18.57
Group Total	$ 3,917	$ 1,007	$ 1,009		11.20	38.30	52.19	6.92	26.19	26.88
ERP Companies										
Oracle Corporation	$ 10,091.0	$ 5,166	$ 3,495		5.78	11.04	20.44	5.43	8.98	15.68
SAP	$ 10,150.0	$ 3,225	$ 1,952		5.40	17.71	35.34	4.72	13.81	24.56
PeopleSoft	$ 2,880.0	$ 491	$ 239		2.60	13.74	69.08	2.05	8.80	24.67
	$ 23,121	$ 8,882	$ 5,686		5.27	13.55	26.35	4.70	10.72	19.11
Oil Field Services (technology based)										
Haliburton	$ 19,200.0	$ 2,563	$ 728		0.80	17.80	(15.97)	0.68	5.89	17.98
Schlumberger	$ 12,300.0	$ 3,656	$ 1,472		2.58	16.10	94.68	2.95	10.43	24.64
Group Total	$ 31,500	$ 6,219	$ 2,200		-	NM	-	1.57	8.56	22.43
Total for group	$ 75,768	$ 21,801	$ 11,950		2.89	13.82	32.65	2.88	11.92	18.26

Income Statement Trend Analysis

	Fiscal year ending June 30,				
Actual Results	**1998**	**1999**	**2000**	**2001**	**2002**
Revenue	252.6	226.6	268.1	326.9	320.6
Cost Of Revenue					
Gross Margin					
Selling and Marketing					
Research and Developmen					
General and Admin					
OPEX from continuing ops					
Income from continuing					
Other/One Time Charges	13.5	17.9	1.5	16.9	31.0
Operating Income					

Actual Results	**1998**	**1999**	**2000**	**2001**	**2002**
EBITDA Calculation					
Income from continuing	37.2	(23.0)	5.1	(12.6)	(35.1)
Depr / Amort	16.0	16.0	16.0	16.0	16.0
EBITDA - continuing	***53.2***	***(7.0)***	***21.1***	***3.4***	***(19.1)***

Expense as a % of Revenue	**1998**	**1999**	**2000**	**2001**	**2002**
Selling and Marketing	30%	38%	34%	35%	36%
Research and Development	17%	21%	19%	21%	23%
General and Admin	8%	10%	9%	9%	11%
Other/One Time Charges	5%	8%	1%	5%	10%
Total	0%	0%	0%	0%	0%

Employees	1518	1448	1731	1927	1927
Selling/Marketing per Employe	49,341	59,185	53,091	58,952	59,782
Revenue per Employee	166,403	156,492	154,882	169,642	166,373

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The Balance Sheet

ASSETS	Acquirer	Target	Consolidated
Current Assets			
Cash and Investments	$1,250	$ 1,000	$2,250
Trade Accounts Receivable	$3,510	$ 1,250	$4,760
Intercompany Recivables			$0
Other Assets	$900	$ 1,250	$2,150
Total Current Assets	***5,660***	***3,500***	***9,160***
Long-Term Assets			
Leasehold Improvements	$2,500	$ 525	$3,025
Furniture & equipment	$4,250	$ 1,257	$5,507
Less Accumulated Depreciation	($2,903)	($980)	($3,883)
Net Fixed Assets	***$ 3,848***	***$ 802***	***$ 4,649***
Goodwill and other Intangibles	$2,500	$ 425	$2,925
Other Long Term Assets	$2,451	***$ 700***	***$ 3,151***
Total Assets	***$ 14,459***	***$ 5,427***	***$ 19,885***

Tangible NW	$ 8,559	$ 1,849	$ 10,407
Working Capital	$ 2,260	$ 1,847	$ 4,107
Adjusted Working Capital	$ 2,630	$ 1,847	$ 4,477

	Acquirer	Target	Consolidated
Current Liabilities			
Current portion - LTD	$0	$ 500	$500
Accounts Payable	$925	$ 1,251	$2,176
Accrued expenses	$1,241	$ 402	$1,643
Deferred revenue	$1,234		$1,234
Total Current Liabilities	***$ 3,400***	***$ 1,653***	***$ 5,053***
Total Long-Term Liabilities		***$ 1,500***	***$ 1,500***
Stockholders Equity			
Paid-in-Capital	$1,200	525	$1,725
Retained Earnings	$9,859	$1,749	$11,607
			$0
	11,059	***2,274***	***13,332***
Shareholders' Equity			
Total Liabilities and Equity	***$ 14,459***	***$ 5,427***	***$ 19,885***

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Cash Flow – Statement of Cash Flows

NETFLIX, INC.
STATEMENTS OF CASH FLOWS
(in thousands)

	2000	2001	2002
Cash flows from operating activities:			
Net loss	$ (57,363)	$ (38,618)	$ (21,947)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:			
Depreciation of property and equipment	3,605	5,507	5,919
Amortization of DVD library	15,681	22,127	17,417
Amortization of intangible assets	546	2,163	3,141
Noncash charges for equity instruments granted to non-employees	598	28	40
Stock-based compensation expense	8,803	5,686	9,831
Loss on disposal of property and equipment	145	—	—
Gain on disposal of DVDs	—	—	(1,674)
Noncash interest and other expense	497	1,017	11,384
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(2,686)	(15)	(44)
Accounts payable	2,356	6,025	6,635
Accrued expenses	2,708	(1,375)	4,558
Deferred revenue	2,302	2,164	4,806
Deferred rent	102	138	48
Net cash (used in) provided by operating activities	$ (22,706)	$ 4,847	$ 40,114
Cash flows from investing activities:			
Purchases of short-term investments	—	—	(43,022)
Proceeds from sale of short-term investments	6,322	—	—
Purchases of property and equipment	(6,210)	(3,233)	(2,751)
Acquisitions of DVD library	(23,895)	(8,851)	(24,070)
Proceeds from sale of DVDs	—	—	1,988
Deposits and other assets	(1,189)	(586)	554
Net cash used in investing activities	$ (24,972)	$ (12,670)	$ (67,301)
Cash flows from financing activities:			
Proceeds from issuance of redeemable convertible preferred stock	50,011	—	—
Proceeds from issuance of common stock	422	125	88,020
Net proceeds from issuance of subordinated notes payable and detachable	—	12,831	—
Repurchases of common stock	(141)	(12)	(6)
Principal payments on notes payable and capital lease obligations	(1,917)	(3,885)	(17,144)
Net cash provided by financing activities	$ 48,375	$ 9,059	$ 70,870
Net increase in cash and cash equivalents	$ 697	$ 1,236	$ 43,683
Cash and cash equivalents, beginning of period	$ 14,198	$ 14,895	$ 16,131
Cash and cash equivalents, end of period	$ 14,895	$ 16,131	$ 59,814
	$ 697	$ 1,236	$ 43,683
Supplemental disclosure:			
Cash paid for interest	948	860	592
Noncash investing and financing activities:			
Purchase of assets under capital lease obligations	3,000	520	583
Discount on capital lease obligation	105	172	—
Warrant issued as a deposit on operating lease	216	—	—
Exchange of Series F non-voting convertible preferred stock for intangible asset	6,128	4,498	1,318
Unrealized gain on short-term investments	—	—	774
Conversion of redeemable convertible preferred stock to common stock	—	—	101,830

Operations

Investing

Financing

Change in Cash

Supplemental

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The Model

Acme Products	Actual (pro forma) **(1)**			Forecast (see assumptions)							
Pro- Forma Income	***2001***	***2002***	***2003***	***2004***	***2005***	***2006***	***2007***	***2008***	***2009***	***2010***	***2011***
REVENUES											
Product Sales	*$ 5,728*	*$ 6,700*	*$ 7,250*	$ 8,156	$ 9,176	$ 10,323	$ 11,613	$ 13,065	$ 14,698	$ 16,535	$ 18,602
Other			$ -								$ -
Total revenues	***$ 5,728***	***$ 6,700***	***$ 7,250***	**$ 8,156**	**$ 9,176**	**$ 10,323**	**$ 11,613**	**$ 13,065**	**$ 14,698**	**$ 16,535**	**$ 18,602**
revenue growth		*17.0%*	8.2%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%
COST OF REVENUES											
Cost of goods	*$ 859*	*$ 1,005*	*$ 1,088*	$ 1,223	$ 1,376	$ 1,548	$ 1,742	$ 1,960	$ 2,205	$ 2,480	$ 2,790
Installation	*$ 1,718*	*$ 2,010*	*$ 2,175*	*$ 2,447*	*$ 2,753*	*$ 3,097*	*$ 3,484*	*$ 3,919*	*$ 4,409*	*$ 4,961*	*$ 5,581*
Other	*$ -*	*$ -*	*$ -*								
Total cost of revenues	***$ 2,578***	***$ 3,015***	**$ 3,263**	**$ 3,670**	**$ 4,129**	**$ 4,645**	**$ 5,226**	**$ 5,879**	**$ 6,614**	**$ 7,441**	**$ 8,371**
GROSS MARGIN	***$ 3,150***	***$ 3,685***	**$ 3,988**	**$ 4,486**	**$ 5,047**	**$ 5,678**	**$ 6,387**	**$ 7,186**	**$ 8,084**	**$ 9,094**	**$ 10,231**
	55.0%	*55.0%*	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%
OPERATING EXPENSES											
Research and development	*$ -*	*$ -*	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Selling and marketing	*$ 800*	*$ 1,005*	*$ 1,088*	$ 1,223	$ 1,376	$ 1,548	$ 1,742	$ 1,960	$ 2,205	$ 2,480	$ 2,790
General and administrative	*$ 650*	*$ 952*	*$ 1,103*	$ 1,375	$ 1,358	$ 1,341	$ 1,324	$ 1,306	$ 1,470	$ 1,654	$ 1,860
Total operating expenses	***1,450***	***1,957***	**2,191**	**2,598**	**2,734**	**$ 2,889**	**3,066**	**3,266**	**3,674**	**4,134**	**4,650**
	53.0%	*71.6%*	30.2%	31.9%	29.8%	28.0%	26.4%	25.0%	25.0%	25.0%	25.0%
EBITDA	***1,700***	***1,728***	**$ 1,797**	**1,888**	**2,313**	**2,788**	**3,322**	**3,919**	**4,409**	**4,961**	**5,581**
	29.7%	*25.8%*	24.8%	23.1%	25.2%	27.0%	28.6%	30.0%	30.0%	30.0%	30.0%

Identify and understand changes in revenue, NI, EBITDA, margins

Assumptions	
1. Assume steady revenue growth	12.5%
2. Revenue Mix - Products	100.0%
3. Revenue Mix - Software	0.0%
5. Cost of goods	15.0%
5. Cost of goods - installation	30.0%
6. Expense growth to sales	30.0%
7. Sales & Marketing	15.0%
8. G&A expense - mature	10.0%
9. Discount rate	25.0%

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Model Assumptions

- Understand Business Dynamics
  - Understand history
    - Relationships of numbers
      - Variable, semi-variable, fixed
    - Growth curve!
- Document!

Assumptions	
1. Assume steady revenue growth	12.5%
2. Revenue Mix - Products	100.0%
3. Revenue Mix - Software	0.0%
5. Cost of goods	15.0%
5. Cost of goods - installation	30.0%
6. Expense growth to sales	30.0%
7. Sales & Marketing	15.0%
8. G&A expense - mature	10.0%
9. Discount rate	25.0%

Analysis

Acme Products	Actual (pro forma) **(1)**			Forecast (see assumptions)							
Pro- Forma Income	***2001***	***2002***	***2003***	***2004***	***2005***	***2006***	***2007***	***2008***	***2009***	***2010***	***2011***
REVENUES											
Product Sales	*$ 5,728*	*$ 6,700*	*$ 7,250*	$ 8,156	$ 9,176	$ 10,323	$ 11,613	$ 13,065	$ 14,698	$ 16,535	$ 18,602
Other											$ -
Total revenues									**$ 14,698**	**$ 16,535**	**$ 18,602**
revenue growth									12.5%	12.5%	12.5%
COST OF REVENUES											
Cost of goods									$ 2,205	$ 2,480	$ 2,790
Installation									*$ 4,409*	*$ 4,961*	*$ 5,581*
Other											
Total cost of revenues									**$ 6,614**	**$ 7,441**	**$ 8,371**
GROSS MARGIN									**$ 8,084**	**$ 9,094**	**$ 10,231**
									55.0%	55.0%	55.0%
OPERATING EXPENSES											
Research and development									$ -	$ -	$ -
Selling and marketing									$ 2,205	$ 2,480	$ 2,790
General and administrative									$ 1,470	$ 1,654	$ 1,860
Total operating expenses	***1,450***	***1,957***	**2,191**	**2,598**	**2,734**	**$ 2,889**	**3,066**	**3,266**	**3,674**	**4,134**	**4,650**
	53.0%	*71.6%*	30.2%	31.9%	29.8%	28.0%	26.4%	25.0%	25.0%	25.0%	25.0%
EBITDA	***1,700***	***1,728***	**$ 1,797**	**1,888**	**2,313**	**2,788**	**3,322**	**3,919**	**4,409**	**4,961**	**5,581**
	29.7%	*25.8%*	24.8%	23.1%	25.2%	27.0%	28.6%	30.0%	30.0%	30.0%	30.0%

Market Cap

Number of shares outstanding	**839**		
Price per share	**10.75**		
	$ 9,019	**OR**	**4.78** x cash

Enterprise Value *

Market Cap	**$ 9,019**
Less: Debt	**$ (1,500)**
Plus: Cash	**$ 1,000**
	$ 8,519

Valutaion

Cash Flow and Revenue muliples

	Exit	Multiple		
Value based on cash flow multiple **(a)**		**6.00**		**$ 11,326**
		5.00		**$ 9,438**
PV Terminal Value - Rev **(b)**	2007	**2.00**		**$ 8,268**
- Cash	2007	**6.00**		**$ 7,441**

		Cash Flow	**Term Value**	**Total**
PV of Cash flow - 5 years ©	2008	**$ 7,660**	**$ 6,278**	**$ 13,938**
- 7 years	2010	**$ 9,672**	**$ 4,470**	**$ 14,141**

1	**2**	**3**	**4**	**5**	**6**	**7**
			$ 26,129			
			$ 23,517	***$ 26,456***		***$ 33,483***
$ 1,792	$ 1,675	$ 1,546	$ 1,414	$ 1,233	$ 1,075	$ 937

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Time Value of Money

What is a Bird in the Hand Worth?

Less than Two in the Bush?

Time Value of Money

P	- Principal (or funds deployed)
R	- Principal at point of exit (Return)
NPV	- Net Present Value
I	- Interest rate * (risk adjusted cost of capital)
N	- Time until you are repaid

P < or > NPV of R

= R*(1+i)^n

Return on Investment ("ROI")

The ROI is the interest rate that reconciles the investment to the expected return at some point in time

- If I Invest 1 Bird and Get 2 Birds in three years, what is the implied interest rate?
- Is that interest rate greater than my cost of capital (my borrowing or financing costs?)
  - If yes, probably a good deal
  - If no, probably not a good deal

What is E.B.I.T.D.A.

- Earnings Before
  - Interest
  - Taxes
  - Depreciation
  - Amortization
- It is a crude measure of cash flow
- ***What it is NOT: true cash flow***

Cash Flow – Statement of Cash Flows

NETFLIX, INC.
STATEMENTS OF CASH FLOWS
(in thousands)

	2000	2001	2002
Cash flows from operating activities:			
Net loss	$ (57,363)	$ (38,618)	$ (21,947)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:			
Depreciation of property and equipment	3,605	5,507	5,919
Amortization of DVD library	15,681	22,127	17,417
Amortization of intangible assets	546	2,163	3,141
Noncash charges for equity instruments granted to non-employees	598	28	40
Stock-based compensation expense	8,803	5,686	9,831
Loss on disposal of property and equipment	145	—	—
Gain on disposal of DVDs	—	—	(1,674)
Noncash interest and other expense	497	1,017	11,384
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(2,686)	(15)	(44)
Accounts payable	2,356	6,025	6,635
Accrued expenses	2,708	(1,375)	4,558
Deferred revenue	2,302	2,164	4,806
Deferred rent	102	138	48
Net cash (used in) provided by operating activities	$ (22,706)	$ 4,847	$ 40,114
Cash flows from investing activities:			
Purchases of short-term investments	—	—	(43,022)
Proceeds from sale of short-term investments	6,322	—	—
Purchases of property and equipment	(6,210)	(3,233)	(2,751)
Acquisitions of DVD library	(23,895)	(8,851)	(24,070)
Proceeds from sale of DVDs	—	—	1,988
Deposits and other assets	(1,189)	(586)	554
Net cash used in investing activities	$ (24,972)	$ (12,670)	$ (67,301)
Cash flows from financing activities:			
Proceeds from issuance of redeemable convertible preferred stock	50,011	—	—
Proceeds from issuance of common stock	422	125	88,020
Net proceeds from issuance of subordinated notes payable and detachable	—	12,831	—
Repurchases of common stock	(141)	(12)	(6)
Principal payments on notes payable and capital lease obligations	(1,917)	(3,885)	(17,144)
Net cash provided by financing activities	$ 48,375	$ 9,059	$ 70,870
Net increase in cash and cash equivalents	$ 697	$ 1,236	$ 43,683
Cash and cash equivalents, beginning of period	$ 14,198	$ 14,895	$ 16,131
Cash and cash equivalents, end of period	$ 14,895	$ 16,131	$ 59,814
	$ 697	$ 1,236	$ 43,683
Supplemental disclosure:			
Cash paid for interest	948	860	592
Noncash investing and financing activities:			
Purchase of assets under capital lease obligations	3,000	520	583
Discount on capital lease obligation	105	172	—
Warrant issued as a deposit on operating lease	216	—	—
Exchange of Series F non-voting convertible preferred stock for intangible asset	6,128	4,498	1,318
Unrealized gain on short-term investments	—	—	774
Conversion of redeemable convertible preferred stock to common stock	—	—	101,830

Operations

Investing

Financing

Change in Cash

Supplemental

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How Good is EBITDA as a Measure of Cash Flow?

NETFLIX, INC.
STATEMENTS OF CASH FLOWS
(in thousands)

	2000		2001		2002
Cash flows from operating activities:					
Net loss	$	(57,363)	$ (38,618)	$	(21,947)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:					
Depreciation of property and equipment		3,605	5,507		5,919
Amortization of DVD library		15,681	22,127		17,417
Amortization of intangible assets		546	2,163		3,141
Noncash charges for equity instruments granted to non-employees		598	28		40
Stock-based compensation expense		8,803	5,686		9,831
Loss on disposal of property and equipment		145	—		—
Gain on disposal of DVDs		—	—		(1,674)
Noncash interest and other expense		497	1,017		11,384
Changes in operating assets and liabilities:					
Prepaid expenses and other current assets		(2,686)	(15)		(44)
Accounts payable		2,356	6,025		6,635
Accrued expenses		2,708	(1,375)		4,558
Deferred revenue		2,302	2,164		4,806
Deferred rent		102	138		48
Net cash (used in) provided by operating activities	$	(22,706)	$ 4,847	$	40,114

What about the other "non-cash" items?

		2002
18)		$ (21,967)
391		10,295
0		0
797	$	26,477
.30)	$	14,805

		2000		2001		2002
Cash and cash equivalents, beginning of period	$	14,198	$	14,895	$	16,131
Actual Change in Cash	$	697	$	1,236	$	43,683
Cash from Operations	$	(22,706)	$	4,847	$	40,114

Supplemental disclosure	2000	2001	2002
Cash paid for interest			
Noncash investing and financing activities:			
Purchase of assets under capital lease obligations	3,000	520	583
Discount on capital lease obligation	105	172	—
Warrant issued as a deposit on operating lease	216	—	—
Exchange of Series F non-voting convertible preferred stock for intangible asset	6,128	4,498	1,318
Unrealized gain on short-term investments	—	—	774
Conversion of redeemable convertible preferred stock to common stock	—	—	101,830

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Revised Look at EBITDA

	2000	2001	2002
Cash flows from operating activities:			
Net loss	$ (57,363)	$ (38,618)	$ (21,947)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:			
Depreciation of property and equipment	3,605	5,507	5,919
Amortization of DVD library	15,681	22,127	17,417
Amortization of intangible assets	546	2,163	3,141
Noncash charges for equity instruments granted to non-employees	598	28	40
Stock-based compensation expense	8,803	5,686	9,831
Loss on disposal of property and equipment	145	—	—
Gain on disposal of DVDs	—	—	(1,674)
Noncash interest and other expense	497	1,017	11,384
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(2,686)	(15)	(44)
Accounts payable	2,356	6,025	6,635
Accrued expenses	2,708	(1,375)	4,558
Deferred revenue	2,302	2,164	4,806
Deferred rent	102	138	48
Net cash (used in) provided by operating activities	**$ (22,706)**	**$ 4,847**	**$ 40,114**

Change in WC
$4782

EBITDA #2	$ (27,682)	$ (699)	$ 34,386
Cash from Operations	$ (22,706)	$ 4,847	$ 40,114

EBITDA vs. Cash Flow

- 2002 EBITDA – $14.5M vs. change of cash of $.7M and cash flow from ops of $40M
- EBITDA is crude
  - Depreciation is, long term, a real number
    - Assets have to be replaced
  - Taxes and interest are real uses of cash
  - Real cash is affected by changes in balance sheet
    - Particularly working capital
- Cash Flow is crude
  - It is a mechanical explanation of the change in cash position

Relative Valuation Worksheet

	Metric	Value	Factor	Valuation	Ratio	Add	Adjusted Value	Ratio	Weigh	Acquirer	Target
I	**Valuation on Revenue - 2003**										
	Acquirer	$ 15,000	**1.50**	22,500	67.4%	$ -	$ 22,500	67.4%		6.7%	
	Target	$ 7,250		$ 10,875	32.6%	$ -	$ 10,875	32.6%			3.3%
	Total NewCo Revenues	**$ 22,250**		**$ 33,375**	100.0%		**$ 33,375**	100.0%	10.0%		
II	**Valuation on EBITDA - 2003**										
	Acquirer	$ 3,150	**6.00**	18,900	63.7%	$ -	$ 18,900	63.7%		9.6%	
	Target	$ 1,797		$ 10,782	36.3%	$ -	$ 10,782	36.3%			5.4%
	Total NewCo Revenues	**$ 4,947**		**$ 29,682**	100.0%		**$ 29,682**	100.0%	15.0%		
III	**Revenue Growth ('00 to '03)**										
	Acquirer	$ 4,000	**4.00**	16,000	64.0%	$ -	$ 16,000	64.0%		6.4%	
	Target	$ 2,250		$ 9,000	36.0%	$ -	$ 9,000	36.0%			3.6%
	Total NewCo Revenues	**$ 6,250**		**$ 25,000**	100.0%		**$ 25,000**	100.0%	10.0%		
IV	**Cash Flow Growth ('00 to '03)**										
	Acquirer	$ 2,400	**6.00**	14,400	63.2%	$ -	$ 14,400	63.2%		6.3%	
	Target	$ 1,397		$ 8,382	36.8%	$ -	$ 8,382	36.8%			3.7%
	Total NewCo Revenues	**$ 3,797**		**$ 22,782**	100.0%		**$ 22,782**	100.0%	10.0%		
V	**2004 Revenue**										
	Acquirer	$ 16,800	**1.50**	25,200	67.3%	$ -	$ 25,200	67.3%		6.7%	
	Target	$ 8,156		$ 12,234	32.7%	$ -	$ 12,234	32.7%			3.3%
	Total NewCo Revenues	**$ 24,956**		**$ 37,434**	100.0%		**$ 37,434**	100.0%	10.0%		
VI	**2004 Cash Flow**										
	Acquirer	$ 3,612	**5.00**	18,060	65.7%	$ -	$ 18,060	65.7%		6.6%	
	Target	$ 1,888		$ 9,438	34.3%	$ -	$ 9,438	34.3%			3.4%
	Total NewCo Revenues	**$ 5,500**		**$ 27,498**	100.0%		**$ 27,498**	100.0%	10.0%		
VII	**PV of 5 year future cash flow**										
	Acquirer	$ 12,500	**1.00**	12,500	62.0%		$ 12,500	62.0%		6.2%	
	Target	$7,660		$ 7,660	38.0%	$ -	$ 7,660	38.0%			3.8%
	Total NewCo Revenues			**$ 20,160**	100.0%		**$ 20,160**	100.0%	10.0%		
VIII	**2004 "Low side" Pre-bonus EBITDA**										
	Acquirer	$ 3,150	**6.00**	18,900	71.6%	$ -	$ 18,900	71.6%		7.2%	
	Target	$ 1,250		$ 7,500	28.4%	$ -	$ 7,500	28.4%			2.8%
	Total NewCo Revenues	**$ 4,400**		**$ 26,400**	100.0%		**$ 26,400**	100.0%	10.0%		
IX	**Working Capital**										
	Acquirer	$ 2,260	**6.00**	13,560	44.3%	$ -	$ 13,560	44.3%		2.2%	
	Target	$ 2,847		$ 17,082	55.7%	$ -	$ 17,082	55.7%			2.8%
	Total NewCo Revenues	**$ 5,107**		**$ 30,642**	100.0%		**$ 30,642**	100.0%	5.0%		
X	**Tangible Net Worth**										
	Acquirer	$ 8,559	**1.00**	8,559	75.0%	$ -	$ 8,559	75.0%		7.5%	
	Target	$ 2,849		$ 2,849	25.0%	$ -	$ 2,849	25.0%			2.5%
	Total NewCo Revenues	**$ 11,407**		**$ 11,407**	100.0%		**$ 11,407**	100.0%	10.0%		
	Total Newco value									**65.4%**	**34.6%**
									100.0%		

Relative Valuation Worksheet

	Metric	Value	Factor	Valuation	Ratio	Add	Adjusted Value	Ratio	Weigh	Acquirer	Target
I	**Valuation on Revenue - 2003**										
	Acquirer	$ 15,000	**1.50**	22,500	67.4%	$ -	$ 22,500	67.4%		6.7%	
	Target	$ 7,250		$ 10,875	32.6%	$ -	$ 10,875	32.6%			3.3%
	Total NewCo Revenues	**$ 22,250**		**$ 33,375**	100.0%		**$ 33,375**	100.0%	10.0%		
II	**Valuation on EBITDA - 2003**										
	Acquirer	$ 3,150	**6.00**	18,900	63.7%	$ -	$ 18,900	63.7%		9.6%	
	Target	$ 1,797		$ 10,782	36.3%	$ -	$ 10,782	36.3%			5.4%
	Total NewCo Revenues	**$ 4,947**		**$ 29,682**	100.0%		**$ 29,682**	100.0%	15.0%		
III	**Revenue Growth ('00 to '03)**										
	Acquirer	$ 4,000	**4.00**	16,000	64.0%	$ -	$ 16,000	64.0%		6.4%	
	Target	$ 2,250		$ 9,000	36.0%	$ -	$ 9,000	36.0%			3.6%
	Total NewCo Revenues	**$ 6,250**		**$ 25,000**	100.0%		**$ 25,000**	100.0%	10.0%		
IV	**Cash Flow Growth ('00 to '03)**										
	Acquirer	$ 2,400	**6.00**	14,400	63.2%	$ -	$ 14,400	63.2%		6.3%	
	Target	$ 1,397		$ 8,382	36.8%	$ -	$ 8,382	36.8%			3.7%
	Total NewCo Revenues	**$ 3,797**		**$ 22,782**	100.0%		**$ 22,782**	100.0%	10.0%		
V	**2004 Revenue**										
	Acquirer									.7%	
	Target										3.3%
	Total NewCo Revenues										
VI	**2004 Cash Flow**										
	Acquirer									.6%	
	Target										3.4%
	Total NewCo Revenues										
VII	**PV of 5 year future cash flow**										
	Acquirer									.2%	
	Target										3.8%
	Total NewCo Revenues										
VIII	**2004 "Low side" Pre-bonus EBITD**										
	Acquirer									.2%	
	Target										2.8%
	Total NewCo Revenues										
IX	**Working Capital**										
	Acquirer	$ 2,260	**6.00**	13,560	44.3%	$ -	$ 13,560	44.3%		2.2%	
	Target	$ 2,847		$ 17,082	55.7%	$ -	$ 17,082	55.7%			2.8%
	Total NewCo Revenues	**$ 5,107**		**$ 30,642**	100.0%		**$ 30,642**	100.0%	5.0%		
X	**Tangible Net Worth**										
	Acquirer	$ 8,559	**1.00**	8,559	75.0%	$ -	$ 8,559	75.0%		7.5%	
	Target	$ 2,849		$ 2,849	25.0%	$ -	$ 2,849	25.0%			2.5%
	Total NewCo Revenues	**$ 11,407**		**$ 11,407**	100.0%		**$ 11,407**	100.0%	10.0%		
	Total Newco value									**65.4%**	**34.6%**
									100.0%		

100.0%

If We are worth **$ 18,900**

Then Target is worth $ 10,004

(less: excess debt) $ (1,500)

$ 8,504

29.4%

$ 28,904

Relative Valuation Worksheet – “The Fact Sheet”

	In dollars			as % of combined			Summary			
	Acquirer	Target	Combined	Acquirer	Target	Combined	weighting	Acquirer	Target	Combined
Revenue										
2003 Revenue	$ 15,000	$ 7,250	$ 22,250	**67.4%**	**32.6%**	**100.0%**	15.0%	**10.1%**	**4.9%**	**15.0%**
2004 Projected Revenue										
Expected case	**$ 16,800**	**$ 8,156**	**$ 24,956**	**67.3%**	**32.7%**	**100.0%**	5.0%	**3.4%**	**1.6%**	**5.0%**
High case	$ 17,900	$ 11,200	$ 29,100	61.5%	38.5%	100.0%	5.0%	**3.1%**	**1.9%**	**5.0%**
Low case	$ 15,800	$ 6,500	$ 22,300	70.9%	29.1%	100.0%	5.0%	**3.5%**	**1.5%**	**5.0%**
2005 Projected Revenue (mid)	$ 18,100	$ 9,176	$ 27,276	**66.4%**	**33.6%**	**100.0%**	5.0%	**3.3%**	**1.7%**	**5.0%**
2006 Projected Revenue	$ 19,250	$ 10,323	$ 29,573	**65.1%**	**34.9%**	**100.0%**	5.0%	**3.3%**	**1.7%**	**5.0%**
EBITDA										
2003	$ 3,150	$ 1,797	$ 4,947	**63.7%**	**36.3%**	**100.0%**	12.5%	**8.0%**	**4.5%**	**12.5%**
2004	$ 3,612	$ 1,888	$ 5,500	**65.7%**	**34.3%**	**100.0%**	12.5%	**8.2%**	**4.3%**	**12.5%**
2005	$ 3,811	$ 2,002	$ 5,813	**65.6%**	**34.4%**	**100.0%**	10.0%	**6.6%**	**3.4%**	**10.0%**
2005 Low Case										
Revenue	$ 25,436	$ 17,596	$ 43,032	**59.1%**	**40.9%**	**100.0%**	7.5%	**4.4%**	**3.1%**	**7.5%**
EBITDA	$ 9,239	$ 7,527	$ 16,767	**55.1%**	**44.9%**	**100.0%**	7.5%	**4.1%**	**3.4%**	**7.5%**
Present Value of 5 year cash	$ 12,500	$ 7,660	$ 20,160	**62.0%**	**38.0%**	**100.0%**	5.0%	**3.1%**	**1.9%**	**5.0%**
Tangible Net Worth	$ 8,559	$ 1,849	$ 10,407	**82.2%**	**17.8%**	**100.0%**	5.0%	**4.1%**	**0.9%**	**5.0%**
							100.0%	**65.2%**	**34.8%**	**100.0%**

Purpose: This worksheet compares various key financial metrics between the entities and is the basis for relative value calculations

Risk vs. Reward Spectrum

Low Risk

High Risk

Low Reward

High Reward

Initial Agreements

Confidentiality Agreements &
Letter of Intent (LOI)

Confidentiality Agreements

Confidentiality Agreement – What is it?

- Usually the First Agreement Negotiated Among the Parties
- Typically More Important to Seller than Buyer, Especially if Competitors
  - Sellers will want confidentiality to protect information from employees, customers and suppliers.
- Buyers May Want the Agreement to Protect Against Competing Bids
- Agreement Opens the Door for Information Flow and Detailed Discussions

Basic Terms - Purpose

"Basically the agreement provides that the agreement itself, the potential transaction, the discussions regarding the potential transaction and all information exchanged by the parties in due diligence are confidential and shall not be disclosed by either of the parties to any third party."

Basic Terms

- The information obtained can only be used to evaluate the transaction.
  - If party does not proceed, information must be returned or destroyed
- The parties and their employees must cooperate with each other.
- Sometimes:
  - Information may not be copied or reproduced and must be kept in one location.
  - restricts who party may contact for due diligence without permission.
  - contains a non-solicitation clause for the disclosing party's clients, prospects, business contacts and employees.

Basic Terms (cont)

- If a public company, clause indicating that it is illegal to trade on nonpublic information.
- Disclaims all reps and warranties with respect to the disclosed information.
- Provides that no agreement exists for the transaction until definitive agreements are executed.
- Provides for equitable relief for a breach of the agreement.
- Typically disclosing party asks for a 3-year term and non-disclosing party a 1-year term.

Basic Terms - Exceptions

- Disclosure to “Need to Know” parties
- Accountants, lawyers, investment bankers, consultants, financial advisors, etc.
- Disclosure as required by law
- Information in the public domain
- Information that is independently developed

Letter of Intent ("LOI")

Letter of Intent ("LOI") - General

- Commits the parties to the transaction prior to reaching a definitive agreement
- Is entered into if Due Diligence indicates both parties desire to proceed
  - Provides for continued, more formal Diligence
- Contains buyers first offer
  - Transaction Consideration
  - Payment Terms
  - Adjustments
- Re-affirms confidentiality agreements
- The LOI is typically heavily negotiated

Letter of Intent

- Why?
  - Commits both parties to the Transaction
    - “Weeds out” those that are not as serious
  - Memorializes major deal issues
  - Identifies other issues for further negotiation
  - Can provide protection for buyer in negotiation (exclusive rights to negotiate)
  - Used to obtain Board/Shareholder/Third Party Approval of the transaction
  - Gives buyer evidence of transaction for financing

Letter of Intent

- Why Not
  - Increased Chance of Litigation if Transaction Fails
  - Parties may become inflexible on Terms in LOI

Letter of Intent – Good Faith

- Duty to negotiate in Good Faith
  - Parties can impose Duty in LOI
  - Some courts imply Duty in LOI
    - Colorado Courts and other Jurisdictions impose duty in contracts
    - Colorado Courts Hold that to have a contract, further negotiations for essential deal terms are not necessary.
- The more specific the LOI, the more likely Duty is imposed
  - LOI should specifically state if Duty applies or not
  - LOI should specify breaches and remedies

Letter of Intent – Terms

- Identity of Parties
- Deal Structure
  - What is being purchased?
  - What is the legal structure of the deal?
  - What is the consideration that is to be paid?
    - Constituencies
      - » Often consideration for the acquisition can be below basis for some shareholders and represent a nice profit for others.
      - » Buyers can be trapped into situation of trying to appease various investor groups
    - Vote Buying
      - » One instance, buyer stepped back, paid a management fee to executives to get the deal done. One founder sued claiming that the management fee brought the vote of the executives, who were also large shareholders.
- Re-affirmation of confidentiality agreement

Letter of Intent – Terms (cont)

- Conditions Precedent to Transaction (discussed in "Definitive Agreements")
  - Might include:
    - Definitive documentation
    - Satisfactory due diligence
      - » Buyer will ask for expanded due diligence rights in LOI (talk to employees, customers, shareholders, vendors, partners etc.)
    - Financing
    - Shareholder approval
    - Third party approval, governmental consents
    - No material adverse changes
    - Audited Financials
    - Fairness opinion.

Letter of Intent – Terms (cont)

- Seller Non-Compete agreements
- Employment Agreements/Consulting agreements
- Escrow, indemnification and holdback requirements
- Pre-closing Conduct
- Expenses – who pays?
- Other points unique to the transaction

Letter of Intent – Terms
Deal Protection Mechanisms

- Exclusivity
  - Buyer may require seller to take the business off the market for some period of time as an incentive to Buyer to expend time and money to quickly complete diligence and close on the transaction
- Break-Up Fee
  - Compensation (liquidated damages) for buyer if seller does not enter into a transaction with buyer and during a tail period enters into a transaction with another buyer
- Standstill
  - If Seller is public, it may require an agreement to prevent buyer from buying any of seller's stock of seller for a specific period of time to avoid a hostile takeover

Letter of Intent – Terms
Deal Protection Mechanisms (cont.)

- Voting Agreements
  - If vote of stockholders of seller is required in connection with transaction, buyer may require voting agreements/proxies from enough stockholders to assure transaction approval
- Fiduciary Out
  - Seller may wish right to terminate the agreement prior to closing so it can accept a better offer, allowing its directors to satisfy their fiduciary duty to stockholders to obtain the best price.
- <u>Omnicare</u>
  - A recent Delaware Supreme Court Decision that calls to question M&A lock-up provisions when they work in combination to the determent of shareholders from receiving the best price.

Letter of Intent

- Who Prepares Documentation
- Termination of LOI
  - The written agreement of the parties
  - The execution of definitive documentation
  - The end of the exclusivity period (or if no exclusivity period, a set time period)
  - Written notice that buyer does not wish to proceed with the transaction

Letter of Intent

- The LOI is generally specific that it is Non-Binding
  - Exceptions
    - Confidentiality
    - Exclusivity
    - Break-up fee
    - Lock-up
    - Non-solicitation
    - Expenses

Types of Acquisitions

Types of Acquisitions

- Asset Purchase
- Stock Purchase
- Mergers
- Tax-free Reorganizations

Types of Acquisitions – Asset Purchase

- Buyer Purchases Specific Identifiable Assets of the Business
  - It may also assume specified liabilities
- Divisions of Companies that are not Separate Entities are Asset Purchases
- The Buyer should Consider Use of a Wholly-owned Sub to Isolate Potential Liabilities of Seller from Buyer's Other Assets

Types of Acquisitions – Asset Purchase

- The Buyer Typically Prefers the Asset Purchase
  - Inherits only specified liabilities reducing the risk of taking on unknown liabilities.
  - Doesn’t inherit all of seller’s contracts, employees, etc
  - Increased basis in assets purchased to the amount paid for such assets.
    - This potentially reduces future capital gains tax upon a sale of the assets
    - It also increases future depreciation expense, thereby reducing income tax.

Types of Acquisitions – Asset Purchase

- The Seller Typically does not Prefer Asset Sales.
  - Seller has capital gains tax on difference between basis in assets sold and purchase price allocated to such assets.
    - This could be substantial if assets are heavily depreciated.
  - If seller desires to dividend the proceeds of the asset sale to the stockholders, the dividend is subject to an additional tax at the stockholder level.
  - If selling the entire business, seller would typically prefer to sell the entire company with employees in place and not have to wind down the company.

Axiomate

HKE ATTORNEYS AT LAW HENSLEY KIM & EDGINGTON, LLC

Types of Acquisitions – Asset Purchase

- Typically a Buyer's Rather than Seller's Preference
  - Buyer can pick assets and liabilities it wants.
  - Seller has capital gains tax on difference between basis in assets sold and purchase price allocated to assets.
    - This can be substantial if assets are heavily depreciated.
  - If seller desires to dividend the proceeds of the asset sale to the stockholders, the dividend is subject to an additional tax at the stockholder level.
  - If selling the entire business, seller would typically prefer to sell the entire company
    - Keep employees in place
    - No wind down of the company.

Types of Acquisitions – Asset Purchase

- Requires purchase agreement to allocate purchase Price among specific list of assets
- Buyer must be assured that all necessary assets are listed
- Sales tax in Colorado
- Closings are more difficult
  - For titled assets such as vehicles and real property, must transfer title of each asset.
  - Most contracts each require consent for transfer.
  - If the entire business is being sold, each employee must be terminated and re-hired by buyer – employee benefit issues.
  - Bills of sale and assumption agreements.

Types of Acquisitions – Stock Purchase

- Buyer Purchases All Outstanding Equity
  - Buyer purchases entire company and all assets and liabilities of the business that come with it.

- Sellers Typically Prefer Stock Purchases
  - Seller only incurs capital gain on difference between basis in stock sold, which is not subject to depreciation, and purchase price for stock.
  - Dividend not required to get proceeds of sale to stockholders and therefore no double tax.
  - Buyer inherits all of seller's contracts, employees, etc
  - No issues for seller in winding down company after closing.

Types of Acquisitions – Stock Purchase

- Buyers Typically do not Prefer Stock Purchases
  - Buyer cannot pick and choose assets and liabilities. It inherits everything, including unknown liabilities.
  - Tax basis in the assets purchased does not get stepped up.
    - There is the potential of a larger capital gains tax on a future sale of heavily depreciated assets.
    - Smaller depreciation expense to reduce income tax
  - However, stock sale does offer buyer less disruption as business entity continues as usual or when the transaction can be treated as a reorganization

Types of Acquisitions – Stock Purchase

- No Requirement to allocate purchase price among specific list of assets
- Buyer and Seller are assured that all assets, contracts and liabilities are included
- No Colorado Sales Tax issue
- Stockholders are more involved in the sale process
- Closings are simplified

Types of Acquisitions – Stock Purchase

- Closings are Simplified
  - No paperwork required to transfer specific assets.
  - Typically fewer contract consents are required.
  - All employees and employee benefits are transferred with the stock sale.
  - No bills of sale and assumption agreements.
    - Though stock certificates must be delivered in exchange for purchase price.
  - If stock is widely held, a transmittal letter may need to be distributed to stockholders to effect the exchange of their stock for the consideration by delivery of their stock certificates.

Types of Acquisitions - Mergers

- Transaction is Typically Structured such that Seller is Merged with a Subsidiary of Buyer
  - The Seller becomes a wholly-owned subsidiary

- Very Similar to Stock Purchase

Types of Acquisitions – Tax Free Reorganization

- Basic Overview
  - **Tax rules are very complicated. A professional tax advisor should be engaged.**
  - If a transaction qualifies as a “reorganization” under the tax code, it can be wholly or partially non-taxable.

- For Asset Purchase:
  - Buyer buys Seller’s assets wholly in exchange for Buyer’s stock
    - Tax Free “C” Reorganization
- For Stock Purchase:
  - Buyer purchases Seller’s stock wholly in exchange for Buyer’s stock
    - Tax Free “B” Reorganization

Types of Acquisitions – Tax Free Reorganization

- Mergers:
  - **Reverse Subsidiary** Merger – Tax Free "A" Reorganization
    - Buyer creates an acquisition subsidiary **that is merged into seller** at closing whereby the Seller becomes a wholly-owned subsidiary of Buyer at closing.
    - Seller's stockholders receive only Buyer's stock at close
  - **Forward Subsidiary** Merger - Tax Free "A" Reorganization
    - Similar, only acquisition subsidiary only **Seller is merged into acquisition sub**. Seller only receives Buyer's stock.
  - **Forward Merger** – Tax Free "A" Reorganization
    - Seller merges directly into Buyer at closing.
    - Seller's stockholders receive only Buyer's stock

Types of Acquisitions – Tax Free Reorganization

- NOTES
  - If Seller receives ANY compensation other than voting stock or warrants of Buyer (cash, property, other securities) we have "Boot." which will be taxable to the Selling shareholders.
  - Boot is allowed only in a reorganization involving a merger.
  - Seller's stockholder's carry over their original basis to the new stock, increased by any gain recognized on the boot.
  - Certain elections can be made under Sec. 338 of the tax code to treat reorganizations as an asset sale, increasing Buyer's basis for tax purposes.

Public Company and Other Transaction Issues

- Public Company Issues
  - Regulation MA
  - Section 16 – Short Swing Profits
  - SEC Registration
- Other Transaction Issues
  - Hart Scott Rodino Act (“HSR”)
  - Information Statement
  - Transmittal Letter

Hart-Scott-Rodino Act ("HSR")

- Overview – beyond scope
- HSR filing is required if the value of the deal is between $50 and $200 million
  - WithTarget > $10M in revenue or total assets; and
  - Purchaser > $100M in revenue or total assets
- If HSR applies, during waiting period companies can not behave like merged firms
  - They can plan for integration, but not behave as such

Information Statement

A. If stock of a private seller is widely held and the transaction requires a stockholder vote, an information statement will need to be prepared and distributed to describe the transaction to stockholders in connection with the stockholder meeting or execution of a stockholder consent to the transaction. In addition, a merger transaction may require dissenter's rights notices to be distributed to stockholders who do not vote for the transaction and desire to perfect appraisal rights for their stock.

The Fundamentals of Due Diligence

What is "Due Diligence?"

Due Diligence is the "Homework" of the Deal

- Understanding the seller's financial and legal structure to ensure the deal can be done
- Confirming the strategy and feasibility of the target's business
- Grasping the essence of the culture and its keys to success
- Verifying operations and assets and liabilities are as represented
- Evaluating opportunities to best fit the acquired with the acquirer and realize promised accretion

What is "Due Diligence?" (cont)

- It is Asking a lot of Questions??
  - What (are you paying attention to?)
    - How fast they can produce requested documents will help validate
  - How (do you go about your day?)
  - Why (Why not?)
- It is asking follow-up questions???
- ***"if I were working here, how would I see it?"***
- Professional Skepticism

Due Diligence – The Process

- **Information Request**
  - Most acquirers have a standard form or checklist
  - The request should go to seller immediately after execution of the LOI.
- **Seller Response**
  - Typically seller is requested to respond to each specific request as soon as possible
    - Note: How quickly they can respond is important
  - Information may be shipped or maintained in a data room
  - If a due diligence review room is used, seller typically is sensitive to having it at its business location due to confidentiality/employee concerns.
  - Seller will also typically restrict who can use the room and what information can be copied.

Due Diligence – The Process (cont)

- **The Review**
  - Questions, review, analysis, consideration, more questions until understanding is reached
  - After review, buyer typically prepares a due diligence memorandum to memorialize the materials and information reviewed.
  - Buyer then typically requests follow-up information on certain points
    - Concern areas usually warrant further investigation
    - May have implications on LOI and Definitive Agreements.
      - additional representations and warranties, hold-back of purchase price or even adjustment of consideration.
  - Due diligence review is typically conducted in a very short time frame to allow buyer to determine if it desires to proceed with the transaction.

Due Diligence – The Process (cont)

- **Coordination with Definitive Agreement Process**
  - Typically, the definitive purchase agreement is being drafted simultaneously with the due diligence review in an effort to speed the process.
  - The diligence group must coordinate with document drafting group to ensure concerns are incorporated in documents as appropriate.
    - Diligence concerns often work their way into the Representations and Warranties of the Definitive Agreement

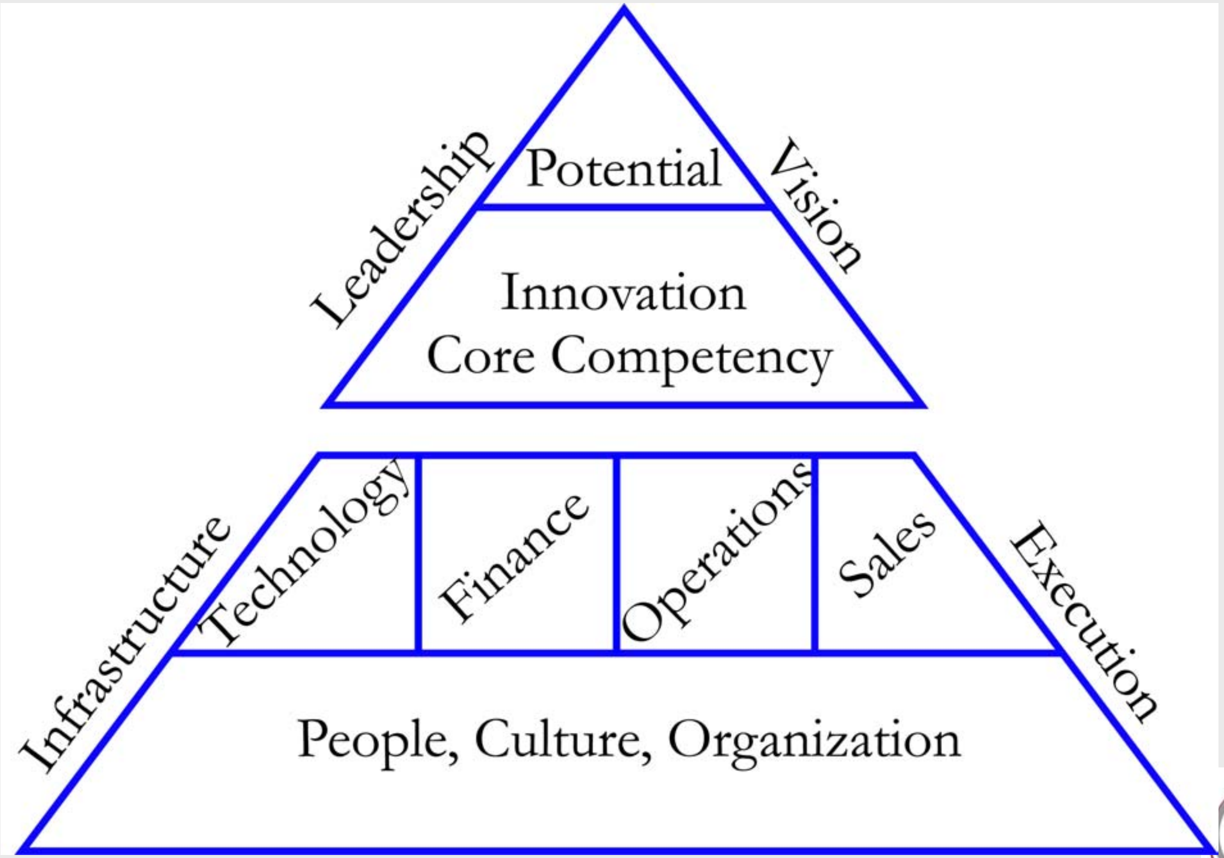
The Fundamentals of Due Diligence - Business

Note: Legal Due Diligence has moved See its new location….

Due Diligence

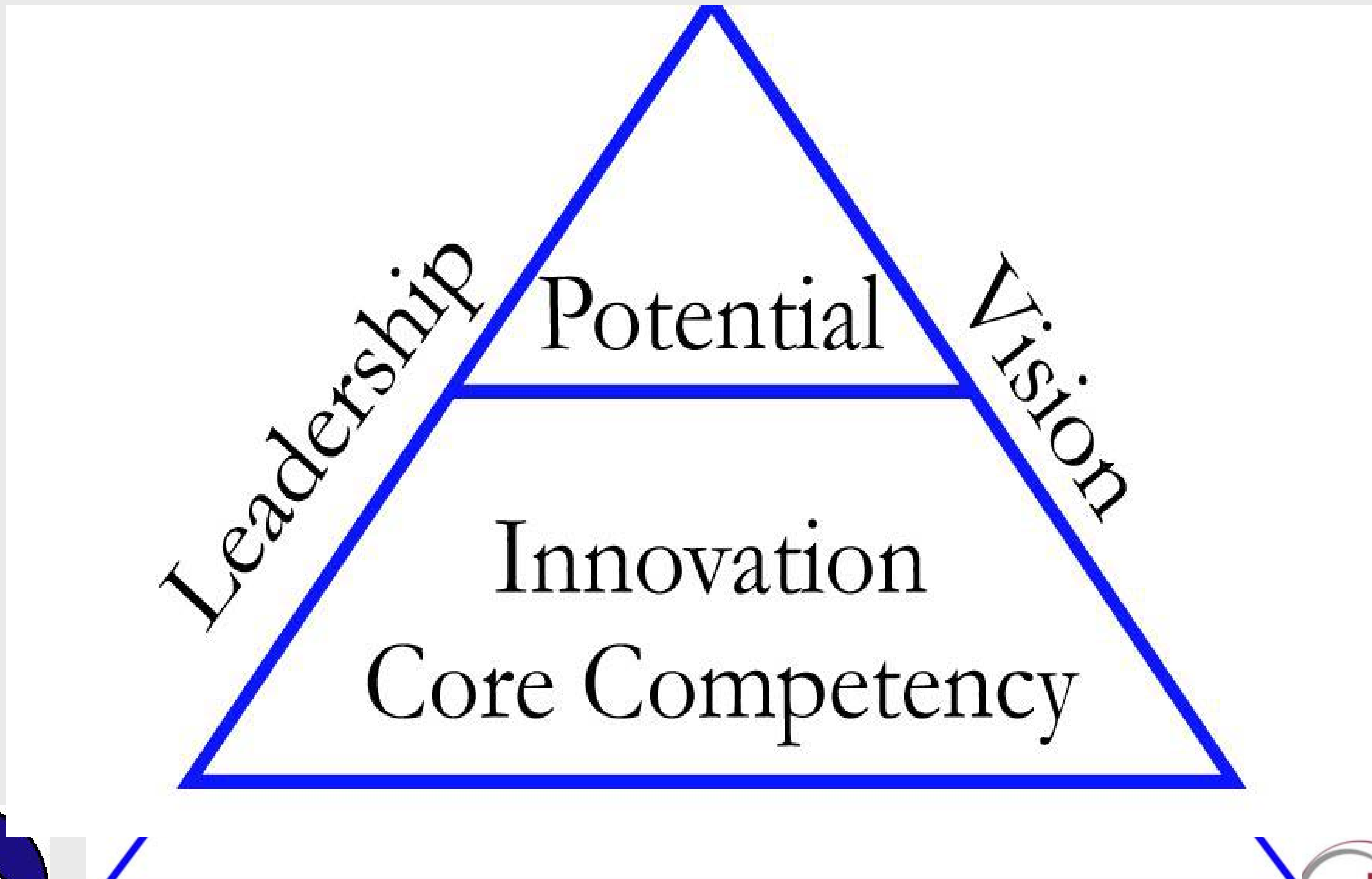
Validating the Assumptions;

Looking for Fissures of Failure



Due Diligence

The Vision



Due Diligence
"More than just Verification"

Verification

Cultural Assessment

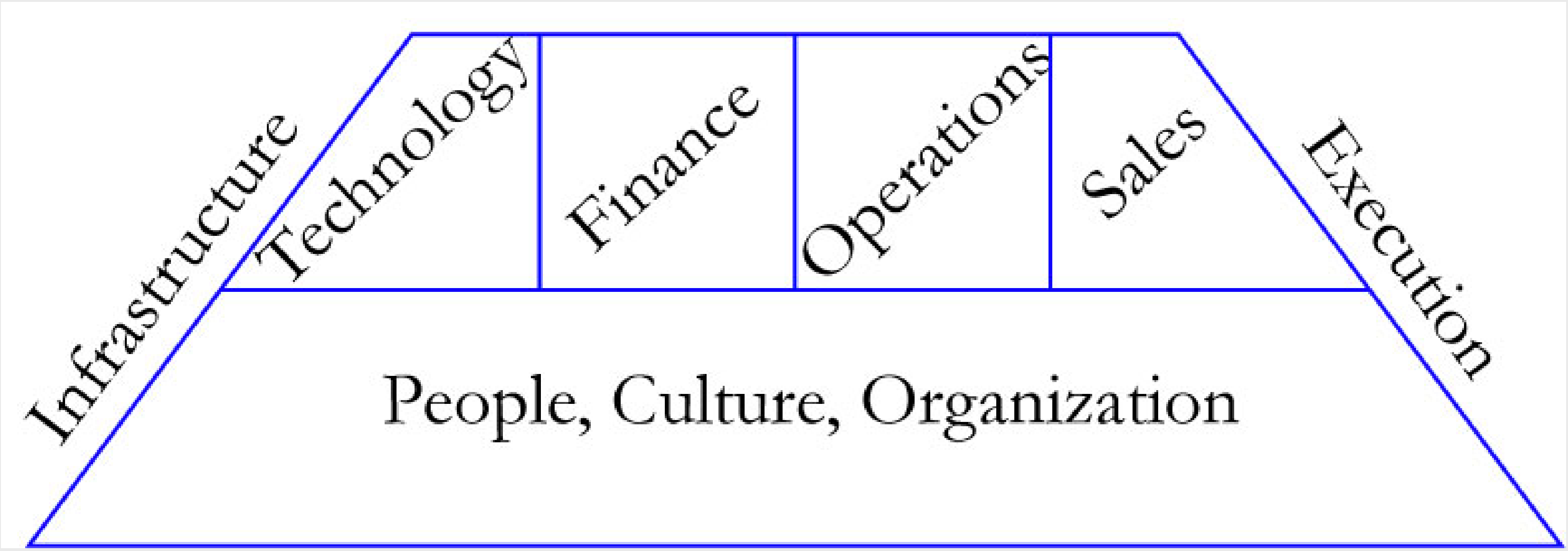
Infrastructure

Human Resources

Execution Assessment

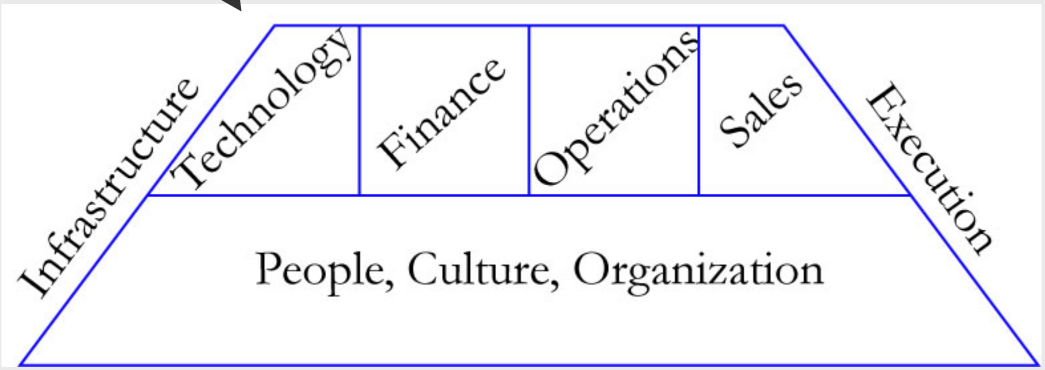
Axiomate

Essential Business Building Blocks



Technology
Essential Business Building Blocks

Infrastructure Architecture
Software Lifecycle
Code Quality
Staffing
E-Business Strategy
Risk Management



Axiomate

Technology, Products & Intellectual Property

- **Infrastructure Architecture**
  - Is there a definitive product architecture? What is it?
  - How or why was it formed?
  - Do all products follow this architecture?
  - How does the "Voice of the Customer" enter into the product definition?
  - What is the process to change the architecture?

Technology, Products & Intellectual Property

Product Lifecycle

- What is the perceived product life?
- Is this consistent with sales trends?
- What is the product development cycle?
- How does this relate to product life?
- Where are existing development projects in the lifecycle?
- What is the staff current working on?
- Promises we can not deliver?

Technology, Products & Intellectual Property

Staffing

- Are resident skills capable of handling near term challenges?
- How do you ensure technical currency and proficiency within your staff base?
- What is key to hiring staff?   Retaining staff?
- Why do people stay and why do they go?
- How does pay scale compare?
- How does turnover compare to peer companies?

Technology, Products & Intellectual Property

Project Management

- Do you have a formal Project management system?
- What are the metrics for management of the system?
- What is the performance (plus or minus time and dollars to plan)?
- How do you measure quality of deliverables for projects?
- Performance metrics?

Technology, Products & Intellectual Property

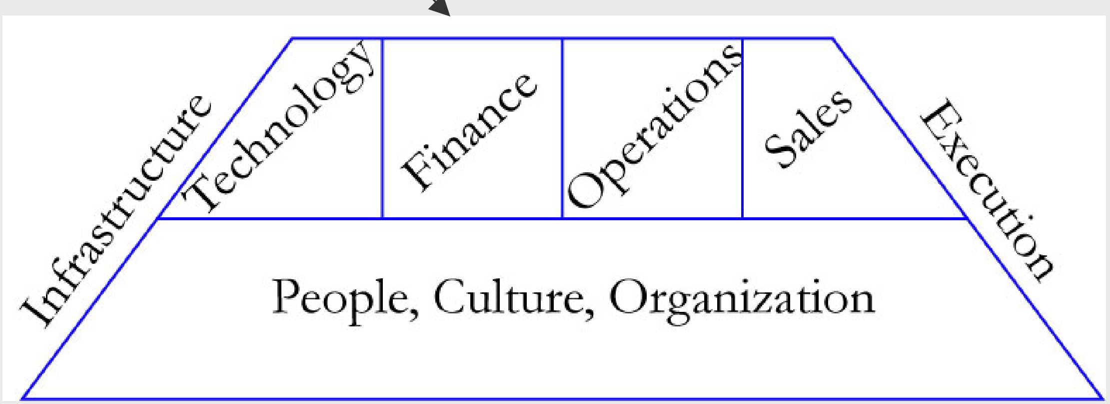
Intellectual Property

- What intellectual property does the target have?
- What has been done to register the IP?
- What has been done to safeguard it from
  - Employees?
  - Customers?
  - Competitors?
  - Partners?
- How has IP protection been enforced?

Finance and Administration

Essential Business Building Blocks

Current Financial Condition
Internal Control Environment
Information Systems
Key Business Relationships
Owner Motivations
Risk Management



Finance and Administration

Current Financial Condition

- What is the true operational cash flow?
- Are there any foreseeable changes?
- Are there seasonal trends?
- Are receivable turns appropriate?
- What are the root causes of slow pays?
- Do slow pays suggest product, service or sales issues?
- Are slow pays also on the sales forecast?
- What off balance sheet financing exists?
- What are the unstated liabilities?
- Are accounts routinely reviewed, or will there be significant year-end accruals or accounting adjustments?
- Are there significant slow-moving items in inventory?
- Have there been recent changes in the sales mix?

Finance and Administration

Current Financial Condition

- Things you will need:
  - Financial statements (3 years, hopefully audited)
    - Absolutely understand EVERY footnote
    - Access to auditor workpapers
      - Understand level of year end adjustments
  - State and Federal tax returns
    - Be certain current and ties to financial statements
  - Copies of leases and debt agreements
    - Understand covenants
    - Understand notice / assumption conditions
  - Customer and strategic partnership agreements (see above)
  - Details of accounts (particularly AR/AP)
  - Payroll register

Finance and Administration

Current Financial Condition

- The Basic Financial Review:
  - Know the components of every material account on the balance sheet
  - Understand changes in sales, cost of sales, operating expenses over the past five years, including their relative ratios between them
  - Understand what it means to "break even" and "meet the numbers."
  - Know the 10 largest customers this year and last? Any changes? Why?
  - Understand the components of the accounts receivable aging. Consider the significance of large customers that owe large amounts of money and/or are late paying.
  - Understand cash flow
  - Review the AP aging. Note average days payment.
  - Understand the payroll!

Finance and Administration

Information Systems

- Are information systems adequate for the existing business?
- Is the information system pro-active or re-active to growth?
- Where are the stress points in the system as the business grows?
- Do system back-ups routinely occur?
  - Are they tested?
  - Are system recovery practiced and tested? Frequency?
- Is there a written computer policy?
- Is the target compliant with software licensing?

Finance & Administration

Internal Control Environment

- Can you readily identify key control points?
- Understand the fundamentals of cash management
  - How is cash received? Managed? Invested? Disbursed?
  - Who signs checks?
- To what extent is the Target's Internal Control documented?
- What has the Target done relative to Sarbanes compliance?
  - Why is this important to a private company?

Finance and Administration

Key Business Relationships

- Are there reviews for changes in volumes of business between company and vendors, customers?
- Are there risk management practices with vendors and customers?
- What is the relationship with key lenders?
  - What are danger points on covenant compliance? Are bank reports timely and accurate?
- Are bills being paid on a reasonable basis?

Finance and Administration

Owner Motivations

- How are owners compensated?
- What are owner take-outs and perks other than salary?
- What is near and long-term equity plan philosophy of company?
- Is management acting consistent with stated philosophy?
- Is individual compensation aligned with objectives of the business?
- Why do owners want to sell?
- What are their cost verses equity motives?

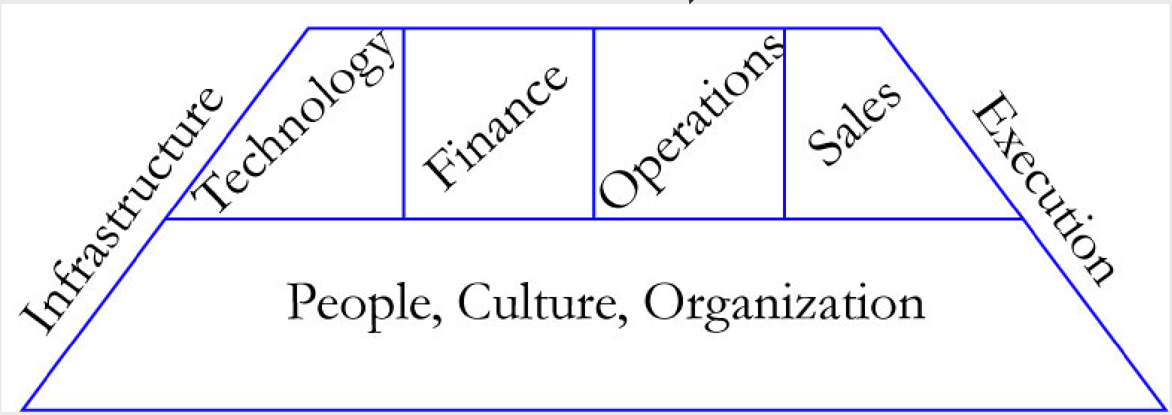
Finance and Administration

Risk Management

- Is insurance coverage methodically reviewed?
- Does coverage make sense for current and anticipated future of business?
- What types of implied commitments and exposures exist within sales agreements and employment agreements?
- Is there a clear and comprehensive human resources policy?
  - Are there exposure areas?
- Are there any pending or potential legal issues?
  - What are the attorney's working on?
  - Have there been any potential or actual legal issues in the last 3 years of business?
- Are we current and compliant in our taxes?

Operations
Essential Business Building Blocks

Process Review
Process Bottlenecks
Enabling Infrastructure
Performance Indicators / Metrics
Management Discipline



Operations

Process Review

- What are the key product development, sales and operational processes?
  - Are they documented? Are they widely known? Are they clear?
- What are your metrics for cost, productivity and quality of your supply/service chain?
- What are the top supporting processes for above?
  - What are the metrics for the supporting processes? Are metrics reported? At what level? Are they trended and acted on? How?

Operations

Process Bottlenecks

- Where do processes currently fail?
- What are the growth stress points on various critical processes?
- Do you measure cycle time, queues and inventory relationships?
- Are they documented?

Operations

Enabling Infrastructure

- What is your operational structure?
- What is your Go to Market structure?
- Do you have an Organizational Development Plan?
- Can all activities and process steps be justified?
- How is enabling infrastructure challenged and justified?

Operations

Performance Indicators / Metrics

- What quantitative measures to you use to track:
  - Customer satisfaction?
  - Tracking on financial goals?
  - Business operating at normal?
  - Technology is current
  - Employee morale is acceptable?
  - Management systems contain pertinent and timely information?

- At what level(s) are your metrics cascaded too?
  - What is the review mechanism? Frequency? Audience?
  - What is your communication plan?
  - What is your motivational, awareness and reward system?

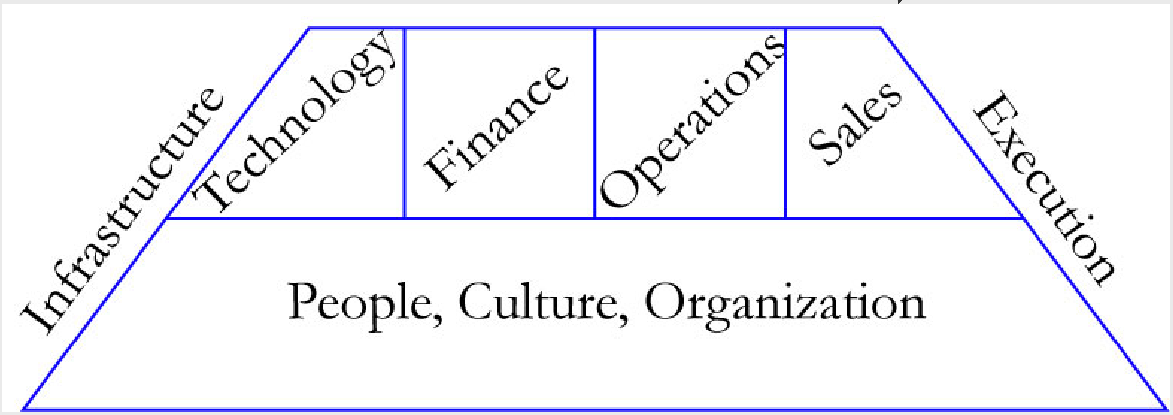
Operations

Management Discipline

- How are processes established?
- How are process performances reviewed?
- What are the management overrides of critical processes?
  - How often do overrides occur?
- What is your escalation process?
  - How often is it used?
- What percentage of organizational effort is:
  - Day Work?
  - Project Work?
  - Breakthrough Thinking?
  - How is this prioritized, managed, and measured?

Sales & Marketing /CRM
Essential Business Building Blocks

Sales Management Process
Pipeline / Lifecycle
Lead Generation Process
Voice of the Customer
Customer Relationships



Sales, Marketing & CRM

Sales Management Process

- Is there a formal process for managing sales activity?
- How are leads managed?
  - What happens to "dropped leads?"
- Does the company have an understanding of its cost of leads?
  - What marketing activities have the lowest cost of leads?
- What marketing activities produce the most qualified leads?
- What tools are used to manage the leads?
- What metrics are documented and reviewed?
  - Frequency? Audience?

Sales, Marketing & CRM

Voice of the Customer

- How are customers found?
- How do customers find you?
- How does the Company stay in touch with its customer?
- How are products and services specified? What is the degree of customer input into the process?
- What are the customers saying about the target?
  - It's products? It's people?
- How does customer support information flow into the Voice of the Customer?
- What is the Frequency of customer contact?
  - Distribution of contact? Who?

Sales, Marketing & CRM

Pipeline / Lifecycle

- Does the sales pipeline provide an adequate forecast of future sales?
- How long is the sales cycle?
- What does it cost to produce a sale?
- Is the pipeline realistic given our review of accounting and customer support?
- What is the percent variance of forecasted sales versus actual?

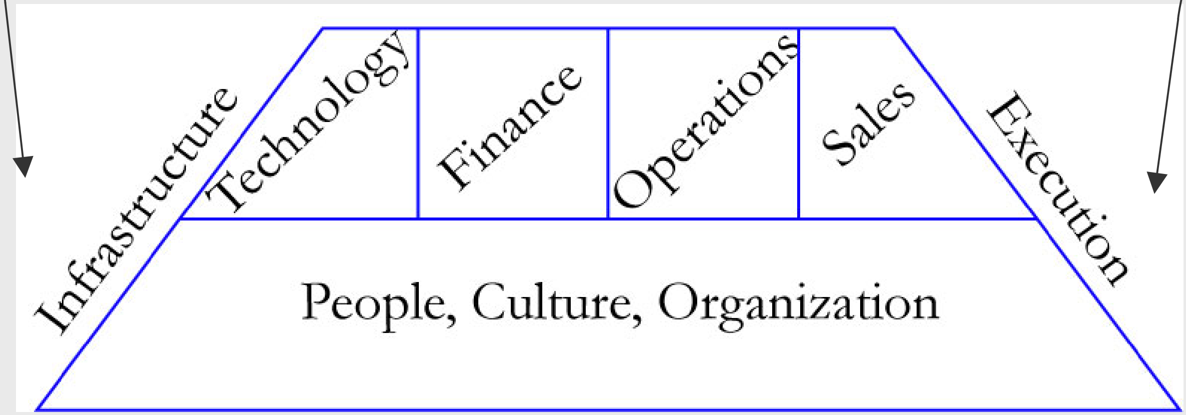
Sales, Marketing & CRM

Customer Relationships

- What is the CRM system?
  - Is it formal and coordinated or ad hoc?
- What are its metrics?
- Who reviews system?
  - Frequency?
- How does customer influence product direction?

People, Culture & Organization
Essential Business Building Blocks

The Organization



Axiomate

People, Culture and Organization

People

- How is the company staffed?
- How does it obtain and retain its people?
- How are people compensated? How does this compare?
- How does human resources work?
- What types of HR issues does the company have? What is its history?
- What are the employee benefits?
- What types of integration issues are we likely to have?

People, Culture and Organization

Culture

- What is the stated mission of the Company?
- How well is the mission known within the rank & file?
- What are the Company's values
  - (stated or implied?)
- What gets people promoted within the organization?
  - What limits careers?
- Is there universal alignment about what makes the Company successful?
- Where are the organizational conflicts?
  - Which group "has the power" within the organization?
  - Which is the "weak sister?"

Axiomate

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People, Culture and Organization

Organization

- What are the people doing?
  - Macro: Staff mix by function?
  - Micro: What is the staff specifically working on?
- Are we appropriately staffed (numbers and skills?)
- What does the organization look like?
- Where is the turnover history of the organization?

SWOT – Interim

Strengths	Weaknesses
1. Company has 5 years of increasing revenue and profits 2. Product is being sold through Walmart and Target 3. Business has a 4 month backlog 4. Company's unit production cost is 25% below ours for same products	1. Walmart's accounts for 60% of sales. 50% of this year's revenue is in AR, and 50% of that is over 90 days, compared to 20% 1 year ago 2. Current ratio is 1 to 1. Was 1.3 to one a year ago. 3. International sales operation cost $500K last year. Produced only $400K in revenue 4. Marketing organization has had 3 VP's in 3 years 5. Customer support reports average call close times in excess of 3 days. The company's CRM system is non-existant 6. Accounting requires 20 days each month to close the books. Prior year audit not yet complete
Opportunities	**Threats**
1. Competition receives 60% of revenue from international sales *2. US sales are primarily through 2 major chains, other chains have not been developed* *3. Company has not taken advantage of offering accessories to its core products* *4. Company has not fully exploited its Target & Walmart relationship* *5. Target may lower our own manufacturing expense*	1. Chief competitor, QuasiModo, just completed a public offering raising $100M 2. Walmart contract is up in December. Contract is cancelable upon change of control 3. Labor contract is up in November. Labor has not had raise in 4 years. 4. Margins are trending down 5. Bank note is due on change of control. Relations with bank are considered "polite." 6. Executives have $1.0M change of control parachute 7. A new CRM system will cost $5.0M 8. The Company spent $75K with attorneys last quarter, up from $10K the previous quarter

Axiomate

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The Fundamentals of Due Diligence - Legal

Fundamental Legal Due Diligence

- Corporate Governance
  - What Must Happen to Approve the Transaction?
    - Articles of Incorporation
      - Basic capital structure
      - Rights & privileges of equity owners
    - Bylaws/Operating Agreements
      - Ascertain necessary approvals and procedures
    - Board minutes
      - Understand corporate history
      - Understand how it handles substantive transactions

Fundamental Legal Due Diligence

- Corporate Governance (cont)
  - Stockholder Agreements
    - Stockholder rights and preferences
  - Capitalization Table
    - Understand all of the ownership and votes within the company
  - Stock Options and Warrants
    - Understand change of control provisions
      - » Do options and warrants vest? Convert? Cancel? Other?

Fundamental Legal Due Diligence

- Key Operating Agreements
  - Bank or Credit Arrangements
    - What are the change of control provisions?
      - Do banks have "veto" power or debt acceleration?
      - Is there a default that could complicate the deal?
      - If we need permission, how long will it take?
      - Are assets pledged?
  - Strategic Partner and Vendor Agreements
    - What are the change of control provisions?
      - Do they have "veto" power, or worse?
      - If we need permission, how long will it take?
  - Supplier Agreements
    - Change of control – right to re-price?
    - Notice provisions

Fundamental Legal Due Diligence

- Key Operating Agreements (cont)
  - Customer Agreements
    - Again, look for change of control provisions
    - Also, look for commitments to customer that have not yet been completed
  - Employment Agreements
    - Golden parachutes that kick in with Change of Control
    - Ascertain extent employee confidentiality and computer policy agreements were used and enforced
    - Non-competition agreements

Fundamental Legal Due Diligence

- Key Operating Agreements (cont)
  - Human Resources
    - Obtain and review employee benefit plans
      - Employee manual – ‘contract’ with the employee
      - Health and retirement plans
  - Intellectual Property
    - Patents, Trademarks, Copyrights
    - Trade secrets, licenses
    - Are they protected?
      - Very important in deals today

Fundamental Legal Due Diligence

- Review Contracts and Closing Documents Around any Other Significant Financing or Business Acquisition Transaction
  - Should cross-check to other information
    - Equity issues should agree to articles and/or bylaws
  - Note continuing reps & warranties and other obligations of Target there under.

Fundamental Legal Due Diligence

- Other
  - Licenses, Permits and Governmental Reports - this will help ascertain if seller has taken the appropriate steps to comply with laws.
  - Investigations - this will help reveal any past compliance problems of seller.
  - Environmental Studies and Reports- this will help determine if there are potential environmental liabilities.
  - Obtain Good Standing Letters in all key jurisdictions
    - Absence could mean a tax problem

Definitive Agreements

Definitive Agreements

- Definitions
- Description of the Transaction and Consideration
- Representations and Warranties of Seller
- Representations and Warranties of Buyer
- Disclosure Schedule
- Pre-Closing Covenants
- Post-Closing Covenants
- Closing Conditions
- Indemnification
- Escrow / Holdbacks
- Termination
- Miscellaneous
- Exhibits

Definitive Agreements - Definitions

- Qualifiers Applicable to Representations and Warranties
- Key Items Defined:
  - Knowledge
  - Material Adverse Effect
  - Materiality

Definitive Agreements - Definitions "Knowledge"

- **Buyer Will Want:**
  - Knowledge to mean something that is ***known or should have been known*** after reasonable investigation.
- **Seller Will Want:**
  - Knowledge to mean ***actual knowledge*** of certain specified officers of seller without investigation.

Definitive Agreements - Definitions "Material Adverse Effect"

"…any effect or change that would be (or could reasonably be expected to be) materially adverse to the business, assets, condition (financial or otherwise), operating results, operations or business prospects of seller or the ability of seller to consummate the transaction…"

Buyer Will Want:

- definition to be broad

Seller Will Want:

- definition to be narrow
  - Will seek exclusions for a) anything the buyer had knowledge of (or should have had knowledge of) and b) changes that are not cured prior to closing.

Definitive Agreements - Definitions "Material"

Assuming the Seller is making most of the representations

Buyer Will Want:

- NO or LOW material threshold so every breach is covered

Seller Will Want:

- seller will seek to have higher definition of materiality

"Watch for double and triple dipping - applying more than one qualifier to a representation and warranty in the representation or warranty itself and in the closing conditions."

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Definitive Agreements
– Transaction Structure and Consideration

- Describes Structure of Transaction Discussed Above
- Describes Consideration Discussed Above
- Earnout
  - Popular, but no one likes them
    - Difficult to draft
    - Difficult to enforce
    - May promote behavior in best interests of the earnout, not necessarily in the best interests of the Company

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Representations and Warranties

Basically, a risk shifting mechanism that allocates the risks inherent in the business (and the transaction) between buyer and seller.

Representations & Warranties - Seller

Organization

- Organization, Qualification, Corporate Power –
  - MAE on qualification
- Authorization
- Non-contravention –
  - Knowledge/MAE
- Broker's Fees
- Capitalization
- Title to Shares/Assets
- Subsidiaries

Representations & Warranties - Seller

Results

- Financial Statements
- Events subsequent to last audit or financial statements
- Undisclosed Liabilities –
  - Knowledge/MAE
- Tax Matters –
  - MAE
- Legal Compliance
  - Knowledge/MAE

Representations & Warranties - Seller

Assets & Property

- Real Property
  - MAE
- Intellectual Property
  - Material licenses
  - Knowledge/MAE
- Tangible Assets –
  - Materiality/MAE
- Contracts –
  - typically lists a $ threshold to be deemed material. Knowledge/MAE
- Accounts Receivable
  - MAE
- Inventory
  - MAE

Representations & Warranties - Seller

- Insurance
  - Standard for industry
- Litigation –
  - Knowledge/MAE
- Product Warranty
- Employees
  - Knowledge
- Employee Benefits
  - MAE
- Guaranties
- Environmental
  - Knowledge/MAE
- Customers and Suppliers
  - Material
- Investment
  - if stock of buyer is consideration
- Transaction Specific

Reps & Warranties - Buyer

- Organization
- Authorization
- Non-contravention
- Brokers' Fees
- Investment
- May be Expanded if Stock of Buyer is Consideration.

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Disclosure Schedules

- Lists exceptions to Representations & Warranties
- Buyer will want disclosure schedule to identify any exception with particularity and describe relevant facts in detail.
  - Mere inclusion in document is not sufficient to disclose exception. Must identify the particular representation for exception
- Seller will seek for any disclosure to be a board exception to all representations
- Buyer should review the disclosure schedule in detail.
  - Add reps and warranties and/or specific indemnification for any matters of concern.
  - Otherwise, the disclosure schedule basically cures a breach of the representation or warranty with no recourse.

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Pre-Closing Covenants

- Best efforts to consummate transaction.
- Notices and consents
  - contracts, governmental, HSR.
- Operating of seller's business –
  - ordinary course prior to closing with restrictions on non-ordinary course actions and a limit on non-ordinary course and transaction expenditures.
- Full access for continued due diligence.
- Notice of developments.
- Exclusivity
  - discussed above in LOI and continued in agreement along with break up fee and other lock-up provisions.

Post-Closing Covenants

- Best efforts to carry out the purpose of agreement
- Litigation support
- Transition of customers, suppliers and other strategic arrangements
- Confidentiality
- Directors and Officer Insurance (“D&O”) tail / indemnification for Seller’s officers and directors
- Covenant Not to Compete
  - Colorado restricts basically to executives and owners in sale
  - Considerations: length, geographic and market restrictions. And types of activity

Closing Conditions

- Representations and warranties are true
  - Watch for doubling and tripling qualifiers
- Covenants shall have been performed
- All 3rd party and governmental consents and waivers have been obtained
- No litigation or other such actions
- All required certificates, legal opinions and other agreements have been executed and delivered
- Resignations of officers and directors of seller

Closing Conditions (cont)

- Approval of Board of Directors and shareholders
- Cap on dissenter's rights
  - Seller will resist this condition
- Financing has been obtained
  - Seller will resist this condition
- Satisfactory due diligence of Buyer
- Delivery of Fairness Opinion
- Title insurance on real property
- Bring down good standing certificates
- Debt payoff
- Other transaction specific conditions

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Indemnification

- Who is indemnifying?
  - Asset Sale – may want to look past the selling entity to principal stockholders if only a shell is left post-transaction
  - Stock Sale – may want to indemnity from principal stockholders
- Who pays?
  - Buyer will want indemnity to be joint & several
  - Seller will seek to tie specific breach to specific parties
- Length of Survival of Reps/Warranties
  - Typically, buyer asks for 3 years; seller offers none. Settle on 1 to 2 years.
  - Often their will be a carve out for longer durations on specific issues (i.e. taxes)
- If buyer knew of breach and closed anyway, is buyer entitled to indemnity for the breach?

Indemnification – Deductibles

- Deductibles and the "Basket"
  - Seller will typically ask for a threshold amount for damages that will obligate Seller only to indemnify (pay) buyer only when damages exceed a specified amount ("the Basket") and only to the extent it exceeds that amount (a deductible.)
  - Buyer will typically want NO deductions. In buyer's view, once the basket has been exceeded, Buyer is entitled to first and all dollars of indemnity.
  - In general, this settles out with a deductible that is lower than the basket.
    - Recent baskets were 2% of the aggregate escrow/indemnity amount.
- CAP
  - Seller will want indemnity capped. Buyer will not.
  - Recent caps were 12-15% of purchase price

Escrow and Holdbacks

- Buyer will want significant holdback of purchase price to secure the potential indemnity obligations. Seller will want entire purchase price paid at close.
- Issues
  - Length of time (usually tracks with survival of reps and warranties)
  - Payout – typically phased over time
  - Amount – recent transactions – 12-15% of purchase price
  - Escrow Agent – typically needs to be a third party
  - Escrow Agreement – another agreement addressing the custody of the escrow. Escrow agent as well as Buyer and Seller(s) is a party
- Offset
  - Buyer may use earnout or other delayed payments to offset indemnity

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Termination

- Mutual written consent
- Either party if such party delivers notice of a breach and such breach is not cured within a specific period of time
- Either party after a mutual “drop dead” date
- Failure to obtain stockholder approval
- Transaction enjoined by final unappealable court order
- Termination will be tied to break up fee conditions

Miscellaneous

- Typically restrict assignment of obligations under the agreement to other parties, other than affiliates of Buyer
- Choice of Law / Choice of Venue / Choice of Jurisdiction
- Court or Arbitration?
- Who pays legal fees in disputes?
- Specific performance as a remedy

Exhibits

- Employment Agreements
  - if there are employees of seller that are key to the business for buyer.
- Consulting Agreements
  - if there are employees/owners of seller that are key to buyer for a period of time to transition the business.
  - Also a way to create an operating expense for buyer to write off.
- Escrow Agreement
- Legal Opinions
- Stockholder Indemnification Agreements
- Voting Agreements

Allocation of Purchase Price

Allocation of Purchase Price

- Fair Value = Book Value
  - Cash – book value
  - AR/AP
- Fair Value <> Book Value
  - Inventory
  - Fixed assets
- Intangibles – Fair Value can be "Subjective."
- Consider Colorado Sales Tax Issue can compete with your interests in allocation for federal tax

Fundamentals of Accounting

For every debit, there must be an equal and corresponding credit(s)

Cash			?	
Dr.	Cr.		Dr.	Cr.
	$ 100.00		$ 100.00	$ -

Creating the Intangible

(what to do with the debit?)

Allocation of Purchase Price - Intangibles

- Making Intangibles "Tangible"
  - Employment and consulting contracts
  - Non-compete agreements
- Customer Lists, Intellectual Property, Software and Business Processes
- Goodwill

Planning for Integration

"Making 1 + 1 = 3"

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Process Steps

1. Business Strategy
2. Operational Goals and Objectives
3. Business Process Rationalization
4. Roles and Resource Levels
5. Organizational Structure
6. Personnel Selection

Integration Teams and Leaders

Integration Oversight Team

- *Executives*

Transition Senior Management Team

- *Functional Managers, Executives, Jr. Executives*

Integration Teams and Leads

- *Strategy and Messaging*
- *Sales and CRM*
- *Product Development*
- *Services*
- *IT Infrastructure*
- *Finance*
- *Human Resources*

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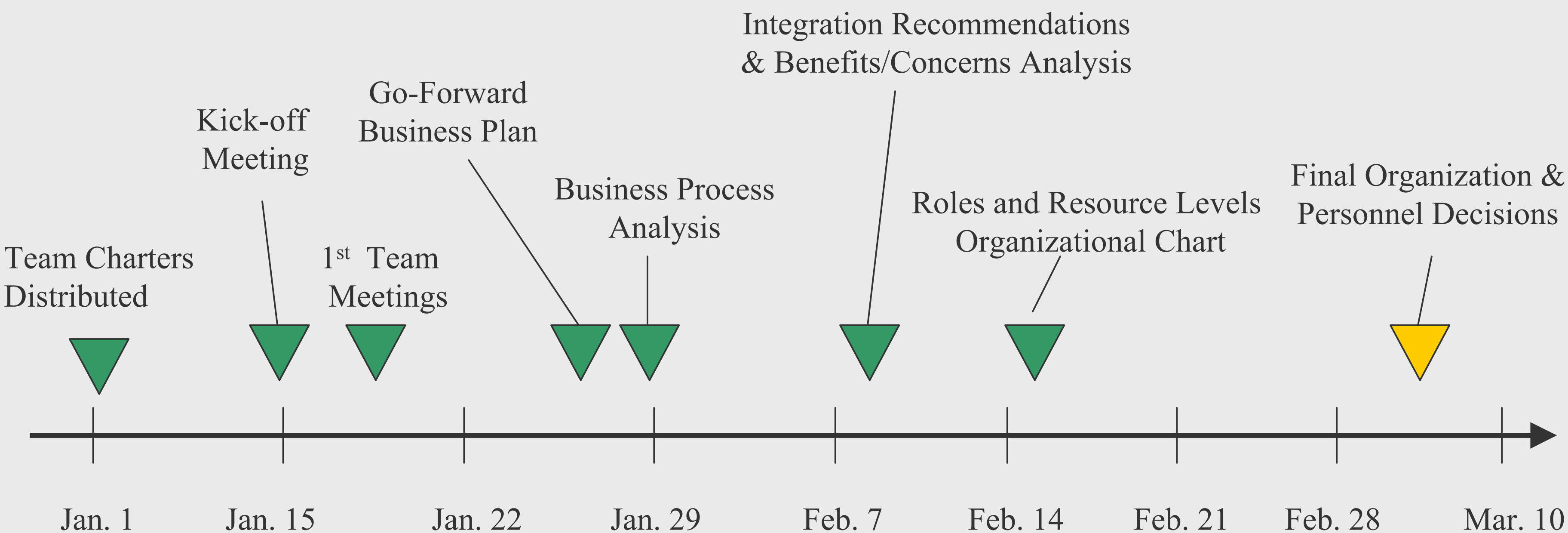
Integration Teams Deliverables & Timeline



Strategic and Tactical Objectives

Current Business Summaries

Skills Forms from Acquirer and Target Employees

Data Gathering Activities

SWOT – Final

Strengths

1. Company has 5 years of increasing revenue and profits
2. Product is being sold through Walmart and Target
3. Business has a 4 month backlog
4. Company's unit production cost is 25% below ours for same products

Weaknesses

1. Walmart's accounts for 60% of sales. 50% of this year's revenue is in AR, and 50% of that is over 90 days, compared to 20% 1 year ago
2. Current ratio is 1 to 1. Was 1.3 to one a year ago.
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Opportunities

1. *Competition receives 60% of revenue from international sales*
2. *US sales are primarily through 2 major chains, other chains have not been developed*
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6. Executives have $1.0M change of control parachute
7. A new CRM system will cost $5.0M
8. The Company spent $75K with attorneys last quarter, up from $10K the previous quarter

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Operational Goals and Objectives

Strategic

1. Streamline operations
2. Expand the application footprint and suite of data products within our existing customer base to extract a larger share of our clients' IT and data budgets.
3. Grow internationally. Hire new head of international sales operations. Consider growth through acquisition.
4. Acquire additional components that can accessorize our core products. Market them to our existing core customers.
5. Through the combination of 1-4, create a $20 million plus revenue base with 20% + EBITDA margins.

Tactical

1. Create a migration path for our larger AA clients which enables the growth of their business, retains them as customers and captures a larger share of their budgets.
2. Capture 10 new distributors, including 2 of top 10, for combined product line. Introduce our AA, BB products to Targets distribution group; and yy and zz to Buyer's customer group.
3. Implement new CRM system within 15 months
3. Close the targeted international acquisition by FYE 2004.
4. Close one additional $5 million + acquisition during FYE 2005.

Combined Organization

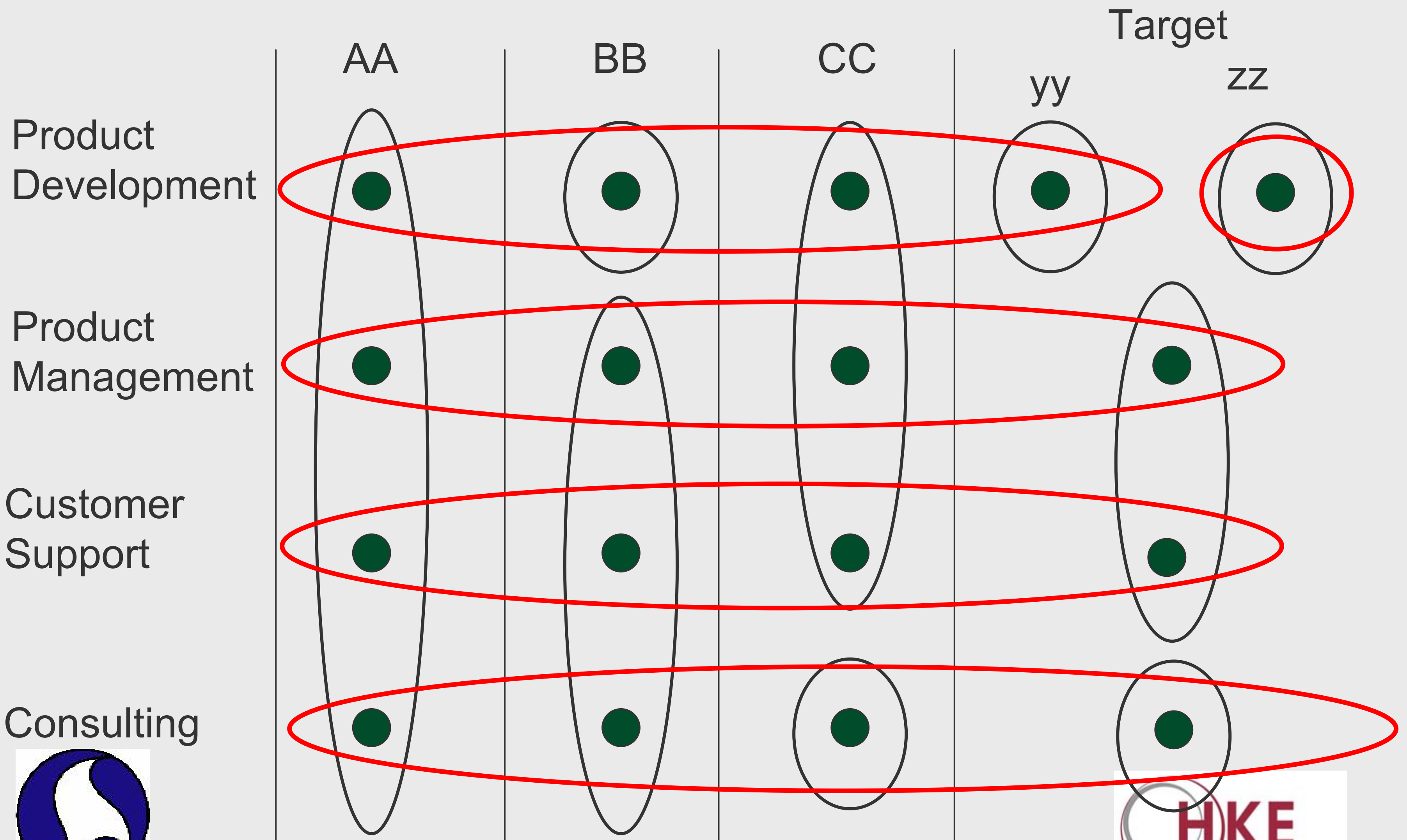
Acquirer

- *Product Based* - functions integrated within products except HR and Finance.
- *Product Based Business Processes* – business processes for Sales, Product Development, Consulting, and Support vary by product.
- *Distributed Product Groups* – most product groups are distributed, including Customer Support and Consulting, is distributed in Denver and Dallas.
- *Centralized Product Development* – product development is centralized in Denver, but organizational grouping is by product.

Target

- *Function Based* – products integrated within functions at a high level, with product subgroups in functional groups.
- *Standard Business Process* – standard business processes for each function Sales, Product Development, Consulting, Support, etc.
- *Distributed Functional Groups* –while organizational grouping are functional, most functional groups have members who are distributed in Denver, Dallas and LA.

Organizational Groupings by Product and Function



Product vs. Functional Organizations

Pluses (+) and Minuses (-)

- Product Organization
  - + Integrated functions within products
  - + Product competency focus
  - + Main communication lines within product modules
  - + Tactical product enhancement
  - + Product Management
  - + Customer service focus
  - + Customer accountability
  - - Redundant functional roles
  - - Branding & messaging coordination
  - - Sales channel coordination
  - - New product development
  - - Technology standardization
- Functional Organization
  - + Integrated products within functions
  - + Functional competency focus
  - + Main communication lines within functional areas
  - + Strategic product migration
  - + Cost and efficiency focus
  - + Technology standardization
  - + Sales channel coordination
  - + Branding & messaging standardization
  - - Customer service
  - - Customer accountability
  - - Incremental product enhancement
  - - Product management

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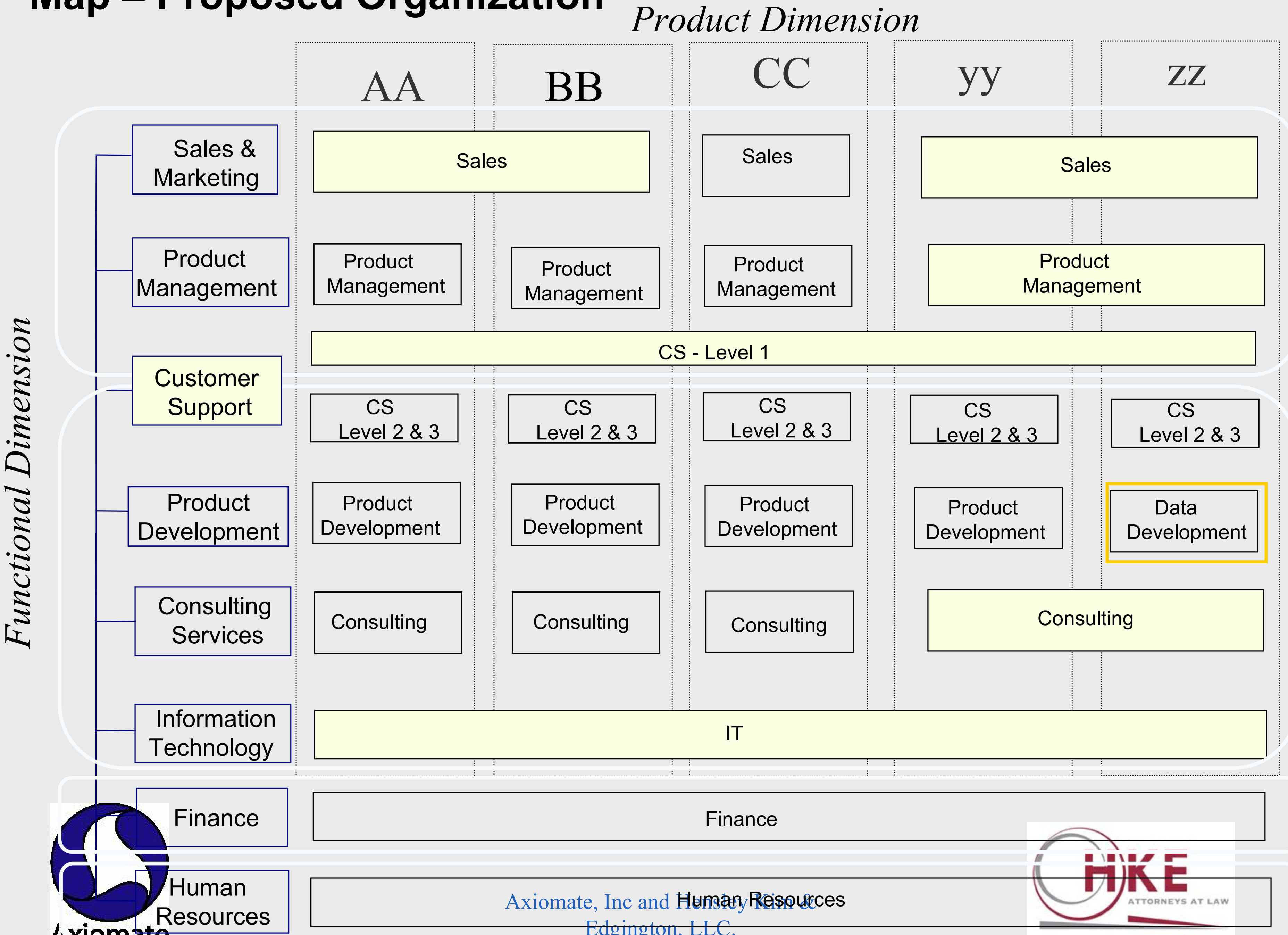
Map – Current Organization

Functional Dimension \ Product Dimension	AA	BB	CC	yy	zz
Sales & Marketing	Sales		Sales	Sales	
Product Management	Product Management	Product Management	Product Management	Product Management	
Customer Support	Customer Support	Customer Support	Customer Support	Customer Support	
Product Development	Product Development	Product Development	Product Development	Product Development	Data Development
Consulting Services	Consulting	Consulting	Consulting	Consulting	
Information Technology	IT		IT (PD) IT (Hosting)	IT	
Finance	Finance		Finance	Finance	
Human Resources	Human Resources			Human Resources	

Map – Proposed Organization



Organizational Groupings - Geography

Centralized vs. Distributed

Map – Current Organization

Product Dimension

Functional Dimension

	AA	BB	CC	Target yy	Target zz
Sales & Marketing	Sales		Sales	Sales	
Product Development	Product Development	Product Development	Product Development	Product Development	
Product Management	Product Management	Product Management	Product Management	Product Management	
Customer Support	Customer Support	Customer Support	Customer Support	Customer Support	
Consulting Services	Consulting	Consulting	Consulting	Consulting	
Information Technology	IT		IT (PD) IT (Hosting)	IT	
Finance	Finance		Finance	Finance	
Human Resources	Human Resources			Human Resources	

Additional Resources

- Analysis / Information Sites
  - Hoovers *www.hoovers.com*
  - Edgar *www.sec.gov*
  - AICPA *www.aicpa.org*
  - RMA *www.rmahq.org*
- Books
  - Corporate Controllers Handbook of Financial Management
  - The Portable MBA in Finance and Accounting
  - The Art of M&A Due Diligence
  - Lorman Bookstore *www.lorman.com*

Thank You!