

Report from Grant Thornton to the Competition Commission, dated 9 May 2007**Thermo Electron Manufacturing Limited (Thermo) and
GV Instruments Limited (GVI)****1 INTRODUCTION**

1.1 In accordance with your letter dated 24 April 2007 (attached at Annex 1), we are pleased to report on the issues raised by the Competition Commission (The Commission).

1.2 Our work has focused on:

- the likely scenarios for GVI in the event that the sale to Thermo did not take place including an evaluation of likely insolvency procedures
- the attitude of Halifax Bank of Scotland (HBoS or The Bank)
- the impact of the procedures on the assets and the employees

SOURCES OF INFORMATION

1.3 The information contained in this report is based primarily on:

- the Excised copy of the Provisional Findings

[✂]

SCOPE OF WORK AND LIMITATIONS

1.4 Our review of the affairs of the companies referred to above **does not constitute an audit** in accordance with Auditing Standards and we have carried out no independent verification work or taxation work. We have relied on explanations and source information provided to us by The Commission. Consequently we do not express an audit opinion on the figures included in the report.

1.5 This report is issued on the understanding that The Commission has drawn our attention to all substantive matters of which it is aware concerning the sale of GVI to Thermo.

2 EXECUTIVE SUMMARY

2.1 In our view, given the scale of GVI's operations, the extent of the interest recently shown in the business by credible third parties and the level of Bank debt we would have expected that Investigating Accountants (IAs) would have recommended that the business be offered to the market using an accelerated disposal process referred to as Distressed Merger & Acquisition (distressed M&A).

2.2 This procedure is commonly adopted where an insolvent company can continue on a broadly cash neutral basis whilst an offer is sought for all or part of the business. It is a particularly relevant mechanism for a business where a significant

element of its value is goodwill which would amortise rapidly in the event of a formal insolvency appointment.

- 2.3 The result of the process is often a sale of the business assets to one or more purchasers in a pre-packaged administration or administrative receivership (albeit the latter process was not available in this case). In some circumstances a solvent solution can be secured.
- 2.4 There are circumstances where the distressed M&A procedure is not available and an immediate formal insolvency is unavoidable. If this had occurred at GVI we are of the opinion that an administration would be the preferred procedure rather than a liquidation. The former process enables the assumption of immediate control with better prospects for the realisation of goodwill than in a liquidation.
- 2.5 The administration strategy would (at least in part) be determined by the extent of funding (if any) available from the Bank.

3 THE LIKELY SCENARIOS FOLLOWING A PUTATIVE FAILURE OF THE SALE TO THERMO

Distressed M&A scenario

- 3.1 We take it at face value that HBoS had determined to appoint IAs in the event that the sale to Thermo failed to close. Such an appointment would be entirely consistent with our experience in dealing with the Bank over many years.
- 3.2 The Bank would outline the case background to the IAs and a brief would be agreed addressing the Bank's primary concerns. This brief would focus on the following key issues:
 - operational viability
 - financial viability including short term cash flow
 - debt servicing
 - management
 - options for the Company and the Bank
 - recommendations.
- 3.3 On the basis of the information provided to us it would be reasonable to suggest that the IAs would conclude that the business was insolvent and that urgent action was required to preserve stakeholder value. Given the recent performance of GVI, we would conclude that the Bank would have no appetite to significantly increase its exposure, certainly without an increase in security. Given the nature of the Bank's charges, no increase in security would be available from GVI.
- 3.4 We assume that the directors would be either unwilling or unable to provide additional funding or security. As such the preservation of value would probably involve a transaction with a third party.
- 3.5 The IAs and the Bank would be focused on the following key issues:
 - the likelihood of significant value attrition in the event of an insolvency (thus threatening the Bank with a loss should the business fail)

- the marketing of the business by its Board and financial advisers over the previous months
 - the quantum of offers received during the process
 - the short term cash requirement
 - the ongoing erosion of goodwill as the business failed to meet production obligations
 - the attitude of the Board in view of the conclusion that the business was insolvent.
- 3.6 We consider that the IAs and the Bank, in conjunction with management, would conclude that there was merit in aggressively marketing GVI outside of a formal insolvency process using an accelerated timetable in recognition of the short term goodwill deterioration. This mechanism is relatively commonplace and is referred to in this document as distressed M&A.
- 3.7 Our opinion is based on the scale of the business, the level of interest shown to date and the level of the Bank debt. The procedure has gained increasing popularity in recent years, particularly with businesses where a significant element of the asset base is goodwill which would amortise rapidly on formal insolvency.
- 3.8 This strategy would be dependent on the short term cash flow forecast of the business. Clearly the business was under significant creditor pressure. The Board would be advised to take no additional credit from suppliers (despite the consequences in relation to ongoing production) even if such credit were to be available. Payments for supplies effectively on a cash basis would be satisfactory if they could be accommodated within the cash flow.
- 3.9 We note that there were significant book debts at the time of the sale to Thermo and only a (relatively) modest provision against recovery was required post acquisition therefore it is possible that there would be sufficient cash flow to fund wages, salaries and some other essential payments in the short term.
- 3.10 The agreement of the Bank would be required as the use of such book debts would reduce the security available under the Bank's debenture (assuming the book debts were not replaced by sales). In our view, the Bank might have been prepared to allow the use of the book debt monies because they were unlikely to be collectible in an insolvency scenario. This latter conclusion is based on our experience in PDZ Europa Limited (PDZ) and appears to have been endorsed by Thermo's expert Mr Roy Bailey of Ernst & Young.
- 3.11 The sales process would be driven by the IA's firm (usually a combination of corporate finance and corporate recovery personnel) with close liaison with the Bank and the Board. An Information Memorandum (IM) would be prepared and potential interested parties identified. The parties would be contacted and IMs issued as appropriate under confidentiality protocols. The bidding timetable would be aggressive—a one month period (often less) would not be unusual with offers being invited for all or parts of the business.
- 3.12 We accept that there would have been a number of significant difficulties militating against a successful sale of all or parts of the business including:
- the distressed nature of the sale process and the associated timescales

- the need to maintain morale and retain key staff
 - the problem of segregating business streams and positioning for piecemeal disposal.
- 3.13 However, given the potential downside associated with an immediate formal insolvency, the process might well have been justified on the basis that the Board and the Bank had little to lose.
- 3.14 We note that the Board had been engaged in an attempt to sell the business, with only limited success with the exception of Thermo, but the Distressed M&A approach invariably concentrates purchasers' minds. They become aware that some transaction is almost certain to take place or an insolvency will ensue.
- 3.15 The process generally results in one of the following:
- the emergence of an equity investor or joint venture partner for the company
 - the emergence of a purchaser for the business as a whole which may be a solvent transaction (as with Thermo) or an insolvent transaction (probably through a pre-packaged Administration: this occurs when the purchaser agrees with the IA to acquire the assets of the business and all legal documentation is finalised subject only to the appointment of the IA as Administrator). In such a scenario the purchaser does not acquire the obligation to pay unsecured creditors but in practice some bridge building may be required to maintain the flow of supplies
 - the emergence of one or several purchasers for some or all of the business segments with the sale process following that referred to above
 - no parties prepared to make an offer.
- 3.16 During the course of this accelerated procedure the IA would seek the agreement of the Board to contact organisations such as Nu Instruments Limited which the Board had previously decided to omit from the sales process and GlenRose which had been slow to progress a purchase of the business. The Board would be left under no illusion that a full and frank disclosure was required (notwithstanding the context of securing the best available deal) if the timetable was to be met and the business (or elements of it) preserved.
- 3.17 As The Commission is aware, Les Ross of this firm was the IA and subsequently Administrator of PDZ Europa Limited (PDZ)—a company engaged in the mass spectrometer market. In that case, shortly before the appointment of the Administrator the company was the subject of a winding up petition, its bank account was frozen and it had effectively ceased to trade. Consequently, the distressed M&A procedure was not available.
- 3.18 It is not possible to predict accurately the likely outcome of such a process although, based on our knowledge of the case, our experience with PDZ and the nature of the interest shown to date, we would have expected a pre-packaged administration sale of at least some of the business segments.

The insolvency scenario

- 3.19 It may have been the case that IAs concluded that the business was insolvent and, for some reason, a distressed M&A process was not available. The reasons for this could have included some or all of the following:
- management reluctance to proceed in view of the insolvency of the business and consequential concerns regarding wrongful trading and personal liability
 - the Bank's reluctance to allow the use of book debt monies to fund the business in the short term
 - resignations by key staff members
 - action by creditors to initiate winding up proceeding or other creditor enforcement action (see PDZ above).
- 3.20 In this case the IA would need to advise the Bank and the Board of an appropriate insolvency procedure. For the purposes of this report we have focussed on two possibilities namely creditors voluntary liquidation (CVL) and Administration. Technically the directors could have attempted a Company Voluntary Arrangement (CVA) but, in view of the parlous state of GVI and the urgent need for new monies, the likelihood of a successful CVA without a new funder would have been extremely remote.
- 3.21 In any event, a CVA is one of the exit routes from an Administration and depending on the course of an Administration it would continue to be available.
- 3.22 We have read Mr Bailey's paper which details his analysis supporting the conclusion that the likely insolvency process would be a liquidation. We comment in the ensuing paragraphs.
- 3.23 Potential realisations in an insolvency have been limited to tangible fixed assets and stock with the realisations being calculated by extrapolating the ratio of book values to actual realisations in the PDZ administration. This approach is reasonable in relation to the physical assets, however, the principal realisation in the PDZ administration was £90,000 (book value nil) for intangible assets namely goodwill, know how, engineering drawings, order book etc.
- 3.24 Mr Bailey attributes a nil value to intangible assets and explains this in a note:
- "No meaningful value has been ascribed to Intangible assets as any value, often with the benefit of a discounted cash flow calculation, will reflect the outcome of a buyer specific negotiation"
- 3.25 Whilst we accept that attributing a precise quantum in respect of intangible realisations would be inappropriate, the balance of Mr Bailey's argument in terms of realisations appears to assume that the value would in fact be zero. Thus in Mr Bailey's conclusion he states that '... the value ascribed to GVI's assets, applying the PDZ rate of return by analogy, is £[£] ...' which is only the amount for tangible assets and stock.
- 3.26 By valuing the goodwill at nil, Mr Bailey assumes that all the GVI assets would be subject to the floating charge of the Bank. Mr Bailey points out the floating charge assets would be required to fund the costs of the administration (namely fees and expenses) the preferential creditors and the prescribed part. Consequently, the

equation in relation to the balance of risk between funding an administration and the prospective rewards appears unattractive.

- 3.27 However, the equation changes if goodwill is considered. Being fixed charge, the Bank would have first call on such realisations (that is before preferential creditors and the prescribed part).
- 3.28 On the basis that the Administrator's fees and expenses were split equally between the fixed and floating charge assets (£[redacted] each using Mr Bailey's analysis) then assuming the Bank met the payroll commitment included in Mr Bailey's paper (£[redacted]) the Bank would break even if goodwill realised only £[redacted] (£[redacted] plus £[redacted]).
- 3.29 Given the PDZ scenario where some £90,000 was realised for goodwill with a much smaller business—the possibility of the Bank agreeing to a speculative investment of this nature would need to be actively considered. This is especially the case given the interest that had been expressed in the business prior to the hypothetical appointment of IAs. We note that net assets at the date of sale to Thermo were £[redacted]. At that date debt (including directors loans of £[redacted]) totalled some £[redacted].
- 3.30 The shares were acquired on a debt free basis for approximately £[redacted] (£11.7 million purchase price less £[redacted] escrow ([redacted]) less the £[redacted] debt implying a goodwill figure at closure of the order of £[redacted] (£[redacted] equity less £[redacted] debt less £[redacted] net assets).
- 3.31 Similarly, the offer from GlenRose implied a significant goodwill element.
- 3.32 Whilst it is likely that the goodwill figure would have been subject to some attrition as a result of an insolvency (or a distressed M&A process), that attrition could have been limited by competitive tension created by interested parties.
- 3.33 In our view, the IA would share this analysis with the Bank and a decision on funding or otherwise would be made. There is no certainty as to what the Bank's decision would ultimately be although if we were to be asked to advise on the approach, we would have suggested that the risks were justified by the interest shown to date and our PDZ experience.
- 3.34 Even if the Bank decided against funding an administration (and we are of the view that at least some funding would be likely to have been made available to retain a core of staff) we would have recommended that the directors opted for an administration. Whilst, in the absence of funding, all the employees would need to be made redundant, we are of the opinion that we would advise that there were greater prospects for a realisation of goodwill in an administration than in a winding up because the process allows the immediate assumption of control. The latter is not available in a CVL as a result of the hiatus period which we discuss below.
- 3.35 CVL requires a hiatus period between the directors resolving to recommend the winding up of the company and a meeting of shareholders to place the company into liquidation. During this period the Board remains in executive control (albeit taking advice from the prospective liquidator) but a disposal of the assets cannot (usually) take place until after the creditors' meeting (there are some exceptions, for instance where goods are perishable but this business would not qualify as an exception).

- 3.36 Given the nature of the assets in this case we would regard this as particularly unhelpful.
- 3.37 In summary, in our experience, given the size and nature of the business, its financial position, the level of interest shown to date and the level of the bank debt the likelihood of a CVL being chosen as the preferred insolvency mechanism is remote.

4 EMPLOYEES

- 4.1 We have been asked to consider the position of employees in the insolvency scenarios. We reiterate that we consider that an administration would be the preferred procedure but compare the procedures as follows.
- 4.2 Technically, employee contracts survive in both a CVL and administration. In practice, if the business is to go into liquidation the majority, if not all, of the employees will probably be made redundant either during the hiatus period or immediately on the appointment.
- 4.3 In an administration, depending on the funding scenarios outlined above the Administrator will either retain a core number of staff commensurate with the realisation of goodwill and/or limited trading or make them redundant.
- 4.4 Employees retained at the time of sale will transfer to the purchaser under the Transfer of Undertakings (protection of Employment) Regulations and the purchaser (or purchasers) may factor the extent of their accrued entitlements into their offers for the business segments. To the extent that transferring employees are integral to the business operation then there is less likelihood that this will impact on the purchase price as their redundancies in the short to medium term would not be being contemplated by the purchaser(s)

5 LIKELY STATE OF ASSETS FOLLOWING A FORMAL INSOLVENCY

- 5.1 Regardless of the adopted realisation process (distressed M&A, CVL or Administration) the assets of the business would be partly impaired because the business would either not be trading normally or will not be trading at all depending on the funding arrangements.
- 5.2 This will lead to an erosion of goodwill although that erosion will be accelerated if the business ceases to trade altogether. In any scenario a purchaser of the business will be faced with a number of difficult problems namely:
- the urgent need to reactivate the supply chain (including possible ransom payments to key suppliers)
 - the need to improve employee morale
 - the need to instil confidence in customers who may have become disaffected by the recent under-performance of the business
 - the problems of customer deposits (which may need to be honoured to preserve goodwill)
 - the possible overstatement of the stock value.

5.3 Generally speaking, in our experience, a purchaser would be in a better position to deal with these issues if the core workforce has been retained and this scenario is much more likely in an administration than in a liquidation.

We trust we have reported in accordance with your instructions. Please do not hesitate to contact us if you require any further information.

Yours faithfully

Grant Thornton UK LLP

**Letter from the Competition Commission to Grant Thornton, dated 24 April
2007**

Thermo Electron/GV instruments inquiry: detailed instructions

1. Further to our letter of 20 April, this letter sets out in more detail our request for your expert opinion as an insolvency practitioner, which will help us in our inquiry into the acquisition of GV Instruments by Thermo Electron.
2. You have already seen an excised copy of the provisional findings. The following additional material is enclosed with this letter of instruction: [✂].
3. [✂]
4. We would like you, as an independent insolvency practitioner, to review the relevant evidence above and to report your opinion as to what is most likely to have occurred to GVI had the business not been acquired by Thermo.
5. When considering the alternative forms of insolvency proceedings, we would like you to comment on the respective effect on GVI's employees, as the availability of key staff (such as R&D scientists and trained testing/installation engineers) may be significant. In particular, if you are of the view that GVI's business would have gone into liquidation, we would like you to comment on the expected state of the asset(s) which would have been acquired and to what extent their purchaser(s) could be expected to utilize them to impose an increased competitive constraint on Thermo's business.
6. You will note as you review the material that Thermo's expert insolvency practitioner has used the administrative receivership of PDZ Europa in 2004 for comparative purposes. Given that you were one of the insolvency practitioners who handled the administration of PDZ Europa, it would be useful if you could draw on your experience when commenting on this analysis and, where relevant, to use your experience of selling Europa's assets, dealing with its employees, and your knowledge of this specialized industry when commenting on the likely outcome of GVI's business failure.
7. To summarize, the areas upon which we require your expert comment include:
 - The likely form of insolvency proceeding which would have occurred for GVI, had the merger not taken place, including:
 - the likelihood that the Bank of Scotland would have funded a period of administration for GVI's business, having taken into account the costs and potential benefits of this process;
 - the likelihood that the Bank of Scotland would have placed GVI into liquidation instead of administration;
 - the factors which would have influenced the bank's decision in these circumstances; and

- any further factors which could have affected the outcome, such as actions by other creditors.
- The likely state of the assets which would have been acquired, either out of administration or liquidation, including:
 - the differences likely to result from each form of insolvency proceeding (including the effects on staff and other assets);
 - any implications arising from the state of GVI's asset(s) if sold in liquidation;
 - any factors which you consider relevant which arise from a comparison to the PDZ Europa administrative receivership in 2004; and
 - to what extent you would expect a purchaser(s) of any of GVI's assets sold out of liquidation to benefit from them in such a way as to increase the competitive constraint they impose on Thermo's business.
- 8. Your opinions will be considered by the Group when it reviews its findings in the light of Thermo's representations and any additional material, and prepares its final report on the merger.
- 9. As soon as you have had an opportunity to review the material enclosed with this letter, you may wish to phone me to discuss our contractual arrangements and the next steps.

Yours sincerely

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