OXFORD METRICA

A report on the valuations of Cytech Limited (formerly Netainment NV) carried out by Corpcapital during the financial years 2000 through 2002

This is an independent report prepared by Dr Rory Knight based on an investigation and analysis of the CorpCapital valuation procedures and reports on Cytech. The report does not constitute a valuation of Cytech and the opinions herein are based entirely on materials and explanations provided by the management of CorpCapital. The management of CorpCapital provided unfettered access to their documents, they responded to all questions effectively and they provided further corroborations where necessary. These circumstances provided an adequate basis for an independent opinion to be formed on the reasonability of the valuations at the time they were made and the adequacy of the procedures that guided the valuation process.

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1. Executive summary

- The valuation of Cytech Ltd was evidently capable of reasonable measurement at each valuation date in the period investigated.
- The valuations were based on Cytech's actual performance and the reasonable projection of expected future cash flow performance.
- These projections, while optimistic, were robustly discounted and deflated in the anticipation of significant risks to the company, thus reducing the valuations.
- The valuations were <u>not</u> based on extant market multiples. Thus the so called "irrational exuberance" subsequently attributed to the stock-markets in this period did not distort the valuations.
- CorpCapital's valuation of Cytech at February 2000 appears to have been undervalued by around 30%. CorpCapital attribute a value of $5.7m. This valuation was not based on the same model as subsequently applied. It seems reasonable that the procedures used for subsequent valuations should have been applied. There was manifestly a market for such businesses at the time and the business was cash flow positive. A full valuation was feasible.
- The valuation model applied from August 2000 onwards is the textbook standard for such companies. The model was carefully applied, the valuations seem to have been undertaken with great care, the process was well documented and very easy to review, the valuation was the subject of an adequate control process and the valuation estimates seem to be reasonable and fair, subject to the issues raised above.
- Unlike many internet companies on-line casinos represent a long established industry being distributed *via* a new technology. This implies that on-line casinos would have a lower risk profile than the average internet company and therefore warrant a higher value.
- The fact that the valuation of Cytech has subsequently been revised downwards does not provide evidence that the earlier valuations were unreasonable. Firstly, expectations at the time appear to have been reasonable even though they may have turned out not to be fully realised and secondly the extremely

high discount rates applied by management imply that a significant amount of uncertainty was anticipated.

- The valuation methods applied by CorpCapital are not unusual and they appear to have been applied properly resulting in reasonable valuations.

2. General Introduction

This report is based on information and explanations supplied to me by the management of CorpCapital. I was granted unfettered access to materials and the forthright explanations offered, which were the subject of corroboration where necessary, have provided an adequate basis to form an independent opinion on the valuations of Cytech LTD (Cytech) carried out by CorpCapital. The valuation period for this report is defined as the period February 2000 through August 2002. This includes six valuation dates at half-yearly intervals. This report focuses on the review of the "Indicative Valuation" reports produced at all but the first of the valuation dates. These reports are comprehensive and estimate the total value in US dollars. Thereafter the CorpCapital's share of 47.5% is computed and the resultant amount is converted to SARand at prevailing exchange rates. Finally, in August 2000 the Rand amount was further reduced by 20% to account for any residual risk before inclusion in the CorpCapital accounts.

In completing this investigation it was not considered appropriate to carry out an alternative valuation. In the process of this investigation the "Indicative Valuation" reports were thoroughly reviewed; management was extensively interviewed on all aspects of the valuation; independent reports on the industry were analysed and the valuations were benchmarked to a peer group of similar companies

I was very impressed by the quality of the valuation reports, the models employed are textbook applications, and the reports are very carefully laid out with all assumptions clearly identified. In fact I was taken by surprise that such a transparent valuation process would require my review. Nevertheless, I understand the seriousness of the overall process and I have thoroughly reviewed the valuations. The next section addresses the specific issues that were raised by management as being central to the investigation. I have raised the key issues in each section and I provide opinion as appropriate. Thereafter I identify a concern regarding the valuations in the 2000 financial year. The report culminates in the overall conclusion that the valuations produced by CorpCapital were reasonable, subject to the various comments I make within this report. Throughout I refer to the underlying investment as Cytech even though for the initial period it was trading under the name Netainment.

3. Addressing the key areas of concern

The management of CorpCapital identified a number of key areas that they wished to be specifically addressed. This section provides my view on each of these. In this section the issues are presented in bold text and my comments are italicised.

3.1 "In order that CorpCapital's investment in Cytech could be accounted for at fair value the value had to be capable of reliable measurement. It is suggested that it was not so for the following reasons:

- At August 2000 the business was only two years old.

Businesses with a short track record are valued and traded all the time. Although Cytech is not listed there is no doubt that there was a market for such an investment at the time of the valuation. In my experience it is very common to establish a fair market value for a business at this stage of its life and earlier.

- The business operated in a new uncertain industry.

It is true that there were considerable risks faced by the industry. These were fairly accounted for in the valuations via the very high discount rate which reduced the amount of the valuation. The uncertainties surrounding on-line gaming were less than the risk facing the average internet company at the time. This is so because in many of the internet companies that I have reviewed everything was untested; from business model through industry to technology. In the case of on-line gaming we observe the long established business of gambling being distributed via a new technology. That is not to say that there are no risks with on-line gaming, I merely wish to point out that the risks were normal. In fact the industry wide predictions of revenue for this industry have been relatively stable.

- In particular, there were uncertainties regarding the current and future legality of the business operations in the US.

The Kyle bill has received much attention in all commentaries on the industry. The consensus appears to be that an outright ban in *the US is unlikely. There is evidence that much consideration was given to the issue during the valuation of Cytech and that due weight was attached to this risk. In addition the potential impact of any adverse developments in the US has been balanced by a business strategy that explicitly diversifies revenue internationally.*

- The DCF valuation methodology forecast cash flows in perpetuity unreliably for an immature business.

The DCF framework applied in the valuation is a textbook standard. The forecast in perpetuity should not be interpreted literally. This is so because the very high discount rate used in the valuation of Cytech neutralises almost entirely the effects of revenue estimates beyond year five. The issue at hand is the confidence level attached to the estimates in the future cash flow. It is apparent from the discount rate used that a significant volatility in future revenues was anticipated into the valuations and the value estimates were reduced accordingly. Many businesses are valued using this method even before experiencing positive cash flows and in a number of cases before sales are booked. My conclusion is that it would be spurious to suggest that a fair valuation could not be established for Cytech.

- The valuation showed a sharp increase from August 1999 to August 2000.

The valuations carried out at August 1999 and February 2000 were not based on the same method subsequently adopted. In fact on discussion with management it became clear that a very conservative approach was adopted at these two initial dates. In my opinion the valuation at February 2000 of $5.7m was excessively conservative. It would seem reasonable to have applied the DCF method at this date. My preliminary analysis suggests that such an approach would have yielded a valuation of $7.4m for 100% of Cytech, a reasonable estimate at the time. CorpCapital's valuation of Cytech at August 2000 was $56.9m (before the 20% reduction for financial reporting purposes). *In the light of information on the underlying business model available at the time this valuation appears optimistic. It would not have been unreasonable to consider reducing this amount by around 20%. This reduction in value*

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relates to an estimate of the value of the jackpot pooling provided by MGS which should not have been considered part of Cytech's value. This aspect of the underlying business model was not considered by management at the time. Management's subsequent decision to discontinue the arrangement with MGS affirms the view that this issue was not likely to have been purposefully ignored. In fairness to CorpCapital the valuation was subjected to a further 20% reduction for the purposes of financial reporting by themselves at August 2000. The combined effect of an undervaluation in February 2000 and an overvaluation in August would reduce the apparent sharp increase between the two dates.

- Significant business changes (the adoption of new software in August 2001) impaired the valuer's ability to predict performance."

There were a number of changes in 2001 including a strategic decision to change the software platform. The change was economically motivated by a desire to reduce the apparently excessive royalty charged by MGS. It is clear from this decision that management did not recognise the value of jackpot pooling associated with the MGS contract. Perversely I believe this genuine oversight resulted in an over valuation of the business and an undervaluation of the perceived benefits from the MGS contract. I do think that more scenario analysis should have supported the valuations at all dates. I believe that all reasonable risks were considered however as a technical matter explicitly understanding the distribution of possible future revenues would have been helpful as the business evolved. I do not think that the valuations would have materially changed since such an excessive discount rate was used to account for the lack of stability in the underlying predictions.

3.2 "The valuations were either incapable of reliable measurement or were not prudent because:

- In the year 2000 the underlying accounts of Cytech were not audited but only reviewed by CorpCapital's auditors who in addition audited CorpCapital's valuation."

My discussions with management and the auditors revealed that although the underlying accounts were not audited there were three factors which provided the necessary confidence in the financial performance data. Firstly, the valuers were intimately involved with the management of the business and they had access to the underlying management accounts which guided the real decisions being taken by the business. Secondly, the key driver of cash flow is revenue since most costs are variable. The revenue numbers are easy to verify and indeed are monitored directly by the software providers. Finally, the CorpCapital auditors had a general ledger program which was capable of interrogating the system to corroborate the underlying transactions. I do not believe that the formal audit of the business would have materially altered the valuations. In my experience the reliance on audited numbers is required in situations where the valuers are at arms length and do not have access to management accounts, patently this was not the case.

Furthermore, Cytech is located in a jurisdiction where an audit is not mandatory. In the year 2001, the accounts of Cytech were audited by CorpCapital's auditors in accordance with SAAS and CorpCapital's auditors audited CorpCapital's valuation. Cytech did not produce audited financial statements in 2001; however in 2002 it did produce audited financial covering four years of activity. Neither the 2002 audit nor any subsequent audit resulted in any material difference to the previously reported results.

3.3 "The DCF valuation methodology used was inappropriate for the following reasons:

- The business had a limited track record

In my experience it is standard practice to use the DCF methodology even where a company has no track record. Most leading companies around the world require such an analysis of long-term projects before there is any hard evidence that revenues will materialise therefrom. During the period under review I was directly involved with a large number of internet company valuations and within this universe Cytech would easily *have been in the top quartile with respect to track record and confidence in the estimates on which the valuations were based. There is little doubt the model is appropriate. Obviously the model needs to be applied effectively and in my opinion there is sufficient evidence to suggest that CorpCapital did apply it correctly in the valuations of Cytech.*

- It operated within a new and uncertain industry rendering forecasts speculative.

Forecasting is an inherent part of any valuation and thus it is hardly surprising that in arriving at a fair valuation of Cytech the process required projections of future cash flows. As indicated in 3.1 bullet number two, above, the on line gaming industry as a whole is considered to be relatively stable in the context of internet investments. Industry predictions have been shown to be quite stable. This does not imply that Cytech was without significant risks; however I do not accept that the forecasts used in the Cytech valuation were speculative. Finally, I reiterate that the volatility in the forecasts was accounted for in the valuations through a very high discount rate which reduced the valuation.

- The use of cash flows in perpetuity were unreliable

I disagree in general with this statement and in particular for Cytech. The use of a perpetuity model does not imply that one is placing a high degree of confidence in the long term forecasts. In fact the model is robust enough to tolerate very high levels of uncertainty in longer term cash flows. The control factor is the discount rate which when applied at a 24% level as with Cytech the long term flows have little or no influence on the value. In fact it was explicitly recognised in the valuations that the confidence levels would decay over time. The valuations were adjusted downwards accordingly.

3.4 The forecasts upon which the valuations were based were imprudently optimistic for the following reasons:

- They took into account reduced fees and expenses for certain key services, on occasions before finalisation of contractual commitments

I have carefully reviewed the valuation process and on occasion estimates were influenced, correctly, by intended future arrangements. According to the representations made to me it seems that in all cases the expectations were realised. In my opinion it would have been imprudent not to account for these expected changes in the way they were handled. I do not believe that such adjustments were reckless and nor do I believe that they detracted from the fairness of the valuation.

- Adjustments to historic profits to arrive at sustainable future profits (by excluding non-recurring expenses) presented a non-commercial representation of the business

It is normal practice to review historic performance and make adjustments for those items that are unlikely to recur. Since I too feel this is a valid concern I investigated each adjustment. In most cases I think there was a valid justification for the adjustment. In all cases I felt the adjustments were not significant and thus would not materially affect the valuations.

- Forecasts were subsequently not met and insufficient attention was paid to this in adopting forecasts for subsequent periods."

Initially the one year forecasts were reasonably accurate. Thus ~~this criticism could only be levelled~~ at valuations after August 2001. I certainly would have preferred to have seen more work on the likely spread of possible values around the expected values used for the future cash flows at each valuation date. It would have been helpful for the valuation reports to have identified at least three possible values for each annual cash flow number., for example 1) optimistic 2) likely and 3) pessimistic. In this way a rudimentary simulation would have generated a range of values against which performance could have been measured. In other words deviations from expectations could have been more effectively evaluated. This was not done. However, I do not think this criticism invalidates the valuations and other types of sensitivity analyses were in evidence. This point is easily made in

Add on before Aug 2001

hindsight, I am confident that the valuations were reasonable at the time they were made.

3.5 The valuation of the investment was conducted by executives of CorpCapital who were also responsible for the sale of the investment creating a conflict which necessarily tarnished their reliability.

It is not inevitable that an experienced corporate finance professional is unable to exercise the due care and diligence required to develop a fair value for the purpose in hand. I rate the individuals at CorpCapital in the highest rank in terms of professional competence and qualification. ~~Their work is easily of~~ world standard and I have no a proiri reason to believe that they would be unable to balance the very usual conflicts that arise in almost every valuation. Furthermore, I have had sight of documentary evidence that contemporaneous negotiations for the sale of the business involved higher valuations. This is prima facie evidence that the valuations used by CorpCapital were not unduly inflated by the exuberance of a seller.

3.6 The valuation was not undertaken by an independent party and is consequently unreliable.

It is true that the valuations are internally generated. The use of independents is no panacea since finally it is the Directors that must take a view on the reasonability of the valuation. The reliability of the valuation should be evaluated on the models, methods, assumptions and controls on the process. The valuations carried out by CorpCapital were remarkably transparent and the board through its audit committee had ample documentation and indeed the opportunity to ensure the reliability of the valuations. I have satisfied myself that the board appeared to have compensated for the lack of an outside valuer. Finally the board took the precaution of reducing the valuations by 20% in the interest of prudence at August 2000.

3.7 The valuations were not prudent (as distinct from comprising a reasonable estimate).

There is always a danger that excessive prudence undermines the fairness of the valuation. I believe that a balance was struck by CorpCapital. The revenue forecasts were probably optimistic, however this was balanced with a very high discount rate and the 20% reduction at August 2000. In fact I argue elsewhere in this report that the February 2000 valuation may have been imprudent by being so low.

3.8 There was no active market for the shares in Cytech, a condition required to render the investment value capable of reliable measurement.

This would imply that only listed firms' value was capable of reliable measurement. It would therefore be impossible for directors to comply with the companies act in the provision of a valuation for unlisted shares. This is patently not true, valuations exist only as a proxy for market value and they are only really necessary where a market price is not immediately available. Thus even if a market does not exist a reliable valuation is feasible. However, despite the fact that Cytech was not listed I believe there was and still is a market for the company.

3.9 The forecasts do not account for income tax, the business being located in a non-tax jurisdiction having being liable for tax historically. This is a fundamentally unsustainable status and one which a potential purchaser would not recognise.

The tax effects will not materially affect the valuation for a number of reasons. Firstly, the cash flows are after-tax using an assumption of a zero tax rate. In any valuation an estimate of future tax rates is necessary, taxes are not constant in most jurisdictions, however they have exhibited long term stability in Cytech's jurisdiction. Secondly, if tax rates are stochastic this will contribute to the overall volatility in after tax cash flows in the same way that any other business risks so contributes. As with other business risks it is usual to adjust the discount rate rather than adjust the cash flows; this is precisely how the matter was handled at CorpCapital. More precisely the valuation does account for tax uncertainty even though the cash flows are not directly impacted. Two other factors render this point mute. Firstly, in present value terms the impact of long-term tax rate changes are *minimal. Secondly it must remembered that the discount rate could arguably be on an after tax basis. Thus the tax status of the purchaser may well increase the valuation. In total the tax aspects have been accounted for very conservatively.*

4. Potential distortions in the valuations

Feb & Aug 2000

An area of concern that I wish to raise relates to the valuation at February 2000. CorpCapital's valuation of Cytech at February 2000 appears to have been undervalued by around 30%. CorpCapital attribute a value of $5.7m Cytech at this date. This valuation was not based on the same model as subsequently applied. It seems reasonable that the procedures used for subsequent valuations should have been applied. There was manifestly a market for such businesses at the time and the business was cash flow positive. A full valuation was feasible.

CorpCapital's valuation of Cytech at August 2000 was $56.9m (before the 20% reduction for financial reporting purposes). In the light of information on the underlying business model available at the time, it would not have been unreasonable to consider reducing this amount by around 20%. This reduction in value relates to an estimate of the value of the jackpot pooling provided by MGS which should not have been considered part of Cytech's value. This aspect of the underlying business model was not considered by management at the time. Management's subsequent decision to discontinue with MGS affirms the view that this issue was not likely to have been purposefully ignored. In fairness to CorpCapital the valuation was subjected to a further 20% reduction for the purposes of financial reporting by themselves and in my view this precaution is adequate provision for such an uncertainty.

I must emphasise that the concern I have raised in this section does not diminish my support for the reasonableness of the valuations reported by CorpCapital.

5. Conclusion

My conclusions have been based on a very detailed analysis of the valuations carried out by CorpCapital. This involved an in depth review of all the relevant documentation, analysis of independent sources of information on the industry and the performance of other companies. I have held detailed interviews with senior management and the professional personnel involved. I have also spoken to the auditors.
My review covered the following areas in significant detail:

The valuations of Cytech from August 2000 onwards
The overall approach
The selection of the model
The analytical review of the performance data
The application of the model
The data inputs
The analysis
Sensitivity analysis
Risk assessments
Interpretation of the results
The valuation review process by the CorpCapital board

With due consideration to all of the above I am satisfied that I have been able to carry out an extensive and effective review of these valuations and I find them to be reasonable.

Dr Rory Knight
Oxford
January, 2004

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6. Appendix: Biographical profile of Dr Rory Knight

Rory F. Knight
MA (Oxon), MCom, PhD, Chartered Accountant (SA)
Dean Emeritus Templeton College University of Oxford

Rory Knight is Chairman of Oxford Metrica and has extensive experience in working and consulting in the financial and corporate sectors. Rory is Director of a number of technology companies. For five years, Rory was Dean of Templeton College, University of Oxford, where he was responsible for Templeton's overall strategy and direction. Rory remains Dean Emeritus at Templeton. Whilst Dean at Templeton, Rory led Oxford's development of a business school and formed a close working relationship with the College's benefactor, Sir John Templeton. In addition, he created and led the Oxford Advanced Management Programme and the Oxford Senior Executive Finance Programme, the latter being the leading international programme on corporate valuations.

Rory's work on shareholder value has been published internationally with particular acclaim given to his extensive public company quantitative analysis based on the ValueCreationQuotient™ (VCQ™). He has published extensively in the area of international finance and strategy. He is author of Financial Performance (Bertoneche & Knight, Butterworth-Heinemann, 2000) and Reputation & Value the case of corporate catastrophes (Knight & Pretty, Oxford Metrica, 2001). Recently he concluded a series of highly influential international reports on risk management, capital market entry and financial reporting.

Dr Knight is an expert in corporate valuations and consults extensively with leading firms. Recent assignments include advising Intel, Cisco and Sun Microsystems.

Previously a Deputy Director in the Swiss National Bank (SNB), Rory's role included providing policy advice on international financial matters and he retains significant links with central banks around the world. Between 1995 and 2000 Dr Knight was chairman of the European Centre for Public Affairs (ECPA). Rory acts as an advisor to a number of multinationals. He was formerly a Professor of Finance in IMI, Geneva and IMD, Lausanne. Rory has been and is currently a visiting professor at a number of institutions worldwide, including HEC, INSEAD and Ecole Nationale des Ponts et Chaussées (Paris), EOI (Madrid), the Amos Tuck School (Dartmouth), Stanford, the Australian Management School, UCLA, the University of Cape Town, the Singapore Institute of Management and Tongi University (Shanghai). He is currently Chair of the Dean's advisory council at the Theseus Institute in France

Special Interests
Dr Knight has been prominent in the current debate on expensing options. In this connection he has contributed on both sides of the Atlantic having addressed regulatory agencies in Washington and Brussels. This work draws on his expertise in financial instruments, financial reporting and corporate governance. Another field in which he is active (working on behalf of a number of US institutions) is the area of attracting and managing international shareholders for both Europe and US firms.