

OLSWANG

The Directors

7 March 2015

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Our Ref DPR\DEPARTMENTAL-CORPORATE
Your Ref

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Dear Sirs

Olswang - Exceptions only due diligence report

1. I am pleased to attach the first draft of our due diligence report and set out some comments in relation to the report which I would like to draw to your attention.

Due diligence exercise

2. The due diligence exercise carried out in respect of the Group has been undertaken by Olswang on a limited, exceptions only basis and accelerated basis due to the very short period of time we have had to access the Data Room.
3. Given the limited time available, we note the Buyer's primary comfort in relation to the Group and the Acquisition has been delivered by the warranties given by the Seller in relation to its statutory and management accounts and also from the work undertaken by Grant Thornton to model the cashflow requirements of the Group going forward to ensure the Group will have sufficient cash to enable it to continue to trade – particularly given the fact that the Group is currently loss making and has been so for several years.
4. As a result, the legal due diligence has been necessarily secondary and we note you take a high degree of comfort of the fact that the Group is and has been for decades a

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high profile retail chain with professional and highly competent management with a stable property portfolio and turnover in excess of £700 million year on year. You are also confident that the turnaround business plan being tabled by management which you are backing is capable of achieving a turnaround in the fortunes of the offering.

5. As regards the legal due diligence process, given the circumstances of the process, we have not been provided with complete answers to all of our Due Diligence Questionnaire and further, whilst we have attempted at every stage of the process to negotiate protection for the Buyer, due to the fact that the purchase price of the Group is £1.00, it has not been ultimately been possible to achieve the sort of protections that a buyer might otherwise expect in traditional M&A transactions (i.e. deferred consideration, escrows etc).

SPA protection

6. Further, whilst we have been able to obtain warranty protection around the statutory accounts of the Group, we have not been able to negotiate a full working capital adjustment mechanism (merely net debt), meaning that the Buyer will inherit the balance sheet of the Group on completion without the benefit of any protections around normalised working capital. That being said, we have been able to agree an enhanced set of line items that include third party debt and some additional debt like items.

Solvency issues

7. We note from the Seller's disclosures in the Data Room that the Group remains solvent due to the ongoing financial assistance provided by the Arcadia group, hence the existence of a £240 million inter-company debt owing from BHS to upstream entities including the Arcadia Group. As such, the Buyer is on notice that there is a funding gap prior to the turnaround being successfully implemented and thus it is critical that the Buyer will be able to ensure the Group remains solvent pending the turn-around.
8. To get comfort on this issue, as mentioned, you have undertaken an extensive cash flow modelling process to get clarity on the cash flow needs of the business for the next 12 months and have negotiated a working capital facility to be available to ensure that the Buyer will have sufficient working capital to enable the Group to remain solvent.
9. It is crucial that the directors of the Buyer have confidence in the working capital analysis and believe that they will have sufficient working capital to ensure that the Group remains able to pay its debts as and when they fall due, which is the test in the *Insolvency Act, 1986* that the directors must continue to be cognitive of post Completion.
10. We note however that the working capital funding that is expected to be put in place at Completion is not currently in place and the directors will be relying on a £40 million bridging loan from Sir Philip Green on Completion. If it is not possible to procure

refinancing for this loan, the directors should be aware that the Group may well be in a situation where it is unable to meet its debts (i.e. the refinancing of the bridge) and could be exposed to insolvency concerns.

11. Hence, we are urging the directors not to transact until they have maximum commercial comfort that they will be able to satisfy the terms of the proposed £120 million working capital facility from Farallon. Ideally, you would postpone completion until the funding was in place.

Pension deficit

12. This Report contains a significant amount of analysis in respect of the current deficit existing in the two defined benefit pension schemes that the Group operates. The existence of the deficit in these schemes is perhaps the most material issue for the directors of the Buyer to understand. Due to the limited access that Olswang and Grant Thornton have been given to information regarding the schemes, the trustees of the schemes and the Pensions Regulator, we are not able to give any material comfort to the directors of the Buyer that it will be possible to avoid an insolvency post completion given the sheer size of the pension deficit. We have only been provided with limited information on the two defined benefit pension schemes, we have not been afforded access to either the pension scheme trustees or the other advisors and as such, our analysis and advice is limited to the types of issue which in our experience arise on a transaction of this sort. Further, most of the material pension warranties have been deleted from the SPA, further increasing the risks to the Buyer on this matter. Also, we have not been able to review and advise on whether there could be any other pension liabilities (e.g. as a result of historic schemes) within the Group.
13. The best case scenario will be that the Group continues to meet its annual pension contributions for the foreseeable future (currently £10 million but likely to increase in 2015) without interference by the trustees of the schemes and the quantum of the deficit diminishes due to the recovery of interest rates.
14. The worst case scenario is that the Group's balance sheet deteriorates post Completion to the point where the Group is unable to continue to trade on a solvent basis which could trigger an acceleration of the funding obligation of the schemes and an almost inevitable collapse of the schemes and an insolvency.
15. We note however, there is a suggestion that following Completion, the Group may be able to effect a restructuring of the schemes in the form of Project Thor which would result in the relevant schemes being transferred to a new company and restructured to a point where there is a chance that they will be self-funding going forward. There is no guarantee that Project Thor will be capable of being effected as the Group would need to be able to demonstrate that it is close to insolvency – which may well have knock on effects to the

trading operations of the Group, in particular it could affect the ability of the Group to purchase trade credit insurance. It is also very possible:

- (i) the scheme trustees will demand a £20 floating charge over the assets of the Group;
 - (ii) the Pensions Regulator, acting on behalf of the UK Pension Protection Fund (the body responsible for dealing with the pension schemes of insolvent employers) may seek an equity stake (possibly as high as 33%) in the new business as its "price" for agreeing any future Project Thor; and
 - (iii) the Group could need to find an additional £5m per year for three years in order to fund Project Thor, in addition to the current £10m per year obligation.
16. Thus, this is a critical issue that the directors of the Buyer will need to consider carefully before deciding to complete the Acquisition.
17. As a result of the above, we are not able to give the directors any material assurance or comfort that Project Thor can be implemented or that it will be possible to adequately deal with the pensions deficit that the Group has and there must be a chance (albeit commercially unlikely given the publicity and job loss such would cause) that if the Group does not monitor its cash flows and liabilities carefully going forward and does not maintain a close and transparent relationship with the trustees of the schemes, that the trustees may not take matters into their own hands and trigger or engineer a triggering of an accelerated funding obligation of the schemes, which would lead to the Group being insolvent.
18. A more detailed analysis of the pension schemes and the risks is contained in the attached Report.

Carmen

19. It has been agreed by the principals that in order to deliver £5m or more of rental savings to the Group, the Buyer should inherit the Group with the corporate entity Carmen Properties Limited ("**Carmen**"). Carmen is a Jersey property company and its balance sheet is to be restructured prior to Completion we are told to reduce the level of indebtedness on its balance sheet from £130m to £70m. We have only just received a copy of the sale and purchase agreement governing the sale and purchase of Carmen and have not been able to conduct any financial or legal due diligence on the group (as there are several subsidiaries). It has been suggested that the Seller may not be able to complete the Carmen restructure before the due date for Completion.
20. There is certainly risk associated with completing the Acquisition before the Carmen restructure has taken place to the satisfaction of the Buyer. In order to protect the

Buyer, we have requested an indemnity in relation to the Carmen restructuring in the SPA, which has been resisted by the Seller.

Arcadia brand Concession agreements

21. We have over the weekend prior to Completion been provided with draft concession agreements to be entered into between BHS and the various Arcadia group concessions, which have to date not been in writing. The agreements seek to perpetuate the same terms as presently in place between BHS and these concessions including in relation to "Concession Area", and restricting the ability of BHS to change the positioning of the concessions without the agreement of Arcadia.
22. There is insufficient time to properly understand the existing arrangements prior to Completion and thus we recommend that the form of these agreements not be agreed prior to Completion as management are not satisfied that the agreements are in the best interest of BHS.

Additional comfort

23. Whilst we have formed the impression over the short diligence process that the Group is well run, has competent systems and staff, we can only review what information we have been provided by the Buyer in these limited circumstances and have relied on warranties and disclosure to complete the picture. Given the sheer size of the Group's operation, it has not been possible in the time frame to undertake due diligence at the level of granularity that we would otherwise advise. Thus, there could well be additional liabilities that have not been uncovered by this limited expedited diligence process which may have a material effect on the Group going forward.
24. We note also that the package of warranty comfort being offered by the Seller has been reduced via the negotiation process, the Seller is offering a cap of £3 million on warranty claims and there is a low likelihood of being able to procure warranty and indemnity insurance post Completion due to the shortened nature of the diligence process. To the extent W&I cover is possible, we recommend it be pursued post Completion.
25. Finally, we note however the commercial comfort that the directors are taking from the representations from Sir Philip Green that he will continue to support the business post Completion and that he has a big commercial interest in ensuring that the Group continues to trade (given the large concession arrangements with Dorothy Perkins, Wallis and Evans) and also due to the reputational risk he is exposed to should BHS fail. We do not doubt these commercial matters and note that great comfort could be drawn from such.
26. That being said, there is no legal obligation on him to do so.

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Yours faithfully

*Olswang
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OLSWANG LLP