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Getting the deal done

By Dan Reid, Grant Thornton National Managing Principal, Transaction Advisory Services
Stephen McGee, Executive Director, Grant Thornton Corporate Finance LLC

What a difference a year makes. At the risk of hyperbole, 2007 — at least the first half — was the heyday of M&A. Since then, dealmaking has slowed, and in some sectors, ground to a halt. We have seen the once-unthinkable and stunning collapse of Wall Street powerhouse Bear Stearns. Financing sources have tightened to such an extent that private equity firms are suing lenders for alleged breach of financing agreements. The subprime mess makes headlines almost daily. And many have conceded that we are close to, or perhaps already in, a recession.

But while the heady days of 2007 are behind us, 2008 could still be a good year for middle-market dealmaking.

Down but Not Out

M&A is cyclical by nature, and the continuous year-over-year growth that began in 2002 simply couldn't be sustained forever. It's not surprising then that the trend would reverse at some point. It has already happened to larger leveraged buyout (LBO) deals, with the truly mega private equity funds all but shut down for the past several months. Middle-market funds, however, are still doing deals, albeit with a bit less, and more expensive, leverage.

There's little doubt, given conditions in the financing markets and the economy, that relative to 2007, this will be a "down" year for middle-market M&A. That said, deal value and volume could drop off substantially and still be above historic norms. Even if we see a year-over-year decline of more than 20%, the M&A market would still surpass 2006.

And as we know, 2006 was no slouch. According to Thomson Financial, announced transactions worldwide that year totaled $3.8 trillion, surpassing all previous records. That was a 40% increase over 2005, which had $2.7 trillion in announced deals, according to Thomson.

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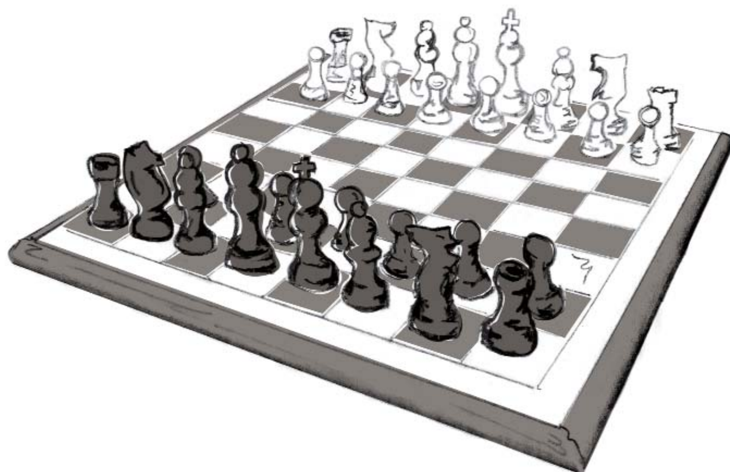

So while middle-market M&A may be down, it is certainly not out. Even so, given the uncertainties in the market, some dealmakers may want to take a wait-and-see approach. Stay on the sidelines, their thinking may go, and wait for the economy to get on more solid footing. For financial buyers, it may mean holding out until the debt markets relax: for sellers, until valuations rise. But is that the best strategy? Timing the market is difficult, or, it could be argued, impossible. While it may not seem like the ideal time to strike a deal, there is risk, perhaps significant, in holding out for a return to the lofty days of early 2007.

Rather than view 2008 with a jaundiced eye, consider it an opportunity to continue doing deals, though perhaps with different players and different deal structures.

A Good Time to Be Strategic

Before the credit crunch, financial buyers could compete toe-to-toe with strategic acquirers. Often, strategics chose to simply sit out the game as highly competitive auctions drove up valuations.

Today's environment is clearly favoring strategic buyers. Among other advantages, strategics can usually pay more than financial acquirers, taking into account the synergies available to them, which do not exist for a financially engineered LBO. Without financing contingencies, there is also greater surety of close, making strategics very attractive to potential sellers, especially given current market conditions.

Importantly, strategic deals are driven by more than macroeconomic conditions. Industry dynamics, which can vary significantly by sector, drive M&A. In industries enjoying good growth, such as health care, M&A is going to happen despite economic or financing issues that may plague the broader market. In industries facing difficulty, such as airlines, consolidation may be necessary simply to survive.

Of course, while strategics may have a leg up in the current environment, mid-market financial buyers are still in the mix. With all the fundraising of the past several years, private equity firms have a large amount of capital to invest.

For buyers in the middle-market, it is certainly possible to find good investments and secure the requisite financing. The key is determining as quickly as possible whether an investment is viable. Perhaps foremost is finding a seller who is realistic regarding the value of their company and the likely terms of a deal. In today's climate, there is often a disconnect between a seller's and a buyer's expectations on price.

From a financing perspective, it is essential to line up funding sources very early in the process. Relationships matter. Getting parties onboard quickly is paramount. Buyers also need to pay careful attention to covenants to avoid potential problems later in the life cycle of the acquired company. It's also essential that buyers complete due diligence earlier, especially with respect to key deal drivers.

With the credit crunch, buyers may also have to write larger checks. This may even require "overequitizing" a deal, putting in more equity than they ordinarily might, and restructuring the deal when debt terms are more favorable. Of course, if they move down market and do smaller deals, they may be able to invest the same amount and hold a larger share of equity in the acquired business.

From a seller's perspective, it is more difficult to close a deal today than it was a year ago. However, deals can get done. It is just no longer as simple as running an auction and realizing a nice multiple. There are fewer buyers participating in the auction process. With less competition, buyers are taking advantage of the uncertainty and poor economic news to depress valuations. Patience and creativity — finding the right buyer, crafting the right structure — are the order of the day.

Prospective sellers might want to look overseas. Foreign businesses with strong currencies are taking advantage of the lackluster dollar to gain or strengthen a strategic foothold in the United States, and it's likely there will be a further increase in cross-border deals this year. According to Bloomberg, non-U.S. buyers accounted for 46% of U.S. mergers and acquisitions announced in the fourth quarter of 2007. That was the largest percentage in the 10 years Bloomberg has compiled the data.

Some of these foreign investments may be in the form of partnerships, whereby U.S. private equity firms team with international strategics to acquire U.S. companies. A recent example was the planned acquisition of U.S.-based 3Com by Bain Capital and China's Huwaei Technologies. Although the deal was scrapped after the Committee on Foreign Investment in the United States announced it would not approve the

transaction as structured, such deals are likely to grow in popularity, given that they offer the financial engineering benefits of a private equity investment, along with the synergies inherent in a strategic partnership. For a seller in today's market, a deal, in whatever form, with an international strategic buyer may be the best way to maximize value.

Of course, that other major class of foreign investor, sovereign-wealth funds, is continuing to grow in importance and influence. The funds have an estimated $3 trillion in assets and have invested more than $43 billion in the United States since January 2007. A Morgan Stanley economist recently estimated that assets in these investment funds could reach $12 trillion by 2015. That is an enormous amount of dry powder to put to work. While, at least today, sovereign-wealth funds are not middle-market players, it could be argued that dealmakers at all levels benefit from the infusion of capital these funds provide.

Sellers might also want to turn an eye to SPACs. Last year, 66 initial public offerings for SPACs raised a total of $12 billion. That is a substantial store of capital, and an avenue for sidestepping issues with the debt markets. With growing enthusiasm for these investment vehicles, it is likely they will play an ever-more prominent role in M&A transactions this year.

Conclusion

M&A is cyclical. While we may be in a trough of sorts, the market remains quite viable — for buyers and sellers. With an abundance of capital and new players in an increasingly global economy, 2008 may turn out to be a very good year for mid-market M&A, at least in historic terms. While it might not quite be business as usual, good deals will get done. •

Grant Thornton in the news

"We are certainly seeing interest in [U.S. auto suppliers] from all parts of the globe and in particular from Chinese and Indian investors and strategics. It's going to be a positive thing for the industry. The Asian companies will bring in investment capital, and they will be operation-focused. It's a good thing for a supplier base that has been struggling."

Steve Brady
Partner
Transaction Advisory Services
Reuters, April 9, 2008

"Although there may be less certainty of close, SPAC sales do present a greater certainty on pricing than do traditional IPOs. Typical public offerings take four to five months to orchestrate. SPACs, however, have already raised their capital and therefore have no fear as to where the market might be. LBO shops are nicely positioned to sell to SPACs, since the buyout firm has cleaned up the company and readied it for its next round of capital."

Cal Hackeman
Managing Partner
Private Equity
Buyouts, March 31, 2008

"The good deals are still getting done. The marginal deals are having difficulty getting done."

Jack DiFranco
Principal
Grant Thornton Corporate Finance LLC
Detroit Free Press, February 8, 2008

Don't I know you? Recognizing the need for resolution

By Paul Beecy, Grant Thornton Partner, Tax Services
Brian Vigneault, Grant Thornton Manager, Tax Services

The enactment of Internal Revenue Code §382, which limits the utilization of net operating losses and certain built-in losses after a change in company ownership, has been one of the foremost tax considerations when analyzing the attractiveness of a target business. Tax losses can reduce cash taxes, which is generally a good result and can impact the after-tax return on a portfolio target.

While ambiguity in tax rules can bring opportunities to reduce taxes, for the most part, it simply leaves matters unresolved. One area of §382 that has historically had relatively little guidance is §382(h), which addresses how the postacquisition recognition of items of income, gain, deduction and loss of a loss corporation should be treated under these rules. Recently, the IRS announced its plan to issue regulations on these unresolved matters in 2008. Every private equity practitioner needs to be aware of the upcoming change.

§382

Prior to the enactment of §382, it was possible for a corporate taxpayer to purchase a target company with limited assets other than tax attributes, and then use those tax attributes to reduce its own tax liability. §382 was enacted to stop the trafficking of a corporation's tax attributes.

Generally, §382 provides that after a change in corporate ownership, a corporation's use of certain prechange tax attributes carried forward may be limited or prohibited. The carryforwards subject to this rule include, for example, net operating losses (NOLs), general business credits (e.g., the §41 credit for increasing research activities), corporate minimum tax credits, foreign tax credits, capital loss carryovers, and net unrealized built-in gain (NUBIG) and loss (NUBIL).

After an ownership change, the amount of income that a corporation may offset each year by prechange tax attributes is generally limited to an amount determined by multiplying the value of the equity of the corporation immediately before the ownership change (subject to certain adjustments) by the U.S. federal long-term tax-exempt rate in effect on the date of the change.

For example, assume that P acquires 100% of the outstanding stock of T for $500,000. Also assume that T has U.S. federal NOLs of $1,000,000 and the U.S. federal long-term tax-exempt rate is 5%. The annual §382 limitation would be 5% of $500,000, or $25,000. Assuming that T's NOLs are available for 20 years before they expire, no more than $500,000 ($25,000 a year times 20 years) of the $1,000,000 in T's NOLs would be available for offset, due to the §382 limitation. The balance of the NOLs would expire worthless.

In addition to limitations of tax attributes realized prior to an ownership change, §382(h) serves to potentially limit unrealized losses that existed at the date of the ownership change. This is based on the policy that had the loss been realized prior to the date of ownership change, it would have been subject to limitation under §382. Conversely, unrealized gains that existed at the date of the ownership change generally result in an increase to the base §382 limitation in the year realized.

Very generally, a NUBIG or NUBIL is the amount by which the fair market value of the assets of a loss corporation, immediately before an ownership change, is more or less than the aggregate adjusted basis of those assets, provided such aggregate NUBIG or NUBIL exceeds a statutory threshold. A loss corporation whose aggregate built-in gain and loss items do not exceed this threshold is neither a NUBIG nor NUBIL corporation and is unaffected by such provisions. A recognized built-in gain or loss (RBIG or RBIL) is the amount of NUBIG or NUBIL recognized during the five-year period following the ownership change, known as the recognition period. Similar rules apply to certain items of income and deduction.

ACG InterGrowth 2008

We hope you enjoyed the ACG InterGrowth conference in April as much as we did. Once again, attendance made it a record-breaking year. Grant Thornton continues to sponsor ACG as a Global Growth Sponsor and is proud to have been a Diamond sponsor of InterGrowth. If we did not get the opportunity to meet you at InterGrowth, please contact us at www.Grant Thornton.com/Private Equity.

Guidance from the IRS

To provide guidance on the treatment of items of income, gain, deduction and loss that a loss corporation recognizes after an ownership change, in 2003 the Internal Revenue Service issued Notice 2003-65. The IRS has indicated it will likely issue proposed Treasury regulations sometime this year, addressing the subject matter in Notice 2003-65. The provisions of the notice provide a basic summary of the approaches being considered by the IRS.

Prior to Notice 2003-65, the treatment of income and deduction items under §382(h) was not clear. Section 382(h) uses the term "attributable to" to define income and deduction items that may be treated as RBIG or RBIL. However, this term is undefined in §382, and Treasury regulations on the matter have yet to be issued.

Notice 2003-65 provides taxpayers with two approaches for identifying built-in income and deduction items that should be treated as RBIL or RBIG for purposes of §382(h). These are the 1374 approach and the 338 approach, each named for respective Code sections that provide the framework for the analyses. Each of these methods assumes a hypothetical sale of the loss company's assets at the time of the ownership change. These methods are not exclusive, but they provide safe harbors.

The 1374 Approach

Under the 1374 approach, NUBIG or NUBIL is calculated as the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the corporation immediately before the ownership change. For these purposes, it is assumed that all assets are sold and all liabilities, including contingent liabilities, are assumed in the hypothetical sale. Adjustments are also made for any liabilities for which a deduction would be triggered by the sale.

Under the 1374 approach, the amount of gain or loss actually recognized during the recognition period on the sale or exchange of an asset is treated as RBIG or RBIL.

The 338 Approach

Under the 338 approach, NUBIG and NUBIL are calculated in the same manner as under the 1374 approach, that is, based on a hypothetical sale of assets. As with the 1374 approach, contingent consideration, including a contingent liability, is taken into account at the time of the ownership change and not when the contingent liability becomes fixed and determinable. This differs from the approach taken in the case of an actual §338 election.

In general, the 338 approach identifies items of RBIG and RBIL by comparing the loss corporation's actual items of income, gain, deduction and loss with those that would have resulted if a §338 election had been made, assuming a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date. Unlike the 1374 approach, built-in gain assets may be treated as generating RBIG even if they are not disposed of at a gain during the recognition period, and deductions for liabilities that exist on the change date may be treated as RBIL.

The 338 approach assumes that an asset with a built-in gain on the ownership change date generates income equal to the cost recovery deduction that would have been allowed if a §338 election had been made. For an asset with a built-in gain, this approach treats as RBIG the excess of the hypothetical cost recovery deduction, e.g., depreciation and amortization, over the loss corporation's actual allowable cost recovery deduction. The converse would also result in treatment as RBIL.

For example: Assume P acquires 100 percent of the outstanding stock of T for $1,000,000. T's sole asset is intellectual property, which has a fair market value of $1,000,000 and an adjusted tax basis of zero. Also assume that T has U.S. federal NOLs of $10,000,000 and the U.S. federal long-term tax-exempt rate is 5%.

Prior to Notice 2003-65, the annual §382 limitation on T's NOLs would be $50,000. Absent the 338 approach of Notice 2003-65, there is no clear authority to increase the annual limitation unless the intellectual property was actually sold. None of the postchange income of T would be treated as prechange income because none of T's income accrued prior to the change date.

The 338 approach under Notice 2003-65 would result in T having a $1,000,000 NUBIG. If T's intellectual property was sold in an actual §338 transaction, it would likely be treated as an intangible asset that would be amortized over a 15-year period. The actual cost recovery by T on the intellectual property is zero. The hypothetical cost recovery under the 338 approach would be approximately $66,667 per year ($1,000,000 over 15 years). Over the five-year recognition period following the acquisition, a total of approximately $333,333 ($66,667 for five years) would be treated as RBIG, resulting in an increase of potential NOL utilization by T of this amount in addition to the $50,000 annual limit calculated in the usual way.

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Don't I know you? Recognizing the need for resolution
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Unsettled Issues
Notice 2003-65 was a benefit to taxpayers. However, a number of issues are not clarified or covered by the notice, resulting in some ambiguity.

Contingent Liabilities
The IRS has long held that a seller being relieved of a contingent liability in an asset transaction ought to include some amount of that relief in proceeds while at the same time denying a buyer basis in the assets until the liability is settled. Under Notice 2003-65, it appears that the loss company is treated as neither the seller nor the buyer since a contingent liability is not considered proceeds at the time of the change nor is it considered proceeds when later settled.

Contingent liabilities are generally ignored for purposes of calculating proceeds realized in the hypothetical asset sales under the 1374 and 338 approaches because these amounts would not otherwise be deductible in a true asset transaction. But of course, contingent liabilities do impact the determination of asset values. Including contingent liabilities for purposes of enterprise value but ignoring them for these purposes can be potentially distortive.

Interaction with Other Provisions
In situations where other rules in connection with NOLs apply, perhaps subject to certain irrevocable elections made before Notice 2003-65 was issued, Notice 2003-65 may have produced a more favorable result. What happens if a loss company taxpayer made an election in an earlier year that is less favorable than the result that could have been achieved under Notice 2003-65? Which set of rules trump: the benefit of Notice 2003-65 or rigid election administration? Will fairness overturn administration? Maybe not, but it's certainly an area that should be addressed.

Application to Closed Tax Years
Notice 2003-65 can be applied retroactively to prior tax years. An area of uncertainty arises when Notice 2003-65 could be applied to increase the amount of NOLs available for use in a closed tax year. Generally, if a taxpayer fails to deduct an NOL in a prior period, the amount of the NOL carryforward is reduced by the amount that should have been absorbed in the prior period. It could be argued that a taxpayer that otherwise calculated the §382 limitation without taking Notice 2003-65 into account and continues to carry forward preownership change NOLs (or has since used the NOLs) may not be entitled to carry the NOLs forward. However, Notice 2003-65 provides that the 1374 and 338 approaches are not exclusive methods. It may also be possible that a taxpayer using an alternate approach would be determined to be using a permissible approach that would not result in this issue.

Conclusion
As we stated, ambiguity can lead to opportunities. However, for the most part, it simply leaves matters unresolved. Notice 2003-65 gave taxpayers favorable guidance on §382(h), but what is needed is true regulation. In recent panel discussions, IRS and Treasury Department representatives indicated a plan to issue regulations this year. Such a move would be welcome, especially to the extent that it eliminates some of the uncertainty regarding RBIG and RBIL. •

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Cal Hackeman
Managing Partner,
Private Equity Initiative
T 703.847.7530
E Cal.Hackeman@gt.com

Dan Reid
National Managing Principal,
Transaction Advisory Services
T 415.354.4800
E Dan.Reid@gt.com

www.GrantThornton.com/PrivateEquity

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