



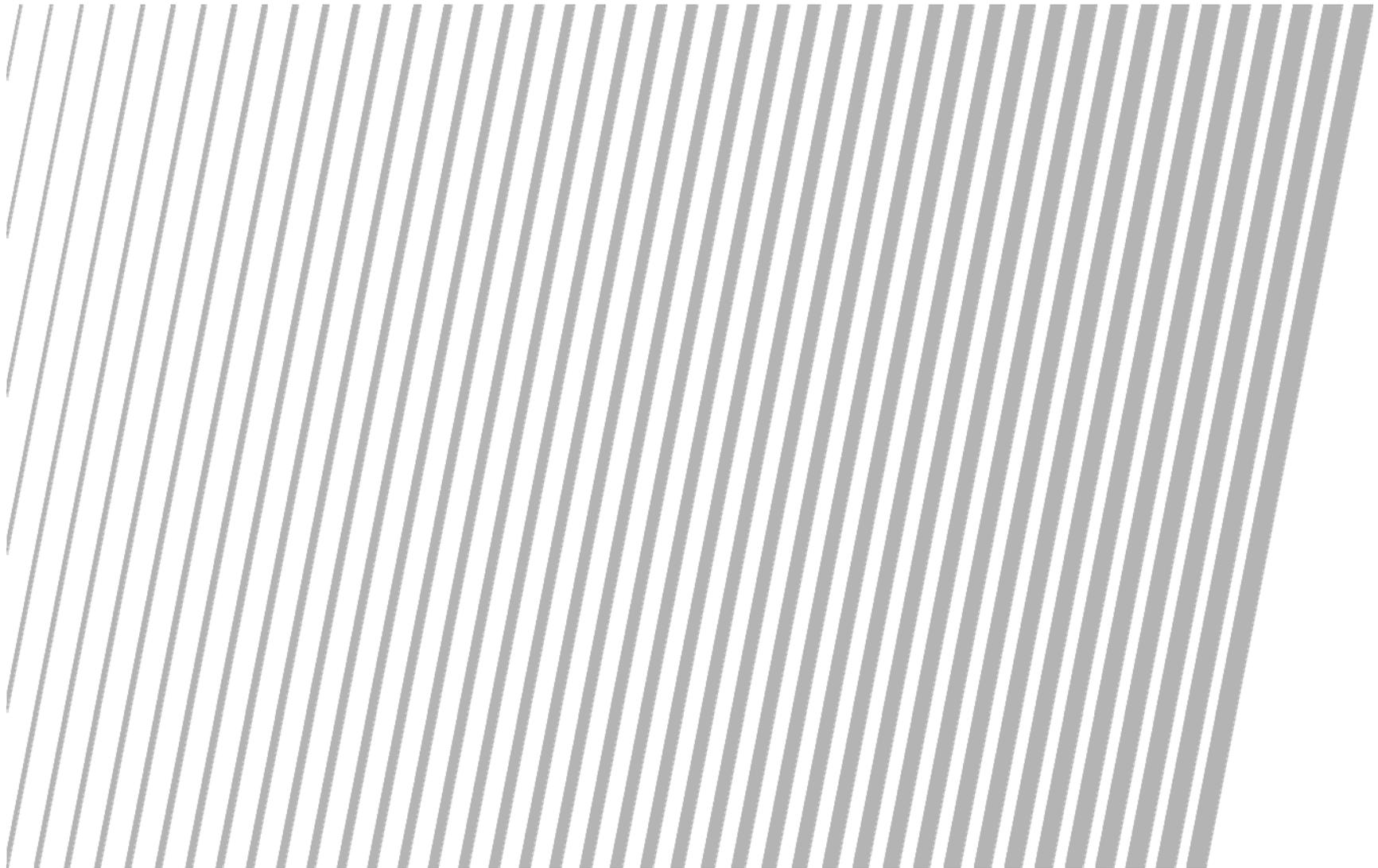
Columbia Business School

Transaction considerations in turbulent times

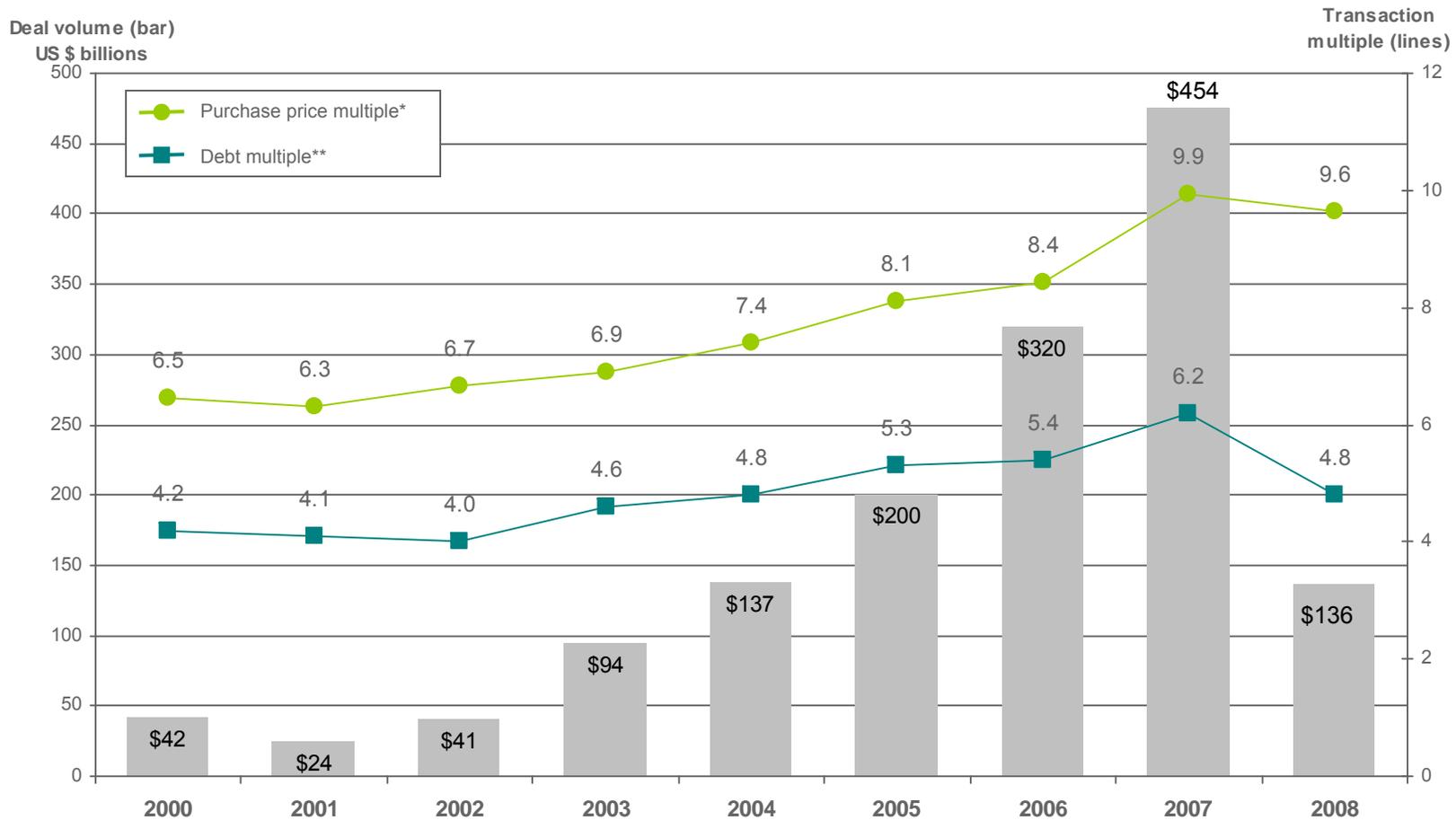
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Financial and accounting considerations



US LBO deal volume and transaction multiples since 2000



* The purchase price multiple is calculated using the average purchase price of LBOs \$500m or greater divided by adjusted EBITDA.

** The annual debt multiple is calculated using the average debt to adjusted EBITDA ratio for LBO transactions for companies with EBITDA greater than \$50m.

Sources: *Buyouts*, 5 January 2009; "M&A Stats," *Standard & Poor's*, vol. 10, no. 12, December 2008.

Deal practices: past, present and tomorrow

- ▶ (Recent) Past:
 - ▶ Available cheap capital > competitive auctions, “less restrictive” covenants
- ▶ Present:
 - ▶ Alternative structures to “classic” LBO model (see separate slide)
 - ▶ LPs not pressing GPs to spend dry powder
 - ▶ Not just lack of credit; sellers not willing to part at low valuations - if healthy
 - ▶ Opportunities for corporates flush with cash
 - ▶ More “exclusives,” sourcing through relationships (I-bank impact)
 - ▶ Prohibitive/more stringent debt covenants
 - ▶ Banks and buyers expected to demand deeper due diligence
 - ▶ All of the above >> not doing deals >> **focus on portfolio and preserving value of existing holdings**
- ▶ Tomorrow:
 - ▶ Greater filtering of deals, lower leverage ratios?, lower ROIs?, consolidation of PE?, lower fees/carry?
 - ▶ Pressure on banks to lend may result in enhanced credit availability for deals needing leverage

Deal practices: past, present and tomorrow (cont.)

Acquisition structure trends

- ▶ Acquisition structures expected to evolve in current market
 - ▶ More unsolicited bids
 - ▶ Rise in use of seller paper
 - ▶ Private investments in public entities (PIPEs)
 - ▶ Convertible debt and redeemable preferred with warrants
 - ▶ Greater proportion of equity
 - ▶ Potentially lower ROI but hope to recap later
 - ▶ More joint or other venture relationships and partnerships
 - ▶ Distressed investments
 - ▶ Buying distressed debt as a means of gaining control
 - ▶ Buying debt on own investees or companies previously diligenced
 - ▶ New investment in debt securities; higher coupons, penny warrants → control
 - ▶ Increased use of earn-outs

What we're hearing from our private equity clients

▶ Fundraising

- ▶ LPs facing pressure from their boards to reduce allocations to alternative investments.
- ▶ LPs are overallocated in alternative investments due to stock market decline.
- ▶ Near-term reduction in private equity fundraising compared to last two to three years; funds likely to be below true targeted amounts
- ▶ Vintage 2006 and 2007 fund performance may impact firms next time they fundraise.

▶ Investing

- ▶ Investing will be slow through 2009 – fewer number of deals
- ▶ Deals will be smaller, involve more equity at more traditional EBITDA multiples and less favorable debt terms.
- ▶ More co-investment opportunities, including strategic partners and sovereign wealth funds
- ▶ Higher percentage of non-control investments
- ▶ Funds are advising their investors to expect longer hold periods. PE firms will have to hold onto their companies longer or take prices far below their once anticipated levels
- ▶ Many are comfortable sitting and waiting this out – did so in 2001/2002.
- ▶ Others view environment as a tremendous opportunity: needs for fresh capital at low prices = better returns.

▶ Operations

- ▶ Operating partners analyzing investees in detail, working capital levels, liquidity and cost reduction/cash preservation opportunities.
- ▶ Most funds have at least a couple businesses that are struggling and a few exceeding expectations.
- ▶ Some firms tackle investee issues more aggressively than others.
- ▶ Most do not do standardized reporting on portfolio companies or back-office operations.
- ▶ The next 12 months will bring more distress

▶ Debt financings

- ▶ Covenant violations, even minor ones, viewed as cataclysmic events given cost of obtaining waivers, or debt being called given event of default.
- ▶ Banks are offering discounts to borrowers and PE funds to buy back debt – can trigger tax payments.

Issues facing distressed investors

- ▶ When to jump in – many aren't
 - ▶ Clients we have spoken to believe the worst companies within a particular industry are the first to get sick and the best are the last to capitulate and therefore distressed investors continue to be patient
- ▶ How will private equity play in this space with traditional distressed investors
 - ▶ Limited partner issues
 - ▶ Capital calls could be problematic for certain LP's; hurdle rates nearing 100%
- ▶ Bid/ask spread still too wide (both for equity or debt) – Sellers/Banks need to come to grips with what their business/position is worth before we see movement; banks have had a tepid reaction to public-private investment program as it will force many to realize losses
- ▶ Poor quality of information at targets
- ▶ Which part of the capital structure to target (what is the fulcrum security in capital structure to buy?)
- ▶ Assumptions of liabilities including employees and pension commitments
- ▶ Value enhancement may be a lengthy process
- ▶ Potential difficulties to extract cash for equity holders as directors have concerns about solvency opinions (fraudulent conveyance)
- ▶ As access to capital reduces, what are the potential exit routes?

Portfolio/investee matters

- ▶ Issues on the minds of our clients:
 - ▶ Debt covenants
 - ▶ Tripping can result in: penalties, calling debt, more prohibitive terms
 - ▶ Cure violations via additional equity (lower ROI), unsecured debt
 - ▶ Preserving and managing cash
 - ▶ 13-week cash flow is the new bible
 - ▶ Balancing revenue generation and cost take-out opportunities
 - ▶ Decreasing SG&A, controlling direct spend, improving EBITDA
 - ▶ Benefit restructuring, rationalizing procurement
 - ▶ Cutting benefits, deferring capex, renegotiating leases
 - ▶ Working-capital optimization
 - ▶ Going concern (separate slide)
 - ▶ Impairments (separate slide)

Portfolio/investee matters (cont.)

Going concern

- ▶ Overview
 - ▶ Auditor evaluates company's ability to meet obligations and operate for 12 months from date of financial statements.
 - ▶ "Substantial doubt" about the company's ability to continue as a going concern, if not mitigated, will result in a qualified opinion (could trip covenants).
 - ▶ Historically a subjective analysis based on company's ability to refinance and achieve projections.
 - ▶ Current environment will raise the bar on mitigating "substantial doubt."

- ▶ Implications of current economic environment on going-concern review
 - ▶ Higher level of skepticism.
 - ▶ Challenge assumptions, forecasts and analysis of management's assessment.
 - ▶ Debt commitment letter may not be enough.
 - ▶ Is parent-company guarantee sufficient if parent is also experiencing difficulties?
 - ▶ Increased focus on potential breaches of debt covenants as well as banking limits.
 - ▶ Focus on availability of financing including ability to draw on current facilities.

Valuation, modeling and diligence matters

- ▶ Prior year or quarter trends and metrics may no longer be relevant.
- ▶ Increased focus on the following areas:
 - ▶ Working-capital trends
 - ▶ Accounts receivable
 - ▶ Inventory
 - ▶ Goodwill and intangible-asset impairments
 - ▶ Fair value considerations
 - ▶ Acquisition considerations/business combinations
 - ▶ Pension and OPEB exposures

Valuation, modeling and diligence matters (cont.)

Accounts receivable and inventory

- ▶ Receivables and revenue recognition
 - ▶ Allowance for doubtful accounts. First and second tier customer health?
 - ▶ Reserves for returns, rebates and other customer incentives
 - ▶ Change in payment terms > Days Sales Outstanding (DSO)
 - ▶ Potential impacts on revenue recognition
- ▶ Inventory
 - ▶ Excess or obsolete inventory
 - ▶ Existing inventory levels – internally and at customers
 - ▶ Lower of cost or market reserves
 - ▶ Cost capitalization (impact of “abnormal” utilization)
 - ▶ Health of key suppliers and availability of alternative sources?

Valuation, modeling and diligence matters (cont.)

Goodwill and intangible-asset impairments

- ▶ These “non-cash” charges could trip covenants, significantly impact EPS for public companies
- ▶ Companies need to perform more sophisticated impairment-test analyses
- ▶ Greater use of third party specialists
- ▶ Indicators: market value being below carrying value
- ▶ Timing of impairment test
 - ▶ Goodwill or indefinite-lived intangibles (FAS 142): annually and if events or changes in circumstances indicate impairment has occurred
 - ▶ Intangible assets (finite-lived) and other LT assets (FAS 144): whenever events or circumstances indicate the carrying amount may not be recoverable

Valuation, modeling and diligence matters (cont.)

Fair value considerations

- ▶ Overview:
 - ▶ FAS 157 (Fair Value Measurements) is a new standard that defines fair value (FV) for financial reporting purposes as the “exit” rather than “entry” price
 - ▶ The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date
 - ▶ Standard establishes a framework/approach for measuring FV, including a hierarchy and more disclosure about use of FV
 - ▶ Little implementation guidance
 - ▶ Does NOT dictate/change when a FV measurement is required
 - ▶ Effective 1 January 2008 for calendar year-end companies
- ▶ Impact:
 - ▶ Increased time and effort dedicated to valuation process and documentation
 - ▶ Changes in market conditions add to the complexity

Valuation, modeling and diligence matters (cont.)

Acquisition considerations/business combinations

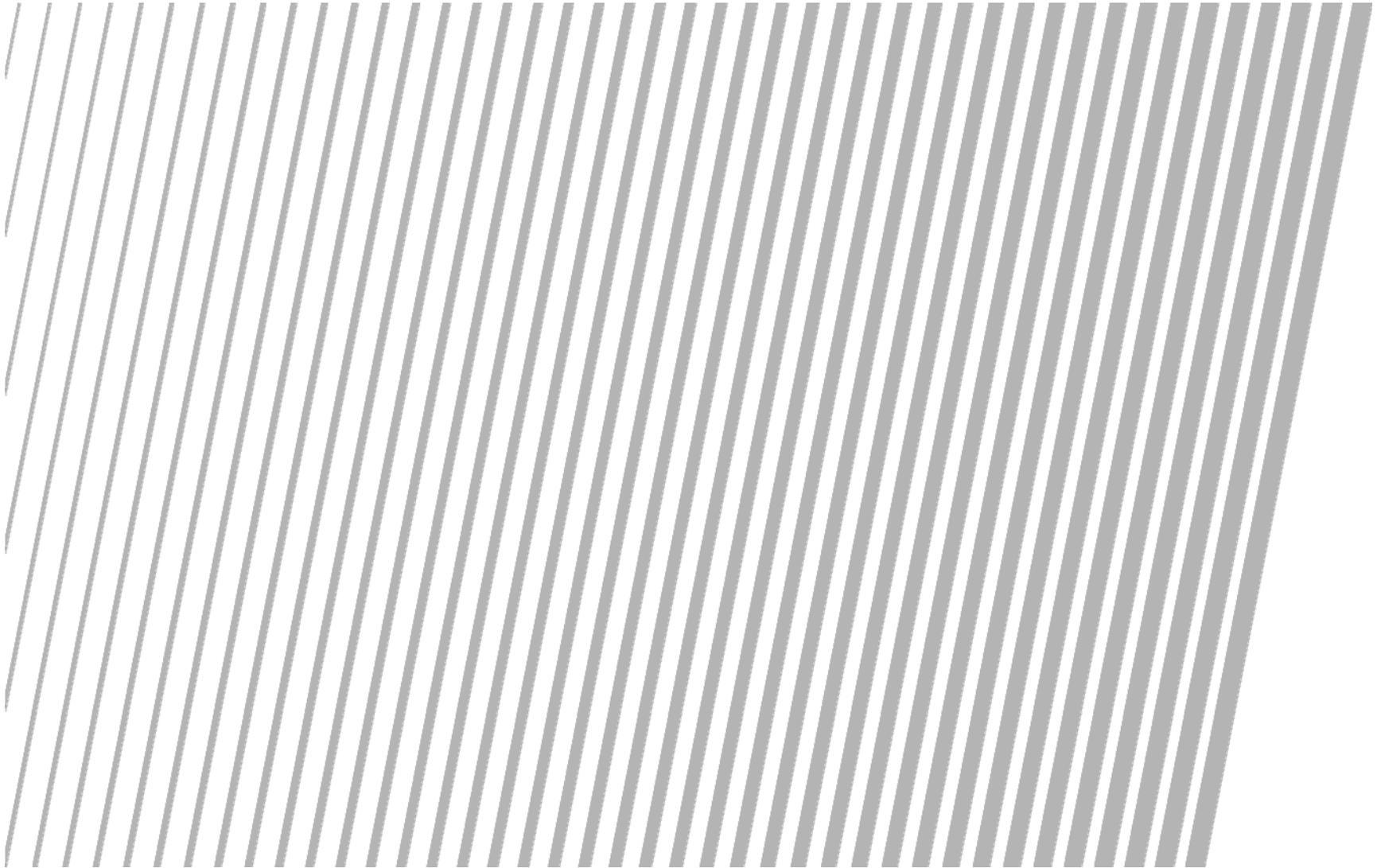
- ▶ FAS 141(R), *Business Combinations* recently issued and replaces FAS 141 - effective for annual periods beginning after 15 December 2008
- ▶ Significant items that are changing:
 - ▶ Transaction costs
 - ▶ Restructuring costs
 - ▶ Contingent liabilities
 - ▶ Contingent purchase price
 - ▶ Valuing intangibles the acquirer does not intend to use
 - ▶ Negative goodwill
- ▶ Modeling/valuation implications
 - ▶ Initial goodwill assumptions may be different from historical practices
 - ▶ More instances where changes in FV of the initial purchase price may be recorded through earnings (as opposed to consideration or “goodwill”)
 - ▶ Covenant impacts/considerations

Valuation, modeling and diligence matters (cont.)

Pension and OPEB exposures

Shareholder's exposure	Pension plan claims on shareholders' stake in the sponsoring company
Balance Sheet exposure	Volatility in recorded pension assets and liabilities with corresponding changes in equity (e.g., accumulated other comprehensive income)
Earnings exposure	Given current market conditions, companies will see lower expected asset returns, which will increase pension expense. Yet 2008 might still have "pension income".
Cash Flow exposure	Declining health of defined-benefit pension plans may result in companies diverting cash from other uses into the pension plans. Cash may be very different from expense.
Business exposure	Changes to working capital, EBITDA, debt service coverage and/or cash funding of benefits could trigger violations of debt covenants or other contractual commitments

Tax strategies in the current environment



Overview

- ▶ Given today's turbulent economic conditions and credit markets, debt instruments of PE fund portfolio companies trade at substantial discounts to their face value.
- ▶ Even though there may be no reduction in the principal amount of the PE fund portfolio company's debt, there can be *significant* US federal income tax consequences (e.g., cancellation of debt ["COD"] income) to the portfolio company debt issuer as a result of the following:
 - ▶ Related party purchase of debt; and/or
 - ▶ Significant modification of debt terms.
- ▶ The 2009 stimulus bill provides some relief through deferral of COD income exclusion and other potential benefits (e.g., applicable high-yield debt obligation ("AHYDO") relief provisions).

Cancellation of Debt (“COD”)

- ▶ Generally, a corporation must recognize income upon a “discharge of its indebtedness.”
- ▶ Amount of COD income is generally:
 - ▶ With respect to cash repayment: difference between the cash and issue price of retired debt.
 - ▶ With respect to a repurchase/modification: difference between issue price of new debt and issue price of the old debt.
 - ▶ Issue price:
 - ▶ Debt issued for \$ - first price a substantial amount of the debt is sold for \$
 - ▶ Publicly traded - FMV when substantial amount is traded
 - ▶ Non-publicly traded - principal amount of debt unless the interest rate < AFR
- ▶ Certain rules may exclude COD income from taxable income if the borrower is insolvent or in bankruptcy.
 - ▶ Excluded COD results in tax attribute (NOLs, depreciable basis, etc.) reduction.

Debt repurchases

By issuer

- ▶ An issuer realizes taxable income from the cancellation of debt (“COD”) upon the purchase of its debt for an amount less than its adjusted issue price.
 - ▶ The amount of COD income is generally the excess of the adjusted issue price of the debt over the fair market value of any consideration paid in exchange for the debt.

By related party

- ▶ When an issuer’s debt is acquired by a related-party from an unrelated party, the debt is treated for US income tax purposes as being satisfied by the issuer and reissued for the amount paid by the related party for the debt. If the related party purchases the debt for a discount, COD income and OID/AHYDO consequences may result.
 - ▶ Complex attribution rules apply in determining whether or not the debt has been purchased by a “*related*” party.
- ▶ Existing tax planning to avoid being considered related parties.

Debt modifications

- ▶ Modifications to a debt instrument can, in certain cases, also result in COD income.
- ▶ This may be the case even if the debtor is still liable for the entire amount of the existing debt.
- ▶ COD income may be created when a portfolio company's debt is "substantially" modified and it is "publicly traded."
 - ▶ A significant modification exists where the rights of the creditor and obligations of the debtor are being altered in an economically significant manner.
 - ▶ Broad definition of "public trading" can include debt instruments that are listed on computer quotation systems (e.g., the Markit system).

Original issue discount (“OID”) Applicable high-yield debt obligation (“AHYDO”)

- ▶ To the extent that the issue price of the new debt is less than its stated redemption price at maturity, the debt has OID.
- ▶ Generally, OID is deductible to the issuer and includible as income to the holder over the life of the debt.
 - ▶ However, where the debt is characterized as a AHYDO (i.e., in general, a debt with a term of greater than five-years and a yield to maturity greater than the AFR plus five percent), there is no deduction for the OID that exceeds the AFR plus six percent, and the remaining OID is only deducted when paid.
- ▶ Regardless of whether the debt is AHYDO or not, the holder is still required to include the interest accrual in income.
 - ▶ Dividends received deduction for disallowed portion.

2009 economic stimulus bill

COD income relief

- ▶ For debt repurchases in 2009 and 2010 -- including related party purchases, debt modifications and repurchases using equity -- a taxpayer can elect to defer resulting COD income recognition until the fifth year after the repurchase (fourth year for 2010 repurchases) and then spread ratably over a five-year period.
- ▶ Applies to debt issued by a C corporation and debt issued by other taxpayers in connection with a trade or business.
 - ▶ For partnerships, deferral election made at the partnership level, not the partner level
- ▶ If the taxpayer liquidated or sold all of its assets (including through a Chapter 11 proceeding), recognition of the deferred items would be accelerated.

2009 economic stimulus bill

OID deferral/AHYDO relief

Corresponding OID deferral

- ▶ To prevent the relief provision from becoming a tax windfall, the OID deduction that result from the deemed debt reissuance of the repurchased or modified debt are generally deferred until the corresponding COD income is recognized.
 - ▶ Holder's OID inclusions are not deferred.

AHYDO relief provisions

- ▶ In the case of a debt modification (but not a related-party debt repurchases) between September 2008 and December 2009, if the debt prior to modification was not an AHYDO, the modified debt will not be treated as an AHYDO.
- ▶ Treasury given authority to extend the sunset date if justified by continuing distressed conditions in debt market.
- ▶ Treasury also given regulatory authority for 2010 and later years to publish threshold for AHYDO treatment different from the usual AFR = 5%.

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