presents

Structuring M&A Financing: New Strategies for the Current Market

Evaluating the Alternatives and Securing the Optimal Deal

A Live 90-Minute Audio Conference with Interactive Q&A

Today's panel features:

Lindsey Alley, Managing Director, **Houlihan Lokey**, Los Angeles

Chelsea A. Grayson, Partner, **Jones Day**, Los Angeles

Stuart M. Finkelstein, Partner, **Skadden Arps Slate Meagher & Flom**, New York

Wednesday, August 12, 2009

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

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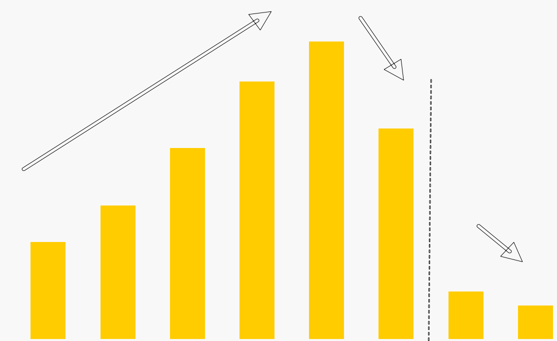
The Panel

- Lindsey Alley, Managing Director, Houlihan Lokey
  - Based in Los Angeles, Mr. Alley runs Houlihan Lokey's West Coast mergers and acquisitions practice. He advises public and private clients, boards of directors and special committees on sellside and buyside mergers and acquisitions, and has significant experience raising growth or acquisition capital for middle-market companies. He works with a diverse group of industries, including consumer, retail, industrial technology, healthcare, engineering and construction, and general manufacturing.
- Stuart M. Finkelstein, Partner, Skadden, Arps, Slate, Meagher & Flom LLP
  - Based in New York, Mr. Finkelstein represents clients on a wide range of tax matters, with particular emphasis on mergers, acquisitions and divestitures, including spin-offs, debt and equity offerings, corporate and partnership restructurings and joint ventures. He is regularly consulted on tax matters related to corporate restructurings.
- Chelsea A. Grayson, Partner, Jones Day
  - Based in Los Angeles, Ms. Grayson advises emerging and established companies, as well as private equity firms, focusing primarily on mergers and acquisitions, distressed mergers and acquisitions, private placements of equity and debt securities (both issuer and venture capital fund representations), general corporate counseling, joint ventures and strategic alliances, and importation and distribution transactions.

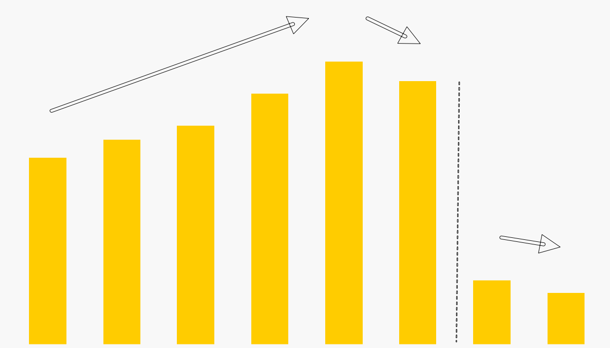
Domestic and Global Activity Has Declined

- Aggregate U.S. deal value in 2007 was driven largely by private equity firms that purchased $495 billion of U.S. assets
- A difficult credit environment and broader economic downturn have diminished appetite for M&A activity in 2008 and 2009

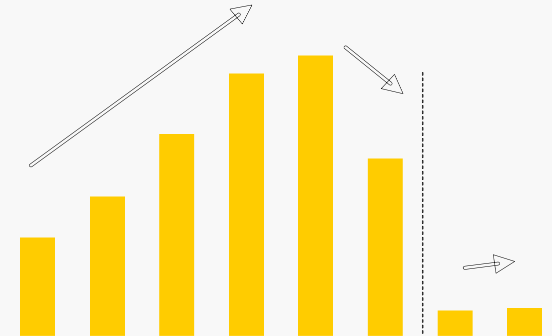
Global M&A Volume: Deal Value



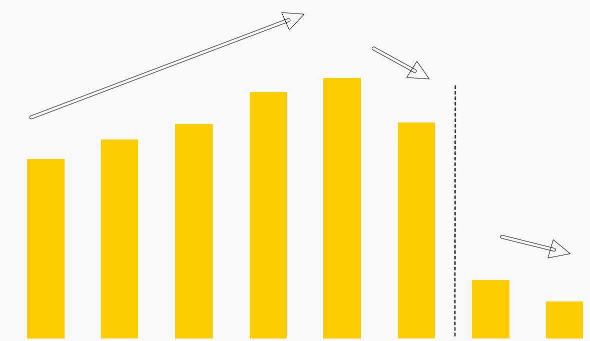
Global M&A Volume: # of Deals



U.S. M&A Volume: Deal Value



U.S. M&A Volume: # of Deals



Current Market and Deal Structure Trends

- Tight credit markets
  - As access to traditional credit sources becomes more restrictive, buyers need to look to creative ways to close M&A transactions
- "Cash is king"
  - More strategic acquisitions
  - Smaller deals
- Perception of value versus reality
- Buyers aren't paying for "potential" up front anymore, but they are willing to pay for "potential" realized post-acquisition
- Current tone & pace of deals
  - Longer, more diligent diligence
  - Negotiation of deal documents takes a quick pace
- Distressed M&A

Two Driving Considerations In Today's Transactions

- Financing the deal
  - Subordinated financing
  - Earnouts
  - Seller notes
  - Asset swaps
  - Rollovers

- Structuring the deal to ensure consummation
  - Minority equity
  - Joint ventures
  - Rollups or opportunistic combinations
  - Simultaneous acquisitions

- Both buckets of considerations informed upon by financial, legal and tax considerations

Financing The Deal

Financing The Deal – Subordinated Financing

- Subordinated financing consists of non-senior securities that are considered debt for accounting purposes, but provide equity-like returns to their investors
- Subordinated debt generally targets returns between 18% and 22% through a combination of cash pay interest and either warrants or "pay in kind" (PIK) interest
- Subordinated debt always matures after the senior debt and is generally a bullet payment with a penalty for early redemption
- In this market, subordinated debt has taken the place of "stretch" senior and has helped soften the blow of the current financing market
- Payment of interest in PIK notes creates tax "original issue discount" or OID, which is includable in the income of the seller and generally deductible by the buyer as it accrues, before cash interest is paid
    - Issuing the notes with warrants also typically creates OID in an amount equal to the fair market value of the warrants
    - If the debt has "significant OID" and has a term of greater than 5 years, it may be treated as an "Applicable High Yield Debt Obligation" or HYDO for tax purposes, which generally prevents the buyer from deducting interest until it is paid in cash and may disallow the deductibility of some of the interest even when it's paid in cash. The seller generally still has to include the interest in income as it accrues.

Financing The Deal – Earnouts

- Traditional method of bridging valuation gaps that is gaining increasing popularity
  - In Seller's market, earn-outs are rarely used given the uncertainty of payment and complexity of documentation
- Seeing provisions here that buyers typically failed to achieve in pro-seller markets
  - Tying accrual of earnout payments to *both* the meeting of financial milestones as well as the continued employment of certain key employees that come over from target
  - Tying earnout payments to continued employment could result in "converting" what would otherwise be treated as sales proceeds, taxed at capital gains rates, to compensation income, taxed at ordinary income rates
- Also seeing pro-seller provisions gain popularity, such as acceleration of contingent payments upon certain events that threaten buyer's ability to make future payments, and the escrowing of full amount potentially due
- Documentation of earn-out provisions is complex with significant risk of post-closing dispute
- Buyer typically doesn't get tax basis in whatever it purchased (stock of the target or target's assets) until the earnout payments are made.
  - A portion of the earnout will typically be recharacterized as interest when paid, giving buyer a tax deduction at such time for such amount; conversely, seller would have to treat a portion of the purchase price as ordinary interest income rather than as additional sales proceeds which would generally result in capital gains
- Depending on the facts, seller may be able to postpone the recognition of the taxable income attributable to the earnout until it is paid, although there could be a current interest charge payable to the IRS on the deferred tax under the "installment method" of tax reporting.
  - Sellers may be able to avoid the interest charge by treating the sale as an "open transaction" for tax purposes, although the IRS believes that this applies only in "rare and extraordinary cases"
- Trend extends overseas
  - In 2008, 12% of all deals in Europe contained earn-outs, but that number shows signs of growth: According to CMS's European Study, "17% of relevant deals in the fourth quarter of 2008 included an earn-out type of structure, compared to just 9% in the first half of 2008"

Financing The Deal – Seller Notes

- A Seller Note is where the Seller helps to finance the transaction through agreeing to retain some portion of the purchase price in the form of a security; to bridge financing or in place of senior secured debt, sellers are more willing to use seller notes, as they sit above sponsor equity and can offer significant upside with interest rates as high as 12%

- According to Reuters Buyouts in January 2009, "seller notes are back on the deal scene, and they're being taken to levels previously unseen… The seller notes of yesteryear typically made up about 10 percent of a deal's total value, today's seller notes can more than double that"

- Seller notes are almost always unsecured and are structurally subordinated to any institutional debt that supports the acquisition
  - Seller notes are typically bullet payments that mature after all other institutional debt

- Seller notes generally receive interest at a rate significantly below what a market-based equivalent security would receive
  - Interest is typically pay-in-kind, but can be cash

- With or without an interest component
  - To the extent the note does not bear interest, the IRS will impute interest by discounting the note to its net present value (using the applicable federal rate) and treating such amount as its issue price—the difference between this amount and the stated principal amount is OID, which is currently deductible by buyer and currently includable by seller over the life of the note
    - This is in contrast to the treatment of most earnouts, where a portion of the purchase price is treated as interest only when the earnout is paid
  - Sellers should consider requesting a gross-up to compensate for the imputed interest income or, alternatively, a note that pays some interest currently in cash to allow seller to pay taxes on the entire imputed amount (i.e., 40% of the imputed interest income)--buyers might push back as this latter alternative is less exact and more likely to yield a windfall for seller

- Even the Real Estate market has increased the use of seller financing in order to close deals
  - According to research firm Real Capital Analytics in July 2009, "7% of total real estate transactions are being financed through seller notes, versus 1% at the market's peak"

Financing The Deal – Asset Swaps

- Good fix when little or no access to cash or credit
- Complicated exchange ratios and valuation characteristics make asset swaps uncommon M&A structures
- Recent workable examples tend towards a swap of divisions rather than loose, unintegrated assets
- May be possible to do "like-kind" exchanges for tax purposes, which may allow a significant portion of the value of the target business to be transferred without current tax.
    - Goodwill or going concern value of one business may not be swapped for goodwill or going concern value of another business, but it may be possible to swap other intangibles on a tax-free basis under these rules
        - The IRS has recently issued guidance which may make these kinds of transfers easier to effect on a tax-free basis
        - Like-kind exchanges of an entire business for another business are very complicated and require detailed tax analysis

Rollovers

- Management rollovers are tending to constitute a higher percentage of transaction value, as a way to decrease the amount of capital buyer needs to come up with
- Historically, typical rollover percentages were usually in the range of 10-20%; in the current market, this number has increased to 20-30% in the typical deal, and in some cases even higher
- Can generally be structured to be tax-free to management but may be more difficult where management's existing ownership in the target is in the form of compensatory stock options

Structuring The Deal To Ensure Consummation

Structuring the Deal – Minority Equity

- Minority equity is an attractive solution for business owners that desire liquidity, but believe that valuations are low
  - Institutional investors versus strategic investors
- Cash rich PE funds that are able to make minority investments are very active in this market as a way to continue to participate, at a time when there is little financing for control buy-outs
- Target returns are 25% - 30% and the equity investment is typically structured as either convertible, redeemable or straight preferred stock
  - Depending on structure, there may be a PIK interest component
- PE will not achieve the same type of control (Board and otherwise) as in a buy-out; seek important veto rights and other protections (e.g., both Board seat and also Board observer positions)
- Company should be mindful of the decreased quantity and type of rights equity typically obtains in this context

Structuring The Deal - Joint Ventures

- A way for parties to contribute their respective strengths and leave behind their respective liabilities
- Typically, quicker pace and less expensive than a merger or an acquisition
  - Diminished diligence
  - Less documentation
- Post transaction execution and relative valuation differences make joint ventures a rarely used vehicle to structure transactions
- Can generally be structured as tax-free contributions of assets to the JV; the complexities arise when either or both parties want to extract cash or other liquid assets (sometimes through the use of leverage) and in dealing with exit strategies
- Using a partnership JV (or LLC treated as a partnership for tax purposes) is generally preferable to using a corporate JV, but each structure has its own issues

Structuring The Deal – Rollups or Opportunistic Combinations

- Can be used to combine two weak performers in a market sector into a larger company with better profitability as a result of operationally synergies
- Can also be used to diversify away from market segment or customer concentration in anticipation of a sale of the combined company
- Relative valuation and integration, execution risks make rollups and private company stock-for-stock combinations difficult to close
  - Requires strong leadership with expertise or guided by experienced advisors
- Depending on the legal structure of the parties, may be possible to structure as tax free acquisitions; to the extent must be structured as taxable acquisitions, may be preferable to both buyer and seller to structure as taxable asset acquisition to give buyer a "step up" in the tax basis of the acquired assets, which should increase the purchase price paid to seller
  - A taxable asset acquisition may not be feasible if the target is a C corporation that is not part of a tax consolidated group (because an asset sale would result in 2 levels of taxation, one at the corporate level and another at the shareholder level)
  - May also be possible to achieve an asset basis step up with a taxable stock acquisition where the parties make a joint "section 338(h)(10) election" to treat the transaction as an asset acquisition solely for tax purposes

Structuring The Deal – Simultaneous Acquisitions

- Rather than acquiring assets that do not necessarily drive the transaction and then divesting immediately post closing (or at some point post closing), buyers team together to each acquire the assets they want

- One set of definitive agreements
  - One set of reps and warranties by seller
  - Carefully structured indemnity and related provisions
  - Closing of each transaction contingent on the other

- Eliminates the risk of the buyer not being able to find a downstream buyer for peripheral or unwanted assets and eliminates potential liabilities associated with making reps and warranties to a downstream buyer in respect of new and unfamiliar assets

- Although might cause additional work for seller during the deal and might lengthen the deal process, in the end this structure eliminates contingencies that a buyer would otherwise desire to incorporate and gives a seller more security that the transaction will close

- Must be structured in the most tax efficient manner, i.e., by ensuring that the assets with the highest tax basis are sold by the target to minimize corporate tax leakage.

Conclusions

- The structure of transactions have evolved to try to maintain an active M&A market
- Manage the expectations of your client early in the process
- Be creative in your thinking regarding how to finance and structure transactions
- Financing conditions must be diligenced and structured in such a way to minimize risks of a failure to obtain financing to close a transaction
- Competition is key to mitigating closing risks and expediting a process that can drag out in today's market
- Get your tax advisor involved early in the process

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