THE NEWSLETTER OF THE BDO SEIDMAN PRIVATE EQUITY PRACTICE

BDO PErspective

Inaugural Issue

Six Keys to a Successful Deal

The financial crisis has ushered in a new world when it comes to successfully executing an acquisition. Increasingly complex capital structures, the rise of mezzanine and minority investments, and more "necessity" transactions are giving way to a new set of challenges for financial buyers and strategic buyers alike. According to BDO Seidman's Private Equity Practice, there are six critical steps that buyers must take when conducting diligence in distressed times.

Make Sure the Scope Fits the Deal: Because no two deals are created equal, the diligence process from deal to deal should not be equal either. By focusing the scope of the exercise, acquirers can ensure that the right level of diligence is performed for the specific transaction – not just the level required by a checklist. The investment thesis, the risks of the current marketplace, the type of investment being considered and the seller's motivation all need to be assessed when scoping the diligence plan. To avoid extraneous procedures being performed at unnecessary cost, buyers should evaluate the overall investment risk when setting the scope – not when they are knee-deep in the engagement. Furthermore, it has become even more critically important to scrutinize the quality of information and where it's coming from – i.e., the sophistication of the IT systems, strength of internal controls and the reporting procedures throughout the company. A "Phased Diligence" program can also help control acquisition cost by concentrating first on the critical areas to avoid overspending on a "broken deal" down the line.

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"One Size Doesn't Fit All" For Valuation Methodology

In an investment community where a readily determinable market value is not commonplace, FASB Statement No. 157, Fair Value Measurements ("FAS 157") has had perhaps the greatest impact on the time it takes to prepare the annual valuation and the amount of documentation required to support the assumptions made. But through proactive discussions, and the use of valuation techniques that reflect the complexity (or lack thereof) of the portfolio being assessed, navigating this process is possible. Here are some general guidelines:

1) **Recognize the subjective nature of the private equity investment valuation.** The objective is to estimate the value at which a hypothetical willing marketplace participant would agree to transact in the principal market or the most advantageous market, and fair value measurements based on market measurements will always be better than those based on assumptions. The Private Equity Industry Guidelines Group ("PEIGG") identifies a number of acceptable methodologies that use these market measurements, including the cost or latest round of financing, comparable company transaction, performance multiples, discounted cash flows, net assets or industry benchmarks.

2) **The valuating methodology should fit the complexity of the portfolio.** To determine which methodology is appropriate, consider the availability, quality and reliability of the data, whether the investment transfers are restricted, the comparability of the entity with other market participants and the development stage of the entity.

3) **Consistency is vital when it comes to methodology.** An approach should be consistent from period to period and among asset classes unless better measurements of fair value become available. To achieve this, planning is necessary and allows all of the interested parties to the valuation to consider the best and most cost-effective approach. The valuation can then be performed by those closest to the investment or a third-party valuation firm.

4) **Understand what drives increases and decreases in valuations.** Some indicators of potential alterations in valuation may include changes to the performance or prospects of the underlying business, met or missed milestones, breached banking covenants or defaults on obligations, or changing trends and risks in the company's industry.

By implementing a reasoned approach that uses the best evidence available, and is consistent and well documented, portfolio managers can plan ahead, allowing them to focus more on the business – and less on the compliance.

Look Forward While Looking Back: History does not always repeat itself. While financial diligence traditionally focused mainly on historic performance, the sustainability of earnings in the current marketplace remains critical, and is growing increasingly complex. Whereas previously a buyer could credibly base future earnings predictions on past performance, economic conditions require buyers to take a more holistic approach to assessing the viability of a seller. Buyers need to understand issues around the seller's capabilities to manage through potentially negative events – i.e., major customer losses, a reduction in orders, the financial challenges of suppliers – while at the same time examine how ongoing business activities will impact future earnings. Contract and other renewal rates, current order levels, changes to discount practices and margin decreases must be scrutinized. If drastic operational cost cuts have been made, these need to be substantiated to ensure they're sustainable for the long-term. And while looser parameters for the aging of both inventory and receivables might be expected in such a market, the underlying valuation issues should not be ignored. Externally, greater emphasis must be placed on the diligence of the health of business constituents, such as vendors and business partners, while assessing integration risk. Also be aware that foreign currency fluctuations in recent months may have significantly distorted historic results.

Critically evaluate key assumptions that will drive future revenue and cost, given the fact that historical performance may not be an ideal indicator of current, or future, value. This fact is supported by an increasing number of contingent deal structures.

Cash Reigns: Cash continues to be king in this marketplace. Now more than ever before, buyers must understand the cash

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generating abilities of a business. Watch out for sellers who may have underinvested in, or even deferred, key expenditures because this could mean that it will take more than just the initial investment to move the business forward. Working capital trends (and variations from historic trends) and prompt payment discounts being offered to bolster cash collection prior to a sale merit additional scrutiny. In addition, lookout for cash outflows that may come due upon a change of control in contractual arrangements with employees, existing lenders and other contracts.

Determine What is “Real” in the Business: While a seller’s numbers might be all over the place, the fundamentals of the business live outside the virtual data room. Consider enhancing the scope of the operational diligence performed to validate the business plan. Some key questions to ask include:

- How are the management team and the business responding to the economic environment?
- How lean are the manufacturing or operating processes?
- How old is the equipment?
- What is the role of each employee and are there opportunities to streamline?

If synergies or other cost-savings are integral to the acquisition decision, it “pays” to validate them. Proactive integration planning during the later stages of the acquisition process can also ensure that these efficiencies are promptly realized.

Mind the GAAP: A business in crisis may not have its eyes on the financial ball. Pressures to achieve results - or dress the company up for sale - may have influenced the company’s accounting decisions and the resulting numbers, especially if they are not subject to periodic independent verification. To uncover any discrepancies between reality and what has been reported, pay particular attention to estimates and judgments, specifically any changes in methodology. Unexplainable changes in accounting practice need to be thoroughly vetted to ensure they do not mask an underlying problem. Furthermore, accounting estimates – such as bad debt reserves, net realizable value of inventory, and other contingencies – should be analyzed as the company engages in the challenges of today’s economic market, and are likely to change from historical levels.

In addition, recent changes to acquisition accounting mean that contingent consideration is no longer an off-balance sheet item and must be recorded at the acquisition date. Consideration tied to future earnings becomes more prevalent in an uncertain market. Multi-year earnouts recorded as a long-term liability can impact leverage-related covenants and should be proactively addressed with lenders to avoid an unforeseen breach.

Take Diligence One Step Further: Background checks on key individuals play a major role in the hiring practices of many corporations when it comes to on-boarding senior executives. But this is one step that is often overlooked in the acquisition decision process. Investigative diligence ensures that buyers are aware of any factors likely to influence the behavior of a seller or a retained management team, such as civil or criminal infractions, personal credit positions and any negative media coverage. The investigative diligence process also allows the buyer to validate a seller or management teams’ credentials.

As acquisition dynamics continue to evolve, buyers must adapt along with the marketplace. The nature of doing deals in distressed times requires that a greater emphasis be placed on the importance of selecting a diligence partner who truly understands the seller’s business and industry. Efficiency and value is generally maximized through an integrated team that can support any breadth of scope. And while acquirers face more challenges than before, buyers who make informed decisions will continue to benefit from successful transactions. PE

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Tax Ramifications of Distressed Debt Restructuring

As a result of the downturn in the global economy, many private equity sponsors are looking to either work with senior and subordinated lenders to restructure the debt of their portfolio companies and/or to invest in distressed debt packages. In evaluating the alternatives for restructuring the debt and investment in distressed debt, there are several tax ramifications that must be considered.

Debt Restructuring

Generally, if the terms of a debt instrument are modified and the modification constitutes a "significant modification," then the existing debt is treated as if it has been retired and reissued for a new debt. The new debt may result in the creation of cancellation of debt income ("CODI") to the portfolio companies (and LPs if a flow-though structure) and create original issue discount ("OID") interest deductions. Depending on various factors such as whether the debtor is insolvent (will need proper structuring if a flow-through structure), the debtor may not be taxed currently on the CODI, but the debtor will have to reduce certain tax attributes such as net operating loss carryovers. In addition, the OID rules will create an interest deduction for the OID that must be taken over the remaining life of the note. Under the applicable high yield discount obligation ("AHYDO") rules the interest deduction may be deferred or disallowed.

Another option is for the portfolio company to extinguish the debt at a discount using equity or cash. However, if the portfolio company repurchases the debt for an amount less than the face amount, they will recognize CODI for an amount equal to the excess of the face amount over the purchase price. Further, if the portfolio company uses equity it may also cause a change in ownership that may limit the ability to use net operating losses and built-in loss items if the portfolio company is a corporation.

The private equity sponsor could also purchase the debt of the portfolio company at a discount with the portfolio company remaining liable for the face amount of the debt. If the private equity sponsor is deemed to be a related party to the debtor and the debt is purchased at a discount, then they will have CODI for the difference in the face amount of the debt and the purchase price. This may give rise to OID of which the interest deduction is deferred and limited under the AHYDO provisions, but with proper planning it may be possible to avoid this result.

The American Recovery and Reinvestment Act of 2009 provides limited relief by allowing an election to defer the recognition of the CODI for debt modifications that occur in 2009 or 2010 until 2014, where it would be recognized ratably over the following five years (the OID deductions would be deferred as well). Additionally, there is some relief available from the AHYDO rules if the new instrument is used to acquire a non-AHYDO instrument from September 1, 2008 to December 31, 2009.

Distressed Debt Funds

In the current market, many private equity sponsors are setting up portfolio companies to invest in distressed debt securities. Distressed securities are traditionally defined as securities and other obligations of companies that are potentially or actually insolvent causing them to trade at substantial discounts to their issue price. However, based on the current tax rules there may be an issue regarding tax treatment of the restructuring of the debt securities. The main concern is that if the debts are not deemed to be publicly traded, and there is a significant modification of the note, then there may be a phantom gain on the restructuring equal to the difference in the new face amount of the debt and the purchase price of the debt.

For example, assume that an original debt that had a face amount of $100 is purchased for $50. If the debt is reworked and it is deemed to be a significant modification and the face amount stays at $100, there is a chance that $50 of phantom gain could be realized even though it is highly unlikely that they will ever collect on the full $100. A way to avoid phantom income is if the debt is publicly traded or if the debt is treated as a security. If the debt is treated as publicly traded, then it will be marked-to-market at the date of the acquisition. If the debt is treated as a security, then it may qualify as a tax-free recapitalization. There are also specific issues that need to be considered for tax-exempt investors and foreign investors if the portfolio companies are flow-through entities for U.S. tax purposes. However, with proper planning it is possible to avoid the unique tax issues associated with investing in distressed debt packages. PE

Retaining Enterprise Value in a Distressed Economy

With few exceptions, virtually all industries in the US and around the globe are experiencing some degree of financial pressure or distress – there's no getting around it. Private equity ("PE") fund managers are working with company owners facing rapid changes on all fronts, from sales and operations, to costs and finance. Unfortunately, the inability to identify, address and resolve issues that are adversely impacting the business in a timely manner may cause a decline in, or loss of, earnings and enterprise value.

A decline in enterprise value is usually evidenced by deteriorating revenue and operating profit, impaired operating cash flow, declining or limited liquidity on bank lines and inadequate working capital. In some cases, the deterioration is not in actual performance but the inability to achieve "expected" performance. As changes and problems develop, communications or shared expectations between a company and the PE fund manager can deteriorate. To start righting the ship, it's essential that portfolio companies and PE firms come together to correct the more controllable, internal factors including:

Cash Management: As companies cope with economic problems and challenges, business executives accustomed to managing the day-to-day business operations typically focus on earnings rather than cash flow. It is possible that a company is reporting earnings but having trouble meeting its current obligations. Critical to stabilizing—and then correcting—a distressed company is the immediate evaluation of cash inflows and outflows. Immediate actions must be taken to ascertain the principle reasons for poor cash flow and to correct the problems. Lender and vendor confidence and support are dependent on strong cash flow management.

Organization Structure and Leadership: Most business executives are experienced in building businesses—few, however, are able to reverse declines and rapidly reposition a company's growth or stability. To succeed in a business turnaround, management must have the proper skills to identify problems and then to provide effective solutions. A lack of leadership or executive action is often worse than bad decisions.

Products/Services: It's important for companies to assess the current market and the company's position within it – and to understand competitors, recent changes in the market and assumptions being made about the market's future size, trends and competitive shifts. Businesses should determine the nature and extent of marketing plans and the company's ability to monitor results. Is the existing business model still relevant?

Production: Companies should evaluate current production processes for effectiveness and efficiency; determine that production cost processes are monitored and competitive; and assess production capacity, if surplus capacity exists, consider both short and long-term needs. In today's environment, it is critical to "fine-tune" the entire business operation, making sure that all components work effectively together.

Administration: The management of many struggling businesses often deal with poor communications and inadequate data including untimely management information. During periods of profitability, these flaws are often masked or perhaps overlooked but during times of economic stress, the flaws can become major problems. For many companies, there is too much communication, whether through reports, meetings, presentations, briefings, phone calls, newsletters and e-mails. Despite all of this communication, management may still be unsure of what is going on and why. What is frequently required is less, but better, communication. Clear direction becomes more crucial in times of difficulty.

Uncertainty creates stress, doubt and panic, diluting focus on critical issues. The fund manager should assess the strengths and weaknesses of the company's current administration and if needed, determine the changes and related costs to improve. PE

Private Equity Events Schedule

(May 2009 – September 2009)

The following is a list of upcoming conferences and seminars from the leading private equity associations and business bureaus:

May 2009

May 12 – 14	**ACG InterGrowth 2009** Wynn Las Vegas Las Vegas, NV
May 21	**The Deal: Doing Deals in a Down Market** Webcast www.Thedeal.com
May 28	**Buyouts PE Firms: Extending Your Capital to Support Your Portfolio** Webinar www.buyoutsconferences.com

June 2009

June 3	**ACG Boston's Growth Conference 2009** Seaport World Trade Center Boston, MA
June 9 – 11	**ACG Capital Connection at the China International Private Equity Forum (CIPEF)** Tianjin International Exhibit Centre Tianjin, China
June 9	**Standard & Poor's Index Services and The Bond Buyer Present: Mid-Year Report – The State of the Tax-Exempt Market, 2009** The Princeton Club New York, NY
June 16	**Buyouts Chicago 2009** The Fairmont Hotel Chicago, IL

July 2009

July 15 – 16	**The PEI Strategic Financial Management Conference** New York Marriott Downtown New York, NY
July 21	**PEI Media Private Equity 101** Hong Kong, China

September 2009

September 15 – 16	**ACG Los Angeles Annual Business Conference** Beverly Hilton Hotel Beverly Hills, CA
September 16 – 17	**Dow Jones Private Equity Analyst Conference 2009** The Waldorf Astoria New York, NY

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