

# Private Equity Review

Trends and insights for private equity funds and their portfolio companies

September 2009

## Anticipating Buyer Scrutiny: Proper Preparation for Maximum Value

Economic turmoil, a sharp decline in acquisition financing and depressed EBITDA multiples have severely depressed M&A activity over the past two years, keeping a lot of private equity firms on the dealmaking sidelines.

Sales by U.S. private equity firms declined 47 percent in 2008 from 2007, and the trend has only accelerated in 2009. Less than 20 percent of the PE firms RSM McGladrey surveyed earlier this year have sold a portfolio company, division or product line in 2009 — and less than half have even considered a sale. Most of these PEGs are delaying the sale of portfolio companies and instead are focusing on strengthening these companies' operations and financial performance.

But this dealmaking drought won't last forever. According to a majority of economists surveyed by the *Wall Street Journal*, the recession has ended and growth will resume (albeit slowly) during the third quarter. And while there remains an imbalance between well-funded buyers and high quality companies for sale, pent-up demand for transactions could eventually prove helpful to PE firms interested in disposing some of their assets.

"The deal market has taken bit of a hiatus over the past 24 months, and the outlook for both the economy and M&A remains somewhat clouded," says Paul Weisbrich, a senior managing director with middle-market investment bank McGladrey Capital Markets. "But we think dealmaking activity is likely to ramp up noticeably in 2010."

Still, Weisbrich notes, both buyers and lenders have significantly tightened their standards, so "sellers need to prove the durability of their revenues and the quality of their earnings."

One thing is certain: for the foreseeable future it will be crucial for sellers to present their businesses in the best light possible while maintaining credibility among buyers. With forecasting difficult at best and transactions being subjected to intensified scrutiny, a seller's accounting and reporting must be able to withstand rigorous examination and evaluation.

The alternative: diminished values, retraded sales prices...and collapsing deals.

In today's cautious environment, "transactions are being retraded at an alarming rate, and due diligence requests are skyrocketing," according to Hector J. Cueller, president of McGladrey Capital Markets. "Companies unable to defend their numbers are getting retraded, which can severely diminish value for the seller."

Accountants and investment bankers agree that the most effective way to help buyers maintain confidence while protecting sellers against eroding values is through [sell-side due diligence](#). It is particularly important in a market beset by uncertainty.

"While sell-side due diligence almost always delivers a good return on investment, it was often neglected during the recent M&A bull market," says Milton Marcotte, a managing director in RSM McGladrey's Transaction Support Services practice. "But it has become critical in today's environment. Sellers seeking to attract buyers and maintain value are recognizing the importance of providing optimal financial transparency. They understand that discrepancies or surprises uncovered during buyer due diligence not only can torpedo a seller's credibility; they can quash a deal entirely."

Marcotte acknowledges that hiring an independent firm to perform due diligence can add to the seller's transaction expense. However, he argues that by "enhancing the seller's negotiating position and reassuring a potentially skittish buyer," the benefits provided by sell side due diligence "vastly outweigh the relatively minor increase in costs."

In addition to substantiating a company's financials and preparing the necessary supporting documentation, sell side due diligence enables the owner to carefully reassess the company before launching the sales process. It thus can help the owner identify potential problems and address them discreetly, before the company is taken to market. It also can enable the seller to craft persuasive arguments in response to potential buyer skepticism.

"We have a relationship with a midsized logistics company that enjoys margins almost twice the industry average," said Weisbrich. "As you can imagine, numbers

[Anticipating Buyer Scrutiny, continued on page 3](#)

## Tax Issues for Troubled Companies: Understanding Opportunities and Pitfalls

*Following are brief excerpts from a White Paper discussing tax issues that should be carefully considered when evaluating restructuring options. The White Paper was authored by Nick Gruidl, Managing Director, Corporate Tax & Transactions.*

Changes to tax laws, as well as historic provisions enacted in the American Recovery and Reinvestment Act of 2009, raise a variety of issues that companies should consider as they evaluate restructuring options. With effective analysis and planning, companies can maximize available tax benefits and mitigate tax costs associated with issues such as net operating losses, cancellation or modification of indebtedness, and the disposition of troubled subsidiaries.

### Preserving NOLs and other attributes

Troubled companies often have significant net operating losses, credit carryovers and other attributes available to offset post-restructuring income. However, they can lose these attributes as a result of a bankruptcy or debt restructuring. The form that a restructuring takes (i.e. bankruptcy, debt modification or exchange for equity, taxable acquisition of assets by creditors) will greatly impact the survival of tax attributes, and how debt is addressed can significantly affect the preservation of tax attributes.

### The effect of bankruptcy on tax attributes

The decision of a company to file for bankruptcy protection is not an easy one and is generally not driven by tax motivations. However, the tax ramifications of a restructuring are a key piece of the puzzle. For companies reorganizing through bankruptcy, special rules under sections 382(l)(5) and (6) provide benefits that allow increased utilization of attributes post-bankruptcy. However, there are a myriad of rules with which a company must comply.

### Managing debt modifications

The law broadly interprets the term “modification” when applying the term to debt instruments. Almost any change to the rights of the debtor or creditor will represent a modification. If the modification reaches the level of “significant,” there is a deemed exchange of the debt, creating numerous tax consequences, including the potential for taxable gain to the company on the deemed exchange.

### Dealing with an insolvent subsidiary

Section 165(g)(3) provides a potential tax savings opportunity for companies that own an insolvent subsidiary upon its liquidation, whether actual or deemed, or upon other disposition of the subsidiary. Notably, section 165(g)(3) allows for the recognition of an ordinary rather than a capital loss on the liquidation

or disposition of the subsidiary’s stock for both domestic subsidiaries of a consolidated group or foreign subsidiaries. In addition, the use of disregarded entities could accelerate the loss into a tax year prior to the actual disposition of the business and, in some cases, allow a loss on the investment without the disposition of the subsidiary’s business.

### Make the most of recent law changes

The Act provides flexibility that will allow companies to increase cash flow through deleveraging or otherwise restructuring existing debt without the tax implications often associated with such restructurings. The new law has special rules for partnerships and other pass-through entities and also may defer future interest deductions on new debts issued in the restructuring. As a result, companies will want to carefully consider all potential exclusions and deferrals and their collateral side effects before electing to apply section 108(i).

### Pass-through rules may differ

Where the company is not a C corporation but rather a Subchapter S corporation or partnership (including an LLC taxed as a partnership), the rules could provide quite different results. Perhaps the most significant difference is found in the application of the exclusions to recognition of COD income under section 108. Where the COD occurs at the partnership or LLC level, the exclusions do not apply at the partnership or LLC level, but rather at the partner or member level. As a result, the bankruptcy or level of insolvency of the partnership or LLC is of no consequence when determining whether the COD is excludable by the partner or member. This may come as quite a shock to an unsuspecting partner or member who has always assumed that a bankruptcy at the entity level is sufficient to avoid taxation on COD.

### Don't forget employee benefit matters

Both opportunities and pitfalls related to existing employee benefit plans must be considered when restructuring a troubled company. Issues to consider will include whether the company should contemplate amending the employee’s retirement plan to reduce or eliminate future contributions; eliminating the pension and executive deferred compensation plans; obtaining a waiver of the minimum funding standard; and various considerations regarding repurchase obligations.

[Download the complete white paper.](#)

## Anticipating Buyer Scrutiny, continued from page 1

like that can stimulate a fair amount of skepticism from potential buyers. Yet in this case there's a legitimate explanation – specifically, a software technology that enables the company to cut its costs while improving performance. In such a situation, having an independent firm validate that numeric competitive advantage can significantly enhance value.”

Another benefit of sell-side due diligence is the assurance of optimal tax structuring during the deal. “Sell-side due diligence should always include a tax component, including a SALT planning and compliance review” says Marcotte. “A deal can implode if the company being sold is found to be out of compliance – especially today, when states are really cracking down on non-compliance.”

According to Marcotte, it's a common misconception that the provision of sell side due diligence is a routine responsibility of the seller's investment bankers – who, he says, “rarely have the resources to perform the necessary analysis.” Cuellar agrees. “An investment banker's role is to position the company in the

marketplace, help prepare a credible forecast, develop a deep pool of prospective buyers, and effectively negotiate the transaction on behalf of the client. But when it comes to putting the supporting details behind the numbers, an investment banker cannot – and should not – replace the role of the accountant.”

Performing due diligence requires an investment of time, and as the saying goes, time is money. But as Weisbrich notes, “taking shortcuts can ultimately prove extremely costly to the seller.” Moreover, he argues that the current lull in dealmaking provides an ideal opportunity for private equity firms and other business owners to invest the time necessary to properly prepare a company for sale.

“There are a variety of steps an owner can take to enhance a company's value and make sure it's ready to attract a premium buyer and a premium price. Retaining a credible third party firm to perform sell side due diligence is one of the smartest things an owner can do to make sure he gets the best deal possible.”

## Sell Side Due Diligence: Systematic Analysis

Experts say an effective seller due diligence engagement must systematically examine an extensive series of issues, in areas ranging from revenues, working capital and accounts receivables to inventory, taxes and information technology.

Milton Marcotte, a managing director in RSM McGladrey's Transaction Support Services practice, says his group employs a **Readiness Checklist**, featuring an in-depth questionnaire, to help guide its seller due diligence engagements.

Following are among the questions Marcotte's team poses to its due diligence clients:

1. Does the company prepare monthly and annual financial statements in accordance with GAAP?
2. Is it able to prepare timely financial statements and business metrics throughout the M&A sales process?
3. Can the company fully explain changes in revenue by customer and by product/service for the last three years – and bridge the changes supporting a positive revenue trend? Does this tie to future revenue projections?
4. Does the company file income and sales taxes in all the necessary states and jurisdictions and understand any potential liabilities? Has there been a “Nexus” study to support current filings?
5. Does the company have an ideal tax structure for the sale – one that will minimize taxes and maximize net cash proceeds? Has it been determined whether an asset or stock sale will be pursued?
6. Does the company have a carefully considered IT strategic plan and disaster recovery plan? Does it maintain a list of active and planned IT projects with timelines and budgets? Do these plans indicate normal expenditure levels for the company and industry?

For more information on RSM McGladrey's sell side due diligence services or the firm's readiness checklist, please contact Milton Marcotte at (312) 634-3143 or [milton.marcotte@rsmi.com](mailto:milton.marcotte@rsmi.com).

## Private Equity Firms Focusing on Portfolio Company Performance, Survey Finds

Faced with a difficult economy and an anemic dealmaking environment, private equity firms are reducing employee headcounts, strengthening working-capital management, freezing salaries, improving business processes and reducing capital spending in an intensive effort to improve portfolio company performance, according to a recent survey.

Survey respondents ranked a weak economy, the ability to meet business forecasts, and the potential for defaults on loan covenants as their primary concerns for 2009.

The survey was conducted by RSM McGladrey and McGladrey Capital Markets. The firms polled approximately 100 senior-level PE firm executives representing a cross-section of fund types, including buyout funds (74 percent), mezzanine funds (13 percent) and venture funds (12 percent). Fund sizes ranged from less than \$100 million in assets to more than \$3 billion.

Almost nine out of ten (88 percent) survey respondents said they have implemented workforce reductions in response to the current economic environment, while another 10 percent are actively considering such actions. Significant majorities are also focusing on working-capital management (83 percent), salary freezes (75 percent), business process improvements (71 percent)

and reductions in capital spending (68 percent). Conversely, relatively few have sought to consolidate vendors or coordinate employee benefits across portfolio companies (16 percent and 14 percent, respectively).

“Private equity firms are increasing communications and becoming even more engaged in the oversight of their portfolio companies. Much of their focus is on helping portfolio companies acquire new customers, increase business with existing customers and enhance existing products and services,” said Bob Jensen, managing director and leader of RSM McGladrey’s Transaction Support Services practice.

“The survey confirmed what private equity executives have been telling us privately: their attention has largely shifted from acquiring new platform companies to managing the profitability of existing investments,” said Hector J. Cuellar, president of McGladrey Capital Markets. “This is unlikely to change until the economic outlook improves and acquisition financing becomes more readily available.”

Download the [2009 Managing Portfolio Investments Survey Report](#).

## RSM McGladrey

Accounting | Tax | Business Consulting

Editor: Todd Cooley

*Private Equity Review* is published by RSM McGladrey, the leading professional services firm providing accounting, tax and business consulting to mid-sized companies. McGladrey & Pullen LLP (a partner-owned CPA firm) delivers audit and attest services. RSM McGladrey and McGladrey & Pullen have an alternative practice structure. Though separate and independent legal entities, they can work together to serve clients’ business needs. They are member firms of RSM International, an affiliation of separate and independent entities.

Information provided in this publication has been obtained by RSM McGladrey Inc. from sources believed to be reliable. However, RSM McGladrey Inc. guarantees neither the accuracy nor completeness of any information and is

not responsible for any errors or omissions or for results obtained by others as a result of reliance upon such information. This publication does not, and is not intended to, provide legal, tax or accounting advice.

Send additional copy requests, change of address, comments or suggestions to [todd.cooley@rsmi.com](mailto:todd.cooley@rsmi.com) or call 949.255.6642.

For more information about RSM McGladrey or any of our business services, visit [www.rsmmcgladrey.com](http://www.rsmmcgladrey.com) or call 800.274.3978.

© 2009 RSM McGladrey Inc. All rights reserved.

Private Equity Review | September 2009 | Printed in U.S.A.