

M&A Monitor

Piper Jaffray Middle Market Mergers & Acquisitions

M&A Monitor: Analyzing M&A Activity—May 17, 2006

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Feature Article**Value of Net Operating Loss Carry-Forwards**by Garry Vaynberg, garry.x.vaynberg@pjc.com, 612 303-6348

Frequently in negotiations, sellers will try to place a high valuation on their Net Operating Loss (NOL) carry-forwards. For a company that has NOLs, each \$1.00 of NOLs can offset a dollar of otherwise future taxable income and therefore save \$0.35 in taxes. However, even though at first glance these valuable assets look attractive, their use by the acquiring party is limited. The following is a simplified explanation of the rules and the resulting limitation in value that can be derived from NOLs.

For any taxable year ending after the date of the ownership change, the amount of taxable income that NOLs of the "loss corporation" (acquired company with pre-merger NOLs) can offset is constrained to an amount known as the Sec. 382 limitation. The key to the application of Sec. 382 is the ownership change. An ownership change is determined according to a specific test and generally results from an acquisition of a majority (by value) of the loss corporation's stock. In such a situation, the annual Sec. 382 limitation is calculated as follows:

$$\begin{array}{r} \text{Value of the Loss Corporation's Stock} \\ \times \\ \text{Federal Long-Term Tax-Exempt Rate (currently set by IRS at 4.3\%)} \end{array}$$

The idea behind the odd calculation is to ensure that the NOL is no more valuable to an acquirer than it would be to the loss corporation had the loss corporation sold all of its assets and invested the proceeds in interest bearing obligations. This is primarily due to the fact that Congress has a view that only the parties on the scene when the loss was sustained should benefit from such a misfortune. Therefore, the Sec 382 limitation typically makes the target's NOLs less valuable to an acquirer than they would be to the hypothetical loss corporation as a stand-alone entity.

The calculation begins by assessing the value of the loss corporation's stock immediately before the ownership change. The thrust of this calculation is to reduce the equity value in cases where the loss corporation is, directly or indirectly, the source of the funds for the repayment of any acquisition debt. For example, when a loss corporation is acquired via an LBO, the equity value is limited only to the amount of equity capital the sponsors bring to the table. Moreover, there are numerous other conditions that eliminate any "gaming" of this rule, such as alternative interpretations of the ownership change. Therefore, for a typical middle market LBO transaction of \$100 million, where a sponsor contributes \$40 million in equity, the limitation would be \$1.7 million (\$40 million x 4.3%). Consequently, a company with a 10% pretax margin will only be able to shield 17% of that income, assuming NOLs for the loss corporation significantly exceed annual pretax income.

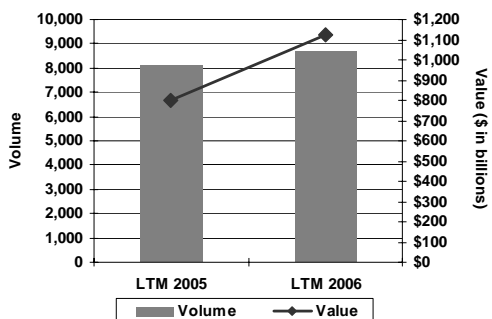
Moreover, this deceptively simple formula is subject to an array of adjustments that in general reduce, but under certain circumstances could also bolster, the Sec. 382 limitation. In any event, when a potential acquirer assesses the value of a corporation that has accumulated substantial NOLs, it is imperative to take into account the rules that inhibit usability of such NOLs. Because of the operation of Sec 382, one cannot assume that the value of such NOLs to a prospective acquirer is simply the gross amount of the NOLs multiplied by the corporate tax rate and discounted to reflect the length of time one expects such NOLs to be utilized to offset the acquirer's taxable income.

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Domestic Transactions

(\$ in billions)	Value*	Volume
LTM: 2005	\$799.9	8,127
LTM: 2006	\$1,126.2	8,680

LTM 2005 vs. LTM 2006



*Total value based on deals with reported values

Source: Thomson Financial Securities Data Corporation

LTM median deal value for 2006 is \$34.1 million compared to \$26.0 million for 2005.

LTM Transaction Multiples

By Size (\$ in millions)	EBIT	EBITDA
Less than \$25	5.9x	2.3x
\$25 to \$100	11.2x	8.4x
\$100 to \$250	12.7x	7.0x
\$250 to \$1,000	12.2x	7.9x
Over \$1,000	14.7x	10.0x

Current data as of May 16, 2006

Source: Thomson Financial Securities Data Corporation

Based on multiples between 0x and 25x; excluding media and telecom.

Public Company Premiums

1 week prior to announcement	22.2%
4 weeks prior to announcement	25.0%

Current data as of May 16, 2006

Source: Thomson Financial Securities Data Corporation

Deal Financing

	Current	1 Year Ago
Leveraged Bank Loan	7.64%	5.57%
High Yield Bond Rate	8.09%	8.21%
Senior Debt/EBITDA*	4.0x	3.8x
Total Debt/EBITDA*	4.5x	4.0x

Current data as of May 16, 2006

Source: Portfolio Management Data, The Wall Street Journal and LCD Comps

*Represents leverage statistics for middle market LBOs (less than \$50 million of EBITDA)

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Buyout Fund Market

(\$ in billions)	2005	2004	2003
Funds Raised	\$173.5	\$42.2	\$24.0
Deals Completed	\$198.0	\$136.5	\$94.8

Data as of May 16, 2006
Source: Buyouts

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