

Dividend Recaps: A New Market for Valuation Opinions

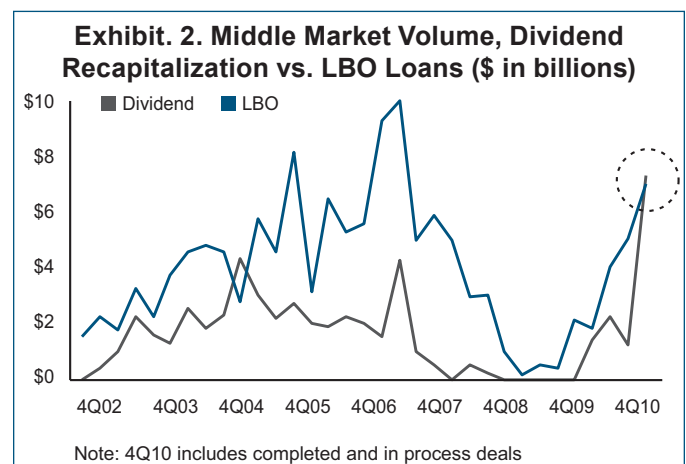
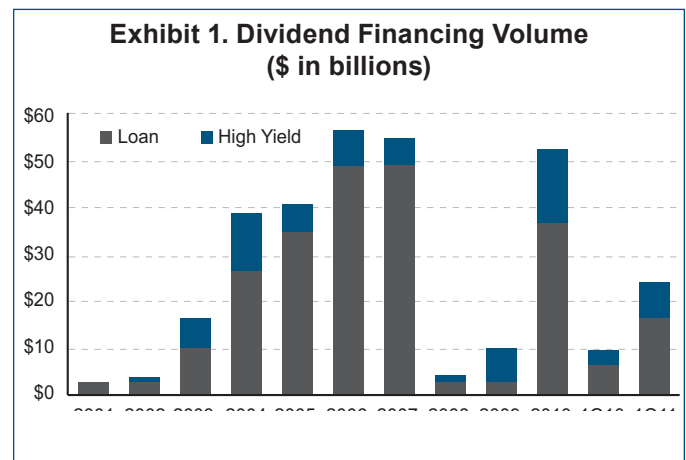
By Patricia J. Luscombe, CFA,
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The recently enacted 2010 Tax Relief Act has extended the Bush era's maximum 15% tax rate for "qualified" dividends through 2012, eliminating the threat of a significantly higher dividend tax rate for two years. Nonetheless, stronger corporate balance sheets (fueled by dramatically improved profitability and cash flows) and accommodating credit markets continue to motivate boards of directors to consider the benefits of a dividend recapitalization. A "dividend recap," as it is known, is a technique where some or all of the proceeds of a new debt offering are dividended-out to the equity shareholders.

The use of dividend recaps grew more in the 1st Q than ever before. Standard & Poor's Leveraged Commentary and Data ("S&P LCD") reports that approximately \$24.3 billion of debt was issued to pay dividends in first quarter 2011 versus \$9.4 billion in first quarter 2010, representing an increase of 158% (see Exhibit 1). This sudden burst of activity is notable because the market for dividend recapitalizations was virtually nonexistent during 2008 and 2009; however, dividend-related transactions increased substantially in the second half of 2010. In fact, according to Thomson Reuters LPC, middle-market sponsored dividend recapitalization volume in fourth quarter 2010 exceeded the volume of debt used to finance leveraged buyouts (see Exhibit 2). While some transactions in the second half of 2010 probably were motivated only by the threat of higher taxes, most market participants expect the volume of dividend recapitalizations to remain strong as the shareholders of private

equity-owned portfolio companies use the technique to extract cash while they wait for improved financial results and a stronger economy before attempting to access the IPO market or to sell assets.

Although conditions might be ripe for a leverage-fueled dividend, boards of directors should engage in certain best practices to minimize the risk of subsequent claims in connection with a



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recapitalization that goes awry. Many states' corporation laws, including Delaware's, require that dividends be paid out of surplus, defined as the fair value of a corporation's total assets minus the fair value of its total liabilities, less the corporation's capital. (Capital is generally defined as no less than the aggregate par value of a company's stock.) For private equity-owned portfolio companies, boards of directors must demonstrate that the portfolio company has sufficient "surplus" to pay the dividend. Other states require not only that the dividend be paid from surplus, but also that the company have the ability to service its debts incurred in the recapitalization as these debts become due. If a company's financial performance deteriorates post-transaction to the point of insolvency, the dividend recapitalization can be "set aside" under fraudulent conveyance laws, and the corporate directors could be subject to personal liability. A fraudulent transfer occurs when a transaction results in the counter-party receiving a benefit at the expense of unsecured creditors, and the company (i) at the time of the transaction is insolvent, or (ii) after the transaction either (a) has unreasonably small capital to continue its business or (b) is unable to repay its obligations as they become due.

Many boards hire an independent financial advisory firm to provide an opinion surrounding the recapitalization to assist them in the deliberation of whether to approve the dividend. Such an opinion can provide an independent and objective assessment of the company's value; it can assist in evaluating alternative scenarios; and it can be useful in defending against a lawsuit.

There are a few different types of opinions requested of a financial advisor in connection with a dividend recapitalization. The first is a capital surplus opinion to determine whether the fair value of the aggregate assets exceeds the stated liabilities and identified contingent liabilities by an amount that is greater than the par value of the outstanding capital stock after giving effect to the payment of the dividend. This type of opinion is typically based on the

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company's going concern enterprise value as estimated using standard valuation approaches rather than book value as defined by accounting rules. In practice, standard valuation approaches and methods include the income approach and the market approach, including selected public company analysis and selected transaction analysis. Once the company's going concern enterprise value is determined, the pro forma debt to be incurred as part of the dividend recapitalization (as well as other stated and identified contingent liabilities) is estimated to determine the resulting equity cushion. The size of the equity cushion, as a percentage of enterprise value, is a useful indicator of the magnitude of the dividend recap.

The second type of opinion is similar to a solvency opinion, in which it is determined whether (i) the fair value of the company's total assets exceeds the sum of its total liabilities (and identified contingent liabilities) after giving effect to the payment of the dividend AND (ii) the company has the ability to pay its indebtedness as it becomes due. This type of opinion applies sensitivity analysis and stress testing to determine whether a margin of safety exists if the company underperforms its projections. For example, projected cash flows should be adjusted to account for "downside scenarios" that attempt to quantify the impact of various adverse developments in the company. In addition, analyzing the company's ability to pay its indebtedness as it becomes due typically involves detailed credit analysis and a sophisticated understanding of today's complex fixed income markets to determine the company's ability to either repay or refinance its debt at maturity.

Finally, a financial advisor might be asked to provide a solvency opinion, which analyzes not only (i) and (ii) noted above, but also considers whether a company has sufficient capital to operate its business (i.e., "the reasonable capital test"). The reasonable capital test seeks to demonstrate whether a company will have a reasonable level of surplus capital following a dividend recapitalization. In practice, a financial advisor performs additional sensitivity analyses to ensure that the company has adequate equity, post-transaction, to support business and financial volatility. Although specific circumstances and state corporation laws may dictate the type of opinion that is advisable or legally required for a proposed transaction, a valuation or solvency-like opinion will provide support to the board of directors approving a dividend recapitalization.

Dividend recapitalizations can provide many benefits, including the ability of companies and private equity firms to "unlock" unrealized appreciation and to benefit from the tax shield attributable to the tax deductibility of interest payments on the newly issued debt. However, boards of directors should always follow best practices in order to reduce the risk of overleveraging a business and attracting litigation. Such best practices should include arranging for an independent financial advisor to assess the proposed transaction and its financial impact on the company.

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