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MERGER & ACQUISITION DEALS: WASHINGTON IS WATCHING

As fall turns to winter, the Washington climate toward mergers and acquisitions will chill. There is more than a little suspicion that the prospect of a White House change may cause a merger rush over the next six months. The political calendar has a lot to do with the mergers surfacing in headlines. On January 4, 2009, the merger-friendly Bush Administration may be replaced by a new Administration that will appoint Justice Department, FTC, and FCC officials who follow more stringent antitrust definitions about mergers involving dominant competitors. Time is running out, and as the savvy say in Washington, "Vote when you've got the votes."

A google of people on Planet Earth may use Google (**GOOG**) to search the Internet, but as far as its Washington critics are concerned it is just a large advertising company trying to corner the market. Opponents, including Microsoft, plan to stop Google from buying DoubleClick by convincing the Federal Trade Commission (FTC), which has the power to block the merger, that the purchase will lead to an off-the-charts amount of market concentration in online advertising. A favorable FTC ruling could depress valuations of the competitors of Google and DoubleClick, including Yahoo! (**YHOO**), ValueClick (**VCLK**), Digital River (**DRIV**), and also advertising companies such as Lamar Advertising (**LAMR**), Catalina (**POS**), Omnicom (**OMC**), Monster Worldwide (**MNST**), and Interpublic Group (**IPG**), which may have no choice but to pony up more when placing online ads for its clients. Large online advertisers like Ebay (**EBAY**), which is the largest user of search ads, also might face higher costs and lower profits.

This is not the only controversial merger that Washington is weighing. Shareholders want to know if the Federal Communications Commission (FCC) will bless the marriage of the two dominant radio satellite broadcasters, Sirius (**SIRI**) and XM (**XMSR**). Other CEOs believe the last sand is running through the hour glass; more controversial merger announcements may be in the offing.

Wall Street compensation for the biggest dealmakers is on the political radar, too. Time may also be running out for private equity companies like Blackstone (**BX**) and Fortress Investment Group (**FIG**). The top tax writers in the Senate, Max Baucus (D-MT) and Chuck Grassley (R-IA), and the Chairman of the House Ways and Means Committee, Charlie Rangel (D-NY) plan to raise their taxes before the year ends.

Preventing "Googleopoly"

Google is in the electronic highway billboard business, disguised as a search engine. Whenever a consumer uses Google to search for a good or service, links pop up on the right hand margin, with several companies offering to sell what the computer user is searching for. Those links did not get there by accident. The company bidding the most gets the top position on Google's billboard and other successful bidders also have their links displayed on the billboard

albeit at less desirable locations. Given its global dominance as the "best search engine," Google captures 76 percent of U.S. "search ad" revenue. Trailing far behind is Yahoo! with 16 percent, then Microsoft, Ask.com and AOL collectively sharing 8 percent. According to SEC filings, globally, Google earned $6.3 billion in search ad revenue, approximately 49 percent of the 2006 $12.9 billion total, with Yahoo! capturing 25 percent.

Google also has the skill to place "contextual ads" for advertising clients. Its computers continuously scan the content of the world's web pages, and so computer users can use Google to search for information from these pages, and advertisers can reach consumers potentially interested in their products. A web page publisher running a story on NASCAR races, for example, might allow Google to place an ad for a beer company on the page. Google will bill the brewer, then split this advertising revenue with the web page publisher, keeping 70 percent of the fee. In the business of contextual advertising, DoubleClick is one of Google's key competitors.

DoubleClick dominates the Internet world in the third type of online advertising, "graphics advertising," a euphemism for placing ads on web pages users visit based on its knowledge of where they have gone previously on the Internet. If you or your spouse uses your computer to check out merchandise offered by Saks and Bloomingdales' on their web sites, your computer is "cookied" by these two merchants, providing a record of every visit someone using your computer makes to these sites. The merchants make this information available to their business partner, DoubleClick. By aggregating all the "cookie" information it has on computer users, DoubleClick can profile them in ways useful to advertisers. If you are known to be a stamp collector, for example, DoubleClick may send you an ad from a stamp merchant that is its client even if you are reading the *Wall Street Journal*'s editorial page online at the time.

The proposed Google-DoubleClick merger will increase the industry concentration in Internet contextual advertising, and create a single dominant player in both search advertising and graphics advertising. Critics warn this "Googleopoly" will crush Internet advertising competition. In addition, the prospect of one company having the ability to profile a majority of all web surfers by combining both individual web search histories *and* web page visit histories gives privacy advocates the "willies." So, political opponents are lining up to prevent the creation of this new giant.

For its part, Google says the merger is pro-consumer since the merged company will send ever more accurate and useful advertising to consumers. It plans to defend and extend its market position also by moving into cell phone searching and advertising. As a strategic matter, Google is right to press forward on a controversial deal that requires federal approval before the sympathetic judges, the Bush's FTC Commissioners, retire.

Anti-trust Merger Rules Enter Cyberspace

Critics of the Google DoubleClick merger include analysts affiliated with the bipartisan American Enterprise Institute/Brookings Foundation Joint Center for Regulatory Studies. Robert Hahn and Hal Singer are convinced that the combination of Google and DoubleClick would be an anti-trust violation. Since 1982, the Federal Trade Commission has used the Herfindahl-

Hirschman Index (HHI) index to calculate if a proposed merger should be subject to heightened anti-trust scrutiny. Examples of how to calculate this widely used index abound; we found one at www.unclaw.com/chin/teaching/antitrust/herfindahl.htm. Any industry with an existing HHI index of 1800 or higher is considered "highly concentrated," and further concentration has potential to harm industry customers due to "market power."

Such mergers may still proceed under modern anti-trust theory, provided the FTC believes that barriers to entry in the highly concentrated industry are modest. In effect, anti-trust enforcers believe that the *threat* of entry can keep even some monopolies from exercising pricing power because other companies can enter and compete easily. If Google and DoubleClick merge, the online advertising market will see its HHI grow from 2,051 to a whopping 3,382, according to Hahn and Singer (see http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1016189 for an abstract of their work). Most analysts believe that the barriers to entry in the search engine/online advertising market are formidable. If the FTC agrees they are and accepts that the $23 billion, and rapidly growing, global online advertising is a specialized market, not a piece of overall advertising, then they will find that the proposed Google/DoubleClick combination would create "market power" and take steps to prevent it.

The Senate Judiciary Committee held hearings on September 27, 2007 on Google's proposed DoubleClick acquisition, heightening the visibility of this proposed merger. Microsoft testified against Google on anti-trust grounds, which brought wry smiles to many who learn this. The merits of the anti-trust case and growing opposition to the merger make it less likely that the FTC will rubber stamp the deal. The FTC could prohibit cross sharing of data internally as a condition of allowing the deal to move forward, for example. Or, it could require that one or both companies divest themselves of their contextual advertising divisions. Maybe nothing can stop Google's surging stock price, but it is hard to see how adverse action by the FTC will do it good. Expect less than a complete FTC win by Google and consider an outright defeat a real possibility.

<u>Satellite Broadcasters and Others May be Lining Up Before It is Too Late</u>

Regardless of which party dominates Washington, most mergers analyzed by the FTC and DOJ fit anti-trust analysis criteria, and are approved. According to the AEI-Brookings Joint Center for Regulatory Studies, the Administration with the highest record of merger challenges since 1981, that of George Bush Sr., objected to only 2.3 percent of the cases brought before the DOJ and FTC. Although the technical analysis of industry concentration changes little when a new Chief Executive sits in the Oval Office, political sympathies matter when the companies involved are in a highly concentrated industry. For such companies, the time to merge is now.

In February, just a month after Federal Communication Commission (FCC) Chairman Kevin Martin stated that combining the two radio satellite giants into one entity would not be allowed under current FCC rules, Sirius and XM Satellite announced plans to merge. This deal faces sizable hurdles. First, a majority of the FCC Commissioners must vote to change the satellite ownership rule. To gain support at the FCC, XM and Sirius have agreed to freeze monthly subscription fees plus allocate bandwidth for public interest programming. When the negotiations are based on trade-offs to get to a deal, their strategy may work. If they win in this

arena, they advance to the Department of Justice where the rules change, and approval depends on proper definition of the "relevant market." Here, advocates for the $4.6 billion transaction must argue that satellite broadcasters operate in a competitive arena, providing service and quality well above that of "free" AM/FM radio stations to justify their monthly subscription fees. In this way, they draw the industry borders wide enough to overcome concentration concerns and produce a HHI index low enough to pass standard horizontal merger analysis.

Major players in energy, drug production, chemicals manufacturing, telecommunications and cable also may be eyeing acquisition candidates because they are high-profile players in concentrated industries and may want the FTC to vote while "they have the votes."

For Private Equity Managers, Washington Matters On Taxes, Too

Time is running out to prevent 23 million taxpayers from having to write unexpected large checks to the IRS in seven months as these unsuspecting souls, earning $75,000 or more, find themselves falling victim to a parallel tax system initially designed for very rich tax evaders. The pressure to act is heightened because 2008 will be an election year.

Taxpayers have to pay the greater of the amount under the regular income tax or the Alternative Minimum Tax (AMT); currently 4 million taxpayers pay the AMT. The major problem is that the standard deduction under the AMT for married couples will drop from $62,550 to $45,000, forcing another 19 million onto the rolls because AMT liability would now exceed regular income tax liability, unless Congress extends the $62,000 AMT standard deduction. Under the "pay as you go" tax rules adopted by Congressional Democrats, Congress must find $50 billion to "pay for" an AMT standard deduction extension for just 2008. The ten year cost of limiting the AMT rolls to 4 million people is $1 trillion.

One political problem Congressional Democrats have selling AMT reform is that the 19 million new taxpayers that will be hit next year if nothing is done do not know it. Therefore, it is hard to earn credit with such voters for saving them from a threat they did not know existed. As a consequence, Ways and Means Committee Chairman Rangel (D-NY) reportedly is planning to couple AMT reform with small tax cuts that would be distributed widely. Increases in the earned income tax credit and child tax credit may be offered, for example. This will create a much larger community of known AMT reform "winners." It also means that Rangel must find more than $50 billion by year-end to pay for AMT reform and the widely spread minor tax cuts.

Congressional Democrats have few ideas on how to cut spending. This makes it especially untimely to be viewed as someone who is not paying his fair share of taxes. Critics of private equity managers believe that current tax laws are too lenient on the treatment of "carried interest." Private equity managers typically earn management investment fees known as "2 and 20". They collect annually 2 percent of the assets placed in their care by their investors as management fees and also 20 percent of profits that the funds earn each year. These profits can take the form of ownership interest in the funds themselves. When private equity managers sell these "carried interests" at least a year later, they now qualify as long-term capital gains subject to a 15 percent maximum tax rate. The critics believe all of the fees earned by money managers by investing other people's money are ordinary income and should be taxed accordingly, up to

35 percent. The dispute is worth billions to a small number of people. The most vulnerable private equity managers of all are those that are publicly-traded. The Senate's top writers, Max Baucus (D-MT) and Chuck Grassley (R-IA), have already stated that they believe publicly-traded private equity managers should lose their carried interest preference. Private equity companies Blackstone (**BX**) and Fortress Investment Group (**FIG**) have a "Scarlet T," for taxes, on their backs. Investors who purchase publicly-traded common units in their partnerships are also buying the "Scarlet T-shirts" as well.

As Democrats scour the landscape for ways to "pay for" AMT reform, the recurring rumor is that they will propose limiting its reach only to those making $250,000 or more, but intensifying the sting of this new SuperAMT by eliminating capital gains and dividend exceptions. Under one plan Rangel is reviewing, *anyone* subject to the new tougher AMT would lose capital gains and dividend preferences. Such income could be taxed at 26 percent or higher, not the 15 percent that now applies. In this case, owners of Blackstone and Fortress units lose even if carried interest tax rules are not explicitly revised. This will be unwelcome news to all of the one or two million who would pay the new SuperAMT, and almost certainly many of those who own interest in Blackstone and Fortress. Such a broad assault on investor tax cuts might whack the entire stock market.

The Bush Administration has said it agrees with Congressional Democrats that AMT reform must be "paid for," which means that private equity managers may not have a friend when they need one most at 1600 Pennsylvania Avenue – even before January 2009.

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