

Issue Commentary

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MAY 23 2012

An Examination of the Risks Associated With Abnormally Low Effective Tax Rates (ETRs)

With one of the highest statutory corporate income tax rates in the world (35%), we would expect U.S. companies to attempt to exploit regulatory loopholes in order to minimize tax burdens. Our analysis indicates that some companies may be more aggressive than others in their efforts to reduce their effective tax rates. In this *Issue Commentary* we examine tax footnote disclosures for a sample of firms to gain insights into strategies that these firms may have used to reduce their tax provisions, including shifting profits to lower-tax jurisdictions, under-reserving for contingent tax liabilities, or releasing previously accrued valuation allowances and uncertain tax reserves. We also analyze the sustainability of these strategies in order to identify firms that may see their ETRs rise in the future.

Five of the six sample firms reviewed in our report (COO, EBIX, HBI, SWK, and TFX) report ETRs that appear out of line with peers and the rest of the domestic, publicly traded universe. *Ceteris paribus*, we expect these firms to face a greater risk of unexpected, large tax settlements, causing their tax provisions to rise disproportionately in the future. To further illustrate this risk, the other firm reviewed (CFN) reported unusually low ETRs before 2010, and then large, unexpected increases in their future tax provisions.

The Cooper Companies Inc. (COO)

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COO reported that 47.1% of 2011 revenue was generated in the U.S., yet only 2.8% of pre-tax income was allocated to the U.S. Similarly, the company allocated 48.0% (-13.9%), 47.7% (21.2%), and 49.1% (-0.5%) of revenues (pre-tax income) to the U.S. during FYs 2008, 2009, and 2010, respectively. Our concern is that the geographic mismatch of revenues and profits may lead to a larger-than-expected tax settlement with the IRS.

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Ebix Inc. (EBIX)

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The company's ETR greatly differs from its peers, at just 2.8% over the period 2008-2011 versus a peer group median of 33.8% over the same period. The unusually low tax rate seen over the last 10 years appears to be due to a consistent release of its DTVA and other tax strategies, such as profit shifting. Accordingly, we question whether the firm's unusually low ETR is sustainable.

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Hanesbrands Inc. (HBI)

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During 2011, HBI reported one of the largest discrepancies between U.S. revenues (87.5% of total revenue) and pre-tax U.S. income (7.8% of total pre-tax income). In fact, we find that this trend has persisted over the past four years. But with HBI suffering from cash-flow weakness and a high debt load, we are concerned that a repatriation of its foreign earnings may be necessary and could dramatically increase its ETR.

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Stanley Black & Decker Inc. (SWK)

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SWK's tax rate has declined in a stair-step fashion over the last four years, falling from 24.7% in 2008 to just 11.4% in 2011. In addition, the firm's ETRs appear unusual relative to the peer-group median of 32.9% over the last four years. An increasing proportion of profits attributed to foreign operations and reportedly favorable IRS settlements explain the majority of the decline in the ETR. Ultimately we believe these trends will prove unsustainable, leading to a rise in the firm's ETR.

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Teleflex Inc. (TFX)

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TFX has also posted a stair-step reduction in its ETR from 31.7% in 2008 to 18.2% in 2011. Much of the decline appears related to an increasing benefit from the allocation of profits to lower-tax jurisdictions. In this regard, the company posted a pre-tax loss of \$8.2 million for U.S. operations during 2011, implying a -1.0% pre-tax margin. An IRS review of 2008 through 2011 taxable years is underway and could cause the ETR to revert.

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CareFusion Corp. (CFN)

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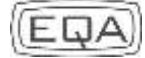
Also after a third-party analysis of its tax positions in 2010, CFN greatly increased its income-tax reserve to guard against potential unfavorable settlements with the IRS. As a result, the firm's ETR surged from an average of 18.5% over the period 2007-2009 to 53.7% in 2010, before returning to a potentially sustainable 29.9% in 2011. Even still, its tax situation appears to be quite complex, and more accruals may be required.

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The Sources and Consequences of Potentially Unsustainable ETRs

SITUATIONS THAT LEAD TO A REDUCTION IN A FIRM'S EFFECTIVE TAX RATE (ETR)

Because the U.S. Tax Code has evolved, in part, as a mechanism to shape economic and political agendas, a company can reduce its current tax bill simply by taking advantage of benefits provided by the government itself. For example, the bonus depreciation provisions of the U.S. Tax Code are designed to encourage companies to invest in new plants and equipment. Likewise, the government often uses tax credits to encourage investments in new jobs, alternative energy, and so on.

In the case of bonus depreciation and other forms of accelerated deductions, the company receives a temporary benefit of approximately \$0.35 for every \$1.00 in accelerated deductions. As a result, accelerated deductions lead to a “temporary difference” between book and tax income. However, there is no effect on the firm’s effective tax rate (ETR), as the difference between book and tax depreciation (and the related difference between the firm’s tax provision and its payments) ultimately reverses over time.

On the other hand, tax credits generally result in a \$1.00 reduction in taxes for every \$1.00 invested. As a result, tax credits generally create permanent differences between book and tax income.

In addition to tax credits, there are a number of other scenarios that may also lead to a reduction in a firm’s ETR. However, these are largely outside of the scope of our analysis. Therefore, for brevity we discuss only one additional scenario that may reduce a firm’s ETR—so-called “tax-planning” strategies.

THE RELATIONSHIP BETWEEN “TAX-PLANNING” STRATEGIES AND “UNCERTAIN TAX POSITIONS”

Currently the United States possesses one of the highest corporate tax rates at 35.0%. Not surprisingly this has caused many domestic companies to adopt “tax-planning” strategies designed to yield much more material, permanent reductions in their tax payments. While a complete discussion of tax-planning strategies is beyond the scope of our analysis, for illustration purposes, we briefly explain one of the more common techniques used by publicly traded U.S. firms—international transfer pricing.

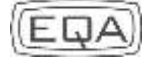
When entities in a consolidated company conduct business with one another, transfer prices must be established in order to record the value of business dealings on the books of each of the related entities. In theory, transfer prices should approximate the prices that would be expected in an arm’s-length transaction. However, in reality there is considerable discretion involved in establishing transfer prices. The discretionary nature of transfer pricing can be used by multinational firms to shift profits to lower-tax-rate jurisdictions. For example, a company with manufacturing operations in a tax-haven location can transfer goods to its U.S. sales operations at inflated prices, thereby increasing





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(decreasing) the level of profits reported in the tax haven (the United States).

To the extent that tax-planning strategies (such as international transfer pricing) are legally allowed, they often result in a permanent reduction in the firm's tax obligations. As such, they often reduce the firm's ETR, at least in the short run. However, there can be no guarantee that the reduction is sustainable. In this regard, all domestic firms are subject to IRS audits. And one key area of examination is the allocation of profits to overseas locations. In cases where profit allocations can be shown to be a result of abusive tax-planning strategies, the IRS can impose additional taxes and penalties.

Even if the firm's tax-planning strategies pass IRS muster, there can be no assurance that its foreign-sourced profits will escape U.S. taxation indefinitely. If the company later decides to repatriate foreign profits back into the U.S., in general it must pay taxes at the full 35% statutory rate less a tax credit for foreign taxes previously paid.¹

ACCOUNTING FOR INCOME TAXES IN GAAP FINANCIAL STATEMENTS

The Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48) in 2006 to address the inherent uncertainty related to income tax assets and liabilities and prescribe a recognition threshold and measurement attributes for the financial-statement recognition of uncertain tax positions (i.e., tax-planning strategies that may be reversed upon audit and, if applicable, subsequent tax-court proceedings). FIN 48 also provides guidance on the accounting for interest and penalties that may be assessed on positions ultimately denied by tax authorities.

The evaluation of a tax position in accordance with this interpretation is a two-step process that involves:

1. Recognition, in which the company determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes; and
2. Measurement, wherein a tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. In general, an uncertain tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement.

With respect to disclosure, a firm also must provide a reconciliation of its reserve for uncertain tax positions in its annual filings, including additions (expenses),

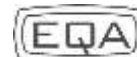
¹In 2004, the U.S. government enacted a repatriation tax holiday, which was intended to encourage multinational U.S. companies to bring back cash stored overseas to spur economic growth and job creation. It is unclear whether the goal was met, as many economists and analysts have opined that a majority of the repatriated earnings went to upper management's bonuses and dividend payments instead of job creation. Regardless of whether the goal was met, Gradient believes that repatriation holidays are unlikely to be perceived favorably in the current political and economic environment, making it all the more problematic for firms that need (or want) to repatriate foreign earnings at some point.





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reductions due to changes in estimates (reversals of previously accrued expenses), settlements with the IRS, and reductions as a result of a lapse of the applicable statute of limitations (also essentially reversals of previously accrued expenses). The company must also disclose the total amount of unrecognized tax benefits that, if recognized, would affect the ETR, penalties recognized in the income statement, and the total amounts of interest and penalties recognized in the balance sheet. Finally, the company must disclose the total amount of unrecognized tax benefits that will significantly change within 12 months of the reporting date and a description of tax years that remain subject to examination by major tax jurisdictions.

FIN 48'S EFFECT ON THE INCOME STATEMENT

As noted earlier, a major uncertainty in regards to taxes has to do with the "correct" amount of taxes due on income accrued in the current year. This is not an exact science by any means. Moreover, to the extent that a firm faces a materially unfavorable settlement with the IRS, it may cause an unexpected increase in the firm's tax provision in the year of settlement. In this regard, the firm may not have sufficient reserves to offset the adverse settlement. And even if it does, it may still have to accrue an unexpectedly large expense to replenish a depleted reserve.

Finally, Gradient believes that impact of unfavorable settlements has not yet been realized given that most firms adopted FIN 48 in CY2007, and for many firms, the IRS is just now beginning to audit the post FIN 48 period (i.e., tax years 2007 and beyond).

HOW RESERVE REVERSALS ALSO MAY CONTRIBUTE TO AN UNSUSTAINABLY LOW ETR

One final issue that is worth considering in the evaluation of ETRs and underlying tax issues is what occurs when a firm releases excess accruals from either its reserve for uncertain tax positions or its deferred tax valuation allowance (DTVA).

The recording of deferred tax assets (DTA) and deferred tax liabilities (DTL), *do not* affect the firm's ETR. These assets and liabilities represent timing differences that determine when a company actually pays cash to the IRS. However, when there is uncertainty as to whether a firm will be able to utilize a DTA, it must record an allowance to reduce the reported valuation on its balance sheet. For example, net operating losses (NOLs) are DTAs that a company can use to reduce future tax obligations. However, when there is uncertainty as to whether a company will have sufficient future taxable income to allow it to use its NOLs, the company must set up a valuation allowance (DTVA) that reduces the net value of these NOLs to the amount that it believes can be used in the future.

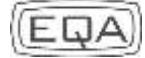
Just like with any other reserve, income can be released through this account as management becomes more confident management regarding future profitability





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for the company.² An interesting fact about the DTVA is that an investor would be able to judge management’s estimates of future profitability just based on whether the DTVA increased or decreased in value. For example, if management guided to profitability in future quarters but at the same time increased its DTVA, this would create conflicting signals regarding management’s thoughts on future earnings.³

Releases of income through the DTVA provide an “exponential”-type effect on profitability because as the business becomes more profitable, income tax expense falls for that period. This can also work in the opposite direction, where we could see a company with an unexpected loss for that period having to show an effective tax rate well above the expected 0% because of a replenishment of the DTVA.

We also view the drawdown of the DTVA as an unsustainable tax strategy because once the reserve is depleted the company’s ETR will shoot back up to normalized levels (see discussion on EBIX, on Page 9).

Highlighting Six Firms with Potentially Unsustainable ETRs

SELECTION OF FIRMS FOR EXAMINATION

In order to illustrate the risks that we believe may face firms with potentially aggressive tax-planning strategies, we identified six firms (COO, EBIX, HBI, SWK, and TFX) with unusually low tax rates relative to both peers and the domestic, publicly traded universe as a whole. In most cases, these firms also exhibit a stair-step (or nearly stair-step) reduction in their ETRs over the past several years. *Ceteris paribus*, we expect these firms to face a greater risk of unexpected, large tax settlements with the IRS, causing their tax provisions to rise disproportionately in the future. For each of the above five firms, we also examined tax footnote disclosures to gain insights into strategies that may have been used to reduce their tax provisions, including shifting profits to lower-tax jurisdictions, under-reserving for contingent tax liabilities, or releasing previously accrued valuation allowances and uncertain tax reserves.

To further illustrate the risks faced by the first five firms reviewed in our study, we also examine the firm CareFusion (CFN), which reported unusually low ETRs before 2010 but has since reported large, unexpected increases in its 2010 and 2011 tax provisions. We also examine the share-price performance of the company following the realization that their prior tax-accounting policies had resulted in an understatement of their true tax obligations.

² In our experience with tax managers and auditors, normally we would see a release of the full DTVA if management was confident in the company’s profitability for the next three years.

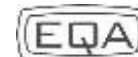
³ Assuming none of the increase in VA was due to acquisition-related items.





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The Cooper Companies Inc. (COO)

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INDUSTRY	Medical Instruments & Supplies
PRICE	\$85.87 (05/22/12)
MARKET CAP	4.07 billion
ENT. VALUE	4.49 billion
P-E RATIO	21.91
EV/REVENUE	3.29
DEBT/EBITDA	1.18
SHORT INTEREST	2.2%
DAYS TO COVER	1.9

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COMPANY DESCRIPTION

The Cooper Companies Inc. (COO) engages in the provision of medical devices for healthcare professionals worldwide. It offers spherical lenses that correct near- and far-sightedness; toric multifocal lenses, which correct near- and far-sightedness, as well as address various complex visual defects, such as astigmatism and presbyopia; and aspherical, toric, and multifocal lens products. The company also develops, manufactures, and markets medical devices, diagnostic products, and surgical instruments and accessories that improve healthcare delivery to women in various clinical settings. It markets its products through sales representatives, independent agents, and distributors. COO was founded in 1980 and is based in Pleasanton, Calif.

AFTER A PERSISTENT DECLINE, THE ETR HITS A 10-YEAR LOW OF JUST 9.0%

COO has benefited from a persistent decline in its ETR from 32.7% in 1999 to just 9.0% in 2011 (see Table 2, Page 8). Moreover, the median ETR for the last 10 (five) years was just 14.5% (12.4%). This greatly differs from the firm's peer group, which reported a median ETR of 28.6% (29.0%) over the last 10 (five) years. The company's ETR was 1,418 bps lower than the peer-group median over the 2002–2011 period.

GEOGRAPHIC ALLOCATION OF PRE-TAX INCOME APPEARS TO EXPLAIN COO'S ABNORMALLY LOW ETR

According to the firm's 10K filings, the "difference between Foreign Tax and U.S. Tax" explains most of the difference between the statutory tax rate and COO's ETR. Since 2002, the company has been reducing its income-tax provision significantly through the use of profit shifting to foreign subsidiaries. For example the company reduced its statutory rate by 11.5%, 12.4%, 16.3%, 26.1%, and 34.4% in 2002, 2003, 2004, 2005, and 2006, respectively, for an average reduction of 20.1% during that time period. This trend continued into recent years, barring a loss in 2007, when the firm reduced its statutory rate by 21.2%, 24.5%, 27.3%, and 29.5% in 2008, 2009, 2010, and 2011, respectively. On average, pre-tax profit allocations to foreign subsidiaries reduced the firm's ETR by 25.6% over the period 2008 to 2011.

We also find that COO's geographic allocation of pre-tax income appears at odds with the location of its assets and the source of its revenues. On average, COO reported that 51.9% of its assets were located in the United States over the period 2002–2011. Additionally, the company reported that 52.4% of its revenues were sourced in the United States over this same 10-year period. However, on average the company allocated just 12.1%⁴ of pre-tax profits to the United States while the proportion of pre-tax income allocated to the United States ranged from -30.1% to 51.4%.

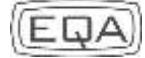
⁴ This does not include FY2007 because of the loss.





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IRS ISSUES NOTICE OF DEFICIENCY FOLLOWING AUDIT OF NET OPERATING LOSS CARRY-FORWARDS

According to the firm's 2011 10K, on 04/01/11 the IRS issued a Notice of Deficiency in connection with its audit of COO's federal net operating loss carry-forwards recognized in 2005 and 2006. Accompanying disclosures made in the 2011 10K state the following:

The Notice asserts that the Company is subject to additional taxes due to a proposed adjustment under the anti-deferral provisions of Subpart F of the Internal Revenue Code. If sustained, such taxes should be offset by the Company's existing federal net operating loss carryforwards leaving a \$1.2 million balance of proposed taxes owed. The Company intends to defend its positions taken in its income tax returns vigorously. However, if the IRS's contentions were sustained, the Company's existing federal net operating loss carryforwards could be materially reduced, which could result in a material adverse effect on the Company's future net income. We are also subject to the examination of our income tax returns by other tax authorities and the outcome of these examinations could have a material adverse effect on our operating results and financial condition.

UNCERTAIN TAX RESERVE APPEARS UNDERFUNDED

COO has not disclosed any settlements within the past four years as its tax returns for the years 2005–2010 are under review by the IRS. As of 10/31/11 the company reported a reserve of \$27.4 million (or 5.4% of total pre-tax income for the period 2008–2011) to guard against IRS settlements. Thus, we question whether COO's uncertain tax reserve will be sufficient given (1) the mismatch between its geographic allocation of pre-tax profits and the geographic attribution of assets and revenues and (2) the number of years left to be reviewed by the IRS.

To provide additional context as to materiality, consider the following. Had the company reported an ETR equal to the peer median in 2008, 2009, 2010, and 2011, we estimate that EPS would have been reduced by approximately \$0.18 (12.3%), \$0.46 (20.9%), \$0.53 (21.8%), and \$0.73 (20.1%), respectively.

(See table, COO Revenue, PP&E, and Pre-Tax Earnings Allocation, *next page*)





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Table 1. COO Revenue, PP&E, and Pre-Tax Earnings Allocation

12M Ended:	2011	2010	2009	2008	2007
U.S. % of total revenue	47.1%	49.1%	47.7%	48.0%	49.4%
International % of total revenue	52.9%	50.9%	52.3%	52.0%	50.6%
U.S. % of total PP&E	61.3%	60.1%	62.3%	62.3%	49.3%
International % of total PP&E	38.7%	39.9%	37.7%	37.7%	50.7%
U.S. % of total pre-tax income	2.8%	-0.5%	21.2%	-13.9%	-1,474.9%
International of % total pre-tax income	97.2%	100.5%	78.8%	113.9%	1,574.9%

Table 2. COO's Reconciliation of Statutory Tax Rate with Peer-Group Comparison

Fiscal Year Ended:	2011	2010	2009	2008	2007
Statutory tax rate	35.0%	35.0%	35.0%	35.0%	35.0%
State income taxes	+0.1%	+0.2%	+1.5%	-1.0%	+41.0%
Tax impact of foreign subsidiaries	-29.5%	-27.3%	-24.5%	-21.2%	+1,426.5%
R&D credit	-0.6%	-0.4%	0.0%	0.0%	0.0%
Nontaxable gain	0.0%	0.0%	-0.7%	0.0%	0.0%
Incentive stock options	-0.1%	0.0%	-0.1%	+0.3%	+121.8%
Tax accrual adjustment	+3.7%	+2.1%	+1.5%	+0.1%	+209.6%
Other	+0.3%	-0.2%	-0.2%	+0.3%	-68.4%
COO effective tax rate	9.0%	9.3%	12.4%	13.5%	1,765.5%
Peer median ⁵	27.3%	29.0%	30.8%	24.1%	30.8%
COO vs. peer median	-18.3%	-19.7%	-18.4%	-10.6%	1,734.7%

Table 3. COO's Reserve for Uncertain Tax Positions (\$ in millions)

Fiscal Year Ended:	2011	2010	2009	2008	2007
Beginning balance	\$19.7	\$15.9	\$19.4	\$24.4	NA
Additions for current year	\$8.9	\$5.2	\$5.7	\$1.3	NA
Additions for prior year	-	-	-	-	NA
Reductions for prior year	-	-	-	-	NA
Settlements	-	-	-	-\$0.4	NA
Expiration of the statute of limitations	-\$1.2	-\$1.4	-\$9.2	-\$5.9	NA
Ending balance	\$27.4	\$19.7	\$15.9	\$19.4	NA

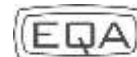
⁵ Peers include Baxter International Inc. (BAX), CR Bard (BCR), Haemonetics Corp. (HAE), Hill-Rom Holdings, Inc. (HRC), Mettler-Toledo International, Inc. (MTD), Thoratec Corp. (THOR), and Young Innovations Inc. (YDNT).





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Ebix Inc. (EBIX)

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INDUSTRY	Business Software & Services
PRICE	\$18.68 (05/22/12)
MARKET CAP	681.28 million
ENT. VALUE	693.35 million
P-E RATIO	10.48
EV/REVENUE	4.01
DEBT/EBITDA	0.17
SHORT INTEREST	29.4%
DAYS TO COVER	33.2

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COMPANY DESCRIPTION

Ebix Inc. (EBIX) provides on-demand software and e-commerce solutions to the insurance industry. The company operates data exchanges, which connect multiple entities within the insurance markets and enable the participants to carry and process data from one end to another in the areas of life insurance, annuities, employee health benefits, risk management, workers compensation, and property and casualty insurance. Additionally, EBIX provides software development, customization, and consulting services to various companies in the insurance industry, such as carriers, brokers, exchanges, and standard making bodies. EBIX was formerly known as Delphi Systems Inc. and changed its name in December 2003. EBIX was founded in 1976 and is based in Atlanta, Georgia.

SINGLE DIGIT ETR IN EIGHT OF THE LAST 10 YEARS

EBIX has benefited from a single-digit effective tax rate (ETR) in eight of the last 10 years. Moreover, during the last 10 years the firm's median annual ETR was just 5.1%, with a range of 1.1% to 14.8%.

EBIX's unusually low tax rate contrasts sharply with the ETRs reported by peers (see Table 5, Page 11). Additionally, the firm had the lowest ETR of its peers in nine of the last 10 years, with an average difference of 2,860 bps below the peer median.

CAUSES OF THE FIRM'S UNUSUALLY LOW ETR

Since 2002 EBIX has benefited from a persistent release of its deferred tax valuation allowance (DTVA). From 2002 through 2009 the release of EBIX's DTVA reduced the firm's tax rate in a range from 9.8% to 33.1%, with an average annual reduction in its ETR of 1,890 bps. The benefit declined to 4.1% in 2010 and 9.0% in 2011, after which the account was reported to be completely depleted (i.e., reduced to zero). As a result, Gradient believes that the firm is unlikely to benefit from additional DTVA releases in the future.

Though the firm's DTVA reserve releases have diminished somewhat in recent years, EBIX has reported increasingly larger benefits from the allocation of profits to subsidiaries in lower-tax jurisdictions. Specifically, the tax impact of foreign subsidiaries reduced the firm's ETR by 20.3%, 19.5%, and 25.6% in 2008, 2009, and 2010, respectively, for an average reduction of 21.8% over the last three years. It further appears that the firm may have realized a similar benefit in 2011, though it was reported in the "other" line item in its reconciliation of its ETR to the statutory rate. According to disclosures in the 2011 10K, the benefit reported within the "other" line was driven primarily by "Tax holiday – India (Permanent Difference)" and "Passive income exemption – Sweden (Permanent Difference)." These benefits reduced the firm's 2011 ETR by 15.1% and 3.0%, respectively.

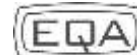
Though the company described the tax savings attributed to business in India and Sweden as "permanent differences" (i.e., income items that will never be taxed), we caution that the IRS may still tax any amounts repatriated back into the





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United States from these countries. Moreover, even if the company never repatriates any of these foreign earnings back into the United States, there can be no guarantee that the IRS will agree with the company's attribution of income to these lower-tax jurisdictions. Thus, if the IRS disagrees with the allocation, the company may still incur a material amount of additional U.S. income taxes on the underlying income.

ALLOCATION OF TAXABLE PROFITS APPEARS AT ODDS WITH LOCATION OF PP&E AND SOURCING OF REVENUES

We have a number of concerns about the sustainability of EBIX's unusually low ETR. One cause for concern is that the firm's geographic allocation of pre-tax profits over the period 2008–2011 appears at odds with the geographic location of its assets and the sourcing of its revenues. According to EBIX's 10K filings, the United States accounted for just 25.8% (between 16.4% and 36.4%) of its pre-tax profits over the last four years. In contrast, the firm's 10K filings for the same period indicate that the United States accounted for an average (range) of 70.5% (64.7%–75.1%) of total revenue. In addition, the company reported that 67.6% (62.4%–74.6%) of its total PP&E was located in the United States during the last four years. In our view, these disparate trends may be indicative of a tax position that could draw scrutiny from IRS auditors.

To further put this issue in perspective, during 2011 EBIX reported pre-tax earnings in the United States of only \$12.0 million on domestic revenue of \$120.8 million, implying a pre-tax margin of just 10.0%. This contrasted greatly with foreign pre-tax earnings of \$61.5 million on foreign revenue of only \$48.1 million, for a pre-tax margin of 127.8%. The fact that the company reported pre-tax margin well over 100% of sales also appears to be a potential red flag.

UNCERTAIN TAX RESERVE MAY BE DANGEROUSLY LOW

One final reason for concern about the sustainability of EBIX's reported ETR is the fact that its uncertain tax reserve is far less than that of peers. In fact, EBIX's uncertain tax reserve was one of the lowest of the companies analyzed, at an average of 1.6% of total pretax income for the last four years.

A review of EBIX's 10K filings indicates that, to date, the company has not offset any settlements with the IRS against its uncertain tax reserve. However according to the 2011 10K the IRS has not yet reviewed years 2007 to 2011—the periods in which the company appears to have taken a more aggressive position with respect to its allocation of taxable income to foreign subsidiaries.

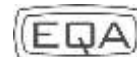
If the firm receives an unfavorable outcome upon review of its 2007–2011 tax returns, it may not have a sufficient reserve to offset the assessment. As a result, Gradient is concerned that the firm's income-tax provision could skyrocket unexpectedly. In this context, had the company had reported an ETR equal to the peer-group median in each of the last four years, we estimate that EPS would have been reduced by approximately \$0.42 (44.7%), \$0.55 (44.1%), \$0.67





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(39.7%), and \$0.70 (36.9%), respectively.

Table 4. EBIX Revenue, PP&E, and Pre-Tax Earnings Allocation

12M Ended:	2011	2010	2009	2008	2007
U.S. % of total revenue	71.5%	70.8%	75.1%	64.7%	70.5%
International % of total revenue	28.5%	29.2%	24.9%	35.3%	29.5%
U.S. % of total PP&E	74.6%	62.4%	70.6%	62.5%	81.3%
International % of total PP&E	25.4%	37.6%	29.4%	37.5%	18.7%
U.S. % of total pre-tax income	16.4%	23.0%	36.4%	27.6%	97.2%
International of % total pre-tax income	83.6%	77.0%	63.6%	72.4%	2.8%

Table 5. EBIX's Reconciliation of Statutory Tax Rate with Peer Group Comparison

Fiscal Year Ended:	2011	2010	2009	2008	2007
Statutory tax rate	35.0%	35.0%	34.0%	34.0%	34.0%
State income taxes	+0.8%	+0.6%	+1.2%	+1.4%	+0.8%
Tax impact of foreign subsidiaries	-5.6%	-25.6%	-19.5%	-20.3%	1.0%
Change in valuation allowance	-9.0%	-4.1%	-18.2%	-9.8%	-33.1%
Uncertain tax matters	+0.2%	0.0%	+5.1%	+1.2%	0.8%
Permanent differences	-1.0%	-5.5%	-0.7%	-0.8%	+0.5%
Other	-17.5%	+0.7%	+0.6%	-0.9%	0.0%
EBIX effective tax rate	2.9%	1.1%	2.5%	4.8%	4.0%
Peer median ⁶	33.6%	33.4%	33.9%	34.1%	34.7%
EBIX vs. peer median	-30.7%	-32.3%	-31.4%	-29.3%	-30.7%

**Table 6. EBIX's Reserve for Uncertain Tax Positions
(\$ in millions)**

Fiscal Year Ended:	2011	2010	2009	2008	2007
Beginning balance	\$3.0	\$3.0	\$0.9	\$0.6	\$0.5
Additions for current year	\$1.9	-	\$1.2	\$0.4	\$0.1
Additions for prior year	\$0.3	-	\$1.4	\$0.2	-
Reductions for prior year	-\$2.1	-	-\$0.5	-\$0.3	-
Settlements	-	-	-	-	-
Ending balance	\$3.2	\$3.0	\$3.0	\$0.9	\$0.6

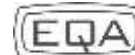
⁶ Peers include Blackbaud Inc. (BLKB), CSG Systems International Inc. (CSGS), Convergys Corp. (CVG), JDA Software Group Inc. (JDAS), Jack & Henry Associates Inc. (JKHY), NetScout Systems Inc. (NTCT), Quest Software Inc. (QSFT), Sapient Corp. (SAPE), SS&C Technologies Holdings Inc. (SSNC), and Verint Systems Inc. (VRNT).





Issue Commentary

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Hanesbrands Inc. (HBI)
1000 East Hanes Mill Rd.
Winston-Salem, NC 27105
(336) 519-8080
www.hanesbrands.com

COMPANY DESCRIPTION

Hanesbrands Inc. (HBI) is a consumer goods company engaged in designing, manufacturing, sourcing, and selling a range of basic apparels in the United States and internationally. It offers T-shirts, bras, panties, men's and kids' underwear, casualwear, activewear, shapewear, socks, and hosiery products primarily under the Hanes, Champion, Bali, Playtex, Just My Size, Leggs, barely there, Wonderbra, Gear for Sports, Stedman, Zorba, Rinbros, Sol y Oro, Outer Banks, and Duofold brands. The company sells its products through various distribution channels, including retailers, wholesalers, and third-party embellishers, as well as directly to consumers. It also licenses its Champion name for footwear and sports accessories. As of 12/31/11, the company operated 216 direct outlet stores. HBI is based in Winston-Salem, N.C. The company went public as a standalone corporation after it spun off from its parent Sara Lee Corp. (SLE) on 09/06/06. HBI's current tax position has been discussed in an *Alert* (dated 04/12/12) in which we graded the company an "F" overall.

INDUSTRY	Textile - Apparel Clothing
PRICE	\$26.00 (05/22/12)
MARKET CAP	2.54 billion
ENT. VALUE	4.64 billion
P-E RATIO	13.44
EV/REVENUE	1.01
DEBT/EBITDA	4.44
SHORT INTEREST	7.9%
DAYS TO COVER	5.4

ETR DECLINES SHARPLY FROM 31.5% IN 2007 TO JUST 14.8% ON AVERAGE SINCE 2008

VIEW **NEG**

After three years of decline—from 31.5% in 2007 to just 9.6% in 2010—HBI reported an increase in its ETR to 15.5% in 2011. Though higher than a year ago, the firm's 2011 ETR is still well below the 35% statutory rate in the United States. Likewise, its average tax rate for the 2008–2011 period was just 14.8% versus a peer median of 35.6%. The firm also reported the lowest ETR among its peer group in each of the last four years.

HBI ALLOCATES SUBSTANTIALLY ALL OF ITS TAXABLE INCOME TO FOREIGN SOURCES

The main cause of HBI's low ETR over the last four years has been the allocation of substantially all of its taxable income to foreign sources. According to the firm's own disclosures, the shifting of profits to foreign jurisdictions reduced the company's statutory tax rate by 1,530 bps, 4,640 bps, 2,450 bps and 1,940 bps, respectively, in 2008, 2009, 2010, and 2011.

In its 10K filings, the company reported that between 87.5% and 88.6% (88.2% on average) of its revenues were generated domestically between 2008 and 2011. In contrast, the company reported domestic pre-tax earnings between -142.8% and 12.1% (-30.6% on average) of total earnings over the same period. As a result, the company reports an average pre-tax margin of 38.8% (-0.3%) reported for foreign (U.S.) operations over the last four years—implying that all of its profits were allocated to non-U.S. sources.

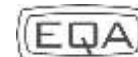
Though we are concerned by the extremely low level of profit allocated to the United States, our level of concern is partially mitigated by HBI's allocation of PP&E. As of 12/31/11, the company reported that 24.2% of its assets were based in the United States, compared with 75.8% based internationally. Similar results





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were reported over the last four years with an average of 30.8% allocated to the United States over that period.

WILL THE UNCERTAIN TAX RESERVE BE SUFFICIENT TO ABSORB IRS CHALLENGES?

HBI reported an uncertain tax reserve of \$41.6 million, or 5.4% of pre-tax income for the last four years, as of 12/31/11. Although management asserts that this amount should be sufficient to guard against unfavorable settlements with the IRS (2011 10K), we remain circumspect with regard to the level of income shifted to foreign locations over the past several years. Moreover, while the firm's 2011 10K does not state which years are under review by the IRS,⁷ based on our analysis of other U.S. firms, we believe it is unlikely that the IRS has reviewed the firm's tax filings for 2008–2011 (i.e., the years with the greatest amounts of income attributed to lower-tax-rate jurisdictions). Had the company had reported an ETR equal to the peer median in each of the last four years, we estimate that EPS would have been reduced by approximately \$0.28 (21.2%), \$0.15 (28.7%), \$0.60 (27.9%), and \$0.45 (16.8%), respectively.

Table 7. HBI Revenue, PP&E, and Pre-Tax Earnings Allocation

12M Ended:	2011	2010	2009	2008	2007
U.S. % of total revenue	87.5%	88.3%	88.6%	88.2%	91.1%
International % of total revenue	12.5%	11.7%	11.4%	11.8%	8.9%
U.S. % of total PP&E	24.2%	27.9%	30.8%	40.4%	58.5%
International % of total PP&E	75.8%	72.1%	69.2%	59.6%	41.5%
U.S. % of total pre-tax income	7.8%	12.1%	-142.8%	0.6%	6.0%
International of % total pre-tax income	92.2%	87.9%	242.8%	99.4%	94.0%

⁷ From research of prior U.S. companies, we note that most years the IRS are reviewing currently are 2008/2009, but we have seen the IRS still reviewing some companies' 2007 tax returns.





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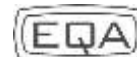


Table 8. HBI's Reconciliation of Statutory Tax Rate with Peer-Group Comparison

Fiscal Year Ended:	2011	2010	2009	2008	2007
Statutory tax rate	35.0%	35.0%	35.0%	35.0%	35.0%
State income taxes	+0.8%	+1.2%	-3.4%	+0.6%	0.0%
Tax impact of foreign subsidiaries	-17.7%	-22.0%	-12.5%	-4.5%	-6.4%
Change in valuation allowance	-0.7%	+3.0%	-9.9%	+1.6%	0.0%
Uncertain tax matters	-0.6%	-8.8%	0.0%	0.0%	0.0%
Change in state ETR	0.0%	0.0%	-14.1%	0.0%	0.0%
Other	-1.3%	+1.2%	+16.9%	-1.2%	+2.9%
HBI effective tax rate	15.5%	9.6%	12.0%	31.5%	31.5%
Peer median ⁸	30.7%	35.7%	37.1%	39.0%	37.3%
HBI vs peer median	-15.2%	-26.1%	-25.1%	-17.0%	-5.8%

Table 9. HBI's Reserve for Uncertain Tax Positions (\$ in millions)

Fiscal Year Ended:	2011	2010	2009	2008	2007
Beginning balance	\$29.7	\$39.9	\$25.2	\$13.6	\$3.3
Additions for current year	\$10.1	\$10.3	\$12.7	\$11.5	\$10.4
Additions for prior year	\$1.8	-	\$2.5	\$0.5	-
Reductions for prior year	-	-\$20.5	-\$0.5	-\$0.5	-
Settlements	-	-	-	-	-
Ending balance	\$41.6	\$29.7	\$39.9	\$25.2	\$13.6

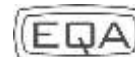
⁸ Peers include Columbia Sportswear Company (COLM), Carter's Inc. (CRI), Gap Inc. (GPS), Limited Brands Inc. (LTD), Maidenforms Brands Inc. (MFB), PVH Corp. (PVH), Under Armor (UA), and Warnaco Group Inc. (WRC).





Issue Commentary

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Stanley Black & Decker, Inc. (SWK)

1000 Stanley Dr.
New Britain, CT 06053
(860) 225-5111
www.stanleyblackanddecker.com

COMPANY DESCRIPTION

Stanley Black and Decker Inc. (SWK), provides power and hand tools, mechanical access solutions, and electronic security and monitoring systems throughout the United States, Canada, Europe, and Latin America. The company's industrial segment offers hand tools, power tools, and engineered-storage solution products; engineered fasteners; and custom pipe-handling machinery, joint welding, and coating machinery, weld inspection services, and hydraulic tools and accessories. This segment sells its products to the automotive, manufacturing, aerospace, and natural gas pipeline industries through third-party distributors and direct sales forces. The company was formerly known as The Stanley Works and changed its name to Stanley Black & Decker Inc. in March 2010, following its merger with Black & Decker. SWK was founded in 1843 and is based in New Britain, Conn.

INDUSTRY	Machine Tools & Accessories
PRICE	\$68.51 (05/22/12)
MARKET CAP	11.71 billion
ENT. VALUE	14.50 billion
P-E RATIO	18.20
EV/REVENUE	1.36
DEBT/EBITDA	1.74
SHORT INTEREST	3.1%
DAYS TO COVER	2.2

VIEW **NEG**

CONSISTENT DOWNWARD TREND IN ETR SINCE 2003

Before 2003, SWK reported an ETR that was essentially in line with peers (slightly in excess of 30%). Since that time the company has reported a relatively steady decline in its ETR to just 11.4% in 2011. Over the last 10 years the firm's ETR has averaged just 22.3%, compared to a peer-group median of 37.7% over the same period.

PROFIT SHIFTING TO LOW TAX JURISDICTIONS ACCELERATES FROM 2002 TO 2011

Several line items related to the taxation of foreign earnings, such as "difference between foreign and federal income tax" and "foreign dividends and related items" have permitted the company to reduce its taxable income by a significant amount since 2002. Looking at these line items (disclosed in the firm's 10K filings over the past 10 years), we find that the benefit provided attributed to the allocation of pre-tax income overseas has jumped from just \$14.3 million in 2002 to \$94.7 million in 2011. As a result, the allocation of income to non-U.S. sources reduced the company's ETR by an average of 8.6% (860 bps) from 2002 to 2006. The effect has been even greater over the last five years with an average reduction of 14.4% over the 2007-2011 period.

Contrary to the firm's allocation of pre-tax profits overseas, we note that over the last five years, the company reported that 49.3% of its assets were located in the United States while 55.3% of sales were sourced domestically. Similarly, over the last four years, SWK has reported an average domestic (foreign) pre-tax margin of 2.3% (11.1%).

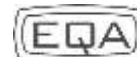
While the above trends have generally persisted in each of the last 10 years, one year in particular (2010) stands out as highly unusual. Specifically, the company reported that 55.3% (45.0%) of revenues (assets) were sourced from (located in) the United States in 2010. However, the company also reported a pre-tax loss of \$182.7 million in the United States and a profit of \$422.5 million outside of the





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U.S. This implies pre-tax margins of -4.0% and +11.3% for domestic and foreign operations, respectively, during 2010.⁹

UNCERTAIN TAX RESERVE GETS BOOST FROM M&A ACTIVITY

On 03/12/10, Stanley completed a merger with the Black & Decker Corp. Concurrent with the merger, the company decided to repatriate \$1.64 billion of legacy Black & Decker foreign earnings, on which U.S. income taxes had not previously been provided (2010 10K). As a result of the repatriation decision, in conjunction with the purchase, the company has recorded tax liabilities of approximately \$442.9 million. As of 12/31/11, the company had \$1.92 billion in foreign earnings that are considered to be permanently reinvested. Alleviating some of our concern, the company added \$318.1 million to the uncertain tax reserve. As a result, this had a +21.1% effect on the statutory rate, but the company was still able to produce an ETR of 15.7% as a result of reductions from foreign-tax differences (-30.8%).

With the company posting its historically lowest ETR's in the last three years,¹⁰ coupled with the IRS reviewing fiscal years 2008 through 2010, we believe SWK may face unfavorable settlements in coming years, especially now that the company is assuming liability for Black & Decker's profit shifting before the merger. In fact, we find that Black & Decker's profit shifting was extremely aggressive from 2007 through 2009, with the company sourcing a domestic loss in each of those years while the company showed a net profit overall. For example, when Black & Decker showed pre-tax profits of \$3.1 million, \$63.7 million, and \$21.8 million overall in 2007, 2008, and 2009, respectively, the company showed losses in the U.S. of \$65.5 million, \$6.1 million, and \$28.7 million, respectively. So while it may seem that the company has bolstered its uncertain tax reserve sufficiently to \$214.2 million in 2011 (see Table 12, Page 18) from an outside perspective, we now see that the company may face a more unfavorable settlement than previously expected.

Had the company had reported an ETR equal to its peers in each of the last four years, we estimate that EPS would have been reduced by approximately \$1.34 (34.9%), \$0.42 (15.0%), \$0.18 (14.0%), and \$0.86 (21.7%), respectively.

(See table, SWK Revenue, PP&E, and Pre-Tax Earnings Allocation, *next page*)

⁹ Another line item that reduced the firm's 2011 tax expense by \$2.1 million was "State income taxes, net of federal benefits." We find a reduction to state taxes peculiar, especially since the company did not post any losses for 2011. No further detail was provided in the 10K regarding the reduction of income tax expense from state taxes.

¹⁰ Excluding FY1997 where the company posted a \$41.9 million loss.





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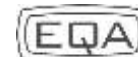


Table 10. SWK Revenue, PP&E, and Pre-Tax Earnings Allocation

12M Ended:	2011	2010	2009	2008	2007
U.S. % of total revenue	50.5%	55.3%	58.8%	56.8%	58.1%
International % of total revenue	49.5%	44.7%	41.2%	43.2%	41.9%
U.S. % of total PP&E	46.0%	45.0%	51.9%	53.1%	52.2%
International % of total PP&E	54.0%	55.0%	48.1%	46.9%	47.8%
U.S. % of total pre-tax income	30.3%	-76.2%	40.7%	28.0%	45.9%
International of % total pre-tax income	69.7%	176.2%	59.3%	72.0%	54.1%

Table 11. SWK's Reconciliation of Statutory Tax Rate with Peer-Group Comparison

Fiscal Year Ended:	2011	2010	2009	2008	2007
Statutory tax rate	35.0%	35.0%	35.0%	35.0%	35.0%
State income taxes	-0.3%	+0.6%	+1.7%	+1.8%	+1.0%
Tax impact of foreign subsidiaries	-12.1%	-30.8%	-9.7%	-11.3%	-8.5%
Uncertain tax matters	+2.5%	+3.1%	-2.9%	-0.2%	+0.5%
Audit settlements	-9.4%	-15.2%	-3.1%	0.0%	0.0%
Change in valuation allowance	-0.2%	+5.2%	0.0%	0.0%	0.0%
Foreign dividends and related items	-1.4%	+3.3%	0.0%	+0.2%	+0.1%
Other	-2.7%	+14.5%	-1.5%	-0.8%	-3.2%
SWK effective tax rate	11.4%	15.7%	19.5%	24.7%	24.9%
Peer median ¹¹	33.9%	30.3%	33.0%	34.5%	33.3%
SWK vs peer median	-22.5%	-14.6%	-13.5%	-9.8%	-8.4%

Table 12. SWK's Reserve for Uncertain Tax Positions
(\$ in millions)

Fiscal Year Ended:	2011	2010	2009	2008	2007
Beginning balance	\$273.6	\$30.3	\$47.8	\$49.1	\$54.0
Additions for current year	\$46.3	\$18.4	\$1.4	\$5.6	\$8.1
Additions for prior year	\$26.7	\$0.7	\$2.3	\$3.0	\$1.8
Reductions for prior year	-\$97.1	-\$36.3	-\$10.6	-\$5.9	-\$7.3
Settlements	-\$22.4	-\$41.0	-\$2.3	-	-\$2.6
Expiration of the statute of limitations	-\$12.9	-\$16.6	-\$8.3	-\$8.7	-\$4.9
Adjustment for 2010 M&A	-	\$318.1	-	-	-
Ending balance	\$214.2	\$273.6	\$30.3	\$43.1	\$49.1

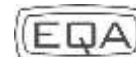
¹¹ Peers include Blount International Inc. (BLT), Kennametal Inc. (KMT), MRC Global (MRC), Proto Labs Inc. (PRLB), RBC Bearings Inc. (ROLL), and Timken Co. (TKR).





Issue Commentary

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Teleflex Inc. (TFX)
155 South Limerick Rd.
Limerick, PA 19468
(610) 948-5100
www.teleflex.com

COMPANY DESCRIPTION

Teleflex Inc. (TFX) provides medical technology products worldwide. The company's critical-care products include vascular access products, such as catheter-based products used in a various clinical procedures; and airway-management products comprising endotracheal tubes, oral and nasal airways, laryngoscopes, face and laryngeal masks, and anesthesia circuits. It also provides anesthesia products, including epidural catheters and trays, spinal needles and trays, and peripheral nerve block needles/catheters and trays; and respiratory products, such as oxygen and aerosol therapy, spirometry, and ventilation management products. Additionally, the company provides original equipment manufacturers (OEMs) with products, comprising custom-configured extrusion, introducer systems, specialty sutures, resins, yarns, and surgical instruments for orthopedic and spinal procedures, as well as micro-machined fixation devices and components. TFX serves hospitals, healthcare providers, distributors, and OEMs of medical devices through its sales forces, and independent representatives and distributor networks. TFX was founded in 1938 and is based in Limerick, Penn.

INDUSTRY	Medical Instruments & Supplies
PRICE	\$58.89 (05/22/12)
MARKET CAP	2.40 billion
ENT. VALUE	2.77 billion
P-E RATIO	12.07 (forward)
EV/REVENUE	1.78
DEBT/EBITDA	1.10
SHORT INTEREST	3.9%
DAYS TO COVER	6.5

VIEW **NEG**

TFX'S EFFECTIVE TAX RATE TRENDS SHARPLY LOWER AFTER 2007

In 2007, TFX posted an ETR of 140.4% as a result of foreign earnings being repatriated back into the United States in connection with the acquisition of Arrow. Since then, the company has disclosed ETR's of 22.6%, 16.7%, and 18.2% for fiscal years 2009, 2010, and 2011, respectively. This compares with a peer-group median ETR of 29.0% for the years 2009–2011.

LOW ETR DRIVEN BY GEOGRAPHIC ALLOCATION OF PROFITS TO NON-U.S. SOURCES AND RELEASING THE FIRM'S UNCERTAIN TAX RESERVE

According to the firm's 2011 10K, the "tax effect of International items" reduced the firm's ETR by 380 bps in 2009, 890 bps in 2010, and 1,400 bps in 2011. In addition, reductions to the firm's uncertain tax reserve caused a 420 bps, 320 bps, and 260 bps reduction in its ETR for 2009, 2010, and 2011, respectively.

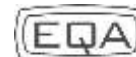
According to the 2011 10K, the company reported that 55.1%, 54.8%, and 52.3% of revenues were derived in the United States in each of the last three years, respectively. In addition, 59.2%, 57.5% and 63.1% of total PP&E was reportedly based in the United States during these same years. However, the company allocated only 18.8%, -7.6% and -5.5% of pre-tax income to the United States. As a result, TFX reported domestic (international) pre-tax margins 3.9% (20.6%), -1.0% (17.9%), and -1.0% (21.5%) in 2009, 2010, and 2011, respectively. This mismatch between the geographic allocation of profits and both the location of assets and sources of revenues causes us to be concerned about the sustainability of TFX's reported tax rate.





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UNCERTAIN TAX RESERVE CONTINUES ITS DECLINE

In 2008, TFX reported a relatively robust reserve account in relation to other firms we have analyzed, with a reserve balance of \$114.7 million. Since that time, however, the company has steadily reduced its reserve to just \$75.0 million, or 13.9% of total pre-tax income for the last four years.

According to the 2011 10K, the company reported total tax settlements with IRS of \$14.1 million over the last four years, with \$7.7 million of this amount attributable to 2011 alone. Of further concern, TFX is still subject to examination by the IRS for years 2008 through 2011, when the company appears to have begun increasing the amount of profits allocated to lower tax jurisdictions.

Had the company had reported an ETR equal to its peers in 2009, 2010, and 2011, we estimate that EPS would have been reduced by approximately \$0.31 (9.9%), \$0.31 (14.1%), and \$0.31 (10.5%), respectively.

Table 13. TFX Revenue, PP&E, and Pre-Tax Earnings Allocation

12M Ended:	2011	2010	2009	2008	2007
U.S. % of total revenue	52.3%	54.8%	55.1%	51.0%	54.1%
International % of total revenue	47.7%	45.2%	44.9%	49.0%	45.9%
U.S. % of total PP&E	63.1%	57.5%	59.2%	53.1%	50.9%
International % of total PP&E	36.9%	42.5%	40.8%	46.9%	49.1%
U.S. % of total pre-tax income	-5.5%	-7.6%	18.8%	-1.3%	-55.0%
International of % total pre-tax income	105.5%	107.6%	81.2%	101.3%	155.0%





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Table 14. TFX's Reconciliation of Statutory Tax Rate with Peer-Group Comparison

Fiscal Year Ended:	2011	2010	2009	2008	2007
Statutory tax rate	35.0%	35.0%	35.0%	35.0%	35.0%
State income taxes	+1.2%	-0.5%	-2.7%	-2.7%	-1.9%
Tax impact of foreign subsidiaries	-14.0%	-8.9%	-3.8%	-0.2%	-17.8%
Uncertain tax matters	-2.6%	-3.2%	-4.2%	+5.6%	+6.3%
Other	-1.4%	-5.6%	-1.7%	-6.0%	+118.8%
TFX effective tax rate	18.2%	16.7%	22.6%	31.7%	140.4%
Peer median ¹²	27.3%	29.0%	30.8%	24.1%	30.8%
TFX vs. peer median	-9.1%	-12.3%	-8.2%	7.6%	109.6%

Table 15. TFX's Reserve for Uncertain Tax Positions
(\$ in millions)

Fiscal Year Ended:	2011	2010	2009	2008	2007
Beginning balance	\$89.3	\$113.2	\$114.7	\$100.4	\$66.1
Additions for current year	\$4.2	\$2.0	\$12.3	\$9.7	\$11.1
Additions for prior year	\$1.9	\$6.2	\$7.3	\$19.3	\$13.0
Reductions for prior year	-\$6.4	-\$10.9	-\$15.3	-\$3.4	-\$1.2
Settlements	-\$7.7	-\$2.0	-\$1.3	-\$3.1	-
Expiration of the statute of limitations	-\$5.9	-\$16.2	-\$5.6	-\$5.1	-\$3.7
Other	-\$0.4	-\$3.0	\$1.2	-\$3.1	\$15.1
<u>Ending balance</u>	<u>\$75.0</u>	<u>\$89.3</u>	<u>\$113.2</u>	<u>\$114.7</u>	<u>\$100.4</u>

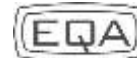
¹² Peers include Baxter International Inc. (BAX), CR Bard (BCR), Haemonetics Corp. (HAE), Hill-Rom Holdings, Inc. (HRC), Mettler-Toledo International, Inc. (MTD), Thoratec Corp. (THOR), and Young Innovations Inc. (YDNT).





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CareFusion Corp. (CFN)

3750 Torrey View Ct.

San Diego, CA 92130

(858) 617-2000

www.carefusion.com

INDUSTRY	Medical Instruments & Supplies
PRICE	\$24.65 (05/22/12)
MARKET CAP	5.47 billion
ENT. VALUE	5.43 billion
P-E RATIO	20.17
EV/REVENUE	1.48
DEBT/EBITDA	0.00
SHORT INTEREST	2.0%
DAYS TO COVER	2.5

VIEW	NEG
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COMPANY DESCRIPTION

CareFusion Corp. (CFN), a medical technology company, provides various healthcare products and services in the United States and internationally. It operates in two segments, Critical Care Technologies, and Medical Technologies and Services. The Critical Care Technologies segment develops, manufactures, and markets equipment and related supplies for infusion, medication and supply dispensing, and respiratory care. The Medical Technologies and Services segment develops, manufactures, and markets single-use skin antiseptic and other patient-preparation products; reusable surgical instruments; hair-removal and skin-care products; neurological monitoring and diagnostic equipment; and interventional specialty products, such as diagnostic trays and biopsy needles, drainage catheters, and vertebral augmentation products. This segment also provides software-based infection detection services. CFN sells its products and services through a combination of direct sales representatives, wholesalers, and third-party distributors. The company was incorporated in 2009 and is based in San Diego, Calif.

CHARGES TAKEN BY CFN ILLUSTRATE THE POTENTIAL RISKS ASSOCIATED WITH TAX-PLANNING STRATEGIES AND THEIR IMPACT ON ETRS

As we explain in detail below, CFN reported an unusually low tax rate from 2006 through 2009, when its ETR averaged 18.5%, compared to a peer median of 26.1% during the same period.¹³ As disclosed in the firm's 2009 10K, the low and generally declining ETR was due to a "Foreign Tax Rate Differential," which according to management reduced the firm's ETR by 970 bps and 940 bps in 2008 and 2009, respectively. In addition, our review of the firm's 2009 10K indicates that the company carried a relatively small uncertain tax reserve of \$122.0 million compared to its pre-tax earnings.

Unfortunately, before closing its books for Q3 FY2010 the company was apparently confronted with information that necessitated a reversal of this prior position. This resulted in an ETR of 122.0% for the quarter and ultimately 53.7% for the full year. The firm's ETR then returned to what may be a more sustainable rate of 29.9% in 2011, compared to a peer-group¹⁴ average of 27.3% in 2011. Even still, the firm's tax situation appears sufficiently complex that we are uncertain as to whether it has accrued sufficient reserves to date.

The 2011 10K describes the sharp jump in the firm's 2010 ETR as follows:

During fiscal year 2010, we completed a detailed analysis of our tax reserves prompted by new information related to our potential tax positions, tax liabilities, and tax planning strategies. For this analysis, we retained third-party advisors to assist in assessing whether, based on the

¹³ In fiscal years 2006, 2007, 2008 and 2009, CFN had a declining ETR of 18.8%, 15.6%, 24.8% and 15.1%, respectively.

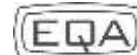
¹⁴ Peers include Hologic Inc. (HOLX), Boston Scientific Corp. (BSX), Johnson & Johnson (JNJ), CR Bard Inc. (BCR), Teleflex Inc. (TFX), Thermo Fisher Scientific (TMO), and Thoratec Corp (THOR).





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new information, our tax risks had changed, and whether additional reserves in excess of those already recorded were necessary. Based on this analysis, we increased our existing tax reserves and recorded a change in estimate of approximately \$58 million as a charge to net income for the quarter ended March 31, 2010.

More recently, in a 04/02/12 letter responding to the SEC's Division of Corporation Finance, the company provided the following additional color on the matter:

The Company advises the [SEC] Staff that the [IRS] Revenue Agent's Report (the "RAR") for fiscal years 2006 and 2007 proposes additional income taxes for those years. The Company did not separately quantify the amount of the additional income taxes proposed in the RAR for fiscal years 2006 and 2007, but did include an amount related to the RAR in its contingent tax reserves, as discussed below.

The RAR for fiscal years 2003 through 2005 was originally disclosed by Cardinal Health, Inc. in its filings with the Commission. Based on the allocation of tax liabilities in connection with the Company's spinoff from Cardinal Health, Inc., a discussion of the RAR for fiscal years 2003 through 2005 was included in the Company's registration statement on Form 10 in connection with the spinoff. Given the magnitude of the potential liability, and the fact that it had been previously disclosed as a separate item, the Company continued to disclose the amount of additional income taxes proposed by the RAR for fiscal years 2003 through 2005 in its periodic filings following the spinoff. The Company has not disclosed the amount of the additional income taxes proposed in the RAR for fiscal years 2006 through 2007 as a separate item in part due to the fact that it is significantly less than that of the RAR for fiscal years 2003 through 2005.

The Company has appealed the RAR for fiscal years 2006 and 2007. As of the date of this letter, the IRS has not commenced the appeals process with respect to these years. The Company has noted the Staff's comment and will expand its disclosure in future filings on Form 10-K if and when the status changes for the RAR for fiscal years 2006 and 2007.

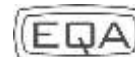
As a result of the adjustments made in 2010 and the more-conservative position taken in 2011, the balance of the firm's uncertain tax reserve was \$289.0 million at 12/31/11, which equates to 18.8% of total pre-tax income for the last four years. On the surface this appears to be a more-sustainable level of reserves, particularly as it relates to the much lower levels of reserves reported by other firms reviewed in this report. On the other hand, given the complexity of its tax issues, the fact that the RAR has assessed additional amounts related to 2006 and 2007, and that the company apparently faces review of tax documents for 2008-2011, we believe the company could be faced with additional accruals to tax reserves, which may cause its ETR to trend higher again in the future.





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CFN'S SHARE PRICE RESPONDS NEGATIVELY TO THE NEWS THAT ITS TAX PROVISION WOULD BE MUCH HIGHER IN 2010 AND BEYOND

Though the charge taken to correct CFN's ETR was, at least in part, a noncash item, ultimately it reflects the discounted expected value of expected future tax payments and related penalties and interest. As such, it represents a real economic cost to the firm. Reflective of the nature of this cost, we note that the company's share price dropped significantly upon the release of this news. Shares fell from \$28.94 at the close on 05/05/10 to \$27.62 at the close on 05/06/10, which was the day that CFN released fiscal Q3 results. Shares continued to fall to a low of \$20.68 on 07/21/10, before climbing back slowly to recent levels (hovering around \$25.00, which is still well below its price in early May 2010).

Table 16. CFN Revenue, PP&E, and Pre-Tax Earnings Allocation

12M Ended:	2011	2010	2009	2008	2007
U.S. % of total revenue	80.0%	78.1%	77.6%	70.8%	74.0%
International % of total revenue	20.0%	21.9%	22.4%	29.2%	26.0%
U.S. % of total PP&E	76.3%	76.6%	68.6%	77.0%	67.4%
International % of total PP&E	23.7%	23.4%	31.4%	23.0%	32.6%
U.S. % of total pre-tax income	39.3%	24.0%	41.7%	35.9%	20.1%
International % of total pre-tax income	60.7%	76.0%	58.3%	64.1%	79.9%

Table 17. CFN's Reconciliation of Statutory Tax Rate with Peer-Group Comparison

Fiscal Year Ended:	2011	2010	2009	2008	2007
Statutory tax rate	35.0%	35.0%	35.0%	35.0%	35.0%
State income taxes	+2.2%	+1.5%	+0.8%	+1.0%	+1.8%
Tax impact of foreign subsidiaries	-9.0%	-2.4%	-9.4%	-9.7%	-21.2%
Nondeductible & nontaxable items	+0.2%	-0.8%	-0.4%	-0.1%	+0.6%
Change in estimate	0.0%	16.4%	0.0%	0.0%	0.0%
Other	+1.6%	+4.0%	-10.9%	-1.4%	-0.6%
CFN effective tax rate	29.9%	53.7%	15.1%	24.8%	15.6%
Peer median ¹⁵	27.3%	29.0%	30.8%	24.1%	30.8%
CFN vs. peer median	2.6%	24.7%	-15.7%	0.7%	-12.0%

¹⁵ Peers include Baxter International Inc. (BAX), CR Bard (BCR), Haemonetics Corp. (HAE), Hill-Rom Holdings, Inc. (HRC), Mettler-Toledo International Inc. (MTD), Thoratec Corp. (THOR), and Young Innovations Inc. (YDNT).





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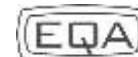


Table 18. CFN's Reserve for Uncertain Tax Positions
(\$ in millions)

Fiscal Year Ended:	2011	2010	2009	2008	2007
Beginning balance	\$259.0	\$219.0	\$122.0	NA	NA
Additions for current year	\$8.0	\$25.0	\$26.0	NA	NA
Additions for prior year	\$25.0	\$37.0	\$94.0	NA	NA
Reductions for prior year	-\$2.0	-\$1.0	-\$10.0	NA	NA
Settlements	-	-\$18.0	-\$9.0	NA	NA
Expiration of the statute of limitations	-\$1.0	-\$3.0	-\$1.0	NA	NA
<u>Ending balance</u>	<u>\$289.0</u>	<u>\$259.0</u>	<u>\$222.0</u>	<u>\$122.0</u>	NA

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