

THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

# BDO PERSPECTIVE



## THE CURRENT STATE OF MIDDLE MARKET M&A

*It Remains a Sellers' Market but ...*

By Dan Shea

**D**emand exceeds supply, and this has been the case for quite a while. Financial and strategic buyers, armed with substantial capital, are eagerly pursuing deals. Unfortunately, deals have been hard to come by.

Indeed, deal count was down by 27 percent in 2013, despite the fact that U.S. private equity firms are sitting on \$466 billion in uninvested capital and U.S. public companies have approximately \$300 billion in excess cash at their disposal (sources: Pitchbook and BDO Capital Research). Adding in the excess cash on private company balance sheets, it is not a stretch to estimate that there is currently over \$1 trillion in uninvested mergers and acquisitions (M&A) capital.

So, where are the sellers? One would think that potential sellers would see an opportunity to divest, given the evident demand as well as the steady stream of solicitations many of them receive. Yet, they appear to be very cautious, if not completely uninterested. But why?

As advisors to both sellers and buyers, and through our involvement in numerous M&A transactions across the country on a monthly basis, we are seeing three main themes emerge regarding the imbalance of supply and demand:

- First, the economic doldrums have worn on business owners. In fact, many of them see heightened risk in completing a deal. They

### DID YOU KNOW...

Data from **PitchBook** highlights Q1 2014 as the most robust first quarter for U.S. private equity investment since 2008, with \$108 billion invested – this is far greater than the \$83 billion in Q1 2013 and the \$51 billion in Q1 2009.

According to **Preqin**, at the close of 2013, private equity firms finished raising new funds worth \$454 billion, the largest amount since the financial crisis. This fundraising added significantly to the dry powder that firms have ready to invest.

Findings from the **2014 BDO IPO Outlook**, which surveyed more than 100 capital markets executives at leading investment banks, found that 63 percent of respondents believe the number of IPOs that list on U.S. exchanges will continue to grow in 2014.

Data from both the **Emerging Markets Private Equity Association (EMPEA) Annual Report** and the **2014 BDO PERSpective Private Equity Study** highlight Asia as a target for private equity investment. According to **EMPEA**, nearly \$24 billion emerging market private equity investment dollars (66.2 percent of total emerging market investment) were invested in emerging Asia. Further, 32 percent of **PERSpective Study** respondents identified Asia, including Southeast Asia, as presenting the greatest opportunity for new private equity investments in 2014.

According to the **2014 BDO Technology Outlook Survey**, 43 percent of the 100 tech CFOs polled believe private equity, which has invested a considerable amount of capital in the tech sector over the past few years, will generate the greatest number of IPOs in 2014. Following private equity, 39 percent of respondents cite venture capital-backed companies as the most likely to go public in 2014.

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**MIDDLE MARKET M&A**

are concerned that an economic shock of some sort could sideline their efforts to sell, so they would rather not invest the time and energy in the first place.

- Second, many business owners see their business as the best ROI opportunity for their capital. Despite the appeal of wealth diversification upon a sale, they often tell us that their after-tax proceeds may not yield an acceptable return, even on a risk-adjusted basis. Holding on is, in essence, a better bet in their view, especially since they have come to know and trust the inner workings of their business and industry.
- Third, as recently highlighted by our colleagues at GF Data, the mindset of business owners seems to be changing - they are more interested in staying active in business later in life. The freeing effects of virtual office technologies allows them to stay engaged while taking more time for themselves, their families and other interests. These remote options, paired with the first two themes, are resulting in business owners holding onto their companies longer and longer.

Meanwhile, buyers are responding to the challenging environment, in part by showing a willingness to pay more. The average EBITDA multiple increased by 0.7 times EBITDA last year, to reach an average of 6.7x (source: GF Data), and it appears pricing will continue to increase. It is now common to see private equity firms pay in excess of 10.0 times EBITDA for coveted properties. Adding fuel to fire, business executive's confidence in the economy is rising, aided by momentum seen in key economic indicators such as GDP, Industrial Production, Durable Goods Sales, Inventories, and others. We see this in our BDO executive surveys and anecdotally in our daily client work.

Higher prices and an improving economy appear to be a winning combination, causing business owners to rethink the aforementioned themes. The evidence is in the deal count for Q1 2014. Our preliminary analysis indicates that closings were up nearly 17 percent during the quarter vis-à-vis Q1 2013 (sources: S&P Capital IQ and BDO Capital Research). Even more interesting,

## BDO'S PRIVATE EQUITY PRACTICE KNOWS INDUSTRIES eBOOK



In uncertain times, it's more important than ever that fund managers engage partners who understand their industry and the industries in which they invest. Fund managers need advisors who recognize the challenges they face when sourcing and closing deals, growing their portfolio companies and, ultimately, exiting their investments. BDO's integrated, multidisciplinary teams support private equity funds and their portfolio companies across the globe and in more than 15 industries with a full spectrum of professional services.

This eBook offers an inside look at how [BDO's Private Equity practice](#) has worked with funds and portfolio companies across a number of industries, including: healthcare, life sciences, manufacturing, natural resources, real estate and retail.

Download the eBook here: [www.bdo.com/download/3104](http://www.bdo.com/download/3104).

closings involving a private equity firm, which accounted for approximately 38 percent of all closings, were up nearly 30 percent from Q1 2013.

This rise in activity, combined with the size of the collective deal pipeline here at BDO, gives us cause for optimism. As such, we see a continuing uptrend in middle market M&A activity in the coming months.

*BDO Capital Advisors, LLC, a FINRA/SIPC member, is a separate legal entity and an affiliated company of BDO USA, LLP, a Delaware limited liability partnership and national professional services firm.*

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# SEAL THE DEAL: MINIMIZING POST-ACQUISITION DISPUTES TO DRIVE VALUE

By Jeffrey M. Katz

Private equity leaders anticipate that 2014 will be another year of moderate deal flow volume, according to the fifth annual *PEerspective Private Equity Study* conducted by BDO USA, LLP. Coming off of a year when rising valuations limited fund managers' ability to source and close deals, only 15 percent of private equity professionals predict they will close more than five deals in 2014. With rising valuations already a concern, it's more important than ever for fund managers to proactively consider recent trends in post-acquisition disputes *before* a deal is finalized. Doing so can minimize the occurrence of post-closing disputes, which will, in turn, directly impact deal valuations. It also allows the fund to focus immediately on driving operational efficiency and setting the company on a path for growth to help ensure, longer-term, the investment generates a return for the fund's Limited Partners.

M&A agreements often contain a post-closing adjustment to the purchase price, which is intended to reflect changes in the balance sheet of an acquired company between the date a deal is negotiated and the date the transaction closes. While the metrics for adjustments vary from one agreement to the next, adjustments are often based on the change in a business's Net Working Capital, Net Assets and/or Company Debt. Disputes often arise because the parties of a mergers and acquisitions (M&A) agreement have differing opinions regarding the amounts that should be recorded on the closing balance sheet. These disputes often focus on the application of generally accepted accounting principles (GAAP) within the context of the terms of the M&A agreement.

Recently, BDO has seen an increase in post-acquisition disputes related to the GAAP determination of whether a company's leases should be classified as operating or capital leases. In many M&A agreements, Company Debt is defined to include "all leases that are to be required to be recorded as capital leases under GAAP." Disputes arise when the buyer alleges that certain leases that the seller had



classified as operating leases should instead have been classified as capital leases, and thereby included as Company Debt. Under GAAP, if a lease is classified as an operating lease, the lease payments are expensed as paid and the future lease payments are not reflected on the balance sheet. If a lease is classified as a capital lease, then the present value of the minimum future lease payments is recorded as a liability on the balance sheet and a corresponding asset is also recorded.

According to Accounting Standard Codification (ASC) 840-10-25, if a lease meets any of four criteria at its inception, then the lease should be accounted for as a capital lease. The four criteria are:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
4. The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at lease inception.

Disputes arise because determination of whether the lease in question meets these criteria is largely based on the estimates and judgments of management, and the

seller's and buyer's management teams often have differing views. As a result, the parties to the transaction should carefully review the accounting for all leases prior to the transaction closing. In order to minimize post-acquisition disputes related to the classification of leases, the parties may want to agree that post-closing purchase price adjustments exclude capital leases. The parties could also agree that no changes will be made to the classification of leases in determining post-closing purchase price adjustments.

Another area in which we have seen an increase in post-acquisition disputes is the accounting for tax liabilities. For example, several recent disputes involved a buyer that claimed the closing date balance sheet should reflect a liability for certain taxes and a seller that asserted it is not probable a liability was incurred and/or the amount of such liability cannot be reasonably estimated. As is common, this dispute is caused by the estimates and judgments that management make when preparing GAAP financial statements. In many of these disputes, the management teams simply have differing views.

The GAAP guidance for determining if a tax liability needs to be recorded depends on whether or not the tax is an income-based tax. If the tax is income-based, then ASC 740, Income Taxes, is the GAAP standard that applies. In general, ASC 740 requires an entity to recognize a liability when it is more likely

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## POST-ACQUISITION DISPUTES

than not that, based on the technical merits of the tax position, the position will be sustained upon examination. "More likely than not" means a likelihood of more than 50 percent. In making this assessment, the following criteria are applied:

- It shall be presumed that the tax position will be examined by the relevant taxing authority that had full knowledge of all relevant facts.
- Technical merits of a tax position derive from sources of authorities in the tax law and their applicability to the facts and circumstances of the tax position.
- Each tax position is to be evaluated without consideration of the possibility of offset or aggregation with other positions.

If the tax at issue is not income-based, then ASC 450, Contingencies, is the applicable GAAP. Under ASC 450, an estimated loss contingency is to be accrued if:

- It is probable that an asset had been impaired or a liability incurred at the date of the financial statements.
- The amount of loss can be reasonably estimated.

In certain disputes that BDO arbitrates, we find that the parties to the transaction are unsure about which standard applies to the tax issue in dispute. In order to minimize post-acquisition disputes related to taxes, it is in some cases best to specifically exclude tax liabilities from the working capital adjustment. Most agreements typically have a tax indemnification provision that protects the buyer in the event of unforeseen tax liabilities, so there may be no need for a working capital adjustment related to tax liabilities.

Understanding that M&A agreements are subject to interpretation and disagreement between the buyer and seller, those negotiating the terms of an agreement can often help to minimize post-acquisition disputes, thereby allowing the buyer to focus on growing the value of its business.

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## BDO SPOTLIGHT:

### Q&A with Scott Cacurak

National Director of Transaction Advisory Services (TAS) at BDO USA



#### *How did your career become focused on transaction advisory services and the private equity industry?*

Prior to joining BDO in 2005, I had already worn many "hats" in my career – as an auditor, an interim-CFO, a CFO advisor and consultant, and in transaction support. I have been able to work with various acquisitive technology and financial services businesses, as well as private equity funds throughout my career and, as such, private equity and mergers and acquisitions (M&A) have always interested me.

When I joined BDO in 2005, the firm was focused on growing its Private Equity practice and service offerings. This planned growth, coupled with my background and interests, made joining the Transaction Advisory Services (TAS) practice at BDO a natural next step. Since then, I have been able to play an active role in the team developing the initiative to grow BDO's private equity services, including our TAS practice. Nearly 10 years ago, I was one of a handful of individuals focused on our private equity services, but today, BDO has an established brand in the space. I am grateful to be part of the team that has driven that development.

#### *How do you see your new role at BDO as National Director of Transaction Advisory Services (TAS) impacting your work?*

Currently, I serve as one of the founding members of BDO's U.S. Private Equity Industry Steering Committee. I have also led the firm's Private Equity Audit practice for many years and I served as a TAS partner in the Bay Area practice, advising on various deals for private equity clients. I am excited about the opportunities that lie ahead in my new role as National Director of TAS. We have some of the best professionals in the industry, and we continue to enhance our brand every year.

Moving forward, I will support our plan to continue to aggressively grow our practice in the U.S., and to work closely with our global TAS leadership to expand internationally.

#### *What experiences have been most influential in shaping your career?*

All of them! Seriously – my career is truly a culmination of my experiences, as well as the professionals I have been able to work with.

Since joining BDO, I have worked with a number of colleagues who have served as professional guides, helping me to find my stride in the Private Equity and TAS practices. I consider Lee Duran, Brian Minnihhan, Paul Heiselmann, Christopher Tower and Jay Duke as important mentors. Soon after joining the firm, I worked collaboratively with a small group of partners on an initiative to develop a business plan around private equity and TAS. Christopher and Jay served as leadership sponsors – and they gave key guidance that aided in the development and success of the plan. Since then, their senior leadership and support has been critical.

As I move into my new role, not only do these folks continue to be influential and provide great guidance, but Wayne Berson and Steve Ferrara have also been amazing supporters, and I look forward to working collaboratively with them as we continue to develop the practice.

Ultimately, BDO embodies a very entrepreneurial culture that fosters professional growth. If you have a good idea and bring it to the attention of leadership, you will receive the support and mentorship you need to be successful.

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## SPOTLIGHT

### ***What are the pressing challenges or concerns facing your private equity clients, and how is TAS addressing them?***

Our private equity clients face a range of challenges – often related to capital deployment, deal flow and transaction oversight.

In today's private equity environment, there is no shortage of dry powder, but our clients are having difficulties identifying the right deals. We understand that deploying capital is paramount to private equity firms, and we work alongside BDO's Audit, Tax and Consulting practices, as well as BDO Capital Advisors, to identify deal flow opportunities to support our private equity clients. For example, in addition to serving private equity groups, we also work with venture capital firms that are invested in great companies. We have found that our venture capital clients are great sources for deal flow to private equity. We have facilitated connections between these clients, resulting in a number of successful outcomes for both.

From a transaction advisory perspective, complex accounting and tax-related matters continue to be key areas of focus and concern in private equity transactions. Our TAS teams work closely with our private equity clients to identify issues, assist in developing solutions and provide input in optimizing terms and structuring in the deal.

Finally, private equity clients are looking for deep industry expertise on their transactions – and that's what BDO focuses on and continues to develop: experts in each industry.

### ***What lies ahead for BDO's work in the private equity industry, both for TAS and the Private Equity practice?***

Continuing to expand our Private Equity and TAS practices is among BDO's top initiatives in the U.S. and globally. As a global firm, the Private Equity practice is a unique group that transcends every industry that we service – it is not just an industry group, but a channel that has the potential to exponentially expand our business. In this regard, we are also continuing to bridge our firm's resources and

great contacts with the wider private equity community through expanded resources and processes to involve all business lines and regions in the development and nurturing of opportunities. We have established a strong brand that is attracting many middle market private equity firms. At BDO, our Private Equity practice is nimble, and we have deep expertise in the specific industries private equity firms are investing in. With this industry expertise and middle market focus, looking ahead, we anticipate substantial growth in both the Private Equity and TAS practices over the next three to five years.

### ***During the InterGrowth 2014 conference, you're facilitating a panel discussion on: "Going Public: Evaluating IPO Markets from a Private Equity Perspective." Can you discuss any themes you expect to emerge from the panel discussion?***

The IPO market is an ever-changing landscape for private equity exit plans and assumptions. In 2013, IPO activity was no doubt the strongest it has been since 2007 and, based on various reports, there has been an increase in private equity-sponsored portfolio companies going public, compared to prior years. Of course, this is great news for private equity firms. This said, many fund managers continue to anticipate that the greatest returns will be generated from sales to strategic buyers, many of which are acquiring these companies at IPO-premium valuations. It should be an interesting discussion and I am looking forward to it.

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# REGULATORY UPDATE

By Dale Thompson



## ► SEC CHARGES PRIVATE FUND MANAGER IN EXPENSE MISALLOCATION SCHEME

On Feb. 24, 2014, the SEC announced seven charges<sup>1</sup> against an Arizona-based private equity fund manager and his investment advisory firm, one of which related to orchestrating a scheme to misallocate their expenses to the funds they manage. The SEC alleges that the manager, Clean Energy Capital LLC (CEC), improperly paid more than \$3 million of the firm's expenses by using assets from 19 private equity funds that invest in private ethanol production plants. CEC did not disclose any such payment arrangement in fund offering documents. Additionally, when the funds ran out of cash to pay the firm's expenses, CEC loaned money to the funds at unfavorable interest rates and unilaterally changed how they calculated investor returns to benefit themselves.

Based on the SEC's order instituting administrative proceedings, among the expenses that CEC has been misallocating to the funds are CEC's rent, salaries and other employee benefits such as tuition costs, retirement and bonuses. The money taken

from the funds for firm expenses was in addition to millions of dollars in management fees already being paid to CEC out of the funds. According to Marshall S. Sprung, co-chief of the SEC Enforcement Division's Asset Management Unit, "Private equity advisers can only charge expenses to their funds when they clearly spell that out for investors."

The SEC staff has cited expense allocation as a key issue for private equity fund managers on several occasions and has stressed that private equity fund managers must ensure that they properly allocate fees and expenses among various client accounts and related funds. Accordingly, it's imperative that private equity fund managers ensure that expenses charged to the funds (and client accounts) are:

- Consistent with those disclosed as the fund's responsibilities/obligations in the respective fund documents, e.g., offering/private placement memorandums, or as applicable, Limited Partnership Agreement, LLC Agreement, Articles of Association, etc.
- Appropriate fund expenses (and not expenses that should otherwise be borne by the manager).
- Allocated among multiple funds/accounts (i) appropriately to the funds/accounts that should bear the related expenses; and (ii) on a reasonable and consistent allocation basis.

For more information on the fines against CEC, here is a link to the SEC order: <http://www.sec.gov/litigation/admin/2014/33-9551.pdf>.

## ► NEVER-BEFORE EXAMINED REGISTERED INVESTMENT ADVISERS INITIATIVE

In a letter directed to executives of Registered Investment Advisers on Feb. 20, 2014, the SEC Office of Compliance Inspections and Examinations (OCIE) announced the launching of its "Never-Before-Examined (NBE) Initiative." The NBE Initiative is directed at SEC-registered investment advisers (RIAs) that have never been examined, focusing on those RIAs that have been registered with the

SEC for three or more years<sup>2</sup>. Excluded from this initiative, are newly registered advisers to private funds (i.e., those registered pursuant to the March 2012 deadline date under Dodd-Frank), which are being examined pursuant to the "Presence Exam" initiative launched in October 2012.

As part of the NBE Initiative, OCIE's examinations will concentrate on the following areas of an RIA: (i) compliance programs, (ii) filings and disclosure, (iii) marketing, (iv) portfolio management, and (v) safekeeping of client assets. After the completion of the examination, OCIE staff will send the RIA a letter indicating that the examination has concluded without findings or a letter that describes the deficiencies identified and any corrective action to be taken. If serious deficiencies are found, in addition to sending an examination summary letter, OICE staff may refer the deficiencies to the SEC's Division of Enforcement, state regulatory agency or other regulator for possible action.

Additional details on the examinations are available in the SEC's letter to the RIAs at: <http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf>.

1 Other charges included in the order relate to custody rule violations, e.g., CEC failed to use a qualified custodian for the securities owned by the funds — the original stock certificates for securities owned by the funds were kept in CEC's office — and the 2011 audited financial statements of the funds were not sent until January 2013, and CEC never obtained a surprise exam.

2 As previously communicated in January 2014, OCIE announced that examining these advisers is a priority in 2014: <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>.

## MARK YOUR CALENDAR

The following is a list of upcoming conferences and seminars from the leading private equity associations and business bureaus:

### MAY

**May 6-7**

**PEI Private Fund Compliance Forum 2014**

Convene Conference Center  
New York, N.Y.

**May 12-15**

**IFC & EMPEA Global Private Equity Conference**

The Ritz-Carlton  
Washington, D.C.

**May 14-15**

**ACG Southwest Mergers & Acquisitions Conference**

Fairmont Scottsdale Princess Resort  
Scottsdale, Ariz.

**May 15**

**New York ACG 10th Annual M&A DealSource**

The Metropolitan Club  
New York, N.Y.

### JUNE

**June 9**

**2014 Upper Midwest ACG Capital Connection**

The Hyatt Regency Minneapolis  
Minneapolis, Minn.

**June 14**

**PEI Responsible Investment Forum 2014**

Marriott Grosvenor Square  
London, U.K.

**June 18-19**

**ACG DealFest Northeast**

The Cyclorama at Boston Center for the Arts  
Boston, Mass.

**June 19-20**

**MidSouth ACG Capital Connection**

Music City Center  
Nashville, Tenn.

**June 24-25**

**Buyouts Midwest 2014**

The Ritz-Carlton Chicago  
Chicago, Ill.

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### BDO PRIVATE EQUITY PRACTICE

Strategically focused and remarkably responsive, the experienced, multidisciplinary partners and directors of BDO's Private Equity practice provide value-added assurance, tax and consulting services for all aspects of a fund's cycle, wherever private equity firms are investing.

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Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.



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