

THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

BDO PE**PERSPECTIVE**



2017 PE-BACKED IPOs WILL BE DRIVEN BY MIDDLE MARKET DEMAND FOR GROWTH CAPITAL

By Lee Duran

Most prognosticators have declared that 2017 will be a strong year for the IPO.

In fact, according to the [2017 BDO IPO Outlook survey](#), which was released earlier this month, two-thirds (67 percent) of respondents predicted an increase in the number of U.S. IPOs in the coming year, with almost one-fifth (19 percent) describing the increase as substantial. Furthermore, two out of three respondents (67 percent) told us that private equity and venture capital firms would be the greatest source of IPOs in 2017.

We have seen increased interest among our private equity clients exploring an IPO, and we have already begun conversations

with several firms who are looking at and preparing for a potential IPO in the next 12 months. By most indications, the outcomes for 2017 IPOs are expected to be positive for all players involved.

There are several short-term factors helping to influence the decision to IPO or not—stocks trading at all-time highs, lower market volatility and pent-up sell-side demand for IPOs due to a less favorable environment in 2016. But there are also a number of longer-term factors impacting how firms are looking at the option and some common goals in what they aim to achieve with the capital secured through an IPO. These longer-term goals are telling a positive story about the state of the private equity industry, specifically, and about the

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2017 PE-BACKED IPOs

rising optimism around economic growth in general.

In order to put this year's expected trend toward private equity-backed IPOs into perspective, it would be useful to briefly discuss the key features of the last time our industry saw an uptick in IPOs, beginning in 2013. Like this year, the 2013 trend followed a year in which IPOs had dropped significantly, so part of the uptick had to do with stifled sell-side opportunity the previous year. Unlike this year, though, many of those IPOs were exits driven by pre-crash buys. Consequently, much of the capital was used for de-leveraging and risk reduction.

In 2017, the spirit driving interest in raising capital through the public markets is unequivocally one seeking access to growth capital, not exit. While there is no one-size-fits-all scenario, we're seeing the highest level of interest in IPOs coming from firms operating in the middle market with a desire to do two things: Transform portfolio company business models leveraging technology and ensure the scalability of those models over the long term. In conversations we've had, there has been a palpable desire for capital to make business models more technology-intensive.

Another interesting characteristic of this year's IPO focus is that it's not sector- or industry-specific. We're seeing interest across the board, including healthcare, manufacturing, hospitality and natural resources. Almost across the board, technology is increasingly seen as a change agent that will transform companies and industries to be better positioned to thrive in a 21st century economy that will be both global and digital in nature.

Over the course of the last couple of years, many of the PE fund sponsors we've spoken to have focused on improving operations by reducing costs and growing revenue. The strategy was to control and improve the things you can in order to better take advantage of an improved economic and market environment, which we're now seeing.

Many of the most promising middle market growth companies, however, are capital intensive. Take the energy sector, for example, where capital to fund necessary R&D activities or expansion through acquisition is a constant. Some companies are feeling the regulatory environment is good and there are a number of undervalued assets in the natural resources market. Under those conditions, the IPO becomes a very attractive option because it

allows the firm to access necessary capital without giving up control equity and provides the currency to do transactions.

In addition to creating a more liquid currency for transactions, the other appealing feature of a public float is that the firm gets a fair market value that is publicly quoted. Once that's established, and particularly in a market where stock prices are trading at high levels, the firm is able to use that public valuation to its advantage in several different ways, from streamlining the process of raising additional capital to simplifying the year-end portfolio company valuation process. That's not a benefit that is necessarily delivered by accessing capital through the private markets.

There are also several known challenges that come with choosing to become a public company. Compliance costs increase, and the time needed to manage the ongoing regulatory filing is not insignificant. In fact, firms often have a clearer understanding of the increased costs than they do of the increased commitment of time required for filings. While there are alternatives that can somewhat reduce that regulatory burden, such as Reg A+ and 144A filings, we think the overall appeal of the public markets in 2017 will be more than enough to compel firms to bring new offers to the market.

It is also worth noting that there is growing cachet in owning an investment in a private equity-backed company, particularly a growth company. Institutional money is looking to place more funding in this space, so we anticipate private equity-backed IPOs will get a lot of attention this year. Taken altogether, these types of private equity-backed IPOs in 2017 promise to deliver longer-term value to the portfolio companies, the economy in general and, ultimately, the investors, both private and public.



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FAMILY OFFICES SCOPE OUT PE FUND TURF

By Ed Smith

I recently had the opportunity to moderate a panel at the ACG Connecticut/Massachusetts Fall Conference, focused on the recent increase in single and multi-family offices entering the private equity arena.

While family offices and other sophisticated investors have long participated in private equity investments through private equity funds and co-investment funds, it's clear a shift is underway. Family offices are increasingly making direct investments into private companies, rather than going through a private equity fund manager.

A recent survey by McNally Capital, a Chicago-based investment firm, found that 77 percent of family offices polled in 2014 stated they preferred direct deals over working through private equity funds, up from 59 percent in 2010. The McNally research also found that 84 percent of the family offices polled said they planned to make a direct investment in a private

company by the end of 2016. The growing competition from family offices could make vying for deals and talent more challenging. To remain successful in a disrupted marketplace, private equity firms will need to continue to clearly articulate their own model and value proposition to prospective portfolio companies. Managers will also need to be able to explain to target companies the pros and cons of the family office model.

WHY ARE FAMILY OFFICES ENTERING PE NOW?

According to UBS, the composite global portfolio of family offices generated a return of 0.3 percent last year, down from 6.1 percent in 2014. Lower returns have been attributed to the low to negative interest-rate environment that most developed markets have seen for the last several years. Faced with limited ability to derive yield and drive returns through traditional investment vehicles, family offices are setting their sights on alternative investments as a more dependable means of generating alpha.

Many family offices view direct investments in private companies as an opportunity to gain transparency into their investments and returns while eliminating management fees. But the appeal of direct investment in private companies goes beyond just the potential for higher returns and lower costs. Many family offices are dissatisfied with the limitations that are associated with investing through private equity funds. Investors into a fund have little say in access to deal flow, participation in portfolio company due diligence and strategic decisions about restructuring the target once it's been acquired. Many family offices are set up to manage the proceeds of business owner clients, so there is already extensive interest and expertise in running successful businesses.

Taken together, the desire to increase returns, disintermediate the manager and apply industry know-how in running successful businesses is a compelling reason for family offices to increase their direct investments into private companies.

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FAMILY OFFICES**WHAT DO PORTFOLIO COMPANIES NEED TO KNOW?**

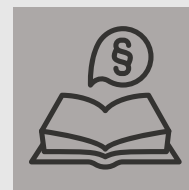
For portfolio companies, family offices may look like a welcome departure from traditional private equity firms. Private equity funds usually have stricter deal terms and are focused almost exclusively on addressing financial issues. They are also known to be quick to sell a portfolio company if the opportunity presents itself, which potential targets may view as a downside. Traditional PE firms are also more likely to make use of leverage than their family office counterparts, which accentuates the risks associated with the transition.

Family offices, by contrast, can be more flexible in structuring their investments and deal terms because they are not beholden to investors. They can also show more flexibility in structuring and timing their exit. In fact, family offices are known to hold on to portfolio companies much longer than the typical four- to six-year investment period for PE firms. The appearance of a more stable, less rigid private investor can have real synergistic appeal for small to mid-sized businesses and, especially, for family-owned companies whose founders may be reaching retirement age.

What companies seeking private investment should keep in mind is that family office investors, while flexible, are not all hands off. Family offices are inherently concerned with legacy preservation and tend to see all investments through the lens of wanting to further a family mission, which is often philanthropic in nature. Given that the investment into portfolio companies can come with these personal and emotional ties, family offices may be more apt to exercise direct influence over the portfolio company to ensure it meets with their ideals, which could result in disagreements and tensions.

SECTION 385:

WHAT PRIVATE EQUITY FIRMS NEED TO KNOW



This October, the IRS and the U.S. Treasury Department released final and temporary IRC Section 385 regulations, which deal with the classification of intercompany debt for U.S. tax purposes.

When the proposed regulations were issued in April, they were set to recharacterize certain intercompany debt instruments as equity. Since intercompany loans are central to the private equity business model, many in the sector were concerned the regulations would have an adverse effect on PE firms. The finalized regulations incorporate aspects of the proposed regulations; however, the alterations represent a reduced compliance burden for PE firms. Internationally based private equity firms can breathe a sigh of relief, as the final regulations do not apply to foreign issuers.

The "Bifurcation Rule," which would have permitted the IRS to recharacterize intercompany debt as part debt and part equity, is one aspect of the proposed regulations omitted from the final rules. The finalized IRC Section 385 regulations are intended to curb certain earnings stripping situations often used as domestic and international tax planning strategies. The regulations' extensive documentation requirements are an initial hurdle to support the treatment of a related party instrument as debt, and require the issuer and holder of the intercompany loan to prepare timely documentation supporting the commercial terms of the debt arrangement. While the finalized regulations lessened some of these requirements, it is a best practice for PE firms to take a close look at their documentation policies so intercompany loans aren't reclassified as equity.

The Section 385 regulations apply to taxable years ending on or after 90 days from the date the regulations were published in the Federal Register. The documentation rules apply to interests issued on or after Jan. 1, 2018. For more in-depth details of the regulations and the various provisions, refer to our [comprehensive alert](#) on Section 385 issued in October.

WHAT DOES THE FUTURE HOLD?

Regardless of the perceptions of portfolio companies, in an environment marked by deal scarcity, private equity funds will likely face increasing competition from family offices. If more family offices allocate a larger portion of their portfolio to direct investments in private companies, funds may also see less money available for fundraising. But competition with family offices is not limited to deals and dollars. Family offices are also increasingly hiring talented managers from the PE industry

to assist in the management of their portfolio companies, which presents both an opportunity and challenge over the long term. As the world of private direct investing grows more crowded, private equity funds need to be ready to handle competition from investors that were once their LPs and more clearly communicate their model and value proposition to potential portfolio companies.



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INDUSTRY INSIGHTS FROM BDO CAPITAL ADVISORS:

THE M&A ENVIRONMENT – WHERE ARE WE NOW, AND WHERE ARE WE HEADING?

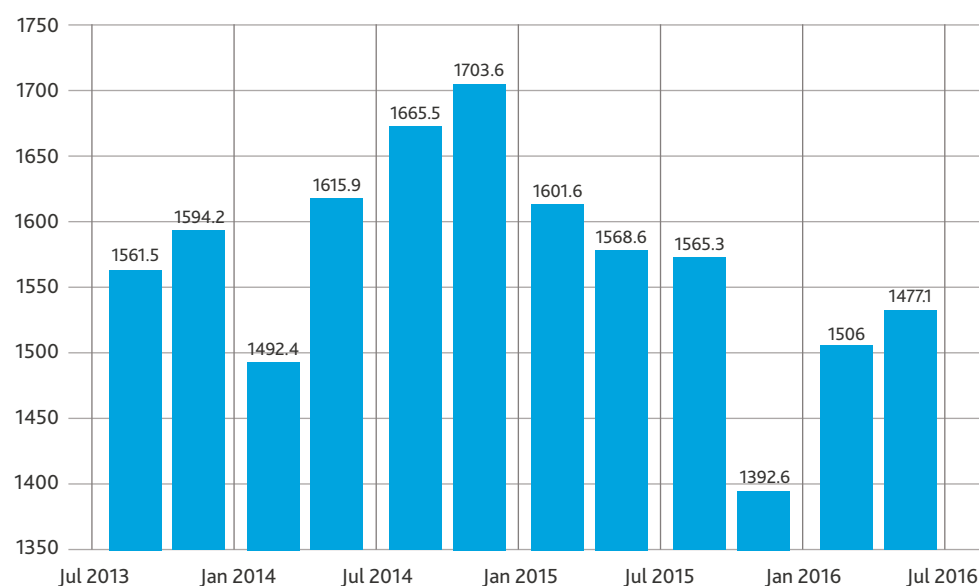
By Dan Shea

THE ECONOMY AND POLITICS

In a slow growth economy and an unfriendly political environment, many are wondering about the resilience and vibrancy of the M&A markets. Against this backdrop, we are often asked about the current state of the transaction world and, more importantly, what the future holds. The current state is much easier to characterize, while the answer to the go-forward question relies on a cloudy crystal ball.

Economic indicators are helpful in answering these questions, and gross domestic product (GDP) is a good place to start. With estimated GDP growth of 1.9 percent during Q4 2016, the U.S. economy appears to be continuing its lackluster performance. While GDP is a broad indicator and may not directly affect the performance of an individual business, we know that general economic health does impact the posture of business owners as they plan for the future. If GDP trends are positive, it may be time to get aggressive; if trends are less rosy, it could be time to hunker down and prepare for turbulence. Slow economic growth, coupled with the long tenure of the current upcycle, has led many business owners to adopt a relatively cautious approach to managing and investing. And, depending on a business owner's age and personal circumstances, as well as the company's position in its lifecycle and market, we continue to

FIGURE 1
U.S. CORPORATE PROFITS
USD Billion



SOURCE: www.tradingeconomics.com | U.S. Bureau of Economic Analysis

see owners making plans for exit before difficult times return.

Corporate profit performance is another important indicator. As shown in Figure 1, the aggregate profit of U.S. publicly traded companies peaked in early 2015 and has since been in decline. This trend, if continued, may have a mixed impact on business leaders, simultaneously increasing cautious behavior while possibly accelerating acquisition activities as executives seek to satiate the thirst for quarterly growth in the public markets.

On the other hand, some see a brighter future when looking at the employment picture. With a current unemployment rate of 4.8 percent, and real wages beginning to rise for the first time since the last recession, it lends support to the idea that the M&A upcycle may persist for some time to come. Consumer sentiment data supports positivity, as well. The latest University of Michigan consumer sentiment reading topped 98.1 in January 2017, up from 87.2 last October. The survey has also recently

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M&A ENVIRONMENT

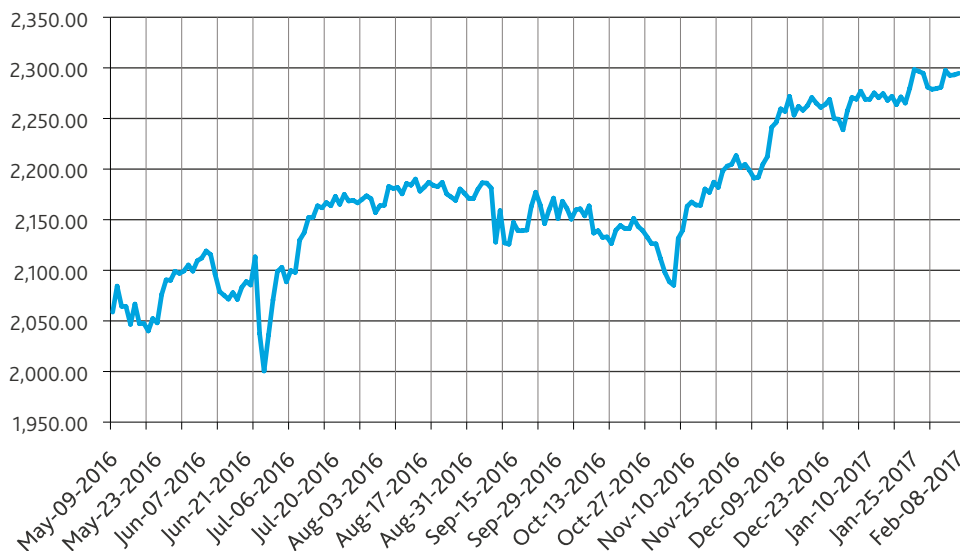
noted a post-election honeymoon period, which has resulted in key stock market indices climbing to new highs after flat to down trends in the preceding 12-month period. Figure 2 illustrates that the S&P 500 stagnated in the 6 months leading up to the election, up only 0.1 percent from May through October, and then climbed approximately 7 percent since election day.

All things considered, including other economic indicators such as labor productivity, housing starts, the ISM indices and household expenditures, we believe that the economy, while somewhat lackluster, will be generally supportive of M&A through 2017. Details of any Trump legislation still remain mostly unknown, but for the time being they appear to be supportive to business growth and M&A. The three pillars of capital formation—private equity funds, corporations and lending institutions—are all flush with cash and generally eager to transact. And with an average of 10,000 baby boomers retiring every day, many upcoming retirees are looking to sell their businesses. Lastly, it is important to note that the U.S. remains the economic high ground for foreign investors. Despite the expensive dollar, offshore investors remain in hot pursuit of U.S.-based acquisitions.

WHAT THE DATA SAY ABOUT DEAL VOLUME AND VALUATION MULTIPLES

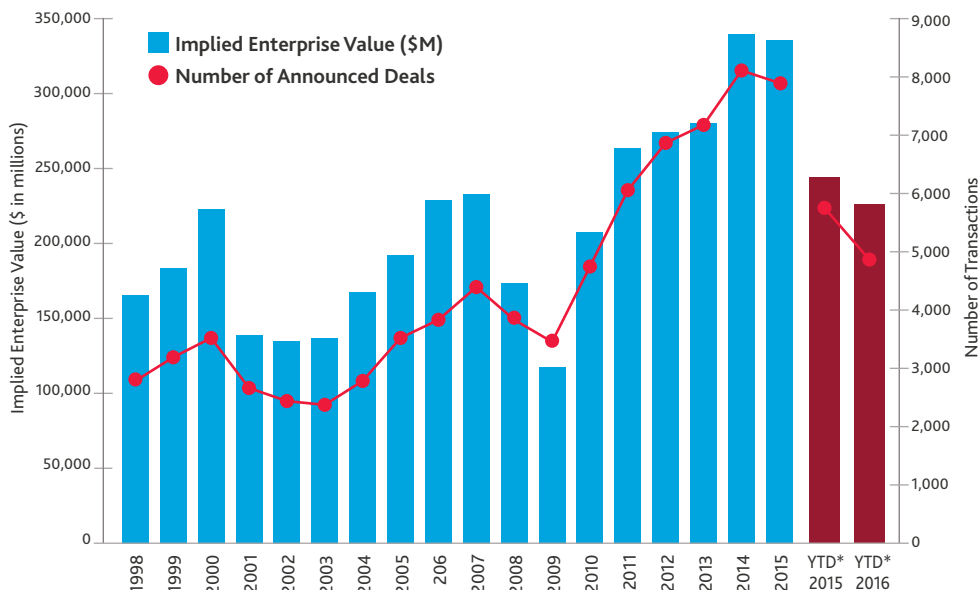
As depicted in Figure 3, M&A volumes are cyclical. It is wise to pay attention to this axiom regardless of whether you are on the buy or the sell side of a transaction and to recognize that we are currently in the sixth year of an upcycle. It cannot go on forever, and recent data suggests that volumes have cooled a bit in the last two years after peaking in 2014. Indeed, transaction activity was at record lows in early 2016, before picking up in the spring and early summer, only to slow down again in Q3. When the final deal is counted, we believe that the year will end up short of 2014 and

FIGURE 2
S&P 500 (^SPX) – INDEX VALUE



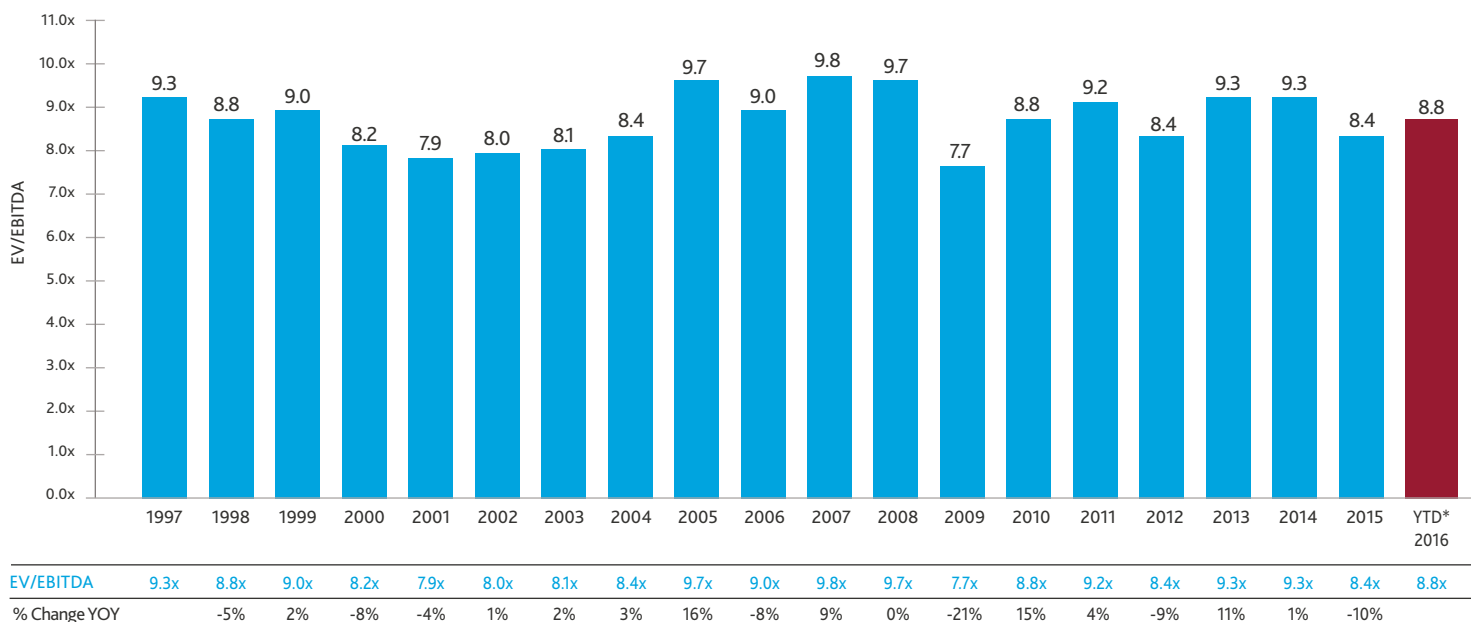
Source: S&P Dow Jones Indices LLC, a division of S&P Global.

FIGURE 3
U.S. ANNUAL MIDDLE MARKET M&A ACTIVITY



*YTD through 9/30

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M&A ENVIRONMENT**FIGURE 4**

Source: S&P Cap IQ

2015, but still higher than 2013—in other words, while transaction activity is a bit lower, it remains at a healthy level.

Business valuations remain very high in the current environment, having risen in stutter-step fashion from the record lows seen during the last recession. This is particularly true for “high performers,” or businesses that have a range of attributes that make them particularly special (high growth, great prospects, high margins, protected products/technology, etc.). As indicated in Figure 4, the average EBITDA multiple now stands at 8.8x for control sale transactions. That said, we are routinely seeing our high-performing clients achieve double-digit sale multiples. It remains a sellers’ market for top-notch businesses. While healthcare and IT targets generally command the highest multiples, we are also seeing remarkably high valuations in the manufacturing and consumer products spaces.

Perhaps the most dynamic segment of the M&A market from a valuation standpoint involves target companies that fall short of achieving “high performer” status; herein referred to as “average performers.”

Average performers are companies that, for any number of reasons, solicit a more disciplined approach from buyers in terms of valuation. While still in demand and very salable, these companies often have one or more limiting characteristics, such as lower historical growth, less attractive prospects, lower margins, customer concentration, commoditized products, management team gaps, etc.

Multiples for average performers have been more volatile in recent years. In the early post-recession days, buyers were very cautious, keeping average multiples for this segment stubbornly low. As the economy regained footing, segment valuations began to rise at a faster rate than for those of high performers. In recent quarters, however, the gap between the two segments has widened. We believe that buyers are signaling increased concern over economic conditions and therefore are adding an extra layer of caution to their valuations of average performers. This trend should not be surprising given the cyclical nature of our economy, as well as the length of the current upcycle.

CONCLUDING REMARKS

It is not surprising that we find ourselves with mixed signals concerning the direction of the M&A marketplace. The severity of the last recession, the associated government response and the length of the recovery combine to raise uncertainty. Economic indicators are mixed, and the post-election uptrend is sure to end at some point soon. With one party in charge of our branches of government, there is now a pathway for economic policies to change. While public markets seem to suggest that these changes are likely to be good for business and M&A, only time will tell whether this is truly the case.



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MARK YOUR CALENDAR

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

FEBRUARY 2017

Feb. 27

Catalyst Financial Partners Cap Intro: Private Equity Fund Investing

The Capital Grille
New York

MARCH 2017

March 1

Opal Group Family Office Winter Forum 2017

New York Marriott Marquis
New York

March 2

Capital Partners Southern Private Equity Conference

The Ritz-Carlton
Dallas

March 8-10

NAIC Women's Private Equity Summit

The Ritz-Carlton Half Moon Bay
Half Moon Bay, Calif.

March 23

Capital Roundtable Best Practices for Launching and Managing an SBIC

TBD
New York

March 29

Financial Research Associates Co-Invest: 2017

Princeton Club of New York
New York

March 29-30

International Research Networks Global Sovereign Wealth Forum

TBD
London

APRIL 2017

April 6-7

SBIA Western Private Equity Conference

Fairmont Miramar Hotel & Bungalows
Santa Monica, Calif.

April 19

Real Deals Private Equity Awards 2017

London Hilton
London

April 23-25

Opal Group Impact Investing Forum 2017

Boca Raton Resort & Club
Boca Raton, Fla.

April 27

PE Investor Relations Conference

TBD
London

MAY 2017

May 11-12

IMN Real Estate Family Office and Private Wealth Management Forum

Hyatt Regency Huntington Beach Resort & Spa
Huntington Beach, Calif.

May 15-18

IFC's Global Private Equity Conference: The Future of Emerging Markets

The Ritz-Carlton
Washington, D.C.

May 16

LPGP Connect Private Debt New York

TBD
New York

DID YOU KNOW...

Average global mid-market deal value was \$87.4 million in the third quarter of 2016 and was among the top 10 average deal values since 2008, according to [BDO's Q3 2016 Horizons Report](#).

According to a [UBS and Campden Research](#) survey of family offices globally, hedge fund allocations decreased by 0.9 percentage points, while funds set aside for private equity investments increased by 2.3 percentage points.

In the first three quarters of 2016, private equity-backed companies accounted for 37 percent of total IPOs, which is consistent with the prior year, according to [Pitchbook](#).

According to the [2016 Preqin Alternative Assets Performance Monitor](#), the alternatives industry is worth \$7.4 trillion globally, with a \$4.3 trillion total assets under management of the private capital industry.

Seventy-two percent of institutional investors plan to increase their exposure to alternative assets, such as private equity, hedge funds and real estate, in the next two years, according to the [Fidelity Global Institutional Investor Survey](#).

BDO PRIVATE EQUITY PRACTICE

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