Provided Courtesy Of
URISH POPECK
accountants and consultants

SPRING 2013
WWW.BDO.COM

THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

BDO PERSPECTIVE

BUY-SIDE DUE DILIGENCE: TAILORING YOUR APPROACH FOR SUCCESS

By Hank Galligan, Jim Johnson, Kevin Kaden and Steven Shill

Due diligence is a critical step toward completing any private equity transaction. Today, more than ever, many private equity funds are subjecting their targets to greater scrutiny as they seek out companies with a compelling growth story that can withstand the ever-changing business environment. While all buyers should conduct a thorough assessment of the financial, operational, technological and human resources health of a potential portfolio company, there are also key diligence considerations that emerge based on the industry in which each target company operates.

To help fund managers navigate these issues, we took a look at the key diligence considerations in three of the sectors that, based on our ***BDO PErspective Private Equity Study***, private equity professionals believe will provide the greatest opportunities for new investments in 2013: Technology, Natural Resources and Healthcare.

▶TECHNOLOGY

When acquiring a technology company, evaluating the technology itself is often one of the most significant due diligence challenges a buyer faces. If a fund is targeting a startup or new technology, it must determine if the technology will ultimately work or be adopted. For established technologies, on the other hand, a buyer must assess whether the technology is setting the market or following it, and anticipate the potential for the technology to be leapfrogged. The answers to

▶ Read more on page 2

DID YOU KNOW...

According to data from ***Thomson Reuters***, M&A activity across the globe was valued at $542.8 billion during the first quarter of 2013. This indicates a 10 percent increase in overall M&A activity from the first quarter of 2012. Private equity-backed deals bolstered this increase, accounting for 22 percent of total global M&A activity.

Of the 100 retail CFOs surveyed in this year's ***BDO Retail Compass Survey***, 94 percent expect M&A activity to increase or remain steady in 2013. The primary driver of this M&A activity will be strategic buyers (according to 59 percent of retail CFOs), followed by financial buyers (41 percent of retail CFOs).

A recent analysis by ***The Wall Street Journal*** called to light the boom of "megadeals" in the first quarter of 2013. Already this year, six deals have topped $15 billion. Comparatively, only four deals exceeded $20 billion in all of 2012.

Leveraged buyouts continue to demonstrate an upward trend, accounting for 62 percent of deal value in 2012, up from 55 percent in 2011, according to ***Preqin***. This trend began to emerge in 2008 when LBOs first accounted for more than half of the deal value in private equity-backed buyouts.

According to the 100 tech CFOs polled in the ***2013 BDO Technology Outlook Survey***, 42 percent plan to use private equity as a means of raising capital. This demonstrates an increase from 2012 when only 35 percent planned to use private equity to raise capital.

Closing out the 2012 calendar year, deal flow spiked with the uncertain tax environment of 2013 looming ahead. Data from ***PitchBook*** highlights the fourth quarter increases, but 2012 still concluded with the lowest deal volume and capital invested since 2009.

CONTINUED FROM PAGE 1

BUY-SIDE DUE DILIGENCE

these questions will have a significant impact on a buyer's ability to project revenue streams and determine an appropriate purchase price.

Similarly, evaluating a target company's ownership of and ability to protect its intellectual property will have a considerable impact on the long-term value of a potential investment. Intellectual property (IP) laws and how they are enforced differ greatly around the world. It's important for a fund looking to acquire a technology company to understand the potential IP risks and challenges its target faces. If a technology company is unable to protect its IP on a global basis, the value of the investment could ultimately be lost or significantly diminished.

Evaluating a target company's historical revenue recognition practices can also prove to be a significant obstacle for buyers trying to determine the current and projected value of a potential acquisition target in the technology sector. This is particularly true for many early-stage or startup businesses that have not had a robust finance or internal audit function. It's critical that a buyer not only determine if the historical practices are correct but, in the case of a bolt-on acquisition, also assess the technology and determine how it will integrate into the acquirer's existing technology.

NATURAL RESOURCES

For private equity funds looking to acquire exploration and production companies in the natural resources industry, it's critical to evaluate what the target company currently has in the ground (its reserves), what the target has the potential to develop in the future (its undeveloped reserves) and whether or not the company has the internal resources and knowledge base to help it meet its long-term growth objectives. Without this information, a buyer cannot determine the current and future value of its potential investment.

When it comes to valuing a target's current reserves, a number of assumptions have to be made (generally by petroleum engineers), and navigating this process can prove to be quite complex. It's critical that a buyer understand the methodologies used to evaluate the estimated quantity in current reserves and the pricing assumptions used to estimate the future value. For example, if a reserve currently holds an estimated 1 million barrels of oil, but they won't be accessible for another five years, are they being valued at the current or projected cost per barrel? And if it's the latter, what assumptions are being made to determine the cost of oil five years from now? Most evaluators use the constant case as a base and perform a sensitivity analysis using forecast prices and costs to provide an answer.

Determining the value of undeveloped reserves presents a different set of challenges. While this acreage is often one of the most attractive components of a potential acquisition target in the sector, it is more challenging to determine its future value. A buyer must evaluate where its target company has acreage positions in future plays, whether those positions align with the strategic vision for the company, and how lucrative those plays will ultimately be. This process is further complicated by the fact that "land rushes" will often inflate the pricing of certain areas, as evidenced by the emergence of shale technology, which has allowed for previously ignored areas to become drilling hotbeds.

Liabilities are also a critical issue when it comes to evaluating a natural resources target. There are financial liabilities that come with plugging and abandoning a well, environmental liabilities associated with historical and potential future oil spills, and extensive regulatory liabilities that come with navigating and complying with federal, state and local regulatory requirements. It's critical that a buyer fully evaluate the layers of scrutiny and full set of current and future liabilities an acquisition target in the natural resources sector may face.

HEALTHCARE

The healthcare industry is experiencing a complete shift, as new reimbursement models, a new paradigm for the uninsured, an aging population and changes mandated under healthcare reform have all combined to reshape the industry. As hospitals and health systems consolidate, physician practices are acquired and new industry players emerge, private equity sponsors face many new challenges and considerations that impact the buy-side due diligence process.

When evaluating a potential acquisition target in the healthcare industry – regardless of the specific sector – it's critical to fully understand the organization and its value proposition, and determine if the leadership team's long-term vision is sustainable within the new healthcare environment. It's also crucially important that the leadership team have the knowledge base and foresight to steer the organization where it needs to go within this rapidly evolving industry. The same cadre of healthcare organizations that have thrived historically will not necessarily succeed in the future, as reimbursement models change and the relationships between payers, providers and patients evolve.

The healthcare industry's evolution is also creating many opportunities (and potential roadblocks) that a buyer should evaluate and fully understand before ultimately making an investment decision. New industry players are emerging, providing technology and services that help providers deliver higher quality of care at lower costs. A buyer should assess and understand these market dynamics before making the decision to acquire a company in the healthcare sector.

Regardless of this rapid change, the healthcare industry continues to be highly regulated at a federal state and local level. Before purchasing a target healthcare company, a buyer must understand these regulations and reimbursement issues and determine if the challenges a potential acquisition faces are prohibitive. Similarly, a buyer has an opportunity to evaluate solutions that can help them overcome some of these issues and maintain or grow the value of a potential investment.

LOOKING AHEAD

Buy-side due diligence, at its core, is meant to protect a buyer from potential risks and enable it to successfully execute an acquisition. But no two deals are the same and, therefore, the diligence process from deal to deal shouldn't be the same either. It's vitally important that a buyer take into consideration the specific due diligence considerations that are pertinent to the industry in which a target company operations. Tailoring the process will get a buyer one step closer to completing the deal and, ultimately, earning a profitable return on its investment.

Hank Galligan is a Director and Software Practice Leader at BDO. He can be reached at hgalligan@bdo.com.

Jim Johnson is a Managing Partner in Assurance Services. He can be reached at JWJohnson@bdo.com.

Kevin Kaden is a Partner and Transaction Advisory Service Leader at BDO. He is also a member of the Private Equity Practice. He can be reached at kkaden@bdo.com.

Steven Shill is a Partner and Healthcare Practice Leader at BDO. He can be reached at sshill@bdo.com.

INCREASED SEC OVERSIGHT – NO LONGER JUST A POSSIBILITY – IT'S HERE

By Lee Duran and Dale Thompson

On April 8, 2013, the U.S. Senate confirmed former federal prosecutor Mary Jo White as the new head of the U.S. Securities and Exchange Commission (SEC). The appointment of a tough prosecutor to lead the SEC is a continuation of a trend at the agency to strengthen its oversight of the many companies and industry professionals it regulates, among them, asset managers.

Regardless of the SEC division, governance is an area that the agency focuses on in every exam, i.e., what's the tone at the top and what's the enterprise risk management program a company has in place? However, when it comes to oversight of investment advisers, investment companies, hedge funds, mutual funds and private equity funds, the SEC's Asset Management Unit director has said that its broader focus areas are compliance with:

- **Stresses in the industry** – fundraising and excess uninvested capital raised during the pre-2008 era chasing too few deals
- **Lack of transparency** – affecting valuation of investments, and misrepresentations of the portfolio companies' financial conditions and operating performance
- **Conflicts of interest** – misappropriation of the funds' assets, favoring preferred clients over others and usurping investment opportunity for the benefit of management or preferred clients

On March 4, 2013, the SEC issued a Risk Alert on compliance with its custody rule for investment advisers. In that alert it noted that about one-third of all company inspections resulted in deficiencies in the custody-related area. In particular, the alert noted failures to:

- **Recognize that they have custody**, such as situations where the adviser serves as trustee, is authorized to write or sign checks for clients, or is authorized to make withdrawals from a client's account as part of bill-paying services
- **Meet the custody rule's surprise examination requirements**
- **Satisfy the custody rule's qualified custodian requirements,** for instance, by commingling client, proprietary and employee assets in a single account, or by lacking a reasonable basis to believe that a qualified custodian is sending quarterly account statements to the client
- **Fully comply with the use of the "audit approach" to satisfy the custody rules**

So, what is a private equity fund manager to do? Bruce Karpati, chief of the SEC's Asset Management Unit, told participants at the Private Equity International Conference in January 2013 to better defend against potential issues, fund managers should:

- **Guard against conscious and unconscious incentives** that might cause them to provide less than disinterested advice. For instance, managers who offer co-investment opportunities only to certain favored clients may be violating their fiduciary duty to other clients who may also be interested in such opportunities
- **Integrate compliance risk into their overall risk management process** and ensure that COOs, CFOs, CCOs and other risk managers are able to proactively spot and correct situations where conflicts of interest may arise
- **Utilize the sponsor's Limited Partnership Advisory Committee**
- **Be alert and prepared for exam inquiries**

You can learn more about some of the focus areas of the SEC by viewing this web link: http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

Lee Duran is a Partner and Private Equity Practice Leader at BDO. He can be reached at lduran@bdo.com.

Dale Thompson is a Partner in the Financial Services Practice at BDO. He can be reached at dthompson@bdo.com.

Digital Content Spotlight: New Consolidated Tax Return Guidance Applicable to Blocker Corporations

BDO's *PErspective* content continues after ACG InterGrowth with an exclusive digital article from Randy A. Schwartzman, Northeast Tax regional managing partner and member of BDO's Transaction Advisory Services team, on the new consolidated tax return guidance applicable to blocker corporations, which private equity firms often set up to acquire corporate targets. This special tax alert will cover:

- How to determine if the blocker corporation or the target is able to deduct extraordinary payments on closing, such as compensation and certain other transaction costs
- Determination as to which returns the deductible extraordinary costs can be taken on (*i.e.,* the pre-acquisition tax return or post-acquisition tax return)
- Tax issues associated with stock options that vest on closing
- Tax issues with costs incurred to retire outstanding target debt
- Insight into the interplay of the consolidated return rules and the change-in-ownership rules, which could possibly limit valuable tax attribute carryforwards such as valuable net operating losses and tax credits

Schwartzman's informative article will be available to those who subscribe to BDO's *PErspective* and Tax content, and online at bdo.com/private-equity in the coming weeks. If you're interested in staying informed, sign up for future *PErspective* newsletters and more at subscriptions.bdo.com.

MARK YOUR CALENDAR

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

MAY

May 1-2
PEI Private Fund Compliance Forum 2013
New York Marriott Downtown
New York, N.Y.

May 14-15
Mid-America ACG Corporate Growth Conference
Chase Park Plaza St. Louis
St. Louis, Mo.

May 16
New York ACG 9th Annual M&A DealSource & ACG Capital Connection
The Metropolitan Club
New York, N.Y.

May 29
Boston ACG Capital Connection
The State Room
Boston, Mass.

JUNE

June 13
PEI Responsible Investment Forum 2013
Marriott Grosvenor Square
London, UK

June 13-14
MidSouth ACG Capital Connection
Downtown Marriott
Louisville, Ky.

June 17-18
Upper Midwest ACG Capital Connection
The Hyatt Minneapolis
Minneapolis, Minn.

June 25-26
Buyouts Chicago 2013
The Ritz-Carlton Chicago
Chicago, Ill.

CONTACT:

LEE DURAN, San Diego
858-431-3410 / lduran@bdo.com

SCOTT HENDON, Dallas
214-665-0750 / shendon@bdo.com

KEVIN KADEN, New York
212-885-8000 / kkaden@bdo.com

RYAN GUTHRIE, Costa Mesa
714-668-7385 / rguthrie@bdo.com

SCOTT CACURAK, Los Angeles
310-557-0300 / scacurak@bdo.com

ALFREDO CEPERO, Miami
305-381-8000 / acepero@bdo.com

MARK ELLENBOGEN, Washington, D.C.
202-904-2402 / mellenbogen@bdo.com

JERRY DENTINGER, Chicago
312-239-9191 / jdentinger@bdo.com

BOB PEARLMAN, Atlanta
404-979-7124 / bpearlman@bdo.com

MATT SEGAL, Chicago
312-616-4630 / msegal@bdo.com

TODD KINNEY, New York
212-885-7485 / tkinney@bdo.com

www.bdo.com/privateequity

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.

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.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 40 offices and more than 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,118 offices in 135 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information, please visit: www.bdo.com.