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FALL 2012
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THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

BDO PERSPECTIVE

THE IMPORTANCE OF PRE- AND POST-ACQUISITION DUE DILIGENCE FOR PRIVATE EQUITY FUNDS ACQUIRING MULTINATIONAL CORPORATIONS

By Brian Mich, Managing Director, and Glenn Pomerantz, Partner, with BDO Consulting

In this issue of ***BDO PErspective***, Brian Mich and Glenn Pomerantz of BDO Consulting shed light on how private equity fund managers can help mitigate FCPA risks when making investments in foreign companies and U.S. companies with foreign operations. Steven Shill, the leader of BDO's Healthcare Industry, also offers insight into key issues impacting private equity through a discussion of how the Supreme Court ruling on the constitutionality of the Patient Protection and Affordable Care Act will impact private equity investments. Finally, Lee Duran and Scott Hendon of BDO's Private Equity practice highlight the latest trends in the IPO market.

During the past decade, heightened enforcement efforts have made compliance with the U.S. Foreign Corrupt Practices Act (FCPA) and other anti-corruption laws around the globe one of the biggest challenges facing both U.S. and foreign corporations conducting business in the United States. While private equity has not yet been subjected to this increased enforcement, there are recent indications that both the U.S. Department of Justice (DOJ) and the U.S. Securities and Exchange Commission (SEC) will be taking a closer look at the conduct of private equity funds to determine whether they are violating the FCPA.

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DID YOU KNOW...

Private equity firms raised $35 billion in the second quarter of 2012, according to ***PitchBook.*** That's the second best total in the last three years.

Private equity firms bought more than $24 billion of assets from other private equity firms as of August 2012, more than double the $10.5 billion for all of 2011 and the highest total since 2007's $44 billion peak, according to ***Dealogic.***

Almost two-thirds (65 percent) of capital market executives believe either venture capital (36 percent) or private equity (29 percent) portfolios will be the greatest source of IPOs in the second half of 2012, according to ***The BDO IPO Halftime Report***.

Data compiled by ***Preqin*** revealed buyout funds still hold 72 percent shares in the companies purchased from 2006 to 2007.

Technology systems have accounted for 20 percent of healthcare deals during the first half of 2012, up from just 12 percent in 2011, according to ***PitchBook.***

Global M&A activity remained slow in the second quarter of 2012, with deal volume sitting at its lowest levels in three years, according to ***Thomson Reuters.*** However, U.S. M&A activity bucked the global trend, with volume up 14 percent.

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PRE- AND POST-ACQUISITION DUE DILIGENCE

The FCPA contains two provisions: (1) an anti-bribery provision, which prohibits paying, offering or promising anything of value to a foreign official in order to obtain or retain business; and (2) a "books and records" provision, which requires a company listed on a U.S. exchange to maintain accurate books and records and to implement a system of internal controls designed to prevent instances of corruption.

During the past 10 years, the DOJ and SEC – which both have criminal and civil enforcement jurisdiction under the Act – have significantly increased the number of enforcement actions being brought against corporations and individuals. These efforts have resulted in substantial jail sentences for guilty individuals, and large monetary penalties, costly internal investigations, court-ordered monitors and debarment for companies that violate the FCPA.

Private equity funds are particularly vulnerable to FCPA risks when making investments in foreign companies and U.S. companies with foreign operations because the FCPA has a successor liability component pursuant to which an acquirer of a controlling interest in a corporation inherits financial responsibility for any pre-acquisition FCPA violations committed by the target company and may have criminal responsibility for any post-acquisition violations. This successor liability necessitates that private equity funds – when acquiring a multinational company, particularly one that operates in corruption-prone countries – both conduct pre-acquisition anti-corruption due diligence and take steps after the acquisition to ensure that the newly acquired portfolio company has an anti-corruption compliance program.

Taking the appropriate steps before and after an acquisition will not only help reduce the risk of an enforcement action, but will also help protect the value of the private equity firm's investment. This latter point cannot be overstated: If an acquirer does not take appropriate steps to identify hidden FCPA risks in a target company before and after the acquisition, a future buyer may find them through its own due diligence process. That discovery can result in a downward purchase price adjustment or, worse yet, a termination of the deal.

The components of an appropriate pre-acquisition anti-corruption due diligence work plan will vary depending on the risk profile of the acquisition company. That being said, typical steps in the due diligence process will include:

1. High-level assessment of the target company's corruption risk by gaining an understanding of, among other things:
   - Industry in which the target company operates
   - Countries in which the target company is based and operates
   - Extent to which the target company transacts business directly with the government
   - Extent to which the business of the target company is regulated by the governments of the countries in which it operates
   - Extent to which the target company relies on third-party intermediaries, such as agents, distributors, resellers, consultants and joint venture partners
   - Target company's control environment, particularly as it relates to disbursements and the screening of third parties
   - Any known history of corruption by the target company, its management or staff

2. Interviews of the target's key management and staff-level employees, including the CEO or head of the business unit being acquired, the CFO and some key accounting personnel to understand how transactions are processed, and local management and sales representatives, particularly those who operate in high-risk countries

3. Review and assessment of the target's anti-corruption policies and procedures, including training

4. Review and assessment of the process by which third-party intermediaries, such as consultants, agents, distributors, resellers and joint venture partners, are retained and monitored

5. Forensic review and sample testing of transactions that are identified as high-risk. These can include:
   - Payments to known government officials and agencies
   - Payments to third-party intermediaries
   - Payments in cash
   - Commission payments
   - Gifts
   - Expense reimbursements
   - Travel and entertainment
   - High-dollar and round-dollar amount payments
   - Payments to freight forwarders, customs agents and other processing agents
   - Payments to charitable organizations and political parties

Of course, if the due diligence process uncovers "red flags" indicating that there may be corruption risks, those will need to be investigated.

In the end, the existence of hidden FCPA issues is one more factor to be considered by a private equity fund when assessing the appropriateness of an acquisition target. Pre-acquisition, anti-corruption due diligence will help shield the fund from potential criminal and regulatory liability and, ultimately, ensure the value of its investment.

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HOW WILL HEALTHCARE REFORM IMPACT PRIVATE EQUITY INVESTMENT?

By Steven Shill, Partner and National Director – Healthcare Industry, with BDO

The highly anticipated Supreme Court ruling on the constitutionality of The Patient Protection and Affordable Care Act, passed into law in 2010, has again spurred much debate regarding the overall impact that these laws will have on business – and on the private equity industry, in particular.

In a recent survey performed by the Financial Executives Research Foundation, senior financial executives were asked about the impact of healthcare reform on private equity transactions over the next 12 to 18 months: 58 percent of respondents indicated they expected little or no impact and another 28 percent said there may be a slight decrease in activity. When looking at the first half of 2012, their predictions seem to be accurate. Deal activity has decreased only slightly in 2012 when compared to the first six months of 2011.

In the healthcare industry, however, there has been a more pronounced change. In the first half of 2012, private equity firms executed only 20 healthcare transactions, according to Dealogic, for a total of $997 million. That's compared to 40 transactions during the first half of 2011, which amounted to nearly $4.4 billion.

The inherent uncertainty surrounding the pending Supreme Court ruling likely drove much of this slowdown, but the decision itself may not lead to an uptick in deal activity. The upcoming presidential election will undoubtedly deliver a second dose of uncertainty and, with it, continued reluctance to invest in healthcare.

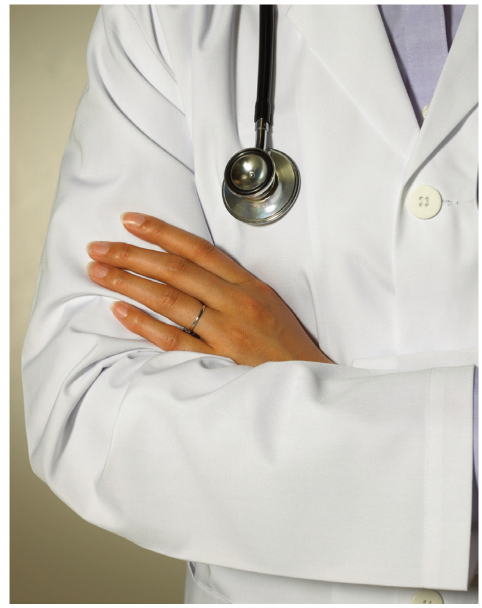
Nonetheless, healthcare reform does create new dynamics within the industry that may lead to investment opportunities for private equity funds:

- One of the primary objectives of healthcare reform is to create a more cost-effective, efficient delivery of healthcare services. As a result, companies that help drive down the costs of healthcare are likely to prosper and attract the attention of investors in the post-reform environment. Examples of these types of companies may include organizations that provide high-tech solutions to lowering the risk of readmissions in hospitals, enhance electronic medical records systems or create solutions that will administer state healthcare insurance exchanges. The iterations are endless.

- The need for cost reductions will also likely increase the tempo of merger and acquisition (M&A) activity among healthcare providers, including the establishment of integrated delivery systems and accountable care organizations (ACOs). These organizations will require complex, high-tech solutions that facilitate the integration of the various businesses. As physicians leave private practice and join these larger organizations, some of the decisions they make regarding drugs prescribed and even medical devices used could change and, accordingly, direct investment toward the winners and away from losers.

- Other segments within the healthcare industry are likely to experience consolidation, as well. The increased regulation of rates and margins at health insurers is expected to lead to increased M&A activity. As only a limited number of formularies emerge from consolidation within the health insurance industry, pharmaceutical and life sciences companies will find their products becoming more standardized. This could drive private equity investment to different parts of the pharmaceutical and life sciences sector.

- It will be increasingly important for providers to drive higher revenues in the new healthcare environment and hospital reimbursements will be directly tied to patient satisfaction. Therefore, the impact of penalties due to readmission rates and patient satisfaction will become more significant. Trends such as translation services that assist medical practitioners in effectively communicating with non-English



speaking patients are emerging, with high-tech solutions being employed that require bandwidth, the recruitment of medical personnel who speak foreign languages and significant amounts of computer hardware to provide these services. Private equity funds will be eying these trends for emerging investment opportunities.

- The myriad of rules and regulations may prove too much for some investors, who will begin looking further afield to diversify their healthcare investment portfolios. As a result, interest from U.S. private equity firms in healthcare companies in emerging economies such as China and India will likely continue to gain momentum.

These examples present a sampling of the magnitude of opportunities that healthcare reform has presented. Although the general consensus is that healthcare reform may not result in a significant change in investment by private equity over the longer term, the healthcare reform act does provide a paradigm shift in investment – and the opportunities that private equity firms entertain will undoubtedly change, as a result.

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PRIVATE EQUITY, VENTURE CAPITAL & THE EVER-CHANGING IPO MARKET

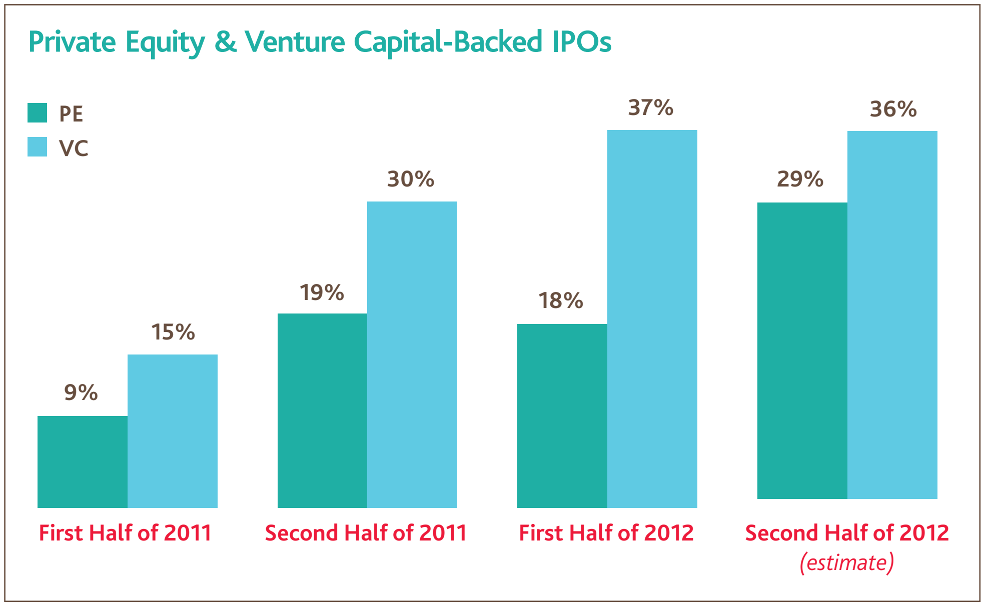
By Lee Duran, Partner and Private Equity Practice Leader, and Scott Hendon, Partner, with BDO

There was little consensus among capital markets executives at leading investment banks when asked to predict the level of initial public offering (IPO) activity in the second half of 2012. Despite a steady increase during the first quarter of the year, renewed concerns about the global economy left the near future of the IPO market unclear. Capital markets executives did agree, however, that private equity (PE) and venture capital (VC) would drive a majority of the IPO activity that would occur during the second half of 2012.

According to ***The 2012 BDO IPO Halftime Report***, capital markets executives expected PE (29 percent) and VC (36 percent) sponsored portfolios to be the source of nearly two-thirds of all IPOs in the second half of this year. The other sources of IPOs identified by these executives were owner-managed, privately held businesses (20 percent), and spinoffs and divestitures (15 percent).

The increased role of PE and VC in the IPO market is a continuation of a trend that has been seen during the past couple of years. According to Capital IQ, PE and VC accounted for 24 percent of IPOs in the first half of 2011, 49 percent in the second half of 2011 and 55 percent in the first half of 2012. The growth in PE and VC exits against the total IPO market may be an indication of the increased interest of PE and VC firms in the IPO market; however, it seems more likely that this increase is, in large part, a result of the overall light IPO volume in recent years.

In fact, while portfolio company sponsors are a significant portion of overall IPOs, IPOs represented only 9 percent of total PE exits in the first half of 2012 and 14 percent of VC exits, according to data from PitchBook. This is up from a recent average of approximately 4 percent of total PE exits, but still a small fraction of total PE and VC exit activity. Even with the changes to the IPO rules included in the Jobs Act of 2012, the cost of going and remaining a public company, combined with continued market uncertainty, has left PE and VC sponsors with a limited appetite for IPOs.



That said, many PE and VC firms are anxious for a liquidity event and the increased percentage of total IPOs being driven by PE and VC firms indicates they believe an IPO in the capital markets can be a viable option, even when compared to a secondary or corporate buyout. There are two trends that are driving this increased focus on IPOs: One, many PE and VC firms are sitting on mature investments that they have held for five years or more and, two, many PE and VC sponsors have strengthened their current portfolio through add-ons. In fact, according to PitchBook, add-on acquisitions have accounted for nearly 50 percent of all PE buyout activity during the past five years.

With today's lackluster IPO market, even a slight uptick in PE- or VC-backed IPOs will prove to have a large impact on the overall IPO market.

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2012 PRIVATE EQUITY EVENT SCHEDULE

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

OCTOBER

Oct. 3-4
Virginia ACG Capital Conference
The Jefferson Hotel
Richmond, Va.

Oct. 18
Alpha Institutes Third Annual Chief Investment Officer Summit
Harvard Club
New York, N.Y.

Oct. 23
Midwest ACG Capital Connection
McCormick Place
Chicago, Ill.

Oct. 25-26
Financial Research Associates Private Equity Operations & Compliance Summit
The Princeton Club
New York, N.Y.

NOVEMBER

Nov. 7-8
Florida ACG Capital Connection
The Ritz Carlton
Amelia Island, Fla.

Nov. 8
ACG CEO Leadership Event
Harvard Club
New York, N.Y.

Nov. 9
ACG Capital Markets Panel: A Year in Review
Kansas City Marriott
Kansas City, Mo.

Nov. 13
ACG Retail Conference
New York Athletic Club
New York, N.Y.

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