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THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

BDO PERSPECTIVE

THE UP-C PARTNERSHIP IPO STRUCTURE

By Jeffrey N. Bilsky, CPA and Avi D. Goodman, CFA, CPA

A company that is considering going public has a long road ahead. When the business is structured as a partnership, it has historically been assumed that the partnership needs to become a corporate entity before the initial public offering (IPO).

However, businesses operating as partnerships can take an alternate route that may yield significantly more value: the Up-C partnership structure.

The Up-C partnership structure is often overlooked, but may be highly advantageous in the right situation. The existing partners can increase their total consideration received on future disposition of partnership units by creating certain tax attributes, and subsequently monetizing the associated benefits in the form of cash received as the tax attributes are used.

In the Up-C structure, the business forms a C corporation and raises capital on the public market via an IPO. The C corporation, in turn, contributes the capital generated from the IPO to the capital of the existing partnership (operating partnership) in exchange for interests in the operating partnership. Effectively, the C corporation (public company) is a holding company and serves as the publicly traded vehicle that is invested in the operating partnership alongside the pre-IPO legacy partners.

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DID YOU KNOW...

The National Center for the Middle Market's ***3Q 2015 Middle Market Indicator*** indicates that in Q3 2015, nearly two-thirds of middle market companies report improved company performance versus one year ago.

Private-equity backed add-on deals hit a record $310 billion through November 4, 2015, exceeding the $274 billion spent on similar deals during all of last year, according to data provider ***Dealogic***.

According to the 2015 ***BDO 600 CEO and CFO Pay Study***, total direct compensation for CFOs in the non-banking financial services sector increased 22 percent between 2014 and 2015, while their CEO counterparts experienced a 5 percent decline in compensation.

The average price multiples buyout firms paid for assets has grown to an all-time high of 11.18 times EBITDA as of the third quarter of 2015, says ***Standard & Poor's Capital IQ's LCD*** unit.

Worldwide mergers and acquisitions, excluding buyouts, have totaled $3.68 trillion this year, beating the previous 2007 record, reports ***Dealogic***. In contrast, the $172 billion total in leveraged buyouts in 2015 is less than a third of the record $639 billion of deals completed in 2006.

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THE UP-C PARTNERSHIP IPO STRUCTURE

TAX ADVANTAGES OF UP-C PARTNERSHIP STRUCTURES

A conventional conversion of a partnership to a C corporation followed by an IPO results in double taxation with respect to the built-in gain inherent in the partnership assets at the time of conversion. Not only are the partners taxed on the ultimate disposition of stock received for their partnership interests, but the corporation is also taxed on a future disposition of acquired partnership assets.

An IPO undertaken using an Up-C partnership structure, on the other hand, features only a single level of taxation on the built-in gain inherent in the partnership assets at the time of conversion. The legacy partners recognize gain on the ultimate disposition of their ownership interests and obtain potential additional benefits, including an increase in the amount ultimately received for their interests if a tax receivable agreement (TRA) is entered into as part of the structure. The public company, in turn, can receive a step-up in the tax basis of its share of partnership assets that, in many cases, can result in additional tax deductions.

Following the IPO, the legacy partners will continue to benefit from the flow-through nature of a partnership, maintaining a single layer of taxation. Further, a TRA as part of an Up-C partnership structure can add value for the legacy partners, typically entitling them to 85 percent of the tax savings derived from the basis step-up achieved by using the structure.

ADDITIONAL CONSIDERATIONS

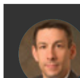
To ensure that the most advantageous post-IPO structure is in place, pre-IPO restructuring transactions are likely necessary. It may not be possible to effectuate certain restructuring steps in a tax-free manner, and some upfront tax costs may result. Any company that is considering an Up-C structure should seek the advice of qualified tax advisors, as determining the optimum pre-IPO structure is not always intuitive. In many cases, several alternative paths lead to the optimum structure, and determining which path is most advantageous to the parties may require complicated tax modeling exercises.

Additionally, the legacy partners will need to evaluate the applicability of the net investment income tax, which imposes a 3.8 percent surtax on investment income in excess of a threshold amount. Net investment income includes net gain attributable to the disposition of property other than assets used in a “non-passive” trade or business. To the extent a legacy partner satisfies the relevant standards and the activity is considered non-passive, an added benefit of the Up-C structure is that the net investment income tax may not apply with respect to that partner.

While many dynamics are at play when it comes to the public market valuation of any security, investment bankers and other market professionals generally do not view a step-up coupled with a TRA obligation as a factor contributing to a reduced market capitalization. One reason for this may be that Wall Street research analysts, and public shareholders in general, typically do not assign full value to the tax attributes of a company, as they can be very difficult to value given the inherent uncertainty regarding their future use. Further, time-value-of-money considerations are also a factor, since many tax attributes can extend 10, 15 or even 20 years into the future, and can have limitations imposed on their ultimate use and may even expire unused. Finally, a common public company valuation metric is a multiple of EBITDA which, by definition, does not take taxes into account.

In addition to working through the complexities of the Up-C structure with tax advisors and counsel, any partnership that is considering such a structure should also work with its investment bankers or other valuation advisors to understand the market dynamics as well as the impact on public market perception and overall valuation.

The above is a condensed version of a 2-part series by the authors as published in the November and December 2015 issues of *The Tax Adviser, a publication of the AICPA®*. Part 1 can be found at http://www.thetaxadviser.com/issues/2015/nov/an-alternate-route-to-ipo-the-up-c-partnership-structure.html.



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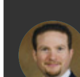

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PE FEE SCRUTINY NO LONGER THE PURVIEW OF JUST THE SEC

By Lee Duran

The SEC Enforcement Division's Asset Management Unit has been scrutinizing the private equity (PE) industry for years to ensure that fund managers aren't misallocating or unfairly charging fees and expenses to investors.

However, it is no longer just the SEC that is examining fee structures and disclosures — recent developments suggest that policymakers and institutional investors are taking a closer look, as well.

The Treasurer of California, John Chiang, recently called for legislation requiring full transparency in the reporting of the fees PE firms charge. Through this request, Mr. Chiang is hoping to "solve the problem of investors who pay excessive fees to PE firms and do not have sufficient visibility into the nature and amount of those fees." Some PE firms have stated that disclosing their agreements with investors would reveal trade secrets. Additionally, private equity fund managers have claimed that classification of operating costs — and the extent to which they should be explained — can be a matter of interpretation. However, this rationale has not satisfied regulators or institutional investors.

The standard fee structure calls for the "2 and 20," wherein a 2 percent annual management fee covers overhead, while the private equity firm earns 20 percent if it achieves a certain return threshold. Generally, investment sponsors to funds will utilize these management fees to cover their costs for normal operations, broken deals, advisory work, etc. However, the SEC has observed an apparent trend in advisors shifting expenses from themselves to their clients during the fund's life without proper disclosure to limited partners.

Among the charges the SEC finds the most problematic are advisory fees, transaction fees and monitoring fees. A common example is the use of third-party advisors or "operating partners." Portfolio companies or funds may directly pay many of these operating partners without sufficient disclosure to investors. Further, these advisors are not usually treated as employees or affiliates of the fund sponsor and, therefore, their fees rarely offset management fees. The SEC states that "Operating Partners are members of the management team and think these costs should be absorbed by the PE fund sponsor out of the management fee. Instead it is charged as an operating cost, which comes out of the pockets of investors."

Another common area criticized by the SEC and institutional investors is the payment of breakup fees in the event that a transaction is not completed. The breakup fee is designed to offset the time and money the PE fund sponsor has spent negotiating a deal that never came to fruition. However, the PE fund sponsor might not inform investors that breakup fees are included in operating expenses.

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The Meaning of Financial Support

As we approach the 2015 reporting season, we thought it pertinent to remind PE fund sponsors of new disclosure requirements regarding financial support provided to a portfolio company.

Pursuant to Accounting Standards Codification (ASC) 946-2050, a fund sponsor is required to disclose quantitative and qualitative information about any financial support that it provides, whether required to provide or otherwise. Accounting standards indicate that financial support includes "loan, capital commitment or guarantee." However, for purposes of applying the disclosure requirements in the standards, financial support would generally include amounts without which the investee would be unable to maintain its existing operations.

Financial support provided to an investee is required to be disclosed and disaggregated by financial support a fund sponsor was contractually required to provide and financial support it was not contractually required to provide. Such disclosure must include the type and amount of financial support (including when the fund sponsor assists an investee in obtaining financial support) and the primary reason for providing the financial support. A fund sponsor is also required to disclose financial support it is contractually required to provide its investees, but has not yet done so.

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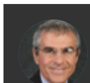
PE FEE SCRUTINY

So, what is a PE fund sponsor to do?

- Fund sponsors should analyze all the direct and indirect fees they are collecting, as well as all expenses being charged to the fund. The sponsor should then determine if these expenses are clearly and accurately disclosed to investors.
- Funds should ensure they have formalized policies and procedures in place to define how fees and expenses are calculated, as well as to review and monitor the accuracy of fee calculations and charges.
- Compare the fees charged to the fund or portfolio companies to ensure that these are reasonable in accordance with the operating agreement. However, determining whether or not a particular fee or expense is covered under existing disclosure requirements could come down to a judgment call. As a result, fund sponsors should carefully consider these costs with their legal counsel. This may also be an indication that the Limited Partnership Agreement needs to be modified to handle the fee arrangement more clearly.
- Ensure disclosure of the types of expenses accompanied by a detailed description of allocations. Some fund sponsors have recommended the issuance of an interim investor memorandum in discussing any changes to fees and expenses being charged to the fund.

In this current environment, PE fund sponsors would do well to consult with their advisors on disclosures and, when in doubt, err on the side of caution and timely disclosure.



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WEBINAR RECAP: IS THERE A CREST IN SIGHT FOR MANUFACTURING & DISTRIBUTION M&A ACTIVITY?

Last month, BDO hosted its first Manufacturing & Distribution (M&D) Merger & Acquisition (M&A) Outlook webinar, "Is There a Crest in Sight for Manufacturing & Distribution M&A Activity?"

Dan Shea, Managing Director and Head of Private Equity Coverage for BDO Capital Advisors, LLC and Jerry Dentinger, Partner and Leader of the firm's Central Region Transaction Advisory Services Practice, co-presented alongside Rick Schreiber, Partner and National Leader of BDO's M&D practice. During the webinar, the thought leaders took attendees on a journey along the path of M&D deal flow in 2015 and shared thoughtful insights on current and future activity in the space. Key takeaways included:

Industry Conditions Favor Investment

Before the Great Recession, investors weren't batting an eye at deals in the manufacturing space. Today, however, the industry is attracting their attention. In fact, manufacturing stocks are tracking alongside the S&P 500's overall performance. Why are investors favoring the industry? For many reasons, including its sustainable energy cost advantage, shrinking labor cost disparity, an influx in niche manufacturers and a competitive edge in innovation. Of equal importance is the space's cyclicality which has typically allowed for reasonable purchase valuations which has ultimately led to attractive investment returns.

Private Equity is Well Positioned to Benefit

This year, the market has been incredibly active with no shortage of deal closing. More private equity investors are taking spots at the table, providing stiff competition against strategic buyers. In many deal negotiations, private equity investors are willing to offer prices comparable to or greater than those offered by strategic buyers. This is partly because private equity investors possess a large pool of un-invested capital totaling approximately $500 billion. The available equity as well as debt capital, coupled with a limited universe of sellers has bolstered intense competition. Both premium as well as average assets have been trading hands as private equity firms aggressively put money into deals where they believe they can build value.

Changes on the Horizon in 2016?

The headline as we look toward 2016 is that while economic indicators could slow the pace of activity, investors are still interested in the sector, though they may be more selective and exhibit more restraint. While the market may remain active, the rate of deals could change, with lenders pulling back should the economy slow. If this is the case, valuations could decline and deal volume could level off. However, the U.S. holds a number of advantages today, including relatively low energy costs, a narrowing labor gap and high levels of innovation, and its economic high ground will continue to attract onshore investment in manufacturing, even despite the strong U.S. dollar. Finally, buyers will most likely display more discipline, which is particularly healthy in light of the advanced age of the current economic upcycle.

Between the arrival of a new—and election—year and the persistence of economic changes, it will be interesting to see how deal flow dynamics in the M&D industry shift in 2016.

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BDO KNOWS INTERNATIONAL PRIVATE EQUITY: SPOTLIGHT ON GREATER CHINA

Lee Duran

Kenneth Yeo

The private investment environment in Greater China – the Chinese mainland, Taiwan and Hong Kong – has seen a great deal of change in recent years as the Chinese government has sought to combat economic stagnation and instability in the stock markets.

Our own **Lee Duran** sat down with **Kenneth Yeo**, director and head of Specialist Advisory Services with BDO in Hong Kong, to discuss his firsthand observations and predictions for private equity investment in the region. Here are some insights from their conversation.

Duran: ***Can you tell me a little more about what the investment environment is like for private equity funds in Hong Kong and Greater China? Are certain regions within Greater China attracting more investment than others?***

Yeo: Hong Kong is the second largest private equity center in Asia after mainland China, with 19 percent of the total capital pool. According to the latest available figures, there were close to 400 Hong Kong-based PE funds with capital under management totaling around $100 billion in U.S. dollars. The majority of PE funds in Hong Kong come from overseas to invest in companies throughout Asia-Pacific, including Japan, Vietnam, Australia, India, Korea and the Chinese mainland.

Hong Kong's profits tax exemption for offshore funds has been extended to private equity funds this year, making Hong Kong a particularly attractive location for investors and strengthening its profile as a venture capital and private equity hub in Asia.

Within the Greater China region, the Chinese mainland is currently host to about 2,400 PE funds, and we're seeing positive trends in the investment environment. Consolidation in China and ongoing reforms in State Owned Enterprises (SOEs) – as a result of China's slowing economy – continue to drive domestic M&A. The Chinese government also proposed a new law this year which, if implemented, will remove many of the current pre-approval requirements foreign investors must meet in order to invest in permitted sectors. Free-trade agreements with Australia and South Korea are also expected to support further deal flow.

What major investment trends are you currently seeing in Hong Kong and China for both inbound and outbound investments?

The first half of 2015 has been a record six months for M&A in Hong Kong, with $179.6 billion in transactions completed. Transaction levels remain high as we enter the second half of the year, as Chinese companies continue to seek back-door listings by acquiring Hong Kong-listed entities. These deals are creating very high premiums for listed shells in the Hong Kong market.

In the Greater China region, we did see a few mega-deals larger than $1 billion close in 2014, which mainly involved the reemergence of sovereign wealth funds as buyers. Looking at the figures for Q1 2015, though, we saw deal pace slow slightly. Only 281 middle-market deals closed that quarter, in contrast to the 400 that closed in Q4 2014. However, the first quarter is traditionally a quieter period, given the Chinese New Year, and the Q1 2015 numbers actually exceeded Q1 2014 levels by about 3 percent.

With outbound investments, China's SOEs are still involved in some of the mega-deals we've observed, particularly in the agricultural, resources, utilities and energy sectors. But many non-SOE investors, such

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SPOTLIGHT

as PE funds, have also been very active as the Chinese government has encouraged increased private investment. Private Chinese companies are expected to be the main drivers of outbound M&A as Chinese businesses continue to look abroad to acquire experience, brands, technology, human capital and new markets.

A clear trend over the past few years in China is the emergence of local or "onshore funds" that are typically founded by experienced, well-connected individuals that had previously worked in the more established or bulge-bracket investment banks. China has historically made it difficult for offshore vehicles to trade in Chinese business, so these new funds are offering new points of entry into the market. Moreover, because global forces must fight the twin forces of economic stagnation and increasing regulatory and compliance burdens in order to invest in China, local funds have had an easier time stepping in. We expect these local funds to continue to grow as regulators increase their scrutiny of offshore jurisdictions.

In terms of valuations, the average multiple of enterprise value to EBITDA for PE-backed transactions in Greater China last year was around 15. Valuations in the China mainland are, however, still generally higher than those in Hong Kong due to the more expensive investment environment on the mainland.

Which industries do you see being most attractive to foreign investors looking into opportunities in Greater China? Are certain industries booming in specific countries?

Consistent with the current drivers of the broader economy, technology, consumer business and financial services have been among the most popular industries in Hong Kong. Real estate continues to attract individual and institutional investors looking for stable and attractive returns amid low interest rates.

Over the past year or so, we've also seen larger Chinese investment groups express increasing interest in acquiring smaller securities brokerage firms and boutique corporate finance advisory practices. These acquisitions have been driven by the link-up of the Shanghai and Hong Kong stock exchanges, such as the Shanghai Hong Kong Stock Connect and a pending link-up of the Shenzhen and Hong Kong exchanges. These arrangements allow investors in Hong Kong and the mainland to trade a specified range of listed stocks in each other's markets through their respective local securities companies.

What type of capital flow are you seeing coming into Greater China?

According to the UN Conference on Trade and Development, China attracted the most foreign direct investment in the world in 2014, while Hong Kong came in second, despite a difficult global economic environment. Hong Kong received about $103 billion in cross-border investment – 40 percent more than the previous year – while China registered inflows of $129 billion, an increase of about 4 percent from 2013. As a result, there is still a lot of cheap funding and liquidity chasing deals in the market. In terms of outflows in 2014, Hong Kong again ranked second, with $143 billion exiting (the United States was ranked first with outflows of $337 billion). The mainland's outflows were lower, totaling $116 billion.

Hong Kong is currently preparing for a potential 600 billion yuan (about $97 billion) asset management bonanza as a result of the July 1 commencement of a mutual recognition scheme to allow funds to be sold between the city and the Chinese mainland on equal terms. The arrangement will help boost Hong Kong's role as an Asian fund management hub. About 100 Hong Kong funds and 850 counterparts in China qualify for the program, together managing around 2.3 trillion yuan in assets.

Hong Kong equity capital raisings broke records in the first half of 2015, reaching about $52 billion. It is also the current global leader for IPOs, with $16.5 billion raised from listings so far this year. Secondary raisings or follow-on stock offers raised another $35.6 billion in the first half of 2015, as well.

What trends are you observing in exits? Who is exiting and how? Are holding periods getting longer, or are they shrinking?

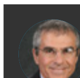
Hong Kong continues to be an ideal platform for private equity exits, with its IPO fundraising ranking among the top three countries since 2009. Both pre-IPO deals and exits benefited from the strong equity markets in the first half of 2015 and received a major boost from the reopening of China's IPO markets in mid-2014. Trade sales account for about 40 percent of all exits for the past few years in terms of value, and 50 percent in terms of volume. Secondary sales have been on the decline but remain a popular exit option given the higher completion probability as compared to trade sales.

However, the recent decline of stock market indices across Greater China – particularly the mainland exchanges – is likely to have an impact on IPO plans in the second half of 2015. The jury is out as to the extent of this impact and how it might reverberate in M&A activity overall.

In terms of holding periods, we've seen an average of three to five years in recent years, though we've trended closer to five years as of late. As a result, there is still significant unrealized value in PE-backed investments.

What do you think will be the next hot opportunity for PE investment in Greater China?

Internet deals have risen significantly following the 2015 Alibaba IPO. The technology sector is red hot at the moment, as well, followed by financial services and healthcare. Healthcare in particular is expected to grow as the overall population ages and there is a greater demand for senior living and long-term care facilities. We've also seen overall improvement in people's access to healthcare services, such as dentistry, which is further driving consumer demand and investor interest.



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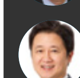

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MARK YOUR CALENDAR

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

JANUARY 2016

Jan. 19
Small Business Investment Alliance Northeast Private Equity Conference
Grand Hyatt
New York

Jan. 25-27
Network 2016
Intercontinental Hotel
Miami

Jan. 27-28
Private Equity International's CFOs and COOs Forum
The Plaza Hotel
New York

FEBRUARY 2016

Feb. 1-3
SuperInvestor
Four Seasons Hotel
San Francisco

Feb. 3-5
Context Miami 2016
Fontainebleau Miami Beach
Miami

Feb. 17
Absolute Return Symposium 2016
10 on the Park
New York

Feb. 26
The University of Texas at Austin 2016 Texas Private Equity Conference
The Hilton Austin
Austin

MARCH 2016

March 9-11
Women's Private Equity Summit
The Ritz-Carlton Half Moon Bay
Half Moon Bay, Calif.

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