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THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

# BDO PERSPECTIVE

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## PE'S DRY POWDER PROBLEM, BOTH A BLESSING AND A CURSE

**By Lee Duran**

**For nearly three years, the private equity industry has been sitting on more than $1 trillion in available undeployed capital. It's the largest and longest dry powder mountain in history, and some have said it is partially to blame for the runup in valuations during the last year.**

Sellers' markets have always made it more challenging for buyers, especially when multiple market forces are involved. And in the current phase of the cycle, excess overhang is just one of many factors contributing to the expanding asset bubble.

The seven-year equities bull market that ran through the end of 2015, fewer attractive sellers in the market and a growing number of strategic buyers have all put upward pressure on valuations.

While savvy firms have resisted the impulse to rush into deals at existing levels, the reality of the private equity business model is that firms must both generate returns and compete against the clock. If capital is not deployed, returns cannot be generated. And that's not good for business.

So what is the right card to play at a time like this? The answer naturally depends on the fund strategy, but there are some basic guidelines that can help you identify and cultivate value for your PCs and LPs.

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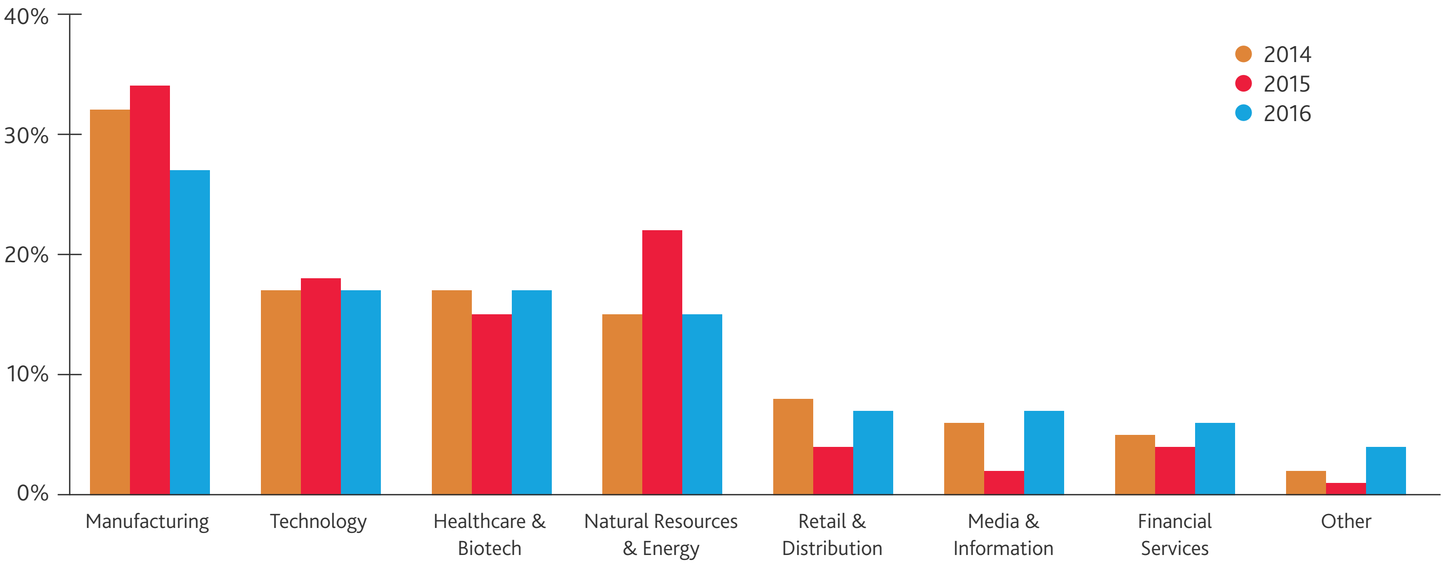
## PE'S DRY POWDER PROBLEM

### INDUSTRIES PROVIDING THE GREATEST INVESTMENT OPPORTUNITY IN 2016

$ of Fund Managers




*Source: BDO PErspective Seventh Annual Private Equity Study, March 2016*

## LOOK TO LEVERAGE YOUR PORTFOLIO COMPANY RELATIONSHIP

As the cost of raising capital through the public markets has risen over the past couple of decades, middle market companies with smart management teams operating in strong markets have been waiting longer to go public and are turning to PE as an alternative capital resource. Although not a new concept, some PE firms are partnering with in-house industry experts to differentiate themselves from competitors. These firms hope this strategy will create value by showing depth in a particular sector. Industry experts can offer impactful insights from day one of an acquisition, and simply leveraging the aura of a marquee industry leader can often sway private company shareholders.

PE firms are also using these industry partners to evaluate opportunities as part of their own internal diligence process. These individuals can identify opportunity in a deal that other firms may have overlooked or call out important red flags. Firms are also trying to tap into these industry experts to source proprietary leads and ideas.

Other firms are opening additional avenues to deploy capital by adding minority deals to their focus and broadening their investment thesis. Firms are also loosening their minimum size bands to see more deal flow and focusing on smaller deals in fragmented industries for a rollup strategy to get to their minimum equity check sizes. We are even seeing firms dedicate specific parts of their funds to evaluating smaller deals so that they are not handicapped by size constraints. In addition, some firms are seeking out and working with potential sellers far in advance of a transaction to help prepare them for a future sale.

## LOOKING FOR THE DIAMOND IN THE ROUGH

In the current environment, we are increasingly hearing from private equity firms that practical is the new sexy. Roughly two thirds of fund managers we surveyed in the BDO [2016 PErspective Private Equity Study] say they see technology (68 percent) and healthcare/biotech (63 percent) as the two sectors most likely to see valuations continue to rise. As a result, many firms are turning back to more traditional industries with softening valuations. In fact, more than one quarter of the fund managers we surveyed indicate the manufacturing industry will generate the greatest opportunity for investment this year, as the sector has seen a boost from lower energy prices.

Other sectors expecting to see valuations level off and opportunities emerge this year are oil and gas (55 percent) and retail and distribution (59 percent), according to the survey.

## RAMP UP DUE DILIGENCE EFFORTS

As valuations rise, so should due diligence efforts. Due diligence teams will need to ensure all aspects of the business tell a consistent story about the company's value. Buyers should scrutinize every facet of the seller's operations to identify and confirm that the key factors driving growth are sustainable. This will help ensure they are

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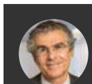
**PE'S DRY POWDER PROBLEM**

not overpaying while also verifying desired returns in a number of economic scenarios. Buyers should be extremely sensitive to any finding that could have an impact on earnings. For example, if a bid is based on a multiple of earnings, any negative adjustments made as a result of due diligence would be exacerbated by the multiplier effect and should be treated as such.

## IT'S NOT ALL GLOOM AND DOOM

Despite growing concerns about excess overhang, it's still a much nicer problem to have than not having capital at all. The market has generally recovered to sustainable transaction levels, which included 1,549 middle market deals closing globally in Q1 2016, according BDO's latest Horizons report. There is definitely value to be had in the marketplace, and a surplus of capital to acquire it. By widening their nets to search for deal flow beyond the traditional sources, proactive buyers are finding reasonably valued opportunities that can be molded into great returns.



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# IRC SEC. 1202 – A VALUABLE OPPORTUNITY FOR PRIVATE EQUITY INVESTORS

**By Randy Schwartzman, CPA, MST, and Patricia Brandstetter, JD, LLM**

**Internal Revenue Code Section (Sec.) 1202 permits a taxpayer other than a corporation to exclude from taxable income a specified percentage of gain—and potentially the entire gain—from the sale or exchange of qualified small business stock (QSBS) held for more than five years.**

The investment in QSBS can be made either directly by an individual or by an eligible pass-through entity, defined in Sec. 1202 as any S-corporation, partnership, regulated investment company or common trust fund. Private equity (PE) and venture capital (VC) firms will be eligible to invest in QSBS in most cases, as they are typically taxed as partnerships, and should consider the potential tax benefits offered by such an opportunity.

## GAIN EXCLUSION PERCENTAGE AND LIMITATION

The percentage of excludable gain depends on the year in which the stock was acquired, and the holding period of QSBS begins on the day after the date of issuance, whether or not the QSBS is received in a taxable or in a non-taxable transaction. After Sec. 1202 was originally enacted with an exclusion percentage of 50 percent, it was later increased to 75 percent and 100 percent, in each case subject to sunset. The Protecting Americans from Tax Hikes (PATH) Act of 2015 made the 100 percent exclusion permanent.

For QSBS acquired **after Sept. 27, 2010**, a taxpayer other than a corporation may exclude from gross income 100 percent of any gain on the sale or exchange of QSBS that was held by the taxpayer for more than five years. In addition, such gain is exempt from both the AMT and the net investment income tax. If QSBS was acquired **after Feb. 17, 2009**, and on or before Sept. 27, 2010, and was held for more than five years, then 75 percent of any gain on its sale or exchange may be excluded from gross income.

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## IRC SEC. 1202

For QSBS acquired after Aug. 10, 1993, and on or before Feb. 17, 2009, and held for more than five years, the gain exclusion totals 50 percent. In both cases, the taxable portion of the gain is subject to a capital gains tax rate of 28 percent. In addition, 7 percent of the gain excluded from gross income on the sale of QSBS is an AMT preference item, meaning that this amount must be added back to income in determining alternative minimum taxable income, which is subject to marginal AMT rates of up to 28 percent.

In all cases, the amount of gain that can be excluded is limited (per taxpayer and per issuer) to the **greater of**:

- $10 million ($5 million in the case of married individuals filing separately); or
- Ten times the taxpayer's aggregate adjusted basis in the QSBS sold during the taxable year.

The $10 million limitation is reduced by the dollar amount of any gain that was excluded in prior years with respect to the same issuing corporation. For a taxpayer who invests cash in QSBS, the tax basis is generally equal to the purchase price. Where a taxpayer exchanges QSBS in exchange for property other than cash (for example, the assets of an existing business), the tax basis for purposes of Sec. 1202 is deemed to be the fair market value of the property transferred.

## REQUIREMENTS FOR GAIN EXCLUSION

Four main requirements must be satisfied in order for gain on the sale of stock to be eligible for exclusion under Sec. 1202:

### *1. Stock Issued by a C-corporation with Assets Not Exceeding $50 Million*

The stock must be originally issued by a domestic C-corporation with aggregate gross assets—cash and other property held by the corporation, taken into account at its adjusted tax basis at the time of the stock issuance—totaling $50 million or less at all times from Aug. 10, 1993, to immediately after the stock is issued.

Cash and property received in the issuance are taken into account for purposes of the aggregate gross assets test. However, if QSBS is acquired in exchange for property, then for purposes of computing the excludable gain and the limitation, the basis of the stock will be deemed to be at least the fair market value of the contributed property. In effect, this limits the exclusion to gain accruing after stock issuance. Contributed property is also taken into account at its fair market value for purposes of applying the $50 million aggregate gross assets test.

### *2. Acquired by Eligible Taxpayer at Original Issuance*

The taxpayer must acquire the stock at its original issuance in exchange for money or property, or as compensation; however, as outlined further below, exceptions apply for certain tax-free transactions.

As stated above, only non-corporate taxpayers are eligible for gain exclusion under Sec. 1202. Therefore, QSBS that qualifies for gain exclusion may be owned through the investment vehicle if the entity meets the statutory requirements of Sec. 1202. The individual investor is eligible for gain exclusion with respect to his proportionate share of the gain if the individual held his interest in the pass-through entity on the date it acquired the stock, and at all times thereafter until its disposition of the QSBS. Moreover, the excludable gain is limited to the individual's interest in the entity at the time the entity acquired the QSBS. The $10 million and 10-times-basis limitations are applied at the individual owner's level by taking into account the owner's allocated share of the gain from sale of the QSBS and the basis in such stock.

### *3. Qualified Trade or Business of Eligible Corporation*

The issuing corporation must be an eligible corporation, defined in Sec. 1202 as any domestic corporation other than a current or former Domestic International Sales Corporation, a Regulated Investment Company, Real Estate Investment Trust, Real Estate Mortgage Investment Conduit or a cooperative.

At least 80 percent of the value of the eligible corporation's assets must be used in a qualified trade or business during substantially all (typically around 90 to 95 percent) of the taxpayer's holding period. The IRS has taken the position that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of certain types of services requiring individual/owner expertise. Therefore, stock issued by corporations that manufacture or sell products, as opposed to selling services/expertise, can more easily meet the requirements for QSBS. Under a look-through rule, the qualified trade or business requirement can be satisfied through a subsidiary corporation.

### *4. Special Rules and Requirements*

The taxpayer must have held the QSBS for more than five years. In general, the holding period for all taxable exchanges begins on the day after the exchange. The holding period of QSBS begins on the day after the date of issuance, whether or not the QSBS is received in a taxable or in a non-taxable transaction. Thus, in certain non-taxable transactions, the holding period of the QSBS could be shorter for purposes of Sec. 1202 than it is for other purposes of the code. Certain restrictions apply to redemptions. Moreover, certain exceptions and special rules exist for contributions into and distributions out of a partnership, stock option transactions, gift transfers and transfers at death.

## OPPORTUNITY FOR PE/VC INVESTMENT AND EXIT

Sec. 1202 gain exclusion is available both to an individual limited partner investor in a PE or VC fund, and to an individual who is allocated capital gains as a partner in the fund's general partner entity. Each partner's allocable share of the exclusion is limited to the amount that the partner could have excluded at the time the QSBS was first acquired by the fund. The limitation of 10 times the investor's basis in the stock is applied by taking into account the investor's proportionate share of the adjusted basis of the fund in the stock. In effect, each partner can only exclude gain equal to his respective ownership interest at the time the QSBS was acquired by the fund, and only if he has been a fund partner for the entire period during which the fund owned the securities. The

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## IRC SEC. 1202

partner will assume the fund's holding period in the QSBS as long as the individual held his interest in the entity when it acquired the QSBS and continuously thereafter.

Moreover, Sec. 1202 applies to both common and preferred stock. When QSBS is acquired by converting preferred stock, the aggregate gross assets test is applied at the time the convertible preferred stock is issued, and the holding period begins when the convertible stock is first acquired.

### *Certain Corporate Formation and Reorganization Transactions*

Many corporations in which PE or VC firms typically choose to invest have gross assets that exceed the $50 million aggregate gross assets threshold, and thus do not meet the requirements for a qualified small business. Further, PE/VC firms typically exit their investment in less than the five-year holding period required under Sec. 1202.

However, Sec. 1202 could apply to a limited extent where QSBS is issued to a corporation that is not a qualified small business in a corporate formation transaction described in Sec. 351, or a reorganization transaction described in Sec. 368. Where a PE/VC fund holding QSBS exchanges it in a tax-free merger or similar reorganization in exchange for stock not qualifying as QSBS, the non-QSBS received nevertheless qualifies as QSBS, and the holding period tacks to the holding period of the surrendered QSBS. However, the amount of gain eligible for Sec. 1202 in the corporate transaction is limited to the appreciation in the old QSBS as of the transaction date.

PE and VC firms may wish to consider Sec. 1202 as part of their investment and exit strategy in the following transactions:

### *PE/VC Fund Investment through a Newly Formed Corporation*

Typical investment opportunities through a new corporation include:

- Using cash to purchase assets or a membership interest in a limited liability company engaged in a qualifying trade or business;
- Using cash to purchase an S-corporation with a Sec. 338(h)(10) election, i.e., a stock sale treated as an asset sale for federal tax purposes; or
- Using cash to purchase a C-corporation, or an S-corporation without a Sec. 338(h)(10) election.

### *PE/VC Fund Investment through a Blocker Corporation*

In this type of transaction, the PE/VC fund invests in a C-corporation (Blocker Corporation) intended to be treated as a qualified small business. The Blocker Corporation could then invest in another corporation, or it could take ownership of an existing trade or business that ceases to exist as a separate entity post-contribution (e.g., a partnership that is converted to a disregarded entity).

Under the Sec. 1202's look-through rule, the qualified trade or business requirement can be satisfied through a subsidiary corporation that is at least 50 percent owned by the C-corporation.

### *Exit Strategies*

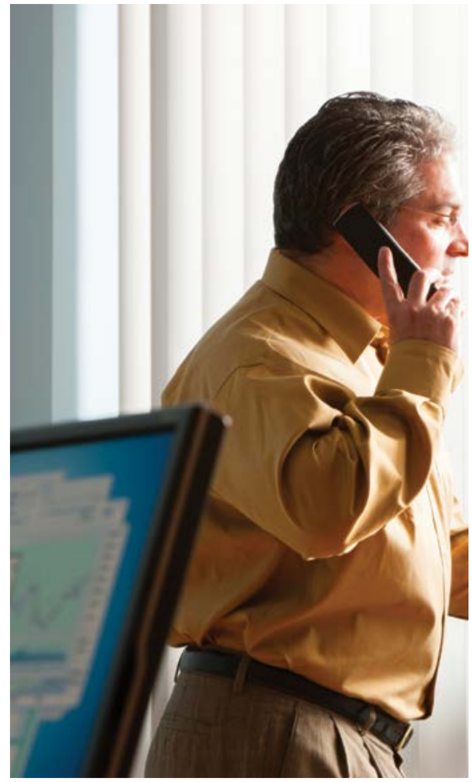
Sec. 1202 can apply to various exit strategies typically employed by PC/VC firms, such as:

- The sale of stock in an initial public offering;
- The taxable exchange of QSBS for publicly traded stock;
- The sale of a company for cash or a combination of cash, stock and debt instruments; or
- The sale of the PC/VC firm's securities back to the company in a redemption transaction that may take the form of a put option.

Depending on the structure of the transaction, gain exclusion under Sec. 1202 may be worth considering in the PC/VC firm's investment and exit strategy.

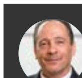
## STATE TAX CONSIDERATIONS

While many states conform to the gain exclusion rules of Sec. 1202, some states do not. Therefore, the state tax consequences



of QSBS should not be overlooked. In a conforming state, such as New York, the reduced amount of gain carries over to the state level, thus reducing the effective state tax rate. However, also in a non-conforming state that has enacted differing rules, such as California, state taxes are based on the full amount of capital gain.

With the 100 percent exclusion now permanent, Sec. 1202 can present a valuable tax savings opportunity for PE funds and their investors upon their exit from investment in a qualified small business. The eligibility criteria for such benefits, though, can be complex and there are many tax issues that are beyond the scope of this article. As a result, interested entities should carefully evaluate their options with a tax professional before proceeding.



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# FCPA RISKS FOR PE FIRMS

By Gerry Zack and Pei Li Wong

**The Foreign Corrupt Practices Act (FCPA) strikes fear into the hearts of many U.S companies with global operations.**

Paying bribes, regardless of the amount, can result in sizable penalties, as well as costly remedial measures and post-violation monitoring. The application of FCPA to international sales, purchasing and shipping operations is widely understood. However, its connection to private equity (PE) firms poses very real risks and may not be quite as clear.

## RISKS FOR PE FIRMS

Direct FCPA risk can arise from a PE firm's investment activities, such as soliciting investors, setting up funds, acquiring and liquidating investments, etc. In recent years, the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) have taken a closer look at the activities of PE firms in the context of the FCPA along with other laws and regulations.

FCPA risks can also arise from PE firms' interactions with government agencies in getting funds approved. These risks can be pronounced when PE firms interact—directly or indirectly—with sovereign wealth funds in their search for investors or partners.

Ancillary FCPA risk can result from the activities of a PE firm's portfolio companies. Such risk can come in the form of successor liability when PE firms acquire investments that had a history of FCPA violations, especially when proper pre-acquisition due diligence is not conducted. It is important for PE firms to monitor for FCPA risk areas and potential violations throughout their ownership of a portfolio company. FCPA red flags may also have an impact on a PE firm's exit strategy and the value of the portfolio company.

Additionally, based on past inquiries made by federal regulators, a PE firm may be required to respond to inquiries from federal regulators regarding the activities of a portfolio company, even if the PE firm is a partial owner. Many PE firms are assumed to have a degree of ownership and control over portfolio companies that render them liable under the FCPA for violations.

## FCPA PRIMER

There are two important applications of FCPA that are relevant to PE firms. First is that the paying of bribes to foreign officials is illegal. This requirement, known as the "business purpose test," includes any payments made by "domestic concerns" intended to induce or influence a foreign official to use his or her position "in order to assist … in obtaining or retaining business for or with, or directing business to, any person." The DOJ enforces these criminal provisions of the FCPA.

A domestic concern is any individual who is a citizen, national or resident of the United States, or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization or sole proprietorship that is organized under the laws of the United States.

The second application of FCPA applies only to an "issuer," defined as a company that has a class of securities registered under the Exchange Act or that is required to file periodic and other reports with SEC. Under this section, issuers are required

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**FCPA RISKS**

to meet certain "books and records" and "internal controls" provisions. Again, these requirements only apply to issuers, and are enforced by the SEC.

## THE IMPORTANCE OF INTERNAL CONTROLS

While the internal controls requirements are formally applicable only to issuers, sound internal controls are key to FCPA risk management and the prevention of FCPA violations. At a minimum, sound internal controls may result in a lower penalty if there ever is an FCPA violation, on the basis that management paid attention to the risk, but a violation simply slipped through the cracks (compared with a situation in which management paid no attention to the risk, that would likely result in a heavier penalty). Ideally, strong internal controls even prevent a violation in the first place, or result in detection in the earliest stages of noncompliance. Accordingly, a careful review of the FCPA internal control provisions is good practice for domestic concerns and issuers alike.

Internal controls addressing a company's specific risks need to be customized using a risk-based approach. Not only is a "one-size-fits-all" approach ineffective, regulators will not take kindly to mere "check-the-box" efforts. A tailored approach may prove challenging in the context of a PE firm reviewing the internal control systems of numerous portfolio companies. Companies should adopt a risk-based approach to implementing and monitoring internal controls, and be aware of the varying levels of risk among different business sectors and geographic locations. For instance, a pharmaceutical company operating in China will have a different FCPA risk profile from that of a retail chain in Europe.

Sound internal controls not only help detect and prevent corrupt transactions, they also help detect and prevent other types of fraudulent transactions. Examples include kickbacks, conflicts of interest, misappropriation (e.g., through expense reimbursements) and accounting fraud.

Some of the specific steps that companies should consider in the design of internal controls systems include:

### *Enhancement of the Control Environment*

- Understand the business model and its corresponding FCPA risks. It is important to understand where the government touchpoints are in the business so they can be assessed for related FCPA risks.
- Implement and communicate written procedures and policies, including those relating to document retention, gift and entertainment, travel, expense reimbursement, third party retention, vendor management and policies around other risk areas such as donations and charitable contributions, imports and exports and government affairs.
- Create, implement and communicate a delegated authorities matrix.
- Provide a channel through which exceptions to policies can be escalated, reviewed thoroughly and, once determined to be appropriate, authorized by legal and compliance.
- Ensure appropriate segregation of duties.
- Clearly communicate the escalation process for suspected wrongdoing or violations of regulations and policies.
- Assign accountability for compliance. Some organizations appoint "compliance champions" in each business unit.

Compliance teams should be made up of professionals with diverse skills to help the company assess risks, evaluate internal controls, and monitor and test transactions. It is particularly effective when companies have individuals who are fluent in the local language, knowledgeable about local laws and have a keen understanding of FCPA requirements and other U.S. laws.

### *Due Diligence Procedures*

PE firms should conduct proper due diligence procedures as part of the hiring process, when contemplating a deal and prior to entering into any fee or service arrangements with third parties, which could include third-party brokers and agents, intermediaries, vendors and/or customer representatives.

A robust pre-acquisition due diligence program helps PE funds properly value deals and alerts buyers to risks that 1) they may not be willing to take on; or 2) they may be willing to take on and remediate with appropriate representations and warranties, but with a corresponding reduction in the valuation.

It is important for PE firms to fully understand how others are conducting business on their behalf and on behalf of their portfolio companies. Due to the dynamic nature of the business environment, the due diligence process should evolve, and relationships with third parties should be reassessed periodically.

### *Post-Acquisition Procedures*

A PE firm should conduct a more robust review of its newly acquired portfolio company after it gains full access to the company's books and records. This review can be folded into its post-acquisition integration process, and can help the PE firm identify areas of concern and take corrective action on a timely basis. The PE firm may even be able to build such a review into the deal terms to help protect its interest.

## CONCLUSION

Too often, executives forget that sound, effective internal controls are a crucial part of good business sense, and the benefits are not limited to FCPA compliance.

PE firms' specific risk profiles and those of their portfolio companies evolve over time. Therefore, not only should PE firms take a risk-based approach toward designing and implementing internal controls, they should also put in place measures that enable enhancement of internal controls as the business evolves.

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# PARTNERS TREATED AS EMPLOYEES OF A PARTNERSHIP

**By Julie Robins and Jeff Bilsky**

**Similar to corporations, businesses operating as partnerships often seek to incentivize their partners and retain highly valued employees by issuing equity compensation.**

Typically, this incentive compensation takes the form of either vested or unvested capital or profits interests in the partnership. Under existing Internal Revenue Service (IRS) guidance, members of a partnership are not considered employees of the partnership. A partner who provides services to the partnership is instead considered self-employed.

Often the partnership and the employee do not fully understand or fail to recognize the tax implications of becoming a partner, especially where the partnership interest is small relative to the overall level of employee/partner compensation. Issuing partnership interests to employees results in often-unforeseen consequences for employment tax withholding and the ability to participate in certain employee benefit programs, such as cafeteria plans, health insurance benefits and qualified plans.

Given the administrative complexity of changing tax status from an employee to a partner, as well as possible loss of available benefits, many partnerships look for alternative structures as a solution. One such structure involves forming a single-member limited liability company wholly owned by the partnership, which is referred to as a "disregarded entity." The disregarded entity then becomes the employer of all partnership employees.

Although there has been considerable controversy regarding the disregarded entity structure, it has been a popular strategy. Many practitioners have questioned whether merely inserting a disregarded entity is sufficient to avoid the general prohibition against treating a partner as an employee. In addition, with the IRS issuing new temporary regulations in early May 2016, it is clear that it never believed this structure complied with the existing regulations. Companies are now facing difficult decisions as a result.

These temporary regulations aim to clarify the employment tax treatment of partners in a partnership using a disregarded entity, stating that if a partnership is the owner of the disregarded entity, the disregarded entity is not treated as a corporation for purposes of employing a partner of the partnership as it would be for purposes of employing a non-partner. In other words, a partner of a partnership that owns a disregarded entity will not be treated as an employee, and is subject to the same self-employment tax rules as a partner of a partnership that does not own a disregarded entity.

Given issuance of the temporary regulations, partnerships that have implemented the disregarded entity structure are facing a new reality where they will either have to discontinue treating their service partners as employees, or potentially restructure their organizations.

## ALTERNATIVE STRUCTURES

Several possible alternative structures may prove attractive to partnerships facing this challenge:

**Upper-Tier Holding Partnership –** Employees of the operating partnership receive interests in a partnership that holds equity interests in the operating partnership. In this structure, the employee does not receive an ownership interest in the operating partnership but obtains the same economic benefits through the upper-tier entity. Use of this structure relies on creation of a respected upper-tier partnership, in which business purpose considerations are necessary. Note, however, it's not clear whether the IRS agrees that this structure allows for continued employee treatment of partner in the upper-tier partnership. In the preamble to the temporary regulations, the IRS specifically requested comments regarding this point. Partnerships that pursue this structure may also eventually face a challenge from the IRS.

**Upper-Tier S-Corporation –** Another common alternative structure involves formation of an S-corporation to hold the equity interest in the operating partnership. By creating the S-corporation—and if the company satisfies the business purpose requirements—the S-corporation (and not the employee) is respected as the owner of the interest in the partnership, meaning the employee should be able to continue to be treated as an employee of the partnership. However, due to limitations on S-corporation income allocations and cash distributions, this structure is not as flexible as the tiered-partnership structure and care must be taken to ensure the intended economic results are achieved.

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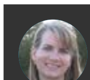
**Upper-Tier C-Corporation –** A variation of the S-corporation alternative involves the use of an upper-tier C-corporation to hold the equity interests in the operating partnership. Under current tax rules, use of a C-corporation should be respected and should not be subject to the same income allocation issues described above. However, using a C-corporation does create a second level of taxation, which any company considering this structure should take into account.

**Employee Leasing Entity –** Another potential structure involves use of a separate entity, typically a corporation, that acts as the employer for all employees of the operating partnership. One variation to this structure involves use of a "professional employer organization," which provides a vehicle for the partnership to "outsource" employee management tasks. Use of this structure can be difficult to implement and there is a significant risk that the operating partnership would continue to be viewed as the employer, thereby eliminating the intended results.

## CONCLUSION

The IRS's recent temporary regulations around disregarded entities clarify a perceived misinterpretation of existing rules. Affected taxpayers should consider whether viable alternatives exist to avoid non-compliance with the temporary regulations. Additionally, partnerships that have partners currently treated as employees should consider whether they can appropriately continue this treatment, or if they should seek an alternative structure.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# CAPITALIZING ON GROWTH: INDUSTRY INSIGHTS FROM BDO CAPITAL ADVISORS

## Summer 2016: Building Products

**Facing unicorn valuations and a narrow pool of attractive targets, many private equity (PE) firms are struggling to identify compelling investment opportunities that one day may generate meaningful returns for their LPs. In separating the wheat from the chaff, PE firms would be well-served to seek out targets in industries that are positioned to buck the current M&A cycle—a cycle that appears to be a bit long in the tooth.**

An all-too-real issue with this approach is the possibility of paying a higher entry multiple than available upon an exit. As a practical matter, PE firms have to consider a potentially less bullish M&A market at the end of the expected hold period and model accordingly. We suggest, however, that there are sectors worth noting that offer the potential for substantial growth and, ultimately, a much higher exit valuation despite the envisioned multiple compression.

One such bright spot is the building products industry. According to BDO Capital's Q1 Manufacturing & Distribution M&A Review and Outlook, though the economy generally follows a four- to seven-year cycle, the building products sector appears to be in the early stages of a 10-year cycle, and deal flow is active. Indeed, it has been nearly 10 years since the housing bubble burst and the real estate and construction industry is back in action. As indicated in the Federal Reserve's most recent Beige Book, the sector is experiencing large pockets of growth throughout the country as new commercial and residential construction ticks steadily upward. Demand is returning to pre-recession levels, as well, with new home sales reaching an eight-year high in April 2016.

Renewed interest in new projects, renovation and home ownership are driving growth for the building products sector. The public markets have already begun to enjoy the upswing, with home improvement retailers like Lowe's and Home Depot reporting significant year-over-year sales growth in Q1 2016 (7.8 percent and 9 percent, respectively), while most other retailers have disappointed investors. Purveyors of essential components, such as roofing, moldings and windows, are on the cusp of a boom, so PE buyers have the opportunity to snap up strong companies with solid pipelines of business at a relatively good value.

PE firms exploring potential investment opportunities in the building products space will want to look for businesses that already have the brand, market positioning and infrastructure in place for growth. The key to success with this strategy is building upon that foundation to foster organic growth in tandem with the real estate and construction market over the next four to six years.

Though PE interest in sexier—and frothier—industries like technology and healthcare is likely to continue despite legitimate valuation concerns, we're beginning to see buyers shift their sights to more practical targets, like the building products sector. PE firms like Industrial Opportunity Partners, Audax and Nautic Partners have all recently acquired businesses in this space, and we expect to see this trend continue in the months to come as more PE firms begin to recognize the opportunity for ROI.

*Capitalizing on Growth is a feature exploring emerging deal flow trends as identified by the BDO Capital Advisors team.*

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Read more ▶

## MARK YOUR CALENDAR

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

### JULY 2016

**July 18-19**
**Financial Research Associates Private Investment Fund, Operations and Compliance Forum East**
The Princeton Club of New York
New York

**July 28**
**2016 Northwest Middle Market Growth Conference**
The Fairmont Olympic Hotel
Seattle

### AUGUST 2016

**Aug. 4**
**Summer NYC VC & Angel Conference**
La Marina
New York

### SEPTEMBER 2016

**Sept. 7-8**
**ACG Charlotte Deal Crawl**
The Ritz-Carlton
Charlotte, N.C.

**Sept. 27**
**The Wall Street Journal Private Equity Analyst Conference**
10 on the Park
New York

**Sept. 27-28**
**Private Debt Investor New York Forum**
Convene Conference Center
New York

## DID YOU KNOW...

The value of deals by buyout firms in Japan fell almost 50 percent, from $1.16 billion in 2014 to $600 million in 2015, according to *Thomson Reuters*.

BDO's Spring 2016 *Initial Offerings Newsletter* reported that there were just eight IPOs in Q1, marking a 76 percent decrease in activity from Q1 2015 and an 87 percent decrease in value. This makes Q1 2016 the least active quarter in seven years, in terms of both offering activity and proceeds raised.

According to *Pitchbook*, private equity firms closed 388 middle market deals in Q1 2016, valued at a total of $71 billion. This represents a 17 percent decline in volume and 2 percent decline in value from Q1 2015.

Recent data compiled by *Preqin* found that 71 percent of investors believe North America will present the best opportunities for investments in 2016, up from 60 percent in 2015.

Fund managers in Latin America raised just $676 million during the first quarter of 2016, a decline of 56 percent year-on-year, according to *EMPEA Data Insights* for Q1.

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