PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 9: ANATOMY OF A TECH DEAL

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION & BACKGROUND QUESTIONS

Todd: Hi. I'd like to welcome our listeners to another episode of BDO's Private Equity PErspectives podcast. My name is Todd Kinney, and I'm the national relationship director for BDO's private equity practice. I'm very excited to have two guests with me today. First, Jeff Becker joins us from JEGI. Jeff is a managing director and co-head of the tech banking practice. Jeff has more than 20 years' experience as a tech banker focused on providing strategic advisories to his clients. Jeff and I actually spent some time together working with the investment banking firm of Cowen and Company years ago. Jeff, good to see you again.

Jeff: Yes. Same.

Todd: And my second guest is Aron Grossman. He is a principal with Gemspring Capital, and he leads the firm's software investing practice, a very important and expanding PE client for BDO. So, Aron, thanks for joining us.

Aron: Thanks for having me.

Todd: Excellent. Well, let's jump into it. Jeff, maybe if you could kick things off and tell us a little bit about JEGI and your role there.

Jeff: Sure. Just briefly, JEGI is an investment banking boutique. We focus on middle market and growth firms. We have been in business since 1987. So, 31 years now, 20 transactions or so a year, predominantly working with PE and growth-equity-backed companies and entrepreneurs on providing liquidity, sell side, sometimes large growth capital raises. Also, worked with larger entities on divestitures and occasionally, buy side work as well. We have

TOPICS DISCUSSED INCLUDE:

Introduction & Background Questions

Software Sector & Innovations

Subsectors

Emerging Markets

Fundraising Outlook

Coffee Break with Aftab Jamil: Best Practices for Investors Pursuing Tech Deals

Market Landscape

Read more

a lot of longevity with our managing directors. All of them have pretty much been in the business for 20-plus years. Most of them have been at JEGI for 10, 15 years or more. I'm one of the newbies. I've been here four years now. And we basically specialize a lot of domain expertise, vertical expertise, and intense best practices on a very efficient process for our clients. On my end, as you said, I've been a tech banker. Actually, I'm getting closer to 25 years now. Hard to believe. So, focused on enterprise software, tech-enabled services that whole time. I used to work on a bunch of public capital markets work as well. For the last 10 years, I've been exclusively focused on providing advisory services for our clients.

Todd: Fantastic. So, Aron, as the leader of Gemspring's tech investing practice, maybe you can tell our listeners a little bit about your firm and your role at Gemspring.

Aron: Sure. Gemspring is a lower mid-market private equity firm. We're based in Westport, Connecticut. We invest across a variety of sectors of tech probably defined being a key focus area for us and where I spend my time. We're control-oriented investors, but I'd say we have a fairly flexible mandate in terms of transaction structure. We really try to customize each deal and structure for the needs of all stakeholders involved. We'll do majority recaps. We'll do corporate carve-outs, full buyouts. We'll even look at structured minority equity investments. Regardless of the sector, we're looking for solid platforms that have the potential for transformational growth whether that be organic, inorganic, or a combination of the two. One thing that I think does differentiate us relative to a lot of other private equity firms is that we have a fairly large team for the size fund. We are a $350 million fund. We take a bit more of a resource of intensive approach to really everything we do that's from sourcing to diligence, but most important, post-investment value creation. A lot of us have operating backgrounds. I myself have spent half my career on the operating side, half on the investing side, predominantly in tech and growth-oriented software businesses. But we're not turnaround investors so I think that's a bit unique that we're looking to invest in solid businesses, have a growth-oriented thesis, but get actively involved in having that operational lens, in addition to the investing lens can be really helpful to our portfolio companies.

SOFTWARE SECTOR & INNOVATIONS

Todd: Great. Well, let's dive into our first topic and, Aron, we'll stay with you. So, I guess, if you can share with our listeners, what beyond the recurring revenue model makes the software sector attractive, and, at the same time, what's risky about it?

Aron: Yeah, so software companies really represent the holy grail in terms of financial characteristics that private equity investors are looking for, right? It's high gross margins, low cap, and working capital requirements. Oftentimes, negative working capital business, sticky customer relationships, oftentimes, a lot of runway for growth. So, those are all things that have investors salivating. I think another thing that's important to note is that we're in one of the longest, if not, the longest, bull markets in history. Most people think that there'll be some correction in the market in the next several years. And it's not to say that software is completely immune to any downturn in the economy, but relative to most other sectors, just a function of the embeddedness with customers and the recurring revenue model are more immune to any recession or cycle in the economy than a lot of other sectors. So, it can be, on a relative basis, somewhat of a safe haven, relative to other industries. In terms of risk factors, I think what's first and foremost on people's minds is valuation. You've got businesses that are trading, not only at very, very healthy EBITDA multiples, but really revenue multiples. And so that all makes sense because a lot of software companies are reinvesting all of their gross profit into R&D, sales, and marketing, and able to expand their market opportunity and grow as fast as possible. But in order to pay a healthy revenue multiple for a business, especially from a bio perspective, you really need to get conviction around the growth and the operating leverage in the business in order to underwrite the returns that we, as private equity investors, are looking for. I think another thing that could be a potential risk factor and applies to some subsectors of software more than others is just the pace of technological change. So, if you take a space like security, for example, you really want to make sure that what you're investing in today is going to be relevant three, four, five years from now and that there isn't going to be some disruptive technology that completely takes the place of what you're investing in. And at least, the business that you're investing can be adaptive to changes that are happening in the market.

Todd: Great insight. Jeff, let's bring you in. You obviously have extensive experience in software and tech-enabled services. Let me throw out a two-part question. What are some of the most promising and exciting innovations you're seeing right now? And I'm also curious if you're seeing more tech-enabled services?

Jeff: Sure. Let me make it a three-part question if I can just to follow up on Aron's point. I think it's so interesting that software is now considered like the holy grail for PE firms because 15 years ago, a software banker like myself couldn't even spell PE because you had perpetual license models, technology was still this black box for most professional investors and things like that, and there was no such thing with the volatility in software companies of a buyout. And nowadays, in our business, it's the majority of our business is dealing with firms like Aron's. We're looking to not

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only own but grow software companies because their occurring revenue models and all the other things that he mentioned. I find that fascinating. Someone with—again, it's a little bit of perspective in the business. So, back to your two questions. As far as promising in innovative areas right now, there's always so many in software and tech-enabled services, what makes it interesting and being able to cover it for so long, because it's constantly changing. Which as Aron mentioned, is a good thing and sometimes a risk. Probably the one area that's the most ubiquitous and most applicable to many different areas around software is in all the interest in artificial intelligence, right? You can't go anywhere anymore without hearing AI thrown around as the latest buzzword. It really does apply to almost every sector, whether you're trying to further automate business processes, which is the core, historically, of enterprise software. Now, also trying to get more actionable intelligence and insights, and then closing a loop and creating predictive opportunities for companies. That's where AI is just applicable everywhere. So that kind of big data buzzword is morphed into AI and machine learning, but it really is applicable, whether it's trying to predict things in supply chain, in health care, in security, in everything, right? So that's clearly the biggest. Beyond that, there's always interest and it's continued to grow, and I think will continue to grow, around various industry verticals in software just because a lot of the horizontal opportunities are pretty mature at this point. In specific industry verticals, it tends to be stickier, it tends to be a lot more leverage to the business model in terms of sales and marketing. Perhaps a more finite group of competitors and you can compete more effectively against more horizontal players. So, we do see a tremendous amount of interest, especially from PE in even smaller and smaller niches of industry verticals. One of them is still more of a broader area I spent is in human capital management. Everything around HR and talent. And since its some great trends going on in terms of a war for talent right now. That's one niche as an example, even though it's not necessarily an industry.

And to your last point around tech-enabled services, actually, that last point I made, the human capital management space is probably one where it's very applicable because you have a lot of technology companies that have been out there doing stuff for a while. But you have other players, whether it's consulting, outsourcing, payroll companies who are trying—all services companies are worried about software eating the world. They're kind of converging and meeting in the middle there. So, you're finding a lot of companies are using technology, but also still providing a complete solution in terms of services. And that's one area, in particular, where tech-enabled services are very broad. But it's really everywhere, so as opposed to, before where bankers like me, perhaps, whether it's venture capital or private equity investors, would maybe shy away from some companies because they had a people element or services element to the business model. A lot of them are being embraced. As long as you can show that it still has that great kind of recurring revenue, low churn, higher margin attributes, it's a solution, and SaaS-like and tech-enabled services are very popular.

Todd: Aron, care to comment?

Aron: Yeah. I think just on that last point, it's important as investors to not be dogmatic about drawing a very finite box around, "We only want to invest in companies that look like this," because it really gets to the financial profile and the revenue model of the business. I think having some flexibility around—they may have people that are performing some functions, so yes, technically, it's more a tech-enabled service than it is truly a software business. But it has all the trappings and the gross margins and recurring profile and thus can be valued very similarly to a software business. I think it's incumbent upon us to have some flexibility in how we're evaluating these businesses and whether it's a tech-enabled service or it's a software business, what you call it is not as important. It's really around the financial profile, the revenue profile, and the growth opportunities of the business.

SUBSECTORS

Todd: Awesome. Lots of great color and insight from both of you on that topic. So, let's kind of transition broadly to subsectors. There are certainly many industries with tech subsectors. I guess take for instance agtech, market tech, ad tech, health tech, fintech, and so on. Aron, let's go to you first, and then Jeff. Are there particular subsectors that stand out to you as attractive?

Aron: Yeah, there are. Where we've been spending a good amount of time is looking at what may be perceived as old, stodgy industries, whether it's logistics, distribution, insurance, construction, that are large markets, have not really been early adopters necessarily of technology. Operators in these businesses are using either legacy on-premise systems, if that, cobbled together home-grown systems, oftentimes are using manual processes and Excel to run their businesses. But you're seeing, whether it's because of generational change or just finally software is starting to—the dominoes are falling in these markets as well. It's huge opportunity for vertical specific software businesses that can really make these businesses a lot more efficient. These tend to be sticky, nice, high-retention businesses, but at the same time, haven't been as picked-over as some other markets, especially maybe some horizontal markets, as Jeff mentioned earlier, so present a really interesting opportunity for us. I think aside from those large vertical markets, there are also a lot of interesting niche-y vertical markets. One of the benefits of

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being a private equity investor as opposed to a venture investor is that we don't need multi-multi-billion-dollar TAMs or addressable markets in order for it to be a successful investment for us. All things being equal, a bigger market is better than a smaller market. But as Jeff mentioned earlier, sometimes the competitive dynamics, just the unit economics of a business can be a lot more attractive for investors like us in some of these niche-ier vertical markets.

Todd: Great. Jeff, what do you think?

Jeff: Yeah, I agree. And as I mentioned before, starting to see a lot more interest in vertical solutions for all the reasons mentioned. I think some of the areas are—because places that have been either backwater for technology where the technology hasn't really gotten there and it's been a laggard, and other places I think where the user populations of these applications are folks who are not necessarily in front a computer, blue collar workers out in the field, more mobile. Of course, now with everybody doing everything on their phone you're having much more consumer-like apps that can do enterprise functionality. So, in industries like construction, logistics, field service, and mobile healthcare workers, you're seeing lots of new different kinds of applications come out that are perhaps mobile first for those specific markets, as an example. Again, and one of the areas that I tend to focus a lot of my time around, the human capital management space, even there, solutions have gotten more vertical for hospitality, for retail, for again some of these field service folks. Because otherwise, you just can't reach them. They're not doing things on a laptop because they don't have a laptop. They don't have a desktop. Finally now, you can bring technology to them. A few clicks, a few texts even, are completing workflow. It's kind of interesting time right now.

EMERGING MARKETS

Todd: So, let's jump to the next topic. What are some of the tech hubs you think are right for incubators, for innovation? We've certainly heard so much for a long time about places like Silicon Valley, New York, Seattle. Jeff, I'll throw it to you and then Aron this time. What geographic regions do you think are emerging markets where exciting activity is really starting to bubble up?

Jeff: Yeah, definitely, obviously the valley. We still go out there all the time. That's not going to change for a while. A lot right here in New York. Certainly Seattle, everything around Amazon and Microsoft, and just a great quality of life. But it's really everywhere. I mean you get a place like Austin, and other places that have popped up. And I suppose the next Amazon headquarters will be one of the next hubs as well. But it's really everywhere. I mean I find myself actually in the process of putting it right now, kind of planning my trips for the rest of the year. And it's like, Chicago, it's Cleveland, Denver. It's all kind of places. It's between companies being able to use AWS to kind of get started to outsource development, talent being able to be more mobile in general, there's really not as much need to just be located just in Silicon Valley where the cost of living is prohibitive anyway. So, really finding very interesting companies in all different locations. I really believe that's a trend that will continue. I think Silicon Valley and some of those other hubs will always be important. There's just good access to capital, and people, and what not. But I do think more and more it will become dispersed around the country. And likewise, internationally. We're all over Europe now. We have a partnership with the firm that's based in Europe, and also Australia, and lots of interesting opportunities all over the place.

Todd: Sure. Aron, what are you seeing?

Aron: Yeah, look, I'd agree with everything that Jeff said. Being control-oriented investors, we're investing in profitable businesses. So oftentimes these are bootstraps, founder-owned companies, family-owned businesses, that haven't raised much if any, outside capital. These companies actually tend not to be in those tech hubs, partly—and these go hand in hand - because the cost of talent can be so high. But also venture investors, they're getting away from this somewhat, but tend to fund businesses that are in their backyards. That's just a whole different ballgame. The companies that we're looking to invest in tend to be outside of those places and are really dispersed in cities across the country. Another factor, as we mentioned earlier, is, given our focus on vertical markets software which makes up the majority of the software businesses that we're looking to invest in, you often find clusters of companies that are tied to a specific sector in a geography where that activity is centered. So, energy and utility software companies that are in Dallas and Houston because that's where the ecosystem is. And there are examples like that throughout the country. So, it's not to say that we wouldn't invest in a business in the Boston, New York, or the Bay area. I still spend a lot of time there, just given the tech ecosystems and the executives, the advisors and everything around that are there. But more often than not, the businesses that we are spending time in are actually in other places in the country besides what you think of as the tech hubs, whether now, or the places of innovation for the future.

Todd: Great. Well, you guys are going to have lots of people following you around the country, now that these new spots you've highlighted.

Jeff: It's more frequent flyer miles.

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FUNDRAISING OUTLOOK

Todd: Let's segue to fundraising for tech, which clearly shows no sign of slowing down, even as investors express concern over PE firms' ability to digest, really, massive amounts of capital that they are absorbing. Jeff, why don't we go to you first. And then, Aron, kind of broadly on the fundraising topic, what's your outlook?

Jeff: I don't really worry about PE and VC firms adjusting and spending the capital. That's their business. I think in economies in good markets like this, they're going to continue to do so. There's lots of capital out there for companies that want to create the next unicorn. Certainly, that's the trend, is lots of folks going for the big win. More of the PE landscape, looking for inorganic opportunities. There's so many of them. A lot of our activity is providing, hopefully, interesting things to look at for firms like Aron's, in terms of add-ons for their portfolio company. So, there's no shortage of ways for them to digest their capital. If the markets were to change and become a down market, if firms are smart, hopefully, they save some of their capital to invest there. Because the last time around, you look at kind of post-Great Recession, post-internet-bubble bursting, some of those investments made in the first couple years after that turned out to be winners. On the other hand, I think there's another route that we're seeing more and more folks go, which is, management teams looking to, not necessarily raise boatloads of capital because it just means that the exit has to be that much higher, that much of a narrower path to success to get a good return, all of that capital. And we're seeing a trend more and more. I'm going to be smarter, I'm going to boost you up a little bit more. I'm going to only raise the capital that I absolutely need. I don't need a $500 million exit, I need $100 million exit and I can personally make a bunch of money with my investors and make a bunch of money, whatnot. So even in the down market, I think you'll start to see, at least from the entrepreneur side, people being a little bit more cautious about the capital.

Todd: Yeah. Aron, how about your outlook?

Aron: So, on the funds side, for all the reasons that I mentioned earlier of why software is so attracted to investors like us, are our limited partners. So, the groups that are investing in our fund see the same thing. Whether it's putting capital into tech-only funds or funds like Gemspring where tech is an important focus. It's because of the financial characteristics and the growth opportunities for software businesses. So certainly, the inflow of capital has made the environment more competitive. That being said, it's still very much a fragmented and target-rich environment. It requires a certain element of hustle and turning over a lot of stones to find those opportunities where, despite the competition, because there's very little, if any, proprietary deals out there despite what most people will say for quality businesses. Despite the competition and the, what some might think of as inflated valuations, you can still underwrite compelling returns which is what we're in business to do. The days are behind us when you can just run the LBO math and go along for the ride and make a good return. It sounds cliché but it's true, you really do need to have expertise in the sectors that you're investing in. You have to filter the opportunities where you have a point-of-view in an angle where you really can create value in these businesses. Because otherwise, it is challenging giving evaluations in the competitive environment.

COFFEE BREAK WITH AFTAB JAMIL: BEST PRACTICES FOR INVESTORS PURSUING TECH DEALS

Todd: Gotcha. I appreciate the insight, guys. And now we'd like to take a quick coffee break with BDO's Aftab Jamil. Aftab is the global leader of BDO's technology practice. Aftab will distill CFO's predictions about M&A activity in 2018 as well as factors that buyer should really keep in mind when evaluating a deal.

MARKET LANDSCAPE

Todd: Thanks, Aftab. And now back to our conversation with Aron and Jeff. Guys, let's talk about, I guess, broadly the market landscape. Jeff, would you describe the landscape as a buyer's or seller's market and what are the opportunities and challenges you face when navigating this current market as you really try to differentiate your firm?

Jeff: I think it's definitely more of a seller's market. That being said, I kind of argue that it's a good market for both in many ways. As Aron said, valuations are high. There's plenty of capital out there. There's good opportunity for exits, the economy's strong, companies are generally doing reasonably well and it does make it more challenging for buyers to be very disciplined from the evaluation perspective. But on their end, there's still plenty of debt available, plenty of capital available and businesses are strong. It's a good fundraising environment for funds. So, I think the buyers are feeling good, the sellers are feeling a little bit better. And that creates a good dynamic for lots of deals. Folks like me or intermediaries, "Hey, it's a great market as far as how do you differentiate." Then I think it comes back to kind of like Aron said. I mean, they're looking at it from a making a return and adding value over the course of a three-to-five-year haul period. We're looking at adding value over the course of a 6-to-24-month get-to-know-you and I'm-working-with-you experience and a process to getting to it quickly. It's really much more about domain

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expertise and being able to add value in terms of making the right introductions and giving some good advice on how to tweak business models, tweak positioning, and think about a process to get that right value and maximize the opportunity that you have in such a good market. Rising tide lifts all boats, but our job is to get even higher above the high-tide level there. So, good market for all right now, but that makes it that much more competitive than for all of us. Both the investors and the advisors kind of work that much harder differentiating ourselves.

Todd: Yep. Makes sense. I've known you for decades. I know you're a trusted advisor, so. I appreciate the insight. Aron, there's a lot of change around how PE is approaching business and really playing more where, historically, buyouts and VC played. Do you care to comment on that trend?

Aron: Yeah. I think it's a good point and it's really interesting. We're seeing private equity firms do LBOs. It's not just investing in but actually raising debt to buy companies that have very little if any EBITDA. It's funny—in a lot of respects, EBITDA is almost a taboo word now in the software, private equity world. And everything's about revenue and multiple ARR, which just wasn't the case 5 and definitely, 10 years ago. You see private equity stepping up and doing control and buyout deals of companies like this. You see lenders really getting comfortable and lending not only of a multiple of cash flow or EBITDA but a multiple of recurring revenue or ARR. Companies that would have been candidates to only go public, raise later-stage venture capital funding or get sold to a strategic. There's now a whole new world of potential buyers for these businesses within the private equity landscape.

Todd: Jeff, care to share your thoughts?

Jeff: I echo that 1,000%. So, the big change over kind of 5, 10, 15 years as a 25-year software banker/tech banker has been the emergence of private equity as a real player in the space to the point where—in all of our processes, almost every single one of them, we have kind of half of the buyer universe is private equity if not moreso. That's now changed again even more over the last two to five years in terms of kind of growth equity buyout, or growth equity recaps where, just like Aron said, you have companies that are still growing, PE might have been looking at more boring businesses that were very mature, that weren't candidates. Now, still, companies that are growing that are not yet fully mature, that are not yet optimizing at all on cash flow are opportunities for majority recapitalizations by PE firms who are now kind of looking for more growth. Likewise, you have more traditional growth equity kind of later stage VC firms who are looking at the later end of the spectrum to try to put more money to work, and there's a big pool of capital kind of right in the middle. We just closed a deal for a great company called ThinkHR where, same thing, it was a majority transaction, but they also put money on the balance sheet. It was a very large check. It's the kind of deal that you would not have seen probably five years ago at all. We had a lot of demand for that and talking to other companies about similar transactions. I think it's a big, big change in the market.

Todd: Great. All right. Well, let's jump to our last topic. And I guess, Aron, I'll go to you and then Jeff. Really, of the criteria to choose from, what do you generally look at when evaluating business plans and company culture and additionally, how do you balance this with evaluating the actual product or service that the company produces?

Aron: Look, I think they go hand in hand, and it's hard to prioritize one versus the other, especially with a tech or a software business where you're selling a product that you've developed. You can't have one without the other. One of the first things we look for when we're looking at a software business is, is the product good, are the customers happy, and there's various ways to measure that through retention, through NPS or CSAT scores and other factors. But the products, despite what people may say, rarely, if ever, do the products sell themselves. So, that's everything from the teams that are continuing to develop and expound the product from a go to market and sales and marketing standpoint. We're evaluating it all, and on the people side, culture is important. It's hard for us as the investors, and I don't think we want to be in a position where part of our thesis is changing the culture. That's something that's either there or it isn't. On the people side, we're obviously looking to back great management teams. Sometimes there are gaps that need to be filled where we can leverage our network to help fill in those gaps over the course of our investment. In some cases, those gaps aren't there, but you need both. You can't have one without the other.

Todd: Jeff?

Jeff: Yeah, from a banker's perspective, similarly, you're looking for a good business model and a good business at its heart, right, because that is a big part of what we're doing. We're not necessarily being seed or series eight type of investors or dealing with companies at that stage. So, at that stage, you're looking for sometimes just a CEO or founder with a great vision or track record, and that could be enough. I think where we are, and where PE universe and audience is, is it is a mix. So you certainly should have some semblance of the business models actually working and the products or services in demand, but it's really the team at that point because we're not going to take on a project if the team isn't going to show well and we don't think has confidence—we don't have confidence in them to execute and be also a good ethical management team. But it's the team. It probably shifts a little bit away from being purely the kind of the CEO founder and the cult of personality. It's great to have that, but you don't necessarily need that. Having a broader team at that point, where

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you're going out to PE universe is really more important. Certainly, there are holes that you could fill, but that team has to kind of gel together. Hopefully, some of the strengths and the weaknesses that maybe the founders have brought out in a strength that the COO has, the head of sales. Likewise, I think one of the areas that are mostly neglected is around the finance function. And whether it's a really good CFO or at least a very, very talented VP finance controller, you do need that, especially as you're getting ready to talk to kind of the PE universe. It'll lessen the brain damage factor of getting a deal done tremendously, make it much easier for both the banker and the potential buyer.

Todd: I think it makes the process easier for all involved.

Jeff: Of course. And having a great accounting firm to work with as well.

Todd: We've come to another end of a really a great podcast. I want to thank Aron Grossman with Gem Spring Capital and Jeff Becker with JEGI. You're both good friends and great relationships to BDO, so we appreciate your time being here today. I know you're both very busy chasing and getting deals done, and I'm confident our listeners are going to enjoy hearing about your experiences and your insight. To our listeners, thanks so much for tuning in. If you haven't already, we'd love you to subscribe, rate, and leave a review of the show on iTunes. Until next time. Thanks for joining us.

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