BDO KNOWS INTERNATIONAL PRIVATE EQUITY: INTRODUCTION TO PRIVATE EQUITY TRENDS IN MAINLAND CHINA

By Bill Liao, Larry Miao, Andy Zheng and Jessie Gao

In recent years, China has emerged as a top player in the global market, with considerable growth in the private equity (PE) sector.

According to the BDO Horizons Q2 2016 Report, China accounted for nearly 23 percent of all global mid-market M&A deals in Q1 2016. In the first half of 2016, sovereign funds participated in at least $16.4 billion cross-border deals, according to Asian Venture Capital Journal. This figure already far exceeds the previous annual record of $11 billion in 2012.

In a historic move in June 2016, the China Securities Regulatory Commission lifted the ban on foreign investment, opening its traditionally closed markets to international investors. The new regulations allow foreign PE funds to invest in domestic stocks and establish asset management services within China.

There has never been a better time for PE funds to get acquainted with the Chinese market. In collaboration with BDO China, we compiled an overview of PE in China that details recent trends, outlines new regulations and provides insights on the growing sector and its changing regulatory landscape.
INDUSTRY OVERVIEW

PE funds in China are structured similarly to U.S. funds, with the main fund structure being the PE investment fund under partnership. Fund managers, or general partners with unlimited liability, usually contribute a small percentage of total committed capital, but earn an annual management fee at a certain percentage. They have the legal power to act on behalf of the investment fund. Passive investors, or limited partners (LPs), normally contribute the majority of the total committed capital with limited liability.

Typical limited partners in China include:

- Sovereign wealth funds, funds-of-funds (FOFs), Social Security funds, banks, insurance and other financial institution-based funds. These are the targeted investors for PE funds.
- The idle funds of state-owned, private and listed companies.
- The idle funds of high-net-worth individuals.

WHAT LIES AHEAD?

2015 marked a period of tremendous growth for PE in China, boasting record-high deal values and volumes. At year-end, the total number of PE funds operating in the country reached 1,314, with funds raised totaling USD $117.7 billion. This marked a 141 percent increase in volume and 46 percent increase in value from the previous year. Despite media reports of overvaluation, the average return for PE firms in China was still 33 times more than the initial investment in 2015. This increased return rate is indicative of continued growth and a successful wave of exits in the years following China’s “National PE Period” in 2011, when there was a nationwide explosion of new Renminbi (RMB) PE funds.

The PE industry showed promising signs of continued growth in 2016 thus far. According to a ChinaVenture report, only 4 percent of Chinese limited partners plan to reduce private equity allocations—a significant decrease from 22 percent last year. Instead, 57 percent of LPs said they plan to maintain allocations to PE this year, up from 34 percent last year.

With PE in China continuing to flourish, we predict a few key trends will emerge in the coming months:

The Online-to-Offline (O2O) market will continue to boom, but attention will gradually return to traditional core businesses.

For the first time in the history of PE in China, startup companies received more funding than developed projects in 2015. Technology, media and telecommunications (TMT) has been a particularly hot area of investment overall. In 2015, TMT investment increased by 330 percent due to the mergers of large enterprises and the return of variable interest equities.

In 2016, we expect that the O2O market will reach maturity as mergers occur, and as “Big Data” and “Internet Plus” continue to grow as the next frontiers of technological innovation. Investors who remain interested in O2O businesses will look for companies to achieve a steady rate of development, so smaller startups looking to attract PE dollars should seek to streamline their businesses, enhance efficiency, integrate their supply chain, establish a compelling brand and improve the quality of their business models.

Sovereign wealth funds (SWFs) will play an important role.

China’s sovereign wealth funds, which operate under government control, will likely take on a dominant role in private equity. Through direct or indirect participation, SWFs function to standardize the investment behavior of capital markets and overcome market failures. To implement national macro-control and industrial policies, SWFs usually focus on innovative small and medium-sized enterprises (SMEs), as well as fields with long-term growth potential, such as biopharmaceutical and environmental protection. To some extent, investments made by SWFs represent the government’s forecast for future development. Foreign LPs may want to closely observe SWFs’ investment strategies for insights into emerging opportunities.

M&A activity will reach its peak.

Many startups are poised to begin scaling through mergers and acquisitions. These enterprises are eyeing targets that will allow them to acquire core technology, expand users, seek new profit growth points and integrate resources. We expect PE and venture capital firms in China will look to take advantage of this appetite by pursuing strategic buyers as a key exit strategy through the end of the year and possibly into 2017.

Interest in the National Equities Exchange and Quotations (NEEQ) market will persist.

NEEQ has changed the pattern of the national capital market. Since its launch in August 2014, transaction volume has skyrocketed and, with IPOs stalling, the number of companies listed on NEEQ increased by 175 percent in the past year. The listing threshold for the NEEQ is low, which leads many investors to view a public listing as a viable exit strategy, and stokes competition among corporate financiers and PE firms alike.

NEXT STEPS

For PE firms interested in exploring investment opportunities in China, the first step is establishing a solid understanding of the regulatory landscape and educating partners accordingly. Once firms cultivate a foundational knowledge base, they can then begin to flesh out an investment strategy and, crucially, a compliance strategy.
CCA DENIES SUCCESS-BASED FEE SAFE HARBOR TO TARGET IN DEEMED ASSET SALE

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

The IRS recently issued a Chief Counsel Advice (CCA), CCA 201624021, to address whether an S corporation whose stock was sold in a transaction treated as a taxable asset sale under IRC Section (Sec.) 338(h)(10) may use the “safe harbor” election of Revenue Procedure (Rev. Proc.) 2011-29 to deduct 70 percent of its success-based transaction fees.

The CCA concludes that the S corporation may not use the safe harbor election, stating that a taxable asset acquisition is not a “covered transaction” with respect to the target, but rather only with respect to the buyer. This is an unfavorable outcome since it is typically the target—not the buyer—who incurs success-based fees in connection with the transaction.

**BACKGROUND**

Among the largest costs strategic buyers and sellers incur in taxable sale transactions are fees paid to investment banks or private equity firms that are contingent on the successful completion of the transaction (success-based fees). The primary tax issue in connection with success-based transaction fees is whether such fees may be deducted as ordinary business expenses under Sec. 162, or whether they must be capitalized.

If a buyer is required to capitalize a fee, then that fee becomes a non-deductible cost of the investment. If a seller capitalizes a fee, it becomes a cost of the sale. The CCA focuses on the treatment of sellers’ success-based fees with respect to the sale of a target in asset sale transactions, including sales of S corporation stock where a Sec. 338(h)(10) election is made (“deemed” asset sale transactions).

The difference between sustaining an ordinary deduction—which could offset other items of ordinary income, including “flow-through” S corporation income in the year of sale as well as taxable wages and interest income—versus capitalization of the transaction costs as an offset to the proceeds of sale could mean significant tax dollars to a seller due to the tax rate differential between capital gains and ordinary income. The tax rate on ordinary income is generally 39.6 percent, while certain items of capital gains are generally taxed at a 20 percent rate for an active shareholder of a selling corporation. This 19.6 percent rate differential as applied to 70 percent of any success-based fees could result in a meaningful increase in overall income tax associated with an actual or deemed asset sale transaction.

This can be especially important for the sale of stock of an S corporation that agrees to have the stock sale treated as a deemed asset sale for tax purposes. An immediate ordinary deduction to the target entity that “flows through” to the individual shareholders can afford a larger tax benefit than treating the success-based transaction fee as a selling cost that offsets goodwill or other capital gain intangibles in the deemed asset sale portion of a stock sale when a Sec. 338(h)(10) election is made.

**Transaction Costs and Rev. Proc. 2011-29**

A taxpayer must capitalize amounts paid to facilitate certain enumerated business transactions, including “an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition)” (Treasury Regulations (Regs.) §1.263(a)-5(a)(1)). The term “facilitate” is very broadly defined to include costs incurred “in the process of investigating or otherwise pursuing
CONTINUED FROM PAGE 5
SUCCESS-BASED FEE SAFE HARBOR

the transaction,” which is determined based on all facts and circumstances.

Success-based fees are presumed to facilitate the transaction, unless the taxpayer can rebut the presumption through sufficient documentation to establish that a portion of the success-based fees pertains to activities that do not facilitate the transaction (Regs. §1.263(a)-5(f)).

In response to much controversy between taxpayers and the IRS regarding the type and extent of documentation required to support the deductible portion of success-based fees, the IRS issued Rev. Proc. 2011-29, which provides for a safe harbor election for success-based fees. Electing taxpayers may deduct 70 percent of such success-based fees, while the remaining 30 percent is capitalized for federal income tax purposes. The safe harbor election is available only for “covered transactions.”

"Covered Transactions"

Regs. §1.263(a)-5(e)(3) define "covered transactions" as one of the following acquisitive transactions (emphases added):

(i) A taxable acquisition by the taxpayer of assets that constitute a trade or business.

(ii) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target in the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b) (which includes a parent-subsidiary controlled group); or

(iii) A reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

CCA 201624021

In CCA 201624021, the shareholders of an S corporation (target) sold all of their outstanding stock to a buyer in a qualified stock purchase that included an election under Sec. 338(h)(10).

A Sec. 338(h)(10) election is made jointly by the buyer and seller in order to treat the stock sale as a taxable asset sale for federal income tax purposes. Buyers typically prefer asset sale transactions from a tax perspective, as they could potentially receive a "step-up" in the tax basis of the assets to fair market value, as opposed to a carryover basis in the underlying assets in a stock sale, when a premium is paid relative to the underlying tax basis of the net assets. A stock sale with Sec. 338(h)(10) election is, in fact, a sale of corporate stock for non-tax purposes; the target’s assets remain owned by the target. The deemed asset sale is a "tax fiction" to provide the buyer with a basis "step-up" reflecting the purchase price.

On the facts of the CCA, the target incurring success-based fees in connection with the deemed asset sale, and attached a statement to its timely filed original income tax return, electing the safe harbor method under Rev. Proc. 2011-29.

The IRS concluded that the target does not qualify for the safe harbor because Regs. §1.263(a)-5(e)(3) refer to a taxable asset acquisition "by the taxpayer," which is interpreted to mean that the provision should apply only to acquiring taxpayers and not to acquired taxpayers or their owners. Accordingly, the costs incurred by the target in a Section 338(h)(10) transaction are not considered related to a "covered transaction" as defined in the regulations. In contrast, the language set forth in Regs. §1.263(a)-5(e)(3)(i) and (iii) regarding the taxable acquisition of an ownership interest (i.e., a stock acquisition) or a tax-free reorganization as "covered transactions" contains the parenthetical "(whether the taxpayer is the acquirer...or the target)."

The IRS thus followed the "tax fiction" of the Sec. 338(h)(10) election in determining the application of Rev. Proc. 2011-29, emphasizing that the "target cannot demonstrate stock ownership post-acquisition." Therefore, the IRS held that the target has to capitalize the success-based fees if it claimed as a current deduction on its return—unless it is able to rebut the statutory presumption through documentation that a portion of the costs is allocable to activities that do not facilitate the transaction.

In order to rebut the presumption that success-based fees facilitate the transaction, documentation of the fees paid to investment bankers and other financial advisors would be required. However, it is difficult to meet the documentation requirement the regulations impose since investment bankers, unlike lawyers or accountants, typically do not keep detailed time sheets of their work.

CONCLUSION

In CCA 201624021, the IRS made it clear that in a taxable asset sale (as opposed to a taxable stock sale or a tax-free reorganization), a seller may not avail itself of the safe harbor to deduct 70 percent of success-based fees under Rev. Proc. 2011-29.

In taxable asset sales, which allow the buyer a "step-up" in the tax basis of the assets, the buyer is typically asked to "gross up" the purchase price for incremental tax due on the actual or deemed sale of assets, as compared to a straight sale of stock. The “gross-up” is generally for marginal state income taxes, differences between ordinary income and capital gains tax rates and any entity level taxes that might exist for built-in gains or excess passive income.

In light of the IRS’s interpretation in CCA 201624021, the IRS advises should also consider a "gross-up" clause to address the fact that a seller that agrees to a Sec. 338(h)(10) election as part of a stock sale will not be able to use the safe harbor method of Rev. Proc. 2011-29. As with all “gross-up” payments, this “gross-up” should also account for any additional payments, since those payments are taxable to the seller when received.

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In September 2015, the Office of Compliance Inspections and Examinations (OCIE), the examination arm of the SEC, announced its second initiative to examine broker-dealers’ and investment advisors’ compliance with the SEC’s cybersecurity guidelines. Expanding these efforts to include more firms in 2016, the OCIE plans to assess cybersecurity-related controls and also test certain areas considered critical.

Registered investment advisors and broker-dealers are required to comply, and they must now identify the best method to do so: leveraging existing internal resources, new hires or external support.

Typically, examiners gather information on and test cybersecurity-related controls to assess their effectiveness. Based on the SEC OCIE guidance, the cybersecurity examination will focus on the following areas:

- Governance and Risk Assessment
- Access Rights and Controls
- Data Loss Prevention
- Incident Response
- Vendor Management
- Training

If the OCIE follows traditional regulatory compliance patterns, an initial review will look for evidence that a firm has assessed its current state, which includes conducting a gap analysis, and has created and enabled both an action plan/timeline to remediate and a process for managing performance against the plan.

The following seven questions can help a firm assess its readiness for—and performance on—an OCIE examination.

1 – Is an employee assigned responsibility for cybersecurity?
As part of the governance process, a firm should employ a security officer responsible for the administration of the security program. At a minimum, this individual should directly manage or oversee the risk assessment process, including developing policies, standards and procedures, in addition to testing security reporting processes. If a firm does not have a security officer, someone should be assigned immediately. Whether the role is full- or part-time depends upon the complexity and risk profile of an organization.

2 – Does the firm have a written cybersecurity policy?
The first step in a cyber examination is a review of key policies and standards to ensure that they sufficiently address the risks identified by the firm. This review can include validating policies and confirming that they are actually enabled and being followed. If documented policies and procedures do not exist, they should be drafted quickly.

3 – Is there a process to assess a firm’s risk profile and cyber risk?
The cornerstone of any cybersecurity program is understanding a firm’s risk profile and regularly conducting security risk assessments against that profile. A regulator will typically attempt to determine whether a risk assessment determines the appropriateness and effectiveness of the security strategy, controls and monitoring that the firm has implemented. If a risk assessment process is not in place, developing a plan to implement one will be necessary.

4 – Is there an access control policy?
A common cause of data breaches is the failure to implement basic controls necessary to prevent unauthorized access to systems or information. Examiners may review how firms control access to various systems and data via management of user credentials, authentication and authorization methods. This can include a review of controls...
associated with remote access, customer logins and passwords, firm protocols to address customer login problems, network segmentation and tiered access. If a firm does not have an access control process in place, creating a plan that provides detail about the process—appropriate to the level of risk—should be implemented.

5 – Does the firm have a cyber training and awareness process?
The weakest link in any firm is the trusted user who either maliciously or unintentionally causes a data breach. Without proper training, employees and vendors can put a firm’s data at risk. During an examination, regulators will look for evidence that a firm has a process to make employees aware of their role in keeping data secure. Training isn’t just for staff; it should include all levels in a firm, including management and the board of directors, as well as contractors and third parties.

6 – Is there a structured third-party vendor management process?
Many of the largest recent data breaches resulted from third-party vendor platforms being hacked. A key aspect of the OCIE’s examination will now seek to determine the scope, completeness, frequency and timeliness of third-party reviews, as well as the third-party service providers’ security posture and assessments. Having a documented and repeatable vendor management process in place is critical.

7 – Does the firm have an incident response plan and process?
A cyber incident is almost inevitable; it’s not if, but when. The middle of an incident is not the time to figure out how to react. The best way to minimize the impact of an incident is to react quickly and appropriately. During an examination, a regulator will look to see whether a firm has an incident response plan and process in place and, more importantly, whether it’s tested regularly.

FINAL THOUGHTS
The questions above are intended to serve as a guide for firms preparing for the cyber portion of an OCIE examination. However, cybersecurity isn’t a one-size-fits-all matter, and every step requires investment. Being prepared is key. Regulators look for evidence that a firm understands what is required and is taking appropriate steps to become compliant, including demonstrating management awareness and engagement. In other words, firms should not wait for an incident to occur or the SEC to call before addressing cybersecurity risks—proactive steps should be taken now.

AUDITOR INDEPENDENCE FOR PRIVATE EQUITY GROUPS

Professional advisors are subject to a number of rules and regulations designed to protect their clients, the auditors themselves and the public at large.

These regulations are established by the federal government and its oversight bodies, such as the PCAOB and the SEC, as well as other professional bodies, including the AICPA. However, the structure of private equity (PE) funds means that adhering to these rules can prove a complicated endeavor.

One area of oversight where this is particularly true is auditor independence. The passing of the Sarbanes-Oxley Act and the Dodd-Frank Act of 2011 have significantly bolstered independence rules, and the AICPA has made significant changes to its own rules in recent years, including expanding its definition of so-called “affiliates.” As a result, many PE firms are, for the first time, finding themselves subject to these regulations. The SEC has clearly stated that maintaining auditor independence is the responsibility of both a company and its auditor, and that “if the auditors’ independence is impaired, then the company has not satisfied the requirements to file financial statements audited by an independent accountant.”

Independence rules are complex, cover many areas and apply at all times when audit or attestation services are being performed. Maintaining independence is a joint effort between an auditor and its clients, and can be particularly challenging when working with both PE funds and their portfolio companies. Without transparency and communication, it can be difficult to determine a client’s affiliates, a situation that can potentially cause inadvertent independence impairments—including replacement of auditors and re-audits, regulatory sanctions, negative publicity, delayed public offerings and more.

In an effort to help offer some clarity around these rules and regulations, BDO’s National Independence team recently developed a new, in-depth brochure exploring the specifics around the SEC’s and AICPA’s independence guidelines, as well as how we work with our clients to ensure compliance. The brochure discusses the definitions of affiliates under each organization’s independence regimes, the auditor’s and client’s respective responsibilities, and services auditors can provide to a PE firm’s affiliates without running afoul of the regulations.

Interested in receiving a copy or learning more? Please contact Laurence Franks at lfranks@bdo.com.
Disruptive changes are altering the healthcare landscape, rewriting the rules that define winners and losers. Investors eager for a slice of the market, which accounts for nearly 20 percent of U.S. Gross Domestic Product (GDP) spending, must proceed carefully. The wealth of new growth opportunities is, in many cases, hinged to significant risks that require a deep understanding of where the industry is heading.

Changing Fundamentals
Reimbursement changes stemming from the Affordable Care Act (ACA) are central to the industry’s transformation. The payments that providers receive under the ACA emphasize treating patients in the lowest cost, highest quality settings and put pressure on providers to collaborate and improve outcomes for patients.

The implications are wide-reaching, affecting where and how patients receive care. Providers along the entire spectrum of healthcare are re-thinking their business models in this new dynamic.

Seeking Scale
In a vast market with so many niche segments, growth opportunities look very different depending on which way you turn.

Scale has become necessary for survival across much of the healthcare field. Deal activity is robust in the highly fragmented post-acute care space (e.g., behavioral health facilities and nursing homes), where the value of deals jumped from $1.67 billion in 2014 to $5.92 billion in 2015. Larger organizations are buying up smaller operators that aren’t able to keep pace with growing regulatory and technology demands. Strategic investors and private equity (PE) are coming together, driving up deal size and multiples.

Entry into the post-acute care market demands a high appetite for risk and a thorough understanding of changing market dynamics. Illustrative of this point is the dramatic impact that one payment change is having on the skilled nursing facilities market. On April 1, the Centers for Medicare and Medicaid Services (CMS) launched a new mandatory bundled payment program that holds participating hospitals responsible for all costs, processes and outcomes for Medicare-covered hip and knee replacements through 90 days after the initial hospitalization. For the first time, hospitals are being incentivized to cull their lists of preferred post-acute care providers to those that offer the best outcomes, most cost-effective care and have higher ratings on the CMS five-star system. Skilled nursing facilities with lower ratings may experience a significant drop in business and valuations may fall accordingly. CMS is testing more mandatory bundled payment programs tied to other common procedures, such as cardiac episodes; if successful, commercial payers are likely to follow suit. Investors must closely scrutinize the strengths of individual facilities in this sector and where they will fit into the pecking order of the future market.

Meanwhile, deal activity is more subdued in the hospital and inpatient services space, with private equity (PE) interest fairly low—indicative of the trend to move more patient care to lower cost outpatient facilities. Emerging partnership models between PE and not-for-profit hospitals appear to be attracting capital, but these initiatives are in the early stages of maturity.

Tech Takes Hold
Healthcare technology, especially in the field of telehealth services, is experiencing rapid growth. MarketsandMarkets estimates the global telehealth market will reach $6.5 billion by 2020, up from $2.2 billion in 2015. The regulatory landscape is quickly evolving too, with more states adopting new telemedicine laws and CMS proposing expanded Medicare coverage for telehealth. Telehealth received a major nod in June when the American Medical Association adopted ethical guidelines for the use of telemedicine.

The broader healthcare tech field should expand further in coming years as providers, payers and primary care increasingly collaborate on patient care, with strong interest in end-to-end care management. In 2015, venture funding of digital health companies hit $4.5 billion, topping 2014’s record $4.3 billion, according to startup incubator Rock Health.

Look Before You Leap
There are opportunities to be had for all investor types in healthcare, whether you’re a value investor or a more conservative family office. However, it’s a highly knowledge-intensive business with many variables that can quickly change the risk profile. It’s not an industry to dip a toe into. The most successful investors in healthcare dive in with an understanding of where the money is flowing and how the shifting landscape will impact future business.

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

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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:

#### OCTOBER 2016

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<td>Oct. 17-18</td>
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<td>Oct. 18-19</td>
<td>Private Equity Investors Private Fund Finance &amp; Compliance Forum</td>
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<td>Oct. 27-28</td>
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#### NOVEMBER 2016

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<td>Nov. 9-10</td>
<td>ACG Los Angeles Business Conference</td>
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<td>Nov. 15-16</td>
<td>PERE New York Summit</td>
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<td>Nov. 17</td>
<td>Privcap Game Change: Healthcare 2016</td>
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### BDO PRIVATE EQUITY PRACTICE

Strategically focused and remarkably responsive, the experienced, multidisciplinary partners and directors of BDO’s Private Equity practice provide value-added assurance, tax and consulting services for all aspects of a fund’s cycle, wherever private equity firms are investing.

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### DID YOU KNOW...

According to BDO’s Q1 2016 Horizons Report.

- Average value per deal in Israel increased 44 percent from Q4 2015.
- According to PitchBook, add-on acquisitions accounted for 62 percent of PE buyout activity in 2015, up nearly 20 percent since 2006.
- Private equity deal activity in Europe decreased by 11.7 percent—from 394 transactions to 348—year over year in the first quarter of 2016, according to Unquote and SL Capital Partners.
- In the first half of 2016, deals in the energy, mining, oil and gas sectors made up 43.2 percent of total deal value in Latin America, according to Mergermarket.
- According to Preqin, 64 percent of institutional investors based in Greater China prefer a venture capital investment strategy, while 38 percent prefer a buyout strategy.
# U.S. PRIVATE EQUITY CONTACTS:

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People who know Private Equity, know BDO.