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THE NEWSLETTER OF THE BDO PRIVATE EQUITY PRACTICE

BDO PERSPECTIVE

CONTENTS

IN THIS SOLID ENVIRONMENT, WHERE IS THE DEAL FLOW?

By Dan Shea

In today's 24-hour news cycle, people are constantly bombarded with information. It can be hard to distill everything down to form sound opinions and actionable insights, particularly as political uncertainty persists at home and abroad.

The world of M&A reflects this confluence of factors. Business executives seemed more cautious in the last year when deciding to pursue transactions, and this is reflected in the latest numbers (see Figure I on page 2). Deal activity decreased by over 25 percent in the first half of 2017 compared to the previous year, continuing a downward trend in M&A volumes that began at the end of 2015.

Turmoil in Washington, D.C., and elsewhere, has had a significant hand in this slowdown. Many executives adopted a "wait and see" investment strategy in the period leading up to the election, and again in the early months of President Trump's administration. The M&A environment is solid, however, and should support a rise in transaction volumes in the near term.

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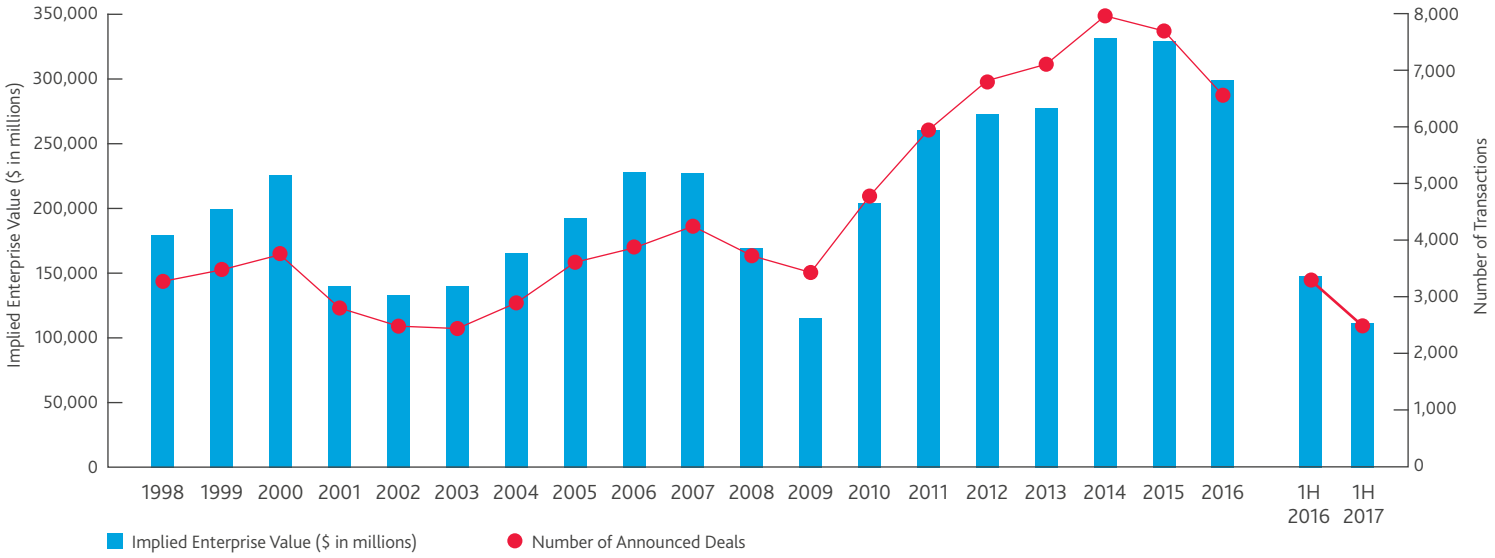
DEAL FLOW

FIGURE I
MIDDLE MARKET M&A DEAL VOLUME AND AGGREGATE VALUE



Source: S&P Capital IQ and BDO Capital Research

MARKET ENVIRONMENT

Valuations Outshine M&A Volume

Despite muted deal flow, valuation multiples remain very high and have actually increased in recent quarters (see Figure II). We have seen multiples rise like this in the past, moving counter to transaction volumes. This is an asset mix issue. When faced with a deal landscape that seems unsteady, such as during and following a contentious election season, companies with lesser value propositions keep a low profile. The asset mix shifts to a better class of companies for sale—albeit fewer in number—thereby creating a seller's market and a rise in multiples. Given that it usually takes six to eight months to properly market and sell a company, the mix of companies sold should soon normalize with closing volumes rising and average multiples moderating.

Good News: Investor Optimism is Undeterred

The public equity markets tell a positive story, rising sharply in the last nine months. The S&P 500 is up by over 17 percent, and the Russell 1000 has had similar results. Advances in corporate profits partly explain the rise, with the aggregate EBITDA of S&P 500 firms up 11.1 percent in the first half of 2017 versus the comparable 2016 period.

Optimism provides the rest of the answer.

Investor optimism resulted in the upward bidding of equities beyond earnings growth, which then expanded multiples. The average EBITDA multiple of S&P 500 firms currently sits at 12.09x, an increase of nearly 9 percent since last November. Anticipation that the new administration will champion business-friendly policies is likely buoying optimism.

Optimism is also evident in numerous C-suite and consumer surveys. The most recent **Index of Small Business Optimism**, published by the National Federation of Independent Business (NFIB), registered 105.2 this July, just shy of its all-time peak of 105.9 in January 2017. The index cites numerous positives including: sales growth, the ability to increase prices, inventory investment, access to credit, low unemployment and increased hiring, real wage growth and increased consumer spending.

Similarly, 89.5 percent of manufacturers expressed optimism about their own company's outlook in the second quarter, according to the **National Association of Manufacturers (NAM) Manufacturers' Outlook Survey**. This result nears the 93.3 percent reached in the first quarter of 2017– the highest reading since the survey began 20 years ago. The survey cites regulatory relief and the prospect of tax reform and infrastructure investment as major positives.

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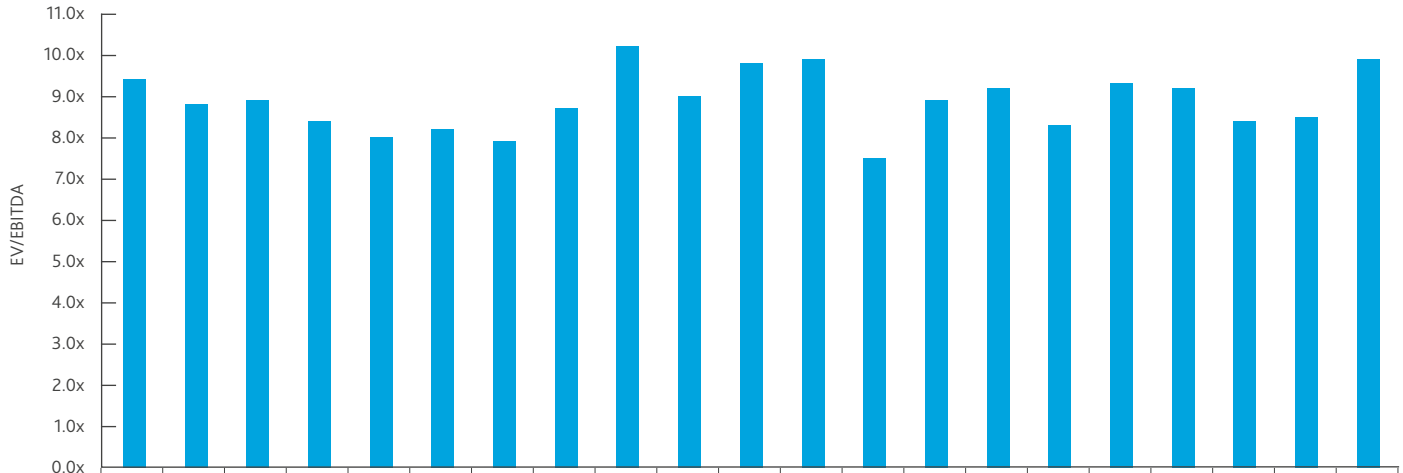
DEAL FLOW

FIGURE II
MIDDLE MARKET EBITDA MULTIPLES (EV $500M OR LESS)



	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	IH 2017
Median EV/EBITDA	9.4x	8.8x	8.9x	8.4x	8.0x	8.2x	7.9x	8.7x	10.2x	9.0x	9.8x	9.9x	7.5x	8.9x	9.2x	8.3x	9.3x	9.2x	8.4x	8.5x	9.9x
% Change YOY		-6%	1%	-5%	-5%	3%	-3%	10%	17%	-12%	9%	1%	-24%	18%	4%	-10%	13%	-2%	-8%	1%	

Source: S&P Capital IQ and BDO Capital Research

However, major legislation out of Washington, D.C., still hangs in the balance. Healthcare reform has been tabled (at least for now), and tax reform and infrastructure investment remain undecided. However, the NAM survey suggests that "many important changes have occurred to the regulatory structure with few if any new rules showing up in the Congressional Register. These changes will seep into the regulatory structure with little fanfare, but will have significant impacts on regulation costs paid by small businesses going forward."

All things considered, the outlook appears positive. A recent *Reuters* survey of over 100 economists seems to substantiate this view. A majority of economists (59.6 percent) surveyed believe that the U.S. will continue to expand for at least the next two years, some (22.8 percent) suggesting that three-plus years is possible. It appears economic upcycles do not simply die of old age, which is good for all of us.

What's Next for M&A?

The supply of companies for sale will naturally increase over the next several years, assuming a stable and modestly growing economy. Baby boomers still own 60 percent of privately held companies in the U.S. and, as they approach retirement, a rise in company sales will be inevitable. Adding to the equation are private equity (PE) funds which, on average, have been holding on to companies longer than historical norms. At present, nearly 40 percent of private equity-backed investments are over five years old (source: Pitchbook). Pressure to sell these older investments is building.

The demand for acquisitions will continue to be high. In a slow-growth world, strategic buyers will likely remain focused on inorganic opportunities to expand; particularly given substantial excess cash currently on public and private company balance sheets. Private equity funds are flush with uninvested capital as well. Their fundraising efforts have been remarkably successful since 2013, and the first half of 2017 was no exception. According to Pitchbook, private equity funds raised an excess of $57 billion in committed capital during the period. They are collectively on track for another big year and, combined with yet-to-be invested capital from previous years, most private equity execs are eager to deploy funds.

Indeed, a more active M&A market is on its way.

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BDO KNOWS INTERNATIONAL PRIVATE EQUITY

SPOTLIGHT ON LATIN AMERICA

Featuring BDO Chile, Panama, Mexico & Puerto Rico

Private equity funds focused on Latin American have raised $45 billion since 2008, the second largest pool of capital among emerging markets, according to Preqin.

BDO USA's Andre Robledo sat down with BDO Global professionals based in Latin America to discuss what opportunities the region holds for private equity. The below conversation features insights from **BDO Chile's** Stephen Crozier and Emilio Venegas Valenzuela, **BDO Panama's** Igal Marancenbaum, **BDO Mexico's** Eugenio Labarthe and Gabriel Llamas and **BDO Puerto Rico's** Ryan Marin and Alina Rivera. Here are some highlights from their conversation:

Which industries in Latin America are the most attractive to foreign investors?

BDO Chile: Interest in Chile's energy industry has substantially increased over the past few years, specifically in metal and non-metal mining, renewable energies such as solar and wind, and the agriculture and agricultural technology industries. In 2016, Chile launched the Energía 2050 campaign to transfer 90 percent of its electricity to renewable sources by the year 2050. Increased investments in green energy infrastructure have significantly lowered electricity prices and accelerated the growth of the country's energy market. According to a report by the International Renewable Energy Agency, Chile earned a spot among the top 10 renewable energy markets in the world.

BDO Panama: In the last few years, foreign investors have flocked to electric energy deals, most often hydroelectricity and natural gas. The U.S., Italy and Colombia are among the most active foreign countries investing in Panama's energy industry. One of the nation's landmark renewable energy projects, a wind energy farm, was developed in 2015 with $430 million in funding, according to the Economic Commission for Latin America and the Caribbean. Education is another attractive sector. In the past, private universities have been sold to international investors. Some retail companies have also changed hands. For example, many drugstores have been sold to supermarkets. In 2017, a company from Guatemala bought a Colombian-owned food company.

BDO Mexico: Since 2000, more than 1,200 private equity investments have been made in Mexico, spanning industries as diverse as consumer services, healthcare, financial services, consumer goods, industrials, telecommunications, oil and gas, technology, real estate and utilities. Energy and telecommunications infrastructure continue to see strong investment interest following the 2013 energy reforms that opened the industry up to foreign investment.

BDO Puerto Rico: Puerto Rico is still dealing with the immediate fallout from Hurricane Maria. While there are likely to be long term negative economic impacts, there are also opportunities that will likely surface as the island rebuilds. Puerto Rico is the most attractive option for investors looking to be under U.S. federal law and work with the U.S. dollar while maximizing incentives under the existing and comprehensive Tax Incentives Act, which covers all major international industries impacting Latin America. Puerto Rico offers an attractive local market, a highly educated workforce and a strategic location within a U.S. jurisdiction from which to provide services throughout Latin America. The island is emerging quickly as an outstanding knowledge services hub both for online monitoring as well as digital content, software development, emerging markets, high-tech, aerospace and telecommunication-related operations like call centers. The investor benefits of operating within a U.S. jurisdiction while offering the tax benefits of a foreign tax jurisdiction have promoted the creation of several tax incentive acts to stimulate economic development and attract foreign direct investment (FDI) in the following sectors: manufacturing, tourism, export services, insurance, financial services, agriculture, hospitality and hotel development, and renewable energy.

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LATIN AMERICA

What type of capital flow are you seeing coming into your country?

BDO Chile: Chile has seen market entry via acquisitions, with some of the larger deals involving pension funds, insurance companies and private funding to consolidate market participation. Digital transformations across industries have also impacted capital flow. There has been a perceived decrease in flows to more traditional mining players and an increased interest in mining technologies. Capital flows for 2016 were approximately 11 percent of GDP, nearly 10 percent of which was FDI. As seen in many parts of the world, there has been an increase in investments from China.

BDO Panama: Considering that electric energy is a rapidly growing industry, it is possible to expect more investment in businesses related to logistics services around the expansion of the Panama Canal. On the newly expanded canal, tolls for energy carriers have been lowered, allowing for a higher volume of large gas-carrying ships to pass through its waterways. International construction companies will also continue operations because of ongoing infrastructure programs. Many Mexican and British companies already have a significant stake in Panama's telecommunications industry. As the number of telecom customers increases, it is probable that these companies will continue investing in telecommunications.

BDO Mexico: There's been a steady stream of investments into Mexico, with accumulated capital commitments reaching more than $42 billion in 2016. Many expect commitments to surpass $60 billion in the coming years. We've seen various types of investors enter the market here in Mexico, including public retirement funds, funds of funds, development banks, family offices, sovereign wealth funds, private pension funds, insurance companies, multilateral agencies and university endowments. Mexico's public Retirement Funds Administrators (AFORES) contribution increased three times from 2011 to 2016. The number of general partners engaged in fundraising and investing for private equity, venture capital, debt, infrastructure and energy, real estate and funds of funds has increased sevenfold from 2005 to 2016. Nearly half (44 percent) of the 168 active general partners in Mexico are foreign.

BDO Puerto Rico: Regarding the benefits of Act 185, The Private Equity Funds Act, corporations and foreign individuals are creating structures in Puerto Rico to receive the benefits under this tax incentive. These funds are funneled mainly from the United States, Dominican Republic, China and Latin American countries. The capital flow is being channeled to Puerto Rico mostly through new corporations, lenders, venture capital, family trusts and individual investors directly injecting capital into their industries of expertise.

Beyond the immediate political uncertainty facing many Latin American economies, what long-term financial potential does the region hold for private equity investors?

BDO Chile: Chile's long-term financial potential includes the increasing size and buying power of the middle class, in concert with its increased access to technology. As the Internet of Things emerges and expands, investing in Chile's technological advancement is becoming a priority to keep pace with other Organization for Economic Cooperation and Development or developed countries. This is also an election year in Chile. As a result, all eyes will focus on the campaign promises of both parties, especially in relation to the tax reforms instated by the current administration, led by President Michelle Bachelet. Double taxation and foreign investment incentives are two potential regulations to consider.

BDO Panama: In the country, there are many family-owned companies that grew in the last few years because of the rise of the middle class–notably, 300,000 Panamanians **overcame** poverty from 2008 through 2014. These family-owned companies are taking steps to become organized, corporate-style businesses, making them interesting targets for international investors and private equity funds. Panama's economy is growing at one of the fastest rates in the world, with a 5.4 percent year-over-year increase in GDP during Q2 2017. The World Bank's **projections** for Panama's market growth remain at a steady pace of 5.5 percent for 2018.

BDO Mexico: Mexico has one of the highest number of free trade agreements in the world. Additionally, its proximity to the U.S. and its participation in the economic region is certainly a potential positive. Mexico's growing middle class, along with potential minimum wage increases, should generate stronger purchasing power, thus internal growth. The supply chain integration of the economic block should improve economic growth in Mexico. The entrepreneurial ecosystem and the possibility of disruptive participants in different industries (probably those recently changed by political reforms, such as energy and telecom) will generate more private equity funding.

BDO Puerto Rico: Puerto Rico is under the U.S. regulatory framework, which provides the highest level of stability for investors and provides direct access to U.S. markets. In addition, the Private Equity Fund Act lays a framework for partnerships and limited liability companies, whether domestic or foreign, to elect to be treated as a private equity fund. Partnerships and LLCs can then obtain significant tax benefits for their funds and their investors, including significant initial investment tax deductions. We believe that private equity investments can play a significant role in turning a corner on Puerto Rico's economy.

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DON'T CUT CORNERS ON SELL-SIDE QUALITY OF EARNINGS REPORTS

By Jerry Dentinger

Private-equity backed exits experienced a slight lull in the second quarter of 2017 with a decrease of about 12 percent from last year, according to Preqin.

However, the market remains favorable for sellers with a significant amount of dry powder in both private equity and strategic coffers. Commissioning an in-depth sell-side Quality of Earnings (QofE) report provides significant value for private equity fund managers to prove and hold value of their investments during a sale process.

Sell-side due diligence and QofE reports have gained traction throughout the private equity space in the past 12-18 months, and have quickly evolved to become an essential element of deal-making for the industry. For portfolio companies with an EBITDA greater than $10 million, it's becoming a common practice for funds to perform sell-side due diligence before engaging in the sale process. For portfolio companies below $10 million in EBITDA, it's even more highly recommended.

So, what made PE fund managers see the light? QofE analyses add value throughout every step of the sale process, and pay for themselves many times over, whether started at the time of sale or years earlier.

Core value propositions driving increased PE demand include:

- In the **auction process**, QofE reports afford sellers significant leverage and maintain the optimum number of buyers to negotiate for the best price and structure.
- During a **deal**, QofE reports add tremendous value. A thorough analysis of a company's financials presented upfront to potential buyers minimizes re-trading during the diligence process.
- Finally, sell-side QofE reports shorten the **selling process**, reducing the risk of surprises and managing access to confidential information. A seller-initiated QofE at the time of sale is often instrumental to holding value during the sale process and lowering overall transaction costs.

FOUR STRATEGIES TO GO BEYOND THE BASICS AND MAXIMIZE QOFE VALUE

Regardless of whether you're courting buyers for an immediate sale or looking to improve a portfolio company's value through process improvements, consider incorporating the following four strategies to maximize the value of a QofE process.

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EARNINGS REPORTS

1. Dig Beyond the Numbers: Don't Overlook the Qualitative Side of QofE

At the most fundamental level, QofE reports function as an examination of a company's fiscal health, including tax and accounting compliance. While that's certainly the fundamental purpose, the most important value proposition of quality of earnings is rooted in the qualitative aspects of a company's business model and a holistic understanding of where value is being created. Examining a company's leadership, reputation, customer and supplier relationships, succession plan and even location are often significant factors to determine its worth and potential for growth.

2. Embrace Big Data Analytics

The proliferation of data has created a major opportunity for both buyers and sellers to analyze and produce meaningful insights. For sellers, QofE analysis proactively identifies new areas to create value. For buyers, it helps confirm or challenge value to justify the investment or re-trade the deal. The process requires sellers to disclose a significant amount of company data to allow buyers to drill into profitability by customer, product, SKU, geography, distribution channel and a variety of other metrics to understand where value is generated. With a variety of Big Data tools available, fund managers can now obtain greater visibility into their investments' key financial variables and their relationships, identify gaps and evaluate business opportunities in significantly less time. For both buyers and sellers, leveraging data analytics in conjunction with a QofE process provides valuable insights into where value is created. Conversely, analytics can also expose whether value is sustainable or if it truly exists, which could inform funds' decisions to continue to hold an investment rather than pursue an immediate sale.

3. Stay Ahead of Schedule

Sellers should consider "reverse due diligence" one or two years before starting a sale process so they can identify and capitalize on process improvement opportunities to increase long-term value, identify lower versus higher profit operations, and generate a higher purchase price. Get ahead of the curve and anticipate the demands you will face in the sale process. Too often sellers don't begin the QofE process until they have a letter of intent or hire a sell-side advisor. At that point in the process, it is often too late to maximize QofE reports due to compressed timelines. Confidentiality clauses start to create challenges the longer funds wait to begin the process as well, making it more difficult to engage financial management in the process. Regardless of whether it is a proprietary sale process or a broad auction, due diligence is extremely detail-oriented, with no topic left off the table. Thus, QofE preparedness should start no later than 90 days before hiring a sell-side advisor to leave time for a robust analysis.

4. Mind the GAAP

How up-to-date are your portfolio companies' financial records? Keeping your books on generally accepted accounting principles (GAAP) as current as possible is prudent if you are considering a sale. Many companies update their ledgers quarterly or even once a year, whether audited or not, and keep certain accounts on a cash basis. In QofE, you need the historical bookend of a trailing 12-month period on accrual basis, and scopes are usually no less than two full years, often three. Monthly GAAP-based financials and corresponding monthly metrics are key.

During sell-side due diligence, simply "checking the boxes" doesn't cut it anymore. Sellers would be wise to adopt a two-pronged approach, incorporating both quantitative and qualitative strategies, to get a complete picture of their portfolio companies' value. Sellers can position themselves for a smoother exit process by crafting thorough, comprehensive defenses of their portfolio companies' worth while simultaneously conveying their value propositions objectively and transparently. Sell-side quality of earnings is likely here to stay.

Jerry Dentinger is a partner and leader of BDO's Central Region Transaction Advisory Services practice. He can be reached at jdentinger@bdo.com.

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EMERGING INTERNET OF THINGS BRINGS OPPORTUNITY AND RISK FOR MANUFACTURING INVESTORS

By Rick Schreiber and Gregory A. Garrett

Ready or not, the next generation of manufacturing has arrived. Manufacturers are up against coalescing forces of technological disruption, economic uncertainty, globalization and trade upheaval—all of which will shape the manufacturing industry of tomorrow. Today, that means there is a wide array of business risks to identify, evaluate and build into business strategy.

There's ample reason to believe, however, that 2017 is primed for the beginnings of a manufacturing renaissance. The Institute for Supply Management's Manufacturing Index inched up to 58.8 in August, beating estimates and indicating the manufacturing economy grew for the 99th consecutive month. New orders, employment and inventories reflect stability and, coupled with the installation of a new administration vocally committed to boosting U.S. manufacturing competitiveness, momentum seems to be building.

For private equity firms focused on the manufacturing industry, there is more than enough evidence demonstrating that the new industrial revolution should provide an opportunity to drive meaningful returns on investment in the sector. The arrival of Industry 4.0, or the fourth industrial revolution, signifies the next era in manufacturing, in which plants, processes, products and people come together in an entirely new way, blurring the line between the digital and physical. Born out of a confluence of technology disruptions—from Big Data and analytics to the Internet of Things to artificial intelligence—Industry 4.0 ultimately hinges on the ability to integrate data with physical processes.

Arguably, the biggest challenge to implementing an Industry 4.0 strategy is the emergence of new cybersecurity risks on factory floors and in products. The integration of new cyber-physical systems creates more potential access points for bad actors, leading to an entirely new set of security risks.

Cybersecurity broke into U.S. manufacturers' top five risks this year, according to the recently published **2017 BDO Manufacturing Risk Factor Report**, which examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. manufacturers across five sectors, including fabricated metal, food processing, machinery, plastics and rubber, and transportation equipment.

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INTERNET OF THINGS

This year, nearly all (96 percent) manufacturers cited potential security breaches in their filings. That represents a 50-percent jump from just four years ago, when 64 percent of manufacturers mentioned them. And there's good reason for growing concern. According to IBM and Panemon, the average cost of a data breach was $4 million in 2016. Beyond the financial fallout of an attack, companies can experience significant reputational costs in the aftermath of a breach if trust in their brand falters.

On the bright side, the prevalence of cyber-attacks like this year's WannaCry, Petya and Equifax has shifted the dialogue around how companies approach cybersecurity protections: it's no longer about *if* a company will experience a breach, but *when*. As companies become more reliant on information systems and operational technology, the focus of cyber-strategy is shifting from prevention to incident response and recovery.

Data from our **2017 MPI Internet of Things Study** suggests, however, that manufacturers still have room for improvement in their cybersecurity protections, and some could be *overconfident*. The majority (81 percent) of manufacturers surveyed globally say they're confident in their current cyber-risk management program to address the security concerns in the increasingly connected manufacturing environment. Yet more than a quarter (27 percent) said they don't have or are not sure if they have a security policy in place for their supply chain partners and other vendors.

So, how should that impact the way manufacturing investors evaluate risk? Private equity firms already face an outsized cyber risk due to the nature of managing multiple, often disparate, technology platforms across their portfolio. If a weakness is exploited in one platform, preventing its spread can prove all the more challenging, particularly among manufacturing companies that are increasingly connecting to the cloud. Running an extensive cyber-risk due diligence process on target companies has become a necessity prior to acquisition, which was one of the primary drivers behind BDO's launch of an IT risk assessment tool early this year.

As manufacturing portfolio companies shift to more connected manufacturing operations, investors must consider the security implications and embed protections into products from design to distribution and everywhere in between. It is imperative that firms build a forward-looking cybersecurity framework that considers the evolving threat environment and cyber risk throughout the entire supply chain. To achieve that, investments should prioritize proactive threat intelligence, detection and rapid response. Cyber risks can also grow exponentially should an attack occur, so firms should take additional care to ensure financial risk is minimized. That includes ensuring sufficient and appropriate cyber-insurance coverage is in place.

For more information on how BDO can support your cyber-risk management initiatives, contact:

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SHOULD BUSINESS DEVELOPMENT COMPANIES BANK ON REGULATORY REFORM?

By Nick Maroules and Dale Thompson

Since their inception in 1980, business development companies (BDCs) have filled a gap in traditional bank lending to provide financing to small and mid-sized businesses.

The growth of this alternative investment vehicle has accelerated in the last decade after gaining popularity during the 2007-2008 financial crisis and following the Volcker Rule's prohibitions on bank investments in traditional private equity funds.

BDCs are essentially publicly registered closed-end funds that have a congressional mandate to provide investment and management expertise to businesses throughout the U.S. to facilitate job creation and business growth.

Although BDCs are not registered under the 1940 Act, they elect to be subject to SEC regulation under many of the 1940 Act provisions. BDCs are also typically registered under the Securities Act of 1933 and the Securities Exchange Act of 1934 and are subject to all registration and reporting requirements under those two statutes.

While most BDCs sell their shares in public offering and are traded on national exchanges, some "unlisted BDCs" make use of broker-dealer networks to sell their shares. They are structured to provide investors with higher-than-average dividends (currently between 7 and 12 percent on average) by avoiding taxation at the corporate level, allowing them to pass along ordinary income and capital gains directly to their investors.

The appetite among asset managers to use the BDC structure as an investment vehicle remains strong as they offer several distinct advantages. They allow asset managers to operate like a traditional private equity fund and have access to permanent capital through the public markets. Unlike traditional private funds that are limited to raising money from "sophisticated investors" who have minimum income and net worth requirements, there are few restrictions on who can invest in BDCs.

Established asset managers continue to enter the industry with Carlyle most recently joining other heavyweights such as BlackRock, TPG, Apollo and Ares. And while the ranks of BDCs continue to increase, there is a growing anxiety among BDC

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REGULATORY REFORM

managers about the current regulatory framework BDCs find themselves operating within. Voluminous regulation coupled with increasing costs to maintain compliance has challenged the industry and fueled a growing movement to modernize the regulatory framework so that BDCs can more easily carry out their policy mandate.

OUTLOOK FOR REGULATORY REFORM

In early October, the U.S. Treasury Department issued a report with recommendations about how to reform the U.S. regulatory system for the capital markets. The report proposes allowing BDCs to use the same securities offering and proxy rules available to traditional operating reporting companies by taking advantage of certain exemptions. This would provide better alignment with other reporting entities and eliminate certain reporting, disclosure and filing burdens specific to BDCs. Also fueling optimism within the BDC community, the Financial CHOICE Act passed in the US House of Representatives in June. The proposed reforms introduced several measures that would enable BDCs to more easily raise and deploy capital, streamline their compliance and reporting responsibilities, eliminate regulatory burdens and better align the BDC regulatory framework with those of other operating companies.

Among the Act's provisions, the most significant for BDCs include:

1. **Reducing the asset coverage ratio to 150 percent, taking on more leverage.**
   This would allow BDCs to increase their leverage up to a 2:1 debt-to-equity ratio, up from where it currently stands at 1:1. Allowing BDCs to take on more debt could expand lending opportunities for the funds. Banks and other types of financing vehicles are often leveraged at significantly higher levels.

2. **Allowing BDCs to purchase interests of registered investment advisors without the need for exemptive relief. Expanding the pool of securities that BDCs could acquire.**
   This would afford BDC managers greater flexibility in carrying out their investment strategies in some cases. Under current law, BDCs are generally prohibited from acquiring securities issued by an investment adviser or a registered investment adviser, although some have been granted exemptive relief while others have not.

3. **Expanding the definition of "qualified assets," granting BDCs more flexibility.**
   Under current law, at least 70 percent of a BDC's total assets are required to be invested generally in securities acquired from "eligible portfolio companies". The proposed reforms would expand the definition of what qualifies for the "70 percent bucket". It would also allow BDCs to hold some interests in investments companies which is currently prohibited.

4. **Diversifying the types of securities that BDCs can offer investors.**
   The CHOICE Act proposes limiting the rights granted to qualified institutional buyers (QIB) that purchase preferred stock. If enacted, BDCs would also be able to issue warrants, options or voting rights to subscribe or convert non-voting securities.

These proposed reforms have long been long-championed by BDCs and their advocates, most notably the **Small Business Investor Alliance** which serves as the trade association for the BDC industry. With a Senate vote still ahead, the CHOICE Act's immediate future is uncertain, but support for the reforms is unlikely to dissipate. BDCs are also keeping an eye on how the newly appointed SEC Chairman Jay Clayton and SEC Director of the Division of Investment Management, Dalia Blass, could shape regulatory developments moving forward.

PERFORMANCE CHECK

2017 has been a mixed bag for BDC performance to date. Several funds are paying out double digit dividends, but the S&P BDC Index's returns have lagged the broader index to date—registering -5.63 percent YTD returns as of early September versus the S&P 500's 11.13 percent haul. *Business Insider* also reported that "sliding loan pricing and increased repayments are continuing to curb the profitability and growth" of BDCs, with the sector trading at an average 7 percent discount to net asset value in mid-August.

Increased competition in middle market lending could also pose challenging for BDCs and could be a factor weighing down returns. BDCs comprise less than 5 percent of the $35 billion raised for middle market lending through August, with direct lending funds accounting for the largest slice of the pie.

Should the Federal Reserve continue to increase interest rates, BDCs are poised to do relatively well compared to other yield-generating investment options like REITs. The funds typically borrow at fixed rates, but offer loans at floating rates. Despite this expected net positive for BDCs, many funds are seeing compressed yields from their assets, leading to declining spreads that outweigh the bump from higher rates on loans issued.

STATUS QUO: A LOOK AT CURRENT BDC REGULATIONS

Investor appetite for exposure to alternative investments appears to be growing. Private equity firms are sitting on record levels of dry powder—totaling $963 billion in July—and 2017 is positioned to be another strong year for fundraising.

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REGULATORY REFORM

For private equity firms monitoring this space and considering whether they should pursue launching a new BDC, here are a few additional regulatory and tax considerations to keep in mind:

- BDCs can benefit from "pass-through" tax treatment by electing to be a regulated investment company (RIC) under Subchapter M of the Internal Revenue Code. In order to qualify as a RIC, they must satisfy certain asset diversification and qualifying income requirements and distribute substantially all (90 percent) of their taxable income to investors annually.
- BDCs are required to provide significant managerial assistance to their portfolio companies.
- Current regulations restrict BDC portfolio allocations into higher-risk sectors (such as financial services) to 30 percent.
- They are required to file quarterly and annual reports as well as proxy statements with the SEC and comply with investment company financial statement and reporting requirements in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 946, as well as Articles 6 and 12 of Regulation S-X.
- Financial statement audits of BDCs are subject to PCAOB auditing standards. Most listed BDCs must comply with the internal controls requirements set forth in the Sarbanes-Oxley Act.
- Under the Jumpstart Our Business Startups Act (JOBS Act), new BDCs may qualify as "emerging growth companies" (EGCs), subject to certain restrictions. EGCs are temporarily exempt (no more than five years) from certain reporting burden requirements.

CONCLUSION

The calls to provide regulatory relief to BDCs have become louder in recent years, stemming from strong advocacy initiatives championed by the industry. While their popularity continues to remain strong and their structure offers distinct advantages to asset managers, it remains clear that the current regulatory environment imposes several operational challenges for BDCs. We have yet to see how far the new presidential administration and Congress will go to modernize the rules and regulations for business development companies.

For more information, to register for upcoming events and to learn more about how BDO can support your BDC fund structure contact:

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Read more ▶

WHAT'S HOT, WHAT'S NOT

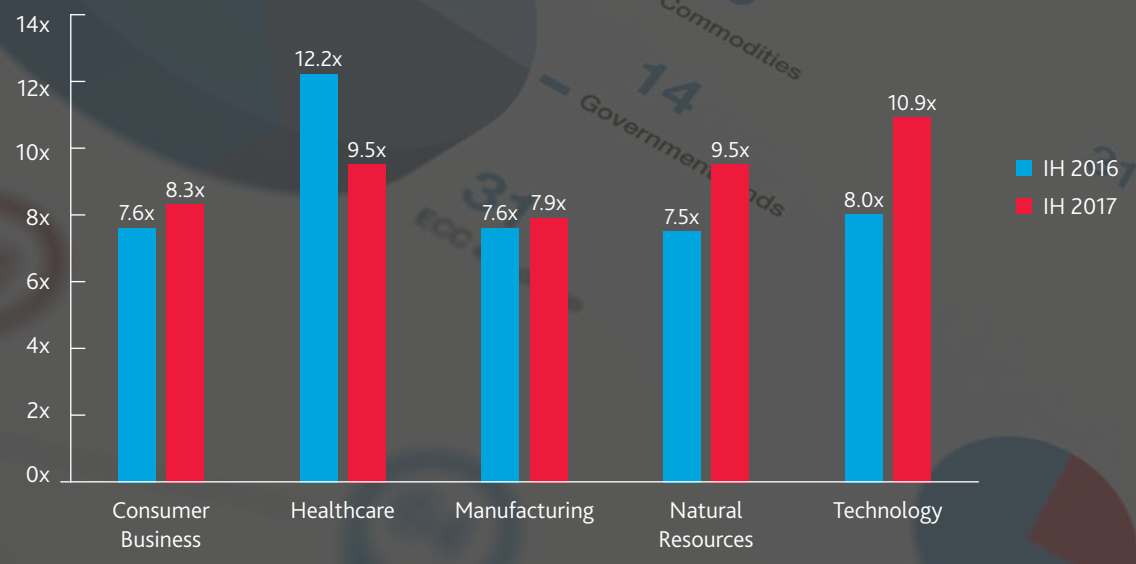
Each quarter, BDO Capital Advisors analyzes M&A and Private Equity deal activity, along with the factors impacting investment decisions. Current "hot" trends are positive factors driving deal flow. Less encouraging trends, mainly emanating from external factors, are sending signs of caution.

- ☑ Highly Motivated, Aggressive Buyers
- ☑ Valuation Multiples
- ☑ Corporate Earnings
- ☑ Debt Availability
- ☑ PE Fundraising/Mega-Funds

- ☒ Limited Quality/Growth Targets
- ☒ Geopolitical Unrest
- ☒ Healthcare Reform
- ☒ Potential Rising Interest Rates
- ☒ Mega-Deals

ECONOMIC SNAPSHOT

MEDIAN EV/EVBITDA MULTIPLES



Read more ▶

MARK YOUR CALENDAR

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

OCTOBER

Oct. 18-19
Operating Partners Forum: New York
Convene Conference Center – Midtown East
New York

Oct. 19
BDO Chicago Private Equity CFO Roundtable
Soho House – Belt Room
Chicago

Oct. 20
SEC's New Focus on Private Funds Breakfast
Tappan Hill Mansion
Westchester, N.Y.

NOVEMBER

Nov. 6-7
ACG EuroGrowth 2017
Hilton London Bankside
London

Nov. 8-9
PERE America: Industry Insights and Powerful Networking
Convene Conference Center – Midtown East
New York City

Nov. 8-9
2017 Florida ACG Capital Connection
Hyatt Regency Grand Cypress
Orlando

Nov. 14-16
30th Annual AVCJ Private Equity & Venture Forum
Four Seasons Hotel
Hong Kong

Nov. 27 – Dec. 1
ACG Middle Market Week
TBD
New York City

DECEMBER

Dec. 4-6
Partner Connect Southwest
Kimpton Hotel Van Zandt
Austin, Texas

Dec. 5-6
Privcap Game Change: Energy 2017
The Houstonian Hotel
Houston

Dec. 12
Best Practices for Overseeing PE Fund Administration & Compliance
TBD
New York City

Dec. 14
Emerging Manager Forum
Shelborne Hotel Miami Beach
Miami

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People who know Private Equity, know BDO.