Floyd Advisory

Deals, Dollars, and Disputes

MAXIMIZING VALUE
MINIMIZING RISK

A Summary of Private Equity Transactions for the Quarter Ended March 31, 2015

CONTENTS

Introduction and Our Objective

We are pleased to present you with our *Deals, Dollars, and Disputes* report for the quarter ended March 31, 2015. Our quarterly report involves a study of the merger and acquisition transactions involving private equity firms ("PE firms") during the recent quarter and over the past five quarters.

Our objective in preparing this report is to provide a general overview of the volume and value of transactions during the year along with an analysis of trends when compared to prior periods.

As an independent consulting firm with financial and accounting expertise, we are committed to contributing thought leadership and relevant research regarding business and valuation matters to assist our clients in today's fast-paced and demanding market. This report is just one example of how we intend to fulfill this commitment.

We appreciate your comments and feedback and welcome requests for any additional analysis that you might find helpful.

Floyd Advisory
APRIL 2015

Our Process and Methodology

We studied financial data for transactions involving PE firms, both as buyers and sellers, over the past five quarters for target companies headquartered in North America.

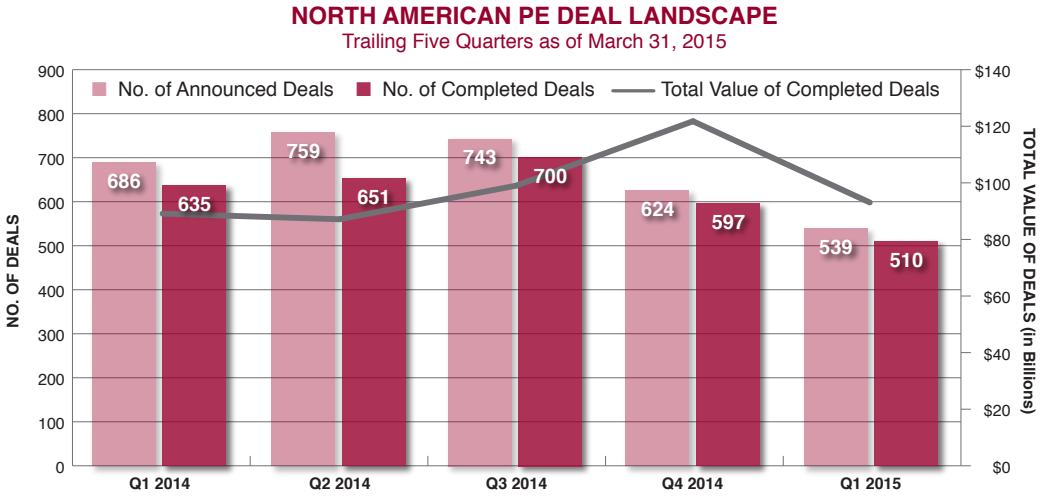
As part of our review, we gathered and analyzed relevant transaction information and data such as industry sector, equity interest, and deal structure, and created a database for our further analyses. From this information, we analyzed market trends by industry, common attributes, valuation premiums, and other characteristics. We have prepared this report applying our professional judgment to these analyses.

For the purposes of this report, the transaction data we have analyzed is limited to publicly available information.

The first quarter of 2015 experienced a significant dip in both value and activity compared to the fourth quarter of 2014.

Summary of Q1 2015 PE Firm Transaction Activity

Volume and Value of PE Deals Decreased in Q1 of 2015



Source: Zephyr
Note: Includes data for which transaction details were reported and available.

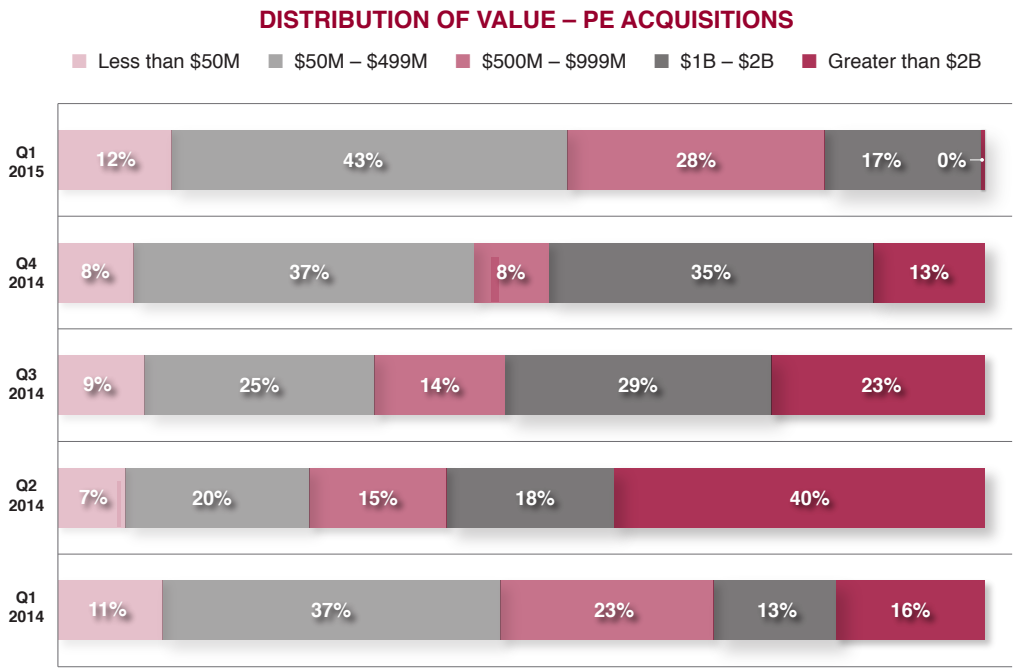
The first quarter of 2015 experienced a significant dip in both value and activity compared to the fourth quarter of 2014. The total value of completed deals decreased 24% and both announced and completed deals decreased more than 13% each. Many in the industry anticipated such first-quarter results given the continued climate of high valuations and increasing competition within the merger and acquisition markets.

When comparing year-over-year results, this year's first quarter scored significantly lower in terms of deal *activity*, but still slightly higher in terms of completed deal *value* relative to a year ago. In Q1 2015, the value of the top 20 completed North American deals was 33% more than those during the first quarter of 2014, driving at least in part this lower-activity/higher-value trend.

Over the last five quarters, there has been an average of eight percent more deals announced than deals completed. Numerous factors including regulatory approval, break-ups, and terminations can explain the variance between deals being announced and those completed. The variance is also partly explained by the difficulties around confirming completions when transactions involve privately-held companies.

Distribution of Deal Values for the Trailing Five Quarters

The two graphs (shown below and on the next page) illustrate subsets of value, segmenting total quarterly PE acquisitions and PE divestitures, respectively. The transaction data behind the percentages depicted in these graphs does not encompass secondary buyouts, wherein both the buyer and seller groups included PE firms.



Source: Zephyr
Note: Includes data for which transaction details were reported and available.

Two acquisition trends appear within the North American PE market over the past four quarters. First, there has been a steady decrease in the total value of acquisitions greater than $2 billion. Second, there has been more investment in the lower-middle market range ($50 million to $500 million). High prices and stiff competition could be partly accountable for these trends, but another dynamic may be the abundance of blockbuster deals over the past year. In a recently published article, *The Wall Street Journal* surmised that the private equity industry is apparently "fresh out of fat targets."[1] This may bear some truth throughout the past quarter, however PE firms are still sitting on sizeable funds awaiting investment.

"A rising economy and the increased availability of financing continue to give middle market company founders, and their private equity partners, reason to sell their companies and take advantage of high exit multiples."

"Private Equity Gearing up for Exits," *Nasdaq.com*, 3/23/2015.

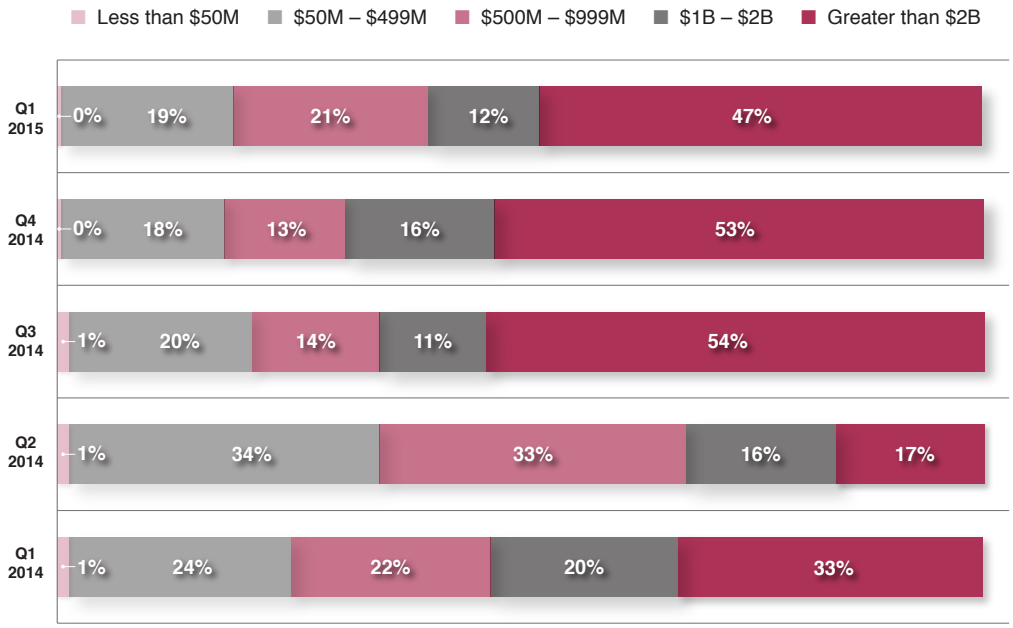
[1] *Kessler, A. "The Glory Days of Private Equity are Over", The Wall Street Journal, 3/29/2015.*

"To be sure, private equity firms will try to innovate in their quest for better performance. But when it comes to fundamental structure, few firms will deviate sharply from what has worked for them for decades. If there is movement, it will be glacial."

Primack, D. "Private equity is changing slower than you've heard," *Fortune*, 3/31/2015.

For PE divestitures, the graph below illustrates a seller's market that is still thriving. PE firms have been able to part ways with their portfolio companies for sums greater than $2 billion with relative consistency for the past three quarters. This uninterrupted streak could be due to sustained low interest rates and strengthening equity markets resulting in confident buyers.

DISTRIBUTION OF VALUE – PE DIVESTITURES



Source: Zephyr
Note: Includes data for which transaction details were reported and available.

Top 20 PE Firm Transactions by Deal Value Completed During Q1 2015

	Deal Value USD (in Millions)	PE Role(s)	Target	Seller	Deal Type	Acquiring Entity (Advisors)	Target Primary US SIC Description
1	$11,184	Buyer, Seller	Safeway Inc.	Jana Partners LLC, Shareholders	MAJ	"AB Acquisition LLC (Cerberus Capital Management LP)"	Online groceries retailer, Supermarket operator
2	$8,700	Buyer, Seller	Petsmart Inc.	Jana Partners LLC, Longviews Asset Management LLC, Shareholders	MAJ	BC Partners LTD, La Caisse de Depot et Placement du Quebecm Stepstone Group LLC	Online pet supply retailer, Pet grooming services, Pet hotel services, Pet supplies retailer, Pet training services, Veterinary services
3	$8,100	Buyer, Seller	Indcor Properties Inc.	The Blackstone Group LP	MAJ	Global Logistics Properties LTD, GIC PTE LTD	Warehouses and industrial properties real estate services
4	$6,205	Seller	Rockwood Holdings Inc.	Kohlberg Kravis Roberts & Company LP, Shareholders	MAJ	Albemarle Corporation	Speciality chemicals manufacturer holding company, Speciality chemicals wholesaler holding company
5	$6,000	Seller	Blue Acquisition Group (owner of Big Heart Pet Brands)	Kohlberg Kravis Roberts & Company LP, Vestar Capital Partners Inc., Centerview Partners LLC, Alpinvest Inc.	MAJ	The JM Smucker Company	Branded pet food manufacturer holding company
6	$2,500	Seller	Trulia Inc.	Sequoia Capital, Accel Management Company LLC, Deep Fork Capital LLC, Shareholders	MAJ	Zillow Group Inc.	Online mobile real estate search application software developer, Online real estate search engine operator
7	$2,400	Seller	First Wind Holdings LLC	De Shaw & Company LP, Madison Dearborn Capital Partners LP, Shareholders	MAJ	Sunedison Inc., Terraform Power Inc.	Wind farm construction services, Wind farm operator
8	$2,250	Seller	Hilton Worldwide Holdings Inc.	The Blackstone Group LP	MIN	Shareholders	Hotel operator holding company
9	$1,585	Seller	Veyance Technologies Inc.	Carlyle Group LP	MAJ	Continental AG	Conveyor belt manufacturer, Rubber hose manufacturer, Rubber products manufacturer, Tire manufacturer
10	$1,500	Buyer, Seller	Presidio Holdings Inc.	American Securities LLC, Management	MAJ	Apollo Global Management LLC	Business enablement system design services holding company, Online cloud-based and managed hosting services holding company
11	$1,400	Buyer	Heidelberg Cement AG's Building Products Business in the US & UK	Heidelberg Cement AG	MAJ	Lone Star Funds	Building products manufacturer
12	$1,300	Seller	Tasc Inc.	Kohlberg Kravis Roberts & Company LP, General Atlantic LLC, Shareholders	MAJ	New East Holdings Inc.	Data analysis services, Engineering consultancy services, Management consulting services
13	$1,215	Buyer	Angus Chemical Company	The Dow Chemical Company	MAJ	Golden Gate Capital LP	Nitroalkane-based chemicals developer, Nitroalkane-based chemicals manufacturer
14	$1,200	Buyer, Seller	IPC Systems Inc.	Silver Lake Partners LP	MAJ	Centerbridge Capital Partners LP	Data connectivity services, Managed services provider, Telephony software developer
15	$1,175	Seller	CRC Health Group Inc.	Bain Capital LLC	MAJ	Acadia Healthcare Company Inc.	Addiction treatment centre operator
16	$1,100	Buyer, Seller	Dynacast International LLC	W Capital Management LLC, Kenner & Company Inc., Babson Capital Management LLC, Macquarie Group LTD, Laurel Crown Partners LLC, Izurium Capital, Advisers Europe LLP	MAJ	Partners Group Holdings AG, Kenner & Company Inc., Management	Die casting services, Metal products manufacturer
17	$1,000	Buyer, Seller	Marquette Transportation Company Holdings LLC	KRG Capital Partners LLC, Shareholders	MAJ	BDT Capital Partners LLC	Marine transport services holding company
18	$1,000	Buyer, Seller	Pods Enterprise	Eagle Merchant Partners	MAJ	Ontario Teachers' Pension Plan	Moving services, Self-storage services
19	$1,000	Buyer, Seller	Neovia Logistics Services LLC	Caterpillar Inc., Platinum Equity LLC	MAJ	Goldman Sachs Group Inc., Rhone Capital LLC	Supply chain management consultancy services, Third party logistics services, Warehousing services
20	$1,000	Seller	Simply Healthcare Holdings Inc.	MBF Healthcare Partners LP	MAJ	Anthem Inc.	Medical care plans provider

Source: Zephyr
Deal types: MAJ = Majority Stake Acquisition, MIN = Minority Stake Acquisition, IPO = Initial Public Offering

"Petsmart's $8.7 billion sale to a consortium led by private equity firm BC Partners is a big year-end coup for hedge fund Jana Partners. The deal is also the second major leveraged buyout spurred on by the Barry Rosenstein-run activist fund in 2014, after the firm urged the sale of supermarket chain Safeway in the first half of the year. In Safeway and now Petsmart, Jana identified large publicly traded retailers that could be swallowed up by private equity firms in spite of their reticence to do mega buyouts and doubts about the ability of banks to finance highly leveraged deals amid new regulations."

"PetSmart's $8.7 Billion Buyout A Second Mega Deal For Jana Partners In 2014", *Forbes*, 12/14/2014.

"Under the terms of the deal, Zillow will pay 0.444 of one of its shares for each share of Trulia. Based on Friday's closing prices [7/25/14], the takeover bid is worth $70.53 a Trulia share, a premium of roughly 25 percent. Together, the two will dominate the traffic for online home listings. Last month, Zillow reported 83 million users, while Trulia reported 54 million—a combined 61 percent of total Internet users for the category, according to the research firm comScore."

"Zillow to Buy Trulia for $3.5 Billion in All-Stock Deal", *The New York Times*, 7/28/2014.

"The company had targeted a $100 million IPO—a number used as a placeholder to calculate fees owed to the U.S. regulator. The most recent regulatory filing said all proceeds from the planned sale would go to its parent company HeidelbergCement AG, which had acquired the Hanson business in 2007. But on Christmas Eve, HeidelbergCement announced it would pursue a private sale instead, with Lone Star agreeing to buy the company for $1.4 billion, including $100 million only payable in 2016 if the company hits unspecified performance targets. HeidelbergCement said it would use the proceeds from the sale to pare back its debt."

"Hanson Building Withdraws IPO After $1.4B Lone Star Deal", *Law360*, 02/05/2015.

"Marquette has annual earnings before interest, tax, depreciation and amortization of close to $150 million." "Paducah, Kentucky-based Marquette provides towboat services in the Mississippi River and other major waterways in the United States. It operates more than 120 boats and 850 barges, serving agricultural and energy companies. The company was created in its current form in 2007 with the merger of three family-owned businesses and backing from KRG."

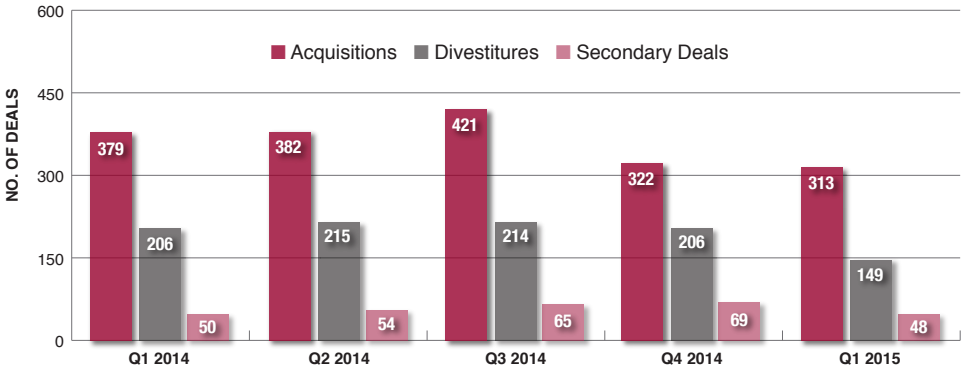
"Marquette Transportation up for sale for more than $1 bln-sources", *Reuters*, 01/29/2015.

Acquisitions, Divestitures, and Secondary Buyouts During the Trailing Five Quarters

Value of Divestitures Continues to Outweigh Acquisitions

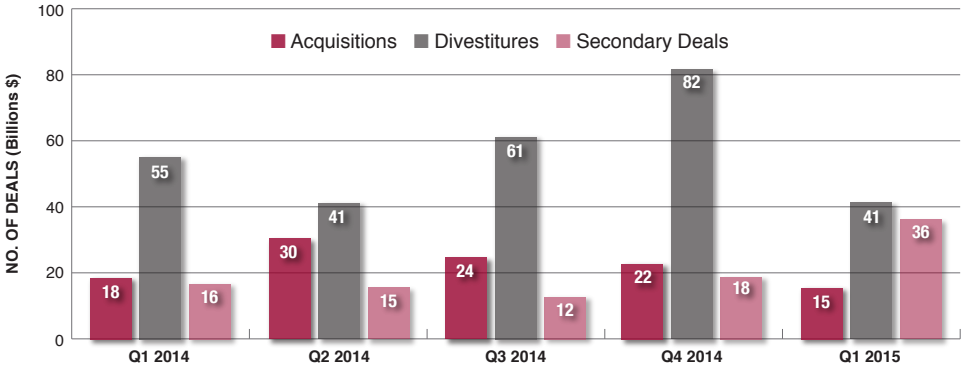
Acquisition and divestiture trends in the PE market over the past five quarters are presented in the two graphs below. The value of divestitures in Q1 of 2015 was half of the value from Q4 of 2014, however the trend of total divestiture value dwarfing acquisition value continued into 2015. The value of Q1 2015 acquisitions was the lowest it's been in the last five quarters, with a marked steady decline since the second quarter of last year.

ACQUISITIONS VS. DIVESTITURES BY COUNT OF DEALS
Q1 2014 – Q1 2015



Source: Zephyr
Note: Includes data for which transaction details were reported and available.

ACQUISITIONS VS. DIVESTITURES BY VALUE OF DEALS
Q1 2010 – Q1 2015



Source: Zephyr
Note: Includes data for which transaction details were reported and available.

Q1 2015 Saw Large Secondary Buyouts

Interestingly, the value of secondary buyouts increased significantly. At this time last year, secondary buyouts totaled $16 billion, but more than doubled to $36 billion in Q1 of 2015. Secondary deals often occur when sellers are eager to divest in advance of typical holding periods to achieve higher rates of return. The upturn we notice in the total value of deals for secondary buyouts appears to be driven primarily by the two largest completed deals in this year's first quarter.

"In its heyday, private equity dominated headlines as financiers with billions of dollars in debt financing would takeover massive companies, replace managements, layoff tons of workers, and then put it right back on the market for a massive profit..... Now, a deal in excess of $10 billion is rare for a private equity firm."

Marino, J. "The Private Equity Game is Changing," *Business Insider*, 4/11/2015.

Often, the acquirer in a secondary buyout will possess unique managerial or financial abilities which will unlock value that the previous owner could not. In other cases, the acquirer may seek to expand the company or spin off certain pieces of the business. Many may perceive fundamental risk in a secondary transaction as equal to that of any deal. Others may recognize heightened risks with less room for restructuring brought on by prior cost cutting and cash-flow measures already implemented by the seller before the sale. We'll continue watching for developing trends within the secondary buyout market.

Transaction Analysis by Industry

VALUE AND NUMBER OF DEALS BY INDUSTRY
For Q1 2015

Industry*	Median Deal Value (In Millions)	Average Deal Value (In Millions)	Total Completed Deals**	
			Value (In Millions)	Count*
Agriculture, Forestry, & Fishing	$440	$440	$440	1
Transportation, Communications, & Utilities	$379	$588	$8,232	14
Mining	$169	$229	$2,285	10
Retail Trade	$92	$2,053	$20,533	10
Construction	$75	$75	$75	1
Finance, Insurance, & Real Estate	$75	$639	$9,584	15
Manufacturing	$61	$481	$24,053	50
Public Administration	$41	$41	$41	1
Services	$40	$193	$27,040	140
Wholesale Trade	$7	$7	$7	1

** Industries are based on main divisions defined in the United States Department of Labor's Standard Identification Codes.*

*** Calculations based on our Zephyr data include only deals that list values.*

Note: Includes data for which transaction details were reported and available.

The services industry deals were clustered around computer processing and prepackaged software, while surgical and medical instrument deals were most prominent in the manufacturing industry; both are sectors that have recently dominated these industries.

Despite concerns surrounding decreasing oil prices, oil and gas field exploration deals continued within the mining industry. For some PE firms in the oil and gas industry, investments took substantial losses in recent quarters, but others have viewed the slump in this market as an opportunity to jump into this otherwise lucrative sector through filling the void left by banks hesitant to offer financing around so much volatility.[2]

"The current deal environment has caused a partial shift in the way many private equity sponsors view deployment of fund capital. As competition for quality deals has increased, including higher pricing and other auction challenges, focus has expanded regarding the "best" deals to get done."

"Private equity firms increase focus on add-ons," *PE Hub*, 2/10/2015.

[2] *Sharma, G. "Private Equity and US Shale: Playing the Long Game," Forbes, 3/16/2015.*

Restaurants continued to be the preferred sector in the retail trade industry. Last year saw deals for giant national chains including Chuck E. Cheese and Red Lobster, whereas throughout the first quarter of this year, smaller regional restaurant chains have proven attractive targets. This could be private equity's reaction to the high multiples which the larger restaurant groups have commanded in recent quarters.[3]

INDUSTRY FOCUS: THE PET INDUSTRY

Robust deal activity in the pet industry this quarter involving PetSmart Inc. and Big Heart Pet Brands, through its parent Blue Acquisition Group, demonstrates the attention drawn to the industry in recent years. Some state that private equity interest kicked off and gained momentum in 2011 after firms noticed how well the pet industry withstood the recession and viewed the underserved industry as a prime market for deals.[4] The industry is also highly fragmented and a variety of smaller operators have emerged among the larger established players. This has given rise to the consolidation of multiple pet companies as a method to secure market share. Companies focused on pet consumables generally attract higher multiples as compared to those which market pet toys or accessories.[5]

"…the DOJ has repeatedly stated that FCPA enforcement is second only to anti-terrorism in its hierarchy of priorities. And earlier this year, the DOJ announced the formation of three new FBI squads with over 30 dedicated special agents focused on investigating foreign bribery."

Simon, D.W. "Why It's Wise to Pay Attention to Your FCPA Compliance—Foreign Corrupt Practices Act," *National Law Review*, 3/26/2015.

Featured Transactions and Insights

Among the transaction activity and related events in the quarter, we select certain deals and market trends that present information we consider especially worthy of further review and analysis by those involved in structuring and negotiating business sales and acquisitions. Our goal is to feature transactions that raise unique considerations from a valuation, deal-structure, or subsequent-dispute standpoint.

Our first feature this quarter looks at subjects PE firms should take into consideration when assessing potential global acquisitions related to risks under the U.S. Foreign Corrupt Practices Act. A recently issued U.S. Department of Justice Opinion Procedure Release has provided additional insight on related successor liability risks. For a second feature, we consider a PE firm's acquisition of a target company embroiled in an accounting fraud investigation, and related value opportunities that may have arisen.

FCPA Risk Mitigation – International Private Equity Targets

Domestic acquirers of international target companies are often faced with many challenges during the due diligence process, including local factors such as language and cultural differences, variations in accounting policies and practices, and regulatory compliance concerns. Among these considerations is the risk of whether or not the target has historically engaged in practices that would be found unlawful under the U.S. Foreign Corrupt Practices Act ("FCPA") and how such conduct might lead to future regulatory issues for the acquirer.

[3] *Maze, J. "High Restaurant Deal Prices May Slow Pace of M&A," Restaurant News, 4/10/2015.*
[4] *Frank, C. "Why is Private Equity So Interested in the Pet Industry and is Your Company a Candidate?" SDR Ventures/carolfrank.com.*
[5] *Rizzo, L. "Pet Product Deals Are Private Equity's Best Friend," Financial News, 12/4/2014.*

On November 7, 2014, the U.S. Department of Justice ("DOJ") issued an Opinion Procedure Release (the "Release") which has provided some practical interpretive guidance with respect to successor liability under the FCPA. In particular, the Release addressed concerns regarding whether or not an acquirer could expect the DOJ to bring an FCPA action against a target company for conduct that took place pre-acquisition, during a time when the target was not governed by regulation under the FCPA. This could create an element of risk that is outside of the acquirer's control and could ultimately impact the overall deal dynamic. However, the DOJ's Release indicated that it did not presently intend to take enforcement action under these circumstances.

The DOJ's Release was issued in response to a request from a U.S. consumer products company (the "Requestor") seeking to acquire a foreign consumer products company (the "Target"). In addition to identifying significant accounting and financial reporting deficiencies at the Target, the Requestor uncovered evidence of certain historical practices that appeared to constitute bribery payments. The DOJ noted that the Requestor presented a plan of integration and remediation that was expected to address these practices. It further noted that the improper payments did not fall under the jurisdiction of U.S. FCPA laws at the time they occurred because the Requestor had not yet acquired the Target. The Release referred to *A Resource Guide to the U.S. Foreign Corrupt Practices Act* stating that, "[s]uccessor liability does not, however, create liability where none existed before. For example, if an issuer were to acquire a foreign company that was not previously subject to the FCPA's jurisdiction, the mere acquisition of that foreign company would not retroactively create FCPA liability for the acquiring issuer."

A Brief Overview of the FCPA

The FCPA was enacted in 1977 with two primary objectives: (1) to prohibit the bribery of foreign public officials and, (2) to require internal controls and accounting standardization for publicly traded companies. These anti-bribery and financial reporting provisions are enforced by the Fraud Section of the DOJ's Criminal Division, which is also supported by specialized units within the Enforcement Division of the Securities and Exchange Commission ("SEC") as well as the U.S. Office of General Counsel within the U.S. Department of Commerce.

Both individuals and companies who violate the provisions of the FCPA can face severe penalties. Criminal penalties for individuals can be as much as $250,000 and/or 5 years in prison per bribery violation and reach upwards of $5 million and/or 20 years in prison for willful books and records violations. Companies face fines of $2 million per bribery violation and may also be forced to disgorge the profits gained through illegal activities. For willful books and records violations companies can face fines up to $25 million. In certain situations, alternative and more punitive fines charged to infringing companies can amount to twice the infringer's total gain or twice the loss suffered by others as a result of the illegal activities. Additional civil penalties may also apply resulting in fines, denial of export licenses, disallowance of U.S. tax deductions, or debarment from doing business with the U.S. government.

Beginning in 2007, there has been a notable increase in the number of FCPA investigations and enforcement actions.[6] The peak of this activity occurred during 2010 and 2011, around the same time that the SEC initiated an industry-wide investigation on financial institutions, investment banks, and private equity firms who interact with

"The SEC's recent enforcement measures reinforce how important it is for companies—particularly those who qualify as issuers—to assess their FCPA compliance risks properly and establish and maintain a system of internal controls to manage those risks effectively."

Robertson, T. "SEC Looks to Increase Focus on Enforcement of FCPA Accounting Provisions," *JDSupra Business Advisor*, 4/17/2014.

[6] *FCPA Digest, Recent Trends and Patterns in the Enforcement of the Foreign Corrupt Practices Act, January 2015, Shearman & Sterling LLP.*

sovereign wealth funds. According to one source, total assets under management by state-owned investment funds amounts to approximately $7.1 trillion.[7] The SEC has expressed concerns that this level of capital and influence attributable to sovereign wealth funds increases the risk of corruption in dealings with them.

A Heightened Focus on Private Equity

In April of 2014, the SEC formed a new private fund unit headed by two industry veterans, which is dedicated to examining private equity firms and hedge funds.[8] Following a period of separate scrutiny on the adequacy of private equity disclosures, particularly in relation to their fee structures, the SEC has now reportedly begun to broaden the scope of its regulatory pressure on the private equity sector with additional requests for information regarding how these firms generate investments from sovereign wealth funds. Some say this is just the beginning and that FCPA enforcement along with general regulatory attention on the private equity industry is expected to continue to increase.

The stakes are high as the cost of defending an FCPA enforcement action can quickly amount to tens or even hundreds of millions of dollars.

This trend of enforcement activity becomes increasingly relevant as the economy continues to regain strength and many U.S. companies seek to expand their operations throughout the world. In addition, with the growth of the alternative investment market and inflow of cash to some private equity funds after a run of recent high value exits, private equity investors are expected to seek diversification and a broader pool of potential targets through foreign markets.

The stakes are high as the cost of defending an FCPA enforcement action can quickly amount to tens or even hundreds of millions of dollars. For example, in its annual reports for the years 2010 through 2013, Avon disclosed that it had spent over $300 million cumulatively on legal fees related to FCPA investigations. Similarly, as part of its Q4 2013 earnings release, Walmart disclosed that it had incurred more than $157 million in professional fees and expenses related to an ongoing FCPA matter.

Recently, a number of high profile enforcement actions resulted in total corporate penalties of approximately $1.6 billion during 2014, representing the second highest year of penalties imposed on companies since the FCPA was enacted. Corporate penalties averaged approximately $156 million during 2014, with the highest penalty of $772 million charged to Alstom S.A., a French power and transportation company.[9]

Mitigating FCPA Risk

While the DOJ's Release does provide some level of comfort to investors exploring opportunities in foreign markets with respect to pre-transaction conduct, regulatory pressures have been building in the alternatives sector and it will become critical that private equity firms safeguard investor value by implementing a robust risk mitigation process designed to identify and address questionable finance and accounting practices within their target companies. Within the Release, the DOJ provided certain best practices for companies engaging in mergers and acquisitions including:

1. Conduct thorough risk-based FCPA and anti-corruption due diligence.
2. Implement the acquiring company's code of conduct and anti-corruption policies as quickly as practicable.

[7] *"Sovereign Wealth Fund Rankings," SWFInstitute, March 13, 2015.*
[8] *"SEC Forms Group To Focus On Private Funds - Law360." SEC Forms Group To Focus On Private Funds - Law360. N.p., n.d. Web. 29 Apr. 2015.*
[9] *FCPA Digest, Recent Trends and Patterns in the Enforcement of the Foreign Corrupt Practices Act, January 2015, Shearman & Sterling LLP.*

3. Conduct FCPA and other relevant training for the acquired entity's directors and employees, as well as third-party agents and partners.
4. Conduct an FCPA-specific audit of the acquired entity as quickly as practicable.
5. Disclose to the Department any corrupt payments discovered during the due diligence process.

These considerations add another layer of complexity to the due diligence process. Assessing FCPA risk often requires an advisory team that is practiced in forensically examining financial and accounting records to identify questionable practices. Ultimately, if FCPA concerns are identified, the success of the transaction will hinge on the acquiring entity's ability to design and implement an effective remediation and integration plan.

Value Opportunity in Market Reaction to Accounting Issues?

On February 10, 2015, Saba Software Inc. ("Saba" or the "Company"), a cloud-based intelligent management solutions provider, announced that it had entered into a definitive agreement for the sale of the Company to Vector Capital ("Vector"), a global private equity firm which invests in established technology companies, including prior lending to Saba of $45 million. Saba disclosed that under the terms of the agreement, Vector has agreed to buy all of the Company's outstanding equity for $9.00 per share. Some have questioned whether $9.00 per share represents fair consideration given Saba's closing price of $9.42 just two trading days prior to the announcement and in comparison with its closing price of $13.49 nearly 30 days prior to the announcement. However, Saba's precipitous decline in market value appears to have been largely driven by disclosures related to uncertainties surrounding a fraud investigation and an anticipated restatement of its historical financial results, which the Company has been in the process of assessing for several years.

"A rise in restatements among accelerated filers coupled with increased accounting enforcement actions at the Securities and Exchange Commission are causing a spike in securities class actions involving accounting allegations."

Whitehouse, T. "Accounting-Related Class-Action Lawsuits Jump in 2014", *Compliance Week*, 4/1/2015.

SEC Allegations against Saba

In September of 2014, the SEC charged Saba and two former executives with accounting fraud, alleging that they had caused timesheets to be falsified in order to fraudulently recognize revenue and manipulate quarterly earnings to meet market expectations. An SEC investigation uncovered that two of the Company's vice presidents directed consultants to falsely record time that had not yet been incurred to inflate revenue and in other instances, exclude actual time that had been incurred to conceal various budget overages. These actions allowed the Company to create the appearance that it was achieving its revenue and profit margin objectives. This scheme was reportedly carried out over the period from the Company's fiscal year 2008 through the second quarter of its fiscal year 2012 and occurred throughout the organization.

The SEC believes that the fraudulent conduct caused at least 40 of Saba's public filings and dozens of press releases to include false financial information and that between the years 2008 and 2012, the Company had overstated its pre-tax earnings by approximately $70 million on a cumulative basis. As a consequence of the SEC's findings, the Company ultimately agreed to pay a $1.75 million settlement with the SEC. In addition, several of Saba's executive management team members have been required to reimburse the Company for bonuses and stock gains that were received during the period that the fraud occurred.

Over the last few years, Saba has struggled to provide timely financial reporting. In fact, Saba was delisted from the NASDAQ Stock Market in June of 2013 due to repeatedly failing to fulfill its public reporting obligations. In an April 4, 2013 press release, Saba disclosed that it was "not current in its periodic report filing requirements with the SEC as a result of the Company's pending restatement of prior financial results." The Company consistently made reference to the pending restatement and/or related internal accounting review when disclosing its reporting delays.

The Effect of Restatements on Value

In a December 15, 2014 press release, Saba provided its most recent update on its restatement analysis, disclosing that the earliest the Company would be able complete its work on the restatement would be sometime during fiscal year 2016 (commencing June 1, 2015). Saba cited the complexity of the exercise and various challenges in compiling historical data necessary to determine the potential adjustments as the primary reasons for the extended timeline. During the trading day immediately following this press release, the Company's stock price dropped severely, closing at $8.75; down 35% from the prior day's closing price of $13.49. The Company's continued delays in financial reporting and vague timeline for completing its restatement work appear to have driven a significant decline in investor sentiment following the December press release.

Investors rely on timely and accurate financial information to develop an informed assessment of a company's performance and perceived risk level.

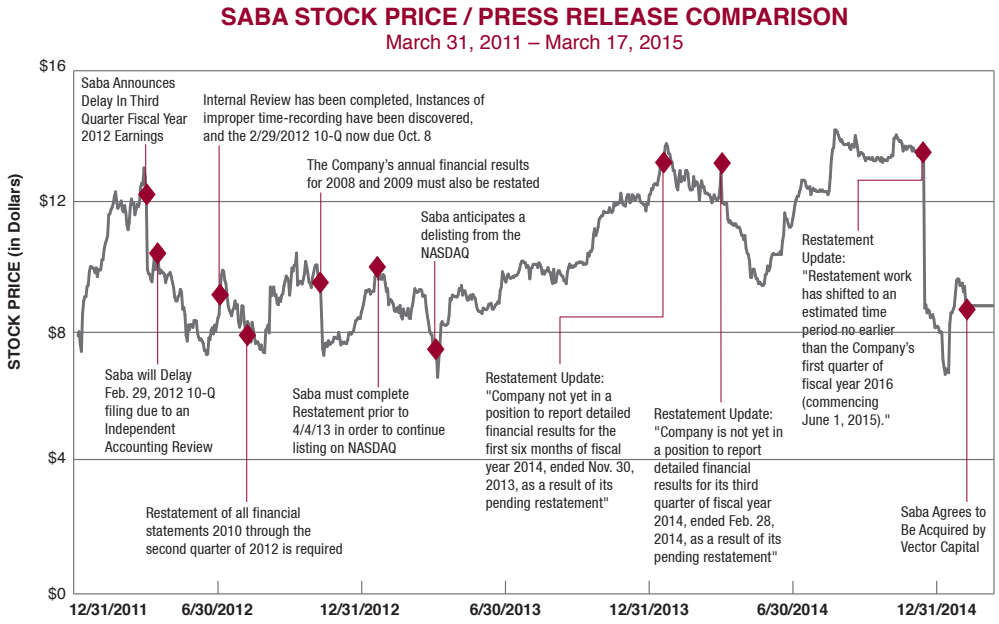
An important underlying premise when valuing a company's stock is that the business is expected to generate economic income into the future that will provide the investor with some rate of return. An investor must not only consider the magnitude of the expected economic income, but also the risk of whether or not this income will actually be realized. The degree of certainty or uncertainty about the company's ability to generate that cash flow has a direct impact on what an investor is willing to pay for the company's stock. Generally speaking and assuming all other factors are held constant, the lower the risk, the greater the present value of an investment and vice versa.

Investors rely on timely and accurate financial information to develop an informed assessment of a company's performance and perceived risk level. Without such information or when information is materially delayed, investors are left with uncertainty, which translates to greater perceived risk. The reporting requirements of the SEC along with generally accepted accounting principles are intended to standardize the presentation and frequency of information that is available to investors and other stakeholders of publicly traded companies. Any material departures from these standards or the timing of public filings have the potential to cause investors to question the risk and hence, the value of a stock.

A recent study titled *Financial Restatement Trends in the United States: 2003 – 2013* by the Center for Audit Quality noted that companies with restatements involving revenue and fraud experience an average decrease in stock price of approximately -4.0% and -6.8%,[10] respectively, within 2 days of the date that the restatement is announced. The perceived severity of a restatement can be influenced by the accounting topic at issue, the length of time restated, indications of fraud, and impact on reported profitability. Another study by Audit Analytics, titled *Financial Statements and Market Reactions*, emphasizes that not all restatements are regarded alike. Audit Analytics noted that on average most companies with restatements regained lost stock value within 50 days after the announcement. However, the report also found that restatements involving operational and integrity issues had the most significant impact on stock price, highlighting that companies with restatements due to revenue recognition errors, "continued their pre-announcement

[10] *Stock price reactions were adjusted for contemporaneous overall market returns.*

trends of losing value even 50 days after the announcement." The timing of relevant press releases and fluctuations in Saba's stock price are reflected in the chart below.



Sources: Stock Price from Yahoo! Finance and press releases from Saba.com.

Weighing Risk and Reward

In the case of Saba, a prudent investor assessing the Company's risk would likely be influenced by the following factors:

- Inability to meet filing requirements
- Uncertainty regarding the ultimate impact of the restatement
- General lack of transparency and potential for other accounting inaccuracies
- Pervasive fraudulent conduct throughout the organization
- Questions regarding the 'tone at the top;' management's influence on the culture and promoting ethical behavior
- Impact of fraud on the Company's perception within its target market and the potential for brand impairment

As evidenced by the transaction announced on February 10th, Vector must believe that the likelihood of Saba's ability generate future cash flows outweighs these risk factors.

A research study conducted by Stanford and Emory universities found that following a restatement companies often take certain actions that are focused on repairing market image and that on average each action can boost share price by approximately 2%.[11] These actions involve tactics such as making charitable donations, offering warranty extensions, corporate restructuring, executive reshuffling, share repurchases, and even special dividends. Vector's approach of taking Saba private would render strategies geared toward the public capital markets to be less productive; however, resolving any underlying accounting issues that remain, enhancing internal controls, and ensuring that the right leadership is in place could mitigate the perception of additional risk factors. Doing so may set the stage for Vector to realize an attractive gain upon exit given its discounted purchase price relative to Saba's valuation prior to its December press release.

A study by Audit Analytics, titled *Financial Statements and Market Reactions*, emphasizes that not all restatements are regarded alike…. restatements involving operational and integrity issues had the most significant impact on stock price.

[11] *Chakravarthy, Jivas, Ed DeHaan, and Shivaram Rajgopal. Reputation Repair after a Serious Restatement. Social Science Research Network. N.p., 7 Nov. 2013. Web. 20 Apr. 2015.*

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