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On Target:

2018 Private Equity Outlook

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McCarthy Tétrault LLP
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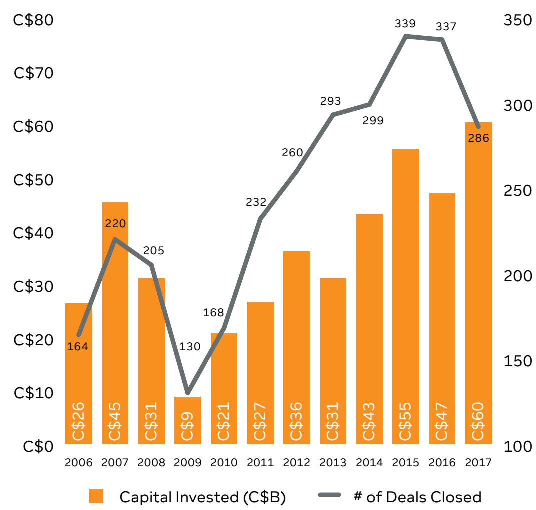
Following Record Year For Deal Value, Canadian Private Equity Remains Poised To Grow

The Canadian private equity market sustained high levels of activity in 2017. Aggregate deal value reached historic levels, while deal volume experienced a modest dip from the all-time high in 2015.

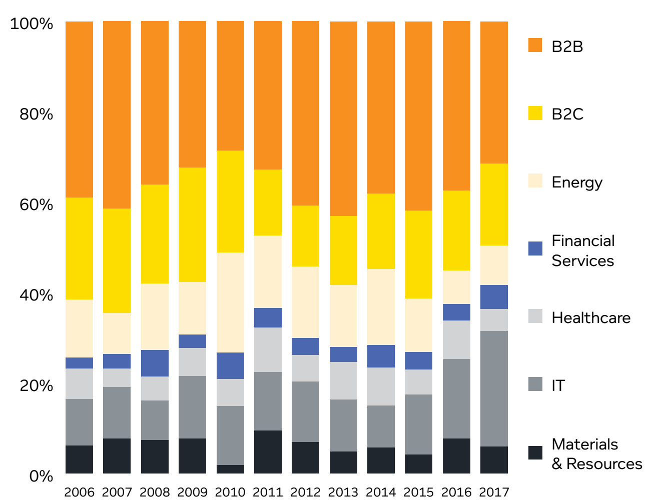
Funds continue to have a build up of capital to deploy and the deal landscape across most of Canada remains highly competitive with auctions continuing to attract interest from domestic and international funds resulting in record aggregate deal values.

Canadian PE activity by year *



In 2017, in relative terms, there was an increase in activity in the IT and financial services sectors and a tightening of activity in the materials and resources, healthcare and B2B sectors, while energy and B2C remained flat. Overall, all sectors continued to experience sustained activity.

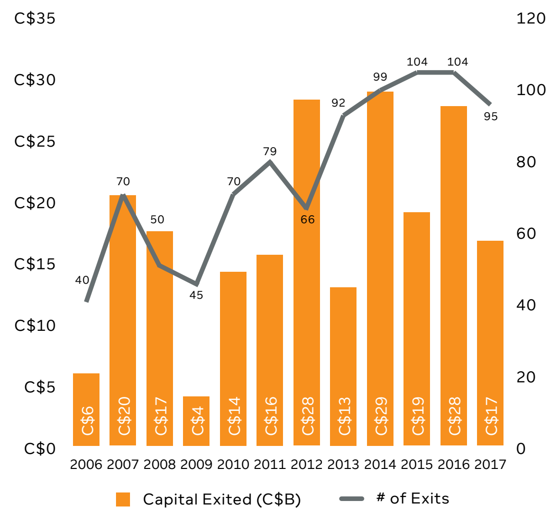
Canadian PE activity (#) by sector *



As predicted in our 2017 Outlook, competitive market tension continued, with knock-on effects on exits and add-on transactions.

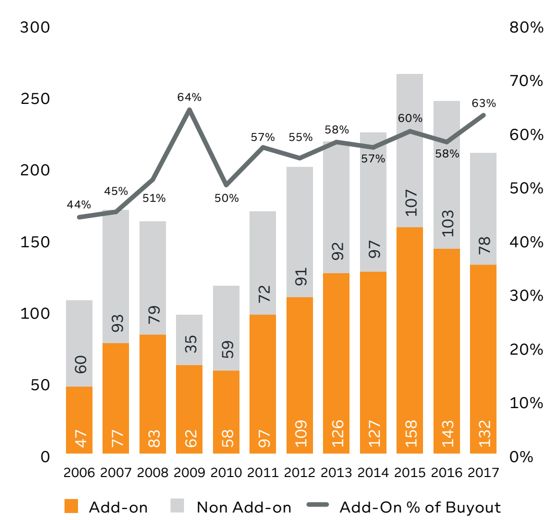
We continue to see a robust number of private equity exits despite a decrease from 2016. The total value of exits in 2017 dropped from $27.58 billion in 2016 to $16.62 billion in 2017. The increase of capital invested in 2017 and the high value of assets being retained by funds signal private equity funds' continued confidence in the market to generate returns and provide potential exit opportunities in the future. More secondary trades between funds, and a resurgence in the IPO market, will continue to provide funds with multiple exit options to achieve desired returns in 2018.

Canadian PE-backed exits by year *



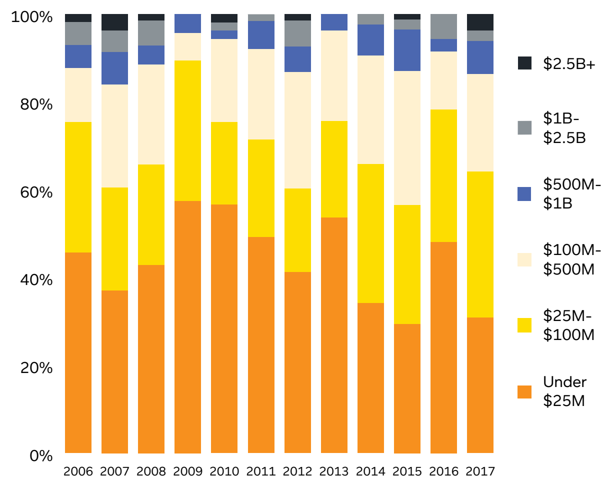
Add-on activity of private equity funds once again increased as a proportion of overall deal activity, representing 63% of all Canadian private equity transactions. The private equity platform approach continues to allow financial buyers to compete as synergies help bridge the valuation gap in a competitive market.

Canadian add-on activity by year *



The outlook for 2018 appears to signal a continued focus on mid-market add-on transactions, as funds continue to build platforms across this market segment. The number of transactions at the top end of the market is also expected to increase with funds holding significant dry powder looking to invest.

Canadian deal # by deal size *(C$B)* *



Longer-Term Funds

Longer-term funds have proliferated in the past few years and continue to do so into 2018. These funds eschew the traditional 10-year fund life span and 3- to 5-year investment hold period that are hallmarks of the majority of buyout funds by locking-up investors for 15 to 20 (or more) years and holding each investment made by the fund for up to 10 years.

Such funds, which have been launched by both seasoned private equity houses and a few newer entrants in Canada, the United States and overseas, typically charge lower management fees to investors (1% instead of 2%) and provide fund principals with a longer period during which to build value for investors by tapping into companies' future potential, the opportunity to offer longer-term partnerships to reinvesting equityholders and a more flexible exit timetable and strategy. The targeted returns of several longer-term funds, however, have tended to hover around or just above 10%, rather than the 20% and higher returns that more traditional buyout funds target, although certain sponsors believe that returns need not be sacrificed. In addition, the longer life span of these funds increases the period of time between capital raising efforts, allowing principals to spend more of their time sourcing new investments and helping portfolio companies to grow, which is the real value they offer to investors.

Investors seeking less volatility albeit decent returns have shown a growing appetite for funds with longer investment horizons. Many such investors are large sovereign wealth funds, public and private pensions funds, insurance companies, family offices, university endowments and other large institutional investors with long investment horizons of their own. These investors are generally nonplussed by the illiquidity that is inherent to such funds, and, indeed, many of them have been making their own direct private equity investments with similar hold periods for many years. Therefore, such funds espouse a long dated investment model with which such institutional investors are already very familiar. Additionally, they offer all investors an alternative within the broad spectrum of available private equity products, between more traditional shorter-life buyout funds and permanent capital.

Although longer-term funds remain, at least for the time being, a niche within the overall buyout fund universe, they will likely continue to capture a growing share of the significant pools of capital that continue to be allocated to private equity.

Family Offices

Another trend that continues to emerge in the private equity industry is the growing appetite of family offices to engage in direct investments, rather than indirect investments through intermediary funds.

Family offices are increasingly seen as competitors to traditional private equity funds and strategic buyers, particularly in the lower- and middle-market. A significant number of family offices are now staffing in-house teams that have the capability to execute on direct investments, which they may complete alone or in tandem with one or more other investors.

This reflects a broader trend of family offices seeking to invest in alternative assets that produce higher yields than traditional public investments. As family offices continue to seek out these private investments, they are increasingly looking to avoid the management and carry fees that would be charged if they invested through a private equity fund. In addition, family offices are often able to hold investments for the long term and would prefer to avoid the finite hold periods (discussed above) imposed by a traditional private equity fund. This ability to invest for the long term can also make family offices attractive to sellers who are looking for an investor to be a partner in their business.

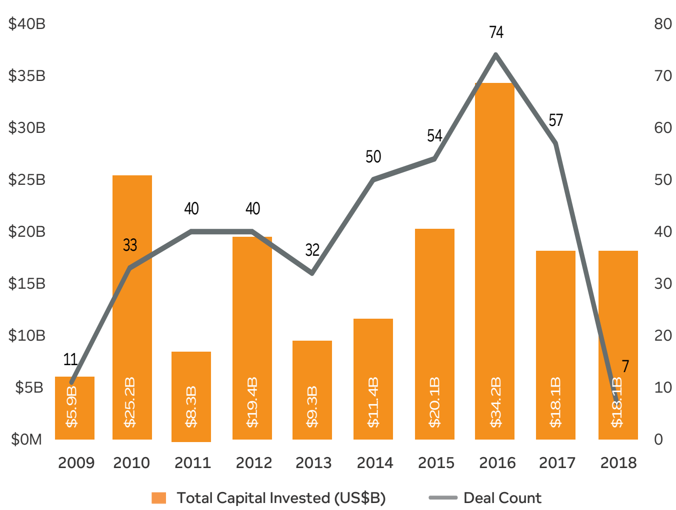
For many family offices, taking a direct role in investments is consistent with the entrepreneurialism that typically initially generated the family's assets. The most significant challenge for many of these offices is to generate sufficient deal flow (in a very crowded and competitive market) to justify the cost of maintaining a team that can execute on direct transactions in the same manner as a private equity fund. However, increasingly we are seeing family offices that are able to use their distinctive profile and outlook to successfully find investment opportunities. Accordingly, we expect that family offices will continue to play a significant role in the market for private assets in years to come.

The Rise of Co-Investments

The beginning of 2018 has shown that private equity fundraising continues to balloon. At the same time, investors in traditional private equity funds continue to look for alternatives to enhance returns – enter the co-investment.

There is wide industry media coverage of limited partners' focus on reducing their exposure to management fees. However, few investors have the appetite to build the in-house infrastructure required to go it alone with direct investing. The ability to enter into co-investments presents a good middle-ground alternative for investors. The Q4 2017 *Assante Survey* indicates that over 80% of investors are looking for co-investment opportunities and that half of those would co-invest with fund sponsors in which the investor is not currently invested. In fact, *PitchBook* reported that U.S. private equity activity with limited partner participation has continued to increase over the last ten years.

U.S. PE activity with LP participation *(as of 01/31/2018)* *



There are many advantages to making co-investments, because they:

- are commonly made on a no-fee/no-carry basis;
- allow an alternative avenue for deploying investors' vast amounts of capital allocated to private equity;
- allow investors who wish to have increased exposure to emerging markets or particular sectors to do so alongside an experienced general partner;
- create opportunities for investors to deepen their relationship with a general partner by working alongside it; and
- create opportunities for investors to broaden their relationships with general partners in whose funds they are not currently invested.

Although the interest in co-investing is clearly on the rise, it is unlikely that co-investing will replace investors' interest in fund investments. The sustained heated fund-raising market reflects the apparently insatiable appetite for investments in private equity funds. The class of investor who will be a viable co-investor is limited due to several factors. First, general partners desire co-investors who can easily execute a transaction. As such, a co-investor must staff its team appropriately to be able to source, diligence and quickly execute co-investment opportunities. Although not as cost-intensive as staffing a full blown general partner office, not all investors have the will or capability to take on this significant time and expense outlay. Second, the attractive no-fee returns may come at a price. Depending on the size of the co-investment, investing directly into a portfolio company may present a more concentrated risk than an investor would normally care to undertake. Third, for those investors who are familiar and equipped to make fund investments, there are other market alternatives available to help enhance returns and diversify exposure that do not involve the inherent cost and risk that comes with co-investing. The recent successful raises of co-investment funds is but one example.

U.S. Tax Reform: Implications for Private Equity[1]

The legislation known as the Tax Cuts and Jobs Act of 2017 (the "Act") was signed into law by the President of the United States on December 22, 2017. The full impact of the Act on the U.S. and international deal economies will likely be wide-reaching, with many aspects not yet quantifiable.

At a high level, the Act makes the following changes which are of particular relevance to private equity investors:

Reduction in Corporate Income Tax Rate

The U.S. federal corporate income tax rate has been reduced dramatically from a top marginal rate of 35%

1 *McCarthy Tétrault LLP lawyers do not practise U.S. law and the observations presented herein are based on their understanding from structuring cross-border deals.*

to 21%. This reduction may make it preferable for certain investments to be held in a taxable corporation that pays the lower rate on its income, rather than in a flow-through entity (such as a partnership or limited liability company) where income is passed on pre tax to upstream investors. A variety of factors will determine which structure is the most tax-efficient for a given investment, including the availability of the new 20% deduction discussed below. When evaluating cross-border deal structures and cross-border leverage, the consolidated effective tax rates (state and federal) must be considered.

20% Deduction on Income for Certain Flow-Through Entities

Investors who own U.S. businesses in flow-through entities, other than certain investing, investment management and service businesses, may be eligible for a deduction equal to 20% of domestic "qualified business income" earned through a flow-through entity. The availability of this deduction will be relevant in assessing whether a flow-through structure is more tax-efficient than having a corporate entity hold the business and pay the reduced 21% corporate tax rate. Under the Act, the deduction is only available until 2025.

Carried Interest Remains Eligible for 20% Rate

Despite certain forecasts that the Act would eliminate the 20% long-term capital gains rate enjoyed by private equity funds on carried interest, the new rules essentially preserve the benefit. The Act does impose a new three-year "holding period" for investments held by a fund receiving a carried interest in order to be eligible for the reduced rate. The sale of an investment that has not been held for at least three years will be taxed at ordinary income rates, a differential of 17% (20% vs. 37%).

Limits on Interest Deductibility

The Act limits the deductibility of interest by a business to 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) until 2021, and thereafter to only 30% of earnings before interest and taxes (EBIT). This limit applies to existing as well as new investments, with no grandfathering or phase-in period, and applies equally to both third party and related-party debt. Certain real estate investors may elect into a different regime. The change will increase the overall cost of capital for investors, but in connection with corporate structures it will be offset in whole or in part by the reduced 21% tax rate. Debt financing alternatives (e.g. preferred equity or convertible note structures) may warrant being considered.

Immediate 100% Expensing of Qualified Property

Taxpayers will be entitled to immediately deduct 100% of the cost of depreciable taxable assets, including those acquired from a third-party seller. The rule is elective, which creates flexibility to avoid creating excess net operating losses which may be trapped in loss-denial limitations. This deduction is available for both new and used tangible property, meaning that where a fund acquires a new business by way of an asset deal (including as a synthetic asset deal for U.S. Internal Revenue Code purposes), a large portion of the assets will be eligible for 100% expensing at the time of purchase. This may make asset deals more attractive to buyers.

Canada appears unlikely to follow the U.S. with any meaningful tax reform of its own. In his keynote speech to the World Economic Forum in Davos on January 23, 2018, Prime Minister Justin Trudeau made his position clear that Canada would not be following the U.S. tax reform example.

The foregoing and other changes imposed by the Act will likely have an immediate impact on cross-border investments. The Act's proponents have heralded the reform as a means to improve U.S. competitiveness and encourage domestic investment. For Canada, which has enjoyed low corporate tax rates relative to the U.S. for many years, the impact of the Act will likely affect the landscape in two respects: (a) making it more competitive for Canadian investment into the U.S. and (b) making it more important to consider leverage and other strategies to minimize the taxable income of existing Canadian private equity portfolio companies and Canadian target companies.

Natural Resources

It was a tale of two different stories for private equity in the Canadian natural resources space in 2017. While interest from energy-focused private equity funds diminished, there was more competition for assets from mining-focussed funds. We see that trend continuing in 2018.

Capital markets in the mining sector somewhat returned to life in 2017 with a number of IPOs, including the debut by zinc miner Nexa Resources S.A. Even with that partial revival, private equity continues to be a viable option for mining companies seeking investment and to monetize assets. With a handful of exceptions, strategic investors have not fully engaged in the sector to rebuild their growth pipelines and there remains a window for private equity funds to provide liquidity and funding for quality assets. While some of the larger mining-focused private equity funds shuttered in 2017, funds focused on smaller deal sizes and alternative funding, such as metal streaming, continue to find opportunities.

Private equity's interest in energy has seen some retrenchment in 2017, notably from foreign funds, some of which closed their Canadian offices. The focus in the Canadian energy sector has largely been on exits and restructurings. However, while there has been diminished interest from foreign funds, Canadian-based private equity funds continue to be a source of funding for energy companies with performing assets. This is especially so because the capital markets for energy companies continue to be challenged.

** Sources for all graphics: Pitchbook Data, Inc. and McCarthy Tétrault analysis*

About McCarthy Tétrault

McCarthy Tétrault provides a broad range of legal services, advising on large and complex assignments for Canadian and international interests. The firm has a substantial presence in Canada's major commercial centres as well as in New York and London.

Built on a unique model of collaboration, the firm brings its legal talent, industry knowledge and practice experience, wherever needed, to help clients achieve the results that are important to them.

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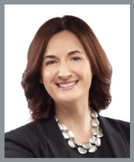
For more information, please contact:

Mark Adkins
Managing Partner, New York Office
madkins@mccarthy.ca
646-940-8966

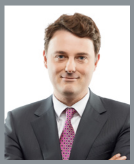
Matthew Cumming
Partner, Co-Head of Private Equity Group
mcumming@mccarthy.ca
416-601-7744



Shevaun McGrath
Partner, Co-Head of Private Equity Group
shmcgrath@mccarthy.ca
416-601-7970

Jonathan See
Partner, Co-Head of Private Equity Group
jsee@mccarthy.ca
416-601-7560

Patrick M. Shea
Partner, Co-Head of Private Equity Group
pshea@mccarthy.ca
514-397-4246



Shea Small
Partner, Co-Leader of Global Mining Group
ssmall@mccarthy.ca
416-601-8425