On Target

2020 Private Equity Outlook

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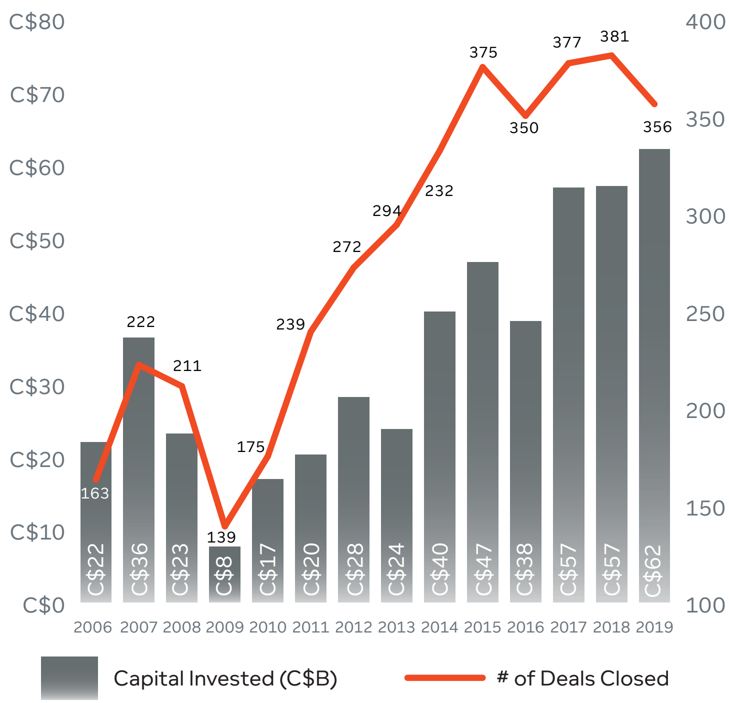
2019 Year in Review: The Numbers

CANADIAN PE OVERVIEW

Canadian private equity activity reached $62 billion in 2019 as measured by capital invested, an all-time high, rising slightly above the $57 billion invested in each of 2017 and 2018. Despite dipping for the first time in three years as measured by number of deals, the industry remains strong. Looking back at 2019, the largest Canadian deals included the $5.2 billion majority investment in security firm GardaWorld by BC Partners, the $5 billion acquisition of airline operator WestJet by Onex (which is expected to close in 2020) and the $6.2 billion purchase of property manager Dream Global REIT by funds managed by Blackstone Group.

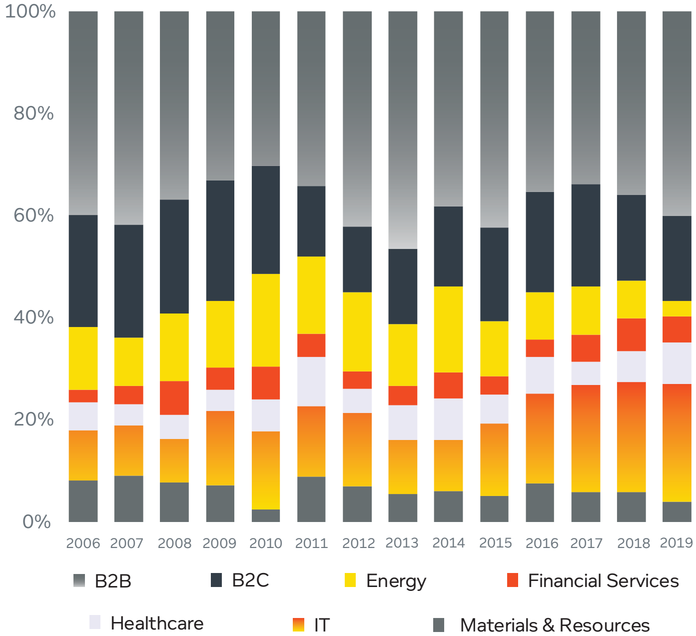
Canadian PE Deal Activity



CANADIAN PE BY SECTOR

In 2019, the activity level in the healthcare and B2B sectors continued its positive trend while the materials & resources and energy sectors experienced another challenging year. The financial services sector saw a tightening of activity, while the IT and B2C sectors remained essentially flat.

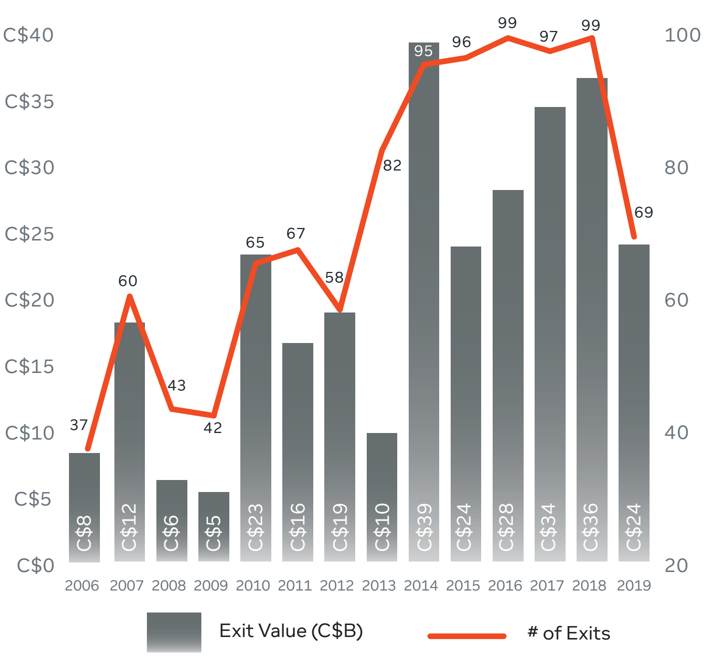
Canadian PE Deal Activity (#) by Sector



CANADIAN PE-BACKED EXITS

Both the deal value and the number of Canadian private equity exits were significantly down in 2019. Firms exited 69 companies for a total value of $24 billion, representing a year-over-year decrease of 34% and 30.3%, respectively.

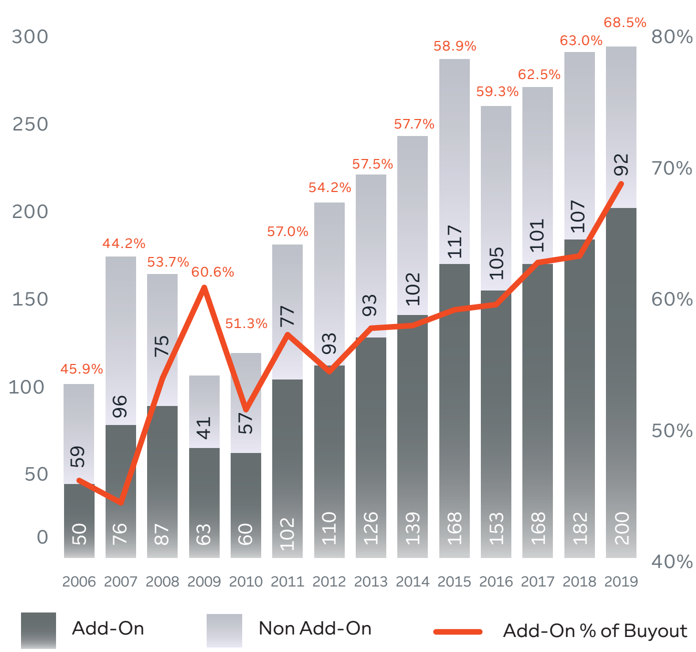
Canadian PE Exit Activity



CANADIAN ADD-ONS

Add-on activity accounted for a record proportion of all buyout activity in 2019, representing almost 69% of overall buyouts. While the number of add-on transactions continue to increase, the number of non-add-on transactions reached lows comparable with 2012. As funds continue to specialize and build expertise in specific industries, these add-on transactions will continue to be in line with industry-focused firms' strategy to create synergies with existing portfolio companies.

Canadian PE Add-on Activity

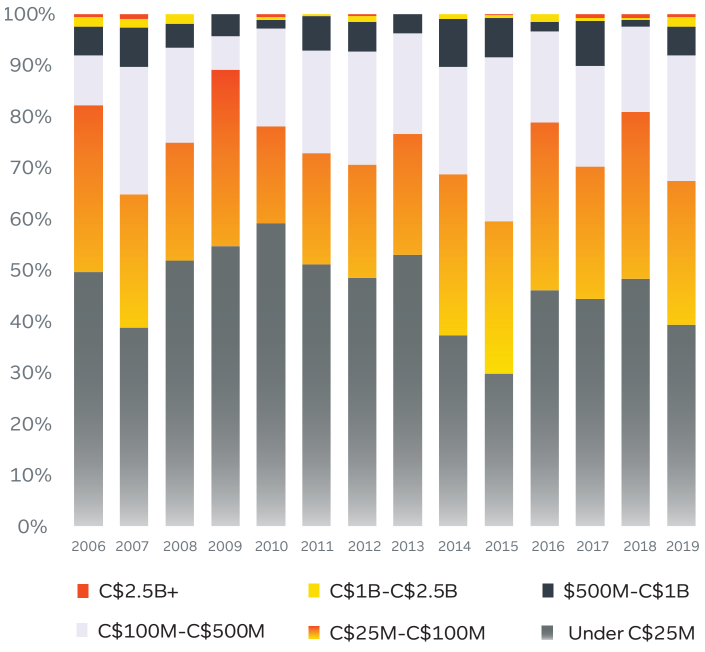


CANADIAN DEAL SIZE

The number of 2019 private equity deals with deal values in the upper tiers ($100 million and more) increased. Deals over $500 million in value saw a significant increase

of 222% in 2019. After a slight decrease in 2018, the $100 million to $500 million range reversed course with a 35% increase in 2019, after a dip in 2018. The lower tiers ($100 million or less) saw a sharp decrease in the number of deals completed.

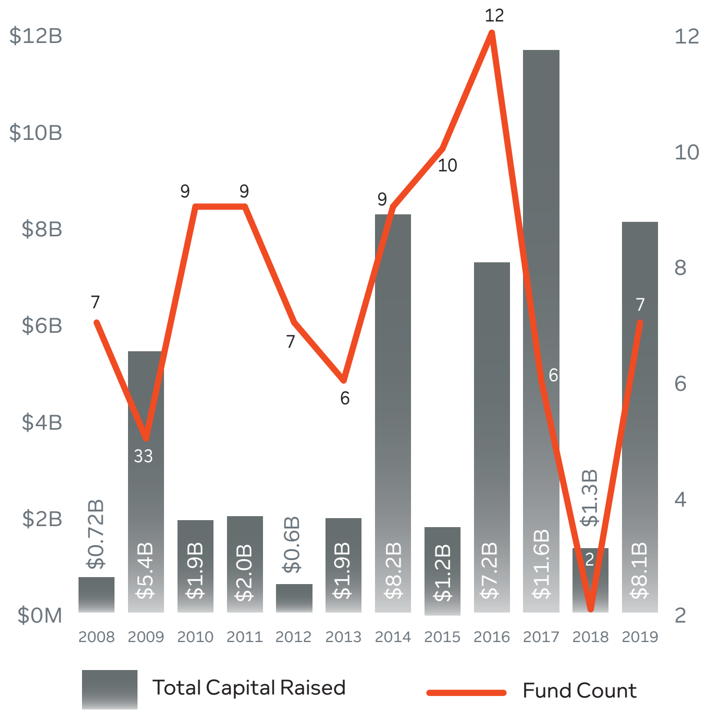
Canadian PE Deal Activity (#) by Size



CANADIAN PE FUNDRAISING

After a quieter year in 2018, Canada's fundraising cycle is back to levels that were seen in 2016 and 2017. The total capital raised in 2019 was $8.08 billion. Buyout funds, including the $3 billion Altas Partners Holdings Fund II and Novacap's $940 million Industries V fund, represent 70% of the capital raised. This is a trend that could continue into 2020, with a number of funds staying open to capture 2020 investment dollars.

Canadian PE Fundraising



As we look forward to 2020, there are several trends that we are following closely. The first, a result of the increase in dry powder available to buyout funds with the conclusion of the 2019 fundraising efforts, is the increase in buyout M&A, including secondary M&A – in particular as other exit options (i.e., IPOs) seem less viable. A second trend is the strategies that funds will deploy to the extent that the North American economy slows, whether this is looking for opportunities in distressed M&A or preparing portfolio companies to ride out a period of uncertainty. Third, we see that with the value that has been created in PE, and the focus of money managers on alternatives, GPs with track records may look to stake deals as a way to unlock further value and fuel growth. Finally, we anticipate that GPs will dedicate additional resources to integrate and operationalize Environmental, Social and Governance (ESG) principles into their fund structure and asset management work.

GP Stakes Investing Moves North

Over the last decade, there has been a marked increase in the number of GP stakes investments – that is, an investment in which an investor takes a minority (and typically passive and non-voting) equity interest in a general partner, which provides the investor with a proportionate share of GP-level cash flows. During this period, several large institutional investors (such as Dyal Capital Partners, Goldman Sachs' Petershill Group and Blackstone's Strategic Capital Holdings) have raised tens of billions of dollars dedicated exclusively to such investments. Dyal announced the closing of its fourth fund in December 2019; the fund was heavily oversubscribed with committed capital of $9 billion, and at that time the fund had already committed 64% of its capital to new stakes investments. A number of smaller investors have also become active in deploying funds towards stakes deals. The market clearly still sees significant opportunity in the sector.

When GP stakes investments first arose, investors focused primarily on stakes in hedge funds. Over time, the investment focus shifted squarely to institutional private equity funds, as well as credit, real estate and venture capital funds. Today, a majority of the largest private equity funds have completed either a public financing or a stake deal with an investor. The large pools of investment capital dedicated to stakes deals, together with a limited pool of target assets (with investments in each GP customarily limited to 20%), have led to higher valuations for GPs and created a streamlined process and structure for negotiations with terms that are relatively favourable to GPs.

As a result of these competitive market dynamics, investors have expanded their target scope into the PE mid-market as well as beyond the United States. A significant Canadian stakes transaction was announced in 2019, and Canadian PE firms generally appear poised to become more active participants in this market. For stakes investors, many Canadian mid-market GPs are attractive targets, with meaningful assets under management and significant potential for growth. Stakes investors typically focus primarily on the prospect of management fees (with carried interest, if and when realized, being a significant bonus), so a future lift in assets under management will lead to high investor returns. For Canadian GPs, investor capital can enable firms to drive growth to a new level, including by way of the pursuit of adjacent fund strategies. A stronger balance sheet allows PE firms to make investments in personnel and technology and other growth initiatives as well as to contribute additional GP capital into their own investments. Further, many of the large institutional investors in this sector are able to offer various support for GPs over the long term that can be valuable to PE firms in accessing new markets and strategies. For some PE firms, a stakes investment can also facilitate liquidity and help transition management of the GP to a new generation, without the challenges attendant to an IPO.

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While there are, of course, important deal terms for each investment that require negotiation between investors and GPs, overall these terms have been relatively standardized. **Valuations generally are perceived to be favourable to issuers, and the governance structure of a stakes investment typically provides GPs with broad latitude to operate their business.** Investors are typically sensitive to ensuring protection against dilution and general alignment of key person participation in the business. The scope of exit rights are, of course, important to both parties; however, as a practical matter, to date there have been very few investor exits in the sector.

In 2020, with abundant investor capital continuing to seek out new targets, we expect to see additional Canadian GPs explore stakes transactions. In readying themselves for a potential transaction, GPs should focus not only on building their firm vision but also on institutionalizing their overall operations, which will be important for investors seeking to minimize the investment risk of a stake in the PE firm (rather than in a fund). With the right preparation, a stakes investment can bring significant value to a Canadian PE firm that is ready to pursue a new level of growth.

Initial Public Offering – A Viable Exit Option?

From Uber's and Lyft's long anticipated IPOs, to WeWork's abandoned IPO, 2019 was a sobering year for the IPO market. The initial excitement at the prospect of disruptive tech companies hitting the public markets was quickly snuffed out when, among other issuers, Uber's stock price steadily plunged

Many of the companies that either went public and then saw a rapid decrease in value or abandoned their offerings altogether, especially in tech sector, had several things in common – market hype, overvaluation and a not-so-clear path to profitability.

after its IPO and WeWork decided to pull the plug on its offering. In addition to these two headliners, the Canadian IPO market also cooled. With a steady start to 2019 with nine IPOs in the first quarter, up from eight in 2018, the rest of the year showed a steady decline in initial public offerings on the Canadian exchanges both in terms of number of offerings and value. There appears to be consensus that the sanity check on the market for overvalued "unicorns" has arrived. Many of the companies that either went public and then saw a rapid decrease in value or abandoned their offerings altogether, especially in tech sector, had several things in common – market hype, overvaluation and a not-so-clear path to profitability. **In 2019, the market experienced what one could characterize as a reset. Not the seismic reset of 1999, but one where valuations will hopefully be based on profitability and sound corporate governance and not the next bright, shiny thing.**

It will be interesting to see whether 2020 brings this same sanity check to the inflated valuations we are seeing in the private equity market, where the quest to deploy unprecedented amounts of capital continues to drive heated valuations of target assets. If the private equity M&A market does not so adjust, we will see whether an IPO, without the benefit of market hype, remains a viable exit option in the face of continued inflated valuations for secondary M&A sales.

Distressed Private Equity

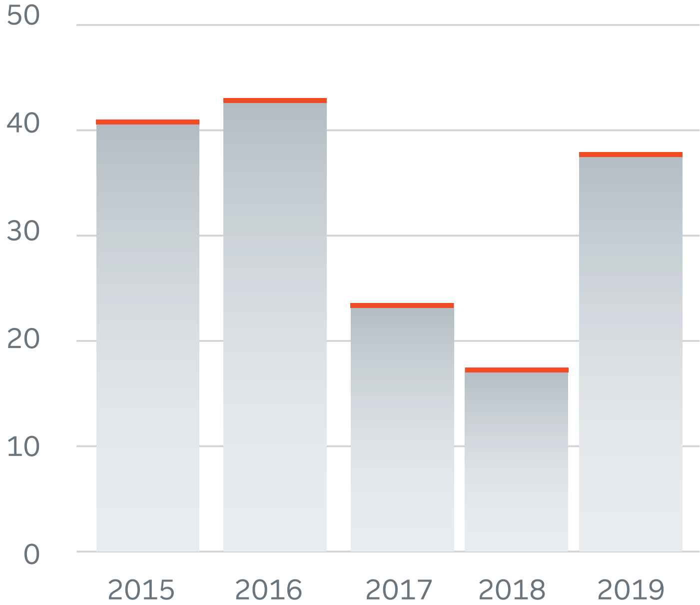
MACROECONOMIC/RESTRUCTURING TRENDS IN THE CANADIAN MARKET

Generally speaking, there has been no significant global economic distress in the Canadian economy since the end of the financial crisis in 2008. This fact, combined with sustained economic growth and low default rates have, to a certain extent, limited opportunities in the distressed market. One notable

exception has been a deepening decline in the Western Canadian petroleum and natural gas industry. Additionally, there has been an overall increase in restructuring activity in 2019 which may portend increased distressed opportunities in 2020.

Canadian corporate restructuring proceedings peaked in the aftermath of the commodity crisis of 2015, bottomed-out in 2017 and 2018 and rose again in 2019. The chart below indicates the number of debtor restructurings commenced under Canada's primary restructuring statute, the *Companies' Creditors Arrangement Act* (CCAA), between 2015 and 2019. CCAA proceedings are a good proxy for overall distress and restructuring activity, including the level of activity in other formal liquidation proceedings, non-performing loans and informal workouts.

CCAA Proceedings



With the foregoing overview in mind, what follows is a discussion of two broad categories of distress situations that potentially engage private equity. The first are those instances where a portfolio company is encountering distress and the second relates to a distinct class of private equity opportunities to invest in the distressed-debt deal space.

DISTRESSED PORTFOLIO COMPANIES – THE PETROLEUM AND NATURAL GAS EXPERIENCE

We have witnessed an uptick in distressed situations in portfolio companies in the Canadian petroleum and natural gas space. Such distress has been occasioned by the continued moribund pricing environment (particularly natural gas), ongoing uncertainty about the ability to expand transportation capacity to facilitate greater access to tidewater and a regulatory environment which is perceived by many market participants to be antithetical to fostering growth in the industry.

Distress in portfolio companies provides opportunities to right-size balance sheets through mechanisms such as recaps via debt-for-equity swaps utilizing corporate law processes or by combining formal insolvency proceedings with corporate law processes. A formal insolvency proceeding brings with it the potential added benefits of compromising trade debt, right-sizing the work force, shedding redundant or under-performing assets and disclaiming certain types of uneconomic agreements.

In a distressed scenario, existing management is often part of the problem or lacking in the skill and acumen required to work through the myriad of issues that distress brings. **Thus, it is important to assess opportunities to add restructuring expertise at the board level or at senior management levels with individuals who have the ability to make timely and decisive decisions, arrest the decline and stabilize the company while a restructuring can be implemented with a return to either existing management or swapping in new teams as part of the process.**

DISTRESSED PRIVATE EQUITY – OPPORTUNITIES ON THE HORIZON?

Unlike traditional leveraged transactions supported by predictable cash flows, the distressed target is axiomatically neither stable nor generating reliable or predicable cash flow. Strategies that are engaged include the acquisition of distressed debt with the goal of converting the debt into a controlling position in the restructured enterprise, acquiring equity or an asset purchase. Any strategy requires quick, decisive and non-template actions because the same competitive factors that lead to head-scratching valuations in the non-distress space attend with equal or greater force in the distressed space, where there are finite opportunities.

> **As both the market for deals in general and the private equity industry more specifically continue to be extremely competitive, private equity firms continue to adapt by adopting innovative new strategies to raise and invest capital.**

For those who subscribe to the theory that the boom times will not last forever, current valuation metrics are not sustainable and that the recent competitive drive to transacting with increasing covenant-light deals have sowed the seeds for distressed opportunities when the credit cycle turns, now may be the time to dust off the distressed-investing playbook.

Increased Specialization of Private Equity Strategies

As both the market for deals in general and the private equity industry more specifically continue to be extremely competitive, private equity firms continue to adapt by adopting innovative new strategies to raise and invest capital.

One piece of evidence of such adaptation is the proliferation of more and more specialized private equity strategies. What just recently may have been considered by many as being very niche strategies have become mainstream.

Specialized strategies include:

- **focusing on specific industries**
- **focusing on geographies**
- **increasing growth equity/minority stake investing**
- **diversifying asset classes**
- **creating funds focused on ethical/impact investing considerations**
- **increasing the investment and hold periods of funds**

By devising and implementing a diversity of differentiated strategies, private equity firms are able to develop in-depth sector-by-sector know-how, expand their networks and connections and their subsequent ability to identify hidden gems within applicable sectors and markets, improve decision-making and better attract top investment and operational talent. This allows firms, within the current context of capital overabundance, to increase their competitiveness in specific industries and markets and to infiltrate industries and markets in which there has traditionally been less competition. And developing these competitive differentiators that limited partners are increasingly expecting normally allows firms to increase their fundraising capacities.

Although there is no evidence of the death knell of the traditional, generalist buyout firm, we believe that increased competitiveness in the market will cause there to be continued specialization of and by private equity funds and additional new bespoke strategies deployed by them in 2020.

Importance of all things ESG

General Partners have in recent years worked to align themselves with Environmental, Social and Governance (ESG) principles and integrate them into their fund structure and asset management. With record fundraising in Canada in 2019, GPs discovered that ESG due diligence was a focus for their limited partners and as a result it was essential for funds to address a broad range of ESG categories each in a specific and meaningful way in order to secure commitments from investors. Areas of focus included climate-change-related risk and disclosure, diversity and inclusion programs and board composition (including having independent directors on portfolio company boards, ensuring diversity of boards and setting term limits for directors). GPs have rushed to become signatories to the various voluntary disclosure and reporting standards that have proliferated in recent years in respect of ESG performance and worked diligently to comply with the

reporting and disclosure rules that come with this association. Voluntary disclosure and reporting have not satiated the investor community, which appears to have a taste for being the catalyst for change. The importance of ESG to GPs has been highlighted by some of the world's largest investors, including Blackrock, in CEO **Larry Fink's letter to CEOs** and State Street Global Advisors, in **CEO Cyrus Taraporevala's letter to board members of its portfolio companies**, both sent in January 2020. GPs that fail to dedicate adequate resources to ESG issues within their own fund structure and portfolio companies will do so at their peril, while those funds that are able to communicate their ESG efforts to the investor community stand to gain in 2020 and beyond.

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> – *Chambers Global* Client Interview (M&A)

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Sources for all graphics: Pitchbook Data, Inc. | ISED Canada, *Insolvency statistics in Canada*, *2015-2019* | McCarthy Tétrault analysis mccarthy tetrault

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