On Target

2023 Private Equity Outlook

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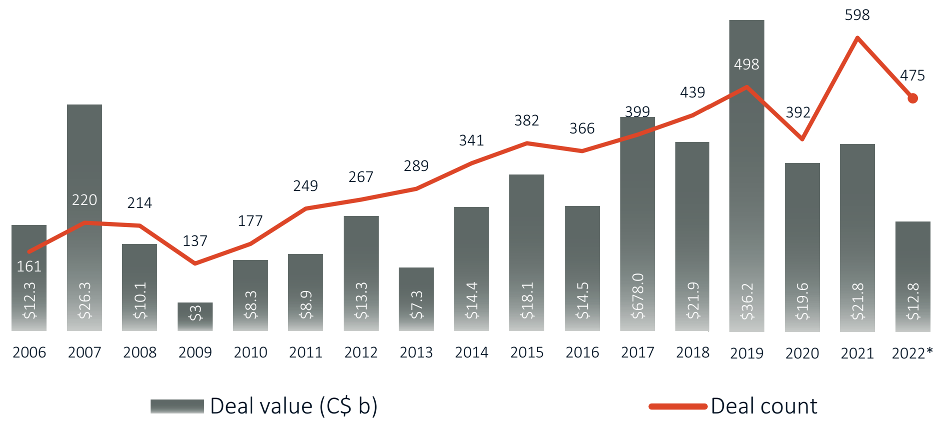
2022 In Numbers – Canadian Private Equity Overview

After the feverish pace of 2021, the Canadian private equity market cooled down considerably in 2022. Rising inflation and borrowing costs coupled with major geopolitical events had PE firms acting more cautiously in respect of their capital deployment. As of December 16, 2022, the total amount of private equity capital invested in Canada in 2022 had only reached C$12.8 billion, based on disclosed deal value, a considerable decline from 2021 (C$21.8 billion) and the lowest since 2013 (C$7.3 billion). Deal activity also declined with only 475 transactions closed as of December 16, 2022, a decrease from the 598 closed in 2021, which was itself a record high.

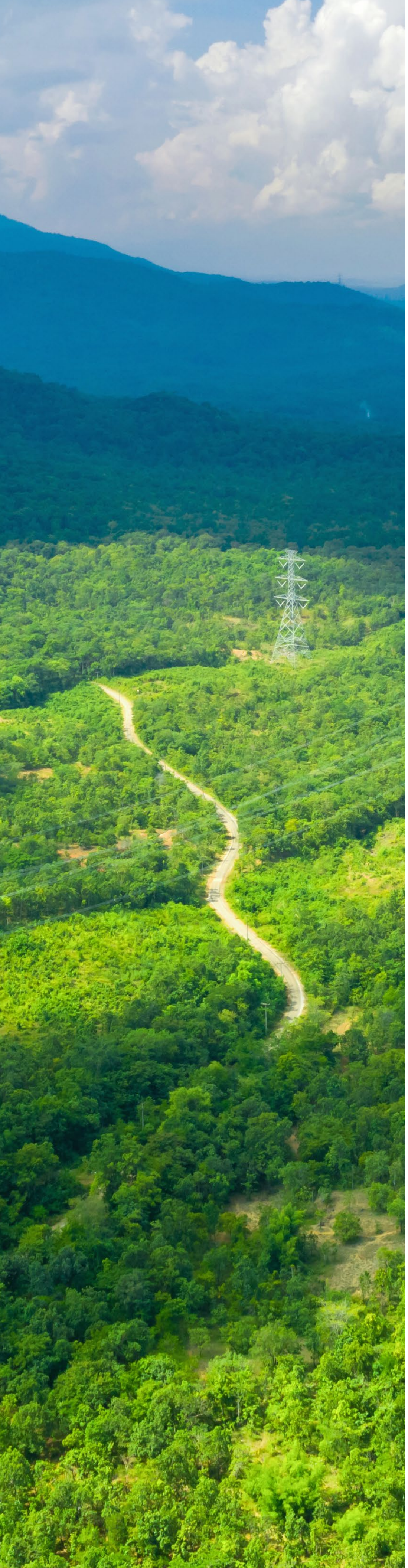
At the time of writing, two weeks remain in Q4 of 2022 but it is shaping up to be a lighter quarter for committed private equity capital with only C$0.6 billion in total private equity capital invested as of December 16, 2022 compared to C$4 billion in Q4 2021. However, deal count has not decreased as significantly with 94 deals having closed as of December 16, 2022 compared to 150 deals closed in Q4 of 2021.

Canadian PE Deal Flow by Year

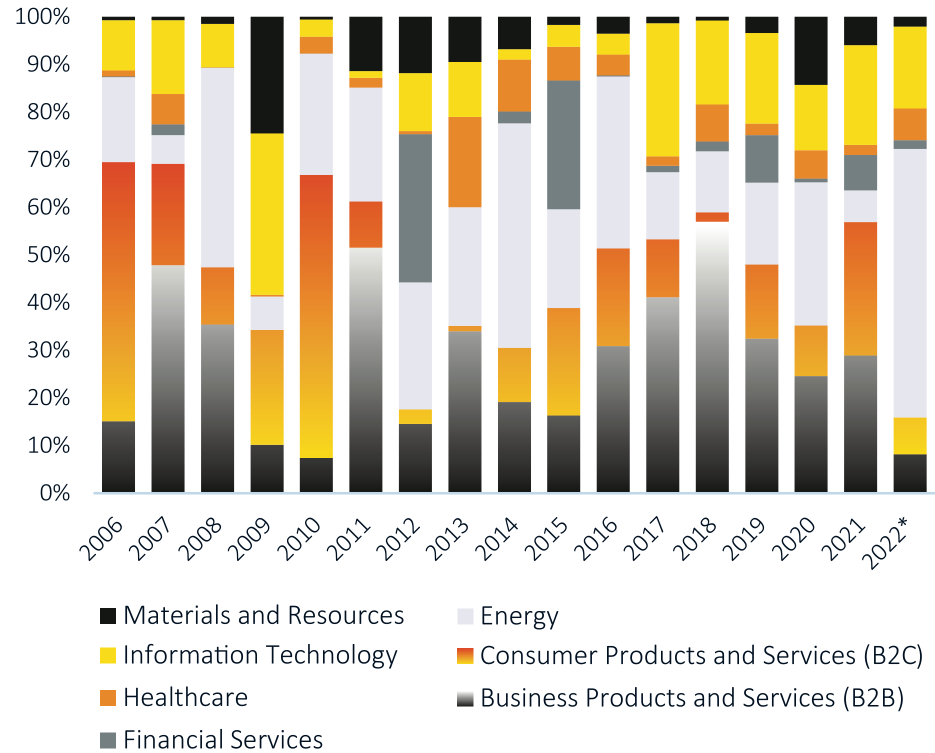


CANADIAN PE BY SECTOR

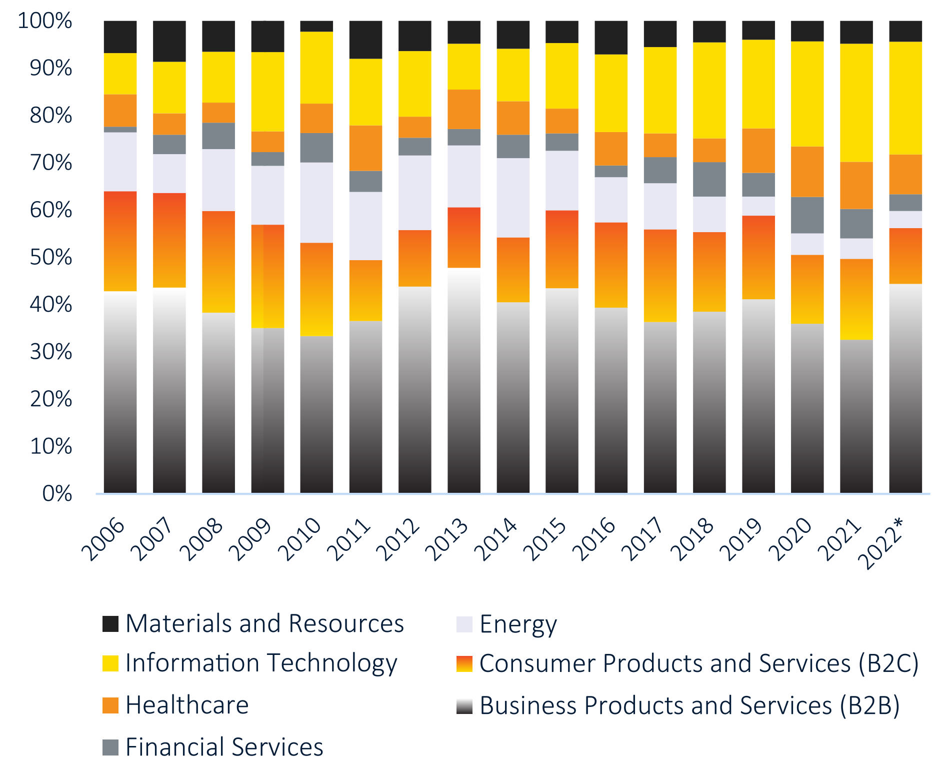
In 2022, the deal value sectoral winners were energy, information technology and B2B, with the energy sector far outpacing the latter two. As of December 16, 2022, C$7.20 billion of private equity capital was invested in the energy sector representing a significant increase from C$1.45 billion in 2021. Investment in the information technology and B2B sectors were considerably lower at C$2.20 billion (2021: C$4.56 billion) and C$1.04 billion (2021: $C6.30 billion) respectively. However, B2B also experienced the greatest reduction in total private equity capital invested because in 2021, it took in C$6.30 billion in total capital compared to this year's C$1.04 billion. Despite the reduction in total private equity capital deployed, deal activity in the B2B sector still represented the greatest number of deals in 2022 at a total of 211 (up from 195 in 2021). By contrast, there were only a total of 17 deals in the energy sector (down from 26 in 2021) and 113 deals in the information technology sector (down from 149 in 2021).



Canadian PE Deal Value by Sector



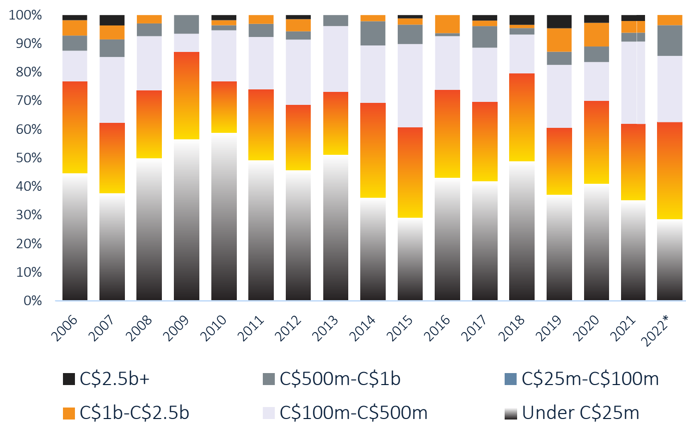
Canadian PE Deal Count by Sector



CANADIAN PE-BACKED EXITS

Readers may recall that 2021 marked a reversal of the historical downward trend in private equity-backed exits in Canada. In line with the broader trends in 2022, the historical downward trend returned with respect to private equity-backed exits as they decreased significantly in 2022. As of December 16, 2022, private equity firms exited 110 companies (2021: 150) with an aggregate value of C$12.55 billion (2021: C$23.86 billion), which, if annualized, would represent a year-over-year decrease of 27% in total activity and of 47% in total value.

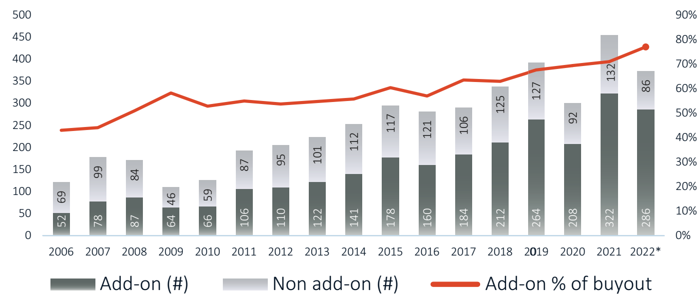
Canadian PE Exit Activity



CANADIAN ADD-ONS

Add-on acquisitions continue to account for the bulk of private equity buyouts in Canada, representing 76.9% of deals by number, which percentage is consistent with the trend over the last five years. As funds continue to specialize and build expertise in specific industries, and with the potential opportunities for firms to acquire distressed assets, we expect to see continued growth in the number of add-on transactions in 2023.

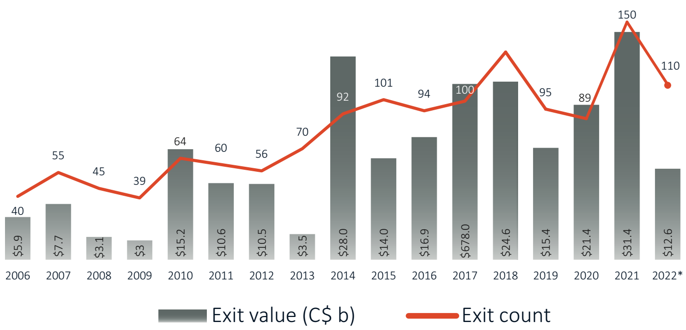
Canadian PE Add-On Activity by Year



CANADIAN DEAL SIZE

Despite the overall reduction in year-over-year deal activity, the under C$500 million category continues to be the backbone of private equity investments in Canada. As of December 16, 2022, these deals accounted for approximately 86% of the total Canadian private equity deal activity. However, deals under C$25 million fell noticeably from 34 in 2021 to only 16 in 2022. In addition, there were only 8 private equity deals over C$500 million as of December 16, 2022, compared to 9 such deals in 2021 and 12 such deals in 2020.

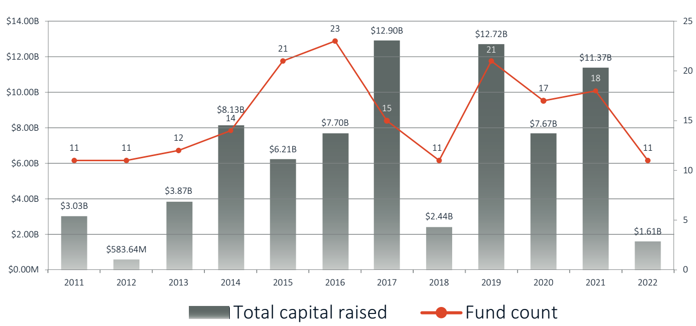
Canadian PE Activity by Deal Size



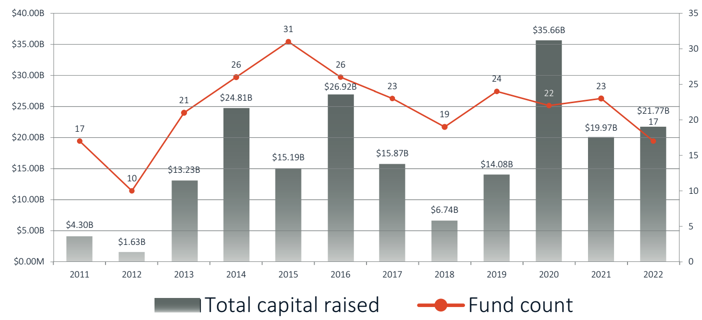
CANADIAN PE FUNDRAISING

Traditional private equity buy-out and similar fund fundraising dramatically declined in 2022. As of December 16, 2022, C$1.61 billion was raised, which is approximately 10% of the total capital raised in 2021 (C$11.37 billion). When combining total capital raised for both traditional private equity buy-out and similar fund fundraising and private debt, real assets and secondary fund fundraising, the total amount raised was C$21.77 billion as of December 16, 2022, which represents a 9% increase from the figure reported for 2021 (C$19.97 billion). However, a significant portion of this figure is due to Brookfield's C$15 billion Brookfield Global Transition Fund that closed in June of 2022.

Canadian PE Buy-out and Similar Fund Fundraising by Year



Canadian PE Buy-out and Similar Fund and Private Debt Real Assets and Secondary Fund Fundraising by Year



CONCLUSION

2022 has been a tumultuous year for the global economy. Canadian PE firms have not been untouched by these broader forces. Persistent inflation, the spectre of a looming global recession, the invasion of Ukraine and other geopolitical events have caused a chilling effect across the global economy. As with other market players, PE firms have responded by becoming more cautious in their capital allocation. This cautiousness is reflected in the overall decrease in the 2022 numbers from deal volume to deal activity. As we look forward, there are several other key trends to follow which may have an impact on growth capacity and deal activity, such as the ability of Canadian companies to handle rising inflation and borrowing costs, the availability of sourcing of raw materials and finished goods and the increasing pressure by both limited partners and potential sellers on private equity firms to have — and to disclose — their ESG policies and track records.

Implications of a Hardening Market

The effect of COVID-19 on Canadian insolvencies, like on much of the economy, was uncharted territory. Although 2021 and the beginning of 2022 saw some of the lowest number of corporate insolvencies in recent memory, the combination of the withdrawal of government support, inflation and supply chain issues saw filings increase in the latter part of 2022. The tightening of global credit and equity markets in late 2022 initially most severely impacted certain industries to be seen as more speculative or over-saturated (for example, cannabis), along with those industries that require frequent and large equity offerings (for example, junior mining companies).

This trend is expected to continue, with the Government of Canada noting in its fall update that "global growth is expected to slow, and recession risks have risen". Although U.S. companies' balance sheets were restructured and "right sized" during recent downturns, including most notably during the financial crisis of 2008, Canadian companies survived relatively unscathed. As a result, Canadian companies, on average, are far more leveraged than their American counterparts. This offers both challenges and opportunities for participants in the private equity space.

When markets were flush and credit plentiful, divesting an underperforming asset in an insolvency process was relatively straightforward: parties would run a sales and investment solicitation process (SISP), the market would speak and the entire process would be completed in relatively short order. As markets have shifted, the quick SISP is less likely to be successful. In 2022, there were a number of matters where the SISP resulted in lackluster results, including insufficient cash bids to pay out the debtor-in-possession financing. The 2022 restructuring of Freshlocal, a grocery delivery service and technology company, serves as a stark warning. The company grew rapidly in the pandemic, entered into a software contract with a major international grocery chain and launched its initial public offering in April, 2021. Despite an extensive marketing process and estimates of value well beyond the amounts owed to its secured creditors, the SISP was unable to obtain any viable offers, and the enterprise was purchased by Third Eye Capital through a credit bid of the debtor-in-possession financing. The secured creditors were unable to recover anything.

As a result of the disadvantages of a SISP in a down market, creative restructuring solutions need to be reviewed to improve recovery. These include traditional compromises, plans of arrangement and restructuring distressed assets and operations to hold in the medium term, instead of immediate divesting. In 2023, we expect

to see more traditional restructurings, as well as lenders being more active in forcing operational and balance sheet restructurings.

These distressed situations, however, also offer opportunities. Private equity firms participating as a debtor-in-possession lenders, such as what Third Eye Capital did for Freshlocal, can obtain leverage in the process and a priority position for a future credit bid. Likewise, where a SISP is necessary, stalking-horse bids and their associated break fees and expense reimbursement protections are likely to be more sought after by creditors looking to ensure a floor. With less competition, there are opportunities for those willing to participate as a stalking-horse bidder to acquire distressed assets at a reduced cost.

Although it remains to be seen what the global economy will do in 2023, the majority of the indicators suggest a global recession. We expect that the insolvency market will be busier than it has recently been, in particular given Canadian companies' more leveraged position, and that creative uses of Canada's flexible restructuring statutes will offer opportunities to interested groups looking to deploy capital into distressed situations.

The Impacts of Changing Credit Conditions

On March 15, 2020, the Federal Reserve Board of the United States decreased the target range for the federal funds rate to 0-0.25% in response to the escalating coronavirus pandemic. On March 27, 2020, the Bank of Canada followed suit, and slashed their overnight rate to 0.25%. In each case, the near-zero interest rates set the stage for a two-year window of cheap debt, market liquidity and lofty valuations that drove unprecedented deal volume in the private equity markets in both the United States and Canada. Looking ahead to 2023, the interest rate and liquidity landscape are dramatically different. The Bank of Canada overnight rate began to tick upwards on March 2, 2022, which has culminated in a 4.25% overnight rate as of December 7, 2022. The Federal Reserve Board's federal fund rate has similarly been raised to a target range of 4.25% to 4.50%. Rising interest rates have been coupled with a shift in monetary policy and quantitative tightening, aimed at targeting inflationary pressures in part driven by the glut of cash introduced into the markets over the past two years. With the heyday of inexpensive leverage and elevated multiples currently behind us, a normalization of deal pace and volume looks to be on the horizon. This may nevertheless present private equity players and their lenders with the opportunity to focus on operational efficiencies, management skill and value creation, and to pursue secure, prudent financing structures.

QUALITY OVER QUANTITY

The rising cost and increasing illiquidity of debt has tempered the red hot markets of 2020 and 2021. In June 2022, in the United States, loan issuance was down by 41% compared to the same month in 2021.[1] In the three months

1 https://www.economist.com/business/2022/07/07/private-equity-may-be-heading-for-a-fall.

leading up to October 21, 2022, U.S. companies raised just US$10.6 billion[2] of leveraged loans to fund buyouts, the lowest such reading in almost seven years. Beyond the impact of more expensive debt on the volume of new loans being extended to finance investments, rising interest rates will largely impact returns on existing investments. Moving into 2023, private equity firms should consider the extent to which their returns over the past two years have been driven by boosting top-line revenue or improving operational efficiencies, as opposed to multiple expansion. As the conditions for such multiple expansion, including cheap debt and excess liquidity, have been removed from the equation, a return to the fundamentals of value creation provides an opportunity for funds and a potential refuge from difficult economic headwinds. For example, investments in small- to medium-sized businesses "that rely less on leverage and financial engineering, and more on bottom-up operational value creation"[3] will be less exposed to tightening credit conditions. Small tuck-in acquisitions to existing platform investments that have continued to perform well may also increase. These conditions ultimately present room to develop genuine operational efficiencies and improve top-line talent, as well as an opportunity for talented fund managers to focus on promising targets without inflated valuations driving up purchase price.

RISK-OFF SENTIMENT

The focus on quality, and not quantity, is a hallmark of the current risk-off environment. The more regularly considered investment strategies that are emblematic of this point in time will likely impact both the volume and pace of deals. We anticipate both lenders and sponsors will undertake detailed diligence processes in light of stricter credit approval conditions, resulting in a return to normalized deal timelines. Riskier deal structures, including leveraged buy-outs with a second lien or junior debt component, may become increasingly rare, and subject to increasing underwriting scrutiny. Lenders may require that equity make up a larger proportion of the purchase price of leveraged buyouts as lenders' seek to limit their exposure and to preserve capital. The terms governing leveraged loans may also shift away from what seemed to be the trend towards looser covenant structures that flourished over the past two years. There may be amplified scrutiny surrounding distribution, incremental debt, investment and acquisition covenants. On existing deals, inflationary stresses and increased interest rates may encourage cooperation between lenders and their fund clients to address potential covenant breaches before they occur, or to find creative solutions to address any covenant breaches that have already happened. These factors may continue to drive deal activity, notwithstanding tempestuous economic conditions, as lenders and sponsors strive to identify quality assets in a risk-off environment.

SHIFTING LENDER ENVIRONMENT

The marked expansion of the direct-lender market that has taken place over the past two years has an ongoing impact to private equity. Direct lenders have benefitted from increased demand for debt to fund leveraged buy-outs. Moreover, as funds have amassed vast amounts of dry powder that have yet to be invested, so too have direct lenders accumulated capital that is yet to be deployed. Although the direct lender market in Canada is less robust than in the U.S., inroads to the U.S. direct lending market for cross-border transactions provide an alternative means of financing to sponsors. And, in the coming year, although deal pace and volume may normalize, the flexibility of direct lenders may provide a gateway to leveraged loans in respect of investments that may fall outside the customary criteria considered in traditional syndicated financings.

2 https://pitchbook.com/news/articles/leveraged-loan-financing-for-lbos-deteriorates-as-cost-of-debt-rises.

3 https://am.jpmorgan.com/us/en/asset-management/institutional/insights/portfolio-insights/portfolio-strategy/allocation-spotlight/private-equity-braced-for-a-turn-in-rates/#.

LOOKING AHEAD

Although we are moving away from the days of cheap debt and excess liquidity for the time being, 2023 presents a unique opportunity for lenders and funds to return to the fundamentals of private equity and focus on targets that would benefit the most from operational efficiencies, top-line improvements, strong management and the guidance of a skilled fund manager. We expect that deal timelines will normalize and diligence processes, by both funds and their lenders, will focus on depth and not speed. Though covenant packages and deal terms may tighten in the short to medium term, we envisage this being coupled with cooperation among lenders and funds driven by neither wanting to miss out on a quality investment.

Loans to Limited Partners: Some Clarifications from the Canada Revenue Agency

The Canada Revenue Agency (CRA) recently issued long-awaited guidance regarding when it would respect the character of loans made by a limited partnership (the principal legal vehicle used by private equity firms) to its limited partners, to be set off by distributions in the following year.

Due to a timing mismatch between when allocations and distributions of partnership income are reflected in a partner's adjusted cost base under the *Income Tax Act* (Canada) (ITA), a limited partner may be deemed to realize a capital gain where a partnership generates and distributes its profits in the same fiscal period. This deemed capital gain may potentially result in double taxation. In this context, some private equity funds allow for distributable proceeds to be loaned to limited partners in the fiscal period in which they are earned. These loans are typically offset against future distributions (generally in the immediately following fiscal period).

In 2016, the CRA stated that it could seek to treat such loans as distributions in certain circumstances, which were not specified. This statement generated a lot of uncertainty regarding the use of loans to limited partners, which subsisted until the Association de planification fiscale et financière's CRA roundtable of October 7, 2022.

When asked to clarify its 2016 position at the roundtable, the CRA answered by listing specific conditions that must generally be met for it to accept that loans to limited partners are actual loans and not distributions.[4] Among them, the amount of all loans received by a particular limited partner for a fiscal period cannot exceed, very generally, the total of (i) the share of the partnership's income allocated to such limited partner for that fiscal period and (ii) the limited partner's adjusted cost base in its partnership interest at the end of that fiscal period. In addition, the loan must be made primarily for the purpose of avoiding the deemed capital gain issue described above. The CRA reaffirmed that in the event a loan does not meet all of the conditions, it may seek to treat the full amount of the loan as a distribution from the partnership to the relevant partner (which could result in a deemed capital gain and potential double taxation as described above) and added that it may consider invoking the general anti-avoidance rule to achieve this.

Although these new comments from the CRA confirm that the loan workaround may be considered acceptable in certain circumstances, the listed conditions provide for a very narrow exception, which may not always be available. In addition, such conditions remain subject to uncertainty in their application and would benefit from further clarification from the CRA. However, most private equity funds whose income, for tax purposes, generally matches distributable proceeds are likely to benefit from this new statement. Other funds may, however, need to consider certain alternatives.

4 "Table ronde sur la fiscalité fédérale" in Congrès 2022, Montreal, Association de planification fiscale et financière 2022, Question 5, p. 9-11; the CRA addressed the issue again at the 2022 Canadian Tax Foundation Annual Tax Conference Canada Revenue Agency Round Table on November 29, 2022 and provided substantially the same response.

Proposed Amendments May Impose Canadian Withholding Tax Obligations on Foreign Funds

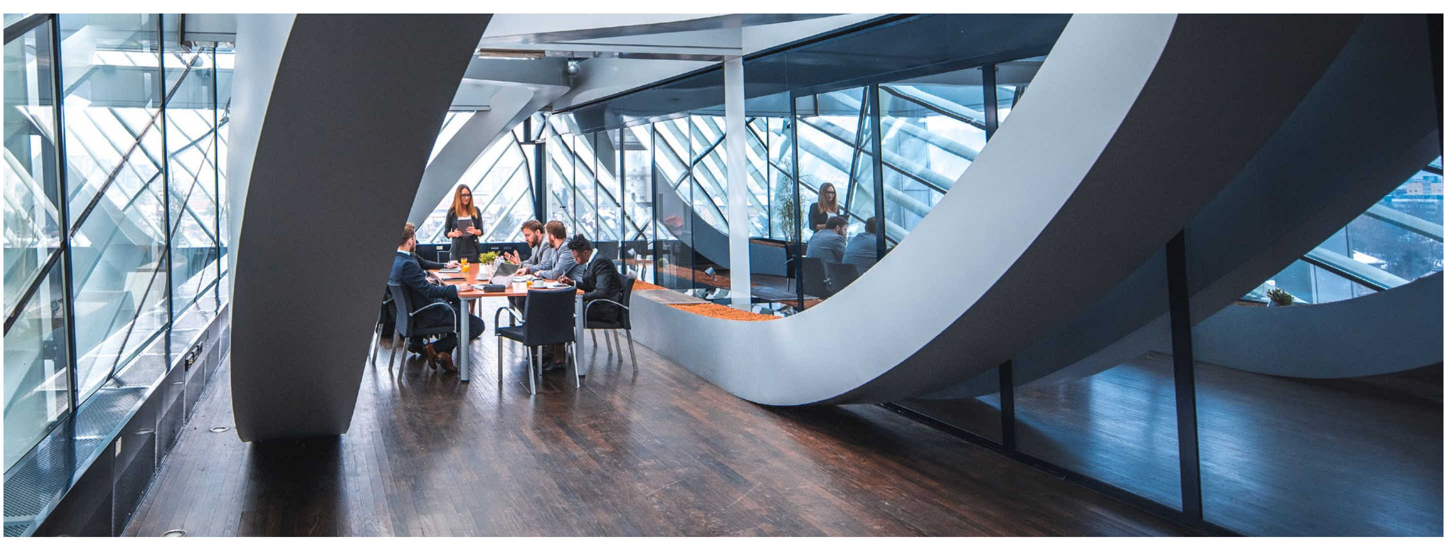
In August 2022, the Department of Finance of Canada released proposed technical amendments to the ITA that may impose Canadian withholding tax obligations on certain foreign private equity funds with Canadian investors, even where the fund has no Canadian investments or other connection with Canada. In addition to imposing a compliance burden on foreign funds, these rules could have a significant impact on Canadian investors. Foreign funds could pass associated costs (including compliance costs and any gross-up for withholding taxes) on to Canadian investors, or simply refuse to admit them.

Subject to relief under an applicable income tax treaty, Canada imposes a 25% withholding tax (under Part XIII of the ITA) on certain amounts paid by a Canadian resident to a non-Canadian resident, including certain management fees. Currently, a partnership is deemed to be a Canadian resident (for purposes of Part XIII) to the extent that such an amount or a portion of it is deductible in computing the partnership's income or loss from a source in Canada. As a result, if a foreign partnership has no Canadian source income (or loss), this deeming rule should not apply. The proposed rules would generally instead deem the partnership to be a Canadian resident to the extent that the amount (or portion) was deductible in computing the share of the partnership's income or loss that is allocable to Canadian residents and certain non-Canadian residents subject to Canadian income tax. The draft legislative amendments also propose rules that would look through tiered partnerships for the purpose of making this determination.

For example, assume that a Canadian resident invests, together with non-Canadian residents, in a foreign fund that is treated as a partnership for Canadian income tax purposes. In this situation, the fund pays a management fee to a related non-Canadian resident manager. The fund makes no Canadian investments and has no other activities or operations in Canada. Under the current rules, the management fee would not be subject to Part XIII withholding tax, because the partnership would not have any income or loss from a source in Canada. Under the new rules, Part XIII tax could apply to the portion of the management fee allocable to the Canadian resident investor, as well as to certain non-Canadian resident investors subject to Canadian income tax, generally to the extent the fee was deductible in computing such non-Canadian resident investors' Canadian income taxes.

As indicated above, where available, Canada's income tax treaties may provide relief from Part XIII withholding tax. In this regard, the business profits section of most of Canada's treaties exempts management fees unless the fees are attributable to a Canadian permanent establishment. In some instances, however, treaty benefits will not be available (such as where the manager is resident in a jurisdiction with which Canada does not have a treaty, or does not qualify for treaty benefits).

The Department of Finance of Canada is currently considering submissions on the proposed amendments, and has indicated that the effective date would not be before the date of a future release of draft legislative proposals.



Proliferation of Continuation Funds

Over the last several years there has been a proliferation of continuation fund transactions. In a continuation fund transaction, the sponsor of a private fund forms a new fund – a continuation fund – and sells one or more portfolio companies from the original fund to the continuation fund. Limited partners in the original fund are given two options: either sell their interest in the target portfolio company for cash or continue to hold their interest in the target portfolio company by rolling it into and becoming a limited partner of the continuation fund.

In addition to the rolling limited partners, the continuation fund is capitalized by new investors who make capital contributions in cash, which is then paid to the original fund as the purchase price for the target portfolio company. The original fund distributes this cash to the limited partners who elect to sell. The new investors tend to be secondaries funds or other institutional investors. One or two of these new investors often act as lead investors, setting the price, in many cases after a competitive auction run by an intermediary, and negotiating the terms of both the purchase agreement for the target portfolio company and the continuation fund partnership agreement. The sponsor markets any remaining interest in the continuation fund to a syndicate of investors who commit smaller amounts and take a more passive role in the transaction.

Historically, continuation funds played a limited role in the private equity market. Sponsors used these vehicles when one of their funds was nearing the end of its term and the sponsor needed more time to manage a portfolio company before putting it on the market for an M&A sale or IPO. As a result, there was a slightly negative perception of the use of these vehicles. That negative perception has disappeared over the last several years, as continuation funds have become increasingly popular with sponsors as an alternative to a traditional exit through an M&A sale or IPO. Continuation funds allow sponsors to offer optionality to their investors, because investors who want liquidity can elect to sell while investors who want to remain invested can elect to roll into the continuation fund. The ability to offer liquidity to investors is particularly attractive in turbulent markets when traditional M&A and IPO exits are not available at all or at acceptable prices.

Continuation funds also allow sponsors to hold on to crown jewel assets longer, giving sponsors more time to manage the assets and therefore benefit from additional increases in value. This value would otherwise accrue to another sponsor or strategic buyer who would acquire the asset if the sponsor were instead forced to sell due to the term limit of the original fund. Another benefit to sponsors is that continuation fund transactions allow sponsors to crystalize carried interest on the target portfolio company, although often they will roll all or a significant portion of the crystalized carried interest into the continuation fund. New investors often make an additional commitment to fund follow-on investments, with rolling investors given the option to do so as well. The original fund may be restricted from injecting new capital into the portfolio company because its capital is fully deployed or because it is constrained by concentration limits, so this fresh capital to grow the portfolio company's business is another advantage of continuation funds.

The aforementioned benefits have led continuation funds to become very popular with sponsors. Private Equity International predicts the world's top 50 largest private equity sponsors will all use a single asset continuation fund at least once in the next two years. As with many private equity trends, the use of continuation funds gained momentum in the United States before catching on in Canada. The trend has now arrived in Canada, however, with high-profile Canadian sponsors such as Novacap, Georgian Partners, Inovia, Imperial Captial and Torquest all launching continuation funds in the last two years.

While sponsors are capitalizing on the benefits of continuation funds, investors are also picking up on this trend, in part due to strong returns from secondaries funds. Fundraising for secondaries funds, which often deploy a significant portion of their capital in continuation funds and other sponsor-led secondaries, took off, peaking in 2020 with 63 funds closing on over US$91 billion (according to Pitchbook), well above historical highs. Although fundraising has come down from this peak, it is still higher than historical levels. This fundraising was driven by traditional secondaries sponsors such as Ardian, Coller and Whitehorse, while other managers like TPG launched new sponsor-led secondaries strategies.

A frothy market with strong investor demand led to a period where sponsors were able to obtain attractive prices and dictate sponsor-friendly terms for continuation funds. Recently, that market has slightly turned. The supply side remains strong as continuation funds remain an attractive option for sponsors, particularly in light of the current challenges in the M&A and IPO markets, but on the demand side the slowing pace of secondaries fundraising and the macroeconomic uncertainty has resulted in investors being more selective as they deploy capital in continuation funds. As a result, there has been somewhat of a decline in sponsor-friendly continuation funds terms, such as premium carried interest. Continuation funds often have tiered carried interest structures, with escalating carried interest rates if the continuation fund achieves higher internal rate of return and/or multiple of invested capital thresholds, with premium carried interest being tiers that pay over 20% to the sponsor. Premium carried interest in continuation funds for top-tier sponsors was fairly common in 2020 and into 2021, but is rarer in the current environment. In addition, sponsors are generally more receptive to investor comments on the continuation fund partnership agreement.

One trend in main fund documentation that has followed from the proliferation of continuation funds is clauses in partnership agreements addressing continuation funds. These clauses attempt to set certain of the terms of a future continuation fund. This may include mandating the option to sell or roll and describing the various legal steps to accomplish this and/or the process, such as setting out how conflicts will be addressed, minimum time periods for review of the continuation proposal or how amendments to the main fund partnership agreement will be made. Before the rise of continuation funds, these types of clauses were rare, but are now appearing with some frequency in the partnership agreements for new funds. Sponsors often try to frame these to give them maximum flexibility in the future when structuring a continuation fund transaction for one of their portfolio companies. Limited partners often resist agreeing to the terms or process of a continuation fund transaction in advance, before they are presented with the full facts of the particular situation. Given the tension between the sponsors' position and the limited partners' position,

these clauses tend to be an area of focus in the negotiation of fund terms and often attract significant comments from limited partners. We anticipate these clauses will continue to appear more frequently and expect that as these get negotiated between sponsors and limited partners, a market norm of what is generally acceptable will develop.

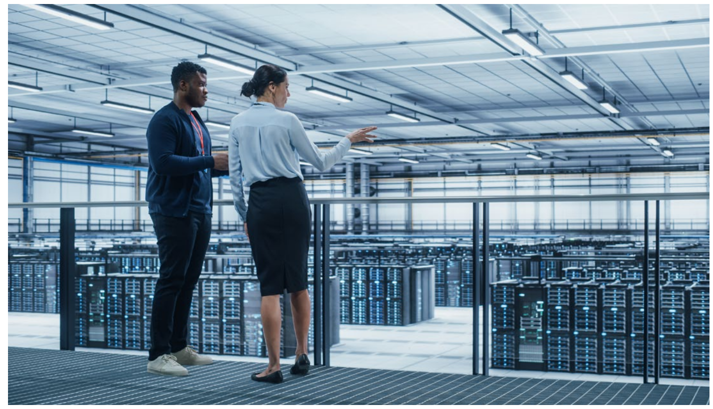
The prevalence of these clauses in main fund documents signifies that sponsors are focused on continuation funds. Although continuation fund transaction volume has slowed somewhat from the heights of 2020-2021, given the benefits of these transactions to sponsors outlined above, the ability of continuation funds to provide liquidity to investors, the large amount of secondaries dry powder and the new entrants launching secondaries funds, continuation funds are expected to continue to be a significant part of the private funds landscape in 2023 and beyond.

The Race to Green: A Perfect Storm for Value Creation or Greenwashing?

The increasing prevalence of physical, financial and social impacts arising from the current climate crisis has shifted investor sentiment and demand for sustainability-related investments. This has created a unique opportunity for value in the transition to a net-zero economy, and a concomitant increased risk for potential "greenwashing" or "climate washing." Global inflows into sustainable assets reached over US$4 trillion, and Canadian investments in sustainable funds more than doubled in 2021, with the growth tapering in 2022.[5] Globally, approximately 72% of private equity firms have incorporated sustainability strategies into their portfolio of asset classes.[6]

EVOLVING DISCLOSURE LANDSCAPE

An evolving disclosure landscape, as well as the lack of any global baseline for consistent comparable mandatory sustainability-related disclosures, has created unique challenges for issuers and asset managers, including



increased risk of scrutiny by stakeholders for greenwashing. In Canada, current mandatory climate-related disclosure requirements are as follows:

- Private companies are only required to meet federal disclosure requirements for greenhouse gas emissions on a facility basis, subject to certain thresholds.[7]
- Publicly listed issuers are subject to mandatory climate-related risk disclosures with enhanced mandatory climate-related disclosure rules proposed by Canadian securities regulators,[8] and are also subject to mandatory federal disclosure requirements for greenhouse gas emission on a facility basis, subject to a reporting threshold.
- Investment funds are not subject to any mandatory sustainability-related specific disclosures or taxonomies. Canadian securities regulators have only provided guidance aimed at reducing the potential for greenwashing[9] within the context of the existing disclosure requirements relating to investment strategies and marketing materials. The use of "green", "ESG" or "sustainable" labels for investment products has increased significantly without any regulated parameters related to the use of such labels. Further, a Canadian taxonomy for green or transition investments has not yet been developed nor has any global taxonomy been endorsed.

5 Morningstar Research Inc., Sustainable Assets are Teetering on the $4 Trillion Mark, November 1, 2021, https://www.morningstar.co.uk/uk/news/216474/sustainable-assets-are-teetering-on-the-%244-trillion-mark.aspx and Sustainable Investing Landscape for Canadian Fund Investors, Q4 2021, January 24, 2022 and Global Sustainable Fund Flows: Q3 2022 in Review, October 27, 2022 (https://www.morningstar.com/lp/global-esg-flows).

6 Humzah Yazdani, "The Bright Spots in a Complicated ESG Framework," World Economic Forum, July 25, 2022, https://www.weforum.org/agenda/2022/07/still-reason-for-optimism-about-esg-investing/.

7 https://www.canada.ca/en/environment-climate-change/services/climate-change/greenhouse-gas-emissions/facility-reporting/reporting.html.

8 https://www.osc.ca/en/securities-law/instruments-rules-policies/5/51-107/51-107-consultation-climate-related-disclosure-update-and-csa-notice-and-request-comment-proposed.

9 https://www.osc.ca/en/securities-law/instruments-rules-policies/8/81-334/csa-staff-notice-81-334-esg-related-investment-fund-disclosure.

Mandatory enhanced disclosure requirements for investment funds and fund managers are at various stages of implementation in other jurisdictions, including the U.S., U.K., Europe and Australia.[10] Recently proposed rules in the U.K. and Europe are of significance, and include general anti-greenwashing rules and prescriptive qualitative thresholds for the use of "ESG" and "sustainable" labels.

GREENWASHING LITIGATION AND REGULATORY ENFORCEMENT

There continues to be a growing wave of civil litigation (including class actions) and related regulatory enforcement proceedings against companies and their directors and officers. Greenwashing allegations span claims of inaccurate or misleading statements about climate-related financial and operational impacts and risks, climate-related commitments or strategies and sustainability-related attributes of products or corporate activities.

Even prior to the implementation of enhanced mandatory sustainability-related disclosure requirements, regulators globally have indicated they will hold investment funds and asset managers, as well as private and public companies (and their directors and officers), responsible for their sustainability-related statements, whether in regulatory filings, voluntary sustainability reports or marketing materials. This will be done using a range of tools, from disclosure deficiency warning letters to enforcement proceedings.

Although no securities enforcement proceedings have commenced in Canada, securities regulators have issued warnings and reports about sustainability-related disclosure deficiencies for both public companies and investment funds, recently making strong statements that enforcement will be used to address greenwashing by capital market participants.[11] The Canadian Competition Bureau has also signaled that greenwashing is a high enforcement priority.[12]

The OSC's 2022 review of investment funds' disclosure highlighted that more than 50% of funds with sustainability-related investment strategies failed to identify or explain any of the sustainability-related factors underlying their investment strategies. In addition, more than a third of the funds held investments in industries that should have been excluded based on their stated investment strategy and 20% had holdings that appeared inconsistent with the fund's name or investment strategies.[13] Given these deficiencies in sustainability-related disclosures and increased investor reliance on such disclosures, there is a significant risk of enforcement action.

We also expect an increased number of whistleblower complaints by investors and other stakeholders to regulators and other government agencies regarding sustainability-related disclosures, including net-zero commitments and other climate-related statements and strategies. Securities and competition regulators in Canada and the United States have implemented formal whistleblower programs (some of which provide monetary rewards) through which interested stakeholders can submit complaints alleging inaccurate or misleading climate-related disclosures. The Canadian Competition Bureau has recently commenced a number of greenwashing investigations and enforcement proceedings following complaints filed by environmental groups and other stakeholders, including an investigation of a Canadian bank for alleged greenwashing statements regarding its climate and sustainable finance commitments, and a recent settlement involving a consumer coffee products company which resulted in a $3 million fine, $800,000 charitable donation and product modifications.[14]

10 https://www.sec.gov/news/press-release/2022-92). (https://www.fca.org.uk/news/press-releases/fca-proposes-new-rules-tackle-greenwashing) https://www.esma.europa.eu/press-news/esma-news/esma-launches-consultation-guidelines-use-esg-or-sustainability-related-terms, https://asic.gov.au/regulatory-resources/financial-services/how-to-avoid-greenwashing-when-offering-or-promoting-sustainability-related-products/.

11 https://www.ft.com/content/cad22116-778a-4327-9bc3-6a7688ce6f76.

12 https://www.canada.ca/en/competition-bureau/news/2022/09/competing-for-green-growth.html.

13 https://www.osc.ca/en/securities-law/instruments-rules-policies/8/81-334/csa-staff-notice-81-334-esg-related-investment-fund-disclosure#N_1_1_1_2_.

14 https://www.canada.ca/en/competition-bureau/news/2022/01/keurig-canada-to-pay-3-million-penalty-to-settle-competition-bureaus-concerns-over-coffee-pod-recycling-claims.html; https://www.reuters.com/world/americas/canadas-watchdog-launches-investigation-into-rbc-over-climate-complaints-2022-10-12/.

In addition, we have also seen a steady upswing in civil litigation, including class actions, against companies and asset managers alleging inaccurate or misleading sustainability-related practices, commitments or product features.[15] Activist stakeholders are increasingly leading such litigation with primary objective of modifying corporation conduct which is shifting the litigation dynamic.[16]

LOOKING FORWARD TO 2023 AND 2024

Given the global focus on sustainability-related disclosures, as well as the ongoing implementation of more prescriptive mandatory sustainability-related disclosures regimes, we expect continued growth in sustainability-related litigation, complaints and regulatory enforcement action in the coming years.

15 See for example: Proposed class action against various retailers commenced in Quebec on October 4, 2022 https://lpclex.com/wp-content/uploads/2022/09/Application-RE-AMENDED-to-authorize-Dollarama-Notified-04OCT2022_Registre.pdf; VBW v. DWS https://www.reuters.com/business/finance/deutsche-banks-dws-sued-by-consumer-group-over-alleged-greenwashing-2022-10-24/ Ramirez v. Exxon Mobil Corp., 334 F. Supp. 3d 832 (N.D. Tex. 2018) (allegations against a multi-national oil and gas company that the company made material misstatements regarding proxy costs for carbon); Jochims v. Oatly Group AB, 1:21-cv-06360 (S.D.N.Y. Oct. 26, 2021) (a U.S. class action which alleges that an oat milk company made false and misleading representations regarding the products' sustainability); Lizama et al v. H&M Hennes & Mauritz LP 4:22 CV-10070 (Eastern District of Missouri Nov. 4, 2022) (a US proposed class action that alleges a clothing line is deceptively marketed as sustainable); and Dwyer v. Allbirds, Inc. (7:21-cv-05238) (a New York class action regarding marketing claims about the sustainability of the defendant's sneakers).

16 See for example: Australasian Center for Corporate Responsibility v. Santos https://www.accr.org.au/news/australasian-centre-for-corporate-responsibility-expands-landmark-federal-court-case-against-santos/; Greenpeace France and others v. TotalEnergies SE https://www.reuters.com/business/sustainable-business/environmental-groups-sue-totalenergies-over-climate-marketing-claims-2022-03-03/.

There are a number of steps private equity firms can take to mitigate such risks, including:

- Implement deliberate and process-driven disclosure and marketing practices: treat sustainability-related statements and the use of sustainability-related labels with the same level of care and scrutiny that is applied to other material financial and strategic disclosures or representations to ensure alignment between market representations and the action being taken through the investment life cycle. Ensure a clear documented record of the process.

- Review sustainability strategies for portfolio assets in light of evolving regulated investment fund labelling requirements and market consensus, including prescriptive guidance on what criteria an investment product must meet to be labelled "ESG", "green" or "sustainable".

- Develop or continually enhance the ability to capture specific, objective and measurable data on ESG performance, which can be used for investment management, compliance and potentially marketing decisions. The nature and quality of data that can be gathered may vary depending on the industry of the investment.

- Implement a governance structure to ensure sustainability-related issues are being appropriately embedded and prioritized throughout the firm. Consider the use of a cross-functional steering committee.

Canadian Take-Privates in 2022 and Looking Forward[17]

Private equity firms continued to be a significant contributor to 2022 activity levels in the Canadian take-private market. Private equity sponsored Canadian take-private transactions constituted approximately 32% of all take-privates struck for Canadian targets in 2022 by deal value, up from 26% in 2021. We anticipate that this trend will continue in 2023.

IMPLICATIONS OF FALLING PUBLIC VALUATIONS

The S&P/TSX Composite Index had fallen as much as 14% at certain points of 2022 and the volatility of the S&P/TSX Composite Index was about 60% higher in 2022 compared to 2021. Canadian public companies were not sheltered from these market realities. Throughout 2022, many Canadian public companies suffered from the same falling public valuations as were experienced by public companies across the globe. In addition, the general economic environment, such as inflation, supply chain issues and rising labour costs, continued to make it difficult for Canadian public companies to meet the short-term earnings expectations of anxious investors. As these public companies continued to trade at a discount to their underlying value, private equity firms sought opportunities to spend their capital.

Although bidders almost always offer target shareholders consideration at a premium to the target's equity price, many of the Canadian take-privates announced this year appeared to be big bargains given where those equities were trading at in the past year. For private-equity-sponsored Canadian take-private transactions that were struck in 2022, the signing price had a premium over the last trading day price in the range of 31% to 82%, with an average premium of 55%. In comparison, the same signing price had a much lower premium (if any) over the applicable past-year highest trading price in the range of -7% to 23%, with an average premium of 8%. This drastic difference suggests that private equity buyers are buying Canadian public companies at deep discounts following market declines earlier this year.

17 The data points described in this section are based on our review of the relevant transactions disclosed on "Practical Law Canada – What's Market – Public Merger Agreements" and https://www.refinitiv.com and the related information on https://money.tmx.com.

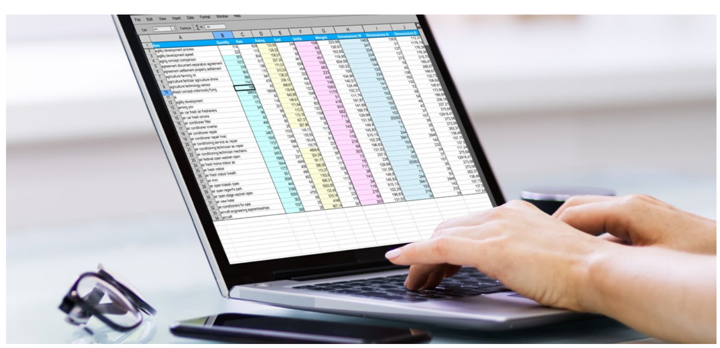
ALIGNMENT OF INCENTIVES BETWEEN TARGETS AND PRIVATE EQUITY BUYERS

As management teams of Canadian public companies continued to feel pressure from anxious investors disappointed by companies failing to meet short-term earnings expectations, take-privates offered some alignment of incentives between the target side and the buyer side, making it easier than it may have been historically to lure companies away from the public markets. Such alignment of incentives was arguably increased by transaction structures which offered management teams the opportunity to stay invested in the target company as minority shareholders alongside private equity buyers. Approximately 13% of the private equity-sponsored-Canadian take-private transactions in the past two years offered an equity roll-over component as part of the consideration.

GETTING DEALS DONE

There are two commonly used methods to acquire a public company in Canada: a take-over bid and a plan of arrangement. In terms of completed deals in 2022, the plan of arrangement structure continued to dominate, with 100% of private-equity-sponsored Canadian take-privates struck in 2022 being implemented pursuant to a court-approved plan of arrangement structure.

On average, it took about 80 days between the announcement and closing of these private-equity-sponsored transactions, with 75% of such deals that were struck in 2022 closing in 2022, 25% remaining to be closed in 2023 and none (so far) falling apart after signing. In 2022, the trend of deal certainty for buyers continued with 100% of private-equity-sponsored Canadian take-privates struck in 2022 having a no-shop provision in the acquisition agreement. In addition, dissent/appraisal rights continued to be more of a theoretical stressor than a practical barrier to executing deals using the plan of arrangement structure, with none of the private-equity-sponsored Canadian take-privates that were struck in 2022 failing to close as a result of the exercise of dissent/appraisal rights.



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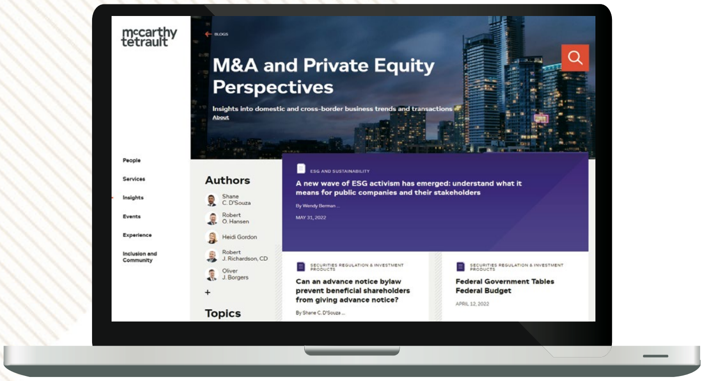

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Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis

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