On Target:

2019 Private Equity Outlook

McCarthy Tétrault LLP
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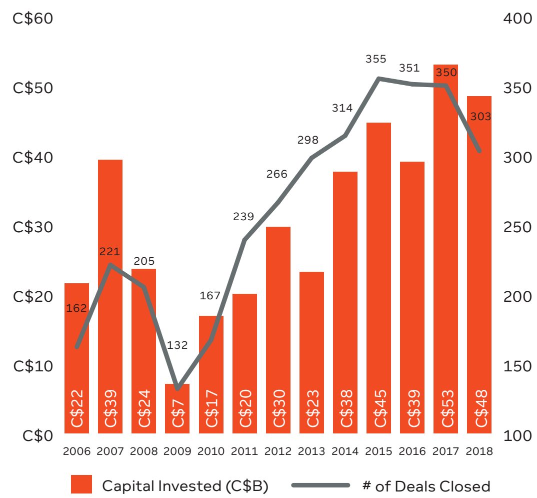
Deal Value Remained Near Peak Highs with Only a Slight Dip in Activity in 2018

The Canadian private equity market had its second-best year (after 2017) since 2006 by deal value and overall activity was down only slightly in 2018 following sustained highs in activity and values. Aggregate deal value was C$48 billion, which was only slightly behind 2017's high of C$53 billion, while deal volume experienced a modest dip to 303 deals from the all time high in 2015 of 355.

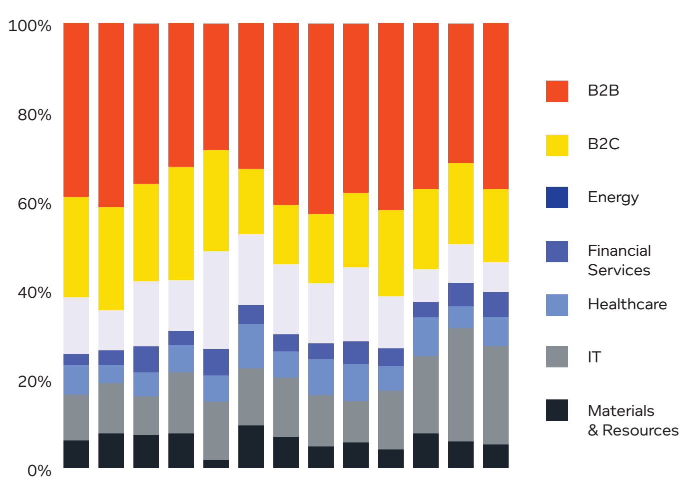
Funds continue to fundraise actively, building on ever increasing dry powder, and the deal landscape across most of Canada remains highly competitive, attracting interest from domestic and international investors. However, certain sectors have softened, with buyers and sellers waiting out uncertainty and volatility in the markets.

Canadian PE activity by year



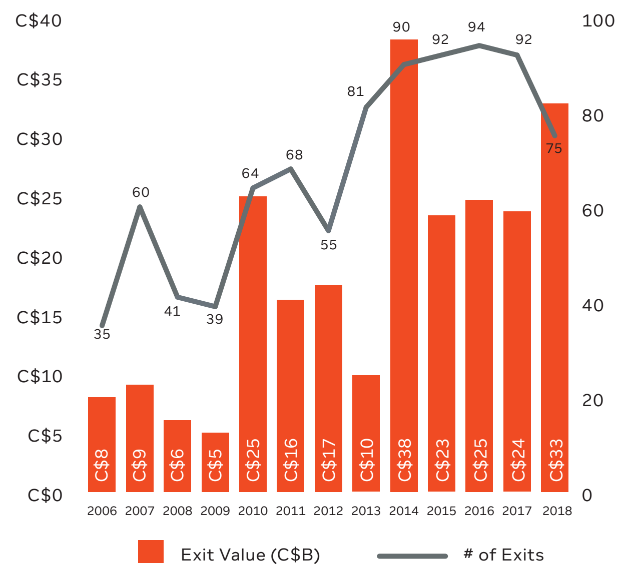
In 2018, there was a relative increase in activity in the healthcare sector and a tightening of activity in the B2C and energy sectors, while the B2B, materials and resources and IT sectors remained flat.

Canadian PE activity (#) by sector



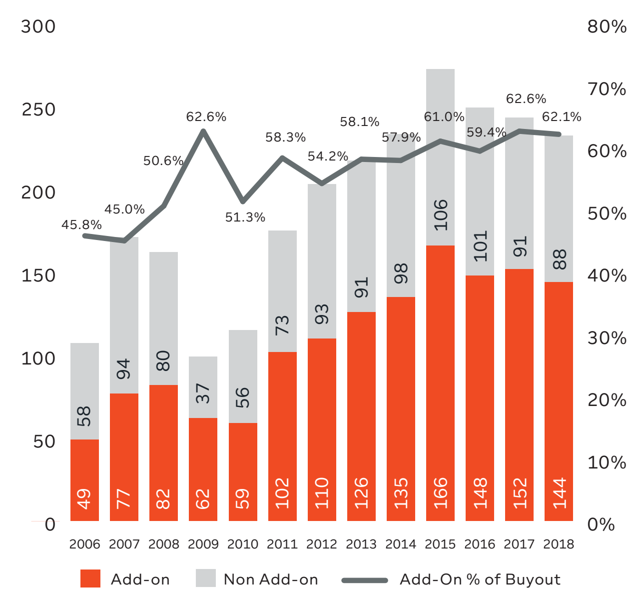
The number of private equity exits was down approximately 20% in 2018, but deal value increased by almost 40% compared with the 2015 to 2017 period. It was evident that although several high-profile and larger transactions were consummated, many funds elected to hold assets, building out their platforms and awaiting more favourable market conditions.

Canadian PE backed exits by year



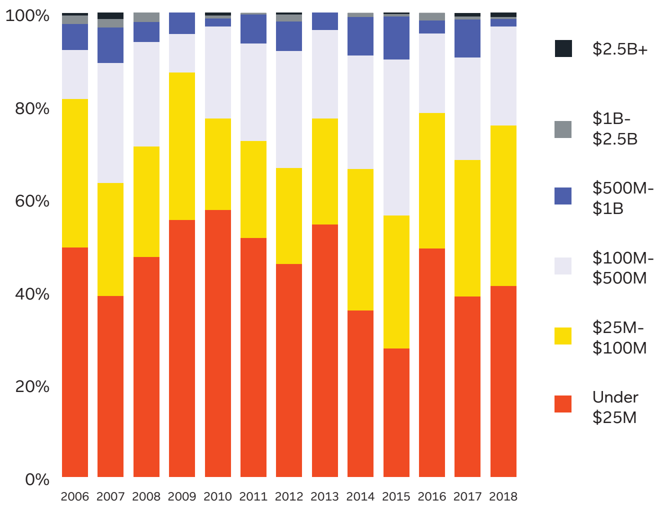
Add on activity of private equity funds in 2018 remained consistent with past years as a proportion of deal count, representing just under two-thirds of overall deal activity. Transactions overall, both add-on and non-add on, were down slightly. This downward trend in the overall number of transactions was not indicative of a relative increase in add-on transactions, suggesting that market conditions did not alter fund strategy in this respect.

Canadian add-on activity by year



The softening trend was most present in the 2018 data at the upper echelons of deal-making, with a significant drop in deals in the C$500 million to C$1 billion value range and a slight decrease in deals in the C$100 million to C$500 million range.

Canadian deal # by deal size (C$B)



The outlook for 2019 suggests a return to the market that brought highs in the number of transactions and values. Continued fundraising, including existing dry powder from participants that were unable to deploy capital in 2018, creates ideal conditions for an increase in deal activity in 2019. Significant fundraising efforts and continued focus on accretive platform building will likely result in a continued increase in add-on transactions in certain segments of the market. There is a high likelihood of a number of high-profile and valuable exits in the first half of 2019 as sellers have waited out market uncertainty in 2018 and seek to exit maturing assets.

Dual-Track Processes: The Best of Both Worlds?

The parallel pursuit by equity sponsors of both an M&A exit and an IPO is not a new development. Recent examples in Canada include ***GFL Environment Inc.***, opting for a sale to ***BC Partners*** in April 2018 over a go-public transaction, and ***Kinder Morgan Canada Limited's*** and ***Neo Performance Materials Inc.'s*** dual-track processes that culminated in IPOs in May and December 2017, respectively. However, in light of increased market volatility in 2018, the dual-track strategy may be relied on by private equity sponsors more heavily in 2019 to help increase valuations without undue impact from choppy markets and to hedge against the risk of a failed or significantly delayed IPO. The U.S. market has recently seen a significant uptick in dual-track processes, much of which has been driven by private equity sponsors. Although dual-track processes may not be as common in Canada as they are in the U.S., we saw a continued increase in 2018 and we expect such processes to become more common for significant sponsor exits in future years.

The dual-track process naturally provides additional pricing tension and closing certainty. While an IPO and an M&A exit each has distinct advantages and disadvantages, pursuing both avenues simultaneously can offer certain potential advantages to an exiting sponsor.

- *Flexibility* – A dual-track process provides flexibility, allowing a sponsor to decide on the preferred transaction once both processes have been significantly advanced. This is particularly useful in times of market uncertainty and resulting narrowing IPO windows. A failed IPO can be viewed negatively and could impact the success or valuation of a subsequent M&A process. A dual-track process leaves open the opportunity to complete an M&A exit in the event market conditions deteriorate and an IPO becomes untenable.

- *Pricing* – A dual-track process also offers the opportunity for comparative price discovery in both the public capital markets and in the private M&A environment. The prospect of an alternative to an M&A exit can provide a sponsor with the leverage necessary to be aggressive with bidders and receive the best value for the company, whether through auction or IPO.

While a dual-track process might provide valuation benefits and enhanced pricing tension in certain circumstances, concerns may arise that a contemporaneous IPO is a distraction from a sale process or perhaps just an elaborate pricing exercise. These concerns, however, can be managed or moderated in a number of ways.

- *Quiet Filings* – Concerns relating to distraction, skepticism of bidders, market perceptions and confidentiality may be alleviated by a company making a "quiet filing" with Canadian securities regulators. While the U.S. Jumpstart Our Business Startups Act (JOBS Act) and recent policy changes from the U.S. Securities and Exchange Commission allow for companies to file a registration statement confidentially, a similar blanket policy is not available for Canadian companies (other than narrower policies in cross-border IPOs or other limited circumstances). As a result, confidential filings are generally not a common practice in Canada. However, in certain limited circumstances (including in certain dual-track processes), Canadian securities regulators may allow a preliminary prospectus to be filed on a confidential basis and allow a company to advance an IPO process to a certain point without any public disclosure. This can provide significant advantages, because it permits the company to address comments from the securities regulators without having disclosed the prospectus to the public. If the company then ultimately pursues a sale process, the company can terminate the IPO. Prior consultation with the principal securities regulator is required in these circumstances to ensure that the regulator is aligned on the case for a quiet filing.

- *Break Fees* – Bidders' concerns regarding the commitment of a company to an auction process running alongside an IPO process can be alleviated by offering break fees or expense reimbursements to a preferred bidder in a dual-track process. The costs of break fees, however, should be weighed against the potential benefits generated. It is also important to note that the Canadian convention for underwritten IPOs is for the issuer to pay the expenses of the underwriters, including the fees of underwriters' counsel (often up to a cap). If a company significantly advances an IPO but ultimately pursues the M&A track, the company will in most cases be required to reimburse the underwriters for their expenses (which can be significant, depending on the stage of the IPO). This is a significant difference from the convention in the U.S. where underwriters typically pay the fees of their own counsel.

- *Testing the Waters* – Canadian securities laws provide for certain limited "testing the waters" activities prior to the public filing of a preliminary prospectus (subject to a "cooling off period"). These activities may allow for a company to confirm whether an IPO is a viable exit path before making a public filing as part of a dual-track process.

Naturally, the most significant disadvantage of a dual track process is the increased cost and management distraction of running both the IPO and the M&A process. However, when weighed against the potential benefits of superior pricing and potential decreased risk of a failed process, a dual-track process could very well provide a net benefit to a sponsor seeking an exit. This is especially true in uncertain market conditions.

Representations and Warranties Insurance in Canada: Here to Stay

While M&A representations and warranties insurance (R&WI) has become widespread in the U.S. market, particularly in large or mid-market private equity deals, the Canadian market has been relatively slower in its adoption. It is no secret that M&A deal terms in Canada closely track trends in the U.S. market, although typically with a lag period. Materiality scrapes, reverse break fees, MAE definitions, sandbagging provisions and various other deal terms that are increasingly standard in Canada were often imported from the U.S.

Insurance brokers and M&A dealmakers have predicted over the past few years that it was only a matter of time before R&WI became increasingly prevalent in Canadian transactions. In 2018, we saw this expectation become a reality. We are now seeing widespread usage of R&WI among private equity firms and certain strategic acquirors in Canadian transactions. For example, a number of active R&WI insurance brokers have indicated that close to, or more than, one-half of their bound policies in Canada are with strategic acquirors (which includes private equity backed strategic acquirors).

A number of factors have led to the embrace of R&WI in Canada

- *Auctions and Competitiveness* – More and more Canadian sale transactions are being done by way of a structured auction process that is managed by a financial advisor. In previous years, buyers would use R&WI (in lieu of, or as a supplement to, traditional indemnification) to competitively differentiate their bids. However, sophisticated sellers and financial advisors that are conducting robust auctions are now including, as part of the formal process, the requirement that any prospective buyer obtain an R&WI policy.

- *More Attractive Policy Terms* – Over the past year, R&WI policy terms have continued to become more attractive. Competition among underwriters has been intense, putting further pressure on premiums – premiums are now typically between 2.5% and 4% of policy coverage. Retention amounts have also decreased significantly with a retention amount of 1% of enterprise value now becoming standard.

- *Fewer Coverage Exclusions* – Just a few of years ago, policies contained numerous broad exclusions from coverage. Common exclusions previously included sensitive areas like tax, environmental matters, cybersecurity, pension funding and compliance with certain laws. This naturally led to specific or supplemental indemnities being negotiated in the purchase agreement to ensure buyers still had recourse for these exclusions, which partially defeated the purpose of R&WI. As underwriters have become more sophisticated and have faced greater competition from new entrants into the market, the number and scope of exclusions have decreased considerably.

- *Evidence of Claims Coverage* – Buyers have naturally been reluctant to shift from traditional indemnification to a relatively new insurance product due to concerns about claims recovery. In an effort to increase adoption of the product and alleviate this concern, various prominent global underwriters have published reports that set out historical information promoting their claims coverage. It is generally in the long-term interest of underwriters to absorb the costs of covering claims for the foreseeable future to demonstrate the effectiveness of the product and build confidence among users.

- *Increased Presence of Brokers* – R&WI brokers are becoming increasingly focused on the Canadian market. Many global insurance brokers have established permanent offices and staff in key Canadian markets to help market and place R&WI.

- *Private Equity* – Private equity firms have been a very important source of deal activity in Canada over recent years. Canadian companies have proven to be very attractive targets, as generational shifts and succession planning have led to numerous companies being put up for sale. As a result, private equity buyers have been a significant force behind the increased usage of R&WI in Canada.

Countervailing factors that are putting pressure on widespread acceptance

- *Gaps in Coverage for Fundamental Representations and Warranties and Pre-Closing Taxes* – R&WI coverage is typically capped at a percentage of the purchase price (in most cases 10% to 20%), which is an effective cap on recovery for breaches of fundamental representations and warranties or pre-closing tax matters. In deals without R&WI, indemnification provisions customarily provide for caps equal to the full purchase price in respect of these issues.

- *Interim Breaches* – It is often forgotten that R&WI does not provide coverage for interim breaches, namely intervening events that arise between signing the purchase agreement (assuming the policy is put in place at that point) and closing the transaction (at which point a bring-down no-claims declaration is provided). In a traditional indemnification deal, intervening events are often covered by the indemnity (and at the very least, there is an ability to terminate the transaction if such intervening events result in the failure to satisfy the closing conditions, such as the bring-down of representations and warranties through to the closing date).

- *Other Exclusions* – Although the number of exclusions has certainly decreased over recent years, policies still have standard exclusions (such as in respect of pension funding and certain environmental liabilities) and exclusions in deal-specific areas of heightened risk.

- *Cost/Benefit* – Canada is a much less litigious business environment than the U.S. In some cases, the costs of R&WI are passed on to, or shared with, sellers, and certain sellers (particularly in low-risk industries or with low-risk businesses) are more inclined to accept holdbacks, escrows and the risks of indemnification than to incur significant upfront out-of-pocket costs that erode their deal proceeds.

- *Dealmaker and Practitioner Discomfort* – Indemnification provisions have been a mainstay of M&A and the exponential growth in R&WI represents a very significant shift in M&A practice. Many advisors who are not well versed in this market are still uncomfortable or unfamiliar with the product, which has tempered its adoption.

There is no question that there is growing acceptance of R&WI in the Canadian M&A landscape, especially where private equity firms are involved. Buyers and sellers are now seeing the transformative impact of R&WI on deal negotiation dynamics and post-closing relationships. As dealmakers become more familiar with the product, and in particular if the seller-friendly environment continues and underwriters continue to demonstrate that the R&WI policies may provide more effective means of recovery than traditional indemnification, we expect that the product will be further embraced in 2019 and that adoption rates will inevitably converge with those in the U.S. over the coming years.

Competition/Antitrust & Foreign Investment: Recent Developments Implicate PE Transactions

Expanded definition of "affiliate" may increase number of *Competition Act* filings

Recent amendments to the Canadian *Competition Act*'s affiliation rules broaden the concept of affiliation for non-corporate entities and are likely to increase the number of transactions caught by the pre-merger notification regime. This development is particularly relevant in the context of private equity acquisitions, which tend to employ complex partnership structures to effect transactions.

Under the *Competition Act*, a transaction is subject to mandatory pre-merger notification where the notifying parties, together with their worldwide *affiliates*, have assets in Canada or gross revenues from sales in, from or into Canada that exceed the prescribed monetary thresholds. Thus, the scope of the definition of "affiliate" has a significant impact on notifiability.

Notably, prior to the recent amendments, a partnership was not an affiliate of its controlled portfolio companies (PCs); likewise, sister partnership funds controlled by the same upstream partnership would typically not be affiliated with each other. Therefore, in the context of an acquisition effected through a controlled PC, neither the parent fund's assets or revenues, nor any of its sister fund's assets, revenues or controlled PCs, would be included in the "size of parties" assessment. The new affiliation rules adopt a controlling interest test for corporate and non-corporate entities alike, such that a partnership is an affiliate of its downstream controlled

PCs and is also an affiliate of its commonly controlled sister funds.

The broader affiliation rules are expected to increase the number of private equity transactions that are subject to pre-merger notification, although re-organizations within partnership structures that previously would have triggered a technical filing will now be exempt from notification as transactions between affiliates. Likewise, information sharing and agreements between (previously unaffiliated) partnerships will now be exempt from potential liability under the criminal conspiracy and civil strategic alliance provisions of the *Competition Act*.

Minority investments subject to increased antitrust scrutiny

The Canadian Competition Bureau has jurisdiction to review (and challenge) acquisitions of minority interests even if such acquisitions do not meet the statutory notification threshold.

While the Bureau rarely exercises its discretion in this regard, it has become increasingly active in assessing the implications of minority interest holdings in the course of its review of a notifiable acquisition. This is important for private equity investors, which often take minority stakes in multiple competing or related businesses in a particular industry.

First, the Bureau's current approach has implications fordisclosure: the Bureau will routinely seek information about any existing 10% or greater investment of the acquirer or its affiliates in a competing or vertically related business. Second, the Bureau's interest in minority investments has implications for the Bureau's substantive review and assessment.

In particular, in accordance with its guidelines, at first instance the Bureau will treat the acquisition of a minority interest in an entity that competes with an existing (minority held or controlled) portfolio company as a full merger. If, when examined as a full merger, the transaction does not raise competition law concerns, the Bureau will not challenge the transaction. Only if a full merger analysis results in substantive concerns will the Bureau consider the specific nature and impact of a minority shareholding and its likely competitive effects. Specifically, the Bureau will then undertake the more nuanced task of assessing the effect that minority shareholdings in two independent competitors will have on the acquirer's ability and incentive to influence either entity's competitive behaviour. This two-stage approach can not only have an impact on the timing associated with a given review, but also on its outcome.

Ongoing sensitivity to SOE and SWF investments

Reforms to the *Investment Canada Act* implemented in 2009 coincident with the introduction of national security review procedures have significantly increased investors' disclosure obligations in the context of notifiable acquisitions of control of Canadian businesses. The more expansive requirements include an obligation to disclose whether a foreign state has a *direct* or *indirect* ownership interest in the acquisition vehicle of greater than 10%. Because the identity of investors and upstream limited partners is often not transparent, this disclosure requirement can raise significant practical and privacy considerations in the context of private equity investments.

In addition to challenges associated with accurate disclosure, and coinciding with the introduction of new Committee on Foreign Investment in the United States rules, we expect that the Canadian government will continue to subject transactions involving state-owned enterprises or state-"influenced" actors to scrutiny on the grounds of national security, especially where sensitive industries, such as technology, critical infrastructure and national defence, are concerned. Importantly, the Canadian government can subject *any* investment in a Canadian business by a non-Canadian to a national security review, including indirect minority investments, and regardless of the transaction value. The timing implications and substantive risk posed by national security reviews are significant, because such reviews can take up to 200 days to complete and may result in a block or divestiture order.

GST/HST Implications for Investment Limited Partnerships

The *Excise Tax Act* (Canada) (ETA) has been amended to impose sales tax (GST/HST) obligations on "investment limited partnerships" (the Amendments). The Amendments were initially announced by the Canadian Department of Finance on September 8, 2017, revised in the February 27, 2018 Budget and enacted on October 25, 2018.

The Amendments impose GST/HST on management or administrative services provided by the general partner of an "investment limited partnership" (ILP). The ETA defines ILP broadly to include a limited partnership, the primary purpose of which is to invest funds in property consisting primarily of financial instruments, if the limited partnership is or forms part of a structure that is represented as a hedge fund, mutual fund, private equity fund, venture capital fund or another similar collective investment vehicle. The definition of ILP also includes certain limited partnerships that are investment vehicles for listed financial institutions.

Pursuant to the Amendments, the general partner of an ILP must register for and collect GST/HST on the fair market value of management and administrative services provided to the ILP after September 7, 2017.

The first step is determining whether a limited partnership is an ILP. If so, the general partner will likely have to register for GST/HST purposes. The general partner will also be required to determine the fair market value of the administrative and management services it provides to the ILP and remit GST/HST in respect of same.

The Amendments also expand the selected listed financial institution (SLFI) rules to ILPs that qualify as SLFIs. The SLFI rules will apply to fiscal years of ILPs that being after 2018.

The Amendments will likely have a significant impact on private equity or other investment plans that use limited partnerships. Fund sponsors should, therefore, examine their structures and consult their advisers to determine the implications of the Amendments.

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

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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 offices in New York and London.

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

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