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On Target

2025 Private Equity Outlook

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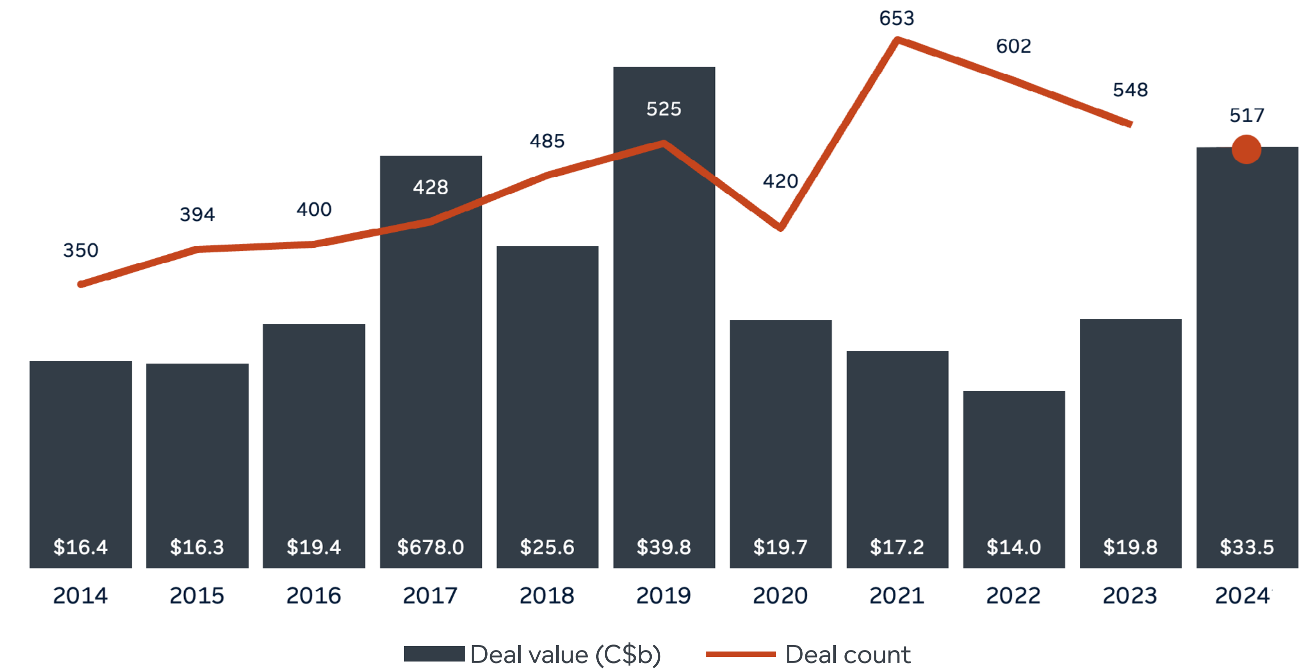
2024 in Numbers — Canadian Private Equity Overview

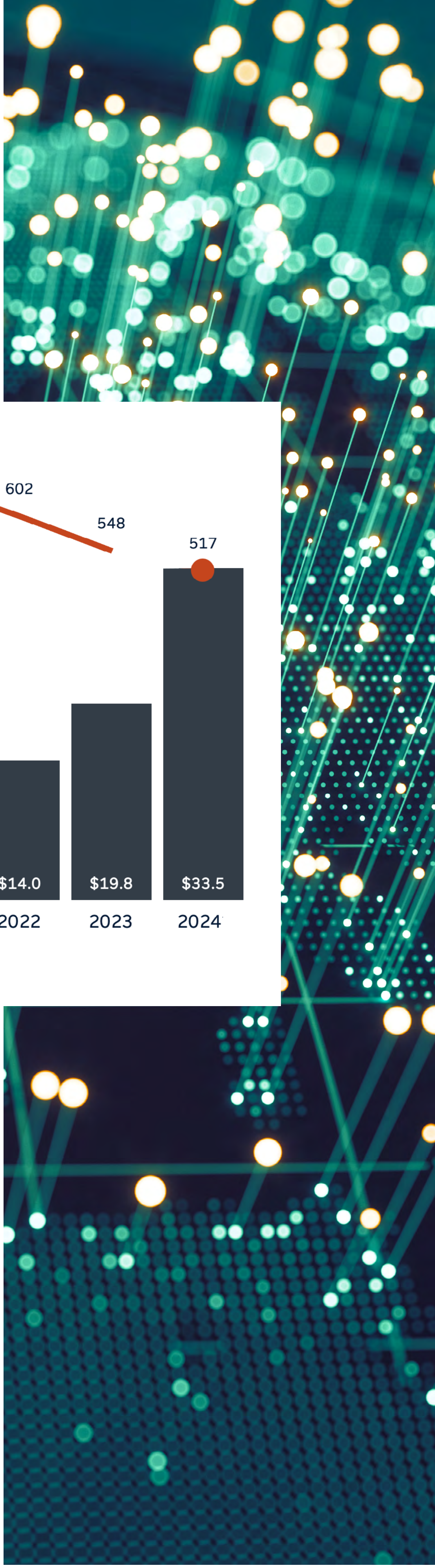
As declining inflation and interest rates confronted ongoing geopolitical unrest and economic uncertainty, the Canadian private equity market showed some contradictory trends in 2024. Although the number of deals declined year-over-year between 2023 and 2024 and fundraising faltered dramatically, aggregate deal value markedly increased, making 2024 a year of contrasts.

Canadian PE Deal Flow by Year



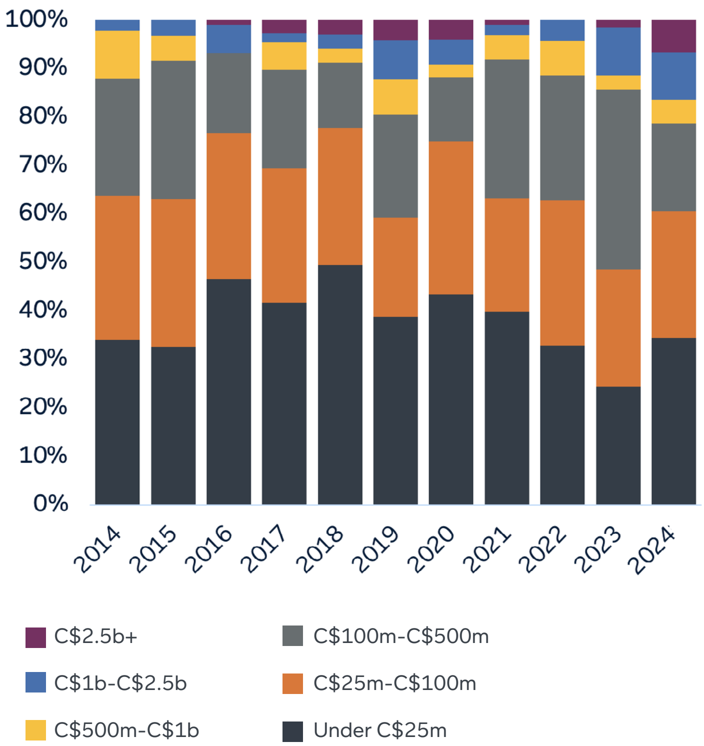
This chart compares deal value and deal count between 2014 and December 5, 2024.[1]

In 2023, most higher-value Canadian private equity buyout investment activity took place in the second half of the year, and the momentum from late 2023 continued into the new year, with the aggregate value of deals in Q1 2024 nearly matching that of Q4 2023 and a slight increase in the number of completed M&A transactions, from 141 in Q4 2023 to 149 in Q1 2024. Deal count stayed steady in Q2 2024 with a further 153 completed deals, but the aggregate deal value surged to C$14.4 billion – the highest-performing quarter by aggregate deal value since Q1 2017, and greater than 2.5 times the aggregate deal value seen in the same quarter of 2023. A significant portion of the deal value in 2024's blockbuster second quarter was represented by its largest deal, the US$6.3 billion take-private of fintech company Nuvei Corporation by Advent International, Philip Fayer, Novacap and CDPQ, with other notable transactions including the acquisition of data storage company eStruxture Data Centers for C$1.8 billion by a consortium led by Toronto-based Fengate Asset Management that included Partners Group Holding AG, Pantheon Ventures and the Laborers'



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

Canadian PE Deal Count by Size



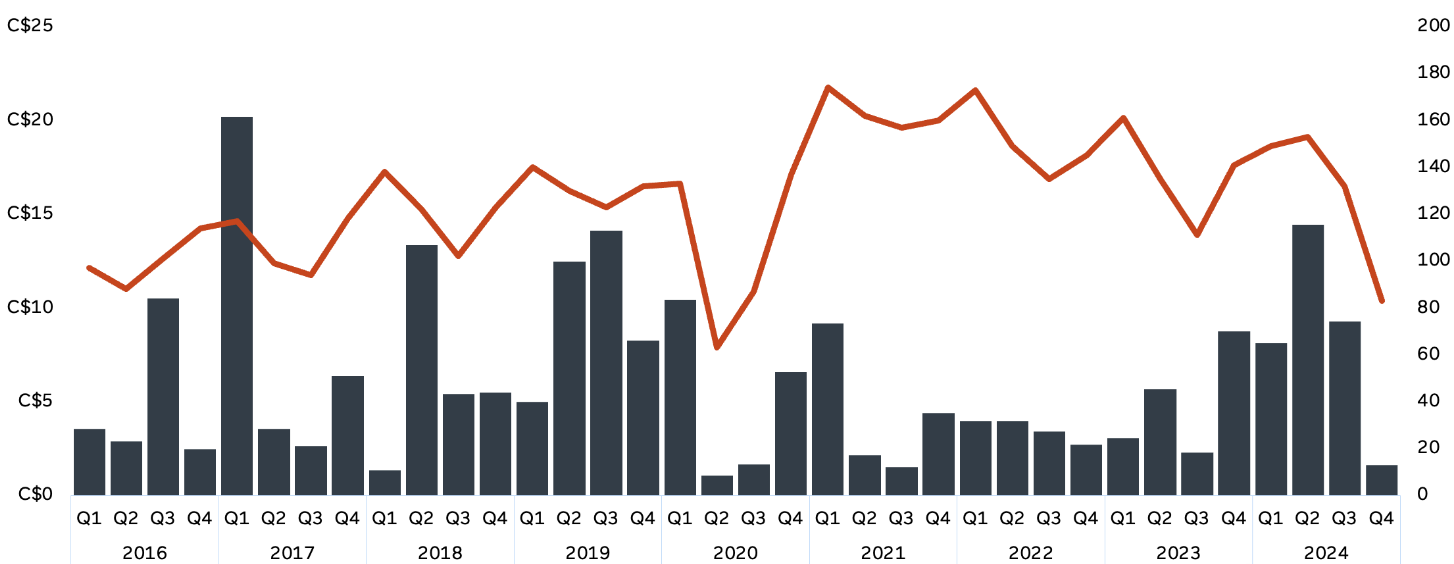
This chart presents deal activity by deal size between 2014 and December 5, 2024.

International Union of North America Pension Fund of Central and Eastern Canada and the C$1 billion take-private of decision analytics software provider Copperleaf Technologies by Industrial and Financial Systems (IFS), through its financial sponsors Advent International, Altaroc, EQT, Foresight Group, Hg, Primark Capital and TA Associates. Overall, the aggregate deal value of private equity transactions closed in Canada in the first half of 2024 showed a dramatic 258% increase over H1 2023, despite a modest 2% year-over-year increase in the number of deals that closed in the first half of the year.

The upward trajectory did not continue into the second half of 2024, however. Though Q3 2024 still significantly outpaced the same period in 2023, with 132 deals representing an impressive further C$9.3 billion in deal value, these numbers marked a decline from Q2 2024's peak, and despite four interest rate cuts by the Bank of Canada in Q3 and Q4 2024, as of December 5, 2024, only 83 deals had been reported closed in Q4, representing a mere C$1.6 billion, though those numbers are likely to increase when full Q4 data is available.

In terms of deal size, although large private equity deals over C$2.5 billion increased in 2024 to four, Canada saw significantly fewer deals in the C$100 million to C$500 million size range than in 2023 (11 in 2024 compared with 26 in 2023). The number of M&A transactions valued under C$25 million, meanwhile, increased slightly over 2023 (21 in 2024 compared with 17 in 2023).

Canadian PE Deal Flow by Quarter



This chart compares deal value and deal count by quarter between 2014 and December 5, 2024.

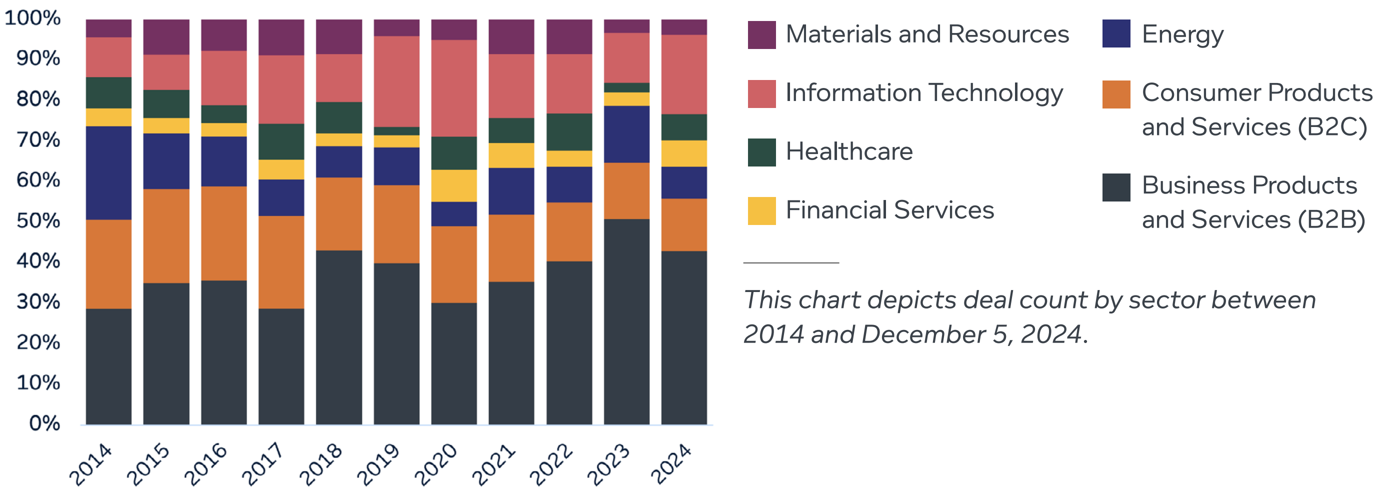
As of December 5, 2024, 517 private equity M&A transactions had been reported closed in Canada in 2024, with an aggregate deal value of C$33.5 billion, significantly exceeding 2023's full-year deal value of C$19.8 billion across 548 deals despite a reduction in the overall number of deals.

CANADIAN PE DEALS BY SECTOR

The information technology sector led Canadian PE deal activity in 2024, with aggregate deal value nearly double that of 2023 at C$16 billion, despite only a 13% increase in the number of IT deals over 2023. The notable increase in deal size was propelled by large deals such as the aforementioned sales of Nuvei, Copperleaf and eStruxture, as well as the acquisition of ancillary revenue solutions provider Plusgrade by General Atlantic from Novacap in a leveraged buyout. Indeed, 11 of the top 25 Canadian PE deals in 2024 were in some part of the information technology sector, with deals involving business and productivity software companies being most prevalent.

Consumer products and services (B2C) was the second-largest sector by Canadian deal value in 2024, at C$9.7 billion, with the energy sector following at C$3.9 billion. While representing a lower aggregate deal value at only C$2.4 billion, business products and services (B2B) represented the most active sector by Canadian deal count, at 214 transactions, compared with 79 in B2C – both numbers that fell below 2023 deal volume (244 B2B and 82 B2C, respectively).

Canadian PE Deal Count by Sector



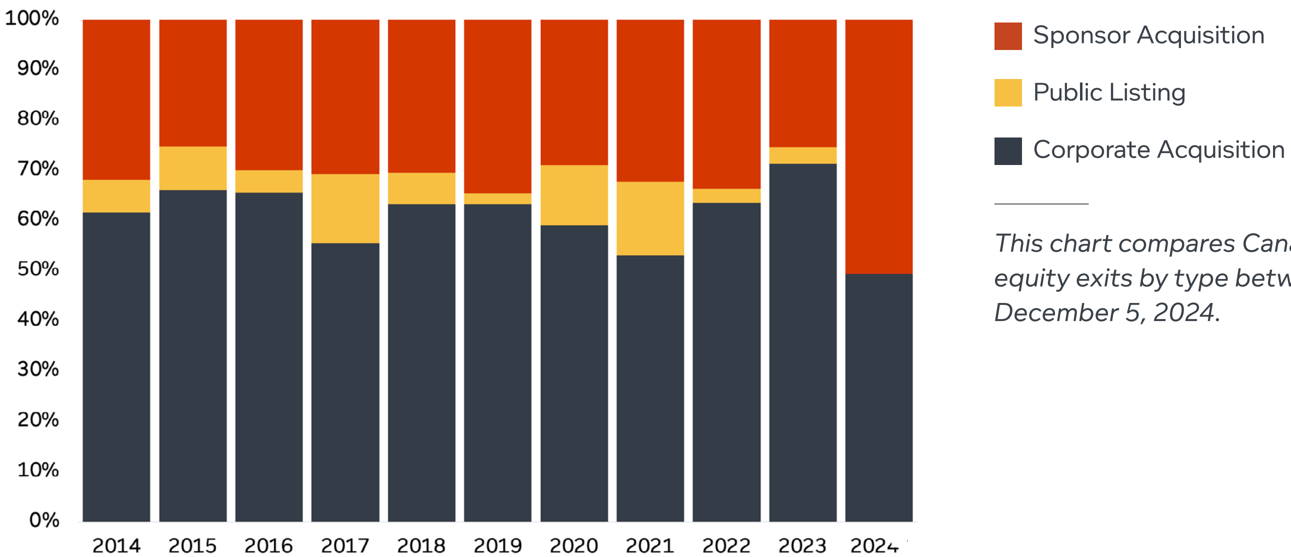
This chart depicts deal count by sector between 2014 and December 5, 2024.

CANADIAN PE-BACKED EXITS

Canadian PE exits declined considerably in 2024, with just 77 transactions, compared with 122 in 2023, continuing a downward trend since 2021. Notwithstanding the significant reduction in deal count, 2024's Canadian PE-backed exits represented a remarkable increase in exit value over 2023 of 387%, at C$21.8 billion, compared with C$5.6 billion in 2023.

As with deal activity overall, the B2B sector saw the greatest volume of PE exit transactions, at 33. As in 2023, sales to corporate acquirors or other sponsors represented almost the entirety of transactions, with no PE-backed exits by IPO reported in 2024, as conditions continued to be unfavourable for public listings. In contrast with 2023, the number of corporate acquisitions and sponsor acquisitions were almost equal in 2024, compared with a much higher proportion of corporate acquisitions in 2023.

Canadian PE Exit Count by Type

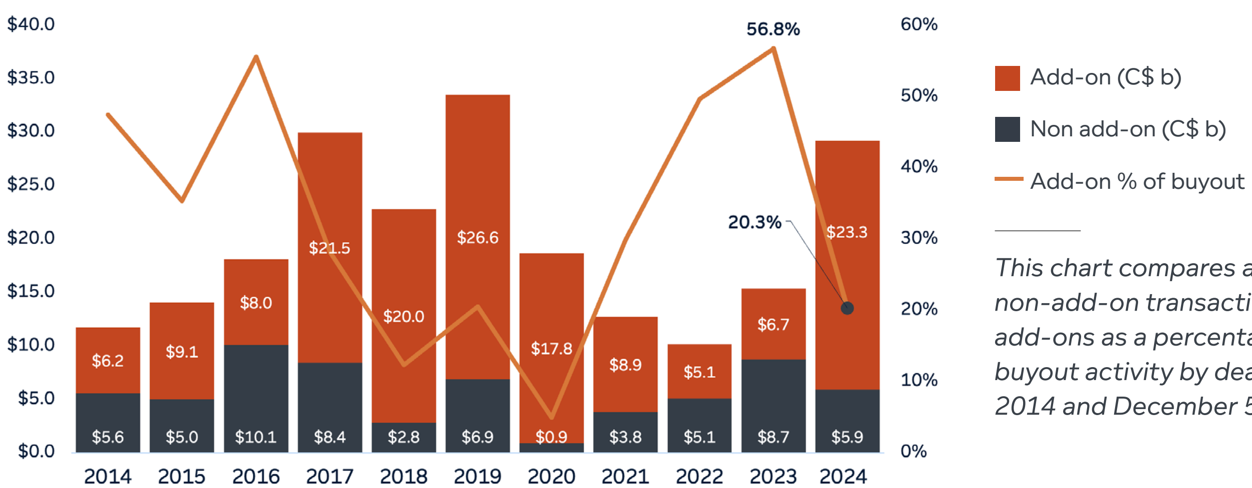


This chart compares Canadian private equity exits by type between 2014 and December 5, 2024.

CANADIAN ADD-ONS

As in 2023, add-on transactions represented the greatest share of private equity transactions in Canada in 2024, representing 70.3% of buyout deals, as private equity firms launched fewer new platforms and focused on add-ons. Notably, however, add-ons represented only 20.3% of Canadian buyout activity in 2024 by value, at C$5.9 billion.

Canadian Add-On Transactions by Value

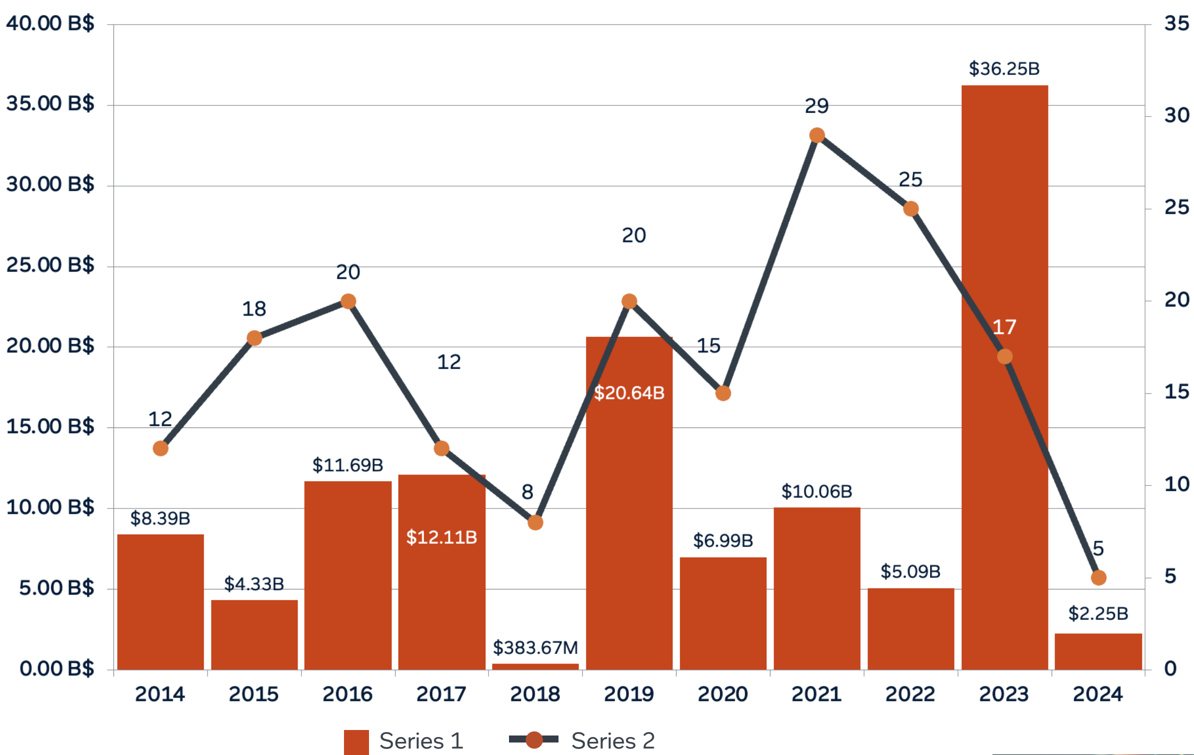


This chart compares add-on and non-add-on transactions, including add-ons as a percentage of Canadian buyout activity by deal value, between 2014 and December 5, 2024.

CANADIAN PE FUNDRAISING

After an impressive rebound in private equity fundraising in 2023, with 17 funds raising a staggering C$36.25 billion, 2024 saw a precipitous decline in fundraising, with only C$2.25 billion raised by five funds – a stark 94% decline year-over-year and the lowest aggregate amount of capital raised since 2018, as challenges achieving liquidity slowed the return of capital to limited partners.

Canadian PE Fundraising Flow



This chart presents total capital raised and the related fund count between 2014 and December 5, 2024.

CONCLUSION

Despite the slowing of inflation and welcome cuts to interest rates on both sides of the border, as of the time of publication, reported deal data suggests that the Canadian private equity M&A market has yet to feel a corresponding boost to activity in the latter part of the year. Nonetheless, with a strong start to the year, a standout Q2 and an active Q3, the year as a whole showed a healthy number of private equity transactions closed in 2024, with transaction numbers that could meet or exceed 2023 deals once all Q4 data is reported, and a compelling increase in aggregate deal value.

AI and Private Capital in Canada – Context and Legal Outlook

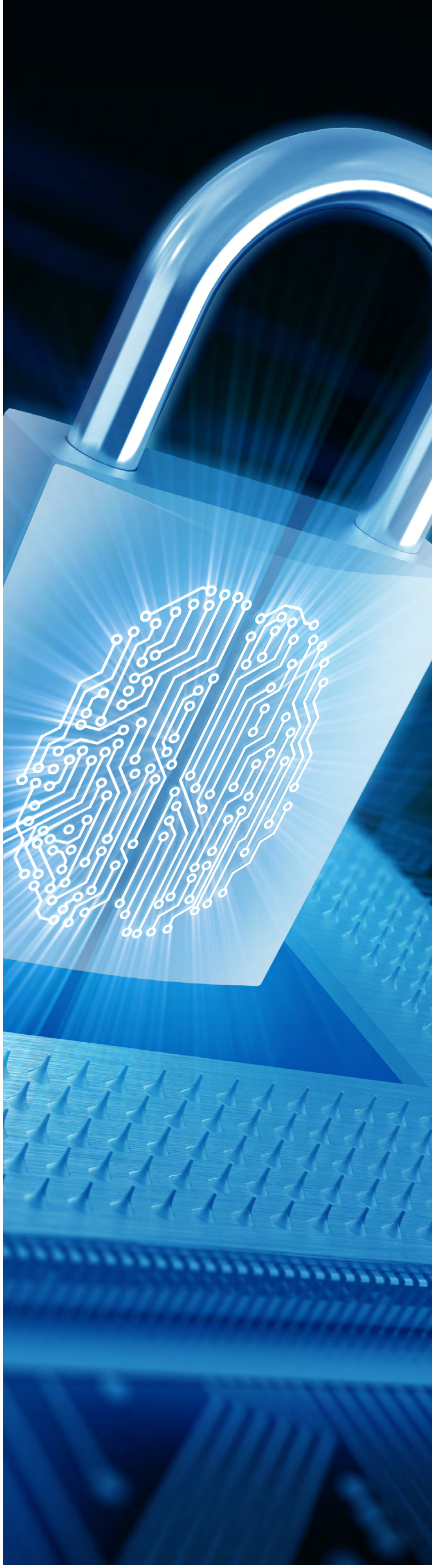
Canada boasts a robust artificial intelligence ("AI") ecosystem fuelled by, among other things, strong and consistent government support and growing venture capital ("VC") and private equity interest therein. With the launch of the Pan-Canadian Artificial Intelligence Strategy in 2017, Canada became the first country in the world to adopt a national AI strategy,[2] through which the Government of Canada is investing in efforts to drive the adoption of artificial intelligence across Canada's economy.[3] Governmental support for measures designed to position Canada as a leading global player in AI research and commercialization is evidenced by substantial funding, including, most recently, the C$2.4 billion that was allocated in Canada's 2024 federal budget for a package of measures to secure Canada's AI advantage (including C$2 billion over five years in support of a new AI Compute Access Fund and Canadian AI Sovereign Compute Strategy),[4] and various initiatives at both the federal and provincial levels.

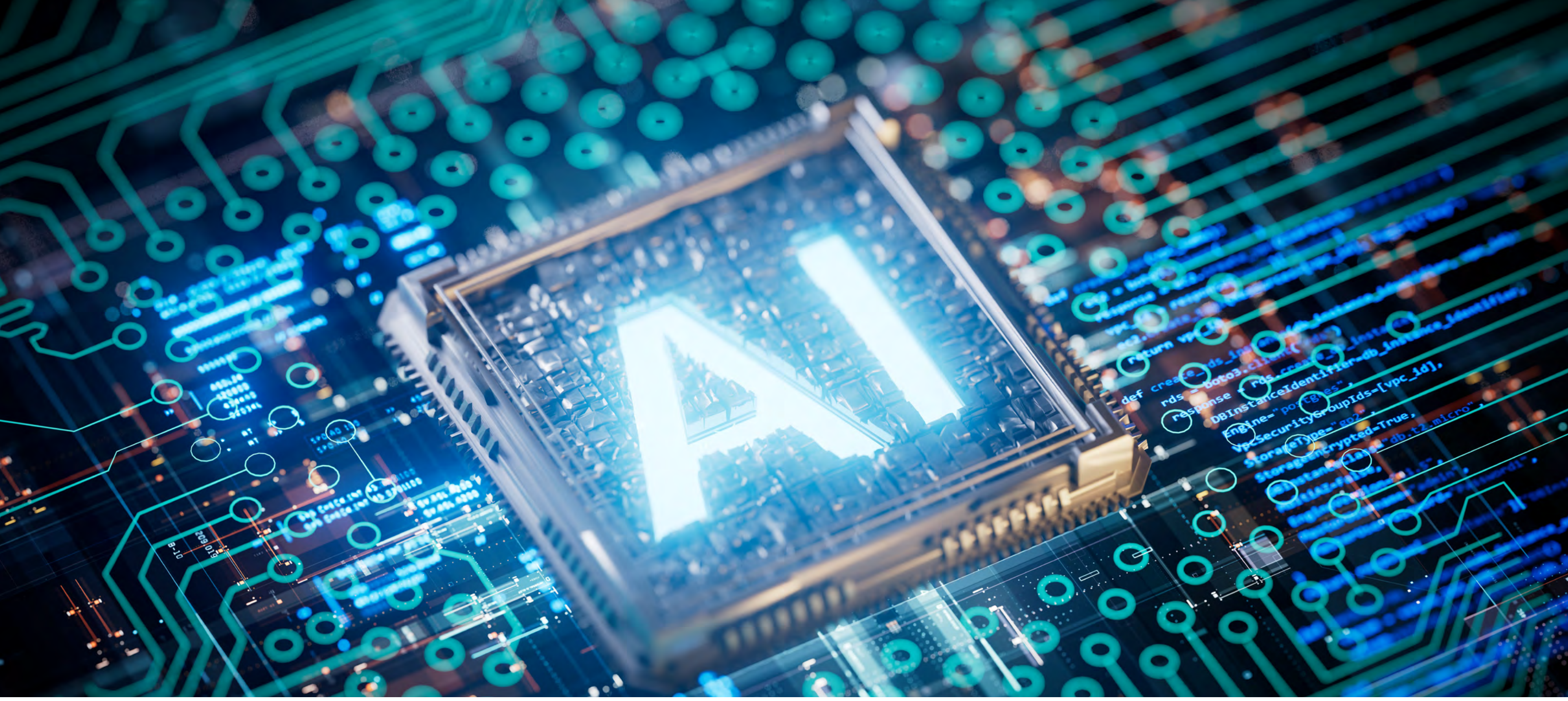
Alongside government investment, the Canadian AI sector has attracted increasing private capital in recent years, with the number of VC and PE AI deals steadily increasing year-over-year since 2014, and deal sizes generally trending upwards over the past 10 years, consistent with global trends.[5] According to the most recent AI report prepared by Deloitte LLP in partnership with the Canadian Institute for Advanced Research and Canada's three national AI institutes, in 2023 Canada ranked third among G7 countries in per capita VC investments in AI enablers, developers and users (behind only the United States and the United Kingdom), with domestic investment constituting 28% of the total VC investment.[6] Over 300 AI/tech announcements regarding foreign direct investments in Canada from 2018 to July 2024 totalled an estimated US$33.6 billion.[7] All signs are pointing to continued private capital activity in the Canadian AI sector as Canada's ecosystem evolves beyond the start-up stage and AI technologies continue to develop.

It is imperative that PE and VC actors pay attention to the rapidly changing legal landscape in Canada and beyond, whether they are contemplating investments in AI-driven companies or deploying AI solutions to support core portfolio management functions such as research, deal sourcing, contract management, due diligence or valuation. Compliance with evolving regulations will be challenging for private capital players because it will require both technical and legal expertise.

On June 16, 2022, the Government of Canada introduced the *Artificial Intelligence and Data Act* ("AIDA"), forming part of Bill C-27, titled *The Digital Charter Implementation Act, 2022*. If adopted, AIDA would become Canada's first law specifically dedicated to regulating AI. AIDA seeks to set out clear requirements for the responsible development, deployment and use of AI

2 https://www.pm.gc.ca/en/news/news-releases/2024/04/07/securing-canadas-ai.
3 https://ised-isde.canada.ca/site/ai-strategy/en.
4 https://www.budget.canada.ca/2024/report-rapport/budget-2024.pdf (page 168).
5 https://central.cvca.ca/mapping-the-growth-of-ai-in-canada-through-investment.
6 https://cifar.ca/cifarnews/2023/09/27/deloitte-report-canada-leads-the-world-in-ai-talent-concentration/.
7 https://cifar.ca/wp-content/uploads/2024/09/pcais-one-pager-eng-8-AODA.pdf.





systems by the private sector. Its stated goal is to put in place a rigorous regulatory framework governing responsible adoption of AI systems to limit the harms those systems may cause, including reproducing and amplifying biases and discrimination in decision-making that may, in turn, propagate considerable systemic harms and erode public trust in the technology, which could have a chilling effect on the development of AI. AIDA's regulatory focus is limited to "high-impact" AI systems within the private sector, the definition of which is left to regulations which have not yet been developed but are expected to be based in part on the severity of potential harms caused by the system. Recent proposed amendments suggest that AIDA could also regulate general-purpose AI, such as generative AI systems. As of October 2024, Bill C-27 is under review by the House Standing Committee on Industry and Technology and, with upcoming Canadian federal elections in 2025, whether and when AIDA will come in to force remains unclear. If enacted, AIDA's impact on any particular PE and VC fund or portfolio companies will need to be assessed on a case-by-case basis by AI technical and legal experts.

Beyond AIDA, the development of Canadian law is evolving, with legislators, regulators and courts subjecting AI to increased scrutiny across disciplines, including human rights, labour and employment, intellectual property, data protection and privacy, cybersecurity, trade and anti-trust and competition. For instance, in May 2023, the Office of the Privacy Commissioner of Canada and its provincial counterparts launched an investigation into OpenAI's ChatGPT which remains ongoing. PE and VC firms must also consider the extraterritorial impact of legislative frameworks outside of Canada, including the European Union's Artificial Intelligence Act, which (like the General Data Protection Regulation) can affect Canadian businesses launching AI products or services in the European Union. Such legislative frameworks should also be seen as useful best practice guides, influencing norms and contractual terms in the AI space.

PE firms that are developing, using or investing in AI should take proactive measures to manage the risks associated with AI, including regulatory compliance and litigation risks. PE firms can start by establishing policies or frameworks for the responsible use of AI both at the fund and portfolio company levels, and ensuring that investment committees and portfolio company boards are well equipped to assess and address AI-related risks and opportunities. Policies or frameworks should be in line with current and expected regulatory requirements and standards and include, among others things, AI governance policies, measures for monitoring the output and performance of AI and fairness and robustness testing for AI models.

As PE and other investors continue to deploy capital in this fast-moving technological, legal and regulatory landscape, deal terms are evolving to address risks specifically facing AI-intensive targets, including data integrity, model robustness, ethical design processes, compliance with established AI standards (including ISO/IEC standards) and reliance on key AI personnel. Beyond terms that are customarily applicable in tech sector transactions, specific representations and warranties, indemnity baskets, recourses provisions and post-closing covenants may be appropriate in instances where, for example, a target's valuation is largely dependent on AI that attracts particular regulatory scrutiny, such as generative AI, or the target's AI governance framework is lacking.

Canadian Take-Privates in 2024 and Looking Forward[8]

Private equity firms continued to contribute significantly to activity levels in the Canadian take-private market throughout 2024. We expect this trend to continue in 2025.

OVERVIEW

There were nearly 100 Canadian take-privates announced or closed during the period from September 1, 2023 to August 31, 2024, representing a total deal value of approximately C$50 billion. Overall, the most active sectors for targets were: metals and mining (approximately 40% of deal count and 30% of deal value), technology (approximately 20% of both deal count and deal value) and energy and power (approximately 11% of deal count and 20% of deal value).

Of the Canadian take-privates announced or closed, PE-backed deals represented about 40% of both overall deal count and deal value. For these PE-backed deals, the most active target sector was tech, representing approximately 40% of PE-backed deals by both deal count and deal value. Other active sectors for targets of PE-backed deals included financial services (representing approximately 10% of deal count), industrials (such as machinery, engineering, transportation and aerospace) (representing approximately 10% of deal count), real estate (representing approximately 20% of deal value) and energy and power (representing approximately 15% of deal value).

Of the remaining Canadian take-privates announced or closed, the most active target sector was metals and mining, representing approximately 60% of non-PE-backed deals by deal count and approximately 50% of non-PE-backed deals by deal value.

CASH CONTINUES TO BE KING

About 80% of the PE-backed Canadian take-privates announced or closed, were structured as all cash transactions, with the remaining 20% containing a non-cash component, such as a management rollover.

TECHNOLOGY ACQUISITIONS ON THE RISE

As the data shows, Canadian tech companies continue to attract attention from PE investors.

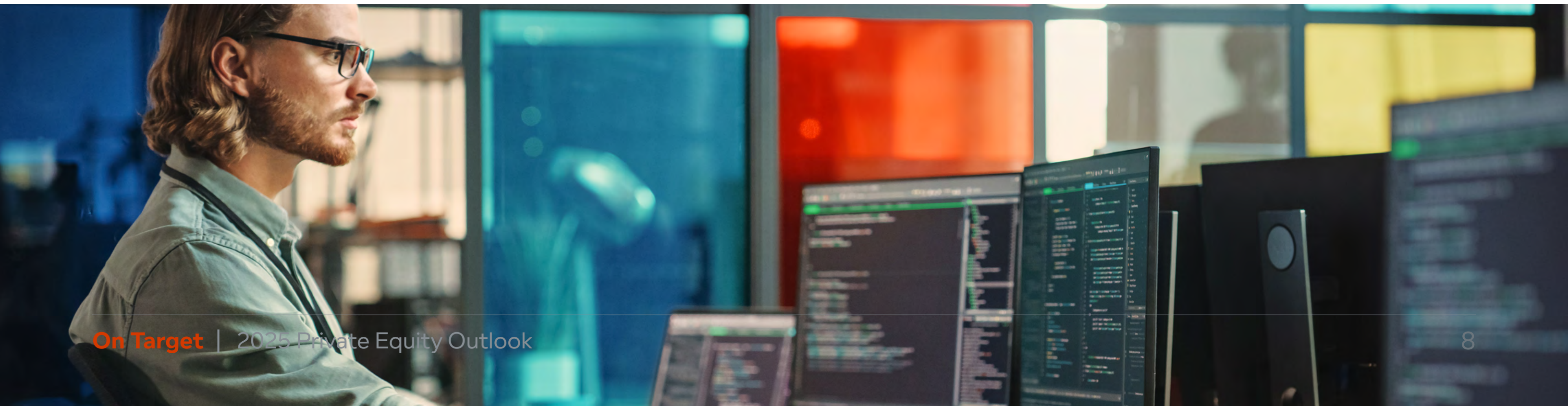
From a valuation perspective, the deal price for Canadian tech take-privates announced or closed, represented an average premium of about 40% compared to the pre-announcement trading price, with premiums for all Canadian tech take-privates ranging from as low as 0% (or less) and as high as approximately 120%, in each case, compared to the pre-announcement trading price. The average premium for the subset of Canadian take-privates that were PE-backed was about 40% as well compared to the pre-announcement trading price.

GETTING DEALS DONE

The success rate of Canadian take-privates continues to be very high following announcement. Fewer than 8% of the deals announced were withdrawn or otherwise unsuccessful, with only one instance of the board terminating the original deal to take a superior proposal and the rest of the withdrawn or failed deals tied to a failure to meet the minimum tender or shareholder approval requirement or other reasons particular to those deals.

The vast majority of Canadian take-privates continue to be friendly transactions carried out using the court-approved plan of arrangement structure (approximately 98% of deals), as compared to being structured as a take-over bid (approximately 2% of deals).

8 The data points described in this section are based on our review of relevant transactions disclosed on https://www.refinitive.com and the related information on https://money.tmx.com, during the period from September 1, 2023 to August 31, 2024.



The Supply Chains Act and its Application to Private Equity

The Canadian *Fighting Against Forced Labour and Child Labour in Supply Chains Act* (the "Supply Chains Act") introduces critical measures to combat forced and child labour in global supply chains. Having come into force on January 1, 2024, this new legislation is aimed at addressing and mitigating the risks of forced labour and child labour within supply chains by imposing a reporting obligation on certain government institutions and entities that meet the relevant criteria. These reports must be filed by May 31 of every year, and must address certain statutorily prescribed criteria regarding the measures taken during the previous financial year to prevent or reduce the risk of forced labour and child labour in any step of the production of goods.

The goal of the Supply Chains Act is to ensure transparency and accountability in supply chains, thereby contributing to Canada's international commitment to combat forced and child labour. After Canada's implementation of a prohibition on the importation of goods that are mined, manufactured or produced wholly or in part by forced labour in 2020, several legislative initiatives were proposed to further address forced labour in the international supply chains of Canadian companies. Of these, the Supply Chains Act is the first to become law.

The reporting obligation in the Supply Chains Act has broad application and applies on an entity-by-entity basis – in other words, simply because one entity is captured doesn't mean that every entity affiliated with that first entity is captured. The criteria for applicability may be broken down into three distinct tests, all three of which must be met by the relevant business organization for the reporting obligation under the Supply Chains Act:

— **The Presence in Canada Test** – Does the business organization have a place of business in Canada, do business in Canada or have assets in Canada?

— **The Financial Threshold Test** – Does the business organization meets at least two of the following conditions for at least one of its two most recent financial years: (i) the entity has at least C$20 million in assets, (ii) the entity has generated at least C$40 million in revenue or (iii) the entity employs an average of at least 250 employees?

— **The Activities Test** – Does the business organization produce, sell or distribute goods in Canada or elsewhere, import into Canada goods produced outside Canada or control another entity engaged in such production, sale, distribution or importation?[9]

The determination whether each of these tests is met involves a nuanced analysis and, although Public Safety Canada has released guidance on their interpretation of the application of the Supply Chains Act (the "PSC Guidance"),[10] there continues to be areas of ambiguity. As such, the determination of whether or not the Supply Chains Act applies to an entity can often be unclear.

Considering the three tests described above, for many private equity firms, the thresholds in the financial threshold test are relatively low such that they are often met. Accordingly, for private equity firm application, the focus of the analysis is frequently on the presence in Canada test and the activities test. Each of these tests can present distinct challenges in a private equity context.

With regards to the activities test, because private equity firms often do not engage in the production, sale or importation of goods themselves, the question frequently turns on whether they can be considered to control an entity that does. The Supply Chains Act does not define the term "control", and only notes that control in the Supply Chains Act covers both direct and indirect control, including deemed indirect control.[11] The PSC Guidance provides some additional insight, noting that:

> "Control includes both direct and indirect control and extends down the entity's organizational chain. The term should be applied broadly in a manner consistent with the purposes of the [Supply Chains Act]. For example, if the reporting entity controls a business that controls another business, both businesses are

9 Public Safety Canada, which administers the Supply Chains Act, has indicated on more than one occasion that it does not view the reporting obligation as applying to entities that do not produce goods or import goods into Canada, despite the fact that entities appear to be subject to the reporting obligation under the Supply Chains Act even if they only engage in selling and/or distributing activities. The current PSC Guidance states that "Entities solely involved in distributing and selling are not expected to report under the Act. Public Safety Canada will not seek enforcement action in those instances." At this time, however, there have been no amendments to the Supply Chains Act that reflect Public Safety Canada's pronouncements in this regard.

10 See "Prepare a Report – Entities", Public Safety Canada (November 15, 2024), online: https://www.publicsafety.gc.ca/cnt/cntrng-crm/frcd-lbr-cndn-spply-chns/prpr-rprt-en.aspx.

11 This is set out in s.10(2) of the Supply Chains Act, which states that "[a]n entity that controls another entity is deemed to control any entity that is controlled or deemed to be controlled by the other entity."

captured by the definition of control. The meaning of control also includes deemed control, as per subsection 10(2) of the [Supply Chains Act].

Accounting standards (e.g., International Financial Reporting Standards, Generally Accepted Accounting Principles (United States), etc.) may be used as the basis for determining whether one entity controls another. The definition of control is, however, not limited to these accounting standards. Control may include situations in which an entity exercises joint control of an operation.

An entity may consider the Office of the Superintendent of Financial Institutions' guidance on the concept of control[12] to assess whether it controls another entity for the purposes of the [Supply Chains Act]."

The PSC Guidance indicates that control should be interpreted broadly, and not be limited to wholly owned (or even majority-owned) subsidiaries. In a private equity context, it would be important to consider broader indications of control, such as special rights afforded to the investor or the ability to control the board of directors, which may indicate that an entity is controlled by the investor even if it does not hold greater than 50% of the entity's ownership interests. The guidance issued by the Office of the Superintendent of Financial Institutions on the concept of control in fact, which is referred to in the PSC Guidance, can also provide useful insight into how the concept of control should be considered in this context.

With regard to the presence in Canada test, a key question for private equity firms located outside of Canada is whether they have sufficient nexus to Canada to be captured. The PSC Guidance provides some insights into Public Safety Canada's interpretation of this test – noting that, for example, the criteria for taxation purposes applied by the Canada Revenue Agency when considering if an organization is "carrying on business in Canada" can be instructive in determining if the organization is doing business in Canada for the purposes of the Supply Chains Act. Further, recent updates of the PSC Guidance have clarified that "securities" would not constitute assets in Canada, such that holding shares in a Canadian company is unlikely to be considered a sufficient nexus to Canada for the presence in Canada test to be met.

Beyond these issues, once an entity determines that it is subject to the reporting obligation, there are questions around what aspects of the business are required to be discussed in its report. As noted above, the Supply Chains Act applies on an entity-by-entity basis, such that reporting is only required for the specific entities that are subject to the reporting obligations, not all of such entities' affiliates. However, for private equity firms where they may have a large number of portfolio companies in a number of different industries that could be reporting, the question of what activities needs to be reported on, and when it makes sense to submit a joint report as opposed to separate ones, can be a complex issue to address.

The Supply Chains Act represents a significant step forward in the global effort to eradicate forced and child labour from supply chains. For many private equity firms, this legislation can be difficult to navigate and, if it does apply, introduces new responsibilities and challenges. However, it also presents opportunities to showcase and promote PE firms' ethical business practices. This could be key as Canada considers implementing even greater measures to address modern slavery issues, and other jurisdictions look at implementing similar measures as well. Looking forward to 2025, we expect that the current (or a new) Canadian federal government will legislate actual due diligence requirements for the de-risking of human rights abuses in supply chains. By understanding and embracing these changes, private equity firms can not only ensure compliance but also enhance their reputation and contribute to a more just and sustainable global economy.

12 See "Guidance – Control in Fact", Office of the Superintendent of Financial Institutions (January 31. 2020), online: **https://www.osfi-bsif.gc.ca/en/guidance/guidance-library/control-fact**.

The Next Frontier of Fundraising

Along with the macroeconomic issues of the post-COVID era has come a noticeable shift in the private equity fundraising environment. The PE fundraising pool, which used to predominately consist of institutional investors, has now diversified to also include numerous high-net-worth individuals and family offices and, on the horizon, retail investors. Preqin, a provider of data and insights in private markets, has noted that, based on its investor surveys, a large proportion of institutional investors are planning on slowing the pace of their capital commitments to private equity, which may lead to a further increase in diversification and potentially a shift in investor pool dynamics.[13]

The related burning questions are what are the underlying forces which have caused this shift and what impact have such forces had on the private equity fund market.

WHAT HAS CONTRIBUTED TO THE SHIFT?

Historically, traditional institutional investors were the only ones who could write a cheque large enough to get an invitation to the private equity investor pool, because larger private equity funds generally required a minimum investment in the range of US$10 million or more, which amount would be locked up for at least 10 years. Private equity firms have now created various fund vehicles which allow for lower investment amounts and, in some cases, more latitude to exit before the end of life of a fund, which arguably has made PE funds more attractive to individual investors.

This shift may be attributable to the fact that many institutional investors have reached the ceiling of their allocation targets for private equity and, therefore, have no latitude to invest any further.[14]

In addition, this trend of greater numbers of individual investors becoming investors in private equity funds could be related to the fact that private companies are generally staying private for longer (on average for more than 10 years), resulting in a significant portion of value being created outside of public markets.[15] This is apparent by the slowdown in the number of IPOs – CPE Analytics reported that in the first nine months of 2024, only 12 IPOs were completed on the four Canadian securities exchanges (excluding capital pool companies and special-purpose acquisition corporations).[16]

The volatility in the public market, particularly in the post-COVID era, may have also contributed to this shift, because individual investors are likely attracted to the controlled private market with historically higher returns in diversified sectors, as opposed to what is available on the public markets. Cambridge Associates U.S. Private Equity Index reported that on a net basis

13 See https://www.preqin.com/Portals/0/Documents/Event/Preqin-Future-of-Alternatives-2027-Australia-Event-2022.pdf.

14 See https://www.barrons.com/articles/wealthy-investors-will-boost-the-private-equity-sector-to-12-trillion-in-assets-688d9328.

15 See https://web-assets.bcg.com/01/cf/60d21c2340269d8ba580e12e7415/unlocking-the-art-of-private-equity-in-wealth-management.pdf.

16 See https://www.financings.ca/reports/.

(after deductions for fees and carry), private equity outperformed public market equivalents over 5- to 20-year periods.[17]

Structurally, there is less red tape involved when individuals and family offices commit their capital, versus the context for institutional counterparts, which often have strict investment mandates and approval processes to enable them to commit capital. Individuals and family offices have the ability to tailor allocations to their preferences, particularly with respect to liquidity, whereas institutional investors typically require consistent and incremental contributions and distributions in order to support their liquidity needs.

WHAT IS THE IMPACT?

— **Emergence of semi-liquid, evergreen funds and open-ended funds** – These address the liquidity concerns generally faced by individual investors and family offices with the traditional private equity fund model, which model traditionally ties up capital for the life of a fund. Generally, these funds include a withdrawal or repurchase mechanism in favour of investors for all or a portion of the invested funds. Such liquidity rights are often subject to gate and suspension constructs, which act as restrictions to liquidity and have to be carefully considered by investors.

— **Growth in digital platforms** – These platforms are increasingly being launched and expanded with access to a variety of private investment offerings.[18] As of July, 2024, Private Equity International identified 26 of such platforms. Of those platforms, 6 of them have independently raised in excess of US$1 billion (the largest and most notable one being iCapital, which has raised just over US$191 billion).[19] They generally have lower minimum commitments as compared to traditional funds, provide access to a curated set of funds which may not have been accessible by individuals previously and provide access to a number of educational and diligence tools to guide investors. These platforms, in some instances, only require a nominal minimum commitment (for example, Moonfare, which only requires a commitment of €10,000 for eligible ELTIF[20] investors) thereby expanding access beyond high-net-worth individuals.

— **Regulatory development** – Regulation with respect to private equity funds is developing to facilitate investment beyond institutional investors. Barclays has cited the European Long Term Investment Fund 2.0 regulation as an example. This regulation has improved access to private market funds by introducing an evergreen, open-ended structure with lower minimum commitments and a streamlined distribution process.[21]

17 See https://www.cambridgeassociates.com/wp-content/uploads/2023/10/WEB-2023-Q2-USPE-Benchmark-Book.pdf.
18 See https://www.privateequityinternational.com/digital-wealth-platforms-for-private-markets-whos-offering-what/.
19 See https://www.privateequityinternational.com/digital-wealth-platforms-for-private-markets-whos-offering-what/.
20 European Long-Term Investment Fund.
21 See https://privatebank.barclays.com/content/dam/privatebank-barclays-com/en-gb/private-bank/documents/insights/2024/September/private-markets-annual-report-2024.pdf.

To the extent a significant number of individual investors access the Canadian private funds market, it is highly likely that we will witness the emergence of similar legislation in Canada as well, in the near future, in order to protect and regulate private funds investment made by such individual investors.

— **Additional capital shifting to the private markets** – Growth in the capital commitments of individual investors in private equity funds is projected to reach US$1.2 trillion by 2025 (up from US$500 billion in 2020 and US$200 billion back in 2015), with individual investors accounting for an average of 10.6% of the capital raised by private equity funds by 2025.[22] A significant factor in connection with this growth can be attributed to the decline in the number of public companies with significant revenue – it is reported that fewer than 15% of U.S. companies with revenue over US$100 million are publicly held.[23] Private assets offer investors a diversified portfolio for investment with attractive returns, versus the limited number of initial public offerings and the higher volatility of the public markets.

Although institutional investors remain the funding backbone of private equity funds, the gate is progressively opening to other investors of varying shapes and sizes. This likely means new investment models and offerings to address the key concerns which are novel to individuals as opposed to institutions and a potential growth in fundraising over the next few years, resulting in significant amounts of additional capital to be deployed in the private market.

22 See https://web-assets.bcg.com/01/cf/60d21c2340269d8ba580e12e7415/unlocking-the-art-of-private-equity-in-wealth-management.pdf.
23 See https://www.bain.com/insights/why-private-equity-is-targeting-individual-investors-global-private-equity-report-2023/.

The New Era of Competition Enforcement: What It Means for Private Equity

In June 2024, the most comprehensive set of reforms to the Canadian *Competition Act* (the "Act") since 2009 became law with the passage of Bill C-59. Although Bill C-59 introduced significant changes to almost all elements of the Act (our analysis of the full set of amendments is available **here**), the federal government's changes to the Act's merger control regime will have the greatest implications for private equity firms in the years ahead.

Three key amendments, all of which are now in force, will likely result in a greater number of private equity transactions being reviewed by the Canadian Competition Bureau (the "Bureau") and foreshadow a stricter enforcement approach to private equity transactions in 2025.

(1) ***Sales "into Canada" must now be included when calculating merger notification thresholds***

Transactions involving the acquisition of an operating business[24] in Canada are subject to a mandatory pre-merger filing where two thresholds are exceeded (additional criteria and exemptions may also apply in particular circumstances):

(i) Size-of-Parties Threshold: The parties to the transaction (together with their affiliates) must have a combined aggregate book value of assets in Canada, or combined annual gross revenues from sales in, from and into Canada, exceeding C$400 million. This threshold was not changed by the recent amendments.

(ii) Size-of-Transaction Threshold: Historically, the book value of the target entity's assets (or, in an asset acquisition, the target assets) was required to exceed C$93 million, or generate annual gross revenues from sales in and from Canada in excess of C$93 million (the monetary value of this threshold can be adjusted annually based on GDP growth). Although the asset side of the threshold analysis remains the same, in-scope revenues has been expanded to the "annual gross revenues from sales in, from or into Canada," requiring consideration of sales from Canadian assets within and outside of Canada as well as sales from non-Canadian assets into Canada.

The inclusion of import sales in the size-of-transaction threshold means that transactions involving a target with cross-border business are more likely to be notifiable to the Bureau. For example, the acquisition of a portfolio company with a sales office in Canada (i.e., an "operating business") that made significant sales (i.e., greater than C$93 million) to Canadian customers exclusively from U.S.-based manufacturing facilities was not previously notifiable, because these cross-border sales were not factored into the size-of-transaction threshold analysis. Under the revised threshold, these cross-border sales would now be caught as sales "into Canada" and, assuming the size-of-parties threshold is also exceeded, the transaction would be notifiable to the Bureau.

24 An operating business is defined in the Act as "a business undertaking in Canada to which employees employed in connection with the undertaking ordinarily report for work."

Given the close commercial and trading relationship between the U.S. and Canada, private equity firms acquiring a U.S.-based (or other foreign-domiciled) company that doesn't have a material manufacturing or sales presence in Canada will nevertheless need to consider whether the company's sales "into" Canada require the transaction to be pre-merger notified under the Act.

(2) *Expanded look-back period will likely increase scrutiny of serial roll-up acquisitions*

Even where transactions are not notified in Canada, there is now an increased likelihood of post-closing scrutiny from the Bureau. The period during which the Bureau can initiate a review of non-notified transactions has been extended from one year after closing to three years after closing. For notified transactions, the limitation period remains at one year after closing.

Consistent with the U.S. Federal Trade Commission and U.S. Department of Justice's focus on roll-up strategies by private equity firms, this expanded look-back period will provide the Bureau with a longer window to more thoroughly assess the implications of, and possibly challenge, smaller transactions that have a cumulative adverse impact on competition in a particular industry. Private equity firms considering serial acquisitions or roll-up strategies in 2025 should be strategic in the ordering of transactions, particularly given the introduction of a structural presumption into the Act (discussed below), and consider the benefits of voluntarily notifying earlier transactions in the series to take advantage of the reduced one-year limitation period for notified transactions.

(3) *Structural presumption will likely result in lengthier and more complex reviews*

Arguably the most significant change to the Act is the introduction of a structural presumption, whereby a transaction that results in, or is likely to result in, market shares in excess of 30% or concentration beyond prescribed thresholds is presumed to be anti-competitive, unless the merging parties can prove otherwise on a balance of probabilities. Although the new structural presumption closely mirrors the structural presumption in the U.S. Department of Justice's 2023 Merger Guidelines, the U.S. guidelines can be revoked or amended at any time and can be applied on a discretionary basis, whereas this new structural presumption is enshrined in law, creating a much more permanent feature of the Canadian regime with limited scope for enforcement discretion.

The Canadian Commissioner of Competition has made clear that the structural presumption will result in a shift towards stricter enforcement, stating in a speech that "you can expect much more healthy skepticism about proposed mergers in concentrated sectors. That's as a result of the repeal of the efficiencies defense coupled with the creation of

> rebuttable structural presumptions. This puts an end to what was—in my view—an overly permissive approach to mergers or, as one of my predecessors described it, 'the weakest merger law among all of our peer countries'."[25]

Although the structural presumption is not likely to result in a material increase in the number of mergers being blocked, it will result in a lengthier and more complex review process for a larger set of transactions, and may well have a chilling effect on transactions that exceed the presumptive thresholds. Private equity firms should pay close attention to their existing portfolio and consider whether a new acquisition would put the combined portfolio above the prescribed market share or concentration thresholds in any relevant market. Where those thresholds are exceeded, the Bureau will be more likely to issue a supplementary information request (akin to a second request under the Hart-Scott-Rodino process in the U.S.), in order to obtain the records and data necessary to closely assess any arguments being made by the parties to rebut the structural presumption.

Although Canada remains open to private equity investment, private equity firms may nevertheless find themselves facing a steeper hill to climb when faced with the Bureau in 2025. Many of the newly introduced levers, including the structural presumption and expanded look-back period, enhance the Bureau's toolkit, and the year ahead will be telling as to how the Bureau plans to incorporate them into its enforcement approach to merger control in Canada.

25 Competition Bureau, *The new era of competition enforcement in Canada* (September 26, 2024), available at **https://www.canada.ca/en/competition-bureau/news/2024/09/the-new-era-of-competition-enforcement-in-canada.html**.

Major League Gains: Private Equity Investment in the North American Sports Industry

OVERVIEW

Private equity investment in the North American sports industry once again came into focus in late 2023 and throughout 2024, highlighted by the announcement of the National Football League ("NFL") in August 2024 that private equity firms would be permitted to acquire passive, minority stakes in NFL franchises.

North of the border, Maple Leafs Sports & Entertainment ("MLSE") grabbed headlines after it was announced that OMERS, one of Canada's largest pension funds, would acquire an indirect stake in MLSE for US$400 million. In September 2024, MLSE was in the news again with Rogers Communications announcing it would acquire Bell Canada's 37.5% stake in MLSE for a sum that puts the valuation of MLSE at C$12.5 billion. After the deal closes, Rogers Communications will be the 75% majority owner of MLSE.

Once the domain of high-net-worth individuals, the ownership of professional sports franchises has become serious business, with the so-called Big Five North American professional sports leagues (the NFL, National Hockey League ("NHL"), Major League Baseball ("MLB"), National Basketball Association ("NBA") and Major League Soccer ("MLS")) commanding nearly US$3.2 billion in average valuations for its franchises. The sale of a minority stake in the Philadelphia Eagles in December 2024 set a sports industry record, valuing the franchise at US$8.3 billion. With numerous global private equity firms now specializing in buying stakes in sports franchises, we expect to see PE investment and fundraising in the sports industry follow a hockey-stick trajectory over the course of 2025 and beyond.

This evolving landscape comes with significant opportunities for incumbent owners seeking liquidity, investors seeking diversification and significant returns, and sports leagues aiming to leverage private equity experience in franchise-adjacent investments involving real estate, hospitality, sporting equipment and media rights. This evolving arena has also posed challenges for investors, franchises and leagues alike that are unique to the asset class and that require careful consideration by private equity buyers.

BACKGROUND AND MAJOR PLAYERS IN THE PE SPORTS INDUSTRY

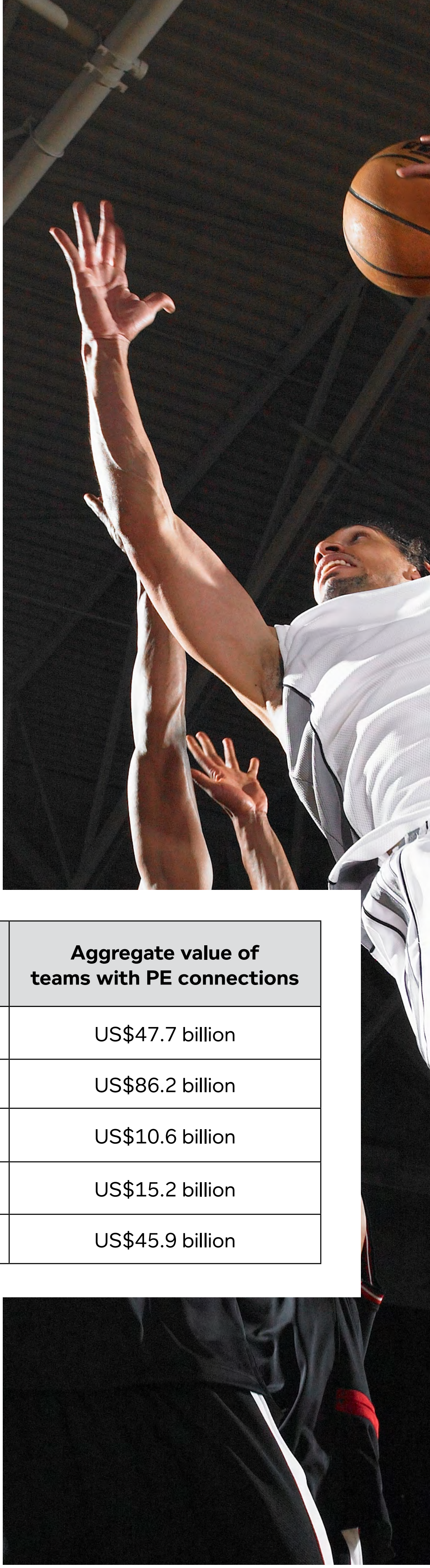
In the less-controlled European market, sports franchises (notably prominent European football (soccer) clubs) began to embrace private equity in the 2000s. In 2006, three American funds (Colony Capital, Butler Capital and Morgan Stanley) purchased a majority stake in what is now France's most famed soccer club, Paris Saint-Germain F.C. Those firms later exited their investment, selling the club to the Qatari sovereign wealth fund, Qatar Sports Investments, in 2011. By 2023, Qatar Sports Investments had sold a minority stake in Paris Saint-Germain F.C. to American firm Arctos Sports Partners, a deal that put the club's valuation at an estimated €4 billion. The European experience proved that owning a stake in a sports franchise could be a lucrative investment, and that trend has only intensified in Europe to the present day. Reporting from 2024 indicates that more than one-third of all European soccer clubs in the major European soccer leagues now have financial backing from private equity, venture capital or private debt firms.

The Big Five professional sports leagues in North America have recently begun to emulate their European counterparts and embrace private equity investment. The MLB led the charge in 2019 when it amended its ownership rules to allow private equity firms to acquire passive, minority stakes in its franchises. The NBA, NHL and MLS would each follow the MLB's lead shortly thereafter,

with the NFL finally giving in to pressure in 2024 and generally following the established investment rules of its sister leagues.

Private equity did not wait long to enter the fray. Months after the NBA opened its doors to minority PE investment, Arctos Sports Partners – a then-recently formed firm focused on buying stakes in major sports franchises – acquired a 13% stake in the NBA's Golden State Warriors and a 17% stake in the NBA's Sacramento Kings (which is also minority owned by Blue Owl Capital's "HomeCourt Partners", an open-ended, sports-focused fund). In 2021, RedBird Capital Partners acquired a minority stake in Fenway Sports Group (the operating company for the Boston Red Sox and Liverpool F.C.) in a deal that valued Fenway Sports Group at US$7.35 billion. Ares Management has since closed its inaugural Sports, Media & Entertainment Finance Fund, securing US$3.7 billion in commitments, of which approximately US$1 billion has been deployed across Spanish soccer (Club Atlético de Madrid), MLB (San Diego Padres), Formula 1 (McLaren Racing) and MLS (Inter Miami CF). As of December 2024, Ares Management had also purchased a 10% stake in the NFL's Miami Dolphins franchise for an undisclosed value. Other firms, including Galatioto Sports Partners, Silver Lake and CVC Capital Partners, have all launched strategies focused on sports franchise and sports-related investments.

With each of the Big Five North American professional sports leagues now open for business, there is no denying that private equity's influence on the North American sporting landscape will continue to grow. At the time of writing, 71 major North American sports teams cumulatively valued at US$205.5 billion have private equity connections. Pitchbook tracks the connections between the Big Five sports leagues and their PE connections, of which the following has been observed:



League	No. of PE-backed teams[25] (as % of league)	No. of PE-affiliated[26] teams (as % of league)	Aggregate value of teams with PE connections
MLB	10 (33.3%)	8 (26.7%)	US$47.7 billion
NBA	9 (30%)	11 (36.7%)	US$86.2 billion
MLS	7 (24.1%)	8 (27.6%)	US$10.6 billion
NHL	5 (15.6%)	5 (15.6%)	US$15.2 billion
NFL	2 (6.25%)	6 (18.8%)	US$45.9 billion

With the aggregate value of the NFL's 32 teams surpassing US$160 billion in 2024, the sales of stakes in NFL franchises will be sure to command significant investor interest and entice new players to enter the game.

26 Pitchbook generally considers a team to be "PE-backed" where a team has received PE investment.
27 Pitchbook generally considers a team to be "PE-affiliated" where the ownership group, or members thereof, have a connection to a private investment firm (e.g., as sponsor/chairperson).

MAKING A PE INVESTMENT IN THE SPORTS INDUSTRY – KEY THINGS TO KNOW

The structure of making long-term, passive, minority (non-controlling) investments is not unique to the sports industry. What is unique is navigating the complexities of the industry: specifically, dealing with dispersed ownership consortia, other franchise owners and complex league approval processes and investment restrictions, each of which requires experienced counsel to navigate.

Below are some of the challenges that private equity firms should consider when deciding whether to enter the arena of sports franchise ownership:

— **Governance and Control Issues** – Across each of North America's major professional sports leagues, private equity firms are limited to the acquisition of passive, minority stakes. League rules typically significantly limit an investor's control and rights to certain information and reporting at the operating company (franchise) level. While more typical for fund-of-fund, co-invest or GP stakes investors, such structures may not align with firms that traditionally specialize in buyout or growth strategies.

— **League Approvals** – PE buyers can expect a significant level of due diligence to be performed on them by the franchise and/or leagues as part of a league's approval processes and procedures. Unlike traditional regulatory approvals, league-led approval processes can vary in duration and complexity and require attention to be paid to other factors beyond the balance sheet (something we have highlighted in a **separate publication**). Unlike traditional investments, firms should also be prepared to have frequent interaction with the relevant leagues in which their franchises are operated, which, as alluded to above, can include requests for direct interaction with a firm's underlying investors and principals. For firms seeking to raise new sports-focused funds, attention should be paid to the terms dictating a GP's ability to procure and provide confidential information concerning underlying beneficial owners to comply with league requests and provisions requiring notice of any events at the beneficial ownership level that can cause reputational impairment to the franchise and/or league vis-à-vis the fund's investment in a franchise.

— **Holding Periods** – Investments in sport franchises require lengthier hold periods, both as a result of league rules mandating certain hold periods and league approvals over exits. These investments often result in a holding period of 10 years or more, which exceed typical holding periods to which PE firms are more accustomed. As a result, exit timing and strategies should be front of mind. For firms sponsoring sports-focused funds, the decision to utilize a closed-end or open-end fund structure is critical, as is consideration to management fee and carry structures in the context of the extended hold period and without periodic distributions from the operating company (franchise). These features suggest that long-term institutional investors such as sovereign wealth funds and pension plans are potentially well-suited for franchise investments.

— **Remedies** – Remedies for an investor in the context of a passive, minority interest are typically quite limited and a PE firm will largely be "along for the ride". Standard key person (i.e., owner) protection may not be available in the context of a franchise investment.

— **Possible Exit Risks** – Before exiting their investment, PE investors will need to have cleared any mandatory holding periods, at which point they may still require formal approval from the league, the other majority owner(s) of the franchise or both. The NFL's new rules exemplify the possible "regulatory" challenges that might be encountered on an attempted exit. Moreover, although the pool of possible investors has expanded with the entry of private equity, the market remains relatively shallow. These factors could become obstacles when attempting to execute on a potential exit via secondary sale or otherwise. To reduce risk, investors should be sure to understand the nature of any potential exit restrictions at the time of investment, including the nature of the applicable regulations and contractual terms governing the investment, and should be prepared to work closely with the league and other owners in the context of a sales process.

HOME-ICE ADVANTAGE: THE CANADIAN EXPERIENCE

Although it can be expected that the majority of transactions will be concentrated in the United States, especially following the NFL's announcement earlier in 2024, there is a glut of untapped potential north of the U.S. border.

There are numerous Canadian professional sports franchises across all of the major North American leagues (except the NFL). The ownership restrictions across the major leagues are equally applicable in the context of those leagues' Canadian franchises, and the general M&A process in Canada is very similar commercially and legally to the process in the United States. Although current ownership of Canadian franchises is already quite consolidated (e.g., Rogers Communications' 100% ownership of the Toronto Blue Jays and MLSE's ownership of the Toronto Maple Leafs and Toronto Raptors), most Canadian franchises across the NHL and MLS are not currently PE-backed. In recent years, NHL teams have benefited from increasing broadcast revenues, league revenue sharing and salary cap rules containing personnel costs. Median operating margins for NHL teams have tripled since the 2018–2019 season (now averaging US$635 million annually), in part because of the league's long-term agreements with Disney and Turner Sports signed in 2021. Further, the Professional Women's Hockey League, the Women's National Basketball Association, the Canadian Football League and both men's and women's soccer leagues emerging across the country could present future opportunities as the PE investment trends gains further steam in North America.

RELATED OPPORTUNITIES FOR CANADIAN PE INVESTMENT

PE investment opportunities also exist outside the world of minority franchise investments, and such investments are often able to be made on more traditional terms without ownership restrictions and limited governance rights. Based on the flurry of related M&A activity in the last 12 months, the underlying drivers of franchise revenue (e.g., media rights deals, merchandising and franchise-branded products) have proven to remain in high demand and be highly valued. In just the last few months in Canada, Swedish private equity firm Altor Equity Partners acquired a significant majority stake in Canadian equipment manufacturer CCM from Birch Hill Equity Partners; Fairfax Financial, a Canadian holding company, acquired a controlling stake in Peak Achievement Athletics, owners of Bauer Hockey, Cascade and Maverik Lacrosse, from Sagard; and Rogers Communications acquired Bell Canada's 37.5% stake in MLSE for C$4.7 billion. Given the many similarities between Canadian and U.S. legal frameworks, investments into Canadian franchises, the surrounding sports ecosystem and other global sports assets can be accomplished using Canadian legal structures that are efficient and predictable.

Canadian Tax Issues for Private Equity Investors

The following select issues will impact deals and tax structuring for private equity investors over the next year.

REPORTABLE TRANSACTIONS/MANDATORY DISCLOSURE RULES REPORTING

Canada has new mandatory disclosure rules, which include the reportable transaction rules. Such rules mandate disclosure of various reportable transactions to the Canada Revenue Agency (the "CRA"). Failure to timely report can result in significant penalties and extended tax limitation periods. Such rules affect both PE investors and relevant portfolio companies.

A "reportable transaction" is a transaction where: (1) the transaction (or any transaction in the series of transactions) is an "avoidance transaction" and (2) the avoidance transaction (or series of transactions) includes a "hallmark" which may involve a contingent fee, confidential protection or contractual protection (as defined under the mandatory disclosure rules). An avoidance transaction exists if it may reasonably be considered that one of the main purposes of entering into such transaction (or a series of transactions, including such transaction) is to obtain a "tax benefit".

The most common issue faced in commercial transactions and investments relates to "avoidance transactions" which implicate "contractual protection". The other triggers are not addressed here.

The avoidance transaction often arises because of the breadth of the "series" concept and the existence of tax-driven elements of a transaction or related transactions.

The contractual protection hallmark is generally met where the taxpayer (or a person that has entered into the avoidance transaction for the benefit of the taxpayer), an advisor, a promoter or a person that does not deal at arm's length with any of the foregoing, receives "contractual protection" in respect of the avoidance transaction or series. Contractual protection may include insurance, compensation, an indemnity or a guarantee. However, in order to be considered contractual protection, the protection must generally protect a person against a failure of the transaction or series to achieve any tax benefit or be in respect of a dispute related to a tax benefit.

The CRA has provided updated administrative guidance intended to shield certain transactions and certain common protections from these reporting requirements, including:[28]

— standard representations and warranties in connection with mergers and acquisition transactions and traditional representation and warranty insurance in relation thereto;

28 https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/mandatory-disclosure-rules-overview/guidance-document.html.

- insurance relating to an arm's-length sale of a business that is linked to pre-closing period tax indemnities or relating to tax attributes;
- insurance relating to 88(1)(d) bump reorganization covenant protections or "taxable Canadian property" risks, in connection with acquisition transactions;
- standard commercial indemnities which do not contemplate a specific identified tax benefit; and
- commercial loan agreement tax gross-up clauses and related indemnities and similar provisions in ISDAs.

The CRA has also commented that, generally, insurance or protections that cover (other) specific identified tax risks would not be shielded from being reportable under the mandatory disclosure rules.

PE investors should bear the reportable transaction rules in mind when negotiating investments and transactions and in addressing different strategies to manage risk. Obtaining specific indemnities for specific tax risks may generally involve mandatory disclosure rules disclosure to the CRA.

TAX-AUDIT PRIVILEGE/ACCOUNTANTS

Tax-audit risk affects the overall risk and economics of any portfolio investment held by PE investors. Minimizing the scope of such tax audits de-risks the investment. One of the means to narrow disclosure to the CRA in the context of an audit is to refuse to disclose certain documents, advice or communications in reliance on legal privilege.

Unlike in certain other jurisdictions where a confidential privilege-like protection is extended to documents and communications exchanged with accountants, such protections do not exist in Canada.

The recent Canadian Tax Court decision in *Coopers Park Real Estate Development Corporation*[29] addressed this issue and the court essentially ruled that privilege did not apply. Consequently, certain documentary disclosure was required to be made to the CRA.

The Coopers Park parties had engaged a law firm affiliate of KPMG, Moskowitz Law, to provide tax law advice and Moskowitz Law had engaged KPMG as its agent to support the provision of the legal advice. Another law firm was also engaged, but its relationship with KPMG was less clear from the retainer letters and other documents. Many of the challenged documents and communications were between KPMG and the other law firm. In some cases, KPMG provided independent advice to the Coopers Park parties. The court refused to protect (as a privileged communication) either the communications between KPMG and the other law firm or the direct advice from KPMG.

PE investors should bear in mind the potential benefits of privilege in relation to confidential or sensitive communications. Such investors should consider having their lawyers appropriately document the scope of the engagements and also arrange for the indirect involvement of relevant accountants, valuation advisors and other non-legal advisors. These steps can help to secure valuable privilege.

CROSS-BORDER CONVERTIBLE DEBT

PE investors often look to acquire convertible debt in Canadian portfolio companies. This provides a fixed priority return with potential equity upside. If the economic cycle turns, the priority associated with a credit instrument will be valuable.

Non-Canadian PE investors which acquire convertible debt of a Canadian issuer will want to minimize Canadian withholding tax on the various payments under such debt, such as regular periodic interest payments and on deemed interest associated with any conversion premium (i.e., the excess of the value of the shares into which the debt is converted over the issue price of the debt).

Canada's domestic tax legislation exempts from interest withholding tax most interest paid on debt held by an "arm's length" person. However, where interest is "participating debt interest" ("PDI") under the *Income Tax Act* (Canada), as amended (the "Tax Act"),[30] withholding tax will apply at a rate of 25%, subject to any applicable tax treaty relief. The definition of PDI generally includes interest all or any portion of which is contingent or dependent on the use of or production from property in Canada or that is computed by reference to revenue, profit, cash flow, commodity price or similar criteria or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.[31]

29 *Coopers Park Real Estate Development Corporation v His Majesty the King*, 2024 TCC 122.
30 Statutory references herein are to the Tax Act, except as otherwise indicated.
31 There are exemptions from PDI for certain interest described in the "fully exempt interest" definition and for "excluded obligations" described in ss. 214(8).

There is a concern that the portion of the interest arising on a conversion of the debt into shares (i.e., the conversion premium that is deemed to be interest under the Tax Act)[32] would be determined to be PDI. The consequent concern is that all interest on the convertible debt (including regular periodic interest) could constitute PDI given the "all or any portion of" element of the PDI definition.

There are various solutions to managing the withholding tax risk associated with cross-border convertible debt issuances.

The CRA has provided an administrative safe harbour for qualifying "standard convertible debt" offerings.[33] CRA has generally taken the position that regular periodic interest payments on such qualifying convertible debts do not constitute PDI and, similarly, that the deemed payment of interest arising from conversion premium on such qualifying convertible debts does not generally constitute PDI. PE investors may rely on such administrative statements where there is comfort that the particular debt satisfies the "standard convertible debt" criteria.

PE investors that have a qualifying treaty blocker or that have qualifying investors,[34] which in each case qualify for the benefits of the Canada-U.S. Income Tax Convention (the "U.S. Treaty"), can often get comfortable that the 0% interest withholding tax provision in the U.S. Treaty should exempt interest paid on a convertible debt held by such a blocker or indirectly by qualifying investors. Although the 0% provision under the U.S. Treaty is not available for participating interest described in Article XI(6)(b) of the U.S. Treaty, the participating exclusion in the U.S. Treaty is a more narrow definition than Canada's PDI provision.[35]

Apart from the PDI-related interest-withholding-tax issues, PE investors will need to consider the following potential risks, depending on the particular structure and the convertible debt terms: (1) interest withholding tax arising from being considered to be a "non-arm's length" person in relation to the debt issuer;[36] (2) interest-deductibility issues arising from Canada's thin-capitalization rules; and (3) deemed equity withholding tax arising as a consequence of denied interest expense under Canada's thin-capitalization rules.

PE investors that are considering convertible debt investments that can't manage the withholding tax through the CRA administrative positions or through the U.S. Treaty should also consider convertible preferred equity investment structures or investments where the "equity kicker" is bifurcated from the underlying preferred fixed-income element of the investment.

32 Refer to ss. 214(7).

33 Refer to CRA docs. 2013-0509061; 2021-0911911.

34 In either case, such blocker (such as a U.S. "C" corporation) or such investors should be "resident" of the U.S. for purposes of the treaty, should be the beneficial owner of any interest, should qualify for benefits pursuant to the limitation on benefits provisions, and should ensure the hybrid denial rules are not engaged under the U.S. Treaty.

35 The definition in Article XI(6)(b) essentially focuses on income, cashflow, distributions and changes in the value of debtor property.

36 This status will include any equity ownership in the issuer as well as any deemed equity ownership in the issuer (including that arising from the equity conversion rights that form part of the convertible debenture) as a result of ss. 251(5)(b), as well as other factors.

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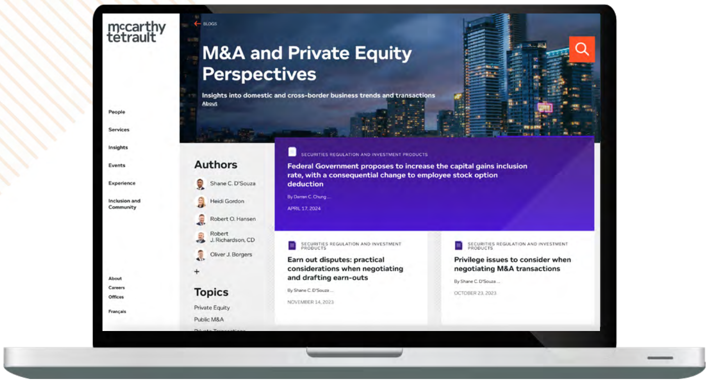

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Our private equity team delivers practical advice and innovative solutions to our private equity industry clients in an increasingly complex business environment. Such clients include numerous large and mid-market private equity firms based in Canada, the United States and elsewhere, as well as Canadian pension funds, international sovereign wealth funds and family offices. The members of our private equity team are entrepreneurial and business-minded lawyers who advocate for our clients at every turn to achieve for them the best outcome possible. As active participants in the private equity industry, we are able to advise our clients on key trends and issues, mitigate risk and apply innovative strategies to acquisitions, dispositions, fund formations, joint ventures and other transactions. With seamless collaboration among our industry groups, offices and foreign counsel across the globe, McCarthy Tétrault helps our clients achieve success.

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