OUTLOOK SERIES 2021
Private Equity & Investments

On Target

2021 Private Equity Outlook

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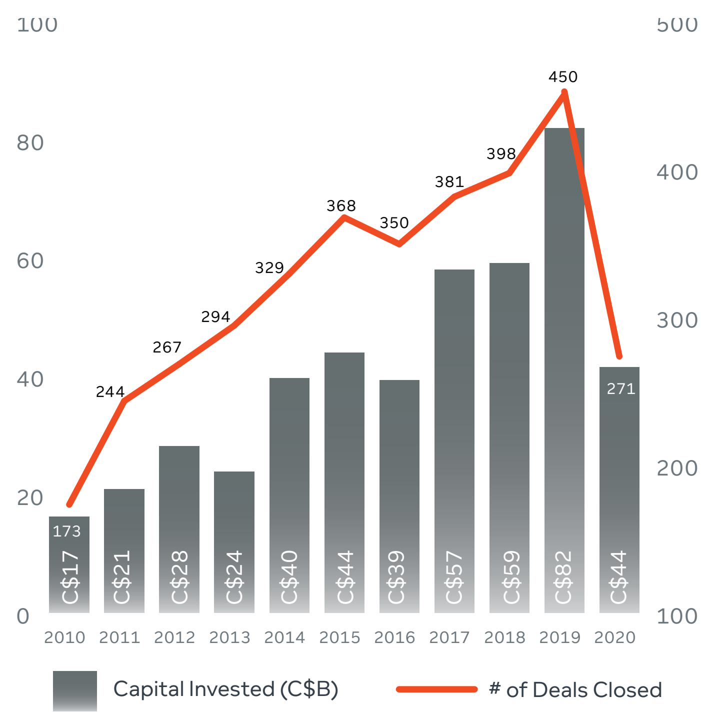
2020 in Review: The Numbers

Not unexpectedly in the bizarre year that was 2020, Canadian private equity activity suffered a setback. As of December 11, 2020, the total private equity capital invested in Canada in 2020 hovered around $44 billion, which suggests investment will fall well short of the $81 billion, $60 billion and $58 billion recorded for 2019, 2018 and 2017, respectively. Deal activity tells a similar story. With 271 deals closed as of December 11, 2020, the Canadian private equity industry is on track to post low numbers that have not been seen since the early 2010s, in stark contrast to the 450 deals that closed in 2019. Despite the understandably quieter year amidst COVID-related restrictions and uncertainty, however, there are positive signs for the Canadian private equity industry, including that (1) mostly pre-pandemic, first-quarter 2020 investments equalled $17 billion, a first-quarter record high, (2) deal activity is back on the rise, with 73 deals closed in Q3, versus only 37 in Q2, and (3) several marquee investments closed despite the challenges of the pandemic economy, including AIMCo and KKR's $2.9 billion acquisition of the Coastal Gaslink Pipeline.

Canadian PE Deal Flow by Year

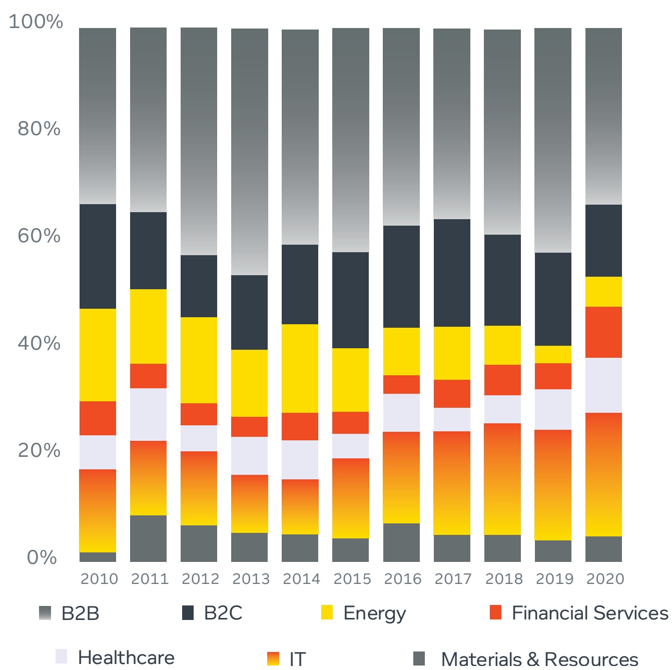


CANADIAN PE BY SECTOR

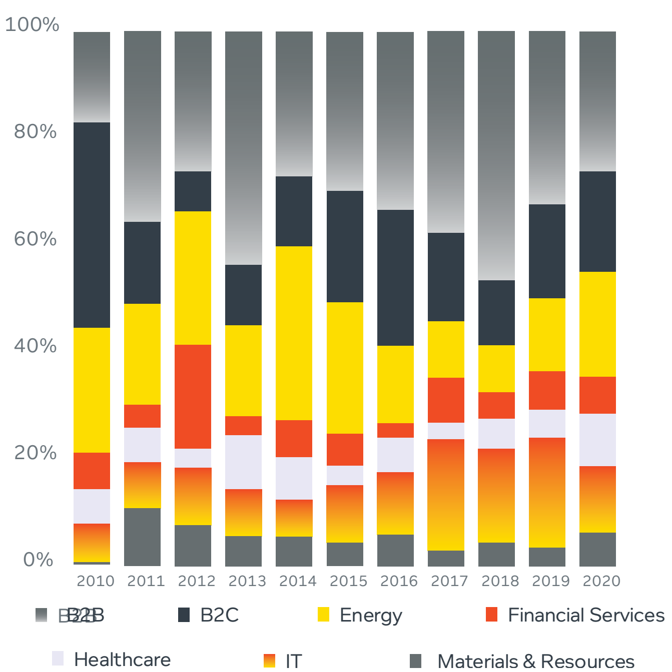
2020 deal count in the healthcare, financial services and energy sectors will likely register growth on a year-over-year basis compared with 2019. The IT and materials & resources sectors are trending towards a moderate slowdown in the number of deals, while the B2C and B2B sectors are on track for record-low activity levels. Measured

by total investment amount, the materials & resources and healthcare sectors are the hot sectors, on track for record-high years, with other sectors – such as energy, B2B, financial services, IT and B2C – experiencing a major tightening of investment, with year-over-year decreases ranging from 45% to 67%.

Canadian PE Deals (#) by Sector



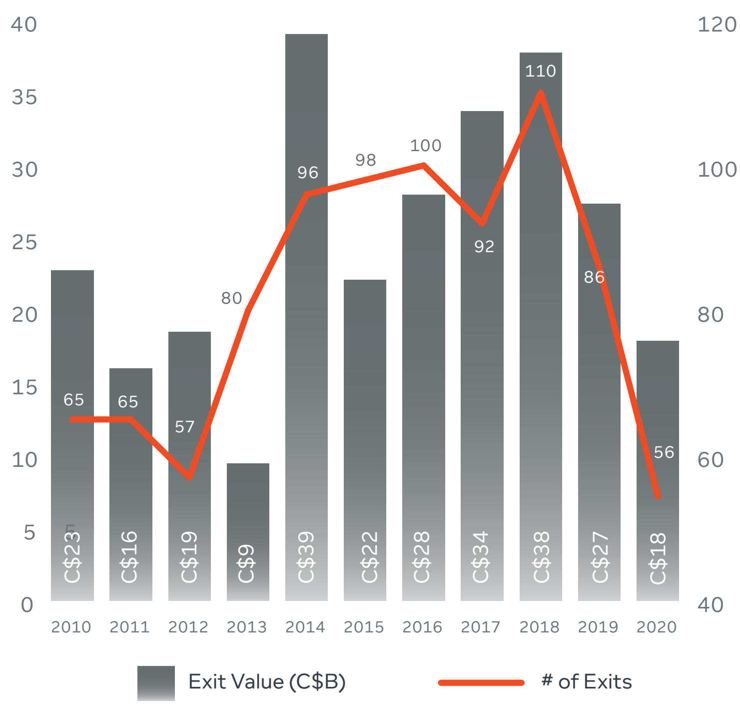
Canadian PE Deals (C$B) by Sector



CANADIAN PE-BACKED EXITS

Both deal value and the number of Canadian private equity exits in 2020 continued the downward trend that started in 2019. As of December 11, 2020, private equity firms exited 56 companies for a total value of $18 billion, which, if annualized, would represent a year-over-year decrease of 31% in total activity and in total value.

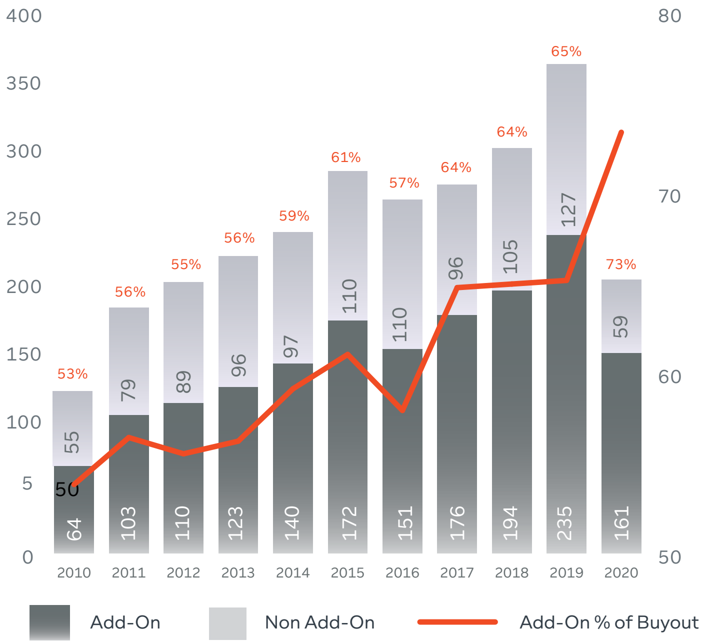
Canadian PE Exit Activity



CANADIAN ADD-ONS

For a fourth year in a row, add-on activity accounted for a record proportion of all buyout activity as of December 11, 2020, representing almost three quarters of overall buyouts. Both the number of add-on transactions and non-add-on transactions fell in 2020, but the non-add-on transactions tumbled more, with numbers not seen since 2010. As funds continue to specialize and build expertise in specific industries, and with the potential opportunities for firms to cheaply acquire distressed assets, we expect early 2021 to see a proliferation of add-on transactions.

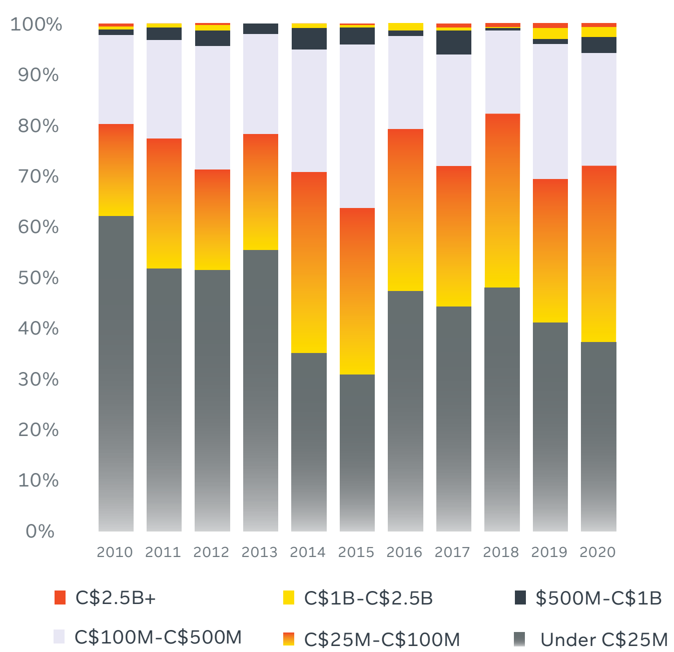
Canadian PE Add-On Activity by Year



CANADIAN DEAL SIZE

The number of 2020 private equity deals with deal values in the highest tiers ($500 million and more) is expected to remain relatively consistent with the 2019 tally. However, deals in the under $100 million range and the $100 million to $500 million range are on track to drop by a staggering 32% and 51%, respectively.

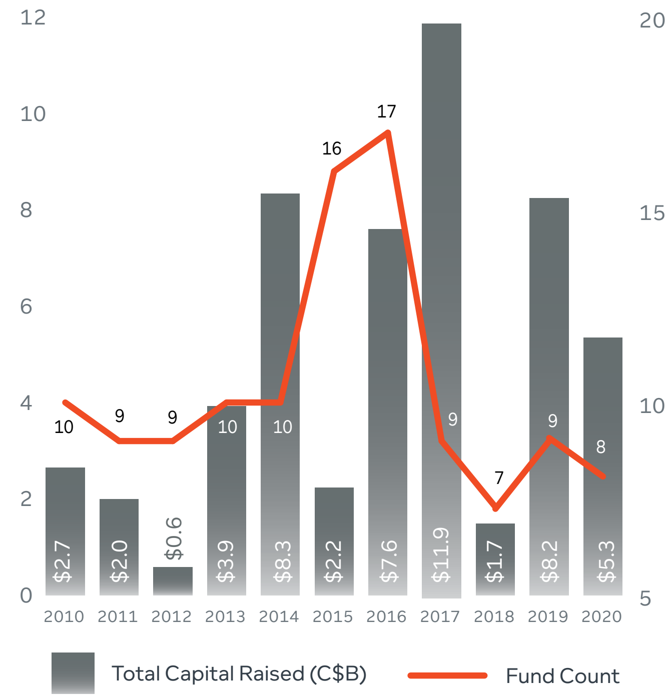
Canadian PE Deal Activity by Size



CANADIAN PE FUNDRAISING

The total private equity capital raised as of December 11, 2020 was $5.34 billion, which represents a decrease from $8.24 billion raised in 2019, though nowhere near a return to the much lower $1.67 billion level of 2018.

Canadian PE Fundraising by Year



As we look to 2021, in addition to wondering whether the private equity industry will see a flurry of deal activity and a return to pre-2020 numbers as the uncertainty surrounding the pandemic and the U.S. election subsides, and whether such activity will be fuelled by distressed M&A, there are several other trends that we are following closely. One trend of interest is the mainstreaming of environmental, social and governance (ESG) issues and the growth of ESG-focused investment vehicles. Also, we will track the movement in the technology sector and, in particular, whether the industry will see a continued interest in the acquisition and spinning out of technology platforms given that technology-platform providers have generally withstood the negative impacts of COVID throughout 2020. Another area of interest is the potential effect of increases to net-benefit thresholds, extended review timelines and a broadened application of national security screens in the realm of Canada's foreign investment rules. We will also analyze the use of Canadian limited partnerships and of SPACs in the private equity industry. Finally, we expect to see capital invested in increasingly creative ways to account for the unique challenges and risks facing companies during the pandemic.

The Mainstreaming of ESG

Private equity firms and other players in the private capital industry have variously been grappling with, heralding, adapting to, embracing, prioritizing and proselytizing environmental, social and governance (ESG) issues over the past several decades. ESG issues cover a very broad agenda, and the weight and emphasis that is given by sponsors, limited partners and other investors to the many individual categories and particular elements thereof vary considerably.

In 2020, although climate change and good governance issues remained as crucial as they had become in recent times, the spotlight shone on ongoing racial injustice and inequality in the U.S., Canada and elsewhere led to the striking emergence of these and related social considerations as important priorities within the private capital industry. Sponsors, portfolio companies and investors have been increasingly pressured over the course of the past year to not simply voice public support for social justice issues, but also to reflect the principles of social equality and opportunity in boardrooms, executive suites and more broadly across personnel ranks.

Not long ago, many sponsors treated ESG factors merely as check-the-box requirements that were necessary to remain onside of the internal policies of their large, institutional and often state-affiliated investors. Today, investors in Canada and elsewhere are increasingly using ESG considerations to better understand and predict financial risks and opportunities. ESG criteria have become essential tools to assess value, rather than being touchstones to signal or promote values. There is increasing evidence that the adoption of stringent ESG criteria by sponsors leads to stronger fund performance. ESG has therefore evolved from a form requirement to a key growth strategy.

There are over 150 investment managers and asset owners in Canada (together with thousands of others worldwide) which are signatories to the United Nations-supported Principles for Responsible Investment (UNPRI), including the five largest Canadian banks and most of Canada's largest pension funds. UNPRI is an initiative to promote responsible investment across various asset classes, including private equity, and requires each signatory to publicly report on its responsible investment activity.

On November 25, 2020, the chief executive officers of Canada's eight leading pension funds – representing approximately $1.6 trillion in assets under management – issued their first-ever joint statement on any topic. They called on investors and all companies to provide consistent and complete ESG information in order to strengthen investment decision-making and to better assess and manage their collective ESG-risk exposures. These pension funds also committed to strengthening their own ESG disclosure and to allocate capital to investments that are best placed to deliver long-term sustainable value creation.

In addition to the very broad integration of ESG criteria and goals across private equity funds generally, there is a growing number of equity investment vehicles focused exclusively or principally on ESG matters. The World Bank estimates that assets under management by impact-focused private equity funds globally have increased by approximately 19% annually over the past 5 years.

All of this continues to have very broad and meaningful impacts on the operations of private equity firms. During the fundraising process, sponsors will need to have an ESG policy and reporting framework (at the fund level and, if applicable, at the portfolio-company level) in place and will need to respond to still non-standardized ESG questionnaires from, and other due diligence investigations by, potential investors, including questions about how sponsors are incorporating ESG metrics into evaluating portfolio company performance. Sponsors also need to consider the availability of ESG-responsible exits that do not compromise their, their investors' or their portfolio companies' social principles or objectives. And in the context of increased ESG-related regulation and quasi-regulation, sponsors which fail to manage ESG issues effectively face increasing legal, reputational and financial challenges and risks.

Creating Greater Value in Tech Companies

As was noted in PitchBook's June 2020 "Buying out Public Tech Companies" report, private equity firms have shifted their approach to technology buyouts, prioritizing growth over profitability. Firms are listing or taking public technology companies private sooner than they have historically, and at higher valuations. In addition, despite the impact of the COVID-19 pandemic, the privatization trend in the wider technology market has continued throughout 2020 with interest in the technology M&A space remaining high, as highlighted by Salesforce's early December 2020 announcement of its US$27.7B blockbuster acquisition of Slack. Given the overall increasing value in both public and private technology targets, private equity firms are taking a close look at the growth potential that technology platforms within traditionally non-pure-play technology companies can create and considering spinning out existing technology platforms from such portfolio companies in order to extract additional value.

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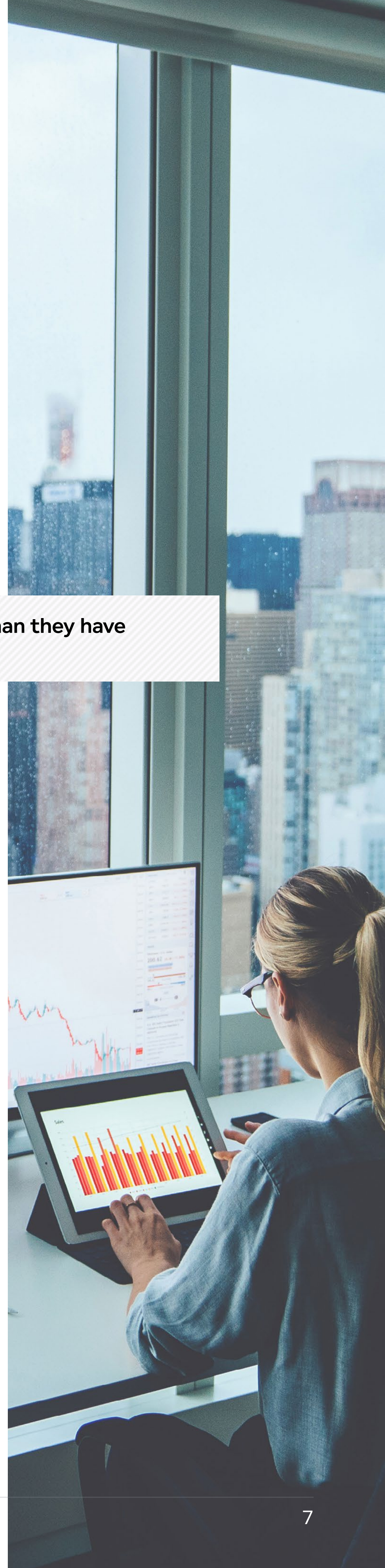


Looking at these technology platforms as stand-alone businesses can generate value for private equity investors. Some examples of leveraging these platforms include: offering technology services and data strategically to other companies in a sponsor's portfolio (or more broadly to the public); retooling existing software platforms to focus on industry verticals; or by distancing the technology platform from the host company's more sensitive products, infrastructure or data.

As technology companies, and software platforms more generally, continue to attract interest not only from private equity investors but also from strategic players, we are likely to continue to witness creative ways for investors to position these assets as stand-alone value generators
and/or platforms in their own right.

Foreign Involvement in M&A Transactions

In recent years, the review thresholds under the *Investment Canada Act*'s net benefit regime have increased significantly. Two of the three thresholds that will apply to most direct acquisitions of control of a Canadian business by non-state-owned enterprise investors[1] from World Trade Organization (WTO) Member States have increased significantly. The private sector trade agreement investors threshold increased in 2020 to $1.613 billion in enterprise value of the target, and the threshold for investors from other WTO Member States increased in 2020 to $1.075 billion in enterprise value of the target.[2] These increased thresholds have

1 The threshold for direct acquisitions of Canadian businesses by state-owned investors from WTO Member States is $428 million (for 2020) in gross book value assets. The enterprise value thresholds and WTO state-owned enterprise threshold are each expected to go down slightly in 2021.

2 The threshold for the direct acquisition of control of a Canadian business that carries on a cultural business by a non-state-owned enterprise investor from a WTO country remains the same: $5 million in asset value of the target.

contributed to a decrease in the number of transactions subject to a net-benefit review (falling from 22 in the 2016-2017 fiscal year to 9 in both the 2017-2018 and 2018-2019 fiscal years).[3]

Although these increased thresholds represent a shift in the federal government's emphasis away from net benefit reviews (focused on economic benefits to Canada), national security is increasingly in the spotlight. The national security review regime applies to any investment that involves a non-Canadian, regardless of size and whether control was acquired. Certain industries are likely to attract greater scrutiny, such as technology, critical infrastructure and defence. The government's Guidelines on the National Security Review of Investments set out a non-exhaustive list of activities that may relate to national security. Although these guidelines provide some insight as to when a national security review may occur, there are notable gaps, and foreign investors often receive limited transparency during the national security review process. If the government believes that a transaction may be injurious to national security, the transaction can be blocked, subjected to conditions or, if already implemented, subject to remedies that can include divestiture. From 2012 through 2019,[4] four transactions were blocked, and various others were subjected to conditions or were abandoned.[5] The majority of the national security reviews that were ordered were in respect of investors from China (14 orders). In response to the pandemic, the government extended the timelines for national security screening, and applied the national security screen to a broader range of investments, including those relating to public health.

Canadian Limited Partnerships: An Attractive Investment Vehicle for Foreign Investors

Foreign investors should consider a Canadian limited partnership as a vehicle when contemplating international investments. Limited partnerships registered in Canada can provide significant advantages as investment vehicles, such as:

- flow-through entity status for Canadian tax purposes;
- ease of formation and minimal reporting obligations; and
- a recognized, well established jurisdiction with a body of law on which investors can rely and a respected judicial system to govern it.

GENERAL CHARACTERISTICS OF CANADIAN LIMITED PARTNERSHIPS

Under Canadian law, limited partnerships are registered arrangements formed between two or more persons that are carrying on a business in common with a view to profit. There are two distinct categories of partners of a limited partnership:

- **limited partners:** do not take an active role in the limited partnership's operation and generally benefit from limited liability protection; and
- **general partners:** are responsible for managing the limited partnership's operation and have unlimited liability for the partnership's debts.

Neither a general partner nor a limited partner is required to be a resident of Canada to register a limited partnership.

FLOW-THROUGH STATUS FOR CANADIAN INCOME TAX PURPOSES

Under the *Income Tax Act* (Canada), a limited partnership is not treated as a separate taxable entity. Instead, a limited partnership established in any province is considered a flow-through entity for Canadian income tax purposes. As long as a limited partnership does not carry on business in Canada, is not a "Canadian partnership" (i.e., a partnership

3 Annual Report, Investment Canada Act, 2018–2019, December 27, 2019.
4 Aggregated statistics regarding the national security review process were first published in 2012. At time of publication, 2020 statistics were not publicly available.
5 Since the implementation of a formal national security review process in 2009, 22 national security review orders were issued between 2012 and 2019. In all but three cases, the transaction was blocked, abandoned or subjected to conditions.

all the members of which are resident in Canada), and is not a specified investment flow-through partnership, then the limited partnership will not be subject to Canadian annual reporting obligations for income tax purposes (noting, however, that a return may be filed as a matter of course in order to start the income tax reassessment period). Profits and losses of the limited partnership can flow through to the non-resident partners of the limited partnership (without incurring Canadian withholding tax), and the non-resident partners will pay tax as required in their country of residence. Notwithstanding the flow-through status for Canadian tax purposes, a limited partnership may elect to be treated as a corporation for U.S. tax purposes. Certain passive income payments, such as rent, paid by a Canadian resident to a non-Canadian partnership would be subject to Canadian withholding taxes. This should be considered before the limited partnership acquires assets in Canada.

EASE OF FORMATION

Each province in Canada has legislation that governs the formation and operation of a limited partnership, and the legal formalities in establishing a limited partnership are fewer than to form a Canadian corporation. Each province offers its own advantages in establishing a limited partnership (e.g., Québec may be a great option for those investors that are more familiar with French and with the civil law system).

A declaration to establish or register a limited partnership is required to be filed with the applicable provincial regulatory body, which generally requires only limited information, such as: (1) the name under which the limited partnership will operate, (2) the general nature of the limited partnership's business, (3) certain information regarding the partners of the limited partnership and (4) the limited partnership's principal place of business. In certain provinces, the declaration of limited partnership must be periodically renewed (e.g., in Ontario, it's every five years). Typically, partners enter into a limited partnership agreement, which governs the management of the limited partnership and provides a great deal of flexibility regarding contributions, distributions and other partnership matters. Limited partnership agreements can be simple or complex, depending on the individual needs of investors.

ESTABLISHED JURISDICTION

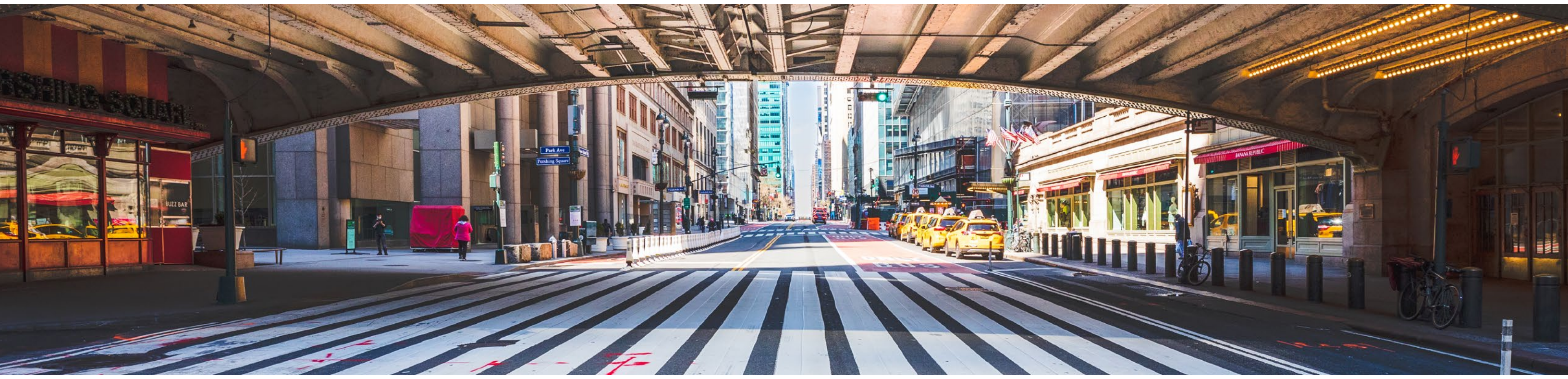
Canada is a highly respected jurisdiction and investors can rely on established partnership law with confidence. Limited partnerships are already an established structuring alternative in Canada and are internationally recognized. For example, many large energy projects utilize limited partnerships, and limited partnerships are able to open and hold Canadian bank accounts.

Foreign investors considering investment (in Canada or elsewhere) should consider a limited partnership as a structuring alternative. We have extensive experience establishing limited partnerships in jurisdictions across Canada and can assist in evaluating whether a Limited partnership would be a suitable investment vehicle.

SPAC Trends in the U.S. and Canada

2020 has been a record-breaking year for special-purpose acquisition companies (SPACs) in the United States. As of November 2020, there have been over 182 SPAC initial public offerings in the U.S., which have raised US$76.3 billion in the aggregate. This far outpaces the 59 SPAC IPOs in the U.S. that raised US$13.6 billion in 2019.

The spike in SPAC launches has been especially notable among U.S. private equity firms, with numerous sponsors opting for SPACs as an alternative financing vehicle in the wake of the COVID-19 pandemic and the related economic uncertainties. During periods of market volatility, SPACs are an attractive investment vehicle because they allow sponsors to raise funds that are ready to be deployed, while waiting for the best opportunities to make an acquisition.



Another benefit of SPACs is that they offer sponsors an avenue for raising funds from retail investors, allowing them to broaden their investment base and avoid certain challenges of raising funds from traditional limited partner investors. SPACs can also be more lucrative to sponsors than managing a private equity fund, in particular when certain assets in the existing funds are underperforming, putting the earning of carried interest at risk.

Thanks to a number of recent SPAC deals backed by big name sponsors, including Apollo Global Management and TPG Capital, SPACs have gone from being viewed as a last-resort capital-raising option, to becoming a legitimate investment option.

Certain limited partners have raised conflict-of-interest concerns surrounding private equity sponsors raising and managing traditional funds while also utilizing firm resources to launch and manage SPACs, which do not benefit fund limited partners. As well, some limited partners are concerned about traditional funds and SPACs potentially competing for prime deals. Another concern is that because SPAC sponsors are under time pressure to successfully close a deal before capital must be returned to investors, they may rush to close deals and overpay for acquisition targets.

Although SPACs have clearly taken off among U.S. private equity sponsors, the question of whether the trend will continue northwards to Canada remains to be answered. SPACs are relatively new in Canada, having only been permitted under new market regulations a few years ago.

Early Canadian SPAC deals have not seen consistent success. First-generation Canadian SPACs were able to raise large amounts of capital, but they failed to successfully deploy the cash. They could not compete with more established private equity firms for choice acquisition targets, and early SPAC investors actively used their votes to make or break deals. The result was that many of these early SPACs did not complete deals before their term expires, and SPAC founders were left out-of-pocket for the organizational and operational expenses incurred by the SPAC after capital was returned to investors.

There has been some recent SPAC activity in the Canadian capital markets, but to date none have been launched by Canadian private equity sponsors. With SPAC activity in the U.S. anticipated to continue increasing, it will be interesting to see whether the trend takes off among Canadian private equity sponsors.

Creative Investment Capital

Over the last nine months, portfolio companies in a number of Canadian industries have experienced significant financial challenges as the pandemic has impeded or prevented their normal operations. At the same time, the dry powder of North American sponsors has continued to grow, with a significant portion of new fundraising allocated to special situations and distressed opportunities. These funds continue to look for opportunities to creatively put their capital to work in this market. At the same time, otherwise healthy target companies are increasingly exploring additional

financing in order to shore up their balance sheet and survive the continued impact of the pandemic.

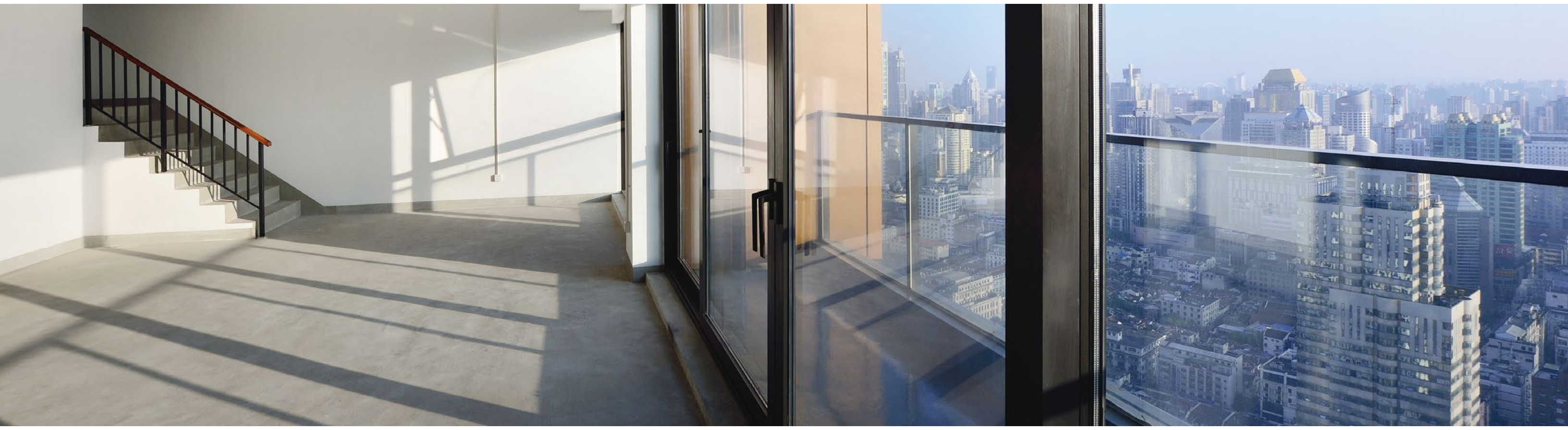
The liquidity challenges of these companies are highly particularized to the current market as well as to their specific industries and circumstances. For instance, there are companies which were thriving prior to 2020 whose operations (and cash flow) have almost entirely ceased pending the resumption of normal social activities; there are companies which have needed to make capital expenditures in order to survive in the new environment, such as by transitioning to an online marketplace or acquiring add-on targets to achieve the same objective; and there are companies experiencing unprecedented demand for their goods and services, such as in certain technology and healthcare sectors, and which are seeking to either monetize their increased valuation or bring in additional investment to capitalize on growth opportunities. The liquidity challenges of these companies are significantly heightened by the underlying uncertainty of how long the pandemic will last and the extent of its impact, as well as by shifting and sometimes unpredictable domestic and foreign government regulations aimed at mitigating the pandemic. All of these same factors create significant uncertainty for investors. The risk of uncertainty, of course, goes hand-in-hand with unique opportunities for reward.

For most portfolio companies in these circumstances, the least expensive source of capital is either additional debt from an existing lender or additional common equity from existing common equityholders. But there are, of course, numerous scenarios in which these sources of capital are unable or unwilling to inject additional funds. This has led companies to seek out capital solutions with third-party debt or equity providers that have the liquidity and appetite for investments in this market.

The capital solutions offered by these investors are often bespoke and highly negotiated with regard to the needs of the particular recipient and the investment mandate of the capital source. Investments may involve a range of securities, including convertible or non-convertible debt and preferred equity, common shares, warrants or a combination of the foregoing, with a package that is structured in a manner to appropriately account for the risk and reward of the individual investment. Of these, convertible preferred stock remains a natural mechanism to allow investors to structurally protect their investment in a downside scenario (by way of priority over common shares in a liquidation or by way of redemption) while enabling participation in the company's upside success (by way of conversion into common equity). But the tax and commercial objectives of each investment may also lead to a more tailored package of debt and equity that maximizes optionality for each party in the particular transaction.

These investments typically also include a variety of governance rights that are specifically tailored to the particular risks of the investment. Key areas of negotiation often focus on composition of the board of directors; veto rights over key matters and general voting rights; covenants regarding operations and financial metrics; and control and protections regarding additional capital issuances. Properly structured, the package of governance rights should work in tandem with the design of the securities to appropriately balance risk and reward for the company and its investors.

The market will remain highly dynamic in 2021, and a number of companies will undoubtedly experience increasing financial pressure. As companies seek liquidity solutions in the midst of this stress, we expect that capital will continue to be available from sponsors, provided that parties are creative and flexible in structuring investments to be attentive to the ever-changing circumstances in which we find ourselves.



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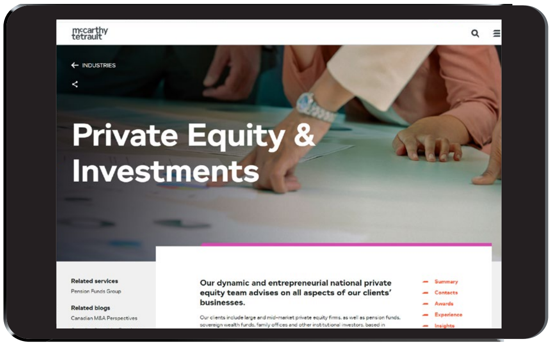

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As active participants in the private equity industry, we are able to advise our clients on key trends and issues, mitigate risk and apply innovative strategies to acquisitions, dispositions, fund formations, joint ventures and other transactions. 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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