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Private equity continues to drive deal activity

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Authors: John Groenewegen, Emmanuel Pressman

The 2019 year-to-date activity levels in the Canadian private equity (PE) space are strong, exceeding 2018 levels for the same period. In this article, we explore a number of key trends we observed.

Strong private equity market

According to Refinitiv, there was a total of $35.3 billion invested in 377 deals during the first three quarters of 2019. This represented an increase in deal value of 41%, compared to the same period in 2018. Buyout and related funds in Canada raised over $17 billion in the first three quarters, up 169% year over year.

Fundraising trends

Fundraising remained active in 2019. As reported by Prequin, there is now estimated to be approximately $2 trillion in capital under management or “dry powder” globally, with over half that amount targeting North America. Despite the need for sponsors to deploy that capital, the private capital markets showed continuing strength as sponsors continued to participate in a range of private offerings and capital raising transactions. Several sponsors returned to market and a number of new offerings raised fresh capital from first-time funds. This strong level of fundraising demonstrates sponsors’ ability to effectively deploy capital in recent years, allowing them to move on to raise successor funds. It also speaks to the continued focus of pension funds and other institutional investors on increasing exposure to the alternative assets space by investing in these PE funds. The glut of newly committed capital and the corresponding need for sponsors to deploy that same capital can be expected to foster the M&A markets and investment activity in 2020.

No significant changes in fundraising terms. The basic economic bargain between limited partners (LPs) (investors) and the general partner (GP) (PE sponsor) remained largely unchanged over the past year. However, there is a general trend toward incorporating terms which are more GP-friendly, echoing terms found in U.S. agreements.

In addition, some of the more successful funds have sought to include increased flexibility in their fund documents around how their investing program is implemented. For example, in some recent private equity funds we have seen a **longer fund life**. Although investors will generally pay more in aggregate fees if the fund life is extended, there is at the same time a recognition that compelling a sale of assets at the wrong time, due to the end of a fund’s term, is not desirable, particularly in economic cycles which are not following traditional historical patterns. Occasionally, investors will benefit from reduced annual fees for those years where the GP has elected to extend the life of the fund. Institutional investors such as pension funds often accept funds with a longer duration, as it aligns with their long-term

liability profile.

Co-investment rights remain a major focus for many institutional LPs. Such institutional players seek to enhance returns by investing in desirable assets alongside a trusted PE sponsor. Fund sponsors with a track record of offering co-investment opportunities are able to use the prospect of future co-investment to attract investors for whom this is important. PE sponsors often prefer to maintain flexibility as to which LPs will be offered these rights, and on what terms. It is critical that co-investors are able to act quickly to meet deal timelines and, for this reason, our experience is that the most active co-investors are sophisticated institutional investors with deep pockets.

Enhanced **disclosure about fees and fund expenses** is a general trend. This development has been imported from the U.S., where the SEC's continued scrutiny of this area – and resulting enforcement actions in respect of inadequate disclosure – has made fulsome disclosure of the components of fees and expenses prudent. Lengthy definitions outlining all possible expenses that can be incurred by a fund, as well as enhanced disclosure about allocation of expenses, fee offset provisions and related party fees, may well become the norm for funds in Canada.

The Institutional Limited Partners Association (ILPA) has produced a model limited partnership agreement for use by the industry. The ILPA's stated goal in publishing this model is to provide transparency and to reduce the complexity, cost and resources required to negotiate the terms of a PE fund. The model is investor-friendly, which is not surprising considering its source. It remains to be seen whether the ILPA model will have an impact on fundraising and negotiations among GPs and LPs. While it may prove to be a useful tool for comparison purposes, we expect that adoption of the model, or parts of it, will take some time (if it occurs at all), particularly as the norm has been for a fund sponsor to largely re-use the fund documents from its prior funds, which have already been negotiated with its investor base.

Deal climate

Canadian deal-making in the private equity arena sustained very active levels, driven by several factors including: cross-border inbound M&A flows; take-private transactions; sponsor-to-sponsor transactions; active deployment of capital by private equity funds; "buy and build" strategies by sponsor-backed portfolio companies; and facilitative debt capital markets. In 2019, examples included

- Blackstone's announced $6.2-billion acquisition of Dream Global REIT
- Onex Corporation's announced $3.5-billion acquisition of WestJet Airlines
- BC Partners' $5.2-billion acquisition of GardaWorld from Rhône Capital
- Platinum Equity's acquisition of Livingston International from Canada Pension Plan Investment Board (CPPIB) and Sterling Partners
- KKR's acquisition of Corel Corporation from Vector Capital

A noteworthy trend has also been the ongoing proliferation of co-investments, team-ups and consortiums involving Canadian pension funds and global private equity sponsors in their pursuit of foreign outbound transactions. In 2019, examples included

- CPPIB's participation in a consortium led by Hellman & Friedman, and including Blackstone, GIC and JMI Equity, to acquire Ultimate Software in a transaction valued at $11 billion

- Ontario Teachers' Pension Plan and CPPIB teaming up with private equity sponsored funds, including Apax Partners and Warburg Pincus, to acquire Inmarsat plc in a transaction valued at $3.5 billion

Infrastructure continues to attract significant interest from PE investors. Attraction to this asset class has been a long-term trend for institutional investors and pension funds. Infrastructure assets are generally perceived as less risky (they are often supported by a concession agreement or other secure income stream) and less affected by economic cycles, in addition to aligning well with the long-term liabilities of many pension funds. Sponsors (as well as pension funds directly) have seized the opportunity and are filling a funding gap where governments are reluctant to invest public funds.

Deal times are often faster than real times. Due to the robust transaction environment, the competitive market and high levels of "dry powder" chasing a finite number of deals, private equity players need to differentiate themselves – by speed of execution capability, track record and transaction certainty, for instance. Sellers have been able to shorten the period during which an auction is conducted and to demand shorter exclusivity periods, forcing buyers to act nimbly. In the same vein, sellers continue to look for deal certainty and limited recourse; more and more deals are being completed on the basis that there are no surviving indemnity obligations for sellers – even for fundamental representations – and buyers are expected to look only to representation and warranty (R&W) insurance for coverage. Competition for deals means that PE buyers are willing to take this approach, as well as to limit conditions requiring third-party consents to only the most material ones.

The use of R&W insurance continues to be prevalent in private equity deal-making. Although R&W insurance is becoming the accepted norm as the primary method of protecting buyers from misrepresentations, deals still get done in the Canadian market without it. As use of R&W insurance grows, it continues to be refined. Insurers have become increasingly comfortable insuring "no indemnity" deals. Insurers are also more willing to insure risks that have traditionally been the subject of policy exclusions such as environmental, tax and product liability, although these are fact-specific. This reflects the maturation of the product, as well as increased competition within the R&W insurance industry.

The financing environment remains highly competitive. Canadian banks are continuing to compete against both Canadian and U.S. banks on M&A financings. Deals are highly competitive, resulting in competition between banks on pricing and overall deal terms. The influx of U.S. alternative sources of credit into the Canadian market, including the credit arms of sponsors, has also resulted in the adoption of certain U.S. concepts in Canadian deals. These include a push for limited conditionality (known as "SunGard" provisions) by sponsors, as well as the right of sponsors to choose the counsel that acts for the lenders on the financing. Given the current market financing conditions, we expect these trends to continue into 2020.

M&A remains the preferred method of exit from PE investments, as in past years. While we have seen PE sponsors continue to pursue a "dual track" process on exit (i.e., preparing for a public offering while also marketing the asset through an auction process), very few Canadian IPOs were undertaken in 2019. This reflects the fact that public markets are not generating a premium to enterprise sales and demonstrates PE's bias toward a clean exit at a price certain.

We are seeing more sponsor-to-sponsor deals. This in part reflects an evolution in the PE industry; as more funds come to market and mature, they are compelled to find exits for their portfolio companies. Along with strategic buyers, other sponsors are a natural source of potential buyers. This trend may also demonstrate that assets are being sold prior to a PE sponsor extracting full value, suggesting that there is indeed a rationale for longer life funds.

Conclusion

We anticipate another strong year in Canadian private equity markets in 2020. The large amount of capital requiring deployment, together with favourable credit markets, should lead to significant deal activity. Although the medium- and long-term economic climates remain uncertain, the ability of private equity buyers to act quickly and opportunistically, in all phases of the economic cycle, can be expected to result in sustained levels of deal-making.