

Canadian Private Equity

Where do we go from here?

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Last year was a record year for private equity in Canada, but the record was set based on activity in the first half of the year. Canada's sound economic fundamentals and a strong Canadian dollar, among other factors, led to increased investment activity (incoming and outgoing) from both Canadian and foreign capital sources. In order to gauge perceptions from private equity participants in the midst of a dynamic period for Canadian private equity, Blakes and mergermarket conducted a Canadian private equity perceptions study. To provide context for the study and the environment in which it was undertaken, the following highlights some of the notable transactions in the past year as well as certain recent trends and developments affecting private equity in Canada.

Significant Canadian Private Equity Transactions in 2007

The highest profile Canadian private equity transaction last year was the approximately \$48 billion agreement to acquire Canada's iconic telecommunications company, BCE Inc., by Ontario Teachers Pension Plan, BCE Inc.'s largest shareholder, Providence Equity Partners and Madison Dearborn Partners. The heated bidding war included a number of consortia, including two competing bids led by prominent Canadian and US private equity funds. Subsequent press coverage describes the financial advisors to BCE urging the BCE board of directors in the summer to act quickly to take advantage of the then unusually high liquidity in the debt markets on the theory that the liquidity wouldn't last long.

The transaction will take Canada's most widely held company private for the first time in more than a century. Adding to the interest in the deal is litigation commenced by a committee of BCE bondholders, alleging, among other things, that the bondholder trustee should have the right to approve the transaction and that the transaction is unfair to the bondholders. Other high profile transactions in the past year have included: Texas Pacific Group acquiring Axcan Pharma Inc., a pharmaceutical company, for USD 1.3 billion; Onex Corporation acquiring Husky Injection Molding Systems Ltd., a plastic injection molding company, for \$960 million; Apax Partners and the private equity investment arm of Morgan Stanley acquiring Hub International Limited, the Canadian incorporated and Chicago-based insurance brokerage firm, for approximately USD 1.7 billion; CAI Capital Partners, Goldman Sachs Capital Partners, Kelso and Company, Vestar Capital Partners, British Columbia Investment Management Corporation, Alberta Investment Management and O.S.S. Capital Management L.P. acquiring CCS Income Trust, a business trust that provides energy and environmental waste management services, for \$3.5 billion; Alinda Capital Partners LLC acquiring UE Waterheater Income Fund, a business trust in the waterheater rental sector, for approximately \$1.74 billion; and an entity formed by Caxton-Iseman Capital Inc. acquiring KCP Income Fund, the manufacturer of national and retailer brand consumer products, for approximately \$800 million. Of note, the Axcan and Husky transactions were announced after the onset of

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the credit tightening in August 2007 and are believed to be financed with significant sponsor equity contributions.

New Deal Landscape

Prior to the summer of 2007, the size of announced private equity buyouts continued to grow larger in an environment of easily accessible credit. With the current constraints in the debt markets, the 'mega deal' boom appears to be over for now; however, recent experience suggests that mid-market Canadian transactions will continue to move forward. This view was reflected in the study, with a majority of respondents believing that the mid-market will see the most M&A opportunities in the next year. In addition, competition from strategic buyers in the marketplace will likely increase given their generally lower reliance on credit. The study reflects this view, with a majority of respondents believing that the credit tightening has resulted in increased participation from strategic buyers.

Increased Focus on Contractual Terms

Recent experience suggests that private equity dealmakers and targets have begun to place greater emphasis on the terms of acquisition agreements, including the structure and implications of material adverse change MAC clauses, break fees, and reverse break fees and sponsor guarantees, as well as the availability of specific performance as a remedy. This trend is reflected in the study, with half of respondents believing that there have been recent changes in approach to MAC clauses and half of respondents seeing some changes in the approach to reverse break up fees due to the credit tightening. Depending on the combination of these provisions in an acquisition agreement, the options available to purchasers wishing to alter the terms or ultimately to walk away from a transaction, as well as the legal remedies at the disposal of the target, may be limited. Given the lack of Canadian case law on these matters, Canadian dealmakers are closely monitoring recent US legal developments on these provisions.

Increased Participation of Canadian Pension Plans

A relatively unique characteristic of the Canadian private equity M&A marketplace is the widespread participation of Canadian pension plans. Private equity investments by the plans have covered a wide spectrum, including LP investments, co-investments with private equity funds and direct and co-sponsored buyouts. Canadian pension plans have also diversified their private equity investments to include a number of different sectors, including infrastructure. Due to foreign ownership restrictions in certain industries in Canada (including telecommunications, as exemplified in the BCE transaction), Canada's pension plans have proven to be valuable strategic partners. The perception of the increased importance of pension plans is reflected in the study, with almost forty percent of respondents viewing new sources of capital coming from pension funds in the coming months and a majority of respondents believing that

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institutional investors have been the most influential factor in the growth of private equity in Canada.

Fundraising Growth

Mirroring the success of US and European funds, Canadian private equity sponsors have experienced significant recent growth in raised capital. While Canadian fundraising last year did not reach the record levels achieved in 2006, this can primarily be attributed to the fact that the largest Canadian funds were already fully committed going into the year. It remains unclear what effect the credit tightening will have on fundraising in 2008; however, growth may be seen in both sponsor and LP interest in distressed asset and debt funds as private equity players attempt to capitalize on the market turbulence. Existing fund investment strategies may also need to be adjusted to manage the current environment and take advantage of new investment opportunities that were not foreseen at the time funds were closed. The study suggests an optimistic fundraising outlook for 2008, with respondents generally expecting there to be an increase in the amount of capital available to private equity firms.

Canadian Income Trusts – Increased M&A but End of the Line as an Exit Strategy

The Government of Canada's announcement on October 31, 2006 that it would substantially eliminate the tax advantages that income trusts hold over corporations led to a tremendous upswing in income trust M&A activity in 2007, largely spurred by financial sponsors looking for low growth, stable income buyout opportunities. The appeal of income trusts as acquisition targets was borne out in the Study, with the majority of respondents viewing stable and predictable cash flow as the most attractive characteristic of income trust businesses to private equity players. The Government's announcement has also resulted in the effective termination of IPOs through Canadian income trusts, which had been an extremely successful exit strategy for private equity investors. It remains to be seen whether the traditional common share equity capital markets will provide a similarly viable exit in Canada in the future.

Withholding Tax Changes

On September 21, 2007, the Government of Canada and the Government of the United States signed the fifth Protocol to the Canada-US Tax Convention which will result in significant changes affecting cross-border transactions. Withholding tax on payments of cross-border interest to unrelated lenders has since been eliminated. The Protocol will also gradually reduce and eventually eliminate the withholding tax rate on payments of cross-border interest to related lenders. In addition, the Protocol introduces, for the first time in Canada, Limitation on Benefits provisions, which may affect the entitlement of a US lender to the benefits of the Convention in respect of interest payments from a Canadian affiliate borrower.

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New Foreign Investment Review Measures

The past year has witnessed increased Canadian governmental attention regarding the regulation of foreign investment in Canada. New Investment Canada Act guidelines have placed restrictions on the ability of state owned enterprises to acquire Canadian businesses. In addition, a Competition Policy Review Panel established in July of 2007 has been tasked with the review of Canada's competition and investment policies which may lead to additional legislative recommendations regarding foreign investment. Perhaps unsurprisingly, a majority of US respondents in the study view the overall Canadian regulatory environment as having an impact on their decision to invest in Canada so such legislative initiatives will be closely monitored in the coming year.

Outlook

Private equity in Canada experienced significant growth in 2007. The continued expansion of domestic private equity markets and positive experiences of US sponsors with Canadian businesses all point to a healthy flow of cross-border private equity transactions in the future. As reflected in the study, Canada will remain an important source of private equity capital and investment opportunities as the industry expands and evolves around the world.

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