Bennett Jones

DUE NORTH: U.S. PRIVATE EQUITY SETS SIGHTS ON CANADA

Mergermarket
An Acuris company

CONTENTS

FOREWORD

METHODOLOGY

In Q2 2018, Mergermarket surveyed 50 private equity executives and 25 portfolio company executives via phone to better understand the challenges and opportunities they face working in Canada. PE respondents were split between the United States (50%) and Canada (50%), and portfolio companies were divided between those backed by U.S. firms (48%) and by Canadian firms (52%). All respondent firms had completed at least one Canadian investment of US$20m or more in the past three years and plan to target Canadian companies for acquisition in the coming 12 months.

The outlook for private equity investment in Canada is promising. The country has become an attractive destination for foreign investors, and the total value of PE deals continues to reach new heights. A strong Canadian economy is good news for Canadian companies and investors.

What are the motivations and experiences of PE firms doing deals in Canada? What is driving their decisions to move ahead and invest, or to hold and take a closer look?

To better understand this, Bennett Jones commissioned Mergermarket to survey Canadian and U.S. PE executives, as well as members of management teams at Canadian portfolio companies of Canadian and U.S. PE firms.

They told us how important it is to understand the Canadian market, where they see the greatest growth opportunities, and what key trends and strategies help structure deals. They also described the main challenges they face, and the points of tension between PE investors and their portfolio companies.

There is above all optimism about the prospects for private equity investment in Canada in the near future. We share this optimism at Bennett Jones and hope you find value in our study, *Due North: U.S. Private Equity Sets Sights on Canada*.

John Mercury
Partner and Vice Chair,
Clients and Industries
T: 403.298.4493
Bennett Jones LLP

Jon McCullough
Partner, Co-Head of
Corporate Department
T: 604.891.5306
Bennett Jones LLP

Introduction

BRIGHT PROSPECTS FOR PRIVATE EQUITY

To outsiders, private equity in Canada is often associated with the country's pension funds, and for good reason—they play an outsized role as investors on the world stage. But the country is also known as an attractive destination for PE investment from abroad, especially from the United States. The total disclosed value of PE deals in Canada last year was the highest in a decade at US$14.1bn, according to Mergermarket data. That figure is on pace to rise further in 2018.

Fueling deal flow in the country is increased interest in PE investment on the part of large domestic players and, especially, an influx of U.S. financial buyers seeking reasonably-priced targets amid heated competition globally. The 79 inbound deals to Canada counted by Mergermarket in 2017 set a new record.

In order to better understand the motivations and experiences of PE firms doing deals in Canada, Bennett Jones conducted a survey of 50 Canadian and U.S. PE executives, as well as 25 members of management teams at Canadian portfolio companies. The survey examines the current opportunities in the country when it comes to targeting; the central challenges faced by Canadian and U.S. PE funds; and the points of tension and alignment between PE investors and their portfolio companies, among other topics.

Canadian target companies are benefiting from a confluence of domestic and global trends, supporting strong growth in the Canadian economy. With robust consumer spending, Canadian GDP grew by approximately 3% last year, and despite a slight hiccup in the first quarter attributable to temporary factors, the economy is expected to grow by about 2.1% in both 2018 and 2019. Against this backdrop, PE investors are identifying opportunities across industry verticals, but in particular in consumer goods, industrials and chemicals, oil and gas, mining and technology.

For all the positive signs, Canadian companies—and the economy more broadly—are burdened by the uncertainty that has hung over U.S.-Canada relations since the change in U.S. presidential administration. After months of negotiations over revisions to the North American Free Trade Agreement (NAFTA), an agreement has still not been finalized, as the United States and Canada continue to spar over dispute resolution mechanics and U.S. access to Canadian dairy markets. Meanwhile, a new minefield has appeared in the form of U.S. tariffs on steel and aluminum.

As investors and businesses watch to see how these trade disputes will be resolved, they will also be keeping an eye on the impact of U.S. tax reform, which Canadian business leaders have warned could diminish Canada's relative appeal to investors. Another question mark is the short-term prospects of the domestic energy sector, which is still struggling with insufficient pipeline capacity.

Despite these headwinds, our survey respondents are largely optimistic about the prospects for private equity in Canada. They make clear that there are ample opportunities to be had for the diligent and patient investor, and explain that the challenges that exist can be overcome with preparation and the right kinds of support. If you commit to the market, they say, the rewards can be substantial.

Part 1

ASSESSING THE CANADIAN MARKET: WHAT MAKES THE COUNTRY ATTRACTIVE TO PE BUYERS?

Last year was big for PE investment in Canada, with the value of domestic and inbound transactions reaching a 10-year high of US$14.1bn. Now, a steady flow of deals appears likely to replicate that performance. But what exactly is encouraging this acceleration in dealmaking?

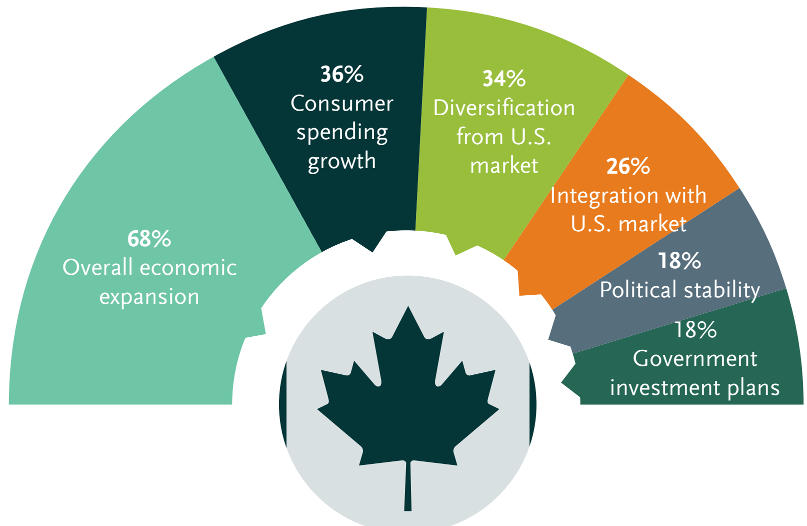
Economic growth, said most respondents in our survey, despite lingering uncertainties over the outcome of NAFTA negotiations and constraints on Canadian energy production. More than two-thirds of respondents (68%) said that Canada's overall economic expansion would be one of the top two macroeconomic factors driving PE investment over the next 12 to 24 months.

Investors have good reason to be confident about Canada's economic prospects: national GDP grew by around 3% in 2017, the highest annual growth rate since 2011, according to World Bank data—and for the first time over that same period, GDP grew in all 10 Canadian provinces. Although last year's growth is unlikely to repeat itself, short-term forecasts are relatively positive—the *Bennett Jones Spring 2018 Economic Outlook* projects growth of 2.1% this year and next.

A surge in consumer spending was vital in 2017, and PE investors took notice. Thirty-six percent of respondents believe that consumer spending growth will be a crucial enticement for investors over the next one to two years—especially since the consumer sector is an attractive one for PE buyers.

"Consumer spending was the biggest driver for the strong growth rate achieved by Canada last year," said a managing director at a New York-based PE firm that invests in Canada out of a fund of US$2.5bn. "The high level of spending lifted sentiments and encouraged companies to expand."

IN YOUR OPINION, WHAT WILL BE THE MOST ATTRACTIVE MACROECONOMIC ASPECTS OF THE CANADIAN MARKET OVER THE NEXT 12-24 MONTHS FOR PE INVESTORS? (SELECT TOP TWO)

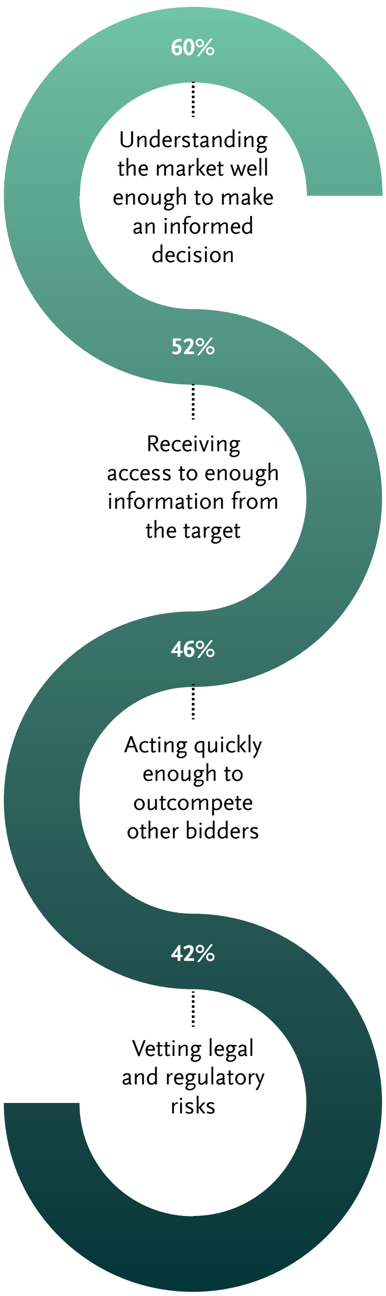


LOCAL MARKET KNOWLEDGE IS KEY

The recent rise in PE investment in Canada has been driven in part by an influx of foreign firms, most from the United States. But notwithstanding their successes north of the border, U.S. firms have to overcome certain disadvantages in Canada—in particular, a shortage of local market knowledge. Sixty percent of respondents said that one of the top two challenges they faced in conducting due diligence on Canadian targets was understanding the market well enough to make an informed decision.

In some cases, acquiring sufficient information from targets themselves can be a challenge. "With the competitive nature of deals, target companies are not always ready to supply enough information to conduct due diligence procedures," said a managing director at a firm with more than US$25bn under management.

WHAT ARE THE BIGGEST CHALLENGES YOU FACE IN CONDUCTING DUE DILIGENCE ON CANADIAN TARGETS? (SELECT TOP TWO)



In other instances, foreign investors can be at a disadvantage simply due to their lack of cultural familiarity. For instance, one respondent from a U.S.-based PE firm noted a difference his firm discovered regarding Canadian consumer behaviour. In Canada, he said, consumers don't demand a wide range of brands at a convenience store—in contrast to the United States, where shoppers expect to find every beverage brand imaginable. This means that Canadian stores can carry a single brand's products and receive rebates. It takes time and some homework to discover such nuances.

Understanding regulatory differences can also be a hurdle—particularly when it comes to human resources issues such as severance. These considerations will ultimately inform a buyer's calculations on whether a particular acquisition is worth the price.

"Canada is not an at-will employment jurisdiction like the United States, and that leads to differences in assumptions and, frankly, dollars and cents," said John Mercury, leader of Bennett Jones' private equity practice.

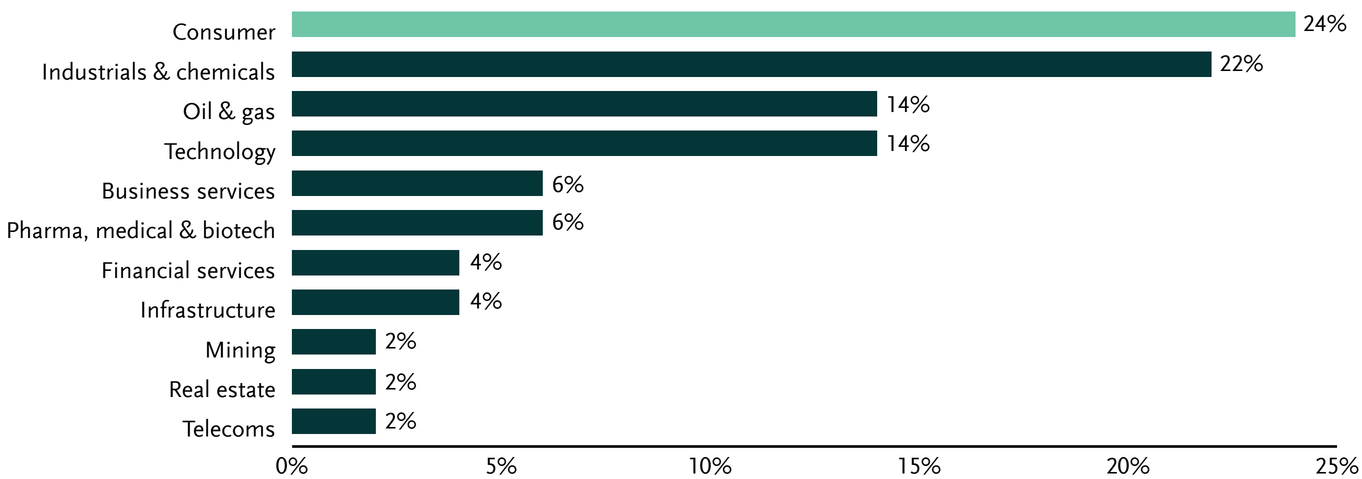
CONSUMER, TECH IN BUYERS' SIGHTS

When asked to name the sectors that their firm would prioritize over the coming 12 months, respondents pointed to four key industries: consumer goods (24%), industrials and chemicals (22%), oil and gas (14%), and technology (14%).

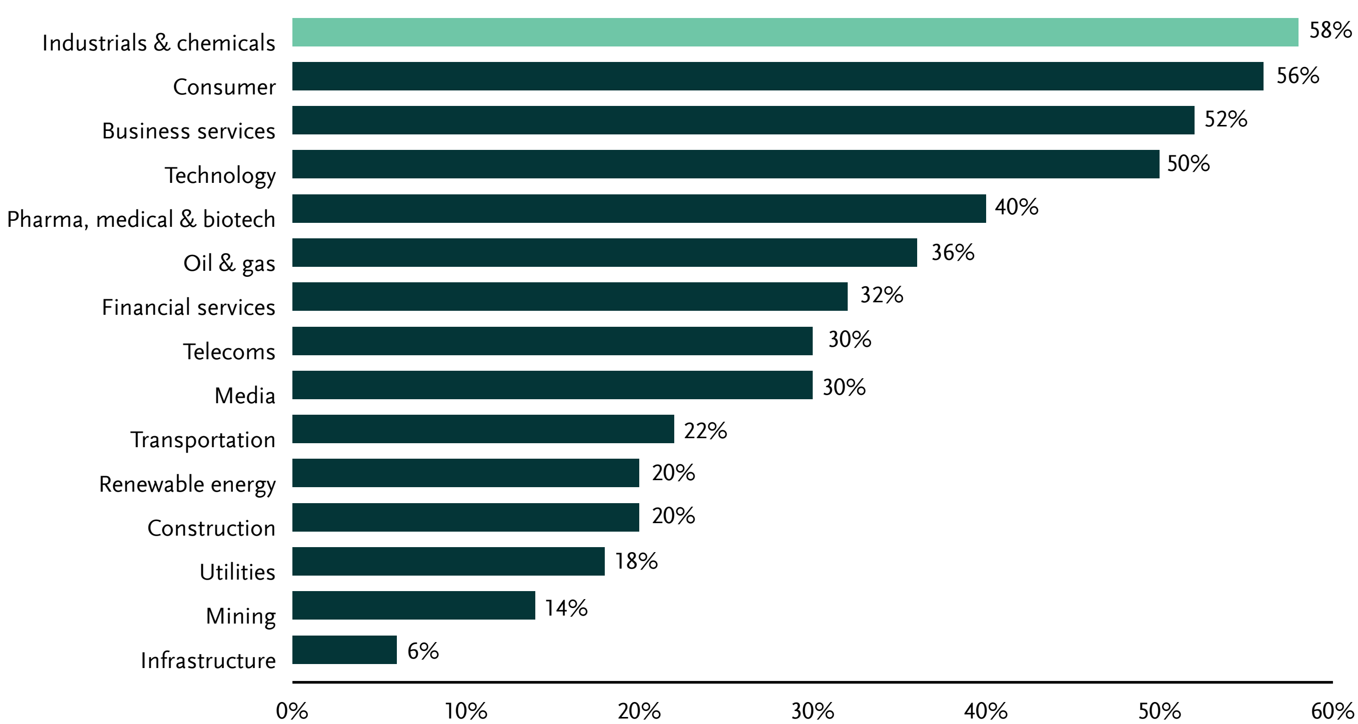
These responses should come as little surprise, given that these four sectors have had the greatest reported deal value in Canada from PE buyouts and buy and build transactions over the last five years.

Respondents whose firms intend to focus on consumer goods anticipate a steady flow of new opportunities, with several citing robust demand and market dynamism as the sector's

WHICH SECTORS DOES YOUR FIRM PLAN TO TARGET FOR INVESTMENT IN CANADA OVER THE NEXT 12 MONTHS? (SELECT THE MOST IMPORTANT)



WHICH SECTORS DOES YOUR FIRM PLAN TO TARGET FOR INVESTMENT IN CANADA OVER THE NEXT 12 MONTHS? (SELECT ALL THAT APPLY)



key strengths. The industrials and chemicals sector elicits similar enthusiasm; in fact, when respondents were permitted to select more than one option, 58% said their firms planned to target this sector—more than any other.

As for oil and gas, the sector is emerging from an undeniably tough period. Foreign direct investment in Canadian oil and gas fell 12.2% in 2017—the steepest drop in a span of nearly two decades.

In addition to the global slump in oil prices that struck in 2014, Canada is dealing with a deficit of pipeline capacity that forces producers to seek other, more expensive means of transport. Regulatory challenges, either real or perceived, also hamper the industry.

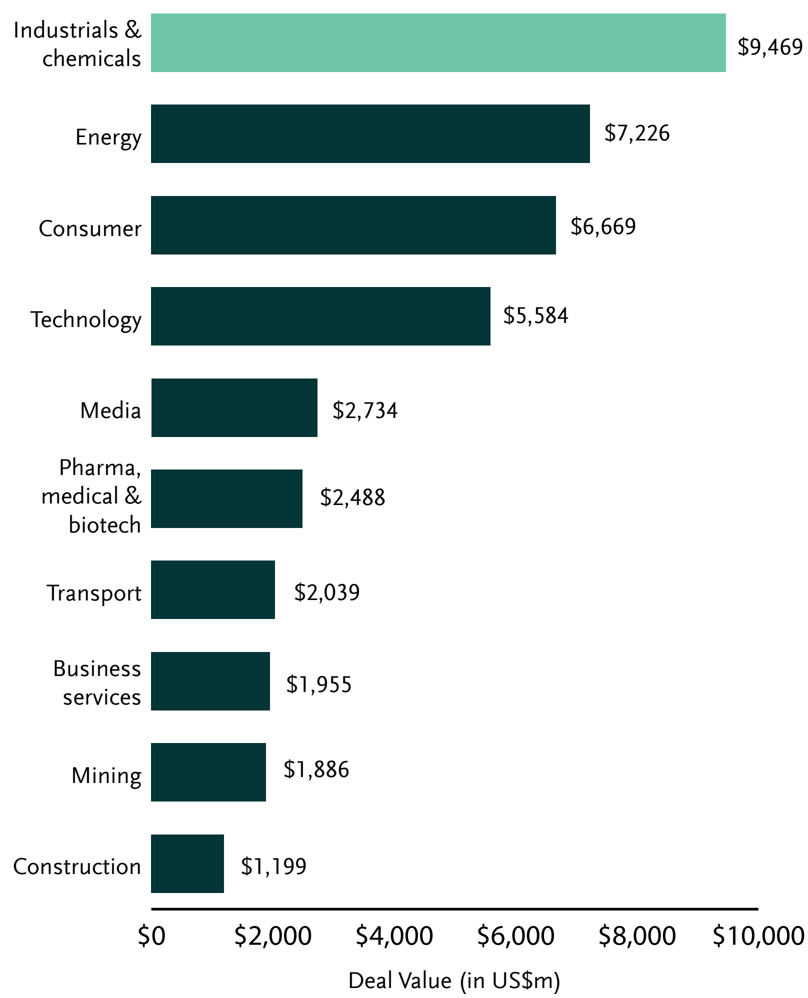
But with oil prices up, some respondents believe this is the moment to seek opportunities in the Canadian energy market. Certain plays in particular, such as the Montney shale formation in Alberta and British Columbia, hold interest for potential buyers.

"This could be the right time to make new investments in Canada to benefit from low valuations," said a partner at an energy-focused PE firm based in Texas.

Finally, the Canadian tech sector—which boasts pioneering research in such areas as artificial intelligence and machine learning—is drawing increasing attention, particularly from foreign buyers.

In January, for instance, North Carolina-based Frontier Capital made a US$47m growth investment in IGLOO Software, a Canadian software company that provides workplace solutions. The investment is intended to help increase IGLOO's sales and strengthen its hold on the North American market.

TOP 10 SECTORS FOR CANADIAN PE DEALS BY TOTAL VALUE, 2013-17



But while the potential for growth is obvious, respondents noted that competition for target companies can become prohibitive.

An operating principal at a Silicon Valley-based investment firm said the major challenge in the Canadian tech sector currently is valuations, due to intense competition from aggressive financial and strategic acquirers. Indeed, the median EBITDA multiple for technology deals

in Canada from 2015 to 2017 reached 16x, according to Mergermarket data.

CROSS-BORDER ACQUIRERS SEE BIG BENEFITS

For respondents based in the United States, plain old geography is yet another good reason to head north. More than one-third (34%) said the opportunity to diversify portfolios geographically was one of the most attractive aspects of Canadian targets.

“Geographic proximity is the main appeal of Canada for us—it’s as simple as that,” said a managing partner at a Silicon Valley-based PE firm focused on the industrial and manufacturing sectors. “We’re exclusively focused on companies that are within North America, so targeting in Canada helps expand our range of possible targets.”

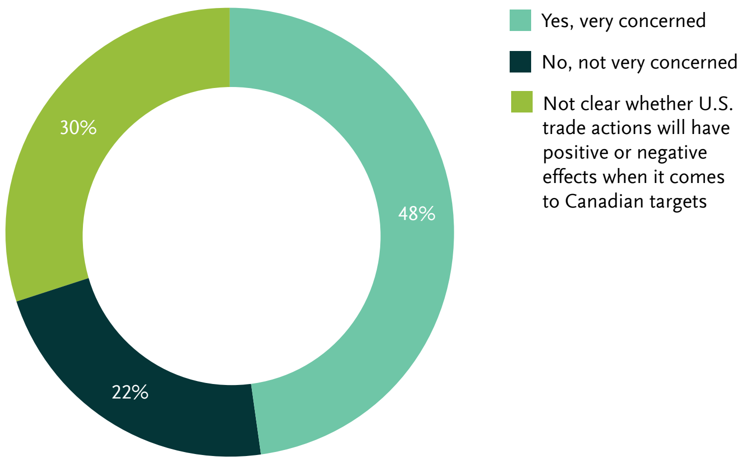
At the same time, about a quarter of respondents (26%) named integration with the U.S. market as one of the top reasons that PE firms would seek out Canadian targets over the next 12 to 24 months.

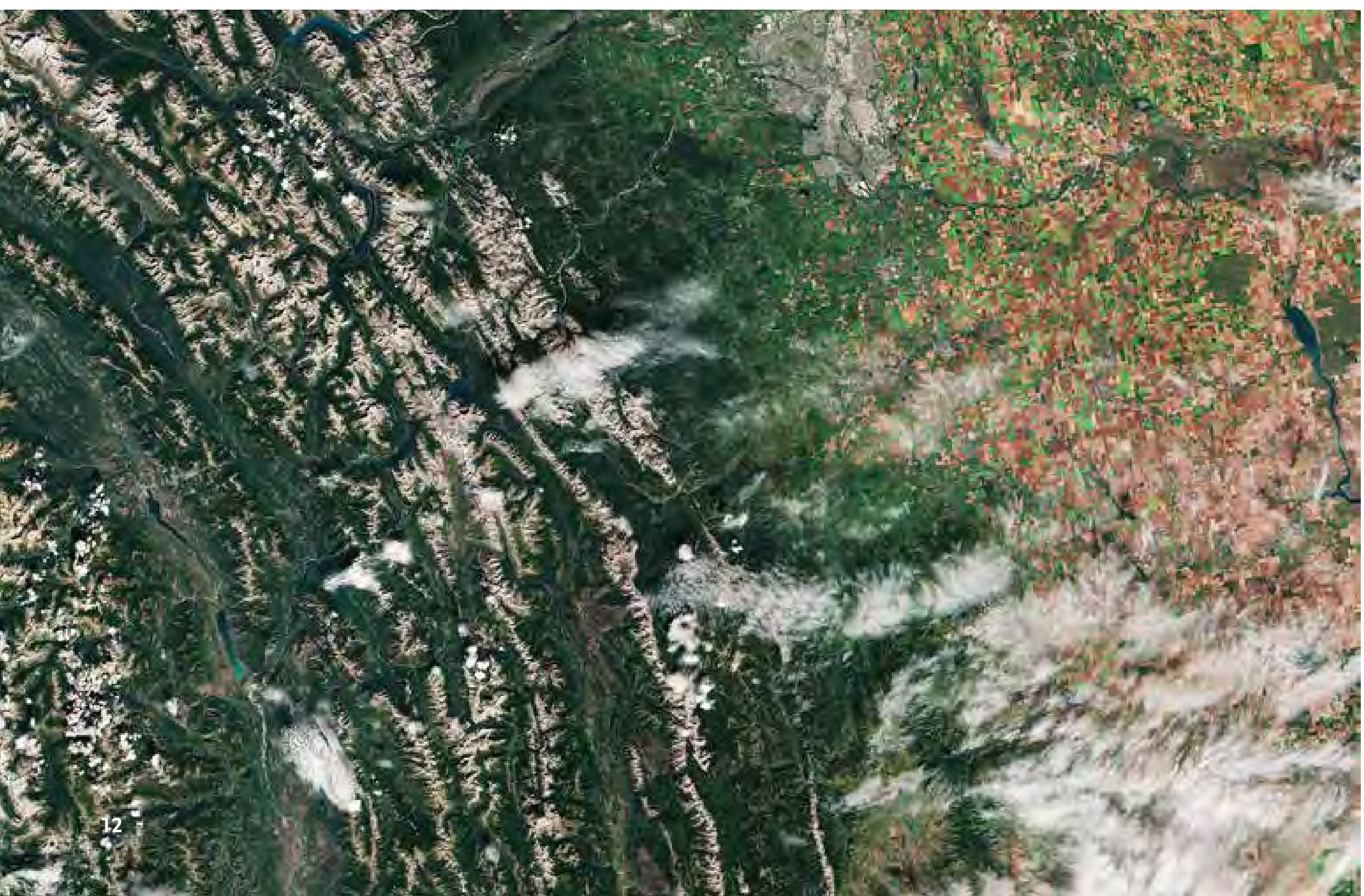
“The ability to jump geographically north-south is always an attractive opportunity,” said a managing director at a U.S.-based PE firm focused exclusively on consumer goods companies. “You can be a major player in Canada and still have an enormous market to try to tap into south of the border.”

Expanding into the U.S. market has certain obvious advantages, such as a much larger population. The recently passed U.S. tax reform bill also promises to make the country more attractive for investment (see "U.S. Tax Reform Deemed a Mixed Blessing," page 13). However, cross-border trade in particular may be under threat due to policies under consideration by the U.S. administration.

Nearly half of respondents (48%) said they were "very concerned" about the effects that possible U.S. trade actions would have on the attractiveness of Canadian targets. Uncertainty has hovered over U.S.-Canada economic relations since the election of Donald Trump, whose White House initiated

ARE YOU CONCERNED ABOUT POTENTIAL U.S. ACTIONS ON TRADE (E.G., NAFTA, NEW TARIFFS, ETC.) WEAKENING THE ATTRACTIVENESS OF CANADIAN INVESTMENT TARGETS?





Credit: ESA (2017), CC BY-SA 3.0 IGO

U.S. TAX REFORM DEEMED A MIXED BLESSING

One additional curveball for PE firms is evaluating the knock-on effects of the recent U.S. tax reforms, which slashed the country's federal corporate income tax rate from 35% to just 21%.

A substantial minority of respondents (36%) said the changes would make Canadian targets less attractive overall, as lower U.S. tax rates pique investors' interest in U.S. targets instead. According to an analysis by EY, the reforms wiped out the relative tax advantage that Canada had previously wielded over the United States, as measured by the aggregate marginal effective tax rate on investment (METR). The United States' aggregate METR now stands at 18.8% to Canada's 20.3%.

But despite this considerable shift, a majority of respondents (54%) said the reforms will have a roughly equal mix of positive and negative effects on Canadian targets. Their ambivalence may reflect the fact that changes to U.S. tax rates do not affect all Canadian firms equally. For instance, Canadian exporters stand to benefit if the reforms help spur growth and loosen purse strings down south.

With trade negotiations ongoing, at least one respondent noted that it is simply too early to say what the impact of U.S. tax reform will ultimately be. "It would be difficult to say anything right now, as NAFTA agreements are still on hold and the effects are yet to be known," said a partner at a Montreal-based PE firm.

WHAT EFFECT, IF ANY, DO YOU EXPECT THE U.S. TAX REFORM LAW TO HAVE ON THE ATTRACTIVENESS OF CANADIAN INVESTMENT TARGETS?

4%	**36%**	**54%**	**6%**
It will make Canadian targets more attractive on the whole	It will make Canadian targets less attractive on the whole	It will have a roughly equal mix of positive and negative effects when it comes to Canadian targets	It will have a negligible effect either way

the renegotiation of NAFTA. Fears of trade and supply chain disruption have only grown with the administration's imposition of steel and aluminum tariffs in June.

Not all respondents expressed equal concern, however. Twenty-two percent said that they were "not very concerned" about the threat of U.S. trade actions, while the remaining 30% said it remained unclear whether changes to trade policy would have positive or negative effects on targets in Canada.

Some respondents even saw a silver lining: by underscoring Canadian exporters' reliance on the U.S. market, the political situation may encourage Canadian firms to seek growth in further-flung markets. Overdependence on the United States "was restricting Canada," said a managing director at a PE firm with an active portfolio of more than 150 companies. "Now Canada has realized that to continuously find growth and become competitive they need to look beyond [the United States]."

> "The ability to jump geographically north-south is always an attractive opportunity."
>
> Managing director at a U.S.-based PE firm

Part 2

TARGETING DEALS IN CANADA: THE HUNT FOR ASSETS AMID GROWING COMPETITION

Facing intense competition at home, U.S. buyers are looking further afield for new acquisitions. And for some, Canada fits the bill.

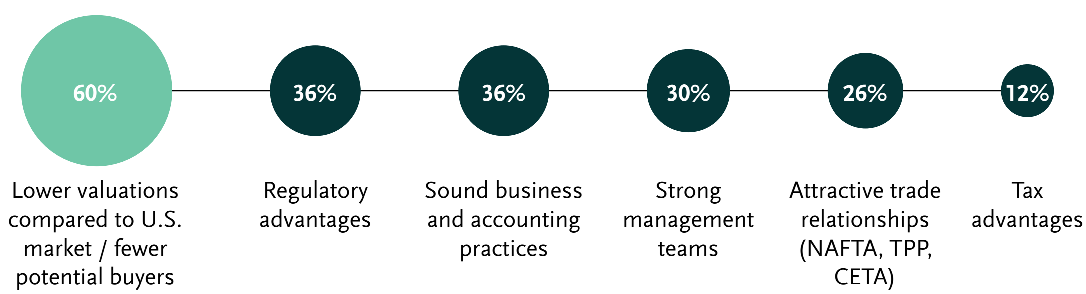
"There's clearly a battle going on down south," said John Mercury of Bennett Jones. "A lot of our private equity clients are U.S.-based, and they're competing vigorously for deal flow at attractive valuations."

Asked to identify the Canadian market's most attractive structural aspects, a majority of our respondents (60%) pointed to the smaller number of potential buyers and to valuations lower than those in the United States.

Another contributing factor is that Canadian deals tend to be less auctioned, said a partner at a firm based in the United States that has made more than 120 investments over its history. With less competitive auctions, PE firms can hope to scoop up promising businesses at lower prices.

But, he added, "Canada is catching up quickly." The last few years have been strong for dealmaking in the country, and with record levels of dry powder globally—US$1.09 trillion at the end of Q1 2018, according to research firm Preqin—it should come as no surprise that more firms are seeking opportunities in the Canadian market.

WHAT ARE THE MOST ATTRACTIVE STRUCTURAL ASPECTS OF THE CANADIAN MARKET FOR PE INVESTORS? (SELECT TOP TWO)



WHAT ARE THE BIGGEST CHALLENGES YOU HAVE FACED OVER THE LAST THREE YEARS IN TARGETING CANADIAN COMPANIES FOR INVESTMENT? (SELECT TOP TWO)

Our respondents are experiencing the resulting pinch: compressed timelines for due diligence and financing (48%) and increased competition for deals (46%) were the most frequently cited challenges in targeting Canadian companies.

A minority of respondents (22%) also named inflated valuations, indicating that heightened competition is pushing up prices in some sectors. In a worrying sign for domestic buyers, several respondents from Canadian firms noted that higher valuations—in large part, the result of foreign competition—have made it harder for them to compete on their own turf.

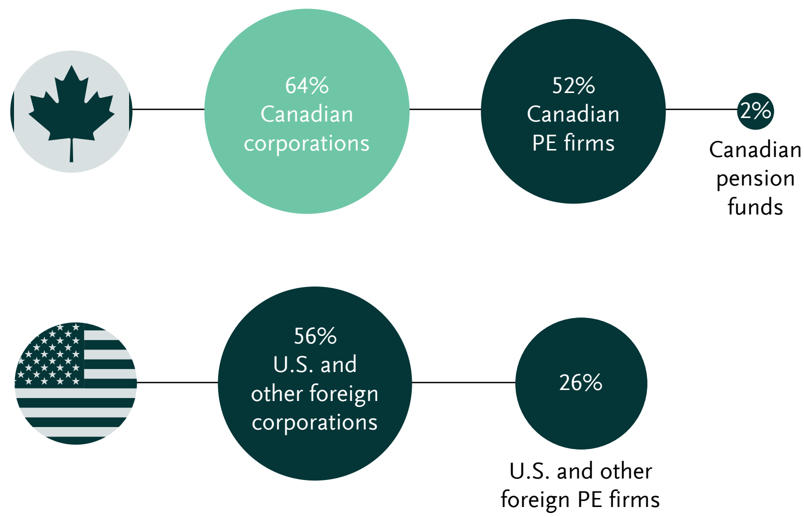
To take one example, the 2017 sale of Ontario-based machinery supplier Husky Injection Molding set off a bidding war that involved several domestic buyers, including the Canada Pension Plan Investment Board, which partnered with U.S.-based Ares Management, and PE buyer Onex, which bid in partnership with Bain Capital. In the end, Husky was sold instead to affiliates of Los Angeles-based Platinum Equity in a deal valued at US$3.8bn.

RIVALRY WITH STRATEGIC ACQUIRERS HEATS UP

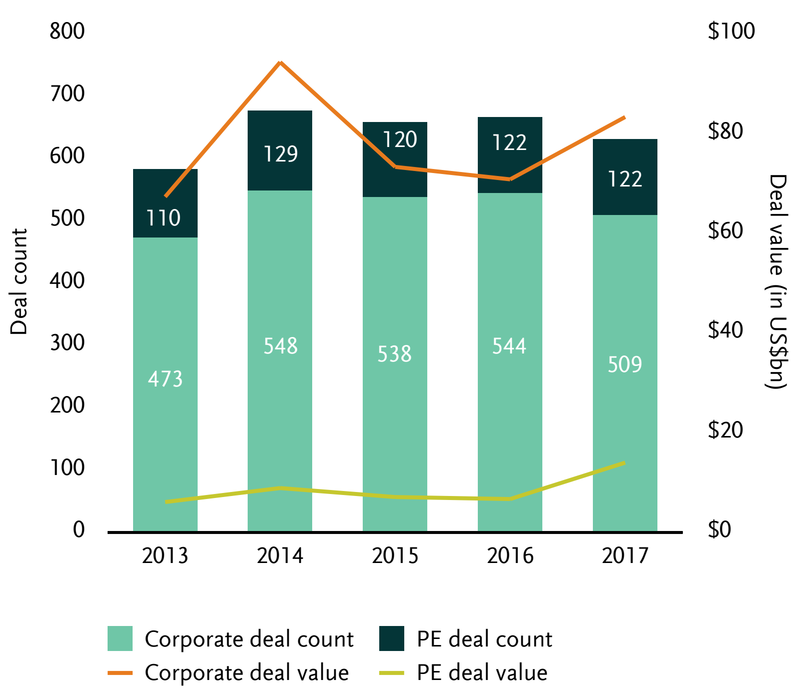
While competition between financial buyers may be escalating, the primary source of competition is still strategic buyers, respondents said. Nearly two-thirds of PE respondents (64%) expect Canadian corporates to be one of the groups presenting the greatest competition for deals in the next one to two years. Fifty-six percent said U.S. and other foreign corporations would be major rivals as well.

Even as buyout activity accelerates in Canada, corporate deals still make up the lion's share of M&A transactions. Corporations were responsible for 509 deals in Canada last year, as compared to 122 deals made by PE firms, according to Mergermarket data.

WHICH TYPES OF BUYERS DO YOU EXPECT TO PRESENT THE GREATEST COMPETITION FOR DEALS IN CANADA OVER THE COMING 12-24 MONTHS? (SELECT TOP TWO)



CORPORATE VS. PE DEAL COUNT + VALUE IN CANADA, 2013-17



Along with strategic buyers' strength in the M&A landscape, there may also be an issue of preference on the part of management and company owners. When asked to name the top obstacles they have faced in the Canadian market, 34% of portfolio company respondents said that management or seller preference for non-PE buyers was a significant barrier to transaction activity.

In part, this is likely due to the lack of knowledge about private equity or an outdated understanding of the nature of a PE deal among some Canadian companies. When a target receives a term sheet from a financial acquirer, they aren't always familiar with the profit-sharing model as compared to a more traditional compensation package involving stock options.

"A principal challenge we've faced is explaining to certain management teams the alignment of interests in the PE model and trying to convert people philosophically," said John Mercury of Bennett Jones. "I think 10 years into that experiment, we have more and more people who understand and accept how the model works."

One way in which PE buyers are competing more successfully with strategics is by acting like them—that is, making add-on acquisitions with platform companies. This trend is increasingly prevalent in Canada, just as it is in the broader PE universe. All of our respondents said they were seeking bolt-on deals at least 25% of the time when targeting Canadian companies, and nearly a quarter of respondents (24%) said they were looking for them half the time or more.

In particular, a number of U.S. PE firms appear to be seeking bolt-on deals in Canada as a way to extend the reach and heft of U.S.-based platform companies. One

PRIVATE DEBT MAKES GAINS

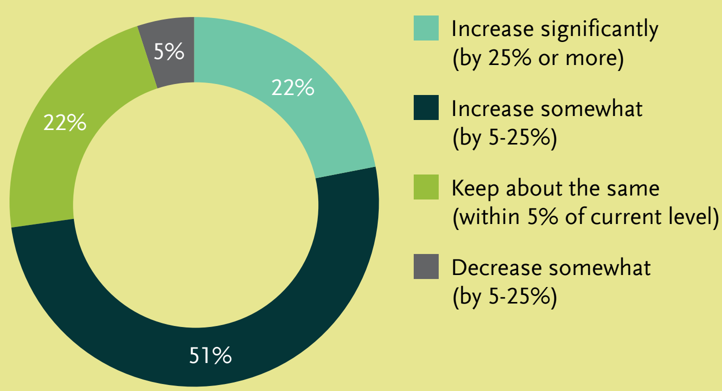
Hungry for higher returns and ways to employ idle capital, PE investors are turning to a new strategy in Canada: private debt. Investment in direct lending has become widespread, with more than two-thirds of respondents (68%) saying they invest in Canadian private debt.

The private debt market has become increasingly prominent across North America and Europe in recent years, largely due to the capital requirements and regulations that governments imposed following the global financial crisis. Globally, private debt funds held US$638bn in assets under management as of mid-2017, an increase from US$400bn five years earlier, according to data tracked by Preqin.

In Canada, major financial players such as pension funds and life insurance companies have already entered the fray. Private equity is right behind them: Onex and Brookfield Asset Management—Canada's two largest PE firms, according to Private Equity International—now offer direct lending services.

Private equity's foray into private debt appears likely to continue in Canada: nearly three-quarters of respondents said their firms plan to increase private debt investments either somewhat (51%) or significantly (22%) over the next 12 to 24 months.

HOW DO YOU PLAN TO CHANGE YOUR PRIVATE DEBT INVESTMENTS IN CANADA OVER THE COMING 12-24 MONTHS, IF AT ALL?



prominent example is the Canadian buying spree of HUB International, a Chicago-based insurance brokerage backed by U.S.-based Hellman & Friedman. HUB has bought at least eight Canadian firms this year in a drive to strengthen its insurance offerings in the country, with recent deals including buyouts of the Québec-based benefits brokerage dElta Group and Alberta-based Carlton Insurance Brokers, both for undisclosed amounts.

The Canadian tech sector is also a hotspot for cross-border bolt-on acquisitions. To take just one example, Florida-based AppRiver, a software company owned by Marlin Equity Partners, acquired the Ottawa-based email filtering firm Roaring Penguin Software in March for an undisclosed amount. AppRiver said that, in addition to expanding its product offerings, the acquisition would boost sales of its other products in Canada.

GAINING A FOOTHOLD IN THE MARKET

Building relationships in Canada—or employing advisers with pre-existing relationships—is essential for identifying Canadian investment targets, according to our respondents. A majority (62%) said that establishing relationships directly with executives at Canadian companies was one of the most effective ways of zeroing in on targets.

While it will surprise no one that relationships are important in private equity, U.S. buyers should note that they are especially critical in the tight-knit Canadian corporate world.

"Reputation matters a lot in Canada. It's a big country with a small business community," said Ian Michael of Bennett Jones. "It's not just the relationships with the company and its management team and its employees; but frankly it also extends to the relationship with other stakeholders, including local lenders."

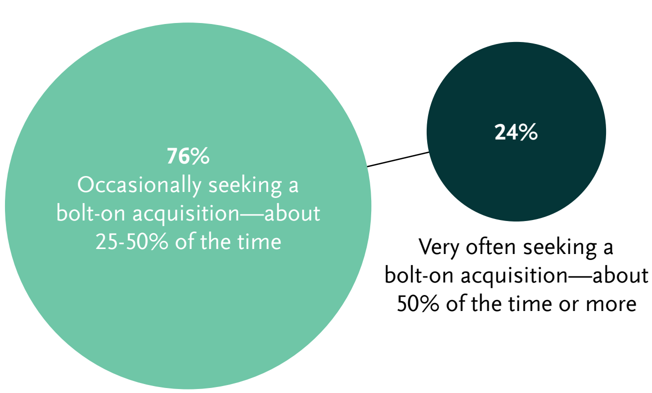
There are only a handful of major banks in Canada, which means funds will typically work with the same bank on multiple deals simultaneously. A bad experience in one deal can inflict much greater damage than foreign players might anticipate.

There are also other ways in which foreign firms can identify investment opportunities in Canada. According to 56% of respondents, working with domestic financial and legal advisors is another effective route. Such intermediaries can include law firms, investment banks, and independent sponsors.

There is a more direct way to build connections, of course: simply set up shop in Canada. This approach may not be as widespread, but 46% of respondents said that having a Canadian office was one of the best ways to find investments.

"It gives us a leg up in terms of talking to people, keeping a dialogue, and showing our commitment to the geography," said the managing director at the consumer products-focused firm. "I think that's important

WHEN TARGETING CANADIAN COMPANIES, HOW OFTEN ARE YOU SEEKING A PLATFORM COMPANY VERSUS A BOLT-ON PURCHASE?



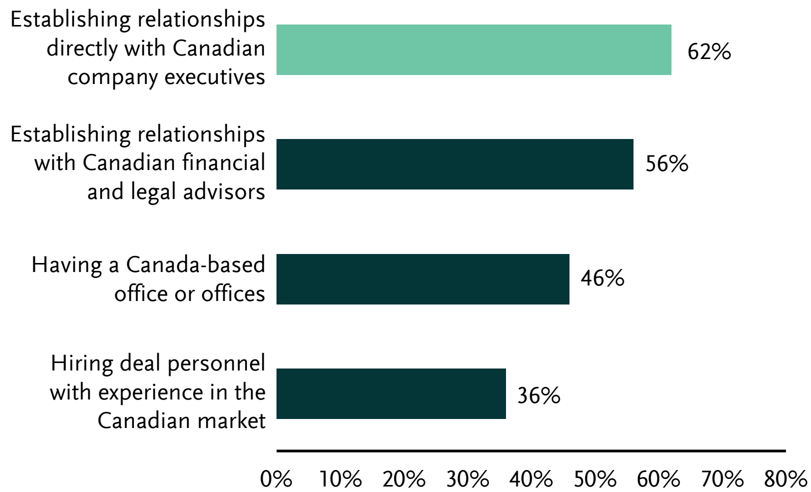
whether we're talking to lenders, bankers, or company owners."

CANADIAN BUYERS MAY HOLD AN EDGE

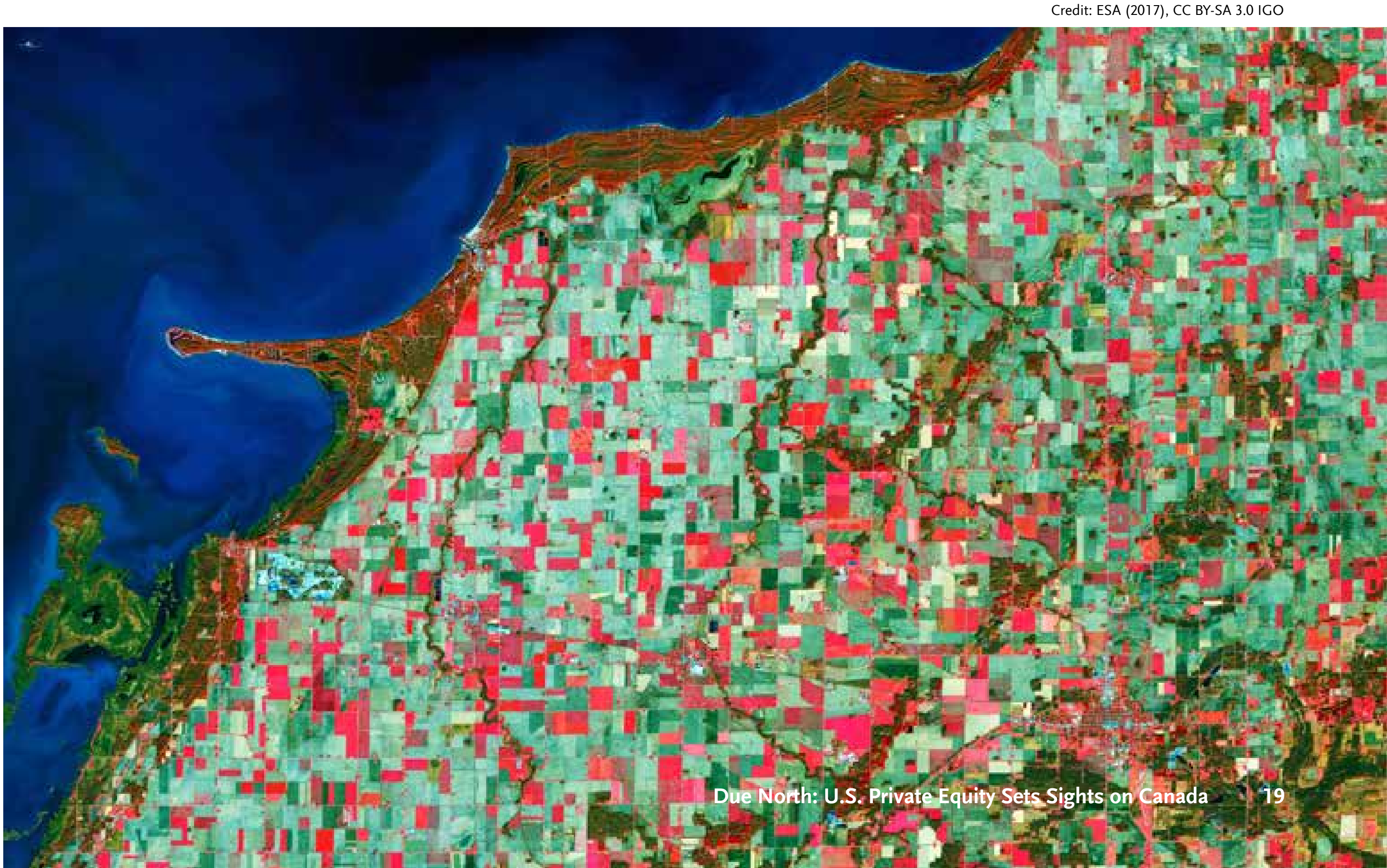
As hungry U.S. buyers vie with domestic firms for deals, it is natural to wonder whether one side might have an inherent advantage. Do Canadian businesses prefer the familiarity of a homegrown firm's approach, or the novelty of a foreign buyer?

In fact, a majority of our respondents (58%) believe that it depends entirely on the target in question. But among the minority of other respondents, a clear plurality (38%) think Canadian bidders have an edge over U.S. firms. A strikingly small proportion of buyers—just 4%—said that U.S. firms hold the upper hand between the two.

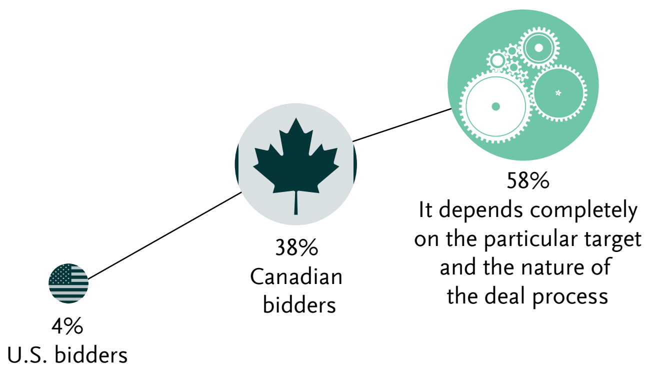
IN YOUR EXPERIENCE, WHAT ARE THE MOST EFFECTIVE WAYS OF IDENTIFYING CANADA-BASED INVESTMENT TARGETS? (SELECT TOP TWO)



Credit: ESA (2017), CC BY-SA 3.0 IGO



WHEN U.S. AND CANADIAN FINANCIAL BUYERS ARE COMPETING FOR THE SAME CANADIAN TARGET, WHO DO YOU THINK MORE OFTEN HAS THE ADVANTAGE?



Assessments vary as to what exactly the Canadian advantage is. Respondents from two Canadian firms, one investing foremost in the industrials and chemicals sector and the other in telecoms, feel that Canadian buyers have better contacts in the market, which can speed up the timeline for closing a deal.

From the competitor's perspective, Canadian firms' superior market knowledge and familiarity with the domestic business culture can be an asset, said a partner at a U.S. mid-market firm that has raised more than US$5bn since its formation.

At the end of the day, however, U.S. firms sometimes have the most compelling attraction: more capital and greater institutional infrastructure. Besides the ability to offer a higher valuation, these firms may have a greater capacity to carry out due diligence and access financing before making their bid.

"That's a big ask, and it's expensive. I think you're seeing some middle-market Canadian buyers being crowded out of certain larger deals," said Jon McCullough of Bennett Jones.

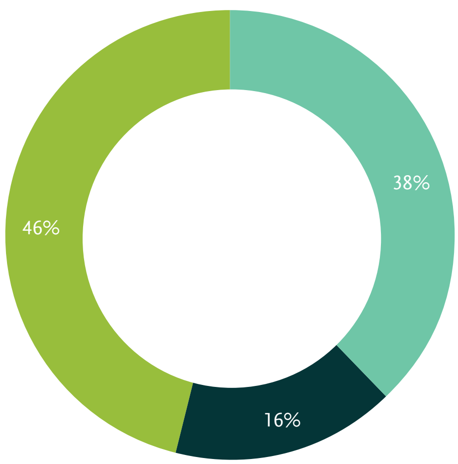
While the buyer's perspective is important, arguably more relevant are the views of management teams when it comes to the benefits of being owned by firms north or south of the border. In our separate survey of portfolio company executives, respondents did see quite distinct advantages to Canadian versus U.S. financial buyers. Executives at companies owned by Canadian firms said that the main benefits were longer hold periods or more flexible capital (46%) and a good cultural fit (38%).

One respondent, the CEO of a packaged food producer, noted that some Canadian financial buyers offer a more flexible approach: "[they] can provide that extra capital along with an extended holding period if the desired result is not achieved."

On the other hand, executives at U.S.-owned portfolio companies said their buyer's top advantage was the ability to pay a higher valuation (42%). Management at U.S.-owned Canadian companies also look to their buyers to help connect them to the global market. One-third (33%) of these respondents named access to international connections, such as U.S. contacts and foreign portfolio companies, as the biggest advantage of being owned by a U.S. firm.

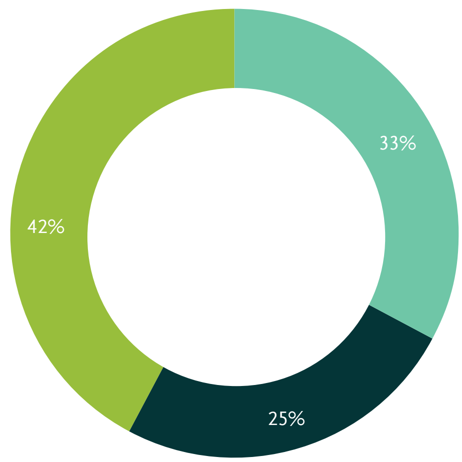
Canadian firms' superior market knowledge and familiarity with the domestic business culture can be an asset.

PORTFOLIO COMPANY RESPONDENTS OWNED BY CANADIAN PE FIRMS: WHAT DO YOU SEE AS THE BIGGEST ADVANTAGE OF BEING OWNED BY A CANADIAN PE FIRM? (SELECT ONE)



- Good cultural fit
- Greater access to domestic connections and contacts
- Longer hold period / more flexible capital

PORTFOLIO COMPANY RESPONDENTS OWNED BY U.S. PE FIRMS: WHAT DO YOU SEE AS THE BIGGEST ADVANTAGE OF BEING OWNED BY A U.S. PE FIRM? (SELECT ONE)



- Greater access to global connections (e.g., international portfolio companies, U.S. contacts)
- More aggressive growth targets
- They were able to pay a higher valuation

Feature

STRUCTURING PE DEALS IN CANADA

The Canadian lending environment and tax system are, in a word, idiosyncratic. At the same time, they are generally viewed positively by PE firms, according to our survey results.

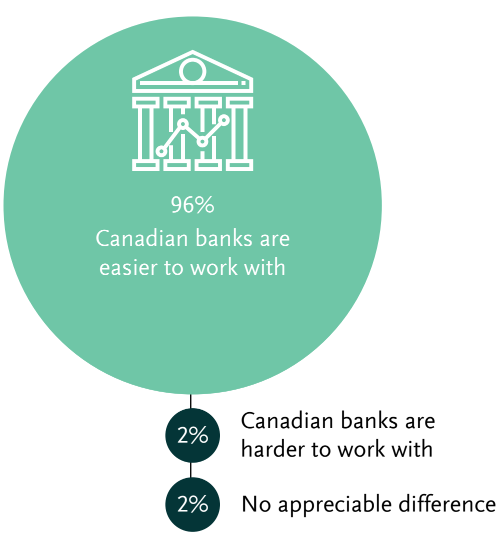
Almost all of our respondents (96%) said they thought Canadian banks were easier to work with than U.S. banks and other lenders. In addition, 74% said the nature of the Canadian tax system made targets more attractive in the country compared to U.S. targets, which may reflect the relative complexity of the U.S. tax system—and the fact that the effects of the recent U.S. tax reform are still being digested.

"The Canadian business environment is a strong one. It's got a really strong banking system and lending community that has stability, one that we've worked with for a very long time," said a managing director at a bicoastal U.S. PE firm that makes investments of up to US$500m. "And it's just got a way of doing business that is positive."

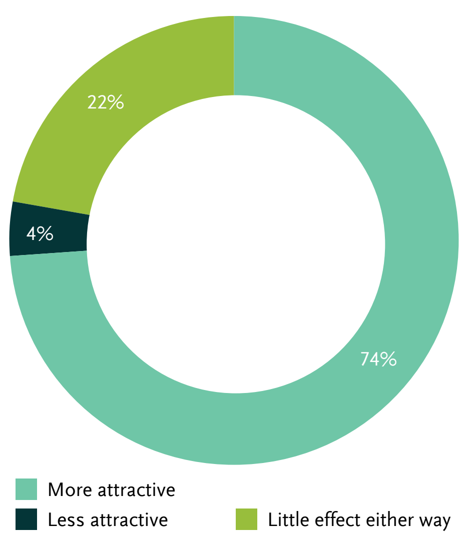
There are fewer lenders and fewer transactions in Canada than in the United States. As a result, there tends to be more acceptance of different kinds of covenant packages and other terms, which can ease the process of securing deal financing. Canada also has a less litigation-prone commercial environment, including in complex situations such as cross-border insolvencies. The U.S. has an array of players who trade in bank debt, and they can act very aggressively toward a company's management team if conditions at the business go south.

"The work-out process in U.S. Chapter 11 is a multiple of what happens in Canada in the same circumstances," said John Mercury of Bennett Jones.

IN YOUR OPINION, ARE CANADIAN BANKS AND OTHER LENDERS HARDER OR EASIER TO WORK WITH THAN U.S. BANKS AND OTHER LENDERS?



IN YOUR OPINION, DOES THE NATURE OF THE CANADIAN TAX SYSTEM MAKE CANADIAN TARGETS MORE ATTRACTIVE, LESS ATTRACTIVE, OR HAVE LITTLE EFFECT EITHER WAY COMPARED TO U.S. TARGETS? (SELECT ONE)

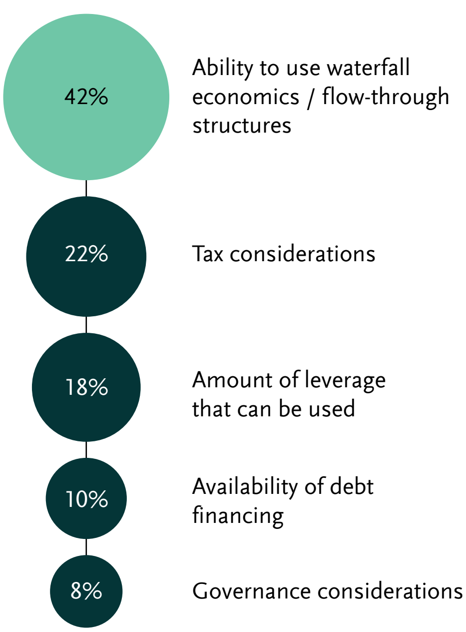


TAX CONSIDERATIONS ARE PARAMOUNT

When it comes to the Canadian tax system, structuring deals according to the laws is crucial to maximizing returns—especially when the buyer is coming from the United States or another foreign jurisdiction. Acquirers need to be mindful of the rules on both sides of the border when structuring investments and subsequent exits, dividend recaps and other matters related to cash flow.

Specifically, a plurality of our survey respondents (42%) said the ability to use "waterfall" economics or flow-through structures was the most important factor when structuring a deal in Canada. Tax considerations (22%) and the amount of leverage that can be used (18%) were also considered important by respondents.

WHAT ARE THE MOST IMPORTANT FACTORS WHEN STRUCTURING A DEAL FOR A CANADIAN TARGET? (SELECT THE MOST IMPORTANT)

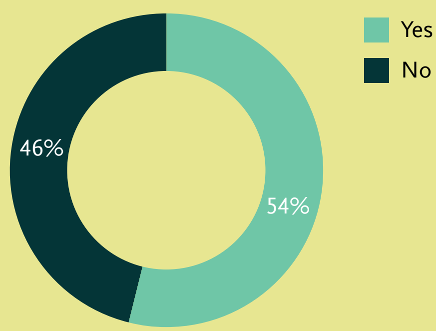


USE OF PRIVATE DEBT SET TO GROW

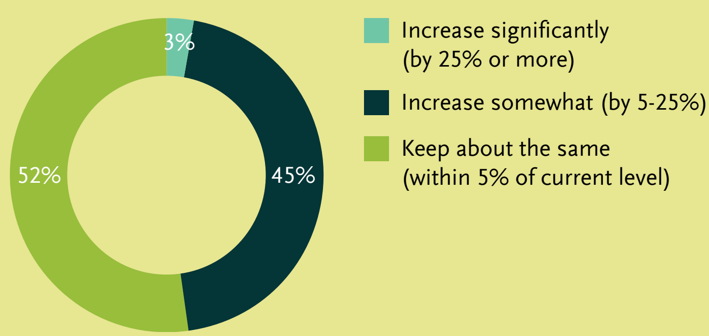
Just as investment in private lending by PE firms is on the rise, the use of private debt for financing deals is set to grow among our respondents. A majority (54%) said they already use private debt in their deals, and 48% of that group said they planned to increase their use of this type of financing either somewhat (45%) or significantly (3%) over the next one to two years.

One needn't look far to find a recent PE deal that utilized private debt for its lending package. For instance, U.S.-based Sentinel Capital Partners employed a lender group that included private debt providers Antares Capital (a CPPIB investment) and Barings in securing financing for its acquisition of Altima Dental Canada, a chain of dental clinics, in January 2017.

DOES YOUR FIRM CURRENTLY MAKE USE OF PRIVATE DEBT IN CANADIAN INVESTMENTS?



HOW DO YOU PLAN TO CHANGE YOUR USE OF PRIVATE DEBT IN CANADA OVER THE COMING 12-24 MONTHS, IF AT ALL?



A managing partner at a Silicon Valley-based PE firm that invests in the manufacturing sector said his firm relied on Canadian tax and legal counsel to help guide them through the process. "They were really the knowledge experts who we turned to in order to help us with the structuring—first so that we could understand the process, and second, so that we could appropriately structure our investment to deal with a few of the differences," the managing partner said.

Among the key differences between Canada and the United States is the way in which dividends are taxed. Any dollar that is distributed by a U.S. corporation is taxable until you exhaust earnings and profits, whereas in Canada capital may be returned tax-free first.

CLOSING A VALUATION GAP

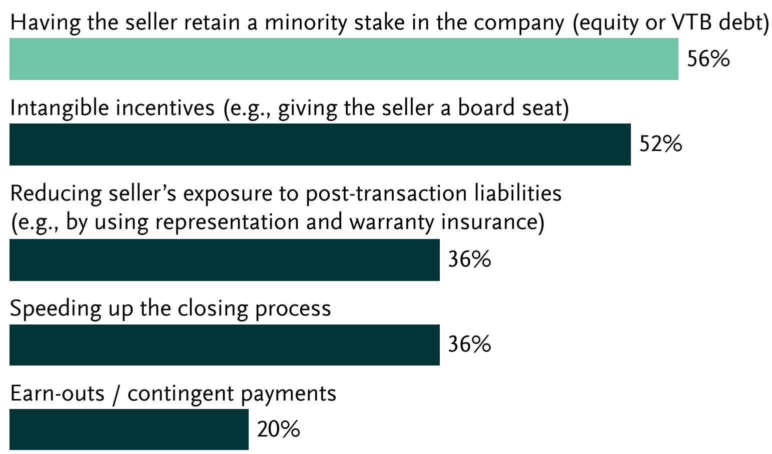
Another important aspect of deal structuring relates to methods for closing a valuation gap with targets. Two approaches to this task stood out as being favorable for respondents: having a seller retain a minority stake in the company (56%) and intangible incentives, such as furnishing the seller with a board seat (52%). Perhaps unsurprisingly, the potentially problematic earn-out is the least favored method (20%) for closing such a gap.

Tax considerations, once again, play a key role in determining the best approach to take when seeking to align the expectations of buyer and seller. The use of suitable incentives for a management team can help the buyer close the deal and ultimately make the partnership more successful.

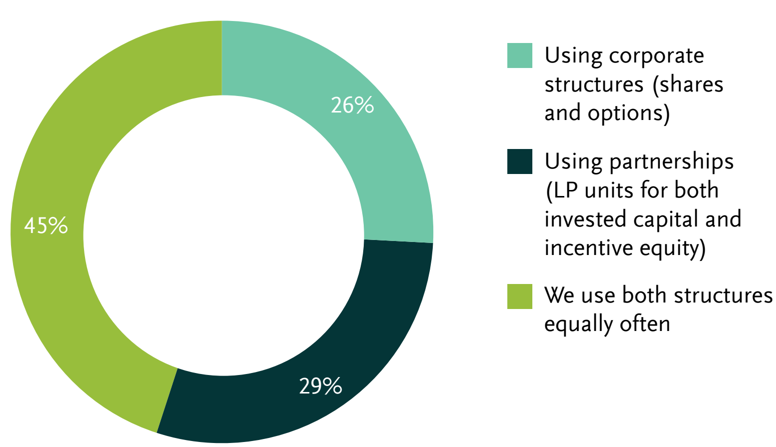
One aspect of configuring incentive programs in Canadian buyouts is the use of corporate structures versus partnerships. Our respondents were largely split on this point, with just over a quarter (26%) saying they use corporate structures more often, an approximately equal proportion (29%) saying they use partnerships more frequently, and the remaining 45% said they use both equally often.

Partnerships can be a good replacement for limited liability corporation (LLC) structures, which are common in the United States but not available in Canada.

IN YOUR EXPERIENCE, WHAT ARE THE MOST EFFECTIVE METHODS OF CLOSING A VALUATION GAP WITH CANADIAN TARGETS? (SELECT TOP TWO)



HOW DO YOU MOST OFTEN STRUCTURE MANAGEMENT INCENTIVE PROGRAMS IN YOUR CANADIAN BUYOUT DEALS? (SELECT ONE)?



Part 3

PARTNERING WITH CANADIAN COMPANIES: ALIGNING THE GOALS AND EXPECTATIONS OF PE OWNERS AND MANAGEMENT TEAMS

Management and PE respondents alike saw growth—both financial and geographical—as a top priority for Canadian companies seeking PE investment. Forty-eight percent of portfolio company executives said that one of the top benefits they hoped to gain by selling to a PE firm was help rapidly growing their business, while 42% of PE respondents agreed that growth was a main area of focus for sellers.

International connections were another priority, although investors emphasized the importance of their networks somewhat more than management did. More than half (52%) of PE respondents believe that their firms' global networks are one of the main benefits that Canadian management teams seek in a buyout, whereas 40% of portfolio company executives said this was a major selling point.

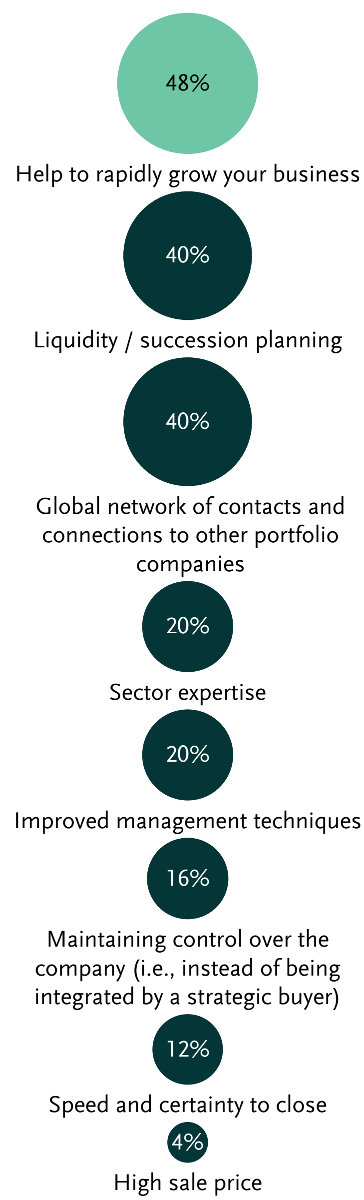
These twin priorities provide a clear advantage to PE firms that make a point of offering target companies both access to financing and links to foreign markets.

"Our main criteria was to rapidly grow our business. The second important factor was to build stronger international connections," said the director of corporate development for a chain of healthcare facilities owned by a U.S. PE firm. "We had to choose a PE firm that possessed both these characteristics."

One example of such a firm is San Francisco-based Swander Pace Capital, which has invested in a number of Canadian companies in its 22-year history. And in several cases, the PE owner both helped its portfolio companies expand in North America and then exited those investments by selling them to European strategic buyers, thereby showcasing its international connections.

In the most recent instance of this pattern, the firm sold British Columbia-based organic

PORTFOLIO COMPANY RESPONDENTS: WHAT WERE THE MAIN BENEFITS YOU SOUGHT IN SELLING TO A PE FIRM? (SELECT TOP TWO)



PE RESPONDENTS: IN YOUR EXPERIENCE, WHAT ARE THE MAIN BENEFITS CANADIAN COMPANIES/ MANAGEMENT TEAMS ARE SEEKING WHEN SELLING TO/ PARTNERING WITH A PE FIRM? (SELECT TOP TWO)

coffee maker Kicking Horse Coffee to Italian coffee company Lavazza for US$128m in 2017.

While executives and PE respondents both saw growth as a priority, their perceptions of other motivations for the partnership diverged to some degree.

For instance, 50% of PE respondents said they thought improved management techniques were a main benefit sought by targets—but just 20% of portfolio company executives confirmed this perception. Moreover, buyers completely missed one of the top reasons that sellers seek partnerships with PE firms: liquidity and succession planning. Forty percent of portfolio company executives said this was a top reason they looked to sell, reflecting the fact that many mid-sized portfolio companies are family-run.

Interestingly, PE respondents also somewhat overestimated the value that sellers place on maintaining control over their companies after a sale. Just 16% of portfolio company executives said that maintaining control of the company was one of the main reasons for selling to a financial buyer as opposed to a strategic buyer, whereas nearly a third (32%) of PE respondents said they thought this was an important factor.

CULTURE, MANAGEMENT TECHNIQUES CAUSE TENSION

According to our respondents, the toughest challenges that PE firms and Canadian companies face in their partnerships are aligning expectations for growth and building healthy working relationships.

The two sides both named growing the company as one of the biggest obstacles in relations with the other party. On the private equity side, about a third (34%) said that expanding or growing the business was one

SKEPTICISM TOWARD SHORT-TERM CAPITAL

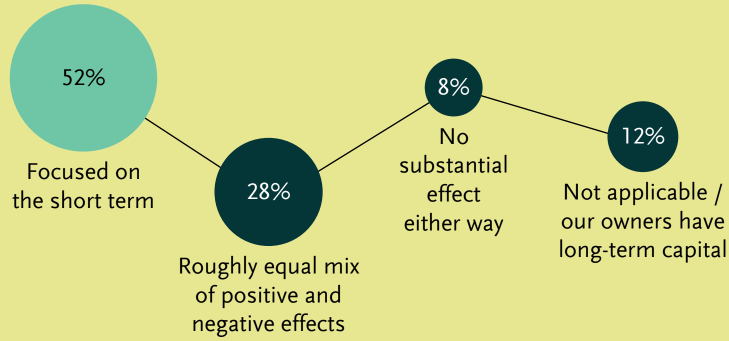
More common than friction over micromanagement or even growth targets, the temporary nature of PE ownership frequently results in tension with Canadian companies. A majority of portfolio firm executives (52%) said the fact that PE capital is short term has an overall negative effect on the business, making their owner's decisions too focused on the near future rather than the longer term. No respondents said that private equity's compressed timeframe has a positive impact.

Moreover, about a third (34%) of PE respondents said that a major difficulty was preparing the portfolio company for the firm's eventual exit. On the other side, 40% of company executives said that managing the company in the face of the owner's exit was one of their key challenges.

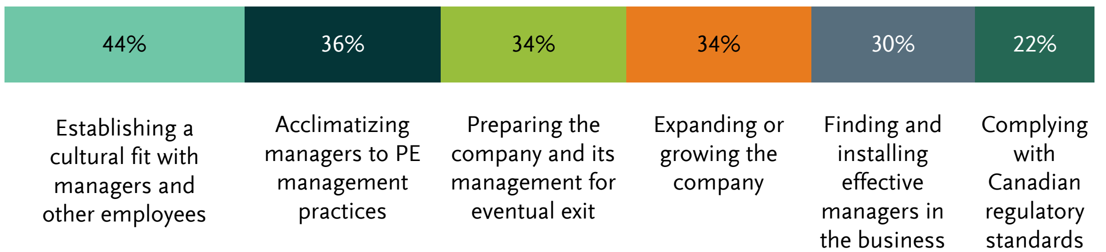
Notably, 12% of respondents said their owners actually have long-term capital—part of a growing trend among PE firms and family offices to extend fund timelines or to make investments without pre-defined exit agendas.

Indeed, a number of firms with investments in Canadian companies allow for longer hold periods, such as Vancouver, B.C.-based Yellow Point Equity Partners, which permits a hold of up to 15 years. This approach has also taken root at the top of the industry, with major firms such as Blackstone and The Carlyle Group launching PE funds focused on long-term investments.

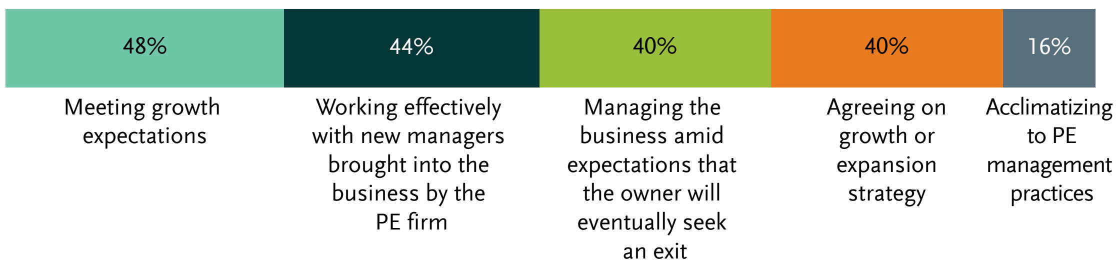
PORTFOLIO COMPANY RESPONDENTS: IN YOUR VIEW, HOW DOES/ DID THE NATURE OF PRIVATE EQUITY AS SHORT-TERM CAPITAL (E.G., OFTEN SEEKING EXITS WITHIN 3 TO 5 YEARS) AFFECT YOUR OWNERS' MANAGEMENT OF YOUR COMPANY? (SELECT ONE)



PE RESPONDENTS: WHAT ARE THE BIGGEST CHALLENGES YOU FACE IN MANAGING YOUR CANADA-BASED PORTFOLIO COMPANIES? (SELECT TOP TWO)



PORTFOLIO COMPANY RESPONDENTS: WHAT ARE/WERE THE BIGGEST CHALLENGES YOU HAVE FACED IN WORKING WITH YOUR PRIVATE EQUITY OWNERS? (SELECT TOP TWO)



of their top two challenges when it came to managing their Canadian portfolio companies.

Issues related to expansion were named even more frequently by management: 48% of executives at the Canadian companies said that meeting their buyer's growth expectations was a stumbling block in the partnership, while 40% said that agreeing on a growth or expansion strategy with their investors was another obstacle.

"Meeting the growth expectations of our owners is difficult," said an executive at a healthcare company owned by a U.S.-based PE firm. "They needed to understand our business before formulating strategies, and we did face challenges initially."

The two sides also agreed that working together can become difficult. A plurality of PE respondents (44%) felt that establishing a cultural fit with managers and other employees is one of their primary management problems.

In part, these issues seem to come down to differences between the PE firm's approach and the way managers handled decisions prior to the buyout. Thirty-six percent of PE respondents thought acclimatizing managers to PE management practices was one of the top challenges they faced, while 44% of portfolio company respondents felt that working effectively with new management installed by the buyer was one of theirs.

PE OWNERS HELP WITH FINANCING, STRATEGY

Although relationships between acquirers and management teams are not always smooth sailing, our portfolio company respondents said they were satisfied overall with the operational role played by their PE owners. More than three-quarters (76%) of respondents said their owners were "involved just the right amount" in the day-to-day operations of the company, without unnecessary interventions or interference in corporate activities.

However, a small but vocal minority (24%) felt that their owners are too involved—with negative consequences for the long-term prospects of the business. In particular, several portfolio company respondents objected to their owners overstepping their boundaries and getting involved in the company's day-to-day operations.

24% of portfolio company executives said that their PE owners were too involved in day-to-day operations

This level of involvement does appear to be the exception rather than the rule, with only about one-third (36%) of company executives observing their owners giving input on day-to-day business decisions. Involvement in hiring is more common, with more than half (56%) of executives saying that their owners provide input on hiring decisions.

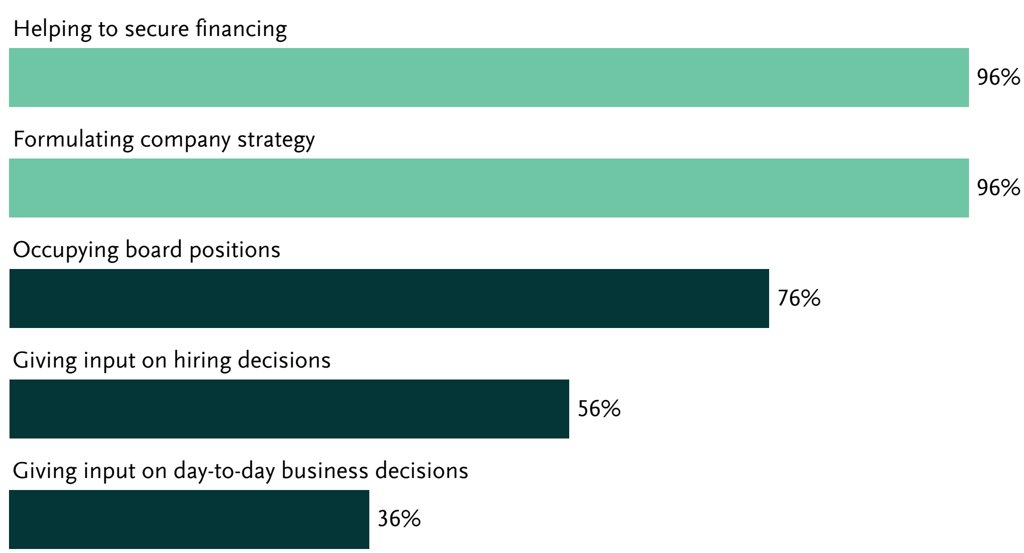
According to the executives, some of the most common ways in which owners take part in operations include helping to secure financing (96%), formulating company strategy (96%), and occupying board positions (76%).

"Now it is not just about investing capital," said the CFO of a technology company owned by a Canadian private equity firm. "PE firms are looking for increased involvement to oversee how their invested capital is used and whether it is going to add value."

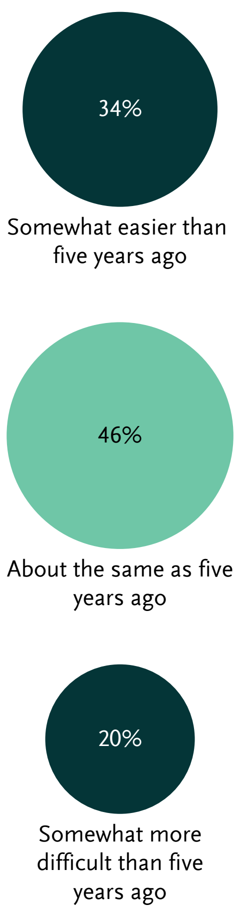
EXIT ENVIRONMENT—STEADY AS SHE GOES

Overall, PE respondents feel that the environment for exits remains stable in Canada, despite headwinds in certain sectors, such as energy.

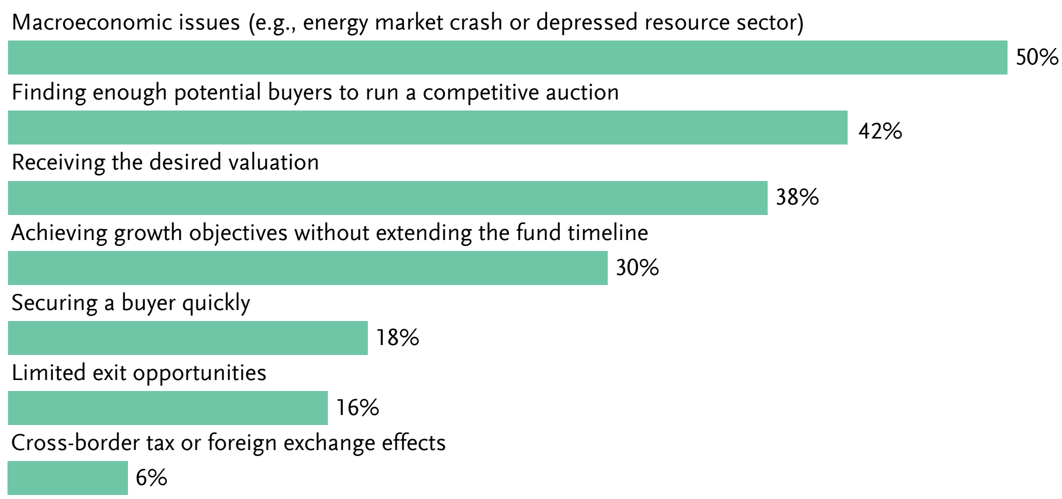
PORTFOLIO COMPANY RESPONDENTS: IN WHICH OF THE FOLLOWING WAYS DO / DID YOUR PE OWNERS TAKE PART IN THE OPERATION OF YOUR COMPANY? (SELECT ALL THAT APPLY)



PE RESPONDENTS: BASED ON YOUR KNOWLEDGE AND EXPERIENCE IN THE MARKET, HOW DIFFICULT IS IT PRESENTLY TO EXIT INVESTMENTS IN CANADIAN PORTFOLIO COMPANIES COMPARED TO FIVE YEARS AGO? (SELECT ONE)



PE RESPONDENTS: WHAT ARE THE BIGGEST CHALLENGES YOU'VE FACED WHEN SEEKING TO EXIT YOUR CANADIAN INVESTMENTS? (SELECT TOP TWO)



The year 2017 saw a record value total for exits of Canada-based assets at US$14.7bn, according to Mergermarket data. Three transactions valued at over US$1bn each—including U.K.-based Permira Advisers' US$2.3bn sale of Québec-based nutritional supplements producer Atrium Innovations to Swiss consumer giant Nestle—represented more than half this amount.

In our survey, a plurality of respondents (46%) said it is currently about as difficult as it was five years ago to exit their investments in Canadian portfolio companies. About a third (34%) said that it has become easier, compared to 20% who said it is now more difficult. Several respondents remarked that improvements in the market for IPOs have been a particular boon for private equity in Canada.

"The exit environment has improved a lot, particularly with the return of the IPO market," said a partner at a Texas-based fund. "For private equity, now is a very good time to exit through IPO."

Several prominent IPOs last year, such as the US$255m listing of outerwear producer Canada Goose, which is backed by alternative investment firm Bain Capital, support this observation.

The biggest challenges that PE firms have faced when seeking an exit are macroeconomic issues (50%) and finding enough potential buyers to run a competitive auction (42%).

Yet another obstacle is increased caution on the part of potential buyers, a trend now seen across the global PE industry. With macroeconomic conditions having become significantly less predictable over the last 18-24 months, buyers are more inclined to spend time negotiating and driving down valuations, said the managing director of a New York-based PE firm focused primarily on infrastructure investments.

Conclusion

KEYS TO SUCCESS

Our survey suggests that Canada will remain an attractive destination for PE investment over the coming years, thanks to both anticipated growth in the Canadian economy and pressure on PE firms to seek out new territory amid intense competition for acquisitions worldwide.

The sectors likely to provoke the most interest on the part of investors are consumer goods, industrials and chemicals, and technology. As for the crucial energy sector, it remains to be seen whether higher prices will give the sector the boost it needs to overcome the recent downturn and domestic political and regulatory challenges.

U.S. firms will continue to examine potential investment targets in Canada, drawn by lower valuations—at least for now—and the opportunity to diversify their assets without straying too far from home. The wild cards will be U.S. trade policy and the as-yet-unknown impact of U.S. tax reform on Canada's competitiveness as an environment for investment.

As for Canadian players, large funds may benefit from a slight home-field advantage, which includes a better cultural fit and greater access to domestic connections. Small buyers also wield that advantage, but may nonetheless be increasingly squeezed by foreign players with greater access to capital and superior infrastructure.

This survey also suggests several lessons that PE firms seeking deals in Canada would be wise to heed. During targeting, developing relationships with company executives is critical, whether through personal interaction, employing intermediaries, or establishing a physical presence in Canada.

When making a bid, it is important to remember that capital is not the only factor Canadian target companies will consider; in some cases, openness to a longer hold period may make a bid significantly more attractive. And once a deal is signed, both PE firms and portfolio company executives should be prepared to carefully navigate the tensions that can arise when transitioning to a new management style and agreeing on growth targets.

Finally, if they want to protect their prospects in the country, foreign firms should exercise caution in interactions with Canadian business entities—creditors in particular. News travels fast in the tight-knit Canadian business community, and just as one good impression can yield benefits down the road, a negative one can do precisely the opposite.

U.S. firms will continue to examine potential targets in Canada, drawn by lower valuations—at least for now—and the opportunity to diversify their assets.

About Mergermarket

Mergermarket

An Acuris company

Mergermarket is an unparalleled, independent mergers & acquisitions (M&A) proprietary intelligence tool. Unlike any other service of its kind, Mergermarket provides a complete overview of the M&A market by offering both a forward-looking intelligence database and a historical deals database, achieving real revenues for Mergermarket clients.

Acuris Studios

Acuris Studios, the events and publications arm of Acuris, offers a range of publishing, research and events service that enable clients to enhance their brand profile, and to develop new business opportunities with their target audience.

To find out more, please visit:
www.acurisstudios.com

For more information, please contact:
Alissa Rozen
Head of Sales, Acuris Studios
Tel: +1 212 500 1394

About Bennett Jones

Bennett Jones

Bennett Jones is one of Canada's premier business law firms and home to 400 lawyers and business advisors. With deep experience in complex transactions and litigation matters, the firm is well equipped to advise businesses and investors with Canadian ventures, and connect Canadian businesses and investors with opportunities around the world.

To find out more, please visit:
www.bennettjones.com

For more information, please contact:

John Mercury
Partner and Vice Chair, Clients and Industries
Bennett Jones LLP
T: 403.298.4493
mercuryj@bennettjones.com

Jon McCullough
Partner, Co-Head of Corporate Department
Bennett Jones LLP
T: 604.891.5306
mcculloughj@bennettjones.com

Bennett Jones

www.bennettjones.com

Mergermarket
An Acuris company

Acuris Studios

www.mergermarket.com

330 Hudson St. FL 4
New York, NY 10013

t: +1 212.686.5606
f: +1 212.686.2664