BUSINESSCLASS
KNOWLEDGE ▪ SEMINARS ▪ INSIGHTS

Blakes

# TRENDS

## PRIVATE EQUITY

As part of our quarterly series on current trends across different industries, our third article examines Canadian private equity. Through our experience advising buyers, sellers, investors and/or targets, we've highlighted some national trends and developments.

By John-Paul Bogden, Rory ffrench, Daniel McLeod, Patrick Menda, Rianna Ritchie, Trevor Rowles and Kurt Sarno

1

### Sellers' Market

While overall year-to-date 2018 deal value has been propped up by a small number of megadeals, there has been considerable deal volume in transactions under C$100-million, according to the CVCA Venture Capital and Private Equity Canadian Market Overview H1 2018.

Irrespective of deal size, it is clear that the seller-friendly dynamics that have been so pervasive in recent years are continuing in full force in 2018, even at the smaller end of the market. With the significant amount of private equity and pension fund dry powder available for deployment, we see no signs of these seller-friendly conditions letting up any time soon.

Near the top of these seller-friendly conditions is the high frequency — and now near-routine nature — of auction sale processes. It is becoming increasingly common to see sellers, even in lower value deals, engaging sell-side financial advisers. Further, the auctions themselves are intensifying with greater bidder participation, both foreign and domestic, and increasingly demanding bid requirements.

In higher value transactions, it is now common to see multiple bidders advance through numerous auction stages, including negotiations of potentially binding transaction agreements, all before a successful bidder is selected. This is driving up the "cost to play" and squeezing bidders not just on price but also on transaction terms.

Examples of the impact on transaction terms can be seen among the post-closing protections that buyers are able to obtain from sellers:

**Baskets & Caps**

In deals where the seller agrees to provide an indemnification package, deal agreements have continued to predominantly include the more seller-friendly form of basket — a deductible instead of a threshold. This is consistent with the findings in our 2018 Canadian Private Equity Deal Study (Deal Study) in which 64 per cent of deals with indemnification packages included deductibles, as compared to 35 per cent of such deals which carried thresholds.

Similarly, consistent with the decline in retentions under representation and warranty (R&W) insurance policies, we have seen a trend towards lower basket sizes, typically 50 per cent of retention amounts. The same type of decline has been seen in general representation and warranty liability caps, which we believe is indicative of both the seller and auction pressure for bidders/buyers to offer lower post-closing exposure for sellers, and the proliferation of R&W insurance policies, which customarily set the cap for general representation and warranty breaches at the retention/deductible under such policies.

**Escrow**

As documented in our Deal Study, there was a sharp drop in escrow size in 2017 as compared to the preceding three years (from medians of approximately five to six per cent of purchase price in 2014-16, down to a median of approximately one per cent of purchase price in 2017) and there has similarly been a steady year-over-year decline in escrow hold periods from 2014 (median of 21 months) to 2017 (median of 14 months).

In 2018, the drop in escrow size and decline in escrow period appear to be changes reflective of a shift in the market rather than a temporary anomaly. With sellers eager to reduce the portion of their proceeds that are tied up for significant periods in escrow, it is not surprising they are putting direct pressure on bidders to minimize their escrow "asks".

These declines are also reflective of the fact that sellers are actively encouraging bidders to use R&W insurance policies as the primary source of post-closing recourse, reducing the need for bidders to rely on and thus negotiate for extensive escrow shelters.

**Fewer Standalone Indemnities for Unknown Liabilities**

We are noticing a continuing trend away from deals including standalone indemnities for unknown liabilities. In line with the theme of sellers aiming to minimize their post-closing exposure and obtain clean exits, these standalone indemnities — which in some industries may have traditionally been common sources of buyer protection (e.g., an environmental indemnity in a sale of a manufacturing target) — have become decreasingly available to bidders.

Such unknown risks are now to be factored into bid prices, captured by representations and warranties (and potentially protected under R&W insurance policies) or just absorbed by bidders as another of the new costs of playing in this space.

**Shorter Survival Periods**

The market position for the survival of general representations and warranties in Canadian private M&A, and in private equity deals specifically, appears to have roughly settled at 18 months (with minor variances). An interesting feature of 2018 deals has been the ongoing acceptance by bidders of finite and in fact increasingly shorter survival periods for fundamental representations and warranties. In our Deal Study, 31 per cent of deals had a fixed survival period on fundamental representations and warranties, and we expect this percentage to grow in 2018.

Similarly, whereas traditional Canadian M&A practice would see a fraud claim related to a breach of a representation or warranty surviving indefinitely — in line with findings in our Deal Study — we are increasingly seeing breaches of representations and warranties due to fraud being treated the same as any other breach of representations and warranties. In 44 per cent of the deals in our Deal Study, a breach of R&Ws arising from fraud was not afforded any special or different treatment as compared to any other breach of such R&Ws.

2

## Representation & Warranty Insurance

Both our Deal Study and our more recent private equity transaction experience have shown that R&W insurance has become a staple in Canadian private equity transactions and that the market for this type of insurance product continues to rapidly evolve. The current "sellers' market" has required buyers to find means of distinguishing themselves from their peers by offering limited post-closing exposure to sellers, similar to public company style transactions.

This trend, coupled with heightened competition among insurers jockeying for increased market share, has led to decreased retentions and premiums, the rise of no-seller recourse policies and an expansion of the coverage offered under R&W insurance, making R&W insurance more accessible and attractive.

**Retentions and Premiums Decreasing**

Data set out in our Deal Study and sourced from R&W insurance brokers BFL Canada, Marsh LLC and Ethos Insurance Partners Inc. has shown that the policy premiums have steadily declined year over year to settle between 2.77 per cent and three per cent of the policy limit for 2017. Our recent transaction experience shows that this downward trend continues in 2018.

Similarly, retention amounts (or deductibles) under R&W insurance policies have also followed this downward trend, dropping well below two per cent of the policy limit for 2017, and some R&W insurance brokers have indicated that retentions have averaged one per cent of the policy limit for 2018.

**No-Seller Indemnity Policies**

Another bi-product of the competitive Canadian private equity M&A marketplace and more robust competition among providers of R&W insurance policies is the increased use of no-seller indemnity R&W insurance policies.

While traditionally sellers would generally share the burden of the retention amount or deductible under the R&W insurance policy — such that they would continue to have some "skin in the game" for a limited period of time following the closing of the transaction — the current sellers' market has fuelled the need for buyers to distinguish themselves from their competition and led to more frequent use of no-seller recourse R&W insurance policies. Under this construct, the sellers do not share in any portion of the retention amount resulting in an exit that, subject to a few exceptions, is similar to a public company style deal by offering a clean break with little to no residual post-closing liability for sellers.

**R&W Scope Expansion**

One other trend that we have noticed over the course of 2018, which likely results in part from the more competitive R&W insurance landscape, is that the scope of representations and warranties covered by R&W insurance has steadily expanded. While certain matters such as pre-closing taxes and environmental matters were typically excluded from R&W insurance — often because the quantum of the liabilities that flow from such matters is difficult to compute and may be material — we've seen a steady trend towards such matters now getting coverage under R&W insurance policies and fewer exclusions from policy coverage.

3

## Industry Trends

**Private Plans of Arrangement Transactions**

We have also seen increased private equity interest in the technology and software sectors, principally from technology-focused private equity funds based in the United States. Unlike Canadian businesses in traditional industries where equity is often concentrated in the hands of key management members and institutional investors, many technology-based businesses — and particularly those that have been through a start-up phase — offer equity to employees and consultants as a primary form of compensation.

Due to the meaningful lifetime capital gains exemption available to individuals under Canadian tax laws and to the more straightforward nature of share transactions as compared to asset transactions, most securityholders of Canadian companies will wish to undertake a sale of their securities as opposed to selling the assets of the company.

Accordingly, private equity buyers seeking to acquire such businesses will often need to contend with lengthy shareholder and optionholder lists and the practicalities of having all such securityholders participate in the transaction.

In such circumstances, private equity buyers must choose between entering into a multiparty securities purchase agreement with all securityholders or acquiring the securities of the target company through a plan of arrangement transaction in which the shareholders of a target company will pass a resolution approving the transaction, and the target company and the buyer will seek a court order conveying or otherwise dealing with the target company's shares and options on terms and conditions agreed between the target company and the private equity buyer.

Both approaches come with drawbacks. While a purchase agreement will be familiar to private equity buyers and offers the most transactional flexibility, ensuring that every single securityholder actually executes and delivers the primary purchase agreement can be practically challenging and can afford a "holdout" securityholder a disproportionate amount of leverage. In turn, a plan of arrangement transaction entails a greater number of steps and complications relative to a purchase agreement transaction, including the following:

- A plan of arrangement and arrangement agreement
- Court materials and shareholder meeting materials, which often include shareholder lockup agreements obliging key shareholders to vote in favour of the arrangement and a detailed management proxy circular to be circulated in connection with the special shareholders meeting
- Court orders approving the shareholder meeting and the completion of the arrangement following a successful shareholder vote.

These additional documents and steps generally lead to significantly increased transaction costs for the private equity buyer and the target company, as well as a lengthier timeline to closing.

Moreover, as private plan of arrangement transactions remain relatively uncommon and the arrangement structure is more conventionally used to acquire public companies, care must be taken when drafting the plan of arrangement transaction documents so that typical private company deal terms that private equity buyers are accustomed to receiving — such as post-closing indemnification obligations, working capital and price adjustment provisions, and third-party escrow provisions — are properly reflected and implemented. Once drafted, these provisions must also be accurately described in the shareholder meeting materials so that shareholders can fairly determine whether to vote in favour of the transaction and must also be described to the court when seeking the court orders needed to effect the plan of arrangement.

Widely held private companies can take the following steps to both avoid the need to utilize a plan of arrangement structure and ameliorate the practical challenges entailed in a multiparty purchase agreement:

- A shareholders' agreement with properly drafted and robust drag-along provisions obliging all shareholders to transfer their shares to a buyer once certain conditions are met can provide comfort to a private equity buyer that there won't be any "holdout" shareholder issues
- A properly drafted option plan that both expressly addresses the sale or surrender of the options in a sale of the company and grants broad powers to the target board of directors or a committee of the board of directors to administer the plan and options may avoid the need for optionholders to be made party to the purchase agreement

**Private Equity in Canadian Energy**

After seeing increases in private equity activity in the upstream oil and natural gas sector after the immediate fallout of the late 2014 oil price crash, activity in 2017 was more muted and 2018 continues to show reduced transaction activity.

The initial shock of the dramatic decrease in commodity prices in 2014 and 2015 led to considerable acquisition and investment opportunities as companies sought to manage their debt and bolster their balance sheets by selling non-core assets.

Through 2017 and into 2018, higher international oil prices, together with leaner Canadian exploration and production (E&P) and energy services companies, have provided enhanced stability to the Canadian energy industry. The industry continues to face challenges, including regulatory uncertainty and operational issues arising from limits on oil and natural gas transportation capacity that has led to record price discounts for Canadian energy products compared to international oil prices. Accordingly, the seller-friendly trends visible in the rest of the Canadian private equity universe have largely not carried over to the Canadian oil and gas space. R&W insurance remains rare in the Alberta market, and general deal terms follow a unique model. Buyers often have the upper hand in negotiations in the current environment, although each transaction will vary depending on the specific deal dynamics.

Still, industry and private equity players do recognize the potential for investment and acquisition opportunities. Strategic acquirers, including those that have made large acquisitions from U.S. majors leaving the Canadian industry in recent years, are likely to look to continue to divest non-core assets to further improve their balance sheets. This will provide experienced management teams with private equity backing with opportunities to start new portfolio companies or expand existing ones.

The relatively low asset valuations and Canadian dollar exchange rate present a potentially attractive investment for private equity firms and their portfolio companies, with tremendous potential upside once transportation capacity and regulatory questions are resolved.

The recent positive final investment decision by the LNG Canada consortium to proceed with the construction of a liquefied natural gas (LNG) export terminal in British Columbia is expected to attract investment and development of the long-suffering Canadian natural gas industry.

Finally, there is continued interest in midstream, transportation and other infrastructure opportunities, in light of the need that oil and gas producers have to move their increased production to market or find alternative uses and markets for their products.

## CONTACTS


### Montréal

**Patrick Menda**
Partner
514-982-5051
patrick.menda@blakes.com

### Toronto

**Kurt Sarno**
Partner
416-863-2681
kurt.sarno@blakes.com

**Rory ffrench**
Associate
416-863-3314
rory.ffrench@blakes.com

### Calgary

**Daniel McLeod**
Partner
403-260-9629
daniel.mcleod@blakes.com

**Trevor Rowles**
Partner
403-260-9750
trevor.rowles@blakes.com

### Vancouver

**John-Paul Bogden**
Partner
604-631-3375
jp.bogden@blakes.com

**Rianna Ritchie**
Associate
604-631-5253
rianna.ritchie@blakes.com