Goodmans LLP

Private Equity: What's in Store for 2014?

The large amounts of undeployed capital available to Canadian private equity ("**PE**") funds and a renewed willingness by banks to extend credit on more favourable terms have set the stage for an active year in the Canadian PE market. Here are five trends to watch for this year.

Increased Reliance on Rep & Warranty Insurance

Representation and warranty insurance (RWI) covers indemnification obligations arising from a breach of representations and warranties in a purchase agreement. RWI policy pricing is transaction-specific, but premiums are generally in the range of 2-4% of the coverage limit and deductibles are typically between 1-3% of the transaction value.

RWI benefits sellers and buyers in several ways:

- It lessens the seller's potential exposure in the event of a breach.
- It may reduce the need for capital clawbacks from investors to fund a successful claim.
- It can reduce or even eliminate the need for traditional means of securing indemnification obligations, such as depositing a portion of the sale proceeds into an escrow account. Minimizing the percentage of sale proceeds deposited into escrow helps maximize the seller's internal rate of return from the investment (an increasingly important metric for PE funds in the current competitive fundraising environment).
- Buyers looking to position bids in a competitive auction can seek a lower escrow or indemnity cap where RWI is in place.
- In the negotiation process, RWI can reduce friction between the parties by taking contentious issues such as escrows and indemnity caps off the table, or at least minimize their significance.
- RWI is particularly attractive where the seller's management retains an ongoing interest in the business by potentially eliminating the unpleasant scenario of having to seek recovery from management for a breach.

Although insurers have offered RWI for over two decades, the use of RWI by both buyers and sellers has rapidly grown in recent years. Of the estimated 1,500 RWI policies issued worldwide over the last decade, approximately 45% were issued in 2012. This trend continued in 2013, with a leading global insurer having issued more than twice as many RWI policies in 2013 in Canada and the U.S. than in 2011. In absolute terms, Aon's North American team placed more than $3 billion of RWI coverage for 60 transactions in 2013, but this still represented a relatively small percentage of overall M&A volume. Aon estimates that RWI insurance was obtained for between just 6-8% of U.S. transactions in 2013 and only 1-2% of deals in Canada. We expect further growth in RWI use in Canada as the market becomes more familiar with its benefits.

Improved Fundraising Climate

Canadian private equity funds continued to report robust fundraising activity in 2013, following on a strong 2012. New capital totaling $6.1 billion was committed to 25 PE funds during the first three quarters of 2013, 27% higher than the level reported in all of 2012. This follows on the heels of the industry's successful fundraising efforts in 2012, when a total of $4.6 billion was committed to 23 domestic funds, up 24% from 2011. Given this abundance of "dry powder," we expect private equity funds to actively seek opportunities to invest this capital in 2014.

Exit Uncertainty

After a relatively strong performance in 2012, the total number of PE fund realizations of Canadian portfolio companies slowed by 16% in the first three quarters of 2013, with 53 exits compared to 63 in the year-earlier period. Sales to strategic acquirers accounted for 60% of the total. Amidst an overall slowdown in the Canadian IPO market, the "dual track process" (where a seller simultaneously explores both an IPO and a negotiated M&A auction) has been followed less frequently by PE sellers, in part because IPO exits for Canadian private equity-backed companies have been relatively infrequent and typically only partial exits. Since 2009, there have been only nine instances where a PE fund exited its investment by way of a Canadian IPO. This differs from the United States, where 57 PE-backed companies went public in 2013 alone.

Balanced against this general slowdown in exits is the structural pressure on private equity funds to realize on aging assets and return capital to their LPs. Many boom era vintage funds are reaching the end of their terms. With each additional quarter, IRRs on many investments made before the global financial crisis are coming under downward pressure, even as valuations have started to increase. This has further enhanced the desire of PE funds to sell. PE funds are increasingly considering an exit from their investments through a sale to other PE funds, rather than selling to a strategic acquirer - the more traditional exit route.

Global secondary buyout activity remained essentially unchanged in 2013, both in terms of the number of overall deals (481 in 2012 versus 480 in 2013) and realized investments (US$77.5 billion in 2012 versus US$78 billion in 2013). After a particularly strong 2012, the pace of U.S. secondary buyouts slowed in 2013, with overall deal value falling to US$79.8 billion, a 7.6% drop from 2012 (US$86.4 billion). The market share of secondary buyouts to total exits increased marginally to 29.5% compared to 29% in the prior year. While the Canadian private equity market has lagged the U.S. in secondary buyout exits (only 23% of Canadian PE exits were to financial buyers through the first three quarters of 2013), the combination of (i) newer funds having access to substantial amounts of capital, (ii) older funds reaching the ends of their terms, and (iii) the U.S. market trends suggests that secondary buyouts may become increasingly common in Canada in 2014.

Use of Sandbagging Provisions

The volume of private M&A activity in the United States dwarfs that in Canada, with the result that certain deal points often take longer to become "market" in Canada. One of these points is whether or not to include "sandbagging" provisions in purchase agreements. These provisions address the impact that a buyer's knowledge of a breach will have on its ability to assert a post-closing indemnity claim against a seller. A "pro-sandbagging" provision generally provides that a buyer's knowledge of a breach will not affect its right to seek indemnification and is obviously more favourable to the buyer. Sellers, on the other hand, would prefer an "anti-sandbagging" clause, which prohibits buyers from making claims if they had pre-closing knowledge of the breach.

The inclusion of pro-sandbagging provisions has held relatively constant in the U.S. over the last several years (according to the 2013 ABA Private Target M&A Deal Points Study, 41% of private M&A transactions surveyed included such a provision), but only recently have a significant number of Canadian agreements followed suit. The 2012 ABA Canadian Private Target M&A Deal Points Study indicates that 24% of the surveyed transactions included a pro-sandbagging provision, more than twice the percentage disclosed in the

2010 Canadian study. In 2012, 9% of Canadian agreements included anti-sandbagging provisions, down from 21% in 2010 but still almost double the corresponding statistic in the 2011 U.S. study. The remaining 67% of Canadian private M&A agreements were silent on the point, compared with 54% in the U.S.

A contributing factor to the greater prevalence of these provisions in U.S. agreements may be the greater volume and the continuing evolution of American jurisprudence on the subject. Under applicable Delaware and New York state case law, for example, a buyer is generally not required to demonstrate reliance in order to maintain a breach of representation claim. By contrast, California courts have taken the view that a buyer must be able to demonstrate reliance in order to support such a claim. Even within the leading commercial jurisdictions of New York and Delaware, the case law is not completely settled and there have been a number of exceptions to these general principles over the last two decades. Accordingly, a substantial percentage of American transactions have sought to provide greater clarity and certainty for the buyer and the seller with respect to sandbagging by including specific provisions in the purchase agreement.

There is no established case law on sandbagging in Canada. However, since Canadian jurisprudence generally requires that reliance be established to pursue a breach of representation claim, an increasing percentage of Canadian purchase agreements can be expected to resemble their U.S. counterparts by including a pro-sandbagging provision.

Waiver of Corporate Opportunities Doctrine

The doctrine of corporate opportunities is well-established in both Canada and the U.S. The doctrine provides that directors and officers cannot personally profit from an opportunity presented to them in their role on the board of a corporation. If a director or officer is found to have improperly taken an opportunity that rightly belonged to the corporation, he or she must disgorge to the corporation any profit received as a result.

For the PE investor whose employees typically sit as directors on boards of its portfolio companies, this doctrine is potentially problematic for a number of reasons. In the course of its business, a PE fund could be presented with business opportunities that may be attractive to one or more of its portfolio companies engaging in similar businesses. If the PE investor has investments in more than one such portfolio company, it could quickly find itself in the untenable position of having to disclose and present the same opportunity to all such portfolio companies. Delaware sought to address this concern in 2000 by amending its *General Corporations Law* to permit Delaware corporations to renounce, in their certificate of incorporation or by action of its board of directors, their interest or expectancy in specified classes of business opportunities presented to them or to one or more of their officers, directors or stockholders.

Since Delaware adopted this amendment, it has become commonplace for U.S. PE funds to include an advance waiver of the corporate opportunities doctrine as a condition to the closing of their investments. U.S. funds are also increasingly requesting unanimous shareholder agreements to reflect advance waivers when making investments into Canadian corporations. Although shareholder consent might be helpful in a litigation context, it is not clear whether such waivers would be enforceable under Canadian law absent an equivalent amendment to Canadian corporate statutes. While PE investors may be insisting on, and receiving, these waivers from their Canadian portfolio companies more frequently, there remains risk that the corporate opportunities doctrine will nonetheless continue to apply to them.

Goodmans' Private Equity Practice

Goodmans is internationally recognized as one of Canada's top private equity law firms. We have a long-standing leading presence in public and private M&A, capital markets, fund investments, tax structuring, debt financing and corporate restructuring. This broad range of expertise enables our private equity team to advise our clients on all aspects of complex transactions and develop innovative ways to get the deal done efficiently.

We advise clients on:

- public and private M&A transactions, including buyout and minority investments
- management arrangements
- shareholder matters
- senior and mezzanine debt financing
- investment in alternative asset funds including private equity, hedge, real estate and infrastructure funds
- fund formation
- tax structuring

We represent leading Canadian private investment players including Birch Hill Equity Partners, Brookfield Asset Management, Canada Pension Plan Investment Board, Clairvest Group, Kilmer Capital Partners, Macquarie North America, OMERS Private Equity, ONCAP and Ontario Teachers' Pension Plan Board and Wellington Financial. We also represent many foreign private equity firms including Apax Partners, Apollo Global Management, The Blackstone Group, Carlyle Group, Colony Capital, Providence Equity Partners, Oak Hill Capital Partners and Fortress Investment Group.

Some recent representative private equity fund transactions in which we have acted are:

- Apax Partners and Hub International in its US$4.4 billion sale of Hub to Hellman & Friedman LLC
- WASH Multifamily Laundry Systems, LLC, a portfolio company of CHS Capital LLC, a Chicago-based private equity firm, in its acquisition of Mississauga, Ontario based Coinamatic Canada Inc.
- Clairvest Group Inc. in a $39.5 million investment in CRS Contractors Rental Supply Limited Partnership
- Canada Pension Plan Investment Board in an US$606 million secondary private equity transaction, in which CPPIB invested US$468 million to acquire a portfolio of food assets from HM Capital Sector Performance Fund and committed US$138 million to Kainos Capital Partners, a newly-formed private equity fund
- Cookie Jar Entertainment Inc. and its largest shareholder, Birch Hill Equity Partners in connection with the acquisition by DHX Media Ltd. of the business of Cookie Jar, an independent entertainment and consumer products company
- Brookfield in its $480 million acquisition of Enwave, Canada's largest district heating and cooling enterprise
- OMERS Private Equity Inc. in connection with the combination of Golf Town USA Holdings Inc. and Golfsmith International Holdings, Inc. for US$163.1 million creating North America's largest specialty golf retailer