TORYS LLP

PE PULSE 2020

Canadian private equity survey

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Methodology

These are the findings of an Ipsos survey conducted on behalf of Torys LLP.

In total, of n=104 private equity and pension fund professionals completed the survey, of which n=66 completed the survey online and n=38 by telephone. The survey was fielded between October 31st and December 20th, 2019, and then again between January 10th and 14th, 2020.

Survey respondents

Most respondents work for private equity organizations (71%) while 28% work for pension funds. Two-thirds (67%) have over 10 years of experience in the industry.

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Executive summary

The results of our first annual Canadian private equity survey suggest that pension funds and private equity firms expect 2020 to be marked by challenges typical of a maturing industry.

These challenges include greater competition in the market due to private equity firms increasing their fund sizes, pension funds and other institutional investors allocating more capital to the private equity industry, and the growing presence of certain types of investors, such as family offices, throwing their hats into the ring. This diversifying and expanding competition and the shortage of transaction opportunities for good assets are all contributing to rising valuations.

Almost half of respondents in our survey say they expect average transaction size to increase, an unsurprising sentiment given the ongoing rise in private equity deal sizes we have seen year over year in Canada. These larger deals have been in part driven by the growth of fund sizes and pressure by LPs to provide co-investment opportunities. Larger transactions also need to compete with public market valuations, further driving up valuations in the private equity sector.

The ongoing competition for good assets shows no sign of stopping, and as many as two-thirds of survey respondents perceive vendor pricing expectations as having increased over the past year, furthering the pressures on their business. Despite valuation tensions, stakeholders plan to spend most of their time on new investments, as well as portfolio-company development, in the near term. Investors are also looking to diversify across sectors, including sectors with emerging and growth potential, such as Canada's technology sector. Deal sourcing, raising new funds, and economic growth/stability are the most commonly cited as factors critical to sponsors' success.

Respondents also report ongoing concerns about a downturn, with a majority of respondents indicating they think the overall economic climate, both in Canada and globally, will worsen. While surveyed respondents were based in Canada, the markets in which they operate are, in many instances, global, and therefore their responses to the survey should be considered through that lens.

However, as we have seen in the last few years, macroeconomic tensions have not proven to impede dealmaking.[1] Those players in the space who remain disciplined and creative in finding opportunities are likeliest to benefit from an active dealmaking year in 2020.

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[1] See Torys' 2020 M&A outlook **here**.

Dealmaking activity

The outlook for 2020 remains generally positive as overall M&A activity, deal volume and transaction sizes are broadly expected to remain the same or improve. Nonetheless, headwinds are anticipated as a majority of survey respondents predict that the domestic and global economic climate and returns on realized investments, as compared to five years ago, will slightly worsen in the coming months (Figure 1).

Most respondents expect the average size of transactions to stay the same or even increase, which would continue the recent trend of larger deals in the Canadian market. The Canadian private equity industry has seen the value of transactions experience ongoing, and in the case of 2019, explosive growth. Last year, the average size of a transaction involving a private equity buyer increased to $605 million, which is over double the average of $292 million from 2018.[2]

Why this spike? In part, it is the result of the broader trend of Canadian and U.S. private equity funds increasingly raising larger and larger funds, along with added pressure by LPs to provide co-investment opportunities. This has made significantly more dry powder available for funds to deploy, which is pushing funds to seek larger transactions and write bigger checks.

Despite the recent growth in fund sizes, twice as many private equity stakeholders say it will become more difficult (43%) than easier (19%) to raise new funds in 2020, compared to 2019 (Figure 2). Could this be because sponsors are concerned that returns will be lower as a result of increased competition and valuations, or that institutional LPs are consolidating their relationships with sponsors? We suspect both these factors are at play and are contributing to this sentiment.

In the Canadian public markets, mega-investments made by big PE buyers also played a role in driving up average transaction value last year. Large deals in 2019 included Onex's $6.56 billion acquisition of WestJet Airlines and Blackstone's $5.9 billion acquisition of Dream Global Real Estate Investment Group (learn more about the rising interest from institutional and private equity investors in the real estate sector **here**).

[2] See Torys' 2020 M&A outlook **here**.

Figure 1

Q: Do you expect the following to improve, stay the same or worsen in 2020?

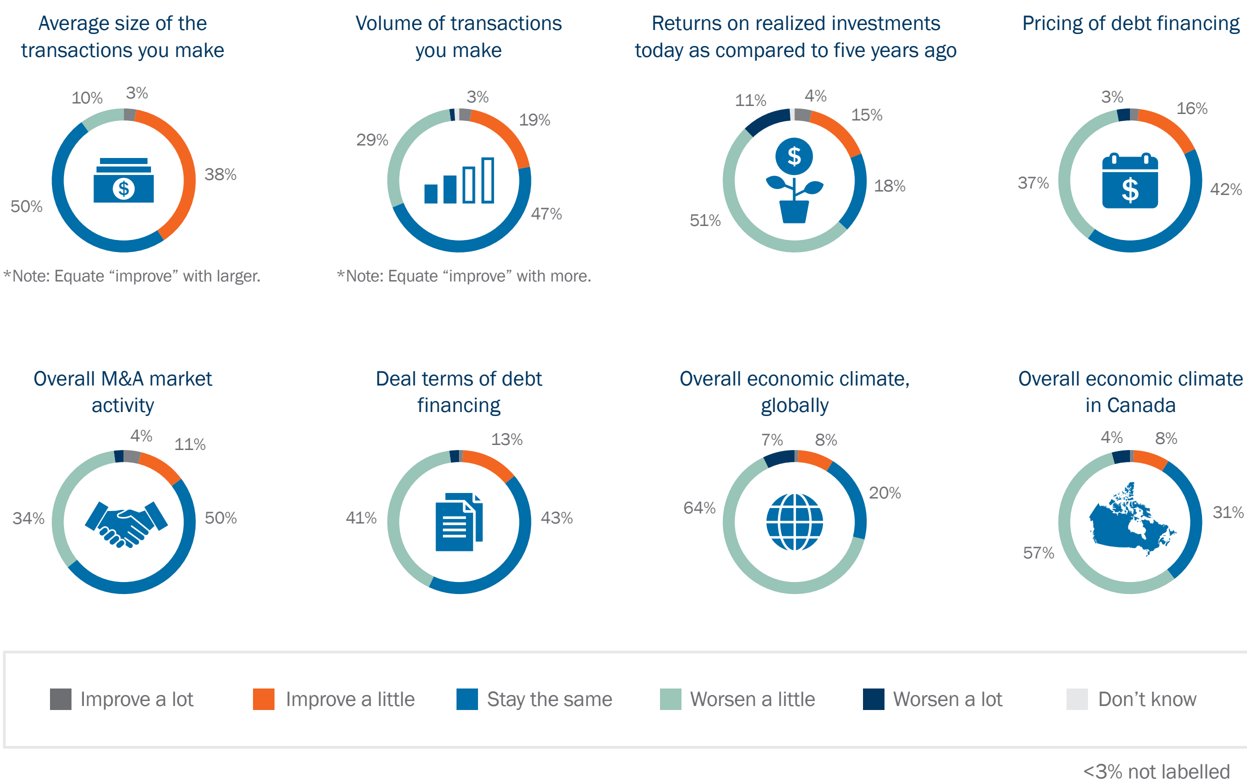
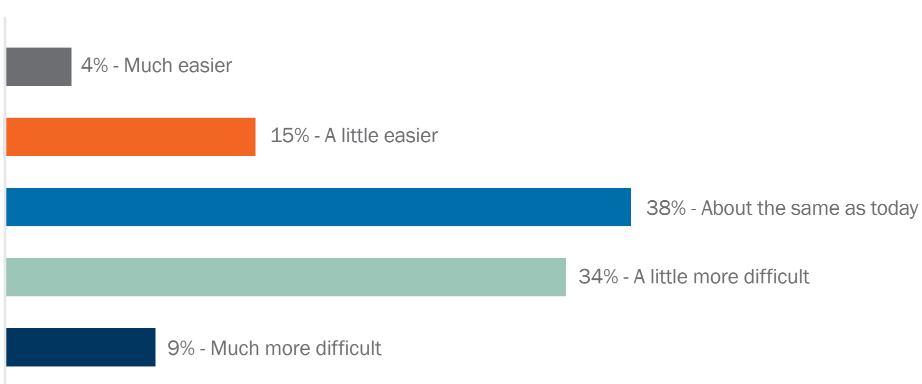


Figure 2

Q: Do you believe that it will become easier or more difficult to raise new funds in 2020 compared to 2019?

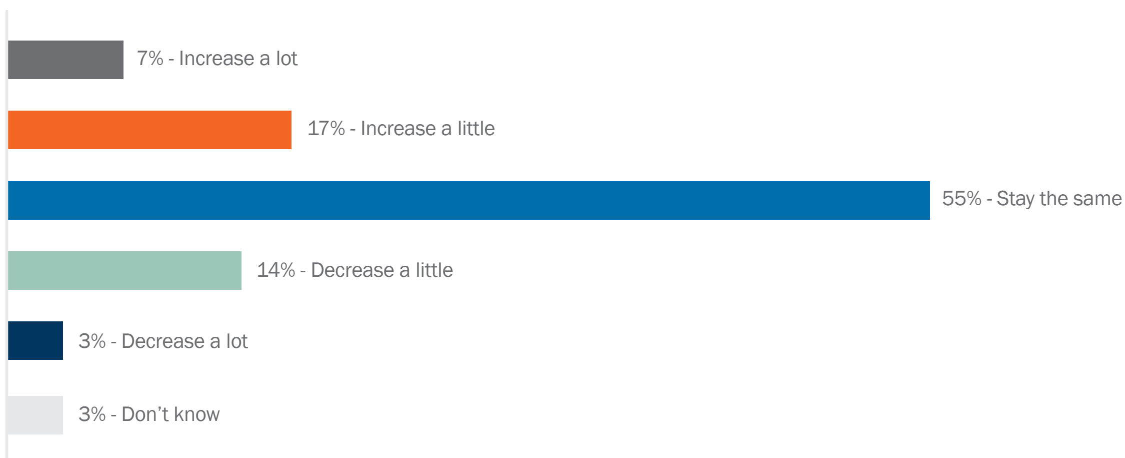


Private equity allocations

An overwhelming majority of survey respondents (79%) indicate that their PE allocations will either stay the same or increase in 2020 (Figure 3). This is unsurprising given the accelerated growth the private equity industry has been consistently experiencing in the recent term.

Figure 3

Q: Do you expect your passive private-equity allocations (to fund investments and passive co-investments) to increase, decrease or stay the same?

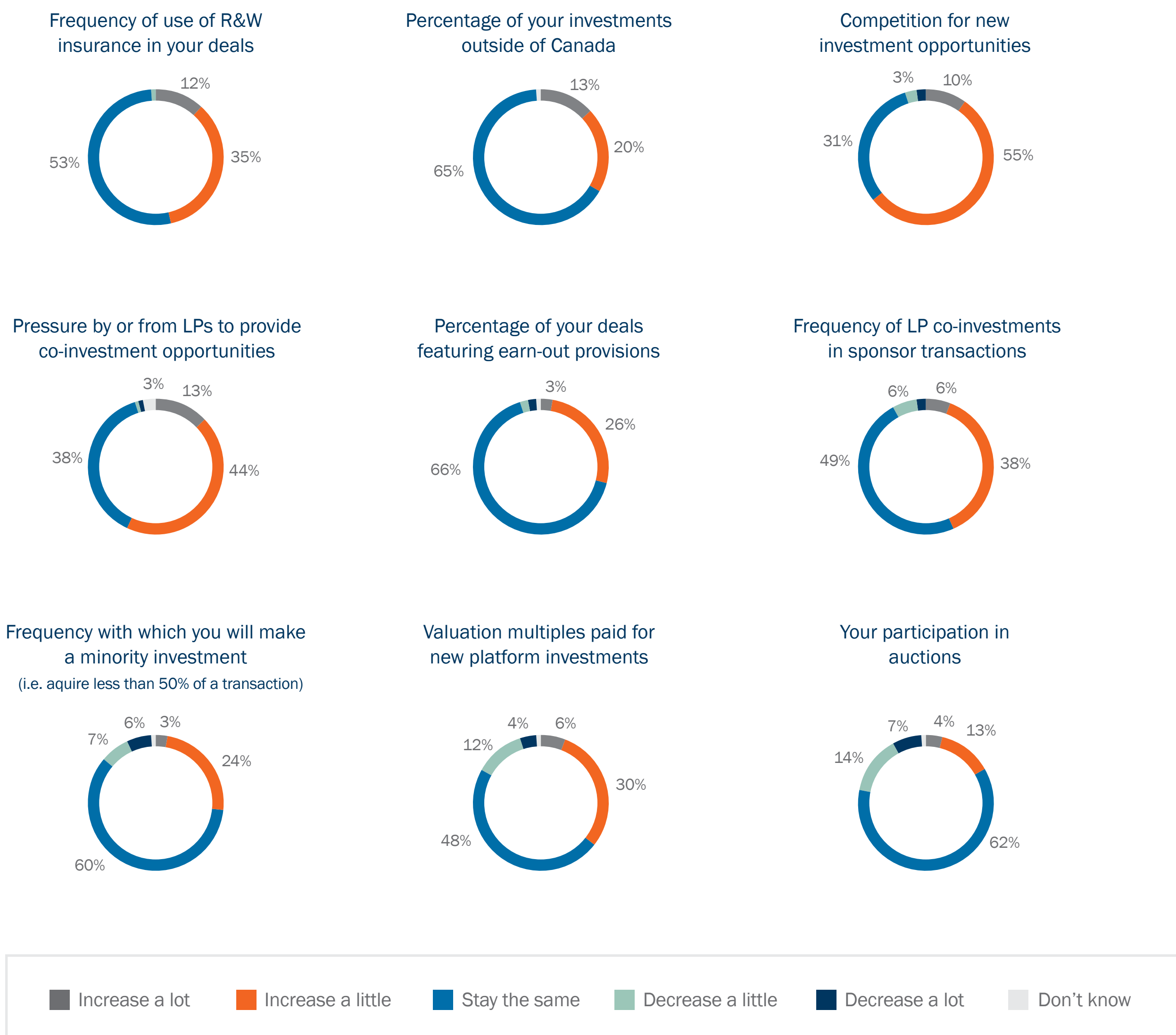


A majority of respondents project the same or increased levels of activity (Figure 4). Competition for new investment opportunities (65%) and pressure from LPs to provide co-investment opportunities (57%) are the areas where the greatest increases are expected to occur, particularly among pension fund professionals.

Specifically, pension funds are more concerned about competition: 83% compared to 57% of sponsors. Unsurprisingly, pension funds are highly focused on obtaining co-investment opportunities, with 90% of pension fund respondents identifying it as a significant pressure point, compared to 46% of PE sponsors. Private equity respondents are less likely to feel this way about the frequency of LP co-investments in sponsor transactions (36% vs. 62% pension fund respondents). This is illustrative of the shift in the co-investment landscape: whereas 10 years ago sponsors would reach out for capital when required, now LPs are making their desire for co-investments opportunities clear with their sponsor relations from the outset.

Figure 4

Q: Do you expect the following to increase, decrease or stay the same in 2020?



<3% not labelled

Over the past few years, prospective buyers have turned to R&W insurance as a way to distinguish their bids. Now, in auctions for good assets, we are seeing that R&W insurance is often required to stay competitive. This year, private equity stakeholders are more likely to expect to see an increase in the usage of R&W insurance in their deals (54% sponsors vs. 28% pension fund professionals). This is unsurprising as the increased use of R&W insurance has been an ongoing trend in the private equity and M&A landscapes generally for some time.[3]

Another trend adding to the already competitive environment is the rise of family offices. We are seeing family offices making strategic hires from the private equity industry as they seek to build their own direct investing and co-investing capabilities (to complement fund investing activities they have been pursuing). As a result, family offices are bringing an increasingly competitive presence to auction processes.

Amid the proliferation of hot auctions, we have seen a variety of strategies emerge for those in the sector to source deals. These strategies include (a) an ongoing emphasis on building out deeper vertical expertise and focusing on the relationship-driven nature of the sector, growing networks of potential vendors and partners, (b) paying a high multiple for a new platform with the goal of growing the business with lower multiple add-ons and (c) greenfielding new platforms. Investors continue to search for opportunities that will allow them to bypass competitive auction processes and source proprietary deals from vendors, tapping into post-acquisition value through the industry expertise of operating partners in their portfolio companies.

[3] See our analysis on developments and strategies resulting from the rise in R&W insurance **here**.

Valuation multiples

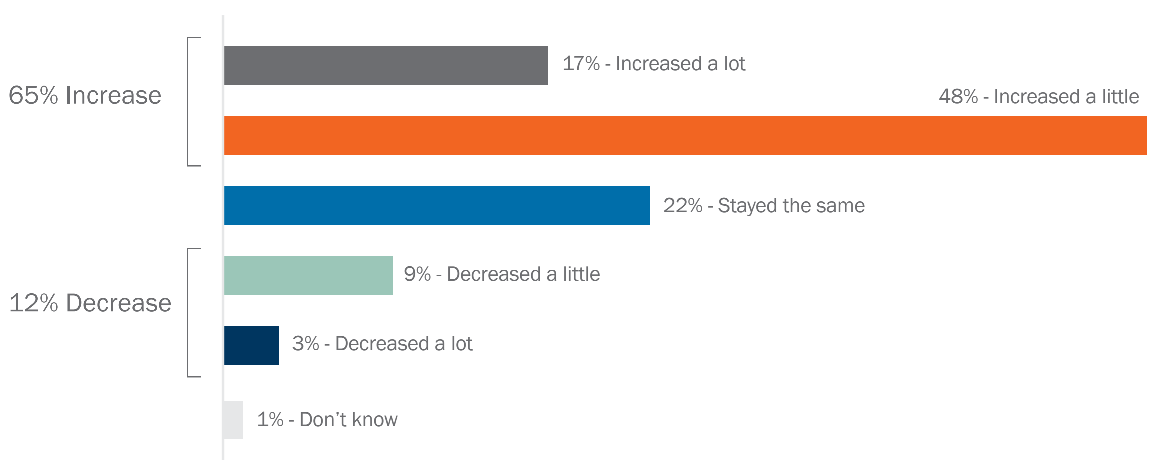
Valuation multiples paid for new platform investments are largely anticipated to remain the same or even rise in the coming year, and one third of respondents expect more earn-out provisions on their deals, a useful mechanic to bridge valuation gaps between buyers and sellers (Figure 4).

Indeed, two-thirds (65%) of professionals perceive vendor pricing expectations as having increased over the past year (Figure 5). Only twelve percent (12%) think there has been a decrease. And the vast majority (89%) of professionals feel the current level of valuation multiples paid during M&A transactions is high (Figure 6). In fact, as many as four in ten (42%) say they are very overvalued, including a clear majority of pension fund professionals (59% vs. 36% of private equity professionals).

Driven at least in part by this environment, we are increasingly seeing GP-led secondaries being used to create for both private equity fund sponsors and their limited partners, liquidity solutions with more attractive valuations than regular dispositions of funds' assets. The market for GP-led secondary transactions has matured in recent years, and it is expected by many market participants that such GP-led secondary transactions will become increasingly popular (read our latest analysis on GP-led fund transactions **here**).

Figure 5

Q: Compared to 1 year ago, would you say that vendor pricing expectations have:



Close to 40% of professionals expect no change in exit-valuation multiples. Those who do are twice as likely to predict there will be a decrease (42%) as opposed to an increase (18%) (Figure 7). Pension fund respondents were more than twice as likely as PE respondents to expect that exit-valuation multiples will increase (31% vs. 14% private equity professionals).

Figure 6

Q: Would you say that the current level of valuation multiples paid during M&A transactions involving private-equity financing are:

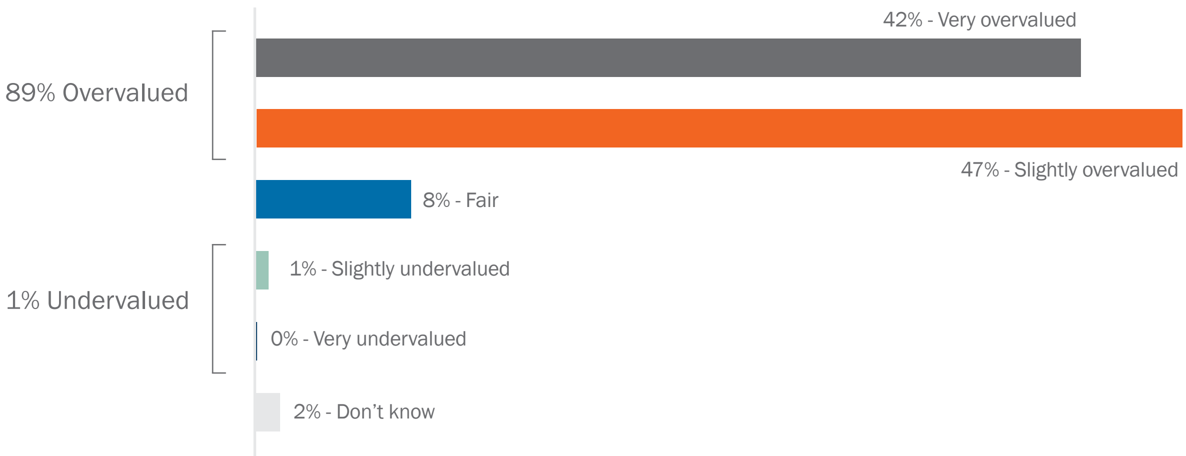
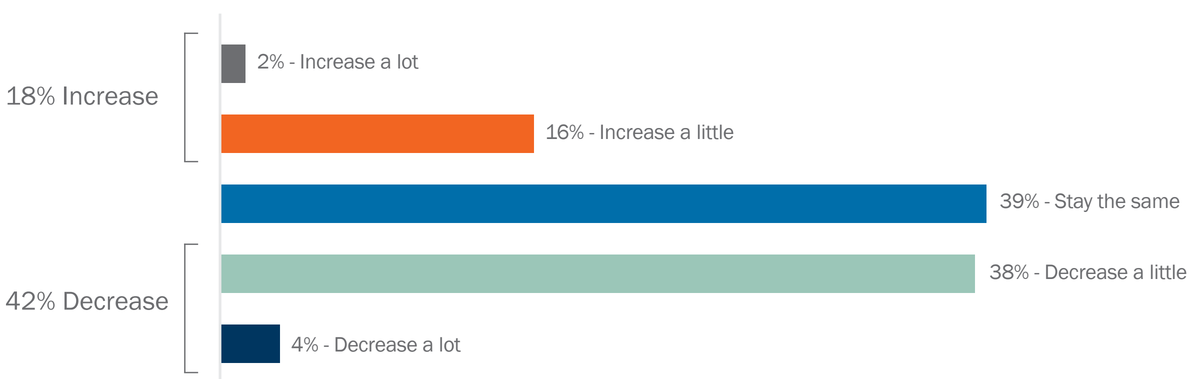


Figure 7

Q: In respect of recent acquisitions, do you expect exit-valuation multiples to increase, decrease or stay the same?



Private equity targets

Private equity investors plan to spend more of their time on new investments (39%) and portfolio company development (30%), on average, and a smaller proportion of their time on divesting investments (15%) or other tasks (16%) (Figure 8). This is consistent with the recent trend of sale transactions by PE investors having reached a ten-year historical low; and nearly 2/3 of Canadian private equity transactions in 2019 involved private equity firms as buyers. Recent notable buy-side transactions include Torquest Partners Inc.'s acquisition of Prepac Manufacturing Ltd. and Peloton Capital Management's investment in 123Dentist Inc., among others (Torys advised the buyers on each of these transactions).[4]

Majority stakes or buy-out investments top the list (at 39%) as the most attractive target in 2020, followed at a great distance by minority stakes in a private corporation (15%), carve-out acquisitions (13%), distressed asset acquisitions (12%) and take-private investments (8%) (Figure 9).

Figure 8

Q: In 2020, what percentage of your time do you anticipate spending on the following tasks?

*Average percentage

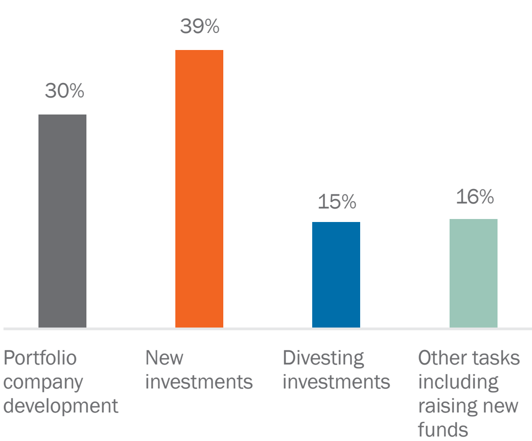
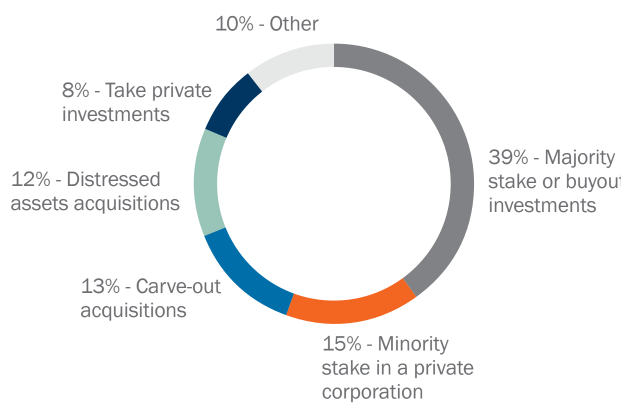


Figure 9

Q: What will be the source of the most attractive targets in 2020?



[4] See Torys' 2020 M&A outlook **here**.

In their own words

Factors critical to success in 2020

We asked our PE and pension fund respondents to elaborate on two key questions (see pages 19 and 20 for the full breakdown of their responses) about their focus on the year ahead: what factors are critical to success in 2020, and what are your biggest challenges? Here are some of their responses.

"Discipline, optimization and outsourcing."

"Portfolio company performance, portfolio company exits, new deal sourcing at reasonable valuations."

"I think the most obvious one is the economic environment, followed by the 2020 election in the US. The third factor would be Brexit."

"Talent development strategies, effective business development, and value creation capabilities."

"Proprietary deal flow, disciplined entry valuations, and access to attractive debt financing."

"Discipline, creativity and tenacity."

"Selling at high valuations, being prudent on new investments and organic growth in portfolio companies."

"Deal flow, strong markets, debt and equity markets, as well as investing in stable, recession-proof businesses."

"Disciplined valuation, certainty of execution, and flexibility of capital."

"Commodity price stability or improvement, energy investor sentiment improvement and progress on TMX pipeline construction."

"Prudently invest, limit losses, and proactive sourcing."

"Agility; more risk-taking; Asia."

"Political stability, regulatory stability, and economic stability."

"Creative ways to deploy capital into our existing portfolio, avoiding auction processes, and hiring and retaining the best talent both at our organization and within our portfolio companies."

"Fundraising, team development and price discipline."

In their own words

Biggest challenges in 2020

"Overall trepidation about a severe economic downturn."

"Sourcing interesting investment opportunities at a reasonable price."

"Regrettably, the adverse climate for oil and gas investment in Canada. For us, all-new investment will be in the US for the foreseeable future which is very disappointing to our firm, but reflects reality of the inability to finance anything to do with the Canadian upstream."

"Lack of recognition of Alberta a technology hub relative to Ontario/BC/US."

"Fundraising during period of investor concern with macroeconomic conditions/ end-of-cycle risks."

"Too much money chasing too few deals and weakening of deal terms."

"Competing for allocation to high quality PE fund managers, and co-investments from those managers."

"The economy, just maintaining its strength, strong economy maintain valuations, maintaining valuations. If it doesn't maintain it would be a problem, strong economy, maintain valuation, continue strength of the debt market would be a challenge and maybe companies maintaining their growth."

"Attracting, retaining and developing investment talent to do direct deals."

"Political influence on macro development."

"Growth in a low-growth environment."

"Closed debt and equity markets for upstream energy, driving a dead exit market for our private companies. Most strategic acquirers have poor valuations and are staying on the sidelines, since it's virtually impossible for them to close on an accretive deal (when everyone is trading at 3-4x cash flow)."

"Valuation, competition, uncertain economic future."

"The level of uncertainty in both economic conditions and the impact of technological change."

Sector outlook

In 2019, private equity deals waned in the financial and consumer sectors, while technology and industrials continue to vie for being the top source of private equity M&A in the country, with both sectors experiencing marked increases in activity. Combined, they accounted for 42% of all PE activity last year.[5]

In particular, [Canada's tech sector]() has been a source of significant U.S. investment, with tech-related M&A accounting for over three-quarters of U.S. inbound investment into Canada from 2015 to now.[6] Rising interest in Canadian tech has not gone unnoticed by survey respondents, a majority of whom identified the tech sector as being the hottest source of dealmaking activity in 2020 (Figure 10). Aside from technology, stakeholders also expect the business services (38%) and personal services (35%) sectors to be busy.

Figure 10

Q: In what sector do you expect to see the most M&A activity with PE involvement in 2020?[7]

9%
Entertainment

38%
Business services

10%
Personal care

35%
Personal services

24%
Industry & agriculture

53%
Technology & other

9%
Other

15%
Don't know / none

[5] See Torys' 2020 M&A outlook **here**.

[6] See our analysis on M&A in Canada's tech sector **here**.

[7] For sector-related questions, respondents were asked to consider all sectors, not just those that were their primary area of focus.

Financial services (27%) and transportation & shipping (22%) top the list as the business service sub-sectors where the most M&A transactions with private equity involvement is expected in 2020 (Figure 11).

Healthcare & pharmaceuticals (27%) are expected to be the sub-sectors within personal services that see the most M&A transactions with private equity involvement in 2020 (Figure 12).

Figure 11

Q: Within the Business Services segment (see Figure 10 for top-level sector breakdown), in what area do you expect to see the most M&A transactions with private-equity involvement in 2020?

2%	Advertising & public relations
27%	Financial services
3%	Management consulting
7%	Marketing & market research
10%	Sales & sales promotion
22%	Transportation & shipping

Figure 12

Q: Within the Personal Services segment (see Figure 10 for top-level sector breakdown), in what area do you expect to see the most merger and acquisition transactions with private-equity involvement in 2020?

9%	Education
3%	Government & politics
6%	Grocery, convenience & dept. stores
27%	Healthcare & pharmaceuticals
12%	Insurance
8%	Real estate & construction
10%	Restaurants
4%	Travel & tourism
15%	Consumer staples
13%	Consumer discretionary

Industrials (17%) are the leading sub-sector within industry and agriculture where the most M&A transactions with private equity involvement are expected in 2020, followed by energy (11%), food and beverage (9%), and materials (9%) (Figure 13).

While it is not surprising that the energy sector does not rank higher with respect to anticipated M&A activity given ongoing challenges,[8] PE buyers and Canadian pension have been driving transactions in Canada's energy infrastructure sector in the last year. In 2019, notable transactions included AIMCo's acquisition of an 85% equity stake in Northern Courier Pipeline from TC Energy Corporation, Northleaf Capital Partners' acquisition of CSV Midstream Solutions Corp from Apollo Global Management, LLC, and KKR's establishment of the C$1.15B Canadian infrastructure platform, SemCAMS Midstream ULC, with SemGroup Corporation, and the platform's C$600 million acquisition of Meritage Midstream ULC and its midstream infrastructure assets from Riverstone.[9]

In 2019, NorthRiver Midstream (owned by Brookfield) also completed its acquisition of federally regulated assets from Enbridge as part of NorthRiver's C$4.31 billion acquisition of Enbridge's Canadian natural gas gathering and processing business in the Montney, Peace River Arch and Liard basins in British Columbia and Alberta.[10] AIMCo and KKR further announced in late 2019 their agreement to team up to acquire a 65% stake in the Coastal GasLink natural gas pipeline from TC Energy.

Figure 13

Q: In what industry sector do you expect to see the most merger and acquisition transactions with private-equity involvement in 2020?

6% Agriculture

3% Automotive

9% Food & beverage

0% Paper products

17% Industrials

1% Toys

6% Pet food & care

5% Utilities

9% Materials

11% Energy

[8] See Torys' 2020 M&A outlook **here**.

[9] Torys acted for the buyers in each of these transactions.

[10] Torys acted for Enbridge.

On balance, pension funds see the most opportunities in technology (17%) and personal services (15%) (Figure 14). Pension fund respondents are statistically more likely (at 28%) to cite personal services than their private equity counterparts (11%).

Figure 14

Q: For pension fund stakeholders, what industry sector do you think will provide the best opportunities for your fund/group, specifically?

2% Entertainment

10% Business services

1% Personal care

15% Personal services

9% Industry & agriculture

17% Technology & other

25% Other

21% Don't know / none

Summing it all up

Areas of focus in 2020

Consistent with the overarching theme of increased competition in the industry, respondents say they are focusing most on finding opportunities: one in five (21%) professionals rank deal sourcing as most critical to their success in 2020. Fourteen percent mention raising new funds while slightly fewer (13%) list economic growth & stability. See pages 13 and 14 for respondents' candid explanations of their responses to the questions in Figures 15 and 16.

Figure 15

Q: What factors will be critical to your success in 2020? Please list up to 3.

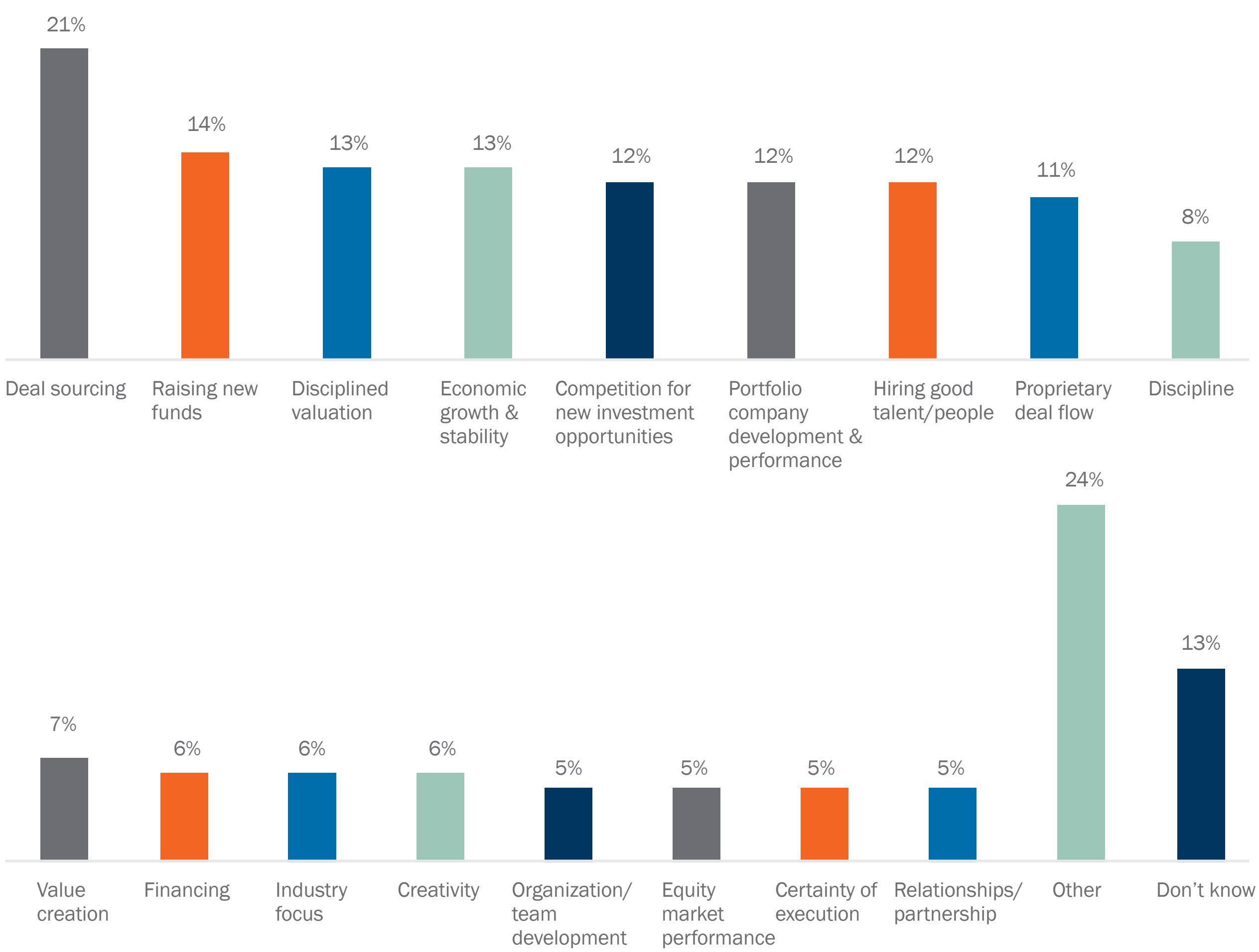
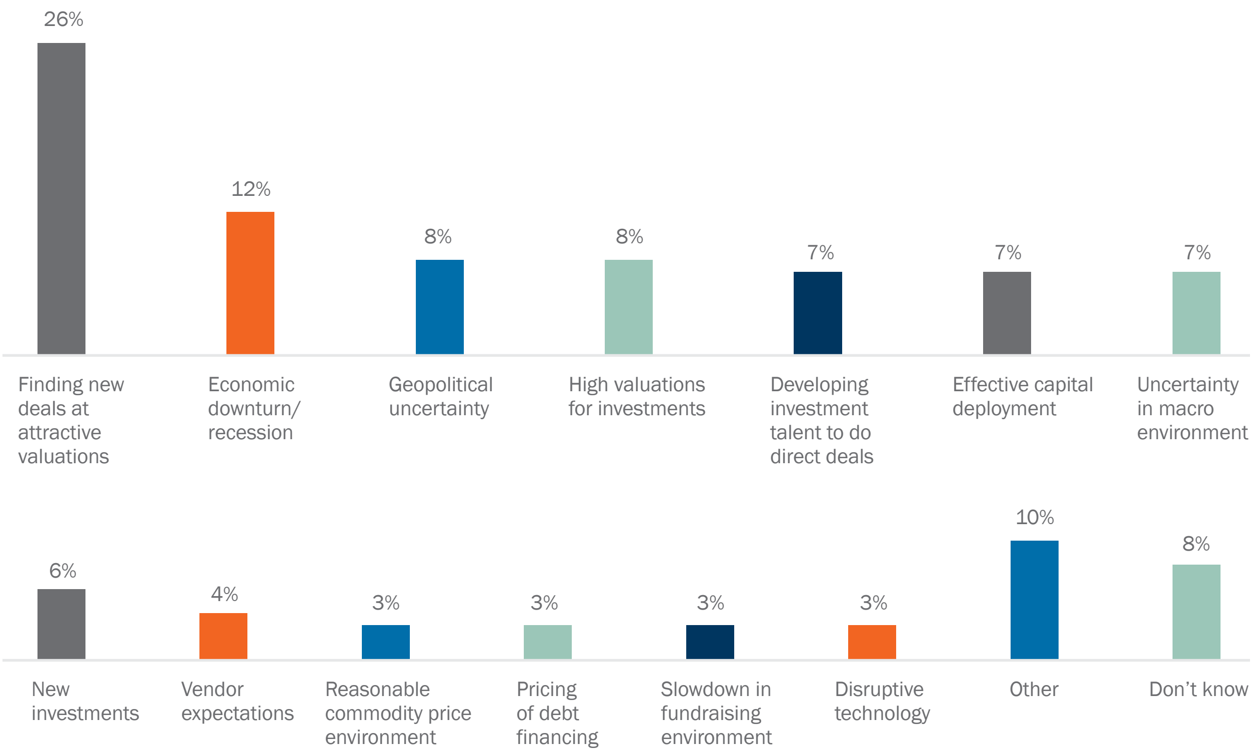


Figure 16

Q: What is the biggest challenge facing you in 2020?



When asked to comment on the biggest challenge facing respondents in 2020, far and away the highest proportion (26%) again points to sourcing deals, saying that finding opportunities at attractive valuations poses the biggest challenge for 2020 (Figure 16). Trailing deal sourcing are concerns about the possibility of an economic downturn (12%). Given their global perspective, pension fund professionals were significantly more likely to cite geopolitical uncertainty as their biggest challenge (21% for pension fund respondents vs. 3% PE respondents); high valuations for investments were also of distinctly greater concern for pension fund respondents (17% vs. 4% PE respondents) than their private equity counterparts.

Conclusion

Macroeconomic issues and other factors are putting pressure on the private equity market. As the industry continues to mature, the ongoing growth and sophistication of market players, the potential for new investment offerings in emerging sectors and a disciplined and creative approach to finding deals will continue to help foster favourable conditions for dealmaking activity in the year ahead.

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About Torys' Private Equity Group

Torys is the leading law firm for Canadian and U.S. private equity transactions, advising Canada's most recognized and most active private equity funds and pension funds on their investment activities in this asset class. We provide an experienced and sophisticated, one-firm solution for cross-border investment, tax, regulatory and other matters. Our private equity lawyers in our Toronto, Calgary and New York offices work seamlessly together to service our clients in the industry. With a close-knit, highly collaborative team of over 40 partners and associates dedicated to private equity transactions and an active deal flow, we provide exceptional counsel that draws both on our long history in the industry and our familiarity with market terms and industry trends.

About Torys LLP

Torys is a respected international business law firm with a reputation for quality, innovation and teamwork. Clients look to us for their largest and most complex transactions, as well as for ongoing matters in which strategic advice is key.

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