

CANADIAN PRIVATE EQUITY: OUTLOOK FOR 2009

A look at eight trends that will drive the Canadian market during the current economic turmoil where cash is king in the buyers' market

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The Canadian private equity market will continue to be affected in 2009 by the economic turmoil that has weakened global credit markets since mid-2007. As deal volume languishes and individual transactions take longer to complete, private equity firms will continue to reassess their strategies to meet the new realities of a redefined marketplace. These include lower valuations based on lower multiples (driven in part by lower earnings and difficulties in leveraging acquisitions), a subpar Canadian dollar, and a steady stream of political and regulatory developments in Canada and abroad.

All is not doom and gloom, however. As doors to the "old" leverage-based acquisition model close, new doors will open. Opportunities will present themselves to certain acquirors, especially cash-rich strategic investors, who will be favored in the wake of a global shortage of available credit. The relative attractiveness of target companies should increase sharply in light of radically depressed share prices, and the valuations that selling shareholders are willing to accept should come down significantly from the historic highs of the recent past.

Certain market sectors may also fare better than others. Canadian private equity's longstanding focus on mid-market deals may serve to isolate the marketplace from the worst of the credit crisis. Historically, this has been a relatively stable market space with lower levels of leverage and more potential buyers.

Opportunities for higher returns and more stable projects should also exist in the infrastructure sector as government efforts to stimulate the flagging economy take effect.

We focus in this article on eight trends that should drive the Canadian market in 2009. In light of the scarcity of buyers and the trend toward deeply discounted pricing, it is highly likely that the overarching theme of 2009 will be: "Cash is king — it's a buyers' market once again."

1. Buyers Calling Most of the Shots

The credit crisis has created a buyers' market. What remains to be seen is who the buyers will be. As already noted, those requiring relatively little leverage will find themselves in an ideal position in 2009 — a reality that will advantage strategic buyers over financial buyers.

For the first time in several years, strategic buyers should find themselves at the front of the line for many transactions, in some sense getting a *de facto* right of first refusal on certain transactions, as they may be able to offer more to sellers and utilize historic competitive advantages, including cash on hand, synergies, industry expertise and scale.

Because a limited number of buyers will be able to pick and choose from among a broader range

of potential sellers, we will almost certainly see a more aggressive type of buyer who will typically be in a good position to negotiate favorable deal terms, including some or all of the following:

- Expanded material adverse effect (MAE)-out clauses and narrowed carve-outs, expanding buyers' "outs" beyond seller-specific matters to include changes generally in the industry.
- Closing the "gap" between deal and financing risk and shifting market risk to sellers by matching MAE clauses negotiated between buyers and lenders with the MAE clauses negotiated between buyers and sellers — with the result being that any change that allows the lender to withdraw financing will allow the buyer to extract itself from the deal.
- Minimal or no reverse break termination fees.
- Demands for exclusive negotiation rights from buyers, together with the general lack of buyers, will mean fewer auction processes and more deals negotiated with one specific buyer in mind. Sellers also have an incentive, in an uncertain market with fluctuating valuations, to avoid time-consuming and potentially unsuccessful auction processes. In other words, it will often be preferable, from the point of view of the seller, to concentrate one's efforts on working out a successful transaction with a single serious buyer with committed financing. Better protection of confidential information is an additional attraction of this approach.
- Fewer lengthy standstills, as buyers resist committing themselves to only one horse in a crowded field.
- More "walk rights" exercisable in the event that the target fails to maintain its credit rating or on the basis of other indicators of financial health.

2. Alternative Deal Structures

The general lack of access to credit will force many, particularly those transacting in the mid-market, to employ different transaction structures than in the recent past. In lieu of the leverage-based acquisition model employed when credit was inexpensive and widely available, dealmakers will be forced to respond creatively. In 2009, we expect to see more alternative structures and mechanisms, such as private investments in public equity (PIPEs), rollover equity and earn-out provisions.

PIPEs

In a year of depressed equity markets and reluctant lenders, Canada is likely to see strong growth in PIPEs, following a trend that is already well established in the United States. PIPEs typically take the form of acquisitions of debt or preferred shares (often convertible), in many cases of companies in financial hardship. The attraction of these investments to investors is that they provide both downside protection (the fixed return) and upside possibilities (the conversion or exercise potential). In addition, PIPEs can serve as the first step in a two step process, with the second step being a future going-private transaction (discussed further below) — in a sense, providing the investor with something of a free look as the investor isn't required to put up all of their cash at first instance. For companies issuing the debt or preferred shares, the attraction is obviously a significant cash infusion at a time when credit can be difficult to obtain.

The "catch" is that because PIPEs have the potential to be very dilutive to shareholders — in many instances, exceeding the levels mandated by stock exchanges — they can often be held up by shareholder approval requirements. In some cases, however, there are financial hardship exemptions that can be relied upon, and recent harmonization of securities laws relating to such private placements should serve to facilitate these types of transactions.

Rollover Equity

In response to tight credit and cash constraints, it is likely that buyers will seek increased participation from sellers in acquisition financing by having sellers roll over a portion of their existing equity into an investment in the buyer. Similar in principle to earn-outs, rolling existing equity over into a stake in the buyer keeps the seller tied to the business following closing and aligns the interests of the seller and the buyer by creating an economic incentive for all parties to ensure that business succeeds. While equity rollovers were by no means uncommon before the credit crunch, what we are likely to see in the current market is an increase in the percentages that sellers will be asked to roll over.

Earn-out Provisions

For the same reasons, and as a possible antidote to the buyer's remorse that has become common as values have dropped, 2009 is likely to feature more "earn-outs" in acquisitions of private companies and operating divisions of public companies. In the face of economic uncertainty, acquirors who are not eager to pay for mere potential may look to an earn-out

arrangement as a means of linking purchase price more closely to realized potential. As with a transaction structure involving a rollover of equity, an earn-out structure can be attractive to buyers and sellers alike by aligning their respective interests to ensure the success of the business going forward.

If structured correctly, earn-outs can receive desirable tax treatment for sellers and allow sellers to receive a desired valuation if targets are achieved. To buyers, an earn-out structure has the added benefit of reducing the price paid on closing, thereby easing financing risk. For sellers, such a structure is attractive as it can reduce closing risk — a major concern in the current buyer's market, as sellers are increasingly being asked to assume additional financial market and regulatory risk and to accept MAE clauses that are being expanded beyond seller-specific matters.

3. Opportunities in Infrastructure

In the wake of the current global economic crisis, governments in Canada and elsewhere are facing enormous pressure to bring relief through “stimulus” packages. In response, the January 27, 2009 federal budget proposes a number of programs and incentives designed to encourage the “fast-tracking” of infrastructure projects in an effort to create jobs and spinoff activity across the country while bolstering long-term economic growth by constructing a more modern and greener infrastructure. Integral to the infrastructure plan is a continued federal commitment to public-private partnerships (PPPs), including through PPP Canada Inc., a Crown corporation created to administer the Public-Private Partnerships Fund that was announced in the 2007 federal budget. The mandate of PPP Canada Inc. is to work cooperatively with the public and private sector to further develop PPP projects in Canada. It should also be noted that a number of Canadian provinces, including Ontario and Québec, have created provincial agencies with similar mandates.

At a minimum, the stimulus plans of federal and provincial governments in Canada, together with the creation of PPP Canada Inc. and similar provincial agencies, suggest that infrastructure opportunities may be one of the major bright spots of the Canadian economy in 2009 and for the foreseeable future, with considerable government support available to those who are interested in participating in infrastructure-related investments.

As evidenced by the number of funds being established to focus on investments in infrastructure,

there does appear to be great interest and perhaps a growing realization that the yields can be as high at home as they are abroad, with the benefit of less market and political risk. All of this should only serve to increase the attractiveness of infrastructure assets in North America and make for an active market in 2009.

4. Increasing Numbers of Going-Private Transactions

In Canada, private Canadian companies that are not subsidiaries of public companies are, generally speaking, not subject (as are their public company

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counterparts) to the comprehensive continuous disclosure or corporate governance requirements or to the rules that apply to related party transactions and other special transactions.

It is partly out of a desire to avoid the regulatory scrutiny and compliance costs associated with continuous disclosure and corporate governance rules that there has been a trend toward taking public companies private in Canada. Add to this the desire, growing out of a turbulent economy, to adopt longer-term and more stable growth strategies and compensation arrangements, and it would seem that the incentive to “go private” will only increase in 2009. The fact that many Canadian public companies have one control-

ling shareholder (often a foreign company), combined with harmonized rules for going-private transactions (including rules dealing with majority-of-minority approvals and valuations) and lower market prices, will facilitate this trend.

Additionally, because Canadian income trusts are set to lose their special tax status in 2011, the number of going-private transactions should increase as the remaining Canadian income trusts that haven't already been sold or converted – made even more attractive targets due to depressed share prices – are themselves put up for sale or taken private.

5. More Opportunities for Debt Restructuring and Distressed M&A

Other areas in which new opportunities will present themselves as the economy continues to struggle are debt restructuring and distressed M&A. Businesses that are in tight financial straits or are experiencing a liquidity crisis will continue to look to formal and informal restructuring processes and, in some cases, seek out stronger partners for potential take-overs.

In particular, the following trends seem certain to continue through 2009:

- Banks and other financial institutions will continue to seek more and tighter security, tougher covenants (no more “covenant-lite” loans) and more equity from existing shareholders. Refinancings requiring additional equity injections have already increased.
- Although in recent years increased recourse to the *Companies' Creditors Arrangement Act* (CCAA) – the Canadian equivalent of Chapter 11 of the *US Bankruptcy Code* – has improved the survival rate of insolvent companies, one or more dispositions have become a routine and expected part of the process.
- Cross-border insolvencies (resulting in dispositions) should also increase since many US and foreign companies have Canadian subsidiaries, which in many cases are still profitable. Increasing recognition by Canadian courts of the reciprocal enforcement principles underlying the UNCITRAL Model Law on International Commercial Arbitration – which may be formalized in a proposed federal statute – may streamline cross-border insolvency proceedings, reducing the frequency of duplicative Chapter 11 and CCAA processes. This trend may provide more certainty in cross-border sales in a debtor-protection or bankruptcy scenario.

We should see more filings beginning in Q2 as companies unable to consummate a transaction in a distressed market are left with no other options, more so as the well of “government handouts” runs dry.

- In tough economic times, where deals fail to close (or close without producing the payoff investors hoped for), directors and officers can expect to find their actions closely scrutinized by disappointed and litigious shareholders. However, the Delaware Supreme Court's March 2009 ruling in *Lyondell v. Ryan* suggests that courts will continue to uphold reasonable responses by a target board to potential acquisitions, even in the current economic situation. Indeed, the Delaware Chancery's 2008 ruling in *Wayne County Employees' Retirement System v. Corti* revealed that in a weak M&A market courts may be less sympathetic than usual to disgruntled shareholders seeking injunctive relief that in the court's view could potentially scuttle the only viable deal available to a company. A similar philosophy was reflected in the recent Supreme Court of Canada decision in *BCE Inc. v. 1976 Debentureholders*, where the court suggested that an acquisition under the “plan of arrangement” process is more likely to be approved by the courts despite a negative impact on securityholders if “the corporation's continued existence” is at stake.

6. Positive Cross-Border Taxation Developments

Canada's M&A market in 2009 will be driven, in part, by positive developments in applicable tax law. Recent amendments to the *Income Tax Act* (Canada) and the ratification by both the US and Canada of the Fifth Protocol to the Canada-United States Income Tax Convention (Treaty) will provide, in most cases, substantial benefits for cross-border acquisitions. In particular:

Elimination of Withholding Tax on Interest Payments

The complete elimination of Canadian withholding tax on interest paid to arm's-length non-residents, regardless of their country of residence, will greatly facilitate direct, cross-border acquisition financing by foreign lenders. In addition, withholding tax on interest payments made to a related US resident will be reduced from its current 10 percent to four percent in 2009 and will be eliminated completely for subsequent years (provided the equity investor satisfies the

“limitations on benefits” provisions of the Treaty). Leveraged cross-border acquisitions (particularly from the US) will become much more tax-efficient.

LLCs

Generally, the Fifth Protocol will extend Treaty benefits, such as reduced withholding tax rates and the exemption for capital gains in certain circumstances, to US limited liability companies.

Other Hybrid Entities

However, the Fifth Protocol will deny Treaty benefits for certain other “hybrid” structures. One rule will deny Treaty benefits to structures, such as “synthetic NROs” (non-resident-owned investment corporations), through which a resident of either the US or Canada derives or receives income, profits or gains through a hybrid entity that is treated as a separate entity in that resident’s country, but is fiscally transparent under the laws of the source country. The insertion of another entity into the structure that is resident in a jurisdiction with which Canada has entered into a tax treaty may assist in avoiding or reducing the adverse effects of this change.

More importantly, the Fifth Protocol may put an end to the use of Canadian unlimited liability companies (ULCs) in acquisition structures as of January 1, 2011. One of the rules under the Protocol will deny Treaty benefits in circumstances where a payment is made to a resident of one country by a hybrid entity that is fiscally transparent under the laws of the resident’s country but is treated as a separate entity in the source country. A ULC (which currently can be incorporated under three provincial jurisdictions) is treated as a Canadian corporation for Canadian tax purposes, but may be considered a Canadian branch for US tax purposes (i.e., tax flow-through vehicle). Thus the full withholding rate of 25 percent will apply on payments by a ULC to the US parent on interest, royalties and dividends on and after January 1, 2010. It may be possible to avoid the adverse results of this rule by inserting an entity resident in another treaty jurisdiction (including Luxembourg and Barbados entities) above the ULC.

Preservation of Losses on Change of Control

In the current economic climate, buyers will become much more focused on their ability to continue to use accumulated (operating) tax loss carry-forwards upon the acquisition of control of a Canadian target. Among other restrictions, such tax losses can only be offset against the income from the same or a similar business carried on following the acquisition.

7. Legislative Changes May Encourage Foreign Investment

In November 2008, the Canadian Federal Government’s Speech from the Throne made reducing roadblocks to foreign investment a top priority. Consistent with this, recent amendments to the Canadian *Competition Act* and *Investment Canada Act* will likely, on balance, encourage M&A activity in Canada. On the *Competition Act* front, amendments that are favourable to M&A activity include increasing the “size of transaction” threshold, thus limiting the number of transactions that must be pre-approved by Canadian antitrust authorities. With respect to the *Investment Canada Act*, the new legislation also raises the generally applicable foreign investment review thresholds and eliminates the special lower review thresholds that previously applied to investments in Canadian transportation, financial services and uranium production businesses (three of the so-called “sensitive sectors” — a lower review threshold will continue to apply to the cultural sector).

That being said, a couple of the amendments are not as positive for foreign investors, including the introduction of a US-style “second request” power with respect to merger review, which grants the Commissioner of Competition discretionary authority to seek additional information from merging parties and “stop the clock” on the no-close waiting period, thus potentially significantly increasing costs and time frames associated with merger review.

Another amendment that may deter foreign investment in certain circumstances is the introduction of a broad “national security” test under the *Investment Canada Act*, which allows the Minister of Industry to review and potentially prohibit or unwind transactions that may be “injurious to Canadian national security.” This could be of particular interest to sovereign wealth funds (SWFs) making direct investments in Canada in the near term. The manner in which these new discretionary powers will be used will determine the extent to which they act as deterrents to foreign investors.

8. More Clarity and Greater Certainty in the Dealmaking Process

In 2008, buyers’ remorse became common as values dropped precipitously and credit became very difficult to obtain on normal terms and conditions and in some circumstances vanished altogether. Buyers looked to material adverse change (MAC) conditions of closing, reverse break fees, litigation and other

means of extricating themselves from what turned out to be bad deals.

In Canada, we anticipate more certainty in M&A deals as courts and regulators continue to clarify the obligations of parties and as parties themselves take an increasingly cautious approach at all stages of the dealmaking process:

- Recent court decisions have given comfort to board members that their fundamental duties will generally be interpreted by the courts with due deference to the good faith exercise of “business judgment” and generally accepted commercial practices. In *Re AiT Advanced Information Technologies Corp.*, for instance, an Ontario Securities Commission (OSC) panel affirmed the widely accepted view that merger discussions generally need not be reported under the *Securities Act*’s material change provisions until the board believes that the parties are committed to the transaction and that there is a “substantial likelihood” of success. In so holding, the OSC panel rejected the position of the OSC’s investigative branch that the report should have been filed when the non-binding letter of intent was signed — a position that many had regarded as commercially unrealistic.
- A second example was *Deer Creek Energy Ltd. v. Paulson & Co.*, in which the Alberta Court of Queen’s Bench also took a “common

sense” approach in rejecting arguments by a small group of dissenting shareholders that the company’s shares had been undervalued by the board, noting that the going-private transaction in question had been vigorously negotiated and had resulted in an offer at a substantial premium to the market price that was acceptable to the vast majority of long-term shareholders. The dissenters’ argument that their decision to invest had been based on much higher potential values touted at presentations made by the early-stage energy company’s management was rejected as “unrealistic and self-serving” by the court.

- The 2008 Delaware Court of Chancery ruling in *Huntsman v. Hexion*, in which Vice Chancellor Stephen Lamb refused to allow the acquiror to invoke a material adverse change (MAC) condition of closing on the basis of the target’s poor post-credit crunch performance, may lead buyers in 2009 and beyond to push for MACs with fewer carve-outs and clearer quantitative criteria than we have seen in recent years (including express limitations on the scope of “materiality” by a dollar amount or otherwise) in an effort to enhance their ability to “walk” in a wider range of circumstances.

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