Private Equity in Canada

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Canadian private equity deal activity levels remained strong in 2012. The pace of private equity transactions reported by Thomson Reuters as of Q3 2012 exceeds the same period in 2011 in terms of number of transactions, albeit with the aggregate value slightly lower year to date.

Activity in 2012

We have seen investment activity across a wide range of markets and industries, including significant transactions in the technology space and in the resource sector, as well as in traditional industrial businesses. The mid-market continued to be a strong area of focus for private equity buyers in Canada, accounting for a significant majority of all reported private equity transactions in 2012 year to date.[1] Private equity and pension fund investment in the resource sector has been increasing, and may increase further with the recent pull back in commodity prices. 2012 has also seen the continuance of large scale exports of capital from Canadian private equity buyers, with some $15.5 billion being reported for 22 global transactions in Q3 alone[2].

Challenges on Exit

Sponsors seeking to realize on their investments have had to be nimble in 2012 with the North American markets for IPOs continuing to be extremely volatile and secondary transactions being difficult to price. Total funds raised to date in 2012 through IPOs are substantially off the relatively slow pace of the last three years and are threatening to be at or below 2008 levels, although there has been a brightening in Q4 with a spate of IPOs in late November. Outside of structured products, real estate and resource issuers, there has only been one completed IPO on the TSX this year as of late November (the recent Hudson's Bay offering). Further, the majority of those IPOs were yield-driven issuers with tax-advantaged flow-through structures. These included a mortgage investment corporation, REITs and oil and gas issuers with a foreign asset income trust (FAIT) structure.

With IPO markets only providing a very limited window, sponsors have been primarily focused on other alternatives, such as recapitalizations or a sale. The Canadian high-yield market has continued to expand at a reasonably fast pace with a record $4.7 billion having been raised though mid-November, exceeding the record amount raised in 2011. That market offers both the opportunity to refinance in Canada and, in the right circumstances, the option of a dividend recapitalization. The latter was undertaken

OSLER REPRESENTED THE FOLLOWING CLIENTS IN 2012:

KingSett Capital and Ontario Pension Board in connection with their $4.4 billion take-over bid to acquire Primaris Retail REIT.

Google Inc. in connection with its acquisition of BufferBox Inc.

Ontario Teachers' Pension Plan Board, **Providence Equity Partners**, **Madison Dearborn Partners LLC and BCE Inc.** in their acquisition of Q9 Networks Inc. for a purchase price of $1.1 billion.

Vector Capital in its acquisition of 20/20 Technologies Inc.

1 Canada's Buyout and Private Equity Market in Q3 2012-Thomson Reuters.

2 Canada's Buyout and Private Equity Market in Q3 2012-Thomson Reuters.

by Livingston International Inc. in 2010, on which Osler acted for the issuer. However, the Canadian high-yield market for dividend recaps still represents a nascent means of recouping a part of a sponsor's investment and not a means for a full exit.

The sale mechanism has been by far the most common exit strategy for North American private equity sponsors for several years, whether it be a sale to a strategic buyer, a pension fund or a private equity fund, or in the case of the recent $1.1 billion Q9 Networks Inc. (Q9) transaction, where Osler acted for the buying group, to a consortium of all three types of buyers. Apart from the Q9 transaction, sales among sponsors in Canada in 2012 to date have tended to be slightly smaller capitalization transactions.

The most common exit, however, in the Canadian marketplace in 2012, not surprisingly, has been sales to strategic buyers, many of whom are holding significant amounts of cash and have access to low cost borrowing. Prominent trade sales include GS Capital Partners' sale of Alliance Films to Entertainment One, GemCom Software's sale by JMI Equity to Dassault Systemes SA, Paragon Pharmacies' sale to Shoppers Drug Mart and the sale of Varicent Software to IBM Corporation. Osler acted for Entertainment One, Shoppers Drug Mart and IBM in their respective purchases.

Return of Privatizations

As Canadian governments at all levels endeavour to reduce budget deficits and ensure that public services are provided in a cost-effective manner, they have increasingly focused on privatization as a possible source of revenue. These privatization initiatives are creating investment opportunities for both domestic and international investors.

At the federal level, the Commercial Reactor Sales and Service division of Atomic Energy of Canada Ltd. (AECL) was sold, and there has been speculation regarding a government review of the public status of many Crown assets including Canada Mortgage and Housing Corp., Canada Post, The Royal Canadian Mint and portions of VIA Rail Canada.

Similarly, provincial governments across the country are considering privatization initiatives. For example, the Ontario government is privatizing Service Ontario and the Ontario Northland Transportation Commission, and has announced its intention to consider "new models that enhance efficiency and optimize the business models of government assets." The government has issued a request for information regarding the commercialization or privatization of certain operations of the Ontario Lottery and Gaming Commission, and private equity investors have stepped forward as potential developers/investors. Provincial politicians have also discussed partial privatizations of Ontario Power Generation, Hydro One, and certain assets of the Liquor Control Board of Ontario, as well as sales of government-owned real estate. The British Columbia government has discussed the possibility of selling surplus government property, while the Saskatchewan government has announced the partial privatization of a Crown corporation responsible for land titles and other registries in the province.

At the municipal level, the City of Toronto and OMERS recently completed the sale of Enwave Energy Corp., an entity which provides heating and cooling for downtown Toronto office buildings.

Generally, purchasers of government assets should expect a very formalized and likely lengthy sales process, as governments manage concerns from public stakeholders, including taxpayers, customers/users, contractual counterparties and often unionized workforces, while at the same time attempting to ensure fairness in the bidding process and the maximization of the ultimate return from the asset. Potential purchasers will need to develop an understanding of the media, labour and political considerations in play, along with the business imperatives, and factor these into their strategy. Regulatory considerations are often among the most significant components of any privatization transaction, intrinsically tied to the valuation of the asset, as purchasers factor in the regulatory framework in which the privatized asset will function and, most importantly, the ability to set pricing in the applicable market.

At the same time that governments are pursuing privatizations as a means to raise capital, institutional and other investors are facing a period of low interest rates and significant uncertainty in the traditional equity and debt markets. These investors are, therefore, increasingly focusing on alternative asset classes, including private equity and infrastructure, as a means to achieving higher real returns. For pension funds, in particular, there is the added benefit that the long-term nature of these assets aligns with their liability profile. We expect pension funds to be major players in the market for privatized assets.

Look Ahead to 2013

Despite the general economic uncertainties, we anticipate that a variety of factors will contribute to another solid year of private equity deal-making in 2013. These include the continued high level of participation by Canadian pension funds, the general availability of credit, the significant amount of capital held by private equity funds awaiting deployment, and the stunted capital markets. The stock market continues to be unforgiving of short-term performance issues, making going-private transactions attractive to management teams and creating opportunities for sponsors to assist capital-starved and mispriced businesses.

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