Cassels

Private Equity Outlook 2022: What Lies Ahead

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February 8, 2022

After A Strong 2021, What Lies Ahead For 2022?

Deal Activity

As the dust settles from 2021, the evidence is clear: the private equity (PE) industry in North America had an extremely robust year. Most metrics – from the number of deals closed to the dollars raised by PE funds – broke records.

In Canada, data from *Refinitiv* indicates that Canadian M&A transactions totalled a record $349 billion across 4,558 deals in 2021. Further, the PE industry played an important role in this strong M&A activity: a *Refinitiv* 2021 Q3 report on Canadian PE indicates that PE-backed buyout deals accounted for 24% of Canadian M&A activity.[1] According to the Q3 report from the *Canadian Venture Capital and Private Equity Association* (CVCA), $13.2 billion was deployed by PE firms in roughly 584 deals during the first three quarters of 2021. As a result, total Canadian PE investments for 2021 are expected to significantly exceed the $14 billion deployed in 2020 and return to pre-pandemic levels. These investments included various PE strategies: we have seen significant activity in buyouts, add-ons, minority investments, and exits. For instance, 2021 buyout and add-on transactions (which accounted for 23% of total PE deal volume) are on track to exceed 2019 levels and outpace the 5-year average.

The middle market continues to be a fundamental driver of deal volume in Canada. The CVCA's Q3 report detailed that 84% of deals had disclosed values of under $25 million. Moreover, a *Crosbie & Company* report on Canadian M&A stated that 91% of Q3 deal activity related to transactions with disclosed values below $250 million. These data points underscore that the Canadian M&A market is dominated by transactions with an enterprise value below $250 million – the "mid-market."

Strong Fundraising Trends Will Continue in 2022

General partners (GPs) were extremely busy in 2021 after fundraising initiatives slowed down in 2020. According to data from *Private Equity International's* (PEI) 2021 fundraising report, at least $733 billion was raised by PE funds globally, surpassing every previous year on record. North American funds raised approximately $310.1 billion in 2021, accounting for more than 40% of the capital raised globally.

Looking ahead, PEI anticipates that limited partners (LPs) will continue to invest heavily in PE strategies throughout 2022, estimating that at least $952 billion will be raised by PE funds. Indeed, a recent *PE Hub* article on fundraising in 2022 noted that, "[t]he pace should remain vigorous as long as the deal environment holds up, and LPs will be challenged to manage a dizzying array of opportunities."

Why are PE Trends Important for the Broader Canadian M&A Sector?

Trends in the PE sector are relevant for M&A broadly, and the Canadian business sector generally, for a few reasons:

- PE deals constitute a significant portion of Canadian M&A activity (as noted above).
- Since PE funds focus on originating and closing transactions, funds and their advisors are often leaders with respect to deal trends. For example, the risk allocation discussions on representation and warranty insurance are often driven by PE's perspective (see trend 4 below).
- Given the impact of PE funds on the larger economy (for example, a Hoover Institution study on the economic effects of PE found that PE-backed buyouts of private companies resulted in employment expanding by 13%), the manner in which the industry addresses important factors such as ESG principles impacts many sectors and regions of the country.

We address below a number of business and legal trends that have emerged, or gained momentum, in 2021 and appear set to continue in 2022. Note that we use the term "Private Equity" (or "PE") as shorthand for the larger alternatives business, including growth equity and secondaries.

Outlook 2022: Top Trending Topics

ESG
Talent in Professional Services
Representation & Warranty Insurance
Indemnification Provisions
Material Adverse Effect Provisions
Anti-Hoarding Provisions
Merger Review
Regulatory Compliance
Tax Consequences
Ontario's Business Laws
Long-Dated Funds
Continuation Funds
Growth Equity
Escrow Amounts
Special Purpose Acquisition Companies
Tech Investments

Trends in Private Equity

(1) ESG: Increased Importance for LPs and a Focus on Consistent Standards and Measurement Criteria

Environmental, social, and governance (ESG) factors continue to increasingly impact PE investment practices and the operations of portfolio companies. LPs continue to emphasize to the alternatives industry that ESG is an important investment consideration as they assess their allocations among PE funds. Of course, the trend is accelerating through the growing importance of ESG issues in public and private spheres, including climate change, gender and diversity initiatives, and anti-bribery and corruption standards. According to a 2022 survey by *Bain* and the *Institutional Limited Partners Association*, 70% of LPs revealed that their organizations deploy investment strategies that incorporate ESG. Further, most PE firms recognize that a strong ESG program can support value creation and protection during investment periods. ESG is also growing in importance for businesses looking to implement such practices into their governance and operational structures. For example, the COVID-19 pandemic has prompted many Canadian businesses, including portfolio companies, to integrate ESG practices into their operations (e.g., tying business plans and management pay to the achievement of certain social and environmental targets). Finally, in a sign that ESG initiatives have become institutionalized in the markets, Canadian securities regulators are taking steps to mandate disclosure requirements for reporting issuers. In October 2021, the Canadian Securities Administrator (CSA) announced new climate-related disclosure requirements under National Instrument 51-107 to help investors make more informed decisions regarding ESG investments.

For PE funds, a primary – and growing – concern relates to the lack of standardized ESG practices, specifically in relation to measuring ESG compliance and performance. An *EY* study on ESG reporting standards cited that there are over 600 reporting standards globally; unsurprisingly, funds and companies have developed inconsistent approaches to ESG reporting as a result. In the 2022 *Bain* survey noted above, LPs noted that less than 35% of GPs were able to provide data on all of the principal adverse indicators (such as carbon emissions, fossil fuel exposure, and a lack of gender diversity) that measure ESG performance in their investments. A similar challenge for GPs relates to the lack of comprehensive ESG disclosure standards.

To address these concerns, the International Financial Reporting Standards (IFRS) announced the formation of the International Sustainability Standards Board (ISSB) on November 3, 2021. The ISSB represents a comprehensive set of disclosure standards for the global financial markets and has strong support in Canada. For example, Canadian regulators and public officials have endorsed the initiative, and it was announced that an ISSB office would be established in Montreal. Louis Morisset, the current Chair of the CSA, noted that “the CSA is supportive of advancing the ISSB, and believes Canada is uniquely positioned to be its home.” The Honourable Chrystia Freeland, Deputy Prime Minister and Minister of Finance, also welcomed the development, noting that the “ISSB will create good jobs here in Canada and accelerate growth in the green economy, at home and around the world.” In addition to the ISSB initiative, Canada already has some active industry standards for ESG, such as the *Towards Sustainable Mining* initiative, which allows Canadian mining companies to address social and environmental obligations within an ESG framework. Lastly, a collective of GPs and LPs, including CPP Investments, established an ESG Data Convergence Project in 2021 to improve mechanisms for reporting in the PE industry. These are significant developments in Canadian PE (and Canadian M&A more broadly) as the launch of the ISSB, the ongoing role of industry-specific standards, and PE-led initiatives will continue to improve ESG disclosure and performance standardization.

PE firms and their portfolio companies should continue to develop and adopt better methods to measure ESG performance and compliance. While there are still many different (and sometimes conflicting) approaches to ESG in Canada, the establishment of comprehensive reporting standards, such as the ISSB, will continue to improve the tools for evaluating ESG performance. In particular, in 2022 PE firms are likely to complete enhanced diligence on ESG factors as they assess investments to ensure the achievement of relevant criteria. We also expect to see more funds dedicated to ESG principles following the recent launch of ESG-focused funds such as Indigena Capital, LP's $250 million Indigenous Equity Partnership Fund, which is focused on renewable energy and agricultural investments through partnerships with Indigenous communities in Canada and the US.

(2) Talent Constraints in Professional Services

Not surprisingly, the record-setting activity in M&A and fundraising is strongly correlated with resource and talent constraints in multiple sectors: from accounting, to representation & warranty insurance (RWI) players, to law firms, a "perfect storm" of high demand and (in many cases) constrained supply hit firms in 2021. After the uncertainty of 2020, many firms took a cautious approach to hiring at the beginning of 2021. However, as deal activity increased in Q1 (from a strong base in Q4 2020), professional firms in North America increased their hiring. At the same time, both PE firms and their advisors, anticipating and recognizing the strong deal flow, expanded hiring.

The exceptionally strong demand for a relatively finite group of experienced deal professionals (in finance, law, and accounting) reverberated across North America. US law firms hired a significant number of Canadian lawyers, offering salary increases and signing bonuses. For instance, some former Canadian associates on Bay Street saw their salaries increase from C$150,000 to US$240,000 (plus bonuses) at US law firms. Some accounting firms were forced to defer or delay mandates. Additionally, many RWI providers reduced underwriting demand for deals in the <$50 million TEV range.

In response to this demand, service providers have focused on hiring practices and improving employee benefits, and law firms like Cassels have significantly expanded technology investments to complement professional services and complete high-volume projects at a lower cost.

Deal participants are advised to engage with service providers early in the process to level set expectations on timing, resource allocation, and responsibility for work product.

We predict that Canadian service providers will succeed in retaining and training more professionals in 2022, and that a combination of market forces and technology enhancements will alleviate, but not eliminate, service constraints.

(3) Higher Costs & Reduced Underwriting Capacity for Representation and Warranty Insurance

The high volume of deal activity in 2021 challenged the RWI market in Canada. While RWI is used on more deals than ever in Canadian M&A, with one insurance broker observing that 75% of PE and private M&A deals are using RWI, the aforementioned supply constraints appeared in the system as the year progressed.

In particular, we observed a reduction in underwriting capacity due to the heavy increase in deal flow and, according to some sources, an increase in claims activity. In a related trend, RWI policy providers became more selective with deals: in some RWI markets, underwriters reduced their supply of services to new businesses in order to process deals that were already in the underwriting process. In other cases, underwriters closed their books to new deals entirely for the balance of 2021. As a result, as the year progressed it became more difficult for some deals to place coverage (particularly lower mid-market transactions).

Additionally, we observed an increase in costs associated with RWI, including (depending on the characteristics of the deal) due diligence fees, minimum premiums, minimum retentions, and/or rates.

PE firms and M&A advisors should consider the possibility that underwriting capacity will continue to be stretched and that higher costs for RWI may continue. PE buyers should continue to build relationships with leading brokers and underwriters, leverage their legal relationships, and plan ahead to ensure that underwriters have the capacity and sufficient time to assist.

(4) The Convergence of Representation and Warranty Insurance & Indemnification Provisions

As RWI plays an increasingly prominent role in Canadian M&A, we expect to see more intense and detailed negotiations between buyers and sellers to determine the extent to which liability is addressed through the indemnification provisions in purchase agreements.

In particular, in 2021 we saw more deals that included RWI and had “no seller recourse” structures: where the Seller has no contractual liability to the buyer for breaches of representations and warranties in the absence of fraud. These have typically been known as “public-style” deals, but as the volume and size of deals increase generally, and the number of US players (particularly financial buyers, which are typically experienced in understanding and managing risk) in the Canadian market increases relatively, this trend gained momentum north of the border.

There are a number of negotiation and drafting points for buyers to consider when faced with requests from sellers for a “no recourse” deal. First, whether RWI will be procured (and can be procured) and if not, how to address the seller’s liability. Second, the commercial and legal implications of agreeing to “no recourse” on an RWI deal – and whether the seller should be liable for a portion of the retention amount. Third, the exclusions from no/limited recourse, such as fundamental representations and warranties and tax. Fourth, the exclusions from the RWI policy (which should be surfaced as soon as possible). Fifth, the interplay between the RWI policy and the indemnity provisions: for example, preserving optionality for the buyer in terms of recourse and tolling survival periods if the buyer pursues RWI coverage.

Of course, the buyer’s diligence will typically result in stand-alone indemnities that are not covered by RWI and parties need to address whether any liability caps apply to same.

RWI serves many useful purposes in facilitating the successful closing of transactions, but it also creates complexity within the liability paradigm. Parties should, more than ever, take the time to consider the implications and establish their interests early in the negotiations.

(5) Negotiating and Drafting MAE Provisions in 2022

“Material adverse effect” provisions (also referred to as material adverse change, MAC, or MAE clauses) continue to be subject to heightened negotiations and scrutiny in an economy impacted by COVID-19. Purchase agreements in the PE context typically contain provisions that address instances where a buyer is permitted to terminate the deal upon the occurrence of a MAE impacting the target business. In a 2021 *Mergermarket* survey of 100 senior-level executives at PE firms globally, over 70% of respondents observed an increase in the use, and negotiation, of MAE provisions, specifically as such terms pertain to events that are excluded from the definition of MAE (also referred to as “carveouts”).

One of the most important developments in Canadian MAE law arrived in December 2021 with the *Cineplex v. Cineworld* decision from the Ontario Superior Court of Justice. While the decision is being appealed, the Court held that Cineworld wrongly terminated its December 2019 agreement with Cineplex, awarding Cineplex $1.2 billion in damages for lost synergies. Among other findings, the Court noted that “the Material Adverse Effect clause squarely addressed the risk of a pandemic and allocated that systemic risk to the buyer.”

The judgement raises a number of important considerations for negotiating and drafting MAE provisions in purchase agreements. In particular, buyers should note the importance of addressing, with specificity, the expected standards of operation for the target between signing the agreement and closing the deal. Terms like “operate the business in the ordinary course” give courts the ambit to apply “mixed fact and law” to their analysis. It is therefore prudent for buyers to consider clarifying the standard of “ordinary course” so that a court can analyze the actions taken – or not taken – by the seller with some objective criteria. Further, the parties should consider the impact of restrictions imposed by applicable law on “ordinary course” operations. On the other hand, the term “consistent with past practice” can be used to clarify the standard of “the ordinary course of business” as it directs the court to consider the acts/omissions of the specific seller on a subjective basis.

Similarly, buyers should consider the potential to capture specific concerns under the portion of an MAE definition that specifies carveouts will not apply to an event that has had a “materially disproportionate effect” on the target and its subsidiaries. Indeed, buyers can set out objective metrics that trigger an MAE, even if it is generally excluded, such as a material decrease in EBITDA, or a reduction in the number of employees or open retail locations. In short, buyers and their advisors should consider developments that would be considered materially adverse for the target, even if most competitors in the industry may be suffering the same fate.

The reinforced lesson from the last two years is that MAE provisions and other covenants and terms in a purchase agreement are interrelated. Since Canadian courts will read “the agreement as a whole” when faced with differing views on interpretation, it is important for deal parties to take thoughtful approaches to drafting, such as considering the MAE provision in the context of the entire purchase agreement and inserting specific triggers for an MAE or act outside "the ordinary course."

(6) The Decline of Anti-Hoarding Provisions in Credit Facilities

Of course, the COVID-19 pandemic caused major economic disruption, resulting in a sharp downturn in financial markets and increased uncertainty. As a result, at the start of the pandemic many creditors began to include anti-hoarding provisions in their credit agreements and/or began amending their existing credit documents to include such anti-hoarding provisions.

Anti-hoarding provisions restrict a borrower’s ability to request an advance if it would result in the borrower having “excess cash” on hand, which sometimes included an express ability for the creditor to refuse to make the loan advance.

These provisions were put in place due to the challenging economic environment at the start of the pandemic which incentivized borrowers to obtain extra loan advances to improve their liquidity, including borrowers with borrowing-based credit facilities facing the prospect of reduced (or perceived reduced) availability.

While the pandemic continues in 2022, and economic disruption remains due to continued lock-downs in certain jurisdictions (including most of Canada), creditors and debtors now have a better general understanding of the economic outlook resulting in less uncertainty compared to the beginning of the pandemic. For this reason, anti-hoarding provisions have come full circle and are no longer being included in most new credit facilities.

(7) Competition Law: A More Aggressive Approach to Merger Review & Foreign Investment Scrutiny

As merger activity continues to surge, the Canadian Competition Bureau (Bureau) has signaled a more aggressive approach to merger review. In a speech last fall to the National Competition Law Section of the Canadian Bar Association (CBA), the Commissioner of Competition (Commissioner) stressed that “Canada needs more competition” and that he views effective and rigorous merger review as a critical tool for realizing that objective. Recent cases (including the Commissioner’s challenge in December 2021 to GFL Environmental Inc.’s acquisition of Terrapure Environmental Inc.) confirm that the Bureau is prepared to back that statement up and that the merger reviews in Canada are going to take longer, be more expensive, and be more likely to end up in court.

Indeed, the Bureau is now clearly on a litigation footing. Over the summer of 2021, the Commissioner unsuccessfully applied for an injunction to block the closing of a merger between two waste services companies (Secure/Tervita) until his challenge to that transaction could be heard by the Competition Tribunal. The Commissioner appears to have been caught flat footed and failed to bring his application in a timely manner. In his speech to the CBA, the Commissioner made clear that he will not make that mistake again. Specifically, he confirmed that the Bureau would be adopting a litigation-focused approach for transactions where the parties refuse to give the Bureau more time to complete its review by agreeing in advance not to close even after they are lawfully permitted to do so. The Commissioner indicated that, in such cases, merging parties should expect less transparency and engagement from the Bureau in the assessment of their transactions. Heightened scrutiny should be anticipated for transactions in sectors which the Bureau views as important to the lives of ordinary Canadians, including (but by no means limited to) digital services, telecommunications, health care, and infrastructure.

Since the onset of the pandemic, foreign investment has also been subject to heightened scrutiny under the *Investment Canada Act*. That scrutiny has been focused on acquisitions of “Canadian businesses that are related to public health or involved in the supply of critical goods and services to Canadians or to the Government” and on the 10 sectors identified by the government as constituting critical infrastructure (namely, energy and utilities, information and communication technologies, finance, health, food, water, transportation, safety, government, and manufacturing). Investments by state-owned enterprises and investors traditionally viewed as being state-controlled or influenced, including those from China and Russia, also continue to attract special attention.

(8) Regulatory Compliance: Developments in Due Diligence Practices

In the area of regulatory compliance, PE firms and private M&A stakeholders are expected to continue a fluid and risk-based approach to due diligence. Multiple regulatory considerations, such as anti-corruption laws, economic sanctions, and export controls, must be considered by parties at all stages of a transaction. More specifically, parties that carry out transactions with a cross-border component will have to consider the regulations of multiple jurisdictions.

Canada's close economic ties to the US have both regulatory and practical effects on the compliance practices of Canadian parties. At the regulatory level, there is increasing Canadian exposure to the "long arm" extraterritorial application of US sanctions, export controls, and anti-corruption laws. For a Canadian company, USD transactions are enough to demonstrate a US nexus. Also, from a practical perspective, Canadian authorities increasingly follow US precedents on sentencing, terms of probation orders, and required compliance measures.

In Canada, companies should regularly review the implementation, execution, and ongoing monitoring of their financial crime compliance measures. Additionally, the screening of third parties is an essential requirement in the compliance toolkit. Lastly, new voluntary disclosure and remedial agreement mechanisms present opportunities for Canadian companies to avoid criminal convictions and penalties.

As the pandemic continues to generate volatility and uncertainty in the economy generally, and regulators take a more aggressive approach on compliance, parties must adapt to developments that come to light during the due diligence process and consider the regulatory consequences. For instance, companies with interests in Russia and China are moving quickly to develop contingency plans as Canada, the US, and the EU threaten increased sanctions against those countries in response to global economic developments. The difficulty is enhanced by companies not knowing in advance what kind of sanctions will be imposed.

(9) Tax Consequences of Non-Resident Control of a Canadian Company

The high volume of cross-border PE and private M&A deal flow underlines the importance of Canada's "foreign affiliate dumping" (FAD) rules in the 2022 investment environment. For in-bound PE investments in Canadian corporations, funds will often use limited partnerships as an investment vehicle, structured with a non-resident GP and non-resident investors as LPs. In this context, careful consideration should be given to the possible application of Canada's FAD rules to ensure no adverse tax consequences arise.

Canada's FAD rules apply where a Canadian corporation is or becomes controlled by a non-resident person (or group of non-resident persons not dealing with each other at arm's length) (i.e., a foreign parent) and makes an "investment" in its own non-resident subsidiaries (i.e., foreign affiliates). If the FAD rules apply, the Canadian corporation may be deemed to have paid a dividend to its foreign parent, which may be subject to Canadian withholding tax. The FAD rules apply in a broad range of circumstances, and below is a selection of issues that may arise in the context of inbound PE investment into Canada.

1. In many instances, the issue with the FAD rules is one of compliance. There are various relieving measures available, such as mandatory and elective paid-up capital (PUC) reductions, which allow for dividends that are otherwise deemed to arise to be offset against the PUC of the shares of the Canadian corporation, and the pertinent loan and indebtedness election, which results in certain loans made to foreign affiliates being subject to interest imputation rules rather than resulting in a deemed dividend subject to withholding tax. However, notification and elections must be timely filed with the CRA to benefit from such relieving measures.
2. The FAD rules contain a rule that deems partners to own their pro rata share of partnership property, based on the relative fair market value of their partnership interests. In the context of investments made through a limited partnership in shares of a Canadian corporation, an interpretive issue may arise with respect to the determination of control of the Canadian corporation for purposes of the FAD rules. Although the deeming rule may not attribute sufficient share ownership to a GP for it to have control of the Canadian corporation on this basis (i.e., more than 50%), the CRA's position is that, in the case of a limited partnership, it is generally the GP that has control.
3. The FAD rules may apply where a foreign parent contributes its shares to a Canadian corporation to be used by the Canadian corporation as consideration in the acquisition of a Canadian target where the fair market value of its foreign affiliates exceeds 75% of its total asset value.
4. For the FAD rules, an "investment" is defined broadly and includes not only direct acquisitions of shares, but capital contributions, the loaning of funds, acquisitions of options, and extending the maturity date of outstanding debt. Given the broad definition of "investment," a fund may be required to confirm, on an ongoing basis, that its investments are not creating an issue under the FAD rules.

(10) Modernizing Ontario's Business Laws

After almost a year-long wait, important amendments to the *Business Corporations Act* (Ontario) (OBCA) took effect on July 5, 2021. The most notable of these amendments is the elimination of the requirement under the OBCA that at least 25% of the directors of a private or public corporation must be a Canadian resident. It finally brings Ontario in line with several other Canadian jurisdictions, such as Quebec, Nova Scotia, New Brunswick, Prince Edward Island, Nunavut, Northwest Territories, and the Yukon.

The 25% director residency requirement was an inconvenient and challenging hurdle for practitioners and clients seeking to incorporate foreign businesses in Ontario. This significant legislative development will make Ontario more attractive to foreign businesses seeking to incorporate in the province for operational, tax, and/or governance purposes. Moreover, it will support the anticipated high deal flow in 2022, providing more flexibility to both PE firms and their portfolio companies.

In addition, the Ontario Ministry of Government and Consumer Services is currently proposing amendments to permanently facilitate virtual meetings under its business law statutes to "help businesses and condominiums adapt to new ways of doing business that are more virtual and allow for broader participation." These provisions, if passed, will align with the trend towards facilitating meetings by electronic and virtual means.

(Cassels partner Jake Bullen, one of the authors of this Report, is a member of the Ontario Business Law Modernization and Burden Reduction Council, which consulted on these amendments.)

(11) Longer-Term Investing Strategy 1: Long-Dated Funds

For years, PE has demonstrated its ability to anticipate, and adapt to, changes in the market. One of the more important fund-level trends is the growing popularity of longer-term investing strategies. Since 2016, PEI data notes that long-dated funds have raised around $50 billion. There is also strong data to suggest that long-dated funds will be a more relevant investing strategy going forward. For instance, *Goldman Sachs* noted in their report "Investment Ideas 2022" that market participants should look to "long-term, less liquid alternative investments that are driven by factors less correlated to market beta, such as private secondary offerings and more complex opportunities in the private markets." Within the private markets themselves, GPs and LPs alike are looking for ways to hold onto their assets beyond the typical fund horizon period.

Generally, the average lifecycle of a PE fund is seven-to-ten years (plus extensions). The long-dated fund is designed to last 15 years or longer depending on the GP's strategy. This alternative fund structure can provide LPs with returns over a longer time frame than a traditional fund, leverage circumstances where portfolio companies may need a longer runway to mature and, in some cases, simply allow investors to support and profit from a strong business over a longer term. Canadian investors, such as Brookfield Asset Management, have recently committed to a long-dated fund strategy.

As more GPs consider longer lifecycles for new funds, the related impact on offering documents, regulatory compliance, and marketing materials should be addressed. In particular, GPs should consider crafting terms that allow for extensions or continuations due to the difficulty associated with predicting the state of the market when the long-dated fund matures.

(12) Longer-Term Investing Strategy 2: Continuation Funds

A continuation fund is a longer-term investing strategy which has become an effective tool for fund management in 2022. Generally, a continuation fund is a new vehicle established by the GP of an existing fund where the objectives are to (a) guarantee liquidity to the LPs of the existing fund by allowing them to sell their interests at a fair price, (b) allow the GPs (and interested LPs) to continue their investment in the underlying portfolio companies, and (c) bring in new investors who will contribute capital to the continuation fund, allowing the GP to pay the LPs for their interests. According to the *Financial Times*, PE groups spent over $42 billion on continuation fund sales in 2021 (i.e., the value of the fund interests sold and the capital raised for the new fund). Further, a recent *Kroll* report on GP-led secondaries notes that a record-setting 73 continuation funds closed through mid-December 2021.[2]

Canadian PE firms should consider continuation funds as an alternative fund management tool while addressing the nuances of this strategy. First and foremost, GPs should consider the practical challenges associated with giving effect to this arrangement. For instance, funds and their advisors should review the voting provisions of the limited partnership agreement and the amount of support needed to effect the transfer of partnership interests between the existing fund and the continuation fund. Also, the GPs of the fund should consider the challenges associated with balancing their efforts to attract new investors to the continuation fund and their fiduciary duty to the LPs of the existing fund, especially the LPs looking to sell their interests.

Due to the challenges associated with executing a continuation fund, it is important for PE firms to plan ahead and engage advisors in advance to assess the key terms and risks in the context of the firm’s existing fund. For example, firms should consider whether management fees and carried interest will differ from the “old” fund. In addition, legal counsel can provide input on a structure that reflects the required approvals and the optionality of LPs (e.g., taking the roll-over versus cashing out; most take the latter, based on recent studies).

(13) Growth Equity Continues To … Grow

Growth equity strategies raised “an all-time high of US$100 billion-plus … and accounted for almost one-quarter of capital raised, well-above its historic share,” according to Buyouts data for 2021. In Canada, we expect to see more money deployed to this strategy as funds of varying sizes seek to bridge the gap between venture and buyout investing and access earlier stage companies in high-growth sectors like “better-for-you” food and beverage products and supplements, as well as tech.

Both growth investors and companies should consider the key governance and operational terms that will apply to their relationship, particularly as volatility continues in areas from supply chain to restrictions on operations.

(14) Purchase Price Considerations in M&A Transactions: Escrow Amounts

In recent PE and M&A transactions, the lines have been shifting over the past couple of years regarding a common capital allocation tool: escrow amounts. The trends reflect the strong M&A market, and the tendency towards seller-friendly deal terms: according to a recent *J.P. Morgan* study on escrow in M&A transactions, the average percentage of purchase price placed in escrow has slowly declined from an average high of 12.9% in 2013 to an average of 7.7% in 2021.[3] In addition, the 2021 *American Bar Association's* (ABA) Private Target Mergers & Acquisitions Deal Points Study notes that the number of deals with no escrow or holdback jumped to 37% in 2020-21 from 15% in 2018-2019.[4]

We expect negotiations over Canadian deal escrow terms (such as the quantum and duration of the escrow account) to intensify in 2022 for a few reasons:

- Generally, if the pace of M&A slows down, and market terms revert more to the median, buyers will have increased leverage.
- Buyers increasingly seek enhanced protections on indemnities and purchase price adjustments as, for example, market volatility increases.
- Sellers may point to RWI coverage to argue against onerous escrow terms.

(15) Private Equity Selling to Special Purpose Acquisition Companies

We could see a rise in the use of special purpose acquisition companies (SPACs) by PE as a viable exit option in 2022. Traditionally, SPACs have not been particularly common in Canada. For instance, there are only two SPACs listed on the TSX as of November 30, 2021. However, the NEO exchange, an alternative securities exchange for innovative companies, had approximately 11 SPACs listed on its exchange as of the end of 2021. PE firms are increasingly open to the idea of utilizing SPACs, essentially a competitive strategy, to generate liquidity for LPs. In a *Mergermarket* report which surveyed 100 senior-level executives within PE firms around the world, over 66% of respondents noted that their firm is either using a SPAC (41%) or has considered a SPAC and is likely to use one in the future (25%). While the SPAC market cooled towards the end of 2021, there are roughly 570 SPACs with $134 billion looking for a target to bring public in 2022. This could be an opportunity for PE funds to identify alternative exit opportunities as SPACs often have a two-to-three year time horizon to complete an acquisition.

Sellers considering a sale to a SPAC should consider all of the pros and cons of a de-SPAC versus traditional exit strategies. The key consideration in determining to move forward with a SPAC is the assessment of the quality, reputation, and experience of its management and sponsor team, as these are really a SPAC's greatest assets in executing a successful acquisition transaction and helping the new business in terms of growth strategy and transitioning to public company life. SPACs can offer a good alternative to traditional exit strategies as they can be highly customized and can execute a single target acquisition or a roll up of multiple targets, which could be attractive to GPs of PE funds.

1. Some of the pros include more economic certainty and potentially higher valuations for sellers to a SPAC due to (a) the fact that it is a reverse merger or reverse takeover acquisition transaction and (b) the value and purchase price are negotiated between the SPAC and the seller, meaning that the price is less prone to market volatility impacting the economics because the business is not marketed to the public and priced in the context of the market by an investment bank or underwriter, as is the case in a traditional IPO process. There is also less scrutiny of the target's business operations, financial health, and liabilities in a de-SPAC transaction because it is a non-offering prospectus (i.e., there is slightly less regulatory oversight than a traditional IPO) and there is not the same involvement of an underwriter conducting detailed due diligence on the business as there is in an IPO. Finally, due to the fact that a maximum of 20% of the founders' stock in the SPAC is locked until the de-SPAC transaction closes, founders have a strong personal interest and incentive to get a deal done within the regulatory timeline to get their promote.
2. On the con side, although some argue that a de-SPAC transaction is also quicker and less expensive than an IPO, in our experience this has not necessarily been the case. While the IPO and direct listing of the SPAC is typically much quicker and less expensive, the process of the SPAC conducting diligence, negotiating, and ultimately completing a de-SPAC acquisition transaction with one or more targets can be a lengthy process that ultimately rivals the completion of a traditional IPO in the end in terms of timing and expense. Following the IPO of the SPAC, the process to complete the acquisition typically involves another underwritten financing raise that is done as private investment in public equity deal, as well as months of negotiation, paperwork, regulatory filings, and often (but not always) a public company shareholder meeting, to close the acquisition transaction.

(16) Private Equity's Focus on Tech Investments

The tech sector remains a popular sector for PE strategies. Data from a *Houlihan Lokey* report for an ABA International M&A Subcommittee presentation indicates that the technology sector represented the largest industry for US M&A in 2021 by both number of transactions and transaction values.[5] According to the CVCA's Q3 2021 report, the top performing sector in Canada was information & communications technology (ICT). Indeed, by Q3 the ICT sector had already surpassed its all-time CVCA deal volume record and was on pace to equal its record of $5 billion set in 2020. Moreover, a recent *Goldman Sachs* report expects that PE firms will play a more important role in M&A transactions where larger companies intend to evolve their business models through, for example, acquisitions of technology companies or innovative companies that have successfully incorporated technology into their businesses.

As many have observed, the pandemic has been a key driver as businesses are looking to invest in or acquire technology companies to support their adaptation to a more digital economy. Importantly, companies in every sector have been reshaping their use of technology as their internal business processes and their interactions with suppliers and customers have been moving online. As such, technology is increasingly becoming more important in most M&A deals, even those outside of the traditional technology sector.

Buyers should refresh their tech due diligence questions and workstreams to reflect developments in areas like privacy and cybersecurity. According to a Gartner report on cybersecurity predictions for 2021-2022, organizations are increasingly measuring cybersecurity risk when assessing targets and counter-parties in M&A transactions and other commercial relationships. Gartner estimates that, by 2025, 60% of organizations will measure cybersecurity risk in business dealings with third parties. A security breach or ransomware attack can cause significant problems for an organization, including the requirement to notify governmental agencies, contacting customers, credit monitoring services and call center services.

In 2022, the due diligence around data security will be more important that ever. For example, the security aspects of the target should be investigated to ensure that data security problems are not being acquired with the target. This may include a review of any prior security breaches, the processes and tools used by the target to prevent security breaches, and the business continuity and recovery processes that are in place. Increasingly, organizations are refusing to pay the ransom and are instead choosing to rebuild their systems. Further, the cybersecurity insurance of the target can be reviewed for adequacy.

The Private Equity Group at Cassels includes over 35 lawyers in Toronto, Calgary, and Vancouver with expertise in all elements of PE transactions. We are leaders in M&A (consistently ranking as a top Canadian firm in PitchBook's global league tables), tax, fund formation, restructuring, competition/foreign investment regulation, debt financing, franchise, and intellectual property. Our clients include PE funds based in Canada, the US, and the rest of the world as well as international and domestic businesses, ranging from large multi-national organizations to start-up companies.

Contributions from across Cassels in the preparation of this report are gratefully acknowledged, including from Ryan Kay, Articling Student, and the following partners and associates:

- Davit Akman
- Jocelyn Arnason
- Tegan O'Brien
- Chuck Rich

- Frank P. Arnone
- Jeremy Barretto
- Andrea FitzGerald
- Dr. Alison R. Manzer
- Doug Richardson
- Brenda C. Swick
- George A. Wowk

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[1] See: Refinitiv, "Canada – Private Equity Buyout Review" (First Nine Months, 2021).

[2] See: Kroll, "GP-Led Secondary Recaps and Related Fund Transactions" (Market Update) (January 2022).

[3] See: J.P. Morgan, "J.P. Morgan 2021 M&A Holdback Escrow Study" (2021).

[4] See: ABA M&A Committee Market Trends Subcommittee Meeting, "Deal Points Study – Private Target Mergers & Acquisitions" (January 28, 2022).

[5] See: Houlihan Lokey, American Bar Associate: International M&A Subcommittee (January 28, 2022).
