Cassels

State of the Market

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An Update on Private Equity M&A in Canada

H1 2024 Results

The M&A market – and particularly mid-market private equity M&A – remains uncertain.

With hopes that H1 2024 would start strongly for M&A, and with some reduction in macroeconomic uncertainty, the deal market continues to be choppy.

From LSEG (formerly Refinitiv):

- On a global scale, M&A activity was up 18% (YoY) in H1 2024 to US$1.5 trillion. When measuring the number of deals, however, H1 2024 was down 25% YoY.
- Private equity-backed buyouts accounted for 24% of M&A activity in H1 2024; up from 21% in H1 2023. Total value of such buyouts hit US$369.5 billion, up 36% YoY.
- On a global scale, the results appear to be strong for PE M&A: “The first half of 2024 ranks as the fourth largest opening period for PE-backed M&A since records began in 1980.”
- In Canada, completed M&A deals were down 11% YoY by value and 17% by number of deals.

With respect to the mid-market, the data show a less positive start to the year:

- Global mid-market M&A hit US$360.3 billion during H1 2024; down 11% YoY and “the slowest first half period for mid-market M&A since 2013.”
- “Private equity-backed mid-market M&A deals totaled US$91.0 billion during the first half of 2024, a decrease of 17% compared to year ago levels and the slowest opening period for private equity-backed mid-market M&A since 2020.”
- In Canada, announced mid-market M&A deals in H1 2024 were down YoY 18% (value) and 14% (number of deals).

Forecast

M&A Data

We're seeing some positive trends for H2 2024:

1. Indications of improving investor outlook. KKR recently noted that its US mid-market strategy had surpassed its US$ fundraising goal, and that "we're starting to see [investor] sentiment shift to positive."
2. A growing sense that the valuation gap between buyers and sellers is narrowing. However, this challenge is not resolving quickly; we continue to hear from our PE clients that valuations are challenging for all but the most "A level" targets.
3. Improving sentiment among GPs and among earnings calls for public PE firms. According to Bain & Company's Private Equity Midyear Report 2024, **"**informal discussions with general partners (GPs) globally suggest that deal pipelines are already starting to refill, and many see the green shoots of a recovery beginning to poke through.". It should be noted, however, that Bain's survey results showed less optimism.

As for timing of a robust recovery, we note this comment from Bain's "Dry Powder: The Private Equity Podcast": "While a lot of the investors are saying 'Yes, 2025' and it could well be 2025 before we see a meaningful uptick, that uptick is coming and it is coming sooner rather than later."

Themes

Two primary themes will continue to dominate the market in H2 2024 - creativity and liquidity. In addition, the importance of relationships has increased.

Creativity

Diligence

In an environment where acquirers remain more focused on diligence and valuations (with concerns ranging from interest rate uncertainty to assessing accurate year-over-year financials), buyers are laser-focused on managing risk. At the same time, PE funds want to close deals. As a result, we continue to see – and help our clients balance - enhanced diligence (legal, financial, and tax) as well as increased efficiencies to keep deals "on track." As noted in our publication titled, Navigating Uncertainty, our Cassels PE M&A team is seeing diligence periods that are (on average) 21-49% longer than in 2021-2022. For example, we're regularly seeing more Quality of Earnings reports produced as well as an enhanced readiness among buyers and sellers to consider Representation & Warranty Insurance (helped in part by better pricing).

In addition, we're seeing a significant increase in the use of "background checks" with respect to the leaders of prospective targets. Our team manages and integrates these processes and findings into the

diligence workstream as part of our project management toolkit. Finally, the increased scrutiny of global supply chains as a result of more expansive anti-corruption legislation adds a complex element to more deals than ever before.

Structuring

In order to get deals done in the face of these challenges, buyers are often willing to deploy creative structuring options, including unique earn-out terms; staggered share purchases; vendor take-backs; and enhanced post-deal integration & vendor support. From the legal perspective, the introduction of such terms requires careful consideration and drafting. As we note below under Legal Trends, Ontario courts recently provided some guidance around the interpretation of earn-out clauses.

The Extension of the "100-Day Plan"

Many PE sponsors continue to focus on portfolio companies: many companies face challenges arising from Pandemic-era factors (such as demand hits and supply chain issues) and inflation. PE sponsors are focused on areas like enhancing value creation, growing revenue and expanding margins as funds balance the distributed to paid-in capital ratio (DPI), fundraising and completing new deals.

This effort translates to our work supporting clients (PE sponsors and portfolio companies) with their "day-to-day" legal needs: contract review; governance; HR matters; protecting IP; dispute resolution; and regulatory compliance. It is important that portfolio companies maximize value in an era where higher interest rates and other challenges make it difficult to drive returns based on leverage or multiple expansion.

Beyond the Buyout

In this challenging market, tuck-ins are more common forms of M&A, although strong platform deals continue to attract interest. In addition, buyers are often more willing to expand their M&A strategy toolkit: many buyers are assessing distressed deals and take-private opportunities. Further, complementary approaches – such as growth equity deals – are allowing sponsors to engage with sellers earlier in the process.

We're also seeing an increase in sales of carve-outs by corporates to private equity.

Liquidity

Many sellers remain motivated to sell (e.g. to execute on succession planning), but are finding the market more challenging than expected.

PE sponsors continue to balance a search for exits at good valuations, deploying dry powder amidst

uncertainty (see above) and fundraising in a tough market.

Collaboration

Given these challenges, it is very important that financial and legal teams coordinate on items like earn-outs & working capital, as these are complex and sensitive provisions.

Other Options for Liquidity

PE sponsors are increasingly accessing strategies such as partial exits, continuation vehicles, secondaries, NAV lending and other methods to provide capital back to LPs or extend hold periods where necessary.

In addition, a trend of PE sponsors aligning with large financial institutions continues (e.g., BMO partners with US private equity giant Carlyle Group on investment fund - The Globe and Mail). These collaborations allow access to private equity investments for some retail investors, and enhance the liquidity in the private assets market.

The Importance of Relationships

During a period of economic uncertainty, our clients regularly reinforce the importance of relationships. Strong connections with talented investment bankers; experienced accounting and legal advisors; leaders in the industry; and (of course) founders/owner-operators are crucial to securing deals, advancing deals to closing, and implementing post-closing value creation strategies.

Legal Trends

1. From the legal perspective, we've seen significant recent developments in Canadian M&A. In areas such as competition law and tax, governments have introduced bold changes, without significant consultation in many cases. These developments will impact M&A for years to come. More immediately, this will push many factors to the top in terms of consideration for deal-makers.

In this issue, please see Generational Changes to the Canadian Merger Review Regime and Canada's Modern Slavery Legislation Is Now in Force – What You Need to Know. We also reference our Tax Group's recent commentary: Budget 2024: Did the Federal Government Get the Balance Right?

As of this writing, our Private Equity team has completed a busy run of transactions structured and closed as a direct response to the Federal Government's increase in the capital gains inclusion rate to two-thirds (subject to certain thresholds for individuals).

2. In Ontario, we've had the benefit of two recent court decisions that provide important guidance for lawyers and M&A professionals in negotiating and executing transactions: *Leeder Automotive Inc. v. Warwick* and *Bhatnagar v Cresco Labs Inc.*

Ontario's Court of Appeal provided guidance on the treatment of a non-mandatory buy-sell clause in a unanimous shareholders agreement, see Use It or Lose It! Non-Compliance With USA Provides Risk of Repudiation of Share Transaction.

The same court also ruled on some key components of earn-out provisions. This is timely guidance since the increased use of earn-out provisions to bridge valuation gaps and risks to the business post-closing has (unsurprisingly) increased the volume of litigation concerning such clauses. Among other findings, the Court ruled (as my litigation colleagues write) that "the duty of good faith and honest performance ought not to extend so far as to place a positive obligation on a party … to provide regular updates on information which a party is not contractually obligated to provide in the first place (and which a capital market participant may not be at liberty to share due to securities regulations)." A summary of the decision can be found here: Breach of the Duty of Honest Performance? Damages Still Need to Flow from the Breach.

As noted above, the drafting of earn-out provisions should be a collaborative effort: lawyers should work closely with the client to ensure that business- and industry-specific concepts are addressed, and the accounting team should be heavily involved to ensure that accounting principles and milestone metrics are consistently and clearly drafted.

Among other prudent practices for buyers in a post-closing earn-out scenario: maintaining solid documentary evidence of how business decisions are made (where they could impact the achievement of the earn-out) is important.

3. In addition, we note that a number of legislative changes in various provinces in recent years have positive implications for private equity sponsors, including the introduction of "corporate opportunity waivers" in Alberta (allowing private equity professionals the flexibility of serving on multiple boards) and the elimination (in Alberta and Ontario) of the requirement to have Canadian resident directors on the board of a corporation.

While not new developments, we see the practical impact of these amendments on everyday business, legal, and operational decisions.

4. As noted above, many deals are taking longer to complete. While the causes vary, we're finding the most common issues to be valuation gaps, diligence concerns (financial and/or legal items), and personnel issues (e.g. discussions around succession and ongoing roles).

5. Buyers continue to seek creative ways to incentivize management and employees. We're seeing

increased focus on the terms of Equity Incentive Plans. In addition to the standard discussions around tax impact, we're negotiating the impact of a "change of control" on such incentives.

6. Not surprisingly, as a "sign of the times" we're seeing more disputes in the market. The most common types:

- Transaction-related disputes. These tend to relate to pre-closing matters such as exclusivity and post-closing matters such as questions around diligence/representations and warranties.
- Commercial disputes. An increase in claims related to product warranties, alleged wrongdoing by executives and tax-related matters.

The "North Star" for PE sponsors remains the thoughtful assessment – and balancing - of risk, settlement options, and cost/benefit analysis of any litigation. In most cases we suggest negotiated alternatives; however, sometimes it is necessary to hit hard.

7. On the debt side, according to our finance partners, the Canadian market has shifted over the last two quarters as there has been a material reduction in debt-financed acquisitions and exits. Although the prime rate is slowly coming down, term rates are somewhat volatile (although are following a downward trend). They note that this can hit the mid-market particularly hard. They also note a reduced number of exits, and they are addressing many extensions of credit. Going forward, our lending colleagues expect to see an increase in deals as rates continue to come down and valuations increase.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.