TORYS LLP

PE PULSE 2021

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, n=101 private equity and pension fund professionals completed the survey, of which n=84 completed the survey online and n=17 by telephone. The survey was fielded between November 6th and December 14th, 2020, and then again between November 25th and December 4th, 2020.

Survey respondents

Most respondents work for private equity organizations (75%) while 25% work for pension funds. Over 60% have in excess of 10 years of experience in the industry.

Contents

Executive summary

The results of our second annual Canadian private equity survey show much optimism for 2021. The private equity and pension fund professionals who responded to our survey expect to see an overall improvement in the transaction environment that will drive dealmaking and fundraising activities throughout the year, despite uncertain global economic conditions as the pandemic persists.

Following the onset of the pandemic in 2020, many in the private equity industry put plans on hold as they worked to quickly respond to the COVID-19 crisis. Part of the optimistic sentiment from respondents can be attributed to the challenges of 2020, with the majority of respondents believing the relative outlook for 2021 will be much improved. More transaction volumes, better debt financing terms and heightened M&A activity are all expected, and year over year, twice as many respondents also anticipate it will be easier to raise new funds in 2021.

Despite the generally positive outlook, challenges persist. Competition for new investment opportunities continues, valuation multiples remain high, and some businesses that have shown COVID-19 resilience are commanding a premium. LPs continue to expect sponsors to deliver co-investment opportunities. And the ongoing disruption caused by COVID-19 is influencing deal terms, with four out of ten respondents expecting to see the use of earn-out provisions to address valuation gaps.

Valuation multiples paid for new platform investments are largely anticipated to rise this year, with pension funds in particular expecting higher valuation multiples. However, there is a shift in sentiment among investors, with more respondents considering whether vendor pricing expectations may be softening.

Technology remains the sector of choice for dealmaking opportunities in 2021, and while sentiment toward sector opportunities remains consistent with 2020 survey results, other sectors are presenting renewed interest from private equity and pension fund professionals, including industry/agriculture, entertainment, personal care and services.

Ultimately, although our survey results reflect the resilience and optimism in Canadian private equity, the pandemic crisis is not over yet, and most respondents identified it as the top challenge for 2021. The many knock-on effects of the pandemic continue to impact the private equity industry, impeding business development, face-to-face meetings with investors and management teams, and ongoing market volatility and disruption.

While the current environment is putting pressure on the private equity market, the sophistication of its players is pervasive, and over 40% predict higher private equity allocations this year—a strong indicator of opportunities and activity in the year ahead.

Dealmaking activity

With a challenging 2020 in the rear view, a high proportion of survey respondents expect to see much improvement in 2021. This positive outlook extends to expectations of increased M&A activity and deal volume—with many survey respondents also anticipating an improved overall economic climate, both domestically and globally. And compared to 2020, more respondents this year predict better debt financing deal terms and pricing, which would be welcomed as further support to a favourable dealmaking environment in 2021 (Figure 2 on next page).

Private equity stakeholders are well positioned to take advantage of post-pandemic market dislocations to pursue opportunistic buyouts and deploy excess capital. They have notably been sitting on record levels of dry powder and expect, far more (at 58%) than their pension fund counterparts (16%), to see their average deal sizes increase over the next year.

In addition, many sponsors have brought new funds to market during the pandemic, including funds specifically focused on distressed assets, as well as open-ended funds—an alternative fund structure to the more traditional closed-ended funds that is growing in popularity in particular for players looking for opportunities to invest in higher cash yield investments with liquidity options (read more **here**).

More fundraising activity is on the horizon for 2021, with twice as many (42%) private equity stakeholders now thinking that it will be easier to raise new funds in 2021 than it was in 2020 (Figure 1).

Figure 1

Q: Do you believe that it will become easier or more difficult to raise new funds in 2021 compared to 2020?

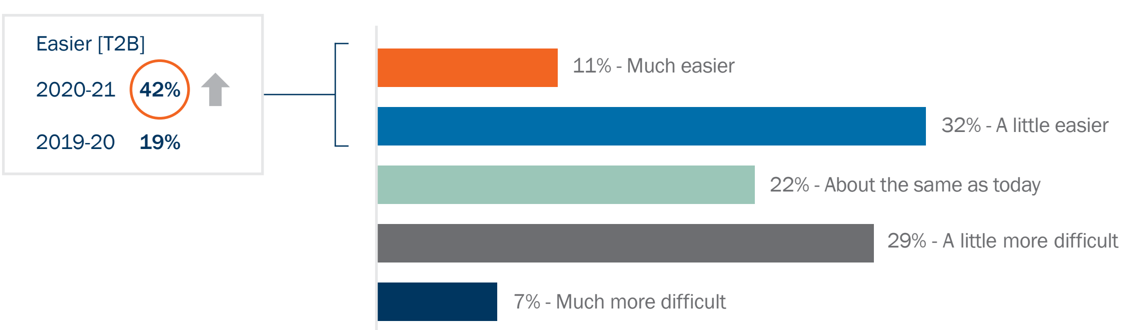
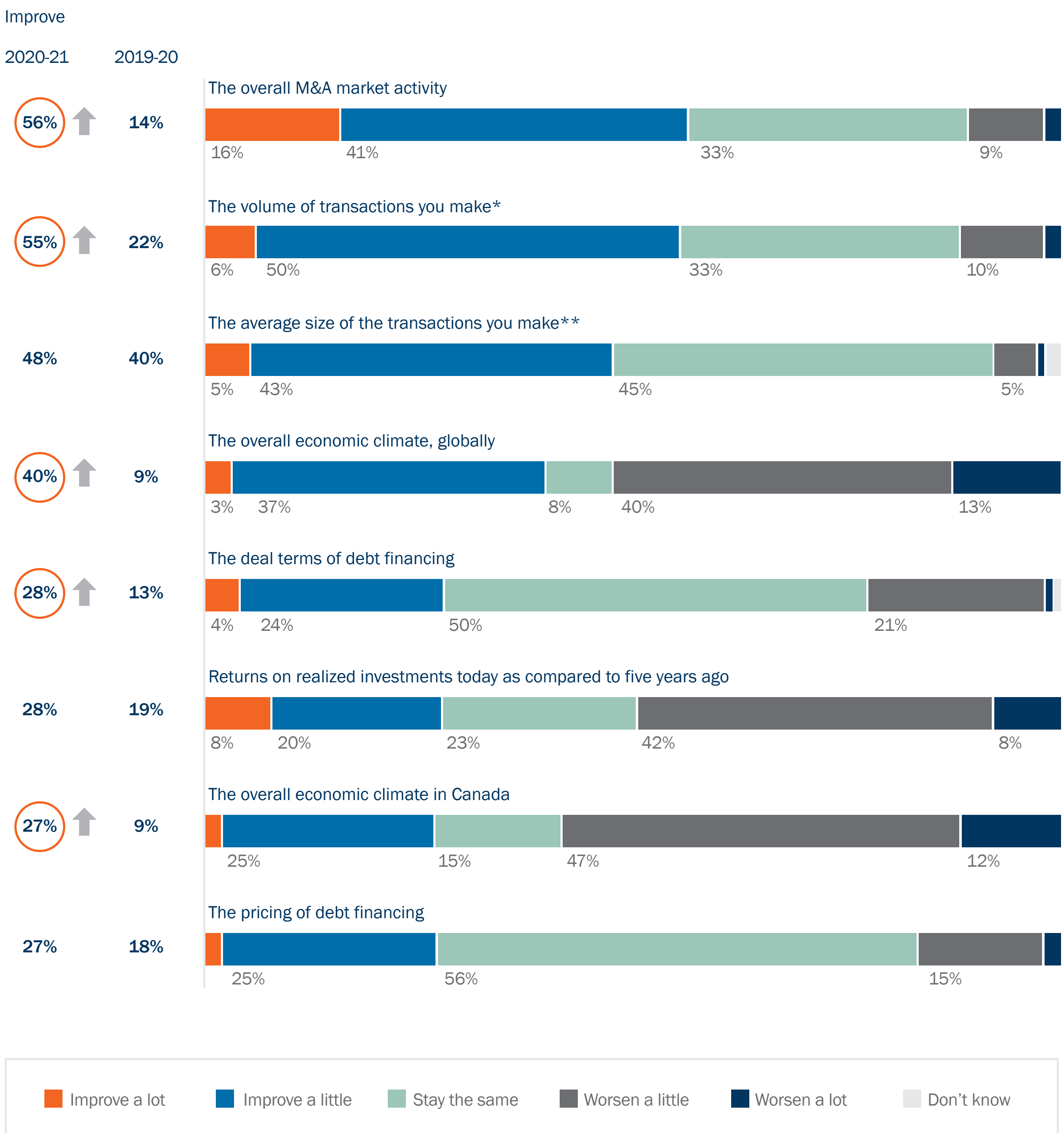


Figure 2

Q: Do you expect the following to improve, stay the same or worsen in 2021?



Data <3% not labelled

*Base: All Stakeholders: 2020-21 (n=101); 2019-20 (n=104) * equate "improve" with more; ** equate "improve" with larger*

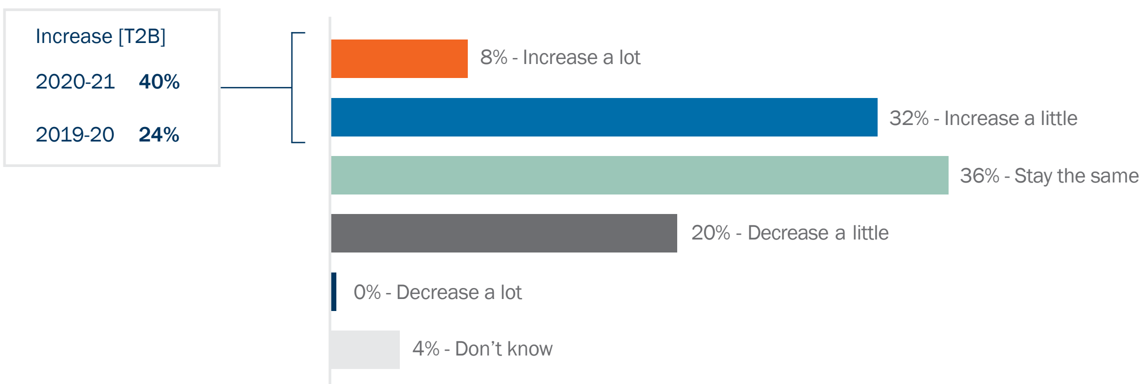
In the broader Canadian public M&A markets, well-funded buyers drove deal activity in 2020, and M&A activity was remarkably robust, surpassing 2019's level by number of deals. At the onset of the pandemic, we saw our private equity and pension fund clients primarily focused on working with their portfolio companies to ensure the safety of their businesses, customers and staff, and ensuring that their investments are both well capitalized and operationally ready to weather the COVID-19 impact. In the second half of 2020, we saw a significant spike of M&A deal activity by private equity and pension funds, who, after an initial period of digesting the impact of the pandemic, moved quickly and adapted to changing market conditions: acquisitions accounted for 44% of overall financial investor deal activity in 2020 (with most occurring in Q3 and Q4), and we expect to see both private equity and pension fund investors continue to drive deal activity in 2021 (learn more about the outlook for Canadian M&A in 2021 **here**).

Private equity allocations

This year twice as many pension fund stakeholders expect private equity allocations to increase (40%) as opposed to decrease (20%) in 2021 (Figure 3). This new perspective may have been informed by rising public market equity valuations, and the potential for higher returns through portfolio company investment and development, and resulting value growth opportunities for private equity investors.

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?



Base: Pension Fund Stakeholders: 2020-21 (n=25); 2019-20 (n=29*) *small base size, use with caution*

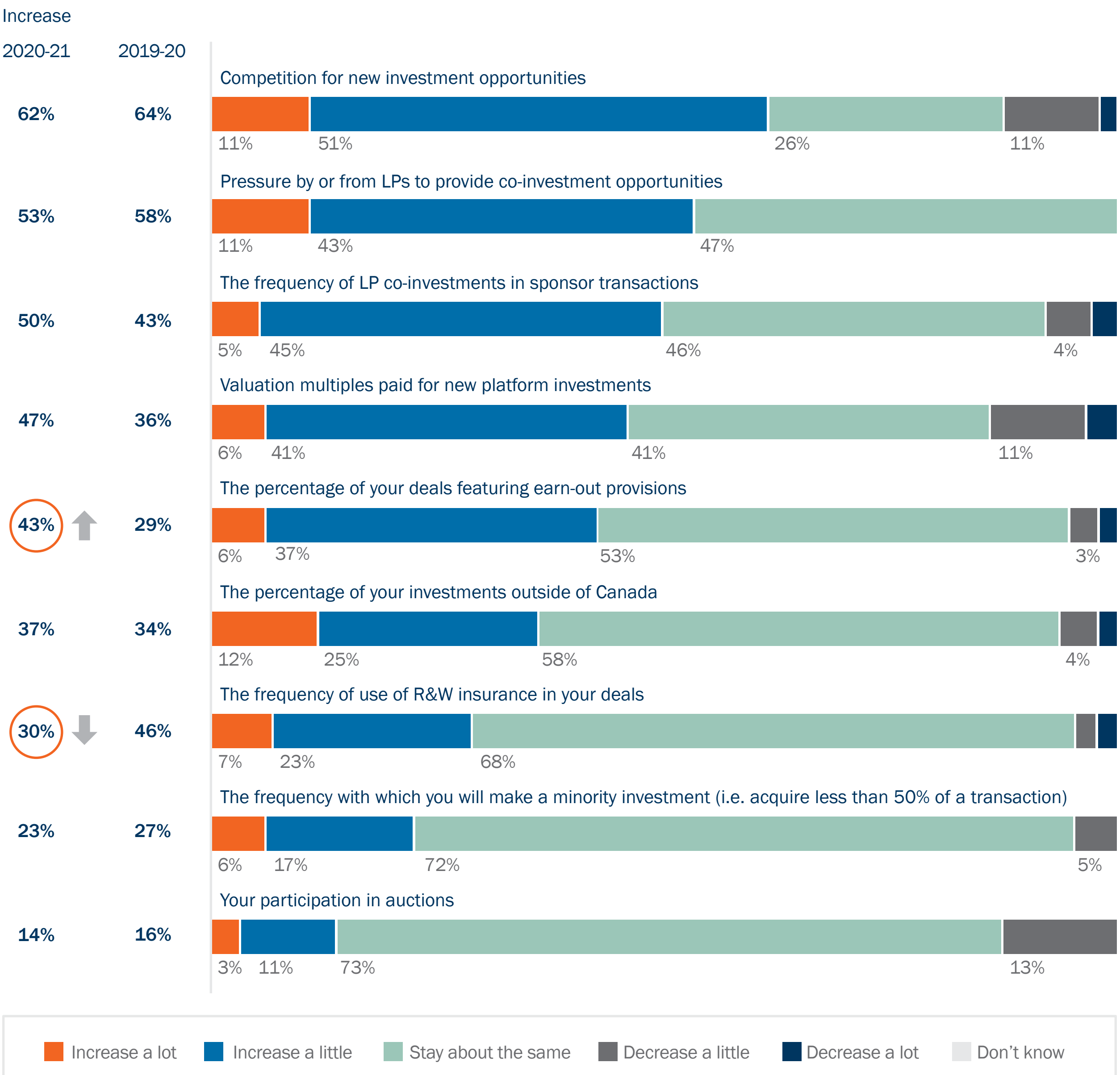
Similar to last year, competition for new investment opportunities (62%) and pressure by or from LPs to provide co-investment opportunities (53%) are the areas most expected to increase, particularly among pension fund professionals (Figure 4). Pension funds are also more likely to see the frequency with which they make a minority investment (44% vs. 16% of private equity funds) increase in 2021.

In a departure from last year's survey results, there has been a significant rise in the proportion of survey respondents who expect to see more earn-out provisions make an appearance in their dealmaking (43%). We tend to see earn-outs as a tool to bridge misalignments in pricing expectations with buyers and sellers having lower and higher expectations, respectively. The anticipated increase in the use of earn-outs in M&A transactions is a trend that we believe can largely be attributed to the pandemic and the economic uncertainty it has created, reconciling buyers' reduced valuation projections with sellers' assessments of the inherent value of their businesses.

Meanwhile, fewer respondents believe they will increase their use of R&W insurance in their deals (30%), relative to a year ago. The R&W insurance industry is in the middle of a state of flux, moving from a novel to a mature industry where claim volumes and size of loss payments have grown. Premiums, which had been falling for years, have now begun to increase and the increased demand, coupled with a claim history, has resulted in some insurers being slightly more discriminating in their offering. Although very few respondents (2%) expect to decrease their use of R&W insurance, these changes may be part of why fewer respondents anticipate increasing its use in deals.

Figure 4

Q: Do you expect the following to increase, decrease, or stay the same in 2021?



Data <3% not labelled

Valuation multiples

Valuation multiples paid for new platform investments are largely anticipated to rise in the coming year (Figure 4), with pension funds particularly expecting to see higher valuation multiples on their investments (64% vs. 41% of private equity funds).

Although on balance pricing expectations are higher, fewer survey respondents (40% vs. 65% last year) believe that vendor pricing expectations have increased over the past year, while nearly twice the number of respondents believe they have decreased (20%) (Figure 5) compared to last year. This changing sentiment may be another knock-on effect of the economic impact of COVID-19, including the increase in Canadian distressed M&A activity triggered by the pandemic—a broad trend likely to continue into 2021 (read more **here**).

A shift may be occurring in pricing expectations for target companies that are facing insolvency or that are already insolvent, presenting opportunities for well-capitalized and viable investors. Despite the changing deal landscape, a vast majority (82%) of survey respondents feel the current level of valuation multiples paid during M&A transactions involving private equity financing remains overvalued (Figure 6).

Compared to a year ago, nearly twice as many professionals predict exit-valuation multiples to increase (33% vs. 18% in 2019-20), while fewer think they will decrease (25% vs. 42% in 2019-2020) (Figure 7). The surge in SPACs that took place in 2020 may be one contributing factor to this shift in sentiment.

Figure 5

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

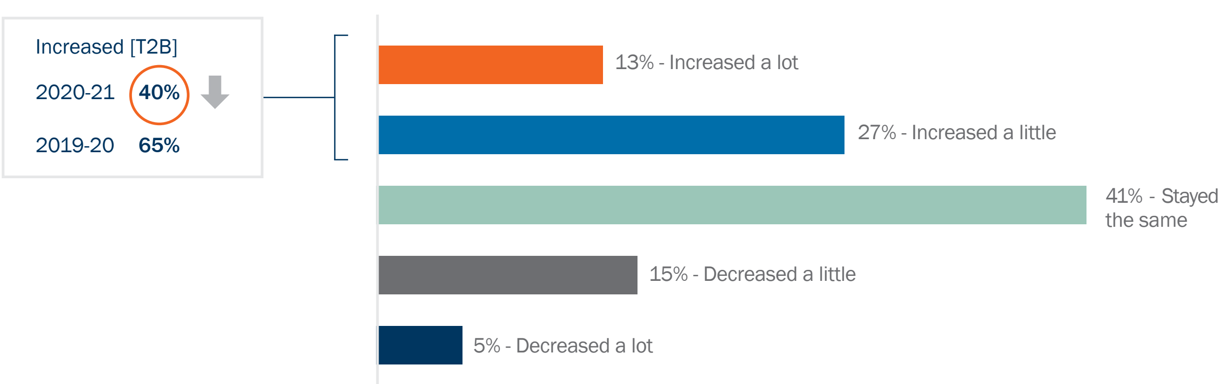


Figure 6

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

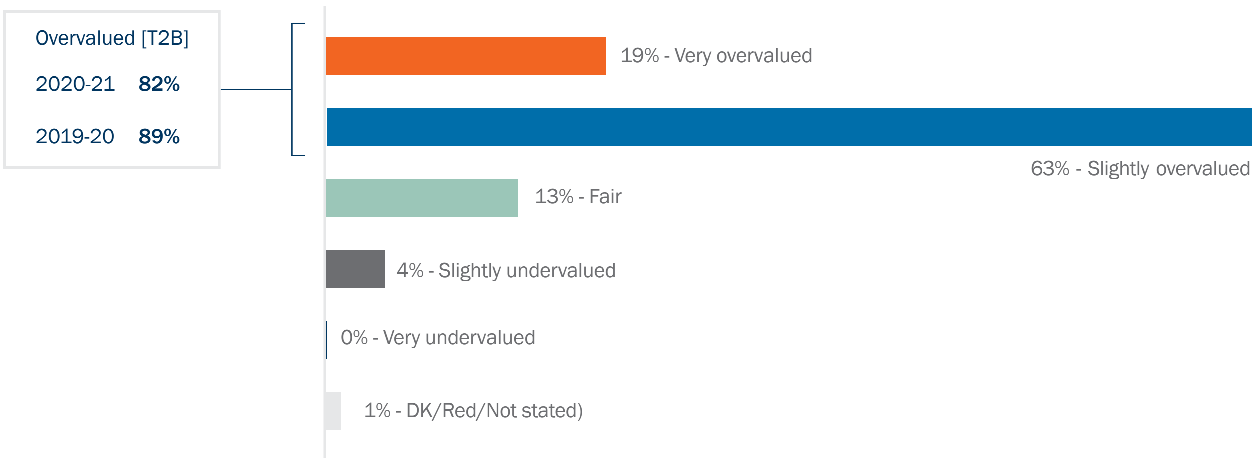
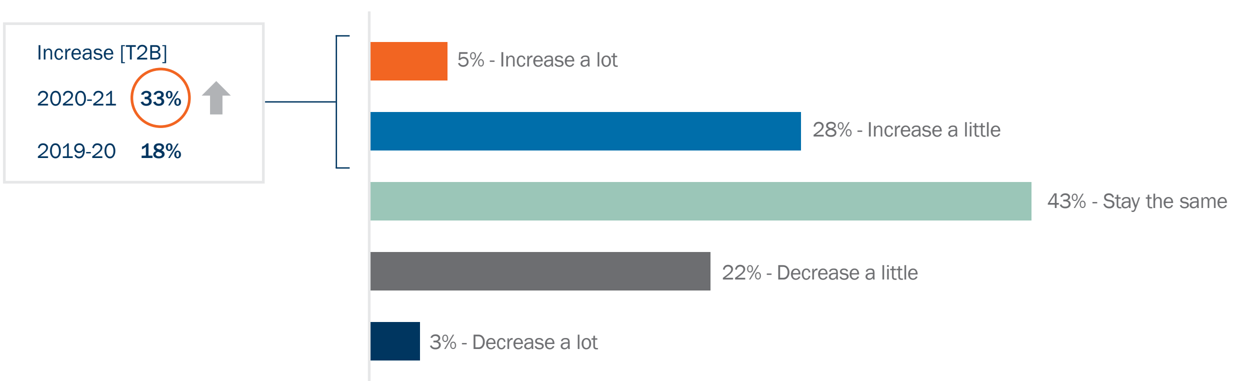


Figure 7

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



Private equity targets

Year-over-year, survey respondents are demonstrating ongoing appetite to pursue buy-side deal activity. Private equity and pension fund professionals indicated that they plan to devote the vast majority of their time in 2021 to new investments and portfolio company development, with a smaller proportion of their time on divesting investments (16%) or other tasks (17%) (Figure 8). Private equity stakeholders anticipate spending significantly more time on average on this last category of tasks, which includes raising new funds (19%), relative to their pension fund counterparts (11%).

Overall, a plurality of respondents (41%) continue to view majority stake or buy-out investments as the most attractive targets in 2021. Despite the overwhelming support for majority-control transactions, more respondents (23% vs. 15% in 2019-20) indicated this year that they intend to focus on minority stake investments (Figure 9).

Figure 8

Q: In 2021, what percentage of your time do you anticipate spending on the following tasks?

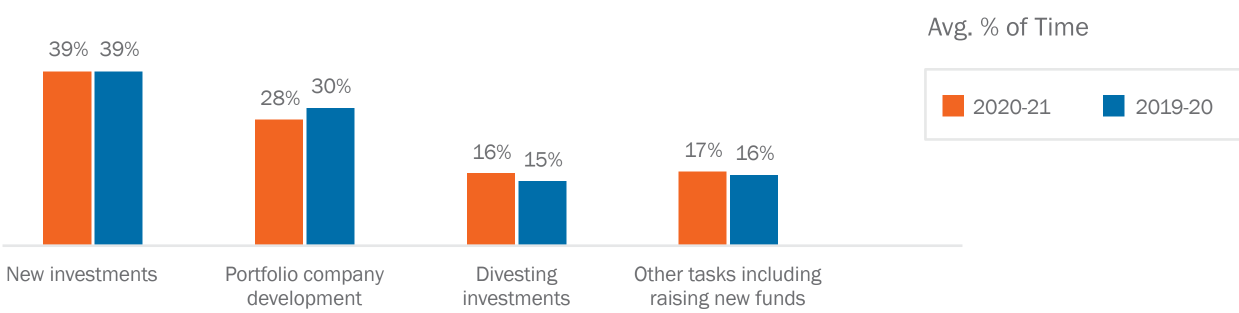
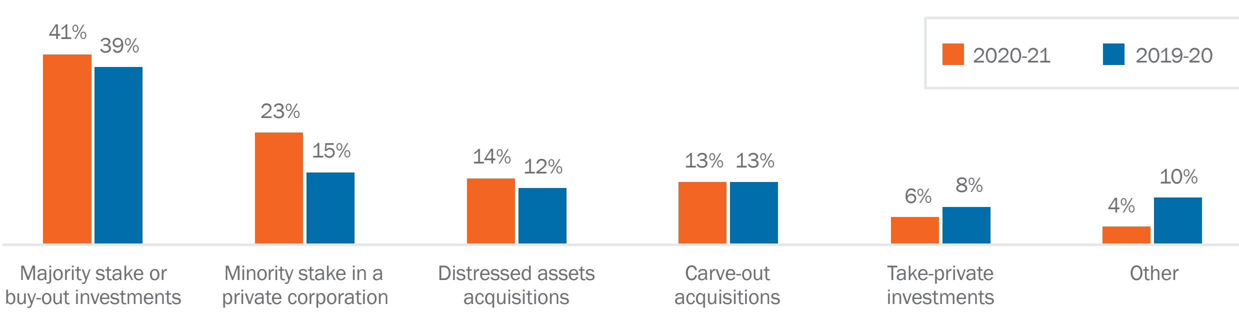


Figure 9

Q: What will be the source of the most attractive targets in 2021?



Sector outlook

Over the course of the pandemic crisis, businesses have been challenged to refocus their strategy for a new reality—one that vastly involves transformation driven by digital innovation and growth as a competitive strength (read more on **post-pandemic insights**). The expansion of online commerce, video and electronic communications technology and innovative healthcare research and applications are some recent examples of industries in transformation.

Given this current landscape, it is unsurprising that the majority of survey respondents predict that technology will present the best dealmaking opportunities in 2021 (Figure 10). While the pandemic has highlighted the significance of the sector, investors' interest in technology is not new: technology represented the top source of private equity M&A in the country in 2020.[1]

On balance, a majority (52%) of pension fund professionals see the most opportunities in technology, compared to over one in four (28%) private equity stakeholders (Figure 11).

Information technology (42%) and internet/ecommerce (37%) are expected to be the sub-sectors within technology that see the most M&A transactions with private equity involvement in 2020 (Figure 12).

Figure 10

Q: In what sector do you expect to see the most M&A activity with PE involvement in 2021?[2]

	Technology	Personal services	Industry & agriculture	Business services	Personal care	Entertainment	Don't know/ none	Other
2020-21	55%	42%	35%	34%	16%	16%	16%	10%
2019-20	53%	35%	24%	38%	10%	9%	16%	9%

[1] CapitalIQ. Based on M&A transactions involving a financial buyer or seller announced from Jan 1, 2020 - Dec 14, 2020.

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

Figure 11

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

	Technology	Personal services	Don't know/ none	Other	Industry & agriculture	Business services	Entertainment	Personal care
2020-21	34%	17%	16%	13%	13%	5%	3%	0%
2019-20	17%	15%	21%	25%	9%	10%	2%	1%

Figure 12

Q: In what industry sector do you expect to see the most merger and acquisition transactions with PE involvement in 2021?

	Technology	Information technology	Internet/ ecommerce	Electronics/ computer/software	Telecom (phone, cell phone, cable)
2020-21	55%	42%	37%	30%	16%
2019-20	53%	38%	36%	36%	17%

Beyond the continued focus on the technology sector, overall sectoral trends are mostly consistent with 2019-20, with notable increases observed for industry/ agriculture, entertainment, personal care and services. In each case, these shifts in sectors of focus can be partly attributed to changes in consumer behaviour driven by the ongoing pandemic.

For example, much of the increase in expected M&A activity within the industry/agriculture sector is being led by the pet food/care (16%) and automotive (10%) sub-sectors (Figure 13). The pet care industry is facing explosive growth, with many consumers turning to pet adoption in the last as they confronted a 'stay-at-home' reality. One notable 2020 transaction in the pet care sub-sector included, for example, Imperial Capital's sale of its majority stake in VetStrategy—Canada's leading and largest operator of veterinary clinics—to Berkshire Partners LLC for approximately US$1.08 billion.[3]

Consumers are also expected to favour private transport post-pandemic which is leading to renewed interest in the automotive industry—with more survey respondents (up 7% year-over-year) anticipating dealmaking in that sub-sector in the year ahead.

Figure 13

Q: In what industry sector do you expect to see the most merger and acquisition transactions with PE involvement in 2021?

	Industry/ agriculture	Food/ beverages	Industrials	Pet food/pet care	Energy
2020-21	35%	18%	17%	16%	15%
2019-20	24%	9%	17%	6%	11%

	Materials	Automotive	Agriculture	Paper products	Utilities	Toys
2020-21	11%	10%	7%	5%	4%	2%
2019-20	9%	3%	6%	0%	5%	1%

[3] Torys advised Imperial Capital.

Meanwhile, higher proportions of survey respondents expect to see more deal activity in the entertainment sector, with movie theatres/cinemas (9%) driving much of this increase (Figure 14).

Figure 14

Q: In what industry sector do you expect to see the most merger and acquisition transactions with PE involvement in 2021?

	Entertainment	Movie theatre/ cinema or chain	Other entertainment	Music	Sports
2020-21	16%	9%	5%	4%	3%
2019-20	9%	1%	3%	2%	5%

	Video games	Film studio	Publishing	Television	Radio
2020-21	3%	3%	1%	0%	0%
2019-20	4%	3%	2%	4%	1%

Within the personal services sector—the second-largest sector of interest to respondents this year—healthcare & pharmaceuticals (30%) and education (17%) are expected to be the sub-sectors with the most private equity M&A in 2021 (Figure 15).

Healthcare and pharmaceuticals saw a dramatic increase in dealmaking activity in light of the pandemic. For example, 84 IPOs took place in the North American biotech space alone in 2020, raising a total of US$15 billion—and $16.8 billion was raised by biotech-focused venture capital funds and $6.3-billion by biotech-focused SPACs (read more here).

Figure 15

Q: In what industry sector do you expect to see the most merger and acquisition transactions with PE involvement in 2021?

	Personal services	Healthcare/ pharmaceuticals	Education	Insurance	Travel/tourism
2020-21	42%	30%	17%	15%	15%
2019-20	35%	27%	9%	12%	4%

	Restaurants	Consumer staples	Real estate/ construction	Grocery/convenience/ dept. stores	Consumer discretionary	Government/politics
2020-21	12%	11%	9%	8%	7%	3%
2019-20	10%	15%	8%	6%	13%	3%

In their own words

Biggest challenges in 2021

"Continue with strategy and not get distracted."

"Valuation expectation of sellers."

"Managing volatility of returns and busy fundraising environment."

"Too many passive, large LPs flooding the market with 'soft' (i.e. too GP friendly) capital."

"Maintaining momentum in the PE firm (<3 years old)—team performance, fundraising, portfolio & business development —under COVID restrictions."

"Proper business development amidst travel restrictions."

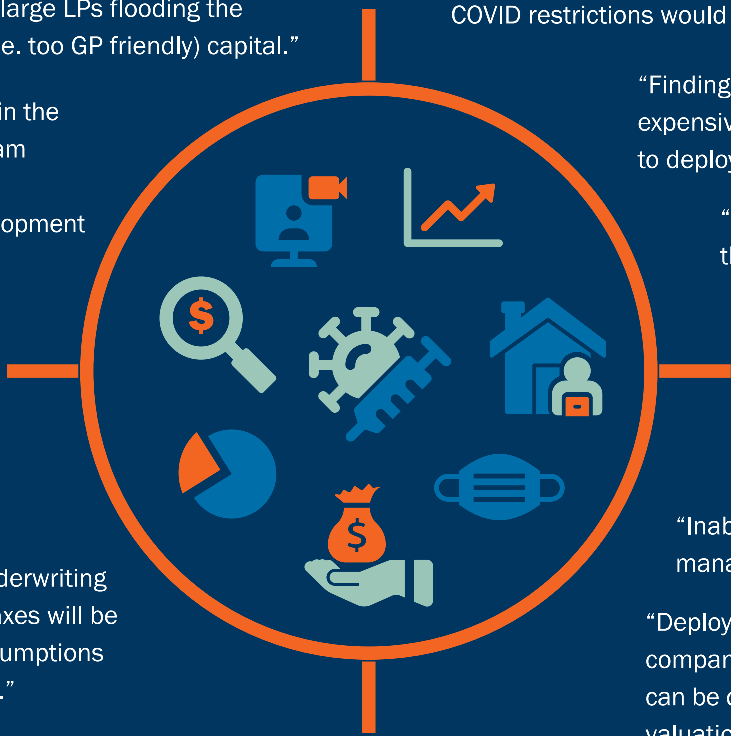
"Fundraising."

"Figuring out in our underwriting what the normalized taxes will be as well as inflation assumptions for the next 5-10 years."

"Investor fatigue and avoidance of the oil and gas sector."

"Deal sourcing/competition for transactions."

"COVID uncertainty."



"Investor/prospect engagement given market volatility/uncertainty, disruption in travel and traditional due diligence patterns and processes."

"COVID-19."

"Sourcing unique opportunities in a crowded market."

"Inability to take part in more traditional deal sourcing activities. If we continue to see the economy shut down, the sources transit out of Canada. Further COVID restrictions would be a challenge."

"Finding value in a relatively expensive market, and being able to deploy capital in spite of this."

"Seeing past the impact of the pandemic."

"Continuing to find compelling transactions at reasonable valuations—competition continues to increase for good assets."

"Inability to meet investors and management teams face to face."

"Deploying capital into companies where COVID risk can be quantified and managing valuation expectations of sellers going into a potential downturn."

"Fundraising as an emerging manager."

"Getting the right people in the right jobs."

Funds and secondaries

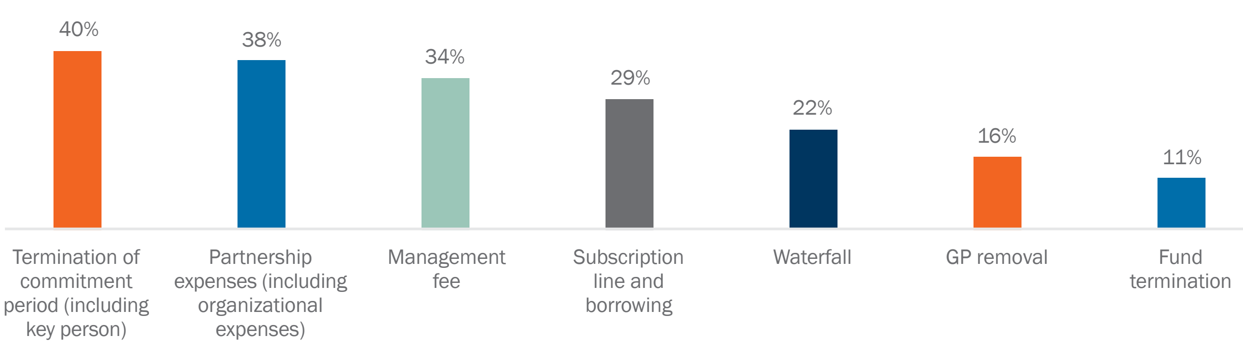
Private equity fundraising throughout 2020 remained strong, with many investors viewing the economic impact caused by the pandemic as a temporary shock and continuing to stay the course. In the last year private fund sponsors and investors have increased their focus on distressed and real estate investments, and certain secondary funds also saw a record high of fundraising activities.[4]

With increased liquidity concerns posed by the ongoing economic disruption, fund sponsors have been more active in seeking to modify certain terms during the fundraising process, such as increased flexibility with follow-on investments, recycling mechanics, and term duration, as well as opportunities to preserve more flexible investment strategies by relaxing investment restrictions.

Our survey found that specific terms of focus for respondents in respect of their fund investments in 2020 were partnership expenses (38%) and remedies with respect to the termination of commitment period (40%), followed closely by management fees (Figure 16). In this regard, one particular area of focus has been the treatment of write-offs and write-downs resulting from significant markdowns in portfolio company value for the purposes of calculating the management fee base after the expiration of the commitment period—and in particular, that these write-offs and write-downs reduce management fees.

Figure 16

Q: Which terms did you spend most of your time negotiating in connection with your fund investments in 2020? You can select up to three responses.



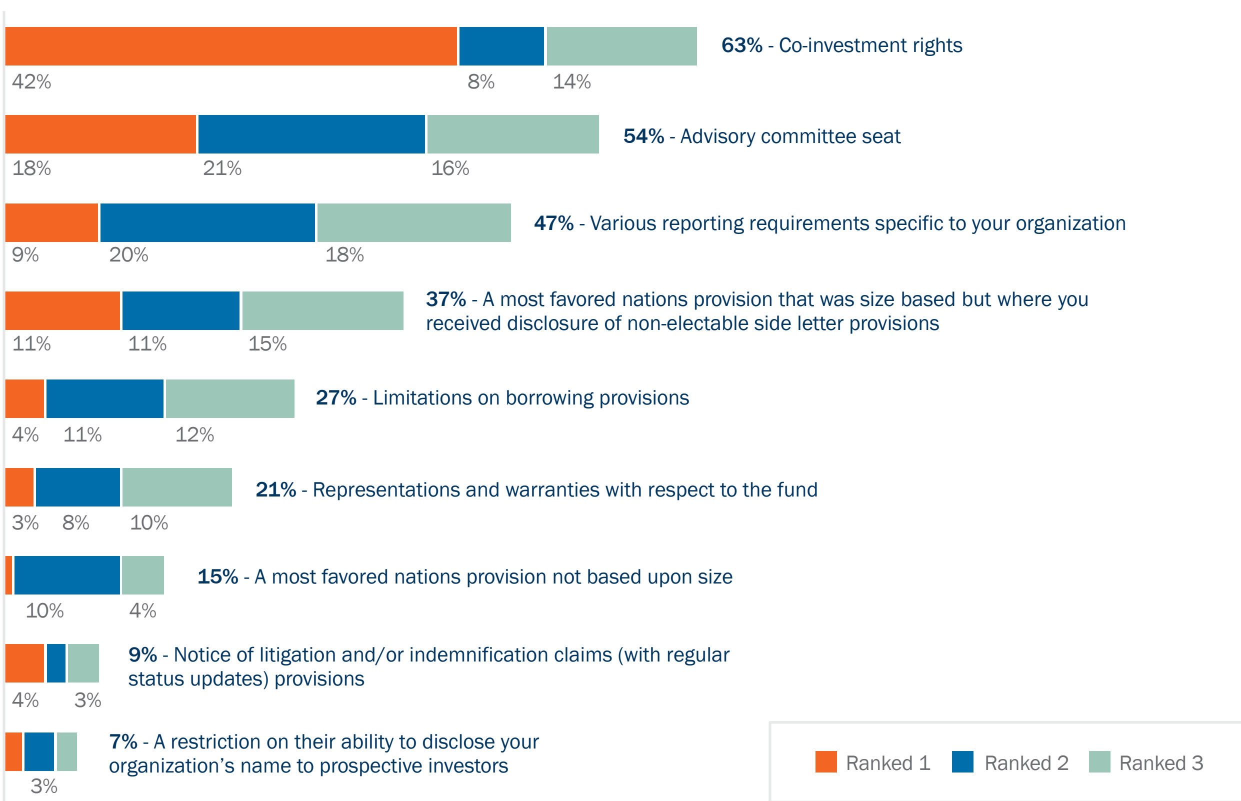
[4] Read more about our observations of COVID-19's impact on private fund sponsors and limited partners **here.**

The historically strong private equity market has helped fuel co-investment activity which continues to remain popular, as co-investors look to increase their private equity exposure on a reduced-fee basis and sponsors look to attract additional capital to access larger deals. Two-thirds (63%) of survey respondents rank co-investment rights as one of the top three most important side letter terms to their organization, including nearly half (42%) who rank it as being of the most importance to their organization (Figure 17) (read more on co-investment essentials **here**).

Securing an advisory committee seat (54%) and addressing organization-specific reporting requirements (47%) were equally significantly important to respondents—with pension fund professionals most likely to rank various report requirements specific to their organization as being most important (rank 1) (24% vs. 4% of private equity professionals).

Figure 17

Q: In connection with your fund investments in 2020, which of the following side letter terms were of the most importance to your organization? Please rank your top three.



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At the onset of the COVID-19 pandemic, the secondary market also witnessed a slowdown as many secondary deal processes were paused and LPs were hesitant to sell their interests in the secondary market. However, this was temporary, and throughout the course of 2020, secondary funds continued their robust fundraising efforts (read more **here**). In addition, GPs increasingly turned to bespoke structuring solutions to help them continue to manage portfolio companies that have yet to fully realize their investment objectives, while at the same time providing liquidity for both private equity fund sponsors and their limited partners, as an alternative to M&A exits.

GP-led fund restructurings—where all or part of a fund's assets are transferred to a new vehicle managed by the same GP—are among the types of secondary transactions becoming increasingly more common in the market. Nearly half (43%) of survey respondents report that their organization has considered or participated in a GP-led restructuring in 2020 (Figure 18). Valuation of the underlying assets represents an area for potential conflicts of interest as the GP is frequently on both sides of the transaction (we explore the key conflict of interest issues **here**).

In GP-led restructurings, a GP enters into an agreement with a secondary buyer to purchase all or a portion of the assets of the fund for an agreed price, often by setting up a new vehicle in which the secondary buyer becomes an LP along with other LPs from the GP's existing fund who choose to rollover their indirect interests in the target assets. This allows "new money" to purchase the interests of the LPs from the GP's existing fund to exit, while allowing the underlying assets to remain under the management/control of the GP for a longer duration of time. Among those who have considered or participated in a GP-led restructuring, a vast majority (88%) rank having an independent valuation of the underlying asset as one of the top three most effective actions that can be taken in managing the associated conflicts (Figure 18). It is interesting to note that private equity professionals are statistically more likely to cite review of the underlying purchase and sale agreement as one of the top three most effective actions that can be taken (59% vs. 25% of pension fund professionals).

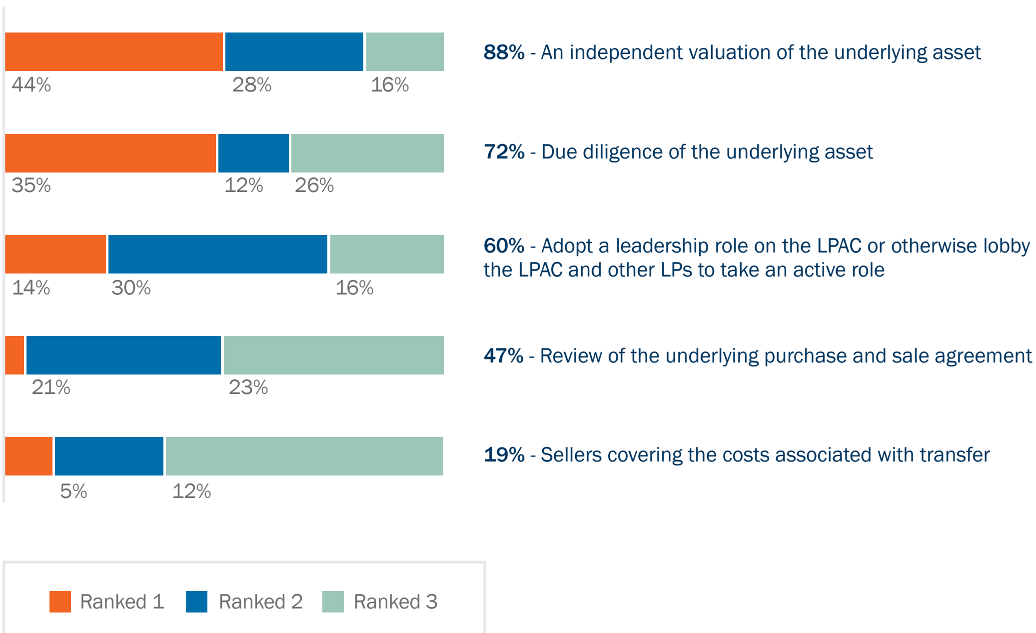
Figure 18

Q: Has your organization considered or otherwise participated in a GP-led restructuring where an asset is spun out of one fund and put into a new fund managed by the same manager (where new money provides an exit for existing investors that choose not to roll their interests into the new fund)?

If you have participated in a GP-led restructuring, rank the top three actions that you perceive to be the most effective in managing the associated conflicts.

43% have considered or participated in a GP-LED restructuring

Most effective actions



Data <3% not labelled

Summing it all up

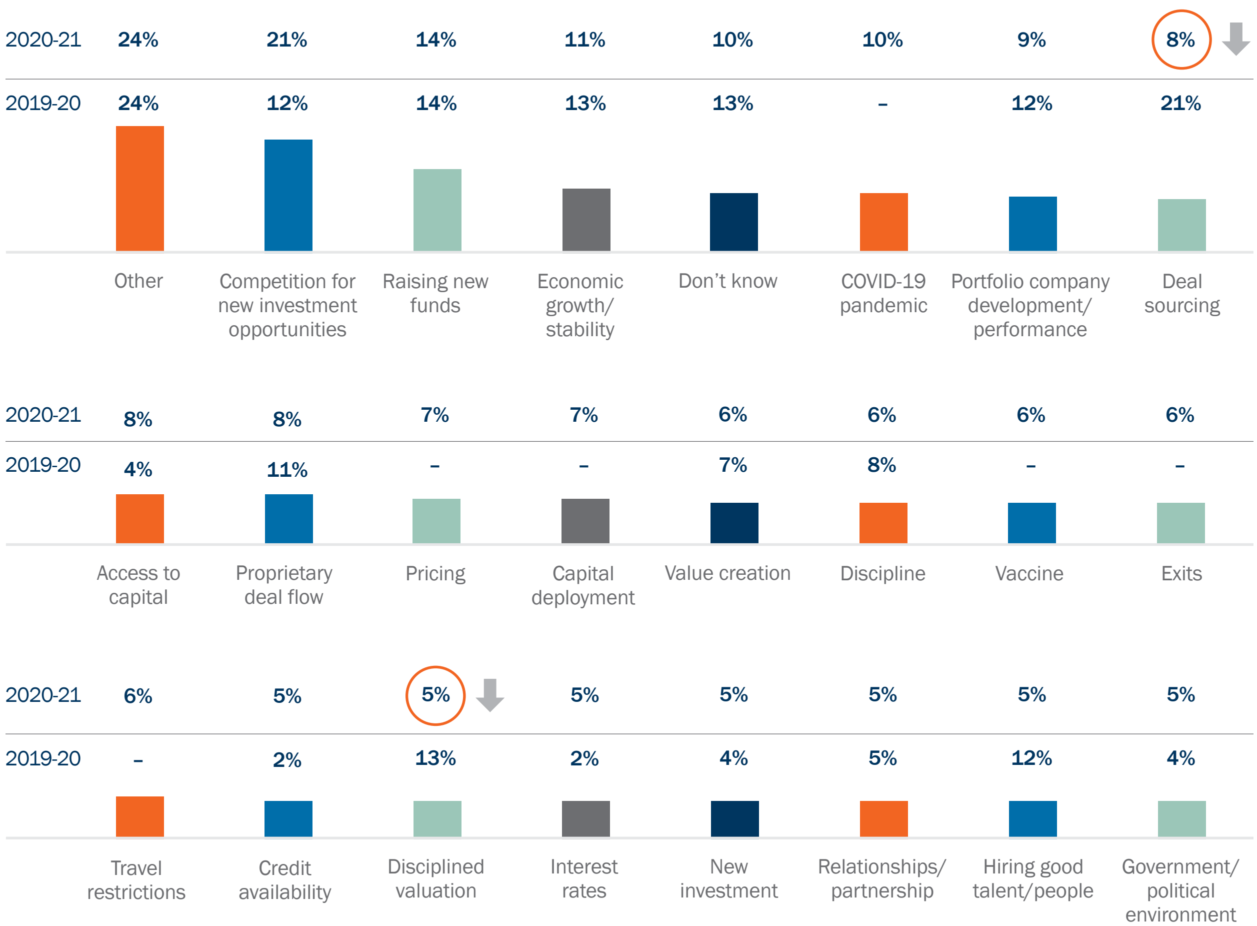
Critical success factors in 2021

When asked to describe factors that are critical to their success in the coming year, the highest proportion of respondents cited competition for new investment opportunities (21%). Fourteen percent mention raising new funds as being the second most important factor, while one in ten professionals ranked economic growth and stability as critical (Figure 19).

See page 18 for respondents' candid explanations of their responses to the question in Figure 19.

Figure 19

Q: What factors will be critical to your success in 2021? List up to three.



Data <3% not labelled

Challenges in the year ahead

Unsurprisingly, the highest proportion of professionals (21%) rank the COVID-19 pandemic as their biggest challenge in the year ahead (Figure 20). While the majority (52%) of professionals believe that COVID-19's impact on the overall transaction environment will improve in 2021, two in ten believe that circumstances will worsen (Figure 21).

Furthermore, four in ten survey respondents believe the 2020-21 vintage of portfolio investments has worsened as a result of COVID-19, while just 21% believe the pandemic has improved the vintage (Figure 22).

While ongoing competition for target assets remains top of mind for pension fund and private equity professionals, fewer believe that finding deals at attractive valuations will be problematic in 2021. At the same time, the overall fundraising sentiment has shifted year over year, with more respondents (12%) believing that slowdowns in the fundraising environment will pose the greatest challenges in 2021 (Figure 20).

Private equity stakeholders are statistically more likely to indicate that finding new deals at attractive valuations will pose the biggest challenge to them in 2021 (16% vs. 0% of pension fund stakeholders).

Figure 20

Q: What is the biggest challenge facing you in 2021? Note: Only responses of 5% or more are shown.

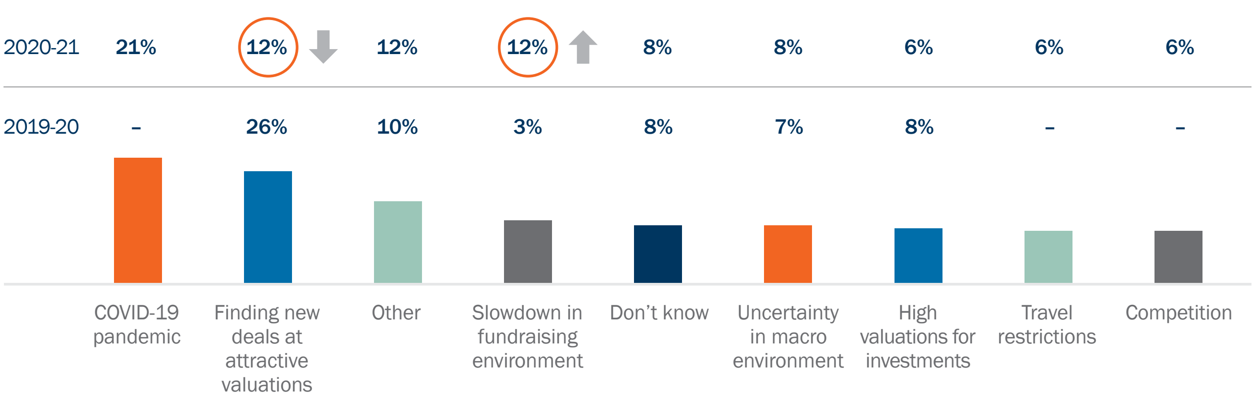


Figure 21

Q: How do you expect the overall transaction environment in 2021 to be impacted by the COVID-19 pandemic, relative to 2020?

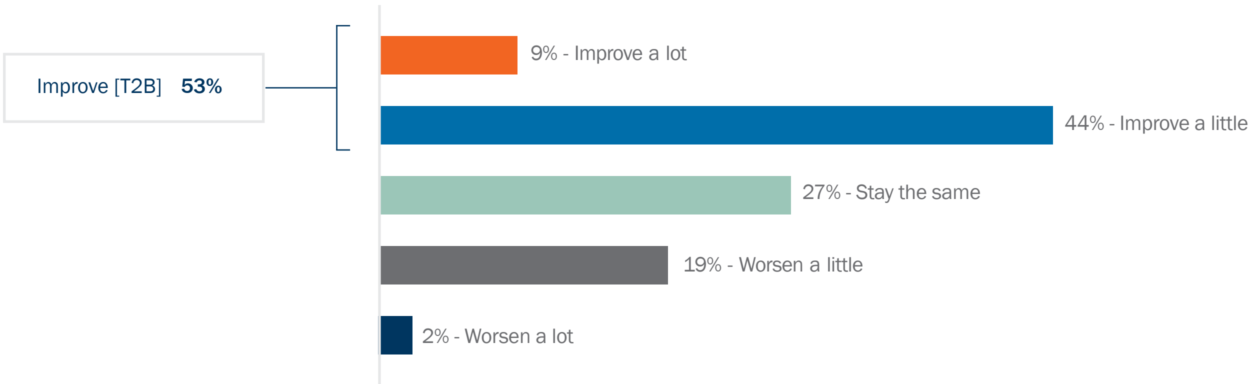
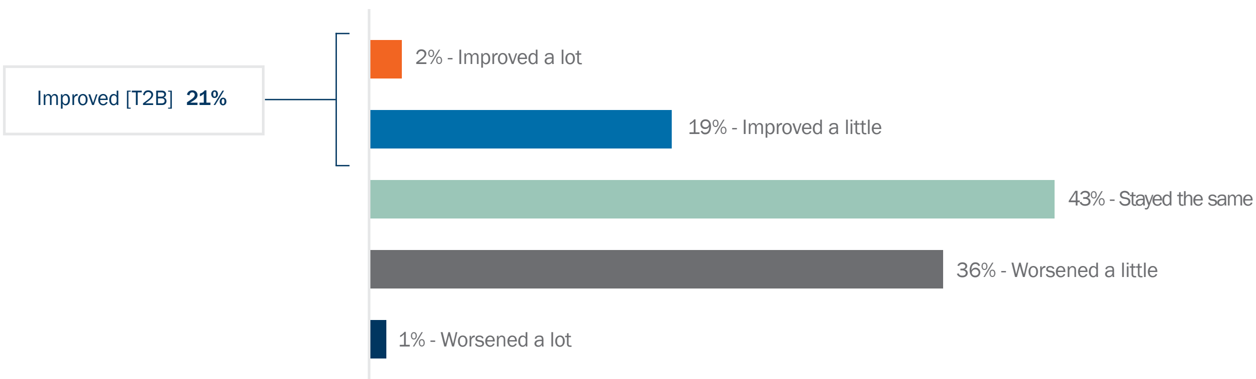


Figure 22

Q: How has the COVID-19 pandemic shaped your expectations regarding the 2020/21 vintage of portfolio investments?



Conclusion

While there is no question that 2021 is trending to be an active M&A environment for private equity, the overall sentiment in the sector appears to bear an optimism that must be viewed relative to the disruption of 2020. While many concerns were allayed as markets rebounded last year, there is an acknowledgement that the challenges of COVID-19 will continue to put pressure on transactional, operational, sector-specific and many other facets of the private equity industry in Canada. That said, creative deal sourcing and dealmaking are central pillars of Canadian private equity, and we expect to see those strengths in full force in the year ahead.

Torys' private equity group contacts

Michael Akkawi
makkawi@torys.com
416-865-8122

Jamie Becker
jbecker@torys.com
416-865-7634

Guy Berman
gberman@torys.com
416-865-8167

Laurie Duke
lduke@torys.com
416-865-7348

Jared Fontaine
jfontaine@torys.com
212-880-6128

Shannon Gotfrit
sgotfrit@torys.com
416-865-8127

Michael Horwitz
mhorwitz@torys.com
212-880-6296

Amy Johnson-Spina
aspina@torys.com
212-880-6154

Neville Jugnauth
njugnauth@torys.com
403-776-3757

Cameron Koziskie
ckoziskie@torys.com
416-865-7684

Guillaume Lavoie
glavoie@torys.com
514-868-5614

Jay Romagnoli
jromagnoli@torys.com
212-880-6034

Stefan Stauder
spstauder@torys.com
212-880-6161

Venera Ziegler
vziegler@torys.com
212-880-6169

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.

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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.