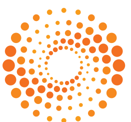
# PRIVATE EQUITY CANADA 2008

## The industry at an inflection point



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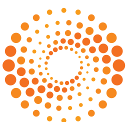

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# Foreword

2008 marked a turning point for the private equity industry. The credit crunch that initially sprang from a troubled US mortgage market mushroomed into a global financial and economic crisis. By November, countries around the world were in recession and global capital markets were in turmoil. The PE industry was hit hard across almost all dimensions, and LPs and GPs alike faced – and are continuing to face – tough challenges.

The economic crisis set several structural changes in motion that will continue to shape the PE landscape long after the world economy rebounds. Some believe that the industry has been irreparably damaged and will not survive. We disagree. The inherent advantages of the PE model – rigorous governance and value creation – are more important than ever, and PE stakeholders could take a number of actions that would help them survive in the short term – and thrive in the long term.

Given the unique macroeconomic environment, we have broken with the traditional format of this annual report in *Private Equity Canada 2008* so we can reflect more broadly on the state of the industry and share our perspectives on its outlook.

This report consists of two sections:

- Part 1 draws on McKinsey's extensive experience in serving PE market participants. It examines the industry in 2008, analyzes the cyclical and structural forces affecting it, provides a perspective on the short- and long-term implications for its players, and identifies actions they could take to outperform in these difficult times.

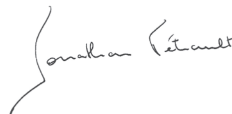
- Part 2, prepared by Thomson Reuters for McKinsey, provides an in-depth review of Canada's PE market over the past year. It describes key trends in the different PE segments and compares market growth rates, the creation of new partnerships, and domestic and global deal activity to prior years. It also includes the results of interviews with a number of Canada's leading PE professionals.

As in previous years, we have based our conclusions on McKinsey's proprietary research and the data Thomson Reuters collected and analyzed from its annual proprietary survey and supplemented with several related surveys and interviews. The 2008 survey is consistent with the 2007 one – and those of previous years

– permitting year-over-year comparisons. The more than 100 survey respondents represent all of the largest PE groups in Canada and 96 percent of the entire capital pool.

We would like to acknowledge the very important role Kirk Falconer of Thomson Reuters and Jessica Nowak of McKinsey's PE Practice played in helping us produce this report. We would also like to thank our McKinsey colleagues: Director Robert Palter and Business Analyst Karim Moolani, as well as Jennifer Iles, Tara Murphy, and Patrick White of McKinsey's Communication Team.

We hope you find *Private Equity Canada 2008* interesting, thought-provoking, and helpful.



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# PART 1:

## 2008: The industry at an inflection point

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# Executive summary

The financial turmoil of the past year has had a tremendous impact on the financial services industry, resulting in a significant reconfiguration of the landscape in the United States and abroad. The PE industry was hit particularly hard across almost all dimensions – fundraising, investments, exits, and returns. The scarcity of credit had a drastic impact on the funds' ability to complete transactions, and exit opportunities disappeared as a result of the challenging market conditions. In addition, many LPs struggled to fund their current commitments – and shied away from new ones.

This environment has been driving GPs to switch their focus from making deals to creating value and preserving the wealth of their portfolios. Moreover, the balance of power between LPs and GPs is shifting, requiring a significant change in the way PE firms do business.

Consequently, in this section of the report, we:

- Examine the state of the industry in 2008, in particular the environment for PE fundraising, investments, exits, and returns
- Analyze the cyclical forces that have been driving the industry's downturn and explore the structural forces that are likely to continue to reshape the industry long after the economy rights itself
- Provide a perspective on the short-term and longer-term implications of the financial crisis for industry participants and share our thoughts on the actions GPs could take to respond to these cyclical and structural changes. These actions include actively managing portfolio companies, developing new strategies to access attractive opportunities, and reinventing LP relationships to ensure a stronger alignment of interests.

Although the global economic crisis is severe, the majority of PE firms will survive in the short-to-medium term. However, the way in which they operate could change considerably.

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# Looking back

In 2008, the PE industry was hit hard across almost all dimensions – fundraising, investments, exits, and returns.

## Fundraising

In recent years, PE fundraising grew to record levels, led by the emergence of mega funds and the battle between the buyout heavyweights for the title of the largest fund ever raised. This trend toward size was also evident in Canada. Global fundraising reached US $1.1 trillion[2] for 2008 vintage year funds, an increase of 43 percent over 2007.[3] Digging into the details, however, quickly revealed that the financial turmoil in the global economy was taking its toll on the industry. By mid-2008, the fundraising environment had changed considerably.

Fundraising slowed as the denominator effect left many LPs overcommitted to the asset class or, given the declining rate of distributions, deciding to make fewer commitments to new funds. In 2006, for example, it took 11 months on average for a PE fund to close;[4] in 2008, it took an additional 4 months on average. As 2008 drew to a close, it was clear that this year had been one of the toughest fundraising environments industry players had ever encountered.

On the supply side, the uncertainty over the market's future made it increasingly difficult for GPs to find and/or close deals. In 2007, at least 13 PE funds worldwide were reported to have abandoned their fundraising efforts. In 2008, this number tripled, with 43 funds shelved because of the difficulties they faced in obtaining commitments. This highlighted the dramatic change in the view of the overall market's outlook. It also raised the question: were certain fund strategies no longer viable in a post-Lehman world?[5]

In all, US buyout vintage 2008 funds reached US $232 billion, up 20.3 percent from 2007. In Canada, fundraising experienced moderate growth, reaching $6.9 billion in 2008, up from $5.7 billion in 2007. Taking a closer look, we found:

- Buyout fundraising accounted for 74 percent of total funds raised, compared to 60 percent in 2007.

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2 All amounts are in Canadian dollars unless stated.
3 Preqin.
4 Preqin.
5 Preqin.

- Venture capital accounted for 15 percent versus 20 percent in 2007.
- Mezzanine accounted for 11 percent in 2008, a slight increase from its 10 percent in 2007.

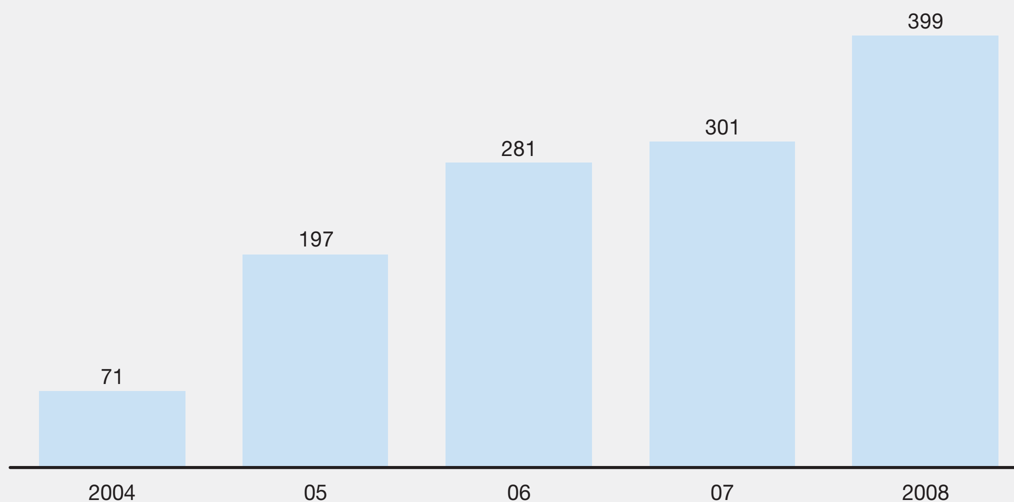
The LPs' liquidity problems (as evidenced partly by the Harvard University endowment's secondary sale) and the GPs' challenges in finding and closing deals also resulted in PE firms reducing fund sizes. Most notably, The Blackstone Group reduced its target for Blackstone Fund VI by US $6.5 billion. Other examples are Carlyle Global Financial Services Partners (reduced by US $4 billion), and CVC European Equity Partners V and Madison Dearborn Fund VI (both reduced by over US $2 billion).

Despite 2008 being a decidedly difficult year for fundraising, opportunities were still available. Some PE firms were able to raise capital in sub-asset classes expected to benefit from the downturn, such as distressed debt, mezzanine, and infrastructure. Oaktree Capital Management, for example, closed on a US $10.9 billion distressed fund, over US $3 billion more than was raised by the next largest distressed fund, led by Cerberus Capital. Also in the United States, Goldman Sachs raised a US $13 billion mezzanine fund. In Canada, Crown Capital Partners closed on a $250 million fund that will invest in domestic subordinated debt, among other things. And Goldman Sachs and Kohlberg Kravis Roberts led the push into

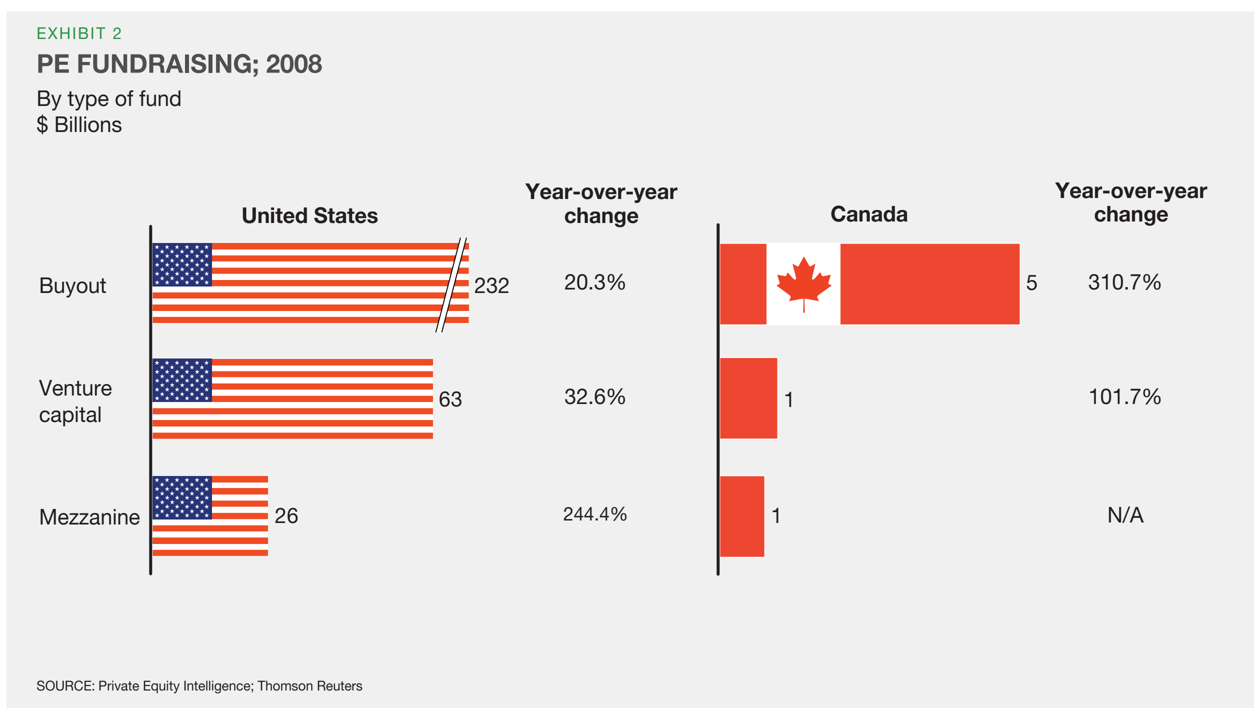
EXHIBIT 1

**Value of global buyout funds**

US $ Billions




SOURCE: Capital IQ




infrastructure, announcing fund targets of US $7.5 billion and US $4 billion, respectively.

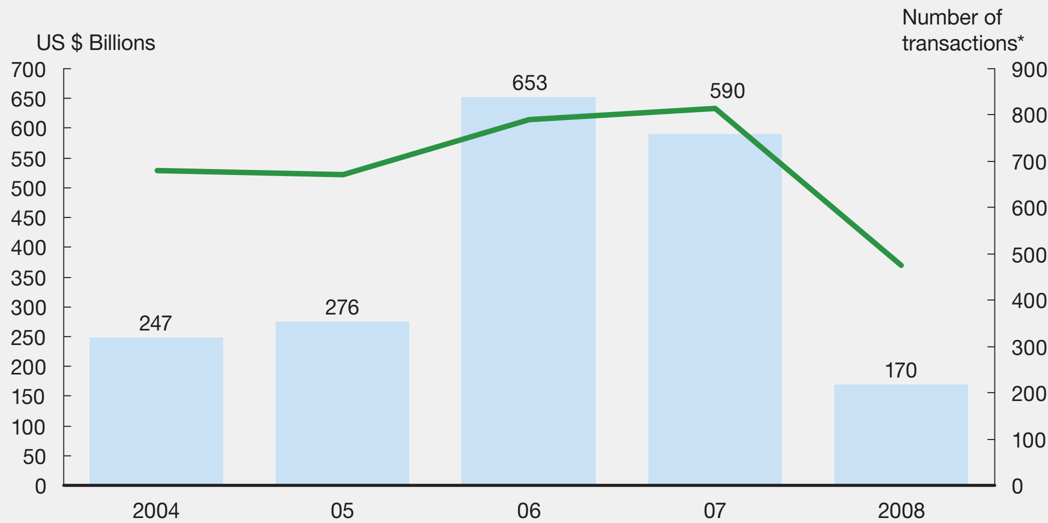
## Investments

PE deal volume sunk to a 5-year low in 2008. Global buyout activity dropped to US $170 billion in 2008, down 70 percent from 2007. There were 475 buyout acquisitions announced or closed in 2008, a year also punctuated by many buyout firms trying to extract themselves from deals that no longer made as much economic sense as they did in more favourable times. Apollo spent months embroiled in a battle to walk away from the US $6.5 billion buyout of Huntsman Corporation and the long-awaited $51.7 billion BCE acquisition fell through. In total, Canada fared slightly better than the rest of the world, with deal values falling “only” 45 percent over the same period.

From a sector perspective, 2008 saw an increase in the concentration of deals in the financial sector as PE firms sought to capitalize on the depressed multiples. Although the total deal volume was relatively small in 2008, more than 30 percent of the total deal value was attributable to the financial sector, an important portion of which was driven by a few large deals (for example, the OneWest deal accounted for 20 percent of the total 2008 deal volume). Investing in financial services is a relatively new phenomenon for the PE industry, which typically pursued investments in more tangible sectors that could support leverage.

EXHIBIT 3

## Global buyout acquisitions



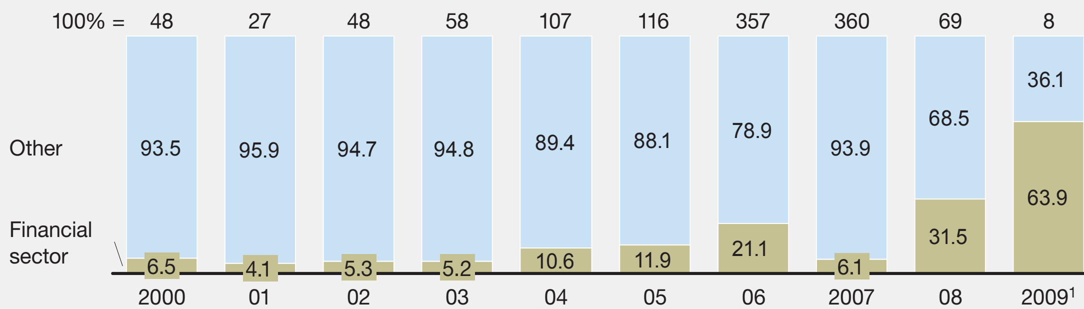

* Disclosed buyouts only

SOURCE: Capital IQ

EXHIBIT 4

## Financial services deals; 2008-2009

US deal value in US $ Billions, Percent




| | 2000 | 01 | 02 | 03 | 04 | 05 | 06 | 2007 | 08 | 2009[1] |
|---|---|---|---|---|---|---|---|---|---|---|
| **For comparison: Market cap of FIG companies** Percent of S&P | 11 | 13 | 14 | 14 | 13 | 16 | 17 | 23 | 11 | 11 |
| **Number of deals** | | | | | | | | | | |
| ▪ Total | 473 | 359 | 428 | 537 | 740 | 682 | 968 | 1,057 | 749 | 135 |
| ▪ Financial services[2] | 16 | 12 | 18 | 21 | 30 | 41 | 49 | 77 | 49 | 13 |

1 Through May 19, 2009
2 Including real estate management and development companies
SOURCE: Capital IQ

EXHIBIT 5

### Largest global buyout acquisitions; 2008

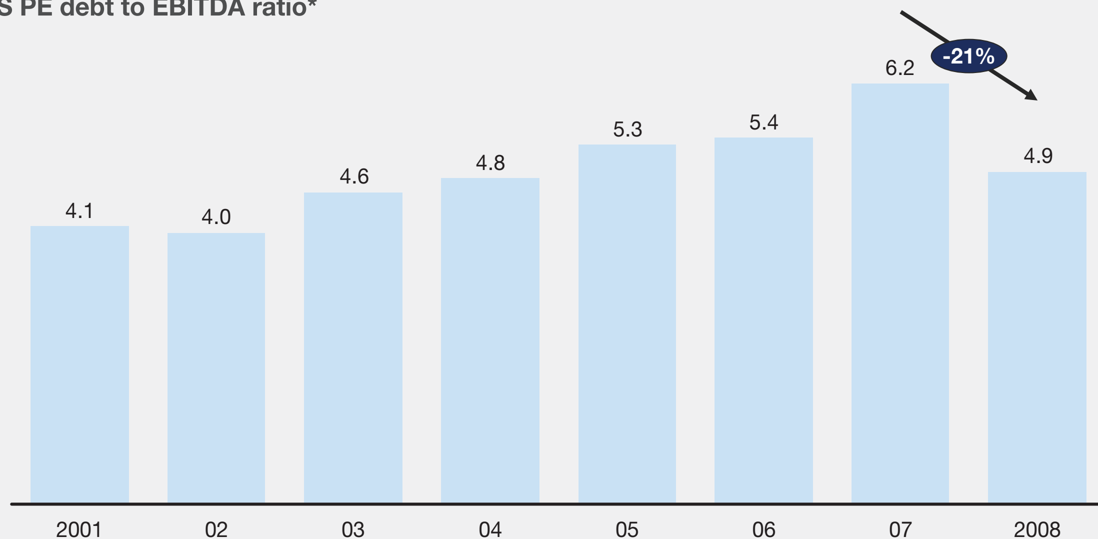
| Target | Date | Transaction size US $ Millions | Select investors | Industry |
|---|---|---|---|---|
| OneWest Bank Group LLC | Dec 31 | 13,900 | Silar Advisors; JC Flowers | Financials |
| Itinere Infraestructuras | Dec 1 | 10,369 | Citi Infrastructure Investors | Industrials |
| Asciano Group | Aug 4 | 7,033 | Global Infra. Partners; TPG | Industrials |
| CIT Group Inc., Home Lending | Jun 30 | 5,900 | Lone Star Funds | Financials |
| LEG | Jun 11 | 5,427 | Goldman Sachs | Financials |
| Northern Rock | Jan 11 | 4,412 | JPMP Capital | Financials |
| ConvaTec | May 2 | 4,100 | Avista Capital; Nordic Capital | Healthcare |
| Expro International Group | Apr 17 | 3,818 | Candover; Goldman Sachs | Energy |
| The Weather Channel | Jul 6 | 3,500 | Bain Capital; Blackstone | Consumer |
| Xella International | Jul 15 | 3,183 | Goldman Sachs Group; PAI | Materials |

SOURCE: Capital IQ

Leverage declined in 2008, primarily due to the financing challenges resulting from the frozen US credit markets.

EXHIBIT 6

### US PE debt to EBITDA ratio*

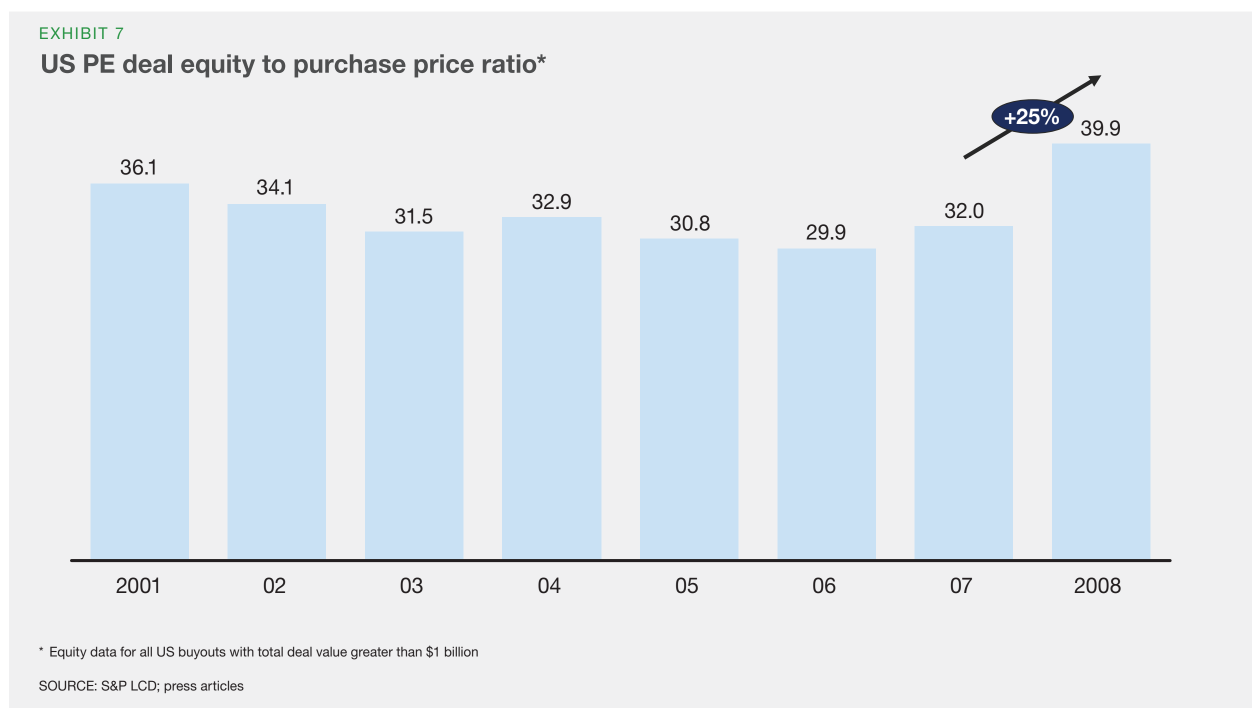



* Leverage data for US large corporate buyouts (issuer with EBITDA greater than $50 million)

SOURCE: S&P LCD; press articles

EXHIBIT 7

US PE deal equity to purchase price ratio*




* Equity data for all US buyouts with total deal value greater than $1 billion

SOURCE: S&P LCD; press articles

The picture was slightly brighter for private investments in public equity. PIPE were down only 2 percent compared to 2007 in dollar terms following a string of multi-billion dollar investments in the financial sector, such as Warburg Pincus's investment in MBIA, Carlyle's investment in Boston Private Financial, and TPG's investment in Washington Mutual.

This increase in activity was the result of the unprecedented funding requirements of large financial institutions, a scarcity of other sources of capital, and an absence of more traditional investment opportunities in the buyout market. Nonetheless, PIPE deal activity slowed considerably by mid-year as the broader market continued to deteriorate. In the second half of 2008, investments dropped 70 percent compared to those in the first half of the year.

## Exits and returns

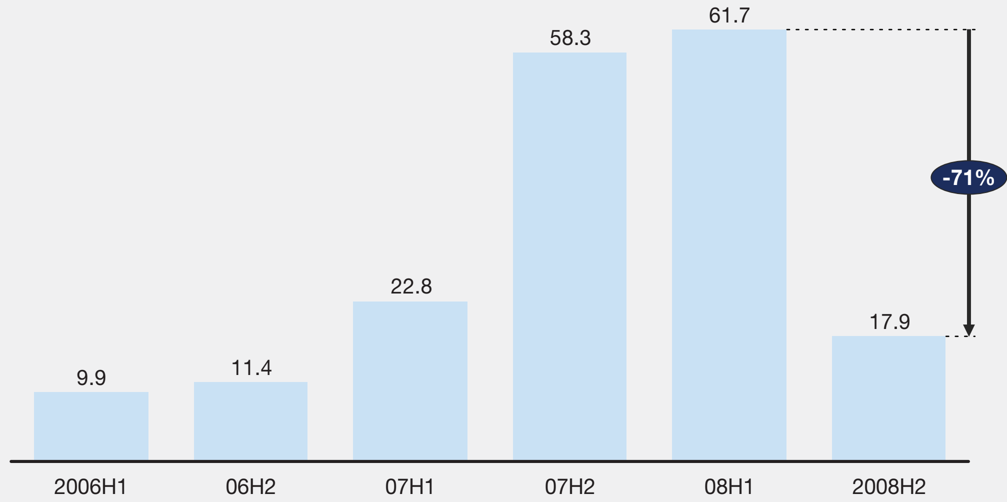
It was also a tough year for LBO firms seeking to exit investments. As the economic environment worsened, the IPO market dried up and trade sales became increasingly difficult as corporate buyers faced cash constraints.

Total annual distributions for all PE funds declined considerably, to US $4 billion in the third quarter, further contributing to LP cash constraints.

EXHIBIT 8

**Global PIPE investments**

US $ Billions

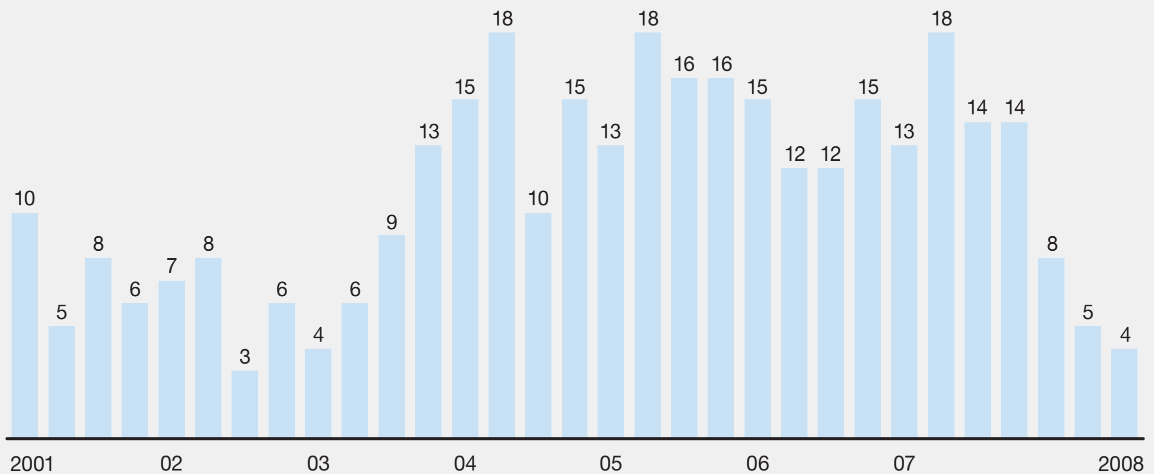



SOURCE: Capital IQ

EXHIBIT 9

**Quarterly global distributions**

US $ Billions



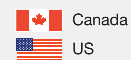

SOURCE: Venture Economics

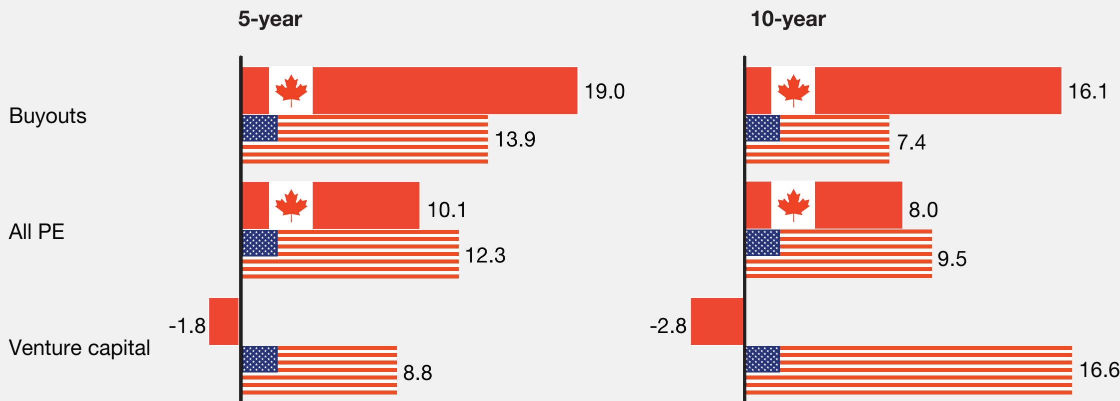
Canadian buyout firms continued to outperform their US counterparts, with 10-year returns reaching 16 percent as of year-end 2008 (the latest period for which data are available), compared to 7 percent returns for US-based funds through December 2008. Canadian venture capital returns, however, remained depressed, with 5-year returns dropping to -2 percent and 10-year returns to -3 percent, compared to US returns of 9 and 17 percent, respectively.

EXHIBIT 10

**Canadian buyouts outperforming US buyouts**

Net PE return comparison
Percent, December 2008




SOURCE: Thomson Reuters; National Venture Capital Association

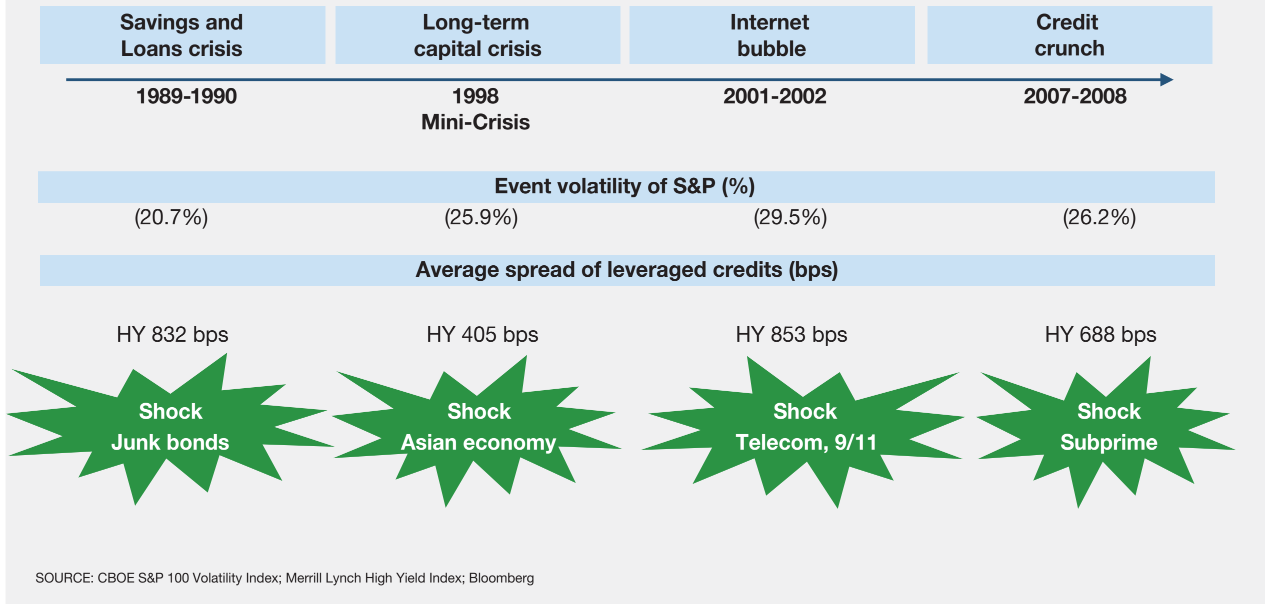
* * *

Although this crisis is severe, and indications suggest it will be prolonged, it is important to place it in context. The global economy has faced crises before and inevitably will face them again. In many ways, this one is strikingly similar to the others. S&P volatility and leveraged credit spreads, in particular, mirror those of past crises.

What are the implications of this crisis for the PE industry? And, more important, what should PE players do so they can adapt quickly to this new environment and position themselves for long-term success when the world economy rebounds?

EXHIBIT 11

## Benchmarking downturn against past cycles




SOURCE: CBOE S&P 100 Volatility Index; Merrill Lynch High Yield Index; Bloomberg

# Forces reshaping the industry

The 2008 economic crisis has impacted the PE industry and its players on many levels, and this challenging environment is not expected to materially improve in 2009. Various economic scenarios point to a weak economy that will inevitably affect existing portfolio companies and a weak credit market that will undoubtedly place continued pressure on new deal origination.

To gain a better understanding of the resulting implications for the industry and its participants, it is helpful to step back and examine not only the cyclical forces driving the downturn but also the structural forces that have been set in motion. We believe these structural changes will fundamentally alter the PE landscape – globally and in Canada – and will continue to have an impact on the industry long after the economy rights itself.

## Cyclical factors

In 2008, the credit crunch that initially sprang from a troubled US mortgage market mushroomed into a global financial and economic crisis. Credit markets froze or became severely constrained, while securities markets essentially shut down.

EXHIBIT 12

**Forces impacting the private equity industry**

**Cyclical forces**

- Denominator effect
- Reduction in distributions
- Significant dry powder
- Increased pressure on portfolio companies

**Industry implications**

- Depressed average returns
- Shift in LP asset allocations
- Deflating fund sizes
- Fewer mega deals
- Shifting talent markets

**Structural forces**

- Fundamental changes in LP behaviour
- Increasing weight of deep-pocketed sovereign wealth funds and other investors underallocated to PE
- Anticipated regulatory changes impacting LPs, banks, and credit markets

SOURCE: McKinsey analysis

In November 2008, the Organisation for Economic Co-operation and Development noted that its 30 members, including the world's major developed economies, were all in recession. Despite massive government efforts to stabilize the financial system, the crisis is still unfolding as the negative effects from the global recession result in further credit losses and instability in global capital markets.[6]

On the funding side, the scarcity of capital has become an ongoing concern as LPs struggle to fund commitments and often shy away from new commitments because of the market turmoil and the resulting denominator effect.

Compounding the pressure on LPs is the dramatic slowdown in the rate of distribution because of the poor market for exits. In the near term, these funding constraints are likely to remain a cause for concern.

The economic environment is also creating a dilemma for GPs, which have over $1 trillion[7] in committed but unspent capital. How to use this "dry powder" most effectively is the subject of much discussion.

Should GPs allocate some of this capital to trying to strengthen the performance of past investments? Or should they focus on allocating resources to drive performance and create value in newer investments? Certainly, many PE-backed companies facing capital and bottom-line challenges – not to mention severe liquidity issues – would welcome this capital. The problem, in many cases, is that this could result in throwing good money after bad. And, given the state of the credit markets, investing in new markets, asset classes, or deal sizes presents its own challenges.

Despite these challenges, we expect the majority of firms will survive in the short-to-medium term – although the way in which they operate will most likely change considerably.

The economic crisis will likely lead to significantly depressed returns on many vintage year 2006-2008 funds. Many LPs will probably undertake a comprehensive review of their asset allocation and some will also review their portfolio of GPs and may end up reducing the number of relationships they have, so they can focus their resources on the best performing funds and most promising relationships.

Buyout fund sizes will likely deflate, dropping from their US $1.2 billion average in 2008 to around the US $500 million to US $800 million range witnessed in the

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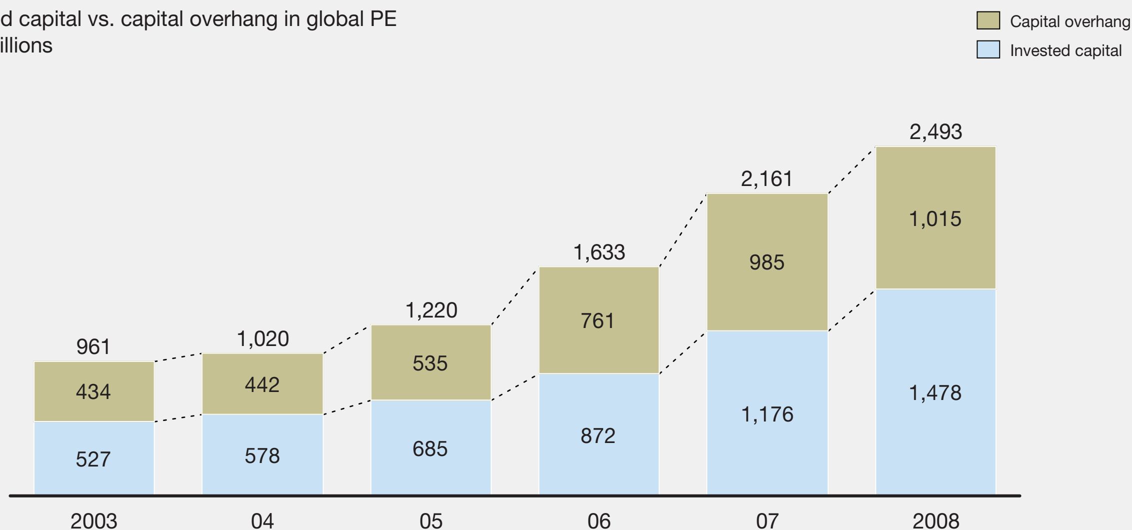
6 McKinsey & Company, *The Unfolding Financial Crisis and Economic Downturn: Managing Under Uncertainty*, by Lowell Bryan, Kevin Buehler, and Diana Farrell, November 2008.

7 Preqin; figure refers to all PE activity, not just buyouts.

EXHIBIT 13

**Global PE firms have significant capital available for investment**




SOURCE: Preqin

2000-2004 period. If recent mega deals perform poorly relative to quoted peers, it could take time for them to re-emerge.

However, the industry should benefit from being able to tap into a larger pool of newly available financial talent, hiring people with the skills, ability, and experience to improve performance and drive value creation in portfolio companies.

## Structural factors

While much of the market commentary has focused on the cyclical factors impacting the industry, we believe the economic downturn has also triggered a number of structural changes that will continue to shape the PE landscape long after the short-term cycle rebounds. These changes include:

- A fundamental shift in LP behaviour
- New entrants poised to commit capital to private equity
- Anticipated changes to industry regulation.

## Fundamental shift in LP behaviour

As recently as early 2007, the future of the PE industry looked bright. Many funds were producing remarkable returns and investors' interest in increasing their

expansion into the asset class was evidenced through a proliferation of mega funds that had little trouble attracting and deploying capital.

However, the credit crisis has given many LPs pause. As they have become more familiar with private equity – building in-house capabilities or co-investing alongside GPs – they no longer view it as an exotic asset class accessible only through externally managed PE funds. Instead, they now tend to view it as just another asset class – and one with the strong likelihood of depressed returns in the near term.

In addition, while most LPs have historically accepted a "2 and 20" fee structure when first quartile performers were delivering returns north of 20 percent, many are now questioning the economic equation underlying this structure. And they are increasingly seeking fee structures that ensure a better alignment of interests between the parties involved. However, the downward pressure on management fees may have a material negative impact on Canadian funds, and particularly on venture capital funds, which by nature are smaller than US or European buyout funds. The reduction of the management fee, often in the order of 25 to 75 basis points, may significantly limit the ability of these smaller funds to access the resources and infrastructure they would need to adequately deploy their capital. The industry will likely recognize the long-term impact of this dynamic on Canadian players and slowly adjust.

### New entrants poised to commit capital

Despite the significant pressures LPs are facing, several potential new entrants are poised to provide a valuable injection of new capital to PE funds in the near term.

As sovereign wealth fund (SWF) liquidities shrunk in 2008 following falling oil prices and slower trade activities, many industry observers began to discount the relative importance of SWFs in the long term. We expect, however, that SWFs will remain core to the LP base due to a continued growth of assets over the next few years. By 2013, the McKinsey Global Institute estimates SWFs will have an additional US $1.1 trillion to US $2.6 trillion in assets. Assuming a 5 percent average allocation to private equity, this could represent a US $50 billion to US $130 billion inflow of capital to PE funds by 2013, in addition to the money in motion opportunity resulting from the asset turnover on the existing allocations.

Some LPs, many of which are still in the early phases of their allocation programs and below asset class targets, are expected to increase commitments to PE funds in 2009. In Europe, for instance, the National Pensions Reserve Fund of Ireland is currently 5 points below its 8 percent target PE allocation. Similarly, in Asia, the US

$110 billion Pension Fund Association of Japan recently hired consultant Hamilton Lane to expand its PE portfolio in the near term.

Several Canadian pension funds are also expected to make new capital commitments in 2009.[8] The British Columbia Investment Management Corporation and Ontario Municipal Employees Retirement System both have significant room to increase their allocations to private equity from 5.4 and 8.5 percent, respectively, to achieve their 10 percent targets. Meanwhile, the Alberta Investment Management Corporation, established in 2008, has been making moves to increase its exposure to the asset class by building internal teams. Currently, the pension fund's allocation to private equity is 3.5 percent compared to the 5.3 percent target, giving it room to grow too.

## Anticipated regulatory changes

The PE industry will certainly face tighter regulations in the years ahead, given the ongoing debate about how best to regulate the systemic risk of financial institutions.

The European Commission is the most eager, having already issued proposals that would regulate the industry to the same extent as banks. In April 2009, the Commission proposed disclosure requirements for PE firms managing more than €100 million in assets or managing more than €500 million if they are not leveraged and have a 5-year lockup period for investors. These firms would have to seek authorization and meet reporting, governance, and risk management standards, including minimum capital requirements.[9]

And the United States Treasury Secretary Timothy Geithner's *Resolution Authority for Systemically Significant Financial Companies Act of 2009,* released in March 2009, recommended that PE and VC funds with assets under management over "a certain threshold" be required to register with the SEC (Securities and Exchange Commission), and thereby be held subject to investor and counterparty disclosure requirements as well as regulatory reporting requirements.

Meanwhile, the International Monetary Fund proposes a "two-tiered approach with an outer and an inner perimeter." All financial institutions within the "outer perimeter would have disclosure obligations to allow the authorities to determine the potential of the institution and its activities to contribute to systemic risk. Those institutions (including both banks and non-banks) within the wider groups that

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8 Company websites.

9 "Picture still murky for PE regulation," *Private Equity Analyst,* April 9, 2009, and "EU rules on hedge funds unlikely to end debate," *Financial Times,* April 30, 2009.

are recognized as being of systemic importance…would be the inner perimeter and subject to higher levels of prudential oversight."[10]

In addition to increased oversight, PE firms are also wrestling with likely changes to how carried interest is taxed. President Barack Obama's proposed Federal budget states that carried interest will be taxed as income, not as capital gains. The tax, which would not be implemented until 2011, combined with slightly higher income tax rates, would mean that the new carried interest tax rate would increase from 15 to 39.6 percent for most firms.

* * *

We do not expect the impact of the cyclical and structural forces to be fleeting. Rather, we anticipate these forces will continue to have a significant impact in both the short and the long term. PE industry players will need to adapt if they are to survive – and thrive.

10 International Monetary Fund, *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management,* February 4, 2009.

# Surviving and thriving in a challenging environment

The rapidly changing PE landscape has important implications for the industry's players. GPs could take a number of steps that could help them ride out the current turmoil – and improve their ability to succeed in the long term. These actions include:

- Actively managing the portfolio
- Rapidly developing new strategies to access attractive opportunities
- Reinventing LP relationships.

## Actively managing the portfolio

Although private equity has received its share of negative publicity of late, the industry remains an effective and powerful ownership model that can add value to portfolio companies, investors, and the broader economy. In particular, we believe the unique PE ownership model – where PE firms apply strong operating discipline and relentlessly focus on value creation – can be highly successful in this economic environment.

However, GPs would need to quickly shift their focus from making deals to creating and preserving the value of their portfolios. As Henry Kravis recently mentioned at the SuperReturn Conference in Berlin, "It's portfolio, portfolio, portfolio…Nothing is more important than managing that portfolio."

Successfully managing the portfolio in this environment would require GPs to systematically apply five principles of active ownership. These principles, based on research conducted by McKinsey in collaboration with the London Business School,[11] can be tailored to manage the specific needs of distressed – or potentially distressed – companies.

- **Simulate the due diligence process to refresh company and market insights.** Top-performing GPs drive this exercise by leveraging internal resources, conducting significant research, and mining sources such as Board

11 London Business School and McKinsey & Company, *Private equity versus PLC Boards: A comparison of practices and effectiveness*, June 2008.

members, management, and trusted outside resources to acquire valuable insights. One novel approach some firms are taking is to simulate the sale of a portfolio company to another deal team within the GP and have that team conduct a rigorous due diligence on the company. This approach generates fresh thinking on the company's market and financial position and frequently yields powerful value creation ideas.

- **Use focused performance incentives and require management investment.** In the best-performing investments, incentives are typically focused on key managers to ensure their alignment with the fund's goals. In addition, a meaningful financial commitment from senior managers is crucial. Today, fully aligning the interests of the company, its managers, and the fund is more critical than ever. To achieve this, GPs would need to adjust their managers' incentives to ensure managers focus their efforts on creating sustainable value rather than on pure revenue or market share growth.

- **Develop a value creation plan.** This plan, as well as the intensity with which the GP executes it, differentiates top performers from the rest. Typically, the process includes overhauling the management plan, with a specific focus on the company's key value drivers, and leveraging the help of independent experts where necessary. The plan should also establish continuous interaction between deal partners and the management team and ensure the organization is ready for change.

  Furthermore, it is critical that GPs develop these plans with a "through cycle mindset" – i.e., combining short-term actions to solidify the balance sheet with longer-term strategic decisions to improve competitive positioning – and take a more hands-on approach to continue to increase the fundamental value of their existing portfolio companies.

  Indeed, history has taught us that recessions lead to a significant reshuffling of industry rankings – for example, only 60 percent of leading US industrial companies remained in the top quartile[12] following the 2000-2001 recession. McKinsey's research suggests that companies with a through-cycle mindset will weather the downturn and be positioned to prosper when the market recovers. They not only aggressively pursue quick wins that free up cash, but they also allocate some of that newly found cash to opportunities that would contribute to their longer-term success, investing in new products and expanding into promising markets.[13] In contrast, industry laggards tend to overlay their

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12 In terms of return on invested capital (ROIC) and market-to-book ratio.
13 McKinsey & Company, *Accelerating Profit and Performance Through the Cycle*, January 2009.

pre-crisis plans with reflexive and often indiscriminate cost-reduction efforts, which leave them vulnerable to short-term pressures.

- **Significantly involve senior deal partners.** In the best-performing deals, partners typically spend over 50 percent of their time within the first 100 days focusing on the company, meeting almost daily with C-suite executives, creating and refining strategic plans, challenging management's assumptions to ensure successful implementation, and evaluating overall management capabilities. In today's climate, partners would probably need to sustain this time commitment well beyond 100 days, primarily to review and refine the company's value creation plan.

- **Proactively strengthen management teams.** Top GPs invest significant time in strengthening the management team and identifying additional replacements. Many GPs leverage specialized firms that provide insights on the portfolio company's senior executives and recommend actions to close capability gaps. Given the wealth of talent newly available in the market, GPs have a unique opportunity to further strengthen the management teams of their most promising portfolio companies.

To support this renewed emphasis on active ownership, GPs would probably need to adapt their organizational structure. For example, will they rely primarily on external resources to develop the value creation plans and support the portfolio companies during the implementation phase? Or will they build internal value creation teams?

In addition, as partners are required to invest more time in each portfolio company to drive performance, organizations could become top heavy. Accordingly, GPs would need to alter compensation structures to reflect the renewed emphasis on improving the portfolios' value, more closely tying operational or industry talent compensation to the performance of the underlying assets.

## Rapidly developing new strategies to access attractive opportunities

PE firms have over $1 trillion of dry powder.[14] Some may opt to return capital to investors when faced with a dearth of investment opportunities. Others have already begun expanding into new markets, targets, and asset classes. Given the economic environment and fast-changing demand from LPs, we believe GPs should start exploring potential investment opportunities outside their traditional realm and building the requisite capabilities to do so successfully.

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14 Preqin.

## New markets

Over the past few years, many North American PE firms have been making significant inroads into emerging market investing. This trend is expected to continue.[15] "There has been no sign of private equity investors in emerging markets running for the hills…This increased investor confidence stems not only from the prospect of stronger growth in emerging economies, but also from the increasing maturity of the sector," said Erwin Roex, a partner at Coller Capital.

In fact, in a survey conducted by Coller Capital and the Emerging Markets Private Equity Association, 62 percent of respondents stated that they plan to maintain or increase commitments to emerging markets in 2009, with China, Brazil, and India ranking as the most attractive. A spate of new fundraising – including The Carlyle Group's recent $500 million MENA fund that is expected to invest in growth companies in the Middle East and North Africa – appears to confirm this trend.

Given this influx of capital, successful GPs will need to differentiate themselves. This would involve adapting their investment models to the local environment by learning to cope with more limited transparency, creating a presence by expanding their local networks and opening offices, and being able to compete in increasingly auction-based markets. In addition, firms would need to significantly strengthen their internal risk management practices to manage these new and unfamiliar risks.

## New types of investments and targets

Although market conditions have been challenging for GPs since the crisis began, attractive opportunities still exist and some firms have started to complete new types of investments. For example, Madison Dearborn Partners recently signalled its commitment to concentrate solely on structured equity transactions, such as PIPEs and minority investments, as long as buyout financing remains difficult.[16] Similarly, Michael Wand, managing director of The Carlyle Group, has stated that his firm would consider strategic investments in publicly quoted companies in return for Board representation.

As GPs turn to new types of investments, they would need to weigh their competitive advantages and ability to add value. To succeed in PIPE or minority stake investing, they would have to carefully negotiate the conditions to ensure they have significant influence over the investments and preserve their governance benefits. This could include securing Board representation, significant discounts to the market share price, or elements of downside protection, like price premium provisions.

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15 "LPs Steadfast on Emerging Markets, Survey Shows," *Private Equity Analyst,* April 9, 2009.
16 "Madison Dearborn Turns to Structured Equity Investments," *Buyouts*, March 2, 2009.

An opportunity also exists for GPs to expand their traditional investment activities to take advantage of cycle-specific opportunities across different sectors' value chains. For example, many firms are now exploring investment opportunities with technology firms that provide advisory services, whereas they used to focus primarily on higher-growth and/or higher-margin product developers and manufacturers.

## New asset classes

Numerous opportunities exist for GPs to invest in secondary markets, distressed assets, or even TARP[17] assets – in which CalPERS, for example, recently signalled interest.[18] In fact, many firms have already begun preparing to enter asset classes that would benefit from the market downturn. Goldman Sachs, Lone Star, and Apollo all recently raised funds to invest in troubled assets or credit-oriented investments, while Goldman Sachs, The Blackstone Group, Apollo, and The Carlyle Group recently closed substantial mezzanine funds. Infrastructure is another asset class receiving attention from PE players with significant dry powder.

Many GPs are also working with LPs to renegotiate investment policies that would grant them more flexibility in shifting assets from traditional buyout funds to emerging investment opportunities. Goldman Sachs recently asked investors in its US $20 billion fund for approval to shift US $4.5 billion of its remaining US $9 billion uninvested capital into stressed and distressed opportunities, while Altor Equity Partners secured an unusually long 15-year lifespan for its latest US $3 billion fund.

To successfully invest in some of these opportunities, many GPs would need to acquire new capabilities and resources. Many are recruiting newly available top talent so they can build these capabilities internally. Others are forming joint ventures. UBS, for example, recently entered into a joint venture with Ashmore Investment Management to buy distressed emerging market assets. To compete in infrastructure, GPs are developing relationships with operators and building their capabilities to manage complex public-private partnerships (PPPs). Regardless of their approach, firms should not underestimate the investments and management attention required to successfully launch these new activities.

When pursuing these new markets, targets, and asset classes, GPs should keep fine-tuning their due diligence process to adjust to the evolving market environment. For example, sophisticated GPs would likely take a more robust approach to stress testing the impact of macroeconomic factors on target companies and on the overall sector in which they operate. They would also develop and apply a coherent analysis to assess potential valuations under different exit scenarios.

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17 The Troubled Asset Relief Program developed by the US government.
18 "CalPERS eyes Citigroup TARP assets," *Reuters,* April 15, 2009.

## Reinventing LP relationships

The balance of power between LPs and GPs is shifting. Jim Leech, president and CEO of Ontario Teachers' Pension Plan, recently noted, "We are using our negotiating power to get better fees, particularly around performance and how the manager is going to be compensated."

Whether "2 and 20" is gone forever is debatable – what is not is the fact that the important dynamics between LPs and GPs are changing and that those GPs that adapt quickly will have an advantage.

Some well-known GPs have already taken steps to alter fund terms in meaningful ways.

- TPG has cut management fees by one-tenth, committed to seeking advisory committee approval before calling more than 30 percent of an investor's total commitment, and allowed LPs to reduce pledges by 10 percent.
- Madison Dearborn has deferred management fees on its latest fund.
- Permira allowed LPs to reduce their exposure to its latest fund if they were concerned about their ability to honour commitments.
- Fortissimo Capital agreed to a request from its LPs to lower management fees between 5 and 15 percent.
- Bain Capital has proposed temporarily waiving quarterly management fees for all its active PE funds, making the capital saved available for follow-on investments in its existing portfolio companies and, ultimately, paying fees back out of the fund's gross profits.

To retain current LPs and attract new ones GPs would need to: 1) review terms and conditions; 2) target new types of LPs; and 3) provide more segmented customer service to better serve LPs' different needs.

## Review terms and conditions

The recent upheaval in the PE market is likely to lead to longer-term changes in the terms and conditions governing relationships between LPs and GPs to ensure a stronger alignment of interests.

- **Fund size.** LPs are taking a hard look at fund sizes to ensure they are aligned with existing market opportunities and relevant GP skills. We expect to see smaller funds with narrower, more focused mandates. LPs are also examining

whether their commitments carry enough weight to warrant more privileged relationships.

- **GP commitments.** LPs are encouraging and, in some cases, mandating GPs to make more sizable commitments to funds to better align interests. Over time, they may also push GPs to disclose each principal's individual investment and whether the investment was made in cash, promissory notes, or through management fee offsets.

- **Management fees.** LPs are clearly pressuring GPs on management fee levels and structures. With many firms now managing four times more capital than they used to, a recent Cambridge Associates report[19] stated that "It would require very compelling evidence to show that the firm's expenses have grown to justify a four-fold increase in management fees." Some possible changes include reducing management fees, scaling fees down at the end of the investment period, and tying fees to a budget to more closely align them with their original purpose.

- **Deployment caps.** LPs are now wary of GPs injecting too much capital at one time and are capping the amount GPs can deploy in a given period.

- **Carried interest.** To limit the need for clawbacks, some LPs are increasingly arguing that GPs should return all capital before allowing carry distributions. LPs are also likely to exert pressure on GPs to increase the disclosure of carried interest and how it is divided among firm managers.

GPs would also need to consider more creative fund models that help align interests more closely, such as:

- Semi-captive fund partnerships, where the lead investor does not control the fund, which would allow the investor to achieve more favourable economic terms by acquiring an equity stake in the PE firm, thereby indirectly reducing the carried interest, as it will now be paid over time.[20]

- Pledge funds, which may assuage LPs' jitters about the level of risk GPs are assuming by allowing the LPs to choose the deals in which they participate. Former Bear Stearns mergers and acquisitions chief, Louis Friedman, recently launched such a fund – Flexis Capital.

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19 Cambridge Associates, *Restoring Balance to GP/LP Relationships*, February 2009.
20 Law Journal Press, *Private Equity Funds: Business Structure and Operations* by James M. Schell.

### Target new types of LPs

The crisis has had a devastating impact on many LPs around the world, creating vulnerabilities in the investor base of many GPs. As a result, some GPs are searching for untapped opportunities in new LP segments, such as sovereign wealth funds or smaller pensions and endowments. For example, Norway's US $326 billion[21] sovereign wealth fund is considering shifting to more active alternative investing in private equity, and the US $65 billion Libyan Investment Authority is contemplating investments in US and European distressed banking and real estate.

Other opportunities include smaller US state, county, municipal, and corporate plan sponsors that have only recently been granted permission to invest in private equity or that did not previously have the resources to invest in the asset class. For example, the US $31.6 billion[22] Tennessee Consolidated Retirement System received permission to commit to private equity in June 2008. The Maine Public Employees Retirement System is also expected to begin investing in buyouts, venture capital, distressed debt, and mezzanine funds.

### Provide more segmented customer service

Our discussions with LPs highlighted a need for GPs to shift from a one-size-fits-all investor relations mindset to a customer-service mindset, offering products and services tailored to investors' specific needs and sophistication.

At one end of the spectrum, more sophisticated LPs are demanding specialized services that add more value. For example, these players are interested in the next generation of risk reporting, which would provide insights into unseen exposures and mitigating actions. Another example is the growing interest in accessing funds that target very specific investment themes across regions and the different parts of the value chain of a given sector (e.g., agricultural transformation and distribution in South East Asia).

At the other end of the spectrum, some less sophisticated LPs are seeking ways to access or increase their exposure to private equity and, as a result, will be interested in specific services, such as advice on investment program and process design and overall portfolio construction.

Given LPs' varying levels of sophistication and their fast-changing needs, GPs will probably have little choice but to develop more tailored approaches to serve them. GPs that move quickly to segment and understand their LPs' needs will be best positioned to differentiate themselves and capitalize on this opportunity.

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21 Sovereign Wealth Fund Institute.
22 As of June 30, 2008.

# Looking forward

Implementing these changes will not be easy. They represent important shifts in the way PE firms do business and require material changes to both strategy and organization. GPs that successfully make this transition would:

- **Actively manage their portfolios**, applying strong operating discipline and focusing relentlessly on value creation. These firms would create an explicit value creation strategy for each of their key portfolio companies and would have access to the deep industry and functional expertise necessary for execution. Some firms would build strong internal value creation teams and staff those teams with proven industry operators. Others would construct a network of partnerships to source these capabilities externally.

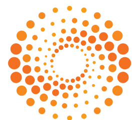
- **Pursue more focused investment strategies, tightly aligned with their business model.** These firms would adopt a multi-niche strategy to pursue opportunities segmented by market, type of investment, target, or asset class and would have developed the capabilities required for success. For example, if a firm competes in less sophisticated and efficient geographic markets, it would need to develop a local presence, seek partners to facilitate sourcing and portfolio management, and tailor risk management systems to cope with less transparency.

- **Build world-class customer service capabilities to manage LP relationships.** These firms would strive to understand the specific needs of their LPs and to maximize service quality by providing more flexible terms and conditions and tailored advice. Delivering this level of service would require transforming the investor relations function – developing new capabilities and, most important, a different mindset.

* * *

While the challenges facing the PE industry are daunting and real, we believe the opportunities for differentiation and outperformance have never been greater.

# PART 2:
## An in-depth review of the Canadian market in 2008



# Introduction

This in-depth review, prepared by Thomson Reuters for McKinsey & Company, is the eighth in an annual series of reports dedicated to profiling important trends in Canada's private equity market and its key investor groups.

Data collected and analyzed by Thomson Reuters for *Private Equity Canada 2008* were drawn from a proprietary survey of Canadian PE fund managers and several related surveys. Survey work was conducted during the latter part of 2008 and between January and April of 2009. The final respondent sample of well over 100 contributors reflects all of the largest PE groups based in Canada – and 96 percent of the entire capital pool.

The data requested, and the questions posed, in the survey were consistent with those of 2007. This serves Thomson Reuters' aim of adding to, and updating, information received previously from fund managers. Consequently, the prior year's data will sometimes reflect changes of note. Thomson Reuters provided supplementary data to augment survey findings to ensure this report reflects market trends as fully as possible.

The report once again features the results of interviews with senior Canadian buyout, mezzanine, venture capital, and other PE professionals about market issues and trends. Thomson Reuters conducted these interviews during March and April 2009. The valuable insights obtained add considerable perspective to the quantitative data.

Thomson Reuters developed the research methodology for all survey work in this and the previous reports going back to 2001. The methodology is comparable to that used internationally for profiling national or regional PE markets.

McKinsey & Company and Thomson Reuters wish to thank the many Canadian fund managers and staff who gave freely of their time to provide confidential data and share their views for this report. *Private Equity Canada 2008* would not have been possible without their generous contributions.

We would also like to thank Thomson Reuters professionals who assisted in the report's production, including analysts Wei Dai and Gavin Penny.

In addition, McKinsey & Company and Thomson Reuters would like to acknowledge the work of Jeff Mitchell and Dan Finos of Carswell, a Thomson Reuters business, which printed and distributed the report.

Kirk Falconer
Director of Research, Private Equity
Thomson Reuters

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**Thomson Reuters** is the authoritative source of information on activity in Canada's private equity space. Its extensive network of contacts and its proprietary data sources have made the firm a focal point for information on Canadian private equity deals and dealmakers. For this reason, Thomson Reuters is a vital, value-adding resource for understanding the full universe of market players in Canada, as well as those based in the United States and other countries that are engaged in cross-border investing. For more information, please visit us at *www.thomsonreuters.com* or contact us by phone at 416 956 1077.

If you have any questions about the *Private Equity Canada 2008* survey methodology or data findings, please contact Kirk Falconer at 613 747 4441 or kirkfalconer@thomsonreuters.com.

# Executive summary

Canada's private equity market entered a down cycle in 2008. According to survey findings obtained by Thomson Reuters on behalf of McKinsey & Company, this slower pace was reflected across the spectrum and in several key indicators of activity. Nonetheless, Canadian investors saw fresh opportunities in this environment, as well as the potential for superior returns.

Despite the prevailing economic uncertainty, the survey found the pool managed by Canadian investors experienced moderate expansion last year. Capital under management totalled $81.2 billion, up 7 percent from 2007.

The lion's share of dollars was captured by buyout and related PE funds, which managed $58.4 billion in 2008, up 23 percent from the year before. This segment's share of the overall market was a record 72 percent, once again due to new partnerships and larger institutional funds.

Mezzanine and other quasi-equity fund managers oversaw $7.8 billion, or 10 percent of the entire pool. New fund formations also contributed to this result.

New commitments to venture capital funds continued to lag in 2008. On balance, capital under management in this segment stood at $14.9 billion last year, or 18 percent of the market total.

## Canada's PE market in 2008

### Quick facts

Capital under management: **$84.7 billion**

Number of active PE fund managers: **190**[1]

Disclosed PE disbursements in Canadian businesses: **$11.9 billion**[2]

Disbursements-to-GDP: **0.8%**

1 Includes buyout, mezzanine, venture capital, and other private equity

2 Includes domestic and foreign deals

SOURCE: Thomson Reuters

Based on survey findings and additional data, Thomson Reuters estimated the entire market universe in Canada to be $84.7 billion in 2008.

Private-independent funds continued to dominate the market landscape in 2008. Private equity partnerships managed $41.5 billion, up 17 percent from 2007, which reflects over half of all resources.

Canada's largest institutional investors remained bullish on private equity, overseeing captive funds totalling $28.1 billion, which is up 14 percent from 2007. This gave them over one-third of the total pool this time around.

Despite continuing consolidation events last year, labour-sponsored and other retail funds accounted for $7.7 billion under management, or a 9 percent market share. Corporate captive funds and government funds accounted for the balance.

New commitments to buyout, mezzanine, and other PE funds increased in 2008, as investors sought new opportunities in a changed market. The survey found a total of $5.9 billion was raised, up 22 percent from 2007.

Fresh supply going to venture capital pools in 2008 was not greatly changed from the year before, totalling $1 billon. However, new partnerships reflected a comparatively high 70 percent of all new commitments in this segment.

Foreign investors were vital to overall Canadian fundraising trends, accounting for 54 percent, or $3.2 billion, of new commitments going to buyout, mezzanine, and other PE funds. Domestic suppliers also assumed a major role, with pension funds contributing $1.5 billion, and corporations, $716 million.

Individual investors continued to be key to venture capital fundraising, committing $337 million, or one-third of the total. However, corporations expanded their role in this segment in 2008, also accounting for a one-third share. Domestic and foreign institutional investors made up most of the balance.

Despite what might be a challenging climate for fundraising in 2009, the survey found the number of Canadian PE investors seeking fresh resources grew to 37, compared to 33 at the start of 2008.

Economic recession and even tighter liquidity conditions caused PE deal volumes and dollars invested to decline sharply on an international basis in 2008. This was also the case in Canada, as activity in all market segments fell uniformly, and for the first time in 5 years.

Last year, Canadian buyout, mezzanine, and other PE fund managers disbursed a total of $6.7 billion of equity and quasi-equity dollars to 562 deals involving domestic and foreign businesses. This is 57 percent below the record $15.4 billion invested in 2007.

Buyout and other PE investors primarily focused on mid-market firms in traditional sectors, with energy, manufacturing, and professional services attracting close to half of total deals done. Other preferred industries included healthcare, IT- and media-related, and wholesale trade.

Venture capital activity also contracted in 2008, with a major drop in cross-border activity significantly influencing trends. In addition, Canadian venture capital fund managers disbursed $1.2 billion to 473 transactions involving domestic and foreign businesses, down 21 percent from $1.5 billion in 2007.

Venture capital investors remained focused on expanding and other late-stage IT and life sciences firms, with these sectors garnering close to three-quarters of deals done. Clean-tech company financings accounted for an 8 percent share, which is up from prior years.

As before, Thomson Reuters supplemented survey findings with interviews with senior Canadian PE professionals on market issues and trends.

Buyout and other PE professionals reported that 2008's dramatically changed market would extend investment horizons and encourage a close portfolio focus, but that Canadian investors were in a good position to weather trends. Interviewees expect few new deals in the near future, except where targets are undervalued or sellers are motivated. They also expect some Canadian investor activity to increase, where it is specialized and sector-specific. They believe that while fund managers must be cautious, they must not stand still; that they should adapt and embrace high-return opportunities.

Venture capital professionals argued that the sharp drop in investment in 2008 had its roots in the market's systemic challenges. Canada's young market has contributed substantially to innovation and the economy, but its inability to sustain continuous activity is a threat to entrepreneurial firms with the potential to become world-class technology leaders. Key to this situation is weak supply conditions, which also obstruct an adequate venture capital response to new opportunities as they emerge. Supply-side remedies must emphasize a market that can perform and be self-sustaining.

# Canada's private equity market in 2008

## Private equity pool surpasses $80 billion

The economic recession and even tighter liquidity conditions impacted PE activity globally in 2008. Nonetheless, the size of the capital pool managed by Canadian investors experienced moderate growth due to private fundraising and a continuing institutional investor appetite for direct deals.

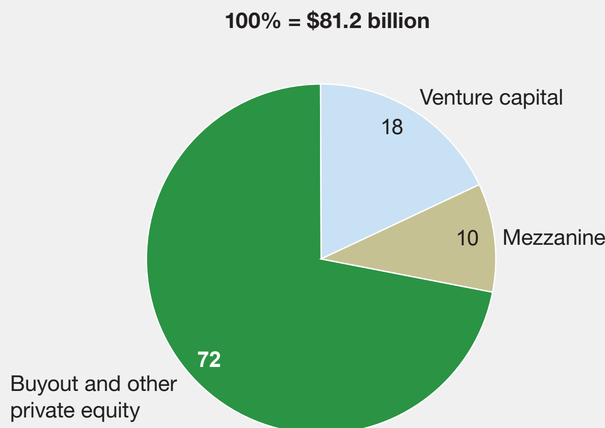
According to the survey (and supplementary data provided by Thomson Reuters), PE fund managers in Canada oversaw a total of $81.2 billion last year. This is 7 percent greater than the $76 billion reported in 2007.

Consistent with recent trends, the lion's share of new dollars was captured by buyout and related PE funds. Domestic investor groups managed $58.4 billion in 2008, up 23 percent from $47.5 billion the year before. This gave the buyout segment a record 72 percent of the overall market.[1]

EXHIBIT 1

**Total capital under management by PE market segment; 2008**

Percent




SOURCE: Thomson Reuters

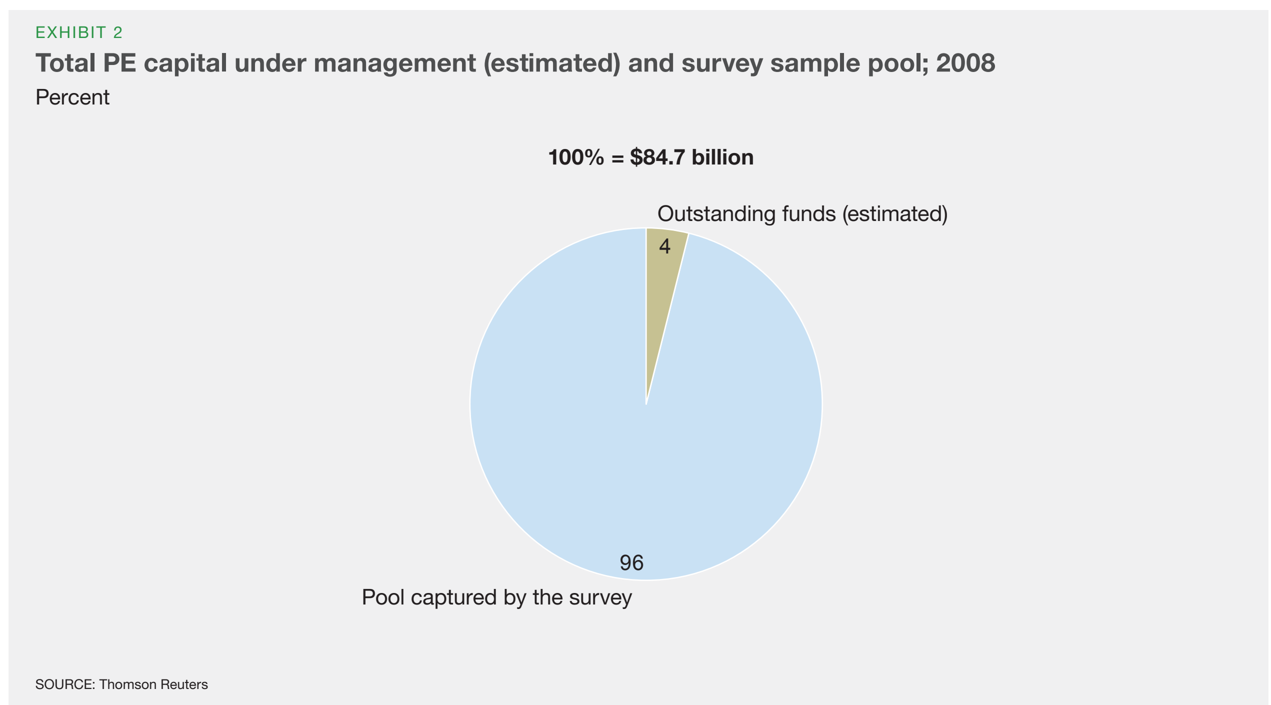
1 In 2009, Thomson Reuters adjusted Canadian capital supply data to capture new trends, including a more diversified market role for Québec-based retail funds. These revised data are reflected in supply estimates discussed in *Private Equity Canada 2008*.

Contributing to this outcome was a spate of new buyout partnerships, including Argosy Shotgun Fund III, Kilmer Capital Fund II LP, Knight's Bridge Capital Partners Fund I, Onex Partners III LP, and Signal Hill Equity Partners II LP. In addition, energy-focused funds, such as ARC Energy Venture Fund 6, JOG LP IV, and KERN Energy Partners III Fund, had a banner year. As well, Canada's top institutional captive funds once again added major assets to their direct programs.

EXHIBIT 2

**Total PE capital under management (estimated) and survey sample pool; 2008**

Percent




SOURCE: Thomson Reuters

Canadian mezzanine and other quasi-equity funds managed $7.8 billion last year, or 10 percent of the entire pool. Private fund formations, such as Crown Capital Financing Limited and Integrated Private Debt Fund LP II, accounted for most of the new capital entering this segment.

While commitments to domestic venture capital funds continued to lag in 2008, this did not prevent the emergence of several new partnerships, including Avrio Ventures LP I, the BlackBerry Partners Fund (managed by JLA Ventures and RBC Venture Partners), iNovia Investment Fund II LP, and Yaletown Ventures II LP. Leading labour-sponsored venture capital corporations (LSVCCs) and other retail funds also attracted more resources.

As in prior years, these inflows of new supply were offset by major outflows precipitated by other investor groups. On balance, venture capital under management stood at $14.9 billion last year, or 18 percent of the market aggregate.[2]

Thomson Reuters once again added its proprietary data to survey findings to obtain an estimate of the Canadian PE market universe as a whole. In 2008, this universe was estimated at $84.7 billion, up from $79.5 billion in 2007.

Based on this estimate, survey data were found to account for 96 percent of all resources underlying Canadian PE fund managers.

## Canada's PE market in 2008

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1 Includes buyout, mezzanine, venture capital, and other private equity

2 Includes domestic and foreign deals

SOURCE: Thomson Reuters

2 Data revisions mentioned in Footnote 1 chiefly account for changes in the estimated size of venture capital under management in 2008 and preceding years.

# Canadian private equity market players in 2008

## Private and institutional funds grow market share

In dollar terms, the survey found private-independent funds continued to dominate Canada's PE landscape. However, private funds were facing more competition from institutional captive funds, which have greatly increased their stakes in North American and global markets.

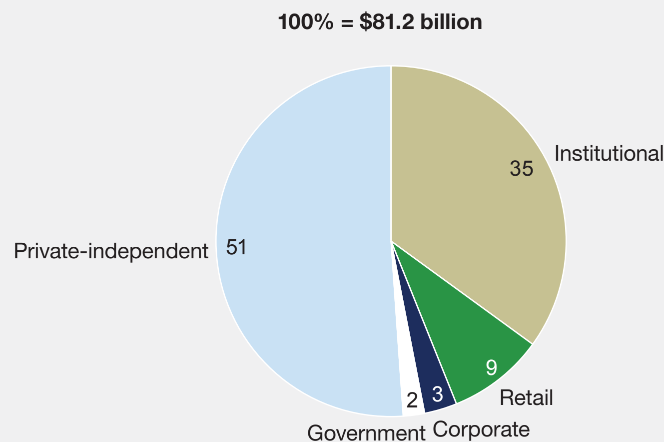
In 2008, partnerships continued to attract substantial commitments from corporate, institutional, and other capital sources, located both at home and abroad. While most fundraising was buyout-related, this activity also benefited mezzanine, venture capital, and other segments of the market. Consequently, private funds reinforced their leadership position, accounting for just over half of all resources.

In real terms, capital managed by private funds totalled $41.5 billion. This is up 17 percent from the $35.6 billion of 2007. Given the changing fundraising environment, it is not yet clear whether comparable growth can be achieved in 2009.

EXHIBIT 3

**Total capital under management by PE fund type; 2008**

Percent




SOURCE: Thomson Reuters

Canada's largest institutional investors remain bullish on private equity. Much of this has been expressed in limited partner activity; however, CDP Capital - Private Equity Group, CPPIB Private Investments, Manulife Capital, OMERS Private Equity, Teachers' Private Capital, and others have also focused on direct investing, especially in the buyout space. These investors are also responding to new opportunities, as seen in CPPIB's 2008 announcement of an operational capacity in leveraged loans, mezzanine, and other private debt solutions.

Given these trends, the survey found institutional captive funds managed $28.1 billion last year, up 14 percent from $24.6 billion reported in 2007. This gave them over one-third of the total pool this time around.

The PE arms of Canadian corporations also persevered with a mix of direct and limited partner activity, with captive funds reflecting $2.2 billion under management, or a 3 percent market share. RBC Venture Partners was among those that made news in 2008, given its central role in the launch of the BlackBerry fund.

Consolidation events continued to be a factor in the activity of LSVCCs and other retail funds in 2008. This was evidenced in the merger between GrowthWorks and the Canadian Medical Discoveries Fund (CMDF). In addition, Desjardins Capital régional et coopératif (CRC), FondAction (CSN), and Fonds de solidarité des travailleurs du Québec (FTQ) were expanding their market roles to include more limited partner activity in private funds, among other things.

On balance, LSVCCs and other retail funds across Canada had stewardship of over $7.7 billion last year, or 9 percent of the entire pool.[3]

Government-owned and directed venture capital and other PE funds continued to have a modest presence in market, accounting for $1.7 billion, or 2 percent of all resources.

3 Data revisions noted in Footnote 1 chiefly account for changes in the estimated size of venture capital under management by LSVCCs and retail fund managers in 2008 and preceding years.

# Trends in private equity fundraising in 2008

## Fundraising down – but not out

International PE fundraising activity in 2008 was down from the year before, but not by much. In the United States, new buyout and mezzanine partnerships captured US $259 billion last year, which is only 13 percent shy of the record in 2007. However, there were indications that fundraising might contract further in 2009.[4]

In Canada, new capital commitments to buyout and mezzanine funds actually rose year-over-year, and they were second only to the record-breaking results of 2006. In contrast, fresh supply going to venture capital pools in 2008 did not greatly change from the year before.

## New partnerships respond to market changes

Canadian buyout and mezzanine fund managers secured a total of $5.9 billion in 2008, or 22 percent more than the amount committed in 2007. The survey found fund formations were responding to new opportunities created by the credit crunch and an uncertain economy.

The largest fund announcement came from Onex Corporation that has raised over $3 billion of third-party capital to date, in addition to $500 million from Onex itself. Already fast approaching its target, Onex Partners III LP will write equity cheques of up to US $600 million for corporate carve-outs, operational restructurings, and other acquisitions across North America.

2008 saw the emergence of other important buyout partnerships. For instance, Kilmer Capital Partners closed on its second fund, exceeding $200 million in total commitments. Kilmer Capital Fund II LP will invest between $15 million and $50 million in company expansions, MBOs, restructurings, and other mid-market activity in Canada.

Toronto's Signal Hill Equity Partners was successful in capping its second fund at $100 million. Signal Hill Equity Partners II LP will make investments ranging from $5 million to $25 million in domestic firms in manufacturing, distribution, consumer products, and business services. It is also prepared to take on small-cap financial and operational restructuring situations.

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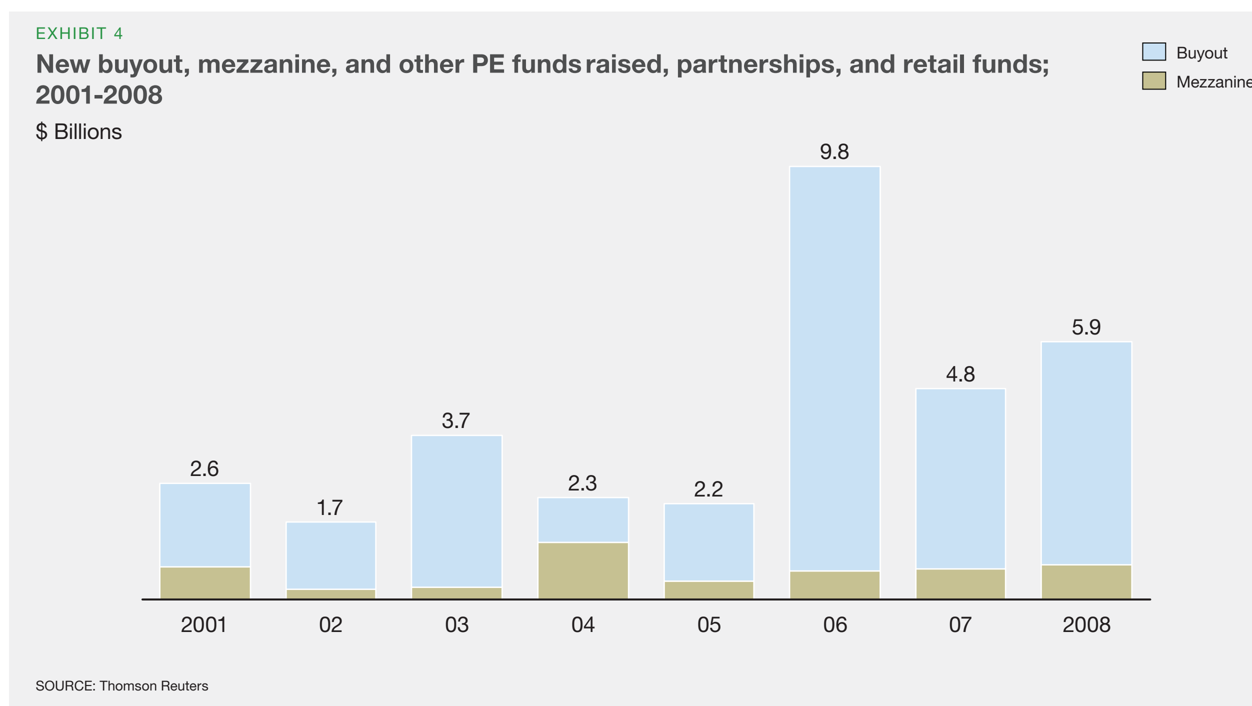
4 *Buyouts*, January 5, 2009.




Knight's Bridge Capital Partners, a subsidiary of Toronto-headquartered Counsel Corporation, introduced its inaugural fund last year. Knight's Bridge raised commitments totalling over $62 million for equity investing of up to $10 million in small and mid-market businesses in Canada and the United States.

In the current economic climate, Canadian market veteran Argosy Partners saw fresh opportunities ready-made for its specialization in shotgun deals involving departing private company shareholders. Consequently, Argosy's Shotgun Fund III did an initial close of over $20 million in 2008.

In the mezzanine space, Crown Capital Partners closed another new partnership. Raising $250 million, Crown Capital Financing Limited will emphasize alternative debt structures ranging from $5 million to $50 million, as well as distressed loans and equity opportunities in select situations, across Canada and the United States.

In addition, Wellington Financial topped up its Fund III in 2008, reaching a final total of $150 million. This fund undertakes domestic subordinated debt, venture debt, and other lending activity up to $60 million.

The current liquidity shortage contributed to the close of the $425 million Integrated Private Debt Fund LP II, announced by Toronto's Integrated Asset Management Corp. Fund proceeds will be used to provide long-term debt financing to domestic

mid-market firms for acquisitions, expansions, MBOs, refinancings, and other events.

## Energy-focused private equity funds score big

Despite the slower market of 2008, the oil and gas sector continued to see a high proportion of PE deals. Canada's community of energy-focused funds reaped the benefits of this trend, attracting substantial new capital commitments.

Leading the pack was ARC Financial Corporation, which completed its sixth fund offering last year. Raising over $957 million, ARC Energy Venture Fund 6 is the largest energy-focused PE partnership in the history of the Canadian market. The new resources will go toward investments of up to $75 million, adding to ARC's portfolio of domestic and global energy firms.

In addition, KERN Partners introduced KERN Energy Partners (KEP) III Fund, bringing in a first close total of approximately $400 million. KEP III will focus on Canadian and international business opportunities in upstream oil and gas, energy infrastructure, energy technology, oil and gas services, and related industries.

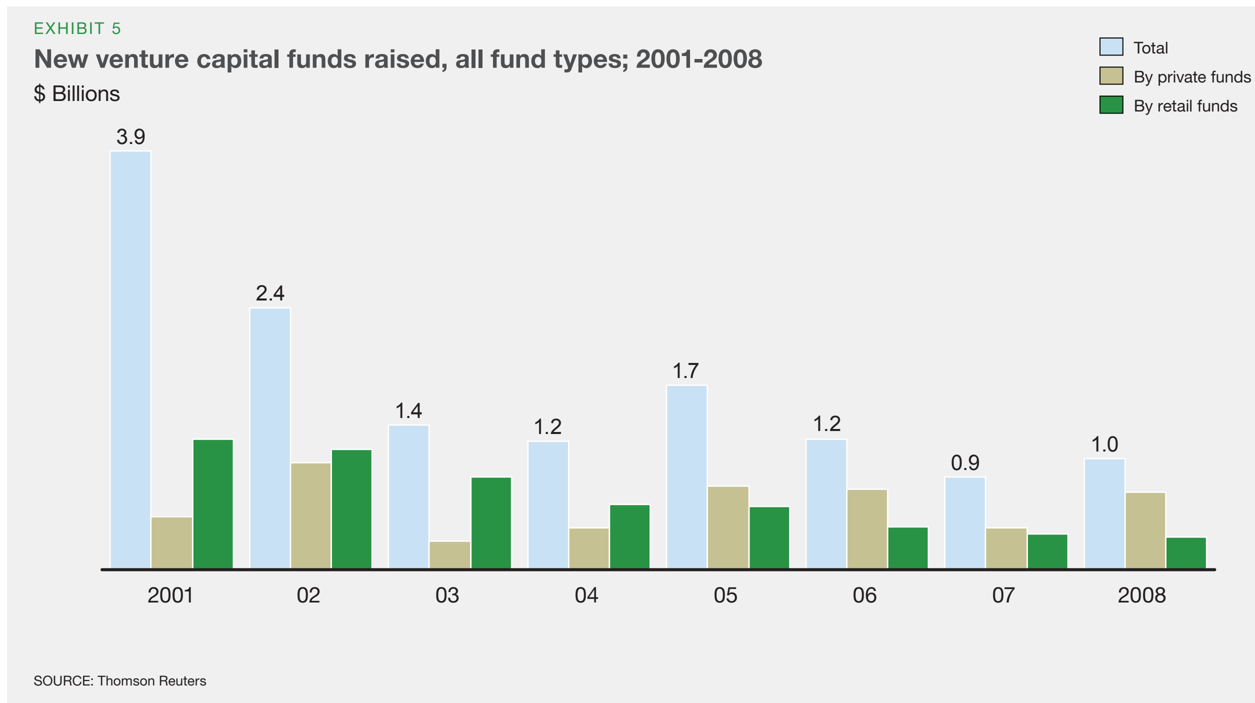
2008 was also notable for the launch of the fourth partnership of JOG Capital, a leading Calgary-based investor in junior energy exploration and development companies across Canada. Initial closings of JOG LP IV have captured $100 million to date.

## More dollars flow into venture capital partnerships

Canadian venture capital funds managers obtained new supply totalling over $1 billion last year, a slight improvement on the historically low fundraising results of 2007. However, these numbers mask some growth in commitments to new partnerships, which accounted for 70 percent of the 2008 amount.

At the forefront of this trend was the inception of the US $150 million BlackBerry Partners Fund by technology giant Research in Motion of Waterloo, in collaboration with Thomson Reuters. Co-managed by JLA Ventures and RBC Venture Partners, this new fund will target opportunities in diverse mobile applications and service developers around the world.

Montréal-based iNovia Capital, formerly MSBi Capital, achieved another major fund closing. Attracting $112 million, iNovia Investment Fund II LP is one of the largest specialty seed and early-stage partnerships ever formed in the Canadian market. It will focus on expanding companies in domestic clean-tech, IT, and life sciences sectors.




2008 saw the successful launch of several other key venture capital partnerships. For instance, Vancouver's Yaletown Venture Partners announced a $65 million first closing on its $100 million second offering, Yaletown Ventures II LP. The fund will focus on seed and early-stage IT and clean-tech firms in Western Canada and the US Pacific Northwest.

In addition, Calgary-headquartered Avrio Ventures Management Corporation did a second close on its inaugural fund, which is oriented to growth opportunities originating with Canadian agricultural or related technologies. Commitments to Avrio Ventures LP I have reached $75 million to date.

The most prodigious retail venture capital fundraisers were once again located in Québec. These included Desjardins CRC, FondAction (CSN), and Fonds de solidarité (FTQ). Other major fund managers, such as GrowthWorks, PFM Capital, VenGrowth Private Equity Partners, VentureLink LP, and Westcap Management, led this activity in other Canadian jurisdictions.

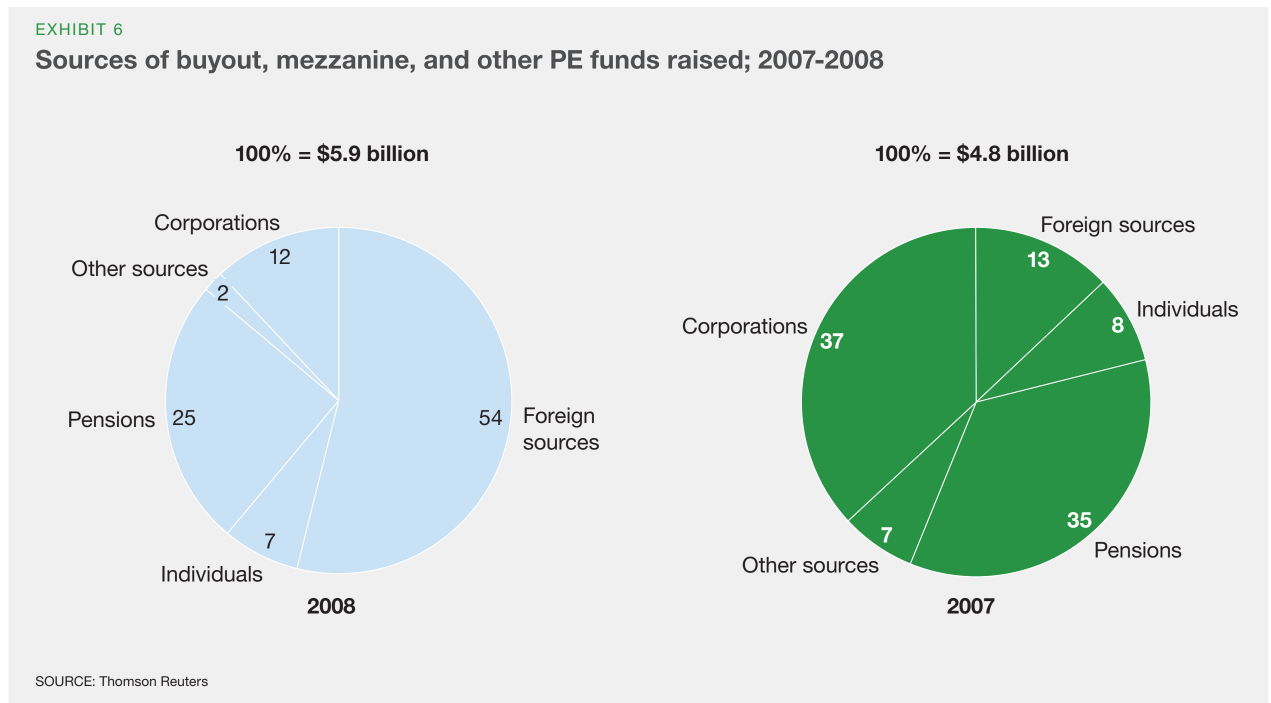
New commitments going into LSVCC and other retail fund coffers were nonetheless subpar on a year-over-year basis, with a total of $296 million garnered in 2008.

## Foreign LPs turn on the tap for Canadian private equity

2008 fundraising in Canada's PE market relied significantly on foreign limited partners, and especially American and European endowments, pension funds, and other institutional investors. The majority of new buyout and other PE partnerships drew on foreign sources, as did several new venture capital partnerships.

EXHIBIT 6

**Sources of buyout, mezzanine, and other PE funds raised; 2007-2008**




SOURCE: Thomson Reuters

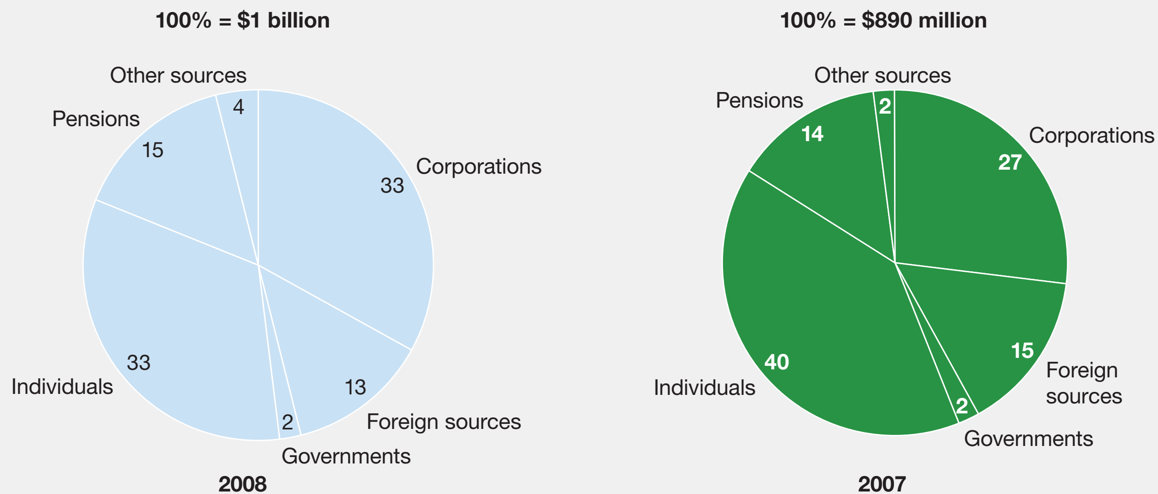
In fact, cross-border investors were the leading source of resources flowing into the buyout and mezzanine segments last year. They accounted for $3.2 billion in new commitments, well up from $606 million the year before, and 54 percent of the total. This is even higher than the share achieved in 2006, when foreign limited partners were equally bullish about Canadian fund offerings.

Domestic institutional investors provided the second largest share. This activity was led by pension funds that contributed $1.5 billion, or one-quarter of the total, though this was down somewhat from 2007 in real terms. Corporations accounted for 12 percent of new supply going into buyout and mezzanine funds, or $716 million, which is quite a drop from the $1.7 billion they committed the year before.

Another major limited partner source was families, high-net-wealth individuals, and retail investors. Taken together, individual Canadian investors contributed $417 million, which is up from 2007.

EXHIBIT 7

**Sources of venture capital funds raised; 2007-2008**




SOURCE: Thomson Reuters

Individual investors were also key to fundraising trends in the venture capital segment in 2008, accounting for $337 million, or one-third of the aggregate. In actual terms, new commitments from this source were reduced only 3 percent from 2007. As in the past, the lion's share of individual resources went to tax-assisted LSVCCs and other retail funds.

Canadian financial and industrial corporations were the other leading suppliers to venture capital pools last year, injecting $336 million, or 37 percent more than the $245 million attributed to them in 2007. Consequently, corporate sources also reflected one-third of funds raised this time around. This activity was supplemented by institutional limited partners, which brought $182 million to the table.

American institutional investors and other foreign sources committed $132 million to venture capital partnerships. While this is down slightly from 2007, the levels of cross-border limited partner activity in 2008 were still high by historical standards.

## Fundraising outlook for 2009

Despite what might be a challenging fundraising climate in 2009, the number of Canadian PE investors seeking fresh resources has increased. The survey found 37 fund managers offering new products in the months ahead, up from 33 in 2008. Many of the fund strategies once again emphasized emerging opportunities.

In the buyout and mezzanine spaces, there were 16 fund managers in the market, some of which have already completed a first close. For instance, Onex, which is already investing from Onex Partners III LP, will continue fundraising into the third quarter of 2009. Argosy Partners and energy-focused investors will also advance their current offerings.

In addition, market veteran CAI Private Equity, with offices in Canada and the United States, has successfully launched its fourth fund, CAI Capital Partners & Co. IV LP. Targeted for $600 million, it is intended to build on CAI's track record of acquiring and investing in mid-market firms across North America.

The survey counted 21 venture capital fund managers looking to attract commitments for initial or final partnership closings. This includes Yaletown Ventures II LP, which will make further strides toward its final target in 2009.

2009 also marks the launch of Georgian Partners Growth Fund I, the premiere offering of Toronto-based Georgian Partners. The fund, which will invest in expanding and late-stage software and other IT firms, got its start through a lead-order commitment from the Ontario Venture Capital Fund (OVCF). OVCF also contributed to the latest partnership of EdgeStone Capital Partners, EdgeStone Capital Venture Fund III LP, targeted for $150 million.

The $205 million OVCF is managed by TD Capital Private Equity Investors, which was selected by the fund-of-funds' government and institutional partners last year. When added to commitments to TD Capital Private Equity Investors IV, which invests in buyout, venture capital, and other PE funds around the world, as well as two customized global mandates, total new resources obtained by TD Capital in 2008 topped $600 million.

Last year, Kensington Capital Partners completed its domestic Fund IV, its International Fund I, and its Co-Investment Fund, and did a follow-on closing of its Global Private Equity Fund. This activity brought total resources of Kensington's most recent program to over $200 million. Kensington continued to invest in diverse PE funds, and to seek co-investment and secondary opportunities, in Canada and abroad.

In early 2009, several new pools of limited partner money were made available to Canadian venture capital funds. These include the Alberta Enterprise Corporation, established to commit $100 million of provincial government capital to funds with specializations in local technology sector clusters.

The 2009 Québec budget also announced a major initiative geared to venture capital fund formations. A professionally managed fund-of-funds, projected to total $825 million, will be capitalized by CDP Capital, Fonds de solidarité (FTQ) and Investissement Québec, with the aim of bringing on institutional partners as well.

Also in the works is a new venture capital partnership oriented to late-stage activity in Canada. BDC Venture Capital has supplied $75 million to leverage this initiative, according to a federal government announcement made last year.

# Trends in private equity investment in 2008

## Pace of deal-making slows

Economic uncertainty sent a chill through global PE investment in 2008. This was certainly the case in the American market, as activity was hit hard by a shaky financial system and even greater restrictions placed on third-party liquidity. Over the course of the year, the signs could be seen in lower deal volumes and even sharper drops in dollars invested.

Slower activity could be observed across most of the market spectrum last year. It was especially apparent in certain types of buyout investment, such as mega-sized publics-to-privates, which characterized much of the prior boom. At the beginning of 2009, many investors were conserving their resources, focusing increasingly on portfolio assets and closely scrutinizing new opportunity flow.

Canadian-based activity was also impacted by the new economic reality of 2008. Across buyout, mezzanine, venture capital, and other PE segments, deal-making levels fell uniformly, and for the first time in 5 years. However, in an environment that historically delivers superior returns, many investors were also looking forward to emerging value opportunities.

## Buyout and mezzanine disbursements drop

After climbing to new heights in 2007, buyout and other PE investment across North America fell to more moderate levels in 2008. In the United States, disclosed disbursements totalled US $136 billion, which was down 71 percent from the year before, and closer to market results last seen in 2004.[5]

The survey found the majority of Canadian buyout, mezzanine, and other PE fund managers were also slowing their rates of activity. Last year, a total of $6.7 billion of equity and quasi-equity dollars was invested in 562 deals involving domestic and foreign businesses. This is 57 percent below the record $15.4 billion invested in 2007.

Key to these trends was the reduced influence of large-market deals. Several important mega transactions notwithstanding, much of the focus in this space in the United States was on the sustainability of existing leveraged activity. This was also

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5 *Buyouts*, January 5, 2009.

apparent in Canada, where the biggest acquisition of all time, the $51.7 billion take-private of Montréal's BCE, Inc., was cancelled in 2008.

However, some large-caps still got completed in Canada. Many originated with foreign investors that continued to show an appetite for opportunities north of the border, particularly in the energy sector. For instance, First Reserve Corporation's takeover of CHC Helicopter for US $2.2 billion was among the largest ever. The Richmond, British Columbia, firm is a provider of helicopter services to the global offshore oil and gas industry.

Similarly, Gibson Energy Holdings, Inc., of Calgary, which is one of Canada's largest midstream oil and gas businesses, was sold by Hunting PLC to Riverstone Holdings LLC, a global energy and power-focused PE investor that is partnered with the Carlyle Group. The final price was $1.2 billion.

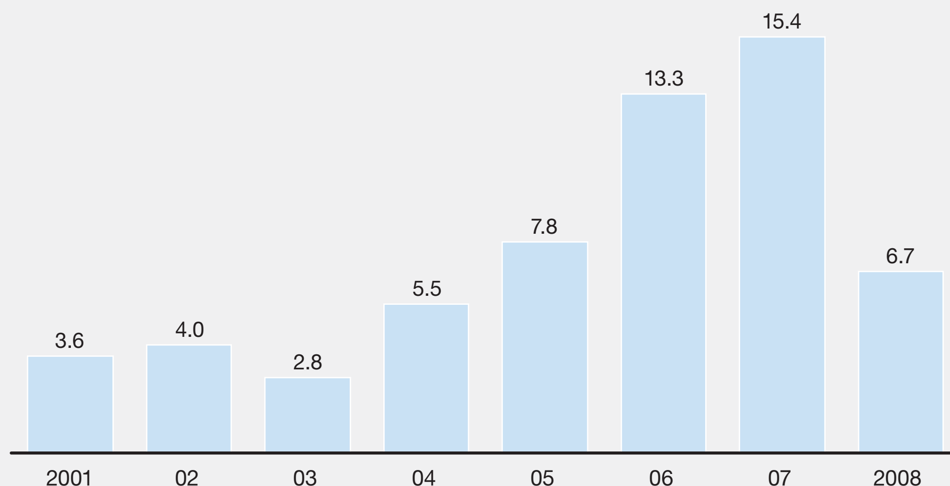
Such foreign-led, large-sized activity contributed substantially to the $9.7 billion in disclosed buyout deal values that Thomson Reuters reported for the domestic market last year. Like the Canadian fund manager disbursements in and outside the country, this tally is well down from 2007.

In contrast, other prominent acquisitions of 2008 reflected the increased attention being paid to mid-market deals. These frequently involved major commercial brand

EXHIBIT 8

**Buyout, mezzanine, and other PE capital invested by Canadian funds; 2001-2008**

$ Billions




SOURCE: Thomson Reuters

names, such as Sleep Country Canada, a leading mattress retailer in North America. Birch Hill Equity Partners bought a controlling share of the parent company, Sleep Country Canada Income Fund, for $356 million. Co-investors included Crossroads Capital LLP, Manulife Capital, and Westerkirk Capital.

The Sleep Country deal is a reminder of opportunities that remain in the income trust sector, given tax status changes on the horizon. Also taking place in this sector last year was the sale of food product subsidiaries, including Clover Leaf Seafoods LP, by Markham's Connor Brothers Income Fund to Centre Partners Management LCC of New York. Upon completion, this buy was valued at US $670 million.

In addition, one of Canada's largest coffee chains, Timothy's Coffees of the World, Inc., was acquired for an undisclosed price by an affiliate of Sun Capital Partners, Inc., headquartered in Boca Raton, Florida. The mezzanine provider to this sponsored transaction was Toronto's Penfund, which invested a total of $18 million.

Canadian buyout and mezzanine investors were also doing high-profile deals in the United States and other global markets in 2008. For instance, Onex Partners II acquired a 50 percent stake in Anaheim, California-based RSI Home Products for US $318 million. RSI is the leading North American manufacturer of bathroom cabinetry.

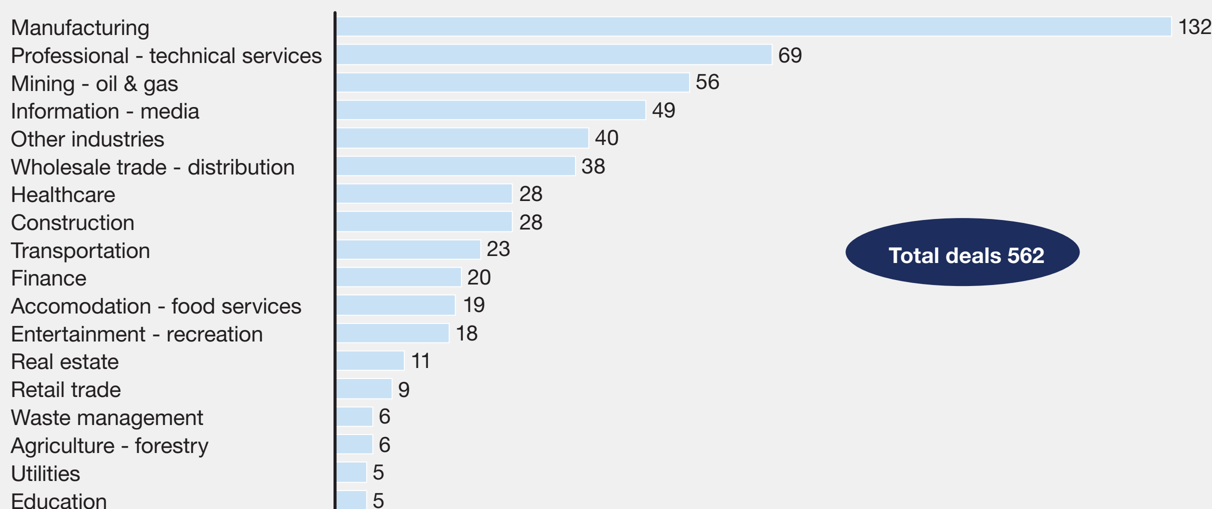
Clairvest Group also made new international investments, particularly in sectors of domain interest. For instance, Clairvest Group and Clairvest Equity Partners III LP sponsored a US $23.4 million recapitalization of Light Towers Rental, Inc., of Odessa, Texas, a regional leader in oilfield equipment services. McKenna Gale Capital also sustained its global focus by contributing a further US $22 million in subordinated debt and equity to this deal.

The survey also counted fewer investment exits – 116 in total – by Canadian buyout and other PE fund managers last year. The majority of those identified by type were strategic sales.

Despite difficult exit market conditions, some fund managers scored big wins in 2008. CAI Private Equity saw a return of more than 3 times its dollars invested from the sale of Aliso Viejo, California's SafeGuard Health Enterprises, Inc., to MetLife, Inc. Similarly, Clairvest realized over 6.5 times its original investment in employee assistance provider Shepell-fgi of Toronto upon its sale to Morneau Sobeco Income Fund.

EXHIBIT 9

**Canadian buyout, mezzanine, and other PE deals by industry sector; 2008**




SOURCE: Thomson Reuters

## Where did buyout and mezzanine money go?

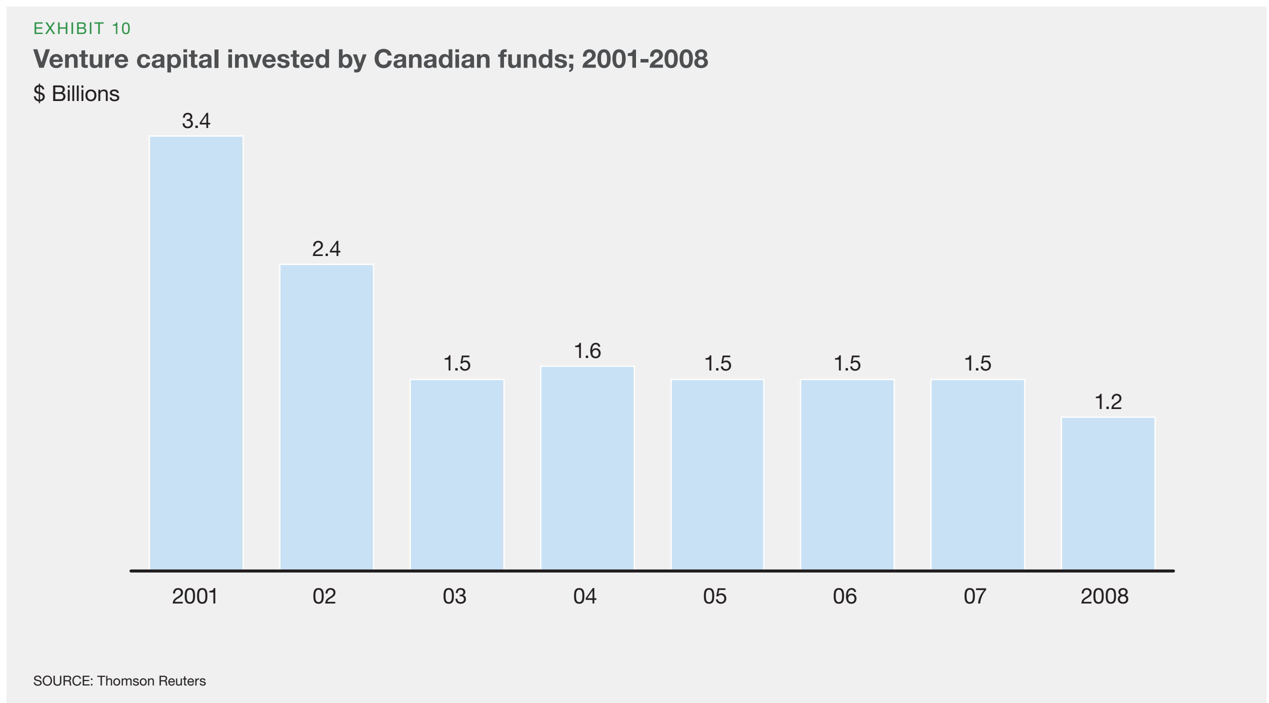
Of domestic and foreign deals done by Canadian buyout, mezzanine, and other PE fund managers in 2008, manufacturing industries captured the largest portion, or almost one-quarter of the total. Professional services took a 12 percent share, and energy and other resource extraction industries, 10 percent, though the latter were highly capital-intensive. Other preferred sectors were construction, finance, healthcare, IT- and media-related, transportation, and wholesale trade.

In transactional terms, fund managers directed approximately three-quarters of their activity to businesses in Canada last year, which is up from 2007. However, well over half of all disbursements flowed into global opportunities.

## Venture capital activity also contracts

According to Thomson Reuters, venture capital investment dropped significantly across North America in 2008. In the United States, disclosed activity fell 9 percent year-over-year, with US $28.2 billion invested. The decline was even greater in Canada, where $1.3 billion was invested, down 36 percent from 2007.

Much of the domestic market contraction resulted from a 56 percent reduction in cross-border activity. As American venture capital funds and other foreign investors are a major source of syndicate resources, this trend also contributed to smaller deals last year.




Locally based investors also assumed a slower pace. In total, Canadian venture capital fund managers disbursed $1.2 billion to 473 transactions involving domestic and foreign businesses. This is down 21 percent from the $1.5 billion they accounted for in 2007.

A key factor in 2008 activity was the impact of public market turmoil on IPOs, acquisitions, and other exit avenues open to young, innovative firms. Consequently, many investors focused on follow-on financings of portfolio companies that were ready for rapid expansion. This was reflected in a number of the year's top deals.

Some of the largest growth financings went to Canadian drug discovery firms moving into later-phase development. Cytochroma of Markham obtained $45 million from BDC, CMDF, GrowthWorks, T2C2 Capital, VenGrowth, VentureLink, and foreign investors Mitsubishi Tanabe Pharma and Nova A/S. Montréal's Gemin X Pharmaceuticals got $38 million from a comparable cross-border syndicate that included lead investor Caxton-Iseman Capital, as well as HIG Ventures, ProQuest Investments, Sanderling Ventures, and VantagePoint Venture Partners.

The Ottawa-based Kleer Semiconductor, which emphasizes wireless audio applications, was also ramping up with a US $28 million financing. Co-investors were BDC, VenGrowth, US Venture Partners, and other foreign investors.

Other firms in expansion mode were found in Canada's clean-technology sectors, which also figured prominently in 2008 trends. For instance, US $15.4 million was invested in alternative energy innovator NxtGen Emission Controls of Burnaby, British Columbia. American investor Altira Group led this deal, in partnership with Yaletown.

In addition, Cobourg, Ontario's Arxx Building Products, a developer of energy-efficient building materials, secured financing rounds totalling $21 million to facilitate an acquisition-to-expansion strategy. Domestic and foreign investors included DFJ Element Ventures, Emerald Technology Ventures, MMV Financial, and Nth Power Technologies.

Early-stage deals continued to get done last year, however, as illustrated by another clean-tech company, 6N Silicon of Vaughan, Ontario. A major supplier to the solar industry, 6N captured US $20 million from Good Energies, Ventures West Management, and Yaletown.

Similarly, Montréal-based company, Neuralitic Systems, which specializes in wireless data services management, successfully completed its startup with a $10 million financing round. The backers in this case were BDC, the BlackBerry fund, GO Capital Fund, and the Israeli fund manager Vertex Venture Capital.

In 2008, disclosed exits from Canadian venture capital investments dropped by more than half compared to the year before. Thomson Reuters reported 22 exit events in total, only one of which was an IPO.

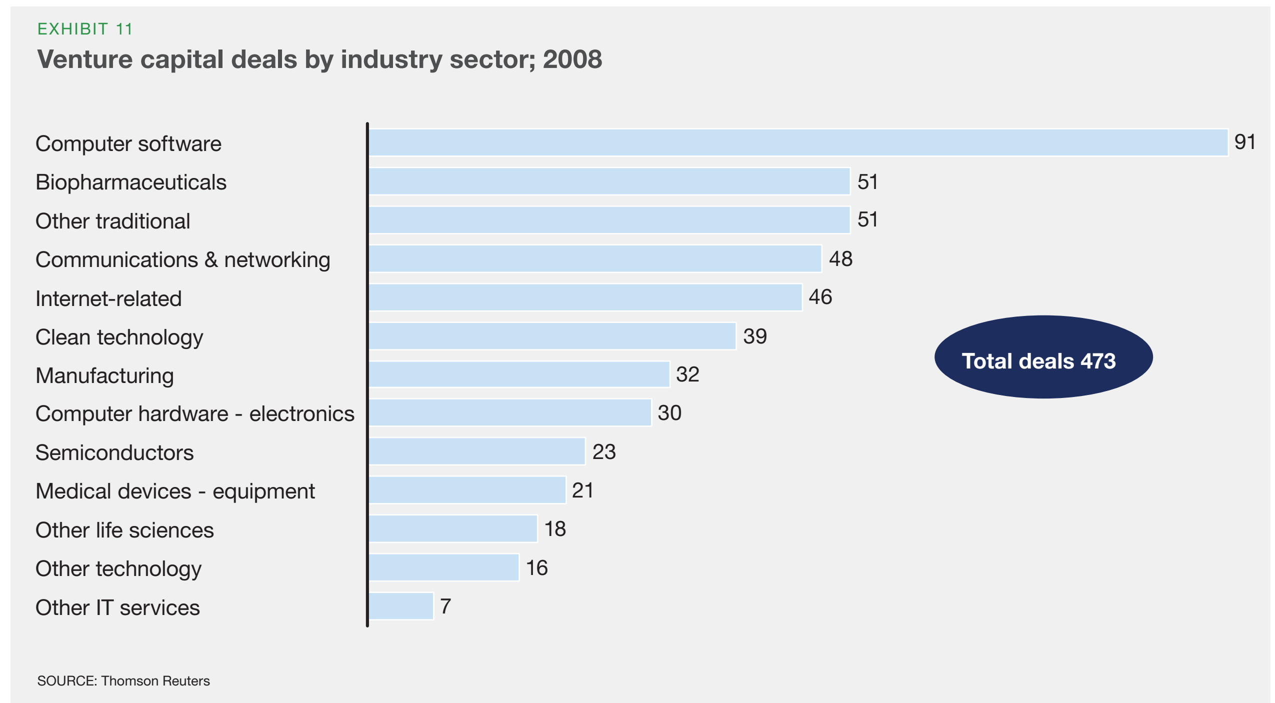
However, a number of high-profile portfolio firms were acquired, some of which paid big dividends to fund managers. For instance, computer hardware developer PlateSpin of Toronto, one of Canada's fastest-growing technology businesses,[6] was sold to Waltham, Massachusetts-based Novell. As a result, Covington Capital Corporation won the Canadian Venture Capital and Private Equity Association's "Venture Capital Deal of the Year."

## Where did venture money go?

The domestic and foreign activity of Canadian venture capital fund managers continued to be technology-oriented in 2008. As in the past, over half of the total deals involved businesses in communications, electronics, semiconductors, software, and other IT sectors. Almost one-fifth featured activity in biopharmaceuticals and other life sciences sectors. Clean-tech company financings accounted for an 8 percent share, which is up from prior years, while non-technology activity accounted for much of the balance.

6 Deloitte Technology Fast 50, 2008.

Fund managers also continued to locate the bulk of their deals and dollars in innovative sector clusters at home. In fact, better than two-thirds of last year's venture capital transactions involved technology firms based in Canada.



# Investors' reflections on private equity trends

### Interviews with private equity professionals

Once again, Thomson Reuters interviewed senior professionals[7] to gain their perspectives on market issues and trends for this report. They were asked for their thoughts on the nature of changes impacting buyout, mezzanine, venture capital, and other PE segments last year both in Canada and globally. And they were also asked to provide an outlook for the year ahead.

## Perspectives on buyout and other private equity activity

### 2008 trends suggest tougher times

The North American landscape for doing buyout, mezzanine, and other PE deals changed dramatically in 2008. Early in the year, investors were already putting on the brakes in response to the credit crunch. Several months later, the Wall Street meltdown and its economic fallout rendered market conditions even less hospitable.

The present market climate, while challenging, offers the prospect of superior performance

This explains the substantial cut in equity and quasi-equity dollars invested by Canadian fund managers last year, said the senior professionals interviewed by Thomson Reuters. And, given the uncertainty that has continued into 2009, most investors are likely to continue to be conservative, they added.

This means preparing for a perhaps longer than anticipated slowdown, with investment-holding periods stretching beyond the domestic average of 3 to 6 years. General partner teams will, for the duration, keep a close watch on portfolio assets. For many, this will involve encouraging organic business growth, making operational improvements, doing add-ons, or introducing survival strategies.

Canadian investors are in a good position to weather these circumstances. Due to recent fundraising trends, many have dry powder. For these domestic investors, the present market climate, while challenging, offers the prospect of superior perform-

7 See list on page 64.

ance. Indeed, their situation contrasts with that of multiple counterpart funds in the United States, which are tied up with highly leveraged transactions of the recent buyout boom.

## New deals are few and far between

Expanding Canadian disbursements since 2004 were driven by new transactions that introduced large numbers of domestic mid-market businesses to a PE alternative. Due to the prevailing economic context, more restrictive liquidity, and business values that have not fully adjusted, there was a dearth of this activity in 2008.

Among the exceptions, the senior professionals said, were the targets of niche investors, such as distress and turnaround funds. There should also be greater opportunities for mezzanine providers in both sponsored and non-sponsored activity. Last year, fund managers were launching partnerships, or adding to in-house capabilities, to reflect these and other areas of emerging interest.

Because of the price environment, it was argued that many other Canadian investors are likely to approach new opportunities with caution and exceptional financial discipline. Cherry-picking would nonetheless take place, especially where companies are demonstrably undervalued or sellers are highly motivated.

Canadian investors are likely to approach new opportunities with caution and exceptional financial discipline

One area that might be ripe for new investments was successions, given the motivation of aging business owners. Senior professionals also believed that consolidations and selected mergers and acquisitions might be compelling, including where the latter add value to existing portfolio firms. In comparison with the immediate past, the United States is a prime source of value targets.

## Sector focus provides a competitive edge

Canadian buyout and other PE funds have recently exhibited new forms of differentiation and specialization. One example is a core emphasis on specific industry sectors or sub-sectors, about which investors have obtained deep knowledge and understanding. Several interviewees saw this as an important source of competitive advantage.

For instance, restructuring funds see considerable deal flow in manufacturing and other troubled, but still viable, sectors. Activity in this realm requires highly specialized approaches and, consequently, stands apart from the activity of many other investors that will instead prefer sectors with recession-proof natures (e.g., food services and healthcare) at the moment.

Some fund mandates are sector-specific. This includes oil patch investors, who came to the fore on both the deal-making and the fundraising fronts in 2008. While activity has pulled back, the nature of energy investment permits flexibility to shift gears. Canada's energy-focused funds have carved out a worldwide reputation, and they have given limited partners an attractive market alternative in part because of their counter-cyclical properties.

Less explicit, but nonetheless important, are the sector preferences of generalist funds, developed through an active investment history. According to the interviewees, a number of Canadian fund managers are working proprietary networks to locate new opportunities in familiar industries, while others are taking their domain expertise to transactions around the globe.

### Prospects for 2009 and beyond

Senior professionals did not foresee a renewal in overall levels of buyout and other PE investment in 2009. In fact, local activity is likely to drop again if the economy deteriorates further. Some sensed that the picture might change late in the year, or in 2010, with price corrections and improved liquidity, and as investors are ready to assume more risk.

While not all PE funds will emerge from the slowdown intact, those that do should thrive

In the meantime, general partners were advised to communicate effectively with limited partners, given new time horizons, strategy shifts, and other features of a changed market. While institutional investors active in private equity remain committed to the asset class, many currently face major pressures that might impact partner relations or delay fundraising plans.

However, interviewees argued that partnerships should be no less strong where the parties are engaged, and interaction is rooted in experience and solid track records. They noted that domestic and foreign limited partners have both come to regard Canadian market opportunities as unique, and the investor community as unsaturated, particularly vis-à-vis the United States.

While not all PE funds will emerge from the slowdown intact, those that do should thrive, the interviewees said. Much depends on decisions made during the previous boom. Caution is vital, but neither large-market nor mid-market investors can stand still. Rather, they should embrace change and make judgments according to their training and temperaments.

## Perspectives on venture capital activity

### The market faces imposing challenges

The sharp drop in Canadian venture capital activity last year was of considerable concern to the senior professionals. They said venture capital fund managers, like other PE investors, must batten down for a slowdown of indeterminate length and severity. Given few attractive liquidity options, this means extending investment horizons and focusing on portfolio needs.

However, interviewees said existing market challenges in Canada were greater than those in the United States and other countries. With risk investment in innovative companies falling to levels last seen in the mid-1990s, trends in 2008 suggested more than just a cyclical change in response to broad economic retrenchment.

Rather, they argued, the Canadian venture capital market is now confronting systemic challenges. These are linked with its underlying supply infrastructure, and with its ability to replenish resources necessary for continuous investment. Indeed, over the past 7 years, the fundraising environment has become weaker.

The Canadian venture capital market is now confronting systemic challenges

Interviewees believed these fundamental issues were brought home in 2008. This was evidenced by the plunge in foreign disbursements, which removed a key source of growth between 2004 and 2007. Due to their supply situation, cash-strapped Canadian investors were unable to offset this decline.

### Canadian technology “gazelles” are endangered

While Canada’s venture capital market is relatively young, it has already had a major impact on emerging technology sectors and, by extension, the economy. A 2009 study published by the CVCA has shed new light on this, finding that 150,000 jobs and $18.3 billion of revenues (or almost 1 percent of GDP) have been generated since 1996.[8]

However, market capacity to build on this track record is under threat. Senior professionals said that, in good times and bad, entrepreneurial firms depend on a steady flow of venture capital. This is particularly true of those with the potential to become world-class technology leaders, like Research in Motion, and that can drive further growth in local sector clusters.

Many of these high-growth companies, or “gazelles,” are endangered by under-financing and reduced access to investor value-added, global networks, and other

8 CVCA, *Why Venture Capital is Essential to the Canadian Economy*, 2009.

resources. Examples of these were identified in IT, life sciences, and other technology sectors, the rapid expansion of which might be curtailed by a lack of follow-on venture capital.

The market cannot count on a revival in foreign activity to fill this high-growth financing gap. This is because the activity of American venture capital funds and other foreign investors has, to a substantial degree, relied on Canadian funds active in firms during their earliest development stages. Only more resources directed to domestic investors will effectively address maturing portfolios comprising gazelles.

### Emerging opportunities are also at risk

Interviewees agreed that economic change also yields venture capital opportunities. One illustration is found in the current job-shedding of established technology businesses. History has shown this frequently results in new sources of quality deal flow, as many former employees bring their talent and technical knowhow to startups.

Economic change also yields venture capital opportunities

Canadian venture capital funds with dry powder will be in an excellent position to act on such opportunities. However, this will not be practical for many others. Thomson Reuters data indicate new activity, or activity that engages firms seeking venture capital for the first time, has experienced an uninterrupted decline since 2001.

As a result, the market cannot adequately respond to ideas and innovations coming from entrepreneurs, laboratories, post-secondary institutions, R&D centres, and other pipeline sources. This has crucial implications for IT and life sciences sectors that have been carefully cultivated since the 1990s, as well as for newer activity, like clean technology.

Senior professionals said that missed Canadian technology opportunities would be the competitive gain of other countries. Another consequence would be a brain drain, as frustrated venture capital investors and entrepreneurial managers who have acquired invaluable skill sets and experience since the 1990s are forced to search for fresh prospects outside Canada.

## Prospects for 2009 and beyond

Senior professionals believed that Canada's venture capital market is at a crossroads in 2009. Remedial supply-side interventions by governments or private-public partnerships should occur promptly, but also with the aim of putting activity on a stronger, and more competitive, footing.

Venture capital activity must ultimately be self-sustaining. This requires a focus on all aspects of market evolution, not just fund formations. It should also be recognized that Canada has a small market, which argues the importance of pooling available resources and allocating them to the best general partner teams.

Interviewees said Canadian investors, while acting locally, must also think in global terms. Consequently, domestic funds must be larger, linked with international networks, and strategically capable of taking innovative firms through optimal life cycle growth. This will also improve fund performance, which is a pre-condition to greater institutional investor participation.

Canadian investors, while acting locally, must also think in global terms

Through a joint focus on new venture capital pools and smarter deployment, the domestic market can leverage its most promising technology startups and flexibly respond to new opportunities. Interviewees argued this would allow the Canadian market to revitalize itself and to emerge from the slowdown in much better shape.

## Private equity professionals interviewed for *Private Equity Canada 2008*

**Jennifer Brooy** is the Vice-President, Equity, at **Export Development Canada** (EDC). Jennifer manages the Ottawa-based **EDC Equity Program**, which provides risk capital, value-added, and international opportunities to high-growth Canadian firms, and is a limited partner in a range of PE funds.

**Stephen Dent** is the Managing Director of **Birch Hill Equity Partners Management Inc.** Headquartered in Toronto, and with $1.7 billion under management in 2008, Birch Hill has been one of Canada's leading buyout investors since 1994, focusing on value creation opportunities found chiefly in the domestic mid-market.

**Jacques Foisy** is a Partner of **Novacap Investments, Inc.**, of Montréal. Founded in 1981, Novacap is one of Canada's best-established PE firms. Jacques is President and Managing Partner of the Novacap Industries funds, which pursue acquisitions in mid-market businesses in traditional sectors.

**Steve Hnatiuk** is a Founder and Partner of Vancouver's **Yaletown Venture Partners, Inc.**, which invests in early-stage IT and clean-tech firms in Western Canada and the US Pacific Northwest. Among Yaletown's backers are North American institutional investors and many successful technology entrepreneurs in the region.

**Chris Johnson** is the Managing Partner and CIO of **Crown Capital Partners, Inc.**, a leading specialty finance company founded in 2000. Operating from Regina and Toronto, Crown focuses on alternative debt structures, as well as selected distressed loans and equity opportunities, across North America.

**Damian Lamb** is a Managing Director of **Genesys Capital Partners, Inc.** Toronto's Genesys is one of Canada's top venture capital investors in high-growth companies in emerging biotechnology, healthcare, and other life sciences sectors. It currently manages over $200 million in committed capital.

**Minhas Mohamed** is the President and CEO of **MMV Financial, Inc.**, of Toronto. With a $400 million-plus investment program, MMV operates with one of the longest standing and most seasoned venture lending teams in North America. It emphasizes debt-financing solutions for technology firms.

**Jason Montemurro** is a Principal, and **Chris Hooper**, Vice-President, of **KERN Partners, Ltd.** Based in Calgary, KERN is a leading PE firm focused on opportunities in energy sector resource and infrastructure development in Canada and on a global basis. Founded in 2003, KERN today manages $1.07 billion, along with a co-investment program.

# Conclusion

Following major expansion over the past 4 years, especially in the buyout space, Canada's PE market entered a down cycle in 2008. According to survey findings and other data provided by Thomson Reuters, this slower pace was reflected across the spectrum and in several key indicators of activity. So far, all signs point to further contraction in 2009.

These domestic trends form part of a broader cyclical change across the North American market, responding to the deterioration in the global economy over the course of last year. Based on the data, as well as feedback obtained from senior professionals, PE activity is likely to continue a close tracking of larger economic events in the months ahead.

This being said, the data and investor commentary also make the case for fresh opportunities in the current environment. While investors in buyout, mezzanine, venture capital, and other PE segments face challenges, history argues that this time also offers the potential of exceptional risk-adjusted returns. Going forward, many Canadian fund managers will recognize this potential, overcome challenges through ingenuity and experience, and take local and international market activity into its next era of growth and development.

# Appendix

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AVAC Ltd.

Avrio Ventures Management Corporation

Banyan Capital Partners

BDC Subordinate Financing

BDC Venture Capital

BEST Funds

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Brightspark Ventures

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CDP Capital – Private Equity Group

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