

# U.S. FIRMS POUR INTO CANADA

By Mark Cecil

**C**anada is hardly a new frontier for private equity, but as U.S. buyout firms look for a competitive advantage more and more outside the lower 48 states, they find to their north a market both robust and challenging for buyouts.

As one PE pro in Canada put it, Canada used to be an environment with "one big transaction every two years." Such was the case beginning in 2000, when **Kohlberg Kravis Roberts & Co.** led a \$2.55 billion buyout of Shoppers Drug Mart Corp. and then came back in 2002 to buy the Bell Canada yellow pages division for \$3 billion.

But since then, buyout activity led by U.S. funds has picked up, spurred partly by those very deals, which showed that there was money to be made in Canada.

**Jim Leech**, senior vice president at **Teachers' Merchant Bank**, said the returns **KKR** got on Shoppers and Bell Canada, "got everyone's attention."

Leech estimates that now there are about a dozen sizeable U.S. private equity players regularly active in Canada, competing with Canada's home-grown buyout funds. According to a report issued by **Goodman and Carr LLP** and Thomson MacDonald, on Canadian PE in 2004, the capital under management in Canada's private equity market is \$51 billion, with the buyout segment comprising \$25.1 billion of that. Leech summed up buyout competition in Canada this way: "Our competition is **Onex [Corp.]** and the U.S. guys."

U.S. firms that have been active in the last two years in Canada include, **The Carlyle Group**, **Monitor Clipper Partners**, **Warburg Pincus**, **Accel-KKR**, **Bain Capital**, **Sentinel Capital Partners** and **KPS Special Situations Funds**, among many others.

These days, if Canada is at all less competitive than the U.S., it is only marginally so, said Leech. For example, in a Canadian auction there may be 10 bidders whereas



in a similar U.S. auction, there would be fifteen, he said.

Reasons for the increase in U.S. fund interest in Canada include: growing amounts of capital, growing numbers of funds, undiscovered Canadian management teams, and the opportunity for liquidity provided by both lower listing requirements in Toronto and Canada's latest IPO fad, Income Trusts.

Income Trusts are financial vehicles unique to Canada that allow companies to access the public market via a trust, similar to how a REIT works. Income Trusts have emerged as ominous competitors to buyout funds because they provide a fairly easy exit for business owners at often outstanding multiples of 6x to 8x.

However, Income Trusts are a double edged sword. "On a number of occasions we have bid on a company only to come in second to an Income Trust," said Leech. "At the same time, it's helped our exits."

**Rick Nathan**, a managing director at **Goodmans Venture Group**, the venture division of **Goodmans LLP**, and also the president of the **Canadian Venture Capital Association (CVCA)**, said the Income Trust market has been "a magnet of interest," with several dozen coming to market over the last year. About two thirds of those, he estimated, had the participation of a private equity fund.

This has also compressed investment lifetimes in the last few years, he said. "You have people turning these deals around in 12 months sometimes," said

Nathan.

**David Rowntree**, a managing director and co-founder of **Tricor Pacific Capital**, which has offices in Chicago and Vancouver, said an income trust IPO can generate another turn or two on a multiple. He said at least six companies **Tricor** has looked at have broken off talks to pursue Income Trust status.

Rowntree recalled one transaction two and a half years ago, when the Income Trust market was peaking, where **Tricor** had a letter of

intent signed to buy a consumer products manufacturer for \$90 million. The company ditched the agreement and instead went public as an income trust for \$180 million. A year ago, another consumer products maker was negotiating with **Tricor** on a \$60 million deal, it went public for more than \$80 million.

"They don't even come to our doorstep anymore. They just go directly to the market," he said.

## Income Trusts Come To An End?

But all is not well with income trusts. In September, Canada said it would review their taxability. The government claims it is losing hundreds of millions per year in taxes, said Nathan. The result has been the deletion of an estimated 13% of what was \$180 billion in market value of Income Trusts in the last few months, said Rowntree.

"Investors didn't think they were buying into political risk [investing in Income Trusts]. This is a case of the government moving the goal post in the middle of the game," said Nathan.

With the uncertainty in the income trust market now, Leech said that anyone hoping to exit into the income trust market has to put its plans on hold for at least the next few months.

There are a number of other difficulties for buyouts in Canada as well.

First among them is Canada's resource-based economy, which is resistant to leverage. Canada's major industries, energy,

lumber and mining, are cyclical, and therefore hard to lend against.

"It's pretty hard to take a commodity-based business and put on significant leverage because you face the volatility in commodity price," said Leech. "Private equity has not ever been able to get its head around the commodity risk in financing."

Leech estimated that about 50% of publicly traded companies in Canada are either banks or oil and gas—neither or which is traditionally looked at by private equity.

Another obstacle—especially for some middle market shops—is taxes.

Rowntree said navigating tax law can present a big upfront expense for a smaller firm, which may of course not even win the auction it's in. The question hampering the smaller players is, "How do I get that money back home once I've made it without getting dinged?" said Rowntree.

Prices in Canada are also moving up. Just as overflows of capital in U.S. funds have driven up prices in the states, it's also pushing up prices in Canada.

"U.S. funds are awash with money and willing to pay higher multiples," said **Earl Lande**, senior vice president and head of Canadian operations at **Roynat**, which arranges and syndicates financing for buyouts. What might have been a 4.5x to 5x EBITDA purchase price multiple becomes a 6.5x multiple once U.S. buyers enter, he said.

Lande noted that U.S. private equity typically doesn't bother going to Canada for anything below a certain threshold, which is estimated to be around a \$20 million equity commitment.

However, in spite of all its challenges, Canada can be a lucrative destination for U.S. investors.

U.S. funds are often larger than Canadian funds, which gives them a number of advantages. "Along with that [size] goes greater financial clout, more aggressiveness, more willingness to take on a longer time horizon and pay a larger multiple for the business," said Lande.

**David Lobel**, managing partner and founder of Sentinel Capital Partners said his firm has been looking in Canada over the last eight or nine years and began investing there by making purchases through an existing U.S. portfolio company. "That way we got our feet wet," he said.

Sentinel has completed two buyouts in the last 24 months in Canada. In January 2004 it bought Listowel, Ontario-based Spinrite LP, then just 13 months later took it public as an income trust for \$203 million. Sentinel invested \$19 million in the company and generated cash proceeds of \$109 million in the IPO.

This June, Sentinel struck again, buying

Nanaimo, British Columbia-based Madill Inc., a maker of forestry equipment, for \$80 million.

Others have also met with success. Between March 2002 and February 2004, KPS co-founders and managing principals **Michael Psaros** and **David Shapiro** saw their investment in Winnipeg, Manitoba-based bus builder New Flyer Industries Ltd. return more than 7.5x their invested capital of \$27.7 million.

But such successes aren't easy, they insisted.

"People think of Canada as another state of the union," said Psaros. However, "it is difficult to become part of the cloth in Canada because it is a very close knit community. It's not like doing a deal in Connecticut."

Lobel was one of many who noted that, in Quebec, especially, cultural barriers can be difficult. In that province, largely French speaking and culturally independent, Lobel said, "it's a whole different story."

Looking at Canada, just a short plane ride away, "The distance makes it seem like it should be easy," said Lobel. "But it's easier said than done."

In KPS's case, the New Flyer deal came their way through contacts KPS had with **Deloitte Touche Tohmatsu**, New Flyer's advisor. Closeness to D&T was key to the success of the deal, said Psaros, because transaction advisors in Canada are much more empowered than their stateside counterparts. An advisor will typically take on a number of roles, said Psaros, advising on tax, M&A, restructuring and auditing. The advisors in Canada typically "are de facto decision makers. They may not be only selling the business but also running it."

Another difference in Canada is the power of labor unions—KPS hammered out a new labor contract as part of the restructuring.

Canada's government will get involved in transactions in a way seldom seen in the U.S., said Shapiro. The province of Manitoba gave the deal a "shot of capital" and from beginning to end took great interest in the transaction, said Shapiro. The federal government also got involved.

In Canada, "You can bring the government into the process in a more meaningful way than you can in the states," said Shapiro. "In our experience it's been to the buyer's advantage to do that," he added.

Technology—at 15% of Canada's GDP—is one area attracting plenty of interest.

Note one recent deal: in October, KKR-affiliated tech fund **Accel-KKR** agreed to sell 3D graphics maker Alias Software to Autodesk Inc. for \$182 million.

**Tom Barnds**, a managing director at

Accel-KKR, said his firm tends to look "off the beaten path" for its middle market and lower middle market transactions. In Canada, Barnds said he finds top quality entrepreneurs and closer partnerships between academic institutions and commercial companies. Animation is a particular strength in Toronto and Montreal, he said.

Key to the Alias transaction was picking a good local partner, who in Accel-KKR's case was Teachers', which had previously worked with KKR. A local partner is instrumental in understanding accounting and legal aspects of a Canadian transaction, he said.

One unsavory aspect of investing in Canada is common law requirements that makes it more difficult to shut down plants, move offices or fire employees because of higher severance pay-outs, said Barnds.

But there are advantages too. For example, in the middle market and below, Barnds said he doesn't see the same kind of pricing pressure that larger Canadian transactions see due to increased U.S. fund presence.

There is also a lower threshold for public listing on the Toronto stock exchange, said Barnds, which gives an easier route to exit. In the U.S., where a \$250 million plus market cap is needed to get on the Nasdaq, said Barnds, on the Toronto Stock Exchange, "you could do it at levels of less than half that. For a mid-market investor, that's another reason Canada can be attractive. You have an earlier path to liquidity."

All told, "Many Americans look at Canada as a very large 51st state and they couldn't be more wrong." However, Barnds said, "Positives far outweigh the negatives in terms of doing business in Canada."

So what's going on in Canada right now?

One high-profile situation is a hostile bid which has put Hudsons Bay Co., Canada's oldest retailer, in play. On Oct. 28, the Toronto-based company announced it had received an unsolicited, \$1 billion offer from U.S. investor **Jerry Zucker's Maple Leaf Heritage Investments**. The board is reviewing its options.

Elsewhere, on Nov. 3, the board of directors of Mississauga, Ontario-based **Vincor International Inc.**, Canada's largest wine maker, rejected an unsolicited \$1.1 billion offer from **Constellation Brands Inc.** Both of these situations reportedly are attracting private equity interest.

CVCA's Nathan said U.S. fund activity in Canada is all but normal by now. "In the mid-90s, if a KKR or Bain decided to bid for a company, that was news," said Nathan. "Now it's every month. It's part of the landscape." ☛