The Growing Appeal of Sponsor-to-Sponsor Deals in Canada

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The Canadian M&A markets have remained active in 2018, with private equity investors taking advantage of strong market conditions, resulting from low interest rates, the availability of debt financing and high levels of dry powder to liquidate investments.

With competition for quality assets remaining strong, private equity funds face challenges in deploying unfunded capital and the volume of sponsor-to-sponsor deals continues to rise. Sponsor-to-sponsor M&A transactions generally move more quickly and with more intensity than deals involving a strategic buyer and/or seller. We discuss a few of the unique dynamics of sponsor-to-sponsor deals and important considerations below.

Smoother Due Diligence Process in Sponsor Sales

Although a seller's preference may be to minimize third-party costs in connection with a sale, failing to devote sufficient resources to sell-side due diligence at the beginning of a process can be a costly error. In addition to creating awareness of any potential issues, preparing for due diligence in advance will allow a sale process to advance efficiently and reduce transaction costs on all sides.

In a sponsor sale transaction, there are many opportunities for a seller to leverage its existing experience and familiarity with the target business, making the process more efficient, maximizing positive outcomes and packaging an attractive deal to potential buyers.

Key considerations include:

- A sponsor seller should take advantage of its experience working with advisers to create a well-organized data room. The process will also benefit from the fact the target company has previously pulled together materials when the sponsor made its initial acquisition.
- In most cases, the target company will have been preparing and providing financial reporting to the sponsor in a form that is helpful to a potential buyer. Additionally, the target company's enterprise software will generally be consistent across the organization, making financial due diligence easier for potential buyers.
- The sponsor seller will be aware of any issues with the business, creating an opportunity to clean up smaller issues in advance and properly position larger ones, demonstrating thoroughness and helping defuse a potential buyer's reaction.

On the buy side, well-organized due diligence materials and strong financial reporting from a private equity-backed business will serve to expedite the sponsors' due diligence process.

Representation and Warranty Insurance

Turning to R&W insurance can distinguish a bid in a competitive auction and reduce the seller's overall liability post-closing. By offloading certain unknown exposures to third-party insurers, the seller gains additional certainty with respect to post-closing liabilities, which can be of particular importance to a private equity fund with a limited life looking to quickly return proceeds from the sale to its limited partners.

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R&W insurance has gone mainstream in mid-market transactions in the United States and is gaining popularity in Canada with many sellers even requiring buy-side policies in their auction draft purchase agreements, underscoring R&W insurance as a key deal consideration. We expect this trend to continue, especially with respect to transactions between sponsors. Canadian private equity sponsors, many having used R&W insurance for the past two to five years, will have a good understanding of policy details, as well as timing and process dynamics. Coupled with the fact that many private equity sponsors have existing relationships with R&W insurance providers, having already negotiated form policies and have considered and internalized the risk of insurer default as a result, a private equity sponsor is better suited than a typical strategic buyer to quickly negotiate and finalize a R&W insurance proposal.

Focusing on Contentious Issues

In a sponsor-to-sponsor deal, both sides will have significant experience managing complex processes and determining the types of issues that deserve extra care and attention from their respective teams. While a strategic party's level of experience with M&A transactions varies, a sponsor will have an internal team specifically devoted to M&A transactions. This will allow the parties in a sponsor-to-sponsor sale to focus on important issues. Additionally, concepts that can often be contentious for non-financial sellers (e.g., equity commitment letters and limited recourse guarantees in place of full parent-company guarantees) are de rigueur and easily understood by sponsor sellers.

Importance of Management

Strategic buyers generally have a long term strategy for a target business, which may not include the current management team. In contrast, sponsor buyers often place a great deal of value in having the existing management team involved in the business going forward. The importance of management to a private equity sponsor can, however, be a double-edged sword: on the one hand, the potential for a greater return will be attractive to management; on the other hand, a new private equity sponsor may delay management's payout for another investment cycle. In a sponsor-to-sponsor deal, management will be familiar working with a private equity owner, but consideration should be given to the following:

- A buyer retaining the existing management team will still need to ensure interests are aligned, which usually involves giving existing management some "skin in the game." The buyer will need to carefully balance the need to incentivize management going forward with avoiding a situation where management is effectively "cashing out."
- Management will generally prefer to participate through the same type of instrument used by the private equity fund to capitalize an acquisition vehicle. Where an acquisition vehicle is funded with debt, however, it may not be efficient from a tax perspective for management to participate in the same manner. Instead, the buyer may consider offering management a tax-deferred rollover into preferred shares of the acquisition vehicle that pays dividends at a similar rate as the rate of interest on the debt used for initial funding.

- Existing management will generally be focused on the shareholders agreement and employment agreements. A private equity sponsor may consider exploring a potential re-investment by management on the next change of control transaction. In addition to helping the private equity sponsor market its exit in the future, this will demonstrate to the private equity buyer that management is confident there is room to grow the business.
- In a going private transaction, additional consideration must be given to whether management is receiving a “collateral benefit,” possibly giving rise to minority approval and valuation requirements under Canadian securities laws.

Conclusion

Sponsor-to-sponsor M&A transactions have unique dynamics that affect both speed and intensity. With a sophisticated private equity fund on either side, the parties and their advisers will know the important issues to focus on and be able to devote more time to the sale process generally. By leveraging M&A experience and knowledge of the target company and considering representation and warranty insurance as an effective way to limit tail liability, the parties in a sponsor-to-sponsor sale can ensure a smooth process resulting in a good deal for both sides.

Torys LLP has recently acted for Canadian sponsors in the following sponsor-to-sponsor transactions:

- Imperial Capital and OPTrust in a significant strategic investment by L Catterton in Dental Corporation of Canada Holdings Inc.;
- ONCAP in its acquisition, with the existing management team, of Laces Group Inc. from NOVACAP and others;
- Torquest Partners in its sale of Spinrite LP to Comvest Partners;
- A private equity firm in its sale of Canadian Addiction Treatment Centres to BayMark Health Services, a portfolio company of Webster Capital; and
- Husky Injection Molding Systems, Berkshire Partners and OMERS Private Equity in the sale of Husky to Platinum Equity Partners IV.