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PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 14: NORTHERN EXPOSURE: WHAT'S DRIVING PE DEALS IN CANADA?

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION

Todd: Hello and welcome to another episode of BDO's Private Equity PErspectives Podcast. I'm Todd Kinney, National Relationship Director with BDO's Private Equity Practice based here in New York City. I'm excited to have three guests with me today, all from BDO Canada, and they're going to talk about the latest trends and issues impacting Canadian deal-making. First, let me introduce Bruno Suppa, who is the Managing Partner for BDO Canada's Greater Toronto Area Group. A native of Toronto, Bruno has 15 years of experience in domestic and international business with a concentration on M&A. Bruno, thanks for joining us.

Bruno: Thank you.

Todd: Yeah. Good to have you. Next, I'll introduce Ryan Farkas. Ryan is a Corporate Finance Partner in BDO's Toronto office. Ryan has successfully closed transactions in various industries, including manufacturing, consumer business, construction, engineering, automotive, and information technology. Is there anything you don't do, Ryan, any sectors? You got them all there. Welcome to the show.

Ryan: Glad to be here.

Todd: And last but not least, we've got Jamie Windle who's a Partner and the National Service Line Leader for Transaction Services also in BDO's Toronto office. Jamie specializes in transaction support, buy-side and sell-side due diligence, and general deal advisory. And he certainly has significant experience in identifying and resolving critical deal issues. Jamie, thanks for joining us.

Jamie: Thank you, looking forward to it.

TOPICS DISCUSSED INCLUDE:

INTRODUCTORY QUESTIONS

Todd: Awesome. All right. Well, let's jump into it. Ryan, I'm going to start with you. It's a bit of a two-parter. First, what's your outlook on U.S. foreign investment into Canada? And second, the overall confidence around inbound capital flow given the dynamics around geopolitical uncertainty?

Ryan: No, it's a good question, Todd. I think it's really relevant to the time. The foreign direct investment within a Canadian context, I'd say over the last number of years, has largely been driven by capital into the oil patch in Western Canada. And naturally, over the last, call it, 36 months, that cycle's been down. And so, what I think we saw through 2016 and '17 was a bit of an exodus of capital, largely driven by money out of those sectors. 2018 was a bit of a bounce back. So, there was about $51 billion, which was a three-year high. And I think what we saw was, as you went through that down cycle within the oil patch, the government started putting in various incentives, and capital started to come into non-energy sectors, has really been the focus. And so, whether that's the emergence of technology and related sectors or manufacturing, I think the government's done a nice job. And geopolitically, Canada is viewed as a bit of a safe harbor for capital, both internationally as well as from the U.S., of course, which is our largest trading partner. And we certainly see a ton of that within the context of the deals that we do. I think on the diligence side, and around half of Jamie's practice is inbound U.S. capital, so tons of opportunity there. I think with respect to the geopolitical piece again, there's a bit of uncertainty from a free trade perspective. I mean, there's an agreement that's out there that is waiting to be ratified. And there's a bit of still-- we've been in an uncertain environment around that, and we probably continue to be, even though it's been negotiated, needs to still be able to get through the House within all three countries. So, I think there's a bit of a status quo that everybody-- I think from our perspective hasn't necessarily impacted deal-making up to this point.

Todd: All right. Terrific. That's some really good insight as we get deeper into things. Bruno, I'm going to kick it over to you. As you oversee a variety of business sectors, I'm wondering if you could share your thoughts with our listeners around some of the key industries for PE and Canada that you think are leading the global market?

Bruno: Yeah. Absolutely. And I'll build on a couple of foreign direct investment themes that Ryan was outlining. The Canadian government has organized itself around five superclusters. Really focused on tech innovation in these areas. I'll lay out the five of them. The first being digital technology. So, think virtual reality, augmented reality, data quantum computing, really to solve productivity, health, and sustainability challenges. The second is protein industries. So, this is an agricultural play focused on plant genomics and processing. The third being advanced manufacturing—and Ryan mentioned the manufacturing space. So, here we're really looking at developing next-gen manufacturing companies through new technologies like robotics and 3D printing. Fourth is AI-powered supply chains, and I'll come back to this one in just a second and the general theme of AI. And the final one being oceans. So, think marine renewable energies, fisheries, and aquaculture. The Canadian government is expecting to infuse about $2 billion into the economy via these sectors and grow GDP by about $50 billion over the next 10 years. So, from a private equity perspective, I think leaning in and understanding these sectors, there's a tremendous amount of opportunity. From an AI perspective, Canada is really world leading. AI institutions that we have in Canada—specifically the Alberta Machine Intelligence Institute in Edmonton, the Montreal Institute for Learning Algorithms, or MILA, in Montreal, and the Vector Institute in Toronto—we're conducting world-leading research in machine, and deep learning, and AI. Toronto, in particular, is home to Geoffrey Hinton, who's the godfather, effectively, of modern-day AI. He splits his time 50/50 between the University of Toronto and Google, where he leads AI for Google. You can trace a lot of his students and people who have worked under him and trained under him to the heads of the AI departments in the largest tech companies in the world. I think it's a little-known fact, but AI—really the government is positioning AI to be poised as Canada's biggest export. It's really a fantastic area that I think everyone should be paying attention to because we talk about disruption and this is at the bleeding edge of it. And if I can offer up a recommendation for a great book to read. There's a book that was written by Ajay Agrawal, Joshua Gans, and Avi Goldfarb. The book is called *Prediction Machines*, written from an economist's perspective. I think it's a fantastic book that really unpacks the world of AI and puts it into terms that I think most can understand.

TRADE & TARIFFS

Todd: Awesome. Might be the first time we've had someone plug a book on the podcast. Exciting stuff. Overall, it sounds like you're pretty bullish, Bruno, so I appreciate the commentary. Let's kind of broadly go to trade and tariffs. Ryan, we'll throw this one to you. Do you think that the continuing uncertainty around the US-Mexico-Canada agreement is having any impact on PE capital that's being deployed?

Ryan: Yeah. Thanks, Todd. I mean, as I mentioned a couple of minutes ago, I think that we've been in an environment of uncertainty for a few years now as NAFTA or the predecessor agreement that was approaching kind of the point where they knew it was going to be renegotiated. And we kind of remain there, despite the fact that a deal is, in principle, is in place; it still needs to be ratified by all three countries involved. Specifically, within Canada, I think a couple of things are going to create an issue in terms of where we stand currently. One is, there is some pretty punitive duties on imports into the U.S. with Canadian aluminum and steel, and that's hugely impactful within the Canadian context. The auto sector in Southwestern Ontario, which, again, as we approach a federal election in Canada in next fall, is going to become a contentious issue to ensure that all parties are kind of taking a stand that preserves kind of that political capital around that. And in drawing a hard line there, I think that, based on the context around the positions of the U.S. on the issue, is something that hasn't necessarily been resolution to.

I think that we remain in an area of uncertainty because it doesn't look like there's a high degree of certainty that it's going to be ratified. From a deal-making perspective, I think when you're in that extended period of uncertainty, eventually people still need to deploy capital. Unless the issue is so pervasive and kind of impacting that specific asset in a direct way, which we've seen occasionally if it was Chinese steel and that was kind of right at the forefront at that point, but outside of that more broadly, I think people are assessing the risks, taking them into context in terms of that specific investment, and then marching on in deploying the capital and taking advantage of the opportunity. Canada is open for business from a U.S. private equity perspective. And we continue to feel like it'll be that way moving forward.

Todd: Yep, certainly. I agree with you. Maybe, Jamie, I'll throw the China topic to you. Wondering if you would agree that, really, the ongoing issues around the China tariffs are having a real effect on cross-border deals with Canada.

Jamie: Yeah. Thanks, Todd. I think the interesting thing about this is that what we're seeing is—maybe I'll just back it up a little bit in terms of the actual deal. What we're seeing is a lot of increase in cross-border activity in U.S. companies redirecting their shipments of Chinese-originating goods or European-originating goods directly to the Canadian market, instead of transshipping maybe through the U.S., as was done historically. With the additional 25% or 10% additional tariffs on Chinese-originating goods and the threat of increased tariffs in the European market, it's making it more cost-effective now to directly ship to seller, set up business in Canada to source the Canadian market. All this to say that it's creating more uncertainty in the North American marketplace, and while there may be opportunities there in the future, I don't think we've seen yet that directly impact the volume of cross-border deals.

COFFEE BREAK WITH KEVIN KADEN OF BDO'S TRANSACTION ADVISORY SERVICES PRACTICE

Todd: Thanks. Well, certainly, Jamie and the points Ryan made, I think these are really just things we need to keep top of mind. And now, we're going to take a moment for our coffee break with Kevin Kaden, who is a Partner in BDO's Transaction Advisory Services Practice and he's based here in New York City. Let's hear Kevin's insights.

Kevin: Thanks, Todd. Cross-border M&A has become increasingly prevalent for the U.S. middle market and is a key component of many companies' strategic growth initiatives. Successfully executing cross-border M&A strategies offers many benefits, which include geographic footprint expansion, opening new distribution channels, and leveraging low-cost environments, to name a few. BDO's Transaction Advisory Services group is dedicated to assisting clients with various types of M&A-related due diligence services. In addition to the traditional financial due diligence, we provide tax, operational and IT due diligence. We also provide employee compensation/benefits due diligence and perform management background checks.

As a member firm of BDO International, our due diligence services extend beyond the U.S. Following the stabilization of the U.S./Canada exchange rates in 2015, we have experienced a significant increase in cross-border transactions with Canada. These, like most other cross-border engagements, present certain unique but subtle due diligence considerations. Beyond the more traditional financial risks of acquiring a domestic business, a cross-border transaction introduces additional risks related to currency, tax, culture and regulatory issues, to name a few..

Currency is often a significant consideration in cross-border transactions. Since 2016, this risk has been reduced as the U.S.-Canadian exchange rate has been relatively stable. Despite this stability, it is important to understand and evaluate a target entity on a "constant currency" basis. Floating exchange rates can often mask true economic performance of a business. A constant currency analysis eliminates the effects of fluctuations when assessing the performance of the Canadian target, or any foreign target for that matter. We've performed this analysis of risk for many foreign targets.

At first glance, tax laws may seem tedious. Getting blindsided by federal or provincial Canadian tax regulations and incentives can be costly and may even kill a deal. We believe an investor should be carefully advised of the impact of Canadian tax regulations and how to best address it through tax planning and structuring. To achieve this, it is important to have the "boots on the ground" knowledge of taxes, and this includes both Canadian and U.S. tax advisors. We work very closely with our BDO Canada tax team to address these risks.

When performing cross-border diligence it's important to understand and respect certain cultural challenges. Besides the obvious language challenge, it is not unusual to encounter unusual financial policies, procedures, and reporting, and the due diligence quickly gets off track without the appropriate level of local knowledge. In Canada, we have successfully addressed these challenges, specifically in the problems of Quebec by working closely with our Montreal-based team.

Last but not least, the U.S. Foreign Corrupt Practices Act of 1977 is the most widely enforced anti-corruption law. It is the first to hold both companies and individuals criminally and civilly responsible for corruption offenses committed abroad. It is very important to investigate the target's compliance with the U.S. Foreign Corrupt Practices Act and similar anti-bribery and anti-money laundering regulations. BDO brings the experts to the engagement to assess this risk and guide our clients. Working with our colleagues from BDO Canada, we have addressed these unique transaction risks and conducted successful due diligence engagements for many of our clients.

INDUSTRY OUTLOOK

Todd: Appreciate your thoughts, Kevin. Very interesting. And now, let's rejoin Ryan, Bruno, and Jamie from the BDO Canada team. I guess we'll broadly kind of go into industry outlook, and Bruno, I'll throw this one to you. What are some of the factors making the real estate market in Canada attractive to PE?

Bruno: Yeah. So real estate's interesting. I think it's sort of not an easy answer. It's relatively complex and tricky these days. We're definitely seeing the larger Canadian cities having been on a tear over the last five to 10 years from a real estate valuation perspective. So, we're in this really strange market where the insiders say that either it's a bubble or potentially could continue to skyrocket. We've experienced a lot of volatility in the capital markets in 2018. There's been some semblance of stability this year, but if we look at and dissect the markets across Canada, or at least the large ones, looking at Vancouver and Toronto, we're seeing a bit of growth slowdown. Still growing, but growth slowdown. And then looking east, and eyes to east, Montreal is really, really picking up. We talked a little bit about the Canadian-US-Mexico trade deal. It's allowed for some deferred foreign investment in real estate to come back into Canada, but chatting again with some real estate insiders, I hear that valuations and cap rates are expected to remain relatively stable. Canada is a safe haven. It's a good place to diversify investments, which is really a main driver, I think, of money looking for real estate within Canada. But foreign investors are-- we often see that they're reluctant to take on riskier construction projects and development projects, and they prefer already-built projects. They have a tough time finding projects where they can outbid domestic players, usually represented, from a capital perspective, by the large Canadian institutional pension funds, and we find that they become successful in acquiring property really mostly when they partner up and team up with Canadian investors. The PE world, in addition, there's been some focus and attention placed on the concept of the BlackRock model. I mean, it's interesting and amazing to see that BlackRock has a, I believe it's $136 billion real estate portfolio, and that's bigger than the market value of the largest S&P investment trust, which is unbelievable. You're seeing Carlyle, KKR spin up similar funds focused on real estate, and the stat that I read as well is that PE funds as a group have greater than $900 billion in real estate investments. So, I think that's another model that people are paying attention to that could be applicable.

ECONOMIC CONDITION

Todd: Good stuff. Some pretty eye-opening stats there. Appreciate that, Bruno. Ryan, maybe we'll turn to you for the economy. According to BDO's 2019 PE survey, 89% of the PE fund managers expect a prolonged downturn in the next two years. So, Ryan, the question is, do you see private equity firms in Canada preparing for an economic slowdown?

Ryan: Yeah. I think you'd have to be silly not to, in some ways, Todd. I think that, when we've been on kind of the bull run that we've been on over the last approaching a decade now, I think that most funds-- and that's when, I think, when we say "funds" in Canada, we're really talking about a pretty thin market in terms from a private equity perspective. And so, we're also-- I would build into that U.S. funds that are looking at assets in Canada because, from a deal perspective, that's a big chunk of the community that we're interacting with on a day-to-day basis. And that group, I think the way that they're approaching it right now is they're pricing it in. It doesn't mean they're not aggressively going after assets, and I think that one of the byproducts of that that we see is when it's an industry or a subsector that is more counter-cyclical or resilient through a cycle—and, I mean, I think what springs to mind is things like food, healthcare—we're actually seeing people kind of lean in and continue to be extremely aggressive in those sectors. But even things where you might see a little cyclicality, whether it's the auto sector, but people are just I think approaching deals with eyes wide open that when you've been moving in the direction for ten years, the graph doesn't go up forever.

Todd: Right. True. Bruno, care to chime in on the same topic?

Bruno: Yeah. From an economic standpoint or macro factor, I think there are some conflicting data points or anecdotes around what's kind of going on from a Canadian economic perspective. We see that GDP growth targets have come down to lower than inflationary levels. We see banks missing earnings targets, so that's sort of unique and potentially indicative of some downturn or correction. We see consumer debt at an all-time high, and that's validated by-- we have a large, north of the border, a large consumer insolvency practice. That group is busier than it has been in years. But contradicting that or counter to that is the fact that we have record level low unemployment. We've got a low-interest rate, high capital environment. So, it's really interesting to kind of see that the feeling or the sentiment certainly suggests that there's some correction looming in the horizon. The question as always is when and how big, right?

Todd: Right. No predictions? Ryan.

Ryan: Well, it's always dangerous to make predictions. But I think the last thing I'd say that I think is really that you need to think about whenever you're looking at a deal in Canada or an asset in Canada is it's very regional—there's a lot of differentiation regionally within the country. To give you a prime example, British Columbia, which is on the west coast, is the fastest growing province economically right now. Well, British Columbia is right beside Alberta—as we've talked about at the outset, based on the oil patch, and the energy sector—has been through a bit of a trough over the last number of years. And so, when you look at aggregated data—and Bruno mentioned kind of conflicting messages around kind of where we're going—a big chunk of what plays into that is really the uniqueness of the various regional economies. And so, you have BC, you have the energy sector in kind of the middle of the country, and then, of course, the kind of the economic hub up [in] Toronto, which—whether it's technology and other types of industries that are driving that. The story's not uniform from coast to coast. There's definitely some nuances depending on the region where the asset is.

Todd: Awesome. Well, you guys have certainly given our listeners some indicators and things to think about. Jamie, did you want to add anything to that?

Jamie: Yeah. I think the other important thing to think about, too, is the US-Canadian exchange rate, and that really drives a lot of business. A lot of Canadian businesses that are of any size do a significant amount of work in the U.S. and typically that involves invoicing and U.S. dollars and, to a lesser extent, probably purchasing in U.S. dollars. I would say where we are today is at probably historical more normal levels of foreign exchange rates. Four or five years ago, we were at a position where we were greater than the U.S. dollar in terms of what that value was, but that was, I would say, a very short period of time and probably a blip in what was and what is normal. So, it's a good boost to especially manufacturing firms that are doing business across the border, in terms of a boost to their earnings.

Todd: Great. Appreciate you adding that. Well, Jamie, I'd be remiss with not throwing out a deal diligence question since I have Canada's finest here with me today. Maybe you could tell our listeners what steps companies should take given increased focus on policies and governance during deal due diligence.

Jamie: Yeah. We're seeing in the marketplace a really heightened level of risk around maybe some taboo words but harassment, and accusations out in the marketplace. More and more we're seeing these things hit the news wires or social media. And what we're seeing is that companies or private equity—obviously, they don't want to see these things in their investments, whether it's in Canada, or anywhere else for that matter. So, there's a lot more diligence being done around reputational diligence on both the company, on the individual management teams that they're investing in and who they're banking on to really drive the growth in their business, so they're really digging deep and understanding sort of not just financial and tax and the operational aspects of the company itself, but a little of more background on who we're getting involved with. I would say there's a bit of a challenge there, though, because, especially in the mid-market, we don't necessarily have a corporate structure that has a lot of policies and procedures in place for these types of things to be collected and communicated outwards. So, I look at that as an opportunity in some ways for private equity who come into Canada or into the mid-market, I guess, more in general, to say there's an opportunity to improve the corporate structure improve the—not just corporate structure around reporting of sort of this level of detail, but more broadly across the organization to improve that, and that'll help drive growth in the future.

Todd: Great. Lots of good insight there for our listeners. This brings us to the end of another BDO Private Equity PErspectives podcast. Bruno, Jamie, and Ryan have to thank you so much for making the trip down in New York and joining the podcast today. Hopefully, it was time well spent. I know our listeners will certainly enjoy your insights.

All: Thanks, sir. Thanks for having us.

Todd: To our listeners, thanks so much for tuning in. If you haven't already, we'd love you to subscribe, rate, and leave a review of the show on iTunes. Until next time, this is BDO's Private Equity PErspectives.For more information on how BDO supports private equity sponsors, funds, and their portfolio companies with a full spectrum of accounting, tax, and advisory services, please visit us at [BDO.com](BDO.com).

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