The Private Equity Experience of Canadian Business.
The report is a detailed look at the buy-out equity experience of Canadian business from the perspective of managers of portfolio companies—the recipients of private equity investments. Private equity is a unique form of finance. Unlike public equity managers, private equity managers are often actively involved in the management of the companies in their investment portfolio. This is because they usually take a controlling ownership stake in their portfolio companies. This report explores the extent of that involvement, and its contributions and challenges.
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Executive Summary

The Private Equity Experience of Canadian Business

At a Glance

- Private equity is a form of long-term investment that seeks to add value through active management of portfolio companies.
- This report is based largely on interviews with 35 senior executives from portfolio companies.
- The report is organized by investment phases—from the rationale for private equity investment, to the investment phase and, lastly, to the exit.
- The private equity company is actively involved in the portfolio company, primarily through strategy, strategic decisions, and finance.
- Portfolio companies give private equity high scores in terms of overall experience. They recommend this form of investment to other companies.

It is fair to say that many Canadians are unfamiliar with private equity (PE). Yet many Canadians are, effectively, private equity investors. Institutional investors—such as the pension plans that manage Canadians’ pension savings—fund private equity.

The origins of Canada’s PE market date to the 1970s. Influenced to a degree by events taking place in the United States, a local fund management industry emerged in the 1980s. A landmark year was 1983, when Gerry Schwartz founded Onex. The PE fund management industry oversaw a capital pool that Thomson Reuters estimates to be $105.4 billion at the end of 2012. By far, the largest portion of this capital pool ($87.7 billion or 83 per cent of total assets) was managed by 172 Canadian firms active in buyout, mezzanine, and related PE segments of the market.

UNDERSTANDING ACTIVE MANAGEMENT

This report is largely based on structured interviews with 35 senior executives (34 chief executive officers and 1 chief financial officer) of companies that have worked with buy-out equity funds. This method allowed us to understand private equity active management from the perspective of portfolio company executives.

Private equity focuses on two key strategies: first, getting more out of existing capital and, second, realizing opportunities for above-average growth.

PE uses two methods. One is concentrated ownership

1 The private equity market numbers quoted in this report are drawn from the Thomson Reuters proprietary database of the Canadian private equity market.
and governance. A second is the pursuit of growth, in both mature and young companies. It is involved in the active management of portfolio companies.

The report is organized around stages of the private equity investment cycle, from the initial rationale for private equity investment to the exiting of the investment.

**WHY COMPANIES LOOK TO PRIVATE EQUITY**

Canada has a large pool of privately held, often family-owned, enterprises. The founder may have worked in the enterprise for many years and built the business through entrepreneurial effort. The owner will have often maintained substantial retained earnings in the company.

The long-term focus of buy-out equity appeals to many of these company owners. For these entrepreneurs, there is an almost visceral fear that a public equity listing will change the fundamental nature of the company. Private equity is more in keeping with the existing governance structure of privately held firms, albeit often replacing family members with professionals.

**SELECTING THE PRIVATE EQUITY FIRM**

Once owners are convinced of private equity’s financial, governance, and operational virtues, they go through a process of firm selection. A surprising finding is that, in most cases, senior executives who sought out private equity funds were largely unfamiliar with the funds, their investment mandates, and their operational styles. For this reason, managers of portfolio companies often employ brokers and/or advisors to help them with firm selection.

The portfolio company executives we interviewed stressed the need to find the right fit. That means understanding the investing style of the PE firm and its record.

**THE INVESTMENT PHASE**

The private equity firm’s influence operates through its concentrated ownership stake and through the board to senior managers. In about 30 per cent of our cases, the CEO was not a voting member of the board. In fact, in some cases, there was an “inner board” consisting of the PE owners and an “outer board” that involved other board members.

Respondents universally acknowledged that private equity made two main contributions: strategic focus and finance. Although private equity funds may have some operational expertise—for instance, some general partners (GPs) may have operational backgrounds—GPs tend to be financial and strategic experts. They come into deals with specific financial mandates from their funders (usually institutions and high-net-worth individuals). They then roll these mandates out to the companies in their portfolio.

The portfolio company executives stressed the need to find the right fit. That means understanding the investing style of the PE firm and its record.

Private equity firms generally do not get involved in the day-to-day operation of their portfolio companies. They tend to set the strategic direction, ensure the firm is adequately capitalized, and then allow the senior managers to get on with the achievement of agreed-upon goals.

**EXITING THE INVESTMENT**

All PE firms go into portfolio companies with an exit strategy. This strategy may involve a period of time (e.g., within five years) and/or performance criteria (e.g., improvement in enterprise value). The actual timing of the exit depends on something beyond the control of the PE firm and the portfolio company—the exit market. In over half of our cases, the PE firm had yet to exit the position. This was partly explained by a soft exit market—a lingering effect of the credit crisis. Those that had exited were much more likely
to have done so through strategic acquisitions or through sales to another PE firm than through an initial public offering.

THE FINAL ANALYSIS

In our sample, private equity scored extremely highly by those individuals who were best placed to evaluate it. They scored PE well over 4 out of 5 in terms of both performance and their willingness to recommend it to others. A subsample of our population realized over 100 per cent growth in earnings and 73 per cent growth in sales over the investment period.

We highlight three specific cases to illustrate the intricate workings of private equity investments. The cases are Calgary’s MEG Energy Corp.; Bluewave Energy Inc. of Dartmouth, Nova Scotia; and Knowlton Development Corporation of Knowlton, Quebec. These cases clearly show that private equity plays a critical role in helping companies to increase scale and to link into global value chains.

The report concludes with key lessons for prospective portfolio companies (in terms of linking up with private equity), private equity financiers, and government policy-makers.
Chapter 1

Introduction

**Chapter Summary**

- Many Canadians are aware of private equity only through political media coverage.
- Political media coverage presents a distorted view of private equity.
- Private equity plays an important role in the portfolios of Canada’s pension plans and as a financing option for Canadian companies.
- This report explores the private equity experience of Canadian businesses from the perspective of senior managers of companies that have received private equity investment (portfolio companies).

Consequently, private equity operates mostly out of the spotlight. Yet many Canadians are, effectively, private equity investors. Institutional investors—such as the pension plans that manage Canadians’ pension savings—fund private equity. Canadians are private equity investors through the Canada Pension Plan Investment Board (CPPIB). In 2011, CPPIB was a partner investor in one of the largest global private equity deals: the US$6.3-billion acquisition of Texas-based Kinetic Concepts Inc.²

Canadian businesses seek private equity capital. They do so to fund growth (both organic growth and new acquisitions) and to help entrepreneurs convert equity into cash, often to fund their own retirements. Private equity is often called upon to restructure failing businesses. In fact, some private equity funds do achieve their investment objectives through techniques like using high leverage or breaking up businesses where capital has been, in their view, misemployed. Pavel Savor of the University of Pennsylvania’s Wharton School says, “...sometimes the firms buy businesses that are bloated and then streamline the operations. Other times, it involves growing a business. It depends on the circumstances.”³

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2 Perkins and Kiladze, “Canadian Pension Firms Team.”
3 Hicks, *Romney’s Claims*. 

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Like all investments, private equity seeks to achieve a risk-adjusted return on capital. The broad class of private equity investment includes three types: buyout, which focuses on mature companies; venture capital, which funds young companies with high growth potential; and mezzanine, a form of subordinated debt (or preferred shares) that is often incorporated into buyout deals. Private equity focuses on two key strategies: first, getting more out of existing capital, and second, realizing opportunities for above-average growth. It does those things through two methods. One is concentrated ownership. A second is the pursuit of growth, in both mature and young companies.

In the 1970s, economists Michael Jensen and William Meckling put forth a withering critique of public equity governance. They pointed to a structural flaw: risk capital providers (the investors) are disengaged from the managers of their capital. Jensen and Meckling were skeptical that a board of directors’ governance is sufficiently strong to keep managers focused on shareholder value. In their view, this results in a lack of senior manager focus, bad investment projects, and the consequent destruction of shareholder value.

Private equity is a way to deal with this so-called agency problem. Private equity creates alignment between owners and managers. It provides privately held (often family-owned) companies with an opportunity to maintain a tight relationship between owners and managers while bringing new capital into the business. Many Canadian companies prefer to develop under private ownership before going public. The reason is that it allows the companies to focus on long-term development as opposed to the short-term returns that are often the priority of public equity shareholders.

In a recent Conference Board of Canada report on innovation finance, we point out that growth is innovation. Given the aging of the Canadian population and the associated modest growth prospects for the Canadian economy, it is virtually impossible for a company to grow unless it innovates. Canada has literally thousands of mature small businesses that have pushed up against their capacity to grow under current capitalization and corporate governance. These companies often need outside capital and expertise to grow. Private equity is an option for these companies. Canada also has thousands of “early stage” companies. These companies also need capital and managerial expertise to move from good ideas to commercial success. Private equity, in the form of venture capital, provides this capital and expertise.

Private equity deals are, by their nature, risky. One of the world’s leading experts on private equity, Josh Lerner, points to the highly variable returns associated with private equity over the years. Yet three other experts recently found that the “average U.S. buyout fund performance has exceeded that of public markets for most vintages for a long period of time. The out-performance versus the S&P 500 averages 20 per cent to 27 per cent over the life of the fund and more than 3 per cent per year.” Yet the authors also found that private equity, as an asset class, has underperformed public equity since 2000. This highly variable performance speaks to the risk associated with private equity. However, risk-taking is key in a dynamic economy and private equity makes an important contribution to risk capital.

Several public policy objectives are advanced through private equity investments. For instance, Canada faces a major challenge with productivity. Canada’s baby boomers are retiring in large numbers. Canada’s pay-as-you-go social programs depend on us getting more out of existing resources—Canada cannot rely on labour force growth. The efficient use of capital is part of the

5 Grant, Financing Innovation.
6 Lerner, Boulevard of Broken Dreams, 29.
7 Harris, Jenkinson, and Kaplan, “Private Equity Performance,” 1.
solution to Canada’s productivity challenge. Private equity is focused on that challenge—not as a social endeavour but in the natural course of business.

In its 2013 budget, the federal government made two separate commitments to venture capital—$60 million over five years to help incubator and accelerator organizations expand their services to entrepreneurs; and $100 million for the Business Development Bank of Canada to invest in graduates of these programs. This was in addition to an earlier $400-million commitment to venture capital. Provincial governments, too, have supported private equity for the same reasons.

ABOUT THIS REPORT

Despite this recent federal government commitment to venture capital, the asset class remains a mystery to many Canadians. Our intention in writing this report was to shed light on private equity investments in the Canadian context. We thought the best way to do this was to speak directly to senior executives whose companies had received buy-out equity funds. We thought they would be in an ideal position to comment on the motivations, benefits, opportunities, and challenges presented by this form of capital.

Our main research method involved structured interviews with 35 senior executives (34 chief executive officers and 1 chief financial officer) of companies that had worked with buy-out equity funds. We worked with leading Canadian private equity funds to identify suitable interview candidates. Between November 2012 and March 2013, The Conference Board of Canada conducted confidential executive interviews. We asked the interviewees to score various aspects of their private equity experience against performance criteria. This allowed us to tabulate findings for our entire sample. Yet each buy-out equity investment is unique, so we spent most of the interview time discussing aspects of the relationship between the private equity company and the portfolio company. We highlight these qualitative findings for the entire sample and detail three cases.

This report explores the nature of private equity investments, deal execution, relationship management during the investment period and, lastly, private equity investment exits. We address three key audiences:

1. **Canadian owners/managers of prospective portfolio companies.** Many companies could benefit from private equity funding but may not know how it works in practice.
2. **Private equity fund managers and their funders.** These people often understand the mechanics of deal execution but may lack knowledge of the day-to-day management factors that distinguish successful private equity investments.
3. **Policy-makers** are interested in growth, employment, productivity, and innovation. They need to understand how private equity investments advance these policy objectives.

OVERVIEW OF THE REPORT CHAPTERS

Chapter 2 reviews data on the Canadian private equity marketplace. This is followed by an analysis of our interview findings (Chapter 3). In Chapter 4, we highlight three exceptional cases of private equity investments: Calgary’s MEG Energy Corp.; Bluewave Energy of Dartmouth, Nova Scotia; and the Knowlton Development Corporation of Knowlton, Quebec. Chapter 5 concludes the report with some summary observations.

PRIVATE EQUITY TERMINOLOGY

Some common private equity terms are described defined on the following page.

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8 Government of Canada, Jobs, Growth and Long-Term Prosperity, 188.
**Private Equity**

Private equity is organized as a long-term (typically 7 to 10 years) investment fund. Investors (limited partners) commit to a fund for this time. They do so under conditions that define their commitment and involvement in aspects of fund operation (including redemptions). Private equity funds invest in tightly held equity or quasi-equity investments. Shares are not listed on public securities exchanges. PE investments often focus on existing private companies. In some cases, private equity is used to take public companies private.

PE investments are distinguished by their relatively high risk and long duration. To compensate for risk, PE investment professionals acquire specialized knowledge and develop practices intended to add value to portfolio companies. These are applied throughout the investment process—from target identification, to the negotiation of deals, to the management of portfolio companies and, ultimately, to the exit of the position. Key concepts include the following:

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<th>PORTFOLIO COMPANIES</th>
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<td>These are the recipients of private equity investments, also known as investees. A funder may make investments in multiple portfolio companies.</td>
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<th>LIMITED PARTNERS</th>
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<td>Limited partners (LPs) are the investors in a private equity fund. They are limited in their liability to the amount they invest in the fund. Limited partners are usually institutional investors (like pension plans) or high-net-worth investors.</td>
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<th>GENERAL PARTNERS</th>
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<td>General partners (GPs) are the managers of the private equity fund. They are the individuals who are actively involved in the portfolio companies. GPs often sit on the board of the portfolio company.</td>
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<th>BUYOUT</th>
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<td>Buyout investments refer to control-stake acquisitions of established companies in relatively mature sectors. Buyouts are frequently leveraged, meaning that a substantial portion of deals use debt to meet the costs of acquisitions. Buyout firms will often make changes to improve the competitiveness of recently acquired firms.</td>
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**GROWTH EQUITY**

Growth equity investments refer to minority investments in companies that are looking for capital to expand, to undertake acquisitions, or to reorganize operations. But the ultimate control is left in the hands of owners-managers and other shareholders. Like buyout firms, growth equity firms prefer mature businesses that have long histories of generating revenue and operating profits.

**DISTRESS AND SPECIAL SITUATIONS**

Distress or special situation investments involve the use of equity or debt in companies that are experiencing financial distress, but that are believed to be viable over the long term. These investments also involve companies that exhibit underlying value that can be unlocked. Company turnaround strategies vary widely.

**MEZZANINE**

Mezzanine investments are hybrids of debt and equity. Mezzanine often plays a role in buyout deals, occupying a middle layer below senior debt and above pure equity. Mezzanine also operates as a form of direct financing of established companies. In both cases, specialty lenders frequently have contracted rights to convert to an equity interest.

**VENTURE CAPITAL**

Venture capital investments refer to equity investments in new companies with high growth potential, many of which are found in emerging technology sectors. In contrast to the other categories of PE activity, venture firms target opportunities for taking companies from early to later stages of growth. Buyout and related PE firms tend to show interest in these companies and sectors once they have reached full maturity.

Source: Thomson Reuters.
Chapter 2

An Overview of Private Equity

Chapter Summary
- This chapter provides background on the development of Canada’s private equity market.
- Onex, which started in 1983, was an early pioneer in Canadian private equity.
- The Canadian industry expanded significantly during the 1990s.
- In 2009, the credit crisis severely affected private equity.
- Since 2009, the asset class has recovered strongly. There were 313 deals completed in 2012.

APPROACH TO VALUE CREATION

Buyout and related PE firms take stakes in companies that they believe have untapped growth potential or undervalued assets. With substantial ownership positions, general partners (GPs)—the managers of the fund—exercise influence over their investments and add value to companies over the length of holding periods. This process, which is central to the performance of PE investors (limited partners), is usually referred to as “active management.”

Active management has been practised in the North American PE market since at least the 1970s. With an increasingly competitive global economy, approaches that put well-informed and experienced GPs in close working relationships with company managers—especially in the early days of investing—have continued to gain currency.

Active management typically begins prior to acquisition. The management consulting firm McKinsey and Company found that top-performing transactions tend to involve an accumulation of proprietary business data by PE firms in periods of due diligence. As deals are closed and companies enter portfolios, a range of techniques are then deployed. The techniques include introducing performance incentives to ensure alignment; developing value creation strategies; setting a new business plan and associated execution milestones; and recruiting professional managers.

As active managers, PE firms are in a position to make improvements to portfolio companies. Through “buy-and-build” strategies, companies might expand their market share by making add-on acquisitions of other businesses and business assets. The companies might

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also increase their competitiveness by divesting themselves of non-core operations, diversifying product lines, or establishing new sector partnerships.

Through active management, PE firms also encourage their portfolio companies to improve profit margins by rendering their operations more cost efficient (e.g., by emphasizing lean production methods) or by raising levels of productivity. The introduction of organizational changes, such as new technologies, performance incentives, and value metrics, is among the ways these objectives are reached.

Finally, active management by PE firms can help put portfolio companies on a more solid financial footing. Companies often gain access to new sources of external financing when they receive the backing of PE firms. In the process, internal capital structures might be rebalanced and financial systems made to operate more effectively.

The nature, focus, and application of active management practices depends on the PE firms involved, the extent of their influence and governance in portfolio companies, and the goals and requirements of the portfolio companies themselves. Regardless, a growing body of research indicates that of the various drivers that are believed to contribute to PE-backed performance, improvements made by PE firms to companies (in partnership with owners-managers) are the most important.²

Research done under the auspices of the World Economic Forum (WEF) has helped advance understanding of the role of active management in PE-backed companies. For example, among the findings in Globalization of Alternative Investments: The Global Economic Impact of Private Equity Report 2009, PE-backed companies were found to be “significantly better managed across a wide range of management practices than government-, family-, and privately owned firms.” This finding was linked with PE-backed companies having “strong operational management practices.” The WEF report also concluded that these companies showed relatively higher productivity growth.³

The rapid growth of the domestic market and fund industry over the past few years strongly suggests that the active management practices of buyout and related PE firms have reached an ever-larger universe of Canadian-based businesses and sectors. This trend is likely to continue.

**CANADA’S PRIVATE EQUITY MARKET EVOLUTION**

Although buyout and related private equity investment has been a part of North America’s financial system for a very long time, today’s market did not really take shape until the 1970s and 1980s. Some of the world’s best-known buyout firms, such as Blackstone Group, Carlyle Group, and Kohlberg Kravis Roberts, were founded in this period. It was in the 1980s that American PE firms increasingly found backers in the institutional investor community. This led to the creation of the limited partnership (LP) style of fund organization, with institutions acting as LP funders and professional investment managers as general partners.

The origins of Canada’s PE market also lie in the 1970s and 1980s. Influenced to a degree by events taking place in the United States, a local fund management industry emerged in the latter decade. A landmark year was 1983, when Gerry Schwartz founded Onex. The following year, Onex made a $220-million acquisition

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of the Canadian subsidiary of American Can Co. At the
time, this was the largest buyout deal in the history of the
domestic market.

Canada’s emerging market and fund industry began to
gain breadth and depth in the 1990s. In that decade, a
number of today’s leading investor groups were either
founded or were actively building on the achievements
of earlier formative years. Many of these firms were,
and remain, stalwarts of mid-market deal making,
which continues to account for most PE investment
in Canada.

A major factor in the emergence of the Canadian
fund industry during this time was the growing inter-
est shown by institutional investors in PE and other
alternative asset investment vehicles. Canada’s large
public pension fund organizations played an especially
catalytic role in the launch of limited partnerships man-
aged by investment professionals in Canadian private-
independent firms.

**Institutional funds have, along with the largest
partnerships, been essential to the Canadian industry’s
capacity to undertake large-cap transactions.**

In fact, the years immediately before and after 2000
saw an unprecedented proliferation of first-time institu-
tionally backed buyout, mezzanine, and other PE part-
nerships—many of them managed by newly assembled
GP teams.

A related trend involved carving out new private firms
from Canadian corporations, which up until then had
sponsored internally managed PE funds. For example,
EdgeStone Capital Partners was spun out of NB Capital
in 2002 with an array of PE funds, including EdgeStone
Capital Equity Fund II LP (2003). Birch Hill Equity
Partners emerged from TD Capital in 2005 with the
launch of Birch Hill Equity Partners III LP. And
Fulcrum Capital Partners emerged from HSBC Capital
(Canada) in 2011 with the launch of Fulcrum Capital
Partners Fund IV LP.

In subsequent years, more new fund managers and
funds were established, contributing to a large influx
capital into the Canadian industry between 2003 and
2012. (See Chart 1.) Over this 10-year span, new capital
committed to buyout, mezzanine, and other PE funds
brought tens of billions of dollars into the market for
investment purposes.

Canadian institutional investors typically entered the
PE market in the 1990s as LPs. However, within a few
years, some of the largest institutions adjusted their
strategies to give more emphasis to direct deal activity.
For this reason, Canada’s fund industry is unique in
reflecting a sizable group of institutional in-house—
or captive—funds. The Caisse de dépôt et placement
du Québec’s PE group, CPPIB Private Investments,
Manulife Capital, OMERS Private Equity, and
Teachers’ Private Capital were pioneers of this activity.

Institutional funds have, along with the largest part-
nerships, been essential to the Canadian industry’s cap-
acity to undertake large-cap transactions. The buyout
of Toronto-based Shoppers Drug Mart Ltd. in 2000
for $2.6 billion was a seminal event in this regard. The
deal was done by Teachers’ Private Capital in syndica-
tion with Bain Capital, Charlesbank Capital Partners,
DJI Merchant Banking Partners, and Kohlberg Kravis
Roberts. The Shoppers acquisition was indicative of
another major trend at this time—increased levels of
investment activity in Canada by U.S.-based, European,
and other foreign PE funds. Thomson Reuters’ data suggest that prior to the early 2000s, foreign participation in the domestic market was comparatively limited.4

Given the record number of partnership closings and other fund formations in the late 1990s and early 2000s, Canada’s PE fund management industry was increasingly well positioned to seek out deals at home and in international markets. In the Canadian market, this activity contributed to buyouts and other PE deals of unparalleled size and scope.

Coinciding with the North American buyout boom, levels of disclosed deals and disbursements involving Canadian-based companies rose steadily between 2003 and 2007. Investment reached a peak in the latter year, when a total of 247 transactions valued at $26.3 billion were reported.5

This five-year period in the Canadian market was characterized by groundbreaking mega-transactions, including the:

- $1.1-billion acquisition of Dollarama (2004)
- $2-billion acquisition of SuperPages Canada (2004)
- $3.1-billion acquisition of Masonite (2005)
- $1.9-billion acquisition of EnCana Gas Storage (2006)
- $1.1-billion acquisition of Hudson’s Bay Company (2006)
- $2.8-billion acquisition of Intrawest (2006)
- $2.3-billion acquisition of Alliance Atlantis (2007)
- $1.3-billion acquisition of Axcan Pharma (2007)
- $3.5-billion acquisition of Tervita (2007)6

The global financial crisis of 2008 brought this growth cycle to a close. Deal activity in the Canadian market dropped sharply in 2009. (See Table 1.) However, with moderate improvement in the economic environment, the market bounced back. Over the period 2010–12, buyout and related PE investment in Canada recovered, eventually showing even higher deal volumes than over 2003–07, albeit with fewer large transactions.

### RECENT TRENDS

The PE fund management industry in Canada (including buyout and related PE funds, as well as venture capital funds) oversaw a capital pool that Thomson Reuters estimated to be $105.4 billion at end of 2012.7

By far the largest portion of this capital pool ($87.7 billion or 83 per cent of total assets) was managed by 172 Canadian firms active in buyout, mezzanine, and related PE segments of the market.8 Many of these firms are focused on acquiring majority or significant minority equity stakes in businesses.

Last year, the largest share of PE capital was managed by private–independent firms. (See Chart 2.) Most of these firms raise limited partnerships that invest directly in companies, holding them in portfolios for up to five

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4 Thomson Reuters proprietary data.
5 Ibid.
6 Ibid.
7 Ibid.
8 Active Canadian PE firms are defined here as firms that are actively investing in companies and/or actively managing existing portfolio assets.
Partnerships are backed by a diverse range of LPs that include banks, corporations, endowments, family offices, high-net-worth individuals, pension funds, and other institutional investors. Private firms oversaw an estimated $51.5 billion in assets in 2012.

The second-largest share was held by institutional captive funds that make direct investments and co-investments in companies. In many respects, the structure, operations, and investment practices of institutional funds replicate those of private funds. Institutional funds focused primarily on buyout and related PE investments managed an estimated $31.7 billion in capital managed in 2012.\(^9\)

Other active fund types included corporate funds (in-house funds of major Canadian financial and industrial corporations), government funds, and retail funds. Taken together, these funds accounted for an estimated $4.5 billion of buyout and related PE assets under management in 2012.

Canada’s PE market saw expansion in deals and disbursements in 2012. Disclosed dollar values totaled $11.6 billion in 2012, up slightly from the year before. However, this was still significantly less than the peak levels reached during the North American buyout boom. On the other hand, the number of control-stake buyouts, minority investments, and other PE transactions—which totalled 313 in 2012—was the highest to date.\(^{10}\)

Top deals done in 2012 included the:
- $1.1-billion acquisition of Garda World Security by Apax Partners and other investors;
- $1.1-billion acquisition of Q9 Networks by a consortium that included Madison Dearborn Partners, Providence Equity Partners, and Teachers’ Private Capital;
- $1-billion investment in CGI Group by the Caisse de dépôt et placement du Québec;
- $500-million investment in Osum Oil Sands by a syndicate that included Blackstone Capital Partners, KERN Partners, and Warburg Pincus;
- $436-million restructuring buyout of Arctic Glacier Income Fund by H.I.G. Capital.\(^{11}\)

In 2012, the most dollar-intensive transactions (over $500 million) took close to one-third of total disclosed values reported in the domestic market. Other large transactions (between $100 million and $500 million) captured 44 per cent of the value. Deals of over $100 million represented 10 per cent of the total number reported last year. Transactions with disclosed values that were below this threshold comprised close to two-thirds of the aggregate number in 2012, although they accounted for less than one-quarter of the dollar flows. (See Table 2.)

Longer term statistical analyses show roughly the same results. This confirms that the Canadian market is primarily mid-market. In the earliest years of buyout and related PE investment in Canada and the United States, most activity tended to be concentrated in established businesses in manufacturing, whole-distribution, services, and affiliated sectors. Thomson Reuters’ data show that more recent deal-making has become increasingly diversified by sector.

\(^9\) This estimate of institutional fund capital under management excludes LP activity (i.e., commitments to private funds).

\(^{10}\) Thomson Reuters, *Canada’s Buyout and Private Equity Market*.

\(^{11}\) Ibid.
This trend was evident in Canada’s PE market in 2012. The manufacturing and processing sectors accounted for the largest share of total transactions (15 per cent). This was followed closely by activity in mining (14 per cent), oil and gas (14 per cent), and retail (12 per cent). When measured by dollars invested, the energy sector dominated investments in 2012, obtaining 28 per cent of the total amount. This was followed by information and media (24 per cent), transportation (10 per cent), financial services (7 per cent), and retail (7 per cent). 12

<table>
<thead>
<tr>
<th>Size</th>
<th>Deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $1 billion</td>
<td>3</td>
</tr>
<tr>
<td>$500 million to less than $1 billion</td>
<td>1</td>
</tr>
<tr>
<td>$100 million to less than $500 million</td>
<td>27</td>
</tr>
<tr>
<td>$25 million to less than $100 million</td>
<td>35</td>
</tr>
<tr>
<td>$25 million or more</td>
<td>168</td>
</tr>
<tr>
<td>Undisclosed deal value</td>
<td>79</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters.

Diversification of investment by sector has been accompanied by a much wider distribution of investment by Canadian province and region. This trend has been strongly influenced by growth in the Canadian PE fund industry, which has included the founding of locally based fund managers and funds in regional markets.

In 2012, the largest number of buyout and related PE deals done in Canada were in Quebec, which accounted for 36 per cent of the total number, followed by Ontario (25 per cent), Alberta (17 per cent) and British Columbia (15 per cent). As Quebec was home to some of the most dollar-intensive transactions last year, it also secured the largest share of disclosed values (38 per cent). This was followed by Alberta (27 per cent) and Ontario (20 per cent). In 2011, it was Ontario that led these key market indicators. 13

Despite the growing influence of cross-border investment over the past decade, most deal-making in Canada continues to be driven by locally based firms. In 2012, local investor groups accounted for 69 per cent of total transactions, with U.S-based, European, and other foreign PE funds accounting for the balance.

12 Thomson Reuters, Canada’s Buyout and Private Equity Market.

13 Thomson Reuters, Canada’s Buyout and Private Equity Market.
Chapter 3

Survey Findings

Chapter Summary

- This chapter reports on the key findings of our interviews with 35 senior executives of portfolio companies.
- The chapter is organized by the chronology of private equity deals.
- We found that most portfolio company managers were unfamiliar with private equity before the investment.
- Private equity makes key contributions to corporate strategy and finance. The idea is to get the business on the right strategic path, ensure optimal capitalization, and leave execution to senior management.
- The working relationship with the portfolio company is critically important to the success of private equity deals.

To be sure, we depended on the cooperation of private equity funds to pave the way for our interviews. We did not randomly select the participants and we focused on a limited number (35) of cases. (See Table 3.) The selection and engagement method means that we cannot generalize our findings to all private equity deals. Our interest was to understand the detailed functioning of the private equity investments. In effect, we decided to sacrifice statistical inference for a detailed understanding of the investment process.

ABOUT THE RESPONDENTS

The vast majority of Canadian companies are privately held. Canada has about a million operating companies and yet Canada’s two main public equity exchanges, the TSX and TSX-V, together have only around 4,000 listings. A clear advantage of private holding is commercial confidentiality. Therefore, we assured our respondents that we would protect their confidentiality. As such, we do not mention specific companies by name. We refer to the businesses, in general terms, and present the quantitative data in aggregated forms.

We sought a good distribution of deals in terms of size, geography, and sector. As seen in Table 3, we were largely successful in this goal. All the deals...
that we considered came to us through 15 Canadian private equity funds (see “Lead contact” in Table 4). Nonetheless, these deals involved investments by 42 funds that provided either equity or mezzanine capital.

**PHASES OF PRIVATE EQUITY INVESTMENTS**

From the perspective of the portfolio company managers, there are three key phases in private equity, as shown in Exhibit 1:

1. **Pre-investment**: The company needs capital and considers private equity.
2. **Investment**: The company executes a deal with a private equity firm and works with the firm to achieve mutually agreed goals.
3. **Exit**: The private equity company sells its stake in the company and both parties assess the success of the relationship.

We organized our findings by these phases—a sort of relationship chronology. The portfolio company starts with a finance need and considers a variety of options to meet those needs. The company then decides to go with private equity. Next, it goes through a process of selecting a firm and negotiates the terms of the relationship.

Subsequently, the portfolio company and the private equity fund work together. Some aspects of the relationship are contracted, but these contracts cannot account for every managerial challenge. Dealing with these challenges as they arise is how the parties truly learn whether they have a successful working relationship. Private equity companies make commitments to their funders (which are usually institutions and high-net-worth individuals) to achieve specific investment goals. Based on the commitments made to their funders, private equity firms decide when to exit their investment. The actual exit may take place through a number of means, most notably through a strategic acquisition by another firm or an initial public offering (IPO).
THE PRE-INVESTMENT PHASE

THE NEED FOR CAPITAL

Although private equity firms sometimes approach prospective portfolio companies, it is more common for company owners to approach private equity companies when they need capital. This is just a matter of odds—the number of prospective portfolio companies greatly outnumbers the number of private equity funds in Canada. According to Thomson Reuters, 33 venture capital funds and 23 buyout and mezzanine funds raised money in 2012. Each fund may have multiple portfolio companies, but private equity holdings are a small fraction of total businesses in Canada.

Our sample provides a good overview of the different motivations of existing owners. Canada has a large pool of privately held, often family-owned, enterprises. The founder may have worked in the enterprise for many years and built the business through entrepreneurial effort. Often the owner will have maintained substantial retained earnings in the company.

As the entrepreneurial founder approaches retirement, he or she is faced with the challenge of converting owner’s equity into cash, often to support retirement. Private equity is one way to achieve this. For the majority of our sample, monetizing equity was the main motivation driving the search for capital. (See Table 5.) As an Edmonton-based entrepreneur put it: “I wanted to take some chips off the table and enjoy the fruits of my years of effort.”

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The remainder of the sample split more or less equally between two motivations. First, some companies simply push up against the limits of their internal capacity to fund growth. They need outside capital to take their company to the next stage. The most outstanding example of a rapidly growing firm from our sample is MEG Energy Corp., which we feature in Chapter 4.

Second, some companies need capital to survive. For numerous reasons, companies become financially distressed. They need a combination of capital and managerial expertise to continue to exist. Private equity is one of the few forms of capital that provides this combination of money and expertise. Hence, financially stressed companies may need private equity to reverse their fate.

**PRIVATE EQUITY ADVANTAGES**

Company owners often have an emotional attachment to their company and an enduring interest in its continuation, even under new owners. One of the key advantages of private equity is that it is, by its nature, a long-term investment. Although there are some quick turnaround private equity firms, most firms invest over multi-year periods. The typical private equity investor stays invested for a period of 5 years but some hold their positions for as many as 10 years. During that period, private equity investors focus on improving shareholder value.

The long-term focus of private equity appeals to many existing company owners. For these entrepreneurs, there is an almost visceral fear that a public equity listing will change the fundamental nature of the company. Private equity is more in keeping with the existing governance structure of privately held firms, albeit often replacing family members with professionals.

In other instances, a company may simply not be in a position to do an initial public offering (IPO). Some companies are not large enough to do one. Others are too immature to appeal to public equity investors. Finally, some companies are in a development phase where they have no earnings. Public equity investors may have difficulty valuing these companies because the potential value of their assets—such as intellectual property, oil and gas, or drilling leases—may be hard to evaluate.

**Table 5**

<table>
<thead>
<tr>
<th>Why Were You Looking for an Investor?</th>
<th>(number of responses; n = 35)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner wanted to sell whole interest</td>
<td>13</td>
</tr>
<tr>
<td>Owner wanted to sell partial interest</td>
<td>8</td>
</tr>
<tr>
<td>Needed investment to grow</td>
<td>7</td>
</tr>
<tr>
<td>Needed investment to survive</td>
<td>5</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada.

The Interviewees on Public Equity

“We never considered going public because we did not want to manage the company on a short-term basis. We wanted to operate the company, not do investor relations. The role of CEO in a public company is investor relations—not running the company.”

“The public board required much more infrastructure in terms of committee preparation. As CEO of a public company, I had to spend about 10 per cent of my time doing things that do not add value from a customer perspective, just because we were a public company.”

Although some of these companies might be in a position to do an IPO, they would end up doing so at prices that, in their view, would not correctly value the company. For example, Calgary’s MEG Energy Corp. had its first private equity investment in 2004 and yet did not have any earnings until 2009. An IPO is not a practical option for these kinds of companies. A company may eventually do an IPO, but the private equity investment allows them to position themselves to get the most out of an IPO. A senior manager of a human resources management company told us that private equity “allows you to crawl, walk, and then run into public markets.”
Taking a long view of a company is more than a cliché—it actually affects a company’s governance and operations on a day-to-day basis. Companies may deploy capital to maximize short-term or long-term earnings. Those that favour the former are more likely to spend capital on optimizing *within the company’s current form*. Those that favour the latter approach are more likely to want to *transform the company* and position it for growth.

With public equity comes public governance. That entails considerable effort in communicating with a diffuse and constantly shifting shareholder base. It also involves a more public disclosure of a company’s strategies and performance. This disclosure may actually undermine a company’s competitive position because the company effectively becomes an open book to its rivals. This is a key barrier to companies going public.

Yet private equity is not for everyone. There is an extremely tight relationship between the owners and senior managers. Some CEOs of publicly listed companies actually prefer a diffuse shareholder base, so that they can be left alone to do their job. With private equity comes professional and focused ownership, which may not be to every CEO’s liking. Still, some owners are looking for help and they recognize that private equity investment comes with help.

**SELECTING THE PRIVATE EQUITY FIRM**

When convinced of private equity’s financial, governance, and operational virtues, an owner goes through a process of firm selection. A surprising finding was that, in most cases, senior executives who sought out private equity funds were largely unfamiliar with the funds, their investment mandates, and their operational styles. For this reason, managers of portfolio companies often employ brokers and/or advisors to help them with firm selection. (See Table 6.) In other instances, they make their selection based on the personal advice of business associates who have directly experienced private equity.

<table>
<thead>
<tr>
<th>Table 6</th>
<th>What Process Did You Use to Select the Private Equity Firm?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(number of responses; n = 35)</td>
</tr>
<tr>
<td><strong>Used a broker</strong></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>17</td>
</tr>
<tr>
<td>No</td>
<td>18</td>
</tr>
<tr>
<td><strong>Type of search</strong></td>
<td></td>
</tr>
<tr>
<td>Large scale</td>
<td>10</td>
</tr>
<tr>
<td>Targeted</td>
<td>20</td>
</tr>
<tr>
<td>Approached by private equity</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada.

This means that there is considerable upfront effort in vetting private equity partners. Private equity funds have well-established and systematic due diligence processes. Yet for the prospective portfolio company, this sort of due diligence is a new, and sometimes a strange, process. Nonetheless, portfolio company due diligence is equally critical to the eventual success of the investment.

The portfolio company executives we interviewed stressed the need to find the right fit. That means understanding the investing style of the PE firm and its record of accomplishment. It is important to evaluate the GPs of the PE firm. Moreover, executives suggested that prospective portfolio companies evaluate the capabilities of the firm and determine whether the firm has the resources to dedicate to the portfolio company. In the words of one interviewee, “You want to avoid a situation where the PE firm is ‘stretched.’” Moreover, some
PE firms have a reputation for “slash and burn” tactics, while others are “growers.” To be sure, there are “cannibalistic” firms. But it is the responsibility of the board of directors to find a firm that aligns with the strategic direction of the company.

In public equity, the front-end part of the investment process may actually be less involved, especially for firms that are good listing candidates. In private equity, the due diligence process is lengthy and costly, both for the private equity firm and the portfolio company. But, in the process of due diligence, both sides take time to get on the same strategic page. (Chart 3 presents interviewees’ observations on the relative advantages of private versus public equity.)

In this sense, the due diligence is part of the process of adding value to the company. Due diligence does not guarantee success, but it greatly improves the odds of success. In public equity, the costs are back-end loaded because there are higher governance costs in the form of disclosure and investor relations. One interviewee with public equity experience told us that it cost about $1 million in legal fees to maintain a public listing. Another interviewee reckoned that the CEO would probably spend about 15 per cent of his or her time on corporate governance. In private equity, the front-end costs are higher but the ongoing governance costs are lower. This helps the parties focus their efforts on running the business.

Private equity definitely has a long-term strategic focus, but this should not be confused with a lack of short-term focus. The short-term focus is on operational targets that are part of the long-term strategic plan. In a public company, the short-term focus tends to be on financial results because the public shareholders have much less influence on or knowledge of the operational realities of the firm. This explains why public companies are much more likely to focus on short-term financial metrics.

**THE INVESTMENT PHASE**

We considered a range of deal sizes: from small, mid-market, large, and mega deals. The average deal size was $380 million for the 18 interviewees who revealed this information. But that average is highly skewed by a few large deals. The deal sizes ranged from as little as $1.2 million to $3 billion. (See Table 7.)
In virtually all the cases, the private equity firm acquired sufficient equity (usually over 50 per cent) to give them ownership control. (See Chart 4.) The average equity stake for our sample was 78 per cent. In 75 per cent of our sample, the private equity company was the lone private equity investor. We found that complicated ownership structures actually undermined one of the main advantages of private equity—focus and clear direction. Several of our interviewees suggested that having one or two PE investors is optimal.

The investment phase is where the PE funder and portfolio company really discover what it is like to work with each other. It is very much akin to a marital relationship. Although partners may be able to determine some level of suitability during courtship, it is not until they are married that they truly discover whether they have a good working relationship that stands the test of time. In fact, one of our interviewees put it this way: “What happens when the marriage turns sour? This was one of my key questions. How do they treat their partner? I was looking for trust and respect.”

**GOVERNANCE**

The private equity firms use a strong equity position to assign board of directors’ seats to themselves and associates. This gives them the authority to run the company as they see fit. But it is the use of that authority that distinguishes successful PE deals from unsuccessful ones. It is common for the parties to sign shareholder agreements with lock-in clauses that keep shareholders and managers together during the investment period.

The private equity firm’s influence on senior managers operates through its concentrated ownership stake and through the board. We were interested in how private equity structured the board for our sample of portfolio companies. On the majority of boards, the CEO had a seat. About 30 per cent of the time, the CEO was not a voting member of the board. (This is something that CEOs need to consider when negotiating the terms of private equity investments.) In fact, in some cases, there was an “inner board” consisting of the PE owners and an “outer board” that involved other board members. It was most common for boards to meet quarterly.

**The Interviewees on Concentrated Ownership**

“With multiple PE partners, it can be difficult to get them all on the same page. It was a rocky road in 2009 during the economic downturn, as it was very difficult to get multiple PE partners to agree on a direction. There can be a deadlock in decision-making. Distributed control makes operating difficult and sometimes dysfunctional.”

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**Chart 4**

*Equity Stake (Per Cent of Portfolio Company Equity) and Number of Investing Partners*

*number of portfolio company respondents; n = 35*

<table>
<thead>
<tr>
<th>Equity Share</th>
<th>Investing Partners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 50</td>
<td>0</td>
</tr>
<tr>
<td>50–59</td>
<td>5</td>
</tr>
<tr>
<td>60–69</td>
<td>10</td>
</tr>
<tr>
<td>70–79</td>
<td>15</td>
</tr>
<tr>
<td>80–89</td>
<td>20</td>
</tr>
<tr>
<td>90–100</td>
<td>25</td>
</tr>
</tbody>
</table>

Note: Investing partners include both equity and mezzanine firms. Source: The Conference Board of Canada.
The number of voting members ranged from 3 to 12, with an average board having 6 members. This is considerably smaller than a typical public company board of directors. According to our interviewees, the combination of a relatively small size and representation from a concentrated shareholder base resulted in more efficient and effective board decision-making. It was much more likely for decisions to be made consensually, and few formal resolutions and votes were required.

Although the interviewees were generally appreciative of this streamlined governance, a few were critical about the way that PE GPs represented themselves on boards. Some board members were seen as “minders” of PE investments and did not have a lot to add in strategic discussions. Clearly, any board is only as good as its members in terms of competency and engagement. Some PE firms clearly were not as engaged and would send junior GPs to sit on the boards.

Given that the investments come with a pre-set time limit, PE partners become less tolerant of operational failures over time.

PE board members tend to be demanding on operational performance. However, they are tolerant of weak, short-term financial performance if they believe operational changes will ultimately result in better financial results over the longer term. But, given that the investments come with a pre-set time limit, PE partners become less tolerant of operational failures over time.

**MANAGEMENT**

One of the key success factors for a good relationship is for the parties to focus on what they are good at and leave their partner to concentrate on their own area of expertise. Problems inevitably arise when there are overlaps in roles and responsibilities. Yet, when these roles and responsibilities are clearly assigned, things tend to go smoothly. One interviewee told us, “You need to make sure that the PE partner trusts management or else they will start managing the company.”

We asked our sample about private equity’s contribution to their success. Respondents universally acknowledged that private equity made two main contributions: strategic focus and finance. Although private equity funds may have some operational expertise (for instance, some GPs may have operational backgrounds), GPs tend to be financial experts. They come into deals with specific financial mandates from their funders (usually institutions and high-net-worth individuals). They then roll these mandates out to the companies in their portfolio.

The rollout starts with being very clear on the portfolio company’s financial goals. Often, a family-owned company loses sight of its goals. Public companies may have a hard time balancing the needs of a diffuse shareholder base. However, in private equity, it is very clear...
from the outset what the PE investor is trying to achieve and how it expects the company to achieve it. Many senior managers of portfolio companies whom we interviewed found this clarity of purpose to be a valuable contribution by private equity. This is seen in the high scores that they assigned to the strategic contribution of private equity. (See Chart 5.)

As this always involves some financial engineering, financing also ranks very high in terms of private equity’s contribution. Sometimes the financial engineering can become a tad complex and, in one case, an interviewee noted that this was actually a barrier to growth. Nevertheless, for the most part, portfolio companies are looking to private equity to raise money for growth and/or survival and the private equity companies do not disappoint.

In private equity, it is very clear from the outset what the PE investor is trying to achieve and how it expects the company to achieve it.

The only time financial issues became a source of contention was with respect to the management fees charged by private equity funds. In a few instances, management fees were not made clear to the portfolio company. Thus, those fees had to be accommodated after the fact, which would then put stress on the portfolio company’s income statement. Other respondents acknowledged that fees were in place; some thought they provided good value.

Indeed, it is not just the fact that private equity provides the initial influx of equity and debt capital to the portfolio company. Repeatedly, we heard that private equity financial connections were key to funding growth throughout the investment period. Although firms may grow organically under private equity guidance, they are also likely to grow through mergers and acquisitions (M&As). Growth through M&As is complicated and involves a lot of fundraising, due diligence, contracts, and the like. Since private equity, by its nature, is in the acquisition business, its companies are highly skilled at executing deals. This makes it much easier for a portfolio company to grow through M&As than if it, for instance, tried to do so as a public company. Through private equity, the portfolio company effectively has this expertise “in house,” whereas public companies have to hire the expertise in the form of investment bankers and lawyers.

From an acquisition perspective, the other advantage of private equity is that PE firms are very good at timing the execution of acquisitions. Their longer time horizon means that they can buy low and sell high. The company does not get caught up in market mania and can pick its spots for executing aspects of its plan in a counter-cyclical way.

The private equity firms that we studied do not generally get involved in the day-to-day operation of their portfolio companies. They tend to set the direction, ensure that the firm is adequately capitalized, and then allow the senior managers to get on with the achievement of agreed-upon goals. This explains why we see much lower scores for the PE company’s involvement in the operational aspects of the business.
The reasonably high scores for “crisis management” are a reflection that private equity is occasionally called in to rescue firms, such as during the credit crisis when liquidity dried up. In turnaround cases, private equity companies may get more involved in day-to-day management. In fact, in the case of one oil and gas services company that we interviewed, the GPs of the private equity company had specific engineering experience that helped deal with some major technical issues that faced the company in its turnaround. But this sort of detailed operational involvement appears to be more the exception than the rule.

The exit phase

All PE firms go into portfolio companies with some idea of when they want to exit their position. This exit strategy may involve a period of time (e.g., within five years) and/or performance criteria (e.g., improvement in enterprise value).

Still, the actual timing of the exit depends on something beyond the control of the PE firm and the portfolio company—the exit market. In over half of our cases, the PE firm had yet to exit the position. This was partly explained by a soft exit market—a lingering effect of the credit crisis. Those that had exited were much more likely to have done so through strategic acquisitions or through sales to another PE firm, rather than through an IPO. That may very well reflect the fact that, while corporate balance sheets are flush with cash, the public markets are still a bit careful about IPOs. As such, the M&A market is likely to be better than the IPO market at this time.

Given all the factors that determine the timing of an exit, a clear exit strategy is not always a priority or even possible. In the words of one of our interviewees: “(It was) the clearest unclearest (exit) plan in the world.” The watchword would appear to be “flexibility” and a focus on shareholder value for as long as the PE firm holds the position. If that is the focus, the PE firm and senior managers are in a position to do well when markets are more amenable to exiting.

Evaluating the relationship

We asked our interviewees to reflect on the relationship with PE investment and score its overall impact on the firm. Although there are clearly challenges along the way, the PE experiences of these Canadian companies were highly favourable. We can see this in Chart 6, which shows that respondents graded private equity by the extent to which its involvement in the portfolio company aligned with their initial expectations of what private equity was supposed to deliver to the business—focus and finance. Senior managers were generally seen as being the sector/operational experts to execute the strategy.

Clearly, the PE firm creates strong linkages to the financial community. However, some of our interviewees had expected that it would also create linkages to the broader business community. They were a bit disappointed when this did not happen (hence the lower scores for this attribute).

In customer satisfaction measurement, the gold standard is the so-called recommendation score. This is a good predictor of customer loyalty because customers put their reputation on the line when they recommend a company to a friend or colleague. We mimicked this technique in our interviews by asking our respondents if
they would recommend private equity to other companies. Not surprisingly, there is a high correlation between the ranking of their overall experience and their willingness to recommend private equity to other companies. (See tables 8 and 9). But the main point is that, in our sample, private equity was scored extremely highly by those individuals who were best placed to evaluate it.

One of the reasons that this sample scored private equity companies so highly was that they did indeed deliver on their value proposition. (See Chart 7.) They tended to stick with the clear roles and responsibilities laid out in the initial agreement. But this particular sample also shows the results of the combination of good strategy, focus, and solid capitalization and financial

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**Table 8**  
How Would You Rate Your Overall Experience With Your Private Equity Partner?  
(number of responses; n = 35)

<table>
<thead>
<tr>
<th>Rating</th>
<th>Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly beneficial</td>
<td>30</td>
</tr>
<tr>
<td>Somewhat beneficial</td>
<td>5</td>
</tr>
<tr>
<td>Somewhat negative</td>
<td>0</td>
</tr>
<tr>
<td>Very negative</td>
<td>0</td>
</tr>
<tr>
<td>No impact</td>
<td>0</td>
</tr>
<tr>
<td>Don’t know</td>
<td>0</td>
</tr>
<tr>
<td><strong>Average score (1–5)</strong></td>
<td><strong>4.86</strong></td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada.

**Table 9**  
Based on Your Experience, Would You Recommend Private Equity?  
(number of responses; n = 35)

<table>
<thead>
<tr>
<th>Rating</th>
<th>Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definitely would</td>
<td>30</td>
</tr>
<tr>
<td>Probably would</td>
<td>5</td>
</tr>
<tr>
<td>Probably would not</td>
<td>0</td>
</tr>
<tr>
<td>Definitely would not</td>
<td>0</td>
</tr>
<tr>
<td>Unsure</td>
<td>0</td>
</tr>
<tr>
<td>Don’t know</td>
<td>0</td>
</tr>
<tr>
<td><strong>Average score (1–5)</strong></td>
<td><strong>4.86</strong></td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada.
results. In the 10 cases for which we were able to access final performance data, we found that portfolio company earnings had grown, on average, by nearly 100 per cent, while sales improved by an average of 73 per cent, over the investment period.\(^2\)

**CONCLUSION**

We reviewed our key survey findings in this chapter. We interviewed 35 senior executives (mainly presidents and chief executive officers) of Canadian companies that had received private equity financing by Canadian PE firms. We detailed the process of firm selection, deal-making, governance, day-to-day operations and, finally, the exit. Our respondents gave private equity high scores because it delivered on its key value proposition in terms of the three Rs—roles, responsibilities, and results.

In this chapter, we have aggregated results for our sample, although we have attempted to bring in the voices of the interviewees through extensive use of quotes from our interviews. In order to shed further light on the specifics of private equity investments, we consider three specific cases of private equity investment in the next chapter.

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2 In six cases, firms did not wish to release performance data. Nineteen of the cases had yet to post final data as they had not yet exited their position.
Chapter 4

Case Studies

**Chapter Summary**

- This chapter provides a detailed look at three private equity deals.
- MEG Energy Corp. provides a good example of a company that took advantage of patient private equity capital.
- Bluewave Energy Inc. shows how private equity positions firms for growth by adding financial muscle.
- Knowlton Development Corporation used private equity to limit its leverage and improve its competitive position with major multinational buyers.

**WARBURG PINCUS, KERN PARTNERS, AND OTHERS INVEST IN MEG ENERGY CORP.**

**NEED FOR CAPITAL**

MEG Energy Corp. was founded in 1999 as a privately held oil sands development company. MEG’s early financing was typical of start-up companies. Equity financing initially came from family and friends, and gradually started coming from high-net-worth individuals in and around Calgary. Early capital was used to accumulate oil sands leases in Alberta’s Christina Lake region. By 2002, MEG had acquired a 100 per cent working interest in 47 square kilometres of leases and begun planning its first core-drilling program. However, the company needed additional capital to acquire and develop more leases.

In 2003, MEG had an opportunity to acquire an additional 34 sections of oil sands leases at Christina Lake. Wellington Management became MEG’s first substantial institutional shareholder, investing $26 million to fund the land acquisition. At the same time, MEG was working with Calgary-based KERN Partners and Warburg Pincus (WP), a U.S. private equity firm with strong expertise in energy. In 2004, WP became MEG’s largest shareholder with a private equity investment totalling $60 million. Nine months later, WP and other private investors provided MEG with a further $192 million to develop its Christina Lake leases.
In 2005, MEG prepared to move forward with the production of 22,000 barrels of oil per day, the Christina Lake Phase 2 commercial project, and the construction of a 300-kilometre pipeline. These projects required substantial amounts of capital. A little-known fact is that China National Offshore Oil Company (CNOOC) made its first oil sands investment in MEG Energy around this time. CNOOC acquired about 17 per cent of MEG Energy’s common shares for $150 million, which provided MEG Energy with a portion of the necessary capital to develop these projects. (In 2012, CNOOC famously acquired Nexen Inc.)

Given the favourable state of the pre-credit crisis debt markets, MEG Energy decided, in 2006, to take on substantial debt to fund its continued development. This took the form of a US$700-million term loan and a US$50-million revolving credit facility. With this expanded capital base, MEG Energy was able to attract other private equity investment, which amounted to $350 million in that year. MEG continued to raise private equity to fund the acquisition of oil sands leases, and exploration and development activities. The company raised approximately $2.5 billion from 2007–09. It subsequently raised capital through an initial public offering in 2010, which raised an additional $700 million. Within a decade, MEG had grown from a small start-up to a large company with a complex capital base that included private equity, debt, and public equity. (See Table 10.)

### CHOOSING PRIVATE EQUITY CAPITAL

The oil sands development and production business requires considerable long-term capital. Investments made today may take a decade or more to generate returns. MEG Energy’s founders understood this inherent nature of its capital needs. They felt that public equity markets were simply too short-term focused to be a good source of capital. They preferred to raise capital with private equity, bootstrap the company

<table>
<thead>
<tr>
<th>Private equity investors</th>
<th>Warburg Pincus, KERN Partners, and others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio company</td>
<td>MEG Energy Corp.</td>
</tr>
<tr>
<td>Portfolio company headquarters</td>
<td>Calgary, Alberta</td>
</tr>
<tr>
<td>About the company</td>
<td>MEG Energy Corp. (MEG) is a Canadian oil sands company focused on sustainable in situ development and production in the southern Athabasca oil sands region of Alberta.</td>
</tr>
<tr>
<td>Investment</td>
<td>In 2003, Wellington Management invested $26 million. In early 2004, Warburg Pincus invested $60 million, followed by other funding rounds totalling more than $190 million from Warburg Pincus, KERN, and other private investors in late 2004. By 2010, the company had over 50 private equity investors.</td>
</tr>
<tr>
<td>Private equity shareholding (per cent)</td>
<td>The maximum amount Warburg Pincus has owned is 45 per cent. KERN ownership varies between 1 and 2 per cent, China National Offshore Oil Company owns 13 per cent, and university endowments and other pension funds and private equity investors owns the remainder. The company received a total of $3.2 billion in private equity investment from 2004 to 2009 from all parties. The company did an IPO in 2010 for about 15 per cent of the company that raised about $700 million. In 2012, the company raised another $800 million through another public offering of shares.</td>
</tr>
<tr>
<td>Year position taken</td>
<td>Initial private equity investment in 2003</td>
</tr>
<tr>
<td>Year position exited</td>
<td>Not exited</td>
</tr>
</tbody>
</table>

Sources: MEG Energy Corp.; The Conference Board of Canada.
through debt, and then issue public shares. Typically, companies like MEG Energy do an IPO earlier in their development—before the company is ready and at the risk of seriously diluting shareholder equity. Private equity allowed MEG to mature and to time its IPO to best effect.

**SELECTION PROCESS**

Calgary-based KERN Partners acted as MEG’s financial advisor and assisted MEG with the completion of its financings from Wellington and Warburg Pincus. Subsequently, when KERN Partners became a fund manager, it was able to bring other co-investors to the company, such as university endowments.

In 2005–06, MEG Energy Corp. was planning for years of intensive capital investment to develop its leases and therefore required significant capital—amounting to around $1 billion in total. MEG executives conducted a “beauty contest” for investment banks to provide advice on the best way to go about raising the required capital. Twelve Canadian and international investment banks submitted proposals for debt/equity funding. Following four months of evaluation, MEG Energy selected Lehman Brothers and Credit Suisse to lead a $350-million private equity and US$750-million debt issue.

In the world of Canadian private equity, the size of the private equity component was very large. And even the debt component made headlines. In 2006, the industry publication *Project Finance* declared the US$50-million revolving credit facility and US$700-million seven-year term loan as the “Americas Oil and Gas Deal of the Year.”

**WORKING RELATIONSHIP**

**Governance**

Prior to the 2010 IPO, there were eight board members—two from Warburg Pincus; two independents nominated by Warburg Pincus; two founders of the company (one of whom was the CEO); and two other independents. Post-IPO, the board expanded to 10 members, 2 of whom are from Warburg Pincus. The board functions very much like a regular publicly held company board. The independent directors have a very strong influence on the board. The board provides strategic guidance and goal-setting, but plays only a minor role in the company’s day-to-day operations.

**Other Involvement**

The private equity investors’ expertise (particularly Warburg Pincus and KERN) in the area of financial structure and planning was a significant advantage to MEG because this was a major challenge for the company. The PE investors provided considerable financial assistance with their own balance sheets and used their credibility in capital markets to raise money from other potential investors. The private equity investors had some influence on the company in terms of strategic goal-setting and measurement. But they had limited involvement in production, employment, and human resources decisions. And their involvement in human resources was principally in the form of setting compensation for senior management.

**Exiting the Relationship**

MEG had over 50 private equity funders as investors prior to its 2010 IPO. It is typical for private equity funders to exit investments after an IPO. Although MEG’s private equity investors have changed their holdings over the years, the majority remain invested in the company today. They stick with the company because they like the growth prospects of the company. As former Chief Financial Officer Dale Hohm noted: “Today, for many of our smaller private equity investors, it is more of an investment than a relationship.”

The company’s direction continues to be aligned with the investment objectives of the funds, so there is no reason for the funds to exit the investments.

**Results**

MEG Energy Corp. took many years to move from a start-up phase to full operations. The company started in 1999. As late as 2009, MEG Energy did not have

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1 Statement supplied by Dale Hohm, former CEO, MEG Energy Corp.

2 Dale Hohm (former CEO, MEG Energy Corp.), telephone interview by Catharine Johnston, February 1, 2013.
any sales. Now that its major projects have come on stream, it has grown rapidly. The following metrics are illustrative:

- From a standing start in 2009, MEG earned a top-line revenue for both 2011 and 2012 of over $1 billion. By 2015, it is forecast to be at least $3 billion.
- The company went from negative EBITDA (earnings before interest, taxes, depreciation, and amortization) in 2009 to $300 million in 2011. Research analysts forecast EBITDA to be $1.5 billion by 2015.
- MEG had no production in 2009. By 2012, it was producing 30,000 barrels per day, which is forecast to grow to 80,000 barrels per day by 2015.
- Today, MEG ranks among the top seven TSX-listed companies in terms of proved reserves (1.3 billion barrels). According to the U.S. Energy Information Administration, the proved reserves of the entire United States are just over 25 billion barrels.3

Portfolio Company’s Evaluation of the Experience
The main challenge facing MEG was raising long-term capital. This is the forte of experienced private equity companies like Warburg Pincus and KERN Partners. From a solid base of private equity, the firm was able to raise debt. This allowed the company to continue with its long-term plans. The private equity base attracted other funders like CNOOC and allowed the firm to have a relatively small number of owners while it matured. Once its commercialization prospects were well established, it was able to undertake an IPO on agreeable terms. All this was possible because of the initial commitment of private equity capital.

In the words of Dale Hohm: “We have been able to do things in the past 10 years that we would not have dreamed of doing 10 years ago because of our private equity investors and favourable capital markets.”

LESSONS LEARNED
The main lesson learned is that private equity is an excellent long-term form of capital that is suitable to companies that need such capital, like MEG Energy. But, obviously, MEG Energy management had a clear strategic direction and a sound value proposition. It showed success in executing its initial business plan. Private equity funds are very much betting on senior managers’ ability to execute. And although private equity bought the managers some time, it was their ability to deliver on the initial value proposition that allowed it to return to the capital markets repeatedly.

Dale Hohm summed up by saying: “With over 170 billion barrels of recoverable oil, Canada’s oil sands are a world-scale asset. The development of this important resource requires experienced management, billions of dollars of capital, and time. Private equity, which takes the time to understand the management team and the business plan and then invests long-term capital, is very well suited to opportunities of this nature.”

BIRCH HILL EQUITY PARTNERS INVEST IN BLUEWAVE ENERGY INC.

NEED FOR CAPITAL
Bluewave Energy Inc. is a Dartmouth-based downstream oil delivery company. In this business, significant working capital is needed to bridge a gap between receivables and payables. Bluewave needed investment capital to bridge this gap, as receivables had grown to $100 million after only three years in business. (See Table 11.)

Bluewave’s main line of business is the regional distribution of Shell petroleum products. When a large multinational like Shell seeks regional distributors, it looks to those that have sufficient working capital and overall strong balance sheets. Bluewave needed to bring in capital to position the company for the Shell business.

CHOOSING PRIVATE EQUITY CAPITAL
Bill Sanford, the President and Chief Executive Officer of Bluewave at the time, had previous experience working in a public company. He chose private equity finance because he felt it was more appropriate for the size of his company. Mr. Sanford knew that private equity has a simpler approach to governance. At the time, he also liked the idea of longer-term financial reporting and planning, more engagement between the

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3 Hohm, interview.
source of capital and the managers of capital, clear goal-setting and target measurement, and greater focus on key strategic business objectives.

**SELECTION PROCESS**

A well-connected financier was a business partner of Mr. Sanford. He introduced Mr. Sanford to various private equity general partners. This business colleague worked with Mr. Sanford to vet private equity offers. Bluewave had some initial experience of private equity through a small equity partner, suggested by a creditor. “They [the GPs] were piranhas,” noted Mr. Sanford.4 He did not want to make the same mistakes when selecting the next private equity partner.

When looking for a second private equity partner, Mr. Sanford’s first priority was fit—specifically, the quality of the working relationship with the GPs. The second criterion was the investment term, and the third was the financial terms of the deal. Given the priorities, it was important to Mr. Sanford that he carefully interview the GPs of each prospective PE firm.

Over two years, Mr. Sanford made business presentations to 20 private equity firms. He pared the initial list down to two firms—Birch Hill Equity Partners and an international firm. The firms differentiated their offers based on their investment strategy. Birch Hill is a medium- to long-term investor, whereas the international company billed itself as a “fast exit” firm. As Bluewave was looking for a longer-term partner, it chose Birch Hill.

**WORKING RELATIONSHIP**

**Governance**

The board of directors consisted of Mr. Sanford, two Birch Hill GPs, and three other mutually agreed-upon board members. Two of these additional three board members were recommendations of Mr. Sanford, and Birch Hill added one nominee from its limited partner investors.

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4 Bill Sanford (former president and CEO, Bluewave Energy Inc.), telephone interview by Catharine Johnston, December 5, 2012.

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**Table 11**

<table>
<thead>
<tr>
<th>About the Investment in Bluewave Energy Inc.</th>
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<tr>
<td><strong>Private equity investor</strong></td>
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<td><strong>Portfolio company</strong></td>
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<td><strong>Portfolio company headquarters</strong></td>
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<tr>
<td><strong>About the company</strong></td>
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<tr>
<td><strong>Investment</strong></td>
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<td><strong>Private equity shareholding (per cent)</strong></td>
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<td><strong>Year position taken</strong></td>
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<tr>
<td><strong>Year position exited</strong></td>
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Sources: Bluewave Energy Inc.; The Conference Board of Canada.
The board worked extremely well together. “In three years we never had a single vote-off” is how Mr. Sanford characterized the relationship. There was no turnover in board membership and this improved overall governance. “Birch Hill folks understood that they were not operators and they never crossed the operating line. We never had any disputes over that at the board level.”

**Other Involvement**
Birch Hill was very significantly involved in deciding on the best financial structure for Bluewave. It was also active in strategic planning, goal-setting, and performance metrics. Birch Hill was less actively involved in day-to-day activities, such as operations, sales, marketing, and employment decisions. These operational matters were left to the prerogative of Bluewave managers.

**Exiting the Relationship**
Birch Hill had a strategy to exit the investment in 7 to 10 years. In the world of private equity investing, this is considered long term. PE companies typically choose to exit their investments through an initial public offering or through a strategic acquisition by another firm.

In this particular case, Birch Hill ended up exiting earlier than usual. The first explanation is that it had numerous unsolicited strategic acquisition offers. Second, the fund that included the Bluewave investment was approaching its maximum level. That might have involved capping Birch Hill’s exposure to Bluewave at a time when the company continued to need capital to fund its growth. For these reasons, Birch Hill decided to sell to Parkland Industries Limited. This allowed Birch Hill to realize its target investment return and Bluewave to avoid the potential financing constraints.

Bluewave and Birch Hill worked closely together on the exit, pulling together the necessary materials and making presentations to various suitors.

**Results**
During the three-year partnership with Birch Hill, Bluewave:
- grew revenue from $20 million to $1 billion (through a combination of organic growth and acquisition);
- improved EBITDA from $4 million to $37 million;
- increased the number of employees from 100 to 400;
- extended ownership to employees through a stock option plan (employee satisfaction improved);
- improved customer satisfaction, especially on the crucial “would you recommend” score.

**Portfolio Company’s Evaluation of the Experience**
Mr. Sanford pointed to Birch Hill’s business expertise and financial networks as key advantages that helped Bluewave. As expected, the private equity style of investment resulted in a higher level of engagement with the shareholder. Instead of managing a diffuse shareholder base, Mr. Sanford went directly to Birch Hill to ask advice and gain insights on a variety of business issues. His entire executive team, which consisted of himself and five vice-presidents, formed a tight working relationship with Birch Hill. Notwithstanding the fact that Birch Hill owned over three-quarters of the company’s shares, it worked very collaboratively with the managers of Bluewave.

Bluewave had a local network of functional consultants (on human resources, legal matters, etc.), while Birch Hill preferred to work with Bay Street companies. An important learning for Bluewave management was to include these considerations in the initial negotiations with the private equity partner. Mr. Sanford suggested that this was not a major drawback, just something that would improve the overall relationship.

Meanwhile, there was a clear understanding that, on operational matters, Bluewave management would be more or less left to their own devices. Hence, there was no conflict on operational matters. Functional areas, however, were often grey areas. Therefore, it would have helped to be clear on who was contributing the

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5 Sanford, interview.

6 Sanford, interview.
expertise—the private equity company or the portfolio company. Yet, in the final analysis, Mr. Sanford felt so favourably about the relationship with Birch Hill that “if I had to do it over again, I would only have to knock on their door.”

LESSONS LEARNED

Mr. Sanford benefited from his experience with private equity. Now retired from Bluewave, he has gone on to establish a small private equity company to help other companies grow. He distilled the four key lessons learned as follows:

1. **Do your due diligence.** Both the portfolio firm and the private equity firm have to do thorough due diligence. It takes time, but it makes for a better working relationship after consummation of the deal. Mr. Sanford recommended having at least one woman involved in assessing the private equity GPs, as he believes women often have good intuition on working relationships and cultural fit.

2. **Be clear on what the parties bring to the table.** Understand the capabilities and limitations of the PE firm and the portfolio company. Private equity companies like Birch Hill clearly are extremely adept at financial matters. Bluewave managers understand the day-to-day functioning of the business. But there can be “grey areas,” such as the contracting of outside functional expertise, that need to be clarified.

3. **Stay aligned.** A big advantage of private equity is the alignment between the objectives of the principal shareholder and those of the senior managers. This alignment is critical to the success of the investment. It is a consideration throughout the entire relationship, from the initial due diligence (ensuring common goals) through governance, day-to-day management and, ultimately, the exit. A key way to achieve this is through stock and compensation policies, which are geared toward goal achievement. A key success factor is to align compensation systems for senior portfolio company executives with the exit threshold goals.

4. **Know the exit strategy, but stay flexible.** Before entering into a relationship with a PE firm, the company needs to understand the exit plan, especially if it is a buyout firm. Will it be a slow or fast exit?

What are the financial goals in terms of the sell threshold? Yet exit strategies are flexible and may change depending on the performance of the firm and the state of the exit markets (strategic acquisition and IPO markets). Through good communication, both the portfolio company and the private equity company can understand how to modify the exit strategy as circumstances change.

NOVACAP AND OTHERS INVEST IN KNOWLTON DEVELOPMENT CORPORATION

**NEED FOR CAPITAL**

Knowlton Development Corporation dates to 1991. The company had success in gradually building its business as a developer and manufacturer of consumer health and beauty products. Yet, in 2000, the company decided that it wanted to accelerate growth. It needed additional capital to fund its growth plans. The owner at the time also wanted a succession plan that would involve bringing in new talent to lead the company. These three needs came together in the company’s search for new capital. (See Table 12.)

**CHOOSING PRIVATE EQUITY CAPITAL**

Knowlton wanted a partner that had a longer-term view of things, not just a focus on quarterly results. It wanted a partner that was in it for the long run and that was not overly concerned with the analyst community assessment of the company. Knowlton opted for private equity as it felt that a private equity partner would be significantly more engaged in the company. This would come in the form of a partnership with senior management, clear goal-setting, and the definition of strategic business objectives.

Knowlton needed a very specific type of private equity funder that was not averse to investing but that did not want to overleverage the company. The current President and Chief Executive Officer John Bertuccini said, “Our competitors leverage to six times EBITDA and this makes them capex (capital expenditure) averse. Knowlton wanted a partner that did not overleverage the
firm and that was willing to invest. Our leverage ratio
is significantly lower than our competitors’ at three
times EBITDA.\textsuperscript{7} 

\textbf{SELECTION PROCESS}
Unlike most of our cases, Novacap pursued Knowlton
as an investment opportunity. Knowlton was not act-
ively seeking private equity. The parties spent over a
year courting. There were no intermediaries involved.
Novacap took a majority stake in 2002 and brought
in Fonds de solidarité des travailleurs du Québec (FTQ),
Fondaction (CSN), and Desjardins Capital de risque (mezzanine providers) in supporting roles. (See
Table 12.)

Novacap holds 51 per cent of the equity, senior
management has a few percentage points, and the
other PE investors (mezzanine investors) have the
remainder. Mr. Bertuccini was recruited by Novacap
to run the company in 2004 after the original owner
who had entered into the deal with Novacap passed
away. Mr. Bertuccini is executing the company’s
growth plans.

\textbf{WORKING RELATIONSHIP}

\textbf{Governance}
The board of directors consists of three members from
Novacap and three outside members (selected by the
other investors). The CEO does not sit on the board,
although he attends all board meetings. The board oper-
ates on consensus and rarely takes issues to a vote. The
CEO has a close working relationship with Novacap
and keeps it well appraised. The idea is to “avoid sur-
prises at board meetings.” Mr. Bertuccini goes to the
board for major capital approvals of anything involving
over $1 million of capex. He has found that the board
approves these plans “99 per cent of the time.”

\textbf{Other Involvement}
Mr. Bertuccini has maintained the same contact at
Novacap over the years. This has helped forge a
strong relationship. The Novacap GP understands

\begin{table}
\centering
\caption{About the Investment in Knowlton Development Corporation}
\begin{tabular}{|l|l|}
\hline
Private equity investors & Novacap (buyout fund); Fonds de solidarité des travailleurs du Québec (FTQ); Fondaction (CSN); Desjardins Capital de risque (mezzanine providers) \\
\hline
Portfolio company & Knowlton Development Corporation \\
\hline
Portfolio company headquarters & Knowlton, Quebec \\
\hline
About the company & Knowlton Development Corporation (KDC) is a contract manufacturer in the health and bath business. It serves a variety of leading companies and brands. KDC develops liquids and “hot pour” products—from soaps and lotions to deodorant sticks. \\
\hline
Investment & $26 million \\
\hline
Private equity shareholding (per cent) & 51 \\
\hline
Year position taken & 2002 \\
\hline
Year position exited & Not exited \\
\hline
\end{tabular}
\textsuperscript{7} John Bertuccini (President and CEO, Knowlton Development Corporation), telephone interview by Catharine Johnston, January 22, 2013.
\end{table}
Knowlton’s strategy. In Mr. Bertuccini’s view, it is important to have this sort of tight relationship that allows for continuity. Other Novacap employees are brought in on a specialized basis.

Although senior managers (10 people) own a small part of the company, their stake is sufficient to motivate them to run the company as if it is their own. This idea of having senior managers as owners is common in private equity deals and was part of the design of Novacap’s original acquisition.

Novacap focuses on the strategic and financial aspects of the company, leaving the senior managers to run the day-to-day business. Novacap has been supportive of the company’s plans, which has allowed Knowlton to grow and take market share from competitors. For instance, Knowlton had to make a major investment in manufacturing equipment to win a major brand’s shampoo and conditioner contract. Knowlton’s competitor could not bid because it was already too highly leveraged—so Knowlton won the contract.

Novacap’s philosophy is conducive to growth. Under Novacap’s ownership, Knowlton has invested over $58 million in plant expansions during the time the two companies have been together. They are both in it for the long term and so view the spending of capital as a necessary part of growing.

Novacap charges a management fee (less than 1 per cent of revenue). The fee also covers the expenses of the Novacap board members. As sales grow, the percentage decreases. Mr. Bertuccini thinks this is reasonable, given the value that Novacap brings to Knowlton.

During the investment period, Novacap has had significant influence in terms of financial structure and planning, strategic goal-setting and measurement, human resources decisions, and crisis management. In terms of human resources, Novacap was involved in the selection of some senior leaders, such as the CEO. Novacap has had some involvement in terms of sales, marketing and promotional activity, and production and employment decisions. The firm has not been involved in collective bargaining and negotiations with employees.

Exiting the Relationship

Although Novacap has a 10- to 12-year exit plan, it is still with Knowlton after 11 years. A growth target of $35 million EBITDA was set in 2004. Even though this has been achieved, Novacap is still with Knowlton and, at this time, it is not actively seeking to exit the position. “They have a vision to make this a billion-dollar company with appropriate EBITDA and so they are not in a rush to exit until then,” said Mr. Bertuccini. “Once that goal is reached, they may consider taking the company public but, for now, they are holding the position.”

Results

Knowlton’s relationship with Novacap has allowed the company to grow and prosper. Progress made since the investment includes the following:

- EBITDA grew from $9.4 million in 2002 to $38.3 million in 2012, a compound average annual rate of growth of 15.1 per cent;
- revenues have more than quadrupled over the same time, growing from $80.2 million in 2002 to $387 million in 2012 (compound average annual growth of 17 per cent);
- employment, over the same time period, grew from 250 employees in 2002 to 2,000 employees in 2012.

In addition, Knowlton has received numerous recognitions from its customers. It is one of only eight Procter & Gamble Company vendors worldwide to receive recognition as Business Partner of the Year in 2012. In addition to receiving this honor, Knowlton received its third P&G Excellence Award in as many years. The Excellence Award recognizes superior and sustained levels of service, operation, innovation, and competitiveness. This award was given to 73 of P&G’s 75,000 suppliers and agencies.

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8 Bertuccini, interview.
Portfolio Company’s Evaluation of the Experience

Overall, Mr. Bertuccini suggested the partnership with Novacap has been “highly beneficial.” He feels that the relationship is better than if the company had gone public. In his view, the long-term focus of Novacap has been a significant advantage. Mr. Betuccini summarized the key benefits of his company’s partnership with Novacap as:

- a focus on medium- to long-term revenue and profit goals;
- financial support to achieve these goals;
- support for mergers and acquisitions, and the fact that Novacap is adept at assessing targets for mergers and acquisitions.

LESSONS LEARNED

Mr. Bertuccini has had almost 10 years of experience in working with Novacap. When asked what key lessons he could pass on to other companies that may want to work with private equity, he suggested the following three:

1. **Keep the private equity partner informed.** Sometimes it can be hard to get the private equity firm’s attention, as they are quite busy, especially if things are going well. Mr. Betuccini asked Novacap once, “Do I have to screw up to get your attention?” When you get the firm’s attention you need to use it well, but it is critical that the PE firm is kept aware of developments.

2. **Pick the right private equity partner.** If your goal is growth, then make sure that you select a partner that is willing to grow and has deep enough pockets to grow. Do not pick a partner that is already significantly leveraged. Do your own due diligence to ensure that you are tying your fate to a partner that can stay in for the long term.

3. **Deal with financial complexity.** Compared with a privately owned company, a partnership with private equity requires more and complex financial reporting. This can put a strain on the finance and accounting group within a company. “It drives them crazy,” said Mr. Bertuccini. “You have to make sure that the internal accounting systems can handle the demands of working with a sophisticated private equity company.”

CONCLUSION

This chapter illustrates some of the themes that we developed in our presentation of the overall survey findings in Chapter 3. These detailed case studies show that each private equity deal is unique. Although some of the techniques are similar, the key to success is to establish a solid working relationship between the PE funder and the managers of the portfolio companies. In these three cases, we highlighted both the keys to success and some of the challenges.
Chapter 5

Takeaways

PROSPECTIVE PORTFOLIO COMPANIES

Literally hundreds of companies with capital and managerial needs may benefit from private equity investment. The problem is that there is no organized way for these companies to reach private equity funds. We were surprised to find that many of our respondents had little knowledge of the PE option prior to their involvement with it. They appear to have stumbled upon the option during their capital search. This means that there are probably some worthy firms that are passed over by private equity and therefore do not realize the benefits of this form of investment. Senior managers of medium-sized companies with good growth prospects need to educate themselves on the private equity option.

Yet it is equally important for portfolio company owners and managers to do due diligence on private equity. This involves understanding a PE firm’s GPs, investment goals, fee structure, governance and management approach, and financial capabilities. On the latter point, one of our interviewees pointed out that it was key to understand a fund’s leverage and solvency. Solvency problems may spill over to the portfolio company in reduced capital expenditure or even a rushed exit. Portfolio company owners and managers need to check the references of PE firms. They need to ask
questions regarding how involved the firms are with portfolio companies’ finances, people, and operations. How much time do they spend with management?

It makes sense for prospective portfolio company managers to contract a third-party advisor who is independent from their broker. That advisor should do a valuation of the company before the firm starts looking for a partner so that the managers understand the valuation. They should understand that their broker is the deal broker and, in the end, wants to get the deal done to realize his or her commission. The PE firm is used to doing valuations and the portfolio company needs help during the process to keep it on a level footing with the PE firm.

The contracting process is especially important. We found that some portfolio companies were unhappy with some aspects, like fees, that they did not document. Once the private equity company makes its investment, it usually controls the company. Hence, the contract process is the last chance that the previous owners and senior managers have to establish operating terms.

Smart private equity firms understand where to draw the line between their competency and the competency of senior managers at portfolio companies.

The due diligence and contracting process is the time to set out the post-acquisition direction for the company. It can be very time-consuming and costly but, clearly, this effort pays substantial dividends over time. The due diligence process moves from “getting to know you” to “strategic planning session.” As it advances, it becomes more relevant to the future direction of the business. At this time, it is crucial to clearly define roles and responsibilities. This process is not wasted time, but an investment in the business’s future.

The portfolio company has to have a strategy for making a smooth transition from negotiating the terms of PE involvement to day-to-day operations under PE ownership. It is difficult for PE firms to emerge from due diligence, where they are immersed in the details, and then step back and be good board members. The parties need to have an honest conversation outlining that, once they close the deal, the PE firm will give the reins back to management. This can be accomplished by asking the firm to “describe Monday morning to me.”

Portfolio companies need to go into the private equity experience with their eyes wide open. The private equity company will be very organized. That is core to their business. Prospective portfolio company managers may only do a deal once in their life. Those firms that find their way to private equity may feel like they are navigating without a map. Therefore, they need a way to go up the learning curve quickly.

PRIVATE EQUITY FIRMS AND THEIR FUNDERS

Private equity firms are clearly masters of finance and strategy. They are extremely adept at setting financial goals and raising funds. However, the achievement of those goals depends on a wide range of managerial factors, most of which are beyond the competency of private equity firms. They have to establish a good working relationship with senior managers. Not surprisingly, private equity firms understand financial incentives (like stock ownership), but there are other aspects too.

Smart private equity firms understand where to draw the line between their competency and the competency of senior managers at portfolio companies. The GPs of private equity companies need to focus on governance, alignment, and engagement with senior managers. We have highlighted cases where private equity investors have clearly understood this distinction. This ends up paying off in the achievement of financial goals.

Although our sample was supportive of private equity investments, there is room for improvement. Even though some of our interviewees told of “cannibalistic” firms and others who excessively leverage their portfolio companies, they themselves had not experienced this. These instances do not represent private equity at its
best and tarnish the many firms that add real value through their relationships with portfolio companies. Some private equity firms need to pay a bit more attention to governance. In some cases, they are seen as sending junior people to “mind” the board. Senior managers at portfolio companies can see through this. They want private equity GPs to be engaged with them and feel cheated if they are not.

For the most part, our respondents had little issue with private equity management fees. Still, sometimes these fees become contentious when they have not been clearly explained or, worse, are excessive for the amount of value the private equity firm creates. For example, one private equity company charged fees for every acquisition that the portfolio company made, even if they had no role. These sorts of practices merely undermine the relationship between private equity firms and senior managers.

Policy goes beyond government to industry. The private equity industry can influence the way that private equity operates through industry policies.

Clearly, these sorts of issues are exceptions rather than the rule. Our sample companies clearly have a good reputation. They should consider ways to help prospective portfolio companies to engage with them. These might be as simple as case studies on their websites or even some tools that prospective owners could use to communicate their value proposition to private equity. Clearly, there is a gap between the deal process knowledge of private equity companies and that of prospective portfolio firms. Anything that private equity can do to bridge this gap would help establish more and better private equity/portfolio company relationships.

For instance, some PE firms (e.g., Birch Hill Equity Partners) host conferences where portfolio company executives can learn from one another. Our interviewees found these most helpful for cross-fertilization among portfolio companies. But the firms might also consider extending these sessions to prospective portfolio firms and fostering cross-fertilization among existing and prospective firms.

**POLICY-MAKERS**

When one hears of “policy-makers,” it is common to think immediately of government policy. To be sure, governments do influence capital formation in the private equity world. The federal government, in particular, has made a sizable financial commitment to the venture capital component of private equity. Provincial governments, too, offer support for labour-sponsored venture capital (LSVC) funds.

For governments that are interested in Canadian companies’ efficiency and growth, private equity is a means to these ends. We have found considerable evidence that, through active management, private equity improves portfolio companies ability to achieve scale and growth. MEG Energy Corp. provides the perfect example of a company that went from start-up to world leader through the involvement of private equity investors. Our other case studies (Bluewave Energy and Knowlton Development Corporation) both demonstrate how private equity helps Canadian companies link into global value chains.

The main message to government policy-makers is “do no harm.” Private equity is a risky form of capital that may be present in failed deals and restructurings. It is easy for politicians to demonize private equity and to cherry-pick instances where things have not gone well. But politicians are generally supportive of productivity and prosperity. Risk capital, in the form of private equity, is critical to the process of wealth generation.

Still, policy goes beyond the government. The private equity industry can influence the way that private equity operates through industry policies. This is a role for organizations like Canada’s Venture Capital and Private Equity Association (CVCA), which has generously sponsored this research. CVCA has a major role
to play in educating prospective portfolio companies on the private equity option. It would establish industry codes of conduct to which individual funds could subscribe to distinguish their brands in the private equity marketplace. It might also consider awards under the categories of “best turnaround deal,” “best growth deal,” or “most highly regarded funder” (based on a survey of portfolio company managers).

These steps would go a long way toward improving private equity’s reputation while growing the number of Canadian companies that benefit from private equity investments. The steps would also demonstrate to the general public that private equity makes a key contribution to growth and prosperity in Canada.
Appendix A

Bibliography


