Top Trends
2015

Torys looks ahead to the 10 trends that will shape M&A.

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OVERVIEW

The year 2014 saw corporate Canada continuing to adapt to the new realities of shareholder activism. Both activist tactics and board responses to activist overtures are evolving. We are seeing a class of activists shift their focus from "winner-take-all" campaigns to an approach of influencing change through proposed operational initiatives or specific transactions. Boards are becoming more responsive to activists' constructive approaches, increasing the potential for more negotiated settlements. We expect this trend to continue.

Expanding investor engagement is creating new challenges in M&A. Public companies looking to grow through acquisitions or to divest parts of their business are recognizing the significance of investor support to successful execution of their M&A strategy. As they continue to respond to greater demands for transparency, they face disclosure pressures from investors who are increasingly engaged and less deferential to boards and management. Separately, dissatisfied investors of M&A targets have, at least in the U.S., been resorting to appraisal litigation as a way to improve deal terms, turning it into a form of deal arbitrage.

In contrast to these buy-side considerations, potential M&A targets can expect to wield more leverage to negotiate deals. Canadian takeover bid rules are changing to empower boards by giving them more time to respond to unsolicited bids. These changes come at a time of growing government skepticism and political concerns about certain types of foreign investment in domestic businesses. M&A deals will continue to get done in Canada, but we predict that bidders will proactively tailor their strategies to accommodate the changing rules and this new wave of protectionism.

In the U.S., the Obama administration's clampdown on inversions is similarly influencing M&A. Although the U.S. government's anti-inversion rules and proposed measures will curb some tax inversion structures, we expect that inversion opportunities for companies seeking to expatriate to other countries will continue in 2015.

In relation to inbound M&A opportunities, we expect North America to continue to draw particular interest from Japanese investors who are looking to overseas markets for investments that can contribute to their long-term growth and sustainability. The renewable energy sector represents a natural fit for the growing pool of acquirors seeking sustainable long-term assets, positioning the sector well for ongoing M&A activity in 2015. For resource players, we expect that buyers of Canadian resource development targets will pay increasing attention to whether appropriate consultation and accommodation have occurred with local Aboriginal communities in light of recent court rulings.

Investors considering other M&A prospects in the year ahead should expect a competitive deal environment. High valuations for good assets in this seller's market are just one of the factors encouraging private equity players to pursue co-investment transactions. We expect the strong demand for co-investments to continue and accelerate in 2015. In private M&A, sellers benefiting from the market's recent frothiness may seek use of the "locked-box" deal structure, which is gaining popularity, especially in the context of "hot" auctions.

Torys looks ahead to the 10 trends that will shape business in 2015.

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SHAREHOLDER ACTIVISM: MORE SETTLEMENTS, FEWER FIGHTS

James Scarlett, Sharon Geraghty, James Tory, Mile Kurta

Shareholder activism has been on the rise for several years and shows no sign of abating. As corporate Canada adapts to this new reality, we are seeing an evolution, both in activist tactics and in how boards respond to activist overtures.

Activists are increasingly looking to achieve positive change through agreed measures short of a change of control, rather than by highly personalized "winner-take-all" campaigns. Likewise, incumbent boards are increasingly responding to activist overtures through dialogue with a view to finding common ground that addresses legitimate concerns, rather than with a reflexive defensive approach. This more nuanced approach is consistent with a board's fiduciary obligations; it leads to a settlement where there is a reasonable settlement to be made; and it best positions the board for a successful defence to activist attack where a fight to the finish is warranted in the interests of the corporation. We think this trend will continue.

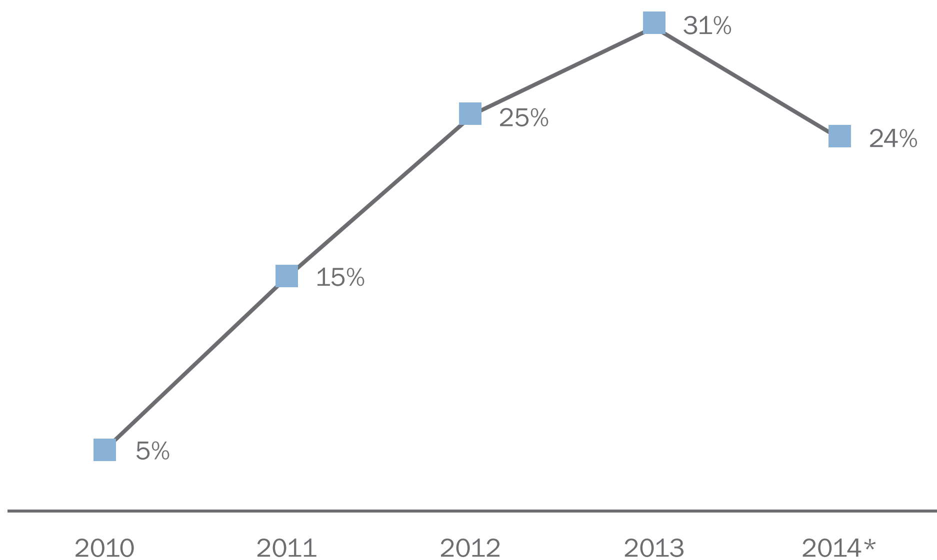
Shareholder activism, which started largely as a U.S. phenomenon, has only recently taken root in Canada. In the past, dissatisfied shareholders typically sold their shares rather than remaining invested and trying to change corporate management or strategy. Various explanations have been offered for this relative quiescence in Canada, including the cozier and more interconnected Canadian business community (as compared with the U.S.) and the "kinder and gentler" Canadian national character; but whatever the reason, things have changed.

Beginning in 2008, Canada experienced a significant increase in more aggressive shareholder action, largely as a result of hedge fund investors who had learned through U.S. experience that there was money to be made in actively advocating that investee companies change strategy—usually with a view to driving shareholder value in the near term—and seeking to replace management where necessary. Investors have also paid attention—capital inflows to activist hedge funds have been increasing steadily, as have returns in such funds.

Activist initiatives usually began with an aggressive overture to management that was followed by an equally aggressive letter outlining the many faults of the current management and demands for immediate and substantial change. In many cases what was demanded amounted to a change-of-control transaction. Failure to comply meant that a shareholders meeting would soon be requisitioned. Large companies with strong corporate governance practices have not been immune to such aggressive attacks, especially in the United States.

This form of shareholder activism still occurs and will likely continue, at least to some degree. However, what we are starting to see is a class of activists shifting away from highly personalized attacks that press for control transactions to an approach of seeking influence to effect change and increase share price through proposed operational initiatives or specific transactions. With more constructive activist overtures of this kind, the issue, as sophisticated boards and shareholders have come to realize, comes down to how best to increase shareholder value and over what timeframe. The challenge becomes convincing shareholders of who has the better plan—the activist or incumbent management?

Launched Activist Campaigns in Canada

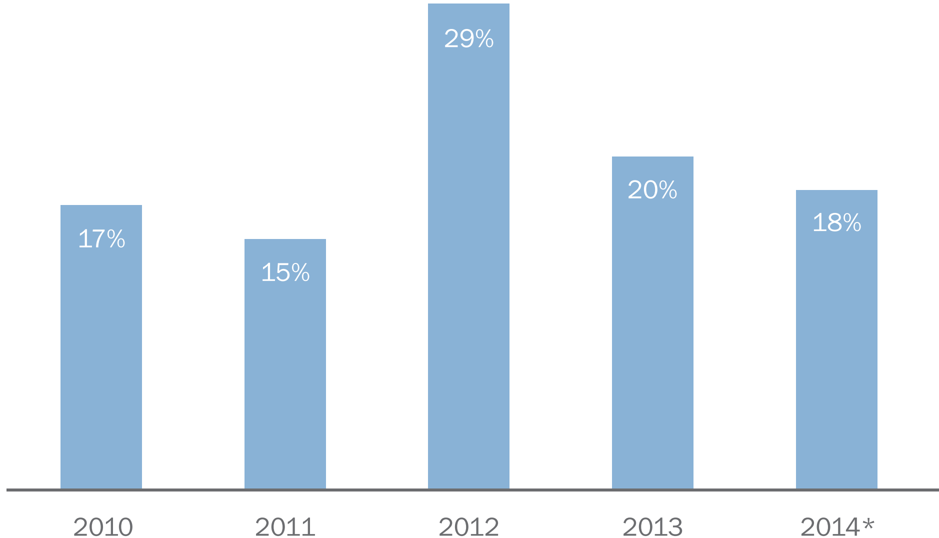


Source: S&P Capital IQ. *2014 data as of November 1, 2014, year-to-date activity.

One of the consequences of this evolution in activist tactics is an increased willingness of incumbent boards to engage with activists, potentially leading to negotiated settlement arrangements with one or more activist nominees going on the board and some or all of the activist's business plan being adopted. With any such settlement, only time will tell whether the new board works well, and how the activist's new influence will affect the company's strategic direction in the long term. Activists have no fiduciary obligation to the company or to its other shareholders,

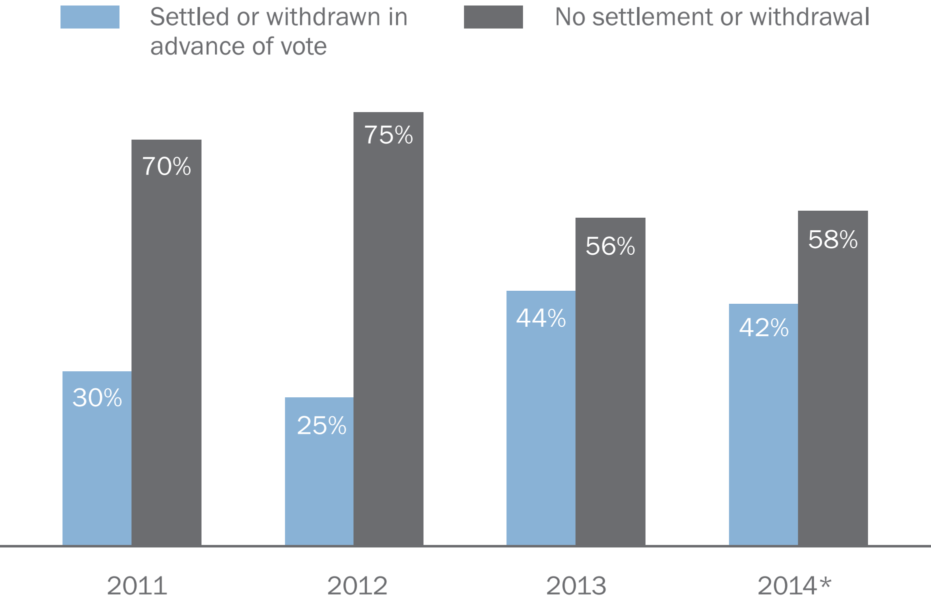
and their investment horizons and incentive will drive behavior that is in their own interests. However, where their interests are aligned with those of the company and its other shareholders, the board may conclude that a settlement makes sense.

Decline in Formal Proxy Contests from Peak in 2012



Statistics based on a review of SEDAR filings. *2014 data as of November 1, 2014.

Settlements and Withdrawals in Advance of Shareholder Vote



Statistics based on a review of SEDAR filings. *2014 data as of November 1, 2014.

The attractions to both boards and activists of a negotiated settlement instead of going through full proxy fights are not hard to understand:

- An activist often makes proposals that drive shareholder value in the near term, which may be compelling to other shareholders (especially institutional shareholders with large stakes), making outright rejection hard for the board.

- In an increasing number of cases, the activist will have, at considerable effort and expense, performed diligence investigations, learned about the company's business and developed a thoughtful thesis on how to improve value. This sort of analysis is difficult for a board to ignore, especially when it knows that the same information will be shared with the company's major shareholders.

- The activist may already have the support of a number of the company's major shareholders, effectively ruling out a "straight-arm" response that ignores the case being made.

- A fight to the finish is time-consuming, distracting and expensive, and involves considerable reputational risk for the incumbent board.

- Settlement arrangements provide the prospect, through a standstill covenant, of a period of stability that will allow the target company to return to focusing on its business. In addition, bringing the activist onto the board and adopting some or all of its business plan suggestions, invests the activist in the company's new plan. In a successful settlement, this results in the opposing parties becoming aligned and focused on increasing shareholder value.

As the landscape of activism continues to change in Canada, we foresee increasingly sophisticated activist approaches and more nuanced board responses that recognize the potential for activists to play a constructive role in the company's evolution.

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CANADA'S NEW PROTECTIONISM WILL SHAPE M&A

John Emanoilidis, Scott Cochlan, Omar Wakil, Dany H. Assaf

Bidders will face more hurdles as Canadian rules are changing to empower targets. These changes come at a time of increased government skepticism about certain types of foreign investment and heightened popular and political concerns regarding foreign takeovers of domestic businesses. M&A deals in Canada will continue to get done, but acquirors will need to proactively tailor strategies to address emerging regulatory hurdles and a new wave of protectionism.

Empowering Boards: Canadian Takeover Bid Reform Evolves

There is a perception that Canada's takeover bid regime is "bidder-friendly" because once a Canadian company is put into play, it typically changes hands—either in favour of the hostile bidder or a white knight. Recent proposals by Canadian securities regulators were intended to address concerns about the limited ability of target boards to respond to hostile bids.

Board empowerment was at the core of the Québec securities regulator's 2013 proposal to overhaul Canada's defensive tactics policy. The regulator proposed to give target boards absolute discretion, absent abuse, to respond to an unsolicited bid. The Canadian Securities Administrators (CSA) released an alternative, more moderate proposal that would allow target boards to maintain a poison pill in the face of a hostile bid so long as shareholders approved the pill within 90 days.

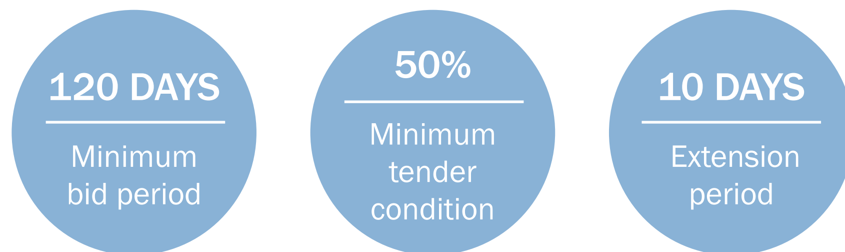
On the heels of these proposals came the Québec Government's announcement in 2014 that it intended to give Québec boards significant tools to resist hostile bids. This was in the wake of Lowe's unsuccessful bid for Rona and public discontent with the hostile transaction. Recommendations included protective measures aimed at facilitating board entrenchment and restricting certain transactions associated with hostile takeover activity. The government's plan was to effectively build a take-over

bid “firewall” surrounding Québec corporations. Since the recommendations were released, there has been a change in provincial power and we do not expect these recommendations to be implemented.

Securities regulators have now abandoned their competing initiatives, and are proposing a new framework intended to balance rather than eliminate the “pro-bidder” elements of Canada’s takeover regime. When implemented, the new rules will extend the time that formal takeover bids must remain open to 120 days, giving target boards more time to respond to unsolicited approaches and seek value-enhancing alternatives. The rules will also require formal bids to include a 50% minimum tender condition with a mandatory 10-day extension period if the minimum tender condition is met.

Although details have yet to be released, this new framework continues to allow target boards to implement poison pills to curtail, for example, creeping acquisitions, or to deal with other special circumstances. We have seen recent examples of boards tailoring their poison pills by adopting non-standard terms to deal with specific approaches, including “voting pills” that are triggered not only by the acquisition of shares, but also by voting control arrangements. At this stage, it is unclear whether or when poison pills will attract regulatory intervention or if the CSA will take steps in the future to regulate their adoption. However, we would expect that the regulators would not generally permit a target board to maintain a poison pill if a bid has been accepted by a majority of disinterested shareholders and if the bid otherwise complies with the new takeover bid rules.

Proposed Canadian Takeover Bid Reform



National Security Reviews

Coupled with the drive to empower Canadian target boards is a growing concern about the foreign acquisition of Canadian businesses by state-owned enterprises or certain investors from emerging markets—particularly acquisitions that may touch on national security concerns. A heightened sensitivity in Canada has led to a growing tendency to review transactions through a “national security” lens as well as an increase in political sensitivity around such deals. Industries particularly sensitive to increased scrutiny include natural resources—especially Alberta’s oil sands—critical infrastructure, technology and media and communications.

Popular opposition to certain transactions is also buoying political intervention, with the Prime Minister's office regularly involved in foreign investment reviews. Standard "net benefit" reviews under Canada's foreign investment review legislation can now garner widespread publicity. Less well known are "national security" reviews being conducted in secret under the same statute.

Since 2009, the government has had the power to review virtually any investment, regardless of size, that it believes could be injurious to Canada's national security. While there are not many data points on these reviews, or real transparency, these reviews appear to be increasing in frequency. Only one national security review has resulted in a public rejection, but many more transactions are believed to have been abandoned in the face of government opposition.

The lack of transparency and guidance from the government can make risk assessment in these cases challenging. As a practical matter, investors and Canadian businesses ought to question both the nature of the foreign investor and the operations of the Canadian target. Does the foreign investor pose a threat? Would foreign control of a Canadian business create a security vulnerability in Canada (or in a close ally of Canada)? Foreign investments, particularly by state-owned, affliated or influenced enterprises, should as a routine matter always go through a national security risk assessment stress-test.

Impact of Bid Reform and National Security Reviews on Bid Strategy

Although government rejection of foreign acquisitions of Canadian businesses remains uncommon, the trend toward protectionism should not be overlooked. Foreign bidders pursuing an acquisition in Canada should proactively manage their M&A process, which may include the following steps:

- more actively engaging with potential targets, as target boards will wield more leverage to negotiate a deal with the benefit of extra time;

- adopting government and stakeholder-relations strategies from the outset—failure to do so may impinge on deal success; and

- structuring negotiated transactions to minimize political concern and satisfy foreign investment review criteria—e.g., including national security risk allocation provisions or clearance as a condition precedent, or incorporating a reverse break fee to be paid in the event of a negative outcome.

The Threat of Protectionism: More Rhetoric Than Reality?

Concerns with foreign acquisitions of certain domestic businesses form part of a broader global trend, as illustrated with recent high-profile cases such as Pfizer/AstraZeneca and GE/Alstom.

In Canada, despite the perception of increased protectionism following regulators' steps to empower boards, and foreign acquisitions becoming highly politicized in certain instances, we expect the outcome of hostile bids under the new regime to likely remain the same—albeit with more breathing room for targets and some adjustment to bidders' strategies. Similarly, although in the current environment certain foreign investments pose higher approval risks under the *Investment Canada Act*, most transactions are still approved in the normal course and the government is still seeking to facilitate those transactions.

Regardless of this tempered outlook for protectionism in Canada, we expect that these latest developments will certainly sharpen foreign bidders' deal-planning efforts in the year ahead.

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GAMBLING ON MERGERS: APPRAISAL LITIGATION AS DEAL ARBITRAGE

Andrew Gray, Matthew Cockburn, David Wawro, David Wood

Investors who conclude that the price of an M&A transaction is too low may have the ability to reject that price by exercising dissent and appraisal rights, asking a court to fix the fair value at which their shares of the target will be acquired. Activist investors in the United States are increasingly turning to appraisal litigation as a way to challenge M&A transactions and put pressure on bidders and targets to improve deal terms. Indeed, some investors are taking positions in targets just for the purpose of appraisal litigation, turning it into a form of deal arbitrage.

The Appeal of Appraisal Litigation

Courts can employ a variety of valuation methodologies in appraisal litigation and, as a recent academic study has shown, in most U.S. cases, courts have typically fixed fair value at a premium to the transaction price offered for the target shares; where the bidder is an insider or related party, the premium may be even higher.[1] M&A transactions are routinely the subject of litigation challenges in the U.S. and these deals are increasingly attracting activist investors. Challenging a transaction through the statutory appraisal remedy—rather than through challenging the target board's M&A process under corporate law—may well be a more effective way to use litigation as an activist tool. While appraisal litigation takes time, reducing an investor's liquidity, the investor is entitled to claim interest at a relatively high rate compared to market alternatives. This may not only compensate the investor for the loss of the use of the investment, but may also actually encourage appraisal litigation.

In the U.S., the rate at which appraisal rights are exercised has spiked in recent years. Appraisal rights are being exercised in more transactions and in connection

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[1] M. Myers and C. Korsmo, "Appraisal Arbitrage and the Future of Public Company M&A," Brooklyn Law School Legal Studies Research Paper No. 338, August 2014.

with large numbers of shares. In 2013, appraisal rights were exercised in 17% of transactions where they were available in connection with US$1.5 billion of shares, representing 1% of the equity value of all mergers. Several specialized investment funds have been established for the sole purpose of pursuing appraisal litigation, including buying into a transaction in order to exercise appraisal rights. In connection with the Dell going-private transaction, for example, shareholders threatened to block the transaction by voting against it and exercising appraisal rights, resulting in the bidder increasing the offer price. Creative activists even established a trust into which dissenting shareholders could deposit their Dell shares in exchange for tradable securities with an interest in the appraisal litigation.

Exercise of Appraisal Rights in the U.S.*

*Source: M. Myers and C. Korsmo, “Appraisal Arbitrage and the Future of Public Company M&A,” Brooklyn Law School Legal Studies Research Paper No. 338, August 2014.

Appraisal Rights and Canadian Deal Dynamics

While appraisal rights have become an attractive tool for activists in U.S. transactions, this trend has not spread to Canada. Appraisal litigation in Canada shares some common features with its American counterpart; however, Canada hasn’t yet seen the same spike in appraisal litigation as the U.S. The recent experience of investment manager Paulson & Co in the *Deer Creek* litigation in Alberta may suggest an approach to dissent cases in Canada that could discourage other activists from employing them as a tool. When Deer Creek was taken over by Total, Paulson claimed that the bidder vastly undervalued the shares of the target, by a factor of at least 300%. After trial, though, the court found that the best measure of the value of Deer Creek shares was the market price, leaving the dissenter with no improvement to the deal price following years of litigation. While a Canadian court, like a U.S. court, can employ a range of valuation methodologies in fixing the fair value of shares, the decision in *Deer Creek* suggests that where the shares of a target trade actively, the market price likely represents fair value.

The approach to valuation taken in *Deer Creek* is less promising to activists in Canada hoping that litigating fair value will yield a premium to the price offered in a transaction. Moreover, if activists do begin to make more use of dissent rights in connection with Canadian deals, bidders and targets might be able to limit the effectiveness of that activist tool. In Canada, a friendly M&A transaction is usually completed as a plan of arrangement, a process in which it is possible to use the

power of the court to constrain or even eliminate dissent rights, subject to the requirement that the court still finds that the transaction is fair and reasonable. Although arrangements typically provide for dissent rights as a matter of course, the availability of this possible structuring solution may also mean that dissent rights will not become a more popular tool for activist investors in Canada even as they are increasingly used in the United States.

As investors turn to appraisal litigation as a form of deal arbitrage in the United States —a trend we expect to continue—in Canada, both investors seeking better value from their investments in the context of M&A transactions and activists looking for new forms of deal arbitrage may have to pursue alternative strategies.

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MORE ENGAGED INVESTORS BRING CHALLENGES TO STRATEGIC M&A

David Chaikof, Karrin Powys-Lybbe, Michael Siltala, Cornell Wright

Investors are more engaged and less deferential to boards and management teams—a trend that is increasingly being felt in M&A. Companies considering strategic transactions have to be aware of the risks of dealing with investors who are critically evaluating strategies developed by management, in some cases going as far as proposing their own competing strategies. This dynamic is creating challenges for companies in pursuing strategic transactions.

Laying the Groundwork

Recognizing that investor support is fundamental to successful M&A execution, management teams are more proactively disclosing to investors the role they see for M&A in their overall strategy, sometimes being fairly specific about sectors, geography or specific assets. Boards are increasingly pressing management teams to bring their analyses of potential opportunities to the board so that they can be more engaged in this element of the company's strategy. Boards are also showing more transparency, including by speaking directly with investors. Direct communication with select investors always carries the risk of selective disclosure. Discussing M&A strategy publicly provides more latitude to management in investor meetings. It continues to be rare to see specific discussion of M&A strategy and goals in a company's MD&A or other disclosure documents; it is more common for companies to discuss these matters in investor presentations or media interviews. While the Canadian regime does impose liability for misrepresentations in public statements, Canada lags behind the U.S. in requiring such communications to be incorporated into a company's formal disclosure record.

Approaching Investors Pre-announcement

Companies frequently consider approaching larger shareholders prior to announcement to gauge how the market will react. This raises "tipping" concerns. The general principle in Canada is that whenever a company wishes to impart confidential information prior to announcement, it has to be comfortable that the communication is in the necessary course of business. Where a transaction does not require shareholder approval, it can be difficult to meet that test. A further complication is that when making the disclosure, the company should impose confidentiality and trading restrictions. Investors are leery of being restricted without knowing more specifics, including how long the restrictions will apply, which may or may not be clear. In addition, hedge fund and other event-driven investors, while always happy to receive information, do not generally accept limitations on their ability to trade. Against this backdrop, companies are often forced to rely on their own judgment, informed by expert advice, regarding the likely market reaction. Companies that understand investors' perspectives on their growth initiatives and overall strategy going into a negotiation are better positioned to make those judgments.

Shareholder Approval Considerations

A key point for companies considering a significant transaction is whether shareholder approval will be required. TSX rules require listed companies to obtain shareholder approval for an acquisition involving the issuance of more than 25% of the company's outstanding shares. For an acquiror, a shareholder vote can introduce significant complexity and risk. Shareholders typically are not receiving any consideration and the vote dynamics are therefore different than in a sale where shareholders are receiving a premium price to entice them to vote in favour. In a buy-side vote, the fact that shareholders have to make a decision and vote on the merits of the deal provides an opportunity for shareholders to express a view on the company's strategy, and its execution to date, without selling their shares. It also gives parties waiting in the wings an opportunity to propose alternatives at a time when both the board and the shareholders will be forced to respond. Acquirors must consider whether they should negotiate for a "fiduciary out" in the event that they themselves become a target in the midst of the deal. This most often arises where an acquisition is sufficiently large to necessitate a buy-side shareholder vote or where the deal is portrayed as a merger. In those cases, parties tend to negotiate for reciprocal deal protections. In addition, boards of acquirors, concerned about the risk of being put "in play," sometimes see advantage in having a fiduciary out because an interloper will be required to pay a break fee, making a competing deal more expensive.

Disclosure in the Spotlight

Companies are holding themselves to a higher standard in the disclosures they provide when significant strategic transactions are announced. More and more,

investors want to see and understand for themselves the analysis on which the company relied. For example, even where not required, companies are providing details on their plans for an acquired business. Companies selling a business face increased pressure to be specific about their plans for sales proceeds. In many transactions, agreeing on an estimate of synergies is essential to settling the financial terms. Investors expect information about the estimated synergies to assist them with their analysis. However, companies are reluctant to provide specifics around the quantum, categories and timing because the numbers used for negotiating purposes will invariably be refined once the transaction has been announced and integration planning begins in earnest. The rules for disclosure of forward-looking information protect companies in disclosing synergies estimates but require them to be specific in disclosing their key assumptions and risks and, in some cases, require actual results to be reconciled to the estimates. This can be challenging for management because the synergies are based on very high-level information.

Compensation issues are receiving more attention from investors in the context of M&A. Retention or termination arrangements are often negotiated or modified as a transaction is being negotiated. Even though these arrangements are of keen interest to investors, the tendency in Canada is to provide disclosure only when and to the extent required. Investors have taken notice. In the U.S., new rules require companies to provide enhanced disclosure of "golden parachute" compensation arrangements and to hold a separate shareholder advisory vote in the context of a merger transaction.

Alternatives to M&A

Companies have to weigh M&A opportunities against alternatives that investors may find more attractive. In the current environment, investors seem increasingly prepared to accept relatively low returns in exchange for more certainty. That makes strategic M&A more challenging because the returns sought are less certain and depend on management's execution over a longer period. With substantial cash accumulating on balance sheets as the economic environment improves, companies are opting to return record amounts of capital to shareholders though increased dividends and share buybacks. Spin-offs also continue to be popular with investors. From a company's perspective, spin-offs can provide a means of disposing of a non-core business without the complexities of negotiating with a third party and the risk that investors will be disappointed by the financial terms. For shareholders, spin-offs are a tax-efficient means of returning capital because shareholders can decide either to hold the spun-off shares or sell them into the market. Although it can be debated whether companies are serving their long-term best interests in favouring immediate value-creation alternatives over long-term growth strategies, it is unlikely that directors face any practical risk or legal challenge in doing so.

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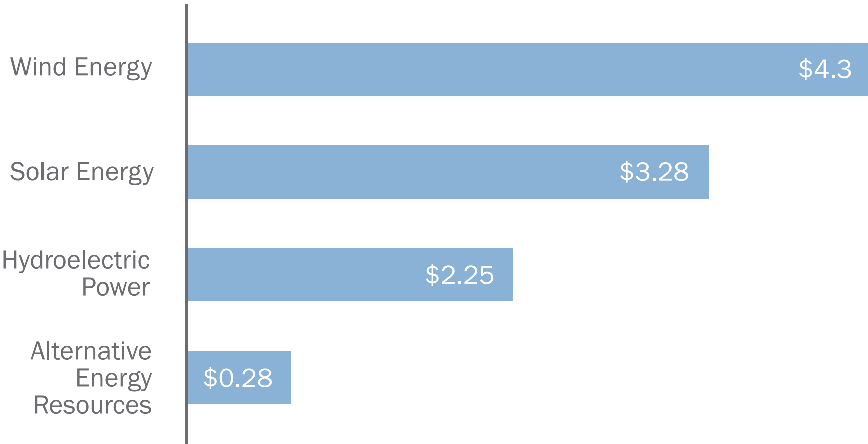
RENEWABLE ENERGY M&A: A SUSTAINABLE GROWTH STORY

Phil Symmonds, Krista Hill, Valerie Helbronner, Aaron Emes

We believe that 2015 will be a significant year for mergers and acquisitions in the renewable energy space. There are a number of factors that will continue to drive deals in this sector, but a key factor—projects reaching operational readiness amid a growing pool of acquirors seeking sustainable long-term assets—positions the sector well for ongoing M&A activity.

Canadian Renewable Energy M&A - Deal Value by Sector 2010-2014* (C$ billion)



Source: S&P Capital IQ. *2014 data as of November 1, 2014, year-to-date activity. Canadian targets only. Allocation determined by target sector.

While there can be shifting sentiments from time to time in various countries regarding the use of renewable energy, as the world as a whole increasingly focuses on climate issues, the overall trend tilts strongly toward a rising use of renewable energy. According to the Global Wind Energy Council, from 2003 through 2013, total worldwide installed

electricity generation from wind power grew from 8,133 MW to 35,289 MW. In addition, according to the *World Energy Outlook 2013 Factsheet*,[1] renewable energy generation is expected to supply nearly half the growth in global electricity generation from 2012 to 2035. Continued development of renewable energy will be supported partly by governments and utilities providing stable and attractive long-term pricing to encourage renewable energy developers.

The long-term trend in the development of the renewable energy market will support the growth of ancillary activities, including mergers and acquisitions. Some of the following factors will drive M&A activity in this space.

Factors Driving Renewable Energy M&A

Operational projects reach critical mass

In many jurisdictions, a number of renewable projects have now reached, or are close to reaching, commercial operation. The development risk is now out of the equation for many projects, and entities with a lower cost of capital are the more natural homes for these assets.

Long-term returns

The long-term power purchase agreements (20-year terms are not unusual) often attached to renewable energy projects provide revenue sustainability and this, combined with cost-side predictability, matches the investment objectives and return expectations of infrastructure funds, pension funds, yieldcos (described below) and international entities with a renewable or "green" focus.

Development of yieldcos in the sector

Yieldcos are publicly traded entities formed to acquire and hold portfolios of renewable energy generating assets. Yieldcos allow developers to monetize their interests in operating projects and use the funds to finance new projects. As yieldcos hold assets that generate steady and consistent returns, they are able to pay out attractive dividends, making them popular with investors. The popularity of yieldcos will support acquisitions in the renewable energy space, both as new yieldcos form and acquire assets and as existing yieldcos seek to add to their existing portfolios.

Increased investor demand

Investors with corporate social responsibility mandates and investing criteria will increasingly call for renewable projects. In particular, we expect that institutional

[1] Published by the International Energy Agency, <http://www.worldenergyoutlook.org/publications/weo-2013>.

investors will increasingly focus on projects with a positive environmental footprint, including through reallocation of existing investments towards those projects.

The trend of growth in renewable energy M&A will continue to mirror the momentum gaining in the renewable energy market, as assets supporting the long-term development of electricity generation will yield related mergers and acquisitions activity for many years to come.

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6

JAPAN OUTSIDE JAPAN: INVESTORS WILL LOOK TO NORTH AMERICA FOR M&A

Jonathan Weisz, Don Bell, Mark Bain, Tara Mackay

There have been a number of significant outbound M&A deals from Japan in recent years. These include Suntory's US$16 billion acquisition of Jim Beam, Softbank's US$21 billion acquisition of Sprint and the US$29 billion merger of Tokyo Electron and Applied Materials. The size of these transactions is unprecedented, establishing Japanese companies as serious contenders in major global M&A transactions. A host of factors suggests that Japanese companies will continue to look outside Japan, and in particular to North America, for M&A opportunities in 2015.

Factors Contributing to Japanese Foreign Investment

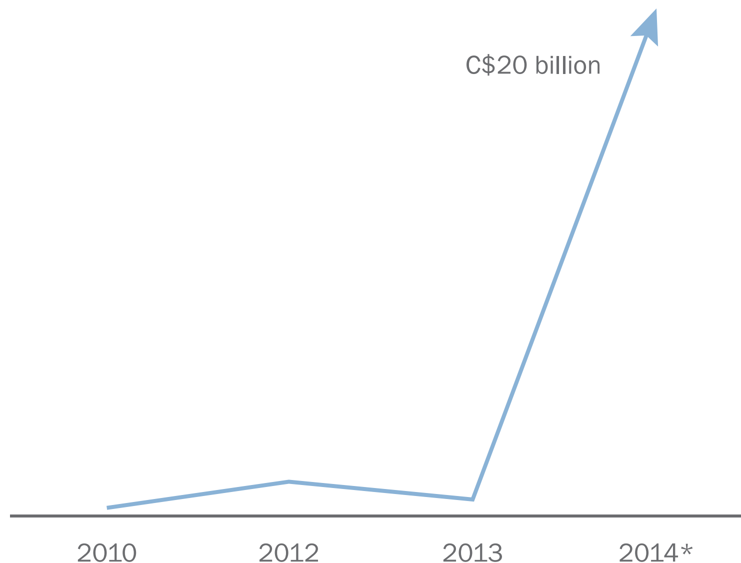
Abenomics

In December 2012, Japan's Prime Minister Abe began implementing the "three arrows" of his Abenomics policy to awaken the "animal spirit" of the Japanese economy: *fiscal stimulus* consisting primarily of government spending targeted at infrastructure and renewable energy projects to generate short-term growth; *monetary easing* aimed at bringing the economy out of a 20-year deflationary spiral; and *structural reform* aimed at fostering long-term growth and making Japan more accessible to foreign investors. The initial effects of Abenomics included a weakened Japanese yen, a rise of more than 50% in Japanese stock prices and an increase in domestic consumption. Increased consumption has since tapered following the rise in consumption tax from 5% to 8% on April 1, 2014. However, a recent Tankan corporate survey showed that business sentiment in Japan has improved notwithstanding the tax rise. Large corporations are reportedly planning an 8.6% increase in investment in the coming year (up from 7.4% as of the time of the previous survey). The long-term effect of Abenomics is still unclear, but the government's objective of increased economic activity is likely to boost M&A activity, including with respect to inbound transactions.

Demographics, shift in M&A focus

Japan's population is declining and aging, and its workforce is shrinking. In an attempt to address this, the government is taking steps to encourage more meaningful participation in the workforce by women and is starting to seriously consider changes to its immigration policy. Despite these initiatives, limited domestic growth is forcing Japanese companies to look outward for growth opportunities. Japanese companies have been involved in overseas investment for years with a focus on trade (primarily export), and the sourcing of raw materials to fuel their domestic industry. However, the limited prospects for domestic growth have resulted in Japanese companies looking to overseas markets for investments that can contribute to their long-term sustainability, as evidenced by the Jim Beam and Sprint transactions described earlier. The desire to be involved in overseas M&A activity is no longer limited to the more traditional multinational trading houses and automobile manufacturers. Now even purely domestic Japanese corporates are focused on expanding their businesses outside of Japan.

Japanese Outbound M&A - Total Transaction Values



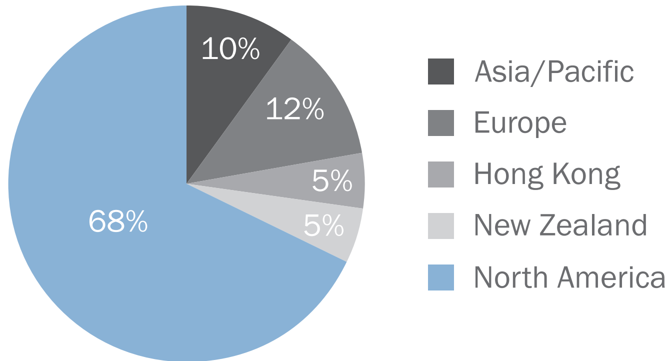
Source: S&P Capital IQ. Year allocations are determined by announced date.
*2014 data as of November 1, 2014, year-to-date activity.

China relations

Geographic proximity to Japan, a large population and dramatic growth in recent years have led many Japanese companies to view China as a natural place to expand their businesses, both through a shift of manufacturing operations to the lower-cost jurisdiction, and by accessing the Chinese market. However, Chinese concerns over Japan's historical militarism, a dispute between the two countries over the Senkaku islands and an increase in Chinese nationalism have all contributed to some Japa-

nese companies feeling that they are no longer welcome in China. This has sparked renewed focus by Japanese companies on other Asian countries, and the Americas, as targets for their investments.

Japanese Outbound M&A - Allocation of Transaction Values by Region 2010-2014*



Source: S&P Capital IQ. *2014 data as of November 1, 2014, year-to-date activity.
Excludes regions where transaction values were 1% or less of total value.

Pension reform

Japan has some of the largest pension funds, including the largest in the world, the Government Pension Investment Fund. However, the bulk of Japanese pension fund assets has historically been invested in Japanese government bonds, realizing annualized returns of approximately 1.5%. With an aging and declining population, Japan's pension funds can no longer afford a low-risk, low-return investment approach. Part of Japan's structural reform includes encouraging more risk-taking by Japanese pension funds, and a greater emphasis on domestic and overseas equity investments. The investment strategies of Canadian pension funds are seen as a positive role model for Japanese pension funds. This pension reform, if successful, is expected to generate significant outbound investment from Japan. The Government Pension Investment Fund recently made a surprise announcement of plans to double its allocation targets for both domestic and foreign equity investments, requiring new equity investments in excess of US$200 billion, with over US$100 billion allocated to investments in non-Japanese companies.

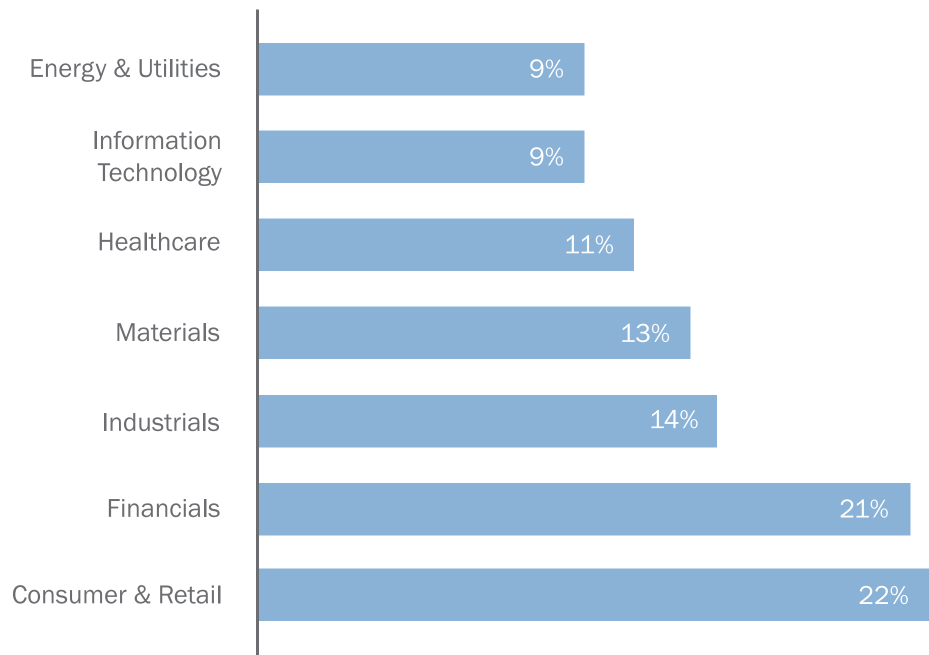
Infrastructure

Japanese banks, trust banks, pension funds, construction and engineering companies, financial and technical advisers, and trading houses are all demonstrating a strong level of interest in infrastructure projects in Japan, North America and Australia. Although Japanese construction and engineering companies have a significant pipeline of new work in anticipation of the 2020 Tokyo Olympics, these companies see a need to begin cultivating a post-Olympics work pipeline now and are actively seeking projects in North America.

Energy

Japan's nuclear power generation has been suspended since the earthquake and tsunami of 2011, resulting in a 26% reduction in power generation. Japan is already the world's largest importer of liquefied natural gas and the second-largest importer of coal. Although the Japanese government is encouraging greater use of renewable energy such as solar, wind, geothermal and biomass, these sources still only make up a small percentage of Japan's total energy consumption. To secure its energy supply, the Japanese government is encouraging participation by Japanese companies in energy exploration and development projects around the world. This is leading to an increase in Japanese investment and M&A activity in the energy sector outside Japan.

Japanese Outbound M&A - Allocation of Transaction Values by Sector 2010-2014*



Source: S&P Capital IQ. *2014 data as of November 1, 2014, year-to-date activity.

One challenge that Japanese companies face in M&A is their relatively slow decision-making processes. This can make it difficult for them to compete in fast-paced North American auctions. However, Japanese companies tend to pay a premium relative to their North American counterparts in exchange for their pace being accommodated. As Japanese outbound M&A continues to rise, we expect that Japanese buyers' willingness to pay a premium will make them attractive alternatives to sellers looking to maximize value in M&A.

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7

RELATIONSHIP BUILDING WITH ABORIGINAL COMMUNITIES WILL COME INTO FOCUS FOR RESOURCE PLAYERS

John Terry, Derek Flaman, Ian Arellano, Michael Pickersgill

The Supreme Court of Canada (SCC) has released two recent seminal decisions that will significantly impact resource development projects where Aboriginal interests might be affected. As M&A activity in the infrastructure, oil and gas and mining sectors unfolds in 2015, we expect buyers of and investors in Canadian targets involved in resource development to pay increasing attention to whether appropriate consultation and accommodation have occurred with local Aboriginal communities, particularly those with existing or potential title claims.

While the practical effect of these decisions will principally be driven by the circumstances of each resource development project, we anticipate due diligence reviews in the transaction process to become more focused on ascertaining potential risks and liabilities associated with possible infringement on Aboriginal title.

The Cases: Aboriginal Title Claims Addressed by SCC

Tsilhqot'in Nation v. British Columbia (*Tsilhqot'in*) marks the first time the SCC has upheld a specific Aboriginal title claim. In that case, the SCC confirmed that the Crown has a duty "to consult in good faith with any Aboriginal groups asserting title to the land about proposed uses of the land and, if appropriate, accommodate the interests of such claimant groups." Where a title claim exists and its holder does not provide consent, the province could only justify an incursion on the title in narrow circumstances where there is a compelling and substantial public objective.

The second case, *Grassy Narrows First Nation v. Ontario* (*Natural Resources*) (*Grassy Narrows*), was released shortly after *Tsilhqot'in* and confirmed that provincial governments can authorize resource development projects on provincial Crown lands covered by Aboriginal treaties—in this case, licensing forestry operations in a treaty-covered area—without the prior consent of the federal government. While a province may not need federal consent, their power to take up treaty lands is nonetheless conditional on consulting and, where appropriate, accommodating any affected Aboriginal interests.

These two decisions appropriately reflect the sophisticated matrix of factors at play when addressing Aboriginal title claims. The degree of consultation and accommodation required will depend on the strength of the Aboriginal claim, with proven Aboriginal title claims requiring the most consultation and accommodation. Even when an Aboriginal title claim is unproven, as the SCC noted in *Tsilhqot'in*, obtaining consent, although not a legal requirement, may avoid a charge of undue infringement if title is later established. According to the SCC, if the Crown authorizes a project without Aboriginal consent, "it may be required to cancel the project upon establishment of [Aboriginal] title if continuation of the project would be unjustifiably infringing."

Sharper Due Diligence Practices in Resource Development M&A

The impact of the SCC decisions will depend largely on the details of each resource development project, including its location and historical circumstances. For example, *Tsilhqot'in* will have the greatest impact in B.C. and other areas of Canada where there are numerous unresolved Aboriginal title claims, and have less impact in jurisdictions like Ontario and Saskatchewan that are largely covered by treaties. Likewise, the extent of the historical presence of Aboriginal communities in a project area will have significant bearing on the degree of consultation and accommodation needed.

Based on the legal framework set out in the SCC decisions, we expect due diligence reviews to increasingly consider the following questions:

Target's record of Aboriginal consultation and accommodation

- Is the target a development project still undertaking consultation, or an operating project with a record of consultation and accommodation behind it?
- Is the record of consultation and accommodation commensurate to the strength of the affected Aboriginal title claim or treaty right?
- Is there any pending or threatened litigation against the Crown for failing to satisfy the duty to consult, or against the target for failing to adequately carry out that duty in practice?

- Does the target have a productive Aboriginal liaison committee for addressing any local community concerns?

Existing agreements, if any, between the target and local Aboriginal communities

- Do the agreements evidence the Aboriginal community's consent to the target's resource development operations?

- Do the agreements provide for capacity funding, economic benefits, employment or educational opportunities, equity participation or other mechanisms for building an enduring, positive relationship between the target and local communities?

The answers to these questions will invariably be highly fact-specific. For example, evaluating whether a target has provided sufficient accommodation to an affected First Nation will depend on many factors, including not only the strength of the First Nation's claim (which in turn depends in part on its historical occupation of the area), but also the typical types and amounts of economic support seen in similar agreements in the area. Given the value of context in these matters, we expect buyers and investors to increasingly retain advisers who are knowledgeable about the relevant Aboriginal communities and their negotiations with the resource development sector.

Importantly, the principles underlying the legal analysis in both *Tsilhqot'in* and *Grassy Narrows* offer a guide not only to doing business in Canada, but also to building relationships with local indigenous communities in other jurisdictions. The SCC decisions' emphasis on meaningful dialogue and compensation around the encroachment on an indigenous community's traditional rights and territory reflect the increasing importance of good relationship building for players in resource development projects around the world.

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8

DEAL CERTAINTY: MORE SELLERS WILL SEEK TO "LOCK THE BOX"

Stefan Stauder, Neville Jugnauth, Patrice Walch-Watson, Tom Yeo

Recent years have seen the rise of an alternative approach to conventional purchase price adjustment mechanisms in private M&A transactions: the so-called "locked-box" structure. The structure first gained prominence in the United Kingdom during the sellers' market of the early 2000s. It made inroads into North America during the 2005-2007 cycle and has regained popularity over the last few years, particularly in the context of "hot" auctions.

Assuming the recent frothy sellers' market continues into 2015, we expect to see more use of the locked box in the near future.

Conventional Closing Balance Sheet Method

Private M&A in North America frequently follows a common template: the target is acquired on a debt-free, cash-free basis, assuming sufficient or "normalized" levels of working capital. Under that structure, the final purchase price is not known at closing. Instead, the parties estimate debt, cash, working capital—and sometimes other adjustment items—and then "true-up" these estimates shortly after closing. That adjustment procedure requires the preparation of a closing balance sheet, often drags on for four months or longer, and is arguably one of the primary sources of disputes among parties to private M&A transactions. Only once that procedure has been completed is the final price set. That price uncertainty, in turn, often requires sellers to post short-term escrows to back up potential repayment obligations.

"Locking the Box"—An Alternative Approach

Under the locked-box structure, the purchase price is fixed at signing. It is calculated as of a so-called effective date, typically the date of a recent audited or unaudited balance sheet (the "reference balance sheet"). From that date forward, the "box is locked," meaning that the risks and rewards of the target business transfer to the

buyer as of the effective date, with negotiated protections addressing value leakage from the target to the seller between the effective date and closing. Critically, there is no purchase price adjustment mechanic. Because the target is effectively sold as of the effective date, sellers frequently request the addition of an interest ticker on the purchase price that runs from the effective date through closing.

The advantages of the locked-box structure are obvious: price certainty at signing, no need to negotiate price adjustment provisions (including setting working capital targets), and the elimination of often time-consuming price-related disputes between the parties after closing. Sellers see additional benefits in the locked-box structure because they control the preparation of the reference balance sheet rather than having to review and work from a closing balance sheet typically prepared by the buyer. In an auction environment, a locked-box offer can also be easier for the seller to value and compare against competing offers. The locked-box approach can equally benefit buyers by reducing any incentive for sellers to manipulate traditional purchase price adjustments to their advantage, for example, by deferring capital expenditures to artificially inflate cash at closing.

Buyer Considerations

Beyond the advantages, however, the locked-box approach presents several issues that a buyer should consider carefully. First, the buyer needs to make an upfront investment of time and money to thoroughly diligence the reference balance sheet, because unlike transactions using the conventional mechanism, there will not be an opportunity to dispute balance sheet positions once the value has been locked. This is particularly true where the reference balance sheet is not audited. It may be difficult to reconcile that upfront due diligence commitment with other transaction dynamics, for example, in situations where speed of execution is key.

A second issue for buyers is that locked-box deals sometimes do not provide for a full bring-down of the seller's representations and warranties to closing–other than with respect to certain fundamental representations and warranties regarding the validity of the transaction. This is another upshot of the basic premise that the buyer, from an economic standpoint, owns the business as of the effective date on a locked-box deal. As a result, the buyer's walk-away rights at closing may be more limited than in the conventional structure. Similarly, locked-box transactions may not permit a buyer to seek indemnification post-closing for breaches of the representations and warranties that occur between signing and closing.

A third key issue for buyers in locked-box transactions which requires particular attention is related-party "leakage"—that is, any transfer of value from the target to the seller and its affiliates between the effective date and closing. Leakage potentially undermines the buyer's fixed purchase price obligation and can be thought of in three categories:

Permitted leakage that should not give rise to a purchase price reduction and may include, for example, amounts payable by the target to affiliates of the seller for services rendered on arm's-length terms;

Negotiated leakage that is permitted under the terms of the purchase agreement but gives rise to a purchase price reduction—examples include the payment of target transaction expenses, management fees to private equity sponsors or stay bonuses; and

Prohibited leakage that comprises all payments to or on behalf of the seller and its affiliates which do not fall into the first two categories. The purchase agreement will typically include provisions that restrict this category of leakage and give the buyer recourse against the seller on heavily negotiated terms if restrictions are violated.

While the locked-box structure presents advantages over the conventional mechanism, these advantages come largely at the buyer's expense. However, in the context of competitive auctions, prospective buyers who are able to get comfortable with the drawbacks of the locked-box structure may find that they can differentiate themselves from their rivals.

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9

STRONG DEMAND FOR PRIVATE EQUITY CO-INVESTMENTS CONTINUES

Cameron Koziskie, Michael Akkawi, Jay Romagnoli, Richard Willoughby

Private equity co-investment transactions have steadily gained popularity with both private equity investors and private equity fund sponsors in the past few years, and we expect this trend to continue and accelerate in 2015.

In a private equity co-investment transaction, an investor invests in an M&A transaction alongside the sponsor's primary fund. Investors are drawn to co-investment as it gives them the opportunity to build out their private equity exposure—often on terms that include reduced management fees and sponsor carry—and the option to select the co-investments in which to participate. This freedom of selection is viewed as an advantage over, or a complementary strategy to, passive blind-pool fund investments.

Sponsors equally view co-investment transactions as beneficial in the right circumstances. Co-investments provide sponsors with access to additional capital to complete larger investments that would otherwise require equity capital in excess of a sponsor's investment concentration limit under the fund's governing documentation, or in excess of the exposure the sponsor feels is appropriate for the fund. Co-investments also have the potential to deepen sponsors' relationships with their limited partners.

Why Are Co-Investments Gaining in Popularity?

The rising popularity of private equity co-investment transactions has been driven by the following factors, each of which we expect will continue:

Increased investor expertise

Leading-edge institutional investors have been developing in-house deal capabilities

for many years. Their successes have inspired many other investors to emulate this model, and a natural first step in developing in-house expertise is to seek out and execute co-investment transactions.

Investor demands for co-investments

Many large private equity investors have become selective in their fund allocations, preferring to develop concentrated relationships with a limited number of sponsors. These investors will often only devote commitments to funds offering meaningful co-investment opportunities to the investor, frequently on a priority basis to other potential co-investors. The increasing prevalence of these arrangements, which are often formally set out in the investors' side letters, naturally leads to an increase in co-investment transaction volumes.

Enhanced net returns

Private equity investors continue to seek ways to increase the net returns on their private equity portfolios. Since co-investors often pay reduced (or no) management fees and carry entitlements on capital deployed in co-investment transactions, those savings can help investors enhance their net returns, which contributes to further investor demand for co-investment opportunities.

High valuations

Given the current seller's market, more and more sponsors are looking to partner with others in order to share the risks of any given investment. Club deals (where a sponsor seeks to partner with other private equity sponsors to complete an M&A transaction) have become less common in part as a result of the highly competitive deal environment and the decreased number of mega-buyouts since the credit crisis. Sponsors are turning instead to "friendly" parties (the sponsor's own limited partners) as deal partners for M&A transactions.

Investor relationship benefits

The fundraising environment for many remains challenging. Sponsors are keen to differentiate their funds from others, and a history of successfully offering co-investment opportunities to investors is a tangible benefit many investors find attractive.

Fundraising benefits

Sponsors have offered co-investment opportunities to investors considering making capital commitments to their funds—the co-investment opportunity is used to build the relationship between the parties and as an inducement to make the future capital commitment.

Other Considerations

Co-investment transactions, however, are not for everyone and sponsors do exercise judgment on when and to whom a co-investment opportunity is offered. An ideal co-investor is often an institution with deep experience in M&A transactions and strong internal resources (so that the co-investor can quickly make decisions and meet funding and other deal timelines). Any relevant industry expertise and networks that could enhance the investment returns are also valuable.

To the extent that a co-investor expects to play an active role in the co-investment (through board seats, veto rights or otherwise), a common view on key deal drivers, as well as a strong working relationship between the sponsor and the co-investor, will be vital. Issues can and do arise down the road, however, including differing investment time horizons, and the resulting friction can be damaging to the sponsor-investor relationship.

We see great opportunities for co-investments to continue to both shape deal-making in 2015 and drive growth in the private equity asset class.

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U.S. CLAMPDOWN ON INVERSIONS CLOSES SOME DOORS BUT LEAVES OTHERS OPEN

Peter Keenan, Corrado Cardarelli, Craig Maurice, David Mattingly

Throughout much of 2014, U.S. tax inversions have drawn the renewed scrutiny of the U.S. Congress and the administration of President Obama. To date, none of the anti-inversion measures proposed by members of the U.S. Congress in 2014 have become law. However, the Obama administration has used its authority to create a number of new anti-inversion rules that became effective for inversions completed on or after September 22, 2014. While the new rules and proposed measures will curb some tax inversion structures, we predict that inversion opportunities will continue in 2015.

An inversion refers to a transaction whereby a U.S.-based multinational corporate group seeks to expatriate to another country to reduce its overall effective tax rate and realize significant tax savings. Typically, shareholders of the U.S. company and its foreign partner transfer their shares to the new foreign parent in exchange for parent stock and possibly other consideration. The key to a successful inversion is that former shareholders of the U.S. company must own less than 80 percent of the stock of the new foreign parent. If the former shareholders own 80 percent or more of the new foreign parent, the parent will then be taxable as a U.S. corporation under the U.S. anti-inversion laws.

The Obama administration's new anti-inversion rules are described in IRS Notice 2014-52. The following is a summary of these new rules and proposed measures, together with our views of the practical impact on future inversion opportunities.

Pre-inversion Rules and Proposals

Limits on a U.S. company's ability to "skinny down" (IRS Notice 2014-52)

To prevent a U.S. target company from circumventing the 80-percent test by decreasing its value in relation to the foreign partner corporation by spinning off or selling assets, a new rule disregards such transactions occurring within three years before the inversion.

While the new rule requires a careful analysis of all pre-inversion distributions that are not in the ordinary course of business, it should not prevent most inversions with a compelling business purpose from succeeding.

Targeting of "cash box" foreign partner corporations (IRS Notice 2014-52)

For purposes of the 80-percent test, a new rule reduces by formula the number of shares treated as issued to shareholders of the foreign partner corporation, if more than half of the foreign partner group's assets consists of passive assets such as cash and marketable securities.

This new rule applies to comparatively few transactions and should have a modest effect.

Lower, 50-percent threshold for inversions (proposed legislation)

To reduce the possibility of inverting, proposed legislation would lower the 80-percent threshold to any percentage greater than 50 percent.

Such a rule would thwart some, but not all inversions. Even if enacted, history suggests such a rule would apply only prospectively, not retroactively.

Post-inversion Rules and Proposals

Re-characterization of "hopscotch" loans (IRS Notice 2014-52)

In the past, a loan made by an inverting U.S. company's foreign subsidiary directly to the new foreign parent generally could avoid attracting U.S. tax. A new rule re-characterizes such "hopscotch" loans as investments in U.S. property subject to tax.

The new rule stymies some but not all current inversions, and it fails to address comparable tax-efficient strategies, such as the "hopscotch" licensing of intellectual property.

Hurdles to corporate restructuring (IRS Notice 2014-52)

As part of its post-inversion planning, a U.S. company may find it tax-efficient to move its foreign subsidiaries outside the U.S. chain, perhaps to release "trapped cash." New rules are expected to make this much more difficult.

The new rules seem unlikely to prevent all such restructurings. Moreover, the rules should have no effect on future business in new subsidiaries formed outside the U.S. chain. Ultimately, new business grown entirely outside the U.S. chain will escape U.S. tax.

Clampdown on earnings stripping (under consideration)

An inverted U.S. company almost invariably seeks to reduce its U.S. taxes by paying interest to a new foreign parent, a practice known as "earnings stripping." Both Congress and the Obama administration are considering measures to limit earnings stripping.

As a practical matter, a concerted attack on earnings stripping would face a political and economic backlash from all foreign companies investing in the United States, not merely inverted companies. Accordingly, rules attacking earnings stripping seem likely to be attenuated and to apply in a limited fashion, preserving the opportunity for many U.S. companies to successfully invert.

Reclassification of debt as equity (under consideration)

An alternative means to limit earnings stripping would be to reclassify as equity any debt issued by an inverted U.S. company to its new foreign parent.

Proposals to reclassify debt as equity for this purpose appear to rest on shaky legal ground. A previous attempt by the U.S. government to issue regulations governing the classification of debt and equity, made with great effort in the 1980s, ultimately was withdrawn.

Prognosis

Given the chance to combine with a suitable foreign partner, the prognosis for a U.S. company seeking to invert remains good. The new and proposed rules seem likely to thwart some inverting companies, while preserving opportunities for others. And as is often the case with innovative tax rules, the law of unintended consequences may well work in the taxpayer's favour.

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