PRIVATE EQUITY CANADA 2009

Have we hit bottom?

THOMSON REUTERS

McKinsey&Company

PRIVATE EQUITY CANADA 2009

Have we hit bottom?

THOMSON REUTERS

McKinsey&Company

This publication is not intended to be used as the basis for trading in the shares of any company, or undertaking any other financial transaction, without consulting appropriate professional advisors in each instance.

The views and opinions expressed in this publication are those of the authors, and they do not necessarily represent those of McKinsey & Company.

Printed in Canada.

Private Equity Canada 2009: Have we hit bottom?

Welcome to the 2009 instalment of the *Private Equity Canada* series. Although this report is similar to those we have published in the past,[1] its format differs from previous versions. First, to reduce our carbon footprint, we have moved the report online. Second, as the deal environment in Canada and the United States was slow in 2009, we have streamlined our analysis of market trends and emphasized the market data we collected. We hope that the pace will pick up in 2010 and that next year we will once again provide a detailed analytical and qualitative review of the events in the Canadian and US PE markets. We also hope that you will continue to enjoy *Private Equity Canada* and will gain fresh insights into these markets.

Looking back on 2009

2009 was a tumultuous year: the stock market crashed and then rebounded over 60 percent from its lowest point; oil prices dropped to $35 per barrel and then rebounded to over $80; interest rates dropped to near record levels; and the economy swung from significant contraction to expansion. However, the PE industry's response to these events appears to have differed in Canada and the United States. The industry saw an unprecedented contraction in deal activity, average deal size, returns, and fundraising. For example, fundraising[2] in Canada and the United States in 2009 was estimated to be US $64 billion versus US $506 billion in 2007. In 2009, deals with an enterprise value of less than US $500 million accounted for 60 percent of the deals done whereas, in 2007, deals of this size were less than 4 percent of the deal activity. In addition, LPs shrunk their allocations or reduced their exposure to private equity through secondary offerings. The rebound experienced in other industries has not yet occurred in private equity, which remains well below the highs it achieved in 2007 and certainly below the levels of 2008.

Why would this be the case? Our analysis of the market and interviews with PE investors in Canada and the United States indicate a high degree of uncertainty in the key elements necessary for successful PE investment: 1) the general economic outlook (and resulting valuations); 2) debt capital markets; 3) equity markets; and

1 As always, we have based our conclusions on McKinsey's proprietary research and the data Thomson Reuters collected and analyzed from its proprietary survey, supplemented with several related surveys, benchmarking, and interviews where we examined over 90 percent of the Canadian market.

2 Includes buyout, venture, growth capital, and PIPES.

4) the regulatory environment. As a result, it is difficult to adequately price risk and optimally allocate capital.

In terms of the economy, many PE investors and experts we interviewed thought the 2009 rebound was a response to players taking advantage of very low asset prices – for example, China's purchasing of extremely large quantities of copper – and not a reflection of underlying economic strength. They also thought the stimulus packages and very low real interest rates masked the economic weakness inherent in private consumption. Many investors commented that they continued to experience slow revenue growth and pricing pressure in many of their portfolio companies and did not see the economic expansion that so many people commented on. PE investors were concerned about the impact of stimulus funding expiring in the next 12 months in Canada and the United States; the possibility of either inflation or an economic slowdown in China; and the instability and financial distress in the Eurozone making investors uncomfortable with the projected EBITDAs for potential investments. The Canadian dollar's value relative to that of the US further complicates issues for Canadian PE investors – particularly those considering investing in companies that derive a significant portion of their revenue from the United States.

Certainly, 2009 will be remembered as the year when the debt capital markets completely shut down and then somewhat reopened after unprecedented interventions by most governments in the developed world. Although the statistics indicate that liquidity has partially returned to the debt capital markets (and credit spreads have narrowed substantially), the reality is that these markets remain difficult to access for many leveraged buyout transactions. Most investors indicate that though they can access some credit, it is in much smaller amounts, with much higher costs, and more restrictive covenants. In addition, the securitization markets have barely reopened. Investors and issuers in Canada and the United States remain sceptical of these markets, which undermines the credit creation cycle. The glory days of large covenant-light debt packages are long gone. Many investors believe this situation is likely to persist, increasing debt costs and affecting investment returns. Equity capital markets in 2009 were like a bouncing ball – straight down and then straight back up. Although many would argue the rebound is favourable, for buyout investors the uncertainty makes it difficult to identify the opportune time to exit the markets. The market's volatility, combined with economic uncertainty, also makes it difficult to determine a reasonable valuation for a security. In addition, a fair amount of capital is sitting on the sidelines. As a result, the IPO market has remained subdued, and only a handful of buyout exits took place in 2009.

In addition to this volatility, 2009's defining characteristic was regulatory uncertainty, particularly in the United States. The US government is overhauling its banking and security regulations. These changes are expected to require banks to put more equity on their balance sheets – some will have to carve out their PE and hedge fund businesses (under the Volcker rule) – and the structure of and rules for securitization markets are likely to change significantly. The result will likely be higher debt financing costs and difficulty accessing debt. It is difficult to know how these changes in the United States will affect Canada given that our banking system emerged unscathed from the economic crisis and Canada is not considering regulatory changes.

In response to this uncertainty, GPs and LPs reduced their outward activity (i.e., investing in new funds or companies) and doubled down their efforts internally. Most GPs we interviewed spent much of 2009 shoring up the balance sheets of their portfolio companies or refinancing them. They worked hard to reduce costs and extract cash from operations and made management changes as necessary. Many smaller LPs or LPs suffering liquidity issues in 2009 re-examined their PE allocations and programs. Some decided they needed to reduce their allocations or sell positions in the secondary market to raise liquidity. Others, interestingly, believed that the expected returns on all other asset classes were likely to remain low, given the low interest rates, and decided to increase their allocations to private equity and other alternatives seeking alpha and higher returns to offset their deficits.

In addition, GPs (particularly underperforming ones) faced increasing pressure from LPs to adjust their investment terms and conditions (e.g., reducing their management fee levels and transaction fees and adding a no-fault divorce clause). For example, many GPs are being forced to move from a 2 percent fee approach to a budget base approach for the management fee. Leading GPs (including many Canadian ones) have made a concerted effort to develop a joint approach to adjusting their terms and conditions to respond to pressure from the Institutional Limited Partners Association.

Within the industry, a great deal of negotiation over committed but undisbursed capital has been taking place. LPs short of liquidity have sought to terminate or minimize their future commitments (often in exchange for “promises” to invest in future funds) so that they can better manage their vintage exposure and limit their exposure to the 2006 and 2007 funds (in which more than 60 percent of investments were made at the peak of the cycle with very high multiples).

Finally, many LPs have decided to further limit the number of GPs they will maintain in their portfolio and to develop more strategic relationships with them (particularly if the LPs have limited dry powder to do co-investments when the markets pick up).

In light of all this uncertainty and change, many in the Canadian and US PE industry are asking: Have we hit bottom? After all, uncertainty about the market has not dissipated – in some cases, it has increased. So, what does the future hold for the industry? There is a case to be made that the medium-term outlook is reasonably strong.

- **Private equity is a cyclical industry.** Over the past 30 years, the PE industry in Canada and the United States has experienced multiple cycles of contraction and expansion, creating a familiar pattern. When the economy starts to expand and liquidity remains tight, private equity becomes an attractive option. As returns improve, more capital is drawn into the industry and ever larger investments are made.

- **Private equity has shown its value in this downturn.** In general, top performing PE firms performed better during the recession. This is in no small part due to their efforts to improve the economics of portfolio companies. We estimate that there is approximately $500 billion of uninvested capital globally that could enter the market and take advantage of the opportunities that may emerge during the crisis.

- **Investors will continue to seek the attractive risk-adjusted returns** that top-quartile private equity provides, particularly in a low-interest-rate environment.

- **Some consolidation in the industry is likely.** A number of firms/funds are likely to be unable to raise subsequent funds because of poor performance and will choose to shut down, somewhat lessening competition.

- **The average size of new funds raised in the coming years will likely be smaller,** again reducing competition.

- **The economy and public equity markets will eventually stabilize and continue to grow,** producing attractive exit opportunities and enhanced returns.

■ ■ ■

2009 was a tumultuous year for the PE industry in Canada and the United States. But GPs and LPs are adapting – and the industry is evolving. While the future is uncertain, it will certainly be interesting.

Robert Palter
Director
McKinsey & Company

Sacha Ghai
Principal
McKinsey & Company

Jonathan Tétrault
Principal
McKinsey & Company

McKinsey & Company[3] is an international management consulting firm that specializes in helping clients achieve substantial and lasting improvements in their performance. Its Canadian Practice, with offices in Toronto, Montreal, and Calgary, draws on McKinsey's network of over 90 offices to provide objective counsel to management teams facing strategic, organizational, or operational opportunities and challenges. For more information, please visit us at *www.mckinsey.com* or contact us by phone at 416 313 3700, 514 939 6800, or 403 538 2160.

3 McKinsey & Company is not an investment advisor and will not provide investment advice.

Contents

An in-depth review of the Canadian market in 2009

Introduction

Private Equity Canada 2009, prepared by Thomson Reuters for McKinsey & Company, is the ninth in an annual series of reports dedicated to profiling key trends in Canada's private equity market and its key investor groups.

Data collected and analyzed by Thomson Reuters for this report were drawn from a proprietary survey of Canadian PE fund managers and several related surveys. Survey work was chiefly conducted during the latter part of 2009 and between January and April of 2010. The final respondent sample, totalling 120 contributors, reflects all of the largest groups based in Canada – and 96 percent of the entire capital pool.

The data requested and the questions posed in the survey were consistent with those of 2008. This serves Thomson Reuters' aim of adding to, and updating, information received previously from fund managers. Consequently, the prior year's data will sometimes reflect changes of note. Thomson Reuters provided supplementary data to augment survey findings to ensure this report reflects market trends as fully as possible.

Thomson Reuters developed the research methodology for all survey work in this and previous reports going back to 2001. The methodology is comparable to that used internationally for profiling national or regional PE markets.

McKinsey & Company and Thomson Reuters wish to thank the many GPs, investment managers, and staff at Canadian buyout, mezzanine, VC, and other PE funds who gave freely of their time to provide confidential data and share their views for this report. *Private Equity Canada 2009* would not have been possible without their generous contributions.

We would also like to thank Thomson Reuters professionals who assisted in the report's production, including analysts Wei Dai and Gavin Penny.

Kirk Falconer
Director of Research, Private Equity
Thomson Reuters (Canada)

Thomson Reuters is the authoritative source of information on activity in Canada's private equity space. Its extensive network of contacts and its proprietary data sources have made the firm a focal point for information on Canadian private equity deals and dealmakers. For this reason, Thomson Reuters is a vital, value-adding resource for understanding the full universe of market players in Canada, as well as those based in the United States and other countries that are engaged in cross-border investing. For more information, please visit us at *www.thomsonreuters.com,* or *www.canadavc.com,* or contact us by phone at 416 956 1077.

If you have any questions about the *Private Equity Canada 2009* survey methodology or data findings, please contact Kirk Falconer at 613 747 4441 or kirkfalconer@thomsonreuters.com.

Executive summary

The struggling global economy in 2009 resulted in one of the slowest environments for PE deal-making and fundraising in many years. According to a survey conducted by Thomson Reuters, 2009 was the second consecutive year of reduced Canadian activity, with overall investment levels dropping as sharply as in 2008. However, Canadian fund managers also said that they believe market indicators will improve in 2010.

The survey found that the challenging market conditions did not preclude some moderate growth in the capital pool managed by Canadian investors in 2009. Private equity resources under management totalled $76 billion, up 3 percent from 2008.

Buyout and related PE fund managers absorbed most new dollars in 2009. They oversaw $53.7 billion or 4 percent more than the year before, accounting for 70 percent of the entire market. The year-over-year increase was driven by several major buyout partnership closings.

Capital managed by mezzanine and other quasi-equity funds stood at $7.3 billion, down somewhat from 2008 but continuing to make up 10 percent of the aggregate amount.

Venture capital investors had stewardship of $14.9 billion, or close to one-fifth of the total pool. For the most part, resources in this segment were unchanged from 2008, despite several important new fund formations.

Based on survey findings and supplementary data, Thomson Reuters estimated the Canadian PE market as a whole to be $79.5 billion in 2009.

Private-independent funds laid claim to even more market share in 2009, according to survey findings. Private equity partnerships managed $44.6 billion, up 7 percent from 2008, accounting for 59 percent of the entire pool.

The slower market conditions of 2009 did not dampen the enthusiasm of Canada’s leading institutional investors for private equity. Institutional captive funds oversaw $20 billion, or just over one-quarter of the aggregate amount this time around.

Labour-sponsored and other retails funds had $7.6 billion under management, or a 10 percent market share. Corporate captive funds and government funds made up the balance, managing $2.3 billion and $1.8 billion, respectively.

The market climate was especially chilly for fundraising last year. Despite some major partnership events, new commitments to Canadian buyout, mezzanine, and other PE funds totalled only $2.5 billion, down 58 percent year over year.

In 2009, new supply inflows targeted to the domestic VC segment remained at subpar levels comparable to those reported in the mid-1990s. Although some important new partnerships and other funds were created, commitments totalled only $1.1 billion.

Domestic and foreign LPs were key contributors to the $3.6 billion raised in aggregate by fund managers based in Canada in 2009. Domestic resources, led by corporations, pension funds, and other institutional investors, accounted for 69 percent of new commitments.

Cross-border investors brought $1.1 billion, or 31 percent, to Canadian PE funds. Buyout and other PE partnerships benefitted most from this activity, drawing 43 percent of new supply from foreign sources in 2009.

Private equity fund managers anticipate some improvement in fundraising trends in 2010. Perhaps as a consequence, the survey found those with new fund offerings had increased to 39 compared with 37 at the start of 2009.

The continuing effects of the economic recession had an impact on PE deal volumes, dollars invested, and other investment indicators across North America and around the world in 2009. Like their global peers, Canadian investors remained cautious – for the second consecutive year, the survey found reduced deal activity in all market segments.

Disbursements by buyout, mezzanine, and other PE funds totalled $3.1 billion in 2009, or 53 percent below 2008 levels. In addition, deals done in domestic and foreign businesses totalled 308, down 45 percent from 2008.

Overall, Canadian buyout and related PE deal-making was the slowest in 6 years. As in 2008, the relative absence of mega-transactions significantly influenced trends in the domestic market; however, important mid-market deals continued to get done.

Canadian VC funds invested a total of $848 million in domestic and foreign businesses, down 32 percent from 2008. Company financings were also down 18 percent year over year, totalling 402.

When combined with foreign VC activity in Canada, levels of domestic investment were the lowest recorded in over a decade. 2009 trends focused on follow-on deals that would take portfolio firms to higher growth, though early-stage activity was not neglected.

Canadian buyout and related PE investors completed only 61 exits from portfolio companies in 2009. The exit activity of VC investors was comparatively steady, with 26 disclosed acquisitions and IPOs.

Canada's private equity market in 2009

Slight growth in private equity resources

The struggling global economy in 2009 resulted in one of the slowest environments for PE deal-making and fundraising in North America in many years. Consequently, the capital pool managed by Canadian investors expanded only marginally, with most new supply coming from successful partnership closings.

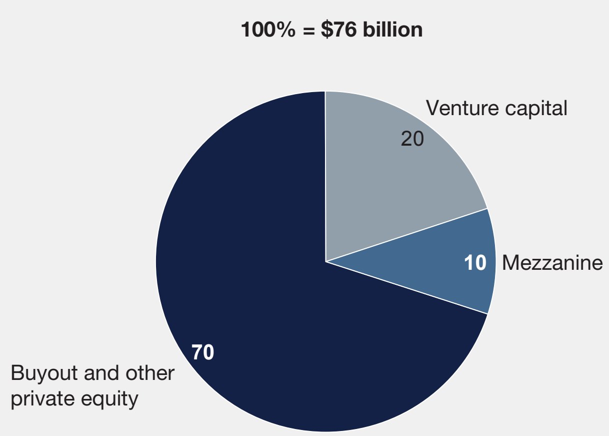
The survey (and supplementary data provided by Thomson Reuters) found PE funds under management in Canada totalled $76 billion in 2009. This is 3 percent more than the $73.7 billion managed in the domestic market in 2008.[1]

In keeping with recent trends, most new dollars were absorbed by buyout and related PE funds. Canadian fund managers oversaw a total of $53.7 billion in 2009, up 4 percent from 2008. As a result, the buyout share of the entire market pool was 70 percent.

EXHIBIT 1

Total capital under management by PE market segment; 2009

Percent



SOURCE: Thomson Reuters

1 In 2010, Thomson Reuters adjusted market supply data to account for Canadian fund manager reports of changes that have taken place in certain funds. This has resulted in revised data, including a new estimate of the size of the capital pool in 2008 and previous years.

Sources of this increased buyout capital were an array of new partnerships, including Onex Partners III LP that – upon completion – was the largest Canadian PE fund raised to date. Other major fund formations included initial closings for Birch Hill Equity Partners IV LP, Clairvest Equity Partners IV LP, and Persistence Capital Partners LP, and final closings for Imperial Capital Acquisition Fund IV and JOG LP IV.

Canadian mezzanine and other quasi-equity funds managed $7.3 billion last year, down somewhat from 2008 but continuing to make up 10 percent of the aggregate amount. The comparatively slow fundraising in this segment helps explain the year-over-year drop in resources in absolute terms.

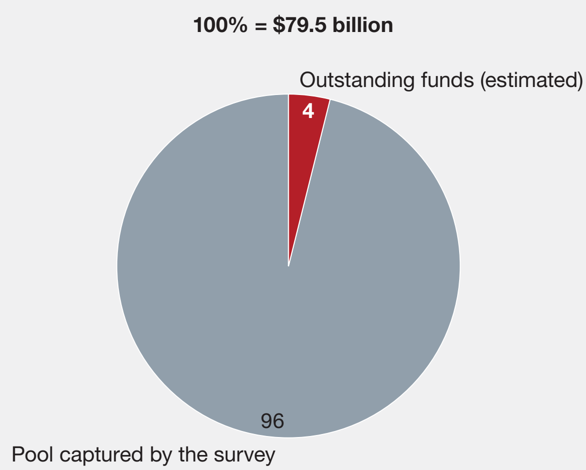
The climate for VC fundraising activity continued to be tepid in 2009. Despite the challenges, a number of important new partnerships were launched or completed, including Cycle Capital Fund I LP, Ontario Emerging Technologies Fund, Tandem Expansion Fund I LP, VanEdge Capital Fund, and Yaletown Ventures II LP.

Overall, Canadian VC fund managers had stewardship of $14.9 billion last year, which represents one-fifth of the total market. Resources managed in the space were largely unchanged from 2008, primarily because of ongoing fund consolidations and related outflows.

EXHIBIT 2

Total PE capital under management (estimated) and survey sample pool; 2009

Percent



SOURCE: Thomson Reuters

Based on survey findings and additional proprietary data provided by Thomson Reuters, the domestic capital pool as a whole was estimated at $79.5 billion in 2009, up from an estimated $77.2 billion the year before.[2]

Based on this estimate, survey data accounted for 96 percent of total supply managed by PE investors based in Canada.

Private funds lay claim to greater market share

In recent years, the survey has found private-independent funds steadily increasing their presence on the Canadian PE landscape. Indeed, over the past 3 years, the private-fund share of total resources under management has exceeded 50 percent.

In 2009, private funds claimed even more market share, as commitments to partnerships accounted for the bulk of new capital inflows. Dollars managed by private funds in buyout, mezzanine, VC, and other PE segments totalled $44.6 billion. This was up 7 percent from $41.8 billion in 2008 and reflects 59 percent of the entire pool.

The slower market of 2009 did not dampen the enthusiasm of Canada's leading institutional investors for private equity. CDP Capital Private Equity, CPPIB Private Investments, Manulife Capital, OMERS Private Equity, Teachers' Private Capital, and others sustained their focus on emerging opportunities, particularly in foreign markets and, in some cases, placed an even greater emphasis on direct deal activity.

As a result, institutional captive funds managed approximately $20 billion in total in 2009. This gave them just over one-quarter of the aggregate amount.[3]

Resources managed by the captive funds of Canadian industrial and financial corporations were slightly greater on a year-over-year basis, totalling $2.3 billion in 2009. As a result, corporate PE funds accounted for 3 percent of the market total.

Merger and acquisition events continued to be a major factor in the community of labour-sponsored and other tax-assisted retail funds. The largest consolidation of 2009 was the nationally active GrowthWorks' takeover of the Canadian Medical Discoveries Fund. At year's end, retail funds under management were $7.6 billion, comprising a 10 percent share.

---

2 Thomson Reuters' estimates of the entire universe of Canadian PE funds have been adjusted to account for fund-specific changes (see previous footnote for details).

3 Data adjustments noted in Footnote 1 primarily account for changes in Thomson Reuters' estimates of capital managed by institutional captive funds for recent years.

Private equity funds owned and directed by federal and provincial government agencies increased their supply of capital to $1.8 billion in 2009, which is equal to 2 percent of the total pool. This was primarily an outcome of public policy initiatives targeted at the VC segment of the Canadian market.

Trends in private equity fundraising in 2009

Fundraising slows even further

Conditions for raising PE funds were particularly difficult in 2009, irrespective of the quality of individual fund offerings and brands. Across all market segments, levels of activity in the United States were at their lowest in 6 years, with new commitments to buyout and mezzanine partnerships falling 76 percent year over year.

The situation was the same in Canada, where the pace of buyout and related PE fundraising was the slowest since 2005. In addition, new supply inflows targeted to the VC segment remained at subpar levels comparable to those reported in the mid-1990s.

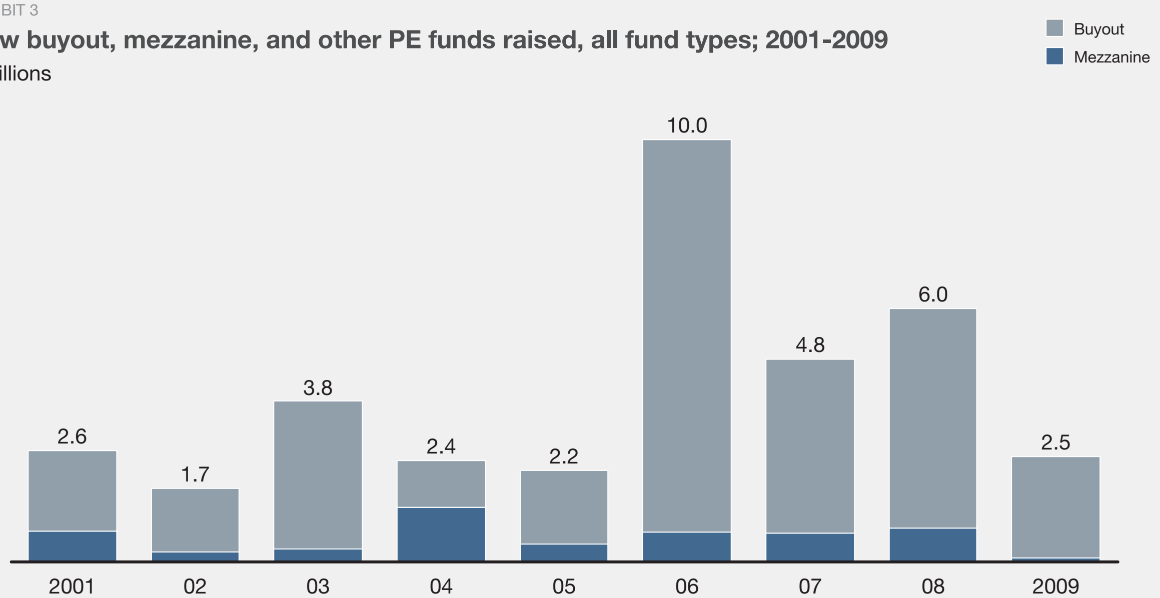
Major buyout funds emerge despite challenges

Dollars going to buyout, mezzanine, and other PE funds totalled $2.5 billion in 2009, or 58 percent less than the $6 billion committed the year before. In spite of this decline, the survey found that some of Canada's most established fund

EXHIBIT 3

New buyout, mezzanine, and other PE funds raised, all fund types; 2001-2009

$ Billions



SOURCE: Thomson Reuters

managers had overcome challenges to launching and successfully concluding new partnerships.

This was certainly the case in the buyout space. A key example was Onex Partners III LP, which closed at an unprecedented US $4.3 billion last year, meeting its original target of US $3.5 billion from third-party investors, with a further US $800 million coming from Onex Corporation. The fund will focus on acquiring North American firms with global operations and writing equity cheques of up to US $600 million for corporate carve-outs, distressed-for-control deals, and restructurings.

As noted earlier, Onex Partners III LP is the largest partnership raised in the history of the Canadian PE market.

Birch Hill Equity Partners Management also had auspicious news in 2009 concerning its fourth fund offering. Emphasizing expansion deals, MBOs, refinancings, and other mid-market opportunities in domestic firms valued between $30 million and $600 million, Birch Hill Equity Partners IV LP has so far captured $570 million. This puts it within reach of the fund manager's final target of $850 million.

Another market veteran, Clairvest Group, has raised over $300 million to date for Clairvest Equity Partners (CEP) IV LP, which is approximately 80 percent of the fund's target. CEP IV LP proceeds will facilitate investments ranging from $15 million to $40 million in established companies, including those in the gaming sector, which has become a Clairvest specialty over the years.

Another highlight of 2009 was the completion of Imperial Capital Acquisition Fund IV at $126 million. Imperial Capital Group's latest partnership will focus on mid-market buyout deal opportunities across Canada and the United States involving firms valued between $5 million and $20 million of EBITDA, especially those in the branded consumer products, healthcare, and business services industries.

Fundraising events in 2008 featured a number of new, energy-focused partnerships. This trend continued in 2009 with the final close of JOG LP IV, totalling $156 million. Calgary-based JOG Capital's fourth fund since 2002, it invests in junior energy exploration and development companies based in Canada.

Montréal-based Persistence Capital Partners (PCP), which focuses exclusively on high-growth opportunities in the healthcare field in Canada, also introduced its inaugural fund in 2009. In fact, PCP closed its fund in early 2010, with commitments in excess of $85 million. To date, PCP's portfolio includes four Canadian-based healthcare services businesses.

Initiated by the Right Honourable Paul Martin and family, the CAPE Fund was also launched in 2009. Emphasizing PE investment that encourages entrepreneurship and business ownership in Canada's Aboriginal community, the fund was capitalized at $50 million by Canadian and international LPs.

New sources fuel venture capital partnerships

In a subpar year for VC fundraising across North America, Canadian investors attracted $1.1 billion in total. However, a handful of fund formations indicated the potential for better outcomes in 2010, in part due to new public-private partnerships.

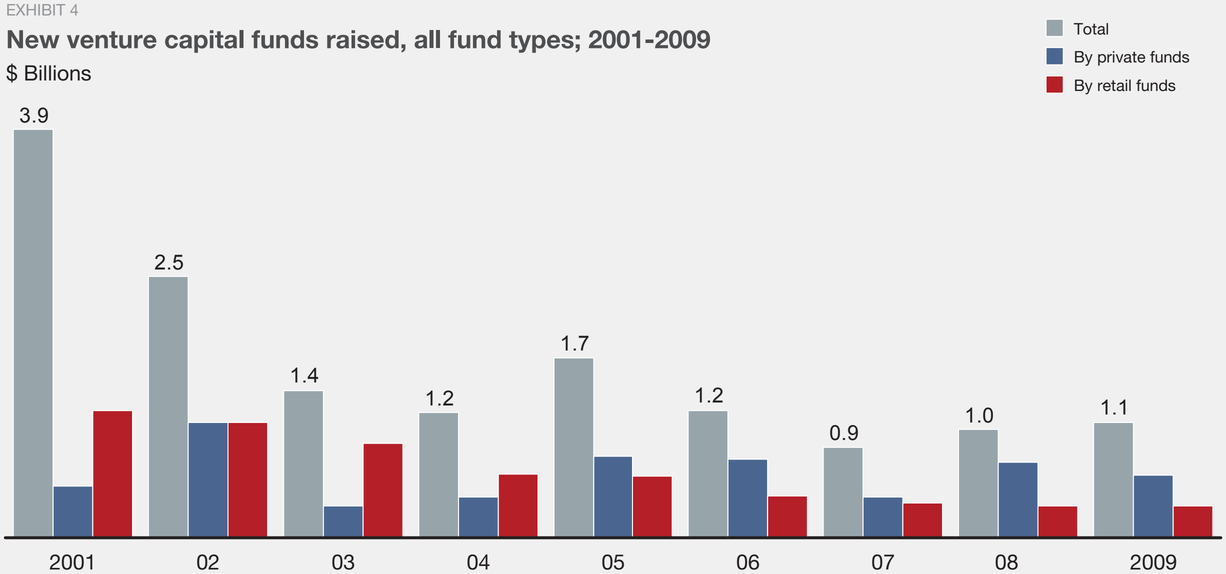
This trend was reflected in the initial closing of Tandem Expansion Fund I LP, which provides growth and late-stage financing to promising Canadian technology businesses. Co-founded by leading PE professionals, Tandem has raised $300 million to date. Among its LPs were two government-leveraged pools, the BC Renaissance Capital Fund and Québec-based Teralys Capital.

Vancouver's Yaletown Venture Partners brought its latest fund offering within a hairbreadth of its final target in 2009. Commitments to Yaletown Ventures II LP, which is focused on early-stage IT and clean-tech firms in Western Canada and the US Pacific Northwest, totalled $95 million in its second close. In fact, not only did the fund meet its final target in early 2010, but it was also oversubscribed at $120 million.

EXHIBIT 4

New venture capital funds raised, all fund types; 2001-2009

$ Billions



SOURCE: Thomson Reuters

Several other important VC partnerships emerged in 2009. For instance, Cycle Capital Management of Montréal did a first closing of its debut fund totalling $80 million. Cycle Capital Fund I LP received backing from multiple sources, including Brookfield Renewable Power and Cascades that will also act as industrial partners on deals involving clean-tech and renewable energy firms.

Also established was the Ontario Emerging Technologies Fund, capitalized at $250 million by government to co-invest with private funds in high-growth companies in IT, life sciences, and other innovative sectors in the province. Ontario Capital Growth Corporation oversees the fund, with the assistance of Covington Capital Corporation and Northwater Capital Management.

With $336 million flowing into the VC segment in 2009, retail fundraising actually increased compared to the year before. This trend was chiefly attributable to the activity of Desjardins Capital régional et coopératif, FondAction (CSN), and Fonds de solidarité des travailleurs du Québec (FTQ) in Québec.

Substantial retail fund commitments were also obtained by Golden Opportunities Fund and SaskWorks Venture Fund in Saskatchewan, while GrowthWorks and VentureLink Funds led activity in other jurisdictions.

Most fresh supply comes from domestic limited partners

In all, $3.6 billion flowed into the coffers of Canadian PE fund managers in 2009. Both domestic and foreign LPs were vital in providing new supply, but a range of domestic sources assumed the primary role this time around.

Investors based in the United States, Europe, and Asia were the largest source of new funds raised in 2009, accounting for $1.1 billion or 31 percent of the total. Buyout and other PE partnerships benefitted most from cross-border activity, drawing 43 percent of their commitments from foreign sources, which is down from 53 percent in 2008.

In combination, Canadian-based sources accounted for 69 percent of total new commitments, with corporations, pension funds, and other institutional investors accounting for the lion’s share of this activity, or $1.4 billion. Of this amount, well over three-quarters was earmarked for fund formations in the buyout segment.

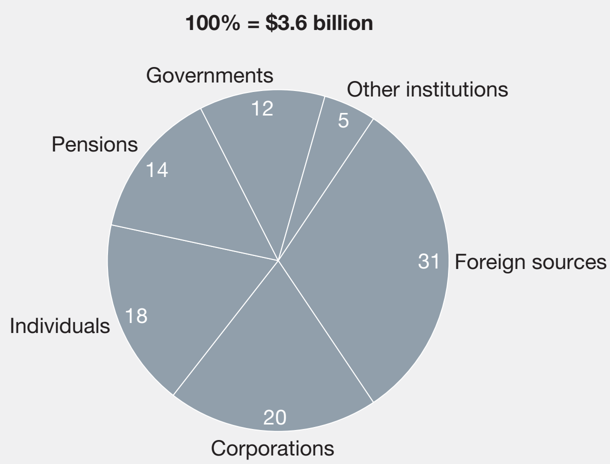
Individual investors were another major source, contributing $651 million in 2009. The largest proportion of these resources originated with individual Canadians buying tax-assisted shares in retail funds, most of which operate in the VC space. The balance came from entrepreneurs, families, and high-net-wealth individuals who participated in partnerships across the market spectrum.

Canadian governments have recently emerged as LPs of some influence, accounting for $434 million in new commitments. In fact, governments were the leading source of fuel to VC fundraising in 2009, providing well over one-third of the total. This is up substantially from 2008, when this share was 3 percent.

EXHIBIT 5

Sources of total PE funds raised; 2009

Percent



SOURCE: Thomson Reuters

Fundraising outlook for 2010

Canadian PE professionals responding to the survey believed that fundraising challenges would persist in 2010. However, almost half of the respondents anticipated improvements in the overall environment, with LPs demonstrating greater receptivity to offerings coming from established GP teams – though perhaps according to new terms.

As 2010 got underway, the survey found a total of 39 fund managers marketing new products, compared with 37 the year before. Eighteen fund managers were seeking fresh commitments for buyout, mezzanine, and related PE partnerships, while 21 fund managers were similarly engaged in the VC space.

As in the past, the survey counted funds that were moving to final closes, as well as funds that have only recently been launched.

Trends in private equity investment in 2009

Deal-making slows to a crawl in 2009

The North American PE market experienced a second consecutive year of slower deal-making in 2009. Particularly in the early months of the year, credit shortages, low public market values, and weak merger and acquisition activity reinforced investor caution. Consequently, overall levels of PE investment dropped as sharply in 2009 as in 2008.

In 2009, most fund managers in Canada and the United States were dealing with issues involving portfolio firms, revisiting strategies, and planning for new contingencies. While some discovered value opportunities created by the recession, many others were quietly scoping out options timed for the market's renewal.

In the latter part of the year, a healthier economic environment provided the first sign that renewal might not be too long in coming. Close to 90 percent of Canadian buyout, mezzanine, VC, and other PE professionals surveyed by Thomson Reuters believed that deal volumes, dollars invested, and other market indicators would show improvement in 2010.

Buyout and mezzanine activity reflects slowdown

According to the data, buyout and related PE deal activity in North America in 2009 was the lowest recorded since the early 2000s. In the United States, activity was reduced 75 percent year over year, with disclosed disbursements totalling US $34 billion. Indeed, market outcomes south of the border more closely approximated those of 2002.[4]

In Canada, a similar story unfolded in 2009. The survey found buyout, mezzanine, and other PE fund managers invested a total of $3.1 billion in domestic and foreign businesses, which is down 53 percent from the $6.7 billion invested the year before. The number of completed transactions also declined, totalling 308 – 45 percent fewer than the 563 deals in 2008.

In dollar terms, Canadian investor activity was the slowest in 6 years. As in 2008, the relative absence of mega-deals significantly influenced trends in the domestic market. One of the few large-cap acquisitions of 2009 was the sale of the enterprise

---

4 *Buyouts,* January 4, 2010.

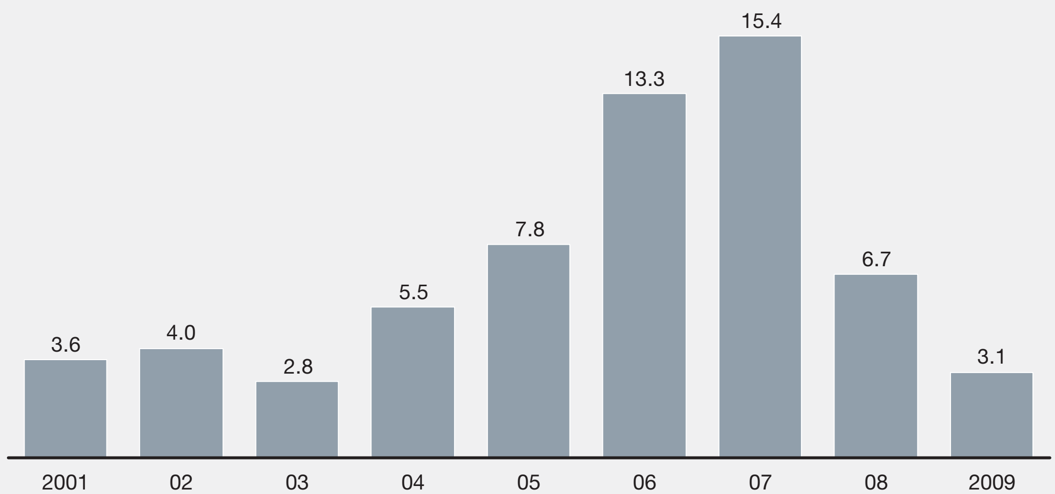
solutions business unit of Nortel Networks Corporation to Basking Ridge, New Jersey's Avaya Inc., which came in at US $900 million. Avaya was bought by Silver Lake Partners and TPG Capital in 2007.

Other important deals were nonetheless getting done in Canada, the majority of which were mid-market in nature. For example, an investor group led by Birch Hill Equity Partners Management and that included Westerkirk Capital, acquired Shred-it International Inc., an on-site document destruction and records management services firm based in Oakville, Ontario. Facilitating Shred-it's recapitalization, Birch put $100 million to work in the transaction.

EXHIBIT 6

Buyout, mezzanine, and other PE disbursements by Canadian funds; 2001-2009

$ Billions



SOURCE: Thomson Reuters

In another prominent example, EdgeStone Capital Partners sold Trimaster Manufacturing Inc., a Guelph, Ontario, designer and manufacturer of precision-machined components and assemblies for global Fortune 500 customers across a diverse range of industries, to GenNx360 Capital Partners, a PE firm based in New York. The price tag was $93.5 million.

Along with raising a new partnership, Clairvest Group also actively acquiried business assets in 2009. This included taking a significant equity interest in PEER 1 Network Exercises Inc., a worldwide internet infrastructure provider head-quartered in Vancouver. The Clairvest investment totalled over $25 million.

Penfund was also active in the Canadian mid-market in 2009, investing $20 million in Toronto-based CanGro Foods Inc., a marketer of shelf-stable fruit, vegetables, and tomatoes under the well-known Alymer and Del Monte brands. CanGro Food was spun off by Kraft Foods Inc. in 2005 and is presently owned by American PE investors Sun Capital Partners and EG Capital Group.

According to the survey, 92 percent of deals done by buyout and other PE fund managers were in the domestic market. This contributed to the $3.3 billion of disclosed transaction values in Canada reported by Thomson Reuters for 2009.[5] However, Canadian investors also found attractive opportunities abroad, especially in the second half of the year.

For instance, in addition to announcing its take-private deal involving Canada's Livingston International Income Fund (closed in 1Q 2010, with Sterling Partners), CPPIB Private Investments was very active internationally. CPPIB and Silver Lake were among the members of a consortium that bought a 70 percent share of the Luxembourg-based Skype communications unit of eBay Inc. At over US $2 billion, this transaction was one of the year's largest.

CPPIB also won a 2009 Canadian Dealmakers Private Equity Award for another top international transaction, the $2.1 billion purchase of Macquarie Communications Infrastructure Group (MCG) and a related Macquarie Bank management entity.[6] Based in Sydney, Australia, MCG (now CPPIB Communications Infrastructure Ltd.) acquires, owns, and manages infrastructure assets in that country and in the United Kingdom.

Canadian fund managers completed only 61 exits from portfolio investments in 2009. Strategic sales once again comprised the largest share of exits identified by type.

KERN Partners achieved a number of successful exits from domestic and foreign investee firms in 2009. Among these was the sale of Calgary's Wave Energy Ltd. to strategic investor Crescent Point Energy Corp. for $655.3 million. Wave Energy, which explores and develops crude oil and natural gas in Canada and the United States, previously secured PE placements led by KERN in 2007 and 2008.

Venture capital activity also drops

Venture capital investment levels also declined across North America in 2009. According to Thomson Reuters, disclosed dollars invested in the United States

5 Disclosed transaction values in Canada account for both domestic and foreign activity.
6 This award was sponsored by the Canadian Venture Capital and Private Equity Association and presented in March 2010.

totalled US $17.7 billion, down 37 percent from 2008. In Canada, just over $1 billion was invested in 2009, a 27 percent drop that reflects one of the lowest market outcomes in over a decade.

One of the factors contributing to this reduced activity in Canada was lagging disbursements by American VC investors, a trend that might be ameliorated by federal government changes to cross-border tax regulations. Just as important was the year-over-year decrease in dollars put to work by domestic investors.

According to the survey, Canadian VC fund managers invested a total of $848 million in domestic and foreign businesses in 2009, down 32 percent from the $1.2 billion they invested in 2008. The number of VC deals completed in 2009 fell to 408, 18 percent less than the 499 transactions completed the previous year.

As in 2008, investor attention was focused on existing portfolio companies and on financings that would take these companies into later stages of growth. This was illustrated by one of 2009's top deals involving Varicent Software Inc. of Toronto, which is increasing its presence in the sales performance management space. EdgeStone Capital Partners, RBC Venture Partners, and FTV Capital syndicated in the $35 million round.

Once again, several of the most capital-intensive follow-on deals involved expanding life sciences firms. For example, 2009's largest financing went to Montréal's Enobia Pharma Inc., a developer of novel therapeutics for serious bone disorders. Enobia received US $50 billion from CTI Capital, Desjardins Capital de risque, Fonds de solidarité (FTQ), Lothian Partners, and OriMed Advisors.

Similarly, Allostera Pharma Inc. secured $17 million from a syndicate comprising BDC Venture Capital, Genesys Capital Partners, iNovia Capital, and other investors. The Montréal-headquartered company has been developing an entirely new class of therapeutic drugs called Allosteramers.

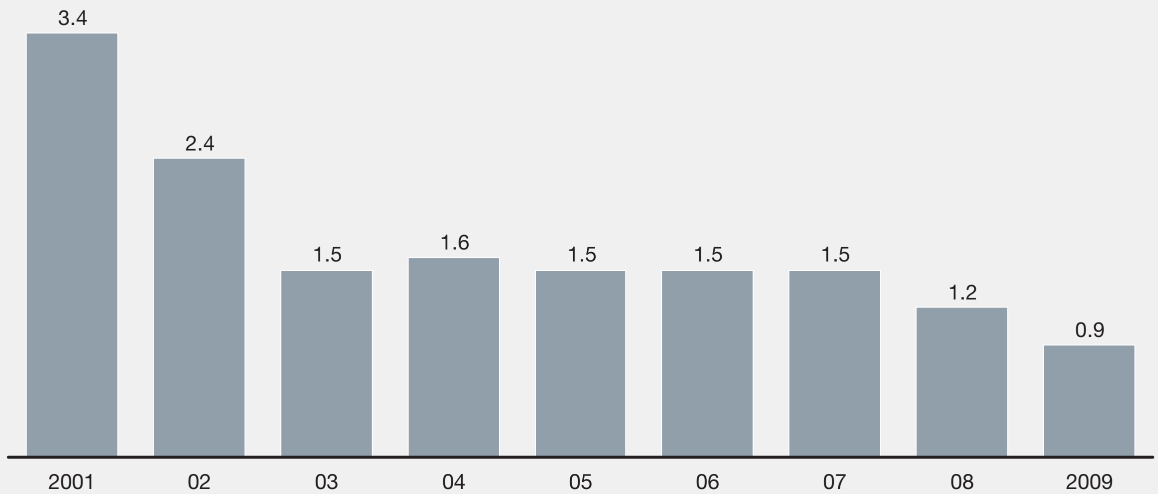
Zeugma Systems Inc., a supplier of telecom solutions for broadband service providers based in Richmond, British Columbia, also saw further expansion supported by its VC backers. GrowthWorks, Lions Capital Corporation, Ventures West Management, Yaletown Venture Partners, Granite Ventures, GTD Capital, and Israel's Vertex Venture Capital together invested $9 million.

But some of the highest profile deals in 2009 featured companies that were still getting started, particularly in emerging sectors like clean-tech. An example was the US $22 million financing of Burnaby, British Columbia's General Fusion, Inc., which develops fusion technology for more cost-effective energy. Co-investors included

EXHIBIT 7

Venture capital invested by Canadian funds; 2001-2009

$ Billions



SOURCE: Thomson Reuters

Chrysalix Energy Venture Capital, GrowthWorks, Braemar Energy Ventures, and The Entrepreneurs Fund.

One of the largest seed investments of recent years had Celtic House Venture Partners, iNovia Capital, and VentureLink Funds syndicating in a $10 million deployment to Peraso Technologies Inc. of Toronto. Peraso is a fabless semiconductor firm focused on the development of innovative Millimeter-Wave technology. Also in this fast-growing sector cluster is Fresco Microchip, which scored a comparable $10 million financing from Celtic House and Ventures West in 2009.

Consistent with historical trends, VC fund managers were most active locally in 2009 – 88 percent of deals were located in Canada.

However, in an increasingly global marketplace, Canadian investors also participated in major deals in the United States and other countries. For instance, Summerhill Venture Partners and Fairhaven Capital Partners co-led the latest round of financing in software firm Trust Digital Inc. of McLean, Virginia, which totalled US $14.5 million. MMV Financial, Avansis Ventures, and Core Capital were among the co-investors.

Exits from Canadian VC investments were fairly steady in 2009, with a total of 26 disclosed acquisitions and IPOs. That is down slightly from the 28 exit events reported by Thomson Reuters the previous year.

Several venture-capital-backed acquisitions were big wins for fund managers. For instance, BDC, CDP Capital, and Fonds de solidarité (FTQ) won the Canadian Venture Capital and Private Equity Association's "Venture Capital Deal of the Year" for the US $420 million purchase of Laval, Québec's ViroChem Pharma Inc. by Vertex Pharmaceuticals Inc., which paid 5.4 times the original investment. ViroChem itself was created by an earlier success story, BioChem Pharma Inc.

Conclusion

Canadian PE fund managers experienced a second year of market slowdown in 2009. In fact, according to survey results, overall conditions were even more challenging than they were in 2008, with all key market indicators showing reduced activity in virtually all market segments. These results highlight the cyclical trends that have been apparent across North America for many months.

However, the survey also detected hints of PE renewal in the increased optimism shown by the vast majority of Canadian PE professionals surveyed. This optimism and the evidence of somewhat greater deal volumes in Canada and the United States in the first and second quarters of 2010 suggest that prospects might indeed improve over the course of this year and the next.

Market confidence will continue to track broader developments in the global economy and financial system. In the months ahead, a number of Canadian buyout, mezzanine, VC, and other PE investors will likely continue to test the waters.

Of course, investors with dry powder will be in the best position to seek fresh opportunities in the near term. Fund managers needing to replenish their resources, however, may find a more conducive fundraising environment, given an increasingly receptive LP community.

Appendix

Data contributors to *Private Equity Canada 2009*

32 Degrees Capital
ARC Financial Corporation
Argosy Partners Ltd.
AVAC Ltd.
Avrio Ventures Management Corporation
Banyan Capital Partners
BC Renaissance Capital Fund
BDC Subordinate Financing
BDC Venture Capital
BEST Funds
Birch Hill Equity Partners Management Inc.
BlackBerry Partners Fund
Bond Capital Partners Ltd.
Brightspark Ventures
Brookfield Asset Management Inc.
Brookfield Special Situations Group
CAI Private Equity
Callisto Capital LP
CAPE Fund
Capimont Inc.
Capital Benoit Inc.
CDP Capital – Private Equity Group
Celtic House Venture Partners
Centrestone Ventures Inc.
Chrysalix Energy Venture Capital
CIBC World Markets, Merchant Banking
Clairvest Group Inc.
Covington Capital Corporation
CPP Investment Board – Private Investments
CPVC Financial Corporation
Crown Capital Partners Inc.
CTI Capital Inc.
Cycle Capital Management Inc.
Desjardins Capital de risque
Discovery Capital Corporation
EDC Equity Fund
EdgeStone Capital Partners Inc.
Emerald Technology Ventures Inc.
Fairhaven Capital Partners
FondAction (CSN)
Fonds de solidarité des travailleurs du Québec (FTQ)
GeneChem Management Inc.
Genesys Capital Partners Inc.
GrowthWorks Ltd.
GTI Capital Inc.
HDL Capital Corporation
HSBC Capital (Canada)
ID Capital Management Inc.
Imperial Capital Group Ltd.
Innovatech Québec
iNovia Capital
Integrated Asset Management Corporation
Investment Accelerator Fund
JLA Ventures
Jefferson Partners
JOG Capital Inc.
KERN Partners Ltd.
Kilmer Capital Partners Ltd.
Lions Capital Corporation
Macquaire Canadian Infrastructure Management Ltd.
Manulife Capital

Manvest Inc.
Maxam Capital Corp.
McKenna Gale Capital Inc.
McLean Watson Capital Inc.
MMV Financial Inc.
Moneta Capital Partners Ltd.
Multiple Capital Inc.
NDI Capital
Network Capital Inc.
New Brunswick Innovations Foundation
New Brunswick Investment Management Corporation
Northleaf Capital Partners
NorthRock Capital Partners
Novacap Investments, Inc.
Nova Scotia Business Inc.
OMERS Private Equity
ONCAP Management Partners LP
Onex Corporation
Ontario Growth Capital Corporation
Orchard Capital Group Inc.
Pangaea Ventures Ltd.
PCP Management Inc.
PenderFund Capital Management Ltd.
Penfund
PFM Capital Inc.
Primaxis Technology Ventures Inc.
PRIVEQ Capital Funds
Propulsion Ventures Inc.
RBC Venture Partners Inc.
Rho Canada
Richardson Capital Limited
ROI Management Ltd.
Roynat Capital Inc.
Signal Hill Equity Partners Inc.
Skypoint Capital Corporation
Summerhill Venture Partners
Tandem Expansion Fund
TD Capital
Teachers' Private Capital
Tech Capital Partners Inc.
TechnoCap Inc.
TELUS Ventures
Teralys Capital Inc.
TorQuest Partners Inc.
Trellis Capital Corporation
TriWest Capital Partners
VanCity Capital Corporation
VenGrowth Private Equity Partners Inc.
Venture Coaches
VentureLink LP
Ventures West Management Inc.
Victoria Park Capital Inc.
Wellington Financial LP
Westcap Mgt. Ltd.
Whitecastle Investments Limited
XPV Capital Corporation
Yaletown Venture Partners Inc.
Yellow Point Equity Partners LP

110 Charles Street West
Toronto, Ontario M5S 1K9
T: 416 313 3700
F: 416 313 2999

1250, boulevard René-Lévesque Ouest
Bureau 4430
Montréal, Québec H3B 4W8
T: 514 939 6800
F: 514 939 6810

Suite 3000
Petro-Canada Centre
West Tower
150 - 6th Avenue S.W.
Calgary, Alberta T2P 3Y7
T: 403 538 2160
F: 403 538 8797

www.mckinsey.com

Thomson Reuters (Canada)
TD Centre, Canadian Pacific Tower
100 Wellington Street West
PO Box 123, Suite 1900
Toronto, Ontario M5K 1H1
T: 416 956 1077
F: 416 956 7554

www.thomsonreuters.com

McKinsey&Company

THOMSON REUTERS