Canadian technology sector M&A activity accelerates into 2021

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As a tumultuous 2020 comes to a close, Canada's technology sector is decidedly on the radar for U.S., international and domestic strategic and financial buyers. The latter half of the year has witnessed a significant increase in technology merger and acquisition (M&A) transactions, with a variety of important trends driving increased activity. In this article, we review the state of the market and the factors contributing to its momentum.

Deal volumes and value

The temporary slowdown in M&A transactional activity during the early months of the COVID-19 pandemic has given way to an increase in closed deals and active processes. Despite a turbulent macroeconomic environment, the North American technology industry continues to demonstrate both its resilience and its reputation as a desirable market in which to invest. As reported by Preqin, after lower reported deal activity in the first half of 2020, deal volume and values rebounded in North America, resulting in total third quarter deal values slightly surpassing pre-pandemic levels for the same period of 2019.

The Canadian experience is similar. According to CVCA Canadian market data, private equity (PE) deal values for the first three quarters of 2020 actually exceeded 2019 totals: C$11.7 billion was invested across 446 deals, compared with C$6.5 billion across 385 deals in 2019.

Macro trends driving Canadian tech M&A

While this M&A activity is made possible in part by the US$1.5 trillion of dry powder mandated to be deployed by PE funds and over US$500 billion in cash on strategic buyer balance sheets (as reported by Pitchbook), important macroeconomic trends are also driving M&A deals in the Canadian tech space.

1. Target company motivations

Whether a target company is motivated to explore M&A opportunities by the need to survive the COVID-19 pandemic or by a desire to capitalize on a hot sector and improving financial fundamentals, conversations with strategic and PE-backed buyers are now front and centre around (virtual) boardroom tables.

Boards of directors and management teams of thriving companies that had previously maintained a "wait and see" attitude towards M&A are now more amenable to inbound expressions of interest. They are also being increasingly proactive in seeking the right deal to capitalize on a market window.

This has led many companies to consider ways to maximize their value through a variety of strategic alternatives. The result has been that many issuers are conducting dual track and multi-track processes, engaging M&A advisors to pursue parallel or multiple strategic paths. Alternatives under consideration include outright sales, buy-side acquisitions and growth equity financing transactions. In many cases, growth equity transactions contain a secondary sale component where founders and early investors obtain some liquidity in the process.

Another parallel track alternative emerged in 2020 for technology companies, namely initial public offerings, with reverse take-overs also gaining traction as an alternate route to going public. The growing appetite for tech IPOs in sectors such as life sciences has created a competitive environment where buyers are required to pay increasing premiums in light of viable strategic alternatives that are available to targets seeking liquidity.

For companies that are struggling, whether due to the COVID-19 pandemic or otherwise, boards of directors appear to be increasingly receptive to M&A discussions stemming from the necessity to restructure operations. At the same time, they are evaluating strategic alternatives in the context of the pandemic. Exploring a dual track process to maximize optionality and value has never been more important for companies in this category.

2. Stock market performance

North American stock markets encountered significant headwinds early in the COVID-19 pandemic. However, coming out of the summer, markets have defied the economic downturn. Stock market gains have bolstered public company balance sheets and the currency of their stock. Fueled by pressure from shareholders to put excess cash to good use, public companies are seeking to acquire technology-focused companies to expedite and enhance their internal digital transformations. This trend even extends to brick-and-mortar companies, as traditional companies look to innovate and enhance their offerings.

An M&A transaction with a public company may provide the selling shareholders of a private technology company with stock in the public company buyer or other long-term equity-based incentives, in addition to cash. Strong stock market performance has enabled these selling shareholders, which often include employees and management of the target, to share in the upside of future stock appreciation of their acquiror.

3. World-class technology talent

The quality of engineering talent in Canada continues to put Canada on the map as a desirable hub for corporate operations. Canada is well-known for its start-up ecosystems in cities such as Toronto, Waterloo, Ottawa, Montreal and Vancouver, with emerging ecosystems in Calgary, Edmonton, Victoria and Halifax, among others. Universities from coast to coast churn out best-in-class computer programmers and scientists. When coupled with Canada's increasingly favourable immigration policies compared with the United States, the access to and mobility of tech talent in Canada are contributing to the attractiveness of Canadian technology companies to international PE funds and corporate buyers.

Large corporations such as Amazon, Salesforce.com, Microsoft and Google have long made Canada a second home for development hubs. Other buyers have gotten wind of the fact that in an increasingly virtual world, Canada is an enviable destination, and we expect this trend to continue.
It is no longer necessary for companies to be located in Silicon Valley to attract investment

and acquisition interest. In fact, given the move by large tech companies such as Twitter to permanent or semi-permanent work-from-home business models, Canada will likely become an even more desirable destination in a post-pandemic world.

Owing to the COVID-19-induced virtual world we are currently inhabiting, M&A transactions are happening completely virtually. In some cases, management teams of the buyer and target may never meet face-to-face. This too has facilitated greater opportunities for cross-border transactions.

4. Canadian cost base

The exchange rate between the U.S. and Canadian dollar continues to make Canadian companies attractive targets to a U.S. purchaser from a cost perspective. Canadian companies have long taken advantage of the currency arbitrage, with their costs largely denominated in Canadian dollars and revenues from customers frequently generated in U.S. dollars.

Additionally, salaries for Canadian technology talent continue to lag behind those offered in the large tech centres in the United States such as San Francisco, Palo Alto, New York and Boston.

Both of these factors have further entrenched Canada's cost advantage from a buyer's perspective.

5. Market sentiment bullish on certain sub-sectors

The COVID-19 pandemic's impact on how we live and work has increased the attractiveness for buyers looking to do rollup transactions to consolidate their respective industries. The focus has been on health tech, biotech, e-commerce, software-as-a-service (SaaS), fintech, artificial intelligence/machine learning, agricultural tech and technologies that enable remote workforces.

Canada has a strong reputation globally in all of these sought-after sectors. The resiliency of these sectors during a period of global economic uncertainty has helped keep Canada on the radar of global PE funds and strategic buyers.

In stark contrast to prior economic downturns (e.g., the 2008 financial crisis and the dotcom bust in 2001-2003), valuations in these sectors are now generally higher than pre-pandemic valuations according to Capital IQ market data.

Although valuations are up overall, the individual dynamics between acquirors and targets have led to valuation gaps in certain negotiations. To bridge this gap, earnouts are creeping into transactions to a greater degree, particularly in the case of mid-market deals and 'acqui-hires' (i.e., acquisitions primarily for talent pools) of early stage ventures. Earnout milestones tend to relate to revenue targets and earnings targets (e.g., EBITDA), as well as customer acquisition and product development and integration thresholds.

6. IPO window is open

The U.S. market has experienced an extended window for initial public offerings, with growing interest in Canadian technology IPOs. PE funds and strategic buyers have recognized that an IPO window has opened up and, seeking to take advantage of this opportunity, the portfolio companies of PE funds and the strategic buyers themselves need to bulk up. In this vein, PE funds are increasingly sponsoring mid-market rollup transactions on behalf of their portfolio companies to achieve critical mass in anticipation of an IPO. Acquiring Canadian technology companies is a popular way to achieve this industry consolidation and reach the necessary critical mass to complete an IPO, a trend that is expected to continue.

Moreover, U.S. and Canadian companies that have successfully completed an IPO in 2020 frequently plan for growth, in many cases through acquisition, taking advantage of the cash on their balance sheet raised through their IPO.

7. Debt is available and cheap

In the early days of the COVID-19 pandemic, questions arose concerning the availability of debt and whether North American debt markets would contract. In reality, lenders have been resilient and have generally continued to extend credit to companies and PE funds. Record low interest rates have allowed targets to use debt capacity on their balance sheet to complete transactions on a cost-effective, leveraged basis.

8. Canadians are now ‘owning the podium’

Foreign buyers have long been aware that Canadian entrepreneurs are capable of building excellent technology. The criticism leveled at Canadian management teams in the past was their propensity to exit too early, before their companies had achieved true scale. Increasingly, Canadian companies are proving that they can also achieve scale, and that Canadian management teams, boards of directors and their investors possess the collective ambition to build world-class ‘anchor tenants.’

Following on the heels of Shopify’s massively successful NYSE IPO in 2015 and subsequent spectacular revenue growth and stock market performance as a public company, the next generation of Canadian unicorns (companies with billion-dollar valuations) and potential future unicorns has emerged on the scene. Notably, the success is spread across the country. This emerging generation of anchor companies includes Applyboard (Waterloo, Ontario), which reached unicorn status with its 2020 financing round; Wealthsimple (Toronto, Ontario), which crossed the unicorn threshold with its 2020 investment by TCV; Lightspeed POS (Montréal, Québec), which completed a successful cross-border IPO on the NASDAQ and TSX; and Clio (Burnaby, British Columbia), which raised the largest growth equity round in B.C. history in 2019, led by TCV and JMI Equity.

Most recently, Verafin (St. John’s, Newfoundland), after eclipsing Clio’s financing record in 2019 with a $515-million growth equity round, announced its pending acquisition by NASDAQ for US$2.75 billion, the largest private technology acquisition in Canadian history. Osler acted as counsel in all of the foregoing transactions.

With many more growth-stage technology companies in the mix, the list of current and future Canadian champions continues to expand. Buyers are now on the hunt for the next Canadian unicorn with a view to pre-emptively taking them off the market with an attractive acquisition offer.

Conclusion

All of these factors have positioned the Canadian technology ecosystem as a desirable destination for cross-border acquisition interest. In parallel, Canadian growth-stage tech companies are themselves growing through acquisition. With positive tailwinds thrusting technology companies out of the doldrums of 2020, we expect these factors to continue to fuel M&A activity well into 2021 and beyond.