Charting the course

The future of Canadian M&A in volatile markets

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Methodology

Citi commissioned Mergermarket to interview 50 senior Canadian M&A practitioners in December 2014 to gain insight on their predictions surrounding dealmaking in Canada in 2015. All responses are anonymous and results are presented in aggregate.

Foreword

Canadian dealmaking is at a crossroads. On one hand deal numbers are healthy and have surpassed pre-crisis figures, private equity activity has risen each year for the last three years and foreign investors have become a key part of Canada's landscape.

As Mergermarket figures show, last year Canadian M&A saw the highest number of deals in the last five years at 658 deals worth almost US$103bn. The climb to the top was partly driven by increasing foreign private equity interest, which has steadily risen over the same time period.

However, Canadian dealmakers are still facing resistance. While the headline news of rapidly falling oil prices has been the most high-profile issue for M&A in Canada, several other problems also lurk beneath. Valuation gaps between buyers and sellers, for instance, still persist. On top of this, regulatory impediments to cross-border transactions highlighted in the media, including the recent changes in the country's tax law and the increased scrutiny on foreign-state owned investments brought on by the Investment Canada Act changes, could provide some issues for investors.

Clearly, the path for Canadian M&A is not so clear. With this in mind, Citi, in association with Mergermarket, is pleased to present *Charting the course: The future of Canadian M&A in volatile markets*. We surveyed 50 leading Canadian executives across the business landscape, to find out what players can expect as we go through 2015. Key findings include:

- Forty-six percent of respondents anticipate Canadian M&A will rise in the next 12 months; 22% believe the level of dealmaking will remain the same while 32% predict activity will somewhat decrease.
- The top drivers of M&A in the country are companies seeing inorganic growth, according to 56% of respondents.
- Volatility in global commodity prices is the greatest challenge to Canadian M&A, 42% of respondents say. It is not surprising then that 60% of respondents believe that the recent drop in oil prices will significantly impact Canadian M&A activity.
- Private equity interest is increasing. The majority of respondents expect private equity activity to increase in cross-border and domestic transactions, with 44% of respondents saying that private equity firms will see the most acquisitions in 2015.

We hope this report sheds light on Canadian deal activity, and as always, we welcome your feedback.

LOOKING FORWARD: CANADIAN M&A IN 2015

The backdrop of falling oil prices and lingering geopolitical uncertainty does not seem to have profoundly impacted the level of Canadian M&A that we're likely to see in the coming months. Forty-six percent of respondents believe that the number of transactions will increase, driven mainly by inorganic growth strategies. However, macroeconomic uncertainty is still reflected among respondents as 32% believe that Canadian M&A will fall in 2015.

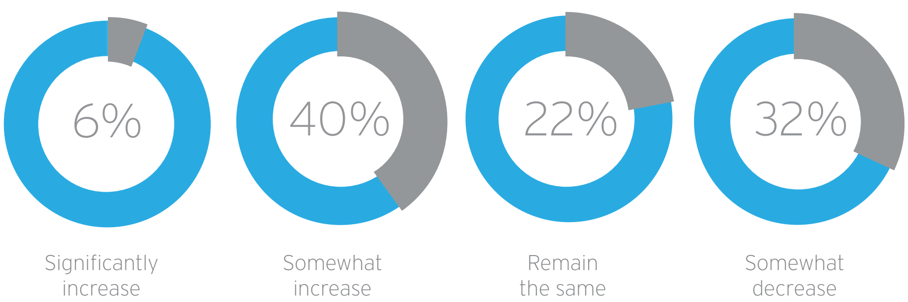
Opportunity knocks

Future acquisition activity will hinge on companies finding worthwhile investments and having the confidence to execute transactions in the current market. The number of Canadian M&A opportunities is set to increase owing to volatile market conditions putting stress on vulnerable companies. This state of distress can be taken as an opportunity by interested bidders as a way to get access to undervalued companies undergoing temporary hardship which would have improved prospects with proper financial backing.

However, the level of dealmaking will, in the end, depend on how confident buyers are about those prospects and the ability of buyers and sellers to reach agreement on underlying value.

On the other side of the coin, some view the possible reduction in M&A as a reflection of Canada's over reliance on a single industry. "The Canadian economy has been mostly dependent on the energy sector, and non-oil and gas sectors have not performed as well as expected, adversely impacting the number of acquisitions," says the head of an advisory firm.

What do you expect to happen to the overall volume of Canadian M&A activity over the next 12 months?



Growing up

Many Canadian companies are set to use dealmaking to expand their businesses aggressively. Fifty-six percent cite inorganic growth as the main driver behind Canadian M&A for the coming year.

"Inorganic growth will be on the minds of many big businesses that will likely use their strong financials to get access to easy capital and cheap financing with reasonable rates," says a CFO of a transportation company. "This quest for further growth will be the greatest driver for M&A in Canada in 2015."

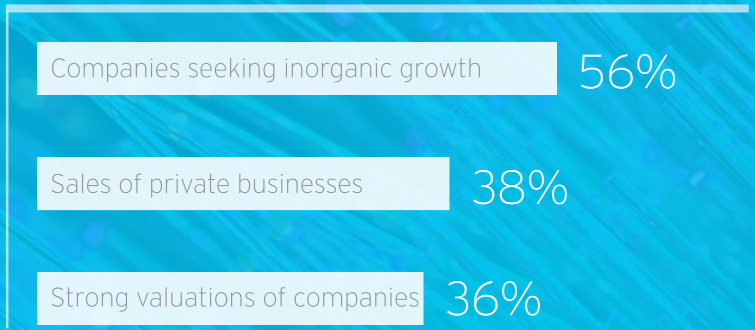
Private business sales are also expected to drive up M&A volume. Respondents think that these businesses will sell nonperforming assets and use the capital on value-enhancing M&A deals. "Private businesses will be selling non-core units as they examine their businesses and try to increase margins then they will reinvest the money on acquisitions, giving rise to M&A activity next year," says a partner at a law firm.

Companies that have strong valuations are also going to be acquirers and are expected to push transaction numbers upwards. "Firms here have been performing well, and their efficient productivity has improved their valuations over the years. This has gathered investor sentiments and there is a good flow of finance in the region," says an M&A head at a communications firm.

"Private businesses will be selling non-core units as they examine their businesses and try to increase margins, then they will reinvest the money on acquisitions."

Partner at a law firm

What do you view as the greatest drivers of Canadian M&A in 2015?



Please note: respondents were allowed to select more than one answer

Dealing with uncertainty

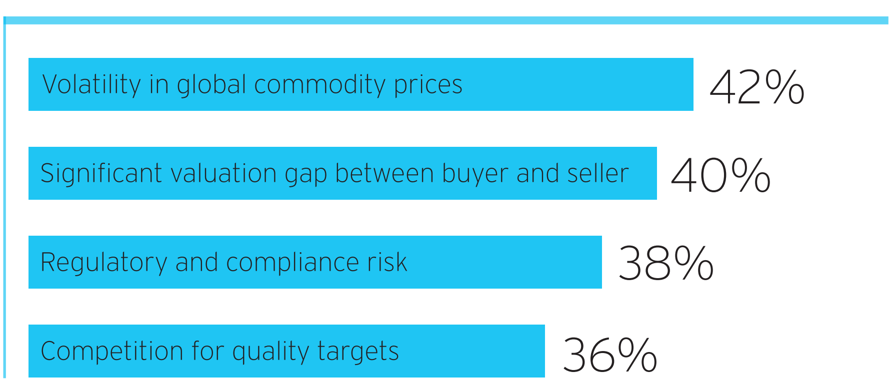
Despite these factors pushing companies towards an M&A-based strategy, both micro and macro obstacles are proving difficult to overcome. On a macro level, volatility in global commodity prices will be the greatest challenge to Canadian M&A in 2015, according to 42% of respondents. This trend will especially impact energy-related industries, as the unevenness affects these firms' ability to manage production and supply chain functions. "Most of the firms within the energy, industrials and manufacturing sectors are facing the burdens of increased input costs and low margins, which have negatively impacted overall profits," says a vice president at a medical company.

Valuation gaps between sellers and buyers, viewed by 40% of respondents as a top challenge to M&A, are also products of the seesawing prices. The fluctuations have negatively affected companies' financial performance. "The overall valuations of the businesses have come down, yet sellers are unwilling to compromise during negotiations to reflect their companies' current value. While sellers still believe that their firms are worth more even given current depressed conditions, buyers are expecting low asset prices that would take into account the distress that the market is going through. This discrepancy in perspective between buyers and sellers regarding the value of companies is hampering overall deal activity," says a partner at a law firm.

Another problem at the top of respondents' minds are regulatory and compliance risk issues (38%) that are exposing companies to a higher level of scrutiny that can dissuade them from pursuing acquisitions.

Intense competition for quality targets (36%) is also a problem for businesses searching for top-tier targets and actively negotiating bids. "The large number of companies that are vying for the same attractive targets narrows down the chances for success of all the firms participating in the bidding," says the head of a transportation company.

What do you perceive as the greatest challenges to Canadian M&A in 2015?



Please note: respondents were allowed to select more than one answer

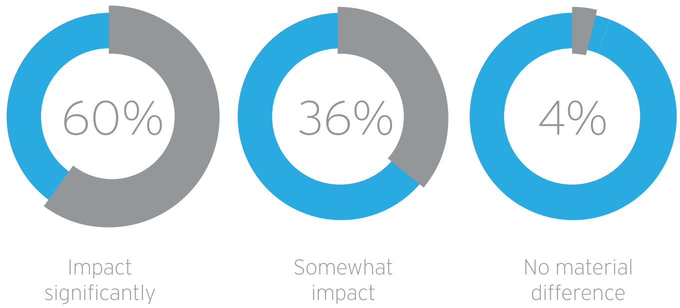
Oil prices: a slippery slope?

The collapse of oil prices will affect future Canadian M&A levels. Sixty percent of respondents go as far as to say that the impact will be nothing less than considerable. With oil prices at historic lows, Canadian companies, specifically in the energy and mining sectors, are evaluating how to alleviate pressures on their cost structure. As one partner at a law firm notes: "The drop in oil prices has evidently affected the companies' valuations and has created distressed situations for them."

"The drop in oil prices has evidently affected the companies' valuations and has created distressed situations."

Partner at a law firm

There has been a significant drop in oil prices recently, affecting company valuations. How will this impact the level of Canadian M&A activity in 2015?



Yet, while this may be evident, the effects this will have on M&A are still up in the air. Here are three key possibilities outlined by our respondents on what falling oil prices will mean for dealmaking in Canada in 2015.

A PERSISTENT VALUATION GAP

As companies struggle in the oil-price downturn, stubborn executives could hold out for prices they would have got last year, perpetuating the gap between buyer and seller. "M&A activity will be impacted significantly as businesses will not able to focus on improving their financial performance to get better valuations," says the partner of a law firm. "Divesting assets at a depreciated amount will not be a choice made willingly by many sellers; therefore, they would likely hold out for more favourable prices for their assets, which might lead to a considerable reduction in M&A deal volumes."

QUALITY, NOT QUANTITY

Doing deals will get harder as valuations become murkier. This provides an opportunity for big corporate players, both in Canada and abroad, to work hard and take advantage of this lack of demand to land themselves a premium asset. "Positive deals will be few and big corporations will push hard to get the best possible targets for M&A activity," says the VP of M&A for an investment dealer. "The major impact will be on value and not volume as deals will be taken as opportunities by offshore businesses."

SINK OR SWIM?

As the year goes on, debt-laden Canadian companies may face a difficult decision when it comes to their valuations and the future of their business — and a decision that could affect more than just their own company. "There will be an impact as there will be several opportunities in other growing areas that will be available in the global market and also value offered for M&A activity will not be in line with the actual standards of valuations," says the partner of a Toronto-based law firm. "The two possibilities that could occur would be businesses functioning under heavy debt but not selling out, and businesses selling out to escape the hike of volume in debt. This will have an effect on the entire economy."

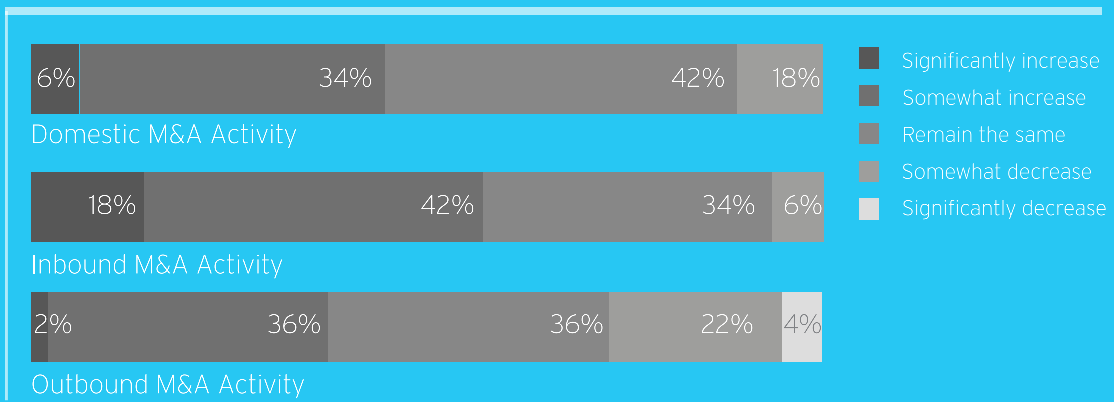
BACK AND FORTH: CANADIAN CROSS-BORDER DEALS

Canadian cross-border M&A activity comes off a successful year, one marked by high-profile transactions both inbound and outbound. On the inbound front, there was Burger King Worldwide's US$12.7bn acquisition of Tim Hortons, as well as Spain's Repsol similarly sized proposed purchase of Canadian oil and gas company Talisman Energy.

Canadian companies were also prominent acquirers during the year, setting their sights on international targets. There was the US$4.9bn acquisition by Canada's Amaya Gaming Group, Inc. of Oldford Group Ltd., creating the largest publicly traded gaming company in the world. And another one from the energy sector — Canada's Encana Corporation US$7bn mega-purchase of its fellow oil and gas exploration and production company, US-based Athlon Energy.

With this fresh in the memory, respondents are relatively hopeful for future deal activity despite existing volatile market conditions. For the most part, they believe that upcoming cross-border activity will either rise or continue on at its current level. Indeed, market volatility could even push companies to divest Canadian assets to foreign buyers. As the vice president of a telecommunications company says: "Firms are looking to expand internationally and exit their Canadian assets to avoid capital costs and budget shortfalls."

What do you expect to happen to the volume of Canadian M&A activity in the following areas over the next 12 months?



Fueling energy

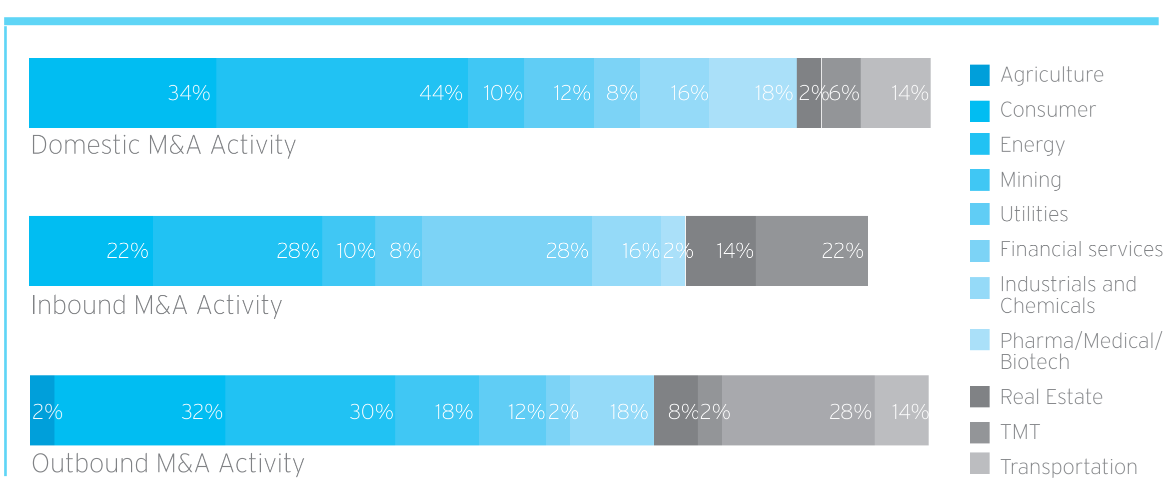
The energy and consumer sectors are the industries that respondents are most bullish about. For inbound deals, a notable portion of respondents (28%) also believe that foreign companies in the industrials and chemicals sector will be active buyers in 2015.

Dealmaking in the energy sector is expected to be driven by smaller energy companies, which are bound to experience distress as oil prices are likely to continue their downward spiral. "Energy companies are not going to be able to meet costs and operational funding requirements and might eventually be forced to sell," says a partner at a private equity firm.

Inbound interest will be spurred on by the availability of low-cost targets. "Lower valuations will be a major driver of buyer interests in Canada, so I expect inbound M&A to increase," explains a partner at a law firm. "There will likely be mergers to withstand the market uncertainties and global competition in the smaller-cap company range, particularly in the energy and industrials and chemicals segments, where the cost to manage operations is relatively higher."

Conversely, the dip in oil prices is having the opposite effect on the consumer sector. Instead of distresses, having oil prices at historical lows can result in increased spending, particularly in the retail and auto industries. For instance, Citi's Canadian economist Dana Peterson suggested that both Canadian consumers and businesses will see benefits including cheaper gasoline and heating costs. Peterson said that sales volume in the October-November 2014 period rose by 1.9% annualized coming after a 4.2% annualized rise in the third quarter. This estimate is in line with a 2% downwardly revised annualized forecast for 4Q 2014 real consumer spending. The estimated C$17 billion boost to household after-tax incomes to-date from the decline in gasoline prices is projected to drive stronger consumer spending in 1H15.

What sectors do you think will see the most Canadian M&A activity in the following areas in 2015?



In fact, William Lee, head of North America Economics for Citi Research, had put an actual dollar figure to the potential savings for Canadians from the dip in energy costs. He says that this will raise disposable income by roughly US$1,400 per household on average, which is equivalent to 3% of median household income. However, there's a caveat that less of this added income can be devoted to actual spending compared to the past since household debt burdens are still high and consumers may be focused on saving their money and deleveraging.

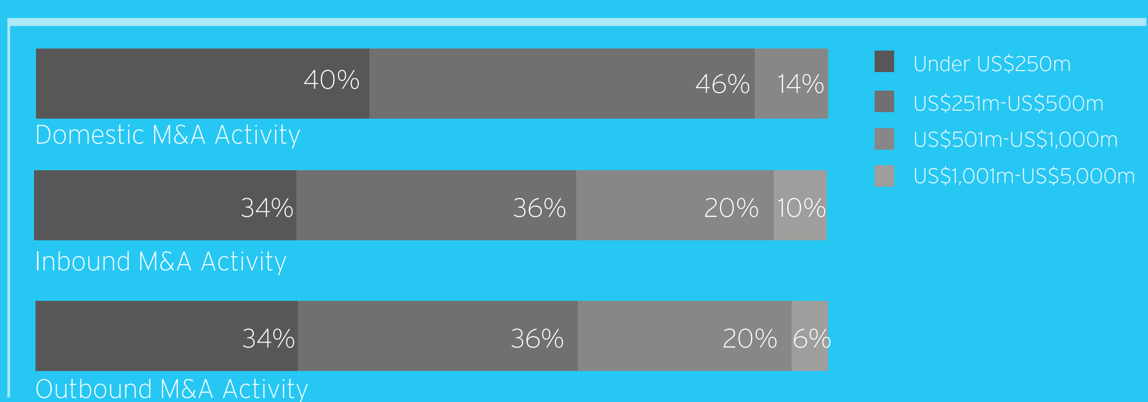
There is also cause for optimism in the consumer space as branded retailers from the US took an interest to Canadian companies in the past year. The list includes hat retailer The LIDS Sports Group, which bought Canada-based sports apparel firm Jersey City Canada; and footwear specialist DSW, which purchased Canadian foot retailer Town Shoes. On the outbound side, non-alcoholic beverage maker Cott Corporation bought US-based bottled water distributor DSS Group back in November.

Mid-market reigns

Although the majority of respondents still believe that most deals in all the areas will be in the mid-market ranges of under US$250m and US$251m-US$500m, a third of them expect that inbound and outbound transactions will be in the higher deal ranges.

Respondent expectations are that many outbound and inbound M&A transactions will involve the large corporations with solid balance sheets and strong cash flows. However, some also noted that market volatility is reducing the value of some deals. A managing director at an investment bank says that most inbound deals will be in the value range of US$1,001m-US$5,000m as "businesses will seek control by investing significant amounts of money and competing with stronger players through a successful M&A deal. However, the transactions' real value would have been much higher, but volatility is helping buyers to make more affordable acquisitions."

In which deal range do you expect to see the most M&A activity in the following areas in 2015?



Access to Money

The availability of financing for cross-border as well as domestic M&A can spur activity and encourage companies to pursue their growth plans. "I think investors are regaining an interest in the Canadian markets and can ease the access to financing, which will empower businesses to undertake expansion activities and drive Canadian M&A in 2015," says a partner at a private equity firm.

A higher percentage of respondents think that the availability and ease of financing will stay the same for inbound deals, while prospects for an improvement seem better for domestic M&A. "Financing for domestic deals will ease as investors of the businesses conducting deals will likely supply credit to their existing portfolios to improve their operational performance and to earn returns hampered during the economic crisis," says a managing director at a private equity firm.

Financing for outbound M&A in Canada presents a rosier picture with 40% of respondents believing that this will rise. This means that Canadian firms can pursue international markets to meet their targets. "Companies that have an easy access to financing will take this chance to exit the vulnerabilities in the domestic markets and will utilize the capital to pursue opportunities in new and emerging markets to make profits," says a bank managing partner.

Asset sales and bank loans are expected by respondents to be the most accessible for inbound and outbound dealmaking. Meanwhile, half of respondents expect assets sales to be the most accessible type of financing for domestic M&A.

Respondents say that asset sales will be the most accessible financing for funding Canadian acquisitions when capital is insufficient. In these instances, companies will have to strategize on how to raise capital through their existing assets and their management teams will have to look closely at the performance or underperformance of the companies' various assets and will divest in appropriate areas to raise money.

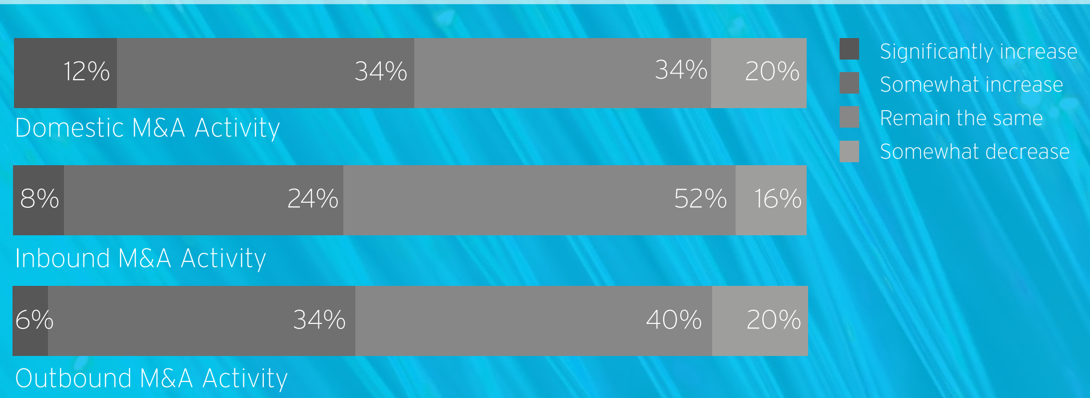
"Investors are regaining an interest in the Canadian markets and can ease the access to financing which will empower businesses to undertake expansion activities."

Partner at private equity firm

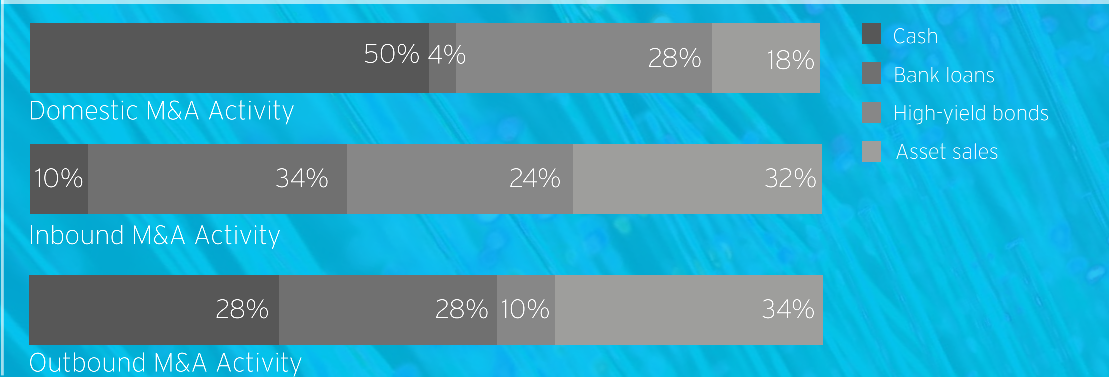
"Businesses will seek control by investing significant amounts of money."

Managing Director at investment bank

What will happen to financing in Canada in the following areas in 2015?



Which type of financing will be most accessible to fund Canadian acquisitions in the following areas in 2015?

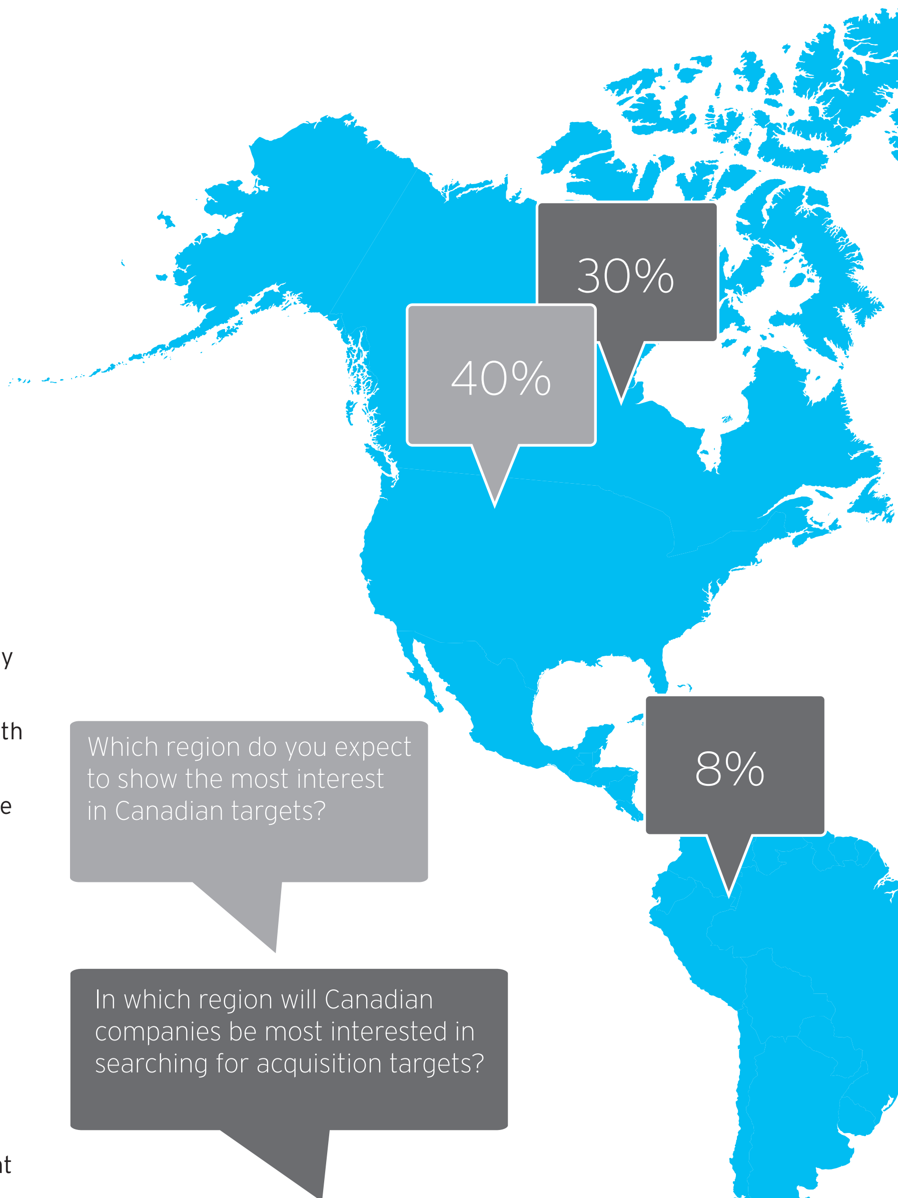


Inbound interest

The survey shows that 40% of respondents expect that North America will be the most interested in Canadian targets, followed by Europe and Asia-Pacific. Being neighbours with the US makes it easier for buyers to make Canadian acquisitions. This is not merely geographic proximity, but extends to cultural similarities and regulatory familiarity. Acquirers from the US markets find it easier to understand the Canadian companies they are buying. "North American companies, specifically the US, will be the most acquisitive into Canada due to various factors, including the easier relationship between the two governments as well as the limited differences in corporate cultures, and labour relations that make post-merger integration easier," says a partner at a law firm.

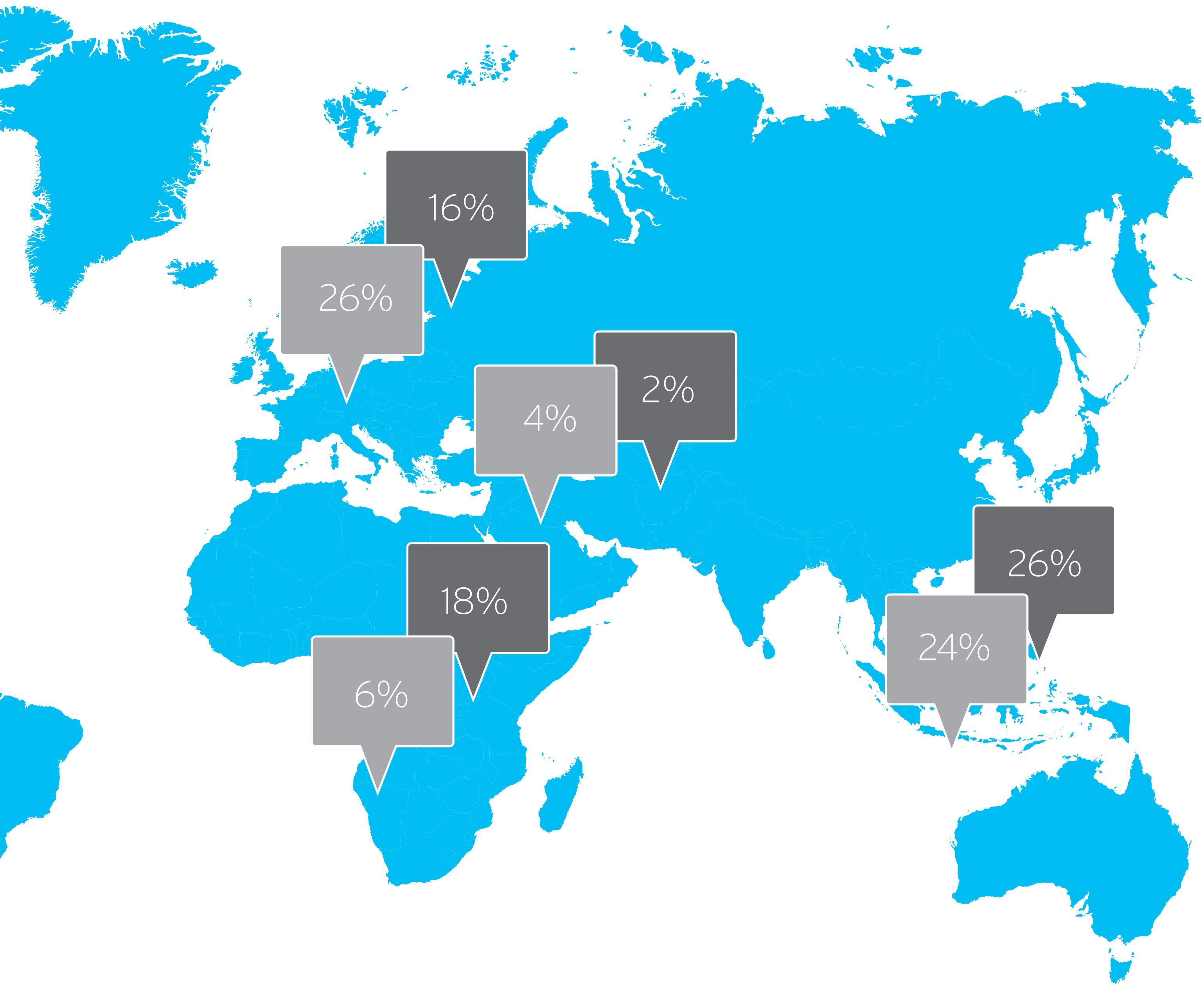
Despite the limitations imposed on state-owned buyers in Canada, 24% of respondents expect Asia-Pacific investors to show the most interest in Canadian targets, mostly due to diversification and cheap asset prices. "Asia-Pacific investors want to have a good mix of businesses in different sectors and geographies," says a vice president in finance. "Businesses from these areas also want to get ahead of the market and acquire assets and businesses in areas where prices have fallen for commodities and services, a category that Canada falls under."

European bidders also have a keen interest in Canadian companies that are for sale, with 26% of respondents saying inbound interest for Canadian assets will come mostly from this region. "I think European businesses will be interested in the Canadian market given that the current price volatility has lowered company valuations. Businesses in Europe also have the wherewithal and capacity to handle the risks and manage large portfolios," says a vice president in a media company.



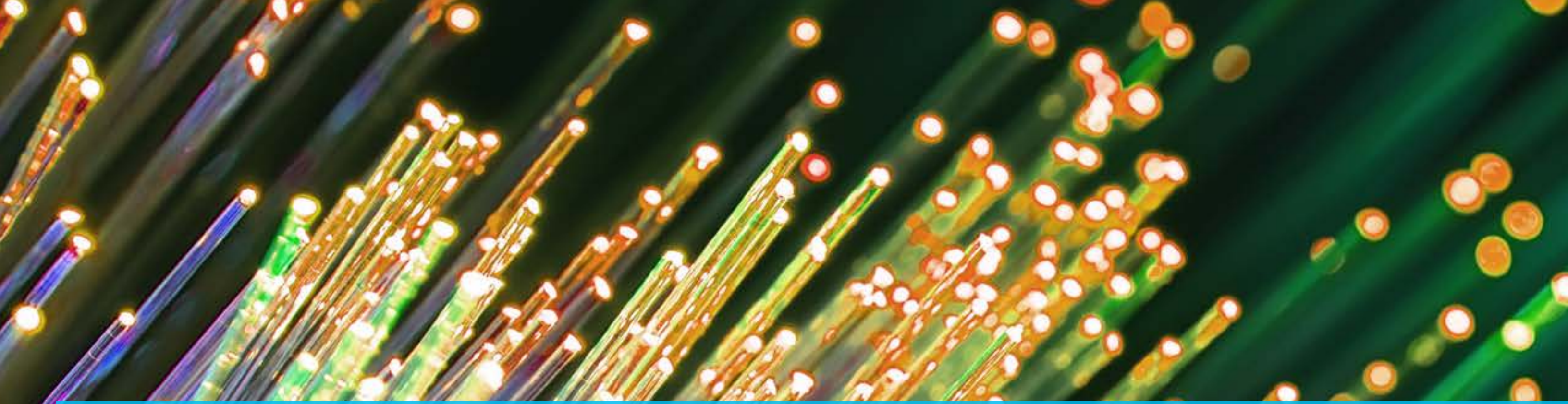
Looking out

Outbound Canadian activity is expected to be mostly focused in North America (30%) and Asia-Pacific (26%). The same reason – affinity – will cause Canadian companies to be most interested in acquiring North American companies. "Canadian companies have generally more experience in dealing with US targets given the proximity of the two locations," says a partner at a law firm. Canadian companies are also attracted to the high-growth markets of Asia-Pacific. "Countries in Asia-Pacific are capable of providing long-term growth and the markets have stable demand, which will help Canadian businesses," says a partner at a law firm.



"Canadian companies have generally more experience in dealing with US targets given the proximity of the two locations."

Partner at a law firm



The recent changes to Canada's tax law and the Investment Canada Act have been considered to be obstacles to M&A activity. However, Canadian dealmakers seem to be taking these changes in stride.

CHANGES TO THE CANADIAN TAX LAW

WHAT HAS HAPPENED?

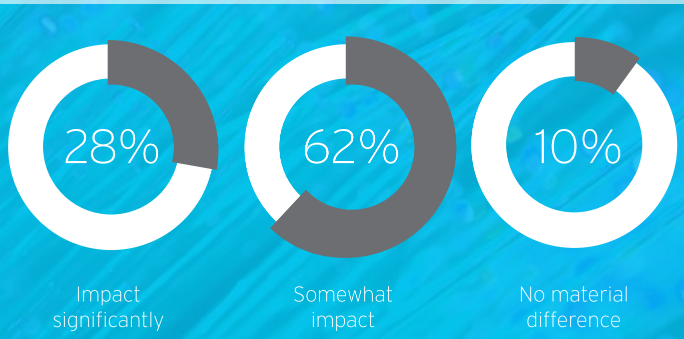
Canadian tax authorities have implemented changes in recent years that could affect M&A. As well as the introduction of foreign affiliate dumping rules, which will affect deal structuring, there have also been changes enacted to Canada's thin capitalization regime. On top of this, changes have also been made around corporate loss trading and upstream loans.

WHAT DOES THIS MEAN?

Almost two-thirds of respondents believe that recent changes in Canadian law affecting the determination of tax charges in an M&A deal will only marginally impact the level of cross-border M&A activity in the country. Respondents think that the buyers' sophistication will mostly negate any untoward impact that these shifts in tax regulations will cause. "As far as acquisitions in Canada are concerned, foreign businesses usually have a well-thought out plan to execute their acquisitions and changes in laws would not affect them a lot as most will find an alternative approach to navigate these tax changes," says a vice president in a construction company.

Despite this, some do see that these changes could cause issues. Indeed, over a quarter (28%) of respondents felt the tax law changes would impact Canadian cross-border M&A significantly. In particular, respondents noted the bad effect this would have on tax planning and consequently post-merger integration. "The recent changes in the Canadian tax laws impacted tax planning and deal structuring during cross-border transactions," says the vice president of corporate development at an investment banking firm. "Most of the firms failed to structure deals accurately, resulting in their collapse, and many faced challenges post integration due to unclear tax liabilities." A mere 10% of respondents predict that tax law changes will have no impact on activity.

There were recent changes to Canadian tax law impacting tax planning and deal structuring in cross-border M&A. How will this impact the level of Canadian cross-border M&A activity in 2015?



INVESTMENT CANADA ACT

WHAT HAS HAPPENED?

Three years ago Canada banned foreign state-owned enterprises from acquiring businesses in the country's oil sands outside of exceptional circumstances, and also said it would carefully monitor transactions of a similar type throughout the economy.

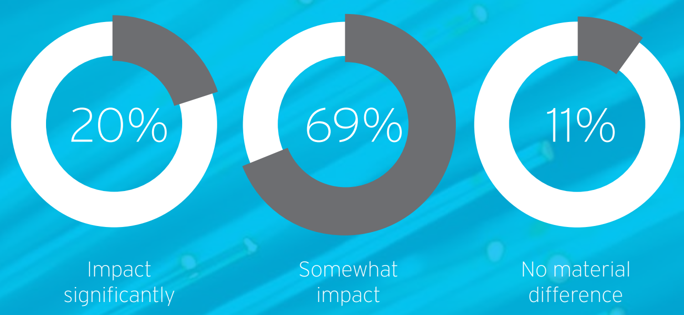
WHAT DOES THIS MEAN?

Sixty-nine percent of respondents believe that the higher level of scrutiny on acquisitions by foreign-state owned enterprises under the Investment Canada Act will only slightly impact cross-border activity in the next year. For one, like companies making the necessary moves to adjust to the tax law changes, these enterprises will be prepared to handle the increased scrutiny. For some, investors will still be fine as long as they prepare well to do deals in Canada. "Businesses that are ambitious will be prepared and the interest of foreign entities in the Canadian market will matter the most which will add to no particular difference," says the managing director of a PE firm. "At the current time, investments and benefits from investments will be the main focus so eager businesses will have the right approach, adhere to the laws and proceed with their quest for more business."

Despite this, some fear that clamping down on such investments could ultimately cost Canada, with a fifth of respondents saying the change would herald a significant impact. "Some of these enterprises might choose other jurisdictions that are more liberal and accommodating," says one investment banker.

Furthermore, some respondents felt that it could also put off investors already currently invested in Canada. "Foreign state-owned enterprises actively invested in the Canadian markets and benefited from the high returning portfolios and low tax regimes," says the vice president of corporate development at an investment bank. "However, the new implications and extremities will definitely create a bad impact on their interests and many will limit their investments."

Under the Investment Canada Act, investments in Canadian businesses, particularly those by foreign state-owned enterprises, are receiving greater scrutiny. How will this impact the level of Canadian cross-border M&A activity in 2015?



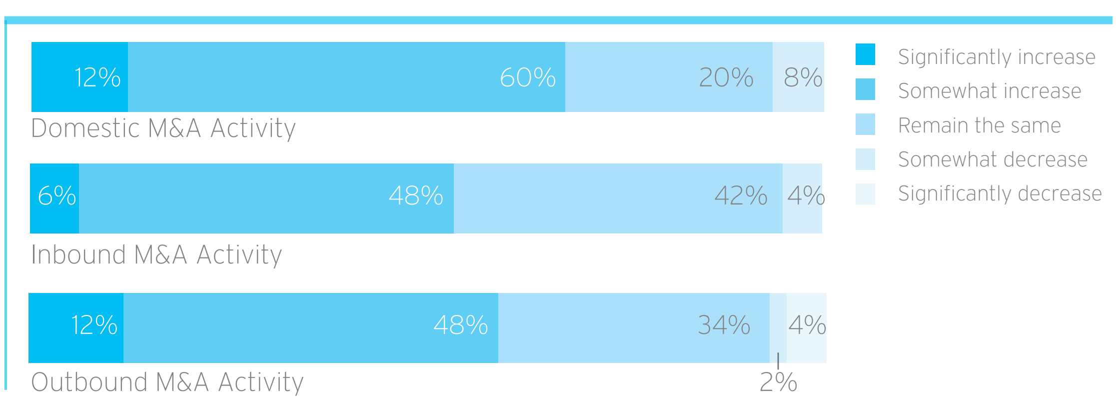
REAPING REWARDS:
PRIVATE EQUITY IN CANADA

Private equity activity is expected to rise in Canada. The underlying reasons for this include the significant amounts of committed capital that these firms have to deploy, combined with the current level of opportunities.

This expected increase comes off the back of a major year for private equity in Canada. There were 77 private equity purchases in 2014, the highest number for the last seven years. Standout deals include Advent International's US$845m buy of a 13.85% stake in athletic clothes designer Lululemon Athletica, and Highbridge Principal Strategies' US$842m share-capital reorganization of waste management firm GFL Environmental.

Respondents are expecting more of an increase in private equity activity involvement in outbound transactions. The head of M&A in a financial services firm believes that the level of private equity activity will increase in the next year for both the domestic and outbound areas as these firms look into newer and increasingly global opportunities. "Although I expect domestic investments to be smaller, international acquisitions will likely be larger as well as more diversified in terms of industries and regions."

What do you expect to happen to the volume of Canadian M&A activity in the following areas over the next 12 months?

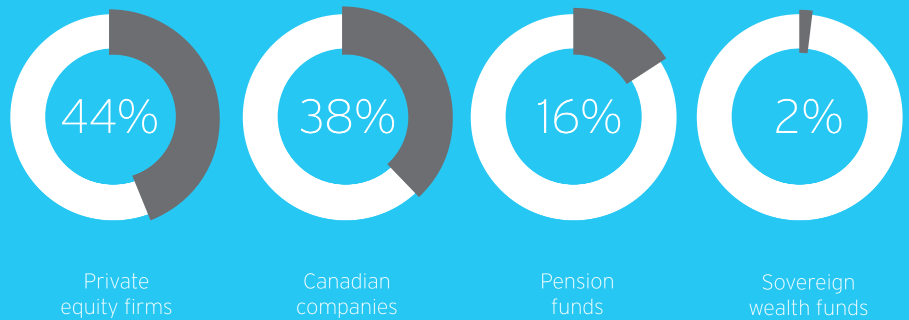


Buying spree

A comparatively higher portion of respondents (44%) believe that private equity firms will be the most acquisitive Canadian company type in 2015. A partner at a law firm expects this trend to happen in 2015 because of key factors that include private equity's significant amount of capital, the mindset to perform and the ability to excel under adverse conditions. "They will get into deals that are not going to lose out on regular profits because of market volatility and distress," says a partner at a law firm. Indeed, one major foreign acquisition undertaken already in 2015 has been Onex's decision to buy survival-equipment maker Survitec Group for US$680m.

> *"They [PE firms] will get into deals that are not going to lose out on regular profits because of market volatility and distress."*
>
> **Partner at a law firm**

Which type of Canadian company will make the most acquisitions in 2015?



CONCLUSION:
CHARTING THE COURSE

The outlook for Canadian M&A in general and cross-border dealmaking in the next 12 months remains positive with expectations for increased activity despite the inevitable market volatility that the fall in oil prices has caused across industries, not just limited to energy-related segments. Some of the effects are favourable — the operational and budget difficulties in the country's oil and gas companies has created opportunities for inbound buyers interested in assets. Aside from oil and gas concerns, consumer-dependent industries are seeing a lot more activity from those feeling the reprieve from expensive gasoline prices.

Away from this, the market also has a lot going for it. Financing prospects are steady. Private equity firms are engaged as these firms find value in Canadian assets and, for those that are Canada-based, international opportunities to enrich their respective portfolios.

This is not to discount the more damaging effects of commodity price volatility that has left in its wake a series of struggling companies. Bearing all this in mind, here are three key points that corporates will keep in mind when charting the course of Canadian M&A this year:

Decision time. Some firms will be faced with the critical decision, as oil prices continue to fall and revenues deteriorate, of whether to stay course through choppy conditions or sell to avoid the headwinds. As the year goes on, the M&A market will in general be driven by what decisions these players make.

The private equity age. A combination of cheaper assets and rich pickings has spurred an increase in private equity activity into Canada. On top of this, Canadian private equity firms are becoming more active outside of their country as they look to solidify investments and returns.

Aggressive growth. Macro factors permitting, companies are still looking to Canada as an attractive market to penetrate, and will undertake acquisitions for this cause. Even in the face of issues such as oil price falls, regulation changes and uncertainty, the country is still an attractive prospect, particularly as emerging markets continue to show signs of slowing.

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GRANT KERNAGHAN
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Canadian Investment Banking

The new powerhouses

Pension funds in Canada and worldwide are becoming increasingly active in direct investments, says Citi's Grant Kernaghan. But they must navigate a tricky path before reaping the rewards.

Canadian pension funds are no longer sitting back. Increasingly they are going it alone or partnering up when it comes to investments.

In February this year, The Ontario Teacher's Pension Plan bought portable moving and storage company PODS for over US$1bn. Elsewhere, others have sought to club together with private equity firms to take major stakes in companies. For example, Caisse de dépôt et placement du Québec (CDPQ) teamed with PE house BC Partners and other investors to acquire PetSmart in December for US$8.6bn. And on the sell side, in April last year, the Canadian Pension Plan Investment Board (CPPIB) along with its PE partner Onex sold Gates, part of the industrial conglomerate Tomkins acquired in 2010 for US$5bn.

On top of this, pension funds have been increasingly active in traditional infrastructure investments. According to Inframation Group, four of Canada's biggest pension funds (CDPQ, CPPIB, OTPP and bcIMC) invested in 12 infrastructure projects in 2014, compared with just three in 2013.

Several factors have underpinned this increase and change in investment strategy. As low interest rates hit returns, pension funds are asserting themselves as independent investment powerhouses in their own right. Outside of Canada, CalPERS announced in January that it plans to cut the number of PE managers it uses by up to two-thirds in a review of its alternative investments portfolio.

Pension funds are also motivated by their obligations to investors to earn significant returns on their investments while managing the risks. This has led to increased calls for diversification of assets to minimize potential pitfalls. In Japan, for instance, new health and welfare minister Yasuhisa Shiozaki said in September his remit with the Government Pension investment fund was "investing safely and efficiently…by diversifying what was biased toward investments in Japanese government bonds."

In moving to direct investments, pension funds have some factors in their favour. Firstly, their size and global reach, that allow them to go head to head with well-funded private equity firms. CPPIB for instance, opened its fourth international office, in Sao Paolo, early last year. Months later, it announced intentions to invest US$396m into Brazilian commercial property, taking its real estate commitments in Brazil to over US$1.8bn. On top of this, these funds can often hold on to their investments for the long-term, in comparison with traditional PE houses who face pressures to monetize investments after a typical holding period of 5-7 years. Additionally, pension fund managers also do not have to worry about fundraising efforts versus private equity firms thanks to their long-term capital.

Clearly, times are changing for pension funds in Canada and beyond. Yet with the opportunities available, there are still issues these institutions face. Here are two key points pension funds should keep in mind for the coming year and beyond:

Reduce the learning curve. Turning from a passive to active investor is a big change, and it is imperative for funds to dedicate the necessary internal resources to ramp up these type of investments. This can include hiring talent with M&A schooling from the corporate and PE world. Last year, for instance, CPPIB hired the managing partner of PE firm 3i group's infrastructure division for its own infrastructure team. Additionally, pension funds should look to hiring advisors who will have specialized M&A teams with experience on both sides of a deal across the world.

Review your options. The long-term nature of pension fund investing might stop some funds from looking carefully at the performance of certain investments. Active portfolio reviews and vocal shareholding can help with this. For the latter, this is already happening. In the US in 2013, for instance, the California State Teachers Retirement System co-sponsored a proposal with activist fund Relational Investors to split steel company Timken into two. The board eventually agreed to the proposal.

The rise of active pension funds is heralding a new era for Canadian and worldwide dealmaking. If funds navigate the challenges that lay ahead, the long-term rewards could be extraordinary.

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