Finding the KEY:

Canadian Institutional Investors and Private Equity

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Macdonald & Associates Limited

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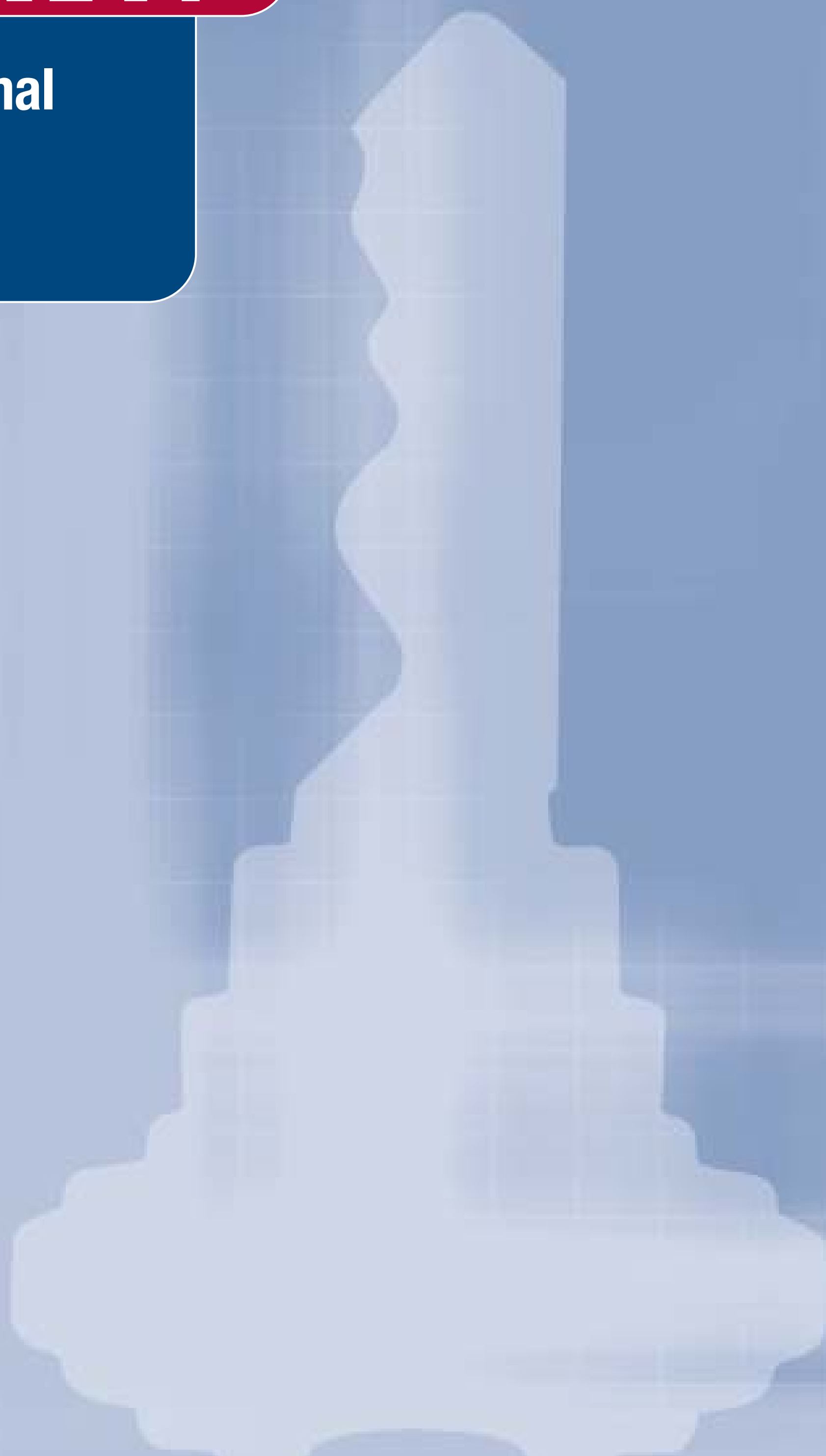
June 2004



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1. Executive Summary

For industrialized countries like Canada and the U.S., fostering the growth of new and developing businesses is essential to a successful economy in the 21st century. Key to this result is access to risk investment that facilitates high growth in innovative firms and competitive transitions for traditional firms. This implies the need for a dynamic and well-established national market for venture capital and other types of private equity.

Finding the Key: Canadian Institutional Investors and Private Equity explores the role of institutional investors (i.e., corporate and public sector pensions, insurance companies, endowments and foundations, and so forth.) in Canada and the U.S. in this realm. While American institutions have found superior, risk-adjusted returns in close to two decades of participation in domestic and global private equity markets, many members of Canada's institutional community remain reluctant to embrace the asset class.

Based on the American experience, and on the leadership shown by large Canadian institutions that have been active in venture capital and other types of private equity since the 1990s, it is evident that an institutional program that is returns-oriented and diversified by market focus and geography can produce benefits to both institutions and the economy as a whole. This is because a diversified approach to private equity will ultimately include viable opportunities in all regions of Canada.

These are just some of the conclusions of *Finding the Key*, which was commissioned by the federal government and six provincial governments, and which was based on surveys of almost 100 institutional managers in Canada and the U.S., conducted by Macdonald & Associates Limited.

Research Methodology

In the summer of 2003, Macdonald & Associates conducted detailed interviews with key informants representing 74 institutional funds, with headquarters in all regions of Canada, on issues relevant to their interest or activity in private equity at home or abroad. At the same time, senior managers of 20 of the largest pensions, endowments and funds-of-funds in the U.S. were interviewed concerning their market experience and interest in Canadian private equity opportunities.

It should be noted that Canadian and U.S. survey samples were generally skewed towards large institutions and those with some interest in private equity. Such respondents tended to be more willing or able to participate.

Institutional Investors and Private Equity: Canada-U.S. Comparisons

Finding the Key discovered that American institutions have a very strong appetite for private equity right across the market spectrum (i.e., buyout, mezzanine and venture capital). This appetite is expressed in the substantial volume of assets currently committed by American institutions, and by the assets they intend to commit in the years ahead. Furthermore, all types and sizes of American institutions participate in the market. By contrast, only Canadian public sector pension funds, and $5-billion-plus Canadian institutions, are similarly active.

EXECUTIVE SUMMARY – FIGURE I
Institutional Allocations (Actual) to Private Equity Canada and the United States, 2002

UNITED STATES	% Of Total Assets
Endowments and Foundations	8.0%
Pension Funds (Corporate)	3.3%
Pension Funds (Public Sector)	3.1%
CANADA	
Endowments and Foundations	1.0%
Pension Funds (Corporate)	1.3%
Pension Funds (Public Sector)	2.8%

Source: Greenwich Associates, 2003

EXECUTIVE SUMMARY – FIGURE II
Institutional Allocations (Actual) to Private Equity* Canada and the United States, 2002

% Total Assets

UNITED STATES (US$)				
Fund Size	+$5 Billion	$1-5 Billion	$501 Million – $1 Billion	-$500 Million
	3.4%	2.6%	1.5%	1.5%
CANADA (CDN$)				
Fund Size	+$5 Billion	$1-5 Billion	$501 Million - $1 Billion	-$500 Million
	3.2%	0.5%	0.1%	0.1%

* Includes available data for endowments/foundations and corporate and public sector pension funds

Source: Greenwich Associates, 2003

Themes from the U.S. Survey

Survey responses that contributed to *Finding the Key* helped to explain this Canada–U.S. gap. Respondents in the U.S. reflected a "who's who" of institutions active in global private equity, with most getting started in the mid-1980s. Since then, American institutional managers have successfully "learned by doing" in a challenging market — an experience that has confirmed their belief in the high return and diversification benefits of the asset class.

American institutional managers proved successful by observing patience and overcoming challenges through the acquisition of market expertise, resources and relationships. For instance, key to their sustained activity was the development of supporting infrastructure, such as specialty advisors and agents (e.g., gatekeepers). In particular, funds-of-funds have been a vital resource, especially to smaller institutions, given their ability to pool assets, house expertise and select funds with strong track records.

American institutions expressed a keen interest in top-tier investment opportunities wherever these exist. However, they also see Canadian opportunities in the context of an increasingly integrated North American market, suggesting that private equity funds in Canada must demonstrate a clear competitive advantage if they are to attract institutional resources from south-of-the-border. American institutional activity in Canada may also be impeded by the costs of addressing, or avoiding, certain tax regulations.

Themes from the Canadian Survey

Survey responses in Canada painted a much different picture. On the one hand, Canadian institutional managers were found to have some new awareness of private equity, apparent in the 14 institutions that have launched programs since 2000 and another four that plan a program launch in the near future.

On the other hand, most current or prospective market participation in Canada's institutional community is represented by public sector pensions, while over half of corporate pension funds were found to be without programs. Doubtless, the number of reluctant institutions would be greater in a larger universe than was reflected in the sample.

In many Canadian institutions, the survey found no significant pressure being applied to managers by trustees, directors or advisors to investigate the potential benefits of private equity. In these cases, knowledge of the asset class was quite limited, with institutional managers viewing such activity in a strictly "Canadian" context and, in so doing, neglecting the advantages of broader diversification, including American exposure.

Many Canadian institutional managers emphasized challenges to entry or sustained activity in the private equity market. For instance, survey respondents gave voice to difficulties accessing expert advice, as some externally based investment consultants do not possess the knowledge or resources to advise them effectively on this topic. These respondents also had difficulty finding reliable, market-specific data.

Structural barriers to private equity activity also appear to be compounded for small and medium-sized institutions in Canada that lack "relative capacity" (i.e., numbers of internal staff, skill sets or other resources).

This issue may be of particular concern to certain types of Canadian institutional investors, including corporate pensions and endowments, as well as those based in regions. "Relative capacity" is even a concern of some larger entities. As in the U.S., such institutions are in particular need of new forms of external support if they are to gain market exposure.

Finding the Key discovered several potential means for overcoming such barriers, including made-in-Canada funds-of-funds, gatekeepers and other types of emerging infrastructure that offer a key source of market leverage for institutions, regardless of size, type or location across the country. In addition, Canadian institutions can already avail themselves of the highly advanced infrastructure based in the U.S.

More Canadian institutional exposure to the market may also result when private equity industry players observe best practices in limited partnership agreements and observe more transparent valuation policies. Finally, tax policies and other regulations should be addressed to remove unintended impediments.

Finding the Key: Conclusions and Recommendations

Finding the Key concludes that Canada faces several fundamental challenges with respect to the participation of our institutional community in domestic and global private equity. For example, many of the attitudes of Canadian institutional managers captured by the 2003 survey are identical to those noted in prior reports. This suggests that, for many institutions, the obstacles associated with undertaking private equity have remained unchanged with the passage of time or events.

One explanation for this situation is the long shadow cast by a negative market experience in the 1980s, when many corporate and public sector pension funds, among others, first made capital commitments to private equity funds. Poor returns and conflicts with investment professionals at that time helped to shape perceptions that persist today, despite many years of subsequent growth and development in the industry.

A second explanation probably exists in the sheer volume of issues that confront a given Canadian institution when it elects to participate in private equity activity. High levels of American institutional participation did not, of course, take place overnight or as a result of a single initiative. Rather, in "learning by doing," American — and some Canadian — institutions found a home in private equity through a variety of strategic solutions.

In the coming years, the national ecosystem for private equity activity — based on a sizeable pool of seasoned investment professionals on the one side and a solid base of entrepreneurial and business management talent that inspires deal flow on the other — must continue to evolve to give Canadian institutions sufficient confidence about the long-term returns they can ultimately obtain.

To change the status quo, Canadian and U.S. survey responses indicated that an important first step was increased communication and education, not just among managers, but also among trustees, directors and advisors. Ideally, this should include more interaction between Canada's institutional and private equity communities, to correct misinformed impressions and to collaborate to meet shared objectives.

For this reason, *Finding the Key* proposes that a new process of multi-stakeholder discussion should begin in Canada. This process should include senior representatives of the institutional community, the private equity industry, government and other interested parties. It should focus on expanding on report findings, on deepening awareness about related issues and on considering alternative strategies for action.

An essential aspect of a national process of discussion would be cross-country seminars organized by federal and provincial governments and by industry associations, including the CVCA-Canada's Venture Capital and Private Equity Association, Réseau de capital de risque du Québec and the Pension Investment Association of Canada.

These same organizations should also be involved in new strategies for increasing awareness and understanding in the American institutional community about distinctive private equity investment opportunities in Canada.

Finally, industry associations should continue their work with the federal Department of Finance and other government bodies concerning tax and regulatory changes on behalf of institutions, private equity professionals and entrepreneurs.

By engaging in an open and thoughtful national dialogue, it is believed that means can be found to increase Canadian institutional activity in private equity in a way that secures the mutual benefits of superior portfolio returns, a stronger domestic industry and a more competitive and productive economy.

2. Introduction

The objective of this report, *Finding the Key: Canadian Institutional Investors and Private Equity*, is to stimulate a process of broad-based discussion in Canada about the role of institutional investors — pensions, insurance companies, endowments, foundations and other investment funds — in venture capital and other types of private equity.

To a significant extent, the impetus behind *Finding the Key* came from federal and provincial government interest in the contribution of venture financing to new generations of high growth businesses in all regions of the country. To obtain these and other "collateral" benefits to economic growth, productivity and jobs, Canada must have a private equity industry that is competitive and increasingly well grounded in stable and diverse sources of capital supply.

It is recognized that multiple elements, and multiple stakeholders, make up a national ecosystem that fosters venture and other private equity investments made in new and developing Canadian businesses. In other words, no one strategic solution will lend additional momentum to private equity activity in this country. This being said, an especially important factor is the market role assumed by pension funds and other institutions in Canada that today manage close to $1.5 trillion in assets.

An international example of this role has been set in the U.S., where the world's largest and most sophisticated private equity market has emerged, chiefly as a result of long-term capital commitments from American pension funds and other institutions seeking superior, risk-adjusted returns.

Canada's venture and private equity professionals are also keenly interested in this topic. Representatives of Canada's Venture Capital and Private Equity Association (CVCA) and Réseau de capital de risque du Québec gave valuable input to *Finding the Key*. Of equal value was the contribution of senior managers of institutions, many of whom are members of the Pension Investment Association of Canada (PIAC) and other national industry associations.

Private equity professionals and institutional managers participating in the market believe that exposure to this asset class is in the financial interest of Canadian institutional investors. Those that have neglected the asset class may well be missing out on a vital source of returns and portfolio diversification over the long term.

All stakeholders in *Finding the Key* — whether government, industry or institutional — believe that Canadian institutions should consider private equity in this financial context, with due regard to their policies for prudent management and risk tolerance.

If experience is the guide, a private equity program that is soundly conceived, returns-oriented and widely diversified by market focus and geography (i.e., North American or global in focus), will produce broader collateral economic benefits to the country as a whole, as well as superior returns to the investor. This is because a diversified approach to private equity will ultimately include viable investment opportunities in all regions of Canada.

To prompt a national discussion about the role of institutional investors in private equity, *Finding the Key* explored a number of issues of consequence. Conducted by Macdonald & Associates Limited over the summer and fall of 2003, this research attempted to build on the findings of several preceding studies of importance (see examples in Appendix III) in Canada and around the world.

Research undertaken for this report consisted of the following.

- Background data and analysis related to this topic, including that which clarifies the scope and dimensions of Canadian institutional exposure to private equity vis-à-vis that of American institutions.
- A survey targeted to leading pension, endowment and fund-of-funds managers in the U.S., to draw lessons from American market experience and gauge awareness of Canadian private equity investment prospects.
- A survey targeted to senior managers of corporate and public sector pensions, life insurance companies, endowments and other institutions in Canada, to gauge perspectives on private equity.
- Other background materials that amplify on data or themes discussed over the course of the report.

The findings of each of these items are found, respectively, in Section 3, Section 4, Section 5 and Appendices II–V.

Based on this research, *Finding the Key* advances recommendations intended to encourage interaction and discussion among Canadian stakeholder groups. These recommendations are found in Section 6.

An advisory committee to this project, which supervised the survey and report-writing process, also provided advice on the recommendations. Committee members consisted of a mix of government representatives and leaders in the institutional community and private equity industry, as well as participating research consultants.

This report was commissioned by the Alberta Ministry of Economic Development; Industry Canada; the Manitoba Ministry of Industry, Trade and Mines; the Nova Scotia Ministry of Economic Development; the Ontario Ministry of Economic Development and Trade; Prince Edward Island Business Development; and the Quebec Ministry of Economic and Regional Development.

2.1 Research Methodology

As the economic presence of institutional investors has grown in Canada and globally, particularly in the 1990s, a body of research literature has developed concerning their influence in capital markets (see Appendix III for selected examples). Some of this research has addressed their role in private equity.

Existing Research Literature in This Area

In 1998, the Organization of Economic Co-operation and Development (OECD) published one of the most important of these studies: *Institutional Investors in the New Financial Landscape*.

This OECD report confirmed the global relevance of research previously conducted in the U.S. by Peter Drucker and the Harvard Business School, among others. In general, such research concluded that a trend towards the "institutionalization" of savings had led to the creation of numerous, massive investors — the largest of which have tended to be pension funds — that were, and remain, fairly new to the financial world.

In all industrialized countries, said the OECD, a key by-product of this phenomenon was "an increased supply of long-term funds" that should result in "an increase in the supply of risk capital."

Recently, the link between institutions and risk capital has been further probed. For example, in 2001, the high-profile "Myners report" (*Institutional Investment in the United Kingdom*) was issued, containing a detailed examination of the perceived low rate of British institutional activity in private equity.

Myners found identifiable barriers to this market participation. Most of these derived from the nature of institution-based investment processes and its failure to secure the necessary resources and expertise for decision-making. To a much lesser extent, government regulation was also held responsible.

Similar ground has been tread in Canada. A 1999 report, *Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy* (Falconer, Canadian Labour Market and Productivity Centre), attested to Myners-like barriers when it came to institutional exposure to venture capital and other types of private investment in this country.

Based on a survey of PIAC members, this report found that Canadian pension managers felt impeded by such challenges as market entry costs, limited access to data, concerns about the ability of private equity professionals to deliver returns, oversight difficulties, and the attitudes of trustees and external advisors.

A common feature of many of these reports has been the research methodology utilized. Instead of relying on quantitative models, research has frequently been driven by qualitative approaches. Qualitative research goes to the heart of structural issues relevant to both institutional management and private equity activity by providing a better understanding of the attitudes and perceptions that underlie decision-making processes.

For instance, considerable economic and business research (e.g., Berger and Udell, 1998, MacIntosh, 1994; see Appendix III) has shown all private capital markets to have inherent inefficiencies, particularly as transactional information is not readily available, in contrast with public markets. For this reason, private equity activity is complex and management-intensive for investors.

In addition, as Myners and Falconer revealed, institutional management cultures are also complex, and internal processes for arriving at well-informed investment decisions are not always optimal. The more challenging the asset class, the more apparent this potential deficiency becomes.

Hence, researchers have often used opinion surveys (or equivalent research tools) of key informants, such as institutional managers, trustees (or directors) and advisors, to consider attitudes toward private equity. Other qualitative research may explore the inputs and outputs of investment processes (to test effectiveness) and other structural issues, such as the influence of regulatory systems.

Research Underlying This Report

In keeping with the methodological approach described above, *Finding the Key* relied on key informant surveys, conducted in an interview format and designed primarily to obtain feedback from institutional managers and their advisors concerning their awareness, attitudes, policies and decision-making procedures with regard to venture capital and other types of private equity.

Questions addressed to key informants were intended to elicit detailed responses concerning structural issues pertaining to private equity, both institution-based and market-based. In addition, researchers probed managers for potential strategies whereby impediments could be overcome.

Before interviews, respondents were assured that their comments would not be disclosed. In Canada's small institutional community, this also precluded non-attributed quotes. Instead, responses have been paraphrased in this report and organized according to primary themes.

The Canadian Survey

Appendix II provides a very brief summary of questions addressed in Canadian interviews. Questions varied according to whether the survey respondent represented an institution with an active private equity program.

The Canadian survey was targeted to a cross-section of institutions, by type (i.e., corporate and public sector pensions, insurance companies, endowments, foundations and other investment funds) and by region.

Where possible, researchers also attempted to diversify the survey sample by size of institution. They tried to ensure the sample had a broad regional composition, based on a minimum of 20 interviews in both Ontario and Quebec and 3, 4 or 5 in each of British Columbia, Alberta, Manitoba and the Atlantic provinces. Their results are found in Figure I and Figure II.

In all, the survey was directed to 94 Canadian institutional investors, 74 of which (79%) agreed to an interview. Respondents tended to be senior managers of individual funds or, in some cases, multi-fund operations (e.g., Alberta Revenue, British Columbia Investment Management Corporation, CDP Capital, New Brunswick Investment Management Corporation and University of Toronto Asset Management).

In addition, interviews were obtained with top consulting firms that advise fiduciary clients, as well as fund-of-funds managers and leading private equity fund managers.

The final Canadian sample, while relatively large for a survey of this kind, reflects several key limitations, which should be recognized.

Surveyed institutions were predominantly large. Institutions with substantial assets under management were more likely to have the time and ability to participate in an interview, so the there was a sample bias towards larger institutions. Of all institutions that agreed to an interview, 62% had assets of over $2 billion (see Figure I). For the majority of respondents that were corporate or public sector pension

FIGURE I

Canadian Survey Respondents and Non-Respondents, Profile Data

Size, Number and Type of Canadian Institutions Interviewed and Not Interviewed

ASSETS	>$10B	$5B-$10B	$2B–$5B	$1B–$2B	< $1B	TOTAL
Agreed to Interview						
Public Sector Pension Funds	6	11	12	10	7	46
Corporate Pension Funds	2	2	9	3	2	18
Foundations/Endowments				2	2	4
Life Companies	3	1		2		6
Declined to Interview						
Public Sector Pension Funds	2		1	1		4
Corporate Pension Funds		1	7	3	1	12
Foundations/Endowments						
Life Companies	2		2			4

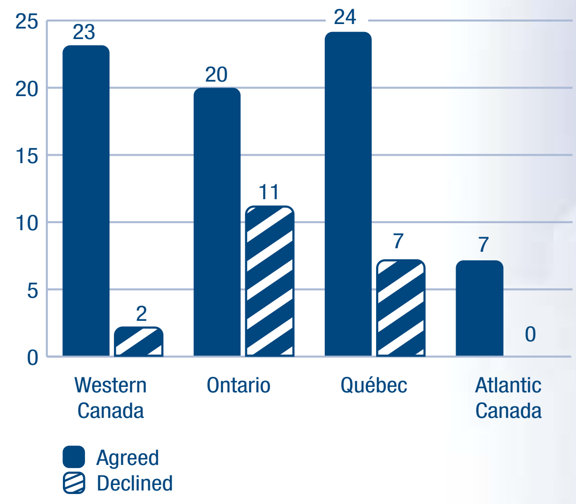
funds, this statistic points to the large size bias, as there are more than 3,000 trusteed funds in Canada (Statistics Canada, 2002) and the 100 largest (as defined by *Benefits Canada*) have assets of approximately $1 billion or greater.

In other words, the survey reached the upper echelon of a broad Canadian institutional universe (i.e., trusteed and other pension funds, insurance firms, endowments, foundations and so on) comprised of literally thousands of individual funds of diverse types and sizes, headquartered in all regions of the country (see Figure II) in a pool of roughly $1.5 trillion. As there is no comprehensive directory of institutions in Canada, it is impossible to calculate precisely the actual percentage of the aggregate number represented by the survey sample.

Greenwich Associates, a U.S.-based financial research firm, conducts an annual institutional survey in North America (quoted in this report). It encounters a comparable large-size bias in its work. Greenwich data from 2003, quoted in *Finding the Key*, shows that 67% of the 402 Canadian institutions contacted also responded. Greenwich confirms that non-responding institutions tended to be smaller than responding institutions.

FIGURE II

Canadian Survey Respondents and Non-Respondents, by Regional Location of Principal Headquarters



The same holds true for the biennial international survey of Goldman, Sachs & Company and Frank Russell Company (also quoted here), in which the respondent cut-off is $US3 billion.

Most respondents had some interest in private equity.
In an effort to fully understand the variables that determine whether an institution allocates assets to private equity, the Canadian survey targeted both institutions active in the market and those that are not. However, those institutional managers that agreed to an interview tended to represent those with private equity programs, currently or formerly, or those that were at least curious about the topic. While some institutional managers declined interviews because of lack of time, most cited lack of interest in the market.

For this reason, it is believed that the survey results reflect a greater interest in private equity than would be found in the Canadian institutional community at large. Lack of interest in the market appears to have been most prevalent among corporate pension funds. Of 30 corporate funds contacted for an interview, 40% declined. By contrast, only 14% of the 29 public sector pension funds approached declined an interview.

Greenwich and Goldman, Sachs-Russell acknowledged a similar characteristic in responses to their surveys.

Insurance companies are under-represented in the sample.
With respect to private equity, insurance companies tend to be those based in the life and health industry. Representatives of 6 of the 10 insurers contacted agreed to an interview, a low response rate that suggests limited interest in the asset class.

The American Survey

The American survey was also targeted to a cross-section of institutions, concentrating on those that have been especially active in private equity over a long period of time (i.e., corporate and public sector pensions, and endowment funds). Interviews were also conducted with top fund-of-funds managers. There were 20 American survey respondents.

Many of the questions posed of Canadians institutions were also put to Americans, so as to draw lessons from more than two decades of American institutional history in the market. In addition, researchers probed American institutional managers concerning their awareness about, and interest in, private equity opportunities in Canada.

Data on Trends in Institutional Activity in Private Equity
To add insight to the input received from key informant interviews, *Finding the Key* also relied on comparative, quantitative market data assembled from assorted research sources. These data highlight recent trends in institutional exposure to private equity, with a strong emphasis on comparisons between Canada and the U.S.

Comparative market data proved useful in establishing the broad parameters of current and anticipated private equity activity in Canada and the U.S. based on specific categories of institutional investor. Greenwich Associates also assembled data for this report that highlight current market participation by different institutional fund sizes. These data were used, in part, to demonstrate the recent impact of different levels of institutional activity in Canada and the U.S. on their respective national private equity industries.

These data also helped to establish an informed context for understanding attitudes and perceptions underlying the private equity decisions of institutions, as revealed in Canadian and American survey responses.

2.2 Key Terms and Acronyms Used in this Report

Alternative assets: Investments that fall outside of the realm of public stocks and bonds, including real estate and private equity.

CVCA: Canada's Venture Capital and Private Equity Association.

Capital commitments: Resources flowing from institutions (and other sources) to private equity funds.

Fiduciaries: Managers or trustees of pensions and some other fund types.

Fund-of-funds: A pool of institutional assets managed by professionals that performs due diligence and selects private equity funds on behalf of clients. According to *Private Equity Analyst*, there are two essential types: the commingled fund-of-funds (a pool based on the assets of multiple investors) and the captive (a pool based on the assets of a single investor).

Gatekeepers: Expert professionals that advise institutional clients on private equity decisions and/or act on their behalf in the market, sometimes through funds-of-funds.

GPs and LPs: General partners (or private equity fund managers) and limited partners (or capital suppliers to private equity funds).

Institutional allocations (actual): The current amount of capital allocated by institutions to an asset class (e.g., private equity), as a percentage of total assets. Over time, the current allocation rises to meet the targeted allocation (see below).

Institutional allocations (targeted): The authorized allocation of institutions to an asset class (e.g., private equity) as a percentage of total assets. Private equity targets typically reflect a relatively small fraction of total assets.

Institutional investors: Trusteed corporate and public sector pensions, other pension funds, insurance companies, university endowments, charitable foundations and other fund types with similar investor characteristics (based on the 1998 OECD definition).

Limited partnerships: Funds managed by GPs on behalf of LPs that supply capital.

PIAC: Pension Investment Association of Canada.

Private equity market: The non-public market for all forms of equity and quasi-equity activity. In a mature market, there are usually three distinct sectors:

> **Buyout:** Risk investment in established mid-market companies, typically in traditional sectors.
>
> **Mezzanine:** Same market focus as buyout, but using subordinated debt.
>
> **Venture Capital:** Risk investment in new or young companies, typically in innovative sectors.

Private equity programs: Defined here as the formal activity of institutional investors, whereby criteria and targets are established and allocations (or commitments) are made regularly.

Réseau Capital: Réseau de capital de risque du Québec.

For additional definitions, readers are invited to visit the glossary on the Macdonald & Associates Web site: **www.canadavc.com**.

3. Institutional Investors and Private Equity: Canada-U.S. Comparisons

Private equity has grown steadily in popularity in the global institutional investor community. Particularly in the 1990s, private equity emerged as a distinct and substantial asset class in many of the world's largest institutional portfolios.

This trend had its genesis in the U.S., where institutions of all kinds and sizes have supplied most of the fuel to a burgeoning market over the past decade. According to the biennial international survey conducted by Goldman, Sachs & Company and Frank Russell Company, called *Alternative Investing by Tax-Exempt Organizations*, institutional funds in other countries are starting to follow this American lead.

Goldman, Sachs-Russell also found that, despite their global focus, American institutions commit most of their considerable private equity assets to funds at home. Not surprisingly then, they have been integral to the growth of the world's largest and most sophisticated market. For this reason, private equity in the U.S. has become a model for other countries.

There are various ways of measuring institutional activity in private equity and comparing measures between two or more countries. Among the most common is to compare private equity allocations (actual or targeted, as a percentage of total assets) among different types of institutions, in different nations. Another is to compare, country by country, the annual rate of new capital commitments that institutions make to private equity funds.

Because of major national differences in retirement income systems, types of institutions and the structure and orientation of private equity industries — as well as different methodologies for describing these components — making direct comparisons is a daunting task and can be misleading. For this reason, the data and analysis that follow are grounded in a North American context (with other international data presented in Appendix IV).

Using both of these measures of institutional activity, data assembled from multiple sources show that there has been, and continues to be, much greater breadth and depth in American institutional exposure to private equity (i.e., by type of institution, by size of institution and so on) as compared to Canadian exposure.

American Institutions Commit More Assets to Private Equity

Figure III highlights actual (as opposed to targeted) allocations to private equity by major institutional types in Canada and the U.S. In its annual survey, Greenwich Associates found that current allocations in the U.S. were typically highest among endowments and foundations (8% of assets), followed by corporate pension funds (3.3%).

Despite allocating a lower share of their total assets, public sector pension funds are now the biggest contributors to American private equity in absolute terms, due to their sheer size.

FIGURE III
Institutional Allocations (Actual) to Private Equity

Canada and the United States, 2002

UNITED STATES	% Of Total Assets
Endowments and Foundations	8.0%
Pension Funds (Corporate)	3.3%
Pension Funds (Public Sector)	3.1%
CANADA	
Endowments and Foundations	1.0%
Pension Funds (Corporate)	1.3%
Pension Funds (Public Sector)	2.8%

Source: Greenwich Associates, 2003

In Canada, the standings are reversed. Public sector pension funds lead with 2.8% of assets allocated to private equity.

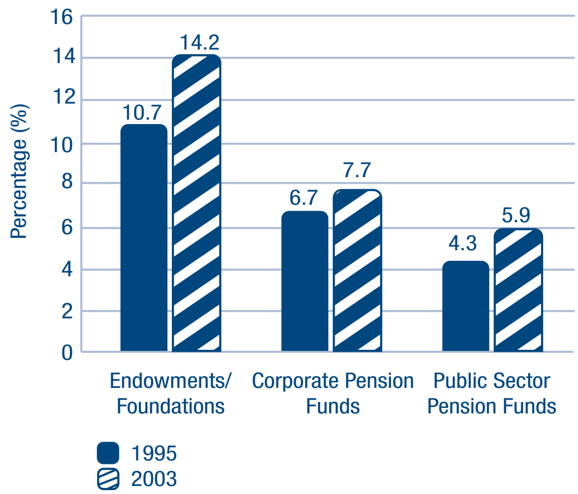
Canadian corporate pension funds are under-represented in private equity, as compared to their American counterparts. It is probable that Greenwich data also include legacy assets, as most Canadian corporate funds are not currently active (suggesting that the Canada–U.S. gap in this area is perhaps even wider).

The data also show that endowments and foundations in this country are only just beginning to form a tangible market presence.

FIGURE IV

Institutional Fund Allocations (Targeted) to Private Equity

North America, 1995 and 2003



Source: Goldman, Sachs-Russell, 2003

There is evidence of a similar pattern in private equity asset allocation targets. For instance, the Goldman, Sachs-Russell survey for 2003 (see Figure IV) shows recent trends in private equity targets, based on a North American sample of comparable institutional categories (consisting predominantly of American respondents). While targets have risen or fallen in individual cases, the long-term, aggregate trend has been steadily upward.

According to survey data collected for *Finding the Key*, Canadian public sector pensions and some other institutions active in the market have generally been part of this trend. However, as compared to the entire Goldman, Sachs-Russell sample for North America, overall Canadian target levels tend to be lower.

Finding the Key discovered that among active Canadian institutions, the average allocation target was 6.0% of total assets in 2003. This compares with the blended North American average of 7.5% of Goldman, Sachs-Russell.

Neither the Greenwich nor Goldman, Sachs-Russell survey samples included Canadian or American insurance companies.

American Private Equity Activity Involves Institutions of All Sizes

The data in Figures III and IV indicate that private equity activity spans at least three major American institutional categories, while only Canadian public sector pension funds are similarly engaged. In addition, the market stakes of American institutions are deeper than those of Canadian institutions.

Further data drawn from the latest Greenwich survey demonstrate that American institutional funds of all sizes also tend to participate in the private equity market.

As Figure V highlights, actual private equity allocations increase with the size of American institutions, with the largest ($5 billion or more) allocating 3.4% of total assets on average, as compared to the smallest ($1 billion or less) with 1.5%.

Canadian allocations in similar categories (even adjusted for currency differentials) typically fall far short of the American standard. The exception is Canada's largest institutions ($5 billion or more), which approximate their American peers in private equity exposure. Asset allocations fall off dramatically for Canadian institutions with less than $5 billon.

FIGURE V

Institutional Allocations (Actual) to Private Equity* Canada and the United States, 2002

% Total Assets

UNITED STATES (US$)				
Fund Size	+$5 Billion	$1-5 Billion	$501 Million – $1 Billion	-$500 Million
	3.4%	2.6%	1.5%	1.5%
CANADA (CDN$)				
Fund Size	+$5 Billion	$1-5 Billion	$501 Million - $1 Billion	-$500 Million
	3.2%	0.5%	0.1%	0.1%

* Includes available data for endowments/foundations and corporate and public sector pension funds

Source: Greenwich Associates, 2003

Data in both countries indicate the importance of "relative capacity" (i.e., numbers of internal staff, skill sets and complementary resources) necessary for undertaking a private equity program. In other words, there is an institutional size threshold whereat launching a program becomes feasible. Furthermore, the dimensions of a program increase with increasing size.

The issue of size and "relative capacity" may have a direct bearing on the Canadian situation, especially with regard to specific institutional categories. For instance, most university endowment funds contacted for *Finding the Key* had assets of around $1 billion or less. In addition, of the 30 corporate pension funds that were contacted (18 of which formed part of the Canadian survey sample), only five had assets greater than $5 billion.

These points notwithstanding, the data also reveal that even small institutions in the U.S. have found the means to create some exposure to the asset class. For the most part, institutions of comparable size in Canada have not.

Greenwich data align with a study by the Centre for Economic Policy Research, University of British Columbia (Chemla, 2003), which was rooted in a survey of Canadian and American pension funds. This study concluded that when size differentials were taken into account, American pensions were still found to commit a significantly greater proportion of their assets to private equity.

Rates of Institutional Participation Key to Private Equity Growth

In both Canada and the U.S., an active private equity program will tend to be diversified by market segment (i.e., buyout, mezzanine and venture capital), with commitment preferences varying from one institution to another. Institutional managers responding to the surveys that contributed to *Finding the Key* (Sections 4 and 5) confirmed this truism.

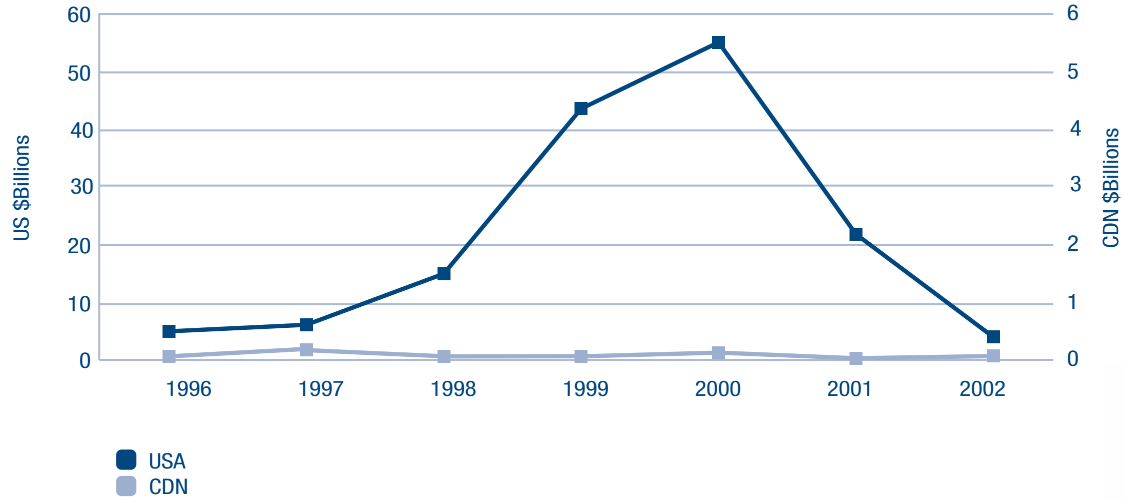
For instance, American survey respondents said that the biggest share of their total private equity allocations typically go to buyout funds (60%), followed by venture funds (35%) and mezzanine funds (5%). From the much smaller universe of Canadian institutional participants in the market, buyout funds will typically attract 45% of committed assets, followed by venture funds with 40% and mezzanine funds with 15%.

It should be recognized that these data provide only a thumbnail sketch of Canadian and American program criteria, based on limited samples of differently mixed institutional categories in the two countries. A more complete sample of institutions active in private equity would doubtless show somewhat different proportions. It should be further recognized that many programs are also diversified by geography, meaning that the market preferences of institutions will benefit funds in more than one country.

FIGURE VI

New Institutional Commitments to Venture Capital*

Canada and the United States, 1996–2002



* Includes available data for corporate and public sector pension funds, endowments/foundations, insurance companies and funds-of-funds.
** Excludes a significant new internal allocation by CDP Capital – Technologies.

Source: Macdonald & Associates, Ltd. Thomson Venture Economics, 2003

This being said, differences between Canadian and American institutional allocations to private equity have had a clear impact on the resources available for investment in their respective national private equity industries. Figure VI compares institutional participation in industries in Canada and the U.S., based on new commitments from 1996 to 2002, using venture capital as a proxy for all private equity activity.

These data show the extraordinary contribution of American pension funds, endowments, insurance companies and other groups to the rapid expansion of American industry resources. In the peak year of venture fund-raising (2000), these investors accounted for 56% of the $US107.2 billion in new supply. Even in the very difficult fund-raising climate of 2002, institutional investors held the course, with their share of new commitments rising to 75% as a result.

These levels reflect a consistent pattern in broad private equity exposure in the U.S. over the past ten or more years. Indeed, institutional assets underlie the bulk of the $US698 billion under management in American buyout, mezzanine and venture sectors at the present time (Thomson Venture Economics, 2003).

In most corresponding years, the share of annual new venture commitments attributable to institutions in Canada was well short of that south of the border.

In 2000 (also a vital year for venture fund-raising in Canada), pension funds, insurance companies and other institutions accounted for 31% of $3.8 billion raised, while in the down-cycle of 2002, they accounted for 16% of $3.2 billion raised. The latter share is more typical of Canadian institutional participation before 2000, when new commitments from this source typically accounted for between 5% and 15% of the new capital coming into the industry each year.

It is also important to clarify that some of the institutional resources entering the Canadian venture industry during this period went into the internal programs of institutions for the purpose of making direct investments.

Comparatively limited institutional activity has had crucial implications for the Canadian private equity industry. While buyout, mezzanine and venture sectors have experienced impressive growth in recent years — with resources under management hitting almost $50 billion in 2003 — a major fraction of overall supply has come from non-institutional sources (e.g., retail investors in the case of labour-sponsored venture capital corporations).

In addition, the more modest size of the private equity industry in this country, relative to the U.S., has led some analysts to argue that the market here may be under-capitalized, precisely because so many Canadian institutions have stayed on the sidelines (*Private Equity Canada 2002*, Goodman & Carr LLP, McKinsey and Company, 2003).

Consideration of the very different industry structures between Canada and the U.S. lends support to this perspective.

While over 80% of American private equity funds are based on institutionally supplied limited partnerships (Thomson Venture Economics), such funds account for 25% of the Canadian industry (Macdonald & Associates). As noted earlier, the smaller Canadian share is partly due to the preference of some Canadian institutions active in the market to invest directly, rather than to focus exclusively on committing capital to external pools.

What Do Canada–U.S. Comparisons Tell Us?

The facts suggest that American institutional investors have embraced private equity to a far greater degree than have their Canadian counterparts. Comparative data substantiate this conclusion in the following ways.

- Current actual and targeted allocations of American institutions to the asset class are generally higher than those of Canadian institutions.
- Private equity activity spans at least three of the major institutional categories in the U.S., while only public sector pensions funds in Canada are similarly engaged.
- American corporate pension funds are leading market players, in contrast with their Canadian counterparts.
- Canadian endowments and foundations are not yet a tangible market force — probably due to size — while their American counterparts are among the most aggressive of participants.
- American institutional funds invest in private equity irrespective of their size (although the extent of activity is size-sensitive), while only the largest Canadian institutions lean towards participating in the market.
- The American institutional appetite for private equity has, in turn, contributed significantly to an American industry of size and scope.
- Canada's private equity industry has not similarly benefited from an infusion of institutional capital.

Why Is There a Canada–U.S. Gap?

In part, the gap can probably be explained by the fact that the U.S. private equity industry has existed in its current form for several decades, with the attendant infrastructure (i.e., advisors, agents, pooling vehicles and other resources) that enables widespread institutional participation to evolve in the process.

By contrast, in Canada, the industry only really just started to gain momentum in the past ten years or so. However, to fully understand why the gap exists, it is important to understand the attitudes and perceptions underlying the decisions of institutional investors. This helps to explain the rationale for conducting interviews with key informants in both countries, the results of which are summarized in Sections 4 and 5.

4. American Institutional Investors and Private Equity

Section 3 provided evidence of the active participation by American institutional investors in the private equity market. But how did this occur and what lessons can be gleaned from American experience that are relevant to Canada? This question is the focus of Section 4.

There was no single event that introduced the full range of American institutions to the market. However, it is clear that fundamental changes in regulatory systems in recent decades laid much of the groundwork for that introduction.

For instance, a milestone of the 1970s was reform of the *Employee Retirement Income Security Act* enshrining the "prudent person" rule. This rule, which gradually became an essential principle of pension supervision in the U.S., Canada, the United Kingdom and other countries, gave fiduciaries more investment freedoms, in the context of more explicit obligations under the law.

Concurrent with federal and state regulatory changes was the development of the private equity limited partnership vehicle. Industry GPs could commingle capital from different types of investors and return it to them on a tax-exempt basis, thereby protecting the income tax status of pension funds. As institutions entered the market, the modus operandi of the American industry itself evolved, to the point where this vehicle became the primary means for raising capital.

Over the 1980s, some of the biggest names in the American institutional community initiated private equity programs. In these pioneering years, institutional managers had to "learn by doing" in an inefficient market. In practice, this meant refining internal procedures and external strategies for sustaining participation over highs and lows in market cycles.

As the following summary of survey responses reveals, American institutions were ultimately successful in this regard. In time, a growing number sought exposure to top-performing funds at home, as well as in Europe, Asia and other regions around the globe. Pension funds have become especially active abroad, becoming key sources of capital in some foreign private equity markets. While hard data are not available, such activity does not appear to be extensive in Canada, however.

To probe the American experience, *Finding the Key* targeted senior managers in some of the top institutional funds in the U.S., 20 of which agreed to an interview. The final sample is a selection of corporate and public sector pensions, endowments and fund-of-fund managers, and "gatekeepers" or advisors based in that country. Taken together, total managed assets of this group approach $US700 billion. In addition, respondents reflect a "who's who" of institutions active in American and international private equity.

American institutional managers were asked questions about their perceptions and experience of private equity at home and in Canada (see 2.1 Research Methodology). In reply, they sent important messages to Canadian institutional managers, private equity professionals, government officials and other interested parties. The following is an overview of what these survey respondents said. Where appropriate, Macdonald & Associates has added background information and analytical points.

4.1 Themes Emerging from the American Survey

Private Equity Exposure Can Contribute Substantially to Overall Returns

The survey found senior managers representing all 20 American pension funds, endowments and fund-of-funds expressing considerable enthusiasm for private equity.

Enthusiasm is grounded in nearly two decades of sustained market participation. The average inception date of the private equity programs of surveyed institutions was 1985. All American managers reported achieving superior, risk-adjusted returns, with several disclosing a net return of 20% overall. For this reason, they are confident about the powers of the asset class to boost overall profitability while at the same time diversifying their portfolios over the long term.

American institutional managers said returns were realized despite major market slowdowns in the early 1990s and since 2000. For them, this affirms the long-term nature of private equity and the need for a patient and sustained commitment to the asset class.

Based on this experience, American institutions cautioned against a "market timing" approach to private equity, whereby activity is guided by short-term trends. This strategy, which is better suited to public markets, will undermine returns from private equity and ultimately sour fiduciaries towards their programs. (It can be argued that this has been a core problem in Canada, where many institutional managers committed to private equity funds in the 1980s and then withdrew from the asset class several years later. See Section 5).

Enthusiasm in the American institutional community helps to explain rising private equity allocation targets between 1995 and 2003, documented by Goldman, Sachs-Russell (Figure IV). With time, American pension and endowment funds have steadily enlarged their presence in the buyout and venture capital sectors, while American insurance companies have given most emphasis to mezzanine investments.

Market Success Depends on Talent, Experience and Relationships

American institutional managers indicated they were faced with the same challenges as their Canadian counterparts are: an unfamiliar market with high entry costs, limited availability of information, oversight difficulties and so on. However, they pursued the perceived opportunity for superior returns and overcame impediments in the process.

The survey found that creation of private equity programs in American institutions has frequently been led by in-house champions on management teams or on boards of trustees (or directors). Typically, these individuals have been pivotal to decisions to introduce private equity because of their knowledge and their willingness to champion new directions.

Key to creating market exposure was the sourcing of expertise. Some institutions did this by recruiting seasoned managers internally, which in turn meant they had to adopt adequate financial compensation systems. Others looked to external professionals such as gatekeepers for support (see below). Regardless, the growth in private equity activity stimulated relationships and networks inside and outside institutions, which allowed for the flow of information and advice. For many American institutions, this process also involved peer group interaction, through forums like the Institutional Limited Partners Association (ILPA). It was suggested that similar activity would be beneficial to Canadian institutions.

Resources are Available to Support Institutions and Benchmark Performance

In the 1990s, growing demand for private equity investments among highly motivated American institutional managers generated a new American industry of specialty advisors and customized resources.

The survey found that the most important of these resources have been funds-of-funds (see below) and gatekeepers, these being professionals who provide one-stop market research to clients and sometimes act on their behalf in the market as intermediaries. In addition, institutional demand prompted traditional investment consultants to enhance advisory services to include private equity.

Over the years, these resources have supplied American institutions of all types and sizes with the tools and vehicles required to become active participants in the private equity market. Taken together, these tools comprised the infrastructure needed to cost-effectively launch and maintain programs. The consequence of a growing American industry of private equity-specific advisors and resources was, in time, greater and more diversified institutional participation.

The role of external agents is to keep clients informed on an ever-larger population of American and global product offerings, to facilitate introductions, and to help access reliable market and performance data so clients can evaluate funds and benchmark returns. Surveyed institutions confirmed the broad availability of market intelligence for these purposes, through such firms as Cambridge Associates and Thomson Venture Economics.

Funds-Of-Funds are Useful, Especially to Smaller Institutions

Survey respondents in American institutions acknowledged funds-of-funds as a valuable resource, given their ability to pool assets, house expertise, screen opportunities and select top-tier GPs. Though always evolving in design, the fund-of-funds model has two essential varieties: the commingled and the captive fund-of-funds.

Institutional managers said that commingled funds-of-funds, which pool the assets of multiple investors, have proved especially useful to small and medium-sized institutions, for which private equity may otherwise be too costly.

For smaller institutions wishing to undertake a program, this vehicle (along with other market innovations) contributes to "relative capacity" (i.e., available staff with skill sets, along with complementary resources, in this case located externally). Doubtless, funds-of-funds partly explain why even American institutions with assets of $1 billon or less have managed to create some significant private equity exposure (see Figure V).

The captive funds-of-funds — or pools based on the assets of a single investor — may be more appealing to large institutions, such as the California Public Employees Retirement System and Oregon Public Employees Retirement Fund, for strategic reasons, such as extending the reach of institutions into a wider network of GPs and private equity funds.

As a result, funds-of-funds have become a crucial fixture on the private equity landscape. According to *Private Equity Analyst*, there are now close to 125 active fund-of-funds worldwide, the bulk of them in the U.S. Most were formed between 1994 and 2003, when over $US70 billion was raised, chiefly from increasing numbers of American pension funds, endowments and other investors entering the market, or from expanding existing programs.

Misalignment of GP–LP Interests Continues, but the Situation is Better

American institutional managers agreed that they are often at odds with GPs when negotiating and administering private equity fund agreements. In these situations, the financial interests of institutional LPs are seen as being misaligned with those of GPs. Items of contention can include management fees charged, carried interest, operating expenses, claw-backs, distribution practices, key man provisions and co-investment rights.

However, it is interesting to note that American institutions have often sought to participate in private equity funds with first quartile historical performance, despite the fact that many of these funds generally have the highest management fees and the highest carried interest.

Surveyed institutions also observed that perspectives on key terms tend to shift with market cycles, particularly with fundraising cycles. At the moment, they attest to a fairly congenial environment in the U.S. When GP–LP relations are less harmonious, American institutions have not been shy about flexing their growing market muscle. For instance, in the 1990s, public sector pension funds and other investors fought for — and won — greater alignment of partnership interests on such priority issues as GP equity stakes, sharing of fee income and preferred returns (or hurdle rates).

Private Equity Opportunities in Canada are not Sufficiently Distinct

In recent years, there has been unprecedented growth in the flow of capital from American private equity funds into Canadian companies. This has occurred mainly as a result of American buyout and venture funds discovering opportunities in Canada, particularly in the telecommunications sector in 2000 and 2001. While the flow has ebbed with the post-bubble decline in private equity activity, it nevertheless raises the question as to whether American institutions might eventually commit more capital to funds in the Canadian industry.

The survey did not find this to be the case, at least among managers representing top American institutions. Generally speaking, they see Canadian private equity in the context of a fairly uniform North American market. In other words, Canadian investment opportunities are not perceived as being significantly distinct from those in the United States. Canada is therefore seen as an extension of the American market rather than as a distinct geographic region with unique opportunities.

In practice, this means that American pension funds, endowments and fund-of-funds are unlikely to pursue diversification in Canada, at least in the same way they might in Europe or Asia. Instead, they will simply directly compare Canadian fund offerings with those available in the United States. Unless Canadian fund managers can articulate a clear competitive advantage, or demonstrate top tier performance, they will probably not be able to attract much American institutional attention.

American Institutional Investors Want Access to Top-Tier Funds

Most American institutional managers believe the American private equity funds in which they already participate can ensure access to premium transactions located in Canada. However, the survey also found that responding American institutions were aware of a few Canadian buyout, mezzanine and venture funds with very experienced GPs and solid track records. They are also open to information about others with similar credentials, particularly in the buyout sector.

Of the 20 American pension, endowment and fund-of-funds managers surveyed, one quarter have committed capital to at least one Canadian fund. An additional dozen have met with one or more Canadian management teams to discuss their fund proposals, though several indicated Canadian fund managers rarely approach them.

In a larger universe of American institutions — and particularly in one that includes small and medium-sized entities — the proportion with at least a single commitment to a Canadian fund would be dramatically lower. Furthermore, American survey respondents were selected in part because of their known link with, or disposition towards, private equity in Canada. Therefore it is likely that the interviews greatly overstate American institutions' knowledge of and interest in the Canadian industry.

Very recently, some Canadian GPs have sparked the interest of American institutions through joint fund-raising with American GPs. In this and related strategies, private equity professionals on both sides of the border are able to tap into a deeper reservoir of institutional money. For this reason, this approach could bear more fruit in the future.

Canadian Law May Have a Deleterious Impact on American Institutional Activity

Because of substantial differences in national tax and legal frameworks, American institutions (and other foreign investors) face barriers — both real and perceived — when actively considering participation in private equity funds based in Canada. Some of these barriers can effectively "disqualify" certain types of American investors from participating in Canadian funds, while others are merely inconvenient, and can be addressed through more complex legal structures.

One example of a serious issue is the lack of recognition of limited liability corporations (LLCs) under the *Canada–United States Income Tax Convention*. In particular, diverse American fund structures often have significant LLC partners, and the lack of treaty relief for these can preclude American exposure to Canadian opportunities.

Another issue that causes some American institutions to avoid Canadian funds is the stricture to file a Canadian tax return, even where no taxes are payable. While this may appear to be just an inconvenience, in fact, it is increasingly common for global funds-of-funds to require that each of their investee funds guarantee there will be no foreign tax filing obligation resulting from a commitment. As these often involve charter requirements, American institutions or their agents may not be able to even consider a Canadian private equity fund in which there are tax consequences.

In addition, there is some uncertainty in the foreign investor community about whether "passive" activity in a Canadian limited partnership involves "carrying on a business," thereby triggering income tax liability in Canada. This issue has been partially addressed by Canadian government policies, but remains somewhat uncertain. Another issue that can increase costs for Canadian funds is the general need to create a separate legal structure for non-resident investors.

Survey respondents in the U.S. were aware of some of these issues and while they did not view tax and other legal hurdles as a primary concern, only a few have in fact had direct experience with a Canadian private equity fund.

By their nature, most of the potential problems arising from these legal issues do not appear in advance, but only with actual experience. When they do appear, unforeseen tax penalties, or the costs of avoiding these, may persuade American institutions to go with less troublesome alternatives in their own country or overseas. There is significant anecdotal evidence of cases where "mere inconveniences," such as delays in their ability to sell shares in a declining market, have cost American investors substantial amounts of money.

What Do American Survey Responses Tell Us?

The interviews confirmed that, after almost two decades of market activity and of "learning by doing," top American institutional investors pursue private equity with even more vigour today. Themes emerging from the survey speak to this finding in the following ways.

- American institutional managers have developed confidence in the ability of the asset class to deliver superior returns over the long term, but patience must be observed.
- American institutions overcame private equity-related barriers by acquiring market expertise and by forging key external relationships.
- Diverse American institutions made a home in private equity through use of specialty advisors and agents, such as gatekeepers, as well as of funds-of-funds and other resources that facilitated their continuous participation.
- GP–LP conflict can ensue over private equity partnership issues, but American institutions have made advances on key terms and conditions.
- American institutions tend to see Canadian private equity funds as an extension of the American market, but they want access to top-tier funds, wherever these may be located.
- Canadian law is not viewed as a major impediment where attractive opportunities exist, but relatively few have tested the regulatory environment by committing to a Canadian private equity fund.

5. Canadian Institutional Investors and Private Equity

This section reports on the Canadian responses to the survey and puts the results into the context of the American perspective documented in Section 4.

As in the U.S., the Canadian institutional path to undertaking private equity was initially cleared by lawmakers. In the 1980s, regulatory frameworks of pension funds were gradually revised by governments — beginning in Ontario, with the *Pension Benefits Act* — to account for the "prudent person" rule.

Until then, the private equity limited partnership model was already in use in Canada, albeit by a small number of fund managers. However, government actions had the effect of stimulating some market exposure among Canadian institutions and, above all, among corporate and public sector pensions.

This early experience was not a happy one. In the mid-1980s, many pensions and insurance companies made major commitments, primarily to Canadian venture funds. Activity peaked in 1987, but plunged thereafter, as the market slowed. At the same time, however, the institutional link to private equity was all but severed, as some GPs and LPs fell into disputes over returns and partnership terms. This situation, compounded by the fact that many institutions entered the market too late to benefit from the prior boom cycle, caused many to quit the asset class altogether (see Falconer, 1999).

This event was damaging for both the nation's institutional community and its private equity industry. Indeed, many battle-scared institutional managers have since been unwilling to reconsider the asset class, irrespective of industry evolution, inside or outside Canadian borders.

In the 1990s, the market role of Canadian institutions was renewed, led by a handful of large public sector pension funds. During this period, the latter emulated Americans by developing private equity programs that were broadly diversified by market focus and by geography, even including international exposure.

Trends over the course of the 1980s and 1990s illuminate the findings of Greenwich Associates in Figure III (Section 3). Because many entered or re-entered the market in the past decade, public sector pensions now lead other institutions in Canada in overall asset exposure. By contrast, many previously active corporate pensions have elected to steer clear of private equity.

FIGURE VII
Canada's Largest Institutional Funds in Private Equity, 2003

Name	Total Assets	Market Focus	Target (%, Assets)
CDP Capital*	$129.6 billion	All private equity	11%
Manulife Financial	$73.9 billion	All private equity	N/A
Ontario Teachers Pension Plan	$68 billion	All private equity	10%
CPP Investment Board	$62 billion	All private equity	10%
British Columbia Investment Management Corporation*	$60 billion	All private equity	5%
Ontario Municipal Employees Retirement System	$34 billion	All private equity	7.5%
Alberta Revenue*	$33 billion	All private equity	4%
Hospitals of Ontario			
Pension Plan	$17 billion	All private equity	N/A
BIMCOR	$12 billion	Venture capital	3%
New Brunswick Investment Management Corporation*	$5.8 billion	All private equity	3%

* Investment managers of multiple pension plans and other fund types.

Figure VII highlights the 10 largest Canadian institutions with active programs in 2003. It is interesting to note that of the top six institutions by size, four have professional management teams in-house and deploy a significant share of their private equity allocation through direct investments in businesses.

This practice appears to be unique to Canadian institutions, as most large American institutions participate in the market chiefly through limited partnerships. The preference of some large Canadian institutions for some direct activity may well have inadvertently slowed the rate at which supporting infrastructure (discussed in Section 3) has evolved in Canada, as market veterans have not yet created the same demand for comparable resources.

5.1 Profile of Survey Responses in Canada

To shed light on the patterns noted above, the survey targeted 94 Canadian institutional investors, 74 of which (79%) agreed to an interview. The final sample is a blend of corporate and public sector pensions, insurance companies, endowments and other investment funds based in all regions of the country. It is important to remember that, as discussed in Section 2.1 (Research Methodology), this sample is biased towards larger institutions and those active or interested in private equity. In addition, interviews were obtained with this country's investment consulting firms and fund-of-funds managers.

Canadian institutional managers were asked about their attitudes and perceptions concerning private equity (see Appendix II). Selected statistical findings of the Canadian survey are summarized in Figure VIII. Here are some of the major findings.

- Sixty-one percent of all institutions surveyed had active private equity programs in 2003.
- The market participation of Canadian institutions has grown very recently, as 31% of those with programs (or 14 institutions in all) launched these in 2000 or 2003.
- Four institutions have plans to launch new programs soon. Among the largest is the $8.5 billion PSP Investment Board, which had announced plans to create 5% asset exposure.
- With some major exceptions, most large public sector pension funds have private equity programs.

FIGURE VIII

Canadian Institutional Investors and Private Equity: 2003 Survey Overview

	Public Sector Pension Funds	Corporate Pension Funds	Life Insurance Companies	Endowments and Others	Total
Institutions Surveyed	43	21	6	4	74
Institutions with Active Private Equity Programs	32	8	3	2	45
Institutions without Active Private Equity Programs	11	13	3	2	29
Institutions Launching Private Equity Programs	2	2			4
Institutions that Recently Considered Private Equity but Declined	9	11	3	2	25

* Investment managers of multiple pension plans and other fund types.

- Over half of corporate pension funds are without active programs and have no plans to establish these in future.
- In 86% of all surveyed institutions without private equity programs, managers, trustees or directors recently considered this option in a formal review of asset allocation policy, but decided against it.

5.2 Themes Emerging from the Canadian Survey

Lower Values in Public Exchanges Make Private Equity More Attractive

In the 1990s, bullish public equity markets attracted institutional investors in droves around the world. During this period, the survey found that Canadian institutional resources available for all alternative assets, including private equity, were apparently squeezed (a contrasting circumstance was evident in the U.S., where private equity allocations continued to skyrocket). Once public stock values began to fall in 2000, Canadian institutions were encouraged to reconsider these asset classes.

In fact, the survey found that the advent of weaker or more volatile public markets has created an opportunity for many Canadian institutions to become familiar with private equity for the first time. Several of the 14 institutional funds that reported having launched a program over the past four years cited this as an important influence in their decision.

Falling public stock values also affected the programs of those already established in private equity. This is apparent in Goldman, Sachs-Russell survey data, which indicate rising asset allocation targets during this period for most institutional categories across North America and particularly in the U.S.

Some Managers Have Limited Knowledge of Private Equity and Little Incentive to Learn

The survey discovered a greater awareness of private equity in Canada's institutional community than has probably existed for some time. According to respondents, this awareness prompted some to recently launch a program. Where this has occurred, internal champions once again proved a key motivating force. As in the U.S., these champions have tended to be experienced individuals in the ranks of fiduciaries who were prepared to carry proposals forward. Among the 45 surveyed institutions with active private equity programs, 78% acknowledged the importance of internal champions in establishing these programs.

Where programs do not exist, there was also anecdotal evidence of more frequent, and more serious, discussions of private equity during regular reviews of investment policies. In such instances, the survey found a stumbling block remains. Many institutional managers still lack motivation to thoroughly investigate the potential benefits of the asset class that might lead them to proposing a change in direction.

Of the 29 institutions that are not currently market participants, 72% signalled there was no significant pressure being applied to managers by trustees, directors or advisors to change course. Instead, these managers were inclined to "hug the benchmark." Given the orientation toward larger funds in the sample, it is reasonable to assume that this inclination is also prevalent across the majority of smaller institutions in Canada.

It is unlikely that Canadian institutions in this situation will be able to move from awareness of private equity to an informed perspective. The American experience confirms this observation, as a great deal of importance was placed on having highly motivated managers taking steps to access market expertise, resources and relationships.

Venture Capital Will Typically be One Part of a Broader Program

Some Canadian institutions surveyed equate private equity with venture capital and, more specifically, Canadian venture capital. This can be an impediment, in and of itself, to introducing a private equity program. While American institutions had the luxury of building a portfolio of private equity fund commitments in their own market, the Canadian market is not sufficiently developed to offer sufficient diversification on its own.

Furthermore, experienced institutional managers argue that the asset class reflects a much broader market than just venture capital and one that it is international in scope. Within the private equity market are different investment options with their own risk and return characteristics. The managers emphasized that private equity, like any other financial activity, must be diversified to realize optimal returns.

In practice, this means a private equity portfolio should be diversified by market focus (buyout, mezzanine and venture capital), by the number of fund commitments (or direct investments), and by geography. In the opening phase of a newly launched private equity program, Canadian institutions may make their first capital commitments to funds based in the U.S., where extensive supporting infrastructure already exists. Once they are more experienced in the market, they can turn to other locales.

Institutional veterans in private equity argued that most programs should be designed along these lines. In fact, by taking a diversified approach, investors increase their ability to participate soundly and prudently in domestic venture capital. Evidence on both sides of the border backs this conclusion. Among American institutions, the California Public Employees Retirement System, the Colorado Public Employees Retirement System and the State of Wisconsin Investment Board each have broad programs that now focus on viable local activity.

Through diversification, which can yield a rich experience in a broad market sphere, these pension funds have developed the capacity to successfully identify and assess opportunities that suit their returns goals, including those that focus on their "local" market. Some Canadian institutions have also taken this approach, including the British Columbia Investment Management Corporation, CDP Capital and the New Brunswick Investment Management Corporation.

It is Too Difficult to Access the Necessary Market Information

Canadian institutional managers were clear that accurate data are crucial to any decision to enter the market and to evaluating opportunities and monitoring activity once there. Above all, there is a need for credible performance data, against which they can benchmark private equity investments against other asset classes.

Of the 74 institutions that participated in survey interviews, 42% believed there was a shortage of relevant, market-specific information in Canada, particularly as it pertained to returns performance. Many institutions, and especially those without active programs, reported having difficulty accessing relevant data. The survey found this was also a problem for investment consultants (see below), who often try to locate performance data to help them advise clients. Perhaps as a result, some Canadian institutional managers and consultants concluded that private equity could probably not be accurately measured.

Unfortunately, a large number were unaware that aggregate returns data for Canada's market do exist. Fully half of institutions surveyed were not aware that the CVCA and Réseau Capital had recently released performance benchmarks for buyout, mezzanine and venture capital funds in Canada, based on several years of national industry performance.

The American experience suggests that market intelligence expands with the availability of advisors, agents and other resources specializing in private equity. All of this intelligence is available to Canadian institutions, although they are likely to seek it out only if they have decided to pursue private equity.

Most Made-In-Canada Returns are Unlikely to be Superior

The survey encountered serious doubt in some institutions about the ability to capture superior, risk-adjusted returns in Canada's private equity market. Of the total polled, 38% reflected this point of view. Some institutional managers felt that many funds in the national industry were too new or too young and, hence, still in the process of developing track records. Some pension fiduciaries referred to bad memories of performance in the 1980s, when funds were even younger.

Canadian institutions with extensive market experience took a different view. Survey respondents in this camp argued that private equity must be seen in an international context and returns sought wherever they are optimal. In other words, institutions interested in the asset class should consider a full menu of options — for instance, participation in the American market where long-term, superior returns are well established — and not just focus on a Canadian context.

For institutional veterans, exposure should ultimately include Canada, where the market has evolved in recent years — and certainly since the 1980s — to produce an array of top-tier fund managers in the buyout, mezzanine and venture sectors.

Some pointed to the CVCA-Réseau Capital returns data as increasingly confirming this outlook. As Canadian industry players are diverse in nature, the data show wide dispersion of returns to date. However, the upper quartile, which largely represents the performance of institutionally supplied funds, is competitive across the full spectrum of private equity as compared with the upper quartile of American funds (see Thomson Venture Economics).

For a detailed description of the research methodology behind the CVCA–Réseau Capital database, along with returns data for the period ending December 31, 2002, see Appendix V.

Some Investment Consultants May be Unprepared to Advise on Private Equity

Many institutional managers and trustees in Canada depend on a small group of independent consulting firms for advice on investment decisions. In fact, 23% of the 74 institutions surveyed indicated their reliance on external advisory services of some kind. For this reason, consultant views, and their knowledge of private equity, are vital.

Canadian consulting professionals noted that very few of their clients are currently active in private equity or have plans to do so. When policy reviews take place, they have tried to provide data that speak to the viability of the asset class as an alternative to public market securities. However, some noted that they are unlikely to recommend such investment where clients have not already expressed a strong interest.

For this reason, several consultants believe that change must first occur inside Canadian institutions. Respondents in some institutions suggested that they have received negative advice on private equity from some consultants.

Some consultants were frank about lacking the in-house expertise and resources to guide institutions on this topic. Several were also sceptical about American and Canadian sources of performance data. Consequently, client discussions tend to focus on barriers to market entry, as opposed to strategies for overcoming them. Interestingly, multinational consulting firms, which generally advocate this asset class in the U.S., often advise against it with their Canadian clients, although it is unclear why this should be so, given their status as professional experts in pension investment.

The Myners report (2001) looked at the British client–advisor relationship, noting a certain "inertia" that can obstruct informed decisions about investments, including private equity. Myners recommended that fiduciaries interested in the market should only seek direction that is clearly grounded in specialist knowledge.

The Smaller the Institution, the Less Likely It Will Embrace Private Equity

As Figure III in Section 2 revealed, Canadian institutional activity in private equity drops precipitously below $5 billon in total assets. This points to the issue of "relative capacity," as many small and medium-sized institutions generally do not have adequate personnel to handle a program that demands time, resources and skills.

Canadian survey sample data shed light on this circumstance. On average, institutions of $5 billion-plus had 50 investment managers, while those with less than $5 billion on average had five investment professionals. Moreover, as was noted in Section 2.1 (Research Methodology), institutional fund size even had a bearing on the survey's response rate, as smaller entities were less likely to agree to participate in interviews.

Participating institutional managers gave some priority to this issue. For instance, at least one-fifth of all respondents felt challenged in undertaking private equity due to limited in-house resources. In addition, 34% of key informants that reported having recently considered private equity, but declined, cited "size" of their organization as a primary concern.

Problems of "relative capacity" are likely to be particularly relevant to endowments and foundations, which typically have a relatively small asset base, and to smaller institutions headquartered in Canadian regions. Even some larger institutions encounter this dilemma, such as corporate pension funds that outsource a substantial portion of investment management.

By contrast, many American institutions that have less than $5 billon in assets also have private equity exposure, which suggests the importance of market infrastructure. As discussed in American survey responses (Section 4), commingled funds-of-funds (see below) and other kinds of external support (such as U.S.-style gatekeepers) can offer a cost-effective solution to smaller institutions.

Canadian institutions interested in private equity can currently access American infrastructure by investing in an American-based fund-of-funds, although for the most part, they do not. As more resources are developed in Canada to support those wishing to participate in the market, they may also be able to turn to these funds-of-funds.

Funds-Of-Funds Can Facilitate Market Entry, but May Have Some Downsides

In 2002, the first fund-of-funds vehicles were launched in Canada. TD Capital Private Equity Investors was created primarily to give mid-sized Canadian institutions an opportunity to pool their capital and together gain access to top-tier private equity funds in North America and Europe. Two other funds-of-funds — Edgestone Venture Capital Fund of Funds and Kensington Fund of Funds — were subsequently established, both of which are closer to the captive variety.

The lower rate of Canadian institutional activity in private equity in past years no doubt limited the interest of U.S.-based funds-of-funds in marketing in this country, and probably delayed the introduction of comparable Canadian-based vehicles. The decision of several of the larger institutions to hire their own private equity professionals and invest directly also probably extended this delay by eliminating some of the larger investors that might contribute to critical mass.

Regardless, the introduction of the fund-of-funds model to Canadian private equity is significant. A key piece of developing Canadian infrastructure, the fund-of-funds addresses market inefficiencies, both as a pooling vehicle and as a way of taking management-intensive duties out of the investor's hands. As the American experience has demonstrated, this tool is appealing to diverse institutions, particularly those that are small, regionally based, and with low-cost operations.

Fund-of-funds vehicles also attract new market entrants effectively. This may give them special significance in Canada. The majority of survey responses agreed that funds-of-funds can effectively facilitate private equity activity. This being said, one-third did not know about the first-time inception of made-in-Canada funds-of-funds last year. Three of the four institutions that disclosed plans to soon launch private equity programs indicated they might use funds-of-funds in Canada or the U.S.

On the other hand, some institutional managers argued that there were potential downsides to funds-of-funds, such as excessive fees, staffing and overhead, which might offset whatever value they may offer.

GP And LP Interests Are Frequently Misaligned.

Like their American counterparts, Canadian institutional managers flagged the potential for misalignment between GP and LP interests in private equity funds. Sometimes, this has resulted in conflict and protracted negotiations as funds are established, as well as during their administration and wind-up.

The survey found Canadians raising the same issues as Americans (see Section 3 for examples), with a particular focus on management fees. However, as previously noted, the funds providing the best returns in the U.S. tend to have the highest fees and carried interest, so partnership terms will not always be an overriding variable.

Of the 74 institutions that participated in survey interviews, 27% identified disputes between GPs and LPs as a major challenge to private equity activity. Most feedback came from institutions currently in the market or those with past experience. The latter group spoke of severe disputes in the late 1980s, when pension manager relationships with Canadian GPs deteriorated swiftly over a range of partnership concerns. This experience contributed to the "long memory" of many fiduciaries when it came to reconsidering this asset class later on.

By all accounts, the American (and Canadian) institutional demands of GPs in the past decade have resulted in more transparent, and better aligned, partnerships practices across North America. In fact, many of today's standard partnership terms and conditions — often viewed as "best practices" in private equity circles —were originally put forward by institutions.

Industry Valuation Practices are Seen as Being Inconsistent

Some Canadian institutions were frustrated by a perceived inconsistency in how private equity funds value their unrealized portfolio assets. They argued that valuation practices varied widely from fund to fund and that, in some cases, practices lack clarity and transparency. As valuations are linked to interim performance outcomes, this is a major concern. Interestingly, while valuations are the subject of on-going discussion in the U.S., institutions have not forced the industry to adopt valuation guidelines. The focus has been, and continues to be, on cash-on-cash returns.

The CVCA and Réseau Capital recently acknowledged the importance of establishing clear industry standards in Canada, within the context of more consistent and precise global standards. To this end, they are currently working with relevant groups, including the International Limited Partner Association. In the interim, the CVCA and Réseau Capital are urging their members to adopt valuation guidelines published by the European Venture Capital Association, allowing for some adjustments relevant to industry practices specific to this country.

Near-Term Liabilities Restrict the Investment Freedom of Corporate Pensions

Data provided by both Greenwich and by Goldman, Sachs-Russell (see Figures III and IV, Section 3) attest to the leading position assumed by American corporate pension funds in private equity. Indeed, the actual and targeted asset allocations of American corporate pensions to the market have long surpassed those of American public sector pensions.

The situation is very different in Canada, where corporate pension funds are much less active. The survey confirmed this, as 40% of the corporate pension managers invited to participate in an interview declined, primarily due to a lack of interest in private equity. Of those that did agree to an interview, over half were without programs.

According to survey respondents in corporate funds, private equity's illiquid nature presents a hurdle. Some of these funds are quite mature and have many more retired plan beneficiaries than active plan members. A good example is seen in one of this country's largest plans, CN Railways Pension, which currently has 45,000 beneficiaries and 20,000 active members in Canada.

Consequently, liquidity is a concern, as these funds must meet very substantial liabilities in the near term. However, given that many corporate pension funds in the U.S. face the same challenge, but solidly embrace private equity nonetheless, liquidity cannot be the sole determining factor for those based in Canada.

Another factor is the impact of a negative market experience in the 1980s. The survey discovered that this experience continues to shape perceptions of private equity among Canadian corporate pension managers.

It is likely that these two variables, when further complicated by those applicable to all Canadian institutions, explain much of the reluctance expressed by corporate funds.

Government Regulations Pose Some Limitations

Most survey responses did not give top priority to tax or government regulations in decisions concerning the market participation of institutions. However, problems related to the tax treatment of private equity partnerships as foreign content were cited most frequently. Under the current rules, Canadian institutions are effectively discouraged from investing in Canadian private equity fund partnerships as they are treated as foreign property for tax purposes. This result flows from the standard commercial terms applicable to a fund that typically does not meet the technical requirements of "Qualified Limited Partnerships" (QLPs).

Three-quarters of institutions surveyed were generally aware and supportive of promises made by federal authorities to address some of these problems through amendments to the QLP rules. Most commentary on foreign property, QLPs and other tax issues came from pension funds with deep roots in the market, suggesting that other respondents might have brought them up if they had programs or more extensive experience.

Life insurers raised regulatory issues as a major concern. Capital adequacy rules from the Office of the Superintendent of Financial Institutions (OSFI) specify capital set-asides that are far greater for private equity relative to private debt. The effect of OSFI rules is to inhibit market entry or continuous exposure to private equity. This situation also explains in part why insurance companies with active private equity programs tend to prefer mezzanine investments. Life insurance managers also mentioned forthcoming international standards (Basle 2) that they believe may impose further reserve requirements on their activity in the asset class.

What Do Canadian Survey Responses Tell Us?

The interviews confirmed that while more Canadian institutions may be expressing an interest in private equity, very substantial challenges remain to achieving participation at American levels. Themes emerging from the survey speak to this finding in the following ways.

- Declining public market values and a somewhat greater awareness of private equity has encouraged some Canadian institutions to consider, or reconsider, participation in the private equity market.
- However, many institutional managers in Canada still have a low level of awareness of and knowledge about private equity, in large part because they do not feel any particular motivation to investigate its potential benefits.
- Many Canadian institutions see private equity activity in a strictly "Canadian" context and, in so doing, may neglect the advantages of broader diversification, including American exposure.
- Many institutions and their advisors see the lack of data as being relevant to decisions concerning private equity. Relevant to this point is the fact that many respondents were unaware of returns performance data in both Canada and the U.S.
- Some external consultants may not possess adequate knowledge, information or other in-house resources with which to effectively advise fiduciary clients on private equity activity.
- Small and medium-sized institutions in Canada (as well as some large institutions) do not have the "relative capacity" to undertake private equity programs and consequently require new forms of external support if this is to occur.
- Made-in-Canada funds-of-funds and other examples of emerging infrastructure in Canada offer key sources of market leverage to institutions of different types, sizes and location across the country. Institutions can already avail themselves of the highly advanced infrastructure in the U.S.
- To attract more institutional investment, the Canadian private equity industry must observe best practices with regard to limited partnership agreements and valuation policies.
- Government regulations are not seen as onerous burden on institutional activity in private equity, but the regulations should be improved to make it easier to enter the market, both in Canada and outside of it.
- The private equity exposure of insurance companies appears to be restricted by the capital adequacy rules imposed by government regulation.

6. *Finding the Key:* Conclusions and Recommendations

As stated at the outset of this report, the objective of *Finding the Key: Canadian Institutional Investors and Private Equity* is to stimulate a national debate about the role of institutional investors in venture capital and other types of private equity.

Section 5 of this report attempts to draw together the findings contained in sections 3, 4 and 5. To inform forthcoming discussions, this section also presents a series of recommendations organized around the main themes emerging from the surveys and supporting data and analysis.

What Does the Research Tell Us?

Various data comparing American and Canadian institutional activity in private equity (Section 3) indicate that American pension funds, endowments and other institutions have embraced the asset class to a far greater degree than have their Canadian counterparts. At present, private equity exposure in the U.S. includes all major institutional types and fund sizes. By contrast, in Canada, only public sector pensions, and funds with assets of $5 billion or more, are similarly engaged in the private equity market.

Consequently, while American institutions have assumed a highly influential role in private equity, both domestically and globally, Canadian institutions occupy a much more moderate position, irrespective of the locale. Interviews with senior managers of American pensions, endowments and funds-of-funds (Section 4) shed light on the reasons why this gap exists.

After more than 20 years of sustained activity, American institutions have developed confidence in the ability of private equity investments to deliver superior returns and diversification benefits over the long term. This occurred through a process of "learning by doing," whereby structural barriers were gradually overcome.

In addition, diverse American institutions have developed infrastructure that enables them to participate in the market, as shown in the range of specialty advisors and agents (such as gatekeepers) and other customized resources that have emerged in recent years. In particular, funds-of-funds have proven useful, especially to smaller investors, given their ability to pool assets, house expertise and select top-tier funds.

In other words, despite the impediments they encountered along the way, American institutional managers found the means to persevere in private equity and obtain the returns they originally sought. The American experience appears to indicate that success lies in finding the right key.

The situation in Canada has evolved differently. Survey respondents in Canada (Section 5) suggested that while there has been some growth in awareness of private equity in the institutional community in recent years — which has, in some cases, prompted market entry — many institutions remain on the sidelines due to real and perceived challenges.

It is clear that some of the attitudes and perceptions expressed by many corporate and public sector pension managers flow directly from a negative experience in the Canadian industry of the 1980s. Regardless, the private equity challenges raised in Canadian interviews as a whole are, by and large, the same as those discussed by American survey respondents in the early days of developing their private equity programs.

Canadian institutional concerns are linked to private market inefficiencies, such as high entry costs, limited availability of information and conflicts engendered by certain opaque industry practices.

Some Canadian institutions, most of which are very large, have overcome these barriers. As in American institutions, Canadian institutions have done this by "learning by doing," by using American-style infrastructure and, in some cases, by setting up in-house programs to invest directly.

However, it seems that many other Canadian institutions (of all types and sizes) view the private equity market within the confines of Canadian borders and have not availed themselves of American opportunities, such as access to supporting infrastructure, that would introduce this asset class into their portfolios.

Changing the Status Quo

This report's introduction noted that the research behind *Finding the Key* builds on a body of international literature concerning the role of institutions in private equity, including prior reports issued in Canada (e.g., Macdonald, 1987, Falconer, 1999). Like past reports, *Finding the Key* discovered in Canadian survey responses a range of concerns about the asset class, its market context and the practical ability of institutions to establish related programs.

Indeed, a great many of the issues raised by Canadian institutional managers in the 2003 survey are identical to those raised previously, as in the 1998 PIAC survey which served as the basis for the Falconer report of 1999. This suggests that, for a good number of institutions in Canada, the challenges associated with undertaking private equity have remained largely unchanged with the passage of time or events.

Why is this the case? One compelling explanation is, as noted above, the long shadow cast by an unhappy market experience in the 1980s, as many current institutional managers in Canada are veterans of that period.

Apparently, the major growth and development since then in the Canadian private equity industry (and even more so in the American industry) cannot set aside institutional memories of that history. This may not be surprising if, as the survey also found, a substantial number of Canadian institutional managers also feel no particular pressure to investigate (or re-investigate) the potential benefits of asset exposure.

A second explanation probably exists in the sheer volume of issues that confront a given Canadian institution when it elects to participate in private equity activity. High levels of American institutional participation did not, of course, take place overnight or as a result of a single initiative. Rather, in "learning by doing," American institutions found a home in private equity through a variety of strategic solutions. For many, this was finally achieved after several years of developing "institution-friendly" infrastructure and resources.

The efforts of American institutions ultimately had a transforming impact on the private equity industry itself. Finding an inefficient marketplace, American institutions and their agents sought to compensate for inefficiencies, always with the motive of obtaining superior returns, diversification and so on. As more institutions embraced the asset class, the American industry adapted to receive them. This process helped to clear a path for even more institutional participation.

A similar process must take place in Canada if private-independent funds — based on the institutionally supplied limited partnership model — are to prosper. However, more Canadian institutions are unlikely to embrace the asset class unless they are confident about the returns promised by a mature industry of GPs with strong track records. To create this confidence, GPs must be able to access capital supply while simultaneously drawing on a reliable base of Canadian entrepreneurial and business management talent that merits the backing of buyout, mezzanine and venture financing.

In other words, the national ecosystem for private equity investment in an array of increasingly competitive, high growth companies in Canada's technology and traditional sectors must continue to grow and evolve.

This ecosystem reflects a wide array of component pieces, including government support for basic research and commercialization, private sector expenditure on R&D, a highly skilled and productive workforce, the availability of high quality graduates in science and engineering, Canadian business sectors that focus on competing in a global economy, a more vibrant angel market, and an increasingly diversified and specialized industry of venture capital and other private equity funds.

Only by making progress in all of these areas can specific efforts to facilitate a greater degree of Canadian institutional activity in private equity be fully justified and rewarded. Only in so doing, can there be movement beyond the status quo.

American and Canadian survey responses indicated that an important first step in moving beyond the status quo was increased communication and education — not just among institutional managers, but among trustees, directors and advisors as well — based on active pursuit of the right market expertise, resources and relationships. Ideally, this should include more interaction between Canada's institutional and private equity communities, to correct misinformed impressions and to collaborate to meet shared objectives.

To ensure the broadest possible private equity activity of institutions, irrespective of size, type or regional location, Canadian institutions should also learn from the American experience about the value of market infrastructure: advisors, intermediaries, resources and pooling vehicles, such as funds-of-funds.

Where possible, government tax and other regulatory policies must also be amended or clarified to ensure that Canadian law does not impose unnecessary costs and restrictions on private equity activity.

Finally, experience in both Canada and the U.S. has demonstrated that successful private equity programs must be widely diversified to secure optimal returns. This means diversification by market focus (buyout, mezzanine and venture capital), by number of portfolio investments and by geography.

By following this model, institutions can develop the capacity to participate successfully in the private equity market situated anywhere in the world. The evidence suggests that this preparedness to invest in quality funds regardless of location will, in time, lead to a deeper and more dynamic fund environment in all regions of the country.

An Agenda for Canadian Multi-Stakeholder Discussions

It is recognized that, to an extent, the research contributing to *Finding the Key* has raised as many questions as it has answered regarding institutional activity in venture capital and other types of private equity. This should not be surprising given the immense size of the topic, as well as its importance to multiple stakeholder groups in Canada.

This fact also points to the validity of a national debate involving senior representatives of Canada's institutional community, the private equity industry, government and other interested parties, in amplifying on report findings, deepening awareness and understanding of related issues, and considering alternative strategies for action.

To help shape an agenda for discussing the subject of institutional investors and private equity, the following are recommendations linked to the primary survey and other research themes.

Communication and Education

1) The CVCA and Réseau Capital should form a closer relationship with PIAC and other industry associations linked to Canada's institutional community to facilitate both increased dialogue and education. The initial goal of this relationship should be to foster an on-going dialogue between institutional and private equity fund managers with a view to further defining and addressing some of the issues raised in this report.

   This initiative may include a series of jointly hosted seminars that would involve a cross-section of institutional managers, trustees/directors, investment consultants, private equity professionals and other relevant advisors in major centres across Canada. Seminars would aim to share data about the nature of the successful private equity programs of Canadian and American institutions, as well as a range of strategies (as discussed in *Finding the Key*) used for overcoming barriers to market entry and long-term participation.

   It is believed that this process could play an important role in raising awareness within the Canadian institutional community about private equity and in determining what steps need to be taken to ensure that community members can successfully and permanently introduce this asset class into their portfolios.

2) The CVCA and Réseau Capital should initiate a variety of formal and informal interactions with senior representatives of American institutions, fund-of-funds, gatekeepers and other interested parties concerning the Canadian private equity industry.

   Such initiatives would have a two-part focus. One objective would be to broaden the understanding and appreciation of American institutional investors, as well as their agents and advisors, for attractive investment opportunities in Canada. A second objective would be to help educate Canadian private equity professionals about the criteria and procedures used by American institutions when assessing and evaluating Canadian GPs and their fund proposals.

Finally, the CVCA and Réseau Capital should work with officials in relevant federal and provincial government departments and agencies to consider strategic alternatives for further communicating with American institutions about the distinctive strengths of the Canadian private equity industry and its domestic sources of quality investment opportunities. Industry association and government representatives should next discuss how an appropriately crafted message should be delivered.

Government Taxation and Regulation

The CVCA, Réseau Capital and the federal Department of Finance should continue their efforts to achieve tax and regulatory reform on behalf of Canadian entrepreneurs, private equity funds and institutional investors.

These efforts should focus both on issues pertaining to Canadian institutional participation in Canadian limited partnerships (such as foreign content rules and QLPs) and issues pertaining to American and other non-resident institutional participation in these, as well as related concerns. OSFI should also be involved in the dialogue to ensure that current regulations, or forthcoming ones (such as Basle II), do not unnecessarily impede insurance companies from participating in the private equity market.

By engaging in an open and thoughtful national dialogue in all of these respects, it is believed that means can be found to grow Canadian institutional activity in private equity in a way that secures the mutual benefits of superior portfolio returns, a stronger domestic industry, and a more competitive and productive economy.

Appendix I:
Canadian and American Contributors to this Report

Canada

Alberta Revenue ***
Alberta Teachers Retirement Fund Board
Alcan Pension Plan
Bank of Montreal Pension Plan
BDC Venture Capital Group
BIMCOR
British Columbia Investment Management Corporation ***
Canadian National Railways Pension Plan
City of Winnipeg Pension Plan
Colleges of Arts and Applied Technology Pension Plan
Canada Life Assurance Company
Canada Post Pension Plan
Canadian Venture Capital Association
CBC Pension Plan
CDP Capital ***
CPP Investment Board
DaimlerChrysler Canada Pension Plan
Domtar Pension Plan
EdgeStone Capital Fund-of-Funds
Fonds Eterna
Frank Russell Canada
General Motors of Canada Pension Plan
Gestion Aequilibrium
Greystone Managed Investments
Hospital Employees Pension Plan of Manitoba
Hydro One Pension Plan
Hydro-Quebec Pension Plan
Imperial Oil Pension Plan
Industrial Alliance Insurance and Financial Services
IWA Forest Industry Pension Plan
Jefferson Partners
La Capital Life Insurance
Lucie and Andre Chagnon Foundation
Manitoba Civil Service Superannuation Board
Maritime Life Assurance Company
McLean Watson Capital
Mercer Investment Consulting
Montreal Transit Pension Plan
Montreal Urban Community Police Pension Association
New Brunswick Investment Management Corporation ***
Nortel Networks Pension Plan
Nova Scotia Hospitals Pension Plan
Nova Scotia Public Service Pension Plan
Ontario Pension Board
Ontario Teachers Pension Plan
Ontario Municipal Employees Retirement System
Pension Investment Association of Canada
Petro-Canada Pension Plan
Province of Newfoundland Pension Plan
PSP Investment Board
Regimes de rentes du Mouvement Desjardin
Réseau de capital de risqué du Canada
Shell Canada Pension Plan
SSQ Financial Group
Stelco Pension Plan
Sun Life Assurance Company
TD Capital Private Equity Investors
Telus Corporation Pension Plan
Toronto Transit Commission Pension Plan
Towers Perrin
University of British Columbia Faculty Pension Plan
University of Laval Pension Plan
University of Montreal Pension Plan
University of Quebec Pension Plan
University of Toronto Asset Management Corporation ***
Ventures West Management

*** *Indicates money manager of multiple pension plans and other funds.*

United States

Abbott Capital Management LLC

BellSouth Pension

California Public Employees Retirement System

California State Teachers Retirement System

Cambridge Associates LLC

Colorado Public Employees Retirement System

Credit Suisse First Boston

Flag Venture Partners

Florida State Board of Administration

Grove Street Advisors

Harbourvest Partners LLC

Harvard Endowment Fund

MIT Endowment Fund

Massachusetts Pension Reserves Investment Management

Oregon Public Employees Retirement Fund

Pennsylvania State Employees Retirement System

RBC Capital Partners (U.S.)

State of Wisconsin Investment Board

Teacher Retirement System of Texas

Verizon Investment Management Corporation

Appendix II:
Summary of Survey Qestions

Survey of Canadian Institutional Investors and Private Equity, 2003

Summary of Interview Topics

The following is a brief synopsis of questions posed in interviews with senior officials at corporate and public sector pensions, life insurance companies, endowments/ foundations and other institutions. Officials were sent this synopsis in advance of interviews.

Is your institutional fund currently active in the venture capital/private equity market?

If YES:

What is the nature of your venture capital/private equity program (e.g., founding year, percentage of total assets, target, managed internally or externally, market focus, benchmarks, etc.)? How might your program change over time? *

What factors persuaded trustees/managers to create exposure to this asset class? What are the benefits to your fund?

What barriers were encountered and how were these eventually overcome? What challenges continue to exist?

How often does your institutional fund make new fund commitments (e.g., annually) or invest directly?

In your view, why are other Canadian institutions reluctant to create exposure to venture capital/private equity? ** What potential market or public policy initiatives are required to help change this situation? ***

If NO:

Has your institutional fund ever had exposure to venture capital/private equity as an asset class? If so, what was the nature of that experience and what factors persuaded trustees/managers to discontinue?

Have there been recent internal discussions (e.g., meetings of Board of Trustees/Directors) about launching a venture capital/private equity program. If so, what were the results? If not, why?

Has the asset class ever been researched internally or in consultation with external advisors on investment decisions? In general, what has been advisor feedback, re: costs and benefits?

In the view of trustees/managers, what are the barriers to launching a venture capital/private equity program in the future? **

How might barriers be overcome? Are there potential market or public policy initiatives that could facilitate your institutional fund's becoming active? ***

* Institutions were requested to provide basic data concerning assets under management, founding year, number of employees, details of private equity/alternative asset programs, etc.

** The opinions and experiences of trustees/directors/ managers were most important here, however, as a discussion tool, interviewers also made available a list of previously identified barriers derived from research literature and requested specific feedback.

*** For discussion purposes, interviewing researchers raised examples of recent initiatives.

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Appendix IV: Institutions and Private Equity, International Data

Section 3 made Canada–U.S. comparisons vis-à-vis institutional activity in private equity. Comparative analysis was based on data assembled from a variety of surveys conducted on a regular basis in North America.

Data used in Section 3 were selected according to their relative compatibility. Greenwich Associates' data rely on a unified survey methodology for comparing the actual private equity allocations of both Canadian and American institutions. Goldman, Sachs-Russell data rely on a similarly unified North American survey methodology when comparing allocation targets (and other data measures) since 1995.

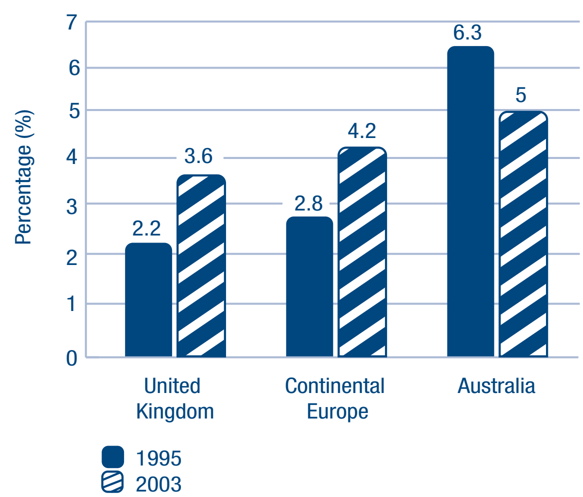
Data are also compatible in Canada–U.S. comparisons of new, annual commitments that institutions have made to private equity funds since 1996. Methodologies deployed by Macdonald & Associates and Thomson Venture Economics are comparable and differences accounted for where these exist. In Figure VI, venture capital was chosen as a proxy for all private equity activity, given the particular richness of such information.

For the purposes of *Finding the Key*, data were also collected from other jurisdictions, including the United Kingdom, Europe and Australia. Because of major national differences in retirement systems, types of institutions and the orientation of private equity industries — as well as methodologies for describing these components — data sets in one jurisdiction are not necessarily compatible with data sets in another. This fact makes comparing data from outside of North America daunting. Indeed, such international comparisons can be highly misleading.

Along with the problem of national differences in key data sets, some private equity market structures lack transparency. In addition, market data provided by non-North American sources can be difficult to ascertain. As verification of data content and quality is critical to making comparisons of any kind, it was decided to exclude non-North American data from analyses contained in Section 3.

However, this appendix presents some of the other data collected for the report. Figure A highlights recent annual trends in new commitments to venture capital and other types of private equity made by institutions in the United Kingdom and Europe. Figure B shows recent private equity allocation targets of institutions in the UK, continental Europe and Australia.

FIGURE A
Institutional Fund Allocations (Targeted) to Private Equity
U.K., Continental Europe and Australia, 1999 and 2003*

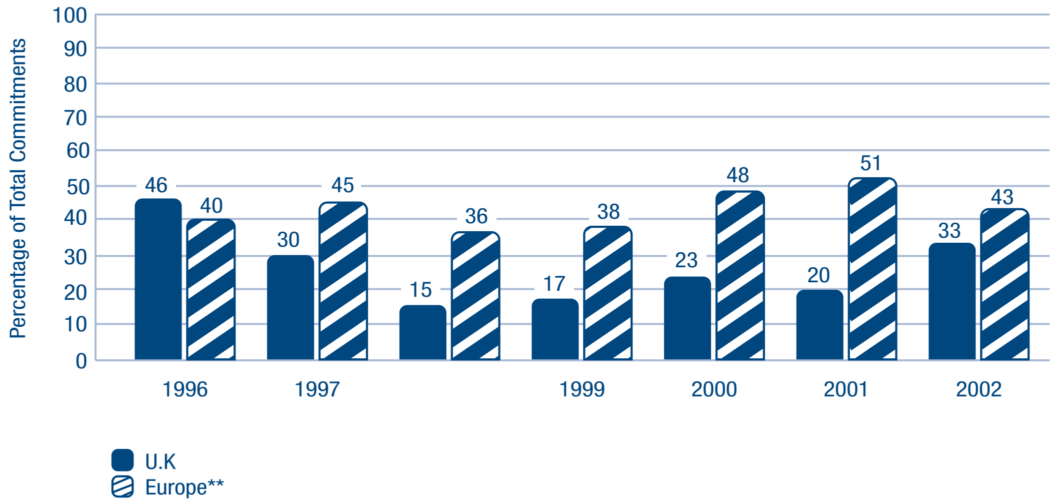


* The 2003 Goldman, Sachs-Russell survey does not breakdown the allocations data for the U.K., Continental Europe and Australia by institutional type.

Figure B

New Institutional Commitments to Venture Capital and Buy -out LPs*

Europe and the United Kingdom, 1996–2002



* Includes available data for corporate and public sector pension funds, endowments/foundations, insurance companies and funds-of-funds.
** Europe data includes the U.K. data.

Source: Macdonald & Associates, Ltd. Thomson Venture Economics, 2003

Appendix V:
Canadian Private Equity Performance, Methodological Notes

In the past, Canadian institutional managers have argued that the absence of returns performance data was a serious impediment to investing in Canadian private equity funds. Such data have been available in the U.S. for almost fifteen years, and in Europe for at least five years. It was not until 2000 that Canadian private equity fund managers were first asked to pool their data for the purposes of calculating aggregate performance statistics in this country.

For the past three years, the CVCA and Réseau Capital have worked with Macdonald & Associates and Thomson Venture Economics to develop reliable performance benchmarking data for Canadian private equity. As such data are based on the confidential cash flow information of individual funds, there was significant preparatory work required to convince Canadian GPs to participate in a survey and thereby develop an adequate sample.

The first Canadian performance database was released in March 2003, covering the period 2000 to December 31st, 2001. Further data up to the end of December 2002 were also released in October 2003. The results are summarized in the table below.

Some key points should be noted with respect to performance methodology:

- The sample includes the full market spectrum of private equity: buyout, mezzanine and venture capital.
- The sample size limits market segmentation.

  The most recent results were taken from a sample of 118 funds, 94 of which were venture-oriented. The sample was large enough to segment returns for early stage and balanced venture funds, but not sufficient to calculate vintage year returns (which would group the funds

Investment Returns for Private Equity Funds

Periods ended December 31, 2002

	IRR% P.A.						
	Periods in Years						
Investment Category	One	Three	Five	Eight	Upper Quartile*	Median*	Lower Quartile*
Early Stage Venture Capital	-25.1	-5.8	2.3	4.3	9.9	-0.2	-15.7
Balanced Venture Capital	-26.5	-11.6	-5.4	4.0	13.1	0.8	-5.8
All Venture Capital	-25.0	-9.6	-3.1	6.1	12.9	0.9	-10.1
Buyout & Mezzanine	7.0	8.5	11.6	19.3	22.5	17.1	0.0
All Venture Capital and Private Equity	-21.3	-7.5	-1.3	9.5	16.5	2.4	-6.7

* Relates to 8 year data

Performance of major public market indices during the above periods is indicated below.

Periods ended December 31, 2002

	Periods in Years			
	One	Three	Five	Eight
TSE 300 (Total Return)	-12.4%	-6.3%	1.3%	7.7%
S&P 500 (U.S. $)	-22.1%	-14.6%	-0.6%	10.3%
Nasdaq Composite (U.S. $)	-31.5%	-31.0%	-3.2%	7.4%

Source: Canadian Venture Capital and Private Equity Association and Macdonald & Associates Limited according to the years in which they were formed). With only eight mezzanine funds in the sample, the mezzanine and buyout fund returns were blended.

It is important to note that not all private equity GPs in Canada choose to participate in the survey.

- Results are not directly comparable with those produced for the U.S. and Europe.

  The majority of private equity funds in the U.S. and Europe are structured as limited partnerships with a fixed life and terms regarding management fees and the carried interest payable to the GPs. As a result, performance benchmarks can be calculated on a "net-returns" basis (i.e., realized and unrealized returns to investors net of management fees and carried interest).

  In Canada, only about 25% of the estimated $50 billion of capital under management is in these traditional partnership vehicles, with the rest managed by corporations, governments, institutions (i.e., internal programs for direct investment) and labour-sponsored venture capital corporations.

  Because management expenses and fees, costs of capital and profit sharing vary widely across these different fund types, it is difficult to calculate meaningful returns on a net basis across the industry.

  The returns for Canadian funds have therefore been calculated on a gross basis, meaning that they are based on the cash flows from the funds to portfolio companies and from the portfolio companies to the funds when there is a liquidity event. As such, they are not directly comparable to the American or European numbers at the present time.

- There is a lack of standard valuation guidelines.

  The issue of valuation guidelines has been hotly debated in the U.S., Europe and Canada in recent years and has been the subject of the attention of the International Limited Partners Association. The European industry has now adopted standard valuation guidelines through the European Venture Capital Association (EVCA).

  The CVCA and Réseau Capital have developed draft guidelines closely modelled on the EVCA guidelines and these have been distributed to members of the industry for their comments. These industry associations expect to be in a position to adopt a set of valuation guidelines by 2004. The American industry has not yet developed or adopted comparable guidelines.

  In Canada, all funds submitting data for the returns survey will be asked to confirm (with the signature of a senior manager) that they have complied with these guidelines in preparing their year-end valuations.

Comparable investment data for U.S. private equity funds can be found at the Web site of Thomson Venture Economics: **www.ventureeconomics.com**.

Appendix VI:
List of Advisory Board Members

ADVISORY BOARD

NAME	COMPANY
Mark Belfry	Prince Edward Island Business Development
John Eckert	McLean Watson Capital Inc.
Brian Elder	Business Development Bank of Canada
Marc Leduc	Quebec Ministry of Economic and Regional Development
Robin Louis	Ventures West Management Inc.
Mary Macdonald	Macdonald & Associates Limited
Claude Miron	InVivo Ventures
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John Sinclair	New Brunswick Investment Management Corp.
Christine Soucy	Industry Canada
Annie Thabet	Celtis Capital
Peter Webber	Industry Canada
Doug Welwood	Ontario Ministry of Economic Development and Trade
Rosemary Zigrossi	Ontario Teachers' Pension Plan Board

PROJECT TEAM

NAME	COMPANY
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Kirk Falconer	Macdonald & Associates Limited
Kathy Jeramaz-Larson	Macdonald & Associates Limited
Mark Nelson	Ontario Ministry of Economic Development and Trade
Beverley Morden	Research Consultant
Lucien Biron	PriceWaterhouseCoopers