

The New Private Capital
or, why 'long term private capital investment'
is no longer an oxymoron

A speech by

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Thank you, _____, and good morning, everyone. As ___ noted, I accepted this speaking invitation when I was head of Teachers' Private Capital, before my appointment as CEO of Teachers'. I'm going to slip back into those private capital shoes for my remarks today, but just before I do that, I want to take a second to say that Teachers' agrees with the FEI's position that the Pension Benefits Act is in need of updating. We also made a presentation to the Arthurs Expert Commission on Pensions in the fall and we titled our submission "It's time to Retire the Current Pension System." I won't go into the details of our presentation, but I wanted to note that we agree with you that pension plan sponsors should have the right to own surpluses to the same extent that they own plan deficits, unless there is a contract to the contrary. Our opinion is based on our position as investors in companies with defined benefit pension plans. We said that the unknown liability risk associated with the funding of such plans reduces the potential upside of investing in such companies.

But I'm not here to talk about the Arthurs commission. I'm here to talk about private capital.

So, what do the Sydney international airport, New Zealand Yellow Pages, Serta mattresses, the Toronto Maple Leafs, Kabel Deutschland, Easton hockey sticks, the Staten Island marine container port, and a Chilean water treatment company all have in common?

The 271,000 active and retired teachers of Ontario, that's what . . . Because they're all part of the Ontario Teachers' Pension Plan private investment portfolio.

I'm here to talk to you today about "The New Private Capital" that characterizes this portfolio. What's so 'new'?, you might ask. The short answer is pension plans. The glib answer is the subtitle of this speech: 'long term private capital investment is no longer an oxymoron'. The real answer is time and cost, which I will spend the rest of my remarks addressing.

Pension funds have been well recognized institutional investors for many years, but for the most part, they have given their money to third parties to manage. It was the vision of Claude Lamoureux, our recently retired CEO, and Bob Bertram, our Chief Investment Officer, that the investment function could be managed as well, or better, in-house. It was a vision they will modestly tell you was born of necessity. Well, born of necessity or not, it changed the way pension plans the world over now invest their funds.

Let me take you back to 1991, when Claude and Bob inherited the newly minted Ontario Teachers' Pension Plan – the former Teachers' Superannuation Fund. At that time, its \$19 billion portfolio was as antiquated as its name.

Bonds. Ontario bonds. And nothing but Ontario bonds. That was the whole portfolio. I think everyone here realizes that one big stack of vanilla, one issuer, below market rate,

non-marketable, bonds could not earn the returns necessary to support the inflation-indexed, defined benefit pensions of a growing number of pensioners.

So Claude and Bob and their team had to devise new investment plans and techniques – none of which had been undertaken by pension funds before – to put some diversity and its resulting heft into the fund.

As a result, Teachers' was the first pension plan to use derivatives – in fact, Bob's investment shop sought and won the federal rulings that gave us all the right to use them. They also introduced the swap market to Canada. They were the first to bring managed index funds inhouse and to use hedge funds. They also were the first pension plan to buy a major operating real estate company ... and were early to invest in infrastructure and timber ...

And that brings me to the 'first' that I'm here to discuss today: Teachers' was the first pension fund to establish a formal direct private investing program.

Now, before I say any more I want to make two important points.

The first is that our initial foray into private investing was less than stellar. One of the first investments was White Rose Crafts and Nursery Sales ... and we lost the entire investment. So, good for the board of directors and executive for having the fortitude to allow the private investment program to continue. It's amazing that they didn't say "OK,

been there, done that, outa here!” But their approach to the risk that private capital represented was well-considered and unemotional – they knew that, while a certain degree of failure could be expected – that a few dry holes came with the territory - overall, there was value to be realized. They allowed the team to progress accordingly. Today our total private investment portfolio, including infrastructure, is over \$16 billion – and is enroute to topping \$20 Billion.

The second point is that, although you hear and read a lot about Teachers’ Private Capital’s investment program, please keep in mind that it represents less than 20% of our \$106 billion fund. We are major players in this market, yes, but we are not the whole Teachers’ fund, by any stretch. Teachers’ is well-diversified, with a risk budget directly linked to our liabilities.

As I said, Teachers’ commenced private investing in 1991. We think of that year as the beginning of the democratization of private capital. Until then, it had been pretty much the sole domain of the usual suspects – KKR, Bain, Blackstone, Carlyle, TPG. However, the entry of pension plans onto the scene as a direct investor, in effect disintermediating and competing with these firms, introduced a whole new factor into the formula: time. A new class of private capital investor had been born ... one that could invest without a defined timeline ... without an artificial exit deadline.

One of the realities of the private capital environment is that it is growing and evolving so quickly it’s difficult to track. According to Thomson Financial, over \$1 TRILLION has

been raised globally, since 2004 (that's roughly the equivalent of the economy of India, according to the BBC). Each year's total has been higher than the year before. Not only has the total number of funds increased dramatically, the number of funds with more than \$1 billion, is also on the rise – to more than 170 currently, from only 5 in 1989.

At the end of 2006, a Thomson-McKinsey report found that the Canadian market had reached a new peak, with nearly \$70 billion in private equity capital under management up 16% from 2005. Buyouts, which accounted for nearly \$40 billion of that total, rose 28% over 2006's levels.

That's what was under management at that time. Now, let's look at funds raised.

In 2006, \$8.7 billion was earmarked for Private Equity in Canada... \$1.8 billion of it by pension funds. For the past two years, pension funds accounted for an average 27.5% of the new private equity. And that makes pension funds a competitive force to be reckoned with. It also would be fair to infer that pension funds' investment priorities now are being reflected vis a vis returns, timelines and cost structures.

2007 was on track to beat all previous years' records until the debt market volatility hit this summer. It will still be a record year, as 2006's levels already had been surpassed by mid-year. Although this volatility has clearly dampened the private equity market, there are some signals that the market is adapting. We may see more cases like the Blackstone/GE banks' decision to pull their financing of the PHH takeover, but in my

view, this is a pause, not a conclusion. And, frankly, most of us could use a bit of a holiday from the frenetic pace of the past couple of years.

Now, let's take a closer look at timelines and cost structures.

I'll start by putting Teachers' liabilities into context. Teachers' is what is known as a 'mature pension plan'. That means our ratio of active-to-retired members is low – in our case 1.6 active teachers for each pensioner. In 1990, that ratio was 4 to 1. Think of it this way: in 1990, the cash flow into the plan from contributions was \$1.3 Billion and the fund's assets were about \$20 Billion. If the plan had suffered a 10% loss back then, it would have equated to one and a half year's contributions. Today, the contributions into the plan are about \$2 Billion but the funds assets are now over \$100 Billion. A 10% loss today would equal about 5 years of contributions. And by the way, today the contribution rate per teacher is about double what it was in 1970.

Obviously, with fewer contributors per pensioner, the need for investment returns within an appropriate risk profile becomes more acute.

We also deal with a very long timeline: 70 years or more. The average teacher in Ontario retires at age 57. The average member pension is paid for 31 years –. And the average survivor pension is paid for another 5 years. This is longer than the member actually works. We have 83 pensioners over the age of 100, and about 3,000 are older than 90. Ex teachers are living longer every year.

Because of that 70-year timeline – from the start of a teacher’s career to the end of their survivor payments – our private capital has the luxury of being able to hold its investments for the long term. We are not a fund that has to divest itself and pay out returns to a group of limited partners. Our partners are our members, and they share our patience. One of the benefits that holding for the long term brings us is that, with our capital profitably at work, we don’t have to take on the cost and effort ... and risk of finding new investments.

Given these longer timelines, pension plan private capital can bring stability to the operation in which it’s invested. Had the operation been purchased by a traditional private equity firm, management would likely have been confronted with planning for the liquidity event starting Day One. That doesn’t mean we buy to hold forever. Rather, it does mean that we will hold for as long as we believe we can continue to realize above average returns.

Our patient capital drives business success in our portfolio companies. This in turn drives growth. Let’s use Maple Leaf Sports and Entertainment as an example. We made our initial investment in 1994 in a company that comprised the Leafs and Maple Leaf Gardens. By 2003 we had increased our share to 58% through a re-capitalization. The capital we injected into the company helped it grow into a sports and entertainment powerhouse. It now boasts: four major sports franchises - the Leafs, Raptors, Toronto FC and the Marlies The Air Canada Centre ... Two television channels...A new

condo and hotel development ... And a soccer stadium. ... It's a conglomerate of logic, which would not have been possible without patient capital. And let me stress that, being the successful investment that it is, and with its prospects for future growth, we expect to continue to hold Maple Leaf Sports and Entertainment for a long time to come.

The Yellow Pages Group is another example, but with a twist. We partnered with KKR on the Yellow Pages deal in late 2002. As a traditional buy-to-sell fund, KKR had a pre-determined exit deadline, which they exercised in 2004, once the company became an income trust. As of the end of 2006, our public equity portfolio still held \$217 million in Yellow Pages units. Our experience with this investment provided us with a template in the acquisition of 50 percent of New Zealand's Yellow Pages in early 2007.

As you can see, we don't much like the idea of passing along successful companies to others. We prefer to reap the ongoing benefits on our members' behalf.

Of course, there are anomalies to every theory and Doane Pet Food was one. We bought it in August 2005. We sold it less than a year later to a pet food company that needed it badly enough to pay us a very significant premium that we simply could not afford to refuse. I guess this exception proves the rule!

I said that our second defining characteristic is low cost. Let me explain.

Our costs are only about one-tenth that of a typical "2 and 20" private equity or hedge fund. Our costs are generally in the neighbourhood of about .5%, while the combination

of their 2% management fee and 20% profit participation generally exceeds 6%. In fact, if you examine Blackstone's recent IPO circular, they indicate that their take has been in excess of 8% per annum. Given our portfolio of \$16 billion, that means it would cost \$1.25 billion per year, for us to invest through Blackstone rather than investing directly. (And by the way, that's the equivalent of 30,000 annual pensions). It also means, however, that we had to break out of the mold of stereotypical pension plans and hire top talented people who can compete successfully head on with the Blackstones of the world. It is noteworthy that today we are ranked among the top 20 private equity firms in the world.

Cost and time set "new private capital" apart from its traditional counterparts. That's why pension fund private capital is sometimes referred to as "flexible ownership." It's an example of why you can think of pension private capital as a bit of a hybrid. The recent Harvard Business Review article "Strategic Secret of Private Equity," describes flexible ownership as the practice of holding onto a business "for as long as it can continue to add significant value by improving performance and fueling growth."

Recently, private equity has attracted some negative press, particularly in Europe. The facts are that private capital, whether it's a pension fund or a traditional fund, has proven it can do many things well. Key among these are accelerating the growth of jobs and generating value in the company, according to a recent AT Kearney report. They found that private equity investors created more than one million jobs in Europe over the past four years – a 5.4% growth rate, compared to 2.9% for traditional firms. In the U.S

between 2000 and 2003, more than 600,000 private equity jobs were created – or the equivalent of the population of Boston. A Financial Times of London study of the 30 largest European private equity transactions in 2003 and 04 states: “overall, more jobs were likely to be gained than lost as a result of private-equity backed buys.”

Added to this job creation is the overall *value* creation that private equity tends to bring to its acquisitions. This value is realized through three main strategies, according to AT Kearney, and they are:

- Improving performance – through a combination of cost cutting and revenue growth measures.
- Re-grouping and re-focusing – so that resources support core competencies and
- Buying and building – to improve the company’s competitive position in the market.

So you see, Private Capital really isn’t the Big Bad Wolf that many have made it out to be. As Harvard Business Review writer Walter Keitchel says: private capital investors “put to use many of the best ideas and analytic techniques developed in the corporate strategy revolution.”

In other words, in private capital, it’s all about focusing on strategy – and ignoring the peripheral noise that distracts an executive team from what is truly needed to drive the corporation.

That was our reality, our litmus test, if you like, when we, with our partners Providence and Madison Dearborne, prepared our BCE bid. We viewed it through the lens of corporate strategy, knowing that, were we successful in our bid, our participation would be at the strategy-setting board level, and not in the day-to-day management of the company.

Shareholders overwhelmingly approved our bid in the September vote - I understand that Bell's Board has arranged psychiatric help for the 2.5% who voted against the takeover. Nevertheless, since we're still awaiting regulatory approvals, I'm limited in what I can say here, but there a few points I would like to recount for you..

As you may know, Bell has been one of our largest holdings since 1991. Telecom is a sector our public equities team targeted long ago. We have been BCE's largest shareholder since 2005, and we increased our holdings last June from just over 5% to just over 6%.

For some time we had felt that BCE's share price did not reflect its underlying value. As stated in the proxy circular, in February, when it became clear that others were planning to initiate a bid for BCE, we told management that we were interested in evaluating a privatization plan ourselves. In early June, we officially entered the bid race.

As you can imagine, every day was a whirlwind for many months. Several contenders entered the race, many then dropped out ... rumours flew ... due diligence was round-

the-clock ... we had more than 100 advisors on the file on our team ... one of our board members had to resign ... another BCE board member recused himself from the proceedings... there was rampant media speculation and competition for facts were fierce.

The bid deadline was June 26. BCE's board announced on the morning of June 30 that they were recommending to shareholders that they accept our Teachers'-led bid.

Of course, primary ownership isn't ours yet.. But our bid was accepted by management above those of KKR and Cerberus, two huge and powerful private capital players. The fact that our consortium's bid was successful is, I think, a testament to the 'new private capital.' If you read the proxy circular, and see the board's two and half solid pages of reasons detailing why they recommended our bid over others, I think you will agree.

Of course the intrigue around Bell never seems to end – in September the CEO caught everyone by surprise by announcing his exit – in October we announced that George Cope would take over when the deal closes. Can you imagine the mess we would be in if Cope wasn't our choice and we had a new CEO in waiting on the sidelines – in the meantime the business would be leaderless for months.

Then BCE was sued by some bondholders – that matter is still before the courts. Private equity and the credit crunch speculation remains in the news, so we continue to get calls asking if our financing is secure, if we remain committed to the deal, and so on. And in

late February we will have the CRTC public hearings which will start a whole new round of intrigue as people speculate whether or not Teachers' is Canadian of all things!! I have to tell you, I look forward to the time when Bell is out of the eye of the media and can concentrate its resources on improving products and services to its millions of customers.

It's been an eventful road from a one-person private capital shop in 1991 to a 60-member team capable of orchestrating the largest LBO in history. And it's a road that promises to become even more eventful, as competition stiffens, credit is hard to source and the economy takes a siesta. Having successfully maneuvered the many curves, speed bumps and blind spots that the road has shown us so far, rest assured that our seat belts are securely fastened for the continuing journey ... or race, as the case may be.

Thank you.