The Drivers of Canadian Private Equity Performance

VC 2007: an industry in transition

Buy out: A performing asset class

Gilles Duruflé

CVCA Annual Conference

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Building Winners with high exit values
The evidence (Reminder – Vancouver 2006)

- **Canadian VC tend to:**
  - be slower to enter new emerging sectors
  - concentrate on early stages
  - invest less frequently at later stages and with much smaller amounts of money
- **Smaller number of exits with much smaller exit value**
- **Exit values on the American markets are much higher**
  - Israeli VC benefit from a much larger proportion of exits in the US
- **Foreign funds seem to play a very important role in Canada in**
  - Financing larger rounds
  - Exiting companies
  - Obtaining higher values at exit
- **Canadian VC have only a small number of big winners (10x+) and are slower to exit non-performing investments**
- **Canadian VC tend to be less demanding than their US counterparts**
- **Their managers' profiles do not match those of the top performing US funds**

2007 Update
Summary

Investment behavior

- Spread on too many deals: changing
- Over weighted in early stages: changing
- Rounds too small: changing but still out of step
- Share of foreign investors: growing

- **Is this a real change in investment philosophy and practice?**
  - Yes – But conflicting with the small size of many funds
- **Is the growing share of foreign investment a threat?**
  - No, overall it is positive. Canadian funds have to become competitive
  - Canada needs stronger and larger funds

Performance and exits

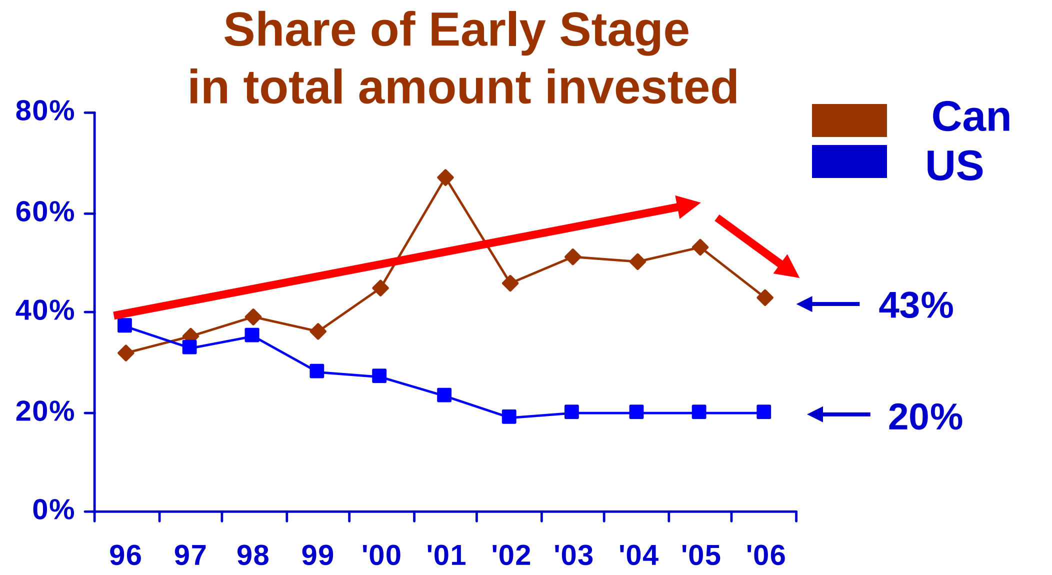
- Performance is improving, but still lagging the US and slower to bounce back
- Total exit value of Canadian companies declined in 2006, contrary to the US
- Foreigners take a growing share in exits

- **Why not better?**
  - Fundamentals are improving but take time to translate into exits and returns
  - How can Canadian funds be faster to enter emerging hot sectors?

Structure of the industry

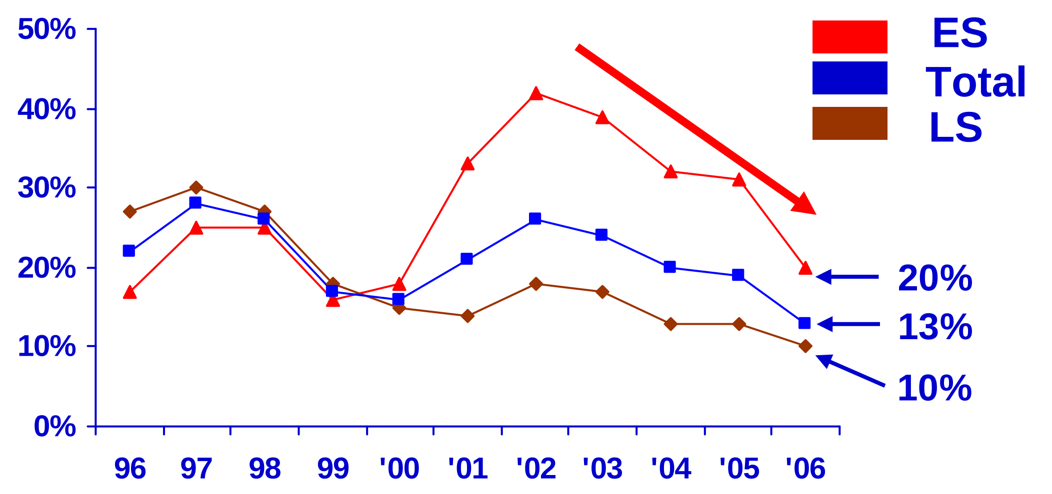
- The industry is evolving towards a more private sector model
- But fund raising is shrinking and investment by Canadian funds declining slightly

Investment behavior seems to be changing

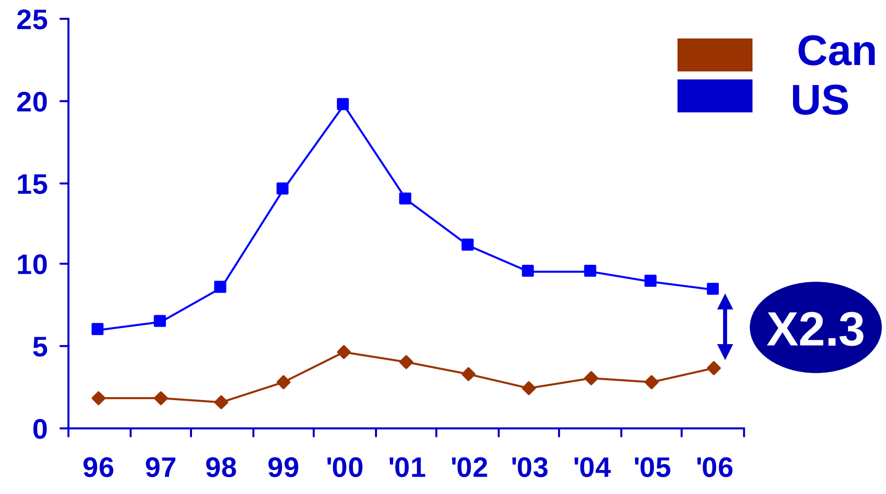


- Share of early stage in total amounts invested used to be growing: the trend has reversed
- Spread over too many early stage deals, compared to the US: changing
- Size of rounds: the gap with the US is still large, but it is narrowing

Number of deals: Canada/US

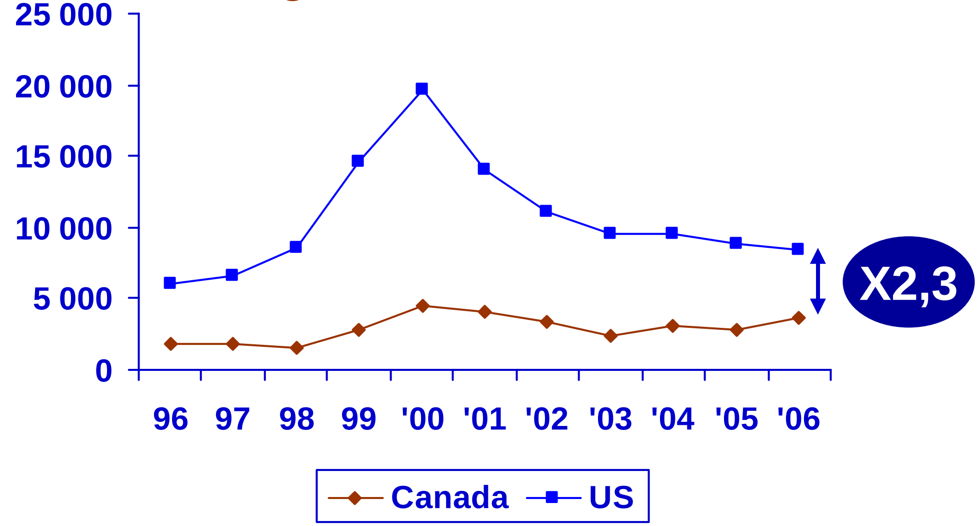


Average Size of Rounds (Can$M)



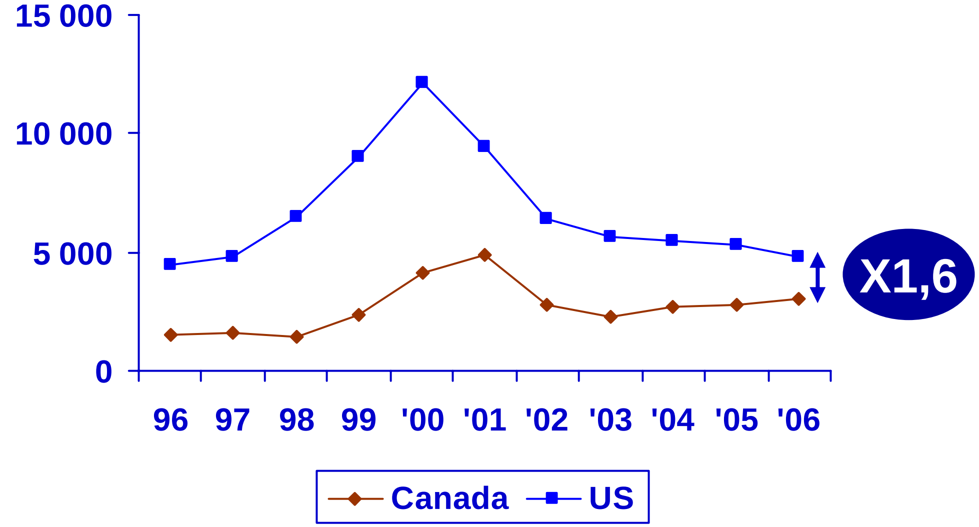
Rounds too small: changing but still far away (details)

Average Size of Rounds

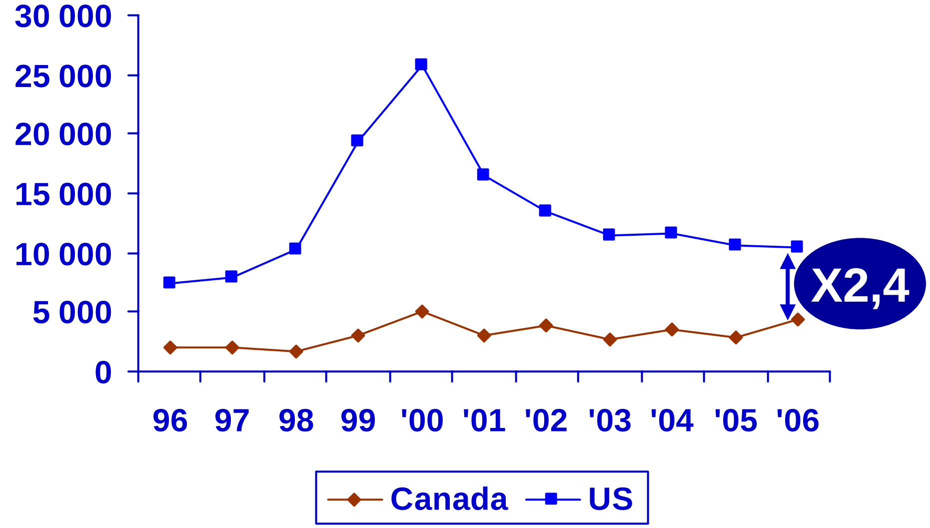


- Since 2003, the average size of rounds is growing in Canada
  - From 2,3 M$ to 3,1 M$ in Early stage
  - From 2,6 M$ to 4,4 M$ in Late Stage
  - From 2,4 M$ to 3,7 M$ overall
- The gap with the US has been reduced, but is still wide, especially in the late stage

Average Size of Rounds: Early State

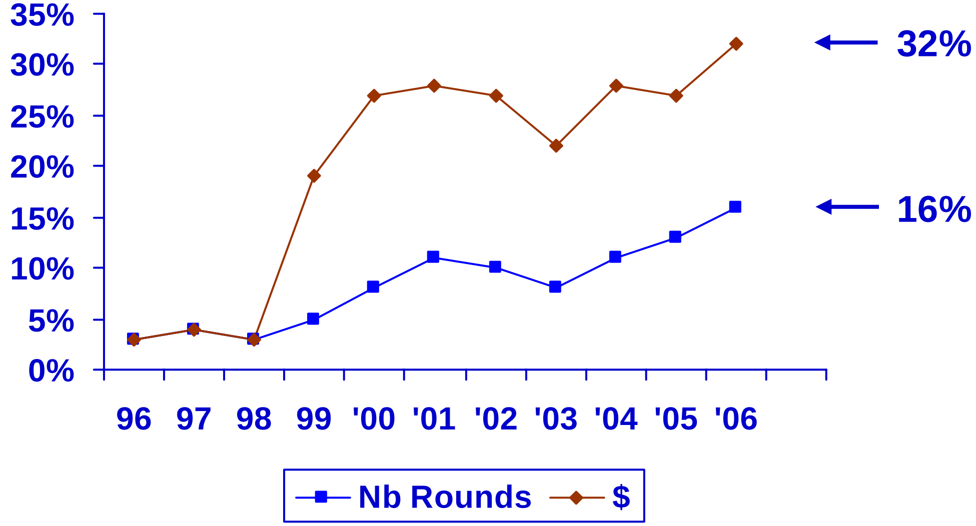


Average Size of Rounds: Late State



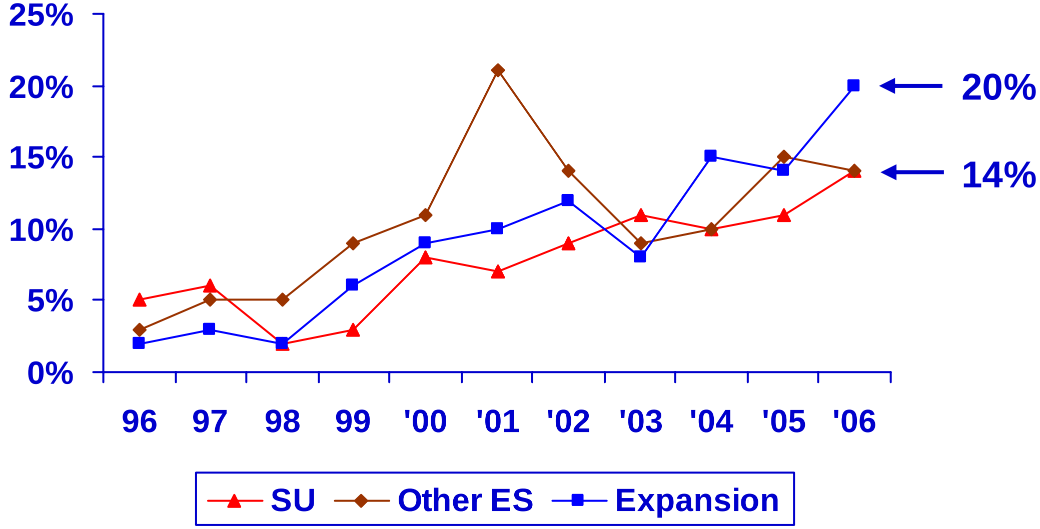
Share of foreigners increasing sharply including in early stages

Share of Foreigners: $ and Nb of Rounds



- In 2006, Foreigners were present in 16% of the rounds and their investments represented 32% of the total VC money invested
- This share is rising regularly and at all stages except the seed stage
- The trend has accelerated in Q1 2007

Share of Foreigners : Nb of rounds by stage



Is this a real change in investment philosophy and behaviour?

Based on interviews

- Yes
  - Funds tend to hire more experienced, operational and specialized managers profiles – directly and indirectly (Venture Partners, Entrepreneurs in Residence)
  - They are more selective on investments, make larger A rounds, reserve more capital for successful investments, work earlier to link with larger funds (most of them US funds)
  - Companies recognize that the level of expertise and value add of VCs they are dealing with, foreign and local, is improving
- However
  - Many funds are limited by their small size and may have to take too much concentration risk
  - Some of the decline in the number of early stage rounds may be due to the fact that outside Quebec, there are fewer funds operating
  - A complete assessment of the early stage situation should take into account the role played by angels, universities and endowments Canada and in the US

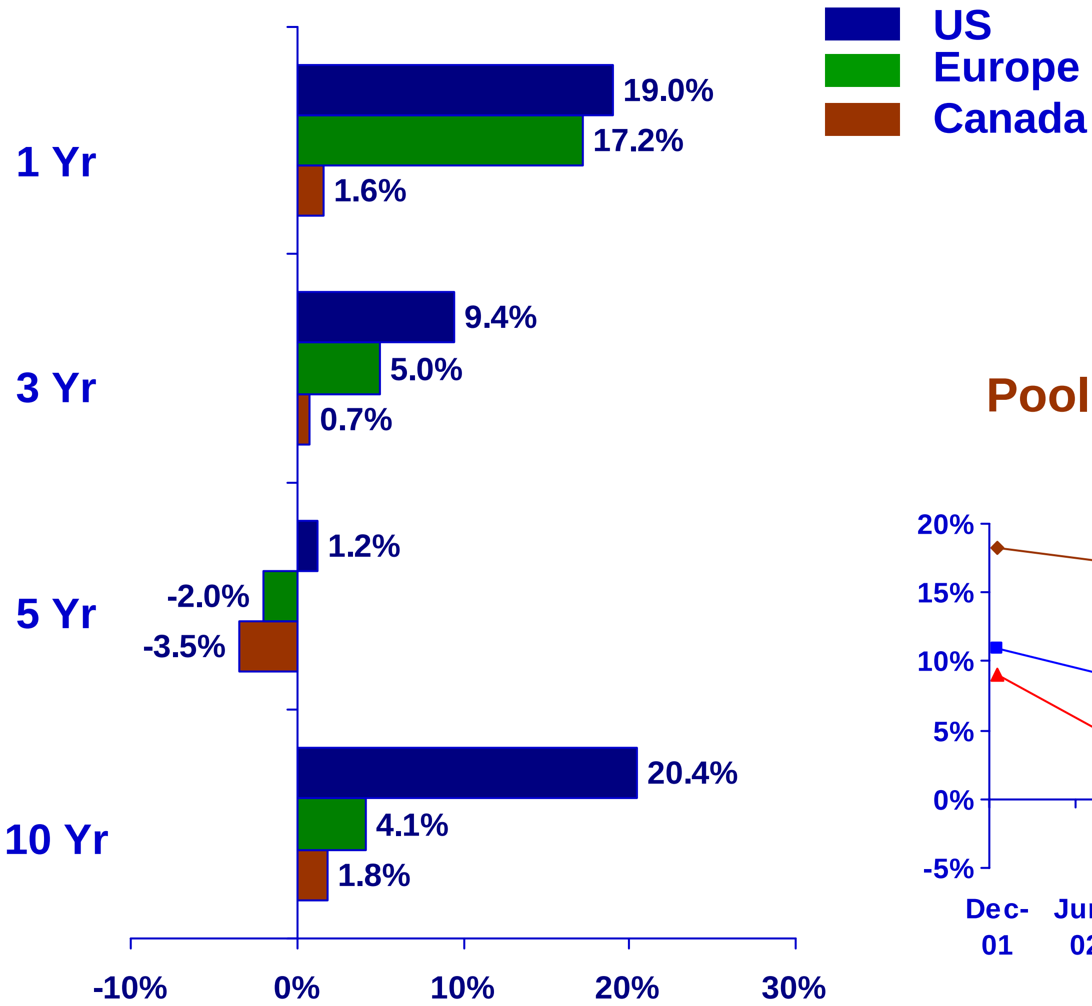
Is this increasing share of foreign investment positive and/or a threat?

Based on interviews

- **Positive? Definitely Yes**
  - Good US funds bring money, competition, networks within the industry, ability to build larger rounds and engineer exits
  - They contribute to spread best practices and raise the bar
  - Their value added is good for companies
  - Canadian funds have to learn to be competitive and become as competitive as them
- **Is it a threat?**
  - For early stage funds: no. Foreign funds need good local investors
  - Canadian funds actively create partnerships with selected US funds
  - Canadian funds have gained in credibility: American funds are more comfortable with local partners
  - Later stage funds: the market is not overcrowded
  - Companies going South: might be a problem
    - Section 116 is an incentive to move the companies to the US
    - Larger and more experienced Canadian funds would reinforce Canadian companies

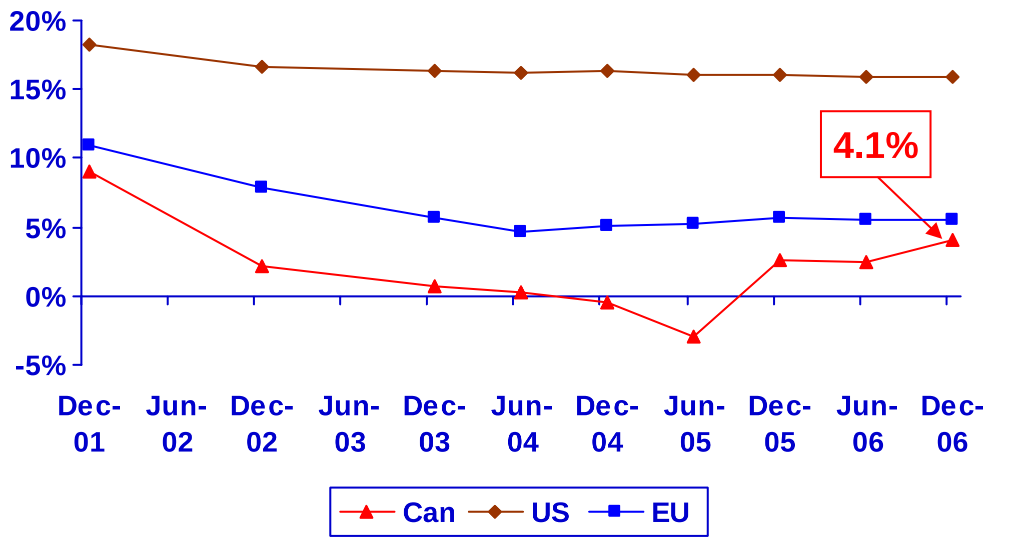
Performance is improving but still lagging as at Dec. 31, 2006

VC Horizon Returns as at Dec. 31, 2006



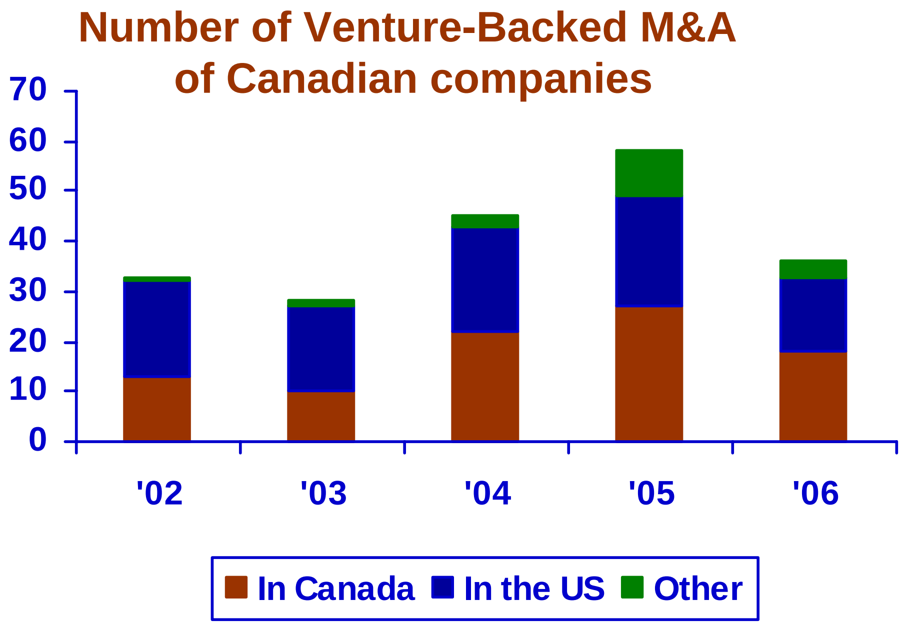
- The Canadian VC performance is slower to bounce back than in Europe or the US
- The pooled average return since inception is still far behind the US, but improving and similar to Europe

Pooled average IRR* since inception as at various dates



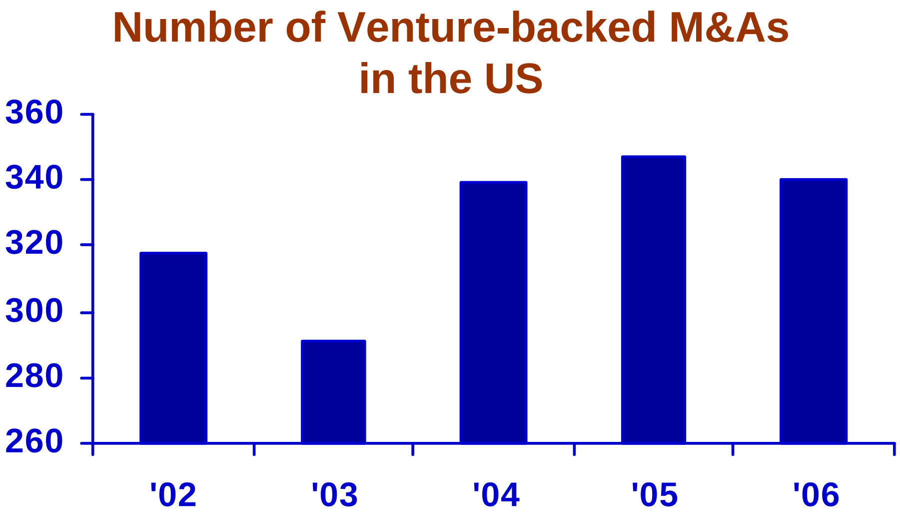
*Before 2005, Canadian IRR are adjusted (-4%) to be comparable with net returns

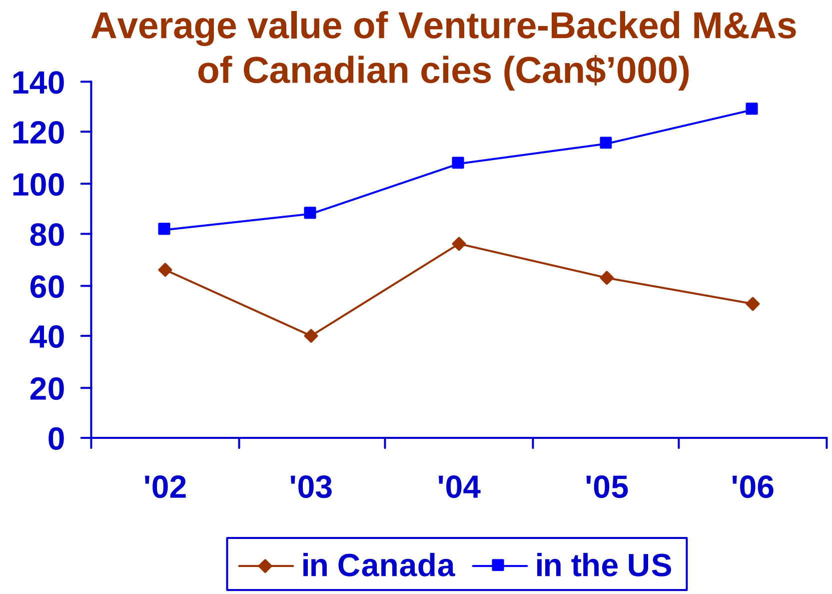
Exits
Number and values of M&As declined in 2006



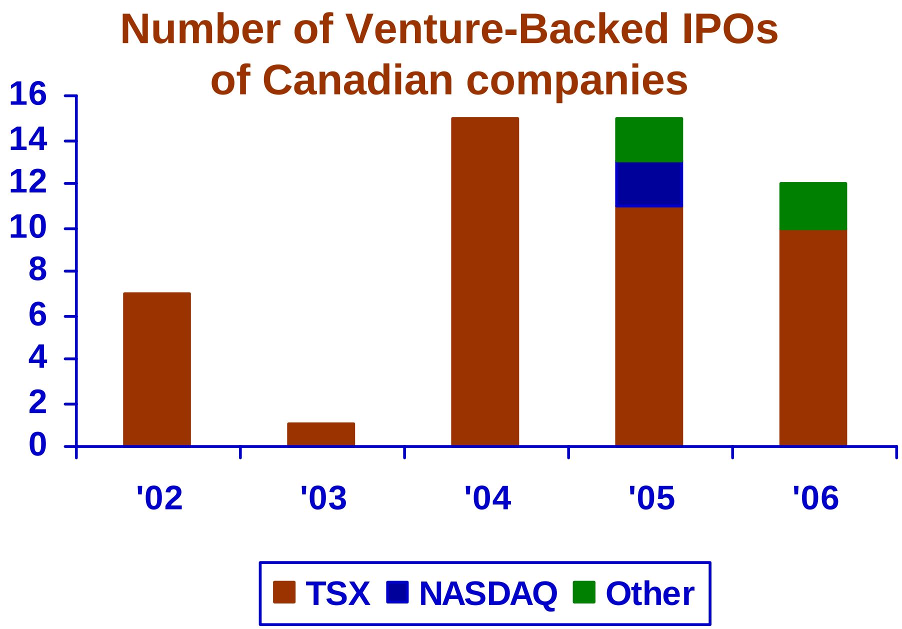
In 2006

- The number of M&As of Canadian venture backed companies purchased either by Canadian or US companies declined
- Whereas the number of M&As in the US was relatively stable
- The average value of M&As of Canadian venture backed companies declined by 16%, whereas in the US it increased by 10%



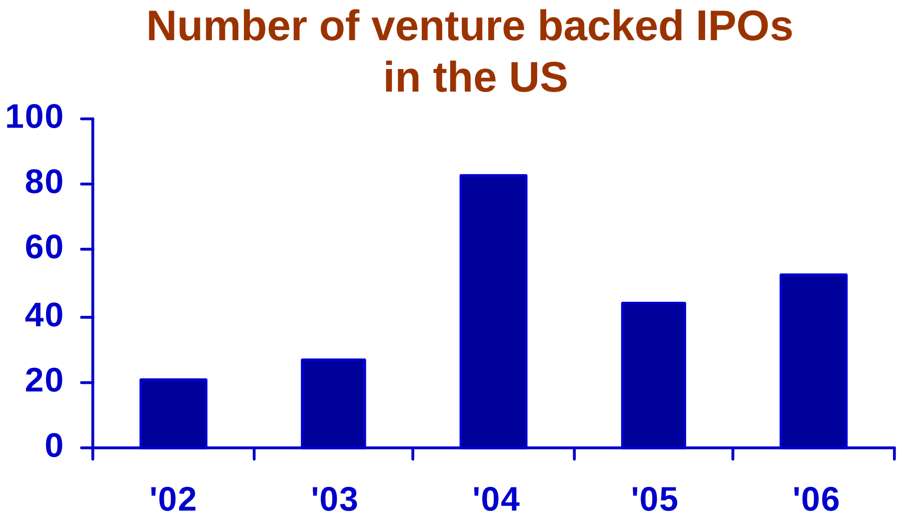


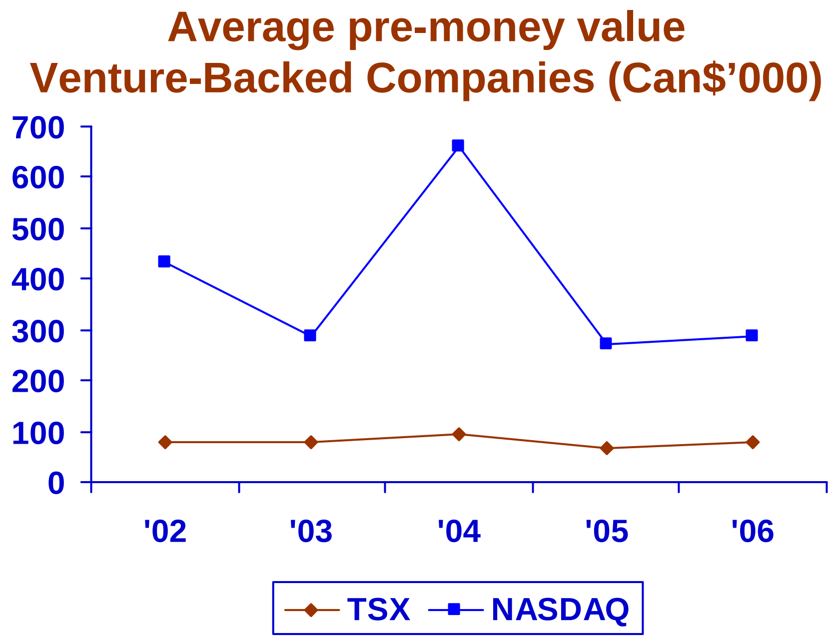
Exits
Number and values of IPOs declined in 2006



In 2006

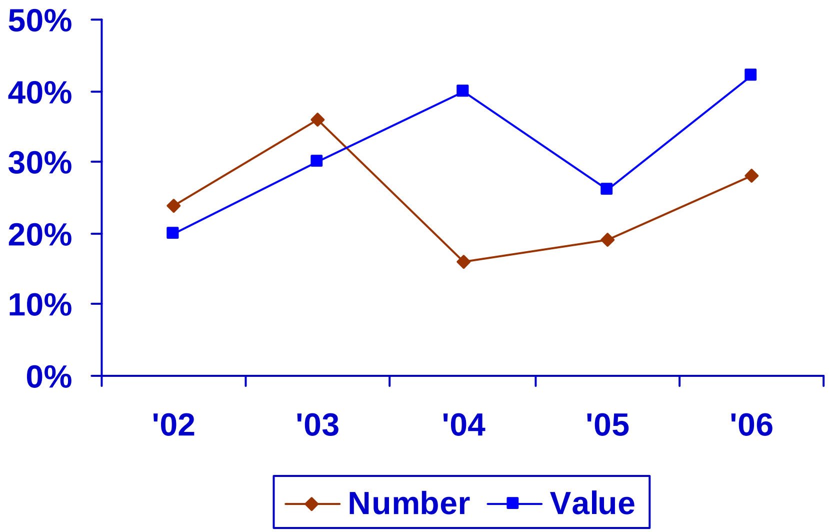
- The number of Canadian venture-backed IPOs on the TSX declined slightly
- There were no Canadian IPOs on the NASDAQ where the pre-money values are much higher which implies a sharp decline in total pre-money value of Canadian IPOs
- In the meantime, the number of venture backed IPOs in the US were slightly up



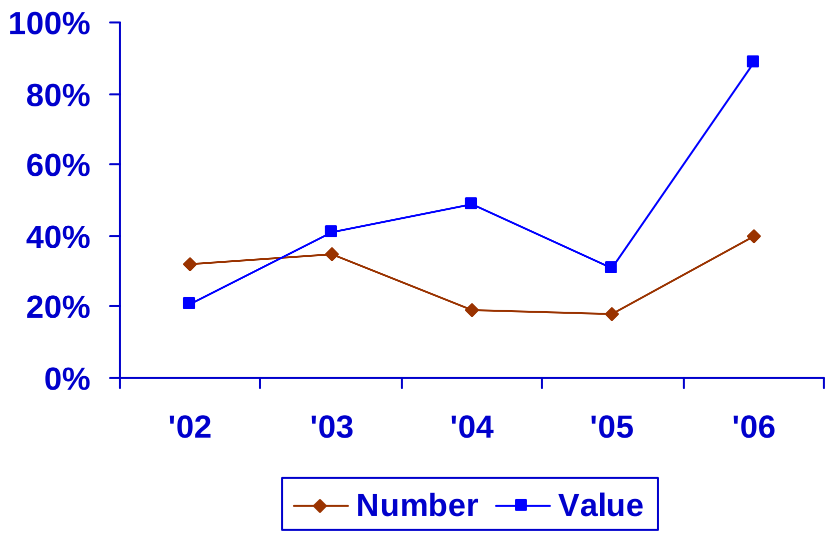


Exits
Foreigners take a growing share

Share of M&As with foreign investors



Share of M&As in the US with foreign investors



In 2006 M&As with foreign investors represent

- 28% of all M&As in number and 42% in value
- 40 % of all M&As of Caanadian investments with US firms and 89% in value
- which shows clearly that when foreign investors are present, exit values are larger

Note

- There is no significant trend in M&A values. Values of M&As in the US remain much higher
- There has been very few IPOs in 2006 and none on the NASDAQ

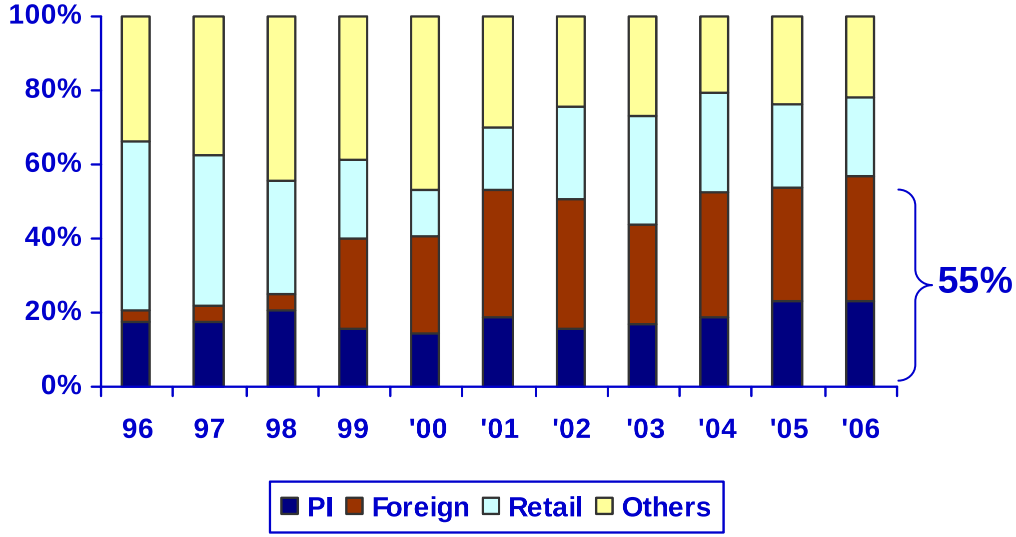
Why is the performance slower to bounce back in Canada?

Based on interviews

- It takes more than 1 or 2 years for changes in investment behavior to translate into changes in value of exits
- Less competition: less up-rounds?
- Are we left out of the new hot sectors?
  - Social networking
  - Content aggregator
  - Open source
  - How do we catch the new waves?
- Technology does not seem to be presently the first choice for talented entrepreneurs in Canada

The structure of the industry is evolving towards private funds and institutional investors (Canada outside Quebec)

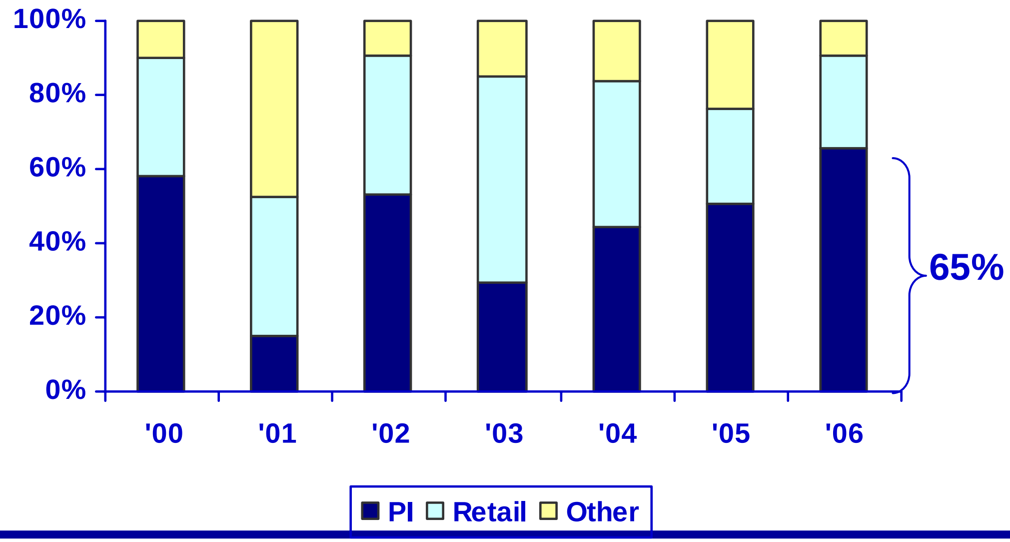
Investment by type of funds ($)



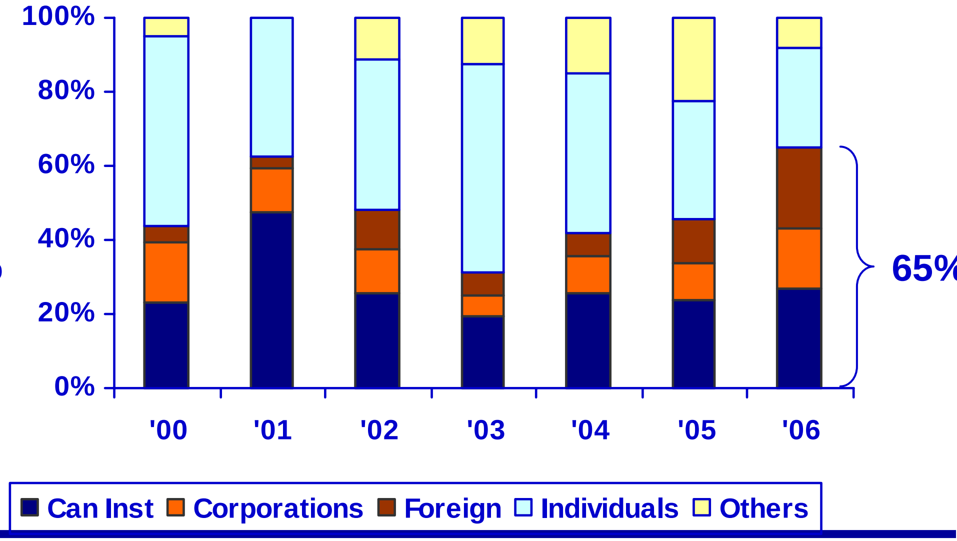
In 2006

- 55% of VC investments are made by Private independent funds, Canadian and foreign
- 65% of funds raised by Canadian VC are raised by PI funds
- 65% of the money raised by Canadian VC come from Canadian institutional investors or corporations and from foreign sources
- These shares have been increasing during the recent years

Capital raised by type of funds

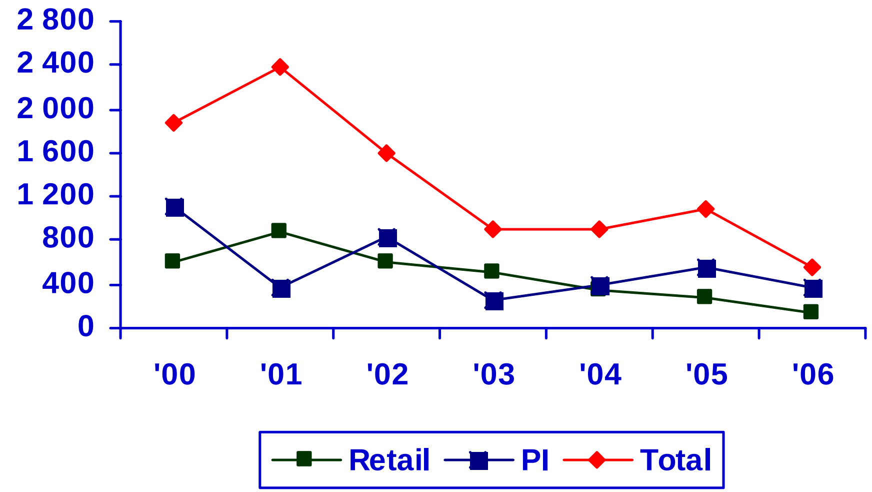


Capital raised by Source

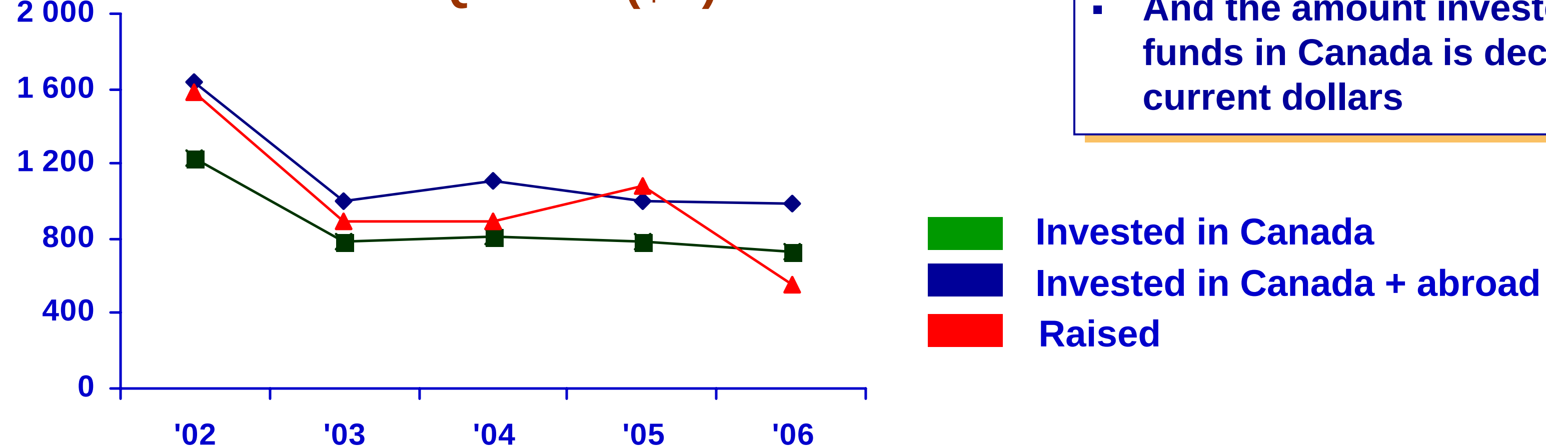


But in a context where fund raising is shrinking and investment by Canadian funds slightly declining

Fund raising outside Quebec ($B)



Raised and invested by Canadian Funds outside Quebec ($B)



- **The decline in fund raising for retail funds and other funds (Corporate, Governments) is not compensated by a rise of PI funds**
- **In 2006, the fund raising level for PI funds has declined**
- **At the LP level, the decline of funds provided by individuals and governments is not compensated by a rise of institutional investors, Canadian and Foreign**
- **As a result there seems to be a gap between the amounts raised by Canadian VCs and the amount they invest in Canada and abroad**
- **And the amount invested by Canadian funds in Canada is declining slightly in current dollars**

Is this a major problem or a mere transition?

Based on interviews

- The industry is rationalizing, which is a good thing
- But there is an acute financing problem in Ontario which is extending to other provinces outside Quebec
- Growing awareness that Canadian funds will have to go outside Canada to raise money.
  - How do you raise money outside Canada when you are a Canadian emerging manager?
  - For existing funds, given their track record, few of them will be able to succeed
  - Good news: the new generation of funds should be more successful and able to raise more money
- What about the transition?
  - Foreign money at the company level
  - Government measures to support the formation of PI funds
  - Other measures?

The Drivers of Canadian Buyout Performance

A performing asset class

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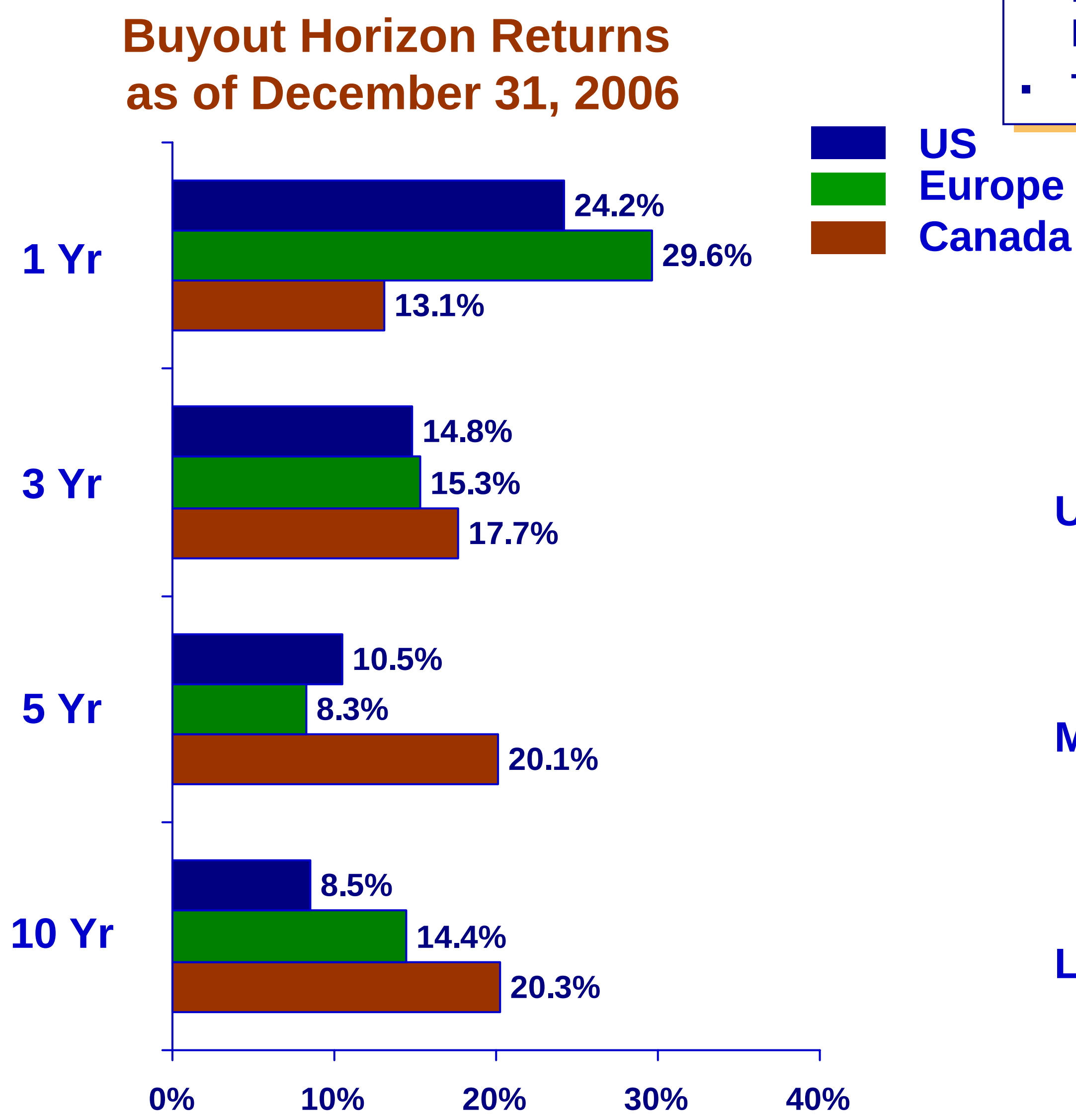
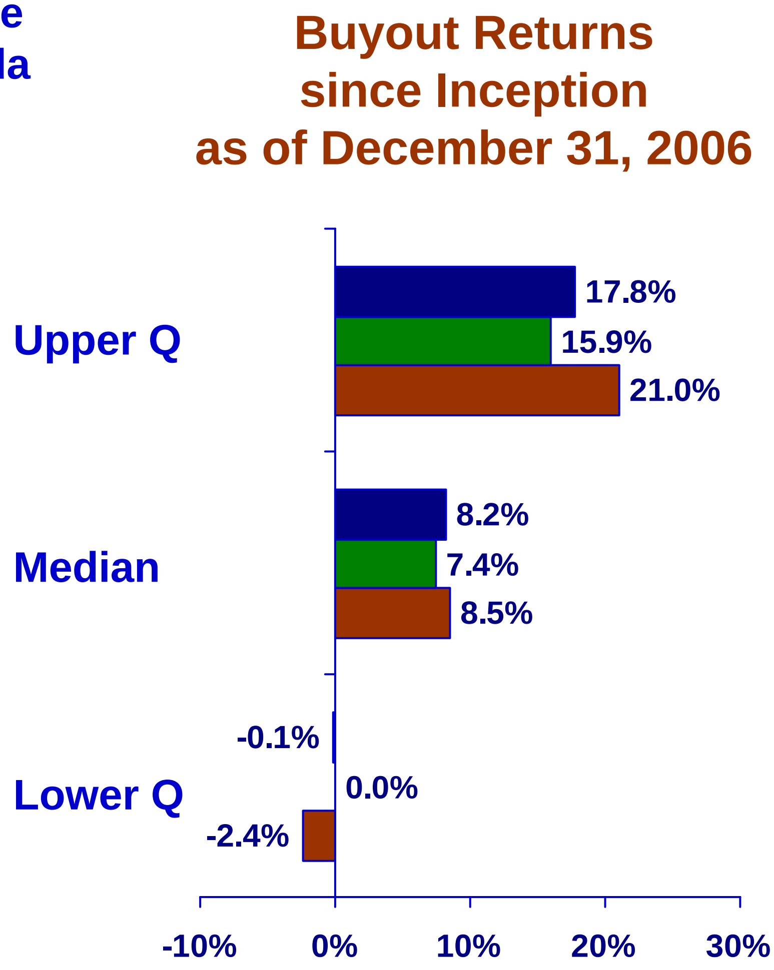
Canadian buyout: a performing asset class

Canadian 3, 5 an 10 yr horizon returns outperform Europe and the US

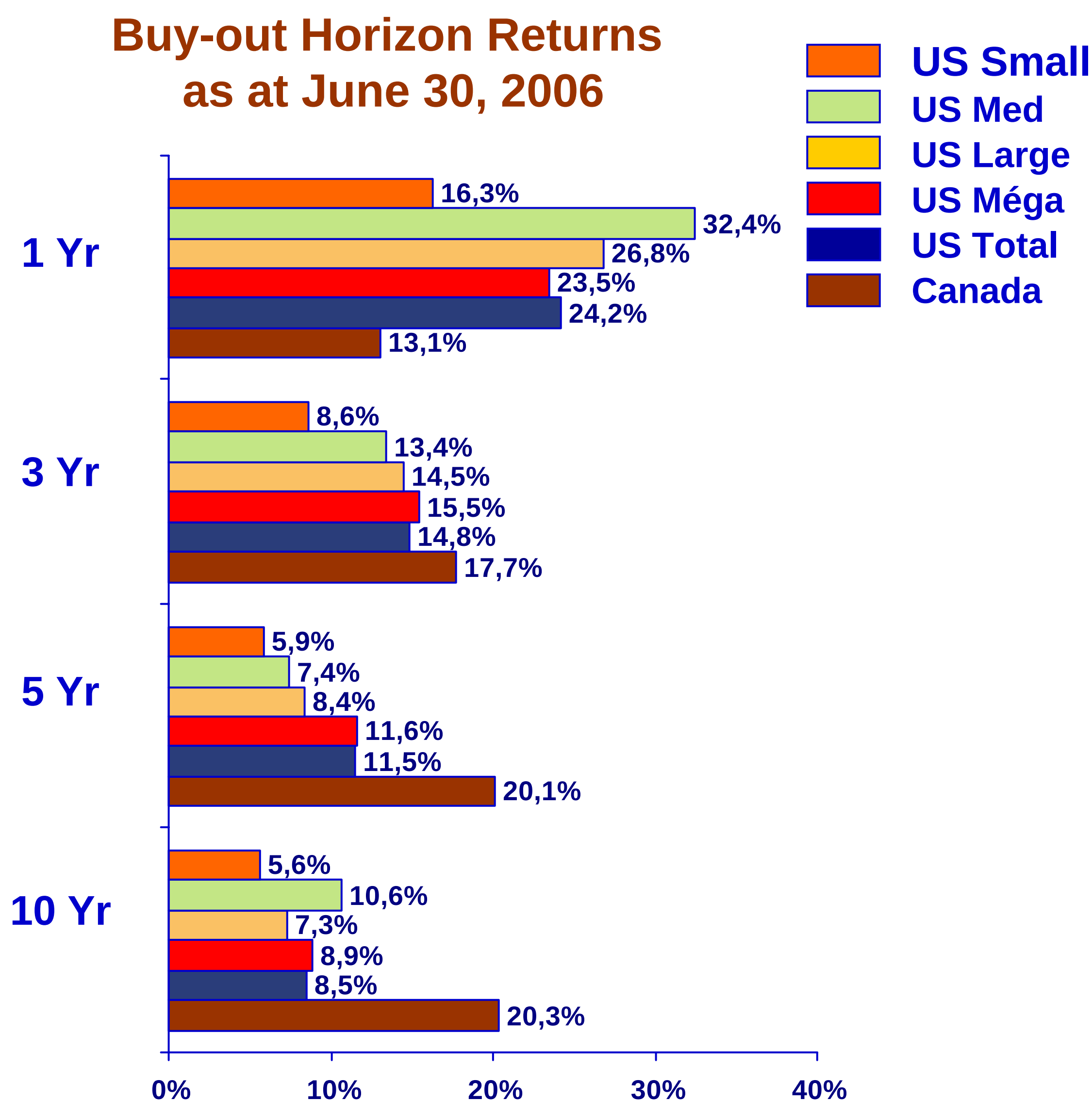
- However this Canadian over performance has been declining over the years
- The size of the sample is relatively small





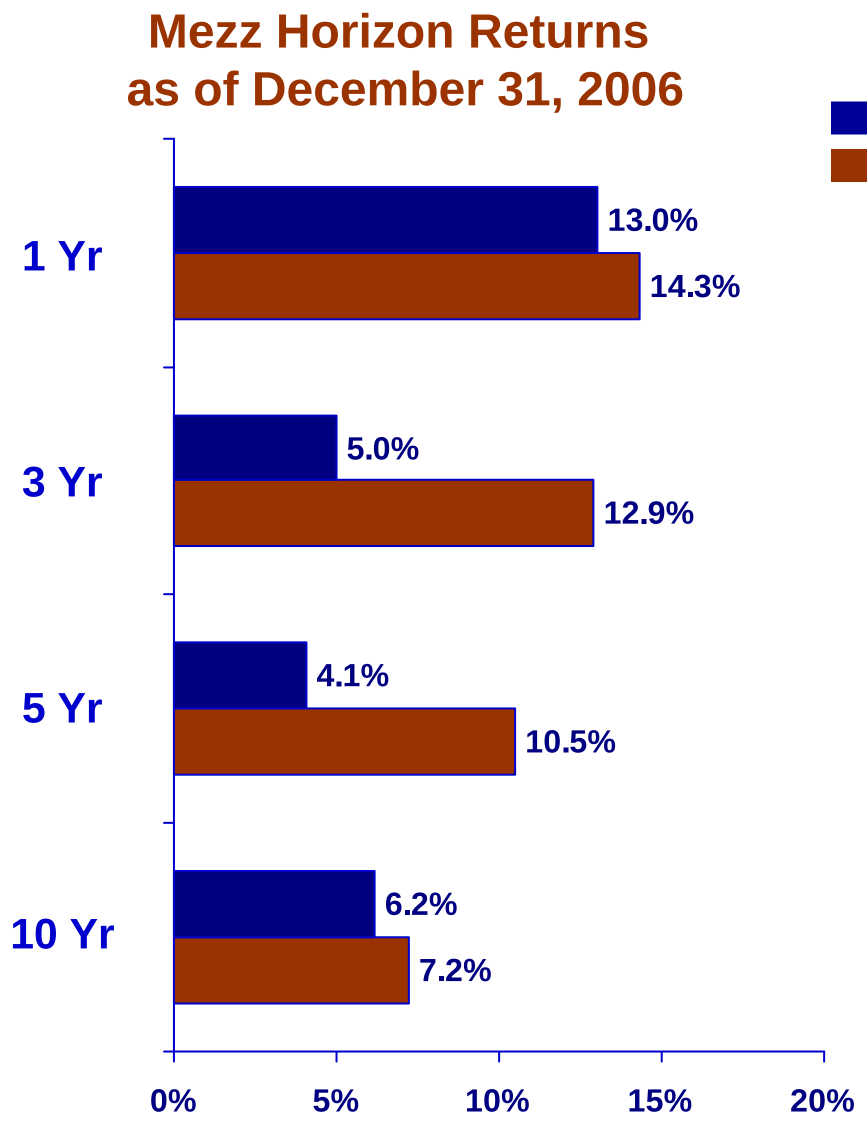
Sample size: 23 funds, 32% of the universe

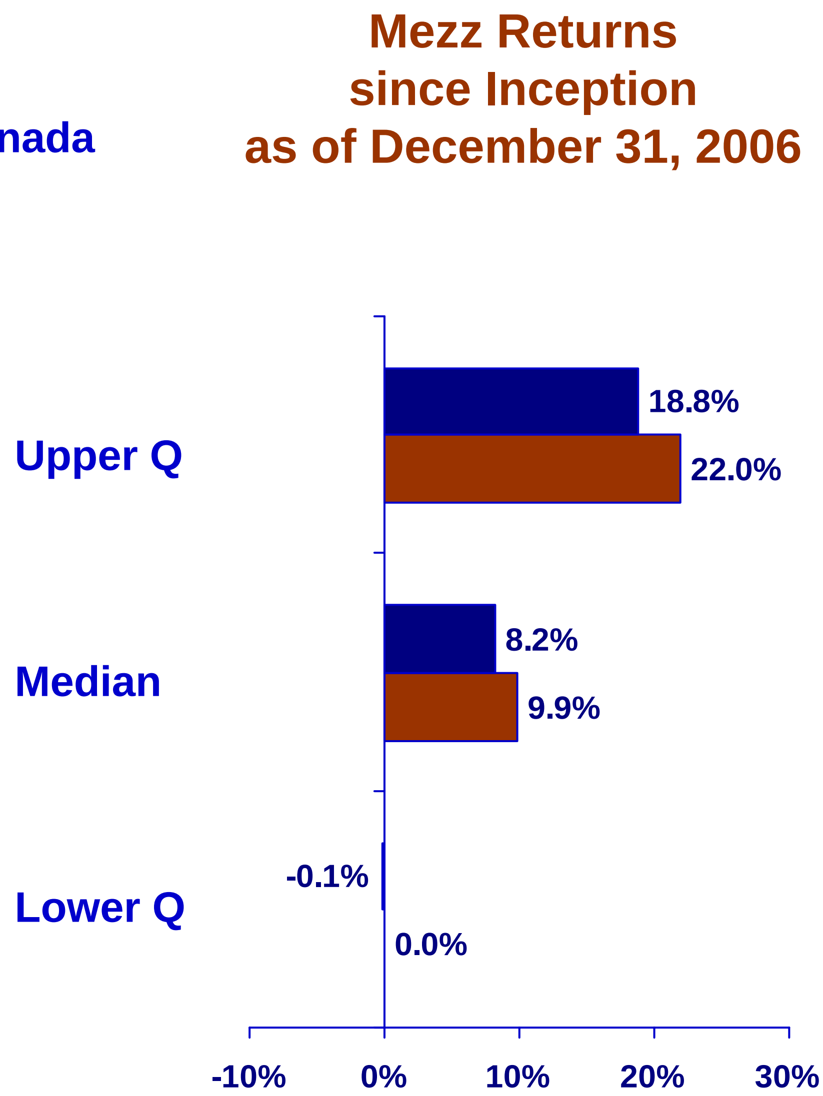
On a 3, 5 and 10 yr horizon, Canada out performs all classes of US buyouts



- On a 3 and 5 year horizon, US mega buyouts outperform the other classes in the US
- Medium and small buyout are the lowest performers
- Though more comparable to the latter, Canadian buyout largely outperform all US classes on a 3, 5 and 10 yr horizon

Canadian mezzanine: a performing asset class which outperforms the US

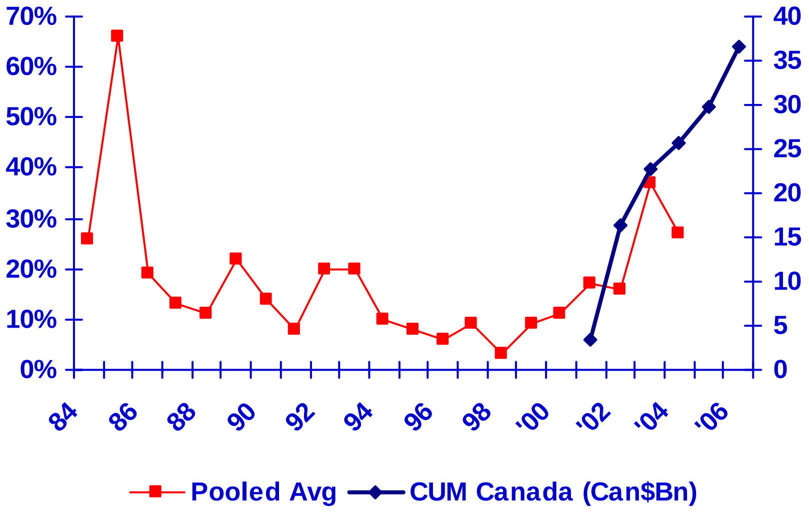




Sample size: 21 funds, 47% of the universe

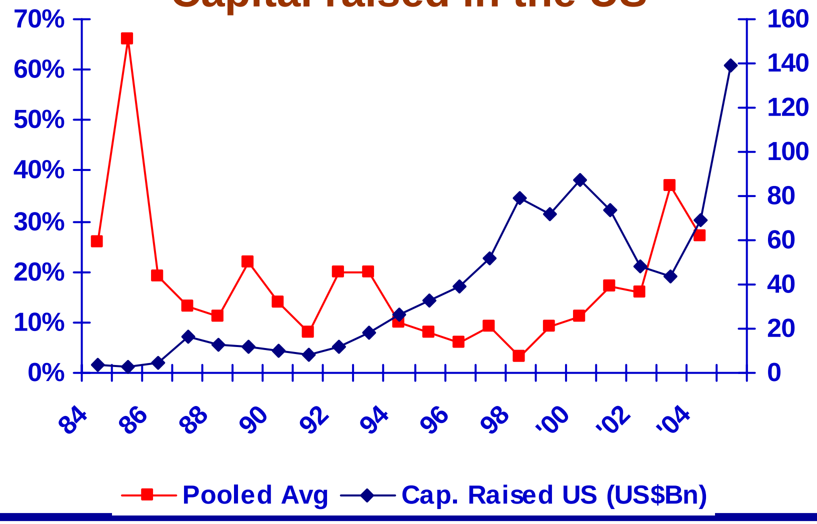
Timing has been favorable for the Canadian buyout

US Returns by vintage year and Capital under management in Canada

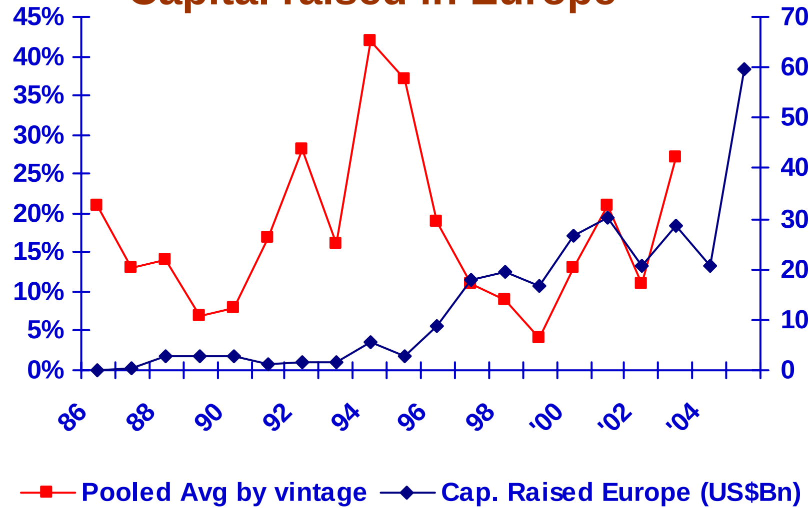


- Capital under management in Canada soared after 2002, during good vintage years (US returns)
- In the US, strong Buyout growth started in the late eighties and expanded through the poor returns of the 90s
- In Europe, it started in the mid 90s

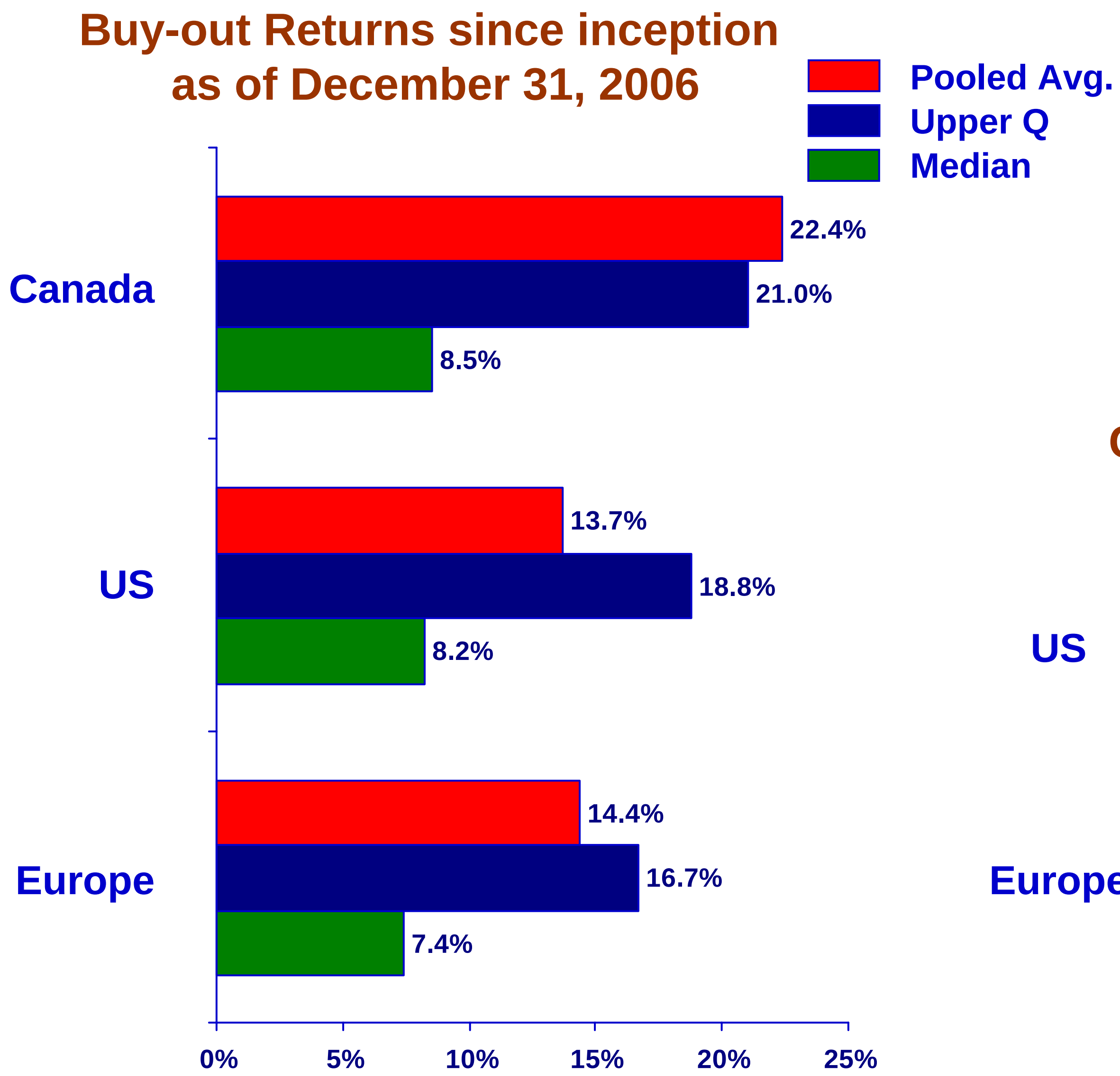
US Returns by vintage year and Capital raised in the US



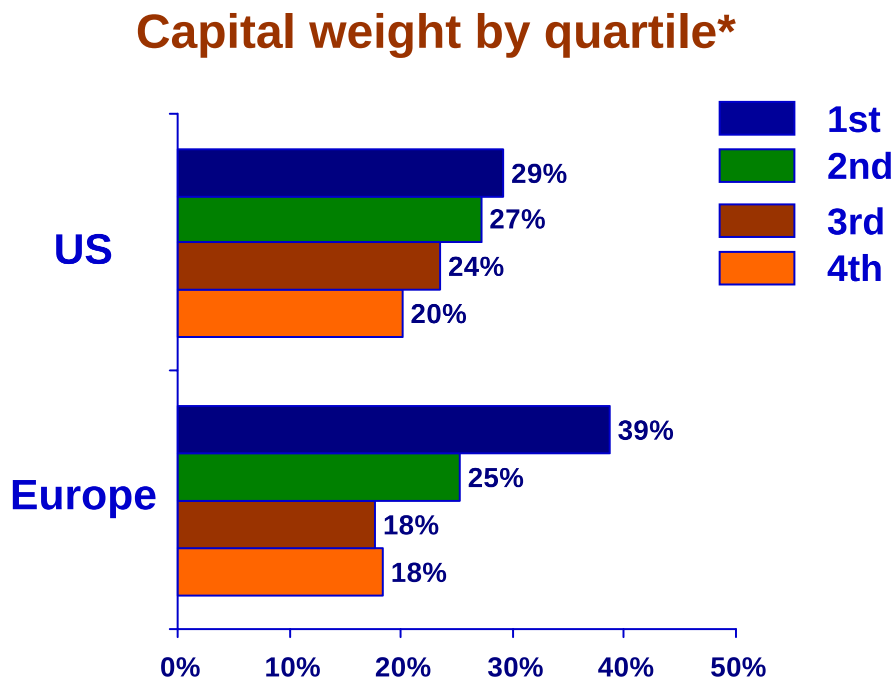
US Returns by vintage year and Capital raised in Europe



Capital is directed to the best performing managers
(Pooled average returns outperform the first quartile)



- The larger weights of the first quartiles (and a distribution of returns skewed to the top) put the pooled average above the median
- In Canada the pooled average return is even above the first quartile which indicates that the money is directed to the best performing managers



*for buyout and mezz funds

Market trends and Best practices
Do they explain Canadian performance?

Market trends

- Increased competition
  - Excess supply of capital
  - Generalization of auctions
- Financial skills becoming commodity
- Maturing industry
  - Larger share of mega-caps
  - Benefits of scale
    - I-banking relationship
    - Access to supply
    - Industry and functional expertise
    - Ability to attract and retain talent
- Performance comes:
  - Not from the market appreciation
  - Not from bets on rising sectors
  - But from better performance of the target company

Best practices

- Successful investors:
  - Leverage expertise before investing
  - Craft and rigorously review their own value creation plan
  - Over-invest time in the first 100 days
  - When necessary, change management early in investment
  - Institute substantial and focused incentives for performance
- They are organized to execute consistently:
  - Have a mix of skills around the table (internal and external)
  - Use higher ratios of associates and analysts to partners
  - Use processes for more effectively including external expertise
  - Make sure that the intelligent, customized metrics critical to success are in place

Source: McKinsey & Company, “How do they do it? Active ownership in private equity” and “Private equity Canada 2005”, vol.2

Was Canadian performance helped by characteristics of the Canadian market?

Based on interviews

- **A market at an earlier stage of development?**
  - Yes, this leads to more opportunities
- **A less competitive market?**
  - Yes, lower prices, less generalized auctions
  - Changing rapidly, growing competition
  - The Canadian market remains different
- **Financial skills are still a differentiator?**
  - Less and less true
- **Positive impact of exits through income trusts?**
  - Yes, very positive
  - Has changed
- **Mezzanine: a less specialized market**
  - Yes
  - Changing, introduction of new products

Is the Canadian buy-out industry ready to face the new challenges?

Based on interviews

- Are Canadian managers adopting best practices?
  - For some: “brand name funds have all focused on
    - Developing skills
    - Finding good executives
    - Picking the few things you can change and make sure that happens”
  - For others: still a long way to go
    - Still too financial profiles
    - Smaller and weaker networks of external expertise
    - “It will hit us over the head”
- Specialization is a difficult issue for Canadian funds
- Increased competition will bring more differentiation between funds
- Even if performance is becoming more challenging, there are still many good opportunities in Canada

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