INTERNATIONAL
FINANCIAL
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Institutional Investor Engagement Project:

Final Report

Submitted to:

Industry Canada

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Table of Contents

1. Executive Summary

This Final Report presents the findings of an initiative by Industry Canada and Canadian Venture Capital & Private Equity Association to engage in targeted discussions with selected Canadian institutional investors on the private equity (PE) asset class, with a view to deepening awareness and considering alternative strategies for action.

The historically low rate of participation by Canadian pension funds in PE investment activities – especially relative to the U.S. market – has been noted by both government and industry stakeholders in Canada. This is particularly the case below the so-called "first tier" of major institutional investment capital, i.e. medium to small Canadian institutional investors with total assets of around $10 billion and under, which are mostly absent from the PE asset class.

The focus for this assignment is to begin addressing this low participation rate by pursuing four key desired outcomes which were agreed with IC and CVCA at the outset of the project. These desired outcomes are summarized below.

1. A strategy for engaging Canadian institutional investors in PE as a new asset class. The strategy will be multi-tiered, comprising a near-term approach for the top 20 investor prospects, a medium-term approach for the next 20 investor prospects, and a longer-term approach for the next 30 investor prospects.
2. Identification, by the end of October 2006, of 3 to 5 new institutional investor prospects that are taking preliminary steps toward entering the PE asset class.
3. Demonstrable progress in having established productive working relationships with relevant institutional investor groups or associations (PIAC, FCM, ILPA, etc.).
4. Better understanding of how U.S. institutional investors with assets of less than $5 billion have overcome hurdles to participation in the PE asset class.

Desired Outcome 1:
A strategy for engaging Canadian institutional investors in PE as a new asset class

The overall objective for this desired outcome is to develop a strategy to increase the level of engagement among Canadian institutional investors in the PE asset class. For the purposes of the overall strategy, the concept of "engagement" is defined as *awareness* plus *participation*. The strategy itself comprises three main strategic objectives.

Strategic Objective 1. Identify and align "communities of interest" among institutional investors

An institutional investor considering the PE asset class will want to do its homework on the PE market itself, and the experiences and lessons learned of other like-minded investors that have considered or – better still – have invested in PE. Unfortunately, few such communities of shared interest exist in Canada. The Institutional Limited Partners Association (ILPA) serves limited partner investors in the global private equity industry, but it is not well known in Canada as its membership is mostly US and international. There are numerous other types of associations in which institutional investors (or their broader organizations) may participate. However, these associations do not have a main focus (or interest) in the area of institutional investment, let alone PE.

Moving forward, more needs to be done to identify and prioritize key organizations for increased awareness and interaction initiatives regarding the PE asset class, and to facilitate dialog and interactions between key like–minded organizations.

Strategic Objective 2. Increase "knowledge velocity" among institutional investors to accelerate awareness and expertise among decision-makers

"Knowledge velocity" refers to the transfer and dissemination of relevant PE market information to key decision makers within the institutional investor community. Two key drivers of this velocity have been most apparent: first, the transfer of PE investment experience and best practices at the operational level of institutions; second, cross-pollination and heightened awareness at the oversight/approval level of institutions. The Canadian market suffers from a relative lack of "connecting fibre" to ensure optimal knowledge velocity for PE as an attractive asset class.

This needs to be addressed via information sharing initiatives involving reports and studies, institutional mentoring, seminars, and accessible, independent information repositories.

Strategic Objective 3. Assess feasibility of facilitative mechanisms to enhance participation by institutional investors in PE

There is significant and growing interest in the concept of a so-called "pooling entity" which could be targeted to the needs of new PE institutional investors. The basic motivation for this concept is that many institutional investors have an interest in the idea of PE, but lack the internal capacity – in terms of technical expertise, financial resources, and risk tolerance – to pursue the asset class in an effective manner. A pooling entity may be one way to help institutions address and overcome these barriers to entry.

This should be addressed via a pre-feasibility study examining the pooling concept and its applicability to the Canadian PE asset class in terms of its potential to address market gaps and increase participation by smaller institutional investors. As well, existing market intermediaries (e.g., gatekeepers, fund-of funds managers, etc.) should be engaged to explore other facilitative approaches or mechanisms.

As part of the strategy, certain guiding principles have been developed to outline key considerations and success factors in implementing the strategic objectives. These are:

1. Ensure engagement tools and channels are unbiased and balanced
2. Strategies must be tailored to different institutional investor segments
3. Facilitative mechanisms must be market driven and reflect the ground-up needs of institutional investors
4. Governments have a role to play without distorting the market

Desired Outcome 2:
Identification, by the end of October 2006, of 3 to 5 new institutional investor prospects that are taking preliminary steps toward entering the PE asset class

The project team succeeded in identifying 8 institutional investors that are taking preliminary steps toward entering the PE asset class. These institutions were identified during the course of various engagement activities conducted during the course of the project including the call program, the on-line survey, and follow up one-on-one discussions. The institutions include public and private plans, spanning several geographic regions and industry sectors.

In addition, several other institutions responded to the on-line survey as being “very interested” in learning more about the PE asset class. These institutions warrant direct follow up to better understand their PE interest and future prospects.

Desired Outcome 3:
Demonstrable progress in having established productive working relationships with relevant institutional investor groups or associations

During the course of this assignment, the project team has advanced working relationships with several relevant groups and associations. This includes ILPA and the Federation of Canadian Municipalities. The main objective of these relationship efforts has been to identify opportunities, resources, and contact networks to advance key project activities and set the groundwork for follow-on institutional investor engagement initiatives. For example, ILPA was instrumental in identifying small U.S. institutional investors active in PE for the case studies. Moving forward, there is tremendous potential for furthering relationships with these organizations, and to use these relationships as a springboard for establishing formal ties with others, such as Pension Investment Association of Canada, Association of Universities and Colleges of Canada, and Canadian Association of University Business Officers.

Desired Outcome 4:
Better understanding of how U.S. institutional investors with assets of less than $5 billion have overcome hurdles to participation in the PE asset class

The project team has developed case studies of three U.S. institutional investors active in PE. They are:

Institution Name	Type
State Universities Retirement System (SURS) of Illinois	Public Plan
University Hospitals Health System	Non-Profit Plan
Case Western University	Endowment

Also, a fourth case study of a smaller Canadian not-for-profit organization was conducted. These case studies yielded important findings and lessons learned that will benefit Canadian institutional investors considering the PE asset class. They also helped to identify several key decision factors influencing these institutions' entry into and growth in PE market activity, such as: an engaged and aware oversight body; a sense of not wanting to miss out on an important and growing asset class; cross-fertilization of PE investment ideas and opportunities via industry associations and former employers; use of expert consultants and advisors; and use of fund-of-funds to help diversify relatively small investment amounts.

2. Introduction

International Financial Consulting Ltd. has been charged by Industry Canada (IC) to engage in targeted discussions with selected Canadian institutional investors on PE investments. IC, in partnership with the Canadian Venture Capital & Private Equity Association (CVCA), has identified a need for increased communication and education among existing and potential institutional investors as PE market participants, and wishes to promote a new process for multi-stakeholder discussions in Canada focusing on deepening awareness about related issues and considering alternative strategies for action.

This project and its accomplishments reflect the efforts and contributions of various parties working in a collaborative team approach. International Financial Consulting Ltd. has served as Project Manager, spearheading the activities and coordinating the feedback of other team members. These others consist primarily of members of a sub-committee of CVCA's Institutional Committee. Their participation has been instrumental in such areas as review of project materials, data provision, investor calls, and one-on-one investor meetings. References herein to the project team mean the Project Manager working in conjunction with other team members.

The following desired outcomes were agreed with IC and CVCA at the outset of the project:

1. A strategy for engaging Canadian institutional investors in PE as a new asset class. The strategy will be multi-tiered, comprising a near-term approach for the top 20 investor prospects, a medium-term approach for the next 20 investor prospects, and a longer-term approach for the next 30 investor prospects.
2. Identification, by the end of October 2006, of 3 to 5 new institutional investor prospects that are taking preliminary steps toward entering the PE asset class.
3. Demonstrable progress in having established productive working relationships with relevant institutional investor groups or associations (PIAC, FCM, ILPA, etc.).
4. Better understanding of how U.S. institutional investors with assets of less than $5 billion have overcome hurdles to participation in the PE asset class.

In July, 2006 the Project Manager submitted to IC its Draft Report 1, which set out: (i) progress to date in achieving the above desired outcomes; (ii) key findings from consultations with U.S. institutional investors, as well as with Canadian and international market intermediaries and industry experts; and (iii) next steps for the project. In early October 2006, the Project Manager submitted its Draft Report 2 which outlined discussions and summarized findings from engagement activities undertaken to date with targeted Canadian institutional investors not currently engaged in PE investment.

This Final Report presents the findings and reports on the accomplishments of the project team arising from this assignment. It is a comprehensive reporting document and, as such, it incorporates material from Draft Reports 1 and 2, as well as additional information, analysis, and conclusions.

The report comprises eight sections. Section 1 presents an Executive Summary of the key findings and outcomes. Sections 3 and 4 summarizes the background, key data, and findings from Draft Reports 1 and 2, while also updating some of the original content in these reports to reflect new information received (e.g., new case study, additional responses from the on-line survey, etc.). Those already familiar with Draft Reports 1 and 2 may wish to skip these sections. Section 5, the main focus area for this Final Report, reports on the project team's achievements regarding the above four desired outcomes. Section 6 summarizes the main conclusions of the report.

Finally, it should be noted that considerable market intelligence was generated by the project team during the course of this assignment, some of which was proprietary or commercially sensitive in nature. Such information has been provided to CVCA under separate cover.

3. Situational Context

3.1 The Need for Institutional Engagement

Various private equity market stakeholders – including fund managers, federal government departments and agencies, provincial governments, and industry associations – have been examining the low rate of participation by Canadian pension funds in private equity investment activities.

It does not appear that the issue is one of lack of capital in an absolute sense. Major Canadian institutional investors are pursing significant private equity investment strategies, focused both on domestic and cross-border opportunities. With the past year, Caisse de Depot et Placement du Quebec announced its intention to invest up to $400 million in non-Canadian funds as well as up to $125 million in Canada on investment funds and direct co-investments; further, Canada Pension Plan Investment Board announced late last year a commitment of up to $250 million targeted at small and middle-market buy-out funds and another $150 million to Canadian venture capital funds. Further, some market analysts predict increasing interest by U.S.-based funds in Canadian private equity transactions, given the perceived lower valuations and fewer competitors compared to the U.S. market.[1]

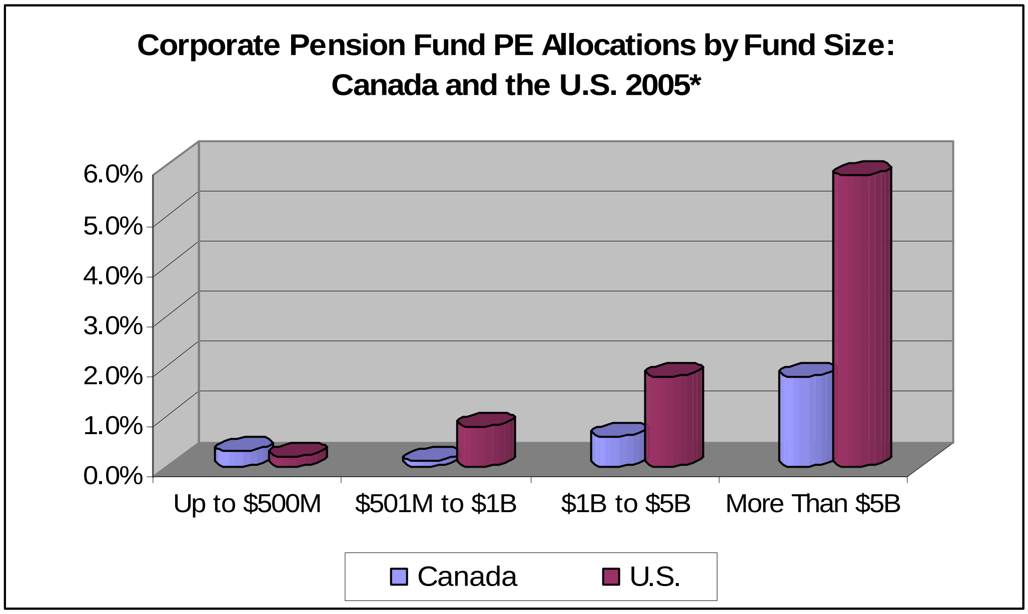
Rather, the main issue is in respect of the breadth of institutional participation, particularly below the so-called "first tier" of major institutional investment capital. Medium to small Canadian institutional investors, those with total assets of around $10 billion and under, are mostly absent from the PE asset class. As a result, overall PE participation rates in Canada are low, both for public and private institutional investors, particularly when compared with the US which has much broad-based participation.

Recent data from Greenwich Associates underlines this situation. Figure 1 shows corporate pension fund allocations to PE (as a % of total assets) by

[1] "Fertile Canada may yield bumper crop of capital" *Pensions & Investments ONLINE*, January 9th, 2006

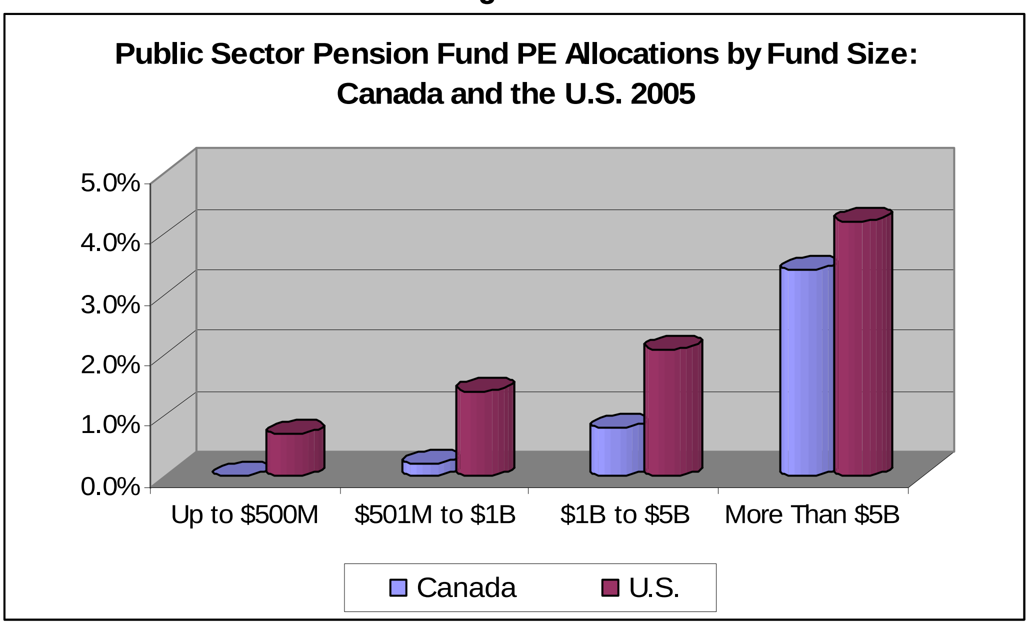
fund size for both Canada and the U.S. for 2005. Figure 2 presents the same data for public-sector pension funds. With the exception of corporate pension funds under $500 million, all fund sizes in Canada (both private and public) have significantly lower levels of PE participation than their U.S. counterparts.

Figure 1



* Excludes pension funds of Canadian subsidiaries of U.S. corporations

Figure 2



IC's report "Finding the Key: Canadian Institutional Investors and Private Equity" identified several challenges inhibiting the participation of Canadian institutional capital in domestic and global private equity. Among its key conclusions and recommendations, the report identified a need for increased communication and education among existing and potential market participants. Further, it proposed a new process for multi-stakeholder discussions in Canada focusing on deepening awareness about related issues and considering alternative strategies for action.

3.2 Factors Impacting on PE Participation rates

From a historical perspective, the combination in the late 1980s and early 1990s of several poorly performing Canadian PE fund managers, a weak domestic economy, and a lack of willingness to seek better investment returns offshore (i.e., U.S. and Europe) led to a very poor experience for many early PE investors, including several smaller institutional investors. As a result, most smaller Canadian institutional investors have never developed a good understanding of PE market dynamics. As a group, these investors remain unconvinced that the PE asset class offers a viable risk-return proposition.

This negative predisposition is sustained by several key inhibitors, summarized in Table 1 below:

Table 1:
Inhibitors to Participating in PE

1. *Awareness and Education*	➢ Perceived risks of the asset class are substantial and entrenched ➢ Often, consultants and advisors to smaller institutional investors have limited experience in PE and thus are not in a position to recommend this asset class to their clients
2. *Trust*	➢ Limited confidence in the ability of the fund manager to generate an attractive return ➢ Absence of "honest brokers" in PE market that are not beholden to a given asset class
3. *Access*	➢ Top quartile performing funds in Canada and the U.S. are often on an "invite" basis only, so new potential investors may effectively be shut out ➢ Many GPs (especially buy-outs) in the U.S., Europe, and – to a lesser degree – Canada are turning down LP funds
4. *Resource Capacity*	➢ Most smaller institutions have limited human resource and technical capacity to develop and implement PE strategies
5. *Risk/Reward*	➢ For a CIO of a smaller fund, a diversification into PE

	Trade-Off	offers little upside ➢ Boards and investment committees can be difficult to convince ➢ PE assets can sit on the books with negative valuations for the early years (the so-called J-curve effect)
6.	*Type of pension plan*	➢ Defined Contribution plans do not lend themselves to PE type investment given the need for daily valuations. ➢ Therefore, plans with Defined Benefits are more likely to be interested in PE.

In considering approaching the PE asset class, a small-institution CIO may succeed in overcoming one or two of the above hurdles, but will soon be overwhelmed by the remaining factors. As a result, status quo becomes a much safer strategy, and the preferred option for most entities. Positions become entrenched, and changing investor motivations and risk perceptions becomes an ever-greater challenge.

4. Summary of Reports 1 & 2

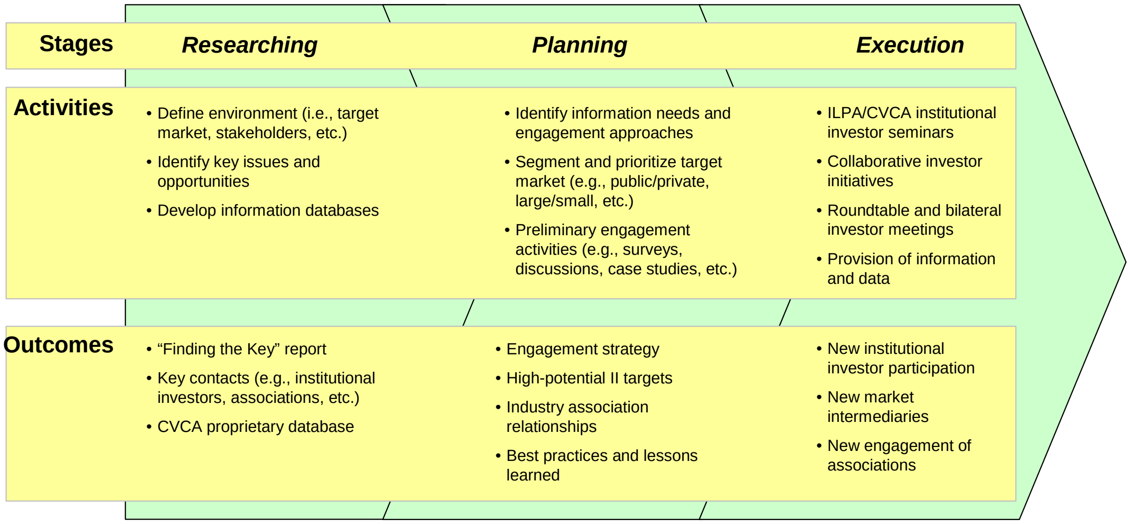
4.1 Context for Engagement Activities

To better understand the approach and methods used by the project team to engage institutional investors, it is helpful to place these activities in the context of recent, current, and prospective activities targeting Canada's institutional investor community.

Figure 3 below positions the project team's activities within the broader picture of institutional investor engagement described above. More particularly, it positions project activities within an overall engagement process, with a view to promoting more effectively greater participation by investors in the PE asset class. The engagement process as shown spans the range of activities from early-stage researching, through to intermediate-stage planning, to later-stage execution. At each stage, key outputs are targeted, achieved, and consolidated prior to advancing to the next stage.

Figure 3

Institutional Investor Engagement Process



A successful engagement process reflects careful concerted planning of both direct (e.g., bilateral presentations, road shows, roundtables, etc.) and indirect measures (e.g., associations, market intermediaries, facilitation mechanisms. Further, it combines pro-active outreach activities, as well as more passive communication approaches (such as the ability to access and download PE market information, fund data, industry contacts, government representatives, etc.).

4.2 Engagement Accomplishments

The project team has undertaken a range of activities aimed at further engaging the Canadian institutional investor community regarding the PE asset class. The main engagement accomplishments are summarized below.

U.S. Institutional Investor Case Studies

The project team researched and prepared a series of case studies describing the approach and strategies of small to mid-size U.S. institutional investors for entering the PE asset class. To a large degree, the challenges and issues facing smaller institutional investors in Canada have been faced – and overcome – by numerous small institutions in the U.S., many of which entered the PE asset class in the early to mid-1990s.

As such, the main purpose of the case studies is to be able to transmit best practices and lessons learned from like-minded institutional investors in the U.S. to their counterparts in Canada. The case studies may also help to inform the development of policy options by IC or others.

In preparation for interviews with U.S. institutional investors, the project team drafted an Interview Guide (see Annex 1) and a preliminary list of target investors with assets less than US$5 billion. These documents were vetted by select CVCA Institutional Committee members, and the project team followed-up with members to obtain additional target investors for interviews. As well, the team consulted with the Institutional Limited Partners Association (ILPA) for their views on the U.S. interview and case study process.

The project team then directly contacted more than ten U.S. institutional investors to request interviews. In addition, the ILPA agreed to solicit its membership for participation in the interview process. In all, four interviews were conducted with U.S. institutional investors and three case studies were prepared.

Identification of Target Canadian Institutional Investors

In working toward achieving the desired outcomes of the project, the team has focused primarily on those Canadian institutional investors which were identified as high-potential in the Consultation Strategy dated May 31, 2006. Generally, high potential institutions were defined as those institutional investors that are interested in considering participating in the PE asset class, but are not currently investing in this area. In most cases, these institutions had never been engaged in PE activities; however, certain of the investors had prior PE investing programs or activities but had withdrawn for various reasons.

These “target” institutional investors, which were derived from CVCA’s proprietary database sources, comprise a range of investor types, including public and private plans as well as endowments. The investors range considerably in size from over $13 billion to under $1 billion in total assets. Further, they differ in awareness and understanding of alternative investments generally, and PE in particular.

Call Program

The project team and members of the sub-committee of the Institutional Committee of the CVCA carried out a call program over the period from August to early October 2006, taking account of the difficulties to access people by phone during the summer period. The purpose of the call program was to make contact with those target institutional investors with which sub-committee members had prior contact or an established relationship, or where a member had knowledge of the institutional investor’s interest in the PE asset class.

In all, more than approximately half of the institutional investors on the target list were contacted. Of these, 11 institutions provided feedback and input to the engagement process.

The institutional investors contacted under the call program were apprised of the current efforts to increase awareness and engagement of the institutional community in the PE asset class. Further, an assessment was made regarding the best means of further engaging such investors.

Institutional Investor On-Line Survey

In August-September, 2006 the project team conducted an on-line survey for Canadian institutional investors. The survey was designed to provide a brief introductory contact with institutional investors not currently active in the PE asset class. In particular, the survey questions sought to determine: (i) whether the institution has (or ever had) an active PE allocation; (ii) the institution's level of interest in learning more about PE as an asset class; and (iii) for those institutions interested in learning more, via what means they would like to receive information. The survey is presented in Annex 3.

The survey was conducted in two phases. First, in early September the survey was sent to the target list of institutional investors, except for certain institutions which were already contacted during the call program and those where a pre-established relation existed with sub-committee members. As well, the survey was sent to all institutions (e.g., Dalhousie University) that had been invited to attend the Rotman/ICPM seminar in November 2005 hosted by CVCA on PE, but had not been included on the original target list because of total asset size or other factors.

Second, the survey was sent to a wide range of smaller Canadian institutional investors contained in CVCA's investor database. It should be noted that none of these smaller institutions had been considered by CVCA to be high-potential investors in PE; however, the project team believed that there was merit in making contact with these institutions, since the incremental effort in doing so was relatively small and the potential benefit in terms of identifying investor interest could be significant. As it turned out, several responses were received from these smaller institutions expressing substantial interest in learning more about PE.

In all, some 700 institutions were contacted, including approximately 65 from the target list. Of those contacted, 33 had responded by the date of this Final Report; this includes 12 from the target list of institutions. Overall, the survey response rate is considered to be quite positive, given the normal challenges in getting feedback from this traditionally resource-constrained group of institutions.

The survey has succeeded in identifying several new high-potential institutions. Also, helpful feedback has been obtained on the types of institutional investors interested in learning more about PE and their preferred means of engagement.

Detailed Investor Database

The feedback and data from the call program and the on-line survey were compiled by the project team in an investor database. This database builds on and refines the information contained in the original institutional investor database provided to the project team by CVCA. Further, it provides a basis for more refined analysis of investor interest and informational preferences, as outlined in Figure 8 below.

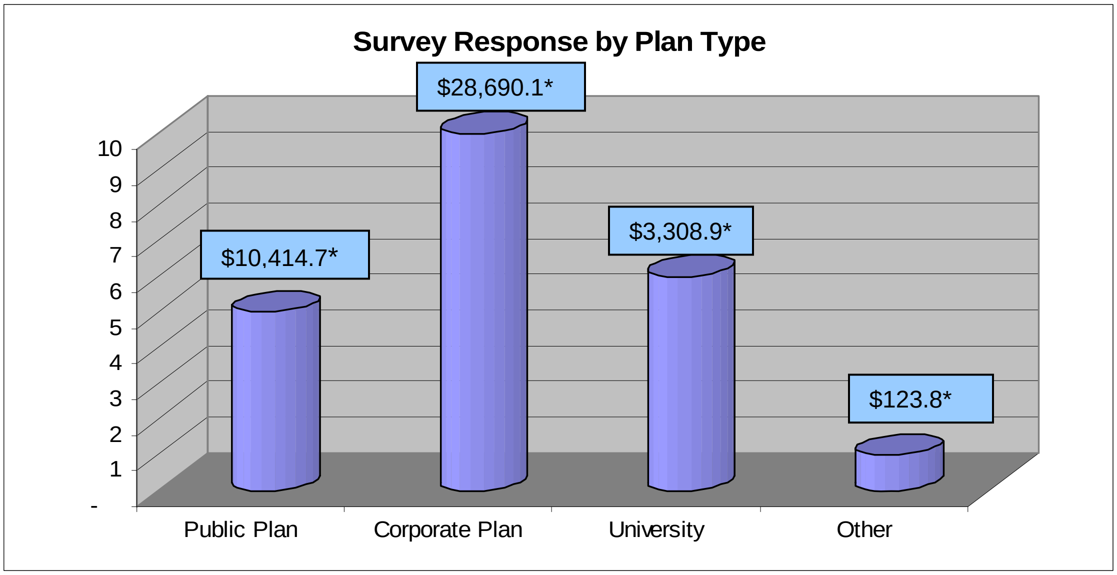
4.3 Review of Survey Results

Survey Respondent Type and Level of Interest

Of the 33 total survey respondents, 24 indicated that they are either “a bit”, “somewhat”, “very”, or “extremely” interested in learning more about PE as an asset class. As such, these respondents have been listed as “high potential” institutions and are the subject of the analysis in this section. A few survey respondents, having taken the time to reply to the survey, indicated that they were “not at all” interested in learning more about PE.

The high-potential target group is broadly based. The 24 respondents represent some $42.5 billion in total assets. They comprise public, private, university, and other types of entities (see Figure 4). Among public-sector entities, both provincial and municipal entities are represented; as well, these entities spanned a range of geographic areas. Private-sector entities span several industry sectors, including natural resources, manufacturing, transportation, and financial services. Corporate plans provided the most responses, followed by universities, and then public plans.

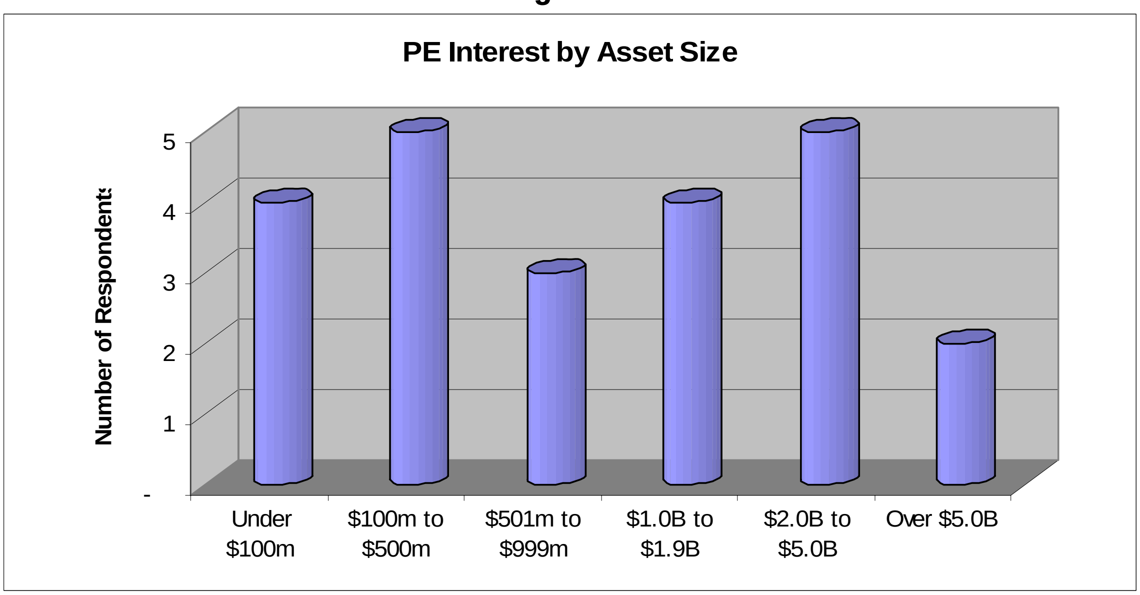
Figure 4



* Total Assets (Billions)

It is notable that much of the respondent interest came from relatively smaller institutional investors (see Figure 5). Of the 24 high potential respondents, fully half have totals assets under $1 billion. Further, several very small investors were among those expressing the greatest interest in obtaining more information about PE.

Figure 5



The level of interest in obtaining further information regarding PE centered in the "somewhat" to "very" interested range (see Figure 6). On the whole, corporate plans expressed a slightly lower degree of interest than did public plans. In terms of interest level by asset size, institutional investors representing some $12.7 billion indicated that they were "very" to "extremely" interested in receiving more information (see Figure 7).

Figure 6

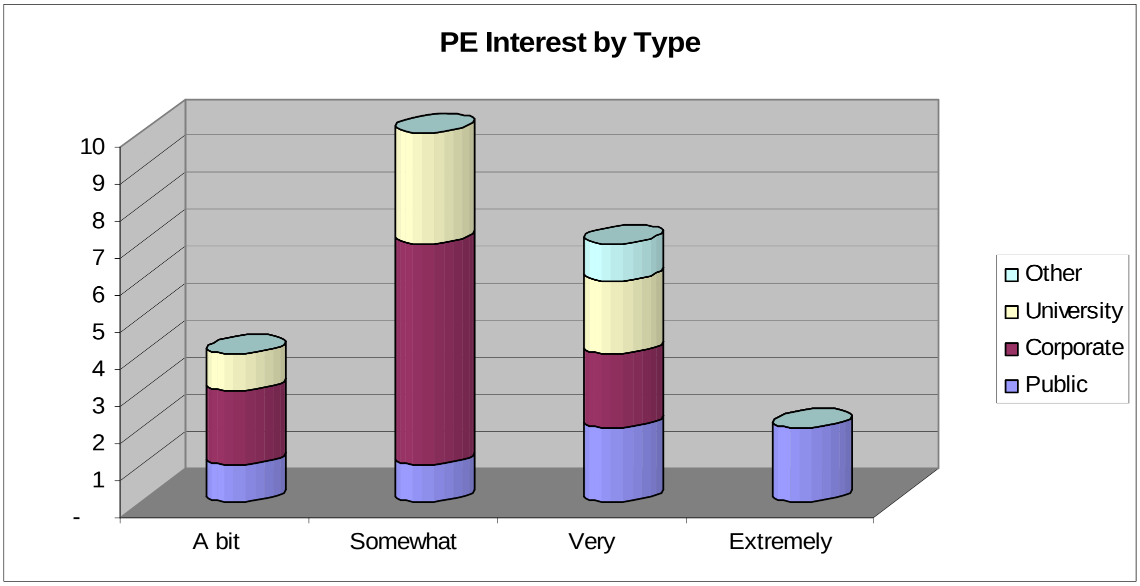
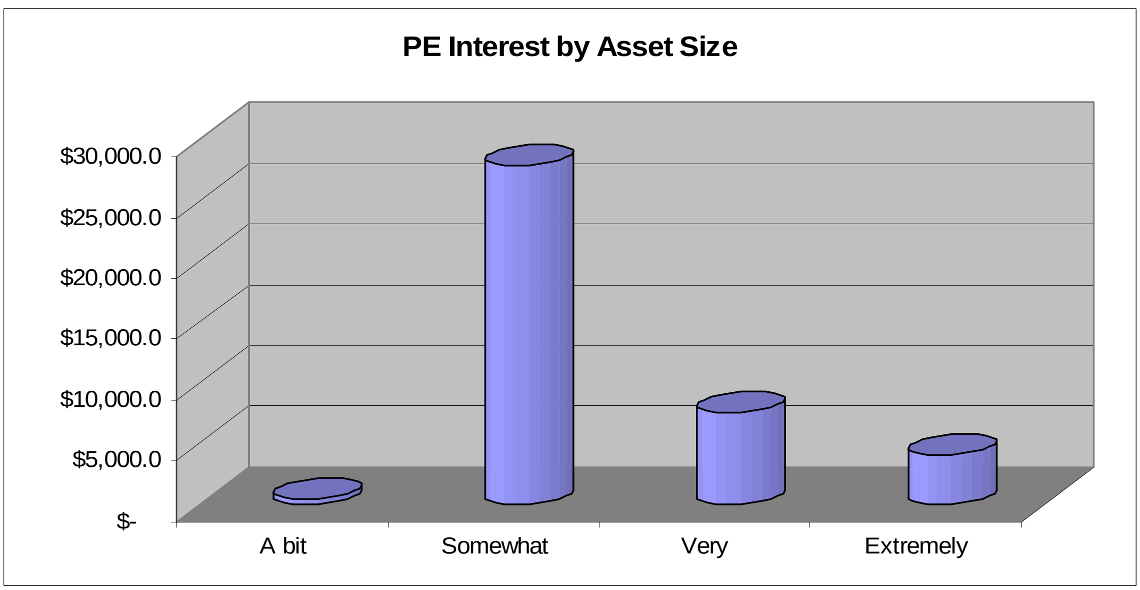


Figure 7



As Figure 7 above shows, larger institutional investors were "somewhat" interested in learning more about PE, while small to mid-sized were very or extremely interested. It may be the case that, generally speaking, larger institutional investors are relatively more informed about PE than smaller institutional investors (e.g. they get approached more often by fund managers, gatekeepers, etc.). However, it became apparent via consultation activities that those smaller institutional investors that were interested in PE had done their homework and they were quite informed about the risks and rewards of the asset class. Several of the smaller institutional investors have even done some thinking on pooling-type approaches and were keen to be involved in future engagement activities in this area.

Investor Information Preferences

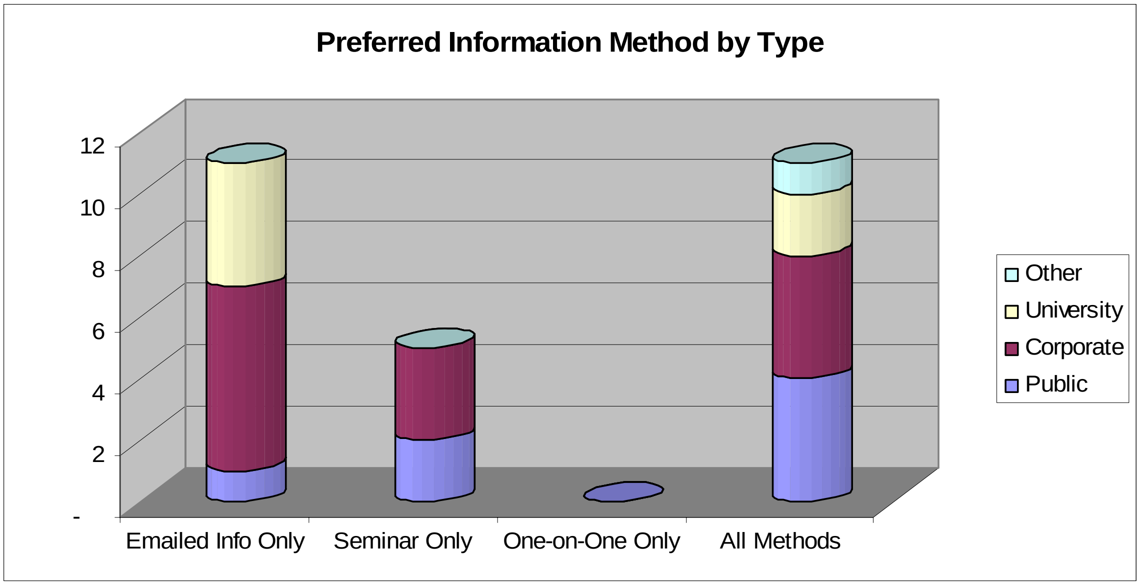
As part of the survey, respondents indicated their preferred means of receiving more information regarding the PE asset class, by choosing from among several options. As summarized in Figure 8, the preferred engagement methods varied significantly according to entity type.

Universities preferred either emailed information only, or some combination of all information methods. While corporates expressed interest in different forms of engagement, their greatest interest was in receiving emailed information. This indicates a possible split between those entities that simply want to receive information before deciding to become more fully engaged, and those that are willing to be engaged face-to-face.

By comparison, public plans agreed with a range of engagement options, but were most likely to prefer the “all methods” option. This suggests that these plans are less likely to become engaged via emailed information, and more likely to be interested in “in person” messaging.

Further, it is worth noting in Figure 8 below that no respondents saw benefit in engagement activities involving only “one-on-one” discussions. This suggests that institutional investors want to make their decisions on pursuing the PE asset class by assessing multiple information sources via several different forms of engagement. It is likely that exclusive one-on-one approaches were not preferred as such situations can feel intimidating – more like a sales pitch with the expectation that they will “buy” than an information exchange about the asset class in general.

Figure 8



5. Report of Desired Outcomes

The following sections present the results of the project teams' engagement activities in the context of the four desired outcomes discussed above.

5.1 Desired Outcome 1: *A strategy for engaging Canadian institutional investors in PE as a new asset class*

The overall objective for this desired outcome is to increase the level of engagement among Canadian institutional investors in the PE asset class. For the purposes of the overall strategy, the concept of "engagement" has two components. The first is *awareness*, that is, the degree of information, knowledge, and expertise that is both credible and unbiased, and that an institutional investor can access in a timely, complete, and effective manner. The second is *participation*, that is, the establishment by institutional investors of PE allocations or the increase in existing allocations, and the investment activities relating thereto.

The strategy comprises three strategic objectives and four guiding principles. The strategic objectives set out the specific activities, timing, and metrics designed to achieve the overall objective. The guiding principles outline the key considerations and success factors governing the implementation of the strategic objectives.

5.1.1 Strategic Objectives

1. *Identify and align "communities of interest" among institutional investors*

Alternative asset classes generally, and the PE asset class specifically, are relatively unfamiliar to most smaller institutional investors. This lack of familiarity, combined with the perceived riskiness of PE investment activity, means that an institutional investor considering the PE asset class will want to do its homework on the PE market itself, and the experiences and lessons learned of other like-minded investors that have considered or – better still – have invested in PE.

Unfortunately, there are few such communities of shared interest. Perhaps the most significant Canadian organization is Pension Investment Association of Canada (PIAC). PIAC's members represent over $700 billion in Canadian institutional investor assets, including some $28 billion allocated to venture capital and other private equity investments. However, the PE activity of PIAC members tends to be concentrated among a limited number of large pension funds. The exposure to PE and market awareness of many of PIAC's medium and smaller pension fund members is more limited.

The Institutional Limited Partners Association (ILPA) is a Canada-based, non-profit organization serving limited partner investors in the global private equity industry. This association is a logical home for institutional investors active in PE to exchange views, experience, and information. However, ILPA is not well known in Canada – in fact, most of its membership is from outside Canada. Moreover, the association would tend to attract institutions that are already LPs (i.e., active PE investors), as opposed to institutions at the earlier stages of considering participating in the asset class.

There are numerous other types of associations in which institutional investors (or their broader organizations) may participate. However, these associations do not have a main focus (or interest) in the area of institutional investment, let alone PE. For example, most municipalities with employee pension plans belong to Federation of Canadian Municipalities which is mandated to promote the interests of Canadian cities and towns. However, FCM is not in a position to pro-actively assist communities with their institutional investment strategies or activities.

Similarly, the Association of Universities and Colleges of Canada (AUCC) represents 89 Canadian public and private not-for-profit universities and university-degree level colleges, many of which have employee pension plans. As well, Canadian Association of University Business Officers (CAUBO) supports professional management in the administrative affairs of Canadian universities and colleges. However, within these associations, as with FCM, there is little if any pro-active focus on institutional investment activities.

Key Priorities and Action Areas:

- Identify and prioritize key organizations/associations for increased awareness and interaction initiatives regarding the PE asset class.
- Augment bilateral discussions with high-priority organizations and associations (e.g., ILPA, PIAC, FCM).
- Facilitate dialog and interactions between key like–minded organizations/associations (e.g., ILPA and CAUBO; PIAC and FCM; etc.).

2. *Increase "knowledge velocity" among institutional investors to accelerate awareness and expertise among decision-makers*

"Knowledge velocity" refers to the transfer and dissemination of relevant PE market information to key decision makers within the institutional investor community. More than mere accessibility of information, it refers to the speed at which such information can travel, as well as the magnitude and sophistication of such information in the market. It deals with the underlying capacity of market channels to transmit – and institutional recipients to process – such information. Moreover, it deals with how information is translated into useful insights for prospective PE participants.

Knowledge velocity has been a critical factor in the growth of institutional PE investment activity in the US over the past decade. Two key drivers of this velocity have been most apparent. The first driver is the transfer of PE investment experience and best practices at the operational level of institutions. There are numerous instances of experienced PE investment personnel at large institutions that became CIOs of smaller institutions and brought their PE market knowledge and track records with them. Similarly, the U.S. offers examples of so-called "pooling" initiatives which have assisted in accelerating the knowledge, awareness, and participation on institutional investors in PE. One such example is the Common Fund which has successfully engaged university endowments in ever-greater PE investment activity.

Commonfund

The Common Fund for Nonprofit Organizations ("Commonfund") is a U.S. tax-exempt membership corporation operated by and for its member colleges, universities, and independent schools. Its mission is to improve investment management practices and to enhance financial resources of the nonprofit community.

Commonfund was organized in 1969 and commenced operations on July 1, 1971. It is an organization without shareholders. Members' fees and other revenues support the organization as a whole and are not allocated for the benefit of particular funds or private owners. Commonfund is governed by a Board of Trustees elected by the members. At the end of 2005, Commonfund had 1,226 members.

Commonfund offers to its members a series of pooled investment funds. For each investment fund, Commonfund's captive management company identifies investment strategies, allocates portfolio assets among these strategies, selects investment managers within each strategic category, and allocates portfolio assets among them. It then monitors management performance, increasing or decreasing allocations, and terminating and replacing managers as appropriate. Total assets of the investment funds of Commonfund were over US$36 billion as of December 31, 2005.

Commonfund believes that, because of its size and experience, it can provide investment and diversification opportunities that would not otherwise be available to most endowments. Further, it believes it can provide a level of monitoring of managers and the capacity to make needed adjustments that are not feasible or efficient for most endowments.

Adapted from "Information for Members, January 2006", available at www.commonfund.org

Second, cross-pollination and heightened awareness at the oversight/approval level of institutions. For example, many of the high net worth individual investors in earlier major private equity funds (such as Kohlberg Kravis Roberts) gained valuable PE investment experience that they were able to transfer to university endowments with which they served as trustees. As a result, it is not unusual for the trustee-level of institutions to press for greater participation in alternative assets (including PE) for fear of "missing the boat" on attractive investment return opportunities.

By comparison, the Canadian market suffers from a relative lack of "connecting fibre" to ensure optimal knowledge velocity for PE as an attractive asset class. This is particularly the case at the institutional oversight and approval levels (e.g., the boards of trustees), which often press for greater portfolio returns without an awareness of the need to consider alternate asset classes as a means to achieve such returns.

Institutional Investor Engagement Seminars

In order to accelerate knowledge velocity for PE, institutional investors must have greater access to like-minded institutions that have succeeded in the asset class. One possibility is to hold a series of seminars/workshops across

Canada (e.g., Toronto, Montreal, Ottawa, Calgary, Winnipeg) designed to engage high-potential target institutional investors. ILPA has indicated an interest in helping to sponsor and conduct these seminars. Other associations representing the interests of institutional investors – such as PIAC, CAUBO, or FCM – may also be interested in supporting the seminars.

The events would serve as a forum to engage investors in a constructive and educational environment, by enabling Canadian institutions to network and learn from U.S. institutions of a similar size and scope that have enjoyed success in PE. The ILPA is an association whose membership includes Canadian, US and international institutional investors involved in PE and thus would serve as a neutral platform to attract those players which have – for whatever reasons – been reluctant to participate.

It would be important to ensure that these seminars are different than other recent roundtable events targeting Canadian institutional investors not currently active in PE (such as the Rotman ICPM event). At many of these prior events, smaller institutional investors for whom scale and costs were an issue, did not feel that the larger PE investors faced the same challenges. Further, where these events have been sponsored and organized, directly or indirectly, by CVCA, they may be seen by potential institutional investors as having too much of a vested “marketing” interest.

The proposed seminars should be structured in a way that is more conducive to engaging Canadian investors in a peer-to-peer dialog on the benefits of the PE asset class. Ideally, the U.S. speakers would represent a mix of corporate and public pension plans and foundations. These seminars would serve as a forum where potential LPs can meet PE-active LPs of a similar size and nature – LPs that have faced the same issues and overcome the same challenges, with success; LPs that have become familiar and comfortable with the PE asset class. The branding of ILPA and/or other such associations would be an additional comfort factor for Canadian institutions, since the direction and focus of these associations are more closely aligned with their interests and concerns.

Each seminar should be in the form of a breakfast or lunch roundtable. Participation would be by invitation only, with up to 20 participants per session. Each session should be moderated by a recognized industry professional with an excellent standing and reputation with the participants.

The session should cover two main subject areas: (i) opportunities and challenges in the Canadian PE market; and (ii) best practices and lessons learned by small institutional PE investors. A draft generic session agenda is provided in Annex 4.

It is anticipated that each such session would cost no more than $5,000, depending on the venue and other logistics.

Key Priorities and Action Areas:

- Send documentation (i.e., case studies, FTK Report, etc.) to on-line survey respondents that requested further information.
- Assess the feasibility of establishing a PE “mentoring” system, whereby institutions or associations (e.g., ILPA) active in PE as LPs help coach institutions of a similar size and focus that are interested in the PE asset class.
- Organize seminars (as described above) across Canada to engage high-potential target institutional investors with like-minded institutions already active in PE.
- Establish a central on-line repository of PE information (e.g., market performance data, PE fund managers, association links, etc.) that is credible, comprehensive, and independent, and which can be accessed by institutional investors interested in the PE asset class.

3. *Assess feasibility of facilitative mechanisms to enhance participation by institutional investors in PE*

There is significant and growing interest in an emerging concept which may prove to be beneficial in engaging institutional investors in the PE asset class. The concept is a so-called “pooling entity” which could be targeted to the needs of new – and especially smaller – PE institutional investors.

The basic motivation for this concept is that many smaller institutional investors have an interest in the idea of PE, but lack the internal capacity – in terms of technical expertise, financial resources, and risk tolerance – to pursue the asset class in an effective manner. A pooling entity may be one way to help institutions address and overcome these barriers to entry.

Of note, there are at least two segments of “smaller” institutional investors for which the pooling concept could hold appeal. One group is mid-size institutions with assets between $5 billion and $10 billion. These institutions are typically large and sophisticated enough to make their own direct investment in PE funds (as opposed to using a fund-of-funds approach), but still see benefit in formally associating with other institutions in order to share information and spread the cost and risk of managing PE investment activities.

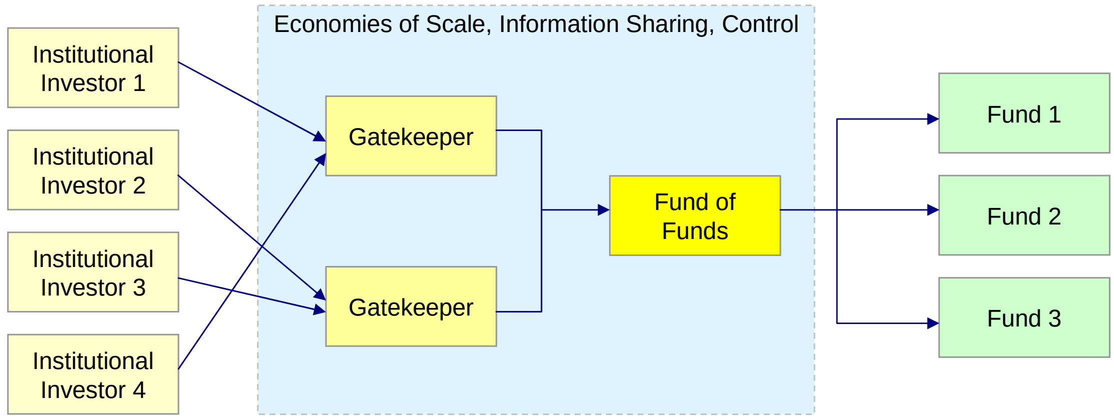
Another group is very small institutions, with assets of less than $1 billion. Because of their size, they often lack the internal resource capacity to manage and monitor PE investment activities. While pursuing a fund-of-funds approach may be an option, a pooling approach may be more attractive in terms of its ability to more effectively represent the interests and “mutualize” the costs and risks of a group of small LPs amongst themselves.

Structurally, a “pool” is a collection of institutional investor funds that is managed by a third party (such as a gatekeeper). The third-party manager would identify and help the pool participants access PE fund (or more likely fund of funds) investment opportunities. In essence, the pool manager can be viewed as a “multilateral gatekeeper”, in that it provides many of the same services as a gatekeeper would for a single client, but under the pooling scenario it would be providing these services to a number of institutions at the same time. Depending on needs of institutions, possible pooling approaches could fall anywhere on a spectrum from more virtual-type models focusing on information sharing and best practices, to actual pooled investment funds with a formally engaged fund manager.

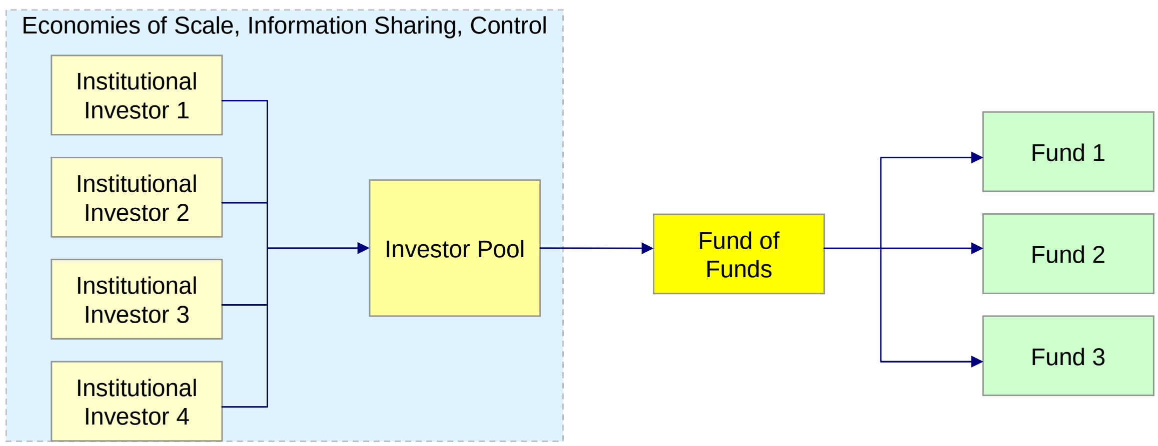
The diagram below conceptually illustrates the potential benefits to investors of a pooling approach. Under normal circumstances (i.e., without pooling), investors individually seek out investment channels, sometimes directly with fund managers, but often by engaging market intermediaries such as gatekeepers or funds-of funds. Unless the institution has a very large PE asset allocation, it is unlikely to be in a position of influence or control; rather, this rests primarily with the market intermediaries. Further, there are limited opportunities and capacity for information sharing among investors.

Under a pooling scenario, investors have the potential to exert greater influence and control over their investment activities, since the critical mass of investment funds is shifted from traditional market intermediaries/ mechanisms toward the investor pool. Since investors collaborate in the pooling structure, there is much greater scope for information sharing and dissemination of market intelligence.

Investment Flow – Without Pooling



Investment Flow – With Pooling



For institutional investors, the potential benefits of the pooling structure could include: (i) a greater ability to share information, expertise, and best practices among different institutional investors, large and small; (ii) a lowering of barriers to entry to the PE market, especially for smaller institutions, since fees, costs, and risks would be spread among a number of pool participants; and (iii) as a result, improved operational economies of scale for PE investors. For existing market intermediaries (such as gatekeepers and fund-of funds managers) that may be interested in helping to manage pooled fund structures, the concept holds the potential to augment their business models by making new investment capital and new institutions available to them.

It should be noted that the pooling concept is not new. It has been used in the U.S. to help introduce and augment PE market participation by university endowments (the Common Fund, see box above). There are also Canadian models which have been used in alternative asset classes other than PE such as real estate.

Through discussions with various institutional investors, there appears to be interest in convening a working group to identify one or more institutional "champions" for the pooling initiative. Some possible candidates have been identified.

Key Priorities and Action Areas:

- Conduct a pre-feasibility study on the pooling concept and its applicability to the Canadian PE asset class in terms of its potential to address market gaps and increase participation by smaller institutional investors.
- Appoint a public-private steering committee to oversee the feasibility study and make recommendations regarding a pooling initiative.
- Engage existing market intermediaries (e.g., gatekeepers, fund-of funds managers, etc.) to explore other facilitative approaches or mechanisms for increasing PE participation by institutional investors.

5.1.2 Execution Plan for Strategic Engagement

Below is a table of proposed time lines and responsibilities for carrying out the various key priorities and action areas associated with each of the Strategic Objectives.

Key Priorities and Action Items	**Time Line (Near, Medium, Long Term)**	**Responsibility**
1. Identify and align "communities of interest" among institutional investors		
Identify and prioritize key organizations/associations for increased awareness and interaction initiatives regarding the PE asset class.	Near Term	Government, CVCA
Augment bilateral discussions with high-priority organizations and associations	Near Term	Government, ILPA
Facilitate dialog and interactions between key like–minded organizations/associations	Near Term	Government, ILPA
2. Increase "knowledge velocity" among institutional investors to accelerate awareness and expertise among decision-makers		
Send documentation to on-line survey respondents that requested further information	Near Term	Government
Assess the feasibility of establishing a PE	Medium Term	Government, ILPA

"mentoring" system, whereby institutions or associations active in PE as LPs help coach institutions of a similar size and focus that are interested in the PE asset class.		
Organize seminars across Canada to engage high-potential target institutional investors with like-minded institutions already active in PE.	Near Term	Government, ILPA
Establish a central on-line repository of PE information that is credible, comprehensive, and independent, and which can be accessed by institutional investors interested in the PE asset class.	Medium Term	Government, CVCA
3. Assess feasibility of facilitative mechanisms to enhance participation by institutional investors in PE		
Conduct a pre-feasibility study on the pooling concept and its applicability to the Canadian PE asset class in terms of its potential to address market gaps and increase participation by smaller institutional investors.	Near Term	Government, CVCA, ILPA
Appoint a public-private steering committee to oversee the feasibility study and make recommendations regarding a pooling initiative.	Near Term	Government, CVCA, ILPA
Engage existing market intermediaries (e.g., gatekeepers, fund-of funds managers, etc.) to explore other facilitative approaches or mechanisms for increasing PE participation by institutional investors	Medium Term	Government

5.1.3 Guiding Principles

1. *Ensure engagement tools and channels are unbiased and balanced*

In considering participating in the PE asset class, institutional investors – both at the operational level and the oversight/approval level – need information, advice, and guidance. Inevitably, institutional investors receive many approaches from funds managers, fund-of-funds, and gatekeepers seeking their investment interest. CVCA also engages in various outreach initiatives, either directly or indirectly (e.g., the Rotman session in late

2005). While these sources do provide helpful advice and insight to institutional investors, many such sources are inevitably viewed by institutions as having their own agenda and as putting their own spin on facts and data.

Thus, institutional investors often seek to augment this information and advice with other sources that would be considered more objective and credible. The survey responses and feedback received in the Call Program were clear and consistent in that institutional investors that are interested in possibly participating in the PE asset class wish to obtain objective facts and data from reliable sources. What is perhaps most interesting are the desired information and engagement channels. For the most part, institutions do not favour obtaining such information or advice via one-on-one meetings. Rather, they prefer to participate in seminars and roundtables, or to receive hard-copy information. Further, the type of information is notable; most institutions indicate a strong preference for obtaining case studies that highlight success stories and lessons learned for like-minded institutions, particularly in terms of asset size. Group events and hard copy materials that provide this information would be welcome. By the same token, smaller institutions do not see value in hearing the views of larger and more established institutional investors, since they do not face the same challenges and constraints.

2. *Strategies must be tailored to different institutional investor segments*

In implementing the engagement strategy, it is important to recognize that different institutions have different engagement preferences and information needs. A critical component in developing an engagement strategy is to try to organize and segment the various preferences, needs, and other factors relating to the potential universe of institutions being targeted.

This likely entails segmenting the same set of institutions in different ways in order to identify separate segments that need to be addressed using different activities and approaches. Further, this could mean initially identifying a limited number of major segments, and then identifying sub-segments within each major segment.

For example, it may be helpful to divide the universe of institutional investors initially by total asset size, such as: greater than $10 billion, between $5 billion and $10 billion, between $1 billion and $5 billion, and less than $1 billion. Within each of these major segments, institutions could be divided according to several different dimensions, such as: (i) level of interest in PE as an asset class; (ii) stage of preparedness to establish a PE investment allocation; and/or (iii) preferred forms of engagement. For larger institutional investors, it may be of interest to segment by private versus public, and to further segment public according to federal, provincial, municipal, or other. Also, it may be important to separate public/private from endowment/university pension plan, if it is deemed that the latter category has certain unique needs or opportunities.

Further, much of the focus to date has been on identifying institutional investors of a significant total asset size (i.e., more than $1 billion) that may be interested in considering a participation in the PE asset class. However, the results of the on-line survey – which was sent to some 700 Canadian institutional investors – indicated a significant degree of interest in the PE asset class from much smaller institutions, with total assets of less than $1 billion.

In many cases, these institutions have been approached bilaterally by various market players, including gatekeepers, advisors, and fund-of-funds managers. However, there has been little if any engagement of these institutions from "non-partisan" intermediaries. As a result, these institutions are left to do their own research and identify their own like-minded contemporaries.

Given their small size, limited internal resources, and relative lack of PE market awareness, these institutions may be good candidates to consider participating in pooling or similar collaborative initiatives. Some of these entities are already familiar with these concepts in general terms and would be keen to contribute to feasibility studies in this area.

3. *Facilitative mechanisms must be market driven and reflect the ground-up needs of institutional investors*

In considering new facilitative mechanisms to help increase participation by institutional investors in the PE asset class, it is important to ensure that any such proposed mechanisms are market-driven and effectively address key market gaps. Further, the concept of a market gap and how to address a gap is not always straightforward. For example, gaps may exist simply because demand exceeds supply, or supply may exist but at a cost that Canadian institutional investors are not willing to pay.

Whatever approaches are pursued, these must "work with the grain" of existing market mechanisms and players. In the case of PE, existing market intermediaries such as gatekeepers and fund-of-funds managers have key roles to play in mobilizing investment capital and working with both institutional investors and fund managers. New facilitative mechanisms, if introduced, must complement, not compete with, these existing entities. Therefore, it is critical to ensure a detailed understanding of what the existing market is prepared to do in the light of the needs to smaller investors. For example, one fund-of-funds manager indicated that they would be in a position to accept twenty individual investments of $5mn each.

As such, any proposed mechanisms should be a measured response to the market gaps, and positioned in a way that does not distort market characteristics, impede existing mechanisms, or operate in a part of the market which currently works well or in which existing players would otherwise be willing to operate. Further, it can be dangerous to leap immediately to “big bang” solutions (e.g., a major new pooling structure) without first considering other more incremental approaches, as these can impose unintended adverse consequences on the existing market landscape.

4. Governments have a role to play without distorting the market.

It should be recognized that governments at all levels in Canada (i.e., federal, provincial/territorial, municipal) all have a stake in this issue, and all have potential roles to play in moving initiatives forward. Governments can serve many functions, such as acting as honest brokers of market information, initiating and growing relationships between different groups of stakeholders, providing local presence and support, and underwriting certain costs and risks.

For example, governments could potentially play a role (at both the federal and provincial levels) in supporting the development of a pooling concept. They would also be a good candidate to host some form of information “portal” for PE market data and contacts, if such an information forum is deemed desirable.

In considering which roles it is willing to play, government must ensure that it does not distort existing market characteristics or mechanisms. For instance, there is a perception that government support for a pooling concept may be conditional on ensuring the resulting institutional investment activity remains within Canada. Thus, if government is involved, it should endeavour to play a facilitative or catalytic function, with limited if any involvement in deciding on or influencing actual operational aspects.

5.2 Desired Outcome 2: *Identification, by the end of October 2006, of 3 to 5 new institutional investor prospects that are taking preliminary steps toward entering the PE asset class*

The project team has identified 8 institutional investors that are taking preliminary steps toward entering the PE asset class. These institutions were identified through various engagement activities conducted during the course of the project, including the call program, the on-line survey, and follow up one-on-one discussions. Several of these institutions are included on the original target list of 70 institutional investors. They range in total asset size from around $100 million to over $10 billion; also, they vary in their stage of preparedness in considering the PE asset class.

In addition to the 8 identified institutional investors, several other institutions responded to the on-line survey as being “very interested” in learning more about the PE asset class. Since it was not possible during the project period to corroborate this feedback with direct discussions with these institutions, they have not been included in the list of 8. However, they do warrant direct follow up to better understand their PE interest and future prospects.

5.3 Desired Outcome 3: *Demonstrable progress in having established productive working relationships with relevant institutional investor groups or associations*

During the course of this assignment, the project team has advanced working relationships with several relevant groups and associations. An overview of these activities and areas for further development are discussed below.

Institutional Limited Partners Association

The Institutional Limited Partners Association (ILPA), based in Toronto, is a non-profit organization serving PE limited partner (LP) investors by providing a forum for communication, education, and promoting PE research and standards. Initially founded as an informal networking group, ILPA is a voluntary association funded by its members.

It comprises more than 155 members from 10 countries, including representation from North America, U.K., Europe, Asia, and the Middle East. The membership consists of corporate and public pension plans, endowments and foundations, insurance companies and other institutional investors in private equity. These members have total assets under management in excess of five trillion U.S. dollars, with more than US$500 billion of PE investments.

ILPA describes itself as the only global organization dedicated to the interests of institutional LPs active in PE. It employs a strict LP-only forum for the private exchange of information, networking and relationship building. This is particularly relevant in the context of this assignment, given the perception of many Canadian institutional investors that there are insufficient sources of credible, unbiased information on the PE market and investment opportunities.

The ILPA sees considerable benefit in helping raise awareness and participation levels among Canadian institutional investors not currently active in the PE asset class. As such, it has provided assistance to the project team in identifying U.S.-based institutional investors for case study profiles, and has contributed to discussions on the informational and other barriers inhibiting greater participation by Canadian institutional investors.

Also, as discussed further below, it has expressed interest in supporting seminars or similar fora designed to engage high-potential target institutional investors in Canada. This could involve an ILPA “branding” of the event, as well as assistance in identifying event participants and moderators. ILPA support for such seminars could be a key success factor in making Canadian institutional investors more comfortable with the PE asset class, given the association's clear alignment of interests with the LP side of the market.

Federation of Canadian Municipalities

Feedback from the on-line survey and the call program suggest that there is an appetite amongst municipalities for learning more about PE. As such, the project team held an initial meeting with the Federation of Canadian Municipalities (FCM), based in Ottawa, to determine the scope for working with FCM to provide information or hold seminars for their members, and in particular those municipalities that expressed an interest in PE via the on-line survey or call program.

FCM has more than 1,400 members, and represents the interests of Canadian municipalities on policy and program matters that fall within federal jurisdiction. Members include Canada's largest cities, small urban and rural communities, and 18 provincial and territorial municipal associations.

Currently, FCM does not have any activity in the area of promoting awareness or key learnings in the area of municipal pension investments. However, it is open to discussing opportunities to better understand the information and access needs of its constituents in this area. It has requested more information on the breakdown of its member communities' activities in this area, such as total asset sizes, provincial distribution, and so on.

It would also like to have a better understanding of what pension investment activities are conducted by municipalities themselves, and which are coordinated on a broader scale (e.g., province-wide basis). For example, City of Hamilton manages certain pension investments for pre-OMERS municipal employees, while OMERS manages all other pensions of Hamilton employees (as well as for other municipalities in Ontario).

It may be that FCM could be most effective in providing support and awareness to a limited number of larger communities that have a substantial total asset size but are not currently active in the PE asset class.

Federal-Provincial-Territorial Working Group on Risk Capital

The project team has participated in several conference call meetings of the Federal-Provincial-Territorial (FPT) Working Group on Risk Capital (chaired by IC). The main focus of this activity is to keep government officials informed regarding project activities and key findings, as well as to solicit feedback and assistance in key project areas.

For instance, FPT members were engaged to assist in disseminating the on-line survey to provincial contacts that were not included on the original target list. Also, FPT members were briefed on the early-stage potential for a pooling concept, including possible structures/models, cost considerations, and differences between the pooling approach and existing market intermediaries such as gatekeepers and fund-of-funds. Preliminary views and input were obtained from FPT members on these considerations.

5.4 Desired Outcome 4: *Better understanding of how U.S. institutional investors with assets of less than $5 billion have overcome hurdles to participation in the PE asset class*

The project team has developed case studies of three U.S. institutional investors active in PE. They are:

Institution Name	Type
State Universities Retirement System (SURS) of Illinois	Public Plan
University Hospitals Health System	Non-Profit Plan
Case Western University	Endowment

An additional case study for a Canadian not-for-profit which has been active for many years is also included.

Key Themes and Findings

In terms of the initial decision to enter into the PE asset class, specific drivers vary but several consistent themes emerge. In most cases, the board, investment committee, or senior management were driven by a desire to diversify the investment portfolio while enhancing returns. Also, there were often one or more forward-thinking individuals with an awareness of alternate asset classes – not just PE but also hedge funds, real estate, commodities, etc. – and a willingness to branch into a new investment area. One institution noted that its decision to expand into PE was a growing realization by its investment committee that its traditional asset mix was no longer state-of-the-art, and that investment in PE (as well as other alternate asset classes) was necessary in order to keep pace with industry trends.

There was also an awareness of the investment and return characteristics of the asset class; for example, the J-curve nature of PE returns were understood and expected. It was noted that, at least among public plans, even the smallest institutions typically have PE allocations.

Many institutions work with consultants and advisors in order to minimize the amount of internal resources required to maintain fund managers relationships, choose the best fund managers, allocated capital among PE investment types (i.e., VC, buy-out, etc.) and industry sectors. Typically, these consultants and advisors recommend investing in one or more fund-of-funds. For public plans, one potential benefit of the fund-of-fund approach is to help mitigate a tendency among some GPs to favour private-sector institutional investors over public-sector investors, due to concerns surrounding public scrutiny of public investors arising from legislation to which they must comply (e.g., Freedom of Information Act, Sudan Divestment Act, etc.).

However, certain institutional investors have also developed arrangements whereby they co-invest alongside fund-of-funds directly in third-party funds (referred to as "separate account relationships"). One key benefit of this latter approach is to keep management fees low, relative to fund-of-funds fees.

Institutional investors are careful to balance PE allocation targets with the quality of available investment and partnership opportunities. One institution noted that its Board of Trustees has set a target allocation of 7% of total assets, but management's current "comfort zone" is only between 4% and 5%.

Of the public plans interviewed, staffing levels range from three full-time investment professionals for the smallest investors (i.e., asset book of around US$800 million), to seven full-time professionals for the largest (i.e., asset book of around US$14 billion). The mid-size institution (asset book of around US$1.7 billion) employed six full-time professionals. One interviewee noted anecdotally that private plans in the U.S. often suffer from understaffing: one such plan with an asset book of US$9 billion employed only three full-time investment professionals, with only one person devoted to PE investments.

Many funds use external consultants and advisors for a variety of functions. In some cases, these parties help monitor the institution's investment activities and identify potential new fund managers. One institution noted that once an investor becomes comfortable with a GP and its performance, then it may consider simply investing in sister funds offered by the same GP, in which case there may be less need for the external consultants. Or the institution may try to seek out other GPs with high-quartile performance, but accessing these funds can be challenging, especially for smaller institutions.

An important lesson in choosing new investment opportunities (particularly in considering new fund-of-funds) is to try to minimize the potential for overlap in focus areas of the various underlying funds, so as to optimize the overall diversification and range of investment activities. One institution noted that within one family of funds offered by a U.S.-based GP, there was around 40% overlap across some funds.

A fairly recent but growing service provided by some advisors is the ability to help LPs sell existing fund investments in the secondary market, thus creating, in effect, an early exit strategy for the LP, and could be a useful tactic in managing overlapping investment activities.

Typically, institutions measure their PE portfolio's success against public equity benchmarks (S&P Index, Wiltshire 5000 Index, etc.) plus a spread, often in the range of 500 basis points. Some investors also benchmark against vintage-year returns analysis. One investor noted that it makes use of a proprietary PE composite index provided by its custodian bank.

Many of these investors are engaged in PE industry associations at the state, national, and international levels, finding these to be helpful for sharing information and best practices, as well as establishing contact networks with investors and fund managers of all sizes and types.

Summary of Key Decision Factors

The case study results suggest that the decision for U.S. institutions to enter into the PE asset class is a combination of factors that are generally consistent across participants, including:

- an engaged and aware oversight body (i.e., Board of Trustees, investment committee, etc.)
- a sense of not wanting to miss out on an important and growing asset class that other institutions of a similar nature are starting to pursue (so-called "critical mass" factor)
- cross-fertilization of PE investment ideas and opportunities via industry associations, former employers, etc.
- use of expert consultants and advisors to help choose funds and monitor investment activities
- use of fund-of-funds as a means of optimally diversifying relatively small investment amounts across sectors, PE asset types, etc.
- gaining comfort with a GP and then expanding the relationship to encompass the GP's sister funds

6. Conclusions and Going Forward Strategy

Medium to small Canadian institutional investors, those with total assets of around $10 billion and under, are mostly absent from the PE asset class. As a result, overall PE participation rates in Canada are low, both for public and private institutional investors, particularly when compared with the U.S. which has much broad-based participation.

Increasing the participation level in PE among Canadian institutional investors will take time, and it will take concerted effort on the part of industry, government, and other stakeholders. This report sets out the key elements of a broad-based strategy for better engaging institutional investors, by building both awareness of the asset class and participation in investment activities.

Going Forward Strategy

It should be emphasized that increasing engagement levels will require an integrated approach in such areas as aligning “communities of interest”, accelerating “knowledge velocity”, and considering new facilitative market mechanisms, such as investment pooling.

In the near term, there are several institutional investors that have been identified as taking preliminary steps toward entering the PE asset class. These institutions should continue to be encouraged using a variety of engagement approaches. Direct approaches should include seminars which bring together prospective PE investors with like-minded peer institutions that are active in PE and have insights to share. Invitation to attend could be sent to all institutional investors with special side event organized for this who have expressed special interest in being involved in the pooling initiative. Also, most respondents to the on-line survey expressed a desire to receive hard-copy reports and other information; these should be provided as soon as possible. Regarding indirect approaches, this should include increased engagement of relevant associations, including FCM, AUCC, CAUBO, and PIAC. In pursuing this, the government could play a facilitative role in association-to-association contact and relationship building (e.g., ILPA and PIAC).

Over the medium term, there are opportunities to engage institutions. For instance, there appears to be interest among key institutional players in developing a PE “mentoring” system, whereby larger or more experienced institutions active in PE help coach smaller or less experienced in entering into and managing PE investment activities. Also, the government could capitalize on its perception among many market participants as an “honest broker” by a centralized on-line repository or portal of credible, independent PE market information.

These activities should be complemented by longer-term efforts to forge new – or strengthen existing – market mechanisms to spur greater PE participation by smaller institutions. This would include an (early) examination of the feasibility and implementation of pooling initiatives by looking at best practices for similar initiatives in other markets or other market segments/sectors. It should also extend to a deliberate and focused engagement of existing market intermediaries (e.g., gatekeepers, funds-of-funds, etc.) to seek opportunities for increasing the PE participation rates of institutions.

Market Segmentation

In implementing engagement activities, it is important to recognize that different institutions have different engagement preferences and information needs. Thus, it is important to ensure appropriate segmentation of the market in accordance with the particular institutional engagement activities being contemplated. Further, this segmentation is likely to be multi-layered, reflecting important distinctions among sub-segments.

For example, in pursuing the development of a pooling initiative, there are likely two different institutional segments: (i) total asset size over $5 billion, and (ii) total asset size under $1 billion. Each of these segments may have unique motivating factors for considering a pooling approach beneficial (e.g., larger investors may prioritize the information sharing benefits; smaller investors may be more interested in achieving economies of scale in terms of administration costs). Further, within each of these segments there may be important sub-segments: public plans may have different motivations than private plans, etc.

By comparison, in organizing seminars, the primary segmentation might be by geographic region, since such seminars would be held on a regional (or city-specific) basis. A secondary segmentation could then be done to ensure appropriate peer grouping of institutions; this is likely to be based primarily on total asset size, however it may be worth considering segmenting by public versus private plans.

Annex 1: Discussion Guide for Case Studies

INSTITUTIONAL INVESTOR ENGAGEMENT PROJECT

INTERVIEW GUIDE
U.S. Institutional Investors

International Financial Consulting Ltd. has been engaged by the Canadian Venture Capital Association (CVCA) and Industry Canada (IC), a Federal Government Department, to develop a strategy for enhancing knowledge and participation by Canadian institutional investors in the private equity (PE) asset class. Both CVCA and IC believe there is potential to broaden and strengthen Canada's PE community by encouraging participation by a greater number of currently non-active institutional investors, including smaller institutions.

As part of this initiative, we are conducting consultations with a number of institutional investors in the United States with assets less than $5 billion, in order to better understand how these investors have succeeded in their PE activities. A particular area of focus is how smaller plans have managed their governance, staffing, and cost structure to be successful in the PE asset class.

Feedback from these consultations will be consolidated into key best practices and lessons learned, and will support engagement activities with the Canadian institutional investor community in the coming months.

1. PART I: GENERAL INFORMATION

Entity Name: ____

Contact Name and Title: _______________________________________

Contact Details (email, phone, fax): _______________________________

Type of Entity:

- ☐ Endowment
- ☐ Foundation
- ☐ Pension Fund – Public
- ☐ Pension Fund – Private
- ☐ Other (please describe): ______________________________

PART II: PRIVATE EQUITY ACTIVITIES AND EXPERIENCE

1. Describe your decision to participate in PE asset class and key lessons learned:

1.1. When was the decision made to enter the asset class? What prompted the initial consideration of this asset class?

1.2. What were the main determining factors in deciding to enter the asset class?

1.3. So far, what have been the greatest challenges in launching into the PE asset class? How were these challenges addressed and overcome?

1.4. Going forward, what challenges do you foresee in your PE activities? How do you think these challenges will be addressed/overcome?

1.5. What advice would you give to an institutional investor that is interested but not yet active in PE investment activity?

2. Describe your PE investment approach:

2.1. Which of the following best describes your PE investment approach

- ☐ Direct investments (including via captive/in-house investment funds)
- ☐ Indirect investments via third-party investment funds
- ☐ Indirect investments via third-party fund-of-funds
- ☐ Some combination of the above approaches
- ☐ Other (please describe): ______________________________

2.2. What other external parties, if any, do you engage to provide advice or support services in conducting your PE activities?

- ☐ External money managers
- ☐ Consultants/advisors
- ☐ Gatekeepers
- ☐ Other (please describe): ______________________________

2.3. If you do engage other external parties, what services do they provide? What are the advantages and disadvantages of engaging these parties?

2.4. How has your investment approach and engagement of external parties evolved over time? For example, has your use of external advisors increased or decreased? What were the main factors which influenced this evolution in approach?

2.5. In your view, what role, if any, do industry associations and other similar fora play in helping to develop or promote the PE asset class?

3. Discuss the scope and characteristics of your PE investment activities:

3.1. What is the current size/value of your PE portfolio?

- ☐ Greater than $1.0 billion
- ☐ $750 million to $1.0 billion
- ☐ $500 million to $750 million
- ☐ $250 million to $500 million
- ☐ $100 million to $250 million
- ☐ Less than $100 million

3.2. What proportion of your overall investment portfolio does this PE value represent?

- ☐ Greater than 25%
- ☐ 20% to 25%
- ☐ 15% to 25%
- ☐ 10% to 15%
- ☐ 5% to 10%
- ☐ Less than 5%

3.3. What are the main factors influencing your PE asset allocation relative to other asset classes?

3.4. In which PE investment categories are you actively investing?

- ☐ Early-stage venture capital
- ☐ Later-stage venture capital
- ☐ Buy-outs
- ☐ Mezzanine
- ☐ Other (please describe): ______________________________

3.5. What are the main factors influencing your preference for one type of investment category over another? Have your investment category preferences changed over time and, if so, why?

3.6. Are there particular geographic, sectoral, or other preference areas for your PE investment activities? If so, describe these preference areas and how they arose.

3.7. What benchmarks or metrics do you use to gauge the performance of your PE investment activity?

- ☐ Investment returns on other alternate asset classes held in your portfolio
- ☐ Historical return performance of your PE asset portfolio
- ☐ Market data on returns by investment funds in comparable PE categories (e.g., VC, buy-out, mezzanine, etc.)
- ☐ Other (please describe): ______________________________

3.8. Has the choice of benchmarks/metrics changed over time? If so, why?

3.9. Overall, would you describe your experience with the PE asset class as a positive one? If so, why? If not, why not?

4. Describe the organization and governance of your PE activities:

4.1. Describe how the PE group is organized. What are the main role functions? To whom does the PE group report?

4.2. Describe the staffing of your PE investment activities. How many people are directly involved in these activities? What is the average experience level (i.e., number of years, etc.)?

4.3. Describe the kinds of oversight, control, and reporting mechanisms which govern your PE investment activities. How are they similar to, or different from, the governance mechanisms for other asset classes in your portfolio?

4.4. What unique technical and managerial competencies, if any, are important to help succeed in PE investment activities, as opposed to other asset classes? Are there certain types of "corporate culture" characteristics that are more conducive to succeeding in PE?

5. Describe the economics of the PE business in terms of cost-benefit and economies of scale:

5.1. Do PE investment activities consume more or less of your resources (i.e., managerial, financial, technical) compared to investment activities in other asset classes in your portfolio? If PE activities consume relatively more resources, on what basis do you justify these PE activities (e.g., higher returns, diversification of risk, etc.)?

5.2. In terms of cost-benefit of PE investment activities, do you think that economies of scale play a major factor? In other words, is bigger always better for PE investing? Or can smaller institutional investors enjoy certain advantages over larger investors?

PART III: PERCEPTIONS OF THE CANADIAN PE INDUSTRY

1. How would you rank your knowledge of the Canadian PE industry?

   - ☐ Very good knowledge
   - ☐ Moderate knowledge
   - ☐ Some knowledge
   - ☐ No knowledge

2. Describe your impressions or perceptions of the Canadian PE industry (e.g., investment opportunities, fund manager capability, return potential, etc.).

3. Are you aware that the Canadian PE industry is looking for more institutional investor participation in the asset class, including from U.S. investors? Have you considered – or would you consider – investing in the Canadian PE market? Why or why not?

4. Are you familiar with the involvement of large Canadian institutional investors – such as Ontario Teachers' Pension Plan Board or Canada Pension Plan Investment Board – in the PE market, either in the U.S. or Canada? If so, describe the context.

Thank you for your participation

Annex 3: Survey of Canadian Institutional Investors

INTERNATIONAL
FINANCIAL
CONSULTING

This survey is being co-sponsored by both the Canadian Venture Capital and Private Equity Association and the Institutional Limited Partnership Association, the leading international association of institutional investors involved in private equity.

It will take less than **5** minutes of your time.

The involvement of Canadian pension plans in private equity, compared to their US counterparts, is significantly lower. Amongst both corporate and public sector pension plans, the asset allocation to private equity by Canadian investors is significantly less than the levels for US investors. For funds with total assets between $1 - 5bn, Canadian plans allocate 0.5% of assets versus 2.6% for US plans. For funds under $1bn in total assets, Canadian plans allocate 0.1% of assets to private equity versus 1.5% for US plans.

Building on the *Finding the Key* Report (a seminal study on barriers faced by institutional investors in private equity) published in 2004 by Industry Canada, we are looking at ways to increase information available about the private equity asset class to interested institutional investors in Canada.

The purpose of this short survey is to find out whether you are interested to learn more about private equity and, if so, how best your informational needs can be met.

1. Do you have a Private Equity allocation?
   a. Yes
   b. No

   If yes, are you active?

2. If no, have you ever had a Private Equity allocation?
   a. Yes
   b. No

   If yes, would you ever reconsider this asset class?
   a. Yes
   b. No

3. How interested are you in learning more about private equity as an alternative asset class?
    - ☐ Not at all
    - ☐ A bit
    - ☐ Somewhat
    - ☐ Very
    - ☐ Extremely

4. How would you like to receive this information?

Yes	Method	What you get?
A	Information emailed to me	- CVCA Institutional Committee Report: "Why Canadian Investors should participate in Global Private Equity - Finding the Key Report Implementation" - US Case studies
B	Participation in a seminar in my city	- An opportunity to learn from industry experts and institutional counterparts in Canada and US that have been successful in PE
C	One-on-one meetings with experts	- An opportunity for a direct consultation with leading industry experts, fund-of-fund managers, other institutional investors, gatekeepers, etc
D	All of the above	
E	None	

5. Do you work with external advisors/consultants?
    a. Yes
    b. No

If yes, can we contact them?

Name
Email
Phone#

Comments:

Please give us your contact details.
Name
Title
Organization
Email
Phone

Annex 4: Seminar Outline

Canadian PE Institutional Investor Engagement Session
Draft Agenda

7:30 – 7:40	Welcome and Introductions
7:40 – 7:50	Opening Remarks: Opportunities and challenges in the Canadian PE market
7:50 – 8:30	Panel: U.S. small institutional investors - lessons learned in PE
8:30 – 9:00	Q & A and wrap-up