

INTERVIEW BY STEVEN LAMB  
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*Labour funds have struggled to earn returns lately. Bad press has soured their appeal, while bad investments have forced some to shut down or merge. Will the sector survive? Steven Lamb interviews VenGrowth managing general partner David Ferguson on what it takes to succeed.*

**Q** Are labour sponsored funds as an asset class being treated unfairly by the mainstream press?

**A** I think they are, and I think that for three reasons. Number one, how they speak about performance and what they benchmark us against. The second issue is taking isolated incidents, like Crocus, and making that out to be an industry issue. Thirdly, they don't acknowledge the impact that venture capital has on the whole Canadian economy.

**Q** What is wrong with benchmarking your performance?

**A** If you look at the performance of LSIFs, I agree that performance is nothing to do cartwheels about, but if you look at what we as an industry invest in, its predominantly technology. Our performance as an asset group will rise and fall with the fortunes of the technology industry. The tech industry has really gone through a bear market that has persisted for five years.

The thing that they most often compare us to is the small-cap index. If you look at information technology and telecom, about 4% of the index is made up of what is our sandbox. The index is predominantly resources – junior oil and gas players and mining. When the press talks about performance, what they are really saying is “don't invest in technology, only invest in oil and gas.” **Every major asset class is cyclical.**

**Q** What about the higher fees LSIFs command?

**A** In terms of fees, we're different from conventional mutual funds, in that we have 24 full time investment managers for a fund that has about \$1 billion in assets. When we raise more money, we have to expand the size of our investment team, because **to do venture capital properly, you shouldn't have any one person responsible for any more than five companies.** Between the three to six months for due diligence and then sitting on the

board of these companies, it's very hands-on and intensive.

**Q** What criticism do you have for the LSIF industry?

**A** As an industry, it's too fragmented. Anyone who wanted to hang their shingle and call themselves a venture capitalist could, so you had people entering the industry who just didn't have the requisite experience. There should really only be about three or four LSIFs, that's it.

**Q** Considering the benefit that tax-credits provide to investors, how does the industry cope with the phase-out of the provincial credits in Ontario?

**A** In down markets the tax credits are really what cause most people to invest in the asset. The up markets you don't rely on it. The phase-out will, without question, impact the amount of monies the industry raises. But the federal tax credits will remain.

For the majority of players, I don't see it as an issue. The only thing from a venture capitalist's perspective is that you have to make sure that you have adequate capital supply to support your existing portfolio of companies. Even though five years is a long time off, I think you'll find the majority of the industry will be taking capital and reserving it for follow-on investment in existing portfolio companies. I think we will see a polarization of where the capital goes in the industry. I think advisors will see that five years from now there won't be as much capital

coming in, and **they'll put their clients into the largest, most liquid and best-capitalized funds.**

**Q** Still, will the impact of the tax-credit phase-out force the industry to consolidate further?

**A** We've already seen quite a bit of consolidation in the industry, and I do think that you'll see more of it happening. Will it have an impact on fund performance? I don't think so.

**Q** If there are fewer, larger firms in the industry, shouldn't they be able to do a better job of it, because of their deeper pockets?

**A** That is the challenge that the smaller funds have had. If you want to become a world-class venture capitalist, you've got to have a lot of capital to be able to do a good job supporting

your companies. Having a two or three-person team trying to make investments – it just doesn't work. The best deals go to the top-tier firms. If you're an entrepreneur, the money is just a commodity. **They want to partner with someone who's going to increase their chances of getting to that successful exit.** They're looking for deep pockets, domain expertise, VCs with an operating background, who are better connected and can bring in U.S. capitalists as well.

In terms of performance, if you're a small fund getting absorbed by a large fund, you're probably better off. From our perspective, despite all the consolidation that has gone on in the industry, we haven't bought anyone.



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**David Ferguson**

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**Q** And VenGrowth has no interest in that?

**A** Never say never, but we've been shown lots of opportunities. We believe that we've seen the best deals; we don't need any more critical mass.

**Q** How would you 'kick the tires' of a potential takeover target?

**A** If we were to take over somebody, and they had 25 investments, it would really be like making 25 brand new investments. You'd have to do all of your research on the entire portfolio, then you have to get comfortable with the valuation, then make an assessment about the investment team. If the investment team is not one that you would keep, then that is very difficult, taking over a portfolio of 20 or 30 companies and getting people onto the boards.

**Q** Given the current position in the cycle, is there a shift from start-up to late-stage financing?

**A** If you look at where the fund flows are going in the LSIF industry, without question the area of mezzanine financing is really growing in popularity. Probably about a third of the funds in the industry have gone into mezzanine financing. I think that reflects investor appetite. You're just providing loans to more mature traditional-based businesses. Typically your return comes from two elements: The interest payment made on the loan and the equity kicker – free equity. When you wrap up that investment maybe five years later, you get a component of the return from the free equity

In technology and life sciences, you get all of your return when you exit the company, say when Cisco comes along and writes a \$300-million cheque to buy the company, or when you take it public. But with mezzanine financing, a portion of your return is coming back every month through the routine interest payments these companies are paying to the fund.

**In this kind of market, where investors want to take a lot less risk, mezzanine financing seems to be the one that resonates the most.** But I can see two years from now where technology is really hot, and suddenly investor appetite will shift again.

**Q** Are you going through more down rounds in financing, where you're buying more of a company for less per share than you paid before?

**A** Yes. Through 2001 down to last year, every round was a down round. That wasn't a reflection of the company, it was just worth less. If the whole technology sector is off 80%, that affects private company valuation. The order of the day for the past number of years has been down rounds. What we're finding now is that rounds have been flat rounds, and **now they are starting to modestly go up, which to me is another sign that we're through the worst of it.** In the States, valuations of private companies have actually appreciated significantly.

**Q** You've mentioned returns have been pretty flat since 2000. What is the timeline on getting out of these companies?

**A It really boils down to one thing: Industry spending.** Through the late 1990s you had an inordinate amount of industry spending. In hindsight you had a spending bubble as carriers and corporate accounts spent billions to update their networks. At the end of the 1990s, the networks in this country looked like the first days of Highway 407 [the electronic toll road that bypasses Toronto] – you could fire a canon down that highway and never hit anything.

Over the last five years, we have seen a tremendous amount of data growth. You look at the amount of e-commerce and the number of devices that are connected to the Internet, you have more users, more applications and more appliances. All of this has created a huge amount of stress on the networks. It now looks

like downtown Toronto in rush-hour traffic. That's really what's causing the next wave of industry spending.

**Q** Will smaller companies play much of a role in that expansion?

**A** The role of smaller companies will be huge. All the large public companies do the same thing. When there's a bear market and sales are weak, they lay people off and cut back on research and development. Their price/earnings ratio sinks to such a low level that there's very little incentive for them to be investing heavily in R&D. The market's not rewarding them for it. **So over the last four or five years, where the innovation has really come from has been in the private companies.**

**Q** So what is the timeline on exits?

**A** That's the \$64,000 question. Anecdotally, **we're getting more phone calls from the larger strategic industry players saying "we should sit down and talk."** We're starting to see more interest from investment bankers on the IPO front as well.

There seems to be an appreciation that the tech market is now really starting to be seen as the sector that has been undervalued. If you look at five years of underspending by the industry, and the continual growth the industry's going to go through, it's really due for a revival.

**Q** Is there a shift in preference for markets in which to take companies public?

**A** Absolutely. **Right now there is a huge appetite among European investors for emerging technology companies.** The Alternative Investment Market in the UK is one that every single venture capitalist is looking at. Among North Americans, there is definitely a shift away from Nasdaq. With Sarbanes-Oxley, the average annual cost of compliance is about \$4 million a year per company. If you were a company with \$5 million in profit, NASDAQ just is not a viable choice for you.

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