



Caisse de dépôt et placement  
du Québec

# **THE CAISSE, BUSINESS FINANCING AND QUÉBEC'S ECONOMIC DEVELOPMENT**

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**The Canadian Club of Montreal  
Luncheon meeting  
Queen Elizabeth Hotel**

**Montréal, January 24, 2005**

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## Introduction

I should like to thank The Canadian Club of Montreal for having invited me to address this luncheon meeting. The invitation is most timely, since the new amendments to the *Act respecting the Caisse de dépôt et placement du Québec* came into force a few days ago. For the first time since it was created 40 years ago, the Caisse has a mission stated formally in a section of the Act. This section stipulates: “The mission of the Fund is to receive moneys on deposit as provided by law and manage them with a view to achieving optimal return on capital within the framework of depositors’ investment policies while at the same time contributing to Québec’s economic development.”

I believe today is the right time to review the arguments underlying this mission statement and to present the strategies we intend to continue using for our private equity investments in companies, in order to optimize the return we earn on depositors’ capital while contributing to Québec’s economic development.

My presentation consists of four parts:

- **In the first part**, I shall discuss how the relationship between the return on depositors’ holdings and economic development constitutes the basis of the Caisse’s mission statement;
- **In the second part**, I shall explain how the Caisse has in years past used its size and what is called the advantage of capital in proximity, to advance the interests of Québec’s companies, the province’s public sector and the Caisse’s depositors;
- **In the third part**, I shall discuss how economic and financial changes have made the Caisse’s current environment highly competitive; and
- Finally, **in the last part**, I shall identify the main strategies we intend to continue using for our private equity investments in companies.

### 1. DEPOSITORS AND ECONOMIC DEVELOPMENT

As at December 31, 2003, the Caisse had 20 depositors, with the seven largest accounting for more than 98% of net assets, which totalled almost CA\$90 billion. The overwhelming majority of these depositors are pension and insurance plans. The main depositors are:

- The Fonds du Régime des rentes du Québec (RRQ) (21%).
- The Government and Public Employees Retirement Plan (RREGOP) (35%).
- The Health and Work Safety Fund (CSST) (8.6%).
- The Société d’assurance automobile du Québec (SAAQ) (7.6%).
- The Fonds d’amortissement du gouvernement du Québec des régimes de retraite du secteur public (FARR) (12.2%).
- The Supplemental Pension Plan for Employees of the Québec Construction Industry (CCQ) (8.7%).
- The Pension Plan for Management (RRPE) (5.4%).

The most important characteristic of these plans is that, for each asset that they own at the Caisse, there is a counterparty, or liability, in other words a contractual commitment vis-à-vis a current or future employee, manager, retiree or beneficiary. The result of this situation is that the Caisse's returns have a direct impact on the contributions required to finance the plans. To cite one example, when the Caisse obtains for RREGOP, the Government and Public Employees Retirement Plan, a long-term return that exceeds the actuarial assumptions, the participants' contributions to the plan can be reduced. Conversely, RREGOP's most recent actuarial analysis shows that a constant 1% decrease in the Caisse's returns could permanently increase employee contributions by 4% a year. The contributors to this plan would be deprived of substantial amounts.

When the members of a plan are deprived of returns on their capital, the resulting increase in contributions has the effect of an income tax hike without any offsetting benefit. In other words, they sustain a dead loss. They must spend less or save less. In both cases, their standard of living drops, and Québec's economic development and job creation are affected adversely.

We can never repeat it often enough: the best way for the Caisse to contribute to Québec's economy is to strive for, and to obtain, the best possible return on its investments, subject to a level of risk that is acceptable to the depositors' plans.

The mission statement in the Act is based on this economic and social logic: economic because we strive to optimize returns while respecting depositors' investment policies; and social because any dead loss incurred by a depositor is a dead loss for society as a whole. It means a lower standard of living for everyone.

This means that a decision to invest in a project or a company has to be based on profitability and risk criteria. But – and this is crucial – the Caisse's investment horizon is not that of an investor looking for a return in the next quarter or even the next year. The Caisse is a long-term investor because the overwhelming majority of its depositors have long-term commitments. In addition, the fact that the Caisse and its managers can count on large amounts of patient capital is a competitive advantage that is essential to their success. The incentive compensation programs that it offers the managers reflect this reality by rewarding their performance over three- and five-year periods.

To optimize returns and manage risks, the Caisse therefore can and must take the time needed to ensure its investments reach their full potential.

To put it plainly – after study, analysis and discussion – , if a transaction proves to be unprofitable or excessively risky on the appropriate horizon, the Caisse's managers, officers and board of directors are obliged to refuse it. The same transaction could be deemed acceptable by another government body that has a mission other than to seek an optimal return on its depositors' holdings; that is exactly why governments have other economic-development tools.

The Caisse's mission statement is aligned directly with the address made by Jean Lesage on June 9, 1965, when the bill to create the Caisse had second reading. He said on that occasion:

In a sense, the Caisse is not intended to substitute for the State in any of its functions. Instead, it must channel the investable resources that Québec needs, so that government policy and private-sector policy can at one and the same time be carried out. Industrial decentralization, assistance for certain activities or the development of certain companies, and grants to local authorities will continue to be the responsibility of the State. The Caisse de dépôt may perhaps in certain cases serve to better ensure the strategic orientation of such policies. It is not intended to defray their cost.

Henceforth, no Caisse manager or Chairman can cite the Caisse's contribution to economic development as the reason for any underperformance. Obviously, that in no way guarantees a sustained performance but it nevertheless lays the foundation for a public organization that is more solid, because at long last its mission has been clarified. The new mission statement does not represent a break with the past, but rather a clarification based on continuity. The clarification could have occurred much earlier (it could even have been included in the Act respecting the Caisse in 1965), without fundamentally changing the way the Caisse has done its work over the past 40 years, apart from a few exceptions.

I should like to set the record straight: despite a few difficult situations, the Caisse has indeed fulfilled its mission of managing its depositors' holdings well. This conclusion is based on two observations:

- First, in the 40 years of its existence, the Caisse has earned a weighted average return of more than 9% on depositors' funds despite seven years of negative returns. These returns, after inflation, have met the actuarial assumptions of the Caisse's depositors over the past 20 years. In the preceding years, that is until 1985, all Canadian pension funds earned disappointing returns, after inflation, mainly because of inflation rates that far exceeded market forecasts.
- Today we can say that the net assets managed by the Caisse is, for all practical purposes, the proceeds of the returns earned on the capital entrusted to us by our depositors, since depositors' cumulative withdrawals have roughly equalled their cumulative deposits over the entire period.

In other words, when its founders created the Caisse, they made a bet, and they won that bet hands down.

Their bet was based on the assumption that a large investor that knew Québec from the inside could obtain perfectly competitive returns by financing the development of Québec's public sector and the growth of its most vibrant companies, with due respect for the rules of the art of investment.

Which leads me to the second part of my presentation: the advantage of capital in proximity.

## **2. THE ADVANTAGE OF CAPITAL IN PROXIMITY**

Business history, financial and economic studies by academics and the Caisse's experience show quite clearly that, in investment, nothing has been as successful as the financing of promising companies located near the source of their financing. That is what is called the advantage of capital in proximity.

The proximity of management teams, knowledge of local markets and, generally speaking, access to quality information at a reasonable cost ensure that investments in geographically close companies have historically earned higher returns for local investors. The risks can be assessed more thoroughly and the investments monitored more effectively. Since the market is local, a local investor's knowledge of the market is an asset that sets it apart from distant or foreign sources of capital and enables it to earn returns that adequately offset the risk of the portfolio's more limited geographic diversification.

In the 1970s, the '80s and a portion of the '90s, the Caisse was often the only or the largest provider of funds, so it took advantage of the context of capital in proximity to Québec and Canada, and in this way it did very well for its partners and depositors. The Caisse's performance in Canadian equities, private equity and real estate in Québec and Canada, as well as the Caisse's ability to take advantage of the "abnormally" and temporarily higher rate spreads on bonds issued by the Québec government, Hydro-Québec and Québec municipalities are examples of the Caisse's ability to use the advantage of capital in proximity. By taking part as it has in the financing of Québec's public and private sectors, the Caisse has contributed to the growth of companies in Québec, as well as the development of the province's public sector, while obtaining attractive returns for its depositors.

Of course, there have been a few exceptions. But when we consider the experience of the past 40 years from the standpoint of depositors' returns and Québec's economic development, we must conclude with pride that the Caisse's track record is a fine one. If the experience we have gained enables us to repeat it over the next 40 years, our children and our children's children will be well satisfied. But things are not and will not be as simple or as easy, because the province of Québec, the financial sector and the world's economy have changed a great deal over the past 40 years.

## **3. A RAPIDLY CHANGING, FIERCELY COMPETITIVE WORLD COMBINED WITH HIGHLY EFFICIENT FINANCIAL MARKETS**

The context in 2005 is radically different from that of the 1960s.

**First**, given the appreciation in recent years of traditional financial instruments, such as stocks and bonds, the rates of return expected on many of these assets are lower than they previously were. All pension funds, in Québec, in Canada and elsewhere in the world, are confronted with this problem, and all are looking to invest in non-traditional vehicles such as real estate, infrastructure, private equity, venture capital, hedge funds, and emerging-market equities and bonds.

**Moreover**, the plans that are the Caisse's depositors are faced with demographic pressures: as a result, they need each dollar of their returns as never before. Not only can they no longer count on the arrival of new contributors to fund future retirements, but they must also cope with a decrease in the number of contributors and an increase in the number of beneficiaries, owing to Québec's demographic trends. In this context, they will quite justifiably become more demanding in order to obtain the best possible rate of return, especially since market globalization has reduced the benefits associated with traditional international diversification.

All these changes are obliging all pension funds in Canada and the Americas to reorient their asset allocation toward non-traditional asset classes. This is the first new source of competing capital that the Caisse now faces.

**The second source** of competition stems from the decision made a few years ago by the federal government and the other provinces to create the Canada Pension Plan Investment Board (CPP Investment Board) as well as the Public Sector Pension Investment Board (PSP Investments), to manage the assets of these pension funds in a diversified, active fashion, as Québec has been doing for the past 40 years. If we add the Ontario institutions – the Ontario Teachers' Pension Plan (Teachers); the Ontario Municipal Employees Retirement System (Omers); the Hospitals of Ontario Pension Plan (Hoops) – and the British Columbia Investment Management Corporation (bcIMC), we can see that the Caisse de dépôt et placement du Québec now faces far stronger competition, and that this competition will only intensify in the years to come.

**The third source** of competing capital comes from funds that offer tax benefits, such as the Solidarity Fund and others, whose growth has been especially strong in Québec over the past 25 years.

**The fourth source** of competing capital in Québec and Canada comes from the massive influx into our markets of international private equity players and investment funds over the past three years.

**The fifth source** of competing capital is the advent in Canada and Québec of certain private fortunes in search of better investment opportunities than those offered by the traditional markets.

Thus the advantage of proximity, of which the Caisse was long the sole beneficiary, has diminished radically in recent years, especially when it comes to large transactions. For one thing, economic activity is no longer local (I'm thinking of the Jean Coutu Group, Rona and Alimentation Couche-Tard). For another, capital from here or elsewhere is increasingly available locally and internationally. The three companies I just referred to easily financed their recent expansion on the North American markets. Moreover, when Québec and Canadian companies are in play, the sources of capital are numerous and diverse in origin. The phenomenal competition engaged in by the major North American institutions over the Yellow Pages Group in 2002 is a fine example of this situation. The same phenomenon is taking place in the real estate sector. The recent Marché central transaction is a case in point. The British Columbia Investment Management Corporation acquired it, to the astonishment of the other Canadian and foreign players.

Although the advantage of capital in proximity has not disappeared, it has been reduced significantly, and the supply of capital is now extremely competitive. In Canada and even Québec, the Caisse competes with large global players that, just like it, are looking for opportunities to invest in private equity, infrastructure, real estate and venture capital to diversify their portfolios and to offset the lower returns expected on traditional assets.

If the demographic context and the financial markets have undergone profound changes since the 1960s, the economic context, especially economic location factors, have changed radically. Our companies are facing unprecedented international competition, particularly from China, India, Southeast Asia and Eastern Europe. The competitive edge of many of our businesses has been blunted by the dwindling of their traditional comparative advantages, by the surging Canadian dollar and by the inability of governments to reduce taxes, which detract from capital spending and job creation, and which also slow high-value-added immigration.

It isn't just capital that is mobile; economic activity itself is moving at a worrisome speed. Still, these international competitors are also potential customers we must quickly serve and potential partners we must rapidly form alliances with. Many Québec companies understand this fact and have already adopted innovative strategies and adjusted their business models accordingly. They have stepped up their investments in R&D and manpower training, they have geared their output to higher levels of value added, and they have made wise use of outsourcing and technology. Some have even acquired competitors. This context creates new and profitable sources of growth and diversification for our local businesses. And it will create opportunities for institutions, like the Caisse, that are eagerly seeking high returns. Supply and demand on the capital market has changed, so the Caisse has had to change its business-financing strategies accordingly.

#### **4. AMBITIOUS STRATEGIES GEARED TO FUTURE CHALLENGES**

In 2005 we are therefore in a demographic, financial and economic context that is radically different from that of the mid-1960s. Rather than fighting this general trend to new sources of capital in Québec and Canada, the Caisse has decided to take advantage of it, in the interests of its depositors, its business partners and Québec.

Our analyses of the financing market for Québec companies have identified three separate market segments:

1. The venture capital and start-up capital segment, where the “manager risk” is the dominant factor;
2. The mid-sized-enterprise segment, where the advantage of capital in proximity is still very important; and
3. The large-enterprise segment, where the supply of capital is very competitive and the advantage of capital in proximity has for all practical purposes disappeared.

We have adopted an appropriate strategy for each of these segments.

#### 4.1 The venture capital and start-up capital segment

The most important characteristic of venture capital investment in information technology, biotechnology and industrial technology, as well as in start-up capital, is its extremely high level of risk. Moreover, it is this high level of risk that justifies the superior returns that such investments generate on average, in comparison with other types of investments in companies. This risk is so great that the difference between first-quartile and third-quartile managers may exceed 35%, especially if you consider the past 10 years.

So the first rule for an institution like the Caisse is to use a large and adequately diversified number of venture capital and start-up capital managers, and to aim for a first-quartile performance. Our own experience in technology venture capital, when we have invested directly, as opposed to using diversified partners, has resulted in high operating costs, a significant rate of personnel turnover and limited access to a quality deal flow, without generating an adequate return. Moreover, the Caisse was regarded as a competitor of the private venture capital industry. The venture capital and start-up capital industry is very young in Québec and North America alike, and this phase was probably inevitable. Still, for the future our objectives and strategies are clear. Here are the main elements:

1. **We want to increase** the calibre of our technology venture capital and start-up capital portfolio and the return it generates;
2. **We want to increase** our investments in this segment in Québec and North America;
3. **We want to help** strengthen Québec's venture capital industry, especially through careful outsourcing of the management of our portfolio and the provision of additional funds.

It is important to note that, here, the Caisse's interest and the market's interest converge completely. To reduce manager risk and to obtain a larger, better-quality portfolio, the Caisse must have access to a larger number of managers, who must have access to a larger deal flow. If the managers we retain can choose from among more transactions, they will necessarily have access to better-quality transactions.

To reach these objectives, we have deployed five strategies:

1. **A partnership strategy** designed to establish partnerships with Québec funds or funds with operations in Québec, by providing them with new funds or by having them manage our portfolio. The agreement concluded in 2003 with the Business Development Bank of Canada to provide start-up capital for small enterprises, and the agreements announced in 2004 with Genechem and Propulsion for venture capital are part of this strategy. The budget for new commitments to this strategy is \$350 million between now and 2007. With the leverage effect, the impact of this strategy should normally exceed a billion dollars.
2. **A strategy of joint investments** with Québec's technology venture capital firms for more advanced rounds of financing. The budget for these new commitments is \$150 million, which the leverage effect should bring to \$450 million by 2007.

3. **A strategy of supporting start-up funds** to give added financial strength to local groups already established on the start-up market and to promote the emergence of new groups, as was the case with T2C2 and Brightspark. The budget for this area is \$20 million, which the leverage effect should raise to \$100 million by 2007.
4. **A strategy of attracting foreign venture capital** to increase the international supply of technology venture capital for Québec. By injecting new funds and by outsourcing its portfolio, the Caisse has contributed directly to the arrival in Québec of foreign funds, such as Sam Private Equity, ProQuest and VantagePoint Venture Partners.
5. **A strategy of openness to foreign players** by continuing to invest in foreign venture capital funds and enabling local players to take advantage of this international network.

Taking into account only the new commitments proposed by the Caisse, we have a total of \$520 million between now and 2007, or an annual rate of investment that is four times the amount the Caisse has invested in this segment of the Québec market in recent years.

#### **4.2 The mid-sized-enterprise segment**

Our analysis of the market has convinced us that, contrary to the large-enterprise segment, when it comes to the financing of expanding mid-sized companies, the advent of new competitors has not eliminated the advantage of capital in proximity. As it has done successfully over the past 25 years, the Caisse is therefore continuing to provide direct support for mid-sized Québec enterprises with sales ranging from \$10 million to \$150 million, by offering them financing ranging from \$2 million to \$10 million or more. It has a specialized team that applies a targeted, customized strategy for each company. The team consists of seasoned professionals who work closely with the appropriate external resources. This collaboration provides the expertise and value added that are needed to meet to the new challenges arising on global markets. It should be noted that this team has a clear mandate: to increase the portfolio by several hundred million dollars of profitable investments in mid-sized Québec enterprises over the next few years.

Our approach is a genuine partnership designed to finance growth, acquisitions and the penetration of new national and international markets. These mid-sized companies in all regions of Québec are the large companies of tomorrow, and we have the capital, the patience, the expertise and the size to take part in their growth and development. Our products include debt, debenture and equity financing, in the currency of their choice, according to their needs and schedules.

We also have a team that specializes in succession financing when the founder of a company wishes to plan an orderly exit while ensuring a secure and richly deserved retirement. This team consists of financiers, tax specialists, lawyers, psychologists and even retired entrepreneurs who have gone through this experience.

Studies show that almost 50% of the CEOs of our family companies plan to retire over the next 10 years. The Caisse wants to be there to plan the transition with them and help

them identify their successors, be they children, relatives or partners. In brief, the Caisse's success with Québec Inc. over the past 25 years can be repeated with the successors to Québec Inc., in a manner that serves the interests of its depositors, its business partners and the province as a whole.

### **4.3 The large-enterprise and large-transaction segment**

When it comes to large enterprises, the Caisse faces an extremely competitive market where the advantage of capital in proximity has almost disappeared. Our strategies for this segment oblige us to be more proactive, to form more partnerships at home and abroad, to reduce our decision-making time and to develop leading-edge expertise. In short, we are adopting the best practices of those who set the rules of the game in this marketplace, namely the large private equity funds of North America and Europe. We have therefore restructured our private equity operations along business lines rather than subsidiaries. The Caisse has the advantage of having on staff high-calibre professionals with many years of experience in this area and major achievements to their credit. These professionals are divided into teams that specialize in buyouts, mezzanine loans, development capital and debt, as well as management of funds of funds and joint-investment programs.

In the case of large investments, we have reduced the number of decision-making levels. We have also reduced the number of funds we have relationships with, and we have concentrated our investments with first-rate managers to optimize performance and to maximize our access to a high-quality deal flow.

In November 2003, the three segments of the business-financing market were therefore combined into a single private equity unit. At the end of 2003, our private equity assets totalled \$9.3 billion and were held in two specialized portfolios: Private Equity (which includes venture capital) and Investments and Infrastructures.

In 2004, the Caisse's private equity unit indicated clearly that it intended to play a leading role in its market. Last year, it made commitments totalling more than \$4.3 billion, including \$1.5 billion for funds and \$2.8 billion for direct transactions. Moreover, as a result of normal portfolio operations, the Caisse will have to deploy more than \$8 billion of capital in these two portfolios alone over the next two or three years, in an environment in which all its competitors are doing the same thing. In brief, we will continue to be proactive in supplying capital and increasing our share of the market.

## **Conclusion**

The Caisse plays an important role that complements other economic development tools. Indeed, the State has many economic-development tools, such as subsidized loans, credits for investments in tax-sheltered funds and so on. These tools may be profitable but they do not aim for, nor do they obtain, an optimal return for the risks incurred. In these cases, the State accepts a trade-off between its desire for an optimal return and the need for economic development, and this situation gives rise to explicit or implicit subsidies that the State eventually finances with additional sales taxes and income taxes.

These actions by the State are totally legitimate and often complement the operations of the Caisse and other players.

But the Caisse's mission statement spelled out in the Act clearly does not concern these public-policy strategies. Instead, the new Act respecting the Caisse clarifies that the Caisse must invest where the returns offset the risk incurred; in other words, it must invest where, on the appropriate horizon, there is no trade-off between investment returns and economic development. This is no guarantee of a sustained performance; but a clear mission statement and tighter governance are vital conditions for the development of a solid Caisse de dépôt et de placement whose performance benefits all the pension and insurance plans that Quebecers belong to.

The Caisse has the size, the capital, the expertise and the patience to succeed as an investor. Our entrepreneurs have the courage, the ambition and the talent to secure an enviable place for themselves in a world that is changing rapidly but offers a wealth of business opportunities.

So let's work together more to make that happen!

Thank you very much.