2005 LSIF UPDATE
(Summary)

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DAN HALLETT & ASSOCIATES INC.
T. 519.254.4141
E. DHA@DANHALLETT.COM

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LSIFs are difficult securities to assess. It is important for all readers to understand the process followed, and what it does and does not provide. The process involved in the selection of funds for DH&A's LSIF recommended list begins with an asset screen. Then, a basic screening questionnaire focussing on the investment process is forwarded to a short list of candidates. Next, information from regulatory filings (i.e. prospectuses, transaction statements, and prospectuses) is reviewed, along with internet searches. Interviews are conducted with most of this short list to get more detail on certain aspects of the fund's management (i.e. internal valuation processes) and an update of recent fund activity. Then, a draft recommended list undergoes a brief additional review in an effort to ensure that nothing was missed. However, given the wealth of information examined – and the manual nature of the analysis – missing some information is inevitable.

This is a rigorous process but, honestly, not as in-depth as we'd like. In 2005, we had our first opportunity to review financial statements of one fund's investee companies and its due diligence documentation. This is a step forward but the process remains, at this point, highly subjective and hampered by a general lack of transparency characteristic of nearly all 'alternative asset' products. Now, for the more formal disclaimer.

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Executive Summary

Trends that began to appear a year ago carried on through 2004. Financing activity is up across North America. Venture capital managers on both sides of the border are showing a growing appetite for larger transactions as assets grow more concentrated.

While the Canadian industry continued its focus on follow-on investments, the emphasis was less than in 2003. Plus, the larger funds with stronger deal flow and more cash to invest focussed more on new deals (proportionately) compared to those with less deal flow and less free cash.

The exit environment, which showed its first recovery signs a year ago, continued its momentum. While the Canadian IPO market is not yet venture capital friendly (given its focus on structured products, income securities, and commodity stocks), the M&A market continues to improve. By contrast, the U.S. IPO market has rebounded nicely with more IPOs in 2004 than in the previous three years combined, with many tech and health care issues.

LSIF Outlook

For two years, we've been saying that the timing is right to buy LSIFs. Portfolios have been pruning their disappointing investments while their stronger companies have excelled financially. However, the lack of a strong domestic exit market precludes the significant write-up of the stronger companies in the absence of any external 'value creation' event.

Hence, the better portfolios may well contain some hidden value. It's far from a sure thing but we will, for a third year, stand strongly by our advice, that now is the time to buy a labour fund.

Transparency trends

We've long been frustrated with the lack of transparency in this sector. But we're pleased to report that one fund allowed us a peak at what goes on behind its doors – a great development. With each passing year, obtaining greater transparency will become an increasingly important factor in the overall analysis and selection of LSIFs for our future recommended lists.

Performance fees

There has been a mixture of changes regarding performance fees. As more funds merge (and they will in Ontario), new managers will implement new fee structures so that they're not left paying for the old manager's mistakes. While this isn't completely fair to longer-term shareholders, it's rather inevitable. And it's the lesser of the evils if it means truly positive changes result from the new manager's portfolio reorganization.

One large, old fund actually changed its fee structure, despite the fact that no change in management or ownership took place. While credit is due for also reducing its base management fee, its performance fee now makes it much easier to collect this bonus.

Finally, it's good to see the emergence of fund-based thresholds built into performance fee structures. We've only found two companies offering such provisions but are hopeful it will catch on.

New Products

There isn't much new this year given the Ontario moratorium on new LSIFs. However, one new fund, which will qualify as an Ontario ROIF (eligible for 35% combined tax credits), aims to enhance these significant tax credits with a dividend equal to 25% of the initial investment (spread over three years).

Don't chase performance

Performance chasing has proven to be a loser's game in the broader investment world. It is a worse strategy when looking at LSIFs and ignores issues critical to this unique asset class.

Charts and Tables

Includes charts on U.S. financing, IPO, and M&A activity. Other details of the U.S. exit market are provided in two additional tables.

Recommended List

Seven LSIFs are included on our 2005 recommended list. Three newer funds are highlighted as honourable mentions. Finally, three funds had their respective status as a recommended fund or honourable mention suspended.

Appendix A contains performance tables for the entire LSIF industry, grouped by inception year.

Appendix B contains a detailed table capturing the structural and calculation details of sixteen funds' performance incentive fees.

Appendix C contains a MER summary for these same funds, in addition to the ratio of investee companies to investment professionals.

Appendix D illustrates, for these funds, the proportion of independence present on fund boards of directors and various committees.