Labour-Sponsored Investment Funds in Canada

Sherman Kreiner Chief Executive Officer Crocus Fund
with assistance by
Kenneth Delaney President and Chief Executive Officer First Ontario Fund

Labour sponsored venture capital corporations are a decade old Canadian phenomenon which now account for more than one-third of all institutional venture capital in that country. What is especially impressive is that the vast majority of the funds' more than $3.1 billion in assets come from small investments made by average working people.

The specific trigger for the creation of the initial funds was the 1981-83 recession and persistent levels of high Canadian unemployment. The labour sponsored venture capital corporation model was initiated by the Quebec Federation of Labour (FTQ) in the Province of Quebec in 1984 to meet identified equity capital gaps for small and medium sized businesses in a manner which would address additional social policy concerns. The idea of a labour sponsored fund was the most recent development in a long tradition of capital retention strategies in Quebec, which include the pooling of pension funds to assist local economic activity, and the development of a comprehensive network of credit unions which re-lend deposits locally.

Today, three additional funds have been created which follow the Quebec model, the Working Opportunity Fund in B.C., the Crocus Fund in Manitoba and the First Ontario Fund in Ontario. These funds are committed to earning competitive returns. At the same time, the funds set out to provide capital to needed sectors, and, in addition, to meet social goals the unions have established , including job creation and retention, and regional economic development. As part of their social mandate, each fund undertakes a "social audit" of each firm it finances, which includes examining labour relations, health and safety, ethical employment and environmental practices. The funds also take a proactive approach to the workforce - encouraging improvements such as financial education for workers, encouraging a high performance workplace, participatory management, and worker ownership.

The target market is small and medium sized businesses. Typically, an equity interest is sought in companies employing less than 500 workers and have total assets of less than $50 million. Most investments range from $500,000 to $2 million.

In raising capital these funds are committed to participation by a broad base of average working people, through marketing by the sponsoring unions or labour federations. The maximum annual individual investment which qualifies for tax credits is legislatively mandated and has ranged from $3,500 to $5,000.

Quebec Solidarity Fund

The Quebec Solidarity Fund (Fonds de Solidarite des Travailleurs du Quebec--FTQ) was the first fund to be created. The initial plan called for a 35% provincial tax credit only for individual investors. The plan was then presented to the Federal government which agreed to match the seed equity commitment of the provincial government ($10 million each) and to provide matching tax credits, provided that the total tax credits did not exceed 40% (20% Provincial and 20% Federal).

The Fund undertook negotiations with the provincial securities commission to permit sales to be made by volunteer members of the FTQ. The Fund raised approximately $500,000 during its first sales season. The Fund now has $1.5 billion dollars in assets. The bulk of sales are made through lump sum investments into the Canadian equivalent of an IRA (an RRSP). These revenues are supplemented by investment via payroll deduction. In addition to mandating employers to implement payroll plans, FTQ affiliated unions have undertaken a major initiative to establish collective bargaining agreement language which compels employers to match employee contributions made via payroll deduction on a dollar for dollar basis. Statistics as at December 31, 1995 indicate that about 65% of the Solidarity Fund's 238,000 shareholders are affiliated with the labour movement, the highest percentage among all Canadian labour sponsored venture capital corporations.

The current investment portfolio of the Fund includes 131 direct investments within a portfolio that also includes investments in regional and sectoral intermediaries, whose value totals $641 million. Investee firms have sales of $2.9 billion $Cdn and employ approximately 17,000 individuals. Recent research by a team attached to Quebec's Institut national de la recherche scientifique has concluded that the Fund's investments have resulted in the creation of more than 15,000 new full time jobs, approximately half at investee companies, with the remainder in other Quebec companies. These investments have further resulted in $964 million in value added to the Quebec economy. In addition the Fund has placed assets in specialised funds serving innovative sectors or specific geographic regions. The sixty five regional and local funds being established over the next five years will make smaller investments, in the $5,000 - $50,000 range.

The same research report also tracked the fiscal impacts of the Fund and concluded that government recouped its seed equity and tax credit investments in the Fund within three years, after which government derives a net gain. Benefits measured included social assistance payments foregone, payroll taxes associated with new job creation, sales taxes, employer contributions to the Quebec Health Plan, tax payments associated with increased activity of Quebec suppliers to investee companies, and taxes generated from increased consumer spending derived from workers' salaries drawn from investee companies. Similar research undertaken by the Canadian Labour Market and Productivity Centre, and focused on both the Solidarity Fund and the Working Opportunity Fund in British Columbia confirmed these return rates on taxpayers' investment.

In addition to its focus on job creation and job retention, the Solidarity Fund has an economic education mandate. It accomplishes that mandate by providing financial training to workers of investee companies, utilising the company's own financial statements. During its 1994 fiscal year, the Fund provided seventy training courses to more than 900 workers.

Other Funds Followed

The second labour sponsored fund was the Working Ventures Fund, established in 1989 by the Canadian Federation of Labour, a small national labour body for the construction trades. Unlike Solidarity, this Ontario based fund was created with a national mandate under Federal legislation, and seeded with $15 million from the Federal government. All Canadians are eligible to receive a 20% Federal tax credit for investment in the Working Ventures Fund. Matching provincial tax credits are available in Ontario, Saskatchewan, New Brunswick and Prince Edward Island. Sales of shares are made exclusively by investment dealers. As of December 31, 1995, total assets were at just under $500 million, of which approximately $133 million is invested in small and medium sized Canadian companies. In the 1996 sales season they raised additional funds to bring their total assets to $848 million.

Provincial funds generally modeled on the Solidarity Fund template were established in British Columbia (Working Opportunity Fund) in 1991 , in Manitoba (Crocus Investment Fund) in 1992 and in Ontario (First Ontario Fund) in 1995. All three funds utilise social screens for investee companies, similar to social screens utilised by ethical mutual funds. Working Opportunity has a specific mandate to support new growth sectors in the Province and high value added investment opportunities. Working Opportunity had $83 million in assets and 15,000 shareholders as of December 31, 1995. In the 1996 sales season Working Opportunities raised another $42 million. Crocus has a specific mandate to promote employee participation to improve productivity in its investee companies, and employee ownership, where local owners are reaching retirement age with no succession plan. Crocus has $50 million in assets, including more than $22 million raised in the 1996 sales season and close to 12,000 shareholders. First Ontario, which has $13 million in assets, has a mandate to invest in companies facing turnaround situations and requiring financial restructuring. First Ontario also seeks out investment opportunities involving worker ownership.

Working Opportunity is sold by investment dealers only. Crocus is sold both by investment dealers and by specially trained and licensed volunteer members of unions affiliated with the Manitoba Federation of Labour. Crocus was the first fund in English-speaking Canada to incorporate this Solidarity Fund feature. (It has since been joined by the First Ontario Fund.) Crocus, which is the first fund established in a small population province, also has provision for investment by institutional investors to supplement its capital base.

Both Working Opportunity and Crocus have surpassed the timetables established by their respective provincial governments for placing assets in small and medium sized provincial businesses.

Investment activity at Working Opportunity, which began in February, 1993, reached close $20 million by the end of 1995. Investee firms are heavily export oriented, earning over 80% of revenues from foreign sales. Investee firms, which generated $65 million in revenue in 1995 have evidenced growth in sales and employment of close to 40%.

First Ontario has just completed its first full marketing season and has not yet made any venture investments.

Investment activity at Crocus, which began in December, 1994, reached close to $10 million by the end of 1995. Export sales among investee companies are also extremely high. Investments support 1100 existing jobs and will create 200 new jobs within one year. Among the Fund's investments is the first broad based leveraged employee buyout in Canada to utilise a U.S. style Employee Stock Ownership Plan structure. The Crocus Fund also encourages employee ownership and participation through:

- a customised organisational assessment of each investee company undertaken with senior management, by the Fund's organisational development specialist;

- training programs for employees of investee companies on topics ranging from reading and understanding financial statements to rights and responsibilities of ownership, to small group decision-making;

- a roundtable for CEO's of investee companies and other employee owned or participative companies in the Province to disseminate information, discuss the risks and benefits of various practices, and provide examples of best practices.

The Problem of "Rent-A-Union" Funds

The last year has been marked by a proliferation of funds in Ontario. Although Working Ventures began raising money there in 1990, two new funds went to market in January, 1994, nine in January 1995, and two additional funds went to market this year. Most of these funds have little or nothing to do with labour.

No provincial fund operating in Ontario, other than First Ontario, uses union members to market directly to other union members, includes a social screen in its investment strategy or makes any attempt to have a positive impact on labour management relations. In fact, many Ontario-based funds aggressively oppose these progressive objectives. Several of them focus on single sectors of the economy such as medical technology, sports, entertainment, and tourism. One fund intends to focus on companies that are already publicly traded. These funds are typically created by private management firms who find small unions or professional associations willing to act as sponsor in exchange for a fee. These funds are typically known as "rent-a-union" funds.

Rent-a-union funds developed because, unlike other provincial governments, the Ontario government did not work with a specific labour body to create a single fund. Since the affiliates of the Ontario Federation of Labour were divided on the question of creating a fund based on the Solidarity Fund model, the government introduced legislation which allowed anyone to create a fund, as long as some union, employee association or professional association was willing to sponsor it. Sponsorship does not require control or active involvement.

There are four funds in Ontario that do not follow the rent-a-union script completely. First Ontario was created and is controlled by United Steelworkers, the Communications, Energy and Paper Workers Union, the Service Employees International Union, the Ontario Worker Co-op Federation, and the Power Workers Union. Working Ventures was created and is controlled by the Canadian Federation of Labour. Retrocomm was created by the International Brotherhood of Electrical Workers, the Labourers International Union, and the Ontario Pipe Trades Council. Integrated Growth was created by the United Food and Commercial Workers Union, United Needleworkers, Industrial and Textile Workers Union, the Labourers International Union, and the Carpenters Union. Although Working Ventures, Retrocomm and IGF were created by their sponsors, only First Ontario is modeled after the Quebec Solidarity Fund.

Some of the Ontario developments stray quite far from the initial fund concept and the special contributions of the labour movement regarding mandate and constituency. Their specialised focus also creates greater risk and an inability to meet legislated targets to place their money. They have been excoriated by the Ontario media and by the national media, which to date, has ignored activities in the other provinces. Because of the activities in Ontario, especially by non-Solidarity Fund modeled funds, the future of labour sponsored funds is more uncertain. Recently, the federal tax credits were reduced to 15% on a maximum of $3,500. Provinces are expected to follow suit and match the federal changes. The funds sponsored by the Canadian Labour Congress affiliates -- the provincial funds in Quebec, British Columbia, and Manitoba, as well as the First Ontario Fund are working in close alliance to encourage government to maintain the special features of the concept. A defining statement prepared by the five funds identifies six essential characteristics:

1. Organisation and direction by a legitimate labour body;
2. A commitment to meeting economic and social goals in making investments;
3. A commitment to provide an equitable rate of return to shareholders;

4. A commitment to provide risk capital in a diversified portfolio;
5. A commitment to participation by a broad base of average working people;
6. Facilitation of co-operation between labour and business.

Labour-Sponsored Investment Funds are a Success Story

According to a study done by the Canadian Labour Market and Productivity Centre, in 1995, the Solidarity Fund and Working Ventures were the two largest venture capital institutions in Canada. Overall, labour sponsored funds manage one-third of total venture capital and were responsible for 30 percent of the dollar value of new and follow-on investment. More than 379,000 Canadians were investors in the funds. Of these, slightly more than half were union members.

These funds are critical to the capital needs of the small and medium sized business sector in the Canadian economy, which is the primary engine for job creation. In the United States there is approximately $55 billion in venture capital. Canada has an economy one tenth the size of the U.S. From this we can extrapolate that Canada should have $5.5 billion in venture capital. However, venture capital from institutional and other conventional venture sources totals $3 billion and is not increasing. Labour sponsored funds, with close to $3.1 billion in total assets fill this gap in Canada's capital markets.

What makes these funds so popular among governments is that, despite the tax expenditures to individuals that invest in the fund, studies show that the new revenue generated by the new employment pays back the tax credits to the provincial and federal governments in less than four years. Shareholders, who make the independent decision to invest in the labour sponsored funds, are also satisfied with the funds. A 1992 survey of Solidarity Fund shareholders found that 87 percent are satisfied with the rate of return they received.

An added benefit of the labour sponsored funds is that new investors are brought into the capital markets - mostly union members. Typically, Canadian shareholders are upper income residents earning more than $75,000 a year. In 1992, a survey of the Solidarity Fund shareholders revealed that 45 percent had never held any investment before investing in the fund.

From an investor's standpoint, Canadian funds have also discovered what investors in the U.S. are learning--that there is a relationship between workplace practices and firm performance. The Solidarity Fund claims that the social audit provides it with as much, if not more, information about the operation of the firm than does traditional financial analysis.

In summary, the Canadian experience offers important lessons:

- The funds have identified a previously untapped source of capital
- The funds provide capital for certain types of enterprises that otherwise have difficulty raising capital (e.g., manufacturing firms trying to expand, employee owned firms including co-operatives, smaller firms cut out of the public markets etcetera.)
- Government tax expenditures are repaid in 3 - 4 years.
- The "ethical screen" improves performance.
- The focus on labour relations enhances productivity and the quality of life for employees.

Perhaps most instructional about the Canadian experience is that even though unions designed the scheme to establish the labour sponsored funds, governments of every political stripe have supported their creation, from the most conservative to the most liberal, from the Conservatives in Manitoba to the New Democratic Party in Ontario. In Canada, it seems, it is universally understood that it is in the national interest for small and medium sized businesses to grow, and government resources are well spent ensuring that they do.

The Canadian labour sponsored venture capital corporation concept is a unique capital strategy for labour. It utilises targeted tax incentives to retain capital in communities and uses that capital for economic development activities with the greatest potential for quality job creation. It also serves as a catalyst for other capital retention strategies. Together, these activities serve as a dramatic counterpoint to the globalization of capital and are worthy of emulation.

Summary:

- Labor sponsored venture capital corporations, initiated by the Quebec Federation of Labor, have existed in Canada for a decade. They serve as intermediaries to channel workers' savings into Canadian small and medium sized businesses. Currently, these funds have total assets of $2.5 billion, and provide one-third of all institutional venture capital in the country. They are responsible for creating and preserving thousands of jobs. The funds also encourage worker education through providing financial training to employees of target companies.
- Tax incentives offered by the provincial and federal governments provide a total 40 percent tax credit to fund investors. Studies show that these are paid back within three years, through various channels, including social assistance payments foregone, payroll taxes associated with new job creation, sales taxes, employer contributions to health plans, and tax payments associated with increased business activities.
- Unions have found that the activities of the funds enhance the public perception of unions and their role in the economy.
- Experience has shown that to operate effectively, the funds must be organized by a legitimate labor body, make a commitment to meeting economic and social goals while providing an equitable rate of return to shareholders, provide risk capital in a diversified portfolio, make a commitment to participation by a broad base of average working people, and facilitate cooperation between labor and business.
- The local focus of the regional funds promotes greater participation by individual investors, and encourages deal flow to the investment funds, in contrast to national capital pools that are farther removed from communities.

Recommendations:

- The U.S. should consider tax incentives to encourage investments in vehicles that provide capital to underserved middle market companies, along the lines of the Canadian-sponsored LSIFs.
- Policy makers should consider how to create investment vehicles that will provide capital back into the communities of investors, while at the same time adequately addressing legitimate concerns regarding diversification, risk and return. These vehicles should incorporate a local nexus between investors and investments, a commitment to job creation, and investments that encourage long-term strategies at companies to promote growth.
- Unions should get more involved in ensuring that worker capital is returned to the communities where there members live and work, and further, must get involved in encouraging the profitability of investments through promoting employee participation in all aspects of firm decision making.