Canada-United States Law Journal

Volume 21 | Issue Article 30

January 1995

Discussion after the Speeches of Mary Macdonald and Robert Pavey

Discussion

Follow this and additional works at: https://scholarlycommons.law.case.edu/cuslj

Part of the Transnational Law Commons

Recommended Citation

Discussion, *Discussion after the Speeches of Mary Macdonald and Robert Pavey*, 21 Can.-U.S. L.J. 219 (1995)

Available at: https://scholarlycommons.law.case.edu/cuslj/vol21/iss/30

This Speech is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Canada-United States Law Journal by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

Discussion After the Speeches of Mary Macdonald and Robert Pavey

QUESTION, *Mr. Robinson*: Can you deal with the mad scientist who just walks in off the street? And if so, what do you do? A guy comes in with the idea, maybe it is a nonpatentable idea, and does not even have a manufacturing facility. Would you be able to match him up, or do you need somebody more mature than that in their scientific and business development before they could tap into a fund like yours?

ANSWER, *Mr. Pavey*: The vast majority of the time we cannot deal with that individual. Fundamentally, we finance a company, and the company may be a raw start-up. But it has to be headed by a business person. To play the role that we play, we need to interface with the CEO of a company. And we will be active members of the board of directors. We will work with them to query and push on a business plan. But the main communication between us and a company is a business plan, and then financial reports against that business plan.

Some of our greatest added value, however, is to help these companies attract the kind of management talent they need. If indeed we know of somebody who could form a marriage with that individual you described, to combine the technologist with the business person, then our interest can develop. I financed a company out in California last year, and four or five years ago here in Cleveland. In each case, the company was started by a technologist who had some really exciting technology. We believed it was in an area where there was capital available, where there were some interesting things happening. So we thought it was worth going in and working on. And in each case we were able to recruit a chief executive officer with significant business talent to come in, begin to take over, and mold and change the business. But it is really essential that that crazy entrepreneur, inventor, whatever, have some wisdom, which they frequently do not, in terms of understanding his or her own weaknesses. Because all too frequently they come in, and want to run their own company. They think that they do not need a business person to help. And we say, good luck. Sometimes they become a great success; we make mistakes. But we generally only back a team of people.

QUESTION, *Mr. Robinson*: To reciprocate and ask one specific question of Mary, too, I was delighted to hear all the good news about labor-sponsored funds and how much money there is in there. But as your chart illustrated, and I think we have seen a fair bit in the press about this recently in Canada, there is more money than specific venture capital projects around. And some of the commentators have been saying that there is not enough that there is a real skills gap in terms of credit analysis and management of small companies, and all those labor-sponsored funds are sitting with pools of capital and innovation out there. Do you see this as a problem, Mary, and if so, how do you solve it?

ANSWER, *Ms. Macdonald*: Yes, it is an issue. And, it ties in very much to what Bob Pavey just said, regarding the whole management issue. The ability of an entrepreneur to put the pieces together to build a company is clearly the key problem.

There are two sets of issues in Canada. Because we have capital concentrated, it puts a very different set of demands and expectations on the people managing that concentrated base of capital. And in my view, if it stays just within those couple of pillars, it will not be successful, and will fall apart. I think it is a wonderful, unique opportunity for some creative partnering with smaller groups that have those skills to work more directly with the entrepreneurs and access into the large pools.

So there is an opportunity there. But on the management side, it is also very interesting. The cultural change in Canada, I think, is so much more extreme than in the United States because our economy was so branch-plant based only ten or fifteen years ago. Most of the people in my generation grew up around dining room tables where people talked about coming to Canada to deal with management. When I quit my job with a major consulting firm in 1984 to start a company, my mother had a heart attack, because you did not do that. And today, I think it is the most common thing in the world.

So we have had a dramatic shift. And over the last decade I think we have started to build a base of much stronger, more capable entrepreneurs. We have people like the Michael Coplands and Terry Matthews who built Mytels, and they have had some successes and some failures. We have people like that, who know how to build companies. And I think they have done us proud on the world stage in terms of applying that knowledge. So it is a long process, and unfortunately you cannot shorten it. You cannot go to school for two weeks and pick up management skills.

But my sense is, the base of people capable of building companies is growing. And if we can get the money out through effective channels, then I think the outcome could be positive.

QUESTION, *Mr. Robinson*: Does that mean, though, that these funds sitting on these big pools of cash are going to be forced to put out some money before they really have the skills to assess the venture, thus the higher rate of failures in the initial stage?

ANSWER, *Ms. Macdonald*: No. And frankly, to a certain extent, the funds have taken a bit of a bad rap. Bob Pavey is going to raise 125 million dollars, and he is going to invest it over four years. These guys raised, in some instances, 150 million dollars in January and February of this year, and then the press gets on them on the 15th of March because the money is not invested. So I think we need to be careful that we do not put too much pressure on them to get it out too fast. There is no question that the market is an equilibrium. And finding opportunities — the real high-growth opportunities — is harder in Canada, clearly, because there are not as many of them. But I do not think it is a bleak situation by any means.

QUESTION, *Professor King*: I had a question of Bob. LBO's, they raise their ugly head again in unnamed companies. In terms of their affect on innovation, do you want to comment on that?

ANSWER, *Mr. Pavey*: Well, like many things, it is a two-edged sword. There is no doubt that LBO's have taken capital away from the venture side of the process. And you might argue that, in terms of financing technology with innovation, the effects are negative.

I view innovation in a broader context, however. We see company after company that is a subsidiary of a larger corporation, or is owned by a founding management team that has not gotten older and does not want to take any risks with their capital. In my judgment, most buy-outs are very innovation positive, not innovation negative. There are certainly the great big financial engineering buy-outs that we describe as buying a company wholesale and selling it retail. You buy it, bust it up, and sell it in pieces.

There is not a lot of innovation other than financial engineering innovation in that. In terms of productivity, in terms of jobs, in terms of marketing innovation, and product innovation, I think that a lot of innovation does go on in the vast majority of buy-outs. Why? Because we go to a management team. We do not do as much of this as a lot of other people, but we go to a management team and say, "We are going to work with you." The MBO is a management buy-out. We are going to work with you to help buy the company you are running. You are going to get some ownership in this company. And yes, you are going to maybe run a little tighter sometimes than you might have when you were working entirely for salary. But you are going to be driven to build a bigger, more exciting, and more interesting company. People get pretty innovative when they own a piece of the company. So I think on balance, it is a plus. It also gets a bad rap because of a small number of very large financially motivated deals.

QUESTION, *Mr. Barrett*: Each country has pretty large, chronic, federal budget deficits. One of the things that happens when you have deficit spending is the government goes in on the buy side to take over or to purchase some of the available pool of capital which is there potentially to be invested in business. What the government does with it, principally, I think is spend it on consumption to finance transfer payments and otherwise. As a result of the government competing for consumption purposes for capital available for investment purposes, do you see in either country a present or future capital shortage or an increase in the cost of capital that would otherwise be available to business for investment?

ANSWER, *Ms. Macdonald*: That is obviously an issue. My understanding is that the situation is clearly even worse in Canada than it is here in the United States. There is no question it has an impact on the competition for funds, a huge portion of our investment capital, the institutional investors, and their lack of participation here. A very significant portion of their investment is in government-issued securities to fund our debt. So clearly, if the trend does not reverse itself, the cost of capital for business investments will continue to increase.

You know, I think that is a given. And it is a really serious situation. I find it a real dilemma, because, if the government is providing any support at all, the question becomes, should they be doing so, given the deficit situation? And my response is, I do not think we can afford to see an absence of capital. I do not think it should be overinflated by any stretch. But at the same time you can not afford to have a dry capital market for what you have deemed to be a growth segment of the economy. So it is a conflict. There is no question.

ANSWER, *Mr. Pavey*: Yes, it is absolutely an issue. And we have the advantage in the United States of a strong, over-the-counter stock market that Mary and I referred to earlier. And it is one of our most under-recognized assets. It is a unique asset in this country. It is the reason there is a venture capital industry. Europe, the United Kingdom, and Far East have all tried to imitate our venture capital industry. They have only been able to make progress once they developed the stock market that can offer liquidity to these investors. In our business if you do not make money on your winners, there is no way to make up for the losers. That reduces risk taking and increases the cost of capital for young risky companies. Our over-the-counter stock market allows venture capitalists to profit from their winners, thereby making capital available to those young risky growth companies. The government deficits significantly increase the cost of capital by making capital more scarce and this particularly impacts these same young growth companies. Many learned economists will say capital is a worldwide phenomenon, and capital costs the same everywhere. I say "hogwash." This may be true for the very large company that can access capital internationally. Some of you are from those larger companies that can access capital nationally or internationally, wherever it is lowest in cost, and you may be less impacted by U.S. government defects. But for the smaller companies that do not have the resources to finance internationally, capital is more expensive here, especially private capital. First, it is taxed more aggressively. We have capital gains taxes that are significant in this country, whereas there are none to speak of in Germany and Japan for young growing companies.

Additionally we do all sorts of things with regulations to increase the cost of capital. But it is important to keep in mind that it would be a mistake to reduce the deficit such as you are talking about by taxing capital. We must find a way to tax consumption, for example, with Value Added Taxes the way they do in Europe, and generate more capital for investment so we can create better jobs.

QUESTION, *Mr. Faye*: Is the saving rate in Canada significantly different from the U.S. rate? Is capital flowing to the Pacific Rim or other sections of the world so you are being shorted in Canada? Then, are natural resources not on the scale of things that people want to invest in? They want to invest in biotechs, computers, and chips. And I am wondering if you are in the bath water right now.

ANSWER, *Ms. Macdonald*: Well, regarding the first part of your question, I honestly do not know what the actual domestic savings rates are in the two countries.

COMMENT, *Mr. Pavey*: I do not know what it is in Canada, I am sorry to say.

ANSWER, *Ms. Macdonald*: Historically I think they have been higher in Canada. I do not know whether it is persistent or not.

COMMENT, *Mr. Pavey*: That is my impression, Mary.

COMMENT, *Mr. Robinson*: It depends on whether you count straight leg policies as savings, because Canadians have always gone to that boring way of putting their money away.

ANSWER, *Ms. Macdonald*: Now they are putting their money away through these venture capital vehicles. Yes, there is a lot of money being invested in the Pacific Rim, there is no question. And natural resources are a critical part of our economy. So yes, yes, yes to all of those.

In terms of the bath water part, to the extent we are a small economy, yes. That is what I was referring to before in terms of the kind of seed change we have been starting to experience in the last ten years. I think Canadians generally, and younger Canadians, people that are still in the first half of their business careers, are very cognizant of the fact that there is a new economy and an old economy. And I think a lot of the resources are increasingly pouring into the new economy. So my sense is that there is perhaps a perception outside of Canada that we are in a bit of bath water. And it is very much the reason why I am always delighted to get this kind of an invitation. Because I think there are a lot of things going on in Canada that do make it a dynamic economy that people are not aware of.

I was doing some work in Asia eighteen months ago, and I was astounded by the number of people, for example, who were very familiar with the companies of Newbring and Corell, and had no idea they were Canadian. We do a very poor job on that part of our profile. And we sometimes go the other way. We come to the United States and pretend we are American because we would like to be more successful. I do not think we are in the bath water, but I think sometimes out of our own borders, it looks as if we are.

COMMENT, *Mr. Robinson*: I am glad Mary put a plug in for one of our favorite clients, NDS, as sort of a leader and innovator here. This is a typical example, is it not, Mary?

Here is a Canadian company which is almost like a public utility based business. It does lab testing for our medical system, which, as you know, is about ninety-nine percent socialized. So, in effect, their client is the government. But they are willing to take their profits, some of their profits, and plow them into these extremely interesting medical and scientific-related venture funds which then spill the money out into various projects. For example, they are said to be ahead in the race for artificial blood through hematology. And if that happens, I would love to own some of that stock.

COMMENT, *Ms. Macdonald*: Canadians are very conscious of doing things in an international context. As I indicated, between the kind of company that Bob Pavey would finance and the kind of company that our counterpart in Canada would finance, the Canadian company has to be better initially, because it has to be able to sell across borders within twelve months. Whereas there are lots of markets here where you can stay at home for at least twenty-four to thirty-six months.

Using the NBS example, part of their strategy very early on was to participate with Bob Pavey's firm, which is recognized as being advanced in the medical and health and biotech arenas here. As a partner, they know that their Canadian companies would not be able to walk over the border and access the U.S. markets. So they built those kinds of strategic relationships early on. And I think that is a good example of the sorts of innovative strategies that some of these investors are adopting.

QUESTION, *Mr. Langmack*: Mary Macdonald mentioned that there are certain tax credits available. We know in this country all of the politicians, whether local or national, are talking about creating jobs. One of the things they talk about is innovative opportunities and the cost of the international field. I did not hear Bob say anything about any tax credits available for anything in the venture capital field. I know we think in this country we are completely overregulated, and I think we are. But, I wondered, between the two of you, in the context of tax credits or regulations or even the incentives for your people to get the innovative jobs going in the market, is there anything in that area between Canada and the United States?

ANSWER, *Ms. Macdonald*: If I can just add, the tax credits are nice on the one hand. On the other hand, we are really seriously taxed in Canada. So there are some incentives to bring the money in. But our tax load is heavier than it is here, particularly on the capital gains side, which is a real issue.

QUESTION, *Mr. Pavey*: It is heavier?

ANSWER, *Ms. Macdonald*: Yes.

COMMENT, *Mr. Pavey*: Tax credits are not a big factor in the innovation process in this country. The government is a big factor at the early stage. And I commented more on this when I addressed this group several years ago. I think the proper role of government is funding very early stage research at academic institutions in biotechnology, in advanced materials technology, in advanced computer science, and whatever. That is not the kind of thing that individuals or venture firms are going to fund. We have all kinds of government support for academic research, and that is enormously productive for innovation. It is not an accident that a lot of the venture capital in this country centers around the institutions that have had that kind of research, MIT for example, and have been good at spinning it out in the young companies. But that ought to be the government's role. Would I like the government to give me some money? Of course. But do I need it to do what I do well? Absolutely not.

The thing I am always afraid of is, what happens here in Ohio? We have four very big pools of capital down in Columbus, public employee retirement funds. There is legislation in Ohio that enables them to invest in a basket of risky securities, anything other than fixed income securities and New York Stock Exchange companies. But the government puts all kinds of limits on what they can do, and frankly they are well behind their competitors in other states that do not have this enabling legislation. They are behind in terms of allocating capital to higher-return kinds of assets. They are frightened that some regulator is going to come look over their shoulder and say, you did not do it right. So mostly the answer — my biases will show here — is to get the government out of the way and the process will work very nicely. Our markets will work and the innovation which deserves financing will raise capital.

COMMENT, *Mr. Robinson*: As a follow-up to Mary's answer, just from the lawyer's perspective, I would like to point out a very important change in legislation in Canada over the last five to ten years is the movement away from rigid restrictions on investments. Pension funds and regulative financial institutions can make the prudent person portfolio test which in each such institution, including the pension funds, has to develop and then police. But there is no five percent junk bond or junk exception, and then the rest of your investments have to fit into a pigeon hole. As a result, we should be seeing these pension funds freed from these regulatory constraints and getting more involved where they seem to be flipping over to the labor-sponsored funds rather than doing their jobs.

ANSWER, *Ms. Macdonald*: Frankly, I would love to be able to, in two-years' time, put these charts up and show the same kind of flow that Bob Pavey has shown, that the institutions have come back in. I am glad the government is there, only because there would be no capital if they were not there at this point in time. And having said that, the ideal situation is that the private sector sees performance and results, and puts the money back in. So hopefully that trend will reverse itself.

COMMENT, *Mr. Pavey*: I am interested to learn that there has been a change in the prudent man rule in Canada. That can be enormously powerful because that was one of the most important things that happened in this country in the late 1970s to change our venture capital industry. You recall from my charts that we were a several-hundred-million-dollar-a-year industry, and the department of labor and its regulation of institutions changed the prudent man policies from an investment-by-investment analysis to a portfolio-based analysis. After the fact, anybody can look at every one of the investments I make that goes bankrupt and say, "That was a stupid thing to do." And in retrospect, obviously it was. I wish I had not done it. If I have to get tested retrospectively on each investment, I am doomed, and so are the institutions. Once they could take a portfolio approach and say, it is prudent to put a few percentage of your assets in high-risk investments, then the money will start to flow. That really happened in this country.

COMMENT, *Mr. Robinson*: We definitely have that in Canada. We do not have an overlay of the regulators saying how much can be put in. So, the regulatory restrictions are off. This was a great blow to Canadian lawyers, because one of the bread-and-butter jobs we used to do was giving what we called the legal-for-life opinion. It was called life, because the key statute was the Canadian and British Insurance Companies Act. It set out the list of pigeon holes, pension funds, and trust funds, and everything would slide in and cross-reference to that. So you would give this opinion that the investment was legal for life. Well, now our opinion is a non-opinion. You have a prudent portfolio, a prudent person portfolio set of criterion that you have developed, so you have done the statutory requirement. Otherwise, lawyers who cannot even add get out of it.

QUESTION, *Mr. Harwood*: There was a little bit of commentary about the availability of quality entrepreneurial managers. And I would like to hear some expansion on that point from the U.S. point-of-view. Also, focus on whether that group of early retirees from large institutional organizations like big oil companies and big corporations, the fifty-five to seventy-year-old engineering or management retiree, how do they fit into that pool of entrepreneurial managers?

ANSWER, *Mr. Pavey*: The honest answer is not very well. Most entrepreneurial executives learn by doing. And when government officials in Ohio come to us and ask, "What do we need to do to have more successful entrepreneurial ventures around here?" We say, that you need more successful entrepreneurial ventures around here. It is a self-reinforcing process. When you have a few, you have to do everything you can to make them successful, because success begets success. These people learn by doing. They learn by watching. And then they spin off and do it themselves.

What we look for in the president of one of our companies is somebody who has either been a vice president of another successful company or maybe an unsuccessful company (they do not always win, and that is understood in this business), or has been a younger profit center manager in a larger corporation, frequently away from headquarters, maybe overseas, where the person has gotten significant individual profit experience and knows how to build a company. Because these companies, when successful, grow very dynamically. A senior executive of a large company that has been going nowhere and not growing very fast really does not have the tools, the mental pictures, or the contacts to know how to build these companies.

I mentioned a company out in California. The CEO we brought into that company had been the number-two person at a very large public company, and he was in his fifties. It was a rapidly growing company, a company called Raychem, and he managed part of their communications business. He was a very senior dynamic executive. And even with that, our biggest risk when we brought him into this company was, could he go into a twenty-person company and survive? Fortunately, in his case, it was like a duck to the water. He was delighted to get rid of his large staff. He threw away his suit, the outfit we all have to wear all the time, and rolled up his shirt sleeves, and went home to his PC and started working on the business plan. So he was the right kind of person. But that is really, I am sorry to say, an exception.