investeco
NEWSLETTER

Canada's First Environmental Investment Company JUNE 2010

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Industry News

1. Investeco acquires a stake in next generation fuel company

The Investeco Private Equity Fund III, L.P. is pleased to announce its first portfolio investment of US$730,000 into Ensyn Corporation, a global biofuels leader with a head office in Ottawa. Using a patented "fast-pyrolysis" technology, Ensyn is able to create a bio-oil that has multiple commercial applications in global sectors such as power generation and transportation. Ensyn has established strong global partnerships to commercialize its technology, including a joint venture with UOP, a subsidiary of Honeywell. Recently, Ensyn announced a partnership with Tolko Industries, a large Canadian-owned forest products company, to build the world's largest fast pyrolysis plant in Alberta, capable of producing 85 million litres of pyrolysis oil a year that will be used to supply electricity for a local community of 3,800 people, as well as to supply power and heat to the plant itself. Investeco is joining a syndicate of investors that includes company management; Impax Group, a large UK-based venture capital fund; and one of the world's largest global fuel companies.

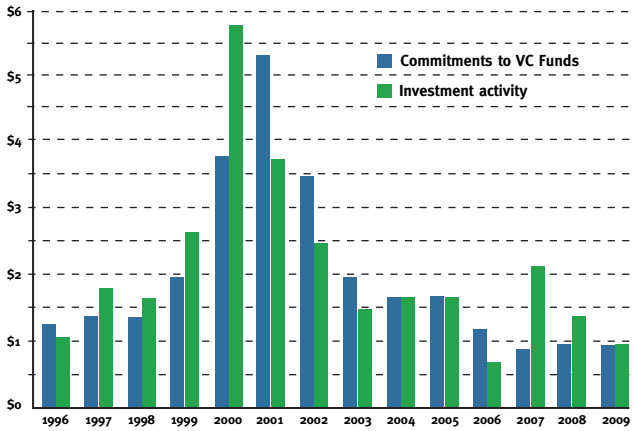
Investeco has followed the Ensyn story for many years and has watched as the company developed its commercial markets. We have come to the conclusion that the company's technology is very efficient at converting biomass to energy, and closer to real commercial scale than most biofuels technologies. On this basis we believe the company is poised for significant revenue growth in the coming years.

2. Could 2010 be the best vintage ever?

Most of us know that the year in which a good Bordeaux wine is bottled can make a huge difference to its taste and value. A truly great vintage is a rare thing and requires a perfect combination of heat and rain through the growing season to produce exceptional grapes. Like the Bordeaux, venture capital funds are also measured by "vintage year" (the year in which a fund starts investing) in order to fairly compare performance. Vintage year is one of the most important contributors to overall fund performance and this year has the potential to be one of the best in a long time.

Historically, the best vintage years for venture funds have been

Canadian Venture Capital ($billions)



Source: Thompson Financial

1977, '78 and '79 and 1995, '96 and '97. Funds launched in those years averaged annual returns in excess of 44%. This compares to the other years between 1969 and 2007, when the average IRR was less than 10%.

What is it that makes some years extraordinary and others very challenging? It seems availability of capital and technological innovation both play significant roles, but availability of capital is more important. In years when private equity capital is not easily available, funds deploying it do not generally have much competition for deals, and therefore are in a better position to pick only the very best investments and to demand attractive investment terms. And, since fewer companies get funded, those that do get funded often spend less to grow market share, as they face less marketplace competition.

Widespread technological change is also a somewhat important factor. For example, developments to the World Wide Web, microprocessors and genetics in the mid-1990s opened up new business opportunities and helped create great vintage years. However, technological developments are no guarantee of great investment success. These technological developments continued into the early 2000s but along with them came historically high levels of VC funding. Because of the excess availability of capital at this time, funds with vintage years 1999-2002 have some of the worst track records in history. Accordingly, it appears that disruptive innovation matters, but a dearth of capital seems to matter more. (It is still too early to know how the funds launched since 2003 will mature.)

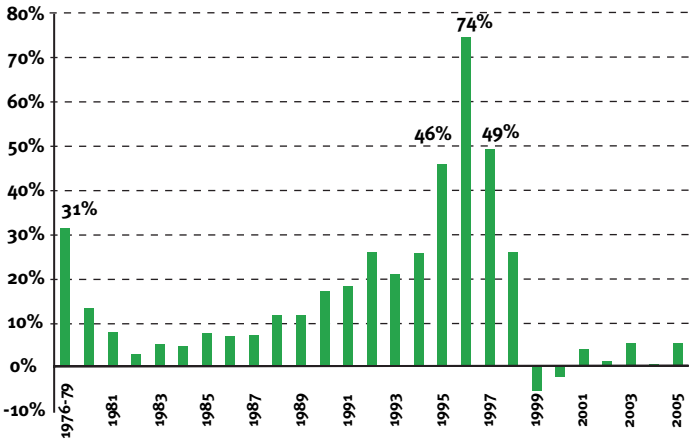
Given the factors that contribute to great vintage years, how does the current environment look for new funds? Last year, VC funding activity was at its lowest level since 1995. Accordingly, one would expect last year to have great potential as a vintage year. And since there is a lag between the raising of private equity capital by investment funds and the making of investments, it is likely that this will remain the case for at least the next couple of years.

Indeed, Investeco has seen private company valuations become considerably more attractive in the past twelve months. This is striking compared to the valuations of similar publicly listed companies that generally have soared over the same time frame. Canada Pension Plan CEO, David Denison, seems to agree that this valuation discrepancy exists and was recently quoted in *The Globe and Mail* saying, "We do believe private assets and infrastructure will outperform the public markets."

The other contributing factor to great vintage years, innovation, is accelerating as well. However, we believe it will look different from the pure technological advances of the 1990s. There will still be stunning technological breakthroughs, but innovation will also come through the adoption of existing technologies. Investment opportunities will come from social innovation, as consumers demand more thoughtful products and new markets emerge. Environmental stresses, resource scarcity and demographic changes will create investment opportunities far beyond those of the mid-1990s.

As with wine it is often years before you know how good a vintage will be, but the capital environment and technological conditions seem to be perfect to ensure that 2010 has the potential to be one of the best vintage years in a long time.

Vintage Year - Average U.S. VC Fund IRR (%)



Source: Thompson Financial

3. Mass transportation's second act

Not since the 19th century have rail transportation investments looked so attractive. New technology, economic productivity and environmental concerns are driving growth of global freight, commuter and urban railway and LRT programs. This growth is creating a significant investment opportunity for engineering and construction companies, rail car manufacturers and information technology companies that ensure the efficiency and safety of the trains.

China is leading the way in long-distance rail-transportation growth. Next year, China will have completed a rail link across the entire country that will enable trains to travel at an astonishing 360km/h. The Chinese government has also allocated US$300 billion for rail construction over the next three years. And by 2020 it is predicted China will spend US$730 billion to extend its rail network to 120,000 km, 18,000 of which will be next-generation high-speed track. The chinese government has a vision to link even disparate parts of the country by rail the same way President Eisenhower did in the 1950s in the United States with his interstate highways project.

And now the U.S. government is also planning more rail. President Obama's stimulus package announced in February 2009 included an US$8 billion railway package, which is to be spent over five years. While the U.S. only has one existing high-speed rail line (Amtrak's Acela Express between Boston and New York), there are plans for at least 13 new high-speed rail corridors across the country to be built in the next 20 years. Some of these even include Canadian cities: Vancouver-Seattle-Portland line and a Montreal-Boston-New York line (Canada for its part is yet to build its first high speed line, despite repeated proposals for a Windsor-Québec City route). Compared to China, it is less clear where the funding for the estimated US$600 billion cost of the new U.S. track will come from, but Obama's US$8 billion is a start.

The rail investment boom is also happening in Europe. European rail trade group UNIFE forecasts that Europe will spend 111 billion Euros in the next five years on rail. And most emerging markets have significant rail plans too.

The rail boom is not confined to long distance and high-speed rail. Investments related to urban metro lines should not be overlooked. Public transit ridership has increased in most cities through the current economic downturn, driven by urban densification, congested streets, higher gasoline costs and environmental concerns. China is again leading the way. Over the next ten years urban rail networks in China will expand from 1,000 km to 4,500 km. To put the enormity of China's urban rail plans in perspective, the TTC's Toronto expansion of the Sheppard line was 5.5 km long, took eight years to build and cost $1 billion. While China may have the most ambitious plans, it is hard to find a large city anywhere in the world that doesn't have an LRT expansion program.

Another good way to get a read on the speed of rail development is to look at the sales of the companies building the rail cars. Alstom, Siemens (both of which are held by our Global Environmental Sectors Fund) and Bombardier are the largest global players but large new players, like China's Southern and Northern Railway and Russia's Transmashholding are also emerging. The rail business of Alstom is expected to bring in about 6 billion Euros this year, or about 30 percent of the group's revenues and one-quarter of its operating profits. As further evidence of large rail company growth, Siemens and Bombardier both won multiple $1 billion-plus rail contracts in 2009.

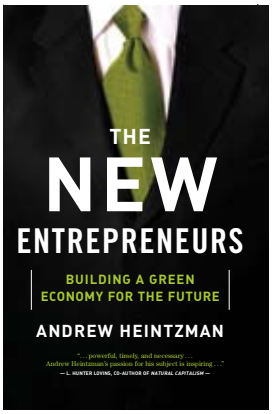
Notwithstanding the impressive growth of large rail companies, it is often the smaller "support" businesses that offer the best investment opportunities when these larger trends happen. In this case, the new high-speed trains, which can easily exceed 300 km/h, need sophisticated systems to manage traffic flow and keep them on the tracks. These systems include laser technologies and advanced software. Consequently, companies like Italy's Ansaldo that provide signaling systems and driverless train technologies and WABTEC which makes train braking systems (both of which companies are held by our Fund) are performing exceedingly well.

Driven by long-term trends, including environmental drivers, we believe that high-speed rail, LRTs and the systems and maintenance that keep the trains running offer a wonderful investment opportunity.

4. Back to the Future: The return of woody biomass as an energy source

Investeco's recent investment into Ensyn follows a lengthy internal focus on woody biomass. Although using wood to make energy is not a new idea — it remains the dominant source of energy in much of the developing world — the idea of wood providing a growing share of energy in the developed world is gaining currency in a time of renewed focus on climate change. Using wood as a fuel is one way to potentially reduce greenhouse gas as our forests provide ample amounts of waste wood that would otherwise rot and release carbon back into the atmosphere. Using this waste to create energy is theoretically carbon neutral.

A growing number of companies are making technologies to turn that wood waste into energy. From fast-pyrolysis as is the case in Ensyn's technology, to gasification for heat and electricity, to thermo-chemical treatment for fuel ethanol, and to torrefaction for use in coal burners, one of the oldest energy sources is getting a new lease on life in a time of greater climate awareness.



Investeco's Andrew Heintzman's latest book, *The New Entrepreneurs,* contains more on biomass and other emerging green technologies.

One approach is gasification, where wood is turned into syngas through high temperatures and pressure. Vancouver-based Nexterra develops small gasification systems that use wood to produce both heat and electricity. Working with partners like Johnson Controls, a leader in automotive design and power systems, Nexterra have targeted "inside the fence" power plants where the energy can be used on location. The sectors they have targeted include pulp and paper: they have built plants at Krueger paper in Vancouver—and the University sector, with one plant being completed at the University of Southern California. They are also building the first residential application of their gasifiers at Dockside Green, a $600 million, 15 acre LEED platinum development in downtown Victoria that will eventually be home to 2,500 residents.

Another approach is to use woody biomass to create fuel ethanol. Mississauga-based Woodland Biofuels, an investment in Investeco's second private equity fund, is using thermo-chemical process called Catalyzed Pressure Reduction (CPR™) technology to turn biomass into fuel ethanol. Like Nexterra, the process starts with gasifiying the feedstock to create a syngas. But after this stage, Woodland uses a three stage catalytic process to turn the syngas into fuel ethanol. The process creates little waste and residue, unlike earlier generations of "cellulosic ethanol" that end up with a bi-product called lignin, and thus promises higher levels of efficiency. With a large grant from the federal government through the Sustainable Development Technologies Fund and another from the Ontario Government's Innovation Development Fund the company is poised to build its first pilot plant in 2010, and assuming it is successful, a full commercial plant after that. The company believes it can create fuel ethanol at substantially less cost than any other technology, with limited negative bi-products and significant greenhouse gas emissions benefits.

A third interesting technology called torrefaction may help convert coal-fired power plants to biomass. The pressure to reduce pollution from coal — the most polluting of all fossil fuels — has pushed many coal plants to move towards mixing biomass into their fuel, or in some cases converting entirely to biomass. In Ontario, for example, the provincial government's promise to eliminate coal power is leading to the conversion of plants like Nanticoke into burning woody biomass for peaking capacity. But there are significant challenges to firing coal plants with biomass. Higher moisture content, challenges storing woody biomass, transportation costs and costly retrofits are creating opportunity for a new thermo chemical process called torrefaction that has the potential of making wood better suited to be used in coal fired burners. Subjecting wood to 200- to 300-degree heat for an hour in the absence of oxygen changes the properties of wood to increase the energy value by weight, to make it more impervious to water, and to improve the durability and uniformity of the resulting "char." In short, torrefied wood works and acts a lot like coal. This may help large coal facilities switch over to biomass to reduce their emissions.

Whatever technologies end up being used, there is little doubt that the use of woody biomass for energy production is going to increase in the future. Investeco believes there is a large enough market for a number of these technologies to succeed, though companies that can get to market with a commercial, cost effective product in the next twenty-four months will have an advantage.

Investeco Capital Corp. News

5. Investeco completes Organic Meadow share sale

On December 19th, 2009, Investeco Private Equity Fund, L.P. sold the balance of its shares to the Organic Meadow Dairy Co-op for a final annualized return exeeding 35%.

6. Woodland Biofuel awarded $4 million by Ontario government

Ontario is investing $4 million through the Innovation Demonstration Fund (IDF) to help Woodland Biofuels Inc. build a groundbreaking demonstration plant that will efficiently produce cellulosic ethanol from renewable wastes. The plant will use Woodland's patented technology, which can produce sustainable fuels from virtually any type of biomass, including wood waste and agricultural waste.

7. Rowe secures $1.32 million capital for future store expansion, opens new store in Guelph

Rowe Farms recently completed a $1.32 million fundraise in order to expand its retail concept and open new stores. The investment round was oversubscribed by $320,000. Investeco participated through our first two private equity funds. The capital should allow Rowe to build on their continuing retail success, starting with a new store launch for downtown Guelph (1027 Gordon St) which opened on June 1.

8. Triton Logging completes first tranche of a $3–5 million financing

Triton closed $1.825 million in financing in May, which represented the first tranche of an expected $3–5 million round. This investment will allow the company to begin to move forward on the concession at Lake Volta in Ghana, which the company acquired through a merger with CSRD, a company founded by former Canadian Prime Minister Joe Clark.

9. Biorem reports record revenue of $18.9 million in 2009

Biorem had a strong fiscal year, with more than 30% growth in revenue and gross profit and a sustained 40% gross margin level, which resulted in $1,387,000 of EBITDA. Peter Bruijns, President & CEO said, "2009 also marked our first full year of positive cash-flow generation, and one of our highest levels of cash to date, representing an 83% increase in cash over 2008 levels. Our performance during 2009 was driven by an increased number of completed air emissions control projects and good order bookings in North America and internationally, notwithstanding the weak economic environment."

10. Schneider Power acquired by Quantum Fuel Systems Technology

Quantum acquired all of the issued and outstanding capital stock of Schneider Power on April 20th, 2010. The business combination merges Schneider Power's wind and solar power generation development portfolio with Quantum's alternative fuel and solar power technologies to create an integrated renewable energy company. The combined portfolio will encompass products that enable energy efficient utilization in hybrid and fuel cell vehicles to solar module manufacturing and clean electricity generation for North American consumers. Quantum Fuel Technology shares are listed on Nasdaq (QTWW).

Investeco Financial Corp. News

11. Global Environmental Sectors Fund - Knowing your price takes the emotion out of investment decisions

May 2010 offered some of the most economically destabilizing events in modern history. Just think, the worst oil spill ever, near default in Greece (a serious test for the European Union), the alleged torpedoing of a South Korean warship by their enemies to the North and a highly controversial attack by Israel on a Turkish relief convoy to Gaza, all in one month. Given that these events occurred in the context of an already fragile global economy it is no wonder that we also witnessed historic stock-market fluctuations.

But stock prices tend to move much more quickly than actual changes to business fundamentals. Investors often let price movement determine their investment decisions more than the actual price itself. Maybe it is Investeco's private equity heritage, but we are far more interested in what a company is worth than what direction its stock is trading. Determining a company's value is a lengthy process that requires research, interviews, financial modeling and years of industry knowledge. Investeco Financial Corp. currently tracks about 500 listed companies for the Global Environmental Sectors Fund and has completed significant diligence on 150 of these. We establish price targets and review our assumptions frequently, but they don't change as quickly as one might think, even in volatile times.

This May and June when events sent many investors looking for exits, Investeco increased our position in half our portfolio holdings and added new companies Boralex Income fund, Hitachi and International Rectifier.

12. Canadian independent power producers (IPPs) consolidate

Last year our preference for developers of renewable energy assets was rewarded when Canadian Hydro Developers was taken out at a substantial premium by utility giant TransAlta. The imminent change in taxation policy for income trusts has provided extra impetus for consolidation to create the next generation of large IPPs. Over the past year, three income trusts have merged (or proposed to merge) with their parent companies to form larger and more simply structured single entities: Boralex, Innergex, and Northland Power. With positions in Boralex and Innergex, we have benefited from the consolidation. Looking forward, we believe that Boralex, in particular, stands to gain with their current proposed transaction, as it provides improved cash flow and low-cost financing for its large wind development in Québec.

Congratulations to Greg Payne, Manager of our Global Environmental Sectors Fund for successfully defending his economics PhD thesis at the University of Toronto. Greg has been studying the sustainability of our health care system – in his spare time!

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