

WHAT SHOULD BE THE MANDATE OF THE MERGED SOCIÉTÉ GÉNÉRALE DE FINANCEMENT?

The Quebec government has just announced its intention to merge the Société générale de financement (SGF) and Investissement Québec. However, nothing indicates that their respective mandates will be modified. The debate that has begun over this reform offers the perfect occasion for evaluating the historical results of the SGF. Doing so will clarify why it is important to redefine the mandate of the government corporation that will result from this merger. The province of Quebec will benefit if the government leaves the financial risks associated with business development to the private sector while guiding economic development through an appropriate regulatory framework.



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The Quebec government created the SGF in July 1962 in order to promote economic development in the province. Initially founded as a mixed public-private corporation, the SGF began its activities by launching a public offering to collect investments from the population. The offering was a success, with the capital collected surpassing the \$45-million mark. Capital subscriptions of \$16.2 million were accepted from the Caisses populaires Desjardins, from other financial institutions and from a certain number of private investors.²

Yet, the operating results of the first years of the mixed corporation dampened this initial enthusiasm, since the SGF recorded cumulative losses of \$4 million as of December 31, 1971.³ The following year, a law was passed authorizing the purchase of all outstanding SGF stock at issue price.

The SGF's preferred method of intervention has been direct participation in capital and in the creation of businesses, notably in the industrial sector, in collaboration with partners.⁴ Very recently however, at the start of 2009, the govern-

ment authorized the SGF to grant loans to help finance businesses during the financial crisis; to this end, the government supplied the SGF with \$500 million of additional capital.⁵

It has long been Investissement Québec's mandate to extend loans to businesses. This situation may have created confusion among businesses seeking financing. At a glance, then, we can look favourably upon this merger of the SGF and Investissement Québec, the purpose of which is to end this redundancy and save some ten million dollars in operating expenses.

Mediocre performance

The SGF has sustained losses one out of every three years since it began operations. However, both the frequency and the size of those losses have increased substantially over the past ten years. The SGF has lost money during six of the last ten fiscal years, which translates into a negative balance of \$1.07 billion over this period.

The funds invested by the Quebec government since the organization's inception



1. The author wishes to thank Philippe Gaucher and Ariane Meunier, who helped him with this research project.
 2. SGF, *Rapport annuel 1963*, pp. 8 and 9.
 3. Author's calculations based on the SGF's annual reports.
 4. SGF, *Mission and Orientations*, <http://www.sgfqc.com/en/portrait-sgf/mission-objectifs.htm>.
 5. SGF, *Rapport annuel 2009*, p. 16. The SGF had already granted financing by convertible debenture in 2003. It still holds this investment.

TABLE 1
The 100 largest Quebec businesses
by type of ownership

	Number of businesses	Employees	
		Number	Proportion
Quebec publicly-traded corporations	34	224,250	38.7%
- listed on the stock market after 1962	25	163,285	28.2%
- listed on the stock market before 1963	9	60,965	10.5%
Quebec closed corporations	18	52,369	9.0%
Government corporations	10	70,048	12.1%
Cooperatives	5	55,902	9.7%
Non-Quebec businesses	33	176,152	30.4%
All businesses	100	578,721	100.0%

Source: <http://www.lesaffaires.com/classements/500-quebec-2010>

Note: Data were adjusted to add five businesses that were included in 2009 but not in 2010.

total \$2.6 billion in capital.⁶ This money was borrowed by the government at an average interest rate of 8.8%.⁷ On December 31, 2009, there remained only \$1.8 billion. The management of the SGF has therefore obtained a negative annual rate of return (-1.0%) on the capital entrusted to it by the government since its creation.

Investing in the SGF entails much more risk than buying Quebec government bonds. To compensate for this risk, an acceptable rate of return should be comparable, for example, to that of companies listed on the stock market.⁸ The Toronto Stock Exchange has earned shareholders an average yearly return of 9.9% since 1962.

Had the SGF's management obtained a rate of return equal to the average rate of return obtained by stock market investors since 1962, its holdings would have been worth \$9.2 billion at the end of 2009. The SGF therefore represented a loss (opportunity cost) of \$7.4 billion for Quebec taxpayers, which is the difference between the amount that would have been obtained by investing the SGF's capital in the stock market since its creation and the amount actually remaining as of December 31, 2009.

By creating the SGF in 1962, the Quebec National Assembly took inspiration from a model of intervention in the economy that was prevalent at the time, but that has since been

increasingly abandoned around the world for failing to live up to its promise. Generally speaking, governments that have left more room to the private sector have seen their economies develop more rapidly.

A negligible influence on the development of large businesses

Given the resources put at the disposal of the SGF since its inception, what role has it played in the development of large Quebec businesses?

The weekly business newspaper *Les Affaires* publishes an annual listing of the largest companies operating in the province of Quebec. The ranking of each business on the list is determined as a function of the number of employees each has in Quebec. At the end of their most recent fiscal year, the 100 largest companies provided work for 579,000 employees, or 15% of the jobs in the province. Sixty-seven of those companies have their headquarters in the province, and they employ 403,000 people (see Table 1). If we exclude the ten government corporations, the five cooperatives and the eighteen closed corporations, we are left with 34 companies that listed their shares on the Toronto Stock Exchange.

These 34 businesses employ 224,000 people in Quebec. Since the creation of the SGF, 25 of these businesses have launched a public offering to obtain the capital they required to develop. The Quebec government corporation has invested in seven of them over the years: Bombardier, Cascades, Domtar, Rona, Saputo, Tembec and Transcontinental. Only Rona resorted to an investment from the SGF before being listed on the Toronto Stock Exchange, and this was in the year preceding its initial public offering, when it had already attained a respectable size. For the six others, the SGF's investment occurred several years after their listing on the stock market.

The SGF has obtained a negative annual rate of return (-1.0%) on the capital entrusted to it by the government since its creation.

6. This amount includes the capital transferred to the SGF following the adoption of the *Act respecting the combination of certain state enterprises* in 1998. Note also that the SGF benefited from \$81.3 million in government aid in 1991 and \$181.5 million more in 1992, help that reduced by as much the realization costs of certain contracts. We have treated these instances of aid as capital injections and we have adjusted the 1991 and 1992 results downward accordingly.

7. For this calculation we used, for each year, the yield at maturity on June 30 of the thirty-year bonds.

8. A premium should also be added to account for the lack of liquidity of this type of investment.

None of these “jewels” of the Quebec economy needed the SGF to develop. When the SGF did intervene, it was after these businesses had already reached an advanced stage of development. The SGF’s influence remains negligible even though 25 of these 34 businesses came into existence after the creation of the government corporation.

A confused investment strategy

In order to understand why the SGF’s performance has been so disappointing, we have made a brief analysis of its portfolio. We have found that it contains a disparate assortment of investments with no unifying thread.

Businesses held in their entirety

The SGF claims, in its mission statement, that it acts with partners. Nonetheless, on December 31, 2009, it held 100% of the stock of six companies active in two different economic sectors: two forestry management companies acquired from Smurfit and Abitibi-Bowater, a sawmill named Temrex, Rexforêt, the Veterinary Medication Distribution Centre (CDMV) and the Canadian Porcine Insemination Centre (CIPQ). What expertise does SGF possess to manage such disparate businesses itself? What justifies this surreptitious nationalization of these businesses, which are the exclusive property of a government corporation?

The SGF has been the sole owner of the CDMV and the CIPQ since its merger with Soquia in 1998. As of December 31, 2009, it had not announced an exit strategy for these investments since they did not appear on the list of investments available for sale at that time. Should we interpret the status quo as an indirect subsidy of Quebec’s agri-food industry?

Overlapping with other government programs

Since 2004, the SGF possesses, through its subsidiary Diaquem, a 50% share of the Ungava diamond project (Foxtrot) on the North Shore. The exploration program, which began in 1996, discovered its first kimberlitic intrusions in 2001. The evaluation of these discoveries is ongoing. Why do we need to supply capital to a mining business when

Quebec already has a very generous program of flow-through shares for this type of activity?⁹

A lack of expertise in specialized sectors

In 2006 and 2007, the SGF made three investments totalling \$258 million in the film industry. None of the members of its management committee, which is comprised of ten vice-presidents in addition to the president and general manager, appeared to have any experience in this sector. We do not know the SGF analyst who has such experience since a legal advisor was chosen to present, in the 2006 annual report, the advantages perceived by the management in the partnership entered into with Dark Castle.¹⁰

Transfer of risk to the government

The SGF, which since 1989 holds what is now a reduced 13% share in the Aluminerie Alouette, is responsible for ensuring both its supply of aluminum oxide and the sale of its share of aluminum on the market.¹¹ In order to ensure the establishment of this aluminum plant in the province, Quebec guaranteed its supply of electricity at a preferential rate that follows the price of the silvery-white metal on the market. The SGF’s private partners in this aluminum plant have succeeded in transferring to Quebec society the risk of price fluctuations for aluminum as well as a portion of its operational risks. Here again, it is clear that the SGF has no exit strategy. It did not take advantage of those times when the price of aluminum was high in order to sell its stake in the company.

Venture capital funds

On December 31, 2009, with the exception of its forestry holdings, we found in the portfolios of each of the SGF’s investment groups at least some shares in venture capital funds. The private managers of these funds seek out investments in businesses that are innovative, in development or just emerging. Their mandate is essentially the same as the SGF’s since economic development necessitates innovation. Why maintain a structure as expensive as the SGF when private managers, sheltered from political intervention, can do the same work and make it profitable? If these fund

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9. For the 2009 tax year, the net cost after taxes of an investment of \$1,000 in flow-through shares could be as low as \$284.

10. SGF, *Rapport annuel 2006*, p. 3.

11. SGF, *Rapport annuel 1990*, p. 9.

managers do not produce the returns expected by investors, they will not be able to attract new funds in the future. The opposite is true for the SGF, where the capital received is inversely proportional to the results obtained.

Business loans

As we saw above, the government granted, at the start of 2009, an additional mandate to the SGF to help Quebec businesses temporarily unable to obtain credit following the financial crisis in the fall of 2008. The organization was given this mandate despite the fact that it had no experience in the area of credit. It completed three loans during 2009 for a total investment of \$175 million.

Several governments in the world similarly supplied liquidity to businesses in order to help them make it through the financial crisis. Contrary to what happened elsewhere, though, the financing offered by the SGF seems to be permanent since no business has yet made any kind of reimbursement of those loans. Numerous American banks helped by their government made a point of reimbursing the borrowed funds quickly. Even General Motors, after a spell under the protection of the courts, has already paid back the loan it was granted. It was reported on September 10, 2010 that Renault and Peugeot each reimbursed one third of the 3-billion-euro loans they received in April 2009, which they did because they can now borrow at a better rate from the private sector.¹²

As the SGF had not deployed the entire \$500 million of capital during the financial crisis, it decided to use the rest of the funds to continue to make loans, this time to businesses that were

in a position to secure financing from the private sector. It lent \$70 million to two businesses as a member of a banking consortium. In another case, it bought \$8 million of convertible debentures during a public offering that had been firmly underwritten by a financial consortium. In none of these cases did the participation of the SGF have anything to do with a lack of liquidity.

Conclusion

The SGF has had mediocre yields since its inception. This is explained by a fuzzy mission whose continued relevance is unclear.

Although it says it favours partnerships, the SGF holds, and has held for several years, 100% of the capital of several businesses whose roles are very different from one another. Whether in film or in business loans, it has invested considerable

sums without relevant experience in the sector.

On the other hand, the “jewels” of the Quebec economy were able to shine without help from the SGF. Only a few of the businesses in which the SGF has invested have succeeded in being listed on the stock market. It is easy to understand in light of the preceding analysis that the type of intervention favoured by the SGF is becoming less and less common around the world. Given the inconclusive historical results of the SGF, we must conclude that the government should seriously consider redefining the role of the new organization that will result from the announced merger with Investissement Québec. This new entity should abandon the part of its mandate that consists in buying direct shares in the capital of various companies.

The SGF's portfolio contains a disparate assortment of investments with no unifying thread.



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12. Reuters, “Renault et Peugeot veulent rembourser l’État rapidement,” *Nouvelobs.com*, September 17, 2010.