



THE ACTIVITY OF AMERICAN VENTURE CAPITAL FUNDS IN THE ONTARIO MARKET: ISSUES, TRENDS AND PROSPECTS

A REPORT PREPARED FOR THE INSTITUTE FOR COMPETITIVENESS AND
PROSPERITY

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EXECUTIVE SUMMARY

This report, prepared by Thomson Macdonald for the Institute for Competitiveness and Prosperity (ICAP), focuses on the emerging role of American venture capital funds and other foreign investors in financing high-growth companies and innovative sectors in Ontario's venture capital market. It has been written in the interest of achieving a better understanding of cross-border activity in the province, and prospects for increasing this activity in future.

This report emerged through a joint exercise between ICAP and the Ministère du Développement économique, de l'Innovation et de l'Exportation (MDEIE), Government of Québec, which sought to examine similar issues in a Québec market context.

Research done for the report had two dimensions. First, Thomson Macdonald undertook a brief analysis of recent trends in American and other foreign investor activity in Ontario. Second, a series of interviews was conducted with key informants representing fourteen major venture capital fund managers in the United States (October 2005) concerning factors that encourage and discourage their activity in both the Ontario and Québec markets.

Prior studies helped to inform this work, including Thomson Macdonald's *Growing the Businesses of Tomorrow: Challenges and Prospects of Early-Stage Venture Capital Investment in Canada* (2005). These studies indicated that fund managers in Canada have welcomed the capital resources, networks and value-added brought by seasoned American investors to syndicates backing venture-backed firms in this country, but that there are also obstacles to this cross-border activity.

I. TRENDS IN AMERICAN VENTURE CAPITAL INVESTOR ACTIVITY IN ONTARIO

Seemingly overnight, American venture capital funds and other foreign investors emerged as a major presence in the Canadian marketplace. This presence was first felt in a significant way in 1999, when cross-border activity began focusing on exceptionally large deals in telecommunications and other IT sectors. At this point, non-resident disbursements in Canada grew to unheard-of levels, which in relative terms, has not diminished in subsequent years, even during periods of overall market decline.

Between 1999 and the first nine months of 2005, cumulative foreign activity in Canada has resulted in disbursements totaling \$5.0 billion in over 300 companies, and has typically accounted for an unprecedented one-quarter of all dollars invested per annum.

The earliest cross-border activity was located in the IT-rich Ontario market, and especially in the Ottawa Valley. In the period 1999-through-2002, Ontario garnered 72% of disbursements nationwide. American and other foreign investors have since diversified their Canadian activity (though Ontario has still taken close to 60% of disbursements annually). To date, activity in Ontario has comprised a total of \$3.4 billion invested in 163 companies.

When venture capital dollars of volume first crossed the border into Ontario, the impact on trends there was instantaneous. 1999 marked the first year in which non-resident investors were the primary source of resources going into company financings in the province (only in 2003 did they take second spot), given their 30-40% share of all disbursements since then. This role may be even more important today due to what has been declining participation among several domestic investor groups (e.g., corporate, institutional funds) in recent years.

The activity of American and other foreign investors in Ontario has been characterized by strong concentration on a small number of high-growth companies (8-12% of the aggregate number) in key technology sectors of interest. In fact, they have been the leading source of IT-focused dollars in since 1999 (in all sectors: communications, electronics/semiconductors, software, etc.), but have so far invested comparatively few resources in life sciences (4% of their total).

Cross-border activity has most frequently engaged Ontario's firms through expansion/late-stage transactions, to which they have brought substantial capitalization (on average, \$21.0 million per company since 1999, as compared to an average of \$8.7 million attributable to domestic investors).

As a result, non-residents have applied upward pressure on overall deal sizes, helping to raise provincial averages from around \$3.0 million per annum immediately prior to 1999, to ranges of between \$4.2 million (2003) and \$10.2 million (2000). Ontario company financing sizes have nonetheless continued to lag those in the United States' market.

Consistent with their strong IT orientation, American and other foreign investors have targeted major urban centres in Ontario where related sector clusters have achieved some critical mass, as 68% of their disbursements since 1999 have gone to Ottawa, 29% to Toronto, and 2% to Kitchener-Waterloo.

II. RESULTS OF A SURVEY OF AMERICAN VENTURE CAPITAL FUND MANAGERS

To cast light on the data findings, Thomson Macdonald asked senior professional managers in the United States to draw on their knowledge and experience in cross-border activity to rank and comment on factors identified in prior research as being of potential importance to decisions to invest in companies based in

Ontario and Québec. In addition, key informants were asked to discuss ways by which Canadian governments might help ameliorate any impediments to their activity.

Fund managers reflected a cross-section of the American venture capital industry, based in different regions, and with diverse investment mandates by sector and by stage. All but one of these fund managers said that they had done at least one deal in Ontario/Québec thus far, and all but one believed they would probably either sustain or increase their activity in these markets in future.

In the interviews, few distinctions were made between Québec and Ontario with respect to factors encouraging or discouraging American investor participation in their markets.

II.1 FACTORS ENCOURAGING ACTIVITY IN THE ONTARIO AND QUÉBEC MARKETS

American investors gave greatest emphasis to the business case for activity in the Ontario and Québec markets, based on quality venture capital deal flow emerging from local technology sector clusters, as well as the R&D/innovation systems and the education/skills base (e.g., well qualified technicians and technologists) that support these. Several interviewees said they have aimed their funds at early local exposure due to perceptions that competition for the best deals in Canada is not as intense as it is in the United States.

Interviewees also recognized a high degree of capital efficiency (i.e., cost-effective deployment of venture capital) in Ontario and Québec transactions, derived from several variables, including currency exchanges rates, lower overall business costs (e.g., labour, real estate) and federal and provincial government spending programs and tax incentives geared to R&D and innovative capacity (e.g., SR&ED tax credits). Most also argued that venture-backed company valuations were usually lower in Canada than they are in the United States.

In addition, most professional managers interviewed for this report said they have been successful in forging close, trustworthy partnerships with Ontario and Québec based funds of all varieties, on which they rely for access to deal flow, market intelligence, syndication and other resources.

Not surprisingly, proximity to the Ontario and Québec markets were deemed to be a positive factor only for those venture capital funds with headquarters in New England and other Northeastern states.

II.2 CHALLENGES TO ACTIVITY IN THE ONTARIO AND QUÉBEC MARKETS

Interviewees argued that the primary challenge to doing deals in Ontario and Québec pertain to a range of tax issues that arise when undertaking cross-border

activity anywhere in Canada. Many of these derive from provisions, or interpretations of provisions, in the *Canada-United States Tax Convention*, relating in some cases to the fund structure of the foreign investor (e.g., treatment of limited liability corporations), and in others to the nature of the domestic investee.

These tax issues have caused the majority of American investors to rely on Delaware corporations (and offshore vehicles) and “exchangeable shares” arrangements when approaching transactions north-of-the-border, which are typically costly and complex, and ultimately limit their activity in Ontario, Québec and other Canadian regions. Interviewees expressed frustration about the lack of government action taken on these concerns to date.

Professional managers interviewed for this report also identified a barrier in comparatively inexperienced technology entrepreneurs in Ontario and Québec. However, most were prepared to address this situation by drawing on seasoned non-resident executives to act as Chief Executive Officers, as well as non-resident managers in sales and marketing, along with other strategies.

Interviewees also noted some misalignment in aims and practices between themselves and certain fund types operating in the two provinces, as well as some broader compatibility issues (e.g., vis-à-vis deal capitalization, transactional documents, reliance on lead investors), which were attributed to a “conservative” propensity in the activity of Canadian investors more generally. Most agreed, however, that practices would harmonize over time, as cross-border partnerships evolved, and with greater rates of private fund formation.

American investors that are currently active in Ontario and Québec said they had sufficient access to market data and intelligence, but felt that their peers in the venture capital industry in the United States were largely unaware and uninformed about the Canadian market as a whole.

Interviewees did not rate other challenges as highly, though unfamiliar corporate governance structures and related legal systems in Ontario and Québec were discussed, as was the issue of proximity for non-resident fund managers operating at some distance from these markets.

II.3 GOVERNMENT’S ROLE IN FACILITATING CROSS-BORDER ACTIVITY IN THE ONTARIO AND QUÉBEC MARKETS

Professional managers interviewed for this report said that public policy initiatives in Ontario and Québec (and at the federal level) should generally focus on shaping a marketplace in which they and their Canadian partners have optimal latitude in targeting young firms with the best growth prospects, in the most

competitive innovative sectors, and in helping these emerge as world-class businesses.

Interviewees believed that an increased level of cross-border activity expedites this objective, as Ontario and Québec based technology companies and their founding entrepreneurs will ultimately gain access to more extensive investor value-added and networks, broader customer and supplier markets, and deeper capital markets in which to continue the process of expansion.

Among their specific recommendations to the Ontario and Québec governments, interviewees expressed the hope that officials would give top priority to communicating the need for action at the federal level on the topic of cross-border tax issues, which they believe threatens continued exposure to all parts of the Canadian market and, by extension, is key to increasing this activity in future.

Interviewees also saw a government role with respect to outreach to inactive or less active American investors, by disseminating information on local technology “success stories” and relevant federal and provincial programs and tax incentives (also to be directed to active American investors), along with sponsoring industry conferences and events, fostering entrepreneurial management skills, and encouraging formation of well-capitalized domestic funds needed in cross-border partnerships.

The Activity of American Venture Capital Funds in the Ontario Market: Issues, Trends and Prospects

INTRODUCTION

The following is a brief report on the emerging role of American venture capital funds and other foreign investors in financing high-growth companies and innovative sectors in Ontario's venture capital market. This report, prepared by Thomson Macdonald for the Institute for Competitiveness and Prosperity (ICAP) has been written in the interest of achieving a better understanding of cross-border activity in the province, and prospects for increasing this activity in future.

This report emerged through a joint exercise between ICAP and the Ministère du Développement économique, de l'Innovation et de l'Exportation (MDEIE), Government of Québec, which sought to examine similar issues in a Québec market context. A separate, but broadly complementary report based on comparable data sources, methodology and analytical points (covering much the same ground), was also prepared for Québec MDEIE.

In preparation for the ICAP report, Thomson Macdonald conducted research of two essential varieties.

First, using Thomson Macdonald's proprietary database, a brief analysis of recent trends in foreign activity in the Ontario market was undertaken. Second, a series of interviews was conducted with key informants in major venture capital funds based in the United States on issues of consequence to participation in deal opportunities in both Ontario and Québec.

Thomson Macdonald wishes to acknowledge with thanks the very valuable advice provided at all stages of the preparation of this report by Stephen Hurwitz, Partner at Choate, Hall & Stewart LLP (Boston, Massachusetts), a legal advisor with expertise on cross-border issues involving venture capital and other private equity market activity.

Research findings are summarized in the following sections of this report:

Section 1 contains a statistical overview of the activity of American venture capital funds and other foreign investors in Ontario in recent years, with a focus on trends since 1999, and with respect to particular areas of concentration (i.e., by region, by sector, by stage, etc.), as well as the broader influence of this activity on overall market indicators.

Section 2 contains the results of interviews with senior American venture professionals, shaped by a survey questionnaire designed by Thomson

Macdonald. These results touch on a diverse number of issues meaningful to exposure to transactional activity in Ontario and Québec at the present time, and include commentary on key factors governing the decision of fund managers in the United States to invest in these markets, as well as key challenges related to doing so.

Section 3 discusses a few public policy implications suggested by the research, drawing on recommendations made during the interviews. This section is followed by a brief Conclusion.

The following is an introduction to the topic of this report.

Seemingly overnight, American venture capital funds and other foreign investors emerged as a major presence in the Canadian marketplace ⁽¹⁾. This is not altogether surprising, given the size of the fund management industry in the United States, the proximity of many funds to Canada's urban centres, and the increasing perception of activity as being North American (and, indeed, global) in scope.

However, while some measure of foreign investor participation in Canadian deal opportunities goes back many years, it was not until 1999 that American fund managers first began to invest especially large sums here. In that year, their (and other foreign) disbursements totaled \$492 million, up by a factor of ten from the \$50 million of 1998.

Since then, sizeable foreign activity has become a fixture on the domestic venture capital landscape – regardless of cyclical market changes – relative to the pre-1999 period. In fact, on a cumulative basis, non-resident investments have engaged over 300 Canadian companies since 1999, at a total dollar value of \$5.0 billion.

Moreover, as foreign investors have persevered with activity in this country, they have also deepened their roots, by seeking out opportunities in new sectors and regions, building strategic partnerships with local fund managers, and in some cases, opening-up Canadian offices or otherwise finding ways to establish a consistent exposure to deal flow.

Consequently, between 1999 and Q3 2005, these investors have, on average, accounted for an unprecedented one-quarter of total dollars invested in venture-backed companies in Canada.

(1) According to Thomson Macdonald, the vast majority of foreign investors active in the Canadian market are American venture capital funds. Other non-residents that have been active include venture capital funds based in Europe and Asia.

The data suggest that the earliest foreign investor landfalls of a substantial nature were located in Ontario, and particularly in the Ottawa Valley, where intense activity in emerging telecommunications and other IT sectors attracted notice at the cusp of the last big North American market up-cycle, and in its immediate aftermath. In the period 1999-through-2002, Ontario garnered 72% of disbursements made by non-residents in this country, and Ottawa garnered 69% of this provincial take.

American and other foreign investors have since diversified their activity in the province, by both region and sector. This occurred in time for the renewal of venture capital industry activity experienced in Ontario in 2004 that was, in no small way, influenced by the first year-over-year growth in dollars moving north across the Canadian border since 2000.

To date (1999 to the first nine months of 2005), cross-border activity involving the Ontario market has comprised disbursements totaling \$3.4 billion, going to a total of 163 provincially based companies.

After close to seven years of sustained activity on the part of American and other foreign investors in the Canadian market, some additional influences have been detected.

Several research studies have recently commented on this topic, including Thomson Macdonald's *Growing the Businesses of Tomorrow: Challenges and Prospects of Early-Stage Venture Capital Investment in Canada* (published by Industry Canada, with the assistance of the Ontario Ministry of Economic Development and Trade, 2005), and PricewaterhouseCoopers LLP's *Foreign VC Investment in Canada: A Profile of Foreign Investors and Domestic Investees* (Industry Canada, 2003).

These reports point to the particular value-added of non-resident investors in syndicates backing Canadian firms. For instance, based on interviews with senior venture professionals based in Canada and the United States, *Growing the Businesses of Tomorrow*, identified benefits deemed most likely to be introduced by activity involving American venture capital funds:

- Far greater potential for substantial deal capitalization (drawing on multiple American funds with comparatively deep pockets) to facilitate rapid company growth;
- Significant company-building skills, based on long-term market experience in the United States and other nations;
- Significant domain expertise, relevant to a variety of emerging technology sectors in Canada;

- Access to seasoned technology executives, sales and marketing managers, and other business talent with which to develop companies strategically.
- Access to North American (and, in some cases, international) customer and supplier markets;
- Access to diverse, and much larger, North American capital markets that offer the potential of major liquidity events (and further company expansion), such as NASDAQ.

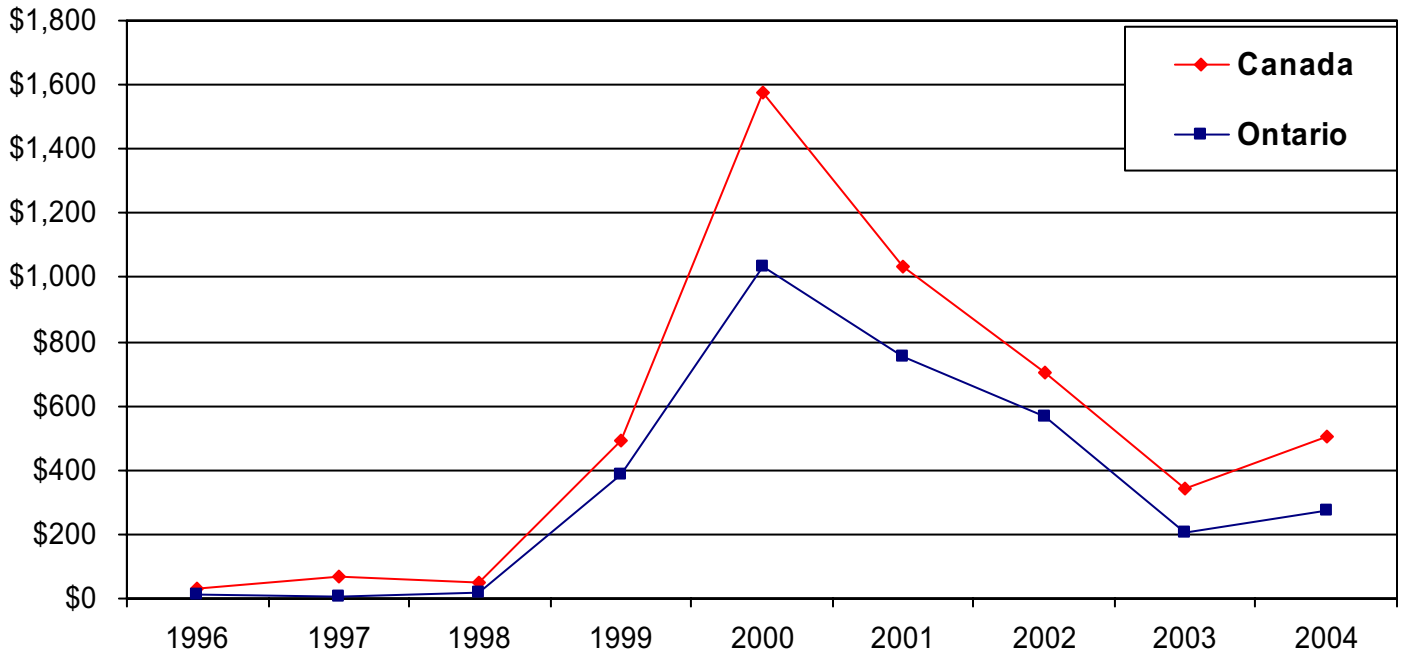
For these and other reasons, co-investment opportunities with American investors have been welcomed in the Canadian venture capital industry, especially in situations where investee firms are deemed to have exceptional growth prospects.

These same reports also reflected on several major challenges (both real and perceived) linked with cross-border activity, such as tax issues prompted in part by the *Canada-United States Tax Convention* (see also: Duruflé, *Cross-Border Fiscal and Regulatory Problems in the Realm of Venture Capital*, 2005, for Québec MDEIE, and; Osler, Hoskin & Harcourt, *Why US Funds are Reluctant to Invest in Private Canadian Companies – And What To Do About It*, 2004) and differences between the markets in Canada and the United States.

With these findings in mind, the following report considers both the possibilities created by cross-border activity involving the Ontario market, as well as the nature of challenges encountered by American venture capital funds that have been responsible for most of the recent activity there.

I. TRENDS IN AMERICAN VENTURE CAPITAL INVESTOR ACTIVITY IN ONTARIO

Fig. 1: VC Disbursements by US/Foreign Investors, All Canada and Ontario, 1996-2004



As was noted in the Introduction, foreign activity in the Canada-wide venture capital space virtually exploded in 1999, which proved to be one of the last years of the biggest boom in the North American market's history. Between 1998 and 1999, dollars crossing the border rose to unheard-of levels, as American fund managers sought out new deal opportunities in emerging Canadian technology sectors – many of them for the very first time.

Indeed, the data show that 1999 was a real turning point, as in subsequent years levels of activity among American and other foreign investors in Canada continued to dwarf levels seen prior to then, even during periods of overall market decline.

Growth was certainly the watchword in 2000, as foreign disbursements in Canada reached a total of \$1.6 billion, or better than triple the \$492 million reached the year before. Even when activity began to flag with the slowdown in 2001, capital invested from this source still topped \$1.0 billion. In 2002, the

telecom-crash sparked a year-over-year drop in foreign disbursements of 32%, followed in 2003 by another drop of 52%.

Cross-border activity began to regain its impetus with the market upturn of 2004, as capital invested stood at \$505 million, up by 48% from the previous year. This trend continued into the first half of 2005, as the \$292 million disbursed surpassed the \$246 million disbursed at the same time in 2004.

In Q3 2005, however, a mere \$38 million was brought by foreign investors to Canadian deals, with the result that activity in the first nine months of this year now lags activity seen last year (\$329 million to date versus \$456 million in the first nine months of 2004). While it is impossible to predict what will happen in the final quarter of this year, cross-border activity in Canada in 2005 appears likely to (at least) improve on levels reached in the full of 2003 (when \$341 million was disbursed).

Ontario has been the scene of most non-resident activity in Canada since 1999, and particularly during its earliest phases, when attention was chiefly fixed on young firms in the Ottawa region's communications and other IT sector clusters. Since then, up-and-down cyclical shifts in foreign investment in Canadian venture-backed companies have typically been led by trends in Ontario.

As occurred nationwide, disbursements by American and other foreign investors in Ontario peaked in 2000 (at \$1.0 billion), but fell steadily thereafter – by 27% in 2001, 25% in 2002, and 64% in 2003. However, even these reduced levels of activity vastly exceeded anything seen in the province before 1999.

The Ontario market was at the forefront of renewed cross-border activity in Canada in 2004, with \$275 million invested, up by 35% from \$203 million the year before. This was also the case between January and June of 2005 when provincially based activity rose to \$176 million, up by 84% from the \$96 million recorded during the same period last year.

However, as once again took place nationwide, Ontario witnessed much less foreign investor participation in its transactions in the third quarter of 2005 (\$19 million), which brings the nine-month total to \$196 million, down by 19% from the \$243 million of the same time in 2004. It remains to be seen whether activity in October-through-December will reverse this pattern, though the potential exists for year-end outcomes to exceed those of 2003.

Fig. 2: VC Disbursements by US/Foreign Investors, by Canadian Region, 1996-First Nine Months of 2005

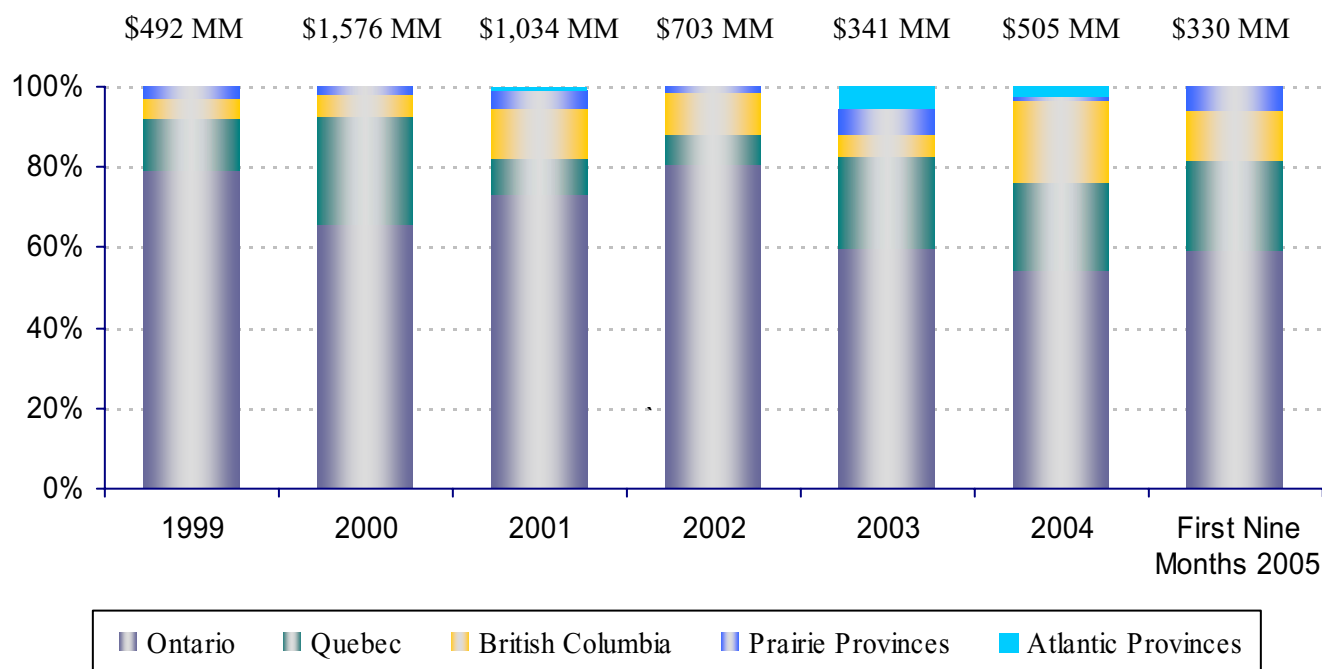
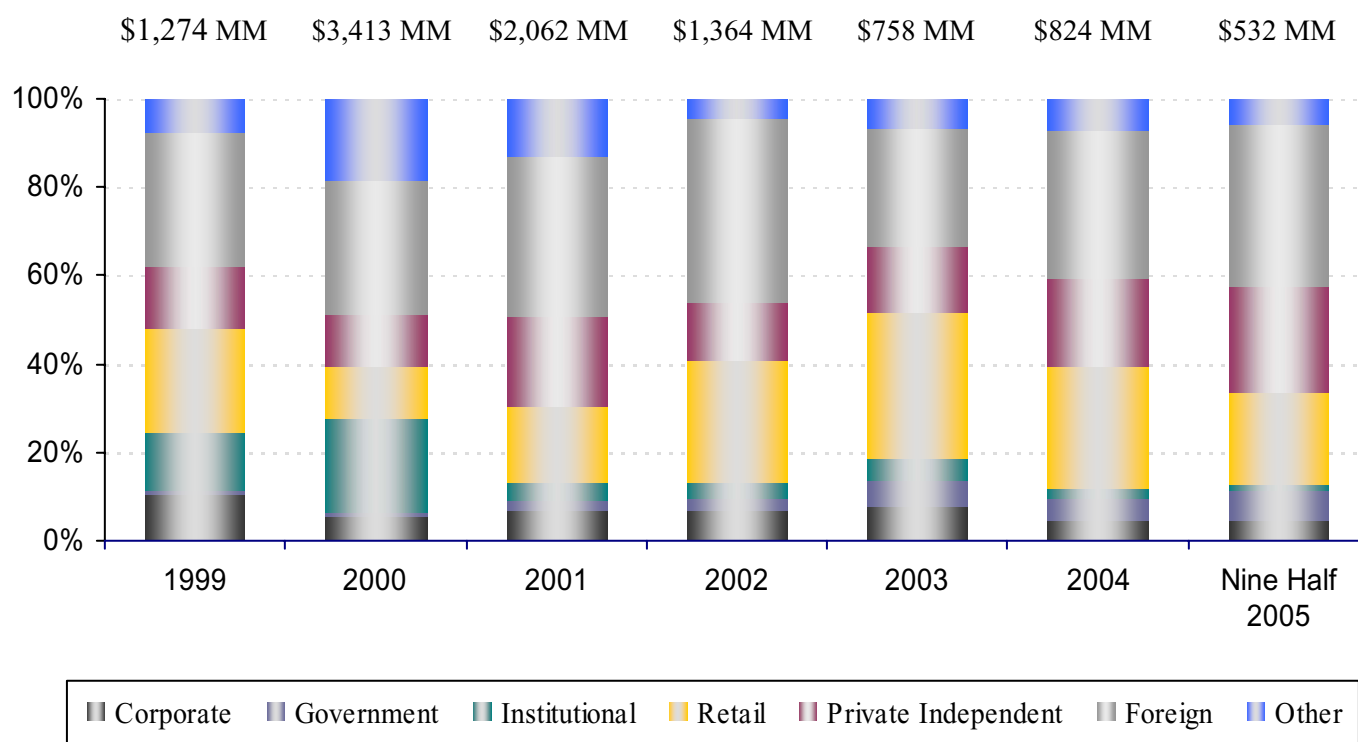


Fig. 2 illustrates the significant weighting of activity among American venture capital funds and other foreign investors in the Canadian market towards deal opportunities located in Ontario and its primary high-tech centres in Ottawa, Toronto and Kitchener-Waterloo (see also: Fig. 7). In fact, of the \$5.0 billion disbursed between 1999 and the first nine months of 2005, 69% has gone into the province. Ontario has also accounted for over half of all companies financed in whole or in part by non-resident resources (53%) over this time.

However, there has also been a discernable shift in the geographic distribution of foreign activity in Canada between 1999 and today.

As discussed in the Introduction, up until the end of 2002, Ontario accounted for between 70-80% of all per annum disbursements made by American and other foreign investors north-of-the-border. Despite Ontario's continued predominance in the years that followed, when it typically assumed close to 60% of disbursements across the country, the data indicate that foreign activity "spread out" in regional terms, with increasing shares often being taken by deals in Québec, Western Canada and the Atlantic provinces.

Fig. 3: VC Disbursements in Ontario by Investor Type, 1999-First Nine Months of 2005

At various phases of venture capital industry activity in Ontario, different types of funds – corporate, government, institutional, labour-sponsored/retail and private-independent – have each exerted some influence ⁽²⁾. In the years immediately prior to 1999, and the arrival of American and other foreign investors on the provincial market landscape, it was labour-sponsored funds that led activity, accounting for between 40-50% of total capital invested, followed by private and corporate funds, which together accounted for an approximate 30% share.

When venture capital dollars of volume first crossed the border into Ontario, the impact on trends there was instantaneous. This is evidenced in the non-resident share of all provincial disbursements, which rose from 3% in 1998 to 30% in 1999. At the same time, the leaders among local industry players – labour-sponsored funds, private-independent funds and corporate funds – saw their shares reduced to 23%, 14% and 10%, respectively.

(2) Retail funds are a broad venture capital fund category in the Canadian industry that rely on tax-supported sales to individual investors. Labour-sponsored venture capital corporations (LSVCCs) form the largest part of this category, and are the only retail fund type currently operating in Ontario.

Consequently, 1999 was a watershed in the Ontario market, as it marked the first year in which American and other foreign investors emerged as the primary source of capital resources going to company financings in the province – a pattern that was to continue in most subsequent years.

At the height of overall Ontario based activity in 2000, non-residents again led with 30% of the total dollar amount, and even increased this proportion in the first two years of the market down-cycle (2001 and 2002), to 37% and 41%, given their steady focus on activity in IT-rich Ottawa.

Only at the bottom of the slowdown in 2003, when total disbursement streams in Ontario dropped to pre-1999 levels, did cross-border activity relinquish its front rank position. In that year, labour-sponsored funds led with one-third of capital invested, followed by non-residents with 27%. However, with the market's renewal in 2004, the latter returned to the top spot, with a 33% share.

As noted, in the first nine months of 2005, foreign activity has been responsible for fewer dollars going to Ontario's venture-backed firms as compared to the year before, at least in absolute terms. However, in relative terms, its take of disbursements has grown to 37%, which surpasses all annual shares since 1999, excepting 2001-2002.

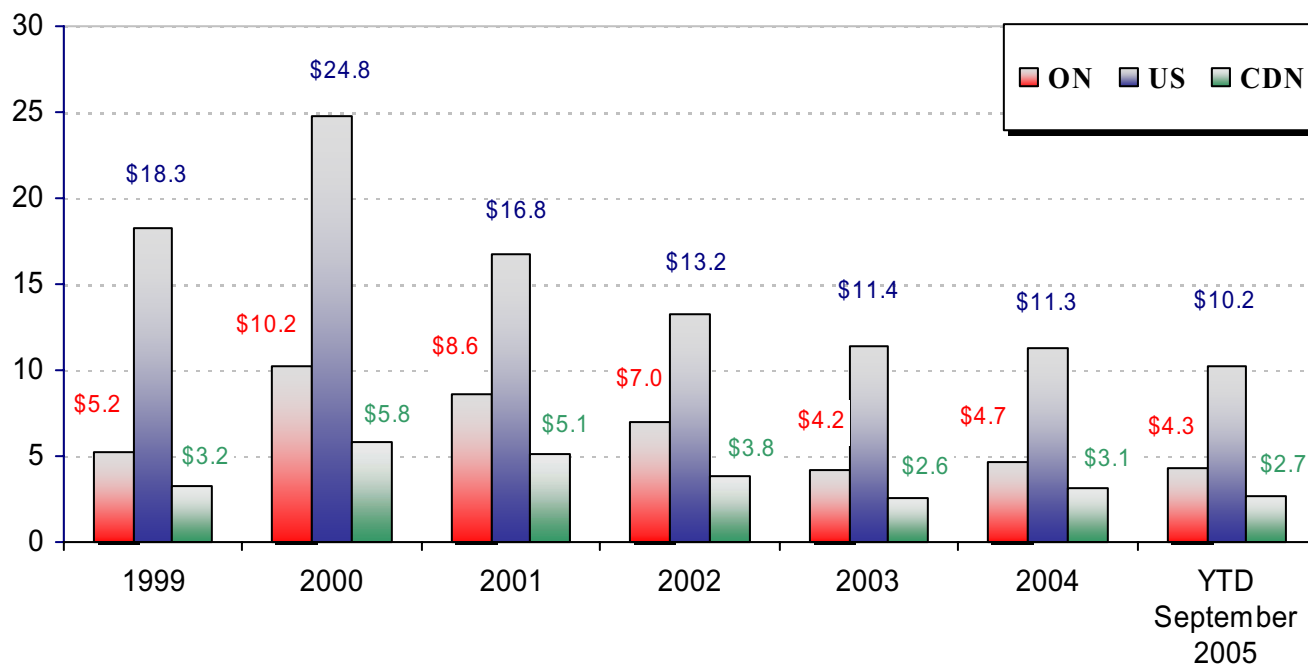
The main reason for this trend has been the lower rate of labor-sponsored fund disbursement, as compared to one year ago. Instead, private funds moved into second spot, with 24% of capital invested.

In short, American and other foreign investors currently remain a vital source of resources in the Ontario market, and may even be expanding this role. Indeed, their sustained activity might be all the more important today, due to what the data show has been declining participation among several domestic investor groups in recent years (e.g., corporate and institutional funds) and what might be a similar experience for labour-sponsored funds, given the 2005 decision of the Ministry of Finance to gradually wind-down the province's tax program.

Interestingly, the large sums brought by non-residents to Ontario transactions have targeted only a small fraction of total companies financed. Since 1999, firms receiving venture capital investment that originated in full or in part from outside of Canadian borders have typically been between 8-12% of the aggregate provincial number.

Instead, it has been a diverse mix of Ontario fund managers that have been responsible for the majority of company financings and, above all labour-sponsored funds, which accounted for roughly one-quarter to one-third of venture-backed firms over the same period, and private funds, which have accounted for one-fifth to one-quarter.

Fig 4: Amounts Invested Per Company, All Canada, Ontario and the US, 1999- First Nine Months of 2005



Comparisons of trends in venture capital activity between Canada and the United States have for some time revealed a major gap in average capital infusions per firm. In recent years, the average size of company financings in the Canadian market has typically been around 3 to 4 times less than the average size in the market south-of-the-border.

The meaning of this gap in deal capitalization between the two national markets was discussed in Thomson Macdonald's *Growing the Businesses of Tomorrow*. Interviews conducted with Canadian professional managers for this report suggested that while smaller deal sizes have afforded the domestic market some advantages, there have also been clear disadvantages linked with the need to grow new business formations rapidly, and often ahead of competitors in North American and global technology sectors.

Since 1999, American and other foreign investors have been a key source of syndicate capital in Canada. This has perhaps had its greatest impact in Ontario, where average company financing sizes still lag those in the United States

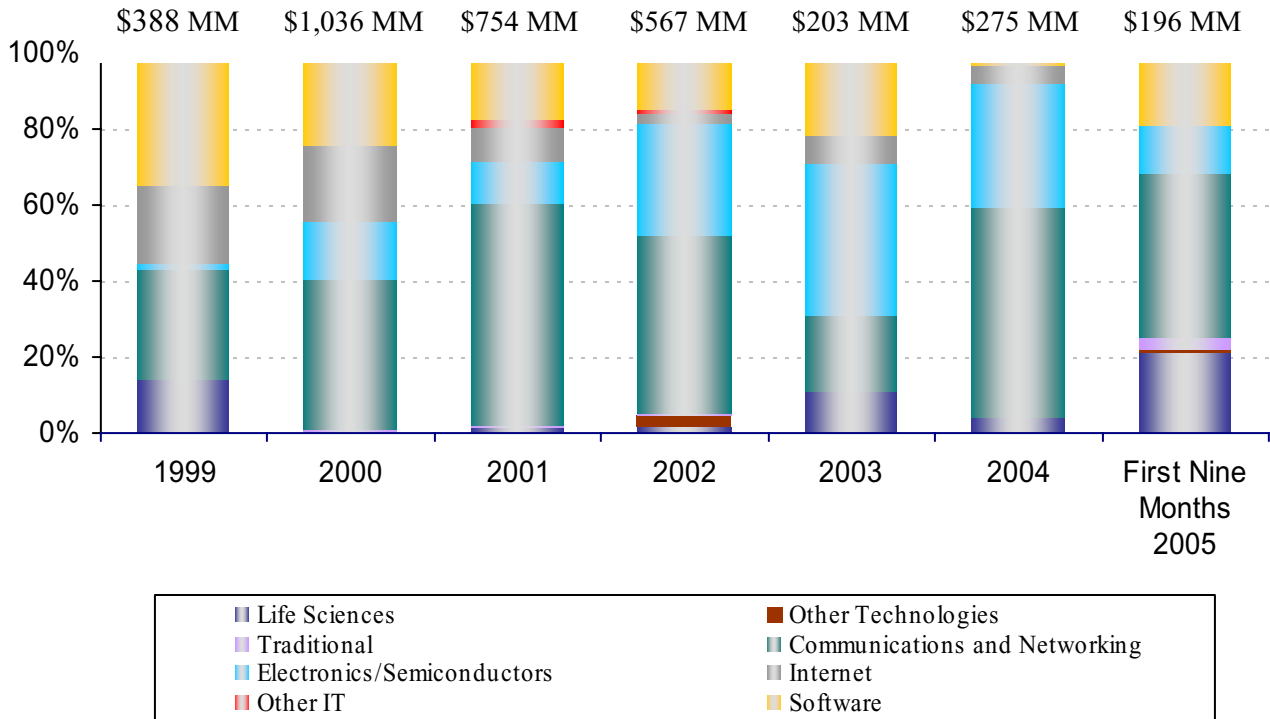
(annual differentials have varied widely, but have been in the zone of 50-60% less in Ontario in recent years), but not to the same extent as they do nationwide.

One measure of the influence of non-resident activity in provincial transactions is evident in average dollar amounts invested per firm. In Ontario, foreign investors have disbursed an average of \$21.0 million per company since 1999. This compares against an average of \$8.7 million disbursed by provincially based venture capital funds and other Canadian investors over the same period.

By comparison, on a Canada-wide basis, American and other foreign investors have disbursed an average of \$16.3 million per company between 1999 and the third quarter of 2005, while domestic investors have disbursed \$5.5 million on average.

Much larger disbursements per venture-backed firm by non-residents have applied substantial upward pressure on overall deal sizes in Ontario. This is perhaps evidenced in the years immediately preceding 1999, when company financing sizes in the province did not usually rise above an average of \$3.0 million. In the post-1999 Ontario market, averages have ranged between a high of \$10.2 million (2000) and a low of \$4.2 million (2003).

Fig 5: VC Disbursements by US/Foreign Investors in Ontario by Sector, 1999- First Nine Months of 2005



In keeping with the sector preferences of American venture capital funds and other foreign investors that have been active in Ontario, deals involving these investors have been distinctly innovation-oriented. Of the \$3.4 billion disbursed in the province since 1999, 44% has gone into communications, 50% into other IT sectors, 4% into life sciences, and the balance (2%) into other technology and traditional sectors.

The data show that these shares of non-resident capital invested reflect a much greater concentration on telecom/IT sectors than has been true of total provincial activity over the same time, but much less emphasis of life sciences. In fact, foreign investors were the leading source of IT-focused dollars in the Ontario market between 1999 and Q3 2005, but the third leading source of life sciences-focused dollars.

Of course, within IT, cross-border activity in Ontario has most frequently preferred communications and networking firms. In the early years of this activity (1999-2002), the largest deals featured high profile companies in the fibreoptics/photonics space, such as BTI Photonic Systems, Meriton Networks and Tropic Networks, which consumed one-quarter of IT-related disbursements, and companies in telecommunications equipment, such as Catena Networks, Natural Convergence and SS8 Networks, which took a 14% share.

Telecom investment has usually been integral to growth in foreign activity in Ontario. This was certainly true in 2000, when the sector accounted for 39% of total capital invested from this source (and even larger shares in the declining, but still appreciable, disbursement levels of 2001 and 2002), and again in 2004, when activity in wireless firms like Redline Communications and TenXc Wireless contributed significantly to its 56% share.

However, the largest proportion of Ontario based companies that have been financed to some extent by American and other foreign investors since 1999 has been in the software sector (26%), including Atreus Systems, DWL, Kinaxis and Ubiquity Software Corporation. Such firms have also attracted the second largest share of dollars (20%).

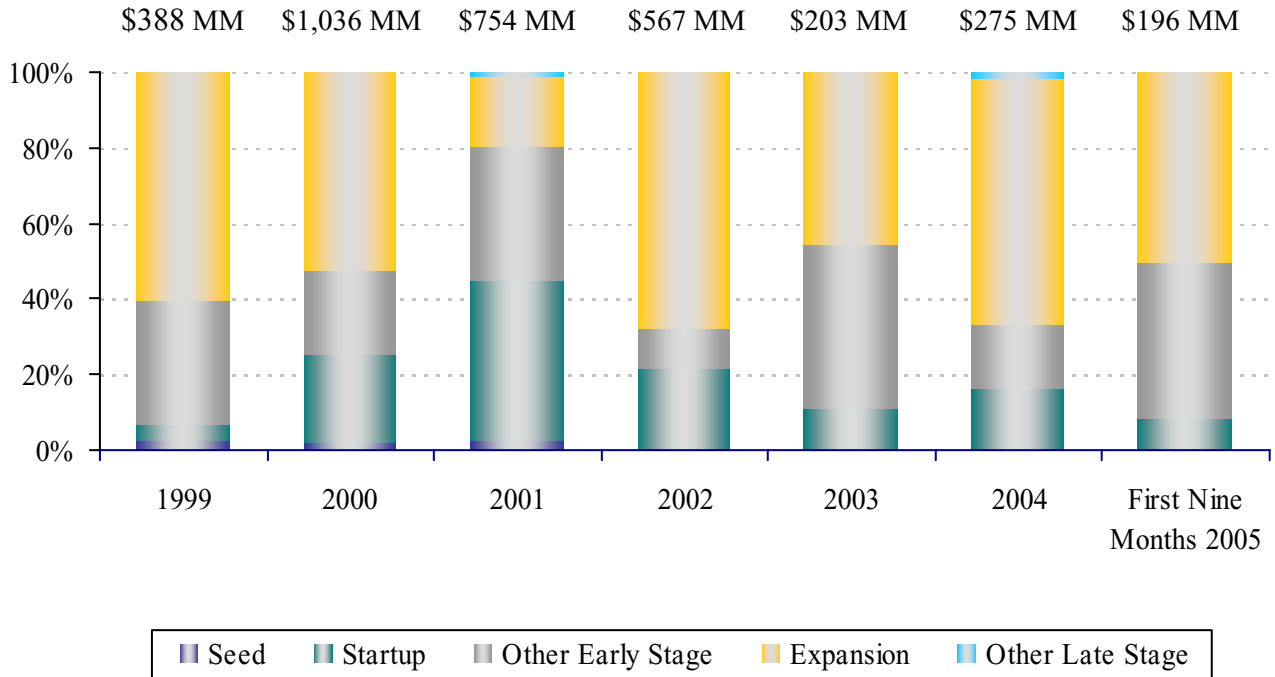
Taking third spot after province's communications and software sectors in non-resident esteem has been electronics, hardware and semiconductors, which have absorbed 18% of resources since 1999, and led activity in 2003 with a 40% share. Major semiconductor transactions have driven the lion's portion of this activity, involving such names as Quake Technologies, SiGe Semiconductor, Silicon Optix and SiRiFic Wireless Corporation.

Internet firms like TrueSpectra and Watchfire have also obtained substantial cross-border backing, though much of this activity occurred prior to 2001.

As indicated, a fairly modest amount of foreign interest has been paid to Ontario's life sciences firms, even in 2003, when the sector attracted much notice from fund managers right across North America. This trend may be changing in 2005, however, given prominent deals engaging Cytochroma and Zelos Therapeutics, which contributed to a 21% share of non-resident disbursements ear-marked for life sciences in the first nine months of this year.

American and other foreign investors have shown an appetite for other emerging sectors in Ontario, including energy and environmental technology, though to date this has been demonstrated in only a handful of company financings.

Fig. 6: VC Disbursements by US/Foreign Investors in Ontario by Stage, 1999- First Nine Months of 2005



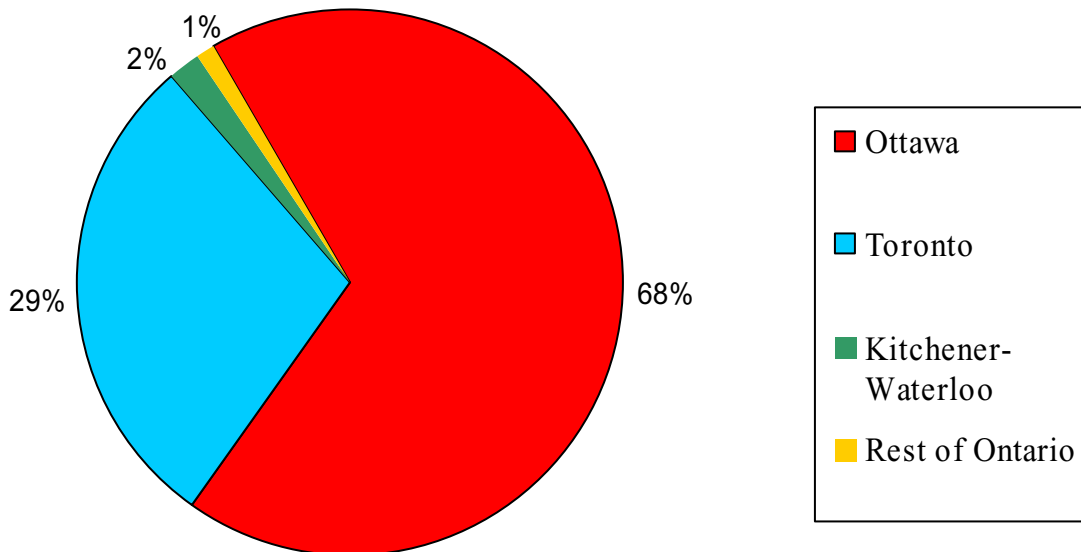
Cross-border activity is most likely to feature foreign investors leading or participating in syndicates in follow-on financing rounds, when companies have already made some early advances in their growth and development. This has frequently occurred as Canadian venture capital funds have sought to obtain

substantial deal capitalization or strategic value from co-investors relevant to rapid expansion of an existing portfolio firm.

This fact is highlighted in the data, which show expansion transactions consuming \$1.7 billion of disbursements by American and other foreign investors in the Ontario market between 1999 and Q3 2005, or 49% of the total. Another \$898 million, or 26% of the total, was attributable to other early-stage deals, when companies are typically ramping up their development to achieve full commercial production and sales that will ultimately move them into the expansion stage.

Deals involving Ontario's company startups accounted for 23% of non-resident resources over the same period, but most of this activity was geared to young and fast-growing firms in the communications sector (76%), and chiefly in the heady days of 2000-2002. The share represented by seed transactions in the province has been 1-2%.

Fig. 7: VC Disbursements by US/Foreign Investors in Ontario by Region, 1999- First Nine Months of 2005 Inclusive



Total: \$3.4 billion

Consistent with their strong technology orientation, American venture capital funds and other foreign investors active in the Ontario market have targeted major urban centres with substantial R&D, innovation and entrepreneurial

infrastructure, and where established sector clusters have achieved some critical mass.

It was already observed that foreign activity has, in dollar terms, been predominantly geared to telecom/IT sector clusters in Ottawa, which absorbed 68% of the \$3.4 billion disbursed between 1999 and the third quarter of 2005. Not surprisingly, Ottawa has also been home to a large portion of provincially based companies financed by non-residents over the same period – 72 of the 163 in total (or 44%).

Diverse sector clusters in the Toronto region have accounted for that city's slightly higher proportion of firms backed through cross-border activity – 77 in all, or 47% of the aggregate number. Toronto's share of related capital invested in the province since 1999 has been 29%, though this share has been greater since the telecom-crash of 2002.

The other major urban centre in Ontario that has been singled out for activity by American and other foreign investors is Kitchener-Waterloo, which has accounted for 2% of their disbursements, as well as 5% of companies financed by them. Again, much of this activity has occurred in the region in recent years.

Non-residents have also found several attractive deal opportunities in other communities, and particularly in Southwestern Ontario, which together have absorbed a 1% share of their resources since 1999.

Fig. 8: Top Twenty American VC Investors in Ontario Since 1999

Warburg Pincus	Technology Crossover Ventures
Goldman Sachs	Banc of America
Kodiak Venture Partners	JK&B Capital
Morgenthaler Ventures	Sierra Ventures
Insight Venture Partners	InterWest Partners
Bain Capital Ventures	Prism Venture Partners
JP Morgan Partners	Apax Venture Partners
Menlo Ventures	KPL Ventures
M/C Venture Partners	Thomas Weisel Partners
VIMAC Ventures	Advanced Technology Ventures

II. RESULTS OF A SURVEY OF AMERICAN VENTURE CAPITAL FUND MANAGERS

To cast light on trends in cross-border activity in Ontario since 1999, Thomson Macdonald conducted interviews with senior professional managers of venture capital funds based in the United States (for a full listing of key informants, see Appendix).

To facilitate these interviews, Thomson Macdonald designed a survey questionnaire that focused on factors influencing the decision of American fund managers to invest in companies in Ontario and Québec, including:

- (1) Factors encouraging investor participation in deal opportunities located in the Ontario and Québec markets;
- (2) Factors identified as impediments to investor participation in deal opportunities located in the Ontario and Québec markets;
- (3) Ways by which government might help ameliorate barriers to cross-border activity, or otherwise promote such activity among American investors.

Where relevant, Thomson Macdonald attempted to find distinctions between the Ontario and Québec markets with respect to factors encouraging or discouraging participation.

Senior venture professionals representing fourteen fund management companies were interviewed in October 2005. To ensure that Thomson Macdonald obtained key informant feedback from a cross-section of American industry players, fund managers were solicited according to the location of their headquarters (and regional offices), their investment focus by sector and by stage, and their level of activity in Ontario and/or Québec to date.

Of the fourteen American fund managers interviewed for this report:

- Five have headquarters in California, four in Massachusetts, four in New Jersey or New York, and one in Florida;
- Five managers specialize in deals in communications and other IT sectors, three specialize in deals in life sciences sectors, and six have diversified technology investment mandates;
- Two managers specialize in seed activity, five specialize in other early-stage activity, three specialize in expansion or other late-stage activity, and four pursue balanced investment mandates;
- As of mid-2005, all but one manager had done at least one deal in Canada, nine had done at least one deal in Ontario, and four had done deals in Québec only.
- Going forward, eight managers indicated they would probably sustain their level of activity in Ontario/Québec, five indicated they would probably

increase activity (of these, one was about to invest for the first time), and one indicated they would probably decrease activity.

A fifteenth interviewee was Stephen Hurwitz, Partner at Boston's Choate, Hall & Stewart LLP, a legal advisor with expertise on cross-border issues involving private equity market activity.

In the interviews with managers of American venture capital funds, a list of factors believed to influence decisions to invest in Ontario and Québec were submitted for ranking and commentary. For the most part, this involved a discussion of factors of relevance to one province followed by comparisons with the other. In general, key informants identified very few differences between the two when it came to key factors that encourage or discourage American investor participation.

Of the factors discussed, interviewees gave their highest ratings to the following (in order of importance) as encouraging participation in the Ontario and Québec markets:

- Ontario/Québec technology sectors are unique and attractive;
- Ontario/Québec R&D/innovation systems generate quality deal flow;
- Ontario/Québec workforces are well-educated, skilled;
- Deal opportunities are capital-efficient;
- There are Ontario/Québec based investors with which to partner.

Interviewees also gave some emphasis to such variables as "Government programs, tax incentives facilitate activity" and "Ontario/Québec markets are in close proximity", but did not see, "Data, intelligence relevant to Ontario/Québec deals are accessible", as factoring into their decisions to invest.

With respect to challenges to their participation in the markets of Ontario and Québec, interviewees gave their highest ratings to the following (in order of importance):

- Cross-border tax issues impose too great a cost, complexity;
- Entrepreneurial managers in Ontario/Québec are not sufficiently developed;
- Ontario/Québec transactional practices differ from those of the United States;
- There are too few local fund managers with which to syndicate.

Interviewees also gave some emphasis to such variables as "American investors are unfamiliar with the Ontario/Québec markets" (though typically in reference to

inactive peers in the United States), and “Issues pertaining to distinct, unfamiliar legal systems in Ontario/Québec”. Other factors (““Ontario/Québec markets are not in close proximity” and “It is too costly, difficult to establish an on-the-ground presence”) were not identified by most as significant barriers.

To elaborate on key informant rankings, the following sections of this report summarize thematically the feedback given during the interviews:

- Section II.1 summarizes commentary on factors encouraging participation in the Ontario and Québec markets;
- Section II.2 summarizes commentary on factors discouraging participation in the Ontario and Québec markets.

This is followed by Section II.3, which summarizes public policy recommendations made in the interviews concerning cross-border activity.

II.1 FACTORS ENCOURAGING ACTIVITY IN THE ONTARIO AND QUÉBEC MARKETS

1) Ontario and Québec offer opportunities in sector clusters based on rich R&D/innovation environments and skilled workforces.

Professional managers interviewed for this report argued that, for them, the primary attraction of markets in Ontario and Québec is deal opportunities in situations where proprietary innovative ideas or products can be leveraged to create high-growth, leading-edge companies operating on a North American or global basis. It was anticipated that participation in these opportunities, most often in follow-on and later-stage financings, would deliver superior, risk-adjusted returns.

Interviewees noted that while many technology sector clusters in Ontario and Québec remain young in evolutionary terms, they are rooted in active innovative systems comprising hospitals, laboratories, post-secondary institutions, R&D centres, and other settings in which entrepreneurs and researchers design new technologies or adapt existing ones. Government programs aimed at intellectual property, R&D, technology transfer and commercialization have proved effective in fostering these systems.

Most American venture capital funds will probably have done assessments of the potential for commercializing technological breakthroughs in key sectors, said interviewees, based on some research of local innovation capacity, the relative success of some first-generation businesses, and their own domain knowledge and market experience.

Several interviewees spoke highly of the education of provincial workforces, and of the large numbers of skilled technicians and technologists. Along these lines, a few cited the report by the Organization for Economic Co-operation and Development (OECD) that put Canada in the number one spot internationally for per capita post-secondary attainment.

These factors contribute to a pipeline of quality venture capital deal flow, said American investors. In the case of Ontario, this was expected to be concentrated in Ottawa and Toronto, where clusters are developing in communications and networking, electronics, hardware and semiconductors, software and other IT, and suggest further opportunities for convergence and spin-off. Of course, this explains why 97% of non-resident dollars invested in Ontario since 1999 has gone to these two cities (see: Fig. 7).

Several interviewees observed that investor competition for the best deals throughout the Canadian market was not as intense as it was in key regions of the United States (e.g., California's Silicon Valley, Massachusetts' Route 128). Consequently, increased activity in recent years could be interpreted partly as an

effort among some American funds to establish an early local exposure, ahead of competitors in the same space.

2) Deal opportunities in Ontario and Québec markets are capital-efficient.

While American venture capital fund managers gave their greatest emphasis to the business case for investing in companies in Ontario and Québec, based on the quality of deal flow emerging from local technology sector clusters, most also drew attention to the cost-effectiveness of doing deals there. Indeed, several interviewees spoke of a capital-efficiency premium in Canadian transactions, derived from a number of key variables.

Interviewees pointed to the purchasing power of the American dollar in Canadian venture capital deals, due to the exchange rate. Just as important was the lower costs of doing business in Canada, which is consistent with KPMG's *Competitive Advantages* study of 2004 that described Canada as a leader among G-7 nations, with costs 8-9% below those in the United States. Interviewees highlighted specific advantages in the price of labour (e.g., lower salaries for qualified technicians and technologists) and the price of real estate.

Many interviewees also perceived valuations of venture-backed companies in all parts of Canada as being typically lower than they are in the United States. This was attributed to comparatively less investor competition for deals north-of-the-border, as previously discussed.

Another contributing factor has been government R&D support, and particularly federal and provincial tax credits (see below: "Government programs and tax incentives facilitate activity in the Ontario and Québec markets").

While interviewees attested to the capital efficiency of deals in the Ontario and Québec markets, they also agreed that cost savings realized did not offset costs incurred in other realms and, preeminently, with respect to tax-related expenses prompted largely by the *Canada-United States Tax Convention* (see: Section II.2, "Cross-border tax issues impose too great a cost and complexity").

3) Government programs and tax incentives facilitate activity in the Ontario and Québec markets.

As was mentioned above, one of the reasons why deals in the Ontario and Québec markets are reasonably valued, from the perspective of non-resident investors, is the range of government programs that support R&D and innovation in local venture-backed companies. A frequently cited example by professional managers interviewed for this report was federal and provincial tax credits available to Canadian privately held firms for expenditures (i.e., equipment,

materials, wages) on scientific research and experimental development (SR&ED).

At the same time, interviewees noted that SR&ED credits and other incentives may be lost when companies begin to operate in the United States (as they will often lose “Canadian” status, under government program rules), usually as Delaware subsidiaries (see: Section II.2, “Cross-border tax issues impose too great a cost and complexity”). It was argued that at least some tax benefits should be preserved in these situations, at least where essential R&D and related workforces continue to reside in Canada.

Some interviewees said that the value of various federal-provincial incentives still remain largely unknown in the American industry (including among several of the most active players in Canada) and should be more widely promoted by the governments.

4) There are local venture capital funds with which to syndicate and form compatible partnerships.

When undertaking cross-border activity, interviewees place great onus on building strong, trustworthy relationships with Canadian venture capital fund managers and agents/intermediaries (e.g., legal advisors). This was as true for non-resident investors with offices near domestic markets as it was for those operating at some distance from these. Indeed, a primary focus of regular visits and attendance at industry conferences and forums in Canada has been to network and develop new and existing partnerships.

The vast majority of professional managers interviewed for this report said they have been largely successful in forging close and rewarding bonds with Ontario and Québec based funds. In practical terms, this has meant relying on counterparts in all types of funds – corporate, government, institutional, labour-sponsored/retail and private-independent – for access to quality deal flow, market intelligence, syndication and other resources.

This being said, a few indicated less success in finding appreciable numbers of compatible partners, while others discussed their perceptions of the characteristics of some existing Canadian partners (e.g., an apparent “conservatism” when investing, as well as the high rate of professional turnover in certain funds). For several interviewees, such characteristics will often limit the extent to which they feel fully comfortable in some of their partnership arrangements.

This issue is taken up in Section II.2 under “The transactional aims and practices of Canadian investors are not always compatible with American investors”.

5) The Ontario and Québec markets are in close geographic proximity.

American venture professionals (like all venture professionals) attach great importance to the proximity of markets in which they invest. When scoping out deal opportunities, they said they must be able to gather intelligence and perform intensive due diligence at a local level. In addition, once companies have entered portfolios, there must be direct access to senior management personnel and an ability to exert influence on decisions of a strategic nature.

Where funds are located at some distance from a region of interest, the odds are that activity in that region's market is likely to be infrequent, and typically reflected in one-off transactions (i.e., lack of proximity becomes a barrier, as discussed in Section II.2, "Proximity to the Ontario and Québec markets is not an issue for most active American investors"). In other words, many such remote funds are not in a position to establish a consistent presence at the local level.

As the majority of professional managers interviewed for this report were located in New England and in other states in the American Northeast, proximity to Ontario and Québec was mostly viewed as a plus. However, even those within fairly close reach flagged important concerns, such as the lack of direct air flights to major urban centres.

6) For active American investors, information necessary to doing deals in Ontario and Québec is available.

As discussed earlier, most American venture capital funds with an interest in Ontario or Québec deal opportunities have probably researched these markets to some degree. For instance, several with highly specialized investment mandates have developed internal databases and other resources for tracking sector-specific activity in key regions in North America or worldwide where clusters are known to exist at various phases of evolution.

Just as common has been the practice of hiring Canadian venture professionals in American funds, or increasing their knowledge of provincial markets through relationships with Canadian institutional investors that are their limited partners (e.g., CDP Capital, OMERS, Ontario Teachers Pension Plan).

Others have obtained intelligence more informally, chiefly in regular visits and attendance at industry conferences and forums (e.g., the Ottawa Venture and Technology Summit, meetings of the Canadian Venture Capital and Private Equity Association), which put them directly in contact with entrepreneurial managers and fund managers (or when these travel south-of-the-border, often to pitch deals).

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For this reason, and the fact that many American investors are active in the Ontario or Québec markets only on a periodic basis, the issue of access to necessary transactional data was not given particular emphasis (as a positive or negative factor). However, interviewees argued that the vast majority of their industry peers in the United States are completely uninformed about the nature of these markets and, in fact, operate with many misconceptions about them.

II.2 CHALLENGES TO ACTIVITY IN THE ONTARIO AND QUÉBEC MARKETS

1) Cross-border tax issues impose too great a cost and complexity.

Professional managers interviewed for this report argued that, for them, the main challenge to doing deals in Ontario and Québec pertain to a range of tax issues that arise when undertaking cross-border activity anywhere in Canada. Furthermore, many were frustrated that prior attempts to raise concerns about these issues with Canadian government officials had not yet resulted in remedial actions.

As discussed in Thomson Macdonald's *Growing the Businesses of Tomorrow*, interviewees tended to describe diverse government taxation issues prompted (in Canada or the United States) by cross-border activity as relating to either (a) the nature of the fund structure of the foreign investor, or (b) the nature of the domestic investee company.

For instance, a major challenge was believed to exist for numerous American venture capital fund managers that are structured as limited liability corporations (LLCs), due to official interpretations of the *Canada-United States Tax Convention*. Such interpretations have argued that LLCs are not covered by the *Convention* and, hence, are not entitled to tax relief provisions (that would be available to differently structured corporate entities in the United States), with the result that LLCs are subject to taxation on income arising from their investments.

In addition, when disposing of shares in a privately held Canadian firm, non-resident investors are required to obtain a Section 116 certificate from authorities. This is typically a long process that can jeopardize returns performance based on the best possible timing of investment exits. In addition, related disclosure requirements, which can involve a fund's limited partners, are perceived as being unnecessarily onerous and intrusive.

At the present time, said interviewees, most American venture capital funds elect not to invest directly in a Canadian company, in part to avoid tax hits and other strictures. Instead, as a condition of investment, a given firm is today commonly expected to affiliate with a Delaware corporation (or some other non-Canadian corporate entity).

In recent years, this has frequently been facilitated by an "exchangeable shares" arrangement, whereby resident and non-resident investors own shares in a company that effectively operates in both Canada and the United States, but with the Delaware as the parent organization.

Despite the prevalence of the Delaware-exchangeable shares strategy in cross-border activity, it and other approaches (e.g., use of tax treaty provisions covering Barbados or Luxembourg corporations) are viewed as being complex, time-consuming and expensive by many investors.

Several professional managers interviewed for this report said costs were prohibitive in certain transactions, leading them to consider only those opportunities where they can make exceptionally large investments in Canada. Others were concerned about the ramifications of Delaware and related strategies on Canadian government and government-assisted funds (i.e., labour-sponsored/retail funds) with which they syndicate, given the geographic restrictions imposed on these by statutes.

Several interviewees noted that cross-border tax issues pose a very serious challenge to their continued activity in the Canadian market. Others mentioned that many of their peers in the American industry are inclined to turn down Canadian deal opportunities outright because of tax considerations alone.

Regardless, American investors were clear that these and other tax issues must be addressed immediately at the public policy level, to avoid jeopardizing existing activity in all Canadian regions, and as a means of stimulating increased activity in future. One specific recommendation was that federal officials review all taxation and regulatory rules governing privately held small and medium-sized businesses in Canada to ensure that cross-border activity relevant to their financing is better facilitated.

2) The environment for Ontario and Québec entrepreneurial managers is not sufficiently developed as yet.

Interviewees believe that while technology entrepreneurship in Canada has made important advances in recent years, it remains in its earliest development phases, as compared to the United States ⁽³⁾. One of the reasons why American venture capital fund managers singled out Ottawa in the first years of significant activity, they said, was because many entrepreneurs in local telecom and IT sectors were relatively experienced.

Several professional managers interviewed for this report said they are unlikely to undertake transactions in Ontario or Québec where entrepreneurial managers do not have demonstrable business backgrounds or some history in growing young companies. However, most were prepared to address this situation at some point by drawing on non-resident technology executives to act as Chief Executive Officers, as well as non-resident managers possessing backgrounds in sales and marketing.

(3) The relative inexperience of Canadian entrepreneurial managers was well documented in *Assessing the Experience of Successful Innovative Firms in Ontario* (ICAP, 2004) based on interviews with technology executives with extensive backgrounds in growing young businesses.

Thomson Macdonald's *Growing the Businesses of Tomorrow* found that many Canadian investors view access to the American talent pool as a major benefit of cross-border partnerships, as business managers can apply skills to the development of portfolio firms, and open doors to broader customer markets. Interviewees argued similarly, noting that technology entrepreneurship in Ontario and Quebec would also grow through this experience, in part through exposure to managers that have repeatedly launched new businesses.

However, despite the potential benefits, interviewees said that some venture capital funds in Canada were reluctant to pay the price of attracting top executives. In addition, reluctance was sometimes shown with respect to situating some key aspects of a company's operations outside of Canadian borders (e.g., sales and marketing), a strategy that American investors believe is frequently critical to optimal growth.

(Canadian professional managers interviewed for *Growing the Businesses of Tomorrow*, tended to broadly agree with their American counterparts on these and related points. However, with respect to situating portfolio firm operations outside of Canada, most argued that a balance must be struck, as it is important to retain the fundamental ability of companies, sector clusters and entrepreneur communities to grow and develop domestically).

American investors were supportive of government programs intended to foster local entrepreneurial management skills. Among new initiatives, several mentioned possible Canadian emulation of programs sponsored by the Ewing Marion Kaufmann Foundation (and similar organizations, such as the affiliated Center for Venture Education) in the United States. Several interviews testified to fund utilization of educational and developmental programs geared to both entrepreneurs and venture professionals.

3) The transactional aims and practices of Canadian investors are not always compatible with American investors.

As discussed earlier, many American investors have had good experiences in finding compatible partners among venture capital funds based in Ontario and Québec for the purposes of deal making. However, several have encountered practical challenges along the way, most of which were linked to a perceived misalignment in fund aims and activity in certain instances.

One concern raised in the interviews was professional turnover in several government or government-assisted funds (i.e., labour-sponsored/retail funds), which can impact continuity in cross-border partnerships. This turnover was attributed to insufficient compensatory programs and incentives designed to retain skilled managers. Another issue was geographic strictures placed on the

activity of many of these same funds, which was felt to limit the growth paths of their investees.

In addition, professional managers interviewed for this report spoke of a “conservative” propensity in the activity of some Canadian investors ⁽⁴⁾. A frequently cited illustration was observed in the undercapitalization of venture capital deals (see: Fig. 4). While acknowledging that this often results from relatively small fund sizes in Canada, in other cases, interviewees argued the issue might be risk tolerance or a different perspective on how to achieve portfolio company growth.

American fund managers believe that high-growth firms only emerge when intellectual property and proprietary technology are leveraged rapidly, and ahead of competitors (to be followed by major liquidity events through acquisition or in such public offering venues as NASDAQ). This “time-to-market” imperative can only be ensured with adequate financing at each stage of company development. It further dictates that funds concentrate on backing only a small number of portfolio firms at any one time.

Interviewees also discussed the lack of common documentation (e.g., term sheets) in cross-border activity. As transactional paperwork is costly and time-consuming, non-uniformity of documents can exacerbate the situation. It was noted that in the United States, the National Venture Capital Association has addressed this issue by developing a set of model forms that reflect industry “best practices”.

Other issues raised included the tendency of many Canadian venture capital funds to require an equal role with other co-investors in all aspect of deals, instead of following a clear lead investor, as is the usual practice in the United States.

While virtually all interviewees recognized differences in American and Canadian market practices, some gave them considerable emphasis, while others viewed them as quite minor in nature. Most agreed that practices would harmonize over time, as cross-border partnerships evolved and the North American market became increasingly integrated.

It was further noted that greater alignment was probable with the advent of more institutionally supplied private-independent funds in Canada, as their characteristics most closely resemble those of the majority of funds in the American industry. However, most also argued that, in the short-term, it is important to have an array of well-capitalized funds, irrespective of type, given their importance as partners.

⁽⁴⁾ This observation was also made in interviews with technology executives in *Assessing the Experience of Successful Innovative Firms in Ontario* (ICAP, 2004).

It was further noted that greater alignment was probable with the advent of more institutionally supplied private-independent funds in Canada, as their characteristics most closely resemble those of the majority of funds in the American industry. However, most also argued that, in the short-term, it is important to have an array of well-capitalized funds, irrespective of type, given their importance as partners.

4) Many American venture capital fund managers are unfamiliar with Ontario and Québec markets and their range of deal opportunities.

As discussed in Section II.1 (“For active American investors, information necessary to doing deals in Ontario and Québec is available”), fund managers based in the United States that have already done deals in Ontario or Québec are typically able to obtain market data and intelligence relevant to their current levels of activity.

When considering this issue, several interviewees instead focused on their inactive counterparts in the American venture capital industry, which they believe are unaware or uninformed about deal opportunities in Ontario and Québec, and frequently have misconceptions about the Canadian market in general. In some cases, this has posed a challenge to active industry players when taking co-investment opportunities to peers.

Several interviewees said that this suggests an outreach role for federal and provincial governments whereby information is disseminated to potential non-resident investors about the market’s strengths in its R&D and innovation environment, “success stories” in key technology sector clusters, and the capital-efficiency of transacting in Canada. Government officials should also advertise local industry conferences and forums, as these networking events are a primary means of encouraging new market entrants.

For both active and inactive American investors, professional managers interviewed for this report also saw a government role in promoting, and perhaps clarifying, the range of federal and provincial programs geared to Canadian venture-backed companies. Some cautioned, however, that major challenges inherent in cross-border tax issues are known among certain industry players in the United States, and that these must be effectively addressed if outreach strategies are to succeed.

5) Issues pertaining to legal systems in Ontario and Québec do not pose a barrier.

Professional managers interviewed for this report spoke of issues pertaining to distinct legal systems in Ontario and Québec, with most of the discussion focusing on the unique character of the *Code civil du Québec* and some

corporate governance structures that were unfamiliar to American investor eyes. Mention was also made of securities regulation at the provincial level in Canada, which interviewees perceived as being costlier and more time-consuming than it is in the United States, which is, of course, relevant to their investment exits.

However, on balance, little concern was expressed about how these and related issues might impact their continuous venture capital activity in either the Ontario or Québec markets.

6) Proximity to Ontario and Québec markets is not an issue for most active American investors.

The significance attached by American venture professionals to the proximity of their core transactional activity has already been discussed under “Factors Encouraging Activity in the Ontario and Québec Markets”. There it was established that those located in more distant states, such as California, might be more inclined to identify lack of geographic proximity as an impediment.

To be regularly active in Ontario or Québec, said interviewees, such non-resident investors must have an especially strong interest in these markets. Typically, these will be managers of international specialty funds that target regions where sector clusters relevant to their investment mandates provide some motivation. In such situations, issues of distance will be overcome in part by frequent visits and utilization of partners at the local level.

As discussed earlier, even those with venture capital funds based in states directly opposite to Ontario and Québec have concerns about access to some opportunities. The most frequently cited of issue was the lack of direct air flights to major urban centres. Without direct flights, noted interviewees, they are unlikely to have full exposure to a given provincial or regional market in Canada.

To gain greater proximity, some American fund managers have elected to open offices in Canada, as Entrepia Ventures, ProQuest Investments and VantagePoint Venture Partners have done in Québec, and Newbury Ventures has done in Ontario.

Several interviewees noted the potential value of permanent residence (or otherwise situating personnel in key regions of interest) in facilitating direct access to deal flow networks linked to technology sectors of interest. Given perceptions about a less competitive and still evolving Canadian market, as compared to the market in the United States, an established local presence might also confer strategic advantages. In their role as limited partners, some domestic institutional investors have also contributed to this development.

II.3 GOVERNMENT'S ROLE IN FACILITATING CROSS-BORDER ACTIVITY IN THE ONTARIO AND QUÉBEC MARKETS

In commenting on factors that potentially encourage or discourage American venture capital funds with respect to investing in companies in Ontario and Québec, key informants made several comments about the role of federal and provincial government officials.

Professional managers interviewed for this report said that public policy initiatives should, in general, focus on shaping a marketplace in which American and Canadian investors have optimal latitude in targeting a select number of young firms with the best growth prospects, and in helping them ultimately emerge as world-class businesses. To do this, the thinking behind relevant government programs must be more often oriented to venture-backed growth opportunities that are North American and global in context, and not strictly local or domestic.

Interviewees believe that an increased rate of cross-border activity will expedite this objective, as Ontario or Québec based technology companies and their founding entrepreneurs will ultimately gain access to more extensive investor value-added and networks, broader customer and supplier markets, and deeper capital markets in which to continue the process of expansion.

By placing an emphasis on supporting synergistic partnerships between American and Canadian funds, public policy can help realize much greater sector cluster growth and diversification in key regions. This will, in turn, contribute to collateral benefits (i.e., economic growth, employment, exports, etc.) that are a natural outcome of this activity.

In addition to helping resident and non-resident venture professionals do their jobs, said interviewees, Canadian government officials should also concentrate on removing, or reducing the impact of, major impediments to cross-border activity. First and foremost on this agenda should be tax issues prompted in part by the *Canada-United States Tax Convention* that are relevant to financing venture-backed firms in both Ontario and Québec.

Along with addressing cross-border tax issues, several other specific recommendations were directed to government officials during the interviews:

- Utilizing diplomatic/trade offices and other government agencies, undertake outreach strategies to promote “success stories” in emerging technology sectors in Ontario and Québec to American venture capital fund managers;
- Widely disseminate information on federal and provincial government spending and tax programs of relevance to venture capital activity (e.g.,

SR&ED credits) to American fund managers (including those that have been active in the Canadian market, but may be unaware of the range of existing programs);

- Sponsor and publicize industry conferences and other events that bring American and domestic venture capital fund managers together, in part to share information and to introduce non-resident newcomers to markets in Ontario and Québec;
- Gear public policies and programs related to R&D/technology transfer, innovative capacity and early-commercialization towards those sector clusters in Ontario and Québec with the best prospects for competitiveness, growth and development in a global economic context;
- Address restrictions on the ability of venture-backed firms based in Ontario and Québec to gain a competitive presence in the United States (e.g., rules pertaining to government and government-assisted funds, continuation of SR&ED credits, etc., in cross-border situations, where essential economic activity remains in Canada);
- Focus on developing entrepreneurial management skills in Ontario and Québec through emulation of successful American programs (e.g., Ewing Marion Kauffmann Foundation) and through incentives, such as the Québec government's five-year tax exemption available to non-resident recruits in innovative fields;
- Encourage the formation of a diverse base of well-resourced venture capital funds in the Ontario and Québec markets, for cross-border partnership purposes, and where possible, greater institutional investor backing for more Canadian private-independent funds;
- Encourage more direct air flights to key urban centres in Ontario and Québec, to ensure ready American investor access to all regions where technology sector clusters are developing a critical mass.
- Consider public policy alternatives for supporting greater local market presence (e.g., permanent residence strategies, or situating personnel in key regions of interest) among American investors interested in this option.

CONCLUSION

Analysis of Thomson Macdonald data indicates that Ontario has been at the hub of substantial American and other foreign investor activity in the national market that began in 1999. Indeed, up-and-down cyclical shifts in non-resident investment in Canadian venture-backed companies have typically been led by trends in Ontario, where this activity has assumed a major share of all disbursements (i.e., between 30-40%) over the past seven years.

The activity of American venture capitals funds (and other non-residents) in the province has been characterized by a strong concentration on a small number of high-growth companies in technology sector clusters of interest, and particularly in telecommunications and other IT (but less so in other sectors, such as life sciences) in key urban centres. This activity has contributed very significantly to capitalization of these firms, which has, in turn, applied upward pressure on overall deal sizes, as compared to the pre-1999 environment.

Cross-border activity remains the leading source of resources in the Ontario market (though chiefly for follow-on, later-stage deals), having played an influential role in that market's upturn in 2004, after three years of slowdown. Indeed, this sustained activity might be all the more important today, given what has been declining participation among several domestic investor groups in the province.

Interviews with senior venture professionals representing fourteen fund management companies in the United States about their experiences in, and/or perceptions of, the Ontario and Québec markets provided vital insights relevant to these data findings.

Interviewees said there was an evident business case for activity in both Ontario and Québec, based on the quality of deal opportunities in emerging sectors, rich R&D/innovation systems, and local technology know-how. Interviewees also recognized a capital-efficiency premium in Canadian transactions, and felt they were able to develop close partnerships with domestic fund managers relevant to activity in both provinces.

At the same time, American investors expressed some strong concerns about doing deals in all parts of Canada.

First and foremost was the challenge presented by cross-border tax issues, which are widely perceived as being costly, complex, and ultimately limiting of the number, size and type of deals done, irrespective of the province or region. Interviewees also identified challenges in the lack of experience among many local entrepreneurs (Ottawa being identified as the exception, at least in relative terms), and in the transactional aims and practices of some local investors.

The majority of professional managers interviewed for this report agreed that certain challenges could be addressed by specific strategies adopted in their cross-border partnerships with Ontario and Québec investors, or might be ameliorated with time and familiarity. However, they said this was emphatically not the case with cross-border tax issues, which they believe threatens continued exposure to the Canadian market as a whole.

Interviewees saw a key government role with respect to outreach to inactive or less active American investors, by disseminating information on technology “success stories” and relevant federal-provincial programs and tax incentives (directed also to active American investors), along with sponsoring industry conferences/events, gearing public policies towards the goal of growing world-class businesses, fostering entrepreneurial management skills, and encouraging formation of well-capitalized local funds needed in cross-border partnerships.

Along with these recommendations, it is important to acknowledge the hope expressed in the interviews that Ontario public policy officials and their advisors give top priority to communicating the need for action at the federal level on the topic of cross-border tax issues.

**APPENDIX: AMERICAN VENTURE PROFESSIONALS AND OTHER KEY INFORMANTS
INTERVIEWED FOR THIS REPORT**

Stephen Hurwitz, Partner
Choate, Hall & Stewart LLP

Amit Srivastava, Chief Investment Officer
Entrepia Ventures

Charles Lax, Managing General Partner
GrandBanks Capital

Aaron Davidson, Managing Director
HIG Ventures

Jean-Luc Abaziou, Venture Partner
Highland Capital Partners

Nina Kjellson, Principal
InterWest Partners

Dave Furneaux, Managing General Partner
Kodiak Venture Partners

Jay Moorin, Partner
ProQuest Investments

Robert McNeil, Managing Director
Sanderling Ventures

Ramana Jampala, Partner
SAS Investors

Carla Newell, General Partner
Technology Crossover Ventures

Jean-David Begin, Vice-President
VantagePoint Venture Partners

Douglas Redding, Chief Operating Officer; Robert Roeper, Managing Director;
Bernhardt Zeisig, Director
VIMAC Ventures

John Occhipinti, Principal
Woodside Fund

William Bridgers, Managing Partner
Zon Capital Partners