

Assessing Challenges and Opportunities In Attracting US Venture Capital to Ontario

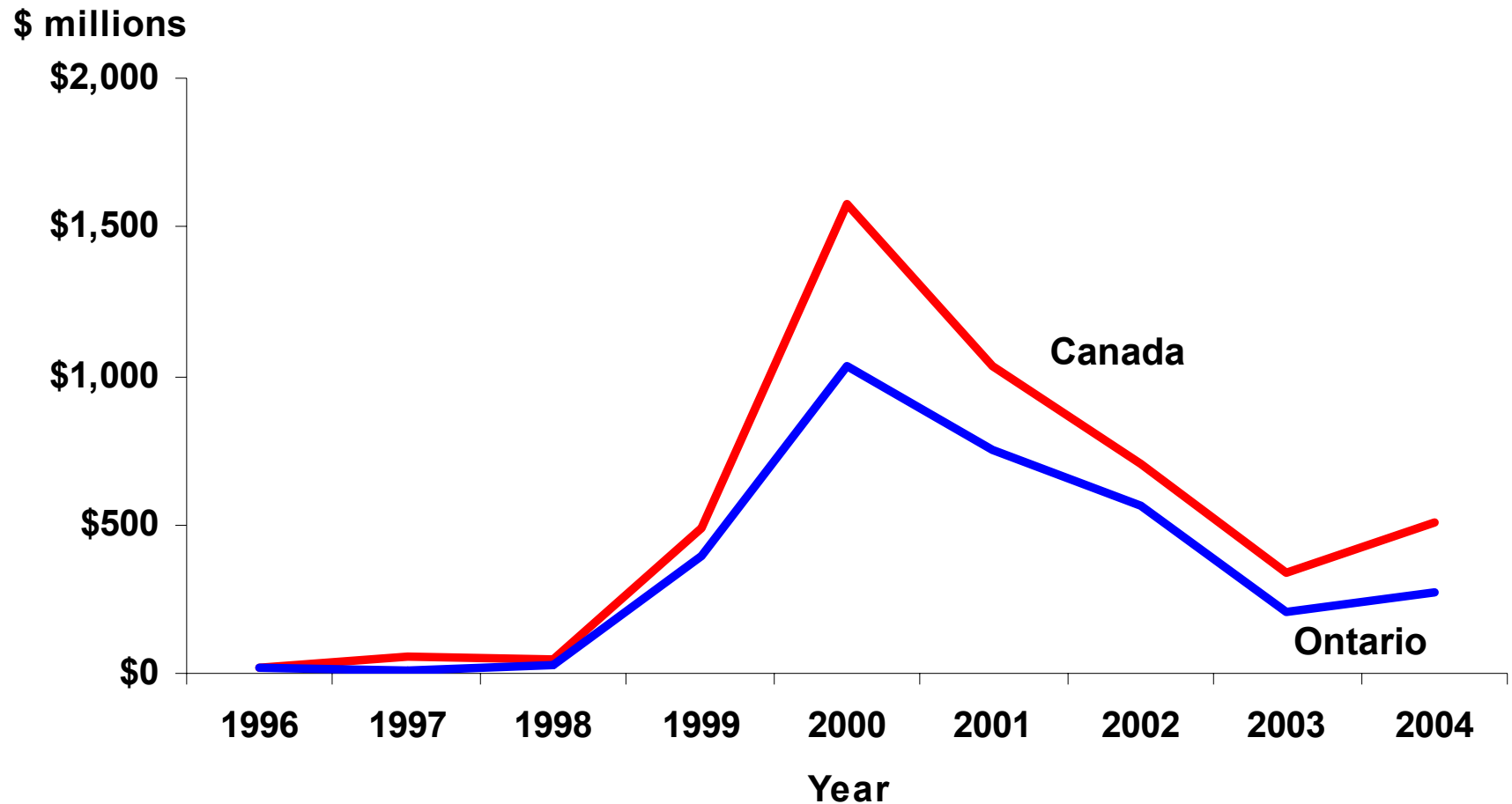
**James Milway, Executive Director
Institute for Competitiveness & Prosperity**

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The Institute for Competitiveness & Prosperity recently engaged Thomson Macdonald to help deepen our understanding of the emerging role of US-based venture capitalists in the Ontario market. The study was in collaboration with Quebec's Ministère du Développement économique, de l'Innovation et de l'Exportation (MDEIE). The report reviewed investment data and focused interviews with 14 major firms based in the US - all with experience in investing in Ontario or Quebec or both. This summarizes the report's findings. The complete report is available at www.competeprosper.ca

Ontario is the primary destination for US Venture Capital in Canada

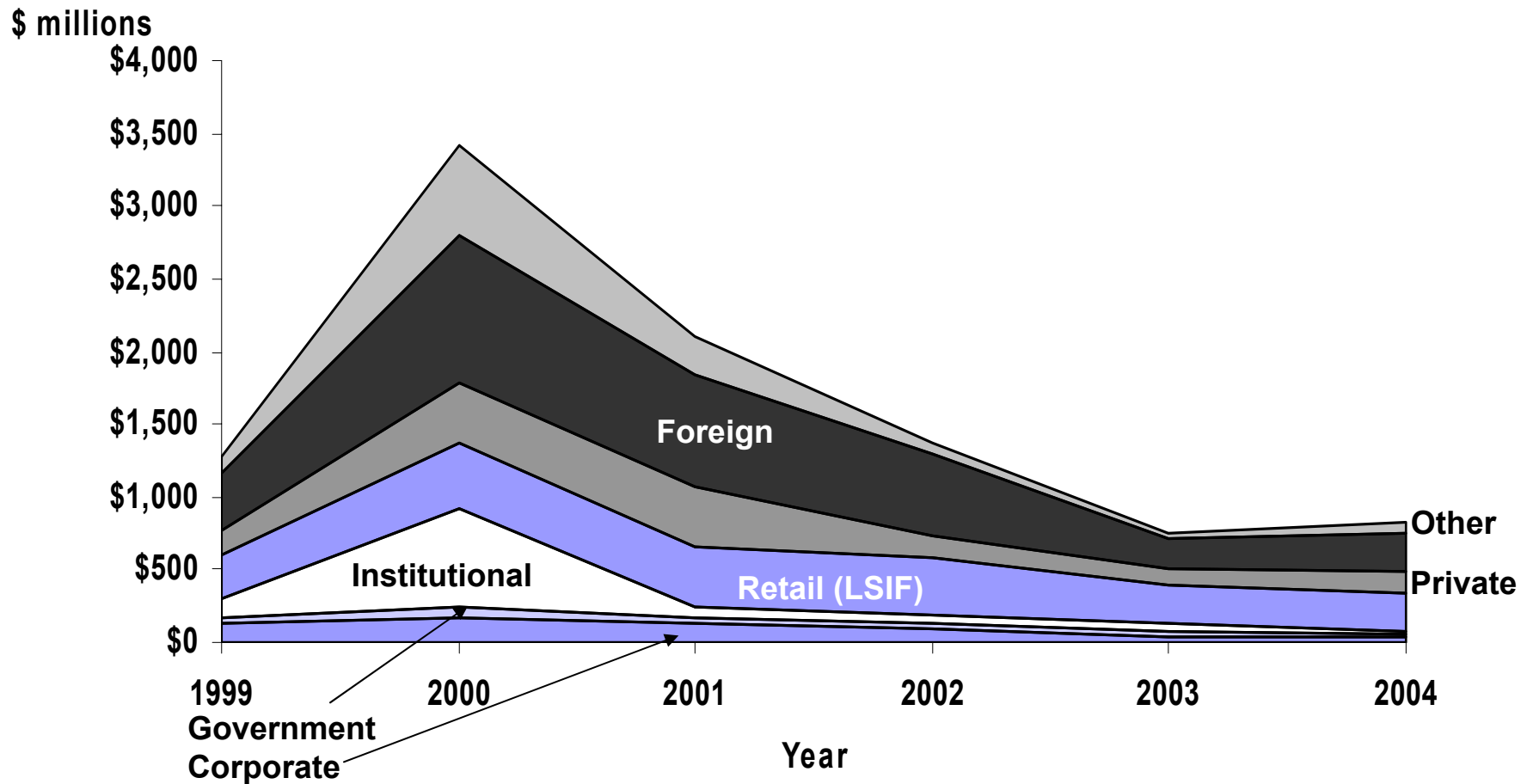
VC Disbursements by Foreign Investors in Canada and Ontario, 1996-2004



Source: Thomson Macdonald

Foreign VC funds have accounted for 27% to 41% of Ontario totals

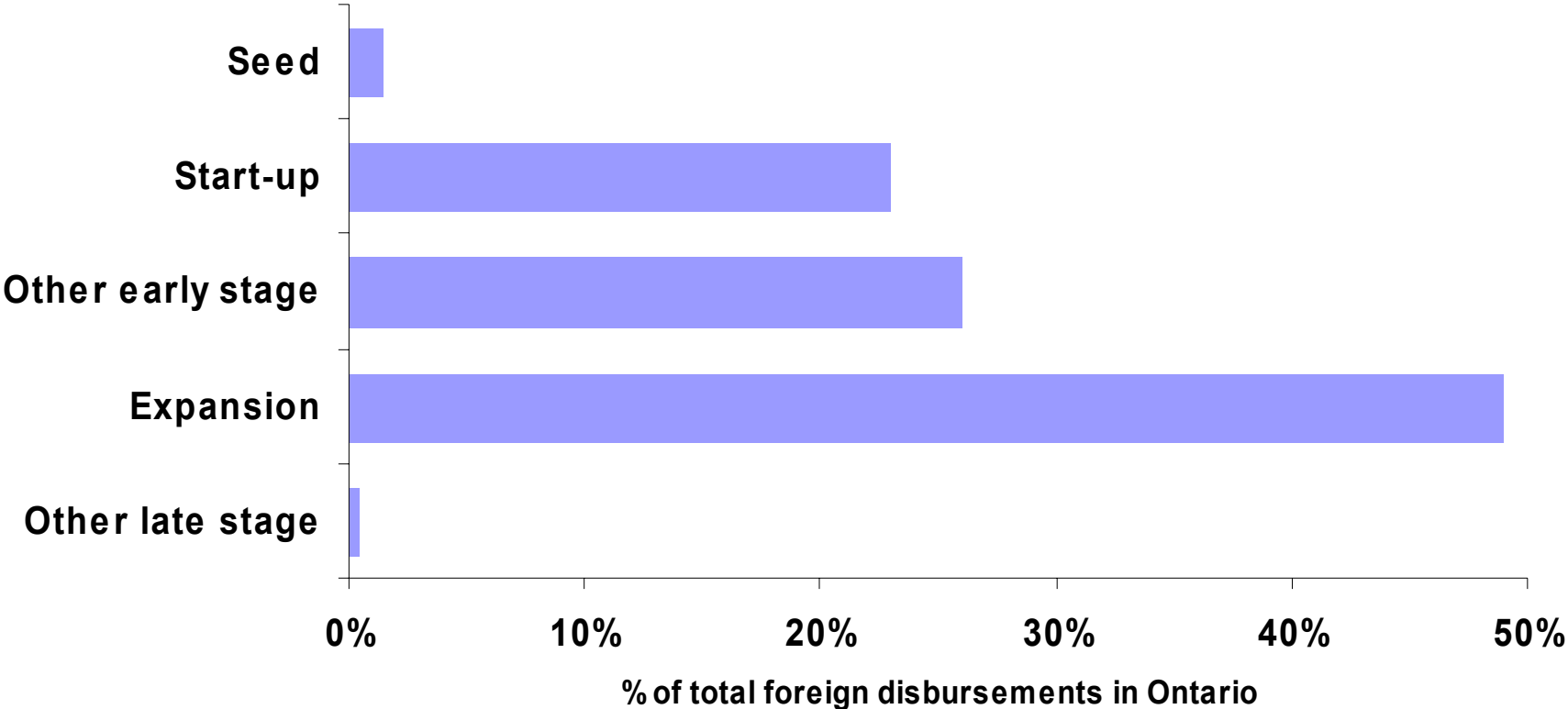
VC Disbursements by Investor Type, Ontario 1999-2004



Source: Thomson Macdonald

Expansion funds account for nearly half of foreign VC in Ontario

**Foreign disbursements by Stage
Ontario 1999 - 2005***

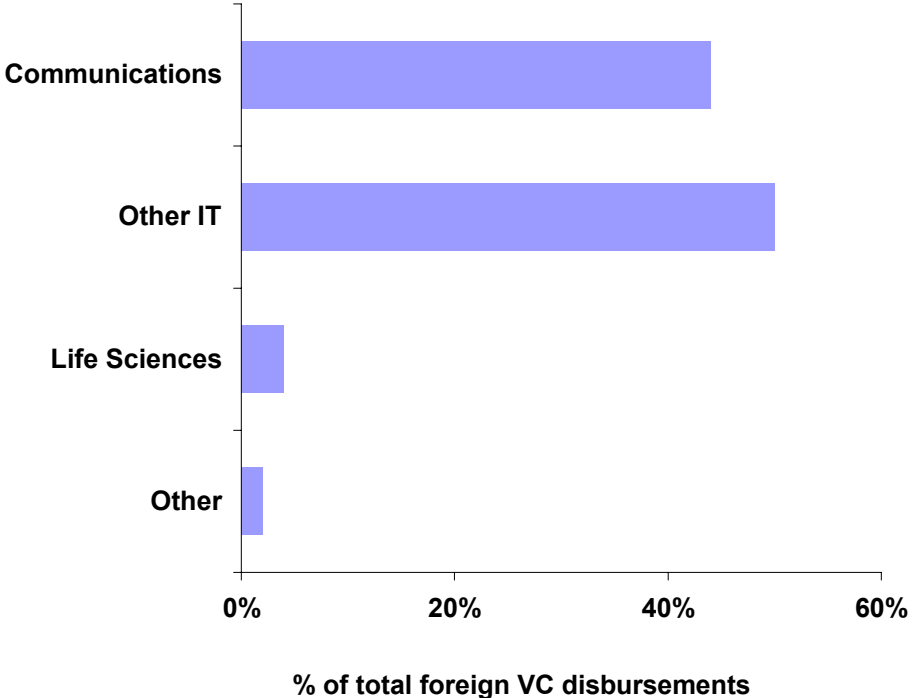


*: 2005 - First 9 months
Source: Thomson Macdonald

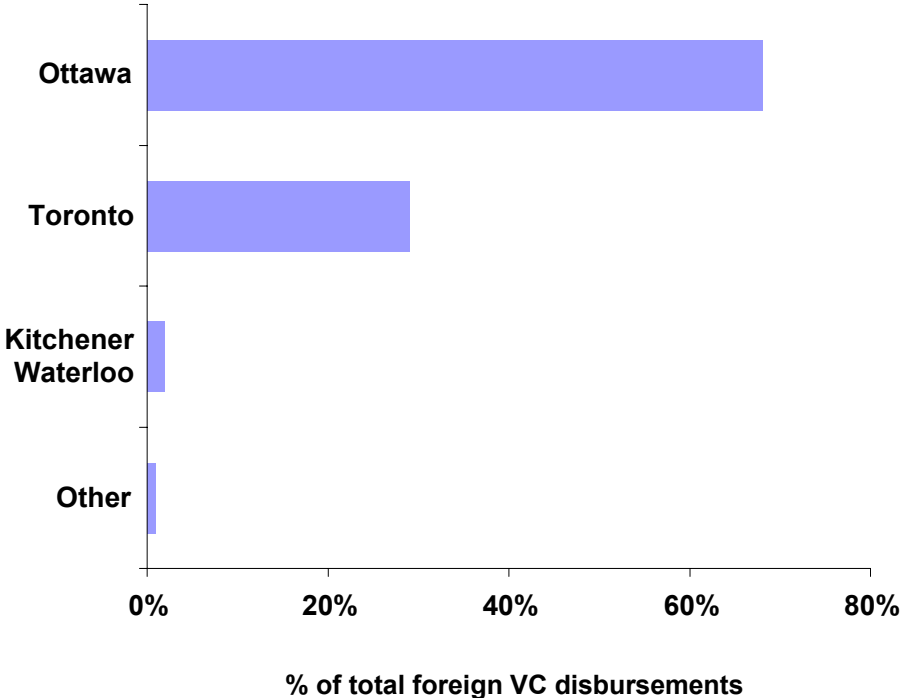
Foreign VC has been focused in ITC and in Ottawa

Foreign VC investments in Ontario, 1999-2005*

By industry



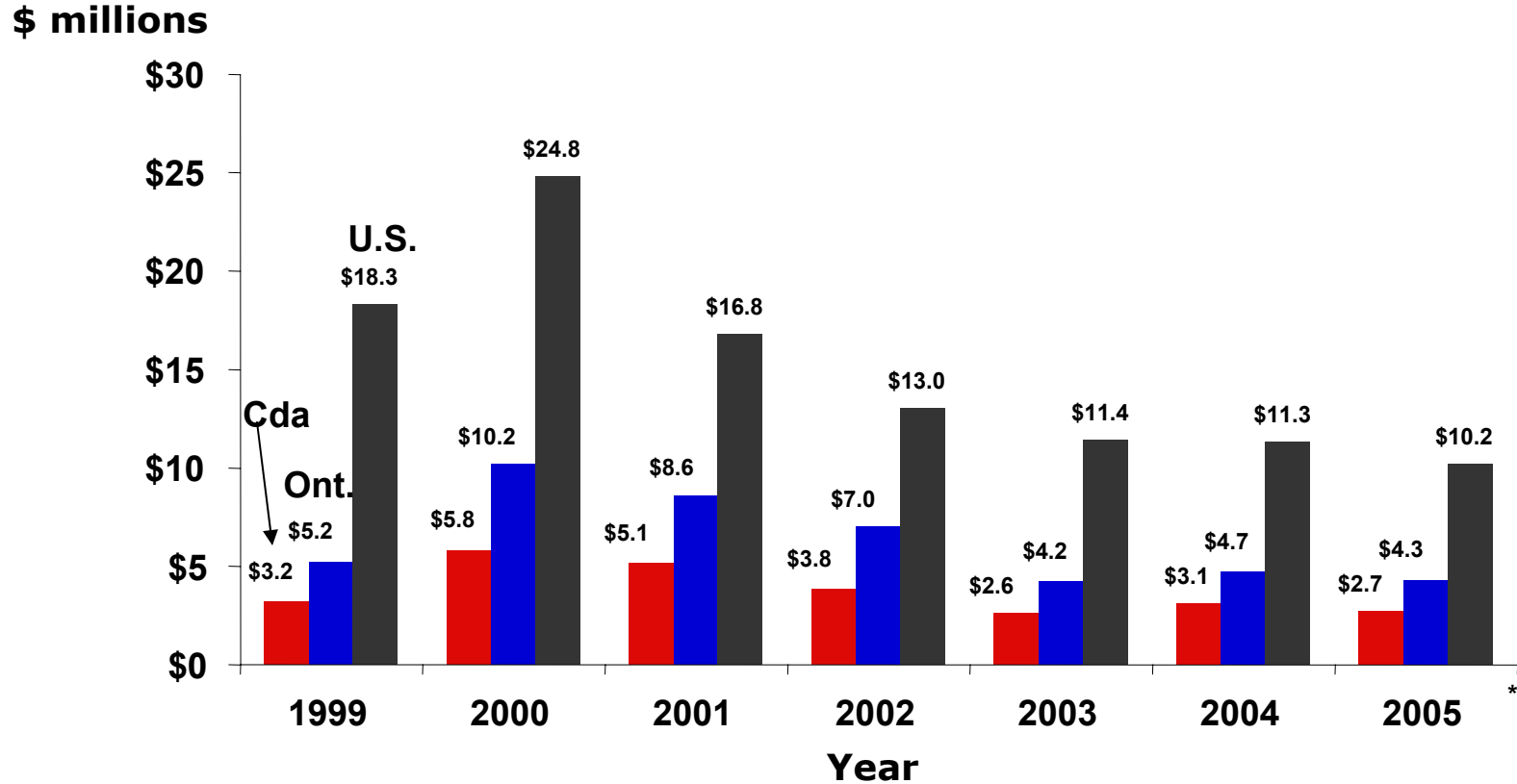
By city



*: 2005 - First 9 months
Source: Thomson Macdonald

VC investors invest much more per company in the US

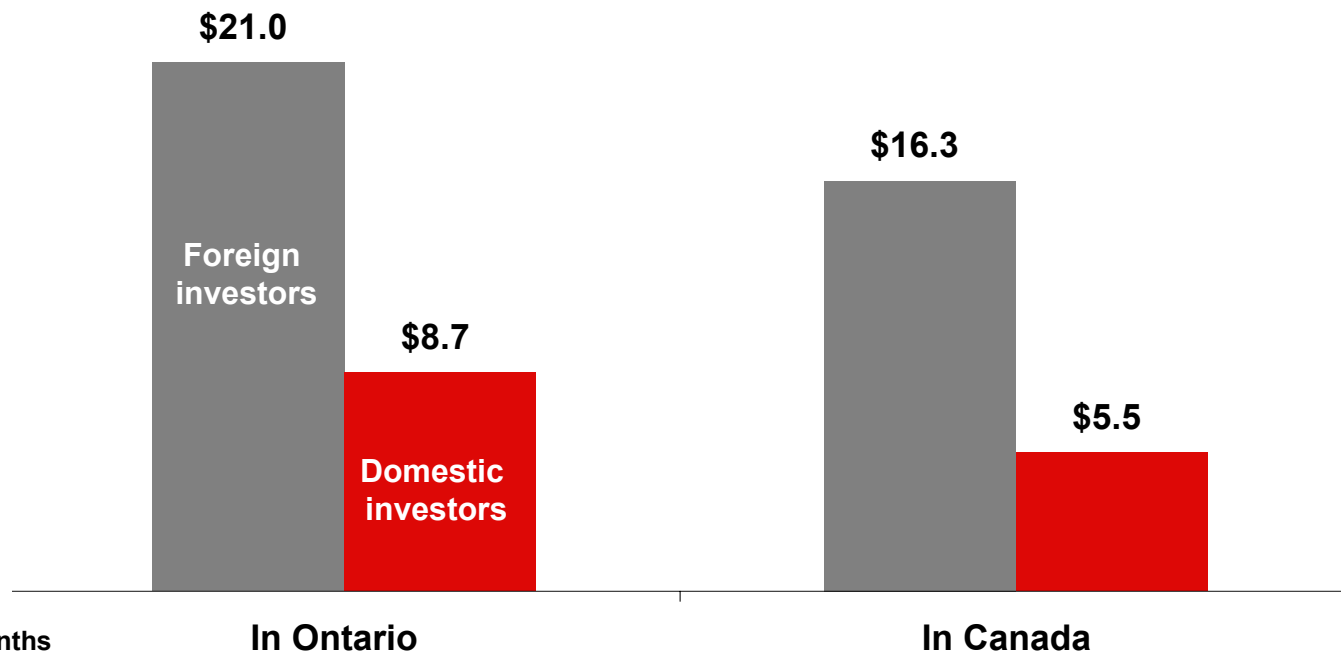
VC investments per company 1999-2005*



*: 2005 - First 9 months
Source: Thomson Macdonald

Foreign VC investors invest more per company in Canada

VC investments per company 1999-2005 \$ millions



*: 2005 - First 9 months
Source: Thomson Macdonald

Perceived advantages of investing in Ontario and Quebec

- **Good technology and skilled workforce**
- **“Capital efficient”**
 - **value of Canadian dollar**
 - **lower cost of doing business, including real estate and labour**
 - **less investor competition thereby lowering valuation multiples**
 - **R&D tax credits**
- **Good network of Canadian VCs with whom US firms can syndicate and partner**
- **Geographic proximity**
- **Available information on Canadian markets**

Source: Thomson Macdonald, *The activity of American venture capital funds in the Ontario market: issues, trends and prospects*, prepared for Institute for Competitiveness & Prosperity, Nov. 2005

Perceived disadvantages of investing in Ontario and Quebec

- **Cross-border tax treatment**
- **Lack of entrepreneurial managers**
- **Incompatible transaction aims and practices of Canadian investors**
 - **professional turnover in several “government or government-assisted funds” - reducing continuity in partnership building**
 - **geographic strictures on Labour Sponsored Funds**
 - **“conservative propensity” of some Canadian investors - leading to smaller deal sizes and potentially slower time to market**
 - **lack of common documentation, e.g., term sheets**
- **Lack of information on markets and opportunities (perceived disadvantage for those not investing in Canada)**

Source: Thomson Macdonald, *The activity of American venture capital funds in the Ontario market: issues, trends and prospects*, prepared for Institute for Competitiveness & Prosperity, Nov. 2005

Tax issues related to US investors' structure

- **CRA does not consider LLC a “resident of US” and therefore is not entitled to preferential treatment in *Canada-US Tax Treaty***
- **Preferences relate to relief from capital gains realized on liquidation and reduced withholding rate on interest and dividends**
- **US LLC can invest through a separate corporate structure to address CRA concerns - but this often causes US tax inefficiencies**
- **US investors in partnerships are required to obtain Sec. 116 Certificate from CCA at disposition - perceived as time consuming, onerous, and intrusive**

Source: *Osler update*, “Why U.S. funds are Reluctant to Invest in Private Canadian Companies - And What to Do About It”, February 13, 2004

- **US investor may be restricted to US companies - Canadian company must reorganize**
 - **“Move” to Delaware or other US jurisdiction - triggers corporate capital gains tax and possibly departure tax**
 - **Merge with US entity - shareholder must pay tax on accrued gain**
 - **Exchangeable shares - Canadian investor invests in Canadian subsidiary of new company; some US investors dislike the complexity of this solution**
- **Current Canadian investors, particularly LSIFs can have their eligibility for preferential treatment affected if company “exports itself”**

Source: *Osler update*, “Why U.S. funds are Reluctant to Invest in Private Canadian Companies - And What to Do About It”, February 13, 2004

Interviewees' advice to Ontario and Quebec governments

- **Encourage federal government to address cross-border tax issues**
- **Disseminate investment success stories and Canadian tax benefits across US venture industry**
- **Sponsor industry conferences to showcase opportunities in Canada**
- **Develop entrepreneurial skills (e.g., Canadian version of Ewing Marion Kauffman Foundation or tax holidays for non-resident recruits in innovative fields)**
- **Encourage formation of base of well capitalized Canadian venture firms ready and able to partner with US firms – and where possible greater Canadian institutional involvement**

Source: Thomson Macdonald, *The activity of American venture capital funds in the Ontario market: issues, trends and prospects*, prepared for Institute for Competitiveness & Prosperity, Nov. 2005